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FISCAL CONSOLIDATION AND CONSUMPTION TAX

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- Japan's fiscal deficit is unsustainable.
- Fiscal reconstruction and social security reform are two sides of the same coin.
- Politicians must exercise leadership to form a national consensus on raising the consumption tax rate.

Japan’s outstanding public debt is more than double its current GDP and constitutes the worst public debt-to-GDP ratio worldwide. About 20 years ago, during the Ryutaro Hashimoto administration, this public debt was roughly on par with GDP. Most developed countries burdened by deficit problems began to consolidate their finances in the latter half of the 1990s, but Japan’s finances have only continued to worsen.

Opinions on the country’s fiscal deficit vary quite widely within Japan. Some economists contend that it represents a crisis, while others insist that the situation is actually not so bad.The latter assert, for instance, that the government owns assets that, subtracted from the ‘gross’ national debt to derive the ‘net’ national debt, ameliorate the situation somewhat. However, these government-owned assets comprise insurance premium reserves to be used in future to pay out retirement benefits, and they thus cannot readily be allocated to the repayment of public debt. In any case, Japan’s net debt-to-GDP ratio is still over 120%, far surpassing the 80% level of the US, the UK, France and others and ranking as the worst among all major countries.

It has also been argued that Japan’s situation is not as problematic as that of Greece because Japanese government bonds are mostly in the hands of the Bank of Japan, Japanese financial institutions and other Japanese bondholders. Would anyone suggest that a company’s shares are risky if held by foreign nationals but safe if the shareholders are Japanese? Share prices are determined by such fundamentals as a company’s management and technical capabilities. Government bonds are the same, with their fundamentals being assessed in terms of the soundness of government finances.

The Maastricht Treaty requires EU members to maintain national government debt-to-GDP ratios of 60% or lower. At present, the only major countries satisfying this EU standard are Germany and Canada, although other major countries (except for Italy) generally have ratios of less than 100%. Japan’s national government debt-to-GDP ratio of over 200% is double that of Italy and clearly an anomaly, and consequently Japan must seriously endeavor to rebuild its finances.

Why exactly is fiscal consolidation necessary? Why have the EU countries established such strict numerical standards? The answer to both questions is that the cost of financial collapse is far too great. A country that suffers a financial collapse will, after discussions with the IMF and other parties, be compelled to make substantial expenditure cuts for the sake of consolidation. This will inevitably prove far more drastic than orderly reforms made to social security programs under ordinary circumstances; in Greece, for instance, reductions in the police force led to a deterioration of public safety. For Japan, a sharp fall in Japanese government bond prices precipitated by a financial collapse would result in a financial crisis because huge amounts of these bonds are held by regional financial institutions having inadequate financial health. As was the case in 1997-98, bankruptcies among small and medium-sized enterprises and rising unemployment would be almost unavoidable. Quite simply, a financial collapse poses enormous risks for the Japanese economy and the welfare of the Japanese people. Fiscal consolidation would be the wisest action to take to avert this risk.

Fiscal consolidation will require Japan's government to constrain the year-to-year growth in its expenditures and increase its revenues. As a look at the FY2018 budget formulated in December reveals, the largest and most significantly growing policy expenses on the expenditure ledger are pensions, medical insurance and other social security-related costs.

The population aging rate, i.e., the percentage of people 65 years of age or older within the total population, is currently 27%, but this figure will rise to 38% by 2060. The 21st century will be a century of population aging and, although an aging society will not be a problem faced by Japan alone, Japan is the top runner in this category.

With Japanese society rapidly aging, total social security benefits continue in an unabated uptrend, and insurance premiums paid by the working generations amount to no more than half of the 120 trillion yen currently paid out in benefits. The national government has covered 32 trillion yen of the shortfall, but insufficient tax revenues means that this coverage directly adds to the fiscal deficit. Consequently, the key to rebuilding Japan's finances lies in holding down the growth of social security-related expenses as the society grays.

On the revenue side, no time should be lost in raising the consumption tax rate. Many EU countries have value-added tax rates of 20% or higher, while Japan's currently sits at 8%. As things stand, maintaining the current social security system will be difficult, and rebuilding the government's finances impossible. The majority of Japanese citizens desire social security programs like those of the EU. While many politicians in Japan believe that raising the consumption tax rate will adversely affect the economy, leadership from a long-term perspective that transcends populism must be exercised to form a national consensus in favor of raising the consumption tax rate.

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