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## Fiscal Deficit and Fiscal Reform in Japan

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**Taro Ohno, Associate Professor at Shinshu University in Japan, explains that “Japan will continue to face daunting fiscal challenges in the years ahead, and thus finding the most effective and equitable fiscal policy should be a top priority for the Japanese government.”**

Over the past few decades, Japan has experienced a number of changes in its social and economic circumstances as its population has been aging, its birth rate has been falling, and its economic growth rate has been declining. These changes all affect central government finances: they encourage increased expenditures (especially with regard to social insurance benefits) and decrease tax revenues, thereby increasing the fiscal deficit.

The key turning point for central government finance came around 1990 when the economic bubble burst, and since that time Japan has been grappling with the issue of fiscal reform. The first attempt to deal with the fiscal deficit was a set of fiscal reforms introduced in 1997, the goal of which was to reduce the deficit by 2003. However, this effort proved ineffective because of the domestic financial crisis that started in 1997. The second attempt came in 2006, when the government set a policy target that sought to shift the primary budget balance to a surplus by 2011. However, this target was deferred in 2008 as a result of the recession. The most recent attempt was the setting of a new policy target in 2010 to eliminate the deficit and create a surplus by 2020. Currently, the Abe cabinet is continuing to pursue that target. It raised the consumption tax rate to 8 percent in 2014 and will raise it to 10 percent in 2019 to achieve this goal. However, these reforms alone are insufficient.

The major contributor to the current negative fiscal situation is the increasing cost of social insurance, and given the country’s aging population, that trend will continue. The current fiscal reform will not be able to achieve its target by relying only on restraining the costs of social insurance, and so a further tax hike is unavoidable.

What kind of tax policy, then, would be most effective? In Japan, current fiscal policy over emphasizes intergenerational redistribution, which places a heavy burden on the younger generation to fund the benefits of social insurance for the elderly generation. In addition, the burden on the younger generation is already heavy due to pension insurance premiums. Therefore, because an income tax has the disadvantage of the burden falling predominantly on those who are younger, an income tax hike is not a feasible approach. What is desired is that both young and old alike bear the burden. A consumption tax has the advantage that the burden falls on all age groups, making it a more feasible approach. However, it also poses a problem. Namely, the consumption tax burden on lower-income households is heavier than that for higher-income households on a point-in-time basis, as the ratio of tax burden to income is

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disproportionate. A consumption tax is “regressive,” meaning that some measures for low-income households would be necessary.

A lower consumption tax burden on higher-income households exists because of their high savings rate. As a household’s ratio of savings to income increases, its ratio of consumption to income decreases. This in turn lowers the ratio of consumption tax burden to income. However, a household will spend down its savings in the future, and thus will eventually bear the consumption tax burden on that spending. In other words, savings only has the effect of changing the timing of consumption; it does not relieve the tax burden entirely. Therefore, it is also necessary to evaluate the tax burden on a lifetime basis. Based on the author’s estimates (Ohno et al. 2014), the consumption tax burden of higher-income households is heavier than that for lower-income households. This implies that the consumption tax is in fact “progressive.” This would imply that any measures for low-income households might be adequate if applied only to the younger age brackets.

The current policy debate in Japan emphasizes the results on a point-in-time basis. This leads to the conclusion that some measures need to be taken to protect low-income households. Several such measures exist as options. First is a reduced consumption tax rate for necessities, such as food. Second is a benefit given only to low-income households—for example cash benefits or an earned income tax credit. In September 2015, Japan’s Ministry of Finance proposed a plan for low-income households that included a combination of the reduced tax rate on food and a tax refund. Each individual’s consumption information would be recorded through a unified electronic card called the “My Number Card,” which is similar to a social security card in the United States. Low-income households could apply for a tax refund equal to the amount of the tax cut for food expenditures at the end of the fiscal year. The public, however, reacted negatively and criticized the plan for the complexity of the system and voiced concerns about the security of the identity card. The public prefers a reduced rate for the consumption tax on food rather than the plan proposed by the Ministry of Finance because it is a simpler system and free from worry about the security of personal information in the unified electronic card. As a result, the government decided to raise the general consumption tax rate to 10 percent while at the same time adopting a reduced tax rate for food. However, the reduced tax rate for food is not an optimally effective policy because higher-income households are benefiting as well.

Barring any sudden drastic changes in the country’s birth rate or immigration policy, Japan will continue to face daunting fiscal challenges in the years ahead, and thus finding the most effective and equitable fiscal policy should be a top priority for the Japanese government. We can conclude that a further consumption tax hike is desirable. Given the current situation in Japan, where a further tax hike is unavoidable, a consumption tax hike is a better option than an income tax hike. However, the policy debates in Japan today seem to emphasize the results only on a point-in-time basis. In designing the optimal policy, it is important to evaluate the current tax system not only on a point-in-time basis but also on a lifetime basis. Finally, the reduced consumption tax rate for food needs to be reconsidered. While the public prefers the reduced tax rate, this policy is less effective in terms of being a measure for lower-income households.

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