

March 2015

*The 41st Medium-Term Economic Forecast (FY2014— FY2025)**Reform Scenario to achieve Fiscal Reconstruction and the Transition of Demographic Trends**JCER Medium-Term Economic Forecast Team*

II. Reform Scenario

1. Macroeconomic Forecast based on the Reform Scenario

(1) Comparison with assumptions for the baseline scenario

By using the JCER medium-term macroeconomic forecast model, we have simulated the effects in the event that countermeasures against the low birth rate, tax and social security reforms and cuts in the government spending described below are all implemented. The funding structure of the reform scenario is shown in Figure 5-1.

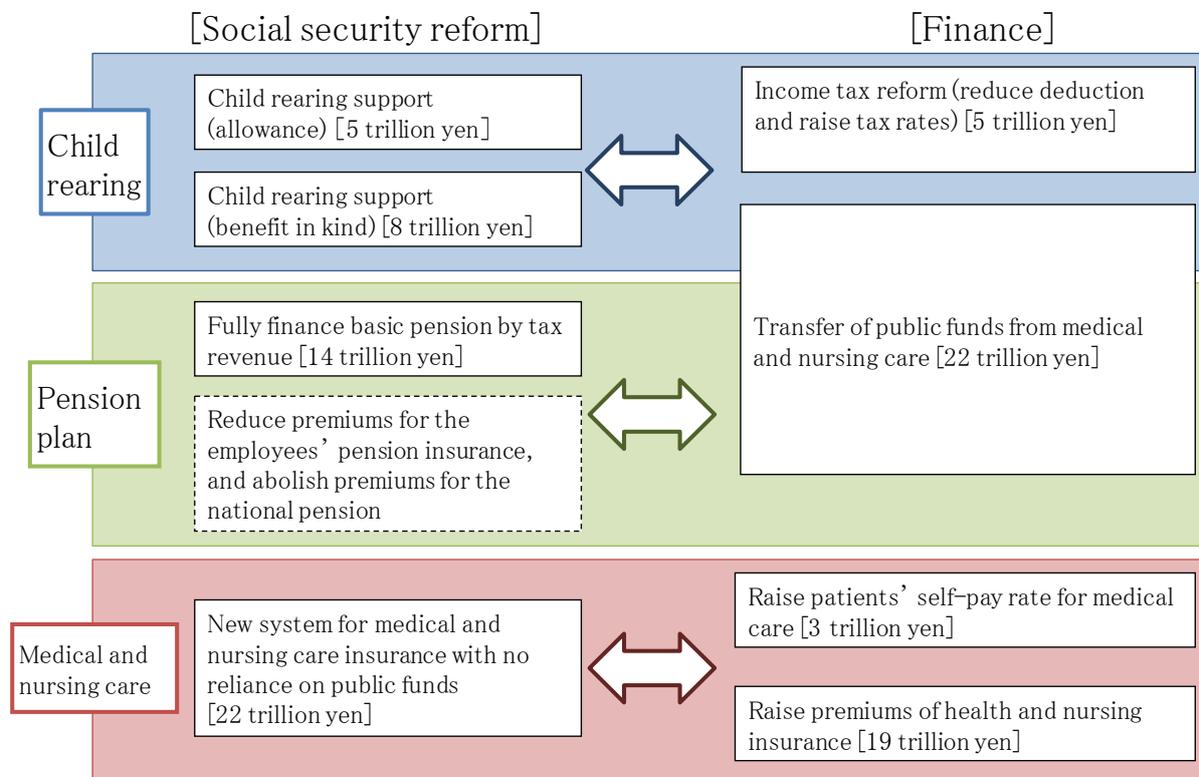
<Assumptions for the reform scenario (changes from the baseline scenario)>

- ✓ Countermeasures against the low birth rate and the low labor force participation rate of women
 - Budget for countermeasures against the low birth rate (payment in kind) will be increased 8 trillion yen.
 - Child allowance will be enhanced by 5 trillion yen.
 - Total fertility rate will rise to 1.8 in 2025.
 - The labor force participation rate of married women will rise to a level similar to that of unmarried women.
- ✓ Tax system reform and cuts in government spending
 - The effective corporate tax rate will be lowered to 25% (by FY2020).
 - The growth rate of TFP will rise 0.4% points compared with the most likely scenario due to various measures involved in the reform scenario.
 - Child allowance enhancements (5 trillion yen) will be financed through an income tax reform.
 - Public works spending will be reduced by 1 trillion yen.
- ✓ Social security reform
 - Public funds for health and nursing care insurance fund will be cut to zero¹.
 - Premium rates for health and nursing care insurance will be raised (6%), and patients' self-pay rates at the counter will be raised 1.5 times.
 - The basic pension will be fully financed by tax revenue.
 - Premiums for the employees' pension insurance will be reduced (from 18.3% to 11%), and premiums for the national pension will be abolished.

¹ Financing of social welfare is assumed to remain from government budget.

- Medical and nursing care expenses will be reduced by 9.2 trillion yen (as of FY2025)

Figure 5-1 Funding structure of the tax and social security system reform (excluding corporate tax)



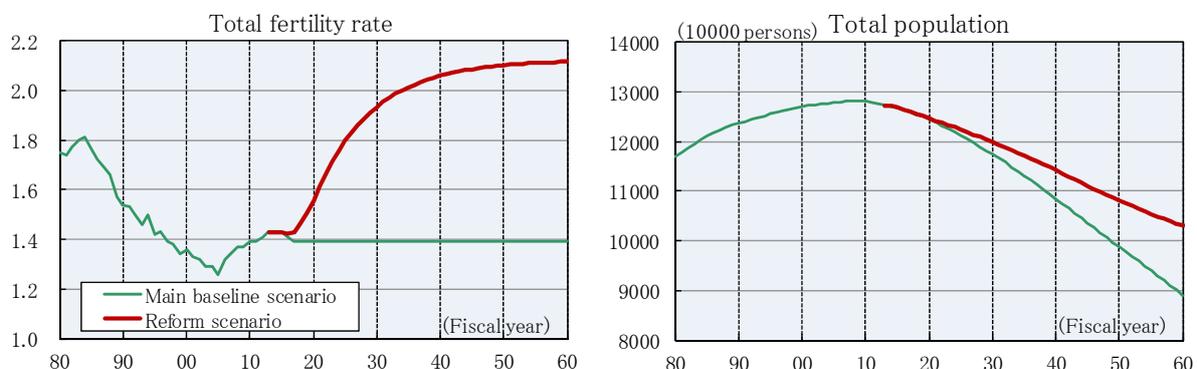
(Estimated expenditures in FY2020 are in brackets)

(2) Forecast results

(i) The declining population trend will become moderate.

The total fertility rate is expected to recover to 1.8 in FY2025 and rise to around 2.1 in 2050, as a result of a 2.6% increase in family benefits public spending as a percentage of nominal GDP (Figure 5-2-1). This will ease the declining trend of total population.

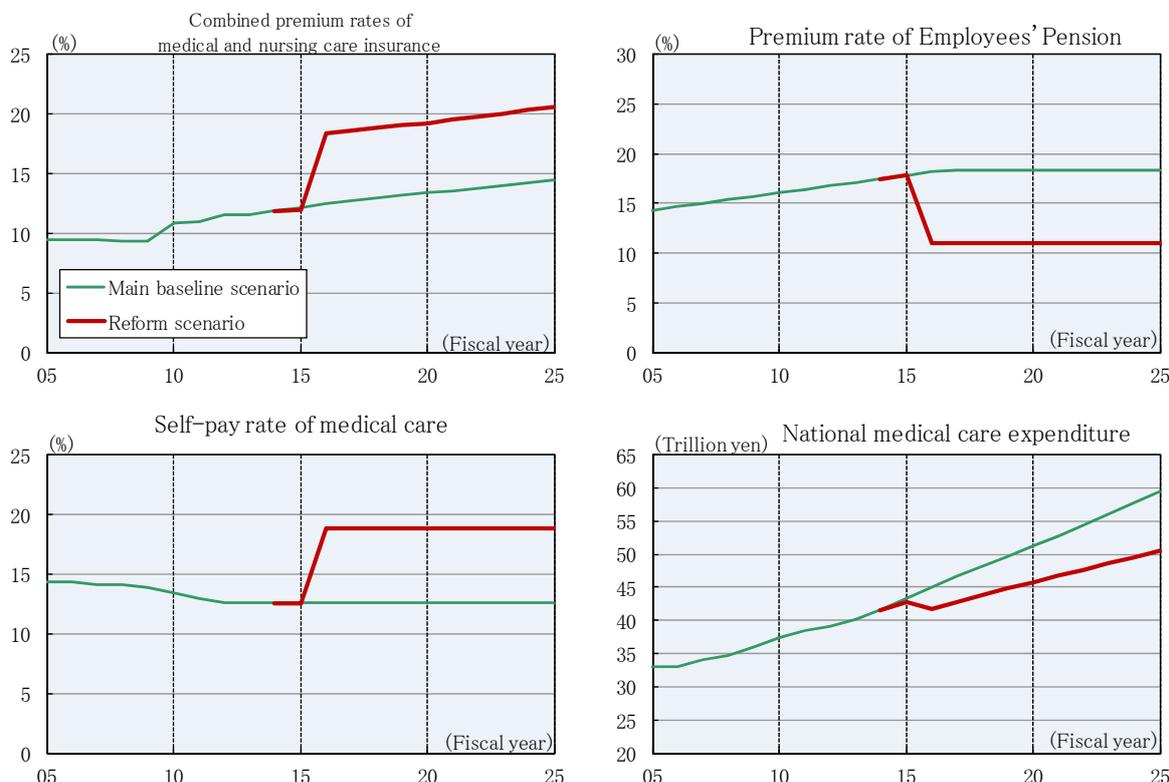
Figure 5-2-1 Total fertility rate and the total population



(ii) Increased premium rates for health and nursing care insurance will be compensated by reduced rates for the pension system.

The total premium rate for health and nursing care insurance will be raised from the current 12% to 18% in FY2016 and rise to around 20% in FY2025, to cover for an increase in spending due to the advancement of aging (Figure 5-2-2).

Figure 5-2-2 Social security burden and national health expenditure



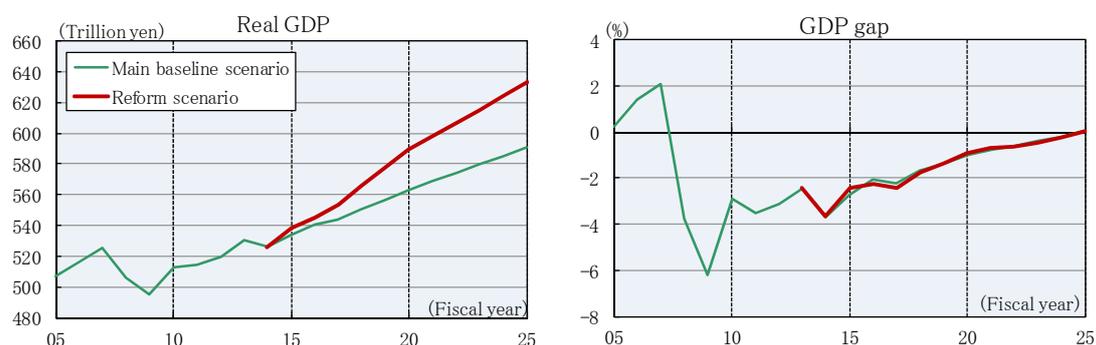
On the other hand, the premium rate for the employees' pension insurance will fall by more than 7% points from 18.3% (the limit to be reached in FY2017) to 11%, as the burden of the basic pension will disappear. Therefore, when the system is changed, an increase in the burden on the working-age population who pay premiums for both health and nursing care insurance and employees' pensions will be almost offset. Patients' self-paid expenses for medical and nursing care insurance will increase significantly, and the effective self-pay ratio of medical insurance will rise from 12.6% to 18.9%. As mentioned in the previous section, national medical expenses will stay at a level about 8.9 trillion yen lower than that in the baseline scenario as of FY2025.

(iii) Real GDP will increase, and the GDP gap will also maintain a shrinking trend.

Improvement in the degree of market openness due to corporate tax cuts and the promotion of gender equality (supporting the active participation of women in society) will strongly push up the real GDP. The average growth rate between FY2013 and FY2025 will be raised to a level 0.6% points higher than in the baseline scenario, and the average growth rate will rise to 1.5% (Figure 5-2-3). The GDP gap will also gradually contract supported by higher exports, as seen in the baseline scenario².

² More precisely, a demand shock is applied so that the path of the GDP gap stays the same.

Figure 5-2-3 Real GDP and the GDP gap



(iv) The primary balance surplus target will not be achieved, but the government debt outstanding will be stabilized.

As the consumption tax rate will stay at 10%, improvement in the primary balance of the central and local governments will be limited, and a deficit of around 1% will remain as of FY2025 (on the left in Figure 5-2-4). However, due to public fund cuts in health and nursing care insurance and a rise in the nominal growth rate to the mid-1% range, the ratio of government debt outstanding to nominal GDP will be stabilized (on the right in Figure 5-2-4 and Figure 5-2-5).

Figure 5-2-4 Primary balance and debt of combined central and local governments

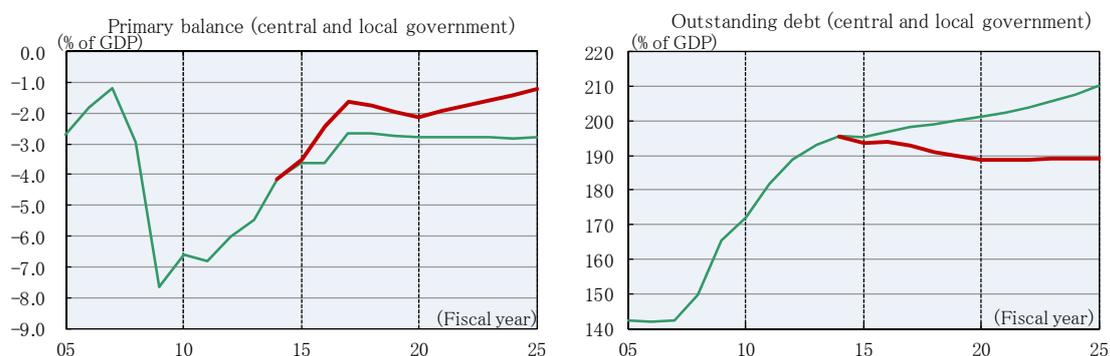


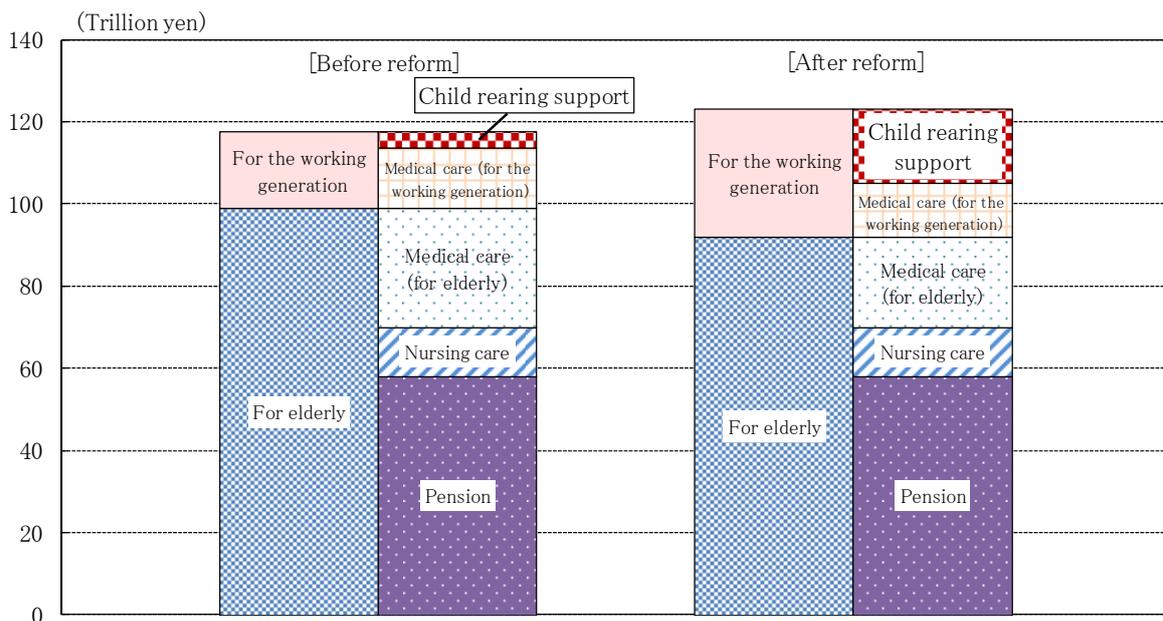
Figure 5-2-5 Summary (Reform scenario)

Indicator	Unit	(Fiscal Year)			
		2006 ~10	2011 ~15	2016 ~20	2021 ~25
Real GDP	annualized growth rate, %	0.2	1.0	1.8	1.4
Nominal GDP	annualized growth rate, %	-1.0	1.2	1.9	1.4
Consumer Price Index	annualized growth rate, %	-0.1	0.8	0.9	0.5
Primary balance (ratio to GDP)	period average, %	-4.0	-5.2	-2.0	-1.6
Outstanding debt (ratio to GDP)	end year, %	172.3	193.4	188.9	189.2

(3) The positive impacts from the fundamental reforms will be large, but burdens on the elderly will increase.

From the simulation results above, it is found that the positive impacts from the tax and social security system reforms into more growth-oriented systems and steps taken to support childcare will be large. In the reform scenario, through cuts in public funds for health and nursing care insurance, the basic pension can be financed through tax revenues, and funds for increased childcare support can be generated. This will alleviate the unfairness among generations (Figure 5-3-1).

Figure 5-3-1 Social security system reforms (FY2020)



Sources: Cabinet Office, "System of National Accounts", Ministry of Health, Labour and Welfare, "Estimates of National Medical Care Expenditure," etc. Estimates by JCER.

Compared with the baseline scenario, the rise in the national burden ratio will not be significant in the reform scenario (Figures 5-3-2 and 5-3-3). Even in the baseline scenario, a substantial rise in the national burden ratio is unavoidable in the first place due to an increase in pension and medical and nursing care expenses because of aging, hence it can be said that the rise in the national burden ratio is relatively small. The reform plan we propose is instead centered on equality among generations in burdens and benefits and the enhancement of countermeasures against the low birth rate.

Figure 5-3-2 National burden rate (baseline scenario)

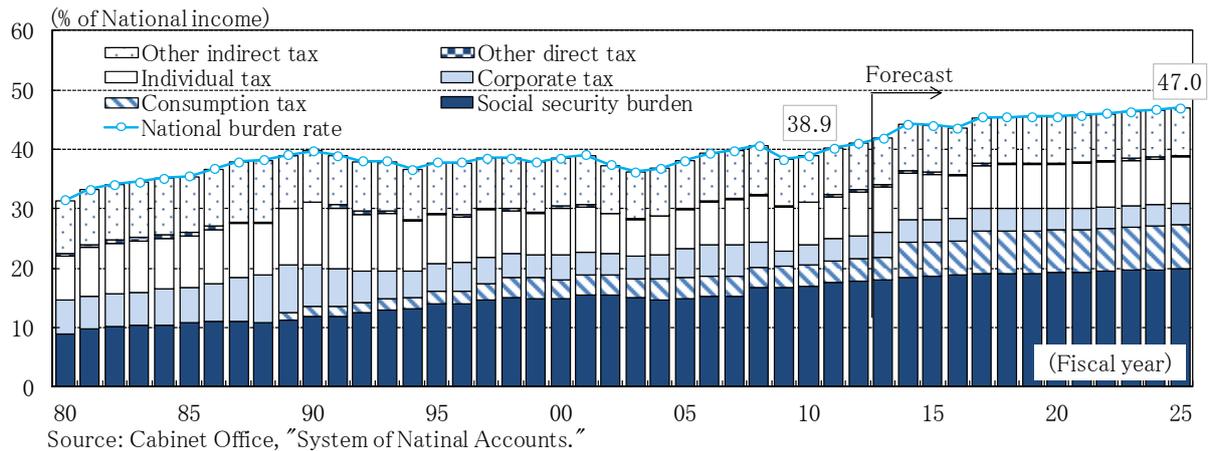
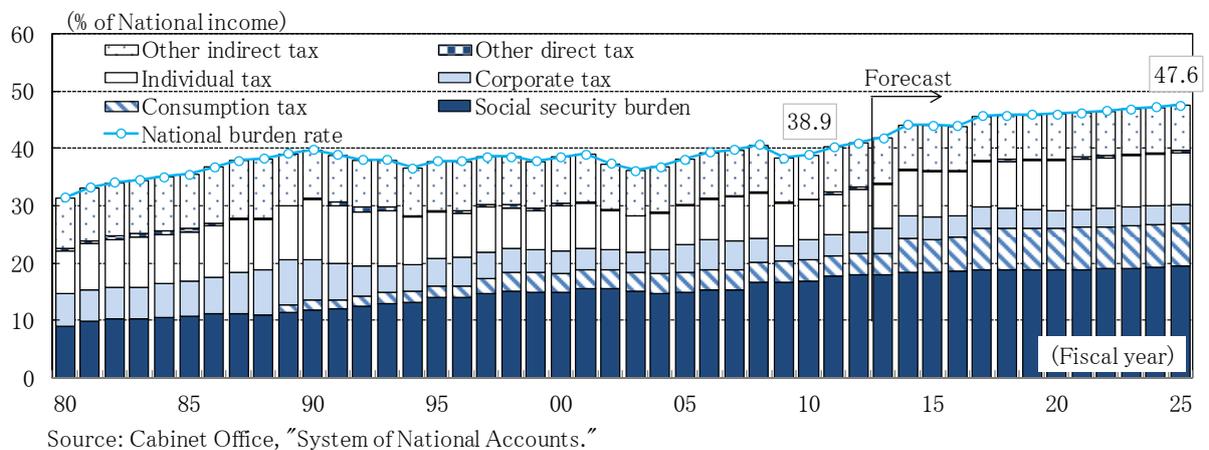


Figure 5-3-3 National burden rate (reform scenario)



To put it the other way around, however, the enhancement of countermeasures against the low birth rate without an increase in overall burdens will be accompanied by an increase in burdens on the elderly. Figure 5-3-4 shows the result of simulating the impact of the tax and social security reforms mentioned above on the household sector. We set up a model household for each household structure, using data in the 2013 Survey of Household Economy of the Ministry of Internal Affairs and Communications. Income of families with small children will improve. Particularly the household with preschool children will be assisted greatly as it will receive a child allowance of as much as 75,000 yen every month, in addition to childcare services which two children will be able to receive for free. A dual income couple, even when both are temporary workers, would be able to make a decent living.

On the other hand, in an aged household, burdens will increase by around 10% of its income. Burdens will also increase on the active single household. As most of the assets of aged households are fixed assets, additional measures to make it easy to liquidate fixed assets such as the promotion of reverse mortgages need to be taken. In any case, care for aged households whose liquid assets become insufficient will also be essential.

Figure 5-3-4 Impact of reforms on the household sector

Structure of model household		Annual income and social security benefits (allowance) in reference year (FY2013)	Effects on household balance
1. Dual income household (full-time and temporary workers) who rear children	Husband aged 47 (full-time worker) Wife aged 45 (temporary worker) Junior high school and elementary school children	7,000,000 yen (wages etc.) 240,000 yen (child rearing support)	Net income increase of 300,000 yen
2. Elderly household (retired)	Husband aged 70 Wife aged 67	80,000 yen (other income) 2,520,000 yen (pension)	Net income decrease of 300,000 yen
3. Dual income household (both temporary workers) who rear children	Husband aged 33 (temporary worker) Wife aged 33 (temporary worker) Child aged 3 (nursery) and child aged 1 (nursery)	5,000,000 yen (wages etc.) 300,000 yen (child rearing support)	Net income increase of 700,000 yen
4. Standard single male worker household	Single male aged 47 (full-time worker)	4,600,000 yen (wages etc.)	Net income decrease of 100,000 yen

Policy proposals

Our views and recommendations on the issues which we examined for our medium-term forecast are as follows. Japan is set to make an important choice, as fiscal reconstruction is a pressing issue, as well as the low birth rate.

- Slower growth in developed economies including Japan is the result of their reaching a highly affluent level and therefore unavoidable to a certain degree. However, growth in productivity is particularly low in Japan, caused by the low degree of market openness and the delay of gender equality. A fall in the savings rate is also becoming an issue.
- Although an aging population with a low birth rate is a worldwide trend, countries that have taken appropriate measures have succeeded in recovering the birth rate, so Japan should be able to emulate them. Japan needs to secure an additional budget of 13 trillion yen for countermeasures against the low birth rate. Putting a brake on the population decline will make the largest contribution to growth in the long term. The promotion of activities where single men and women can socialize “naturally” is also important.
- Japan should seek to promote growth with tax and social security reforms. As a measure to promote growth, corporate tax cuts to raise the degree of market openness and the promotion of gender equality (supporting the active participation of women in society) as a means of securing and developing human resources prove effective. The 13 trillion yen countermeasure against the low birth rate will also promote growth in the long term.
- With respect to the health and nursing care insurance, which is a cause of the fiscal deficit, we propose to cut public funds in order to make them self-sustaining. This will help restore incentives for insurers and improve operational efficiency. The government should finance the basic pension entirely by tax revenue and consider the privatization of the second tier and above. The current social insurance system is maintained simply by mortgaging future generations. The greatest victims are the future generations.
- For the health and nursing care insurance systems to be maintained, their revenues should be financed by premiums and patients’ own expenses. What we present in this forecast is an alternative which has made clear the beneficiary liability.
- If the increase in burdens on the elderly proves too heavy, financing medical and nursing care expenses with a consumption tax hike may be another option. In that case, an additional increase of about 10% in consumption tax rate will be necessary, as indicated in

the forecast last year. However, while intergenerational inequality will be corrected if the expenses are paid by the users based on the beneficiaries-pay principle, inequality will remain to some extent, and the national burden rate will also be heavy.

- The increase in benefit expenses should be minimized by improving the efficiency of health and nursing care insurance as much as possible. To reduce medical and nursing care expenses, it is important to raise the employment rate of the elderly and apply information technological innovations, such as big data.
- Japanese companies need to adapt to changes in the demand that will be delivered by the population decline and aging over the next few decades. As some industries are already suffering a labor shortage due to the distortion of the age structure, a long-term perspective for the development of human resources is important.

We propose the realization of growth-oriented tax and social security reforms and improvements in health and nursing care services efficiency, to secure the budget for countermeasures against the low birth rate. If achieved, the Japanese economy will be able to attain growth at an annual average rate 0.6% points higher than the baseline scenario by 2025, reconstruct the government budget and reverse the declining population trend.

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