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Time schedule for tax and social security reform should be prepared within two years

- Maintain fiscal discipline by establishing an independent institution
- Implement drastic reform to accelerate growth

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JCER forecasts that the Japanese economy will be sluggish in FY2016 due to the slowing down of the global economy, particularly in emerging nations, and the strong local earthquake that struck the Kumamoto Region in Kyushu. The government is scheduled to increase the consumption tax rate to 10% in April 2017, but this may be postponed. The consumption tax hike to 10% is essentially unavoidable to address the current issues, including the low birthrate, aging population and the repayment of massive public debt. If the tax hike is postponed every time the economic situation worsens, trust will be lost in the finances of Japan and the risk of financial failure may increase. In order to draw a path to fiscal consolidation while paying attention to the economy, we propose to establish a Fiscal Evaluation Council that presents economic and financial prospects independently from the government, and sets goals for fiscal consolidation, including social security reform.

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<Overview of the proposal>

- Fiscal expenditure of 5 trillion yen to support the recent economy and specific measures from a medium- to long-term perspective are required. Questionable budget handouts must be avoided.

- A tax hike in the medium to long term is unavoidable in order to maintain the social security system and achieve financial sustainability.

- If the consumption tax hike is further postponed, a Fiscal Evaluation Council that is independent from the government should be established to prepare economic and fiscal prospects and sets the fiscal consolidation goals, including social security system reform.

- A time schedule should be prepared within two years to implement tax reforms and social security system reforms based on the fiscal consolidation goals set by the Council.

- The Council should be given the highest level of authority. It should neither be instructed nor supervised by the ministers of government ministries and others. It estimates the government's level of achievement and makes recommendations for improvement to the government.

- The reform must be conducted immediately, including accepting immigrants for growth promotion and fully utilizing ICT.

1. Fiscal expenditure of 5 trillion yen to support the recent economy

There has recently been an increasing air of recession due to the deterioration of the global economy, especially in emerging nations and resource-rich countries. The strong earthquake that struck the Kumamoto Region in April 2016 requires an emergency response including the restoration of affected areas and the implementation of economic measures. Reportedly, the government has already started considering a supplementary budget of 1 trillion yen for recovery measures.[2] It must be swiftly enacted through collaboration between the ruling and opposition parties.

With a view to the structural measures for the slump in consumption, a second supplementary budget will also be required. It is important, however, to strictly refrain from

[2] Morning edition of the *Nihon keizai shimbun* on April 27, 2016

questionable budget handouts, such as the distribution of gift vouchers, and invest in infrastructure development that can lead to medium- to long-term growth. Potential investment toward the Tokyo Olympics includes Information and Communication Technology (ICT) infrastructure for realizing a cashless society, education and training in preparation for the “fourth industrial revolution” in which ICT is fully utilized, as well as disaster prevention infrastructure on the assumption that an earthquake could directly hit the Tokyo Metropolitan Area.

To cite an example, we believe that it is necessary to invest approximately 50 trillion yen in software by FY2030 for achieving medium-term sustainable growth. Based on this standpoint, we propose approving a tax deduction for part of the investment in software. If 10% ~ 20% of an investment qualifies for a deduction, the total deduction amount will be approximately 500 billion yen. In addition, increasing the birthrate to 1.8 requires childcare support worth around 8 trillion yen annually (JCER 2014, 2016), part of which may be paid in the form of childcare vouchers. We propose spending around 3 trillion yen combined with nursing care vouchers. Note that, however, a drastic review for the deregulation of childcare and nursing care fees should be simultaneously implemented to actually make the increased support.

Looking at permanent measures to encourage consumer spending, there is room for consideration for the tax system and interest subsidy to promote increases in the use of consumer loans and card loans, including loan for education, and childcare and home improvement. We propose the deduction of part of the interest for loans aimed at purchasing consumer products and services (amortization loans and card loans) such as medical and long-term care, education and child-raising, home improvements and indispensable car purchases. If this is applied to consumer loans and card loans by private banks, the deduction amount will be approximately 100 billion yen (on the assumption that the marginal rate of income tax is 10%). In South Korea, similar measures to encourage consumer spending were previously implemented as part of the promotion of the use of credit cards. The total cost of the disaster recovery and economic measures described above is estimated to be around 5 trillion yen.

2. If the consumption tax rate remains at 8%, even a zero interest rate will lead to excessive debt

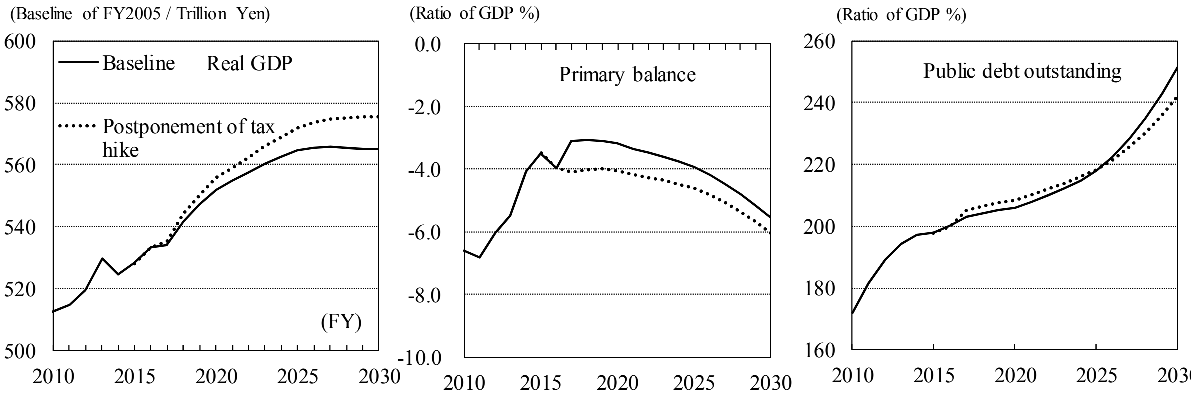
In light of the current business conditions, it is possible that the consumption tax hike that is scheduled to be implemented in April 2017 may be further postponed.

It is essentially difficult to achieve fiscal consolidation without a tax hike under circumstances where there is still uncertainty over the realization of the growth strategy included in the Abe Cabinet’s philosophy. Based on the premise that the annual average nominal growth rate will be 3% from FY2016 to FY2020, the government stated that the deficit in the primary balance (PB) of the national and local governments will be reduced to

1.1% of the nominal GDP in FY2020 (estimation of the medium- and long-term economic and fiscal situation, January 21, 2016). According to our medium-term forecast, on the other hand, the nominal growth rate from FY2016 to FY2020 will remain at 0.6% per annum, even in the standard scenario.

If the consumption tax hike is further postponed based on this assumption, the deficit in PB will expand and the ratio of public debt outstanding to nominal GDP will exceed 240% (FY2030), even if the long-term interest rate remains at zero (**Figure 1**).

Figure1 Impact of postponement of consumption tax hike on economic growth and finances



Note: "Baseline" refers to the baseline scenario based on the 42nd Medium-Term Economic Forecast, which assumes that the consumption tax rate will be raised to 10% in FY2017 and the long-term interest rate will be raised to 0.4% in FY2020 and 1.5% in FY2030. "Postponement of tax hike" assumes that the consumption tax rate will remain at 8% from FY2017 and the long-term interest rate will remain at zero until FY2030. Both scenarios assume the same inflation rate.
Source: SNA (National Accounts of Japan) and others

In order to build a society where future generations can live in hope, we have insisted that the consumption tax rate must be raised by 1% annually, eventually to around the 25% level, while pushing through the integrated tax reform and social security system reform and measures for revitalizing the private sector, including a reduction in corporate tax (JCER 2011, 2014). Our basic idea is consistent with the proposal of the Organization for Economic Co-operation and Development (OECD). Angel Gurría, the OECD Secretary-General, recently offered his opinion to Prime Minister Abe that "the consumption tax rate must be raised at least to 15% to achieve financial sustainability." [3]

3. The tax hike should not be merely postponed, and an independent institution should be established to ensure fiscal discipline

If the consumption tax hike is to be further postponed in consideration of the business

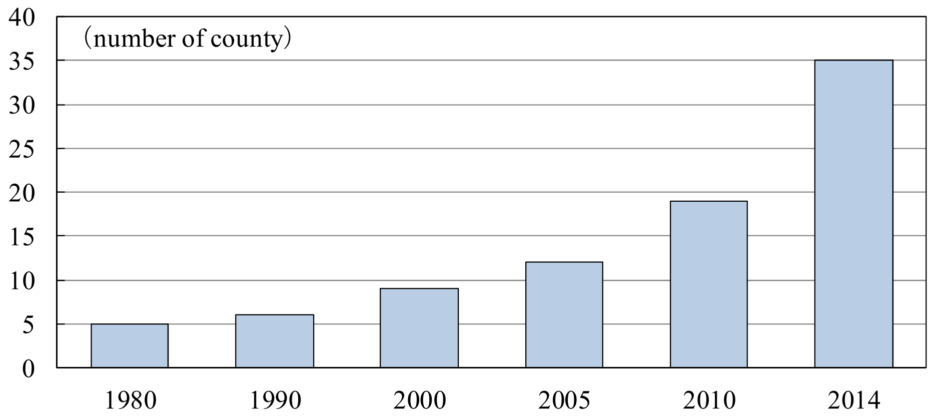
[3] Fifth Analysis Meeting on International Finance and Economy (held at the Prime Minister's Office on April 13, 2016)

conditions, it should not be merely postponed, and a specific time schedule for achieving fiscal consolidation must be provided. We request that the time schedule should be prepared and implemented within two years in an effort to further increase the consumption tax rate and implement reforms of the social security system.

At the same time, we propose establishing a Fiscal Evaluation Council as an institutional framework to promote fiscal soundness and ensure fiscal discipline. The Council will have the following roles: (1) Preparing and publishing its economic and fiscal prospects from a neutral perspective, (2) Estimating the generational accounting to assess the burden and benefit of tax and social security, (3) Setting the goals for fiscal revenue and expenditure, and (4) Evaluating the government's level of achievement. The Council will consist of academic experts who are not stakeholders of parties or government institutions. In Japan, there was a precedent where interparty Diet members attempted to establish such a council in their joint names (Tokyo Foundation, 2013).

An institution that prepares and publishes its economic and fiscal prospects from a neutral perspective and provides advice and recommendations to the government is called an independent fiscal institution, and these are increasingly being introduced on a global scale (**Figure 2**).

Figure 2　Rapidly increasing independent fiscal institutions



Source: IMF　Fiscal Council Dataset 2015　(at the end of 2014)

Most independent institutions overseas take a role in promoting the balance of financial income and expenditure. In Japan, where the population is aging and decreasing, an excessive burden might be imposed on the younger generations, and it is also important to examine the distortion of the system. To obtain an understanding of the burden increase, it is indispensable to assess the benefits of the public expenditure and the burden such as tax and social insurance premiums by generation.

To contribute to these purposes, the Fiscal Evaluation Council will provide objective economic and financial analyses, predictions and advice. The reason why such an institution should be independent is because the government tends to publish predictions with an optimistic bias. Looking back on the government's medium- and long-term growth rate prospects, they have always been overestimated, and the nominal growth rate was higher than the actual growth rate by 2.4% on average (**Figure 3**). Assuming a higher growth rate, the required amount of government spending reductions will be smaller even if the same amount of deficit must be reduced, which is more politically acceptable. It seems unlikely that the existing politicians and administration officers can take the role of checking the ballooning fiscal deficit. Accordingly, we consider it indispensable to establish an independent council to ensure governance to secure sustainability.

Figure 3 Prediction of nominal growth rate continuously overestimated by the government

(Forecast of the growth rate over the next 5 years)

estimation year	Estimation by the gov't <annual rate %> (1)	Actual growth <annual rate %> (2)	Difference <annual rate %> (3)	Over-estimation (4)
2002	1.4	0.3	+1.1	×
03	1.3	0.6	+0.7	×
04	1.9	-0.5	+2.4	×
05	2.6	-1.2	+3.8	×
06	2.7	-1.0	+3.7	×
07	3.2	-1.4	+4.6	×
08	2.7	-1.9	+4.6	×
09	2.0	0.3	+1.7	×
10	1.6	0.9	+0.7	×
11	1.3	0.8	+0.5	×
average			+2.4	

Source: Calculated by JCER by reference to the medium- to long-term estimations by the Cabinet Office and SNA(National Accounts of Japan)

Note 1: In principle, an estimation year refers to a year in which the medium- to long-term estimations by the Cabinet Office were published (as a rule, the estimation of January is used).

Note 2: As for (1) and (2), compounded growth rates were calculated based on the nominal GDP in the year before the estimation year (in FY2001 if the estimation year is 2002) and in the year five years after (in FY2006 if the estimation year is 2002).

Note 3: (2) was calculated based on the current standard GDP. The value of FY2015 was tentatively calculated based on our short-term forecast of JCER.

The overview of the Fiscal Evaluation Council is described as follows: In order to maintain its independence, the Council must be an Article 3-based commission (the same as the Nuclear Regulation Authority and Japan Fair Trade Commission) that is neither instructed nor supervised by the ministers of government ministries and others. The Council members including the chairperson are appointed by the Cabinet and approved by the Diet. The Council secures a stable financial base and employs staff members in its own right. It legally guarantees a right to obtain government information.

The government assumes an obligation to prepare budgets in deference to the Council's advice, but the goals of fiscal consolidation should be set in consideration of the boom-bust cycle. The balance of income and expenditure should be pursued in normal conditions, while expansionism, such as covering demand, should be accepted during recessions. The Fiscal Structure Reform Act, which obliged the government to achieve fiscal consolidation in the 1990s, did not include elastic clauses, which resulted in suspension. Most of the financial regulations devised overseas after the failure of Lehman Brothers include such elasticity clauses (Schaechter et al., 2012).

There are two practical approaches for achieving fiscal soundness and dealing with a recession at the same time. One is to aim for structural fiscal balance, which is calculated by subtracting the tax revenue that fluctuates depending on the booms and busts and the amount of fiscal stimulus included in the economic measures. The other is to set a goal, for example, that the average in five years should be x% of the surplus. When the government sets such a goal, the Fiscal Evaluation Council will measure compliance every year. Even if the consumption tax rate is raised in spring in 2017 as scheduled, it is essential to consider establishing a Fiscal Evaluation Council to prevent fiscal profligacy and catastrophe.

4. Drastic reform must be pushed through to boost growth potential

Regardless of the method of drawing a path to fiscal consolidation, it is difficult for people to accept the tax increase without convincing proof of medium- and long-term stable growth. In the “Plan for promoting dynamic engagement of all citizens” and the new growth strategy, the government intends to reveal market development, personnel training, regulation reform and other aspects, although its efforts are still inadequate. Through the Long-Term Economic Forecast (JCER 2014) and the Medium-Term Economic Forecast (JCER 2016), JCER proposed a reform to boost growth potential (potential growth rate), which includes a goal of increasing labor productivity by 2% (tripling of the current increase rate) and realizing GDP of 600 trillion yen in the early 2020s.

The first measure is to powerfully promote the open diplomatic policy starting from the Trans-Pacific Partnership (TPP). Foreign capital should be encouraged to invest in Japan, and the ratio of the net acceptance of immigrants to the total population should be increased to one-half of that in the U.K.

The second is to fully utilize ICT. Instead of merely increasing software investment and introducing ICT into each field in society, it is necessary to conduct regulation reform and human resource development to make use of potential as well as to review companies’ business lineup.

The third measure is, in order to secure the labor force, to accept a significant number of foreign workers in the medical and long-term care field in addition to highly trained personnel. The minimum goal is to accept 80,000 immigrants a year by 2030.

If the reform is immediately put into practice and it becomes likely to be able to maintain 2% of growth in the 2020s, the standard of living (real consumption) will not decrease even if the consumption tax rate is raised by 17% (from 8% to 25%), and the minimum requirements will be satisfied to accept the burden increase that people cannot avoid in the medium and long term.

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