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Pension Reform: Take "Energizing" Approach
—Stimulate Private Investment and Consumption
—Scrap Premiums: Finance via Consumption Tax

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Points:

- Cut effective corporation income tax rate to 26%, in line with other Asian countries
- Privatize earnings-related pension component and finance shortfall with long-term government bonds
- Boost growth rate by stimulating private demand

Coping with the problem of an increasingly aged Japanese population requires urgent reform of the nation's tax and social security systems. There is an active debate on how to fund this reform, but effecting it by relying mainly on higher taxes carries the risk of hurting the economy, which would render it even more difficult to increase tax revenue and rebuild government finances. It is most important to leverage the vitality of the private sector via thoroughgoing reform and give working young people a reason for hope.

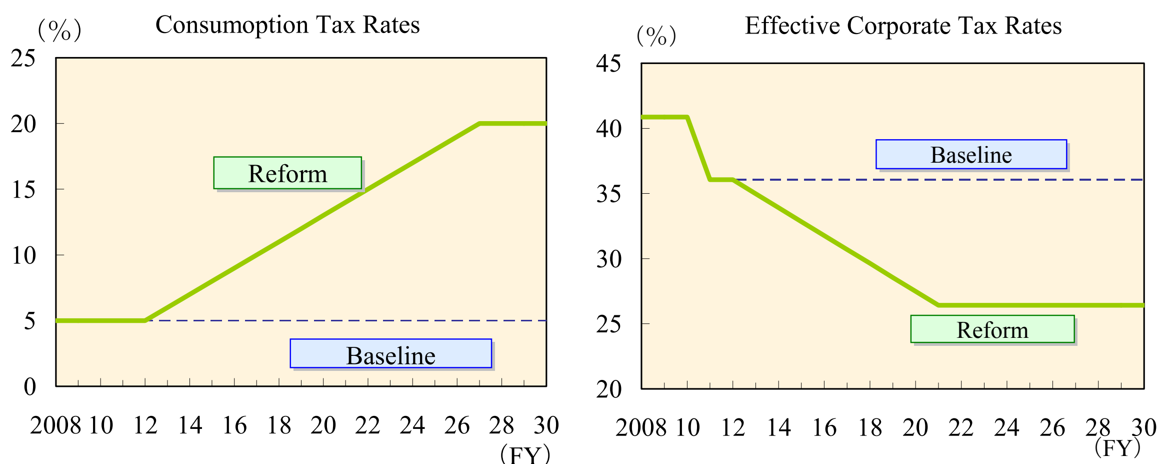
We have worked out a proposal comprising a package of extensive, growth-friendly extensive reforms. Our proposal takes a integrated approach to reforming both tax and pension systems by: (i) using taxes to finance the basic pension (or first-level portion) received by all citizens; (ii) privatizing the earnings-related component (second-level portion) of the employee's pension schemes; and (iii) cutting the corporation income tax rate.

Japan's public pension system is based on a pay-as-you-go financing system under which pension payments to retired generations are financed by the pension premiums paid in by the working generations. Unlike a funded system, under which pension payouts received after retirement are funded by premiums contributed during one's working years, pension insurance premiums under a pay-as-you-go system are, in practice, a tax on wages.

Under our proposal, the 16% pension premium born equally by employers and employees as in the case of ordinary company workers would

be scrapped in FY2013. At the same time, the corporation tax rate would each year be lowered 1% until the effective combined national and local tax rate fell from about 36% to about 26%. This would put it in line with those of other Asian nations. This cut would be financed by raising the consumption tax rate by 1% each year over a period of fifteen years beginning in FY2013 until it reached 20%.

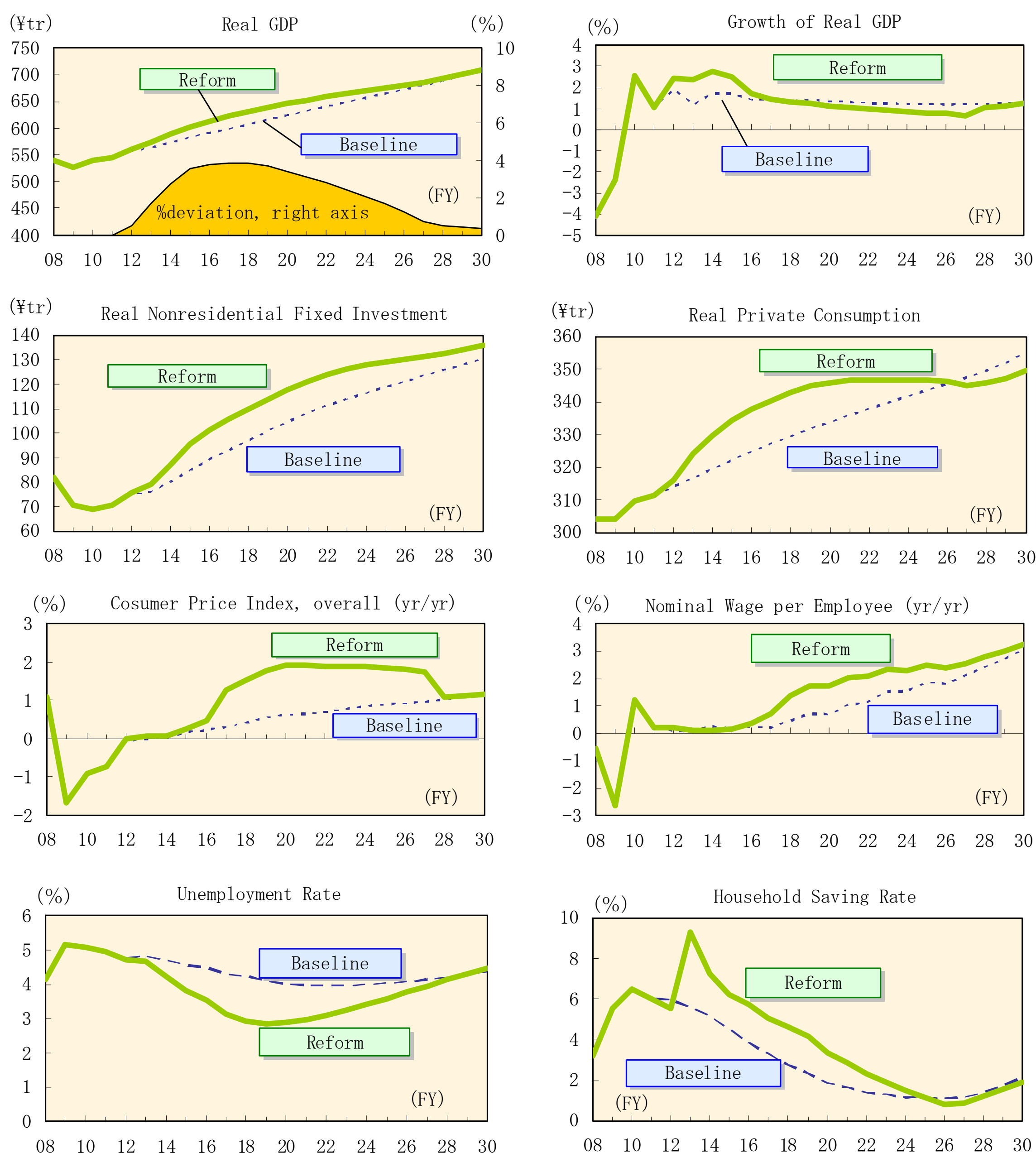
Figure 1. Assumption of tax rates



Such a reform would stimulate the economy by invigorating the private sector. We have estimated the economic impact using JCER macroeconomic models. Although the hike in the consumption tax would remain a weight on consumption, abolition of pension premiums and lowering of the corporation tax would stimulate growth not only in private nonresidential investment but private consumption, leading to a higher growth rate. The rate of household savings would turn up again, capital accumulation would gain ground and the potential growth rate would also rise. But since growth far exceeding that could be expected, the economy would experience a substantial excess of demand.

Labor conditions would tighten, and the unemployment rate would fall under 3% in the second half of the decade. As a result, the nominal wage per person would show a stable growth rate of 2% to 3%. The rate of increase in consumer prices would also stabilize at around 2%, eradicating the bane of deflation. Tight labor conditions would not lead to inflation because the scrapping of pension premiums would lower corporate labor costs and in turn cap any rise in rise in the prices of goods.

Figure 2. The expected impact on the economy of our reform proposal



Source:Macro Econometric Model Simulations by JCER, without the effects of the Great Earthquake incorporated

The gap in the "public burden" between different generations would also narrow. Under a pay-as-you-go system, there is a huge transfer of income from the working generations to the retired generations. According to "generation accounting," which indicates the size of the public burden and benefits throughout the lifespan of each generation, the gap in Japan between the young and unborn generations on the one hand and retired generations on the other is largest of all advanced industrialized countries. The public pension system is overwhelmingly

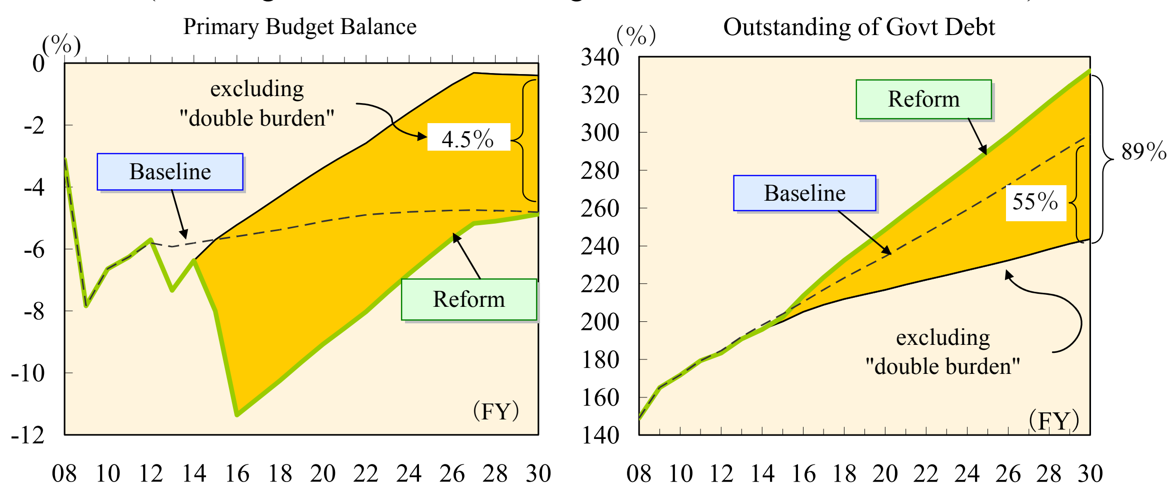
disadvantageous to the young and unborn generations, and under this system, it is very difficult for them to have hope for a brighter future. Scrapping the pay-as-you-go public pension system and replacing the premiums otherwise paid by the working generation with a consumption tax shared by the older generation would greatly help to rectify this intergenerational inequity.

The question, of course, is how this proposal would affect the fiscal deficit. Reform of the public pension system raises the “past pension liability problem,” namely the problem of how to cope with outstanding pension liabilities arising from the shortfall in pension funding. If the earnings-related component is privatized, it will give rise to a “dual burden” problem involving the unfunded portion of benefits payable to prior generations and premiums to fund future benefits.

Under our proposal, that portion of pension reserves other than the contingency reserves would be allocated to the unfunded portion of past pension liabilities, with the shortfall being made up by issuing government bonds maturing in not less than ten years. This would provide sufficient time to eliminate the liability. With regard to that portion already paid in, it would be possible to continue benefit payments to citizens in accordance with the contributions they have made.

This proposal would initially worsen the fiscal deficit. However, the increase in tax revenues following from the acceleration of growth and the elimination of deflation would mean that the primary balance in FY2030 would be essentially in line with the standard scenario not incorporating this reform. This would be a “revenue expenditure-neutral reform” under which the rise and fall of expenditures and revenues would balance at about ¥40 trillion.

Figure 3. Outlook of the fiscal conditions of Japanese Government (including both central and local governments, ratio to nominal GDP)



Source:Macro Econometric Model Simulations by JCER,
without the effects of the Great Earthquake incorporated.

Excepting the portion representing the "double burden," moreover, the primary balance would improve by 4.5% by FY2030. The proposed reform package would raise the ratio of government debt to nominal gross domestic product (GDP) by 34% if the issuance of government bonds to cope with the "dual burden" problem is taken into consideration. Otherwise, it would narrow the ratio by 55%.

What, then, should be done to fix the government deficit? Different alternatives exist within the framework of the proposed plan to shift the funding of the basic pension to a tax-based system.

For example, at least three options have been proposed. First, the Democratic Party of Japan has suggested a tax-funded minimum guaranteed pension which is reduced in accordance with income. The Japan Association of Corporate Executives has proposed that business firms continue to bear the earnings-related component, with the revenue applied to past pension liabilities or to a reduction in the corporation income tax. The Nihon Keizai Shimbun has proposed reduction of the basic pension in accordance with the period during which premiums have not been paid. Raising the consumption tax to 5% in FY2013 and by 1% each year thereafter in stages would make it possible to improve the fiscal balance.

In the wake of the Lehman shock, the central banks of advanced industrialized nations began quantitative easing measures. They bought up government bonds issued as an economic stimulus measure, such that monetary policy partially substituted for fiscal policy.

However, Professor Martin Feldstein of Harvard University stated in 2002 that Japan should raise the consumption tax by 1% each quarter while at the same time cutting taxes on wages. This would spark consumer demand ahead of each impending hike in the consumption tax, while the increase in disposable income would also boost private demand.

Narayana Kocherlakota, president of the Minneapolis Federal Reserve Bank, further refined this proposal, arguing that a hike in the consumption tax combined with a reduction in taxes on wages and investment together would have the same impact as an additional cut in interest rates when rates are already at zero and can not be lowered any further. This proposal is one of substituting fiscal policy for monetary policy, or the direct opposite of quantitative easing.

In comparing our proposal with that of Kocherlakota, it should be noted that, although Kocherlakota would cut investment taxes rather than corporation taxes, and while there is some difference in the scope and timing of the cuts and hikes, both approaches are analogous to a cut in interest rates aimed at boosting the growth rate by stimulating private demand.

While our estimates stem from a standard scenario which did not take account of the Great East Japan Earthquake, in terms of the difference between the standard scenario and the reform scenario, our estimates would remain basically unchanged even in the disaster is taken into consideration.

Implementation of the public pension reforms we propose would raise wages for the working population, initiating new growth led mainly by private demand. The legacy which is left to the younger generations and those not yet born must under no circumstances be a negative one. That legacy should be a society which can provide them with hope for the future.

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