



International Monetary Fund



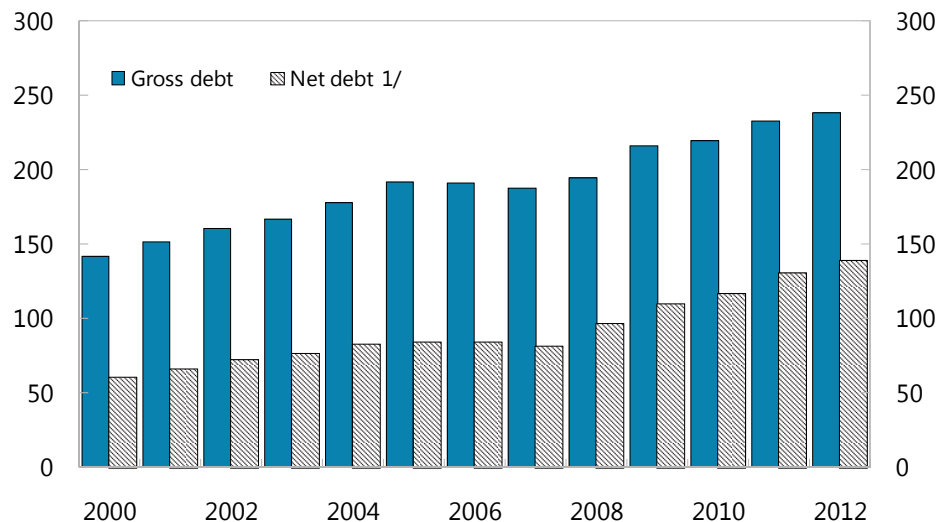
Introduction

- Japan's Fiscal Position: How did we get here?
- How to Secure Fiscal Sustainability?
 - *Striking a balance between new revenue measures and limits on spending.*
- The Strategy for Raising the VAT: the "four Ss"
 - *Sooner rather than later; Stepwise; Sustained, and Simple*
- Implications for Growth, Inflation, and Equity
- Preview and Lessons for Other Countries?

Japan's Fiscal Position: How Did We Get Here?

Over the past two decades, gross debt has more than tripled to over 200 percent of GDP....

Japan: General Government Debt (In percent of GDP)



Source: IMF WEO database; IMF staff projections

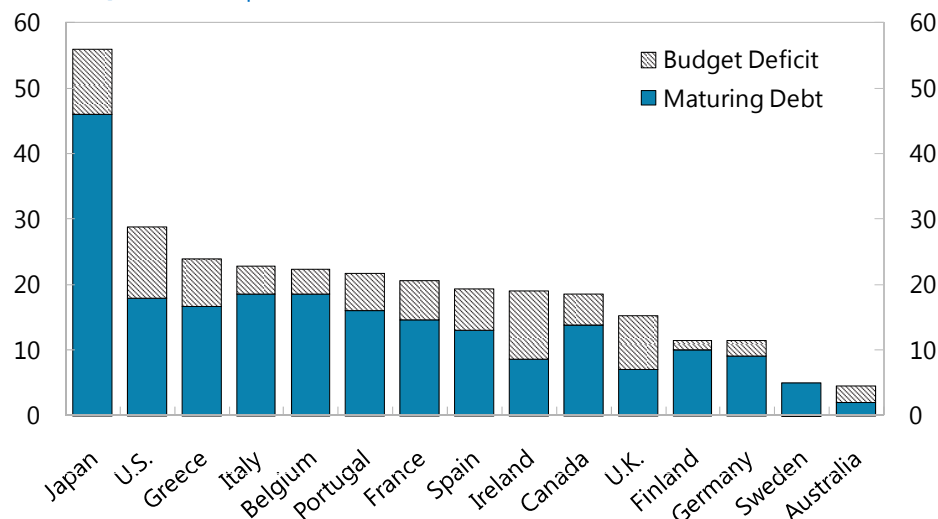
1/ Net debt refers to gross debt minus gross financial assets of the general government.

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Japan's Fiscal Position: How Did We Get Here?

...and gross public financing needs are around 55 percent of GDP.

Selected Advanced Economies' Gross Public Financing Needs, 2011 (In percent of GDP)



Source: IMF Fiscal Monitor (April 2011).

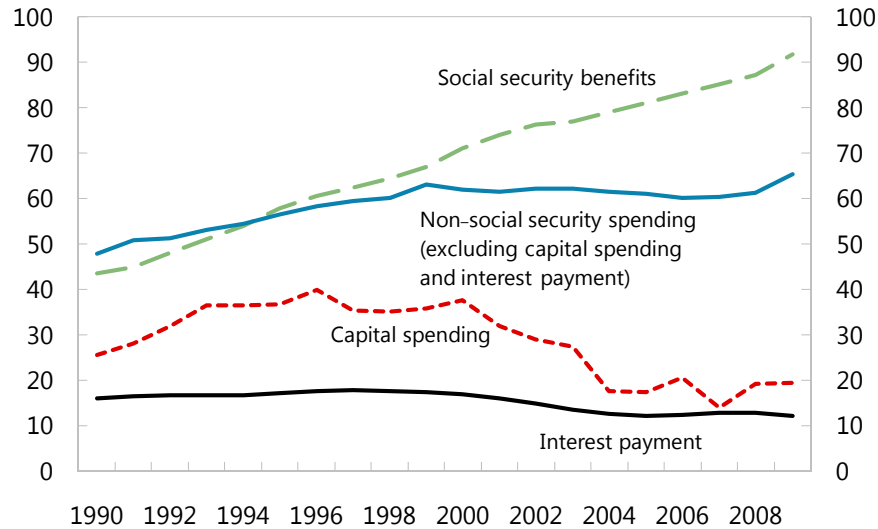
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Japan's Fiscal Position: How Did We Get Here?

A key factor behind the surge in debt has been rising social security spending.

Japan: General Government Nominal Expenditure

(in trillions of yen)



Source: IMF WEO database.

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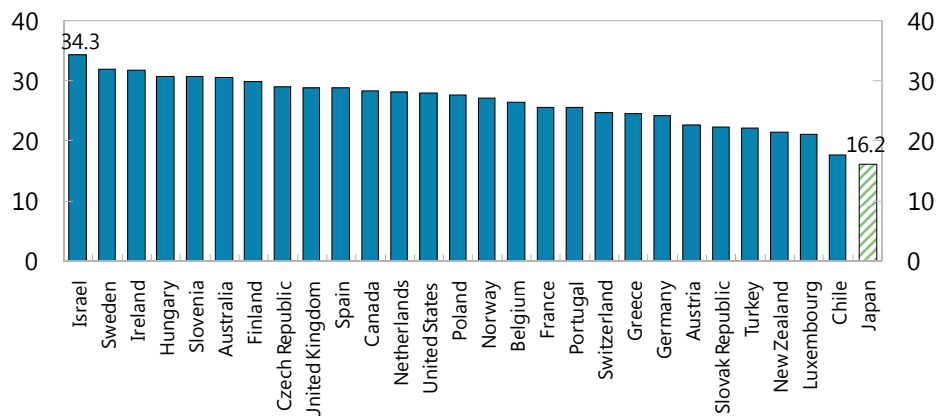
How To Secure Fiscal Sustainability?

Non-social security spending has been well-contained...

OECD Countries ^{1/}:

Non-social Security and Non-interest Spending in 2008 ^{2/}

(In percent of GDP)



1/ OECD countries with missing data (e.g., Italy) are not reported here.

2/ General government basis.

Source: IMF WEO database.

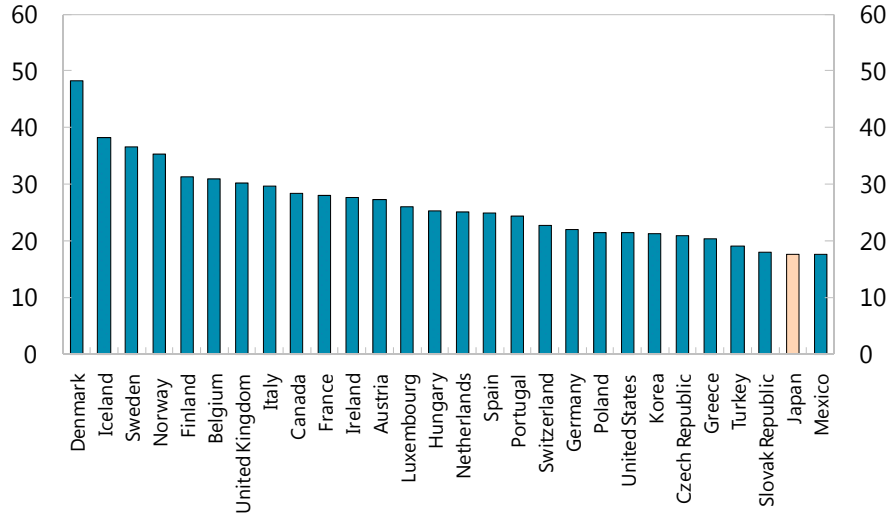
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How To Secure Fiscal Sustainability?

...but tax revenue is low.

OECD Countries:

General Government Tax Revenue 2006 ^{1/} (in percent of GDP)



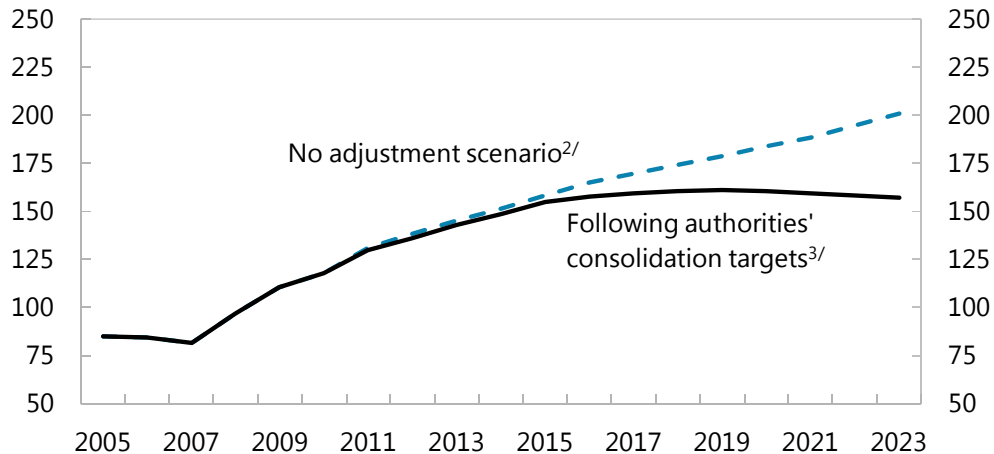
Source: OECD
1/ Excluding social security contributions.

The Need for an Ambitious Fiscal Strategy

The authorities' medium-term fiscal strategy envisions stabilizing the debt ratio by FY2021 at the latest...

Japan: Net Public Debt ^{1/}

(In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections.
1/ Net debt of the general government including the social security fund.
2/ No new tax measures are assumed.
3/ Staff's estimates.

IMF's Recommendation: Difficult but Doable

- **Goal:** Stabilize the net debt to GDP ratio earlier by 2016;
→ Lower to around 135 percent of GDP by 2020
- **Target:** Reduce the (structural) primary deficit by 10 percent of GDP over 10-years.
- **Strategy:** Strike a balance between comprehensive tax reform and limits on spending growth.

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Options for Adjustment and Policy Tradeoffs

Possible Options for Reducing the Primary Deficit by
10 Percent of GDP over 10 Years
(In percent of GDP)

		Consumption Tax Rate (In percent, currently at 5 pct)		
		14	15	18
Revenue from consumption tax		4.5	5.0	6.5
	Assumed impact over 10 years			
Withdrawal of fiscal stimulus	1.0	✓	✓	✓
Modest increase in personal income tax through broadening the base	0.5	✓	✓	✓
Freeze non social security spending in nominal terms (excluding interest payment)	2.5	✓	✓	✓
Limit annual nominal growth in non pension social security spending at 1-1.5 percent	1.0	✓	✓	
Freeze central government contributions to the public pension system in nominal terms, including through raising pension retirement age	0.5	✓	✓	
Corporate tax cut (by 5 percentage points)	-0.5		✓	✓
Total savings		10.0	10.0	10.0

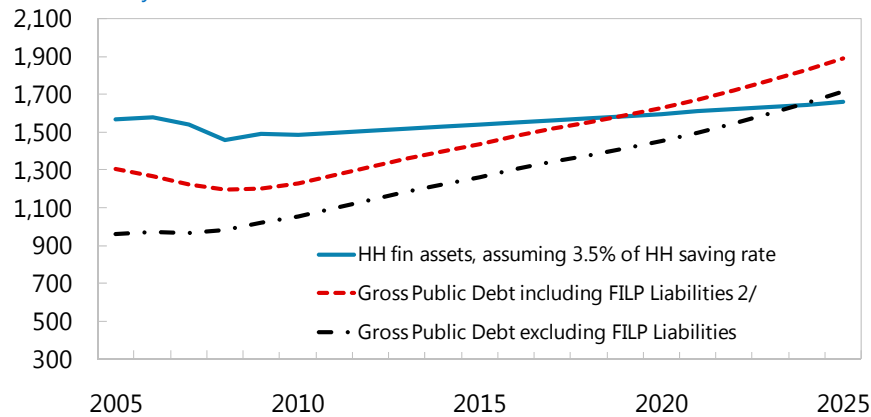
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Why the Rush? Time for adjustment is running out...

Going forward, without a significant policy adjustment, gross public debt could exceed household financial assets in around 10 years.

Japan: Household Financial Assets and Gross Public Debt 1/

(In trillions of yen)



Sources: IMF WEO database, BoJ, and staff's calculations.

1/ Gross debt of the general government including and excluding liabilities owed by the Fiscal Investment and Loan Program (FILP).

2/ For 2011 and on, FILP liabilities are assumed to stay at the same level as in 2010.

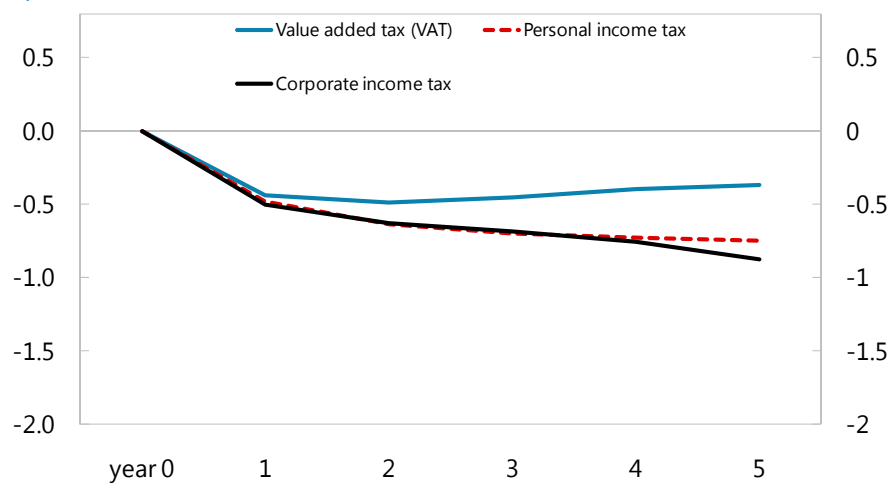
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Why is the Consumption Tax (VAT) Appealing for Japan?

Theory, econometrics and simulations suggest more growth-friendly than most other sources of revenue.

Japan: GDP Impact of a Permanent Tax Hike by 1 Percent of GDP 1/

(In percent of GDP)



Source: Staff's simulation results using Global Integrated Monetary and Fiscal Model (GIMF)

1/ GDP impact is measured as the deviation from the baseline (without a tax hike) GDP level.

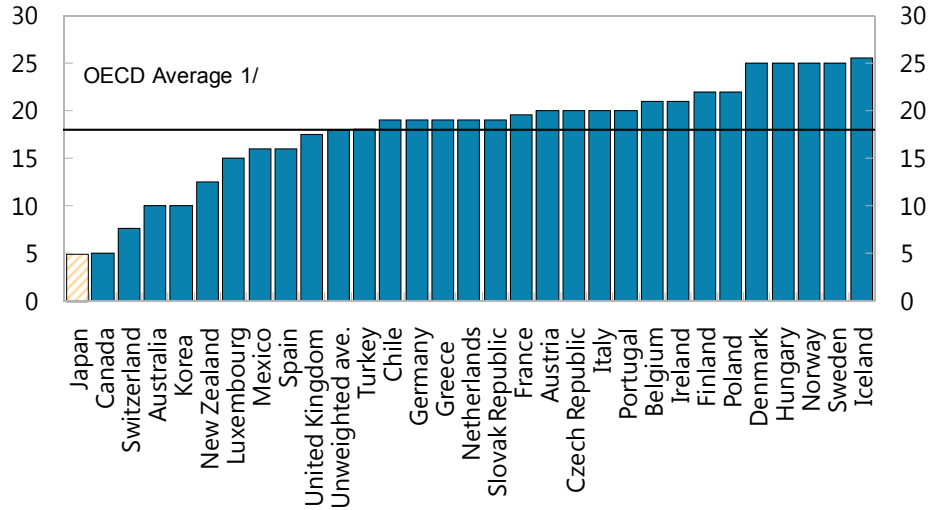
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Why is the Consumption Tax (VAT) Appealing for Japan?

One of the lowest rates in the world...

OECD Economies: Standard VAT Rate, 2010

(In percent)



Source: OECD

1/ Average of OECD countries which have adopted VAT.

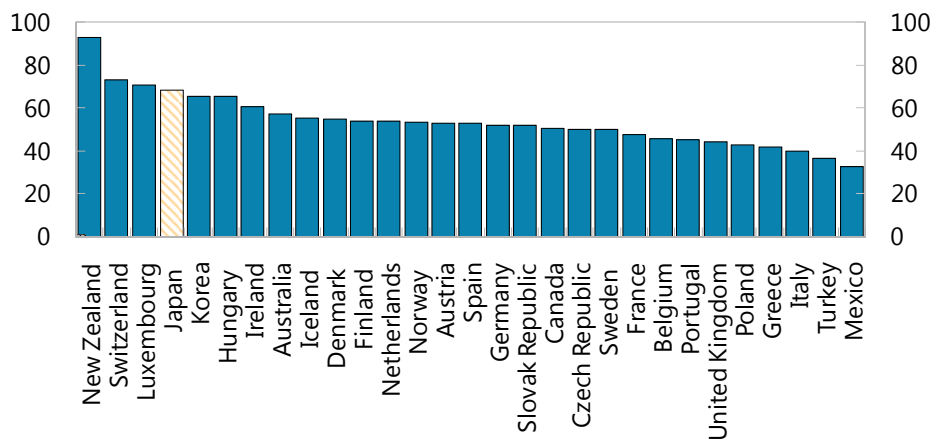
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Why is the Consumption Tax (VAT) Appealing for Japan? (cont.)

...and one of the most efficient VATs

OECD Economies: C-Efficiency Ratio 1/

(In percent)



Sources: IMF, WEO database; Revenue Statistics Database (OECD); National Account Database (OECD); International Bureau of Fiscal Documentation (IBFD); Corporate Taxes (2007), Worldwide Summaries 1/ VAT revenue divided by total consumption times the standard rate.

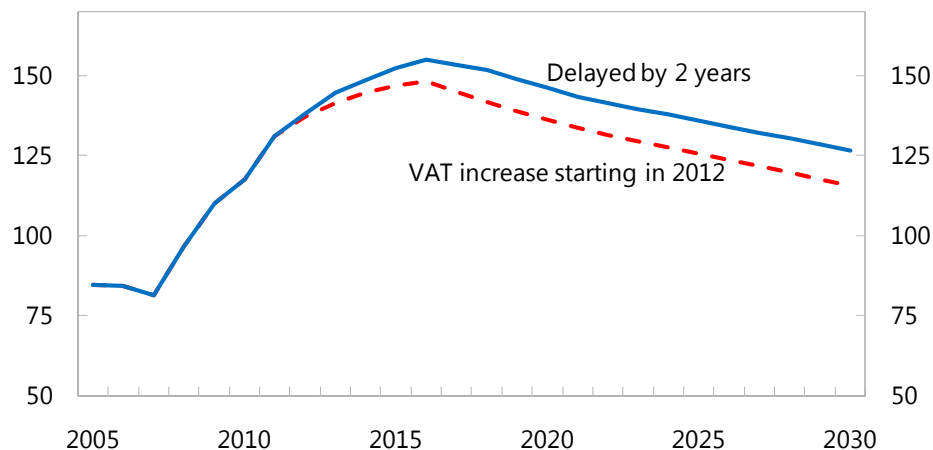
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Impact of a VAT Increase on Debt and Economy

The IMF's fiscal adjustment scenario, featuring a gradual VAT increase starting in 2012, puts the debt-to-GDP ratio firmly on a downward path.

Japan: Net Public Debt ^{1/}

(In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections.

^{1/} Nominal interest rate growth differential is assumed to converge to 1¼ percent (pre-crisis average since 2000) over the long term.

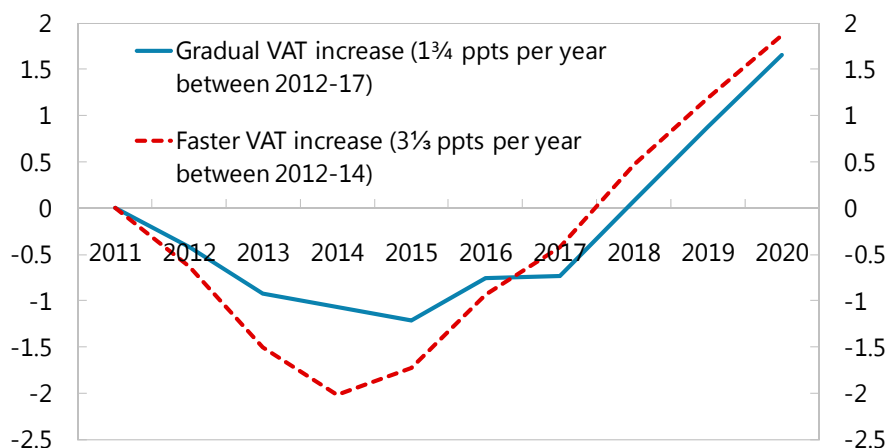
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Impact of a VAT Increase on Debt and Economy (cont.)

Raising the VAT would dampen growth initially, but this could be offset over time by improved confidence.

Japan: GDP Level Impact of IMF's Adjustment Scenario ^{1/}

(In percent of GDP)



Source: Staff's simulation results using Global Integrated Monetary and Fiscal Model (GIMF)

^{1/} GDP impact is measured as the deviation from the GDP level under no fiscal adjustment.

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Impact of a VAT Increase on Debt and Economy (cont.)

A pre-announced, stepwise increase in the rate would:

- **Stimulate consumption in advance of the increase:**

- In the quarter before Japan increased the consumption tax rate in 1997 from 3 to 5 percent, consumers accelerated their spending by about 1½ percent (Ito and Mishkin, 2006)

- In 2009, the U.K. temporarily reduced its VAT rate from 17.5 to 15 percent before raising it to 17.5 percent in 2010, estimated to boost consumer spending by 1.25 percent

- **Potentially have a beneficial impact on inflationary expectations**

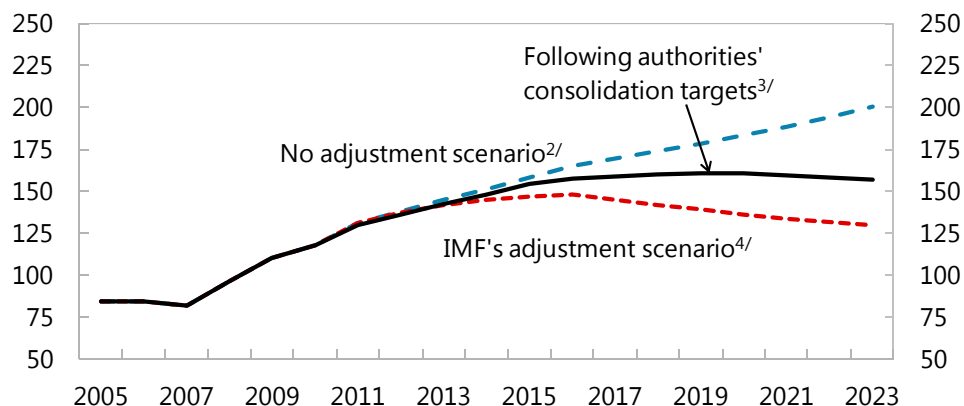
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Impact of a VAT Increase on Debt and Economy (cont.)

Welcome the authorities' tax and social security reform plan, but more needs to be done.

Japan: Net Public Debt ^{1/}

(In percent of GDP)



Source: Cabinet Office; and staff estimates and projections.

1/ Net debt of the general government including the social security fund.

2/ No new tax measures are assumed.

3/ IMF's estimates.

4/ Adjustment scenario assumes a 10 percent of GDP improvement (7.5 percent of GDP relative to no adjustment scenario) of the structural primary balance between 2010-20.

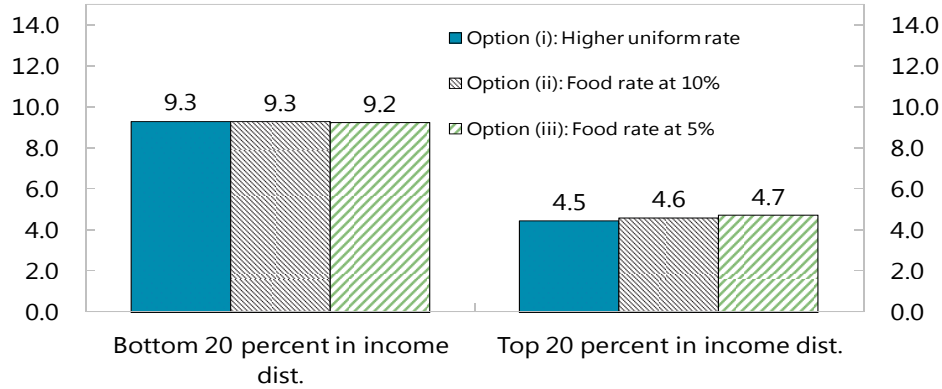
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How to Address Equity Concerns?

VAT is not progressive but (1) it is progressivity of entire tax-benefit system that matters, (2) rate differentiation could play only a very limited role.

Japan: Additional Tax Burden 1/

(In percent of 2010 income)

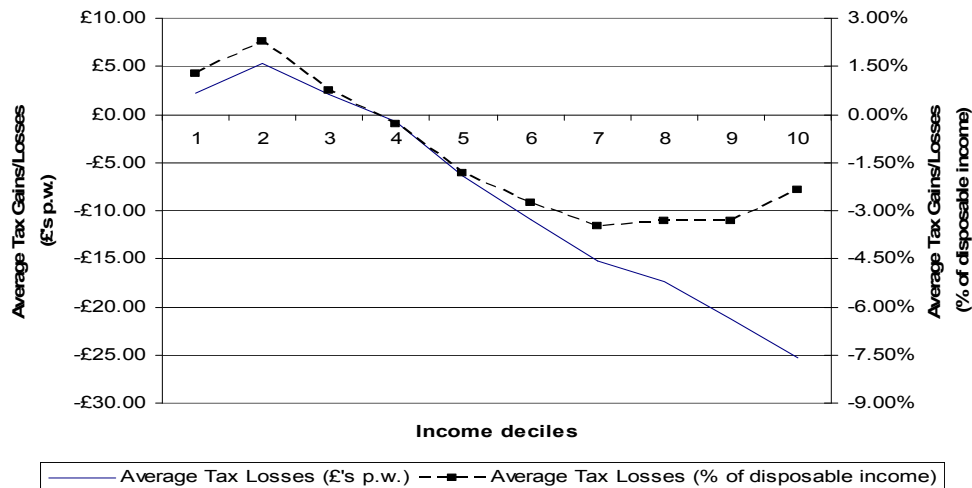


1/ The latest Japanese household income and expenditure data (2010) are used to determine income and consumption parameters. For simplicity, we assume that the consumption bundle does not change before and after the tax increase, thus ignoring behavioral effects.

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How to Address Equity Concerns?

A key lesson from elsewhere is that there are better ways to pursue equity goals than by using multiple VAT rates –and mistakes are hard to correct



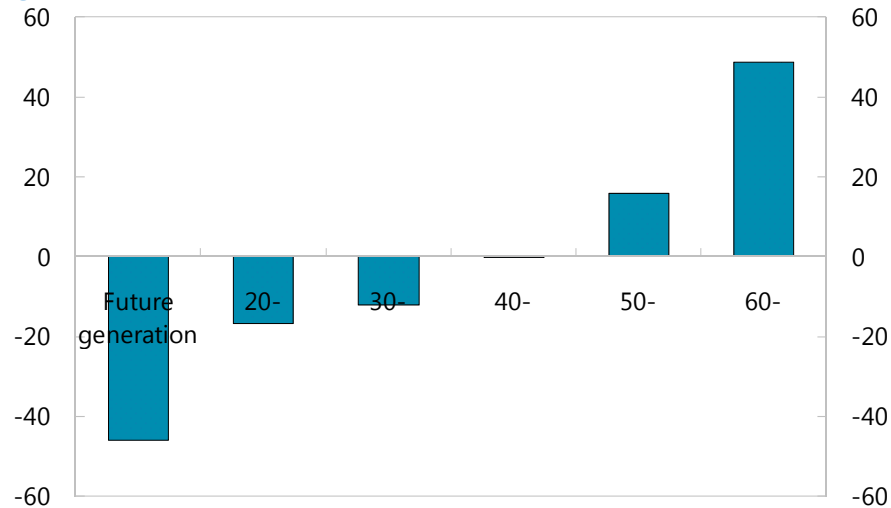
Source: Crawford, Keen and Smith (2010)

Figure shows the impact of eliminating zero-rating in the U.K. and protecting the poor by targeted measures

Equity across Generations?

A VAT increase may be fairer given the imbalance in the distribution of lifetime benefits across cohorts

Japan: Lifetime Net Transfers from the Government by Age Group, 2005 (In millions of yen)



Source: Cabinet Office (Japanese Government)

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Summary

The strategy for raising the consumption tax be guided by the “four Ss”:

- **Sooner rather than later**—to take advantage of the cyclical recovery expected in 2012 and to strengthen credibility of the fiscal adjustment.
- **Stepwise**—because a series of pre-announced modest rate increases may limit the initial adverse impact on growth.
- **Sustained**—so as to meaningfully advance consolidation.
- **Simple**—preserving the single rate structure to limit distortions and ease implementation. Well-targeted spending measures are a better way to protect those on low incomes.

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