

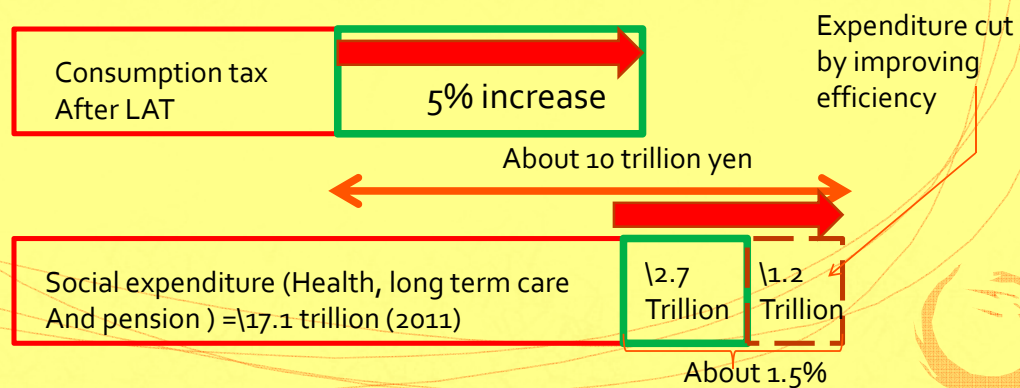
Consumption tax increase in Japan

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Fiscal consolidation in Japan

- The government has proposed to gradually double the consumption tax to 10 percent by the mid of 2010s so as to
 - (i) halve the primary fiscal deficit (about 3%) and
 - (ii) to enhance social security spending (about 1%)



Different missions in Mind?

- There are several stakeholders in the consumption tax increase, pursuing different missions.

⇒ Consensus building with ambiguous interpretation

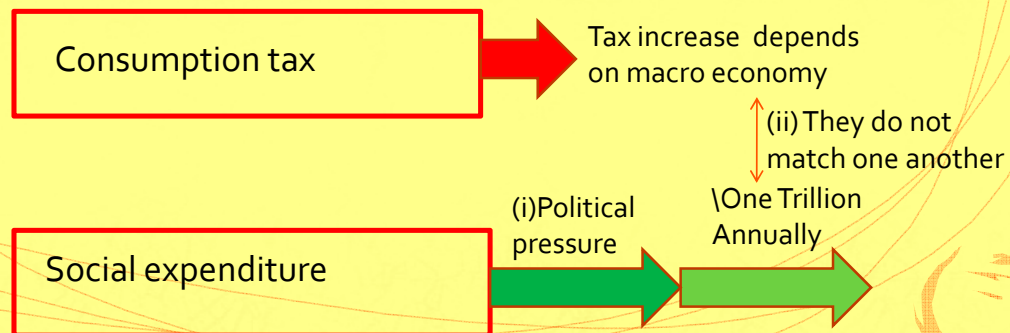
	Missions
Ministry of finance	Fiscal restructuring of the central government
Ministry of welfare and labor	Enhancing social expenditure Including health and child care
Local governments	Raising local own revenue and LAT(Local allocation tax)

Remaining issues

- There are remaining issues after consumption tax increase
- ◆ Social expenditure itself must be contained
- ✓ Earmarking consumption tax increase for social expenditure may send wrong signals
- ◆ Intergovernmental revenue sharing must be reconstructed.
- ◆ 5% tax increase is not sufficient for fiscal consolidation

Social VAT?

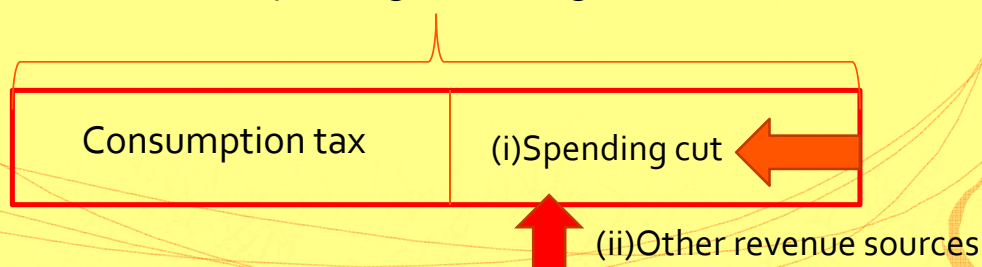
- There may be political pressure and/or expectation for social spending increase so as to match consumption tax increase \Rightarrow The earmarking is not apparent but may have real impact
- Consumption tax revenue increase largely relies on economic growth whereas social expenditure increase is determined by demographic factors.



Earmarked VAT

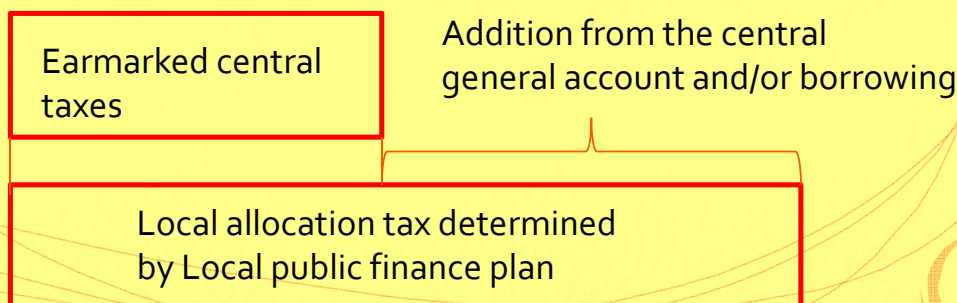
- Does earmarking mean that (i) social spending must be contained by consumption tax revenue or (ii) consumption tax should be directed for social spending?
 \Rightarrow In the case of the latter, the gap must be filled by other revenue sources including debt which works against fiscal consolidation effort.

Social spending from the general account



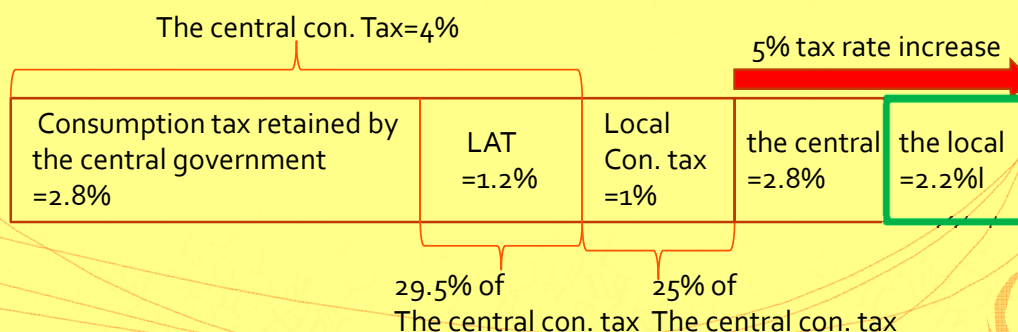
Remark: Local allocation tax

- Certain portions of the major central taxes are earmarked for general purpose transfers called local allocation tax (LAT).
- On the other hand, total amount of LAT is determined by local public finance plan reflecting obligated and promoted spending of local governments.



Local VAT

- Local consumption tax is tied to 25% of (central) consumption tax
 - In addition, a fixed portion of consumption tax is earmarked for LAT
- ⇒ The central government can retain only 2.8% out of 5% tax rate increase.



Primary fiscal imbalance

- The fiscal gap is much larger at the central level than at the local level
⇒ The current revenue arrangement does not fit current fiscal balance of the two level governments.
- Local governments address that they need additional consumption tax revenue to fulfill local social spending.

trillion yen

	FY2008	FY2009	FY2010
Central	-19.4	-43.4	-32.9
Local	+3.3	+4.9	+2.1
Total	-16.1	-38.5	-30.8

Can we avoid fiscal crisis?

- 5% tax rate increase is not sufficient for fiscal consolidation generating primary fiscal surplus by FY2020.
- Additional tax increase or measure to contain (social) expenditure needs to be in place.

% of GDP

Primary fiscal balance	FY2012	FY2015	FY2020	FY2023
Prudent scenario	▲5.0	▲3.0	▲3.1	▲3.2
Optimistic scenario	▲5.0	▲2.0	▲1.4	▲0.8

Note: the two scenarios suppose different growth and inflation rates
Source: Ministry of Cabinet

Is this time different?

- Japan government has not been much successful in implementing fiscal restructuring plan
- Structural reform of public finance of 1997.
 - involving deficit reduction plan
 - terminated in 1998
- Basic principle of 2006
 - removing primary fiscal deficit by FY2011
 - terminated after the Lehman shock.
- It is difficult to commit to fiscal restructuring

