

**TAX REFORM FOR AGING SOCIETIES:
TOUGH CHOICES IN JAPAN
AND THE UNITED STATES**

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ABBREVIATIONS

BOJ	Bank of Japan
CAO	Cabinet Office of Japan
CAP	Upper limit for discretionary expenditure
CBO	Congressional Budget Office
CEA	Council of Economic Advisors
CPI	Consumer price index
FRB	Federal Reserve Board
GDP	Gross domestic product
IPSS	National Institute of Population and Social Study Research
IT	Information technology
MOF	Ministry of Finance
NBER	National Bureau Economic Research
NPR	National Performance Review
OECD	Organisation of Economic Co-operation and Development
OMB	Office of Management and Budget
VAT	Value-added tax
ZEW	Centre for European Economic Research

INTRODUCTION

DEMOGRAPHY AS DESTINY

Is Japan's economic recovery sustainable? Is the resurgence solid and real? These questions are at the center of continuous debates over current political economics and global financial markets. In practice, Japan's nominal economic growth is expected to increase by slightly more than 2 percent in FY2006, and the country's consumer price index (CPI) has been rising to the surface (above 0 percent). Although it has taken an extraordinarily long time, Japan's economy seems to have escaped from the slow growth/deflation trap of the 1990's and to have achieved an amazing comeback. Taking in the facts, however, both those concerning monetary policy and fiscal policy, the main pillars of Japan's economic policy still seem to be in an emergency mode.

With regard to monetary policy, although the Bank of Japan (BOJ) has just announced an end to its quantitative easing – its unprecedented policy of pumping money into the banking system to fight deflation – Japan's short-term interest rate has remained at almost zero.

With respect to its fiscal framework, the government has retained a huge fiscal deficit that is approximately 6 percent of the gross domestic product (GDP), the worst position of any developed country. In addition to these current woes, Japan's economy is now facing another challenge from its declining population, which is also rapidly aging.

In November 2005, an intellectual giant known as “The Father of Business Administration” died at the age of 95. His name was Peter F. Drucker, and he had been the leading analyst of 20th-century industrial society for about 70 years. As is often pointed out, his distinguished insights were applied not only to business, but also to changes in human society. Surprisingly enough, in his book *The Unseen Revolution*, published in 1976, this great thinker

recognized the harmful influence of aging societies 30 years before this became apparent to others.¹ He predicted that the costs of pension funds and health care would rise and that economic growth would decrease because of the increased burdens placed on most developed economies. “The demographic change,” he wrote, “has gone equally unnoticed. The figures are known, of course; but no one seems to consider their impact.”²

The late Japanese economic historian Michio Morishima has also pointed out the importance of demographic changes in the analysis of human society.³ In addition, political scientist Samuel P. Huntington of Harvard University has described the shifting balance of civilizations and based his work on the changing rates of population growth in major Muslim countries.⁴ Until recently, however, people in developed countries, and especially in Japan, were not very concerned about demographic changes; this was because their economies had grown steadily along with their populations. Ironically, in 2005, just when the government was declaring an economic revival, the population of Japan appeared to be declining,⁵ and an aging population is now plaguing the United States as well.⁶ It is clear that plans and policies that deal with aging societies are urgently required (see Table 1).

This paper considers mainly the tax reforms needed to cope with an aging society, especially that of Japan, which is facing the world’s most rapid shift in this regard. Although the

¹Akira Kojima (2005) 3.

²Drucker (1976). He also predicted the complete collapse of the Soviet Union using the data of demographic change in his book *The New Realities* published in 1989, two years before it happened.

³Morishima (2000).

⁴Huntington (1996).

⁵Jiro Kawasaki, Minister of Health, Labor and Welfare of Japan, noted officially that “de-population seemed to begin in 2005.” *Nihon Keizai Shimbun*, 17 December 2005: 5.

⁶United Nations (2002).

Japanese budget is already precarious, huge fiscal outlays will be needed for social security, to cover health care and pensions. This is a situation familiar to most advanced countries around the globe, even the People's Republic of China.⁷ For that reason, an examination of the appropriate tax reforms made in other advanced countries is likely to reap significant rewards: first of all, because in traditional Japanese tax discussions, the government almost always assigns priority to fiscal balance and rarely to the real economy. In my view, more attention must be paid to sustainable economic growth planning and promoting tax systems. Secondly, in Japan's current political climate, some powerful politicians, even ministers, are openly claiming that tax increases will be needed in the near future. At the same time, however, other ministers, Minister of Internal Affairs Heizo Takenaka, for example, are insisting that the government cut spending before increasing taxes. This paper seeks to contribute to the debate in both politics and economics by investigating, in detail, successful cases of past fiscal adjustments (in some OECD countries as well as in the United States).

The Japanese economy is the second largest in the world, next only to that of the United States, and its sustainable growth is indispensable for the health of the global economy. Therefore, its aging population may be an insidious threat not only for Japan and the United States, but for the entire world as well. If Japan fails to cope with this situation, it will be difficult for the nation to support itself, much less to contribute to global society.

This paper is structured as follows. Chapter 1 examines the impact of aging on economic growth and fiscal expansion and stresses the unequal burden placed on different generations. Chapter 2 outlines past fiscal adjustments in Europe and the United States, in particular, the U.S. experience in the 1990's when that country's fiscal condition was successfully improved. Chapter 3 focuses on Japan's current tax system and the sustainability of economic growth in the

⁷Organisation for Economic Co-operation and Development (OECD) (2005).

presence of fiscal adjustments that seek ways to manage mixed global competition policies for long periods of time.

Some tentative conclusions I have drawn from this comparative analysis are that: 1) Japan's corporate tax should be decreased or stabilized to make Japanese companies more competitive; 2) the consumption tax (Japanese value-added tax) rate should be increased from 5 to 7.5 percent (but not to more than 10 percent) to maintain the country's welfare system and to preserve equilibrium between existing and future generations; and 3) at the same time, government should open public works to the private sector and encourage deregulation to boost potential economic growth.⁸ My main idea is that an increase of a consumer surplus – originating in economic growth, deregulation, and a gradual rise in asset prices – might offset some of the economic burden of a tax increase and ease some of the political distrust of the government as well.⁹

⁸Most of these arguments are based on the following books that I have co-authored: Nihon Keizai Shimbun, *Zei o Tadasu* [Examination of Japan's Taxation] (Tokyo: Nihon Keizai Shimbun, Inc., 2002), and Nihon Keizai Shimbun, *Shoshi ni Idomu* [The Challenge for Japan's Aging Society] (Tokyo: Nihon Keizai Shimbun, Inc., 2005).

⁹In this paper, I will focus only on economic policies as ways to prevent a decline in the birth rate rather than on such social policies.

CHAPTER 1

THE IMPACT OF AGING AND A DECLINING POPULATION

The “Incredible Shrinking Country”

At the outset, I would like to clarify the facts and situations that Japan is facing today and will be facing in the near future. Most experts are convinced that Japan’s population, now about 127 million, peaked in 2005.¹⁰ Prior to that, it had barely been growing at all. Moreover, it is said that the current rapid decline will continue for at least a few decades, and there are no signs or indicators that might mitigate this dire prediction. According to Japan’s National Institute of Population and Social Security Research (IPSS), the country’s population may decline to 92 million by 2050. This is a worst-case scenario. It seems inevitable, however, that the population will decrease significantly within the next half century. In the course of human history, no other advanced country has experienced this kind of depopulation except as a result of war or plague.¹¹ In fact, in late 2004, the influential magazine *The Economist* referred to Japan as the “incredible shrinking country.”¹²

It is obvious that the cause of this demographic change is the decline in the birth rate (the number of children a woman bears during her lifetime).¹³ In turn, one of the most visible reasons

¹⁰In its *Annual Report on the Aging Society 2005*, the Japanese government acknowledged that the peak would come by 2006.

¹¹Hiroshi Kito (2000), a professor at Sophia University, noted that a small decrease of population occurred in the Edo era.

¹²“The Incredible Shrinking Country,” *The Economist* 13 November 2004: 33.

¹³See CAO (2003). Japan’s total fertility rate hit an all-time low of 1.29 in 2004. By contrast, the rate in 1947 was 4.54. Although it dropped sharply around 1960 and remained stable at about 2.0 during the 1960’s and 1970’s, a period of rapid economic growth, it began to decline again in 1989. This trend brought Japan’s fertility rate far below 2.07, the rate necessary to maintain a stable level of population.

for this is the general tendency for people to remain unmarried or to marry later in life.¹⁴ Some people also cite the increase in the costs of raising children, while others insist on the need for women's participation in society.¹⁵ I suppose there are a variety of reasons, but the most important point is that Japan cannot avoid the fate of a declining population over the next few decades. There is no way of dramatically changing this pattern.

In addition, the aging of Japan's population is also progressing very rapidly along with the decline in the birth rate. That too is destiny¹⁶ and drastically affects the proportions in the population. It is predicted not only that the ratio of juveniles (0-14 years old) to the total population will decrease; the ratio of the productive (working) population (15-64 years old) to the total population will also decline. In 2000, the productive population stood at 86.2 million, accounting for 68.1 percent of the total population. It is forecast that, by 2050, these figures will decrease to 53.8 million and 53.6 percent, respectively. This disproportion should draw attention to two serious problems in Japan's society. First, a decrease in the productive population might inhibit sustainable economic growth, since it would reduce labor input. Second, damage to the social security system is unavoidable in the face of a decline in the ratio of the productive population to the total population. To put it simply, these developments mean a decrease in the number of people supporting the elderly. In other words, Japan's fiscal situation will become critical with the passage of time.¹⁷

¹⁴See CAO (2003). The percentage of unmarried people, which stood at 28.5 percent for men and 20.9 percent for women in 1980, had risen to 31.8 percent for men and 23.7 percent for women by 2000.

¹⁵According to a recent Japanese government survey, most people have complained about the costs of raising children, especially for education.

¹⁶In 2002, the number of elderly people, 65 or older, was 23.6 million and their ratio to Japan's total population stood at 18.5 percent. According to the IPSS projection of the country's estimated future population, the ratio of elderly people in Japan is expected to continue to rise, hitting 28.7 percent in 2025 and 35.7 percent in 2050.

¹⁷Akihiko Matsutani (2004).

Pressure on Economic Growth

Let me first describe how economic growth can be affected. As we have seen above, Japan's productive population has already begun to decline, and, as we know, labor input is a major component of economic growth. As a natural consequence of a decline in population and the resultant drop in labor input, economic growth will slow. Moreover, if the savings rate of the country continues to slump as more older people rely on their savings, the contribution of capital input to economic growth will also decline, unless increasing productivity helps to support economic growth. The Cabinet Office of Japan (CAO) has predicted the influence of an aging population using economic models, estimating that the average growth rate, for decade as a whole, would be between 0.2 percent and 0.4 percent for each 10-year period after fiscal year 2011. This would mean that Japan's economic growth rate would be close to zero.¹⁸

Some economists point out that, even if macroeconomic GDP growth decreased, there would still be a possibility that per-capita GDP growth could increase. In this sense, per-capita GDP growth is of primary importance when discussing the average living standard of each individual in a given country. From an individual point of view, even if the macroeconomic GDP does shrink, people should not become overly distressed as long as the per-capita GDP continues to increase.¹⁹ When arguing about the sustainability of the social security system and public finance, however, the danger of overconfidence in a bright future should be taken into consideration. Under Japan's current social security system, most income revenues from the working generation are used as financial resources for the older generation. In view of this fact,

¹⁸Some private institutes believe that the government's view is too pessimistic. For instance, the average economic growth rate (2002-2025) predicted by the Japan Center for Economic Research is 1.6 percent. Even if this prospect materializes, however, de-population will continue to inhibit Japan's economic growth.

¹⁹E.g. Yutaka Harada, the chief economist at the Daiwa Institute of Research, often expresses this kind of opinion.

if macroeconomic GDP growth should decline, the nominal income of the working generation would also decrease. Under these conditions, there would be insufficient tax revenue to support the elderly population. Hence, more attention should be paid to the sustainability of Japan's public finance.²⁰

A Looming Fiscal Implosion

Next, let me again discuss the effects on the public sector. A declining population and decreased economic growth would lower tax revenues. Moreover, an aging population is expected to increase the cost of medical benefits and pensions. Japan's public debt is 170 percent relative to its GDP and still increasing. The country's fiscal position is the worst of all the developed countries.²¹

At the same time, I should point out that this is not the only problem Japan is facing. Most developed countries, including the United States, have to deal with aging and the accompanying fiscal deficit. The Congressional Budget Office (CBO) in the United States has warned that the proportion of federal outlays in the GDP will rise from 18 percent in 2005 to 40 percent by FY 2075, a substantial demographic change. In addition, the CBO pointed out that the average rate of economic growth, which was 4.1 percent per year from 1995 to 2000, will be 1.8 percent in 2020, as the number of workers decreases and fiscal burdens for the elderly hinder

²⁰Some employers, even those who might normally disagree, believe that an increased acceptance of immigrant workers could solve this problem. To make up the shortfall, however, how many immigrant workers would be sufficient? In view of the current situation in Japanese society with regard to foreigners, there would surely be many conflicts before Japan accepted more immigrant workers. For one thing, the infrastructure needed to accept more immigrants, such as the public education system and public safety, is not in place.

²¹David Weinstein, a professor at Columbia University, has recently argued that these worries are overblown. He insists that, in 2004, the net-debt of Japan was only 78 percent of the GDP (*Nihon Keizai Shimbun* 29 November 2005: 25). Attention must be paid to the level of debt, however, because this is still high.

capital input.²² The problem outlined above is the main reason why U.S. President George W. Bush promised Social Security reform in the last half of his administration. It is easy to understand his priority on domestic policy; this is because the oldest baby boomers in the United States will begin to retire at the end of his second term in 2008. Bush is proposing “personal accounts,” in which people can deposit a portion of their current payroll tax. An investment account is a private account that people would actually own themselves. Personal accounts could also provide a way to pre-fund a person’s future social security benefits. From my point of view, implementing this proposal would be one of the most effective measures that countries facing an aging society could take.²³

Today, there are almost 36 million Americans age 65 or older. Their Social Security retirement benefits are funded by today’s workers and their employers who jointly pay Social Security taxes – just as the money they paid into Social Security was used to pay benefits to those who retired before them. Unless action is taken soon to strengthen Social Security, in just 14 years we will begin paying more in benefits than we collect in taxes. Without changes, by 2042, the Social Security Trust Fund will be exhausted...²⁴

In November 2004, these comments from the Social Security commissioner, Jo Anne B. Barnhart, were put into letters destined for people aged 25 or older in the United States. They represent an acknowledgement of the fact that there will not be enough money to provide the benefits that have been promised to these individuals.²⁵ In this context, N. Gregory Mankiw, the former chair of the Council of Economic Advisors, remarked in 2004 that “the Social Security benefits now scheduled for future generations under current law are not sustainable given the

²²The Congressional Budget Office (2002).

²³Glenn Hubbard (2004).

²⁴From a letter sent by the Social Security Administration in November 2004.

²⁵Laurence J. Kotlikoff and Scott Burns (2005) 173-74.

projected path of payroll tax revenue.”²⁶ Actually, in 2008, the first wave of 77 million baby boomers will start to take their old age benefits. Medicare and Medicaid will also need to be reformed, as future medical costs will increase more rapidly than economic growth. Today, not only Japan and the United States, but also most advanced European countries are suffering from an increase in their aging populations. Even China, whose economy has grown on an average of 9.5 percent annually over the last 20 years, will soon be facing the same problem.²⁷

Unfairness Among Generations

Third, I would like to explore the issue of unfairness among generations as a result of aging. As mentioned above, most social security systems, such as pension funds and medical care, are a sort of remittance sent from the working generations to those who have retired. If the country has fiscal deficits, the burden of providing benefits to older people will also be shared by future generations. Decade after decade, the present generations, including elders, have taken money from those who have not yet been born. It is almost as if they had borrowed money from them without any concern. It is very hard to show a significant unfairness, but we can measure it with a relatively new method called *generation accounting*, which has been in use for about 15 years and has been applied in approximately 30 countries, as well as by the International Monetary Fund, the World Bank, the European Union, and the BOJ. This new method, established in part by economist Laurence J. Kotlikoff, a professor at Boston University, can directly measure the fiscal burden that present generations are imposing on future generations.²⁸

²⁶*The Wall Street Journal* 16 December 2004: A16.

²⁷In a 2005 report, the OECD cited the necessity of reforming pension and tax systems in China.

²⁸The main idea of generation accounting is as follows:

$$A + B = C + D$$

A stands for the present value of net taxes of future generations; B stands for the present value of net taxes of current generations; C stands for the present value of government purchases; and D stands for the official net debt

According to Kotlikoff's latest research, if the United States hopes to achieve a generational balance (the equalization of lifetime tax rates placed on current and future generations), U.S. citizens and companies would soon have to accept a 78 percent federal tax increase. There is little doubt that this will ever happen. Therefore, from a fiscal point of view, the huge burden of debt will fall on future generations. Kotlikoff calls this scenario the "generational storm."

The situation that Japan is facing is much worse than that of the United States. In 1995, the financial gap in Japan between the current and future generations was among the worst in the advanced OECD countries.²⁹ The Japanese government had never before used generation accounting, but, in 2003, it suddenly announced the results of its official calculations.³⁰ These showed that Japanese people aged 60 or above in 2001 would have had net benefits of about ¥65 million (\$560,000) during the course of their lifetime. On the other hand, the younger generations would not receive any net benefits at all. Instead, the net contributions of future Japanese generations aged 20 or less in 2001 will have been about ¥52 million (\$450,000). This means that the financial gap between current and future generations is already about ¥117 million (\$1.01 million, see Figure 1.). I think that the problem of the gap in benefits and burdens among generations will become a very serious issue and shake the foundations of the Japanese economy and the social security system.

of official assets. According to this concept, the present value of the net taxes of future and current generations has to be equal to the present value of government purchases and net debt. In any case, someone has to pay the bills. Hence, if we examine the burden placed on future generations, it might be better to arrange the equation in the following way:

$$A = C + D - B$$

In these terms, it is obvious, given the extent of the government's bills, that the less that current generations pay, the greater the burdens left for the coming generations.

²⁹Alan J. Auerbach, Willy Leibfritz, and Laurence J. Kotlikoff (1999).

³⁰Cabinet Office, Government of Japan (2003).

In this chapter, I have considered the destiny of advanced countries, including Japan and the United States, in the first half of this century. The most important point is that the impact of an aging population must be accepted as inevitable, and policies to cope with this demographic change must be developed. Top priority should be given to such topics as: 1) increasing the nominal macroeconomic GDP growth rate to obtain the resources necessary for maintaining basic public services; 2) making optimal fiscal adjustments that will not be obstacles to economic growth; and 3) realizing equilibrium between the tax burdens of the current and future generations. I am convinced that it will be quite difficult to balance these three targets, but if this cannot be achieved, our future will be dim. In the next chapter, I would like to analyze the lessons learned from past fiscal adjustments in some OECD countries as well as in the United States.

CHAPTER 2

LESSONS FROM PAST FISCAL ADJUSTMENTS

Fiscal Adjustments in OECD Countries

As I have noted in the previous section, ways to combine sustainable economic growth and fiscal adjustment must be found. This is a challenging goal; some remarkable studies, however, have been done on this complicated issue. In this section, let me first analyze the lessons learned from past experience in advanced countries.

Alesina and Perotti (1996) studied how the composition of fiscal adjustments influenced the likelihood of “success” when countries were facing fiscal deficits.³¹ They defined “successful adjustment” as long-lasting deficit reduction. In this context, they examined former fiscal adjustments in OECD countries using economic models and found that fiscal adjustments that relied mainly on spending cuts, especially in social security benefits and the government wage bill, had a better chance of success and were, therefore, expansionary for the economy. On the other hand, fiscal adjustments that relied mainly on tax increases and cuts in public investment tended to be short-lived.

Their research is outlined as follows. First, they considered a sample of 20 OECD countries during the period between 1960 and 1994. Then they defined a period of successful tight fiscal policy as one in which one of the two following conditions prevailed: 1) in the three years after the tight period, the ratio of the primary deficit to the GDP was on average at least 2 percent below the GDP of the last year of the tight period; 2) three years after the last year of the tight period, the debt-to-GDP ratio was 5 percent below the GDP of the level of the last year of the tight period.

³¹Alberto Alesina and Roberto Perotti (1996).

According to their research, 16 out of 62 fiscal adjustments were successful. In these successful adjustments, the contribution of spending cuts for fiscal balance averaged 72 percent, while the corresponding figure from tax increases was 28 percent. On the other hand, in the 46 cases of failure, the average contribution from tax increases was greater than that from spending cuts, at 56 percent and 44 percent, respectively. These findings demonstrate that fiscal adjustments that depend chiefly on tax increases tend to end in failure. In other words, it is difficult to use tax increases as instruments for fiscal adjustment. In the words of Alesina and Ardagna (1998): “Typically, a fiscal consolidation based on tax increases is short-lived.”³²

Alesina and Ardagna also examined the composition of spending cuts. In successful cases, the reduction of government officials in real numbers and wages contributed to the greatest expenditure cuts, approximately 27 percent. The second largest contribution was in the reduction of social security expenditures, 23 percent, and the third largest was in the reduction of costs for public works. All these results demonstrate that, if a continuous attempt is made to cut given levels of expenditures, the cost to the public and social security will have to be reduced. In a later report, Alesina asserted that: “To be long-lasting, it (fiscal adjustment) must include cuts in public employment... and government wages.”³³

Finally, Alesina and Perotti made a detailed examination of the composition of tax increases. In successful adjustments, tax increases were levied on businesses and also appeared as indirect taxes on sales. The most important point to be made here, however, is that the increase in business taxes may have been the result of a larger tax base, not higher tax rates. In addition, taxes on households did not increase at all in the successful cases.

³²Alberto Alesina and Silvia Ardagna (1998).

³³Alesina and Ardagna.

On the contrary, the tax increases of unsuccessful adjustments were widely distributed, and this was true of taxes on businesses and households, as well as indirect taxes. Indeed, as Alesina and Perotti have said: “The contrast between cases of success and failure is particularly striking for taxes on households.”³⁴

U.S. “Rubinomics” in the 1990’s

Next, I would like to explore the lessons learned from U.S. fiscal adjustments in the 1990’s. In 1992, the U.S. fiscal deficit (including the Social Security trust fund surplus) was 5.8 percent of the nation’s GDP, the highest of any developed country. Nonetheless, this regrettable situation improved within a period of only six years during President Bill Clinton’s tenure. In 1998, the U.S. federal fiscal balance changed to a surplus of 0.4 percent of the GDP. From a Keynesian point of view, spending cuts and increased revenues tend to restrain economic growth, but in those days, the U.S. economy grew dramatically even in the presence of fiscal adjustments.

The key person who oversaw these fiscal adjustments and fostered economic prosperity was Robert Rubin, the first director of the National Economic Council and the second Secretary of the Treasury under Clinton. As a result, his economic policies are often referred to as “Rubinomics.” In his book *In an Uncertain World*, he explains these theories as follows: “The view that fiscal discipline was being restored contributed to lower interest rates and increased confidence, and that led to more spending and investment, which in turn led to job creation, lower unemployment rates, and increased productivity.”³⁵ In short, Rubin was successful at creating a virtuous cycle in which fiscal discipline led to economic growth using a parameter of

³⁴Alesina and Perotti.

³⁵Robert E. Rubin and Jacob Weisberg (2004) 122.

interest rates. As he said: “Deficit deduction contributed to economic growth, which, through increased government revenues, contributed to further deficit deduction, which, in turn led to more growth.”³⁶ In addition, improved fiscal and economic conditions were a factor in the rising stock market and this, in turn, fed back into deficit deduction and economic growth.

Dr. Jeffrey Liebman, professor of public policy at Harvard’s Kennedy School of Government, served as Special Assistant for Economic Policy under Clinton from 1998 to 1999. He summarizes the key points of the U.S. fiscal adjustment in the 1990’s as follows: 1) personal income tax revenue increased significantly more than expected; 2) defense spending dropped sharply; 3) Medicare and Medicaid outlays declined relative to projections; and 4) interest costs started falling, leading to a virtuous cycle.³⁷

On the basis of his summary, I would now like to examine the U.S. fiscal adjustment of the 1990’s in detail.

Revenue Side Approach

According to Liebman, typically most of the tax increases during this period were achieved with almost no significant changes in tax policy. In practice, from 1993 to 1998, a significant federal tax policy change occurred just once, and that was in 1993. Rubin explains that half of the fiscal reduction in the plan came from spending cuts (including interest saved by reducing the level of the national debt) and half from tax increases.³⁸ These were mainly engineered by means of a gas tax estimated at only \$36 a year for an average family of four, and

³⁶Rubin and Weisberg.

³⁷Lecture at the Kennedy School of Government, Harvard University “American Economic Policy” (24 February 2006).

³⁸Rubin and Weisberg 130.

a personal income tax that affected the wealthiest 1.2 percent of Americans. In the original proposal, a 2 percent increase in corporate tax rates was included. But the business community objected, and the proposal was withdrawn.

During the period, although the initial tax increase was not so dramatic, the personal income tax revenue was relative to the GDP. Why was this? Liebman gives the following reasons: 1) As economic growth accelerated, the nominal wage increased; 2) as stock prices rose, personal capital gains increased; and 3) the real tax bracket began to inch up, with most people finding themselves in a higher income tax bracket. In this context, we can see that sustainable economic growth is an important element in the natural increase of tax revenues.

In addition, in terms of increased productivity, the Clinton Administration set a new standard for building economic strength: they proposed permanent investment tax credits for research and development. This may be one of the reasons why the United States recovered its productivity and enjoyed a sustainable economic boom during the 1990's.

Spending Side Approach

On the spending side, the Clinton Administration also tried to deduct fiscal deficits, passing a law in 1993 called "The Omnibus Budget Reconciliation Act." This included an upper limit for discretionary expenditure (CAP) and a pay-as-you-go system. Under these provisions, when a necessary expenditure was found or added, the expenditure for other items had to be reduced to offset the cost. This meant that even Medicare and Medicaid were constrained within certain limits. The Office of Management and Budget (OMB) estimated that initial spending cuts (i.e., between FY1994 and FY1998) would be \$254.7 billion, and this goal was achieved.

In addition, it was remarkable that the Clinton Administration also tackled government reform and reduced the number of government workers. Between 1995 and 1999, the government eliminated approximately 250,000 federal jobs, a total of 12 percent. This reform was based on a report known as the National Performance Review (NPR), administered by Vice President Al Gore. In his report, submitted in 1993, he suggested 384 government reforms, the main idea being “to cut red tape.” It seems to me that these types of government reforms were really useful in getting people to trust the government and accept fiscal adjustments that included a tax increase.

Dr. Elaine C. Kamarck, who served in the White House from 1993 to 1997 and managed the Clinton Administration’s NPR, told me that, prior to this reform, there had been an anti-government revolt going on in the United States for nearly two decades. She said: “At that time, bureaucracy was the people’s enemy. That’s why we had to create a modern and efficient government like the private sector.”³⁹ She also felt that one of the reasons why Clinton’s health care reform failed in 1994 was that people thought it would just result in more bureaucracy. Her views imply that government should address administrative reforms in order to gain the people’s trust, even when it is attempting to implement beneficial benefits.

General Rules and the Current U.S. Situation

From the U.S. experience cited above, can some general rules for optimal fiscal adjustments be elicited? Looking back on American economic policy, Prof. Martin Feldstein of Harvard University, who served as Chairman of the Council of Economic Advisers (CEA) from 1982 to 1984, summarized the federal budget policy in terms of a maximum sustainable long-

³⁹Lecture at the Kennedy School of Government, Harvard University “Innovation and Reform in 21st-Century Democracies” (7 November 2005).

term deficit (excluding state deficits) as follows: 1) A deficit is sustainable if the debt-to-GDP ratio does not rise; 2) the growth rate of government debt, therefore, must not exceed the growth rate of the nominal GDP; and 3) this implies that the “deficit-to-GDP” ratio must not exceed the product of the debt-to-GDP ratio and the rate of growth of the nominal GDP.⁴⁰ He also examined the current U.S. fiscal situation concluding that: 1) The growth rate of the nominal GDP will be about 6 percent; 2) the federal deficit in 2005 was 2.5 percent of the GDP; 3) according to this theory, a deficit of 2.5 percent of the GDP can be sustained with a debt-to-GDP ratio of 42 percent; 4) the current ratio of debt to the GDP is 37.4 percent; and 5) thus, the deficit will be manageable. In conclusion, he expressed a relatively optimistic view about the U.S. fiscal deficit.

Certainly, there are both kinds of arguments about the U.S. deficit – optimistic and pessimistic. Liebman, for example, suggests that the coming debt-to-GDP ratio projected by the CBO is slightly low and that the United States should initiate a certain amount of fiscal adjustment. He also adds that the retirement of the baby boomers will place a heavy burden on the federal budget – sooner or later.

Implications for Japan

In the case of Japan, what kind of implications can be drawn from the studies and examples described above?

First, it is obvious that Japan’s fiscal deficit is not sustainable. The growth rate of the nation’s government debt was 3.0 percent in FY2005, while that of its nominal GDP was only about 2.0 percent. Applying Feldstein’s rule, it would seem that Japan’s deficit has already exceeded the sustainable level.

⁴⁰Lecture at the Kennedy School of Government, Harvard University “American Economic Policy” (27 February 2006).

Second, it is also obvious that priority should be given to spending cuts in any attempt to reduce fiscal deficits. In other words, tax increases should be avoided for as long as possible. It seems to me that this is already a familiar concept in advanced countries, particularly after the U.S. fiscal adjustments in the 1990's. Alan Greenspan, the former chairman of the Federal Reserve Board (FRB) of the United States, warned that: "Tax increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base." In addition, he emphasized that the government should seek to "close the fiscal gap primarily, if not wholly, from the outlay side."⁴¹

Third, structural reforms should be stepped up when trying to implement spending cuts that include the reduction of government officials in real numbers and in wages. Considering Japan's aging population, it is also quite important to control the cost of medical care.

Fourth, drastic measures to increase productivity are vital, because this is an important way to raise the nominal economic growth rate in the face of a declining population and additional spending cuts. In retrospect, it seems that the Clinton Administration aggressively adopted information technology (IT) to increase government efficiency.

Fifth, it should be a basic assumption that the deflation afflicting Japan's economy could be terminated if appropriate price increases were adopted not only to sustain economic growth, but also to increase tax revenues.

Sixth, at the same time, it is also necessary to tame global financial markets. If long-term interest rates overshoot concerns about inflation, it would be quite difficult to reduce the deficit while interest costs continue to increase. Concerning the minus-effect of a fiscal adjustment for the economy, it is not necessary to raise interest rates hastily. Yet, considering the significant

⁴¹*The New York Times* 3 December 2005. Mr. Greenspan, who left his post at the end of January 2006, also said: "I fear that we may have already committed more physical resources to the baby boom generation in its retirement years than our economy has the capacity to deliver."

role of the FRB in the 1990's, Japan's central bank – the BOJ – has a huge responsibility to manage markets.

In the case of Japan, fiscal adjustments made only through spending cuts might have reached their limit, because the deficit is now almost too huge to manage. If this is true, how should the revenue side be arranged? In the next chapter, I would like to suggest the appropriate framework for tax reform in Japan.

CHAPTER 3

PROPOSALS TO FIX JAPAN'S TAX SYSTEM

The Basic Concept and the Tentative Goal

It would be easier if fiscal deficits could be reduced without tax increases. In the case of Japan, however, it seems to me that this will be difficult. The nation's fiscal deficit is too large to be resolved with spending cuts alone. I would now like to examine the latest information about the Japanese fiscal situation: the general account expenditures for FY2006 are expected to be slightly below ¥80 trillion (\$695.6 billion), but tax revenues for FY2006 will be only around ¥46 trillion (\$400 billion). Even though the economy has been recovering, the fiscal gap will still be huge. On the other hand, the tax burden for Japanese people is relatively low when compared with those in other developed countries. It is generally believed that some tax increases will be inevitable, even with strenuous efforts to cut spending.

If such tax increases are unavoidable, I would still like to confirm what the philosophy behind them should be. This is because recent tax reforms in Japan have been little more than small adjustments designed to collect money from sectors that are easy to collect from. In my opinion, taxation in Japan has suffered from two chronic ills: first, the government always collects tax revenues from sectors that are easy to manage, such as company employees; and second, it usually assigns priority to the fiscal balance, rarely to the real economy. These policies are based on the belief that the government should allocate resources and national wealth, but the question is: "Has the government always allocated economic resources in an optimal manner?" The idea that the government can and should control the economy is generally known as socialism. My question is, "Is Japan a country of socialists?"

The following comments are modest suggestions for ways to reverse the priorities of tax reform in Japan. The approaches I would like to put forward are these: 1) priority should be given to entities that can create wealth, because without wealth, Japan cannot distribute wealth to the nation; 2) Japan should be more aware of globalization and marketization, because capital flows easily across borders; and 3) Japan should plan tax systems that take national savings into account because the national savings rate has been declining along with the aging of the population.

In addition, more attention should be paid to the inequality that exists between the older and younger generations. Specifically, I think that the key is not to increase corporate and individual income taxes excessively. The general theory that I would like to present is based on a broadening tax base, a decreasing tax rate, and a reduction in useless tax expenditures. More generally, I think that – in order to cope with its aging society – Japan must move away from income-based taxation and turn to consumption-based taxation.

These changes I have mentioned are already trends in many other tax reform systems. According to the latest OECD survey, the average corporate income tax rate of 30 advanced countries fell from 33.6 percent in 2000 to 29.8 percent in 2004, while the average top personal income tax rate fell from 47.1 percent to 44.0 percent.⁴² Certainly, there is a significant difference between European-type taxation and U.S.-type taxation. In general, European countries depend chiefly on value-added-taxes, while the United States raises federal tax revenues by means of an individual income tax. Still, it has become clear that both the United States and Europe are planning to share a similar set of goals that are to be achieved by lowering income taxes and raising consumption-based taxes.

⁴²OECD (2005).

In this context, attention should also be directed to the November 2005 report of the U.S. President's Advisory Panel on Federal Tax Reform.⁴³ This report recommended two options, both built upon the same assumption of tax revenue neutrality, and the panel said that "the plans share a common goal of providing simple and straightforward ways for Americans to save free of tax and lower the tax burden on productivity-enhancing investment by business."⁴⁴ With regard to their second opinion, entitled the Growth and Investment Tax Plan, the panel said that "it would move our tax system closer to a consumption tax and impose a reduced flat rate tax on capital income received by individuals."⁴⁵

In my view, this concept slightly overlaps the direction of Japan's current tax reform. I will examine this in the last part of this chapter, but first, I would like to discuss the tentative goals of Japan's tax reform.

How Much of a Tax Increase Will Be Needed?

How much of a tax increase will be needed for Japan's fiscal adjustment? And what is that fiscal adjustment? According to this fiscal balance, budgetary expenditures for a given year will be furnished by taxes and other revenues for that year without resorting to new borrowing.⁴⁶ In addition, the benefits that the current generation receives will be covered by their own tax burden. That should be the baseline for fiscal sustainability and generational equality.

Unfortunately, the CAO has estimated that, if it hopes to achieve a primary balance in

⁴³This panel was created by President Bush in January 2005, with instructions to recommend options that would make the tax code *simpler, fairer, and more conducive to economic growth*.

⁴⁴Report of the President's Advisory Panel on Federal Tax Reform (2005).

⁴⁵Report of the President's Advisory Panel.

⁴⁶The Japanese government plans to achieve the primary balance in FY2011. The balance slipped down to approximately 6 percent of the GDP in FY2003, but improved to 3.3 percent in FY2005.

FY2011, Japan's government will have to come up with ¥20 trillion (\$173.9 billion) within five years by means of spending cuts or tax increases. Applying the 1990's U.S. case, in which spending cuts and tax increases were more or less equal, ¥10 trillion (\$86.9 billion) in tax increases would be needed in five years. In my view, this would place a very heavy burden on Japan's economy, because ¥4 trillion (\$34.7 billion, including spending cuts), approximately 0.8 percent of the nominal GDP, would be reduced from the aggregate demand each year.

Concerning this point, I would like to mention the natural increase in tax revenues that tends to accompany economic growth. When I checked the current value of elasticity, which compares the degree to which individual and corporate income tax revenues increase with nominal economic growth, I found that the rate has been increasing with Japan's economic recovery. It is obvious to me that tax revenues are still strongly linked to the nominal economic growth rate. Moreover, it seems to me that that linkage has tightened with the broadening of the tax base. Some private research institutions project that Japan's government will be able to achieve a primary balance before its target date because of naturally increasing tax revenues.⁴⁷ It would, indeed, be better if Japan could avoid heavy tax increases, but it is likely that the nation's government will seek out every chance it can get to raise tax revenues. Below, I examine three major components of Japanese tax revenues.

⁴⁷For instance, Goldman Sachs predicts that Japan can achieve the primary balance in FY2009, two years before the government's official prediction.

The Reform of Major Tax Items

What Is the Real Corporate Tax Rate?

Let me first describe the corporate tax. The Tax Commission of Japan, the nation's official committee for submitting tax reform plans, has reported that the issue of reducing corporate tax rates must be based on a number of factors. These include the economic environment, the relationship between the tax burden level and a desirable concept of the whole tax system; and a tax rate balance with other advanced countries.⁴⁸ In other words, the tax committee has rejected a corporate tax rate cut, which might have been expected to increase economic growth. The Ministry of Finance (MOF) and the tax commission have emphasized that the corporate tax rate of Japan is not nearly as high as those of other advanced countries. Japan's effective corporate tax rate is 39.54 percent (FY2005), and that includes local taxes.⁴⁹ The question remains, however, does the rate on tax codes suggest the actual corporate tax rate? In advanced countries, there are numerous tax deductions for companies that promote investment and employment. If the real tax rate is defined as the real tax burden for companies, another truth may be revealed.

I compared the real tax burden for Japanese companies with that of American companies. In this investigation, I defined the real tax burden as the ratio of total tax to untaxed corporate income. In the case of Toyota, the largest automobile company in Japan, the ratio was 47.3 percent in 2001. On the other hand, in the case of General Motors, one of the Big Three, the corresponding figure was only 14.5 percent from 1996 to 1998. In the case of Panasonic, the

⁴⁸The Tax Commission of Japan (2003).

⁴⁹By way of contrast, the effective corporate tax rate of the United Kingdom is 30 percent, that of France is 33.83 percent, and that of Germany is 38.31 percent.

ratio was 49.5 percent in 2001, while that of General Electric was 8.1 percent.⁵⁰ When I compared corporate tax rates and tax codes, there was almost no difference between Japan and the United States.⁵¹ The effective tax rates of both, including local corporate taxes, were approximately 40 percent. The reason for the difference between the official and the actual tax rates is mainly a tax deduction given to companies to promote investment. In the United States, tax preferences for companies represent a major government policy that supports economic growth. Roger B. Porter, a professor of business and government at Harvard University, says that economic growth and efficiency have been top priorities in tax reform in the United States.⁵² In Japan, however, companies, which have a leading role in economic growth, have been treated less favorably. Almost half their income goes to taxes, but most Japanese people think that this is normal.

For my part, I would like to emphasize, once again, that without wealth, we cannot distribute wealth to the nation. Japan needs to be more aware of the current situation in which companies are able to move across borders easily. Tax burdens are one of the major conditions that can influence a company's decision about where to locate. If prospering and value-added companies begin to disappear from Japan, many people will be out of jobs, and the MOF will lose not only corporate, but also personal income, taxes. It is necessary for companies to pay a certain amount of taxes, but, in my opinion, the government of Japan should not increase corporate taxes. It would seem to me that it would be better to decrease the tax rate from 40 to 35

⁵⁰These results are calculated by the respective statements of income. It is necessary to note that these tax burdens include not only corporate taxes, but other taxes, such as property taxes.

⁵¹In the United States, corporate taxes, including local taxes, vary widely from state to state. It is generally known that the rate in California is approximately 40.75 percent.

⁵²Comments at his course "The Business-Government Relationship in the United States" 13 October 2005. He also pointed out the importance of equity, simplicity, flexibility, and enforceability.

percent than to keep it stationary. Japan has to be more aware of taxation in other East Asian countries, especially China. These countries are all competitors of Japan, and their corporate tax rates are considerably lower.⁵³ China, in particular, has a special corporate tax rate of 15 percent for foreign companies, which is far below the corporate tax rate of Japan.

There is another reason why I recommend a decrease in the tax rate, not increased tax deductions for companies. In Japan, only about a third of all companies pay corporate income taxes. Thus, it would seem to me that there are many companies that use special tax deductions to avoid paying their taxes. We call these deductions tax expenditures or tax subsidies. Even in Japan's corporate tax code, tax deductions amounted to ¥1.8 trillion (\$15.6 billion), or approximately 20 percent of the total corporate income tax revenue, in FY2003. There is a similar problem in the U.S. tax code, where there are almost 40 kinds of tax preferences for corporate investments, and the marginal effective tax rates on the capital income of corporations vary by asset types. The rate for computers, for example, is 36.9 percent, while that for petroleum is only 9.2 percent.⁵⁴ Particular attention should be paid to the opinion of the Panel on U.S. Federal Tax Reform, which has recommended a more dramatic approach to business investment. That option would replace the depreciation allowance system with one that combines complete expensing of business investment, while abolishing all current tax deductions. Furthermore, this option includes a corporate income tax rate cut from the current 35 percent to 30-31.5 percent. If it included local taxes, that level would be lower than Japan's.

⁵³The corporate tax rates (excluding local taxes) of South Korea and Taiwan are 25 percent; in Hong Kong, it is only 17.5 percent.

⁵⁴Report of the President's Advisory Panel . The effective tax rates represent a combination of statutory tax rates and other features of the tax system, such as the depreciation schedule for assets. The higher the rate, the more likely it is that the tax system will discourage investment.

There has been a remarkable study done on this complicated issue by Prof. Mihir A. Desai of the Harvard Business School. In his report, compiled with the assistance of two other distinguished scholars, he analyzes the interaction between corporate taxes and corporate governance and demonstrates that stronger tax enforcement can reduce stratagems for tax cheating. He also claims that this could raise the stock market value of a company despite the increase in the tax burden.⁵⁵ From my point of view, this research justifies the abolishment of archaic tax deductions in favor of a decrease in corporate income tax rates. In addition, from a macro statistic point of view, there are now fewer advanced countries that depend on corporate income taxes in their revenues, because this would create a double taxation problem.⁵⁶ To conclude this section, I would say that the best kind of corporate tax reform for aging societies would be to decrease tax rates, while broadening the tax base.

What Constitutes Real Inequality in Individual Income Taxes?

At this point, I would like to analyze individual income taxes in Japan. The government's revenue from such levies is its principal source of income, approximately ¥14 trillion (\$121.7 billion) per fiscal year. According to the MOF, the ratio of individual income tax to national income in Japan has remained very low (6.1 percent in FY2003) when it is compared to the double-digit levels of other advanced countries. The majority of Japanese taxpayers belong to the lowest tax bracket, which is a unique situation among advanced countries.⁵⁷ The MOF claims

⁵⁵Mihir A. Desai et al. (2004).

⁵⁶Corporate earnings are taxed once at the corporate level and again at the individual level when the earnings are distributed as dividends or realized from the sale of stocks. Desai points out that the tax bias against using the corporate form is clearly demonstrated by the rapid growth in business entities not subject to the corporate income tax, such as LLCs and S corporations, which provide legal benefits of limited liability, but are taxed only once on the individual owner's tax returns (at his course "Public Sector Economics" 24 February 2006).

⁵⁷The Tax Commission of Japan (2003).

that this is mainly the result of repeated tax cuts, such as personal exemption expansions, tax rate cuts, and tax bracket enlargements. Moreover, the ministry points out that it is necessary to make efforts to restore the original function of the individual income tax as a means of raising revenues and redistributing income.

I agree that there are some tax distortions in the individual income tax system. As a result, a good deal of individual income is excluded from the tax base, and that imposes an unequal burden on other incomes. It also creates inequality among taxpayers. Take, for example, public pension deductions. In Japan, they are applied to all pensions received by elderly people regardless of whether those people have other sources of revenue or not. Burden imbalances exist not only between and among, but also within, generations, e.g., the older generation. I would think that these kinds of deductions should be decreased. The desirable structure of burden-sharing for individual income taxes in the future should be to allocate the burden broadly and fairly.

Nonetheless, I would like to repeat my contention that, without wealth, we cannot distribute wealth to the nation. We have to ask ourselves, who are the people who are earning money? Needless to say, they are the working generations and, in establishing a new burden structure, inter-generational fairness must be secured. Heavier burdens must not be placed on the working generations.

Let me analyze the real inequality in Japan's individual income tax using statistics reported by the National Tax Agency of Japan.⁵⁸ First, I will examine the relationship between the numbers of wage earners and the individual income tax revenues that they paid. The number of wage earners who received more than ¥8 million (\$69,500) as a salary in 2004 was 4.4 million

⁵⁸National Tax Agency of Japan (2004).

(10 percent of the total). The individual income taxes they paid in that year, however, amounted to ¥4.6 trillion (\$40 billion, 52.8 percent of the total). This indicates that only 10 percent of wage earners pay more than half of all personal income tax. Specifically, the wage earners who earned ¥8 million to ¥10 million (\$86,900) in 2004 represented only 5.1 percent of the total, but the individual income taxes they paid were 11.9 percent of the total. In the case of those who earned from ¥10 million to ¥15 million (\$130,400), only 3.7 percent of all taxpayers paid 17.0 percent of the total taxes (see Figure 2.).

Certainly, according to the principle of capability, it is natural for a person who earns more money to pay more taxes. That is generally the reason why the individual income tax rate has a progressive structure. Considering the data, however, the burden of individual income taxes is over-weighted on the middle-class, which is largely comprised of fathers and mothers who are struggling to take care of their children and aging parents. These are the people whose tax burdens should be eased.

Next, I would like to compare Japan's individual income tax with that of the United States. In the United States, the federal income tax paid by the upper 20 percent of wage earners in 2005 was 64.3 percent of the country's total income taxes (see Table 2).⁵⁹ In the case of Japan, the proportion was approximately 66.8 percent. These data show that Japan still has a more progressive individual income tax structure than the United States.

Nonetheless, there are people who claim that Japan's individual income taxes should be more progressive because income inequality has broadened. Even though this is true, when compared with other advanced countries, Japan is still the most equal society in terms of income. The income of the highest 20 percent of wage earners in Japan is 35.7 percent of the total, and

⁵⁹Congressional Budget Office (2005).

that of the lowest 20 percent is 10.6 percent. In the United States, the highest 20 percent earn 45.8 percent of the total, while the lowest 20 percent earn only 5.4 percent. In the case of China, the figures are 50 percent and 4.7 percent, respectively (see Table 3).⁶⁰ It is reasonable that the United States relies mainly on progressive individual income taxes to distribute income. This is because before taxes, there is a distinct income inequality.

On the other hand, Japan has greater income equality before taxes. The individual income tax reforms that should be considered for an aging society would ease the burden placed on working generations who are also taking care of their children and elderly parents. A more progressive tax structure is not needed. For that reason, it seems to me that it would be appropriate to create a new tax deduction that focuses on children instead of abolishing old-fashioned deductions like that for housewives. In any discussion of such a change, the possibility of making the deduction framework into a tax credit instead of an income deduction could be examined. This is because, in general, a tax credit would provide a greater incentive than would a deduction.

In conclusion, the most significant issue I have noted in this section is that low wage earners in Japan pay little or no income tax despite what they may say. That is one reason why the tax burden is over-weighted on the so-called middle class. In an aging society with a declining fertility rate, it is necessary to support a system in which such public burdens as social security, etc. are fairly shared. The situation I have described, however, demonstrates the political difficulty of increasing revenues by means of individual income taxes. A tax increase at a lower income level would entail a political conflict. I would agree to a moderate income tax

⁶⁰These data were cited by Prof. Gregory Mankiw, Harvard University, in his lecture “Rich and Poor: The Income Distribution and Public Policy,” 14 December 2005.

increase so long as it did not impose a greater burden on the middle class, but there should be another alternative.

When and by How Much Can the Level of Consumption Tax Be Raised?

The last principal revenue that remains is the consumption tax (Japanese value-added tax, VAT). Since its introduction in 1989, this levy has played an important role in terms of the fair sharing of the cost burden for public services, especially social security. During the last decade, the consumption tax seems to have become accepted as one of the fundamental taxes in Japan. It possesses the following three main features: 1) its tax sources have been stable and account for approximately 20 percent of the nation's tax revenues; and 2) it has distributed the burden of public services evenly among all generations; but 3) it is a regressive tax that places a heavier burden on the poor.

I think that fairness and equality among generations will be more important considerations when Japan's tax system is reformed. From my point of view, if it is necessary, the consumption tax is an optimal resource for raising revenues to address the issue of our nation's aging society. As I have said above, there is an inequality between the older generations and future generations in terms of their net-benefits and burdens. It seems to me that the elderly should share a certain amount of the burden.

Furthermore, economists tend to agree that a consumption-based tax is an optimal resource for long-term economic growth, even though it has enormous power to raise revenues.⁶¹ Dr. Lawrence Summers, former president of Harvard University and former U.S. secretary of the treasury, demonstrated the effect of raising the consumption tax rate by using long-term

⁶¹Ihori (2001).

simulations.⁶² According to his research, raising the consumption tax rate would be the most effective way to save money; using that system, capital accumulation would lead to increased economic growth. BU's Kotlikoff and Sabine Jokisch from the Centre for European Economic Research (ZEW) have also shown that The Fair Tax, a consumption-based tax they propose, would offer a real opportunity to improve the U.S. economy's performance and welfare.⁶³ According to their simulated model, the policy change to adopt The Fair Tax would almost double U.S. capital stock by the end of the century and raise long-term real wages by 19 percent more than the base case alternative. They claim that, once one moves beyond the baby boomer generation, there will be positive welfare gains for all income groups.

It was, indeed, remarkable that the U.S. President's Advisory Panel on Federal Tax Reform should put forward a proposal to adopt a VAT that would replace portions of both the individual and corporate income taxes. In the end, however, the panel could not reach a consensus on the changes to be made.⁶⁴ Nonetheless, they did say that consumption taxes would have a more positive effect on economic growth than would income taxes, and a broad-based VAT applied at a single rate would be economically efficient because it would not distort consumer choices of goods and services, discourage savings, or distort the allocation of capital. In addition, they claimed that reducing the corporate income tax rate by adopting a VAT would improve incentives for capital investment in the United States by U.S. residents and foreigners alike. It is obvious that the trends I have mentioned above are now a part of new tax reform

⁶²Summers 1981.

⁶³Kotlikoff and Jokisch (2005). Their "The Fair Tax" proposes to replace the federal payroll tax, personal income tax, corporate income tax, and estate tax with a progressive consumption tax delivered in the form of a federal retail tax plus a rebate.

⁶⁴Report of the President's Advisory Panel. The panel mentioned that it viewed a "partial replacement VAT as an option worthy of further discussion."

systems. In other words, it has been necessary for advanced countries to rely more on consumption-based taxes than on individual and corporate income taxes; raising the level of the consumption tax, however, is a controversial political issue and one that reflects the regressive nature of the consumption tax.

There have been some remarkable studies done on this complicated issue. Dr. Junko Kato of Tokyo University analyzed past tax reforms by OECD countries and found that, in any shift to regressive taxes, there was differentiation in the tax structure.⁶⁵ Kato's conclusions can be summarized as follows:

1) Typical welfare states, such as Sweden, Denmark, and Finland, rely more heavily on individual income taxes (and less on corporate taxes), as well as on an extensive use of general consumption taxes. Most of these countries introduced consumption taxes (VATs) at or before the beginning of the 1970's.

2) The countries that introduced these taxes before the rapid postwar economic growth ended in a worldwide recession (in the early 1970's) were more likely to continue expanding and/or maintaining social security expenditures.

3) On the other hand, the countries that institutionalized their consumption taxes after the early 1970's leaned toward less spending and welfare retrenchment because their budget deficits frequently aroused public suspicion about tax increases that were designed exclusively to eliminate fiscal deficits.

4) Japan was a country in which a revenue reliance shift was attempted and consumption taxes were introduced after the country had begun to experience fiscal deficits. That was the main reason why the government of Japan encountered strong public opposition to this action and why tax rates remained relatively low.

⁶⁵Junko Kato (2003).

Kato concluded that Japan made a typical, but serious, mistake when it introduced VATs. She also predicted that it would now be politically very difficult for the nation to raise the level of its consumption taxes. At the same time, she cited New Zealand, the only country that had succeeded in introducing a higher VAT following a period of rapid economic growth, and suggested that the same approach might be the only way in which Japan could progress to a similar state of deregulation and ease the public's distrust of the government.⁶⁶

In my opinion, Japan is in better shape than the United States because it has already adopted a VAT system. In the case of the United States, it would be difficult, in the presence of state sales taxes, to adjust the tax structure to accommodate a federal VAT.⁶⁷ The problem that Japan is facing is when and to what degree the level of consumption taxes can be raised.

First, with regard to the level, I believe that it would be appropriate to raise the rate from the current 5 percent to 7.5 percent.⁶⁸ This is because a 1 percent increase in the Japanese consumption tax could raise approximately ¥2.5 trillion (\$21.7 billion) in revenues, i.e., 0.5 percent of its GDP. Looking back on the U.S. experience in the 1990's, it would seem difficult to raise the equivalent of more than 1 percent of the GDP from aggregate demand at one time. Particular attention should be paid to the fact that spending cuts and the natural increase of tax revenues will also restrain private demand. In the case of the United States, the 1993 tax increases were equivalent to approximately 0.4 percent of its GDP. In my view, that level is appropriate both economically and politically.

⁶⁶Shinichi Kitaoka and Aiji Tanaka (2005) 40-42.

⁶⁷Prof. Oliver Oldman, Harvard Law School, a co-author of *The Value-Added Tax: A Comparative Approach in Theory and Practice*, suggested this point in his reading group in February 2006.

⁶⁸In Japan's current tax system, the consumption tax rate consists of the national consumption tax (4 percent) and the local consumption tax (1 percent). It is now a legal rule that the local consumption tax rate should be a quarter of the national consumption tax. The rate, 7.5 percent, that I describe means the 6 percent in national tax and 1.5 percent in local tax. There have been major discussions about the proportion between national taxes and local taxes.

Secondly, when and how? Even at 2.5 percent, raising the rate of the consumption tax would constrain Japan's economy and have serious political consequences. On the other hand, the result of lowering individual taxes instead of raising the consumption tax would be worse. If Japan adopted an individual tax cut, especially for lower incomes, it would be quite difficult to recover that in the future. As a result, it would seem to be better for Japan's government to broaden the individual tax base earlier on and increase the consumption tax at a later time.

Finally, in terms of a regressive approach, I would like to add two options. First, it might be necessary to add a new highest tax bracket to the individual income tax structure to lessen the opposition from people with lower incomes. This is the same political strategy that was applied in the United States with its 1993 federal tax increase. Second, it may also be necessary to provide a tax rebate for people with lower incomes. At present, however, these options are still open to political discussion. It would be better not to adopt them if not absolutely necessary.

Development of Dual Income Taxation

In concluding this chapter, I would like to suggest some implications for future tax reforms both in Japan and in the United States. As I have said, aging societies need to move away from income-based taxation and turn to consumption-based taxation. Theoretically, this means that priority should be given to the theory of an expenditure tax, as established by the British economist, N. Kaldor, and not to the more traditional comprehensive taxation of incomes. Although Japan's post-war taxation system initially favored the comprehensive taxation of incomes, Japan has since introduced separate taxation on a variety of incomes, in particular, financial incomes. In the United States, the President's Advisory Panel on Federal Tax Reform has also proposed separate taxation of dividends and interest incomes. In my view, that proposal

represents a remarkable departure for pro-growth taxation. These trends would suggest that both Japan and the United States are seeking new tax arrangements, like “dual income taxation,” in which individual incomes are categorized and separated into earnings from work and earnings or incomes from financial assets. Under this system, all financial incomes are taxed at the same rate.

It is clear that easing the tax rate and adopting the adjustment of profits and losses in this separated income category will lead not only to the capital accumulation needed for economic growth, but also to greater individual wealth in the form of dividends and capital gains. It seems to me that these benefits could offset some of the burden of a tax increase in the form of consumption taxes.

CONCLUSION

Current Japanese demographic changes demonstrate that increasing productivity is necessary not only for Japan, but also for most advanced countries to balance threefold targets – economic growth, fiscal adjustment, and equality among generations. For that, previous successful efforts indicate that both Japan and the United States will have to make some tough choices, e.g., increasing consumption taxes and abolishing income tax deductions, and that these choices will be regressive. At the same time, however, the U.S. experience in the 1990's also implies that we can reach our goals by taming financial markets and the political distrust of the government, even if tax increases are unavoidable. It seems to me that shifting to a consumption-based and a dual income tax would yield significant dividends and help the two governments to cope with their aging societies.

Specifically, a comparative analysis of the Japanese tax system compels us to reevaluate our understanding of inequality, efficiency, and income redistribution, and how they interrelate. On the one hand, it is obvious that Japan must develop a strong and efficient pro-growth policy with efficiency and explore the ways in which the nation can increase its standard of living with fewer resources. On the other hand, it is true that there are many invisible vested interests that are the result of wily corporations, the dependent poor, and, perhaps, government officials. Ironically enough, thinking in terms of numbers, it will be more difficult to rein in such vested interests and to balance the inequality among generations as the number of the elderly increases. Hence, for the coming generations, we must build a strong pro-growth consensus. More generally, this paper has shown that consistent and humble political leadership, with a watchful eye on the economy, will be needed to increase the public welfare.

Table 1
The Aging World and Future Population Declines

Country or Area	2000	2025	2050	% 60+ in 2050
Japan	127.1	123.8	109.2	42.3
United States	283.2	346.8	397.1	26.9
Europe	727.3	683.5	603.3	36.6
France	59.2	62.7	61.8	32.7
Germany	82	78.9	70.8	38.1
Italy	57.5	52.4	43	42.3
Russia	145.5	125.7	104.3	37.2
China	1275.1	1470.8	1462.1	29.9

Source: United Nations, *World Population Aging: 1950-2050* (2002)

Notes: The peak period is in bold type; population figures are in millions.

Table 2
The Distribution of U.S. Federal Taxes

Quintile	Taxes as a Percent of Income	Percent of All Income	Percent of All Taxes
Lowest	5.5	4.2	1.1
Second	12.0	9.2	5.1
Middle	15.6	14.2	10.3
Fourth	19.6	20.7	19.0
Highest	26.3	52.4	64.3
Top 1 percent	31.1	14.8	21.5

Source: Congressional Budget Office, Estimates for 2005

Table 3

Inequality Around the World (Income Distribution Before Taxes)

Country	Lowest 20 percent	Highest 20 percent
Japan	10.6	35.7
Germany	8.5	36.9
India	8.9	41.6
Canada	7.0	40.4
United Kingdom	6.1	44.0
United States	5.4	45.8
China	4.7	50.0

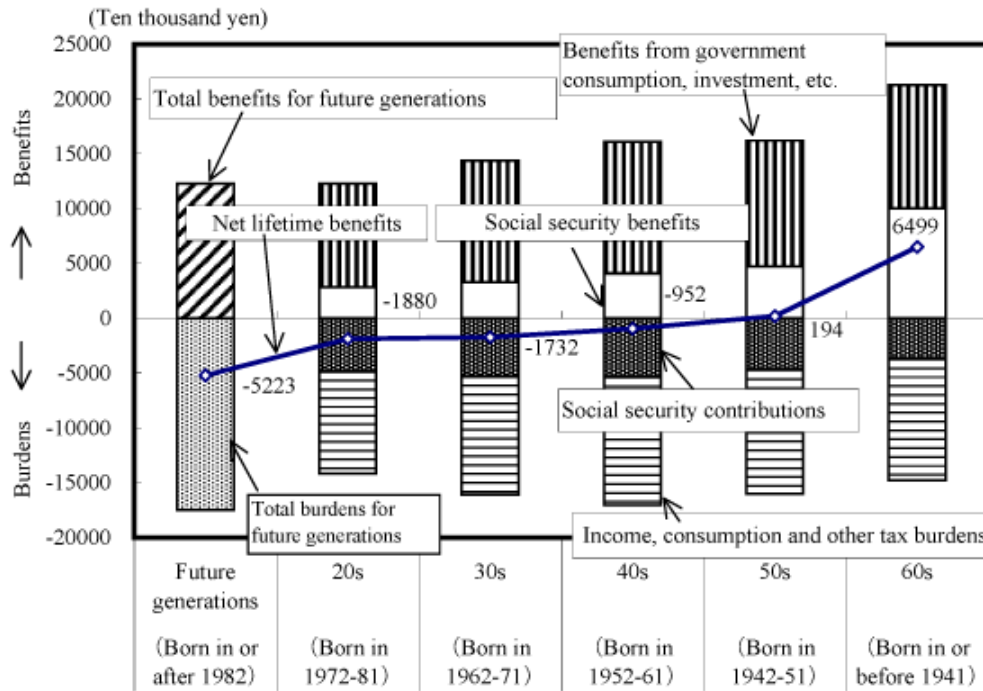
Source: Lecture Handout of Prof. N. Gregory Mankiw (December 14, 2005)

Figure 1

Lifetime Benefits and Burdens in Japan

Figure 3-3-5 Lifetime benefits and burdens

Future generations have substantial net burdens

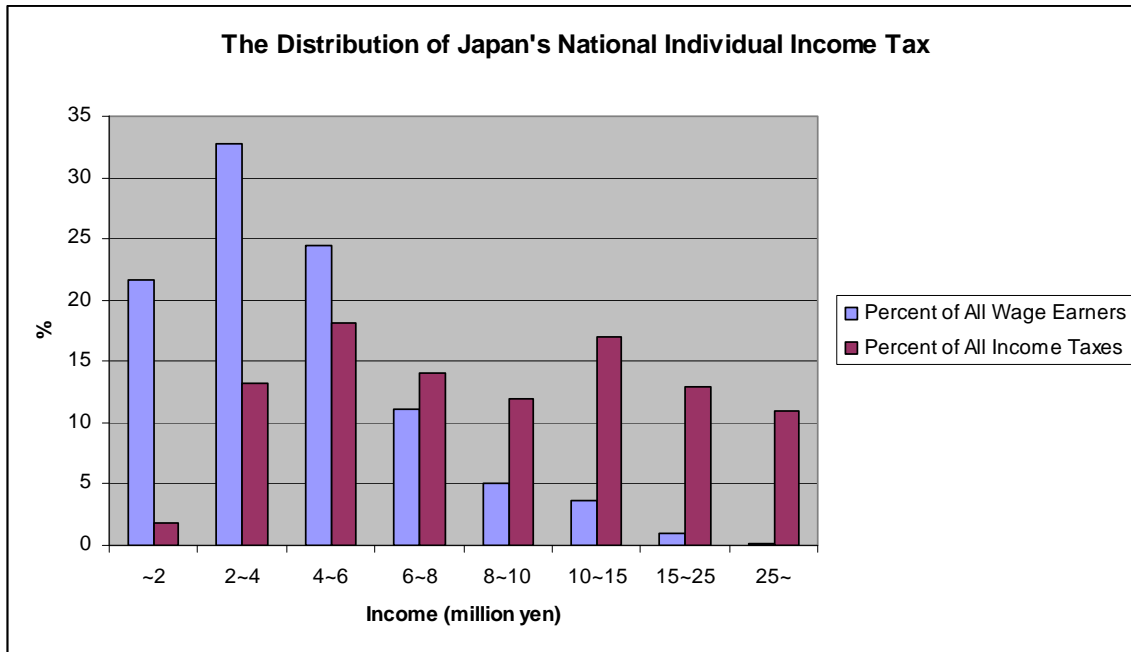


Sources: *National Accounts*, Cabinet Office; *Family Income and Expenditure Survey*, *National Survey of Family Income and Expenditure*, *Population Census*, Ministry of Public Management, Home Affairs, Posts and Telecommunications; etc.

Note: Net lifetime benefits (total lifetime benefits - total lifetime burdens) are calculated for one household in each generation.

Source: Cabinet Office, Government of Japan, *Annual Report on the Japanese Economy and Public Finance 2002-03* (2003)

Figure 2



Source: The National Tax Agency Japan, *Statistical Survey of Actual Status for Salary in the Private Sector* (2004)

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