

## **Social Security, Taxation, and Public Finance Program**

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The public debt-to-GDP ratio of Japan is at a very high level, rarely seen in other parts of the world, which is gradually increasing the risk of a rise in interest rates due to higher risk premiums demanded in the financial markets. The Great East Japan Earthquake and the serious accident at the Fukushima Daiichi Nuclear Power Plant are negative factors for Japan's already tough fiscal condition. The shrinking economy will decrease tax revenue, while the increased fiscal spending for the reconstruction of the social capital damaged by the earthquake and tsunami, the implementation of programs to support the disaster victims, and compensation for the losses associated with the radiation contamination, etc. will significantly increase the fiscal deficit. According to the estimate announced by the Cabinet Office on March 23, total losses in social capital, housing, and private-sector companies' facilities from the earthquake disaster are expected to be between 16-25 trillion yen. Thus, a huge additional fiscal burden, as a result of increased spending and decreased tax revenue, is expected to be inevitable in the coming reconstruction period. Furthermore, in addition to the appreciation of the yen, the sovereign debt crises of Greece and others with the resulting significant rise in government bond interest rates in the eurozone will affect Japan in two ways. First, the European economy might enter into a serious recession with the worsening crisis, which would negatively and significantly affect Japan's exports, both directly and indirectly. Second, the sovereign crisis of the European nations with lower public debt-to-GDP ratios than Japan might make the market participants recognize anew the seriousness of Japan's fiscal problem, possibly triggering the rise in Japanese government bond interest rates.

Hence, Japan will also be required to increase government revenue through tax increases, etc. and to restrain government spending by reviewing the overall social security system. It is, however, facing a difficult issue in that if the fiscal tightening leads to a recession, it would make fiscal restoration itself difficult. Greece, in fact, is facing the dilemma that severe fiscal tightening and its unstable financial system have led to a significantly negative GDP growth rate, making fiscal restoration difficult. While it is very challenging to realize the three goals of resurgence from the earthquake disaster, economic recovery, and fiscal restoration, this program will examine and consider policy to manage realization of fiscal restoration while minimizing its negative effects on economic recovery.

The overall program will be designed around the following research projects:

- To map out fiscal crisis scenarios and their possible negative impacts that may occur in Japan by comparing Japan with nations that have faced fiscal crises;
- To estimate Japan's potential growth rate based on demographic estimates and expected capital stock and prepare a realistic forecast of government revenues;
- To analyze empirically the relationship between Japan's deflation rate and labor and capital utilization rates and clarify why deflation is continuing. Also to explain what would be the problems if deflation is left unsolved;
- To study and propose policy measures that would recover sustainable fiscal balance in the long term, while avoiding economic slowdown;

- To review the problems of the current taxation and social security systems and propose fundamental reform of these systems, going beyond the conventional tax reform to address both social insurance premium and social security entitlement issues.

While we will make specific policy proposals as we make progress in our research, feasible policy measures include the following:

- (1) Phased raising of the consumption tax, combined with the abolition of the flat-sum premium of the National Pension System and the decrease in the premium rates of the Welfare Pension Insurance withheld at source from employment income; and
- (2) Phased introduction of a carbon tax combined with efficiency-focused investment subsidies for measures against global warming.

The above policy proposals assume a phased increase of indirect taxes which, by artificially raising prices, would encourage accelerated spending through inter-temporal consumption substitution. They also take into consideration the effect that the improvement in financial backing for social security will have on stimulating consumption, namely, by recovering people's trust in the public pension system. On the other hand, the abolishment of the highly regressive, flat-sum social security premium would offset the increased burden on low-income earners due to the consumption tax raise. Also, the decrease in the rates of pension and other social security insurance premiums withheld at the income source is expected to encourage employment of full-time workers by decreasing taxation associated with employment.

In the project which I will be directly involved as a faculty fellow, we will estimate a macro production function in order to estimate the total factor productivity (TFP) growth rate. With this function, we can estimate the potential growth rate of Japan. By breaking down the growth rate into contributions from labor, capital, and TFP, we can better understand the causes that led to the long-term stagnation of the Japanese economy. We will also estimate the positive effects of increased employment brought about by a lower social security tax rate and increased investment resulting from investment subsidies generated by carbon-tax revenues.