What needs to be done of personal income tax of Japan? A perspective for reform under deflation and aging population*

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Abstract

The purpose of this paper is to study the problems and reforms of personal income tax in consideration of the current status of the economy, fiscal position and social security of Japan remaining under prolonged deflation since the collapse of asset bubbles. One prominent feature of the Japanese economy in deflation is that while companies have continued to secure profits, employee income has kept on dropping due to wage cuts and a shift in employment arrangements from regular employment to non-regular employment. As a result, a vicious circle of slumping domestic demand escalating deflation has arisen. In the meantime, the government has supported the Japanese economy through fiscal expansion. Fiscal expansion has shifted from public investment to social security expenditures, so the growth in social security expenditures has continued unchecked amid the ongoing aging of society.

Under these circumstances, the generational gap in the tax and social security burdens has been expanding. This paper paid attention to the current situation where the social insurance payments burden has become heavier than the tax burden for younger people with low income. As a reform measure to correct this problem, the paper first called for integrating tax and social security premium burdens into a widely defined income tax burden and for introducing tax credits to lessen the social insurance premium burden that cannot be mitigated through income deduction. Second, the paper argues that in order to finance the tax credit, it is necessary to require people with high income to bear a heavier burden than now by cutting income tax deductions and expanding the tax base, instead of raising the top marginal tax rate, which is currently 55%, including national and local taxes.

Third, the paper argues that it is necessary to reform the deductions for social-insurance premiums and public pension. Taking into consideration the feasibility of the reform, the paper argues that it is urgent to abolish the public pension deduction (for calculating income for taxation) for correcting the present inequality of burden among generations and reducing the tax burden on elderly low-income earners.

Keywords: deflationary economy, personal income tax, social insurance premiums, tax credit, public pension deduction
JEL Classification: H24, H61, H62

I. Introduction

Since the collapse of asset bubbles, the Japanese economy has remained in deflation, with economic globalization making progress against the backdrop of the yen's appreciation. Japanese companies' strategies under deflation have included cost reduction for securing profit. In cost cutting efforts, they have first implemented employment adjustment and wage cuts. In the adjustment, regular employees for whom employers pay high fixed costs including social insurance premiums have been replaced by non-regular employees, leading to more unstableemployment. At the same time, domestic labor has been replaced by overseas labor amid companies' overseas expansion, increasing downward pressure on wages.

Such situation has been prolonged under deflation. Stagnating wages have led domestic demand to shrink, prompting companies to further cut wages to secure profit. Ironically, however, people in the deflationary economy have felt rather comfortable. For aged people whose pension and assets can keeptheir real value in the absence of price hikes, deflation means a fall in their costs of living and is not necessarily bad. Amid protracted deflation, companies have found ways to secure profit, while unable to continue their dependence on cost cuts forever. Most seriously affected by deflation are working people, particularly young workers. The decline in costs of livinghas managed to support the livelihood of young workers.

In this way, deflation amounts to hypothermia of the Japanese economy. The economy in prolonged deflation gets used to deflation, loses its vitality and has growing difficulties in recovering the vitality. Overcoming deflation is turning out to be a top priority for Japan. The Bank of Japan's "bold monetary easing" to set a target of a 2% hike in consumer prices and continue buying public bonds until the achievement of the target has been devised as part of an emergency economic policy. In addition to the so-called quantitative easing, the Bank of Japan has imposed a negative interest rate on financial institutions' deposits at the central bank in a bid to promote their outflow into the market. Quantitative monetary easing and negative interest rates can be expected to induce industrial and residential investment and eventually correct the yen's appreciation to stimulate export-oriented demand. However, monetary policy is nothing more than a means to guide the real economy. In the face of the stagnant world economy, it is difficult to place great hopes on the effect of monetary policy.

What are problems in Japan's tax system in the deflationary economy? How should the tax system be reformed to addressthe problems? From the viewpoint of overcoming hypothermia, the corporation tax should be called into question and reduced. Instead of cutting the corporation tax unilaterally, however, the government must secure adequate tax on income from overseas expansion.

As for the personal income tax, however, the problem is that the burden of social insurance premiums on wages stagnating under protracted deflation is growing in line with the aging of population. Japan must prevent tax and social security systems from leading deflation to further deepen. While reforming the social security system and securing financial resources, the government must boldly lower the burden on working people, particularly young low-

income workers. The key here is integrating tax and social security premium burdens. Another problem is that consumption tax revenues are earmarked for pension, healthcare, long-termlong-term care and child care. If it is impossible for consumption tax revenues alone to cover the four growing expenditures, the social security system may have to be reformed to meet the limited tax sources.

This paper takes up personal income tax based on the reform of redistribution policy. The reform has been required because the social security burden on working people including low-income workers has increased due to the aging population while wages have remained stagnant under prolonged deflation, as described above. This paper seeks to illustrate the personal income tax problems and provide the ways for reform. Personal income tax here covers the national income tax and the local individual inhabitant tax.

In the following, the paper first discusses the history and present situation of Japan's economy and fiscal position after the collapse of asset bubbles. Since the collapse, fiscal spending has played a great role in supporting the economy. However, fiscal conditions have deteriorated, with public debt being two times as much as Japan's gross domestic product. The paper indicates that fiscal expansion since the collapse of asset bubbles has made a transition from public investment in the form of local government expenditure expansion to transferable spending to cover the burden on social security beneficiaries. Second, the paper clarifies the realities of public expenditures on social security and a mechanism for the expenditure's growth. The paper indicates the problem is that the government has been committed to to paying a certain share of social security benefits and continued to do so, instead of using public expenditures only to cover shortages in financial resources for social security benefits.

The third issue represents personal income tax problems based on the above. While the social insurance premium burden as financial resources supporting social security has already increased, it is difficult for the government to continue depending on deficit-financing government bonds for covering public expenditures on social security. Social insurance premiums must cover social security benefits. It is important to simultaneously think about personal tax and social insurance premium burdens. Particularly, the problem is that the social insurance premium burden growing on the aging population has shifted to young low-income workers whose wages have remained stagnant in the deflationary economy. The paper clarifies the realities of the personal income tax and social insurance premium burdens and discusses the need and way to reduce the burdens on young low-income workers.

II. Fiscal Problems

II-1. Economic growth and distribution

The above argued that wages fail to grow while companies attempt to secure profit amid deepening deflation. Here, the Cabinet Office's final National Accounts for FY2013 (flow), known as Japan's GDP statistics, is used to review the realities of the economy. It must be

Figure 1-1 Annual changes in nominal and real GDP (%)

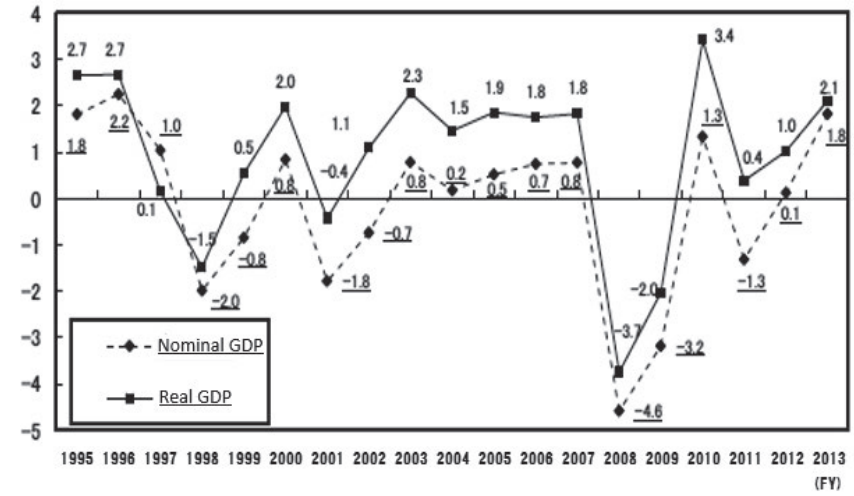
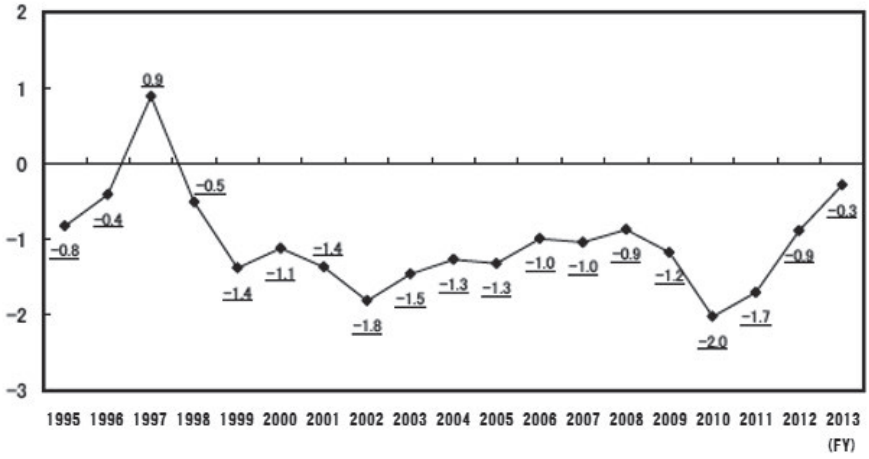


Figure 1-2 Annual GDP deflator changes (%)



(Source) Department of National Accounts, Economic and Social Research Institute, Cabinet Office, "National Accounts for FY2013 (Flow), Points" December 25, 2014

noted that the latest final data available at present are for FY2013. Data for FY2014 are preliminary. From FY2013 to FY2014, nominal GDP grew 1.6%. On a real basis, however, GDP shrank 0.9%. Figure 1-1 indicates Japan's annual nominal and real GDP changes, or growth rates. In all the years listed in the figure, excluding FY1995-97, nominal growth rates slipped below real growth rates. Their gap represents the GDP deflator, a price index for GDP. As shown in Figure 1-2, the GDP deflator was negative in all the years other than FY1997, indicating the Japanese economy remained in deflation in the years. The GDP deflator came to a positive 2.5% for FY2014 due to an increase of the consumption tax rate from 5% to 8% in April 2014, meaning that deflation did not necessarily ended in the year.

Table 1-1 National income and its breakdown

In trillions of yen

	National income	Compensation of employees	Property income	Entrepreneurial income	
				Total	Private corporations
FY1995	370.8	270.2	36.5	64.1	34.6
FY2000	375.2	269.2	24.5	81.5	45.0
FY2005	374.1	254.1	24.4	95.6	53.6
FY2006	378.2	255.7	28.4	94.1	52.8
FY2007	381.2	255.6	27.6	98.0	57.8
FY2008	355.0	254.3	23.1	77.1	40.1
FY2009	344.4	243.0	21.5	79.9	42.2
FY2010	352.7	244.0	20.2	88.6	49.9
FY2011	349.6	245.6	20.7	83.3	45.7
FY2012	352.0	245.9	21.5	84.6	46.6
FY2013	362.1	248.3	23.1	90.7	51.9

Table 1-2 National income shares for compensation of employees (labor share), property income and entrepreneurial income (%)

	Compensation of employees (Labor share)	Property income	Entrepreneurial income	
			Total	Private corporations
FY1995	72.9	9.8	17.3	9.3
FY2000	71.7	6.5	21.7	12.0
FY2005	67.9	6.5	25.6	14.3
FY2006	67.6	7.5	24.9	14.0
FY2007	67.1	7.2	25.7	15.2
FY2008	71.6	6.5	21.7	11.3
FY2009	70.6	6.2	23.2	12.3
FY2010	69.2	5.7	25.1	14.1
FY2011	70.3	5.9	23.8	13.1
FY2012	69.9	6.1	24.0	13.2
FY2013	68.6	6.4	25.0	14.3

(Source) Same as for Figure 1

What was workers' and companies' income under deflation? Table 1-1 shows the trend and breakdown of national income, or distributive income determined by subtracting indirect tax and depreciation cost from GDP. Over about 20 years from FY1995, nominal national income decreased from 370.8 trillion yen to 362.1 trillion yen in FY2013. Compensation of employees, which represents what is referred to as wages in this paper, decreased 22 trillion yen from 270.2 trillion yen to 248.3 trillion yen over the period. Property income also declined, reflecting low interest rates. In contrast, entrepreneurial income increased sharply on a total basis and on a private corporation basis. Private corporations' income expanded from 34.6 trillion yen in FY1995 to 51.9 trillion yen in FY2013. While overall national

income declined, entrepreneurial income increased faster than wages declined.

Table 1-2 shows each income category's share of national income, representing a distribution rate. The so-called labor share is the proportion of employees'compensation to national income. Over the period from FY1995 to FY2013 subject to the analysis, the labor share dropped from 72.9% to 68.6% while the entrepreneurial income share rose substantially from 17.3% to 25.0%. These data represent the true face of the deflationary economy.

II-2. Financial surplus or deficit for households, enterprises and government

While compensation of employees accounted for most of household income declined, entrepreneurial income increased, as noted above. Let us turn to the demand side changes to search causes for deflation. Here, a financial surplus or deficit position is checked for the household, corporation and government sectors to find causes for GDP stagnation. If households save consumption and increase savings to protect their livelihood, their financial surplus (lending) increases to lower GDP growth.

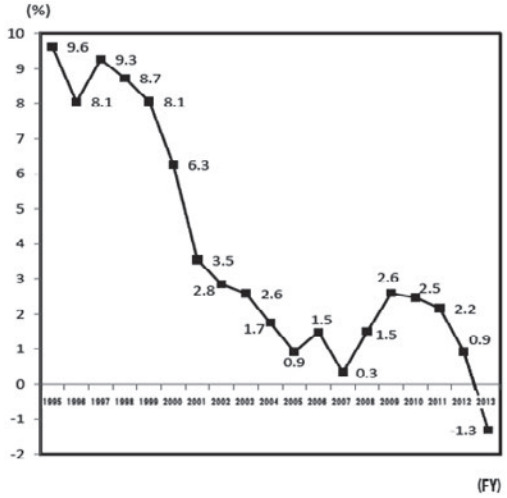
Figure 2 shows the household savings rate. Over the period from FY1995 to FY2013 subject to the analysis, the rate declined substantially. The household savings rate fell sharply after increasing for several years from FY2008, the year that saw the Lehman Shock. The substantial decline is apparently attributable to an income drop and a rise in the propensity to consume amid expansion in elderly people's share of population. In FY2013, the household savings rate fell to a negative 1.3%. These data apparently indicate that household consumption shortages are not responsible for deflation.

Figure 3 shows financial surplus or deficit for corporations (non-financial and financial) and the general government sector (covering national and local governments, and social security funds) as well as households. The overseas sector covers the world other than Japan. The overseas sector's financial deficit (net borrowings) means that Japan has net loans to the rest of the world. The figure provides some interesting findings.

The household sector substantially reduced its role as lender in line with the decline in the savings rate. As funds flow into and out of financial corporations, their financial position does not influence GDP representing the real economy. Influencing GDP are non-financial corporations including manufacturers and service providers. Non-financial corporations had supported the Japanese economy's growth through their robust investment. In a change to which attention must be paid in regard to deflation, non-financial corporations made a transition from borrowers to lenders around FY1998. Under deflation, non-financial corporations secured profit by cutting costs and saved domestic investment to create surplus funds as financial assets for holdings. Non-financial corporations are no longer driving the Japanese economy through investment.

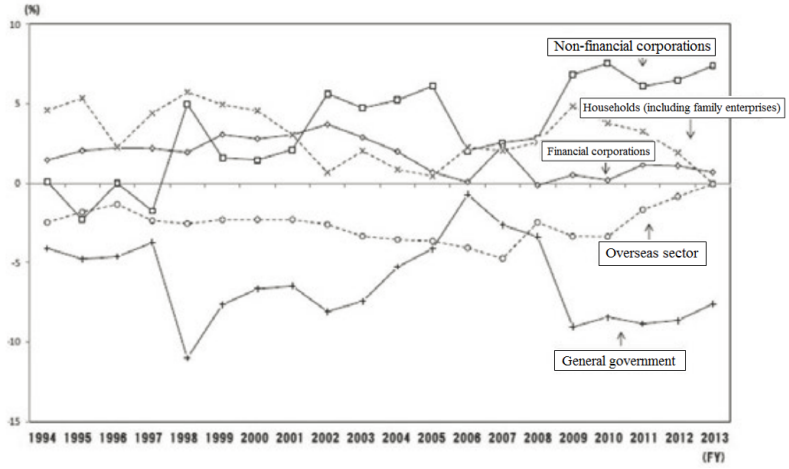
At the same time as the corporation sector made a transition to a financial surplus position, the general government sector became a fund borrower. Since then, the corporation sector has remained in a financial surplus position in contrast to a financial deficit position for the general government sector. This means that the general government sector has covered a

Figure 2 Household savings rate trend



(Source) Same as for Figure 1

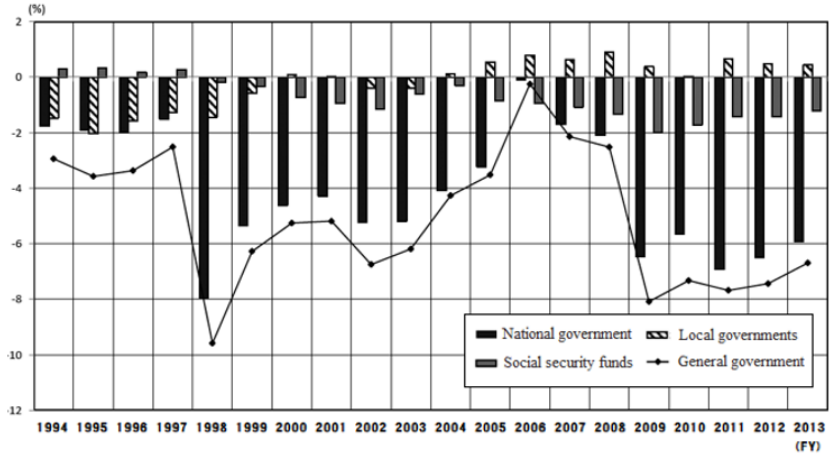
Figure 3 Net loans (+) and borrowings (-) by sector as percent of GDP



(Source) Same as for Figure 1

demand shortage at the corporation sector. In macroeconomic terms, government spending has supported the economy in deflation. In the meantime, the overseas sector has retained a financial deficit position. Japan as a whole has remained in a financial surplus position, providing net loans to the rest of the world. However, the financial surplus position has weakened substantially over recent years. A factor behind the weakening financial surplus position is that Japan has had no choice but to increase dependence on fossil fuel imports for power generation as the Great East Japan Earthquake has led nuclear power plants to be shut down. Even without this factor, however, Japan's financial surplus position has weakened.

Figure 4 General government primary balance breakdown (as percentage of GDP)



(Source) Same as for Figure 1

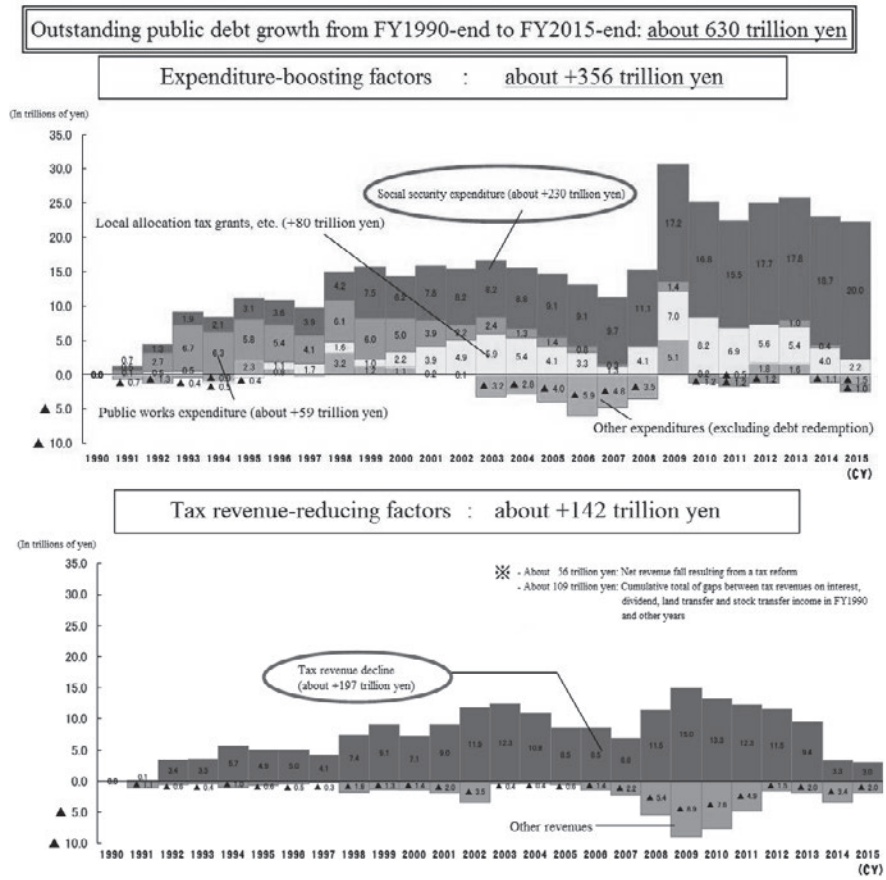
The above indicates that the general government sector drove the economy plagued with deflation, playing a key role in creating demand. However, the cost for the government sector was huge. Figure 4 shows the general government primary balance's ratio to GDP. Over the period subject to the analysis, the primary budget balance remained in deficit. Recently, an annual primary balance deficit amounted to nearly 7% of GDP. Clearly, the national government accounted for most of the deficit. The annual budget deficit worked to expand outstanding general government debt sharply to 201% of GDP in FY2013.

Figure 5 shows factors behind outstanding general government debt growth. From FY1990 to FY2015, outstanding public debt increased 630 trillion yen. Of the increase, spending growth accounted for 356 trillion yen and tax and other revenue falls for 142 trillion yen. Tax revenue decline as well as spending growth was substantial due to tax cuts for boosting the economy and falling tax revenue under deflation.

The financial surplus or deficit positions for economic sectors pointed out above indicate that government spending supported the economy from the demand side under deflation. Figure 5 shows details of the situation. From around FY1992 just after the collapse of asset bubbles to FY1999 when Japan was shaken by the Asian economic crisis and the disposal of non-performing loans, public investment played the main role in expanding government spending. Public investment was designed for boosting the economy. Later, social security expenditures expanded. Local allocation tax grants also increased to cover local government deficits. However, social security expenditure growth was dominant.

While government spending drove the deflationary economy, government spending priority shifted from public investment for boosting the economy to tax allocation to local governments and social security as reviewed above. Social security expenditures mean that the government shoulders the cost of services to citizens, including pension, healthcare and long-term care. While public bonds continued to be issued during the shift, those bonds

Figure 5 Factors behind growth in outstanding public debt



(Note) In addition to the above-cited factors behind outstanding public debt growth, there are the revenue-outlay gap of 71 trillion yen in FY1990 and the succession of 61 trillion yen in debt from the defunct Japanese National Railways.
(Source) Ministry of Finance, "Japan's Fiscal Data," September 2015

shifted from construction bonds backed by public capital formation to deficit-financing bonds to cover annual current account revenue shortfalls.

Details of government spending backed by growing public debt issues must be called into question now. In local finance, a special addition made to local allocation tax grants under an emergency economic stimulus package in response to the Lehman Shock has been maintained. The government covers most of social security expenditures by passing the cost of current services on to the future. Such practice is problematic from the viewpoint of intergenerational equity. Although government spending has surely played a key role in supporting the deflationary economy, it is not sustainable to continue expanding public debt at a time when outstanding general government debt exceeds 200% of GDP. Government spending must be reformed now. If the reduction of deficit-financing bond issues inevitably causes the burden to increase, the problem will be linked to the tax system.

For the macroeconomic purpose of overcoming deflation, meanwhile, domestic demand must be stimulated. Instead of forcing government spending to play a role in stimulating domestic demand, the government should promote effective use of surplus funds reserved at companies now serving as lenders and lead them to raise return on equity, wages and dividends to more effectively overcome deflation. Wolf (2015) compared a saving glut at companies in Japan with those in other developed countries and called for making effective use of internal reserves at companies through such measures as taxation on such reserves. Smithers (2014) attributed Japanese companies' financial surplus to higher depreciation costs than indicated by decelerating investment and called for cutting depreciation costs boldly to increase their income for raising dividends and wages. Both paid attention to the corporation side in considering how to stimulate demand in the Japanese economy and are useful for considering future policies in Japan.

III. Why do social security expenditures continue increasing?

III-1. Social security expenditures and their financial resources

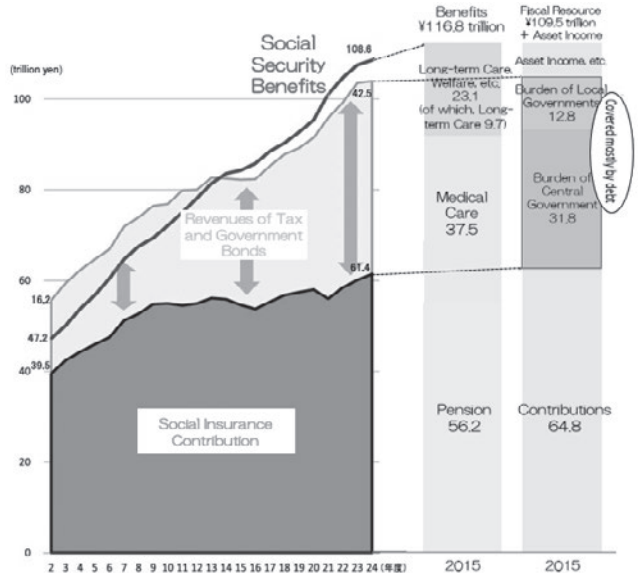
It has been noted that Japan's government debt stems primarily from social security expenditures. Here, social security expenditure trends and relevant financial resources are checked first. Later, reasons for social security expenditure growth are clarified, based on healthcare and long-term long-term care insurance systems.

Japan's social security comprises pension, healthcare, long-term care and employment based on social insurance systems, and livelihood aid and livelihood subsidies financed by tax. Figure 6 shows the trends of social security benefits and insurance premiums. Social security benefits increased substantially in about 20 years from 47.2 trillion yen in FY1990 to 108.6 trillion yen in FY2012. They included 56.2 trillion yen for pensions, 37.5 trillion yen for healthcare and 9.7 trillion yen for long-term care. The three components totaled 103.4 trillion yen accounting for most of social security benefits.

In the meantime, social insurance premiums grew from 39.5 trillion yen to only 61.4 trillion yen, leading a gap between social security benefits and premiums to expand from 7.7 trillion yen to 47.2 trillion yen. The gap is mostly covered by national and local governments expenditures (public expenditures). Of the total gap, the national government covered 31.8 trillion yen and local governments 12.8 trillion yen. Figure 7 shows a breakdown of the national government's social security expenditures. In FY2015, the national government provided 11.2 trillion yen for pensions, 11.4 trillion yen for healthcare and 2.7 trillion yen for long-term care. It must be noted that the government also provided 150 billion yen for employment insurance. Figure 8 shows the trend of the national government's social security expenditures. Those expenditures increased from 11.6 trillion yen in FY1990 to 31.5 trillion yen in FY2015. Their share of the national government budget rose sharply from 2.6% to 6.2%.

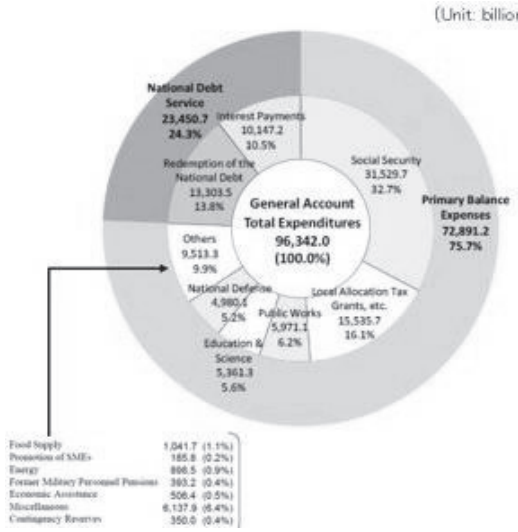
What were the financial resources for growing social security expenditures? To find the

Figure 6 Social security benefits and their financial resources



(Source) Ministry of Finance, "Japan's Fiscal Data," September 2015. Original data are from National Institute of Population and Social Security Research, "The Cost of Social Security in Japan," and the Ministry of Health, Labor and Welfare budget.

Figure 7 Social security expenditures in national budget (FY2014 and FY2015)

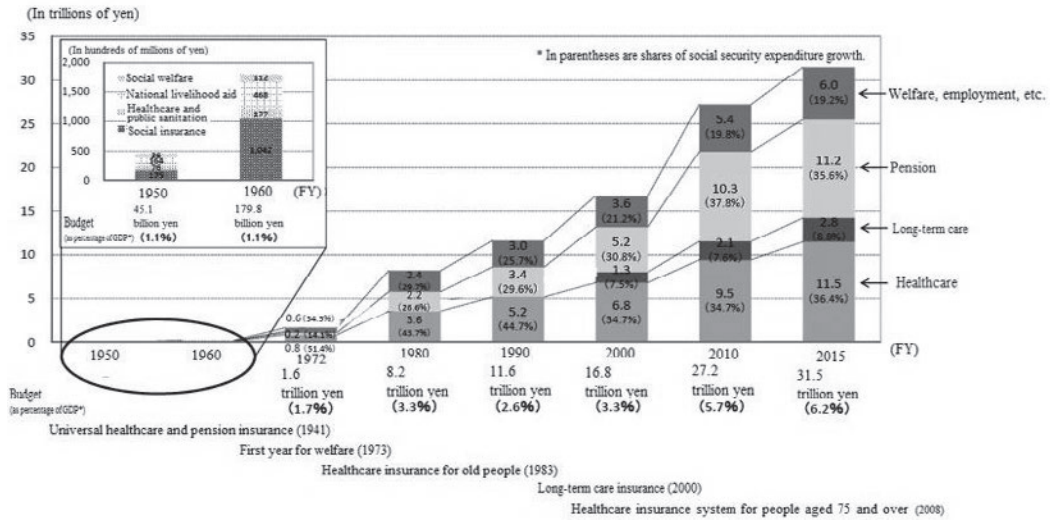


(Unit: 100 million yen)

Category	FY2014	FY2015	Changes
1. Healthcare	111,990	114,891	2,901
2. Pension	109,025	112,398	3,373
3. Long-term care	26,899	27,592	693
4. Welfare, etc.	57,353	60,415	3,063
(1) livelihood aid	9,434	9,301	△ 133
(2) Child education/care subsidies	4,672	6,090	1,417
(3) Employment insurance	1,536	1,459	△ 77
(4) Others	41,710	43,565	1,855
(Livelihood subsidies, repeated)	(29,202)	(29,022)	△ 180
(Social security enhancement, etc., repeated)	3,789	9,615	5,826
Total	305,266	315,297	10,030

(Source) Ministry of Finance, Fiscal System Council Fiscal System Subcommittee documents, April 2015

Figure 8 Trend and breakdown of national social security expenditures



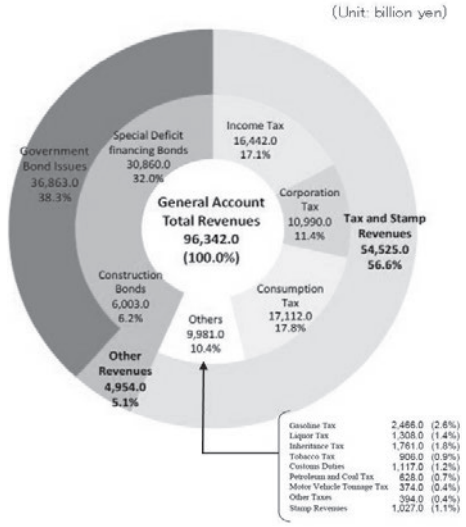
(Source) Ministry of Finance, Fiscal System Council Fiscal System Subcommittee documents, September 2015

answer to the question, the extent to which income, corporation and consumption tax revenues as mainstay national revenue sources can cover social security expenditures is considered. As shown in Figure 9, income tax revenue is estimated at 16.4 trillion yen for FY2015, corporation tax revenue at 10.9 trillion yen and consumption tax revenue at 17.1 trillion yen. Of their total, about one-third is statutorily earmarked for local allocation tax grants. The three tax revenues are thus estimated to provide nearly 30 trillion for the national government. Given social security expenditures at 31.5 trillion yen, income, corporation and consumption tax revenues available for the national government fall short of covering all social security expenditures.

The government also appropriated5.9 trillion yen for public works, 5.3 trillion yen for education and science, 4.9 trillion yen for national defense and 9.5 trillion yen for others including agriculture, forestry and fisheries, small and medium enterprises, and official development assistance. These expenditures total 25.6 trillion yen. Tax revenues fall far short of covering national government expenditures in Japan. This fact is behind primary budget balance deficits shown in Figure 4. Actually, deficit-financing government bond issues totaled 30.9 trillion yen in FY2015.

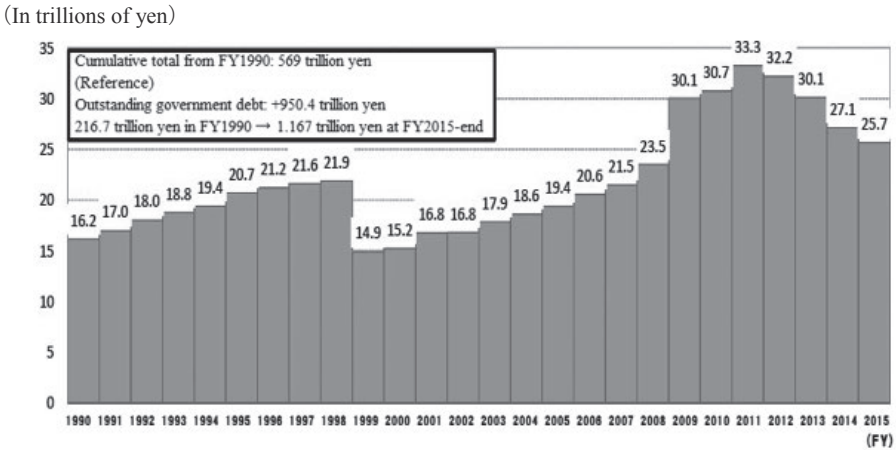
The extent to which consumption tax revenue designated for social security can cover public social security expenditures is checked here to clarify the problem of financial resources for social security. As one percentage point of local consumption tax has been designated as financial resources for local governments since before the tax and social security reform, the extent to which national and local consumption tax revenue excluding this portion can cover public (national and local government) social security expenditures is considered.

Figure 9 National general account revenues and their mix (FY2015)



(Source) Ministry of Finance, "Japan's Fiscal Data," September 2015

Figure 10 Gap between public national and local public social security expenditures and consumption tax revenue (excluding a 1% portion for local governments)



(Source) Ministry of Finance, Fiscal System Council Fiscal System Subcommittee documents, September 2015

The extent is shown in Figure 10. Consumption tax revenue fell 25.7 trillion yen short of social security expenditures in FY2015, although the shortfall narrowed slightly reflecting a consumption tax increase in April 2014. The shortfall amounts to more than 10 percentage points on a consumption tax rate basis. This rough estimate indicates how difficult it is to raise financial resources for national and local social security expenditures exceeding 40 trillion yen.

III-2. Reasons for growing social security expenditures

As social security benefit growth has forced public social security expenditures to expand, it has become difficult to secure financial resources for such expenditures, as reviewed above. The social security budget includes the so-called natural increase of nearly 1 trillion yen per year stemming from the aging of population and the advancement of medical treatment techniques. How to lower the natural increase is one of the keys to fiscal reconstruction. The Plan for Economic and Fiscal Revitalization in the Basic Policies for Economic and Fiscal Management and Reform 2015 called for continuing the rationalization of livelihood subsidies, the revision of drug prices and long-term care fees and other measures that worked to limit the annual natural increase to around 500 billion yen in the past three years.

Why have social security expenditures continued to increase? As social security benefits increase, a rise in public social security expenditures is taken as natural. However, such interpretation is unobvious. An increase in Japan's social security expenditures as a percentage of GDP in the past 20 years is compared with such increases in the United States, Germany, the United Kingdom, France and Italy where the population is aging as in Japan. The increase in Japan came to 11.2 percentage points (from 12.8% in FY1995 to 24.0% in FY2013), followed by 5.3 points (from 22.9% to 28.2%) in Italy and lower growth in other foreign countries. Germany posted a decline of 0.6 points (from 26.4% to 25.8%) (Fiscal System Council Fiscal System Subcommittee documents, October 9, 2015).

The relatively higher growth in Japan is attributable to public expenditures' unique relations with pensions, healthcare and long-term care benefits. Japan not only eases insurance premium burdens on low-income earners but also features public social security expenditures representing the government sector's guarantee of some portion of benefits for each insurance system. For example, the national government shoulders 50% of basic pensions. Public expenditures on healthcare and long-term care are also fixed at certain portions of benefits and subventions from insurers. As a result, government social security expenditures increase automatically as social security benefits grow.

Public expenditures on pensions expand as benefits increase on a rise in the number of pensioners. Under a pension reform, nevertheless, per capita pension is designed to decline in accordance with the aging of the population and the fall of birthrates, with the maximum premium rate fixed. However, healthcare benefits have been persistently growing in accordance with the aging of population and the advancement of medical treatment techniques. Long-term care benefits are destined to increase as the number of old people aged 75 and more grows.

In this way, social security benefits will continue expanding. As the Japanese social security system designs government expenditures to automatically cover certain portions of social security benefits, it is difficult to control government social security expenditures. In contrast, foreign countries have stricter rules to restrict government expenditures' coverage of social security benefits, limit benefits to specific tax revenue or cover social security

benefits with premiums alone without government expenditures in principle. In a typical example, Germany strictly restricts public expenditures' coverage of healthcare insurance benefits and adopts a full insurance system for long-term care to determine benefits in line with premium income.

In Japan, the government's commitment to shoulder certain portions of social security benefits lead healthcare and long-term care costs to expand. The government provides expenditures to lower healthcare and long-term care service users' burden, encouraging citizens to excessively use those services. Given the results of free healthcare services for elderly people in the 1970s and 1980s, such encouragement is plausible. Meanwhile, healthcare and long-term care service providers tend to expand services excessively as subsidies are given to users under systems that differ from pure insurance systems. In this way, Japan has a mechanism for citizens, and doctors and medical institutions to expand costs. As a result, public national and local government expenditures or subsidies are required to meet growing healthcare and long-term care costs that increase based on government expenditures, leading to a vicious circle.

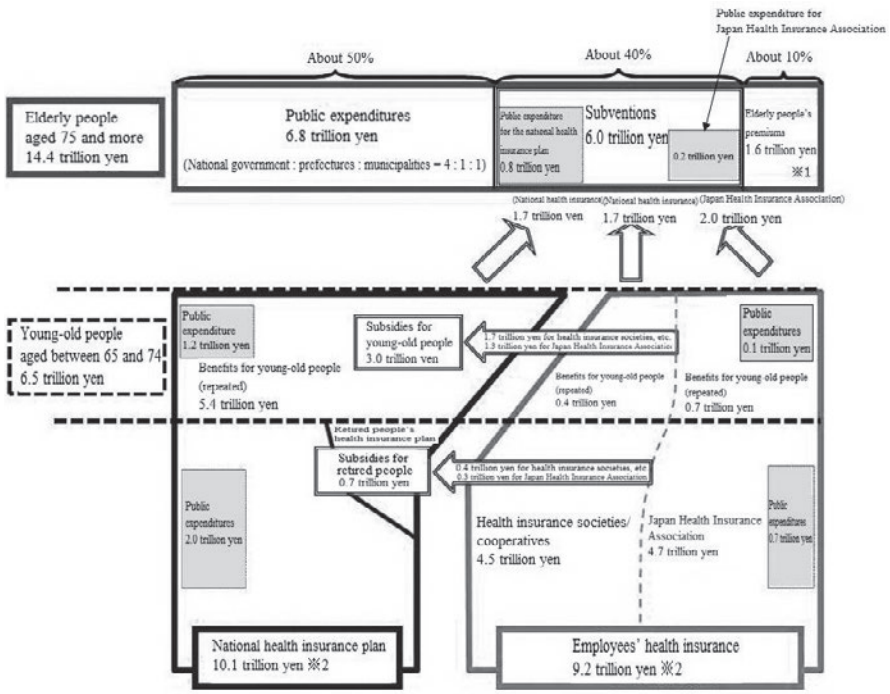
Figure 11 shows financial resources for the healthcare insurance system. The Japanese healthcare insurance system comprises employees' insurance (provided by healthcare insurance societies and cooperatives, and the Japan Health Insurance Association) and other people's insurance which is called the national health insurance plan. For people aged between 65 and 74 who are covered by the national health insurance plan, employees' insurance providers as well as the plan shoulder some costs. Furthermore, people aged 75 and more are covered by a healthcare insurance plan designed for old-old people.

The government covers a fixed share of benefits for each healthcare insurance plan. The national government shoulders 50% of benefits for the national health insurance plan. Concerning the benefits for the Japan Health Insurance Association plan mainly for small and medium enterprises, the national government provides 16.4%. Under the healthcare insurance plan for old-old people, public expenditures cover 50% of benefits, with 40% provided by subventions from the national health insurance plan and employees' insurance. The remaining 10% is covered by premiums paid by insured people (the national government eases the premium burden on low-income earners). Furthermore, the national government shoulders the same portions of subventions from the national health insurance plan and employees' insurance as those of benefits for these insurance plans.

In this way, the national government shoulders some portions of healthcare insurance benefits in a multi-layered manner. As a result, healthcare service users remain unaware of information on healthcare costs. Their healthcare costs are shouldered by their own payment and insurance premiums, and by subsidies from national and local governments, which have difficulties in raising financial resources for such subsidies and have no choice but to issue deficit-financing bonds in a manner to pass the burden on to future generations. Healthcare service users are left uncertain about such mechanism.

Public expenditures also cover some portion of benefits under the long-term care insurance system. Figure 12 shows the financial resources mix for the system. The mix is

Figure 11 Financial resources mix for healthcare insurance system



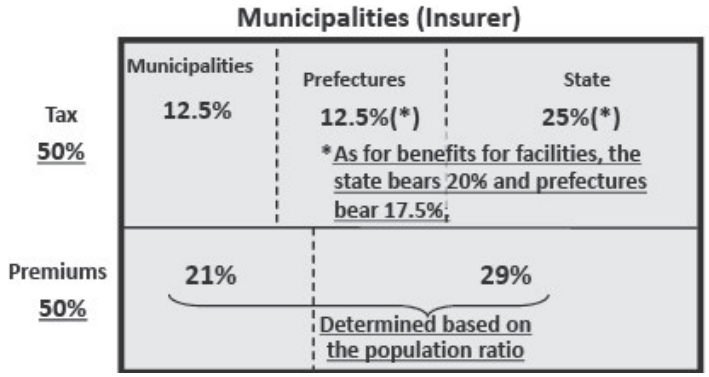
(Note) Public expenditures' shares of insurance benefits or subventions to the healthcare insurance plan for old-old people are as follows: 50% for the national health insurance plan managed by municipal governments, 16.4% for the Japan Health Insurance Association, zero (excluding some share level) for health insurance societies or cooperatives and 50% for the healthcare insurance plan for old-old people.

(Source) Ministry of Health, Labor and Welfare, "Japan's Healthcare Insurance"

close to that for the healthcare insurance plan for old-old people. In fact, the long-term care insurance system was launched in FY2000 before the healthcare insurance plan for old-old people was introduced in 2008 in a manner to imitate the financial resources mix for the long-term care system. Of long-term care insurance benefits, 50% is covered by public expenditures and the remainder by insurance premiums. Of the public expenditures, the national government accounts for 50%, prefectural governments for 25% and municipal governments for 25%. Premiums paid by elderly people aged 65 and more, or main users of long-term care services, cover 21% of benefits. Premiums paid by people aged between 40 and 64 cover 29% of benefits through their respective healthcare insurance plans. Based on the long-term care system framework, the healthcare insurance plan for old-old people fixes shares of benefits for public expenditures, subventions and premiums. Both take advantage of public expenditures and subventions to substantially ease the burden on service users.

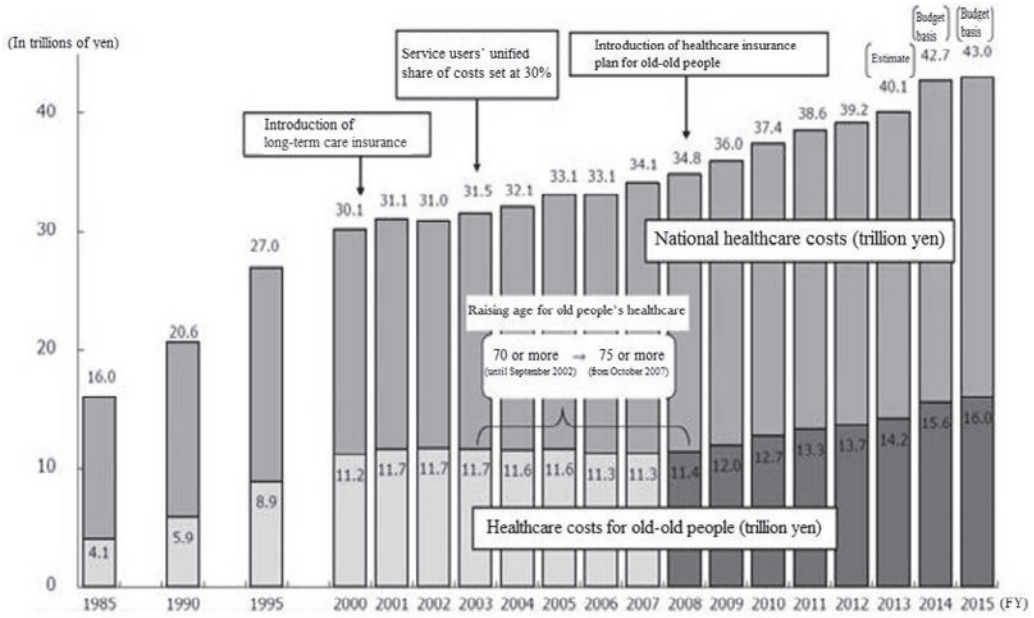
Figures 13 and 14 show healthcare and long-term care cost trends. National healthcare costs totaled 43 trillion yen on a budget basis in FY2015. Long-term care costs stood at 9.4 trillion yen in FY2013 and are estimated to have reached 10 trillion yen in FY2015 based on

Figure 12 Financial resources of the long-term care insurance system



(Source) Ministry of Health, Labor and Welfare, "Present Long-term care Insurance System and Its Future Role," FY2014

Figure 13 Healthcare cost trend

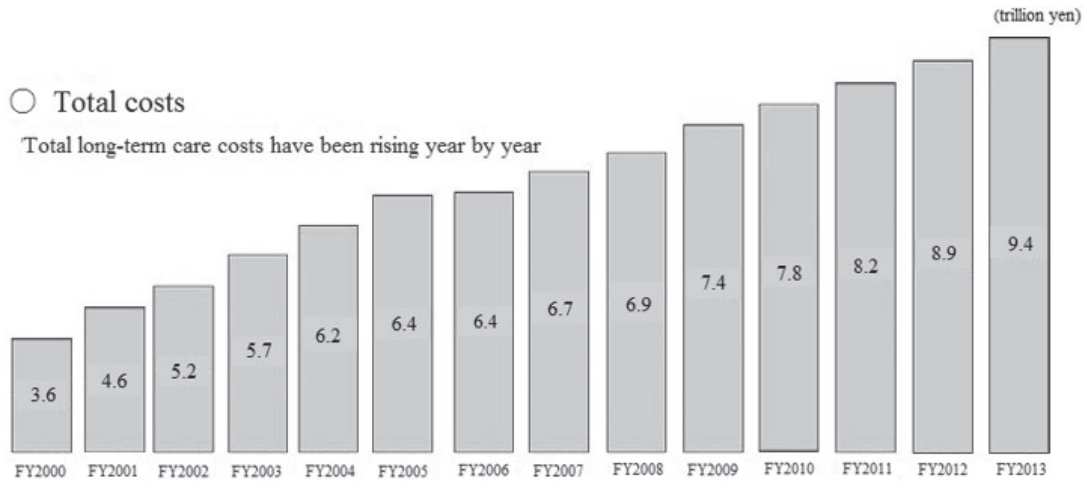


(Source) Ministry of Finance, Fiscal System Council Fiscal System Subcommittee documents, April 27, 2015. Original data are from Ministry of Health, Labor and Welfare, "Healthcare Cost Trend Survey"

the past pace of growth. Healthcare costs have increased 2-3% annually. Particularly, healthcare costs for old-old people have risen faster, accounting for 37% of total healthcare costs in FY2015. Long-term care costs have soared even faster than healthcare costs, growing 2.5-fold from 4 trillion yen in the initial year for the long-term care insurance system to FY2015 on an estimated basis.

Behind healthcare and long-term care cost growth have been the aging population,

Figure 14 Long-term care cost trend



(Note) Costs are actual for FY2000-2011 and estimated in initial budgets for FY2012-2013.
(Source) Ministry of Health, Labor and Welfare, "Present Long-term care Insurance System and its Future Roles," FY2014

technique advancement and increasing rewards for service providers. However, public expenditures' partial coverage of healthcare and long-term care costs has encouraged service users and providers to expand the costs. As for the healthcare insurance plan for old-old people and the long-term care insurance system for which benefits are expected to increase, whether government expenditures' coverage of costs or benefits should be left unchanged should be fundamentally reconsidered.

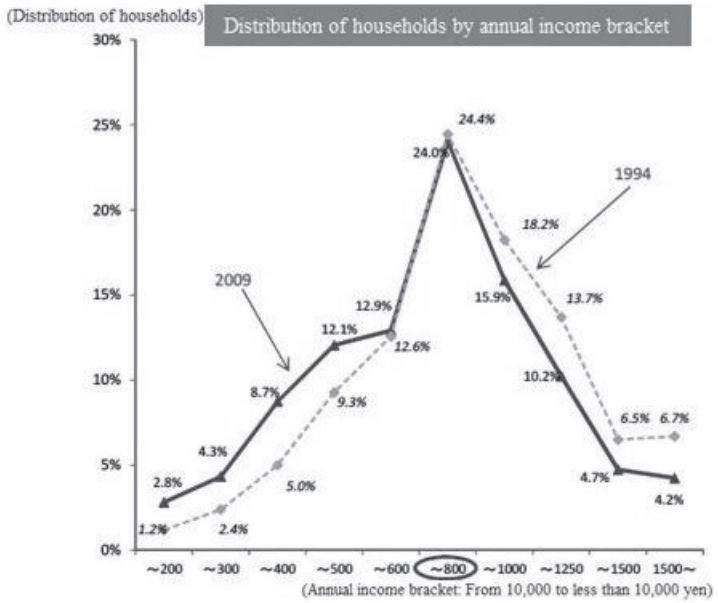
IV. Perspectives for reforming personal income tax

IV-1. Income and employment changes

The compensation of employees share of national income has decreased under protracted deflation while entrepreneurial income has continued to increase. As a result, the labor share has declined, as noted above. In fiscal aspects, the government has supported the economy by continuing to borrow funds. However, a main factor behind budget deficits has made a transition from being public investment for boosting the economy just after the collapse of asset bubbles to public expenditures on social security. Effectively, the government is passing part of present costs for pensions, healthcare and long-term care benefits on to future generations through debt issues. While how to address growing social security costs under the aging of population has failed to be fully considered, an excessive burden has been exerted on deficit-financing public bonds.

Under such situation, the most important problem for the tax and fiscal systems is to reform heavy fiscal dependence on deficit-financing public bonds. To this end, national and

Figure 15 Distribution of households by annual income
(two- or more member households led by householders in the prime of manhood)



(Note) Householders are aged between 30 and 59 in the prime working age group.
(Source) Government Tax Commission documents, July 31, 2015

local governments must cooperate in reforming both expenditures and revenues. Particularly important is how to reform persistently growing public expenditures on healthcare and long-term care. On the premise of fiscal and social security reform involving the whole of the Japanese economy, this chapter shifts focus to the tax system, considering problems with the income tax and specific reform measures required to address these problems.

How has employee income changed under deflation? Figure 15 compares a breakdown of two- or more member households headed by people aged 30 to 59 (in the prime working age group) by income level in 1994 with that in 2009. From 1994 to 2009, the highest share being represented by the most frequently observed income level of 8 million yen remained unchanged. The share for an income bracket between 6 million and 8 million yen also stayed unchanged. In contrast, shares for income levels below 6 million yen and above 8 million yen shrank, with the distribution line shifting leftward in the figure. These results indicated that income for all households—except those in the 6 to 8 million yen income range—decreased over the 15 year period. Indications are that deflation led to a household income decline. The figure shows such change only for householders in the prime working age group. For other households, however, the trend is similar.

People grew poorer amid an employment arrangements shift. Companies primarily reduced wages in response to deflation. The same was true for national and local governments plagued with stagnant tax revenues. One wage-cutting method was to replace regular

Table 2 Non-regular employees' shares
(non-regular employees' percentage share of total employees)

	Total		Men		Women	
	All ages	65-	All ages	25-34	All ages	25-34
1995	20.9	50.4	8.9	2.9	39.1	26.8
2014	37.4	73.1	21.8	16.9	56.7	42.1

(Source) Government Tax Commission documents, September 3, 2015

employees with non-regular ones who were left out of seniority-based wage and other traditional systems. Employers took advantage of such replacement to reduce their social security premium payments for employees. Table 2 shows non-regular employees' shares of all employees in 1995 and 2014.

Non-regular employees' shares increased generally. However, consideration should be given to the effect of age on shares. In general, elderly people qualified to receive pension benefits may not want to take full-time jobs. If job seekers increase among elderly people, non-regular employees' share for the age bracket may increase. This change is natural for the aging society. The problem is non-regular employees' growing shares for younger age brackets.

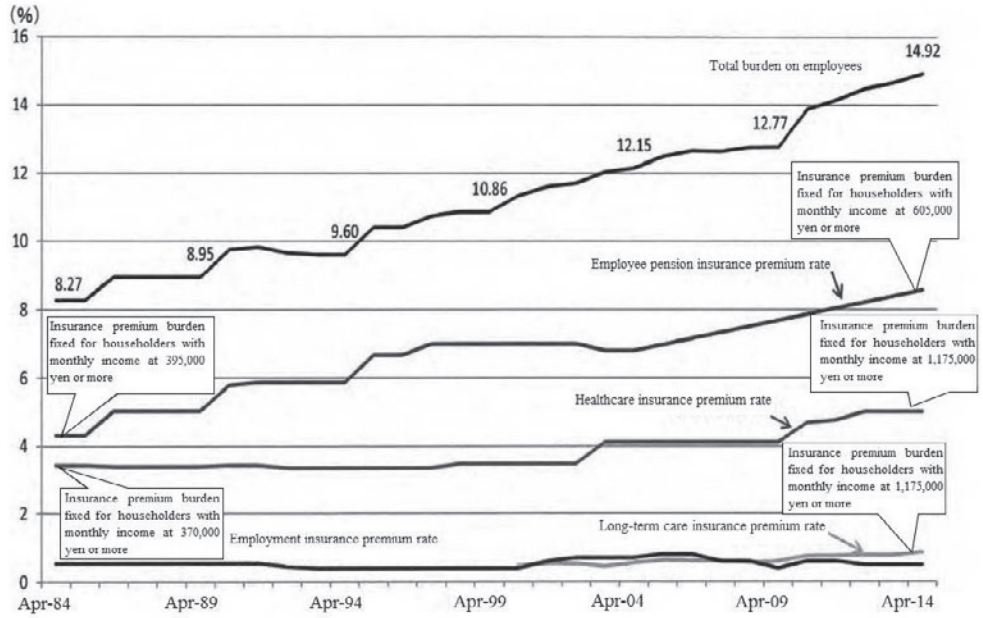
Table 2 indicates non-regular employees' growing shares for the total of men and women and all age brackets. The share increased for the elderly bracket faster than for other age brackets. As noted above, this increase is no problem. Rather, it is desirable for working elderly people to increase amid the population decline. Regarding wage cuts under deflation, attention should be paid to non-regular employees' share of young workers aged between 25 and 34. The share for men increased sharply from 2.9% in 1995 to 16.9% in 2014. For women, the share was as high as 42.1%. Non-regular employees' high share of women workers does not necessarily reflect deflation as women voluntarily choose to be part-timers for lifestyle or family reasons. Even with consideration given to the above, the table finds that non-regular employees are deep-rooted in the young bracket aged between 25 and 34.

IV-2. Income tax problems and reform

Exerting an additional burden on stagnant income are growing social insurance premiums. While public expenditures on social security have increased as noted above, social insurance premiums have also expanded. As it is difficult for public expenditures to continue covering portions of social security benefits growing in line with the aging of population, social security insurance premiums that have been held down by public expenditures have no choice but to be raised. Given this point, the combination of tax and social insurance premium burdens grows even more important for ordinary workers. Here are income tax problems.

First, the trend of social insurance premiums is checked here. Figure 16 shows insurance premium rates for employment, long-term care (from FY2000), healthcare and employees'

Figure 16 Social insurance premium rate trend



(Source) Government Tax Commission documents, October 14, 2015

pension from 1984 to 2014. Pension and healthcare insurance premium rates were high and rising. As a result, the total employee burden combining all insurance premium rates increased substantially from 8.27% in 1984 to 14.92% in 2014. If premiums paid by employers are included, the total burden reached nearly 30%. While how employees and employers share social insurance premiums is uncertain, a clear way for employers to avoid their social insurance premium burden is replacing regular employees with non-regular ones. Factors behind non-regular employees' growing share of employment include not only rigid wage systems for regular employees but also rising social insurance premiums.

What have tax (income tax and local individual inhabitant tax) and insurance premium burdens been as a result of rising social insurance premiums? Table 3-1 shows income redistribution by age bracket of householders according to "Income Redistribution Survey Report" (Ministry of Health, Labor and Welfare, 2011). Here, income for redistribution covers not only initial income but also tax, social insurance premiums, cash benefits (including pension and livelihood subsidies) and other cash benefits (including healthcare and long-term care benefits). The combination of initial income and cash benefits is called gross income. The table indicates that gross income for householders aged between 50 and 54 totals 7.12 million yen, the largest among age brackets. As pension and other cash benefits increase for householders aged above 60, gross income for householders aged between 65 and 69 at 4.82 million yen is close to gross income for those aged between 30 and 34 at 4.99 million yen.

Table 3-2 shows burdens' and benefits' shares of gross income. In the table, the following

Table 3-1 Income redistribution by age bracket of householders (1,000 yen)

	Initial income	Cash benefits	Gross income	Tax	Insurance premiums	Cash benefits	Healthcare, nursing care and other cash benefits
Total	4,047	1,146	5,193	471	477	1,146	615
-29	2,765	104	2,869	162	258	104	167
30-34	4,657	242	4, 899	373	511	242	359
35-39	4,732	287	5,019	387	505	287	298
40-44	5,521	293	5,814	507	609	293	246
45-49	6,552	274	6,826	654	708	274	342
50-54	6,762	358	7,120	649	782	358	612
55-59	6,721	274	6,995	751	773	274	479
60-64	4,756	943	5,699	569	526	943	534
65-69	2,749	2,079	4,828	399	364	2,079	715
70-74	1,820	2,295	4,115	312	301	2,295	612
75-	1,685	2,181	3,866	369	246	2,181	1,185

(Source) Ministry of Health, Labor and Welfare, "Income Redistribution Survey Report," 2011

Table 3-2 Burdens' (contributions') and benefits' percentage shares of gross income

	Tax burden	Social insurance premium burden	Cash benefits	Healthcare, nursing care and other cash benefits	Net income
Total	9.1	9.2	22.1	11.8	15.7
-29	5.6	9.0	3.6	5.8	−5.2
30-34	7.6	10.4	4.9	7.3	−5.8
35-39	7.7	10.1	5.7	5.9	−6.1
40-44	8.7	10.5	5.0	4.2	−9.9
45-49	9.6	10.4	4.0	5.0	−10.9
50-54	9.1	11.0	5.0	8.6	−6.5
55-59	10.7	11.1	3.9	6.8	−11.0
60-64	10.0	9.2	16.5	9.4	6.7
65-69	8.3	7.5	43.1	14.8	42.1
70-74	7.6	7.3	55.8	14.9	55.7
75-	9.5	6.4	56.4	30.7	71.2

(Source) Ministry of Health, Labor and Welfare, "Income Redistribution Survey Report," 2011

interesting facts are found:

- In total, the tax and social insurance premium shares are almost equal around 9%. The combination of tax and social insurance premium shares is less than that of cash, healthcare, long-term care and other benefits. Their gap representing net income comes to 15.7%. This means that benefits exceeding those covered by income tax and social insurance premiums are provided through other taxes and public expenditures.

- By householder age, net income is negative for householders aged 59 or less and positive for those above the age, indicating that the working generation aged 60 or less is supporting the older generation.
- For all age brackets for working people, the tax burden is less than the social insurance premium burden. The net income share, though not being fully regressive, is as high as 5.2% for the lowest income bracket.
- For all aged at 60 or more, the tax burden is more than the social insurance premium burden. The net income share is 42.1% for the age bracket of 65-69, 55.7% for 70-74 and 71.2% for 75-, indicating benefits' great role for elderly people.

The table indicates that social insurance premiums have become a greater burden than tax as wages have stagnated under deflation. Under such situation, it is difficult for the Japanese economy to continue growing, as indicated by the negative growth in 2011. At a time when jobs are flowing out of Japan on progress in economic globalization, companies other than big ones enjoying high earnings have difficulties in raising wages. In such economic environment, it is undesirable or impossible to continue placing the growing social insurance premium burden on young people, given their living conditions.

Given the above, income tax problems are summarized as follows: First, the social insurance premium burden is greater than the tax burden particularly on young people. On non-regular employees, the burden of national pension and healthcare insurance premiums is great, even though the tax burden is close to zero. Behind young people's failure to pay pension insurance premiums is the great premium burden. Income tax cuts are of little effect for giving non-regular young employees access to social insurance. Some other measures should be taken to reduce the social insurance premium burden.

A globally leading measure to this end is a tax credit to refund a part of insurance premiums to young low-income earners. This means that income tax and social insurance premium burdens should be integrated into a widely defined income tax burden for tax cuts. In this case, tax cuts will be the tax credit, or a tax refund from the government, which will enable young long-income earners to pay social insurance premiums. If the tax credit is expanded to cover employers' social insurance premium burden, the incentive for employers to replace regular employees with non-regular ones for the reason of the social insurance premium burden will become smaller.

Regrettably, Japan does not have the tax credit system that has become a global standard to mitigate the tax burden. In Japan, various income deductionshave been introducedto maketax burdenlower for low-income earners. On the other hand, the aging of population forces these people to bear the burden of social security expenditures. Under the current system, as noted above, the burden on young low-income earners cannot be mitigated.

If the reduction of the burden through the income tax credit is institutionally impossible, the government may secure financial resources for mitigating young low-income earners' social insurance premium burden and provide benefits through the social security system. As 50% of basic pension benefits are covered by consumption tax revenue and provided through the Japan Pension Service, financial resources for mitigating social insurance premiums may

be covered with some tax revenue and provided to young low-income earners under the social security system. If tax and social insurance premiums are interpreted as the income tax burden, the financial resources may be raised from income tax revenue through an adequate reform.

The second problem toward the reform is how to secure financial resources within the income tax framework. The maximum income tax rate now stands at as high as 55% including 10 percentage points for the local individual inhabitant tax. Any high marginal tax rate may discourage taxpayers from working and induce various tax-saving measures. The current maximum rate is too high. Therefore, the income deduction system must be reformed to expand taxable base so that more revenue is collected withoug raising the alreay-too-high marginal tax rate. In this case, a tax increase through the reduction of the income deduction would be larger for high-income earners.

The third problem toward the reform is to correct tax on public pensions in view of burden equality and the income tax mechanism. As mentioned above, pension, healthcare and long-term care benefits for elderly people are mostly financed by the working generation. Given that these benefits are financed by deficit-financing bonds as well as insurance premiums and tax revenues, the burden spills over to future generations. Such burden inequality must be corrected.

An important point in this respect is that the Japanese pension tax system features double deductions including the social insurance premium deduction and the public pension deduction for calculating taxable income. The social insurance premium deduction covers insurance premiums for not only pensions but also healthcare and long-term care. We need to note also that pensions, healthcare and long-term care insurance premium payments are immediately used for benefits instead of being accumulated.

Given the above, two approaches are conceivable on the taxation system involving social insurance. One approach calls for treating social insurance premiums and tax in the same way, paying attention to the fact that financial resources for pension, healthcare and long-term care insurance benefits include not only insurance premiums but also tax revenues and deficit-financing bonds (to be covered by future tax revenues). This means that social insurance premiums may be collected as payroll tax. In this case, the social insurance premium deduction may be abolished. If benefits are cash like pensions, a relevant tax burden adjustment may be based on income and assets of elderly pension recipients, with the public pension deduction abolished.

Another taxation approach separates the tax system from the social security system and allows social insurance premiums as contributions to the social security system to be deducted from income for taxation. In this case, social insurance premiums must be considered as costs for calculating income. Benefits in cash or in kind, when being paid, are subjected to taxation as social insurance premiums are treated as costs. However, it is difficult to impose tax on in-kind benefits for healthcare and long-term care. Therefore, pensions are subjected to taxation. As insurance premiums are deducted as costs from income for taxation, pensions should befully subjected to taxation.

Whether pensioners' tax burden should be mitigated or not must be separated from the pension taxation mechanism. As is the case with social insurance premiums treated as payroll tax, income deduction may be applied if necessary for elderly low-income earners. In this way, social insurance premiums can be considered as payroll tax or cost (contributions) for social security services. Given the realities of social security burdens and benefits in Japan, as mentioned above, current benefits are supported by social insurance premiums and various tax revenues (at present and in the future). In this sense, it is appropriate to consider social insurance premiums as payroll tax. In fact, the United States and many other countries collect social insurance premiums as payroll tax.

The above is a theory of taxation on social insurance burdens and benefits. Given Japan's present situation, the conclusion should be the abolition of the social insurance premium deduction and the public pension deduction. If necessary, a special deduction should be introduced for elderly low-income earners. In this way, the present mechanism is required to be reformed into a greatly different system. With a different system in mind, the government is urgently required to reform the public pension deduction by using a more realistic approach to mitigate the inequality of burden among generations. As noted above, the reform should abolish the public pension deduction for calculating tax on public pension and introduce a tax burden mitigation system for elderly low-income earners. Support for elderly people subject to the reform should be provided through social welfare as well as tax measures.

V. Conclusions

The paper studied the problems and reform of personal income tax in consideration of the current economy, the fiscal position and social security of Japan, which remains under protracted deflation since the collapse of asset bubbles. Under deflation, companies cut wages to secure profit only to invite domestic demand stagnation and deepen deflation, making it difficult for Japan to overcome deflation. As part of that approach, non-regular jobs increased to replace regular jobs in the jobs market. On the other hand, the government supported the Japanese economy through fiscal expansion. However, the purpose of budget deficits gradually shifted from public investment for boosting the economy to social security expenditures due mainly to the aging of population. As much as 40 trillion yen in national and local government social security expenditures have resulted not only from national and local government practices to cover part of social security costs but also the mechanism of financial resources for social security that led the national and local government fiscal burden to expand out of control.

Against the backdrop of such economic and fiscal situation, this paper illustrated problems and offered reform proposals focusing on personal income tax. The working generation below the age of around 60 has differences with the older generation in tax and social security burdens and benefits in cash and kind. The net income representing the benefits' gap with burdens is negative (net burdens) for the working generation and positive (net benefits) for the older generation, indicating that the two generations are supporting each other. Given that

everyone becomes an elderly person for whom pension, healthcare and long-term care benefits are important, the two generations should support each other. The mutual support is what should be realized.

The problem is continuous increase of social insurance premiums as part of financial resources for social security benefits. As a result, the social security burden far exceeds the tax burden for the working generation, particularly young workers. A heavy burden of social insurance premiums is imposed on young people who are non-regular workers. This is a factor behind some young people's failure to pay social insurance premiums.

In view of young low-income earners, this paper concluded that the problem with personal income tax is the social security premium burden's excess over the tax burden. As a reform measure to correct this problem, the paper first called for integrating tax and social security premium burdens into a widely defined income tax burden and for introducing tax credits to lessen the social insurance premium burden that cannot be mitigated through income deduction. Second, the paper argued that in order to finance the tax credit, the government should require high-income earners to bear a heavier burden than now by reforming income tax deductions and expanding the tax base, instead of raising the top marginal tax rate as high as 55%. Third, the paper argued that it is desirable to abolish the deductions for social insurance premiums and public pension. Taking into consideration the feasibility of the reform, however, the paper argued that it is urgent to abolish the public pension deduction (for calculating income for taxation) for correcting the present inequality of burden among generations and reduce the tax burden on elderly low-income earners who should be given relief.

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