Comments on
“Challenges confronting Abenomics and Japanese public finance
Fiscal consolidation must start by squarely facing reality”
by Kazumasa Oguro

by
Henry J. Aaron

The message of this paper is straightforward, clear, and persuasive. Japan’s current fiscal trajectory is unsustainable. Economic growth alone cannot prevent the debt/GDP ratio from growing explosively, with all of the attendant risks of hyper-inflation or default. Large tax increases or cuts in social insurance benefits—and probably both—are inescapable. Professor Oguro relies on a simple equation, familiar to all public finance economists. The debt/GDP ratio will rise as long as the government’s budget deficit, inclusive of interest payments, measured as a percent of GDP exceeds the growth of GDP.

Even if the Japanese economy performs considerably better than it has done for the past quarter century, growth alone is unlikely to grow fast enough to prevent the debt/GDP ratio from rising. Japanese population age 15 to 64 is projected to fall between now and 2030 at an annual rate of 0.86 percent per year. The economy even now is near its potential. By 2015, according to the OECD, output will exceed potential GDP. Japan’s actual growth over the past quarter century, when the prime age population was almost stable, has not averaged even 2 percent annually. Professor Oguro’s central argument is that expecting an economy with a labor force shrinking nearly 1 percent a year to grow on a sustained basis more than 2 percent a year is unreasonable. It is therefore unrealistic to believe that Japan can grow or inflate its way back to fiscal balance.

The statistics in the table (slide) buttress his skepticism. By 2015, the OECD projects that the Japanese economy will be operating above potential. The primary budget deficit adjusted for potential is projected to still be nearly 5 percent of GDP. If worker productivity grows at 3 percent annually—a high rate for an economy as advanced as Japan’s—overall GDP growth would be 2 percent, the number professor Oguro uses in his example. If the real interest rate rises to 3 percent, the surplus in the primary budget would have to be 3 percent to stabilize the debt/GDP ratio. That would require a swing of roughly 8 percent of GDP from a projected deficit of nearly 5 percent gap to a surplus of 3 percent of GDP.
Of course, output growth of more than 3 percent a year would help, but it is not likely. There are only two ways to boost growth: raise growth of output per person or increase growth of population. Keeping growth of worker productivity above 3 percent in an advanced economy such as Japan’s is extremely difficult. To be sure, productivity in important sectors of Japan’s economy remains low, but doing something about low productivity in agriculture and retail trade involves important sensitivities.

So would measures to boost population growth. That would require either higher birth rates or increased immigration.

Net immigration is now zero. Japan has been and remains leery of large scale immigration. Immigration carries many costs, but it has important benefits as well, not the least of which is that it can prevent or slow the population implosion that casts a dark shadow over Japan’s future.

There is no sure-fire way to boost fertility rates, but policies to provide day-care for children from a very early age and that assure women that they can return to jobs they previously held after generous and well-compensated maternity leave are among them.

It seems inevitable that restoring fiscal sustainability will require higher taxes, lower spending, or both. Moving from a cyclically adjusted primary deficit of nearly 5 percent of GDP to a surplus of 3 percent—a swing of 8 percent of GDP—is daunting. But other countries have done it. And, one way or another, Japan will have to do it too.

Part of the swing, as professor Oguro points out, along with others he cites, will have to be increased taxation. Without spending cuts, consumption tax rates would have to be tripled, or more. Such an increase would make Japanese consumption taxes among the highest in the world. Under the best of political circumstances, such increases would provoke vigorous resistance. But using revenues from such tax increases to pay for cuts in such other taxes as the corporation income tax makes the job even harder.

A second way to shift the budget would be to cut social insurance. Doing so is also enormously difficult. Japan has already cut pensions a great deal. Currently, they are far from munificent. Cutting them still further will raise the specter of widespread poverty among the elderly or the extension of working lives. As Japanese labor force participation
among older age cohorts is already higher than in all large economies other than Korea’s, extending working lives also will be difficult.

    Still, Japan has the highest life-expectancy among large nations. Labor force participation among people over age 65 has fallen sharply in the past two decades. One dividend from economic stimulus could well be a reversal of that trend.

    As a foreigner, it would ill become me to suggest how much reliance Japan should place on population policy versus fiscal policy and how much of any fiscal shift should come from tax increases or spending cuts.

    But I do believe that the political process would be helped in confronting and making difficult decisions if the public were given good information to inform them about the magnitude of the choices before them. Specifically, I would urge that Japan consider regularly publishing long-term projections of pension obligations similar to those published annually in the United States and in some other countries. I tried to explain in the paper that I presented earlier the powerful and benign discipline that has come from the use of trust fund accounting for pensions and from the frequent release of comprehensible data on the long term prospects of these trust funds. Trust funds imbalances are easily understood. They help everyone—citizens, journalists, analysts, and elected officials—to see whether people are paying for the pensions that they will one day receive and, if not, how large the gap is that must somehow be filled. These projections show how long benefits can be paid at promised levels if taxes are not raised, how much taxes have to be raised in order to sustain promised benefits or how much benefits will have to be cut if people refuse to pay higher taxes. Such reports do not make the difficult political choices, but they do educate people as to the size and character of those choices. Most importantly, they remind everyone that such choices are inescapable.

    That is what professor Oguro is trying to do with his clear and forceful paper, and I congratulate him for his effort.