The Prospects for the Japanese Economy with a Higher Consumption Tax

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It seems that the Japanese economy will undergo a significant change between 2013 and 2014.

The Cabinet Office officially announced in August 2013 that April 2012 was an economic trough. In other words, the economy experienced a downturn after April 2012. That's because Japanese exports declined when world economic growth slowed due to the European currency crisis and the decelerating Chinese economy.

GDP data shows that Japanese exports declined 0.7% in the April–June quarter of 2012 and 16.8% in the July–September quarter, falling for the second consecutive quarter (real annualized growth; the same applies below). As a result, the GDP growth rate was −1.2% in the April–June quarter and −3.5% in the July–September quarter, shrinking for two quarters in a row.

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However, the Japanese economy clearly entered a new phase after November 2012, when the Abe administration was inaugurated, as it appears to have been turning up since then. The ESP Forecast Survey, published monthly by the Japan Center for Economic Research, tallies the forecasts of approximately forty frontline Japanese economists and indicates their average. According to this survey (September 2013), thirty-eight out of forty economists indicated that November 2012 was an economic trough.

GDP growth has also been positive for the third quarter in a row, increasing 1.1% in the October–December quarter of 2012, 4.1% in the January–March quarter of 2013, and 3.8% in the April–June quarter. This economic growth is also expected to continue in fiscal 2013 (from April 2013 to March 2014). In its economic outlook, announced in August 2013, the government expected the growth rate for fiscal 2013 to be 2.8%. The ESP Forecast Survey also reports that the average forecast of private-sector economists is 2.7%, almost the same as the government's forecast. This means that a relatively high growth rate is expected for fiscal 2013, given that Japan's average growth rate for the last ten years (from fiscal 2003 to fiscal 2012) was 0.9%.

However, the growth rate is expected to decelerate considerably in fiscal 2014. According to the ESP Forecast Survey, the average growth rate for fiscal 2014 forecast by private-sector economists is only 0.6%. So why is the growth rate expected to slow down so much in fiscal 2014? Because the higher consumption tax rate is expected to have a strong impact.

The Japanese government decided to raise the consumption tax rate from its current 5% to 8% in April 2014. This higher consumption tax rate will impact growth through two channels.

One is front-loaded demand. Since everyone knows that the consumption tax rate will be raised 3 percentage points, they will try to buy goods before the tax rate hike goes into effect. This means that demand that would normally increase later will be front-loaded, and therefore demand will decline after the consumption tax rate goes up. This front-loaded demand is likely to happen in particular for high-ticket items such as automobiles and houses. In fact, sales of automobiles and houses are increasing substantially.

The question is how large this front-loaded demand will be. The Japan Center for Economic Research estimates that it will be equivalent to about 0.7% of GDP. If this is correct, the growth rate in fiscal 2013 will be 0.7% higher than it would be otherwise, apparently, while the growth rate in fiscal 2014 will seemingly decline by as much as 1.4%. That is why growth in fiscal 2014 will slow down significantly compared to fiscal 2013.

The other channel is the negative effects of the consumption tax itself on the economy. If the consumption tax is raised 3 percentage points, consumer prices will rise by that much. Real household income will therefore decline, and consumer spending will fall. This will have a negative impact on the economy in fiscal 2014. The economic model of the Economic and Social Research Institute of the Cabinet Office shows that a 1 percentage point increase in the consumption tax rate will lower the GDP growth rate by 0.15%. So, the current 3 percentage point hike will reduce the growth rate by about 0.5%.

Due to the combination of these two adverse effects, the growth rate in fiscal 2014 will be subjected to downward pressure of as much as 1.9% compared to fiscal 2013.

To prevent this weakening of the economy, the government has decided to implement 5 trillion yen in stimulus measures (about 1% of nominal GDP). These measures include an increase in public investment, cash benefits to low-income earners, corporate tax cuts to stimulate investment, and a reduction of the corporate income tax rate. However, the following arguments are underway regarding implementing such policy measures.

The first argument is whether these economic measures are necessary in the first place. Placing the highest policy priority on breaking away from deflation, the government is worried that the recovery trend in the economy will come to a halt if the consumption tax rate is raised. The consumption tax rate was raised from 3% to 5% in Japan in 1997, and the Japanese economy plunged into a serious recession after that. Based on this experience, many are concerned that if we do nothing, the same thing will happen again this time.

On the other hand, some say that such economic measures are unnecessary. One majority opinion is as follows: While it's true that the economy will weaken in fiscal 2014 as front-loaded demand tapers off, it is not necessary to implement policies to deal with this weakening, as it is simply a time lag in the realization of demand. In addition, some believe that the impact of the higher consumption tax rate itself on the economy will only be about 0.5% in terms of GDP, as mentioned above, and that the reason why the economy declined significantly after the consumption tax hike in 1997 is because the Asian currency crisis and the financial crisis in Japan happened at the same time. So, the economy will not weaken that much this time, they say. This view is also dominant.

The second argument is what will happen to fiscal reconstruction if the consumption tax rate is raised. First of all, the purpose of the current consumption tax rate hike is to help create a surplus in the primary balance by fiscal 2020, the objective of fiscal reconstruction. It seems contradictory to increase fiscal spending for economic measures on the one hand, while taking steps to increase taxes on the other hand.

In contrast, those who call for economic measures argue that it is necessary, above all, to prevent the economy from weakening, because fiscal reconstruction will not be possible if the economy is weakened by the higher consumption tax rate. They say that as the current economic measures will be financed by the leeway in the revenue source arising from tax revenues in excess of the planned amount for fiscal 2013, the fiscal deficit will not increase as a result of the economic measures. On the other hand, those who prioritize fiscal reconstruction believe that because Japan's financial condition is seriously compromised, it would be difficult to achieve the government's goal of fiscal reconstruction even if the consumption tax rate is raised as planned this time, so more tax hikes and a further reduction of social security expenses will be necessary in the future. Given these circumstances, any leeway in the revenue source ought to be used to reduce the fiscal deficit first, because fiscal reconstruction will be less feasible if it is used for economic measures, they argue.

The third argument is about reducing the corporate income tax rate. Some criticize the lack of balance, saying that the financial burden of households will be increased by the higher consumption tax rate, while corporate taxes will be reduced through stimulus measures. On the other hand, those calling for a reduction in the corporate income tax burden argue that the internationally high tax rates in Japan are leading to the hollowing-out of the Japanese economy, and that the economy will not be jump-started unless companies are more incentivized.

After listening to these arguments, the government is trying to put into practice a policy of implementing large-scale economic measures while raising the consumption tax rate. This will attract attention to what the Japanese economy will look like as a result, and how the government can pave the way for fiscal reconstruction at the same time.

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