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Achieving Fiscal  
Consolidation while  
Promoting Social Cohesion  
in Japan

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**Kohei Fukawa**

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ECONOMICS DEPARTMENT

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**By Randall S. Jones and Kohei Fukawa**

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**ABSTRACT/RÉSUMÉ****Achieving fiscal consolidation while promoting social cohesion in Japan**

With gross government debt of 226% of GDP, Japan's fiscal situation is in uncharted territory and puts the economy at risk. Japan needs a detailed and credible fiscal consolidation plan, including specific revenue increases and measures to control spending to restore its fiscal sustainability. The major concern on the spending side are social spending pressures in the context of rapid population ageing, making reforms to contain such spending a priority. Much of the consolidation, though, will have to be on the revenue side, primarily through hikes in the consumption tax rate beyond the 10% now planned for 2017. Fiscal consolidation should be accompanied by measures to promote social cohesion through the tax and benefit system and by breaking down labour market dualism. In particular, an earned income tax credit is a priority to assist the working poor.

This Working Paper relates to the 2015 *OECD Economic Survey of Japan* ([www.oecd.org/eco/surveys/economic-survey-japan.htm](http://www.oecd.org/eco/surveys/economic-survey-japan.htm))

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Keywords: Japan, Abenomics, fiscal policy, public debt, social security, consumption tax, fiscal consolidation, fiscal sustainability, debt dynamics, fiscal management strategy, independent fiscal councils, poverty, inequality, pensions, labour market dualism, non-regular workers, health care, pensions, EITC.

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**Assainir les finances publiques tout en promouvant la cohésion sociale au Japon**

Avec une dette publique brute de 226 % du PIB, le Japon se trouve dans une situation budgétaire sans précédent, qui met en péril son économie. Le Japon a besoin d'un programme d'assainissement budgétaire précis et crédible, prévoyant des mesures spécifiques d'accroissement des recettes et de maîtrise des dépenses, afin de renouer avec la viabilité budgétaire. La principale préoccupation au chapitre des dépenses tient aux pressions sur les dépenses sociales sur fond de vieillissement démographique rapide. Il est donc prioritaire d'engager des réformes pour contenir ces dépenses. L'effort d'assainissement des finances publiques devra cependant porter en grande partie sur les recettes, essentiellement sous la forme d'une hausse du taux de la taxe sur la consommation allant au-delà de son relèvement à 10 %, qui est maintenant prévu pour 2017. L'assainissement budgétaire devrait s'accompagner de mesures destinées à promouvoir la cohésion sociale en s'appuyant sur le système de prélèvements et de prestations et en mettant fin au dualisme du marché du travail. Il est notamment prioritaire de mettre en place un crédit d'impôt sur les revenus du travail pour aider les travailleurs pauvres.

Ce Document de travail a trait à *l'Étude économique de l'OCDE du Japon, 2015* ([www.oecd.org/fr/eco/etudes/etude-economique-japon.htm](http://www.oecd.org/fr/eco/etudes/etude-economique-japon.htm)).

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Mots clés : Japon, Abenomics, politique budgétaire, dette publique, sécurité sociale, impôt sur la consommation, assainissement budgétaire, viabilité budgétaire, dynamique de la dette, stratégie de gestion budgétaire, conseils budgétaires indépendants, pauvreté, inégalité, dualisme du marché du travail, travailleurs non réguliers, retraite, soins de santé.

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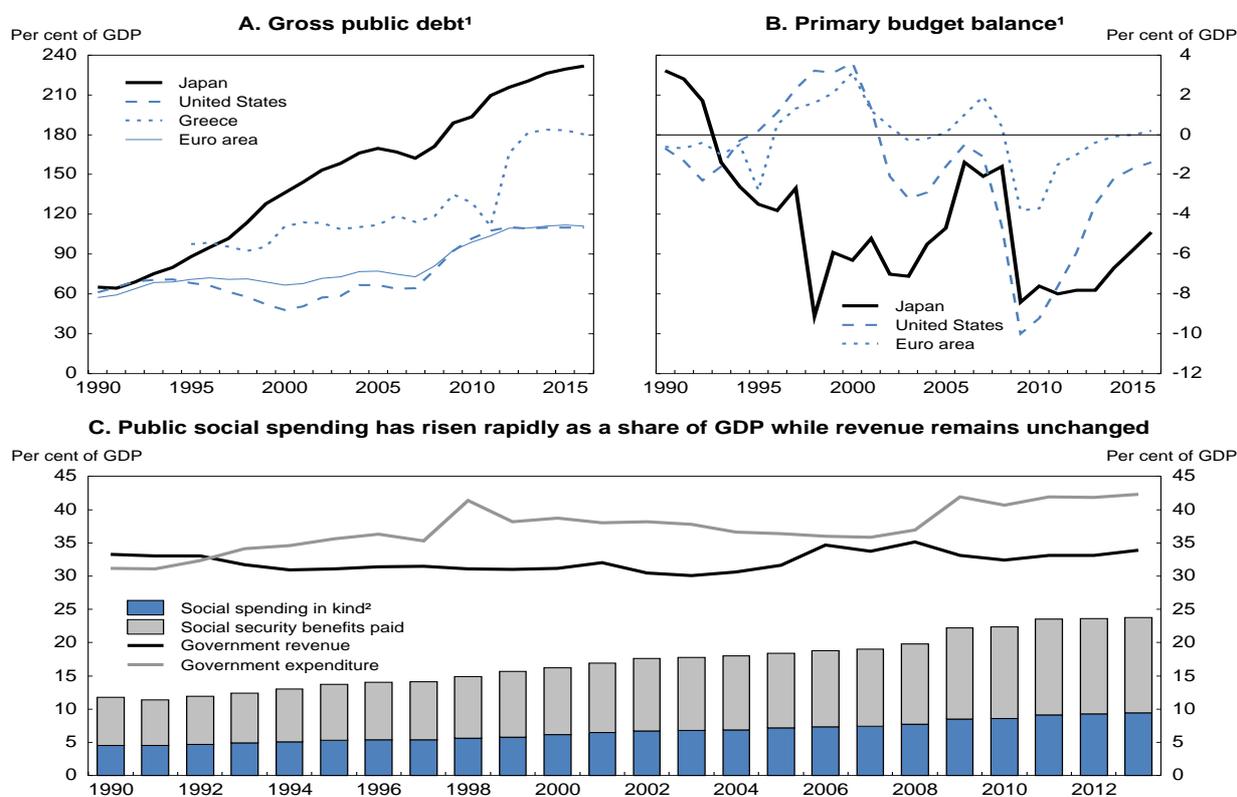
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## ACHIEVING FISCAL CONSOLIDATION WHILE PROMOTING SOCIAL COHESION IN JAPAN

By Randall S. Jones and Kohei Fukawa<sup>1</sup>

Twenty-two years of budget deficits have driven up gross public debt from 70% of GDP in 1992 to around 226% in 2014, the highest ever recorded in the OECD area (Figure 1). In net terms, the debt ratio is 129% of GDP, again the highest in the OECD. The primary deficit is projected to remain high at around 5% of GDP in 2016 (Panel B), further pushing up debt. Japan's fiscal problem reflects the doubling of public social spending, from 12% of GDP in 1990 to 24% in 2013, while revenues were unchanged at one-third of GDP (Panel C). By FY 2013, social spending accounted for more than half of general government spending.

**Figure 1. Japan's fiscal situation has deteriorated over the past 20 years with the increase of social spending**  
In per cent of GDP



1. OECD estimates for 2014 and projections for 2015-16.

2. "Social spending in kind" is calculated from fiscal year data.

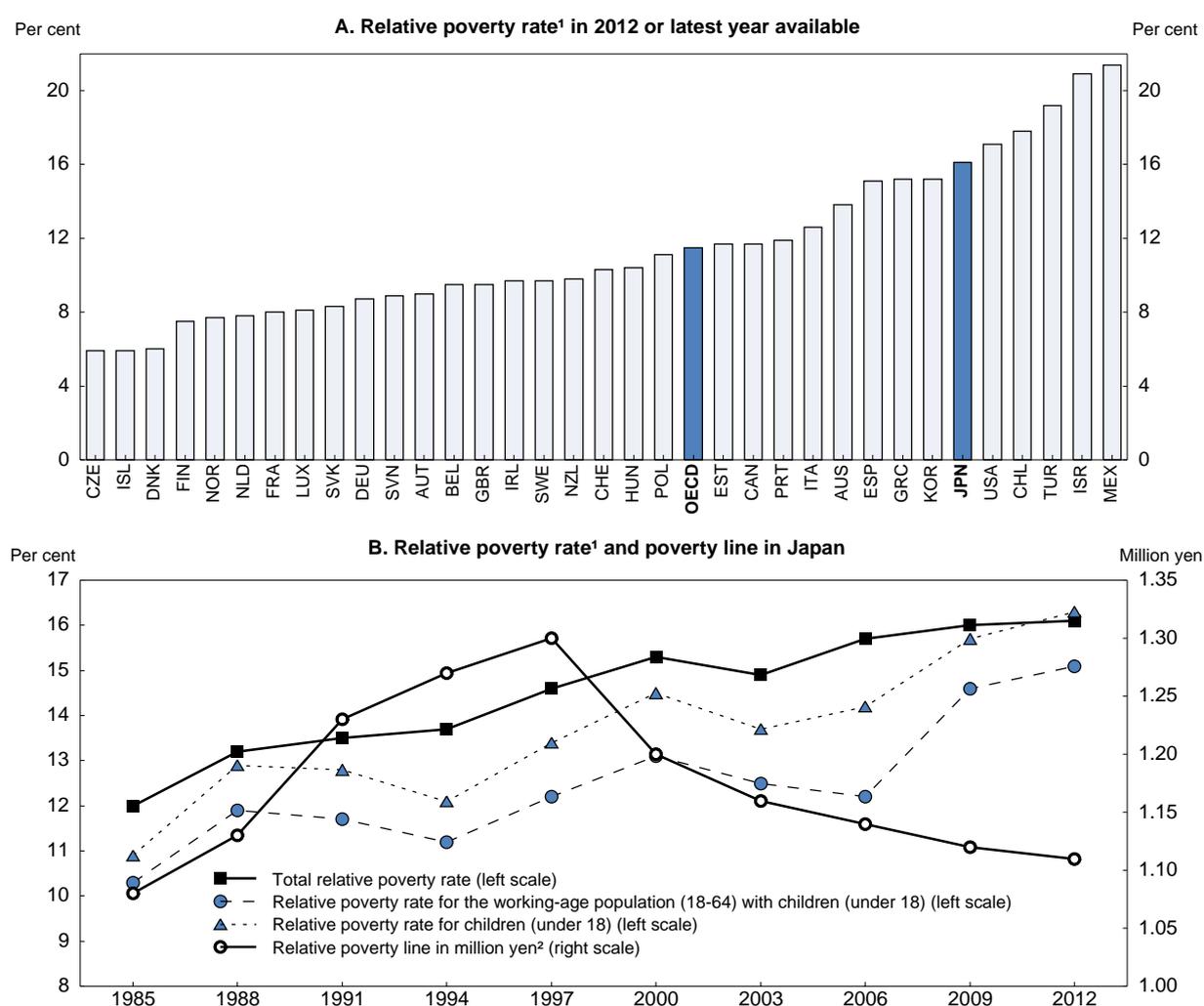
Source: OECD Economic Outlook Database.

1. Randall S. Jones is head of the Japan/Korea Desk in the Economics Department of the OECD and Kohei Fukawa is an economist on the Desk. This paper is based on the second chapter of the *OECD Economic Survey of Japan* published in April 2015, prior to the announcement of Japan's Economic and Fiscal Management Strategy at the end of June 2015. The *Survey* was released under the authority of the Economic and Development Review Committee (EDRC). The authors would like to thank the Japanese authorities, as well as Bert Brys, Robert Ford, Yvan Guillemette, Vincent Koen, Alvaro Pereira and members of the EDRC for helpful comments and suggestions. Special thanks go to Lutécia Daniel for technical assistance and to Nadine Dufour and Mercedes Burgos for secretarial assistance.

The impact of high debt is mitigated at present by low interest rates, reflecting persistent deflation and the risk aversion and “home bias” of investors, as well as large-scale purchases by the Bank of Japan (BoJ) under its “Quantitative and Qualitative Easing” (QQE) policy. Around 90% of government debt is domestically held and the government’s external debt (including the BoJ) was less than \$1 trillion in mid-2014 (around a quarter of GDP). However, the outlook for the government bond market will be more uncertain once the BoJ achieves its inflation target and phases out QQE.

At the same time, Japan faces high poverty and income inequality. The relative poverty rate, defined as the share of the national population with an income below half of the national median, was the sixth highest in the OECD area (Figure 2). It increased from 12.0% in 1985 to 16.1% in 2012, driven by a rise among the working-age population (Panel B). The relative poverty rate of children in Japan was the ninth

**Figure 2. Japan faces a problem of high poverty and social cohesion**



1. The relative poverty rate is the share of the population with an income after taxes and transfers below half the “median equivalent disposable income”, which equals household disposable income divided by the square root of the number of household members. Japanese data are based on the Comprehensive Survey of Living Conditions, which is submitted to the OECD by Japan. Another survey, the National Survey of Family Income and Expenditure, shows a much lower relative poverty rate of 10.1%.
2. Defined as half the median disposable income nationwide. It is in real terms.

Source: OECD Income Distribution and Poverty Database; Ministry of Health, Labour and Welfare, *Comprehensive Survey of Living Conditions*.

highest in the OECD at 16.3% in 2012. Moreover, the “relative poverty line” – 50% of the national median income – has fallen by 15% in real terms since 1997, indicating that conditions have deteriorated in absolute terms for those in relative poverty (Oshio, 2013). Income inequality has also increased, driven by a rise in inequality for the working-age population.

The poverty issue among the working-age population and children reflects two factors. *First*, public social spending transfers income from those under age 65 to the elderly. Indeed, 80% of social security benefits go to the 40% of households with a person aged 65 or older. Those households hold nearly half of total household financial assets but only 14% of debt (Tanaka, 2010). *Second*, labour market dualism creates high wage inequality. The rising share of non-regular workers has been identified as the major cause of inequality (Ministry of Health, Labour and Welfare, 2014a), despite a small increase in the earnings of non-regular workers from 62.3% of regular workers in FY 2012 to 63.4% in FY 2014.

After an overview of Japan’s fiscal predicament, this paper reviews policy options to achieve fiscal sustainability, beginning with the revenue side. The third section analyses measures to control spending, primarily by limiting the growth of public social expenditures. Policy recommendations are summarised in Box 3. The main findings include:

- The very high level of government debt leaves Japan vulnerable to a loss of confidence and a run-up in interest rates, which would have destabilising effects on public finances, the financial sector and the real economy. A detailed and credible plan to maintain confidence is thus crucial.
- With government revenue low compared to other OECD countries, there is scope for revenue increases, focusing on taxes that are less harmful for growth, such as the consumption tax.
- Given that rising government spending is driven by social expenditures related to population ageing, reform of pension and health and long-term care is crucial to contain spending growth.
- The issues of high relative poverty should be addressed by improving social welfare programmes and by attacking the underlying causes of inequality, notably labour market dualism.

## **Japan’s fiscal situation is not sustainable**

### ***Japan’s fiscal management policy***

In 2013, the government adopted fiscal targets that are broadly in line with the fiscal strategy laid out in 2010:

- Halving the primary deficit of central and local governments from 6.6% of GDP in FY 2010 to 3.3% by FY 2015;
- Achieving a primary surplus by FY 2020.
- Steadily reducing the public debt to GDP ratio thereafter.

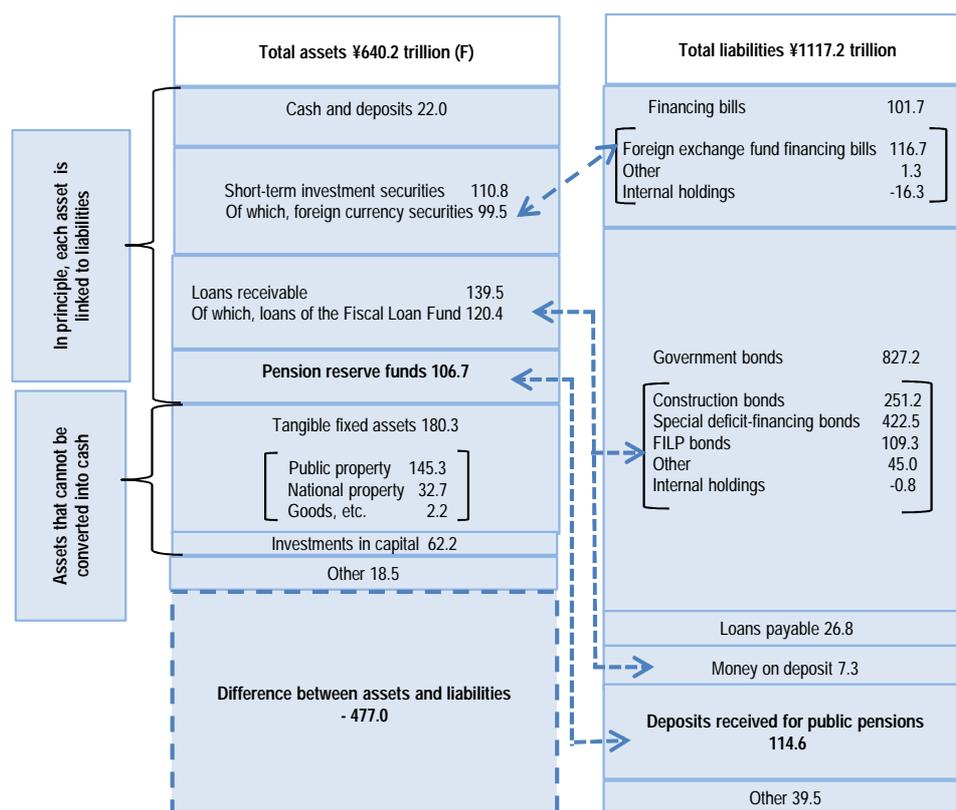
The targets were established by “The Basic Policies for Economic and Fiscal Management and Reform” and were spelled out in more detail in the “Medium-term Fiscal Plan”, which were adopted in 2013. Fiscal policy targets gross, rather than net, debt (Box 1).

### Box 1. Gross versus net government debt

As noted above, Japan's government debt, on both a gross and net basis, is the highest among OECD countries. Moreover, government assets – the difference between gross debt and net debt – are also large at nearly 100% of GDP. Some of these assets also generate income. In 2013, about two-thirds of the interest payments on liabilities were offset by government interest receipts, helping to limit net government interest payments to 0.7% of GDP. It is sometimes argued that net debt is the most appropriate measure of government debt as it excludes intra-governmental debt, which has no direct, immediate impact on the economy (CBO, 2009). In addition, the large stock of assets may provide Japan a cushion that could help protect it against a sovereign debt crisis.

The usefulness of government assets as a cushion, however, is limited by several factors. *First*, only about a third of government assets are in the form of liquid instruments, such as cash and bonds. For example, tangible fixed assets, such as roads and public buildings, account for more than a quarter of central government assets (Figure 3), and these cannot be easily turned into cash in case of emergency. *Second*, assets are linked to corresponding liabilities. For example, loans made by the Fiscal Loan Fund, which amounted to some 120.4 trillion yen (25% of GDP) in FY 2012 were financed by Fiscal Investment Loan Programme bonds of a similar amount. Similarly, pension reserve funds (106.7 trillion yen) are backed by deposits received for public pensions (114.6 trillion yen), while foreign exchange reserves, which are nearly 100 trillion yen, are financed by 116.7 trillion yen of foreign exchange fund financing bills. If these large assets were used for other purposes during a contingency, the matching liabilities would have to be met through higher government revenue. *Third*, the quality of some government assets, such as loans made by the Fiscal Loan Fund, is doubtful (2005 *OECD Economic Survey of Japan*).

Figure 3. Central government assets and liabilities in FY 2012



Source: Ministry of Finance.

In sum, while the large stock of government assets needs to be borne in mind, gross government debt appears to be the best summary measure of the public-sector position. In fact, even gross debt may understate the government's eventual obligations, as it does not include unfunded future liabilities, notably for public pensions, which are estimated at 450 trillion yen (92% of 2014 GDP) (Ministry of Health, Labour and Welfare, 2010). In addition, it excludes contingent liabilities, such as government loan guarantees for quasi-government institutions.

The FY 2015 general account budget reflects the challenge of achieving the FY 2020 primary surplus target. To limit the rise in nominal spending, the budget cuts outlays on energy (6.8%), science (3.9%) and education (0.5%), while keeping public works unchanged (Table 1). Consequently, primary spending, excluding social security outlays, falls by 1.7%. However, significant increases in social security (3.3%) and debt service (0.8%) will boost total spending by 0.5% to a record high 96.3 trillion yen. Indeed, social security outlays and debt service account for over half of total general account outlays (Figure 4).

**Table 1. Initial FY 2015 budget**

General account in trillion yen in nominal terms

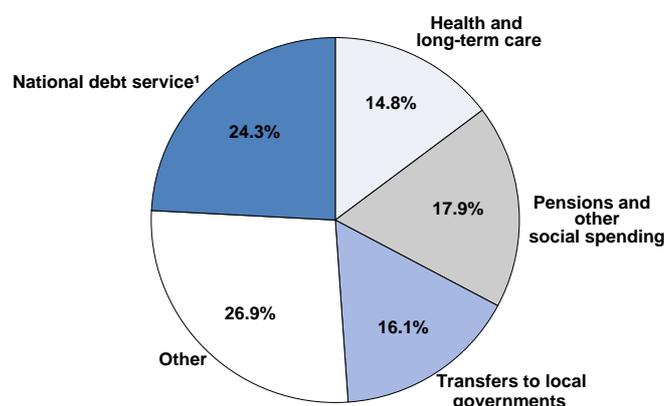
Expenditure category	FY 2014 budget (initial)	FY 2015 draft budget	Change in trillion yen	Percentage change
<b>A. Primary spending</b>	<b>72.6</b>	<b>72.9</b>	<b>0.3</b>	<b>0.4</b>
Social security	30.5	31.5	1.0	3.3
Pensions	10.9	11.2	0.3	3.1
Health and long-term care	13.9	14.2	0.4	2.6
Social assistance and other	5.7	6.0	0.3	5.3
Education	4.1	4.1	-0.0	-0.5
Science	1.3	1.3	-0.1	-3.9
Local allocation tax grants, etc.	16.1	15.5	-0.6	-3.8
National defence	4.9	5.0	0.1	2.0
Public works	6.0	6.0	0.0	0.0
Economic assistance	0.5	0.5	0.0	-0.7
Measures for SMEs	0.2	0.2	0.0	0.2
Energy	1.0	0.9	-0.1	-6.8
Food supply	1.1	1.0	0.0	-0.9
Other	6.9	6.9	-0.1	-1.0
<b>B. National debt service</b>	<b>23.3</b>	<b>23.5</b>	<b>0.2</b>	<b>0.8</b>
Interest payments	10.1	10.1	0.0	0.0
Debt redemption <sup>1</sup>	13.1	13.3	0.2	1.3
<b>Total</b>	<b>95.9</b>	<b>96.3</b>	<b>0.5</b>	<b>0.5</b>

1. These outlays are not included in government spending on a general government basis.

Source: Ministry of Finance.

In addition to the record amount of spending in the FY 2015 draft budget, spending will be increased by another 3.1 trillion yen (0.6% of GDP) by the FY 2014 supplementary budget approved by the Diet in February 2015. The package is intended to promote growth, after two quarters of output decline, by supporting households and small firms and improving disaster preparedness (Table 2). Another focus is regional revitalisation and additional transfers to local governments, on top of the FY 2015 draft budget and the fiscal plan of local governments. The supplementary budget will be financed by 2 trillion yen from remaining funds from the settlement of accounts for the FY 2013 budget<sup>2</sup> and higher-than-expected tax receipts of 1.7 trillion yen. More than four-fifths of the 3.7 trillion yen in untapped resources is thus being used to increase spending rather than to cut government borrowing. Meanwhile, local governments plan to increase their spending by 2.3% from 83.4 trillion yen in FY 2014 to 85.3 trillion yen in FY 2015.

2. After the end of each fiscal year at the end of March, each ministry and agency accounts for its actual expenditures and presents a statement of accounts to the Ministry of Finance (MOF) by the end of July. Based on these statements, the MOF aggregates the individual settlement of accounts and comes up with the settlement of total revenues and expenditures.

**Figure 4. Debt service and social security accounts for more than half of the FY 2015 draft budget**

1. National debt service includes 13.3 trillion yen of debt redemption, which is not included in general government spending, and 10.1 trillion yen of interest payments. By law, about 1.6% of existing debt has to be redeemed each year.

Source: Ministry of Finance.

The government expects to achieve the primary deficit target of 3.3% of GDP for central and local governments in FY 2015, even including the FY 2014 supplementary budget.<sup>3</sup> In February 2015, the government projected that the deficit would fall from 5.7% of GDP in FY 2013 to 5.2% in FY 2014. Consequently, meeting the 3.3% target implies reducing the primary deficit by around 2 percentage points of GDP in FY 2015. Such a large reduction requires limiting other components of spending, namely special accounts and local government spending, which nearly matches primary spending by the central government.

**Table 2. FY 2014 supplementary budget**

General account in trillion yen

Expenditure category	Expenditure
A. Supporting households and small businesses	1.2
Support for households and small businesses	0.6
Measures to reduce energy costs	0.4
Measures to revitalise housing markets	0.2
B. Regional revitalisation	0.6
Fostering human resources and job creation	0.2
Economic revitalisation through industrial development in regional areas	0.4
C. Disaster preparedness	0.8
D. Local Allocation Tax grants (for local governments)	1.0
E. Other	0.4
F. Reduction in fixed expenses (including national debt service)	-1.8
G. Provision for Special Account for Reconstruction	1.0
<b>Total</b>	<b>3.1</b>

Source: Ministry of Finance.

3. The OECD Secretariat projects budget balances on a general government basis and does not have a separate estimate for central and local governments. In addition, it projects on a calendar year basis, rather than for fiscal years, which begin on 1 April each year.

Reducing the primary deficit by 2 percentage points of GDP in FY 2015 also hinges on achieving the projected 9% increase in tax revenue, while nominal GDP is forecast to rise by 2.7%, according to the government. The increase in tax receipts is to be led by an 11.6% gain in consumption tax revenues, reflecting the lagged effect of the April 2014 tax hike, even though the government projects that private consumption will rise by 2.8% in nominal terms in FY 2015. Corporate income tax receipts are expected to increase by 4.5% in FY 2015 despite a cut in the tax rate from 34.6% in FY 2014 to 32.1% in FY 2015. However, measures to broaden the tax base are likely to limit the impact of the tax cut on revenues.<sup>4</sup> In addition, non-tax revenue is forecast to rise by 7%, thanks in part to one-off measures, such as the sale of government equity holdings and the use of reserves in state funds. If the large revenue increase fails to materialise, meeting the FY 2015 target would require scaling back planned spending. In any case, the target provides discipline in limiting government spending, even if the FY 2015 primary deficit outcome will not be known until 2017.

Looking ahead to FY 2020, the Cabinet Office projected in February 2015 that the primary deficit of central and local governments would be 1.6% of GDP in FY 2020 even under the following favourable assumptions: *i*) the second consumption tax hike to 10% is implemented in 2017; *ii*) nominal GDP grows by 3.1% a year on average for FY 2013-22 (the “economic revitalisation case”); and *iii*) primary spending, excluding social security, is constant in real terms after FY 2016 (Cabinet Office, 2015). Under the baseline case, with annual nominal GDP growth of 1.4%, the government projects that the primary deficit would be 3.0% of GDP in FY 2020. The decision in late 2014 to delay the second consumption tax hike to 10% planned for October 2015 until April 2017 may make it even more difficult to achieve the planned fiscal consolidation path.

### ***Key elements needed in a new medium-term strategy***

The government is preparing a new medium-term strategy, to be announced by the summer of 2015, which aims to achieve a primary surplus by FY 2020, while promoting economic revitalisation. It should target a primary surplus large enough to achieve the third goal of putting the government debt ratio on a downward trend. The current Strategy covers only central and local governments, even though the evolution of public debt depends on the general government balance, which includes the social security balance. The social security fund has been in the red every year since FY 2007, with a deficit averaging 0.8% of GDP. It is expected to remain in deficit according to the government’s projection through FY 2023. Focusing on the general government balance, which includes the social security system, increases the amount of fiscal consolidation required to stabilise the public debt ratio.

The size of the primary surplus necessary to stabilise the government debt ratio gap equals the gap between the nominal interest rate and nominal growth rate multiplied by the level of debt. If the gap were to match its 1½ percentage-point average since 1980, Japan would need a primary surplus of around 3½ per cent of GDP. In the government’s medium to long-term projections, the gap is assumed to be 1.3 points in FY 2023, which would imply that a primary surplus of 3% of GDP would be necessary to stabilise the debt ratio.<sup>5</sup>

The large-scale fiscal consolidation – from a general government primary deficit of around 7% of GDP in 2014 to a surplus of around 3% – requires decisive political will and commitment, backed by

- 
4. There are four measures in the FY 2015 tax reform: *i*) tax deduction of losses carried forward is reduced from a maximum of 80% of income to 65%; *ii*) the exclusion of dividends from gross profit is reduced to the share ownership ratio up to 25%; *iii*) pro-forma standard taxation for large corporations is increased; and *iv*) special tax measures, such as R&D incentives, are reduced.
  5. Assuming that the debt ratio in FY 2020 remains around its current level of 230% of GDP, the size of the primary surplus necessary to stabilise the debt ratio would be around 3%, i.e. 230% \* 1.3.

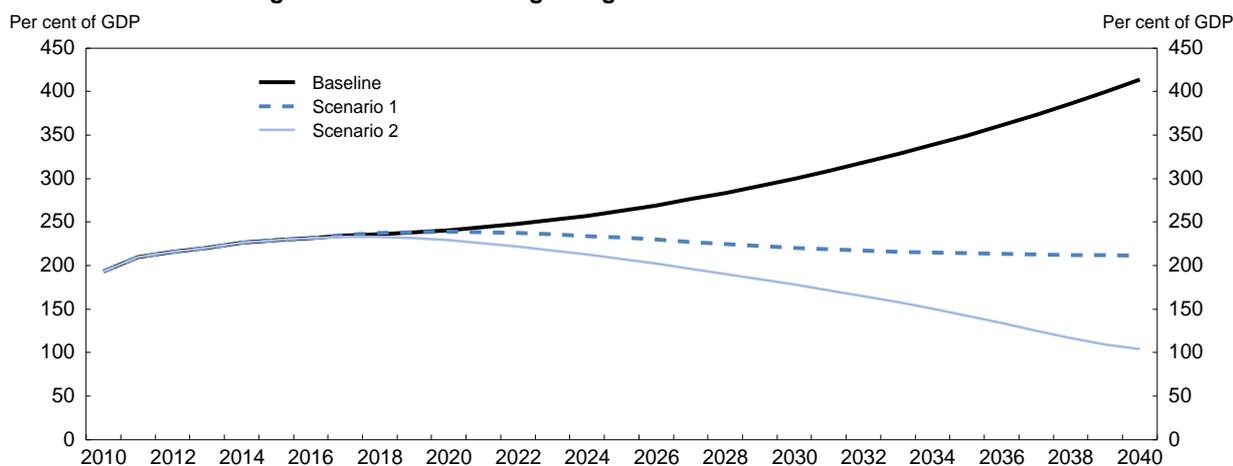
public support. It is crucial to maintain confidence in Japan's fiscal sustainability, despite its high level of debt, during the extended period of consolidation ahead, which may take more than a decade. To sustain such confidence, it is crucial to draw up and commit to a detailed and credible medium-term plan that contains specific spending cuts and tax increases necessary to achieve the required primary surplus. Such a commitment would be strengthened by improving the fiscal policy framework through a stronger legal basis for fiscal targets. Past country experience with large fiscal consolidations suggests that it is helpful to have an expenditure rule in addition to a budget balance rule (IMF, 2009).

In addition, good fiscal institutions are a necessary condition for fiscal discipline and to help sustain political commitment to medium-term goals (Hagemann, 2010). Fiscal policy can benefit from having an impartial body provide: *i*) costing of various government initiatives; *ii*) ex ante evaluation of whether fiscal policy is likely to meet its mid-term target; *iii*) ex post evaluation of whether fiscal policy has met its targets; and *iv*) an analysis of the long-run sustainability of fiscal policy (Calmfors, 2011). In Japan, the Council on Economic and Fiscal Policy, which includes the Prime Minister, five ministers, the governor of the Bank of Japan, two academic experts and two business leaders plays some of these roles.

### *Achieving fiscal sustainability requires all three arrows of Abenomics*

Without further consolidation measures, Japan's debt-to-GDP ratio would rise inexorably, according to the OECD's model of Japan's debt dynamics. The baseline, which assumes no fiscal consolidation after 2016, shows a gross debt ratio of more than 400% by 2040 (Figure 5).

**Figure 5. Simulations of gross government debt as a share of GDP<sup>1</sup>**



1. In the baseline, there is no fiscal consolidation, while consolidation of 7% of GDP over the decade 2017-26 is assumed in the two scenarios, which are based on different growth rate assumptions (see Box 2).

Source: OECD Economic Outlook Database; OECD calculations.

The model is used to simulate the impact of a 7 percentage-point of GDP consolidation over the decade 2017-26 (Box 2). However, in the first scenario, with annual nominal output growth of 1½ per cent between 2014 and 2040, the debt ratio remains alarmingly high at above 200% of GDP through 2040 despite the fiscal consolidation measures. In contrast, fiscal consolidation, combined with effective implementation of the first and third arrows, would put the debt ratio on a downward trend, falling to nearly 100% of GDP by 2040 in Scenario 2. Nominal output growth is 4% thanks to the success of quantitative and qualitative monetary easing in achieving the 2% inflation target and the Japan Revitalisation Strategy in boosting real output growth to 2%. In sum, fiscal measures are not enough to reduce government debt but need to be accompanied by faster growth. In turn, lower debt would be positive for growth. It has been estimated that gross debt between 50% and 80% of GDP is growth maximising (Checherita-Westphal et. al, 2011).

### Box 2. Long-term debt simulations

The OECD has developed a model of Japan's debt dynamics (Guillemette and Strasky, 2014). The evolution of gross debt as a share of GDP ( $d$ ) depends on the primary balance as a share of GDP ( $pb$ ), on the difference between the real interest rate ( $r$ ) and the growth rate of real GDP ( $g$ ), and approximately follows:

$$\Delta d_t = -pb_t + (r_t - g_t)d_{t-1}$$

The model illustrates the importance of nominal GDP growth in reducing debt (Table 3). Even with fiscal consolidation of 7% of GDP, the debt ratio remains fairly constant if nominal GDP growth averages 1½ per cent (Scenario 1). However, if nominal growth were to reach 4% (Scenario 2), the same amount of fiscal consolidation would put the debt ratio on a steady downward trend. The main features of the model are:

- Real growth depends on potential growth, the output gap and the fiscal impulse. The model assumes a fiscal multiplier of 0.5, which is in line with the government's macroeconomic model developed by the Economic and Social Research Institute in the Cabinet Office, which estimates a multiplier of 0.3 to 0.6 for tax hikes, and close to a recent estimate of around 0.6 (Baum et al., 2012). The fiscal multiplier may turn out to be higher than 0.5, particularly if consolidation includes spending reductions (Guillemette and Strasky, 2014). With a higher fiscal multiplier, the negative effects of fiscal consolidation on economic activity in the scenarios presented above become more significant. In scenario 1, for example, assuming a fiscal multiplier of 1.0 would result in a government debt ratio of 236% of GDP in 2040, 25 basic points higher than with a multiplier of 0.5.
- Fiscal policy is implemented through assumptions on the path of the structural primary balance. In the baseline, with no fiscal consolidation after 2016, the primary balance stays around its level of more than 5% of GDP through 2040 (Table 3). In the two scenarios, the 7% of GDP in fiscal consolidation results in primary surpluses of 1.7% and 4% of GDP in 2026, respectively, reflecting different output growth rates in the two scenarios.

**Table 3. Long-term debt simulation results**

Annual averages as a percentage of GDP

Baseline: Nominal growth averages 2¾ per cent (real growth = 1%, inflation = 1¾ per cent)

	2014-26	2026-40	2014-40	2040
Long term interest rate	3.1	6.0	4.7	6.9
Government balance	-7.4	-16.5	-12.4	-23.0
Government primary balance	-5.3	-5.0	-5.1	-5.0
Gross debt	243.8	333.1	292.5	413.8

**Scenario 1:** Nominal growth averages 1½ per cent (real growth=1%, inflation= ½ per cent)

	2014-26	2026-40	2014-40	2040
Long term interest rate	1.4	3.8	2.7	4.2
Government balance	-2.1	-0.7	-1.4	-1.9
Government primary balance	-2.1	1.9	0.0	2.0
Gross debt	234.5	217.8	225.2	211.5

**Scenario 2:** Nominal growth averages 4 per cent (real growth=2%, inflation= 2%)

	2014-26	2026-40	2014-40	2040
Long term interest rate	3.1	6.4	4.8	6.4
Government balance	-2.5	4.5	1.3	9.8
Government primary balance	-1.3	6.8	3.0	9.3
Gross debt	223.2	155.1	186.1	103.7

Source: OECD Economic Outlook Database; OECD calculations.

- Inflation, defined in terms of the GDP deflator, is modelled using an expectations-augmented Phillips curve.
- The monetary policy stance is driven by interest-rate smoothing toward a standard Taylor rate but cannot fall below an assumed bound of 0.1%.
- The long-term (10-year) interest rate is modelled as a 10-year average of future short-term policy rates (under perfect foresight), a term premium (fixed at 0.7%) and a fiscal-risk premium which depends on the gross debt ratio. Consequently, the interest rate varies between the two scenarios and the baseline, where the rising debt raises the interest rate, further boosting the debt ratio in a vicious circle.
- The cost of debt servicing depends on the maturity structure of debt, as well as on past and projected interest rates.

### ***Fiscal policy should also promote social sustainability***

Given its high public debt and rising ageing-related expenditure, Japan's tax burden needs to be increased while reducing expenditure. At the same time, it is important that fiscal consolidation aim to promote social cohesion, which has weakened in the face of rising poverty and income inequality.<sup>6</sup> However, the impact of Japan's tax and benefit system on income inequality and relative poverty is weaker than the OECD average, reflecting the fact that it primarily redistributes income over life-cycles rather than across individuals (OECD, 2013). Indeed, it results in substantial income transfers from the young to the elderly through the pension, health and long-term care insurance systems (Figure 6). Consequently, social spending only has a significant impact on the Gini coefficient among the elderly (Panel B).

### **Increasing government revenue while promoting social cohesion**

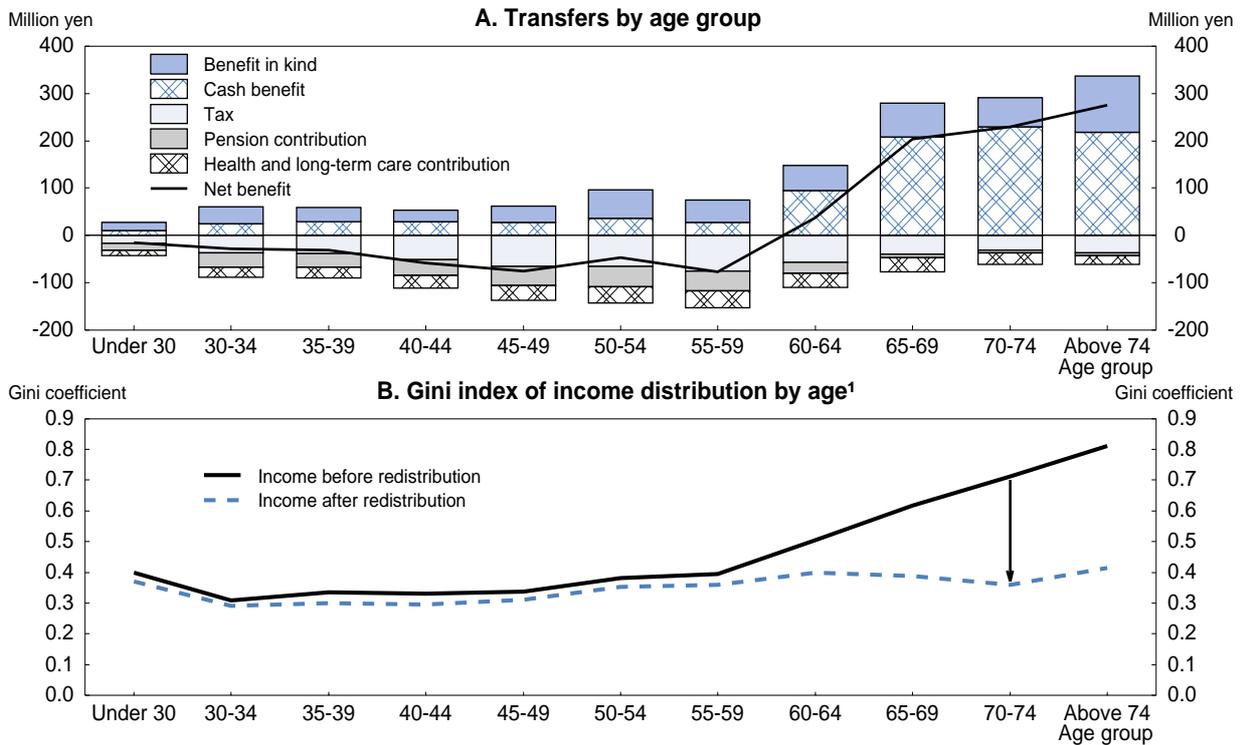
Ensuring fiscal sustainability will require measures to boost revenues from their relatively low levels while constraining the growth of spending, particularly that related to population ageing. Taxes and social insurance contributions amounted to only 29% of GDP in 2012, the eighth-lowest share in the OECD (Figure 7). Japan's tax system stands out in several regards. *First*, the consumption tax rate in Japan is low. Even after the planned hike to 10% in 2017, it will remain the third lowest value-added tax rate in the OECD. *Second*, personal income tax revenue, at 5.5% of GDP, is well below the OECD average of 8.6%. *Third*, the corporate income tax rate is still among the highest in the OECD. *Fourth*, environmental tax revenue as a share of GDP is well below the OECD average.

### ***Japan needs to further raise the consumption tax, while keeping a single rate***

The small share of revenue from indirect taxes in Japan reflects the low consumption tax rate (Figure 8). A VAT, such as Japan's consumption tax, is acknowledged to be a relatively stable revenue source and is less harmful for economic growth, as it imposes fewer distortions on employment and investment (Arnold et al., 2011). A greater role for the VAT would also improve intergenerational equity, as the elderly would bear more of the tax burden. In short, a VAT is the most appropriate tax for raising revenue in Japan.

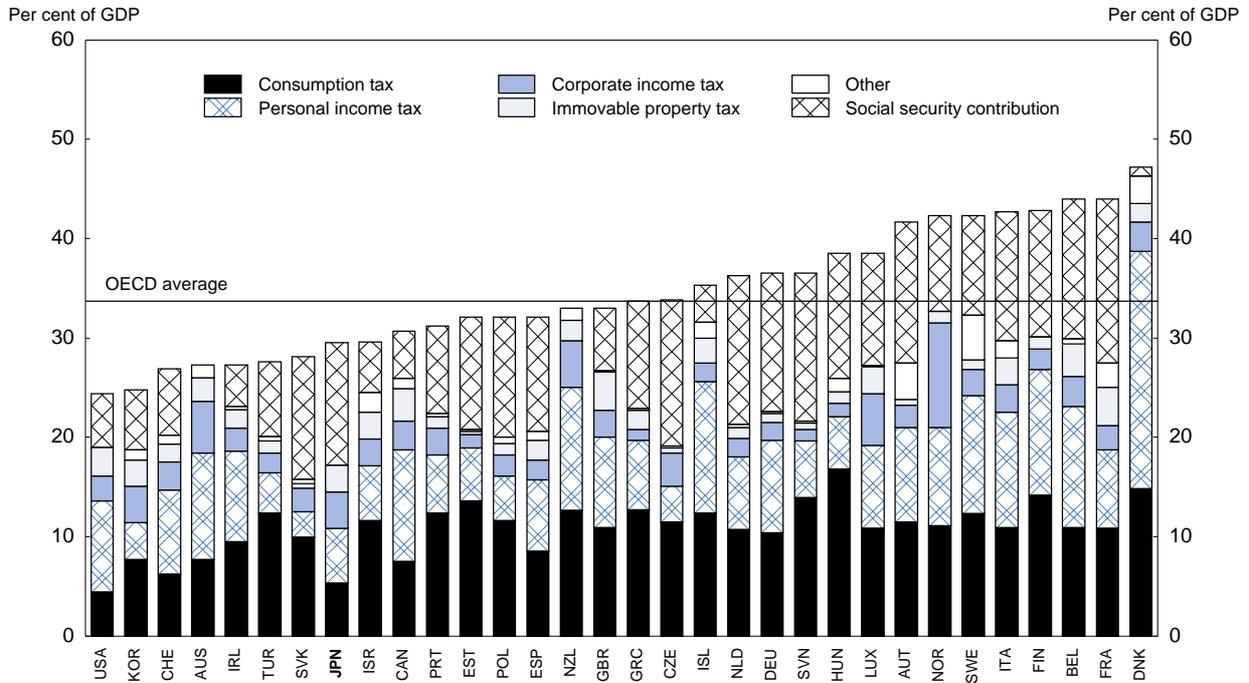
6. The share of the population that answered that their life is "hard" ("very hard" and "rather hard") increased from 51% in 2001 to 60% in 2012. The share was 66% of households with children and 54% of elderly households (Ministry of Health, Labour and Welfare, *National Livelihood Survey 2012*).

**Figure 6. Japan's tax and benefit system transfers income from young to old**  
In 2011



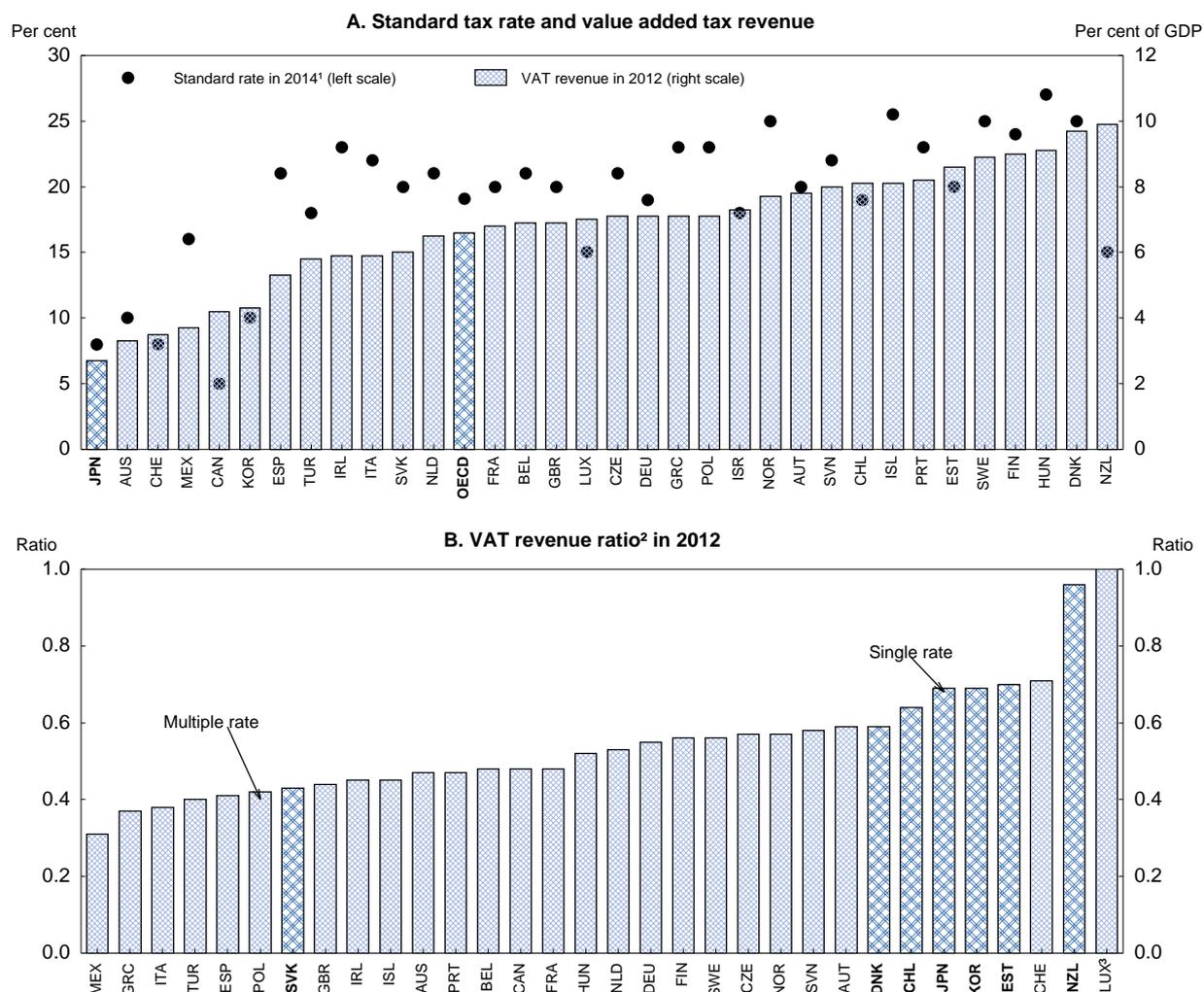
1. The Gini coefficient ranges from 0 (perfect equality) to 1 (perfect inequality).  
Source: Ministry of Health, Labour and Welfare, *Survey on Income Redistribution in 2011*.

**Figure 7. Japan's tax and social security burden is relatively low**  
In 2012



Source: OECD Revenue Statistics Database.

Figure 8. Japan's consumption tax should be raised further while keeping a single rate



1. The standard rate in January 2014, except for Japan, which reflects the consumption tax hike to 8% in April 2014.
2. VAT revenue ratio = actual VAT revenue / ((Final consumption expenditure – actual VAT revenues) × standard rate). A ratio close to one indicates that the VAT is effective in raising revenue.
3. The VAT revenue ratio for Luxembourg in 2012 was 1.13. The exceptionally high ratio reflects Luxembourg's position as a financial centre and as a hub for European e-commerce.

Source: OECD Consumption Tax Trends 2014.

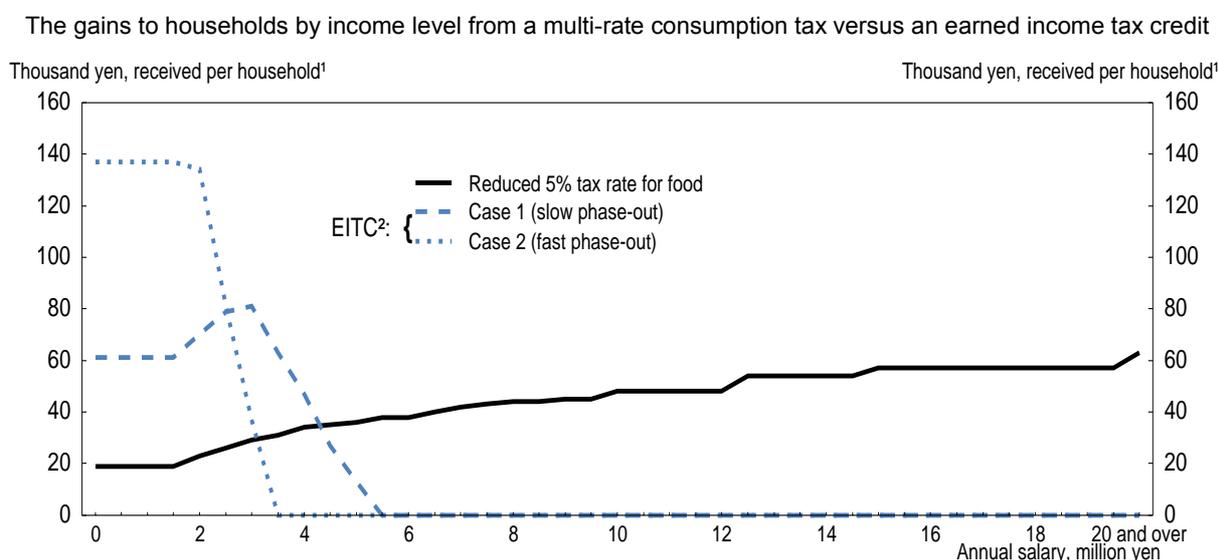
As noted above, the government's projection shows a primary deficit of 1.6% of GDP in FY 2020, even with a hike in the consumption tax rate to 10% in 2017. If the primary deficit were to be balanced through the consumption tax alone, the rate would need to rise by slightly more than 3 percentage points, given that a one-point hike in the consumption tax rate generates revenue equivalent to ½ per cent of GDP. Achieving a primary surplus of around 3% to stabilise the debt ratio would require another 6 percentage-point hike in the tax rate. Consequently, if Japan were to achieve its fiscal targets by relying solely on the consumption tax, the rate would have to converge toward the 22% average in Europe. Moreover, reducing the debt ratio from 2021 would require an even larger tax hike.

Given that Japan has a single consumption tax rate, the tax is effective in raising revenues, as shown by its high "VAT revenue ratio" (Figure 8, Panel B). However, the ruling coalition parties have agreed to

introduce multiple rates when the tax rate is 10% in order to soften the redistributive impact. A multiple-rate VAT would limit the revenue increase, requiring an even higher standard rate. For example, a 5% rate for food (including beverages and eating out) would reduce tax revenue by 3.3 trillion yen (0.7% of GDP) (Ruling Parties' Council on the Tax System, 2014), requiring a standard rate of 11.4% to offset it. Introducing multiple VAT rates has additional drawbacks (2013 *OECD Economic Survey of Japan*). *First*, it would entail higher administrative and compliance costs, especially for SMEs. *Second*, it would provide opportunities for fraud through the misclassification of items. *Third*, it would reduce the neutrality of the VAT, thus distorting consumption decisions and decreasing welfare.

Moreover, multiple tax rates are not effective in mitigating the regressive impact of raising the consumption tax rate, as most of the benefits go to high-income households (OECD, 2014c). A 5% rate for food would reduce the consumption tax payments of households with an annual income of 15 million yen by an average of 55 000 yen per year (Figure 9). In contrast, households with an income of 3 million yen would only benefit half as much.

**Figure 9. An earned income tax credit can offset the regressive impact of raising the consumption tax rate**



1. The gain is due either to the reduced rate of 5% on food, including beverages and eating out (the solid line), or an EITC benefit (cases 1 and 2), with a single 10% tax rate.
2. Assumes a single 10% consumption tax rate. The total amount paid as EITC benefits in both cases 1 and 2 equals the amount of foregone revenue that would have resulted from introducing a 5% rate on food, including beverages and eating out.

Source: Ministry of Internal Affairs and Communications, *National Survey of Family Income and Expenditure in 2009*; OECD calculations.

If the revenue foregone by introducing a lower VAT rate for food were instead used to finance an earned income tax credit (EITC), an in-work benefit for low-income earners, the gains would be better-targeted on low-income earners. For example, if the EITC were gradually phased out by an income of 6 million yen, it would provide an annual benefit of 60 000 yen to households with income below 2 million yen (case 1 in Figure 9). Alternatively, if the EITC were more concentrated among low-income households by phasing it out by 4 million yen, it would provide an annual benefit of 134 000 for households below 2 million yen (case 2). In both cases, the spending for an EITC would match the amount of revenue that would have been lost by introducing a 5% consumption tax rate for food. Although Japan has been considering the introduction of an EITC, there is concern about the lack of transparency about income, particularly among the self-employed. Under the 2012 reform of social security and taxes, identification numbers for taxpayers and those contributing to social security were to be introduced in mid-2014 and put

into use in 2015. However, the introduction was delayed until 2016. The numbers will be important to enhance transparency about income and facilitate the introduction of an EITC, as well as a reduction in the wage income deduction in the personal income tax (see below).

***Broaden the tax base for personal income tax, which would have positive effects on social cohesion***

Personal income tax revenue in Japan is low because of a narrow base. Indeed, less than half of the estimated 260 trillion yen in personal income in FY 2014 is taxable (Table 4). *First*, deductions for wage income and public pension benefits reduce taxable income by around 80 trillion yen, nearly a third of personal income. *Second*, a number of income deductions further lower taxable income by around 60 trillion yen.

**Table 4. Japan's personal income tax base is narrowed by a range of deductions**

Trillion yen based on the FY 2014 budget

Personal income = 260 trillion yen (of which, wages -- 210 trillion yen; pension benefits -- 30 trillion yen; income from business/real estate -- 20 trillion yen)

Deductions = around 140 trillion yen

Deductions for expenses (about 80 trillion yen)		Income deduction (60 trillion yen)		Personal income tax base (110 trillion yen)
		Personal exemptions (30 trillion yen)	Other (about 30 trillion yen)	
Wage income deduction (62 trillion yen)	Public pension deduction, etc. (14 trillion yen)	Basic deduction (18 trillion yen)	Exemption for social insurance premiums (26 trillion yen)	Personal income tax base (110 trillion yen)
		Spouse deduction (5 trillion yen)		
		General allowance for dependents (2 trillion yen)	Exemption for life insurance premiums (2 trillion yen)	Personal income tax (11.7 trillion yen) <sup>1</sup>
		Special allowance for dependents (19-22) (1 trillion yen)	Other (2 trillion yen)	
		Allowance for elderly dependents (1 trillion yen)		
		Other (3 trillion yen)		

1. Tax payments are further reduced by a tax deduction of 0.7 trillion yen for home mortgage payments and dividends.

Source: Ministry of Finance.

For a four-person household with a single worker earning the average wage, Japan's personal income tax base is narrowed by deductions amounting to 60.5%, the fourth highest in the OECD (Table 5). The largest deduction is for wage income, set at 31% of personal income regardless of household type. This deduction, which was introduced in 1913, has been steadily expanded, partly to equalise the tax burden with the self-employed, who appear to avoid a significant portion of their tax liability compared to wage earners (Government Tax Committee, 2010). This underlines the need for greater transparency about the income of the self-employed, in part through the effective use of taxpayer identification numbers once they are introduced in 2016. The income exemption, which is at least 650 000 yen (\$5 530), is thought to be larger than employment expenses (such as newspapers, books and clothing), which have been estimated at 360 000 yen on average (Government Tax Committee, 2010).

**Table 5. Japan's personal income tax deductions are more generous than in other countries**

## A. Married household with two children with one worker earning the average wage (per cent of income)

	Basic deduction	Spouse deduction	Child-rearing deduction	Deduction for social insurance premium	Wage income exemption	Others	Total deduction
<b>Japan</b>	<b>7.8</b>	<b>7.8</b>		<b>13.9</b>	<b>31.0</b>		<b>60.5</b>
United States	41.3		16.1				57.4
Germany	36.0			13.8	2.2	0.2	52.2
United Kingdom	26.6						26.6
Netherlands							0.0
Sweden	3.3						3.3

## B. Single household earning the average wage (per cent of income)

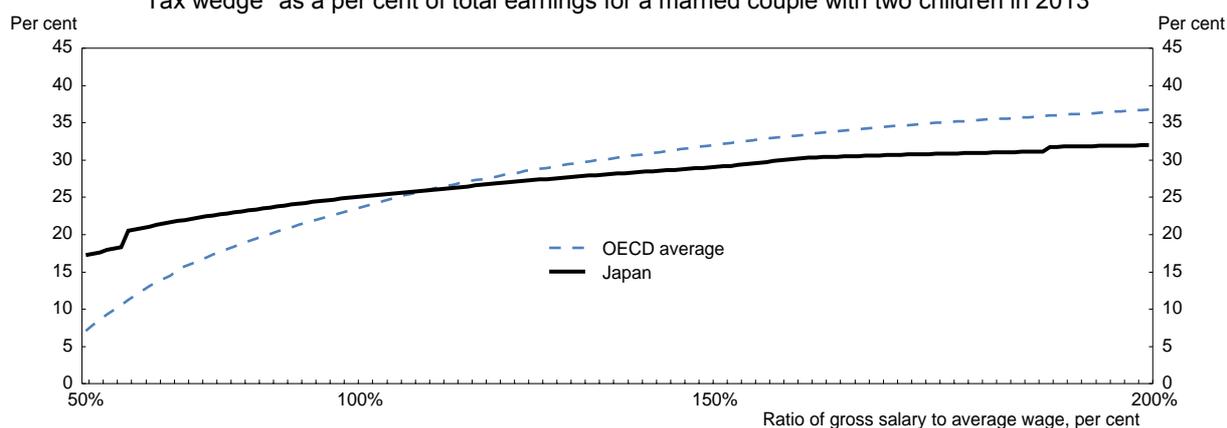
	Basic deduction	Spouse deduction	Child-rearing deduction	Deduction for social insurance premium	Wage income exemption	Others	Total deduction
<b>Japan</b>	<b>7.8</b>			<b>13.9</b>	<b>31.0</b>		<b>52.7</b>
United States	20.6						20.6
Germany	18.0			14.1	2.2	0.1	34.4
United Kingdom	26.6						26.6
Netherlands							0.0
Sweden	3.3						3.3

Source: OECD (2014b).

*Making the tax system more progressive by reducing the burden on low-income households*

Broadening the base of the personal income tax would make Japan's progressive tax rates more effective in reducing inequality. Under the current tax system, the tax wedge is significantly higher than the OECD average for low-income families with children (Figure 10). Moreover, it is relatively flat across the income distribution.

**Figure 10. Japan's tax wedge is high for low-income households**  
Tax wedge<sup>1</sup> as a per cent of total earnings for a married couple with two children in 2013



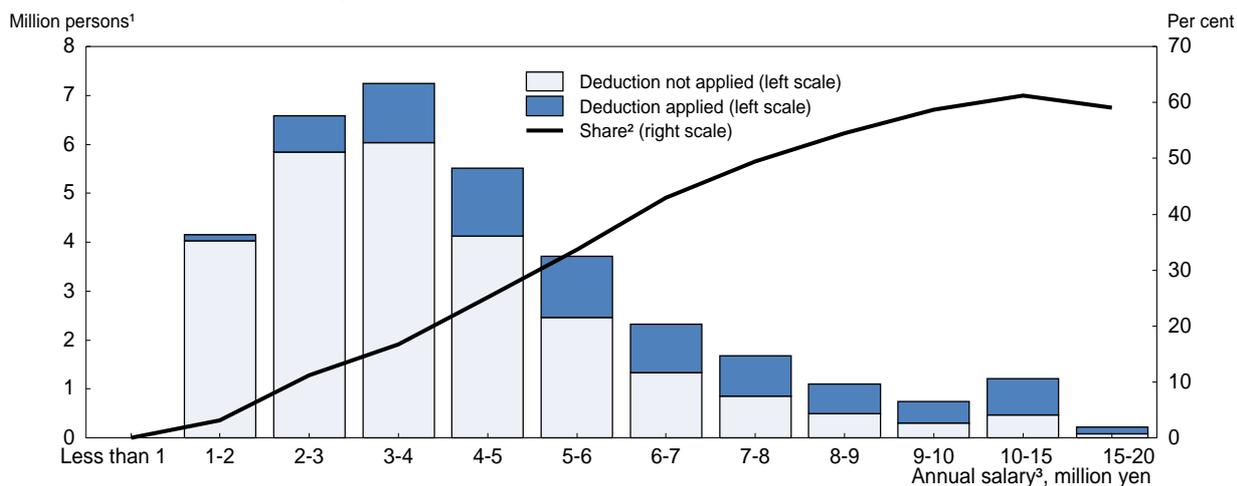
1. Includes the income taxes and social security contributions paid by workers and their employers and the family benefits that workers receive in the form of cash transfers as a share of total earnings.

Source: OECD (2014b).

One of the largest deductions is for spouses, which exempts second earners' income up to 1.03 million yen and allows them to be claimed as a dependent by the main earner. This deduction, which amounts to around 5 trillion yen (1% of GDP), reduces female labour supply by encouraging women to work part-time. Moreover, the spouse deduction benefits higher-income households; the share using the

deduction rises to more than half at annual incomes above 8 million yen, compared to only 10% for incomes below 3 million yen (Figure 11). One reason may be that spouses in low-income households work full-time as they need the income. Deductions focused on high-income households reduce the redistributive power of the personal income tax system. While the Japan Revitalisation Strategy states that the spouse deduction will be discussed, it does not commit to any reform. Finally, personal income tax receipts are reduced by almost 0.7 trillion yen (6% of the total) by tax deductions for housing loans and dividends, which again primarily benefit higher-income households.

**Figure 11. The spouse income deduction mainly benefits higher-income individuals**



1. The graph excludes those who do not pay personal income tax.
2. Individuals claiming the spouse deduction as a percentage of the total number of individuals, including those who are not eligible for the spouse deduction, such as those who are not married.
3. Annual salary of individuals.

Source: Government Tax Committee (2014).

Reducing deductions could significantly alleviate the tax burden for low-income households. For example, if the spouse deduction, along with the basic deduction and allowances for dependents for personal income and local inhabitant tax were abolished, and replaced by a tax credit distributed evenly across the income distribution to offset tax and social security contributions, the tax and social security burden of the lowest income decile would be reduced by nearly 10 percentage points (Figure 12). Decreases in the tax burden in the lower half of the income distribution would be offset by slightly higher burdens for the upper half. Targeting the tax credit at lower-income households would have an even larger impact on income distribution. In addition, reducing tax deductions for housing loans and dividends would broaden the tax base, while enhancing the redistributive impact of personal income taxes. It is also important to implement more fundamental reform, such as reducing the deduction for wage income. As for the EITC, this requires enhancing transparency about the income of the self-employed.

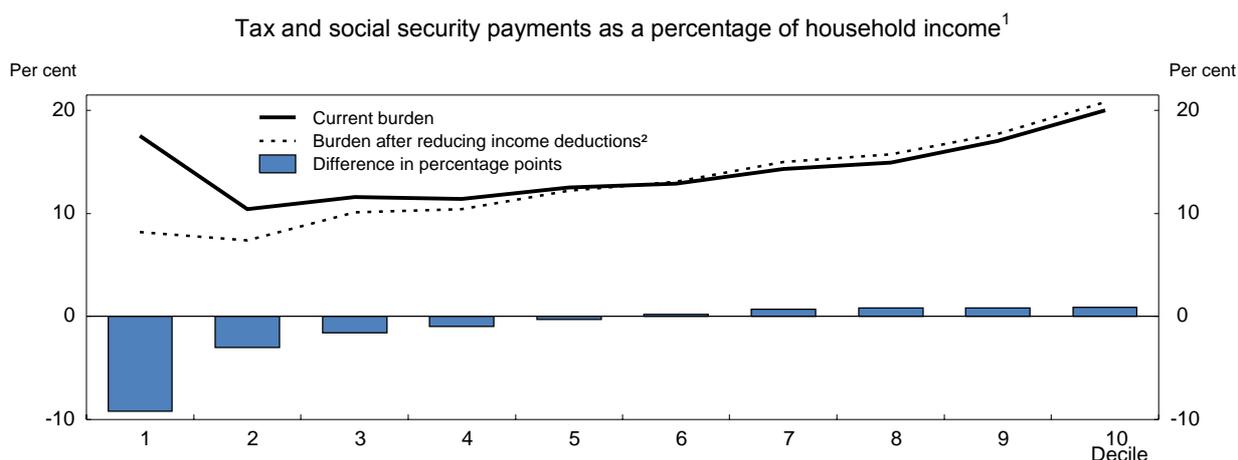
### *Reducing transfers from young to old*

As noted above, the tax and benefit system transfers income from the working-age population to the elderly. One reason is that the deduction for pension income – which amounts to nearly half of pension benefits – is even more generous than that for wage income (Table 4).<sup>7</sup> In addition, pension contributions are deducted from the personal income tax base. Comparing consumption levels in “pension households”

7. The pension benefit exemption is guaranteed to be at least 0.7 million yen (\$5 960) for those under age 65 and 1.2 million yen for those above age 65. The pension income deduction is more generous than that for wage income at every income bracket.

(more than half of income from pensions) to that in “worker households” (more than half of income from wages or business income) reveals a lack of fairness between generations (Figure 13). The consumption of pension households exceeds that of worker households beginning in the third decile, reflecting the fact that the tax and social security burdens of worker households are double those of pension households. Increasing the taxation of pension benefits would contribute to generational fairness (Ihori, 2010). It would also promote efficiency by reducing the tax burden on the working-age population, thereby encouraging them to work and save.

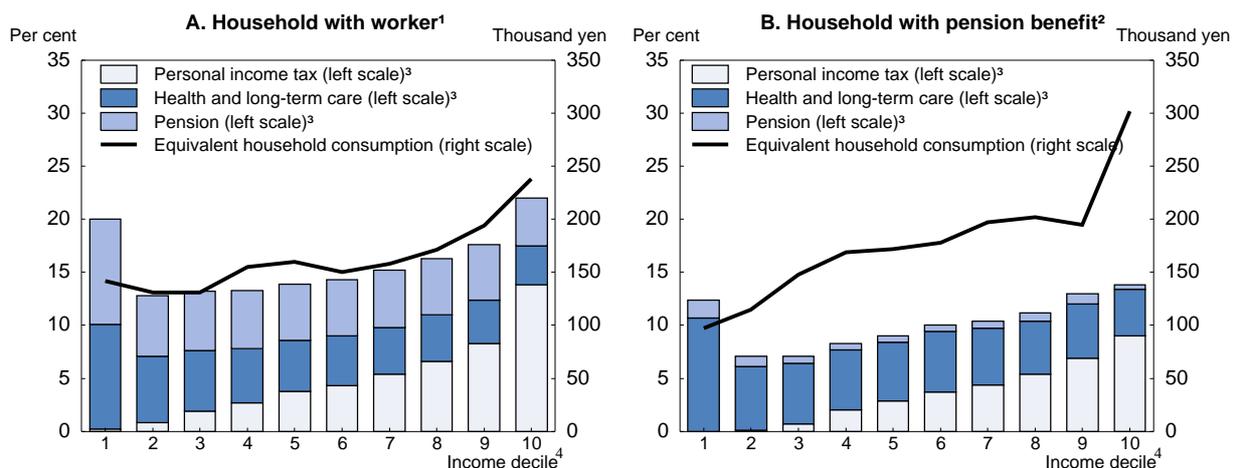
**Figure 12. Reducing income deductions would lower the tax burden on low-income households**



1. Tax and social security payments (personal income and local inhabitant tax and contributions to health, long-term care, pension, and employment insurance) in 2009 are divided by household income, which includes salary and business income as well as income from rent, interest, dividends, public and person pension benefits, livelihood subsidies and childcare allowances. This is based on a household panel survey from 2009.
2. The basic allowance, spouse deduction and all allowances for dependants in the personal income and local inhabitant tax are abolished. The resulting income tax revenue is evenly divided among households as a tax credit (186 000 yen), which is assumed to be used to reduce their social security burden.

Source: Doi and Park (2011); OECD calculations.

**Figure 13. Consumption is higher in households receiving pension income**



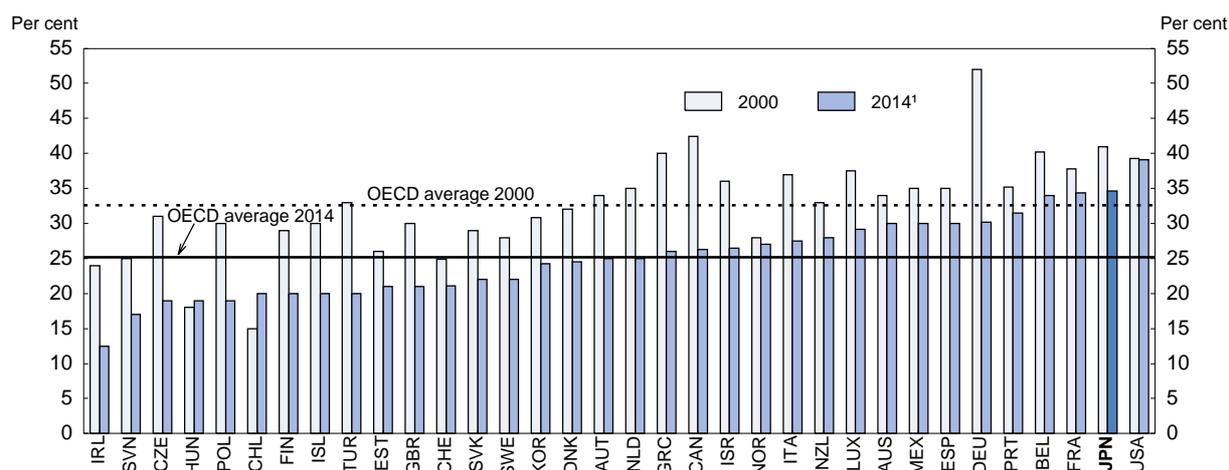
1. "Household with worker" refers to households in which more than half of its income comes from salary or business income.
2. "Household with pension benefit" refers to households in which more than half of its income comes from pension benefits.
3. As a per cent of household income.
4. Based on equivalised household income for the entire sample. The sample includes around 20 000 households.

Source: Tajika and Yashio (2008).

### Cutting corporate income taxes

In 2014, Japan reduced its combined (national and local governments) corporate income tax rate from 37%, the second highest in the OECD, to 34.6%. Moreover, it plans to cut the rate further to 32.1% in FY 2015 and 31.3% in FY 2016 to promote growth while broadening the base. This initiative is intended to “raise companies’ profitability by spreading the tax burden more widely and reducing the burden on companies with profit-earning power” (Ministry of Finance, 2015). The economic benefits of the tax cuts have been questioned as business investment has remained sluggish despite record profit levels and already high levels of cash holdings (2015 *OECD Economic Survey of Japan*). Nevertheless, each point of reduction in the combined corporate tax rate could boost investment by 0.4%, although the impact will be reduced by base broadening (De Mooij and Saito, 2014). It could thus help unlock the large cash reserves of Japanese firms. Moreover, a number of studies have found that lower corporate tax rates increase inflows of foreign direct investment and total factor productivity growth (OECD 2007, Schweltnus and Arnold, 2008 and Arnold et al., 2011). Even after the cut to 31.3% in FY 2016, the combined corporate tax rate will remain above the OECD average of 25% (Figure 14). Given the fiscal situation, it is essential that the rate cuts be revenue neutral by broadening the tax base. The priorities in this regard are to abolish the lower tax rate for SMEs and reduce the generosity of the tax depreciation allowance, which exceeds economic depreciation (OECD, 2010).

**Figure 14. Japan’s corporate income tax rate is still among the highest in the OECD**



1. Japan 2014 data are from Japan’s Ministry of Finance and this rate is applied from October 2014. The rate is to be cut further to 32.1% in FY 2015 and 31.3% in FY 2016.

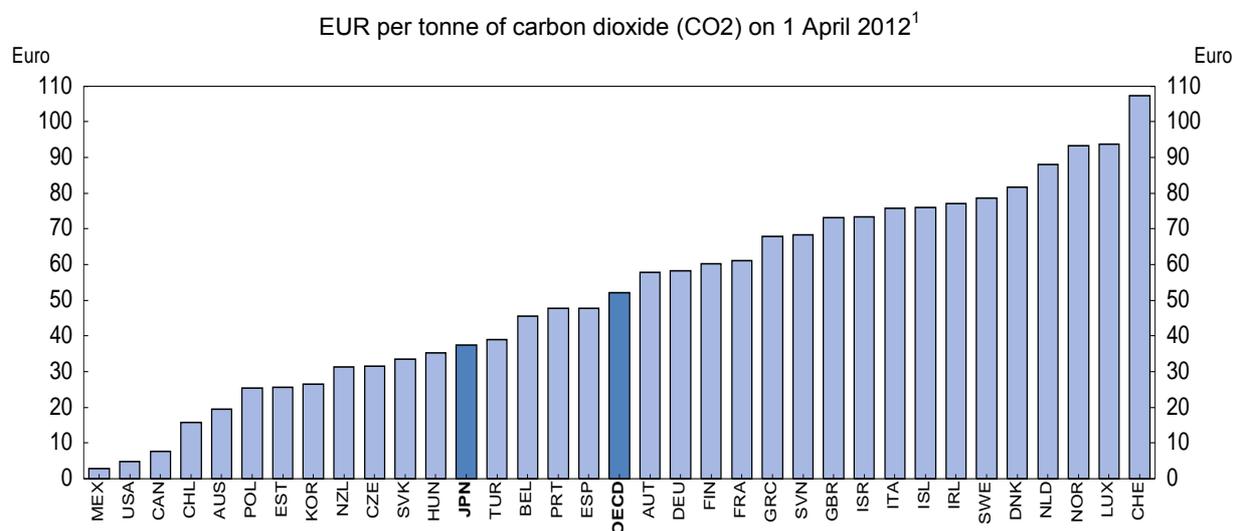
Source: OECD Tax Database; MOF, *International Comparison of Combined CIT Rate*.

### Environment-related taxes

Japan’s economy has long been characterised by relatively high energy efficiency and low greenhouse gas (GHG) emissions. Indeed, emissions were below the OECD average from 1990 to 2010 on both a per capita basis and relative to GDP. However, the closure of Japan’s nuclear power plants has resulted in a sharp spike in the carbon intensity of Japan’s energy mix since 2011. The 2009 objective of reducing GHG emissions by 25% from their 1990 level was revised in 2013. The new target calls for cutting emissions by 3.8% from their 2005 level, implying a 3% rise from the 1990 level. Raising environmental taxes would boost revenue while helping to cut GHG emissions and achieve other environmental objectives, such as reducing pollution (2013 *OECD Economic Survey of Japan*). Japan has taken steps in this regard, notably by introducing the Tax for Climate Change Mitigation, which is increasing the existing tax on petroleum and coal in three steps in 2012, 2014 and 2016. The revenues are earmarked for renewable energy and

energy conservation. However, there is room for further increases as taxes on energy use are still below the OECD average (Figure 15).

**Figure 15. The average effective tax rate on energy use in Japan is still low compared to Europe**



1. July 2012 for Australia.

Source: OECD (2013c).

### Controlling spending while fostering socially-inclusive growth

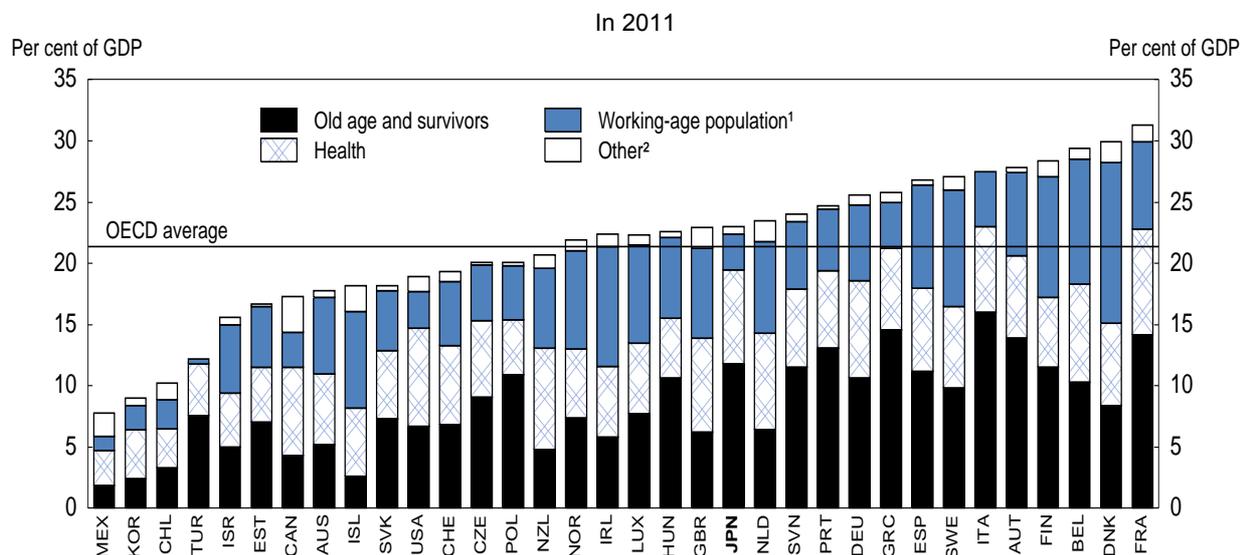
General government spending, excluding interest payments and social security outlays, in Japan, was the ninth lowest in the OECD in 2013, suggesting limited scope for spending cuts other than in social security. One possibility, though, is public investment, which fell from more than 7% of GDP in the 1980s to 3.9% by 2011. Following the Great East Japan Earthquake in 2011, reconstruction spending boosted public investment to an estimated 4.3% of GDP in 2014. With 23 trillion yen (4.7% of GDP) already spent on reconstruction, the downward trend in public investment could resume. At the same time, it is important to sustain Japan's growth potential through productive public investment, which requires closing unnecessary infrastructure to reduce maintenance costs. According to the government, maintenance costs, which accounted for around half of total investment in FY 2010, will exceed the current level of all public investment by FY 2037, thus crowding out new investment projects (Ministry of Land, Infrastructure and Transport, 2010). Public investment should concentrate on projects with the highest returns, which are usually found in urban areas. The allocation should thus be shifted away from its focus on promoting regional development by investing in poorer rural areas.

Local government is another source of potential savings. The central government should contain local spending, given that half of local government deficits are funded by the central government's general account. In addition, the supplementary tax transfers to local governments that were launched in FY 2009, around 1.1 trillion yen on average, should be phased out.

Given that the increase in government expenditures is driven by the rise in social security spending from 12% of GDP in 1990 to 24% in 2013 (Figure 1), social security reform is the priority. The share of social spending allocated to programmes focused on the elderly – pensions, long-term care and health, which rises sharply with age – is more than four-fifths, the second highest in the OECD (Figure 16). The upward pressure on spending is likely to continue as the proportion of the population over age 65 is projected to increase from 24% in 2012 to 30% in 2025, keeping it the highest in the OECD. Consequently,

the ratio of working-age persons to the elderly will fall further from 2.4 to 1.8. Taking account of planned reforms, public social spending is projected to rise from 22.8% of GDP in FY 2012 to 24.4% in FY 2025, with the cost borne by the central and local governments (Table 6).

**Figure 16. Public social spending in Japan is concentrated in health and elderly-related outlays**



1. The OECD categorises social expenditure into nine categories. Social expenditure for the working-age population includes family benefits, active labour market programmes, unemployment benefits and incapacity benefits.
2. The "Other" category includes housing and other social areas.

Source: OECD Social Expenditure Database.

### ***Pension reform***

Pension spending is projected to fall from 11.4% of GDP in FY 2012 to 9.9% in FY 2025, despite population ageing, thanks to the 2004 pension reform (Table 6). The reform introduced “macroeconomic indexation”, which adjusts pension benefits based on changes in the number of contributors and life expectancy, and hikes the contribution rate from 13.6% in FY 2004 to 18.3% by FY 2017. In other words, the benefit level is to adjust to the contribution schedule so as to achieve financial balance. Macroeconomic indexation, which would reduce benefits by 0.9% on average each year through FY 2025, is in addition to price indexation, which adjusts pension benefit levels based on the consumer price index. Macroeconomic indexation should be allowed to operate fully, even with deflation, to limit the government’s future pension sustainability.

However, actual pension benefits are substantially higher than implied by the two indexation methods. *First*, the price indexation of benefits was suspended in the early 2000s in the context of deflation. Consequently, pension benefits fell only 2% between FY 1999 and FY 2012, rather than the 5% implied by price indexation (Figure 17). In 2012, the government decided to eliminate the overpayment of pension benefits in three steps by FY 2015. Nevertheless, excess pension payments were a cumulative 9 trillion yen (1.8% of 2014 GDP) over FY 2000-14. *Second*, with pension benefits above the level implied by price indexation, macroeconomic indexation was not implemented, resulting in an additional 12 trillion yen of pension overpayments over FY 2000-14. In sum, total excess pension payments amounted to 21 trillion yen (4.3% of GDP) (Nakazawa et al, 2014).

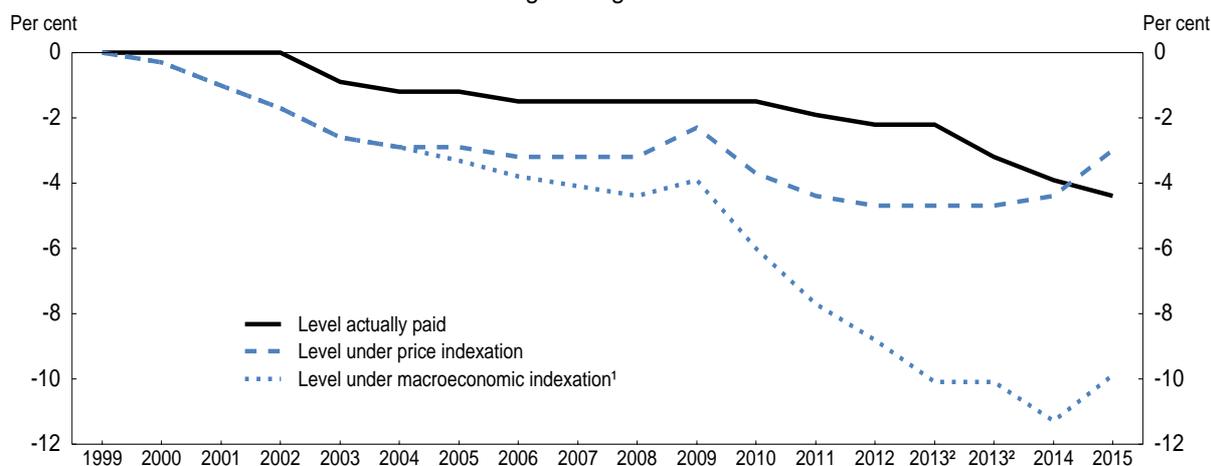
**Table 6. Social security spending projections**

	FY 2012		FY 2020 <sup>1</sup>				FY 2025 <sup>1</sup>			
			Without reform		With reform <sup>2</sup>		Without reform		With reform <sup>2</sup>	
	Trillion yen	Per cent of GDP	Trillion yen	Per cent of GDP	Trillion yen	Per cent of GDP	Trillion yen	Per cent of GDP	Trillion yen	Per cent of GDP
<b>Total benefits</b>	<b>108.6</b>	<b>22.8</b>	<b>131.8</b>	<b>23.6</b>	<b>134.4</b>	<b>24.1</b>	<b>144.8</b>	<b>23.7</b>	<b>148.9</b>	<b>24.4</b>
Pension	54.0	11.4	58.5	10.5	-	-	60.4	9.9	-	-
Healthcare	34.6	7.3	46.1	8.3	46.9	8.4	53.3	8.7	54.0	8.9
Long-term care	8.4	1.8	13.1	2.3	14.9	2.7	16.4	2.7	19.8	3.2
Childcare	4.9	1.0	5.8	1.0	-	-	5.6	0.9	-	-
Others	6.6	1.4	8.4	1.5	-	-	9.0	1.5	-	-
<b>Total contributions</b>	<b>103.9</b>	<b>21.1</b>	<b>126.8</b>	<b>22.7</b>	<b>129.5</b>	<b>23.2</b>	<b>142.1</b>	<b>23.3</b>	<b>146.2</b>	<b>23.9</b>
Premium payments	61.4	12.9	75.3	13.5	76.5	13.7	83.9	13.7	85.7	14.0
Government	42.5	9.0	51.6	9.2	52.9	9.5	58.3	9.5	60.5	9.9
<i>Of which:</i>										
Pension <sup>3</sup>	13.0	2.6	13.2	2.4	-	-	13.7	2.2	-	-
Healthcare <sup>3</sup>	15.7	3.0	21.1	3.8	21.4	3.8	25.2	4.1	25.5	4.2
Long-term care	4.5	1.0	7.3	1.3	8.4	1.5	9.2	1.5	11.1	1.8

1. The GDP growth rate is based on the Cabinet Office's "prudent scenario" announced in January 2012. The Ministry of Health, Labour and Welfare assumes an annual nominal growth rate of 1.7% after FY 2023.
2. Includes the new spending measures planned in the comprehensive social security reform, such as the provision of high-level hospital and in-home care and the reduction of payments for health insurance premiums.
3. The figures for FY 2012 are calculated by using the ratio of each to government outlays reported in Ministry of Health, Labour and Welfare (2012).

Source: National Institute of Population and Social Security Research (2014); Ministry of Health, Labour and Welfare (2012).

The share of the population contributing to the mandatory basic pension has fallen from 85% in FY 1990 to 61% in FY 2013, far below the 80% necessary to maintain the current system. The decline suggests a loss of confidence in the future of the public pension system, which has seen its reserve fund decline faster than projected. There are three levers to ensure the sustainability of the pension system: raising the pension eligibility age, increasing contributions and reducing pension benefits. However, benefits are already low despite the overpayment discussed above. Indeed, the average gross replacement

**Figure 17. Trends in pension benefit levels**  
Percentage change relative to 1999

1. Macroeconomic indexation implies that price indexation is fully implemented.
  2. There were two revisions in 2013 (April and October).
- Source: Nakazawa et al. (2014).

rate (as a share of average lifetime earnings) of Japan's public pension scheme is 35.6% at the average wage, compared to the OECD average of 40.6%. Moreover, including mandatory private schemes (which Japan does not have), the OECD average rises to 54.0% (OECD, 2013b). In addition, the government's 2014 projections show the replacement rate falling further, from the current average of 62.7% (by the Japanese calculation) to as low as 42% by mid-century in some cases (Table 7).<sup>8</sup> As for boosting the contribution rate beyond what is already planned, it could further reduce the number of persons contributing to the pension system, while weakening work incentives by raising the tax burden.

**Table 7. Raising the pensionable age leads to a large increase in the replacement rate**

Per cent

Cases <sup>1</sup>	Real GDP growth rate		Replacement rate <sup>2</sup> (%) in 2050 for pension eligibility age of:		
	FY 2014-23	FY 2024 onward	65 years	68 years	70 years
Case C	1.1	0.9	51.0	63.9	72.5
Case E	1.1	0.4	50.5	63.3	71.8
Case G <sup>3</sup>	0.2	-0.2	42.0	52.8	60.0
Case H <sup>4</sup>	0.2	-0.4	41.9	52.7	59.8

1. The table shows four of the eight simulations done by the Ministry of Health, Labour and Welfare (2014b). Total pension benefit payments are fixed, resulting in variations in the replacement rate.
2. The pension benefit, including the impact of macroeconomic indexation, as a percentage of final earnings. The replacement rate was 62.7% in FY 2014.
3. For the retirement age of 65, the replacement rate is for 2058.
4. For the retirement age of 65, the replacement rate is for 2054.

Source: Ministry of Health, Labour and Welfare (2014b and 2014c); OECD calculations.

The best option is thus to increase the pension eligibility age, as it would lower spending, raise the labour participation of older persons and reduce intergenerational transfers, which favour current pension recipients (Sutherland et al., 2012). The pension eligibility age is now 65 for men (63 for women) for the basic pension and 61 for men (60 for women) for the Employees' Pension Insurance (EPI). Although the age for the EPI is to be raised to 65 by 2025 for men and 2030 for women, it will remain relatively low compared to Japan's life expectancy, which is now 83.4 years, the world's longest. Accelerating the increase in the eligibility age to 65 and raising it further – through a link to longevity – would help ensure the sustainability of the pension system and improve intergenerational equality and have a positive effect on economic growth (Kashiwase et al., 2012).

Calculations based on government simulations suggest that raising the pension eligibility and retirement ages from 65 to 68 in FY 2033 would have a strong positive impact on pension benefits (Table 7). The simulations show the impact of raising the pension eligibility age on the replacement rate, assuming a fixed amount of total pension spending. In cases C and E, the replacement rate would be around 63% (including the impact of macroeconomic indexation) in 2050, matching the current replacement rate. However, the replacement rate would fall to around 50% if the pension eligibility age were to remain at 65. If the eligibility age were increased further to 70 in FY 2035, the replacement rate would rise to around 72%, allowing scope to reduce pension benefits. In the slower growth scenarios (cases G and H), replacement rates are markedly lower, showing the importance of output growth in sustaining the public pension scheme. Finally, the decision to increase the share of the Government Pension Investment Fund held in equities from 25% to 50%, equally split between domestic and foreign

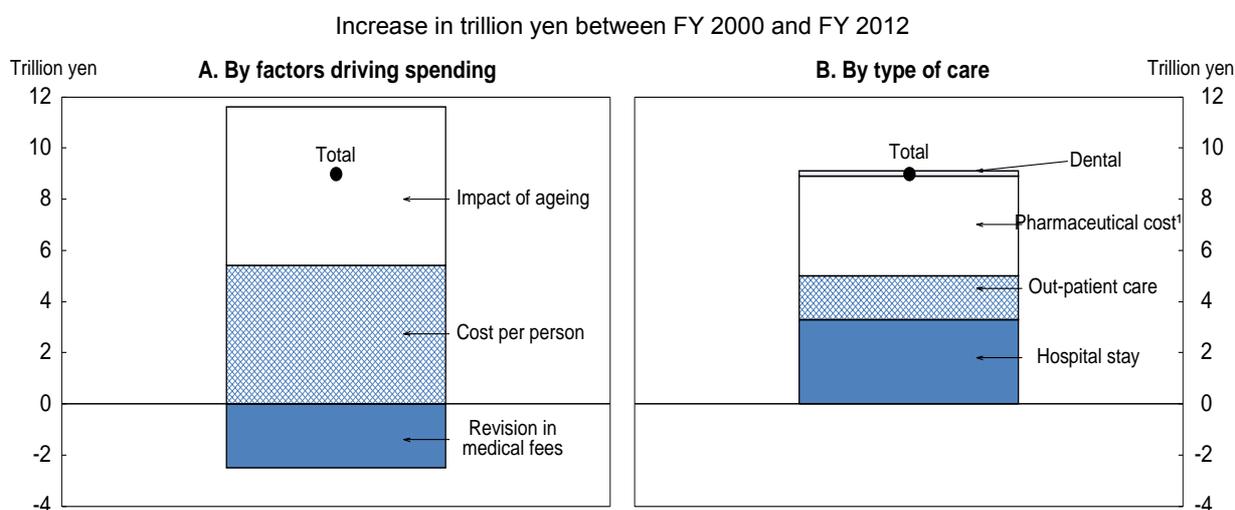
8. The replacement rate is defined as the monthly old-age pension benefit received at age 65 by a specified couple (the husband was covered by the Employees' Pension Insurance from age 20-59 and his wife is a dependent) divided by the average monthly disposable income (including bonuses) of working-age employees. If the replacement rate drops below 50% in the benchmark case, the law requires that macroeconomic indexation be terminated and pension benefits and contributions revised.

shares, while reducing the share of government bonds, should lift the return, thereby helping to improve the sustainability of public pensions.

### *Health and long-term care reform*

Health spending has been increasing at a 2.2% annual rate over FY 2000-12, while nominal GDP has been falling at a rate of -0.6%. Consequently, health spending has risen from 7.6% of GDP to 10.3% in 2012, surpassing the OECD average of 9.3%. Increased health spending is driven in almost equal measure by population ageing and increasing costs per person, reflecting more intensive care and the rising cost of drugs and medical devices (Figure 18). These two factors have been partially offset by cuts of around 3% in medical fees in 2002 and 2006. Population ageing alone could increase healthcare spending by some 3½ per cent of GDP by 2030 (Nozaki, et al., 2014).

**Figure 18. Health spending has increased due to ageing and more intensive care**



1. Includes only pharmaceuticals sold at pharmacies. Those sold elsewhere are included in the other categories.

Source: Ministry of Health, Labour and Welfare, *National Health Expenditure*; Ministry of Internal Affairs and Communication, *Demographic Statistics*; OECD calculations.

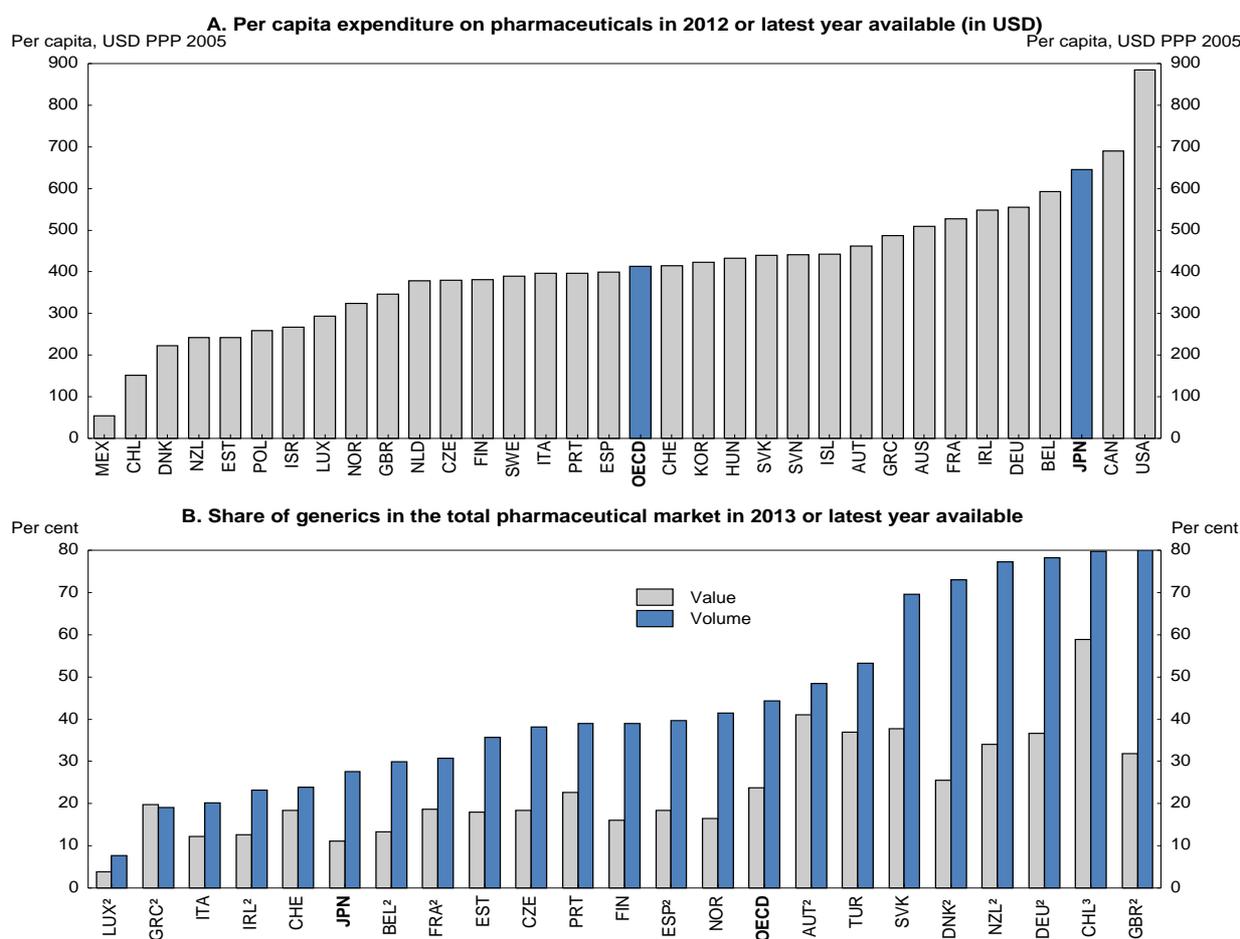
Significant cuts in medical fees in the revisions that take place every two years would run counter to the government's pledge to upgrade the quality of services covered by public health insurance. *First*, the government has speeded up its review of new drugs, narrowing Japan's "drug lag" caused by a slow approval process compared to the United States and Europe (Jones, 2009). The Pharmaceuticals and Medical Devices Agency (PMDA), which is responsible for approving new products, has been greatly expanded. Review times have been cut in half and the number of new pharmaceuticals approved increased from 75 in FY 2008 to 138 in FY 2013. *Second*, the traditional practice of lowering the price of pharmaceuticals every two years has been changed, at least for high-tech products. Instead, their price can be maintained throughout the life of the patent.

Such measures are positive for Japanese consumers and promote R&D in health sciences. They are consistent with the Revitalisation Strategy, which calls for reforms "to revitalise the healthcare industry". However, accelerating the introduction of expensive new pharmaceuticals and treatments into public health insurance would boost health spending by the government, which already accounts for 82% of total health spending. On the other hand, leaving new treatments outside of public health insurance limits their availability due to restrictions on "mixed billing": patients who combine new medicines or treatments that are not included in public insurance with services that are included must pay not only the cost of the additional treatments but also the cost of services normally covered by public insurance. The government

will introduce an optional insurance scheme to give patients faster access to new treatments not covered by the universal public insurance, thereby promoting the health industry, while avoiding an additional financial burden on public finances.

The goal of revitalising healthcare must be balanced with the need to reduce spending on pharmaceuticals, which accounted for 44% of the rise in health spending over FY 2000-12 (Figure 18). At \$645 per capita in 2012, Japan's per capita consumption of pharmaceuticals is the third highest in the OECD and 56% above the OECD average (Figure 19). The rapid growth in spending on pharmaceuticals is driven by population ageing and the low market penetration of generic drugs. Indeed, generics accounted for only 28% of the pharmaceutical market in 2013 in volume terms, well below the OECD average of 44% (Panel B). The government wants to raise the share to around 34% by FY 2017, which would reduce health spending by 0.4 trillion yen (Ministry of Finance, 2014). If the share of generics in Japan were to reach the US level of 84%, and their price reduced by 10%, pharmaceutical spending could be cut in half (Ikegami, 2014). The sales of generics should be increased by requiring pharmacies to fill prescriptions using generics when they are available and moving towards making it the standard for reimbursement for every prescription (Jones, 2009).

**Figure 19. Pharmaceutical consumption per capita is high in Japan, reflecting less use of generic drugs<sup>1</sup>**



1. Includes medical non-durables.
  2. Reimbursed pharmaceutical market.
  3. Community pharmacy market.
- Source: OECD Health Statistics.

Limiting the growth of public health spending also requires reducing hospital stays, which accounted for 36% of the rise in total health spending over FY 2000-12 (Figure 18). Japan stands out for its exceptionally long hospital stays, which averaged 31.2 days in 2012, almost four times the OECD average (Table 8). Long hospital stays reflect the provision of long-term care in hospitals; the average stay for curative care is substantially lower at 17.5 days (although still double the OECD average). Indeed, only about half of hospital patients in acute-care beds receive healthcare, with the remainder just receiving help with daily living at most (Tsutsui et al., 2015). Shifting patients not needing healthcare to home-based care or specialised institutions would sharply lower costs, given the higher cost of hospitals, reflecting the requirements for medical staff and equipment.

**Table 8. International comparison of healthcare shows room for cost savings in Japan**

In 2012 or latest year available

	Average total hospital stay <sup>1</sup>	Average hospital stay for curative care <sup>1</sup>	Total number of hospital beds <sup>2</sup>	Number of acute-care beds <sup>2,3</sup>	Number of long-term care beds <sup>2,3,4</sup>	Number of beds in long-term care facilities <sup>2,4</sup>	Number of doctor consultations per capita per year
<b>Japan</b>	<b>31.2</b>	<b>17.5</b>	<b>13.4</b>	<b>7.9</b>	<b>2.7 (11.1)</b>	<b>6.0 (25.0)</b>	<b>13.0</b>
OECD average	8.4	7.4	4.8	3.3	0.6 (3.8)	7.7 (48.5)	6.7
Highest country	31.2	17.5	13.4	7.9	3.2 (27.4)	13.5 (72.2)	14.3
Lowest country	3.9	3.9	1.6	1.5	0.0 (0.0)	2.4 (17.7)	2.7

1. In days.
2. Per 1 000 population.
3. In hospitals.
4. The numbers in parentheses show the number of beds per 1 000 population aged 65 and over.

Source: OECD Health Database.

The number of hospital beds per capita in Japan is also the highest in the OECD (Table 8). In 2014, the government required each prefecture to project the number of hospital beds needed in the future by category and to shift excess beds to other functions. Shifting long-term beds to long-term care facilities would also help ensure adequate long-term care, with the number of elderly receiving long-term care rising by 8% a year. Indeed, long-term care facilities in Japan have only half as many beds, relative to the elderly population, as the OECD average (Table 8). The central government should provide sufficient incentives for prefectural governments to meet their target. The length of hospital stays by prefecture is positively correlated with the number of “excess beds”, as defined by the difference between the actual number and the benchmark level set by each prefecture, following central government guidelines. The planned transfer of National Health Insurance from municipal to prefectural governments should help in this regard.

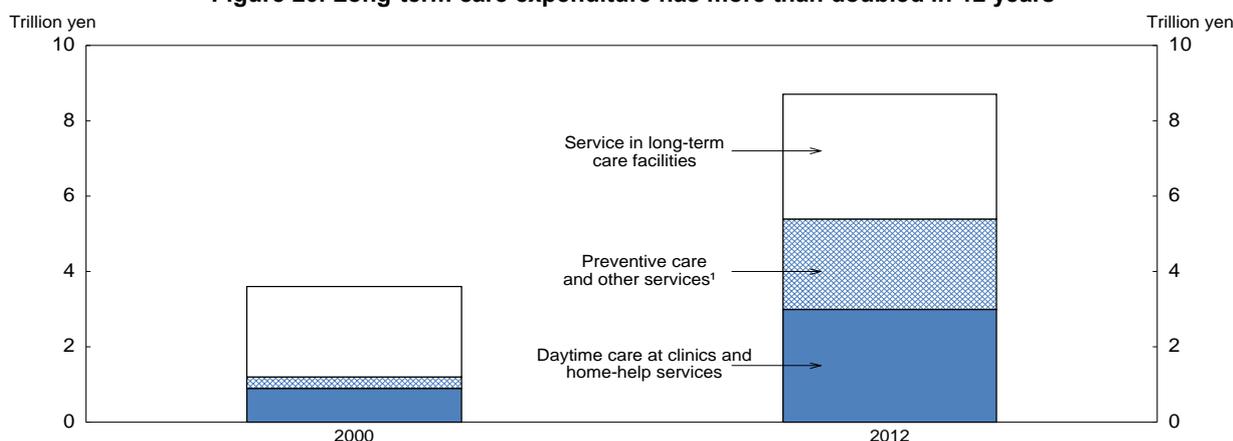
Setting aside the issue of long-term care in hospitals, the length of hospital stays for curative care in Japan is also the longest and the number of acute-care hospital beds the highest in the OECD (Table 8). This suggests shifting further from a fee-for-service system to a diagnosis-related group approach. In 2003, Japan introduced a case-mix based payment, the Diagnosis Procedure Combination (DPC), which sets an overall fee according to the illness, while promoting the standardisation of treatment and length of hospital stay. The DPC needs to be made more effective by increasing the coverage of hospitals and illnesses and basing fees on the most efficient hospitals. Finally, efficiency in the hospital sector would be promoted by abolishing the rule limiting the direction of hospitals and clinics to medical doctors and relaxing restrictions on equity finance.

Shifting away from fee-for-service would also help reduce the number of doctor consultations per person, which is double the OECD average (Table 8). In addition, it would be useful to increase co-payments, especially for people aged 70 or more, most of whom now pay only 10% (except those who earn

as much as the working-age population and thus pay the standard 30% co-payment rate). Indeed, a government survey found that only half of the population age 75 and over found the co-payment to be burdensome. While the low co-payment increases the quantity of out-patient care, it has little positive effect on patients. One study compared the behaviour of 69-year-olds, who normally pay a 30% co-payment, with 70-year-olds, who pay only 10%. It found increased outpatient and inpatient care for 70-year-olds, indicating that demand is price sensitive. However, the increased healthcare for the 70-year-olds had little impact on mortality and other health outcomes (Shigeoka, 2014), suggesting a need for higher co-payment rates, while taking account of the implications for equity. Co-payments as a share of health spending in Japan are below the OECD average (Nozaki et al., 2014). The increase in the co-payment rate to 20% for persons aged 70-74 who reached age 70 after April 2014 is a step in the right direction.

Long-term care spending has shown the fastest growth among social programmes, with outlays rising at a 7.6% annual pace since the introduction of long-term care insurance in FY 2000 (Figure 20). The number of persons receiving care reached 12.8% of the elderly population in 2011, matching the OECD average. The long-term care insurance premium, which is paid by persons aged 40 and over, has increased sharply. For those over age 65, the average premium has risen by 71% since FY 2000.

**Figure 20. Long-term care expenditure has more than doubled in 12 years**



1. Other services include short-stay service, rental of welfare equipment and fee for home repair, etc. Preventive care services started in FY 2006.

Source: Ministry of Health, Labour and Welfare, *Survey of Actual Condition of Long-term Care Benefits in FY 2000 and FY 2012*.

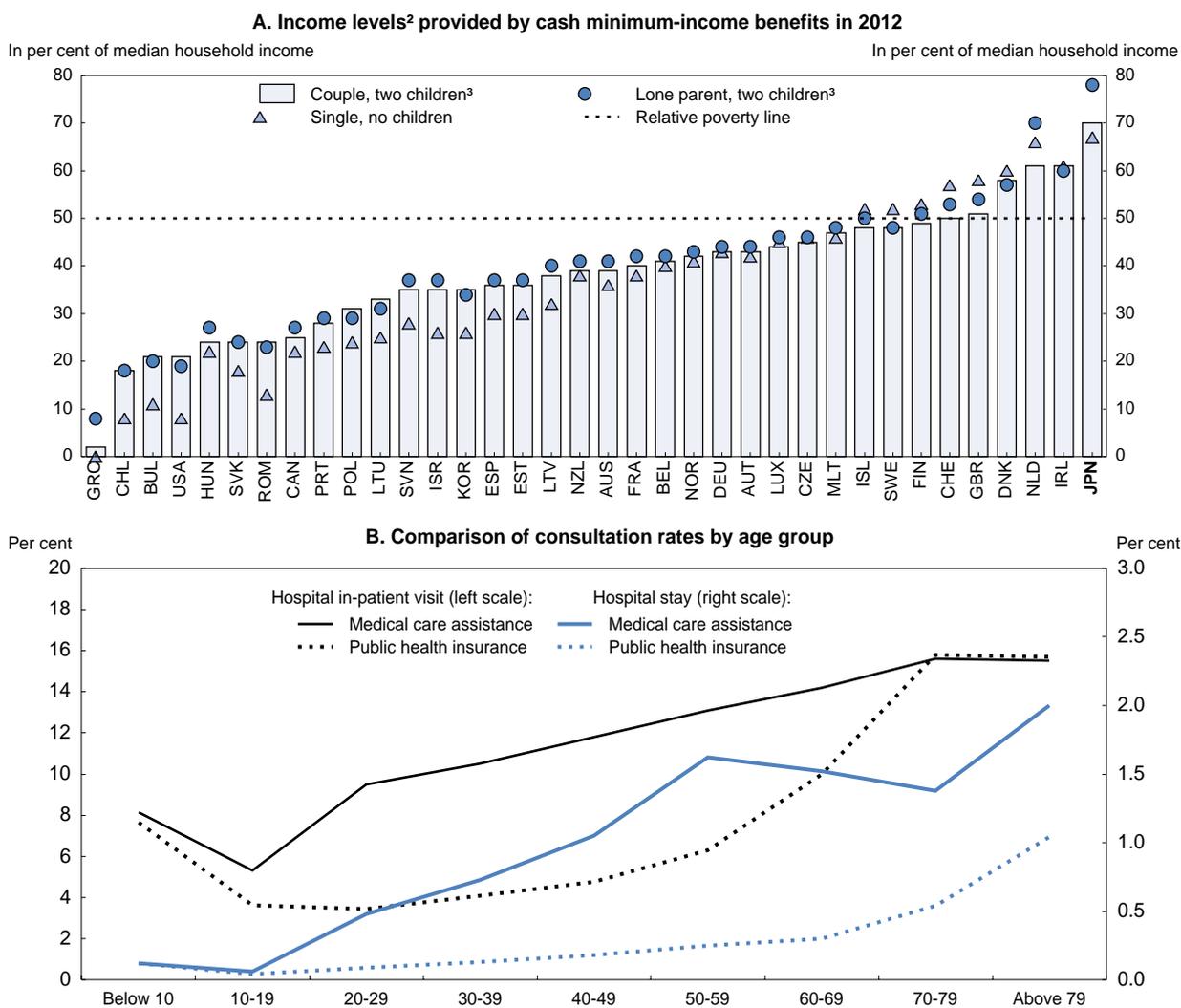
The number of care recipients will rise rapidly as the share of the population over age 75 increases, making it crucial to contain costs. More than 80% of the increased spending comes from the first two categories of “daytime care at clinics and home-help services” and “preventive care and other services”, which together rose more than four times over FY 2000-12. To contain spending, the government decided to increase co-payments to 20% and raise the payment ceiling by 19% to 44 000 yen (\$375) per household per month from October 2015. However, the reforms are applied only to the elderly who earn as much as the working-age population, who are likely to be relatively few among those receiving long-term care. Further increasing the co-payment is essential given the high price elasticity, especially for less-intensive services. One option would be to follow the example of other countries with long-term care insurance, such as Germany and Korea, which restrict insurance coverage to older persons with more severe needs for care (MOF, 2014).

### ***Minimum-income benefit reform***

Japan’s tax and social security benefit system mainly redistributes income from the working-age population to the elderly through social insurance systems. Support aimed at the working-age population is

only 3% of GDP, well below the OECD average of 6%. The key social welfare policy is the Basic Livelihood Protection Programme (BLPP), which provides a minimum standard of living to impoverished persons who meet the eligibility criteria, while promoting self-reliance. The BLPP is a last-resort measure that provides cash and a package of in-kind benefits to those living under the absolute poverty line. The number of recipients has risen by 34% since 2008, reaching its highest level since 1951, which may reflect a higher number of non-regular workers and elderly persons receiving the benefit. The level of benefits is very generous at 67% to 78% of the average wage, depending on household type (Figure 21). Indeed, the level of benefits is the highest in the OECD and would be even higher if it included all of the in-kind benefits offered to BLPP recipients.

**Figure 21. The Basic Livelihood Protection Programme provides generous in-kind and cash benefits<sup>1</sup>**



1. The results from the OECD tax-benefit model are shown on an equivalised basis (square root of household size).
2. Income level includes all relevant cash benefits (social assistance, family benefits, housing-related cash support) for a family with a working-age head, no other income sources and no entitlements to primary benefits such as unemployment insurance. However, it excludes in-kind benefits such as free healthcare, subsidised transport, free school meals and subsidised childcare and water. Benefits are net of any income taxes and social contributions.
3. Calculations for families with children assume two children aged 4 and 6 and do not include childcare benefits and costs.

Source: OECD, *Tax-Benefit Models*; Ministry of Health, Labour and Welfare.

However, there are a number of problems with the BLPP. *First*, the public assistance rate of only 1.7% of the population, which reflects strict eligibility conditions, is inadequate given the 16% relative poverty rate. Lower benefits that are spread more widely to poor households, while limiting moral hazard problems, would be more effective in reducing relative poverty. *Second*, the BLPP weakens work incentives due to the high effective tax rates on persons leaving the BLPP to accept full-time employment. For those who can earn the average wage, the rate is 85.4%, the highest in the OECD for a single parent (Table 9), reflecting the loss of benefits and the impact of taxes and social contributions. Consequently, once people join the programme, they tend to receive benefits for a long time. *Third*, the BLPP's medical assistance, which ensures free provision of healthcare without any co-payment, encourages greater use of health services. Indeed, working-age people with medical assistance are hospitalised five times more than those belonging to the public health insurance, who make co-payments of 30%, although this may also reflect a poorer health status (Figure 21, Panel B). Moreover, those with medical assistance receive out-patient care at hospitals more than twice as frequently.

**Table 9. The effective tax rate on moving to employment is high in Japan<sup>1</sup>**

Household with two children (aged 4 and 6) in 2012

	Single parent Earnings as a share of average worker <sup>2</sup>			Two parents, one of whom works Earnings as a share of average worker <sup>2</sup>		
	50%	67%	100%	50%	67%	100%
<b>Japan</b>	85.0	87.9	84.3	85.0	87.9	85.4 <sup>3</sup>
OECD average	58.2	56.5	54.8	69.5	66.2	59.8
Highest country	98.8	87.9	84.3	113.5	97.7	97.3
Lowest country	-11.7	2.7	20.3	-11.7	2.0	16.1

1. The results are from the OECD tax-benefit model. The effective tax rates measure the extent to which taxes and benefits reduce the financial gain of moving into work. The estimates here are for a person who is not employed, but not entitled to unemployment benefits. They are eligible for social assistance and other means-tested benefits.
2. With a full-time job.
3. Japan is the second highest in the OECD.

Source: OECD Tax-Benefit Models.

Japan should reduce the generous BLPP payments and introduce policies to encourage work and eliminate the poverty trap. In August 2013, some measures were taken to reduce the disincentive for work by BLPP recipients.<sup>9</sup> In addition, an in-work benefit introduced in July 2014 is a step in the right direction. When recipients leave the BLPP, the government provides a lump-sum benefit that is calculated based on the amount they earned while receiving public assistance. For working-age people, it is also important to provide training and job support for those with weak vocational skills. The top priority, though, is the EITC, which would make it advantageous to leave the BLPP for employment. Indeed, some countries have negative effective tax rates on returning to work, thanks to an EITC (Table 9). An EITC is also needed to reduce the large number of working poor. Japan's share of households in relative poverty despite having two or more workers is the second highest in the OECD.

### *The issue of regional inequality*

While a few major urban centres are expected to continue gaining population, many regions and cities are likely to experience even faster ageing and population decline than Japan as a whole. Smaller towns

9. The working income deduction was changed: *i*) the fully deductible limit was raised from 8 000 yen per month to 15 000 yen; and *ii*) the deduction rate was changed from a range of 0 to 17.2% to a flat rate of 10%.

and rural communities face a particularly uncertain future. Given current demographic trends, such strains are unavoidable and will lead to increased economic disparities in Japan, a country that has hitherto had relatively low inter-regional disparities. An increasing concentration of population – and in particular, of working-age population – will complicate the provision of essential public services, which can be costlier and more difficult to sustain in very low-density areas. Japan already has the sixth-largest disparity in access to services in the OECD (OECD, 2014g).

The Japan Revitalisation Strategy emphasises the potential for compact urban development to contribute to the agglomeration of jobs in cities (OECD, 2012). It also envisages more compact development of small towns and rural settlements, with a view to sustaining some degree of economically viable settlement in depopulating areas by concentrating population around key service centres. This is a long-term undertaking but it already raises difficult questions for the authorities, who have to decide where to replace or upgrade essential infrastructure and where to “downsize” local communities. It also underscores the painful trade-offs that may lie ahead when balancing growth and equity objectives.

### ***Breaking down labour market dualism***

In addition to fiscal measures, it is essential to attack the root causes of relative poverty and inequality, notably labour market dualism. To enhance employment flexibility and reduce labour costs, firms increased the number of non-regular workers from 8.8 million (20.2% of total employment) in 1994 to 19.6 million in 2014 (37.4%). Non-regular workers, a category that includes fixed-term, part-time and dispatched workers (i.e. workers sent from private employment agencies), earn relatively little: in 2012, 77% of non-regular workers were paid less than 2 million yen (\$17 700) a year, compared to 9.9% of regular workers. According to a 2010 government survey, 49% of non-regular workers are the main earner in their households (Ministry of Health, Labour and Welfare, 2011a). In a household where only the husband works, the relative poverty rate is 5% if he is a regular worker, but 35% if he is non-regular. If the wife is also a non-regular worker, the relative poverty rate stays high at 19% (Table 10).

**Table 10. Non-regular worker households suffer from a high poverty rate**

Poverty rate by employment status of spouses<sup>1</sup>

Husband (%)	Wife (%)			
	Regular	Non-regular	Self-employed	Not employed
Regular	1	3	3	5
Non-regular	7	19	16	35
Self-employed	5	16	13	23
Unemployed	8	38	21	47

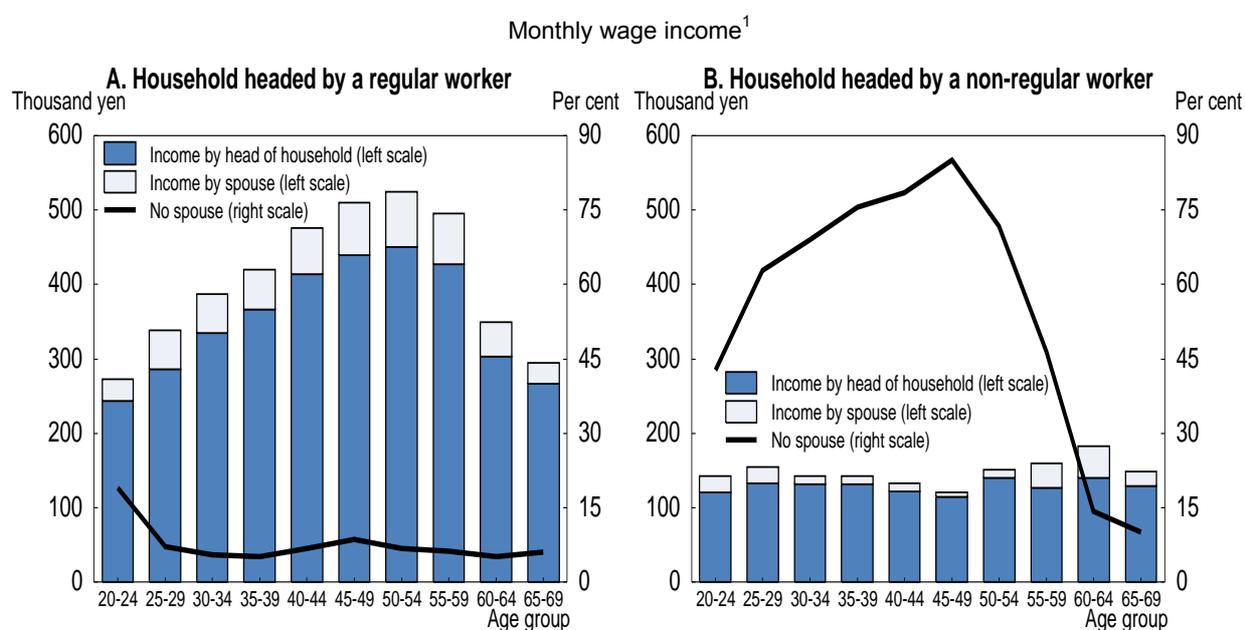
1. The data are based on a survey of nearly 10 000 people.

Source: Higuchi (2013).

On an hourly basis, earnings of non-regular workers are around 60% of regular workers (excluding bonus payment). Non-regular workers are penalised by their relatively short tenure in firms, given the importance of seniority in setting wages. Consequently, the income gap between households headed by regular workers and those headed by non-regular workers increases over time (Figure 22). Indeed, the average income of households headed by regular workers in the 45-49 age group was four times higher than for those headed by a non-regular worker. Furthermore, the lower income of non-regular workers discourages marriage; the share of non-regular workers in the 45-49 age group who are single is ten times

higher than the share for regular workers. A government survey found that around a third of young people in their 20s and 30s who want to marry but remain single said they did not marry as they do not have enough money for married life. A similar proportion stated they do not want children because of concern about a lack of income (Cabinet Office, 2013).

**Figure 22. Significant income gaps between regular and non-regular workers**



1. The survey covers households with two or more members.

Source: Ministry of Health, Labour and Welfare (2014a).

Besides lower income and higher relative poverty, non-regular workers receive less coverage by social security. One of the reasons firms hire non-regular workers is to reduce their social security contributions, which amount to 16% of total labour cost. Around one-third of non-regular workers are not covered by employment insurance and about one-half are excluded from Employees' Pension Insurance (EPI) and firm-based health insurance (Ministry of Health, Labour and Welfare, 2011a). By law, employees who work more than 20 hours per week and are employed for more than 31 days must be covered by employment insurance. In addition, more than 20% and 5% of unmarried part-timers have no public pension (basic or employee-based) and health insurance, respectively (Table 11). This creates a serious social problem as such persons will receive less family support in their old age, given that they have less chance of marriage. In contrast, 99.5% of regular workers are covered by EPI and employees' health insurance (Ministry of Health, Labour and Welfare, 2011a). Finally, 70% of part-timers do not receive bonus payments and 90% do not receive the lump-sum retirement benefits paid by firms. A 2012 law extended the EPI and health insurance coverage to another 250 000 part-timers.<sup>10</sup> It will be important to effectively enforce the law and further extend the mandated coverage.

The negative consequences of labour market dualism are aggravated by the limited mobility between regular and non-regular employment, which is not a stepping-stone to regular employment. Studies show

10. It expanded coverage to part-timer workers who: *i*) work more than 20 hours per week; *ii*) are paid more than 88 000 yen per month (about a third of the average wage); *iii*) have worked in the same firm for more than a year; *iv*) work in a company employing more than 500 people; and *v*) are not students.

that those who begin their careers as non-regular workers have less success later in life in terms of career stability, incomes and marriage (Higuchi and Sakai, 2005). While the government offers subsidies to firms that shift non-regular workers to regular status, progress is slow as firms enjoy the advantages of employment flexibility and lower wages costs stemming from hiring non-regular workers.

**Table 11. Unmarried part-time workers have receive less social security coverage**

Per cent of part-time workers covered by social security in 2011

	Not covered by unemployment benefits	Not covered by health insurance	Not covered by public pension <sup>1</sup>	Covered by employees' health insurance <sup>2</sup>	Covered by employees' pension <sup>2</sup>
<b>Total</b>	<b>44.1</b>	<b>2.2</b>	<b>8.7</b>	<b>68.2</b>	<b>59.7</b>
Married		0.6	2.6	72.1	69.3
Unmarried		5.4	21.6	60.3	39.4
<b>Male</b>	<b>54.2</b>	<b>4.7</b>	<b>15.3</b>	<b>49.2</b>	<b>32.7</b>
Married		0.8	1.5	40.9	34.5
Unmarried		9.5	32.3	59.8	30.2
<b>Female</b>	<b>39.8</b>	<b>1.1</b>	<b>5.9</b>	<b>76.2</b>	<b>71.1</b>
Married		0.6	2.9	82.0	80.3
Unmarried		2.5	14.0	60.7	45.9

1. Not covered by the basic pension, nor the employee pension.

2. Covered either through their own job or that of their spouse.

Source: Ministry of Health, Labour and Welfare (2011b), *Comprehensive Actual Condition Survey on Part-timers, 2011*.

It is crucial to address the issue of labour market dualism, which affects a large share of the population and creates inequality and poverty. It also has important implications for government spending as non-regular workers' lack of social insurance coverage is driving up the use of social assistance and the problem will become worse in the future. The government has introduced measures aimed at limiting non-regular employment by restricting the use of dispatched workers and limiting the length of fixed-term contracts. However, experience in some OECD countries shows that simply restricting the use of non-regular workers may not necessarily prompt firms to hire more regular workers (OECD, 2008). Instead, a comprehensive strategy is needed to reduce the factors that encourage firms to hire non-regular workers, and break down labour market dualism by increasing the coverage of social insurance and upgrading training programmes for non-regular workers and reducing effective employment protection for regular workers, in particular by increasing transparency (2013 *OECD Economic Survey of Japan*). The government has made some efforts in this regard by expanding vocational training for workers, including non-regular workers, and is extending the coverage of EPI and health insurance. The government has also introduced a legal ban on discrimination against non-regular workers and is promoting the transition to regular worker status through subsidies to firms.

Ambiguous criteria about the conditions under which workers can be dismissed on economic grounds increases effective employment protection for regular workers (OECD, 2015a). The Labour Contract Law states that "a dismissal shall, where it lacks objectively reasonable grounds and is not considered to be appropriate in general societal terms, be regarded as a misuse of the right and therefore be renounced". But the law does not specify the meaning of the word "appropriate", leaving an exact determination in each specific dispute to individual judges. The government has established "Employment Guidelines" that detail judicial decisions regarding dismissal and other labour disputes. These guidelines are disseminated in National Strategic Special Zones to help global companies aiming to start businesses in Japan and new firms. The guidelines are also applicable nationwide. However, the government has no intention to introduce a financial settlement system that enables employers to dismiss workers by just paying money to them.

**Box 3. Main policy recommendations to reduce government debt while promoting social cohesion*****Develop a credible fiscal consolidation plan***

- Maintain the current medium and long-term fiscal targets.
- Set out a detailed and credible plan to constrain government spending and raise revenues so as to achieve the target of a primary surplus by FY 2020.
- Strengthen the fiscal policy framework to maintain confidence in the fiscal situation and prevent a run-up in interest rates.

***Increase government revenue, while promoting social cohesion***

- Rely primarily on the consumption tax with a single rate and a broadening of the personal and corporate income tax base to boost government revenue, while raising environmental taxes.
- Improve the targeting of public social spending and introduce an earned income tax credit for low-income workers.

***Limit government spending while fostering socially-inclusive growth***

- Reform social security to limit spending increases, particularly in health and long-term care, by increasing efficiency and raising co-payments, while taking account of equity implications.
- Ensure the sustainability and intergenerational equity of the public pension scheme, primarily by increasing the pension eligibility age above 65 and fully applying macroeconomic indexation.
- Reform social assistance by reducing benefits and enhancing work incentives while expanding its coverage.
- Break down labour market dualism by increasing the coverage of social insurance and upgrading training programmes for non-regular workers and reducing effective employment protection for regular workers, in particular by increasing transparency.

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