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Linking Consumption Tax Hike to Economic Recovery

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Fiscal consolidation or economic recovery? The unfortunate dichotomy between the two has led Japan to delay a decision. Regarding the government-planned “comprehensive reform of social security and tax” in *Speaking Out #127*, I concluded that a 5-percentage-point consumption tax hike is the minimum necessary measure for Japan and would not be any issue for a national election. Rather, I give priority to the "comprehensive reform of economic policy and tax," believing that a consumption tax hike will lead to economic recovery.

Cap deficit-financing government bond issues

Regrettably, international financial markets have grown sensitive to fiscal conditions under the European sovereign debt crisis where a country's fiscal policy has become a speculation target for excess money growing since the 2008 Lehman Shock. If Japan postpones the consumption tax hike again, it may induce government bond selling expected to boost interest rates. Interest rate increases could affect the economy far more gravely than the consumption tax hike. Given the balance of government debt close to 100 trillion yen, an interest rate hike of several percentage points can be expected to push annual interest payments on government bonds up by billions of yen. The government may then be forced to issue additional bonds. A government bond price decline (an interest rate rise) may deteriorate bank assets, endangering citizens' deposits at banks. Deflation may grow even more serious on banks' credit crunch or withdrawal.

However, Japan’s required macroeconomic measure at present is aggressive fiscal spending to create real demand and overcome deflation. Here, construction government bonds for forming assets for the future should be separated from deficit-financing bonds for only increasing citizens’ future contributions. The fiscal discipline problem linked to the creditworthiness of Japanese government bonds means the lax fiscal management where the government has covered growing social security spending with deficit-financing bonds leaving burdens to future generations. By raising the consumption tax to cap deficit-financing bond issues and solve the fiscal discipline problem, Japan can increase construction government bond issues to raise funds for government investment to stimulate the economy.

Fortunately, Japan has more than 2,000 trillion yen in financial assets held by households and nonfinancial corporations and the world’s largest net external assets.

More significant domestic investment targets are required for the huge assets. Construction bonds can become a significant investment target. The government's investment expansion may produce savings and new assets. This money cycle will help overcome a decline in savings amid the aging of population. The post-disaster reconstruction of northeastern Japan and the construction of a disaster-resistant country provide a good opportunity for government investment to create real demand with significant asset formation.

Implement priority-oriented fiscal management

Japan should now discriminate construction bonds for aggressive fiscal spending from deficit-financing bonds for administrative and fiscal discipline problems and combine policies to expand the former and reduce the latter. Why not dividing the government's general account into a government investment account financed by construction bonds and a current account financed by tax revenues and deficit-financing bonds? A social security account may be separated from the current account and financed by consumption tax revenues. Any financial shortage may be covered by deficit-financing bonds as burdens left on future generations. Such reform may help specify the consumption tax hike not as any administrative issue but as the issue of equity between generations regarding social security benefits and contributions.

The logic of separation beyond the fiscal logic may lead to the creation of systems where people can clearly see the relationship between costs and benefits, bringing about a priority-oriented, transparent fiscal management. If the consumption tax hike is based on the people's decision and satisfaction, it may be a hopeful tax hike.

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