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TAXING TIMES FOR ABENOMICS

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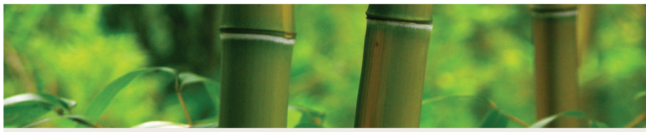
Even as doubts grow about Prime Minister Shinzo Abe's continued commitment to economic reform in Japan, "Abenomics" may suffer another blow on April 1, when the nation's consumption tax rises from 5 to 8 percent. Critics warn that the tax hike could once again nip Japan's recovery in the bud, much as the last increase in 1997 is widely viewed to have done. But the culprit then—and the risk today—is not the tax increase per se, but rather errors of both commission and omission in other areas of economic policy.



Upcoming Events

- March 21: US-Japan Security Seminar (Pacific Forum CSIS)
- March 28: China Reality Check Series: China's Human Rights Diplomacy (CSIS)
- April 15: Chinese Economic Decision-Making (CSIS)

The saga of the consumption tax has been a central theme of Japan's political economy for over three decades. First proposed in 1979 to secure the nation's public finances in the face of a structural slowdown in economic growth, a 3 percent consumption tax (actually a value-added tax imposed at each stage of production) was finally introduced a decade later by Prime Minister Noboru Takeshita. The tax was hugely unpopular, and Takeshita promptly fell on his sword and resigned. A successor, Ryutaro Hashimoto, managed to force through an increase to 5 percent in 1997, but he fell from power a year later after the ruling party took a beating in Upper House elections.

With gross public debt having grown to over twice the size of Japan's economy, Prime Minister Yoshihiko Noda (like Takeshita and Hashimoto, a former finance minister) pushed through legislation in the summer of 2012 to raise the consumption tax again in two stages: to 8 percent on April 1, 2014, and to 10 percent on October 1, 2015. As required by the legislation, Abe determined last fall that economic conditions were strong enough to warrant going ahead with the first-stage increase next month. (Abe needs to make a similar determination about the 2015 hike before the end of this year.)

The 1997 experience is instructive in assessing the likely impact of the upcoming tax hikes—indeed, in evaluating the overall prospects for Abenomics. On one level, the history is worrying: after rising sharply in the two quarters leading up to the April 1997 consumption tax increase, Japanese growth plummeted 3.7 percent on an annualized basis in the following quarter, and the economy slipped back into recession in 1998–1999.

But a number of other policy actions—and nonactions—by Tokyo at the time were key contributing factors to the slump. For one thing, overall fiscal policy was sharply contractionary: in addition to the consumption tax increase, Tokyo allowed an earlier temporary income tax cut to lapse at the beginning of 1997; national insurance premiums were raised at the same time; and the pipeline of spending from two large stimulus packages in 1995 and 1996 had largely dried up.

As it happens, I was U.S. Treasury representative in Tokyo at that time, and I recall a ride to the Finance Ministry with then-Deputy Treasury Secretary Larry Summers in late 1996 in which he said that he planned to raise no objections to the consumption tax hike itself—the United States should also be moving toward indirect taxes as a more stable source of revenue—but did plan to express serious concern about the austere stance of Japanese policy overall. This, he warned presciently, would lead Japan's economy into "the fiscal abyss."

Moreover, there was no "first arrow" of Abenomics in 1997, that is, an aggressive monetary policy. True, the Bank of Japan (BOJ) had cut its discount rate to as low as 0.5 percent in 1995, but after that it took no additional monetary stimulus until the fall of 1998. In fact, in a speech in November 1997, then-Governor Yasuo Matsushita of the BOJ reminded his audience that the Bank's goal was price and financial stability, and he defended the BOJ's "dramatic and prolonged" monetary easing against criticism that it was delaying structural adjustment.

TAXING TIMES FOR ABENOMICS *(continued)*

By contrast, both monetary and fiscal policy today is far more supportive of growth. Current Governor Haruhiko Kuroda of the BOJ has essentially said that he will do whatever it takes to achieve the target of 2 percent inflation by next year, and he has already signaled that he will step in with further monetary stimulus if growth falters after the consumption tax hike takes effect. Meanwhile, Tokyo's commitment under the second arrow of Abenomics to a "flexible" fiscal policy implies that if February's $53 billion stimulus package is insufficient to sustain growth, more government spending is likely.

Despite the more favorable macroeconomic policy stance, there is one worrisome constant between the two periods: the inability of Japanese governments to deliver comprehensive structural reform. The fact that the third arrow of Abenomics is all about structural reform, and includes many of the same items that would have been on a to-do list 17 years ago—from deregulation to making labor markets more flexible to improving the climate for foreign direct investment—shows how much work remains to be done in this area. The International Monetary Fund has estimated that well-targeted structural reform could roughly double Japan's potential growth rate from around 1 percent to as much as 2 percent over a decade.

Frankly, unless Tokyo can get more people—notably women—into the workforce, raise productivity in the agriculture and services sectors (completion of a market-opening Trans-Pacific Partnership trade agreement would help), and encourage more competitive "churn" in the economy, we will likely still be talking about slow Japanese growth 17 years from now.

To be sure, structural reform is politically difficult, because it requires overcoming vested interests that have most to lose. And even if successfully carried out, reform can depress growth in the near term by forcing painful reallocation of resources in the economy. But think of Abenomics as the ultimate "confidence game": the key is not to fix everything at once, but to announce a few priorities, move ahead on these, and convince people that you are making steady progress. Far from being a drag on the economy, this approach can break through vested interests, bolster confidence, and have a positive dynamic effect on growth.

The good news is that Japan today has one thing that it arguably has not had for most of the past two decades: a prime minister with demonstrated confidence, a secure political position, and a credible economic strategy. The question is whether Shinzo Abe will continue to use these assets to push ahead with structural reform, or whether he will allow himself to be distracted by other—frankly lesser—priorities.

So let next month's tax hike proceed. Forcing consumers to pay more at the till may seem odd for a country trying to promote consumption-led growth. But it is arguably the right thing for Japan to do in light of its massive debt burden. The real test of Abenomics will be whether Tokyo gets the surrounding policies right: keeping other fiscal and monetary policies accommodative and—most important—moving ahead selectively yet purposefully with meaningful structural reform. ■

Matthew P. Goodman *holds the Simon Chair.* ***Global Economics Monthly*** *is published by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author.*

Simon Says…

Implementation of next month's consumption tax hike represents another hard-earned victory for Japan's once-beleaguered Ministry of Finance (MOF). Historically the most powerful and prestigious of the country's bureaucratic agencies, MOF was brought down to size in the late 1990s by poor management of the country's nonperforming loan problem and a series of scandals involving male officials soliciting bribes from bankers, taking "naps" with call girls, and, in one case, collecting enormous quantities of women's lingerie.

As a result, MOF lost control of the Bank of Japan in 1998, and the same year was stripped of its financial regulatory functions, which moved to a new Financial Services Agency housed in the prime minister's office. In a final indignity, MOF was forced to change its name in Japanese from the storied "Okura-sho" (literally, Treasury) to the common "Zaimusho" (Finance Ministry).

In addition to getting its way on the consumption tax, MOF today has regained its hold on a number of other levers of power. The current finance minister, Taro Aso, also serves as deputy prime minister, while BOJ governor Kuroda is a former MOF vice minister. The Okura-sho is dead; long live the Okura-sho… ■