Call for Growth Strategy Implementation and Decisive Action for Fiscal Reconstruction — Leading Japan Out of the Present Crisis —

May 15, 2012

Keidanren

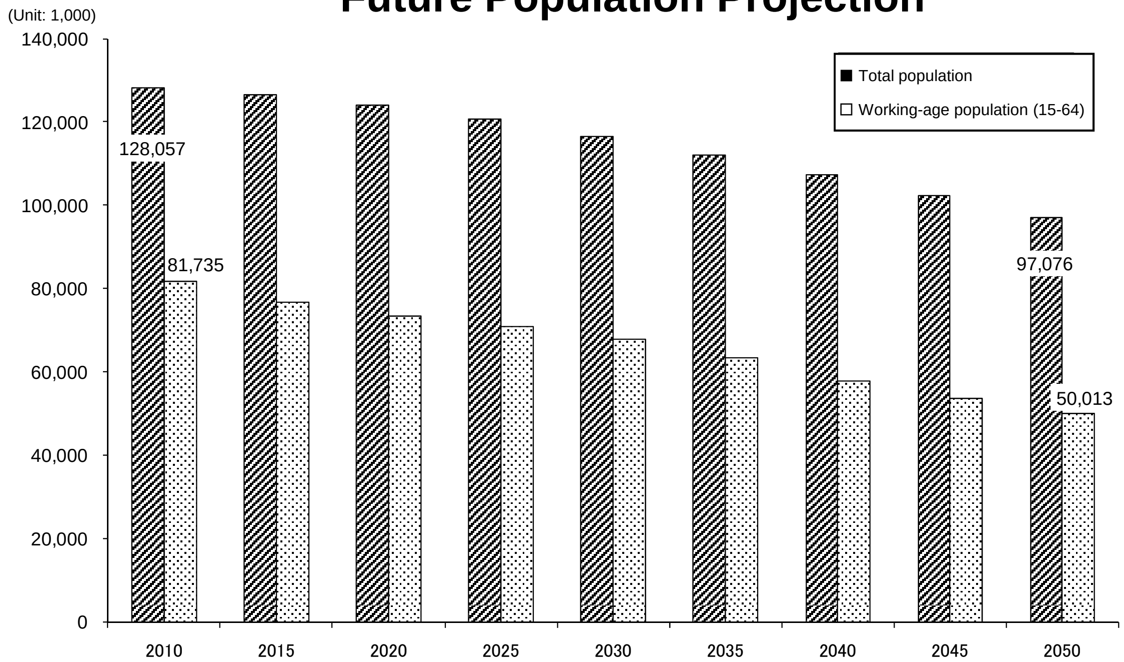
Executive Summary

- Japan's global presence will steadily diminish if deflation continues and the enormous fiscal deficit remains unaddressed amid ongoing political indecision. Based on such sense of crisis, this proposal calls upon the Japanese government to deal with the crisis by prompt and steady implementation of growth stimulus measures which Keidanren has repeatedly proposed and by reinforcing efforts for fiscal reconstruction through expenditure control and tax increases.
- Keidanren and the government share the goal of achieving economic growth exceeding 2% in real terms and 3% in nominal terms. Specific measures to achieve this aim include: (1) using special reconstruction zones to achieve early restoration and reconstruction following the Great East Japan Earthquake, (2) establishing a level playing field in the international business environment through steps including the reduction of effective corporate tax rates to 25%, (3) realization of measures for promotion of innovations, including expansion of government research and development investments and tax programs for promoting research and development, (4) stimulating domestic demand through drastic regulatory reforms in the fields of agriculture, medical care/nursing, and urban/community development, and (5) boosting overseas demand through promotion of economic partnerships such as the Trans-Pacific Partnership (TPP), expansion of package-style infrastructure exports to Asia, and efforts including tourism promotion.
- As for fiscal reconstruction, Keidanren proposes: (1) comprehensive reform of social security and tax based on the twin pillars of ensuring controls on benefits through streamlining and prioritization in all fields of social security and assuring stable sources of revenue, and (2) introduction of new expenditure control programs by setting spending caps in each major policy field.
- We also emphasize the need for clear timelines, firm government commitment, and rigorous control of progress in order to implement these measures.
- The proposal sets out projections calculated using a macroeconomic model to illustrate the quantitative effects of the above measures. They show that actual growth of 2% and nominal growth of 3% could be achieved in 10 years, and that the increase in government debt could be restrained in the mid-2020s at around 250% of nominal GDP.
- Finally, we set out our hopes for decision and action by the Noda Cabinet, emphasizing the need to quickly pass the bill to raise consumption tax currently under deliberation and to draw up a revitalization strategy for Japan based on implementation of the New Growth Strategy.

1. Introduction

- Japan faces a shrinking population, yet is slow in responding to globalization and is in other respects failing cope sufficiently with economic and social changes.
- The situation is deteriorating, and it will be difficult to achieve Keidanren's long-standing target of economic growth exceeding 2% in real terms and 3% in nominal terms (a goal shared by the government).
- To break out of the current stagnation and ensure prosperity, implementation of growth strategy and decisive action for fiscal reconstruction are required.

Future Population Projection

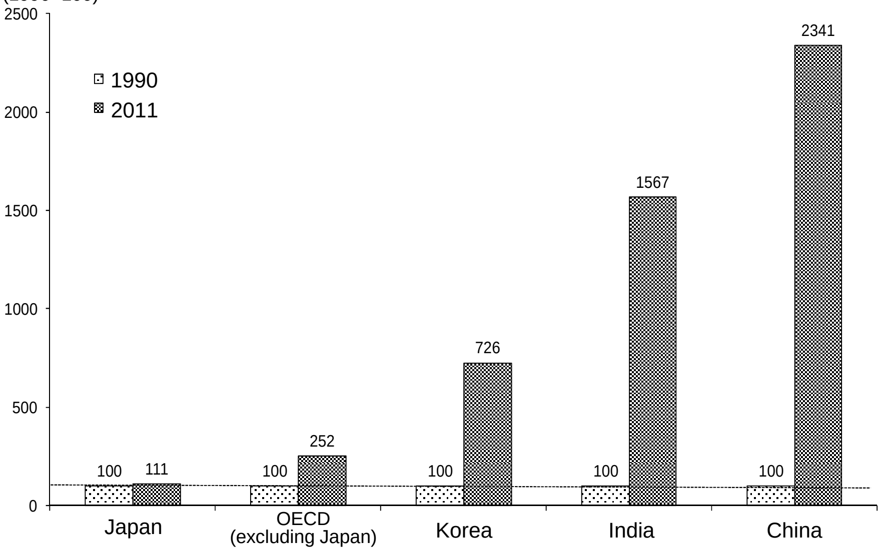


Source: National Institute of Population and Social Security Research
Note: Created from statistics assuming medium-fertility (medium-mortality)

2. Japan's Economic and Fiscal Challenges
(1) Diminishing presence in the global economy

- Over the past dozen or so years, China and other emerging Asian economies have achieved dramatic economic growth, while Japan has continued to record low growth over the long term.
- Japan's per-capita nominal GDP ranking fell from 10th in the world in 1990 to 25th in 2011.
- Japan's economic status is steadily declining.

Nominal GDP Growth (1990–2011)



Source: Prepared from IMF, OECD, and Cabinet Office documents
Note: OECD (excluding Japan) shows 2010 data

Per-Capita Nominal GDP Rankings (based on purchasing power parity)

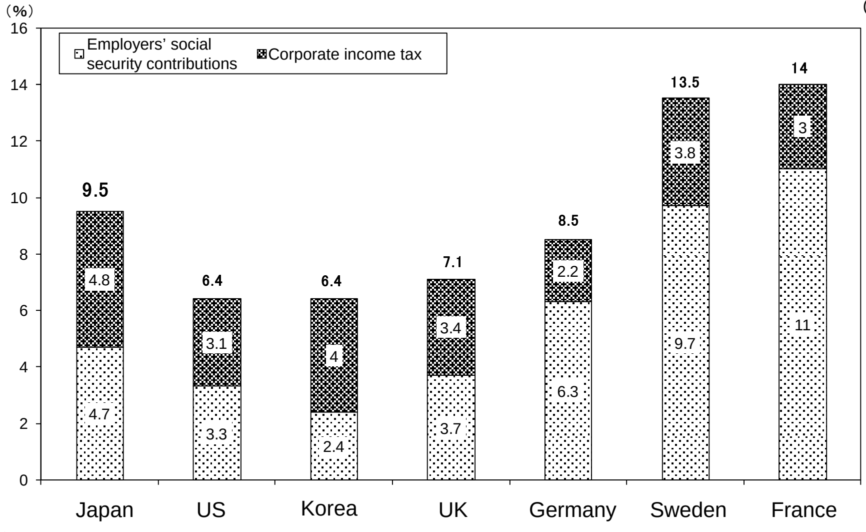
Rank	Country (1990) US$	Country (2011) US$
1	Brunei $36,242	Qatar $102,943
2	Qatar $33,132	Luxembourg $80,119
3	UAE $32,143	Singapore $59,711
4	Luxembourg $31,647	Norway $53,470
...	...	...
10	Japan $19,203	Netherlands $42,183
...	...	...
25	United Kingdom $16,306	Japan $34,740

Source: IMF

2. Japan's Economic and Fiscal Challenges
(2) Hollowing out of industry and loss of jobs

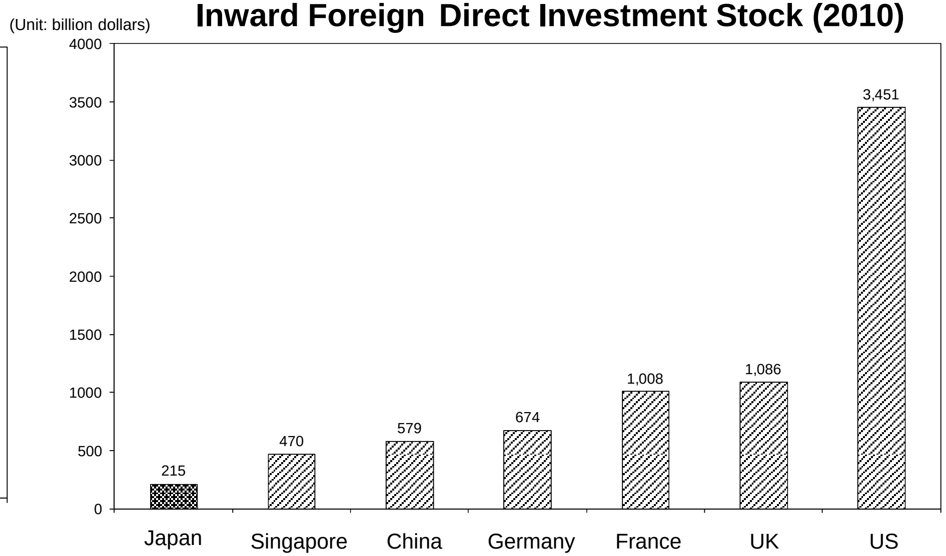
- A host of problems including the appreciation of the yen, deflation, electricity supply shortages, and rising costs are undermining Japan's competitive advantage. In particular, the combined burden of corporate income taxes and employers' social security contributions is far higher than the levels seen in the US or Korea.
- In order to attract foreign investment, countries around the world are striving to enhance the competitive advantage of their institutions and infrastructure by reducing corporate tax rates and enhancing infrastructure needed to make their industries more competitive. Amid this trend, inward foreign direct investment stock in Japan falls far short of that in other countries.
- As hollowing out makes it difficult to create or maintain jobs and jeopardizes the very standards of technology and expertise that have made the Japanese economy competitive, markedly lower growth rates become inevitable.

International Comparison of Corporate Income Taxes + Employers' Social Security Contributions (as proportion of GDP)



Source: Japanese Government Tax Commission documents (2007)

Inward Foreign Direct Investment Stock (2010)

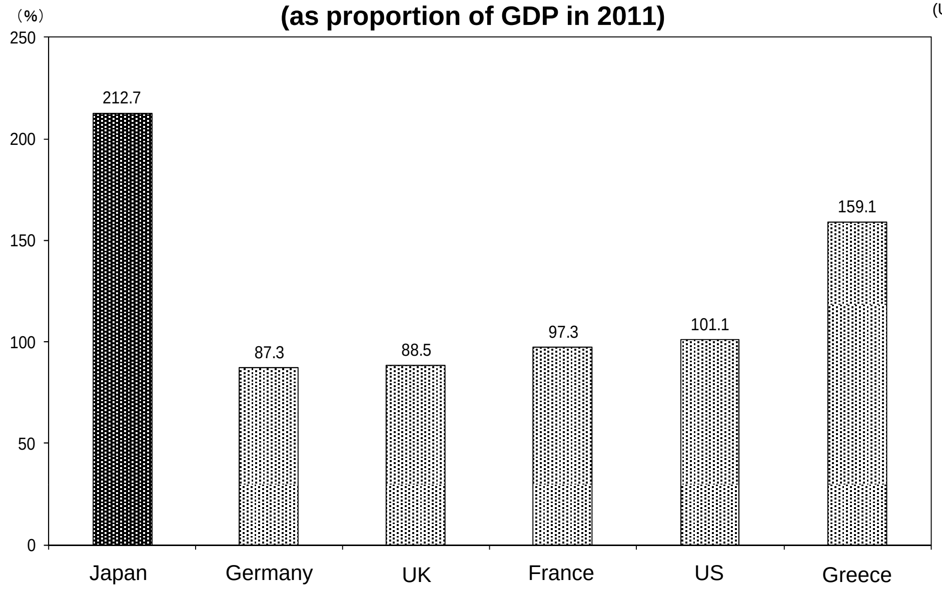


Source: Institute for International Trade and Investment

2. Japan's Economic and Fiscal Challenges
(3) Continuing deterioration of public finances

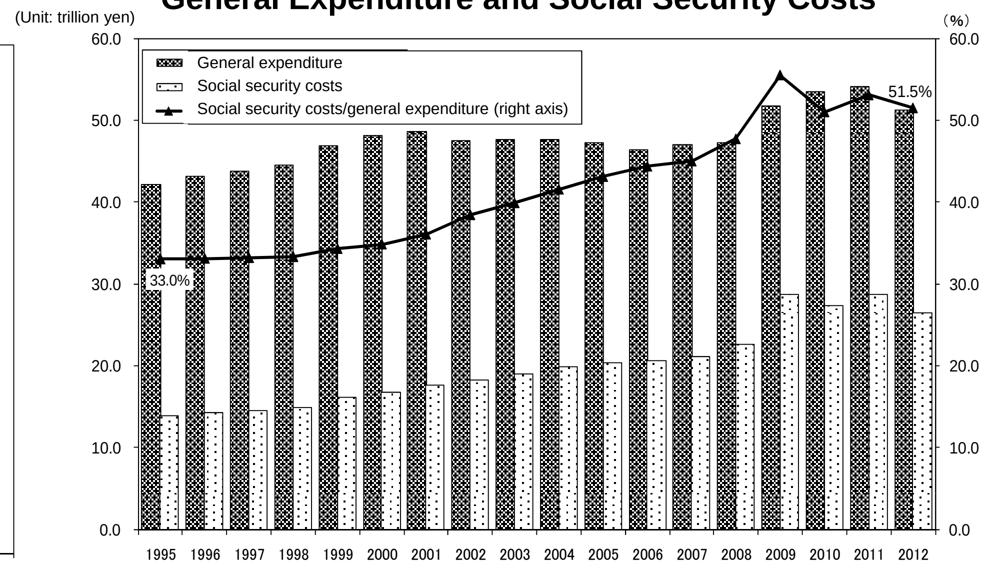
- Japan's public finances are among the worst in the world.
- Although public investment has been on a downward trend during much of the past two decades, social security expenses rose by around 1.3 trillion yen each year and now account for more than half of general expenditure.
- The Lehman crisis and the Great East Japan Earthquake required emergency expenditure that placed further strain on public finances, yet lavish measures introduced since the change in administration to the DPJ, including Child Allowance ('kodomo teate') and free high school education, undeniably contributed further to the budget deficit, and there are no signs of the deterioration in public finances being stemmed.

International Comparison of Government Debt (as proportion of GDP in 2011)



Source: Ministry of Finance, Eurostat
Note: Figures based on general government debt

General Expenditure and Social Security Costs



Source: Ministry of Finance
Note: FY2012 figures based on initial budgets

3. If Growth Strategy and Fiscal Reconstruction Are Postponed ("Business as Usual" Scenario)

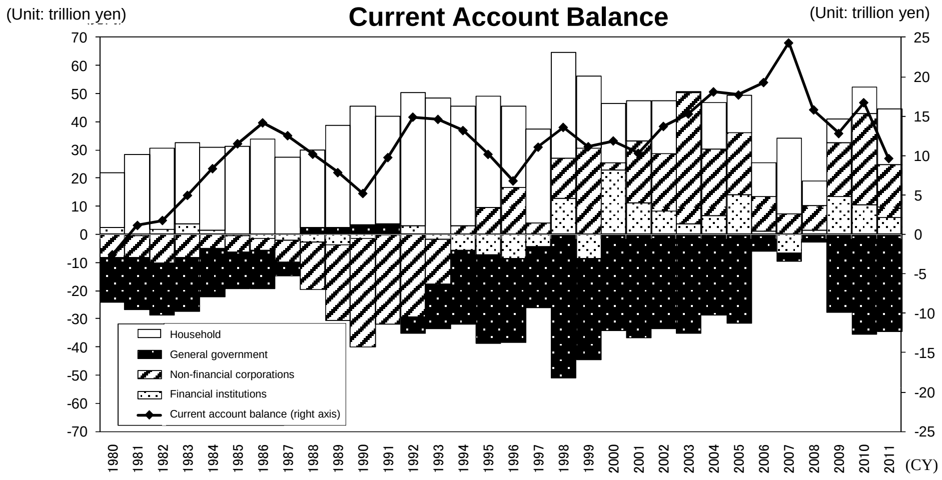
(1) Fear of sovereign risk

- The longer the government delays efforts to implement growth strategy and rebuild public finances, the greater the risk of Japan being driven to fiscal failure. If markets perceive such risk, the impact on people's living in Japan could be serious and swift, through a downward spiral in the financial system and the real economy with the currency sharp depreciation and severe inflation.
- Japan's public-sector deficit (national debt) has been supported by private-sector savings generated by companies adopting sounder financial positions, but if an aging society demolishes these savings and the trade deficit worsens, twin fiscal and current account deficits will leave Japan facing the risk of sharp currency depreciation and interest rate rises.

(2) Suppressed growth due to fiscal deterioration

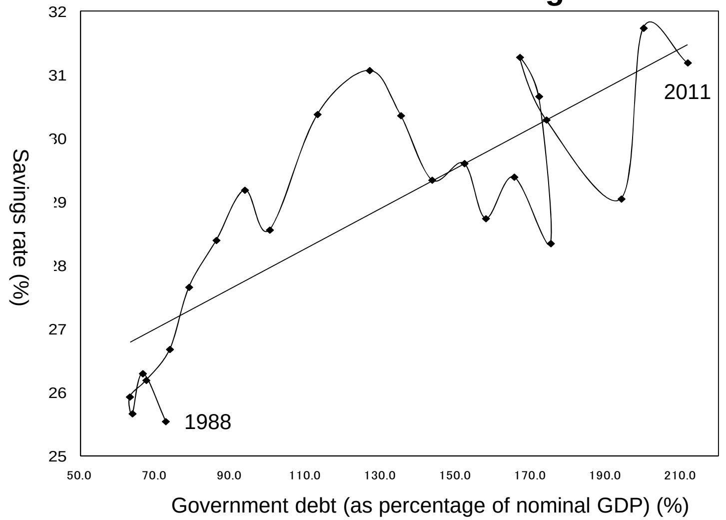
- Excessive public debt inhibits economic growth. Public debt eats into private savings, and this not only obstructs efficient accumulation of capital, but also increases uncertainty for younger people, since it leaves massive debts for future generations.
- Acting age are restricting consumption because they recognize the need for private savings for their old age, given uncertainties over the sustainability of Japan's public finances and social security systems. This behavior further constricts domestic demand and has a severely negative impact on economic growth.

Saving/Investment Balance and Current Account Balance



Source: Flow of Funds Account Statistics, Bank of Japan
Notes: 1. Positive figures show savings surplus, negative figures show deficit expenditure (investment)
2. Figures to 1997 based on former statistics
3. Excludes impact of carry-over of assets and debts associated with privatization of four public highway corporations in 2005

Government Debt and Savings Rate



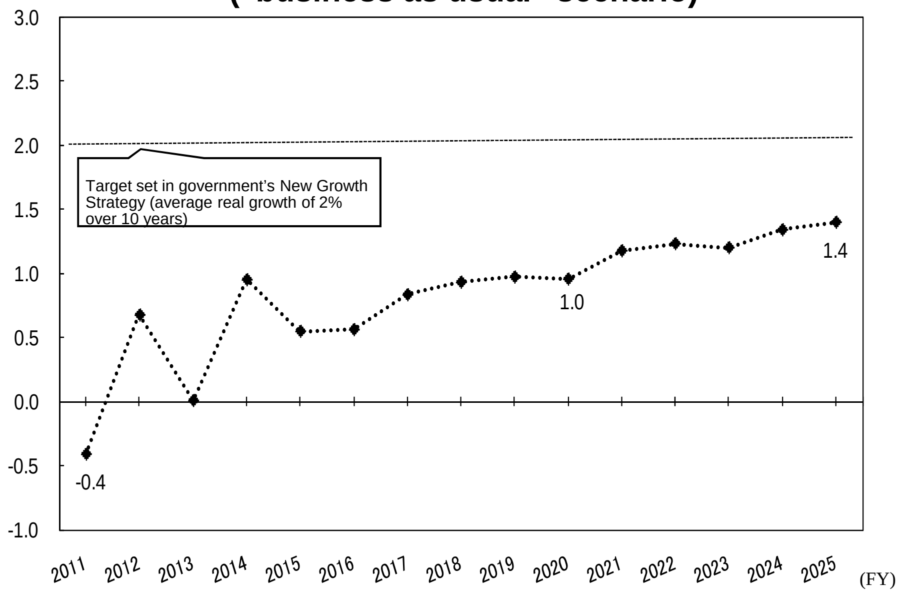
Sources: Ministry of Internal Affairs and Communications, Ministry of Finance

3. If Growth Strategy and Fiscal Reconstruction Are Postponed ("Business as Usual" Scenario)

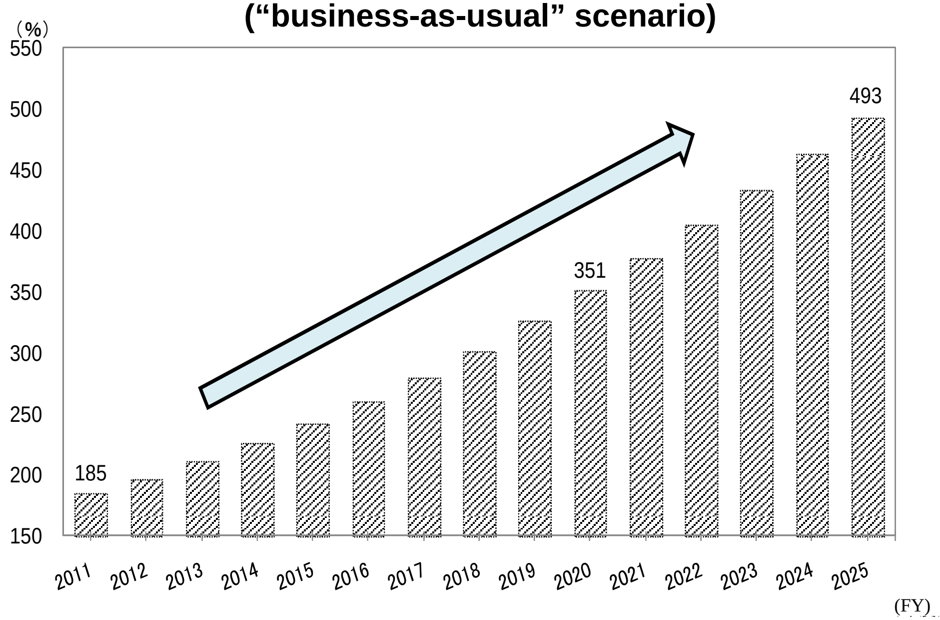
(3) Economic and fiscal effects of the "business as usual" scenario (macroeconomic model projections)

- Using a macroeconomic model, Keidanren has made economic and fiscal projections for the period until fiscal 2025 based on the "business as usual" scenario, where growth strategy and fiscal reconstruction are postponed.
- The economic growth rate will remain at low levels throughout the projected period (FY2011–FY2025), with real and nominal growth of little more than 1%.
- Sluggish growth will stunt tax revenue, and issuance of government bonds will snowball to make up the shortfall, leading to an explosion of public debt.

Real GDP Growth Rate ("business as usual" scenario)



Government Debt as Percentage of Nominal GDP ("business-as-usual" scenario)



4. Specific Measures toward Growth Strategy Implementation and Decisive Action for Fiscal Reconstruction (Reform Scenario)

(1) Fundamentals

- To maintain prosperity in Japan, growth strategy should be implemented in the aim of achieving economic growth of 2% in real terms and 3% in nominal terms.

- In implementing growth strategy and taking decisive action for fiscal reconstruction, it will be crucial to strike a balance between economic growth on the one hand and curbing expenditure and reforming revenue-gathering (increasing taxes) on the other.

- The following three points are essential to generating a positive cycle fed by both growth strategy and fiscal reconstruction:

(1) A clear timeline for prompt implementation of growth strategy

(2) Political commitment to fiscal reconstruction by the Government and ruling/opposition parties

(3) Rigorous management to ensure progress of reforms

4. Specific Measures toward Growth Strategy Implementation and Decisive Action for Fiscal Reconstruction (Reform Scenario)

(2) Steady implementation of growth strategy

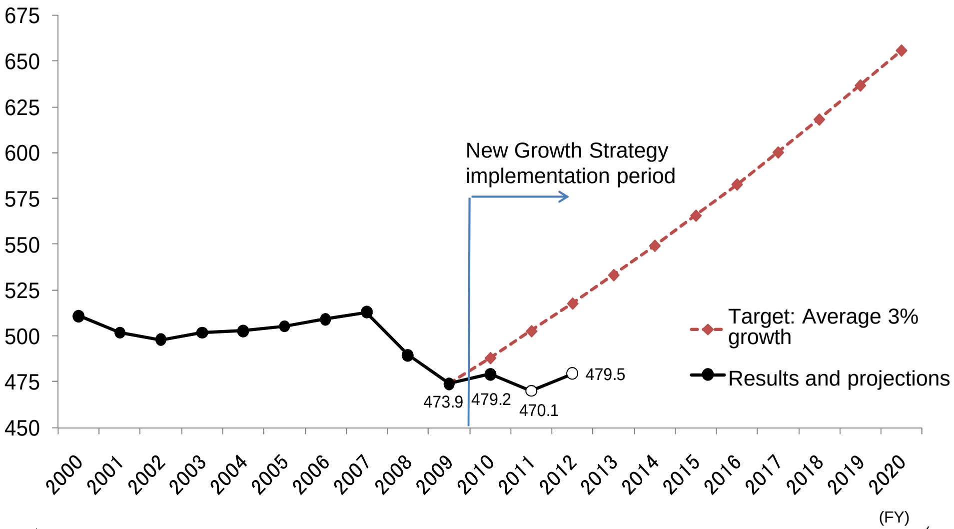
(1) Follow-up on government's New Growth Strategy

- The measures set out in the government's New Growth Strategy are generally in line with the direction for growth strategy sought by Keidanren, but when we verified economic performance since fiscal 2010 and the rate of progress on certain measures, the results so far were unimpressive. The government should devote every effort to implementing its plans and achieving its objectives.

(2) Five measures requiring swift action

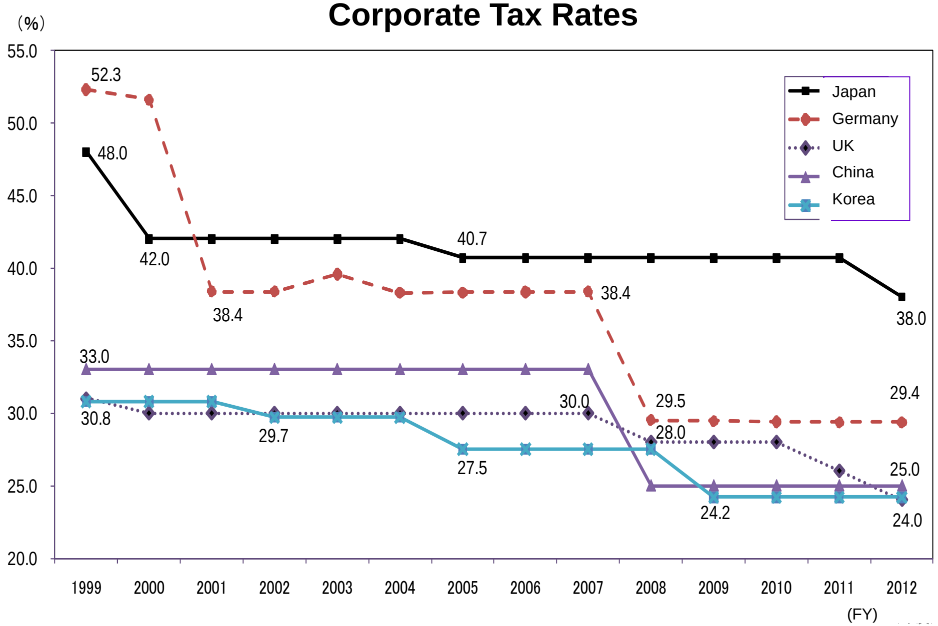
- i) Promptly restore and reconstruct in the wake of the earthquake, ii) Establish a level playing field in the international business environment on an equal footing with other countries, iii) Promote innovation, iv) Stimulate domestic demand through regulatory reform, v) Quickly boost external demand

Nominal GDP Levels (Follow-up on New Growth Strategy)



Source: Cabinet Office National Accounts of Japan, Fiscal 2012 Economic Outlook and Basic Stance for Economic and Fiscal Management, and government's New Growth Strategy
Note: White circles show government projections (made in Jan. 2012)

International Comparison of Effective Corporate Tax Rates



Source: KPMG

4. Specific Measures toward Growth Strategy Implementation and Decisive Action for Fiscal Reconstruction (Reform Scenario)

(3) Ongoing efforts to rebuild public finances

(1) Comprehensive reform of social security and tax

- In the social security field, there is an urgent need to forge ahead with painful reforms to prioritize benefit systems and make them more efficient, and to secure stable sources of revenue, especially through consumption tax. The rate of consumption tax should be raised to 10% in fiscal 2015 and to the high teens by the mid-2020s.

  Medical and nursing care: Restrict natural rise in benefit expenses to, for example, within economic growth rate

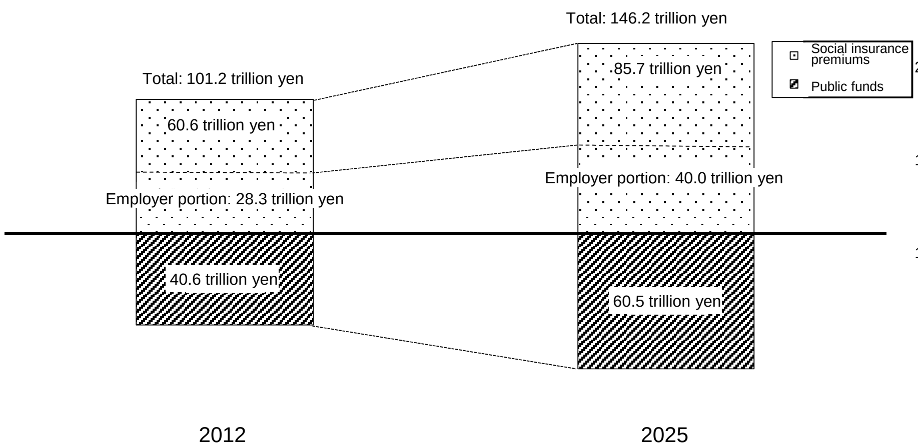
  Childcare: Review Child Allowance eligibility and payments

  Pensions: Activate Macro-Economic Slide Formula during deflation

(2) New programs to control spending

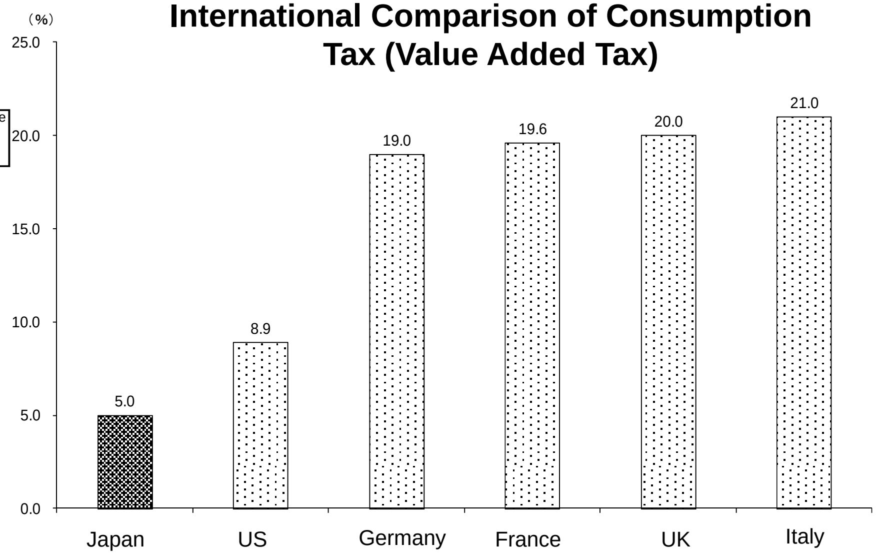
- Expenditure caps are required for major expenses including social security and personnel costs, and national and local governments need to make efforts to control expenditure.

Projected Social Security Benefit Costs



Source: Prepared from "Revised Projections for Social Security Expenses," Ministry of Health, Labour and Welfare (March 2012)
Notes: 1. Employer portion of insurance premiums calculated on assumption that 2011 figure of 27.8 trillion yen will rise in proportion with benefits
2. Figures for 2025 incorporate effects of comprehensive reform of social security and tax

International Comparison of Consumption Tax (Value Added Tax)



Source: Prepared from Ministry of Finance documents
Note: Figures for US show rate of retail sales tax in New York City/New York State

4. Specific Measures toward Growth Strategy Implementation and Decisive Action for Fiscal Reconstruction (Reform Scenario)

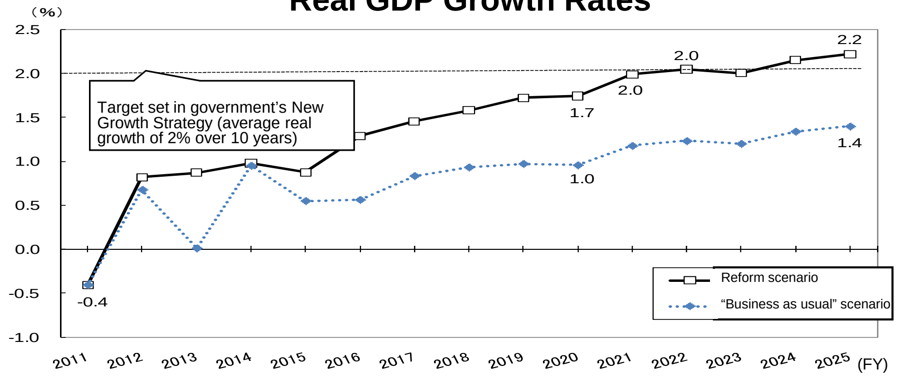
(4) Monetary policy

- The Bank of Japan needs to continue to take powerful monetary easing measures as required.

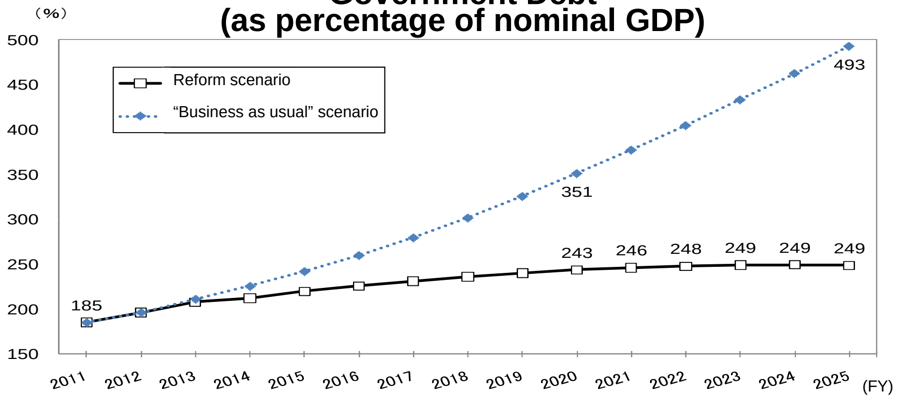
(5) Economic and fiscal effects of the reform scenario (macroeconomic model projections)

- Comprehensive package of growth stimulus measures achieves growth of around 2% in real terms and 3% in nominal terms after fiscal 2020.
- Government debt plateaus at around 250% of nominal GDP in mid-2020s, thanks to higher growth rate and efforts to rebuild public finances.
- National contribution rate (ratio of taxes and social security premiums to gross national income) increases from 39.9% in fiscal 2012 to 53.1% in fiscal 2025.

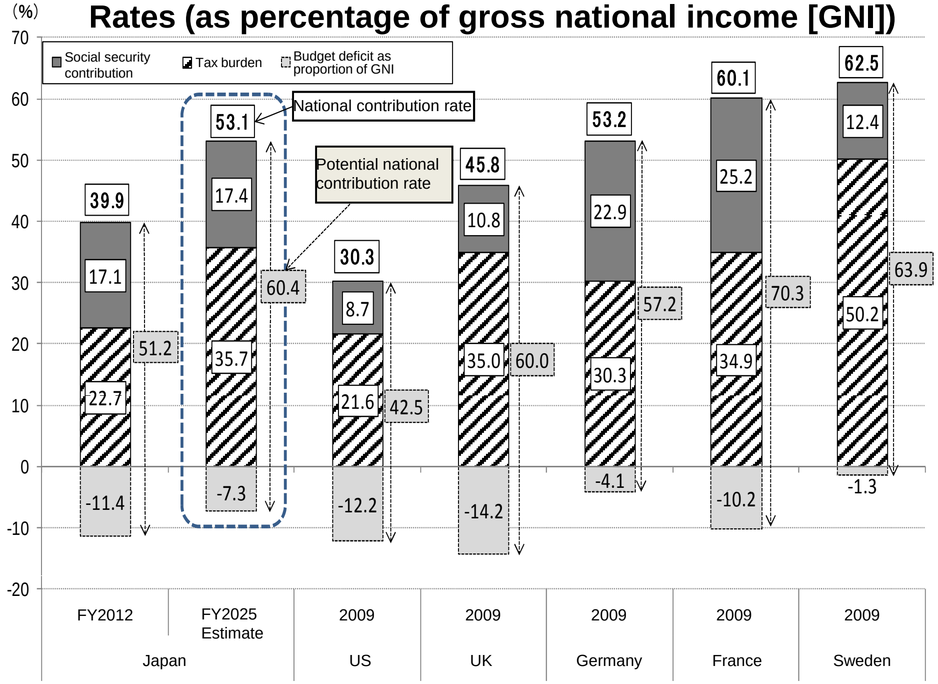
Real GDP Growth Rates



Government Debt (as percentage of nominal GDP)



International Comparison of National Contribution Rates (as percentage of gross national income [GNI])



Source: Ministry of Finance, OECD
Note: Japan's FY2012 figures are government projections. Other countries show actual 2009 figures.

5. Conclusion

- The bill to raise the rate of consumption tax currently under deliberation in the Diet should be passed promptly to send a clear message, both domestically and internationally, that the first step has been taken toward fiscal reconstruction.

- At the same time, it is vital to draw up a growth-stimulating revitalization strategy for Japan based on the New Growth Strategy, and to take a unified national approach to swiftly and steadily implementing it.

- Keidanren will act to assist in Japan's revitalization through independent private-sector-led initiatives including "Future City Model Projects" that will accelerate innovation together with enhanced education and training of global human resources.

- We call on the Noda Cabinet to take swift, bold decisions and action on both domestic and international affairs.