Ozawa and

Consumption Tax Consequences

As much as we don't like DPJ politician Ichiro Ozawa and his money-tainted politics, we have to agree with him on one thing, that raising the consumption tax in Japan could be harmful. Ozawa's public position is that consumption tax is a regressive tax on the poor and that the government has not done enough to root out wastage in the bureaucracies and should focus on that first. He has a point. While the traditional argument is that consumption tax is fairer because it requires everyone in the country to pay, not just salary earners, this argument is usually presented in countries where there is a high level of underground trading.

But Japan is both a highly compliant country in regards to tax payment, AND, it has a lot of poor people who will be affected by the increase. Indeed, as of 2007, it had the 4th highest level of poverty amongst OECD countries and there were at least 10m households below the poverty line (JPY2m annual income). Shockingly, that accounts for 15% of Japan's kids. No wonder, then, that there has been some talk of not charging consumption tax on some foodstuffs and other essentials. You can review the child poverty issue at:

http://www.japaninc.com/tt555_child_poverty_in_Japan

But actually, the reason we think consumption tax will be harmful to Japan is not because it will hurt the poor. Poor people have been getting the rough end of the stick for a long time. Rather, the problem is that a sudden influx of fresh cash will let the government engage in another 10+ years of profligacy, encouraging them to put off hard decisions that they should be making now.

A possible raise in consumption tax has been the "ace up the sleeve" for successive Japanese governments for a while now, who look at the 22% rate in the UK and realize that once you get the population used to the idea, admittedly after a rough start-up period, then they accept it and you're done with worrying about whether sufficient companies are earning profits and people are employed -- so as to cover tax requirements. We're willing to bet that the prospect of a flood of extra cash is the main reason why that the DPJ brought out a raft of vote-winning policies -- such as handing out cash to families with kids, and now a proposed minimum JPY70,000 pension. Both of these moves are admirable from a social safety net point of view, but who's going to pay for them?

Yes, a good question... Right now, to fund a budget of JPY90.33trn, the country expects income taxes to provide about JPY36.92trn, while bonds, asset sales, and other creative fund raising will take care of the rest. In fact, this is the third year in a row where fund-raising through government bonds has exceeded tax income -- obviously an unsustainable situation. Unfortunately, the annual deficit is going to get worse. Not counting the proposed guaranteed pension, the aging population is ratcheting up social security costs by an additional JPY1trn a year.

Therefore, it is no wonder that increasing the consumption tax is such an attractive option. Taking the tax rate to 10% will bring in an additional JPY12.5trn annually to government coffers, while if it went to 20%, then the amount would be about JPY37.5trn. Look forward 35 or so years into the future, when there will be 20% less people, and the income and expenditure numbers could conceivably balance. Therefore, our take is that once the government locks in a 10% rate, something they are trying to do by October 2015 (8% by April 2014), then it won't be long before 15% or even 20% will be considered viable as well. Indeed, even Noda in a recent Keiyo University address said that this might happen, although the government has since pulled back from that position.

So, back to the profligacy argument. Ozawa is right that there are so many areas that the government could be tightening up on its spending, before focusing on more taxes. Just take a look at the ongoing public works, the overkill in new regulations such as barring the sales of OTC drugs online, and worst of all, the thousands of semi-governmental organizations sucking at governmental income. These organizations are typically set up to "support" various industries (with licence fees, registrations, certifications, etc.) but in reality exist to provide Old Boys with jobs and high salaries.

A good example recently in the news is the Japan Atomic Power Company (JAPC). This is an organization that was set up with government cash to build two nuclear reactors some decades ago. This last fiscal year it was still levying its power utilities customers 75% of its 2010 charges, thanks to a fixed pricing system, even though it is only supplying 4.6% of the power it was in FY2010. Meanwhile, the utilities are deep in the red and struggling with the costs of importing massive amounts of oil and LNG to fuel their generators. JAPC has nicely positioned itself in the supply chain for power with TEPCO, and due to the fact it staffs itself from the utilities (TEPCO's president Tsunehisa Katsumata will join the board after resigning from TEPCO to take responsibility for the Fukushima disaster), it clearly has the power to set its own pricing and policy agenda. This kind of arrangement is really quite disgusting, and it really makes you wonder where and when the government will ever get the gumption to tackle such subtle corruption.

OK, so we concede that the DPJ did try for a while to eliminate some of these special interest bloodsucking organizations, but it has made very little headway recently. Not unreasonably, they have been distracted by the earthquake and now by divisive politics. A recent poll by by Kyodo News found that 72% of voters feel the same way -- that the government has not done enough to eliminate waste, and should focus on that before raising the consumption tax. Ozawa is a wily old fox and is tapping into a deep well of public resentment over the issue.

If there is no consumption tax increase, then we believe the government will hit the wall within 3-4 years in terms of being able to borrow on the local markets, and will have to turn overseas for cash, at much higher interest rates. There is a very good study from the Chicago University website (bit.ly/KnWgUr) that posits the limit of government domestic borrowing will be when it uses up the net total of the nation's household financial assets, which are expected to decline to about JPY1,340trn in 2016. This will be the year at which Government debt will be a larger number.

One wonders why Ozawa is being so obstinate on fighting an increase in the consumption tax. Is it because he fears that the DPJ will be kicked out of office by a public that rejects the increase? We don't think so, since polls done on a regular basis indicate that 48%-58% (depending on the poll) of voters already agree that an increase in consumption tax is inevitable. Or is it simply that he is playing a game of political chicken, and is trying to divide the party so that Noda gets kicked out and he can step back in? Probably.

But if he does hold back the consumption tax decision, although he wouldn't know it, he will probably be doing the nation a huge favor, by precipitating national change. We say this because whomever wins the next election will within their term be forced to resolve the fiscal imbalance in one way or another. **The Chicago University paper speculates that the IMF may have to be called in to supervise a massive cut in spending and significant**

increases in taxes, forcing Japan's political system to do what it has been unwilling to do so far.

And maybe that's what is going to be required: a massive financial shock and some good old fashioned "gaiatsu" (foreign pressure).