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The growth strategy of Abenomics and fiscal consolidation [☆]



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ABSTRACT

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Using a general equilibrium model with an overlapping generation structure, this study examines the impacts of a new Abenomics growth strategy on fiscal consolidation in Japan. Our simulation yielded the following results. (i) It is difficult to achieve the government target of fiscal consolidation by the year 2020 even when assuming that the growth strategy has the desired effects. (ii) Moreover, further economic and fiscal reforms are required from 2030 to 2070 because of accelerated population aging. (iii) However, population policy and an extended retirement age contribute to significant improvements in Japan's fiscal condition after 2070. (iv) In contrast, the promotion of productivity and the labor force participation rate have a lesser impact on fiscal reconstruction. *J. Japanese Int. Economies* **37** (2015) 82–99. Faculty of Economics, Kyushu University, 6-10-1 Hakosaki, Higashi-ku, Fukuoka 812-8581, Japan; Faculty of Economics, University of Toyama, 3190 Gofuku, Toyama 930-0055, Japan.

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1. Introduction

As the “third arrow” of Abenomics, a new growth strategy was announced publicly in June 2013. The Basic Policies for the Economic and Fiscal Management and Reform presented basic plans for Abenomics and outlined the growth strategy. Additionally, the Japan Revitalization Strategy provided detailed contents of the growth strategy and targets, such as the promotion of productivity. In June 2014, these two plans were revised. The revised plans targeted a stable demographic structure, maintenance of the population at approximately 100 million people in 50 years’ time,¹ and promotion of women’s labor force participation.

On the other hand, to maintain credibility in Japan’s fiscal policy, the Cabinet approved basic directions for fiscal consolidation, the Basic Framework for Fiscal Consolidation: Medium-term Fiscal Plan, in August 2013. The plan states that the government’s fiscal consolidation target is to halve the ratio of the primary balance against Gross Domestic Product (GDP) between FY2010 and FY2015, achieve a primary surplus by FY2020, and steadily decrease the debt balance as a percentage of GDP after FY2020.

This study addresses the following two questions. First, is it possible to achieve the government’s medium-term fiscal targets by adopting the growth strategy of Abenomics? Second, what is the impact of the growth strategy on fiscal conditions in the long-run?

The government provided responses to questions in Economic and Fiscal Projections for Medium to Long Term Analysis (July 2014) (EFP). EFP conducted projections using a large scale macro econometric model and concluded that, under optimistic assumptions, the target of halving the ratio of the primary deficit to GDP from the FY2010 rate by FY2015 is achievable by Abenomics. However, it insisted that further efforts are necessary to steadily reduce the ratio of debt to GDP. The ratio of debt to GDP is projected to be approximately 185.5% in FY2020 and to remain at that level thereafter.

In contrast to the government projections, we provide economic projections based on a general equilibrium model. It is desirable to conduct economic and fiscal projections based on a model where consumers maximize their utility and firms maximize their profit. A macro econometric model without such a micro foundation may fail to quantify the impact of future policy reform precisely. Lucas (1976) criticizes that the use of estimated statistical relationships may lead to a wrong policy implication because the estimated regression coefficient will change along with agents’ behaviors in response to a new policy. Therefore, unlike EFP, this study provides long-run projections for the Japanese economy using a model with a profound micro foundation. Specifically, we use the general equilibrium overlapping generations (OLG) model calibrated to the Japanese economy, which contains optimal and forward-looking behaviors of households and firms.

For exogenous policy shocks, our simulation adopts the same assumptions as what were used by EFP and Choice for the Future (CFF).² EFP assumed that the technology growth rate and labor force participation rate (LFPR) would improve drastically as a result of Abenomics. CFF which is an interim report by the Committee for Japan’s Future analyzed the conditions required to maintain the population target as stated in the Basic Policies. CFF also proposed increasing the retirement age to 70 years. Given these assumptions, we calculate the tax rate required to achieve the government’s fiscal consolidation target. If the calculated rate is higher than the current rate, this implies difficulty in achieving fiscal consolidation.

We obtained the following results. First, the government’s mid-term fiscal target is difficult to achieve even when policy reforms are assumed to have been executed completely. Our simulation projects that consumption tax should be raised more than 10% between the years 2010 and 2030 compared to the average rate in the 2000s. Although the Japanese government increased the tax rate on consumption by 3% in 2014, our simulation implies that this increase is insufficient to achieve the fiscal target. Moreover, because of accelerated population aging, the tax rate on consumption should

¹ The population target was stated in the revised Basic Policies. We consider a policy that aims at this target as a part of the growth strategy of Abenomics.

² While the Basic Policies and the Japan Revitalization Strategy outlined a growth strategy, EFP and CFF provided quantitative targets and effects of the growth strategy. We, therefore, assume the targets and effects of the latter as a consequence of the Abenomics growth strategy.

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