Box A

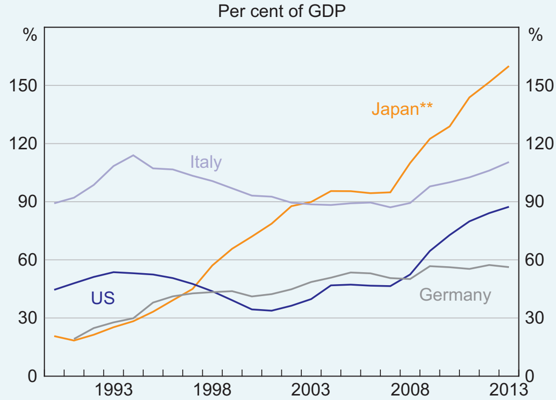
Japan's Consumption Tax Increase

Japan first introduced a consumption tax in 1989. The rate was initially set at 3 per cent, and was raised to 5 per cent in 1997. Following an improvement in economic conditions in 2013, the Japanese Government has decided to proceed with a further increase in the consumption tax rate to 8 per cent in April this year. The tax rate is legislated to increase a further 2 percentage points in October 2015, to 10 per cent. These increases will have important implications for the profile of consumption and economic activity around the time of implementation.

Following the collapse of property prices in the early 1990s and the subsequent recession, Japan's economy entered a period of slow growth in output and a general decline in prices. These developments, combined with an ageing population, contributed to a sustained weakening of the fiscal position and a substantial build-up in Japan's net public debt, which increased from 21 per cent of GDP in 1990 to 160 per cent in 2013, the highest of any advanced economy (Graph A1).

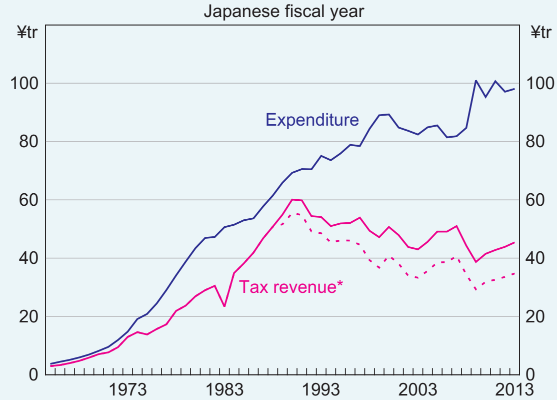
Between 1990 and 2013, tax revenues decreased by around 25 per cent in nominal terms (and by around 40 per cent excluding consumption tax revenue), while public expenditure rose by around 40 per cent (Graph A2). About two-thirds of the increase in public expenditure over that period was accounted for by higher social security payments owing to the ageing of the population. From 1990 to 2013, the share of Japan's population aged 65 years and over increased from 12 per cent to 25 per cent. This share is expected to increase to 32 per cent by 2030. The increases in the consumption tax rate in 2014 and 2015 form an important part of the government's plans for fiscal consolidation.

Graph A1
General Government Net Debt*
Per cent of GDP



* Data for 2012 and 2013 for countries other than Japan are IMF projections
** Adjusted to exclude the government's net equity assets
Sources: IMF; Ministry of Finance Japan; RBA; Thomson Reuters

Graph A2
Government Revenue and Expenditure
Japanese fiscal year



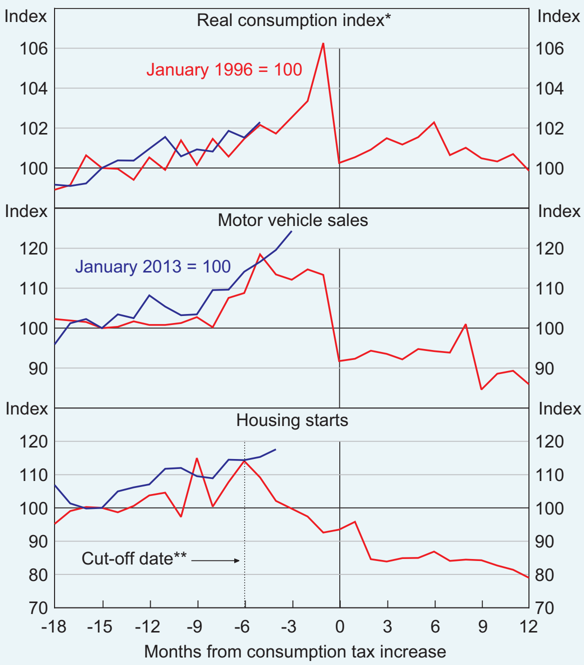
* Tax revenue excluding consumption tax revenue is indicated by the dotted line
Sources: Ministry of Finance Japan; RBA

Expected Effect on Activity and Prices

In the lead-up to the consumption tax increase in April 1997, private consumption grew strongly as consumers brought forward purchases to avoid the impending increase in the tax rate. Consumption then contracted after the tax was increased (Graph A3). This pattern was most evident for durable goods, for which there is more discretion in the timing of purchases. For example, motor vehicle sales increased by around 10 per cent in the six months leading up to the tax increase and fell by almost 20 per cent in the following month. Residential investment was also affected by the tax increase (contracts signed before 1 October 1996 were not subject to the higher tax rate). While consumption and residential investment growth remained subdued for several years following the tax increase, this period coincided with the Asian financial crisis and the expiration of a temporary income tax rebate, making it difficult to isolate the adverse effects of the consumption tax increase on economic activity.

A similar shifting of expenditure is expected to occur in the first half of 2014. Consumption is likely to grow

Graph A3
Japan – Effects of the Consumption Tax Increase



* The Cabinet Office's monthly measure of real private consumption
** Contracts signed before October are subject to the lower tax rate
Sources: RBA; Thomson Reuters

strongly in the first quarter of 2014 – as consumers bring some spending forward in anticipation of the tax increase – but then contract in the June quarter. Timely indicators provide some early evidence of this, with motor vehicle sales having grown strongly in recent months. The expected effect of the tax increase on residential investment is more uncertain. As in 1997, contracts entered into before 1 October 2013 (when the tax increase was confirmed) are subject to the current 5 per cent tax rate, regardless of when the transfer of assets takes place. Given that the possibility of the tax increase was well publicised, it is not surprising that sales of off-the-plan apartments rose sharply over the September quarter and then fell. However, whether this will affect the timing of construction activity is unclear given the potential for builders to smooth their construction activity over time. Housing starts – a leading indicator of residential investment – have held up through to December, suggesting that residential building activity is not likely to fall in the very near term.

In anticipation of the contractionary effect of the tax increase on economic activity, the Japanese Government announced that it will implement a temporary ¥5.5 trillion fiscal stimulus package in 2014 (equivalent to around 1.1 per cent of GDP). The package includes tax breaks for capital expenditure, public works projects (including facilities for the 2020 Tokyo Olympics), measures to accelerate the reconstruction of earthquake-affected areas and direct transfers to low-income earners.

The increase in the consumption tax rate is also expected to temporarily increase inflation. According to the Bank of Japan, around two-thirds of the items by weight in Japan's CPI are directly affected by the consumption tax, implying that the increase in the tax rate will raise the level of the CPI by around 2 per cent in April (assuming the tax increase is passed through to prices one for one). Excluding food and energy, consumer prices are expected to increase by around 1.6 per cent as a result of the tax increase.