New Philosophy of Social Security & Direction of Reform – “Housing” as a Pillar of Social Security

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Introduction

Japan currently faces a variety of problems, but looking 10 to 30 years into the future, the most serious economic problems can be attributed to three major environmental changes: a contracting population (including a low birthrate and aging population); low growth; and increased poverty. If Japan’s economic strength declines, the underpinnings of the country’s diplomacy and national security could be shaken as well. What is serious about the three problems of a contracting population, low growth, and increased poverty is that various “foundations” of Japanese society and people’s daily lives, which people have come to rely on as sources of income and benefits, could be shaken at both the macro (e.g. national, local, corporate) and micro (e.g. household) levels.

Unlike during times of rapid population growth, the uniform, rigid “Japanese economic system” (e.g. the social security system and taxes, governing structures including the relationship between national and local governments) has today become unable to address these problems efficiently, and this is causing various problems at the individual level, including in terms of daily lives and employment.

For example, in rural areas where population decline is increasing the number of abandoned houses, people are becoming more attracted to cities, creating a greater likelihood of infrastructure decay and accelerated population outflow. While low growth means intensified competition among companies on the one hand, the Japanese employment system – characterized by lifetime employment and age-based salaries – is being shaken, and the function of social safety nets is declining. The makeup of families is diversifying as the number of single-person households of older and unmarried people increases, and as the support function of families declines, isolation is increasing. As functions carried out by communities, families, and companies weaken and various risks become more complex, weak individuals are being overwhelmed by complex and complicated risks that conventional social security is unable to address. As low growth widens inequality, insufficient social security functions lead to increased poverty.

Failure of Social Security to Function

The failure of social security to function is particularly intense. Conventional social security has been based on “self-help”, with “cooperative help” (social security) in place to provide against risks in daily life that can be dispersed using logarithms (e.g. the uncertainty of life, risks of illness and nursing care). Cooperative help supports self-help, and cases of poverty or other circumstances that cannot be addressed through self-help and cooperative help are addressed through supplementary “public assistance” (e.g. welfare). This basic philosophy envisions the typical risks people face directly in their lives and builds a framework of cooperative help and public assistance to address them, but it is already becoming clear that this existing system may be reaching its limits.

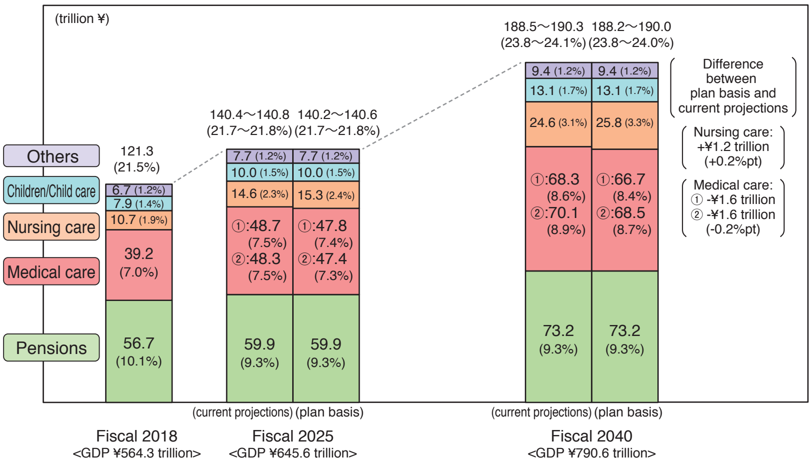
One sign of this can be seen in public finances. Currently, the total debt outstanding for the national and local governments combined (as a percentage of GDP) is more than 200%, meaning that Japan’s public finances are in an extremely unique situation historically speaking. Since 1989, roughly 70% of the aggregate increase in outstanding debt has come from increases in social security-related expenses and decreases in tax revenue, and if the supplementary portion of tax revenue distributed to local governments from the general account is included, this percentage rises to roughly 80%.

The fact that social security reform will be at the core of fiscal reconstruction cannot be overstated, but what will the trend for social security expenses look like going forward? At its meeting on May 21, 2018, the government’s Council on Economic and Fiscal Policy announced the “Future Outlook for the Social Security System Towards 2040” (the “Forecast of Benefits and Costs”), compiled jointly by the Cabinet Secretariat, the Cabinet Office, the Ministry of Finance, and the Ministry of Health, Labour and Welfare, as a basis for a “national” discussion of social security reform from a medium-to long-term perspective *(Chart 1)*.

This theoretical calculation shows the Forecast of Benefits and Costs for social security including pensions, medical care, and nursing care, and estimates them (as a percentage of GDP) from fiscal 2018 through fiscal 2040, and is equivalent to the Revised Future Projection of Costs Required for Social Security released by the Ministry of Health, Labour and Welfare roughly six years ago (in March 2012). The previous calculation covered the period from fiscal 2012 to fiscal 2025, and this time it has been expanded to extend to fiscal 2040.

What, then, is the meaning of the new calculation? In a word, it shows the extremely severe shape of social security. But first, before going into that explanation, let us confirm in simple terms the calculation’s premises. The population figures used in the calculation

CHART 1
Projected costs of social security benefits
(vs GDP; baseline case)



Source: Extracts from the "Future Outlook for the Social Security System Towards 2040", submitted by the Ministry of Health, Labour and Welfare to the Council on Economic and Fiscal Policy on May 21, 2018

are from the National Institute of Population and Social Security Research's Population Projection for Japan (2017 projection). In addition, the assumptions for nominal GDP growth rates and price increase rates are based on the Cabinet Office's Economic and Fiscal Projections for Medium- to Long-Term Analysis (January 2018 edition) for the period to fiscal 2027, and on the public pension 2014 Actuarial Evaluation for fiscal 2028 and beyond.

For example, the growth scenario uses a nominal GDP growth rate of 3.5% for fiscal 2027, and 1.6% for fiscal 2028 and beyond, while the rates in the baseline scenario are 1.7% for fiscal 2027 and 1.2% for fiscal 2028 and beyond. Nevertheless, the average nominal GDP growth rate for the roughly 20 years from fiscal 1995 to fiscal 2016 was only 0.3%. There is no problem when growth rates surpass forecasts, but is there really no risk in considering reform based on an assumption that nominal GDP growth rates going forward will rise by more than four times above this level?

Using the above assumptions, even under the baseline scenario, the main point of the calculation (Forecast of Benefits and Costs) is that the cost of social security benefits (pensions, medical care, nursing care, etc.) is 21.5% of fiscal 2018 GDP, and this rises to a maximum of 24% for fiscal 2040. In other words, the cost of social security benefits (as a percentage of GDP) will rise by 2.5 percentage points over roughly 20 years. Given that current GDP is roughly ¥550 trillion, this indicates that the cost of social security benefits will increase by roughly ¥14 trillion (¥550 trillion x 2.5%).

A one percentage-point increase in the consumption tax rate (excluding the effect of any offsetting tax rate reductions) will generate roughly ¥2.8 trillion, so if the consumption tax is to be used to address this increase in social security costs, the consumption tax rate would need to be raised by roughly five percentage points. Furthermore, in addition to the current fiscal deficit, taking into account the need to reduce the fiscal deficit by roughly ¥20 trillion given that interest costs increase as deficits continue, it would mean that by fiscal 2040 the consumption tax rate will need to be raised to 22% from 10%.

The Ministry of Finance's "Long-Term Estimates of Japan's Public Finances (Revised Edition)" (April 6, 2018) also serves as reference. This estimate was first released in April 2014 as a draft from policy proposal members of the Fiscal Policy Council's Fiscal System Subcommittee, and revisions to the long-term estimates were released in October 2015 and April 2018. The April 2018 estimate puts the cost of medical and nursing care at roughly 9% of GDP in around fiscal 2020, and rising to roughly 14% by around fiscal 2060 *(Chart 2)*. A roughly five percentage-point increase in the combined cost of medical and nursing care over 40 years means a roughly 2.5% increase over the 20 years from fiscal 2020 to fiscal 2040, which is consistent with the Cabinet Office's current calculation. If the Ministry of Finance's long-term estimate is appropriate, the cost of social security benefits (as a percentage of GDP) would rise by an additional 2.5% points from fiscal 2040 to fiscal 2060.

This suggests that an additional consumption tax rate increase of roughly five percentage points will be needed. Given the risk of increased interest costs on debt, and assuming that social security is not drastically reformed, this means that the stabilization of public finances is ultimately likely to require a consumption tax rate of roughly 30%. The OECD's Economic Survey of Japan, released in mid-April 2019, also sounded a warning with regard to the contracting population and Japan's economy, and emphasized the need for a consumption tax rate hike of up to 26% to stabilize Japan's public finances, which is generally consistent with the 30% figure for the consumption tax rate.

Need for a "New Philosophy of Social Security"

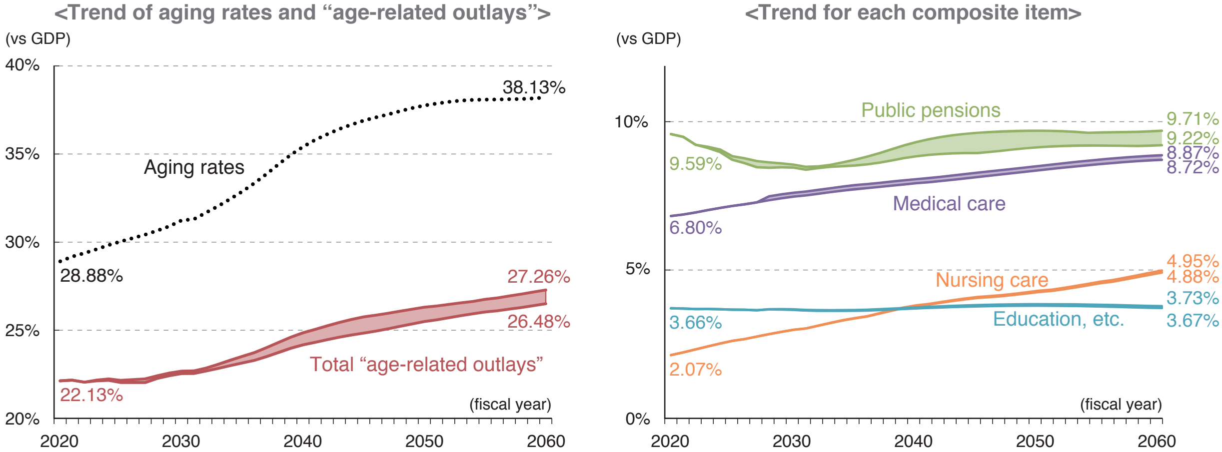
As shown above, the system's fiscal limitations are clear, but public finances are not what is really important. A serious examination of how to rebuild social security is needed. Against a backdrop of obvious fiscal limitations and rural decline, the maintenance of the purpose and role of social security requires a new approach that goes beyond the system's rigid assignment of responsibilities that has existed to date.

In that case, what is particularly important, for example, is the concept of "separating the 'insurance' (risk dispersal) function from the 'tax' (redistribution) function and focusing the distribution of public expenditures on persons who are truly in need". In other words, the most important thing is to create a "new philosophy of social security".

The cost of social security benefits today has ballooned to roughly ¥120 trillion, with the funds to cover social security coming from insurance premiums (roughly ¥70 trillion), as well as sources

CHART 2

Trend of "age-related outlays" focusing on medical & nursing care expenditures



Source: Ministry of Finance (2018), "Long-Term Estimates of Japan's Public Finances (Revised Edition)" (April 6, 2018)

including the national treasury (roughly ¥34 trillion), local governments (roughly ¥13 trillion), and so on. Of these, in many cases the use of national and local government expenditures (national treasury and local governments' share) can be seen as inefficient from the perspective of redistribution.

For example, public expenditures (national treasury) account for half of the source of funds for basic pensions. Going forward, the number of poor older persons with low pensions is expected to increase, but regardless of the size of these pension benefits, public expenditures will pay for half of basic pensions. For example, it is understandable that for an older person receiving a pension of ¥1 million per year, public expenditures would account for half of the basic pension, but it is difficult to understand why for an older person receiving an annual pension of ¥3 million, it would be appropriate for public expenditures to cover half of that basic pension. In other words, if there is a rapid increase in the number of poor older persons with low pensions, the amount of public expenditures used for basic pensions for persons receiving high pensions should be reduced, and concentrated in payments for older persons with low pensions (persons truly in need).

Housing Policies as Social Security

Furthermore, in Europe and the United States, "housing" is one pillar of social security, but a similar argument exists in the field of housing policy. As is well known, Japan's population is set to shrink rapidly over the next 100 years, and by around 2080 is expected to be half of what it was in 2010. By region, the less population an area has to start with, the faster the contraction is set to be. This is the backdrop behind the rapid increase in the number of abandoned houses.

According to the Ministry of Internal Affairs and Communications' Housing and Land Survey, the number of abandoned houses increased 1.8 times (to 8.20 million from 4.48 million) over the 20 years from 1993 to 2013. The percentage of abandoned houses in 2013 was 13.5%, and a June 2015 report by the Nomura Research Institute estimates that by 2033 this percentage will reach 30.2%.

Nevertheless, the total number of residential units in Japan in 2013 was 60.63 million, which was 3.04 million (5.3%) more than in 2008. This clearly shows that there is already an oversupply of housing inventory. Furthermore, the creation of supply relies on strong demand for housing, and mortgages are what individuals rely on the most when purchasing a residence. According to the Bank of Japan's Flow of Funds statistics, the outstanding balance of residential mortgages in fiscal 2017 (extended to individuals by financial institutions) was approximately ¥200 trillion. Given the high price of housing, few consumers purchase housing with a single cash payment, and in most cases consumers use mortgages.

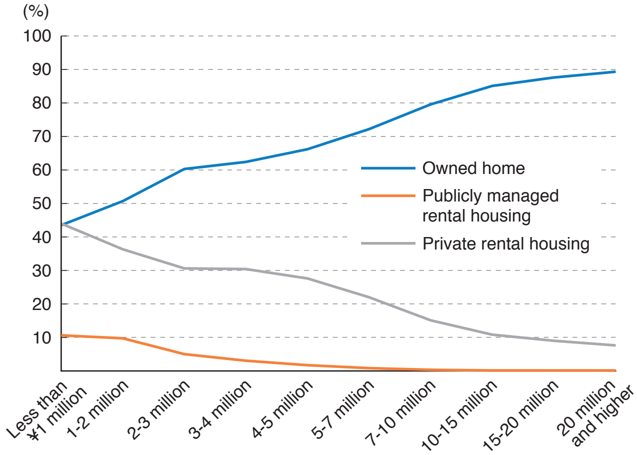
There are two types of housing – owned homes and rental housing – and in the postwar period housing policy has prioritized owned homes, with an emphasis placed on support for housing purchased through individuals' own efforts. A mortgage tax reduction has been at the core of policies to support residential purchases. Japan began with the "housing purchase deduction system" that ran for six years from 1972, and the first time a mortgage-related tax deduction was introduced in 1978.

Afterward, the content and names of the system changed many times, including the "housing purchase promotion tax", and today we have the "mortgage tax credit system". Under this system, when a residence is purchased (or expanded) using a mortgage of 10 or more years, income tax owed is partially reduced based on a set of defined rules.

The amount of the credit is limited to 1% of the year-end mortgage outstanding, with a cap of ¥400,000. The total amount of tax revenue

CHART 3

Home ownership & rental housing rates by household income



Source: Ministry of Internal Affairs and Communications (2015), "2013 Housing and Land Survey"

lost as a result of this system changes in line with revisions to the tax code every few years, but is generally within the range of ¥500 billion to ¥1 trillion annually. The mortgage tax reduction has been expanded over time as needed, and currently has an upper limit of a mortgage balance of ¥50 million (in the case of durable high-quality housing, otherwise ¥40 million).

Given this, have we thought about which group – among low-, medium-, and high-income individuals – benefits the most from the mortgage tax reduction?

The answer is simple: it is the middle- and high-income groups and not the low-income group. In the first place, low-income people who have difficulty making ends meet do not have the resources to purchase something as expensive as a residence. In other words, those who use the mortgage tax reduction the most are medium- and high-income individuals.

Chart 3 shows the rates of home ownership and rental housing by household income, based on data from the Housing and Land Survey. Home ownership among households with annual incomes of less than ¥1 million is roughly 40%, but this rises to roughly 90% for households earning ¥20 million a year or more.

Mortgage tax reduction policies reduce the total burden for wealthy individuals who are able to purchase a residence, but this is financed by taxes and other payments from other people including people with low incomes, raising the possibility that taxation principles are unfair. Furthermore, revisions of the tax code in recent years have seen a shift in emphasis for taxes paid to the central government, from direct taxes (employment income tax, corporate income tax) to indirect taxes (e.g. the consumption tax), and because the shift to taxes like the consumption tax means an increased tax burden for low-income people, that trend could become more pronounced. We must also not forget that the portion of resources for mortgage tax reductions that is covered by fiscal deficits is placing a burden on future generations.

In addition, mortgage tax reductions have come to be emphasized as counter cyclical economic measures by the central government. The explanation for this is that newly constructed housing leads to purchases of furniture and other durable consumer goods, which in turn have various other economic effects, but mortgage tax reductions are also linked to local taxes, so unlike general income tax reductions, the inclusion of local tax in this inducement-type of tax policy could represent a deviation from taxation principles.

Furthermore, a portion of mortgages is securitized through the Japan Housing Finance Agency, representing an implicit government guarantee, and this raises the problem of major losses on mortgage-backed securities like those experienced by Ginnie Mae and Fannie Mae in the US.

Given these issues, as a housing policy, this system of deduction for mortgage interest has received much criticism for not functioning in a way that helps people who need assistance the most, and the systems were abolished in the United Kingdom in 2000, in Germany in 1994, and in France in 1997. This can also be seen as "public expenditures focusing on transfer payments to those who are truly in need" as a "new philosophy of social security".

In other words, this involves abolishing mortgage tax reductions, and using those savings to increase payments like "housing allowances" to households with incomes below a certain level, from the perspective of making fair and efficient use of limited resources. A housing allowance guarantees a minimum level of housing standards for families in accordance with their need, and while in Europe there is a basis for some programs to guarantee a minimum standard of living, unlike child allowances, these are not well known in Japan.

It is often pointed out that poor older persons fall into "residential poverty", and as the trend of declining birthrate and aging population accelerates, Japan is likely to see a large increase in the number of these poor older persons. By my own calculation, roughly 1 million people aged 65 or older today are poor older persons receiving public assistance, and this could more than double to surpass 2 million by 2048, and climb further to 2.15 million by 2065. With its contracting population and sharp rise in the number of "abandoned houses", the time has come not only for Japan to rebuild a new philosophy of social security, review mortgage tax reductions, and expand housing allowances, but also to begin to consider housing policies that pay benefits with physical goods, including making effective use of abandoned houses. JS

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