markit

4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Markit Economic Research

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Japan

Sales tax rise confirmed for April 2014

- **Japan's recent economic growth looks solid enough to withstand tax hike**
- **Cost inflation poses risk to consumer demand**
- **Impact of recent sales tax increases in other OECD countries has been minimal**

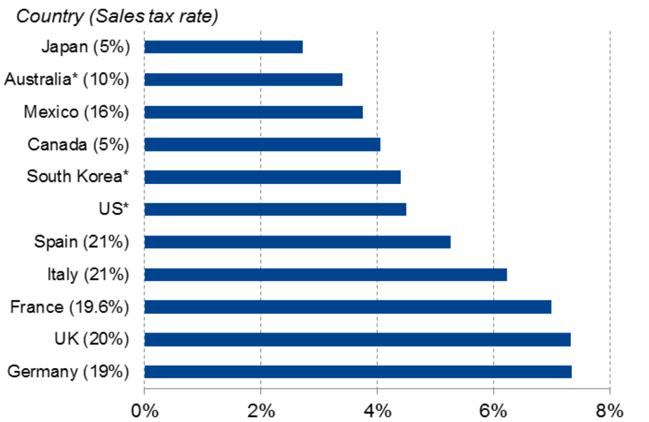
The long anticipated sales tax hike was announced on the 1st October, accompanied by the promise of a 5 trillion yen stimulus package to soften any blow to consumer spending.

In light of the recent growth in the Japanese economy, and the growing public debt (currently over than twice the size of GDP), Shinzō Abe's decision to raise the tax was largely unsurprising. The latest PMI data indicated that growth-momentum continued to build, as the private sector Composite PMI rose to a four-month high in September.

The 5 trillion yen of government spending meanwhile is designed to shore up consumer demand and minimise the risk posed to growth by the sales tax rise. Recent inflation is also a factor, because so far wages have been largely left behind by increases in the price level. The degree to which Abe's stimulus will be able to counteract this remains to be seen, but his planned spending on low income families and increased benefits should have a positive effect on consumption.

Putting the tax hike in perspective

Sales Tax revenues (% of GDP)



All data from 2011, except where (*) indicates 2010. There is no federal sales tax in the US; the level varies state to state.

Source: OECD

Japan's current sales tax is the joint lowest (with Canada) of the OECD economies, and its revenue as a percentage of GDP is considerably below that of its OECD peers, as the chart illustrates. Therefore, there is significant scope for increasing the tax in the fight against mounting public debt, but more measures will be needed to reduce the debt burden in the longer-term.

Cost-inflation poses barrier to consumer demand

A number of potential pitfalls accompany the increase in sales tax, in particular inflation combined with stagnating wages. Inflation recently hit a five year high in Japan, a reassuring indication that policy initiatives targeted at ending the deflation which has plagued Japan for the best part of two decades are having effect. However, without concurrent growth in wages, rising prices erodes real incomes, the impact of which will exacerbate the effect of the sales tax on consumption.

Structural reforms, to curtail the erosion of real incomes, could minimise some of the negative impacts of the tax hike. Though Abe's third policy 'arrow' which was said to be addressing this, has so far proved less potent than the first two.

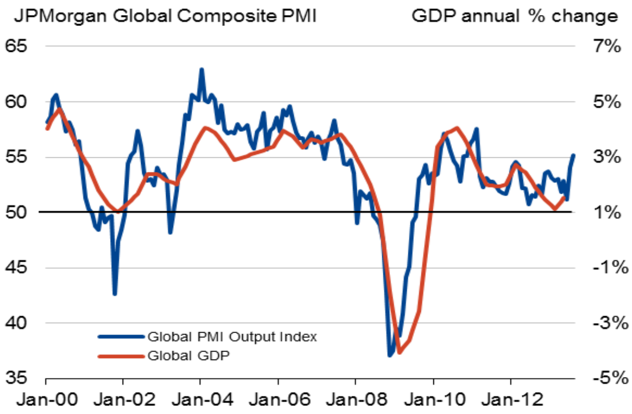
Concerns over 1997 sales tax hike

A key reason Japan's sales tax has remained so low, in comparison to other developed nations and in spite of the rising government debt, is its huge political unpopularity. This largely stems from the last increase in 1997, from 3% to 5%, which was followed by a deep recession lasting nearly two years.

This correlation is somewhat misleading though, and whilst the rise in sales tax may have been the trigger, there were many other underlying causes. The combination of a sharp reduction in public spending, a property bubble and recessions in the US and the rest of Asia were more likely the leading causes of the slump in 1997.

The current economic situation is thus very different, as the wider global economy is signalling strong growth, as shown below by the JPMorgan Global Composite PMI and Global GDP. Furthermore, Japan's own economy is expanding at a strong pace, the broad-based nature of which indicates a sustainability which should provide the momentum needed to continue growing in the near term.

Global Economy



Source: Markit

Comparisons with other recent sales tax hikes

Recent increases in sales taxes in developed countries have had relatively little impacts on the demand for goods and services as the following graphs illustrate.

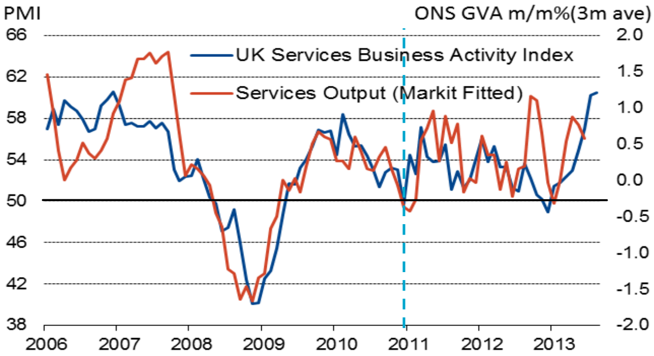
The impact of the 2.5% increase in VAT in the UK on the 4th of January 2011 was very limited, and the slight decline in service sector business activity which followed was more likely due to severe weather disruption. Germany's economy reacted to the 2007 sales tax rise, from 16% to 19%, in a similarly restrained way and service sector business activity continued to grow at much the same pace for several months until the financial crisis took hold in 2008.

Spain is a minor exception as business activity, particularly in the hotel and restaurant sector, contracted moderately following the rise in sales tax in September 2012. However, this was partially due to the reclassification of sectors, which were previously on a reduced rate, resulting in a number of firms facing increases from 8% to 21%. Furthermore, the rise was accompanied by many other taxes and spending cuts, so the impact of the VAT rise itself is difficult to distinguish.

Given the recent evidence, it appears that the rise in sales tax in Japan is unlikely to hamper growth unless accompanied by other factors, such as falling real wages. The large stimulus package of 5 trillion yen will soften the impact on consumption and as long as wages begin to rise in the coming months, consumer demand is unlikely to contract to a significant degree.

UK

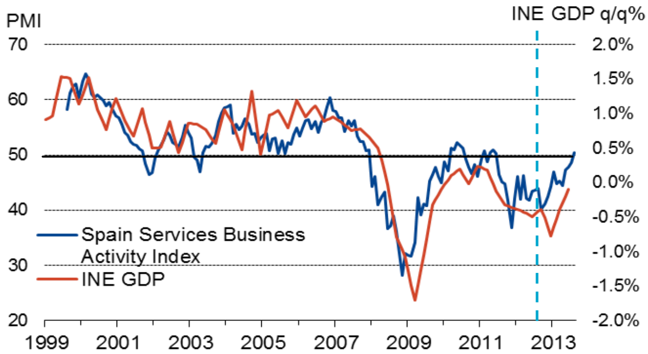
4th January 2011, sales tax increase 17.5% to 20%



Sources: Markit, Office of National Statistics

Spain

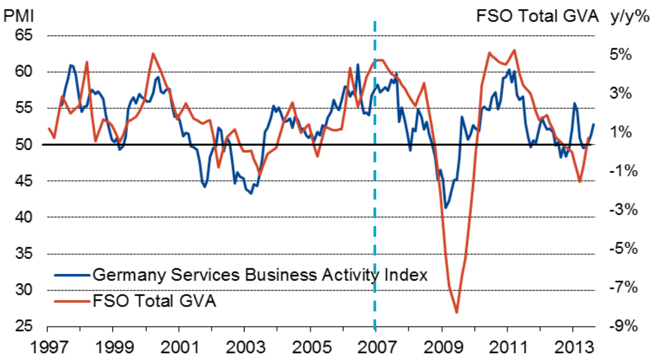
1st September 2012, sales tax increase 18% to 21%



Sources: Markit, Instituto Nacional de Estadistica

Germany

1st January 2007, sales tax increase 16% to 19%



Sources: Markit, Federal Statistics Office

Claudia Tillbrooke

Economist

Markit

Tel: +44 1491 461039

Email: Claudia.Tillbrooke@markit.com

For further information, please visit www.markit.com