The timing of government debt reductions in the presence of inequality

Akio Ino
Keiichiro Kobayashi

January 16, 2020

Abstract

Japan's public debt has been increasing for a long time, and in 2018 the public debt to the gross domestic product (GDP) ratio is around 200%. To finance the increase in the social security cost, the Japanese government increased the consumption tax from 5% to 8% in 2014 and will be increased to 10% in October 2019. The latter consumption tax hike was originally scheduled in 2015 but postponed twice to 2019.

Should we increase the consumption tax early or late if we want to decrease the government debt to GDP ratio? Who benefits from early debt restructuring? This paper uses an incomplete market model with government debt to answer these questions. Under the incomplete market, an endogenous distribution of household assets arises, which allow us to explore the effect of the timing of taxation on households with different asset profiles. In addition, we analyze the transition path associated with the consumption tax hike to take into account the short-run effect as well as the long-run effect.

We computed the transition dynamics associated with a sudden increase in the government purchase and early or late increases in the consumption tax. The result shows the different response from the different asset classes: Poor people prefer early restructuring as late restructuring require a larger increase in consumption tax, and Rich people prefer late restructuring because it increases the interest rate. The overall change in the social welfare is determined by the endogenous distribution of assets.