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Calculating Impact of Child Allowance

Benefit of child allowance reduced to 20% if kept at half proposed level

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Summary

- The child allowance act passed on 26 March stipulates that a monthly allowance of Y13,000 will be paid to households for every child in junior high school or younger (no means test) in FY10 (ending Mar 2011). The Democratic Party of Japan's (DPJ) manifesto calls for the payment to rise to Y26,000 in FY11.

- Financing the full Y26,000 allowance will pose a significant challenge. Even the half payment in FY10 will effectively require (together with waiving of high school tuition fees) the issue of Y1.52 trillion in new government bonds. Payment of the full allowance in FY11, together with the high school tuition fee waiver, would require the issue of Y4.07 trillion in government bonds.

- Keeping the monthly allowance at Y13,000 in FY11 and beyond would reduce the FY11 funding shortfall to Y1.42 trillion, but would also reduce the boost to household disposable income to 20% of the level that would be generated by the full payment (also taking into account tax amendments). At this level, the government would almost entirely surrender its initial objective of strongly supporting households raising children.

- The administration needs to choose whether to pay the full allowance—reducing other expenditure and increasing taxation as necessary on the basis that society as a whole is responsible for raising children—or to prioritize fiscal discipline and abandon the full allowance.

1. Outline of Child Allowance, High School Tuition Fee Waiver, and Tax Reforms

Japan passed several laws and amendments in March 2010: FY10 tax reforms on the 24th, a child allowance law on the 26th, and a high school tuition fee waiver law on the 31st.

The child allowance system provides for a monthly allowance of Y13,000 to be paid to households for each child in junior high school or younger in FY10 (measures for FY11 onward discussed later). The high school tuition fee waiver, which applies from FY10, eliminates tuition fees for public high schools (about Y120,000 annually) and reduces fees for private high schools by the same amount (more for low-income earners).

The dependents tax deduction formerly available to people raising children has been abolished for junior high school and younger children (under 16 years old per tax law) and reduced for high school students (16-18 years old). The monthly allowance of Y5,000-10,000 per child paid until FY09 to households raising elementary school and younger children has also been abolished. [1]

Financial support for households raising junior high school and younger children, previously split between tax deductions and allowances, has been consolidated into the child allowance.

The law stipulates only that the monthly child allowance will be Y13,000 in FY10; no provisions have been established for FY11 and beyond. The DPJ's manifesto for the 2009 general election called for the allowance to rise to Y26,000 in FY11. The administration would therefore carry out its initial policy by paying the full amount.

It will be extremely difficult to finance payment of the full allowance. The initial aim of lowering spending by trimming the budget has produced only modest savings and the economic slowdown has slashed corporate and income tax revenues. There is a move within the DPJ itself to reconsider the amount of the allowance from FY11 ahead of the summer Upper House elections.

2. Reforms by Age Bracket

Below we present the amendments pertaining to each age bracket.

Households with elementary school and younger children

Households will receive a monthly allowance of Y13,000 per elementary school and younger child in FY10 (rising to Y26,000 in FY11 per DPJ's original policy).

The former means-tested monthly child allowance of Y5,000-10,000 paid for children up to the end of primary school has been abolished as of FY10.

Dependents deductions for children in junior high school or younger (children under 16 years old) will be abolished from income tax starting with 2011 income (deduction to be eliminated from Jan 2011) and from residents tax in FY12 (eliminated from Jun 2012; applicable to 2011 income).

Households with junior high school children

Households with junior high school children will be paid the new *kodomo teate* child allowance instead of the *jido teate* child allowance paid until FY09. They will

[1] More precisely, former child allowance (*jido teate*) will continue to be paid in FY10, with difference between former and current allowance to be paid under new provisions (*kodomo teate*). Local governments and companies will continue to fund *jido teate* portion. From recipients' point of view, only name will change—they will still receive Y13,000 per month in 2010.

thus receive the same per-child monthly allowance of Y13,000 applicable to children in primary school and younger in FY10 (rising to Y26,000 in FY11 per DPJ's original policy).

Dependents deductions will be abolished from income tax in 2011 and from residents tax in FY12 (as for households with elementary school and younger children).

Households with high school children

Households with high school children will have tuition fees waived or reduced under the high school tuition fee waiver legislation. Public school tuition fees of around Y120,000 per annum will no longer be levied from FY10. Private schools will receive an annual payment of around Y120,000 per child and will reduce their tuition fees by that amount (more for low-income earners).

The tax deduction for specified dependents paid for high school students (16-18 years old) will be replaced by the general dependents deduction. The deduction will fall from Y630,000 to Y380,000 for income tax (from 2011) and from Y450,000 to Y330,000 for residents tax (from FY12).

Households with university students or dependent children over 22 years old

Households with university students or dependent children over 22 years old will not be affected by changes to education policy or tax laws. The current deductions for specified dependents (Y630,000 for income tax, Y450,000 for residents tax) will continue to apply for university students (19-22 years old) and the current dependents deductions (Y380,000 for income tax, Y330,000 for residents tax) will continue to apply for dependent children over 22 years old.

Single, spouse-only, and other childless households

Single, spouse-only, and other childless households will not be affected by the tax reforms.

Government Child and Education Measures Contained in FY10 Tax Reforms **Chart 1**

	Before reforms (until 2009)	After reforms (fully applicable from Jun 2012)
Elementary school and younger children	Monthly child allowance (*jido teate*) of Y5,000-10,000, means-tested Dependents deduction (Y380,000 for income tax, Y330,000 for residents tax)	Uniform monthly child allowance[1] (*kodomo teate*) of Y26,000, no means test **Dependents deduction abolished for both income and residents tax**
Junior high school students	Dependents deduction (Y380,000 for income tax, Y330,000 for residents tax)	Uniform monthly child allowance[1] (*kodomo teate*) of Y26,000, no means test **Dependents deduction abolished for both income and residents tax**
High school students (16-18 years old per tax law)	Specified dependents deduction (Y630,000 for income tax, Y450,000 for residents tax)	Public high school tuition fees waived, private schools subsidized (annual payment of about Y120,000) Dependents deduction[2] **(reduced to Y380,000 for income tax, Y330,000 for residents tax)**
University students (19-22 years old per tax law)	Specified dependents deduction (Y630,000 for income tax, Y450,000 for residents tax)	Specified dependents deduction (Y630,000 for income tax, Y450,000 for residents tax)—**status quo**
23 year old and over	Dependents deduction (Y380,000 for income tax, Y330,000 for residents tax)	Dependents deduction (Y380,000 for income tax, Y330,000 for residents tax)—**status quo**

Source: Fiscal 2010 Tax Reforms; compiled by Legal and Tax Research Dept, DIR.
Notes: 1) Current legislation sets the amount of the *kodomo teate* child allowance (Y13,000 per month) only for FY10; the payment for FY11 and beyond will be established by a separate law.
2) The deduction pertaining to high school students will change name to "dependents deduction."

3. Calculating Impact on Household Budgets of Full and Half Allowances

We have calculated the impact on household budgets of payment from FY11 of the full monthly allowance of Y26,000 per child promised in the ruling party's election manifesto as well as maintenance of the Y13,000 half allowance.

We have considered a household covered by social insurance and composed of a salary earner, a housewife, and two children from 3 years old up to and including primary school children. We have looked at four annual income levels: Y3 million, Y5 million, Y7 million, and Y10 million.

Chart 2 presents the impact of payment from April 2011 of the full Y26,000 allowance promised by the administration's manifesto on the left and continuation in FY11 onward of the Y13,000 half allowance on the right.

In both cases, we have factored in the abolition of dependents deductions for children 15 years old or younger from income tax in January 2011 and from residents tax in June 2012, as established by FY10 tax reforms. The new system, including these tax increases, will apply for the full year from 2013.

Boost to Household Annual Disposable Income from New Child Allowance and Tax Reforms (Y) Chart 2

Household income	Payment of full allowance from FY11				Continuation of half allowance			
↓	2010	2011	2012	2013 onward	2010	2011	2012	2013 onward
Y3 million	144,000	390,200	429,700	402,200	144,000	156,200	117,700	90,200
Y5 million	144,000	385,900	425,400	397,900	144,000	151,900	113,400	85,900
Y7 million	144,000	343,000	382,500	355,000	144,000	109,000	70,500	43,000
Y10 million	234,000	394,000	433,500	406,000	234,000	160,000	121,500	94,000

Source: Legal and Tax Research Dept, DIR.
Note: Assumes household composed of salary earner, housewife, and two children 3 years old up to and including primary school children. Base year for increases in disposable income for each calendar year is 2009. Figures take into account FY10 tax reforms abolishing dependents deductions for income and residents tax as well as previous child allowance. Full impact of tax reforms will emerge in 2013.

In 2013, when the transition to the new system will be complete, the disposable income of a household with annual income of Y3 million will rise Y402,000 from the 2009 level if the full allowance comes into effect. If the half allowance is paid, the boost falls to Y90,200, or 22.4% of the benefit of the full allowance. With annual income of Y5 million, the boost drops from Y397,900 for the full payment to Y85,900 for the half payment (21.6%). With Y7 million annual income, the benefit falls from Y355,000 to Y43,000 (12.1%). With Y10 million annual income, the benefit falls from Y406,000 to Y94,000 (23.2%).

If the child allowance remains at the current half payment level, the benefit to households raising children will not be half that of the full payment, but only around 20%.

A boost to household disposable income of 20% the level originally anticipated by the administration's manifesto would constitute a major change in policy. Essentially, the situation would be unchanged from that in 2009, before the introduction of the new child allowance.

4. Financing Full Child Allowance

Chart 3 summarizes the amount of money and financing needed for the child allowance and high school tuition fee waiver.

Revenue made available by abolishing the dependents deduction for under 16 year olds and reducing the specified dependents deduction for 16-18 year olds and revenue previously used for the former child allowance will be redirected to partly fund the new child allowance and high school tuition waiver.

This would still leave a Y4.07 trillion shortfall if the full child allowance were to be paid from FY11.

Financing Child Allowance and High School Tuition Waiver (Y bil) **Chart 3**

			FY10	FY11 Full child allowance	FY11 Half child allowance
Allowance	Child allowance payments		2,225.4	About 5,300.0	About 2,650.0
	High school tuition waiver		393.3	About Y400.0	About 400.0
Funds needed (A)			2,618.7	About 5,700.0	About 3,050.0
Financing	Abolishment of former child allowance (used as funding source)		1,016.0	1,016.0	1,.016.0
	Abolishment of dependents deduction	National tax	81.8	518.5	518.5
		Local tax	-	-	-
	Reduction of specified dependents deduction	National tax	-	95.7	95.7
		Local tax	-	-	-
Funds raised (B)			1,097.8	1,630.2	1,.630.2
Fiscal shortfall (A – B)			1,520.9	About 4,070.0	About 1,420.0

Source: Ministry of Finance and Ministry of Internal Affairs and Communications; compiled by Legal and Tax Research Dept, DIR.
Note: Local tax increases will not be source of funding in FY11 as they will apply from Jun 2012.

When framing the FY10 budget, the Ministry of Finance said the child allowance and other new measures could be funded with minimal new government bond issues, instead using non-tax revenue such as funds returned to treasury through budget trimming.[2]

In drawing up the FY11 budget, it will be difficult to maintain non-tax revenue from budget trimming at the FY10 level and to secure funds through spending cuts.

We believe Y4.07 trillion in government bonds would need to be issued to fund the child allowance if the government were to avoid raising taxes. This leaves three options up for debate: (1) pay the full child allowance, funded by tax increases, (2) pay the full child allowance, funded by the issue of substantial government bonds, and (3) avoid introducing the full child allowance.

If the government were to choose to keep the allowance at half the initially proposed level, the fiscal shortfall would be Y1.42 trillion and expenditure would not rise from the FY10 level. Keeping the half allowance could be considered a compromise between fiscal discipline and the administration's election platform.

[2] Even at that stage, though, proposed funding source for child allowance equivalent to issuing new government bonds. Most non-tax revenue derived from budget trimming is extraordinary revenue from one-off asset sales. Once-only extraordinary revenue drawn from special accounts has usually been used to retire existing government debt. In FY08, Y9.8 trillion was drawn from fiscal investment and loan special account to purchase and retire JGBs. Extraordinary revenue that should ordinarily be used to extinguish government debt will now used to fund child allowance, effectively increasing value of new government bonds that need to be issued.

5. Pros and Cons of Full Child Allowance

Funding the child allowance through spending cuts alone would ostensibly not increase the burden on anybody and cause little pain to citizens. This was the scenario the DPJ initially envisioned in its manifesto.

However, spending cuts seldom form a permanent funding source. We believe the government will be forced to choose between the options noted above: (1) paying the full child allowance, funded by tax increases, (2) paying the full child allowance, funded by the issue of substantial government bonds, or (3) avoiding introduction of the full child allowance.

Looking at the first option, paying the full allowance, together with waiving high school tuition fees, would leave a fiscal shortfall of Y3.6 trillion.[3] Funding this by raising taxes would require, for example, a 1.5-point increase in the consumption tax rate.

The current economic slump, which calls for supportive financial policy, is a poor time to raise taxes. The government could therefore choose the second option, spelling out a path to future fiscal reform to garner support for a temporary increase in government debt.

The only difference between the first and second options is the timing of tax increases. In either case, the government will need to clearly explain to all Japanese citizens, particularly households without children, the burden they will bear in supporting the raising of children.

If the government instead chooses the third option, keeping the allowance at half the originally proposed level,[4] fiscal expenditure and the disposable income of households raising children would rise by only 20% of the level initially anticipated—significantly reducing the impact of the measure. This would constitute a significant reversal from the ruling party’s policy of stimulating economic growth by supporting domestic demand through direct spending on “people, not concrete” and would lead to the need to develop new policies.

We believe the government will face tough decisions about whether or not to proceed with payment of the full child allowance.

3 Based on FY13 budget when income and residents tax hikes take full effect.
4 One way to reduce child allowance expenditure would be to reduce number of recipients by imposing means test rather than reducing payment amount. To reduce expenditure to same level as if payment maintained at half level the number of eligible children would need to be halved. This would require setting income limit at Y4-5 million, for which it would be extremely difficult to gain public support. This means it is probably not feasible to reduce child allowance expenditure by imposing means test.