JAPANESE FISCAL POLICIES: LESSONS FROM THE PAST AND ISSUES FOR THE FUTURE

Alan S. Gutterman*

I. INTRODUCTION: THE VARIOUS ROLES OF GOVERNMENT FINANCE

In Japan, as in every other industrialized and rapidly developing nation, significant debates occur regarding the proper role of the central government in national economic activities. Government finance, which is undertaken in the context of fiscal and monetary policies, serves a number of functions within a nation's economic, political and social system, including resource allocation, income redistribution, and economic stabilization. In each case, the government seeks to utilize its various spending, taxation, and credit allocation tools to alter the effect of the basic price mechanism within the economy. In addition, the government, through its central banking facility, may use monetary policies which are intended to achieve goals and objectives which are consistent with any given fiscal policies.

With respect to resource allocation, the government will intervene in various aspects of the economy to influence economies of scale, externalities, and imperfect competition, each of which are beyond the reach of the price mechanism in the market. The government will also supply public services, in the form of legal regulations and enforcement procedures designed to guarantee that market mechanisms function smoothly, and social overhead capital, including transportation and communication facilities. These public goods must be provided by the government to insure that adequate supply exists and that there is no incentive for members of the public to "free ride" by using public goods paid for by others.[1]

Income redistribution within the economy refers to adjustments effected through the government's system of collections and expenditures intended to modify the income distribution otherwise realized through the market

* M.B.A., 1980, University of California at Berkeley; J.D., 1981, Boalt Hall School of Law. Alan S. Gutterman is Counsel to the international law firm of Pettit & Martin, where his practice focuses upon various aspects of finance, securities, international law and intellectual property. He currently serves as the Chair of the Subcommittee on Emerging Capital Markets in Developing Countries of the ABA's Section of International Law and Practice and has written in the area of developmental law and business practices.

1. With respect to the resource allocation function, there is a tendency toward an excessive supply through "free-ride" factors which would not necessarily occur under the market mechanism, resulting from the deviation of benefits and costs as public goods are supplied through government finance. These factors are particularly important in cases where the goods to be supplied are "quasi-public," such as public housing and education, where the actual benefits are specific to the owner of the house or the recipient of the education, and the cost is borne by society as a whole.

mechanism. The purpose is to correct perceived inequalities in income distribution. Specifically, income redistribution can be roughly divided into two forms: vertical redistribution, intended to move income from higher income to lower income groups, and horizontal redistribution of income through social security and insurance systems, including disability, retirement, and unemployment benefits.[2] The role of government, as well as the possibility of excess or unproductive income transfers, tends to increase in relation to the degree of horizontal redistribution.[3]

Economic stabilization refers to the maintenance of stable employment and prices by an attempt to balance supply and demand in the entire economy through planned imbalances between fiscal revenues and expenditures against cyclical unemployment or inflation.[4] Since many people benefit from the expansion of fiscal expenditures during a recession, there is usually strong resistance to any decreases in expenditures or increases in taxes after economic recovery has begun. Accordingly, there is a real possibility that the permanent level of fiscal expenditures will be raised during each business cycle as expenditures, once increased during a recession, are maintained during the next period of economic recovery.[5]

The aforementioned functions of government finance, particularly resource allocation, have been demonstrable features of Japanese fiscal policy

2. Obviously, the most common example of horizontal income redistribution is the collection of social security funds from younger workers and the payment of such funds to retired workers. The implementation of a horizontal income redistribution system raises a number of practical issues, particularly the government's ability to properly estimate the actuarial value of future welfare and social insurance obligations, the rate of contribution to the welfare system and its relation to the ability to pay of the contributor, the use of surplus funds in the social security account and, finally, the entitlement features of the program in relation to need at the time of payment as well as the ability of citizens to "opt out" from the program.

3. As noted above, when the class of potential recipients of social insurance benefits increases, the administrative costs associated with the program also increase. Moreover, the social insurance system may create obligations in favor of citizens who have little or no actual needs for the distributed funds, yet qualify by virtue of the defined class of recipients (*e.g.*, all citizens over a specified age).

4. For example, excess unemployment in the economy will cause the government to stimulate activity through increased expenditures, which may take the form of purchases of current goods and services, investment, or a planned reduction in tax revenues to increase the amount of disposable income in the private sector. Similarly, an "overheated" economy may cause the government to take actions designed to reduce "excess demand," including a reduction in government expenditures and increases in tax rates. In each case, the short-term effect of government policies is designed to create a fiscal imbalance in the form of a surplus or deficit.

5. In fact, it appears that such a relationship may well exist with respect to the experiences of the countries in The Organization of Economic Cooperation and Development [hereinafter OECD], which indicates that the rate of change in the ratio of total government expenditures to GDP has increased in direct relation to the slowdown in overall economic growth which has occurred since 1961. *See* OECD, ECON. OUTLOOK, Dec. 1984, at 29-32.

This tendency for the permanent level of fiscal expenditures to rise to increasingly higher amounts makes it more difficult for the government to adopt "contractionary" policies with respect to excess demand which may be created during the course of a subsequent period of economic recovery and strength.

since the end of World War II and have served as the focus of policy debates regarding the appropriate future role of tax, government expenditure and public investment policies in Japan. In this paper, we will examine a number of aspects of Japanese fiscal policy, beginning with an overview of post-War fiscal policy trends in the industrialized countries, continuing with a detailed analysis of specific Japanese fiscal policies and ending with some thoughts on future fiscal policy in Japan and some of the lessons from Japan that might be advantageously adapted for use in the United States.[6]

II. THE FISCAL ENVIRONMENT IN THE OECD IN THE POST-WAR PERIOD

The historical evolution of Japan's fiscal policies since the end of World War II is a function of the nation's own development goals and objectives and the circumstances created by various external factors, such as the First and Second Oil Crises, and business conditions within Japan and its major trading partners. Although the next section will consider Japanese fiscal policy matters in depth, it is important to initially identify the following three distinct analytical periods within the broader context of the OECD as a whole:

Initial Rapid Growth Period. From the early 1950's until the mid-1960's, government economic policies in Japan focused upon the promotion of growth to improve the standard of living within the nation.[7] As a result, fiscal policies tended to serve a resource allocation function and, with economic growth running as high as ten percent per annum during this period,[8] the government realized comparable increases in tax revenues which led to surpluses in the government's current budgets. Tax reductions followed, which were then converted into additional funds for private savings and investment. Accordingly, government remained "small" and no current or long-term imbalance existed between public expenditures and revenues.[9]

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6. We will briefly discuss modifications to existing tax policies in the United States that might be used to encourage investment in manufacturing activities while increasing the international competitiveness of domestic industries, where "competitiveness" is loosely defined as the ability of domestic enterprises to profitably manufacture and distribute its goods and services in domestic and foreign markets.

7. While the subject is far too complex for this paper, Japan's decision to pursue economic growth meant that individual welfare was to be pursued through expansion of the entire economy, thereby theoretically increasing the per capita wealth of each citizen, rather than by redistributing a relatively stable set of resources amongst the citizens. A choice of this type was consistent with the nation's traditional ideologies with respect to the relation between the nation and its citizens.

8. As noted below, it appears that Japan's policies regarding the level of governmental revenues evidenced an intention to maintain a constant ratio between revenues and the overall level of national income.

9. The "size" of government can take on a variety of measures, including the number of employees, the ratio of expenditures to GNP and the perceived intrusion of government into the day-to-day affairs of its citizens, through regulation or otherwise. The concept of "current" and "long-term" government imbalances recognizes that the government has a current budget,

The Welfare State and the Oil Crisis. From 1965 to the First Oil Crisis, there were times when government expenditures In Japan exceeded revenues in some phases of the business cycle. Several factors caused these deficits, which still did not exceed one percent of national income. First, a recession in 1965 forced the government to issue "deficit-reduction" bonds which, as explained below, created a new structural budgetary expenditure in the form of interest payment obligations. Second, the income elasticity of tax revenues appeared to decrease during this period.[10] Finally, government began to engage in income redistribution, albeit on a small scale, as the nation began to seek social security and welfare as a product of the rapid economic growth in prior years.

Stabilization and Deficits. The third period covers a time of extensive deficits in the fiscal balance from 1974, after the First Oil Crisis, up to the late 1980's. Government revenues drastically decreased by 2.5 percent on the national income basis from 1974 to 1975, when a negative economic growth rate was recorded. The gap between expenditures and revenues created in 1975 persisted for the following ten years.[11] As a result, the annual fiscal deficit during this time accumulated into public debt, creating a heavy burden for fiscal management. From the mid-1970's onward, the income redistribution function of the government, such as social security transfers, exacerbated the move toward "bigger" government in Japan.

Despite Japan's extraordinary and unique record of rapid growth and expansion, the nation's experience with respect to the role of government in the economy is surprisingly similar to that of the other industrialized nations. A review of various fiscal and economic indicators for major OECD countries from 1960 to 1982 indicates a general pattern of expansion in the role of the public sector in economic activities. Specifically:

1. For the OECD as a whole, the ratio of government expenditure to GNP increased by about 70 percent, from the average of 26 percent in 1960 to 45 percent in 1982. The increase in Japan's ratio, from 18.3 percent in 1960 to 34 percent in 1982, was among the highest; however, only Spain had a lower ratio in 1982 and nations such as Sweden and the Netherlands had ratios exceeded 60 percent in that year.[12]

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analogous to an income and expense statement, and a "net worth" or capital position, analogous to a balance sheet position. As noted below, systematic deficits in current budgets can, in the absence of countervailing increases in asset values relative to obligations, create a deficit position in the nation's capital account.

10. "Income elasticity of tax revenues" refers to the relationship between the increase in tax revenues associated with a corresponding increase in national income. A decrease in income elasticity meant that tax revenues failed to rise as sharply as they did during the "Initial Rapid Growth Period," even though the overall rate of growth in the economy continued at the same rate until just before the First Oil Crisis.

11. OECD, ANNUAL REPORT OF NATIONAL ACCOUNTS 23 (1985).

12. *Id.*

2. Government revenues in the OECD failed to increase, on average, with expenditures. The average ratio of government revenues to GNP increased by about 49 percent, from the average of 28 percent in 1960 to over 41 percent in 1982. Again, the increase in Japan's ratio was quite telling, moving from 20.7 percent in 1960 to 29.3 percent in 1982, leaving Japan with the lowest ratio of government revenues amongst the OECD nations in that year.[13]

3. Net government borrowing, which reflected the gap between total government expenditures and revenues, expanded significantly in almost all of the OECD countries during that period, reaching an average of 3.7 percent of GNP in 1982 and increasing to 4.2 percent of GNP in 1983. Japan's ratio stood at 3.3 percent in 1983.[14]

4. Analysis of this period shows that the role of OECD governments in effecting transfer payments through public finance increased significantly.[15] Social security transfers, which almost doubled from an average of 7.4 percent in 1960-67 to 14.1 percent in 1980-82, accounted for about 60 percent of the increase in government expenditures during the period. Moreover, interest on public debt also increased. In Japan, increases in both items exceeded those of the OECD nations taken as a whole.[16]

5. With respect to increases in revenue during this same period, direct taxes,[17] particularly personal income taxes, and social security contributions increased significantly. Trends in Japan were similar to those experienced in other OECD nations; however, the ratio of direct taxes

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13. *Id.* As noted elsewhere, this phenomenon is not necessarily surprising, given the propensity of Japanese policymakers for reducing effective tax rates as the level of national income increased over time.

14. *Id.*

15. In an economy where significant transfer payments occur, in the form of social security payments or other subsidies, a tendency exists on the part of the recipients to encourage maximization of transfer receipts. As a result, the adoption of a social security system causes one to observe a prolongation of job-seeking periods due to the unavailability of unemployment insurance and excessive diagnostic treatment due to the availability of medical insurance. Obviously, trade-offs need to be made between economic efficiency and social welfare; however, the economic costs of a social security system which is not limited to specific income groups tends to expand steadily.

16. *See* OECD, REVENUE STATISTICS OF OECD MEMBER COUNTRIES 1965-1983 12-50 (1983); OECD, HISTORICAL STATISTICS 1960-1982 3-42 (1982).

17. A tax of this type, being a tax on income rather than consumption, tends to fall most heavily upon such productive factors as labor and capital. An increase in individual income tax is an increase in the taxation on the labor supply and, at least in relation to a consumption tax, decreases the amount of after-tax funds that are available for private saving and investment.

Increases in corporate taxes inhibit private capital investment through a decrease in after-tax profits and, further, an increase in the required employer contribution to social security may decrease the demand for labor due to the increase in labor factor costs.

in Japan increased consistently from 51 percent in 1955 to 71 percent by 1983, resulting in a considerable increase in tax revenues while the economy was expanding.[18]

6. The ratio of government expenditures to GNP in the industrial nations expanded at every recession and, in most instances, the government was unable to effect a decrease in fiscal expenditures once recovery has begun, thereby expanding the structural portion of the government's financing obligations. In addition to the long-term costs associated with an increase in the structural deficit,[19] real questions exist as to whether or not a government can execute a policy of fiscal expansion in a timely fashion[20] or, even if it could, whether or not any change in total demand can be achieved by policies that merely seek broad "across-the-board" increases in fiscal spending.[21]

7. After the First Oil Crisis, industrialized governments gave priority to expansive fiscal policies designed to stimulate business recovery. As a result, the fiscal deficits in OECD countries which had not existed in 1973, rose to 4.3 percent of GNP in 1975 and generally have persisted through the Second Oil Crisis and on into the balance of the 1980's.[22]

By comparing Japan to other OECD nations, it is possible to identify several special characteristics regarding the expansion of fiscal activities in Japan during this period. For example, Japanese government consumption continually remains lower than other OECD nations. This trend reflects Japanese reluctance to spend on public goods, other than key infrastructure items, during the period of rapid expansion, and the small burden of defense expenses in Japan. However, government consumption began to expand in the late 1970's, primarily focusing on social welfare, housing and local community services.

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18. REVENUE STATISTICS, *supra* note 16, at 38.

19. Among the problems to be considered is the ability of the government to finance the deficit, particularly in light of the need to make changes in the monetary supply in order for the expanded fiscal deficit to lead directly to an increase in final demand. However, sudden changes in the money supply run the risk of causing adverse modifications to the appropriate exchange rate level, a concern that became particularly acute in light of constant tension created by Japan's export prowess.

20. Errors in timing result from forecasting errors and the inability to accurately predict the fiscal multiplier effect due to variations in the cyclical phases of inventory investment and fixed investment.

21. For example, the increasing weight of quasi-public goods and services such as education and medical care in total government consumption tends to limit the increase in total demand which can be expected from increases in fiscal expenditures. Moreover, the existence of a structural deficit also tends to limit the breadth of the government's options with respect to expansionary policies.

22. *See* ECON. OUTLOOK, *supra* note 5, at 96.

During the 1970's, extensive improvements in the social security system, including the introduction of the cost-of-living adjustments into public pensions and the application of the free health care system in 1973, contributed to a rapid expansion of social security transfers. Western-style "welfare" arose out of the recognition that traditional Japanese support systems of family and kinship could no longer provide security in the face of the rapid division of labor and economic growth.[23]

Finally, like almost every OECD nation, Japan faced significant amounts of annual and accrued government indebtedness. Due to the high levels of net private saving in Japan, there appeared to be more room for absorbing governmental imbalances than might exist in other industrialized nations. However, because government bonds were issued to cover deficits, debt increased and, the ratio of the balance of public debt to GNP in Japan increased rapidly and reached a level second highest among the seven industrialized nations, following Italy.[24] Accordingly, the cost of interest payment of public debt became significant in Japan.

On balance, Japan's experiences in the domain of public finance from the early 1950's to the mid-1980's reflect both its own unique situation, and pressures similar to those facing other OECD nations. Although the role of the Japanese government as a consumer was quite limited and a decided preference was shown for investment projects, Japan shared with other OECD nations the rising burden of welfare obligations and public indebtedness.

III. DETAILED ANALYSIS OF POST-WAR JAPANESE FISCAL POLICIES

A. The Framework for Fiscal Policy

Japanese fiscal policy has typically been defined in light of the efforts of the nation's institution of economic planning, the Economic Planning Agency, and the directions provided by the various ministries, particularly the Ministry of Finance (MOF)[25] and the Ministry of International Trade and

23. It is expected that social security transfers will continue to increase as the population becomes more aged and will eventually surpass the current level of major European countries by the end of the century. *Id.* at 99.

24. *Id.* at 96-7.

25. The MOF also has operational responsibilities for all fiscal affairs, including preparation of the budget, and plays the primary role in international monetary and domestic financial affairs. The Budget Bureau of the MOF receives and reviews, on an annual basis, the expenditure recommendations of all central government ministries and agencies, and prepares a proposed expenditure budget. At the same time, the MOF's Tax Bureau prepares recommended changes in the tax schedule, including rates, exemptions and deductions, and forecasts government revenues based on these changes. The MOF also prepares plans for bond issues and other borrowing, the budgets of the various public corporations and the FILP (as defined below). The entire package is submitted to, and approved by, the Cabinet and the Diet, Japan's legislative body. As noted below, supplementary budget packages are usually enacted during the fiscal year. *See* G. Ackley, *Fiscal, Monetary, and Related Policies*, in ASIA'S NEW GIANT: HOW THE JAPANESE ECONOMY WORKS 210-11 (H. Patrick & H. Rosovsky eds. 1976) [hereinafter Ackley].

Industry (MITI). These entities have the responsibility for compiling and reporting economic statistics, interpreting major macroeconomic events and for articulating the overall economic objectives of the nation, primarily as targets announced as part of a series of annual and multi-year economic plans.

In order to fully understand the operation of Japan's fiscal policy measures, one must first examine the overall budgetary structure.[26] Annual budgets go through a number of stages, including the presentation of an initial budget several months before the beginning of each new fiscal year in April, approval of the initial budget by the Diet in the first quarter of each new calendar year and, most importantly, the promulgation and implementation of supplementary budgets during the actual fiscal year. Supplementary budgets take the form of additional appropriations or, in cases where the government wishes to contract spending activities, delays in the implementation of appropriations and projects originally approved for that fiscal year in the initial budget.

Central and local government are the key loci of budgetary activities in Japan. The "central government" administrative budget consists of a general account[27] and various special accounts.[28] In addition, the budgets of government-affiliated corporations[29] and the Fiscal Investment and Loan Program (FILP)[30] must also be approved by the Diet. However, the budgets of those public corporations[31] which have activities that are related to the central

26. The summary contained herein has been adapted from OECD ECON. SURVEYS, JAPAN, July 1988, at 111-16 & 125-32. [hereinafter 1988 ECON. SURVEY].

27. The general account is the account for basic national policy matters (*i.e.*, social security, military, education, etc.) which are financed by national taxes. In addition, amounts are transferred from the general account to other accounts, including the government's own central account, the local governments and the related special accounts.

28. Special accounts are established when (i) the government runs a particular business; (ii) the government holds particular funds for investment; (iii) particular revenue of the government is tied to specific expenditure to be distinguished from the general revenue. Revenue for special accounts may come from transfers from the general account, as noted above, or from fees, charges and premiums. Special accounts are categorized by the following activities: business special accounts, control special accounts, insurance special accounts, loans special accounts and rearrangement special accounts.

29. As of 1988, there were nine public finance corporations (*e.g.*, the Housing Loan Corporation) and two government related banks, the Japan Development Bank and Japan Export-Import Bank, which had been established by special laws and the capital for which was totally supplied by the government.

30. The FILP is organized by the central government to finance various activities to meet national objectives. Funds for the FILP consist of private sector savings (*i.e.*, Postal Savings), accumulated savings in state pension funds and repayments of loans and interest receipts. Funds are used to finance the activities of the general government and to purchase central and local government bonds. The sum of the loans to public corporations mainly engaged in public works, such as the Japan Road Public Corporation, must roughly correspond to public works expenditures by the FILP.

31. Public corporations are established by the government for the promotion of important activities which are required by law. They include the government-affiliated corporations referred to above and other public enterprises and agencies. Some of the corporations are established by the private sector with the permission of the appropriate ministries, including the Bank of Japan and mutual-aid associations for public employees.

government need not be approved by the Diet, with certain limited exceptions.[32] Local government budgets consist of a general account and various special accounts, although the coverage of these accounts will vary depending on specific local concerns.[33]

In order to understand the budgets of the central and local governments in the context of the System of National Accounts (SNA), it is necessary to distinguish how the individual budgets and public corporations are reclassified into either general government or public enterprises.[34] General government in the SNA consists of central government,[35] local government[36], and the Social Security Fund.[37] Public enterprises consist of non-financial[38] and financial public enterprises.[39] It should be noted that in the central govern-

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32. 1988 ECON. SURVEY, *supra* note 26, at 127-32.

33. With respect to local governments, there exists an ordinary account, which is the sum of general and special accounts excluding public service accounts. The ordinary account is comparable with the central government general account, and is mainly financed by local taxes, transfer payments and subsidies from the central government and by issuing local government bonds, some portion of which is purchased by the FILP.

Major expenditure items are wages, general administrative costs, debt-interest payments and investment spending. The public service accounts for local government consist of eight service accounts, of which public corporations accounts are the most important. Local public corporations are established by local governments for public purposes and includes such things as water supplies, hospitals and transports.

Other public service accounts consist of national health insurance service accounts, business service accounts, public universities and health service accounts. By law, a specified percentage of all central government revenue from income and corporate income taxes and from the liquor tax are automatically transferred to the local governments, and these so-called Local Allocation Taxes contributed about 20 percent of revenues in the mid-1980's. The local governments also collect local property taxes, income taxes and corporate taxes at rates which are strongly influenced by the central government.

Local Finance Plans are published once a year in January or February, taking into account the central government's draft budget and the Local Bonds Plan; however, little detail is available with respect to the specifics of a given local budget. *See* OECD ECONOMIC SURVEYS, JAPAN, Aug. 1985, at 83 [hereinafter 1985 ECON. SURVEY].

34. The reclassification is based on the purpose of the activities, the extent of government control, and the extent of financing by the government.

35. Central government includes central government general accounts (excluding activities for the construction of housing for government employees), special accounts with non-corporate activities and agencies with non-corporate activities.

36. Local government consists of local government ordinary accounts, public enterprise accounts with non-corporate activities (such as hospitals and public sewage) and public service accounts with non-corporate activities.

37. The Social Security Fund consists of central government non-corporate special accounts for social security, mutual-aid associations, employee pension funds, health insurance associations and local government public service accounts.

38. Non-financial public enterprises include housing for government employees in the central government general accounts; central government (non-financial) corporation special accounts, including the Postal Service Account; public corporations and other similar accounts at the local level.

39. Financial public enterprises include central government financial corporation special accounts, such as the Trust Fund Bureau; the Bank of Japan; government-affiliated banks, such as The Japan Development Bank and The Export-Import Bank of Japan; government-affiliated public finance corporations; and other financial institutions financed by the government.

ment, the major expenditure item is current transfer to other governmental sectors, and the Social Security Fund has historically run a huge surplus, for the reasons described below, which has been used to finance the investment by public enterprises through the Trust Fund Bureau.

In light of the foregoing, two characteristics of the budget structure should be borne in mind. First, a large imbalance has existed between two of the sub-sectors of the general government: a huge deficit in the central government offsetting the surplus in the Social Security Fund.[40] Second, about one-third of public investment is made by public enterprises financed partly by the FILP and fiscal policy action usually includes modifications to the expenditures by the FILP. Such public investment is not generally reflected in the general government budget balance; accordingly it may be more appropriate to focus upon the balance of the public sector (*i.e.*, the general government *plus* public enterprises) as an indicator of fiscal policy stance, even though in other countries many of the activities of the public corporations are carried out by the private sector.

Japanese fiscal policies balance the amount of current receipts, the decisions made with regard to the level of government consumption, lending activities to various industrial sectors, and the degree to which public enterprises, including financial institutions, provide services that are carried out by the private sector in other countries.[41] The government has retained a good deal of latitude to divert revenues, including contributions to the Social Security Fund which have been "earmarked" for future obligations, to productive investment activities. As noted below, Japanese tax policies have been quite flexible and the government has acted as a financial intermediary with respect to investment of high levels of private savings.

B. Fiscal Policies During the Initial Rapid Growth Period

Since World War II, Japan's primary goal has been to achieve economic independence through planned and rapid growth, investment, and strong export capacity.[42] Given Japan's lack of both natural resources and access to an overseas empire, the idea that Japan could develop the volume of exports necessary for growth, above and beyond mere survival, seemed to many observers to be far-fetched. However, the stated goals did mean that Japanese expenditure and tax policies would need to be structured in a manner that would encourage savings, investments and exports, including

40. The surplus in the Social Security Fund is intended to meet the rapid rise in transfer payments in the future and is distinguished from other current revenue of the government.

41. 1988 ECON. SURVEY, *supra* note 26, at 126-7.

42. In fact, the title of Japan's first five-year economic plan, adopted in 1955, was "The Five-Year Plan for Economic Independence." Ackley, *supra* note 25, at 159.

heavy public investment in productive, rather than social, capital items.[43] In this part, we will examine some of the important features of Japan's governmental expenditure and taxation policies as it began to rebuild from the turmoil and destruction caused by the War.

An important feature of Japan's government expenditure structure after the War was the virtual absence of military expenses, which had occupied nearly 50 percent of the average pre-War total in Japan and which accounted for more than 50 percent of government expenditures after the War in the United States.[44] As a result, a far greater proportion of public revenues was available for growth and welfare projects of a non-military nature than before the War in Japan or in any militarized and industrialized nation immediately following the War. Moreover, the absence of large military obligations contributed to the overall stability of the economy as well as to the elimination of inflationary and public debt pressures which usually accompany a rapid increase in government expenditures on current consumption for military purposes.[45]

Another distinctive feature of Japan's post-War budgetary structure was the creation and use of special accounts which, in contrast to the general accounts, were not accountable to the Diet[46] and were not dependent upon the amount of tax receipts for funding. The special accounts had increased to 65.7 percent of the government's budget by 1960[47] and were used to fund farm subsidies, road construction, public works, land conservation and the FILP, which in turn provided grants and interest-free loans for investment

43. Also, government could be expected to maintain a monetary policy that involved low interest rates and easy credit requirements in order to stimulate capital-intensive private investment, but not housing or consumer durables, and to provide indirect forms of export subsidies. It is worth noting that while direct management of Japanese monetary policies is vested in the Bank of Japan (BOJ), it actions with respect to major policy actions are made in consultation with the MOF and MITI. Moreover, the government's role as a financial intermediary to insure that capital flowed from savings to appropriate investment activities was also recognized. Ackley, *supra* note 25, at 160-61.

44. K. KURIHARA, THE GROWTH POTENTIAL OF THE JAPANESE ECONOMY 64-5 (1971). It was noted that defense spending in Japan had been reduced to 5.2 percent of expenditures by the government in 1960. *Id.* at 65.

45. The lack of a military and defense infrastructure meant that government expenditures on research and development could be focused on commercial applications. As a result, the role of the government with respect to research in Japan was quite different than that which existed in the United States where a good deal of resources were expended on research and development devoted toward new technologies for military applications. Also, the focus upon commercial, rather than military-based, research and development led to different attitudes toward diffusion of new technologies into the marketplace.

46. As noted above, the level of Diet approval over various aspects of the budgetary process have been modified to reflect the structure described in the 1988 ECON. SURVEY, *supra* note 26, at 111-16 & 125-32. However, given the historical deference of the legislative body to the budgetary policies of the bureaucrats and central government planners, the need for legislative approval was not a significant hurdle to the broad discretion exercised by the governmental agencies in Japan.

47. KURIHARA, *supra* note 44, at 65. Special accounts amounted to only 34.6 percent of the budget in 1900. *Id.*

projects of central and local government agencies and selected private enterprises. As a result of these special accounts, the government was able to play an expansive role in the economy without regard to conventional concerns regarding the generation or availability of tax revenues.

Post-War Japan's government expenditure structure was also heavily influenced by the capital account, whereas the current account was the dominant consideration in the pre-War years.[48] Since, as noted above, post-War Japan's capital expenditures did not include massive amounts of merely demand-generating military investment, which tend to serve a "stabilizing" function within the economy, the government became an increasingly important investor in fixed capital. As a result, government investment contributed to the overall expansion of capacity in Japan, a factor that was sorely needed given the destruction to existing plants and facilities brought by the War.[49]

The total amount of governmental transfers and subsidies in Japan increased substantially during the 1950's.[50] By far the largest amount of the transfers and subsidies were allocated to the agricultural sector, with somewhat smaller amounts going to industry and to households directly.[51] As a result, fiscal aid to industry was provided primarily in the form of loans under the FILP and revenue-side items.

The Japanese also went to extremes in insuring that expected government expenditures were announced in advance in order to provide private investors with assurances that the government would continue to provide support for activities in designated economic sectors. Guidance of this type was grounded in the assumption that current private investment was an increasing function of anticipatory national income, an assumption that was reinforced

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48. *Id.* Capital account expenditures in Japan, as a percentage of total governmental expenditures, equalled 43.1 percent in 1946-50, 43 percent in 1951-55 and 45 percent in 1956-60, whereas the percentage represented less than 20 percent prior to the War. *Id.*

49. Actually, Japan established and followed what has been referred to as a "balanced-budget" rule until the mid-1960's, when recession required a number of significant expenditures to facilitate economic recovery. The rule came to mean that the central government could not borrow, other than temporarily, from the BOJ, or issue marketable bonds. However, since 1965, bonds have been issued in each year, although in generally declining amounts until the early 1970's.

Moreover, direct borrowings are made by a few of the special accounts, as well as by the government-affiliated agencies, often with the assistance of a government guarantee. Since the departure from balanced budgets in 1965, the government has often maintained that the level of borrowing is constrained by various alternative rules, such as the amount of borrowing shall never exceed the amounts spent on construction and that bond issues must meet the tests of "market acceptance," a somewhat dubious criterion given the ability of the government to influence interest rates through its formal and informal relationships with the nation's public and commercial banks and the capacity for absorption in the economy created by the high rates of domestic savings. Ackley, *supra* note 25, at 212.

50. Total government transfers and subsidies increased from 155 billion Yen in 1950 to 593 billion Yen in 1960. KURIHARA, *supra* note 44, at 66.

51. Agriculture received 70 percent, industry 20 percent and households 10 percent. *Id.*

by the private sector's deference to the government borne out of traditional state paternalism.[52] "Pump-priming" by the government was further facilitated by the existence of the aforementioned special accounts, which were discretionary and independent of tax revenues.[53]

Finally, the post-War governmental expenditure structure in Japan clearly showed an aversion to reducing the pressures of inflation under full employment conditions through cutbacks in government expenditures.[54] As a result, the government appeared to pursue politically-motivated policies which focused upon the rapid and continued expansion of plant and equipment in Japan for use in export-driven growth, even though such policies might prompt increases in the domestic consumer price level. This attitude was consistent with historical differentials between domestic retail prices on the one hand and wholesale and export prices on the other hand. To this day, critics of Japanese economic policies argue for the necessity of reducing consumer domestic prices as part of market liberalization of the entire economy.

Overall, both in relation to the size of the economy and to the level of government revenues, government expenditures after the War in Japan were smaller than in any other major developed country. Although government expenditures were rising in 1955-65 at a rate which exceeded that of almost every other OECD country, and more than twice as rapidly as in the United States, Japan was the only OECD country in which *direct* government expenditures grew less rapidly than GNP during that period, a trend which continued into the early 1970's.[55] Accordingly, Japan's fiscal policies could be characterized as "restrictive," a conclusion that is affirmed when government expenditures are compared to the size of government revenues.[56]

Japan's expenditure policies must be viewed in the context of the government's role as a significant investor. In the post-War period, the general government undertook between 13 and 18 percent of the economy's total gross domestic investment, in the form of public buildings, roads, flood-con-

52. The following pronouncement was made by an important Japanese policymaker: "The announcement that government expenditure will not be reduced (to be sustained via deficit financing, if necessary) serves to avert a further downswing of private economic activity." *Id.* at 67.

53. To state that the funding of the special accounts was "independent" of tax revenues does not mean that some fiscal constraints were imposed upon their operations, particularly since the government eventually began to issue bonds to fund further appropriations. However, independence was achieved to the extent that expenditure levels were not tied to revenues from a specific set of tax measures and collections from the Social Security Fund were available for other investment purposes.

54. In fact, it appears that total government purchases of goods and services in constant prices, including the investments of government enterprises, played a consistently countercyclical roles in most business cycles since 1954 in Japan. Ackley, *supra* note 25, at 229-30.

55. *Id.* at 213. However, as noted below, the rate of growth of *all* government expenditures during the period exceeded the rate of growth in GNP, indicating that Japanese fiscal policies emphasized investment activities, rather than direct expenditures.

56. *Id.*

trol works, harbors, airports and the like.[57] Moreover, even though the level of government investment was quite large, it was regularly exceeded by the amount of government savings,[58] itself another measure of the restrictiveness of overall fiscal policies. At the same time that government actions worked to constrain the level of domestic demand, government investment appeared to contribute substantially to the growth of potential output, which could be expected to create demand for future output.

The willingness of Japanese policymakers to fund investment activities through revenues not related to the system of current tax receipts means that tax policies could serve a different function in Japan than in nations where the budgetary focus is on the balance in the current account. The key aspect of early post-War tax policy in Japan was the determination that tax schedules should be adjusted on an annual basis, predominantly downward, in order to keep total national and local tax revenues at or near 20 percent of projected national income.[59] This practice not only tended to have a stabilizing effect on the overall economy, but also discouraged any expansion of the government's own consumption activities.[60]

During the post-War period, Japan's tax system more closely resembled that of the United States than those of the countries of Western Europe.[61] Revenues at the national level came primarily from individual and corporate income taxes, and the local governments relied on property taxes and income taxes. A payroll tax financed social security benefits and the national health insurance system and while there was no general sales or value-added tax in Japan, substantial revenues were raised from selected excise and consumption taxes. By 1972, the individual and corporate income taxes accounted for 50 percent of total tax revenues; taxes on commodities and services[62] made up 24 percent of total taxes; payroll taxes accounted for about 19

57. As noted above, the Japanese budgetary process allowed for governmental investment through the various public enterprises. These activities were not reflected in the national income accounts, but instead were funded through bond issuances and receipts from Postal Savings and insurance. *Id.* at 215-8.

58. General government saving ranged between 21 and 41 percent of total government current revenues between 1955 and 1972, and between 4 and 8.5 percent of GNP during that period. *Id.* at 214.

59. *Id.* at 212.

60. For example, if tax schedules are set at the beginning of each fiscal period to provide revenue proportional to the forecast of GNP and the forecast turns out to be incorrect, revenue will rise as a percentage of GNP if GNP is unexpectedly high or fall if GNP is unexpectedly low, thus introducing a stabilizing effect.

61. A detailed description of the Japanese tax system is beyond the scope of this paper. Reference should be made to the discussion in Ackley, *supra* note 25, at 320-52 & 373-82.

62. These taxes include: consumption and excise taxes, taxes on imports, exports, and transfers of property and securities, and other transactions taxes paid by enterprises. *Id.* at 319.

See *id.* at 319-20 for a discussion of the relatively high levels of "goods and services" taxes in the Western European countries in comparison to Japan and the United States.

percent; property taxes accounted for five percent; and other taxes for the remaining two percent.[63]

Japanese taxation policies differ from those in the United States in at least three specific ways. First, the Japanese had virtually a unitary fiscal system and the budgets of local governments were heavily dependent upon the discretionary decisions of the central government. Second, due to the high growth rate, Japanese tax revenues exceeded the amount necessary for public expenditures,[64] thereby creating a fiscal dividend which could be used to augment national savings and to provide tax reductions every year. Finally, Japan adopted a number of tax measures intended to encourage special behavior by consumers and businesses, particularly private investment in activities with a high national economic priority.

Although the level of direct taxes, expressed as a ratio in relation to indirect taxes, was to rise significantly during the 1970's and early 1980's, the characteristics of Japan's post-War tax structure reflected a clear reliance upon indirect taxes, such as excise and payroll taxes.[65] The reliance on indirect taxes of a regressive nature, offset the effects of progressive income taxes,[66] allowed the country to reinvest a higher proportion of its output into productive investment, and also leads to higher levels of saving and investment. However, in using such regressive taxes, Japan made a social and political decision to reject the "ability to pay" democratic-welfare system of taxation in favor of rapid growth for the economy as a whole.[67]

63. *Id.* at 319-20.

64. Even so, compared with Australia and thirteen other countries in Western Europe and North America, Japan's tax burden by 1972 was the lowest. Except for the corporate income tax, all the major taxes were much lower relative to GNP in Japan than in most other countries. Individual income tax revenues were only 5.4 percent of the GNP in Japan, but they averaged 9.8 percent in the other countries; payroll taxes, 4.1 percent in Japan, averaged 10.2 percent in the other countries; and taxes on goods and services, 5.1 percent in Japan, averaged 11.8 percent in the other countries. *Id.* at 338-9.

In spite of the size of the tax burden in Japan, the income tax structure is such that fiscal drag is relatively powerful in Japan. For example, the income elasticity of income tax paid by employee households averaged about 2.5 for the period from 1978 to 1983. 1985 ECON. SURVEY, *supra* note 33, at 82.

65. In 1964, the Japanese Ministry of Finance estimated indirect taxes at 41.3 percent of the total. KURIHARA, *supra* note 44, at 68.

66. Progressive income taxes affect high-income earners adversely and since high-income earners show a high propensity to save and invest the use of indirect taxes, which "level" the overall tax structure, should increase the average propensity to save and invest within the economy. *Id.* at 69-71.

67. Consider that an excise or payroll tax is imposed without regard to the ability of the individual or entity to bear the burden of the tax. For example, a 20 percent tax on consumption falls equally upon each taxpayer who consumes $100 of goods and services, even if the total income of different taxpayers varies widely. As a result, "higher-income" taxpayers have more "after-tax" income in that situation.

A second feature of Japan's post-War tax structure was the use of various tax exemptions for the benefit of investors and savers.[68] For example, Japan enacted an exemption of taxes on intercorporate dividends, on the income from the sale of officially designated "important products", and on capital gains and interest earnings, thereby encouraging the accumulation of financial capital by investors through investment and lending activities.[69] Exemptions thought important during the 1950's, were abandoned during the 1960's.[70]

Tax exemptions were complemented by a series of selective tax deductions which were available for certain investments of large firms. Among these deductions were: accelerated depreciation for industrial equipment;[71] additional initial depreciation for important industries; a generous deduction on special reserves of corporations, that part of the firm's profits retained in anticipation of losses and expenses arising out of a specified activity;[72] specified deductions from the income of exporting firms;[73] and a prescribed percentage deduction from the income of firms paying out dividends on new shares that were issued in order to raise capital for expansion. Obviously,

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68. The Special Tax Measures Law lists most, though not all, of the incentive provisions applicable to individual and corporate income taxes. Special tax measures were usually, but not always, adopted with a termination date.

MITI plays a significant role in the development of special tax measures, usually in conjunction with representatives of the business federations and trade associations. Ultimately, negotiations on specific proposals will be undertaken between MITI, the Tax Bureau and the Tax Advisory Commission, although other government agencies will also participate where appropriate.

The first tax exemptions that were enacted in the early 1950's consisted of tax exemptions for specified types of interest income, a reduced withholding rate for dividend income and a tax-free reserve for bad debts. *See* Ackley, *supra* note 25, at 329 & 352.

69. KURIHARA, *supra* note 44, at 72.

70. For example, in 1957 the tax exemption for interest income was abolished, although at the same time accelerated depreciation for important industries was liberalized. In 1963 accelerated depreciation was granted to small- and medium-sized enterprises, and interest income from small deposits were made tax exempt. By the late 1960's, a number of new measures were adopted: initial depreciation for machinery and equipment used for the prevention of environmental pollution was increased; tax credits were adopted for savings for housing and for increases in research and development expenditure; interest income from small holdings of government bonds were exempted from tax. On the other hand, the government was to impose heavy taxes on capital gains on the sale of land and buildings held for less than five years and abolish accelerated depreciation provisions for export industries. *See* Ackley, *supra* note 25, at 352-54.

71. For example, permitting an initial depreciation allowance in the first year, as high as 50 percent of the original value of the depreciable asset, with the remaining cost of the asset being written off in equal annual installments over the useful life of the asset. KURIHARA, *supra* note 44, at 72.

72. Including bad debt reserves, price fluctuation reserves, retirement allowance reserves and extraordinary loss reserves. *Id.*

73. Deductions ranged from three percent of export sales to 80 percent of net income from export sales. *Id.*

A tax-free reserve was also available for losses from export transactions. *See* Ackley, *supra* note 25, at 353.

the utility of these deductions depended on taxable income; the benefits tended to accrue to larger firms with the resources to undertake high levels of investment.

Finally, Japanese policymakers were able to create new and unorthodox methods of raising funds for budgetary purposes. The government was more than willing to risk inflationary pressures by continuing to expand national income through public investments and transfers and subsidies to the private sector.[74] Moreover, the government allowed nationalized industries[75] to issue their own debentures to raise capital for expansion; acquired non-tax revenues and funds from the sale of long-term government securities and foreign exchange to the central bank, from postal savings and postal insurance premium payments, and from foreign borrowing to meet expenditure needs on special accounts; and acquired sizable non-tax revenues from the sale of government monopoly products.

Japanese fiscal policies were the product of substantial agreement among all sectors of society with respect to the need to achieve rapid growth through export-driven activities. Although there was often a good deal of skepticism regarding the nation's ability to achieve its objectives, from 1959 until the early 1970's the Japanese economy grew at an average annual rate of 10.8 percent.[76] However, the new decade was to usher in a series of issues created by the economy's first post-War exposure to severe inflationary pressures and recession, each of which could be attributed, in large part, to the onset of the First Oil Crisis and the corresponding impact on price levels.[77]

Japanese fiscal policies from the mid-1950's to the beginning of the 1970's, when the economy began to face a relative decrease in annual growth, served a number of broad objectives: maintaining a high degree of restraint on an otherwise excessive aggregate demand; general promotion of investment, including government investments; assisting in the financing of investment by public corporations and local authorities, and financing of preferred

74. Tax rates were set in a manner that maintained a constant ratio between tax revenues and national income levels. Japan was able to achieve relatively constant budget surplus on a current account basis while sustaining periodic deficits in the capital account for the purpose of funding growth through long-term investment.

As was the case in most of the industrialized nations, the rate of growth in government expenditures in Japan from 1954 to 1965 (12.5 percent) exceeded the rate of growth in real GNP (10.3 percent) during that same period. Higher rates of growth in each category were posted by those nations with a "growth-oriented" focus (*i.e.*, Japan, France and West Germany), as opposed to such "welfare-oriented" nations as the United Kingdom and the United States. Japan's rate of growth in each category was the highest of the five nations mentioned above. *See* KURIHARA, *supra* note 44, at 64.

75. Including railways, telegraph and telephone and the government-controlled banks, such as the Japan Development Bank.

76. *See* Ackley, *supra* note 25, at 12.

77. *Id.* at 14.

categories of private investment;[78] and, finally, keeping the size of the budget small, at least by international standards, as a percentage of GNP.[79] Although these policies were quite successful, each was to come under criticism as Japan moved forward into the new decade.

C. Fiscal Policies During the Early 1970's

By the mid-1970's, Japan was submerged in a recession which, both in terms of duration and depth, was one of the worst since the end of the World War II.[80] Moreover, even though substantial capacity existed within the economy, wages and prices rose dramatically in 1973 and 1974[81] due, in large part, to the effects of the First Oil Crisis. Unemployment was high in relation to historical levels in Japan,[82] although still much lower than in most other OECD nations. As a result, Japanese policymakers used fiscal policy quite actively during this period, first to curb the expansion of aggregate demand and, thereafter, to provide support for the depressed economy. These policies, and the level of debt which was to be created in the public sector,[83] were to have a number of consequences for macroeconomic management during the remainder of the 1970's and throughout the next decade.

An expansionary budget was initially approved for the 1973 fiscal year; however, due to the mounting inflationary pressures, fiscal policies became restrictive.[84] A number of public works projects were postponed and budgeted expenditures for the 1974 fiscal year for public works projects indicated

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78. Although not the subject of this paper, it should not be forgotten that the government played an active role in the financing opportunities to be made available in the private sector, primarily through its ability to control various aspects of credit regulation in the public and commercial banking systems. *Id.* at 195-210 with respect to Japan's monetary policies during this period.

79. *Id.* at 231.

80. OECD ECON. SURVEYS, JAPAN, July 1975, at 5-6 [hereinafter 1975 CON. SURVEY]. By the first quarter of 1975, the contractionary phase had lasted for five quarters and the fall in real GNP was greater than in previous recessions.

81. During the first nine months of 1974, wholesale and consumer prices rose at annual rates of 21 and 24 percent, respectively. Also, the basic wages paid by major companies rose by 30 percent on average during the spring of 1974. Increases continued through the balance of 1974 and only began to decline in the first part of 1975. *Id.* at 20.

82. In March 1975, according to official statistics, the number of wholly unemployed persons in Japan reached 1,120,000 persons, one of the highest levels since the War. Moreover, it appeared that the overall participation rate declined substantially, as a number of workers removed themselves from the labor force. *Id.* at 16-9.

83. Actually the level of public bond issuances began to show dramatic increases in the 1971 and 1972 fiscal years, as did the level of local government bond issuances. *Id.* at 66-7.

84. On a national accounts basis, general government expenditures on goods and services, including investment, declined by 1.5 percent in volume in the 1973 fiscal year. The increases in expenditures which did occur were largely limited to "inflation-driven" obligations, including additional salary payments and funds necessary in order to finance deficits in the various food subsidies accounts. *Id.* at 44.

only minimal increases[85] in light of the primary objective of reducing inflation. As aggregate demand weakened and prices began to level off, total public works projects began to increase near the end of the 1974 fiscal year along with loans to small- and medium-sized businesses and those sectors particularly hard hit by the recession.[86]

For the 1975 fiscal year, the budget was characterized as "neutral while putting emphasis on price stability and public welfare."[87] General account expenditures reflected the smallest increases since 1967, with public works expenditures remaining strictly limited, although significant outlays were to be made for various social expenditures,[88] education and the development of scientific technology. With respect to taxes, a slight reduction of personal income taxes was proposed, which followed a more substantial cut in the prior fiscal year,[89] The planned issuance of government bonds for the 1975 fiscal year was less than initially scheduled in the budget for the previous fiscal year, an indication of the government's contractionary stance.

The early 1970's marked Japan's first experience with slower rates of overall growth and inflationary pressures. As a result, the OECD speculated that Japan's future planning efforts would need to focus upon a number of the effects of the moderated growth rate[90] and developing the economic and social framework of the nation. Accordingly, the OECD focused upon the following policy objectives, at least as they related to fiscal policies:[91]

1. A "reallocation of resources" to programs designed to promote welfare and improve the quality of life. Among the objectives cited were the improvement of health conditions; better living conditions, particularly housing; development of a system of permanent education funded

85. Spending on public works, which had the largest multiplier effects on GNP, were to stagnate in nominal terms and to decline substantially in volume. Overall, the percentage change in the volume of both public consumption and investment by the government decreased sharply in the 1974 fiscal year. *Id.* at 10.

86. *Id.* at 45. As a result of these policy changes, public expenditures on goods and services rose significantly during the last two quarters of the 1974 fiscal year. *Id.*

87. *Id.*

88. *Id.* Funds were to be allocated to the elderly, the physically and mentally handicapped and to fatherless families. Coupled with plans to improve health services and to develop medical research, the share of social security expenditures was to rise to 18.4 percent of total general account appropriations, compared with 16.9 percent in the 1974 fiscal year. *Id.*

89. Proposals were made to effect increases in certain indirect taxes, particularly on alcohol and tobacco.

90. *Id.* at 47-9. Moderate growth was anticipated for a number of reasons in the mid-1970's: dependence on imported energy and various other physical limiting factors, particularly the shortage of land for new industrial projects; a decrease in the amount of work hours to be contributed by the labor force, due in part to reductions in the average work week as well as a decrease in the number of new entrants to the work force; and an increase in the level of private consumption, resulting in a corresponding decrease in the level of savings and investment. *Id.*

91. *Id.* at 50-3. The objectives themselves were derived from a report made by MITI. *Id.*

by the government;[92] and more responsibilities in the public sector for social risks, signaling a need for more social transfer payments.[93]

2. Increases in public consumption, which would need to be funded in the budget process through an increase in taxes. Since taxation as a percentage of GNP in Japan was perceived to be quite low in comparison to other nations,[94] it was anticipated that significant tax reform would be necessary to generate the funds necessary for the government's public works and welfare projects. Moreover, steps would need to be taken to redeploy resources to those sectors, such as building and construction, where public investment projects were anticipated.

3. As the government began to assume a greater degree of responsibility for social risks, and the nation moved toward more consumptive and leisure activities, the level of household savings[95] was expected to decrease thereby making it more difficult for business enterprises to obtain funds. Moreover, pressures for wage increases, as well as higher energy costs, could be expected to lead to price increases. As such, fiscal policy would need to take into account the effect of inflation for some years to come.[96]

In summary, Japanese fiscal policy at the mid-point of the 1970's faced a very delicate set of issues. Demand management and inflation remained as key concerns, as they would for the balance of the decade and through the Second Oil Crisis. In addition, pressures were building for a more pro-active approach by the government to social welfare issues, as well as for aid to

92. *Id.* at 50. The OECD cited MITI's target of reducing the average work week in Japan to 35 hours by 1985, thereby creating a good deal more leisure time and changing the balance between consumption and investment spending. *Id.*

93. *Id.* at 50. Social transfer payments in Japan at that time accounted for only 20 percent of public expenditures. In 1973, social benefits accounted for almost 45 percent of public expenditures in France, 28 percent in the United States, 26 percent in the United Kingdom, 30 percent in the Federal Republic of Germany and 28 percent in Canada.

The inadequacies of the nation's pension system were also noted, particularly concerns regarding the amounts received upon retirement under then-existing employment practices. *Id.*

94. *Id.* at 53. In 1973 tax revenues including social security contributions were the equivalent of approximately 33 percent of GNP in the United Kingdom, 28 percent in the United States, 34 percent in Canada, 35 percent in France, 37 percent in the Federal Republic of Germany, and 29 percent in Italy, as against only 22 percent in Japan. *Id.*

95. The household savings ratio was exceptionally high in Japan when compared with that of the other OECD nations. The savings ratio of households, from 1953 to 1972, averaged 15.8 percent in Japan, greatly exceeding comparable rates in France, Germany, Italy, the United Kingdom and the United States, where the rate was eight percent.

96. Obviously, demand management policies would often contradict the pursuit of such medium-term objectives as an increase in the level of public investment. For example, the restrictive budget policies for the 1974 fiscal year did help to slow down inflationary pressures; however, the postponement of public investment did little to further the medium-term policies of the government.

research and development and education. Given the apparent additional need for tax reforms, Japanese fiscal policy appeared to be entering a period where income redistribution formed the background for any particular short-term policy decision.

D. *Fiscal Policies During the Late 1970's*

Despite the forecasts of moderate growth, real GNP growth in the last part of# the 1970's remained faster in Japan[97] than in most OECD nations. Moreover, unemployment also returned to the historically low levels of prior years. By 1979 the economy had successfully adjusted to the First Oil Crisis, with the steady expansion of domestic demand, a very low rate of inflation, a roughly balanced external position and improving labor market conditions. Even though inflationary pressures were to return with the Second Oil Crisis, external inflationary impulses were not exacerbated by domestic capacity problems, as was the case with the First Oil Crisis.

The actual conduct of fiscal policy from 1975 to the end of the decade was, in fact, quite active and expansionary,[98] which led to the creation of significant levels of government debt that remain with the nation to this day. Public consumption, which had been reduced substantially in the mid-1970's to cope with inflationary pressures, increased in each of the three years through 1978, and public investment also expanded rapidly in 1977 and 1978,[99] although the rate of increase of social security contributions actually decreased during that period. However, the onset of the Second Oil Crisis led the government toward a more restrictive stance[100] in the spring of 1979 in order to insure that inflationary pressures remained under control.

The first of a series of substantial increases in the amount of government bonds occurred in the 1975 fiscal year and was to continue through the end

97. OECD ECON. SURVEYS, JAPAN, July 1980, at 7 [hereinafter 1980 ECON. SURVEY]. Real GNP growth during this period approximated five percent per annum. *Id.*

98. *Id.* at 39. Although some upward revisions were made in tax rates, including increases in taxes on gasoline and jet fuels and the tightening of capital gains and various special allowances, total current receipts remained generally unchanged. The government also used tax policies to promote structural changes in industry, including a 10 percent investment tax credit on equipment and machinery when a firm belonging to industries officially designated as "structurally depressed" invested in other industries. The tax credit was only available for a limited period of time. *Id.* at 39-40.

99. *Id.* at 38-41. While central government general account expenditures were budgeted to expand less in the 1979 fiscal year than in the previous year, public works projects were expected to rise significantly. Overall, the general account deficit was projected to rise from 31.3 percent of total expenditures in the 1978 fiscal year to 39.6 percent in the 1979 fiscal year. Appropriations under the FILP were also expected to increase significantly, particularly in the housing area. *Id.*

100. *Id.* at 14. For example, the volume of public investment decelerated sharply from 18.3 percent in 1978 to 2.9 percent in 1979, and its contribution to real GNP growth amounted to only 0.4 percentage points compared with 1.0 and 1.6 percentage points in 1977 and 1978, respectively. *Id.*

of the decade.[101] As a result, by the 1979 fiscal year the amount of the government bond issues was equivalent to 35.4 percent of the general account expenditure and about 6.2 percent of the nation's GNP, one of the highest among the major OECD countries.[102] In line with historical practices, the major share of new issuances had been absorbed by the various financial institutions[103] and virtually all transactions have been negotiated between the government and a syndicate consisting of financial institutions and securities companies. While most of the new issuances were ten years in duration, some effort was made to begin to diversify the length of the maturities of the government bonds.[104]

While increases in government debt tended to raise concerns regarding the absorptive capacity of the economy, issuances up to the 1979 fiscal year did not cause significant increases in the interest rate structure in Japan. However, by 1979, expectations of rising interest rates began to be shared by various market participants and, as a result, the government experienced a good deal of difficulty in placing its bonds in that year. Moreover, bond prices collapsed in spite of significant intervention by the Trust Fund Bureau. As a result, it had become clear that the government would need to consider new strategies for further bond issuances in the future.[105]

The 1970's ended with the determination by the government to attempt to restore fiscal balance through restrictive budgetary practices and a number of administrative reforms. Although the planned level of central government general account expenditures for the 1980 fiscal year reflected the lowest level of annual growth since the 1960 fiscal year, public works expenditures were kept unchanged in nominal terms,[106] and the effective tax rates for households and corporations were to be raised slightly.[107] As a result, both

101. *Id.* at 40.

102. *Id.* While not strictly comparable, in 1978 the central government borrowing requirement, including treasury bills and loans, expressed as a percentage of GNP in the major OECD countries was as follows: United States (3.0), Japan (9.4), Germany (3.1), France (3.0) and the United Kingdom (5.9). *Id.*

103. *Id.* at 41. Since the 1975 fiscal year, and on a cumulative basis, around 70 percent of new government bond issuances were absorbed by financial institutions, principally the city banks, 12.5 percent by the Trust Fund Bureau and 17.5 percent by securities companies.

104. *Id.* For example, five-year discount bonds were issued since 1976, two- and three-year bonds since 1978, and four-year bonds were introduced in 1979. *Id.*

105. Among the issues to be considered were the degree to which the nation's banks should participate in the purchase of government bonds, particularly given the risk of large capital losses due to any fall in bond prices and the use of such alternative marketing programs as private placements to sell subsequent bond offerings.

106. *Id.* at 44.

107. *Id.* The rate of basic exemption for wage and salary incomes was to be reduced, the limit on tax-exempt reserves for retirement funds was to be lowered, the tax on electricity production which was used to finance the development of alternative energy sources was raised, and taxes on the sale of land purchased before 1969 was relaxed in order to promote the sale of residential sites. *Id.*

the deficit in the general account and the amount of the central government bond issues were reduced. Moreover, the administrative reforms were expected to induce an overall reduction in the central government activities over the next five years.[108]

E. Fiscal Policies During the 1980's

Japan was able to withstand the effects of the Second Oil Crisis and, on balance, the nation had better control over the rate of inflation and suffered no significant deceleration in the rate of real GNP growth.[109] Following the second oil crisis, the sizable levels of public sector debt, and the accompanying needs of government to undertake substantial borrowings, raised real concerns about the government's continuing ability to provide counter-cyclical assistance to the economy in the event that business activity slowed. Accordingly, management of budget finance became the key fiscal issue at the beginning of the decade. Japan's industrial policy responded by shifting resources from declining to emerging industry sectors.[110]

By 1980, very few of the trends anticipated in 1975 had come to pass with respect to the shift in savings and investment within Japan.[111] Japan continued to experience steady annual growth of GNP through 1979 and growth

108. *Id.* at 45. The plan, which was approved by the Cabinet in December 1979, was designed to achieve the following objectives: reducing the number of special-purpose public enterprises from 111 to 95; abolishing over 230 local branches and affiliated organizations of various ministries and agencies; restraining the net increase in the number of central government employees; systematically reducing the number of subsidies by at least 25 percent and rationalizing administrative operations.

109. *Id.* at 50-54. The demand management policies of the government were much less severe at the time of the Second Oil Crisis and the recessionary pressures were less onerous than those that persisted in the middle of the 1970's.

For a comparison of price developments in various OECD countries, see 1985 ECON. SURVEY, *supra* note 33, at 20. Consumer prices in Japan showed an average annual rate of change during 1967-72 of 5.8 percent, during 1972-78 of 11.4 percent and during 1978-84 of 3.8 percent, which compared to 4.9, 9.6 and 8.6 in all of the OECD countries during those same periods. *Id.*

110. 1980 ECON. SURVEY, *supra* note 97, at 49. While industrial restructuring was generally to be achieved through the market mechanism, and government initiatives were to be limited to areas requiring long lead times, large initial investments and the integration of research efforts amongst firms, certain tax policies were used to facilitate the movement of resources from those industries that either faced increased competition from newly industrialized countries or which were losing competitiveness due to higher energy costs. For example, the government implemented a number of measures to encouraged scrapping of excess capacities. Also, energy-conserving measures were to be facilitated through one time tax credits, a special depreciation allowance and a reduction in the real estate holding tax. *Id.*

111. *Id.* at 81-2. For example, social security expenditures grew only moderately during this period and while the savings of households and private non-profit institutions, expressed as a percentage of disposable income, fell from 20.7 percent in 1974 to 17.0 percent in 1978, the average level of savings for the period from 1975 to 1978 exceeded that of the four year period beginning in 1970 and ending with 1973. *Id.*

was expected to continue into the first five years of the 1980's.[112] It was expected that economic growth would reduce the level of public sector debt, which had reached as high as 7.9 percent of GNP for the 1978 fiscal year. Nonetheless, the amount of the government deficit remained a key issue at the beginning of the 1980's, particularly given the aforementioned concerns regarding the ability of the financial institutions to absorb further bond issuances.[113]

Budgets during the first part of the decade reflected the government's intention to reduce the large central government deficits[114] by limiting the growth of public expenditures and allowing relatively strong GNP growth to increase governmental revenues.[115] The value of public works projects continued to be reduced and the level of social security transfers rose slowly.[116] Tax increases were generally avoided, although rapid growth contributed to the increase in tax revenues. Dependence on direct taxes increased during the first part of the decade; direct taxes accounted for 73 percent of the total taxes in the central government's general account in the 1985 fiscal year, compared with 66 percent in the 1970 fiscal year.[117]

As a result of the government's policies, the deficit of the general government was reduced from 4.4 percent of GNP in the 1979 fiscal year to 3.0 percent in the 1983 fiscal year and the debt to GNP ratio was expected

112. 1985 ECON. SURVEY, *supra* note 33, at 7-12. In fact, strong expansion of export markets during the early part of the 1980's continued to stimulate economic activity and real GNP grew by 5.8 percent in 1984, the highest rate since 1979. Export volumes of goods and services on a national accounts basis rose by 18.1 percent in 1984, after only 4.7 percent in 1983, an increase that was attributable to a number of factors: a strong recovery of domestic demand in the United States that led to a demand for Japanese exports; major changes in the structure of output in Japan, which led to a significant drop in the nation's import propensity; oil and primary commodity prices became somewhat depressed; and exchange rate developments. *Id.* at 7-12, 39-40 & 78.

113. Among the concerns cited were those relating to the effect of government bond issuances on the overall interest rate structure in Japan, particularly in light of the then-current efforts to liberalize interest rate policies and disengage the activities of the nation's commercial banks from the directives of the government. Moreover, the effect of repeated government bond issuances on monetary policies were also uncertain which, given the need to manage exchange rate policies, also motivated the government toward management of the fiscal debt situation.

114. 1985 ECON. SURVEY, *supra* note 33, at 47-8.

115. *See id.* at 30. Revenues expanded at a much higher rate than expenditures during the early 1980's and the level of government issuances actually decreased from the prior year in each of 1983, 1984 and 1985. As a result, the amount of the bond issuance as a percentage of total expenditures decreased from 29.7 percent in 1982 to 22.2 percent in 1985. However, the amount of national bonds outstanding, as a percentage of GNP, continued to rise from 36.1 percent in 1982 to 42.3 percent in 1985. *Id.* at 30-1.

116. *Id.* at 31. The rate of year-to-year change in public works expenditures decreased from 2.3 percent in 1982 to -7.5 percent in 1985. With regard to social security, a similar decline occurred: 4.1 percent in 1982 to -1.1 percent in 1985. Also, expenditures under the FILP were to be reduced by 1.2 percent in the 1985 fiscal year, the first reduction since 1954, and loans to public financial institutions were to experience similar reductions. *Id.*

117. *Id.* at 30. As noted above, the percentage of direct taxes in 1964 was only 58.7 percent. With respect to the level of direct taxation in Japan, see *id.* at 30, 104 & 111.

to stabilize.[118] By the 1983 fiscal year, the general government deficit consisted of a large central government deficit, a much smaller local government deficit, and a substantial surplus on the social security funds.[119] Government fiscal policy was believed to be justified for a number of reasons: the perception that high levels of debt are contrary to the maintenance of "economic vitality;" the belief that the burden of accumulated debt is too heavy and; finally, concerns regarding the effects of an aging population upon future fiscal policy flexibility.

Japan's social security system presented a number of challenging issues, each of which set the stage for policy debates within and without the nation.[120] In the mid-1980's, social security charges were much higher than household income taxes and the expansion of health insurance and improvements in medical technology led to a large increase in health spending.[121] Due to concerns regarding the rise in public costs of medical care, the government moved to increase the patient's own contribution to medical costs in 1984, and further modifications of this type were expected to be implemented in the future.[122]

With respect to the availability of public pensions, concern focused not only on the future budgetary impact but also upon the effect on aggregate savings levels in Japan. Contributions and benefits under Japan's social security system are based on the amount of "monthly standard remuneration"[124] and, by 1986, the combined rate of social insurance charges exceeded 21 percent of the monthly standard remuneration, although the burden was shared equally by the employee and the employer.[124] The growth of the

118. *Id.* at 33 & 47.

119. *Id.* In 1983, the general government deficit consisted of a large central government deficit (five percent of GNP), a much smaller local government deficit (0.7 percent of GNP), and a substantial surplus on the social security funds (2.7 percent of GNP).

By 1986, the general government deficit had been reduced to 1.1 percent of GNP, a significant reduction from the 5.5 percent level that existed in 1978, and one of the lowest levels amongst OECD countries. However, the central government deficit stood at 3.1 percent of GNP and was balanced by the continuing surplus of 2.9 percent on the social security funds. *See* 1988 ECON. SURVEY *supra* note 26, at 33-5.

120. For a detailed summary of the development of the Japanese pension systems, see OECD ECON. SURVEYS, JAPAN, July 1983, at 55-59.

121. 1985 ECON. SURVEY, *supra* note 33, at 48.

122. *Id.*

123. *Id.* at 91. This measure broadly corresponds to contract wages, and excludes bonus payments, which typically constituted about 25 percent of cash earnings in the mid-1980's. *Id.*

124. *Id.* Non-government employees have contributions made to the Employees' Pension Insurance scheme and to the government medical insurance system, with the amount of contribution being shared by the employer and the employee.

For a description of the principal pension schemes that existed in Japan in 1985, see *id.* at 91-3. Pension schemes in Japan were established later in Japan than in most other OECD countries and the level of pensions did not increase to those in other countries until the early 1970's. Even so, public pensions provided 43.3 percent of the total income of the elderly by the mid-1980's, an amount which still did not remove the need to continue working. The aging population implies that the overall burden of social security benefits will rise to a level similar to that faced by European OECD countries. *Id.* at 83 n.35, & 91.

Japanese national pension system raised concerns that households would reduce their level of savings in anticipation of pension benefits and that the overall redistribution of income from the worker to the retiree would also depress the level of saving.[125]

Japan's pension systems are "funded," rather than "pay-as-you-go," and initially huge surpluses were built up in order to finance future liabilities. However, the basic calculations with respect to future funding of the social security systems were made at a time when few expected the sharp decreases in the growth of real income which were to occur as the economy began to mature. Although contributions continued to exceed expenditures for some period of years,[126] it was becoming clear that by the year 2000 the surplus would disappear, even if planned increases in the amount of the contribution rates were implemented.[127] As a result, the government made a number of reforms in the pension system in 1985, with the short-term effect of a significant rise in pension surpluses in 1985 and 1986.[128]

The attempts to control current budget deficits were linked to the government's efforts to manage the reduction in the amount of debt which had been created to offset the persistent deficits incurred after the First Oil Crisis. Once again, the nation's ratio of gross debt to GNP rose to a level exceeding that of any other major OECD country, other than Italy, although the level of net debt was lower due to the substantial amount of social security reserves.[129] In light of the foregoing, the government took the position that

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125. *Id.* at 91. For a description of the impact of Japan's social security system on the nation's overall fiscal position, see *id.* at 91-5.

The increase in the role of government was attributable, in large part, to the expansion of the welfare system. For example, by 1983, the level of total government spending in Japan (28.1 percent of GNP) was proportionally lower than both the United States (36.9 percent of GNP) and the larger European countries (46 percent of GNP); however, excluding defense expenditures, the difference between the United States and Japan was less marked, with transfers roughly equal to the same share of GNP in both nation. *Id.* at 93-94. Also, social security benefits as a percentage of national income rose from 6.0 percent in 1965 to 14.1 percent in 1982, and were expected to rise to 27 to 30 percent by 2010, when social security contributions as a percentage of nation income were to be between 19 and 21 percent. Still another issue was whether or not the increases in social security contributions would adversely affect the rate of growth of the economy. *Id.* at 95.

126. *Id.* at 50. In addition, interest was earned on the surplus funds, particularly through the investment of those funds in government bonds. *Id.*

127. *Id.* at 50.

128. *Id.* The full government pension due in the early 21st Century was to be reduced from over 60 percent of average cash earnings (*i.e.*, including bonuses) to a little over 50 percent and the "standard" contribution period was to be increased from 32 to 40 years.

The central government's contributions to the pension schemes were to be progressively restrained and consideration was to be given to raising the pensionable age from 60 to 65.

Finally, contribution rates were to be raised from 10.6 percent to 12.4 percent, effective in October 1985, and further projected increases were to lead to a contribution rate of 16.0 percent by the year 2000. *Id.*

129. *See id.* at 5 & 53. Outstanding long-term national bonds as a percentage of GNP for the 1984 fiscal year equalled 41 percent. *Id.* at 53.

new borrowing undertaken for investment purposes and financed by "construction bonds" was acceptable, while borrowing in order to finance consumption on a current basis was not.[130]

Debt reduction was undertaken in the context of the government's overall "privatization" program,[131] since it was initially intended that the proceeds realized from the sale of the government's interest in a number of public enterprises were to be used for the redemption of outstanding government bonds. Most of the traditional public enterprises in Japan incurred substantial losses and the tendency of the government from the mid-1970's into the early 1980's was to gradually reduce the amount of current investment and total borrowing with respect to the public sector.[132] Moreover, perceived inefficiencies in these public corporations and the desire to create more competition in those industrial sectors in which the public enterprises operated led to privatization and deregulation in a number of key areas in the mid-1980's.[133]

Japan's efforts to control its fiscal imbalances were complicated by a number of demands from the nation's trading partners to stimulate domestic demand and liberalize the nation's markets for imported goods. At the same time, domestic constituencies urged that the nation adopt a number of

130. *Id.* at 47. In 1983, the government announced its intention to end the issuance of deficit-financing bonds by the 1990 fiscal year. Current expenditures of the general government, as a percentage of GDP, in 1983 in Japan were 10.2 percent, which compared to 19.3 percent in the United States and over 20 percent in a number of OECD nations. *Id.*

131. *Id.* at 32. As of 1985, the government had announced a number of measures with respect to privatizing various public enterprises.

The operation of the tobacco monopoly was changed in April 1985 and the government also announced at that time its intention to sell shares of the Nippon Telegraph and Telephone company (NTT), the state-owned domestic telephone and telecommunication company. The intent was to use the proceeds for these sales to redeem outstanding government debt, although the government would retain one-third of the company's new assets and continue to regulate fees, although without Diet approval. *Id.* at 32-33.

132. In the mid-1970's, public enterprises' investment amounted to over three percent of GNP. *Id.* at 50. By the 1983 fiscal year, it had been reduced to 2.3 percent. *Id.* at 112.

133. See 1988 ECON. SURVEY, *supra* note 26, at 81-96 for a detailed discussion of the various issues relating to privatization and deregulation of Japan's major public corporations, particularly in the areas of telecommunications and transport.

It is noted that reforming the major public corporations has been an important element of structural adjustments during the 1980's, given that such corporations have been beset by inefficient management, deteriorating services and continuous price increases. Privatization also facilitates fiscal consolidation, since the process would reduce governmental budget deficits and provide an immediate source of funds for the redemption of outstanding government bonds. *Id.* at 84-5.

Major privatization efforts have been initiated with respect to NTT, Japan National Railways, Japan Air Lines and the Japan Tobacco Inc. The degree of privatization has differed significantly from case to case, with the government retaining a good deal of influence over pricing and the management of the resultant private firms. *Id.* at 95.

sweeping social and welfare reforms.[134] For example, the initial budget for the 1987 fiscal year was designed to effect further financial reconstruction; however, weak growth prospects and the high level of external surplus led not only to the announcement of a major increase in public investment, but also to a reduction in taxes in the household sector.[135] As a result, the OECD characterized Japanese fiscal policies as "broadly expansionary" in the 1987 fiscal year.[136]

The initial central government budget for the 1988 fiscal year continued the trend of increased levels of public works spending[137] while the budget deficit was expected to fall due to the growth in the amount of tax revenues.[138] As a result, it was expected that the ratio of outstanding national bonds to GNP would be reduced for the first time since 1971.[139] Moreover, stronger revenue growth and the sale of public sector assets in the next few years were expected to lead to the elimination of deficit-financing bonds by 1990.[140] The nation's fiscal policies were characterized by the OECD as appropriately "neutral" for the 1988 fiscal year[141] and authorities were urged to consider further structural reforms, particularly taxes,[142] which would further medium-term objectives of fiscal consolidation and the expansion of domestic demand.

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134. 1985 ECON. SURVEY, *supra* note 33, at 53-4. For example, the OECD referred to the nation's own Okita Report, which suggested that domestic demand be stimulated by simplifying regulations that stifle market forces; wider introduction of the five-day working week; increasing investment in the social infrastructure, encouraging private sector participation wherever possible; and reviewing the tax system in order to achieve a better balance among savings, consumption and investment. *Id.* at 54.

135. 1988 ECON. SURVEY, *supra* note 26, at 36.

136. *Id.*

137. *Id.* at 37. The OECD projected that total public works expenditures would rise by 1.4 percent in the 1988 fiscal year, including interest-free loans for public works financed from the proceeds of sales of NTT shares to the public; higher local government expenditures on investment projects that enjoy subsidies from central government; and FILP expenditures for public investment.

Total public works expenditures are the aggregate public works controllable by the central government, which consists of ordinary public works of central government plus subsidized ordinary public works of local government plus public-works related expenditures by public corporations, part of which are financed by the FILP. Public works loans often take the form of interest-free loans which are to be repaid in 5 to 20 years from the project's profits. *Id.* at 109-11.

138. *Id.* at 39.

139. *Id.* at 38-9.

140. *Id.* at 36. Central government bonds outstanding amounted to nearly 50 percent of GNP and gross interest payments were 19.8 percent of total budget expenditures, based on budget estimates for the 1988 fiscal year. *Id.* 36-7.

141. *Id.* at 39. High levels of public investment in the 1988 fiscal year were expected to come from increases in total FILP investment (6.8 percent) and investment in the Local Finance Plan (11 percent).

On a general government basis, net government borrowing was projected to be between 0.3 to 0.4 percent of GNP in 1988 and 1989. *Id.*

142. The government discussed the prospect of introducing a broadly-based indirect tax to finance another cut in income taxes. *Id.* at 39.

IV. DISTINGUISHING FEATURES OF POST-WAR JAPANESE FISCAL POLICIES

In the previous section an effort was made to analyze the various aspects of Japan's fiscal policies since the period of post-War growth and modernization begun in the early 1950's. In this section, we use the results of that analysis to identify some of the distinguishing features of fiscal policy analysis, and the issues that may occupy fiscal policymakers in Japan, in the years to come. In particular, it would appear that the following elements are important to an overall understanding of the topic:

The Size of Governmental Activities. A great deal of debate continues regarding the proper size of the central government in a given national economy. Typical measures of the amount of governmental intrusion include calculating governmental revenues, expenditures and the resultant surplus/deficit as a percentage of the nation's overall GNP. A far more intangible measure would be the degree to which governmental regulations and policies effect the day-to-day commercial decisions of private firms and individuals. By most quantitative measures, the size of government in Japan has remained small during the post-War period; however, there can be little doubt regarding the government influence in key economic functions: planning, credit allocation and interest rate management, and the provision of key services through the various public enterprises.

Resource Allocation and Redeployment. The most striking element of Japan's fiscal activities during the post-War period was the degree to which the government facilitated the allocation of financial resources between savings and investment. In doing so, the government often substituted its own judgment for that of the marketplace, identifying and encouraging what it perceived to be the most important industries for long-term development and self-sufficiency. Moreover, in addition to the financial aid and assistance provided by the government, in the form of both direct grants and loans, a number of specific measures were taken with respect to various national "issues" and concerns, including some of the following policies in the areas of public enterprises, agricultural supports, the adjustment of depressed industries and support to new areas and, finally, assistance with respect to research and development activities:

1. Japan chose to provide a number of essential services through so-called public enterprises, including telephone and telegraph, railways and various other forms of transportation. Moreover, the creation and use of various development banks and financial institutions provided additional opportunities for government intervention in the marketplace.

2. Support prices were used in the agricultural area, particularly with respect to rice, to maintain parity between the growth of agricultural

incomes and the rapidly growing incomes in the manufacturing sector. Supports have been maintained for a number of non-economic reasons, particularly in the face of rising surpluses of stock and changing habits of dietary consumption. Among the reasons cited are the national objective of maintaining an overall self-sufficiency ratio of 70 percent, preserving the rural environment and society and, finally, the political leverage of the farming lobby. Agricultural supports required a state monopsonist which bought and sold domestic and imported foodstuffs, with consumers bearing the burden of higher prices. Nonetheless, government expenditures on agricultural supports have caused concerns from a fiscal perspective, and efforts to enhance productivity have run into a number of structural problems.[143]

3. The government's efforts to assist in the reallocation of resources from those industries which had lost their competitiveness were seen as a desirable alternative to widespread unemployment and the resultant increased burden on the nation's public financial resources. Japanese employment practices supported the accomplishment of the necessary adjustments without laying off regular employees. Among the measures utilized were the establishment of targets for scrapping existing excess equipment, diversion of resources to new activities and the development of new facilities; a special credit guarantee fund established by the Japan Development Bank and the private sector to make loan guarantees with respect to resource reallocation activities; and cooperative "arrangements," or cartels, for the disposal of excess capacities.[144]

4. Government policies promoted the development of technology and new industries in Japan, primarily by developing and disseminating a consensus regarding the direction of future economic development. Specific policy measures have included such things as providing conditional loans for the development costs of new machinery, measures designed to establish a strong domestic market position prior to entering foreign markets, pooling of public and private research and development efforts on basis research projects with the results being available for commercial application through the market process, and the use of "framework" policies: educational policies with a strong emphasis on engineering and "smart worker" skills; cooperative research and development laboratories, partly financed by public funds,

143. 1985 ECON. SURVEY, *supra* note 33, 59-64.
144. *Id.* at 64-71.

for diffusing new skills and technologies to smaller firms;[145] and industrial standardization and other measures designed to accelerate the rate of private fixed investment in research and development.[146]

Government Expenditures. Public finance activities in Japan have shown a clear preference for investment funding, rather than current consumption. As a result, the level of direct government expenditures in Japan, as a percentage of GNP, is much lower than in other industrialized nations, particularly those which expend amounts on maintaining a large defense capability. The apparent emphasis on investment activities creates the opportunity for greater long-term growth; however, it would appear that a number of future issues are presented by the desire to reduce overall savings, which actually provides the funding for the investment activities of the government, in favor of current consumption.

Income Redistribution. Like every industrialized nation, Japan's policies with regard to horizontal and vertical income transfers present a number of economic and social issues. For the balance of the post-War period, social security contributions have far exceeded the fund's obligations and the fund has provided a ready source of assets for the investment activity of the government. However, it is necessary for the government to consider the degree of social services, in the form of pensions and health insurance, that will be available to citizens and the manner in which the cost of those obligations will be allocated amongst the state and various income groups.

Economic Stabilization. The economic stabilization function of government finance has previously been noted and it is clear that Japan and each of the OECD nations have attempted to utilize fiscal policies to offset recessionary and inflationary pressures within the economy. Japan has, from the mid-1950's, shown a bias toward policies designed to mitigate unemployment and unused capacities, even at the risk of exacerbating any underlying inflationary tendencies. However, economic stabilization policy has been conducted in the context of rapid domestic and export growth far in excess of that achieved by other industrialized nations. Future policies must take into account any changes that might be required by slower growth, either through the contraction of export opportunities or an internal shift away from investment and toward current consumption.

Savings and Investment. Given the government's primary focus upon resource allocation within the economy, it should come as little surprise that Japan's policies with regard to savings and investment have few peers amongst developed economies, even though the nation has not lacked for

145. *Id.* at 86. Interestingly, in marked contrast to other OECD nations, public research and development subsidies in Japan go mainly to low-technology industries where the small scale and limited profitability of firms constrains their own ability to invest in new technologies. *Id.* at 86 n.68

146. *Id.* at 71-7.

opportunities for domestic consumption in recent years. Levels of both public and private savings and investment in Japan have remained extremely high in the years following the War, partly as a result of artfully formulated policies designed to encourage private savings and investment.

Tax Policy Measures. The revenue creation goals of Japanese policymakers increasing production in those industries perceived to be important to the nation's overall competitiveness. As such, Japanese tax policies can provide policymakers in other nations with a good number of ideas with regard to structuring a framework which best suits the needs of the nation's development objectives. It would appear that some, if not all, of the following factors should be considered:

1. Personal savings were promoted by the exemptions granted for small amounts of property income and the taxation of other property income at low rates. For example, interest income from savings deposits, government bonds and postal savings up to a given principal value were exempted from tax and interest from specified workers' savings accounts was also not taxable up to a given principal value. In addition, Japanese tax laws permitted taxpayers to elect to be taxed separately on their interest and dividends at a specified flat rate.

2. Capital gains from the sale of securities were the subject of a complete exemption from taxation, unless the taxpayer was engaged in continuous trading, and separate rates also applied to capital gains arising from the sale of land or buildings, although even in those cases separate deductions were available.

3. Tax advantages with respect to the ownership of housing have taken the form of tax credits. Credit is given for amounts saved pursuant to special contracts with any financial institution to be applied toward the purchase of a home and also for an amount equal to a small percentage of the purchase price of a home. Additional deductions are available for the cost of certain premiums on insurance available for homeowners.

4. Business saving and investment were encouraged through accelerated depreciation, increased allowances for the initial depreciation amount, tax-free reserves,[147] and tax credits. These measures were used to

147. Tax-free reserves were of two types. First, reserves were recognized for purposes of business accounting; second, reserves were permitted in order to encourage involvement in risky activities. The tax-free accounting reserves included reserves for bad debts, accounts receivable, bonuses payable to employees and employee retirement allowances. The special measures included tax-free reserves for losses in market prices of inventories or securities; losses incurred in the development of natural resources, structural improvement projects for small- and medium-sized enterprises and construction of designated facilities; and losses caused by the repurchases of computers and by guarantees of the quality of computer programs. *See* Ackley, *supra* note 25, at 356.

promote specific industries and certain firms, including small- and medium-sized businesses.

5. Tax credits were used to encourage increases in the level of research and development expenses,[148] although the overall amount of the credit was limited to a specified percentage of corporate income taxes for that year.

6. Interestingly, tax measures directed at the promotion of export and foreign investment activities have been significantly reduced over the years. From 1953 to 1965, producers of exported goods were permitted to deduct three percent of their gross sales abroad, up to 80 percent of their net operating income from exports. However, this provision was repealed due to the fact that it violated GATT regulations against export subsidies. However, from 1961 to 1972, firms were permitted accelerated depreciation for their equipment if they raised the proportion of their business from exports over the previous year's level. After that time, inducements appear to have been limited to special deductions for transactions involving the provision of overseas services, tax-free reserves for overseas market development by firms active in the export area, and tax-free reserves for losses from overseas investments.

Studies regarding the overall effect of the various tax policies are inconclusive and analysts appear to have difficulty in relating tax policies to a given level of public and private investment. However, in 1972 it appears that special measures to promote individual saving and investment accounted for 40 percent of the perceived revenue loss to the government, business saving and investment accounted for 34 percent, exports and foreign investment for three percent and other measures, mainly a deduction for physicians' fees,[149] for 23 percent of the revenue loss.[150]

Deficit Management. Like almost all of the OECD nations, Japan has been confronted with increase in central government indebtedness. Government debt creates concerns regarding the ability of the economy to absorb

148. For example, if a firm's outlays for research and development in any year exceeded its outlays in any previous year, 25 percent of the excess is allowed as a tax credit and the credit would be raised to 50 percent of the portion of the excess above 15 percent of the amount spent in the previous "peak" year.

149. To offset the low levels at which their fees were set under the social insurance system, physicians may deduct 72 percent of their fees for medical care provided.

150. See Ackley, *supra* note 25, at 357-61 for a discussion of the use of various tax incentives in Japan, as well as their impact on total revenue to the government. See also *id.* at 371-2 for a discussion of the overall effect of Japanese tax policies where it is noted that many of Japan's tax policies, such as annual reductions and modifications to concessions and preferences, are not transferable to other countries. Ackley also suggested that Japan might be better off with a broader tax base and lower nominal rates, a theme that continues to this day in the debate regarding inequities in the tax system.

government bond issuances and the creation of a structural obligation with respect to interest payments on outstanding debt. As a result, Japan has made deficit reduction a key objective of fiscal policies during the last decade, a stance which has often been at variance with other perceived medium-term objectives that would create a number of additional fiscal obligations with respect to the government.

Budgetary Process and Execution. The final element of the fiscal policies in Japan is the budgetary process itself, and the role such policies plays in the overall market process in Japan. Like many elements of Japanese industrial policies, the development of fiscal policy is a consultative process involving the various ministries, the powerful bureaucracy and leaders of private industry. Moreover, an effort is made to coordinate fiscal policies with the nation's overall monetary and trade policies, thus insuring coordinated and flexible execution of specific taxation and expenditure measures. Also, an effort is made to provide administrative guidance and rational expectations to the private sector through pre-announcement of the government spending objectives.

Clearly, in light of the multitude of factors that have contributed to Japan's economic success during the post-War era, it is difficult to attach a specific value to the aforementioned characteristics of Japanese fiscal policy. Similarly, it is difficult to isolate future economic issues within Japan that can be addressed solely as a matter of fiscal policy. However, it seems that the following issues must be borne in mind:

Welfare, Living Conditions and Pensions. The complex issues regarding social welfare and income distribution which are about to confront Japan will create debate and tension across the full spectrum of economic, social and political arenas within and outside of Japan. It is evident that many of the same "welfare state" concerns confronting the United States and Western Europe will, in some form, occupy Japanese policymakers in the near future. Specifically, social security funds will no longer be available to fund current investment and the need to insure that pension obligations are properly funded will modify existing savings and investment functions in both the public and private sectors.[151]

Forces within Japan, as well as a number of Japan's trading partners, have argued that the government's fiscal policies must insure that adequate funding is available for public works and housing projects which "improve" the current standard of living. If implemented, it is possible that fiscal expenditures would take a decided shift away from investment toward

151. Some analysts believe that rising retirement rates in the early parts of the next century, with accompanying calls upon existing savings, will result in up to a 50 percent reduction in Japan's traditionally high savings rates. L. Richman, *The Coming World Labor Shortage*, FORTUNE, April 9, 1990, at 70-1. The use of the elderly, as well as working mothers, in the work force in the coming years will be a key social and economic issue and will create additional demands upon the nation's fiscal structure.

current consumption, a process that will significantly increase the difficulty in achieving the government's announced intention to significantly reduce the pre-existing levels of public indebtedness.

Demand Management and Consumer Rights. The fiscal policies of the government have traditionally been very active in the management of domestic demand. Moreover, a number of other industrial policies have been used to intervene in the domestic pricing mechanism, each of which has been designed to either maximize the competitiveness of domestic firms in the export arena or to subsidize activities of various sectors deemed to be important to the national interest, such as agriculture and the other enterprises managed by the government as public corporations.

A good deal of pressure has been exerted upon the Japanese to "liberalize" their domestic markets, many of which have been effectively closed to imported goods through a complex set of non-tariff trade barriers, including impediments in the nation's distribution system, certification standards and in the pricing practices of domestic firms and their suppliers. The government has been asked to consider "expansionary" fiscal policies to create demand for imported goods, even at the expense of deficit budgeting. If implemented, these measures would take the form of tax reductions, government spending and, most importantly, a number of regulatory actions designed to facilitate access to domestic markets.[152]

Tax Reform. Tax reform appears to be another priority for Japanese policymakers in the new decade. In many ways, the present tax system is perceived to be unbalanced and inequitable, with a relatively heavy tax burden on wage earners and significant exemptions being available for unearned income. Moreover, the indirect tax base is very narrow, suggesting that a broader base and lower rates would be fairer and more efficient. The present arrangements regarding taxation of land designated as agricultural in urban areas. At present, owners are granted special tax treatment, making it more attractive to hold such land than to hold financial assets.

152. For example, modifications have been promised with respect to the implementation of the nation's laws regarding retail stores. Also, the government has committed itself to a more aggressive enforcement stance with regard to the nation's antitrust laws, as well as the elimination of tariff and import restrictions in a number of agricultural areas.

There has been a decided shift in Japanese growth patterns toward consumer spending. As a result, Japanese firms are rapidly increasing their own savings, in the form of capital investment, to levels almost twice that of their competitors in the United States. In particular, the private sector is taking the initiative to invest substantial amounts in research and development and new products, thereby complementing any overall specifications of government policy in that area. Investment of this type, aimed at increasing productivity, also addresses social issued raised by labor shortages and gaps in retaining of working, both of which are often the subject of fiscal policy measures in developed nations. *Id.* at 71.

V. CONCLUSION

In this paper, we have attempted to present and analyze some of the more important aspects of Japanese fiscal policies since the end of the World War II. In many instances, the experience and policy measures of the Japanese are unique to their particular stage of economic development and, in large part, are not subject to easy adaptation by other nations.[153] However, the framework developed in this section, which utilized our analysis of Japan, should aid the reader in making a complete and thorough review of a number of important issues which confront government planners in both the industrialized nations and in those nations which might seek to emulate the economic growth experience of the Japanese.[154]

153. Moreover, the economic success of Japan has thrust upon the nation a number of new issues that have historically been reserved for industrialized and developed nations, such as income redistribution and "consumer rights". The most interesting economic issues of the new decade relate to the manner in which the Japanese deal with these issues, particularly since they clearly do not inted to mindlessly emulate the policies of the United States and Western Europe. Also, outside analysis of Japanese policies in this regard remain difficult and it is worth noting that such independent studies as those published by the OECD have consistently been incorrect with regard to the timing and direction of specific Japanese policy shifts in the fiscal and monetary areas.

154. In fact, an appropriate additional study would be to examine the fiscal policies of the other emerging East Asian nations, such as Korea, Taiwan and Singapore, in light of such matters as the budgetary and planning process, the resource allocation function, the income redistribution function, tax policies and incentives and the management of public debt.