

Chapter 1: Fiscal and Monetary Policies before and after the First Oil Crisis

Section 1 Fiscal policy

1 Fiscal Policy before the First Oil Crisis

External Economic Issues and Countermeasures against Recession. Until the FY1971 budget was compiled, fiscal management had been going relatively well, riding on the strength of high economic growth. However, fiscal authorities were suddenly confronted with a critical situation at the stage of budget implementation, because of various issues at home and abroad. As a result, after the Nixon Shock in August 1971, fiscal authorities concentrated their efforts on eliminating economic unrest and stimulating recovery from the recession.

The compilation of the FY1972 budget was accompanied by various unusual challenges, because of many issues that occurred at home and abroad before and after the budget request deadline at the end of August 1971. More specifically, the Japan Socialist Party gained substantial seats in the ninth election of the House of Councilors in June, as they successfully criticized the government for failures in welfare and pollution policies. Moreover, Okinawa promotion measures were recognized as being an urgent matter because negotiations for the reversion of Okinawa to Japan from the US were in the final stages. Furthermore, even after budget requests were made by the ministries, additional measures were still required to overcome the recession which had been brought about by the “Nixon Shock”, or the shift to a floating exchange rate system. Due to the result of the House of Councilors election, the compilation of the FY1972 budget faced many problems which could only be solved by social security measures, such as the enhancement of social security for the elderly, the reduction of medical expenses for the elderly by infusing public funds, the increase of welfare annuities for the elderly, the increase of medical service fees and introduction of fixed-rate grants for national health insurance.

In addition, as regards public works, a substantial budget increase for road works, caused by full implementation of the automobile weight tax, was an important problem, while other issues like the fourth defense power improvement program and an increase in subsidies for Japanese National Railways still needed to be handled. Meanwhile, the revenue policy of issuing a large amount of government bonds was decided upon, to secure fiscal resources for the implementation of planned policies and measures to stimulate the economy. Then a new question arose as to whether or not the issuance of government bonds should be expanded to include the issuance of special deficit-financing bonds.

While the Fiscal System Council accepted the large amount of bond issuance in its proposal in December 1971, the council required the government to abide by the principle of construction bonds (the principle of allowing the government to issue only capital investment financing bonds) and the principle of prohibiting bond subscription by the government. In its proposal, the council also advised that tax-cuts should be implemented carefully and from a long-term point of view. Under the circumstances, the government decided to expand the size of the budget and issue 1.95 trillion yen in construction bonds, in order to respond quickly to the new international economic developments caused by the currency adjustment, based on a policy of seeking to overcome the economic stagnation and promote national welfare. Therefore, the budget draft of the government in FY1972 contained an increase in public works and the introduction of various measures related to social security, such as free medical care for the elderly. Consequently, the General Account Expenditure increased by 21.8%, the highest increase since FY1966, from the previous year to 11.4677 trillion yen.

In the course of the FY 1972 budget implementation, in May the government set the target ratio for the progress of public works for the first half of the year at 72.4%, to implement the budget effectively. This action was taken as a countermeasure to the delay of the Diet's approval of the budget, and after the government had had to compile a one-month provisional budget. The practical purpose of this action was to make up for the delay in the implementation of measures to stimulate the economy. In addition, as external economic emergency measures, the government cut the official discount rate substantially and increased the Fiscal Investment and Loan Program (FILP). To wrap up this series of economic policies, the "Promotion of External Economic Policy" (the third program for yen) including the promotion of imports and the adjustment of exports by the liberalization and tariff reduction was decided upon, and the FY1972 supplementary budget featuring public investments for economic measures like the initial budget was compiled and approved by the Diet on November 13.

Aggressive Large Budget in the Mood of Revamping Japan. Unlike the previous year, in which the government had continued to struggle with recession and external economic problems, Japan's economy returned to a moderate recovery path, mainly due to domestic demand at the beginning of FY1973, and the economy showed a steady recovery from the autumn of the year onward. Mr. Kakuei Tanaka took over the Cabinet from Mr. Eisaku Sato, and showed his intention to realize aggressive economic policies through the FY1973 budget. The ministries were allowed to submit additional budget requests until the end of September, while budget requests usually had to be submitted

by the end of August in ordinary years. Consequently, the total amount of budget requests for public investments increased by 38.0%, as compared to the previous year. Among other public investments, investments in facilities for improving living environments increased by 82.3%, and expenditures on measures for housing increased by 56.9%, respectively, compared to the previous year. In short, budget requests from the ministries for budget compilation were very aggressive compared with those in ordinary years, because the newly formed Cabinet clearly intended to revamp Japan. The fourth defense power improvement program (FY1972-1976), which had been a pending problem, was approved by the Cabinet in October 1972.

The FY1973 budget draft which was compiled under these circumstances was a large-scale and aggressive one. In the draft, the General Account Expenditure increased by 24.6% compared to the previous year, a higher growth rate than that in FY1972. As for respective expenditure items, expenditure on social welfare increased considerably, within the expenditure on social security. Among other matters, the government placed much importance on the expansion of the free medical service for the elderly, the increase in expenditure on the management nursing homes and the increase in home helpers. In addition, the government promoted improving the pension system, securing finances for national health insurance and expanding the coverage of child-care allowances.

Despite the mood created by the idea of revamping Japan, the growth rate of expenditure on public works was relatively low in the Finance Ministry's original budget draft, but the expenditure increased in the process of negotiations between the MOF and the ministries. On the other hand, the overall expenditure on environmental protection and dealing with environmental pollution was increased by 61.7%, as compared to the previous year, because measures for the prevention of air and water pollution, the development of pollution control technology and the relief of pollution sufferers were enhanced further. On the revenue side, a significant automatic increase of tax revenue was expected, and the revenue from bond issuance was increased by 390 billion yen over the year to 2.34 trillion yen.

Regarding the evaluation of this large-scale and aggressive budget, some critics insist that compiling such a budget was not justified from the view point of price stability, because the price of goods and land were obviously rising. Some people also thought a tightening policy would have been adequate at the time. On the other hand, some point out that the government may have intended to calm down the international opinion that required yen appreciation, by slowing down the increase in exports by raising domestic prices somewhat relative to international prices, as fiscal measures

were expected for economic recovery by the business world, and some people had anticipated controlled inflation in order to avoid the further appreciation of yen at the time.

In FY1973 the government had to deal with new problems that came up at the beginning of the year while implementing measures in the budget for revamping Japan. Although Prime Minister Tanaka pledged to make efforts against a further appreciation of the yen in his administrative policy speech in the Diet on January 26, 1973, the yen's exchange rate against the dollar began to surge after the introduction of the floating exchange rate system. Besides, in 1973 wholesale prices soared from the beginning of the year, and consumer prices followed the same trend a little later. In addition, signs that indicated the overheating of the economy could be seen, while investment in plants and equipment increased further. In response to this situation, the government launched a flexible implementation of public works after the passage of the FY1973 provisional and principal budget, in order to show its intention to control economic overheating. As for public works, the government set the target of keeping the concluded contracts within 60% of all projects in the first half of the budget year, and then lowered the target to 50% in June. However, private companies' willingness to invest was still very strong, although the government squeezed or postponed public investment. Import prices continued to go up in spite of the yen appreciation, and the rise of wholesale prices accelerated. In the meantime, the Bank of Japan raised the official discount rate gradually on April 2, May 30, July 2, and August 29. These were the circumstances under which the first Oil Crisis occurred in October.

Fiscal Measures of the Inaugural Year of Japanese Welfare. The economic growth after WWII had clearly made a great contribution to the improvement of national welfare. However, people recognized that economic growth did not always support an increase of welfare when a period of high economic growth was coming to an end. It was true that full-employment had almost been realized and that standards of living had increased significantly due to rapid economic growth, but various issues including environmental damage, overpopulation and congestion in large cities and the collapse of local communities had also emerged. Therefore, the government was required to play a more active role in resource allocation and income redistribution, and people called for more efforts from the government to promote national welfare.

Under the above circumstances, the growth rate (28.8%) of the budget for social security in FY1973 was the highest in ten years and the amount of the social security budget reached two trillion yen for the first time. Looking at the breakdown, there was a

significant increase in expenditure on social welfare, mainly for medical and welfare service to the elderly, and expenditure on social insurance, mainly for the improvement of the pension system.

The reason why the FY1973 budget was called the “Budget to overcome the trilemma” was that the budget was expected to realize conflicting goals: namely, to establish an equilibrium in the balance of payments (correction of trade surplus), to ensure stability of prices, and to improve welfare. At first, the Ministry of Finance started compiling the budget based on the view that it would not be impossible to achieve these three conflicting goals at the same time. This was because economic structural reform like import liberalization was possible only in terms of an international trade issue, and the measures for promoting national welfare were expected to contribute to solving the problem of trade surplus. In other words, it was thought that the problems could be solved by diversified operations of fiscal and monetary policies and comprehensive price policy, including measures for price stability. However, this expectation was shattered by the first Oil Crisis, which occurred at the stage of the FY1973 budget implementation. Therefore, the government had to place its highest priority on the containment of overall demand and price stability through a comprehensive price policy, including emergency countermeasures for oil prices, deferment of government spending, the compilation of the FY1973 supplementary budget, and the compilation of the FY1974 budget, as described below.

2 Fiscal Policy after the First Oil Crisis

Supplementary Budget Aiming to Restrain Overall Demand. In order to tackle the serious effects arising from the first Oil Crisis, the government took measures like the strengthening of demand squeeze, the control of public utility charges, securing of daily essentials and stabilization of prices, based on its “Outline of emergency oil measures” and “Immediate emergency measures” decided upon on November 16 and December 22, 1973, respectively. Four more measures for additional expenditure, through the fiscal investment and loan program (FILP) and the compilation of the FY1973 supplementary budget, etc., were put into practice as fiscal measures, although most of these measures could be regarded as passive ones to the rise of price and wages. The FY1973 supplementary budget approved on December 14 was a large one, and it amounted to 989 billion yen, which was equivalent to 6.9% of the FY1973 initial budget. On the expenditure side, the increase from the initial budget including spending on wage increases for public workers amounted to 1.2017 trillion yen, while some expenditure

was cut by 213 billion yen. On the revenue side, the increase, which mainly consisted of tax revenue, amounted to 1.5185 trillion yen, while national debt servicing was cut by 530 billion yen. In short, about 70% of the revenue increase was allocated to the increase of expenditure, and about 30% was provided by the reduction of national debt service. As is symbolized by this 530 billion yen cut of the national debt service, the FY1973 supplementary budget directly reflected the steep rise of nominal growth rates and prices. The revenue reflected a considerable increase in tax revenues while the increase in expenditure mainly consisted of wage increases for public workers. Hence, the policy intention of prioritizing demand restraint and price stability was maintained.

The Austere Budget of FY1974. At the beginning of the FY1974 budget compilation, the Cabinet decided in July 1973 that the budget request should be limited to within a 25% increase (ceiling) over the previous year as before. As the FY1974 budget was destined to be an austere one, a reduction in the budget size and the bond dependency ratio were discussed. More specifically, the restraint of public works and the promotion of social security measures became specific issues to be dealt with. Furthermore, the first Oil Crisis encouraged the government to take strong measures to contain overall demand both on the fiscal and monetary fronts. Consequently, the growth rate of expenditure on public works was maintained at zero percent compared to the previous year.

Minister of Finance Takeo Fukuda, who succeeded to the post after his predecessor Mr. Kiichi Aichi died suddenly on November 23, 1973, said in his financial policy speech, “In order to attain price stability, it is essential to restrain overall demand, above all other matters. Therefore, the government will concentrate its efforts on this one objective when it carries out fiscal and monetary measures.” As a result, in the FY 1947 budget draft, the General Account Expenditure amounted to 18.0 trillion yen and the growth rate remained 19.7% over the previous year, which was much lower than the growth rate (24.6%) in the previous year. Specifically, expenditure related to public works was contained to less than the amount in the FY1973 initial budget, while the budget was sufficiently allocated to housing and living environment facilities from the view point of improving national welfare. Regarding the increased items, most noticeably there was a record-high growth rate of 36.7% for expenditure related to social security, which exceeded the growth rate in FY1973 and became the highest in the stable growth period, except for the rapid expenditure growth for mandatory increase and the local allocation tax grants. The substantial increase in expenditure on social security was regarded as consistent with predetermined policy because the

government had already showed its intention to maintain the social security budget by improvement of the pension system and increasing child-care allowance in FY1973. As a new systemic revision, the increase in benefits for the senior welfare annuity and the fatherless family welfare annuity, and the extension of the coverage of the child-care allowance were realized. Meanwhile, on the revenue front, the amount of government bond issuance was compressed at 2.2 trillion yen, and consequently the bond dependency rate was reduced.

The implementation of the FY1974 budget started at a restrained pace in the first half of the year. The government first compiled a provisional budget for ten days. Then the Cabinet decided to restrain the contract rate at a little over 20% in the first quarter, in the Cabinet approval of the restraint of budget execution. The effect of these measures appeared as stability in prices by the middle of the year. However, the Cabinet decided to maintain the policy of overall demand restraint, because the underlying demand remained strong. Although this restraining of fiscal management was recognized as an adequate policy when the prices soared and continued to rise after the first Oil Shock, the problem became an issue of timing as to when the price restraining policies, including monetary policy such as discount rate hikes, should be terminated.

From Austerity to Expansion. Immediately after the 10th election of House of Councilors on July 7, 1974, Deputy Prime Minister Takeo Miki criticized the political attitude of Prime Minister Kakuei Tanaka and resigned from his position. This was followed by the resignation of Finance Minister Takeo Fukuda and Director General of Administrative Management Agency Shigeru Hori. As a result, the solidarity of the Liberal Democratic Party collapsed. At the same time, the preparation of the FY1975 budget which shifted to an expansionary budget, moved into high gear under the leadership of Minister of Finance Masayoshi Ohira, the former Minister of Foreign Affairs.

The expansionary feature of the FY1975 budget was not included from the beginning. On the contrary, maintaining a restraining policy - such as by the reduction of budget scale, deferment of large tax cuts, and lowering of bond dependency rate - was the initial policy goal. Actually, the Cabinet approved the postponement of the budget execution on August 30 and the restraint of contracts for public works in the third quarter of the year was decided. In addition, in its recommendations, the Fiscal System Council required the government to reduce the scale of the FY1975 budget, make cutbacks in bond issuance and adjust the tax burden. In this way, a restraining approach was firmly maintained as the initial budgeting policy. However, after Mr. Miki

took over the Cabinet from Mr. Tanaka, the FY1974 supplementary budget (approved on December 23) which was compiled before the FY1975 budget, inevitably became a rather expansionary one - not necessarily because of policy intention, but because of price escalation. The amount of the supplementary budget was doubled from the FY1973 supplementary budget and it amounted to 2,098.7 billion yen. Although a tax revenue of 1,612 billion yen was prepared as a part of the financial resources for the supplementary budget, there was a significant increase in expenditure caused by increasing the local allocation tax grant, adjustment of salaries for civil servants and transfer of funds to the Foodstuff Control Special Account associated with the rice price hike. Therefore, the amount of bond issuance was not reduced.

At the beginning of 1975, the economic recovery slowed down, as the effects of the austere FY1974 budget became widespread. Moreover, a significant shortage of tax revenue was expected. The slowdown of business activity, decrease of corporate profit and job uncertainty became obvious. It can be said that government policy changed from a conventional high growth one to a stable growth one around this period. In other words the government adopted an aggressive fiscal policy in order to realize stable economic recovery, as well as to cope with imbalanced growth among industries, delayed employment recovery and a large number of corporate bankruptcies. The General Account Expenditure of the FY1975 budget draft increased by 24.5% over the previous year and amounted to 21.2898 trillion yen. This growth rate was the second highest after the FY1973 budget. As for expenditure, social security-related spending including spending to enhance measures for families receiving public assistance and the elderly increased by 1.0361 trillion yen (+35.8%) and amounted to 3.9269 trillion yen. Local allocation tax grants were also significantly increased by 1.0264 trillion yen and amounted to 4.4086 trillion yen. While public work-related spending was restrained, the growth rate of natural increase expenditure exceeded that in FY1974. Therefore, the budget draft gave a strong impression, as a whole, that it was an expansionary budget.

Measures against the Significant Tax Revenue Shortfall. The overall demand restraining policy resulted in a negative economic growth rate for the first time in the postwar period. However, the signs of recession, such as the slowdown in production and increase in unemployment, were thought to be a byproduct that arose in the process of overcoming the sharp rise in prices. In the meantime, the significant shortfall in tax revenues brought about by the recession became a problem, as the recession and the stagnation became worse and more obvious.

Thus, the trend in tax revenue was different from the initial expectation in early

1975 as stated above, and the tax revenue shortage for FY1974 on a revised basis after the supplementary budget was expected to be ¥771.1 billion. With regard to the shortage, a revision of the “Cabinet order implementing the Law on National Tax Revenue Adjustment Fund” was approved by the Cabinet on April 15, 1975. This law specified that the tax revenue collected in April should belong to the year when the tax payer was liable for the tax. In other words, even though the tax revenue belonged to FY1975 according to the conventional method, it was changed to tax revenue for FY1974 if the day of the tax liability in each case was effective on a day in FY1974. Therefore, ¥433 billion was added to the tax revenue, and the tax revenue shortage for FY1974 was decreased to ¥338.1 billion. In addition, as additional non-tax revenue of ¥259.9 billion was estimated and expenditures of ¥181 billion had been unused, the tax revenue shortage for FY1974 was compensated for, and finally even some surplus was left over.

In FY1975, too, a significant tax revenue shortage was estimated and there were even predictions of a natural decrease in tax revenue, which had never happened before during the high economic growth period. For natural decreases in tax revenue, if bond revenue was applied to fiscal resources, it would depend heavily on special deficit-financing bonds. There was concern that it would have a serious negative impact on the fiscal management to follow if such a trend were to continue.

Regarding the fiscal policy in FY1975, the government had to shift their policy priority from the stabilization of prices to overcoming the recession. The government took economic stimulation measures in sequence, as follows: the first economic measure was taken in February 1975 (the facilitation of loans for small and medium companies, speeding up contracted public works contracts); the second economic measure was taken in March (the smooth execution of public works expenditures); and the third economic measure was taken in June (promotion of housing construction and the extension of loans for environmental pollution prevention works, etc.). The Japanese government then took a fourth economic measure in September (additional public works and interest rate cuts, etc.), although demand for private equipment investment, consumption and exports remained stagnant. The government stance on fiscal and economic policy changed definitively from a policy to restrain overall demand to an economic stimulation policy. These positive fiscal and monetary policies, in other words, the implementation of the four economic measures and the official discount rate cut by the Bank of Japan, represented Japan’s posture to tackle the various issues related to the changing international economy.

Under these circumstances, the FY1975 supplementary budget was approved on November 7. As for the expenditures, the additional budgetary correction was ¥823

billion, which included public works and hikes in civil servants' wages. On the other hand, the deducted corrections, such as a reduction in local allocation tax grants (¥1.1005 trillion), were ¥1.2747 trillion. As for the revenue side, there was a deducted correction including tax revenues (such as corporation tax and income tax) and monopoly profit from Salt and Tobacco of ¥4.0197 trillion and an additional correction, which mainly comprised of bond revenue, of ¥3.5680 trillion. Therefore, the budgetary correction decreased by ¥451.6 billion, which reflected a significant tax revenue shortage. Meanwhile, regarding the local allocation tax grants, a reduction of the three national taxes (income tax, corporation tax and liquor tax) resulted in a significant decrease in allocations from the General Account, as mentioned above, but the total amount of local allocation tax grants was secured as planned in the initial budget by taking into consideration the local fiscal management. Specifically, the requirements of the local allocation tax grants included the additional ¥41.5 billion for the hike in local civil servants' wages, other than the compensation of the reduction of ¥1.1005 trillion as mentioned earlier, so a total of ¥1.1420 trillion of the allocation was required. Therefore, the Special Account for Allotment of Local Allocation Tax and Transferred Tax borrowed ¥1.1200 trillion from Trust Fund Bureau Funds and the temporary special local distributions, and ¥22 billion in the General Account was accepted as the special treatment only for FY1975. However, borrowing for the Special Account for Allotment of Local Allocation Tax and Transferred Tax from the Trust Fund Bureau continued as a significant compensation measure for local finance for over 10 years since then. The total amount of debts also accumulated.

In the end, the tax revenue shortage of ¥3.8790 trillion in FY1975 was compensated by the supplementary budget as above, so that government bonds of ¥5.4800 trillion were issued. The government bonds included special deficit-financing bonds of ¥2.2900 trillion based on the "Law concerning a Special Treatment for Public Bond Issue for FY1975" and construction bonds of ¥1.1900 trillion. This showed that the purpose of the supplementary budget was not only as a measure against tax revenue shortage, but also by such measures as adding public works, part of the government's efforts to promote the economy. It aimed to show that the revenue shortage was too large and the issuance of special deficit-financing bonds was unusual, by issuing not only construction bonds under Article 4 of the "Public Finance Law", but also by issuing deficit financing bonds. Accordingly, since the FY1975 supplementary budget, a large scale financing system dependent on the special deficit-financing bonds was begun.

However, the government financial dependence on special deficit-financing bonds was not a sound or desirable fiscal stance, and therefore, the top priority task for the

government became to restore a sound fiscal system as soon as possible.

Positive Budgeting under Large-scale Government Bond Issues. The Japanese economy started to recover at the end of FY1975, thanks to the effects of the four sets of economic measures in 1975. The basic policy for fiscal management accordingly significantly shifted to a new direction. The FY1976 budget compilation was devised to implement the Fiscal System Council's interim report on "How the administrative finance should be in an era of stable growth" in July 1975, to restrain budget expansion and to streamline expenses drastically. The guideline for budget requests was decreased from +25%, which it had been since FY1968, to +15% (See Table 1-1-1).

Table 1-1-1 Change of Budgetary Requests

Fiscal Year 36~39 budgetary request	Within the range of 50%
Fiscal Year 40~42 budgetary request	Within the range of 30%
Fiscal Year 43~50 budgetary request	Within the range of 25%
Fiscal Year 51 budgetary request	Within the range of 15%
Fiscal Year 52 budgetary request	<div> <div>General Administrative Expense 10% increase</div> <div>Others 15% increase</div> <div>Within the range of total amount</div> </div>
Fiscal Year 53, 54 budgetary request (approved by the Cabinet)	<div> <div>General Administrative Expense</div> <div>Business Expense 0</div> <div>Others 5% increase</div> <div>Others 13.5% increase</div> <div>Within the range of total amount</div> </div>
Fiscal Year 55 budgetary request (54.7.31)	<div> <div>General Administrative Expense 0</div> <div>Others 10% increase</div> <div>Within the range of total amount</div> </div>
Fiscal Year 56 budgetary request (55.7.29)	<div> <div>General Administrative Expense 0</div> <div>Others 7.5% increase</div> <div>Within the range of total amount</div> </div>
Fiscal Year 57 budgetary request (56.6.5)	0
Fiscal Year 58 budgetary request (57.7.9)	Within - 5% (except investment expense)
Fiscal Year 59 budgetary request (58.7.12)	<div> <div>Ordinary - 10%</div> <div>Investment section - 5%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 60 Budgetary Request Standard (59.7.31)	<div> <div>Ordinary - 10%</div> <div>Investment section - 5%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 61 Budgetary Request Standard (60.7.26)	<div> <div>Ordinary - 10%</div> <div>Investment section - 5%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 62 Budgetary Request Standard (61.7.21)	<div> <div>Ordinary - 10%</div> <div>Investment section - 5%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 63 Budgetary Request Standard (62.7.31)	<div> <div>Ordinary - 10%</div> <div>Investment section 0%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 1990 Budgetary Request Standard (63.7.15)	<div> <div>Ordinary - 10%</div> <div>Investment section 0%</div> <div>Within the range of total amount</div> </div>
Fiscal Year 1991 Budgetary Request Standard (1.7.11)	<div> <div>Ordinary - 10%</div> <div>Investment section 0%</div> <div>Within the range of total amount</div> </div>

(Source) "National Budget" Finance Research Council, Annual Issue (Hase Shobo)

(Note) Fiscal Year 85 ~Fiscal Year 1991: Industrial Investment Special Account other than above (NTT Stock)

¥1.3 trillion reported.

The FY1976 government budget draft restrained the General Account expenditures to ¥24.2960 trillion, or a 14.1% increase compared to the initial budget of the previous year. But at the same time, economic measures including public works had to be taken under the revenue shortage, due to the insufficient tax revenues. The expenditures were heavily allocated to public works, which was effective in creating aggregate demand. In addition, this shows the enhancement of social security measures (e.g. raising the level of lifestyle assistance and the amount of pensions, etc.) to adapt to the new economic growth pattern. In terms of revenue, government bonds issued to compensate for tax revenue shortage increased to ¥7.2750 trillion, or showed an increase of ¥5.2750 trillion over the previous fiscal year, and the bond dependency ratio was 29.9%, an increase by 20.5% points over the previous fiscal year and the highest level since World War II. Moreover, ¥3.7500 trillion or more than half of bond revenues were special deficit-financing bonds appropriated in an initial budget.

In the discussion for the budget in the Diet, the opposition parties requested the target year for, and the measures necessary for escaping from the heavy government dependence on special deficit-financing bonds. Therefore, the MOF, for the first time, proposed its “Mid-term Fiscal Outlook”, estimating revenues and expenditures up until FY1980, at the Committee on Budget of the House of Representatives on February 6, 1976. This proposal showed the target year for making the special deficit-financing bonds issuance zero for the two cases of FY1979 and FY 1980, with a high tax revenue was assumed in both cases. For the FY1980 case, in spite of the tax revenue increase, the outstanding government debt including construction bonds was estimated at more than ¥51 trillion, so a tight budget was needed. In either case, it stated that the budget needed to be compiled based on the mid- and long-term viewpoint of the “Mid-term Fiscal Outlook” proposal.

As stated earlier, government policy had shifted to one for the stable growth of the economy at the execution stage of FY1976 budget, but there was economic friction due to changes in the industrial structure such as unbalance among types of industry, the delay in employment recovery and the increase in business bankruptcy. Therefore, the economic policy, “On the Current Economic Situation and the Measures to cope with it” was decided upon by Ministerial Conference for Economic Measures in November 1976, aiming to mitigate potential frictions in the process of economic recovery and to achieve sustainable stable growth. Based on these policies, the seven measures were taken, including the promotion of public works execution, partial release for reductions in construction work for Japanese National Railways and the Nippon Telegraph and Telephone Public Corporation, the promotion of housing construction, the promotion of

the private equipment investment such as in the electric power and oil refinery business, the promotion of plant exports, measures for small and medium-sized companies and employment measures. The FY1976 supplementary budget was thus approved on February 22, 1977.

As for the FY1977 budget, in which no significant natural increase of revenues was expected, the government decided to reduce expenditures to escape from the dependency on special deficit-financing bonds, and established more severe budget standards compared to those of FY1976. The budget provided for an increase in general administrative expenses while the remainder (policy-related expenditure) should be restrained to within 10% and 15% respectively for the initial budget. However, natural increase expenditures, including national debt service, local allocation tax grants, social security-related expenditures and official wages, were far in excess of those of the previous year.

Meanwhile, policymakers in some countries were insisting on “Locomotive Theory”, which claimed that the role of the United States, West Germany and Japan was to be the driving force of the world economy, after their excellent economic performance around the time of the Puerto Rico Summit Conference on June 27-28 in 1976, and thus domestic demand expansion for this purpose was reflected in Japanese fiscal policies. Consequently, the fiscal authorities in Japan, who were aiming for fiscal soundness, were also requested to achieve this task at the same time in the FY1977 budget. The government budget draft was compiled as ¥28.5143 trillion in General Account expenditures, a 17.4% increase compared to the previous year, and public works-related expenditures were increased to 21.4% compared to the previous year, under the basic policy to promote a steady economic recovery while stabilizing prices. Hence, such an aggressive budget with a tremendous amount of government bond issuance (¥7.2750 trillion in FY1976 and ¥8.4800 trillion in FY1977) was compiled, given the background of the delay in economic recovery and current account surplus that existed at the time of compiling the budget for FY1976 and FY1977. The effects of continuous public investments in positive macro policies came out gradually, and shifted in an upward direction from November 1977. The production turnover level in March 1978 exceeded the level before the Oil Crisis.

The guideline for FY1978 budget requests showed a 5% increase in general administrative expenses, while the remainder, excluding current expenses, was an increase of 13.5%. The ceiling was further restrained compared to FY1977 to cope with the fiscal crisis, and about 30% of revenue was to be covered by issuing special deficit-financing bonds for the three years after FY1975. In the meantime, faced with

high demand for taking economic measures, the FY1978 budget was compiled as a 15-month budget, combined with the FY1977 supplementary (secondary) budget, including drastic measures to stimulate the economy such as housing construction. As a result of these measures, the FY1978 government budget draft was approved as follows: General Account expenditures ¥34.2950 trillion, which was a 20.3% increase from the previous year; with government bonds issued for ¥10.9850 trillion, an increase by ¥2.5050 trillion compared to the previous year.

Japan, Germany, and “Locomotive Theory” and the Enforcement of Economic Measures. Five years after the first Oil Crisis, the economy began to be led by domestic demand again in FY1978. In the second half of the fiscal year in particular, a moderate economic recovery led by the private demand continued. This was the result of various efforts to adapt to the economic environment at home and abroad, such as the promotion of public works execution from April 1978, the declaration of 7% growth in the Bonn Summit in July, and FY1978 supplementary budget compilation (approved on October 12), based upon comprehensive economic measures taken in September 1978.

In the first half of FY1978, the economic recovery was negatively affected by a significant reduction of exports due to a drastic yen appreciation, and there was a continuous substantial surplus trend in the current account of the balance of payments. In the Bonn Summit conducted in July 1978, under these circumstances, the participant countries were talking about Japan and Germany and “Locomotive Theory”. Japan made a commitment (1) to make efforts to achieve a real growth rate of 7%, which was an increase of about 1.5% points from the previous year, (2) to increase imports and restrain exports in order to reduce the current account surplus, (3) to double its Official Development Assistance within 3 years. The government decided on comprehensive economic measures, mainly comprising domestic demand expansion measures, by significantly adding public investment from a fiscal viewpoint. Then, in addition, the FY1978 supplementary budget was compiled and approved on October 13, in order to implement these measures.

The Bond dependency ratio in FY1978 remained at a high level sequentially from the previous year, because of the additions of government bond issuance for the supplementary budget. Therefore, in the process of FY1979 budget compilation, achieving fiscal soundness was an important issue from an early stage, so that the Fiscal System Council requested the government to achieve fiscal soundness by restraining the expenditure, or reducing the special deficit-financing bond, and making the guidelines for FY1978 budget request level the same as that for FY1978, as well as further

consolidating subsidies. The Council also stated that Japan should conduct fiscal reconstruction by restraining expenses including administrative reform. However, the Liberal Democratic Party and business circles showed strong expectations for an economy-stimulating type of budget compilation. The FY1979 government budget draft compiled under these conditions was as follows: General Account expenditures ¥38.6001 trillion, or a 12.6% increase compared to the initial budget of the previous year. The expenditures included considerable increases, such as 20.0% increase in works-related expenditures, and 12.5% in social security-related expenditures. In terms of revenue, due to insufficient tax revenues, bond revenues were ¥15.2700 trillion, which was an increase of ¥4.2850 trillion from the previous year, and the special deficit-financing bonds were increased to ¥8.0550 trillion. The bond dependency ratio was 39.6%, which represented the peak during the “stable growth period”. Among the major expenditure programs in the budget, the increase in national debt service recorded the highest among expenditures - 26.6% - and it was a symbolic record that the amount reached ¥4 trillion.

The Target of Delivering Government Finances from their Dependence on Deficit-bonds by Fiscal year 1984. On January 31, 1979, the MOF submitted the “Medium-term fiscal outlook (on a FY1979 basis)” to the Diet as a model for Japanese government finance according to the FY1979 budget draft. This estimate was consistent with the “New Economic and Social Seven-Year Plan” which had been accepted by the Cabinet in January and it showed a model case of the fiscal outlook of FY1985 - the final year of the program - by a macro econometric method and not by summation method. However, in terms of the long term economic program, delivering government finances from its dependence on special deficit-financing bonds was targeted for FY1984 (in the program with a “target of delivering government finances from its dependence on deficit-bonds by fiscal year 1984”). Therefore, the “New Economic and Social Seven-Year Plan” was proposed by national agreement on fiscal reconstruction as being one of the most important policy targets for the new and stable growth of the economy in the early 1980s. This was because the government had to insist before the people, to obtain their consent, that it was essential to restore various financial functions, and to have them clearly recognize the side-effects, such as fiscal inflation or the sliding of welfare standards under the aging society, which would occur if the fiscal crisis was neglected.

On the other hand, according to the MOF’s “Medium-term fiscal outlook” the expenditures for FY1979 were to be ¥38.6000 trillion, against ¥64.9700 trillion in

FY1984, tax revenues were to be ¥56.1500 trillion in FY1984, compared to ¥21.4870 trillion in FY1979, and as for bond revenues, construction bonds were to be ¥12.3400 trillion in FY1984, compared to ¥7.2100 trillion in FY1979, and special deficit-financing bonds were to be zero for FY1984 and had been ¥ 8.5000 trillion in FY1979. FY1984 was set as the target year to escape from dependence on special deficit-financing bonds because the redemption of government bonds in cash started in full in FY1985 for the special deficit-financing bonds issued in FY1975, and financial resources for redemption were required. This target assumed that a serious tax revenue shortage was expected during the above period.

Fiscal Policy after the Second Oil Crisis. The Japanese economy in FY1979 was clearly making steady progress toward recovery, thanks to flexible fiscal and monetary policies by the government, although there were outstanding negative issues such as a steep rise in wholesale prices and the worsening of the current account balance, owing to the crude oil price hike triggered by the unstable Iranian political situation. As for the macro economic policy, first of all, “On the Execution of Public Works” was decided upon by the Cabinet on April 6, right after the FY1979 budget was approved. As for the execution of public works, the government had to pay attention to both economic growth and prices, while maintaining the basic economic recovery by paying attention to price trends. Specifically, the target contract ratio of public works in the first half of the fiscal year was 65-70%, slightly less than that of FY1977 and FY1978 (the target ratio for the first half of each was 73%). For the second half of the fiscal year, in a Cabinet decision about the execution of public works in FY1979 in third quarter in October, the government decided upon maintaining a level of 80% completion of contract targets as in other years, the neutral execution of public works.

However, as the price trend fell into crisis after that, “On Comprehensive Promotion Measures for Price” was determined upon on November 27, 1979, so that particular care would be taken regarding economic trends in the execution of public works, in order to prevent price hikes. For FY1979 as a whole, although problems relating to the price and balance of payments still remained, autonomous economic recovery was achieved in the adjustment period after the Oil Crisis, so that the tax revenue was expected to increase again. Therefore, government bond issuance exceeded ¥1 trillion in the FY1979 supplementary budget approved on February 14, 1980.

Regarding the reduction in government bond issuance in the FY1979 supplementary budget in specific, the scale of correction was ¥1.0674 trillion, equivalent to 2.8 % of the initial budget of FY1979. Expenditures included the corrected reduction of ¥274.6

billion of existing expenditures and reserve funds for public works. On the revenue side, the balance net increase, such as tax revenues and the carried-over surplus, etc., was ¥2.2874 trillion. The total for the supplementary budget financial reserve was ¥2.5621 trillion, and of that, ¥1.3421 trillion was allocated to additional expenditure, while ¥1.22 trillion was allocated to the reduction of government bond issuance. Regarding the reduction of government bond issuance, the reduction of the special deficit-financing bonds was particularly taken into consideration, and the amount was ¥1.1380 trillion. The FY1979 initial budget estimated an enormous amount of bond revenues - totaling ¥15.2700 trillion - but the issue amount of government bonds was eventually compressed comparatively, due to the increase in tax revenues because of the economic recovery. As a result of these budget corrections, the bond dependency ratio in FY1979 declined to 35.4% from 39.6% in the initial budget.

3 The Trend in Large-scale Government Bond Issuance and Government Debt Management Policy

Government Debt Management policy after the Nixon Shock. As stated above, Japan was facing severe economic stagnation after the Nixon Shock in August 1971, and active fiscal measures were taken from the FY1971 supplementary budget to FY1973 budget. This resulted in a drastic increase in the bond dependency ratio, from 4.6% of the FY1971 initial budget to 17.0% of the FY1972 initial budget, which had been declining since FY1967.

In FY1972, the active fiscal and monetary policy was enforced by using bond revenues, while the initial budget and supplementary budget were compiled aiming at economic recovery and the adjustment of the balance of payments imbalance. In addition, 10-year government bonds (coupon rate 7.0%) were issued as long-term government bonds from January 1972, at the time of the additional government bond issuance of the supplementary budget. With the FY1972 budget, the government bond issuance was sharply increased to ¥1.9500 trillion (the initially planned amount hereinafter), but ¥250 billion of this was subscriptions by the Trust Fund Bureau Fund, and personal subscriptions by syndicate underwriting was ¥1.7000 trillion - the ratio of personal subscriptions increased to 90%, greatly exceeding the previous year. On June 24, 1972, the official discount rate was reduced from 4.75% to 4.25%, and interest rates on deposits and savings were cut for the first time for 11 years. With this trend in low interest rates, the decrease in the long-term interest rate was getting on track, and the coupon rate of long-term government bonds was reduced to 6.5% in July.

When the FY1973 budget was compiled, government bond issuance increased to ¥2.3400 trillion, but the bond dependency ratio was restrained to 16.4%, which was slightly restrained compared to that in FY1972. The personal subscription of the government bonds restrained at ¥1.8700 trillion, and increased subscription by the Trust Fund Bureau Fund to ¥470 billion, from ¥250 billion in the previous year. Thus, the FY1973 government bond issuance plan was different from the active one at the time of FY1972 supplementary budget. The supplementary budget to cope with the first Oil Crisis was approved on December 14, and the issue amount of government bonds was restrained to ¥530 billion with a favorable estimate of the tax revenue. In FY1973, the coupon rate of the 10-year government bonds was raised to 7% from August, in concurrence with the increase in the official discount rate. The official discount rate was increased by 2% point to 9% on December 22, while the bond coupon rate was increased from 7% to 7.75% from January.

At for the FY1974 budget, the amount of government bond issuance was ¥2.1600 trillion. It was decreased from the initial plan, but was still well above ¥1.8100 trillion, which was the amount after the deduction of the FY1973 supplementary budget. As in the FY1973 budget draft, subscription by the Trust Fund Bureau Fund for ¥420 billion, and personal subscriptions of government bonds for ¥1.7400 trillion were planned. The government bonds subscript funds by the Trust Fund Bureau for were mainly carried-over surplus. However, the Fiscal Investment and Loan Program (FILP) restrained Trust Fund Bureau Funds operation in order to be consistent with the policy to restraining aggregate demand for the FY1974 General Account, and the unused financial resource funds were applied to the subscription of government bonds. It was a fiscal policy which adjusted the operation scale of the FILP in order to cope with the economic situation, so that the flexible subscription by the Trust Fund Bureau Fund started under this intention thereafter. However, the increase in government bond issuance resulted in a slack government bond market after half of the year. In order to cope with this condition, the coupon rate was raised to 8%, from the 10-year interest-bearing bonds issued in October.

Change in the Government Bond Issuance Policy and an Era of Large-scale Bond Issuance. The FY1975 budget was compiled under the restraining aggregate demand policy, the same as for FY1974, and the amount of government bond issuance was ¥ 2 trillion, which was ¥160 billion below that for FY1974. Subscription by the Trust Fund Bureau was ¥420 billion. Personal subscriptions through syndicate underwriting were ¥1.5800 trillion.

Under these circumstances, the Minister of Finance Masayoshi Ohira admitted that there would be a tax revenue shortage in FY1975 to the Committee on Finance of the House of Representatives, on April 15, 1975, when the shortage in financial resources was highlighted. The issue here was that financial resources had to be dependent on government bond issuance under the Special Case Law conducted in FY1965, because the construction bond would not be sufficient to cover it. At worst, the shortage was as immense as ¥3.4800 trillion, so that there was a question of how to get subscriptions for the government bonds issued. It was quite a difficult challenge, which, it was thought, might last even into FY1976 and beyond for the government.

The supplementary budget for the tax revenue shortage was approved on November 7, 1975, before the government bond issuance meeting was held on October 8, when an additional issuance of government bonds was proposed by the MOF for ¥3.4800 trillion and it was approved, far exceeding the initially planned amount of ¥2 trillion. Specifically, construction bonds were ¥1.1900 trillion and the remaining ¥2.29 trillion was in special deficit-financing bond. On December 25, then, the “Law concerning the Special Treatment of the Public Bond Issue for Fiscal Year 1975” was enacted. The special measures were then taken, with the construction bonds being issued before the bill was passed, as it had been delayed from the planned date, and the special deficit-financing bonds of ¥235 billion were issued within a short time, because of the need to obtain financial resources for the public purse in December.

This was the process that resulted in the era of large-scale government bonds issuance since FY1975. However, there was concern beforehand that government bonds held by private financial institutions would increase sharply and even make smooth subscriptions difficult, if such large-scale issuance continued. Therefore, the MOF started to study measures from many aspects, such as relief of liability for private financial institutions, care for individual financial asset allocation, development of the government bond market, revision of the issuance conditions, enhancement of the bond sales system, improvement of the secondary market and issuance of a new kind of government bond, etc.

In the FY1976 budget, the government bond issuance was drastically increased to ¥7.2750 trillion, which exceeded the initial plan of FY1975 by ¥5.2750 trillion, and the revised budget by ¥1.7950 trillion. Specifically, subscription by the Trust Fund Bureau Fund doubled to ¥1 trillion, while syndicate underwriting almost quadrupled to ¥6.275 trillion. One of the major features of the FY1976 budget was the first special deficit-financing bond applied to the initial budget since World War II, and the postponement of the income tax cut. The special deficit-financing bond scale was

¥3.7500 trillion. The approval of issuance was continuously discussed in the Diet and finally approved on October 15. After the budget was revised, ¥100 billion in additional government bonds were issued as a whole. In January 1977, 5-year discount government bonds of ¥98.9 billion were issued as a measure to promote personal subscriptions. Other than that, the buying operation of the long-term government bonds was conducted by the Bank of Japan in June and December, as the slack market continued due to the large-scale government bond issues since the beginning of the fiscal year.

Large-scale Bond Issuance and the Beginning of Bond Trading in the Market. In FY 1977, the public bond issuance conditions were good, and government bond trading in the market (selling in the market) started. The government bond issuance of FY 1977 reached ¥8.4800 trillion, which exceeded that of the previous year by more than ¥1 trillion. Subscriptions by the Trust Fund Bureau Fund were planned to be ¥1 trillion, the same amount as was initially planned in the previous fiscal year, and personal subscriptions were ¥7.4800 trillion. The official discount rate was gradually reduced on March 12, April 19, and September 5, in 1977, and on March 16, 1978. It reached 3.5%, the lowest level since World War II by the end of FY 1977. The interest rate reduction that resulted was then associated with a discount rate cut, the booming of the government bond market and the 10-year interest-bearing government bond issuance conditions being updated one after another. On October 24, the first supplementary budget was approved, and the issuance of construction bonds increased to ¥251 billion, the special deficit-financing bond reduced to ¥112 billion, and ¥139 billion was added on a net basis. Moreover, the secondary supplementary budget, which was approved on January 31, 1978, included an increase in construction bonds to ¥347 billion, an increase in special deficit-financing bonds to ¥1.0190 trillion, and ¥1.3660 trillion was added as a whole. This resulted in the total amount of government bonds, after the supplementary budget, reaching ¥9.9850 trillion. The era of ¥10 trillion was close at hand.

In FY1978, subscription by the Trust Fund Bureau Fund was not planned due to a shortage in financial resources, but syndicate underwriting was applied to personal subscriptions including ¥1 trillion issuance by price competitive auction. Then the government bond market grew weaker and the yield started to rise because the market felt that the interest rate had hit the bottom. While the MOF considered the diversification of the type of government bonds, it showed the medium-term bond framework draft to the underwriting syndicate in May (e.g. 3-year interest-bearing

government bond, public offering auction and the upper limit issuance for FY1978 as ¥1 trillion) and issued ¥300 billion in June. It was the first attempt of an auction issue of medium term bonds for the government debt management policy since World War II. Eventually, medium term bonds were tendered, with a far larger amount than expected. In July, the allowance system for government bond price fluctuation was established, to secure the soundness of the accounting of financial institutions, and was applied from the terminal accounts in September. However, it resulted in the weakening of the government bond market, as financial institutions' bond selling was accelerated. In order to counter this situation, ¥306.3 billion in personal subscriptions were conducted by the Trust Fund Bureau in September. Even after that, an additional issuance of government bonds of ¥300 billion (2-year interest-bearing government bonds) in the FY1978 supplementary budget, approved on October 12, was subscribed by the Trust Fund Bureau, the authorities took measures regarding the weakening government bond market by restraining the funds from syndicate underwriting as much as possible. Accordingly, subscription by the Trust Fund Bureau Fund for government bonds started to play an important role in stabilizing the conditions for absorbing government bonds.

On the other hand, government bond trading in the secondary market had started in April 1977, with special deficit-financing bonds that had no problem about conversion. After that, government bond trading gradually progressed until the abolition of self-imposed bond trading control measures held by financial institutions, in September 1995. Originally, as most syndicate underwriting-funded government bonds were bought by the Bank of Japan after one year from issuance as their buying operation account in the late 1960s to the early 1970s, there was almost no need to sell to the trading market. Likewise, the government bonds were less popular in the trading market due to their lack of liquidity compared to other public and corporate bonds, and the yield determined in the market did not correctly reflect the market credibility of the various bonds. After FY 1975, large-scale issuance of government bonds resulted in lowering the ratio of government bonds absorbed by buying operations, while, on the other hand, the government bonds held by financial institutions increased. Major city banks, which were afraid of government bond appraisal loss and selling loss, started to request the authority that they wanted to change their fund position by selling the government bonds. Then, the government gave consideration to the trading of government bonds in early 1977 and, in April, made possible the selling of special deficit-financing bonds after one year from issuance. From October, it also became possible to sell construction bonds after 1 year of issuance. The paper issued by the Study Group on Government Debt Management Policy (June 1977) pointed out the

problems: 1) City banks and regional banks, in particular, showed a strong demand for the trading of government bonds due to uneven distribution of funds, the imbalance of underwriting shares and funds resources, the impact on liquidity accompanied by the increase in government bonds held, and the portfolio management problem; and, (2) Proper improvements of the bond market are required, as it is still problematic for the market to absorb a large number of trading Japanese Government Bonds at the same time, although the bond trading market is developing, and the government bond rollover system should be improved as a part of the system maintenance to accompany increasing bond fluidity. This made the MOF fully promote the improvement of the trading environment to improve the fluidity of the government bonds.

The Target of Delivering the Government's Finances from its dependence on Special Deficit-financing Bonds and the Peak of the Bond Dependency Ratio. In January 1979, the “Target of Delivering the Government's Finances from its Dependence on Special Deficit-financing Bonds by FY1984” was released, but the FY1979 budget draft being discussed in the Diet at that time included ¥15.2700 trillion in bond revenue. At the end, the FY1979 government bond issuance initially planned was ¥15.2700 trillion, and special deficit-financing bonds comprised ¥8.0550 trillion, making up the majority of the government bond issuance for the first time. The bond dependency ratio at 39.6% was a considerable increase – of 30% - from the 9.4% it was in FY1975. Furthermore, the Trust Fund Bureau had no plan to receive subscriptions in FY1978, and started to receive subscriptions of ¥1.5000 trillion in FY1979, and the auction issue was increased to ¥2.7000 trillion, while syndicate underwriting was ¥11.0700 trillion, which was almost the same level as the previous year.

The FY1979 government bond market became more depressed than in FY1978. The 6.5% coupon rate of 10-year interest-bearing government bonds in March 1979 was raised to 7.2% in April, 7.7% in August and then to 8.0% in March of 1980, reflecting the fifth consecutive rise in the official discount rate since April 17, 1979. With a sharp increase in the interest rate, a high interest rate was expected in the future, together with an increase in financial resources, and thanks to the economic recovery, financial institutions started to sell government bonds, which worsened the government bond market. Then the MOF decided to consider the government debt management policy regarding the weakening government bond market for the first time since 1979, and released the paper, “On the present Government Debt Management Policy”(the so-called “7 Points Program”) at a meeting of government debt problems in May. Under

this program, the restriction of the issuance amount and the mitigation of syndicate underwriting were to be implemented, as well as absorbing more than ¥1 trillion in government bonds, by buying the bonds through the National Debt Consolidation Fund in June and buying through the Trust Fund Bureau Fund in July. It was eventually decided to reduce the government bond issuance, in order to cope with the slack in the auction market. In the fiscal year-end supplementary budget, the government bond issuance was also reduced by nearly ¥1.2200 trillion, in accordance with an increase in tax revenue.

Since the large-scale issuance of government bonds began, the issuance of government bonds exceeded ¥10 trillion in FY1978 and reached ¥15.2700 trillion in FY1979, while the bond dependency ratio reached a peak of 39.6%. The government recognized that there would be a negative impact on flexible fiscal management if such large-scale bond dependency continued. This is why it was thought that an escape from dependence on deficit-bonds would lead to stable development of the economy and improvement of the quality of public lifestyles in the future.

4 Stable Economic Growth and the Reconstruction of the Tax System

After the Report on the Long-term Tax System. In the early 1960s, the government started to reform the tax system according to a Tax Commission report. The Tax Commission compiled its “Report on the Long-term Tax System” in August 1971, which represented their concept that a “modest tax burden increase should be admitted and that indirect tax should be maintained appropriately in the tax system”. As for indirect tax, the government was required to consider expanding the tax base for individual consumption taxes and a shift to a general consumption tax. After the Nixon Shock, the government was requested at the end of every fiscal year to conduct tax reductions, especially of income tax, as a recession measure through tax reform. The following is a history of tax reform up to FY 1979, according to the report above.

Even before the “Report on the Long-term Tax System”, the slowdown in the domestic economy and the tax revenue shortage had been considered to be problematic. The government then started to consider countermeasures against the recession and the MOF examined the possibility of a tax reduction. Just then Nixon Shock occurred in August 1971, and tax reform against the recession became an urgent and critical issue, due to the huge impact on the Japanese economy. In the process of discussion at the Tax Commission in October, income tax reduction was confirmed as being needed as an immediate economic measure, and the tax was cut eventually conducted back to April

1971.

The FY1972 Tax Reform Report was compiled on December 27, 1971, and only covered a tax reduction for local tax, not national tax, but included the introduction of tax credit for aged dependents and the expansion of those applicable as tax deduction widows. The surtax rate of corporation tax continued for 2 years, and aviation fuel tax was newly introduced. The plan also showed a stance for the reexamination of the special treatment of taxation on medical fees covered by social insurance. The “Outline of the FY1972 Tax Reform”, which was approved by the Cabinet on January 25, 1972, also included the tax credit for housing acquisition requested by the Liberal Democratic Party, as well as tax deductions for small- and medium-sized companies as a countermeasure against recession and enhancement of the special treatment for pollution prevention measures, that were considered to be critical issues.

Review of Small Business Taxation and Land Taxation. In the tax reform of FY1973, the major issues considered by the Tax Commission included: the taxation of social insurance medical fees for doctors, small business taxation (the issue of introduction of entrepreneurs’ remuneration system) and separate withholding taxation on capital gains from land transfer. Among these issues, the entrepreneurs’ remuneration system had some background. Specifically, a tax deduction for family employees and wages of individual enterprises had been fully permitted in FY1968, but the Japanese Blue Return Tax Payer’s Association and the Ministry of International Trade and Industry had requested the introduction of a tax deduction for entrepreneurs’ remuneration. However, the Tax Commission opposed the introduction of this, saying that it was meaningless if entrepreneurs pay a salary to themselves, and it would be a misuse of tax a deduction for an employment income. However, this was followed by the suggestion of a reserve for the special expenses of proprietors filing blue returns in FY 1971, as an alternative measure to allow the tax deduction of an entrepreneurs’ remuneration, and deductions for blue returns in this system were introduced in FY1972, which led the way to mitigating the income tax burden of individual enterprises. Regarding the separate withholding taxation on capital gains from land transfer which came into force in FY1969 and which encouraged companies to obtain real estate, a reexamination of the land tax system was also discussed. In addition, Prime Minister Kakuei Tanaka’s campaign pledge of a ¥500 billion tax reduction drew a lot of attention from various fields as to how the Tax Commission would deal with the commitment. In the end, the FY1973 Tax Reform Report on December 30, 1972 included a reduction in income tax and inhabitant tax, but the rectification of the taxation for social insurance

medical fees was postponed. The Research commission on the Tax System of the Liberal Democratic Party's "Outline of Tax Reform", issued on the day before, included the introduction of an entrepreneur's remuneration system that was excluded from the basic taxation system by the Tax Commission, and as for the land tax, it requested that the government make an immediate resolution to restrain the speculative trading of land. On January 8, 1973, the government's "Outline of Tax Reform" introduced the special treatment of the entrepreneurs' remuneration system for 5 years and presented the policy to seek an immediate resolution for land taxation. In addition, the tax reform outline of the government included tax reduction by raising various tax credit, regarding income tax, tax reduction of inheritance tax, by increasing the basic deduction by 50%, and the special treatment for welfare, anti-pollution and housing. The "Outline of the FY 1973 Tax Reform" approved by the Cabinet on January 19, 1973, upon the Report of the Tax Commission, introduced the special landholding tax as a local tax, surtax on corporate capital gains from land transaction, and the increase in the special deductions in capital gains from land transactions as a national tax, in addition to the items specified in the Outline.

Reform of Income tax and Corporation tax during the First Oil Crisis. With the 1974 tax reform, the government focused on the major reform items including a considerable raise in the lowest taxable limit for income tax from an early stage, and the authorities considered them in a study by the Tax Commission. This was because then Prime Minister Kakuei Tanaka had made a speech in the Committee on Finance of the House of Representatives in Spring 1973, saying that a drastic tax reduction should be enforced in FY1974. After that, the government started to consider a so-called "¥2 trillion tax reduction". In the discussion at the Tax Commission in Autumn 1973, a drastic increase in employment income deductions to mitigate the burden of employees was confirmed. Although the first Oil Crisis then occurred, the tax system assessment continued to be concerned with policy issues such as a desirable form of the tax burden of income tax, corporation tax and inhabitant tax. Furthermore, a report, including a discussion on indirect tax and special taxation measures, was submitted on December 21, 1973. This report said the scale of the income tax reduction could be about ¥2 trillion, through a drastic increase in employment income deductions and the expansion of the applicable income brackets. As for Corporation tax, the tax increased through a tax rate raise. While there was also the cautious opinion that the government should first watch the effects of the Oil Crisis before introducing a tax reduction, the content of the report was consistent with the initial policy of the Tax Commission's report, reflecting

the strong intention of Prime Minister Tanaka and the Liberal Democratic Party.

The MOF thought that the tax structure itself could be improved by tax reforms, including income tax reduction, corporate tax rate rise and reexamination of indirect tax. In particular, the standard tax rate of corporation tax was raised from 36.75% to 40%, but it was because the authorities considered that an increase in the tax burden to companies would not affect their competitiveness in the international market, as the effective tax rate was still less than the standard for Western countries, and Japanese corporations could remain competitive in the international market. The long-term economic plan of the Japanese government (the “Basic Economic and Social Plan”) predicted an increase in the tax burden of citizens, so that the corporation tax and indirect tax hike was needed. However, the tax reform based on the “Outline of the FY1974 Tax Reform” decided upon by the Cabinet on January 11, 1974, was not enough to successfully implement the plans. In other words, owing to the price hike due to the Oil Crisis and a considerable rise in the nominal wage, income tax cut policy changed its nature to a counteractive price adjustment tax-cut. Under this condition, a tax revenue increase could not be expected due to a reduction in corporate profits.

Examination of the Act on Special Measures Concerning Taxation. The Ministry of Finance intended to proceed with the reform of the tax system for FY1974 and FY1975, and at the same time, they realized the income tax reduction and the corporation tax hike in the FY1974 reform. They then decided to consider the issues regarding the rectification of the special treatment of the taxation of social insurance and medical fees for doctors (the so-called preferential tax system for doctors) and separate withholding taxation at source on interest and dividends in FY1975. The Tax Commission’s ad hoc meeting report said that the 72% uniform rate admitted as necessary expenses in the income tax for doctors should be reformed, and the actual expense ratio and special exemptions should be combined as taxation for them. In the report of the FY1975 tax reform, dated December 27, a rise in personal exemption for the income tax, a rectification of the special treatment in the taxation of social insurance and medical fee, and a surtax on capital gain from the land trading and tax raise on the income from interest and dividends were requested. The report also requested a significant tax reduction, in order to mitigate the inheritance tax and donation tax burden hike, in conjunction with the price hike.

The objectives of the special taxation measures were wide ranging: from the encouragement of saving, the promotion of environmental improvements and regional development, the modernization of technologies and facilities, and the promotion of

natural resource development, to the enhancement of the internal reserve strengthening of the constitution of business corporations. These measures were also deeply related to the profits of individual economic units. Therefore, the desirable form of the special taxation measures has been controversial since mid 1950s. The Tax Commission tried to correct as much as possible the unfairness of the tax burden and considered measures in the direction of avoiding the long-term existence of a preferential system and vested rights. This was why the authorities tried to change or abolish the special taxation measures in the discussion of tax reform at the end of every fiscal year. However, as for the preferential tax system for doctors, the Tax Commission tried to review, which was not reflected into the Liberal Democratic Party's "Outline of tax reform" approved on December 25, 1974, or in the "Outline of the FY 1975 Tax Reform" decided by the Cabinet on January 24, 1975.

A Tax System to Cope with Fiscal Policy Changes. In FY1975, while a significant tax revenue reduction was anticipated after the budget was approved, the management of fiscal policy was required to change drastically. It is well known that this was the year when special deficit-financing bonds were issued in the supplementary budget, and the bond dependency ratio increased from then onward. Regarding the tax system, the Tax Commission discussed various measures to increase the tax revenue as much as possible. The Fiscal System Council also requested a tax raise and the streamlining of expenditures. The Research Commission on the Tax System of the ruling Liberal Democratic Party (LDP), proposed the introduction of a new tax. Under these circumstances, as for the 1976 tax reform, the postponement of an income tax reduction, a review of special taxation measures and a tax increase for automobile-related taxation were proposed. More specifically, as for the special taxation measures, the focus was upon the medical treatment fees of doctors, entertainment and social expenses, and allowances. The report of the Tax Commission submitted on December 23, 1975, proposed increasing the tax revenue by rectification of the unfair taxation, under the premise that the tax burden cannot help but increase in the mid-term. After all these proposals, the special taxation measures were streamlined, 11 of them were abolished and 58 items were downsized. In addition to this, a tax rate hike on automobile-related items was requested.

This was followed by another tax reform study to escape from the dependence on special deficit-financing bonds. For instance, various new taxes such as an EC-type value-added tax were also considered. The Tax Commission raised the issue of comprehensive income taxation on interest and dividends aiming at gradual correction

of the unfairness of income taxation. Regarding asset tax and consumption tax, the introduction of wealth tax or value-added tax were considered. In particular, it was considered common sense to share the load, since the indirect tax burden level in Japan was still low compared to Western countries, so that the indirect tax reform was positively considered to be the most important issue of the “Mid-term tax system”. The reform of the special taxation measures was emphasized as being one of the items which anticipated a tax revenue increase, which was represented by the rectification of the special treatment in the taxation of social insurance and medical fees. In the interim report on the “Mid-Term Tax System” compiled in December, 1976, it was proposed that there was room for an income tax raise and that the introduction of a general consumption tax should also be considered. The FY1977 tax reform, according to the Tax Commission, proposed some income tax reduction through price adjustment to be taken as a counteractive tax-cut for economic recovery and the stability of lifestyles, under the common understanding that it was not the right time to implement a large tax hike to achieve fiscal balance recovery in FY 1977. On the other hand, the special taxation measure was required to increase the tax rate of income on interest and dividends and strengthening of the taxation on entertainment and social expenses.

In the discussion between the ruling and opposition parties on the FY1977 tax reform, a “tax rebate” for a tax credit type income tax was determined by legislation introduced by a Diet member. The government clearly stated that the tax reduction should not be conducted in FY1977, due to fiscal difficulties, but Prime Minister Takeo Fukuda in December, 1976, made a decision that the counteractive tax-cut against price hike needed to be implemented. Specifically, in order to cope with the fiscal difficulties, they decided to combine the income tax reduction and corporation tax hike. On a net basis, the tax reduction would exceed that of the initial year, but there would eventually be a tax hike in the following fiscal year. This was because the ruling and opposition parties ran a dead heat in the House of Representatives election in December, and the budget for FY1977 was difficult to pass, unless it reflected the opposition parties’ intention regarding the budget. The MOF insisted on creating a desirable income tax system by adjusting a minimum taxable level and the tax rate, but eventually agreed to the opposition parties as a “tax rebate” could be considered as a provisional measure, at least. Its fiscal resource was the FY 1976 surplus fund, and the tax reduction implemented in July, 1977, was on a scale of ¥300 billion. These “tax rebate” type tax reductions were also implemented in 1978, but the fiscal resource was not applied to the surplus fund but the government bond issuance.

Before the 11th House of Councilors election in July 1977, the Minister of Finance

Hideo Bou showed a willingness to introduce a general consumption tax, but it was still controversial in the ruling party, from the viewpoint that the tax might worsen the economy. In the discussions of the Tax Commission for FY1978 tax reform, a consumption tax was proposed in order to solve the fiscal difficulties, while showing a tax hike type revision, including an increase in the securities exchange tax and liquor tax.

The Introduction of a General Consumption Tax. Economic policies focused on the enhancement of welfare and the expansion of social infrastructure around 1970. The Tax Commission also considered a drastic change in indirect tax, to compensate for the expanding government expenditures. Then, the focus on indirect tax reform in the early 1970s shifted to the introduction of the general consumption tax.

According to the “Report on the Long-term Tax System and the Assessment of the Contents and Progress” (1971), as stated earlier in this Section, a general consumption tax should be introduced to recover the delay in responding with a specific consumption tax, at a time when consumption behaviors were drastically changing. However, it did not mention a specific timing for when this should be introduced but only stated “these methods (higher dependency on income tax, higher burden of corporation tax and introducing a general consumption tax) should be selected by Japanese citizens at that time. After that, discussions regarding indirect tax hike were pending, due to the Nixon Shock and the two Oil Crises, but the MOF started to face a fiscal crisis campaign, as people became concerned about fiscal rigidity, due to an increase in the special deficit-financing bond in FY1975. Furthermore, after FY 1976, the “Medium-term fiscal outlook” was compiled, to show the need for a large hike in the tax burden ratio, in order to escape from the dependence on special deficit-financing bonds. Therefore, studies on general consumption tax were enhanced.

Views on the discussion to introduce a general consumption tax were, as stated above, and the Tax Commission established a working group to study technical issues in July 1976. In the “interim report” in October 1977, it was clearly stated that the existing system was limited in its capacity for fiscal reconstruction, so a general consumption tax should be introduced. The timing of the introduction, however, remained unspecified, and conditional on the unfair taxation being rectified first.

The MOF also set the introduction of a consumption tax shown in the “interim report” as a policy issue, so that the Tax Commission could continue to discuss this issue as one of the important items of FY1979 tax reform. The fiscal conditions at that time were in difficulty due to a tax revenue shortage, so the date of corporation tax

revenue was postponed in the FY1978 budget compilation process. As it was expected that the severe conditions for fiscal management would last into and after FY1979, the government started a specific study on the general consumption tax in June 1978, and set the target of developing the framework of the plan by September. In this process, the outline of the general consumption tax was shown more specifically through the assessment report of the Chairman of the Tax Commission. Then, the general consumption tax draft was prepared early in September, which pointed out the difference between consumption tax and turnover tax, by exempting small businesses from the object of taxation, while maintaining the rationalization of the conventional indirect tax. The Research Commission on the Tax System of the LDP's "Outline on tax reform" also admitted the need for the introduction of the general consumption tax, and requested it to be implemented within FY1980.

The report of the Tax Commission in December 1978 (the "General Consumption Tax Outline" was attached to this report) stressed that a general consumption tax was inevitable, in responding to the "policy that should be taken through tax system in order to improve the fiscal conditions through national and local government, aiming at the sound development of Japanese economy" proposed by Prime Minister Takeo Fukuda in November 1977, and it included the specific timing for implementing the general consumption tax as January 1980. The Minister of Finance, Ippei Kaneko, in Masayoshi Ohira's new Cabinet said in his fiscal policy speech on January 25, 1979, "the imbalance of the government expenditures and revenues now has grown so large that it can no longer hope to perform the proper missions of national finance, such as the stabilization of the economy and enhancement of the standard of welfare without raising the general tax burden," and he made request for understanding to the Diet and the public regarding the new tax system. However, the opposition parties criticized the statement, saying that the government should reduce its expenditure and rectify unfair taxation before the introduction of new tax. As the day of the 35th House of Representatives Election was approaching in October 1979, not only the opposition parties but also some members of the Liberal Democratic Party opposed the introduction of a general consumption tax. This made Prime Minister Ohira express his intention to give up the introduction of a general consumption tax within FY1980. Moreover, the "Resolution on Fiscal Reconstruction" was decided upon by the Diet (December 21) in the plenary sessions of both Diet chambers of the year-end Diet, after the defeat of the Liberal Democratic Party in the General Election. The content of the resolution was that fiscal reconstruction should be achieved by the expansion of fiscal resources through cost saving, accompanied by the administrative reform, cuts in and

rationalization of expenditures, a fair tax burden and a review of the existing tax system, without the introduction of the general consumption tax.

As mentioned in Chapter 2.1, the political situation prevented the acceptance of the introduction of a general consumption tax, so that the tax reform, along with the government's intended goal of achieving fiscal reconstruction, looked to remain incomplete for the foreseeable future.

Review of the Preferential Tax System for Doctors. As stated earlier, special taxation measures – including rectification of the special treatment in the taxation of social insurance and medical fees - had been discussed for years. Particularly, in the review process of the FY1979 tax reform, in line with the review regarding a general consumption tax, discussion regarding the consolidation and rationalization of the special taxation measures had progressed, and stressed the need to abolish the reserve for price fluctuation, and also said that the issue of taxation of social insurance and medical fees would be difficult to accomplish.

Under these circumstances, the FY1979 tax reform was conducted including a tax rate hike, such as a gasoline tax, and a review of the special taxation measures. Of these, as for the special taxation measures, a rectification of the special treatment in the taxation of social insurance and medical fees was finally achieved, so that the rise in the tax burden for medical treatment fees was decided with a gradual deduction rate. Specifically, necessary expenses in the income tax of doctors, which was 72% as a flat tax rate, was changed to 72% for the social security income for up to ¥25 million, 70% for up to ¥30 million, 62% for up to ¥40 million, 57% for up to ¥ 50 million, and 52% for over ¥50 million. This decision reflected the idea of the Tax Commission and the MOF that the social insurance medical's public nature should be considered for income up to ¥50 million. As for the other items, they included a tax increase on gains from the trading of securities, entertainment and social expenses, and a statutory reduction ratio of allowance for the bad debts of corporations. Thus, the tax reform in FY1979 tackled the rectification of unfair taxation, as a first step towards the introduction of a general consumption tax.