Chapter 2: Fiscal and Monetary Policies under International Economic Friction

Section 1 Fiscal policy

1 Changes to the Fiscal Reconstruction Policy

The Summer Review and Tentative Calculation of the Frame. With the formation of the second Masayoshi Ohira Cabinet on November 9, 1979, Noboru Takeshita was appointed as the Minster of Finance, after Ippei Kaneko, and a new step was taken toward the fiscal reconstruction target named the “Target of Delivering the Government’s Finances from its Dependence on Deficit-bonds by Fiscal Year 1984”. The Ministry of Finance, in the meantime, had already started an advance assessment of FY1980 budget compilation with the other ministries in May, as the government bond dependency ratio in the initial budget FY1979 was a record high of 39.6%. This was known as the “Summer Review”. The Summer Review was regarded as a task which was an entire Cabinet project, as it was approved by the Cabinet. The ultimate theme was to consider how to rationalize and restrain expenditures, to reduce the issuance of government bonds. For instance, items of expenditures included obligatory expenditures such as local allocation tax grants and national debt service. As the problems of the debt accumulation of the “3Ks” (Kome: Rice; Kokutetsu: National Railways; and Kenkohoken: National Health Insurance) and pensions were reviewed, the ministries were requested to thoroughly check and correct their expenditures. Therefore, how to reduce or rationalize the expenditures gained a lot of attention, while they once tended to focus on the amount or increase rate of expenditures in the budget compilation. In terms of the guideline for the budget requests of FY1980, the general administrative expenses was restrained to be equivalent to the budget of the previous year and the remainder was restrained within 10% of it.

To consider the prospective for budget compilation and fiscal reconstruction, an estimation of the fiscal condition FY1980 (tentative calculation of the budget frame) was announced in November under the circumstances that the FY1980 budget was in an extremely difficult phase in terms of both revenue and expenditure. In terms of revenue, the large-scale Japanese Government Bonds issuance had reached its limit due to the increase in the interest rate. Expenditures far exceeded ¥1 trillion only for national debt service and local allocation tax grants. Then, in order to disclose the facts to the mass media and the public to make them understand the current fiscal situation, the MOF announced (the “Case A” and “Case B” budget frame) to reduce the government bond issue by ¥1 trillion in the FY1980 budget. Case A was to significantly reduce the natural and semi-natural increase in general expenditures and shrink the amount of increase in general expenditures to one third of that of FY1979. In Case B, it would be necessary to increase taxes to cover the shortage in tax revenues which could not be made up only by the natural increase in revenue. Therefore, the MOF tried to find a practical solution by referring these extreme cases (“Case A” and “Case B”) and planned to reduce ¥1 trillion in government bond issuance.

In addition to these efforts, the Fiscal System Council also showed their acknowledgement that drastic rationalization and reduction of expenditures would be necessary for the fiscal reconstruction in their “Report on problems of public bond, reduction and rationalization of government expenditures” on December 19. Moreover, the “Resolution on fiscal reconstruction” was adopted in the Diet on December 21, so that fiscal reconstruction was planned to build a sound fiscal foundation through cost saving by administrative reform, reduction and rationalization of expenditures and a fair taxation, and not by the introduction of a general consumption tax.

In the end, the FY1980 government budget draft was compiled under these circumstances, and the general account expenditure was ¥42.5888 trillion, a 10.3% increase compared to the previous year. The bond revenues were ¥14.2700 trillion. With the draft, the increase in expenditure was strictly restrained to the lowest level since the FY1959 budget (an 8.2% increase), and the reduction and rationalization of government expenditures were severely limited by keeping general public works (excluding disaster reconstruction costs) at the same level as the previous year, reducing subsidies (as far as possible) and carrying out administrative reform, such as reducing the number of civil servants. As for revenues, an increase in tax revenues was expected so that it showed a reduction of ¥1 trillion in government bond issuance as planned (special deficit-financing bond was reduced by ¥570 billion), which was a successful first step towards the further reduction of government bond issuance that had been increasing since FY1975. It should be noted that the general expenditures of the budget frame were restrained to a 5.1% increase compared to the previous year, but it was still the lowest for over 20 years, although the bond dependency ratio remained high as 33.5%, a 6.1% point decrease from the previous year. Accordingly, the FY1980 budget was the starting point for taking big steps towards a fiscal reconstruction policy.

On implementing the FY1980 budget, the same expenditure control policy was maintained as that for the initial budget, such as restraining the target contact ratio for public works in the first half of the year to no more than 60%. However, while prices were stable around spring, there were signs of economic slowdown, which required the government to watch both price stability and economic growth. The government started to change its policy in the autumn, to one of increasing the target ratio of public works for the three quarter of the year by 30% compared to the previous year and adopted an easy money policy. These measures contributed to prevent economic slowdown in the second half of the fiscal year.

The Budget for the First Year of Fiscal Reconstruction. As for the FY1981 budget compilation, the government started its Summer Review in May, aiming at full-scale fiscal reconstruction. In this Review, the "Target of Delivering the Government's Finance of Dependence on Deficit-bonds by Fiscal Year 1984" was followed. It showed strict conditions regarding fiscal reconstruction, including a reduction of government bond issuance by more ¥2 trillion compared to FY1980 and making the increase rate of general expenditures 0% in principle, even though a natural increase of tax revenue was expected. Furthermore, the guidelines for budget requests were restraining, as general administrative expenses were not to exceed those of the previous year, and the increase for the remainder was to be restrained to no more than 7.5% compared to the previous year. As for revenue, the Tax Commission submitted "A Report on Tax Measures to Improve the Fiscal Position" in November for the reassessment of the "beneficiaries pay" principle and the review of taxation from the viewpoint of fiscal reconstruction. The "Outline of FY1981 Tax Reform" proposed a considerable increase in national and local tax according to the report, and aimed to reinforce the tax burden measures, which reversed the postwar common sense on tax reform, which used to mean tax reduction.

The FY1981 government budget draft compiled under these circumstances included ¥46.7881 trillion of general account expenditures, a 9.9% increase from the initial budget of the previous year, which achieved the only single-digit increase for the first time in 22 years, since FY1959. The budget cut various items such as public investment, the number of civil servants, rice prices, national railway works, and measures for local government finance, and increased tax revenue, due to the tax reform of corporation tax, stamp tax and liquor tax as well as a natural tax, which significantly contributed to the result. Therefore, construction bonds remained unchanged from the previous year but the special deficit-financing bonds were significantly reduced by ¥2 trillion. As a result, bond revenues and the bond dependency ratio were reduced to ¥12.2700 trillion and 26.2% respectively. Furthermore, the increase rate of general expenditures was 4.3%, which was the lowest for the first time in 25 years, though 0% could not be achieved, as had been proposed by the Summer Review.

Therefore, the FY1981 budget prominently showed the intention of the government to reduce public bonds by ¥2 trillion from the beginning of the budget compilation, in what was eventually called the “Budget for the First Year of Fiscal Reconstruction”. The MOF published its “*Saishutsu Hyakka (Expenditure Review)*” (July 1980) as fiscal reconstruction measures in part of a nationwide campaign in order to ask the public for understanding and cooperation on the rationalization and efficiency improvement of expenditures. In this year, the “Medium-term Trial Estimate of the National Budget” replaced the “Medium-term Fiscal Outlook”, and required adjustment of the balance between revenues and expenditures and application of an accumulation method in order to accurately reflect the fiscal conditions.

In spite of the strong intention of the government to reform, with its “Budget for the First Year of Fiscal Reconstruction”, tax revenues were not obtained as expected, due to the delay in the recovery of domestic demand during the implementation phase of the budget. This tax revenue shortage actually became worse towards the end of the fiscal year. The following is a review of the history of the process toward fiscal reconstruction.

From Zero Ceiling to Minus Ceiling. The FY1981 budget was another step toward fiscal reconstruction, by restraining expenditures and large-scale tax increases. However, in the FY1982 budget compilation, the government could not anticipate an increase in tax revenues due to an economic recession, and the general consumption tax had not yet been approved under the “Resolution on Fiscal Reconstruction”. Therefore, it was still extremely difficult to restrain government bond issuance. Under these circumstances, the ministries were requested to strictly review their entire budgets, and a zero percentage gain policy (a “Zero Ceiling”) was applied. Prior to the FY1981 budget request, the Minister of Finance, Michio Watanabe, revealed the hardship of government finance saying, “We should be reminded that the outstanding after issuance of government bonds by the end of FY1984 will exceed ¥100 trillion, even if we succeed in escaping from dependence on deficit-financing bonds by FY1984 and maintain the issuance of government bonds of Article 4 (construction bonds) at the same level as before”. The Second Ad Hoc Commission on Administrative Reform (known as the “Second Ad Hoc Commission”), which was established in March 1981 to achieve administrative and fiscal reform, as the basic policy of Zenko Suzuki’s Cabinet, proposed that the reduction of expenditures and promotion of fiscal reconstruction were the urgent issues for reform, in the first report of the commission on July 10, as well as specific measures for reform under the current policy of the “Reconstruction of Public Finances without Relying on Tax Increases”. In the FY1982 budget preparation, a Zero

Ceiling was applied on quantitative budgetary restriction. On the other hand, the first report of the Second Ad Hoc Commission was for the qualitative restriction. In addition, the "Current Basic Policy on Administrative and Fiscal Reforms" was determined based on the first report of the Second Ad Hoc Commission on August 25, and the so-called "Special Case Law concerning Administrative Reform" integrating the 36 laws was enacted. This special law specified an overall policy concerning various expenditure reduction measures for fiscal reconstruction. It included the consolidation and rationalization of all subsidies, the reduction of treasury contributions to the welfare pension funds, class reorganizations in schools and restraining the increase in the number of school teachers as well as increasing the flexibility of the legal loan rates of government related financial institutions.

The FY1982 government budget draft, which was compiled in the mood of promoting the government-led fiscal reconstruction, restrained the general account expenditures to ¥49.6808 trillion or a 6.2 % increase compared to the initial budget of the previous year. The general expenditures increase rate compared to that of the previous year remained at only 1.8%. These were the lowest rates since FY1955 and 1956, and the budget for these years had been known as the "¥1 trillion budget".

The expenditure cut was realized by restraining public works-related expenditures to the same amount as that of the previous year, and reducing grants in accordance with the first report of the Second Ad Hoc Commission. As for the revenue side, the bond revenues were ¥10.4400 trillion, which was ¥1.8300 trillion less than the previous year, so that the bond dependency ratio decreased to 21.0%, which was less than that of the previous year. The issue amount of government bonds decreased from the previous year, which was ¥1.561 trillion and ¥269 billion for the special deficit-financing bonds and construction bonds, respectively. These reduction plans of government bond issuance were based on the tax revenue increase anticipated for over ¥4 trillion. In terms of FY1982, most of the revenue was considered to be a natural increase in the tax revenue.

While the pace of the economic recovery remained slow, the FY1981 tax revenues dropped significantly, so that the government decided to make a supplementary budget to cope with the reduction in tax revenues (approved on February 17, 1982). In order to tackle the tax revenue reduction, special deficit-financing bonds of ¥375 billion and construction bonds of ¥255 billion for disaster reconstruction were issued, so that as a result, the intended reduction of government bond issuance by ¥2 trillion in FY1981was downsized eventually. Moreover, with anxieties for the prospect of the economy in FY1982, the government faced difficulties in its FY1983 budget compilation from the start.

The Fiscal Emergency Declaration. The guideline for FY1983 budget requests was to achieve a 5% decrease except in special cases (Minus Ceiling). However, in spite of such measures to restrain expenditures, the government could not restrain the government bond issuance adopted until FY1982 in its budget compilation, because of insufficient tax revenue. In the meantime, the Second Ad Hoc Commission submitted a report for the secondary phase in 1982 to specify measures toward the "Reconstruction of Public Finance without Relying on Tax Increases". Particularly, the third report in July 1982 (the basic report) proposed the privatization of Japanese National Railways, Nippon Telegraph and Telephone Public Corporation, and Japan Tobacco and Salt Public Corporation (Japan's major three public corporations). The Fiscal System Council also tried to show a path to achieve fiscal reconstruction by submitting the expenditure reduction list.

In this process, the revenue shortage in the FY1981 settlement account became obvious, which eventually led to the "Fiscal Emergency Declaration" and the announcement of the resignation of Prime Minister Suzuki. As for FY1981 tax revenue, the tax authority was concerned that it might be far less than the initial amount estimated (¥32.2840 trillion). The government also revised the tax revenue downward in the FY1981 supplementary budget, which was approved in February 1982, but the tax revenue prospect as of the settlement in spring 1982 grew worse, as a shortage of more than ¥2.8 trillion became clear, compared to the revised budget of FY1981. The government explained that this was because of the worldwide economic stagnation, and particularly the economic slump following the sharp decrease of exports after December 1981, and the fall in general prices beyond its expectations. In July 1982, it was finally decided to compensate for the revenue shortage of ¥2.4948 trillion in the settlement of FY1981 by using ¥242.3 billion from the Settlement Adjustment Fund, established in FY1977, and ¥2.2524 trillion from the National Debt Consolidation Fund, through the Settlement Adjustment Fund. In August, the Minister of Finance, Michio Watanabe, announced that there would be ¥5-6 trillion shortage in tax revenue compared to the initial budget in FY1982, and that special deficit-financing bonds would need to be additionally issued. However, it would be necessary to restrain bond issuance at the ¥3 trillion level, at which acceptance by the market would be possible, by downward adjustment of the current expenditure, restraining the wages of civil servants and limiting additional fiscal demands, as well as cutting local expenses. This was followed by Prime Minister Zenko Suzuki's announcement of the "Fiscal Emergency Declaration" on September 16. He described the fiscal conditions as "unprecedented difficulties" and an "emergency", saying that the government needed a thorough review and cut of expenditures, the suspension of fixed rate transfers from the General Account to the National Debt Consolidation Fund and limiting of the wages of civil servants, as well as additional issuance of special deficit bonds to overcome the fiscal difficulties. Consequently, Prime Minister Suzuki announced his resignation on October 12.

Upon the resignation of Prime Minister Suzuki, Yasuhiro Nakasone won the Liberal Democratic Party presidential election. The Nakasone Cabinet was formed on November 27. Under the governance of the new Minster of Finance, Noboru Takeshita, the FY1982 supplementary budget was prepared (approved on December 25) to compensate for the decline of tax revenue by ¥6.1460 trillion, by the reduction of current expenditures, the reduction of local allocation tax grants, the suspension of fixed rate transfers from the General Account to the National Debt Consolidation Fund and issuance of special deficit-financing bonds. This was followed by the FY1983 government budget draft being submitted to the Cabinet. The budget draft represented the lowest increase rate since the "¥1 trillion budget" (FY 1955), with a 1.4% increase compared to the initial budget of the previous year, including General Account expenditures at ¥ 50.3796. The general expenditures decreased by ¥500 million. The restraint of the expenditures continued along the policy of Second Ad Hoc Commission, while public works-related expenditures remained unchanged from the previous year, and the foodstuff control expenditures and subsidies for Japanese National Railways decreased. The increase rate of social security-related expenditures was at the lowest level (a 0.6% increase) since they were categorized as major expenditures in FY1955. However, in spite of the efforts to restrain the expenditures, the bond revenue reached ¥13.3450 trillion with an increase of ¥2.9050 trillion, due to the shortage in tax revenue as announced in the "Fiscal Emergency Declaration". The bond dependency ratio eventually increased again to 26.5%.

Revision of Fiscal Reconstruction Targets. The "Medium-term Trial Estimate of the National Budget" proposed in the Diet session for the FY1983 budget, indicated neither the target of delivering the government's finances from its dependence on deficit-bonds in FY1984, nor provided a new target year. Even though the Cabinet had changed from Suzuki to Nakasone, fiscal reconstruction was still one of the most important issues. Therefore, it had been anticipated that the government would provide a new target year and make efforts to achieve fiscal reconstruction.

The guideline for FY1984 budget requests showed targets of -10% for current expenditures and -5% for investment expenditures in general expenditures in principle. As the government debt outstanding exceeded ¥100 trillion by the end of June, such a minus ceiling policy was applied in order to quickly respond to the stringent fiscal conditions. Then, the long term economic plan (the "Outlook and Guidelines for the Economy and Society in the 1980s") was finalized by the Cabinet in accordance with the Economic Council report in August 1983, providing guidelines for the management of the economy and public finance. One of these measures was to set the basic objective of the fiscal reform to end its special deficit-financing bond dependency by "FY1990". This was a change in the fiscal reconstruction target of "delivering the government's finances from its dependence on deficit-bonds by fiscal year 1984" stated in the "New Economic and Social Seven-Year Plan" and meant the beginning of another phase of new fiscal reconstruction.

The government finalized its Comprehensive Economic Measures for economic promotion by the expansion of domestic demands October 21, 1983. While these measures were being taken, there was still an ongoing, fixed policy of expenditure reduction for fiscal reconstruction. On December 29, the Administrative Reform Council submitted a request to make the amount of general expenditures less than, or the same as, those of the previous year. The Fiscal System Council also made a similar proposal. After this process, the FY1984 government budget draft included general account expenditures of ¥50.6272 trillion, or a 0.5% increase compared to the initial budget of the previous year, which restrained the increase in general expenditures, as well as limiting individual items such as public works and foodstuff control expenditures. The increase rate of social security-related expenditures, which was the biggest among general expenditures, was also strictly restrained, through measures for the reform of medical expenses, such as increasing the burden to the beneficiaries of the government-managed national health insurance. However, the tax revenue did not rise dramatically in spite of the tax increase, and the amount of bond revenues decreased by only ¥665 billion (special deficit-financing bonds decreased by ¥525 billion) to ¥12.6800 trillion. The bond dependency ratio remained at 25.0%, which showed a slight reduction from the previous year. The FY1983 supplementary budget (approved on February 24, 1984) dealt with disaster measures and the tax reduction to be conducted within the fiscal year, but additional issuance of special deficit bonds was avoided, by saving the current expenditure and applying the net surplus of FY1982 to the revenue.

Japan went through a long-lasting economic slump for 3 years after the second Oil Crisis, and FY1983 was the year in which its full-blown economic recovery began. In particular, Japan enjoyed an increase in exports to the U.S., caused by the recovery of the U.S. economy from the latter half of FY1983. Japan's domestic demand also tended to recover, such as in private equipment investment. In FY1984, the highest growth rate since the first Oil Crisis was recorded at 5.7%, because of the stable economic recovery mainly caused by the boost in domestic demand, although it was slightly affected by the economic slowdown of the United States in the second half of the year. Under these circumstances, the FY1984 supplementary budget (approved on February 13, 1985) posted a considerable increase in revenues from corporation tax and securities transaction tax, and other revenues. Regarding expenditures, while additional costs such as obligatory expenditures and disaster reconstruction expenses were the major items, a reduction in current expenditures and reserve funds was also included. Regarding the supplement of government bonds, construction bonds were added, but the bond dependency ratio for the supplementary budget was equivalent to the initial budget at 25.0%.

Since Ohira Cabinet's target (set in 1979) for fiscal reconstruction to deliver the government's finances from its dependency on special deficit-financing bonds in FY1984 could not be achieved, the target year was changed. The Ad Hoc Commission on Administrative Reform-proposed the "Reconstruction of Public Finance Without Relying on Tax Increases" in March 1983, which was maintained as the basic policy of the government, so that efforts were continuously made to cut and rationalize expenditures.

2 Government Debt Management Policy in Fiscal Reconstruction

Measures Taken for the Target of Delivering the Government's Finances from its Dependence on Deficit-bonds. As mentioned earlier, the issuance of government bonds in the FY1980 budget was ¥14.2700 trillion, which was ¥1 trillion less than that of the previous fiscal year. This reduction of ¥1 trillion was enabled by limiting the issuance of both construction bonds and special deficit-financing bonds at the same time. Special deficit-financing bonds were reduced for the first time compared to the initial budgets. As market acceptance of government bonds was growing more difficult, bonds held by the Trust Fund Bureau were increased by ¥1 trillion compared to the previous year to ¥2.5 trillion, and the acceptance by the market was reduced by ¥2 trillion, to try to balance the environment for the issuance. On the other hand, the government debt management policy in and after the early 1980s was operated under unprecedented conditions. Hence, the bond dependency ratio which surged after FY1975 hit a peak of 39.6% in FY1979, and then started to decline from FY1980. Furthermore, although the "Fiscal Emergency Declaration" (of September 16, 1982) was a setback, the trends of a low bond dependency ratio and less issuance of government bonds continued until the end of the “bubble economy”.

In the FY1981 budget, the government bond issuance decreased by ¥2 trillion compared to the previous year, to ¥12.2700 trillion. In addition, the bonds held by the Trust Fund Bureau increased by ¥1 trillion, to ¥3.5000 trillion, so that the acceptance by the market decreased by nearly ¥2 trillion. In the FY1982 budget compilation, the government bond issuance decreased by ¥1.8300 trillion, to ¥10.4400 trillion, with the momentum for promoting fiscal reconstruction. The amount of bonds held by the Trust Fund Bureau was the same as that in FY1981. As the acceptance by the market of government bonds was difficult, the bonds held by syndicate underwriting was decreased preferentially, in the same manner as in FY1981. However, in FY1982, the tax revenue fell well below the expected amount by the middle of the fiscal year, so that a large amount of government bond issuance was required. The FY1982 supplementary budget (approved on December 25) included the additional issuance of government bonds. However, as this amendment resulted from the reduction of expenditures such as the suspension of the fixed rate transfer of the national debt and the reduction of the local allocation tax grants, the Trust Fund Bureau became incapable of holding government bonds by providing loans to the Special Account for Local Allocation Tax Grants. Therefore, the government bonds needed to be additionally issued, although they still could not make up the shortage of tax revenue. Due to this situation, the issuance of government bonds in FY1982 increased to ¥14.0447 trillion yen, exceeding the amount of the previous year by ¥1.1448 trillion.

The government bonds issuance of the FY1983 budget was for ¥13.3450 trillion, which was an increase from the previous fiscal year of ¥2.9050 trillion. The bonds subscripted by the Trust Fund Bureau reached ¥3.7000 trillion yen, which was more than that of the previous fiscal year by ¥200 billion, and the acceptance by the market was planned to be ¥ 9.6450 trillion. In the middle of the fiscal year, the government debt outstanding at the end of June 1983 exceeded ¥100 trillion yen, and the “Target of Delivering the Government’s Finance of Dependence on Deficit-bonds by Fiscal Year 1990” was newly set in August. With the shortage of tax revenues, the government recognized that fiscal reconstruction was a urgent task. In the FY1984 budget, the government bond issuance was shrunk by ¥12.6800 trillion from the previous fiscal year, which was followed by the trend of decreasing government bond issuance throughout the stable growth period.

Meanwhile, a new problem was raised in FY1984 of how to deal with the refunding of the government bonds, which would begin in full from FY1985. “Refunding” means redemption of the expired government bonds by using the resources obtained by newly issued government bonds (refunding bonds). Regarding the large volume of refunding for the government bonds, in accordance with the Conference on the Problems of Government Bonds whether or not front-loading of refunding should be implemented was considered by the MOF, but it was not implemented eventually. In the end, the issue amount of refunding bonds was ¥3.2727 trillion for FY1982, 4.5145 trillion for FY1983, and 5.3603 trillion for FY1984. The amount in FY1984 was not so much of an increase on that of the previous year. However, it was ¥8.9573 trillion in FY1985, which literally created a rush of government bond issuance, when including those newly issued.

Suspension of the Fixed Rate Transfer of National Debt Service. The "Special Account Law for the National Debt Consolidation Fund" specified that the amount equivalent to 1.6 % of the government debt outstanding at the beginning of the previous fiscal year would be allocated to the National Debt Consolidation fund. However, as mentioned earlier, with the FY1982 supplementary budget, this fixed rate transfer had been suspended. This is because the tax revenue was far below the initially expected amount, so that a large amount of government bonds needed to be issued. In spite of this, the National Debt Consolidation Fund had sufficient accumulated resources, which meant that it did not affect the government bond redemption even when the fixed rate transfer was suspended. The proposal of the suspension of the fixed rate transfer was passed for consultation to the Fiscal System Council in September 1982, and it was accepted as an inevitable measure. The government enacted the "Law concerning the Special Measures of Fund Resources to be Transferred to the National Debt Consolidation Fund for Fiscal Management in Fiscal Year 1982" to suspend the fixed rate transfer for the government bond redemption. Accordingly, the fixed rate transfer was suspended under the special law each year from FY1983 to FY1989.

This suspension of the fixed rate transfer emerged as a big problem under the government debt management policy at that time. This was because that it was likely to continue into the following year and beyond, though it had been an emergency measure in FY1982. In such a case, the National Debt Consolidation Fund was expected to bottom out as early as FY1984. In practice, the fixed rate transfer was suspended since the issue of a large number of government bonds, including the special deficit-financing bonds, was requested, even with cost-cutting and rationalization of expenditures in FY1983. The consolidation fund could keep its liquidity to cope with the redemption of the government bonds even though the fixed rate transfer would be suspended in FY1983. Furthermore, although the fiscal conditions required the government to issue a large amount of government bonds, including special deficit-financing bonds, even with the cutting and rationalization of expenditure for FY1984 budget compilation, the National Debt Consolidation Fund was not so crucial as to negatively affect the redemption of government bonds without the fixed rate transfer. Therefore the fixed rate transfer was suspended as an inevitable measure.

The Allowance for the Refunding of the Special Deficit-financing Bonds. Although the construction bonds were to be redeemed under the 60-year redemption rule from the beginning, it was hoped that special deficit-financing bonds would not have be issued and that the balance could be shrunk as early as possible, so that they could be redeemed in cash (to pay the loan off in cash within 10 years of the maturity date) without issuing refunding bonds. The “Special Deficit-financing Bond Law” also specified that the refunding bonds should not be issued.

However, if special deficit-financing bond redemption was to be conducted in cash and delivering the government’s finances from its dependence on special deficit-financing bonds was to be completed as intended by “FY 1990”, an extreme cost cut or an increase of the tax burden, or both, might be inevitable as a national policy. This might give rise to a negative impact on the national economy and the public livelihood. Therefore, the article restraining the conversion of traditional “Special Deficit-financing Bond Law” was abolished, as the resources for the special deficit-financing bond redemption would inevitably be obtained through the issuance of refunding bonds. More specifically, in the “Law concerning Special Measures to Secure Funds Necessary for the Fiscal Management for Fiscal Year 1984”, the article restraining the conversion of special deficit-financing bonds issued in FY1984 and earlier was abolished, and in addition, it was regulated that as few refunding bonds for special deficit-financing bonds would be issued as possible, by taking the fiscal conditions into consideration, and even if issued, efforts should be made to reduce the balance. With this policy change, the important thing to consider was how long it would take to implement the cash redemption of the special deficit-financing bonds, whose conversion would be allowed. It was recognized, however, as being difficult to achieve, because the special deficit-financing bonds should be reduced at an early stage, and their redemption should be completed within the specific term in principle. Consequently, it was determined to apply the 60-year redemption rule as a basis for the special deficit-financing bond redemption, since the reserve of the resources to reduce the bonds was based on the same redemption rule as the construction bonds.

The Progress of Government Bond Liquidity. The trading trends of Japanese Government Bonds in the market were described in the Chapter 1.1. In addition to the increase in government bonds held by financial institutions, there was progress in liquidity in and after FY1980. From May 1980, government bonds were allowed to be sold after listing (after 7-9 months from issuance). From April 1981, selling was also allowed in the beginning of the fourth month after bond issuance.

This deregulation of bond trading was implemented as financial institutions, and especially major banks, needed to sell a large amount of government bonds constantly, because their fund position had become worse due to the slowdown of deposits at that time. Thus, underwriting syndicates had requested that the MOF abolish the restrictions on the trading of government bonds in the market. The MOF also positively accepted deregulation as it realized that the secondary market needed to be extended for smooth trading, as well as to sell the government bonds easily in the market. In turn, as financial institutions needed to sell the bonds in order to hold new government bonds, as a large amount of government bonds was continuously issued in the 1980s, the MOF decided to leave it to the discretion of financial institutions as to whether to sell the government bonds 7-9 months passed after their issuance, as a part of a five-point program ("On the Present Government Bonds Policy"). However, even after the deregulation, financial institutions still requested the further shortening of the selling term, or the abolition of the regulation. Although there was a controversy, since many said it was unnatural to set a limitation on selling securities once they were issued, the MOF was reluctant to further shorten the selling term or to abolish the regulation, since the selling limitation was an effective measure to constantly reduce the large amount of government bonds.

Consequently, the MOF sought to resolve this issue by a gradual system reform, and deregulated the selling limitations in and after June 1985, eventually abolishing the regulations in September 1995.

3 Principles of the Reconstruction of Public Finance without Relying on Tax Increases and the Tax System

The Examination of the Introduction of a Green Card System. After it was decided to postpone the introduction of a general consumption tax, priorities were placed on how to secure tax revenues, as well as rectifying the unfair taxation before the introduction of a new tax. In practice, the tax reform plan in FY1980 was expected to increase tax, thanks to the economic recovery, so the government carried out the consolidation and rationalization of special taxation measures, and deductions for employment income and land and house taxation, without making a major tax increase. In the meantime, regarding the interests and dividends tax that had been discussed for years, it was decided to change the category to comprehensive taxation in FY1984, in accordance with the results of a review by the Tax Commission, so that the introduction of a so-called "Green Card" was decided upon for those who have a small amount of savings. It was also decided to extend the term of validity of elected separate withholding taxation at source on interest and dividends, until the change of system to the comprehensive taxation started.

The introduction of a Green Card system was considered because there was a controversy in and out of the government that the interest and dividends income should be changed to comprehensive taxation for fairer taxation. In 1970, it was decided to implement the elected separate withholding taxation system at the end of 1975. Then in 1975, the term was put off until the end of 1980. Just before that time, the Tax Commission made a final review regarding the status change of the taxes to comprehensive taxation, in the special tax committee in June 1979. In this committee, there was a consistency of opinion that a tax payer identification number system would be the most appropriate way to solve the issues, but it was still unclear whether they could obtain the agreement of the public. The Green Card system was finally accepted in December 1979. This system was to apply a Green Card for the identification of users only for savings. The government had been considering a comprehensive income taxation at source on interest and dividends for years, and thought that the Green Card would be a solution for the fair taxation of those who had a small amount of savings. The Tax Commission's report in December stated that the system was the most practical and effective measure for identification and saving accounts integration for both non-taxable savings and taxable savings.

In either case, this proposal was decisive in introducing the system, and through the amendment law of the income tax law, promulgated on March 31 1980, it was decided to introduce the Green Card system effective January 1, 1984. However, this system was revealed as being incomplete and allowing inappropriate use (tax-exempted savings beyond the limitation) and caused criticisms from various fields, including the political parties. Eventually, it was not implemented. In the end, the system was abolished in 1985, after the 3 years of pending since the FY1983 tax reform.

The Massive Tax Increase in FY1981. The interim report compiled by the Tax Commission on November 7, 1980, was "A Report on Tax Measures to Improve the Fiscal Structure". The main difference from the previous interim report in 1977, was that it strongly requested the government to restrain expenditure, as well as to provide a limitation on the increases tax burden and propose additional options to increasing the tax burden. In the elections of the House of Councilors and House of Representatives on the same day in June 1980, the ruling party secured power, but plenty of tax revenues were not expected from the viewpoint of economic condition. There was also concern about a massive tax shortage emerging around autumn. Under these circumstances, the Tax Commission interim report triggered a massive tax increase policy toward the FY1981 tax reform. In January 1981, the "Outline of FY1981 Tax Reform", intended to increase the tax revenue by ¥1.544 trillion for an average year, including corporation tax, liquor tax, sales tax, stamp tax and securities transaction tax, which was to increase tax revenues as much as possible within the framework of the existing tax system (Overall Tax Increase). For instance, the tax reform represented increases of tax by 2% points for corporation tax, 24% for liquor tax, in principle, and 0.55% for securities transaction tax, in terms of stock certificates from 0.45%. Although an income tax reduction was promised in the decision of the Chairman of the House of Representatives in March 1981, it was appropriated as a resource for the tax reduction in the FY1981 supplementary budget by the surplus funds after the reduction of the special deficit-financing bond issuance in the settlement in FY1980. This tax reduction was only for ¥2,000 per average family of two parents and two children, and was called the "Ramen tax-cut" that the tax cut was only good for buying four bowls of Ramen noodles for the members of a family.

The FY1981 tax reform was a drastic one, as stated above. However, in the following year FY1982, the tax reform was not so drastic, as it only included the consolidation and rationalization of the special taxation measures and a downsizing system of the postponement of corporation tax payment. While there was no major reform in FY1983 either, there was also a consideration of the basic policy the "Reconstruction of Public Finance without Relying on Tax Increases", proposed in the first report of the Ad Hoc Commission on Administrative Reform (July 1981).

The Report Entitled "The Desirable Form of the Tax System in the future". This report (the interim report after November 1980) submitted by the Tax Commission on November 16, 1983, stressed that it would be necessary to recover the fiscal soundness of the national and local governments, as well as fiscal strength, in order to maintain the stability and fullness of Japan's economy in the aging society to come. It proposed that immediate measures be taken to correct the abnormal conditions of the tax revenue, accounting for only 64% of the expenditures of the FY1983 budget, due to Japan's vulnerability in terms of recovery in this term, and it also suggested that particular attention be paid to the close relations between tax items and to expanding the tax base to rationalize the indirect tax system. In terms of the individual tax items, income tax, for instance, needed to be reconsidered to ease the public's sense of an increased tax burden, as its tax threshold remained unchanged since 1978. As for the taxation on capital gains, it was proposed only to retain the land tax reform in FY1982 as the basic system for long-term stabilization, and to maintain the taxation on gains from the transfer of securities unchanged until a sound system for securities trading was obtained, before the shift to comprehensive taxation.

In March 1981, the Ad Hoc Commission on Administrative Reform launched a policy of administrative reforms called the "Reconstruction of Public Finance without Relying on Tax Increases". The government made efforts for fiscal reconstruction under this policy, aiming for administrative reform and the reduction of expenditures. Therefore, no major tax reform was conducted in FY1982 and FY1983. This meant that no income tax reduction was conducted either. Tax reductions were conducted almost every year until the early 1970s, but it remained unchanged for some years in late 1970s. In the Diet session for the FY1983 budget, the income tax reduction issue gained a lot of attention as an important political issue, with the background of demands for tax reduction mainly among employment income earners. No tax reduction was implemented in the FY1983 tax reform, but the government promised a large scale tax reduction in FY1984. However, as fiscal conditions were still heavily dependent on government bonds and fiscal reconstruction was underway, such a large-scale net tax reduction was impractical. Therefore, in fact, the government intended to launch the full-blown income tax reductions with an increase in corporation, liquor and petroleum taxes.

The tax reform under the circumstances described above included the income tax reform as proposed by the "interim report" and the corporation tax reform. In terms of income tax, the tax threshold increased from ¥2.015 million to ¥2.357 million since FY1981 for the employment income earners of a married couple. The brackets for the income tax rate were also simplified from 19-10% for those with income under ¥600,000 to 75% for those with income over ¥80 million, to 15-10.5 % for those with income less than ¥500,000 to 70% for those with income over ¥80 million. These reforms to the income tax structure were made since 1974, aiming to ease negative feelings about the tax burden caused by (so-called) Bracket Creep. As the immediate implementation of a large-scale income tax reduction was a promise by both the ruling and opposition parties, the ¥870 billion income tax reduction was implemented, which was the second largest in scale next to the “¥2 trillion tax reduction” in FY1974. On the other hand, the standard corporation tax rate increased by 1.3% to 43.3% for retention, and 33.3% for dividends in FY1984. In terms of indirect tax, liquor tax was raised by about 20% on average, and the petroleum tax was also raised from 3.5% to 4.7%.

Suspension of Discussions on General Consumption Tax. Prime Minister Masayoshi Ohira stated in a press conference in July 1979 that Japan’s fiscal reconstruction would require escaping from its dependence on deficit-bonds or reducing expenditures, and if the tax revenue was still short, an increase in income tax, or the introduction of a general consumption tax would be necessary. However, as shown in Chapter 1.1, the 35th House of Representative elections in October focused on the general consumption tax, so that criticism occurred from both ruling and opposition parties. In the “Resolution on Fiscal Reconstruction” in December, it was decided not to depend upon the general consumption tax for fiscal reconstruction but to restrain expenditures for fiscal reconstruction.

Then, the discussion on a massive indirect tax was not discussed openly for a while. In the interim report in November 1983, an extension of the taxation base was proposed to rationalize the aforementioned indirect tax system, but no specific proposal was made by the Tax Commission, because the Second Ad Hoc Commission’s report, the “Reconstruction of Public Finance Without Relying on Tax Increases” was still the basic principle of the fiscal policy. On the other hand, the difficulties in achieving fiscal reconstruction within the current taxation system were also recognized again. Minor tax reforms were also made every year in order to secure tax revenues, but these were no longer effective enough.

Thus, the “distortion” or “imbalance” between the real economy and the existing tax system was realized, and, therefore, Prime Minister Yasuhiro Nakasone requested the Tax Commission to work on a “Drastic Review of the Tax System” in September 1985. The report on a “New Type of Indirect Tax” was submitted to the Prime Minister in October 1986 (see Chapter 3.1.4). Before then, in the FY1985 tax reform report, the Tax Commission proposed that this was the time to study a drastic reform of the overall tax system, and stated that partial revisions would not be sufficient to make a fair tax burden between income, asset and consumption. This report also proposed that the government should make efforts to seek understanding and cooperation from the public on this issue. Thus, the long path of preparation for the introduction of a general consumption tax was finally nearing an end.