Chapter 3: Fiscal and Monetary Policies after the Plaza Accord

Section 1 Fiscal Policy

1. Measures to Expand Domestic Demand and Fiscal Policy

The Budget for Fiscal Reconstruction. Efforts to reduce expenditure in the budget compilation for each fiscal year continued, past the original target year for the government's finances to escape from its dependence on special deficit-financing bonds, which was extended to "FY1990" in the long-term government economic plan, "Outlook and Guidelines for the Economy and Society in the 1980s" (August 1983).

The guideline for budget requests (or "ceiling") was set severely, to about the level of FY1984, with a current expenditures decrease of 10%, and an investment expenditures decrease of 5% respectively, in the FY1985 budget compilation. Moreover, greater focus was placed on the consolidation and rationalization of subsidies compared to other fiscal years, and the government also decided to review the measures for local finance. In the process of budget compilation, the policy of the privatization of the Nippon Telegraph and Telephone Public Corporation and the Japan Tobacco & Salt Public Corporation (April 1985) was decided. Two thirds of the Nippon Telegraph and Telephone Co. (NTT) stocks and half of the Japan Tobacco Inc. (JT) stocks were placed into the National Debt Consolidation Fund as fiscal resources to redeem government bonds, and the remainder was allotted to the Industrial Investment Special Account, to use the dividends as revenue to promote social overhead capital. While the overall review of the budget system and the administrative and fiscal reforms were underway, a fiscal reconstruction-type budget draft for FY1985 was finalized, and the General Account expenditure showed ¥52.4996 trillion, an increase of 3.7% compared to the initial budget of the previous year. In terms of expenditure, the national debt service accounted for ¥10.2242 trillion, as the biggest part among the major expenditure, which exceeded the social security-related expenditure of ¥9.5736 trillion. As local allocation tax grants were also enormous at ¥9.6901 trillion, the trend of the fiscal rigidity became more obvious. Moreover, the reductions were focused on foodstuff control expenditures and public works-related expenditures, etc. for the current expenditure, which had been reduced continuously for 3 years since 1983.

On the other hand, the bond revenue in FY1985 declined by ¥1 trillion (special deficit-financing bonds were reduced by ¥725 billion) to ¥11.68 trillion, because the tax revenue estimate increased by 11.4%, thanks to economic expansion. However, at the implementation stage of the budget, the increase in tax revenue was less than had been expected, so the supplementary budget was revised significantly downward (approved

February 15, 1986) mainly for the corporation tax, and the government bond issuance was revised upward.

The government showed the stance of a severe expenditure reduction, even for the FY1986 budget compilation. The guideline for budget requests showed a 10% and 5% decrease on the current expenditures and investment expenditures respectively, compared to the initial budget of the previous year. Then, as the yen appreciated rapidly by coordinated intervention to correct dollar depreciation, based on the “Plaza Accord” in September 1985, the Japanese government decided upon and implemented its “Measures for the Increase of Domestic Demand”. However, this was a measure regarding the demand of fiscal reconstruction, so that the increase in domestic demand here mainly depended on the Fiscal Investment and Loan Program, utilization of the private sector’s vitality to the public sector and tax reduction for investment. In the end, in the FY1986 budget draft, General Account expenditure was ¥54.0886 trillion which was an increase of 3% from the initial budget of the previous year. The bond revenue was reduced by ¥734 billion to ¥10.9460 trillion. While the policy to control expenditures contributed to saving of the general expenditure for four consecutive years, as it had in the previous year, the increase rate of defense-related expenditure, which was considered to be a “sanctuary” from the stage of budget requests, was higher than that of other main expenditures. This was because the “Medium-Term Defense Program” for FY1986-1990 had been decided upon by the Cabinet (September 18), and FY1986 was the initial year of a new defense program. The Medium-Term Defense Program was expected to be ¥18.4 trillion in total, which was 1.038% annually compared to GNP. Under these circumstances, the opposition parties demanded the firm maintenance of the 1% frame for national defense expenditure compared to GNP. Then, in the discussion in the Diet in the autumn, Prime Minister Yasuhiro Nakasone finally confirmed that the ratio should maintain within the 1% frame in the FY1986 budget compilation, and the ruling party reached agreement with the opposition parties.

Although the government was able to keep the general expenditure of the FY1986 budget to the equivalent or below the amount of the initial budget of the previous year, there was little hope for additional tax revenues. Therefore, the reduction of special deficit-financing bonds was only ¥484 billion and fiscal consolidation did not make much progress. In the FY1985 supplementary budget (approved February 15, 1986), which was submitted to the Diet at the same time as the FY1986 budget, since tax revenues would not cover the expenses of disaster reconstruction and the hike in civil servant’s wages, the shortage was covered by the additional issuance of special deficit-financing bonds of ¥405 billion, in addition to the construction bonds.

Meanwhile, although the idea of the “Reconstruction of Public Finance Without Dependence on Tax Increases” and the technique of “Zero Ceiling or Minus Ceiling” budget compilation were effective in controlling the natural increase of obligatory expenditures and increasing the opportunity to reduce government bond issuance, some specific budget techniques were taken to achieve the fiscal reconstruction in each fiscal year. For instance, the issuance of the refunding of government bonds conversion greatly contributed to reducing government bonds by ¥1 trillion in the FY1985 budget, as mentioned above. Another significant reason for the reduction of the government bond issue was the suspension of fixed rate transfer from the General Account to the National debt Consolidation Fund since FY1982. Since obligatory expenditures, such as national debt service and local allocation tax grants increased rapidly, social security-related expenditures and public works-related expenditures were controlled severely. In addition, measures that meant that the financial burden was carried over to the following fiscal year were taken, such as postponing the transfer from the general account fund to welfare pensions under the “Special Case Law concerning Administrative Reform” for another one year (see Chapter 2.1.1). Accordingly, the reduction of the special deficit-financing bond issue from FY1984 was not that easy, but in some regards it showed the limits of the “Reconstruction of Public Finance Without Dependence on Tax Increases”. A tax increase would also be necessary, concurrent with a severe cut in government expenditures, to accomplish fiscal reconstruction. Therefore, it was further acknowledged that a drastic tax reform, including a review of the ratio of direct-indirect taxes and an expansion of the tax base, were necessary.

Measures for the Recession Caused by Yen Appreciation after the Supplementary Budget of FY1986. The government faced opposite requests ―both for measures for domestic demand expansion and measures for fiscal reconstruction― due to the economic slump after the “Plaza Accord” in September 1985. Moreover, fiscal authorities had the important task of completing a drastic review of the tax system.

Based on the process of budget compilation at that time, the guideline for FY1987 budget requests showed a 10% and 5% decrease in current expenditure and investment expenditure respectively. The government showed its determination to significantly reduce government expenditures. This was because it was seen that it was not the time to ease the ceiling, by taking into consideration the increase in national debt service and local allocation tax grants, and requests to decrease the issue of government bonds, even though there would be a natural increase in tax revenue. Before the deadline of budget requests, on the other hand, there was concern that the rapid yen appreciation in July

1986 may affect the earnings of export-related companies and tax revenues. Therefore, the government decided upon its “Comprehensive Economic Measures” (measures for recession caused by yen appreciation) mainly regarding public investment, in September. Moreover, in the FY1986 supplementary budget (approved on November 11) it prepared to execute measures intended to deal with a decrease in tax revenue of ¥1.12 trillion. It also maintained the amount of transfer from the General Account to the National Debt Consolidation Fund at ¥410 billion, and the issuance of construction bonds of ¥549 billion as a fiscal resource for public works was also scheduled, besides the carried-over surplus which was assumed to be a fiscal resource. The FY1986 budget was, in the meantime, executed with 77% of the contract ratio for public works in the first half of the year, which was the biggest advanced implementation ever. Moreover, public works-related expenditures were significantly added to the supplementary budget. Consequently, the Comprehensive Economic Measures were not effective in achieving sufficient effect for the sluggish economy.

The General Account expenditure of the FY1987 restraining-type budget draft was ¥54.1010 trillion, representing a rate of 0.0% increase compared to the initial budget of the previous year. The general expenditure had been decreasing for five years in a row, while social security-related expenditures, which exceeded ¥10 trillion yen for the first time, were controlled at an increase rate of 2.6% compared to the initial budget, and the pace of increase rate was restrained constantly from FY1985. However, the Fiscal Investment and Loan Program plan showed the highest growth (22.2%) for the first time since FY1973, in contrast to the control policies of the General Account budget. This then contributed to domestic demand expansion, with subscription to government bonds of ¥2.4 trillion. The bond revenues reached ¥10.5010 trillion. Although the issue amount of special deficit-financing bonds decreased to ¥4.9810 trillion, the reduction of the issue amount compared to the previous year was only ¥445 billion for overall government bonds, and ¥265 billion for special-deficit financing bonds. In such a process of budget compilation, it was decided that the Japanese National Railways would be privatized (April 1987), following the privatization of the Nippon Telegraph and Telephone Public Corporation and the Japan Tobacco & Salt Public Corporation.

The biggest issue in the discussion on the FY1987 budget was sales tax. The opposition parties demanded an additional speech and refused to make their questions to the Diet, causing the Diet to go into turmoil, because Prime Minister Yasuhiro Nakasone had not addressed the issue of a sales tax in his administrative policy speech (January 26, 1988). Arguments about the FY1987 budget were suspended, as the opposition parties refused to discuss it until the ruling Liberal Democratic Party attended the Diet and first made an explanation of the budget draft by the Minister of Finance Kiichi Miyazawa in the budget committee of the House of Representatives without the opposition parties. This resulted in the suspension of discussion even for other issues, such as the government and ministerial ordinance related to sales tax, and its discussion scheduling. Therefore, a provisional budget needed to be compiled for FY1987 due to the delay in such discussion. While a provisional budget should not include policy-related expenditure in principle, it is necessary to include the expenditures for public works, with due consideration for business activity, if the period covered by a provisional budget is more than a month. In this case, a provisional budget for fifty days until May 20 was compiled, since the budget approval was anticipated as being delayed until May, due to the nationwide gubernatorial elections scheduled on April 12, and the House of Representatives' vote for the budget was expected to be made after that.

Emergency Economic Measures and the Large-scale FY1987 Supplementary budget. As the Comprehensive Economic Measures in September 1986 were not effective, as mentioned above, the government proposed a large-scale economic measure on May 29 after the FY1987 budget was approved, and finalized the Emergency Economic Measures with a fiscal measure of more than ¥6 trillion. This was not only an economic measure but also one to execute the External Economic Measures that were agreed in the Finance Ministers meeting and the Japan-U.S. Summit talks. Therefore, it was a comprehensive measure for the expansion of domestic demand, such as public investment, tax reduction, revitalizing local economies and measures for small- and medium-sized enterprises, as well as fiscal measures, monetary policy and activation measures for the mobilization of private sector vitality. A large-scale supplementary budget (the first) of ¥2 trillion was approved, to secure fiscal resources for the Emergency Economic Measures on July 24, 1987. With this supplementary budget, the General Account expenditure in FY1987 increased to ¥56.1803 trillion, and an additional issuance of construction bonds of ¥1.36 trillion was made for public works. Moreover, the revenue from government-held shares of Nippon Telegraph and Telephone Co., after its privatization from the Nippon Telegraph and Telephone Public Corporation, was used to provide social overhead capital at this time. The revenue from the sales of NTT shares should have been allotted to the fiscal resources for government bonds redemption in principle, but it was decided to give permission to use the revenue, as long as it did not interfere with the management of the National Debt Consolidation Fund. In addition, it could be transferred to the Social Capital Adjustment Account, newly categorized in the Industrial Investment Special Account, through the General

Account, which would be available for lending without interest. In addition, the special measure expenses for government procurement were included as a temporary exceptional measure of the supplementary budget to contribute to the expansion of imports. With this measure, government planes and a super-computer were procured.

The “Yen appreciation recession”, representing the economy of 1986, turned out to rapidly shift to economic recovery in FY1987. A sense of economic boom was widespread by around summer. In terms of the settlement tax revenue in FY1987, the tax revenue increase was remarkable, mainly because of plentiful corporation tax revenue. A secondary supplementary budget (February 20, 1988) was compiled under these conditions. The feature of this ¥2.3390 trillion supplementary budget was in its revenue. The government bonds issue was back to the level of the initial budget draft by including the reduction of the special deficit-financing bonds for ¥1.322 trillion. The “Medium-term Estimates of the National Budget (FY1986-1990)” submitted by the MOF to the Committees on Budget in both the Houses of Representatives and Councilors in February 1987, showed a ¥1.66 trillion reduction of special deficit-financing bonds was necessary every year, in order that the special deficit-financing bond issuance would be zero by FY1990. This meant that the reduction of ¥1.5870 in the FY1987 revised budget, based upon the two supplementary budgets, would be big step towards the fiscal reconstruction.

The Privatization of Japanese National Railways. The Japanese National Railways (JNR) reform including its financial matters was considered to be one of the biggest issues for the Second Ad Hoc Commission on Administrative Reform (Chairman Toshio Doko), launched in March 1981, because of the difficulty of the privatization initiative of JNR, and its social and economic impact.

There were once three public corporations - the JNR, the Nippon Telephone and Telegram Public Corporation and the Japan Tobacco & Salt Public Corporation - at one time. However, the limits of public enterprise management started to be exposed in the business substance, management system and financial management of these companies in the first half of the 1970s, so that the necessity for drastic reform was pointed out from various fields. Especially, the financial problems of the JNR were serious, and it was recognized as being one of the “3K” national debt accumulation problems (3K: JNR, rice price, and health insurance). Railway traffic had started declining due to motorization and qualitative changes in transportation needs after the early 1960s. Furthermore, with the delay in the rationalization of management caused by cost rises and labor problem, the annual financial balance turned to a deficit in FY1964. After this change, the JNR accumulated an enormous amount of financial deficit, since the JNR's business management did not fit with economic and social trends, and it had various conflicts with other fields. After discussion in the Fiscal System Council, the "Measures for the Financial Reconstruction of the Japanese National Railways" were approved by the Cabinet in February 1973, and the target of turning the financial balance after depreciation to a surplus, by FY1982, was set. In addition, revisions and improvements to the reform plans were made, such as by Cabinet decision (the "Outline of the Measures for Financial Reconstruction of Japanese National Railways") in December 1975, and enactment of the "Law Concerning the Special Measures for the Acceleration of the Reconstruction of the Management of the Japanese National Railways", including rationalization of local lines which created deficit, on December 27, 1980.

The Second Ad Hoc Commission on Administrative Reform declared in its third report (Base Report), on July 30, 1982, that "Not only is the Japanese National Railways going bankrupt, but also the other two public corporations are not able to perform as public entities, and even spoils their public image. It is even doubtful nowadays if a public corporation system can keep the advantage of both its public character and role as an enterprise in harmony", although once public corporations had had an important role for the national economy, in the postwar reconstruction and high growth eras. With this basic recognition, a basic policy for JNR reform, by area segmentation and by privatization, was proposed. More specifically, the achievement of the JNR reform within five years, and the establishment of executive committee for the reconstruction of the JNR, were decided based on a Cabinet decision ("The Special Programs of Administrative Reform for the Future") in September of the same year. This committee also reported its "Opinions on the Reform of the Japanese National Railways –For the Future of Railway Services", in June 1983. The policy clearly stated how the management should be reconstructed as a sound business unit, by cutting its enormous liabilities and rationalization of its excessive workers, aiming for the privatization of the JNR. This proposal was effective for enabling the government to proceed with the reform, and the "Law concerning Railway Company and Freight Railway Company" was enacted, for the execution of the JNR reform, including seven area segmentation and privatization of the JNR, in April 1987.

The "Japanese National Railways Settlement Corporation Law", one of the seven laws related to the JNR reform, specified the shift of the JNR to the Japanese National Railways Settlement Corporation, for settlement of its assets and liabilities, as well as promotion of staff's reemployment. Finally, the long-term liabilities which belonged to the Japanese National Railways Settlement Corporation were about ¥25.5 trillion, at the beginning of FY1987. Therefore, a settlement plan, including selling the estate of the old Japanese National Railways and its JR stocks, was made.

2 Fiscal Policy in the "Bubble Economy"

Continuance of Measures for Domestic Demand Expansion. The stance of taking large-scale aggressive economic measures, by making a supplementary budget after the initial budget approval, was still continued in the FY1988 budget compilation. The guideline for FY1988 budget requests showed a 10% decrease in current expenditures, but investment expenditures remained unchanged from the initial budget of the previous year, for the first time since the Minus Ceiling was adopted. This guideline implied that investment was maintained to the level of public works in the investment expenditures of the FY1987 revised budget, for domestic demand expansion. However, for fiscal reconstruction, the report by the Temporary Administrative Reform Council in July 1987 was submitted to the government, stating that the postponement of fiscal reform was not permitted, and the government also reconfirmed its policy to reduce special deficit-financing bonds as much as possible. Furthermore, the opinion was that the issuance of construction bonds should be controlled as much as possible, as mentioned by the Fiscal System Council chairman. And the revenues from the sales of NTT share purchases, as a result of the administrative reform, should be used as fiscal resources for investment. In the FY1988 budget draft, decided by the Takeshita Cabinet that was launched in November, the General Account expenditures were ¥56.6997 trillion, a 4.8% increase from the initial budget of the previous year, and bond revenues were ¥8.841 trillion. The increase rate of General Account expenditures was the largest since the FY1982 budget (6.2%) but the reduction of special deficit-financing bonds, which did not progress till then, turned out to be ¥1.8300 trillion, all at once the prospects of success in fiscal reform looked good. That success was brought about by the revenue from sales of NTT stock of ¥1.3000 trillion, in addition to the expectation of a great increase in tax revenue.

As for the FY1987 second supplementary budget, which was submitted to the Diet at the same time as the FY1988 budget, the amount of the supplement was ¥ 2.3390 trillion, the financial resources were a ¥1.893 trillion tax revenue increase, as well as ¥1.934 trillion in carried-over surplus from FY1986. However, as mentioned earlier, this was a completely opposite direction of progress compared to the FY1986 supplementary budget, as the special deficit-financing bonds were reduced by ¥1.322

trillion. The pace of economic recovery was fast, and a large sum in tax revenue increases was expected, which was more than the tax revenue reduction upon withdrawal of the sales tax bill.

Economic Recovery and the Prospects for Fiscal Reform. As mentioned above, the fiscal outlook and budget compilation faced favorable conditions, because the tax revenue increased, thanks to the rapid economic recovery. The "Medium-term Trial Estimates of the National Budget (FY1987 to 1991)" stated that even though the increase rate of tax revenue was estimated to be at a low level of 5.5%, on the premise that the special deficit-financing bond of ¥3.151 trillion in FY1988 should be zero by FY1990, the shortage of revenue would be ¥5.51 trillion in FY1990. However, the final results of the FY1987 tax revenue exceeded the upward revised budget, which had been corrected upward for ¥3.71 trillion, so that it seemed that the target of delivering the government's finance from its dependence on deficit-financing bonds could be achieved before FY1990. This encouraged the government to introduce an indirect tax with a broad tax base, to take the place of the sales tax bill, which had already been abolished. The achievement of this goal, with the tax reduction on a net basis, was motivated by such favorable financial conditions.

The guideline for FY1989 budget requests showed a 10% decrease in current account expenditures and the same amount for investment. Moreover, it was expected to use the revenue from sales of NTT stock of ¥1.3 trillion, the same as the previous fiscal year. However, it was assumed that the consolidation and rationalization of government finance remained an issue, because the government debt outstanding was still high, at ¥158 trillion at the end of FY1988, even if the fiscal condition had recovered. On the other hand, the movement for tax reform also accelerated. "The Outline of Tax Reform" of June 1988, stated that, income tax, corporation tax, inheritance tax, and gift tax should be reduced, and a consumption tax newly applied, in place of the commodity tax and other excises. It also included the reform of local taxes and local allocation tax grants. This large-scale tax reform draft showed a net tax reduction of ¥3.78 trillion (annual). The related bills were submitted to the Diet on July 29, and approved on December 24, upon correction.

The new era of "Heisei" started with demise of Emperor Hirohito (January 7, 1989), and the FY1989 budget draft, decided upon by the Cabinet on January 24, was ¥60.4142 trillion for General Account expenditures, a 6.6% increase from the previous year. Special deficit-financing bonds were expected to be ¥1.331 trillion, with a significant decrease of ¥1.82 trillion, as the tax revenue increase was expected to be ¥5.92 trillion.

While two thirds of the increase in expenditures resulted from the increase in local allocation tax grants, this was because of the increase of tax revenue and the additional ratio of 24% for consumption tax and 25% for the tobacco tax, which were newly allocated to local allocation tax grants. Thus, the FY1989 budget was designed to aim for fiscal reform, such as by the consolidation and rationalization of expenditures, to achieve the “Target of Delivering the Government’s Finances from its Dependence on Deficit-bonds in FY1990”, while considering the continued expansion of the domestic demand.

The FY1988 supplementary budget, approved on March 7, 1989, should have been compiled earlier, as the tax reform had been implemented since 1988, but discussions in the Diet were delayed because of the “Recruit” scandal. An increase in tax revenue of ¥3.16 trillion was included in the supplementary revenue, in addition to the carried-over surplus of ¥2.9745 trillion for FY1987. Therefore, a large amount of tax revenue increase was expected, mainly because of the increase in corporation tax, in spite of tax the reduction, of about ¥2 trillion, and special deficit-financing bonds were also reduced by ¥1.38 trillion. On the other hand, for supplementary expenditures, the transfer to the Welfare Insurance Special Account ¥1.5078 trillion was appropriated, which has been put back as the termination of the special measures of the “Special Case Law Concerning Administrative Reform” after FY1982. Due to this supplementary budget for ¥5.152 trillion, the issue amount of the special deficit-financing bonds in FY1988 was ¥1.7710 trillion, which was reduced to a level even close to the initial budget of FY1989. Furthermore, as the tax revenue exceeded the supplementary budget for ¥2.7200 trillion, it could easily be anticipated that the FY1989 tax revenue would also exceed the budget draft.

Achievement of the Fiscal Reform Target. As domestic demand kept increasing, the business upturn continued in FY1989. On the other hand, the current account surplus tended to decrease due to an increase in imports.

The guideline for FY1990 budget requests showed a 10% decrease in current expenditures, and the investment expenditures were assumed to be the equivalent to the initial budget of the previous year. Moreover, the use of the revenue from the sales of NTT stock purchases was expected to be ¥1.3 trillion, the same amount as in FY1989. The FY1990 budget compilation aimed at emerging from the bond dependent finance and achieving the “Target of Delivering the Government’s Finances from its Dependence on Deficit-bonds by Fiscal Year 1990” as the first stage of the fiscal reform. A thorough consolidation and rationalization of government expenditures was made for this purpose, which made the FY1990 national budget reach ¥66.2736 trillion for the General Account expenditures, a 9.7% increase compared to the initial budget of the previous year. The tax revenue was still expected to increase by ¥6.994 trillion, while the issue amount of government bonds was reduced by ¥1.481 trillion compared to FY1989, with only ¥5.63 trillion in construction bonds. However, the House of Representatives was dissolved on January 24, 1990, and the 39th general election of the House of Representatives was held on February 18. Therefore, expenditures related to the general election were suspended according to the termination of House of Representatives members, so that the FY1990 budget needed to be revised for reduced adjustment. Eventually, the FY1990 budget was approved on June 17, 1990 with ¥66.2368 trillion for the General Account expenditures, a 9.6% increase compared to the initial budget of the previous year. The issue amount of government bonds included construction bonds of ¥5.5932 trillion and there were no special deficit-financing bonds issued. This contributed to achieve the fiscal reconstruction that the government had been aiming for a long time. Although the bond dependency ratio dropped to 8.4% (11.8% for the FY1989), the government debt outstanding remained high at over ¥166 trillion. Therefore, the fiscal reconstruction needed to be further promoted strongly, in order to cope with various issues, such as the rapid accumulation of the national debt service, the rapid progress of the aging society and the increased responsibility of Japan in the international community, in a flexible manner.

The “Heisei Boom” supported by the “Bubble Economy” ended with its peak in February 1991, and the economy turned downward (the so-called “Heisei recession”). Then, the government started to make efforts to reduce the official discount rate and take economic measures to expand domestic demand against the depression of domestic demand, as symbolized by the significant decrease in private equipment investment.

The Gulf Crisis, the Gulf War and Japan’s Contribution to the Middle East. The “Gulf Crisis” broke out concurrently with the end of the “Bubble Economy”. Iraq invaded Kuwait on August 2, 1990, which affected the world economy, such as with soaring crude oil prices. The following describes the financial support of Japan to the allied forces in the Gulf War, which was organized immediately after “Gulf Crisis.”

When the “Gulf Crisis” occurred, Japanese government announced economic sanctions on Iraq on August 5, assuming a ban on the import of crude oil and the suspension of economic cooperation. As the U.S. and the U.K. dispatched their military forces to Saudi Arabia on August 7, the Japanese government started to consider measures for its contribution to Middle East. Consequentially, Prime Minister Toshiki

Kaifu decided on sending financial support of $1 billion to the allied forces on August 30, and notified President George Bush of this program. In addition, the Japanese Government made additional financial support of $1 billion and contributed $2 billion in financial support to the three countries (Egypt, Turkey and Jordan). Finally, the government decided on $4 billion in all, for its Middle East contribution plans.

Under the circumstances, Japan was required to provide support appropriate to its status in the international community, to the peacekeeping operations in the Gulf region. The fund scheme was made upon request of the "Gulf Peace Fund" for donation to the allied forces, as part of the Middle East support program. As for the financial resources, firstly, $1 billion was financed from the reserve funds of the FY1990 budget and another $1 billion was financed from the supplementary budget. The emergency commodity credit was applied as a contribution to the three countries (Egypt, Turkey and Jordan). The FY1990 supplementary budget was approved on December 17 (it was automatically enacted after rejection by the House of Councilors) and the amount was ¥2.281 trillion, including ¥130 billion in contribution to the Gulf Peace Fund.

Around the end of 1990, the negotiations for a peaceful resolution were unsuccessful and the withdrawal limit from Kuwait in Iraq by the U.N. Resolutions expired on January 15, 1991. The military action to Iraq by the allied forces therefore could not be avoided. Thus, the attack by the allied forces began (the "Gulf War"). Then the government decided to make a contribution of $9 billion (¥1.17 trillion) to the new Middle East support program on January 24. The FY1990 supplementary budget (secondary) was organized as its financial resources. The expenditures included ¥1.17 trillion for contribution to the Gulf Peace Fund. The ad-hoc special deficit-financing bonds for ¥968.9 billion were appropriated on the revenue side. The supplementary budget (secondary) was eventually approved on March 6, which was after the end of the "Gulf War" (February 27).

The New Target of the Mid-term Fiscal Management. The fiscal authorities expedited to make the framework for the new target of mid-term fiscal management, by the end of FY1990, when the government's finance could be delivered from its dependence on the special deficit-financing bond. The Fiscal System Council submitted a report for the mid-term fiscal management to the Minster of Finance, Ryutaro Hashimoto, on March 1, 1990, which was followed by the MOF's preparation of a basic concept for the promotion of fiscal reform. This was submitted to the Diet on March 7.

The Fiscal System Council report pointed out that the fiscal structure still showed potential for the government becoming dependent on special deficit-financing bonds again, if the tax revenue was short, due to recession or other reasons. Therefore, it was concluded that it was necessary to create fiscal conditions which would prevent the accumulation of outstanding government bonds, by reducing the bond dependency ratio and making efforts for the early redemption of special deficit-financing bonds. In practical terms, the “Medium-term Trial Estimates of the National Budget (FY1991 to 1993)” of the MOF assumed a reduction of government bonds of ¥400 billion every fiscal year, on condition that the standard of bond dependency ratio would be “below 5%”, as the Fiscal System Council proposed. However, the government bonds reduction in FY1991 remained at only ¥250.2 billion, which revealed that it was still difficult to strengthen fiscal structure. As mentioned above, due to the economic slump called the “Heisei Recession” after the peak of boom in February 1991, government bonds tended to significantly increase, as the government implemented a series of economic measures to stimulate domestic demand. In addition, special deficit-financing bonds were issued again after FY1994, in order to stimulate economic recovery, so that the government kept issuing government bonds (special deficit-financing bonds) at a high level, even surpassing the level of the 1970s or the 1980s.

3 Prospects for Fiscal Soundness and Government Debt Management Policy

Flexible Issuance of Refunding Bonds. The refunding of government bonds after FY1985 was executed according to the method that had been shown in the “Basic approach to Immediate Problems of Conversion of Government Bonds”, issued by the Conference on the Problems of Government Bonds (May 25, 1984). It confirmed that in order to securely eliminate the large amount of refunding bonds, the relation of maturity between the maturing bonds and the refunding bonds should be maintained, from the viewpoint of avoiding a concentration of maturity distribution. However, particular care should be taken to consider the arrangement for maturity that might be most easily accepted by the market under the various situations, such as the new issue amount and the market conditions. Thus, refunding bonds were to be issued in the most advantageous and appropriate way, according to the financial conditions, with occasional issues of bonds, if necessary. Moreover, the maturity bonds and the refunding bonds were to be issued according to the term and the maturity date at the end of fiscal year. Therefore, the refunding funds were issued in a flexible manner, according to the current financial conditions, regardless of the maturity of each maturing bond.

In addition, the National Debt Consolidation Fund Special Account Law was amended on June 28, 1985, in order to allow the front-loaded issuance of refunding bonds for redemption and refinancing of the large amount of government bonds. Such front-loaded issuance of refunding bonds was executed when the financial conditions were good, and it was advantageous to move up the front-loaded issuance of refunding bonds in the following year, or the equalization of bond issuance would be needed, as compared to the underwriting capability of the market in order to deal with the large-scale redemption of government bonds in the following year. The front-loaded issuance of refunding bonds up to FY1990 accounted for ¥6.5923 trillion, after the system was introduced in FY1985.

The Promotion Policy of the Government Bonds Market. The issue amount of government bonds in the FY1987 budget was ¥10.5010 trillion, which showed a reduction of ¥445 billion from the initial budget of the previous year. It was assumed that the current state of allowing a large scale government bond issuance should remain unchanged, even though the issue amount of special deficit-financing bonds was being downsized and there was a trend for the reduction of government bonds. The MOF, therefore, enhanced the promotion policy of the government bond market, increasing banks bonds and enhancing the handling of the public offering of government bonds. Thus, the complete competitive auction of 20-year bonds, underwriting amount auctions for 10-year bond, and the introduction of the handling of life insurance commodities by banks were implemented from October.

In addition, the government bond issuance in FY1987 was especially to be noted in view of the substantial issuance of public offering bonds. While the super long-term bonds of 20 years were underwritten by public subscription or by the Trust Fund Bureau at the beginning of FY1986, a significant amount of these were changed to that of public subscription in FY1987, though some continued to belong to the Trust Fund Bureau. In terms of the 10-year bonds, the underwriting amount auction was applied for 20% of public subscription from November. In the meantime, dealing of outstanding issues, which began in 1986, increased by as much as 2.5 times compared to the previous year by the end of 1987. Thus, the government debt outstanding at the end of FY1987 reached ¥151.8093 trillion, as it increased cumulatively because refunding bonds increased, although new issue amount were suppressed. It only took four years for government debt outstanding, which was ¥10 billion at the end of 1983, to reach ¥150 trillion. Furthermore, low interest bonds were promoted by refunding, so that the change of the government bond market in FY1987 was further promoted in the following fiscal year, 1988.

The Problem of Market Access for Foreign Financial Institutions. The U.S. government had been insisting on the maintenance of the impartiality of 10-year bonds, within the framework of the syndicate underwriting system, in relation to market access for foreign financial institutions to the Japanese government bond market, since the "Yen-Dollar Committee Follow-up Meeting" in April 1988. The expansion of the underwriting share of syndicate underwriting for foreign financial institutions was requested to a great extent, as well as the introduction of a competitive auction system, even partially. As the scale of the financial and capital market, including the secondary government bond market, started to expand with the progress of liberalization and internationalization, the Japanese government also acknowledged the necessity to encourage competition in the bond market. Therefore, the MOF announced in the document entitled "On the Maintenance of the Government Bond Market" on September 6, 1988, that they would introduce a partial competitive auction to improve the competitiveness and transparency of the Japanese bond market, within the framework of the syndicate underwriting system of 10-year bonds, and to contribute to the improvement of market access for foreign financial institutions to the government bond market. Thus, 40% of the monthly amount of 10-year bond issuance was allocated to price competitive auction by syndicate underwriting, and the remainder was subscripted by a fixed rate share, and a so-called partial competitive auction system was adopted from April 1989. Then, the ratio of price competitive auction by underwriting syndicate increased to 60% from October 1990.

Issuance of Ad-hoc Special–deficit Financing Bonds. After the outbreak of the "Gulf War" on January 17, 1991, the Japanese government decided to contribute $9 billion to the new Middle East support plan (refer to 2 in this section). The FY1990 supplementary budget of the General Account (secondary) included revenues arising from the special measures of transfer from the Foreign Exchange Fund Special Account to the General Account, and from the General Account to the National Debt Consolidation Fund Special Account, as well as the foundation of a special provisional corporation surtax and a special provisional petroleum surtax. Concurrently, "Ad-hoc Special Deficit-financing Bonds" of ¥968.9 billion were issued as government bonds, which should be redeemed by the revenue transferred from the General Account and the above-mentioned special provisional tax. For the redemption of the ad-hoc special deficit-financing bonds, ¥201.7 billion was transferred from the General Account to the National Debt Consolidation Fund Special Account, which continued until FY1994.

4 The History of Tax Reform: The Introduction of the Consumption Tax

Background to the Drastic Tax Reform. The fiscal conditions of the Japanese government worsened from the late 1970s to the early 1980s. It was difficult to implement tax cuts, including to income tax. Measures to the increase tax burden within the existing tax system, such as by corporation tax and indirect tax, were conducted repeatedly, from the viewpoint of correcting the imbalance between fiscal revenue and expenditure. As mentioned in Chapter 2.1, although an income tax cut was made in FY1984 for the first time in seven years, the tax reform demanded financial resources from the increase of corporation tax and indirect tax, in order to prevent the fiscal conditions from being worsened. As time passed, various “imbalances” and “distortions” between the changing economy and society and the existing tax system were revealed, and the government started to recognize the importance of solving these critical issues. The report on the FY1985 tax reform argued for the necessity of a drastic review of overall tax system, as partial changes could cause confusion. The Tax Commission received consultation regarding a drastic review of the overall tax system from Prime Minister Yasuhiro Nakasone in September 1985, and began discussing this issue immediately. In this consultation, the Commission was required to propose a desirable tax system, based on principles such as impartiality, fairness, simplicity, choice, and vitality of taxation, in line with the changing economy and society, such as the restructuring of industry and employment, and the improvement and equalization of the income level. The main aims of the review were to eliminate the “distortion” or “imbalance” of the tax system, so that the government could establish a stable revenue system. The following is the history of the drastic tax reform.

Examination for a Drastic Tax Reform. As a result of the examination, the second sub-committee (income tax and inhabitant tax) and the third sub-committee (corporation taxation, property taxation and indirect tax) of the Tax Commission submitted an interim report to the plenary meeting in April 1986, for the drastic reform of taxes. Firstly, the report made proposals on income tax and inhabitant tax, including the rationalization of the tax burden, the easing of progressive structure, special exemptions for spouses, and the clarification of the characteristics of deduction for employment income. With regards to corporation taxation, property taxation and indirect tax, it was considered to review the tax reform, by assuming a 50% reduction of the effective tax rate, in considering the trend of tax cuts in foreign countries. Then the Tax commission proposal summarized the above, and submitted its “Report on a Drastic Review of the

Tax System" ("Drastic Reform Report") to Prime Minister Yasuhiro Nakasone on October 28.

The basic philosophy of this Report was to assume neutrality and internationalism in addition to equity, fairness, simplicity, choice, and vitality of tax, as discussed in the consultation. It aimed to extend the tax base of the overall tax system. It showed that the tax burden should be borne broadly and thinly by the public, in order to prevent tax revenue from decreasing. It represents a stance of neutrality, as no burden should remain for future generations. More specifically, it involved the reduction of the tax rate and progressive flattening of the tax rate structure for income tax and inhabitant tax (as for income tax, there were six brackets, and its maximum tax rate was 50% for incomes of more than ¥15 million), etc. Special exemptions for spouses were also requested. As for the taxation on capital gains, the gain from the transfer of securities was expected to be taxed in principle, to extend its tax base and also the gain from land transfer. In addition, the standard tax rate was to be reduced towards the direction of the effective tax rate cut, and the tax rate of the small and medium business enterprises brought close to the standard tax rate. In addition, the reduced tax rate on dividends-paid at the corporation stage was also abolished, aiming to adjust the taxation at the individual stage. In addition, a review of deductive reserve and special taxation measures was requested, in order to extend the tax base.

On the other hand, the indirect tax further required drastic tax reform. The report was based on the idea that it was appropriate to introduce a new type of consumption tax, which required that the burden would be spread broadly over consumption, in order to cope with the changing economy and society. The report also proposed three types and four systems as a general consumption tax, which included manufacturer sales tax (Plan A), a duty-free sales tax between companies (Plan B) and a Japanese-type added-value tax (Plan C). Although the report suggested that Plan C was the most effective, it concluded that the tax reform should be considered from a wider range of views, by watching the trend of public opinion to identify which type should be introduced.

Tax Reform Before and After the "Drastic Reform Report". The 1985 tax reform included: the reduction of the statutory ratio of deductive reserve for bad debts of corporation tax, the abolishment of the "Green Card system" for preferable measures for taxes on gain from interest and dividends, and the improvement of the tax exemption system, such as organizing the paperwork for the tax-free small-sum saving system. As for the consolidation and rationalization of special taxation measures, the development of a tax haven system and a reassessment of the special treatment of taxation on land and housing were conducted. The tax reform of FY1986 was for a newly created tax regime to encourage residential acquisitions, a measure for the mobilization of the vitality of the private sector, a one-year extension of the special measures of the corporation tax system, and a tobacco excise tax hike. Of these, the tobacco excise tax was newly established in 1985, as a measure related to the privatization of the Japan Tobacco & Salt Public Corporation. Extra revenue generated from the tax hike was applied to special local distributions.

As for the tax reform of FY1987, a tax bill was prepared according to the principles of the above-mentioned “Drastic Reform Report”. An income tax cut was conducted, mainly to reduce the burden of salaried workers for the two years of 1987 and 1988. The tax rate structure was simplified to 12 brackets, from 15 brackets, and the maximum tax rate was changed from 70% for income more than ¥80 million, to 60% for income more than ¥50 million. In addition, the special exemption for spouses was newly established and interest and dividend incomes were taxed in principle, so that separate withholding taxation at source on interests and dividends was introduced. Thus, the tax-exempt system for small-lot savings was restructured into those for the savings of the elderly, etc. On the other hand, the sales tax was expected to be introduced in January 1988, as it needed to be adjusted with the existing indirect tax. Consequentially, the government removed the sales tax and corporation tax from the tax reform bill, after the abolishment of the sales tax bill in May 1987, in order to avoid any confusion in the Diet session on the introduction of sales tax, but submitted the bill for the reduction and rationalization of individual income taxation, and a review of taxation on interest and dividends in July. These bills were approved in September.

The Drastic Review of Interest Taxation. With the income tax reform of FY1987, the taxation on interest and dividend incomes began to be taxed as above, and separate withholding taxation at source was introduced. The FY1987 report on the tax reform of the Tax Commission pointed out that the equity of the tax burden among various kinds of income had been spoiled, as the majority of individual savings received the benefits of the tax-exempt system for interest of small-lot savings, so that a large sum of interest was not being taxed. From the viewpoint that the higher a person’s income, the greater its benefit, it is less necessary to protect them uniformly under the policy to encourage savings. Therefore, it was requested that the tax-exempt savings system be reassessed. The report proposed that it would be appropriate to reform the system to be beneficial to those who are not capable of receiving a sufficient income for living, including the elderly, fatherless families, and the handicapped. The MOF, therefore, decided to apply a series of review plans such as: 1) a tax-exempt system for interest on small-lot savings (the "Maruyu" system) and small-lot postal savings to be restructured into those for the savings of the elderly, fatherless families, and the handicapped (up to ¥3.5 million for the original principal); 2) the abolishment of the tax-exempt system for interest on small-sum government bonds (the special non-taxable system remained unchanged); and 3) the introduction of separate withholding taxation at source, with a 20% tax rate (15% for national tax and 5% for local tax). Then, during the Diet sessions, additionally, 4) the tax exemption system of interest income from employee's assets formation savings was abolished, but a tax exemption system of interest income from employee's assets formation savings earmarked for house acquisition was established. The new, reorganized interest taxation system was executed, and became effective on April 1, 1988, after the amendment of the Income Tax Law. In addition, the special treatment of tax exemptions for employment income earners' specified expenditures (a tax exemption for the expenses of salaried workers) and a deduction for public pensions etc., were newly established.

The History of the Introduction of the Consumption Tax. In the Diet session over the tax reform bill in FY1987, the biggest issue was the introduction of the sales tax. The Liberal Democratic Party consequentially won a great victory in the election, on its manifesto regarding the implementation of the sales tax, in the election of both the House of Representatives and the House of Councilors, on the same day in July 1986. The government submitted a bill for the sales tax and amendment bills, such as the Income Tax Law (a tax cut for income tax and corporation tax; the abolishment of the "Maruyu" system), to the Diet in February 1987. However, the bill met with intense opposition from the opposition parties, and demands for the withdrawal of the sales tax were heard even from some members of the ruling Liberal Democratic Party. The budgetary discussions for the FY1987 budget became complicated owing to the proposed introduction of the sales tax. Eventually, Speaker of the House of Representatives Hara suggested a mediation proposal, to practically abolish the sales tax bill. Then, the four opposition parties agreed to this proposal, and the budget plan was approved. The sales tax bill was finally abolished on May 27 upon consultation between the ruling and opposition parties.

Therefore, direct tax reform was not reviewed concretely until FY1988. At that time, the Takeshita Cabinet was established, on November 6, 1987, and the Tax Commission received the consultation concerning the basic idea of the "Report of a Drastic Review of the Tax System" and the desirable form of the tax system based on various conditions. It was intended to make a bill to establish a stable tax structure among income, consumption and assets, in order to maintain a society of long-life and welfare. The Tax Commission then resumed its reform of indirect tax again. However, there was no time to submit the FY1988 tax reform bill, based on discussions in the Tax Commission, therefore it was only raised as an issue to be implemented in a prompt manner in conjunction with the drastic tax reform plan. However, in terms of land taxation, as one of the measures of the "Emergency Land Measures" based on the Report of the Administrative Reform Council, the special treatment of capital gains from the transfer of properties was reformed.

Next, the Tax Commission submitted its interim report in April 1988, as an immediate plan for the tax system review, including the reform of indirect tax. In addition, the "Report of the Tax Reform" was submitted in June. The government then decided upon its "Outline of Tax Reform" on June 28, based on these reports, to take a step forward towards achieving these objectives. In terms of the indirect tax, the most controversial issue was assumed to be the establishment of a "Consumption tax", an accumulative deduction-type tax, and the bill was submitted to the Diet on July 29. This consumption tax was to have consumers bear the burden broadly and thinly. For small-sized companies which had gained sales of ¥30 million or less in the previous year (the previous accounting period before), they would be exempted from the consumption tax, by tax credit for consumption tax on purchases based on the company's account (book keeping). In addition, the taxation system would be simplified to calculate the amount of tax from the sales of companies' annual sales of ¥500 million or less in the previous year (the previous accounting period before). At that time, moreover, there was confusion in the Diet on issues for discussion due to the "Recruit" scandal in July, which was just before the bill was submitted.

In September, the Special Committee for Research on Taxation was launched, to discuss tax issues including the rectification of unfair taxation, such as strengthening the taxation on gains from the transfer of securities. Then, the three parities of the Liberal Democratic Party, the Komeito and the Japan Democratic Socialist Party reached a basic agreement on the establishment of a special committee regarding the "Recruit" scandal and six bills related to the tax reform, so that the six bills were amended and approved in the House of Representatives' plenary session (opposed by the Komeito and the Japan Democratic Socialist Party, and in the absence of the Japan Socialist Party and Japan Communist Party). Thus, the six bills related to tax reform, focusing on the introduction of consumption tax, were amended and adopted (the Komeito and

Democratic Socialist Party were opposed, and Japan Socialist Party and Japan Communist Party were absent) in the House of Councilors plenary session, through parliamentary deliberations confused due to the “Recruit” scandal and the submarine “Nadashio” collision accident, etc. on December 24. The enforcement of the Consumption Tax Law occurred April 1, 1989.

Tax Reform after the Introduction of Consumption Tax. The tax system was greatly simplified from 12 brackets, of up to 60% for income over ¥50 million, to 6 brackets, in the FY1988 tax reform, based on the “Report of the Tax Reform”. Regarding corporation tax, the tax rate on dividends-paid was reduced and a reduction of the tax rate was implemented. In addition, the maximum tax rate for inheritance tax and gift tax were reduced and the taxation brackets were extended, as well as the tax threshold being increased. As a result of these measures, the amount of net tax reduction exceeded ¥2 trillion annually.

The tax reform in FY1989 focused on land taxation, regional revitalization, and social policy considerations. The reform of the special exemption for capital gains from land transfer from January 1, 1989 to December 31, 1989, was enforced regarding land taxation. In terms of measures for regional revitalization, the special depreciation system was extended and the license tax was exempted, under certain conditions using the system of interest-free loans, based on the Law concerning the Special Measures for the Progress of Social Overhead Capital, from the sales of government-held shares in NTT. Income tax was also reformed to increase the tax threshold from ¥2.619 million to ¥3.198 million for employment income earners in married couples with two children after 1989, by the FY1988 reform, and the tax rate was simplified. The tax rate structure was simplified from 6 brackets to 5 brackets, and the maximum tax rate changed from up to 60% for income of ¥50 million, to up to 50% for income of ¥20 million. In 1991, the consumption tax was revised to extend the scope of exemptions and increase the opportunity for tax filing and payment, in order to establish the consumption tax firmly. The reform of land taxation was also recognized as an immediate issue to be implemented, as in FY1989. The FY1990 tax reform included a review of the special treatment of the taxation on capital gains from land transfer.