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Not enough yen to balance the budget

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Like other industrialized and energy-dependent countries hit hard by the oil crisis in 1973, Japan has been struggling the last few years to balance its federal budget. In the following article, Mr. Fukuyama traces his government's unsuccessful attempts to do so by means of fundamental changes in the Japanese tax laws. [Editor]

In 1973, before the first oil crisis, Japan maintained an annual economic growth in real terms of approximately 10 percent. As company profits and individual taxpayer income grew year by year during this high-growth period, so did tax revenue. This revenue was enough to finance almost all government spending and avoid having to issue government bonds to finance any revenue shortage. During this period, the Ministry of International Trade and Industry proposed various tax incentives almost every year, and the Ministry of Finance usually gave favorable consideration to these proposals, knowing that economic growth eventually resulted in an overall increase in tax revenue.

When the effects of the first oil crisis began to be felt, the character of the Japanese economy began to change, as did the government's fiscal policy. In the last two quarters of fiscal 1974, Japan experienced a negative growth in GNP, the first since World War II. Between then and 1980, GNP rose once again but only to about half of what it had been before the oil crisis. After the second oil crisis hit in 1980, that growth further slowed to 2 or 3 percent. But to maintain even this level of growth, government spending had to sustain approximately an 18 percent annual increase, because the government had pushed up public works spending.

With corporate earnings and wage earners' income deteriorating, tax revenue did not increase at the same rate as public spending. Therefore, to
finance this growing spending, government bonds had to be issued. The value of these bonds increased from 20 percent of federal spending in 1974 to 35 percent in 1978 and after.

At the same time, the tax incentives incorporated in income tax laws had been squeezed to the maximum in spite of opposition by business circles. The corporate income tax rate, including local income taxes, was about 54 percent (56 percent after 1980), and the individual income tax rate structure had a very sharp progressive pattern: 57 percent on incremental income over $40,000 (¥10 million), 71 percent on income above $80,000, and 93 percent on income over $320,000, with an average ceiling of 80 percent on total income.

In Japan, the ratio of income tax to all types of taxes, including local taxes, is 70 to 74 percent, which is considerably higher than the ratio is in European countries. For example, in France it is 38 percent, in Germany, 50 percent, and in the U.K., 60 percent. Thus, it was decided that only non-income taxes would allow for increase.

Taxable Alternatives

With individual income tax rates so high, it was clear that there would be no room for a further increase, nor would the slow growth in corporate profit and individual income produce tax revenue sufficient to satisfy ever-increasing government spending—especially on such controversial items as social insurance (medical expenses and pension), National Railroad assistance, and agricultural subsidies. So instead, the government proposed a 5 percent value-added tax (VAT), to take effect on April 1, 1980. Its objective was to have more people share the tax burden.

Because VAT would be passed on to consumers regardless of their income bracket, the government made every effort to get a consensus of opinion by as many groups as possible. One of its concerns was that VAT would be inflationary. Due to a lack of public support, however, the VAT law was never actually voted on in the Diet, Japan's legislature. Any new tax law is always unpopular with the public, and the government party did not want to lose votes in the 1979 general election.

At about the same time as VAT was proposed, Japanese tax authorities suggested a system of taxpayer serial numbers to prevent tax evasion. Under the current tax law, a taxpayer can pay tax on interest and dividend income in one of two ways. He may pay a tentative 20 percent withholding tax upon receipt of such income and then include such interest and dividends in his annual return, for which he pays progressive rates of income tax based on his aggregate annual income; or, he may pay a 35 percent withholding tax without being required to state his annual aggregation of interest, dividends, and all other income. Moreover, a tax exemption for interest income is permitted, with a ceiling of $12,000 (¥3 million) on the principal amount of savings producing interest in any of three groups of savings: postal savings, government bonds, and a third group, including bank deposits, corporate bonds, debentures, and loan trusts.

Effective January 1, 1984, however, the government has proposed to abolish the nonaggregated 35 percent withholding tax system and exercise more strictly the ceilings for interest exemption. As a current practice, financial institutions have no choice but to accept savings without any assurance from a depositor that the total sum of savings has reached the ceiling. The taxpayer serial number system is strenuously opposed by both voters and the political parties, mainly because of possible infringement of taxpayers' privacy.

The Green Card System

In place of the original taxpayer serial numbers system, the government has proposed an alternative—the Green Card System. Under this plan, if a taxpayer wants to have tax-free savings, he must request a Green Card from the

![Growth of Japanese Economy](image-url)
district tax office and then submit that card to his financial institution, which is required to confirm whether or not he has reached the interest exemption ceiling. The Green Card summarizes his interest-ceiling status.

The government succeeded in passing the Green Card System legislation in March 1980, with a 45-month moratorium and an implementation date on or after January 1, 1984. The reasons that the system has succeeded thus far are that only wealthy people will be affected, that the moratorium period is lengthy, and that "green" has a nice sound to it.

As its implementation date nears, taxpayers have started to recognize the likely impact of the Green Card. Interest income on savings in excess of the ceilings ($36,000 of principal for all three types of savings) could be taxed at 93 percent, if annual income exceeds $320,000, and at 61 percent, if income is between $48,000 and $60,000. A savings principal of $36,000 is not an overly significant amount in Tokyo, however. For example, an apartment with 700 square feet of floor space and located an hour's commuting distance from the heart of Tokyo costs about $200,000.

To escape the Green Card System, some depositors are taking their savings and moving them to other investments. One indication of this is that postal savings have been slowing down. In March of last year, a record net withdrawal of $1.3 billion was registered. And the import of gold for the first half of 1981 was five times greater than it was a year earlier, when gold fever quickly broke with the sharp drop in gold prices.

"Zero Coupon Bonds"

Those not buying gold have been making a rush, particularly since the beginning of last year, to acquire so-called "zero coupon bonds"—original-issue discount bonds denominated in foreign currency—because they consider such bonds to be beyond the control of the Green Card System. In February alone, a massive $780 million worth of these bonds was purchased by Japanese investors. Under the current law, it is true that capital gains from sales of shares, bonds, and debentures are, in principle, tax free to the individual taxpayer. However, original-issue discount bonds are taxable to the bond holders at the time they mature and are redeemed, although no withholding tax is imposed if the bonds are issued outside Japan. Thus, if a bond holder sells a zero coupon bond before its maturity date, no Japanese tax will be imposed on the gain from its sale.

To prevent investors from circumventing the Green Card System, the Ministry of Finance (MOF) formally notified all security companies in March to refrain for the time being from selling zero coupon bonds. The MOF feels that this will decrease the outflow of capital from Japan, which appears to be one of the leading factors for strengthening the yen. Tax authorities also have recommended that this year's revision in the tax law include a reporting requirement by securities companies to identify the purchasers of these bonds. Due to foreign exchange regulation, securities companies currently sell zero coupon bonds to a customer's account without actually delivering the bond certificates to that customer. With the imposition of the reporting requirement, bondholders might be wary about purchasing more bonds because the tax authorities could trace the source of cash.

In the past few months, opposition to the introduction of the Green Card System has increased sharply, due to signs that tremendous shifts of money are about to trigger major disruptions of the money market. The ruling political party has proposed a three-year freeze of the law and has deferred its implementations from 1984 to 1987.

One of the reasons for the Green Card freeze is that this system might have an adverse effect on Japan's ratio of savings to disposable income. Compared to that in western countries, this ratio has been extraordinarily high. It peaked at 24.3 percent in 1974 and declined to 20.6 percent in 1981. This may be compared with 4.3 percent in the U.S. and 9.5 percent in West Germany in 1979.

The high rate of savings has made available vast amounts of funds for corporate investments in plants and equipment, which in turn supported the high economic growth in Japan before the first oil crisis. Since then, this savings has been a primary source of funds for purchasing government bonds. Without sufficient savings, the issuance of great numbers of government bonds would have led to high inflation, as well as to the crowding out of corporate borrowers from the capital market.

Conclusion

For the last few years, the Japanese government has been unsuccessful in making a fundamental change in the tax laws. And while a powerful Members Committee has been organized to plan for a smaller government, people feel that such a plan would be difficult to implement.

Without either an increase in tax revenue or a decrease in government spending, the government's revenue shortfall will have to be financed by the sale of bonds, the outstanding balance of which has reached almost 40 percent of Japan's GNP. Assuming that the interest rate on these bonds is 8 percent per annum, the government's annual interest payments amount to 3.2 percent of GNP. But because the government budget is roughly 20 percent of GNP, 16 percent of the government budget must be used for interest payments.

People agree that there needs to be some fundamental change in Japanese fiscal policy, but they do not like to change their own lives.