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JAPANESE TAX POLICY

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BEFORE THE

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JAPANESE TAX POLICY

MONDAY, SEPTEMBER 24, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Daniel E. Lungren (member of the committee) presiding.

Present: Representative Lungren.

Also present: Charles H. Bradford, assistant director; and William R. Buechner and Christopher J. Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE LUNGREN, PRESIDING

Representative LUNGREN. Good morning.

It gives me great pleasure to welcome our distinguished witnesses here this morning for this hearing of the Joint Economic Committee on Japanese tax policy.

In recent years we have seen a tremendous increase of American interest in Japan. The success and international competitiveness of Japanese businesses, and their ability to quickly adopt the latest technology and innovations, have made the Japanese economy a subject of intense academic study as well as the envy of many other nations. The high rate of economic growth, productivity gains, and harmonious labor/management relations have led to much speculation about something called Japanese industrial policy. Some see this as a form of centralized economic planning that should be considered by U.S. policymakers. To others, Japan's success isn't due to extensive government planning, but rather more to relatively low levels of government taxing and spending.

While the industrial policy debate raged, close scrutiny was given to almost every feature of Government activity in Japan. Oddly enough, Japanese tax policy was not, for some reason, given the same amount of attention. Though the industrial policy debate in the United States appears to have abated for the time being, I believe that Japanese tax policy, in its own right, warrants the serious examination of Congress and the public.

It is widely recognized that through much of the postwar period Japan had cut taxes almost every year to keep the tax burden moderate. Until the mid-1970's the Japanese Government intentionally held the GNP share of national and local tax receipts below 20 percent. This relatively low share of national output consumed by the government has risen somewhat in recent years. By 1980, for example, total

tax receipts—for all levels of government—as a percentage of GNP was 26 percent in Japan, compared to 31 percent in the United States. In the United States, Japan's relatively low tax burden is regarded as a positive feature of its fiscal policy. However, much less is known in this country about the structure and provisions of the Japanese tax system.

For this reason the Joint Economic Committee has asked the General Accounting Office [GAO] for an up-to-date description of the provisions of the 1984 Japanese tax system. Since little seems to be available in English on this topic, it is the committee's hope that the printed record of this hearing will be a valuable resource for Congress, academia, and the general public. In addition, we have invited a distinguished panel of economists to analyze the impact of the postwar Japanese tax system on the economy.

The overall structure of the Japanese tax system is similar in some respects to the U.S. Internal Revenue Code. Given the vital advisory role of the Shoup Commission, this is not at all surprising. However, the most interesting features of Japanese taxation are the generous incentives provided for saving and investment which were established as part of a conscious, deliberate effort to increase the savings rate and to foster rapid capital accumulation and economic growth.

Few would dispute the assertion that the postwar economic performance of Japan has been spectacular. Saving as a percentage of personal disposable income in Japan is almost four times the U.S. rate. Japanese economic growth in the postwar period has far outstripped that of most advanced nations. The obvious question that comes to mind is whether Japanese tax policy, given its objectives, has made a significant contribution to the superior performance of the Japanese economy.

This morning we will hear a variety of views on this important question. Since the issue of tax reform has generated increasing interest in this country, perhaps the Japanese experience can give us some guidance on promising avenues of reform.

We will begin this morning with testimony from Allan Mendelowitz of the General Accounting Office on the report from the GAO on the current Japanese tax system. You may proceed as you wish. Any prepared statement that you have will be made a part of the record, and we would ask to have perhaps a 10- to 15-minute opening presentation and then we can have questions addressed to you.

STATEMENT OF ALLAN I. MENDELOWITZ, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JAMES McDERMOTT AND THOMAS RICHARDS

Mr. MENDELOWITZ. Thank you, Congressman Lungren. I will be happy to submit a prepared statement for the record and summarize the points I wish to make in a brief statement. I am accompanied this morning by Jim McDermott on my left and Tom Richards on my right, who have spent the past several months in intensive work in response to your request.

As you know, your committee asked us to look at the major features of the Japanese tax system and its incentives for saving and investment. This information was requested to better understand how other nations use tax laws to pursue saving and investment objectives and to help determine whether the United States could benefit by adopting tax provisions employed elsewhere.

Over the past 20 years, Japan's growth rate has generally exceeded that of other developed nations, including the United States. A tax policy favoring saving and investment has frequently been cited as an important part of Japan's policies favoring economic growth.

In general design, however, the United States and Japanese tax systems are strikingly similar. Both rely on individual and corporate income taxes as the primary revenue sources rather than the indirect taxes—such as the value-added tax—frequently employed elsewhere.

Both nations provide some types of tax preferences to encourage saving. In Japan, interest earned by individuals on deposits up to 3 million yen in the postal savings system, on bank deposits up to 3 million yen, and on holdings of certain government bonds valued up to 3 million yen is not taxed. These amounts are each equivalent to $12,500. Examples of tax preferences for savings in the United States include deductions for contributions to individual retirement accounts [IRA's] and Keogh plans and an extensive tax-exempt municipal bond market.

Similarly, both nations provide businesses with tax incentives to invest. Each allows some type of accelerated depreciation or capital cost recovery allowance on industrial investment. In addition, both tax systems offer some form of investment tax credit [ITC]. Japan's use of the ITC has been a temporary provision, limited to depressed industries and to particular investments, such as energy conservation equipment. In its fiscal year 1981 tax reform, for instance, Japan allowed an investment tax credit for investment in energy-saving equipment for a 3-year period, with the credit limited to 20 percent of tax liability and carryover of unused credits allowed only for the next tax year. In the U.S. tax system, a broad range of investment is eligible for the credit. Taxpayers are allowed more generous carryover allowances and may use the credit to offset as much as their full tax liability.

While the two systems are similar in many regards, they differ in the specific tax practices used to meet their objectives and in their burdens.

Japan has sought to keep its tax burden under 20 percent of its gross national product. Rapid economic growth and an even faster increase in tax revenue enabled Japan to adhere to this limit until the mid-1970's and still provide virtually annual tax cuts. Since the mid-1970's, however, Japan has run budget deficits and has not been able to meet this objective. Although total taxes—including Social Security contributions—had risen to 26 percent of GNP by 1980, this remains well below the average tax burden for OECD nations, which was 35.8 percent in 1980. In that year, the U.S. tax burden was 30.7 percent of GNP.

Japan, furthermore, relies more heavily on revenues from the corporate income tax than does the United States. In Japan's budget for

its fiscal year 1983, for instance, the corporate income tax was estimated to generate 27.8 percent of the national government's tax revenue and the individual income tax 40.5 percent. In the U.S. budget estimate for its 1984 fiscal year, the corporate income tax accounts for 17.7 percent of Government receipts—excluding Social Security taxes—and individual income taxes 77.8 percent.

I would now like to turn to differences in the tax practices in the two nations. While the U.S. tax system is relatively neutral regarding alternative uses of borrowed funds, Japan's tax system is not. Japan's treatment of interest expense is intended to favor business use of borrowed funds, while the United States allows an interest deduction from personal income for funds borrowed for virtually any purpose. Individuals in Japan can deduct interest only on debt incurred to buy corporate equity or to finance business activities. Taxpayers in Japan generally cannot deduct interest expenses on home mortgages or consumer debt. In the United States, the mortgage and consumer debt interest deductions are among the largest tax expenditures.

Japan's treatment of capital gains realized by individuals also reflects a desire to promote investment in securities. Individuals are not subject to tax on capital gains realized on the sale of securities but are subject to tax on other capital gains. Their other long-term gains, however, are generally taxed at one-half normal rates. In the United States, the tax on long-term capital gains is 40 percent of normal rates. Assets must be held for longer periods in Japan than in the United States to qualify gains as long-term gains.

Unlike the U.S. corporate income tax, Japan's corporate income tax seeks to avoid double taxation of corporate earnings. Japan does this by assessing a lower rate on distributed earnings than on retained earnings—33.3 percent versus 43.3 percent—and allowing individuals receiving corporate dividends to take a tax credit of up to 10 percent of dividends received. The corporate tax rates were changed by the 1984 tax package. They had been 32 and 42 percent, respectively; the current rates are in effect during Japan's 1984 and 1985 fiscal years.

Lessons from Japan's experience with its tax system may not simply or neatly transfer to the United States. Observations of how Japan's tax system treats saving and investment and how that compares with U.S. taxation must be tempered by understanding how the two economies differ.

While we have examined tax incentives that Japan employs at the national level in this testimony, taxes imposed by any level of government may influence decisions by taxpayers. In Japan, prefecture and municipal governments impose taxes, but do so under the control of the national government. By contrast, State and, to a lesser degree, local governments in the United States have independent taxing power and impose a broad range of taxes. The types of taxes and rates vary across States, complicating comparisons with the uniform Japanese system.

Another important difference is the nature of corporate financing in the two nations. U.S. corporations rely much more heavily on equity financing than do Japanese corporations. Bank debt was 230 percent of equity for Japanese manufacturing firms in the late 1970's according to one estimate, but only 68 percent of equity in the United States. The greater reliance on debt by Japanese corporations changes the way that the corporate tax affects investments. Retained earnings are a less

important source of investment funding in Japan than they are in the United States, for instance, so higher taxes on retained earnings in Japan may not have the same effect there as they might in the United States.

While we are not proposing that you consider adopting any aspects of Japan's tax system that differ from the U.S. system, our limited review indicates the three most significant differences between the two systems are:

Japan's restriction of interest deductions by individuals to interest on funds borrowed for purchasing corporate equity or undertaking business activity;

The tax-free status in Japan of capital gains realized by individuals in the sale of securities; and

Japan's attempt to avoid double taxation of corporate income.

Mr. Chairman, I think this should conclude my summary statement and I would be happy to try to answer any questions you may have.

[The prepared statement of Mr. Mendelowitz follows:]

PREPARED STATEMENT OF ALLAN I. MENDELOWITZ

JAPANESE TAX INCENTIVES TO SAVE AND INVEST

Mr. Chairman and Members of the Committee:

In response to your request, we are providing this overview of the Japanese tax system, concentrating on tax preferences for savings and investment. You requested this information to better understand how other nations use tax laws to pursue saving and investment objectives and to help determine whether the United States would benefit by adopting tax provisions employed elsewhere.

The first part of my statement this morning summarizes the major features of Japan's tax system and its incentives for savings and industrial development. The second part outlines the overall tax system and explains the incentives to save and invest in greater detail. We based our work on published analyses of Japanese and U.S. tax practices and on interviews with U.S. and Japanese government officials and with academic researchers.

OVERVIEW

Over the past 20 years, Japan's growth rate has generally exceeded that of other developed nations, including the United States. A tax policy favoring saving and investment has frequently been cited as an important part of Japan's policies favoring economic growth.

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Both nations provide some type of tax preference to encourage saving. In Japan, interest earned by individuals on deposits up to Y 3 million in the Postal Savings System, on bank deposits and certain other assets up to Y 3 million, and on holdings of certain government bonds valued up to Y 3 million is not taxed. These amounts are each equivalent to $12,500.[1] Examples of tax preferences for savings in the United States include deductions for contributions to individual retirement accounts (IRAs) and Keogh plans and an extensive tax-exempt municipal bond market.

Similarly, both nations provide businesses with tax incentives to invest. Each allows some type of accelerated depreciation or capital cost recovery allowance on industrial investment. In addition, both tax systems offer some form of investment tax credit (ITC). Japan's use of the ITC has been a temporary provision, limited to depressed industries and to particular investments, such as energy conservation equipment. In its fiscal year 1981 tax reform, for instance, Japan allowed an ITC for investment in energy-saving equipment for a 3-year period, with the credit limited to 20 percent of tax liability and carryover of unused credits only for the next tax year. In the U.S. tax system, a broad range of investment is eligible for the credit. Taxpayers are allowed more generous carryover allowances and may use the credit to offset as much as their full tax liability.

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[1]Dollar equivalents in this testimony are calculated using Y 240 to $1.00 as the exchange rate.

While the two systems are similar in many regards, they differ in the specific tax practices used to meet their objectives and in their burdens.

Japan has sought to keep its tax burden under 20 percent of its gross national product. Rapid economic growth and an even faster increase in tax revenue enabled Japan to adhere to this limit until the mid-1970s and still provide virtually annual tax cuts. Since the mid-1970s, however, Japan has run budget deficits and has not been able to meet this objective. Although total taxes (including social security contributions) had risen to 26 percent of GNP by 1980, this remains well below the average tax burden for OECD nations, which was 35.8 percent in 1980. In that year, the U.S. tax burden was 30.7 percent of GNP.

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expense is intended to favor business use of borrowed funds, while the United States allows an interest deduction from personal income for funds borrowed for virtually any purpose.[2] Individuals in Japan can deduct interest only on debt incurred to buy corporate equity or to finance business activities. Taxpayers in Japan generally cannot deduct interest expenses on home mortgages or consumer debt. In the United States, the mortgage and consumer debt interest deductions are among the largest tax expenditures.

Japan's treatment of capital gains realized by individuals also reflects a desire to promote investment in securities. Individuals are not subject to tax on capital gains realized on the sale of securities but are subject to tax on other capital gains. Their other long-term gains, however, are generally taxed at one-half normal rates. In the United States, the tax on long-term capital gains is 40 percent of normal rates. Assets must be held for longer periods in Japan than in the United States to qualify gains as long-term gains.

Unlike the U.S. corporate income tax, Japan's corporate income tax seeks to avoid double taxation of corporate earnings. Japan does this by assessing a lower rate on distributed earnings than on retained earnings (33.3 percent versus 43.3 percent) and allowing individuals receiving corporate divi-

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[2]Interest paid on loans taken to purchase tax-exempt securities is not deductible under the U.S. federal income tax.

dends to take a tax credit of up to 10 percent of dividends received. (The corporate tax rates were changed by the 1984 tax package. They had been 32 and 42 percent, respectively; the current rates are in effect during Japan's 1984 and 1985 fiscal years.)

CAN THE UNITED STATES LEARN FROM JAPAN'S TAX SYSTEM?

Lessons from Japan's experience with its tax system may not simply or neatly transfer to the United States. Observations of how Japan's tax system treats saving and investment and how that compares with U.S. taxation must be tempered by understanding how the two economies differ.

While we have examined tax incentives that Japan employs at the national level in this testimony, taxes imposed by any level of government may influence decisions by taxpayers. In Japan, prefecture and municipal governments impose taxes, but do so under the control of the national government. By contrast, state and, to a lesser degree, local governments in the United States have independent taxing power and impose a broad range of taxes. The types of taxes and rates vary across states, complicating comparisons with the uniform Japanese system.

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of equity in the United States.[3] The greater reliance on debt by Japanese corporations changes the way that the corporate tax affects investments. Retained earnings are a less important source of investment funding in Japan than they are in the United States, for instance, so higher taxes on retained earnings in Japan may not have the same effect there as they might in the United States.

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--Japan's restriction of interest deductions by individuals to interest on funds borrowed for purchasing corporate securities or undertaking business activity,

--the tax-free status in Japan of capital gains realized by individuals in the sale of securities, and

--Japan's attempt to avoid double taxation of corporate income.

[3]R. Hofheinz and K. Calder: The Eastasia Edge (New York: Basic Books, 1982), p. 135.

OUTLINE OF JAPAN'S TAX SYSTEM

Japan, like the United States, raises most of its revenue through income taxes. Individual and corporate income taxes together yielded approximately 70 percent of all the central government taxes since 1973. Indirect taxes (commodity and excise) are secondary sources of tax revenue. Prefecture and municipal governments also collect taxes. In the Japanese fiscal year beginning April 1, 1983, these local governments collected 35 percent of all taxes. In contrast to local government taxes in the United States, property taxes are minor revenue sources in Japan.

Development of Japan's tax policy

Reliance on income taxes may be the most important legacy of U.S. efforts to create an ideal tax system in Japan. During the U.S. occupation, a commission headed by Carl S. Shoup, Professor of Economics at Columbia University, recommended that the tax system be completely restructured to repeal an existing quilt of income and turnover taxes. Comprehensive income taxation was to be a component of a tax system featuring net worth and inheritance taxes at the national level and locally imposed value-added taxes. The corporate and individual taxes were to be integrated, with the corporate tax functioning as a withholding tax on the earnings of shareholders. Capital gains were to be counted as income.

The tax system soon moved away from this prescription. While the Japanese Ministry of Finance indicates that the plans were "too idealistic to fit in with the reality of the Japanese economy and standard of living," other analysts believe that the evolution of the tax system stems from the government's orientation to business and industrial development. The unified tax on all sources of income was replaced by a schedular tax, imposing taxes that vary according to income source. The net worth tax was abolished, as was the tax on capital gains realized on the sale of securities. The local government value-added tax was never implemented. A tax on retained corporate earnings, designed to prevent the indefinite deferral of shareholders' tax liabilities, was removed. Finally, the government decided to use taxes selectively to promote economic growth rather than adhere consistently to principles of tax equity and efficiency.

Limits on tax burdens were of paramount importance to encourage economic growth through the tax system. Following the lead of its Tax Commission, the Japanese government sought to limit taxes to 20 percent of national income. Japan's economy experienced strong enough growth between the 1950s and early 1970s that tax revenues could grow steadily. Because of the system's reliance on progressive income taxation, tax revenues grew faster than income. For instance, in their analysis of the Japanese tax system, Joseph Pechman of the Brookings Institution and Keimei Kaizuka of Tokyo University found that tax revenues grew at 1.3 times the rate of income growth. From the early

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1950s until 1977, Japanese taxes were cut annually in several ways, including rate reductions, increased exemptions, or special measures (generally tax expenditure items).

Since 1977, the picture has changed. Budget deficits have become contentious issues, so there has been an unwillingness to increase deficits through tax cuts. Individual income taxes were cut earlier this year, but corporate taxes were raised by virtually the full amount of the individual tax cut. As table 1 shows, furthermore, when social security contributions are included, taxes have started to take a larger share of GNP product than the 20-percent limit.

Table I

Tax revenue as a percent of Japan's Gross National Product[a]

Year	Percent
1960	18.2
1965	17.8
1970	19.7
1975	21.0
1980	26.1

[a]Includes employers' and employees' social security contributions

Source: Organization for Economic Cooperation and Development: Japan (July 1983)

It would be misleading to conclude that sustained high rates of economic growth have been the only targets of Japanese tax policy. Energy conservation and pollution control are among its current objectives. Each objective is understandable in the context of Japan's economy, such as its severely limited energy supplies, but pursuing these goals has altered the growth orientation of the tax system.

Like any other tax system, Japan's system is subject to political pressures. Specific groups have been able to gain concessions, such as those who receive income from selling timber and owners of businesses, such as shopkeepers. Depressed regions and industries receive many special benefits, as do other industries targeted for aid. Industries investing in Okinawa or businesses that employ the handicapped as 25 percent or more of their work forces are eligible for special tax preferences. The result is a tax system that contains many features designed to encourage economic growth as well as special preferences given to achieve other goals.

Other taxes at the national level

While income taxes are its most important sources of revenue, Japan's national government also levies inheritance, commodity and transactions taxes. As table 2 shows, no other revenue source approaches the importance of the income taxes.

Table 2

Tax revenues in Japan

(Fiscal year 1983 budget estimate[a])

Type of tax	Percent of total revenue	
Income taxes:	68.3	
Corporate Income Tax		27.8
Individual Income Tax		40.5
Inheritance Tax	2.3	
Other taxes: (total)[b]	27.0	
Liquor		5.5
Gasoline		4.8
Petroleum		1.3
Commodity		3.9
Motor vehicle tonnage		1.4
Customs duties		2.1
Stamp tax revenue		3.8
Profits on state monopolies		2.9

[a]Fiscal year 1983 ran from April 1, 1983 to March 31, 1984; final data are not available.

[b]Includes other taxes contributing less than 1 percent of general account revenue.

Source: Ministry of Finance, Tax Bureau, An Outline of Japanese Taxes 1983, pp. 294-5.

Some of these taxes were adopted with specific economic goals in mind. Petroleum tax revenues, for instance, finance projects to "secure [a] stable supply of petroleum and to develop and introduce alternative energy sources." Likewise, electric utilities pay a tax earmarked for measures promoting atomic, hydroelectric, and thermoelectric powerplant development in order to lessen use of oil-fired generators.[4] In the 1983 budget, petroleum tax revenues were estimated at Y 429 billion (approximately $1.8 billion) and the earmarked tax on utilities at Y 176 billion (approximately $732 million).

Local government taxes

The 1947 constitution provides for autonomous prefectural and municipal governments, but local taxes are subject to considerable central control. The "Local Tax Law" defines the basis of tax computation, collection method, and standard tax rate. Rates above the standard are allowed but cannot exceed specified limits. Any other taxes must be sanctioned by the Ministry of Home Affairs. Furthermore, the central government provides funding for local governments through transferred tax revenue (local road taxes, motor vehicle tonnage tax, and others), grants, and subsidies.

Both prefectures and municipalities collect their own inhabitants tax, assessed on individuals, businesses, and corpora-

[4]An Outline of Japanese Taxes 1983, pp. 143 and 158.

tions. The inhabitants tax is assessed on a per capita (per corporation) basis as well as on a taxable income basis for individuals and as a corporate income tax surcharge. National taxes are not deductible for computing this tax (nor are local inhabitants taxes deductible for calculating national income taxes).

Prefectures also collect enterprise taxes on corporation or business income and transfer and commodity taxes. Municipalities also collect property taxes and consumption taxes.

SAVINGS INCENTIVES IN JAPAN' INDIVIDUAL INCOME TAX

Pechman and Kaizuka have characterized the individual income tax in Japan as having a narrow base and steeply progressive rates. Deductions, such as an employment income deduction, and exclusions from income are substantial, including large allowances for tax-free interest income, while marginal tax rates reach 70 percent above Y 80,000,000 ($333,333) of taxable income. (See table 3.)

Table 3

Marginal Tax Rates in the Japanese Individual Income Tax
Fiscal year 1984

Taxable income range (thousands of yen)	Dollar equivalent[a]	Marginal tax rate (percent)
under Y 500	under $2,033	10.5
Y500 - Y 1,200	$ 2,833 - $ 5,000	12
1,200 - 2,000	5,000 - 8,333	14
2,000 - 3,000	8,333 - 12,500	17
3,000 - 4,000	12,500 - 16,667	25
4,000 - 6,000	16,667 - 25,000	25
6,000 - 8,000	25,000 - 33,333	30
8,000 - 10,000	33,333 - 41,667	35
10,000 - 12,000	41,667 - 50,000	40
12,000 - 15,000	50,000 - 62,500	45
15,000 - 20,000	62,500 - 83,333	50
20,000 - 30,000	83,333 - 125,000	55
30,000 - 50,000	125,000 - 208,333	60
50,000 - 80,000	208,333 - 333,333	65
over 80,000	over 333,333	70

[a]Dollar equivalents calculated at Y 240 to $1.00.

Source: Embassy of Japan, January 30, 1984

While all income is, in principle, subject to taxation according to the same marginal tax rate schedule, Japan's tax law recognizes 10 forms of income[5] and sets out different ways to compute income and deductions for each. Taxpayers receiving employment income, for example, deduct a percent of their income as an "employment deduction." Those receiving business income have several ways to calculate their taxes, including an option to be taxed as a corporation rather than as an individual.

Several features of Japan's individual income tax either encourage savings over consumption or encourage investment in industry over other investments, such as investment in housing. Specific features that influence savings and investment decisions in the current tax system are:

--Allowing tax-free interest on savings, up to generous limits.

--Excluding from the tax base capital gains on sales of securities except for "continuous" traders.

--Restricting interest deductions to interest paid on debt incurred to finance the purchase of securities.

--Providing a credit for dividends received.

[5]Interest income, dividends, real estate income, business income, employment income, retirement income, timber sale or transfer income, capital gains, occasional, and miscellaneous income are the recognized categories.

Lax enforcement of the tax on interest earned on savings above the tax-free amount or on business income is an implicit preference to savings and business investment, according to some observers. This issue is impossible to assess, however, because the evidence of noncompliance is anecdotal rather than quantitative.

The importance of the tax limitation policy and the tax cuts on individual savings and investment is not clear. The tax cuts took several forms, including rate cuts, increases in allowable exclusions or deductions from income, and special provisions. There is no definitive analysis that we are aware of that attributes any particular share of savings to the tax cuts.

Interest and capital gains exclusion

Both the basic income tax law and related special provision laws establish categories of nontaxable income. While these categories cover a wide range of activities, several are intended as incentives for savings and business-related investment:

1. Interest earned on deposits up to Y 3 million in the postal savings system.
2. Interest on bank deposits or certain types of investment and bond trusts and holdings of debentures if the total principal does not exceed Y 3 million.
3. Interest earned on government bonds issued by either the central or local governments.

4. Contract savings plans for workers up to a principal of Y 5 million.

5. Capital gains realized on the sale of securities, except in specified situations or from "continuous trading in securities."

A temporary measure currently allows taxpayers to have taxable interest and dividends taxed separately from all other income at a rate far below the highest marginal tax rates. The importance of this provision, which usually requires withholding at the source, is not known. Until December 31, 1986, interest on time or ordinary deposits, profits from trusts, and certain other dividends (generally small amounts of dividends received by shareholders with small holdings) can be taxed, at the taxpayer's option, at 35 percent (20 percent for "ordinary deposits") or included as a part of the taxpayer's total income. If included in total income, the interest is subject to the normal marginal tax rate schedule, with marginal rates as high as 70 percent. Taxpayers start to pay a 35-percent marginal tax rate at a taxable income of Y 8 million ($33,333). Income distribution data do not permit accurately gauging how many taxpayers may benefit from this provision. In 1981, however, only 6.6 percent of all individual taxpayers filed returns reporting gross income over Y 10 million ($41,667). These taxpayers accounted for 36.1 percent of total reported income. Another reason preventing accurate assessment of how many taxpayers take advantage of the lower rate on taxable interest andand dividends

is the uncertain extent of tax evasion. As noted earlier, taxpayers may establish anonymous accounts or otherwise evade the limits on tax-free interest entirely.

Capital gains on the sale of securities are not taxed in most situations, but other capital gains are subject to tax, with long-term capital gains taxed at lower rates. The general method of computing the tax on capital gains divides the gains into long and short-term gains, with 5 years being the dividing line. A Y 500,000 ($2,083) deduction is taken first from the short-term gain then the long-term gain. Taxable gains then are the sum of the post-deduction, short-term gains plus one-half the net long-term gains (net of any available deduction remaining after subtraction from short-term gains). Taxable capital gains are then added to taxable income from other sources to obtain total income for tax purposes.

Some other forms of capital gains are given preferential treatment. Long-term gains on land sales, for instance, are taxed at 20 percent of the capital gain, if the gain is Y 40 million or less. Larger capital gains are taxed according to a formula that essentially excludes one-half of the gain exceeding Y 40 million from taxation. Short-term capital gains are taxed at the higher of (1) 40 percent of the gain or (2) 110 percent of the difference between the tax computed on total income in-

cluding the gain and total income excluding the capital gain. A Y 1 million ($4,166) deduction from capital gains is allowed, with the requirement that it be taken first from short-term gains and then from long-term gains. In the sale of a residence, up to Y 30 million ($125,000) may be deducted. If the taxpayer pays more for a replacement house than the sales price of his former residence, any capital gains realized are not taxed. (If the purchase price of the new residence is less than the selling price of the old, only the difference is a taxable gain.)

Limited interest deduction

Deductions of mortgage and consumer interest are among the largest tax expenditures in the U.S. tax system. It is generally accepted that this provision has had a substantial effect on household financial decisions and on the level of housing investment. Since no such deductibility exists in the Japanese tax system, the differences should be considerable.

Housing and mortgage markets in Japan and the United States are different in many ways. Housing in Japan is smaller than housing in the United States and mortgage debt is substantially lower. While the fact that Japan's tax law permits no deduction for mortgage interest probably plays some role in this, it would be a mistake to attribute all the differences in the housing and

mortgage markets in Japan with those in the United States to the tax systems. Most of Japan's population lives in metropolitan areas, with high housing prices being the rule. This appears to be more the product of employment location than the tax treatment of housing or mortgage debt.

If a taxpayer buys a house before December 31, 1984, and finances the purchase with a loan for 10 or more years, however, Japanese tax law does allow a tax credit of 18 percent of loan repayments over Y 300,000 ($1,250). This credit may be taken during the year when the taxpayer occupies the house and two succeeding years. The tax credit cannot exceed Y 150,000 ($625) and is not available to taxpayers whose total income exceeds Y 8 million ($33,333) or to taxpayers who take advantage of the tax exemption of capital gains on the sale of a residence when a replacement of equal or greater value is purchased. (When the replacement value is less than the price of the former residence, the taxable capital gains on the sale are limited to the difference between the sales price and the cost of the replacement property.) Again, the effects of this are uncertain.

Japanese tax law allows an individual interest deduction for borrowing tied to business activities. Taxpayers reporting dividend income also may deduct interest paid on debt incurred to purchase the stock yielding dividend income, although this also reduces the credit that can be claimed on dividend income.

Dividend credit

As noted earlier, Japanese tax law considers a corporation to be a collection of individuals rather than a separate entity. Corporate taxes are thus looked at as advance payments of individual tax liabilities. The corporate tax is assessed by a split rate, with retained earnings taxed at 43.3 percent and distributed earnings at 33.3 percent. Individuals receiving dividends and whose total taxable income is under Y 10 million ($41,667), furthermore, may credit 10 percent of the dividends, less interest expense paid on debt used to buy the stock, against their tax liability. This credit is limited to 5 percent on those dividends that exceed the Y 10 million ceiling. This credit and split-rate system is an effort to avoid double taxation of a corporation's earnings. This credit is not refundable (i.e., the credit cannot exceed the taxpayer's total tax liability). The taxpayer is given the option of having 35 percent of the dividends withheld to satisfy any tax liability, which would be attractive to taxpayers in high marginal tax rate brackets.

Individual tax filing and compliance

Taxpayers do not have to file tax returns if their only source of taxable income is from employment; furthermore, employers are obligated to adjust tax withholding for the final salary, wage, or bonus payment earned during the year so that

total withholding satisfies the tax liability. Taxpayers receiving business income (such as shopkeepers) are responsible for self-assessment of their tax bills. They are given the option of expensing salaries paid to family members and, if they meet certain standards for accurate bookkeeping, can file a "blue return" that provides preferential treatment. One preference allowed to taxpayers filing "blue returns" is the option of treating the proprietorship as a corporation for tax purposes. When this happens, the taxpayer may deduct his or her own salary as an expense of the quasi-corporation and gain other benefits of corporate tax treatment.

Given the different tax assessment practices for those receiving salaries and those owning a business, it is not surprising that tax differences are controversial. The ease with which some occupations may evade taxes has been captured in a common belief in a "9-6-4 system," with 90 percent of wage and salary income purportedly being reported to the tax authorities but only 60 percent of business income and 40 percent of farm income.

We must stress, however, that we know of no quantitative examination of Japanese taxpayer compliance. Appropriate data apparently are unavailable to analyze differences in reporting income by source. Evasion of taxes on interest income also is

reputed to be extensive but difficult to gauge. Taxpayers are allowed only one tax-free account in the Postal Savings system (with interest earned on up to Y 3 million excluded from taxable income.) However, accounts are set up under ficticious names.

If the potential to evade taxes affects taxpayers' decisions, tax evasion may have economic consequences. Any consequences cannot be accurately assessed in the absence of data, but concern over compliance has appeared to be less than the concern that taxes in general be cut. Until the latter half of the 1970s, tax revenues grew so fast that revenue losses from evasion did not warrant increased enforcement.

INDUSTRIAL INVESTMENT AND DEVELOPMENT INCENTIVES IN JAPAN'S CORPORATE INCOME TAX

The Japanese system of taxing corporations contains provisions to promote industrial investment and development in two separate laws. One, the Corporation Tax Law, sets forth the general principles of corporate taxation. The other, the Special Taxation Measures Law, makes available to qualifying corporations the tax preferences and incentives deemed necessary by the Japanese government to help attain certain economic policy objectives.

While the Corporation Tax Law is considered to be permanent in nature, the Special Taxation Measures Law is considered to be

temporary and is, in fact, periodically revised to reflect changing economic priorities. However, because the tax preferences contained in that law are generally narrowly drawn and amount only to about 3 percent of the tax due under the Corporation Tax Law, their importance to overall Japanese industrial development should not be overemphasized.

Rather, attention should be directed to the cumulative effects of the two laws; that is the income tax burden imposed on the corporate sector. In comparison to the United States, the relatively low rate of corporate taxation in effect prior to the mid 1970s may have stimulated Japanese industrial development more than the narrowly targeted tax preferences. Relative tax burdens have shifted since then, due in large part to 1981 changes in the U.S. corporate tax, but we feel that it is too early to conclusively assess the implications of the changes in corporate tax burden.

General principles of taxation under Japan's Corporation Tax Law

Essentially, the Japanese system of corporate taxation resembles that of the United States. The principal difference is that in Japan distributed corporate income is taxed at a lower rate than retained income. Also, the tax rates established are generally not progressive with respect to corporate income.

The Japanese corporate tax rates are set out in attachment I to my statement. Currently, the undistributed income of large Japanese corporations is taxed at a flat rate of 43.3 percent and the distributed income at a flat 33.3 percent. Smaller corporations are taxed at a lower rate on the first Y 8 million (about $33,333) of annual income but at the same rate on additional income. As we noted earlier, under individual income tax laws, individuals receiving corporate dividends are entitled to a tax credit of up to 10 percent of the amount of dividends received.

The reduction in the corporate tax rate taken in conjunction with the tax credit for individuals has the effect of reducing the double taxation of corporate profits. Furthermore, the tax credit may act as an incentive for individuals to invest in corporate stocks, while the reduced tax rate may act as an incentive for corporations to seek out investors as opposed to seeking out debt financing for capital investments, the traditional practice.[6]

[6]The split rate corporate tax system with tax credits available to individuals receiving dividends was adopted by the Japanese in 1961. It was introduced as an incentive to increase the equity capital of corporations in comparison with borrowed capital. Traditionally, Japanese corporations relied on debt to finance capital expenditures rather than using equity markets as is the customary practice in the United States. Even with the tax incentives, however, Japanese corporations rely more heavily on debt financing than do U.S. corporations. According to current estimates by the American Business Conference, the debt-to-equity ratios of Japanese and U.S. corporations are approximately 3 to 1 and 1 to 3, respectively.

To compute income subject to the tax rates, Japanese corporations begin with the profit figure reported on their financial statements that are prepared in accordance with generally accepted accounting principles in Japan.[7] Adjustments are then made to account for the differences between tax law and accounting principles, such as carrying losses forward for up to 5 years and back one, claiming accelerated depreciation allowances, and taking certain additional tax deductions.[8]

All categories of corporate income, no matter what their source, are taxed at the corporate tax rates shown in attachment I unless specifically excluded by law. As in the United States, for example, operating income resulting from sales (calculated as the excess of sales proceeds over the cost of goods sold) is included in taxable income. Also included in Japanese corporate taxable income are various categories of nonoperating income, such as interest and royalties; certain donation income, such as the value of assets received as gifts and the amount of loans forgiven; foreign currency gains and losses; and revaluation of assets in the course of a merger. As a general rule, capital

[7]In practice, however, many Japanese corporations prepare financial statements in accordance with tax laws.

[8]To take advantage of all favorable tax provisions, corporations must apply for the privilege of filing a "blue return." In part, this requires corporations to adopt a bookkeeping system approved by the appropriate Japanese tax office, keep accurate records, and report income following accrual basis accounting.

gains from the sale, exchange, or transfer of securities, real estate, and other capital assets are also included in taxable income and taxed at the applicable corporate tax rate. On the other hand, dividends received from domestic corporations are excluded from taxable income,[9] provided that the corporation pays out at least as large a sum in dividends.[10] For consistent application of tax law, interest expense attributable to the acquisition and holding of the corporate shares yielding the untaxed dividends may not be deducted as an expense for tax purposes.

Generally speaking, all ordinary expenses necessary to the conduct of corporate business and all losses realized in the conduct of such business are deductible in calculating taxable income, except as limited by law and regulations. As in U.S. tax practice, expenses that are unnecessary or excessive are not deductible. Below are some examples of tax deductible expenses.

--Payment of salaries, bonuses, and retirement allowances.

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[9]Also excluded or deferred from inclusion in taxable income are certain gains from mergers, tax free spin-offs, exchange of certain real property, reinvestment of insurance proceeds, involuntary conversions, reinvestment of sales proceeds from certain real property and real property held long term, and refunds of nondeductible taxes.

[10]If the amount of dividends received exceeds the amount of dividends paid out by the recipient corporation, 25 percent of the excess must be included in taxable income of the recipient corporation.

--Cost of most employee fringe benefits such as housing and meal subsidies, transportation allowances, and medical treatment (employee fringe benefits are deductible expenses to the corporation even though the value of the benefits may not be included as taxable income to the employee).

--Losses resulting from the sale, exchange, or transfer of securities or real estate and other capital losses.

--Interest and royalty payments.

--Some, but not all, local taxes.

--Certain organizational expenses.

--Entertainment expenses only for corporations with paid-in capital of 50 million yen (about $208,000) or less and then only within specified limits.

--Donations within specified limits.

--Amounts credited to reserve accounts for bad debts, sales returns, employee bonuses, employee retirement allowances, special repairs, and warranty repairs.

--Depreciation and amortization.

In making plant and equipment investment decisions, the depreciation expenses allowed under the tax laws are of considerable interest to corporations. In general, the shorter the useful life prescribed under tax laws, the sooner the corporations may recover the full cost of the asset in computing their tax liabilities.

In Japan, depreciable assets are assigned a useful life in regulations issued by the Ministry of Finance. Generally, assets with a useful life of more than one year and costing over Y 100,000 (about $417) must be capitalized and depreciated over

prescribed periods of time.[11] Some examples of the useful lives of plant and equipment prescribed by the Ministry are shown in attachment II to my statement. For example, automobiles may be depreciated over 4 years and automobile manufacturing plants over 10 years. These periods appear to be shorter than the economic lives of these assets.

In general, assets may be depreciated to a residual value of 5 percent of cost regardless of depreciation method.[12] Cost includes acquisition price plus other costs of putting the asset in service. Permissible methods for depreciating tangible fixed assets include the straight-line method, the declining balance method, or another method if it is specifically approved by the appropriate local tax office. However, the declining balance method is to be used unless advance notice is given to the local tax office.

The tax law permits corporations to write off the full cost of certain intangible assets and certain expenses in the year in which incurred. Most notably, in terms of tax provisions favoring industrial activity, corporations may write off certain

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[11]Depreciation is not allowed for land, rights to land, and certain articles, such as precious stones and paintings.

[12]The remaining 5 percent of cost may be recognized as an expense at the time of asset disposal.

costs related to research and development; development of new markets, products, or production techniques; and corporate organizational activities during the year the costs are incurred or may amortize those costs over a period of up to 5 years. This option gives corporations the flexibility to postpone the recognition of certain costs to years when there are profits to offset instead of recognizing those costs before a product is developed for sale or before any sales are made.

Against this general framework of corporate income taxation, the Japanese have enacted special measures designed to help attain certain specific economic policy objectives. I would now like to turn to those special taxation measures.

Incentives for industrial investment and development under the Special Taxation Measures Law

To stimulate industrial activity, including the promotion of corporate investment and research activities, Japan's Special Taxation Measures Law makes available to qualifying corporations 3 categories of tax preferences: special depreciation allowances, tax credits and special deductions, and tax free reserves. The Japanese government estimates that these tax preferences reduced corporate tax revenues by Y 258 billion (about $1.1 billion) in 1983 or about 3 percent of the corporate tax that otherwise would have been collected.

While there are similarities between the types of tax preferences provided to corporations under Japanese and U.S. tax rules, the Japanese tax preferences are generally more narrowly targeted to affect certain industries, geographic areas, or specific types of equipment. Also, the Japanese have tended to avoid tax credits as a general investment incentive.

Special depreciation allowances

As measured by foregone tax revenues, the most significant category of Japan's special taxation measures are the tax preferences entitling certain corporations to accelerate the depreciation of qualifying assets. The Japanese government estimates that these special depreciation measures cost about Y 153 billion (about $630 million) in foregone tax revenues in 1983, or almost 60 percent of the cost of all the tax preferences available to corporations through the Special Taxation Measures Law during that year.

The economic rationale for offering special depreciation measures is to stimulate the private sector to invest in particular types of assets. Certain corporations may depreciate qualifying assets by one of two accelerated methods specified by the Special Taxation Measures Law and thereby recover their costs sooner than they would by following the methods authorized by the Corporation Tax Law. This assumes, of course, that the

corporations have earned profits in excess of the allowable depreciation expense.

Under one method, certain corporations are entitled to an extra depreciation allowance during the first year a qualifying asset is placed in service. As shown in attachment III, this allowance usually ranges from 8 to 30 percent of the cost of the asset. For example, air transportation enterprises are entitled to an additional first-year depreciation allowance of 11 percent of the cost of new aircraft. Also, very favorable treatment is provided for certain research and experimentation expenditures that, under normal tax rules, would be capitalized. Corporations are authorized to write off, in the year incurred, 100 percent of expenditures for research and development that are paid to specified associations engaged in a research work sanctioned by the government.

Under the second method, certain corporations investing in qualifying assets may deduct, during each authorized year, an additional percent of the regular depreciation computed under the Corporation Tax Law. Attachment IV summarizes these measures. For example, corporations acquiring certain newly constructed facilities storing liquified petroleum gas are authorized to deduct an additional 34 percent of the regular depreciation allowance during each of the first 5 years the storage tanks are in service.

An indication of the importance of any one special depreciation measure is the degree to which it is used. An analysis of available Ministry of Finance data shows the importance of favored depreciation treatment given to small and medium-sized businesses and emphasis given to anti-pollution and energy saving investments. Of the total tax revenues foregone in 1983 due to special depreciation measures

--48 percent was attributable to small and medium-sized corporations taking additional first year depreciation allowances for investments in machinery and equipment;

--22 percent was attributable to corporations taking additional first year depreciation allowances for investments in machinery and equipment preventing environmental pollution or promoting efficient resource use;

--11 percent was attributable to corporations taking additional first year depreciation allowances for investments in energy saving equipment;

--10 percent was attributable to corporations taking additional first year depreciation allowances for investments in manufacturing machinery used in underdeveloped areas; and

--9 percent was attributable to other provisions.

Before turning to the next largest component of special tax measures--tax credits and special deductions--I would like to again point out that, regardless of the special depreciation allowances taken by corporations, as a general rule those corporations may not depreciate tangible assets to less than a residual value of 5 percent.

Tax credits and special deductions

As measured by foregone tax revenues, the tax preferences entitling corporations to tax credits and additional tax deductions from taxable income are the second most significant category of Japan's special tax measures. The Japanese government estimates that corporate use of these tax preferences cost about Y 63 billion (about $263 million) in foregone tax revenues in 1983, or about 24 percent of the total tax preferences made available to corporations by the Special Taxation Measures Law during that year.

Among measures to help promote domestic industrial development, the Special Taxation Measures Law provides tax credits to corporations engaging in certain applied research and development activities, making certain energy-saving investments, and modernizing certain industrial facilities.[13] These tax credits allow qualifying corporations to directly reduce the amount of taxes owed under the Corporation Tax Law by a specified percent of the corporations' investment or research expense covered by the special measure. As such, the Japanese government is helping finance these desired corporate expenditures.

To stimulate certain research and development activities, the Special Taxation Measures Law entitles qualifying corpora-

[13]Other tax credits, such as those for withholding and foreign taxes paid, are also available to corporations.

tions to a tax credit equal to 20 percent of the amount of covered research and development expenses incurred during the tax year that exceeds the largest amount of such expenses incurred in any year since about 1965. Covered research and development expenses are generally defined as those incurred to develop new products, designs, and production techniques. These expenses may include employee salaries, equipment depreciation, and other related expenses such as overhead. However, the tax credit is limited to 10 percent of the corporate tax that would otherwise be due without the credit.

To promote corporate investment in certain energy-saving facilities, the Special Taxation Measures Law entitles corporations to take a tax credit equal to 7 percent of the acquisition cost of covered investments. These covered investments include machinery, equipment, and other depreciable assets that reduce energy consumption in the manufacturing process, use energy sources other than petroleum, and reduce pollution from the use of non-petroleum-based energy sources. The available energy credit, however, is limited to 20 percent of the corporate tax liability computed without the credit, but credits not taken because of the limit may be carried over to the following year.

This energy-related investment tax credit is an outgrowth of the tax credit concept first introduced in Japan in 1978. At

that time, the investment tax credit was envisioned as a 1-year temporary measure to encourage investment in specific industrial facilities, such as energy-saving or anti-pollution facilities. From this beginning, and after substantial modification, the Japanese have retained an energy-related investment tax credit; and, beginning in 1984, a tax credit for small businesses investing in plant and equipment to increase efficiency. This tax credit is equal to 7 percent of the covered investments and is envisioned as a 2-year temporary measure.

The Special Taxation Measures Law also provides for additional deductions in computing corporate taxable income as an incentive for corporations to engage in certain business activities, primarily as follows.

--Corporations selling or licensing technical and industrial property rights to foreign parties may deduct 28 percent of the foreign transaction's gross proceeds from corporate taxable income otherwise computed.

--Corporations performing research or technical support for foreign parties may deduct 16 percent of the gross proceeds from corporate taxable income otherwise computed;[14]

--Corporations engaged in mineral exploration may deduct an additional amount equal to the amount of expenses and depreciation attributable to exploration activities from corporate taxable income otherwise computed.[15]

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[14]The sum of this and the preceding deduction is limited to 40 percent of corporate taxable income computed without the deduction.

[15]The deduction is subject to certain limitations, such as that the deduction may not exceed corporate taxable income.

An analysis of available Ministry of Finance data shows the importance of the favorable treatment given to corporate research and experimentation expenditures. Of the total tax revenues foregone in 1983 due to the special tax credit and deduction measures:

--60 percent was attributable to corporations taking the tax credit for research and experimentation;

--30 percent was attributable to corporations taking the two special deductions for income derived from overseas technical service transactions; and

--10 percent was attributable to corporations taking other tax credits and special deductions.

I would now like to turn to the last category of special taxation measures--tax free reserves.

Tax free reserves

As measured by foregone tax revenues, the least significant of the tax preferences made available to corporations under the Special Taxation Measures Law are those that entitle corporations to defer taxation on part of their business proceeds by establishing tax free reserve accounts. The Japanese government estimates that corporate use of tax free reserves cost about Y 42 billion (about $175 million) in foregone tax revenue in 1983. This amounts to about 16 percent of the total tax preferences made available to corporations by the Special Taxation Measures Law.

In general, the tax free reserves authorized by the Special Taxation Measures Law are intended to encourage certain specific types of investments and business activities and to provide relief from certain potentially harsh business conditions. This is accomplished by providing corporations that are engaged in covered business activities or subject to extreme price fluctuations of certain commodities with a mechanism for taking a tax deduction for certain estimated business expenses before the expenses are actually incurred and before they would be recognized following generally accepted accounting principles.

In addition to providing relief from certain types of extreme price fluctuations, the types of business activities favored by the tax free reserve measures include

--overseas market development;

--overseas investment;

--nuclear fuel reprocessing;

--designated economic cooperation investments; and

--certain specified industrial activities, such as mineral exploration, computer development and sales, nuclear power plant construction, and other miscellaneous activities.

Data from the Ministry of Finance shows that about 20 percent of the estimated tax revenue loss is attributable to the recognition of computer repurchase losses. All other provisions cost much less.

In general, the computer repurchase loss reserve provides that corporations engaged in the manufacture or sale of electronic computers to qualified leasing corporations under compulsory repurchase sales agreements may recognize as a current expense for tax purposes an estimated amount equal to 20 percent of the gross proceeds received. However, as is generally true for all the reserve accounts, if actual loss expense differs from that estimated, an appropriate adjustment to income is made in subsequent years.

This completes my detailed presentation of the various tax preferences used by the Japanese government to stimulate desired corporate industrial activity. I will conclude my statement with an examination of the corporate tax burden in Japan.

Japanese corporate tax burden

Gaining some insights into the cumulative effect of all the special taxation measures and the basic provisions of the Corporation Tax Law may be more important when considering overall industrial development than the merits of each of the individual provisions. This becomes particularly evident when it is recognized that many of the taxation measures have been instituted to meet many objectives, such as promoting energy efficiency to compensate for a lack of natural resources, coping with environmental pollution, aiding underdeveloped areas, restructuring depressed industries, or advancing the development of new

industries such as computers. Moreover, the point has been advanced by some academic studies that Japanese industrial growth may have been affected more by lower tax burdens--corporate and individual tax burdens on a national and subnational basis--than by any single tax preference or combination of tax preferences.[16]

The tax rates specified in Japan's national tax laws do not, however, provide a comprehensive measure of the tax burden on corporations. For example, the tax preferences--accelerated depreciation allowances, tax credits and special deductions, and tax free reserves--used by the Japanese government as incentives for industrial investment and research and development, reduce taxes paid by Japanese corporations. (These incentives reduced corporate tax revenues by about 2.7 percent in 1983). Other factors may also substantially affect the tax burden imposed on corporate business activities. Most notably, dividends are taxed at a lower rate than retained earnings. Also, a reduced

[16]This is one of a number of observations made by J. Pechman and K. Kaizuka in Asia's New Giant. Further, the authors concluded that "In total, the erosion of the tax base through [special tax measures and other preferences] is much larger in Japan than it is in the United States and most other developed countries (even though some of the special measures have been abolished in recent years). The few studies that have been made have concluded that the tax preferences promoted modernization of plant and equipment in the steel and machinery industries but had little influence either on savings of households or on investment in other industries. On the basis of the evidence, the Japanese would probably be better off with a broader tax base and lower nominal tax rates."

tax rate is applied to certain portions of income earned by smaller corporations.

Corporate taxes paid to municipal and prefecture governments also affect the total tax burden on corporations, just like state and local taxes in the United States. Municipal and prefecture taxes, which are controlled by the central government, are essentially computed on the basis of corporate taxable income as determined under the Corporation Tax Law. Attachment V provides an overview of the corporate income tax rates imposed by these tax laws. In general, the subnational income taxes may increase corporate taxes by as much as one-third. For 1982, according to Japanese national income account data, total corporate income taxes under national and subnational tax laws amounted to Y 11.6 trillion (about $48 billion).

To develop a measure of the tax burden imposed on Japanese corporations, we adopted a technique followed by Pechman and Kaizuka in their 1976 study of Japanese taxation.[17] That technique directly takes into account the tax preferences involved in corporate recognition of asset depreciation expense by computing tax burdens as the rate of taxes paid by corporations on gross profits; that is, profits before the deduction of depreciation expense allowances.

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[17]J. Pechman and K. Kaizuka, "Taxation," in Asia's New Giant (Washington, D.C.: The Brookings Institution 1976.)

Also, to establish a benchmark to show the relative Japanese corporate tax burden computed in accordance with the Pechman and Kaizuka methodology, we compared the results with a similarly computed U.S. corporate tax burden. The data to make these comparative analyses were obtained from the national income account data of both countries. The results are shown in attachment VI.

Japanese corporations did experience lower tax burdens than U.S. corporations during the 1960s and into the early 1970s. In 1970, for example, Japanese corporations paid about 17 percent of their total gross profits in taxes while U.S. corporations paid about 25 percent. Accordingly, this may have had a stimulative effect on Japan's overall industrial growth when compared to that of the United States. However, as shown in attachment VI, the tax burden on Japanese corporations has been increasing in recent years, while in the United States the corporate tax burden has been substantially reduced. By 1982, following this analytical methodology, the total U.S. corporate tax burden was about one-half that of Japan's.

The reversal in corporate tax burdens between the two countries has been borne out by a recent study completed by the Congressional Research Service that compared the tax burdens on

manufacturing.[18] Using a different analytical method, one that examines how the tax structure affects the profitability of investment, the Congressional Research Service estimates that, at least since 1977, the effective corporate tax burden on marginal investment in Japan has exceeded that in the United States. With respect to national corporate income taxes, the Congressional Research Service analysis shows that this corporate tax burden in Japan rose from 33.8 percent in 1977 to 35.8 percent in 1981 while in the United States it dropped from 37.5 percent to 25.3 percent. Moreover, when considering national and subnational corporate income taxes, the Congressional Research Service estimates that the effective tax rate in Japan is about twice that of the United States.

Accordingly, the stimulative impact of Japan's lower corporate tax burden may very well have run its course and been overcome by the need to finance government programs and services. Since 1975, Japan has been faced with increasing national budget deficits. In recent years, these deficits have amounted to about one-third of the central government's budgets.

To solve the deficit problem, the Japanese government, in part, has turned to corporations as a source of additional tax

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[18] Comparative Corporate Tax Burdens in the United States and Japan and Implications for Relative Economic Growth, HJ4625, Jane Gravelle, Congressional Research Service, Washington, D.C., Sept. 6, 1982.

revenues. Since 1975, while the system for taxing corporations has remained unchanged, the tax rates have been increased and the value of tax preferences curtailed. In 1981, the corporation tax rates were increased from 40 percent on undistributed profits and 30 percent on distributed profits to 42 percent and 32 percent, respectively. In 1984, the rates were again adjusted upward to 43.3 percent and 33.3 percent, respectively. This latest increase is planned to be effective for two tax years beginning April 1, 1984. At the same time, tax preferences have been curtailed. In 1975, the special measures affecting corporations amounted to about 7.4 percent of corporate tax revenues. By 1983, the special measures had been reduced to 2.7 percent of corporate tax revenues.

In view of these changes and aside from Japan's split rate tax system with its attendant lower tax rate on distributed profits, our limited research of current Japanese corporate tax rules did not contradict a view held by many researchers that corporate tax preferences are not the leading cause of Japan's industrial development.

This concludes my statement on Japan's tax system. I will be happy to answer any questions that you may have.

ATTACHMENT I

ATTACHMENT I

CORPORATE TAX RATES
UNDER JAPAN'S
CORPORATION TAX LAW
1984

Description of Corporate Taxpayer	Percentage Tax Rates: Taxable income earmarked for dividends	Percentage Tax Rates: Taxable income retained
Corporations with paid-in capital in excess of 100 million yen (about $416,666)	33.3	43.3
Corporations with paid-in capital of 100 million yen (about $416,666) or less:		
First 8 million yen (about $33,333) of annual taxable income	25.0	31.0
Remainder of taxable income	33.3	43.3

The corporate tax rates shown are to be effective from April 1, 1984 to March 31, 1986. This represents a planned temporary increase from the previous 42-percent tax on retained earnings and 32 percent tax on earnings earmarked for dividends. Also, the tax rates on the first $33,333 of small corporation taxable income, whether retained or distributed as dividends, were previously one percent lower. Exchange rate used to compute dollar amounts is 1 U.S. dollar equals 240 yen.

Source: Information provided by the Japanese Embassy, Washington, D.C., September 1984.

ATTACHMENT II

ATTACHMENT II

USEFUL LIVES OF SELECTED ASSETS
UNDER JAPAN'S CORPORATION TAX LAW
1984

Description of Asset	Useful life (years)
Tangible fixed assets other than machinery and equipment	
1. Reinforced concrete buildings (for office)	65
2. Wooden buildings (for office)	26
3. Elevators	17
4. Air conditioners or heaters	15
5. Steel vessels (2,000 tons or more)	15
6. Steel tankers (2,000 tons or more)	13
7. Steel fishing vessels (500 tons or more)	12
8. Airplanes (for international service)	10
9. Trucks (for transport business)	4
10. Passenger automobiles (taxis)	4
11. Electronic computers	6
12. Desks, chairs, or cabinets made of metal	15
13. Typewriters	5
Machinery and equipment	
1. Chemical condiment manufacturing plants	7
2. Sugar refinery plants	13
3. Beer brewery plants	14
4. Raw silk manufacturing plants	10
5. Worsted spinning plants	10

ATTACHMENT II

ATTACHMENT II

Description of Asset (cont.)	Useful Life (years)
6. Pulp manufacturing plants	12
7. Chemical fertilizer manufacturing plants	10
8. Polyethylene manufacturing plants	8
9. Synthetic fiber manufacturing plants	7
10. Rayon yarn or rayon staple manufacturing plants	9
11. Plate or sheet glass manufacturing plants	14
12. Cement furnaces	13
13. Iron and steel manufacturing plants	14
14. Metallic machine tool manufacturing plants	10
15. Electrical machinery and appliance manufacturing plants	11
16. Automobile manufacturing plants	10
17. Lens or other optical instrument manufacturing plants	11
18. Radio or television broadcasting equipment	6
19. Hydraulic power generation plant for electric utilities	22
Intangible fixed assets	
1. Patent rights	8
2. Utility model rights	5

Source: Information provided by the Japanese Embassy, Washington, D.C., September 1984.

ATTACHMENT III

ATTACHMENT III

INCREASED INITIAL YEAR DEPRECIATION
AND AMORTIZATION EXPENSE RECOGNITION
UNDER JAPAN'S SPECIAL TAXATION MEASURES LAW
1984

Description of qualifying asset	Allowance computed as a percent of acquisition cost
Initial depreciation for qualifying machinery and equipment acquired and placed in service within prescribed periods:	
1. Machinery and equipment to prevent environmental pollution	25
2. Machinery and equipment designed not to cause environmental pollution	18
3. Specified water-supply equipment	18
4. Machinery and equipment for recycling which may promote efficient resource use	16
5. Machinery and equipment for saving energy	18
6. Certain assets used for the structural adjustment of specific basic material industries	
a. machinery	18
b. assets other than machinery	8
7. Steel vessels used by ocean transportation enterprises	15
8. Aircraft used by air transportation enterprises	11
9. Buildings for stores and shops jointly operated by retailers	8

ATTACHMENT III

ATTACHMENT III

Description of qualifying asset (cont.)	Allowance computed as a percent of acquisition cost
B. Initial depreciation of assets used for earthquake disaster prevention	18
C. Initial depreciation for machinery, equipment, and factories whose prices exceed 15 million yen and are located in	
1. Underdeveloped areas or certain industrial development areas	
a. machinery and equipment	16
b. factory building	8
2. Coal mining regions, depopulated areas or depressed local industrial areas	
a. machinery and equipment	18
b. factory building	8
3. Okinawa industrial development areas	
a. machinery and equipment	34
b. factory building	20
4. Okinawa free trade zone	
a. machinery and equipment	50
b. factory building	25
D. Initial depreciation for machinery and equipment acquired by small or medium sized enterprises or agricultural cooperative associations and costing over 1.4 million yen	30 /a
E. Initial depreciation of specific shafts and lifts for mining use	100
F. Initial amortization of forestation expenses	27 /b

ATTACHMENT III

ATTACHMENT III

Description of qualifying asset (cont.)	Allowance computed as a percent of acquisition cost
G. Initial depreciation of facilities for members mutual benefits	/c
H. Amortization of expenditures for research and development purposes paid to specified associations mainly engaged in research work	100/b
I. Initial depreciation of machinery and equipment acquired by small and medium-sized firms located together in specific areas in accordance with certain government programs	
a. machinery and equipment	18
b. building	8
J. Initial depreciation of machinery and equipment for medical use acquired by medical corporations and costing over 1.4 million yen	18
K. Initial depreciation of certain machinery and equipment used by high-technology firms in designated "technopolis" areas	
a. machinery and equipment	30
b. building	15

a. Computed on the excess of the cost over the average yearly investment for the past 5 years.

b. Computed on the basis of covered expenses incurred during the year.

c. Varies between 8 and 23 percent depending on certain circumstances.

Source: Information provided by the Japanese Embassy, Washington, D.C., September 1984.

ATTACHMENT IV

ATTACHMENT IV

ADDITIONAL DEPRECIATION EXPENSE RECOGNITION
UNDER JAPAN'S SPECIAL TAXATION MEASURES LAW
1984

Description of Qualifying Asset	Allowance[a]
Machinery used to promote rationalization of small and medium sized enterprises or the textile industry improvement project	30% for the first 5[b] years
Machinery, equipment, and buildings of enterprises employing handicapped individuals	
machinery and equipment	18% each year
building	25% each year
Houses newly built for rent with	
useful life of less than 45 years	47% for the first 5 years
useful life over 45 years	70% for the first 5 years
Building construction covered by the law concerning redevelopment of metropolitan areas	14% for first 5 years
Facilities for storing liquified petroleum gas	34% for first 5 years
Certain warehouses	27% for first 5 years
Silos for grains	27% for first 5 years

Notes: [a]The additional depreciation allowances shown are computed on the basis of the depreciation allowance determined under the Corporation Tax Law. Other provisions provide for the shortening of the useful lives of certain hotels.

[b]For structural improvement of small and medium-size enterprises in the fishing industry, the additional depreciation allowance is 27 percent.

Source: Information provided by the Japanese Embassy, Washington, D.C., September 1984

ATTACHMENT V

ATTACHMENT V

NATIONAL AND SUBNATIONAL
CORPORATE INCOME TAX
RATES IN JAPAN
1984

	Percentage Tax Rates	
	Taxable income earmarked for dividends	Taxable income retained
National Corporate Tax	33.3	43.3
Local Enterprise Tax	13.2	13.2
Local Inhabitants Tax	6.6	8.7
Estimated Adjustment for deductibility of local enterprise tax from National Corporate Tax	- 7.5	- 7.5
Estimated Aggregate Tax Rate	45.6	57.7

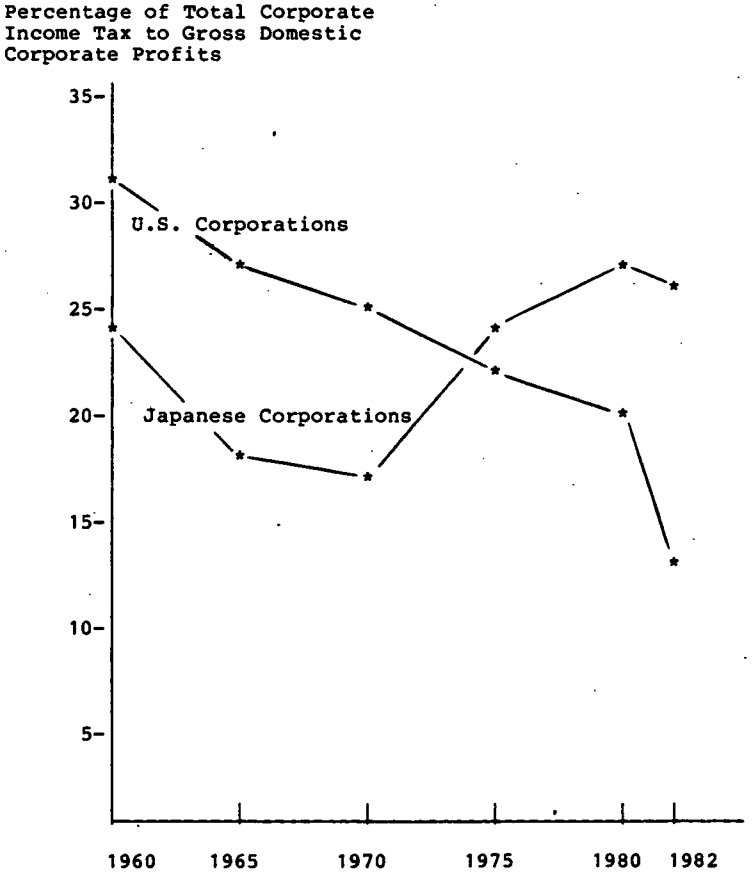
Note: The national corporate tax, local enterprise tax, and local inhabitants tax rates shown reflect only the maximum tax rates. With certain exceptions the local taxes are based on taxable income as determined under the Corporation Tax Law--the national corporate income tax.

Source: Tax Management Inc.: Foreign Income Portfolios, Business Operations in Japan; 1984, updated with the national corporate tax rate increase of 1984.

ATTACHMENT VI

ATTACHMENT VI

COMPARISON OF TOTAL CORPORATE
INCOME TAX BURDEN IN JAPAN
AND THE UNITED STATES
1960 THROUGH 1982



Source: National income accounts as reported by the U.S. Department of Commerce and Japan's Ministry of Finance. U.S. data adjusted to account for Federal Reserve Bank data in national account totals.

Representative LUNGREN. Thank you very much. I know you have given us a rather extensive prepared statement here that we will make a part of the record and I hope my questions won't just be a repetition of that.

I'd like to go to a couple things, however. As I understand it, the interest income on qualified savings accounts in Japan with principal under 3 million yen is currently tax free.

Has this level of 3 million yen always been a feature of the tax law or have they tried to periodically adjust it for inflation?

Mr. MENDELOWITZ. The Japanese tax code has basic or permanent features and then temporary features. The investment tax credits and special additional depreciation for various purposes are part of the special temporary tax incentives.

The exclusion from taxable income of interest on these qualifying savings accounts has been a feature of the permanent tax code and, while it has been constant for some time, has changed.

Representative LUNGREN. As I understand it, that would translate to about $12,500. That's been current for some time?

Mr. MENDELOWITZ. Yes, that is correct. That figure has not changed since at least 1974, but what has changed is the dollar value of that 3 million yen because the value of the yen has changed considerably over the past decade.

Representative LUNGREN. In your prepared statement you mention that one of the most significant differences between the Japanese tax system and ours is their exemption of most capital gains realized by individuals. Does this feature of their system tend to help any particular type of Japanese firm or industry?

Mr. MENDELOWITZ. I think Mr. Richards would like to answer that.

Mr. RICHARDS. We don't have any information that would specify any particular industry that's benefited from it, but it should be noted that the capital gains treatment isn't limited to any particular industry. Many of the provisions in the Japanese tax code tend to be narrowly drawn or focused on one particular sector of the economy. This particular provision would apply across all Japanese industries.

Representative LUNGREN. The reason I ask that is oftentimes when this provision is brought up in comparisons between the U.S. Tax Code and the Japanese tax code, people will say, well, there are cultural differences that really make it difficult to analyze it and say exactly how that approach might work in the United States. I just wondered if there was some underlying differences in the makeup of their firms or corporations that would make that particularly attractive to some segments and not to others.

Mr. MENDELOWITZ. There are two features that we should keep in mind when trying to assess that. One is that Japan does not have the substantial venture capital market that the United States has, so that you might view this type of exemption somewhat as a substitute for the inadequacy of the venture capital market.

A second consideration is my understanding that there's a considerable amount of Japanese corporate stock held by other corporations and the amount of stock that's actually traded on the public markets is a fairly small amount and represents a thin market, so you get rather wide fluctuations in share prices. It might be possible to view this provision of the tax code as an offset to the somewhat wider

fluctuations in the stock prices of Japan that follow from the thinness of the market.

Representative LUNGREN. In your prepared statement you have noted that Japan has sought to keep its tax burden under 20 percent of its GNP and they had been able to do that over the last decade. Was that a conscious effort by the government? If it were, what was the purpose for that policy?

Mr. MENDELOWITZ. The 20-percent figure goes back to a study that the National Tax Commission made in 1959 which recommended a number of changes in the tax law. One of the items that they focused on was the appropriate share of GNP that should be taken by taxation, and that 20-percent figure was the recommendation that came from the Tax Commission and in effect became a policy of successive Japanese governments.

I don't know, though, whether there was a fine-tuned econometric model at the time that said 20 percent was the magic number. My guess is there probably wasn't.

Representative LUNGREN. But in some way there was a consensus that this was about where they wanted to be and they managed to maintain that level?

Mr. MENDELOWITZ. The function of the Tax Commission in the Japanese system is, in effect, to come up with a consensus with respect to changes in the tax system and the objectives of tax policy. So, when the Tax Commission recommended the 20-percent tax burden as the goal, they in fact were presenting what was a consensus view on the appropriate level of taxation at that time for the Japanese economy.

Representative LUNGREN. Now we hear various statements made about what has happened in Japan with respect to individual income tax rates. Could you tell me about how many times the individual tax rates have been cut in the postwar period in Japan?

Mr. MENDELOWITZ. We can give you the exact number for the record, but as a general matter, throughout the period from the Tax Commission's recommendations in 1959 on through the middle of the decade of the 1970's, our understanding is that tax cuts came virtually every year. But we would have to provide specific details for the record on how many tax cuts came through rate reductions, if you're interested in specific details.

[The information referred to was subsequently supplied for the record:]

Since 1954, individual tax rates have been changed 12 times, in 1955, 1957, 1959, 1961, 1962, 1966, 1968, 1969, 1970, 1971, 1974, and 1984.

Mr. MENDELOWITZ. Essentially what happened in the Japanese experience is that in the 1960's and 1970's Japan experienced substantial rapid economic growth. The tax base was fairly elastic. This means that tax revenue would increase proportionally more than GNP as GNP grew, and that's the aspect of the Japanese system that permitted the frequent reductions in taxes. But the changes took many forms. There weren't only changes in tax rates. Special measures adopted, various exemptions were increased, and there were also changes in rates. For example, just recently there was a reduction in the personal income tax in Japan, even though Japan faces budget deficit problems, and that was affected, in part, by a reduction in rates. However, that

reduction in personal income tax rates was offset by an increase in the tax rates of corporations, so the total tax revenues of the government was essentially not affected.

Representative LUNGREN. With the exemptions and deduction adjustments you mentioned they had in some years instead of tax cuts, were those adjustments made on an individualized basis? That is, individual decisions as opposed to having effected some sort of, in effect self-correcting mechanism for inflation?

Mr. MENDELOWITZ. Mr. McDermott would like to answer that.

Mr. MCDERMOTT. There are a number of things that Japan has tried to accomplish with the tax cuts. At some points, they were trying to compensate for inflation in the early 1970's. At other times the rate of exemption increased in special measures that were somewhat more targeted. We could provide additional details of the tax cuts during the postwar period for the record.

[The following information was subsequently supplied for the record:]

The tax cuts were designed, in general, to maintain the 20 percent limit on the tax share of Japan's GNP. In inflationary periods, nominal tax revenue would grow at a faster rate than nominal income, leading to a higher tax share of real GNP if taxes were not cut.

Representative LUNGREN. In your prepared statement, you talk about treatment of contract savings plans for workers as one of the tax incentives. Would you discuss that a little bit? Does this refer to the amount saved or the return on such savings?

Mr. MCDERMOTT. The 5 million yen exemption for such contract savings is the principal in these savings accounts. As we understand the accounts, they are probably best described as an equivalent or an analogue to our payroll savings plans.

Representative LUNGREN. Is the mechanism of the savings plan a contractual agreement with the employer, is it something that the employer has to make the indication on, like we have sometimes to check the box and there's an automatic savings for the United Way? How does that actually work in Japan?

Mr. MCDERMOTT. I'm not sure of the procedures that are used for this particular type of savings plan. Again, we can find out for the record on this. It's our understanding that participation is not obligatory in any sense, and relative to the other tax-exempt forms of savings, this is a relatively minor tax loss feature according to government estimates.

Representative LUNGREN. Is it a fairly new phenomenon there or is it something they have had in their system for some time?

Mr. MCDERMOTT. I believe it's been in effect since 1971. Again, I could verify that for the record.

[The information referred to was subsequently supplied for the record:]

This contract savings system, formally known as the System for Savings for the Formation of Employee Assets, was instituted in 1971. The income exclusion is provided by the Special Tax Measures Law and thus is not a part of the basic tax structure.

Representative LUNGREN. OK. In your prepared statement you describe the 20-percent tax credit for qualified R&D expenses for the increments that exceed the largest amount of such expenses incurred in any year since 1965. When was this provision placed in the law?

Mr. RICHARDS. I believe that was introduced in 1967.

Representative LUNGREN. Is that a permanent feature of their tax system or is it something like our R&D tax credit which may expire next year, depending on what we do with it here in the Congress?

Mr. RICHARDS. In the Japanese tax system, all the special measures are temporary. Some have a sunset date on them and some do not have a sunset date. I am not exactly sure if this is carrying a particular expiration date, but the very nature of it being a special measure indicates that it is temporary.

Representative LUNGREN. In your prepared statement you note, and you just indicated a second ago, that while there was a reduction in individual tax rates recently, there was an increase in corporate tax rates.

In your prepared statement you state that the corporate tax revenues comprise a larger share of the total budget receipts in Japan than they do in this country. How do corporate profits as a share of national income in the two countries compare?

Mr. MENDELOWITZ. I don't have the exact figures, but my understanding is that they are higher in Japan, but the issue of exactly what the corporate profit is depends upon the accounting conventions. It depends upon, for example, how much of your investment is a function of equity, how much is a function of borrowed funds. While our understanding is that it's higher in Japan, it is very difficult to make exact comparisons because of differences in conventions and differences in practices.

Representative LUNGREN. You mentioned that one of the distinguishing features of the Japanese tax system is their attempt to eliminate to some extent the double taxation of corporate income. Has that been a permanent feature of their system, first of all?

Mr. RICHARDS. That basically goes back to the design of their tax system in 1950. There have been some changes in the manner in which it's been carried out, but it was one of the guiding principles right from the reestablishment of the corporate income tax and the individual income tax following World War II.

Representative LUNGREN. Has there been any substantial change in the makeup of it since it was started?

Mr. RICHARDS. Initially, when it was passed, it was effected totally through a credit to individuals. It wasn't until 1961, I believe, when the corporate tax rate was reduced on earnings that were distributed for dividends.

So now you have an effect on two sides: A lower tax rate on the corporate side and a tax credit to individuals.

Representative LUNGREN. Maybe this is a naive question on my part, but whenever we talk about that question here in the United States in the context of a political debate it's an extremely controversial issue. Immediately people say, well, the rich are already getting richer, and ask what distributional impact would it have and it seems like one of the great hobgoblins of political discussion.

Is it so ingrained in the Japanese tax system to suggest that from the very beginning there was not much controversy over it? Is it one of the things that is subject to attack on a regular basis or is it accepted through the system as something which does provide a gain overall in the economy?

Mr. MENDELOWITZ. The incidence of the credit is somewhat unclear. However, the full value of the credit only applies to certain income levels. For example, the tax credit that an individual may claim for the amount of dividends received, which is currently 10 percent, applies primarily to lower and middle income small holders of securities and does not apply to the wealthy. So, small holders of equity receive more of a benefit from this than the quite rich ones.

Mr. RICHARDS. What Mr. Mendelowitz was referring to is a split rate dividend credit. The 10-percent credit is available to individuals having a relatively low threshold of income whereas for high wage earners the tax credit is limited to 5 percent of the dividends received. So from an equity issue, they seem to have approached charges of some bias to the wealthy by splitting the rate. We are unaware of any controversy at the current time in Japan that would tend to change their system.

Also, this shouldn't be viewed as a temporary measure. It should be viewed as an integral part of their tax system.

Representative LUNGREN. One of the questions that we have in the Congress for at least the past 4 years, and I'm sure long before that is the impact of marginal rates and so forth, and it's often pointed out that the top personal marginal tax rate in Japan is 70 percent but then immediately people indicate, yes, but most people don't pay that; there are various ways to avoid it. And they point often to the question of the election taxpayers can have for a special 35-percent flat rate applied to their investment income. How long has that 35-percent rate been in effect?

Mr. MCDERMOTT. There's been a similar provision going at least back to the early or mid-1970's. At that time the tax rate option was 25 percent for the tax rate on investment. I can supply for the record the exact date when the change to the current 35 percent took place.

Representative LUNGREN. So it was lower at one time?

Mr. MCDERMOTT. It was lower at one time.

Representative LUNGREN. Has there been any analysis done of the impact of the raising of that?

Mr. MCDERMOTT. Not to the best of my knowledge.

Representative LUNGREN. Going back for a second to the corporate question, on table 2 of the prepared statement you provided for us, you indicate that Japanese corporate income taxes were estimated to contribute about 40.5 percent of total revenues in 1983. Isn't that figure rather high even for a country whose corporations generate large incomes?

Mr. MENDELOWITZ. That figure is net of the Social Security payments. If we roll in Social Security payments that figure, of course, would be lower.

[The information referred to was subsequently supplied for the record:]

The correct corporate tax share of Japan's general account receipts is 27.8 percent, with 40.5 percent being the individual income tax share; the two numbers had inadvertently been reversed in the draft statement.

Representative LUNGREN. I see. Do you have any idea what it would be if we rolled in the Social Security?

Mr. MCDERMOTT. It would be somewhere in the 20 percent range. The reason that table 2 excludes Social Security is that we concentrated on Japan's general account receipts for this table.

Representative LUNGREN. I understand. Well, I've got a whole host of questions I could ask you but I believe that many of them have been answered in your prepared statement, which is rather detailed and very much accomplishes what we hoped to accomplish, which was to make a record of this question to at least begin the inquiry. Obviously in the short period of time we have with the three of you and the following three panelists we can only begin to scratch the surface of this question. That's what I want to try to do because we don't have a whole lot of discussion on this.

We sort of talk about it in the abstract or we often talk about it offhand or as an afterthought when we're discussing policy here in the Congress, and while I certainly don't think that you can transport ideas that may have been ingrained in the Japanese system automatically to the United States, it certainly makes a legitimate line of inquiry for us to consider. After all, Americans certainly influenced where Japan began after World War II, and some of the changes that they have made are somewhat different, strikingly different from what we have done in the United States.

You have in an academic sense a laboratory that you can take a look at and try to draw some lessons from to help and hopefully guide some public policy decisions here. And I want to thank you for the work that you have done over the last couple of months in preparing the report. I thank you for your testimony. And if you could make available for the record some responses for some of those oral questions, I would very much appreciate it. I'm sure this is not the end of this nor the end of our inquiry or our request for assistance of you and your agency. Thank you very much.

Mr. MENDELOWITZ. Thank you very much.

Representative LUNGREN. Next I'd ask Mr. Jim Wheeler from the Hudson Institute, Mr. Edward J. Lincoln from the Brookings Institution, and Mr. Leon Hollerman from Claremont McKenna College to come forward.

Gentlemen, what I'd ask you to please do is perhaps present your remarks in 10 to 20 minutes or so and then we will go into the questions.

One of the things I have tried to do with the panels in the past when we have had them before our Joint Economic Committee is to see if I can draw out some differences so I will not at all be upset if we draw out a variety of views. I guess I will be disappointed if I don't draw out some differences among the three of you.

First of all, we will start off with Mr. Jim Wheeler, the deputy director of economic studies at the Hudson Institute. Mr. Wheeler, you may proceed as you wish. Your prepared statement will be made a part of the record and you may refer to it or proceed from it as you wish.

STATEMENT OF JIMMY W. WHEELER, DEPUTY DIRECTOR, ECONOMIC STUDIES, HUDSON INSTITUTE, INC.

Mr. WHEELER. Thank you very much, Congressman Lungren.

Since Mr. Mendelowitz provided an excellent description of the Japanese tax system, what I will do, rather than summarize the rather extensive document on the system which I have submitted for the

record, is to address a number of key issues on which I strongly support the GAO document, and to react to several of the questions that you addressed to Mr. Mendelowitz.

The first point is that clearly Japan has used modifications of the tax system for very explicit economic goals. There's nothing mysterious about the tax system. The instruments and methods used are all very straightforward. Moreover, tax policy has a systematic core that changes rarely, with a component that is modified every year; this special taxation measures law, explicitly addresses special economic problems, concerns, and issues. Thus, it's relatively easy to track changes in Japanese interests as expressed in their tax policy because they include it in this legislation.

I think the main strength of Japanese tax policy is that it has been used to complement the policy interests and the market forces of the day. On the other hand one of the central problems with identifying the effects of Japanese tax policy is that there's a great shortage of people who have tried to quantify the effects of tax policy and since such policy has been so consistent with all the other policies of the day, it's very difficult to sort out tax effects from all others.

In general, I would argue that the broad bias in the tax system for savings and investment is probably more important than any specific targeting that you can identify.

In particular, I would like to address contract savings that you raised a question about. As I understand the system, this is a contract prepared by the employee with a financial institution, through his employer who usually establishes a salary deduction. It's a voluntary program with a variety of specific aspects.

One special aspect is for a savings contract to purchase a house. For such a contract, there is an additional savings incentive over and above the tax-free interest on the 5 million yen principal. I do not have the exact magnitude of this extra benefit for 1984, but in 1981, for which I do have good information, 8 percent of annual contribution to that contract could be taken as a tax credit on 3-to-6-year contracts. On a 7-year-plus contract, again to purchase a house, you could take 10 percent of your annual contribution as a tax credit. So there's an additional housing tax credit over and above the benefit of the basic employee property formation promotion law. With regard to this year—I have read one source that the maximum amount that can be taken as a tax credit has been raised to 150,000 yen, but that is not a verified number and I would hasten to add that that needs to be checked. As I understand it, that was the increase in the 1983 tax reform. That's six hundred and some odd dollars.

There are a number of comparisons that interest me. Allan noted that the tax rate on corporations is higher as a percent of profits in Japan than in the United States, but as a percent of sales they are quite a bit lower, which is consistent with the general perception that Japanese firms are higher sales and lower profit companies.

Before the 1981 U.S. tax cuts, the tax burden on corporations as a percent of sales was about double in the United States what it was in Japan.

Specifically addressing your earlier question about the exclusion of capital gains, as I understand the history, the reason for the exclusion of capital gains was to try to stimulate a market for equities in Japan

which had not been very active. In fact a number of individuals that I have talked to about this remain quite unhappy with the degree to which the individual market for equities in Japan has developed. It's still very much an institutional market. It's a very thin market, as Mr. Mendelowitz indicated, and the Japanese are indeed actively interested in seeking ways to encourage growth of equity markets. So the exclusion of capital gains was, again as I understand it, and remains deliberately designed to stimulate the growth of that market, especially with the perceived shortage of venture capital.

There is also an incentive for cross-ownership of corporations built into the corporate tax law, in that dividends paid from one corporation to another, at the lower tax rate on the issuer, as Mr. Mendelowitz indicated, is not taxed as income to the recipient. There is a tax on capital gains in the corporate tax but not on dividends among corporations. There is an incentive built into the tax system to support the traditional Japanese cross-ownership within company groups. Historically, this provides a safety net for individual companies through cross-support.

Attempts to sort out the specific incentives for savings in the tax system is more difficult than in the U.S. tax expenditures since the Japanese don't report as completely. To the extent that aggregate tax expenditure data are available, they reveal some very interesting trends.

First, the revenue losses to corporate tax expenditures as a percent of corporate tax revenue fell dramatically during the period of the 1970's. As budget deficits grew in the 1970's, tax expenditures as a percent of corporate tax fell from 9 percent of corporate tax revenue to 2.7 percent in 1983. The Ministry of Finance seemed to be relatively successful in closing tax loopholes.

One tax expenditure that has grown in absolute terms even as the share of all declined during the 1970's is that devoted to the promotion of science and technology. It is the only broad category of tax expenditures that grew in absolute terms.

It turns out that when the Ministry of Finance calculates tax expenditures, they are prevented, for political reasons, from calculating the tax losses due to the tax exclusion on savings account interest in postal savings accounts. Partly, this is due to the fact that there's a tremendous amount of cheating in the postal savings system. Individuals hold multiple accounts under false names. A very common citation is that the number of accounts in the postal savings system is something over double the Japanese population. So there's a lot of cheating going on in those under 3 million yen deposits.

I calculated a very rough estimate of the tax losses, making a great many assumptions along the way, but being reasonably conservative, just to get a rough idea. I came out with a 1981 tax loss on the order of 1.2 trillion yen. This is larger than all tax expenditures calculated by the Ministry of Finance that year. So that my estimate of the savings incentive from that one tax measure was rather striking.

I hasten to qualify that this was a very back-of-the-envelope calculation, but the number is quite striking and indicates to me that the bias in all of the tax-free, interest-free programs is quite large. However, I have not been able to sort this out in any hard econometric fashion in terms of the effects on savings rates.

Also the impact of special tax measures, by the very nature of their dramatic decline in size over the 1970's, have become much less important. So the major incentives for savings and investment that one can identify in the tax system are those built into the core part of the system. The special measures to promote high technology have increased and there's a very clear bias in some of these measures that I would like to note. First there is a tendency in Japanese tax policy to make markets.

For example, one of the special depreciation measures, an accelerated depreciation measure, is for combined equipment. Combined equipment is defined in Japan as anything that joins a microprocessor or computerized device with a mechanical machine. A special accelerated depreciation for combined equipment lowers the price to users of that type of equipment which the Prime Minister would like to promote production in Japan. Now the item doesn't have to be produced in Japan. It's neutral by source. But the point is they are making a market for a type of equipment that they would like to promote.

So there's a general bias toward saving and investment. Going through the detailed tax measures there's also a general bias within the investment bias toward certain types of manufacturing industries, and that bias has changed over time from a wide range of mechanical technologies, to electronics technologies, and now to what they call knowledge intensification investments, which support services as much as other kinds of investments.

Thank you very much.

[The prepared statement of Mr. Wheeler follows:]

PREPARED STATEMENT OF JIMMY W. WHEELER

JAPANESE TAX POLICIES: INCENTIVES FOR SAVING, INVESTMENT, AND INNOVATION

By

Jimmy W. Wheeler
Deputy Director, Economic Studies

Excerpted in modified form from
"Japanese Industrial Policies:
Past, Present, and Future"

Chapter 3 in

COMPETING WITH JAPAN

by Thomas Pepper, Merit E. Janow and Jimmy W. Wheeler
(New York: Praeger Publishers, forthcoming)

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JAPANESE TAX POLICIES: INCENTIVES FOR SAVING, INVESTMENT, AND INNOVATION

Japan's continued economic success, in spite of two major oil price increases and the stagflationary record of the world economy for nearly a decade after 1973, has led a great number of Americans to assume that the Japanese experience must offer useful lessons for the U.S. Because the Japanese government has traditionally played a more active and direct role in the management of the Japanese economy than the U.S. government has played in the management of the U.S. economy, particularly in directing or appearing to direct both public and private funds to particular sectors, industries, or firms, many Americans assume that Japan's economic success must in large measure be due to superior government policies. Moreover, since Japanese policies have at times been explicitly aimed at limiting foreign participation in the Japanese economy, many Americans assume that these government policies have also been designed to promote Japanese economic development at the expense of foreign (mainly U.S.) economic interests and to do so by taking unfair advantage of the non-discriminatory rules of the postwar international trading system. These views have led, in turn, to suggestions that the U.S. adopt economic policies modeled on Japan's, either as a means of improving U.S. competitiveness or as a way of retaliating against Japan's alleged unfairness, or both. Indeed, U.S. resentment at Japanese policies or commercial practices has at times run so high that some Americans have advocated retaliation in any case--whether or not U.S. economic performance would benefit from such retaliation and whether or not such retaliation were part of a broader effort to improve U.S. competitiveness.

The record of Japanese postwar economic development demonstrates clearly enough the success Japan has achieved during both favorable and unfavorable global economic conditions. But the degree to which this success can be attributed to Japanese government policies, as against broader social and historical factors, particularly private sector initiatives, is in our view a much more difficult question. Just to identify which government policies might be given particular credit for Japanese economic success is itself difficult. Indeed, many current discussions attribute Japan's economic success to its industrial policies without necessarily defining what constitutes industrial policies against other economic policies and without attempting to measure the impact of these (often undefined) industrial policies as against the impact of other economic policies or even broader social and historical factors.

In our view, there is nothing particularly mysterious about the way the Japanese government has fostered economic growth and industrial development in the postwar years. In analyzing various specific policies the Japanese government has employed over the years, including such quantifiable measures as tax benefits and credit allocations, as well as much broader, qualitative measures, such as the formulation of future-oriented "visions" and the government's "administrative guidance" to private firms, we find the process to have been reasonably straightforward, in the sense of using policy instruments that have often been used in other countries as well. That Japan's use of such instruments may have been more effective than other countries' is a separate question. The main strength of Japanese industrial policies has lain not in any particular instrument or set of instruments, but rather in the way in which these various instruments have

been used together, complementing one another directly or indirectly. In fact, to a degree that is probably unmatched anywhere, the Japanese government formulated and then held to a more or less clear commitment to economic growth as a basic national policy, and for many years evaluated most important policy measures by whether they promoted this goal.

Evolution of Japanese Industrial Policies

This paper specifically looks at the role tax policy played in the broader policy framework of the day, and the role it can be expected to play in the future. Accordingly, a summary of the evolution of industrial policies is provided before tax policy is overviewed in some detail. This is followed by a review of trends in impacts of and prospects for Japanese tax policies.

After Japan's defeat in World War II, the government and the country as a whole was intensely interested in "re-catching up" to the other industrialized countries of the West. This required an emphasis on economic growth that was not, however, based on the precise way in which this term was defined by Simon Kuznets, namely "sustained increases in product per capita."* Rather, economic growth has traditionally been associated in Japan with a much broader concept of "national strength," including miltary strength, economic strength, social stability, and, as a result, overall political strength.** In the early postwar years, and continuing

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*Simon Kuznets, Modern Economic Growth: Rate, Structure and Spread (New Haven, CT: Yale University Press, 1966), p. 1.

**The prewar term kokuryoku (literally "national strength") now has a harsh ring to it, reminding people of wartime excesses, and as such is no longer used. In effect, the notion of economic growth replaced kokuryoku after the war as a basic national goal. Beginning in the

at least through the early 1970s, the goal of economic growth was more or less synonymous with the notion of building up Japan's "national strength." This goal was then translated into policies that promoted savings and investment, and more specifically a high level of investment in certain specified sectors deemed critical to the growth process. The key role of the government in this process, especially in the immediate postwar years, was as a catalyst to growth: Industrial policies provided specific incentives to the private sector that supported a general sense of confidence and that in turn encouraged a desired pattern of investment and high growth. The ways in which government policies interacted with general economic conditions changed markedly over time; the post World War II history can usefully be grouped into three periods, 1945-65, 1965-73, and 1973 to the present.

The process of promoting economic growth began as soon as the war ended, and was considerably accelerated in 1948-49, when U.S. occupation policy shifted from one of trying to limit Japan's reemergence as a major power to one that deliberately favored such reemergence as a counterweight to newly perceived threats represented by the Soviet Union and the new communist government in China. In 1949, the Ministry of International Trade and Industry (MITI) was formed as an amalgamation of the Ministry of Commerce and Industry and an occupation-organized Board of Trade.

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late 1970s, as more of the earlier postwar taboos against Japanese interest in national defense weakened, a new term that is also broader than economic growth--sogo anzen hosho, literally "comprehensive security"--has come into use. The new term incorporates the orthodox idea of national defense, but in a way that de-emphasizes a traditionally military-oriented approach to defense, while emphasizing various broad-based factors affecting national security, e.g., energy security, raw materials supplies, and high investment levels as a source of continued high growth and presumably, thereby, domestic social and political stability as well.

Since then, MITI has exercised more influence on Japanese industrial policy than any other ministry or government agency, though this influence has always been constrained by limited budgetary allocations from the Ministry of Finance (MOF). MITI's actual budget remains small even today, e.g., only 1.6 percent of the total government budget in 1983. Moreover, as discussed below, MITI's direct influence on industrial development has diminished as the economy itself has grown. In the early postwar years, MITI's policies adhered closely to traditional concepts of "national strength," going back to prewar and even the Meiji period. The government was expected to influence both the kinds of products to be produced and the levels of production.* In this regard, the main

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*Chalmers Johnson, in his extensive work on the history of MITI, characterizes this as a "plan-rational" system. He distinguishes between economies that are "market-rational," where "efficiency," in the sense of achieving a certain output with a minimum expenditure of inputs (or the maximum possible output for a fixed quantity of inputs), is the main criterion of decision-making, and economies that are "plan-rational," where "effectiveness," in the sense of achieving certain specified objectives without necessarily seeking an economy of resources in achieving these objectives, is the main criterion of decision-making. Johnson considers Japan and other later developing countries to be plan-rational, and he sees the government in such states as naturally taking a more active role in promoting economic development than it did or has since done in countries that developed earlier. Carrying the point a step further, Johnson argues that in a market-rational economy, the state concerns itself mainly with regulating the ground rules within which economic activities take place, without trying to direct which economic activities might be undertaken. In a plan-rational economy, on the other hand, a key role of the state is to direct what economic activities are best engaged in. Obviously, the plan-rational state is more likely to have an industrial policy--indeed, as Johnson notes, to give such policy "the greatest precedence." By contrast, "the market-rational state usually will not even have an industrial policy (or, at any rate, will not recognize it as such)." In Johnson's classification system, the U.S. today is a good example of a market-rational economy, Japan of a plan-rational economy. See Chalmers Johnson, MITI and the Japanese Miracle (Stanford, CA: Stanford University Press, 1983), pp. 18-19.

goal of the early postwar years and the main policy emphasis pursued by MITI was to revive and expand Japan's basic manufacturing industries, and to do so in a way that would also produce goods for export. In resource-poor Japan, great quantities of imported raw materials were needed to provide inputs for manufacturing industries; competitive exports were therefore required to earn the foreign exchange needed to pay for these imports. Japan's industrial development activities sought to build up economies of scale in industries facing income-elastic demand, which in turn drove down per unit prices, thereby producing goods able to compete in international markets.

The policy instruments available to the Japanese government during this period enabled it to influence the economy in a detailed and powerful manner, with the emphasis on a revival and expansion of basic manufacturing industries. Thus, partly by design, and partly through the cooperation of the U.S. government, which led the way in setting the rules of international trade at that time, Japanese manufacturers enjoyed considerable infant-industry protection for most of the first 20 years of the postwar period. They also benefited, though clearly more as a coincidence than from any design on their part, from the most rapid period of world growth in output and trade ever recorded. In other words, Japanese manufacturers in this period enjoyed the double benefits of a rapidly expanding and captive domestic market and a large and growing world market. New Japanese products were rarely developed exclusively for export, however. In most cases, a domestic market was developed first, giving producers long production runs through which they could achieve the economies of scale that enabled such goods subsequently to be exported at highly competitive prices.

Japan's export successes in consumer electronics, steel, and automobiles all illustrate the point. This pattern of industrial development (and attendant policies supporting the development of basic manufacturing industries) continued without interruption until 1965, when Japan's balance on merchandise trade (i.e., the value of its exports less its imports of goods) turned significantly and, to date indefinitely, positive.*

Although any period might be described as one of transition, the years between 1965 and 1973 were clearly transitional for Japan's industrial policies. The kinds of government policies that were appropriate for a period of recovery from war, such as direct administrative control over the use of scarce foreign exchange earnings, quite naturally became inappropriate once economc development gradually advanced beyond a recovery stage. Similarly, trade and investment policies designed specifically for infant industries became unjustified once such industries succeeded in establishing a competitive position in world markets. In 1964, when Japan, with U.S. sponsorship, was admitted to membership in the OECD--with the specific implication that it was joining the ranks of the developed countries--the Japanese government was thereby committed to follow the same policies of relatively free trade and investment that already prevailed among other OECD countries.** As a result, pressures for change from

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*There were small surpluses in earlier years, but a trend was established after 1965.

**Japan had declared Article 11 status in the GATT in 1963; this involved a commitment to remove certain export subsidies and foreign exchange allocations. Japan shifted from Article 14 to Article 8 status in the International Monetary Fund in 1964, a step that required it to end controls on foreign exchange used for current account transactions and restrictions on yen convertibility by nonresidents. These steps were followed in 1967 by a phased program of liberalization of capital account transactions.

trading partners, most notably the U.S., became increasingly strong. On the surface, Japan did little more than fight a series of holding actions against mounting criticism of its residual trade restrictions and of the pace at which capital liberalization was scheduled to take place.* In fact, within the government, and particularly within MITI, the period was one of great ferment. Indeed, the ferment itself probably delayed decisive action. As a result, actual changes in industrial or trade policy during these years were almost minimal.

Throughout this period, MITI was in the midst of a major debate on the future direction of the Japanese economy and its own role in that future. Already in 1970, the Asahi Shimbun had launched its kutabare

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*In itself, the idea of a gradual liberalization of international capital transitions was completely consistent with established practice; in any developed country, immediate (i.e., non-gradual) changes in the regulatory environment would be deemed arbitrary. Nonetheless, heated criticism of the pace of Japan's capital liberalization program began to increase in the late 1960s in large part because Japan's trade surpluses, particularly with the U.S., were also increasing. Thus, the capital liberalization program became a partial scapegoat for the inability of other countries, for whatever reasons, to sell more goods to Japan. Norman Macrae, Deputy Editor of The Economist, observed as early as May 1967, before the capital liberalization program had officially been unveiled, that it would hardly constitute an opening of the floodgates to foreign investment. As he noted at the time, when he asked a MITI official in which industries foreigners might hope to set up wholly-owned subsidiaries, he was jokingly told that geta, or Japanese-style wooden clogs, might qualify. In a more serious vein, Macrae went on to conclude that the "first list for so-called capital liberalization is likely to be restricted to industries in which Japanese companies are already so strong, or else in which the Japanese market is already so over-supplied, that only a foreign lunatic would set up a new venture." See Norman Macrae, "The Risen Sun," The Economist, May 27, 1967, p. xxvii. In these years, between 1965 and 1973, foreign government officials often spoke with great bitterness about Japan's capital liberalization program, as though they had somehow been misinformed about its provisions or schedule. More likely, they had failed to understand it as well as Macrae did, and were then naturally reluctant to blame themselves for problems that were more expediently blamed on the Japanese government. Of course the possibility that such a negative political reaction would arise was a risk the Japanese government took in devising the limited program it did.

GNP (down with GNP) campaign, and the sarcastic slogan "Gross National Pollution" had gained much public appeal. The public began to criticize MITI for serving the interests of business rather than society as a whole. For a time, the reaction against economic growth as a national goal (and against expanding basic manufacturing industries as an unqualified benefit to the economy) seemed to grow as rapidly as the economy itself had been growing. MITI tried to respond to these criticisms with programs to rectify complaints and to give itself a role in the suddenly important field of environmental protection.* MITI was also reorganized during this period to introduce so-called horizontal bureaus, covering broad policy areas, in addition to the traditionally powerful vertical, or industry-by-industry, bureaus. The aim was to promote greater consistency both within MITI and among ministries.** More important, for the longer term at least, were the formulation and publication of broad-based MITI plans for industrial structure shifts away from basic manufacturing and toward so-called "knowledge-intensive" industries, meaning those with higher capital per worker, requiring (and permitting) higher skills and wages. These plans were made public in various policy papers or "visions," produced either by MITI itself or by various public/private advisory groups, notably the Industrial Structure Council.***

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*On the theory that environmental protection and the promotion of business interests should not be in the same ministry, an Environmental Agency, with cabinet rank, was established in July 1971, with the mission of setting environmental standards and coordinating the environmental protection activities of other ministries.

**For details, see Johnson, op. cit., Chapter VIII.

***Such "visions" have been produced at various times since 1963, and have generated the usual disagreements among scholars, officials,

Another version of then-current ideas within MITI evolved into an openly political document when a former MITI Minister, Kakuei Tanaka, borrowed heavily from in-house material to develop a plan for infrastructure development that he then used as part of a campaign for the Prime Ministership. This plan, Nippon Retto Kaizō-Ron (literally, An Essay on the Reconstruction of the Japanese Islands), more commonly known as "The Tanaka Plan,"* stirred great interest, partly because, in contrast to the Asahi-led critique of past policies, it took a positive approach.** In terms of its scope, the Tanaka plan was bold indeed. Among other things, it called for a vast decentralization of manufacturing away from the overcrowded Pacific coastline, aiming thereby at a revitalization of other parts of Japan that were otherwise experiencing declining populations. The plan also call for road, school, hospital, and park construction on a scale never before imagined. Although these ideas doubtless contributed to Tanaka's popularity during his early months as Prime Minister, the actual results proved disappointing--or worse. Land speculation, together with alleged favoritism in contracting for the numerous infrastructure development

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business executives, and journalists as to their importance, either in real or symbolic terms. Yoshihisa Ojimi, then Administrative Vice Minister of MITI, presented what then became the most well-known such "vision" to a meeting of the OECD Industry Committee in Tokyo in June 1970. This statement was subsequently incorporated into an English-language reference work, The Industrial Policy of Japan (Paris: Organisation of Economic Co-operation and Development, 1972).

*Nippon Retto Kaizō-Ron (Tokyo: Nikkan Kogyō Shimbun, Ltd., 1972), translated and published in English as Building a New Japan (Tokyo: The Simul Press, 1973).

**The plan appealed to Japanese who, though perhaps disillusioned with previous policies that emphasized basic manufacturing industries almost to the exclusion of anything else, were nonetheless still strongly in favor of continued economic growth.

projects called for in the plan, added to the disillusionment and brought about a dramatic inflation in land prices. A worldwide boom in commodity prices, culminating in the "oil shock" of late 1973 and the subsequent worldwide recession, brought this almost unprecedented political initiative to a sudden end.*

From the mid-1960s to the early 1970s, the earlier degree of government control over economic activities became increasingly inappropriate, given the level of prosperity achieved, and in some cases inconsistent with international agreements (but nonetheless mostly tolerated by the U.S. and other advanced countries). Meanwhile, as per capita income increased, a great variety of new goals emerged in addition to economic growth, e.g., protection of the environment, better health care facilities for the aged, and increased leisure time activities. As a result, considerable ferment arose behind the scenes as to how to deal with this newfound heterogeneity in policy choices, combined with considerable paralysis

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*The idea of further infrastructure development still remains basically popular--provided, of course, that such development can be undertaken without triggering the punishing inflation rates of the post-oil shock/post-Tanaka Plan days, and without resembling the pork barrel politics of the Tanaka Plan. Because Japan still needs new or improved schools, roads, parks, hospitals, and perhaps most importantly, housing space, the question is really not whether such infrastucture will be developed, but when, how, how much, and at what cost. Because of the large debt burden now hanging over the economy, the Japanese government cannot undertake such infrastructure development through "normal" spending programs; moreover, it seems to have made an economic judgment against an expanded issuance of national bonds to finance such projects, and a political judgment against appreciably increasing the net taxation burden. In principle, the government could play an important role in trying to tap the country's large pool of private savings and channel these into infrastructure projects. Various proposals for doing this have been made, including the notion of private sector financing of infrastructure development. Nothing specific has emerged, however, and the issue remains one under seemingly continuing, but inconclusive, discussion. For an earlier discussion of these issues, see Kahn and Pepper, op. cit., especially Chapter 7.

in the actual implementation of new policies. Much preparatory work for new policies, both within companies and within MITI, was performed. However, perhaps because the range of choices was already too wide, Japan's much-vaunted consensus-building process failed to work as well as it had in earlier postwar years. Even in cases where certain preparatory plans were taken off the shelf and put forward as prospective courses of action, e.g., in energy policy after the first "oil shock," many of the detailed provisions were not actually carried out until a "second oil shock" six years later drove home the extent of the changes in the external environment.*

As they worked their way through the economy, the increases in energy prices in 1973-74 and in 1979-80 had an effect on Japanese industrial development that was far greater than the policy measures taken up to that point--and particularly greater than the combination of intellectual ferment and de facto inaction described above. For example, the initial energy price increases were passed on to users to a far greater degree

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*Commenting on certain differences between a plan-rational economy such as Japan and a market-oriented economy such as the U.S., Johnson notes that "when a consensus exists, the plan-rational system will outperform the market-rational system on the same benchmark, such as growth of GNP, as long as growth of GNP is the goal of the plan-rational system. But when a consensus does not exist, when there is confusion or conflict over the overarching goal in a plan-rational economy, it will appear to be quite adrift, incapable of coming to grips with basic problems and unable to place responsibility for failures." He specifically cites Japan in 1971 and 1973 as experiencing exactly this kind of drift. "Generally speaking," Johnson contends, "the great strength of the plan-rational system lies in its effectiveness in dealing with routine problems, whereas the great strength of the market-rational system lies in its effectiveness in dealing with critical problems. In the latter case, the emphasis on rules, procedures, and executive responsibility helps to promote action when problems of an unfamiliar or unknown magnitude arise." See Johnson, op. cit., p. 22.

than in the U.S., and Japan instituted a series of sweeping energy conservation measures. Moreover, wage increases were remarkably modest, compared to the high rate of inflation that developed in 1974. However, given the five-year decline in oil prices in real terms between mid-1974 and mid-1979, it took a second round of price increases to bring about many of the actual changes in industrial structure that had been talked about for more than a decade. Specifically, energy-intensive manufacturing, such as aluminum smelting, suddenly became much less competitive (even though the handwriting had been on the wall for some years). Nevertheless, the adjustments in energy use that had been successfully introduced after the first round of energy prices increases provided a strong foundation for further adjustments in many parts of the economy when the second round of energy price increases occurred. The earlier commitment to restrain the inflationary shock of the speculative boom of 1972-73 and the energy price increases of 1973-74 set the stage for much faster adjustment to the second round of energy price increases in 1979-80. In this way, Japan's deflationary reaction to the outside shocks of the 1970s was sharp but brief. In contrast to the U.S. and many other OECD countries, the stagflationary legacy in Japan was much less lengthy.

Looking ahead, Japan faces serious problems of industrial change. In particular, as more basic manufacturing industries continue to lose their competitiveness (whether because of higher energy costs than prevalent in other countries, because various NICs have developed to a point where their goods can compete effectively with Japanese goods, or because Japanese labor costs are now comparable to other industrial countries), MITI is finding itself increasingly constrained in its ability to use industrial

policy as a way of preserving (or even delaying the demise of) these industries. This much is occasionally admitted even in public.* Some MITI officials sometimes suggest that the government should expand its role and explicitly subsidize industries, either in the name of national security, or in the name of short-term adjustment assistance to enable an industry to survive along a path of alleged long-term viability.** Either argument is familiar to Americans, who heard and accepted virtually the same viewpoints in debates over the proposed government bailouts of Lockheed and Chrysler, the institution of trigger prices for steel imports, and the continuing restrictions on imports of Japanese automobiles. The second argument is relatively new for MITI. In the past, Japanese efforts to protect industries from international competition were concentrated in newly developed, or so-called infant industries, e.g., most notably, in recent years, computers and electronics.*** Until recently, the phasing out of basic manufacturing industries had not been a central issue in Japan, primarily because the country's stage of development had not yet led it to have to face the question of whether or how to phase out such industries in order to make room

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*For example, in a concluding section to a statement presented to the Industry Committee of the OECD in March 1981, Makoto Kuroda, then Director-General of MITI's Research and Statistics Department, said "the smooth implementation of industrial policy is becoming increasingly difficult." See "Japanese Industrial Policy," Japan Reporting series, JR-4 (Tokyo: Ministry of International Trade and Industry, June 1981), p. 15.

**See Keiji Miyamoto, "What is Happening to Japan's Industrial Structure," Journal of Japanese Trade and Industry, Vol. 1, No. 3, May 1982, pp. 37-46. Miyamoto uses the term "economic security," but the logic of his argument makes it clear that he is speaking of national security broadly-defined, or the term referred to earlier, "national strength."

***Excluding, of course, the special political problems associated with agricultural imports into Japan. for newer, still higher technology

for newer, still higher technology industries. Since the mid-1970s, however, the difficulties MITI has already encountered in its efforts to facilitate adjustments in mature industries such as shipbuilding, petroleum refining, petrochemicals, and aluminum suggest that the implementation of future Japanese policies is likely to become increasingly difficult.*

The decline in competitiveness that took place in certain Japanese manufacturing industries in the 1970s suggests that global market pressures were the decisive factor leading to economic restructuring, not government policies aimed at shifting to higher value-added production. But because the main market pressures of the decade crystallized so suddenly, especially the large-scale energy price increases brought on by exceptional supply/demand conditions and relatively unpredictable political factors, the changes that subsequently took place in certain Japanese industries often seemed at first glance to have stemmed from government policies. To the degree that the energy price increases of the 1970s were in fact more sudden than most price changes in most markets, they can be likened to the political pressures imposed on Japan by the Nixon Administration in the early 1970s: Both kinds of shocks originated outside Japan, and both hastened the timing of many changes that would have come about eventually anyway. But the basic direction of Japan's industrial shifts has long been clear. The timing and pace at which these shifts occurred have depended all too often on the extent to which outside shocks were applied, consciously or otherwise. Nonetheless, such shocks are hardly the only or even the major determinants of Japanese

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*Specific problems in a number of declining industries are discussed in Chapter 6.

policy or private sector actions. The actual behavior of firms and consumers is determined by the overall combination of pressures on supply and demand, of which government policy is only one.

In general, the Japanese government's role in promoting industrial development has declined over the course of the postwar period. On the other hand, government intervention in the economy for other reasons, e.g., for environmental protection, promotion of social welfare goals, regional development, etc., has increased over time. Japanese industrial policies, in the narrowly defined sense in which this term was described earlier, have been most evident through the use of the tax system and the provision of direct government financial assistance. The following section focuses explicitly on the Japanese use of its tax system to promote savings and investment in general, and investment in specific sectors and industries.

The Tax System as an Instrument of Industrial Policy

The tax system has contributed significantly to Japan's post-World War II economic growth, although mainly as a means of promoting aggregate saving and investment rather than investment in any particular sector, industry, or firm. Moreover, the actual measures employed have not been unusual; many similar measures have been used to promote saving and investment in other countries. The creation of an overall environment favorable to saving and investment led as a matter of course to an environment favorable, in the initial postwar years, to basic manufacturing industries and in subsequent years to higher technology manufacturing and nowadays to services as well. The key point is the consistent use of broad-based measures to create a generally pro-investment environment for whatever

industrial development would naturally follow the achievements made to date. Specific measures directed at particular industries or groups of firms have also been important. Nonetheless, because in our view these specific measures have been less important to Japan's economic development than broad-based incentives to save and invest, the discussion focuses on these specific targeted measures in the context of the broader measures.*

Historical Evolution**

The postwar Japanese tax system was strongly influenced by allied occupation policies, in particular the stabilization policies promulgated by Joseph M. Dodge and the recommendations of a special tax mission headed by Carl S. Shoup. The latter provided the foundation for the 1950 tax reform, whose basic structure remains in effect to this day.***

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*We have found no satisfactory estimates of the general impact of the tax system on saving and investment. Macroeconomic models of the Japanese economy tend to be too aggregative to sort out the effects of specific instruments, while the more detailed studies of investment and consumer behavior are typically too specialized or are not structured in a way that is directly applicable to the question.

**Details of Japan's tax system discussed below are drawn from An Outline of Japanese Taxes, 1983 (Tokyo: Ministry of Finance, 1983), and Yuji Gomi, Guide to Japanese Taxes, 1981-82 (Tokyo: Zaikei shoho sha, 1982). Both of these volumes are revised annually to reflect changes in legislation.

***The key recommendations of the Shoup mission, as reflected in the system that emerged at the time, were as follows:

1. Direct taxes became the foundation of the new system, most importantly progressive individual income and corporate taxes.
2. Unlike in the U.S., a corporation was defined as an aggregation of shareholders, not as an independent taxable entity. Thus, the corporate tax represented an advance payment of individual income tax by shareholders; as a result, the overall tax system was specifically designed to avoid double taxation of corporate income.

A variety of tax modifications were introduced in the early 1950s that moved away from some of the principles on which the 1950 Tax Reform was based. Proponents of these modifications argued that economic conditions--specifically a desire for high growth--warranted moving away from the earlier principles of unitary taxation of income and non-distortion of investment incentives, among others.*

3. All income was to be taxed equally regardless of source--again, unlike the U.S. system of distinguishing between, say, capital gains and ordinary income.

4. Due to the high inflation rates immediately after the war, a wide difference emerged between the book value and the current value of fixed assets. In order to make the tax structure more realistic, a reassessment of assets was undertaken. A reassessment of business assets was optional, while the assets of individuals were to be reassessed at the time of transfer of such assets. Income from any up-valuation was taxed at a special low and flat rate.

5. The maximum marginal income tax rate was lowered from 85 to 55 percent, while a progressive net worth tax was introduced on persons with large property incomes.

6. The extraordinarily complex prewar special tax treatment of individual sectors, industries, and firms was reduced to "a practicable minimum." The idea here was to avoid a situation in which the tax system itself might distort investment incentives.

7. Various local political entities were granted an independent right to tax.

*In 1952, the two percent tax surcharge on corporate retained profits was abolished. In 1953, capital gains from securities transactions were excluded from taxable income, partly to promote development of a securities market, but more importantly, perhaps, because this tax proved difficult to assess and collect. Although the effect may not have been intended, this policy shift introduced a growth-oriented bias into the tax system--at least to the extent that holders of securities influence corporate decision making. The net worth tax was abolished at the same time--again, primarily because of an inability to assess and collect it equitably. In an effort to stimulate economic growth, certain special targeted tax measures, similar to those abolished in the 1950 reform, were re-introduced. Various measures were also introduced to provide for expanded depreciation allowances, a wider application of reserves for bad debts and price fluctuations, the exemption from tax of certain income from exports, and the differential taxation of income from various sources.

With rapid and continuing economic growth in the latter half of the 1950s, tax revenue gains were spectacular. Consequently, annual tax reductions became a pattern--and later an expectation. The frequency of tax rate reductions led the government to create a bureaucratic entity to review the overall tax system and recommend changes. In 1956, the Tax Commission was established as an advisory body to the Cabinet. Since then, regular tax reforms have been based primarily on reports submitted by this commission. However, since the latter half of the 1970s, when economic growth rates fell to much lower levels than in the past while a burgeoning government deficit called for at least some increase in tax rates, attempts by the Tax Commission to persuade the government to raise taxes came to naught.*

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*The first major long-term review of the tax system was completed by the Tax Commission in 1959. Among other things, the Commission recommended that: (1) the overall tax burden of the nation should be limited to approximately 20 percent of national income; (2) as had been the case since the mid-1950s, annual tax rate reductions should return some fraction of the unanticipated revenue resulting from economic growth; (3) the indirect tax rate should in principle average some 10 percent of consumer prices or 20 percent of producer prices; and (4) a General Law of National Taxes should be enacted to bring together the general and fundamental principles of taxation; this was done in 1962. In 1964, the Tax Commission presented a new long-term plan for the evolution of the tax system. It argued that income taxes should continue to allocate resources without distorting the price mechanism, redistribute income through progressive tax rates, and serve as a built-in stabilizer over the business cycle. In addition, the Commission called for the eventual abolition of the special targeted tax measures that had proliferated since the mid-1950s.

This new long-term plan was followed with one important exception: reducing the importance of special taxation measures, which the Commission was unable to implement during the 1960s. Later, as the revenue losses from these measures rose dramatically in the late 1960s and early 1970s, serious attention began to be paid once again to the elimination of these benefits.

Government budget deficits and accumulated government debt grew dramatically during the 1970s (see Figure 1). The large increase in government expenditure after the mid-1970s stemmed in part from an overdue need to build up social infrastructure and in part from the unstable economic conditions that occurred in the wake of the 1973-74 increase in oil prices. Indeed, the deficit reached 34.3 percent of national budget expenditures, or 6 percent of GNP, in fiscal 1979, before beginning to decline.* This has naturally resulted in continuing pressure to increase tax revenues, and correspondingly to reduce the scope of various special tax measures granting tax relief for certain specified purposes. Moreover, the broadly-conceived goal of rationalizing the functions of government and restraining its overall growth has been a major plank in the political programs put forth by Prime Ministers Suzuki and Nakasone.** Pent-up demand for improved infrastructure development and greater welfare spending remains strong, however. The government also faces pressure for greater defense expenditures, both for reasons of its own and from the U.S. Thus, taxes are almost certain to rise at some point, and the tax share

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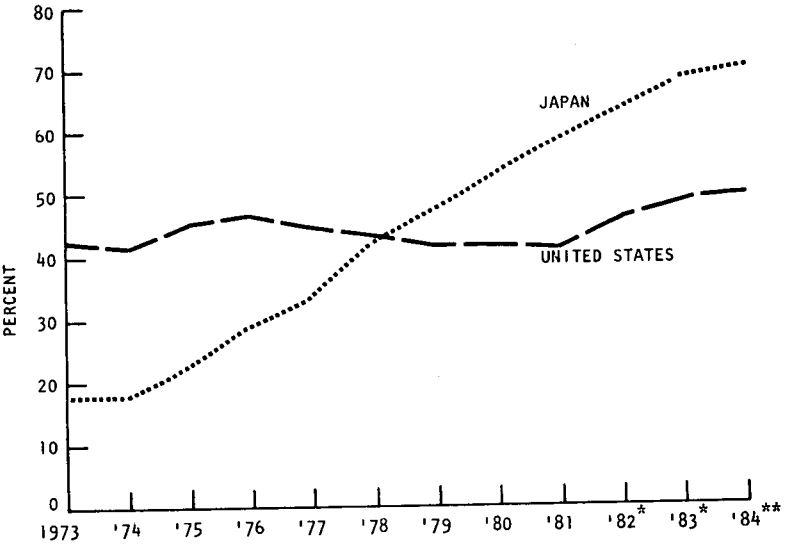
*OECD Economic Surveys, 1982-1983, Japan (Paris: Organisation for Economic Co-operation and Development, July 1983), p. 52.

**Both have made a point of saying that, under their administration, the government would not raise tax rates until it had achieved some success in rationalizing administrative expenditures. Under Prime Minister Nakasone, the government decreased income tax rates somewhat in 1983, while simultaneously increasing various excise taxes; the two moves roughly cancelled each other out, but the income tax cut was thought to be politically popular by LDP leaders. More recent discussion suggests that net tax increases will have to be made to avoid issuing more deficit-financing government bonds; the latter have become more difficult to issue in any case because of increased international equilibration of interest rates, which makes Japanese banks reluctant to purchase government bonds carrying below-market interest rates.

Figure 1

PERCENTAGE OF GOVERNMENT DEBT
TO NOMINAL GDP: 1973-1984



*ESTIMATES
**FORECAST

SOURCE: OECD, ECONOMIC OUTLOOK 34, DECEMBER 1983, P. 43.

of national income, 29.3 percent in 1981, is unlikely ever again to fall as low as the average for 1974-81 of 25.6 percent and certainly not to the average for 1961-73 of 20.5 percent.*

The Present Tax System

Japan's use of tax measures as instruments of industrial policy that we view as most significant stem mainly from various provisions in the structure of individual and corporate income taxes.** This section focuses on some of the detailed incentives for savings and investment that grow out of these provisions.***

Individual income taxes in 1983 represented nearly 41 percent of Japanese government revenues.**** The overall system is highly progressive on paper, although various exclusions, deductions, and credits significantly

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*Data from OECD Economic Outlook 34, op. cit., p. 160.

**Other taxes also create specific incentives, e.g., the use of petroleum taxes to support energy research and development, but are of minor importance, compared to the measures associated with individual and corporate income taxes, and for this reason are not discussed in detail. The principal national and local taxes and estimated 1983 revenues are shown in Appendix Table A-1.

***Individual and corporate income taxes contain many measures that provide benefits or impose costs, i.e., incentives for certain types of activities. Most, but not all, of these measures are incorporated in a Special Taxation Measures Law. Since the law itself identifies the incentives and disincentives designed to target specific industries, and targeted tax measures are almost always temporary and directed toward specific policy goals, one can frequently relate changes in policy goals to actual implementation by reviewing the periodic revisions of the law.

****Table A-2 provides historical data on the income tax share of total national tax revenue. The income tax is progressive, reaching a maximum marginal rate of 75 percent for incomes over ¥80 million ($363,636 at ¥220 = $1), not including prefectural and municipal income levies (see Table A-3). Prefectural and municipal tax schedules are shown in Table A-4.

reduce both the progressivity and the total burden. As seen in Table 1, the share of income tax in national income rose from 1960 to 1973, fell through 1977, and then rose sharply through 1981. Even at its peak in 1981, income tax accounted only for 5.6 percent of national income (7.8 percent including local taxes); the decade average, ending in 1981, was 4.8 percent (6.6 percent). Comparable figures for the U.S. have averaged more than twice those for Japan (contrast column 7 with column 5), showing that the actual individual income tax burden in Japan remains relatively low.*

Numerous exemptions, credits, and deductions have the effect of undercutting the goal of unitary income taxation, although the principle remains on the books as an ideal to aim for. A key result of these exemptions, credits, and deductions has been to provide indirect support for economic growth through a bias in the system toward saving and investment; two examples are discussed below as particularly important indicators of this biasing.

First, interest received on "small-size" savings accounts, on certain accounts in the postal savings system, and on central and local government bonds are exempt from taxation--in all cases on principal amounts up to ¥3 million ($13,636 at ¥220 = $1)--as are various other sources of interest

*The progressivity of the individual income tax system is significantly reduced by generous exclusions and/or deductions for income other than wages and salaries. Perhaps the most important of such benefits include the exclusion of the value of employer-subsidized housing from taxable income, and the special treatment of retirement payments to employees (typically lump-sum payments). With respect to the latter, only 50 percent of retirement income beyond a generous special retirement deduction is taxable. Also important are various tax-free recreational and other benefits provided by large firms (weekend resort facilities, subsidized overseas travel, etc.). For executives, such tax-free items as expense accounts, chauffered cars, subsidized loans, etc., are added to the compensation package.

Table 1

BURDEN OF INCOME TAX AND LOCAL INHABITANTS TAXES, JAPAN AND THE U.S.; 1950-81

FISCAL YEAR	JAPANESE INCOME TAX AS A PERCENT OF NATIONAL INCOME	JAPANESE INCOME TAX PLUS LOCAL INHABITANTS TAXES AS A PERCENT OF NATIONAL INCOME	U.S. PERSONAL INCOME TAX AS A PERCENT OF NATIONAL INCOME
1950	7.2 %	8.7 %	--
1955	3.9	4.9	--
1960	3.2	4.1	--
1965	3.5	4.7	8.6 %
1970	3.8	4.9	11.8
1973	5.4	6.9	10.7
1976	4.3	6.0	10.6
1979	4.9	6.9	13.0
1981	5.6	7.8	14.0

NOTES: 1. THE FIGURES ARE PERSONAL INCOME FOR FY 1950, 1955, AND 1960 AND ARE NOT CONSISTENT WITH SUCCESSIVE FIGURES.

2. THE FIGURES OF INCOME TAX FOR 1978 INCLUDE 13 MONTHS (1978/5-1979/5).

SOURCE: AN OUTLINE OF JAPANESE TAXES, 1983 (TOKYO: MINISTRY OF FINANCE, 1983), P. 278; OECD, NATIONAL ACCOUNTS OF OECD COUNTRIES, 1962-1979, VOL. II, DETAILED TABLES, TABLE 6, P. 24 AND TABLE 6, P. 36; U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE U.S. (1976), P. 1107, 241; IDEM, STATISTICAL ABSTRACT OF THE UNITED STATES, VARIOUS ISSUES; AND IDEM, BUREAU OF ECONOMIC ANALYSIS, BUSINESS CONDITIONS DIGEST, VARIOUS ISSUES.

income.* This has doubtless greatly stimulated saving by the ordinary citizen, all the more so because multiple accounts under various guises have been tolerated by officials of the postal savings system, in spite of continued but ineffectual dismay on the part of tax officials in the MOF.** In addition, interest rates and deposit regulations are manipulated in favor of the postal savings system, thereby diverting much of the small savings that might otherwise go to banks into the postal savings system, i.e., directly into government hands, for investment in favored industries or, in recent years, to favored infrastructure projects.*** Secondly, capital gains accrued from the sale of shares or other kinds of securities are also excluded from individual taxation. One of the principal effects of this exclusion is to make capital gains

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*The degree to which Japan's high propensity to save is based on an alleged culturally-derived frugality, as against specific incentives to save, is a question that is frequently, if inconclusively, discussed among specialists. Many observers have noticed, for example, that Japan's savings rate before World War II was roughly the same as the prewar U.S. rate. This suggests that Japan's extremely high postwar savings rate stems from other, more proximate causes than a culturally-derived proclivity for high savings, e.g., an obvious and immediate economic need to rebuild capital lost during the war, and specific policies such as the above-mentioned tax exemption on "small size" savings accounts designed to support this objective.

**One indication of the degree of tax evasion permitted through the postal savings system is the number of deposits--over twice Japan's total population! In the early 1980s, MOF officials tried to introduce a system, called a "Green Card," that would record all small-saver transactions on a single, computerized record, and in this way cut down on tax evasion. The idea died when politicians of all parties, and many people in the general public realized that such a system might greatly hamper their ability to conceal funds from tax authorities.

***In effect, the government compensates for its revenue losses through the tax exemption on small savings by getting the use of these funds through manipulation of interest rates in favor of the postal savings system.

more attractive to stockholders than dividends, which are taxed (either at the corporate or individual level).

Certain tax credits available to individuals also contribute to Japanese industrial policies. For example, a credit for dividend income, though it does not completely eliminate the tax burden as in the case of excluding capital gains income, does reduce the degree of taxation of income from corporate sources.* Moreover, special savings deposits for housing purchases receive a tax credit; this credit carries a variety of conditions, but represents a substantial savings incentive.** Individuals are also permitted a tax credit for experimental and research expenditures similar to those allowed corporations; this provision benefits primarily unincorporated family businesses.***

The corporate tax also operates in ways that indirectly promote industrial development.**** The system is progressive, and the maximum rate is comparable to those in other advanced industrial countries. In some respects, however, this comparison is misleading, since many of the tax benefits discussed below apply to the computation of net taxable

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*For individuals in tax brackets below ¥10 million ($45,454 at ¥220 = $1), a tax credit equaling 10 percent of dividend income is permitted; for individuals in tax brackets above ¥10 million, the credit is 5 percent. Under Japanese tax principles, this measure is justified as a means of preventing double taxation of corporate income.

**Although the tax break to housing is reputed to be less than that given by the deductibility of interest payments in the U.S., the important difference is in the effects on the system itself: in the U.S. the incentive is to borrow; in Japan the incentive is to save.

***Until 1984, 20 percent of experimental and research expenditures above the largest previous amount of such expenditures (since 1966) could be credited against taxes, not to exceed 10 percent of the income tax on business income (of the individual) before the credit.

****Effective corporate tax rates are shown in Table A-5.

income. A different perspective is provided by comparing taxes to total sales (see Table 2). The corporate tax burden on sales is progressive, with an average of 1.1 percent. Roughly comparable data for the U.S. (a 2.1 percent average, as shown in Table 3) suggest a heavier level of taxation for U.S. firms; this difference would be even more pronounced if income of U.S. firms other than sales receipts (such as dividend income and interest receipts) were excluded to bring the U.S. data more in line with Japanese data.* The data used here do not permit more detailed comparison, since the Japanese definition of capital and the U.S. definition of assets are not analogous.

As noted previously, the Japanese system is structured to minimize double taxation of corporate income. Moreover, as also noted above, most capital gains income received by individuals is untaxed, while dividend income received by individuals is taxed. As far as individual owners of stock are concerned, these features bias the system in favor of higher growth through reinvested earnings, and thus toward capital gains rather than dividend payments. In addition, corporate income paid out as dividends faces considerably lower corporate tax rates than retained earnings--for large companies 32 percent as against 42 percent. This feature encourages considerable cross-ownership, since, with some limiting conditions, dividends received from other corporations are also excluded from corporate taxable

*U.S. corporate income is taxed again when realized as capital gains or distributed as dividends to shareholders. Note however that the Economic Recovery Act of 1981 substantially altered the U.S. tax burden on corporations. Data for a year at a comparable phase of the business cycle under this new legislation are not yet available.

Table 2

CORPORATE TAX REVENUE, SALES, AND TAX REVENUE SHARE OF SALES, BY AMOUNT OF CAPITAL: 1981

CAPITAL (¥ MILLION)		CORPORATIONS		TOTAL SALES (¥ 100 MILLION)	TAX AMOUNT (¥ 100 MILLION)	TAX AS A PERCENT OF SALES
		NUMBER	AS PERCENT OF TOTAL			
MORE THAN	NOT MORE THAN					
	1	204,237	13.6	213,299	1,868	0.9%
1	5	774,599	51.7	771,001	4,799	0.6
5	10	251,525	16.8	525,759	4,395	0.8
10	50	232,091	15.5	1,625,769	15,796	1.0
50	100	19,366	1.3	503,031	5,241	1.0
100	1,000	14,713	1.0	1,276,858	14,947	1.2
1,000	5,000	1,719	0.1	756,800	10,429	1.4
5,000	10,000	322	0.0	443,794	5,944	1.3
10,000	--	316	0.0	2,087,831	27,404	1.3
TOTAL		1,498,888	100.0	8,204,142	90,824	1.1

SOURCE: THE 107TH ANNUAL STATISTICS REPORT OF THE NATIONAL TAX ADMINISTRATION FOR 1981, AS REPORTED IN AN OUTLINE OF JAPANESE TAXES, 1983 (TOKYO: MINISTRY OF FINANCE,1983), P. 292.

Table 3

U.S. CORPORATION INCOME TAX RETURNS--SELECTED ITEMS, BY ASSET-SIZE CLASS: 1979

ASSET-SIZE CLASS ($1,000,000) AT LEAST	LESS THAN	NUMBER OF RETURNS[1] (1,000)	TOTAL RECEIPTS ($ BILLION)	TAX[2] ($ BILLION)	TAX AS A PERCENT OF THE RECEIPTS
--	10[3]	2,524	1,890.1	18.1	1.0%
10	25	15	264.1	4.7	1.8
25	50	7	191.0	3.8	2.0
50	100	4	211.2	4.0	1.9
100	250	3	299.0	6.3	2.1
250		3	2,743.2	83.1	3.0
TOTAL		2,557	5,598.7	120.0	2.1

[1] ACTIVE CORPORATIONS.

[2] BEFORE DEDUCTIONS FOR FOREIGN TAX, U.S. POSSESSIONS TAX INVESTMENT, WORK INCENTIVE (WIN) AND NEW JOBS CREDITS. INCLUDES ADDITIONAL TAX FOR TAX PREFERENCES, TAXES FROM RECOMPUTING PRIOR YEAR INVESTMENT, AND WORK INCENTIVE (WIN) CREDITS.

[3] INCLUDES CORPORATIONS WITH ZERO ASSETS.

SOURCE: U.S. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS, 1979; AS REPORTED IN U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1982-83 (103RD EDITION), WASHINGTON, D.C., 1982, P. 276.

income. Lower tax rates also apply to smaller corporations, cooperatives, and corporations in the "public interest."*

Certain measures within the corporate tax system are used to target specific industrial policy objectives. The most widely used of these measures fall into three categories: added depreciation, tax-free reserve funds, and tax credits.

General depreciation rules are similar to those in other advanced industrial countries, but may have been applied in Japan more flexibly and with specific policy objectives in mind.** However, the Special Taxation Measures Law permits a variety of special types of depreciation.

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*Types of organizations that fit the latter two categories are too numerous to list. However, most of the special industry corporations and associations set up to undertake joint research and development, to coordinate disinvestment in declining industries, etc., are included.

**The main depreciation rules are as follows:

1. Both tangible fixed assets and intangible fixed assets (such as copyrights, patents, rights of business, deferred assets, etc.) are depreciable on the basis of acquisition cost and salvage value.
2. Minor assets, i.e., those with a useful life of less than one year or acquisition costs of less than ¥100,000 ($455 at ¥220 = $1), can be written off in the year purchased.
3. A firm may elect to use either a straight line or a declining balances method. Other depreciation methods may be used with special approval.
4. A corporation may apply, for each item or group of properties, whichever method of depreciation it prefers for that item or group.
5. Statutory useful lives for assets are determined by the government; a list is provided in Table A-6. Under certain conditions, a corporation may apply to alter the statutory life of an asset if, for example, the asset cannot live out its statutory life, or if it acquires a used asset.

The economic rationale for offering special depreciation measures is to stimulate the private sector to purchase particular types of assets. These measures are available to firms submitting a "blue return."* Special depreciation measures come in two broad types: increased initial depreciation and accelerated depreciation. In the former case, this simply means that, in addition to the ordinary depreciation schedule, the firm can deduct a specified portion of the acquisition cost of an asset during the first accounting period in which the asset was acquired. In the second case, firms may deduct part of the acquisition cost of the asset over and above the ordinary depreciation schedule for a designated number of consecutive accounting periods. In neither case can cumulative depreciation exceed acquisition cost. If an asset is eligible for more than one special depreciation measure, the firm can pick the most favorable choice, but such measures cannot be used in combination. The variety of policy goals embedded in these measures is considerable.** More striking, perhaps, is the relatively narrow and specific nature of the incentives provided. Indeed, many of the measures are for "designated plant and equipment." This permits detailed, discretionary government intervention for one or another policy goal. The pattern of special depreciation measures is

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*Filing a "blue return" requires that a corporation or an individual follow certain designated accounting principles and provide more information to the government than on "white returns." In exchange, certain tax benefits are provided. In practice, most special tax benefits are available only to those firms, foreign or domestic, that file a "blue return."

**Recent legislation on special depreciation measures is summarized in Table A-7.

biased towards manufacturing in general, especially by stimulating markets for types of goods that the government would like produced domestically.

Tax-free reserve funds can be created to provide tax deferral; they are initially deductible from income as expenses, but must be added back into income at a later date. For example, corporations can establish a reserve for bad debts, based on expected losses in the collections of receivables. With the bad debt reserve, the amount credited in each period must be added back, less actual losses, to income in the succeeding accounting period; the measure amounts, in effect, to a one-year tax postponement. Perhaps the main benefit of tax-free reserves is the provision of cash before the expense or loss is actually incurred. For highly leveraged Japanese corporations, use of this up-front cash is particularly valuable.*

Many types of tax-free reserve funds are permitted. One of particular interest is a reserve against losses resulting from fluctuations in the market price of inventories of items designated as especially vulnerable, such as iron ore, raw cotton, and stocks listed on the Stock Exchange. Although no empirical research has been found that estimates the impact of this incentive (or that provides good estimates of any tax

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*Japanese tax law classifies tax-free reserves in two groups: hikiatekin and junbikin. The former are roughly those justified by general accounting principles, e.g., the bad debt reserve. The latter are those introduced to achieve certain economic policy goals, even though they may not be fully justified by generally accepted accounting principles. Obviously, junbikin is the more important category for identifying specific industrial policy incentives. However, if the reserve is defined in such a way that the contingency costs for which it was designed never equals the size of the reserve (which appears to have been the case for the bad debt reserve, for example), then the distinction between hikiatekin and junkikin becomes considerably less useful.

incentive effects), one can well imagine that it should increase domestic price flexibility, both in the aggregate and relative senses--particularly in an era of volatile exchange rates. This reserve is scheduled to be abolished after FY 1985. The current schedule drops the maximum tax-free reserve deduction from 2.5 percent of the book value of inventories and shares in FY 1983 to 1.5 percent in 1984 and 0.5 percent in 1985. Small companies may establish an overseas market development reserve. Specific conditions for this measure depend on type of activity and registered capital.* This specific reserve spreads the tax postponement over five years; one-fifth of the amount credited to the reserve fund in an accounting period must be added back as income in each of the five succeeding years. This clearly promotes exports by smaller companies, but the estimated tax losses from this provision have declined sharply since 1976--¥12 billion in 1976 to ¥4 billion in 1981.**

In addition, a specific reserve has been created to stimulate overseas investment for any size firm. An overseas investment loss reserve is permitted for acquisitions of stocks issued by, or the extension of credit to, designated types of companies under specified conditions. This reserve fund compensates for possible losses caused by a decline in stock price, among other things. It is calculated on the basis of acquisition cost, and can be held in full for five years. From the sixth year, one-fifth must be added back to income for five succeeding

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*The greatest incentives are for those firms capitalized under ¥100 million ($454,000 at ¥220 = $1), although some benefits accrue to firms capitalized as high as ¥1 billion ($4.5 million at ¥220 = $1).

**Data drawn from Table A-8.

years. Although details and reserve amounts vary, the specific incentives favor investment in developing countries, foreign-sited nuclear fuel recycling facilities, and natural resources. In fact, certain natural resource investments can establish a reserve fund with a maximum of 100 percent of acquisition cost.*

Two reserves that are particularly important for frontier industries are: (1) a reserve for losses caused by the repurchase of computers, and (2) a reserve fund for the guarantee of domestically produced software programs. The reserve for repurchasing losses was created to permit computer and computer sales corporations (particularly the Japan Electronic Computer Corporation) to deduct a certain fraction of revenue growth as an expense. Since most computer sales are based on lease arrangements, a company forced to repurchase a computer ahead of schedule can realize a loss. With the reserve provisions, however, such a loss can be debited against the reserve fund and thereby have its effects mitigated. The remaining reserve is added back to income after five years. This reserve was originally designed as part of a package of measures to make Japan-based computer companies competitive with U.S.-based companies--principally IBM. The reserve for software development allows companies to offset costs associated with debugging programs in the course of the industry's

*Besides those mentioned already, other reserves with significant industrial policy impact include: a reserve fund for investment losses in the free trade zone in Okinawa; a structural improvement project reserve for small and medium-sized enterprises; a reserve for the prevention of mineral pollution in metal mining; a depreciation reserve for specified railway construction; a depreciation reserve for the construction of atomic power plants; a depreciation reserve for the construction of specific gas distribution facilities; and a series of reserves targeted on specific types of business which meet special conditions.

development. This measure--in effect, an infant industry aid--addresses the perceived weakness of the Japanese software industry vis-a-vis foreign-based firms.*

Besides targeted depreciation allowances and tax-free reserves, still other special tax measures address specific industrial policy goals. For example, a corporation deriving income wholly or partly from overseas sales of technical services is permitted a special deduction from taxable income. This incentive is designed to stimulate export of (1) patents and others know-how developed out of domestic research, and (2) such technical services as planning, consulting, and supervision related to the construction or production of plant and equipment or to specified technical services for agriculture or fishery.** Firms prospecting for mineral deposits overseas are also permitted special deductions, reserves, and exemptions. An investment tax credit was introduced, initially as a temporary measure, to encourage investment in specific industrial facilities such as those to conserve energy or reduce pollution levels. This credit was later extended in 1979 to aid only those corporations engaged in industries specified by law and cabinet order as permanently depressed industries or certain specially defined small- and medium-sized corporations.

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*Despite this infant industry bias, foreign-based firms in Japan are not excluded from using this same tax advantage.

**These service exports must bring in foreign currency or its equivalent, and in the case of technical services, only contracts worth ¥2 million ($9,090 at ¥220 = $1) or more are eligible. The export incentive from this deduction is relatively large--a firm may deduct as an expense 28 percent of revenue in case one, and 16 percent in case two--although the absolute size of this deduction cannot exceed 40 percent of corporate income.

Tax-free reserves and other special tax measures are less obviously biased towards the manufacturing sector than the depreciation measures discussed earlier. No single sector obviously dominates as a beneficiary of these measures. Small businesses and firms investing overseas (or otherwise exposed to certain foreign risks) receive special attention. Two explicit export subsidies remain on the books: the provision dealing with overseas sales of technical services and the overseas market development reserve for small companies. The first of these measures, with several others, reflects the broad policy goals of "knowledge intensification," and illustrates a shift in emphasis from manufacturing per se to higher technology activities--whether in manufacturing or services.

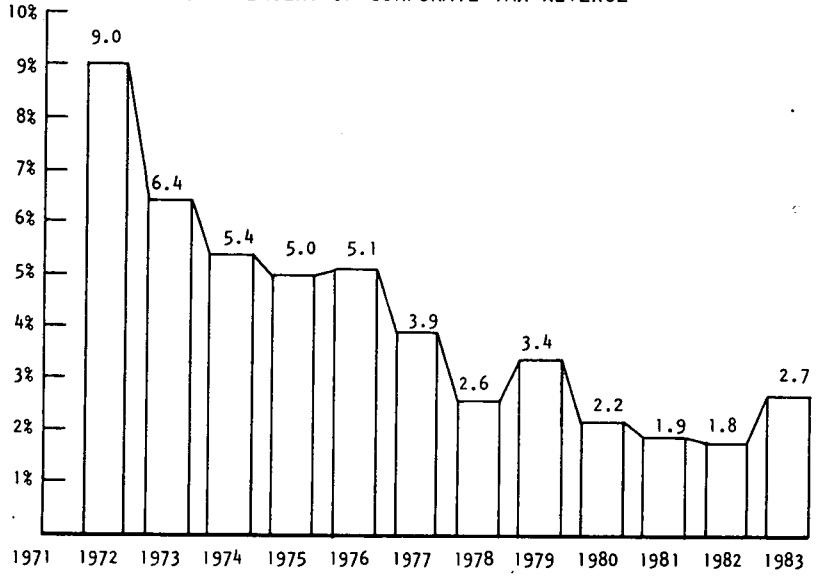
In general, because the Japanese corporate sector is highly leveraged (i.e., debt-equity ratios, though declining, are still much higher than in other advanced industrial countries), any increase in cash-flow is particularly valuable, all the more so during periods of recession or slower growth. For this reason, accelerated depreciation, tax-free reserves, and similar general tax measures built into the Japanese corporate tax system provide strong direct benefits to any Japanese company, quite apart from whatever benefits might be derived from special targeting on specific industries or activities.

Recent Tax Trends

For reasons noted above, the specific benefits and incentives incorporated into the Special Tax Measures Law began to be curtailed in the late 1960s. As seen in Figure 3-1, government revenue losses (i.e., tax expenditures, in the language of U.S. tax jargon) from the Special Tax Measures Law have declined dramatically since the early 1970s. The fall-off in

Figure 2

REVENUE LOSSES DUE TO SPECIAL TAX MEASURES FOR CORPORATIONS
AS A PERCENT OF CORPORATE TAX REVENUE



SOURCE: TAX BUREAU, MINISTRY OF FINANCE, AND BRADLEY M. RICHARDSON, SUBMISSION TO THE INTERNATIONAL TRADE COMMISSION IN INVESTIGATION NO. 332-162, JUNE 1983, P. A-10. AS REPORTED IN FOREIGN INDUSTRIAL TARGETING AND ITS EFFECTS ON U.S. INDUSTRIES PHASE 1: JAPAN. REPORT TO THE SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES ON INVESTIGATION NO. 332-162, P.77. (WASHINGTON D.C.: U.S. I.T.C. OCTOBER 1983).

benefits to companies has been particularly notable. Losses from special tax measures benefiting corporations declined from 9 percent of corporate tax revenues in 1972 to an estimated 2.7 percent in 1983.* When their impact was larger than it has become now, these measures unquestionably represented an important instrument through which MITI could influence individual industries or firms. Correspondingly, the now-lessened impact of these measures represents the loss of a key instrument of MITI influence.

The rough magnitude of the revenue losses of special tax measures for enterprises in various policy areas since 1960 is shown in Table 4. These data are incomplete, since certain incentives built into the general tax laws are not included in the compilation. However, virtually all the tax instruments that discriminate among specific activities, industries, and firms are included. Although one can quibble about the way that various items are aggregated, the data provide extremely interesting patterns. In 1960, two items dominated: those designed to strengthen the financial position of firms and those designed to promote exports. The former declined steadily in importance. The latter grew in importance until 1970, but sometime after that disappeared altogether. In part, these declines reflect an increase, in relative terms, in the importance of more selective tax measures directed at natural resource and energy development, the promotion of science and technology, and the selective targeting of small businesses and agriculture.**

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*Obviously revenue losses are only estimates. The data shown here were provided by MOF officials, but we were not provided, nor could we discover, the methodology or the assumptions used. Thus, we have no basis for evaluating the quality of these estimates.

**Since 1975, those categories with a growing share mostly have experienced smaller absolute cuts. The main exception is the promotion of science and technology.

Table 4

SPECIAL TAXATION MEASURES FOR ENTERPRISES: ESTIMATED REVENUE LOSSES
(100 MILLION YEN, %)

DESCRIPTION	1960		1965		1970		1975		1981	
	REVENUE LOSSES	SHARE	REVENUE LOSSES	SHARE	REVENUE LOSSES	SHARE	REVENUE LOSSES	SHARE	REVENUE LOSSES	SHARE
1. SMALL BUSINESS AND AGRICULTURE, ETC.	¥ 4	0.9%	¥ 104	15.8%	¥ 296	16.4%	¥ 800	26.3%	¥ 570	28.7%
2. ENVIRONMENT	15	3.2	69	10.5	195	10.8	980	32.2	380	19.1
3. REGIONAL DEVELOPMENT	0	0.0	6	0.9	22	1.2	120	4.0	110	5.5
4. NATURAL RESOURCES AND ENERGY	10	2.1	49	7.4	124	6.8	290	9.5	260	13.1
5. PROMOTION OF SCIENCE AND TECHNOLOGY	15	3.2	44	6.7	145	8.0	380	12.5	470	23.6
6. STRENGTHENING OF THE FINANCIAL POSITION OF FIRMS	312	66.2	141	21.4	221	12.2	450	14.8	170	8.5
7. PROMOTION OF EXPORTATION	115	24.4	246	37.3	759	42.0	0	0.0	0	0.0
8. INCOME MEASUREMENT, ETC.	0	0.0	0	0.0	47	2.6	20	0.7	30	1.5
TOTAL	471	100.0	659	100.0	1,809	100.0	3,040	100.0	1,990	100.0

SOURCE: TAX BUREAU, MINISTRY OF FINANCE.

Indeed, in 1981, the single most important subsidies provided to enterprises through the tax system were directed toward small businesses and agriculture, promotion of science and technology, protection of the environment, and natural resources and energy development. It is important to note, however, that funds for items 2 to 5 were going mostly to large firms, much the same group as received funds earlier for strengthening the financial position of firms and for the promotion of exports. Even though the same group of firms received the benefit, the incentive effects of these new goals remain important. Changes in tax losses from special tax measures broadly reflect changes in policy targets expressed in various economic plans and policies, as they evolved over the years and as described earlier in the chapter.*

This review of the tax system identifies several important general points about Japan's use of tax measures as instruments of industrial policy. First, the Japanese system is based on conventional taxation

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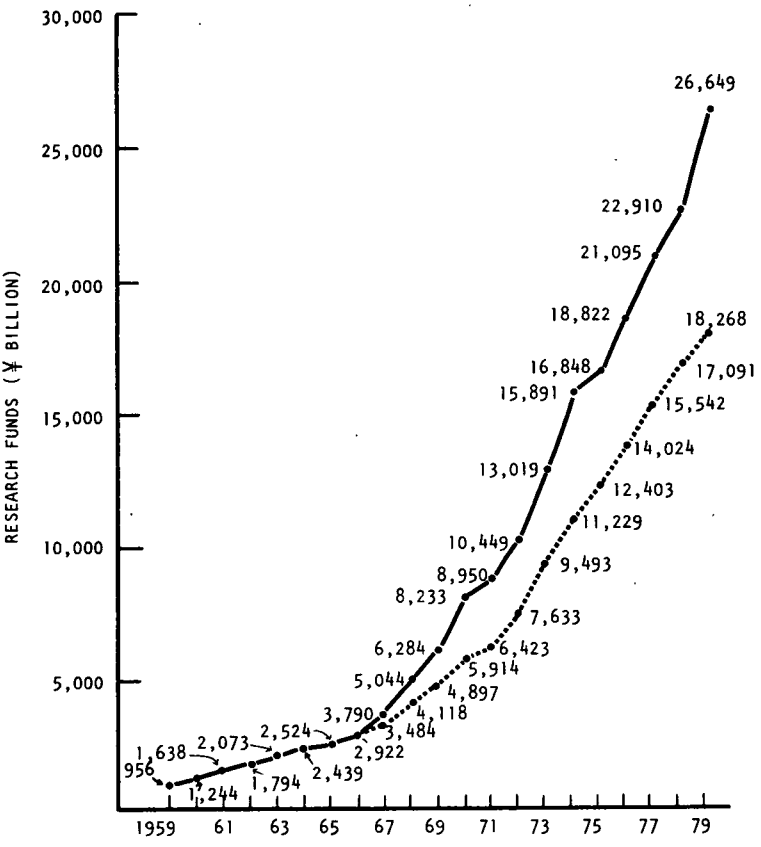
*Table A-8 provides greater detail on revenue losses attributable to special taxation measures. Unfortunately, the categories in Tables 3-4 and A-8 do not correspond completely. Still, the detail in Table A-8 is useful for identifying the impact of individual tax instruments that are directly relevant to industrial policy. For example, under Item 3, Resource Development, Measure No. 10, the Overseas Investment Loss Reserve, shows an estimated zero loss since 1979. This is surprising, since, as noted earlier in the chapter, this measure would appear to be relatively important, given the wording of the tax law, Japan's level of economic development, its suitability as a capital exporter, and the government's expressed interest in promoting resource development overseas. Either firms are simply not taking advantage of a lucrative benefit, or there are constraints on its use that are not stated. The next measure on the list, No. 11, for Atomic Power Plant Construction, has grown rapidly in importance in recent years. Another important measure is under Item 4, No. 13, for Experimental and Research Expenditures. This is estimated to have cost the government some ¥27 billion ($123 million at ¥220 = $1) in lost revenue in 1981. Measures No. 16 and 17, the special depreciation allowances for the promotion of high-technology plant and equipment and for machinery acquisition by small enterprises, led to a revenue loss of ¥73 billion ($332 million at ¥220 = $1) in 1981.

principles, i.e., it is generally comparable to systems in other advanced industrial countries; indeed, the system remains one that is largely based on the concepts introduced by allied occupation authorities. Secondly, within this conventional framework, there is a specific bias in favor of saving and investment. This is achieved by avoiding double taxation of corporate income (perhaps to the point of over-compensating), by excluding from taxable income much, if not most, interest income for small savers, by favoring capital gains over dividend income, and by keeping the average tax burden low (compared with other advanced industrial countries). Thirdly, within this bias in favor of saving and investment, there has been an additional bias in favor of the manufacturing sector, achieved by limiting of many special tax benefits to designated plant and equipment. Now, however, with the value of these special tax benefits having been greatly curtailed since the early 1970s, these biases toward manufacturing will be much less important in the future.

One cannot, of course, extrapolate simply from a calculation of tax losses to the degree to which firms have been assisted as a matter of policy. One cannot even assume that the categories used by the MOF to present this data truly reflect their components, and thus the policy incentives. Recognizing the limitations of the data, one can nonetheless make "ballpark" estimates of the policy effects of various individual measures remain useful. For example, the Science and Technology Agency (STA) devised an extremely rough estimate of the impact of tax credits on total private expenditures on testing, research, and development through the late 1970s (see Figure 2). Based in the relationship between national income and research expenditures before introduction of the tax

Figure 3

R&D EXPENDITURE WITH SPECIAL TAX CREDITS
COMPARED TO ESTIMATED R&D EXPENDITURE
WITHOUT SPECIAL TAX CREDITS



SOURCE: PLANNING BUREAU, SCIENCE AND TECHNOLOGY AGENCY, OCTOBER 1981.

incentive, STA calculated an average elasticity figure (the percentage change in research expenditures resulting from a one percent change in national income). This figure was used to estimate research and development spending as if there were no tax credit for the rest of the period, after its introduction in 1967. As can be seen, the gap opens up immediately and grows continually. Crude as this procedure is, it nevertheless reveals an interest in the effectiveness of policy. STA is claiming here that the tax credit increased the average elasticity of R&D expenditures to national income by some 0.25 percentage points (from 1.06 to 1.31).

In general, Japan's promotion of saving and investment as a whole seems to us more important to economic growth and industrial development than the various special tax measures designed to aid specific industries. This seems particularly true since the early 1970s, when, as noted above, the total benefits provided by special tax measures began to decline precipitously. Among the most narrowly targeted of the tax measures have been the special depreciation measures for specified plant and equipment and similar measures for machinery for small enterprises. For example, in 1981 the estimated tax losses from the former were ¥16 billion, from the latter ¥57 billion, for a total of ¥73 billion. This was less than 17 percent of the revenue losses attributable to special taxation measures.* These depreciation measures unquestionably bias investment towards the acquisition of targeted types of equipment by lowering their effective price. Nonetheless, the total benefits provided

*This calculation is based on the incomplete list of special taxation measures shown in Table A-8.

by such narrowly targeted measures are small, compared with other, less narrowly targeted special tax measures. Total revenue losses from special taxation measures in 1981 were only 3.3 percent of general account revenue, down from 6.6 percent in 1972.* Moreover, total estimated tax losses from special taxation measures are much less than comparably estimated tax losses from the promotion of saving and investment through general measures, e.g., the exclusion from taxation of interest income on postal savings and of capital gains income on securities transactions. Official estimates of tax losses from general measures are unavailable-- indeed, the MOF is prevented for political reasons from officially estimating (or at least releasing) tax losses from the postal savings exclusion. A simple "ballpark" estimate of the latter, assuming postal savings of ¥80 trillion, and a 5.0 percent interest rate, yields an annual interest income of ¥4.0 trillion.** Assuming that income taxes are paid on virtually none of these deposits and a marginal tax rate of 30 percent, this would yield a tax loss of ¥1.2 trillion. By itself, this one general tax measure yields a tax loss larger than the total estimated tax losses from all special tax measures in 1981. By implication, the tax losses from all general tax measures would be much larger, perhaps by an order of magnitude, than those stemming from special targeted tax measures.

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*Based on unpublished data provided to the authors by the Tax Bureau, Ministry of Finance.

**In June 1983, postal savings deposits totaled ¥80.32 trillion (the two main types of deposits totaled ¥6.83 trillion in ordinary deposits, and ¥71.65 trillion in savings certificates). The interest rate on ordinary savings effective at that time was 3.12 percent; the rates on savings certificates ranged from 4.25 percent for under one year to 6.0 percent for 3 years or more. See Bank of Japan, Economic Statistics Monthly, No. 439, October 1983, Tables 46 and 60.

Two characteristics of targeted tax policy in Japan do remain important, however: (1) its general use as a carrot rather than a stick, e.g., the use of special targeted tax measures to provide an improvement to cash flow or profits as a means, in turn, of inducing some positive action, rather than as a penalty against actions already taken, and (2) in this same spirit, the granting of benefits to both producers and consumers of the particular sectors or goods chosen for promotion. Important "market making" tax benefits are on the books for both frontier and declining industries. An example of market-making use of tax policy was the granting of special depreciation measures to purchasers of so-called combined machinery, that which combined electronics with mechanical processes--smart machines broadly defined. As far as as can be inferred from available information, there is no restriction on this tax benefit to only domestically produced goods; they almost certainly benefit substantially from the resulting incentives to expand the size of the market.*

During the 1950s and 1960s, special tax measures were extremely detailed, but as noted above, these have declined substantially since the early 1970s, both in terms of their absolute number and the degree of benefit allowed. Yet, as in the past, current targeted tax measures can be so narrowly focused as to benefit specific firms (e.g., the special loss reserve for repurchase of computers) or specific types of activities (e.g., overseas prospecting for raw materials). In the earlier postwar

*Of course the broader aim of this policy was to create an incentive for all men of machinery to invest in what is clearly the leading edge of productivity-enhancing equipment. Expansion of the market for domestic smart machine producers appears to have been an important but still secondary concern.

years, targeted tax instruments usually had the goal of stimulating economic growth and comparative advantage--meaning, at that time, basic manufacturing industries. As new social welfare goals became increasingly important during the 1970s, these, too, were promoted by special tax measures, and the overall value of measures directed at these new goals came to exceed the value of measures directed at basic manufacturing goals.

Partly as a matter of principle, but mostly because of the large government budget deficits of recent years, the MOF continues to fight for even further reductions in special targeted tax measures. As a result, one can expect to see a further decline in their importance. There will be exceptions for declining industries, small businesses, and frontier industries, but the quantitative benefits, as measured by tax losses, will remain small. Indeed, as noted above, measures to promote science and technology are the only broad category in the published statistics for which estimated tax losses continued to expand in absolute terms. While special tax measures proved useful in the past, and if perceived as necessary to achieve a particularly important goal, new ones might again be introduced in the future, in general their importance is declining.

Table A-1

TAX REVENUE ESTIMATES BY ITEM: 1983
(¥ 100 Million & Percent)

NATIONAL TAXES			LOCAL TAXES		
TAX ITEM	AMOUNT	%	TAX ITEM	AMOUNT	%
I. GENERAL ACCOUNT			I. ORDINARY TAXES		
Direct Taxes			Prefectural Taxes		
Income Tax	138,050	40.5	Prefectural Inhabitants Tax	24,227	12.5
Corporation Tax	94,970	27.8	Enterprise Tax	30,734	19.2
Inheritance Tax & Gift Tax	7,930	2.3	Real Property Acquisition Tax	3,617	1.7
			Prefectural Tobacco Consumption Tax	2,836	1.5
Indirect Taxes, etc.			Local Entertainment Tax	999	0.5
Liquor Tax	18,600	5.5	Tax on Consumption at Hotels and Restaurants	4,618	2.4
Sugar Excise Tax	410	0.1	Automobile Tax	8,635	4.5
Gasoline Tax	16,530	4.8	Mine-lot Tax	10	0.0
Liquified Petroleum Gas Tax	150	0.0	Hunters License Tax	32	0.0
Aviation Fuel Tax	520	0.2	Prefectural Property Tax	87	0.0
Petroleum Tax	4,290	1.3			
Commodity Tax	13,140	3.9	Municipal Taxes		
Playing-cards Tax	10	0.0	Municipal Inhabitants Tax	52,430	27.5
Bourse Tax	150	0.0	Municipal Property Tax**	36,215	19.0
Securities Transaction Tax	2,570	0.8	Light Vehicle Tax	499	0.3
Travel Tax	750	0.2	Municipal Tobacco Consumption Tax	4,983	2.6
Admission Tax	80	0.0	Electricity & Gas Taxes	4,541	2.4
Motor Vehicle Tonnage Tax	4,690	1.4	Mineral Product Tax	43	0.0
Customs Duty	7,200	2.1	Timber Delivery Tax	25	0.0
Tonnage Due	80	0.0	Special Landholding Tax	546	0.3
Stamp Revenue	13,030	3.8			
Monopoly Profits	9,878	2.9	II. EARMARKED TAXES		
II. SPECIAL ACCOUNTS					
Local Road Tax*	2,973	0.9	To, Do, Fu & Prefectures***	7,696	4.0
Liquefied Petroleum Gas Tax*	150	0.0	Cities, Towns & Villages****	7,916	4.2
Aviation Fuel Tax*	95	0.0			
Motor Vehicle Tonnage Tax*	1,563	0.5			
Special Tonnage Duty*	100	0.0			
Customs Duty on Oil	1,360	0.4			
Promotion of Resources Development Tax	1,757	0.5			
TOTAL	341,026	100.0	TOTAL	190,689	100.0

*Distributed to the local governments.

**Municipal property tax includes Charges on National Assets & Public Corporation's Assets.

***Automobile acquisition tax, Light-oil Delivery Tax, etc., are included.

****Bathing Tax, Business Office Tax, City Planning, etc., are included.

SOURCE: An Outline of Japanese Taxes, 1983 (Tokyo: Ministry of Finance, 1983), pp. 15-16.

Table A-2

SHARES OF CORPORATION TAX AND INCOME TAX IN TOTAL NATIONAL TAX REVENUE; 1950-1981

(¥ 100 million and percent)

ITEM / YEAR	TOTAL NATIONAL TAX REVENUE	CORPORATION TAX		INCOME TAX	
		AMOUNT	%	AMOUNT	%
1950	5,708	838	14.7	2,201	38.6
1955	9,369	1,921	20.5	2,787	29.7
1960	18,015	5,734	31.8	3,906	21.7
1965	32,797	9,271	28.3	9,704	29.6
1970	77,754	25,672	33.0	24,282	31.2
1975	145,068	41,279	28.5	54,823	37.8
1980	283,731	89,227	31.4	107,996	38.1
1981	304,622	88,225	29.0	119,804	39.3
Revised Budget 1982	320,056	90,560	28.3	127,690	39.9
Budget 1983	341,026	94,970	27.8	138,050	40.5

SOURCE: AN OUTLINE OF JAPANESE TAXES, 1983, (TOKYO: MINISTRY OF FINANCE, 1983), P. 291.

Table A-3

RATES OF INDIVIDUAL INCOME TAX

TAXABLE INCOME (YEN) (A)		MARGINAL TAX RATE (B)	CUMULATIVE TAX FOR EACH BRACKET (YEN) (C)	AVERAGE TAX RATE (AT BRACKET MAXIMUM)
OVER	BUT NOT OVER			
–	600,000	10%	-	10.0%
600,000	1,200,000	12	60,000	11.0
1,200,000	1,800,000	14	132,000	12.0
1,800,000	2,400,000	16	216,000	13.0
2,400,000	3,000,000	18	312,000	14.0
3,000,000	4,000,000	21	420,000	15.8
4,000,000	5,000,000	24	630,000	17.4
5,000,000	6,000,000	27	870,000	19.0
6,000,000	7,000,000	30	1,140,000	20.6
7,000,000	8,000,000	34	1,440,000	22.3
8,000,000	10,000,000	38	1,780,000	25.5
10,000,000	12,000,000	42	2,540,000	28.2
12,000,000	15,000,000	46	3,380,000	31.7
15,000,000	20,000,000	50	4,760,000	36.3
20,000,000	30,000,000	55	7,260,000	42.5
30,000,000	40,000,000	60	12,760,000	46.9
40,000,000	60,000,000	65	18,760,000	52.9
60,000,000	80,000,000	70	31,760,000	57.2
80,000,000		75	45,760,000	--

NOTE: TAX LIABILITY IS OBTAINED BY MULTIPLYING THE TAXABLE INCOME IN EXCESS OF THE AMOUNT (A) BY THE RATE (B) AND ADDING THE AMOUNT (C). FOR EXAMPLE, INCOME TAX DUE ON TAXABLE INCOME OF 25 MILLION YEN IS: (¥25,000,000--¥20,000,000(A)) X 0.55 (B) + ¥7,260,000 (C) = ¥10,010,000.

SOURCE: AN OUTLINE OF JAPANESE TAXES, 1983, (TOKYO: MINISTRY OF FINANCE, 1983), P. 53.

Table A-4

LOCAL INCOME LEVIES

PREFECTURAL TAX RATE			MUNICIPAL TAX RATE		
(¥ THOUSANDS)		%	(¥ THOUSANDS)		%
not over	300	2	not over	300	2
"	500	2	"	450	3
"	800	2	"	700	4
"	1,100	2	"	1,000	5
"	1,500	2	"	1,300	6
"	2,500	4	"	2,300	7
"	4,000	4	"	3,700	8
"	6,000	4	"	5,700	9
"	10,000	4	"	9,500	10
"	20,000	4	"	19,000	11
"	30,000	4	"	29,000	12
"	50,000	4	"	49,000	13
over	50,000	4	over	49,000	14

SOURCE: YUJI GOMI, GUIDE TO JAPANESE TAXES, 1981-82 (TOKYO: ZAIKEI SHŌHŌ SHA, 1981), P. 32

Table A-5

TAX BURDEN ON CORPORATE INCOME

(EFFECTIVE TAX RATE)

	UP TO ¥3.5 MIL.	¥3.5 MIL. --¥7 MIL.	¥7 MIL. --¥8 MIL.	OVER ¥8 MIL.
CORPORATE	26.60%	25.88%	25.18%	34.82%
INHABITANT TAXES: (1) PREFECTURAL	1.33	1.29	1.26	1.74
(2) MUNICIPAL	3.27	3.18	3.10	4.28
ENTERPRISE TAX	5.66	8.26	10.71	10.71
TOTAL	36.86	38.61	40.25	51.55

NOTE: THE ENTERPRISE TAX IS DEDUCTIBLE IN COMPUTING THE TAX BASIS FOR THE CORPORATE TAX AND THE ENTERPRISE TAX ITSELF. INDIRECTLY IT IS ALSO DEDUCTIBLE IN COMPUTING THE INHABITANT TAX AS WELL. IT IS ASSUMED THAT 30 PERCENT OF CORPORATE INCOME BEFORE TAX IS DISTRIBUTED AS DIVIDENDS--TO WHICH A LOWER MARGINAL TAX RATE IS APPLIED.

SOURCE: YUJI GOMI, GUIDE TO JAPANESE TAXES, 1982-83 (TOKYO: ZAIKEI SHŌHŌ SHA, 1982), P. 26.

Table A-6

USEFUL LIVES OF SELECTED FIXED ASSETS

DESCRIPTION OF ASSETS	USEFUL LIFE (YEARS)
(1) TANGIBLE FIXED ASSETS OTHER THAN MACHINERY AND EQUIPMENT	
REINFORCED CONCRETE BUILDINGS (FOR OFFICE)	65
WOODEN BUILDINGS (FOR OFFICE)	26
STEEL VESSELS (2,000 TONS OR MORE)	15
STEEL TANKERS (2,000 TONS OR MORE)	13
STEEL FISHING VESSELS (500 TONS OR MORE)	12
ELEVATORS	17
AIRPLANES (FOR INTERNATIONAL SERVICE)	10
ELECTRONIC COMPUTERS	6
DESKS, CHAIRS OR CABINETS MADE OF METAL	15
AIR CONDITIONERS OR HEATERS	15
TYPEWRITERS	5
TRUCKS (FOR TRANSPORT BUSINESS)	4
PASSENGER AUTOMOBILES (TAXIS)	4
(2) MACHINERY AND EQUIPMENT	
CHEMICAL CONDIMENT MANUFACTURING PLANTS	7
SUGAR REFINERY PLANTS	13
BEER BREWERY PLANTS	14
RAW SILK MANUFACTURING PLANTS	10
WORSTED SPINNING PLANTS	10
PULP MANUFACTURING PLANTS	12
CHEMICAL FERTILIZER MANUFACTURING PLANTS	10
POLYETHYLENE MANUFACTURING PLANTS	8
SYNTHETIC FIBER MANUFACTURING PLANTS	7
RAYON YARN OR RAYON STAPLE MANUFACTURING PLANTS	9
PLATE OR SHEET GLASS MANUFACTURING PLANTS	14
CEMENT FURNACES	13
IRON AND STEEL MANUFACTURING PLANTS	14
METALLIC MACHINE TOOL MANUFACTURING PLANTS	10
ELECTRICAL MACHINERY AND APPLIANCES MANUFACTURING PLANTS	11
AUTOMOBILE MANUFACTURING PLANTS	10
LENS OR OTHER OPTICAL INSTRUMENT MANUFACTURING PLANTS	11
RADIO OR TELEVISION BROADCASTING EQUIPMENT	6
HYDRAULIC POWER GENERATION PLANT FOR ELECTRIC UTILITIES	22
(3) INTANGIBLE FIXED ASSETS	
PATENT RIGHTS	8
UTILITY MODEL RIGHTS	5

SOURCE: AN OUTLINE OF JAPANESE TAXES, 1983 (TOKYO: MINISTRY OF FINANCE, 1983), p. 84.

Table A-7

SPECIAL DEPRECIATION ALLOWANCES

	ALLOWANCE*
I. INCREASED INITIAL DEPRECIATION	
A. ENERGY SAVING EQUIPMENT (APRIL 1, 1981-MARCH 31, 1984)	30%**
B. DESIGNATED PLANT AND EQUIPMENT	
1. USED FOR THE PREVENTION OF ENVIRONMENTAL POLLUTION	25
2. DESIGNED NOT TO CAUSE ENVIRONMENTAL POLLUTION	18
3. FOR INDUSTRIAL WATER-SUPPLY, CONSTRUCTED IN LIEU OF A WELL IN DESIGNATED AREAS	18
4. FOR RECYCLING WHICH MAY CONTRIBUTE TO THE PROMOTION OF EFFICIENT USE OF RESOURCES	18
5. AND OTHER DEPRECIABLE ASSETS WHICH ARE NEWLY DEVELOPED TO USE EFFECTIVELY THE ENERGY RESOURCES	18
6. COMPOSING AN INTEGRATED SYSTEM, SUCH AS COMBINATION OF ELECTRONIC EQUIPMENT FOR DATA ANALYSIS AND INDUSTRIAL MACHINERY	10**
7. CERTAIN ASSETS USED FOR THE STRUCTURAL ADJUSTMENT OF THE SPECIFIC BASIC MATERIAL INDUSTRIES	18** (8 OTHER THAN MACHINERY)
8. STEEL VESSELS USED BY OCEAN TRANSPORTATION ENTERPRISES	15
9. AIRCRAFT USED BY AIR TRANSPORTATION ENTERPRISES	11
10. BUILDINGS FOR STORES AND SHOPS JOINTLY OPERATED BY RETAILERS	8
C. DESIGNATED PLANT AND EQUIPMENT IN DEVELOPING AREAS, WHOSE PRICES ARE MORE THAN ¥ 15 MILLION	
1. UNDERDEVELOPED AREAS, COAL MINING REGIONS, AGRICULTURAL AREAS, DEPOPULATED AREAS, SEVERELY DEPRESSED LOCAL INDUSTRIAL AREAS, AND INDUSTRIAL DEVELOPMENT AREAS	18 (EQUIP.) 8 (PLANT)
2. OKINAWA INDUSTRIAL DEVELOPMENT REGION**	34 (EQUIP.) 20 (PLANT)
3. OKINAWA FREE TRADE ZONE**	50 (EQUIP.) 25 (PLANT)
D. ASSETS USED FOR EARTHQUAKE DISASTER PREVENTION	18

Table A-7 (cont'd)

	ALLOWANCE*
E. MACHINERY AND EQUIPMENT	
1. ACQUIRED BY SMALL- OR MEDIUM-SIZED ENTERPRISES OR AGRICULTURAL COOPERATIVE ASSOCIATIONS, ETC., AND WHOSE PRICES ARE MORE THAN 1,400,000 YEN	14%
2. FOR MEDICAL USE ACQUIRED BY MEDICAL CORPORATIONS AND WHOSE PRICES ARE MORE THAN 1,400,000 YEN	18
F. SPECIFIC SHAFTS AND LIFTS FOR MINING USE	100
G. FORESTATION	
1. SPECIAL INITIAL AMORTIZATION ON FORESTATION EXPENSES IN THE YEAR IN WHICH THE EXPENSES ARE INCURRED	27
2. SPECIAL INITIAL DEPRECIATION OF THE ACQUISITION COST OF THE SPECIFIC CONSTRUCTIONS FOR FORESTATION	20
H. SPECIAL INITIAL DEPRECIATION OF THE ACQUISITION COST OF FACILITIES FOR MEMBERS' MUTUAL BENEFITS (FOR BUILDINGS, THE ALLOWANCE IS 16% OR 8% OF THE ACQUISITION COST) ACQUIRED BY A DESIGNATED ASSOCIATION WHICH ACCUMULATES (a) RESERVES FOR STRUCTURAL IMPROVEMENT PROJECT OF SMALL- AND MEDIUM-SIZED ENTERPRISES, (b) RESERVES FOR PROMOTION OF SMALL- AND MEDIUM-SIZED ENTERPRISES AS SUBCONTRACTORS OR (c) RESERVES FOR PROMOTION OF TRADITIONAL CRAFT INDUSTRIES	25
I. SPECIAL AMORTIZATION OF EXPENDITURES FOR RESEARCH AND DEVELOPMENT PURPOSES PAID TO SPECIFIED ASSOCIATIONS MAINLY ENGAGED IN A RESEARCH WORK	100
J. SPECIAL INITIAL DEPRECIATION ON ASSETS ACQUIRED BY SMALL- AND MEDIUM-SIZED ENTERPRISES ACCORDING TO THE RATIONALIZATION PROGRAM UNDER THE LAW ON EXTRAORDINARY MEASURES FOR SMALL- AND MEDIUM ENTERPRISES LOCATED TOGETHER IN SPECIFIC AREAS	18 (EQUIP.) 8 (PLANT)
II. ACCELERATED DEPRECIATION	
A. HOUSES NEWLY BUILT FOR RENT	
1. USEFUL LIFE UNDER 45 YEARS	47%/5***
2. USEFUL LIFE 45 YEARS OR OVER	70%/5

Table A-7 (cont'd)

	ALLOWANCE*
B. CONSTRUCTION ELIGIBLE FOR REQUIREMENTS OF LAW CONCERNING REDEVELOPMENT OF METROPOLITAN AREA	14%/5
C. NEWLY CONSTRUCTED STORAGE FOR CRUDE LIQUEFIED PETROLEUM GAS	34%/5
D. SPECIFIED FIRE-PROOF WAREHOUSES USED FOR TRADE PURPOSES AND SILOS FOR GRAINS	30%/5
E. MACHINERY USED BY MEMBERS OF THE COMMERCIAL AND INDUSTRIAL COOPERATIVES, TEXTILE INDUSTRY, ETC., WHICH EXECUTE THE PLAN FOR PROMOTION OF RATIONALIZATION OF SMALL- AND MEDIUM-SIZED ENTERPRISES, OR THE STRUCTURAL IMPROVEMENT PROJECT OF TEXTILE INDUSTRY	30%/5
F. A CORPORATION WHERE NOT LESS THAN 25% OF THE EMPLOYEES AT THE END OF ACCOUNTING PERIOD ARE HANDICAPPED PERSONS	18%/LIFE 25%/LIFE (FACTORY BUILDINGS)
G. MISCELLANEOUS OTHER ACCELERATED DEPRECIATION BENEFITS ARE GIVEN, INCLUDING DESIGNATED EQUIPMENT FOR SMALL- AND MEDIUM-SIZED ENTERPRISES CHANGING ITS BUSINESS IN ORDER TO COPE WITH THE GRANT OF A PREFERENTIAL TARIFF, THE FACILITIES FOR A QUALIFIED INTERNATIONAL TOURIST HOTEL, AND FOR VARIOUS MINING AND FORESTRY INDUSTRIES.	

*THESE ALLOWANCES ARE IN ADDITION TO THE REGULAR DEPRECIATION SCHEDULE.

**THIS ITEM WAS REPORTED ON IN ONE OF THE TWO SOURCES USED.

***THIS DESIGNATION IS DEFINED TO MEAN THAT THE FIRM IS PERMITTED TO ADD 50 PERCENT TO ORDINARY DEPRECIATION FOR THE FIRST FIVE YEARS. SUBSEQUENT USE IS INTERPRETED ANALOGOUSLY.

SOURCES: AN OUTLINE OF JAPANESE TAXES, 1983 (TOKYO: MINISTRY OF FINANCE, 1983), PP. 85-88; AND YUJI GOMI, GUIDE TO JAPANESE TAXES, 1982-83 (TOKYO, ZAIKEI SHŌHŌ SHA, 1982), PP. 316-322.

Table A-8

REVENUE LOSSES ATTRIBUTABLE TO SPECIAL TAXATION MEASURES
1972-1981 (UNIT: BILLION YEN)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
1. PROMOTION OF SAVING, ETC.										
1. EXEMPTION FOR INTEREST ON SMALL (MINOR) DEPOSITS	69	71	87	97	109	131	147	159	206	263
2. SEPARATE TAXATION ON INTEREST INCOME	28	27	22	11	12	7	8	7	9	13
3. SEPARATE TAXATION ON DIVIDEND INCOME	41	53	49	50	34	30	35	42	51	58
4. LIFE INSURANCE PREMIUMS DEDUCTION	76	88	89	106	111	147	152	156	163	191
5. OTHERS	5	7	6	7	8	9	10	11	11	12
2. ENVIRONMENTAL DEVELOPMENT, REGIONAL DEVELOPMENT, ETC.										
6. REDUCED TAXATION FOR OBTAINING HOUSES	40	74	106	84	83	81	97	102	110	106
7. REDUCED TAXATION FOR OVER POPULATED CITY RELIEF MEASURES	3	4	3	0	2	1	0	3	1	3
8. REDUCED TAXATION FOR REGIONAL DEVELOPMENT	3	5	8	12	12	14	12	13	8	11
9. REDUCED TAXATION FOR POLLUTION CONTROL	34	38	49	61	37	24	29	37	28	33
3. RESOURCE DEVELOPMENT, ETC.										
10. OVERSEAS INVESTMENT LOSS RESERVE	14	15	19	26	20	12	7	0	0	0
11. ATOMIC POWER PLANT CONSTRUCTION RESERVE	5	10	1	1	0	15	8	18	19	21
12. EXPENDITURE IN PROSPECTING FOR MINERAL DEPOSITS	1	2	4	2	2	3	0	0	0	0

Table A-8 (cont'd)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
4. PROMOTION OF TECHNOLOGY, MODERNIZATION OF EQUIPMENT										
13. EXPERIMENTAL AND RESEARCH EXPENSES TAX CREDIT	9	20	21	21	14	17	15	21	24	27
14. OVERSEAS TECHNICAL SERVICE TRANSACTIONS	4	5	10	12	8	12	10	13	14	15
15. ELECTRONIC COMPUTER REPURCHASE LOSS RESERVE	10	6	3	5	5	3	0	3	2	2
16. SPECIAL DEPRECIATION FOR SPECIFIED PLANT & EQUIPMENT	31	13	17	12	11	9	15	14	16	16
17. SPECIAL DEPRECIATION OF MACHINERIES FOR SMALL ENTERPRISES	47	52	54	60	54	50	45	62	53	57
18. OTHERS	1	2	1	1	4	6	9	8	4	5
5. FULFILLING INTERNAL RESERVES & STRENGTHENING CORPORATE PROFILE										
19. PRICE FLUCTUATION RESERVE	15	2	12	19	2	3	0	0	0	0
20. UNUSUAL CASUALTY RESERVE	13	20	17	18	13	18	1	3	3	5
21. SECURITY TRANSACTION RESPONSIBILITY RESERVE	.2	.2	0	0	0	0	0	3.0	1.0	0
22. RESERVE FOR OVERSEAS MARKET DEVELOPMENT BY SMALL ENTERPRISES	8.0	3.1	7.0	12.0	12.0	8.0	9.0	7.0	5.0	4.0
23. ALLOWANCE FOR BLUE RETURN	20.6	28.4	20.0	28.0	27.0	25.0	28.0	32.0	38.0	42.0
24. BAD DEBT RESERVES BY SMALL ENTERPRISES	1.6	4.4	5.0	7.0	7.0	7.0	6.0	5.0	0	0
25. OTHER	5.2	5.2	5.0	5.0	6.0	6.0	6.0	8.0	6.0	7.0

Table A-8 (cont'd)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
6. OTHERS										
26. SPECIAL COMPUTATION OF MEDICAL INCOME BASED ON SOCIAL INSURANCE	80.0	88.0	105.0	132.0	158.0	189.0	226.0	157.0	168.0	141.0
27. SPECIAL ALLOWANCE FOR OLD AND DEPENDENT	-	-	-	-	-	-	-	14.0	15.0	17.0
28. OTHERS	13.8	3.5	7.0	7.0	8.0	13.0	20.0	23.0	26.0	27.0
29. ADDITIONAL TAXATION ON ENTERTAINMENT EXPENSES (+)	129.7	180.5	207.0	235.0	267.0	396.0	416.0	512.0	543.0	638.0
TOTAL	450.7	464.5	520.0	561.0	492.0	444.0	479.0	409.0	438.0	438.0

SOURCE: TAX BUREAU, MINISTRY OF FINANCE.

Representative LUNGREN. Thank you very much.

Next we will hear from Edward J. Lincoln, research associate, The Brookings Institution.

STATEMENT OF EDWARD J. LINCOLN, RESEARCH ASSOCIATE, THE BROOKINGS INSTITUTION

Mr. LINCOLN. Congressman Lungren, thank you.

I think the General Accounting Office has submitted to you an excellent summary of the Japanese tax system and those features of it which are intended to promote savings and investment in Japan. I find very little with which to disagree in their report. I think that they have wisely taken a very cautious view of the impact of those incentives on the performance of the Japanese economy.

You referred to Japan as being a laboratory for looking at economic policy. The difficulty is that since the issues which are of interest to the Japanese often are quite different than those that are of interest to us, the data and available writings and discussion in Japan are often not there. I'm afraid we have all suffered to some extent in looking at the Japanese tax system from that difficulty.

Perhaps you will find there's not as much disagreement among the three panelists here as would be exciting, but perhaps I'll come out a little bit more on the skeptical end.

What I do disagree with strongly are the statements of some Americans who have chosen to portray Japan as something of a paragon of supply-side successs, attributing the high economic growth rates of the early postwar period to the low Japanese taxes in general, plus the special incentives for savings and investment. Even President Reagan made such a statement when he visited Japan last November.

I believe that any serious analysis of Japanese taxes must come to a fairly skeptical conclusion. Certainly all taxes affect economic choices, but in order to demonstrate that Japan's tax system had a significant positive effect on the Japanese economy I think two questions must be answered first. First, is the Japanese or was the Japanese tax system significantly different from that in the United States; and second, do those differences then explain Japan's relatively greater economic success in the postwar period?

If there is any aspect of Japan's tax policy that can be described as different from United States and possibly having this kind of positive impact, I would say it was generally the low levels of taxation relative to other industrial countries that prevailed during the 1950's and 1960's.

At that time, as you know, Japan was experiencing extraordinarily high economic growth rates and because the country was unwilling to allow significant borrowing from abroad, the very strong domestic investment demand that was part of this economic growth had to be funded by the domestic supply of savings.

In this set of circumstances, the government consciously chose, as has been discussed earlier today, to limit its own demand upon economic resources, freeing more of those resources to fuel this very strong private domestic investment demand.

However, I think it would be a serious mistake to take that policy and then say that the high growth of the period was generated by it.

Rapid growth in Japan was caused by a large number of factors, including among them recovery from wartime destruction, the technological lag between Japan and the United States which made new investment using imported technology highly profitable, stable or declining world prices for raw materials which Japan needed, declining levels of import protection in Japan's major overseas export markets, and a stable political system at home.

Combined, these factors and others resulted in more than two decades of average real GNP growth in excess of 10 percent.

The decision of the government to keep the government sector small helped to accommodate this high growth, but I believe that it hardly caused it. Some supply-side economists in the United States have gone further and pointed to the rise in the government share in the 1970's and 1980's as then a cause of the slowdown in economic growth. Once again, I think their reasoning is backwards. The economic slowdown in Japan was caused by other factors which then created conditions in which the rise in the governmental share was an important and necessary response.

We should also point out that Japan also paid a heavy price for its decision to maintain a small government sector in the 1950's and 1960's. By the late 1960's, Japan faced some of the most serious pollution problems in the world as well as a lamentable underinvestment in roads, sidewalks, sewers, public parks, and other forms of social amenities.

Frankly, I see no lesson for the United States in this history. We have not been devastated by war; we are not lagging years behind in technology; and we are not willing to sacrifice basic public amenities for added industrial investment. Japan in the 1950's and 1960's was a rather unique country, and the overall level of taxation that was best suited for that era, whether we say the Japanese came upon the magic number of 20 percent of GNP deliberately or whether it was just a guess, would be appropriate neither for Japan today nor for the United States.

Aside from the question of the overall level of the tax bite in the economy is the question of tax structure and the specific incentives for saving and investment. There is absolutely no doubt that the intended purpose of these measures was to promote more rapid economic growth, but there is great skepticism as to the actual impact, as the General Accounting Office has noted.

On the side of saving, the incentives in the personal sector are clear; the exemption of interest income on particular forms of savings accounts, the nontaxation of capital gains from securities transactions and nondeductibility of mortgage interest payments are fairly strong incentives and stand in fairly clear contrast to U.S. policy. But once again, the reasons for the high rates of saving are many, including the need to finance retirement—given the relatively poor state of pensions in the past—the need to finance higher education costs, and others. I have long been struck, for example, at how closely the size of personal savings in worker households corresponds to the size of the semiannual bonuses paid by Japanese corporations. I hesitate to make too much of that, but the closeness in size of these amounts is really striking. The tax incentives may have affected the form of savings to some extent by causing money to flow into the postal savings system—because

of the great potential for evading taxes through multiple accounts—but there's no economic analysis of which I am aware that has found any significant positive impact on the overall amount of saving.

Other aspects of the policy to promote saving have not necessarily worked at all. The GAO report speaks of the intention of encouraging purchase of corporate securities and discouraging housing. Despite both the nontaxation of capital gains on securities and the tremendous performance of stock prices in the postwar period in Japan, it has already been pointed out here that the stock market is rather thin in Japan. The proportion of outstanding corporate stock held by the personal sector has been continuously declining in the postwar period and it is now down to 28 percent. By the way, during the prewar Japanese economic history, conditions were considerably different. Corporations did raise a lot more money through equity and there was a much more vigorous stock market in the prewar period in Japan.

If we look at data on personal financial assets in Japan, these data show that the Japanese hold a much smaller proportion of their portfolios in the form of equities than do Americans and a much higher proportion in the form of savings deposits. So I would say that encouragement of the corporate equity market through tax incentives has not been terribly important for economic growth in postwar Japan.

Discouragement of housing does not seem to have worked either. Despite the high price of land in Japan and the nondeductibility of mortgage interest, the proportion of Japanese families owning their own homes is not far different from the United States. It would seem that our two countries share a strong desire for home ownership. In fact, the Japanese Government has moved somewhat in the other direction, partially offsetting the tax disincentive by creating two government-owned corporations in the postwar period—the Housing Loan Corp. and the Japan Housing Corp.—the first to provide preferential financing for private housing and the second to provide subsidized public housing. If Japanese housing seems small and inadequate by American standards, I believe that most of that difference is due to the very high density of population and price of land in those parts of Japan where economic activity and population are concentrated. In addition, the lower levels of income in the recent past seriously limited the size and quality of housing that people could afford plus the very rapid technological change in the housing industry means that almost any house in Japan that is more than 20 years old looks rather primitive by modern Japanese standards.

On the side of investment, the intent of the Japanese Government in tax policy I think is equally clear and the outcome equally unclear. Here, I think the incentives fail on both counts. They are not significantly greater than the incentives provided in the United States and those that do exist do not seem to have had a major impact on the economy. In fact, as has already been pointed out, the statistics on the loss of tax revenue from special corporate investment breaks show a much lower loss of revenue in Japan than in the United States.

I think it's interesting to note that at the same time this committee is considering Japanese tax policy as a model, the major business organization in Japan, Keidanren, the Federation of Economic Organiza-

tions, a major voice of big business in Japan, is using the United States as a model to argue with the Japanese Government that it ought to adopt a general investment tax credit such as we have here. The Ministry of International Trade and Industry, MITI, is also pressing the Ministry of Finance to allow favorable tax treatment of research and development more along the line of what we offer in the United States.

The GAO study concludes that the lower tax burden on Japanese corporations relative to the United States in the past may have given them more investment funds in the form of retained earnings, despite the offsetting differential between taxation on retained earnings and dividends. That may be true, but we should keep in mind that retained earnings in Japan during the postwar period have never provided a greater share of total corporate investment funds than has been the case in the United States. Depreciation allowances may also look more generous than those in the United States, but again, the proportion of investment funds raised by corporations through depreciation has been considerably smaller in Japan than it has in the United States. With new equity issues, we discussed the intention of tax policy to encourage the equities markets, but they have never been a significant source of corporate investment capital.

In fact, there is, in Japan, a great deal of lamenting over the fact that there is not a vigorous venture capital market such as we have in this country and there have been various proposals and actions by the Japanese Government to try to stimulate that kind of a market.

It may be true that the investment incentives provided in Japan through special depreciation tax measures are more specific—I hesitate to use the word targeted but perhaps that's the familiar term—more targeted than those in the United States, but once again, the impact of these on success in particular industries for overall growth is certainly unclear. For almost any industry that has received special tax benefits, other, and often more important factors for success can be found. In addition, back in the 1950's and 1960's when the tax revenue loss from these kinds of measures was somewhat higher, the political pressures upon the Government caused these tax breaks to proliferate to the point where they lost much of their specific nature. I think that the GAO also correctly points out that today the special depreciation allowances deal with a variety of social goals of which economic growth is only one. Other goals include pollution control, employment of the handicapped, and earthquake disaster prevention.

Japanese industry invested at a high rate in the earlier postwar period because of the high rate of return on investments using imported technologies. That rate of return was influenced primarily by the technology gap between Japan and the industrial countries combined with the stable price of labor. In that environment, the Japanese Government provided relatively few tax incentives for corporate investment compared to the United States. With the slower growth that has prevailed over the past decade, one might expect such incentives to have become more important to provide additional stimulus. However, the overriding desire of the Ministry of Finance to reduce the size of the government deficit has caused the special depreciation measures to diminish and the overall level of corporate taxes to rise.

In conclusion, let me reiterate that to attribute past Japanese success to its tax policies is a mistake. The reasons for Japan's economic performance have been many and varied, and these other factors far outweigh tax policy in importance. However, at the very least, I suppose one can say that Japan's tax policies have been consistent with economic growth and development goals. The lower levels of taxation and spending in the high growth era were supportive of and consistent with strong private investment demand; special measures for certain industries may not have provided a major stimulus, but certainly did not hurt; and the incentives for personal saving were not inconsistent with the goal of increasing savings and may have been marginally beneficial. Perhaps this is the lesson from Japan: we should not expect great success merely from increasing the incentives for saving and investment, but the consistency between economic development goals and taxes certainly cannot hurt.

Thank you.

[The prepared statement of Mr. Lincoln follows:]

PREPARED STATEMENT OF EDWARD J. LINCOLN

SAVINGS AND INVESTMENT INCENTIVES IN THE JAPANESE TAX SYSTEM

Mr. Chairman and the members of the Committee, thank you for this opportunity to speak on the Japanese tax system. I am a research associate at the Brooking Institute specializing on the Japanese Economy. However, these comments are solely my own and should not be attributed to the Institution, its trustees, officers, other staff members or the organizations that support its research.

The General Accounting Office has submitted to you an excellent, detailed summary of the Japanese tax system and those features of it which are intended to promote saving and investment. I find little with which to disagree in their report. They have wisely taken a very cautious view of the impact of those incentives on the performance of the Japanese economy.

What I do disagree with strongly are the statements of some Americans who choose to portray Japan as a paragon of supply-side success, attributing the high growth rates of the earlier postwar period to the low level of Japanese taxes in general and to the special incentives for savings and investment. Even President Reagan made such a statement during his visit to Japan last November. I believe that any serious analysis of Japanese taxes must come to a very skeptical conclusion, and, if anything, I am more skeptical than the General Accounting Office.

All taxes affect economic choices, but in order to demonstrate that Japan's tax system had a significant positive effect in the Japanese economy, two questions must be solved. First, has Japan's tax policy been significantly different from that in the United States?

Second, does that difference explain Japan's economic success?

If any aspect of tax policy can be described as different from the United States and possibly having a positive impact during the postwar period, it was the generally low levels of taxation (relative to other industrial countries) that prevailed in the 1950s and 1960s. At that time, Japan was experiencing extraordinarily high economic growth rates. Unwilling to allow significant borrowing from abroad, the very strong domestic investment demand had to be funded by the domestic supply of savings. In this circumstance, the government consciously chose to limit its own demand upon economic resources, freeing more of them to fuel the strong private sector growth.

However, it would be a serious mistake to say that the high growth of the period was caused by this policy of maintaining a low tax and expenditure share. Rapid growth was caused by a number of factors, including recovery from wartime destruction, the technological lag between Japan and the industrial countries (which made new investments using imported technology very profitable), stable or declining world prices for raw materials, declining levels of import protection in Japan's overseas markets, and a stable political system at home. Combined, these and other factors resulted in more than two decades of an average real GNP growth rate of 10 percent.

The decision to keep the government sector small helped to accomodate the high growth generated by these special factors, but it hardly caused it. Some supply-side economists in the United States have also pointed to the rise in government share in the 1970s and

1980s as a cause of the slowdown in economic growth. Once again, their reasoning is backwards; the economic slowdown created conditions in which the rise in the governmental share was an important and necessary response.

Japan also payed a heavy price for its decision to mainain a small government sector in the 1950s and 1960s. By the late 1960s, Japan faced serious pollution problems as well as lamentable underinvestment in roads, sidewalks, sewers, public parks and other social amenities.

I see no lesson for the United States in this history. We have not been devastated by war; we are not lagging years behind in technology; and we are not willing to sacrifice basic public infrastructure for added industrial investment. Japan in the 1950s and 1960s was a unique country, and the overall level of taxation best suited for that era would be appropriate neither for the United States nor for Japan today.

Aside from the question of the overall level of the tax bite in the economy is the question of tax structure and the specific incentives for saving and investment. There is no doubt that the intended purpose of these measures was to promote more rapid economic growth, but there is great skepticism as to the actual impact, as the General Accounting Office notes.

On the side of saving, the incentives to promote saving in the personal sector are clear; the exemption of interest income on particular forms of savings accounts up to a specified size, the non-taxation of capital gains from securities transactions and the

non-deductability of mortgage interest payments are strong incentives which certainly stand in contrast to U.S. policy. But the reasons for the high rates of saving are many, including the need to finance retirement (given the relatively poor state of pensions in the past), the need to finance higher education costs, and others. I have long been struck, for example, at how closely the size of personal savings in worker households corresponds to the size of the semiannual bonuses paid by Japanese corporations. The tax incentives may have affected the form of savings to some extent by causing money to flow into the postal savings system (because of the potential for evading taxes through multiple accounts), but no economic analysis of which I am aware has found a positive impact on the overall amount of saving.

Other aspects of the policy to promote saving have not necessarily worked at all. The GAO Report speaks of the intention of encouraging purchase of corporate securities and discouraging housing. Despite both the non-taxation of capital gains on securities and the tremendous performance of stock prices, the proportion of outstanding corporate stock held by the personal sector has been continuously declining in the postwar period, and is now down to about 30 percent. Data on personal financial assets show that the Japanese hold a much smaller proportion of their portfolios in the forms of equities and a much higher proportion in the form of savings deposits than do Americans. Encouragement of the corporate equity market through tax incentives has not worked.

Discouragement of housing has not worked either. Despite the high price of land in Japan and the non-deductability of mortgage interest, the proportion of Japanese families owning their own houses is not far different from the United States. Our two countries share a strong desire for home ownership. In fact, the Japanese government partially offset the tax disincentive by creating two government-owned corporations--the Housing Loan Corporation and the Japan Housing Corporation--the first to finance private homes at preferential interest rates and the second to provide public housing. If Japanese housing seems small and inadequate by American standards, most of that difference is due to the very high density of population and price of land in those parts of Japan where economic activity is concentrated, the low levels of income in the recent past which limited the size and quality of much of what is now the existing housing stock, as well as the very rapid technological change in the housing industry (such that any house 20 years old in Japan appears primitive by current Japanese standards).

On the side of investment, the intent of the Japanese government is equally clear, and the outcome equally unclear. I believe that the investment incentives fail on both counts: they are not significantly greater than incentives in the United States and those that do exist do not seem to have had a major impact on the economy. In fact, the statistics on loss of tax revenue due to special corporate investment tax breaks show a much higher loss of revenue in the United States than in Japan. At the same time that this Committee is considering lessons

from Japan's tax policy, Keidanren (the major voice of big business in Japan) is using the United States as a model in urging the Japanese government to adopt a general investment tax credit. The Ministry of International Trade and Industry (MITI) is also pressing the Ministry of Finance to allow favorable tax treatment of research and development more in line with the U.S. policy.

The GAO study concludes that the lower tax burden on Japanese corporations (relative to the United States) in the past gave them more investment funds in the form of retained earnings. That may be true, but retained earnings in Japan during the postwar period have never provided a greater share of total investment funds than is the case in the United States. Depreciation allowances may also have been more generous than those in the United States, but these provided a considerably smaller share of corporate investment funds than in the United States. The same is true of new equity issues; tax policy may have encouraged use of equity markets, but they have never been a significant source of corporate investment capital. In fact, the Japanese government has been lamenting the virtual absence of the kind of venture capital market that exists in the United States.

It may be true that the investment incentives provided in Japan through special depreciation measures are more specific than those in the United States, but the importance of these for economic success is unclear. For almost any industry that has received special tax benefits, other more important factors in success can be found. In addition, back in the 1950s and 1960s when the tax revenue loss from

these measures was higher (though still modest), political pressures caused tax breaks to proliferate to the point that they lost their specific nature. The GAO also correctly points out that today the special depreciation allowances deal with social concerns other than industrial growth--including pollution control, employment of the handicapped, and earthquake disaster prevention.

Japanese industry invested at a high rate in the earlier postwar period because the rate of return on investments using imported technologies was high. That rate of return was influenced primarily by the technology gap between Japan and the industrial countries and the stable price of labor. In that environment, the Japanese government provided relatively few tax incentives for corporate investment compared to the United States. With the slower economic growth that has prevailed during the past decade, one might expect such incentives to have become more important. However, the overriding desire of the Ministry of Finance to reduce the government deficit has caused the special depreciation measures to diminish and the overall level of corporate taxes to rise.

In conclusion, let me reiterate that to attribute past Japanese success to its tax policies is a mistake. The reasons for Japan's economic performance have been many and varied, and these other factors far outweigh tax policy in importance. However, at least one can say that Japan's tax policies have been consistent with economic growth and development goals. The lower levels of taxation and spending in the high growth era were supportive of and consistent with strong private

investment demand; special measures for certain industries may not have provided a major stimulus, but certainly did not hurt; and the incentives for personal saving were not inconsistent with the goal of increasing savings and may have been marginally beneficial. Perhaps this is the lesson from Japan: we should not expect great success merely from increasing the savings and investment incentives in the tax system, but consistancy between economic development goals and taxes certainly cannot hurt.

Representative LUNGREN. Thank you very much.

Now we will hear from Leon Hollerman, professor of economics, from the Claremont McKenna College, Claremont, CA.

STATEMENT OF LEON HOLLERMAN, PROFESSOR OF ECONOMICS, CLAREMONT McKENNA COLLEGE, CLAREMONT, CA

Mr. HOLLERMAN. Thank you, Congressman Lungren.

I'd like to depart somewhat from my prepared statement in order to provide the element of controversy that the chairman invited.

I have the greatest respect for my colleagues and I thoroughly agree with the facts they have presented. However, I think there may be room for some difference of interpretation and emphasis, particularly on the matter of evaluation of the effect of tax incentives. The GAO's inability to statistically demonstrate the precise contribution of those incentives does not justify the conclusion that no contribution exists. That's an error, I believe, that has its origin in the Pechman and Kaizuka article in the Patrick and Rosovsky volume on "Asia's New Giant." I'd like to return to that point.

Let me concentrate my comments on three points. First, the tax incentives for saving and investment; second, evaluation of the effectiveness of tax incentives; and third, the moral of the United States.

I am not skeptical as my colleagues apparently are about the contribution of tax incentives for the growth process of the Japanese economy.

First, so far as incentives for saving are concerned, it's generally agreed that saving in Japan is not a mere residual of income left over after consumption expenditures have been made. Rather, the saving process is itself a decision variable and so the question arises as to what are the incentives and motivations for decisions to save.

There are about a dozen of them conventionally mentioned and they include the traditional frugality of the Japanese people, the inadequate social security system, the life cycle hypothesis, saving to buy a house, the bonus system, the lag of consumption behind the rise in income, the inequality in distribution of income, the effect of including unincorporated business enterprise in the compilation of savings statistics, the liquid assets ratio which Japanese attempt to increase, and the lack of consumer credit facilities. Those are some of the main arguments usually mentioned, and there is something wrong with every one of them. There is controversy among the experts on all of these points.

On the other hand, very little has been written about the role of tax incentives in the saving process in Japan, essentially for the reason which has been mentioned here today; namely, the difficulty of evaluating them.

However, the fact that there is considerable doubt about the effectiveness of nontax incentives certainly implies a strong presumption that some neglected considerations, that is, tax incentives, may be very important.

Now there are two distinct types of tax incentives for saving in Japan: First, the legal; and second, the illegal. The legal incentives include special advantages connected with the postal savings system as has been mentioned, and saving by means of certain types of government bonds and saving for the formation of employee assets.

The illegal incentives are notoriously connected with the postal savings system, as has already been mentioned and in the establishment of multiple accounts under fictitious names within that system.

There are other illegal incentives as well that have not been mentioned, which include tax evasion and saving related to the self-assessment of income of unincorporated business enterprises, the income of professional practitioners, farmers, politicians and others.

So we can proceed from there to recognize that in Japan illegal incentives for saving redound primarily to the advantage of the wealthy and this promotes capital accumulation and economic growth because it encourages saving and investment, primarily among those who are best able to save and invest.

Now Japan is not an egalitarian society. That's one of the reasons, as Mr. Lincoln has mentioned, it's not comparable to the United States and that may be another reason for not prematurely deciding that what they do is something we can do.

However, the question here today is what has been the contribution of tax incentives to the growth of saving and investment in the Japanese economy.

These incentives include tax treatment of securities, land, and other property, and tax treatment of gifts and inherited wealth. All of these constitute elements of favor to the wealthy and are conducive to capital accumulation and thus to economic growth.

Now I don't recommend that the United States imitate Japan in the promotion of tax evasion, but the point I'd like to make is that acquiescence of the Japanese Government in various types of tax evasion constitute in effect a legally authorized reduction in statutory tax rates. The acquiescence of the Japanese Government in these various types of tax evasion constitutes an implicit reduction in statutory tax rates. Therefore, I think it's erroneous to describe the tax expenditures of incentives as though they were something negative. In fact, they are a positive instrument for the promotion of saving.

This legally authorized, implicitly legally authorized I should say, reduction in statutory tax rates makes the comparison of Japanese statutory tax rates and American statutory tax rates totally fictitious and there's no comparability.

An important aspect of Japanese tax incentives for business saving and investment and innovation was the sectoral distribution of those incentives. They were very deliberately applied to the export sector as well as to the domestic industrial sector. And here again, they were applied principally for the benefit of big business rather than small or medium-sized business, which is another aspect of the unbalanced character of the Japanese economy.

Within the industrial sector itself, tax incentives were applied to specific types of industry and even specific types of machinery. The literature contains a good deal of discussion about tax incentives for investment and technological innovation, and these tax devices include such matters as initial depreciation, accelerated subsequent depreciation, tax-free reserves of various kinds, and tax credits.

Now my second point concerns the statistical evaluation of the effectiveness of Japanese tax incentives for saving, investment and innovation leading to economic growth.

First, the motives for saving are difficult to ascertain. Second, data on saving are among the weakest in the national income accounts of Japan and other countries. Third, in Japan tax incentives are combined, as Mr. Lincoln emphasized, with other Japanese government policies for economic growth.

What are some of these other policies? They are low interest loans by quasi-governmental institutions, import restriction by means of duties and nontariff barriers, coordination of investment in plant and equipment, promotion of economies of scale, improvement of efficiency by means of mergers and consolidations, deferment of trade and capital liberalization measures, and various types of administrative guidance.

So it is unclear and statistically probably impossible to demonstrate what the relative contribution is of each of these various measures. Nevertheless, it is their interaction, in addition to what Mr. Wheeler says is the broad bias of Japanese Government policies, which contributes to the growth process.

Apart from the difficulties of evaluating the contribution of tax incentives within the mix of other Japanese growth promoting policies within Japan itself, you have the further formidable difficulty of attempting to evaluate the transferability of those incentives to the United States.

What are those difficulties? First, there's an enormous difference in the industrial structure of the United States and Japan, a difference in the mode of industrial organization, and a difference in the degree of the use of debt versus equity. Also, there are differences in the degree of economic concentration, oligopoly and monopoly in Japan as compared with the United States. There are differences in the dynamics of shifting and incidence of taxation. There are differences in the government policies and in the method of combination of government policies in Japan and the United States. There are differences in the administrative as compared with the legislative implementation of incentives and encouragement to saving and investment.

For example, the depreciation allowances in Japan are determined primarily by administrative rather than by legislative means. Therefore, the Japanese system is more flexible than ours.

Thus a tax incentive that is nominally identical in the United States with a tax incentive in Japan may have entirely different results in the two countries.

Finally, there are differences in the interaction effects of the various policies which are implemented by the two countries respectively. But difficulties of evaluation do not warrant the conclusion either that there has been no benefit of tax incentives to economic growth in Japan or that tax incentives would be of no benefit to saving and investment in the United States. Going back to fundamentals, there is no economic development theory that does not emphasize the importance of investment in the process of economic growth. Investment, however, depends upon capital accumulation, and capital accumulation depends upon saving. You can't make an omelet without eggs.

Well, those are my basic objections to the emphasis that's been placed on the facts that we all agree on. One reason I feel that it's important to accept the proposition that tax incentives have made an important contribution to saving, investment, and economic growth in Japan is

the fact that the Japanese Government, which is highly pragmatic, sophisticated, and dedicated to the proposition that Japanese growth must be promoted, accepts this policy and has implemented it perseveringly. That's one point.

Another point is that Japanese economists, very eminent ones, are agreed in the considered opinion that tax policy has made a very substantial contribution to economic growth in Japan.

So what is the moral for the United States? There are three. First, it's apparent that the use of tax incentives, as distinguished from administrative guidance and other policies of which we disapprove, tax incentives are appropriate for use in a market economy such as ours.

The second moral refers to the way in which tax incentives were channeled in promoting Japanese economic growth. The use of tax incentives to generate international competitive power was specifically implemented in the export sector and this had dynamic spillover effects, a virtuous circle effect, in the domestic economy.

Finally, the moral is that whereas the Japanese tax system is designed to provide incentives for saving, investment and innovation, the U.S. tax system is designed to provide incentives for borrowing and consumption.

Thank you.

[The prepared statement of Mr. Hollerman follows:]

PREPARED STATEMENT OF LEON HOLLERMAN

TAX INCENTIVES FOR SAVING, INVESTMENT, AND INNOVATION IN POSTWAR JAPAN

Questions concerning the incidence and shifting of taxation are among the most controversial in the field of economics. Ascertainment of incentives for saving and investment is likewise controversial. Thus evaluation of the effect of taxation on saving and investment is subject to compound difficulties. These difficulties are reflected in the scarcity of quantitative studies concerning various tax incentives.[1] To some extent, they are impossible to quantify. One thing is clear, however, namely that following World War II, the policies of the Japanese government to promote saving, investment, and innovation were formulated primarily in the form of tax incentives. In the opinion of eminent economists, these policies have been effective.[2] Disagreement remains only about why they have been effective.

Incentives for Saving

It is generally agreed that saving in Japan is not a mere residual of income left over after consumption, but rather that the level of saving is itself a decision variable.[3] In contrast with the apparent constancy in the long term rate of saving in the United States, moreover, Japan achieved a rising secular trend in the rate of gross national saving from a level of about 12 percent in the early years of Meiji to about 40 percent in the late 1960s. This achievement was mainly the result of saving in the private sector, which was motivated by various incentives, including those provided by the government. Personal saving accounts for about one-third of gross domestic saving.

It is interesting that the literature on saving in Japan, unlike the literature on investment and innovation, rarely mentions the role of tax incentives. Instead, it attributes saving to various other motives, many of which may be questioned. The reasons

usually given for saving, and some conflicts among the authorities are as follows:

"For culturally conditioned reasons of frugality, abstinence, and selfdenial, Japanese have been traditionally predisposed to maintain a high level of saving." Prior to Meiji, however, the savings ratio was very low. With the advent of Meiji came the government policy of enforced consumer abstinence. Even so, as mentioned above, the prewar saving rate in Japan was far lower than the postwar rate.

"The Japanese social security system is inadequate. Thus people must save for their old age." Nobuo Shōji has demonstrated that statistical verification of this proposition is virtually insupportable.[4] In 1975-79, moreover, social security expenditures in Japan amounted to 6.9 percent of GDP, not greatly different from the figure of 7.6 percent of GDP in the United States.

"According to Colin Clark's life-cycle hypothesis, saving is higher during youth and lower during old age. Thus a country with a high proportion of young people would have a higher savings ratio while a country of aged people would have a lower savings ratio." Hisao Kanamori, however, has argued that in postwar Japan, the savings ratio becomes higher as the age of the household head rises.[5]

"There are many households now living in rented houses or rented rooms that are saving to build homes." This hypothesis is shown by Nobuo Shōji to be statistically unverifiable.[6]

"Saving in Japan has been prompted by increases in the proportion of bonuses to regular earnings." According to Kazuo Sato, this argument "belongs to folklore."[7] It has been argued by others that bonuses are not "unanticipated" and hence cannot be

characterized as "transitory income" (in Milton Friedman's term).

"When income rises, the level of consumption lags due to inertia, thus inadvertently increasing saving." This argument may have been plausible during the period of rapid economic growth prior to the first oil crisis, but according to Kazuo Sato, its validity is suspect in the 1970s.

"Saving has been promoted by the rising price of land." Kazuo Sato observes that land is an illiquid asset and that except when actually sold it has had no noticeable effect on the level of saving.

"Saving is promoted by a high degree of inequality in the distribution of income." The distribution of income in Japan, however, appears to be no more skewed than in the United States. (The distribution of wealth is perhaps becoming increasingly skewed.) Moreover, postwar Japan has a much higher saving rate than prewar Japan despite the fact that the income distribution was much more inequitable in prewar Japan.

"The savings of unincorporated businesses are included with personal savings in the national income statistics. The high percentage of individual enterprises in the Japanese economy and the high rate of saving they perform (partly due to the improper reporting of personal expenses as business expenses) raises the gross savings ratio." A study by Hisao Kanamori, however, rejected the hypothesis that family business helps account for Japan's high savings ratio.[8] Moreover, the relative contribution of the savings of individual proprietors declined from 24 percent of total individual income in FY1965 to 15.6 percent in FY1975.

"The ratio of liquid assets to national income declined sharply following World War II. Efforts of Japanese to increase their liquid assets contributed to the rise in the savings ratio." Yasusuke Murakami, however, observes that the ratio of liquid assets in Japan is becoming comparable to that in other wealthy countries.

"Lack of consumer credit facilities have induced saving in order to enable consumers to pay cash." Recently, however, credit and mortgage facilities have been substantially expanded.

Most conventional accounts of personal saving in Japan make no reference to the role of tax incentives. The omission is glaring in view of the policy of the Japanese government to encourage saving by means of both explicit and implicit tax incentives. The former include various legal measures, the latter include government acquiescence in tax evasion. The fact that conventional stories about saving incentives in Japan are increasingly seen to be inadequate suggests that neglected considerations, among which tax incentives are conspicuous, may be of substantial importance.

As an exception to the neglect, a list of tax incentives for various purposes, including personal and business saving, has been compiled by Joseph Pechman and Keimei Kaizuka.[9] (They also cite without comment four of the controversial factors mentioned above as incentives for personal saving.) The Special Tax Measures Law by which they are authorized includes more than one hundred provisions with regard to tax incentives. These are classified by Pechman and Kaizuka into four categories: (1) promotion of personal saving and housing investment; (2) promotion of business saving and investment; (3) promotion of exports and foreign investments; and (4) miscellaneous.

Personal saving is encouraged, for example, by the "exemption of small amounts of property income from tax and the taxation of other property income at low rates. Interest income from savings deposits, government bonds, and postal savings with

principal value up to ¥ 3 million [respectively] is not subject to tax. In addition, interest from workers' savings designated as Savings for the Formation of Employees Assets are not taxable up to a principal value of ¥ 5 million. Beyond the actual exemption of modest amounts of interest income in these ways, the law also permits taxpayers to elect to be taxed separately on their interest and dividends at a rate of 25 percent." Among other incentives, capital gains from the sale of securities are completely tax exempt, "except where an individual is regarded as being engaged in continuous trading, defined as more than fifty transactions per year that involve a total of more than 200,000 shares." Other tax credits are provided for the promotion of saving for home ownership.

Government acquiescence in tax evasion constitutes another important although officially unacknowledged item in the structure of tax incentives for saving. As publicly perceived, its extent is expressed in a popular saying, Tō-gō-san-pin (10-5-3-1), which on a scale of one to ten refers to the proportion of gross income reported by various classes in Japanese society. Wage earners report ten, proprietors of unincorporated business report five, farmers report three, and politicians report one. In actuality, in FY1981, at least 84 percent of salaried workers were taxed, while taxes were received from only 42 percent of self-employed workers and 15 percent of farmers.[10]

Tax evasion is notorious in connection with the postal savings accounts mentioned above. Although banks are required to report individuals who claim tax exemption on interest received from deposits of less then ¥ 3 million, the postal savings system is exempt from this requirement. Moreover, the Japanese tax authorities do not have the right to enter and investigate the accounts of the postal savings system. Employees of the postal savings system, who receive a commission of up to 0.54 percent on deposits received, encourage depositors to establish under fictitious names multiple accounts within the tax-free limit. Deposits in the Japanese postal savings system amount to more than 30 percent of Japan's total savings deposits. In 1981, its deposits amounted to ¥ 62 trillion, or three times the amount of total deposits in the Bank of America. As a result

of government acquiescence in evasion of taxes on interest income, the number of tax-free personal accounts is twice as large as the number of people in Japan.

Although the anomaly of the postal savings system survives because it is politically untouchable,[11] the rationale of its revival following World War II was to mobilize the savings without which investment and economic growth could not occur. Saving is the essential prerequisite for investment. The contribution of the postal savings system, which pays a slightly higher rate of interest than commercial banks and which subsidizes saving by means of its collusion in tax evasion, is generally unappreciated outside Japan. In the United States, the tax system subsidizes borrowing and consumption; in Japan, it subsidizes saving and investment.

The role of implicitly authorized tax evasion in reducing the effective impact of statutory tax rates creates one of the statistical difficulties in evaluating the precise contribution of the Japanese tax system to saving, investment, and technical innovation. The intention and results of the system, however, clearly show that it supports the government's objective of accelerating economic growth. One of Japan's leading economic experts, in explaining the relative importance of various measures taken to achieve economic growth in Japan following World War II, lists "special tax measures" as the first of seven basic policies.[12]

While the effective tax burden in Japan is unusually low by the standards of every other major country in Europe or North America, the equity or inequity of the distribution of the tax burden, as well as its absolute size, has a bearing on incentives for saving and investment. An important consideration with regard to the Japanese tax system is that many of its devices, including implicitly authorized tax evasion, redound to the advantage of the rich rather than the poor. This discrimination in the distribution of the tax burden, whether planned or not, may have the practical effect of stimulating saving among those best able to perform it. As repeatedly shown in public opinion polls, it is widely agreed in Japan that the distribution of the tax burden is unfair. As indicated above, tax evasion is

rampant among politicians, farmers, and proprietors of unincorporated business. There are also many incorporated entities, such as farm cooperatives, industry and trade associations, schools and hospitals that have acquired substantial capital assets and which reward themselves with handsome salaries, but which are exempt from taxes in whole or in part. Selfassessment of tax obligations by professional practitioners and individual entrepreneurs results in concealment of income and deduction of personal consumption in the guise of business expenses. Most wage and salary earners, on the other hand, are subject to tax withholding at source.

The tax treatment of income from securities and real property is likewise of benefit principally to the rich. Separation of interest and dividend income from other income and taxation of the former at lower rates than the latter is of little benefit to the general public. Capital gains on the sale of securities are not subject to tax, and capital gains on land held for more than five years are taxed at a maximum rate of 20 percent. It was the 1953 tax revision that made capital gains in securities tax exempt. Traditionally, Japanese corporations raised additional capital by issuing new shares at par to current stockholders. After 1953, however, it became the practice of corporations to issue new stock at market value, the difference between market value and par value accruing to the corporation as an untaxed capital gain. Theory and practice diverge, moreover, in various respects advantageous to those with property. Land, for example, is supposed to be valued for tax purposes at market value, while buildings and equipment are to be valued at replacement cost minus depreciation. In practice, assessments are only a fraction of these values. Furthermore, gift and inheritance taxes are modest, which is conducive to capital accumulation and concentration of wealth. It is sometimes maintained that the tax system in Japan is less regressive than before the war when 70 percent of the national government's tax revenue was in the form of indirect taxes. Since World War II, 65 percent of its revenue has been in the form of direct taxes. The equity of the postwar system, however, has been warped by the regressive features mentioned above. Since the

mid-1970s, moreover, the Japanese government has been increasing the tax burden. Without removal of the inequities in the present system, it may be more difficult to impose further increases in the future, as the government seems disposed to do.

Investment and Innovation

In coping with the scanty resources of their physical endowment, the Japanese have learned to become the world's foremost economizers. Their talent for economizing is evident both in their cultural characteristics and in their institutional arrangements. Japanese capitalism is characterized by its use of a minimum of means, including a minimal government establishment, to achieve a maximum of results. Although government intervention is a prominent feature of the system, it complements but does not supersede the market mechanism. Since World War II, the government's preeminent achievement has been to induce capital accumulation and technological innovation, especially with the use of tax incentives.

Business saving and investment have been encouraged by the following types of tax devices: (1) accelerated depreciation; (2) increased initial depreciation; (3) tax-free reserves; and (4) tax credits. In many instances two or more devices and two or more development policies are used to promote a given objective. Having served their purpose (as well as being illegal under GATT), many of the tax subsidies and other devices for export promotion have been terminated in recent years. A central feature of the dynamics of capital accumulation in Japan's economic miracle was the virtuous-circle interaction between investment and exports. Tax incentives promoted investment in export industries as well as in those with export potential. In so doing, tax incentives were highly effective in contributing to Japan's economic growth. It should be noted that the effectiveness of the tax incentives was enhanced by the "unbalanced" nature of Japan's industrial and technological development. In accordance with government guidance, the postwar rehabilitation and expansion of the Japanese economy was

concentrated on directly productive facilities rather than on infrastructure and upon "key industries" within the industrial sector. Investment was channeled in ways that would augment Japan's international competitive power. These measures were implemented in conjunction with import protection of the entire spectrum of Japanese infant industries. As can be seen in the statistical record of Japan's foreign trade performance during the period 1955-1980, a remarkably rapid evolution occurred in the commodity composition of Japan's exports. With the combined benefit of tax incentives and import protection, as well as other subsidies and privileges, potential export industries became active exporters. These included not only capital-intensive industries (such as steel and petrochemicals) but also labor-intensive industries which involve a high degree of processing (such as automobiles, electronic equipment, and apparel). In the structural transformation of exports, textiles were progressively displaced by exports of machinery and equipment.

In the administration of tax incentives to industry, two guiding principles were utilized. First was the "income elasticity criterion" with regard to the development of potential export industries. Industries to be favored were those in which the elasticity of export demand was high in relation to real world income. Second was the "comparative technical progress criterion" which selected for development those industries susceptible of a high degree of technical progress, even though at the outset they lacked international competitive power.[13]

During the period of high economic growth (1950-1973), government guidance in Japan was designed to shift the structure of production away from products embodying a high proportion of imported resources and to develop industries in which domestically added value was predominant. Capital formation in such industries, moreover, embodies a high degree of technical innovation. Special tax measures were designed both to encourage saving and to impel the "virtuous circle" interaction between the growth of investment in selected industries and the growth of exports. The steel and machinery industries were prominent early beneficiaries of the special tax measures and became star

performers in the virtuous circle process.

As the industrial structure evolved, benefits of the special tax measures, principally tax-free reserves and initial and accelerated depreciation allowances, were extended from key industries to a wide variety of targets, including pollution control and diverse social objectives. Whatever the extent of such diversification may be, the Japanese government has been defensive about the U.S. attack on its "targeting" policies. It has maintained that with regard to depreciation allowances, the accelerated cost recovery system (ACRS) adopted in the United States in 1981 constitutes a more favorable depreciation system than the one existing in Japan on that date. Japanese tax credit for research and development is extended to the extent of 20 percent of R&D spending in excess of the previous maximum expenditure for that purpose incurred by the taxpayer (the maximum credit being limited to ten percent of the taxpayer's return).

Since the mid-1970s, some tax subsidies for industrial production and for exports have been phased out. With unfortunate timing, the Japanese government expanded its social security commitments just prior to the first oil crisis. This added to the fiscal burden of the national railroads, the rice subsidies, and health insurance, the three demons that haunt the Ministry of Finance. Thus it became necessary to raise tax revenue at the very time when the decline in the growth rate made tax collections more onerous. (Of course, business — especially big business — remains a favored client of the government and continues to receive benefits not necessarily associated with the tax system.) At the present time, a controversy is being waged between Keidanren [Japan Federation of Economic Organizations] and the Ministry of Finance concerning the level of corporation taxes, in which Keidanren maintains that Japanese corporations are more heavily taxed than those in the United States. This controversy symbolizes the new state of events in Japan.

Regardless of the recent rise in the level of taxation, the aggregate burden of taxes in relation to GNP is still substantially less in Japan than in the United States. Moreover,

important subsidies for saving remain intact, including the explicit and implicit tax allowances for interest income. It is notable that a high rate of private saving has continued to prevail in Japan even after the rate of capital formation declined following the oil crisis of 1973. This saving has enabled the Japanese government to finance its deficits without inflation and may be one of the reasons for its acquiescence in tax evasion on interest income. It is striking that the level of taxation is lower and the level of saving higher in Japan than in the United States. This may help account for the fact that Japan's diminished rate of growth since 1973 still exceeds the growth rate of the United States.

FOOTNOTES

[1]Two econometric studies suggest that special tax measures have been fairly effective in raising the level of investment. See C. Tait Ratcliffe, "Tax Policy and Investment Behavior in Postwar Japan" (Ph.D. thesis, University of California, Berkeley, n.d.), and Soshichi Kinoshita, "Investment Behavior and Postwar Tax Policy," Gendai Keizai [Contemporary Economics], vol. 5 (June 1972), pp. 180-98. Cited in Joseph Pechman and Keimei Kaizuka, "Taxation", in Hugh Patrick and Henry Rosovsky (eds.), Asia's New Giant (Washington, D.C.: The Brookings Institution, 1976), p. 368.

[2]In 1953, for example, favorable tax treatment was accorded to business by means of exemption of income from the transfer of securities, tax deductions on export income, authorization of a system of tax-free reserves against export losses, a tax exemption system on key products, expansion of a bankruptcy reserve fund, and other devices. Professor Takafusa Nakamura remarks, "Needless to say, these measures promoted capital accumulation, and they became the basis of the subsequent business tax system." Takafusa Nakamura, The Postwar Japanese Economy (Tokyo: University of Tokyo Press, 1980), p. 45.

[3]See Yutaka Kosai and Yoshitaro Ogino, The Contemporary Japanese Economy (New York: M. E. Sharpe, Inc., 1984), p. 114; also Kazuo Sato, "Japan's Savings and Internal and External Macroeconomic Balance", in Kozo Yamamura (ed.), Policy and Trade Issues of the Japanese Economy (Seattle and London: University of Washington Press, 1982), p. 156.

[4]Cited in Takafusa Nakamura, op. cit., p. 97.

[5]Cited in Miyohei Shinohara, Industrial Growth, Trade, and Dynamic Patterns in the Japanese Economy (Tokyo: University of Tokyo Press, 1982), p. 159. Shinohara also presents objections to various other versions of the life-cycle hypothesis.

[6]Nakamura, op. cit., p. 98.

[7]Sato, op. cit., p. 149.

[8]Cited in Yasusuke Murakami, "Toward a Socioinstitutional Explanation of Japan's Economic Performance", in Kozo Yamamura (ed.), op. cit., pp. 31-32.

[9]Joseph Pechman and Keimei Kaizuka, "Taxation", in Patrick and Rosovsky, op. cit., pp. 354-357. In the same volume (pp. 451-458), see also the extensive list of tax incentives for export promotion prepared by Lawrence Krause and Sueo Sekiguchi.

[10]Nomura Research Institute, NRI Quarterly Economic Review, January 1982, p. 9.

[11]A "Green Card" system designed to reduce tax evasion by means of unauthorized multiple tax-exempt savings accounts was supposed to have been inaugurated beginning January 1, 1984. However, due to the public outcry against it and the fear of a capital exodus from Japan, implementation was "postponed" for five years.

[12]Miyohei Shinohara, op. cit., p. 27. The others are as follows: low interest loans by quasi-governmental financial institutions; import restrictions by means of duties, non-tariff barriers, etc.; coordination of investment in plant and equipment; promotion of economies of scale and improvement of production efficiency by merger and other combined production; deferment of trade and capital liberalization measures; and other administrative guidance.

[13]cf. Shinohara, op. cit., pp. 24-25.

Representative LUNGREN. Thank you very much.

I know we will get some disagreement here along the line. One of the things in the whole industrial policy debate that at least became clear to me was that those who tried to look at Japan as sort of a blueprint for the United States failed to understand that Japan was in a rather unique situation following World War II, and there was a clear blueprint for them to follow, and that was the United States.

The consensus was rather easy to go to or gain because almost everybody knew what they wanted to be. They were an industrial power before they were devastated by World War II. They wanted to regain that. They followed the United States.

Today, we have a little different situation. There is no blueprint for the future that any particular No. 1 country has that every other country can look at. We are in a race with the Japanese. So to merely look at them and say let's borrow MITI and let's borrow this or that is inappropriate. Nonetheless, when we look to Japan, there tends to be an emphasis by many of us in policymaking positions on MITI, or certain trade policies, or at what is viewed as protectionist policy, in trying to elicit overwhelming conclusions from those elements, and very, very little credit, in my estimation, has been given to tax policy.

So, Mr. Lincoln, obviously you have a slightly different point of view. If I could sum up your position, it would be that you're damning the concept of the usefulness of tax incentives for saving and investment with faint praise. I don't think I have overstated that.

You suggest that the tax incentive approach used by the Japanese Government did not cause the high growth that we saw, but it was at least consistent with the high growth strategy. Do you suggest it had nothing to do with it or it was insignificant or, as Mr. Hollerman suggests and other authors have suggested, that we just can't measure it?

Mr. LINCOLN. Certainly to some extent we can't measure it. The way I would put it would be that Japan was in a situation where it lagged considerably behind the industrial countries so that the profits to be gained at the private corporate level and the profits in terms of economic growth to be gained at the national level from the importation and adaption of foreign technologies in industry were tremendously high. If that condition had not prevailed, I doubt that the tax incentives would have been able to produce any major increase in the rate of Japanese growth, so that the cause of growth is not favorable taxation.

As to whether one wants to call that a terribly significant decision or a fairly minor one, we probably all could come up with different statements and mean the same thing. In some sense, it was very important that the Japanese government did choose to allow the private sector to take the ball and run with it, but I guess I see that as less significant than a policy that could be said to generate growth.

Representative LUNGREN. I understand what you're saying. Maybe it is just a matter of emphasis, but I suppose one could also come back and say that if you didn't have the tax system which allowed that to happen, it wouldn't have happened. It would have interfered with it.

Mr. LINCOLN. That's true. I suppose it depends on to what extent you could develop any tax system that interfered with it.

Representative LUNGREN. Some of us think we do a pretty good job here.

Mr. LINCOLN. My guess would be that even without a tax system that was as favorable as the one the Japanese developed, there still would have been fairly rapid growth in Japan, because the demand for investment was really very strong and it would have taken considerable disincentives in taxes to have abated that.

Representative LUNGREN. Mr. Wheeler, would you agree with that?

Mr. WHEELER. Well, I would come down somewhat more positive on the importance of not just tax policy but the entire policy process as evaluating essentially all policy actions for whatever reason against the goal of growth. Mr. Lincoln made the point about the terrible environmental problems of the late 1960's and early 1970's in Japan. Japan proceeded to institute some of the most severe environmental regulations in the world, much more severe on some items than the United States.

Representative LUNGREN. They weren't the only country that noticed it. We discovered it about the same time.

Mr. WHEELER. But when the Japanese did so they introduced these regulations with accelerated depreciation measures and with special loans from the Japan Development Bank for the promotion of industries to make equipment for this. The whole policy mechanism of the country was designed not necessarily coherently or in some massive meeting, but there was a process of providing tax policies, financial policies, and other policies to offset the costs that the new regulations imposed upon business.

Representative LUNGREN. Let me ask you this way. Are you suggesting that when they looked at the problem confronting them with respect to pollution and how they were going to deal with it, that they tried to fashion solutions within a framework of understanding or appreciation of their bias toward savings and investment?

Mr. WHEELER. I would say overwhelmingly so. I would argue that one characteristic of the Japanese economy well into the 1970's—this is less true today than it was in the early part of the 1970's—that essentially all policy actions were weighed first against economic growth, and savings and investment, in terms of the effect that these other actions they were doing for domestic reasons had on those goals.

Representative LUNGREN. My final question is, does it make a difference and did it make a difference?

Mr. WHEELER. My bottom line is yes.

Representative LUNGREN. Mr. Hollerman.

Mr. HOLLERMAN. Tax policy, explicit and implicit, made an enormous difference. Moreover, I think the attention to pollution in Japan was not a distraction or an impediment to the growth process. In fact, overcoming the problem of pollution made a contribution to that process. You can't say that just because the Japanese broadened the focus of their tax incentives to include pollution that they lost sight of the growth objective. Actually, the attempt to overcome pollution was a contribution in itself to achieving growth.

Representative LUNGREN. Well, in response to my question about whether it made any difference in terms of having this background and this continuing approach toward saving and investment—and I don't know if you call it shoe-horning in—but somehow trying to make the attack on pollution compatible with that bias——

Mr. LINCOLN. In general, if there is something of importance here, I would say it comes from an intangible that I think Jim Wheeler has alluded to, that the combination of policies alerts the private sector. Because they are involved in the discussions that conclude which societal goals are important, acceptable, or desirable, I think this eases or encourages the movement of resources in those directions. In the 1950's and 1960's the Japanese Government was saying grow, and people got the idea. Maybe they needed to be told particularly, or a consensus developed on pollution. I think it's true that the development of pollution controls in Japan is not necessarily inconsistent with continued economic growth, especially if we define economic growth in a broader sense as the welfare of the people.

Although measured GNP growth has been slower in the 1970's and 1980's in Japan, I am not at all convinced that the annual increase in the welfare of the Japanese people has been that much slower because of the shift in resources.

Representative LUNGREN. Mr. Lincoln, let me ask you this question. Do you believe the tax incentives for saving have had any positive impact on the savings rate in Japan? Are we unable to determine whether that's the case?

Mr. LINCOLN. I think we are unable to determine what that impact is. The research which I have seen tends not to find any relationship.

Representative LUNGREN. Let me ask you this then. To what do you attribute the high savings rate? We all acknowledge that there is a relatively high savings rate compared to the United States. Mr. Hollerman has mentioned a number of other elements. What would you pick out of that list or do you have your own list?

Mr. LINCOLN. I don't think I would pick any single item out of that list. As Professor Hollerman just pointed out, you can take any single item and find fault with it. Somewhere, though, in the combination of those items I think comes the answer, that there are a great many factors involved in causing Japanese savings and if we were to rank those, I guess I would put taxation somewhere near the bottom, and certainly not at the top.

Representative LUNGREN. So then you would discount whether their tax policy could be used for some guidance in trying to increase the savings rate in the United States?

Mr. LINCOLN. I would tend not to look to them as an example for what we ought to do. I hate to say that. As a personal matter, I would love to have some tax incentives for savings, although, as I think happened in Japan, I would take those incentives to guide the manner in which I saved rather than to make decisions about the overall level of savings that I would be involved in.

On the other hand, again from looking at the standpoint of the personal sector, I don't think that those incentives could hurt. If nothing else, it would be a signal to the American public that saving is a good idea and there may be some impact there other than the direct monetary impact.

Representative LUNGREN. Mr. Hollerman.

Mr. HOLLERMAN. I would suggest since we lack many of the other policies which the Japanese do have in order to promote investment in economic growth, that therefore the role of tax incentives for saving in this country should probably be given more weight than my colleagues attribute to it in Japan.

Representative LUNGREN. Mr. Wheeler.

Mr. WHEELER. Well, I think that one point Ed brought up is probably more important than he gives it credit for, that even if total savings doesn't change much, the distinction between savings in the form of real assets and savings in the form of financial assets can be very important. In a system as biased as the United States toward borrowing and consumption there is a tendency—consistent with the Friedman permanent consumption hypothesis—to save in the form of land, in the form of durable goods, and various kinds of real assets. You borrow and hold for appreciation.

In the Japanese system this is not the bias. There is a bias against borrowing and for saving. Even in the housing case, the Japanese bias is to create a savings package in advance of buying the housing asset. The fact that there's a strong incentive to buy housing in both societies is not surprising, but the fact is that in the United States there's an incentive to borrow up front and pay that asset off over time and save in the form of capital appreciation. In Japan, you do the saving up front and then buy the house.

I think a change in the bias of the system may not change total savings if we included U.S. savings in real assets, but may in fact shift savings toward financial assets, increasing the supply of funds in capital markets which is one of our current problems.

Representative LUNGREN. The Japanese system is certainly more dedicated to a high growth strategy than what we have now.

Mr. Hollerman, in your prepared statement you debunked some of the more important cultural reasons often given for the Japanese high savings rate. In your judgment, can we say that tax incentives are more important than the cultural reasons often given for Japan's high savings rate?

Mr. HOLLERMAN. Yes, we certainly can. Moreover, one thing that is clearly agreed on is that tax incentives for investment as distinguished from savings have been very effective and I think in that regard we can further appreciate the example of the Japanese.

Representative LUNGREN. Mr. Wheeler. I don't mean to skip over you, Mr. Lincoln, but you already told me you think it's one of the most insignificant ones.

Mr. WHEELER. I would rate incentives for investment as being a bias toward investment but not a strong bias on the investment side.

The proportion of tax saving, so to speak, if the various kinds of measures just don't contribute that much to cash flow. In a highly leveraged firm, small improvements in cash flow have more importance than in the United States where firms are less leveraged. So it's a little hard to compare the exact effect. Any change in cash flow through tax incentives is an aid to a highly leveraged firm, so I would rate tax incentives as important but not overwhelmingly important, given the other factors for growth. But again, the improvement in cash flow in highly leveraged firms is important. That's why venture capital is so important in the United States.

Representative LUNGREN. Mr. Hollerman, you indicated that the Japanese society is not an egalitarian society.

Mr. HOLLERMAN. Yes.

Representative LUNGREN. It's not egalitarian politically compared to the United States and that the system there does promote policies which do benefit those in the upper income groups. What lessons does it

give us with respect to the savings attitude of those that are not rich, the savings attitude of the worker as we like to call him?

Mr. HOLLERMAN. I think the lesson is that the Japanese Government has attempted to provide an environment within which economic growth can proceed effectively. Their environment is much different from ours. Within our environment I think the role of the saving incentive would actually have a more positive role than it does even in theirs because of the reasons that have been mentioned.

Representative LUNGREN. I guess what I'm getting at is this: I have been interested, as I'm sure all you panelists are interested, in what we can do to fashion public policy to encourage savings and investment, but not just in the overall sense of encouraging savings and investment for a high growth strategy, which I think is extremely important, but also in terms of encouraging it all throughout the system, including those of moderate income. And are there lessons that you would think that we have learned or not learned from the Japanese experience which would assist us in that regard? For instance, we have mentioned the worker account and you have indicated that they are not involuntary—it's a contractual agreement and it's something that they do.

We have our IRA's. We try to find out how they are working. Part of the problem is penetrating the consciousness of average American workers to let them know that they have that opportunity. The previous spokesman we had for the GAO suggested that at this point in time it was their feeling that the worker account was not that significant.

First of all, is that a proper observation? And second, is there anything we could take out of that that might indicate to us that in fact you can encourage a greater participation in the savings world by the worker on the assembly line or the worker in the lower incomes?

Mr. HOLLERMAN. Saving on the part of U.S. workers would be greatly stimulated by tax incentives of the type available in Japan. In Japan itself, however, I don't believe there's any published record of who are the depositors in most of the savings system of that country. We don't know what proportion of them are workers and what proportion are not workers.

Mr. WHEELER. That's quite true. The fact of the abysmal failure of the green card, the attempt to introduce the so-called green card system a couple years ago in Japan, is testimony as to how politically unpalatable a registration system for these illegal savings was. It was pushed, very high profile, very, very active political pressure to introduce this, and it disappeared in a very embarrassing way for the government.

To go back to the discussion about employee contribution savings compared to other savings schemes are relatively small, say compared to Postal Savings System or others, partly because they are long-term contracts. You are signing a commitment to contribute so much on a periodic basis for years—short contracts are 3 to 6 years and long contracts are 7 years or more—during which you essentially do not have access to those funds, whereas you can go into a long-term trust account and keep under 3 million yen in each account and get tax-free and funds that you have immediate access to. So the access is much easier.

The advantage of these employee schemes are that they have a bigger base and if you're saving for a house they offer the extra advantage. So in terms of the precise details, some of the administrative work is more difficult, but they're a more rigid system than some of the others.

For example, an IRA with lower penalties for emergencies may have a bigger incentive for increasing IRA use in the United States than anything like the employee contribution plan in Japan.

I think that contract saving is small, despite having fairly significant inducements for saving probably has a lot to do with how flexible it is compared to the other options available to the saver.

Representative LUNGREN. Everybody has indicated that it's fairly well known that you have the illegal approach to lowering tax rates in Japan primarily through the Postal Savings account and other tax-favored accounts. Can we take that to mean that the toleration of these multiple tax savings accounts can be regarded as a conscious component of Japanese tax policy? If it's as widespread as the three of you suggest, it seemingly results in a lowering of effective tax rates.

Mr. WHEELER. It does lower tax rates and, as I said, the one very serious attempt to introduce a system to register those accounts just met with abysmal political failure. So there are people in the country who would like to correct this problem, including many in the Ministry of Finance, to reduce the rather serious deficits in the Japanese budget, but they have been unable to do so.

Representative LUNGREN. Mr. Wheeler, in your prepared statement you noted that the Japanese believe their tax credit research and development has had a positive effect. First of all, I would like to ask whether the two other witnesses have any comments on that in terms of the impact of the tax credit for R&D in the Japanese system.

Mr. LINCOLN. Well, I would assume that it does have some positive impact, but what I would come back to is that that impact is no different than the impact we would expect in the United States, that in fact at the present time, although the tax treatment of R&D may change in both countries, the United States does provide a somewhat more generous treatment of R&D than does Japan.

I might add also that, although Japan has now come up close to the levels of R&D spending relative to GNP that we have in the United States, they certainly haven't surpassed us and there's continued talk in Japan about not having enough R&D and the need to foster more, and very often the United States is a model in that.

Representative LUNGREN. It just strikes me that it ought to be something we're concerned about, considering the expiration of the R&D tax credit next year. If we're relatively even now, considering the advantageous position regarding Japanese tax treatment of R&D, maybe our credit is something we ought to be very careful about eliminating.

Mr. WHEELER. Well, the Japanese have extended that temporary measure at least once, if not twice. Being part of the special taxation measures, it's almost automatic sunset legislation and it terminates after a certain length of time, but it's been extended at least once and I think it's been extended a second time in the belief that it supports an important national goal which is research and development.

Representative LUNGREN. Well, I want to thank the three of you for appearing here today. It's getting around noon and I don't want to hold you much longer. You have been generous with your time. We have, as I suggested earlier, just scratched the surface on this. It's an inquiry that I think is important for our committee and for the entire Congress. I think we have to be somewhat cautious about immediately saying there's a lesson to be learned that's immediately transferable from another country here, but when I see a great deal of discussion maintaining itself in the Congress and in other councils about how we compete and continue to compete with Japan, and when I see a lot of attention given to virtually every other element of that nation and very little given to the whole question of tax policy, it strikes me as deficient thinking, to say the least.

You have helped us begin that inquiry. I want to thank you for it and I hope perhaps sometime in the future we might call upon you again to give us the benefit of your expertise and your analysis. Thank you for being with us today.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

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