TAX REFORM AND CORPORATE TAXATION: INDUSTRIAL POLICY IN JAPAN AND THE UNITED STATES

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Corporate taxation has a major impact on competitiveness through its effects on after-tax rates of return and thus the incentives to invest in various corporate activities. Corporate taxation is a potentially powerful instrument of industrial policy and one that is used to some extent by all industrial countries. Industrial policy has been defined in various ways. It is here taken to refer to the use of government policy instruments that have a distinct differential impact on the allocation of productive resources across industries. Over time the use of these instruments affects growth or rationalization in particular industries or sectors of the economy. Industrial policy can include not only policy instruments that have a limited application to specific industries but also macroeconomic or general policy instruments that create substantially different supply-side effects across industries.

This article examines corporate income taxation as an instrument of industrial policy. It has two major goals. First, through a summary of the systems of corporate taxation in Japan and the United States as they evolved to the mid-1980s, the paper compares the use of corporate taxation as an instrument of policy toward industry in the two countries. This topic is taken up in section I, where the general tax systems are discussed and the major features of corporate taxation are described. The role of corporate taxation as a policy instrument is explored by focusing on the effective rate of taxation of corporate profits. The conclusions of this discussion are that, by the early 1980s, effective rates of corporate taxation were substantially higher in Japan than in the United States and

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that the variation of tax rates across industries and assets was substantially lower in Japan than in the United States.

The second and more important goal is an examination of the process of revising the tax system as an example of the process of forming industrial policy in the two countries. Section II provides an overview of the typical process of tax revision in each country. Section III provides an extended discussion of efforts in the mid-1980s toward a major reform of the tax systems in both countries. The last section of the paper discusses the implications of the comparisons of taxation and tax reform efforts.

Given the definition of industrial policy adopted, the article shows that both countries have such a policy and that both use tax policy to some extent as an instrument of industrial policy. In both countries decisions about the use of tax policy as an instrument of industrial policy are influenced by both concepts of the national interest and special-interest politics. Both countries make only limited use of tax policy as an instrument of industrial policy, but the reasons for the limited use differ somewhat. In Japan a rather coherent framework for applying industrial policy exists and could be used to guide such use of tax policy. However, the increasing importance of other policy goals and the continuing government budget deficits severely limit this use. In the United States no conceptual framework for pursuing an activist industrial policy exists. Decisions to implement tax (and other) policies that benefit certain industries are ad hoc. In addition, American tax policies are subject to rather abrupt shifts, and the use of tax policies to benefit certain industries sometimes involves the use of general tax rules that create other unintended effects across industries.

The comparison demonstrates other differences between Japan and the United States in the formation of economic policy. Power is diffused in the United States, with Congress playing a major role. In Japan power resides largely in the ministries, although the complexity of the loci of power appears to be increasing. Policy conflict in the United States is often manifested in Congress, where lobbying by special interests can overwhelm broader national economic interests. Policy conflict occurs largely between (and within) ministries in Japan. The process is also subject to special-interest pressures in Japan, and the Liberal Democratic Party increasingly is influencing some outcomes. Close business-government cooperation in the area of taxation is not now evident in Japan. Nonetheless, Japan has not experienced the wide swings in corporate tax policy that have occurred in the United States. The decline in the use of tax policy as an instrument of industrial policy has been rather gradual in Japan.

Acceptance of open conflict is greater in the United States than in Japan, and this difference appears to influence differences in both the processes and the outcomes of the tax reform efforts in the two

countries. The outline of the tax reform package in the United States changed substantially several times during the process of enactment, but the acceptance of conflict eventually resulted in the enactment of a comprehensive reform. The outline of the proposed tax reform package in Japan was known for several years and changed little during this time. However, a failure to achieve consensus on one of the major elements of the package delayed its enactment. After open conflict developed, the package was withdrawn, and instead a more limited package, including only two of the four original major elements, was enacted in 1987.

I. TAX SYSTEMS AND CORPORATE TAXATION IN JAPAN AND THE UNITED STATES

The United States and Japan have highly developed systems of taxation. In order to provide a framework for the subsequent discussion of corporate taxation and tax reform efforts in the United States and Japan, this section begins with an overview of the tax systems of the two countries as existed in the mid-1980s.[1]

Table 1 shows the major sources of tax revenues (for all levels of government combined) in each country for selected years from 1955 to 1983. In the United States the individual (or personal) income tax raised about a third of total tax revenues, and its share has been rising slowly. In 1955 corporate income taxes accounted for a fifth of all tax revenues. This share fell to a tenth by 1980, and the tax reduction of 1981 resulted in this share falling to about a twentieth by 1983. Social security contributions have risen dramatically since 1955, while the shares of property, inheritance, and gift taxes, and taxes on goods and services declined somewhat.

In Japan individual income taxes accounted for about a fourth of all tax revenues, although this share was somewhat lower in the 1960s. Corporate taxes accounted for about a fifth of tax revenues, and this share has been rather steady since 1975. Social security contributions also rose dramatically in Japan since 1955, while the share of property, inheritance, and gift taxes has been rather stable. The share of taxes on goods and services, all of which fell on specific items, declined dramatically after 1955. There was no broad-based tax on goods and services in Japan at either the national or local level.

Table 1 also shows tax revenues as a share of gross domestic

1. A detailed discussion of the American tax system and corporate taxation can be found in J. PECHMAN, FEDERAL TAX POLICY (4th ed. 1983) [hereinafter PECHMAN]. For a discussion of the Japanese tax system, including corporate taxation, *see* Pechman & Kaizuka, *Taxation*, in ASIA'S NEW GIANT (H. Patrick & H. Rosovsky eds. 1976) [hereinafter Pechman & Kaizuka] or TAX BUREAU, [JAPAN] MINISTRY OF FINANCE, OUTLINE OF JAPANESE TAXES (1985).

Table 1: Distribution of Tax Revenues As Shares of Total Tax Revenues and Total Tax Revenues as Shares of GDP, United States and Japan, 1955-83 (in Percentages)

Country and Share	*1955*	*1960*	*1965*	*1970*	*1975*	*1980*	*1983*
United States: Shares of Total Tax Revenues							
Individual Income	33.09	32.70	30.53	35.20	32.98	36.94	37.12
Corporate	20.29	17.17	15.81	12.71	10.79	10.17	5.52
Social Security	11.03	14.38	16.40	19.30	24.48	26.14	28.71
Property, Inheritance, and Gift	13.49	14.28	15.31	13.61	13.28	10.08	10.62
Goods and Services	22.10	21.47	21.94	19.19	18.47	16.67	18.02
United States: Tax Revenues as Share of GDP	23.63	26.51	26.31	29.79	29.63	30.35	29.03
Japan: Shares of Total Tax Revenues							
Individual Income	24.49	17.10	21.68	21.46	23.90	24.31	25.57
Corporate	18.40	28.04	22.20	26.29	20.65	21.81	19.62
Social Security	12.71	13.82	21.78	22.30	28.99	29.11	29.95
Property, Inheritance, and Gift	9.86	9.31	8.07	7.58	9.09	8.19	9.39
Goods and Services	33.95	31.53	26.25	22.36	17.31	16.34	15.20
Japan: Tax Revenues as Share of GDP	17.09	18.19	18.35	19.71	21.00	25.91	27.71

Source: Adapted from Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1984 (1985), Tables 3, 11, 13, 15, 21, 23, 25, 112, 113, 115, 116.

product (GDP). The share has risen in both countries since 1955. In 1955 the share was substantially lower in Japan, but by 1983 the shares were nearly equal.

Table 2 shows the distribution of tax revenues by type of tax and by level of government for both countries in 1983. Central (federal or national) government taxes accounted for sixty-nine percent of tax revenues in the United States and seventy-four percent in Japan.

This article focuses on taxation at the federal or national level. This is the major part of taxation in both countries. In the United States each state and many localities control their own taxes. Any consideration of American taxation at the state and local level thus is very complex. In Japan most prefecture and local taxes are subject to control at the national level, and many are uniform throughout the country. Although consideration of prefecture and local taxes thus would be manageable for Japan, this article maintains symmetry by focusing on national taxes. In both countries tax reform efforts in the mid-1980s focused on the federal or national level of taxation.

Table 2: Distribution of Tax Revenues, Central Government and State and Local Government, United States and Japan, 1983 (in Percentages of Total Tax Revenue)

Country and Tax	Central	State and Local
United States	69.26	30.74
Individual Income	31.16	5.96
Corporate	4.00	1.52
Social Security[1]	28.71	—
Property, Inheritance, and Gift	0.65	9.97
Goods and Services	4.73	13.29
Japan	74.26	25.74
Individual Income	17.69	7.88
Corporate	12.74	6.88
Social Security[1]	29.95	—
Property, Inheritance, and Gift	3.26	6.13
Goods and Services	10.61	4.59

[1]All social security contributions attributed to the central government.

Source: Adapted from Organization for Economic Cooperation and Development, Revenue Statistics of the OECD Member Countries, 1965-1984 (1985), Tables 137, 148.

A. Individual Income Taxation

Before examining the systems of corporate taxation in the United States and Japan, several features of the individual income tax in each country as of the mid-1980s, especially those provisions affecting saving and the after-tax return on financial investments, should be mentioned. In the United States a major feature of the personal income tax was the deductibility of interest expenses, especially interest on mortgages. Several other features of the tax system, including a lower rate for taxing realized long-term capital gains, tax-deductible and tax-deferred individual retirement accounts (IRAs), and a limited exclusion for dividends received, favored saving and financial investment. Nonetheless, it appears that the American system favored current consumption, personal borrowing, and home ownership.

In Japan the individual income tax allowed a deduction for interest expenses only against non-interest investments and business income and only if the indebtedness was incurred to finance the investments or business. Several features of the system favored saving and financial investment. Interest received on various small-sized savings accounts, postal savings accounts, and certain other finan-

cial investments was exempt from taxation. A tax credit existed for special savings deposits to be used for housing purchases, and high-income individuals could elect to have taxable interest and dividends received taxed separately at rates lower than their marginal tax rates on other income. A tax credit of ten percent (reduced to five percent for high income individuals) applied to dividends received. Although other realized capital gains were taxable, capital gains on securities transactions were not taxed. Thus, the individual tax system in Japan favored saving by enhancing the after-tax returns to various financial investments.

B. Corporate Taxation

Corporate taxation began in the United States in 1909 as an "excise on the privilege of doing business as a corporation." Currently the corporate income tax is usually justified as a separate tax either because the corporation is viewed as managed by its officers and directors, and thus not actually controlled by its shareholders, or because protection is needed against the avoidance of personal income taxation through the use of a corporation.

Taxation of corporate profits began in Japan in 1899. A major reform occurred in 1940, and another in 1950. The reform in 1950 was based on the recommendations of the Shoup mission during the Occupation. Several recommendations were of major importance to corporate taxation. Based on modern public finance economics, the mission recommended that the corporation should be viewed as an aggregation of shareholders and not as an independent taxable entity. In principle, the corporate tax was then a prepayment of the individual income tax, and an attempt should be made to minimize double taxation of corporate income. The mission also recommended substantial reductions of the large number of special tax treatments of different sectors, industries, and firms that existed at that time. The reform of 1950 did eliminate most of the special tax treatments, but a large number of tax breaks (often called "special taxation measures") were introduced into the tax system during the next two decades.

The Japanese tax system has had several features to reduce the double taxation of corporate income. The individual income tax exempts capital gains on securities transactions and offers a tax credit for dividends received. In addition, a lower corporate tax rate for the portion of income paid as dividends was instituted in 1961.

Corporate taxation in both the United States and Japan involves a complex set of provisions. The next sub-sections provide an overview of the major features of corporate taxation in these two countries as of the mid-1980s, focusing on provisions relevant to industrial policy or to efforts toward tax reform in the mid-1980s.

1. Statutory Tax Rates

Changes in statutory rates of taxation of corporate profits have occurred periodically in both the United States and Japan. In 1979 the top tax rate in the United States became 46%, with four lower rates (15, 18, 30, and 40%) applying to income brackets for smaller amounts of profit.

Japan has a split-rate system. In the mid-1980s large corporations were paying a rate of 42% plus a 1.3% surcharge on profits that are retained, and a rate of 32% plus a 1.3% surcharge on profits that are paid to shareholders as dividends. The surcharge was enacted as a temporary two-year measure in 1984, but was extended in 1986. Smaller corporations with smaller profits paid 30% plus a 1% surcharge on retained profits and 24% plus a 1% surcharge on profits paid out as dividends. Lower tax rates also applied to cooperatives and public interest corporations, such as corporations set up to pursue joint research and development (R&D) or corporations used to coordinate disinvestment in declining industries.

2. Depreciation

The tax rules applying to allowable depreciation have a major impact on the determination of taxable profits and thus on the amount of corporate income taxes paid. Before 1981 depreciation allowed by the American tax system was based on the concept that an asset should be depreciated over its useful life. Various rules also permitted depreciation to be accelerated in relation to this useful life. In 1981 a major change occurred with the adoption of the accelerated cost recovery system (ACRS). Four broad categories of assets were recognized under ACRS. Automobiles, trucks, and R&D equipment were depreciated over a three-year period, most other equipment over a five-year period, long-lived utility equipment, railroad tank cars, and coal utilization equipment over a ten-year period, and buildings and certain other long-lived equipment over a fifteen-year period (subsequently increased to nineteen years). Thus, the depreciation period became largely unrelated to, and generally shorter than, an asset's useful life. The change in 1981 was partly justified as an adjustment for inflation, but the arbitrary shortening had no real relation to the issue of inflation.

In Japan the useful life of an asset guided the period used for depreciation, based on a set of about 400 asset categories whose useful lives were last subjected to a full-scale review in 1966. A corporation could apply to alter the depreciation period if the useful life was expected to be shorter than that shown in this set.

Special accelerated depreciation for designated plant and equipment was one of the tax breaks available to Japanese corporations. This tax break was used to stimulate the purchase of particu-

lar types of assets and the list of designated plant and equipment was revised periodically. The goals pursued and the types of plant and equipment promoted have been diverse.[2]

3. Investment Tax Credit

The United States adopted a general investment tax credit (ITC) in 1962. This provision, although ended temporarily several times, was made "permanent" in 1981. Under the 1981 law assets eligible for three-year depreciation under ACRS received a six percent ITC. Other depreciable assets received a ten percent ITC, but most buildings were not eligible for an ITC. The amount of ITC that could be claimed was limited according to the tax owed. Under the 1981 law the full value of the asset could be used to calculate depreciation, but changes enacted in 1982 required a reduction of the asset value for depreciation by one-half the amount of the ITC received.

Japan had no general ITC, but as of the mid-1980s a specific ITC applied to investment in certain equipment related to energy conservation or pollution reduction by declining industries and by certain small and medium-sized enterprises. This ITC was also limited according to the tax owed.

4. R&D Expenditures

Most R&D expenditures can be treated as current expenses rather than capitalized and depreciated, in both the United States and Japan. In 1966 Japan introduced a tax credit for the increase in R&D expenditures over the largest previous amount spent.[3] As of the mid-1980s the credit was twenty percent of the increase, limited to ten percent of the income tax otherwise owed. In 1981 the United States introduced a tax credit of twenty-five percent for increases in R&D expenditures over the average of the expenditures in the three previous years, with no limit.[4]

5. Tax-free Reserves

Deductions for reserves in excess of the amounts justified by

2. See the discussion in JAPAN ECONOMICS INST. OF AM., JAPAN'S INDUSTRIAL POLICIES: WHAT ARE THEY, DO THEY MATTER, AND ARE THEY DIFFERENT FROM THOSE IN THE UNITED STATES? (1984) or T. PEPPER, M. JANOW & J. WHEELER, THE COMPETITION: DEALING WITH JAPAN (1985) [hereinafter PEPPER].

3. PEPPER, *supra* note 2, includes a discussion of a rough and probably overly generous analysis done by the Japan Science and Technology Agency of the effects of this credit.

4. See Eisner, Albert & Sullivan, *The New Incremental Tax Credit for R&D: Incentive or Disincentive?* 37 NAT'L TAX J. 171 (1984) for a more skeptical analysis of the effects of this type of tax credit. *See also* Mansfield, *The R&D Credit and Other Technology Policy Issues*, 76 AM. ECON. REV. 190 (1986), and the references cited therein.

the economic situation of an industry are tax breaks permitted under certain circumstances in both countries. In the United States the major beneficiaries have been financial institutions. In Japan tax-free reserves have been used more widely. As with special depreciation, the goals pursued and the industries benefiting in Japan have been diverse.[5] For instance, as of the mid-1980s tax-free reserves were offered for the early repurchase of computers and for the guarantee of software, two reserves with a clear relationship to the promotion of high-technology industry. But other tax-free reserves were related to environmental protection, nuclear power, and other energy development. Indeed, tax-free reserves were used most intensively by several Japanese industries outside of the manufacturing sector, namely financial institutions, public transportation, and utilities. Their use by financial institutions has been declining.[6]

6. Export Promotion

Substantial tax breaks for exporting existed in Japan from 1953 to 1972.[7] Almost no incentives existed as of the mid-1980s—the exception was that small and medium-sized enterprises could set up tax-free reserves related to overseas market development. In addition, a special deduction was permitted in relation to foreign sales of technical services.

In 1971 the United States instituted a tax break for exports, the Domestic International Sales Corporation (DISC). In 1984, in response to findings that DISC violated the General Agreement on Tariffs and Trade, the United States replaced it with the Foreign Sales Corporation, which acted as a tax incentive for American exports by permitting American corporations to shelter part of their American export profits in foreign affiliates.[8]

7. Other Provisions

Several other provisions of corporate taxation in the United States should be mentioned. As of the mid-1980s, net losses in the

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5. See the discussion in PEPPER.

6. *See* Ikemoto, Tajika & Yui, *On the Fiscal Incentives to Investment: The Case of Postwar Japan*, 22 DEVELOPING ECONOMIES 372 (1984) [hereinafter Ikemoto]; Ishi, *Corporate Tax Burdens and Tax Incentives in Japan*, in GOVERNMENT POLICY TOWARDS INDUSTRY IN THE UNITED STATES AND JAPAN (J. Shoren ed. 1988) [hereinafter Ishi].

7. For an analysis of the effects of these incentives, see Okita, *Japan's Fiscal Incentives for Exports*, in JAPANESE ECONOMY IN PERSPECTIVE (I. Frank ed. 1975).

8. See Horst & Pugel, *The Impact of DISC on the Prices and Profitability of U.S. Exports*, 7 PUB. ECONOMIES 73 (1977) for an analysis of the effects of DISC on American exports. See Lee & Bloom, *Deficit Reduction Act of 1984: Changes in Export Incentives*, 20 COLUM. J. WORLD BUS. 63 (1985) for a comparison of DISC and the Foreign Sales Corporation.

United States could be carried back three years and carried forward fifteen years. In Japan losses could be carried back one year and carried forward five years, but the carryback provision was temporarily ended (for two years) beginning in fiscal year 1984, and this curtailment was extended in 1986.

In 1981 the United States adopted rules to facilitate leasing used to transfer tax benefits (such as the ITC) between corporations, but such leasing was limited somewhat by further changes in 1982. Also, the United States has imposed a minimum tax (of fifteen percent at the margin) to prevent excessive use of the various preference items permitted under United States tax law. For a variety of technical reasons, this minimum tax was not particularly effective.

Special tax rules applied to energy and natural resources in the United States, with immediate expensing of exploration and development costs and percentage depletion applying to a number of extraction activities. In Japan various special tax-free reserves, deductions, and exemptions promoted prospecting, developing, and extracting foreign natural resource deposits.

C. Effective Corporate Tax Rates

The complexity of the corporate tax provisions makes it difficult to determine their effects on after-tax rates of return and on investment decisions. A useful summary measure of the effects of the corporate tax system used by many researchers is the effective rate of taxation of corporate economic profits. Such effective rates can be measured and evaluated at the aggregate level for the entire corporate sector, or they can be used to compare the effects of the corporate tax system across different industries. The aggregate analysis is often used to analyze the effects of corporate taxation on aggregate real investment and on the macroeconomic performance of a country. The comparison across industries is often used to analyze the effects on the composition of real investment across industries. Although the latter is more clearly related to issues of industrial policy, both are related to the overall industrial performance of the country. In addition, any comparison of corporate taxation between countries is further complicated by differing concepts and definitions used in the systems of corporate taxation in different countries.

Various features of the tax system create effective rates of corporate taxation that differ from statutory rates. In the United States accelerated depreciation and the ITC were especially likely to reduce the effective rate below the statutory rate, with other provisions having a smaller impact at the aggregate level but some importance in creating variations across industries. In Japan the

various tax breaks applicable to corporations could have an impact both at the aggregate level and across industries.

While no data exist that provide a perfect comparison of effective corporate tax rates in the United States and Japan, a reasonable comparison at the aggregate level can be obtained using data drawn from each country's national income accounts. The strength of this data is that definitions are very similar between the two countries, but the weakness is that the items measured do not conform exactly to the economic concepts desired. Table 3 provides one measure of average effective rates of taxation of corporate income at the aggregate level, namely corporate taxes as a share of corporate operating surplus, for the United States and Japan from 1971 through 1983.

Table 3: Corporate Taxes As a Share of Corporate Operating Surplus, United States and Japan, 1971-83 (in Percentages)

Year	United States	Japan
1971	38.15	28.92
1972	37.18	26.85
1973	39.19	32.69
1974	42.97	51.78
1975	36.55	47.61
1976	38.91	40.38
1977	36.69	43.33
1978	36.32	40.96
1979	36.00	43.13
1980	35.32	42.15
1981	29.27	46.02
1982	24.94	47.91
1983	25.53	51.20

Source: Adapted from Organization for Economic Cooperation and Development, National Accounts, 1971-1983, Detailed Tables, 41, 67 (1985).

The following conclusions seem reasonable given the information shown in Table 3. In the early 1970s the effective rate of corporate taxation was lower in Japan than in the United States. In 1974 Japan enacted a general increase in corporate taxation, and at about the same time it began to curtail many tax breaks benefiting Japanese corporations. The rates shown for 1974 and 1975 may be biased somewhat by the recessions that occurred in both countries at that time, but by the late 1970s the effective rates of taxation were roughly the same in the two countries and perhaps even slightly higher in Japan. The 1981 tax reduction in the United States and especially the introduction of ACRS caused a substantial decline in

effective tax rates in the United States. By the early 1980s the average effective tax rate in Japan was substantially higher than that in the United States.

This analysis is confirmed by the results of other studies that use somewhat different methods and sources of data.[9] Joseph Pechman estimates that United States federal corporate taxes as a percentage of corporate profits were greater than 40% for each year between 1951 and 1961, greater than 30% but less than 40% for each year between 1962 and 1973, greater than 20% but less than 30% for each year between 1974 and 1981, and only 13% in 1982. Thus, by the early 1980s the various tax breaks available under United States law were large enough to lower the effective tax paid on corporate profits to rates substantially below the statutory rates.

In contrast, revenue losses from tax breaks benefiting corporations in relation to corporate taxes paid in Japan are estimated to have been 28.6% in 1955,[10] 9.0% in 1972, 4.9% in 1976, 2.2% in 1980, and 3.2% in 1985.[11] There were several reasons for the reduction in the number and revenue effect of these tax breaks. First, large government budget deficits developed after 1973, and reductions in tax breaks were part of the general efforts to reduce the deficits. Second, a number of the policy goals used to legitimize certain of the tax breaks were achieved, so that opposition to their repeal was strengthened. For instance, by the early 1970s it was evident that the tax breaks for exporting were no longer needed, and in this case foreign governments also pressured Japan to end the breaks. Various studies, for instance one by Yukio Noguchi in 1985, conclude that tax breaks toward corporations are now relatively unimportant at the aggregate level. In Japan the effective rate of corporate taxation is now very close to the statutory rate.

A number of studies of the variations of effective corporate tax rates across industries exist for the United States and for Japan. The various American studies find noticeable differences across industries and types of assets, especially after the 1981 tax cut. This variation resulted from the large and largely arbitrary shortening of depreciation periods in relation to useful asset lives incorporated in ACRS and from the interaction of ACRS with the ITC. The 1981 tax cut thus provided a large tax bias in favor of investment in

9. For two comparative studies, see J. GRAVELLE, COMPARATIVE CORPORATE TAX BURDENS IN THE UNITED STATES AND JAPAN AND IMPLICATIONS FOR RELATIVE ECONOMIC GROWTH (Congressional Research Service Report No. 83-177E) (1983) and Kubouchi, *Tax Burden on Corporate Income: An International Comparison*, 87 KEIDANREN REV. 9 (1984).

10. ADVISORY COUNCIL ON JAPAN-U.S. ECONOMIC RELATIONS, JAPAN-U.S. BUSINESSMEN'S CONFERENCE, UNDERSTANDING THE INDUSTRIAL POLICIES AND PRACTICES OF JAPAN AND THE UNITED STATES: A BUSINESS PERSPECTIVE 99 (1984).

11. Data from Japan Ministry of Finance as reported in Ishi, *supra* note 6, at 99, 102.

equipment in comparison with buildings, and favored some kinds of equipment much more than others. In fact, investments in certain assets incurred negative tax rates; an economically profitable investment would also result in a lowering of taxes paid on the return to a corporation's other profitable investments.

A major study by Fullerton and Henderson (1985) calculated the effective long-run corporate tax rates on marginal investments for eighteen broad industries.[12] Under the 1980 law the average effective tax rate for these industries was 42.0%, with a high rate of 48.4%, a low rate of 28.4%, and a standard deviation of 4.2 percentage points. Under the 1981 law the average fell to 33.7%, with a high of 43.3%, a low of 13.2%, and a larger standard deviation of 7.7 percentage points. The tax increase enacted in 1982, especially the reduction of the asset value used for depreciation by half of the ITC, reduced some of this variation, but differences across specific assets and industries continued to exist. Under the 1982 law the average effective tax rate for the eighteen industries was 37.2%, with a high of 44.0%, a low of 25.4%, and a standard deviation of 4.8 percentage points.

Studies of variations in corporate taxation across Japanese industries, although not fully comparable to American studies, conclude that by the late 1970s differences across industries were very small.[13] Depreciation periods in Japan were rather closely related to an asset's useful life, and many tax breaks had been curtailed or ended by the late 1970s.

In conclusion, the studies summarized above suggest that corporate tax policy may once have been a major instrument of industrial policy in Japan but that its importance has declined substantially. By the early 1980s, corporations in Japan were subject to relatively high effective rates of corporate taxation, and these rates were relatively uniform across industries. Tax breaks continued to act as incentives to certain activities and investments, but the scope of this promotion is closely circumscribed and its intensity generally mild.

In contrast, in the United States effective corporate tax rates fell in the early 1980s, and important variations arose across assets and industries. Some of this variation were intended; certain tax breaks applied only to specific industries or assets, and general tax rules that create tax breaks, such as ACRS, were written to benefit certain industries or assets more than others. However, these gen-

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12. Fullerton & Henderson, *Long-Run Effects of the Accelerated Cost Recovery System*, 67 REV. ECON. & STATISTICS 363 (1985). Another important study is A. AUERBACH, CORPORATE TAXATION IN THE UNITED STATES (Brookings Papers on Economic Activity) 451 (1983).

13. *See* Ikemoto; Ishi, *supra* note 6.

eral rules also created unintended, and sometimes unexpected, benefits for other industries and assets.

II. OVERVIEW OF THE PROCESSES OF TAX REFORM

Taxation is by its nature controversial. The tax system has different impacts on different groups, including different industries. It influences individual behavior and decision-making as well as the performance of the national economy. Various groups may desire changes in the country's tax system, and they attempt to enact revisions.

Tax revision follows a typical process in the United States and Japan, and the discussion of the current tax reform efforts in these countries is best understood within the framework of each country's typical process. This section briefly describes the typical process of revision in each country. The discussion makes clear the considerable amount of open debate that occurs in the United States, with important roles played by the President and by Congress. Informal discussions to achieve consensus on desirable changes, to the contrary, are of major importance in Japan, and the formal role of the Diet is typically minor.

A. The Typical Process of Tax Revision in the United States

Revisions to the tax code have been made regularly in the United States. Pechman identifies twenty-two major tax bills enacted along with many lesser bills between 1948 and 1982.

Most major bills follow a similar process toward enactment.[14] The President and his administration usually initiate a tax revision bill, although occasionally Congress does so. The President may decide to pursue such a bill for any of a number of reasons: the state of the economy or some of its sectors, requests from various constituents, or his broad philosophical beliefs, among others. The Treasury Department has the major responsibility for preparing a recommendation to Congress. Preparation often begins months before a recommendation is sent to Congress.

The staffs of various government agencies, both within and outside of the Treasury Department, contribute to the preparation. The Treasury Department may also call upon consultants from outside the government, and it receives input from various groups that might be affected by the changes. The Secretary of the Treasury keeps informed of the progress of the work and makes the final decision on the program given to the President.

The President makes the final decisions on the recommendations and discloses them to Congress and the public. Disclosure of

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14. *See generally* PECHMAN, *supra* note 1, at 30-49.

a major tax revision sets off a public debate. Various groups examine the recommendations and discuss their desirability from the point of view of their own interests or the public interest. The forces of support and opposition are rather clearly defined by the time Congress begins to discuss the proposals formally.

Article I, Section 7 of the United States Constitution states that "[a]ll bills for raising revenue shall originate in the House of Representatives . . . ." This formal requirement can be satisfied even though the Senate actually leads the process; however, the House usually does begin the Congressional consideration of a tax bill.

The House Ways and Means Committee has jurisdiction over all tax bills, as well as bills regarding the national debt, foreign trade, social security, and various other social programs. The Committee begins its formal consideration of a tax bill by holding public hearings. The first witness is the Secretary of the Treasury, and the next witnesses often come from other executive agencies, including the Office of Management and the Budget, the Council of Economic Advisors, and the Federal Reserve Board. The Committee then hears witnesses from various private groups who request the opportunity to testify. These witnesses usually discuss the bill from the point of view of their own "special" interest, objecting to some provisions, suggesting modifications to others, or proposing additional provisions. The length of these hearings varies, but may take several months. At the same time, various groups pursue less formal contacts (lobbying) with the Committee members and their staffs to try to influence the bill reported by the Committee.

After the hearings are concluded, the Committee moves to a mark-up session to draft the actual bill to be considered by the House. Technical assistance comes from the staffs of the committee members and often from the Treasury Department. Once decisions on the contents of the bill are made, the legislative counsel of the House supervises drafting these decisions into legislative language. It is a painstaking effort because the bill must be explicit, unambiguous, and administrable. The Committee also prepares a detailed report providing an analysis of the bill's provisions, their rationale, and estimates the bill's impact on tax revenues. Minority views may also be contained in this report.

The entire House usually considers the tax bill under the "modified closed rule," under which the allowable amendments and alternatives to be considered are only those approved beforehand by the Ways and Means Committee. Given these restrictions, debate of the bill is usually brief. At the end of the debate, a motion is usually made to send the bill back to the Ways and Means Committee for further consideration. If this fails, the House votes on any

amendments and then conducts a vote on the bill. If approved, the bill is sent to the Senate.

In the Senate, the Committee on Finance has jurisdiction over tax bills, in addition to bills concerning foreign trade, health, social security, veterans' affairs, and other finance matters. The Committee begins its formal consideration of the tax bill with public hearings. The Committee hears many of the same witnesses, including the Secretary of the Treasury. These witnesses may focus on the House bill, suggesting certain modifications, deletions, or additions. Various groups also attempt to influence the Committee members by lobbying. After the hearings the Committee moves into a markup session. The Committee usually drafts a bill that is different from the House bill. The Committee then sends its draft bill and detailed report to the full Senate.

In Senate debate of the Committee bill, there is no limit placed on discussions or amendments. Many amendments are usually offered, and the debate is often long. Administration officials and Senate leaders are active in attempting to defeat unacceptable amendments, many of which are obviously responsive to special interests, and otherwise to modify the bill to their liking. The Senate votes on the various amendments, some of which pass, and votes on the entire bill. If the vote fails, the bill is sent back to the Finance Committee or abandoned.

If the bill passes, the Senate version is usually different from the House version. The House usually adopts a motion not to accept the Senate version. A Conference Committee is then appointed by the speaker of the House and the president of the Senate, based on the recommendations of the chairmen of the tax committees from each chamber. Each chamber has one vote on the Conference Committee, with each vote determined by the majority of the Committee members from that chamber.

The Conference Committee is formally charged with eliminating the differences in the two versions but may go beyond this in seeking a version acceptable to both chambers. The Committee members use their own staffs and Treasury staff. The formal sessions are open to the public, but much occurs informally in an effort to shield decisions from interest group pressure. Among those attempting to influence the outcome are the President and his administration. Agreement is usually achieved, and a Conference Report is issued showing and explaining the changes accepted. After some discussion, both chambers almost always approve the Report and send the bill to the President.

Various executive agencies and departments analyze the bill and submit statements to the Office of Management and Budget, which summarizes the major issues for the President. The Presi-

dent considers and discusses these issues. He usually signs the tax bill into law and issues a statement about the bill. The date of effectiveness varies and can be retroactive. The executive branch then prepares new regulations, forms, and related materials to administer the new law.

A veto of a tax bill is rare because the administration has been continuously involved in the legislative process. If the President does veto the bill, he issues a statement explaining his reasons for doing so. Congress then may attempt to override the veto by a two-thirds majority of each chamber, attempt to revise the bill and send it again to the President, or abandon the tax revision effort for the time being.

B. The Typical Process of Tax Revision in Japan

Revisions to the tax code have occurred almost annually in Japan, as part of the process of enacting a budget for the next fiscal year. The enactment of tax revisions follows a regular process.[15] The major participants in this process include the Ministry of Finance (MOF), especially its Tax Bureau, the government's Tax Commission (GTC), the Tax Commission of the Liberal Democratic Party (LDPTC), the Prime Minister and the Cabinet, and the Diet.

During the summer the various ministries consider possibilities for changes in the tax code that they will recommend to the MOF. The ministries focus on tax issues of direct interest to the groups that fall within their purview, and they also examine the implications and indirect effects of other possible changes on these groups. For instance, in the Ministry of International Trade and Industry (MITI), industry bureau chiefs receive suggestions from the representatives of business federations and trade associations and obtain comments from these groups on possible tax changes being considered by MITI or other government bodies. The bureau chiefs decide which recommendations to send to the Business Activity Division, the coordinating office for tax (and other) matters in MITI. This office conducts further study and discussion in order to reach decisions on which proposals to send to the MOF.

By September the various ministries have sent their suggestions and proposals to the Tax Bureau of the MOF. The career officials of the Tax Bureau discuss these proposals with the ministries and various interest groups. In the fall the Tax Bureau presents a report to the GTC. The report includes various points of view and opinions, but it also makes clear the preferences of the MOF as to desir-

15. *See* Pechman & Kaizuka, *supra* note 1, for a discussion of this process.

able tax revisions. For instance, the MOF recently has successfully opposed most MITI suggestions for new special taxation measures.

The GTC, established in 1955, is composed of about thirty regular members appointed by the Prime Minister. It may also have ad hoc and economist members, also appointed by the Prime Minister. The ad hoc members can attend all meetings and express opinions; they are thus nearly equal to the regular members. The regular and ad hoc members include journalists; academics (especially authorities on public finance); former national and local government officials; labor unionists; representatives of large corporations, small and medium-sized enterprises, and agriculture; and others. The diversity of occupations and interest groups is deliberate. The GTC attempts to act as an arbiter among interest groups and a developer of a viable political consensus on desirable tax revisions.

The GTC takes up discussion of the recommendations and options presented by the Tax Bureau. The GTC uses the Tax Bureau for staff work such as data and analysis, and it also occasionally uses ad hoc committees or panels of experts. The level of discussion is often not technical, and there appears to be at most a minor impact of rigorous quantitative economic studies of tax issues. The Tax Bureau actively promotes the positions favored by the MOF, but the GTC also discusses the proposals with other government ministries and agencies or receives their views through one of the members of the commission. For instance, the views of MITI may be transmitted through the business representatives. The GTC also receives input from other groups, again often through its members and the opinions they express. The GTC occasionally holds public hearings, but these are not frequent or wide-ranging. By December the GTC sends to the Prime Minister its recommendations for tax revisions to be included in the budget for the next fiscal year. Its recommendations are usually similar to those advocated by the Tax Bureau.

At the same time that the GTC is discussing the annual tax revisions, the LDPTC is also doing so. The LDPTC receives the Tax Bureau report on recommendations, options, and opinions. It has no independent staff but uses the Tax Bureau as an informal staff. It receives input from various constituents and interest groups. This lobbying is qualitatively different from the lobbying that occurs in the United States. In Japan lobbying is not usually done by professionals. It is more informal and based on old acquaintance and long-term relationships. In addition, money contributions may play a larger role in Japan in gaining attention and influence; at the least, it is unlikely that money is of less importance. In its decisions the LDPTC is apparently more responsive to interest groups that are closely allied to the LDP than is the GTC, even

though the GTC is appointed by the Liberal Democratic Prime Minister.

By December the Prime Minister receives the recommendations of the GTC and the LDPTC. The Prime Minister and the Cabinet discuss these recommendations. By January 1 they must reach a final decision on the tax revisions to be included in the budget for the next fiscal year, which starts April 1. This process forces the tax revisions to be considered as part of the overall budget. The tax revisions usually include some changes in special taxation measures. Increasingly in the last decade, the LDPTC recommendations have been chosen over those of the GTC when the two differ. This pattern seems to reflect the GTC's failure to forge a viable political consensus and the LDPTC's consequently successful defense of its proposals as politically necessary. For instance, the LDPTC in recent years has successfully opposed the curtailment of the tax exemption on physicians' earnings from the national health insurance system, a revision that has been proposed several times by the GTC.

The budget is then submitted to the Diet, which must enact a new budget, including any tax revisions, by April 1.[16] The House of Representatives is the first to consider the budget bill. Most debate takes place in the Budget Committee, composed of fifty members distributed by party in proportion to the overall composition of the house. Visitors and observers attend only with the permission of the Committee. The Management Committee sets the date and time at which the entire House considers the bill and the order in which speakers take the floor to discuss it. If the bill passes the House of Representatives, it is sent to the House of Councilors, where a similar procedure is followed. The Budget Committee of this House is composed of forty-five members, who are distributed according to the party composition of the House.

If the House of Councilors passes a bill different from that passed by the House of Representatives, or if it fails to pass a bill, then a joint committee is set up to work out a compromise, or a second vote by two-thirds of the House of Representatives can enact the bill. Because the LDP has had working control of both Houses since its formation in 1955, such procedures have not been used since the 1950s. More importantly, a budget bill becomes law if passed by the House of Representatives, regardless of the action taken by the House of Councilors. After being enacted by the Diet, the new budget and the tax revisions which it contains go into effect on April 1, the beginning of the new fiscal year.

16. The role of the Diet and the process of enacting a bill are described in Matsui, *The Diet*, in THE DIET, ELECTIONS, AND POLITICAL PARTIES (About Japan Series No. 13) (1985).

Although the LDP has working control of both Houses, the opposition parties can resort to a variety of delaying tactics to register opposition to a bill. In response to such delaying tactics, the LDP can use railroading tactics. It may move for termination of deliberations and a vote in the relevant committee or unilaterally call the bill before the full house, attend the session alone, and pass the bill. The LDP can also call for an interim report on the bill by the relevant committee to the full house, and then force a vote on the bill. The opposition usually boycotts not only the session at which the controversial bill is considered but also subsequent sessions for some or all of the remainder of the Diet term.

Such forcing of a vote by the LDP generates negative public opinion, as it represents a departure from the practice of reaching a consensus through discussion and compromise. Consequently, the LDP usually fashions bills so that they obtain at least the informal acceptance of most of the opposition parties, or it amends controversial bills to gain this acceptance.

Given these practices, the real work in designing the budget is done before the budget bill is formally submitted to the Diet. The LDP settles any differences with the opposition parties in informal discussions. Even if the opposition parties publicly oppose the provisions of the budget, the LDP can design provisions that the opposition parties will quietly or implicitly accept.

III. TAX REFORM EFFORTS IN THE MID-1980S

The United States and Japan were both in the process of enacting major tax reforms during the mid-1980s. This section describes these efforts.

A. The United States

Politicians in the United States regularly announce that they favor tax reform to simplify the federal tax system and to increase its fairness. In August 1982 two Democrats, Senator Bradley and Representative Gephardt, introduced a bill calling for the elimination of many tax breaks and a large reduction in general tax rates. By late 1983, strategists for the Republican Party began to worry that the Democrats might make taxation and tax simplification major issues in the 1984 election. In his State of the Union address in January 1984, President Reagan called for a study by the Treasury Department of major tax reform, with the report due after the election. This effectively neutralized the issue during the election, but during the year Reagan became more committed to seeking a major reform.

Following his landslide reelection, President Reagan made tax reform a top domestic priority of his second administration. This

full-scale revision of the Internal Revenue Code, the first since 1954, was to create a simpler and fairer system. He imposed two major constraints on the revision. First, the changes had to be revenue-neutral, given the large and continuing government budget deficits. Second, the changes should not be anti-growth or anti-business.

In late November 1984 the Reagan administration unveiled the Treasury report, known as "Treasury I," containing a plan for a major tax reform. The plan apparently was drafted by technical tax experts in the Treasury Department with little political guidance from the President or his close advisors. Some of the major features of this reform plan, as well as the corresponding information for the then-existing law and for subsequent versions of reform, are shown in Table 4.

Almost immediately after the plan was made public, a variety of groups and individuals attacked it. Reagan admitted that the plan was flawed and promised to revise it. In early 1985 James A. Baker III succeeded Donald T. Regan as Secretary of the Treasury and took charge of the revision.

The revised plan, known as "Treasury II," was released to the public on May 28, 1985. A comparison of the two plans suggests that Treasury I was fairly good economics and a substantial reform, but poor politics. Treasury II was more responsive to political concerns, but it was not a major simplification of the tax system. Nonetheless, as a reform it did have some economic value in that it would create a corporate tax system that was more nearly neutral across classes of investments, thus reducing the rather arbitrary variations introduced by the 1981 tax changes, especially ACRS.

By this time it was becoming clear that Reagan faced major political problems in his effort to enact tax reform. Republican members of both the House and the Senate appeared uninterested in tax reform. Thus, Reagan was forced to rely on the House Democrats, and especially on Dan Rostenkowski, the Chairman of the House Ways and Means Committee, to begin the process of enacting a tax reform.

In June and July, Treasury II served as the basis for public hearings in the Ways and Means Committee. Most witnesses (following Baker, the first witness) were opposed to Treasury II in some way. By August the administration had essentially abandoned Treasury II and instead looked to Rostenkowski to produce some bill from his committee. Drafting of the tax reform legislation began on September 17 and proceeded slowly. The committee finally approved the specific content of a bill on November 23. The tedious process of actually drafting the legal language of the bill was completed in early December.

The House bill retained a number of the features of Treasury II

Table 4: Selected Features of the U.S. Taxation System: Previous Law, Various Reform Plans and Bills, and New Law

	Previous Law	Treasury I	Treasury II	House Version	Senate Version	New Law
Top Personal Tax Rate	50%	35%	35%	38%	27%[1]	28%[2]
Top Capital Gains Tax Rate:						
Long-term	20%	35% with inflation indexing	17.5%	22%	27%[1]	28%[2]
Short-term	50%	35%	35%	38%	27%[1]	28%[2]
Top Corporate Tax Rate	46%	33%	33%	36%	33%	34%
Equipment Depreciation:						
Acceleration	ACRS	Almost none	Moderate	Somewhat	More thanACRS	Somewhat less than ACRS
Inflation Indexation	None	Full	Full	Partial	None	None
Investment Tax Credit	6-10%	None	None	None	None	None[3]
Incremental R&D Tax Credit	25%	25%	25%	20%	25%	20%
Special Treatment of Dividends	Personal Exclusion $100-200	Corporate Deduction 50%	Corporate Deduction 10%	Corporate Deduction 10%	None	None
Corporate Minimum Tax	15% Applies to Few Companies	None	20% Tougher	25% Tougher	20% Tougher	20% Tougher
Crude Oil and Natural Gas	Major Tax Breaks	Substantially Reduced	Reduced	Reduced	Largely Maintained	Largely Maintained

[1]In the income range in which the phase-outs of the lower rate and the personal exemptions apply, the effective marginal rate can be 32% or more.

[2]In the income range in which the phase-outs of the lower rate and the personal exemptions apply, the effective marginal rate is 33%.

Repealed retroactive to January 1, 1986.

but in a variety of ways provided even less simplification. For example, the House bill was 1357 pages long.

It was estimated that the House bill would result in an increase in corporate taxes and a tax cut for individuals of about $140 billion over the first five years. The estimated shift under Treasury II would have been somewhat smaller, $118 billion.

Most business organizations began lobbying against the House bill, stressing that the tax reform diverted attention from the major issue confronting the nation, the fiscal budget deficit. They also in-

dicated that the changes would reduce incentives for investment and reduce economic growth. However, some other business organizations supported the bill because they would benefit from the general lowering of tax rates.

In early December Reagan urged the Republican representatives to vote for the committee bill so that it could be sent to the Senate, but on December 11 the House defeated a motion to adopt the standard procedure of limiting debate and ruling out any amendments offered from the floor. Only 14 of 182 Republicans voted yes.

Reagan intensified his lobbying of the Republican House members. On December 16 he sent a letter to Republican representatives, urging them to vote for the House bill, and promising to veto any reform bill eventually sent to him if it did not meet several conditions. Simplification was not one of the conditions. In essence, Reagan was asking the Republican representatives to vote for a bill that he himself promised to veto if it ever reached his desk.

These efforts changed the votes of some Republican representatives, and on December 17 the House voted again and approved the procedures. Later that day, after the Republican alternative and the motion to send the bill back to the Committee both failed to pass, the House approved the tax reform bill by voice vote, and the bill was sent to the Senate.

In January 1986 the Senate Finance Committee began its consideration of a tax reform bill. Many Committee members remained unconvinced of the need for reform. The chairman, Republican Robert Packwood, had previously stated that he liked the tax code as it was. He believed in using tax breaks to advance various social and economic goals, and he had sponsored or supported enactment of many of the existing breaks.

The Committee held public hearings in late January and February. Most witnesses opposed or expressed concern about various aspects of the House bill.

In March Packwood issued a reform plan to the rest of the Committee members and made it public. Among its features was a new category of depreciable assets, "productivity property," that would permit more accelerated depreciation for certain equipment used in certain industries. The stated objective of this change was to enhance the international competitiveness of various industries, but some observers suggested that some of the equipment or industries were included for political reasons.

In drafting sessions in early April the Committee voted to retain many tax breaks for industry and individuals. By April 18 the bill had become so loaded with tax breaks that Packwood was compelled to withdraw it. The efforts toward tax reform were in danger

of coming to a halt. Packwood decided that something drastic had to be done. On April 24 Packwood unveiled a new plan to reduce the maximum personal tax rate to twenty-five percent and to eliminate almost all tax breaks for personal taxpayers. Other Committee members viewed the plan as too radical, and Packwood withdrew it.

On April 29 Packwood presented a third plan that lowered the top personal tax rate to twenty-seven percent, eliminated a number of personal tax breaks, but maintained certain others that had strong political support. A core group of six other committee members, three Republicans and three Democrats, endorsed the plan. A key member of this group was Senator Bradley, a Democrat; the plan was very similar to the bill that he and Gephardt first introduced in 1982.

The Committee began to meet behind closed doors, violating Senate rules requiring public hearings. The shift away from the first version of the bill was so sudden that many lobbyists were not able to react effectively to protect their interests. The Committee adopted a rule that any revenue-losing amendments to the bill must specify how the revenue would be regained.

Based on this strategy, the Committee unanimously voted on May 7 to adopt the plan as the reform bill. It survived largely intact, although concessions to maintain certain tax breaks for oil and gas drilling were accepted to gain the support of several senators from oil-producing states.

The full Senate began its debate of the tax reform bill on June 4. An informal rule was accepted that any amendment that proposed a change that reduced revenue had to indicate the source of additional revenue to offset the loss. A few minor amendments were passed, but many others were defeated or withdrawn. On June 24 the Senate passed the bill, with the only no votes cast by three Democrats.

The Senate version would have increased corporate taxes and lowered personal taxes by about $100 billion over its first five years, an amount less than that suggested by the House version. Whereas the House version would have made minor changes in personal income taxation and major changes in corporate taxation, the Senate version would have done the opposite. Neither version would have been a simplification of the tax code. The Senate version of the bill was almost 3000 pages long, and the taxation of corporate income would have become noticeably more complicated.

The Conference Committee to reconcile the two versions of the tax reform bill began its deliberations on July 17. At first the Conference Committee made no progress. Rostenkowski and Packwood then met alone for four days and nights to complete a reconciled version. On August 16 the Conference Committee ap-

proved the basic tax reform bill, but various transition rules were not completed until September 18. The bill was about 2000 pages long. As shown in Table 4, in many of its features the new law is based more on the Senate version than on the House version. The bill is expected during its first five years to reduce personal income taxes and to increase corporate taxes by about $120 billion.

In late September the House and the Senate each approved the conference bill with little debate. Efforts to draft corrections and additional transition rules continued but eventually failed. On October 21 President Reagan signed the tax reform bill into law. Most of its provisions became effective on January 1, 1987, and some have gradual phase-in periods.

B. Japan

The need for a major tax reform, the first since 1950, has been under discussion in Japan for several years. An important aspect of the discussion has been the belief that the tax system is no longer equitable, for wage earners are treated differently from those who run their own businesses and there is widespread tax evasion by certain groups. This belief in relation to the individual income tax is evident in the expression "9-6-4." Employed workers pay taxes on ninety percent of their income, the self-employed and the owners of small businesses on sixty percent of their income, and farmers on forty percent of their income. There is also widespread concern that businesses inflate expenses or understate revenues in order to show losses or at least little or no profit.

The discussion in Japan had proceeded on the basis that the tax reform probably would include four major elements. These four elements were cuts in the rates of individual income taxation, an end to (or at least a tightening of the rules concerning the use of) the exclusion from taxation of interest earned on small savings deposits, reductions in corporate income taxation, and the introduction of a broad-based indirect tax. The reductions in individual and corporate income taxation were generally acceptable, but the other two changes were controversial, as were possible elimination or curtailment of a number of special taxation measures.

Consensus to curtail the tax exemption for small savings was slow to develop, and major interest groups were resisting any change at all. The Ministry of Posts and Telecommunications (MOPT) had been successful in deflecting past efforts by the MOF and the GTC to reform the tax-exempt savings system to reduce widespread illegal holding of multiple accounts. In addition, the end of the exemption was a politically unattractive change because most voters would experience a highly visible tax increase.

As in the United States, a major constraint imposed on the tax

reform effort in Japan was that the package should be revenue-neutral so that the government budget deficit would not become larger. However, the size of the reductions in individual and corporate income taxation would be much larger than any revenue increases resulting from the end to the small-savings exemption and the curtailment of certain other tax breaks. Thus, another source of revenue was needed, and the introduction of a broad-based indirect tax could provide this revenue. Discussion of such a tax had occurred in the past. Prime Minister Ohira suggested early in the 1979 election campaign for the House of Representatives that an indirect tax should be introduced in order to reduce the government budget deficit. The LDP then suffered a setback at the polls and failed to win a majority of the seats in the House. The Diet subsequently passed a resolution registering its opposition to a general consumption tax.

Because of these various controversial items, progress toward tax reform was slow, even though a variety of meetings took place and groups formed to seek a consensus. For instance, Prime Minister Nakasone and several other LDP leaders met with leaders of the business community in late 1984 to discuss tax reform. The business leaders included the chairman and the vice president of the Keidanren (an organization of top executives), the president of the Japan Chamber of Commerce and Industry, the chairman of the Japan Committee for Economic Development, and the president of the Japan Federation of Employers Associations. A shift in the positions of the business leaders seemed to occur. The Keidanren and the Japan Chamber of Commerce and Industry had been maintaining a policy opposed to any new taxes and supporting further restraint on government spending. Keidanren Chairman Inayama cited the need to bring about a fairer distribution of the tax burden, which was interpreted to mean that business would be willing to accept a broad-based indirect tax if other taxes were lowered. Chairman Gotoh of the Chamber stated more clearly a willingness to accept the introduction of a broad-based indirect tax. However, by March 1985 both organizations had reverted to their opposition to any new tax or tax increase.

In September 1985, Nakasone, after almost three years as Prime Minister, during which time he often discussed the need for a major tax reform, formally charged the GTC to study tax reform. He requested that the GTC submit an interim report in the spring of 1986 on the tax reductions to be included in the reform and a full report by fall 1986 outlining both tax reductions and tax increases. Nakasone announced that the major reform should be adopted as part of the budget for fiscal year 1987 (beginning in April 1987).

Nakasone was concerned about the manner in which the GTC would study and promote tax reform, so much so that he considered setting up a separate tax reform committee. Instead, he de-

cided to alter the GTC by adding ten more ad hoc members. The composition of the GTC in early 1986 is shown in Table 5. The distribution of newly appointed ad hoc members is particularly interesting. Rather than adding expertise to the Commission, Nakasone apparently was interested in adding business representatives who could work toward a business consensus and in adding media representatives who might influence public opinion in favor of the tax reform package that would eventually emerge from the commission. A peculiar omission is the lack of any representative on the GTC from the distribution industries, even though these industries were probably the clearest business opponents to any broad-based indirect tax.

Table 5: Composition of Japan's Government Tax Commission, Early 1986

		Ad Hoc Members	
Group Represented	Ordinary Members	Previously Appointed	Newly Appointed[1]
News Media	7	4	5
Former National Government Officials	4	4	1
Local Government Officials	3		
Large Corporations	5	1	3
Small and Medium-Sized Enterprises	1		
Labor Unions	2	0	0
Academics[2]	5	5	1
Other	3	4	0

[1]New appointments made in fall 1985.

[2]There are also twelve economist members who are all professors at various universities.

Other groups were also studying tax reform and preparing reports and position statements. In October 1985 the MOF submitted a report to the GTC prepared with the assistance of the National Institute for Research Advancement. The report suggested a reduction of individual and corporate income taxes and the introduction of a broad-based indirect tax. The advantages of the indirect tax would include not only the revenue generated but also the more equitable spreading of the tax burden because the tax would be difficult to evade. The disadvantages would be both the obvious political opposition to a new tax and the cost and complexity of administering it. Several other considerations were considered neu-

tral or unimportant. The tax would be applied to almost all products, including food. Any concerns about the possible regressiveness of such a tax were considered rather minor. The effect on saving—that is, the possibility that a consumption-based tax might further increase the high personal saving rate—was likewise considered to be of not much importance, partly because of the other tax changes, including the reduction in or end to the tax exemption on small savings. Nonetheless, there has been some ongoing discussion of the possible effects on saving behavior.

Also in October, a panel of tax experts appointed in March 1985 and chaired by former Finance Minister Tatsuo Murayama presented its interim report on tax reform to the LDP, for use by the LDPTC. The panel's recommendations were very similar to those in the MOF report.

In December decisions were made on the budget for fiscal year 1986. As had happened in the previous several years, expectation of a major tax reform in the near future was used as a basis for resisting major changes in the tax system for the next fiscal year. Therefore, only a few minor changes were included in the new budget.

In March 1986 a MITI advisory panel, in a report submitted to the GTC, stated that corporate taxes needed to be lowered because the tax burden on Japanese corporate income was higher than that in other industrial countries. The report called not only for an end to the surtax but also for a lowering of statutory rates. The report recommended an acceleration of the depreciation periods through a shortening of the useful lives recognized for tax purposes, and the restoration of full use of carry-forward and carry-back privileges by corporations showing losses. MOF auditing would prevent the abuse of these provisions. The report also called for the introduction, retention, or strengthening of several tax breaks, including incentives for investment, technology development, imports, and overseas investment. The report recommended the end of tax-exempt savings but did not take a position on the indirect tax. Some industries supervised by MITI opposed the tax, and this opposition prevented MITI from stating any position publicly.

Also in March, the Keidanren issued its position in support of a review of the entire existing tax system. The Keidanren was seeking a number of changes in corporate taxes, including general reductions similar to those contained in the MITI report but not any new special tax measures or incentives. The report also called for a reduction of individual income taxes on wage earnings and the end to tax-exempt savings and other unfair tax breaks. Although the Keidanren formally maintained its position favoring fiscal restraint without any tax increases, the report also stated that the system should accomplish a fairer distribution of the tax burden. The

Keidanren seemed again to be giving implicit support to the introduction of a broad-based indirect tax, although it could not say so directly because no consensus existed among its members. Indeed, some industry associations, especially those from the wholesale and retail distribution industries, were actively opposing the indirect tax, and no industry association was actively supporting this tax.

In late April the GTC submitted its interim report on tax reform, supporting the expected four basic elements. The LDPTC also adopted an interim report similar to that of the GTC. As interim reports, most details of the changes were not spelled out.

A double election for the Diet was held in early July 1986. Nakasone and the other LDP leaders hoped to avoid discussion of the indirect tax and other possible tax increases. This was presumably the major purpose for requesting the full report from the GTC in fall 1986. However, in the election campaign the opposition parties pressed the LDP on tax issues. Nakasone and other LDP leaders responded by issuing carefully worded statements that the LDP would not attempt to introduce any large-scale indirect tax opposed by the public. Several LDP leaders also indicated that the exemption for small savings would not be abolished. In the election the LDP won a large majority of seats. Subsequently, Nakasone received a one-year extension of his term as Prime Minister in order to allow him to complete the process of adopting the major tax reform and the other economic reforms that he supported.

In late October the GTC submitted its final recommendations for the major tax reform, including almost 3 trillion per year in individual income tax reductions, almost 2 trillion per year in corporate tax reductions, an end to tax-exempt small savings (to raise about 1 trillion per year), and a new broad-based indirect tax (to raise about 4 trillion per year). However, the GTC did not recommend a specific type of indirect tax but instead outlined eight alternative forms. In December the LDPTC approved its plan for major tax reform, similar in outline to that of the GTC, with two differences; the new tax on small savings was to raise almost 2 trillion per year, and the new indirect tax about 3 trillion per year.

Opposition to the proposed new indirect tax was severe. Some LDP Diet members, several local LDP chapters, and many business groups expressed opposition. Tens of thousands of people attended antitax rallies, and polls showed that four-fifths of the Japanese people opposed the indirect tax. In late January 1987 the opposition parties boycotted the Diet soon after it opened, shutting it down for five days.

Nonetheless, on February 4 the government submitted two packages of tax reform bills, including a complex new indirect tax. The complexity developed as the MOF sought to enhance support

for the tax by exempting small firms and fifty-one categories of items. The exemption for small firms was apparently poorly designed, for a larger total tax would be collected if a small, tax-exempt firm was in the middle of a chain of transactions. Nakasone argued that he had not broken his campaign promise since, because of the various exemptions, the indirect tax would be "medium-scale" rather than "large-scale."

After the LDP convened the Budget Committee of the House of Representatives to consider tax reform without the attendance of the opposition parties, these parties effectively closed the Diet for several weeks by boycotting all deliberations. With the beginning of the new fiscal year approaching, the LDP announced that it would hold hearings on the budget proposal. Nevertheless, the opposition renewed their boycott. Hearings finally began in late March, but the opposition delayed the budget bill, demanding the withdrawal of the indirect tax proposal. The government began the new fiscal year operating on a fifty-day provisional budget.

On April 15 the LDP railroaded the fiscal 1987 budget through the Budget Committee. The opposition then used various delaying tactics, including long speeches, no-confidence motions, and slow-motion voting, to prevent a vote on the budget in the full House. On April 23 Nakasone agreed to send the tax reform plan to an LDP-opposition committee for further study. The Diet then quickly approved the rest of the budget without debate.

In September the Diet approved a tax bill that included reductions in individual income taxes of 1.5 trillion per year and an end to the tax-exempt savings system. This bill did not include any major changes in corporate taxation or the introduction of a broad-based indirect tax. In October Noboru Takeshita became the new Prime Minister. He stated that tax reform, including a broad-based indirect tax, remained a major objective of the government.

IV. DISCUSSION AND CONCLUSIONS

The process of designing and enacting major tax reform has been difficult and lengthy in both Japan and the United States. In the United States the initial motivating objectives for pursuing tax reform were simplification and fairness. In Japan these were evasion-reduction and fairness. In each country changes in the tax laws produce immediate gainers and immediate losers. In addition, even those who benefit overall from the package of changes have an incentive to attempt to influence specific aspects of the package in their favor. Thus, different interest groups take different positions on the desirability and desirable form of the tax changes. Both countries were constrained by their large fiscal deficits, so that both were attempting to implement reform packages that were revenue-

neutral. In Japan tax changes are considered as part of the general process of defining the budget, whereas in the United States tax changes are debated as an item separate from the budget. This creates certain pressures in the United States. On the one hand, the two issues compete for the time and attention of congressmen, their staffs, and the public. On the other hand, there were some efforts to merge the two, or at least to use the tax reform effort to increase tax revenues and thereby reduce the budget deficit.

This article has presented an examination of taxation, tax revision, and efforts toward tax reform in the mid-1980s in Japan and the United States. Comparing and contrasting the experiences in the two countries shed light on a number of issues in the formation of industrial and other economic policies.

A. Industrial Policy

The discussion of corporate taxation and tax reform makes it clear that both Japan and the United States have an "industrial policy," although the American government does not usually use that term. In both countries tax policy has been used at times to influence the development, growth, competitiveness, or rationalization of various industries. In both countries decisions about the use of industrial policy intended to have differential effects across industries or sectors are influenced both by economic ideology and concepts of the national interest and by special-interest politics.

In Japan a conceptual framework for pursuing an activist industrial policy exists and has some coherence. Currently there is broad agreement that industrial policy should promote the development and growth of various high-technology (or knowledge-intensive) industries and assist the adjustment of declining industries.

However, a confluence of factors has reduced the effectiveness of industrial policy in Japan. Not only is business willing and able to be more independent of government guidance, but policies directed toward increasingly important goals other than economic growth and industrial restructuring compete for available government resources. Furthermore, the continuing government budget deficits in Japan have placed a severe limit on the growth of available government resources and have resulted in the reduction of many tax breaks in order to raise additional tax revenue without increases in general tax rates. Certain tax breaks and other aspects of the tax system are directed toward the two major current objectives of Japan's industrial policy. However, the tax system provides only a small amount of implicit subsidy to activities supported by industrial policy, and much of this is in the form of special depreciation, deferrals, and temporary reserves that provide the equivalent of interest-free loans rather than outright grants. Many other tax

breaks exist. Some of these are directed toward national objectives other than those of industrial policy, while others were created and are maintained largely in response to politically powerful special-interest groups.

In the United States there is no clear conceptual framework for the conduct of an activist industrial policy beyond broad macroeconomic policies intended to promote aggregate business investment or international competitiveness. Rather, the prevailing economic philosophy stresses the role of market forces in guiding economic developments and growth. Government intervention, especially into the activities of specific industries, is generally viewed with skepticism, both about its motivation and about its possible effectiveness. Lacking any clear framework, industrial policy in the United States is developed largely as an ad hoc response to specific problems and issues that arise. It is shaped largely by the pressures of special-interest politics, in competition with the prevailing philosophy of nonintervention.

Many of the industries that receive specific tax breaks in the United States maintain their benefits largely through the support of congressmen whose home districts or states are the locations of major production activities by these industries. In these cases, industrial policy is determined by regional special-interest politics. For instance, various tax breaks for oil and gas development can be related to American federal energy policy, but they remain controversial nonetheless. They were reduced very little in the federal tax reform, largely because of the political power of Senators from the producing states.

One potential new instrument of an active United States industrial policy surfaced in the discussion about tax reform. This was the concept of "productivity assets," certain equipment used in certain industries that would receive additional depreciation benefits. Charges that the concept was largely special-interest politics in disguise arose quickly, however, and the idea was dropped. Such charges are difficult to refute without a framework for industrial policy that implies criteria for choosing who should benefit.

In addition, the discussion of corporate taxation and tax reform indicates that policy toward industry is continuously shifting and changing in both countries. In Japan the change generally is gradual, as industrial and other economic policies are adjusted to such factors as the emergence of a larger number of important policy goals and the continuing budget deficits. The annual tax revisions impart a continual flexibility to the Japanese tax system and allow its ongoing adjustment to changing economic circumstances. Although this adjustment is often pursued effectively, some changes can be blocked by political considerations.

In the United States, policy toward industry in tax and other areas is subject to rapid, large changes. Not only did the 1981 tax changes bring a large decline in corporate taxes, but changes such as ACRS also created large changes in the relative tax positions of different industries. The incentives for investment in different industries were dramatically altered. Although some bias toward mature, capital-intensive manufacturing industries, the "smokestack" industries, was probably intended, benefits to other industries were largely unintended. Tax reform in the mid-1980s has resulted in a substantial increase in corporate taxation. The repeal of the ITC (which had been suspended several times in the past two decades but was supposedly made "permanent" in 1981) and the alteration of depreciation rules reduce the distortions in the incentives to invest in different assets and industries. This can be viewed as a return toward the position that the government should not in general pursue policies that alter the structure of the economy, but rather should allow competition in the capital and product markets to determine this structure.

The claim of close business-government cooperation often made about Japan is not supported by the examination of recent tax revisions and the tax reform effort in Japan. The various tax revisions enacted in the past two decades have resulted not only in the decline in the use of business tax breaks aimed at achieving particular industrial policy objectives, but also in the increase in the corporate tax burden to a level that is now high by international comparison. The portion of the tax reform enacted in Japan in 1987 included no reduction in corporate taxation.

Business in Japan has not been effective in taking a clear stand on tax issues. For instance, the inability to achieve a consensus on the acceptability of a broad-based indirect tax has reduced lobbying by the major business organizations to statements that the burden of corporate taxes in Japan is too high and should be reduced. This position has been inadequate to have a major influence on the reform package. In another case, there is broad agreement that depreciation should be accelerated through a general shortening of useful lifetimes. However, some industries could be harmed by a full-scale review if the useful lives of their plant and equipment are lengthened. These industries apparently offered some resistance to such a review. Given this, MITI had difficulty in formulating an acceptable proposal regarding the general acceleration of depreciation.

In the United States the 1980s have seen wide swings in the business-government relationship with respect to the tax system, and this occurred under a Republican president who had apparently not shifted his ideology. The 1981 tax changes provided such a large reduction in corporate taxation that there was discussion of

the de facto, if not de jure disappearance of the corporate tax. Reagan stated that he was in favor of abolishing the corporate income tax, calling it illogical and the equivalent of double taxation. Nonetheless, the tax reform proposals issued by his administration in 1984 and 1985 and the tax reform eventually enacted in 1986 reduce many of the tax benefits provided by the earlier changes and, on net, result in a large increase in corporate tax collections.

Lobbying by business in the United States is generally strong. However, members of the business community were split on the recent tax reform, with some supporting it and others opposing it either in its entirety or in some of its specifics. Indirectly, this split may have promoted the achievement of reform and the general raising of the corporate tax rate.

B. Power and Conflict

The loci of power in economic policy-making differ between Japan and the United States. In Japan the administrative bureaucracy has substantial power. This is evident in the primary role of the MOF in tax revision and reform efforts. The MOF is the collector and organizer of various tax proposals, as well as an effective advocate for the changes that it views as desirable. The MOF provides major reports to the two important tax commissions, the GTC and the LDPTC. The MOF also provides ongoing staff work for these two commissions.

However, a rising complexity in the loci of power is also apparent in Japan. The LDP politicians, including the LDP Diet members, are increasingly vocal and active in fashioning tax proposals that are politically acceptable to interest groups allied to the LDP. Individual LDP members and groups openly opposed aspects of the tax reform proposal submitted by the LDP government in February 1987. At the same time, the Diet itself is generally not an initiator or drafter of important legislation, and the Diet members have very small staffs. Therefore, they must rely on the ministries for staff work. Nonetheless, opposition parties, although in the minority, can block or slow down legislative change. The boycotts and slowdowns initiated by the opposition parties forced the withdrawal of the reform package in April 1987, based on adamant opposition to the broad-based indirect tax. The tax bill passed later in the year did not include this indirect tax.

In the United States power is more diffused, and Congress is stronger and more independent than is the Diet. Based on work by the Treasury Department, the President usually provides the initial proposal for a tax revision or reform. Congress then drafts and redrafts the proposal, usually at least three times, once in the House of Representatives, once in the Senate, and once in the Conference

Committee formed to reconcile the House and Senate versions. The members of Congress utilize their own relatively large staffs, as well as obtaining staff work from Treasury and from other agencies and organizations.

The power of the administrative bureaucracy in the United States is limited by turnover in personnel. Responsibilities change, and people move in and out of government service rather frequently. Such changes also bring shifts in policy emphasis, not only as the result of shifting election results, but also as the philosophy and personality of the specific people in charge change. In the tax area, even such a seemingly minor shift as Baker replacing Regan as Treasury Secretary in early 1985 brought about a change in emphasis. Regan apparently took the objective of simplification seriously, while Baker was more willing to shape the tax change proposal to fit political imperatives.

The types of conflict within the government and the ways they are manifested and resolved also differ between Japan and the United States. In Japan much intragovernmental conflict is interministerial. MITI is searching for a new approach to implementing industrial policy. In the tax area, MITI continues to propose new special taxation measures and to defend existing ones. The MOF adopted the position that in principle there should be no new government spending programs and no new tax breaks, for the budget deficit has been too large. The MOF was successful in recent years in limiting new initiatives by MITI. The MOF also apparently used the prospect of an imminent tax reform to resist any major changes being incorporated into the annual tax revisions in the mid-1980s.

In the United States much of the intragovernmental conflict is manifested in Congress. Various interest groups focus their efforts on influencing the Congressional process. In the face of these pressures, broader economic considerations and national policy goals are often overwhelmed. The tax reform package was written and rewritten at least five times. In the process, a major goal of simplification was sacrificed.

Unusual alliances and compromises may appear as the conflict evolves. In order to keep the process of tax reform going, Reagan first had to rely on Dan Rostenkowski, a Democrat, to draft a tax bill in the House of Representatives. Then, when the Ways and Means Committee had predictably produced a bill that was not acceptable to most Republican representatives (and some Democratic representatives), Reagan had to pressure the Republicans to vote for the bill. In order to gain enough support, he had to promise to veto the bill he was asking them to vote for if it was eventually sent to him in anything close to that version. In the Senate the key event was the conversion of Robert Packwood from a defender of tax

breaks into the sponsor of a tax reform bill that would greatly reduce tax breaks for individual taxpayers (although not for corporations) in exchange for dramatically lower tax rates. Essentially, Republican Packwood adopted the approach to tax reform that had been advocated for several years by Democratic Senator Bill Bradley, and the two became close allies in guiding the bill through committee and the full Senate. In the case of Packwood's conversion, it may be that the broader national interest prevailed over the collection of various special interests. The completion of the compromise bill by the Conference Committee then depended on the personal cooperation of Democrat Rostenkowski and Republican Packwood. It may also be noted that the Department of Commerce appears to have little influence or even visibility in the process of tax reform, in contrast to the role played by MITI in Japan in attempting to influence tax changes.

The discussion of tax reform also shows differences in the processes of conflict resolution in the two countries. These differences have implications for the ability to achieve controversial policy changes. In Japan meetings, councils, committees, and commissions are used to build a consensus about desirable changes. Although conflicts do arise, various groups are often circumspect in stating their positions. A lack of internal consensus may also force an organization to remain silent, at least in public statements, about certain issues. This is seen in the lack of clear statements by MITI and the Keidanren about the possible imposition of a broad-based indirect tax. In another forum, the LDP usually obtains the implicit acceptance by the opposition of any bills that are passed in the Diet. Although there may be public debate, true conflict has been minimized by prior informal discussion and compromise. Thus, in Japan efforts are made to resolve conflicts without contention and confrontation. At times this can result in an inability to address and resolve conflicts.

In the United States conflict is much more open, with substantial, real public debate and majority voting over truly contentious issues occurring in Congress. Lobbying is rather open, and lobbying groups may change their positions as the outline of a bill changes while proceeding through Congress. For instance, various business organizations changed their position from support for tax reform to opposition as alterations were made in the proposed changes in corporate taxation in the House version of the reform bill. Once it became clear that some version of tax reform was likely to be enacted, many of these organizations then became supporters of the Senate version because it was less harmful to their interests.

Such different manners of dealing with conflict have an impact on the likely outcome and its predictability. In both countries the

process of tax reform has been a lengthy one because the conflicts are important and broad. In the United States the acceptance of open conflict led to several large shifts in the outline of the reform package. At the same time, the willingness to accept open conflict permitted a movement toward a reform that was acceptable to a majority in Congress and to the President. In situations where conflict is inevitable and serious, open, constructive confrontation can lead to successful resolution.

In Japan the approach of minimizing conflict can work well if various groups agree to objectives and acceptable trade-offs. This approach, however, is likely to be increasingly unsuccessful as the number of objectives increases or the differences between the effects on various groups become more severe. The Japanese approach's ability to achieve changes in fundamental policies, such as taxation, that have such disparate effects is limited. Certain groups may refuse to accept changes, forcing a continuation of the status quo, even though it is not necessarily in the national interest.

Thus, in Japan the general outline of the proposed tax reform had been known for some time. The government attempted and failed to build a consensus for the package, especially because one element, the broad-based indirect tax, was unacceptable to certain groups (and also was not popular with the general public). The inability to achieve consensus in the face of this conflict prevented the enactment of a comprehensive tax reform in Japan in 1987.