3 The Politics of a Consumption Tax Increase

THE HOSOKAWA ADMINISTRATION’S FAILED ATTEMPT IN EARLY 1994

In August 1993, an eight-party coalition replaced the Liberal Democratic Party (LDP) in power, and Morihiro Hosokawa of the Japan New Party (JNP) became prime minister. The Hosokawa administration attempted to raise the consumption tax rate from the current 3 per cent to 7 per cent under the new name of a ‘national welfare tax’. This tax increase attempt was compelled by the policy exigencies of both the domestic economy and international politics. Japan’s protracted economic recession intensified demand among all domestic groups and foreign governments for income tax reductions to stimulate the economy in 1993. Japan also expected future spending increases in welfare that would require additional revenues. The Ministry of Finance (MOF) – which had longed to raise the consumption tax rate – seized the opportunity and tried to increase the rate as a financial source for the income tax cuts. The MOF obtained Hosokawa’s agreement to a consumption tax increase in exchange for the tax reductions. The MOF considered high public approval for the Hosokawa administration a facilitating factor for tax reform.

Opposition to the tax increase was significantly weaker in 1994 than it had been in 1989 when the consumption tax was introduced. Visible public opposition was non-existent. Neither did businesses put up fierce opposition as they previously had. Various economic groups, instead, expressed conditional support for the increase by mid-1994. Reflecting this tendency among the public and constituents, politicians were not nearly as averse to seeking the increase. Most coalition and opposition politicians
also understood the unavoidability of a tax increase to finance the income tax cuts and future welfare spending.

Nevertheless, the Hosokawa administration failed to legislate the consumption tax increase. We will review the administration’s attempt and explain why it failed.

The Process

A majority of the eight parties of the Hosokawa coalition opposed a consumption tax increase. The Social Democratic Party of Japan (SDPJ), Clean Government Party (CGP), and Democratic Socialist Party (DSP) insisted on the maintenance of the current 3 per cent rate and the issuance of deficit bonds to finance income tax reductions. The New Party Harbinger (Shintō Sakigake), and Democratic Reform League (Minshu Kaikaku Rengō) also opposed the tax hike. Only the Renewal Party (Shinseitō) and JNP showed a willingness to consider the hike if necessary. The Shinseitō and Sakigake also opposed the financing of the tax reductions with deficit bonds.

The MOF wanted to avoid issuing deficit bonds to finance income tax cuts and implementing the cuts without simultaneously legislating the consumption tax increase. The MOF was apprehensive that if it let politicians win the tax cuts first, they might not deliver on their promise to raise the consumption tax later. The ministry also knew that unless the tax hike was legislated soon, the nationwide local elections and upper house election, upcoming in 1995, would make it difficult for politicians to increase the tax (Yomiuri Shimbun, 14 January 1994).

Hosokawa sided with the MOF; he expressed his reservations about issuing deficit bonds and stated that the minimum condition for the tax reduction was the simultaneous legislation of the consumption tax increase (Asahi Shimbun, 26 August, 25 September 1993). In October, he unofficially decided to carry out income and residential tax reductions starting in January 1994 and to increase the consumption tax beginning in April 1995. During the period when the tax cuts preceded the increase, reduced revenues would be covered by short-term deficit bonds. The Government Tax System Research Commission announced a tax reform