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# 9 Public Policy and Housing in Japan

Takatoshi Ito

## 9.1 Introduction

In this paper, I examine effects of various land-related taxes and regulations in Japan. A sharp increase in land prices in the second half of the 1980s drew criticism from employees who felt their dreams of owning a house or moving into a bigger house had disappeared. By the time that policy measures, such as a limit on land-related lendings from banks and a land-holding tax, were introduced, the land price had more or less peaked.

I examine intentions and results of public policy. The traditional view is that the heart of the problem is land prices that are too high. Hence, any measure to lower land prices is good. This justified, for example, the introduction of the price monitoring system: the price of land transactions has to be approved by the municipal government prior to sale. A national landholding tax was proposed, because the local property (real estate) tax was not enough. Deductions for capital gains in the case of house replacement were abolished. There have also been proposals to raise the capital gains tax on properties held for the long term.

This paper distinguishes itself from the conventional view, which has dominated the political discussions in recent years, by emphasizing the importance of efficient use of the land rather than lowering land prices. The conventional view implicitly assumes that a sharp increase in land prices, or at least its major portion, comes from speculative investment. In order to correct a situation, a heavier burden on land-related taxes would work. In particular it has been

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recommended to increase tax rates on landholding and on capital gains, and to make assessments of land values closer to market values.

This paper emphasizes analyses of effects and distortions that are implied by various land-related and housing-related taxes and regulations in Japan. The conventional wisdom is that there is enough owner-occupied housing, but I show that household formation in Japan is discouraged, probably because of high housing costs.

Both the number of houses and quality of housing were not adequate in Japan. In the past, the emphasis of public policy was on public housing, maximizing the number of housing units. However, the emphasis seems to be shifting to quality.

The Japanese system of taxes on land acquisition, landownership, and housing is examined. In particular, the system of capital gains tax and property tax is discussed from the viewpoint of lock-in effects. Conventional wisdom is that the cost of landholding (property tax) is relatively low, so that speculative investment in real estate has been encouraged. Based on this conventional wisdom, raising the real estate assessment by prefectural government and creating a national landholding tax are often recommended. In addition, capital gains taxes are raised (especially for the short-term holding) to "prevent" speculative demand. This paper cautiously recommends the use of capital gains tax for this purpose.

Second, the bequest tax is shown to have caused distortions. Assessment of land and structures for bequest tax is much lower than the market value. The Japanese bequeathed assets consist mostly of real estate, in contrast to the United States. In fact, the Japanese elderly who plan to bequeath some assets have a strong incentive (1) to hold on to their principal residence, no matter how mismatched for their needs in retirement years, and (2) to borrow to buy more real estate. The latter feature is an effective tax-saving strategy, since real estate is assessed at less than market value and the mortgage liability is deducted from an estate in full. It is suspected that this tax distortion also causes a lock-in effect until the uncertain timing of death.

The paper further examines the taxes and regulations relevant to the own-rent tenure choice. There are two salient features on this point. First, interest payments for loans used to buy owner-occupied housing give only a partial tax benefit (in the form of a tax credit) in Japan. This works as less incentive for owning a house in Japan. (This, in combination with a large down-payment burden, works to delay the first-house purchase in one's life cycle.) Second, the Building Lease Law in Japan protects tenants so much that no landlords would want to put high-quality housing on the rental market. (Note that the horizon of a lease is virtually indefinite. It is almost impossible to ask tenants to leave upon the expiration of the lease.) The result is that, as children are born and the family size grows, it is necessary to purchase a house instead of relocating to larger rental housing.

Another peculiar aspect of the Japanese housing market is the existence of

company housing (*shataku*) and public-servant housing (*komuin shukusha*), both of which are heavily subsidized in rents. Costs of operating company housing can be deducted as operating expenses of the corporation, while the subsidized part of rents (fringe benefits) is not taxable in employees' income. This tax wedge is part of the reason for the prevalence of company housing. Public-servant housing is generally low quality but heavily subsidized in rents. This fringe benefit is also nontaxable in government employee's income tax. These distortions may partly be responsible for not developing high-quality housing.

As a philosophy (a principle beyond allocative efficiency) of public policy regarding land and housing, "protection of the underprivileged" is most frequently mentioned in Japan. A close examination, however, reveals that taxes and regulations that are meant to protect the underprivileged often have the opposite effect. For example, the tenant law that "overly" protects the tenant discourages the supply of high-quality rental housing, so that potential tenants for that market are hurt. (There is an analogy to rent control in the United States.) Low assessments for real estate taxes and bequest taxes are often defended by the same argument. It is against the philosophy of protecting the underprivileged if they are assessed in full when land prices are skyrocketing. It is a pity if a long-term resident has to sell a home and move due to real estate taxes. However, reducing the assessment encourages the underuse of land, with owners putting off capital gains or leaving a bequest. Heavily subsidized corporate and government employee housing also works against development of high-quality housing.

## 9.2 Overview

### 9.2.1 Land Value in Japan

The high cost of housing in Japan is well known. The price of a typical new home is about two to three times annual income in the United States and about five to eight times annual income in Japan. (See Noguchi's paper, ch. 1 in this volume.) This relative disadvantage persists although the average area of new housing in Japan is 84.4 square meters, compared to 134.8 square meters in the United States. Moreover, there are 0.7 residents per room in Japan, compared to 0.5 in the United States. Since most of a typical new house's price is the cost of land, the land problem is synonymous with the housing problem.

The situation of high land prices in recent years can be highlighted by comparing the total valuation of the land area of Japan and the United States (in the balance sheet of the nations). At the end of 1988, the national land wealth of Japan was 1,892 trillion yen, equivalent to \$14.6 trillion (at 130 yen/dollar), quadrupling the U.S. land value of \$3.6 trillion. Since the total area of Japan is about one-twenty-fifth of the United States, the unit cost of land in Japan is about one hundred times that in the United States.

The high cost and low quality of Japanese housing prompts complaints from its citizens. High housing prices arouse the concerns of those who cannot expect to inherit a house, but must work to purchase one. Episodes of rising housing prices, especially in 1973–75 and 1986–87, have created a sense of widening inequality between those who already have a house and those who do not. Such sentiments signal difficult political problems, and the housing/land problem has reached top priority in public policy in the past five years. The seriousness of the problem has been acknowledged in government reports and long-term plans in the second half of the 1980s: the Maekawa report,<sup>1</sup> the so-called new Maekawa report, and the Economic Planning Agency's five-year plan.<sup>2</sup>

### 9.2.2 Housing/Land Problem in Japan

To better understand the housing situation in Japan, it is helpful to review briefly some key facts in both time-series and cross-section perspectives. (See Noguchi's introduction to this volume and Ito [1992, ch. 14] for details.) First, the quantity, quality, and costs of housing Japan are examined. Second, government policies regarding housing are reviewed.

Is there enough housing? In the 1960s and 1970s, Japan made large public and private investments in housing. In fact, the number of housing units has been increasing so much that officials at the Ministry of Construction wrote

1. Prime Minister Nakasone formed a commission headed by Maekawa, the former governor of the Bank of Japan. The task of the Maekawa commission was to recommend a strategy for the structural adjustment of the Japanese economy to reduce current account surpluses and to improve the standard of living (quality of life). The Maekawa commission reported in April 1986, and another report (the so-called new Maekawa report) by the Economic Council (Keizai Shingikai) was delivered to the prime minister in May 1987. The progress in implementing measures recommended in the report is being monitored (a progress report was released in January 1988).

It was understood from the beginning that the economic structure of Japan would have to be transformed from export-dependent to domestic demand-oriented. It was also recognized that one key component of domestic demand is housing. The Maekawa report specifically recommended the following items: (1) domestic demand stimulation, aiming at improving the quality of life; (2) transforming industrial structures to encourage imports; (3) improving access of the Japanese markets by foreign companies; (4) aligning the exchange rate to the level consistent with fundamentals; and, (5) promoting international policy coordinations. Among the five pillars, the first addresses the land/housing problem. High land price is recognized as the stumbling block to achieving a high standard of living. A main purpose of the second item is to reduce the size of the external surplus to avoid criticism from abroad. However, redirecting resources from export industries to domestic sectors will encourage, in general, a better quality in residences. More imports, the aim of the third item, will lower domestic prices and contribute to higher real income of consumers. Hence, the main purpose of the Maekawa report is arguably to increase the quality of life.

2. The Economic Planning Agency prepared the five-year plan called "Japan, coexisting with the world" (Sekai to Tomoni Ikiru Nihon) in May 1988. In this report, three major planning objectives are mentioned: raising affluence of life, smoothing changes in industrial structure and balanced growth of regions other than Tokyo, and correcting external balances and contribution to the rest of the world. In the "affluent life" section, solving the land/housing problem is listed as the first priority. However, the plan does not give any details on how to achieve better housing. There seems to be a consensus among policymakers that the land/housing problem needs immediate attention.

that the housing problem is quality and not the number of units. In the housing survey done every five years, housing units have outnumbered households nationwide since 1968. See Noguchi's introduction to this volume.) In 1988, the number of housing units was 11 percent more than the number of households. Moreover, the "ownership ratio," that is, the ratio of owner-occupied units to total housing units, in Japan is comparable to that of the United States. (See table 9.1.) These facts are frequently quoted by policymakers in Japan, who argue that the focus of housing policy should be shifted toward seeking improvements in the quality of housing.

These statistics, however, are deceptive. If the formation of households is "endogenous," the adequacy of housing may not be inferred from the fact that the ratio of housing to households is more than one. Table 9.1 rows *g* and *h* show that the number of houses per eligible member of the population in Japan still lags behind the United States. In fact, the statistics suggest that the shortage of affordable housing discourages the early formation of households. Unmarried men and women in Japan tend to live with their parents, when they attend school or work in the same town or city. Moreover, the elderly in Japan tend to live in the household of their children. However, the ratio of independent households among the elderly appears to rise with household wealth in both time-series and cross-section analyses. Many surveys also have suggested that the elderly in Japan wish to maintain an independent household, though in close proximity to their children.

The ownership ratio is just a ratio of owner-occupied housing to the entire housing stock. In Japan, the numbers of both rental and owner-occupied housing units lag behind counterparts in other advanced countries. This fact is not picked up by the ownership ratio. A better measure would be a ratio of people owning homes to the population of that cohort.

Another aspect of the housing problem is the quality of housing. The Japanese house is typically smaller than the American house: fewer rooms per

**Table 9.1** Ownership Ratio and Housing per Capita

	United States 1987	Japan 1988
(a) Occupied units	90,888,000	37,413,000
(b) Owner-occupied	58,164,000	22,948,000
(c) Rented	32,724,000	14,015,000
(d) Ownership ratio (b)/(a)	64.0%	61.3%
(e) Population	243,942,000	122,783,000
(f) Population, 20 years and older	173,031,000	88,908,000
(g) = (a)/(e)	37.3%	30.5%
(h) = (a)/(f)	51.5%	42.1%

Sources: Japan: *1988 Housing Survey of Japan*. United States: *Statistical Abstract of the United States*, 13, 726.

Note: Japan's *b* and *c* do not add up to *a*, because some units cannot be classified as *b* or *c*.

house, more people per room, and fewer square meters per house. Moreover, the quality of facilities in a house is below international standards. (See Noguchi's introduction to this volume.)

Various studies, for example Hayashi, Ito, and Slemrod (1988) and Horioka (1988), suggest that housing in Japan is much more expensive than that in the United States. Hence, a large down payment is required to purchase a house. Hayashi, Ito, and Slemrod (1988) report that the age by which half of a generational cohort has purchased a house is about thirty in the United States and about 40 in Japan. Due to practices in financial markets, about 25 percent, on average, of the house price is paid as a down payment in the United States, compared with 35 percent in Japan. A typical mortgage maturity is thirty years in the United States, compared with twenty years in Japan. In sum, housing in Japan is certainly expensive in relative terms, which leads Japanese to purchase a house later in the life cycle than Americans.

### 9.2.3 Land Price Movement

Land prices have increased much faster than the consumer price index (CPI) over the entire postwar period. Table 9.2 compares land prices, defined as the average price of urban land, with the CPI index and the economic growth rate in five-year intervals.

Figure 9.1 plots the change in the real land prices measured by the log of land price minus the log of the wholesale price index (WPI). Table 9.2 and figure 9.1 confirm that land prices rose much faster from the late 1950s to the early 1970s than since then. Because real GNP grew more than twice as rapidly between 1955 and 1970 than between 1970 and 1985, we might hypothesize that real land price increases correlate with the real GNP growth rate.

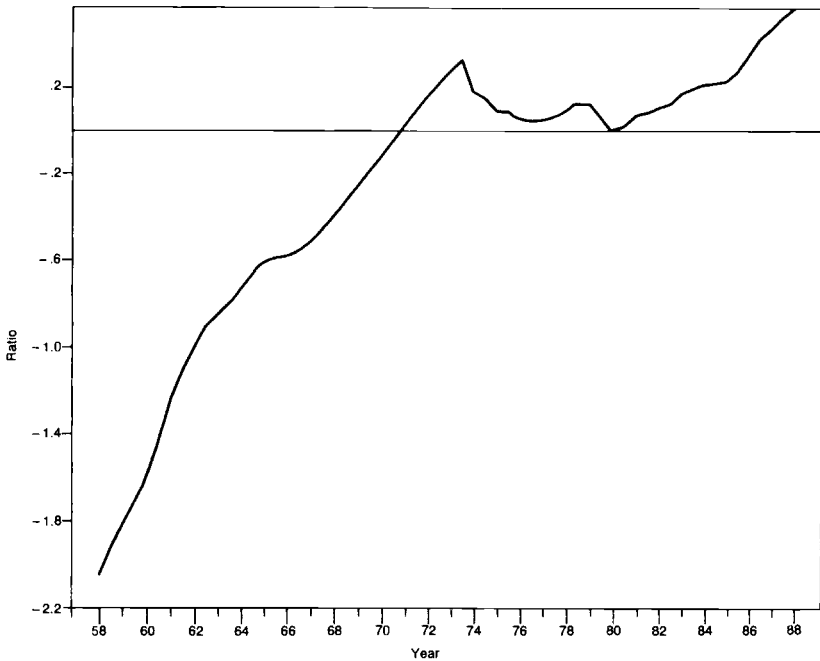
Figure 9.2 shows the average nationwide land inflation rate versus the land inflation rate of the six major metropolitan areas. The price increase in the six largest cities has far outpaced that of the rest of the country after 1984. This is unusual in that the price increase in those cities has been more or less equal to the rest of the country over the long run.

Figure 9.3 shows the land inflation rates for industrial, residential, and commercial uses. The price of industrial land outpaced other land in 1961–62, the price of residential land outpaced others in 1973–74, and commercial land was the leader in 1986–87. The evidence presented in figures 9.2 and 9.3 confirms

**Table 9.2** Five-Year Inflation and Growth Rates

	1955–60	1960–65	1965–70	1970–75	1975–80	1980–85	1985–90
Land	180.0	174.3	81.6	92.9	20.1	29.3	46.4
CPI	10.3	35.1	8.7	72.8	36.7	13.3	7.5
Real GNP	54.7	55.0	71.7	24.0	26.9	21.1	25.7

*Sources:* Land: Zenkoku Shigaichi Tochi Kakaku Shisuu (urban area index) Real Estate Institute. CPI: Management and Coordination Agency. Real GNP: Economic Planning Agency.



**Fig. 9.1** Land prices relative to wholesale price index

Source: Land price indices published by the Real Estate Institute.

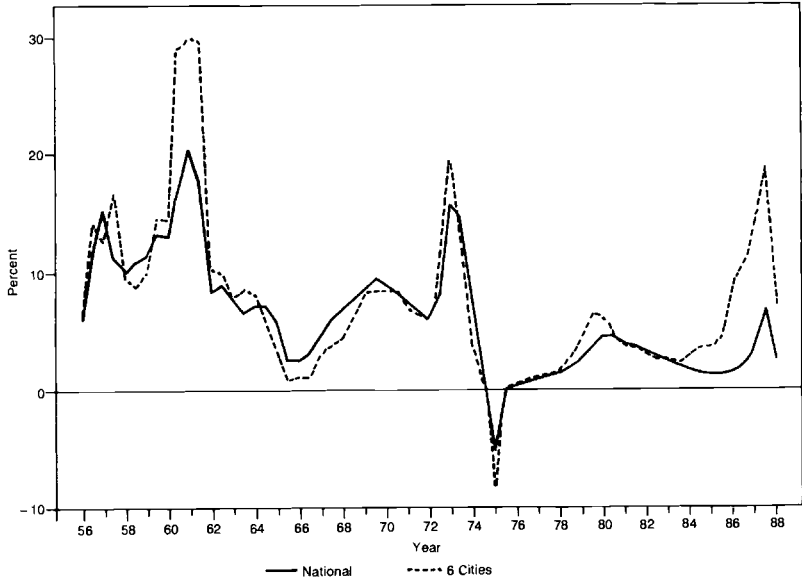
that the most recent land price increase was mainly concentrated in the large cities and pertained to commercial uses of land. In this sense, the evidence is consistent with an observation that the most recent episode of land price inflation is the "Tokyo problem," derived from the fact that Tokyo became one of the commercial (and international financial) centers of the world. It is fundamentally different from the situation in 1973–74, when the nationwide price of land rose at a rapid pace.

There have been three peaks of especially sharp real land price increases, 1961–62, 1973–74, and 1986–87. The first period was led by industrial land prices and occurred during Japan's rapid economic growth with industrialization (and a boom associated with the Tokyo Olympic Games). More generally, the high land inflation rate during the 1950s and 1960s was matched by rapid economic growth and relatively high CPI inflation rate. This is evident from a smooth trend in figure 9.1 and from table 9.2.

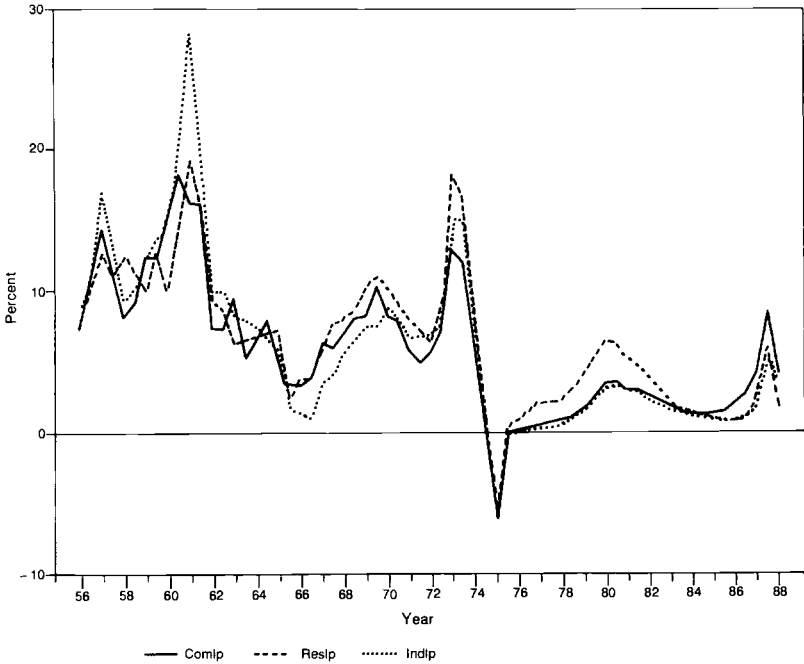
The second sharp acceleration appears to have been led by residential land price increases. But a sharp increase and a subsequent drop in prices for all uses suggest that presence of a bubble in 1973 and 1974.

The commercial land price increase led the third acceleration. This observation, coupled with the fact that prices in metropolitan areas outpaced prices in





**Fig. 9.2 Land inflation rates: national average versus six cities**  
 Source: Land price indices published by the Real Estate Institute.



**Fig. 9.3 Land inflation rates for various uses**  
 Source: Land price indices published by the Real Estate Institute.  
 Notes: *Comp* = commercial land price index; *Reslp* = residential land price index; *Indlp* = industrial land price index.

rural medium-sized cities, gives support to a casual observation that the 1986–87 increase was triggered, if not caused, by the internationalization and deregulation of the Tokyo financial market and by a resulting increase in demand from financial corporations for new or expanded space in the Tokyo office market.

This interpretation is based on a belief that land price movements are mostly explained by “fundamentals,” with a possible episode of the forming and popping of a bubble in 1973–75. (See a theoretical model in Ito [1993] for a general-equilibrium steady state where the real land price increased at a rate of real economic growth. See also Noguchi, ch. 1 in this volume, for a view emphasizing a bubble.) However, the evidence is not clear enough to conclude one way or the other. At the least, it should be kept in mind when public policy questions are asked that not all land price increases have been bubbles.

#### 9.2.4 Public Housing

Various government affiliated agencies build housing units for sale or for rent. At the national government level, the Housing and Urban Development Corporation, which resulted from a merger of two earlier corporations in 1981, builds apartment buildings and rents them to tenants. Local governments, that is, prefectures and municipalities, also contributed to public housing, sometimes directly operating rental apartments and sometimes setting up government-affiliated corporations.

Table 9.3 shows how the number of housing units by ownership has changed over time. Public housing was aggressively built in the 1950s and 1960s. In

**Table 9.3** Housing Units by Ownership and Landlord (in thousands)

	Total Units (1) + (2)	Owner- Occupied (1)	Rental			
			Total (2)	Public (2a)	Private (2b)	Employee (2c)
1958	17,432 (100)	12,419 (71.2)	5,013 (28.8)	614 (3.5)	3,233 (18.5)	1,166 (6.7)
1963	20,372 (100)	13,093 (64.3)	7,279 (35.7)	944 (4.6)	4,904 (24.1)	1,433 (7.0)
1968	24,198 (100)	14,594 (60.3)	9,604 (39.7)	1,403 (5.8)	6,527 (27.0)	1,674 (6.9)
1973	28,731 (100)	17,007 (59.2)	11,724 (40.8)	1,995 (6.9)	7,889 (27.4)	1,839 (6.4)
1978	32,189 (100)	19,428 (60.4)	12,689 (39.4)	2,442 (7.5)	8,409 (26.1)	1,839 (5.7)
1983	34,705 (100)	21,650 (62.4)	12,951 (37.3)	2,645 (7.6)	8,487 (24.5)	1,819 (5.2)
1988	37,413 (100)	22,948 (61.3)	14,015 (37.5)	2,799 (7.5)	9,666 (25.8)	1,550 (4.1)

Source: Management and Coordination Agency 1986, 22, based on the housing surveys conducted every five years.

Note: Numbers in parentheses are ratio to total.

fact, the number of public housing units more than doubled from 1958 to 1968. To increase the number of housing units was a high priority. Many of the units built in those years are now considered to be too small even for the government standard.

The rate of increase has been cut by a third in recent years. It seems that the policy has shifted from just increasing public housing units to provide good quality housing and to introduce more of a market mechanism. This is a necessary change in the policy in the era of diversified needs for housing.

### 9.2.5 Government Guidelines

It is instructive to examine the government view of the standard quality of housing. The "minimum" and "desired" (*yudo*) standards were used, for example, by the Ministry of Construction in the fourth five-year plan installed in March 1981. The standards are defined in (1) room assignments to family members, (2) facilities, (3) environment, and (4) floor space (of rooms and of housing units) and the number of rooms. The government residential housing committee, *Jutaku Takuchi Shingikai*, revised the standards in 1985. In table 9.4, only the room assignments and floor space of the rooms (in tatami mats, the old standard) are used. (One tatami mat is 180 cm by 90 cm. Here it is used as a unit of floor space.) These standards are guidelines only and are not used for tax and subsidy purposes. The minimum standard, for example, means: (1) Parents exclusively occupy a bedroom of more than 6 tatami mats, with the possible exception of sharing it with a child no older than five years. (2) Children ages six to seventeen have bedrooms separate from their parents. Two children may share a bedroom of more than 6 tatami mats, or one child may occupy a bedroom of more than 4.5 tatami mats. Boys and girls age twelve and over should have separate bedrooms. (3) Any adult (age eighteen and over) should have a private bedroom with more than 4.5 tatami mats. (4) The dining-kitchen area should be separate (meaning a dining area should not be used as a bedroom at night). The desired standard has some improved conditions over the minimum: (1) Parents occupy a bedroom of more than 8 tatami mats, possi-

**Table 9.4** Housing Standards by Floor Space

	Total (1) + (2)	Owner- Occupied (1)	Rental			
			Total (2)	Public	Private	Employee
Above desired standard	10,289	9,252	1,037	100	747	190
Minimum standard	23,123	13,070	10,054	1,931	6,945	1,178
Below minimum standard	3,550	626	2,924	768	1,975	182
Total	37,413	22,948	14,015	2,799	9,667	1,550

Source: 1988 Housing Survey of Japan.

Note: "Desired" and "minimum" standards are described in text.

bly sharing it with an infant age three or younger. (2) Children ages four to fourteen have bedrooms independent from parents, and two of them (under age twelve) may share a room of 8 tatami mats or larger, or each may have a room of 6 tatami mats or larger. (3) Any child age twelve and over has a separate bedroom. (4) The dining room (4.5 tatami mats for a family of three or four) and kitchen (4.5 tatami mats for a family of four or more) are separate from the bedrooms.

Some old housing units do not achieve even the minimum standard. One-fourth of public housing units fail to achieve the minimum standard, while less than 3 percent of owner-occupied housing units is below the minimum. Among the rental housing in the private market, one out of five fails the minimum standard. If public housing serves the role of safety net, the low quality may have to be endured. However, the quality of the safety net may have to be upgraded over time.

### 9.3 Land-Related and Housing-Related Taxes

#### 9.3.1 Land Assessment

In the following, it is useful to distinguish the following land prices for the same piece of land: (1) the market price, or transaction price; (2) monitoring price by the Land Agency, or the government benchmark (land) prices (*koji kakaku*); (3) assessment for bequest tax purpose by the National Tax Agency, or street value (*rosen ka*); (4) assessment for the property tax, administered by the municipal government, in consultation with the central and prefectural governments; and (5) monitoring for representative places by the prefectural government. There is also the land price index of urban districts surveyed by the Japan Real Estate Institute, a nongovernment agency.

The *koji kakaku* has been tabulated by the Land Agency every January 1 since 1970. The price is determined by actual transactions in neighboring places, with some considerations to the value calculated as the sum of discounted future rents. Points where prices are monitored currently number about 17,000 nationwide. (The number of monitoring points was much smaller until the mid-1970s.) There are significant overlaps for monitoring points every year, although there are several substitutions. It is widely believed that the *koji kakaku* is below the market value by 20–30 percent.

How to tax real estate is a sensitive political issue, since many land and housing owners are traditional supporters of the Liberal democratic party. In the United States, various local referenda passed in the early 1980s, to limit the property tax rate in the community. In Japan, the property tax (prefectural tax) “rate” is “standardized” at 1.4 percent by law (to be explained shortly). However, assessment of real estate (mostly land) varies with prefectures: wealthy prefectures assess land far below its market value, while relatively poor prefectures assess land near its market value. Homma and Atoda (1990,

134–35) investigated the gap between the *koji kakaku* and *rosen ka* at the places of highest *rosen ka* in the capital cities of prefectures. They found that in 1988 the gap ranged from 33.5 percent (in Kyoto) to 94.1 percent (in Kōfu), with the average of 56.5 percent of *koji kakaku*.

The assessment of property for bequest taxes is based on a different assessment schedule. The *rosen ka*, for bequest, is 50–70 percent of the *koji kakaku*. This means that the *rosen ka* is about a quarter to a half of the market value.

### 9.3.2 Land-Related Taxes

This section summarizes all land-related taxes. Various implications are examined in section 9.4. There are four types of taxes at the time of land acquisition. (1) The property, including land and structures, is assessed at real estate tax assessment and taxed by a prefecture. The tax rate is 4 percent. Structures as well as land values are taxed. (2) Special land acquisition tax at the time of purchase is imposed by a municipality (city, town, or village). The land assessment is the actual purchase price. The tax rate is 3 percent. The real estate acquisition tax is deductible from the value. An application of this tax is very limited. (3) Registration tax is collected at the rate of 0.5 percent by the national government at the time of title transfer. Real estate tax assessment is used for valuation of land. (4) Inheritance tax is imposed on acquisition by bequest. *Rosen ka* is used for assessing the value of land. For an estate, value per beneficiary is subject to the 10–70 percent progressive marginal tax rate. (See Barthold and Ito [1992] for details.)

There are three kinds of landholding tax. (1) The property tax is imposed by a municipality on the value of land and structures assessed by real estate tax assessment. The standard rate is 1.4 percent; in limited cases, the rate is 2.1 percent. (2) City planning tax is also imposed by a municipality at the rate of 0.3 percent of the same base of real estate tax. (3) Special landholding tax may be assessed by a municipality at the rate of 1.4 percent. This is imposed on the base of the purchase price.

There are three types of capital gains tax. Individual income tax and corporate income tax is imposed by the national government. Prefectural and municipal inhabitant tax is imposed on top of the national income tax. An application of this tax is very limited.

#### *Real Estate Tax*

The assessment of real estate under the property tax is systematically below market value by as much as 50 percent. The heavy transfer tax, combined with light property tax, encourages hoarding when prices are expected to rise. As mentioned above, the standard rate for the real estate tax is nationally set at 1.4 percent. (This is legislated in the Local Tax Law, administered by the Ministry of Home Affairs [Jichisho].) However, the municipal governments tend to set the assessment below the market value (within some bound below the value of reference points in each prefecture, which is determined by the central govern-

ment). One of the reasons for the proposed landholding tax is that the Ministry of Home Affairs or the Ministry of Finance has not been able to make local governments commit themselves to raise assessed land values for real estate tax purposes. Local governments are viewed as appeasing their constituents rather than popping a bubble.

### *Capital Gains Tax*

Capital gains tax is levied when property is sold. If a property was held by an individual for more than five years, the marginal rate is 20 percent (plus local inhabitants' tax of 6 percent) for up to 40 million yen, and 25 percent (plus 7.5 percent local inhabitants' tax) for the value beyond 40 million yen. The tax schedule is higher for property held less than five years: the marginal rate is 40 percent plus inhabitants' tax of 12 percent. It is now proposed to raise the tax rate for the more-than-five year property (20 percent) to that of the less-than-five-year category (40 percent).

Another surcharge is applicable if gains were made as miscellaneous income or property business income and the land was held for less than two years. The surcharge and tax rate amounts to 50 percent plus inhabitants' tax of 15 percent. These provisions are introduced to prevent speculative (short-term) demand on land. During the periods when the land prices rose sharply, many real estate companies still made large profits by quick turnovers.

A reduction in the tax rate is applicable for an owner-occupied property where the owner lived for more than ten years. The capital gains tax rate for such a property is 10 percent (plus 4 percent inhabitants' tax) up to 4 million yen and 15 percent (plus 5 percent inhabitants' tax) beyond that.

There are several deductions in calculating taxable capital gains. One million yen is deductible for the property owned by individuals beyond five years; 30 million yen is deductible for an owner-occupied property; and 50 million yen is deductible for a property sold because of the government's forceful acquisition (eminent domain in the United States, as for construction of a road or an airport).

For corporations, the capital gains from property are treated separately. A surcharge of 30 percent of the corporate income tax is assessed for property held for less than two years, bringing the effective tax rate to 85.17 percent (surcharge of 30 percent, ordinary corporate tax of 37.5 percent, corporate inhabitants' tax of 11.67 percent, and corporate enterprise tax of 6 percent). The effective rate is reduced to 73.45 percent for property held between two and five years. The capital gains tax for property held more than five years is treated as regular corporate income tax. The capital gains tax is double-edged. On the one hand, it helps to pop a bubble and restore "equity" among people who make real estate investment in different locations. On the other hand, the capital gains tax is known to cause a lock-in effect. When a high rate of capital gains tax is applied, people are not encouraged to sell property. That is, once land is purchased and has experienced capital gains, an owner (or an investor)

becomes reluctant to take capital gains realizations, even if other factors favor selling units. Other factors include a change in family size, a change in job location, a demand for liquidity of housing equities, and a desired shift of portfolio prompted by a change in various market conditions. Since property tax in Japan is generally considered lower than in the United States, this explains why some of the land in the most expensive areas in Tokyo is left without being developed. When land tends to be locked in by the tax system, it is difficult to plan large-scale housing or commercial development projects. Until 1988, the capital gains tax on residential housing was waived if the house was replaced by another house with equal or greater value (as in the U.S. system). However, in the wake of "sprawling" land price increases from the center of Tokyo to the suburbs, the Ministry of Finance suddenly suspended the provision in 1988. This has further discouraged the sale of housing in the last few years.

Economists are divided as to whether the capital gains tax should be raised or lowered. There are two major factors for the difference in judgment: whether the land price contains speculative bubbles and whether the lock-in effect is considered large. Increasing property taxes and lowering capital gains taxes on properties are advocated from the viewpoint of efficient development and usage of land by those who consider the lock-in effect to be large and the bubble component in land small. Even those who consider that land prices contain significant bubbles may favor lowering capital gains, if the tax savings can be passed on to the buyers easily, so that an imposition of capital gains would not deter speculative activities.

If land prices increase happen to have a bubble component, transaction taxes and *short-term* capital gains taxes are an effective way to curb a bubble. Increasing the capital gains tax is favored by those who think that land prices increase due to speculative activities and that an imposition of capital gains taxes would deter speculations. Those who believe that an equitable distribution of wealth has the top priority also tend to oppose lowering capital gains taxes. Lowering the current capital gains tax is *not* advocated by those who consider that the lock-in effect is small; that is, the decision to sell a property is prompted by factors other than taxes, and the current tax rate would not change the decision anyway. They also consider that, if capital gains tax relief (or deferment) is available for change of a principal residence (replacement sale), this would restore locational efficiency to some extent.

In Japan, it is currently recommended that the capital gains tax rate for a long-term property holding be increased. Since a bubble is not likely to survive five years, the new proposal is to restore "equity," or, to put it bluntly, to bash windfall gainers. However, this would make reallocation of land through the market mechanism more difficult. The trade-off is unfortunately not carefully evaluated in the tax reform discussions. The Ministry of Finance usually states that the elasticity of land supply with respect to capital gains is low. Some authors also believe that the lock-in effect is rather minor (for example,

Kanemoto, Hayashi, and Wago 1987). However, this may cause an unexpected liquidity problem.

### *Bequest Tax*

The inheritance tax burden in Japan is much heavier than in the United States. The marginal rate goes up to 70 percent quickly, and there is no simple way to create a tax-exempt trust for one's heirs. Because the inter vivos gift is taxed at a higher tax rate (with the 600,000-yen annual deductible), most intergenerational gifts take place at the time of death. (However, annual deductibles may be used repeatedly for many years in order to lessen the taxes for intergenerational transfers.) While bonds and other securities are assessed at market value for the purpose of the inheritance tax, real estate is assessed below market value. The assessment for bequest taxes (using *rosen ka*) is about half the market value, while the liabilities for the real estate are fully deductible. (If the property is bought within three years prior to the death, the property is evaluated at the purchase price. This provision, introduced at the end of the 1980s, is to prevent "last-minute tax planning" by the family.) If and when one plans a bequest, it is preferable from the standpoint of tax savings to hold real assets rather than financial assets at the time of death. (This is analogous to "flower bonds" in the United States.) This helps explain why the elderly in Japan retain housing and other real estate until their death. The share of real estate in taxable bequests in Japan is about 60 percent, while the comparable ratio in the United States is about 25 percent. (See Barthold and Ito [1992] for details.) To the extent that real estate becomes a vehicle for bequests, land and housing prices are likely to contain a premium relating to this vehicle. Although it is not clear how significant this premium is in actual land prices, it may be quite large, given the extent of undervaluation of real estate. There is no question from the viewpoint of efficient resource allocation about the need to adjust the assessment of real properties to the market value, that is, to *increase* the effective bequest tax. However, from an equity point of view, *lowering* the bequest tax rate has been advocated. This argument emphasizes unexpected rises in land prices that jeopardize the bequest plans of ordinary citizens. If a bequest motive to hand down a family asset to the next generation should be respected, then an unexpected burden in inheritance taxes from speculative bubbles should be lightened. However, if the land price increase is within the range of expectations reflecting "fundamentals," then the increase in tax burden just reflects the increased value in resource allocations. There is no reason to reduce tax burden in this case. The value of land in the bequeathed state may be further reduced if the land, or the structure on the land, is leased or rented out. (See section 9.3.3 for details.) Moreover, the assessment of land up to two hundred square meters, in cases of owner-occupied housing and of rental business (more than ten units), is further reduced. (The provision could be applied to the sum of several lots.) For example, if the decedent owned a



principal residence of two hundred square meters, then the value of land (pro-rated to two hundred square meters) is reduced by 50 percent. If the land was used for a rental business, then the land value is reduced by 60 percent.

#### *Taxes on Agricultural Land in Cities*

Agricultural land is taxed much more lightly than residential land. While some arguments, such as national security regarding food, have been made to support this approach, there is little ground for permitting preferential treatment for small agricultural lots in cities. From the viewpoint of city planning, agricultural plots in city residential areas should be taxed at the same rate as residential plots. This was what the tax law of 1982 was supposed to achieve: in the three largest metropolitan areas (Tokyo, Osaka, and Nagoya), agricultural lots in areas that city planning designates as residential or commercial and where the appraisal value is more than 30,000 yen per 3.3 square meters are supposed to be taxed at the residential rate, in order to increase land supply. However, this provision has a loophole. If a lot is more than 990 square meters and the owner farmer plans to continue farming for the coming ten years, the lot is exempted from being taxed at the residential or commercial rate. The farming rate is on average 1/37 for the three metropolitan areas and 1/57 in Tokyo. Because the definition of farming is rather arbitrary, the loophole is widely exploited. Only 15.5 percent of such agricultural lots are taxed at the residential rates (table 9.5).

#### *Tax-Exempt Fringe Benefits*

Another peculiar aspect of the Japanese housing market is the prevalence of company housing and public-servant housing, both of which are heavily subsidized in rents. Costs of operating company housing can be deducted as

**Table 9.5** Agricultural Lots in the Special Residential Area

Fiscal Year	Tokyo <sup>a</sup>			Three Metropolitan Areas		
	Applicable (hectares) (1)	Exempted (hectares) (2)	% (2)/(1)	Applicable (hectares) (3)	Exempted (hectares) (4)	% (4)/(3)
1982	30,261	24,510	90.0	42,472	35,030	82.5
1983	29,065	24,191	83.2	40,922	34,526	84.4
1984	28,299	23,484	83.0	39,904	33,592	84.2
1985 <sup>b</sup>	29,612	24,709	83.4	44,975	38,120	84.8
1986	28,824	23,970	83.2	43,932	37,121	84.5

Source: Namekawa 1988, 98.

<sup>a</sup>The Tokyo area includes Tokyo, Ibaraki, Saitama, Chiba, and Kanagawa prefectures.

<sup>b</sup>After an appraisal change in 1985, more land was assessed at more than 30,000 yen per 3.3 square meters.

operating expenses of the corporation, while the subsidized part of rents (fringe benefits) are not taxable in employee's income. This tax wedge is part of the reason for the prevalence of company housing. Public-servant housing is generally low quality but heavily subsidized in rents. This fringe benefit is also nontaxable in government employees' income tax. In 1983, 14 percent of rental housing units were in the form of company and public-servant housing (Management and Coordination Agency 1986).

### 9.3.3 Housing-Related Taxes

Owner-occupied housing enjoys some tax benefits in both Japan and the United States. The tax benefits are not readily compared. In the United States, interest payments on mortgages for owner-occupied housing (and land) may be deducted from taxable income when itemized deductions are chosen. In many cases, itemized deductions become preferable over the standard basic deduction only after one becomes an owner of a principal residence.

In Japan, a tax credit (not income deduction) for owner-occupied housing loans is calculated from the balance of loans for structures (not including loans for land) and is applicable only for six years after acquisition. This provision was introduced only in tax year 1987 (and the limit was five years until 1990). The amount of tax credit is 1 percent of the loan balance at the end of the calendar year. Because of the six-year limitation, the tax benefit for owner-occupied housing is relatively minor in Japan.

Landlords of rental housing units also benefit from favorable tax treatment. Interest payments for housing loans toward constructing rental housing units (housing and land purchases), along with maintenance costs, are fully deductible from rental income. (If interest payments and other costs exceeded rental income, deficits were deductible from other income, such as earned income. However, it has been limited to interest payments resulting from loans for structures since 1991.) Management of rental housing enjoys different kinds of tax benefits. If a landlord manages more than ten units, the rental income is considered to be a real estate business. This qualifies for broadened deductible expenses, including presumed salary payments to family members.

Holding rental housing provides additional benefits in bequest tax calculation. As mentioned above, real estate is valued at about half of the market value. However, the assessment of land and housing structures is further reduced by 30 percent if the property is rented out. (A parallel bequest tax provision is applied to leases. Leases are valued at 30 percent of the property value in the bequeathed properties of lessors. These provisions can be justified, because it is difficult to get rid of tenants, as explained in section 9.4.1.) Also, recall the special bequest tax provision: the value of land up to two hundred square meters is further reduced if the estate has rental housing of more than ten units.

In sum, tax benefits for owner-occupied housing are very limited, while there are strong tax benefits, in every year and in the case of bequests, to own

properties of more than ten rental units. This is said to have contributed to a sharp increase in the supply of rental units in the second half of the 1980s.

## 9.4 Land-Related Legal Problems

### 9.4.1 Overprotection of Tenants

The law regarding the leasing of a piece of land, the Land Lease Law (Shakuchi Ho), and the law regarding the rental of a house, the Building Lease Law (Shakuya Ho), are known to protect tenants rather than landlords. The laws contain provisions to extend leases almost automatically: if land is leased indefinitely and the lessee builds a concrete building, then the lease must extend sixty years; if the structure is not concrete, for example, a wooden house, then the lease must extend thirty years. Even if the original lease expires, so long as the building is maintained in good condition, the lease is automatically extended and cannot be terminated at the will of the landlord.

In the case of house rentals, leases extend no less than one year. This is apparently not too restrictive. However, the landlord cannot terminate a lease, unless the landlord moves into the unit or under a "rightful cause," a provision that is typically interpreted, in court cases, very strictly. Raising rents in order to force tenants to move out is virtually impossible. If tenants dispute the increase in rents, they may deposit rents in an escrow account while they ask for an arbitration at the district court. Precedents in such cases allowed rents to rise at a rate near cost increases or general inflation.

In sum, it is extremely difficult for landlords to remove a tenant. One way is to pay a considerable compensation to the renter (lessee) to move out.

Several difficulties result from these laws. First, there is little large-size and/or high-quality rental housing in Japan. Landlords are afraid of large investments that might go sour. Second, it has become common practice to require large payments from renters (equivalent to two months' rent) to initiate the lease. This constitutes a risk premium for the landlord. Third, redevelopment is impeded when it is difficult to remove a small number of remaining residents in a run-down apartment building despite large vacancies, or when a large development project covering a block contains a few renters of land.

These difficulties may also contribute to high land prices. Because the supply of land, if currently leased, is restrained by these factors, the neighborhood and relative advantage of a particular lot changes drastically.

### 9.4.2 Sunshine Law and Cubic Restriction

In most cases, the height and total cubic size of buildings are regulated. For example, if the area is designated as a class-one residential area, then a structure must be under ten meters high. The sunshine restriction puts limits on building a house or other structure that deprives sunlight from a neighboring house for more than certain limits (usually three hours a day during the winter

time). Of course, zoning is established for a good reason, and the sunshine law is important to protect a family from negative externalities. However, a Pareto-improving solution can be prepared in most cases. If the actual development of surrounding areas, such as new subway lines and highway construction, takes a path not expected at the time of zoning, rezoning should be recommended. Moreover, if neighbors could agree, many small houses should be able to get together to build a high-rise. High-rise development may run into problems of rezoning and the tenant law mentioned above.

#### 9.4.3 Direct Intervention (Price Monitoring)

In the wake of the sharp price increase in 1986–87, particularly in the large cities, various measures were introduced in an attempt to curb land price increases. Most of the emergency measures explained below were introduced on the implicit assumption that the price increases were mostly bubbles.

The trading of land above a certain size in a designated neighborhood of large cities became subject to a government agency's approval in 1987. Price monitoring, as a measure empowered by the Act for Planning the Use of the Land (*Kokudo Riyo Keikaku Ho*), was enforced in twenty-three wards and neighboring cities in Tokyo after August 1987, in suburban cities of Tokyo after 1987, in Yokohama and Kawasaki after August 1987, and in parts of Osaka after December 1987.

For example, in the twenty-three wards and some neighboring cities of Tokyo, trade involving more than one hundred square meters in commercial and residential areas (*shigaika kuiki*) has to be reviewed by the Tokyo government. If the price of land is judged to be too high, then the seller and the buyer are "advised" to lower the sale price. This price monitoring system was designed to check land price inflation and to protect innocent buyers who were uninformed of the unreasonableness of the price. In a highly publicized case, the sale of land of the Australian Embassy in Tokyo was not approved at the original terms.

Regulations invite more regulations. First, to gain information about an acceptable range, which is not made public, the realtors present insincere sale applications. In order to check these applications, regulatory authorities warn realtors that they failed to carry out preapproved trades. Second, if disapproval of a price is feared, the buyer and the seller can agree to put a higher price on structures and a lower price on land. The regulatory authority has not been prepared to evaluate the value of structures. Third, the exemption of smaller lots from price monitoring encourages subdivision. To prevent this, the threshold size had to be reduced. (In the twenty-three Tokyo wards, the threshold was reduced to one hundred from three hundreds square meters in November 1987.)

Another problem arises from the inefficient use of public lands. Auctions of unused public land have been indefinitely suspended out of concern that the high bid price would enhance a speculative bubble in the neighborhood.

These regulations are not only ineffective but counterproductive, if the real causes of land price increases are “fundamentals.” Price monitoring would decrease the supply if the perceived acceptable range is too low. Moreover, if the price monitoring is viewed as a temporary measure, potential sellers may wait until it become politically unsustainable. Therefore, the supply will most likely decrease under the monitoring system, thus contributing to higher prices. Direct intervention can be unfair, too. Some individuals need to sell land to resolve immediate cash-flow problems: those who pay their bequest tax by selling a part of the bequeathed land and those who liquidate a failed company. Selling under price monitoring may mean obtaining less than fair value for their assets.

Why did these regulations come to exist, if they are ineffective, counterproductive, and unfair? One reason is that the government wanted to shift the blame for the higher price from the government, which failed to increase supply to a scapegoat, the speculators. Another reason is that the current landowners who do not plan to sell wish to keep assessment values down, by restricting sales with high prices in their neighborhood.

If the recent experience of land price increases involves an extraordinary bubble, measures to increase the land supply will pop the bubble. Direct intervention, on the other hand, would not help pop the bubble. Rather, it would make the bubble larger by restricting supply. If the land price increase is due to strong economic growth, as suggested above, then direct intervention only induces creative ways to avoid regulations. Moreover, measures to increase land supply will surely slow the price increase, even if the land price increase was caused by a demand pull.

## 9.5 Public Policy for Quality

The housing stock in Japan is of low quality in comparison with other Organization for Economic Cooperation and Development (OECD) countries: it is smaller and has fewer facilities and amenities. Even if the number of houses per adult in Japan rises to the U.S. level, the quality of housing in Japan is likely to remain far below that of in the United States. Although equity considerations are important, there may be better ways to help the poor while minimizing the violation of efficiency. In many ways, public policy has been targeted to increase the quantity of housing units. Only recently has attention been given to quality. Public policy for quality, if ever needed, may be quite different from that for quantity. For example, the (lowest) subsidized mortgage rate granted by the public-sector Japan Housing Loan Corporation applies only to the floor space of a purchased house below a threshold size. (See Seko, ch. 3 in this volume, for details.) Perhaps a ceiling on the yen amount of subsidized loans could be justified from the fairness point of view; however, the floor-space restriction encourages the construction of small houses and prevents development of high-quality housing in suburban areas. The government has

more direct ways of contributing to improvements in the housing stock. First, many government entities maintain subsidized (rental) housing for their employees. While most of them satisfy the minimum standard of living, some are simply too old and too small. In fact, some of these units in Tokyo do not even have flush toilets. Second, much of the public rental housing is of low quality: more than 90 percent of public rental housing units fall short of the target size of housing (table 9.4).

It is extremely important to renovate or replace aging government properties with very small units, both those used by government employees and those used as rental housing. Many of those buildings are low-rises and could be replaced by high-rises with larger units. For example, the Tokyo Municipal Housing Corporation built 59,803 units between 1950 and 1985. Many units built in the 1950s and early 1960s have floor space of less than forty square meters. No buildings have been rebuilt, often because of the opposition by a small number of residents (recall the overprotection of tenants).

## **9.6 Efficiency versus Equity**

As a philosophy (a principle beyond allocative efficiency) of public policy regarding to land and housing, protection of the underprivileged is most frequently mentioned in Japan. A close examination, however, reveals that taxes and regulations with an intention of protecting the underprivileged often have the opposite effect. For example, the Building Lease Law that overly protects the tenant discourages the supply of high-quality rental housing, so that potential tenants for that market are hurt. (There is an analogy to rent control in the United States.) Low assessments for real estate taxes and bequest taxes are often defended by the same argument. It is against the philosophy of protecting the underprivileged if market values are assessed in full when the land price is skyrocketing. It is a pity if a long-term resident has to sell a home and move due to real estate taxes. However, reducing the assessment encourages the underuse of land, while waiting for capital gains and the death of the owner. Heavy subsidies to corporate and government employee housing also work against development of high-quality housing. Hence, tax system and regulations regarding the philosophy may turn out to be counterproductive for efficient use of land. A proper balance between efficiency and equity (and not just an attempt to lower land prices) must be sought in future tax reform and regulatory changes with regard to land use.

## **9.7 Concluding Remarks**

This paper examined important public policy related to housing in Japan. The emphasis is on analyses of effects and distortions that are implied by various land-related and housing-related taxes and regulations in Japan. The conventional wisdom is that the number of units of owner-occupied housing is

enough, but household formation in Japan is discouraged, probably because of high housing costs.

From the viewpoint that more attention should be paid toward efficiency in land allocation, several problems in current taxes and regulations were critically examined. First, the land-related and housing-related taxes were examined. In particular, property taxes and the system of capital gains were discussed from the viewpoint of lock-in effects. Conventional wisdom is that the property tax is relatively low so that speculative investment in real estate is not prevented. It is often recommended to raise the real estate assessment by prefectural government and/or to create a national landholding tax. In addition, capital gains taxes are raised (especially for the short-term holding) to "prevent" a speculative demand. I cautiously advocate the use of capital gains tax for this purpose, because of its lock-in effect.

Second, the bequest tax was shown to have caused distortions. Assessment of land and structures for bequest taxes is much lower than the market value. The Japanese bequeathed assets consist mostly of real estate, in contrast to the U.S. bequeathed assets. In fact, the Japanese elderly, who plan to bequeath some assets, have strong incentive (1) to hold on to their principal residence, no matter how mismatched for their needs in retirement years, and (2) to purchase real estate with a high leverage. The latter feature is an effect tax-saving strategy, since real estate is assessed at much less than market value and liability is deducted from the estate in full. It is suspected that this tax distortion also cause a lock-in effect until the uncertain timing of death.

The paper further examined the housing-related taxes and regulations. There are two salient features on this point. First, housing loans for owner-occupied housing have only a partial tax benefit (in the form of tax credit) in Japan. This, in combination with a large down-payment burden, works to delay house purchasing in one's life cycle. In contrast, landlords of rental housing property, especially with more than ten units, enjoy various tax benefits. Second, the Land Lease and Building Lease Laws in Japan protect tenants so much that no landlords would want to put high-quality housing on the rental market. Note that the horizon of a lease is virtually indefinite, although the contract has an apparent termination date. The result is that when a family becomes large, it is necessary to purchase a house instead of relocating to larger rental housing, which is nonexistent.

Another peculiar aspect of the Japanese housing market is the prevalence of company housing and public-servant housing, both of which are heavily subsidized in rents. This seems to be at least partly due to the tax advantage that benefits both employers and employees: operating expenses of company housing are deductible in the company's profit calculation, while the subsidized part of rents (fringe benefits) are not taxable in employees' income. Public-servant housing is generally low quality but heavily subsidized in rents. This fringe benefit is also nontaxable in government employees' income tax. These distortions may partly develop high-quality housing.

Public policy regarding land and housing emphasizes protection of the underprivileged in Japan. However, taxes and regulations with an intention of protecting the underprivileged often have the opposite economic effects.

In summary, all economists in Japan recommend raising the assessments of land for property and bequest taxes in order to eliminate distortions. Those who believe that lock-in effects are large recommend a reduction in capital gains tax (at least for the long-term holding). Combined with less transactions tax, less capital gains tax would enhance the efficient allocation of land. However, these changes may be opposed by those who want to use the tax system to achieve equity instead of efficiency and to prevent bubbles from forming in the housing market. Also, economists are generally in favor of modifying the Land Lease and Building Lease Laws to allow landlords to terminate leases at the time of their expiration. These changes would increase the supply of high-quality rental housing.

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