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3 Tax Reform in Japan

Masaaki Homma

3.1 Introduction

The tax systems of industrialized countries are changing rapidly and, in some cases, are undergoing major reforms. The ongoing tax reform in Japan is part of this global movement that has been going on since the late 1970s. Although the tax reform plans of other countries differ greatly, they share a number of features with Japan's. In particular, Japan's movement seems to be inspired by a wider introduction of the value-added tax (VAT) in countries such as Korea and to be accelerated by the achievement of the U.S. tax reform, which lowered the income tax rates and broadened the tax base.

More than ten years have passed, however, since the Japanese government took a first step toward tax reform. In 1979 Prime Minister Masayoshi Ohira proposed the plan that includes the VAT and minor revisions of tax preferences. Expanding fiscal deficits were the initial motivation for the tax reform. From the first oil crisis in 1973 to the second in 1979, the Japanese economy experienced unprecedented serious structural changes. The sharp decline in the economic growth rate meant a drop in tax revenues, and new social welfare programs and public investment to stimulate domestic demand drastically increased government spending.

A quick inspection of table 3.1 indicates how much the government budget changed. Up to 1974, the government had a budget surplus or at least a balanced budget. But huge government deficits arose in 1975 from the first oil shock and accelerated due to the second one. As a result, the budget deficits at the general government level amounted to 4.4 percent of the GNP in 1979.

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Comments from Professors Tatsuo Hatta, Hiromitsu Ishi, Takatoshi Ito, and Charles McLure are greatly appreciated.

Table 3.1 **Sectoral Saving-Investment Balance as Percentage of GNP, 1970–88**

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Public sector	−0.6	−2.3	−2.6	−0.5	−3.8	−7.5	−6.8	−7.3	−7.4	−7.1
General government	1.8	0.5	0.2	2.0	0.0	−3.7	−3.6	−4.2	−4.2	−4.4
Central government	0.0	−1.0	−1.1	0.4	−1.4	−4.0	−4.3	−5.0	−4.8	−5.7
Local government	−0.4	−1.0	−1.1	−1.0	−1.3	−2.1	−1.6	−1.8	−1.7	−1.4
Social security fund	2.2	2.5	2.4	2.6	2.6	2.4	2.3	2.7	2.4	2.6
Public enterprise	−2.4	−2.8	−2.8	−2.5	−3.7	−3.8	−3.2	−3.2	−3.2	−2.7
Private enterprise	−5.5	−4.7	−5.1	−9.4	−8.2	−4.7	−3.4	−1.5	0.1	−2.5
Household	7.9	8.8	10.1	10.6	11.6	11.5	10.9	10.4	8.7	7.6
Domestic	1.8	1.8	2.3	0.7	−0.4	−0.8	0.7	1.6	1.4	−2.0

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Public sector	−6.4	−6.2	−5.7	−5.2	−4.1	−2.9	−2.3	−0.9	
General government	−4.0	−3.7	−3.4	−3.0	−1.8	−0.8	−0.3	0.8	2.9
Central government	−5.4	−5.3	−5.2	−4.9	−4.0	−3.7	−3.1	−2.0	
Local government	−1.3	−1.2	−0.9	−0.8	−0.6	−0.3	−0.4	−0.3	
Social security fund	2.6	2.8	2.7	2.7	2.8	3.2	3.1	3.1	
Public enterprise	−2.3	−2.5	−2.3	−2.2	−2.3	−2.1	−2.0	−1.7	
Private enterprise	−3.3	−3.5	−2.5	−1.7	−2.6	−3.9	−3.1	−4.2	−8.3
Household	9.3	9.8	8.2	9.2	8.9	9.9	9.7	7.8	8.4
Domestic	−0.4	0.2	0.0	2.3	2.1	3.1	4.3	2.7	3.0

Source: Economic Planning Agency, National Economic Accounting, 1989.

Since then, there has been growing concern with how to eliminate government budget deficits.

Unfortunately, strong opposition has emerged to the introduction of the Japanese type of VAT, the "general consumption tax," which is a tax credit type of VAT without invoices. The ruling Liberal Democratic Party (LDP) lost many seats in the lower house in the 1979 general election, mainly due to public resistance to this general consumption tax. This election forced the government to give up plans for the general consumption tax and to change to a strategy of curtailing budget deficits. The only measure that remained was the spending-cut policy.

The government rushed on a campaign for "fiscal reconstruction," which aimed to reduce budget deficits by cutting government expenditures. It adopted the so-called ceiling method, imposing guidelines on the preliminary budget requests from each ministry. This spending cut policy beginning in 1980 was highly successful in that nonentitled central government expenditure remained constant from fiscal 1983 to fiscal 1986. There were two major reasons for this success. One was the reform of social welfare systems such as health insurance in 1984 and social security in 1985. Another was the sharp decline in public investment, which decreased from over 10 percent to 6.5 percent of the GNP.

It should be emphasized that revenues also contributed to the reduction in the budget deficits. The government left the individual income tax untouched except for minor changes after failing to introduce the general consumption tax. This led to automatic increases in income tax burdens, owing to bracket creep from income increases and inflation. Moreover, the corporate income tax rates were raised. For example, in 1984, the basic rate was raised from 42 to 43.3 percent as a temporary measure.

Dramatic recovery from budget deficits started in fiscal 1984. Table 3.1 shows that the budget deficit on the general government level became 0.8 percent of the GNP in 1985, which was better by 3.6 percent than the deficit in 1979. Behind this recovery lay growing criticism of the existing tax system, and the problem of tax reform had become the most important political issue.

The process of tax reform started in September 1985, when Prime Minister Yasuhiro Nakasone appointed the tax advisory commission to review the current tax system and make suggestions for a new one adapted to the challenges of the twenty-first century. Nakasone announced a number of fine-sounding goals, which loosely translated are "equity, fairness, simplicity, freedom of choice, and economic vitality."

3.2 Increased Demand for Tax Reform

Before describing the Nakasone tax reform proposals, I shall analyze why Japan needed the tax reform. The structure of the current tax system was originally based on the recommendations of the Shoup mission in 1949. Although the tax system has been revised occasionally, it has failed to keep up with the big changes in Japanese society and its economy. The tax system and the economy have been badly matched, especially for the last fifteen years.

From 1975 to 1984, the tax burden rose sharply in Japan. Measured in terms of national income, central government taxes were up 4.1 percent and local taxes 2.7 percent. This sort of increase has not been observed in other countries, and both families and businesses feel more heavily and unfairly taxed.

Common dissatisfactions with the present tax system are summarized here.

Tax Burden Differences among Taxpayers. There have been serious complaints about horizontal inequality in Japan, with big differences in tax burden among salaried workers, the self-employed, farmers, and politicians. The popular "10:5:3:1" formulation indicates that labor income of salaried workers is reported in full to the tax authority, while the self-employed can declare only 50 percent of what they earn, farmers 30 percent, and politicians a mere 10 percent.

Differences in tax burden arise partly because the tax collection system for salaried workers is fundamentally different from that for other taxpayers. The former have their taxes withheld by their employers, while the latter pay on the basis of the income they declare in their tax returns. In addition, the self-employed and others filing under the self-assessment system enjoy a far wider variety of tax breaks. The special treatment of unincorporated businesses as quasi-corporations, that is, deemed corporations, is a typical example. This tax preference allows them to deduct all business expenses from taxable earnings and to reclassify much of these earnings as salary payments to themselves and family members. And by making use of the standard deduction for all salaried workers, they further reduce their tax bill.

Differences in the tax collection system and several measures favoring the self-employed and farmers are major causes of the horizontal inequities in the personal income tax. Equity requires elimination of such preferential treatments.

Mismatch between the Wage System and Income Tax Structures. National and local income taxes paid by salaried workers rose from 8.3 percent of their wage earnings in 1970 to 10.6 percent in 1984. This rise has widened a mismatch between the wage system and the individual income tax. Wages in Japan tend to be strongly determined by seniority, and the wage profile rises by age. Yet Japan's income taxes are extremely progressive, placing a pronounced emphasis on the redistribution of income. Between 1970 and 1984, national tax rates ranged from 10.5 to 70 percent in fifteen brackets, local taxes from 4.5 to 18 percent in fourteen brackets.

Such steep graduation does not exist in other countries. Extraordinary progressiveness results in marked unevenness in the distribution of the tax burden among age groups in a society where wages rise with seniority. As workers grow older and earn more money, their tax rates go up steeply, subjecting them to a form of bracket creep.

Figure 3.1 shows the individual income tax burdens at different life stages for the average salaried worker born in 1953. Middle-class or middle-age salaried workers, particularly in their forties and fifties, who are spending a lot for their children's education or for a residence always feel that their tax burden is too heavy. From this point of view, reduction in the progressiveness of the income tax, especially for middle-class salaried workers, has become one of the most important subjects in the tax reform.

Unfairness in Taxation on Capital Income. Tax reform is also aimed at unfair taxation on capital income. Interest income is exempt from income taxation, up to a certain total face value of personal savings. This tax preference is called the "Maruyu system." Moreover, capital gains from selling stock are not taxed in principle, and dividends are preferentially treated under special reduced rates.

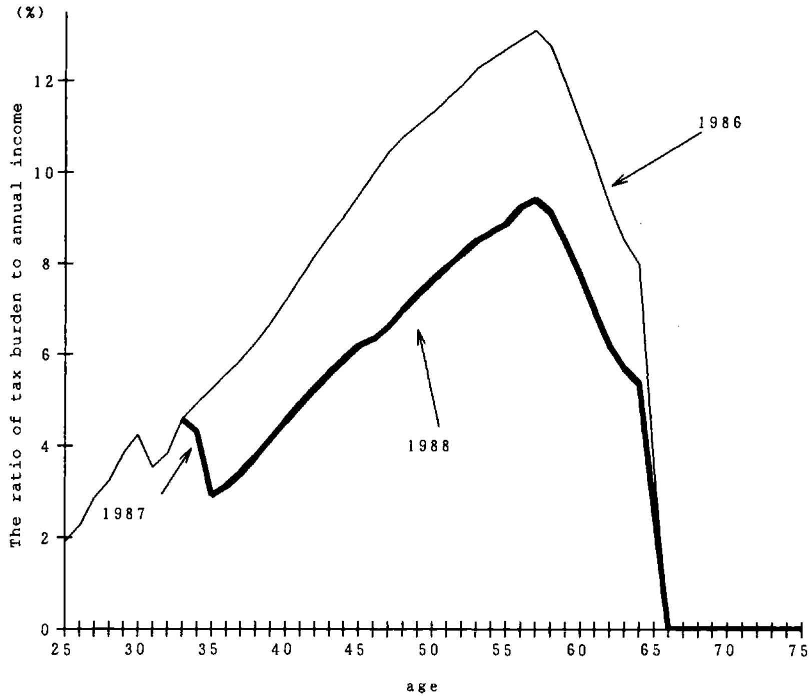

Fig. 3.1 Life-stage tax burden (individual income tax plus local inhabitants' tax)
Source: Basic calculations in Hashimoto et al. 1990.

These special tax measures were initiated to stimulate personal savings and to promote economic growth through capital accumulation. In fact, Japan's high saving rate may have been one of the major factors contributing to the country's rapid growth in the past. But the situation has changed greatly. Preferential tax treatment of personal savings has given rise to especially sharp complaints, not only internally but overseas, as being a source of inequitable tax systems and a factor behind the massive current account surplus. Revising the taxation of income from capital, both to achieve vertical equity and to bring it into line with international standards, is an indispensable part of tax reform.

Complaints about Heavy Corporate Tax Burden. Businessmen often unfavorably compare Japan's corporate income tax to that of other countries. Corporate tax rates have risen several times since 1970, mainly to finance budget deficits. According to Ministry of Finance (MOF) calculations, the effective corporate tax rate, measuring the combined burden of national and local taxes, was 52.92 percent in 1984. This rate is extraordinarily high compared to the United States. As figure 3.2 shows, the marginal U.S. corporate tax rate dropped sharply from 51.55 to 40.34 percent, based on the MOF formula, as a result of Ronald Reagan's tax reform. It has been emphasized in Japan that active corporations might move their place of business to countries where tax burdens are lower, and such a reaction could damage Japanese competitiveness at the international level.

Numerous tax preferences in the corporate income tax, mainly to encourage export and business saving and investment, and a differential rate have added to the complexity of the corporate income tax in Japan. The main objective of corporate income tax reform has been to reduce the tax burden by lowering tax rates and broadening the tax base.

Outdatedness of Indirect Taxes. The outdatedness of Japan's indirect taxes is another problem, because of diversification of consumer spending. From 1970 to 1984, the ratio of indirect tax revenue to final consumer spending shrank from 8.8 percent to 7.7 percent, not because the existing indirect taxes on special categories of consumption had been lowered. On the contrary, the rates had been raised repeatedly, but the tax base was limited to a small number of selected items. Most revenue from excise taxes was collected on purchases of automobiles and home appliances. Many luxuries have never been drawn into the tax base. Services, meanwhile, remained virtually untaxed, even though they accounted for about half of consumption. The failure to update the indirect tax system so as to reflect changing consumption patterns was one of the major reasons indirect taxes had declined in importance relative to direct taxes. A fundamental revision of the indirect tax system is a matter of urgent necessity.

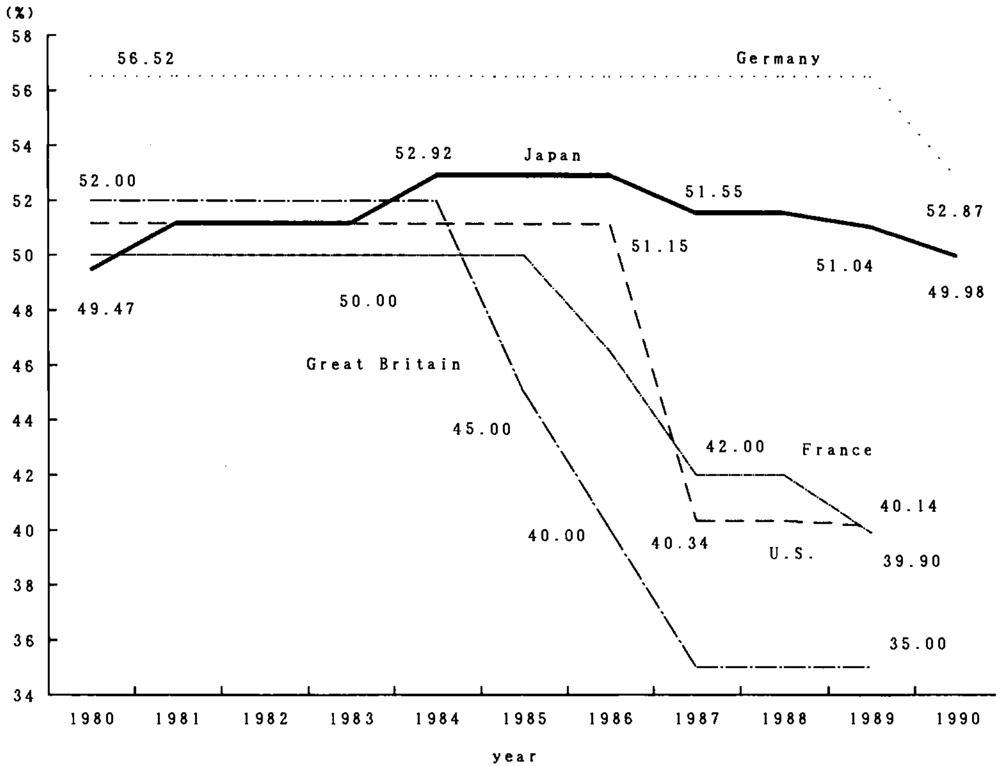

Fig. 3.2 Effective rates of corporate tax (in terms of MOF measure)
Source: Homma and Atoda 1989.

3.3 The Nakasone Tax Reform

Motivated by increased taxpayers' demand for tax reform and inspired by the accomplishment of Reagan's tax reform, Prime Minister Yasuhiro Nakasone took a second step toward tax reform. At his request, the tax advisory commission submitted "The Report on the Overall Review of the Tax System," which constructed a tax reform plan in October 1986. According to the report, the Nakasone administration proposed a fiscal year 1987 tax reform that consisted of the four major recommendations:

1. Reduction of the income tax burden, especially for middle-income salaried workers, mainly through simplification of the tax rates structure and introduction of the special deduction for a spouse.
2. Reduction of the basic tax rate on corporate income to less than 50 percent from the current 52.9 percent, measured in terms of the MOF's effective tax rate.
3. Abolition of tax exemption on interest income for small savers through the adoption of a 20 percent withholding tax.
4. Introduction of the sales tax, which is a variant of the European Community (EC) VAT, in place of the current excise taxes.

Table 3.2 summarizes the reform package of tax increases and reductions. The characteristic feature is that the package was proposed to satisfy "revenue neutrality" in its first year. The concept of revenue neutrality in Japan is slightly different from that in the United States. The U.S. tax reform was designed to be revenue-neutral in the succeeding five years. It should be noted that this mixed reform package results in a shift in the tax mix toward indirect taxes.

As stated above, the basic structure of the Nakasone tax reform would lower the individual and corporate income tax rates by bringing into the tax base income and consumption sources previously excluded, i.e., repeal of the tax exemption for interest income and adoption of a broad-based consumption tax. Thus the Nakasone tax reform avoided the elimination of preferential tax treatment in the individual and corporate income tax, which was strongly resisted by special groups of taxpayers. Instead, it was emphasized that the introduction of a broad-based consumption tax, the sales tax, could contribute

Table 3.2 **Tax Bill Proposed in 1987 (in billions of yen)**

Tax Reductions		Tax Increases	
Individual income tax	27,000	Introduction of the sales tax	35,000
Corporate income tax	18,000	Repeal of tax exemption for small savers	10,000
Total	45,000	Total	45,000

Source: Ministry of Finance, *Monthly Report of Fiscal and Financial Statistics, Special Issue on Tax,* 1988.

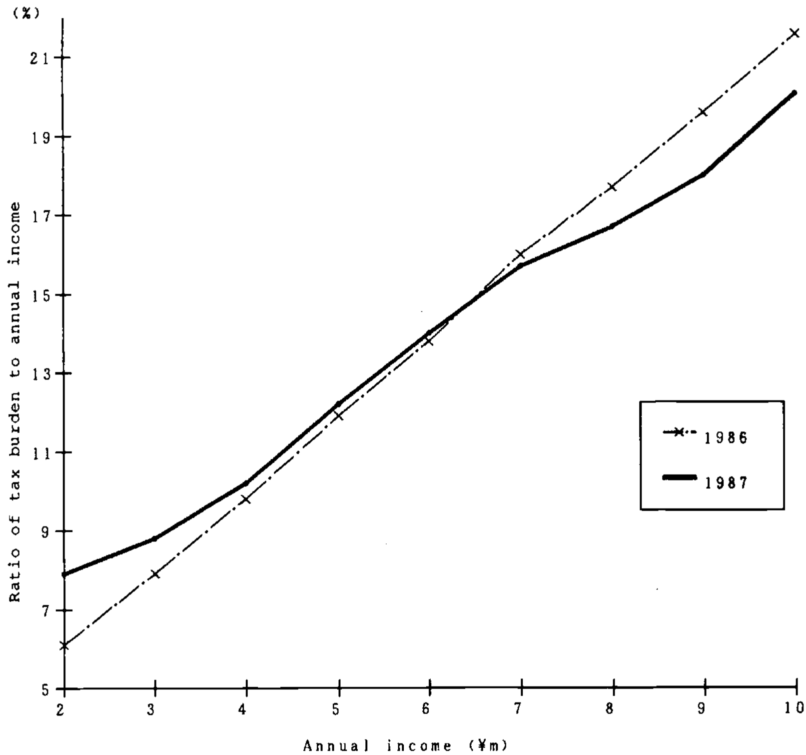

Fig. 3.3 Tax burden on households
Source: Hashimoto et al. 1990.

to horizontal equity because the tax burden would be spread evenly among consumers, irrespective of whether they are salaried workers or self-employed.

Strong opposition to this proposal emerged immediately, for three major reasons. The first was Nakasone's political mistake. During the campaign for the general election in July 1986, he pledged not to introduce a "large-scale" indirect tax. After a landslide victory for the LDP, the tax proposal introduced a large-scale indirect tax, "the sales tax." The general public accused Nakasone of dishonesty.

The second reason was the regressiveness of the package of individual tax reductions and indirect tax increases: the reform was favorable to high-income people rather than to middle- or low-income people. Figure 3.3 shows that those who earned more than ¥6 million annually would benefit from the tax reform, those who earned less would lose.[1] The majority of taxpayers felt betrayed and did not support Nakasone's tax reform.

The third source of opposition was small businesses in the wholesale and

1. See my estimate (1986) for a detailed analysis.

retail trade. Small traders feared that they could not pass the sales tax on at each stage of transactions and would have to bear the tax burden, and that the sales tax with invoices would force them to reveal all their transactions to the tax authority and make it impossible to avoid income tax as they had been doing.

The proposal failed to get approval, and the government was forced to withdraw the bill in May 1987. The Nakasone administration gave up introducing sales taxes and submitted a revised bill to the Diet. The revised bill that was passed in September 1987 was the final product of Nakasone's tax reform.

Let me summarize briefly Nakasone's achievement before proceeding to the next stage of tax reform.

Simplification of Tax Rate Structure. Simplification of the progressive tax rates is much more modest than in the original plan. The original proposal of 10–50 percent in only six income brackets was revised to 10.5–60 percent in twelve brackets. The range of taxable income to which the minimum rate applies was widened, so that about two-thirds of salaried workers would be taxed at the minimum. The maximum rate was lowered from 70 percent to 60 percent. See table 3.3.

Introduction of Special Exemption for Spouse. As explained earlier, a self-employed person is permitted to reduce individual tax by sharing income with a spouse and other family members under special preferences of deemed cor-

Table 3.3 Statutory Rates of Income Taxes

1986		1987	
Taxable Income (millions of Y)	Tax Rates (%)	Taxable Income (millions of Y)	Tax Rates (%)
Under 0.5	10.5	Under 1.5	10.5
0.5–1.2	12	1.5–2.0	12
1.2–2.0	14	2.0–3.0	16
2.0–3.0	17	3.0–5.0	20
3.0–4.0	21	5.0–6.0	25
4.0–6.0	25	6.0–8.0	30
6.0–8.0	30	8.0–10.0	35
8.0–10.0	35	10.0–12.0	40
10.0–12.0	40	12.0–15.0	45
12.0–15.0	45	15.0–30.0	50
15.0–20.0	50		
10.0–30.0	55	30.0–50.0	55
30.0–50.0	60	50.0 and over	60
50.0–80.0	65		
80.0 and over	70		

Source: Ministry of Finance, *Monthly Report of Fiscal and Financial Statistics, Special Issue on Tax*, 1988.

porations. Salaried workers who have no way to split income complain about this preferential treatment, which results in a big tax gap between salaried workers and the self-employed. To lessen this gap, a special exemption of ¥165,000 for spouses of salaried workers is deductable from total income in addition to the ordinary deduction of ¥300,000

Revision of Tax Exemption for Small Savers. As explained earlier, interest income was tax exempt for small savers. This exemption had been abused extensively by rich people because Japan had no adequate enforcement of the limitation on the maximum amount of saving eligible. Since the revision, interest income is taxed in principle by a withholding tax at the uniform rate of 20 percent except for the elderly, fatherless families, and handicapped people.

Minor Reduction of Corporate Tax Rates. The corporate income tax had two split rates, one for retained income (43.3 percent), another for dividends (33.3 percent). In each tax rate, 1.3 percent was temporarily surcharged to help "fiscal reconstruction." This surcharge was abolished by the bill, and the effective corporate tax rate dropped from 52.92 to 51.56 percent in terms of MOF's effective tax rate. See figure 3.2.

3.4 The Takeshita Tax Reform

The Nakasone tax reform ended in September 1987 after he achieved only half of his original plan. But his main ideas of tax reform were adopted by the next cabinet. Nakasone appointed Noboru Takeshita as his successor, asking him to go forward with the tax reform.

When the Takeshita administration relaunched the tax reform in November 1987, great changes were visible in the Japanese economy. Stable and strong economic growth resulted in large tax revenue increases in 1987 and the following years. Thus budget deficits disappeared, and in fact a huge budget surplus at the general government level appeared for the central government, local government, and social security account (see table 3.1).

Taking these changes into consideration, the Takeshita administration abandoned the "revenue-neutral" tax reform approach and offered in 1988 a new tax plan that contained a ¥24,000 billion net tax reduction (see table 3.4). This tax reduction was more attractive to taxpayers and to other countries, for it could increase the domestic market.

Moreover, asset prices such as land and stock soared. This stressed the unfair distribution of asset holdings among the rich and the poor, and revealed that the present tax preferences for income derived from selling land and stock were very inequitable. In addition to the remaining reforms suggested by Nakasone, i.e., introduction of broad-based indirect tax, the Takeshita tax reform plan had to include a new taxation system for capital gains on the sale of stocks.

Table 3.4 **Tax Bill Proposed in 1988 (in billions of yen)**

Tax Reductions		Tax Increases	
Individual income tax	3,100	Introduction of consumption tax (5,400) minus repeal of selective excise tax (3,400)	2,000
Corporate income tax	600		
Inheritance tax	700		
Total	4,400	Total	2,000
	Net reduction 2,400		

Source: Ministry of Finance, *Monthly Report of Fiscal and Financial Statistics, Special Issue on Tax*, 1989.

The four basic features of the tax reform sent to the Diet in July 1988 by the Takeshita administration are summarized here.

Further Reductions of the National Individual Income Tax and the Local Inhabitants' Tax. The number of income tax brackets was reduced from fifteen to twelve by the Nakasone tax reform. A flatter tax schedule is proposed by the Takeshita tax reform (see fig. 3.4), ranging from 10 to 50 percent in five income brackets. Also, the progressiveness of the local inhabitants' tax has been reduced to 5–15 percent with three income brackets.

The personal exemption for spouses and the exemption for dependants simultaneously rose from ¥300,000 (¥280,000 for local inhabitants' tax) to ¥330,000 (¥300,000). And two additional measures are expanded or introduced in favor of specific taxpayers. The special exemption for spouses in one-earner couples was introduced at ¥100,000 (¥50,000).

Further Cut and Unification in Corporate Tax Rates. The basic rate for retained income levied on ordinary corporations gradually decreased from 42 percent to 37.5 percent after fiscal 1990, while the reduced rate for dividends rose from 32 percent to 37.5 percent. The two split tax rates are now a single tax rate, simplifying the present corporate income tax. A similar modification applies to tax rates on small and medium-size corporations; the basic rate decreased from 30 to 28 percent, and the reduced rate rose from 24 to 28 percent.

Introduction of the Consumption Tax. The most important issue in the Takeshita tax reform was the new consumption tax, which is a special variant of VAT. The sales tax proposed by the Nakasone tax reform was the invoice-credit method, as used in the EC, but this was clearly rejected by the public. Learning from this experience, the government adopted a VAT that uses no invoices.

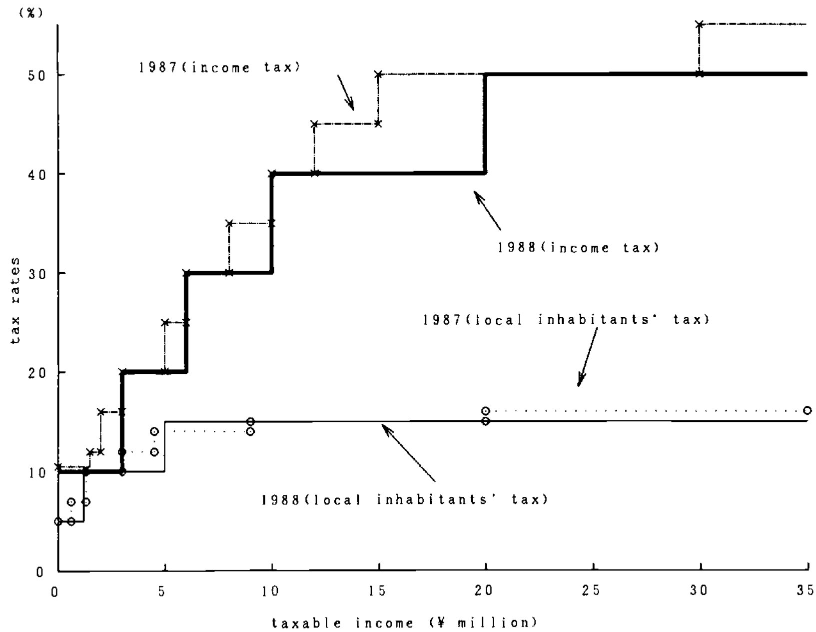

Fig. 3.4 Marginal rates of income tax and local inhabitants' tax for a family of four with a single wage-earner
Source: Basic calculations in Homma et al. (1988).

The consumption tax without invoices depends on the subtraction method of the VAT, which uses bookkeeping to calculate a firm's VAT. In this sense, it is called the account type of VAT. Subtracting total taxable purchases from total taxable sales gives the taxable value added, subject to a 3 percent VAT.

The account type of VAT is useful mainly because it mitigates opposition to the new tax from groups in retail or wholesale businesses. It has several problems, however. First, tracing the transactions from one stage to another is impossible—a strong incentive for cheating, because accurate assessment of the tax base is very difficult for the tax authority.

Second, the account type of VAT cannot make clear distinctions among fully taxed, tax-reduced, and tax-exempt goods and services. This is why the consumption tax covers only a few tax-exempt goods and services, such as some education, medical care, and welfare programs, and abandons multiple tax rates. The broad tax base and single tax rate save compliance costs but appropriately cope with the distributional problem.

Moreover, the consumption tax has a special simplified rule for computing tax that favors smaller firms whose annual sales are less than ¥500 million. This special rule assumes that the total value of purchases from other firms is 80 percent of total sales value for retailers (90 percent for wholesalers). This implies that the value added is 20 percent of total sales, and therefore tax is automatically equal to the total sales value multiplied by 0.6 percent (0.20 of the 3 percent rate). Completely exempt are firms whose annual sales are less than ¥30 million, 68 percent of the total number of firms in 1986.

Taxation on Capital Gains from Selling Stocks. Capital gains on the sale of stocks were to be taxed under the Shoup tax proposals in 1950. But the government decided not to tax these capital gains, partly because they could stimulate domestic savings and promote economic growth and partly because effective enforcement of the tax was very difficult. Since then, capital gains had in principle been tax-exempt except for people who continuously dealt with stocks in large volumes.

Reflecting a sharp rise in stock prices, untaxed capital gains on the sale of stocks had been seriously attacked as a symbol of unfairness. In response the Takeshita administration proposed that taxpayers could choose at each transaction between two tax methods. One was the self-assessed declaration, in which realized capital gains would be taxed separately from other income at 26 percent including local tax. The second was withholding, in which the taxpayers would have to pay 1 percent of the stock sales price, assuming that the capital gain at each transaction is 5 percent of the stock sales prices.

3.5 Effects of the Reform on Households

When a country's tax system is thoroughly overhauled, all taxpayers are affected in one way or another. The Japanese reform, designed to reduce taxes overall, seems basically sound in its thrust. The new consumption tax has a broad revenue-enhancing effect. National and local income taxes are being reduced, mainly through a flatter rate schedule that lowers the maximum rate and raises the minimum amount of income subject to taxation. Other noteworthy changes include a large hike in the special exemption for spouses, which applies only to one-earner couples, and an enhanced exemption for certain dependents aged 16–22.

One basic effect of the reform will be a redistribution of the tax burden on each category of household. Compare, for instance, two-earner couples, in which both spouses work, with one-earner couples. Before the reform a two-earner couple usually paid substantially less taxes than a one-earner couple with the same amount of income, providing an incentive for both spouses to hold jobs. The flattening of the tax schedule reduces this difference, as does the larger exemption for a spouse, which cannot be used by two-earner couples. Introducing a consumption tax will have a similar effect, since it will raise the prices of the domestic services that two-earner couples often hire and the value of those that one-earner couples provide within the home.

Couples living on pensions should see a rise in their tax burden. They will not benefit from the cut in income taxes, and they will be paying more consumption taxes. Neither will the reduction in income taxes help unmarried taxpayers much, unless they happen to earn a lot of money: they generally are big consumers, and the exemption for spouses does not apply.

I have conducted a series of simulations to clarify these and other effects of the tax reform on different household categories. Below I summarize the main findings.

For our study, we used the five-category breakdown of households shown in figure 3.5, drawing on a nationwide survey of consumption. Slightly more than half all Japanese households are in the one-earner couple or single-income category. Less than one-tenth are one-member households—mostly younger men or women living independently. Senior citizens above the pension-entitlement age account for a small fraction of the total. About half of these "old-aged couples," as we label this category, have some employment income; the rest depend almost entirely on pensions. All other households are those in which both husband and wife work.

I have broken this last group into two categories, each of which accounts for about one-sixth of all households. In the "single plus part-time income" category, usually the husband is a full-time worker and the wife supplements the family income with part-time employment, bringing in less than

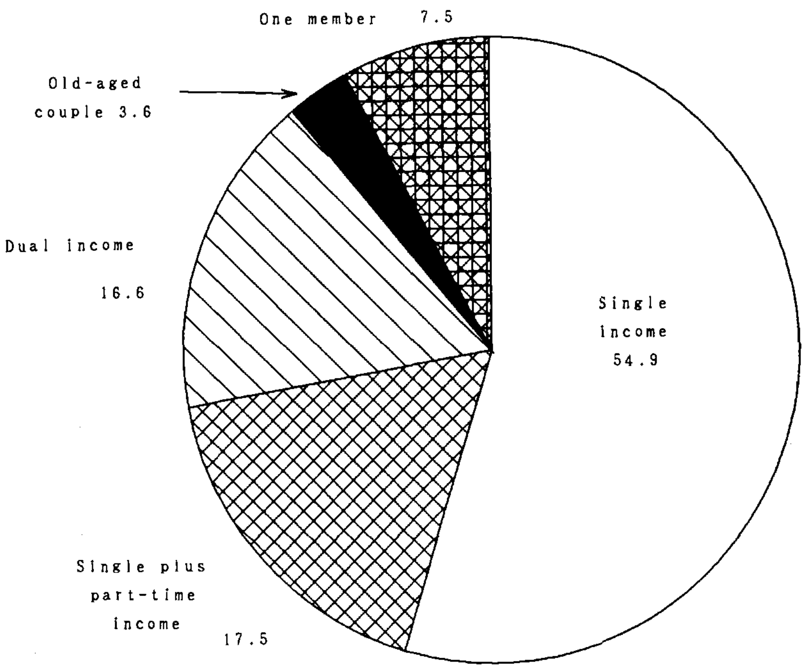

Fig. 3.5 Categories of households (% of total households)
Source: Calculations from Homma et al. (1988).

¥900,000 per year, the threshold beyond which a spouse could not be claimed as a dependent before the reform. The other is the true two-earner couple or dual-income category; it covers all families in which the second worker's income exceeds ¥900,000.

3.5.1 The Rich and the Poor

Next let us consider the typical income profile of these five household categories. On a scale extending from the vicinity of ¥2 million, the earnings of an entry-level employee or lower-class family, to ¥10 million or more for people in upper income brackets, the average family has an annual income of around ¥4 million or ¥5 million.

As shown in figure 3.6, single-income households and younger people living alone account for the majority of low-income families (Homma et al. 1988). At incomes up to ¥2 million, almost 90 percent of all households fall in one of these two categories, and the rest are people living on pensions. On the upper end of the scale, 82 percent of the households earning ¥10 million or more are single-income families, and almost all the rest are dual-income families.

Households of young unmarried people and of old-aged couples are clustered in the lower income brackets; as income reaches the ¥6 million level, their percentage of all households diminishes to a tiny fraction. By contrast, few families with two earners, including the category where the spouse works part time, fall in the lowest income brackets.

Looking more closely at the three categories of households in which both spouses are in their productive years, we can note differentials in their distribution. Thought the one-earner families are prominent in all income brackets, they are most highly represented in the relatively low ¥3 million–¥4 million income range. Families in which the wife works part time are, as noted, infrequent on the upper end. Their distribution rises sharply to a peak in the ¥4 million–¥5 million range and declines almost as sharply. The true dual-income couples naturally have a somewhat richer profile. Their distribution peaks in the ¥5 million–¥7 million range and then declines gradually. A fairly large percentage of the households in this category are in the upper income brackets.

3.5.2 Divided Impact on the Middle Class

Now we can proceed to an analysis of the Takeshita tax reform's impact. As is customary in this sort of analysis, I assume that the "standard" family has two parents and two dependents. What we are looking for is the change in total taxes after the new measures, except for the corporate income tax, are all in place compared with taxes in 1987, before the first measures went into effect.

As noted, one change is a larger special exemption for spouses with no job,

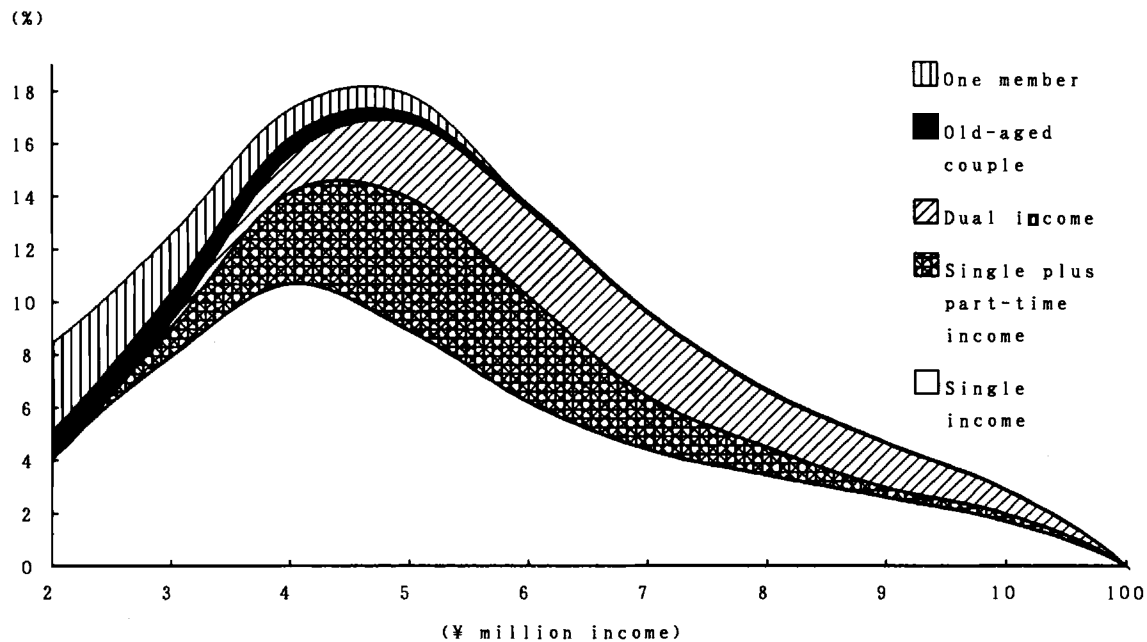

Fig. 3.6 Breakdown of households by annual income

which has been boosted from ¥165,000 annually to ¥350,000. This exemption can be claimed by any one-earner family earning up to ¥10 million a year. Another change is a small ¥20,000 increase in the exemption for each dependent, to ¥350,000, together with a provision enabling families with children between 16 and 22, who have high education expenses, to claim a larger exemption of ¥450,000. These breaks should more than offset the burden of consumption tax for one-earner couples, reducing their total taxes.

Figure 3.7 shows the effects of the reform on middle-class families. Looking first at one-earner couples, we can see that their taxes will decline substantially if they can claim the large exemption for an older child. Slightly smaller but still significant reductions result even when the enhanced exemption cannot be claimed. The biggest savings will be realized by families in the upper-middle class with incomes in the ¥7 million–¥10 million range, who should see a reduction in their taxes of 10 percent or more. For the lower-middle class, which might be defined as families earning between ¥4 million and ¥6 million, the reduction in taxes is slightly lower. A one-earner family earning ¥3 million will benefit only modestly; below that there could be an increase in taxes. Such observations provide clear evidence of the reformers' intention of slanting the benefits in the direction of the middle and upper classes.

Still, even low-income families with one earner will not necessarily bear a heavier tax burden. As long as they have no children or only one, reducing their consumption and thus the burden of consumption tax, I calculate that their taxes should decline slightly even if they are in the ¥2 million–¥3 million bracket. The biggest break is the much larger special exemption for spouses. Families with many children will pay more because of consumption tax; the comparatively small hikes in dependent exemptions will not cancel its effect.

Families in which the wife works part time do not fare as well. They can claim the special exemption only if the second worker brings home ¥570,000 or less. Above that the deduction decreases. Those couples earning less than ¥4 million each year will see a fairly large rise in their tax bills. As I have noted, however, many families in the single plus part-time income category earn more than ¥4 million, and they should all see an average reduction in their taxes of about 5 percent.

The worst off will be the two-earner families who earn less than ¥8 million. They will all have to pay more taxes because consumption tax will more than offset the relatively small cuts in national and local income taxes for their income brackets. Since only a minority of two-earner families earn more than ¥8 million, we can conclude that the reform is not designed to improve the situation of the average family in this category.

Above I noted that families in which both spouses hold regular jobs have been favored in the tax system thus far. By reporting their income separately instead of together, they have been eligible for more breaks. Since many of

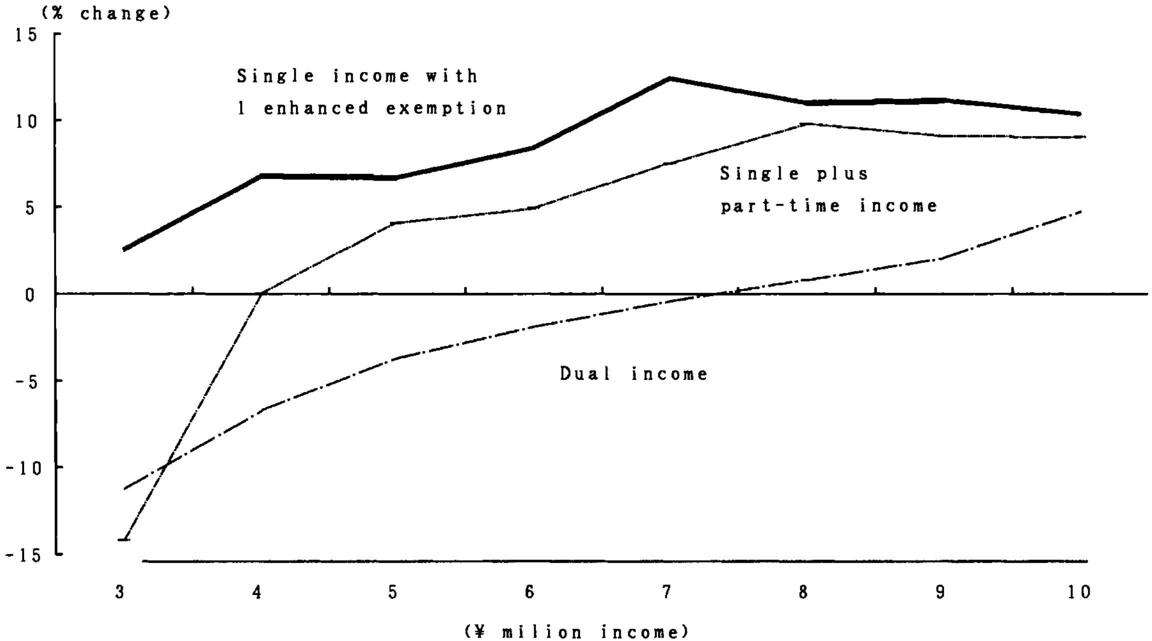

Fig. 3.7 Tax changes for four-member families
Source: Homma et al. (1988).

these two-earner couples will now have a higher tax bill, at least relative to one-earner couples, the reform has moved their taxation closer to the average.

One further point deserves attention. Under the old tax system the two-earner couples came out ahead of the one-earner couples only if their income amounted to ¥5 million or more; below that, their tax burden was slightly higher. Now the breakeven point comes in the vicinity of ¥6 million. Above that, the dual-income family will still pay somewhat less; below that, the size of its disadvantage will grow larger. Of all working couples, these are the ones that are hardest hit.

3.5.3 The Plight of Pensioners

How will Japan's young singles and old-aged couples come out? I have calculated their taxes using average income statistics for their households. As noted earlier, 7.5 percent of all households are those of young people living alone. They divide evenly between males and females, but whereas single men earn ¥2.5 million in employment income on the average, single women earn only ¥1.9 million. The women are better at saving, earning ¥68,000 in interest and dividends compared with ¥39,000 for the men. The women consume less than the men, but their consumption is a higher percentage of income because of their lower earnings.

Before the reform, single men incurred total taxes amounting to ¥329,000 on the average, a level that comes to 13 percent of their income. After the reform their burden will be almost unchanged, moving up slightly to ¥341,000. Single women will be hit harder. Their prereform tax burden of ¥216,000 will climb by 9 percent to ¥235,000, elevating their ratio of taxes to income from 11 percent to 12 percent.

Among the 3.6 percent of households receiving pensions, meanwhile, the reform's impact will differ between those senior citizens who also have employment income and those who do not. Old-aged couples receiving money from both jobs and pensions have an average annual income of ¥4.5 million. Before the reform, their total tax bill, including payments for local and indirect taxes, came to ¥257,000; after the reform it should drop by 7 percent to ¥239,000. This will slightly reduce their ratio of taxes to income from 5.7 percent to 5.3 percent.

One of the heaviest increases in taxes will be shouldered by old-aged couples who are almost entirely dependent on pensions, living on some ¥2.5 million a year. Most of the taxes they pay are the various existing indirect taxes; the introduction of a consumption tax scheme will shift their payments from ¥118,000 to ¥139,000, a sharp rise of 18 percent. As a result, the tax-to-income ratio will climb from 4.7 percent to 5.5 percent.

3.5.4 Adding up the Losers

Having reviewed the tax changes in each household category, we are now in a position to estimate the percentage of households that will be forced to bear a heavier tax burden. Before proceeding, note that my source for the distribution of households in each income bracket is from 1984. Since there has been a rise in income levels since then, the estimates may be somewhat high.

Virtually all one-earner couples will receive tax relief; those that may see an increase in their payments are limited to families earning less than ¥3 million. Even among these, there may still be a slight reduction in taxes depending on their life-style. The families in the ¥2 million–¥3 million bracket with just one child may come out ahead. All in all, I calculate that one-earner couples that will be paying more taxes come to 8.4 percent of all Japanese households.

For families with part-time income from spouses, taxes will increase only for the 4.5 percent of all households that have income of under ¥4 million. Dual-income families in the ¥6 million–¥8 million bracket will still be paying less taxes than single-income families who earn less than ¥6 million. They account for 7.8 percent of all households.

Among old-aged couples, the only beneficiaries are those who have employment income and whose total annual income exceeds ¥4 million. Since most senior citizens do not have that much income, we can add another 3.0 percent share to the households that will be hurt by the tax reform. And the same can be said of the 7.5 percent share of single men and women, almost all of whom will be paying more taxes.

Adding up these shares, we find that slightly over 30 percent of all Japanese households will see a modest to large increase in their taxes. Put another way, the great majority of households should benefit from the reform—or at least not be seriously harmed by it.

3.5.5 The Life-Stage Tax Burden

The Takeshita reform package, switching from direct to indirect taxation, works well in terms of the life-stage tax burden on households. As emphasized in section 3.2, wages in Japan are strongly determined by seniority, and the income tax rate structure of has been extremely progressive. Under this situation, middle-age salaried workers in their forties and fifties have had a heavy tax burden (see fig. 3.1).

As a result of income tax cuts and an increased consumption tax, the tax burden is flattened and averaged over the whole life. Figure 3.8 confirms that this is the case. The combination of income tax cuts and an increased consumption tax will shift the tax burden from the middle-aged stage to the younger or older-aged stage.

3.6 Prospects for Further Reform

I have briefly reviewed the process and contents of tax reform in Japan. Judged from the present achievements, the tax reform unfortunately is far

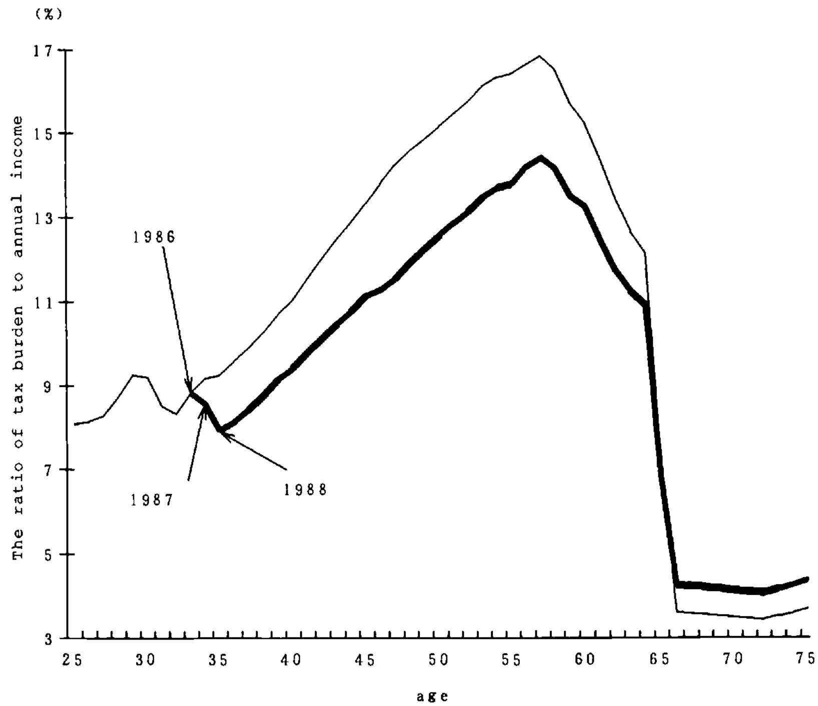

Fig. 3.8 Life-stage tax burden (individual income tax, local inhabitants' tax, and consumption tax)
Source: Homma et al. (1988).

from satisfactory and we still have a lot of work to improve the tax system. Here I shall note prospects for further reform.

The standard procedure for tax reform is to reduce marginal tax rates by broadening the tax base. This is an indispensable step to attain consistent fairness, neutrality, and simplicity. But broadening the tax base is insufficient to substantially reduce individual income tax rates and corporate tax rates.

One approach to broadening the tax base is to repeal special exemptions and deductions for particular groups of taxpayers. Typical examples are the special treatment of the income that medical doctors receive from social insurance programs: the special treatment of unincorporated businesses as deemed corporations; and tax-free reserves, depreciation allowances, and tax credits in corporate tax. These preferences are untouched, except for the elimination of the deductability of corporations' interest payments on land purchases, because the government fears strong political repercussions. In order to secure fair taxation, greater efforts must be made to eliminate these tax preferences.

Another measure to broaden the tax base is to include income sources that were previously excluded. The current tax reform marks a great advance in taxation of capital income. More specifically, the abolition of the tax exemption on interest income for small savers and the repeal of the exemption of capital gains on the sale of stocks have been achieved. But small savers are not very happy about the adoption of a separate withholding tax rate. It is often claimed that the present taxation system on capital income must be changed into a comprehensive tax system. To do so, we must introduce the tax identification number. This has been a most controversial issue in Japan, however, and has not been settled.

The taxation of land has been heatedly discussed. As mentioned earlier, land prices have soared sharply since 1987, accompanied by growing criticism against the present taxation system. The tax base of the real estate tax is extremely undervalued relative to current prices, and therefore the effective real estate tax rates are extraordinarily low. In addition, special treatments for agriculture have induced landholders not to sell their land and have been a major cause of high land prices.

There has been great concern about the revision of consumption tax introduced in the current tax reform. To obtain support from opposing groups in retail and wholesale, the consumption tax has several special measures that are likely to wipe out the possible merits of the usual VAT. The most serious drawback is the subtraction method, which uses bookkeeping without invoices. As explained earlier, there is a strong incentive for cheating, because the chain of transactions from one stage to another cannot be traced. Moreover, the subtraction method is an imprecise way to deal with the export tax credit, compared to the usual type of VAT, i.e., the invoice method.

Special treatment of small or medium-size traders should also be formulated by international standards. Some type of exemption system frees small traders from the VAT in every country. The consumption tax in Japan sets the exemption level of ¥30 million in terms of annual sales, extraordinarily high compared to other countries. In addition, the special simplified procedures for measuring the tax base must be reconsidered, because they include too many taxpayers. Taxable traders with annual sales of less than ¥500 million can apply the simplified procedures, which use fixed percentages. This greatly impairs fairness and distorts economic activity.

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Comment Hiromitsu Ishi

Masaaki Homma has two objectives in his paper on recent tax reforms in Japan: to trace the trends of previous tax reforms and to estimate the distributional effects of the Takeshita tax reform. Both parts are interesting and stimulating and should be of great help to foreign observers. In particular, the first part of this paper is a well-drawn clarification of many issues in the tax reforms attempted by the Japanese government over the past decade.

The facts in this paper are limited to the distributional effects of tax reform. However, Homma does not clearly derive his policy implications from these facts. For instance, he demonstrates that slightly over 30 percent of all Japanese households will see a modest tax increase as a result of the Takeshita reform package. Does this imply a successful tax reform or not? Of course, it is a bit difficult to assess such a complicated reform package, but I'd like to hear Homma's overall judgment of the sweeping tax reforms in Japan.

Second, his argument is restricted to short-term effects of the tax reforms. However, sweeping tax reforms by the Nakasone and Takeshita governments have obvious links to the future performance of the Japanese economy, given Japan's aging population. Consequently, the reform package should be assessed on its long-term policy effect. (Yukio Noguchi puts a positive value on Japan's VAT over the long run [see chapter 9].)

Third, it seems to me that Homma supports a heavier tax burden on capital income, such as interest and capital gains, but does not state his position on comprehensive income tax. I think it is crucial to address taxing of capital income in the controversy over income tax versus expenditure tax.

Even though capital income has been taxed more heavily in recent tax reforms, rates are different from those for other income. Homma does not say whether this tax change on capital income is justifiable. Theoretically, Japan's

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tax system is still midway between a comprehensive income tax and an expenditure tax.

To continue tax reform, which direction, income tax or expenditure tax, should we take in the future? In view of capital income taxation, should we maintain the current system, levy heavier taxes on capital income, or mitigate its tax burden until it is tax free?

Comment Charles E. McLure, Jr.

My comments on Masaaki Homma's paper fall into four general categories. They are as much comments on Japanese tax reform as on the paper.

Defects of the Subtraction VAT

Japan has adopted a subtraction-method value-added tax at a time when the defects of such a tax are coming to be widely recognized. Unlike the credit method, the subtraction method involves calculating and taxing "slices" of value added. Thus the tax rate applied at each stage in the production-distribution process actually matters, contrary to the situation under the credit method. Such a tax can operate effectively only if the tax base is comprehensive and there is only one rate. Multiple rates create distortions and make accurate border tax adjustment (taxation of imports and tax rebates on exports) impossible. In the recent Canadian debate this feature of the subtraction method was seen by some to be an asset: politicians would be constrained by the technical features of the tax to avoid legislating multiple rates and exemptions. My own view is that this is naive; legislators will do what they want, whether it makes sense or not. Japanese experience may suggest that those favoring the subtraction method in Canada were right, since there is only one rate in Japan. But one wonders whether the uniqueness of the rate will survive if additional revenues—and higher rates—are required.

The provision of relief for small business is also problematical under the subtraction method. Under the credit method an exemption actually increases tax liability, rather than decreasing it; as a result, no business with substantial purchases of taxed inputs that is capable of compliance with the tax would voluntarily choose to be exempt. By comparison, under the subtraction method, exemption lowers tax liability and is much to be desired. Depending on eligibility requirements for exemption, a small business exemption can encourage fragmentation of business, resulting in inequities, economic distor-

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tions, and loss of revenue. The potential for mischief is reduced in the Japanese system by an arbitrary assumption that taxed purchases constitute 80 percent of sales. This approach, however, has another disadvantage. It converts the VAT into a turnover tax for businesses that use this provision.

Biting the Bullet

One is struck by the Japanese government's unwillingness to make politically hard choices that would raise taxes on certain segments of society—primarily small business—by introducing commonplace improvements in administrative techniques. The invoice-based credit-method VAT was rejected because taxpayers feared that the audit trail produced by the invoices would facilitate income tax administration. Japan still does not have a comprehensive taxpayer identification number. Those in business are allowed to pay tax-deductible salaries to family members, without regard to whether or not services of equal value are rendered in exchange, a practice that is commonly outlawed in other countries. This kowtowing to small business stands in marked contrast to the increase in the taxation of two-earner families. One wonders whether the lack of a capital gains tax on stock allows the tax on real estate gains to be circumvented by holding assets in corporate form.

Finally, one also wonders why there has been such opposition to the relatively modest 3 percent VAT on the part of housewives. Is it a "foot in the door" phenomenon: the fear that the rate will not remain at 3 percent for long? Are housewives simply fronting for neighborhood merchants who scare them with rumors of tax increases?

Reducing Saving Incentives

Japan, by introducing taxation of interest income, like other countries, has tilted from the consumption tax end of the income-consumption spectrum toward the income tax end. This leads me to make a short comment that may be more relevant for other papers given at this conference than for Homma's paper on Japan.

Economic theory tells us that under certain idealized circumstances, expensing of investment leads to a zero marginal effective tax rate on the income from equity investment. If investment is debt financed, an interest deduction creates a negative marginal effective tax rate at the firm level. This may, however, be compensated if interest income is taxed, though such compensation is sometimes only partial because of differences in tax rates paid by borrowers and lenders. If interest income is exempt, however, the combined marginal effective tax rate paid by firms and their creditors is negative. Even if depreciation allowance (together with whatever investment allowances exist) is less generous than expensing, it is still quite possible to have a negative marginal effective tax rate if interest is exempt or only partially taxed.

This line of reasoning raises interesting questions for the countries represented at this conference. What is the resource allocation effect of a tax policy that implies negative marginal effective tax rates? It is quite common to have theoretical results favoring the exemption of income from capital. It is less common, though not unknown, to have theoretical justifications for negative marginal effective tax rates.