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Japanese Taxation and the 1989 Reforms

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On December 24, 1988, Japan's Diet adopted a set of legislative tax reforms including an introduction of consumption tax, which is a variant of the VAT, and alleviation of income tax, corporation tax, and inheritance tax. These reforms are said to be the most drastic overhaul since 1950, when the basic structure of the Japanese tax system was established. The proportion of direct taxes to indirect taxes has certainly changed as the result of the tax overhaul, but has it solved the problems which existed in Japanese taxation? This article describes trends and features of Japanese taxation and the 1989 reforms, and considers some of most important problems relating to them.

I. Trends in Japanese Taxation

The overall tax level in Japan is low compared to other industrialized countries. As shown in table 1 this is the case for the whole period covered. But the size of the total tax revenue has increased rapidly over this period. Expressed in current prices the total tax revenue in 1985 is roughly 14-15 times larger than in 1965.

With few exceptions the annual percentage increase in total tax revenue has exceeded the GDP-growth. This has naturally resulted in an increase

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TABLE I. Total Tax Revenue as Percentage of GDP, 1965, 1970, 1975, 1980, and 1985
(Percent)

Country	1965	1970	1975	1980	1985
Australia	23.5	24.5	27.9	29.2	30.3
Germany	31.6	32.9	35.7	38.0	37.8
Italy	23.6	24.2	25.1	30.0	34.7
Japan	18.3	19.7	20.9	25.5	28.0
Sweden	35.4	40.2	43.9	49.4	50.5
United Kingdom	30.6	37.1	35.4	35.3	38.1
United States	25.9	29.2	29.0	29.5	29.2

Source : Organization for Economic Cooperation and Developement, *Revenue Statistics of OECD Member Countries, 1965–1986,* Paris : OECD, 1987.

ratio when total tax revenue is compared to GDP. In 1965 the ratio was 18.3%. In 1985 the ratio had increased to 28.0%.

The period of rapid economic growth from 1965 to 1975 stands in contrast to the period of slow economic growth from 1975 to 1985. In the former period the total tax revenue increased rapidly, while the tax revenue as percentage of GDP increased slowly. In the latter period, on the contrary, the total tax revenue has grew slowly, but the proportion of the tax revenue to GDP had rapidly grown. In the same period there was scarcely a tax reduction and as a result tax burden of people has substantially risen.

The taxes on income and profits in Japan are particularly significant revenue items. The proportion of these taxes to total tax revenue is 45.8 % in 1985 and the proportion of these to GDP is 12.8%. The proportion to GDP has increased but the proportion to total tax revenue has not increased.

Taxes on personal income have increased both as percentage of total

TABLE 2. Different Taxes as Percentage of Total Tax Revenue, 1965, 1970, 1975, 1980, and 1985
(Percent)

Items	1965	1970	1975	1980	1985
Total tax revenue	100.0	100.0	100.0	100.0	100.0
Taxes on income and profit	43.9	47.7	44.6	46.1	45.8
Individuals	21.7	21.5	23.9	24.3	24.8
Corporate	22.2	26.3	20.6	21.8	21.0
Social security contribution	21.8	22.3	29.0	29.1	30.2
Employees	7.2	8.5	10.8	10.2	10.7
Employers	9.5	11.6	15.1	14.8	15.4
Taxes on property	8.1	7.6	9.1	8.2	9.7
Taxes on goods and services	26.2	22.4	17.3	16.3	14.0

Source : Organization for Economic Cooperation and Development, *Revenue Statistics of OECD Member Countries, 1965–1986,* Paris : OECD, 1987.

TABLE 3. Different Taxes as Percentage of GDP, 1965, 1970, 1975, 1980, and 1985
(Percent)

Items	1965	1970	1975	1980	1985
Total tax revenue	18.3	19.7	20.9	25.5	28.0
Taxes on income and profit	8.0	9.4	9.3	11.7	12.8
Individuals	4.0	4.2	5.0	6.2	6.9
Corporate	4.1	5.2	4.3	5.6	5.9
Social security contribution	4.0	4.4	6.1	7.4	8.5
Employees	1.3	1.7	2.3	2.6	3.0
Employers	1.7	2.3	3.2	3.8	4.3
Taxes on property	1.5	1.5	1.9	2.1	2.7
Taxes on goods and services	4.8	4.4	3.6	4.2	3.9

Source : Organization for Economic Cooperation and Development, *Revenue Statistics of OECD Member Countries, 1965–1986,* Paris : OECD, 1987.

tax revenue and as GDP. These taxes as percentage of total tax revenue have increased from 21.1% in 1965 to 24.8% in 1985. This means that tax burden of people has risen remarkably concerning taxes on individual income.

Taxes on corporate income is as an important revenue item as taxes on personal income in Japan. The proportion of former to GDP was 5.9% and that to total tax revenue, 21.0% in 1985. This is the highest level in OECD countries. As causes of this it is mentioned that corporate activities are relatively important in the national economy and that many individual proprietorships incorporated after World War II. This proportion to GDP has risen from 4.1% in 1965 to 5.9% in 1985 but this proportion to total tax revenue has not risen.

Social security contribution is the type of tax that has had the highest increase during this period in Japan. This proportion to GDP has become more than doubled from 1965 to 1985.

Taxes on goods and services consist of taxes on special goods and services. There are not any value added taxes in Japan. These taxes as a percentage of total tax revenue is significantly decreasing (approximately from 26% to 14%). Expressed as a percentage of GDP the decrease is less significant (approximately from 5% to 4%). The decrease in the ratio of consumption taxes to total tax revenue is therefore partly caused by the increase of other types of tax.

Taxes on property mainly consist of municipal property tax, estate, inheritance and gift taxes and stamp revenues. These taxes are increasing but are below 10% as a percentage of total tax revenue in 1985.

Taxes levied by local governments (no distinction as to different levels of local government is made) as a ratio of the total tax revenue (excluding social security contribution) is roughly 36-37.5% during the period and is increasing slightly.

The local taxes mainly consist of taxes on income and profit, taxes on property and taxes on goods and services.

II. Features of Japanese Taxation before Reform in 1989

1. The Historical Background

The basic structure of the Japanese tax system before the reform in 1989 was established in 1950 on the basis of *Report on Japanese Taxation by the Shoup Mission* published in the previous year. The mission was headed by Professor Carl S. Shoup of Columbia University. Under the Shoup reforms, the individual income tax and the corporation tax became the centerpiece of the whole tax structure.

The first reason why the report recommended the income tax as the centerpiece of whole tax structure is that a system of heavy indirect taxes hide from the citizen the amount that he is contributing to government and even make him unaware that he is contributing at all. "Government then seems to him something remote, with which he has little or nothing to do except as he asks an occasional favor from it." [1]

The second reason is that the indirect taxes cannot take proper account of differences in income and wealth, and in family burdens. "They are crude machines for distributing fairly the large tax requirements of the modern state." [2]

On the contrary, it said, the ratio of direct-tax revenue to indirect-tax revenue is a rough indication of the extent to which the people are conscious of their tax obligation. It also usually shows whether the system as a whole is reasonably fitted to individuals' differing degrees of ability to tax. [3]

A feature of the individual tax in the Shoup Report lies in the progressive taxation on aggregate income including capital gains. A separate low tax rate or exemption on a certain kind of income generates loopholes and enlarges inequity. "The important fact is that capital gains give the possessor an increase in economic power just as surely as does interest or dividends. Still more significant is the ease with which astute tax avoiders can, by altering the legal form in which they realize their profits, change other forms of income into capital gains." [4] As for tax rate of the income tax the report recommended the reduction in the top rate from 85% to 55%. To fill the gap left by the reduction in the top rates of the income tax, an annual, low-rate tax on net worth of well-to-do individuals was recommended to be introduced. [5]

The corporation tax was associated with the individual income tax. First, the corporation tax in the report was based on the fictitious theory of corporation. A low proportional corporation tax rate of 35%, a credit for earh individual stockholder against his individual income tax of an amount equal to 25% of the dividends he receives, and exclusion of all intercorporate dividends from the net taxable income of corporations were based on this theory. [6]

'Modern accounting theory', that is, the flexible calculating methods of profit and loss, was for the first time introduced in Japan, for example, options of depreciation methods and creation of the reserve fund for dead loans. After that, another methods of reserve fund for future costs were established and the rate of transfer into funds were raised.

The Shoup report was almost totally accepted in Japanese tax reform in 1950 except a few points. The framework of the report, the individual income tax and the corporation tax as the centerpiece of the whole tax structure, and application of the fictitious theory of corporation and modern accounting theory etc. have been kept up since then. Japanese taxes were , however, altered in many points. These are now causing more inequity and accelerating capital accumulation still more.

2. The narrow tax base

The most important principle of taxation is equity. Although neutrality, simplicity, economic growth and stability are insisted on as purposes or principles, these have to be discussed on the basis of equity.[7] There are two equity principles, vertical and horizontal. Because inequality in income distribution is increasing now, the vertical equity principle ought to be stressed. The broad income tax base assures both vertical and horizontal equity. Now the base in Japan is, however, not broad.

Personal incomes are classified into the following ten categories for the purposes of tax computation: (1)interest, (2)dividends, (3)real estate income, (4)business income, (5)employment income, (6)retirement income, (7) forestry income, (8)capital gain, (9)occasional income, and (10)miscellaneous income.

As written above, the Shoup report recommended an aggregate income tax and this tax was introduced in 1950. Now as well as before the reform, however, preferential treatments are eroding the tax base of the aggregate income tax and undermining equity.

First, interest is separately taxed from other income at the rate of 20%. Before March 31 in 1988, there were three taxes on interest, aggregate income tax, separated tax at the rate of 35%, and tax exemption on interest from small deposits less than ¥3,000,000. As the result of tax reform in 1988, these taxes were raised for small and middle income earners, with the exception of the old etc. and reduced for high income earners.

The savings rate is high in Japan compared to other industrialized countries. The reason for that lies in low level of social security. According to the Public Opinion Poll about Saving by the Central Committee of Saving Augmentation in 1987, 76.4% of people answered that the purpose of saving is insurance against disease and disaster (plural answers within 3 are possible). The tax exemption on interest from small deposits is, therefore, necessary until social expenditure becomes high level. On the contrary, interests of high income earners ought to be subject to the aggregate income tax.

Secondly, before the reform capital gains from the sale of stock shares was exempt from tax unless it involved 30 transactions and 120,000 shares or more during the year. People who transact 30 times and 120,000 shares or more in a year were so few that almost all capital gains from the sale of shares were substantially exempt from tax.

Thirdly, if capital gains are from the sale of land or buildings which the taxpayer has owned for over five years (the long term capital gains), any amount less than ¥40,000,000 is taxed at the rate of 20% (local tax rate is 6%) and only half of the amount over ¥40,000,000 is added to aggregate income to be taxed at the progressive rates. As the result of this, the tax rate on the long term capital gains is actually between 26% and 38%. This capital gain tax is quite light, compared to a case in which the amount is fully added to aggregate income. The tax on the short term capital gains, on the contrary, is relatively heavy.

3. Tax rate

Before the reform income tax rates were graduated 12 steps from the lowest level of 10.5% for taxable income of ¥1,500,000 or less to the highest of 60% for income of over ¥50,000,000. Local income tax has a less progressive rate structure than the national income tax. The lowest rate was 5% and the highest rate was 16%. Therefore the highest rate of income tax including local income tax was 76%.

The marginal tax rate is, however, different from the effective tax rate. The effective tax rate is calculated from the tax amount divided by whole income. As mentioned above, the current Japanese tax system has exemptions, separate taxes and special treatments. As a result the effective tax rate is quite lower than the marginal tax rate.

Table 4 shows the number of taxpayers who filed income tax returns, their

TABLE 4. The Effective Income Tax Rates, by Income Classes, 1984

Taxable income (thousands of yen)	Taxpayers[a] (the number of persons)	(percent)	Average taxes (thousands of yen)	Effective tax rate (percent)
500 and less	92,175	1.3	8	1.8
501 – 700	223,746	3.1	17	2.8
701 – 1,000	504,550	7.1	29	3.3
1,001 – 1,500	1,082,111	15.2	46	3.7
1,501 – 2,000	1,121,883	15.7	74	4.2
2,001 – 3,000	1,506,982	21.1	135	5.5
3,001 – 4,000	798,529	11.2	263	7.6
4,001 – 5,000	470,773	6.6	439	9.8
5,001 – 7,000	505,106	7.1	749	12.7
7,001 – 10,000	340,112	4.8	1,401	16.9
10,001 – 20,000	329,006	4.6	3,177	23.3
20,001 – 30,000	79,386	1.1	7,122	29.4
30,001 – 50,000	50,164	0.7	12,378	32.9
over 50,000	24,940	0.3	31,164	36.2
Total	28,712,257	100.0	650	16.1

Source : Junichi Fujioka, *Nippon Keizai no Tenkai to Zaisei (Changes of Economic Structure and Public Finance in Japan),* Kyoto : Bunrikaku, 1987, p.232.
a. This table includes only taxpayers who filed income tax returns.

average taxes, and effective tax rates in 1984. This concerns only to national income tax (not including local income tax) and current income tax rates are different from those in 1984. In that year the top marginal tax rate was 70%, but we can roughly see the level of the effective income tax rates from this table.[8]

The effective income tax rate increases from 1.8% for income of ¥500,000 or less to 36.2% for income of over ¥50,000,000. What is surprising is that the top effective rate is almost half of the top marginal rate. This is partly because people in the high income class have much capital gains from the sale of land or buildings which taxpayers have held for long terms (over 10 years in 1984). 56.4% of whole income in the income class over ¥50,000,000 was constituted by those capital gains.

These incomes do not include both capital gains from the sale of stocks which are exempt from tax and interests on which tax is withheld. If these capital gains and interests are included with the denominator, the top of the effective tax rate will be still lower.

Tax on wages and salaries is withheld at the source, and adjustment between withheld amounts and final tax liability are made at the last payment of such wages and salaries during the year. The majority of wage and salary earners, ie., those with earnings of not more than ¥15,000,000, are not required to file a return. The effective tax rate of wage and salary earners who belonged to the income class over ¥20,000,000 in 1984 was 32.9%. A reason of this low rate lies in that the number of wage and salary earners in high income tax bracket is low.

4. The minimum taxable income (the tax threshold)

All incomes, except incomes that are exempt from tax and/or separately taxed, are added together. Subtracted from this total income were ¥330,000 each for the basic exemption, exemption for spouse, and exemption for each dependent before the reform. Taking these personal exemptions into account, a family of three with income under ¥990,000 was free from the national income tax.

According to R.Goode the personal exemptions have four functions.[9]

(1) keeping the total number of returns within manageable proportion and particularly holding down the number of tax liability less than the cost of collection;

(2) freeing from tax the income needed to maintain a minimum standard of living;

(3) helping achieve a smooth graduation of effective tax rates at the lower end of the scale; and

(4) differentiation of tax liability according to family size.

The second function is the most important of the four. This minimum standard of living alters as time goes on. Different nations have these different standards because the wage and salary standard and the price level of a nation differ from those of others.

A criterion to evaluate the minimum taxable income is the standard of welfare, which implies a minimum level of living. The amount of this standard which is applied for family of three is ¥130,944 in a month, namely, ¥1,571, 328 pro year in 1988, which is much more than the minimum taxable income.

Special deductions for employment are 5 to 40% of wages and salaries, the minimum deductible being ¥570,000. Although there are opinions that these special deductions have to be included with the minimum taxable income, this is different from the personal exemptions mentioned above. The special deductions are instituted, firstly, in order to deduct costs, roughly estimated, which are necessary to earn wages and salaries, and secondly, in order to adjust the difference of tax burden between employment income and other incomes.[10]

The special deduction for spouse was created in 1988. A person whose spouse's income is below a certain amount is allowed to deduct from the total income of the couple ¥165,000, besides the ordinary deduction for a spouse of ¥330,000. The purpose of this deduction is explained below.

"The Japanese individual income tax allows a self-employed person to reduce his tax by paying salary to his spouse and other members of his family for their contribution to business. For wage earners, however, there is no way to split income for tax purposes, even though spouses may be contributing to family earnings by working at home. This situation gave rise to the criticism that an imbalance existed between the tax burden of wage earners and the self-employed. To correct this imbalance, a special deduction for spouses was created."[11]

Many spouses of self-employed persons, however, actually engage in business with them and do housework, too. It is therefore natural not to tax a certain amount of the salary of their spouses. Besides, although two-income families also have to do housework, they do not have any special deductions like that. Moreover, this deduction makes Japanese taxation more complicated than before.

5. Corporation Tax

The revenues from the corporation tax as a percentage of total national tax revenue, which is estimated at 30% for FY 1988, are far greater than in other industrialized countries. The large share of the corporation tax is mainly ascribed to high profits of big companies and to the incorporation of individual proprietorships after World War II.

Before the reform in 1989 the corporation tax rates were 42% on undistributed profits and 32% on distributed profits. For corporations with capital of less than ¥100,000,000, tax rates on profits up to ¥8,000,000 was 30% if retained, and 24% if distributed. The reduced rate of 28% was applied for cooperatives (23% on distributed earnings) and public interest corporations. Prefectural inhabitant tax, enterprise tax and municipal inhabitant tax are also imposed on corporations as local taxes.

There are many concessions to corporation tax. First, corporations are permitted to deduct additions to reserves, for example, Reserve for Retirement Allowances, Reserve for Bad Debts, in computing net income. The maximum amount of Reserve for Retirement Allowance is 40% of the amount which employers have to pay in the case that all employees retire. The maximum amount of Reserve for Bad Debts of financial institutions has been reduced from 0.5% to 0.3% of all advances in 1981, that of wholesales and retails has been reduced from 13% to 10% in 1985. Maximum amounts of these reserves are so much that corporations can legally undercompute their income.

Secondly, all entertainment allowances which corporations expended are principally included with expense accounts and deducted from corporate income. As for small corporations whose capital is less than ¥50,000,000, only a certain amount of ¥3,000,000 can be deducted, and ¥4,000,000 for corporations whose capital is less than ¥10,000,000.

Thirdly, there are many kinds of tax credit and accelerated depreciation. For example, 20% of research and development costs which exceed the amount of previous years are credited from tax. Adding to this tax credit, 7% of acquisition values of assets for research and development of basic technology like bio-technology, new ceramics technology and high electronic technology are also exempt. Depreciation rate of 30% in the first year after acquisition is admitted for high technology industries located in certain areas where high technologies are accumulated.

Fourthly, current corporation tax is principally based on the fictional theory of corporation. To avoid double taxation of intercorporate dividends, dividends which corporations receive are added to expense accounts, except for interest payments for debts which the corporation needed to finance stock as capital.

The foreign tax credit system is similar to other countries to avoid international double taxation. There are four kinds of the system in Japan: direct credit system, indirect credit system, tax sparing credit system, and foreign tax credit system linked with taxation measures against tax havens.

The Japanese system, however, has some features different from many other industrialized countries.[12] Firstly, not only national taxes but atso local taxes are included with foreign corporation tax (or income tax) which are credited. Secondly, the Japanese foreign tax credit system does not adopt the par-country limitation but the overall limitation as computing limitations of foreign taxes which can be credited. Thirdly, if foreign taxes which was paid in a certain year exceed the limitation of that year, the exceeding amount can be carried forward within 5 years. In reverse, if the limitation of the foreign tax credit of a certain year exceeds foreign taxes which were paid in that year, the amount of room to credit can also be carried forward within 5 years. Fourthly, an indirect credit system is allowed for dividends from foreign subsidiary companies of which parent companies hold more than 25% of the stock for 6 months or more.

6. Taxes on consumption

Excise taxes are levied on particular commodities and services. Before the reform the leading items were liquor, commodity, gasoline, and automobile-related taxes. As shown in table 2, taxes on goods and services as percentage of total tax revenue has steadily decreased. The estimate for FY 1985 was 14%.

The liquor tax is the single largest consumption tax, accounting for 18.6% of revenues from indirect taxes in the FY 1985. For tax purpose, liquors are classified into 10 categories such as sake, beer, wine, and whiskey. The following are illustrations of the effective tax rates on retail prices before the reform: sake, 40.1% for special class, and 14.1 % for second class; beer, 48.8%; wine, 5.5%; and whiskey, 50.3% for special class, and 29.5% for second class.[13]

The majority of taxable commodities were luxury items, expensive goods, or goods used for amusement and hobbies. By the amendment of 1984, commodity tax items were increased from 80 to 85. In FY 1985, revenues from commodity taxes accounted for 14.6% of the total indirect tax revenues. More than one third of commodity tax revenues were from passenger cars.

III. Tax Reform in 1989

The tax reform bill had passed the Diet on 24th December in 1988. By this reform taxes were altered mainly at 5 points.

(1) Introduction of a new consumption tax.

(2) Enlargement of the income bracket for the lowest tax rate and reduction of degree of progressivity as well as increase of personal exemptions in individual income taxes.

(3) Abolition of tax-exempt system for capital gains from securities transaction.

(4) Cut in corporation tax rate from the international viewpoint and widening this tax base.

(5) Alleviation of the burden of inheritance tax.

Taxes decreased and increased are shown in table 5. An excess of tax revenue over the initial budget of FY 1988 which was estimated at more than ¥5 trillion enabled decreased taxes to excess over those increased. The revenue estimated from the consumption tax seems, however, to be

TABLE 5. Estimate of Tax Revenue[a] Increased and Decreased by Tax Reform of 1989
(trillions of yen)

Total	−2.600
Tax revenue increased	6,600
Introduction of consumption tax	5,400
Ensuring a fair share of tax burden	1,200
Tax revenue decreased	−9,200
Reduction of income tax	−3,300
Reduction of corporation tax	−1,800
Reduction of inheritance tax	−700
Abolition and revision of existing indirect taxes	−3,400

Source : Ministry of Finance
a. This table includes both central and local taxes.

less than the revenue which will be actually generated by the tax.

1. Background of tax reform

In September 1985, then Prime Minister Yasuhiro Nakasone requested the tax advisory commission to review the current tax system and make suggestions to establish a new one adapted to the challenges of the twenty-first century. After examination, the commission submitted *The Report on the Overall Review of the Tax System* in October 1986. The reform proposed by the commission included, among other measures, alleviating the individual income tax burden and replacing the current excise taxes with a new type of indirect tax on consumption.

In December 1986, the tax commission published *The Report on the Fiscal Year 1987 Tax Reform*, which outlined the concrete steps that should be taken to implement its report. In accordance with these recommendations, the government's fiscal year 1987 tax reform proposals consisted of the following points:

(1) Introduction of the sales tax in place of the current excise taxes.

(2) Reduction and rationalization of the income tax burden, especially for middle-income earners.

(3) Reduction of the corporation tax rates.

(4) Review of the tax-exempt saving system.

This proposal faced strong opposition in the Diet and failed to get approval. The government introduced a revised tax reform bill to the Diet, including reduction of the income tax burden, reform of the tax-exempt saving system, and a review of the taxation on land. In September 1987, the Diet adopted the proposed legislation with some amendments.[14]

Tax Commission received the request from Prime Minister Takesita on November 12th, 1987. On April 28th, 1988, it has written up *Interim*

Report on Tax Overhaul and submitted it to the Prime Minister on the same day. On June 15th, 1988, the Commission submitted *Report on Tax Overhaul* to the Prime Minister. The tax reform bill which passed the Diet in December 1988 was·introduced in accordance with proposals of the report.

Interim Report wrote about the necessity of tax overhaul and stated that there are apparent distortions in the current tax system based upon the Shoup Recommendation because of friction between the current tax system, principally unchanged, and changes in Japan's economy and society, for example, change in employment structure, reaching high income level & equalization of income distribution, diversification of consumption & increasing weight of services in final household consumption, aging of population, and internationalization of the economy.

"Although income level has rapidly increased and income distribution has equalized for the past ten years, the salary man bears a sense of heavy tax burden and inequity because of the steep progressivity of individual income tax, various concessions and unbalance of recognition among various types of income in this tax." [15]

"It is not to be ignored with respect to the vitality of economic enterprises that Japan's corporation tax rate is higher than those of foreign countries in these times of the internationalization of economic transaction." [16]

"As for taxes on consumption, the weight of these taxes in all tax revenues has continued to decrease and current selective consumption taxes, like commodity taxes, have critically unbalanced the tax burden among commodities subject to tax. These taxes therefore lag behind the diversification of consumption patterns and the increasing weight of services." [17]

"As the aging of society proceeds at an unheard of pace, it is expected that both social security benefits and social security contribution would rapidly increase on the assumption that current system will not change. It is also anticipated that tax burden on earned income will rise even more if the current tax system does not change."[18]

In response the Tax Commission proposed as a desirable tax system, a system based on properly combined taxes on income, consumption, property etc.

I will summarize reforms of the consumption tax, income tax and corporation tax and write problems about them below.

2. Introduction of new indirect tax system

From April 1, the new consumption tax will be imposed on all commodities and services with a few exceptions. Although this tax is a kind of VAT, the method of calculation is different from that of Europe. European countries adopt the credit method with invoices at calculation. Japan also adopts the credit method but taxes are principally calculated by relying on accounts in the book without invoices, ie, it adopts the account measure. The so called "cross checking" situation would not exist without invoices, which are necessary in Europe, so that firms may have an incentive to understate their sales for either value added or income tax purposes like the subtraction method. Moreover, firms can raise prices of their goods more than tax rate in some cases, but cannot raise prices as high as the tax rate in the case that they are weak competitors. In the latter case taxes are paid from their own profits. If the company is small or a self-employed person, it or he may be obliged to change jobs or functions because of lack of competitiveness.

The Fair Trade Commission published *Manual about the Shifting of the Consumption Tax and the Anti-monopoly Law* three days after the tax reform bill passed the diet。 It is a compass to orient cartels for price shifting and for price listing relative to the shifting of the consumption tax without violating the Anti-monopoly law. Such a measurehas never been taken in the world. Because small businesses are not accustomed to form cartels, it is doubtful that they can fully shift tax into price.

The most frequent criticism of a value added tax is that the distribution of the tax burden by income group would be unfair. "Two aspects to this criticism can be identified: (1) the absolute burden of a value-added tax on low income individuals and families, and (2) the relative burden of the value-added tax at various income level."[19] The Treasury Department Report to the President of 1984 in the US mentioned that of these two elements, the absolute burden of the value-added tax on the poor is the more serious problem, since the tax would deprive those persons of the income necessary to maintain a minimum standard of living.[20]

Zero rating or exemption from taxes on food and other necessities would lessen the burden of the tax on lower income families to some extent. The consumption tax which was introduced in Japan, however, has only a few exemptions, like tuition fee and medical expenses to which health insurances are applied. Almost all necessities including food are taxed. On the contrary, disposition of land and securities, and interest on loans etc. are not subject to tax because it is consumption that is taxed.

The tax rate is 3%. There are, however, concessions to small businesses. Businesses of which the taxable sales is less than or equal to ¥30,000,000 per yers can be exempt from tax if they choose so. 68.2% of all enterprises are included in this range. Businesses of which taxable sales are less than ¥500,000,000 can select a simpler method under which 80% of tax due on their sales is deemed as tax paid on purchases (90% with respect to wholesalers). Therefore they have to pay 0.6% of their sales as tax. 96.7% of all enterprises are included in this range. And if they select the method, they are not permitted to change to the other menthod for two years. Because the actual value added rate in sales is almost 18% in many businesses, they have to pay taxes from their profit in part, if they select this menthod. Moreover, it is feared that a new inequity among businesses will be generated because actual value added rates differ according to enterprises. This method is substantially the same as the turnover tax ie. the cascading sales tax at 0.6% rate.

Introduction of the consumption tax is accompanied by reform of existing indirect taxes. (1)Commodity tax, tax on playing cards, sugar consumption tax, admission tax, travel tax, electricity tax, gas tax etc. were abolished. (2)Liquor and tobacco were levied both through the consumption tax and existing taxes, while at the same time latter tax rate was lowered. (3)Taxes relating to petroleum and its products are simply added to the consumption tax burden.

Apart from this reform accompanied by introduction of the consumption tax, the liquor tax was altered. (1)Ad valorem duty which is applicable on imported liquors was abolished. (2)Classes in whiskey and sake was abolished. (3)Difference of tax burden among distilled liquor became smaller, etc..

3. Individual income tax

The individual income tax burden was reduced by reducing the tax rates and by enlarging personal exemptions. The joint taxation of capital income has also been abolished.

As shown in table 6, the minimum rate of 10.5% was reduced to 10% and the maximum rate of 60% to 50%. The number of brackets was decreased from 12 to 5. In all, the degree of progressivity was reduced. The maximum rate of the local income tax was reduced from 16% to 15%.

TABLE 6. Individual Income Tax Rates,.before and after Revision

Taxable income before revision (thousands of yen)	Rate (percent)	Taxable income after revision (thousands of yen)	Rate (percent)
1,500 and less	10.5	3,000 and less	10.0
1,501－2,000	12.0	3,001－6,000	20.0
2,001－3,0000	16.0	6,001－10,000	30.0
3,001－5,000	20.0	10,001－20,000	40.0
5,001－6,000	25.0	over 20,000	50.0
6,001－8,000	30.0		
8,001－10,000	35.0		
10,001－12,000	40.0		
12,001－15,000	45.0		
15,001－30,000	50.0		
30,001－50,000	55.0		
over 50,000	60.0		

As shown in table 7, basic personal exemptions were raised from ¥ 330,000 to ¥350,000 respectively. As the result of this, the minimum taxable income of family of three was increased from ¥990,000 to ¥1,050,000.

TABLE 7. Personal Exemptions and Deductions, before and after Revision

Items	before revision (thousands of yen)	after revision (thousands of yen)
Basic exemption	330	350
Exemption for spouse	330	350
Exemption for dependent	330	350
Special deduction for spouse	165	350
Additional deduction for dependent whose age is between 16 and 22 years old	－	100
Exemption for handicapped	250	270
Exemption for widow	250	270
Exemption for working student	250	270

A new personal exemption was introduced. ¥450,000 can be deducted for a dependent who is 16-22 years old, in place of the ordinary exemption for each dependent. This personal exemption is called the tax reduction of educational costs of a family.

The special deduction for spouse was also raised from ¥165,000 to ¥350,000. The exemptions for a handicapped, a widow, and a working student were also increased.

It is retreat from equity that joint taxation of capital income was abolished. For reduction of maximum tax rate will generate inequity if it is not accompanied by an extension of the tax base and a strengthening of the tax on capital income or assets. The vertical equity is still very important under the present condition that differences of income and assets among people are widening.

Although income taxes were slightly reduced in 1983, 1984, 1985, tax reform as indexation has not been done for the three basic personal exemptions since 1977, and for tax rate structure since 1974. Since then income taxes have been substantially increasing and the tax burden of the people has also been rising. Because consumption prices have increased about 50% from 1977 to 1987, and taking this rise into account, the basic personal exemption ought to be raised from ¥290,000 in 1977 to ¥435,000 in 1987. For two income families and single persons to which special deduction for spouse is not admitted, therefore, rise of personal exemptions does not substantially mean reduction of tax. As for tax rate, as shown in table 8, for taxpayers whose taxable incomes are over ¥900,000 to ¥3,000,000, income tax was substantially reduced, but for taxpayers whose taxable incomes are over ¥3,000,000 to ¥4,500,000 and over ¥6,000,000 to ¥9,000,000, tax was not substantially reduced.

TABLE 8. Indexation of Tax Rates and Revised Rates

Taxable income in 1977 (thousands of yen)	Rate (percent)	Taxable income indexed (thousands of yen)	Rate (percent)	Taxable income after revision (thousands of yen)	Rate (percent)
600 and less	10	900 and less	10		
601 – 1,200	12	901 – 1,800	12		
1,201 – 1,800	14	1,801 – 2,700	14	3,000 and less	10
1,801 – 2,400	16	2,701 – 3,600	16	3,001 – 6,000	20
2,401 – 3,000	18	3,601 – 4,500	18		
3,001 – 4,000	21	4,501 – 6,000	21		
4,001 – 5,000	24	6,001 – 7,500	24	6,001 – 10,000	30
5,001 – 6,000	27	7,501 – 9,000	27		
6,001 – 7,000	30	9,001 – 10,500	30	10,001 – 20,000	40
7,001 – 8,000	34	10,501 – 12,000	34		
8,001 – 10,000	38	12,001 – 15,000	38		
10,001 – 12,000	42	15,001 – 18,000	42		
12,001 – 15,000	46	18,001 – 22,500	46	over 20,000	50
15,001 – 20,000	50	22,501 – 30,000	50		
20,001 – 30,000	55	30,001 – 45,000	55		
30,001 – 40,000	60	45,001 – 60,000	60		
40,001 – 60,000	65	60,001 – 90,000	65		
60,001 – 80,000	70	90,001 – 120,000	70		
over 80,000	75	over 120,000	75		

Source : N.Sekita, "Chuken Salary Man Genzei no Hyoka to Juzeikan" (Evaluation of Tax Reduction for Middle Salary Men and a Sense of Heavy Tax Burden), *Zeikeitsusin (Communication of Tax and Economy)*, Tokyo : Zeimukeirikyokai, 1988/ vol. 43/ no. 8, p.40.

4. Capital gains tax

A choice system between separate taxation at source and taxation by filing return was adopted as new taxation on capital gains from security transactions. If taxpayers select separate taxation at source, 5% of sales price (in the case of convertible bonds 2.5%) is regarded as income from sales of stocks etc. with the exception of credit transaction. The tax rate is 20%, so that 1% of sales price has to be paid as tax.

If they select taxation by filing return, income from sales of stocks etc. is taxed at a 20% rate separated from other incomes. In this case the income is calculated by subtracting capital losses from capital gains in the year. Persons who receive money from sales have to notify security companies of their names and addresses by submitting public papers like resident cards, when they receive the money. Security companies have to submit payment records.

From the equity point of view, it is very important to include capital gains in aggregate income and to tax at progressive rates. But the flat rate of 20% on capital gains separated from other incomes has a problem: high income earners who receive income from sales of stocks need not pay tax at the high rate which is suitable for them. To establish the aggregate income tax including capital gains, it is necessary to prohibit fictitious names, to check filed returns with submitted payment records from security companies by computer, and to complete the existing assets return system that people whose income is more than ¥15,000,000 have to file assets returns, or to introduce a taxpayers' number system. It should be mentioned that latter method has a problem of infringing on personal privacy.

There is a securities transaction tax in Japan. The rate of the tax on stocks was, for example, reduced from 2.5/10,000 to 1/10,000 in lieu of the introduction of the tax on capital gains on stocks.

As mentioned above, the current tax on the long term capital gains is quite light. Amounts less than ¥40,000,000 of long term capital gains are taxed at a flat rate of 20% and only half of any amount over ¥40,000,000 is added to aggregate income to be taxed at progressive rates. The tax on the long term capital gains was still more alleviated by the present tax reform. Any amount over ¥40,000,000 is to be taxed at a flat rate of 25%.

Even if the introduction of the new capital gains tax for securities is taken into account, taxes which many high income earners have to pay was significantly reduced by the reduction of the maximum tax rate of individual income tax, the abolition of joint taxation of capital income, the alleviation of the tax on the long term capital gains from sales of land or buildings, and the alleviation of the securities transaction tax.

5. Corporation Tax

Tax rate on corporate income was reduced from 42% to 40% in 1989 and will be reduced to 37.5% in and after 1990. The reduced rate for medium and small-size enterprises was slightly lowered from 30% to 29% in 1989 and will be also slightly lowered to 28% in and after 1990. The reduced rate for public interest corporation continues to be 27%. Difference between the basic rate of the corportion tax and the reduced rate has, therfore, been narrowed. The reduced rate applicable to income distributed as dividends was abolished as shown in table 9.

The tax base of corporation tax was not so largely widened. The maximum amount for Retirement Allowances and that for Bad Debts were not limited. All entertainment allowances which corporations expended

TABLE 9. Corporation Tax Rates, 1988, 1989, and 1990 (percent)

Items	1988	1989	1990
Basic Rate			
Reserves	42	40	37.5
Dividends	32	35	37.5
Reduced Rate for medium and small-size enterprises			
Reserves	30	29	28
Dividends	24	26	28
Reduced Rate for corporation of public interest			
Reserves	27	27	27
Dividends	25	25	27

principally continue to be included with expense accounts and deducted from corporation income. Only a portion of received dividends, however, came to be included in gross revenue, 10% in 1989 and 20% in and after 1990.

The credit for foreign taxes was also only slightly limited. (1)Half of income which is not laid tax from a foreign country can now be deducted from income outside, and the highest possible ratio of foreign income against total income is limited to 90%. (2)Foreign tax whose rate is higher than usual is not included in deductible tax. (3)The carry-over period is shortened from 5 years to 3 years.

6. Distributional effect of tax reform

How does the tax reform affect the tax burden of individuals? By reduction of individual income tax, the tax burden of many taxpayears certainly decreases. The introduction of the consumption tax, however, makes it higher. Generally speaking, by tax reform of both income tax and indirect taxes, the burden of high income earners decreases and that of low income earners rises. The turning point where decrease of the tax burden changes into increase depends on whether the family is a two-income family or not. For single-income families can apply the special deduction of spouse and therefore they experience a relatively large reduction of income tax, although two-income families connot apply it.

There are many trial calculations about reduced taxes and increased ones of each income class. All the results of these are different from each other. The reasons of the differences lie in that the proportion of the consumption tax burden in the consumption expenditure of family, the proportion of income between a husband and a wife of a two-income family etc. differ from each other. The former proportion is 1.1% according to the Ministry of Finance, but its proportion is the lowest of all. The researcher group of Public Finance and Tax Law at Shizuoka University shows a proportion of 1.36%, Japanese Socialist Party, 1.5%, and Japanese Communist Party, 2.3%. The proportion of income between a husband and a wife is 3.3 to 1 according to the Ministry of Finance. The researcher group at Shizuoka University, however, shows the proportion as 2 to 1, Japanese Socialist Party, 1 to 1, and Japanese Communist Party, 1 to 1.[21]

Table 10, 11, and 12 show the trial calculations of the researcher group at Shizuoka University. In the case of single-income family, taxes on families whose income is more than ¥3,500,000 are reduced, al-

TABLE 10. Effect of Tax Reform on Housekeeping by Income Classes, Single-Income Families of Four Including Two Children

Yearly income[a] (thousands of yen)	Taxes decreased[b] by reduction of income tax[c]	Taxes increased by introduction of consumption tax	Balance of taxes increased and decreased
Average	¥ −78,300	¥ +41,300	¥ −37,000
Under 1,500	0	+23,000	+23,000
1,500−2,500	0	+26,500	+26,500
2,500−3,500	−26,300	+31,600	+5,300
3,500−4,500	−63,300	+36,600	−26,700
4,500−5,500	−77,000	+40,300	−36,700
5,500−6,500	−92,900	+44,800	−48,100
6,500−8,000	−101,600	+52,500	−49,100
8,000−10,000	−123,400	+58,200	−65,200
10,000 and over	−258,400	+75,100	−183,300

Source : Researcher group of Public Finance and Tax Law at Shizuoka University, *Simulation Zeisei Kaikaku (Simulation of Tax Reform)*, Tokyo : Aoki Shoten, 1988, p.102.

a. The yearly income includes not only employment income but also interests, dividends, rents, and social security benefits.

b. Taxes decreased is calculated on the basis of employment income.

c. The income tax includes both central and local taxes. Income of a wife is assumed zero. Two children (from 16 to 22 years old) are assumed to apply additional deduction for dependent.

though taxes on families less than the amount are increased. The rate of tax reduction is the highest at the top class and the rate of tax increase is the highest at the bottom class. As for two-income families, the turning point jumps to ¥10,000,000. For all families whose income is below ¥10,000,000, taxes are increased. The rate of tax increase is the highest at the bottom class. Single persons have to pay more tax than before by ¥11,300 or ¥13,100 per year and old persons by ¥21,500.[22]

TABLE 11. Effect of Tax Reform on Housekeeping by Income Classes, Two-Income Families of Four Including Two Children

Yearly income[a] (thousands of yen)	Taxes decreased[b] by reduction of income tax[c]	Taxes increased by introduction of consumption tax	Balance of taxes increased and decreased
Average	¥ −28,700	¥ +46,700	¥ +18,000
Under 1,000	0	+23,600	+23,600
1,000−2,000	0	+24,100	+24,100
2,000−3,000	−4,500	+29,800	+25,300
3,000−4,000	−26,200	+34,700	+8,500
4,000−5,000	−17,000	+40,200	+23,200
5,000−6,000	−23,200	+44,000	+20,800
6,000−8,000	−34,000	+51,500	+17,500
8,000−10,000	−47,400	+62,300	+14,900
10,000 and over	−96,900	+75,900	−21,000

Source : Researcher group of Public Finance and Tax Law at Shizuoka University, *Simulation Zeisei Kaikaku (Simulation of Tax Reform)*, Tokyo : Aoki Shoten, 1988, p.104

a. The yearly income includes not only employment income but also interests, dividends, rents, and sosial security benefits.

b. Taxes decreased is calculated on the basis of employment income.

c. The income tax includes both central and local taxes. Income of a wife is assumed half of income of a husband. Two children are assumed not to apply additional deduction for dependent.

TABLE 12. Effect of Tax Reform on Housekeeping, Single Persons and Old Aged Families

	Single persons		Old aged
	Males	Females	families[a]
Average age (years old)	24.4	23.2	72.0
Yearly income (thousands of yen)	2,461	2,080	2,457
Current income (thousands of yen)	2,161	1,791	—
Taxes decreased[b] by reduction of income tax (yen)	−13,100	−7,600	−3,100
Taxes increased by introduction of consumption tax (yen)	+24,400	+20,700	+24,600
Balance of taxes increased and decreased (yen)	+11,300	+13,100	+21,500

Source : Researcher group of Public Finance and Tax Law at Shizuoka University, *Simulation Zeisei Kaikaku (Simulation of Tax Reform)*, Tokyo : Aoki Shoten, 1988, p.106.

a. Families older than 65. Husbands and wives of old aged families are assumed to have no job.

b. Taxes decreased are calculated on the basis of current income.

Summary

This paper reveals that the tax reform in 1989 has important problems: (1)the consumption tax which was introduced in Japan is the most regressive and most cloudy in the world. Even if alleviation of income tax burden is taken into account, total balance of taxes increased and decreased is inequitably distributed among income classes. (2)Tax base of the income tax has hardly broadened. Reduction of the maximum tax rate and abolition of the joint taxation of capital income without broadening the tax base reduced high income earners tax burden. The tax on capital gains from the sale of securities was limited to a flat rate of 20%. (3) The base of the corporatin tax has also hardly broadened. It is very interesting that R.Goode proposes to limit destructive tax competition among countries.[23]

ENDNOTES

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5. ibid., p.82.
6. ibid., p.107 & p.121.
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8. Junichi Fujioka, *Nippon Keizai no Tenkai to Zaisei* (*Changes of Economic Structure and Public Finance in Japan*), Kyoto: Bunrikaku, 1987, p.232.
9. Richard Goode, *The Individual Income Tax,* Princeton University Press, 1964, pp.224-225.
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13. Torao Aoki, "The National Taxation System", Tokue Shibata ed., *Public Finance in Japan,* Tokyo: University of Tokyo Press, 1986, p.116.
14. Atsushi Nagano, op. cit., pp.157-158.
15. Japanese Tax Commission, "Zeisei Kaikaku nitsuiteno Chukan Hokoku" (Interim Report on Tax Overhaul), Hiroshi Watanabe ed., *Zeisei Kaikaku* (*Tax Overhaul*), Tokyo: Okura Zaimukyokai, 1988, p.51.
16. ibid.
17. ibid.
18. ibid., pp.51-52.
19. U.S.Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth-The Treasury Department Report to the President,* Washington, D.C.: U.S.Department of Treasury, 1984, vol.3,

p.89.

20. ibid.

21. Researcher group of Public Finance and Tax Law at Shizuoka University, *Simulation Zeisei Kaikaku* (*Simulation of Tax Reform*), Tokyo: Aòki Shoten, 1988, p.110.

22. ibid., pp.101-107.

23. Richard Goode, "Overview", Joseph A.Pechman ed., op. cit., p.275.