

**The difference in taxation on financial transactions
between Japan and the United States**

- Can the U.S. system and theory be the model ? -

Naotaka Kawakami*

Visiting Fellow

Center on Japanese Economy and Business

Columbia Business School

521 Uris Hall, MC 5968

3022 Broadway

New York, NY 10027

(212) 854-3976

nk460@columbia.edu

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Abstract

The income taxation systems on financial transactions in Japan are much different from those in the U.S.; they adopt withholding and separated taxation systems on interest and capital gains from security transactions. These current systems reflect two characteristics of the Japanese society – an excess savings economy and the restriction of tax implementation.

The U.S. comprehensive income taxation system has long been a model since Japan had an overall tax reform based on the recommendations by Columbia Professor Shoup in 1950, but recently, many proposals of overall tax reform in the U.S. seem to deviate from the conventional idea of comprehensive income taxation and prefer a consumption tax or a broad-based income tax like the Comprehensive Business Income Tax (CBIT).

Also in Japan, deviating from the idea of comprehensive taxation, the Dual Income Taxation(DIT) in the Nordic countries, which taxes all capital income at the proportional corporate tax rate lower than that on labor income, seem to attract more interest from tax specialists.

Japan had major reforms of taxation on capital gains from security transactions in 2001. Focusing on the argument over the capital gains taxation and the overall taxation on capital income, this paper surveys the arguments of U.S. economists over them and their implications, evaluates the recent reforms of capital gains taxation in Japan, and argues about the desirable future taxation system in Japan.

I. Introduction

Income taxation on financial transactions is one of the main issues of the current tax debate in Japan.

The U.S. comprehensive income taxation system has long been a model since Japan had an overall tax reform based on the recommendations by Columbia University Professor Carl S. Shoup in 1950. But as to the taxation on financial transactions, Professor Shoup's ideal was modified early in the 1950s, and has developed in a different way since then.

Recently, the U.S. model itself has seemed to fluctuate. Many proposals for overall tax reform in the U.S. seem to deviate from the conventional idea of comprehensive income taxation. They prefer a consumption tax or a broad-based income tax like the CBIT. Capital gains taxation seems to be a focus of this tax dispute. The tax rate on capital gains was once unified to that on other incomes in the 1986 reform, but again lowered in the 1990s.

Also in Japan, we had major reforms of taxation on capital gains from security transactions in 2001. As to the model for capital income taxation, deviating from the idea of comprehensive taxation, the Dual Income Taxation in the Nordic countries -- which taxes all capital income at the proportional corporate tax rate lower than that on labor income -- seems to attract more interest from tax specialists recently.

Therefore, the views on the ideal capital income taxation are divided in Japan.

On the other hand, there are many theoretical analyses by U.S. economists on the ideal capital income taxation, although their conclusions are also divided. Their methods and knowledge may provide another perspective to analyze and think about the tax system in Japan.

Focusing on the argument over capital gains taxation and the overall taxation on capital income, this paper analyzes the background of the current Japanese systems different from that in the U.S., surveys the arguments of U.S. economists over them and their implication, evaluates

the recent reforms of capital gains taxation in Japan, and argues about the desirable future taxation system in Japan.

The following sections are organized as follows: section 2 provides an overview of the characteristics of the Japanese tax system and its historical and social background different from that of the U.S.; section 3 and 4 provides a comparison of the arguments in both countries over taxation on capital gains from security transactions and the overall capital income taxation, respectively; and section 5 presents concluding comments¹.

II. Characteristics of the Japanese tax system and its historical and social background

1. The major differences of the Japanese tax system from the U.S. system

The following are the major characteristics of the Japanese income tax system (before the tax reform of capital gains taxation in mid FY 2001) compared with the U.S. system mainly focusing on the treatment of capital income.

The whole personal income tax:

- The national tax has four brackets (10%-37%). The local tax has three brackets (5-13%).
- There is no standard deduction. Instead, there is a relatively generous employment income deduction(40-50% of salaries) for salaried workers.
- Deductions for medical expenses, donations, etc are allowed in addition to the employment income deduction.
- There is no indexing to inflation.
- There is no Earned Income Tax Credit, no phase-in, out (except Special Allowance for Spouses), no Alternative Minimum Tax.
- Withholding taxation is frequently used. Combined with the year-end adjustment of employment income by employers, a majority of salaried workers do not need tax

¹ The view I present in this paper is my personal one. It has no relationship with the official view of the Ministry of Finance.

filings at all.

Income taxation on capital income:

- Interest is subject to separate withholding tax (15% + local 5%).
 - i. It is not taxed on an accrual basis.
 - ii. Small deposits owned by the elderly, disabled persons, etc. are exempt.
- Capital gains from security transactions are subject to the separated taxation at the rate of 20% + local 6%.
 - i. No deduction of capital losses from other income is allowed.
 - ii. No loss carryover is allowed.
 - iii. Tax basis is carried over to heirs at death (no “step-up in basis”).

If capital gains are derived from the sale of listed stocks, a separate *withholding* tax of 1.05% of the proceeds from selling is available. (The separate withholding tax is a taxation at source. The separated taxation is a taxation by tax return.)
- Dividends are basically subject to comprehensive taxation and tax credit (10% + local 2.8% or 5% + local 1.4% of dividends) is allowed. Taxpayers also can opt for a separate withholding tax of 35% (20% for small amount).
- Full deduction or special deduction for contribution to pension funds, special allowance for pensions and annuities are allowed (pensions are almost tax-free at both stages: contributions and benefits).
- The conventional pensions are all defined benefit plans. There were no defined contribution plans until 2001.
- Deduction for insurance premiums up to a certain amount is allowed, and tax credit (not a deduction) for housing loans is allowed up to a certain income class as a special measure.

In short, the personal income tax in Japan has a simpler structure, withholding and separated taxation systems are frequently used on capital incomes, and the tax treatments of pensions and some saving plans are more generous.

These characteristics of the tax system clearly reflect the historical and social

background of Japanese society different from that of the United States.

2. The major characteristics of the postwar society affecting capital income taxation

After WWII, the period of excess investment and insufficient savings had lasted for a long time.

In that period, the allocation of money was mainly performed through bank loans and it worked

effectively. Although the tax system established in 1950 based on Shoup's recommendations

required a comprehensive taxation on capital income, it was modified early in the early 1950s

when interest and capital gains from security transactions up to considerable amounts became tax

exempt. This system lasted until the 1987-88 reform.

Under the conventional Japanese legal system, corporations have been the dominant form of business and there was little tradition of pass-through entities. Until recently, reflecting the major flow of money I mention above, "main banks" have seemed to play a larger role in the governance of corporations than shareholders.² The cross-shareholding among companies also restricted the exercise of individual shareholders' voting power. Combined with a lifetime employment system, this situation has formed a general notion of "employees' company" rather than "shareholders' company." Since Shoup's tax system, Japan has had a partial adjustment system for "double taxation," but it has not attracted much attention from the political world and

² For more details of the "main bank system" see Aoki, Patrick and Sheard(1994).

only a small degree of adjustment by the tax credit at the shareholder's level remains after the 1987-88 reform. Measures to prevent managerial discretion or abuse of fringe benefits, such as the denial of deduction of social expenses for large companies or the additional taxation on unaccounted-for expenditures, maintain strong political support.³

One of the major reasons of the deviation of taxation on financial transactions in the early 1950s from a comprehensive taxation model was poor implementation. To achieve compensatory "fairness," the Security Transactions Tax was introduced as a substitute for capital gains tax in 1953 and existed until 1999. Under Japanese postwar democratic society, it is difficult to introduce new tools of tax implementation like a tax identification number which are innovated after Shoup's time, but have some potential threat to an individual's privacy. In the early 1980s, under the tax exempt system of interest at that time, an identification system to check the upper limit of an individual's tax exempt deposit passed the Diet once but was overturned and repealed before its implementation.

³ It is impressive that different from most U.S. economists' view, the idea of taxing corporations has also strong political support in the U.S., although it may not be stronger than that in Japan.

In the 1986 Tax Reform Act, tax deductions for luxury cars are reduced and only 80% of entertainment expenses and meals were deductible. In 1993, this was further reduced to 50%.

According to Stiglitz, in the 1986 reform, to make the increase in the size of the pie look bigger, corporation income taxes were increased so that individual income taxes could, overall, be reduced. Since most people do not accurately see the burden imposed upon them by the corporation tax, this enabled more individuals to see themselves as net winners. (Stiglitz, 2000, Chapter 25)

Besides a tax identification number, the range of information reporting is smaller and the burden of proof on the tax authorities in tax lawsuits is heavier in Japan.

This stronger restriction on tax implementation limits the choice of income taxation systems in many fields. Frequent use of withholding and separated taxation is a natural result. Thanks to the separated taxation for much capital income and the well-established year-end adjustment system by employers for withholding tax on employment income, a majority of salaried workers do not need annual tax filings at all. A relatively generous standard employment income deduction allowed to salaried workers, which aims to compensate for the difference from the self-employed who are less subject to restrictions accompanying their jobs and can identify more clearly the deductible costs of their business, also contributes to this situation.

3. The recent change affecting capital income taxation and the 1987-88 reform

During the last decade, while still following the traditional trend I mention above in many fields, Japanese society experienced some major changes which are still in progress now. Some of these changes were reflected in the 1987-88 reform of capital income taxation.

One major change is the change from the excess investment economy to the excess savings economy. Saving-favoring systems are no longer necessary. The U.S. government also demanded reform because of the concern about the trade imbalance resulting from excess

savings in Japan.

Another major change was the threat of the aging society. The burden of the conventional income tax was thought to be too concentrated on working generations and earned incomes. Consequently, more weight on horizontal equity was required and the idea of broadening the tax base and lowering tax rates became dominant. The streamlining of favorable treatment for taxation on financial transactions was thought to be necessary to strengthen horizontal equity.

Accordingly, the tax exemption for interest and capital gains was abolished and separated taxation on these incomes was introduced in the 1987-88 reform. Only the exemption of interest on small deposits owned by the elderly, disabled persons, etc. was maintained.

In introducing the new taxation system, the restriction on tax implementation and taxpayers' demands for simplicity played a major role in specifying the types of taxation. With restriction on implementation including the non-existence of a tax identification number, separate taxation on interest and capital gains was thought to be a realistic way to broaden the tax base on these incomes. The notion of the difference between taxpayers who receive interest and those who receive capital gains (capital gains were thought to be the income of wealthier people) required the difference of tax rates between these two incomes. Although it is generally difficult to apply a withholding tax on capital gains because of the difference of tax basis among

assets, the separated withholding tax of approximately 1% of the proceeds from selling was also allowed on sales of listed stocks as a transitional alternative method.

4. The changes in Japanese financial systems in the 1990s and the tax reforms

In the 1990s, although many resources had to be spent on general tax cuts to stimulate a long stagnating economy, tax reforms have also responded to some structural changes in Japanese financial systems.

To revitalize the stagnant Tokyo financial market, the Japanese government started the “Big Bang” in 1997. To reduce the security transaction costs in tandem with the deregulation on broker’s commissions, the Security Transaction Tax was halved in 1998 and eventually abolished in 1999. The abolishment of the separated *withholding* tax (1.05% of the proceeds from selling) on capital gains from security transactions in 2001 was also determined.

The long-lasting non-performing loans problem and consequent stagnant bank lending require the diversification of the ways of financing new investments. To facilitate liquidation of the collateral assets of non-performing loans, the legal frameworks to allow new pass-through entities were established and the exclusion of “double taxation” for these entities was introduced simultaneously in 1998.

To facilitate investment in venture companies, special treatment of capital gains (loss

carryover for 3 years, special low rate) for “angel” (an individual investor in venture companies) was introduced in 2000. To facilitate restructuring of corporations, in tandem with the revision of the Commercial Code, a new taxation system relating to the restructuring of corporations, such as splits and mergers, was created in 2001.

But because of the bad memories of the burst of the “bubble” in the early 1990s in which most investors lost their money, individual investors are generally still cautious about investing equities. With the excuse of the bad performance of the market, the scheduled abolition of the separated withholding tax on capital gains from security transactions was postponed to 2003.

5. Reforms of capital income taxation in mid-2001 and in 2002

As a part of economic stimulus measures, the taxation on capital gains from security transactions was reformed in mid-2001. As a permanent reform,

- separate *withholding* taxation (at source) of listed stocks mentioned above will be abolished by end CY 2002.
- tax rate of separated taxation on listed stocks will be reduced to 15% + local 5% from CY 2003.
- carryover of capital losses for 3 years will be introduced from CY 2003.

As a temporary measure,

- special tax exemption for small long-term capital gains (up to 1 million yen, over 1 year) of listed stocks was introduced October 2001 and will continue until end CY 2005.
- tax rate for long-term capital gains of listed stocks will be reduced to 7% + local 3% from CY 2003 to CY 2005.
- capital gains of listed stocks purchased until end CY 2002, held between CY 2003 and CY 2004, and sold between CY 2005 and CY 2007 will be tax exempt up to 10 million yen of total *purchase* cost.

With the introduction of a consolidated taxation system, and other reforms, there is a reform of interest income tax in the 2002 reform. Exemption of interest income on small deposits owned by the elderly, disabled persons, etc. will be reformed in January 2006 and applied only to small deposits owned by disabled persons, etc.

III. Comparison of the arguments over the capital gains tax from security transactions in both countries and the evaluation of recent reforms in Japan

Here I will survey the arguments over taxation on capital gains in both countries and evaluate the recent reforms of capital gains taxation from security transactions in Japan.

Capital gains taxation seems to be a focus of partisan confrontation and intensely discussed in the U.S. like the Consumption Tax is in Japan. The treatment of the tax rate on capital gains is also the main issue in the argument over the uniform tax rate on all capital incomes I will mention later.

1. The arguments over the tax rate on capital gains in the U.S.

According to Burman⁴, cutting the capital gains tax is said to:

- lead to more saving and investment and thus higher economic growth.
- induce so many additional realizations that revenues increase.
- reduce “lock-in,” the effect that encourages investors to hold on appreciated assets to postpone tax, and give taxpayers more incentive to diversify their portfolios.
- encourage risky new ventures that are most likely to pay all their returns in the form of capital gains.
- reduce distortions from double taxation.
- reduce unfairness from capital gains that simply represent inflation.

In regards to these points, Burman summarizes the arguments in the U.S. in saying as to the effect of tax differentials on saving, the net effect depends not only on private saving but also public saving.

Empirical studies show that the general response of private saving to a lower tax rate on capital income is thought to be small or even negative. Because capital gains constitute only a small share of total capital income, a preferential tax on capital gains is likely to have little effect on private saving.

As to the impact on public saving (change in the tax revenue of the government), empirical estimates embrace a range of possible outcomes and the debate about revenues is not

⁴ The following analysis in the U.S. is based on Burman(1999).

settled.⁵ In addition, an indirect revenue loss by the conversion of ordinary income into capital gains should be considered and scant but some empirical evidence suggests this move.

Putting these factors together, whether total saving increases or decreases, the change is likely to be small compared with the size of the total economy.⁶ In addition, even if savings are responsive to the tax change, the effect on investment also depends on its elasticity to the cost of capital. Furthermore, in an open economy in which a considerable portion of domestic investment is financed from abroad, tax incentives for saving may have a limited effect on aggregate investment in the United States.

As to the lock-in effect, a tax cut probably reduces the effect, but it could be accomplished more effectively by taxing capital gains at death in the U.S. case, and its importance for efficient capital allocation is not clear:

- Lock-in is a serious problem only for taxpayers who own a few capital gains assets and those people account for a very small share of capital gains.

⁵ According to Burman's classification, the analyses of cross-sectional data tend to suggest a higher elasticity, while analyses of time-series data tend to suggest a lower elasticity. While many economists argue cross-sectional data largely reflect the response to temporary difference of tax rates rather than the effect of the permanent change, the studies on time-series data tend to be unstable.

⁶ The estimate by the Joint Committee on Taxation in 1997 shows that even if the largest saving response consistent with mainstream empirical research is assumed (elasticity of 0.6), a 50% exclusion of capital gains tax is unlikely to increase national saving over the long run. (5 years period +0.8%, 10 years period +0.3%) (Burman(1999), Chapter 4)

- The tax cut would give corporate managers an incentive to retain earnings rather than pay them out in the form of dividends even if internal investments earn below-market rates of return. Considering this another kind of “lock-in” effect, researchers have calculated that a capital gains tax cut could make society worse off because lost tax revenues and increased corporate lock-in effect may exceed individuals’ gains from a reduced lock-in effect.
- A primary cause of the lock-in is the failure to tax capital gains at death (“step-up in basis”). If the lock-in is an important issue, its change should be considered.

As to risk taking, it should be noted that, with full deductibility of capital losses, the tax decreases the variability of returns (because the government shares the risk) and *encourages* risk-taking. In addition, allowing taxpayers to defer the taxation of gains but to claim losses when they occur provides further inducements to risk-taking.

In reality, to prevent abuse, most developed countries do not allow deductibility of capital gains from other income. In the U.S., this deductibility is allowed but with a loss limit of \$3000 and the excessive loss is carried over to future tax years. Although it creates some asymmetry, according to Burman, statistics show the \$3000 loss limit in the U.S. is relatively large compared with the size of losses that most lower-income investors incur.⁷

⁷ See Burman(1999), Chapter 5.

Capital gains tax might actually encourage risk-taking with a risk-sharing with the government and a relatively large loss limit. The lower tax rate may encourage investments in assets that produce capital gains which are inherently riskier than other safe assets but less risky within capital gains assets, so overall effect on risk-taking is, at best, ambiguous.

As to entrepreneurship, the effect of a lower tax rate on entrepreneurship is ambiguous.

Burman introduces the study by Poterba and the counterargument against it. Poterba found that more than three-quarters of the funds that are invested in start-up firms are provided by investors who are not subject to the individual capital gains tax in the U.S.⁸ But people in the venture capital sector counter that much of the funding in the earliest stages comes from the entrepreneur's family and friends but data are not available because the funding is outside the formal markets.

More fundamentally, a large part of what entrepreneurs bring to a new business is their human capital. Since they contribute before-tax earnings by taking a lower salary, their investment is actually treated as tax-favored retirement accounts and pensions.

But there is already the 1993 U.S. tax law which provides benefit for small entrepreneurs.

(Exclusion up to 50%, deduction of first \$17,000 investment.)⁹

⁸ See Poterba(1989).

⁹ Stiglitz indicates that the one area in which the capital gains tax may have a significant effect on the production efficiency of the economy is in smaller, owner-managed firms and the 1993 law targeted them. He also points out that the 1997 tax cut, by contrast, was

As to the double taxation of capital equity, as will be seen later, its effect on the efficiency of the overall economy is still controversial. A capital gains tax cut would reduce the overall tax burden on investments in corporate stock and offset part of the corporate income tax. But it is a crude instrument because, as already mentioned, it would discourage corporations from paying out earnings in the form of dividends.

As to the taxation on inflation, it might be undesirable to tax income attributable to inflation, but in the context of the present system, either by a preferential tax rate or indexing, adjusting capital gains for inflation would provide an unfair advantage for capital gains assets over other forms of assets and would increase the incentive to convert other income to capital gains. Even without a preferential treatment, a growth asset that pays returns in the form of capital gains is subject to a lower effective tax rate than a bond because of deferral.¹⁰ The effective tax rate increases with inflation, but less so than for interest, dividends, or rents.

As to the overall efficiency of the economy, a preferential tax on capital gains wastes society's scarce resources by encouraging inefficient tax shelters and creating revenue loss in the U.S. Fully deductible interest and partly taxed capital gains makes a strong tax shelter, which is

across-the-board and criticized it because much of the benefit would accrue to investments that had already been made. (Stiglitz(2000), Chapter 21.)

¹⁰ Stiglitz points out that, for many investors, the benefits of postponement are more than offset by the costs of taxing nominal income and this is especially true for investors who finance a significant part of their investments by borrowing. (Stiglitz(2000), Chapter 21.)

profitable only because of taxes. Tax Reform Act of 1986 made traditional tax shelters less attractive,¹¹ but as already mentioned, financial innovations have produced highly efficient means of converting ordinary income into capital gains.

With full consideration of above mentioned points, Burman concludes that tax preferences for capital gains are more likely to depress economic productivity than improve it and taxing capital gains like other income is the fairest option. He also emphasizes that a preference for capital gains favors the wealthy over others, and those with a great deal of flexibility about how to receive their income over those who have little choice. His conclusion must still be controversial, but his viewpoints are also useful for analyzing the Japanese case.¹²

¹¹ For example, TRA 1986 has the following provisions.

- ①The passive loss limitation in which taxpayers may not deduct losses on businesses that the taxpayers do not actually participate in managing(“ passive investment”) against other income.
- ②The investment interest limitation that constrains the ability of investors to deduct interest expenses incurred to finance investments to the extent of investment income.

¹² Burman also argues about the merits and defects of certain structures of capital gains taxation. These arguments are also useful for policymakers in Japan.

- ①Even without any rate preference, the effective tax rate declines with the holding period because of the deferral. Creating tax rates that decline with holding periods exacerbates lock-in. The 1997 reform in the U.S. made capital gains tax rates decline with the holding period and it exaggerates the value of deferral.
- ②To exclude a certain amount of capital gains from tax each year would vastly simplify accounting for the majority of investors. But because there would not be any feedback effect on taxable realizations, it would be a revenue loser.
- ③A prospective tax cut would provide exactly the same incentives for new investment as a tax cut applied to all sales(a retrospective tax cut) but would have smaller revenue costs.

2. An evaluation of capital gains taxation on security transactions in Japan before and after the reforms in mid-2001

As already mentioned, the conventional system of capital gains taxation on security transactions in Japan is considerably different from that in the United States. Following Burman's viewpoints, its merits and defects compared with the U.S. system are as follows.

- As a separated taxation system, it has less room for tax arbitrage exploiting the difference between capital gains and other incomes.
- With no "step-up in basis," inefficiency from the lock-in effect may be smaller.

Taxpayers have an incentive to sell old assets and buy new ones or choose to "mark to market" old assets, and because all of the induced realization would be fully taxed, revenue gained in the short run is more than a retrospective cut, even if the induced realizations were much smaller. Over a sufficient long period, both cuts have identical effects, but part of the short-run revenue gain is a permanent one.

④Temporary exclusion retrospectively followed by prospective indexing provides a very strong incentive to sell assets.

⑤A temporary cut would strongly prompt realizations, but it is uncertain whether it would raise more or less revenue than a prospective cut, because of the decrease of revenue on sales that would have occurred without a tax cut.

⑥Theoretically, one alternative system would be the "retrospective capital gains taxation" which imputes a normal gain given a risk-free rate of return and the holding period. Absent taxes, an investor will hold assets that, after adjusting for risk, are expected to pay at least the risk-free rate of return. Because this system does not alter these incentives, it is neutral in the holding period, and would end lock-in. But because it depends solely on the sale price, it would be hard to convince any politician of its fairness, although undeniably economically efficient and fair ex ante.

(Burman(1999),Chapter 8.)

- With no distinction of tax rate with the holding period, distortion by deferral is smaller.
- With the special tax treatment for “angel” (an individual investor for venture companies), there was already a consideration for entrepreneurship by venture companies like the 1993 tax law in the U.S.
- Because of a separated system, a deduction of capital losses from other income is not allowed. In addition, under the conventional Japanese system, a carryover of capital losses was also not allowed. With the lack of both a loss offset and a loss carryover, it might have a discouraging effect on risk-taking.

On the other hand, the proportional tax rate might be slightly more encouraging for risk-taking than the current U.S. system, which has two stage tax rates.¹³

- Under the conventional system, the tax rate (20%+ local 6%) was higher than that on interest (15%+ local 5%) which is also subject to separated taxation. It might also be discouraging for risk-taking. But with the existence of the separate withholding taxation and the inherent characteristic of capital gains that could enjoy the benefit of deferral, the overall effect on risk-taking was ambiguous.
- Also under the conventional system, a separate *withholding* taxation was available as an alternative. Under this system, capital gains derived from the sale of listed stocks and the like

¹³ See footnote 18 on page 25.

were taxed at source at the amount of 1.05% of the proceeds from selling and did not require tax filing. It was problematic because it did not reflect the real amount of income and could be used arbitrarily (Taxpayers were able to choose either system transaction by transaction). It is substantially equivalent to the Securities Transaction Tax which was abolished in 1999. It was introduced in 1988 as an “interim” measure until the development of compliance systems between taxpayers and the security companies, but has lasted for over a decade with the excuse of long-lasting bearish markets and has become a symbol of the delay of the improvement of tax compliance.

In addition to the above-mentioned points, it should be noted that there is no need to encourage saving in general, almost no need to adjust for inflation, and probably less need for an adjustment for double taxation, as I will mention later, under the current Japanese economy.

- Under the new system after the reforms in mid-2001, the separate *withholding* system will be abolished. It will exclude most of the distortions from the conventional system.
- After temporary tax cuts, the tax rates on capital gains from security transactions and interest will converge to 20% after 2005. Considering the benefit of deferral, the new system will encourage risk-taking by buying equities more than buying safe assets.
- A carryover of capital loss will be introduced for all capital gains from security transactions. It will also encourage risk-taking more than the conventional system.

So after this tax reform, the major problems concerning capital gains taxation from security transactions will be solved and the problems remaining, if any, will be those of overall capital income taxation.

IV. Comparison of the arguments over the overall capital income taxation in Japan, the U.S. and the Nordic countries

Next, I will survey the arguments over the overall capital income taxation in these countries and their implications for future reforms in Japan.

1. The trends of capital income taxation in Japan

The Japanese current situation, including an excess-saving economy, naturally requires strengthening the taxation on financial transactions rather than reducing it.

Since Shoup's Recommendations in 1950, the conventional idea about the ideal for future capital income taxation had long been a comprehensive taxation. Under the conventional idea, the current system was thought to be a second best because of restrictions on implementation, especially the lack of tax identification numbers. But under the influence of the theory of optimal taxation, in recent years, the Dual Income Taxation system in the Nordic countries seems to attract more interest from tax specialists and policymakers in Japan, as an alternative ideal to the conventional comprehensive taxation.¹⁴ In this system, all income is separated into either

¹⁴ This trend was clearly shown in the report of the Tax Commission in 1997(the Sub-Committee

capital income or labor income. All capital income is taxed at the proportional corporate tax rate, while labor income is subject to additional progressive personal tax rates. The lower rate on labor income is set at the same level as the proportional corporate tax rate. Single taxation of capital income is ensured through withholding or source taxes at the company level at the same rates as the corporate tax. They represent the final tax liability.¹⁵

At least, the two characteristics of this system, the separation from the labor income and the proportional tax rate, seem to be more familiar with the current capital taxation in Japan than the conventional comprehensive taxation ideal. The idea of a lower uniform tax rate seems to be consistent with the recent reforms of capital gains taxation from security transactions I have already mentioned.

2. The arguments over overall income tax reforms in the U.S.

As we can see in the arguments over the merits of a consumption tax, the recent arguments in the U.S. put more weight on eliminating the distortions within the current income tax.¹⁶ It can be

on Taxation on Financial Transactions, Kinyuu Shisutemu Kaikaku to Kinyuu Kanren Zeisei, December 1997) and has continued since then.

¹⁵ The following description of the Dual Income Tax is based on Cnossen(1997) and Sorensen(1998). I also refer to Baba(2000).

¹⁶ For details of the arguments in the U.S. over the merit of a consumption tax, see my paper “What does the consumption tax mean to Japanese Society and U.S. Society? – The difference in the priorities overall tax reforms in both countries”.

done by replacing the income tax with a consumption tax, but also can be done to a similar extent by an overall income tax reform. It is noteworthy that some proposals of this kind also include a proportional tax rate on capital income. The Comprehensive Business Income Tax (CBIT) proposed by the Treasury in 1992 is an example. CBIT is a broad-based income tax. Under this system, all income earned by corporations is taxed once under the corporate tax with the elimination of interest deductions. The income is indexed for inflation. One difference from a consumption tax is depreciation instead of deduction for capital investments. But with the integration of the corporate and personal-income tax systems, it eliminates the distortions from the tax distinction between: corporate and noncorporate businesses; debt and equity finance; and retentions in the corporation and distributions to shareholders, similar effects to those of a consumption tax.¹⁷

3. The characteristics of the Dual Income Tax

As to the treatment of different kinds of capital incomes, just like CBIT, the Dual Income Tax

¹⁷ The following description of CBIT is based on Gentry and Hubbard(1998).

As Gentry and Hubbard pointed out, one of the differences between the two taxes may be the opportunity for tax-planning by the creation of intangible capital. Different from under a consumption tax, under CBIT, treating the transaction as “financial” may lower the total tax liability because the buyer will get deductions only over the life of the intangible capital if the transaction is “real”. By structuring M&A as financial rather than real, the present value of total tax liability can be lowered.(because the present value of the tax saving by the exclusion of the purchase price from the seller’s tax base exceeds the present value of any additional taxes paid by the buyer from smaller depreciation allowances.)

has an idea of a proportional tax rate on all capital income at the level of a corporate tax rate.

On the other hand, opposite to CBIT, it sets the tax rate on capital income at the lowest of the graduated rates on labor income.

The reasons for the *proportional* rate on capital income of the Dual Income Tax are as follows:¹⁸

i. The intersectoral distortions of capital allocation caused by the conventional income tax is more serious than the intertemporal distortion of the overall savings level on which traditional tax theories have tended to focus on.

ii. The proportional taxation of capital income eliminates certain forms of tax arbitrage which rely on exploitation of the difference in the marginal tax rates faced by different individual taxpayers. Arbitrage activity by the owners of corporations taking advantage of interest deductibility against a high marginal personal tax rate combined with a lower corporate income tax rate and a postponement of capital gains tax becomes unprofitable.

iii It may be impossible to implement a consistent taxation on capital gains unless the marginal tax rate is fairly low because of deferral, and a low flat tax rate on capital income may

¹⁸ In addition to the points above, many economists argue that, with a progressive tax structure, returns to successful investments are taxed more heavily and there is a built-in bias against risk taking. The proportional tax rate on capital income must be good for risk-taking. (For example Stiglitz(2000), Chapter 21.)

make it easier to tax capital gains at the same rate.

As to the first and second point, the priority seems to be same as that of CBIT. One major reason for *separated* taxation under the Dual Income Tax is the defect of comprehensive taxation in the past in Nordic countries. Traditionally having liberal rules for interest deductibility combined with favorable tax treatment of several types of capital income, most notably the return to pension savings and owner-occupied housing, personal taxes on capital income in these countries have historically tended to imply a substantial loss of revenue. It aims to prevent tax arbitrage by separating individuals' capital income from their labor income, while CBIT aims to do the same thing by taxing capital income only at the corporate level.

The main reasons raised for *lower* tax rate on capital income are as follows:

- i. The theory of optimal taxation supports that capital income should not be taxed at the same rate as labor income because of the greater elasticity of supply of capital. Financial capital is becoming increasingly mobile internationally given the practical difficulties of enforcing residence-based taxes on foreign source income.
- ii. A lower rate on capital income mitigates the distortions of the conventional comprehensive income tax.
- iii. The tax on labor income is essentially a cash-flow type of levy which is not affected by

inflation.

iv. Human capital investment enjoys a favorable tax treatment because the cost of acquiring human capital, which typically takes the form of foregone taxable wage income during the period of education or training, is not included in the tax base at all (full expensing).

On the other hand, the system may create new room for tax avoidance through the transformation of labor income into capital income. Taxable profits of proprietorships and closely-held companies have to be split into two components under this system and these income-splitting rules¹⁹ are criticized as involving administrative difficulties. This is a problem unique to this system.

4. The applicability of the Dual Income Taxation to Japan

When we examine the applicability of the Dual Income Tax to the Japanese case, the first concern is this difficulty in distinction between capital income and labor income. Furthermore, as to the *lower* tax rate on capital income, most of the reasons raised above reflect specific factors of Nordic countries and can not equally apply to the Japanese situation.

- In these countries, there has been a concern about the low level of private savings. The

¹⁹ The capital income component is calculated by applying a presumptive return to the value of the business capital, and the residual is considered as labor income.

Japanese situation is totally different.²⁰

- Nordic countries are very near to other major European financial markets. The elasticity of supply of capital may also be different for Japan. It requires further examination.
- The assumption of favorable treatment for human capital ignores the externality of education or complementary inputs from the government. It also should be noted that in these countries privately-held physical and financial capital is subject to net wealth tax except in Denmark, and is thought to be distributed more equally than human capital. So the necessity of a *lower* tax rate on capital income should be further examined for the Japanese case.

The following are the tax rates in the Nordic countries. It should be noted that even after the temporary tax cuts, the tax rates on interest and capital gains in Japan will converge into 20%, which is still considerably lower than those in the Nordic countries (see next page).

²⁰ Sorensen indicates the background of the introduction of a low flat rate of tax on capital income as “high rate of inflation, extremely low private savings rates, considerable tax subsidies to owner-occupation due to interest deductibility, and overheated housing markets” in the 1980s. (Sorensen(1998))

(in 1999, except Japan)

					(%)
	Norway	Finland	Sweden	Denmark	Japan
Capital income					
(Corporate)	28	28	28	32	30(40.87)*
(Other)	28	28	30	39.7-59	15 (20)**
Labor income	28-41.5	22.5-54.5	31-56	39.7-59	10-37(15-50)

* The numbers in parentheses are including local taxes.

** Tax rates on interest and capital gains.

On the other hand, not only the experience in the Nordic countries but also the recent experience of distortions by tax arbitrage in the U.S. suggest that the comprehensive income taxation system is not necessarily the best system. Financial innovations and the recent creation of pass-through entities may create similar conditions in Japan in the near future. The generous treatments of some saving plans also have potential opportunity for tax arbitrages. There seems to be a good reason for *separated* taxation on capital income.

As to the *proportional* or *uniform* tax rate, we should distinguish two ideas: one is a uniform tax rate on all capital income, and another is a single tax rate on different amounts of capital income. As to the idea of a uniform tax rate on all capital income, the treatment of capital gains and dividends may be the main problem. As already argued, imposing the same tax rate on capital gains and other capital incomes does not necessary mean an equal treatment of them because of the merits of deferral for capital gains, but it may be a good balance for

risk-taking. On the other hand, the treatment of the tax rate on dividends should be further examined because, as will be mentioned later, it closely relates to the argument over “double taxation”.

As to the idea of a single tax rate on different amounts of capital income, considering the characteristics of capital income and the need for vertical equity, it may still be controversial as to whether it is preferable or not. When considering the balance between tax rates on different incomes, the balance with the corporate income tax rate should be also considered. It should be noted that while the corporate income tax rate and the lowest tax rate on individuals’ labor income are almost same in the Nordic countries, they are clearly different in Japan (30% vs.10%).

5. The adjustment of “double taxation” and its effect on efficiency

It should be noted that the main objective of CBIT is the integration between personal income tax and corporate income tax. The Dual Income Tax also typically adopts a full imputation system to adjust “double taxation.” (Though Sweden has no such a system and the adjustment in Denmark is not full.) Among Nordic countries, Norway has a unique system to further eliminate “double taxation.”

Under the Norwegian system, double taxation of retained profits at the company level in

conjunction with the taxation of realized capital gains at the shareholder level is avoided by permitting shareholders to write up the basis of the shares by retained profits net of corporate tax. It may be theoretically better, but its complexity is problematic.

Different from the arguments over the “equal” treatment of capital income, the views of U.S. economists on the efficiency effect of integration are clearly divided.²¹

As to the effect of corporate income tax and the consequence of integration, the U.S. economists’ views are divided into Harberger’s model and Stiglitz’s model.

- Harberger’s model shows that if corporations use only equity finance, the corporate tax lowers the rate of return to capital and the burden is borne by owners of capital.²² So the tax has substantial real effects on investment. Under this model, an integration eliminates a costly distortion of organization form, reduces the burden on investment and the tax burden on owners of capital generally, thus increasing the marginal return on equity-financed investment.

- Stiglitz’s model indicates that if corporations use debt at the margin, no extra tax is

²¹ The following overview is based on Gentry and Hubbard(1998) and Zodrow(1991).

²² Harberger’s model assumes that overall supply of capital is fixed but that capital is perfectly mobile between corporate and unincorporated sectors. In equilibrium, the after-tax return on capital is the same in both sectors. Because the corporate sector is relatively capital intensive, a shift in demand toward the unincorporated sector indirectly reduces the demand for capital and the return to capital. (Harberger(1962))

imposed on the critical margin of corporate use of capital (the rate of return to capital) , even though the corporate tax might be collected on the returns from better-than-marginal investments.²³ The tax does not distort investment decisions and the burden is born by inframarginal equity and any economic rents associated with new investments. Under this model, the efficiency consequences of integration are minimal.

Related to the above, as to the effect of dividend tax and the consequence of integration, there is also a clear division of views.

- The “traditional view” is the view that dividend taxation at the individual level results in double taxation of the income attributable to investments financed with retained earnings. It assumes that dividends are paid out because they have non-tax benefits to offset the tax disadvantage and that marginal investments are effectively financed by new share issues.²⁴

²³ Stiglitz suggests that, typically, firms first use retained earnings and investment beyond that amount is financed by borrowing, so much of investment is financed by debt at the margin.

On the other hand, he admits that many firms are credit constrained. In this case, taxes reduce the funds available and thus investment, so the impact of the tax depends on average tax rates, not marginal tax rates. He indicates that the corporate income tax can be viewed as a tax on new, credit-constrained, entrepreneurial firms. The effects of corporate tax are not so much associated with the reallocation of resources between corporate and noncorporate sectors but do with the degree of innovativeness and technical progress. He points out that this concern led to preferential treatment of capital gains in new firms in 1993 bill. (Stiglitz(2000),Chapter 23. See also Stiglitz(1973))

²⁴ According to Zodrow the two key assumptions of the “traditional view” are as follows.

①shareholders derive a positive benefit (“signalling” profit information or reducing

Under this view, an integration lowers the effective tax rate on investment income, encourages investment and raises the dividend payout rate.

- The “new view” or the “tax capitalization view” is the view that dividend taxation at the individual level has no effect on marginal investments financed with retained earnings. It assumes that dividends offer no non-tax benefits and dividends are the only way of distribution.

For most firms, equity-financed investments are financed from retained earnings and future dividend taxes are capitalized in share prices.²⁵ For these firms, the corporate tax does not

managerial discretion) from receiving dividends that offsets the tax disadvantage of paying dividends. So the opportunity cost of one dollar of investment financed with retained earnings is simply one dollar and, in equilibrium, investors are indifferent between equity finance in the form of retained earnings and new share issues.

② marginal investments are effectively financed with new share issues and each firm maintains an equilibrium amount of retained earnings and dividends paid.

In this case, the net return is $g(1-TB)[f(1-TI)+(1-f)(1-TG)]$ (g: before-tax, net-of-depreciation return, TB: corporate tax rate, f: dividend payout rate, TI: dividend tax rate, TG: capital gains tax rate).

Under these assumptions, a dividend tax cut

- ① lowers the effective tax rate on investment income and encourages investment.
- ② raises the dividend payout rate as the cost of “signalling” profit information or reducing managerial discretion has decreased.

²⁵ According to Zodrow, the common critical assumption of the “new view” is that earnings on equity-financed investments can ultimately be distributed to shareholders only in the form of taxable dividends.

① If new investment is financed with retained earnings, from the perspective of shareholders, one dollar of foregone after-tax dividends gives rise to an investment at the firm level of $(1-TG)/(1-TI)$ (TI: dividend tax rate, TG: capital gains tax rate), So the net return that the shareholder receives is $g[(1-TG)/(1-TI)](1-TB)(1-TI) =$

distort investment decisions - the view consistent with Stiglitz's case- and has no effects on dividend payout decisions. Under this view, for most firms, an integration only results in a windfall gain to existing shareholders. The primary effect of integration is to eliminate a tax disincentive against new share issues which is likely to have a negative impact only on new firms.

$g(1-TG)(1-TB)$ (g : before-tax, net-of-depreciation return, TB : corporate tax rate).

Thus the effective rate of taxation of investment financed with retained earnings is independent of the individual tax rate on dividends.

②If new investment is financed with new share issues, the shareholder receives $g(1-TB)(1-TI)$. So as long as capital gains are taxed at a lower rate ($TG < TI$), investment financed with retained earnings is subject to a lower tax rate.

③As firms are precluded from new share issues, "Tobin's q " which is the ratio of the market value of a firm to the replacement cost of its capital assets can be below 1 in equilibrium. The shareholder is indifferent between retained earnings and distributions only when $1-TI$ (the marginal value to the shareholder of a dollar of earnings paid out as dividends) = $q(1-TG)$ (the marginal value to the shareholder of a dollar of retained earnings), so the lower bound of $q = (1-TI)/(1-TG)$, and for higher q , retained earnings are preferred.

While new firms have to rely on new share issues, are subject to full double taxation and invest until the marginal return to investment falls to the point at which the marginal $q = 1$, firms in a period of "internal growth" retain all earnings and invest until the marginal return to investment falls to the point at which $q = (1-TI)/(1-TG)$, and "mature" firms that have sufficient retained earnings also invest in the same way and distribute funds still left over as dividends to shareholders. This view implies that the future dividend taxes are capitalized into share prices.

Under this view, a dividend tax cut

- ①has no effect on marginal investments.
- ②has no effect on the dividend payout rate.
- ③but results in a windfall gain to existing shareholders.

The Treasury's 1992 integration report is based on the "traditional view," but the views of economists and their empirical studies seem to be still divided.²⁶ It is an impressive thing

²⁶ 1. Both views are criticized for their own critical assumptions.

①The critics of the "traditional view" indicate that the use of taxable dividends as a means of signaling profit information or reducing managerial discretion seems to be rather expensive. Despite the fact that information problems are most severe for small, rapidly growing firms, such firms engage in very little "dividend signaling".

②The critics of the "capitalization view" point out that the assumption that firms have no alternative means of distributing funds is counterfactual.

2. There are also some alleged facts against the "tax capitalization view".

①If in equilibrium marginal q is less than one and not significantly lower than average q , firms should prefer to take over other firms rather than purchasing capital directly.

②Dividends should fluctuate considerably in the face of investment opportunities under the "tax capitalization view", but actually dividend payments are stable. Firms increase dividends when economic conditions are favorable, rather than reduce them.

③Firms should never simultaneously pay dividends and issue new shares under the "tax capitalization view", but actually there are numerous instances of this occurring.

3. Empirical tests also seem to be divided.

①The empirical test by Poterba and Summers in 1985 is an example which supports the "traditional view".

They find a strong negative relationship between temporary dividend tax changes and payouts in the U.K. They also find that the q model based on the traditional view ($q = 1$, marginal equity financing comes through new share issues) has greater explanatory power. (Poterba and Summers(1985))

②The empirical test by Harris, Hubbard, and Kemsley is an example supporting the "tax capitalization" view.

They find that accumulated retained earnings that are subject to dividend taxes on distribution are valued less than paid-in equity which can be returned to shareholders tax-free. They also find that differences in dividend tax rates across past U.S. tax regimes are associated with differences in the magnitude of the implied tax discount of retained earnings, as are differences in dividend tax rates across Australia, Japan, France, Germany and the U.K. (Harris, Hubbard and Kemsley (2001))

that, while many European countries adopt imputation systems to eliminate or adjust “double taxation”, and while there are many proposals to eliminate “double taxation” at home, the U.S. still maintains a perfect “double taxation”.

Stiglitz analyzes the reasons for difficulty about imputing the earnings of a corporation to shareholders. For one, shareholders worry that they would face a tax liability, even though they have received no checks from the corporation. Secondly, corporate executives worry about distributing more and reducing their degree of discretion; they did not even support the tax deductibility of dividend distributions. Also, most forms of integration would reduce revenues and if tax cuts are to be made, politicians have chosen child care or education tax credits.²⁷

The second and third point may also apply to the argument over CBIT.

It is also impressive that even though the ratio of equity finance is much larger in the U.S., many U.S. economists take the view that most firms in the U.S. finance their marginal investments from retained earnings and debt.

Both the “traditional view” and the “tax capitalization view” seem to agree on some need to offset a tax disincentive to new firms that rely on new share issues for their source of funds. As I already mentioned, the 1993 U.S. tax law which provides preferential treatment of capital gains for small entrepreneurs already responds to this need. As to this issue, the

²⁷ See Stiglitz(2000),Chapter 23.

situation in Japan is similar.

As I already mentioned, Japan now has only a small degree of adjustment by the tax credit at the shareholder's level. Before the 1987-88 reform, besides the current tax credit for dividends, there had also been a preferential corporate tax rate on dividends. The system had been thought to be a measure to strengthen the equity capital of Japanese companies but it was abolished in the reform because of its ineffectiveness and the windfall gain for foreign and tax-exempt investors.

In the 2002 reform, as one of the measures to make up revenue loss from the introduction of the consolidated taxation system, the ratio of the dividends excluded from corporate taxable income is reduced from 80% to 50%. This reform is also in the direction to "strengthen" double taxation.

As already mentioned, Japan also has the "angel" taxation, which is a preferential treatment of capital gains for individual investors in venture companies since 2000.

The factors Stiglitz indicates about the U.S. case will probably also be adopted in the Japanese case. As already mentioned, in Japan, corporate finance has been more debt oriented for a long time and more marginal investments are likely to be financed by debt. If the elimination of "double taxation" does not collect enough support in the U.S., it is less likely to in Japan.

When it comes to the integration between the personal income tax and the corporate

income tax, there are still many things to be examined in Japan. Even if there is a need for Japan to introduce an integration system in the future, there must be enough consideration about what model should be adopted.

The imputation system which is widely used in European countries including the Nordic countries may be a choice. But as we saw in the Norwegian case, if we further consider the “double taxation” of retained profits at the company level in conjunction with the taxation of realized capital gains at the shareholder level, the current imputation system is also not perfect.

CBIT would be a more comprehensive solution. It may be suitable to the idea of “taxing corporation” which is common to both countries, but it may have a problem of less “visibility” of capital income taxation. As I already mentioned, the proportional rate of CBIT can also be a problem. Furthermore, one major defect of CBIT must be the lack of taxation on capital income that is not derived from corporations. In the Japanese case, capital gains from land are too important to be ignored.

V. Concluding Comments

One clear difference of the Japanese society from the U.S. is its excess savings economy. This situation naturally requires strengthening the taxation on financial transactions rather than reducing it.

Under the restriction of tax implementation, a large part of capital income is now subject to separated taxation. Under this system, combined with underdeveloped financial technologies, Japan suffers less from sophisticated tax-planning so far.

Taxation on capital gains from security transactions is one of the fields that the U.S. arguments have focused on. The criteria of efficiency discussed in the U.S. may also be useful to analyze the Japanese system. The recent reforms in Japan can be highly evaluated as excluding distortions and encouraging risk-taking.

The recent distortions by tax arbitrage in the U.S. suggest that comprehensive income taxation is not necessarily the best system. There seems to be a good reason for the *separated* taxation on capital income. In this sense, it would be natural that the Dual Income Taxation attracts the interest of tax specialists in Japan.

But as to the *lower* tax rate on capital income than labor income under the Dual Income Taxation, the merits and defects should be further examined based on the Japanese situation.

In addition, the merits and defects of a *proportional* tax rate on capital income, as well as its balance with the corporate tax rate, should also be considered further. It should be noted that some proposals like CBIT in the U.S. also put more weight on eliminating distortions within the income tax and adopt a proportional tax rate on capital income the same as that on (other) corporate income.

As to the elimination of “double taxation,” its effect on efficiency is still controversial even in the U.S. and the effect should be examined based on the Japanese case. Even if there will be a need for it in the future in Japan, there must be enough consideration about what system should be adopted. CBIT can be a comprehensive solution but has defects from the Japanese perspective, including the lack of taxation on capital income that is not derived from corporations.

It is difficult to find a clear answer for the future of overall capital income taxation now. There seems to be no clear model for it. Further studies based on Japanese data are urgently required. But the criteria mentioned above must be useful to examine future tax systems.

Besides the above-mentioned systems, the revision of other generous treatments of saving such as those for pension and life insurance plans should also be a priority.

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