What does the consumption tax mean to Japanese society and U.S. society?

-The difference in the priorities of overall tax reforms in both countries-

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Abstract

The Japanese tax system reflects the characteristics of postwar Japanese society. The emphasis on an equal income distribution, the concern for assets -- especially land, and the dominance of corporations as a form of business are the consistent trends. More recent trends are the realities of the aging society and the transformation from insufficient savings to excess savings. Combined with the restriction of tax implementation, these two trends were the main motives for the introduction of the current Consumption Tax and the current separated taxation on a large part of capital income in the 1987-88 reform.

Based on different backgrounds, the priorities of tax reforms in Japan and in the U.S. are also different. One confusing thing from a Japanese perspective is that a consumption tax also seems to attract many U.S. economists and policymakers. Mainly surveying the arguments over the consumption tax, this paper shows what is common and what is different between the debates on overall tax reforms in the two countries. While there are many problems unique to the Japanese Consumption Tax, there may be something in the U.S. arguments over a consumption tax we Japanese should also learn from.

In the U.S., the advocates of a consumption tax focus on the merits of efficiency and simplicity. In the last decade, while the need for the adjustment for inflation and the encouragement of savings might have decreased to some extent, the need to fix the distortions from sophisticated tax planning by financial innovations seems to have increased. In Japan the motives for the introduction of the Consumption Tax were rather the concern for equity -- horizontal equity, equity through the life cycle and between generations. It was thought to be a complement rather than a total substitute for the income tax. Eliminating the distortions under the conventional excise taxes and stabilizing the tax revenue were also motives.

I. Introduction

A tax system always reflects the characteristics of the relevant society. As social values and economic situations vary from country to country, tax systems also vary considerably. The current situation in the EU shows how difficult it is to harmonize tax systems across the boundaries between different sovereign countries even after the merger of currencies.

For Japanese tax policymakers, the U.S. comprehensive income taxation and the European VAT had long been two established models for its tax system. But in reality, the Japanese system has been modified synchronizing with the characteristics of the Japanese society.

The Japanese government succeeded in introducing the Consumption Tax in 1989 but the new system turned out to be a little different from the European VAT after a long political dispute. The U.S. comprehensive income taxation system has long been a model since Japan had an overall tax reform based on the recommendation by Columbia University Professor Carl S. Shoup in 1950. But as for the taxation on financial transactions, Professor Shoup's ideal was modified early in the 1950s and has developed in a different way since then.

Because of the overwhelming prosperity of the U.S. economy and the long-lasting stagnation of the Japanese economy in contrast during the last decade, in every field in the social system, the U.S. standard is praised as the "global standard" and many "reformers" advocate simply imitating the U.S. system.

The tax system is not an exception. When the Japanese government started the "Big Bang" to revitalize the Tokyo financial market in 1997, the Security Transaction Tax was accused of being against the "global standard" and a major reason for the stagnation of the Tokyo market. However, it was equivalent to the stamp tax in Britain, and the Tokyo market had actually enjoyed the "bubble" with a higher rate of the same tax. It was halved in 1998 and eventually abolished in 1999.

However, the problems are not always so simple. One confusing thing from the Japanese perspective is that many proposals for overall tax reform in the U.S. seem to deviate from comprehensive income taxation and prefer consumption-type taxes even though the U.S. federal government does not have any type of these taxes.

This January, responding to a request from Prime Minister Koizumi, the Council on Economic and Fiscal Policy and the Tax Commission started a discussion of overall tax reform in Japan. The future of the Consumption Tax as well as that of the income tax must be the main issue of this discussion.

Mainly focusing on the argument over the consumption tax, this paper analyzes the background of the Japanese tax system which is different from that of the U.S., surveys the arguments of U.S. economists over tax reforms and their implication for the Japanese system.

The following sections are organized as follows: section 2 provides an overview of the characteristics of the Japanese tax system and their historical and social background compared to those of the U.S.; section 3 provides a comparison of the arguments in both countries over consumption taxes; section 4 presents concluding comments[1].

II. **The major differences of Japanese tax system from the U.S. system and their background**

Appendix 1 shows the major characteristics of the Japanese tax system compared with the U.S. system. In short, Japan has a consumption tax which does not exist in the U.S. and is simpler than the European VAT. It has a personal income tax with a simpler structure and less burden on the lower and middle classes, a corporate tax which still has a considerable share, an inheritance tax which has higher progressivity, withholding and separated income taxation systems frequently used on capital incomes, more generous treatments of pensions

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

and some saving plans.[2]

These characteristics of the tax system clearly reflect the historical and social background of postwar Japanese society shown in Appendix 2. The emphasis on an equal income distribution, the concern for assets especially land, the dominance of corporations as a form of business, and the restriction of tax implementation are consistent trends. More recent trends are the realities of the aging society and the transformation from insufficient savings to excess savings.

As to the introduction of Japan's current Consumption Tax in the 1987-88 reform, the main motive was the reality of the aging society. While the aging of baby boomers is expected in the near future, the birth rate is radically decreasing reflecting the change in lifestyle. The burden of the conventional income tax was thought to be too concentrated on working generations.

More weight on the horizontal equality and the equity between generations, more emphasis on individual incentives was consequently required. Broadening the tax base and lowering tax rates were the general ideas. The trend of major tax reforms in the U.S. and Britain in the 1980s also supported this idea.

In this context, combined with income tax cuts, the Consumption Tax was introduced

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[2] Contrary to the Japanese system, the U.S. system seems to be more complex. As to the complexity of the U.S. system, Stiglitz evaluates the recent tax reforms as follows.

①Tax Reform Act of 1986 was a major improvement to reduce tax planning including the full taxation of capital gains.

On the other hand, the act created another complexity. It is attributable to the two approaches that Congress took to attack tax shelters instead of eliminating provisions themselves: limiting the extent to which losses on one category of income could be used to offset income in other categories; imposing more effective minimum tax.

②The tax reform in 1990s accelerated the complexity by introducing new systems which could be new ways of tax avoidance including the tax gap between capital gains and ordinary income. In the 1990s, there has been increasing reliance on tax policy as an instrument for pursuing economic and social goals, simply because of the strong resistance to new taxes and increased direct expenditures. Rather than focusing on base broadening, the reforms of 1993 and 1997 focused on using the tax system to express values, especially family values, even when the provisions themselves have limited economic impacts.(Stiglitz (2000) , Chapter 24-25) as a major part of the 1987-88 overall tax reform. It is thought to be a complement of income tax to support this aspect of equity rather than to be a total substitute for it.

It should be noted that the abolishment of the tax exemption for interest and capital gains and the introduction of separated taxation on them were also realized in the 1987-88 reform. The major motive of this capital income taxation was the transformation to an excess savings economy.

In introducing both new taxation systems, the restriction on tax implementation and taxpayers' demand for simplicity played a major role in specifying the types of taxation. With a subtraction method (no-credit-invoice), a single tax rate, and few tax exemptions, the Japanese Consumption Tax is much simpler than the European VAT. With restriction on implementation including the non-existence of tax identification numbers, separate taxation on interest and capital gains from security transactions was thought to be a realistic way to broaden the tax base on these incomes.

III. **Comparison of the arguments over consumption taxes in both countries**

Based on different backgrounds, the priorities of tax reforms in both countries also seem to be different. Here I will survey the arguments over consumption taxes in both countries and their implications.

The shortcomings of the existing income tax in the U.S.

The shortcomings of the existing U.S. income tax system enumerated by U.S. economists are as follows[3]:

1. By taxing interest income, the income tax inherently makes future consumption more expensive, taxes the early-earning individual heavier and benefits

For details of the reform of capital income taxation, see my paper "The difference in taxation on financial transactions between Japan and the United States – Can the U.S. system and theory be the model?,,

3 These points are based on Bradford(1986).

borrowers over lenders.

2. This may have a negative effect on aggregate savings. However, it is not necessarily the case because by making the individual worse off, the interest taxation will also reduce current consumption (income effect), and this effect may offset the effect of a lower return from postponing consumption which encourages current consumption (substitution effect). The evidence concerning this effect is still ambiguous.[4] The consensus among economists may be that, whether the effect is negative or positive, the effect is small.

3. The current system produces distortions from the treatment of saving and investment in many ways by deviating from perfect accrual-income accounting:

   i. by allowing deduction of interest without fully taxed returns like the treatment of owner-occupied housing.

   ii. by no adjustment of interest and capital gains for inflation.

   iii. by deferral of realization of capital gains, favorable tax rate for capital

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4 Stiglitz indicates that most empirical estimates suggest that the substitution effect of interest income tax slightly outweighs the income effect so that the tax has a slight negative effect on savings. He also points out that the recent tax changes seem to have had little effect on the recent trend of the personal saving rate, which decreased through the 1980s, hit a low in 1994 and later rebounded a little. (For details see Stiglitz (2000), Chapter 19.) Burman classifies the empirical estimates as follows.

①Estimates derived from models based on individual's preferences for future consumption (saving) over current consumption suggest that saving is responsive to the preferential tax.

②The more conventional approach based on an aggregate consumption function finds that the response of saving is small or even negative. (For details see Burman (1999),Chapter 4.)

Stiglitz also indicates the following points.

①Advocates of consumption tax point out that what matters is the compensated interest elasticity of savings – taking into account that as the interest income tax falls, other taxes would have to increase. In this case, the substitution effect is predominant. A reduction in the interest income tax compensated by an increase in a wage or consumption tax, in such a way as to leave the individual just as well off, unambiguously leads to increased private savings and lower government deficits.

②The fact that the net effect is small does not mean the distortionary effect is small but since most Americans save relatively small, both effects are relatively small. Because distortionary effects increase with the square of the tax, the deadweight loss of the rich may still be significant and remains a subject of controversy.

gains, and favorable tax treatments of retirement income .

iv. by deviation from economic depreciation.

While some advocate applying more consistent accrual-income accounting, many economists see it as unrealistic.

4. The hybrid character of the current system between income-tax rules and consumption tax rules, combined with the current classical corporate tax, creates many distortions and complexity. They include organizational forms (corporate vs. noncorporate), capital structure (debt vs. equity), and timing (postponement of the payment of dividends, deferral of capital gains, M&A). Tax rate differences across investors create tax-motivated clienteles for the assets.[5]

5. As to the implementation of income tax, three general problems are also pointed out: determining what "income" is; determining when somebody has received some income; and deciding what deductions from income to allow.

In determining income,

i. in many instances it is impossible to ascertain what are legitimate business expenses and what are not.

ii. even when the distinctions are conceptually clear, the required monitoring is often impossible.[6]

The merits of consumption taxes enumerated in the U.S.

Many U.S. economists advocate consumption taxes as a fundamental solution for the problems of current income tax. The enumerated merits of the consumption taxes are as follows[7] and they have a good contrast with the defects of the current income tax mentioned

5 This argument is based on Gentry and Hubbard (1998).

6 This argument is shown in Stiglitz (2000).

7 These points are also based on Stiglitz (2000) and Bradford (1986).

above.

1. Cash-flow accounting associated with consumption taxes is inherently on a realization basis and provides easy solutions to problems of accrual income and promotes efficient resource use.

    i. It eliminates distortions arising from the hybrid tax system, with some saving (owner-occupied housing, retirement income, capital gains) taxed differently from others and with deviation from economic depreciation.

    ii. It automatically provides correction for inflation.

    iii. It avoids altogether the need for integrating corporation and individual accounts.

2. A consumption tax realizes administrative simplicity because much of the system's complexity arises from the attempt to tax capital income and to reduce the avoidance of capital income taxation.

3. If the interest income taxation has a negative effect on savings, a consumption tax eliminates this effect and increases savings and investment.

4. It eliminates discrimination against consumption later in life. If one ignores inheritances and bequests, taxing life-cycle income is equivalent to taxing consumption. Two individuals with the same lifetime income have the same total tax burden. (Inequities are introduced if inheritances escape taxation.)

5. There is also a broad philosophical argument that it is more appropriate to tax individuals on the basis of what they take out of society (their consumption) than on what they contribute to society (measured by their income).[8]

8 Irving Fisher argued this merit. See Stiglitz (2000), Chapter 21. Bradford expresses the similar merit of consumption taxes as an equal

American economists who are interested in economic efficiency rather than equity seem to put much weight on the first three points. In short, the consumption taxes are expected to correct the distortions accompanying the current income tax easily, to create a simpler tax system and to increase saving and investment.

As I already mentioned, the third point, the effect on savings seems to be small or even negative. 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.[9],[10]

In the 1980s, the argument over the defects of the current income tax in the U.S. seemed to focus on the probable negative effect on savings and the distortion amplified by inflation. In the last decade, under the conditions of economic prosperity without inflation, while the need for the adjustment for inflation and the encouragement of savings might decrease to some extent, financial innovations seemed to develop much more sophisticated tax planning and amplify the problem of distortions under the current income tax. Through derivative securities, investors can trade the risk characteristics of assets without giving up the tax characteristics[11], and through the hybrid securities such as MIPS (Monthly-Income Preferred Stock), long-maturity zero-coupon bonds, and contingent debts, borrowers can

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burden on those who have good options for choices or endowments. (Bradford 1986)

9 See Burman (1999), Chapter 4 and Appendix B.

10 According to Stiglitz, foreign capital is not a perfect substitute for domestic savings and empirical studies show a high correlation between domestic savings and investment. (Stiglitz (2000), Chapter 21.)

11 For example, by replacing the risky return on equity with the safe return on debt through a swap contract, a taxable investor can hedge the risk of owning the equity and defer the taxation of this safe return until the settlement of the swap contract. If the owner of the equity has an unrealized capital gain, through a swap contract, the owner can hedge the risk of future price changes but continue to defer the tax on the gain. For details, see Gentry and Hubbard(1998).

exploit the difference of tax treatment between debt and equity. [12] The merits of correcting distortions and creating a simpler system seem to have more weight in the recent arguments over fundamental tax reforms in the United States.

The differences in the situation of the Japanese tax system

Some of these arguments supporting the consumption tax in the U.S. do not directly translate to the situation in Japan.

1. First of all, the excess saving economy in Japan is quite opposite to the situation in the U.S. There is no need to stimulate saving through tax incentives in Japan. It should be noted that capital taxation was strengthened simultaneously with the introduction of the Consumption Tax in the 1987-88 overall tax reform.
2. Some distortions typically seen in the U.S. case are not widely seen in Japan because of the differences in the current income tax system.

    i. Because of separated taxation on capital gains from security transactions, the room for a tax arbitrage exploiting the difference of tax treatment between capital gains and other incomes, which might be seen in the U.S. before the 1986 reform, is small in Japan. While the "step-up in basis at death," in which heirs use the price at the time of death as the basis for computing capital gains on the asset, not the price at the date their

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12 I owe most of my knowledge on recent tax planning strategies in the U.S. to William M.Gentry. MIPS (Monthly-Income Preferred Stock) was a security developed by Goldman Sachs in 1993. It inserts a noncorporate financial intermediary (often a Limited Liability Company) controlled by the issuer of the security between the issuer and the buyer, and the LLC issues publicly traded preferred stock and loans the proceeds to the parent. The owners of the MIPS receive dividends equal to their share of the LLC's income which is the interest payment from the parent. Because the parent's interest expense is tax-deductible, for the issuer, dividends can be paid with pre-tax income. Individual investors can get higher yields on MIPS than other preferred stock dividends under the same tax treatment. Contingent debt is a security which has variable payoffs but still gets the tax treatment of debt. While securities with returns that vary with performance are clarified as equity and securities with relatively fixed payoffs are clarified as debt generally, the distinction between these two depends on the control rights associated with the security and other features of the security.

benefactor acquired the asset, greatly increases the benefit of deferral and amplifies the distortion in the U.S.,[13] Japan does not have the same kind of system.[14]

ii. Because of the dominance of the corporate form and little tradition of pass-through entities, distortions through organization forms are also fewer.

iii. Because mortgage interest is not subject to deductions (a tax credit exists but is limited to a certain income class), the treatment of owner-occupied housing is less problematic, at least theoretically. Combined with less developed financial technologies, sophisticated tax planning typically seen in the U.S. is not yet widely seen[15] and at least never attracts much attention in the political world so far in Japan.

3. As mentioned in Appendix 2, thanks to the separated taxation for a large part of 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 in Japan. Compared with the U.S. system, for a majority of individuals, the current personal income tax system is much simpler.

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13 "Shorting-against-the-box," a transaction in which a taxpayer who owns appreciated stock borrows the same stock and sells it instead of the stock he or she owns, was a notorious way to extract the gain from an appreciated asset without recognizing a gain for tax purposes. Taxpayer Relief Act of 1997 banned it as a pure tax-planning device, but with the use of a portfolio of options in which the owner retains sufficient exposure to risk, similar tax planning can be done without violating this rule.

14 Japan has a "carryover basis" in which heirs assume the basis of the benefactor when they sell the asset. The U.S. Congress once enacted a law applying carryover basis to bequests in 1976, effective the following year, but later delayed the effective date, and finally repealed it in 1980 (Burman 1999,Chapter 2).

15 One exception might be investing real estates by borrowing. In this case, the Japanese tax law denies the interest deductibility.

Although simplicity is raised as one of the objectives of tax reforms also in Japan, it almost exclusively relates to self-employed small businesses who actually need tax filings or the tax authority who suffers from the restrictions on implementation such as the lack of tax identification number. A simpler individual tax filing, which is a major sales point of many tax reform proposals in the U.S., such as the Flat Tax, could not be a major objective of reforms in Japan. On the other hand, as I will mention later, the request from self-employed small businesses for simplicity is so strong that it actually defines the structure of the current Consumption Tax.

The reasons for the introduction of the Consumption Tax in Japan

The fourth point（equal burden on the same lifetime income）and fifth point (philosophical argument over the ideal share of burden) of the merits of a consumption tax and the first (unequal burden among different life-time earning patterns) and fifth point (implementation problems in determining “income”) of the defects of income tax argued in the U.S. are equally seen in the arguments in Japan. But the motives for the introduction of the Consumption Tax in Japan are in many points different from the arguments in the U.S. that I mentioned above.

1. Before the introduction of the Consumption Tax in 1989, there were many excise taxes in Japan. Most of them were specific taxes, which are specified as a fixed amount per unit of specific goods or services. They had been criticized for the distortions created among goods and services. After the first oil shock, personal income tax cuts to adjust the increase of tax burden under inflation often became a political issue. These excise taxes were often raised to gain offsetting revenues for medium size income tax cuts made from the late 1970s to early 1980s, and this exacerbated the distortions. Based on this historical background, eliminating the

distortions under the conventional excise taxes was one of the main reasons for the introduction of the Consumption Tax.

2. Focusing on taxing one's annual income with progressive tax rates, an income tax inevitably taxes heavily a certain stage of the life cycle, especially middle age. While total burden is expected to increase under the coming aging society, this imbalance of tax burden through the life cycle would not be sustainable. Annual consumption is thought to represent one's life-time ability to pay better than annual income and taxation on it is thought to realize moderate tax burden through out the life cycle.

3. The arbitrariness of the income tax calculation on businesses is always a source of complaint among taxpayers. The large difference of tax reporting procedures between salaried workers under a well-established withholding system and the self-employed may amplify this feeling. The simplicity of cash-flow accounting accompanying the Consumption Tax is expected to reduce this arbitrariness.

4. Through these factors, the Consumption Tax is expected to realize horizontal equity and equity between generations as a complement of income tax. Because regressiveness is an inevitable defect of this tax, it is not thought to be a total substitute for the income tax. The tax mix of a moderate income tax and a new consumption tax with a low and broad burden is thought to be a better combination.

5. In addition, the stability of tax revenue on consumption against fluctuation of economic conditions is also thought to be a merit to sustain the continuous demand for government expenditures under the coming aging society.

In short, the main reason for the introduction of the Consumption Tax in Japan is equity of the distribution of tax burden. It does not specifically relate to the efficiency of capital income taxation. This is clear contrast with the arguments in the U.S. which typically tend to focus on efficiency issues, and devise some proposals such as the Flat Tax[16] trying to minimize the effect of the new tax on the distribution among individuals and that on the preexisting wealth.

The difference in the argument over bequests and gifts in both countries

The difference of the motives of introducing a consumption tax may also relate to the tax treatment of bequests and gifts in both countries.

If we follow the logic of the view that consumption better represents life-cycle income, bequests and gifts should be taxed more heavily by another tax under a consumption regime than under an income tax regime. This is because bequests and gifts are not included in the donor's taxable consumption under the conventional consumption tax, but are given out of the donor's after-tax income under an income tax regime. This view is familiar with the conventional Japanese perspective which puts a considerable weight on taxation of assets.

On the other hand, if the taxation on bequests is bad for savings or produces excessive complexity, it would be consistent that the advocates of consumption taxes also support the repeal of taxation on bequests and gifts. This may be the case in the United States.

Although the reason for the scheduled reductions and repeal of estate tax by 2010 is not so clear, the overview by Gale and Slemrod suggests the main defects of which the estate tax is accused are as follows:

16 By splitting off the compensation portion at the employee level which has personal deductions or graduated rates, the Flat Tax can keep progressivity within the system. There is generally a claim against a shift to a consumption tax regime that the elderly who have accumulated assets to finance retirement consumption under the income tax regime must pay tax again. But the extent to which the elderly bear this tax depends on the change in the after-tax price of consumption and, different from a VAT, the Flat Tax is less likely to change the economy's price level.

1. The desired degree of progressivity could be obtained from the income tax alone.
2. Taxing at death is unfair.
3. Compliance costs are so high and the tax is so easy to avoid.
4. The impact on family farms and businesses is huge.
5. Optimal taxation requires no special tax on bequests.
6. The estate tax reduces saving and entrepreneurship.

Gale and Slemrod themselves refute the first four points as follows.

- The tax adds to progressivity in a way that the income tax cannot easily do, because of capital gains issues.
- Death may prove to be a convenient time to impose taxes because the process may reveal information about well-being that is difficult to obtain in the course of enforcement of the income tax. In addition, a number of prominent economists have argued that taxes imposed at death are likely to have smaller disincentive effects on lifetime labor supply and saving than taxes that raise the same revenue (in present value terms) but are imposed during life.
- The actual costs of compliance are often exaggerated. But it is clear that a tax with easy avoidance opportunities should be changed.
- Family farms and businesses already receive special treatment (calculation of the value, a special deduction) and only a tiny fraction of them pay estate taxes. Eliminating the tax is a very blunt instrument for dealing with its problems. (Gale and Slemrod 2001)

They also show that the fifth (optimal tax) and the sixth (saving and entrepreneurship) point depend on the assumptions of models and there are conflicting arguments. [17]

17 As to these theoretical issues, Gale and Slemrod introduce conflicting arguments. (Gale and Slemrod 2001)

1.Optimal tax theory indicates that if lifetime consumption and bequests are equally complementary with respect to leisure, these uses of labor income should be taxed equally in an efficient system, so there should be no special tax on bequests. But the efficiency implications

From the Japanese perspective, the first three points are not likely to get much support now. The fourth point is also a problem in Japan but it has been solved by special calculation rules of value and special deductions. The fifth and sixth points are rarely argued so far in Japan.

The difference in taxation systems in both countries may affect the difference of arguments over this tax to some extent. In Japan, different from the U.S. system, the current gift tax is calculated on an annual basis at higher rates than the inheritance tax and there is no adjustment between the two taxes. This system is criticized as not being neutral and as delaying the transfer of assets from the older generation to the younger generation. The introduction of new adjustment system between the two taxes to facilitate the transfer of assets between generations is likely to be proposed by the Tax Commission. There is also criticism against the top tax rate (70%) of the inheritance tax as being extremely high

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of taxes on intergenerational transfers also depend in ways on why people give transfers and bequeath wealth in the first place.

① If bequests are unintended, the tax creates no excess burden.

② If bequests are payments for services provided by potential inheritors, the optimal taxation depends on whether the services provided are complements or substitutes for leisure.

③ If bequests are out of pure altruism, because a social welfare function counts the utility from child's consumption twice, the model supports a subsidy rather than a tax. But if the child knows the parent's altruism, the child has incentives to overconsume when young to elicit a large bequest, and the tax improves social welfare by reducing this overconsumption.

④Another motive may be that people enjoy the act of giving per se. Again, this leads to an optimal subsidy. But this model is unappealing because under some circumstances it favors a policy that lowers the consumption of both generations.

2. As to the effect on saving, Kopczuk and Slemrod find that in years when the estate tax has been relatively high, reported estates as a fraction of national wealth are lower. But the relation is statistically fragile and is consistent with either a depressing effect on wealth accumulation by donors, an encouraging effect on estate tax avoidance.(See also Kopczuk and Slemrod 2000) Evidence also suggests that large inheritances reduce the work effort of recipients and raise their consumption. The empirical evidence on saving is ambiguous because the impact of the tax on saving will depend critically on why people give transfers. (See also Gale and Perozek 2000)

①If bequests are unintended, estate taxes will not affect saving by the donor, but raise the recipients' saving.

②If bequests are payment for services provided by children, the impact of taxes depends on the elasticity of the parent's demand for services. If demand is inelastic, taxes will raise donor's saving.

③If bequests are motivated by altruism, the effects are ambiguous, but simulations suggest that the effect will be positive or non-negative under many circumstances.

compared with that of other countries. The reduction of the top rate is also likely to be proposed. On the other hand, different from the U.S. “estate” tax system, the current taxation system levied on the “inheritance” received by each heir can avoid the allegation as “death tax”.

But the main reason for the difference of views over the tax in both countries must be the difference in social and economic background. Similar to the arguments over the Consumption Tax, in Japan, the inheritance tax is mainly argued in the context of fair distribution under the aging society. The basic idea of the Tax Commission is that this tax should play a proper role for redistribution of wealth under the shift to a stock-based economy, the enhancement of social security and the aging population.

On the other hand, in the U.S. society, an individual seems to have more possibility or expectation to earn a large annual income and think of personal wealth as a result of an individual’s effort rather than a windfall from the externality of economic growth (“American dream”). This characteristic of U.S. society may be one of the main reasons why the repeal of estate tax got considerable political support, although many economists including Gale and Slemrod oppose it.

The evaluation of the Flat Tax from the Japanese perspective

Although it was not well received in the political arena in 1996 when it was advocated by presidential candidate Steve Forbes in the Republican primaries, the Flat Tax type tax reform still seems to be firmly supported by a considerable number of economists in the U.S. The claimed merits of the Flat Tax different from other types of consumption taxes are that by splitting off the compensation portion at the employee level, which has personal deductions or graduated rates, it can keep progressivity within the system and also keep the system visible to everyone.

The Flat Tax has some typical points which may reflect the background of U.S. society and economy but which cannot be adopted from the Japanese perspective:

- It neglects taxation on returns from assets which are too important to be neglected in Japan. By splitting off the employee level tax from the business tax and focusing on compensation (wages, salary and pension benefits) at the employee level, it seems to neglect taxation on inheritance and capital gains from asset transactions between individuals like those of land.[18]
- Different from a VAT, the Flat Tax does not typically tax preexisting wealth because it is less likely to change the economy's price level. It may reflect the above-mentioned characteristics of U.S. economists which tend to focus on economic efficiency issues.[19] But as I already mentioned, for the arguments in Japan,

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[18] In the Flat Tax proposal, Hall and Rabushka write as follows.
"The inheritance tax should be eliminated. It is not necessary under a system with comprehensive, watertight taxation of income, which taxes all income once. An inheritance tax constitutes double taxation, which violates a sacred principle of sound tax policy." "Gift represents a transfer of income that has already been taxed, and there is no reason to tax it again."(Hall and Rabushka(1995),pp.126-127)

In the Flat Tax proposal, land transactions are included in the Flat Tax because "it is difficult to separate the value of land from the value of building on it." (Hall and Rabushka (1995), pp.111) But capital gains on owner-occupied houses are not taxed under the proposal. Hall and Rabshka raise the reasons as follows.

①capital gains on owner-occupied homes arise from the capitalization of rental values, which are heavily taxed by state and local governments. It would be double taxation for the federal government to tax the capital gains again.

②A good part of any capital gains on owner-occupied homes is simply inflation.

③Few capital gains on houses are taxed under the current tax system. (Hall and Rabushka (1995), pp.73, 117-118)

[19] As to the regressiveness, Gentry and Hubbard indicate that capital income can be decomposed into 4 components: ①the opportunity cost of capital (the return to waiting);② the expected risk premium(the return to risk-taking);③inframarginal returns to investing ("economic profit", rents to ideas, managerial skill, market power); ④a remainder that reflects realizations differing from expectation; and that relative to an income tax, a consumption tax exempts only the tax on ①.
They find the following three things and conclude that the switch from a pure income tax to a consumption tax is likely to be less regressive than commonly assumed.

①Overall losses in asset values by eliminating differential capital taxation are concentrated among high-income and high-net-worth households.

what most matters is the equity of distribution.[20]

- By splitting off the employee level tax, it intentionally keeps the system visible to everyone. On the other hand, by focusing on the compensation at the employee level, it eliminates most of complexity of personal tax filing. But, in Japan, as I already mentioned, the majority of salaried workers do not need annual tax filings at all. So from the perspective of Japanese employees, the additional merit of simplicity by the introduction of the Flat Tax will be small. On the contrary, as I will mention later, the unbalanced "visibility" of the Consumption Tax seems to be a source of complaint against the tax.

The special characteristics of the Consumption Tax in Japan

Based on different motives from the arguments in the U.S., the Japanese government introduced the Consumption Tax in 1989, and the tax mix of the income tax and the consumption tax has been in operation since then. Reflecting the political dispute over its introduction, the Consumption Tax has some special characteristics even compared with a European VAT.

The first proposal of VAT type consumption tax by the government in 1987 ("Sales Tax") was more similar to a European VAT or rather more complicated than a European VAT. It had a 5% tax rate, a credit-invoice system and many tax exempt goods and services,

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②Holdings of assets most easily identified with inframarginal returns (active business) are highly concentrated among high-income and high-net-worth households.
③Transition losses by switching tax bases are concentrated among high-income and high-net-worth households. (Gentry and Hubbard(1997))

[20] Gentry and Hubbard point out that because consumption taxes offer higher expected future after-tax returns to saving, to the extent that the transition tax is borne by individuals with relatively long future consumption horizons, the consumption tax may make better off even households bearing the transition tax. They also analyze how the shift to a consumption tax regime affects asset prices and discuss the overall effect on distribution. (Gentry and Hubbard 1997) This kind of analysis is also desirable for the future reforms in Japan.

responding to many economic and social needs.

As a result of a strong political dispute over the tax, it did not pass the Diet and was abandoned. One of the major reasons for the death of the "Sales Tax" was its complexity and additional compliance costs for small businesses.[21]

Reflecting the argument at that time, the current system was devised, passed the Diet in 1988 and introduced on April 1989. In addition to the rate reduction to 3%, the new system was modified in many points for simplicity responding to requests from small businesses and these characteristics are still maintained now.

1. It has a "subtraction method" in which firms can deduct the tax on their purchases by keeping ledger and documentation the same as those used for the corporate income tax. It does not require a special document which records the amount of tax charged (like an "invoice" in European VAT) for each transaction.
2. It has a single rate (introduced at 3%, 5% now) and almost no tax exempt goods. Only a few services mainly related to welfare, medical care, education and housing rent are tax exempt.
3. It has a relatively high threshold of tax exemption (30 million yen) for small businesses. If it were taken under the "credit-invoice" system, it might cause the exclusion of tax exempt small businesses from transactions, because they can not issue invoices required for the buyers to deduct the tax on their purchases. Thanks to the "subtraction method," even the buyers from these small businesses can deduct fully 5% of their purchases, thus no exclusion may occur.
4. It has simplified systems for small enterprises to calculate the tax amount

[21] Ozaki analyzes that the major criticisms against the "Sales Tax" were ①short time to prepare,②the concern about the shift of tax burden,③complexity and compliance costs from the credit-invoice, ④too many tax exemptions, ⑤the name of the tax which can be misunderstood as a tax on businesses.(Ozaki 1987)

directly from sales by assuming their value added as a certain portion of their sales. Although originally meant to reduce increased compliance costs, the high threshold and simplified taxation systems have the possibility in general to allow small businesses to "pocket" a part of the money which they received from consumers as "tax." The simplified taxation system was streamlined in 1991 and 1997, but the tax-exempt threshold remains unchanged, and these two systems are still one of the major targets of criticism against the tax.

5. The separate quotation of tax amount on the price is also a characteristic accompanying the system and a source of complaint against the tax. This is not a legal requirement. But probably because every one- both traders at every stage of transactions and consumers- worried so much about whether the tax burden was shifted to the consumers correctly at the time of introduction, this method has formed a custom in most industries since then. As most salaried workers don't need to file their income tax reports to the tax authorities, the Consumption Tax is actually the only "visible" tax for them.

The problems proper to the Japanese Consumption Tax and its tax mix

Thanks to a strong request for simplicity, the current Consumption Tax has become a simpler and less distorted tax even compared with a European VAT. As a result, its shape seems to best suit efficiency arguments in the U.S., although its background was clearly different from the U.S. perspective.

After a decade from its introduction, the Japanese Consumption Tax and its tax mix with the income tax are now confronting problems. These problems are different from those of the U.S. system and can not be solved by applying the arguments in the U.S.

Because of successive tax cuts as stimulus measures in this decade, especially because of large personal and corporate income tax cuts in 1999 without raising offsetting revenues, combined with long-lasting stagnant business condition, the estimated total tax revenue in 2002 is still at the level of 1987. The rate of the Consumption Tax (5%) is still much lower than that in European countries. In addition, because of across-the-board personal income tax cuts in the last decade, the average tax burden of personal income tax has also become much lower than that in other developed countries. The current threshold of income tax has become so high that one fourth of the working population is estimated to pay no income tax at all.

Under the current situation, some tax incentives to further stimulate the economy may still be necessary. But with the huge accumulation of government debt and the large gap between expenditures and revenues, strengthening the revenue side as well as restructuring expenditures will be inevitable in the near future.

One of the main problems must be finding the best combination of the income tax and the Consumption Tax. Probably one clear difference from the past is that we can no longer afford a big cut of either tax. It is a big intragenerational and intergenerational issue which requires overall arguments including those about social security contributions and beyond the scope of this paper. Here I can make only basic comments on some relevant issues.

1. *The threshold of personal income tax*

The high threshold of personal income tax has already become a target of discussion. As long as we maintain the personal income tax as the main part of the whole tax system, the current situation must be problematic. The fact that so many people are out of the income tax system also means that the government can not approach these people by income tax policy although the income tax must be the best tax to reflect an individual's situation. If it were in the U.S., the government could approach these people through the earned income tax credit, but Japan does not have the same kind of system and without a tax identification number, it could not be feasible.

It also should be noted that the threshold consists of a number of different kinds of deductions. The following is its breakdown. The threshold is an aggregate of a number of policy considerations. The policy implication of the change of the threshold varies so much depending on which deductions are actually reviewed.

[Breakdown of the threshold for a one-earner couple with 2 children]

	(thousand yen)
employment income deduction[22]	1,308
basic deduction	380
allowance for spouse	380
special allowance for spouse[23]	380
allowance for dependent	380
allowance for special dependent	630
(a dependent from 16 to 22 years old)	
deduction for social insurance premiums[24]	384
total	3,842

A change in the employment income deduction would change the balance between salaried workers and the self-employed. If it is cut by a considerable margin, it might increase the number of itemizers, which are now quite few, and affect the implementation costs to the tax authorities.

Deduction for social insurance premiums is a part of the generous tax treatment of pensions and annuities. If it is reviewed, it should be done in the context

22 For employment income which does not exceed 1,800 thousand yen , the deduction is 40% of income with the minimum guaranteed amount of 650 thousand yen. For income between 1,800 and 3,600 thousand yen, the percentage is 30% and for income between 3,600 and 6,600 thousand yen, the percentage is 20%.

23 Special allowance for spouses is a diminishing deduction. The deductible amount diminishes as the spouse’s income increases.

of an overall review of the taxation on pensions and annuities.

Allowance for spouse and special allowance for spouse are based on an individual-based system which is clearly different from the family-based system in the United States.

Allowance for special dependent was introduced as a policy to consider the burden of families who generally spend more money on their children's living expenses especially on their education than other families. But there can be an argument over the need for this special treatment.

Special allowance for spouse may be the most controversial system. It was introduced in 1987 to settle the so-called "part-time worker question" in which the net after-tax receipts of a household were reversed when a spouse's employment revenue exceeded slightly her or his own threshold because it also made the spouse "an independent taxpayer" and excluded the application of the allowance for spouse to the partner's income. In the era when most women worked as part-timers, the system was welcomed because it was an across-the-board tax benefit for both types of women: those who did not work at all and those who worked as part-timers. But now when more women have full time jobs, the system is criticized for the imbalance between working women and homemakers and its negative effect on labor supply. As a phase-out deduction, which is rare in the Japanese system, it also causes some complexity.

2. *The earmarking of the revenue of the Consumption Tax*

There is a strong political argument for earmarking the revenue of the Consumption Tax to social security funds in Japan. The main reasons may be: (a) to get a political

[24] Social insurance premiums are 100% deductible.

support for the tax which is still relatively unpopular; (b) to secure funds for expanding social security expenditures and stabilizing the system; (c) to share the burden among a wider range of people including recipients of the benefits; (d) to prevent delinquency which is widely seen in the collection of social security contributions from the self-employed.

Reflecting this argument in the ruling parties, since 1999, the revenue of national government from the Consumption Tax is provided by annual budget to be spent on basic pensions, medical care for the elderly, and nursing care. But so far, the tax revenue is far short of these expenditures and there is no one-to-one correspondence.

Earmarking in its strict meaning has no example in developed countries and has many problems. It will harm the flexibility of fiscal policy. For example, it may be unrealistic to raise the tax rate automatically corresponding to the need for expenditures, irrespective of the macroeconomic situation. Also, it will break the current relationship between benefits and contributions in the system. One can receive a benefit irrespective of one's contribution. This may produce a moral hazard. It should be noted that, different from the payroll tax in the U.S., it is impossible to define an individual's annual payment of the Consumption Tax and thus to connect the benefit to the tax payment.

When all of the benefits are financed by the tax, it may be natural to limit the qualification of recipients and impose a means test. This will change the basic characteristics of the social security system.

Under the current system, a considerable part of the contribution is now paid by employers. The treatment of this part is problematic. Also, those who already have paid their contribution must pay the new tax again. The treatment of this transaction effect will take a long time.

Compared with other developed countries, even the current social security system has relatively generous government subsidies. We should be careful about the argument for earmarking.

3. *The future structure of the Consumption Tax*

Simplicity and a broad tax base are the main virtues of the current Consumption Tax. As I already mentioned, it has many merits in the equity of distribution as well as efficiency issues, and may have a larger role in the tax system in the future.

But regressiveness is an inevitable characteristic of this tax. If the tax rate should be raised by a considerable margin in the future, it might require some measures to alleviate its regressiveness.[25] In 1989 and in 1997, income tax reductions and a temporary increase in welfare expenditures followed by price-indexing were the solutions. The current high threshold of income tax must restrict the scope for solution by an income tax policy.

We do not have a tax refund system like an earned income tax credit in the U.S. and it would not be feasible without a tax identification number. If we really step into the usage of tax refunds as a measure to alleviate the regressiveness, the treatment of capital income, which is subject to separated taxation under the current system, may also be a problem. (It does not necessarily require comprehensive taxation but may require a system to add up individuals' whole incomes.)

Considering the example of European countries, multiple tax rates that are preferable for "necessities" may be a probable solution. But it will require many changes in the system and sacrifice some of the merits of simplicity and efficiency of

[25] As already mentioned in the footnote 20, Gentry and Hubbard analyze how the shift to a consumption tax regime affects asset prices and discuss the overall effect on distribution. (Gentry and Hubbard 1997) This kind of comprehensive analysis is also desirable for the future reforms in Japan.

the system at present.

It will probably be difficult to implement multiple tax rates fairly with the current subtraction method, because taxpayers have to distinguish between goods and services of high tax rate and those of low tax rate. The change into the credit-invoice system must cause the problem of exclusion of tax exempt small businesses from transactions which have a political impact.

The revision of the simplified taxation system and the threshold of tax exemption will also be required, because with a higher tax rate, the potential amount of pocketed "tax" will also increase.

4. *The "visibility" of tax burden*

Some people argue excess "visibility" of the Consumption Tax amplifies the pain of this tax and advocate the shift to a tax-inclusive system. Other people argue that this "visibility" is good for democracy.

From the consumers' view, whether the sellers adopt the separate tax quotation system or the tax-inclusive system, to know the total amount they have to pay is at least useful. The system to show the total amount of consumers' purchase is an established consumer policy in European countries and Japan should follow this example.

To further improve "visibility" of taxes, some people argue that Japan should have a system in which salaried workers make their own income tax returns. It relates to the treatments of many capital incomes which are subject to separated withholding taxation systems now. More fundamentally, it requires examining the impact on society and on the capacity of the tax authorities.

5. *Tax Identification Number*

The effect of the Tax Identification Number on tax implementation relies so much on the range of transactions in which the TIN is actually required. In the past, the effect of the TIN might be exaggerated in the context of comprehensive income taxation. But the lack of TIN not only prevents a comprehensive income taxation but also restricts many other choices of possible tax structures. Under a separated taxation, the TIN is also useful, for example, to implement loss offset or loss carryover within separated incomes. It generally has a considerable effect on the implementation of taxation on assets, especially financial assets. As I already mentioned, if we step into the usage of a tax refund system as a policy tool like an Earned Income Tax Credit in the U.S., it will also require a TIN for its fair implementation. The fact that the TIN is also useful or even necessary for distributing more attentive tax benefits to each individual should be recognized more widely.

Because there is still a strong concern for individuals' privacy, it is difficult to judge the Japanese people's future decision about whether to introduce a TIN or not, but this decision should be based on the recognition of factors mentioned above.

A potential future problem under a consumption tax – the treatment of financial services

Many U.S. economists also argue some potential problems anticipated after the shift to a consumption tax regime. These arguments may also be useful for Japan, which is actually implementing the tax. One argument which may attract specialists' interest in Japan would be the treatment of financial services under a consumption tax.

Because financial transactions are normally not included in the tax base, tax payments by financial institutions are relatively small or even negative under a consumption tax. Bradford shows that the problem of taxing financial services itself is not special for a consumption tax [26] but the "visibility" of the problem under a consumption tax may have political importance.

Under an exemption for financial services, because the financial institution is also denied any credit for taxes paid on purchased goods and services used in producing those financial services, what is left out is only the value added by the financial institution. For sales to households, the exemption results in a somewhat lower tax burden than would be if the financial services were treated like other sales. For sales to businesses, the situation is the opposite because the businesses receive no credit for purchases. Therefore the issue of taxing financial services is mainly an issue of measuring household consumption.

The problem is the measurement of the financial services because financial services are usually provided implicitly by the difference between the interest that financial institutions actually charge and the interest that they would charge without services they actually provide.

Bradford suggests that services of financial intermediaries could be taxed by the "imputation" approach or by the "cash-flow" approach. In the "imputation" approach, the financial institutions are obliged to report an amount imputed as the value of services they provide but do not explicitly sell as a taxable receipt. It requires a benchmark payoff to calculate the value of services.[27]

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[26] Taking the example of the demand deposit case, Bradford shows that the current income tax has also the problem because the depositor is not taxed on the service yield from the funds on deposit. If the financial services paid for by forgone interest should be considered as consumption, the effect of the current treatment under the income tax is to subsidize the services at the depositor's marginal tax rate. (If the bank paid the full interest rate and charged for the services, the depositor would have an additional taxable interest income.) (Bradford 1996)

[27] According to Bradford, the "imputation" approach could also be used under the income tax. But the correction could be more costly or imperfect because of the difference of marginal tax rates among taxpayers. (Bradford(1996))

In the “cash-flow” approach, the financial institutions are obliged to pay an up-front tax on the original deposit and are allowed future deductions for the explicit interest payments and the costs of implicit services. The forgone interest on the initial tax payment is offset by the tax rebates by the deductions. If tax rates change, accounts should be segregated by the tax rates of the time when they were built up.

But as to the “imputation” approach, how it would work in complex cases does not seem to be clear. As to the “cash-flow” approach, the feasibility of both the up-front tax on deposits and the segregation of accounts seems to be uncertain.[28] Besides these technical issues, the more fundamental problem is that the disadvantage of any correction would be confined to individual depositors and borrowers.

This problem has never been conspicuous in Japan and seems to remain a theoretical issue even in other developed countries so far. The current treatment under the consumption tax may not be theoretically perfect but can be a realistic approximation because of the expected political impact of corrections. But this problem should not be ignored because it relates to the consistency of the system. If the Consumption Tax plays a larger role in the future Japanese tax system, the difference of tax treatment between financial sectors and other sectors will attract more attention.

[28] Bradford also examines the application of these methods to other financial services.
①Options for dealing with demand deposits can be adopted to mortgage loans. One difficulty is the measurement of outstanding liability because the contractual amounts may differ from market values. The cash-flow method can be applied and the bank would deduct the amount loaned and take into the tax base all repayments.
②Like bank deposits, the cash-flow treatment would correct the income measure of property-casualty insurance and life insurance.
③In conclusion, cash-flow approaches promise relatively simple solutions. (Bradford 1996)

IV. Concluding Comments

Among the many trends in the current Japanese society, the aging of the population and the excess savings economy are the most important ones.

Different from the U.S. situation, there is no need to improve savings in Japan now. On the other hand, under the current system in which a large part of capital income is subject to separated taxation, combined with underdeveloped financial technologies, Japan suffers less from sophisticated tax-planning so far.

Therefore, the main motive of the introduction of Consumption Tax in Japan was neither the need to improve savings nor the need to reduce sophisticated tax-planning both of which are major motives for advocates of consumption taxes in the U.S. It was the concern for equity of distribution under the aging society -- horizontal equity, equity through the life cycle, and between generations.

Different from the argument in the U.S., the Consumption Tax was thought to be a complement rather than a total substitute for the income tax. Eliminating the distortions under the conventional excise taxes and stabilizing the tax revenue were also the motives. The difference in perspectives may relate to the difference in the tax treatment of bequests and gifts in both countries. This difference also explains the indifference to the Flat Tax proposal in Japan.

After the across-the-board income tax cuts in this decade, the tax mix of the Consumption Tax and the income tax has many problems to solve - the threshold of personal income tax, the earmarking of the revenue of the Consumption Tax, the future structure of the Consumption Tax, the “visibility” of tax burden, the Tax Identification Number - but they are mainly the problems of distribution proper to the Japanese system. It is difficult to find a solution for these problems in the U.S. arguments.

It does not necessarily mean that there is nothing in the U.S. arguments over a consumption tax we Japanese should learn from. We can learn a lot from the theoretical analyses of tax systems by U.S. economists. The argument over the potential problem of the treatment of financial services under a consumption tax can be an example.

[Appendix 1]

The following are the major characteristics of the Japanese 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.

1. The whole system

① The existence of the Consumption Tax since 1989 is one of the major differences. It has a subtraction method (no credit-invoice), a single rate (introduced at 3%, 5% now), and almost no tax exempt goods.

② The weight of the personal income tax in the whole tax system is less than that in the U.S., although it is still the first major source of revenue same as in the U.S.

- The national tax has 4 brackets (10%-37%). The local tax has 3 brackets(5-13%).
- It has a relatively high tax threshold (3,842 thousand yen for couple with 2 children).

Although the tax rate is lower than that in the U.S., the weight of the corporate income tax is still larger than that in the U.S.

- The tax rate is 30% at the national level, 40.87% including local taxes.
- No deduction is allowed for social expenses except for small corporations.
- An additional tax is levied on unaccounted-for expenditures.

The inheritance tax is levied based on the statutory share of each heir of inherited properties.

- It has 9 brackets (10%-70%).
- Special rules for calculation of the tax base apply to certain sites for business and residence.

A special tax treatment applies to agricultural land.

2. The whole personal income tax

There is no standard deduction. Instead, there is a relatively generous employment income deduction(40-5% 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 filings at all.

There is an individual-based system for families(Allowance for Spouses, Special allowance for spouses)

There is no child tax credit, no tuition tax credits, no child care expense tax credit.

3. Income taxation on capital income

① Interest is subject to separate withholding tax(15% + local 5%).

- It is not taxed on an accrual basis.
- 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%.

- No deduction of capital losses from other income is allowed.
- No loss carryover is allowed.
- 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.)

③ 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.

Tax credit (not a deduction) for housing loans is allowed up to a certain income class as a special measure.

[Appendix 2]

The following are the major characteristics of the postwar Japanese society and their implications for tax systems.

1. The postwar Japanese society has by far a more equal income distribution. The salaries of most of the directors of big companies are much lower than those in the U.S. To endorse this situation, the postwar tax system put much weight on vertical equity for a long time and highly progressive tax rates on personal income was the major tool to achieve this goal. Those highly progressive rates were actually moderated three times in 1987-88, 1994 and 1999. But these reforms also increased deductions and allowances so that the benefit of tax cuts would not be concentrated on high brackets taxpayers. The result of these across-the-board tax cuts is the current relatively high threshold.
2. With a large population in a small country, land has been thought to be the most valuable asset for a long time, and even after the burst of the "real estate bubble", it still occupies a major part of individuals' wealth and inheritance. One major characteristic of land as an asset is that its appreciation is mainly an externality of economic growth and it produces a typical "unearned" income. The concern for the assets, especially for land, has been a considerable part of tax policy. The fact that land occupies a major part of bequests (over 60%) endorses stable implementation of inheritance tax. [29]

   Following the asset recession in the last decade, the tax on land value, which was introduced in 1991 just after the "real estate bubble", is now suspended, the capital gains tax on land transactions is reduced, and the inheritance tax is also moderated. But the taxation on assets is still thought of as the third pillar of the whole tax system (in addition to the taxation on income and consumption).

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[29] Different from the Japanese situation, Poterba and Weisbrenner show that more than half of all estates in excess of $10 million have more than half of their wealth in the form of unrealized capital gains.(Poterba and Weisbrenner 2001)

3. 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 recommendation required a comprehensive taxation on capital income, it was modified 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.

4. 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. The cross-share holding among companies also restricted the exercise of individual shareholders' voting power. Combined with a life-time 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 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.

   In this decade, 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. But corporations still remain the dominant form of business, which leads to a relatively large share of corporate tax in the total tax revenues.

5. 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 as I mention above. 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. 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.

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