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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: JAPAN

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Abstract
This paper is part of a wider research on South and East Asia countries' taxation, carried on at the Department of Public and Environmental Economics of the University of Pavia, under the direction of L. Bernardi, A. Fraschini and P. Shome and the supervision of V. Tanzi. The paper briefly describes and evaluates the Japanese Tax System. The Japanese fiscal burden has traditionally been modest compared with that of the other G7 countries. The sizeable reductions in statutory marginal tax rates in both the personal and the corporate tax during the 1990's have strengthened this feature. Significant loopholes and non-neutralities are in place in key parts of the tax system, leading to potentially substantial efficiency losses once the tax-to-GDP ratio starts rising to accommodate the restoration of public finances as well as the expenditure needs related to the ageing population. After the introduction, in the second section, the paper describes the tax revenue composition and its development during the last 30 years, in the third section it examines the main Japanese national taxes; the fourth section evaluates the tax system in terms of efficiency and redistributive impact and the final section describes the planned reforms of the system.

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1. Introduction, contents and main conclusions

This chapter briefly describes and evaluates the Japanese Tax System. The next section is devoted to a short reminder of Japanese economy and to an outline of the development of the Japanese tax system during the last decades. The Japanese fiscal burden has traditionally been modest compared with other G7 countries. The sizeable reductions in statutory marginal tax rates in both the personal and the corporate tax during the 1990's have strengthened this feature. Significant loopholes and non-neutralities are in place in key parts of the tax system, leading to potentially substantial efficiency losses

The third section examines the main Japanese national taxes. Particular attention is paid to the personal income tax, the corporate income tax and the value added tax. The latter has been introduced in Japan only in 1989, after long-standing hesitations and controversies and has some particular features. First of all, the tax rate's schedule has a single rate which stays among the lowest in the developed countries while the tax base is the broadest. Second, Japan employs the subtraction method instead than the credit invoice method that is used by all the other OECD countries: what is taxed is the difference between a taxpayer's sales and his taxed inputs.

The fourth section evaluates the tax system in terms of its redistributive impact, as to the horizontal and vertical equity and evaluates marginal effective tax rates on labour and capital. Although the distribution in both pre and post tax terms became more concentrate since the 1950s, the Japanese society is still among the most equitable inside the OECD area, apart from Nordic countries and the Netherlands. Since the pre-tax income distribution is already fairly even, the total amount of tax-redistribution is relatively low, roughly the same as that of the United States. On the other side the tax burden seems not to be evenly distributed. The subsequent tax reductions of the 1990s have compromised the vertical and horizontal equity of the system. Moreover the favourable treatment of public pensions, which has no comparison with the systems of the other major countries, determines an unevenly distribution of tax burden among generations. The end of the section examines the effects of the tax system on labour and capital in terms of marginal effective tax rates and elasticity. The evidence is that the tax system does not pose major obstacles to a high utilization of labour force, and also the influence of tax burden on investment seems to be low.

The final section presents the current situation of the public finance and the prospects of reform of the tax system. The final objectives of the new medium-long term tax strategy are common to the reforms undertaken in many other countries: to secure stable tax revenue for public services, to increase the fairness of the system, to reduce distortions and inefficiencies and make the system simpler.

2. A broad view at the current structure of the tax system

2.1 A short reminder of Japanese economy and public sector ouline

Japan is the second greatest economic power in the world after the United States with the GDP being approximately 45 per cent of that of the United States. Its production constitutes about 75 per cent of the production of the entire Asian market. For three decades overall real economic growth had been spectacular: a 10 per cent average in the 1960s, a 5 per cent average in the 1970s, and a 4 per cent average in the 1980s. Growth slowed markedly in the 1990s (Figure 1) largely because of the after effects of overinvestment during the late 1980s and contractionary domestic policies intended to wring speculative excesses from the stock and real estate markets. Subsequent government efforts to revive economic growth have met little success and were further hampered in late 2000 by the slowing of the US and Asian economies.

(Figure 1)

Some changes in the economic situation occurred in 2003. Recently announced real GDP in the first quarter of 2004 grew an annualized 5.6 per cent over the preceding quarter. Likewise, nominal GDP was up an annualized 3.2 per cent (Figure 1). In the corporate sector, export volume has rending upward, reflecting recovery of overseas economies. Industrial production has also expanded, though with some fluctuations.

Figure 2 summarizes the rates of growth of the main components of GDP. Since 2001 private consumption has started to grow at significant levels and since 2002 the foreign balance displays an important enhancement. As a result, after an uninterrupted growth of 12 years, the unemployment rate will decrease from 5.4 per cent to 4.6 per cent, between 2002 and 2005 (Figure 3). However, even if the worse period seems to be finished, significant sources of concern are still valid for Japan. The financial position of the country has deteriorated significantly from the early 1990s in terms of fiscal deficit and debt accumulation, reflecting the sluggish economy and successive expansionary policies. Over the long term, a further element of pressure on public finances will come from the ageing of the population, as the ratio of elderly to younger people continues to increase more rapidly than in other OECD countries. Public expenditure on pensions has doubled from 6 to 12 per cent of national income in the past decade and will rise to 17 per cent by 2060 if no further action is taken.

A second source of concern for Japan is the persistent deflation. Nagaosa (2002) recognizes three sets of factors to be the cause of that. There are supply-side factor such as the increase in low-priced imports and the progress in technological innovation, demand-side factors stemming from the weakness on business front and last monetary policy factors. These are linked with the fact that Japan also attempted to boost its economy by gradually lower the official discount of rate from its high of six per cent in August 1990 right down to the adoption of a zero interest rate policy in February 1999.

(Figure 2)

(Figure 3)

2.2 The structure of the system and its development during last decades

The current taxes levied by national and local governments in Japan can be classified into three groups: taxes on income, taxes on property and taxes on consumption. In 2002, of total tax revenue collected in Japan, 49.7 per cent came from taxes on income, 17.6 per cent came from taxes on property and 32.7 per cent from taxes on consumption (OECD 2002).

The taxes on income at the national level are the Individual Income Tax and the Corporation Tax while the taxes on income at the local level are the Prefectural Inhabitants Tax, the Municipal Inhabitants Tax and the Enterprise Tax.

The taxes on property at national level are the Inheritance Tax, the Gift Tax, the Land Value Tax, the Registration and Licence Tax and the Stamp Tax. On the other side, the main taxes on property at local level are the Automobile Tax, the Property Tax and the Special Landholding Tax.

The taxes on consumption are given by the General consumption tax and several excises (e.g. on liquor, tobacco, gasoline, local road, petroleum and coal, and so forth).

(Figure 4)

Figure 4 compares the total fiscal revenue and its composition as a percentage of GDP between Japan, the other G7 countries and Korea. The Japanese tax system shows some typical features.

- *The fiscal burden is one of the lowest among the G7 countries*. The ratio between tax revenue and GDP is 27.1 per cent. Among the comparison group, only Korea features a lower ratio (26.1 per cent).
- *The relative share of taxes on income is the lowest among the G7 countries*. The ratio between the fiscal revenue from these taxes and the GDP is 9.2 per cent. Again, only the Korean tax system features a lower ratio, 7.5 per cent. The lower tax burden on income in Japan is mainly due to the low tax burden on individuals, while the tax burden on corporations is substantially in line with the other developed countries.
- *Social security contributions are relatively high*. The ratio between social security contributions and total fiscal revenue is the highest in our sample, perhaps a reflection of the fact that Japan faces the aging problem earlier than most countries do.
- *The relative share of taxes on goods and services is the lowest among the sample.* Among major advanced countries, Japan is the only one that had not imposed a general consumption tax until 1989. Even in 2000, the relative share of this tax was at the lowest level between OECD countries; revenues from indirect taxes rely heavily on specific excise taxes.
- Minor sources of revenue are obtained from death and gift taxes, while property taxes, a main source of local government revenue, occupy a relatively higher share on the total.

The process of developing a modern-type tax system in post-war Japan was initiated by the US. In 1947, several important reforms were undertaken under the influence of US occupation authorities. The schedular tax on individual income was replaced by a unified tax on an aggregate basis with progressive tax rates. In 1949, a tax mission headed by Carl S. Shoup came to Japan with the task of reorganizing the tax system as a whole. Essentially, the Shoup recommendations placed more importance on direct taxes, mainly income taxes on individuals and corporations. The most important issue in the income tax field was the introduction of a concept that the corporation tax was an advanced payment of individual income tax by shareholders. In order to avoid double taxation, dividends received by corporations were exempt and a 25 per cent credit with respect to income tax was granted for dividends received by individuals. On the other side, a new law was enacted in 1950 to introduce a value added tax under the local tax system. The tax base of the value added tax was the gross receipts of an enterprise less its purchases from other enterprises. Consequently, wages payable to its employees as well as interest were included in the base.

The ideal tax system achieved by the initiative of US influences was just temporary: many of these taxes were abolished or modified soon after their enactment. Two tendencies emerged from these modifications: several tax cutting policies to maintain a lower tax burden and an incentive tax policy to achieve specific policy goals (Ishi 2001). The growing economy of post-war Japan generated large increase in annual tax revenue. From 1950 to 1970 the GNP rose by an average of 15 per cent by year. As a consequence, the fiscal revenue should have risen by an average of more than 20 per cent by year (the elasticity of tax revenue on income exceeds 1.0). However, until 1965, the Japanese government adopted a tax cutting policy in order to keep constant the ratio of public expenditure on national income. A large reduction of the marginal tax rates was combined with a reduction of the tax base. Especially before the oil shock in 1973, there was a wide agreement in Japanese government and business circles that the tax system should be actively employed to promote economic growth. Based on tax incentive policies a number of special measures were formulated to promote exports, private savings and investment, housing, environmental quality and technological development. These usually included tax exemption, accelerated depreciations and lower rates on selected incomes.

A radical change of this policy has occurred in 1976. In accordance with the new direction of fiscal consolidation, annual tax policy has adopted the opposite stance towards tax increases. The trend of tax increase, however, was ended in fiscal 1987 and thereafter tax reduction policy was initiated once again by using increased revenue due to the bubble boom until 1991.

(Table 1)

A drastic tax reform took place in Japan between 1988 and 1989. First of all, there was a strong mitigation of the progressive tax rate structure for the personal income tax: from 12 brackets with marginal tax rate between 10.5 per cent and 60 per cent towards 5 brackets with marginal tax rate between 10 and 50 per cent. Also the personal tax base was strongly reduced as a consequence of a great increase in standard personal exemption. The corporate income tax features a great reduction in the tax rate for the ordinary corporations from 42 per cent to 37.5 per cent as well as for the small and medium sized corporations from 30 per cent to 28 per cent. Finally, a general consumption tax was introduced. Since the introduction, its tax revenue has increased steadily, now accounting for about 15 per cent of total tax revenue.

In the 1990s after the collapse of the bubble, fiscal stimuli packages led to successive rounds of large reductions in direct taxes to buoy up the depressed economy. In 1994, from the standpoint of realising a welfare state embodying fairness and dynamism, the government decreased the tax burden by changing the tax structure of individual income tax and by relaxing progressiveness in order to alleviate the perception of a progressive tax burden, especially among the middle-income class. At the same time, the government increased the weight of the VAT by increasing the tax rate from 3 per cent to 4 per cent. In 1999, a new reform has strongly reduced the tax rates of the direct taxes. The top rate bracket of the individual income tax has been cut from 50 to 37 per cent and the tax rate of the corporate income tax has decreased to 30 per cent.

The result of these subsequent tax reductions can be inferred from Table 1. From 1990 to 1999, the total tax revenue decreased from 21.3 per cent of GDP to 16.3 per cent and the total fiscal revenue decreased from 30.1 per cent to 26.1 per cent. The revenues from the personal income tax and from the corporation income tax were almost halved. On the other side there has been a sharp increase in the revenue from the indirect taxes, due to the rise of the consumption tax rate in 1994 and an increase in the social contributions due to the rapid aging population.

3. Some quantitative and institutional features of main taxes

3.1 Personal Income Tax

Similar to all the other developed countries, Japan depends upon the individual income tax for a significant portion of its tax revenues. In principle, the Japanese tax system still maintains a global system of individual income taxation, although in actual practice, separate taxation methods have been introduced as exceptional cases. Each income earner first adds up his income from all taxable sources, then subtracts allowable exemptions and deductions to attain the amount of taxable income. After applying a single progressive rate schedule to such taxable income, the taxpayer use tax credits to arrive at the final amount due.

Under the Income Tax Law, taxable income is classified for the purpose of calculation into the following ten categories in accordance with the nature of income:

1. Employment income
2. Business income
3. Retirement income
4. Occasional income
5. Real estate income
6. Timber income
7. Miscellaneous income
8. Interest income
9. Dividend income
10. Capital gains

Fundamental personal deductions for households consist of the basic exemption, the exemption for spouse and the exemption for dependants. The *basic exemption* is equal to 380,000 yen and it is guaranteed to all the taxpayers. The *exemption for spouse* is provided to the taxpayers who live with a spouse whose annual income does not exceed 380,000 yen. It is equal to 380,000 yen (480,000 yen, if the spouse is older than 70 years old). Finally the taxpayer receives an *exemption for dependants.* This exemption is equal to 380,000 yen for each relative supported except the spouse (480,000 yen, if the relative is older than 70 years old).

In addition to the personal exemptions, which are applied to the taxable income as a whole, numerous deductions are applied to the single sources of income.

Employment income is given a special deduction. The main aim is to put wage and salary workers, the only categories to whom this deduction is available on a more equal level with the self-employed, who can treat their personal expenditure as business expenses.

A variety of special treatments is also involved in the determination of business income. In particular, a special deduction for wages paid to family employees is allowed. Even the proprietor's own remuneration is deductible from his business income and can benefit of the special deduction on employment income.

Retirement income is taxed separately from other income. Only 50 per cent of the retirement income in taxed. Moreover there is a deduction (from 400,000 yen to 8,000,000 yen) and a minimum guaranteed amount of 800,000 yen.

Finally, only 50 per cent of occasional income is taxed after subtracting 500,000 yen as a special deduction.

Interest income and some specific capital gains are taxed separately at the source at special rates; also, dividend income may be so taxed as well.

Interest paid to residents is normally subject to withholding at the source at the rate of 15 per cent (a five per cent local inhabitants tax is levied in addition.). Some kinds of interest are still excluded from taxation, for example, interests from current bank deposit and, when received by certain categories of individuals (such elderly until the end of 2005) interests from small deposit, from central and local government bonds and from postal savings.

Capital gains derived from the sale of securities are also taxed separately. The tax rate applied is 20 per cent (7 per cent from 2003 to 2007 for listed stocks). The losses that are not deductible during the relevant year may be carried forward to be deducted within the next three years.

The gross personal income tax due is computed by applying tax rates to the taxable income. Income tax rates are progressive ranging from 10 per cent to 37 per cent (Table 2).

(Table 2)

Finally, to compute the net tax liability, several tax credits should also be accounted, such as credit for dividend, credit for foreign taxes, credit for incremental research and experimental expenditure, credit for acquisition of a house.

The Income Tax Law allows a taxpayer to deduct 10 per cent of dividend income from income tax. However if ordinary taxable income, including dividends, exceeds 10 millions of yen, a tax credit of only five per cent is applicable to the fraction of dividend income equal to the ordinary taxable income.

Foreign income taxes of residents may be credited against their Japanese income liability. This credit cannot exceed the result of product between the Japanese income tax and the share of the total income outside Japan on the entire income subject to Japanese income tax.

3.2 Corporate Income Tax

The Corporate Income Tax is levied on the net income earned by both domestic and foreign corporations in each accounting period or in liquidation. The computation of the net income accords with the actual practices of the modern business accounting system; however, some adjustments on capital incomes and investments should be made to obtain the taxable income.

The capital gains accrued by corporations are subject to taxation in full as they are realized. These capital gains are taxed at the same rates as operating profits, although capital gains from short term transactions of land are additionally levied a special tax burden. On the other side, 50 per cent (in the case of specific shares, 100 per cent) of dividends less a portion of the interest paid by corporation on the borrowed funds, is excluded from revenue for tax purpose.

Depreciation is allowed on the basis of the acquisition cost, salvage value (10 per cent in the case of tangible assets and nil otherwise) and the statutory useful lives or the numbers of years during which such assets are serviceable. If the acquisition cost is less than 100,000 yen, corporation may deduct it in the accounting period of the acquisition. Generous provisions have been allowed for accelerated depreciation, increased initial depreciation and special tax free reserves to stimulate particular types of investments.

The corporation tax for each accounting period is computed by multiplying the taxable income of the corporation by the tax rates listed in Table 3.

(Table 3)

Family corporations are subject to an additional special tax on retained earnings exceeding a prescribed level.[1] This additional tax is designed primarily to deter shareholders of closely held corporations to avoid the progressive individual income tax that would be imposed on dividend distributions.

A corporation can carry forward losses for five years following the loss year or carry back losses one year preceding the loss year.

3.3 Value Added Tax

The Value Added Tax was finally introduced in the Japanese tax system in April 1989, after long-standing hesitations and controversies.

The Japanese governments started to stress the importance of a Value Added Tax since the late 1970s. However, the first attempts to adopt it were frustrated by the strong opposition of influential parts of the Japanese society. Ishi (2001) found three main reasons to this vigorous resistance to the Vat.

First of all, there was a general opposition to the regressive effects of this tax in a country with a strongly progressive tax structure. Secondly, small traders feared that the new tax would force them to reveal all of their transactions to the tax offices and that they would therefore being unable to partially avoid income tax. Lastly, there was a general perception of an inefficient use of public funds and therefore it was a political taboo proposing a new indirect tax.

[1] A "family corporation" is a company of which 50 per cent or more of all capital stocks are owned by no more than three shareholders and persons or corporations connected to them.

Whenever attempts were frustrated to adopt VAT, different names for it were applied so as to defuse political tensions, i.e. the general consumption tax in 1979, the sales tax in 1987 and the consumption tax in 1989.

In 1989, in order to minimize the political opposition, the tax base of the Vat was conceived to be as breadth as possible. In this way, the tax would have been simpler and less onerous to business and with a lower tax rate.

Given its history, it is not surprising that the coverage of the Japanese Consumption Tax seems to be among the broadest in the world and that the tax rate is a single one and the lowest in the world.

Another singularity of the Japanese Vat is that no invoices are provided for. Invoices admit the use of the tax-credit method, universally preferred in all VAT countries. Each invoice for a purchase from another firm indicates the total amount of the tax already paid. Firms collect all invoices and aggregate the input tax shown on them. This is the amount credited against the firm's own gross tax in order to calculate the VAT payable. The VAT without invoices must rely on the accounts method. Total purchases are subtracted from total sales by using the bookkeeping records and the tax rate is applied on this difference.

The Consumption Tax Law applies to domestic transactions, made as business activity, effected for compensation and categorized as sales of assets or provisions of services. The main non-taxable transactions are the following:

1. Sales and leasing of land
2. Sales of securities, money lending and other financial transactions
3. Medical services
4. Social welfare services
5. Educational services
6. Housing rent

In principle, consumption tax seeks to impose tax on goods and services in the country where they are consumed (principle of taxation at consumption places). Therefore, transfer of taxable assets that taxable business operators engage in trades, similar to export trading and international transportation, is exempt from consumption taxation.

The "base period" is the period that determines the existence or absence of tax liability.[2]

Taxpayers are the enterprises and the individuals who receive foreign goods from bounded areas. In other words, taxpayers in domestic transactions are limited to enterprises. In contrast, consumers can become tax payers when they receive taxable cargoes from bounded areas. Small enterprises with taxable sales less than 10 millions yen in a base period are exempt from tax liability on sales of taxable assets during that tax period.

The current tax rate is four per cent (a one per cent Local Consumption Tax has also been introduced, for a total current rate of 50 per cent).

A simplified tax system has been designed to help small enterprises (taxable sales are less than 50 millions yen) to easily calculate deductible tax on purchases. These enterprises can choose to compute the tax deduction for purchases by multiplying their taxes on purchases by a deemed rate. Those deemed rate can vary from 90 per cent (businesses corresponding to wholesalers) to 50 per cent (businesses corresponding to real estate, transport and service industry). Once the simplified system is chosen, it cannot be changed for two years.

3.4. Excise duties

Japanese excise taxes can be classified into two groups: excises on alcohol and tobacco and earmarked excises.

The first group includes the liquor tax, the tobacco tax and the special tobacco tax. These excises are normally justified with two reasons. The first one is that they correct a negative externality, limiting the diseconomies generated by the consumption of alcohol and tobacco. The second is that they are taxes on non-essential or luxury items considered proxies for taxpaying taxation.

The liquor tax has traditionally been one of the most important in the national tax system. In the 1950s, it produced 18.5 per cent of total national tax revenue. However, its importance has gradually decreased accounting now for not more than three per cent of total tax revenue. It is levied on domestic alcoholic beverages shipped from

[2] For individual proprietors, it is the calendar year two years before the current tax year. For corporations, with an accounting period of one year, it is the period two years before the current accounting period.

manufacturing premises and on imported ones, which are drawn from bounded areas. Alcoholic beverages are classified in five categories and a specific tax rate is applied to each category.

The second group of excises includes gasoline tax, liquefied petroleum gas, aviation fuel tax, petroleum and coal tax, motor vehicle tonnage tax and promotion of power resource development tax. These taxes have been conceived as service charges for the use of road, airports and power plants. Since the consumption of these services is exclusive to some extent, it seems fair that beneficiaries should pay for them in proportion to their use, even if the government does provide services.

4. An evaluation of the tax system in terms of equity and efficiency

4.1 Redistributive impact of Japanese tax system

It is widely accepted that taxation can reduce the inequality of income distribution. A determinant role is here played by the individual income tax, as it is typically equipped with progressive tax rates. For studying the inequality in distribution, we may look at the Gini coefficient. Before directly investigating the effects of income taxes on distribution, consider the long-term variation in terms of pre-tax income distribution for self-employed and wage earnings in Japan (Figure 5). An interesting feature of this statistics is that while self-employed incomes move towards a greater inequality, wage earnings move to an opposite way. Particular attention should be paid to the sharp rise in the inequality of self-employed incomes during the 1980s due to the rise of capital gains. However, after the collapsing bubble phenomenon in 1991, this type of income has moved rapidly toward more even distribution.

(Figure 5)

The effects of taxation on income distribution are studied by computing the percentage difference between the pre tax and post tax Gini coefficient. The results are depicted in Figure 6. The most evident conclusion is that the redistributional effects of income taxes have strongly decreased over the past four decades.

(Figure 6)

With an important exception between 1969 and 1973, the extent of redistributive effects had been lower for wage and salary earnings (withholding tax) than for self employed and other incomes (self-assessed tax) until the late 1980. The reason is that the formers include all property income and capital gains. These items of income tend to be concentrated at higher income brackets: thus, the income tax levied on them has greater power to equalize income distribution through its progressive structure. The equalizing power of income tax on self employed and other incomes has fallen in the 1990s because of the combined effects of two factors: a great reduction in the capital gains due to the explosion of the financial bubble and a reduction in the progressivity of the tax system.

As we have seen, the post-war history of income taxes had been characterized by annual reductions until 1979. Those reductions consisted of increasing exemptions and deductions, lowering progressive tax rates and enlarging special tax measures. Undoubtedly, annual tax reductions must have substantially affected the redistributive effect of income taxes. Raising the levels of *exemptions* and *deductions* implies that a certain amount of income is removed from the tax rolls, thus narrowing the whole scope of taxable income. More importantly, such a tax cuts tends to weaken the equalizing power of progressive tax rate.

On the other side, it is difficult to assent on the effects of *tax rate adjustments* on redistribution. Those measures have been less frequent than the increasing in the exemptions and with no clear directions. Only in the 1990s, a sharp decrease in the top marginal rate of the individual income tax and a decrease in the rate of the corporate tax can be considered as the main cause of the reduction of the redistributive impact of the tax system.

A more significant impact on the distribution of income has been made by the introduction of *special tax measures* to achieving specific policy goals (especially capital accumulation). Two special measures merit particular consideration: the partial exclusion from the tax base (as for dividend income) and the separate taxation under reduced tax rates (as for interest and capital gains). Some Authors believe that special tax measures have been a major contributory cause of the decreasing redistributive effects of the income tax especially with respect to self-employed and other incomes. The great reduction of the redistributive effects of the self-assessed tax between 1968 and 1969 can be explained by some special tax measures (the typical example, in these years, is the tax concessions for capital gains on land granted in 1969).

(Table 4)

The OECD statistics revealed that, although the distribution in both pre and post tax terms has widened since the 1950s, the Japanese society is still among the most equitable in the OECD, apart from the Nordic countries and the Netherlands. Since the pre-tax income distribution is already fairly even, the total amount of redistribution is relatively low, roughly the same as that of the United States.

4.2 Horizontal and vertical equity

Japanese tax system has developed in such a way as to deviate substantially from the original coherent Shoup design of the 1950s. After the continuous tax cuts implemented in the 1990s, to face deflation and stimulate economic recovery, the tax system lost its internal coherence and even though it raises a very low amount of revenue, compared to other countries, it does so by concentrating the burden on an exceptionally narrow group of taxpayers (Giannini and Guerra 2003). As stated in the Tax Commission Report (2002) almost 80 per cent of personal taxpayers pay their income tax at the lowest rate of 10 per cent and 16 per cent fall in the next 20 per cent bracket; moreover, 70 per cent of corporations do not pay any corporation tax at all.

As it is well known, tax experts view equity and fairness in two dimensions, vertical and horizontal.

Vertical equity is concerned with the distribution of tax burden among different income classes. Progressive taxation of all income on an all-inclusive basis is an essential condition in allocating different tax burdens fairly between the rich and the poor: we have already seen how much tax reductions in the last years have compromised the vertical equity of the Japanese tax system.

Horizontal equity is concerned with equalizing the tax burden among people in similar economic conditions. This clearly requires that the income tax base is as broad as possible. However several tax deductions are granted for the personal income tax (basic exemption, exemption for spouse, exemption for dependents, employment income deductions and pension and retirement income deduction). Tajika and Furutani (2002) have studied the horizontal equity. Consider Table 3. Deductions are not only very large in comparison with the income earned but their variance is significant as well. The average deduction rate of income class 6 is 62.5 per cent; however, it varies from 0-20 per cent to over 80 per cent, with the two largest groups, 39.4 per cent and 33 per cent respectively in the ranges of 60-80 per cent and 40-60 per cent. Moreover, 16.8 per cent of those in the average income group have deducted more than 80 per cent of their income to reach their taxable income.

In sum, the table seems to suggest that granting deductions in the personal income tax may not be as fair as it intends to be.

(Table 5)

The tax burden is unevenly distributed also between generations, particularly because of the very favourable treatment of public pensions, which has no comparisons with the systems of the other major countries. Like in most of developed countries, also in Japan contributions to public and private tax schemes are exempt. However, differently from the other countries, lump sum payments and annuities paid by qualified pensions are also exempt or at least lightly taxed. Lump sum payments are classified as retirement income. These items of income are taxed only for 50 per cent netted of a special deduction that increases with the years of income from 4 millions to 20 millions of yen. Annuities are classified as miscellaneous income and enjoy a preferential treatment as well. In particular, they benefit of a generous deduction that is similar to the employment deduction for pensioner younger than 65 years old and much higher for older pensioner.

An OECD survey (2002) compared the fiscal treatment of pension and labour income computing the per cent difference between the effective tax rate on worker and the effective tax rate on pensioner for fiscal year 2000. The relative advantage attributed to Japanese pensioners is very high with respect to other countries. Only

Germany and US are relatively more generous than Japan for a pensioner with income equal or higher than the average worker income.

Combined with the rapid aging of the population, the spontaneous result of this highly favourable treatment of retirement and pension income would be an increasing intergenerational inequities and the shrinking of tax revenue (Giannini and Guerra 2003). According to Morinobu (2002), the future income tax base to national income in Japan estimated to be 29.4 per cent in 2000 will drop to 25.8 per cent in 2005, 22.3 per cent in 2010 and 14.2 per cent in 2025 only as a consequence of the interaction between the favourable treatment of pensions and the rapid aging society.

4.3 Incentive to work, save and invest

The total labour market distortion caused by taxation is given by the combination of marginal tax rates and labour supply elasticities.

Table 6 reports the marginal tax rate on labour in some OECD countries: Japan features the lowest value among G7 countries. Only Korea does better in our sample. Moreover the progressivity of the tax schedule unfolds relatively smoothly compared with many other countries, implying a virtual absence of problems related to unemployment and poverty traps, which are often caused by abrupt changes in tax rates along the income schedule (Dalsgaard and Kawagoe 2000).

The labour supply elasticities are determined by a host of factors, including the wage bargaining framework, labour market policies and the degree of competition in the product markets. Most cross country studies find that labour supply elasticities are low and often insignificant for primary earners, whereas they tend to gain in importance for secondary households earners, typically women. This pattern also appears to exist in Japan, although the evidence is scarce (Tachibanaki 1997). The phasing out of spousal allowances as well as the introduction of pension contributions when spouses earn more than 1.3 million yen annually create high marginal tax rates for the households when the spouse enters the labour market. The elasticity of Japanese married women with respect to own wages is 1.1 and with respect to family income is -0.2. These elasticities are similar to estimates found for France and Germany but higher than those found in the United States (Tachibanaki 1997).

Last, as shown on p. __, the average personal tax rate in Japan has been traditionally low if compared to the other developed countries. Taxpayers with an annual income below 12 million yen (around 95 per cent of all personal taxpayers) face average rates, including social contributions, below 20 per cent (MOF 1999).

Dalsgaard and Kawagoe (2000) conclude that the tax system, unlike those in many other OECD countries, does not pose major obstacles to a high utilization of labour force. This conclusion is underpinned by the fact that Japan has one of the highest market participation ratios in the OECD, although this is due to a combination of very high male participation and a female participation ratio closer to the OECD average. Participation rates of the elderly (55-64) are also relatively high and hence so is the average effective retirement age.

(Table 6)

Incentive to save and invest in physical capital also benefit from the overall level of taxation. To what extent the tax burdens for corporations and individuals influence aggregate investment levels is a question of how much taxation changes the cost of capital and to what degree the cost of capital determines investment. Table 7 shows the marginal effective tax wedge in manufacturing, computed using the King-Fullerton methodology. Most OECD tax systems favour debt finance since corporate interest payment are deductible from the corporate tax base and because effective tax rates on personal interest income are often low. This is also the case of Japan, where the marginal tax wedge on debt is the lowest among G7 countries while the marginal tax wedge on retained earnings and new equity is higher and substantially in line with the other G7 countries.

The influence of tax burden on investments seems to be low in Japan. Tachibanaki (1997) concludes that “the effect of various tax policies on investment was very minor”. The Economic Planning Agency (1998) likewise concludes that even a significant cut in corporate tax rates would imply only a small change in the cost of capital.

(Table 7)

5. Tax reforms

5.1 A quick glance at macroeconomic and budget outlook

A significant source of concern for Japan is its fiscal deficit. The budget position has deteriorated significantly from the early 1990s in terms of fiscal deficit and debt accumulation.

Probably Japanese economy has passed the most difficult economic period of its post-war. After enjoying great economic performance in the 1950s, 1960s and 1970s, it entered in an era that was known as "bubble economy" around the late 1980s. After hitting its peak in 1991, the bubble burst triggering Japan's plunge into a period of stagnation of unprecedented length. The annual rate of growth rate during the 1990s was a mere 1 per cent on average, in contrast to the 6 per cent level of the 1980s.

In order to struggle the sluggish economy, successive expansionary policies took place in Japan. These policies are summarized in Table 8: 136 trillion of Yen was injected as a continuous fiscal stimulus in the form of public investment and various tax incentives. However, these Keynesian fiscal policies have not brought about the desired effect of boosting the economy. Since 1991, the difference between total expenditure and tax revenue began to grow: from 1999, the total expenditure has been almost double of the tax revenue (Figure 7). As a result, since 1991, the debt of Japan, as a percentage of GDP, started to increase exponentially and in 1999 it became the highest among G7 countries (Figure 8). Nowadays it accounts for more than 150 per cent of GDP.

(Table 8)

(Figure 7)

(Figure 8)

The worsening of the Japanese financial position is not only a result of the expansionary policies of the last decade but is also related to the impact of the Japan's aging population. Japan's population is becoming the most aged among G7 countries.

The ratio of working population (aged 20-64) to the elderly population has been falling rapidly, from 7.7 in 1975, to 3.6 in 2000, to 1.9 in 2025. This implies that, in 2025, for every two persons in the working population, there will be one elderly person who needs to support. As a matter of fact, this determines lower fiscal entrance, due to the very favourable treatment of public and private pensions and higher social cost. Pension and health insurance benefit payments currently amount to roughly 70 trillion yen per year: this amount will be doubled by 2025.

The Japanese government is still sticking to achieve a primary balance surplus not before than the late 2010s. According to Dekke (2002) estimates, under unchanged spending policies, for the government to be solvent, taxes would need to increase from the current 28 per cent to GDP to over 40 per cent by 2020. Even considering the officially stated commitment to rationalize and cut public expenditure, it is increasingly recognized that an higher national tax burden in the future will be unavoidable (Giannini and Guerra 2003).

5.2 Reforming direct taxation in Japan

The drastic change in the population structure will have an enormous impact on Japan's economy and society. The declining labour force due to the declining birthrate and aging of the population and the lower saving rate may cause a drop in the economic growth rate and an increase in the social security burden on working generations. As a consequence the tax system needs to be reformed.

The major objectives of the reform, as stated in the Tax Commission Report, are the following:

1. Restoring a tax system that inspire confidence for the future
2. Improving tax fairness
3. Encouraging the productivity of individuals and corporations.

As the population ages, increases in public expenditure is inevitable. As both national and local finances are experiencing a difficult moment, the people have a sense of uncertainty regarding increases in tax or social security contributions in future. Therefore, even a low tax burden has no effects in boosting the economy, if it is perceived as temporary.

As we have seen, the tax burden is unevenly distributed between generations, particularly because of the very favourable treatment of public pensions which are almost tax exempt. As the ratio of elderly population will drop rapidly, excess burden on the working generations will take away their motivation to exercise their social responsability as long as the current structure is mantained. The working generations will not be able to expect large increase in salaries but they will still be responsible for bearing the burden of the public service costs, while such costs are projected to increase rapidly in the future (Tax Commission 2003).

An important task is to formulate a tax system that encourages the partecipation of elderly persons and women to the economy of the society, so as to establish a lifelong working society. Futhermore, improvement in productivity is a key element for generating economic wealth in a society with a smaller population. Corporations, which play a central role in productivity, need to develop enviroments where they can cope flexibility with foreseeable structural changes such as globalization. The tax system should be reviewed in a simple, neutral and clear way so that it does not hinder individual employment or corporate choice (Tax Commission 2003).

Concerning the individual income tax reform, the major objectives stated in the Tax Commission's Reports are restoring the major role of this tax as revenue raising instrument and restoring its redistributive function. The *leitmotiv* in the reform debate to pursue such objectives is the need to broad the tax base simplifying, consolidating and in some cases withdrawing the existing exemptions and deductions. (Giannini and Guerra 2004). According to the estimates of Tajika and Futurani (2002) a cut of the deduction by 30 per cent generates an increase in revenue up by 45.1 per cent. A total deletion of the deductions triples the fiscal revenues. OECD (1999) estimates that tax relief could even approach 10 per cent of GDP. On the other side, removing or reducing existing allowances hurts vested interests and for this reason the debate on the subject is particularly alive. The only measure taken with the 2003 tax reform has been the reduction, from the year after, of the special allowance for spouse.

Concerning the capital income taxation, the tax treatment of interests, capital gains from stocks and dividend on listed stocks have been unified at the rate of 20 per cent. However, there are still several loopholes in the tax base and significat discriminations among different assets and types of subscribers. First, some kinds of interest are excluded from taxation (such as interests from current bank deposits), as well as when received by certain categories of individuals (such as elderly). Second, dividends may be partially double taxed. The taxpayer can decide to tax them at the source at the rate of 20 per cent, without tax credit, or to include them in the income tax base and benefits of a tax credit equal to 10 per cent. Third, capital gains on bonds, other than convertible bonds, are not taxed. This approach reflects the idea that capital gains should be taxed only when deriving from a speculative activity.

The efforts of the capital income tax reforms in the fiscal year 2002 and 2004 regards mainly the capital gains and aims to ensure tax neutrality and equity. Nowadays, the innovation in the financial markets makes it possible to speculate on the bond market as well as on the stock markets. Moreover, the exemption of capital gains on bonds can easily promote tax avoidance behaviours, consisting in transforming interests (which are taxed) in capital gains on bonds (which are exempt). For this reason the orientation of the Tax Commission is toward a generalized taxation of all kinds of capital gains at the rate of 20 per cent. Another problem regarding capital gains concerns tax enforcement, since the aquisition price necessary to determine the tax base is not easily known. In order to solve this problem, Japan has experienced a fixed tax rate on the selling price. The most important shortcoming of this solution is that it deeply distorts the functioning of financial markets since it penalizes trading (Giannini and Guerra 2004). An alternative way to face this problem is getting intermediaries directly involved: all agents trading on financial markets communicate the identity of taxpayers involved in transactions to the tax authorities. This solution is adopted in the majority of OECD countries but not in Japan. The difficulties of adopting it in Japan concers the fact that this country has not yet introduced a taxpayer identification code. The tax reform in 2002 has introduced in Japan a different and innovative solution to this problem: it makes it possible to