The Japanese Tax System — Directions for Reform


Author Satoshi Watanabe

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Challenges for the Japanese Tax System

The Japanese economy is facing several serious challenges and the Japanese tax system is expected to cope with the difficulties arising from these challenges. First, the Japanese population has begun to decline and the population structure is aging rapidly, which causes uncertainties over the long-term sustainability of the social security system. Second, with the process of the globalization of economic activities, the tax system has to be more carefully designed so that it remains effective without producing too many adverse effects, including the loss of industrial competitiveness. Third, the tax system needs to be adapted to the “digitization” of the economy with ever evolving information and communication technology and new business models. Although some aspects of these challenges bring about opportunities for the economy, it is indispensable to seek to establish a tax system that is more suited to the rapidly changing environment.

Population Structure

The Japanese population peaked at about 128 million around 2010, and has been declining gradually since then. The pace of the decrease in population will accelerate in the coming decades and the population in 2050 is expected to be around 100 million *(Table)*. The aging of the population is even more remarkable. In 2060, the share of people who are 60 years old or over is estimated to reach 45% of the total population. Also, it is projected that the share of very old people who are 80 years old or older will increase from 9% in 2020 to 19% in 2060. In the coming decades Japan is expected to become a “super-aging society”, in which the share of very old people among older people becomes quite substantial. The ratio of people older than 80 to people older than 60 will increase from 25% in 2020 to 42% in 2060.

TABLE
Population & its structure in the coming decades

	Total Population (millions)	Age 60 and over (%)	Age 70 and over (%)	Age 80 and over (%)
2020	1.25	35%	22%	9%
2030	1.19	38%	25%	13%
2040	1.11	43%	27%	14%
2050	1.01	44%	31%	16%
2060	0.93	45%	32%	19%

Source: National Institute of Population and Social Security Research, “Population Projections for Japan (2017)”

The Japanese social security system, including the public pension systems and the public medical and care insurance systems, is basically managed on a pay-as-you-go basis. Therefore, the increasing share of the older population puts the sustainability of the social security system at risk. While public pension expenditure increases at a similar pace as the population of people who are older than the pension age, which is in principle 65, expenditure for medical and care services generally increases at an even higher pace as the process of “super-aging” continues. To make the social security system slimmer and more efficient is a crucial goal in Japanese social policy. However, restraints in social expenditure alone cannot achieve the sustainability of the system with some reasonable level of social security benefits. Therefore, measures to raise revenues from taxes or social security contributions are also required. This point is very relevant when we discuss directions for tax reform, and the aging of the population raises a formidable challenge for the Japanese tax system.

Globalization

The globalization of economic activities poses a difficult challenge for the tax system. The process of globalization in recent decades, together with the development of information and communication technologies (ICT), has nullified the effectiveness of border controls on international economic activities in many areas. The tax system, however, has to be managed by the tax authorities of each country, and the relative position of the tax administrations *vis-à-vis* multinational corporations (MNCs) has substantially weakened.

The globalization process has made it easier for MNCs to choose the country where they operate. Because tax is one of the factors in that choice, some countries have tried to attract MNCs by offering lower tax burdens, which has intensified international tax competition. Countries engaged in extremely aggressive tax competition are sometimes called tax havens. Also, MNCs have gained more geographical flexibility in arranging their global operations. Thus, business taxation on MNCs has become more difficult, and the effectiveness of corporate income tax (CIT) on international transactions has been reduced.

Tax authorities all over the world are facing the challenge of globalization and the base erosion and profit shifting (BEPS) project has been promoted by the G20 and OECD, with a view to restraining abusive tax avoidance by MNCs. If the BEPS project is successfully implemented and international cooperation between tax authorities is strengthened, the CIT system might be able to survive. (International cooperation, in particular effective exchange of relevant information among the tax authorities, is recognized as important also in the context of personal income tax (PIT) and value added tax (VAT).) However, it should be noted that too severe regulation of MNCs to make them improve their tax compliance might have an adverse effect on their efficient international economic activities.

Digitization

With the rapid progress of ITC, digital technology is already an indispensable element of the current economy. On the one hand, new business models equipped with new technologies often annoy tax administrations. On the other hand, tax administrations in many countries are making efforts to use ICT to enhance their abilities in implementing the tax system. The digital economy, or the digitized economy, has both negative and positive implications for tax administrations. It would be desirable if ITC is used for making tax administration more effective and for reducing the tax compliance burden for taxpayers.

With the digitization of the economy, various kinds of multi-sided platform business, which connect different types of users of platforms, have emerged, for example in the case of Airbnb, between people who want to get short-term accommodation as guests and people who want to rent a vacant room for a short-term basis as hosts. Multi-sided platform businesses can reduce transaction costs, which makes both sides better off through the indirect network effect. For example, travelers or potential guests are better off as the number of available rooms increases and potential hosts are better off as the number of travelers increases. The indirect network effect also makes the pricing strategy of multi-sided platforms complicated and they often subsidize one side of the users instead of charging service fees.

In the digitized economy, successful platform businesses get huge profits and cause international tax problems because a country might not be able to get any CIT revenue from them even though a lot of users of the platform live within the country. The problem might be more difficult if the users in the country just provide data to the platform without paying any fees. Multi-sided platforms also render the concept of the place of business obscure, which irritates the tax policy makers in some countries, as I will discuss.

What About Income Discrepancies?

So far, we have discussed the aging of the population structure, globalization, and digitization. While many people would agree that these challenges are important elements to be considered in the context of tax policy, some people might ask about the role of tax in improving distribution of income and wealth. In Japan, as in many other countries, the problem of income discrepancies has become serious. Too much inequality is not only against the principle of equity but also might be harmful for economic growth. All of the factors mentioned above — aging, globalization, and digitization — tend to make income distribution more uneven. I agree that income discrepancy is a serious issue and to cope with it is one of the most important policy goals.

I believe, however, that the scope of the role of tax policy in addressing the distributional issue is quite limited. In traditional textbooks on public finance, it was discussed that tax policies, particularly policies on PIT, should play an important role in improving income distribution and the concept of progressive income tax has been cherished. However, globalization makes it difficult for tax policy makers to make the tax system very progressive. If you place too heavy an income tax burden on wealthy people, they would have a stronger incentive to engage in tax avoidance. In particular, they would shift their wealth to overseas, and they might even emigrate to other countries with lower taxes. If you charge too heavy a CIT on businesses, they might shift their operations to overseas. In Japan, these reactions would erode the tax base. Moreover, it is difficult to help very poor people through tax policies because they do not bear much tax burden in the first place. Because the level of minimum income subject to PIT is relatively high in Japan, many lower-income people do not pay any PIT. Thus, policies to improve income distribution through progressive taxation face serious limitations.

The major tool for supporting the poor is to provide social security benefits including public assistance, which should be managed outside the tax system. Some people advocate introducing a “refundable tax credit” system in the PIT, but the nature of this type of “tax credit” is simply a form of providing social security benefits. While it is important to support the unemployed in getting jobs and to support families with young children in raising them, these policies should directly aim at fostering the accumulation of human capital.

Directions for Tax Reform

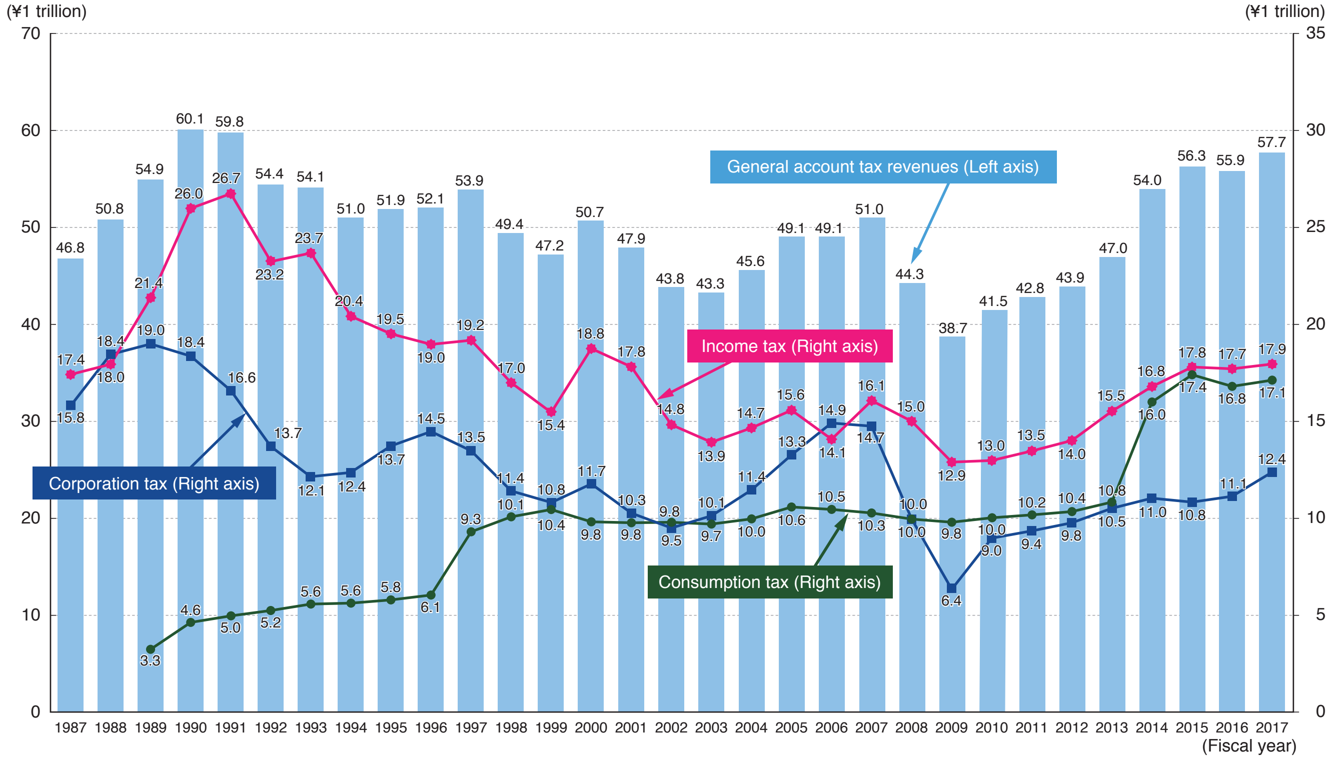
Now we will turn to the issue of tax reform. Before getting into concrete points, it should be emphasized that tax policies are part of overall economic policies and that we cannot expect tax policies to resolve all kinds of economic problems. As discussed above, the income discrepancy problem cannot be addressed by tax policy alone. That problem should be dealt with by social security and social welfare policies, together with labor and education policies. I believe there are two important factors that are relevant for the direction of tax reform in Japan. First, sufficient tax revenues and social security contributions should be secured in order to maintain the sustainability of the social security system in a super-aging society. Second, the tax system should be reformed to be more efficient and effective in the changing economic environment caused by globalization and digitization.

Sustainability of the Social Security System

As discussed above, the process of rapid super-aging has started to increase pressures on social security expenditures. Because the total population is declining and the pace of the decrease in the number of people of working age will accelerate further, the base of taxes and social security contributions is not likely to increase strongly, and Japan faces a serious risk in the sustainability of the social security system. In order to cope with this severe situation, it is indispensable to undertake a through reform of the social security system, including raising the pension age and reducing the subsidy rate for medical and

CHART 1

Trend of general account tax revenues (1987-2017)



Source: Ministry of Finance

care services, as soon as possible. As time goes by, the proportion of elderly people continues to increase, making social security reform politically more difficult. To increase the labor participation rate of elderly people is another important factor. However, some measures to increase revenues for social security expenditure are necessary. Even if we succeed in restraining per capita expenditure for social security benefits, total expenditure is expected to increase because the number of aged people, and of the very elderly in particular, will continue to rise over the next 20 years and beyond.

If more revenue is needed for increasing social security expenditures, we have to think how to raise it. Social security contributions will continue to be a major revenue source, but we need to examine the possibility of raising taxes. The major tax items are PIT, CIT, and VAT *(Chart 1)*. It is difficult to raise the CIT rate because the global trend is to reduce CIT rates. Until the Tax Reform implemented by US President Donald Trump, the US CIT tax rate was higher than Japan's, but now it is no longer the case. The CIT rate of France is still higher than in Japan, but it is expected to be lowered, and Japan is going to become the country with the highest CIT rate.

To raise the PIT burden for upper-income people is difficult because of globalization, and even if it is implemented the expected revenue would be small because of the small number of upper-income people. To raise PIT rates on lower incomes might be possible because more than 80% of taxpayers in Japan are subject to the marginal tax rate of no more than 10% (no more than 20% together with local personal income taxes). However, only VAT, known in Japan as the Consumption Tax, is likely to produce substantial revenue to make the social security system sustainable.

The Role of Consumption Tax

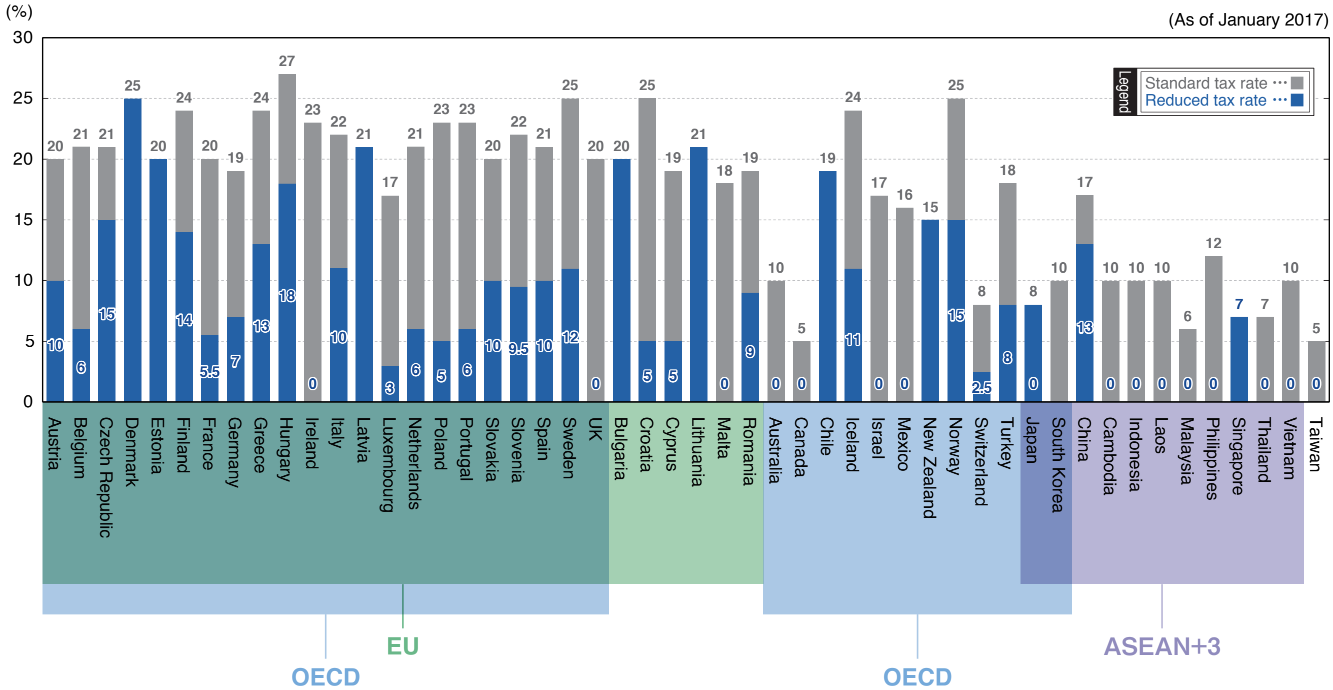
The Consumption Tax was introduced in Japan in 1989. The tax rate was only 3% when it was introduced, but was increased to 5% in 1997 and to 8% in 2014. As indicated in *Chart 1*, the Consumption Tax has produced stable revenue, whereas revenues from PIT and CIT have fluctuated because they are strongly influenced by such factors as business cycles and asset prices. Because of the stability of revenue, the Consumption Tax might be considered to be lacking in the function of a "built-in stabilizer", which is expected to smoothen the business cycle. Still, the stability of revenue is a desirable feature as a source for social security expenditure. The standard rate of the Consumption Tax is scheduled to be raised to 10% in October 2019, which is a first important step toward sustaining the social security system in the near future.

Another feature of the Consumption Tax is that its burden is born by all generations, including the elderly, whereas the incidence of PIT is mainly on working generations. Also, the burden of the Consumption Tax is clearly recognized by consumers, where the incidence of CIT is not transparent. These are some of the reasons why the Consumption Tax is so unpopular among people in general, and particularly among the older generations. Although the Consumption Tax needs to be raised further in the coming years, this issue will face tremendous political difficulties.

The Consumption Tax has not adopted a reduced-rate system and

CHART 2

International comparison of VAT rates (standard tax rates & tax rates on food)



Source: Ministry of Finance

has kept a single-rate system, which makes the current system simple and efficient. As indicated in *Chart 2*, some countries including Denmark, Estonia, Latvia, Chile, and New Zealand have single-rate systems, although the standard tax rates of these countries are much higher than 8%, the current Japanese Consumption Tax rate. Unfortunately, a reduced rate of 8%, which is applied to food and newspapers, is to be introduced for political reasons when the Consumption Tax rate is increased to 10% in 2019. A multiple-rate system for VAT is infamous among tax scholars as a poor tool for income redistribution. If you want to support the poor, direct income transfer is much better than a reduced VAT rate on food or other necessities. To introduce a reduced rate is a serious step backward for the Japanese Consumption Tax system.

Tax Reform in the Globalized & Digitized Economy

As the economy is more and more globalized and digitized, it becomes even more difficult for the tax authorities to implement taxation on profits of MNCs and the sustainability of the CIT system is at risk. In order to cope with these difficulties, the tax authorities of the world recognize that they have to strengthen international cooperation to exchange tax information. Also, they have started to recognize that it is no longer possible for any country to keep a CIT system that is very different from other countries. Japan is probably going to be obliged to streamline the CIT system so that the risk of being evaded (or avoided) by MNCs is reduced. Thus, it is expected that the ratio of CIT in the total tax revenue will gradually decline, and the Consumption Tax will become more and more important as a revenue source.

Some European countries are making arguments for a drastic reform of the current international tax system. In March 2018, the European Commission proposed to introduce a "digital tax" to be imposed on some huge IT companies (mostly, US companies) which provide electronic services within the European Union. The United Kingdom and India have other new tax measures with similar purposes. While it is becoming more difficult for the current CIT system to survive in the digital environment, it might cause other problems if some countries introduce unilateral measures. Japan, together with the OECD, is expected to play a role in promoting careful discussions on the possible reform of the international tax system so that it will not distort international economic activities.

Finally, Japan has to substantially strengthen efforts to modernize the tax administration system so that it adapts to the digital environment. While Japan has finally introduced a taxpayer identification number system, which is called the "my number" system, it is not fully used as yet. Although the Japanese authorities have to care about the protection of people's private information, they can never construct an effective tax system without a taxpayer identification system equipped with digital technologies. The "my number" system is also expected to play an important role in making the social security system work efficiently. To promote e-government functions in Japan is indispensable not only for adapting the tax system to the digital economic environment but also for enabling the social security system to survive under the pressure of super-aging that Japan will face in the coming decades. JS

Satoshi Watanabe is a professor at the School of International and Public Policy, Hitotsubashi University. He is a former Ministry of Finance official, and specializes in taxation and public finance.