Japan's Tax Structure

By Shigemitsu Sugisaki

One of the main features of taxation in Japan is that it is heavily skewed toward direct taxation at both the national and local levels. At the national level, there is a strong reliance on income taxes, especially withholding taxes (taxes withheld at the source when the taxpayer receives salary, interest, dividends or other moneys), and on corporation taxes (Fig. 1). Together, income taxes and corporation taxes account for about 70% of all national tax revenues. Among the main indirect taxes are the alcohol tax, excise taxes and other taxes levied on specific products, but there has been a conspicious decline in the percentage of national tax revenues provided by these indirect taxes.

At the local level too, direct taxation provides the bulk of tax revenues as prefectures rely on the enterprise tax and inhabitants tax and local communities on the inhabitants tax and property taxes.

Focusing primarily on the national level, this paper will describe the present tax system, the problems that have arisen, and the efforts that are now being made to redress the situation.

The present tax system

The basic framework for taxation in postwar Japan was set forth in the recommendations of the Shoup Tax Mission. Headed by Dr. Carl Shoup, the mission submitted its recommendations to the Allied occupation forces in 1949. Despite the many changes in the Japanese economy and society, the tax system has remained basically unchanged for the last 40 years. As a result, a number of problems have arisen.

Looking at long-term trends since the Shoup Mission, Japanese income levels have risen sharply as a result of the rapid economic growth in the 1950s and 1960s and, at the same time, the income distribution has become more egalitarian. What has this meant for personal income taxes, the mainstay of Japanese taxation since the Shoup Mission's recommendations were adopted?

Even though the average burden itself is not all that high, middle-ranking salaried employees feel that they are heavily taxed. For example, workers commonly complain that even if they get a raise, their taxes also go up, with the result that they do not end up with as much more cash in hand as they expected. This is especially true of working people in their prime—people in their 40s and 50s—who have good incomes but, with the expenses of children and mortgage payments, do not feel they have much disposable income. These people are especially prone to feel that the personal income tax is oppressive.

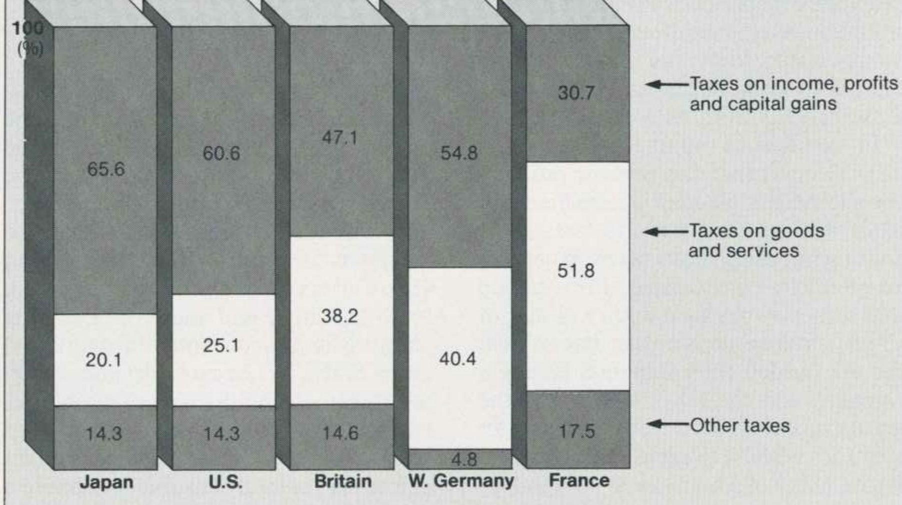
This would seem to indicate that the Japanese tax system's very progressive structure—tax schedules being far more progressive than in most other nations—is no longer compatible with the Japanese earnings structure. It has also been noted that there are problems in that the tax office is better able to track some kinds of income than others, with the suspicion that the easily tracked incomes are more likely to be taxed. This difference is particularly noticeable between salaried employees and people who are self-employed.

With the recent soaring of land prices and the steady value increases on the stock markets, there has also recently been heightened interest in how land, stock and other assets are and should be taxed. The feeling that assets are inadequately taxed is another source of dissatisfaction with the present tax system. There are also reverse problems with the inheritance tax. Inheritance tax rates have not been revised since 1975, and record land prices recently have resulted in strong calls for alleviating the inheritance tax burden.

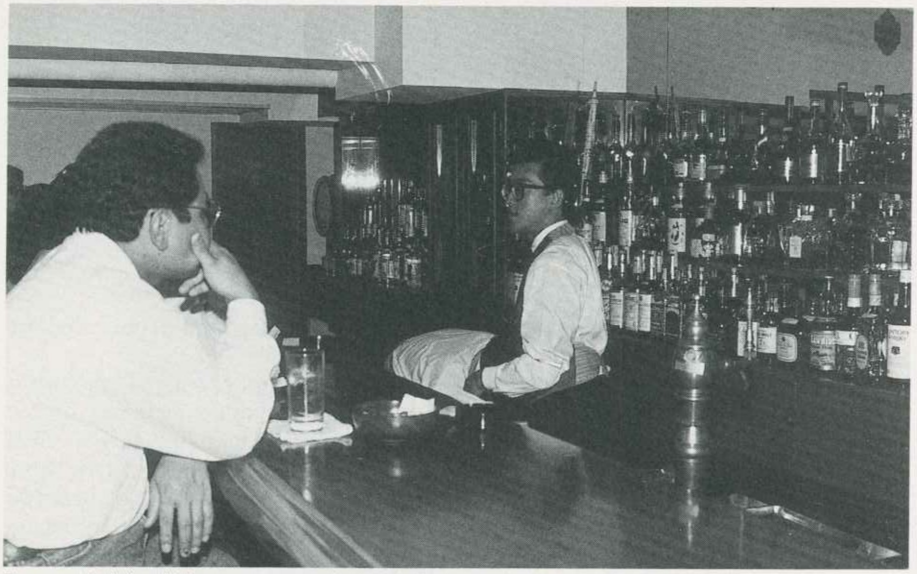
If things are bad on the direct taxation front, they are no better on the indirect taxation front. Japanese indirect taxation is today product-specific, levying taxes on particular products such as alcohol, tobacco and automobiles rather than across the entire spectrum of consumption. Yet most other countries have general consumption taxes on the total range of goods and services, and the Japanese product-specific system is very much the exception.

With the tax system levying specific taxes on specific products, it is very diffi-

Fig. 1 **International Comparison of Tax Revenue Structures (Including Local Taxes)**



Note: Figures for Britain are for CY 1985; all other figures are for FY 1985.



Taxes on alcohol and tobacco are among the main indirect taxes in the present system.

cult for the tax code to keep up with the rising tide of innovation and the flood of new goods and services that are available today. At the same time, as people's values change, it becomes increasingly difficult to gain a consensus on which products should be taxed and which products should be exempted. In this vein, it is noteworthy that the share of recreational services, telecommunications, transportation and other services in total Japanese consumption has become increasingly large. Today, purchases of services account for more than half of total consumption, but the present tax system levies very few taxes on such services.

Under the circumstances, the proportion of indirect taxes to total tax revenues has been steadily declining. Indirect taxation is supposed to be advantageous in imposing basically the same burden on everyone who has basically the same consumption level, regardless of where their money comes from, and in not damping the will to work, but Japan is not getting these benefits from its present system.

In addition, a number of countries have claimed that the present product-specific indirect taxation system discriminates against their exports because it ends up imposing heavy taxes on particular products. For example, it is assumed that someone buying a luxury (2-liter or larger) automobile is better able to bear the tax burden than someone buying a compact, and the tax is heavier on the luxury models. This creates problems for countries wishing to export luxury cars to Japan, many of whom—even though Japanese luxury cars are subject to exactly the same tax schedule—complain that the Japanese tax schedule is prohibitive for imported automobiles.

As the Japanese economy becomes more and more integrated into the international economy, the fact that the Japanese corporation tax rate is higher than that in most other countries also creates problems. Japanese corporation taxes have been raised a number of times since the early 1970s to provide the offsetting revenues needed to pay for personal income tax deductions, and the rate is today high by international comparison. As a result, there has been concern expressed that corporations may be forced to relocate to countries where the corporation tax rate is lower, and that the result could be to leave the Japanese economy an empty shell.

Toward a better tax structure

These problems and distortions in the present tax system are acutely reflected in the tax revenue pattern. When the Shoup Mission's recommendations were first introduced, direct taxes accounted for about 55% and indirect taxes about 45% of all tax revenues. With this division between direct and indirect taxes, the Shoup Mission concentrated mainly on direct taxes. Yet because Japanese indirect taxes are product-specific, and because the specific products that are taxed now account for a smaller and smaller percentage of total consumption, indirect taxes have come to account for less and less of total tax revenues. In fiscal 1986, for example, indirect tax revenues accounted for only 26.9% of tax revenues at the national level (Fig. 2).

Inverse to this decline in indirect taxes, direct taxes have naturally come to account for sharply more of total tax revenues. This is especially true because the income tax schedule is progressively structured, such that it automatically becomes increasingly important as time passes. Since there have been almost no major income tax cuts since 1975, withholding taxes on employment income have risen from 17.6% of total national tax revenues in fiscal 1975 to 21.8% in fiscal 1986. This is a major reason why people feel so overtaxed.

Projecting these trends into the future, what is the outlook? Extrapolating mechanically and assuming no changes whatever in the present tax structure, it is predicted that there will be a sharp increase in employment income taxes and inhabitants taxes. Assuming that Japanese national income grows 4–5.5% per annum, the gross tax ratio to national income will rise from 25.5% (budgeted for fiscal 1988) to 27.1–27.5% in fiscal 2000 and 28.1–28.9% in fiscal 2010. On the other hand, the ratio of employment income taxes to national income would go up from 4.8% in fiscal 1988 to 7.1–8.2% in fiscal 2000 and 10.1–13.1% in fiscal 2010.

Although gross taxation would only rise about three percentage points, employment income taxation would increase 5–8 points, becoming two or three times more than it is at present. What this means is that revenues from employment income taxes will increase faster than total tax revenues increase, thus reinforcing the impression that employment income is overtaxed.

The average age of the Japanese population is increasing at an unprecedented speed. Looking at the ratio between people aged 20–64 and those aged 65 or over, there are at present 5.9 working-age people supporting every old person. In 2000, this is expected to fall to 3.7, and in 2010 to 2.8. When this older population bulge is at its peak in 2020, it is expected that there will be only 2.3 working-age people for every old person, and Japan will have the most geriatric-skewed population in the world.

It is therefore inevitable, assuming there is no change in present systems, that there will be sharply higher expenditures for social security and other social welfare services. There seems to be no way to avoid an increase in the national tax burden (calculated by adding the tax burden ratio and the social security tax ratio). Unless something is done, the result will be an increasing burden on a proportionately smaller working population, resulting in further exacerbation of the feeling of being overtaxed and unfairly taxed.

There is a clear and urgent need to initiate radical reform of the present tax system if we are to redress these distortions and pressures. Given this, the next question becomes that of what kind of a tax structure would be desirable.

Any advantage argued for any tax can also be seen as a disadvantage from a different vantage point. This is inevitable. Yet for the tax structure to rely unduly on a few specific items is for the problems inherent in those taxes to be highlighted, for the structure to run counter to the overriding principle of fairness, and for the tax to thus have an adverse impact on the economy.

With the provisions for exemptions and deductions and with the progressive tax schedule, the income tax is structured so as to contribute to greater vertical equality among the taxpaying population. Because it relies on self-declaration for non-salary income, however, there is the possibility that different kinds of income may end up being taxed at different rates if, for example, one is underreported. By contrast, a consumption tax treats all taxpayers the same and makes it possible to exact basically the same tax from everyone who has basically the same level of consumption. As such, it is an excellent way to promote horizontal equality.

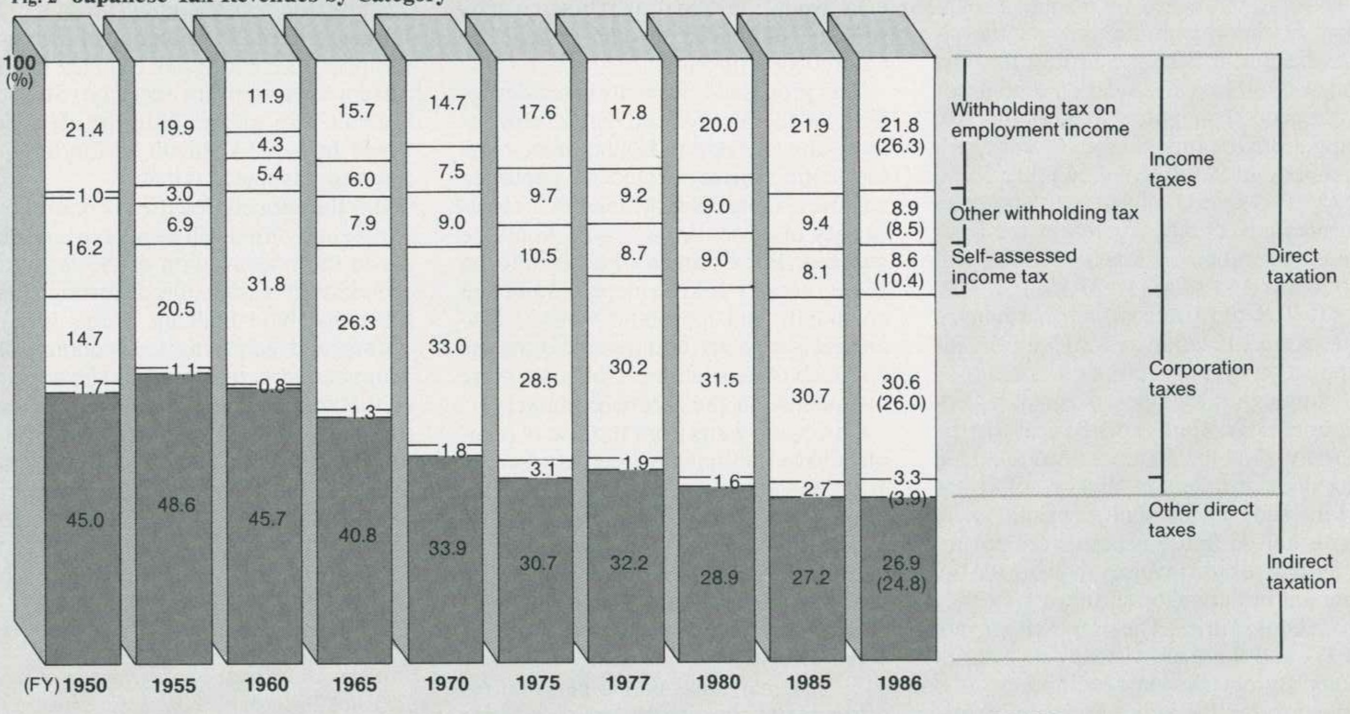
With the rising income levels and the increasing tax burdens of late, there has been increasing interest in achieving horizontal equality, yet as noted above, the Japanese tax structure has tilted sharply to taxing earned income and the entire tax structure has become less able to contribute to horizontal equality. This is another reason for the heightened feeling of being overtaxed.

Accordingly, while maintaining income taxes' pivotal role in the tax structure and taking measures to promote more equitable burden-sharing in these income taxes, the need to restructure the tax system so as to seek enhanced de facto burden equality makes it imperative that efforts be made to create a tax structure that all taxpayers can trust is fair and equitable by, for example, reducing income taxes, making the tax burden commensurate with consumption, and rectifying the asset tax burden.

The proposed reforms

Given these problems and this imperative for reform, the Japanese authorities have given long and hard study to the is-

Fig. 2 Japanese Tax Revenues by Category



Note: Figures in parentheses for 1986 are what they would have been had there been no changes in the tax system since FY 1977.

Middle-aged salaried workers complain that they bear an unfair tax burden.

sue of tax reform and come up with a tax reform bill embodying a number of important provisions. This bill is now being deliberated by the Diet.

(1) The first reform is to make the tax schedule less progressive and to increase the scope of exemptions and deductions, thus sharply reducing personal income and inhabitants taxes. At present, the income tax schedule is 12-tiered, with the graduations running from 10.5% to 60%. It is proposed to reduce this to five tiers running from 10% to 50%. Because this will be accompanied by a sharp expansion in the maximum income that is tax-exempt, it is expected that the vast majority of Japanese salaried employees will spend their entire lives at the 10% rung, from the time they go to work for a company until the day they retire.

(2) The second reform is to lower the corporation tax rate. At present, the Japanese corporation tax rate is 42%. This will be reduced in stages to 37.5%.

(3) The third reform is to rationalize the indirect taxation system with the introduction of a consumption tax.

Although the proposed Japanese consumption tax would work basically in the same way as the European value-added tax does, it differs in that an effort has been made to forestall any build-up of taxes and in that businesses are not required to submit invoices showing the tax amount but are allowed to work entirely from book entries. The proposed tax rate is 3%, and there are virtually no exemptions. By not allowing exemptions, it is hoped to tax the entire spectrum lightly and hence to achieve a fairer tax system.

This consumption tax would replace the present excise taxes, with their very high tax rates on specific products. For example, automobiles are presently taxed at 18.5% on the ex-factory price (the CIF price for imports). Under the proposed consumption tax, automobiles would be taxed at 3% of the retail price (6% as a transitional measure until March 31, 1992). This would mean a sharply lower tax. At the same time, the excise tax's differential treatment of luxury cars would also be abolished and all automobiles would be taxed at the same rate, which would have a favorable impact on automobile imports.

The proposed reform also includes reform of the alcohol tax. Under this reform, the ad valorem tax on brandy and top-brand whiskey would be abolished and the tax rate disparity for different categories of alcoholic beverages would be reduced. For example, the tax rate on *shochu* liquor would be increased and that on brandy and top-brand whiskey lowered. It is expected that these reforms will do much to make imported liquors more competitive in the Japanese market.

(4) Capital gains from the sale of securities have traditionally been tax-free, in principle, for individual investors. This would change, with the taxpayer able to select whichever of the following two formulas is more advantageous:

1) The securities company withholds 1% of the proceeds from the sale of the securities.

2) The individual files a personal return stating how much profit was made on the sale of the securities and these profits (capital gains) are taxed at 20%. If this format is chosen, the securities company is required to file information on the individual's trading with the local tax office.

At the same time, the securities trading tax rate will be sharply reduced.

(5) The reform also includes a doubling of the maximum inheritance value that is exempt from inheritance taxes, and this increased exemption would be accompanied by efforts to alleviate and rationalize the inheritance tax burden by, for example, revising the tax schedule.

Although the present tax reform bill would institute income tax and other tax reductions starting in 1988, the consumption tax is not scheduled to go into effect until April 1989. This timing difference represents a considerable bonus for taxpayers.

Even after the consumption tax is in place, it is expected that the total tax reduction from the lower income and inhabitants taxes, the lower corporation tax rate, the reduced inheritance taxes and the abolition of product-specific excise taxes would total about ¥9 trillion. In contrast, the revenue enhancements resulting from the introduction of the consumption tax and other changes in the current tax system are expected to be only about ¥6.6 trillion. Thus the net effect would be a ¥2.4 trillion saving for the Japanese taxpaying public.

It is thus hoped that the tax reform bill as now submitted will be able to contribute to the revitalization of the Japanese economy by easing the distorting pressures that have built up in the present system and achieving an economically neutral tax structure, and it is also expected that the net tax reduction will further stimulate domestic demand. According to Ministry of Finance calculations, the reforms should serve to boost Japanese real GNP growth about 0.2% over the medium term.

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