

Taxation Reform

– Raising Expectations, Inviting Disappointment –

By Tani Sadafumi

The direction of taxation reform has been set. On June 14, the government Tax Commission submitted a report entitled "Basic Policy Toward Creating a Desirable Tax System" to the prime minister. On June 13, the government's Council on Economic and Fiscal Policy (CEFP), which is headed by the prime minister himself, also presented a report entitled "Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002," which included taxation reforms and methods of financial administration. The two reports agreed in that they both advocated the principle of "wide and shallow" taxation. However, in respect to their basic stance on how to treat taxation to encourage economic revitalization, the reports served to highlight the difference of opinion between the head of the Tax Commission Ishi Hiromitsu (President of Hitotsubashi University) and private-sector members of the CEFP, including Honma Masaaki (Professor at Osaka University). As a result of the attention focused on this conflict of opinion, taxation reform, which should have been part of the economic measures to revitalize the economy, ironically pushed down share prices on the Tokyo Stock Exchange.

Japan's economy seemed to show signs of recovery at the beginning of the spring, and the government declared it had "bottomed out" in its May monthly economic report. The first "flash report" figures, published in early June, for real gross domestic product (GDP) for the January to March quarter indicated that Japan's GDP was up 1.4% on the previous quarter (corresponding to an annual growth rate of 5.7%). However, looking at the figures by demand category, while exports had grown 6.4% for the quarter, private-sector capital investment remained depressed, declining

3.2%. Individual consumption grew a tolerable 1.6%, but the severe employment environment is expected to continue, and the future is clouded with uncertainty.

In other words, recent data shows that Japan's economy is largely dependent on external demand and is not achieving autonomous recovery. The nation is still waiting for internal demand, supposedly the main engine of the economy, to ignite. Taxation reform is one way of developing an environment in which internal demand will spring to life.

The main content of the amendments to the tax system for the next fiscal year (April 1, 2003 to March 31, 2004) announced by Prime Minister Koizumi Jun-ichiro on June 7 were as follows. First, in regard to reducing tax: (1) a reduction in effective corporate tax rates, (2) lower taxes on companies' research and development (R&D) and investment spending, and (3) a reduction in the top rate applied to the inheritance tax and greater flexibility for making gifts before death. To this was added the governing party's secondary anti-deflationary measure of a reduction in real estate-related transfer taxes (including registration and license tax). On the other hand, the following measures are likely to lead to taxation increases: (1) revision of the deductibility of spouses and dependents (lowering the minimum taxable income), (2) adopting a tax based on the size of a business for the regional enterprise tax on corporations, (3) review of inheritance tax deductions (lowering the minimum taxable income from inherited property), and (4) a reduction in the so-called "ekizei" (profit taxes).¹ Among these amendments, the reduction in inheritance and gift taxes, the reduction in the real estate-related transfer taxes, and reduced taxes on R&D and investment are expected to be implemented

three months ahead of schedule, starting in January of next year.

The government is trying to coordinate this short-term revision of the taxation system with a middle-term view of the aging of society and the falling birthrate. That is, the reduction in the tax revenue accompanying the lowering of tax rates is intended to be offset by a broadening of the tax base, resulting in a wide and shallow tax base. Koizumi has restrained the ruling parties, which lean toward demanding tax reductions, by declaring that there "can be no tax decreases without a sufficient source of revenue." With this basic philosophy, there is no difference between the government Tax Commission and the private members of the CEFP. There is not a great deal of difference between the philosophies of Honma, who has taken the lead in the Council's arguments, and Ishi, head of the Tax Commission, which came up with the "Desirable Tax System."

The two have different views on whether the lowering tax rates to stimulate the economy will increase tax revenue. Ishi, who was asked to make a special appearance at the May 30 meeting of the CEFP, expressed his opinion that, in the tax reduction policies since the Obuchi government (1998-2000), the "shallow" tax base argument, in respect of income and corporate taxes, is already fait accompli. Honma demonstrated vehement opposition to this, accusing his adversary of "low goals." In respect to the theory that lowering taxes will later lead to increased tax revenue, Ishi believes that this does not actually happen in practice. On the other hand, in recognizing the importance of the reconstruction of public finances, the two share common ground, but in Honma's eyes, the government's Tax Commission is a mouthpiece for the financial supremacy advocated by the Ministry of Finance

The main points of next year's tax revisions

- A reduction of the effective corporate tax rate, i.e. introduction of a tax based on the size of a business
- A reduction of tax on R&D and investment spending
- The review of inheritance and gift taxes
- Reorganize deductibility for spouses and dependents
- Scaling back of the so-called "profit tax"

(MOF).

The opposing positions of the two were reported in the mass media on a chart as: government Tax Commission = higher taxes, CEFP = lower taxes. Looking back over the situation from the end of last year to the beginning of this spring, as the Koizumi government recognized it had been backed into a corner with popular support for it plunging, dangling the expectation of tax reform before the nation served a useful purpose. For politicians, it is natural that leading members of the governing parties, such as the Liberal Democratic Party's (LDP) Aso Taro, chairman of the LDP's Policy Research Council, make strong public assertions about moving toward tax reduction. However, as it sunk in that there was little likelihood of actually achieving major tax reductions because of the difficulty of coordination within the government, the disappointment was as strong as the expectations built up.

What has been discussed thus far is only the broad outline of tax reform. What actually determines the revisions of the tax system every year is the LDP's Research Commission on the Tax System. The following is a brief description of the main points of next year's tax revisions, which will be finalized between this autumn and the year end.

• A reduction of the effective corporate tax rate, seen as a pillar of economic revitalization, is being examined as part of a package including the introduction of a tax based on the size of a business. Currently, Japan's effective tax rate is just over 40%, when national and regional taxes are combined. This is about the same level as the United States (California). And this rate is heading down to between Germany's rate of just over 38% and France's of just over 34%. The amount of reduction will be offset by the implementation of the new approach where tax is calculated based on such criteria as the company's capital and number of employees. However, because this type of taxation will also be applied to companies which are in the red, the LDP, which has a powerful support

base among small and medium-sized enterprises, will not be able to accept it easily.

• The second main point is a reduction of tax on R&D and investment spending. The problem is what will qualify as R&D and investment, and the size of the reduction. The MOF wants to confine the reduction to such areas as information technology and the environment, and to maintain financial resources by abolishing or scaling back government tax reductions for existing companies. Currently, however, around ¥500 billion in proposed tax reductions is being held up by a variety of small items and there are interested parties at every turn. The problem is whether the government is able to summon the resolve to wield the hatchet.

• The review of inheritance and gift taxes aims to stimulate the economy by encouraging the transfer of assets before death from older people, with a comparatively high level of savings, to their children and grandchildren, who will spend and consume them. Japan taxes gifts and inheritances in each year they occur. This will be changed to a system that aggregates the amount gifted or inherited over a certain period as in the United Kingdom, Germany and France. The result will be a lowering of gift and inheritance taxation. But this will invite criticism of "special tax breaks for the rich."

• In reorganizing deductibility for spouses and dependents, the focus has been on bringing down the minimum threshold of annual income that attracts taxation from the current comparatively high level of ¥3.842 million. This has resulted in strong criticism, both from

the governing and opposition parties, of "picking on low income earners." In its report, the Tax Commission introduced three types of deductibility systems, but only got as far as calling for public debate and came to no conclusion.

• The necessity of a scaling back of the so-called "profit tax" has been pointed out for some time. For example, the level of annual sales below which vendors are exempt from submitting consumption tax to the government is ¥30 million. Compared to European countries, which pioneered value-added taxes, this is a very high level. From the viewpoint of consumers, it seems odd that the money they believed they paid as consumption tax should remain in the pocket of the vendor. The public would find it hard to agree to an increase in the consumption tax rate that would amplify this unfairness. By scaling back the "profit tax," the government is preparing the ground for a future increase in consumption tax. JTI

Note

1) Under the current system, businesses with up to ¥30 million in annual taxable sales do not have to pay the consumption tax, providing them with room to pocket tax they would otherwise have had to pay.

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