

A Taxing Situation: The LDP's Tax Reform Proposal

By Shigeru Saito

On December 23, 1986, the ruling Liberal-Democratic Party's Research Commission on the Tax System formally announced what may become the most sweeping overhaul of the Japanese tax system since the recommendations of the 1949 Shoup mission. Fleshing out the "Basic Directions for Tax Reform" announced on December 5, the "Outline of Basic Tax Reforms and Tax Amendments for Fiscal 1987" (Table 1(a) and (b)) takes its scalpel to the entire body of Japanese tax law.

Under the LDP's proposal, personal income and inhabitant taxes are to be cut (by reducing the number of tax brackets and lowering the top tax rate) and corporate taxes lowered (by lowering the effective tax rate) effective April 1987.

To make up for the lost revenue, the tax exemption on small-account interest will be eliminated for bank and postal savings accounts as of October 1987 and a sales tax (Japanese-type value-added tax) levied starting in January 1988. Although the corporate tax reductions will not be fully phased in until fiscal 1989, all other tax reforms will be operational by fiscal 1988, with transitional tax rates applied in the interim.

The fiscal 1987 economic impact

The tax cuts to be implemented beginning in April 1987 will total ¥1.74 trillion: ¥1 trillion in personal income taxes, ¥270 billion in individual inhabitant taxes and ¥470 billion in corporate taxes.

Since the proposed sales tax will not take effect until January 1988, it will gross only about ¥750 billion in fiscal 1987, approximately a quarter of the full-year figure. The other main revenue item, the

elimination of tax exemptions for interest income from small savings accounts to be implemented effective October 1987, is expected to bring in another ¥150 billion. Ordinarily, this would be expected to yield ¥1.6 trillion in the average full fiscal year, but revenues in fiscal 1987 are down because the taxes on savings account interest will not be withheld until interest payments are made.

Another ¥840 billion in tax revenues is thus needed in order to achieve a reve-

nue-neutral bill. The LDP believes this revenue can be gotten by eliminating the corporate exemption (thought to be good for ¥365 billion) on reserves set aside for bonus payments, by strengthening the collection of securities trading taxes and from other sources, although it is not yet clear how much revenue can be expected from each source.

Efforts are already under way to exempt some items from the sales tax, and a list of 44 tax-exempt items has

Table 1(a) Outline of Tax Cuts

	For fiscal 1987		For average fiscal year	
Income tax				
Tax bracket redefinition (now 15 brackets)	13 brackets		6 brackets	
Minimum tax rate (now 10.5%)	10.5%	¥600 billion	10%	¥1.5 trillion
Maximum tax rate (now 70%)	60%		50%	
Special deduction for full-time homemakers	¥125,000		¥150,000	
Allowing salaried employees to itemize business expenses		¥400 billion		¥400 billion
Increasing deduction for family members assisting self-employed professionals to ¥600,000 (up ¥150,000)				
Individual inhabitant tax				
Tax bracket redefinition (now 14 brackets)	10 brackets		4 brackets	
Maximum tax rate (now 18%)	17%		15%	
Special deduction for full-time homemakers (now ¥120,000)				
Increasing deduction for family members assisting self-employed professionals to ¥600,000 (up ¥150,000)		¥270 billion		¥800 billion
Raising deductions for self, spouse and dependents to ¥280,000 each (now ¥260,000 each)				
Corporate tax (including corporate inhabitant tax)				
Basic tax rate (currently 43.3%)	42%		37.5%	
Tax on profits paid as dividends (now 33.3%) to be eliminated; to be included in basic tax rate as of fiscal 1989	35%	¥470 billion	37.5%	¥1.8 trillion
		Total: ¥1.74 trillion		Total: ¥4.5 trillion

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been drawn up that includes foodstuffs, medical fees, educational costs, transport costs and capital gains on securities trading. In addition, businesses with annual sales of ¥100 million or less will not be subject to the sales tax system. (The sales tax that Prime Minister Ohira tried to introduce in 1979 would have exempted companies with annual sales of ¥20 million or less.)

Revenue-neutral results in fiscal 1987

Assuming that a revenue-neutral bill can be devised for fiscal 1987, how will this affect the Japanese economy? Negatively, for the most part. Growth in domestic demand as reflected in private consumption, housing investment and plant investment will actually go down,

although this will be largely offset by an almost equal decline in imports. As a result, there will be a slight slippage in real GNP growth (-0.05%). This sluggishness in demand will also mean slower growth in both production and corporate income. On the other hand, prices, both wholesale and consumer, are expected to go up.

Table 2 shows the likely impact on the Japanese economy, although it should be noted that this table ignores the impact of unquantifiable changes other than the proposed elimination of tax-exempt reserves for bonus payments and other corporate tax reforms.

In drawing up this table, it was assumed that the tax cuts would be worth ¥1.3 trillion in personal income and inhabitant taxes and approximately ¥100 billion net in corporate taxes, all to be effective starting April 1987. The tax increases that were assumed are ¥200 billion from the elimination of the interest-tax exemption on savings accounts (effective October 1987) and ¥700 billion from the new sales tax to be introduced in January 1988. As may be seen from these figures, the table assumes an actual tax reduction of around ¥500 billion.

Table 1(b) Outline of Tax Increases

	For fiscal 1987	For average fiscal year
New sales tax (as of January 1988) 5% tax rate Companies with annual sales of ¥100 million or less to be exempt 44 commodity and service items to be exempt	¥750 billion	¥2.9 trillion
Elimination of all tax exemptions on bank and postal savings account interest (as of October 1987) 20% tax rate (total for national and local taxes) Continued exemption for elderly people and fatherless households	¥150 billion	¥1.6 trillion
Elimination of exemption for corporate reserves set aside for bonus payments	¥365 billion	
Strengthened collection of securities trading and trading income taxes	¥130 billion	
Increase in property registration tax	¥150 billion	
Reduction of exemption for profits from sale of business assets	¥50 billion	
Stiffer taxes on short-term real estate trading income	¥40 billion	
Closing loopholes on asset formation funds and other financial instruments	¥10 billion	
Tax on unreasonable salaries paid by de facto corporations	}	amount unknown
Raising minimum medical costs before deduction is allowed to ¥100,000 (from ¥50,000)		
Strengthened collection of securities trading tax		
Total: ¥1.74 trillion		Total: ¥4.5 trillion

Lag helps GNP growth

Based on these estimates, real GNP growth is expected to be 0.18% higher in fiscal 1987 than it would have been without any tax reform. Growth in private consumption, housing investment and other factors will push domestic demand growth up 0.12%. The impact is especially strong in housing investment, which is expected to enjoy 1.02% better growth. Increased domestic demand should help to boost production growth by around 0.24%, which will in turn improve corporate income levels and encourage greater plant investment. Although the sales tax will cause both wholesale and consumer prices to go up, they should rise by no more than 0.4-0.5%.

Because the tax cuts will be in place well before the tax increases start to hurt, it should be possible to encourage greater growth in domestic demand, with a particularly strong surge in individual housing investment. If the government insists on enacting a bill that is revenue neutral in fiscal 1987, the results will be generally growth adverse. This is especially true in light of the price hikes triggered by the proposed sales tax. Accordingly, the fiscal 1987 emphasis should be on easing the tax burden and encouraging the steady growth now under way in domestic consumption.

Table 2 Expected Effects of the Tax Reform

(unit: %)

	Fiscal 1987			Income tax cuts	Corporate tax cuts	Indirect (sales tax) increase	Elimination of tax-exempt savings accounts
	1st half	2nd half	Total				
GNP (nominal)	0.08	0.82	0.48	0.21	0.00	0.29	-0.02
GNP (real)	0.10	0.23	0.18	0.25	0.00	-0.04	-0.02
Domestic demand							
Private consumption	0.13	0.09	0.11	0.26	0.00	-0.12	-0.04
Housing investment	0.46	1.58	1.02	1.16	0.00	0.00	-0.13
Plant investment	0.10	0.40	0.25	0.30	0.00	-0.03	-0.03
Total	0.12	0.12	0.12	-	-	-	-
Imports, etc.	0.09	-0.69	-0.33	0.25	0.00	-0.56	-0.03
Consumer prices	0.00	0.94	0.51	-0.06	0.00	0.56	0.01
Wholesale prices	0.00	0.96	0.44	0.00	0.00	0.43	0.00
Mining and manufacturing production	0.11	0.52	0.24	0.32	0.00	-0.05	-0.03

Note: Percentages indicate differences in growth rates that can be expected with the implementation of tax reform.