Taxation In Japan Essay, Research Paper

The role of taxation in the transformation of the Japanese

Economy Introduction Before the Meiji restoration under the

feudal Tokugawa Shogunate, taxation was mainly a tool for

warfare and military power. The system was highly

regressive and pressed lightly on the rich and profit-earners.

It was calculated to preserve a very unequal distribution on

incomes and to stimulate the accumulation of private capital.

This tendency somehow continued and was magnified before

W.W.II when direct taxation was introduced for a more

equal and balanced system. However, the Meiji restoration

did bring with it tremendous changes to the tax system and

the use of the revenues. The Japanese government has since

had an active participation in the economy, yet not

controlling it directly but rather through market mechanisms.

It took responsibility for promoting economic growth by

using incentives and taxes collected in an effective way. The

often cited goal of taxation in western countries that was

equality was often sacrificed for the goal of economic growth

in order to prevent being colonized, then to pursuit the desire

to become an imperialist nation and then for pride and

export. The role of government and its fiscal policies played

an important role in the transformation of the Japanese

economy through the periods of Meiji restoration, before

W.W.II and post W.W.II period where taxes respectively

shifted from land taxes to internal indirect taxes to income /

direct taxes. (Fig 1) Period of Meiji Restoration During the

first years of the Meiji reforms, the government had serious

financial difficulties with tax revenues inadequate for its

massive commitments. In 1873, land reforms gave tittles to

landowners and customary tenants, freed the transfer and

sale of land from feudal restrictions and imposed tax

obligations equal to 3 per cent (which was lowered to 2.5%

in 1878) of the value of land. In addition a 30% local surtax

was imposed on the land taxes. These heavy land taxes were

used to provide monetary compensations to the old ruling

class for the termination of their feudal incomes in kind and

to finance the new administration which introduced new

education and to support its military. The agricultural sector,

and in fact the peasants, therefore bore the great bulk of the

cost to Japan’s modernization. The land taxes contributed to

over 70% of the central government’s revenue during the first

decade of the Restoration. Since the capital needs of

agriculture were small even after the landlords devotion to

the improvement of agricultural techniques and introduction

of winter drainage, the increasing savings and surplus of

landlords were transferred out of the primary sector into

other sectors. The fiscal system as a whole was heavy in

absolute terms yet highly regressive. The burden was

constantly on the agriculture sector, even when

non-agricultural sectors were growing at a phenomenal rate.

As seen in Figure 1, under indirect taxes, before the turn of

the century, the excise taxes played a prominent yet second

to land taxes at about 20% of the government’s total

revenue. These included taxes on soya, sugar, textiles and

government monopoly profits in tobacco, camphor and salt.

The combined effect of the land taxes and consumption

taxes was heavy taxes on both peasant and consumer and a

lighter burden for the landlord and industrial-merchant

classes. The income tax did not appear until 1887 and the

business tax which was the corporate tax did not come into

effect until 1896 and at a low flat rate of 3%. The result was

the subsidizing of the manufacturing and service sector at the

expense of the primary sector. To strengthen the incentives

for reinvestment and accumulation of productive wealth was

strengthened by the absence of inheritance and real estate

taxes before 1905 and a relatively low rate thereafter. The

role of the family and the firm that existed also as a closely

bound unit also made the saving, transferring form generation

to generation and development favorable. Therefore, the

Zaibatsus, the conglomerate oligopolies could charge

monopoly prices and concentrate on exports. At this time,

between the 1870-1900, there was the traditional export

expansion of silk and other produces, coupled with mild

primary import substitution. Tariffs and revenue on foreign

trade were also low at the time due to the fact that the

Japanese government was under the influence of foreign

countries and autonomy of tariffs was not until 1899.

However, this tradition had little change even after the

gradual regaining of autonomy. This was a very different

from the path followed by other developing countries which

usually place heavy taxes on trade because they are the

simplest and easiest form of taxation. Japan, by not following

the easy path and concentrating on export substitution and

land taxes for internal revenue creating a thriving export of

primary goods before the 1920s. Period before W.W.II The

era of the land taxes ended in 1908 and was followed by

indirect taxes, mainly on alcoholic beverages and tobacco. It

was not until 1935 that income taxes on individuals and

corporations became the most important source of total

revenues. The modern tax form only took form in the 1940

to prepare for the wartime economy, the whole tax system

was thoroughly overhauled to base on direct taxes. The

individual tax was a scheduler tax, under which different

sources of income were levied by different tax rates. It was

supplemented by a progressive comprehensive tax which

applied to an individual’s aggregated income above a specific

amount. On the other hand, the corporate income tax was

imposed on corporate income at a flat rate of 18%. The

commodity tax was introduced in 1937 mainly to collect

revenue for wartime expenses, and the tax on alcoholic

beverage was also simplified in 1940. The relative share of

indirect taxes fell as a result of the tax reforms. The 1940

reform also separated the personal income tax from

corporate income tax. This period saw the rise of the power

of the military in the government and influence after the

winning wars of the Sino-Japaneses and Russia-Japanese

earlier in the century and the ailing and corruption of the

civilian government. The government was engaged in

continuous military activities and was penalized with

increased tariffs. However, due to expansion of its own

empire and influence which included Taiwan and Korea,

export suffered little and actually had a 70% increase in

volume between 1929 and 1937. This period also saw

heavy taxes and direct investment of government in industries

resulting in rapid growth of war related industries. This

period ended with the GNP declining from 1939 and 1944.

The tax system became the tool for direct financing in this

period. The military drove the economy and accounted for

27.98% of GNP by the second world war which could be

said as the grand continuation of the feudal Tokugawa

Shogunate military expansion policies. Post W.W.II With the

occupation forces lead by the United States taking over the

government, reforms were held on all aspects of the

government. Immediately after the war, the scheduler tax on

individual income was replaced by a unified tax on an

aggregate basis with graduated tax rates. In order to collect

necessary revenues, a 1% turnover tax was levied on the

basis of the sales amount at every stage of transaction. As

for the long term tax system design, it was also based on the

US system but was also an experimental ground for the

Shoup Mission which was a pioneer in many aspects of the

direct tax. The Shoup reform in 1949 was not the first

reform after the war to the chaotic after-war tax system, but

it has had the most lasting effect on the development of the

Japanese economy. The Shops Report tried to build a

progressive direct tax based tax system with local autonomy

and simplicity that would be permanent and stable. Indirect

taxes were not recommended due to the inequality among

the tax payers, dull the sense of civic responsibility and make

local governments uneasy. However, the Japanese

government regained autonomy during the Korean war and

made modifications such as the resuming taxation at the

national level and sacrificing equity which Shops put at the

utmost priority for convenience of efficiency and

administration. The burden on firms, especially big business

was lowered. This was to give priority to the restoration of

the postwar economy and the promotion of capital

accumulation. Capital gains tax was abolished, under the

missions guidelines and this had a effect of the promotion of

capital accumulation as a national goal. Although partially

successful, the Shoup plan broke away from the military

roots of the Japanese tax system and engaged in a

responsive tax system which was in touch with the economy.

The four major taxes, income, corporate, accession and

consumption taxes all varied to different degrees from the

Shops Mission. However, the four taxes have been

remarkably stable in structure since 1950. The global income

tax system proposed by Shops was modified to a

combination of a comprehensive tax and a scheduler tax.

Instead of aggregating most incomes with progressive tax

rates, some incomes such as capital gains or interest income

were now subject to income taxation or were taxed at

reduced flat rates, separate from other incomes. These tax

concessions were intended to stimulate savings and income

and to improve the welfare level among specific taxpayers.

As for corporate income taxes, a split-rate system rather

than a uniform one in which a single rate is imposed on a

whole corporate income. This was similar to the one used in

West Germany in which retained profits and dividends were

taxed at different rates. Numerous tax measures have made

the corporate income tax extraordinarily complicated. As for

the accession tax on transfer of wealth proposed by Shops

Mission was replaced by a combination of inheritance and

gift taxes. Consumption taxes, in contrast to the general

modification of direct taxes remained unchanged since the

Shops Mission and there has been no general consumption

tax in Japan until April 1989. Therefore, Japan depends its

revenue from taxes on income and corporate income taxes,

which is the highest among OECD countries. Social security

contributions which are equivalent to payroll taxes also play

an equally important role in the raising of taxes. Japan is also

the only advanced country that does not impose a general

consumption tax. In 1985, of the total tax revenues collected

in Japan, 45.8% came from individuals and corporate

income taxes, 30.2% from social security contributions, 14%

from taxes on goods and services, 8.6% from property tax

and 1.1% from inheritance and gift taxes. Before the 1973

oil shock, the government engaged in a tax system with

incentives to promote exports, private savings and

investment, housing and technological development to

promote economic growth. These measures were included in

the Special Tax Measures Law and was formulated to

prepare a list of most of the incentive provisions applying

mainly to individual and corporate income taxes. As seen in

Figure 2 and Table 1, the corporate revenue lost to these

special tax measures but declined in importance after the mid

-1970s. The special tax measures was around 12.6 and

13.2% of total income tax revenues in the late 1950s fell to

8-9% in 1961-1962 then rose to 12% in 1965 and then

gradually declined to 5.0% in the early 1980s. The special

measures could be classified into tax exemptions and credits

and tax deferrals like accelerated depreciation and tax-free

reserves. These exemptions targeted specific industries such

as steel and machinery and also developing technological

innovation. The six main objectives of the tax incentives are

outlined the Ministry of Finance (MOF) as promotion of

saving; promotion of environmental quality and regional

development, promotion of natural resources, promotion of

technological development and modernization of industrial

equipment, strengthening of the financial position of firms and

other incentives. As seen in Table 2, the greatest decline in

importance is promotion of export and foreign investment

which included special deductions of export income from

taxation and accelerated depreciation for export orientated

firms. However, this is still an understatement of the

magnitude of tax incentives due to hidden incentives that are

not included by the MOF in special tax incentives. Firstly,

there is the provision for capital gains, interest and dividends

as part of the basic income tax law. Second, the

fractionation of individual income tax into separate classified

taxes loses a great deal of revenue and greatly reduces the

progressivity of the nominal rate structure, particularly at the

top brackets. Third, business expenses as special

depreciation accounting and deduction for part of social and

entertainment expenses are also not included. Fourth,

housing subsidy and low interest loans to executives are not

regarded as special tax measure. Fifth, the official estimate of

revenue is constantly low, so therefore, the special tax

measures are estimated low. Another feature of the Japanese

growth economy was the annual tax-cutting policy due to the

fact that GNP rose by an average of 15% a year between

1950 and 1960. The reason for the annual cuts were due to

the fact that Japan had a highly elastic income tax reaching

2.0 in the 1960s meaning that for every 10% growth in GDP

that would be a 20% growth in revenue. The Japanese

government did not use the money in the expansion of

government or counter-cyclical to obtain stable growth.

Social welfare was also limited for the insistence on

investment into growth and export. The tax cutting policy is

to keep the revenues to national income constant at around

20%. This was maintained between 1955 to 1965. This was

targeted at the individual income tax while both corporate

income tax and indirect taxes showed varying changes over

time. Corporate taxes increased much more frequently while

indirect taxes were raised to adjusted for the rise in

commodity prices. The result of the tax cutting and keeping a

lid on the growth of the public sector coupled by the lowest

expense on defense in the developed country was the lowest

tax rates in the developed country. Therefore, this permitted

the rapid increase in private demand. As mentioned above,

the tax system stresses simplicity instead of equity with the

result of benefiting business and professionals rather than the

employee. First, the Shops Mission suggested the "blue

return" system which is a self-assessment income tax for

small to medium size businesses. The benefits of the blue

return include basic deduction for blue return, special

deductions for wages of family members working in the

same company, and special tax-tree reserves for employees’

retirements, allowance for bad debt etc. These special

treatments reduce the tax burden of the family small business

firms. Secondly, there is the issue of withholding tax system

for wage and salary incomes. More than 80% of individual

income tax is withheld at the source. Although withholding is

applied to interest, dividend, and other income, the largest

portion of withheld taxes relate to employment income. As

seen in Figure 3, the income of salary earners is almost fully

identified by tax authorities while self-employed and farmers

have much an advantage in taxable income. This is often

referred as the "ku-ro-yon", 9-6-4 ratio of salaried workers,

self-employed and farmers. The third issue is the anonymous

and fictitious accounts. Banks accounts could be opened

with seals rather than signatures and banks make no attempt

to identify the seals. By creating a number of these tax-free

treatments, the wealthy was able to abuse the system.

Therefore, although the tax system structure was not

prominently regressive, the legislative side make the

wage-earners pay a higher price of taxation for the reason of

simplicity to businesses as proposed by the government. Tax

Structure and Economic Development In the period since

the Meiji Restoration, there has been government transfer

and tax incentive from the peasant and wage earners to

business to stimulate growth. Japan has had phenomenal

growth in the past hundred years, however, the question is

that if there is a direct relationship between tax structure and

economic development. In Table 3, y/N stands for per

capita real GNP with N as the total population, Ag/Y is the

agricultural products’ share in GNP with Ag as the output of

the primary sector, M/Y or (M+X)/Y as the openness of the

economy where M and X stand for import and export

respectively. As seen in Table 3, there is a significant

correlation between y/N, Ag/Y and T/Y between

1885-1944. Before the war, the agriculture sector still

played an important role in taxation structure. This is often

referred to as the dual sector and where the taxes in the form

of land taxes were charged heavily in taxation. There is also

no correlation between the postwar period of 1951-86 but

y/N and T/Y are still significantly related. As from

1951-1986, openness provides a better index than the other

two variables mentioned 25 years before the prewar period,

and it becomes even more significant in explaining T/Y for

the postwar period. Therefore, there is a correlation

between the openness of the economy, which is imports and

exports and the taxation structure. However, one could

emphasize the passive nature of the evolving tax system , in

which one could even say that the major determinant of tax

structure change is the structural change in the economy itself

during the process of economic development. When we

consider Table 4, where Tl is land taxes, Ti is indirect taxes,

and Ty income taxes on individual and corporate income. It

shows the relationship (R2)that land taxes made up the

principal shares revenue in 1885-1898 while indirect taxes

made up 1899-1935 and incomes taxes from 1936-86. This

proves the time division as mentioned above. However,

more importantly, as y/N increases, Tl/Tn and Ti/Tn

decreases. The relative importance of land and indirect taxes

faded when growth increased. As for the openness (M/Y or

(M+X)/Y) can be explained from the opposite signs in Ti/Tn

before and after the war (3.101 to -1.808). The negative

correlation after the war showed that openness was no

longer effective in increasing the indirect tax base at this level

of economic development and that the declining importance

of indirect taxes happen to have a close bearing with the

openness in a growing economy. That leaves us with Ty/Tn

dominantly affected by y/N, with the relative share of income

taxes rising in the course of development. The supply-side

point of view emphasizes the link between savings and

investment with I=S+(T-G) with net export as zero. As taxes

revenue were greater than government expenditures before

1975, investment from saving could be maximized. With net

exports as positive, it would also help on investment in the

country. As seen in Table 5, there was constant government

surplus before 1975. Therefore, it was only 1975, that the

government could continue the role using taxes to promote

investment and growth. As deficit grew, it would eat into the

savings and therefore investment. This was also the

tax-cutting policy which was before 1975 to prevent the

overburden of the tax payer with their high elasticity of

personal tax revenue. The growth can be shown using the

formula k=sx-(n+d)k which means for an increase in capital

stock savings has to be larger than depreciation. The

Japanese government promoted savings through tax cuts and

tax incentives and also allowed increased depreciation under

tax laws more rapid growth. Studies of the impact of the

special tax measures on Japanese economic growth are, for

the most part, inconclusive. There is virtually no relation

between the special tax measure to promote household

savings and the rate of private savings. Many of the special

tax measure were used in industries that were not regarded

as strategic from the standpoint of growth, such as the textile

industry which received favorable treatment but grew

relatively slowly. As mentioned above, though, the initial

depreciation allowances were used widely for expansion and

modernization in such strategic industries as steel and

machinery. Therefore, except for the stimulus in these

industries, the special tax measure did not have a substantial

effect on investment and growth. Although the tax system

and its effect on the economy is inconclusive, tax system may

affect economic activity in several ways. First, fro business

and managerial incentives, the regular salary earners with tax

withholding has a fully taxable income. As for the business

innovator and risk taker, the rewards are scarcely taxed by

the tax system which permits the tax-free accumulation of

capital gains and requires only modest tax payments on other

property incomes. As for management incentive, the typical

manager obtains his satisfaction through prestige of job,

expense of account which is often easily deductible under tax

laws. Implicit tax exemption fro unrealized capital gains

derived from undistributed corporate earnings permit the

manager to accumulate large amount of corporate wealth.

Second, the effect on economic stability, Japan with its high

elasticity on income taxation could be used for the stabilizing

effect of the economy to cushion the economic bumps.

However, the Japanese government has reduced the tax rate

and used monetary policy for short-run stabilization. As for

the effects on saving and investment, gross savings increased

from about 25% of GNP in the mid-1950s to about 40% in

the 1970s. Increase of the stock of capital is important for

growth because it raises productivity directly and permits the

adoption of newer and more efficient technologies. The

national budget with its surpluses added to the national

saving and helped to provide the margin of resources needed

for the production of large and growing volume of investment

good. Government savings also averaged above 40% of

private savings even with the annual tax reductions. This was

due to the systematic underestimation of tax revenues. The

policies to promote private investment such as accelerated

depreciation makes bankers more willing to make loans.

Therefore, the tax incentives made have had an indirect

effect on investment and growth. Finally, the simple fact that

the low tax rate in Japan may be the prevailing explanation

for the high rate of private saving and investment in Japan.

Other Determinants of Tax Structure Development and

Growth The military factor before W.W.II and after was

reduced drastically to less than 1 % of GNP. Before the

W.W.II the figure was around 28% of GNP. This is low in

international comparisons of military expenses-GNP ratio

where it is 6.3% in the USA. Japan has a low level of

welfare commitments. The average transfer payments to

national income in 1961-1970 in various countries was

20.8% in France, 7% in USA with 5% in Japan. By 1984,

the US ratio grew to 15.1% while France went up to

35.2%, in comparison with Japan’s 14%. Another factor is

the savings in Japanese thriftiness. Even at high direct

taxation on the wage earner, the average saving rate was still

between 25% and 40% GNP. This started since the Meiji

Restoration with moral suasion from the government with

slogans like "Let us avoid all luxuries so that we keep up

with the world; truly the development of our national

productive strength has its roots in reverent obedience." This

was coupled with the favorable inheritance tax laws and

capital gains law that made accumulation of wealth feasible

and worthwhile to the family centered Japanese worker.

Future of Tax System in Japan As seen in Table 5, huge

deficits arose since 1975 from the first oil shock and

accelerated due to the second one and amounted to 4.4 %

of the GNP in 1979. This has caused more alarm compared

with other countries with similar levels of debt. The

government was no longer able to cut taxes on personal

taxes and government incentive programs because of their

large losses in tax revenue were cut (Table 1). On top of the

economic repercussions, the original tax system was

repressive and unjust for the stress on simplicity. In 1989,

the Value Added Tax (VAT) was added as the consumption

indirect tax after almost ten years of debate at 3%. Reform

was necessary for between 1975 and 1984, the tax burden

rose sharply in Japan with central government taxes up by

4.1% and local taxes by 2.7% taxes. The dissatisfactions

could be categorized in the difference in tax burden among

taxpayers in which the tax ratio was "ku-ro-yon", 9-6-4 ratio

among workers, self-employed and farmers. Mismatch

between the wage system and income tax structure in which

the wages rose with seniority and taxes also increased

steeply where the middle class need it the most with the

children’s education or for a residence. Therefore the

progressiveness of the income tax for middle-class salaried

workers is too high. The unfairness in taxation on capital

income, as mentioned above is major source of savings and

investment but also is a source of inequitable tax system and

behind the massive account surpluses. The heavy corporate

tax burden which has risked dramatically since the 1970s

have caused much complaint. The outdated indirect taxes

which pose no tax on service is a failure to reflect the

changing consumption patterns. The standard procedure for

the tax reform is to reduce marginal tax rates by broadening

the tax base with the introduction of indirect consumption

taxes. It is also a cheaper and more effective way to

stimulate savings for consumption tax does not tax savings

instead of using special tax incentives. The reform is also

necessary in view of the aging population and its need for

larger social security . Tax preferences for expenses and

depreciation allowance should be reduced to reduce the loss

in tax revenue. A comprehensive tax system will not only will

achieve what Shops Mission’s real goal of tax equity but also

ensure the future mature growth of Japan for with a large

deficit, the previous tax provisions and incentives can no

longer be continued. Japan’s tax system is still midway

between a comprehensive income tax and an expenditure

tax. Change is necessary, but the role of government and

taxation still pose many hard decisions to politicians.

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