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ECONOMIC AND ELECTORAL EFFECTS OF JAPANESE TAX REFORMS: A HISTORICAL OVERVIEW*

Seiji FURUTA

Abstract: This paper reviews changing patterns of Japanese tax systems from the end of the last century to the present, and examines in particular how the government did fail so many times to introduce general consumption tax into national or local tax systems from 1936 to 1986.

The Japanese government finally succeeded in introducing Consumption Tax of accounts method in 1989, a product of compromise between economic and electoral forces. Political and administrative inequities in Japanese income tax are also investigated.

[1] *Objectives of the Tax Reform*

(i) Changing patterns of tax system

Almost all tax systems in the world tend to go out of date. Japanese tax system is not an exception to this rule. Economic and social conditions change. Therefore, a tax structure which was right for one situation may become quite inappropriate for later conditions.

For instance, after the Meiji Restoration (1868) when Japan emerged from feudalism, the Japanese tax system relied mainly upon land tax as a source of government revenue, yielding more than 80% of the total tax collection. But, rapid development of the capitalistic economy in the Meiji Era brought about a gradual change in the tax system.⁽¹⁾

Excise taxes, of which liquor tax was the most important, expanded more than land tax. At the end of 19 C., the liquor tax revenue finally got ahead of the land tax.

As the modern tax system developed in Japan, however, income tax which had been introduced in 1887 continued to increase the revenue steadily.

In 1918, the income tax became the most important tax from the revenue point of view. This tendency lasted until 1940, when as a result of an overall tax reform the income tax system was expanded and the land tax decreased its importance.

Owing to the tax reform, the income tax was divided into (individual) income tax and corporation (income) tax.

In 1949, a mission led by Carl S. Shoup, Professor of Economics at Columbia University, was sent to Japan to help reform the tax system. Prof. Shoup placed direct taxes, in particular income and corporation tax, in the center of the whole tax system.

The last half of the 1950's observed a remarkable development in the Japanese economy. The revenue gains resulting from the economic growth were so enormous

that annual tax revisions were designed to mitigate autonomously increasing burden of income taxation. As a result, the share of corporation tax revenue in the total national tax revenue reached its peak in 1957 and kept its position for the next 10 years.

In 1965, when the economy was confronted with recession, the government changed its fiscal policy radically to reflect the new economic conditions. Since the end of the war, there was no new flotation of government bonds for general revenue purposes. Hereafter, fiscal policy shifted from one of maintaining a balanced budget to one of deficit financing through government borrowing. This helped the economy quickly recover from the recession by spending on public works in 1966.

During the 1970s, the Japanese economy slowed down its growth rate. The breakdown of the Bretton Woods monetary agreement and the two oil crises caused severe changes in Japanese economy. An economic recession occurred in 1975, causing a decrease in tax revenues. The government again issued deficit-covering bonds to make up the deficit, with money spent not only public works but also on personnel expenses.

At this time, however, Japan became one of the top major economic powers. Like the United States and Australia, Japan places heavy reliance on individual and corporate income taxes and eschews a broad-based consumption tax. But, as will be argued later, the need to introduce a general consumption tax was increasing during this period.

(ii) Needs for reform

The successive cabinets of the Liberal Democratic Party, which have sought to broaden consumption tax bases for a decade, have explained repeatedly that there are three main reasons why the general consumption tax is necessary.⁽²⁾

First, the cabinets stressed their heavy reliance upon direct income taxes for budget revenue which were placing a tremendous burden on Japanese income taxpayers and corporations. It is often pointed out that the ratio of direct to indirect tax must be altered from the present 7.3:2.7 to 6:4. If the tax system keeps as it is, the ratio will become "worse" such as 8:2 because of high income elasticities of income taxes. The general consumption tax can help take over some of that burden. This, the cabinets explain, should mean a "better balance" between direct and indirect taxes.

Second, the general consumption tax is a necessary preparation for the occasion a few decades from now when Japan will have one of the most aged societies in the world. Economic specialists predict that by the early 21st century, a large proportion of Japan's population will be receiving government pensions and paying no income taxes. Without drastic tax revisions, Japan would be confronted with difficulties in supporting retirees, and the tax authority consider it virtually impossible to meet the challenge by further raising the already high income tax rates.

Third, it is often maintained that the general consumption tax should promote

greater equity among taxpayers. At present, a lot of medical practitioners, farmers, shopkeepers and other self-employed people escape out of the tax collectors' net, paying considerably less tax than most wage earners subject to with-holding income taxes. If the general consumption tax is introduced into the system, even those who have escaped the income taxes are bound to pay the general consumption tax in so far as they consume.

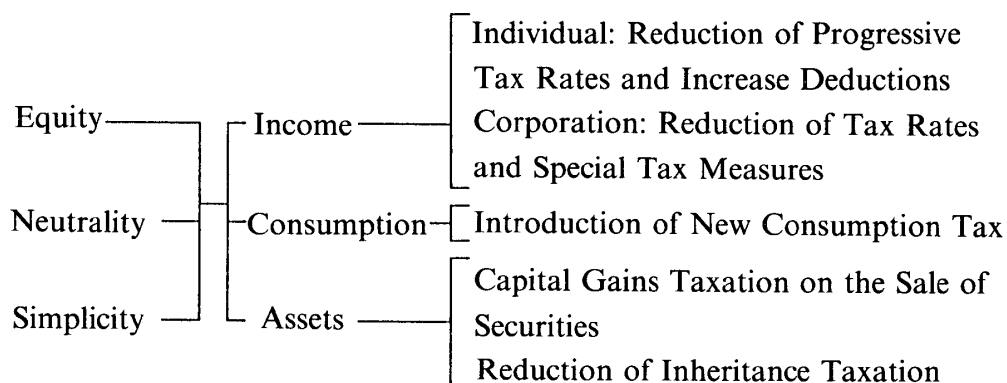
Thus the most important target of the recent trial of tax reform was placed on the introduction of general consumption tax.

(iii) Tax reform in 1989

A Tax Advisory Commission established in 1955 to assist government tax policy submitted a draft report on fundamental tax reform in May 1988. The report begins by noting that the fundamental tax reform is one of the most important national problems. The draft report is based on the principles of fairness, neutrality and simplicity as useful foundations for building an ideal tax system. The objective of tax reform is to construct a stable tax system with a balanced burden of taxes on income, consumption and assets designed to alleviate feelings of unfairness maintained by taxpayers at large.

In the case of income tax, it was argued that progressive tax rates should be reduced. In addition, it was recommended to increase four kinds of deductions such as special deduction for spouses. It was also proposed that corporation tax base should be boadened and this was combined with a reduction of its tax rates in order to keep up with international development in this field. The outline of tax reform in 1989 can be briefly summarized as follows.⁽³⁾

Outline of Tax Reform in 1989



We shall not get into the detail of the tax reform in 1989, but it may be useful to point out its outstanding features against the background history of Japanese tax reforms.

First, the tax burdens of middle class salary and wage earners are reduced considerably through the simplification of income tax brackets.

Second, caital gains on securities were exempt from income taxation in principle,

but are now taxed as a rule.

Third, tax exempt-items of consumption tax were limited to minimum essentials so that the tax became a “true” broad-based consumption tax.

Compared with the earlier attempts of tax reforms hitherto, the tax reform in 1989 may be considered as a step forward to an “ideal” system of taxation.

[2] *General Consumption Taxes (GCT)—Past and Present—*

In looking back over the history of GCT in Japan, we can trace it back to the pre-war period. The Japanese government tried to introduce general consumption taxes into the national and local tax systems 5 times since 1936.⁽⁴⁾

(i) Turnover tax—the first trial in 1936—

In order to finance the Sino-Japanese War, the government announced the introduction of turnover tax (paid each time a commodity ‘turn over’ from one firm to another) in 1936. The cabinet of the government, however, resigned just after the announcement of the introduction. Therefore, the first trial of tax reform on GCT failed.

(ii) Turnover tax—the second trial in 1948–49—

After the War, the Japanese government won success in introducing the turnover tax as an important part of the national tax system. This tax was the GCT Japanese people experienced for the first time. The tax was the so-called cascade tax imposing a tax on a tax for every stage of transactions. Exempt transactions include food, agricultural products, rent, exports, water services, text books, securities and so on. Tax rate was 0.1 percent for each transaction.

The tax was promulgated on 1 July and enforced on 1 September 1948. The tax raised revenues of ¥33.7 billion which amounted to 6.6% in total of national tax revenue in 1949. The tax, however, was criticized severely from several points of view, e.g., its regressive incidence, excessive compliance, accelerating inflation and so on. At the same time, a political scandal of the cabinet which was composed of Democratic, Socialist and National Cooperation parties was disclosed. And then, both of the unpopular tax and political scandal brought down the cabinet. The tax was repealed after its administration for only 1 year and 4 months. The trial of introducing GCT failed the second time.⁽⁵⁾

(iii) Value-added tax of income type—the third trial in 1950—

The Shoup Mission recommended a complete overhaul of the tax system, including repeal of the turnover tax. In stead of the tax, a local ogvernment value-added tax of income-type with 4% tax rate was recommended to introduce. Even though the recommendation was approved by Parliaments in 1950, the enactment of the tax was postponed several times. The tax was later repealed without ever having gone into effect. This can be considered the third failure of trying to introduce GCT.

(iv) General Consumption Tax of accounts method—the fourth trial in 1979—

In 1979, the Japanese government announced the introduction of the so-called

account-type value-added tax into the national tax system. The tax was called literally "general consumption tax". The tax rate of 5% was intended to be levied on margin between the buying cost and sales price on most goods and services, excluding food, education fees, medical treatment of social insurance, export and so on, effective from April 1980.

Just before the day of the general election of October 1979, the prime minister abandoned the introduction of the tax. But, the government party was defeated at the election, ending up with only 248 seats in the House of Representatives, less than half of the seats. After the election, an announcement is unanimously passed never to introduce any kind of general consumption tax at the extraordinary session of the Diet.

(v) Sales Tax of invoice method—the fifth trial in 1986—

In July 1986, the government party got a landslide victory of 304 seats at the general election partly owing to the then premier's public promise that the general consumption tax shall never be introduced. The party, however, presented "Sales Tax" (i.e. broad-based consumption tax) bills to the Diet notwithstanding the premier's public promise.

Main characteristics of the "Sales Tax" are similar to the ones of VAT now in practice in EC and as follows: (1) Those whose sales are ¥100 million and less are exempt. (2) Taxable firms must issue invoice for each transaction. (3) Taxation employs the so-called invoice method for each transaction, i.e., the tax is paid at each stage of production, up to and including the retail level. (4) Exempt items amount to 51 items, including food, housing etc. (5) Tax rate is 5%. (6) Small businesses whose annual sales are ¥100 million or less would be to use a simplified formula for computing the tax.

Opposition movement against the tax was led by the Association of Retailers including nation-wide businesses such as department stores and supermarkets. LDP lost their seats substantially at local as well as prefectural parliaments at every election. LDP leaders lost their power to control young members of the party. The major tax reform bills were not approved during the ordinary session of the Diet which ended 27 May 1987. But, in September, the number of income tax brackets was reduced from 15 to 12 with the maximum tax rate lowered from 70% to 60%. And the exemption of tax on interest income from deposits in financial institutions, postal savings and government bonds was abolished and a new system of tax exemption for persons 65 years or older, fatherless families and the disabled was introduced instead.

(vi) Consumption Tax of accounts method—the six trial in 1988—

Now, let us turn to the sixth trial of introducing the same kind of tax in 1988. In June 14, a Tax Research Council of LDP proposed the tax reform package of which the main feature was a new consumption tax; A 3% consumption tax of account method type would be levied on the margin between the buying cost and sales price on most goods and services, including food, effective from April 1989.

Companies with annual sales of ¥30 million or less would be exempt from the

tax and those with annual sales of ¥500 million or less would be able to use a simplified formula for computing the tax.

Land deals, transfers of securities, insurance premiums, postal transfers, public medical insurance programs and tuition fees would be exempt from the tax.

Eight indirect taxes, including commodity taxes, a travel tax and an entrance admission tax, would be abolished. The grading system-based liquor tax would be simplified, and the ad valorem tax on liquor would be abolished.

The tax reform legislation that passed both Houses of the Diet at the end of 1988 represented the most drastic overhaul of the tax system since the Shoup tax reform in the early 1950'. The consumption tax which was the centerpiece of the reform was a historic proposal because it would shift the burden of revenue away from income taxes and toward indirect levies on goods and services. The tax was to become effective April 1 1989, the start of the new fiscal year.

The cabinet of the LDP finally succeeded in the introduction of the broad-based consumption tax. From the beginning of the introduction, however, it gave rise to strong criticism and dissatisfaction from various groups, especially housewives and retailers. In the next section, we will examine the main features of the tax as well as opinions expressed by different interest groups.

[3] *The Consumption Tax in 1989*

(i) The structure of CT (Consumption Tax)

CT is a value-added tax similar to but somewhat different from the one adopted in many European countries. The new tax covers consumption of most goods and services, except 8 items including medical care of social insurance, social welfare activities, tuition fees and so on. The number of exemption items are reduced considerably from 51 items in the case of the former Sales Tax.

Manufacturers, wholesalers and retailers are required to calculate and pay the tax to the government. But the eventual tax burden shall be shifted to consumers.

(a) Accounts method

The new tax differs slightly from a typical European value-added tax. To calculate the tax owed, businesses are not required to use the invoice issued for each transaction. European VAT follows the so-called invoice method. In the case of the new tax, however, they are asked simply to keep accounts, as evidences of how much they buy and sell. It is often pointed out that this practice makes it difficult for tax collectors to check whether the tax is accurately shifted to the next stage of transaction.

Businesses are required to preserve their accounts for at least seven years so that tax collectors can investigate potential evaders. The government is, from the outset, considering measures to prevent tax evasion and other problems resulting from this accounts method. Officials also suggested that the government may eventually switch to the use of invoice method. As will be discussed later, the accounts method is considered to be the most weak point of the new tax. This practice of accounts method applies only to the 4% of Japanese companies that

have sales of more than ¥500 million a year. That means that smaller businesses are given preferential tax treatment.

(b) Simplified procedure

Another weak point of the tax is found in its simplified procedure of calculating tax. Companies with annual sales of ¥500 million or less are able to follow the simplified procedure. The purpose of the procedure is to ease both their paperwork load and tax burden. Such companies comprise 96% of Japanese businesses but represent only 19% in sales.

In this simplified procedure, companies are not required to do book-keepings. They are allowed to regard 80% of their sales—90% if they are wholesalers—as the purchase cost regardless of how large or small their profit margins are. Therefore, 20% of their sales—10% in case of wholesalers—are regarded as the value newly added. They pay 3% of this value added, or 0.6% of its total sales value—0.3% in case of wholesalers. Once the simplified procedure is chosen, it is to be kept for two years.

(c) Tax-exempt businesses

Small businesses with annual sales of ¥30 million or less—about two-thirds of the nation's businesses—are exempt from the consumption tax. It is, however, not necessarily cheaper to buy goods and services from these businesses. The Fair Trade Commission allows tax-free businesses to raise their sales prices in the same way as other businesses that must pay the tax. For instance, books carry the same list prices at any bookstore even if the store is tax-exempt.

(d) Marginal deduction system

Tax rates of less than 3% can be applied to businesses that have annual sales ranging from ¥30 million to ¥60 million so that a drastic increase in the burden may be avoided. Amount of tax due can be calculated as follows:

$$\text{normal tax liabilities} \times \frac{\text{taxable sales} - \text{¥30 million}}{\text{¥30 million}} = \text{amount of tax due}$$

By applying this way of calculation, the amount of tax due for businesses with annual sales of ¥30 million or less is reduced to zero, and of ¥40 million or less is reduced by two third, and of ¥50 million or less is reduced by one third. For instance, as seen in Figure 1, a company selling ¥45 million in goods and services would pay half of the 3% tax.

(e) Unification with existing excise taxes

Of the former 29 excise taxes, eight—five national and three local taxes—are abolished or modified following the introduction of CT. In need of urgent improvement was the commodity tax, which covered purchases of 85 items, including cars, jewelry, electric appliances, furs, golf goods, furnitures and soda drinks. It is abolished and intergrated in to CT. The other four national taxes—levied on playing cards, sugar, travel and admission fees to entertainment centers—are also integrated into CT.

Turning to local taxes, three taxes levied on electricity charges, gas charges and

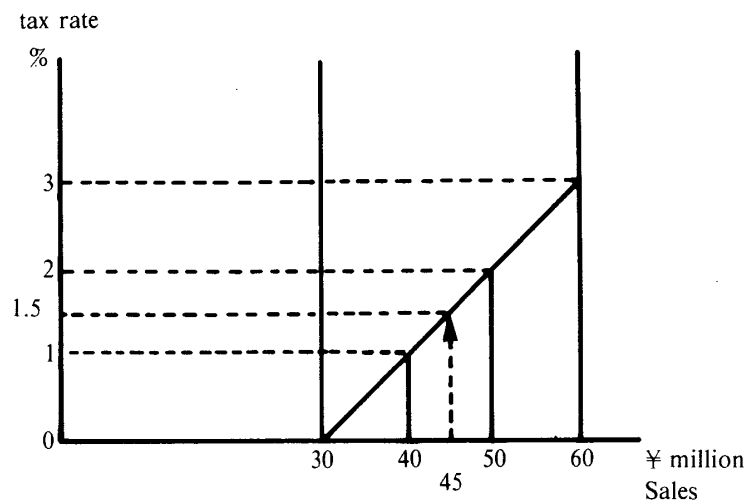


Figure 1

timber purchases are also abolished and integrated into CT.

The 3% consumption tax is expected to cause sales prices to rise by an average of 1.5%. Prices of daily necessities, such as foods, are expected to rise by an amount approximately to the 3% CT. On the other hand, the integration of existing excise taxes to CT is expected to push down the retail prices of many luxury products, upon which consumers paid taxes of up to 30%.

(ii) CT—products of compromise between economic and electoral effects

On March 1988, the then prime minister explained at the Diet that there are six kinds of “anxieties” among taxpayers on the enforcement of CT:

(1) CT makes the tax system more regressive so that its function of income redistribution will be weakened.

(2) Sense of unfairness to taxation among middle income earners shall be aggravated by CT.

(3) CT forces excessive burdens upon those who pay no income taxes (central and local).

(4) It is often too easy to raise the CT rate because of the lack of taxpayers’ pain when CT is included in the prices.

(5) CT create paperwork and calculations for businesses too excessive to tolerate.

(6) Introduction of CT tends to raise prices, and inflation becomes inevitable.

In the process of Diet debate, however, the prime minister added another three kinds of “anxieties” to CT as follows.

(7) Shifting of the tax burdens from small traders to consumers may not be possible.

(8) Some of the local taxes, such as electricity tax and gas tax, are repealed following the introduction of CT so that local autonomies at large are bound to be confronted with fiscal difficulties.

(9) The simplified procedure should be modified since not all the tax money

paid by consumers to businesses go to the treasury.

These “anxieties” pointed out by the prime minister have turned out, in general, to be true. Most of them are considered to be the characteristics inherent to CT.

As tax reforms require as a rule an alteration of tax burdens among individual voters and interests groups of many kind, it is natural that governments tend to be more concerned with their electoral effects than with their economic effects. Many tax reform proposals have been deferred or altered to accommodate electoral pressures (e.g. the Australian reforms of 1985–86 and the trials of introducing Japanese general consumption taxes as stated in the last section).

In order to make CT acceptable to taxpayers (electorate), the government (the ruling Liberal-Democratic Party) paid a great amount of efforts to find out compromises between its electoral and economic effects. The adoption of accounts method instead of invoice one may be understood as a representative example of compromises. The simplified procedure, tax-exempt businesses and marginal deduction system are also considered to be special tax treatments to make CT acceptable to businesses, but not consumers, especially, housewives.

From the then prime minister's viewpoint, it was indispensable to get support from businesses for the introduction of CT in view of the defeat of the former premier in the battle for Sales Tax in the previous year, who for months faced howls of protest from opposition parties, retailers, labor unions and many other interest groups over the introduction of CT.

The then prime minister expected to get support at least from businesses by adopting those special tax treatments. Since businesses are not required to use invoices, however, suspicion would remain about whether they accurately report their CT to the government. At any rate, they are not still inclined to support the introduction of CT. On the other hand, consumers, especially, housewives have been increasing their irritation as well as suspicion about CT through the pains felt everyday shopping.

(iii) Outcomes of electoral effects

Since the enactment of CT, LDP lost seats everytime whenever prefectural or municipal elections took place.

Finally, the voters delivered a harsh verdict against the ruling LDP in the July 23 House of Councilors election. The election has resulted in a historic defeat for the ruling LDP. Opposition parties, centering around the Japan Socialist Party, have replaced collectively the LDP as the majority in the Upper House.

Pre-election public opinion polls found that the voters had a strong sense of awareness of following three issues, which manifested themselves in the election results. Firstly, the Recruit stock-for-favor scandal, which jolted the nation's political world for nearly one year since June 1988, demonstrated to the voters how thoroughly the conservative politics is tainted by money. Secondly, with young farmers' alienation from the LDP due to its agricultural policies, including liberalization of rice imports, the ruling party's electoral fate was almost in danger. Thirdly, more than 80% of voters had regarded CT in their mind as the most

important issue.

It is of great significance that the majority of the nation's taxpayers have voted against CT. The fundamental cause of the problem seems to be in the fact that the LDP rushed the tax reform bills through the last session of the Diet without conducting thorough debate about them and, more importantly, without making due efforts to obtain the taxpayers' understanding of the purpose and consequences of the intended tax reform. The importance of public education in the process of tax reform should, I believe, be strongly emphasized.

What is worse is that the government and LDP made some debatable concessions in this processes of tax reform. As a result, controversial tax inequities in the field of income tax were left uncorrected and new loopholes in CT were created.

Alarmed and shocked by the strong opposition of the electorate against CT, both the LDP and government tax committees have begun to review the new tax. In addition, leaders of the LDP have suggested lowering the maximum tax exemption limit of ¥30 million and changing the current system based on accounts method to the one based on the invoice method.

Their suggestions of these changes, however, seem only to increase suspicion and fears among taxpayers including small traders as well as housewives. For those are the loopholes that the government and LDP acquiesced in an attempt to mitigate the opposition against CT.

The ¥30 million exemption limit, for example, was adopted for the purpose of preventing small traders from deserting the LDP. And the system allowing such businesses to pay CT on the accounts method is obviously intended to keep open the opportunities for them to avoid paying their full amount of taxes due.

Is it possible for the LDP to accept the outcomes of modifying these and other special tax treatments? Removal of these treatments will alienate many of those small traders and many housewives, the outcome of which will be an even more serious loss for the LDP in the next national election.

Doing nothing, on the other hand, will make most of the temporary deserters probably permanent ones. The LDP have been too slow to recognize that the half-baked tax reform would eventually throw them into a real dilemma.

[4] *Political and Administrative Inequities in CT and Income Tax*

(i) 2 among 3 are against CT

Another public opinion poll was carried out on tax reform in October 1988. The result was amazing in the sense that 65 percent of answers for questionnaire are against and only 18% are for CT, i.e., 2 among 3 are against CT.⁽⁶⁾

First of all, it is worthy of note that taxpayers still have suspicion and nonconfidence about tax reform.

Secondly, it should be more noteworthy that percentage of those with reservations decreased sharply from 36 percent when the former poll made in June to 14 percent and in turn increased the percentage of those who were opposed to 65 percent. The reason why people of the neutral stand turned out to the

opposition could be understood by no less than the Recruit stock-for-favor scandal and thereby induced extensive criticism against unfair part of the tax system.

Thirdly, in this public opinion poll, a new questionnaire was added: what part of tax system is urgently in need of improvement if unfairness does exist in the system? To this questionnaire, the answers are in order of large number as follows: ① Taxation of politicians' revenues out of holding parties, ② correction of tax expenditures⁽⁷⁾ for medical practitioners, ③ taxing business and farm incomes as fairly as salaried income under PAYE system, ④ heavier taxation of capital gains i.e. returns on sales of stocks.

Opposition parties submitted a joint proposal for the correction of the unfair tax system as an alternative to the plan of tax reform proposed by LDP in summer 1989. LDP in turn made a counter-proposal so that the correction of the unfair tax system turned out to be the most important issue of tax reform.

There is no 'scientific' answer in textbooks of public finance for such a fundamental question as what is unfairness in tax systems. There is, unfortunately, no measurement of unfairness in the field of tax system, i.e., whether a tax system is fair or unfair is to be left to the individual value judgement.

If one asks anyone, however, what is the unfair tax system, he (or she) will give an example as shown in the above public opinion poll.

In order to make the matter clear, I believe, it is instrumental to distinguish 'inequity produced by politics' from 'inequity produced by administration'.

For instance, three distinct tax privileges enjoyed by medical practitioners, quasi-corporations for tax purposes, and temples and shrines are all considered 'big shots' of inequity, i.e., typical examples of unfair tax treatments. These 'big shots' are created through discussions and decisions in the Diet so that they could be called the 'inequity produced by politics' or simply political inequity.

In contrast to this kind of inequity, another important aspect of unfairness in the present individual income tax system is referred to as 9-6-4, or sometimes 10-5-3-1. These numbers referred to the commonly believed fact that 90–100 percent of the income of salaried persons is subject to tax but only 50–60 percent of business income (in particular the income of small traders) is reported and only 30–40 percent of agricultural income is subject to tax. This sort of inequity is created by an amalgam of inadequacy of tax administration and noncompliance of taxpayers so that it could be called the 'inequity produced by tax administration' or simply administrative inequity.

It is the political inequity rather than administrative one⁽⁸⁾ that is considered to be in a crying need of correction among taxpayers in general.

(ii) Three major tax expenditures

(a) Tax expenditures for medical practitioners

The special tax treatment for medical practitioners is a peculiar feature of Japanese tax system never possibly found in other countries. This special treatment allows medical practitioners to deduct 52 to 72 percent of necessary expenses out of their revenue of medical treatment on health insurance so that their tax burdens

are reduced substantially.

In addition to this favourable treatment, they enjoy two more special tax treatment, i.e., accelerated depreciation on medical apparatuses as well as exemption of enterprise (local) tax.

One might wonder why only medical practitioners are given such favourable treatment on income taxation. To answer this question, we must briefly review the history of why this favourable treatment was created.

To begin with, in 1951, Japanese Association of Medical Practitioners asked the government to revise fees paid through the social insurance for diagnoses and treatment because they were too low. Negotiations continued between them. In 1954, however, with no prospect for increasing fees 'for the time being', the special tax treatment which raised the ratio of expense to income by up to 72 percent was enacted through legislation by House members.

This history suggests that some qualifications are due to critics against the special treatment. The question remains, however, why should the tax system only assume so heavy responsibility. Should this special tax treatment serving the vested interests need no amendment?

From the incumbent throughout the opposition parties, i.e., from LDP to the Communist Party, all are reluctant to repeal this favourable tax treatment. The reason is quite simple. The Association always has played a powerful role as a vote-collecting machine whenever elections took place. What is more, the Association would threaten the government demanding that if it did not continue the favourable tax treatments, all medical practitioners would refuse to be school health doctors. The government would be at a loss for how to cope with this demand.

(b) Tax expenditures for quasi-corporations of personal businesses

The quasi-corporations of personal businesses for tax purposes seem to need further explanation. This special tax treatment deems personal businesses as corporations for tax purposes in order to reduce their tax burdens. In 1973, blue return taxpayers who were able to keep proper books and records were allowed to elect to be treated as quasi-corporations for tax purposes.

This treatment permits business proprietors to deduct their own salaries as well as the salaries of family employees as expenses of doing business. In addition, the net income of the business remaining after the deduction of these salaries is considered corporate income and taxed at the reduced rate applicable to dividend distributions. These distributions, in turn, are taxed together with the imputed salary of proprietor under the individual income tax, allowing also for the special deduction available to wage and salary income and for the tax credit that is provided for dividends at the individual level.

The aim of this treatment is placed on taking the balance of tax burdens between personal businesses and corporations. This treatment, however, is considered unfair from the view-point of at least wage and salary earners.

In 1988, therefore, the government set an upper limit on the salaries of business

proprietors so that some of them felt the treatment not attractive any longer.

The government, however, is still hesitating to repeal the favourable treatment itself. Why is it hesitating?

One reason is found in the electoral effects of repealing the treatment which would affect business proprietors who could play dominant roles in election campaigns for LDP as well as for opposition parties. It is understandable that both of incumbent and opposition parties are undecided on whether to abolish it.

Another reason lies in the policy of the tax administration authority. From the standpoint of the authority, the treatment is useful as a counter-vailing power to contain anti-taxation groups which were once rampant under the influence of Japanese Communist Party.

(c) Tax expenditures for temples and shrines

Private non-profit organizations devoted to the promotion of public interests, such as charitable foundations, temples and shrines etc., are given favourable tax treatments of various kinds compared to profit-making corporations.

Revenues from their own undertakings for public interests are tax-exempt. In addition, if they engage in profit-making undertakings, 30 percent of their profits are deductible as an endowment to their undertakings for public interests. Furthermore, a tax rate of only 27 percent is applied to the rest of their profits.

Profit-making undertakings which are aberrant from their own religious activities have been conspicuous these years. In addition to hotels, wedding halls and publishing businesses, the temples and shrines now extend to real estate dealing spurred by skyrocketing rise of land price in metropolitan areas.

On the one hand, a number of temples and shrines have earned a lot of income by repeating transactions of land. On the other, there are cases, noticeably increasing, where real estate businesses and businesses of household electric appliances buy temples and shrines in order to abuse them for tax evasion.

There are so many different temples and shrines ranging from giant corporations collecting hundreds billion yen to a temple with only one priest that the correction of the favourable tax treatment was postponed. The delay also reflects difficulty of controlling the religious world.

Why is it the government has never tried to repeal the favourable tax treatment for temples and shrines? The government takes an exoteric position that it is impossible to tax on belief, but at the same time knows well that a countless number of believers are voters themselves. This is true not only for the incumbent but also for opposition parties so that it is not easy to get consensus on this problem.

In the United States, however, religious foundations are allowed to enjoy privilege of tax exemption under the provisions of Federal Income Tax Law that they are unable to engage in any kind of political activities. Private non-profit activities in general, including activities of temples and shrines, are not well understood among Japanese people so that it will take time to rectify the favourable tax treatment for temples and shrines.

(iii) "Take a detour if in a hurry"

At the end of the 1950s, the famous British writer C. N. Parkinson made the following observations: "The number of government employees keeps increasing irrespective of the volume of work to be done", and "Expenditure rises to meet income". Subsequent developments in advanced countries indicate that these observations seem undeniable. In most countries, including Japan, the scale of government has kept expanding, and more money has gone out than has come in.

After the defeat of general election in 1979, the government established the Second Extraordinary Administrative Research Council to investigate reforms and revisions of the structures, system and policies of the central government as well as those of government corporations. The aims of this investigation were not only restricting the size of government but also by so doing regaining voters' confidence in LDP which was lost at the introduction of CT.

On the basis of the five reports submitted by the Council, the government finally achieved privatization of three government corporations, i.e., Japan National Railways, Nippon Telegraph and Telephone Public Corporation and Japan Tobacco & Salt Public Corporation. Administrative reforms for the central government were also carried out to reduce new bond issues each year for the purpose of curtailing deficit accumulation.

The government, however, has been still dependent on the revenue from public bonds, including deficit-financing bonds since 1975. Consequently, the amount of outstanding government bonds has increased to reach 158 trillion yen, or 43.2% of GNP by the end of 1988. These figures reveal that the Japanese government performances are relatively less efficient than those of other major industrial nations.

It should be remembered that there are two essential prerequisites to Japanese tax reform, i.e., reduction of public expenditures and corrections of unfair parts of the tax system. From this viewpoint, people are not satisfied with the present outcome, especially the current CT, because the reduction of public expenditures are not sufficient and the unfair parts of tax system are left uncorrected.

The Japan Socialist Party and other opposition parties are calling for abolishing CT. Their call for the scrapping of this tax has drawn strong public support, but their counterproposals to secure necessary tax revenues lack in reality and far from convincing. In short, they maintain to ensure revenues through correction of tax inequities and heavier taxes on the rich, both individuals and corporations, while cutting back on expenditures, including defense spending.

The results of the last election showed that Japan is sharply divided over the issue of CT. It is an obligation of both the ruling and opposition parties to conduct concentrated debates on the tax reform in the Diet. It will provide the taxpayers with an opportunity to better understand what will truly promote their benefit and the nation in the years to come.

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(1) A brief history of Japanese tax system can be found in H. Udagawa & S. Furuta, '*Zeisei to Sozeifutan*' (The Tax System and the Burden of Taxation) 1974 Toyokeizai Shinposha, especially in Chapter I. For a more detailed history of the tax system in post-war period, see S. Sato & H. Miyajima, '*Sengo Zeiseishi*' (*The Post-war History of Taxation*), Zeimukeiri Kyokai, 1979.

(2) There are numerous books and articles which deal the reasons why the government were bound to reform the tax system. See, e.g., Zaikai Shohosha ed. (under the supervision of the general affairs section, Tax Bureau), the Ministry of Finance, '*Zeisei-kaikaku no Yoten*' (The Point of The Tax Reform), Zaikai Shohosha, 1988.

(3) For details of the tax reform proposal made by the Tax Advisory Commission, see, e.g., *The Japan Economic Journal*, Nov. 26, Vol. 1. 26, No. 1340, 1988.

(4) C.f. Okura-sho, Showa-Zaiseishi-Henshushitsu-hen (Editorial Office of Showa History of Public Finance, Ministry of Finance ed.), '*Showa Zaiseishi*, Dai 5 Kan, Sozei' (Showa History of Public Finance, Vol. 5, Taxation), Toyokeizai Shinposha, 1957. H. Taniyama ed. '*Shohizei Haishi Dokuhon*' (A Reader on Repeal of the Consumption Tax), Shin-Nippon Shuppansha, 1989. H. Watanabe ed. and translated, '*Reports by Tax Commission on Tax Overhaul*', Okurazaimu Kyokai, 1988.

(5) See, Tax Bureau, Ministry of Finance, *An Outline of Japanese Tax System*, 1979, p. 5.

(6) See, '*Zeisei Kaikaku Seiji ga unda Fukohei zeisei o Tadase*' (Correct by tax reform the Unfair Practices Produced by Politics) contributed by Seiji Furuta, in *Nippon Keizai Shinbun* (Japan Economic Newspaper), 9 November, 1988.

(7) Tax preferences may be viewed as subsidy payments to preferred taxpayers. Such implicit payments have recently been referred to as "tax expenditures" in the U.S. and the recent Budget Act requires that they be listed in the budget. See Stanley S. Surrey, *Passways to Tax Reform*, 1973 Harvard, Cambridge, Mass.

(8) Income deduction for salaried persons to counterbalance this kind of administrative inequity has been introduced. This practice, however, tends to create a different kind of administrative inequity. For details, see, e.g., Peckman, J. A., and K. Kaizuka, "Taxation" in *Asia's New Giant: How the Japanese Economy Works*, ed. by H. T. Patrick and H. Rosovsky 1976 Washington D.C. The Brookings Institution.