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The Process of Tax Reform in Japan  
-- A Comparative View --

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## Introduction

It is not so easy for an economist to examine the political process of tax reform. However, as an economist who have been interested in the institutional aspects of tax system in the broad sense, reviewing the features of tax process which could influence the result of tax reform seems to be an attractive subject. So in this paper I dare to tackle the problem probably in a different way from political scientists.

### 1. The Tax Process in Japan

Let me briefly explain the tax process in Japan mainly in comparison with United States.

Japan adopts representative democracy like U.K., so from the institutional point of view the tax process is quite different from U.S. which adopts the

presidency. Japan has the annual budget proposed by the government (mainly prepared by the Ministry of Finance) in the strict sense of the word. In other words the budget including both expenditures and revenues (taxed and national debt) is strictly confined within one year and the diet can authorize any expenditure by administration only within one year. New tax or tax revision also are usually proposed in the annual budget so that expenditures and taxes must be simultaneously enacted in the annual budget. In U.S. the appropriation for expenditures are decided by each specific appropriation committee and spending in expenditures is usually not confined within a year, so in this respect U.S. does not have such annual budget as that in U.K. and Japan.

Naturally in the tax process the government (Prime Minister) usually proposes the tax revision or a new tax to the diet and the diet whose majority is the governing party passes the tax revision or a new tax after the arguments with opposition parties. Currently the majority of the Lower House is the liberal democratic party and the majority of the Upper House is composed of socialist party and other opposition parties, so the situation is very much complicated. In the Lower House, the Government and LDP want to pass the revision of the consumption tax adopted in 1989, but the opposition parties want to pass the act of abolishing the consumption tax in the Upper House.

In the usual tax process, the tax revision or the tax reform is prepared by the tax bureau of the Ministry of Finance. 1) In this preparation, the Tax Advisory Commission play a role in examining various views on the tax revision or the tax reform and in acting as arbiter among the interest groups that influence the tax policy. The thirty or so members of the Tax Advisory Commission, appointed by the Prime Minister come from different walk of life, including academic experts in public finance, journalists, former officials of the minis-

try of Finance and Home Affairs, former mayors, and representatives of labor unions and of large and small business and agriculture. None of the Commission members is a government official, but the government has much influence on its recommendations, both because many of its members formerly were associated with the government and because the commission relies primarily on data and analysis prepared by the Tax Bureau. As well known, the Japanese bureaucracy usually utilizes various committees set up by its segments in the bureaucracy in justifying to maintain the scope of activities of the segment and also in guiding the direction of policy to along its own intention. The Tax Advisory Commission is not no exception although the Tax Bureau does not afraid of wide range of opinions among members.

As will be argued later, the influence of the Tax Advisory Council on tax policy has been deteriorated in recent years because of long-time dominance of LDP in political scene. In other words, the tax committee of LDP has more influence in arbitrating conflicts among interest groups. LDP's influence become bigger especially in implementing the details of tax reform or tax revision because sometimes the changes in details of the tax system could affect critically the businesses of interest groups.

In U.S. the tax revision or tax reform is proposed by members of Congress. In this respect the situation in U.S. is quite different from Japan although proposals of opposition parties in Japan could influence the final act in such a case as the reversal of the opposition parties in both house in the diet since 1989. The influence of the chairmen of Ways and Means Committee in the House and the chairman of Finance Committee of Representatives in the Senate are much stronger than the chairman of tax committee in LDP.

The annual budget in Japan which contains the government's tax proposals is

submitted early in the calendar year and is acted on by the diet by April 1. The tax process in tax revision begins with a presentation of alternative tax proposals by the Tax Bureau to the Tax Advisory Commission sometimes in the fall before the budget is to be submitted. In such a tax reform as the introduction of consumption tax, the tax process takes a longer period. More than one year was needed for the arguments on pros and cons on adoption of new tax and on the choice of specific forms of consumption tax, namely, VAT or turnover tax and tax on manufacturing stage. In any way, a tax reform plan is finally adopted in annual budget. The tax committee of the ruling political party also makes tax recommendations and those are usually similar to those of the Tax Bureau because the mutual adjustment of proposals of both committee is implicitly made beforehand. LDP committees' influence has been bigger, and sometimes the political decision has had priority over the Tax Advisory Council. In any way, the commission's recommendations are transmitted to the prime minister in time to be used in the budget decisions which usually are made around the end of the calendar year. The final decision are made by the cabinet on the bases of both recommendations.

Let me briefly explain the tax process of U.K. in comparison with Japan. 2) As is already mentioned, U.K. maintains the traditional representative democracy, so roughly speaking the tax process is similar to that in Japan. The cabinet proposes the Finance Bill to the parliament and tax process formally begin in March or April and ends by the vote in the parliament in July. The ruling party votes for the Finance Bill proposed by the cabinet, so that usually there is a narrow room for the revision of the Finance Bill in the parliament. These features are similar to the tax process in Japan, but there are differences in the process in U.K. compared with the Japanese case. One is the

strong influence of the Prime Minister and the Chancellor of Exchequer on the tax process. The content of the Finance Bill is sometimes consulted with in narrow circle of the cabinet, so that the Prime Minister and the Chancellor of Exchequer could have a strong initiative. And the government or the administration is powerful in implementing the new tax proposed by the Finance Bill because they actually can impose the new tax before the Finance Bill passes the parliament. Roughly speaking, the British government has more power in tax policy than the Japanese government though the difference should not be overemphasized.

## 2. Conceivable Factors for Comparison

In this section we explore the several factors useful for differentiating the relations between tax processes and the results of tax reform among three countries and try to apply these factors for specific tax reforms.

a) Differences in Initial Conditions in the Tax System: Tax reform or tax revision starts from the initial conditions before tax reform or tax revision, and differences of initial conditions among countries influence the direction of tax reform in a certain degree in each country. Among the various initial conditions, the initial condition of tax system is important. Take the case of U.S. and Japan, the following difference in the initial condition needs to be emphasized: in U.S. before the Reagan tax reform the tax burden or the effective tax rate of corporate income tax is rather low because of heavy reliances on investment tax credit and accelerated depreciation, and in Japan before

Nakasone and Takeshita Reform the effective tax rate of the corporate income tax is rather high because of curtailment of special tax measure since late 1970's and the dependence of local finance on corporate income. Reflecting the difference U.S. tax reform could not choose further reduction of tax rate in corporate income tax and Japanese tax reform could not choose heavier tax burden on corporate income tax mainly because more differentiated tax rates on corporate income results in more distortion in global decision of corporate businesses. Naturally, the tax reform incorporating heavier tax rate for corporate income is usually more progressive on personal income compared with tax reform incorporating lighter tax rate for corporate income if we maintain progressivity of other composition of tax system.

In the tax reform, U.S. chose more burden on corporate income tax through abolishing investment tax credits and Japan chose the reduction of statutory rate of corporate income tax from 42% to 37.5%. Both countries tried to reduce tax burden of personal income through flattening the rate structure and increasing such deduction as basic deductions (U.S. & Japan) and sprouces' special deduction (Japan) although U.S. tax reform strengthen the capital gain taxation. In U.S. the tax reform was designed to be revenue neutral including corporate income tax and personal income tax, and in Japan the tax reform was originally designed to be revenue neutral including corporate income tax, personal income tax and the new consumption tax. The result of the tax reform in the U.S. is progressive because of more heavy tax burden on corporate income and strengthening of taxing capital gains, the the result of tax reform in Japan is regressive because of reduction of corporate income tax and regressiveness of newly introduced consumption tax. 3)

Overall effects of the tax reform on redistributive function of the tax sys-

tem could have the critical effect on political success of the reform. In the case of U.S. tax reform, the progressive result of the tax reform was welcomed on the whole and could be a favorable factor for the success. In the case of Japan, especially Nakasone's reform, the introduction sales tax added a regressive element on the tax system and one of the critical factors for political failure. In the reform by Takeshita the regressivity was hidden by abandoning the tax revenue neutrality, namely choosing net reduction in tax revenue in total in the tax reform. In other words, more tax reduction in personal income tax almost seemed to wipe out the regressive elements introduced by the new consumption tax and the argument on regressivity could not reach a serious point in the tax process.

b) The Persuasiveness of Ideas: Next we turn to the persuasiveness of ideas which promote the tax reform. Political scientists is used to neglect of the role of ideas. They usually regard the interest-group politics important. However, this approach can not explain at all the political success of Reagan Tax Reform. 4) In the Japanese political scene, arguments based on ideas seem to have much less influence on the political results of tax reform because as is well known the real debate on the difference of ideas rarely is not taken in such political forum as in the diet or other places. The principles (Tatemaie) rarely dominate practices (Honno). Even this is so, the recent debates on tax reform in Japan to some extent showed that ideas has play a role.

Here we define the idea as something based on tax theory or tax principles. The idea functions as the justification for tax reform because of fitness to objectives of good tax system and is usually shared by experts. In this respect, the Reagan Tax Reform succeeded to comprise the idea of liberals as well as the



idea of conservatives. The tax reform which broadens tax base with flattening tax rate attracted believers in comprehensive taxation in liberals and at the same time got support from supply-siders of the conservatives who like a flat tax because of its neutrality.

In the tax reform in Japan, the situation was rather complicated. Majority of tax experts implicitly supported the idea of comprehensive income taxation under the tradition of Shoup's recommendation although Shoup's recommendation had been deformed substantially almost just after its initiation (1949). On one hand supply-siders in Japan was not so influential like in U.S., and on the other hand opposing parties in Japan were sensitive on the issue on vertical equity in personal income tax.

The tax reform which combine reduction in the number of tax brackets in personal income tax, reducing tax rate in corporate income tax and introducing a new consumption tax has not been so easily acceptable in the framework of existing ideas. The present author and some other experts support the idea of expenditure tax and accept the consumption tax, but its influence is not so strong.

The government try to present the case for appropriate tax-mix among income, consumptions and asset to justify their proposal. However, the case is not necessarily so persuasive to counterattack the argument of opposing party based on vertical inequity. In any way these ideas which support the tax reform is not so influential like the idea incorporated in the Reagan Tax Reform. The difficulty of Tax Reform in Japan partly lies in persuasiveness of ideas.

c) Role of Symbols: In political battle ground or in popular arguments symbols rather than ideas sometimes play the effective role in promoting tax reform. Here symbols is not so consistent as ideas but for their simplicity and symbolic

meaning attract many people. 5)

In U.S. tax reform, "fairness" and "simplicity" have the most influential symbols. People do not understand correctly the words as the experts, but these words had symbolic meanings and became key words. Both words contributed to the success of tax reform by giving many people good impression on tax reform. In Japanese case, both Nakasone and Takeshita tax reform used the delicate symbol, namely "wide and thin burden". This symbol was used frequently by politician of LDP and sometimes used by experts. This is also the key word in the recommendation of Tax Advisory Council on fundamental tax reform. This symbol implicitly indicate the way the new sales tax or new consumption tax is levied and seemed to some extent to be successful in giving people the image of the new tax which had never been implemented in the Japanese tax system.

Against this symbol, the opposition party used the word "unfair". This symbol is also strong especially for attacking tax reforms. In other words, "unfair" is a very convenient word which implies something wider than not fair in terms of tax analysis. Opposition parties in Japan effectively used this symbol, and they could almost offset the positive symbol of the administration, and this is one of the source of the difficulties which Japanese tax reform faced.

In respect to U.K., though the author is not well informed the symbol used, or the ideas declared, it is possible to say that Mrs. Thatchers economic policy is clearly relied on efficiency through market mechanism and on smaller government. Naturally the ideas is supported by conservative people. "Leave people with more of their own money" is the expression near to symbol and probably plays the role of supporting tax revision through Thatchers' administration.

d) Differences in the Function of Representative Democracy: Next we turn to the main difference on tax revision between U.K. and Japan. As is already mentioned before, roughly speaking the political system of U.K. and Japan belong to the same category, namely, the representative democracy. Even this is so, there is a big difference in the course of tax reform or tax revision. In U.K. the tax system has changed distinctly responding to changes of the ruling parties, namely, the Conservative Party and the Labor Party. Let me show several examples. In 1965 when the Labor Party became the ruling party, they proposed the introduction of capital gain tax and the corporate income tax in the classical form (corporate income tax without any adjustment for double taxation on dividend). Those were the big changes in the tax system because before the revision the British tax system traditionally had no capital gain taxation in personal income and corporate income had been taxed as the profit tax at lower rate(15%). However, when the Conservative Party won the election corporate income tax was transformed into imputation method and VAT was introduced (1973). Those changes could be called as a tax reform because they changed the basic features of British Tax System. In 1979 and 1975 the Labor Party again became the ruling party and Capital Transfer Tax was adopted in order to strengthen the estate tax at that time. The Labor Party wanted to introduce wealth tax, but failed to implement it.

Those changes were big and could be comparable to swings of pendulum because the basic ideas under the tax revision of both parties were entirely in the opposite direction. These may be the reflection of the class structure in the British community.

In Japan at least before July in 1989 LDP had been the ruling party for thirty years. The Socialist Party is used to oppose any proposal of LDP just

for the sake of opposition, and in this sense the Socialist Party could not influence policy decisions of the administration because its case for opposition was usually very unrealistic and was not acceptable to LDP in any sense. The Socialist Party is used to occupy about 30% in the seats of diet and not to propose serious policy options for replacing LDP in the administration.

In this type of representative democracy, we could not expect big change in the tax system because the ruling party is usually satisfied to be marginal or incremental in its decision. On the whole except the recent tax reform, changes in tax system had been minor even though minor changes resulted in changes in substantial degree in the long run. Take the case of special measures, in 1950's the government was eager to adopt measures for promotion of export, investment and saving so that the cumulated effect of introducing specific measures is rather substantial. In 1970's the government tried to squeeze the special measures in corporate income tax so that the tax preferences in corporate income tax has been curtailed in a sizeable degree for years.

However, the case for introducing a new consumption tax is not incremental or marginal to the tax system. In this sense, the tax reform of Nakasone and Takeshita administration made the exception. We easily expect that nonincremental change in tax system could induce a big resistance in the political battle field. We are not sure that the recent result of the election in the diet change the functions in the representative democracy in Japan. At least two directions could be mentioned. One is the British style, that is LDP and the Socialist Party shift alternatively in the administration. The other is the coalition among LDP and other small parties except the Socialist Party.

e) "An Old Tax is a Good Tax": This is an economists' argument. This saying

can be interpreted in economic analysis in the following way: the announcement of introducing a new tax has an effect in economic behavior because each economic agent expects the introduction of a new tax change tax burden and price ratios of goods and services and he makes adjustment according to his expectation. This produces clearly unfair position when the announcement of a new tax is unexpected.

Here, we extend the meaning of the saying more than that in economics analysis. The tax system is the institutional framework under which economic agents behave. Economic agents take the tax system for granted especially in its basic structure. Economic transactions of economic agents has been adjusted in assessing tax burden and in paying taxes. For example, corporate income tax needs to be consistent with the calculation of profits in corporate firms, and the way of paying indirect tax by sellers needs to be accommodated to pricing by sellers. However, if the basic structure of the tax system is changed in the tax reform, transactions of economic agents should be readjusted to changes in assessing tax burden and in paying taxes. This readjustment sometimes is costly for tax payers and for tax administration even though the readjustment is usually needed once and for all at the time of introduction of a new tax.

In the case of U.K., there were several examples of introduction of new taxes. The introduction of VAT in 1973 by Conservative Government was a big change. VAT was introduced and substituted for purchase tax and selective employment tax. However, in this case the critical issue was not the introduction of VAT but the question whether U.K. joined to EC or not. In this sense, this was not an issue on tax policy and the introduction of VAT should be followed by joining to EC as a due process. The introduction of tax credit method which is near to negative income tax was also the big change in 1972. The

change meant the reform on the structure of social welfare system and the argument against the introduction of tax credit was mainly based on the premise that the old welfare system and the old withholding system (PAYE) was good system. The failure of introducing Wealth Tax by the Labor government is also explained partly by the reasoning of "An old Tax is a Good Tax."

In the case of Japanese tax reform, the plan of introducing sales tax by Nakasone administration and the plan of introducing consumption tax by Takeshita administration were big changes. Unfortunately the Japanese tax system has never had general sales tax as a national tax or as a local tax. For Japanese taxpayers general sales tax is a completely new experience and this is true for tax administration. This is one of difficulties which the tax reform in Japan faced. Particularly, the VAT type of general sales tax needs invoices in each transaction and invoices are sent to tax offices. Japanese firms particularly small-sized firms have almost never accustomed to such a practice and their tax returns has been usually underassessed. Therefore, they were very much afraid of introduction of the VAT type sales tax. Notably or notoriously small firms have had a very strong influence on political process in almost every sphere. Nakasone administration adopted the VAT types but it failed to introduce the new tax. Even though there are the other reasons of the failure as was explained, the small firms' opposition was a critical one. Takeshita administration adopted the consumption tax on account basis which is very unique and is rather the awkward type of sales tax. The main reason why this type was adopted is to alleviate the opposition of small firms. In any way, the implication of the saying "An Old Tax is a Good Tax" could be a factor which influence the success or failure of tax reform.

f) Other Factors: Differences of influences of interest groups and characteristics of bureaucracy may be result in changes in the course of tax reform. Therefore, let me briefly check these factors among three countries.

Though it is not easy for us to judge the extent of influences of interest groups, roughly speaking influences of interest groups are comparable between U.S. and Japan in spite of the differences in their channels of lobbying. In U.S. the main targets for lobbying are the members of Congress, and especially in tax policy, are the chairman and members of the Ways and Means Committee and the Finance Committee. This is a natural results considering that Congress has the power to enact bills. In Japan, the diet members and also bureaucracy has been involved in lobbying of interest groups. Sometimes the members of specific committees of LDP could be a target.

In U.K. traditionally the influence of interest groups is said to be weaker than U.S. and Japan and it seems that the same could be applied to the issue of tax policy.

There has been several differences on the characteristics of bureaucracy among these three countries. The Japanese bureaucracy has been more influential on policy making because of its high prestige, closer cooperation with LDP and its ability to present new options for policy issues. On the recent tax reform, on the surface LDP has had initiation but Tax Bureaus of Ministry of Finance carefully has guided the direction of tax reform though at several occasions politicians has decided the critical matters. In U.S. the bureaucracy is more or less is detached from the Congress and in this sense its influence on the legislature is weak. In U.K. the bureaucracy has kept its neutrality on policy issues. The ruling party and the opposition party has alternated frequently and their views on policy issues have been distinctly different each other. In the

circumstance the bureaucracy has played its role only along the neutral stance. Therefore, the British bureaucracy has less influence on tax reform because of its neutrality though there has been the several occasions where Treasury Department in U.K. intervened tax process on technical and administrative reasons.

On the whole Japanese bureaucracy has more influential than those in U.S. and U.K. However, it is difficult for us to judge to what extent this has been favorable factor for tax reform.

### 3. Several Implications

So far we explained the conceivable factors which could differentiate the result of tax reform in tax process. Now let us derive several implications mainly for tax reform of U.S. and Japan. Comparing with U.K.'s case is not easy because U.K. has had many tax reforms for comparisons and success and failure of the tax reforms has been diverse. However, U.K.'s case is useful to compare the tax reform under Japanese representative democracy.

The Reagan tax reform was truly successful. In respect to the factors explained in section 2, almost all the factors was favorable to the Reagan reform. Starting from the initial condition the reform could chosen the option of the progressive nature i.e. more tax on corporate income and less tax on personal income. The idea comprised both elements which supply-siders in Republicans favored and believers in comprehensive income taxation accepted, namely flat tax and tax base broadening. The symbols of "fairness" and "simplicity" played a positive role. The implication of the saying "An Old tax is a good tax" was



also favorable because the Reagan reform kept the basic structure of tax system intact and did not intend to introduce a new tax.

One of the difficulty which U.S. tax process faces is the possible disagreement between Congress and the President. Congress enacts new tax laws, but the President could intervene the process. If there is the clear difference of opinions on tax policy between Congress and the President tax process does not work smoothly. Usually the representative democracy does not have such a difficulty, and in this respect U.K. and Japan share a favorable condition for tax reform. However, in the case of Reagan tax reform, the peculiar relationship between the President and Congress did not affect the tax process badly because there was no serious conflict on opinions. The President stood rather calmly behind the tax process in Congress and in a sense Congress moved to achieve miraculously the tax reform through its own political game. 6)

Comparing with U.S. tax reform the factors for the Japanese tax reform are unfavorable. Initial conditions for tax reform was unfavorable because there is no room for tax increases in corporation income tax and it is not easy for tax reform to adopt the options of progressive nature. The idea of the appropriate tax-mix among income, consumption and asset played to some extent a positive role but is not necessarily so persuasive to counterattack the argument of opposing partly based on vertical inequity. The symbol, namely "wide and thin burden" also a positive role in the process but the opposition party's symbol, namely, "unfair" was so effective that it could offset the positive role of "wide and thin burden". Comparing with U.K., Japanese representative democracy has been quite different in virtually no alternation of the ruling party. For thirty years LDP has been the ruling party, and many policy decisions has been made incrementarily. Clearly the recent tax reform was not incremental, and the

tax reform is problematic in the political sense. Probably the critical factor for the success of reform seems to be the implication under the saying "An Old Tax is a Good Tax". The failure of Nakasone's reform and the seemingly success of Takeshita's failure stemmed from the difference how the politician pay the respect the implication of saying. A new tax is anyhow unpopular because tax payers are not accustomed to pay a new tax. For Japanese taxpayer the general sales tax is a completely new tax. Consumers and taxpayers (sellers) are reluctant to comply paying a new tax. In any way, a new tax includes a new transaction cost. Especially small firms' opposition toward VAT type of sales tax was quite strong. Nakasone failed to adopt a foreign tax (VAT). Takeshita adopted seemingly direct tax version of sales tax (consumption tax on account basis) avoided the strangeness of a new tax and anyhow passed the new act in the diet.

#### 4. Aftermath

The big tax reform naturally has its aftermath. In U.S. capital gain taxation has been an issue. In Japan the aftermath has been just formidable. Last year at the election of the Upper House the opposition against the new consumption tax was one of main causes and the opposition parties gained the majority. At February's election in the Lower House LDP gained the majority though the introduction of consumption was still a big issue. The government propose the revision of the consumption tax in the diet, but the revision will be rejected at the Upper House. The opposition party propose the abolishment of the consumption tax in the diet, but this proposition will be rejected in the Lower House. Therefore, the government or opposition parties could not pass any

serious proposal of tax policy in the diet.

We expect a kind of stalemate on the tax policy in near future. Without a new tax law, the present tax, namely, the consumption tax proposed by Takeshita administration continues to be taxed. This means that gradually the new tax becomes an old tax and we expect that the allergy toward the consumption tax will be faded gradually.

## Notes

- 1) See J.A. Pechman and K. Kaizuka "Taxation " in Asia's New Giant ed. by H. Rosovsky and H. Patrick (Brookings Institution 1977).
- 2) See Ann Robinson and Cederic Sandford, Tax Policy-Making in the United Kingdom (Heineman, 1983)
- 3) Professor M. Homma of the University of Osaka presented the case in the course of Nakasone reform and a roused the heated arguments.
- 4) See T.J. Conlan, M.T. Wrighson and D.R. Beam, Taxing Choices, (Congressional Quarterly Inc. 1990)
- 5) See also Taxing Choices
- 6) See J.H. Birnbaum and A.S. Murry, Showdown at Gucci Gulch, (Random House, 1987).