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Development of the Japanese Economy**

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Introduction

This paper aims to evaluate the impact of the Recommendation made by the Shoup Mission on the post-war tax system in Japan and also to try to assess the effect of tax structure on the postwar development of the Japanese economy.

1. The Shoup Recommendation and the Subsequent Change

Let us first briefly review the content of the Shoup recommendation and trace the subsequent changes of the Japanese tax system.

As is well-known the Shoup Mission recommended the tax reform at the request of General McAtther of Allied Powers during the occupation period in 1949. Under unusual political circumstance, the Mission could propose the radical reform and also could actually enact the main part of the proposal in 1950 except the introduction of VAT of income type in local finance.

The Recommendation is radical in the sense that the idea of comprehensive income taxation had been unexpectedly introduced in the Japanese tax system which had adopted a schedular system and whose tax base had been partial. The tax climate at that time was also foreign to the idea of comprehensive income taxation in the sense that even tax experts were not familiar to the idea and ordinary people was very conscious of heavy tax burden but not of equity in the tax system.

Basic Principle and Main Elements in the Shoup Recommendation: The principle on which the Shoup Recommendation (Shoup et al, 1949) is the consistent application of the idea of the comprehensive income taxation to the tax system. In this respect it is possible to say that the Recommendation was superior to any tax reform or tax proposal in any other countries at that time. The several main elements of the Recommendation

derived from the principle are as follows. First personal income tax took the central position in order to achieve equity in the tax system. Indirect taxes other than alcoholic beverage tax and tobacco taxes were thought to be complementary to income tax (i.e. consumption taxes on luxuries). The definition of income was so comprehensive that special measures (i.e. tax expenditures) was proposed to be very much limited. Second the corporate income tax thought to be prepayment of personal income tax and both taxes were carefully coordinated. For example, the elimination of progression tax rate, the credit for dividend in personal income tax to shareholders (25% of dividend income) and the repeal of excess profit tax were proposed. Third horizontal and vertical equity in personal income tax were considered to be guaranteed by the establishment of the reliable tax administration. The Recommendation emphasized voluntary compliance in assessing income of taxpayers. For example, the blue return system which aimed to encourage small firms to set up simple books and assess income and tax on these books was proposed.

Two new taxes in the Recommendation deserve attentions. A net wealth tax was proposed to tax wealthies in stead of maintaining high degree of progressiveness in personal income tax (85% in the top bracket rate). A value-added tax for the prefectures was proposed to be substituted for enterprise tax which taxed net profit on business activities in prefectures. The value-added tax in the Shoup Recommendation was the first example of the VAT of income type proposed in the tax reform in the world.

The Shoup Recommendation also emphasized local autonomy in public finance system and proposed the radical changes of intergovernmental relation. Though this aspect of the Recommendation is important in respect to the Japanese political system, we omit the problem here and concentrate our arguments mainly on the tax system.

Subsequent Change: Following the Recommendation the Japanese government presented various bills incorporating the tax reform faithfully along the Recommendation to the diet in 1950. All most of the Recommendation was carried out at least for a time except the introduction

of the value-added tax. The bill on the value-added tax was presented to the diet but the effective date postponed annually through 1953 and finally repealed in 1954.

In respect to personal income tax, single, not schedular tax was adopted, capital gain was fully included or deducted in income source, collection (separately from other income) of interest income was abolished and the top bracket rate was reduced from 85% to 55%. However, in 1951 a modification of the original bill already started, namely source collection was restored. In 1952 the gains and losses from security sales was excluded from income and replaced by security transaction tax. In 1953 top brackets rate was raised to 65% when the net wealth tax was abolished. In 1953, interest income was separated from other income and taxed at 10%. Through these changes the personal income tax originally designed as a comprehensive income tax returned to a schedular tax.

In respect to corporate income tax, in 1952 the rate was raised to 42% and in 1955 differentiated rates were applied to lower income corporations (35% on first ¥500,000 income and 40% on the remainder). On local taxes, the value-added tax was never carried out and enterprise tax remained in effect and property tax was partly assigned to prefectures.

In summarizing the subsequent changes after the bill adopted the Recommendation, we can say that the basic structure of the Recommendation changed in considerable degrees in the actual system. In the rigorous use of the term, the principles of the comprehensive income taxation had been discarded in a few year after the Recommendation.

2. Impact of the Shoup Recommendation

The Japanese economy after the Second World War can be divided around early 1970's (before the first oil shock) into two period in terms of growth rates of the real aggregates (see Table 1), namely the high growth period and the moderate growth period. We briefly trace changes in the tax system during the period of high economic growth (1956-70) and assess the impact of the Shoup Recommendation.

The Tax System in the Period of High Economic Growth: This period can be characterized as the period of tax incentives even though the Tax Advisory Commissions of the Government which included academic people warned against the frequent uses of tax incentives because of introducing inequities in the tax system (Pechman & Kaizuka 1976, Ishi 1989).

Promotion of the personal saving was one of the objectives of tax incentives. The incentives in personal taxation already started just after the tax reform based on the Shoup Recommendation, namely the favorable treatment of capital income. As was already mentioned separate taxation on interest income began at 10% rate in 1953, then it was completely exempted in 1955, and again returned to the separate taxation in 1959 in the same rate as in 1953. Beside these treatments, interest income from deposit under a certain amount was tax-exempt. Considering the exclusion of capital gains from the sale of securities from taxable income, we can say that tax on capital income among small savers had been negligible and also tax on capital income even among big savers had been light during the period.

As to objectives of promotion of business saving and investment we had had a host of tax incentives in corporate income tax during the period of high economic growth. These also started just after the tax reform by the Shoup Recommendation, namely accelerated depreciation for important industrial equipment (1951), additional initial depreciation for important industries (1952) initial depreciation for equipment embodying new technology (1958), accelerated depreciation for equipment for medium and small enterprises (1963), and tax credit for research and development expenditure (1967).

There had been the tax incentives directly related to the objective of export promotion in high economic growth period. From 1953 to 1965 producers of exported goods were permitted to deduct 3% of their gross sales abroad, up to 80% of their net operating income from exports. This provision was finally eliminated because it was in direct violation of the rules of GATT which prohibit export subsidies. From 1961 to 1972 firms were allowed accelerated depreciation for their equipment if they raised the proportion of their business from exports over the previous year's level.

The Impact of the Shoup Recommendation on the Tax System: The Japanese tax system had kept the basic structures of the period of high economic growth until the introduction of VAT (i.e. VAT in account type) in 1989. Capital income continued to be taxed lightly and tax incentives in personal income tax was kept intact in spite of the curtailment of special measures in corporate income tax. Indirect taxes continued to play minor roles in the system.

Various authors had different views on the impact of the Shoup recommendation on the Japanese tax system. It is not difficult for us to find a negative view from the process that the tax reform originally recommend had been deformed particularly through returning from the comprehensive system in income tax to the schedular system. Though we certainly admit the fact that the tax system proposed by the Shoup Mission is different from our system maintained from the middle of 1950's to today, probably we could not emphasize this aspect too much.

Another view by several experts in specialists of public finance, has maintained that the tax reform proposed by the Recommendation aims to stimulated the capital accumulation in the postwar period. However, it is easy for us to deny the view by the reason that the tax system based on the comprehensive income taxation cannot be neutral and has many elements restraining savings and investment in the private sector.

The present author thinks that the Shoup Recommendation left behind two things: one is to show a goal of the equitable tax system as a concrete example and the other is to establish efficient tax administration. On the former the idea of comprehensive income taxation has impressed many people very much and even now the idea is accepted even among the experts. The process of recent tax reform reflected that the legacy of the Shoup recommendation remained and the introduction of VAT had encountered a serious opposition based on comprehensive income taxation (Kaizuka 1991). On the latter the emphasis on tax administration in the Recommendation has prompted to change archaic administration to rather efficient tax administration though too much reliance on withholding at source of income

has brought an element of inequity in personal income tax.

3. Economic Development and Tax System

The question how far the tax system in the postwar period contributed to economic development is a big one. In this paper we confine the question to assess the effect of tax system on investment in the private sector because the investment behavior is crucial in the process of economic development. To take the Japanese case, Table 1 shows the high rate of capital formation in the private sector in high growth period, and without the high rate of capital formation the high growth rates around 10% in real GDP for fifteen years could not be achieved.

Before considering the problem we need to clarify the role of the Shoup Recommendation in the context. As was already mentioned the tax system based on the comprehensive income tax is not the system favors economic growth, and in this sense the Shoup recommendation did not introduced the tax system favored the high rate of capital formation. It is rather the deformed system followed by the tax reform based the Recommendation which promoted the high rate of capital formation.

The Significance of the Tax Incentives: There has been several approaches in evaluating the effect of tax incentives on investment in the private sector. In respect to the role of tax incentives, the approach based Tobin's q explicitly recognizes the distinction between the expected rate of return of investment and the cost of capital modified by tax incentives. In other words, the high level of investment could be caused by the high rate of expected return and not necessarily caused by the lower cost of capital implemented by tax incentives. In high growth period we could not deny that the expected rate of return had been very high and the contribution of tax incentive in promoting investment had been limited. Several empirical results (Hayashi 1985, Homma et al. 1987) support the view though the estimation of Tobin's q includes tricky processes of evaluation.

If we could neglect or neutralize the effect of expected rate of return, then the effect of tax incentives on the cost of capital plays its own role.

There have been two types of the research on this problem: namely the measurement on the degree of favorableness of tax incentives and the estimation of investment behavior reflecting tax incentives. The high degree of favorableness does not necessarily indicate that the investment behavior could be statistically well explained by tax incentives because of the factors than tax incentives, for example, prices of capital equipment varied frequently than tax measures.

The degree of favorableness had been sizable in both corporate and personal income tax in the period from 1956-70. One estimate shows that the degree of reduction in the revenue of corporate income tax through tax incentives around 15% in 1970 (Noguchi 1985). The effective rate of personal income tax on interest income on the average was distinctly lower than 20% in 1970. In order to assess the effectiveness of tax incentives correctly we need to elaborate the simulation model further in such a way as to incorporate the big change in the tax system.

Tax Incentive among Various Instruments: Finally it is important for us to add that the role of tax instrument in economic development needs to be properly evaluated among various policy instruments for development. In Japanese case the tax incentives could be understood as an instrument for industrial policy (Komiya et al. 1988, Kaizuka 1989). Along tax incentives trade policy and financial policy had played a role. In respect to trade policy, quota for imports and protective tariffs had been important in the high growth period. The government tried to delay eliminating those measures as late as possible in spite of frequent demands for liberalization by foreign government. In respect to financial policy, the government can use its own financial intermediaries in allocating some portion of funds for investments among industries by offering preferential lower rates for loan compared with the level of interest rates prevailing among private financial intermediaries. A study (Iwata et al. 1987) suggests that the incentive effect through lower lending rates in government financial institution has almost the effect which is roughly comparable to tax incentives.

These policy instruments have gradually faded under the circumstance of

free trade and financial deregulation in recent years. We need to reformulate the tax system in the new circumstances in order to play the proper role in the world economy.

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Table 1: Annual Growth Rates of the Main Real
 Aggregates (Fifteen years average)
 (%)

| | 1956-70 | 1971-85 |
|-------------------|---------|---------|
| Final Consumption | | |
| Expenditure | | |
| Private | 8.81 | 3.13 |
| Public | 5.18 | 4.07 |
| Domestic Fixed | | |
| Capital Formation | | |
| Private | 18.09 | 3.61 |
| Public | 13.65 | 3.05 |
| Exports | 14.60 | 9.23 |
| Gross Domestic | | |
| Expenditure | 9.95 | 4.40 |

Source: EPA, Annual Report on National
Accounts