ECONOMIC ANALYSIS OF THE JAPANESE INDIVIDUAL INCOME TAX

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ABSTRACT

This paper analyses the Japanese Individual Income Tax, including its historical development, its role in Japan's government macroeconomic policies, the importance as a source of revenue, the minimum taxable income. Also, a comparison is made with taxes on personal income of other member-countries of the Organization for Economic Cooperation and Development (OECD). The conclusion is that favorable tax treatment for income from capital should gradually be abolished, as a way to restore the role of the Japanese Individual Income Tax as a tool for income redistribution, diminish the tax erosion and consequently increase the tax collection, presently low for international standards and inadequate to meet the needs of the Central government.

INTRODUCTION

The tax on income was first implemented in 1799, in England, as a temporary tax, as a source of revenue needed to finance the war against the French Army, lead by Napoleon. It was repealed in 1816, after the English triumph in the Waterloo Battle, due to strong opposition by society and the Parliament. The permanent implementation of the tax on income occurred only in 1842, justified by the increasing deficit of the English Treasury.

Nowadays, taxes on income are levied in most of the tax systems of the world. In some developed countries, they are responsible for more than half of the national tax collection. Taxes on income are frequently divided in tax on personal income and in tax on corporate income. This paper analyses the taxation on individual income in Japan.

The tax on personal income can be defined as the fairest among the present taxes. It allows the tax administration to assess accurately the ability to pay of the taxpayer, fulfilling the principles of vertical equity (taxpayers with more ability to pay should be charged proportionately more) and horizontal equity (taxpayers with the same income should be charged evenly).

Besides the collection function, the tax on personal income can have many other important functions: it allows for an allocation of economic resources without distorting relative prices; it can be an important tool for income redistribution, through progressive brackets; yet it fulfils a classic macroeconomic function, that is, the stabilization of economic fluctuations.

The study of the taxation on personal income should take into consideration the stage of development of the period under analysis. For this reason, in this paper deductions and tax brackets will often be estimated in terms of per capita GDP.

This paper analyses mainly the taxation on personal income in Japan. The study includes its implementation, the reforms after World War II, the development of the tax schedule, the minimum taxable income, the local taxes on personal income, the cooperation system and the tax collection. Moreover, non-fiscal functions of the taxes on personal income will be examined, such as the stabilization of economic fluctuations, the role in the income equalization and the tax policy for economic growth. Then, the paper finishes with a short conclusion and with some recommendations for the future of the taxation on personal income in Japan.

1. IMPLEMENTATION OF TAXATION ON INCOME

Japan was one of the first countries to adopt an income tax system, in 1887. However, since economic development was still at an early stage, and the tax rates were low (1% to 3%), its proportion in the total tax revenue was meager (1.5% in 1888). The number of people paying income tax was only 118,600, in a population of 39 million. In 1888, land tax was responsible for 53.8% of total tax revenue.

2. TAX REFORMS OF THE OCCUPATION FORCES AND SHOUP RECOMMENDATIONS

The change in Japan's tax system in the postwar period is part of the democratization reforms implemented by the Supreme Commander of the Allied Power (SCAP), which can be considered as prerequisites for the following successful reconstruction and accelerated growth.[1] The pre-war tax structure was seen as highly regressive, with the great burden of tax (mainly indirect) falling on those least able to pay. The later system took into consideration the ability to pay of the individual, redistributed wealth and contributed to enhance a strong domestic market.

Justice and equity were two major concerns of the Supreme Commander of the Allied Power (SCAP) when reforming Japan's system. Apart from the regressivity of the tax system, the lack of autonomy of local governments, dependent on the central authorities for maintaining their activities, was criticized.

The tax reform of the SCAP had as its main goals: i) to levy a tax on concentrated wealth; and ii) to reform entirely the tax system, especially the individual income tax, aiming at better redistributing the tax burden.

[1] Amongst the democratic reforms implemented, the principal were the zaibatsu (Japanese conglomerates) dissolution, the land reform, the labor reform and the tax reform. The latter emphasized the equity principle of taxation and the income redistribution, seem as fundamental for the Supreme Commander of the Allied Power, inasmuch as it analyzed that the search for foreign markets, due to the unfair income distribution of Japan and consequently restricted domestic market, was one of the reasons for the aggressive Japanese policy before and during World War II.

The redistribution of the national income came through the introduction in 1946 of a net wealth worth tax. It was levied on those who owned more than 100,000 yen. Its tax rates were extraordinarily progressive, ranging from 25 percent to 90 percent. The most affected were the royal family and the zaibatsu. On the other hand, a highly progressive personal income tax was implemented, with the top bracket achieving 85 percent.

After the establishment of the initial reforms by the occupation forces, Carl S. Shoup, a professor of Columbia University, in 1949 headed a mission of tax specialists to Japan in charge of making recommendations for changes in the Japanese tax system. Due to the Shoup reforms, Japan's tax burden shifted from indirect to direct taxation.

Before the Shoup reforms, there was a schedular income tax, divided according to the nature of income, instead of a consolidated and progressive tax on individual income.

The Shoup recommendations established the framework of the present Japanese tax system. Emphasis was placed on the equity principle of taxation and in the direct taxation (especially in the taxes on corporate and on individual income). The recommendations were also focused in the goal for sustainable economic growth (in this sense, it was highlighted the importance of the taxes on income, for their role as built-in stabilizers).

Taxes on income, as the core of the Shoup tax system (his aim was to make them the centerpiece of the tax structure), were modeled in the net worth accretion theory, in the consolidated income principle and in the legal entity doctrine. We will describe briefly these theories.

- The <u>net worth accretion theory</u> refers to the notion that, supposing that an individual spends zero on consumption during a certain period, the net increase in the value of his assets should be regarded as his income for that period. According to this point of view, not only regular income, such as wages or interests, but also temporary income, such as capital gains, should be classified as taxable income.

- The consolidated income principle refers to a system in which progressive tax rates are applied to the total income of the person: wages, interests, dividends, etc.
- The legal entity doctrine considers that a corporation, for taxation purposes, is considered as an entity separated from its owners. The denial of this theory means that all income of an enterprise is deemed to belong to its shareholders.

Under the 1950 reform, for example, temporary income, such as the retirement income, forestry income and capital gains could be averaged out for several years. However, their total amount was to be added to all other incomes before the application of the tax rate due. Moreover, the taxation of capital gains became more comprehensive, including gratuitous transfers of assets by inheritance or gift. Under the previous system, the taxpayer had been allowed to separate interest income from other incomes, but that system was repealed, under the premise that it violated the principle of consolidated income.

As we will see during this paper, among the Shoup recommendations, some are not in place anymore. For example, interests, dividends and capital gains are now taxed separately. In spite of that, even now, at the beginning of the twenty-first century, the report Shoup submitted after the complexion of his mission is taken as a reference for tax reforms in Japan. That is the case of the implementation of the Japanese consumption tax, recommended by Shoup and permanently implemented in 1988.

As a result of the reformulation of the tax system, the share of direct and indirect taxes in the total tax collection changed.

Table 1 - Revenue from national taxes in terms of incidence (%)

	1934-36	1950	1955	1960	1970	1980	1990	1995	2000	2001	2002
DIRECT TAXES	34.8	55.0	51.4	54.3	66.1	71.1	73.7	66.1	61.3	59.5	56.7
INDIRECT TAXES	65.2	45.0	48.6	45.7	33.9	28.9	26.3	33.9	38.7	40.5	43.3

Sources: Shibata (1990, p. 104) for 1934-36; National Tax Agency (2005b) for other years.

As it is shown in table 1, there was a momentary reversal in the shift of tax burden from indirect to direct taxes. In 1950 (before the enactment of the first special tax measures)[2] the percentage of direct taxes in the national tax revenue was 55 percent, higher than in 1955 and 1960. In spite of that, indirect taxes never exceeded direct taxes after the implementation of the SCAP tax reforms.

3. DEVELOPMENT OF THE TAX SCHEDULE OF THE JAPANESE INDIVIDUAL INCOME TAX

In the second half of the 1940s, a highly progressive personal income tax, consolidated, was implemented, with tax rates ranging from 20 to 85 percent (for income above 1 million yen).

In 1950, the maximum tax rate diminished. Tax rates ranged from 20% income up to 50,000 yen) to 55% (income more than 500,000 yen).

More tax alleviation occurred in the following years. In 1951, the tax rate of 55% started to be applied for income more 2 million yen (there was an overall change in the tax schedule). In 1952, the exemption increased to 50,000 yen, and a new tax schedule alleviated the burden for the lower-income brackets. In 1953, the maximum tax rate was raised from 55% for income exceeding two million yen, to 65% for income exceeding five million yen. In 1955, though the maximum rate remained at 65%, the tax table was restructured, so taxpayers with income until 2 million yen received tax alleviation.[3]

In 1957, though the highest marginal tax rate increased (to 70% for income over 50 million yen[4]), there was an overall alleviation in the incidence of the personal income tax, due to wider income class intervals. The table started with a 10% tax rate, for income until 50,000 yen.[5]

[2] The Special tax measures aimed at fostering the economic growth, and were widely used during the rapid economic growth period.
[3] Note: tax alleviation for taxpayers with per capita income until 21.3 times of per capita income. Hereafter, per capita income is calculated by the author, dividing Japan's GDP by the population.
[4] 418 times of per capita income. Estimation of the author.
[5] 0.42 times the per capita income.

As a result of the changes in the legislation of the personal income tax, there was an overall alleviation of the burden of the Japanese Individual Income Tax. Particularly, taxpayers in the lower brackets saw their burden decrease substantially. *“Almost every year has witnessed an increase in basic exemptions and exemptions for dependents, as well as a reduction in the progressive rates, Consequently, the exemption point up to which income is tax-free has risen markedly, while the effective rates have become considerably lower than before (...) tax-free income was approximately 2.6 times as much as it was in 1950.”* The real income tax rate for workers` families *“decreased from approximately 6.6 per cent in 1953 to 3.4 per cent in 1960.”* (Fujita 1966, p. 35).

According to Fujita, the effective income tax rates in 1950 for a family of five (a couple and three children) were 7.33%, 32.70% and 43.33% for annual income of 150 mil yen, 500,000 yen and 1 million yen, respectively. *“Since per capita income approximately tripled from 1950 to 1960, 450,000 yen, 1.5 million yen and 3 million yen may be regarded as the 1960 equivalents of the above three 1950 income levels.” (ibid p. 43).* In 1960, the effective tax rates of these equivalent income tax levels were 2.20%, 16.08% and 25.08%, respectively. Thus, the burden of the tax on personal income diminished throughout the 1950s, benefiting most the low-income brackets.

Table 2 – Effective tax rate for a family of five (1950 and 1960)

YEAR	Yearly income (yen)	Yearly income / per capita income(1)	Effective tax rate (%)
1950	150,000	2.62	7.33
	500,000	8.75	32.70
	1,000,000	17.50	43.33
1960	450,000	2.62	2.20
	1,500,000	8.75	16.08
	3,000,000	17.50	25.08

Sources: Fujita 1966; Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications (2005).

(1) Estimation of the author. As in the Statistics Bureau there is no 1950 GDP, the relation yearly income / per capita income of 1950 is based on the premise of Fujita (1966), that the 1960 per capita income tripled the 1950 per capita income.

The tax schedule was again modified in 1961 and in 1962. The revisions of 1961 concentrated tax reductions in the lower income classes, while the 1962 revisions lowered the tax rates in all income classes, except those earning above six million yen (those saw their marginal tax rate increase to 75%).[6]

3.1. Recent changes in the tax schedule

The tax reform of 1988 started a mitigation of the progressiveness of the taxes on personal income. Thus, the Individual Income Tax, whose rates previously ranged from 10.5% to 60%, in 12 brackets, got a new schedule with tax rates ranging from 10% to 50%, in 5 brackets.

Table 3 - Tax schedule of the Individual Income Tax after the 1988 tax reform

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income (1)
Until 3	10%	0.98
From 3 to 6	20%	1.97
From 6 to 10	30%	3.28
From 10 to 20	40%	6.56
Over 20	50%	-

Sources: National Tax Agency (2005a); Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications (2005).

(1) Estimation of the author, related to the year 1988.

Further decrease in the progressiveness was implemented with the tax reform of 1994. The new tax schedule had the same highest marginal tax rate, though for income over 30 million yen.

[6] Only 0.1% of taxpayers were subject to the highest bracket, in 1960. (Yamamura 1967).

Table 4 - Tax schedule of the Individual Income Tax after the 1994 tax reform

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income [(1)]
Until 3.3	10%	0.86
From 3.3 to 9	20%	2.35
From 9 to 18	30%	4.70
From 18 to 30	40%	7.84
Over 30	50%	-

Source: ibid.

(1) Estimation of the author, related to the year 1994.

We can observe that, comparing to 1988, the tax reform of 1994 brought about actual tax alleviation for taxpayers earning more than 3.3 million yen per year. For those bellow this limit, the upper limit of their bracket in 1994 was lower, in terms of per capita income, at the same tax rate, than the upper limit in 1988.

The last substantial reform in the individual income tax was carried out in 1999, decreasing again the progressivity of the tax schedule. From then and until now (2005), the tax rates range from 10% (net taxable income until 3.3 million yen) to 37% (net taxable income of more than 18 million yen).

Table 5 – Tax schedule of the Individual Income Tax after the 1999 tax reform

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income [(1)]
Until 3.3	10%	0.82
From 3.3 to 9	20%	2.25
From 9 to 18	30%	4.50
More than 18	37%	-

Source: ibid.

(1) Estimation of the author, related to the year 1999.

We can note that real alleviation, comparing to the 1994 schedule, occurred for taxpayers earning above 9 million yen, as for those earning bellow this amount the upper limit of their bracket, in relation to per capita income, was in 1999 bellow the 1994 level.

4. DEDUCTIONS ALLOWED

As it happens in most of the tax systems throughout the world, in the case of the taxation on personal income several deductions and tax credits are allowed, aiming at taking into consideration the ability to pay of the taxpayer. Unless otherwise expressed, all income of the individual is aggregated. Some exceptions are timber income, capital gains, dividends and interests.

<u>Some deductions allowed for the aggregate ordinary income in Japan are:</u>

- Basic exemption: 380,000 yen.
- Employment income deduction: 650,000 yen when income receivable is not more than 1,625,000 yen, 40% of income when exceeding 1,625,000 yen but not 1,800,000 yen, 30% of income plus 180,000 yen when exceeding 1,800,000 yen but not 3,600,000 yen, 20% of income plus 540,000 yen exceeding 3,600,000 yen but not 6,600,000 yen, 10% of income plus 1,200,000 yen when exceeding 6,600,000 yen but not 10 million yen, and 5% of income plus 1,700,000 yen when exceeding 10 million yen.
- Deduction for dependents: 380,000 yen. Some specific cases: 480,000 yen for each elderly dependent 70 years old or older; 480,000 yen for each young dependent younger than 16 years of age; 630,000 for a specific dependent from 16 to 22 years of age.
- Deduction for the elderly: 500,000 yen.
- Deduction for the handicapped: 270,000 yen (400,000 yen for the severely handicapped).
- Deduction for widows or working students: 270,000 yen (350,000 yen for special widows).
- Deduction for spouses: 380,000 yen (480,000 yen for elderly spouses 70 years old or older.
- Medical expenses in excess of 5% of total income or 100,000 yen, whichever is smaller, but not exceeding 2 million yen.

- Social insurance premiums.

5. MINIMUM TAXABLE INCOME

The deductions of the Japanese Individual Income Tax clearly favor the wage-earner who is the married and whose spouse is not income-earner.[7]

The table 6 shows the minimum taxable income for employment income, calculated by the Tax Bureau of the Japanese Ministry of Finance.

Table 6 – Minimum taxable income for employment income

in thousands of yen

YEAR	Single	Married couple without child	Married couple with one child	Married couple with two children
1955	93	143	174	205
1960	118	210	250	289
1965	196	351	413	474
1970	344	580	728	880
1975	800	1,073	1,418	1,830
1980	831	1,136	1,569	2,015
1985	967	1,322	1,833	2,357
1990	1,075	1,928	2,484	3,198
1995	1,107	2,095	2,698	3,539
1996	1,107	2,095	2,698	3,539
1997	1,107	2,095	2,698	3,539
1998	1,107	2,095	2,698	3,616
1999	1,144	2,200	2,833	3,821
2000	1,144	2,200	2,833	3,842
2001	1,144	2,200	2,833	3,842
2002	1,144	2,200	2,833	3,842

Source: Ministry of Finance of Japan. (2005)
1) Minimum taxable income is calculated by summing up the basic exemption, allowances for spouses and dependents, employment income deductions and social insurance premium deductions.
2) In all situations, only one income earner in the family.

Then, we compared the values of table 6 with the per capita income.

[7] We can attribute this fact to the custom, still in place in Japan, of wives to leave the job to take care of the children. By allowing generous deductions for the spouse and other dependents, the tax system favors the maintenance of this tradition.

Table 7 – Minimum taxable income for employment income, in relation to per capita GDP

YEAR	Per capita income (thousand yen) (A)	Single /(A)	Married couple without child/ (A)	Married couple with one child /(A)	Married couple with two children/(A)
1955	94	0.99	1.53	1.86	2.19
1960	171	0.69	1.23	1.46	1.69
1965	334	0.59	1.05	1.23	1.42
1970	707	0.49	0.82	1.03	1.24
1975	1,325	0.60	0.81	1.07	1.38
1980	2,052	0.41	0.55	0.76	0.98
1985	2,647	0.37	0.50	0.69	0.89
1990	3,479	0.31	0.55	0.71	0.92
1995	3,848	0.29	0.54	0.70	0.92
1996	3,975	0.28	0.53	0.68	0.89
1997	4,040	0.27	0.52	0.67	0.88
1998	3,942	0.28	0.53	0.68	0.92
1999	4,004	0.29	0.55	0.71	0.95
2000	4,030	0.28	0.55	0.70	0.95
2001	3,974	0.29	0.55	0.71	0.97
2002	3,909	0.29	0.56	0.72	0.98

Sources: Ministry of Finance of Japan. (2005); Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications (2005).
Note: estimation of the author

We can observe that the income tax threshold for a wage-earner married with two children is just around the per capita GDP, having reached as much as 2.19 times the GDP in 1955.

According to Fujita (1966), tax-free income for a family of five (wage-earner, non-working spouse and three children) was in 1960 2.6 times higher than in 1950. *"This rate of increase is higher than that for both real personal income and real personal consumption expenditures on a per capita basis (about 2.0 times)."* (Fujita 1966, p. 35).

6. LOCAL TAXES ON PERSONAL INCOME

Taxes are charged by the national and by local governments. Japan is one of the few countries in the world that levy tax on personal income also at the local level.

As a result of the tax reform of 1988, the tax schedule of the individual inhabitants tax, which previously ranged from 5% to 16%, in 7 brackets, was changed, the new rates ranging from 5% to 15%, in 3 brackets.

Table 8 - Tax schedule of the Individual Inhabitants tax after the 1988 tax reform

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income (1)
Until 1.6	5%	0.53
From 1.6 to 5.5	10%	1.81
Over 5.5	15%	-

Source: National Tax Agency (2005a); Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications (2005).

(1) Estimation of the author, related to the year 1988.

Another change was brought about by the 1994 tax reform. The upper limit of the brackets in relation to per capita income had similar levels as after the 1988 schedule, showing that the 1994 tax reform was somehow neutral in terms of income distribution, if we consider only the individual inhabitants tax.

Table 9 - Tax schedule of the Individual Inhabitants tax after the 1994 tax reform

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income (1)
Until 2.0	5%	0.52
From 2.0 to 7.0	10%	1.83
Over 7.0	15%	-

Source: ibid.

(1) Estimation of the author, related to the year 1994.

New changes were implemented with the 1999 tax reform. From then and up to the present time (2005), the maximum marginal tax rate stands at 13%. The individual inhabitants tax is assessed by Prefectures and municipalities.

a) Prefectural inhabitants tax

It is composed of two parts:

i) The income of the previous year. The tax rates are shown in the table 10.

Table 10 – Tax schedule of the Prefectural Inhabitants Tax

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income (1)
Until 7	2.0%	0.50
More than 7	3.0%	-

Source: ibid..

(1) Estimation of the author, related to the year 1999.

ii) Lump sum tax: 1,000 yen per individual

b) Municipal inhabitants tax

It is also composed of two parts:

i) The income of the previous year. The tax rates are shown in the table 11.

Table 11 – Tax schedule of the Municipal Inhabitants Tax

Taxable income (million yen)	Tax rate	Upper limit of the bracket / per capita income (1)
Until 2	3.0%	0.50
From 2 to 7	8.0%	1.75
More than 7	10.0%	-

Source: ibid.

(1) Estimation of the author, related to the year 1999.

ii) Lump sum tax: 3,000 yen per individual

Thus, the total tax rate on personal income, considering the three government levels, reaches 50%, for individuals with taxable income over 18 million yen. However, before the 1988 tax reform, the highest marginal tax rate was as high as 76% (60% for the Individual Income Tax, 16% for the Individual Inhabitants Tax).

7. THE COOPERATION SYSTEM OF THE JAPANESE INCOME TAX

Taxation on income in Japan is extremely interconnected, with local governments depending on the national assessment for calculating their own taxable income.

There is an official assessment for local inhabitants tax. The local governments have to file returns based on the taxpayers' previous year income. The national government sends a copy of the file returns of income tax to local governments for them to assess the inhabitants tax. Inhabitants tax depends on the national tax collection, on the national withholding system.

Prefectural and municipal governments are usually cooperative. For instance, they receive individual income tax returns. There is also a regular exchange of information on the economic situation of the taxpayer among all government levels.

The described system saves a great deal of work for taxpayers. They have only to file returns for the national government. Overall, we can conclude that the cooperation system of Japan's income tax is an example of how cooperation can work to reduce taxpayer's burden and increase efficiency of tax collection.

8. NON-FISCAL FUNCTIONS OF THE JAPANESE INCOME TAX

8.1 Stabilization of economic fluctuations

During the rapid economic growth era, the progressive income tax acted as a stabilizer of economic fluctuations, as the tax collection increased more than the GDP in periods of prosperity, and declined proportionately more in periods of recession. "*The very progressive income tax levied during this period worked as a built-in stabilizer whereby the growth rate of tax revenue exceeded the growth rate of national income in times of prosperity and declined in times of recession (…)*". (Nakamura 1995, p. 126). It is the principle of passive flexibility of taxation[8] applied in the Japanese taxation system. The tax satisfy this principle when, tax laws

[8] In Newmark 1994

remaining unchanged, it contributes to soften short-term fluctuations of the economy without hindering the long-term economic growth.

8.2 Redistribution of income

Another function of the Japanese Individual Income Tax is the redistribution of income. By changing the wealth distribution before tax, taxes on income can reduce the income inequality. Until 1987, the level of improvement of the income distribution, due to the progressive Japanese Individual Income Tax, was considerable. However, due to the reductions in the tax rates that started at the end of the 1980s, the level of improvement of the income distribution has been diminishing, being only 0.8% in 2002.

Table 12 – Gini Coefficient before and after the Individual Income Tax

YEAR	Initial income	Income redistributed through tax (Initial income – Tax)	
	Gini Coefficient	Gini Coefficient	Level of improvement
1980	0.3491	0.3301	5.4%
1983	0.3975	0.3824	3.8%
1986	0.4049	0.3879	4.2%
1987	0.4049	0.3879	4.2%
1990	0.4334	0.4207	2.9%
1993	0.4394	0.4255	3.2%
1996	0.4412	0.4338	1.7%
1999	0.4720	0.4660	1.3%
2002	0.4983	0.4941	0.8%

Sources: Nakamura 1995, p. 133; Kanazawa (2005).

Note: (1) Level of improvement (%) =

$$\frac{\text{Gini Coefficient for Initial Income} - \text{Gini Coefficient for Redistributed Income}}{\text{Gini Coefficient for Initial Income}}$$

(2) The redistribution through the social security system is not shown in this table.

According to the United Nations (2005), Japan had the second best income distribution in the world, with Gini Coefficient of 0.249, surpassed only by Denmark (0.247). That situation, though, may have changed to the present time, as the data related to Japan was of the year 1993, and since then the level of improvement of the income distribution through the Individual Income Tax has decreased substantially.

8.3 Tax policy for economic growth

During the rapid economic growth era (1955-1973)□government policies were centered on the allocation of economic resources. Among those policies, we could cite the special measures of the Individual Income Tax. Those measures partly stood against the Shoup recommendations.

<u>Savings and economic growth</u>

The growth rate is defined by the Harrod-Domar model as the ratio of the gross saving ratio (α) and the capital-output ratio ($K/Y = \beta$) minus the depreciation of fixed assets (δ). So,

$$G = (\alpha/\beta) - \delta \qquad (1)$$

By equation 1 it can be concluded that a high rate of savings is essential to sustain rapid growth.

For this reason, the Japanese tax policy aimed at promoting the private saving, thus stimulating the economic growth. In this sense the Special Taxation Measures Law was first enacted in 1952.

Income tax disincentive savings. The disposable income of today

$$(1 - t)Y \qquad (2)$$

where t = tax rate

Y = pre-tax income,

can be utilized for consumption or savings ($C_1 + S$), so

$$C_1 + S = (1 - t)Y \qquad (3)$$

Savings plus interest rate earned are equal to consumption in the following period. Thus,

$$C_2 = (1+r)S \qquad (4)$$

where r = interest rate

But if interest rates are taxed at a rate s,

$$C_2 = (1-s)(1+r)S \qquad (5)$$

Therefore, income tax on interest rates result in less consumption in period 2. The result is that individuals and companies are less willing to save.

It is also argued that taxation on dividends and on capital gains may affect the will of individuals and companies to invest.

How did the Japanese taxation policy encourage personal savings?

Some measures adopted were:

- Separate taxation of interest income from other incomes. The former was taxed at a flat rate of 10 percent, substantially lower than the ordinary income brackets. Interest income was tax-free during the period 1955-59. Its taxation resumed in 1960. In 1963-64, the tax on interest income was reduced for two years from a flat 10 percent to a flat 5 percent. Interest income continued to be given special treatment throughout the 60s;
- Exemption, up to a certain limit, of postal savings interest tax; the exemption limit increased, from 30,000 yen in 1950 to 500,000 yen in 1962;
- Special provisions for dividend income; reduced from 15 percent to 10 percent in 1955-59, and the exemption for that period was increased from 25 percent to 30 percent; in 1963-64, again its rates were reduced to a flat 10 percent and the exemption raised to 30 percent; dividend income continued to be given special treatment during the rapid growth era; those measures were taken in the view that they would help industries to endure international competition that would come with the coming trade liberalization;
- Tax exemption for capital gains; Professor Shoup recommended a consolidated income tax; capital gains were exempted from 1953 to 1969.

One of the features of the postwar Japanese economy was precisely its high rate of savings in relation to the GDP. Japan's personal savings were unusually high in comparison with other advanced countries.

Table 13 - Average propensity to save in selected countries (1950-60)

Japan	16.2
USA	7.4
West Germany	13.2
France	6.1
UK	2.9
Canada	7.6
Holland	10.2

Source: extracted from Komiya (1966, p. 175).

It must be pointed out that it is difficult to determine whether the favorable tax treatment for income derived from capital affected Japan's average propensity to save.

Presently, the taxation on interest income, dividend income and capital gains still receives favorable treatment (see section 9). Tax rates on income from capital are much lower than the rates for ordinary aggregate income. We can conclude, therefore, that the Japanese tax system still encourages personal savings, since: i) interest income, dividend income and capital gains are taxed at a lower level than ordinary aggregate income; and ii) deduction of interests paid is not allowed, except for specific cases.

9. TAXATION OF DIVIDENDS, CAPITAL GAINS AND INTERESTS

As a special measure, interest income, dividend income and capital gains may be taxed separately from other income, as follow:

- Numerous types of interest income are tax exempt (for example, interest on central and local government bonds, not exceeding 3.5 million yen). As a general rule, interest on ordinary deposit and other deposits of a similar level are taxed exclusively at the source at the rate of 15% at the national level, and a 5% local inhabitants tax is levied in addition.

- Dividends (except the distribution of gains from privately-subscribed bond investment trusts, etc.) paid to residents are normally subject to withholding at the source at a rate of 20%. The total tax (national and local) on dividends derived from listed companies will be withheld at the rate of 10% from 1 April 2003 to 31 March 2008 . The distribution of gains from privately-subscribed bond investment trusts, etc. is subject to withholding at the source at a rate of 15% (a 5% local inhabitants tax is levied in addition). Dividends accruing from securities issued outside of Japan are subject to withholding at payment intermediaries at the rate of 15% or 20%.
- The Income Tax Law allows a taxpayer to deduct 10% of dividend income from income tax. However, if ordinary taxable income, including dividends, exceeds 10 million yen, a tax credit of only 5% is applicable to the fraction of dividend income equal to the ordinary taxable income minus 10 million yen, and that of 10% is applicable to remaining dividend income. In the case of distribution of profits from securities investment trusts, 5% of such distribution income may be deducted from income tax. If taxable ordinary income exceeds 10 million yen, 2.5% of that distribution income, which is equal to the ordinary taxable income minus 10 million yen, is deductible.
- There is also special treatment for capital gains, divided in short-term capital gains and long-term capital gains. From the capital gain, the taxpayer is allowed to deduct 500,000 yen as a special deduction. Then, for the net taxable short-term capital-gain it is added 50% of the sum of net long-term capital gain.

It must be pointed out that special tax treatment for interest income, dividend income and capital gains harm the principle of the equity of tax burden, which may negatively impact the morality of taxpayers. Another of its negative effects is the accompanying tax erosion. Particularly, the favorable treatment for these forms of income clearly benefit high income earners, being difficult to demonstrate any economic effect that could offset its demerits.

10. WITHHOLDING INCOME TAX PER INCOME TYPE

The table 14 shows the withholding income tax per income type. It may be clearly seen that the drop in the collection of interest income was responsible for almost the totality of the decrease in the withholding Individual Income Tax, between 2001 and 2002.

Table 14 - Withholding Income Tax per income type

(in yen million)

	Interest income	Dividends	Capital gains of listed stocks	Wage and salaries
1997	1,322,436	848,165	127,012	13,153,888
1998	1,094,877	848,072	101,260	10,783,223
1999	924,959	917,115	416,534	10,319,434
2000	3,161,555	1,018,800	385,460	10,176,191
2001	3,986,258	942,989	180,810	10,137,116
2002	1,258,008	1,053,721	196,831	9,703,525
	Retirement income	Remuneration, fee, etc.	Income of non-residents	**TOTAL**
1997	257,671	1,159,264	294,191	**17,162,627**
1998	275,545	1,029,676	301,198	**14,433,851**
1999	315,900	1,096,231	302,620	**14,292,793**
2000	294,155	1,101,342	335,842	**16,473,344**
2001	321,573	1,114,021	401,261	**17,084,029**
2002	380,695	1,100,616	391,049	**14,084,444**

Source: National Tax Agency (2005b).

11. TAX AMOUNT OF THE JAPANESE INDIVIDUAL INCOME TAX PER CLASS OF INCOME

The table 15 demonstrates the sum of the wage-earners, who were subject to the withholding income tax, with the taxpayers filing returns, per class of income.

Table 15 – Tax amount per class of income (2001)

Class of income (per million yen)	Number of taxpayers (thousand)	% of taxpayers	Tax amount (yen billion)	% of tax amount
Until 1	810	1.76%	17.8	0.16%
From 1 to 2	5,350	11.66%	168.2	1.47%
From 2 to 3	7,690	16.75%	518.4	4.52%
From 3 to 5	15,120	32.94%	1,745.1	15.22%
From 5 to 10	13,730	29.91%	3,519.1	30.70%
Over 10	3,200	6.97%	5,495.1	47.93%
TOTAL	45,900	100.00%	11,463.7	100.00%

Source: Ministry of Finance of Japan (2005), p. 386.

We can see that taxpayers with yearly income over 10 million yen were responsible for almost 48% of the tax amount. On the other hand, taxpayers with aggregate income up to 2 million yen (13.42% of the total) paid 1.63% of the total national Individual Income Tax.

The Number of taxpayers of the Individual Income Tax (45.9 million in 2001) was equivalent to 36% of the population, a very high share.

12. TAX COLLECTION OF THE INDIVIDUAL INCOME TAX

After World War II, the tax collection increased by a large extent, favored by the rapid economic growth. Also, Public Finance Law did not allow the Japanese government to finance its annual expenditure (except expenditure for public utilities) using government bonds or loans. Even when the government was permitted to issue bonds, the Bank of Japan (Japan's central bank) was in principle not permitted to underwrite them. This was called "Sound Fiscal Policy."

The new tax system established after the war was centered on the taxes on income. The steep growth of the Japanese economy pushed up personal income tax revenues due to its progressive tax rate structure and also contributed to the increase in the corporate tax revenue. This led to a high ratio of income tax revenues to total tax revenue, reaching 72% in 1974. Thereafter, as Japan's economic growth started slowing down, the income tax revenues increased less remarkably than in the high economic growth era, and the ratio of income tax revenues stayed around 70% until 1991. With the tax reforms of 1988 (decrease in the tax rates of taxes on income and implementation of the consumption tax) and 1994 (another decrease in the tax rates of taxes on income and increase on the rate of the consumption tax, from 3% to 5%), the importance of taxes on income have diminished, though they are still the centerpiece of the taxation system. Consumption tax has gradually occupied larger share in total tax revenue, but the central focus was still on income tax. Recently, reductions in individual and corporate tax rates and the persistent economic recession have caused a decrease in the collection of direct taxes. The greatest share of the Individual Income Tax in the National Tax collection occurred in 1990, when it collected 41.4% of national taxes.

Table 16 – Share of the Individual Income Tax in the National Revenue

In billion yen

YEAR	Total National Tax Revenue (A)	Individual Income Tax Revenue (B)	B/A
1950	570.20	220.10	38.60%
1955	936.30	278.70	29.77%
1960	1,801.00	390.60	21.69%
1965	3,278.50	970.40	29.60%
1970	7,773.20	2,428.20	31.24%
1975	14,504.30	5,482.30	37.80%
1980	28,368.80	10,799.60	38.07%
1985	39,150.20	15,435.00	39.43%
1990	62,779.80	25,995.50	41.41%
1995	54,963.00	19,515.10	35.51%
1996	55,226.00	18,964.90	34.34%
1997	55,600.70	20,882.00	37.56%
1998	51,197.70	17,376.80	33.94%
1999	49,213.90	16,903.80	34.35%
2000	52,720.90	18,788.90	35.64%
2001	49,968.40	17,806.50	35.64%
2002	45,844.20	14,708.00	32.08%

Source: Ministry of Finance of Japan (2005).
Note: Social Security contributions are not included.

In spite of the reduction in its relative importance, still the individual income tax is the first in terms of national tax collection.

In the table 17, we added the collection of the Individual Income Tax and the Local Inhabitants Tax. Then, we compared this result with the total tax collection (national tax collection plus local tax collection).

Table 17 – Total collection of the Individual Income Tax and Local Inhabitants Taxes

In yen billion

YEAR	Total Tax Collection (A)	National Individual Income Tax	Local Inhabitants Taxes	Total taxes on personal income (B)	B/A
1950	758.5	220.1	46.4	266.5	35.14%
1955	1,317.9	278.7	71.5	350.2	26.57%
1960	2,545.2	390.6	99.6	490.2	19.26%
1965	4,827.9	970.4	343.0	1,313.4	27.20%
1970	11,523.9	2,428.2	696.9	3,125.1	27.12%
1975	22,659.1	5,482.3	2,099.0	7,581.3	33.46%
1980	44,262.6	10,799.6	4,304.7	15,104.3	34.12%
1985	64,266.7	15,435.0	6,603.1	22,038.1	34.29%
1990	96,230.2	25,995.5	10,555.8	36,551.3	37.98%
1995	88,638.0	19,515.1	10,187.2	29,702.3	33.51%
1996	90,319.8	18,964.9	9,554.9	28,519.8	31.58%
1997	91,756.2	20,882.0	10,427.5	31,309.5	34.12%
1998	87,119.9	17,376.8	9,318.3	26,695.1	30.64%
1999	84,240.0	16,903.8	9,149.0	26,052.8	30.93%
2000	88,267.3	18,788.9	9,720.2	28,509.1	32.30%
2001	85,517.2	17,806.5	9,541.9	27,348.4	31.98%
2002	79,704.2	14,708.0	8,674.4	23,382.4	29.34%

Source: Ministry of Finance of Japan (2005).
Note: Social Security contributions are not included.

We also compared the collection of the taxes on personal income with the Japanese GDP.

Table 18 - National and local taxes on personal income in relation to GDP

YEAR	GDP (billion of yen)	National IIT/GDP	Local IT/GDP	(Total taxes on personal income)/GDP
1955	8,370	3.33%	0.85%	4.18%
1960	16,010	2.44%	0.62%	3.06%
1965	32,866	2.95%	1.04%	4.00%
1970	73,345	3.31%	0.95%	4.26%
1975	148,327	3.70%	1.42%	5.11%
1980	240,176	4.50%	1.79%	6.29%
1985	320,419	4.82%	2.06%	6.88%
1990	430,040	6.04%	2.45%	8.50%
1995	483,220	4.04%	2.11%	6.15%
1996	500,310	3.79%	1.91%	5.70%
1997	509,645	4.10%	2.05%	6.14%
1998	498,499	3.49%	1.87%	5.36%
1999	507,224	3.33%	1.80%	5.14%
2000	511,462	3.67%	1.90%	5.57%
2001	505,847	3.52%	1.89%	5.41%
2002	498,102	2.95%	1.74%	4.69%

Source: ibid.

The collection of the individual income tax achieved as much as 8.5% of GDP, in 1990, standing just below 5% in 2002. The highest tax collection matches, perhaps not surprisingly, with the end of the period of stable growth. At the beginning of the 1990s, after the burst of the financial bubble, Japan would enter into a long period of recession.

13. INTERNATIONAL COMPARISON

In the table 19, we compare some data of the taxation on personal income and the tax burden of Japan with the data of the other member-countries of the Organization for Economic Cooperation and Development (OECD). We can see that, though Japan's highest marginal tax rate on personal income is one of the highest of the OECD, its collection in relation to GDP is relatively low. Also, Japan's tax burden is much lower than OECD's average. Perhaps fortuitously, the two biggest economies of the world[9] have comparatively low tax burden.

[9] The USA and Japan, according to the United Nations (2005).

Table 19 – Highest marginal tax rate of taxes on personal income, personal income tax revenue in relation to GDP and tax burden of OECD countries

Country	Highest marginal tax rate of taxes on personal income	Personal Income tax revenue (% of GDP - 2001)	Tax burden (2002)
Australia	48.5%	12.3%	31.5%
Austria	50.0%	10.4%	44.0%
Belgium	53.5%	14.5%	46.4%
Canada	46.4%	13.0%	33.9%
Czech Republic	32.0%	4.8%	39.3%
Denmark	59.7%	26.3%	48.9%
Finland	52.1%	14.1%	45.9%
France	55.7%	8.0%	44.0%
Germany	47.5%	10.0%	36.0%
Greece	40.0%	5.4%	35.9%
Hungary	38.0%	7.6%	38.3%
Iceland	43.6%	14.5%	38.1%
Ireland	42.0%	8.9%	28.4%
Italy	46.1%	10.9%	42.6%
Japan	**50.0%**	**5.5%**	**25.8%**
Korea	39.6%	3.8%	24.4%
Luxembourg	38.9%	7.2%	41.8%
Mexico	33.0%	-	18.1%
Netherlands	52.0%	6.5%	41.8%
New Zealand	39.0%	14.5%	34.9%
Norway	47.5%	10.5%	43.5%
Poland	40.0%	7.9%	32.6%
Portugal	40.0%	6.0%	33.9%
Slovak Republic	19.0%	3.5%	33.1%
Spain	45.0%	6.9%	35.6%
Sweden	56.5%	16.4%	50.2%
Switzerland	42.1%	9.8%	30.3%
Turkey	40.6%	7.7%	31.1%
United Kingdom	40.0%	11.3%	38.8%
United States	41.6%	12.2%	26.4%
OECD unweighted average	**44.0%**	**10.0%**	**36.5%**

Source: Organization for Economic Cooperation and Development - OECD (2003 and 2005a).
Note: Local personal income tax rates are added, when that is the case. Among the OECD members, Japan, Canada, Spain, Switzerland and the USA have personal income taxes at local level.

Japan's tax burden, though may be considered for some economic analysts as beneficial for economic growth, is not sustainable in the long run. In 2002, the budget deficit was 8,4% of GDP, and total public debt reached 129% of GDP.[10]

[10] Source: http://www.mof.go.jp/english/budget/pamphlet/cjfc.htm; http://www.mof.go.jp/english/e1c020.htm; Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications (2005); estimation of the author.

CONCLUSION

Thought the taxation on income was implemented in 1887, it was only with the democratic reforms of the occupation forces that it became the centerpiece of the taxation system. With the changes implemented by the SCAP, it was shown that it is viable the implementation of a modern and fair tax system, even before a certain country reaches a high stage of development. During the reconstruction period (1945-55) Japan already had a progressive system, whose core was the taxes on income.

The role of the Individual Income Tax as a tool for income redistribution was in the past more prominent than today. The level of improvement of the Gini index has significantly diminished since the beginning of the 1980s, what can be partially attributed to the lowering of the progressivity of the tax schedule.

The maximum marginal tax rate of the Japanese Individual Income Tax reached as much as 85%, in the second half of the 1940s, having varied frequently until a process of steady decrease was initiated, in the 1980s. Presently, adding the tax rates of the central government and the local governments, the highest rate is 50%. This rate is above the average of the OECD countries, though the collection of taxes on personal income in Japan is lower than that achieved by most of the OECD partners.

The deductions allowed by the legislation of the Individual Income Tax clearly favor the wage-earner who is married to a non-working spouse and who have children, contributing to maintain the tradition of wives leaving the work to take care of the children. Nowadays, a wage-earner married to a non-working spouse and with two children has exempt income close to the per capita GDP, what is much higher than the level of deductions allowed for a single taxpayer but lower than the level of deductions allowed in the 1950s and 1960s.

In spite of recent drawbacks in the tax collection, the Individual Income Tax is still the tax with the highest collection at national level. Also, Local Inhabitants Tax is an important source of revenue for Prefectural and Municipal governments.

The personal income is in general taxed on an aggregate base, following the Shoup recommendations. Some exceptions are timber income, capital gains, interest income and dividend income. There is special tax treatment for these last three forms of income, what causes erosion of the collection of the Individual Income Tax.

Last, it should be noted the efficiency of the cooperation system of taxes on personal income in Japan, an example of how cooperation can work to reduce taxpayer's burden and increase efficiency of tax collection.

RECOMMENDATIONS

The goal of public finances should be to develop a tax system that is neutral in the choices between savings and investment, that is, a system that do not distort the decisions regarding present and future consumption. The Japanese tax system can be defined as favoring savings, since incomes from capital (dividends, interest, capital gains) are taxed lighter than employment income. That causes erosion of the tax basis and stands against the principle of ability to pay. Therefore, future changes in Japan's tax system should contemplate the equalization of the taxation of different forms of income, with the aim of promoting tax neutrality and fairness.

This favored treatment of savings may have had logic during the reconstruction period (1945-55), when the main goal was to replace the capital stock destroyed in the period of World War II, and during the rapid economic growth era (1955-1973), when the high marginal propensity to save was essential for rapid accumulation of fixed capital and for the maintenance of the balance of payments equilibrium.

However, to the present time Japan's economic situation has changed dramatically. It has a highly developed secondary sector, with the basic consumption demands satisfied. Moreover, as Japan has been having substantial surplus in the current account balance and the productive capacity surpasses the demand (domestic and foreign), emphasis should be put not on savings promotion, but on the lifting of the domestic consumption, as a way to more effectively underpin the economic recovery.

In this sense, a reform of the Japanese Individual Income tax, encouraging the domestic consumption, could help the economic recovery and, at the same time, reduce the unbalanced relation between savings and investment,[11] which causes commercial tensions with other countries.

[11] As Japan's aggregate savings is considerably higher than aggregate investment, it has been achieving huge trade surpluses, target of complaints by countries with negative trade balance towards Japan, like the USA.

The highest tax rate of the Japanese Individual Income Tax is not low for international standards. However, it should be better analyzed the reasons why it has lost capability to redistribute the nation's wealth, and measures should be thought of to restore its role as a tool for income redistribution.

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