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Moving toward a Dual Income Tax in Japan¹

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Abstract

The aim of this paper is to explore the recent move toward a system of dual income tax (DIT) in Japan, tracing back to the development of the individual income tax in the postwar period. Focus is upon very pragmatic considerations institutionally, rather than abstract theoretical arguments. In what follows, main issues are divided into four parts. First, as an introductory part, the basic features of Nordic DIT are summarized briefly. Second, the shift from a comprehensive income tax (CIT) and its aftermath is studied in light of special tax measures for capital income taxation. Third, an idea of integrating “financial income” into one global system, which was proposed by the Government Tax Commission, is examined as the first step to move toward a DIT in the future. Lastly, paper is concluded to stress that individual income tax reform toward a DIT seems to be inevitable as a result of trial and error that the Japanese tax system has experienced in the past.

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1. Introduction; Significance of a dual income tax Basic features of a Nordic DIT

Since the Nordic countries played an active role in the hectic tax reform efforts in light of dual income taxation in the 1990s, there have been a number of literature to study its basic features in theory and practice (see, for example, Sorensen 1994 and 1998, Sorensen and Nielsen 1997, Boadway 2005). A special feature of adopting a DIT was to move away from the principle of the CIT to a new tax framework. Under a progressive CIT, a single progressive tax schedule is applied to comprehensive income; that is, to the sum of the taxpayer's incomes from all sources.³

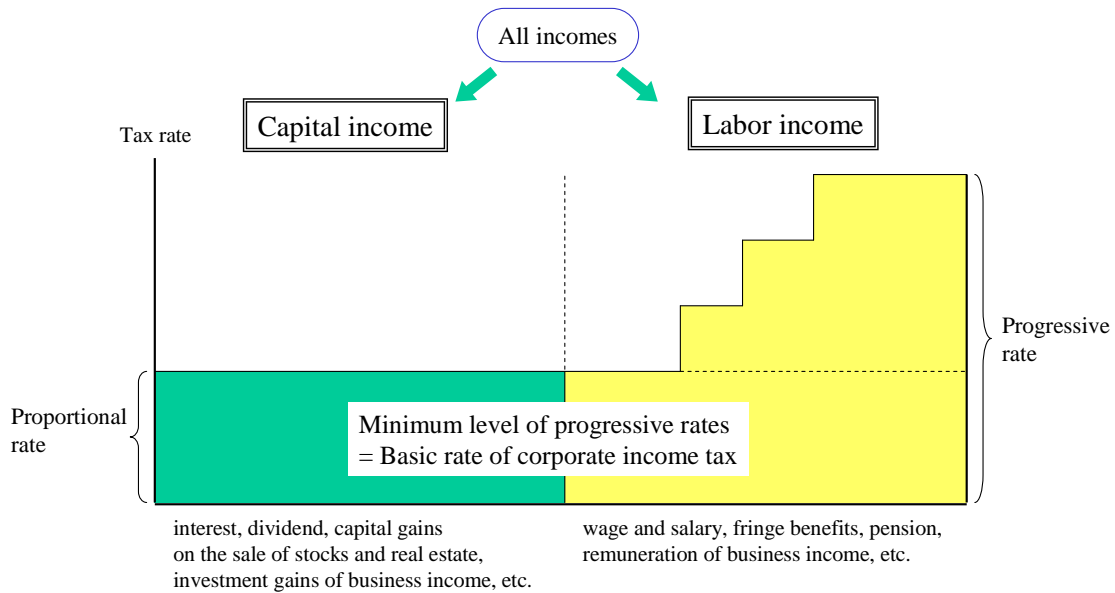
In contrast, the new Nordic DIT is a form of scheduler taxation because it distinguishes the taxation of capital income from that of other sources of income; that is, labor income. Theoretically speaking, a system of DIT combines progressive taxation of labor income with a proportional tax on income from capital at a level equal to the corporate income tax rate. Also, the minimum tax rate of labor income is expected to be the same as a flat tax rate of capital income.

Figure.1 is depicted to clarify basic framework of DIT in accordance with the Nordic tax system. Main points are three as follows;

- (1) All incomes are divided into two parts of capital and labor income each, consisting of the component taxed by proportional rate and that by progressive rate schedule.
- (2) Contents of capital income are interest, dividend, capital gains, investment gains of business income, etc., while those of labor income are wage and salary, fringe benefits, pension, remuneration of business income and so on. Certain income like business income must be divided into two parts because it contains both elements by nature.
- (3) In principle, the tax rates are two; (i) one proportionate rate applied to capital income as a single flat rate, which in turn becomes the lowest rate of labor income and the basic rate of corporate income tax, and (ii) above this flat tax line, progressive rate structure in multiple income brackets are added to impose labor income.

³. Basic idea is derived from the philosophy of a Haig-Simons comprehensive income concept, see, Simons 1938.

Figure 1 Basic Framework of Dual Income Tax (DIT)



No doubt, there are a number of pros and cons for or against the introduction of such a new tax system, ranging from pure theoretical arguments to practical policy-oriented considerations. For instance, dual income taxation obviously violates the familiar principle of the convenient CIT, but it seems to supplement the actual weakness of CIT, for instance, due to the difficulties of inflation adjustments of taxable nominal capital income. Furthermore, a CIT might cause any distortions to resource allocation (e.g., capital flights) than the conventional income tax.

On the other hand, the DIT system is often criticized to require an income splitting of the self-employed income and the active owners' income of small enterprises into a labor income component and a capital income component. It tends to generate considerable administrative difficulties. Despite these arguments, in the end it seems to be worth seeking the practical feasibility of individual income tax reform in Japan from a standpoint of DIT system.

Japan's individual income tax reforms and the elements of DIT

Let us begin with the brief explanation of how the income tax system has historically been developed in Japan, dating back to the prewar period (see, Ishi 2001, ch.1). The origin of a modern tax system in Japan can be dated to 1887, when the national government instituted an income tax on individuals. Thereafter, in 1899 the income tax was extended to impose corporate income. Although this took a truly modern form only in 1940, Japan is thus counted as a pioneer in the use of the income tax. However, since the Japanese economy was at that time still

underdeveloped, the income tax played only a minor role in total national tax revenues (say, 1.5 % in 1888).

Before the income tax became predominant in the tax system as a whole, the main revenues for the national government were raised first from a land tax, and then from indirect taxes. In fact, the land tax accounted for the largest share of national taxes until 1908, after which time the primary source was revenues from indirect taxes, mainly on alcoholic beverages and tobacco. Only after 1935 did income tax on individuals and corporations become the most important single source of total revenues. In short, before World War II the Japanese government relied mainly on indirect taxes, deriving more than two-thirds of its total revenue from them.

In 1940 an overall tax reform was carried out to prepare for the wartime economy. The whole tax system was thoroughly overhauled, resulting in the modern tax system, based mainly on direct taxes. Although individual and corporate incomes had been taxed together by a single form of income tax until then, separate taxes were imposed for each type of income in 1940. Since then, individual and corporate income taxes have coexisted in the tax system.

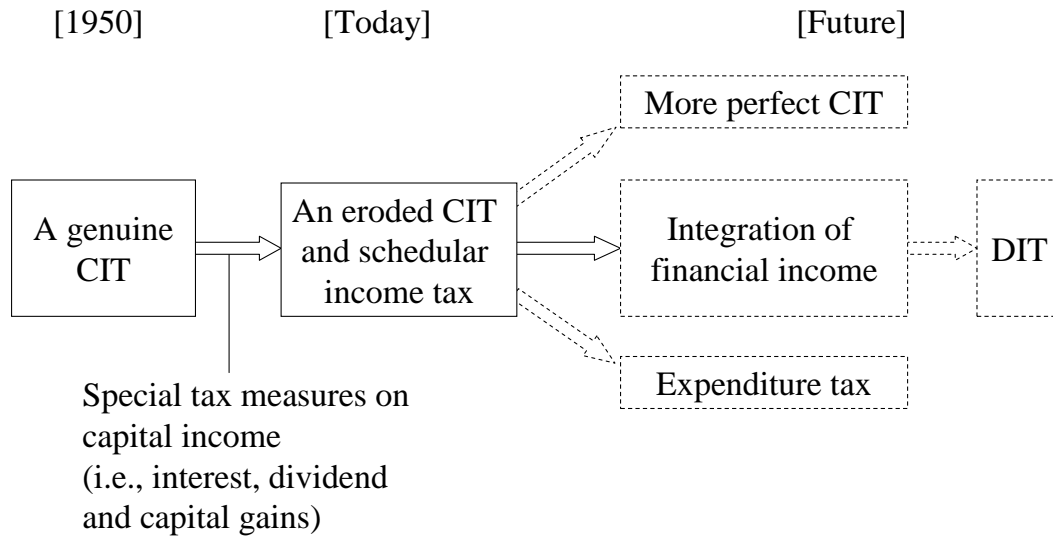
The individual income tax was a schedular tax, under which different sources of income were levied by different tax rates. It was supplemented by a progressive comprehensive tax which applied to an individual's aggregated income above a specific amount. On the other hand, the corporate income tax was imposed on corporate income at a flat rate of 18 %.

The process of developing the tax system in postwar Japan was initiated by the US. In 1947, several important reforms were undertaken under the influence of the US occupation authorities. The schedular tax on individual income was replaced by a global income tax on an aggregate basis with graduated tax rates. Moreover, in 1950 a genuine CIT was adopted by the tax recommendations of the Shoup Mission, in which the top rate of individual income tax was lowered from 85% to 55%, supplemented by the net worth tax to increase tax burden of wealthy asset holders.

In Figure.2, a rough sketch is drawn to summarize the development of individual income taxation since Shoup tax reform in 1950. After introducing a genuine CIT in the individual income tax, it immediately began to be eroded by special tax concessions on capital gains on the sale of stocks and interest income mainly to promote specific policy goals, such as capital accumulation for economic growth. Thus, Japan's individual income tax became a hybrid of an eroded CIT and schedular income tax. Throughout the postwar period, such a hybrid income tax has basically continued until today. At present, we are facing three alternative ways for reforming the income tax;

- (1) retuning to a more perfect CIT
- (2) moving to a DIT via the integration of financial income
- (3) adopting a new direction of a life-cycle expenditure tax.

Figure 2 A Sketch of Changing Process
in the Individual Income Tax



It seems to be almost impossible and not desirable to take the directions of (1) (3), as will be argued later. Given the past and present tax arguments in Japan, (2) would perhaps be a most appropriate alternative

2. The CIT and Its Eroded Process

The Emergence of a genuine comprehensive income tax

Similar to practically all other developed countries, Japan depends upon the individual income tax for a significant portion of its tax revenues. Throughout the postwar period, the individual income tax has reigned supreme in the Japanese tax system. That is to say, the Japanese tax system has traditionally taken the view that income is the best index of an ability to pay. This bias towards income originated with the introduction of a CIT at the inauguration of the postwar tax system.

In 1949 a tax mission headed by Dr. Carl S. Shoup came to Japan with the task of reorganizing the tax system as a whole. The Shoup Mission recommended a tax plan intended to achieve a complete overhaul of the Japanese tax system. Essentially, the Shoup recommendations placed more importance on direct taxes, mainly income taxes on individuals. The entire tax system was fully reconstructed, producing epoch-making change. At the initiative of the Shoup Mission, the individual income tax base was defined to include almost all forms of income, with no major exceptions. In actual practice, Japan adopted the comprehensive tax base in the true sense of the term that expanded the economic concept of income as widely as possible (see

Pechman 1986, chs. 4-6). Furthermore, such broadly based taxable income was taxed strictly at progressive tax rates under a global tax system.

However, the ideal tax system achieved by the initiative of US influences was of temporary duration: many of the taxes were modified or abolished soon after their enactment. For instance, comprehensive income taxation has been, as was mentioned previously, replaced by a combination of a comprehensive tax and a schedular tax. This hybrid system was produced as a result of modifying the global income tax approach of the Shoup proposals. For example, instead of aggregating most incomes with progressive tax rates, some incomes (e.g. capital gains, interest and dividend incomes) are not now subject to comprehensive income taxation but are taxed at reduced flat rates, separate from other incomes. This special treatment is due to a number of tax concessions intended to stimulate saving and investment and to improve the welfare level among specific taxpayers.

Significance of Tax Incentives and Special Tax measures

When the Japanese economy saw very rapid and sustained growth (see Patrick 1970; Patrick and Rosovsky 1976, Ishi 2002) in the 1950s and 1960s, a Japanese brand of tax system gradually developed as part of postwar growth policy. As a result, many of the Shoup tax proposals were replaced by Japan's own tax measures. Soon after the new tax system initiated by the Shoup Mission was enacted, modifications began to be proposed, mainly for two reasons.

First, the new tax system proved too idealistic and far-reaching for the relatively conservative government. Second, the government wished to enable Japan to revive its postwar economy more rapidly; thus, it behaved in a more growth-oriented manner and used the tax system more effectively to promote economic growth. For this purpose, great stress was placed on an incentive tax policy to achieve specific policy goals.

Especially before the outbreak of the first oil shock in 1973, there was wide agreement in Japanese government and business circles that the tax system should be actively employed to encourage economic growth. Based on tax incentive policies, a number of special measures were formulated to promote exports, private saving and investment, housing, technological development, environmental quality, etc. These usually included tax exemption, reduced tax rates, tax-free reserves, and accelerated depreciation for individuals and corporations. Linked with Japanese-type industrial policies, such measures deserve attention as contributing factors to rapid economic growth in the 1950s and 1960s⁴

⁴. In the postwar period, numerous tax measures were introduced to stimulate economic growth and other related policy targets that had a high national priority. Such measures are included in the Special Tax Measures Law, which is separate from the ordinary income tax laws. However, it must be noted that the same type of incentive measures are often found in the ordinary income tax

The MOF classifies the special tax measures of individual and corporate income taxes into six different objectives, as seen Table 1 which summarizes the percentage distribution of revenue losses from the special tax measures, dating back to 1960. The first category, the promotion of individual saving and housing, is tied exclusively to the individual income tax. The other categories are related mainly to the corporate income tax. Throughout every time period, the first category has maintained the highest share. In addition, it has recently shown a trend towards an increasing relative share until 2000, because the other tax incentives in the corporate category have been substantially eliminated.

Table 1 Percentage distribution of the estimated revenue loss from special tax measures, by type of tax incentives (%)

| Fiscal Year | Promotion of individual saving and housing (1) | Promotion of business saving and investment (2) | Promotion of export and foreign investment (3) | Promotion of environment quality (4) | others (5) |
|-------------|---|--|---|---|---------------|
| 1960 | 45.6 | 35.9 | 12.6 | 0.0 | 5.9 |
| 1970 | 47.0 | 18.1 | 19.3 | 1.6 | 14.0 |
| 1980 | 53.6 | 20.6 | 1.9 | 3.6 | 20.4 |
| 1990 | 60.3 | 22.8 | 0.8 | 3.5 | 12.7 |
| 2000 | 60.8 | 27.8 | 0.1 | 1.9 | 9.4 |
| 2005 | 46.8 | 33.6 | — | 1.8 | 17.8 |

Source: Data presented to the Budget Committee, National Diet by the Tax Bureau, MOF

Thus, it is important to note that the eroded phenomena of comprehensive income taxation has been expanded by the development of such special tax measures. To sum up, special tax measures were initiated to implement specific policy goals--- in particular, capital accumulation, i.e. the promotion of savings and equity investments, during the process of rapid

laws as well. Thus, the Ministry of Finance (MOF) defines 'special tax measures' as those concept including two laws. That is to say, each item included in the 'special tax measures' is drawn from both the Special Tax Measures Law and the ordinary income tax laws, in accordance with the specific definition of policy incentives adopted by the MOF. There is no comprehensive list of 'tax expenditures' for Japan comparable to that contained in the US budget. The scope of 'special tax measures' seems to be narrower than that of 'tax expenditures' in the USA in terms of tax incentive policy (see Office of Management and Budget 1986).

economic growth. Capital accumulation was promoted in two ways;

- (1) by the full or partial exclusion of certain capital income from the tax base
- (2) by the separate application of special reduced tax rates to certain capital income.

These measures were designed to give preferential treatment to interest, dividends, capital gains, and other such incomes in order to stimulate personal savings. Although some special provisions were phased out, tax preferences for savings were maintained intact until fiscal year 1988. Thus, a major effect of the Japanese tax system has been its impact on saving behavior, although the nature of its impact is difficult to pin down.

Tax Preferences for Savings

Accordingly, main concern should first be with the tax preferences for specific personal savings. According to this system, until March 1987, income earned from interest, up to a specific limit of total principal (or total face value) of personal savings (or public bonds), was exempt from individual income taxation. These privileged savings consisted of five sources, including the well-known 'Maruyu' (specially favored) system (see Table 2). As a consequence, the individual income tax law in Japan permitted each individual to earn tax-exempt interest on personal savings of up to ¥14.5 million (US\$96 666, where \$1 = ¥150). In spite of the strict requirements necessary to take advantage of these measures, the amount of savings that was tax-favored was abnormally high by international standards.⁵

⁵ These tax preferences developed gradually over a long time as a variety of government activities were designed to promote savings. For instance, the origin of tax-free postal savings dates back to 1920, and the limit on the principal was altered frequently, although the postal savings system was founded in 1875. Similarly, the idea of not taxing the interest earned on small savings was instituted in 1920 to encourage national savings for the war effort. In contrast, a provision for savings enabling the formation of employees' assets was enacted in 1972, following the West German attempt to stimulate employees to create their own assets.

Table 2 Personal Savings with non-taxable interest income, 1987

| | Limit | million yen (\$1000) |
|--|-------|----------------------|
| (1) 'Maruyu' system | | 3.0 (20.0) |
| (2) Postal savings | | 3.0 (20.0) |
| (3) National and local bonds | | 3.0 (20.0) |
| (4) Savings for the formation of employee's assets | | 5.0 (33.3) |
| (5) Postal installment savings for housing | | 0.5 (3.3) |
| Total | | 14.5 (96.7) |

Note: (1) includes deposits at bank, securities companies and other private institutions. Savings under this system can exceed 3.0 million yen, the interest of which is subject to taxation. In contrast, (2) cannot exceed the threshold by law. (4) is eligible for only salaried workers.

In addition to the full or partial tax exemption of earned interest under the tax-favored saving system, the Japanese tax system developed another type of tax concession on interest. In the case of taxpayers who exceeded the limit on privileged savings, excess interest income was taxed separately from other incomes. It was also possible to apply reduced tax rates under the separation method to interest exceeding the threshold of tax-favored savings.

The past record of reduced tax rates since 1951 is summarized in Table 3. Following relatively higher tax rates of 50 % in 1951-2, tax rates on interest were lowered to 10 % in 1953 when the Shoup proposals were substantially modified for the first time. Furthermore, no tax was levied on interest income earned on both short- and long-term savings in 1955 and 1956. Since the 1970s, these special rates have begun to be raised in response to criticisms of inequitable income taxation. In addition, it should be noted that gains from discount bonds were subject, at the time of issuance, to a withholding tax rate of 16 %. Needless to say, such special measures applicable to specific sources of income are a clear deviation from a global tax system proposed by the Shoup Mission. There were several forms of savings that received exemption or highly favorable tax treatment.

Table 3 Special tax measures for interest income:
reduced tax rates in the case of separate taxation at source

| Reduced tax rates (%) | Period |
|--|---------|
| 50 | 1951-2 |
| 10 | 1953 |
| 5 (long-term saving) } 10 (short-term saving) } | 1954 |
| 0 (short-term saving) | 1955-6 |
| 0 (long-term saving) | 1955-8 |
| 10 (short-term saving) | 1957-62 |
| 10 (long-term saving) | 1959-62 |
| 5 (both) | 1963-4 |
| 10 (both) | 1965-6 |
| 15 (both) | 1967-70 |
| 20 (both) | 1971-2 |
| 25 (both) | 1973-5 |
| 30 (both) | 1976-7 |
| 35 (both) | 1978-87 |

Source: MOF, *Primary Statistics of Taxation* (Zeisei Sanko Shiryoshu), February 1988.

However, in April 1988 when the Takeshita tax reform was enforced, these special treatments of tax-favored saving system including 'Maruyu' system were all replaced by a flat rate of 20 % on interest at source, remaining one exception for elderly tax benefits on personal savings in view of welfare policy .

Special Treatment of Dividends and Capital Gains

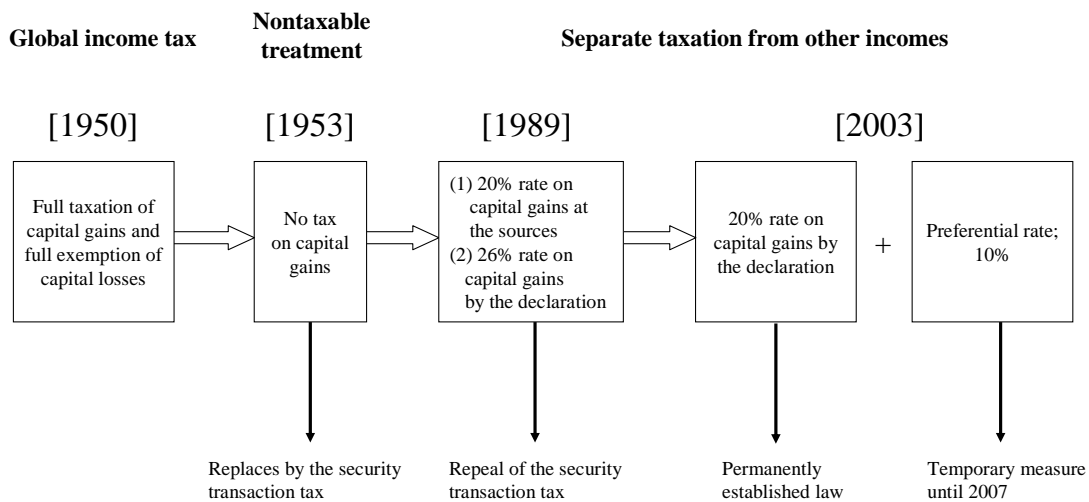
Dividends as well as interest income are treated under special tax measures. Although they have no counterpart to the 'Maruyu' system, two types of separate reduced tax rates, 20 and 35 %, were applied to dividends in a similar fashion until fiscal 1987. For one thing, dividends were taxed at source at the rate of 20 %, but were included in taxable income for filling a return. The other was that they might be levied at the reduced rate of 35 %, separate from other incomes, and removed from taxable income when filling a tax return. This was an optional system for taxpayers.

Furthermore, recipients of dividends were allowed to credit 10 % of their dividends against their income tax as compensation for the double taxation of dividends. The tax credit was reduced, however, to 5 % if the individual's total income is more than ¥10 million. A tax credit of 5 % is thus applicable to such fraction of dividends as is equal to the amount of total income minus ¥10 million, and the rest is credited against total income at 10 %.

Of great interest is the favorable tax treatment given to capital gains on the sale of stocks, compared with taxes on other capital incomes. Non-taxable treatment of capital gains on the sale of stocks had become a symbol of unfairness of the existing income tax. As seen in

Figure. 3, capital gains had once been fully taxed (losses fully exempted) in accordance with the Shoup tax proposals, they were exempted from taxation in 1953 because the administration of the tax was too difficult to enforce with no taxpayer numbering system. Since then, capital gains had in principle been tax-exempt, but those who continuously dealt with stocks in large volumes (thirty transactions a year, involving more than 120 000 shares in 1988) had been required to include capital gains in their tax base, which was then subject to aggregate taxation. At that time, the capital gains tax was replaced by the security transaction tax as a supplementary tax.

Figure 3 Capital Gains Taxation on the Sale of Stocks in the Past



In response to criticism of the non-taxable status of capital gains, the tax reform in 1989 proposed two alternative capital gains taxes, irrespective of the introduction of the Tax Identification Number (TIN). The first was to impose a 20 % tax on capital gains at the sources. Capital gains were deemed as 5 % of gross proceeds derived from the stock sales price. Consequently, the taxpayer would be required to pay 1 % (0.2×0.05) of the stock sales price as a deemed capital gains tax under the withholding system. This is exactly the same as the existing securities transaction tax. The second was to apply realized capital gains to the self-assessed declaration method, separate from other incomes, at a rate of 26 % (including 6 % for the local inhabitants' tax). The taxpayer could have the choice of self-assessed or withholding methods. Taxation of capital gains from the sale of stocks became effective from April 1989 under the separate method.⁶

⁶ At that time, additional requirements were introduced. When capital gains are obtained from the

It is, however, clear that the new system was still too loosely worded to resolve burdens via the capital gains tax, although it could be seen to some extent as the first step towards the final goal of global taxation. In particular, the repeal of the device designed to tax those who were continuous and voluminous dealers in stocks would increase the unfairness in the system, because it unreasonably favors those who have earned substantial income from capital gains and who should pay at least 1 % of the withholding tax rate on the sale price of stock.

As a consequence, in response to these complaints in view of equitable tax burden, in 2003 all capital gains on stocks were changed into one declaration method with a flat tax rate of 20%. However, as will be argued later, one temporary measure to buoy up the stock price in the markets were introduced once again to apply only 10 % to capital gains and dividend.

3. The Emergence of a Hybrid Income Tax

A New Dimension of Capital Income Taxation

During the years following the war, as has repeatedly been stressed, the individual income tax began to be eroded considerably by numerous special provisions. It is interesting to note that the eroding process of the comprehensive income tax base has advanced mainly in the area of income from investment and savings. Most capital gains from the sale of stocks had been removed from the individual income tax base for 1953-87, and a large portion of interest income became non-taxable under a system of tax-exempt savings for 1955-58. In addition, dividends, capital gains on real estate sales, and taxable interest are taxed favorably at a separate flat tax rate. So long as a CTI principle could be maintained, this is considered to be a tax erosion phenomenon (see, for expanded discussion, Ishi 2001, ch.6)

However, a new dimension against interests, dividends and capital gains began to emerge from the 1988-89 tax reform. At that time, the primary goal of its tax reform was to correct the unfairness of the existing income tax system in relation to the introduction of a new broad-based indirect tax (the so-called VAT and later the consumption tax). After PM Nakasone

initial public offering (IPO) of stocks in the market, taxpayers cannot opt for separate taxation at source. Such gains must be filed in a return if they are acquired before the IPO and sold within one year, being subject to national and local income taxes in the following formula:

- (1) Short-term gains (stocks held for 3 years or less prior to the IPO)---the entire capital gains are included in taxable income.
- (2) Long-term gains (stocks held for more than 3 years)---only half of such gains are included in taxable income.

completely failed to adopt such a new tax in 1987, a revised bill was deliberated, including the elimination of the tax-free saving system. This bill was finally passed in September 1987, and took effect in fiscal 1988.

The important structural change contained in this bill was to realize the imposition of tax on interest income from tax-favored savings accounts that had been the MOF's long time dream, and this was an epoch-making change of individual income taxation to strengthen tax burden on capital income. That is to say, tax preferences for savings were eliminated and all interest incomes except certain portion of the aged people began to be applied by a flat rate of 20 % at source. The 1988 tax reform was merely the first trail to restore equitable tax burden and to prepare for the adoption of broad-based indirect tax in future. In fact, capital gains on the sale of stocks and other capital incomes had remained unchanged with favorite tax treatment. Thus, the next target of regaining equitable income tax burden was no doubt to impose capital gains.⁷

In response to complaints among general taxpayers about the unfairness mainly involved in capital gains taxation, the Takeshita tax reform strengthened the tax burden on individuals' capital gains on stocks in 1989. Capital gains tax on the sale of stocks alone was virtually restructured under the 1989 tax reform when a new consumption tax was introduced in a package reform. Non-taxable treatment was eliminated and without exception, these capital gains have been taxed from April 1989 in one of the above-mentioned two ways;

A hybrid income tax ?

In a word, both the 1988 and 1989 tax reforms resulted in strengthening the tax burden on capital income in light of interest income and capital gains with simultaneous adoption of the

⁷ The repeal of tax-exempt interest on small savings accounts induced another tax distortion. A flat 20 % withholding tax has been levied on almost all savings from fiscal year 1988 by the Nakasone tax reform, but this resulted in distorting the portfolio investment of individual savers. In 1988, capital gains on the sale of stocks were still not taxed except in a few cases ('continuous and voluminous transactions'). Some financial assets, such as life-insurance-type savings (Yohro Hoken), discount bank debentures (Waribiki kinyu sai), or investment trusts (Toshi Shintaku), were still treated more favorably in terms of after-tax rates of returns. Thus, a shift from one financial asset to another was stimulated by the termination of tax-favored small savings accounts in April 1988. Traditional forms of personal savings, such as postal savings and ordinary time deposits, increased much more slowly on a monthly basis since then. Also, a substantial amount of money for portfolio investment flowed into the stock market, reflecting the favorable tax treatment of capital gains on stock sales.

consumption tax. These attempts were partially successful in broadening the tax base in view of returning to a CIT, but a small amount of capital income was just partly taxed with reduced tax rates. Obviously, this is not a global income tax under the slogan of CIT. Since 1989, the individual income tax has basically continued in an eroded CIT as a result of making compromises, although there have been a couple of structural changes in each item.

How should we interpret such a new structure of income taxation? Japan seems to have deviated from the CIT and phased in a hybrid income tax in which different sources of income are taxed at different rates. It can be concluded that a sort of schedular income tax has reappeared which is much like the prewar individual income tax of 1940.

At the same time it might be possible to explain it as a hybrid contained the element of expenditure tax.⁸ The distinction between an income tax and an expenditure tax depends upon the treatment of savings. Under an expenditure tax, either savings or interest is excluded from the tax base. As a consequence, savings cannot be subject to taxation. Similar effects of an expenditure tax on consumption over the life-cycle can be achieved by excluding interest from the tax base. The treatment of savings or interest income in Japan was almost the same as that which would be applied to all savings under an expenditure tax as described above. In effect, the Japanese individual income tax had partially been transformed into an expenditure tax before 1988. Even if interest income and capital gains are now taxed more uniformly, apart from full tax-free treatment, it could be considered a hybrid of a income tax and an expenditure tax, because interest income and capital gains are still favored specially by applying flat reduced tax rates, different from a global income tax approach.

Where should we go from here ?

A major conclusion that has emerged from the preceding discussion is that the Japanese income tax was, and still is, a hybrid. Since many forms of savings were allowed full or partial tax exemption, it was frequently pointed out that the individual income tax was really incomplete in term of being a genuine CIT. Although interest and capital gains on stock began to be levied at a flat rate from 1988 and 1989, they are still taxed separately from other incomes. As stressed

⁸ A great deal of controversy has raged over the choice between income and expenditure as alternative tax bases. It seems, however, that past discussion offers no decisive conclusions on either theoretical or practical grounds in Japan. As a great deal of literature is available on this debate. we need not concern ourselves with the various arguments here . See, for instance, Andrew 1974, US Treasury 1977, Institute of Fiscal Affairs 1978, Kay and King 1986, Aaron and Galper 1985, Pechman 1986.

earlier, we must say that this is far from a genuine CIT. This being the case, where should we go from here?

Because of its split nature, it seems that there are three alternatives for future tax reform, as seen Figure. 2. One choice would be to get back to a more CIT and curtail the area of tax benefits for capital income. Another alternative would be to expand the range of tax benefits on all forms of savings in order to take us nearer to the expenditure base. Such a piecemeal approach would avoid the full-blooded switch to a direct expenditure tax, and as a consequence might gradually mitigate the investment distortion among savers. Finally, as a third possible solution, we could maintain the existing intermediate position and may be justified as a form of schedular income tax which in turn should improve it more toward a dual income tax.

Judging by the recent tax reforms, it seems that a decision has been made to opt for the third alternative, a move to a dual income tax. In my view, this is the best choice, and can be justified by its ability to improve the horizontal and vertical equity, and furthermore the neutrality, of the present tax system. The second approach would perhaps be the least defensible of the three, given the current state of tax argument in Japan.

4. The case for the integration of financial income in one global system

Justification for a move toward a dual income tax

In undertaking a fundamental reform of the Japanese tax system, it is important to specify clearly the goals or criteria that should guide such an endeavor. Generally speaking, the essential criteria for assessing a tax reform are equity, neutrality, and simplicity. Judging from the general criteria for tax reform under the actual taxpayers' attitude in Japan, there are clearly two points to be stressed in support of a dual income tax.

First, the most important reason for this decision seems to be major complaints among taxpayers regarding inequitable taxation, particularly tax preferences on capital gains. Now, most Japanese taxpayers regard such a tax that exempts capital income as unfair. Indeed, it is a well-known fact that individuals in higher income classes are given preferential treatment of capital gains from the sales of stocks, other securities and land, interest and dividends under the present income tax. These special provisions permit them to accumulate large fortunes with little or no payment of income tax.

These complaints can easily be explained, taking the assumed case that we would admit the adoption of an expenditure tax, one of other important candidates instead of an income tax. An expenditure tax would theoretically preclude the necessity of taxing capital income. In principle, an expenditure tax does not reach such incomes until they are spent.⁹ While the

⁹ The most conspicuous difference between income and expenditure taxes is in the definition of

accumulation of savings continues to provide people with great benefits in terms of safety, security, and social prestige, the expenditure tax provides no means of taxing such increased spending power in accordance with the ability to pay.

Thus, it leads to an excessive concentration of wealth in the long run. Proponents of an expenditure tax do not explain this to the general public. Considering the taxpayers' perception of inequality in the context of the recent tax reforms, I believe that the expenditure tax does not satisfy the test of taxation according to the ability to pay; it would exclude truly necessary income, such as capital gains, from the tax base. (See, for a similar argument, Pechman 1987, ch. 6.)

The second reason to support a dual income tax is concerned with the distorted effects of returning to a more perfect CIT in view of tax neutrality. For this purpose, without a doubt, it is necessary to broaden the tax base as much as possible. There is wide agreement that an inequitable tax system is unlikely to be remedied without a comprehensive tax base. If certain types of income are omitted from the tax base, or if particular uses of income are treated more favorably than others, then taxpayers with similar economic situations will not be taxed equally. In addition, since deviations from a comprehensive tax base tend to accrue to higher-income-earners, it is absolutely necessary to broaden the tax base in order to achieve vertical equity.

How should we evaluate this base-broadening direction to reform the individual income tax? If a more perfect CIT would be created in the future, it is obviously worried out that great damage will be incurred in capital and financial markets by global taxation, generating capital flights from Japan to overseas. Even if any flatter tax proposal could be realized, investors' attitude will be greatly impaired by including a more comprehensive definition of income, such as capital income. In fact, the Japanese government and business groups have always attached great importance to maintain the higher level of stock price in the markets by using favorable tax policy in the past. Businessmen groups are likely to support such bad influence hit by the markets. In general, it would not a good idea to strengthen more the tax burden of capital income in

the time period relevant for measuring the tax base. With income tax, income is defined for a specific time period, currently one year. If we take a longer view and think of an individual's income over his lifetime, the difference between income and expenditure becomes unimportant. It can be deduced under some assumptions that a man's total lifetime income is equal to the total of what he spends on consumption and what he bequeaths to others. Therefore, the effect of raising a tax on consumption on an annual basis and a tax on bequest after death would be the same as imposing a tax on total lifetime income.

accordance with a global system of CIT.¹⁰

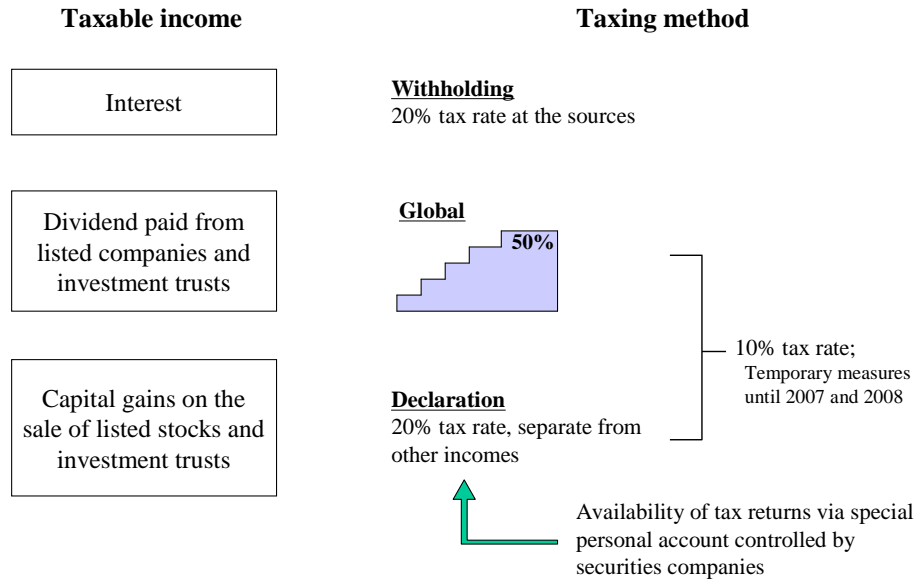
.The first step to move toward a DIT

No doubt, we should shift from an imperfect CIT (i.e., a hybrid income tax) to the third approach of a DIT, given an ongoing tax reform process. This might be justified by the tax criterion of equity and neutrality, but it is very difficult to jump up from the present position to an ideal style of DIT like that in Nordic countries. There are a couple of steps to reach the final goal. The first thing to be done is evidently to integrate financial income, which is composed of interest, dividend and capital gains on the sale of stocks, into one global system. No doubt, financial income is the proximate source of most capital income (see, for example, Boadway and Keen 2003). After completing this integration at the practical level, other capital gains on real property, such as land and buildings, should be added in the group of capital income to be contrasted with labor income in the definition of a more perfect DIT.

Figure. 4 shows the present tax structure of three different financial income. Interest income is withheld with a 20% tax rate (15% of national income tax and 5% local inhabitants' tax) at the sources, while dividends paid from listed companies and investment trusts are in principle levied under a system of global income tax by progressive tax rates up to 50%(40 % of national and 10% of local taxes). On the other hand, capital gains on the sale of listed stocks and investment trusts are taxed with a 20% rate, separate from other incomes, under the declaration method by taxpayers themselves. However, for the sake of personal investors unfamiliar with stock market, special personal accounts are admitted to use tax returns which can be completed via security companies, instead of going to tax offices. They are under the control of security companies.

¹⁰ This view is also defended from the theory of optimal taxation, in which the tax rates should be differentiated to allow for the relative sensitivity of labor supply and savings with respect to the after-tax real wage rate and the after-tax real interest rate. As a result, it is second-best optimal to impose a higher tax rate on labor income than that on capital income.

Figure 4 Present Tax Structures of
“Financial Income”



As noted above, temporarily special preferential measures are available to apply only 10% rate to dividends and capital gains on the sale of stocks to stimulate the stock market in relation to expansionary tax-cut policy to combat with post-bubble recession. They were introduced in the context of business recovery program in 2003 and the dividends case will be continued until Dec. 2007 while the capital gains case until March 2008. Thereafter, reduced tax rates of 10% will be integrated in 20% with other financial incomes. Before that, it would be practically impossible to integrate all financial incomes into one global income system with the same tax rate.

In June 2004, Sub-Committee on the Taxation of Financial Income of the Government Tax Commission published the report of “Basic Study on Integrating the Taxation of Financial Income”. Basic idea is to integrate interest, dividend and capital gains on stocks etc., in one category and to tax in a similar formula after offsetting losses incurred in each income. Main points are summarized as follows;

- (1) Capital gains on stocks, public bonds and publicly-subscribed bond investment trusts are subject to 20% tax rate under the separate taxation of taxpayers’ declaration, apart from temporary 10% reduced tax rates..
- (2) Dividends from listed companies (except large volumes) and the distribution of gains from publicly-subscribed stock investment trusts are treated in the same as above, apart from global income taxation and temporary measures.
- (3) Interest income is withheld at the sources with a 20% of rate, separate from other incomes,

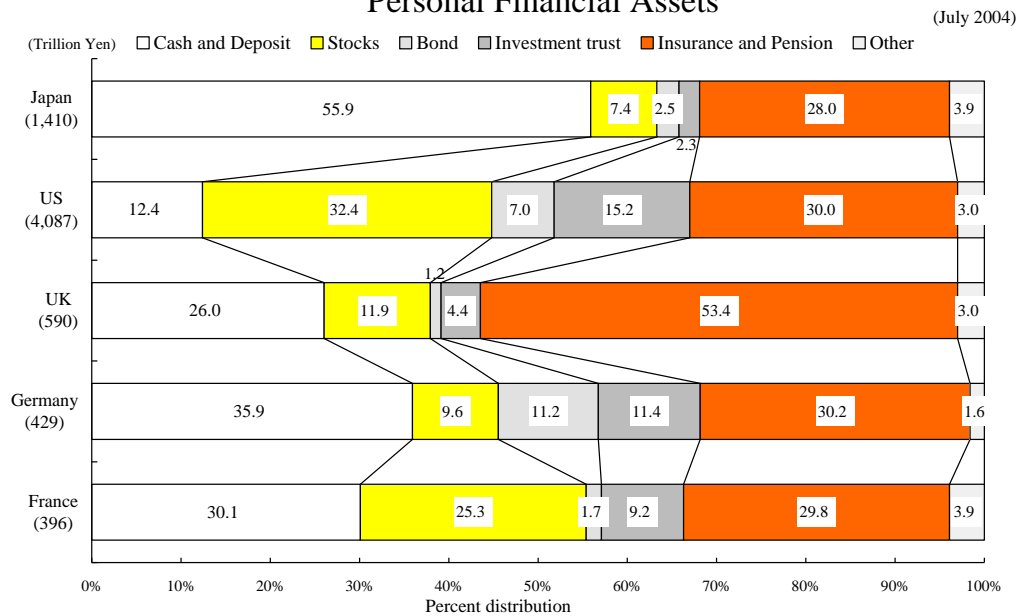
but those who would like to get loss-offsets against other financial income have to declare it for final returns.

- (4) Gains due to differential exchange rate for foreign deposits, which are now included in miscellaneous income, are subject to taxation in a similar to (1) (2), apart from global income taxation.
- (5) Profits and premiums of quasi-insurance classified in occasional and miscellaneous incomes are subject to the same as (1) (2).

For the sake of securing a correct assessment of financial incomes listed above, their payers are required to submit payment records to the tax offices.

The movement for making such a report was supported as a policy slogan of “ From bank and postal savings to portfolio investment in the markets ”, which was strongly proposed by the Japanese government. As seen in Figure. 5, personal financial assets in Japan is mainly distributed in cash and deposits; i.e., its relative share is occupied by 55.9% in total, followed by 28% of insurance and pensions. Stocks have only 7.4% in relative share which is very unique to Japan’s portfolio investment.

Figure 5 International Comparison of Personal Financial Assets



Source Japan: Bank of Japan. “Monthly Statistics of Finance and Economy”, US: Federal Reserve Board. “Flow of Funds Accounts”, UK: Office for National Statistics. “Financial Statistics”, German: Deutsche Bundesbank. “Financial Accounts for Germany”, France: Banque de France. “Comptes et Indicateurs Economique”

In contrast, all other countries have their own features in distributing personal financial assets; the largest share is stocks in the US, and insurance & pensions in the UK respectively while almost even share is between cash & deposits and insurance & pensions in German and France. Thus, it was considered in Japan to be necessary to shift private financial fund from

banking sector to stock markets which in turn was to buoy up stock price for full business recovery. No doubt, minor shares of stocks, bond and investment trusts will be increased in support of loss-offsetting procedures under a global taxation of financial income. This was an idea of political slogan mentioned above.

The role of tax identification number

It is widely acknowledged that the introduction of tax identification number (TIN) would be inevitable to integrate various financial incomes into one income group for tax purpose. This lesson is derived from the failure of full taxation of capital gains from the sale of stocks which was proposed without any numbering system by the Shoup Tax mission in 1950.

In the past, heated arguments have taken place for or against introducing the TIN, like the US social security number, which is intended to assess capital income accurately. No one can deny the necessity of TIN when considering the fair and accurate taxation of capital gains, interest and dividends from the standpoint of tax administration. The adoption of TIN in the Japanese tax system had been a prerequisite for imposing proper taxes on capital income under a global income system.

As regards the introduction of TIN, the Government Tax Commission has repeatedly argued its feasibility in the past to return to global income taxation. With a view to the 1993 tax reform, it discussed at length during autumn 1992 the feasibility of aggregating interest and capital gains from the sale of stocks with other incomes in view of comprehensive income taxation. Of course, the other side of the coin, i.e. the introduction of TIN, was equally taken into consideration. However, a decisive conclusion has not reached on the future direction of tax reform regarding the global taxation of capital income.

Two reasons behind this are worth noting. First, as has been explained previously, withholding collection at source in taxing interest and capital gains, separate from other incomes, has been firmly built into the Japanese tax system. From the standpoint of tax administration and revenue-raising, the present collection system is highly valued by both the tax authorities and taxpayers. Therefore, there was no strong motivation to change to a new scheme of tax collection which may promote considerable confusion.

Second, related to the first reason, it was not the time to seek a national consensus as to which direction should be taken for a more desirable form of capital taxation; opinion was so divided that any consensus was unlikely. In particular there have been a number of controversial debates in terms of privacy.

Simply speaking, to avoid possible big changes to a well-established system, decisions have been put off until the future. The present tax on capital income, therefore, has remained unchanged for practical reasons.

However, if the attempt for the integration of financial income will be made in the

future, we have to solve this issue about the TIN. The necessity of using the TIN is obviously the same as the case for the integration of financial income. In order to get loss-offsetting measures, the TIN is absolutely needed. Once again the Government Tax Commission begins to seek the genuine possibility of introducing the TIN deliberately. One idea is presented in terms of “financial number” which is limited to use only loss-offsets among various types of financial incomes. This new number is planned not to enlarge its use to cover the wider scope of other tax purposes or social security program in response to anti-movement of TIN in general.

Right now there are two numbering system for non-tax purpose; (1) pension number and (2) personal number based on inhabitants’ record, which were established in 1997 and in 2002 each. If we tried to expand its use as large as possible to cover tax purpose, we shall be able to get more general type of TIN. Discussion will be still continued to reach any final goal.

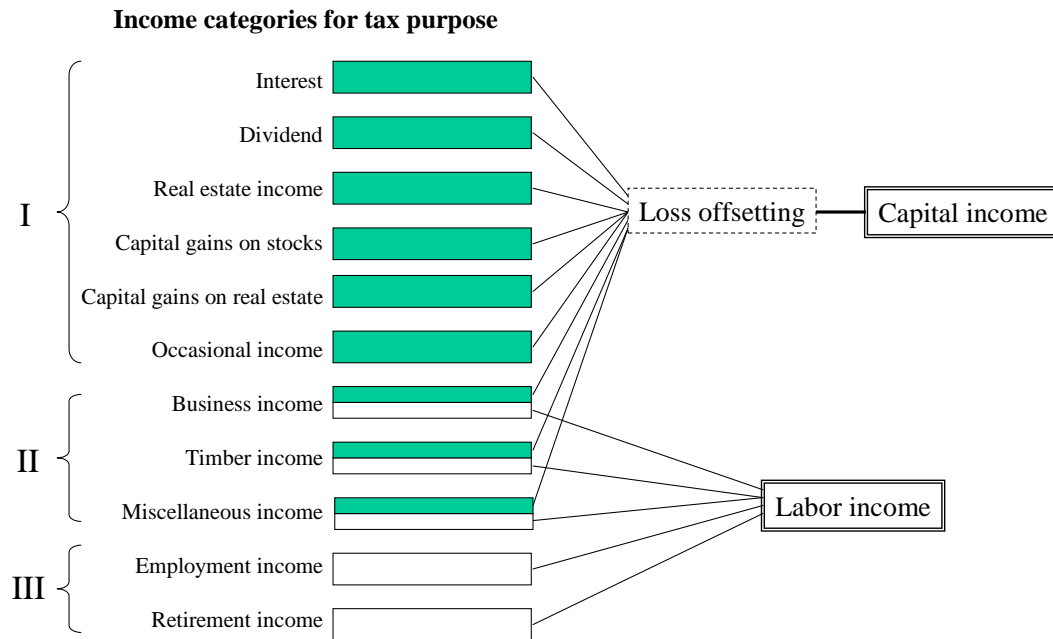
Further step in the future reform

The trial for grouping financial incomes in one category is merely the first step to move toward a DIT. Further step is evidently required to be made for the future tax reform which would be thought of to be unavoidable. Consequently, we shall have to devise any ideal form of DIT to well-match with the individual income tax system. The most important task is to explore how well all individual incomes should be divided into capital and labor income each in accordance to the basic framework of DIT as seen in Figure.1.

At present, taxable income in the individual income tax is classified into ten categories: (1) interest income, (2) dividends, (3) real estate income, (4) business income, (5) employment income, (6) retirement income, (7) timber income, (8) capital gains, (9) occasional income and (10) miscellaneous income. How could we regroup these ten incomes into two new categories?

An attempt is made in Figure. 6 to obtain the division between capital and labor income. Grossly speaking, all incomes are divided into three groups; group I is directly included in a genuine capital income, group II contains two elements which should be divided in two components of each income, and group III is considered to be truly labor income. Thus, capital income is composed of five incomes, say (1) (2) (3) (8) (9) listed above, and labor income includes both of (5)(6). The difficult task would no doubt distinguish one portion of remuneration from other of investment gains in the category of (4) (7) (10). It is easier to understand the division of business and timber income into two parts. Likewise, miscellaneous income, which is consisting of pension benefit, honorarium of manuscripts and lectures, investment gains of quasi-financial goods (installment savings, lump-sum endowment insurance, discounted bonds etc.), must be divided in a similar way.

Figure 6 A Concept of Dual Income



After aggregating capital income into one concept, losses should be offset each to self-assessed taxable income for making tax returns under the declaration method. On the other hand, labor income should basically be withheld at the sources without any loss-offsetting. On this point, the withholding tax return system should be employed as many as possible with a view to both simplicity and efficiency of tax administration.

The Japanese tax system has traditionally placed greater reliance on withholding taxes at source. One of the most marked features is that the majority of wage and salary workers are not required to file tax returns. Thus, nearly 80 % of individual income taxes are withheld at source, resulting in little direct cost to the tax authorities. In order to support the advantage of such a withholding system, two other devices exist: (1) a year-end adjustment of wage and salary by employers, and (2) the separate taxation of almost all of employees' capital income at sources.

As a consequence, tax reform toward a DIT might strengthen the use of withholding collection and as a result accelerate the trend towards making the tax system simpler and more efficient. If a separate flat tax (say, 20 %) would be applied to many components of capital income at source via withholding in parallel with the declaration method, a new tax system of DIT might neither complicate the existing tax system nor increase the cost of tax compliance and administration.

From this standpoint, it is recommended to withhold interest, dividends and capital gains in the case of those who do not need any loss-offsetting procedures, instead of filing returns under a bit complicated declaration method. For this purpose, special personal account should be

allowed to be used as before.

In addition to the classification of ten incomes into two parts, the present rate structure of individual income taxation¹¹ ought to be rearranged for two sets of a flat proportionate rate and a progressive rate schedule in multiple income brackets, if we follow a Nordic style of DIT as shown in Figure.1 However, this is a very hard task because the present lowest rate of national income tax is only 5 %, which is quite different from an assumed 20 % of capital income taxation and a 30 % of basic rate of corporate income tax.

5. Concluding Remarks

It is officially acknowledged that in principle, the Japanese tax system still maintains a global system of individual income taxation, but in actual practice separate taxation methods have widely been accepted as exceptional cases. Today, the majority of the ten taxable incomes described above are subject to forms of separate taxation at specially reduced rates. So long as we observe the present income tax structure, these so-called exceptions seem to be more common, in which a schedular income tax is at first sight prevalent.

Generally speaking, the process of tax reforms in the postwar period has not been altogether satisfactory. Many reforms have been proposed, based on an ideal CIT, and some of them have partially been put in place. If we would be sticky to return to a global tax system of comprehensive income taxation, it was not entirely necessary to separate certain income sources from others for tax purposes: all incomes should be targeted to be aggregated and taxed at progressive rates. However, some necessary reforms toward a more perfect CIT have been tactically avoided because the government feared strong repercussions on the economy and markets. As a result of the past compromises, a substantial number of inadequate and inconsistent tax devices have been left for future reforms to take care of, particularly in the area of capital income taxation.

As a consequence, we have selected to return from a half-way to a more perfect CIT, while avoiding controversial arguments over the choice among a global income tax, a schedular income tax and an expenditure tax. Now we have to decide the basic direction of future reform in Japan. On this point, as have already been described, a move toward the integration of financial incomes should be made for the moment and further reforms should be attempted to achieve a more perfect DIT from a long-run viewpoint. This choice we have finally reached may be defensible as a result of trial and error with agonies of reforming the Japanese individual income tax system in the past.

¹¹ In the 2006 tax reform, national income tax rates start from 5 % of taxable income up to ¥ 1.9 million, rising to a top rate of 50 % above ¥1.8 million. By contrast, local income tax rates, consisting of both prefectural and municipal rates, are a flat rate of 10 %.

It seems that world tax reform has recently been making along this line. In many advanced countries, such as the US, and the UK, Germany, France, Sweden etc., a move is directed toward an adoption of de facto DIT with lighter tax burden on capital income by any means.¹²

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¹² For instance, the President Advisory Panel in the US has recently proposed to tax lighter burden on capital gains on stocks and dividends in both cases of the simplified income tax plan, and the growth and investment tax plan (see, The President Advisory Panel, 2005).

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