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**The Need for Tax Reforms to Support Economic Reconstruction**

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**The Japan Research Institute, Limited  
Economics Department  
Center for Financial and Public Policy Research**

For more information on the content of this report, please contact  
Kenji Yumoto, Senior Economist  
Economics Department, Center for Financial and Public Policy Research

Tel: 03-3288-4737 Fax: 03-3288-4690

E-Mail: [yumoto.kenji@jri.co.jp](mailto:yumoto.kenji@jri.co.jp)

**I. Introduction**

Discussions preparatory to a radical reform of Japan's tax system began in January this year, on the instructions of Prime Minister Junichiro Koizumi. The government Tax Commission has pointed to the danger of a "hollowing-out of

taxation", and there is strong pressure for measures to restore fiscal soundness such as spreading the tax burden thinly and evenly across the population by lowering the minimum tax threshold. Meanwhile, the debate at meetings of the Council on Economic and Fiscal Policy (CEFP) whose members include representatives of the private sector, has centered on how best to use the tax system to stimulate the economy. The distance between these two positions is considerable. The Koizumi Administration, which has set itself policy targets of "limiting issuance of government bonds to ¥30 trillion" and "putting the primary balance back into the black", is well aware that resolving the worst fiscal deficit of any of the developed nations will mean cutting expenditure on public works, etc., and is also aware of the danger of fiscal collapse, in the medium term, if it fails to secure sources of tax revenue. Meanwhile, economic conditions are still bad, and there is still no firm prospect of improvement. With fiscal and monetary policy running out of options, it is, perhaps, understandable that great expectations should be placed on reform of the tax system as a trump card for the revitalization of the economy.

However, on one hand, announcing that taxes will be raised in order to restore the soundness of public finance would be to risk a further deterioration of economic conditions due to a cooling of consumer and corporate confidence. On the other hand, making substantial tax cuts in order to stimulate the economy would inevitably lead to a further decline in tax revenue, and lead to the swelling of the fiscal deficit. What kind of tax reforms are required to resolve this dilemma, and rejuvenate the economy while upholding the medium-term objective of restoring the soundness of public finance? This article proposes a number of basic viewpoints and specific measures that would allow the government to combine restoration of fiscal soundness with reform of the tax system.

## **II. Basic Viewpoints on Tax Reform**

### **1. Restoring the Soundness of Public Finance Should be a Medium-Term Objective**

The first viewpoint is that **the government should not be in too great a hurry to restore the soundness of public finance, but should make it a medium-term objective. The goal of limiting issuance of government bonds to ¥30 trillion, so as to balance income and expenditure in a single fiscal year, is hampering both public finance policy and tax reform, and should be abandoned without delay.** The government is right to make "putting the primary balance back into the black" a medium-term goal, to be achieved within ten years or so, but sticking rigidly to the time limit of ten years would be to court failure. Another point to remember is that **this goal should be achieved solely by reducing expenditure, and that any significant lowering of the minimum tax threshold or increase in taxation through a raising of the consumption tax rate should be avoided until the economy has recovered.** Over the next 20-30 years, Japan is likely to see a sharp increase in its pension, medical care and nursing cost burden. Assuming (i) nominal economic growth of 2.5%, (ii) the conversion of basic pensions to 100% tax-based funding, (iii) the creation of tax-based systems to provide medical care and nursing for the elderly, (iv) a 20% cut in employees' pension payments (the second stage of the public pension system) and 30% reduction in medical care costs through a streamlining of medical services, the public burden of social security in 2025 is likely to be ¥79.7 trillion, and the tax increase required to cover this amount would be equivalent to raising the consumption tax rate to 19.3%. **Raising the consumption tax rate to restore the soundness of public finance in the short term**

would eventually mean imposing a consumption tax rate of well over 30%, and it is clear that the economy could never bear the strain of such an increase.

## **2. Revitalization of the Economy Through Large-Scale Tax Reductions Alone is an Over-optimistic View**

The second viewpoint is that **it would be foolhardy to suppose that large-scale tax reductions will simultaneously revitalize the economy and restore the soundness of public finance.** Recently, it has been suggested in some quarters that large-scale tax reductions should be implemented as a matter of priority, in order to revitalize the economy. However, not only is it uncertain whether or not tax reductions would in fact bring about economic recovery, but even if the economy did begin to recover, there is no guarantee that tax revenue would rise sufficiently to make up the fiscal deficit (which would grow as a result of the tax reductions). This approach cannot, therefore, escape criticism as being not only risky, but even irresponsible.

The view that large-scale tax reductions are the solution is based on the fact that the tax reforms implemented by the Reagan and Thatcher administrations in the 1980s were successful in revitalizing the US and British economies, and that the fiscal deficit problems from which the United States and United Kingdom suffered also improved rapidly in the second half of the 1990s, but, in reality, it is doubtful whether either economy revived on the strength of large-scale tax reductions alone. In 1981, the Reagan Administration significantly reduced taxation on capital investment, introducing the ACRS (accelerated cost recovery system) and a 10% allowance against investment tax. Meanwhile, the recovery in capital investment

did not start until 1984, after the economy as a whole had begun to recover. **To a great extent, the revitalization of the US and British economies was achieved by a combination of structural reforms (in the shape of bold deregulation, rationalization and streamlining of the public sector through privatization, conversion to agencies, etc.) and tax reforms, which allowed the efficient redistribution of resources across the economy as a whole.**

Moreover, **these tax reductions pushed the US and British fiscal deficits to an extremely high level, and the current of tax reform has since shifted from neutrality towards increasing taxes.** Japan, too, has implemented tax reductions, namely, the corporate tax reductions of 1998 and 1999 (¥1.4 trillion in 1998 and ¥2.5 trillion in 1999, achieved by lowering the effective tax rate), the income tax reduction of 1999 (¥4.1 trillion, achieved by reducing the maximum rate of tax, among other measures). However, owing to the slow progress with structural reforms, the resulting improvement in the economic trend was a temporary phenomenon, and the tax reductions not only failed to achieve economic revitalization, but led to a sharp increase in the fiscal deficit.

### **3. Tax Reform Should be Implemented Organically and Integrally With Measures to Stimulate the Economy, Based on Medium-to-Long Term Objectives**

The third viewpoint is that **tax reform should not be used as a short-term tool for the creation of demand, but should be implemented organically and integrally with medium-to-long term measures to stimulate the economy.**

The term "tax incentive" stands for measures implemented as and when judged necessary for the realization of government policy objectives. Typical examples are reductions in housing loan and capital investment tax, and most are implemented as special taxation measures. Properly speaking, such tax reduction measures violate the governing principles of "neutrality on the distribution of resources" and "fairness", but, where justified by a policy objective, it is permissible to intentionally influence the distribution of resources in specific sectors of the economy, at the expense of neutrality and fairness. Even in such cases, the tax reduction measures should be implemented only as "temporary measures with a limited scope of application". However, **as many as 70% of the 78 different special taxation measures currently applied to companies have been in force for ten years or more, and could hardly be described as "temporary". Special taxation measures that have served their purpose should be repealed without delay.**

On the other hand, **realization of Japan as an IT nation, urban regeneration, the revitalization of the financial and capital markets, and the promotion of venture businesses and entrepreneurs are important policy issues if Japan is to revitalize its economy. Using the tax system organically and integrally with policy measures such as deregulation, and the injection of funds for the creation of infrastructure and subsidies into these fields, could serve as a catalyst to the revitalization of the economy.** Moreover, reform of the tax system is also vital in the medium term as a means of supporting structural reforms such as reform of the social security system and the local allocation tax system.

### **III. Proposals for Tax Reform With a View to Economic Revitalization**

Taking due consideration of the above three viewpoints, the author proposes a range of specific tax reforms geared to economic revitalization.

### **1. Temporary Measures**

The following tax reforms should be implemented on a temporary basis, their duration being initially limited to three years.

#### **(1) Measures to promote investment in IT**

For all companies investing in IT (hardware, the creation of B-to-B and other IT-related systems, etc.), a 7% allowance against investment tax or a 30% special depreciation rate in the first year (applicable where the amount that a company invests in IT in a year exceeds the amount it invested in the previous fiscal year) should be introduced. In parallel with these measures, the reduction of investment tax currently applicable to small and medium-sized businesses alone should be abolished.

#### **(2) Preferential treatment under real estate-related taxation to promote urban regeneration**

Some ten areas around the country should be designated as "special areas for urban regeneration". In these areas, regulations on floor area ratio to land area, building coverage and shadows should be substantially relaxed, and taxation on real estate transactions (registration and license tax, real estate transaction tax, stamp duty, special land holding tax, city planning tax) and tax on gains from land transfer should be suspended. At the same time, special depreciation rates should

be allowed on high-rise housing and commercial facilities in these areas, and reductions of fixed asset tax should be introduced.

### **(3) Preferential tax treatment of stock investment trusts**

The scope of application of preferential measures currently applied on a temporary basis to listed shares, etc., including (i) exemption from tax on stock transfer gains up to a purchase price of ¥10 million, (ii) the application of a tax rate of 10% for tax on transfer gains on long-term shareholding, etc. and (iii) the application of a special tax deduction of ¥1 million on transfer gains, should be extended to publicly subscribed stock investment trusts.

## **2. Permanent Measures**

To promote research & development, foster venture businesses and new industries, and revitalize the financial and capital markets, the following reforms should be implemented.

### **(1) Expansion of tax breaks to promote experimental research**

The tax breaks for additional experimental research costs should be raised from its current level of 15% to 20%. At the same time, the maximum deduction ratio should be raised (from the current level of 12% of the amount of corporate tax payable to 25%). To expand the range of businesses to which these measures apply, the American system of deducting a fixed proportion in reflection of the

ratio of experimental research costs to sales<sup>1</sup> should be adopted, and businesses should be allowed to choose between the two systems.

**(2) Expansions of taxation measures to foster ventures and promote the establishment of new businesses**

- (i) The current "angel tax system" should be expanded. (Provided certain conditions are met, transfer gains should be tax free — at present, 75% of the tax is exempted —, and the period over which losses can be carried over should be extended from the present three years to five years.)
- (ii) The system of reserves against losses for venture capital should be expanded. (Venture capital businesses should be allowed to claim for the entire amount of reserves against losses.)
- (iii) The tax measures to support the establishment of new businesses should be expanded. (The period over which losses can be carried over under the law concerning establishment of new businesses and law for the promotion of establishment of small and medium-sized enterprises should be extended from the present seven years to ten years, and the range of companies qualifying should be expanded.)
- (iv) To facilitate business succession among small businesses, the deduction rate against the taxable base for inheritance on non-listed stock should be raised from the current level of 10% to 50%.

**(3) Introduction of unified income taxation**

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<sup>1</sup> Ratio to sales 1-1.5%:	deduction rate 2.65%
Ratio to sales 1.5-2%:	deduction rate 3.2%
Ratio to sales 2%+:	deduction rate 3.75%

The present complex system of taxation of financial products, under which taxation differs for each type of product, should be subjected to a bold review.

- (i) Interest, dividends, and capital gains (including land transfer gains) should be unified under the title of "capital income", and should be subject to taxation at a low rate, separately from "labor income" (general taxation). The tax rate should be level with the current rate of 20% applied to interest income.
- (ii) The period over which capital losses can be carried over should be extended from the present three years to five years.
- (iii) The aggregation of profit and loss should be permitted between different types of capital income. In this case, profit and loss on futures, options and other derivatives should be treated as a capital gain or loss and their aggregation should be permitted.

### **III. Conclusion**

**The government should aim to implement the tax reforms described above from 2003, following the discussion of concrete measures by the Government Tax Commission, Opposition Tax Commission and Council on Economic and Fiscal Policy. These measures will amount to tax reductions worth approximately ¥2.5 trillion yen in the average fiscal year, but this amount is within the range that it should be possible to cover through the abolition of the special taxation measures for businesses, a review of the consumption tax system (the lowering of the taxable minimum and abolition of the simplified taxation system), measures to correct the income supplementation rate gap (the so-called "ku-ro-**

**yon" [90:60:40]), and the realization of a simpler and fairer tax system.** The very idea of using tax reductions to elicit demand in the short term is nonsense, and, in any case, it is doubtful whether the reductions would have this effect in practice. However, it is very possible that reform of the tax system would support the process of structural reform by ensuring the optimum distribution of resources in Japan, and lead to the creation of fresh demand. Now is the time for the Koizumi Administration to put on its thinking cap.