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Perspective Lacking in the Discussion on Financial Income Taxation

—Proposal for Introduction of comprehensive selective taxation and emphasis on "equality of opportunity" —

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〈Summary〉

- Since the Liberal Democratic Party (LDP) presidential election in September this year, discussions on strengthening the financial income taxation have been attracting attention in Japan. For high-income earners with an income of more than 100 million yen, the lower their income tax burden rate becomes (regressive) as incomes rise, a problem arises from the perspective of income redistribution (the so-called "100-million-yen barrier"). It has been pointed out that the ratio of financial income to total income is high in the high-income group, while the tax rate for financial income subject to separate taxation is lower than the progressive tax rate on labor income subject to comprehensive taxation.

- Many countries adopt a system in which financial income is separated from labor income and taxed at a lower rate. In the wake of economic globalization and digitalization, taxes on labor income, which is not easily transported across national borders, have become heavier, while taxes on financial income, which is easily transported across national borders, have been reduced.

- To strengthen the financial income taxation, raising the rate of the tax levied separately, not only yields the space for consideration of the tax burden and the impact on the financial market, but also contains several problems such as （1）if the increase is small, regressivity will not be eliminated and （2）the tax burden on low-income households will increase.

- On the other hand, adopting the progressive tax rate under the comprehensive taxation shall yield the outcome that , (1) the income tax burden rate on the income group exceeding 100

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million yen will also be progressive, and (2) the tax burden on the financial income of the low-income group will be reduced, therefore the income redistribution will be strengthened, but the tax rate on the financial income of the high-income group will rise from 20% to 30 ~ 55%.

◆ If we strengthen the financial income taxation in order to strengthen its income redistribution function, it is desirable for us, in addition to raise the proportional tax rate, to adopt a system that enables anyone to select the comprehensive taxation, not the separate taxation, for his interest income and capital gains from stocks. We can avoid an increase in the burden on low-income households.

◆ Regarding recent discussions on the strengthening of financial income taxation, the problem is that those who argue for it are too focused on equality of results for the current generation and lack the perspective of equality of opportunity. Instead of focusing on strengthening taxation on financial income based on "equality of results," we should review the entire tax system, including strengthening inheritance and gift taxes, by focusing on measures to enhance "equality of opportunity."

- **This is an English version of "金融所得課税の議論に欠けている視点 ― 選択制総合課税の導入と｢機会の平等｣重視を ―" in JRI Research Focus (The original version is available at https://www.jri.co.jp/MediaLibrary/file/report/researchfocus/pdf/13056.pdf)**

1. Background of the Debate on Strengthening the Financial Income Taxation ... The so-called "100-million-Yen Barrier"

Discussions on strengthening the financial income taxation have drawn much attention in Japan. In recent years, there have been concerns that the number of people in the lower income bracket is increasing, due to an increase in the number of non-regular employees. So how to prevent the widening of, or shrink, the income disparities have been emphasized as a policy issue that must be addressed. It is still fresh in our memory that an influential figure such as Prime Minister Kishida mentioned strengthening the financial income taxation during the LDP presidential campaign in the fall of 2021 and also when he was inaugurated as the new president of the LDP. Fearing the negative effect on the economy, the tax system reform in FY 2022 is not expected to contain any specific measures of strengthening the financial income taxation, discussions on strengthening the system are expected to continue.

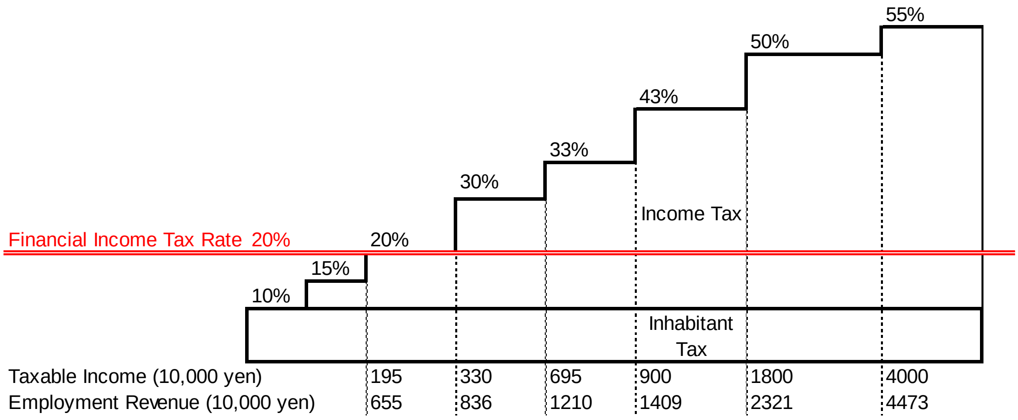
Financial income taxation refers to income taxation on interest income, dividend income, and capital gains of stocks, etc. Unlike taxation on labor income, etc., it is separate taxation at the uniform proportional rate of 20% (Table 1). On the other hand, labor income, such as employment income and business income, which accounts for a large portion of income, is comprehensive taxation with a progressive tax rate of 10 ~ 55% according to the total amount of income generated (Figure 1). Therefore, the tax rate on financial income exceeds the tax rate on labor income in the low-income group to which the low progressive tax rate is applied, while the tax rate on financial income falls below the tax rate on labor income in the high-income group to which the high progressive tax rate is applied.

Table 1. Overview of Tax Methods by Income Type

Type of Income	Synthesis /Separation	Applicable Tax Rate	Type of income	Synthesis /Separation	Applicable Tax Rate
Employment Income	Comprehensive Taxation	Progressive Tax Rate	Capital Gains (real estate, etc.)	Separate Taxation	Proportional Tax Rate
Business Income	Comprehensive Taxation	Progressive Tax Rate	Retirement Income	Separate Taxation	Progressive Tax Rate
Real property Income	Comprehensive Taxation	Progressive Tax Rate	Timber Income	Separate Taxation	Other
Capital Gains Income (comprehensive and long-term)	Comprehensive Taxation	Progressive Tax Rate			
Occasional Income	Comprehensive Taxation	Progressive Tax Rate	[Financial Income]		
Miscellaneous Income	Comprehensive Taxation	Progressive Tax Rate	Interest Income	Separate Taxation	Proportional Tax Rate
[Financial Income]			Dividend Income *	Separate Taxation	Proportional Tax Rate
Dividend Income *	Comprehensive Taxation	Progressive tax rate	Capital Gains (from listed shares, etc.)	Separate Taxation	Proportional Tax Rate

Source: Prepared by The Japan Research Institute based on Ministry of Finance data.
Note: * For dividend income from listed shares, etc., taxpayers can select either comprehensive taxation (dividend deduction is applicable) or separate self-assessment taxation when filing a return.

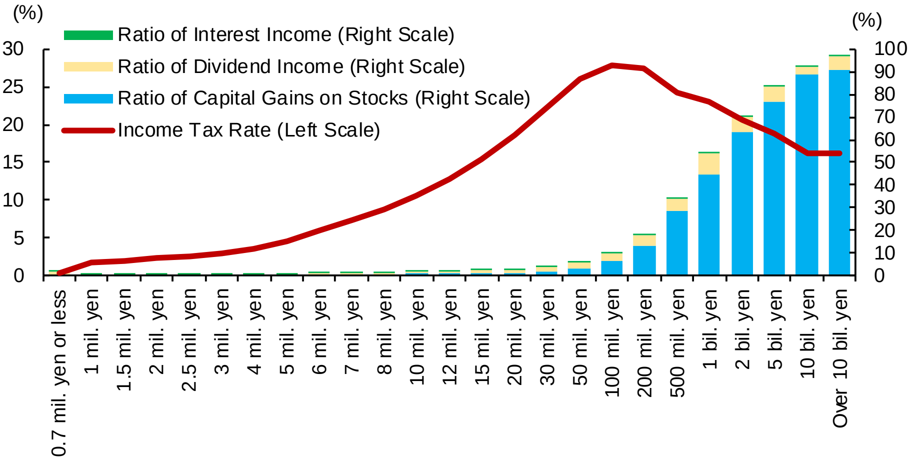
Figure 1. Progressive Income Tax Rate and Financial Income Tax Rate



Source: Prepared by The Japan Research Institute based on Ministry of Finance data.
Note 1: In addition to the above, special income tax for reconstruction (2.1% of income tax) was imposed from 2013 to 2037. The financial income tax rate is 15% for national taxes, 5% for resident.
Note 2: The amount of employment revenue of an employment income earner in a single-income household consisting of a married couple and two children, one of whom falls within the category of specified dependent relative (age 19~23 years) and the other within the category of ordinary dependent relative (16~18 years or 23~70 years).

Looking at the total income tax burden rate by income bracket, the burden rate on those with incomes over 100 million yen per year decreases as their income increases (the so-called 100-million-yen barrier), and this is viewed as a problem from the perspective of income redistribution (Figure 2). As a factor for this, it has been pointed out that the higher the income group, the higher the ratio of financial income to total income, and that the tax rate on the financial income of the upper income group will be lower than the tax rate on labor income. In fact, whereas the ratio of the financial income to total income is less than 1% for those earning under 6 million yen per year, the ratio of those earning between 100 million yen and 200 million yen is 17.8%. And for those earning more than 5 billion yen per year, the ratio is over 90%.

Figure 2. Income Tax Rate and Financial Income Ratio by Income Tier (2019)



Source: Prepared by The Japan Research Institute based on National Tax Agency data.
Note: Income tax burden ratio = (withholding tax amount + self-assessment tax amount)/Total income

2. Various countries also adopt separate taxation on financial income

As in Japan, a system in which financial income is separated from labor income and taxed at a lower rate has been adopted in various countries (Table 2). For example, in the United States, salary income, etc. is subject to comprehensive taxation at a progressive rate of 10 ~ 37% (federal income tax), while dividends and gains on stock transfers are subject to separate taxation at rates of 0%, 15%, and 20%. In Germany, employment income is taxed at a progressive rate of 0 ~ 47.5% (income tax + federal surtax), while financial income is taxed at a proportional rate of 26.375%. However, it is also possible to choose comprehensive taxation upon declaration.

The impact of economic globalization and digitalization has been pointed out as the background to the adoption of such a system in various countries. These days funds can move quite easily beyond national borders, so wealthy people shift their financial assets to the countries with lower financial income tax burdens in order to avoid high tax burdens. As a result, adverse effects such as a decrease in investment, loss of tax sources, and a heightened sense of unfairness in tax burdens have been raised in countries with higher financial income tax burdens. As a result of the measures taken by each country, it has been pointed out that, from a global perspective, while taxation on labor income, etc. that is not easily transported beyond national borders tends to be heavier, taxation on financial income, etc. that is easily transported across national borders tends to be reduced.

Table 2. Overview of Financial Income Taxation in Major Countries

	Japan	U.S.A	United Kingdom	Germany	France
Interest	Separate Taxation (Withholding at Source)	Comprehensive Taxation	Separate Taxation (Gradual Taxation)	Separate Taxation (Withholding) Upon filing a Tax Return, Comprehensive Taxation is Imposed. Selectable	With the Separate Taxation Choice of Comprehensive Taxation
	20%	10~37% (+ State and Local Taxes)	0, 20, 40, 45%	26.38%	Separate Taxation 30% General Taxation 17.2 ~ 62.2%
Dividend	As Separate Taxation (Declaration) Choice of Comprehensive Taxation	Country: Separate Taxation (Stage Taxation) State and Local Governments: Comprehensive Taxation	Separate Taxation (Gradual Taxation)	Separate Taxation (Withholding) Upon Filing a Tax Return, Comprehensive Taxation is Imposed. Selectable	With the Separate Taxation Choice of Comprehensive Taxation
	Separate Taxation 20% General Taxation 10 ~ 55%	0, 15, 20% (+ State and Local Taxes)	7.5, 32.5, 38.1%	26.38%	Separate Taxation 30% General Taxation 17.2 ~ 62.2%
Stocks Gain on Transfer	Separate Taxation (Declaration) Only Withholding at Specific Accounts can be selected	Contry: Separate Taxation (Stage Taxation) Total Taxation for Holdings of 12 Months or Less State and local governments: comprehensive taxation	Separate Taxation (Gradual Taxation)	Separate Taxation (Withholding) Upon Filing a Tax Return, Comprehensive Taxation is imposed. Selectable	With the Separate Taxation Choice of Comprehensive Taxation
	20%	0, 15, 20% (+ State and Local Taxes)	10, 20%	26.38%	Separate Taxation 30% General Taxation 17.2 ~ 62.2%
Progressive Tax Rate	10% ~ 55% (Country + Region)	10% ~ 37% (State)	20% ~ 45%	0% ~ 47.5%	9.7% ~ 54.7%

Source: Prepared by The Japan Research Institute based on Ministry of Finance data.

3. Perspective to the proposal to strengthen the financial income tax

Recently in Japan, it's actively discussed about whether to strengthen financial income taxation. The purpose to strengthen it is to address the regressivity of the tax burden as mentioned above. In the discussion, there are two main directions to review the system of financial income tax.

① raise the current proportional tax rate of 20%, leaving the financial income taxation separated from the income tax as a whole [1]

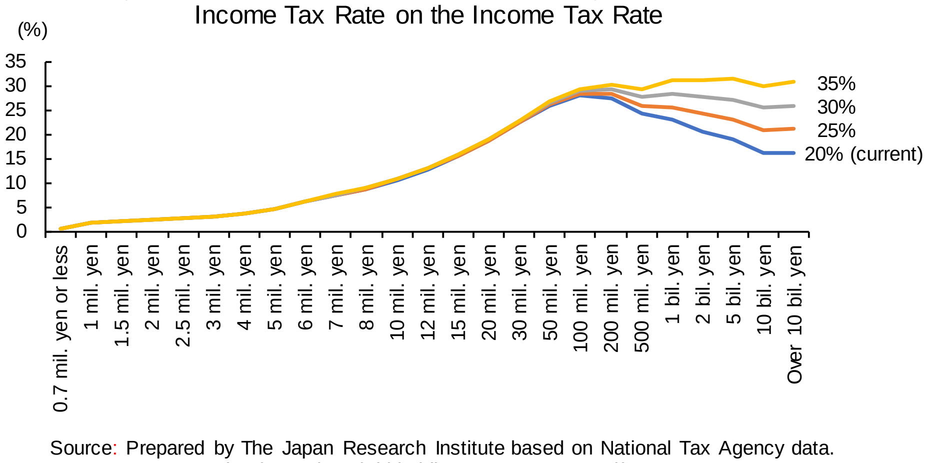
②combine financial income, as with the case of labor income, comprehensively into the income tax as a whole, and apply the progressive rate

The impact of these changes on the expected income tax burden will be as follows.

(1) Cases in which the tax rate is raised while separate taxation is maintained

In this case, the tax rate can be raised gradually, taking into consideration the individual income tax burden and the impact on the financial market. However, if the markup of the tax rate is small, the effect of strengthening of the income redistribution function will be limited. Calculating the changes in the income tax burden ratio as a result of the increase in the tax rate by income bracket (Figure 3) shows that, for example, if the tax rate is raised by 5% to 25%, the income tax burden ratio for the income group above 100 million yen will increase to a certain extent, but the regressivity will not be eliminated. If the proportional tax rate is raised to the point that the regressivity is eliminated, a markup of at least 15% (from 20% to over 35%) will be required.

Figure 3. Estimation of the Effects of Raising the Financial Income Tax Rate on the Income Tax Rate



Source: Prepared by The Japan Research Institute based on National Tax Agency data.
Note 1: Income tax burden ratio = (withholding tax amount + self-assessment tax amount)/Total income
Note 2: Burden rate after tax rate increase = Burden rate before tax rate increase + Tax rate increase width x Ratio of financial income

[1] In this case, it is possible to set multiple tax rates with separate taxation, as in the United States and the UK. In this case, unlike the across-the-board increase in the tax rate, there is a possibility of avoiding an increase in the burden on low-income groups, but it seems necessary to set a substantially higher tax rate on the financial income of high-income groups as described below in order to eliminate the regressivity.

On the other hand, it should be kept in mind that a uniform increase in the tax rate would not only increase the tax burden on high-income groups but low-income groups as well. Therefore, if the increase in the tax rate is too high on the purpose to eliminate regressivity, there are concerns that it will have a negative impact on the disposable income of pensioners and others who use financial income as part of their living expenses, as well as on asset formation by young people who do not have sufficient savings.

(2) The case of applying a progressive tax rate as a comprehensive tax

In this case, since financial income is taxed at a progressive rate of up to 55% depending on the amount of income as a whole, the income tax burden rate for those earn more than 100 million yen will also increase progressively. In addition, the income tax burden rate will decrease for the income group whose progressive tax rate is lower than the financial income tax rate, which will lead to the strengthening of income redistribution. As for the share of the taxpayers whose comprehensive tax rate on income tax and inhabitant tax is lower than the financial income tax rate, for example, approximately 58% of all income tax payers are applied the progressive income tax rate of 5 % (15% on total with inhabitant tax)(the FY 2020 budget) (Table 3). In fact, there would be more tax payers than 58 % whose burden would be reduced, since there are some people who pay only inhabitant tax, no national income tax.

Table 3. Percentage of Income Tax Taxpayers by Marginal Tax Rate (Budget 2020)

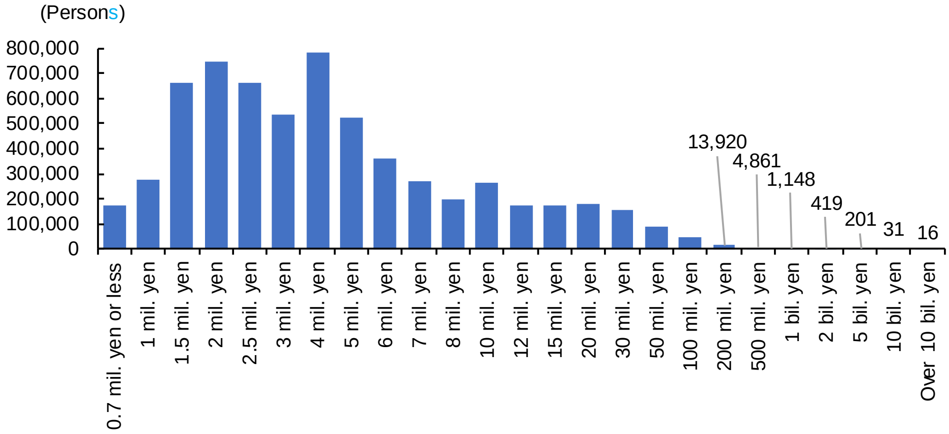
Marginal Tax Rate		Income-tax To the Taxpayer Percentage of Total
Income Tax	Income Tax + Resident Tax	
5%	15%	58%
10%	20%	23%
20%	30%	15%
More than 20%	More than 30%	4%

Source: Prepared by The Japan Research Institute based on Ministry of Finance data.
Note: Since the source document is a percentage of taxpayers by income tax bracket, it does not include those who are only subject to resident tax or those who are exempt from resident tax.

On the other hand, as for the people in the income bracket where the progressive tax rate is 30% (20% income tax + 10% inhabitant tax) or higher, the tax rate on financial income will rise from 20% to 30 ~ 55%. Taxpayers who are currently subject to a progressive tax rate of 30% or higher account for approximately 19% of all income tax payers, and there are concerns that a significant increase in the tax rate could have a considerable negative impact on financial and capital markets such as stock prices.

The number of people earning more than 100 million yen, which has been pointed out to be regressive, is about 20,000 on a filer basis, accounting for only 0.3% of all filers (Figure 4). The National Tax Agency's "Sample Survey for Self-Assessment Income Tax" which is the source of this data, does not include salaried workers who have paid their taxes only through withholding, so the percentage of those earning more than 100 million yen is expected to be lower. It will be necessary to consider the pros and cons of raising the tax burden on nearly 20% of taxpayers on the purpose to eliminate this regressivity among income groups.

Figure 4. Number of Filers by Total Income (2019)



Source: by The Japan Research Institute based on National Tax Agency data.
Note: The total number of applicants is 6,305,589.

4. Direction of future response required

(1)Proposal to introduce a comprehensive and selective taxation system for the sake of low-income earners

In light of the above considerations of taxation on financial income, to strengthen the taxation, it would be desirable to adopt a system that enable all taxpayers to select comprehensive taxation or separate taxation, on interest income and capital gains from stocks, which are currently subject to separate taxation only, as well as on dividend income, in conjunction with an increase in the proportional tax rate. In this way, although the tax burden on the high-income group will increase, as long as the proportional tax rate on financial income taxation is lower than the progressive tax rate on labor income, separate taxation will be chosen. Therefore, when setting the proportional tax rate, it is possible to take into account the effect on income redistribution and the impact on financial markets, etc. On the other hand, for the income group where the progressive tax rate on labor income is lower than the proportional tax rate on financial income tax, comprehensive taxation is considered to be chosen, and the tax burden on interest income and capital gains from stocks can be reduced. However, if the increase in the proportional tax rate is small, the regressivity of the income group above 100 million yen will not be eliminated. Therefore, it can be said that strengthening of the income redistribution function is limited only by reviewing financial income tax.

(2) Viewpoint of "equality of opportunity" required in discussions on strengthening income redistribution

When we discuss the function of income redistribution, it is essential to not only consider the current state of differences in income and assets (equality of results) but also the circumstances under which these differences occur (equality of opportunity). However, the current debate on the taxation of financial income shows that equality of results is excessively emphasized and the perspective of equality of opportunity is lacking.

Looking again at the breakdown of the financial income of filers whose regressivity is regarded as problematic and whose income exceeds 100 million yen, we can see that capital gains such as stocks account for the majority (Figure 2 again). Therefore, when we consider the types of people who declare more than 100 million yen, we can imagine, the following examples: (1) they manage assets inherited from their parents with stocks, etc.; and (2) they sell the stocks of the companies that they have established and grown. Among them, many people will feel that the low tax burden is not fair in cases such as (1) where a large amount of income is obtained from financial assets, etc. obtained through a process of inheritance that cannot be considered an equal opportunity. On the other hand, as shown in (2) above, imposing a heavy tax burden on income earned through one's own efforts and risk-taking business can be a hindrance to starting a business or investing in Japan. However, even in the case of (2), if the majority of assets are inherited only by the entrepreneur's own children or grandchildren, it would undermine "equality of opportunity" for the next generation as a whole, and there is concern that income and asset disparities would become fixed across generations.

In this context, to enhance the income redistribution function without impairing the vitality of the economy and society, it is necessary to review the entire tax system, including strengthening inheritance and gift taxes, with an eye toward measures to enhance the 'equality of opportunity,' rather than focusing on strengthening financial income taxation while being preoccupied with 'equality of results' in the near term. In recent years, since 2015, the inheritance tax has been strengthened by lowering the basic exemption and raising the maximum tax rate. On the other hand, the gift tax has expanded the requirements and extended the application period of the tax exemption for gifts of a certain amount of funds related to housing acquisition, education, marriage and child rearing. While these measures to reduce gift taxes are considered to have social significance, such as measures to stop the declining birth rate, there is concern that they will lead to the inheritance and fixation of income and asset disparities among future generations. To strengthen the function of income redistribution, it is necessary to consider further raising the maximum inheritance tax rate from the perspective of enhancing "equality of opportunity," and to reconsider the appropriateness of measures to reduce gift taxes from a social perspective.