CHALLENGING TAX REFORM IN JAPAN

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Introduction

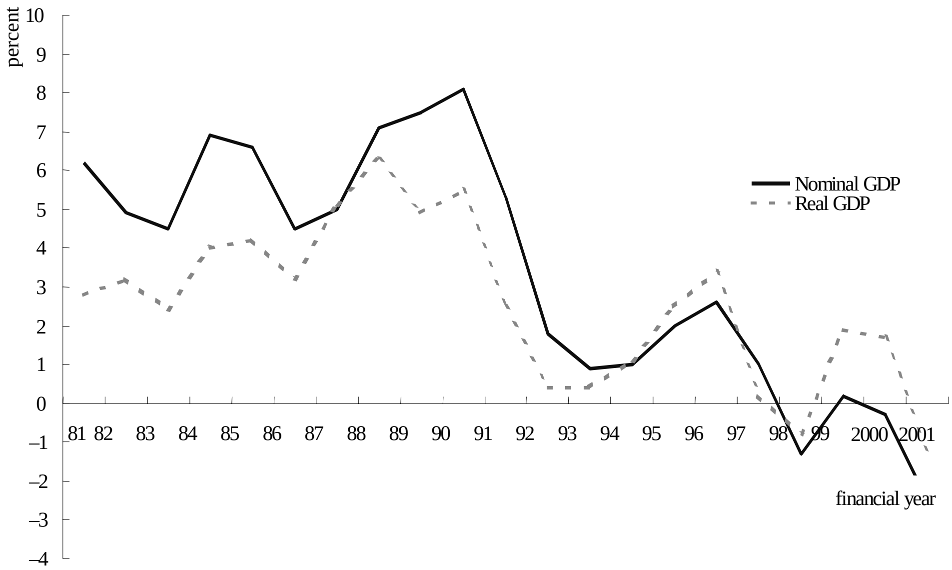
Japan is facing a very tough economic situation under the changing socio-economic circumstances. The Koizumi administration has been trying to climb out of this bind through undertaking structural reforms including tax reform. This paper is aimed at describing the background and the main features of the FY2003 Tax Reform in Japan and summarizing the basic direction of forthcoming Tax Reform.

1. Overview of the economic and fiscal situations in Japan

Nowadays Japan is in a very difficult economic situation (see Figure 1). After enjoying great economic performance in the post-war period – the highest rate of

Figure 1

Rates of Economic Growth, 1981-2001



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Opinions expressed in this paper do not necessarily represent those of the Ministry of Finance.

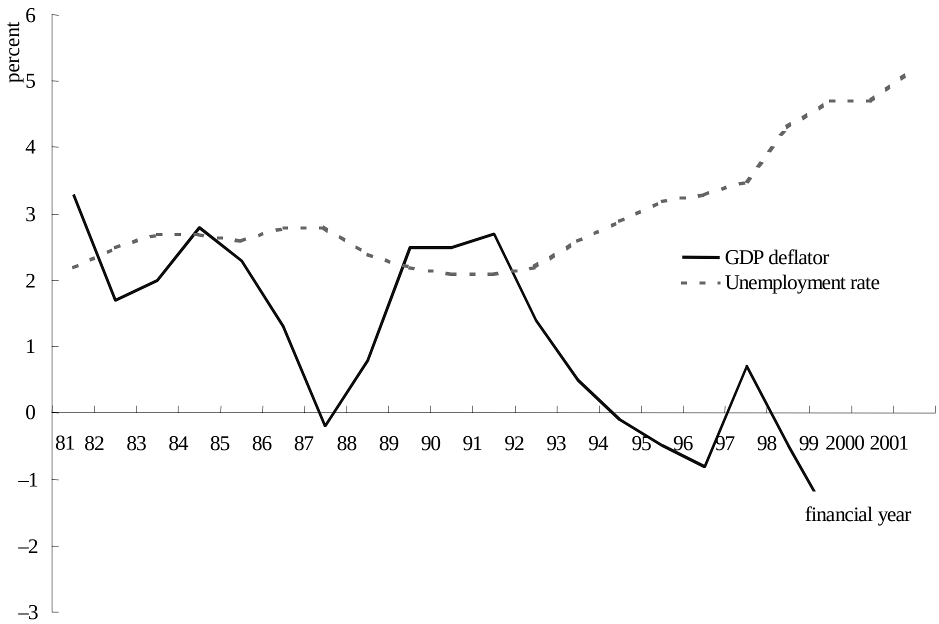
economic growth without the problems of unemployment or inflation – we entered the era that was known as the ‘bubble economy’ around the late 1980s. After hitting its peak in 1991, the ‘bubble’ burst, triggering Japan’s plunge into a period of stagnation of unprecedented length. The annual real growth rate during the 1990s was a mere 1 percent on average, in contrast to the 6 per cent level of the 1980s.

Of our major headaches, by far the most persistent is deflation, the continuous decline in the prices of goods, services and assets (see Figure 2). Particular attention should be paid to the fact that the nominal growth rate has been lower than the real growth rate since the mid-1990s. This situation is unprecedented among advanced countries in the postwar era.

Three sets of factors are said to be the cause of deflation. First, we have supply-side structural factors, such as the increase in low-priced imports and progress in technological innovation. Second, there are demand factors stemming from weakness on the business front. On top of that, some argue that deflation is deeply connected to our monetary policy stance. With regard to the theme of my presentation today – ongoing tax reform in Japan – quite a few voices are calling for anti-deflation measures in tax policy as well as in other fields.

Figure 2

Price Level and Unemployment Rate

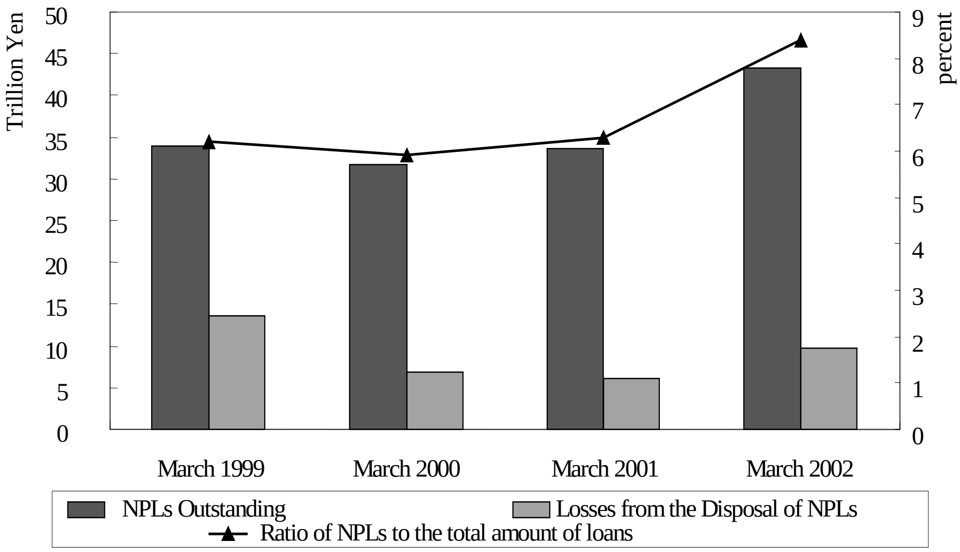


Related to the major headache mentioned above is another problem of great concern – non-performing loans (NPLs) coupled with overhanging debts in the corporate sector (see Figure 3). Deflation and NPLs are closely interrelated. On the one hand, the deflationary economic environment is generating new NPLs, despite banks' efforts to write off past NPLs. On the other hand, the NPL-rooted weakening of financial intermediary functions and sluggish corporate demand for borrowing are undermining the effectiveness of our monetary policy, which is aimed at combating deflation. Again, quite a few people are demanding effective tax measures, which are supposed to expedite the improvement of this situation. Unfortunately, however, we have not come up with the appropriate solutions as of yet.

To an extent even greater than the problems of deflation and NPLs, the most significant source of concern for Japan is its fiscal deficit (see Figures 4 and 5). Our fiscal position has deteriorated significantly from the early 1990s in terms of fiscal deficits and debt accumulation, reflecting the sluggish economy and successive expansionary policies – including fairly large-scale tax cuts – since the collapse of the bubble. The amount of government bond issuance budgeted for FY2003 was more than 36 trillion Yen, which is nearly 45 per cent of government expenditure, or 6 per cent of GDP. Tax revenue has declined by 18 trillion Yen from its peak of 60

Figure 3

Non-Performing Loans of Banks

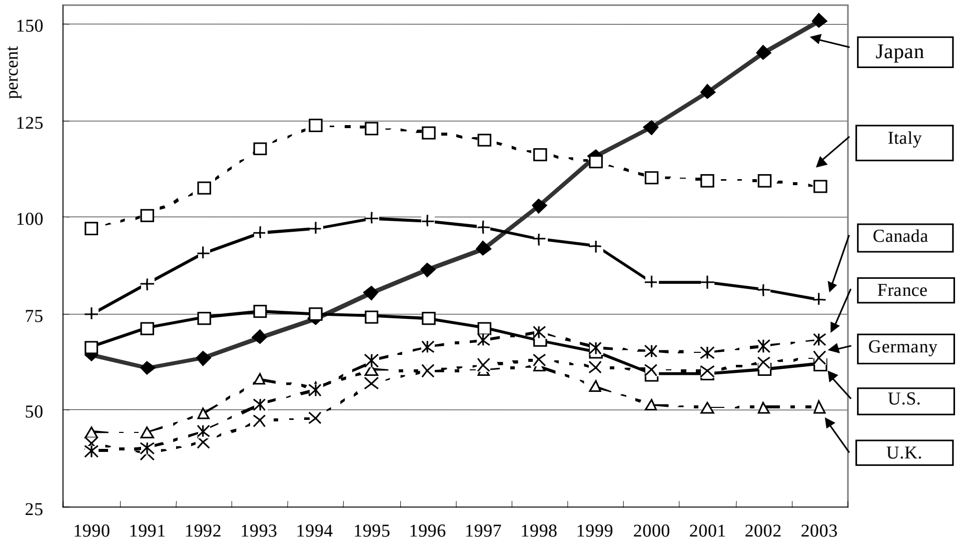


Source: FSA / Ministry of Finance.

NB. Losses from the disposal of NPLs: Book value write off of NPLs, sales of NPLs, new specific provisions specific against loans, less provisions made for the NPLs and the realised value of collateral.

Figure 4

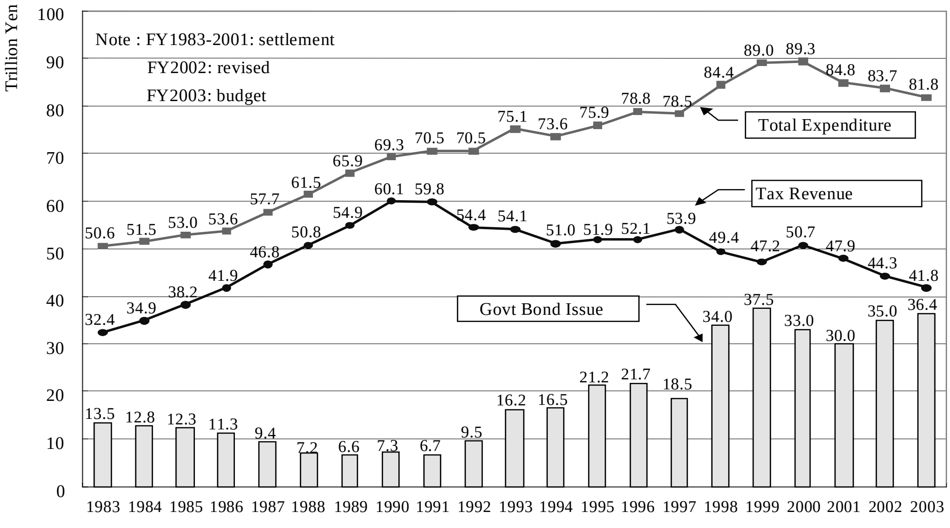
Debt (National and Local) Outstanding
(percent of GDP)



Source: OECD.

Figure 5

Revenue, Expenditure and Bond Issuance (National)



Source: Ministry of Finance.

trillion Yen in FY1990 to 42 trillion Yen in FY 2003. It is widely acknowledged that the causes of deficits in the 1990s were more structural – such as tax cuts – than cyclical. As a matter of fact, the ratio of tax burden to GDP in Japan is relatively low in comparison with other G7 countries.

The shortfall in the primary balance of the central and local governments is expected to be more than 5 per cent in FY2002. This estimate includes additional fiscal expenditure along with the decrease in tax revenues in FY2002. We are still sticking to the goal of achieving a primary balance surplus by the early 2010s, even though this goal might seem very tough to achieve.

2. Tax reform as one of the four pillars of structural reform

As mentioned already, during the prolonged recession in the 1990s, the Japanese government tried to stimulate the economy by adopting expansionary fiscal policy packages (see Table 1). A total of 140 trillion Yen (more than 1,000 billion

Table 1

Expansionary Fiscal Policy Packages since 1992

- Total: 136 Trillion Yen* (727 billion Pounds, 1,046 billion US$)
- 2.7% of GDP per annum* * 1992-2001

	Total			**(Billion Yen)**
		Investment	**Tax Cut**	**Others**
August 1992	10,700	6,250	0	4,450
April 1993	13,200	7,620	150	5,430
September 1993	6,200	1,950	0	4,200
February 1994	15,300	4,500	5,850	4,900
April 1995	4,600	1,077	0	3,543
September 1995	12,800	6,540	0	6,270
April 1998	16,700	7,700	4,600	4,350
November 1998	23,900	8,100	6,000	9,800
November 1999	18,000	6,800	0	11,200
October 2000	11,000	5,200	0	5,800
November 2001	1,000	400		600
February 2002	2,600	2,600		
Total	**136,000**	**58,737**	**16,600**	**59,543**

Note: Over 6 trillion Yen (1.3 % of GDP) in tax cuts have been implemented since Fiscal Year 1999.

Source: Table 8 of OECD Economic Survey, Japan (November 2001) and Ministry of Finance.

USD) was injected as continuous fiscal stimulus in the form of public investment and various tax incentives. However, these Keynesian-type fiscal policies have not brought about the desired effect of boosting the economy.

Japan also attempted to make its economy more buoyant by gradually lowering the official discount rate from its high of six percent in August 1990 right down to the adoption of a zero-interest-rate policy in February 1999. And very recently, the BOJ has been implementing a quantitative monetary easing policy because there is no room for further interest rate cuts. Nevertheless, in real terms, the monetary conditions in Japan remain restrictive *vis-à-vis* promoting investment activity.

Against this backdrop, the Koizumi Cabinet has placed increasing emphasis on carrying out structural reforms, rather than pursuing the conventional expansionary policy. The four main pillars of structural reform are as follows: (1) financial system reform; (2) regulatory reform; (3) government spending reform; and (4) sweeping tax reform.

In the light of these circumstances, the Government Tax Commission ("the Commission", hereinafter) have been engaging in intensive study on sweeping tax reform since January 2002. Following an instruction from the Prime Minister Koizumi, the Commission conducted extensive study on comprehensive tax reform from a long-term perspective and published "Policy Guidance on the Establishment of a Desirable Tax System" ("the Report", hereinafter) in June 2002.

As the next step, the Prime Minister Koizumi instructed the Commission to study specific items to be incorporated in the FY2003 tax reform. The Commission conducted deliberation on specific measures to be taken in the FY2003 tax reform from various items reviewed in the Report, and submitted its recommendation to the Prime Minister. The main part of the FY2003 tax reform bill, which passed the Diet this March, is based on this recommendation.

Talking of the Commission, I suppose it would be very useful to explain the decision-making process for tax policy in Japan.

The Commission consists of three main groups of members, which are: (a) tax experts, such as professors and accountants; (b) opinion leaders; and (c) representatives from various interest groups. The main responsibilities of the Commission are to review the tax system from a theoretical perspective and to make recommendations on tax policy to the Prime Minister.

On the other hand, the ruling parties also have their own tax commission that determines actual specific amendments in tax laws. Generally speaking, because taxation affects the conflicting interests of all people, the role of the ruling parties in the decision-making process of tax policy may be greater than in other areas of public policy. Therefore, for many years, the Commission conducted its deliberations while paying attention to the policy-making process in the ruling parties, and was careful to submit recommendations on tax policy that were in accordance with the prevailing political consensus within the ruling parties, not only in terms of the timing of their submission but also in respect of their actual content. While this was the case in the past, the Prime Minister Koizumi came into office with the clear intention of leading the discussion and decision-making process in the field of tax policy himself. The initiative the Minister Koizumi took was one of opposing the traditional practices of his own party. As I mentioned above, during the process of FY2003 tax reform, the Prime Minister took the initiative and set the ball rolling for deliberations as early as January, and in response to his request, the Commission submitted its recommendation in November, prior to the culmination of the ruling parties' decision-making process, which was an unprecedented case in Japan. In this sense, it is no exaggeration to say that the initiative of the Prime Minister played a key role in the decision-making process for the FY2003 tax reform.

3. Basic frame of reference of tax reform

The designing of a desirable tax system as recommended in the Report of June 2002 is guided by four basic principles. I would now like to outline the basic frame of reference of the FY2003 tax reform, based on remarks by Doctor Hiromitsu Ishi, the Chairman of the Commission.

3.1 Time perspective

First of all, we have taken a long-term perspective in our discussion on tax reform to design a desirable tax system. Since the economy is not performing well, with no sign of any full recovery visible at the present time, there were widespread voices supporting another round of tax cuts as fiscal stimulus – the short-run viewpoint. However, in accordance with the request from the Prime Minister in January, the Commission took a long-term perspective, rather than focusing exclusively on the short-term policy to be taken, or in other words, tax cuts.

3.2 Changes in the socio-economic structure

Second, there are two aims in conducting the reform. The first is to rectify the mismatch that exists between today's socio-economic structure and the current tax system. The framework of the current tax system was founded on the recommendation of the US tax mission headed by Dr. Carl Shoup in 1950. Since then, the tax system has been subject to constant review, but there still remains a need to adjust it in line with the changing economic and social situation. For example, Japan was in the past a much younger society with a larger proportion of its population in the workforce. Elderly people were given tax privileges because they were considered to be socially vulnerable. Family lifestyle has changed as well. Until recent years, many married women stayed at home to do the housework and those that worked outside the home were in the minority. This is not the case nowadays. Certain exemptions for spouses were introduced to meet the needs of family lifestyle in the past, but they may no longer be appropriate for families in the gender-equal society of today. The other objective is to secure a stable revenue raising structure.

As discussed earlier, the government of Japan took expansionary fiscal measures in the 1990s, including tax cuts... tax cuts… and more tax cuts. As a result, the ability of the Japanese tax system to raise the revenue necessary for public services has become poor. Given that Japan is moving rapidly towards becoming a society with fewer children and an aged population, the tax system will soon be unable to fulfill its fundamental role. Therefore, establishing a stable revenue base is another important goal of the tax proposal.

3.3 Streamlining of expenditure

Third, expenditure cuts and administrative reform are emphasized as an absolute prerequisite to tax reform. It is obvious that revenue-increasing measures need to be taken in the future. The general public, however, will not accept any attempts to increase their burden without assurances that the tax money they pay is spent effectively and efficiently by the government. The Commission is giving very serious consideration to this problem and expenditure cuts and administrative reform will be one of the starting points of the sweeping tax reform.

3.4 Stimulation of the economy

Fourth, although the basic thinking behind the tax reform is to focus on the medium-to-long-term perspective, we cannot ignore the current issue of buoying the depressed economy. The Minister Koizumi has accepted the necessity of taking tax measures to revive the flagging economy. At the same time, however, adding to the fiscal deficit was obviously something that had to be avoided.

As described earlier, a number of fiscal measures to stimulate the economy have been taken in the past. At those times, it was constantly hoped that the economy would be boosted by such measures, through which economic recovery could in turn recoup the loss in revenue from the tax cuts. Such an irresponsible attitude can no longer be tolerated. The design of short-term tax measures to pull the economy out of recession should be compatible with the long-term perspective of the reform.

In this context, at first, the Prime Minister seemed to be insisting that the tax reform package should be single-year revenue-neutral. In August of last year, he gave the instruction that a FY2003 tax reform package should be formulated, including over 1 trillion Yen in advance tax cuts on a revenue-neutral basis over several fiscal years. This indicates his firm commitment to employ all policy tools – including taxation – toward improving the Japanese economy without further damaging the fiscal situation.

The FY2003 Tax Reform package, that is summarized below, includes advance tax cuts from FY2003 (tax incentives for R&D and plant-equipment investment, as well as rate reduction and base broadening in inheritance and gift taxes), and subsequent tax increases (widening the income tax base and diminishing the scope of special treatments for small traders in the consumption tax) that will be implemented later. The plan is that the resulting loss in revenue will be recovered in 6 to 7 years. What is important is that both tax cuts and tax increases are enacted through *one* law, the whole of which has been passed in the Diet at the same time.

4. Reform of each tax

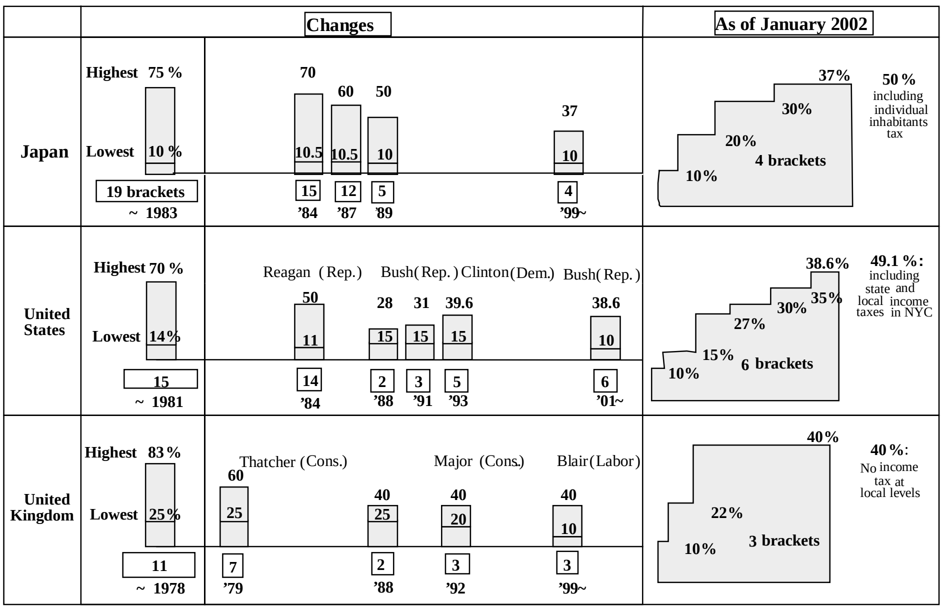
In light of this basic frame of reference, we have reviewed each tax and set the following objectives in terms of achieving a desirable tax system.

4.1 Individual income tax

With regard to individual income tax, the number of tax brackets has been reduced from nineteen in 1983 to four in 1999, and the top rate has been cut from 75 to 37 per cent (see Figure 6). The progressive structure of tax has become very

Figure 6

Changes in Income Tax Rates



Source: Tax Commission.

moderate. This policy trend has been explained as the policy means to enhance people's incentive to work, in particular workers in the middle or upper ranks in terms of income.

On the other hand, broadening of the base of the income tax has not been carried out. We need to reduce or eliminate numerous exemptions and deductions, which add up to more than 20 items in the existing tax system. In 1950, when the Shoup tax system was established, there were only five or six exemptions and deductions in the individual income tax. These 20-plus items have increased the level of minimum income at which obligation to pay income tax starts (the so-called tax threshold) and are greatly eroding the tax base.

In addition, a mismatch between the current tax system and the socio-economic structure is created by these numerous exemptions and deductions. For instance, the criticism is often made that the special exemption for spouses is not appropriate in this gender-equal society, and that it hinders the employment opportunities of housewives. Similarly, with respect to broadening the tax base, it is also important to remove or lessen the scope of several deductions for salary income, retirement income, pensions, working students and so on.

These factors have led to the phenomenon known as "hollowing out" occurring for individual income tax. As a matter of fact, approximately a quarter of the total workforce does not pay income tax, mainly due to the high tax threshold. The burden of individual income tax to National Income is remarkably low in Japan compared with other advanced countries. This not only brings about tax revenue shortfall but also leads to deterioration of the built-in stabilizer and income redistribution functions.

From these viewpoints, from 2004, we are abolishing the special deduction allowed for spouses (maximum of 380,000 Yen). This deduction serves to lower the tax threshold – for example, from 3.84 to 3.25 million Yen for a family of a husband and wife with two children (see Table 2). Surprisingly, this is the first attempt to raise individual income tax in the postwar period in Japan.

The remaining issues related to individual income tax are as follows.

a) reorganizing other family-related deductions;

b) reviewing elderly-people-related deductions including the public pension deduction;

c) widening the minimum marginal rate bracket, which covers about 80 per cent of taxpayers under the current system.

4.2 Corporation tax

Businesses pay corporation tax on the profits they create by production, sales, services and other activities. These business activities are a source of vitality for the Japanese economy. It has, therefore, been argued that the corporation tax burden

Table 2

Tax Threshold of Individual Income Tax (A Couple With 2 Children)
(thousands of Yen)

Current

Deduction of Employment Income	Deduction of Social Insurance Payment	Basic Allowance	Allowance For Spouse	Special Allowance for Spouse	Allowance for Dependent	Allowance for Specific Dependents
(1,308)	(384)	(380)	(380)	(380)	(380)	(630)

3,842

From 2004

Deduction of Employment Income	Deduction of Social Insurance Payment	Basic Allowance	Allowance For Spouse	Allowance for Dependent	Allowance for Specific Dependents
(1,155)	(325)	(380)	(380)	(380)	(630)

3,250

should be reduced to some extent so as to make Japanese corporations more competitive in the global market.

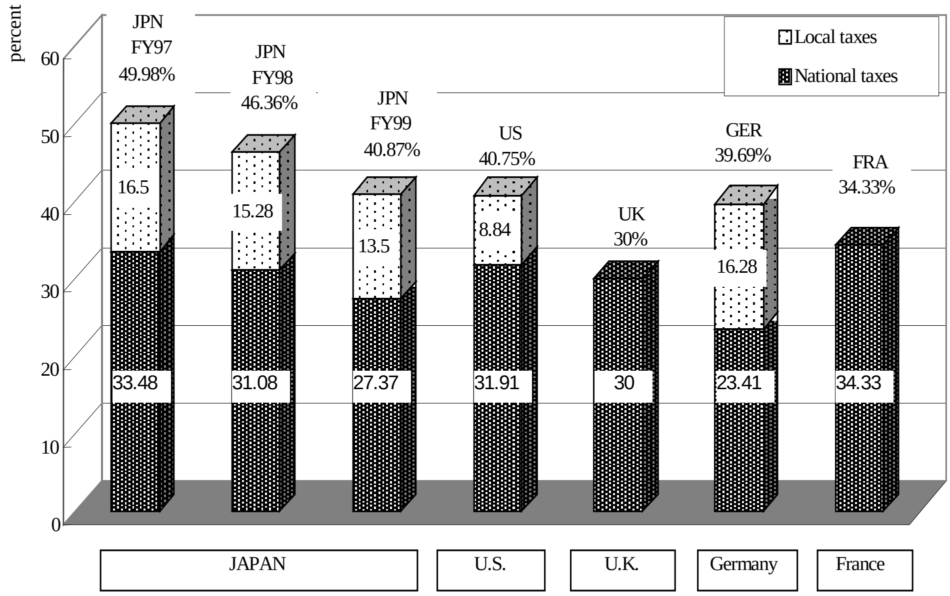
Based on this standpoint, the corporate tax system has undergone a number of reforms since fiscal 1998. On the one hand, the corporate tax rate has been reduced to a level compatible with the levels of other major advanced countries. From 1998 to 1999, the effective corporate tax rate in Japan was reduced from 49.98 percent (FY1997) to 40.87 percent (FY1999). This was a tremendously large tax cut for such a relatively short period (see Figure 7).

Japan's corporate tax burden is higher than that of the UK or France, mainly due to the tax imposed at local government level. Although the UK and France have no local corporate-related taxes, there are other taxes on corporations collected by local governments, such as "non-domestic rates" in the UK and "tax professional" in France. It is therefore difficult to accurately compare the situation among various countries with different tax systems.

Unfortunately, in the sluggish economic conditions, we have not been able to present factual evidence of the effects of reduced taxation on corporations' activities

Figure 7

International Comparison of Effective Corporation Tax Rates



Source: Tax Commission, as of Jan 2003.

Statutory Tax Rates

	JAPAN -FY98	JAPAN -FY99	JAPAN After FY99	USA	UK	GER	FRA
Corporation Tax (CT)	37.5%	34.5%	30%	35%	30%	26.5%	33 1/3%
	(Enterprise Tax)			8.84% (1)	n.a.	19.45% (2)	CT x 3% (4)
	12%	11%	9.6%				
	(Corporation Inhabitants Tax)					CTx 5.5% (3)	
	CT x 17.3%						

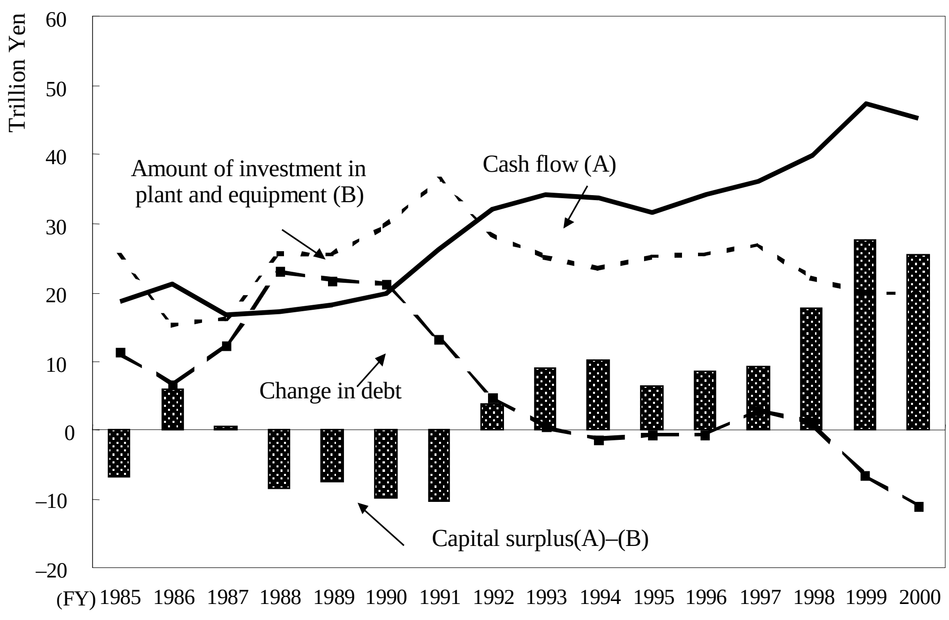
such as capital investment and so on. The corporate sector in Japan has recently been a large source of excess saving (see Figure 8). In other words, on the whole, Japan's corporate sector does not need a great amount of cash flow. Under these circumstances, Japanese corporations would probably repay outstanding debts rather than making productive investment, if they were to obtain cash flow by virtue of a general corporate tax rate cut.

Therefore, we have decided not to lower the current level of corporate tax rate any further at this time, even though some influential voices have been calling for a further rate cut.

Then again, it is very important to strengthen the global competitiveness of Japanese corporations. From this viewpoint, in FY2001, we introduced a new taxation system relating to the restructuring of corporations, such as splits, mergers and investment in kind. In FY2002, we installed the consolidated tax system, under which corporation tax is charged on the integrated amount of profit and loss of all of the corporations in a given corporate group. On top of that, in FY2003, a new framework for R&D tax credit and focused investment incentives will be introduced as follows.

Figure 8

Investment and Cash Flow in the Corporate Sector of Japan



Source: METI, MOF.

a) Proportional R&D Tax Credit

A new proportional R&D tax credit shall be introduced as an alternative to the existing incremental R&D tax credit. For R&D activities conducted by corporations, a proportional R&D tax credit of eight percent plus two percent (applicable only for FY2003 to FY2005) of the amount of R&D expenditure shall be introduced. For corporations with a higher proportion of R&D expenses, up to two percent of additional tax credit shall be applied.

b) IT Investment Incentives

Since IT investment would create immediate demand and improve productivity in the mid to long-term, the investment incentives outlined below shall be applied for FY2003 to FY2005.

- Scope of qualified IT investment includes both hardware and software.
- Certain expenses for leasing are to be eligible.
- Corporations may select tax credit (10 per cent) or special allowance for accelerated depreciation (50 per cent).

c) Accelerated depreciation for R&D investment

In addition to the R&D tax credit (above), a special allowance (50 per cent) shall be applied for R&D investment in FY2003 to FY2005.

4.3 Taxation related to financial assets

As is the case in other countries, taxation related to financial assets is one of the most serious concerns in tax policy, especially under the current circumstances. From the viewpoint of creating simplified taxation related to financial assets to ensure neutrality among them, taxation of listed stocks and publicly traded stock investment funds shall be revised and the usability of a “designated account” for stocks, which allows stock holders to skip the step of filing returns, shall be improved on a permanent basis.

- Dividends from listed stocks will be taxed (by selection) at the rate of 20 percent by withholding (after the passing of five years as mentioned below).
- Losses arising from publicly traded stock investment funds can be aggregated with capital gains, if any, on stocks.
- A new type of special account system will be introduced under which tax will be paid by withholding and no filing of returns will be required.

In addition, we shall take special tax measures to promote a shift from deposit saving to security investment as follows:

- Dividends from listed stocks and distribution from publicly traded stock investment funds will be taxed at the reduced rate of 10 percent by withholding for five years.
- Capital gains on listed stocks will be taxed at the rate of 10 percent for five years.

As a matter of fact, even in the current difficult times in the stock markets of Japan, the price performance of high-dividend-rate stocks has been fairly good (see Figure 9).

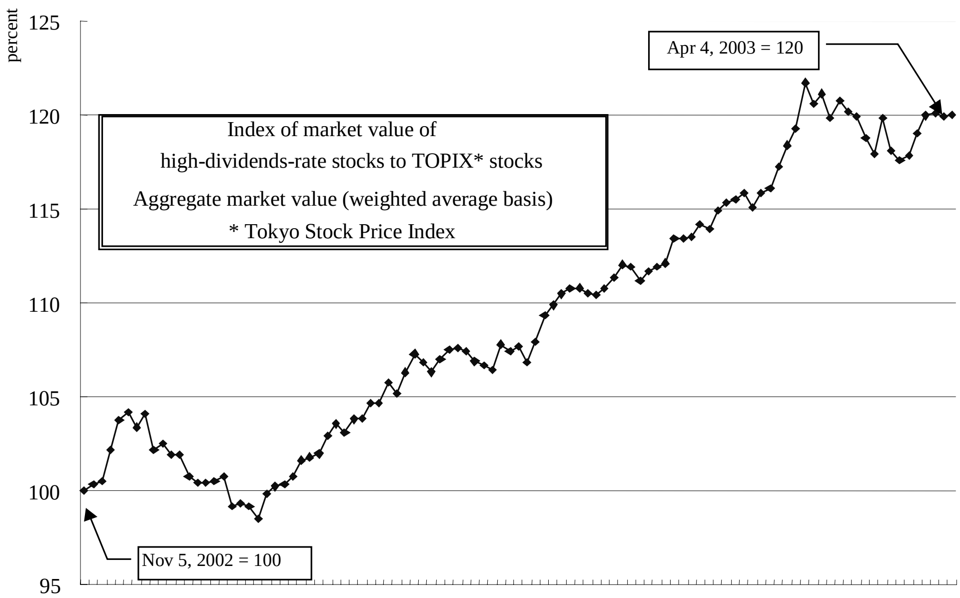
4.4 Consumption tax

It has been more than ten years since we introduced the consumption tax (Japan's VAT) in 1989 as a totally brand new tax in Japan. Needless to say, the consumption tax is one of the typical examples of "broad and thin burden," because this tax has quite limited non-taxable transactions and its rate is only 5 per cent as a single rate.

The consumption tax will play an even more important role in Japan in the future, since the cost of social security expenditure will inevitably rise in the rapidly

Figure 9

Movement of Stock Price Indices



Source: Author.

aging society. There are a couple of advantages to the consumption tax, although a regressive tax burden is unavoidable among low-earners. For example, the burden of consumption tax does not fall excessively on the working generation but is shouldered by the elderly population too. Accordingly, the consumption tax promotes fairness between generations.

Since the introduction of the consumption tax in 1989, its tax revenue has increased steadily, now accounting for about 20 per cent of total national tax revenue, and staking a claim to a position as one of the major taxes in the present tax system. However, the current rate of Japan's consumption tax is still ranked at one of the lowest levels in an international comparison.

Given the future importance of consumption tax in Japan, it is obviously necessary to gain broad majority support for such a tax among the Japanese people. Efforts should be made to improve the transparency of the consumption tax, whose base should be broadened, and to ensure that revenue gains due to special privileges for small vendors are not produced.

For this purpose, we shall introduce the following measures after FY2004.

- Diminishing the exemption for small vendors to a level one third the current level: Reducing the tax exemption threshold for eligible small vendors from 30 million Yen (current level) to 10 million Yen.
- Scaling down the simplified method for calculation of taxation (*i.e.,* use of the deemed ratio for a purchase): Restricting eligibility for the application of the simplified tax scheme by lowering the ceiling from vendors with annual sales of Yen 200 million or less to those with annual sales of Yen 50 million or less.
- Increasing of the frequency of tax payment: Taxpayers whose annual tax amount exceeds 60 million Yen should pay every month (currently once every three months).
- Making net price display obligatory: Vendors shall be obliged to display the net price (cost plus tax) of goods and services

4.5 Inheritance and gift taxes

From the viewpoint of promoting the transfer of assets held by the older generation (*i.e.,* parents) to the younger generation (*i.e.,* children), we will introduce a new system for adjusting gift tax at the time of inheritance. In other words, we aim to reduce the prohibitive effects that the gift tax has been imposing on asset transfer between generations.

A new system to calculate gift and inheritance taxes at the time of inheritance (applied by selection) shall be introduced by deducting the amount of previously paid gift tax from the total tax amount calculated on the total amount of gifts and inheritance property.

- Qualified gifts: the new system will be applied for gifts from parents of age 65 or older to children of age 20 or older;
- Exemption threshold at the time of receiving gifts: gifts not exceeding 25 million Yen (in total) will be exempt from tax;
- Tax rate at the time of receiving gifts: prepayment of gift tax will be charged at the rate of 20 per cent on the amount exceeding the exemption threshold. The amount of gift tax will be treated as prepayment of tax against inheritance tax at the time of inheritance (refundable);
- Additional exemption for residential housing: a tax exemption threshold of 35 million Yen will be applied for gifts from parents (no age qualification applies) to children (20 years or over) for the purpose of purchasing residential housing until 2005.

On top of that, the top rates of inheritance tax (currently 70 per cent) and gift tax (also 70 per cent) will both be reduced (to 50 per cent) along with a reduction of the number of inheritance tax brackets (from nine to six) and gift tax brackets (from thirteen to six).

5. Next step of tax reform

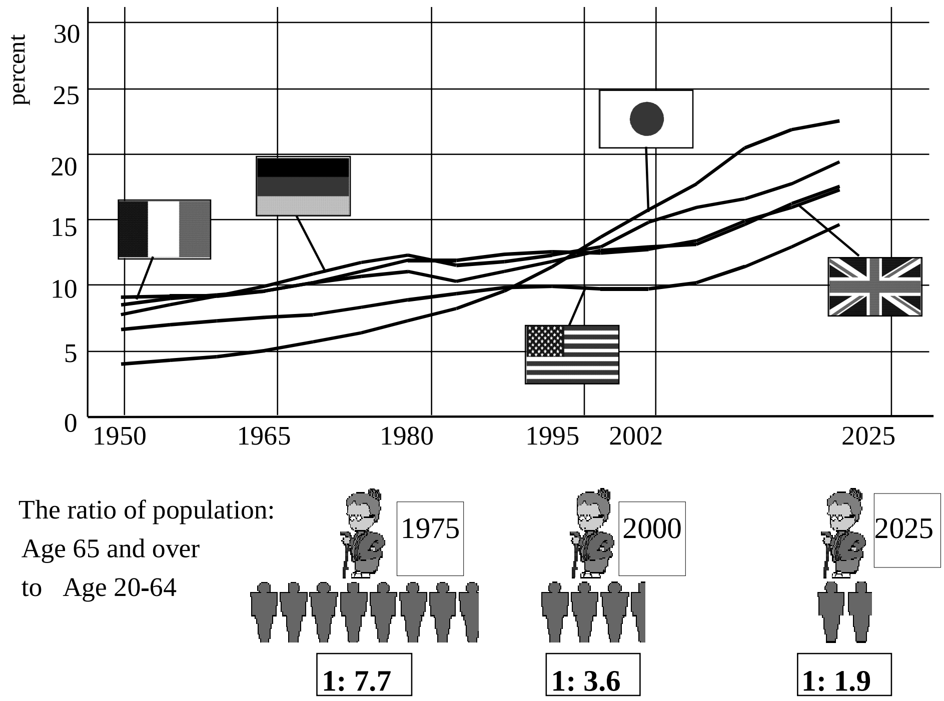
We started another stage of the deliberations on tax reform this January. One of the key points in these deliberations is related to the impact that Japan's aging population would have on the tax system. The increase of the proportion of the population that is elderly will place increasing burdens on non-elderly persons to maintain public services such as pensions and medical care. The phenomenon of the aging population is seen in the sharp rise of the elderly ratio (the proportion of the population that is 65 or over to total population) in G7 countries (see Figure 10). Particular attention should be paid to the projected surge in Japan's elderly ratio in the first quarter of the 21st century. Indeed, Japan's population is becoming the most aged among G7 countries. The ratio of the working population (aged 20-64) to the elderly population has been falling rapidly, from 7.7 in 1975, to 3.6 in 2000, to 1.9 in 2025. This implies that, in 2025, for every two persons in the working population, there will be one elderly person who needs to be supported.

In conjunction with this point, the decline in our potential economic growth rate would also be on the agenda in our deliberations. As shown in Figure 1, Japan's growth rate was slightly above four percent in the 1980s, the level of which is relatively high for a mature economy. Moving into the 1990s, we entered a 1-to-2 per cent-growth era. Some critics called that period "the lost decade." But the main reason for this trend is the decline of the potential growth rate, which is closely related to Japan's economic system from not only the domestic viewpoint but also from the global perspective.

On the other hand, in the case of today's Japan, the National Burden Ratio (ratio of total national and local tax revenues to national income) is fairly low

Figure 10

Japan's Population is Rapidly Aging (Age 65 and Over)



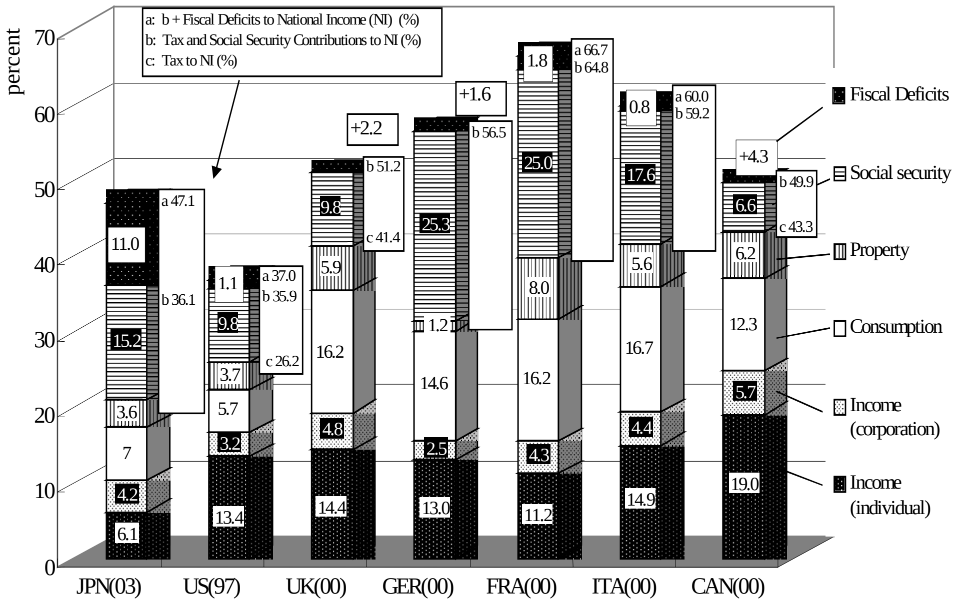
compared with those in other countries (see Figure 11). The outstanding characteristics of national burden in Japan are as follows and Japan should readjust its tax system in light of the change in the economic situation mentioned earlier. No longer can we rely on an increase in tax revenue occurring naturally along with economic growth.

- The tax burden, in particular on individual income and consumption, is very low, as discussed earlier.
- Social security contributions are on a par with those in other countries.
- And finally, very regrettably, the large fiscal deficit stands out.

First off, as for individual income tax, we should widen the tax base proactively because the current tax system has various exemptions, such as favorable treatment for elderly people. In particular, taxation related to the public pension system should be reviewed. Under the current system, the amount of contribution to pension funds is completely deductible and pension payments are

Figure 11

National Burden Ratio in Major Countries



Source: Ministry of Finance.

almost totally excluded from the tax base due to the large amount of public pension deduction. We need to include pension payment in the tax base, irrespective of whether this is done at the “entrance” or “exit” stage.

Additionally, we should investigate the economic and political feasibility of an increase in the consumption tax rate.

With regard to this point, the Minister Koizumi has been asserting that he has no intention of raising the consumption tax rate during his time as the Prime Minister, because he believes by far the most pressing issue is to streamline the public expenditure structure.

Dr. Ishi, the Chairman of the Commission, has asserted that the consumption tax rate will inevitably have to be raised to a two-digit rate “in the future”. He has also said that sweeping tax reform cannot be achieved without widespread support from the Japanese public. In this sense, to hold nationwide, discussion-type public hearings is very meaningful. The Commission held such hearings to explain the reform plan, and to engage in a mutual exchange of views with the general public. The meetings were held at eleven venues during the period of March-September, 2002. And we are going to hold such meetings in the coming summer, too.

As referred earlier, the consumption tax *was* a totally brand new tax when it was introduced in Japan. Therefore, it took some time for the Japanese people including consumers and business people to get used to this tax. In this sense, one cannot be positive that the consumption tax is very popular among Japanese people. However, one might be able to say that, in particular, younger-generation people in Japan are less disinclined towards the consumption tax compared with older-generation people because, when they became independent consumers, this tax already existed and because they often go abroad and experience paying tax of a similar type as the consumption tax in Japan. Interestingly enough, about 70 percent of the participants in those meetings supported the Commission's idea of a desirable tax system including the possible increase of the tax burden in the future.

Of course, we need to exert our best efforts to streamline the expenditure structure as the Prime Minister Koizumi has been saying and to consider improvement of the system of the consumption tax, for example, by the introduction of the"invoice"system and multiple-rate system to avoid too much regressiveness if necessary.

Anyway, as Chairman Ishi said once, Japanese people will be able to accept future tax increases but a precise roadmap and firm commitment to advance will be needed.

6. Mid-term report of the tax commission (June 2003)

Since the Perugia workshop in April, the Tax Commission submitted its mid-term report "A sustainable tax system for Japan's aging society" to Prime Minister Koizumi in June 2003. The new report discusses further a new desirable tax system. A new tax system outlined in the report is a tax system with: (i) Confidence (secure stable revenue sources for public services. Carry out expenditure reform); (ii) Participation (younger and older generations pay equally according to their ability to pay); and (iii) Enhanced Vitality (neutral and simple tax system with minimum distortion in economic choices and easy to understand). Please see attached informal translation of the report for more detail.