

THE LEGACY OF THE SHOUP MISSION: TAXATION INEQUITIES AND TAX REFORM IN JAPAN

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I. INTRODUCTION

A tax system cannot succeed unless it is—and is perceived to be—fair in its distribution of the overall tax burden. Adam Smith first articulated this truism when *The Wealth of Nations* identified equity, neutrality, certainty, and administrative efficiency as the criteria of a good tax system.

Fairness is approached in two ways, horizontal equity and vertical equity. Horizontal equity is the notion that people in like economic circumstances will receive the same tax treatment, irrespective of the source of their wealth. The principle of vertical equity is that those with greater ability to pay should pay more taxes. Vertical equity has the effect of equalizing the distribution of wealth.

In 1989, Japan effected its most extensive tax reforms since the immediate postwar period. The postwar system had failed to keep pace with the changes in the Japanese economy, resulting in inequities such as certain types of receipts being untaxed and certain portions of the population bearing the majority of the tax burden. Although the reforms were intended to remove these inequities, their reception has been lukewarm at best.

This article surveys the history of the Japanese tax system, with particular emphasis on the recommendations of the Shoup Mission in 1950 and the implementation of those recommendations in the years that followed. It then analyzes the 1989 reforms, their background, purpose and expected effect. Finally, in light of the

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latest tax reforms made in 1989, conclusions are drawn regarding the success of tax reform in Japan.

II. HISTORY

Modern Japan arose with the Meiji Restoration of the late 19th century. Japan's modern taxation system also dates from this period. Japan introduced taxation of income in 1887, although traditional land taxes remained the main source of revenue until 1908.¹ However, by 1935, income taxation became the most important source of tax revenue for the Japanese government.

Wartime economic needs prompted an overall reform of the tax system in 1940. Personal income became subject to tax at progressive rates ranging from 10% to 60%, while corporate income was separately taxed at a flat rate of 18%. Although there was indirect taxation of a few commodities during the war, direct taxes comprised over 60% of the total tax revenue.²

After the war, Japan was faced with a shattered economy and intense inflation. The inflation was aggravated by the fact that much of the war effort had been funded by bond issues.³ To stifle inflation, public bonds were redeemed in an attempt to shift from bond-related public finance to tax-related public finance. Other measures taken to control inflation and restore the economy included freezing deposits, converting pre-war currency to new yen notes, revising the price structure, subsidizing priority industries, and introducing property taxes. In addition, minor adjustments in tax rates and tax bases were made at a rate of about once every six months.⁴

Before 1947, all tax revisions made were mere modifications of the wartime dual income tax system.⁵ However, in 1947, this was replaced by a self-assessment system, wherein taxpayers were to ascertain their own tax liability based on their actual income for the tax year.⁶ At the same time, a turnover tax, a form of consumption tax, was introduced. The 1% turnover tax was levied at every stage of transaction.⁷ By 1948, these changes had boosted production

1. See generally MINISTRY OF FIN., JAPAN TAX BUREAU, AN OUTLINE OF JAPANESE TAXES 1-3 (1990) [hereinafter MOF (1990)].

2. For a general discussion of the Japanese tax system see *id.*

3. SABURO SHIOMI, JAPAN'S FINANCE AND TAXATION: 1940-1956 15 (1957).

4. See generally *id.* at 64-79.

5. Under this system, certain categories of income, such as business income and agricultural income, were assessed on the basis of the previous year's income, rather than actual income.

6. MOF (1990), *supra* note 1, at 4-5. Note that the taxation authorities retained absolute discretion to issue amended assessments based on their opinion as to what amount of income the taxpayer should have claimed. *Id.*

7. *Id.* at 5.

levels, although inflation was still rampant.⁸

Shortly after the introduction of the Dodge Line Policy,⁹ further reforms to the tax system were deferred awaiting the outcome of a study by the Shoup Mission. The Shoup Mission (hereinafter "Mission") was a group of seven American economists and tax specialists who, in 1949, devoted four months to examining Japanese public finance.¹⁰

III. THE SHOUP REFORMS

The Shoup Mission proposed a system of direct taxes on personal and corporate income with rates and allowable deductions designed to make the system progressive yet fair. In keeping with its goal of a progressive tax system, it also advocated indirect taxation of certain luxury commodities. The Mission recommended placing more taxation power in the hands of local government and provided for a clear delineation of taxes collectible by the prefecture and the municipality. It also instituted changes to improve tax administration and increase taxpayer understanding of the system. Overall, the proposals were intended to decentralize wealth while stimulating the economy.

A. Direct Taxes

The Mission proposed that the core of the tax system would be direct taxation of individual and corporate income. While tax revenue during the postwar period was relatively evenly divided between direct and indirect taxes,¹¹ it was estimated that 75% of total tax revenue would ultimately come from national and local income taxes.¹²

A dominant income tax was not a radical change; in the immediate postwar period approximately 70% of direct taxes were collected in the form of personal income taxes.¹³ However, under the Shoup Reforms, "income" was widened to include capital gains¹⁴ and other accretions to wealth. This dramatically broadened the tax base.

8. SHIOMI, *supra* note 3, at 7-8.

9. Named for Dr. Joseph M. Dodge, an American banker who acted as adviser to the Allied Forces, the policy essentially maintained that inflation could only be controlled through a balanced budget. *See generally id.* at 78-81; MOF (1990), *supra* note 1, at 6.

10. SHIOMI, *supra* note 3, at 79.

11. *Id.* at 20.

12. *Id.* at 85.

13. Torao Aoki, *The National Taxation System*, in PUBLIC FINANCE IN JAPAN 104 (Tokue Shibata ed., 1986).

14. *See generally* 1 SHOUP MISSION, REPORT ON JAPANESE TAXATION 90-91 (1949). Under the existing system, only 50% of capital gains were taxable.

The Mission favored direct taxes because they could be assessed at progressive rates.¹⁵ It acknowledged, however, that there was a potential problem of noncompliance, and suggested that its proposals be adopted gradually, over five to ten years, to minimize problems.¹⁶

One measure expected to encourage compliance with the personal income tax was to simultaneously reduce tax rates while increasing allowable deductions. Hence, marginal income tax rates were lowered by roughly 25%, with the highest rate dropping from 80% to 55%.¹⁷ In addition, personal exemptions and dependent allowances for wage earners were increased, resulting in less tax withheld at the source. The latter measure was particularly important because most wage earners perceived the system to be unfair, since farmers and other self-employed persons, who were not taxed at the source, could easily evade paying income taxes.

Moreover, the definition of "dependent" for deduction purposes was expanded to include "any person who receives more than half of his maintenance from the taxpayer."¹⁸ In the past, taxpayers were limited to deductions for spouses and family members who were over sixty years old, disabled, or under the age of nineteen. The incomes of dependents were now to be added to the taxpayer's income.¹⁹

In addition to discouraging tax evasion, the reductions in marginal income tax rates were also directed at another goal of tax reform, the stimulation of production. The reforms were structured so that taxpayers belonging to higher income brackets would, theoretically, spend their increased net income on capital investments.²⁰

The progressive nature of the income tax was to serve two purposes, first, to tax according to the taxpayer's ability to pay, and second, to "provide a substantial obstacle to the accumulation of huge fortunes that threaten to concentrate the control of the economic system in the hands of a few wealthy individuals."²¹ To aid in the latter, a net worth tax was also proposed.²²

The net worth tax subjected taxpayers whose net worth exceeded ¥5 million to additional tax liability. The net worth tax was assessed at progressive rates ranging from 0.5% to 3%, with

15. Because they are geared towards each individual taxpayer's ability to pay, progressive taxes promote vertical equity.

16. See 1 SHOUP MISSION, *supra* note 14, at 45.

17. SHIOMI, *supra* note 3, at 86.

18. 1 SHOUP MISSION, *supra* note 14, at 74-75.

19. *Id.* at 75.

20. SHIOMI, *supra* note 3, at 86.

21. 1 SHOUP MISSION, *supra* note 14, at 81.

22. See *id.* at 81-82.

the first ¥5 million of assets exempted from taxation.²³ The rate was deliberately kept low so that payment of the tax would not require disposal of capital assets.

Corporate income taxation presented the Mission with the problems of double taxation of dividends (i.e. taxation of both the corporation and the shareholder on the same income earned), and tax deferral through nondistribution of dividends.²⁴ The Mission proposed that the existing corporate income tax rate of 35% be maintained, but that individual taxpayers be entitled to a tax credit of 25% of the dividends received.²⁵ The tax credit would alleviate double taxation.

The Mission also proposed a tax of 2% on undistributed profits.²⁶ This was not intended to penalize nondistribution, but rather to remove the incentive to accumulate profits within the corporation due to the absence of tax liability. The Mission was careful, however, to set the tax rate low enough so that it would not interfere with reasonable capital accumulation by corporations.²⁷

B. Taxation of Property

The second goal of the Shoup reforms, the decentralization of wealth, was to be achieved through taxation of property rather than the direct taxation of income. This involved taxing gratuitous transfers of property, such as gifts and bequests.²⁸ From 1905 to 1949, transfers of wealth were taxed by means of an estate tax. The Mission replaced the estate tax with an accessions tax, which imposed a graduated tax on the cumulative amount received by the taxpayer via gift, inheritance, or bequest.²⁹ The accessions tax was structured in a way that reduced the total tax paid on the entire property if the property was distributed to more than one recipient, therefore encouraging the distribution of wealth by dividing the property among several recipients. In addition, by taxing all gratuitous transfers equally, the previous practice of minimizing tax liability by carefully dividing transfers between gifts and bequests was discouraged.

Two additional measures to decentralize wealth and encourage economic activity were to increase the local house and land tax, and to abolish the real estate acquisition tax.³⁰ The house and land tax was originally assessed against rent received, but this practice pro-

23. *Id.* at 88.

24. *See id.* at 105-06.

25. *Id.* at 107.

26. MOF (1990), *supra* note 1, at 6.

27. 1 SHOUP MISSION, *supra* note 14, at 109.

28. *See* SHIOMI, *supra* note 3, at 87.

29. Carl S. Shoup, *Tax Reform in Japan*, 7 AUSTL. TAX F. 411, 416 (1990).

30. *See* 2 SHOUP MISSION, *supra* note 14, at 207-08.

duced widespread tax evasion schemes. Accordingly, the Mission felt that the tax should be assessed against capital value instead. This broadened the tax base to include all depreciable capital assets,³¹ resulting in both increased revenue and a more equitable distribution of taxpayer contributions to local government.

C. Indirect Taxes

By increasing the role of direct taxation, it followed that indirect taxation would decrease. The Mission stressed that it did not disapprove of indirect taxes, but rather it felt that increased direct taxation would result in a better tax system overall.

Japan's indirect tax rates were exceedingly high, but these taxes were assessed only against luxury items, such as liquor and tobacco.³² The Mission advocated continuation of that policy.

The tobacco industry in Japan was a government monopoly. As such, the industry's profits, ranging from 200% to 600%, achieved the function of taxation since it generated government revenue.³³ The Mission recommended a slight decrease in taxation at the bottom end of the scale, either by reducing prices or improving quality.³⁴ This change was calculated to reduce the burden on the taxpayer and eliminate the demand filled by the black market.

On the other hand, the Mission felt that the liquor tax could be substantially raised.³⁵ Since liquor was taxed by volume rather than by value, postwar inflation meant that liquor taxes had been decreasing. However, in terms of consumption patterns, liquor was a luxury. Consequently, taxing it heavily was in line with the progressive taxation advocated by the Mission.

Excise taxation was to be limited to "luxury" items; "commodities used wholly or chiefly in business" were specifically exempted.³⁶ Indirect taxes to be repealed were the turnover tax, which was not income productive, the textile tax, and the sugar tax.³⁷

D. Local Taxes

Centralization under the prewar tax system meant that local taxes were generally levied as surtaxes to national taxes.³⁸ Local enterprise taxes and land and house taxes were also levied according

31. *Id.* at 190-91.

32. 1 *id.* at 13-14.

33. 2 *id.* at 156-57.

34. *Id.* at 158.

35. *Id.* at 161-62.

36. *Id.* at 170.

37. *Id.* at 165-68, 171-74.

38. SHIOMI, *supra* note 3, at 82.

to national tax office assessments.³⁹ This resulted in unnecessary complexity and a complete lack of local autonomy.⁴⁰

Stimulation of local autonomy was a major goal of the Occupation and the Japanese government. The Shoup Mission adopted this priority, pointing out that money in the hands of local government could be spent on long-term societal investments, such as education, health, security, and business opportunities.⁴¹ The lack of local autonomy had strained the finances of many local governments.⁴² Hence, the Mission suggested additional local revenue and fewer local expenditures.⁴³ It also recommended that national and local tax sources be separated so that local taxes would be locally assessed.⁴⁴

While the Mission proposed greater taxation powers for local authorities, it also recommended trimming municipal and prefecture taxes,⁴⁵ making local revenue dependent upon a very small number of local taxes.

The principal local taxes had been the house and land tax, the inhabitant's tax, and the enterprise tax.⁴⁶ The Mission proposed that the inhabitant's tax and the house and land tax become the principal sources of municipal revenue, and that the enterprise tax, the admissions tax, and the amusement, eating and drinking tax dominate at the prefecture level.⁴⁷

The existing inhabitant's tax was a combination of a per capita tax and a tax assessed according to some measure of ability to pay, generally income. The tax was assessed by both the prefecture and the municipality, and the rate was set each year depending on fiscal needs.⁴⁸ The modifications proposed by the Mission were the following: first, that the tax be exclusive to municipalities; second, that the tax be assessed against all income earners who file income tax returns in their own right; and finally, in light of other proposed taxes on property and wealth, that the tax be limited to income.⁴⁹ These changes were expected to double the revenue produced by the tax.

The Mission felt that the revenue from the admissions tax and the amusement, eating and drinking tax could best be used by the prefecture. Because these taxes increased with population and pa-

39. *Id.*

40. See 1 SHOUP MISSION, *supra* note 14, at 21.

41. 3 *id.* at A4.

42. *Id.* at A12.

43. 1 *id.* at 21.

44. 3 *id.* at A9.

45. SHIOMI, *supra* note 3, at 83; cf. 3 SHOUP MISSION app., *supra* note 14, at A9.

46. 1 SHOUP MISSION, *supra* note 14, at 24.

47. SHIOMI, *supra* note 3, at 83.

48. 2 SHOUP MISSION, *supra* note 14, at 182.

49. *Id.* at 184-86.

tronage, they were an unequal source of revenue as between municipalities.⁵⁰

In addition, the Mission recommended keeping the enterprise tax as a prefecture tax, with a few modifications. The existing enterprise tax was levied as a surcharge on the national tax⁵¹ and no deductions were allowed. The proposed changes would allow deductions and simplify administration of the tax. Essentially, the Mission advocated a value-added tax. The tax base would be "total gross receipts minus all purchases from other firms, including purchase of capital equipment, land, and buildings."⁵² The value-added tax would encourage investment in capital equipment, and would be simple to administer since it was independent from national taxes.

E. Tax Administration

Proper administration is vital to the success of any tax system. The self-assessment system introduced in 1947 was confusing to taxpayers, thus resulting in widespread reassessments by the tax office.⁵³ The Shoup Mission realized that the previous tax system could have produced between 25% to 100% of additional revenue if it had been properly enforced.⁵⁴ It did not wish the same fate for its proposals.

To facilitate administration, the National Tax Administration was established in 1949.⁵⁵ The Mission recommended an increase in its personnel and a reduction in non-tax related functions.⁵⁶ It also proposed that the National Tax Administration be separate and distinct from the Tax Bureau of the Ministry of Finance.

To improve the calculation of income and the amount of tax liability, the Mission proposed a simplified tax return.⁵⁷ Furthermore, the Mission advocated a program of education and inducements to encourage record keeping, essential to determining income and deductions, which was nearly non-existent in postwar Japan.⁵⁸

One such inducement was the "blue return."⁵⁹ Taxpayers

50. *Id.* at 208.

51. *Id.* at 197-98.

52. *Id.* at 201.

53. MOF (1990), *supra* note 1, at 5.

54. 1 SHOUP MISSION, *supra* note 14, at 15.

55. MOF (1990), *supra* note 1, at 5.

56. SHOUP MISSION, SECOND REPORT ON JAPANESE TAXATION 11 (1950).

57. 4 SHOUP MISSION app., *supra* note 14, at D12.

58. *Id.* at D58.

59. In an interview in October 1988, Dr. Shoup reflected: "I think perhaps of all our recommendations, the blue return form proved to be the most useful. At least it took some of the pressure off taxpayers. They no longer had to fear arbitrary reassessment." *Japanese Taxation: The Shoup Mission in Retrospect, an Interview*, 16 JAPAN FOUND. NEWSLETTER, March 1989, at 6 [hereinafter *Interview*].

could file blue returns, printed on blue paper to distinguish them from regular returns, only if they maintained proper records. Blue return filers could be reassessed only after a full audit, while arbitrary reassessment potentially faced taxpayers filing regular returns.⁶⁰ In addition, certain special deductions were accorded to blue return filers.⁶¹ Furthermore, self-employed taxpayers were allowed to allocate a portion of their incomes to family employees.⁶²

Tax collection was a problem, particularly among self-assessed taxpayers, such as farmers and self-employed persons, who could evade tax more easily than wage earners.⁶³ One illustration of the severity of the problem was that on July 31, 1950, there was ¥47 billion of uncollected taxes on 1949 incomes, and ¥26 billion on earlier years' incomes. The Administration lacked the personnel to collect these amounts⁶⁴ and reassessment often escalated the amounts due beyond the taxpayer's means.⁶⁵ Therefore, the Mission proposed developing more stringent accounting techniques, allowing prepayments of estimated tax, and eliminating the ability of tax administrators to make arbitrary assessments.⁶⁶

At the same time, the Mission advocated establishing a "rigorous enforcement program," including criminal prosecution, to combat tax evasion.⁶⁷ For bribery or embezzlement by tax officials, the Mission advocated immediate dismissal and vigorous prosecution.

A final proposal was to shorten the statute of limitations period for reassessment. The Mission felt that the five year statute of limitations for reassessment of tax liability was too long, and instead recommended a period of "three years after the date on which the return was due, or two years after the date on which the return was filed, whichever is later."⁶⁸

IV. IMPLEMENTATION AND SUBSEQUENT CHANGES

The reforms proposed by the Shoup Mission were intended to create an ideal tax system that would stimulate production, equalize distribution of wealth, and provide added autonomy to local government. Because the reforms proposed were systemic, and therefore interrelated, the Mission made it clear that failure to adopt the

60. 4 SHOUP MISSION app., *supra* note 14, at D58.

61. MOF (1990), *supra* note 1, at 64.

62. HIROMITSU ISHI, *THE JAPANESE TAX SYSTEM* 294 (1989).

63. See 1 SHOUP MISSION, *supra* note 14, at 46. Note that this problem is currently being addressed by reform proposals. Clearly, it has not yet been resolved.

64. SHOUP MISSION, *supra* note 56, at 9.

65. *Cf. id.* at 10.

66. 1 SHOUP MISSION, *supra* note 14, at 46; 2 *id.* at 214.

67. SHOUP MISSION, *supra* note 56, at 11.

68. *Id.* at 12.

reforms in their entirety could jeopardize the overall success.⁶⁹

While Japan purported to embrace the proposals of the Shoup Mission,⁷⁰ in fact, many recommendations were never adopted. This leaves some doubt as to whether the basic structure of the postwar Japanese tax system was formed by the Shoup reforms.⁷¹

The value-added tax was not adopted. A law implementing the proposed tax was enacted in 1950,⁷² but the business community pushed for a variety of minor amendments and moratoriums on the law's enforcement.⁷³ Finally, in 1954, the untried law was repealed.⁷⁴

Additionally, both the net worth tax and the capital gains tax on disposal of securities were also repealed within a few years of implementation.⁷⁵ The net worth tax⁷⁶ was repealed because of the potential for tax evasion by taxpayers who held their wealth in assets other than easily identifiable real estate.⁷⁷ The repeal of the capital gains tax on securities was justified as being administratively cumbersome and a hinderance to market development.⁷⁸

Other Shoup Mission proposals were adopted but were subtly changed over the years. Some of the changes, such as annual adjustments to the basic exemption and dependency deduction rates,⁷⁹ were not systemic. Rather, they were seen as essential to overall stability by preventing an automatic increase of the relative tax bur-

69. 1 SHOUP MISSION, *supra* note 14, at ii.

70. See, e.g., SHIOMI, *supra* note 3, at 90-92.

71. Yukio Noguchi, *The Development and Present State of Public Finance*, in PUBLIC FINANCE IN JAPAN, *supra* note 13, at 38. Noguchi continues: "However, the implications of the Shoup reform were quite profound . . . it established the basis of the Japanese tax system in the postwar period." *Id.* Perhaps it is for this reason that in 1988, when it came time to advocate for serious reforms to the tax system, it was the Shoup Mission that was blamed for the distortions that the tax system caused to the overall economy; cf. MINISTRY OF FIN., JAPAN TAX BUREAU, AN OUTLINE OF JAPANESE TAXES 271 (1988) [hereinafter MOF (1988)].

72. CHIHŌ ZEIHŌ [REGIONAL TAX LAW], Law No. 226 of 1950.

73. MOF (1990), *supra* note 1, at 7-8.

74. CHIHŌ ZEIHŌ NO ICHIBU O KAISEI SURU HŌRITSU [LAW PARTIALLY AMENDING THE REGIONAL TAX LAW], Law No. 95 of 1954; see also HIROSHI KANEKO, SOZEIHŌ [TAXATION LAW] 67 (3d ed. 1990). In fact, the pre-reform Enterprise Tax was reintroduced. Reflecting on this ill-fated tax, Dr. Shoup stated, "the value-added tax was a brand new concept, and perhaps it was asking too much of the prefectures to take it on." *Interview*, *supra* note 59, at 3-4.

75. SHIOMI, *supra* note 3, at 99.

76. FUYŪ ZEIHŌ [NET WORTH TAX LAW], Law No. 174 of 1950, repealed by FUYŪ ZEIHŌ O HAISHI SURU HŌRITSU [LAW TO REPEAL THE NET WORTH TAX LAW], Law No. 164 of 1953.

77. MOF (1990), *supra* note 1, at 8.

78. *Id.* Note, however, that the repealed tax was replaced by a securities transaction tax. YŪKA SHŌKEN TORIHIKI ZEIHŌ [SECURITIES TRANSACTION TAX LAW], Law No. 102 of 1953.

79. SHIOMI, *supra* note 3, at 99.

den⁸⁰ and to encourage "capital accumulation."⁸¹ Other changes, however, did affect the overall system. Tax equity was altered by the reduction in the taxation of retirement income and the exemption of interest on savings accounts from taxation.⁸²

The goal of decentralizing and discouraging wealth to be passed on intact became less attainable because of the decreases in accession tax rates, as well as the exemption of certain items of wealth from taxation.⁸³ In 1953, the pre-reform system of taxing gifts during life and bequests at death separately was re-instituted.⁸⁴ At the same time, tax due on an estate was calculated based on the number of statutory heirs, despite variances in the actual distribution.

Corporate taxation also experienced a variety of changes. First, the 2% tax on retained corporate profits, with the exception of family-owned corporations, was abandoned in 1952.⁸⁵ The repeal was due to the fact that retained profits were a common means of corporate finance in Japan, and consequently, the government preferred not to tax them.⁸⁶ However, the corporate income tax rate was raised to 42%.⁸⁷

Second, a tax on liquidation income was established, and the tax on accumulated reserves of family-owned corporations was replaced with a one-time 10% levy.⁸⁸ Finally, corporations were permitted to deduct certain kinds of special accumulated reserves. These measures encouraged investment in capital equipment and stimulated overall growth.

In 1957, a modern Special Taxation Measures Law was enacted.⁸⁹ This law provided for temporary short-term modifications

80. Noguchi, *supra* note 71, at 39.

81. SHIOMI, *supra* note 3, at 100.

82. SHOTOKU ZEIHŌ NO ICHIBU O KAISEI SURU HŌRITSU [LAW PARTIALLY AMENDING THE INCOME TAX LAW], Law No. 53 of 1952; *see also* MASAYOSHI HOMMA ET AL., *Japan, in COMPARATIVE TAX SYSTEMS: EUROPE, CANADA AND JAPAN* 403, 406 (Joseph A. Pechman ed., 1987); Hiromitsu Ishii, *Historical Background of the Japanese Tax System*, 29 HITOTSUBASHI J. ECON. 16 (1988).

83. SHIOMI, *supra* note 3, at 100.

84. SŌZOKU ZEIHŌ NO ICHIBU O KAISEI SURU HŌRITSU [LAW PARTIALLY AMENDING THE INHERITANCE TAX LAW], Law No. 165 of 1953; *cf.* KANEKO, *supra* note 74, at 67.

85. HŌJIN ZEIHŌ NO ICHIBU O KAISEI SURU HŌRITSU [LAW PARTIALLY AMENDING THE CORPORATION TAX LAW], Law No. 54 of 1952; *see also* MOF (1990), *supra* note 1, at 8.

86. MOF (1990), *supra* note 1, at 8. Dr. Shoup's observation on the repeal of this tax was that "perhaps [the revenue produced by the tax] wasn't worth the fuss." *Interview*, *supra* note 59, at 4.

87. SHIOMI, *supra* note 3, at 99. In 1955 the rate was lowered to 35% on incomes of less than ¥500,000 and 40% on the portion above that amount. *See id.* at 101.

88. *Id.* at 99.

89. SOZEI TOKUBETSU SOCHI HŌ [SPECIAL MEASURE TAX LAW], Law No. 26 of 1957.

to the tax law for the purpose of promoting specific economic policies.⁹⁰ The Special Taxation Measures Law, in combination with government financing and other tax reductions mentioned above, further stimulated the economy.

In summary, the taxation system that was ultimately adopted had as its core not direct taxes in general, but rather the personal income tax. Even within personal income tax, certain exemptions, specifically, exemptions for capital gains from the sale of securities, and interest income from small savings accounts, contributed to inequity in the calculation of taxable income. To stimulate growth, corporations were afforded several tax advantages that reduced their tax burden significantly. Further, many of the measures to decentralize wealth had been dismantled.

Administratively, there were few changes. National tax offices continued to control tax rates, assessment, and collection procedures.⁹¹ The Shoup Mission's recommendations that were abandoned were replaced by a "return to pre-war traditions and practices."⁹²

The reasons for the incomplete acceptance of the Mission's proposals included the inability of the still weakened Japanese economy to handle the heavy tax burden and the confusion caused by unfamiliarity with the new system.⁹³ The Japanese government justified the changes it made to the proposed system by citing changed economic and social circumstances, as well as suggesting that "some of the provisions are not suitable to Japanese life."⁹⁴

90. MOF (1990), *supra* note 1, at 22. Dr. Shoup's reaction: "I regretted to see the adoption in the 1950s and 1960s of special tax relief for this and that commendable activity. Of course, it's always nice to have economic growth, but if you relieve one taxpayer you have to tax somebody else more, and it brings up all the old questions. So I was unhappy to see that kind of development." *Interview, supra* note 59, at 5.

91. Shoup, *supra* note 29, at 422.

92. Ishi, *supra* note 82, at 14.

93. SHIOMI, *supra* note 3, at 94. The changes proposed by the Mission were in no way radical. The Mission had been requested by General MacArthur to avoid experimentation with new concepts in the overall design. Dr. Shoup felt that the only "new thing" introduced was the value-added tax which ultimately failed. *See Interview, supra* note 59, at 4. While the Mission's proposals were not radical, they may have seemed so to the Japanese. Ishi speaks of the "new and advanced views" expressed in the Shoup Report, and of the "novel features" the recommendations incorporated. Ishi, *supra* note 82, at 11.

94. Ishi, *supra* note 82, at 11. It is interesting to note this reasoning, as Japanese businessmen these days are notorious for negotiating contract changes and business deals on the basis of "changed circumstances." *See, e.g.,* MITCHELL F. DEUTSCH, *DOING BUSINESS WITH THE JAPANESE* 123 (1983); EDWARD T. HALL & MILDRED REED HALL, *HIDDEN DIFFERENCES: DOING BUSINESS WITH THE JAPANESE* 128 (1987).

V. THE RESULTANT INEQUITIES AND THE MOVE TO FURTHER REFORM

The Japanese economy changed dramatically in the 1950s and 1960s. The war-shattered economy of the 1940s faded into memory as Japan enjoyed "unprecedented economic growth."⁹⁵ The government operated on a balanced budget, floated no new bonds, and actually had excess savings.⁹⁶

The quality of life for average Japanese citizens was improving; necessities were plentiful, luxuries were affordable, and they had money left over. Excess domestic savings became available to the corporate sector, particularly to the low-productivity sectors in need of stimulation in the form of government-operated financing.⁹⁷ This resulted in continued increases in production, consumption, and wealth. During this period of growth the inequity of the tax system went unnoticed. The salaried middle-income worker, economically better off than ever before, did not mind that other taxpayers were completely exempt from taxation because their income source was classified as nontaxable. Nor did he care if farmers and self-employed taxpayers were able to conceal substantial portions of their income,⁹⁸ or reduce their tax burden by dividing income among family members.⁹⁹

The economy continued to grow, albeit with minor ebbs and flows, until the oil crises of the early 1970s. By this time, the national budget had grown to sustain substantial public works and social welfare programs. With the oil crises, however, taxable corporate revenues dropped, forcing the government to rely more heavily on bond issues to supplement tax revenues.¹⁰⁰ Annual adjustments to the income tax rate to prevent inflationary bracket creep were discontinued, producing an increase in the share of income tax revenue in total national income.¹⁰¹ For the first time, the average middle-income family began to feel the effects of both inflation and the eroded tax base.

95. Noguchi, *supra* note 71, at 38.

96. *Id.* at 39.

97. *Id.* at 39-40. It is significant to note that "[w]ith most government expenditures used for industrial facilities, spending for public amenities, such as parks, libraries, and sewage plants has been minimal." Tokue Shibata, *General Survey, in PUBLIC FINANCE IN JAPAN*, *supra* note 13, at 17.

98. Although the Shoup Mission made substantial proposals for means to fully tax the income of farmers and other self-employed taxpayers, there is no indication in subsequent literature that any of these proposals were actually implemented. Indeed, figures used during the tax reform debates of the early 1980s indicate that they were not implemented, and that self-employed taxpayers continued to be undertaxed in comparison to salaried employees. See *infra* note 107 and accompanying text.

99. Ishi, *supra* note 62, at 294.

100. Noguchi, *supra* note 71, at 43-44.

101. *Id.* at 46; see also Ishi, *supra* note 62, at 276.

By the late 1970s the economy had slowed and there was clearly a need for "fiscal reconstruction."¹⁰² The government, operating at a deficit, needed to either generate more revenue or spend less.

Consequently, a value-added tax was proposed in 1979.¹⁰³ However, the value-added tax was opposed by the small business sector which was concerned that the required bookkeeping would destroy other tax avoidance measures. The tax closely resembled the value-added tax proposed by the Shoup Mission that the small business sector had successfully defeated nearly 30 years before. Furthermore, the proposed value-added tax was seen as inequitable and unnecessary. Taxpayers felt the best solution was for the government to decrease spending.¹⁰⁴ Hence, it was apparent that a more cohesive package, coupled with a campaign to promote public acceptance, was necessary.

From 1983 to 1986, studies and tax reform proposals were prepared by government, academia, trade unions and the business community. The general problem recognized by all sectors was taxpayer dissatisfaction with the distortions created by the operation of the postwar tax system in the existing economic climate. One reason for dissatisfaction was the high progressivity rates of the present system, in light of the fact that a larger percentage of the population now belonged to higher income brackets and of the diminished disparity between high and low incomes levels.¹⁰⁵

The other problems enumerated were: (1) tax exemptions for income from certain sources allowing taxpayers to structure their transactions accordingly to avoid paying taxes; (2) distortions in consumption patterns created by excising only certain commodities; and (3) the special considerations afforded corporations.¹⁰⁶

All the studies agreed that personal income tax rates should be reduced, and that the system be made less progressive by reducing the number of tax brackets. There was also an understanding that the tax base should be broadened by reducing deductions and/or eliminating some tax exemptions.

However, with regards to the other types of taxation, the various sectors did not come to a consensus. In the area of corporate income tax, the trade unions and academia felt that the special tax measures and deductions should be eliminated, thereby increasing revenue by broadening the corporate tax base.¹⁰⁷ The government, on the other hand, felt that preferences for small corporations, co-

102. ISHI, *supra* note 62, at 272.

103. *Id.* at 273.

104. *Id.*

105. *Id.* at 282-83.

106. HOMMA ET AL., *supra* note 82, at 432-33.

107. *Id.* at 431-32.

operative associations, and public interest corporations should be removed, and that a flat rate tax be implemented.¹⁰⁸ In contrast, the business community took the position that corporate taxes should be further reduced.¹⁰⁹

Government, academia, and the business community all advocated more indirect taxation. In particular, they wanted a broadening of the tax base to include consumption of additional types of commodities and perhaps even services. They argued that taxing services would contribute to the creation of an equitable tax system, since consumption patterns had shifted from purchases of durable consumer goods to more diverse consumption of both goods and services.¹¹⁰

The Japan Tax Association favored a consumption tax, but indicated that certain necessities such as food, medicine, and education should be exempt from taxation.¹¹¹ This would minimize the regression that is inevitable in indirect taxation.

On the other hand, the trade unions were strongly opposed to any sort of broad-based consumption tax,¹¹² undoubtedly because of its regressive nature. They also opposed eliminating the tax exemption for savings interest.

In 1987, on the heels of these studies and reform proposals, the Nakasone government introduced tax reform legislation that included cuts in personal income taxation, elimination of the savings interest exemption, a reduction in the corporate tax rate (accompanied by inclusion of capital reserves in the tax base), and the introduction of a broad-based value-added tax.¹¹³

The value-added tax, commonly known as a sales tax, was calculated on a tax credit method, whereby firms maintained invoices to obtain credit for taxes already paid on the same goods by other firms.¹¹⁴

Despite the various studies made, the general public was not convinced that tax reform was necessary. Nakasone had campaigned on the promise that he would not institute a "large-scale indirect tax that cannot obtain the approval of the public," and his tax package was seen as a breach of that promise.¹¹⁵ Because his tax package met widespread opposition, it was quickly withdrawn.

Because of this debacle, the only changes Nakasone was able to implement were minor, including minimal income tax reductions

108. *Id.* at 428.

109. *Id.* at 432.

110. ISHI, *supra* note 62, at 284.

111. HOMMA ET AL., *supra* note 82, at 431.

112. *Id.* at 432.

113. ISHI, *supra* note 62, at 280-81.

114. *Id.* at 308.

115. *Id.* at 280.

and elimination of the small savings interest exemption.¹¹⁶ These changes actually resulted in decreasing, instead of increasing, government revenue. Furthermore, the increases in exemptions and deductions resulted in a narrowing of the income tax base, spawning further inequities.

VI. THE 1988 PROPOSALS

When Noboru Takeshita took the reigns of leadership in late 1987, he requested the Tax Advisory Commission to prepare proposals designed to deal with two problems: (1) the need to secure stable revenues in light of the rapidly aging Japanese society;¹¹⁷ and (2) the need to produce a system that balanced taxation of income, consumption, and property.¹¹⁸ This approach differed from that of his predecessor who focused on the inequity of the existing tax system. However, the goals of the Takeshita government were no different from those of the Nakasone government. Both wanted to revamp the system to produce greater equity and secure long-term revenue.

The government's position that the existing tax system was inequitable impacted two sets of taxpayers—those who stood to gain from change and those who stood to lose. The focus on the aging society gave the people a social cause to rally behind. However, the Japanese people understood that keeping the existing system would be detrimental to everyone.

Having gained public acceptance of the necessity for reform, the government still faced the task of constructing acceptable reforms. The goal was an equitable system that would produce an appropriate level of revenue and would be simple to administer.¹¹⁹

Since the inequity was seen largely as a horizontal failing (that people in similar situations were not being taxed alike), the obvious solution was to broaden the tax base. The task was to find ways to tax wealth not presently subject to taxation.

The various methods implemented to broaden the tax base were: first, the inclusion in income of capital gains from the sale of securities; second, the removal of special treatment for doctors and religious organizations; and third, utilization of specific means designed to retrieve the hidden income of self-employed persons.

116. *Id.* at 281.

117. The ramifications of an aging population means that a large number of people no longer earn income, and therefore no longer pay taxes. This means decreased tax revenues at a time when the government will be increasingly called upon to make substantially more social welfare payments. See MOF (1988), *supra* note 71, at 272.

118. *Id.* at 271-72; ISHI, *supra* note 62, at 281-82.

119. It is interesting to note that these were the goals the Shoup Mission was striving for and, indeed, are what every good tax system should have. See generally 1 SHOUP MISSION, *supra* note 14, at 15-20.

Under the Takeshita tax reforms, a loosely structured plan to tax securities gains was introduced, but the other areas were ignored.¹²⁰

However, instead of broadening the income tax base, the Takeshita reforms instituted reductions in the personal and corporate income tax, increased the tax rates on dividends, restricted corporate deductions to prevent land speculation, and increased the inheritance tax threshold. The reduction in tax revenues was part of Takeshita's strategy to win popular support for his tax reforms, and the power of the yen in 1988 meant that the government could indulge this strategy without going further into debt. Consequently, the only tax base that was broadened was the indirect tax base.

Reductions in personal income tax were achieved through flattening the progressive rate structure. This change promotes equal tax treatment of taxpayers with equal incomes, removes distortions that could potentially affect the economic decisions of the taxpayer (i.e., choices between work and leisure and between saving and spending), and mitigates incentives to evade tax. However, it creates potential problems. Specifically, unless the tax base has been broadened to catch "the kinds of capital income characteristic of higher-income brackets," flatter tax rates benefit taxpayers belonging to higher income brackets more than those belonging to lower income brackets.¹²¹

The corporate income tax structure was simplified by reducing tax rates and widening the tax base.¹²² Even with the lower tax rate, adjustments to the tax base, combined with limitations on deductions, meant that increased tax revenue could be expected.¹²³ Although the tax system contained various special incentives for corporations in order to stimulate growth, it was necessary to raise the tax rate in 1984.¹²⁴

Given the flexibility with which corporations can move across national borders, some parity of corporate tax rates worldwide is necessary to prevent companies from making business decisions based on where they can derive the greatest tax advantage. In this regard, even after reduction, Japan's corporate income tax rate of 37.5% is still higher than the rates in many other countries.¹²⁵

The sudden rise in property values meant that the number of taxable estates had also risen sharply.¹²⁶ Accordingly, an important amendment to the inheritance tax was a doubling of the minimum taxable threshold. In addition, the reforms also reduced the inheri-

120. Hiromitsu Ishi, *Changes in Store*, LOOK JAPAN, Oct. 1988, at 5.

121. *Id.* at 6.

122. ISHI, *supra* note 62, at 300.

123. *Id.* at 301.

124. HOMMA ET AL., *supra* note 82, at 413.

125. Ishi, *supra* note 120, at 6.

126. Hiromitsu Ishi, *Why Tax Reform Now?*, 15 JAPAN ECHO, Summer 1988, at 36.

tance tax rate and introduced measures to allow greater exemptions for surviving spouses.¹²⁷

As previously discussed, the only tax base broadened by the Takeshita reforms was the indirect tax base. Since the existing indirect tax system distorted economic choices to a great degree, the Tax Advisory Commission believed that a fairly light tax on consumption of a broad range of goods and services would be more fair.¹²⁸ Several criteria were established for the consumption tax. It had to be simple, neutral with respect to economic activities, and administratively economical.

As a result, the consumption tax ultimately adopted¹²⁹ is broadly based, exempting only a few items, such as education, medical care, welfare programs, and exports.¹³⁰ To keep the system simple, a single rate of 3% is applied.¹³¹ This low rate also contributes to the neutrality of the tax.

Structurally, the consumption tax is charged at each stage of a transaction.¹³² To prevent cascade taxation, enterprises which on-sell goods¹³³ are entitled to a credit for the tax paid at the earlier stages of the transaction.¹³⁴ Because of the negative reception of Nakasone's proposed sales tax, the new consumption tax does not require invoices for the calculation of tax credits. Instead, tax is paid on the difference between a firm's total purchases and its total sales.¹³⁵ This subtraction method, combined with the exemption for firms with less than ¥30 million in annual sales,¹³⁶ made the tax more palatable to small enterprises, which were accustomed to concealing a portion of their incomes.

Due to the adoption of the consumption tax, many commodity

127. MOF (1988), *supra* note 71, at 278.

128. *Id.* at 280-81.

129. SHŌHI ZEIHŌ [CONSUMPTION TAX LAW], Law No. 108 of 1988.

130. ISHI, *supra* note 62, at 307. Note that the amendments which took effect in October 1991 added housing rentals, childbirth expenses, funeral expenses, and school entrance fees to the list of exempt items. See *infra* note 142 and accompanying text.

131. As an interim measure, a 6% rate was applied to the sale of regular passenger automobiles until March 31, 1992. SHŌHI ZEIHŌ [CONSUMPTION TAX LAW] art. 11, Law No. 108 of 1988, *as amended*. A modified extension of this interim measure is currently under debate. *Tax Hike of 737 Billion in Works*, NIKKEI WEEKLY, Jan. 4, 1992, at 4.

132. MOF (1990), *supra* note 1, at 3.

133. "On-sell" means resale of goods to another person or entity. The on-sell good does not have to be in its original form when resold (i.e. it may be a component of the final product) and the term applies to both wholesale and retail sales transactions. Because tax is charged every time the good is resold, to prevent cascade taxation, the on-sale transaction entitles the taxpayer (seller) to a tax credit at the time the good is resold, in the amount of tax that the taxpayer paid during the original purchase of the good on-sold.

134. MOF (1990), *supra* note 1, at 3.

135. ISHI, *supra* note 62, at 308.

136. SHŌHI ZEIHŌ [CONSUMPTION TAX LAW] art. 9, Law No. 108 of 1988.

excise taxes were repealed and the rates of those remaining were reduced.¹³⁷

VII. THE IMPACT OF THE 1988 REFORMS

The Takeshita tax reforms were passed by the Diet in December 1988 and took effect on April 1, 1989. The reforms accomplished nearly everything that the Nakasone government had set out to do with its tax package two years earlier.

The reduction in personal income tax, coupled with the introduction of the broad-based consumption tax, helped to alleviate horizontal inequity. The increased inheritance tax threshold promoted vertical equity. Changes in corporate income tax rates moved Japan closer to parity with other industrialized countries, a necessity given the international character of the Japanese economy.

Despite these improvements, however, the Takeshita reforms failed to sufficiently broaden the income tax base to create true horizontal equity. Because of the existing exemptions, certain special interest groups inevitably oppose a broadening of the tax base. The political cost of broadening the tax base is greater than the cost of the inequities resulting from a narrow tax base.

Furthermore, despite the earlier recommendations of the Shoup Mission, farmers and self-employed persons have never been fully taxed. Since tax on salaried income is withheld at the source, whereas farmers and self-employed persons pay taxes based on the amount of income they choose to declare, the situation creates its own form of horizontal inequity, since farmers and the self-employed can easily underdeclare income. Although both salaried employees and government are aware of the inequity, the government has not developed efficient means to capture the incomes of farmers and self-employed taxpayers.¹³⁸

However, one solution to the problems of a narrow tax base and underdeclared incomes has been to levy tax at the point of expenditure rather than at the point of receipt. While this has had some political cost, it was probably the most economical alternative that the government could find.¹³⁹

These solutions are not immune to problems; the broad base of

137. ISHI, *supra* note 62, at 309.

138. In all fairness, it must be pointed out that every government wrestles with this problem and not one has resolved it completely.

139. One alternative considered was to require taxpayer identification numbers. This idea has been tossed around in Japan for over a decade without success. Most recently, however, labor unions (the sector least able to evade taxation), realizing that their constituency stands to gain from the use of taxpayer identification numbers, have begun to show support for them. It is possible that we will see taxpayer identification numbers implemented sometime in the near future.

the consumption tax inevitably results in regressive taxation. Further, the average salaried employee, aware that the tax base remains narrow and that self-employed taxpayers continue to underdeclare income, will not be satisfied that reducing personal income taxes and implementing consumption taxes will create a fairer system.

Furthermore, there are additional drawbacks of the consumption tax. The primary problem is its potential for tax evasion, since by replacing the invoice method with the subtraction method, cheating has become a simple matter. Second, the exemption for firms making less than ¥30 million in annual sales creates an opportunity for price gouging. These firms can raise their prices corresponding to the amount of their tax liabilities and simply keep the profit. An estimated 70% of Japanese firms belong to this category.¹⁴⁰ Finally, the ¥30 million threshold is rather high by international standards.¹⁴¹

Although the Takeshita reforms have been generally successful, they have created new inequities, resulting in further reforms. In 1991, the Diet amended the Consumption Tax Law,¹⁴² creating new exemptions,¹⁴³ while at the same time removing others by altering tax collection to prevent abuse of the system.

Under the original Consumption Tax Law, companies were responsible for collecting the tax and were required to make interim returns every six months. Many companies invested the collected tax proceeds into short term deposits, thereby profiting from the proceeds before submitting them to the government.¹⁴⁴ To discourage this practice, interim returns are now required quarterly.¹⁴⁵ In addition, while the original Consumption Tax Law entitled companies generating sales between ¥30 million and ¥60 million to pay a prorated tax, now only those companies with taxable sales between ¥30 million and ¥50 million can avail themselves of this relief.¹⁴⁶

The proposal that food be exempted from consumption tax failed, purportedly due to disagreement regarding the mechanics of the exemption.¹⁴⁷ So long as food remains subject to the consump-

140. KOJI ISHIMURA, JAPAN NATIONAL CONSUMPTION TAX LAW: AN ENGLISH TRANSLATION xiii (1989).

141. ISHI, *supra* note 62, at 327.

142. SHŌHI ZEIHŌ NO ICHIBU WO KAISEI SURU HŌRITSU [A LAW PARTIALLY AMENDING THE CONSUMPTION TAX LAW], Law No. 73 of 1991.

143. *See supra* note 130 and accompanying text.

144. *Japan Approves Bills on Retail Stores, Consumption Tax*, ASIAN WALL ST. J., May 9, 1991, at 3.

145. SHŌHI ZEIHŌ [CONSUMPTION TAX LAW] art. 42, Law No. 108 of 1988, as amended.

146. *See id.* art. 40.

147. Naoyuki Isono, *Some Holes In Consumption Tax Expected To Be Plugged*, JAPAN ECON. J., May 4, 1991, at 5.

tion tax, the system remains regressive and equity is more difficult to achieve.

Another measure adopted by the Diet in 1991 was the landholding tax,¹⁴⁸ a national tax levied on the value of all land within Japan. The tax was designed to keep land prices down by discouraging speculative buying, although many critics speculate that since the measure that was ultimately adopted has been watered down, it will not achieve this goal.¹⁴⁹

VIII. CONCLUSION

Since World War II, Japan has seen two major reforms and a number of minor adjustments to its tax system. The first reform, undertaken based on the proposals of the Shoup Mission, endeavored to create a perfect tax system, but disregarded other socio-economic goals of the nation. Although some socio-economic policy was incorporated into the ultimate adoption of the Shoup proposals, and periodic adjustments were made, the system was improperly implemented and was unable to cope with sudden global economic changes. A second major reform was recently undertaken in an attempt to rectify the friction between taxation and economic policies.

Economies are not static and, accordingly, tax systems should not be static either. The taxation system proposed by the Shoup Mission was ideal during that time. Even if it had been successfully adopted in the 1950s, however, it may not have withstood the test of time. Economic growth and aging populations worldwide have resulted in a consensus for indirect taxation. This could not have been anticipated by the Shoup Mission.

Some tax inequities are not created by the system; they evolve due to the rigidity of the tax system and its failure to keep up with economic changes. The quality and efficacy of any tax system depends largely on the economic environment in which it exists. Therefore, once an equitable tax system is established, flexibility and the willingness to make seasonal adjustments are essential to maintaining equitability. However, constant change within the increasingly interdependent world economy may mean that it is impossible to design a system that will remain ideal despite socio-economic changes. Therefore periodic tax reforms, such as those made by the Diet in May 1991, can be expected to continue.¹⁵⁰

148. CHIKA ZEIHŌ [LANDHOLDING TAX LAW], Law No. 69 of 1991.

149. See, e.g., Yukio Noguchi, *The Loopholes in the Planned Landholding Tax*, 12 ECON. EYE, Spring 1991, at 22-23.

150. The amendments under debate in early 1992 have not been directed to the quality of the tax system but to economic factors. Specifically, the amendments seek to improve the national budget by increasing revenue, to stimulate international investment and trade, and to promote domestic economic policies.