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Title

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Journal

UCLA Pacific Basin Law Journal, 7(1-2)

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Publication Date

1990

DOI

10.5070/P871-2021950

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TAX REFORM IN JAPAN: AN INTERNATIONAL PERSPECTIVE IN AN OVERVIEW

Minoru Nakazato*

I. INTRODUCTION

During the past several years, both the United States and Japan have seen the introduction of extensive tax reform packages. Some packages, like the repeal of *General Utilities*¹ in the United States, have passed; others, like the introduction of a value-added tax in Japan, have not. At the same time that these tax packages were at issue, the trade imbalance between the United States and Japan has also grown to unprecedented levels. Although very few observers have tried to tie the two phenomena together, tax policies and trade are intimately linked. This essay will explore the relationship between tax reform and the bilateral trade imbalance.

A. Taxpayer Complaints

As in any other country, taxpayers in Japan complain about their tax system. This raises two fundamental issues:²

1. Inequality of the Income Tax

The first issue concerns the unequal distribution of the income tax burden among taxpayers. It is often contended that a wage

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1. "The *General Utilities* doctrine provides that a corporation recognizes no gain or loss on the disposition of assets in connection with certain qualifying sales of assets or distributions to shareholders." (Zolt, *The General Utilities Doctrine: Examining the Scope of Repeal*, 65 TAXES-THE TAX MAGAZINE 819, 820 (1987)).

2. For further details, see Kaneko, *Japan: An Overview of Current Taxation Issues*, 1986 INTERTAX 32; Kaneko & Gomi, *Outlook for Japan*, TAX POLICY IN THE TWENTY-FIRST CENTURY 148 (H. Stein ed. 1988); JAPAN-FACING ECONOMIC MATURITY 111 (E. Lincoln ed. 1988).

earner's tax burden is generally higher than that of either a self-employed person or a farmer.³ Critics point out several reasons for this. First, the computation of income by self-employed people and farmers is less accurate than that by wage earners, mainly because a wage earner's income is fully reported by the employer at the time the withholding tax is applied. Second, self-employed people and farmers can fully deduct their expenses, whereas wage earners can use only a limited standard deduction. Third, self-employed people can establish small corporations and use the corporate structure to divide their income among family members.⁴

Whether or not this complaint is justified,⁵ it has strong political appeal since the majority of Japanese taxpayers are now wage earners.

2. The High Corporate Tax Rate

The second complaint is that Japan's corporate income tax rate is higher than in other industrialized nations. The average effective total corporate tax rate in Japan is well over fifty percent.⁶ This heavy tax burden falls mainly on large corporations. Although there are well over a million corporations in Japan, most of them are small operations—established to alleviate the tax burden of the self-employed. Many of these small corporations pay no taxes at all⁷ because they are used to dividing income among household

3. However, the Supreme Court rejected, in its decision on March 27, 1985, a taxpayer's argument that the present income tax system was against the equal protection clause of Article 14 of the Constitution. See *Oshima v. Sakyo Zeimu Shocho*, 39-2 Minshu 247 (1985).

4. In addition to this, a taxpayer can deduct his business expenses at the corporate level and can take a standard deduction on his salary as a director, that is, a wage-earner of the corporation.

5. As a result of these factors, it is said that the percentage of taxpayers who paid any income tax at all during the recent taxable years has been 90% among wage-earners, 40% among the self-employed and 25% among farmers. However, note that the standard deduction for the salary income category is quite high. For example, a taxpayer who earns an annual salary of 600 million yen (\$48,000) has a standard deduction of about 170 million yen (\$13,600) for the taxable year of 1987.

6. According to the research of the Japan Federation of Business Organizations (Keidanren) cited in Kaneko, *supra* note 2, at 36, the statutory rate and the average rate are as follows:

	Japan	U.K.	U.S.	Germany	France
Year	1984	1982	1985	1984	1980
Statutory Rate	52.92	52.00	51.18	56.52	50.00
Average Effective Rate	51.57	18.06	32.28	49.84	45.70

7. According to the statistics of the National Tax Administration *Kokuzeicho Dai 110-kai Kokuzei Tokei Nempo-sho, Showa 59-nendo-ban* [The 110th National Tax Administration's Annual Statistics for the year 1984], published in May 1986, in the year

members and no corporate taxable income remains after the deduction of the salaries of those family members.⁸

Prior to the Arab oil price increases of the early 1970s, when the growth rate of Japan's Gross National Product (GNP) was close to ten percent, the corporate tax burden was not as high as it is currently.⁹ However, this changed when the Japanese government began to develop large budget deficits in the 1970s. As surprising as it may seem to tax scholars, many Japanese people continue to think the corporate tax burden is actually borne by the corporations themselves. They believe that because large corporations are rich, they should be forced to bear a heavy tax burden. As a result, politicians have found it easier to raise the corporate tax burden by increasing the rate of taxation and by eliminating various tax incentives,¹⁰ than to raise personal income taxes or to introduce a new tax. Ironically, while the Japanese government was raising its corporate tax rate, almost all other major industrialized countries were lowering their corporate tax rates. At the margin, this creates an incentive for Japanese companies to operate in foreign countries, which may increase Japanese unemployment. Of course, many other problems in the Japanese tax system exist, but for several years the two most critical problems have been those discussed above.

B. Japanese Tax Reform and the International Economy

To respond to these complaints, the Japanese government is trying to reduce both the income tax burden on wage earners and the corporate tax rate. To do so, however, other sources of revenue are needed.¹¹ The government is attempting to raise that revenue

1984, among 1,624,261 corporations, 899,186 corporations have deficits, 281,706 have taxable income of less than 1 million yen, 92,044 have taxable income of over 1 million yen and less than 2 million yen, 119,140 have taxable income of over 2 million yen and less than 5 million yen, and so on. Note that in Japan, partnerships under the Commercial Code (*Gomei-gaisha*, which is comparable to *société en nom collectif* in France and *offene Handelsgesellschaft* in West Germany) and limited partnerships under the Commercial Code (*Goshi-gaisha*, which is comparable to *société en commandité simple* in France and *Kommandigesellschaft* in West Germany) are also subject to the corporation tax. Thus the statistics above include these partnerships. However, among the 1,624,261 entities which are in the scope of the corporation tax, 868,955 are corporations, 704,099 are limited companies (*Yugen-gaisha*, which is comparable to *société à responsabilité limitée* in France and *Gesellschaft mit beschränkter Haftung* in West Germany), 6,471 are commercial partnerships and 9,687 are others.

8. A household member is entitled to a standard deduction from his or her salary income. Thus, both the deduction of expenses at the corporation level and the standard deduction at the individual level are available.

9. Kaneko, *supra* note 2, at 33.

10. Nagano, WORLD TAX REFORM-A PROGRESS REPORT 155, 156 (J. Pechman ed. 1988); Kaizuka, *Comment*, WORLD TAX REFORM-A PROGRESS REPORT 162, 164 (J. Pechman ed. 1988); LINCOLN, *supra* note 2, at 107-9.

11. Of course, revenue sources are also needed to face the budget deficits.

by abolishing the favorable treatment accorded to investment income and by introducing a new tax on consumption. These measures could have dramatic consequences for international trade.

As is well known, the United States' huge trade deficit, combined with Japan's huge trade surplus, is causing serious problems in the realm of trade between the countries. Fundamental differences also exist between the tax policies of the United States and those of Japan. These differences in tax policies may be contributing to the trade imbalance between the two countries. Because former Prime Minister Nakasone's government demonstrated, in the Maekawa Report¹² on April 7, 1986, its intent to reduce the trade surplus by stimulating domestic demands, it is essential to understand the changes in the tax system that would move Japan in this direction.¹³

Part II of this Article begins by discussing how Japanese tax incentives have contributed to Japan's high savings rate. Part III discusses how the two principal tax reform measures, the abolishment of the interest income exemption that went into effect on April 1, 1988 and the proposal to introduce a value-added tax, would influence the Japanese savings rate and the trade surplus. Finally, the Conclusion suggests what possible course future tax reform measures may take.

II. THE DOMESTIC ECONOMIC IMPACT OF THE JAPANESE TAX SYSTEM

Much of the Japanese tax policy can be understood in terms of supply-side economic theory.¹⁴ Consciously or not, the government has been using a type of consumption-based income tax that supply-side theorists have advocated for years.

12. See Yamamura, *Shedding the Shackles of Success: Saving Less for Japan's Future*, THE TRADE CRISIS: HOW WILL JAPAN RESPOND? 33 (K. Pyle ed. 1987).

13. See Makin and Shoven, *Are There Lessons for the United States in the Japanese Tax System?*, CONTEMPORARY ECONOMIC PROBLEMS: DEFICITS, TAXES AND ECONOMIC ADJUSTMENTS 305 (R. Cagan ed. 1987). See also, Tajika, *Shisan Shotoku Kazei no Seido to Jittai*, SHISAN SHOTOKU KAZEI NO SEIDO TO JITTAI TO SONO RIRON, ch.2 (Kinyū-seido Chōsākai ed. 1986).

14. "In the late 1970s, and particularly during the 1980 presidential campaign, the public became aware of something called supply-side economics. At the risk of oversimplifying, supply-side economics emphasizes the way that government programs, especially taxes, can reduce national output (and hence national income) by reducing the incentive of people to work, save and invest. But supply-siders go on to emphasize a novel and often overlooked point: A higher tax rate will not necessarily produce more tax revenue if the base of the tax (income, or whatever) falls significantly in response to the higher rate." E. BROWNING & J. BROWNING, PUBLIC FINANCE AND THE PRICE SYSTEM 452 (3d ed. 1987).

A. Taxation of Interest Income

To individual taxpayers, interest income was essentially tax free. However, there was a limit to this favorable treatment. For example, when the principal exceeded a certain amount, the interest income on the excess was taxable. Nevertheless, because this ceiling was quite high, and because the Japanese tax authority has almost no effective means of identifying depositors (taxpayer identification numbers are used because of concerns over the right to privacy), interest income remained largely untaxed until March 31, 1988.¹⁵

B. Taxation of Capital Gains From Securities

Capital gains from the sale of securities are also tax free for individuals. Again, there is a limit to this treatment based upon the frequency and volume of the transactions. However, for the same reasons stated above, the capital gains from the sale of securities are, for all practical purposes, almost entirely tax-free.¹⁶

C. Deduction of Interest Expenses

Interest payments on any debt incurred during the consumption of or in the purchase of personal property are not deductible.¹⁷

D. Aggregate Effect on Capital Formation

The effect of the above enunciated tax policies on capital formation is quite clear: households retain their financial assets.¹⁸ In other words, because of these measures, household savings have flowed through financial intermediaries into productive activities instead of being consumed by households.¹⁹ As a result, Japan's busi-

15. The total amount of the tax-exempt savings as of March 31, 1984 was 245 trillion yen. (Kaneko, *supra* note 2, at 36).

16. Only 100-200 taxpayers pay income taxes on capital gains from securities each year. On the other hand, income tax on capital gains from real estate is quite high.

17. Thus, only business interest and investment interest are deductible. "Taxpayers may borrow to invest in tax-favored investments. Current deductibility of the interest cost combines with deferral or exemption of the investment return to produce tax arbitrage." Shakow, *Confronting the Problem of Tax Arbitrage*, 43 TAX L. REV. 1 (1987). However, there are some limitations in the deduction of investment interest. First, no deduction for interest payment on debt incurred in the purchase of property producing Interest Income (this is one of the ten categories of income in Income Tax Law) is permitted in the income category of Interest Income (Income Tax Law § 23,2). Second, net losses in the income categories of Dividend Income and Miscellaneous Income are not deductible from other categories of income. We can say that tax arbitrage is not easy in such a system.

18. As income tax on capital gains from real estate is high, people have not used real estate as a way of saving. That is, people do not buy real estate with loans when young, sell when getting old and receive capital gains. Instead, people have retained financial assets.

19. Prof. Kaizuka says, "These divergences from the original plans [that is, the idea of comprehensive income tax] have converted the Japanese income tax virtually to

ness sector has been able to obtain money for its investments in new machines and new equipment at a lower cost. The net effect has been a significant contribution to economic expansion.²⁰

The bilateral trade imbalance between the U.S. and Japan cannot be accounted for solely by the Japanese tax policy. Nonetheless, this tax policy appears to have contributed significantly to the trade surplus. Additionally, the abolishment of the interest income exemption and the proposed introduction of the value-added tax will have a significant impact on future trade issues.

III. ABOLISHMENT OF THE INTEREST INCOME EXEMPTION

A. The 1987 Tax Reform

After much debate, the exemption of interest income was abolished in 1987.²¹ The new law took effect on April 1, 1988. As noted earlier, Japan has been facing serious budget deficit problems for quite some time.²² The Japanese government had previously tried to raise tax revenues, but with no success.²³ However, in 1987, Prime Minister Nakasone succeeded in abolishing the special treatment of interest income. Although his ostensible aim was to make the tax system fairer, his real intent was probably to raise revenues in order to reduce deficits and alleviate the extraordinarily heavy tax burden on wage earners.

Given the country's high savings rate and huge trade surplus,²⁴ the Japanese government has sought to stimulate consumption, as detailed in the Maekawa Report. It is reasonable to assume that the abolishment of the interest income exemption will help Japan reach this goal. In fact, the United States government has welcomed the elimination of this exemption because it may make Japan's economy less savings-oriented, which in turn would raise both consumption and imports.

a highly progressive tax on wages. In certain conditions, wage tax is equivalent to a consumption tax; in effect, therefore, the Japanese personal income tax instead has been approaching a consumption tax." Kaizuka, *supra* note 10, at 163-64.

20. For economic growth, it is not enough to stimulate private savings; it is necessary to stimulate the business sector to use those savings — to invest the private savings in productive activity. Various tax measures, such as full deduction of interest on corporate debts (non-existence of the limitation like that found in I.R.C. § 385), have contributed to this. However, I will not discuss these measures in detail here. See Makin and Shoven, *supra* note 13, at 305.

21. Nagano, *supra* note 10, at 160.

22. See text accompanying note 9. The reason for this may be obvious: the Japanese tax burden, at about 25 percent of GNP, has been too light.

23. See Lincoln, *supra* note 2, at 103-13.

24. The savings rate was about 18 percent in 1987. The trade surplus was roughly \$95 billion in 1987.

B. The Effects of the Abolishment of the Interest Income Exemption

However, there are still doubts about whether this tax reform measure will appreciably lower Japan's savings rate.²⁵ While the tax exemption of investment income and the lack of a deduction for consumer interest partially account for the high savings rate, there are many other contributing factors:

1. Wage or Salary Payment System

Wages and salaries are generally made in monthly payments and increase bonuses are paid twice a year. Each bonus is roughly equal to three months' compensation, but the amount ultimately depends upon the employer's payment policy and the employee's salary. The amount of these bonuses fluctuates according to current economic conditions. Thus, some argue that many people consume only their monthly payments, while saving their bonuses.

2. Psychological Factors

(a) Desire to leave Money to Children

One economic study suggests the following as the major reason for Japan's high savings rate:

It is common in Japan that when parents become very old, or especially when one of them dies, they are "looked after" by one of the children. . . . [I]n "return" for being taken care of, it is customary that the child who looks after the parents inherits the parents' home. (This is an extreme form of "strategic bequests", as advocated by Bernheim, Shleifer and Summers, *The Strategic Bequest Motive*, 93 J. Pol. Econ. 1045 (1985)).²⁶

(b) Uncertainty About the Future

One can also argue that the Japanese save more because they are risk-averse and perceive greater risks in the future than do Americans. In January 1988, for example, former United States Trade Representative, Robert S. Strauss, made the following statement to the *New York Times*:

Now as you know, the Germans are a nation that's been through terrible times. There's a tendency almost to hoard in their caution to have economic security. The same thing is true of the Japanese. We're a consuming nation, we're a buying nation,

25. There is a conflict of views concerning this point. See M. HOMMA, T. MAEDA & K. HASHIMOTO, *COMPARATIVE TAX SYSTEMS-EUROPE, CANADA AND JAPAN* 416-17 (J. Pechman ed. 1987).

26. F. HAYASHI, T. ITO & J. SLEMMOD, *HOUSING FINANCE IMPERFECTIONS AND PRIVATE SAVING: A COMPARATIVE SIMULATION ANALYSIS OF THE U.S. AND JAPAN* 4 (National Bureau of Economic Research, Working Paper No. 2272, 1987).

even the poorest among us—we're all consumers here. We never think of saving.

What you're really talking about here is the culture of the nations of the world. Until we get a cultural change that makes this nation get into saving habits, and others change enough to get into purchasing habits, we're always going to be spenders, it seems to me, and there're always going to be savers.²⁷

To put these psychological factors into economic terms, one would say that utility in Japan is a function not just of consumption but also of wealth.²⁸ That is, Japanese people gain utility by accumulating wealth. Americans, on the other hand, may well view this quite differently. In December 1987, *Time* magazine quoted an American woman as saying:

"Holding money in the bank doesn't do anything for me. I feel I owe it to myself to enjoy myself."²⁹

If this is representative of Americans, then the American utility function is simply one of consumption.

3. The Housing Market

According to one economic study, a typical Japanese person buys his first house at roughly 40 years of age, while his U.S. counterpart does the same at roughly 30 years of age. Furthermore, Japanese pay a higher proportional downpayment, 35 to 40 percent of the purchase price, than the 25 to 30 percent paid by Americans.³⁰

Thus when these non-tax factors are emphasized, even if interest income is taxed, the savings rate may remain high.

IV. INTRODUCTION OF THE VALUE-ADDED TAX

A. Historical Background

For the last ten years, the Japanese government has tried to introduce a value-added tax ("VAT") in order to raise revenue.³¹ In the late 1970's, Prime Minister Ohira campaigned on a platform that included the introduction of a "General Consumption Tax." He lost the election. In 1987, Prime Minister Nakasone tried to introduce a "Sales Tax," and likewise failed. Prime Minister Takeshita tried introduce a new "Consumption Tax". All these proposed taxes are essentially VATs.

27. *U.S. Trade: Taking the Long View*, N.Y. Times, Jan. 17, 1988, at 4, col. 1.

28. See R. MUSGRAVE, *PUBLIC FINANCE IN A DEMOCRATIC SOCIETY* 305-7 (1986).

29. Koepf, *Fighting the Urge to Splurge*, TIME, Dec. 14, 1987, at 59.

30. F. Hayashi, T. Ito & J. Slemrod, *supra* note 26, at 9-13. "The Japanese household is induced to save more early in the life cycle in order to meet the higher downpayment." (*ibid.*, at abstract). "[I]t is rare that the elderly sell the home in order to move into a rental unit." (*ibid.*, at 14).

31. Kaneko & Gomi, *supra* note 2, at 156; LINCOLN, *supra* note 2, at 103-13.

B. The VAT and the Level of Consumption

Since a VAT taxes consumption, it is natural to assume that it would have a negative effect on consumption. One could argue that the resulting decrease in Japanese consumption levels would lead to an increase in Japan's trade surplus. However, I do not believe that the introduction of a VAT is likely to significantly alter the Japanese balance of payments for the following reasons.³² First, at the same time that it introduces the VAT, the Japanese government will abolish a number of existing indirect taxes (such as taxes on commodities, playing-cards, sugar excise, admission, electricity, and gas). Second, one of the major incentives for savings, the exemption of interest income, was already abolished in 1987.³³ Third, the government is also trying to reduce individual and corporate income taxes through the introduction of a VAT. All three of these factors will offset the consumption-reducing effect of a VAT. Fourth, the Japanese yen has risen by almost 100 percent since 1985, from about Y250 per dollar to Y125 per dollar. This has had a significant effect on the income tax system. Specifically, although the income tax schedule has not changed in terms of yen, the "progressivity" of Japan's income tax has declined in such imaginary currency unit as an average of all world currencies.

However, the effect of the yen's rise has not been fully reflected in Japanese prices. Thus, it is not suitable to use an imaginary currency unit because, except for some travelers, the currency fluctuations will cause the real progressivity of the tax system to change only if those currency fluctuations alter the buying power of the yen in Japan, through inflation or deflation.³⁴

Consider, however, the fact that consumer prices have been staying at the same level (they even fell at some points) and that business profits earned through the rise of the yen have raised Japanese household income levels³⁵ (by raising salaries, stock prices, dividends, etc.). Both of these factors have stimulated consumption.

32. Considering the fact that many countries have some type of general consumption tax, the introduction of a VAT in Japan would not be a problem even if it were to have a negative effect on consumption.

33. The government also plans to abolish the other major incentive for saving — the exemption of capital gains from the sale of securities.

34. Travelers that go abroad from Japan can directly benefit from the rise of the yen.

35. "Between October 1985 and January 1988, says the Economic Planning Agency, the rise of the yen against the dollar, together with falling oil prices, could have made goods in Japan 29 trillion yen cheaper to buy (\$230 billion at today's exchange rate). Of that, however, only 11 trillion yen was passed through to consumers in lower prices. The rest was siphoned off as higher profits by importers, distributors and retailers." *Cheaper Shopping in Japan*, THE ECONOMIST, Jan. 28, 1989, at 15. Note that someone must have benefitted from the "rest siphoned off."

Furthermore, the Japanese government is trying to reduce the income tax burden,³⁶ which will also work to stimulate consumption. Thus, the introduction of a VAT may be justified.

Of course, while the consumption-reducing effect of a VAT will be offset in part by the other factors discussed above, the introduction of a VAT itself will still reduce consumption to levels below those that would exist without a VAT. After all, if a VAT were not introduced, these other factors which would offset the consumption-reducing effect of a VAT would encourage consumption even more. For these reasons, the introduction of a VAT at a low rate would be justified.

C. The Export-Stimulating Effect of the VAT

Some may fear that the introduction of a VAT will stimulate exports. The introduction of a VAT in Japan may reduce the price of some Japanese products sold overseas. This could happen because under Article III of the General Agreement on Tariffs and Trade (GATT), it is not necessary for a consumption tax to be imposed on goods exported from the taxing country. In fact, almost no industrialized country imposes consumption taxes on exported goods. This system is similar to that of the United States' sales taxes at the state level. Usually only the country of destination (where the goods are consumed) exercises the power to impose a consumption tax on the goods under Art. XVI of the GATT. As a result, if Japan introduces a VAT and lowers its corporate income tax rate, and if changes in the corporate tax burden affect the final price of the goods sold (i.e. if a significant portion of the corporate tax is shifted to consumers), then the switch from a high corporate income tax to the VAT will result in lower prices for exported products.³⁷

Note, however, that the price cut and export stimulus derive from the reduction in the corporate tax rate, not the introduction of the VAT. Considering the fact that the Japanese corporate tax rate is higher than the rates in almost all other industrialized countries, the prices of Japanese products may be higher than they should already be to the extent that the corporate tax is shifted to consumers. Therefore, if Japanese manufacturers demand a cut in the corporate tax rate, it may be to bring it in line with other countries, rather than to obtain a subsidy.

36. It is possible for prices to go down, then Japan may well make its income tax higher and more progressive just to maintain its income tax at the same level.

37. Note that border tax adjustments based on the destination principle cannot be applied to the corporate income tax. See G. Carlson, G. Hufbauer & M. Kraus, *Destination Principle Border Tax Adjustments for the Corporate Income and Social Security Taxes: An Analysis of Sectoral Effects*, 1976 PROC. OF THE 69TH ANN. CONF. ON TAX'N 97 (1977).

V. FUTURE DIRECTIONS IN TAX REFORM

A. Social Changes

Japanese society is changing rapidly. These changes have the following implications for tax policy.

1. A Consumption-Oriented Younger Generation and the Rise of the Nouveau Riche

Younger people are increasingly saving less and consuming more. This may be because of the recent dramatic price increases in housing and real estate.³⁸ As housing prices skyrocket, buying a decent house is becoming more and more difficult. Thus, many people are abandoning the dream of homeownership and starting to spend.³⁹ On the other hand, the nouveau riche who have become wealthy through real estate price increases see no need to save for the future, and are also spending heavily.⁴⁰ In this respect, Japan seems to be following the route the United States has taken,⁴¹ and the abolishment of the interest income exemption will only accentuate this phenomenon.

2. Increase in Elderly Population

Some decades ago, Japan was a "developing nation" with only a small percentage of its population retired. Today, however, longevity has increased to the point where Japanese women have the

38. *Shōhi no Shuyaku ga Kōtai-chū? (A different type of people are consuming?)*, Asahi Shimbun, Dec. 20, 1987, at 11.

39. See *supra* note 38, at 11. Of course, the rent must go up as housing prices go up, but rents are limited because of tenant protection laws and the availability of cheaper apartments.

40. Consider a recent article in *The Economist—The Japanese Sitting on a Fortune*, THE ECONOMIST 34 (Jan. 16, 1988):

Ask Japanese which class they belong to and nine out of ten say "middle". The American occupation softened Japan's rigid class structure; since then the country has achieved one of the world's most equal distributions of wealth. The result has been social harmony, a low crime rate and few slums. It has helped the economy by boosting demand for consumer goods, which in turn encouraged the Japanese talent for mass production; and, by making education universally affordable, it has helped produce a well-trained workforce.

These benefits may now be at risk. . . .

The biggest reason for the change is the sharp rise in land prices, which makes a lot of Japanese instant millionaires when they sell their property. . . . Those left behind, wage-earners unable to buy homes of their own, are conscious of having slipped. . . . Controlling land prices and reducing the tax burden on wage-earners have become political issues in a country long mostly apolitical.

41. The savings rate has been falling from 23 percent of disposable income in 1975 to 16 percent in 1985. See *A Survey of International Banking*, THE ECONOMIST 54 (March 26, 1988).

world's longest life expectancy, and Japanese men have the world's second or third longest. As a result, the elderly are becoming an increasingly large percentage of the population.⁴² This fact distinguishes Japan from other industrialized countries in the West. The increasing number of the elderly will reduce per capita productivity in Japan and increase consumption and government spending.

3. The Rise of the Yen

Due to the rapid rise of the yen in recent years, Japanese manufacturing companies have begun to operate overseas. This may lead to unemployment in the future.

B. The Direction of Tax Reform

What direction should tax reform take? This is a difficult question to answer. Japan must cut its trade surplus and at the same time prepare for a future in which it will have a large elderly population and in which people will generally be more consumption-oriented than they are today. Let me make five proposals.

First, Japan should reduce the heavy tax burden on middle class wage earners since they play the most important role in the Japanese economy today. Japan should maintain strong incentives for them to work.⁴³

Second, Japan must reduce the heavy corporate tax burden. Otherwise, manufacturing companies will operate increasingly overseas rather than in Japan.

Third, Japan must introduce some type of VAT. Considering the increasing number of elderly people, we desperately need new sources of revenue. With this revenue from the VAT, the government could offset the loss from the income tax and corporate tax reductions.

Fourth, in the long run it may be better to have some type of favorable treatment for capital income.⁴⁴ Given the bilateral trade problems between Japan and the United States, perhaps the abolish-

42. According to Professor Kaneko's article (Kaneko & Gomi, *supra* note 2, at 157), the ratio of the aged people is as follows:

Ratio of Population Over 65 for Five Countries					
Year	1950	1970	1985	2000	2020
1. Japan	4.9	7.1	10.3	16.3	23.6
2. W. Germany	9.4	13.2	14.5	16.7	21.2
3. France	11.4	12.9	12.4	14.7	18.0
4. U.K.	10.7	12.9	15.1	15.3	17.8
5. U.S.	8.1	9.8	11.7	12.0	15.4

43. Nagano, *supra* note 10, at 155-56.

44. Kaizuka, *supra* note 10, at 165.

ment of the interest income exemption and the proposed abolishment of the tax-free treatment of capital gains from securities can be justified as temporary measures to stimulate consumption instead of savings. However, the changes should only be temporary; it will not be difficult to bring these systems back in the future — *cutting* the tax burden is always relatively easy.⁴⁵

Fifth, the government will need to spend greater amounts on its infrastructure. To cope with the graying of Japan, it is necessary for the Japanese people to save and prepare for the future. Yet, at the same time Japan has to export less. To solve this dilemma, Japan should now invest in its social stock.

In conclusion, the Japanese government's tax reform are largely justified. However, it remains to be seen whether the government will achieve success.

POSTSCRIPT

This article was written in 1988, when the Japanese Diet was still debating how to accomplish tax reform. In December 1988, however, the Diet finally approved the government's tax reform proposals. This tax reform brought about such fundamental changes as the following:

The reduction of the income tax burden.

The reduction of the corporate income tax rate.

The abolishment of the exemption of individual capital gains from securities.

The introduction of a VAT called the "Consumption Tax."

45. However, if new revenue sources are needed to introduce favorable treatment for capital income, it will cause a serious problem.