Consumption Tax in Japan

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1. Characteristics of Japanese Tax System

After World War II, the Japanese tax system was built mainly on the recommendations of a mission headed by Professor Carl S. Shoup who came to Japan both in 1949 and 1950. Its recommendations attached great importance to direct taxes, mainly income taxes on individuals and corporations. As experience gained, the tax regime was evolved. Nevertheless, the heavy reliance on direct taxes characteristic to the Japanese tax system remained unchanged.

Thus according to the OECD statistics, as compared with the major European countries, taxes on income and profits in Japan are high while those on goods and services are low.

To put in another way, the share of indirect taxes in the total tax revenues in Japan are far greater than those of direct taxes. According to the Ministry of Finance of Japan, even after her introduction of a consumption tax, in the initial budget of fiscal 1993, the direct taxes accounted for 72.6% of the total national tax revenues as against indirect taxes of 27.4%. The comparable figures of the U. K. and Germany in fiscal 1991 and France in fiscal 1990 are 57.3% and 42.7%, 49.6% and 50.4%, 40.0% and 60.0% respectively. The United States is an exception where the share of direct taxes is large, accounting for 90.8% of the total Federal tax revenues in fiscal year 1991. As a matter of fact in Japan herself also before the war between 1934 and 36 on an average the ratio of direct and indirect taxes was 34.8% to 65.2%, which is now reversed. Insidentally, according to the draft budget for fiscal 1994 recently submitted to the National Diet, as a result of income tax cut, the share of direct taxes in the total national revenues will be lowered to 68.1%, hitting the sixty per cent-mark for the first time in the last 15 years.

By international standards, Japan's tax burden, either including or excluding social security, has been and is by no means high as shown in the OECD statistics. In 1991, Japan's total tax tax revenue including social security as percentage of gross domestic product is 30.9%, ranking 4 th from the bottom among the 24 OECD member countries. If social security excluded, it is 21.6%, ranking 3 rd from the bottom, the comparable percentages in 1965, 1975 and 1985 were 18.3% and 14.3%, 20.9% and 14.5% and 27.6% and 19.3%, respectively.

Nevertheless, direct taxes which played a major role in the Japanese tax regime made taxpayers feel that the their tax burden was onerous. Despite the relatively sophisticated tax administration, it was difficult to convince taxpayers of the fairness and reliability of

Tax Revenue of Main Headings as Percentage of Total

	1960		1965		1970		1975	
	Income & Profits	Goods & Services	Income & Profits	Goods & Services	Income & Profits	Goods & Services	Income & Profits	Goods & Services
Japan	45. 1	31. 5	43. 7	26. 2	47. 7	22. 4	44. 6	17. 3
Canada	39. 6	37. 7	38. 6	40. 5	44. 6	31. 7	47. 2	32. 0
France			15. 9	38. 4	18. 3	38. 1	17. 6	33. 3
Germany	31. 9	32. 9	33. 8	33. 0	32. 3	31. 8	34. 4	26. 9
Italy	15. 7	42. 3	17. 8	39. 5	17. 4	38. 7	21. 5	29. 4
UK	37. 5	34. 5	37. 0	33. 0	40. 4	28. 8	44. 5	25. 4
US	49. 9	21. 5	46. 3	21. 9	47. 9	19. 2	43. 6	18. 5
OECD Europe			31. 1	40. 1	32. 2	38. 3	34. 2	33. 3

Source: OECD, *Revenue Statistics 1965—1992*

the system. Thus they came to have perception of heavy tax burden and complained about inequity among different types of income.

Thanks to fast economic growth, the national standard of living was substantially improved and people's way of life was remarkably diversified. Excise taxes on selected items could no longer be justified due to social and economic changes; a glaring imbalance between taxed and untaxed items surfaced. Specifically, in recent years the economy was more service-oriented. This was illustrated by the fact the share of the tertiary industry in gross domestic product increased from 42. 2% in 1950 to 61. 4% in 1987 and the number of employed persons of that industry as percentage of the total employed persons almost doubled from 26. 6% to 58. 0% between the same period. Nevertheless, only a small portion of that industry was taxed. A broad-based indirect tax with relatively low rates was badly needed to meet this situation. Moreover, creation of a tax of this kind would help mitigate the perception of a heavy tax burden by shifting emphasis from direct to indirect tax. In this way, fund preparations could be made for the aging of the society in the twenty-first century.

For the background and features of the Japanese tax system, see Ishi 1993; and Aoki 1987 and 1993.

2. Attempts to introduce a VAT

Against the background described above, when Mr Masayoshi Ohira was Prime Minister, his government's Tax Commission proposed a new tax on consumption on a broad tax base in 1978. In the following year, the new tax, named "general consumption tax", was designed to be levied at a uniform rate of 5% on the amount of value added (gross rates minus purchares) for all business firms. However, mainly bacause of this unpopular new tax proposal, the ruling Liberal Democratic Party lost the general election for the

Taxation (including Social Security Contributions)

1980		1985		1987		1990		1991	
Income & Profits	Goods & Services	Income & Profits	Goods & Services	Income & Profits	Goods & Services	Income & Profits	Goods & Services	Income & Profits	Goods & Services
46. 1	16. 3	45. 8	14. 0	47. 0	12. 9	48. 3	13. 2	46. 9	13. 5
46. 6	32. 6	56. 8	31. 8	56. 0	29. 1	58. 3	27. 1	59. 1	27. 3
18. 1	30. 4	17. 3	29. 7	18. 0	29. 3	17. 2	28. 3	18. 0	27. 1
35. 1	27. 1	34. 8	25. 7	34. 1	25. 4	32. 4	26. 7	31. 4	26. 7
31. 1	29. 4	36. 8	26. 5	36. 1	25. 4	36. 5	28. 0	36. 1	28. 1
38. 2	29. 2	39. 1	31. 2	37. 1	31. 5	39. 6	30. 1	37. 4	32. 7
47. 0	16. 6	42. 8	17. 8	44. 3	16. 7	43. 2	16. 5	42. 2	16. 8
35. 6	32. 1	34. 7	33. 0	33. 8	33. 5	34. 0	32. 0	33. 9	32. 1

House of Representatives in October and both the Lower and Upper Houses passed a resolution to abolish the general consumption tax in December 1979. Since then, the issue of adopting a broad-based indirect tax was a political taboo for the time being.

However, in his policy speech at the Diet session in January 1985, Prime Minister Yasuhiro Nakasone stated that in view of various problems of the tax system due to the social and economic changes an overall tax reform on a broad basis would be required as a task for some time to come. Premier Nakasone requested the Tax Commission to make an in-depth review of the present tax system. In the area of indirect taxes, to mention a few, the revenues therefrom as percentage of the personal consumption expenditure was 7. 3% in Japan for fiscal year 1986 but the corresponding figures for the U. K., Germany and France mere 19. 4%, 18. 1% and 20. 2%, respectively, in 1984. Furthermore, in Japan, the revenue from tax on services accounted for only 4. 9% of the total indirect tax revenues in fiscal 1985.

In the campaign for the Parliamentary elections for both the Lower and Upper Houses held in July 1986, Premier Nakasone pledged that his government would not introduce a large-scale indirect tax opposed by the people and ruling party members. In the same month, the expert sub-committee of the Tax Commission proposed three types of new indirect taxes: (Type A) Manufacturers' sales tax, (Type B) Retail sales and (Type C) the Japanese-style value added tax. The final report of the Commission, published in October 1986 selected Type C which was named "sales tax". The proposed sales tax was a consumption type of value added tax with tax credits determined according to invoice to be imposed at a single 5% rate with a zero-rating on exports. From the very beginning, its tax base was considerably eroded by the political compromise as evidenced by as many as 51 tax-exempted items and high exemption level of annual sales of less than 100 million yen. The tax reform bill including the sales tax was submitted to the Diet in February 1987 but again met a storm of opposition. The government was forced to withdraw the ill-faited bill in May 1987 when the Diet session was closed.

3. Introduction of Consumption Tax

In November 1987, the new Prime Minister, Noboru Takeshita requested the Tax Commission to study a tax system which balances charges on income, consumption and assets. In April 1988, the Tax Commission published an interim report to clarify basic forms of a new broad-based indirect tax which was later named as the "consumption tax", by the Tax Council of the ruling Liberal Democratic Party. In July, the tax bills, including the introduction of the consumption tax, were submitted to the Diet. After many turns and twists, on November 16, 1988, the bills were approved by the House of Representatives where the Japan Socialist Communist Parties did not appear and on December 24, by the House of Councillors where a majority of opposition parties were absent for voting. As a result, within the relatively short lead-in time from the passage of the bill, a new VAT named the "consumption tax" came into force as from April 1, 1989 in Japan.

Along with the adoption of the consumption tax, a selective commodity tax, a sugar excise, a playing-card tax, an admission tax and a travel tax at national level and electricity, gas and timber delivery taxes at local level were abolished. Taxes on liquor and tobacco products were adjusted and a stamp tax, a securities transaction tax, a bourse tax and a petroleum tax were slightly amended.

4. Features of the Consumption Tax

From its past futile attempts, the government came to realize that the key to a broad-based indirect tax for Japan was the breadth and uniformity of its coverage. Besides, to cope with strong political pressures against the bill and to make it more easily acceptable especially to small- and medium-sized enterprises, some concessions were badly needed in adopting the proposed consumption tax.

(1) Rate

The consumption tax in Japan is levied at a uniform rate of 3% on almost all consumer goods and services. As a transitional measure, however, the rate of 6% was applicable to passenger cars for the first three years and 4.5% for the subsequent two years. It is because before the inception of the consumption tax, passenger cars were subject to commodity tax at the rate of 23% and, the single most important item of the commodity tax, accounting for about 40% of the total revenue therefrom. Perhaps, 3% is the lowest standard rate in the world to the best of the writer's knowledge. Reportedly, only Singapore will introduce a goods and services tax at the rate of 3% as from April 1994. Other countries with the single digit percentage rate are 5% of Taiwan and 7% of Thailand among our Asian neighbors and 7% of Canada on her goods and services tax and a couple of Latin American nations. Japan's current rate is so low that no multiple-rate regime is necessary to achieve special policy objectives. The single rate makes the tax system and administration very simple and easy. It serves the interest of both tax collectors and taxpayers by making it unnecessary to adopt systems of classifying goods and services into different categories which are prone to dispute.

(2) **Coverage**

The consumption tax is levied on almost all on domestic sales and leases of goods and services including essential daily necessities such as foodstuffs. Tax-exempted goods and services were extremely limited to only a few items, i. e. selected tuition fees, certain medical and welfare services, specified securities and stamps, the sale of land and exported goods. As Prof. Ishi points out, as far as the coverage is concerned, that of Japan's consumption tax seems to be broadest in the world, bearing a close resemblance to the goods and services tax in New Zealand.

(3) **Accounts Method**

Unlike all other VAT countries employing the tax credit method, Japan does not require invoices but relies on book accounts. The accounts method without use of invoices was adopted in response to the request of the businesses who were not well accustomed to invoices. But the fact remains it will be difficult to ascertain the exact creditable amount. Therefore, eventually the invoice-credit method should be employed.

(4) **Tax Exemption for Small Businesses**

To alleviate the tax burdens of small businesses, those whose taxable annual sales are 30 million yen or less are made exempt from tax liability. Such an exemption of small businesses is common practice in many other countries. But this threshold, which was equivalent to about US $ 200, 000, was high by international standards as compared with £ 25, 400 (5, 740, 000 yen, 1 £=¥ 226) of the U. K. and DM 25, 000 (1, 880, 000 yen, IDM =¥ 75) for the preceding year and estimated DM 100, 000 (7, 500, 000 yen) of Germany and practically F. F. 1, 350 (29, 700 yen, 1 F. Fr=22 yen) under the *forfait* system of France and W 40, 000 (8, 800 yen, won=22 yen) of the Republic of Korea.

(5) **Simplified Scheme for Computation of Tax**

For the same purpose, a special simplified scheme for computation of tax has been designed for firms whose annual sales are 500 million yen or less. Under this regime, 80% of taxable sales are deemed taxable purchares for retailers and 90% for wholesalers. Thus, the tax amount for retailers is equivalent to 0. 6% of their sales (3% of the sales net of purchasing costs) and for wholesalers 0. 3%. The paper submitted by the Finance Ministry to the Tax Commission reveals that fiscal year 1989 of a total of more than 1. 9 million taxpayers, 1. 3 million (accounting for 67. 7%) opted for the simplified method; this percentage was higher, being 76. 4%, for those whose sales are between 30 million yen and 500 million yen. Incidentally, as of May 1990, the comparable percentage was 72. 8% comprising 75. 1% for individual taxpayers and 71. 5% for corporate taxpayers.

(6) **Marginal deductions**

A marginal deduction or vanishing exemption method has also been introduced for small enterprises whose annual sales are above 30 million yen but less than 60 million yen. In such a case, the tax due gradually reduced to zero by a marginal reduction that takes the form of tax credit. The calculation is as follows:

Tax Payable=Tax Otherwise Payable×(Taxable Sales−30 million yen)/20 million yen.

Thus the tax vanishes at the level of a trader with 30 million yen of sales because the tax credit is equal to the tax otherwise due.

(7) **Tax Return and Payment**

The calendar year represents the tax period for individual proprietors and the accounting period for corporations. Taxable enterprises should file tax returns and pay tax due within two months following the close of the tax period. Enterprises must file interim tax returns and pay half of the tax amount reported in the previous year's final return and to pay the remainder of the tax due within two months (until 1991, three months for individual proprietors) of the day following the last day of the tax period.

The standard taxable period is somewhat longer than is common in many countries. Taxpayers may benefits from such "grace period" by both saving preparation of tax returns and investing money until the tax due is actually paid.

5. Partial Amendments

The new consumption tax settled down smoothly in Japan only a year after it was enacted. However, consumers complained about the following points which were controversial issues between the ruling Liberal Democratic Party and the opposition parties:

(1) Regresive tax burden among lower income-earners.

(2) Cash flow benefits for a period before revenues are handed over to the tax authorities.

(3) Windfall revenue gains under the special simplified scheme.

To rectify the situation, the consumption tax was amended as follows effective as from October 1, 1991:

(1) Tax exemptions were extended to include housing rent, school entrance and facilities fees, certain welfare goods, midwife services and funeral services.

(2) The threshold to entitle small business to the simplified method was lowered from annual sales of 500 million yen to 400 million yen. The deemed rates of purchasing costs under such a simplified method was changed from 90% for wholesalers or 80% for others to 90% for wholesalers, 80% for retailers, 70% for manufactures, etc., or 60% for rendereres or various services. Thus, for example, the tax amount for retailers is equivalent to 0.6% of their sales (3% of the sales net of purchasing costs).

(3) The upper limit for qualifying the marginal deduction was lowered from annual sales of less than 60 million yen to less than 50 million yen.

(4) Business entities whose tax amount in the previous taxable year was over 5 million yen should pay tax in advance three times a year. However, small enterprises whose tax amount is 300,000 yen or less are not required to file interim returns.

6. Revenue from the Consumption Tax

While the share of indirect taxes in the total national tax revenues has not necessarily increased, that of the consumption tax in the total revenues from the indirect taxes has steadily grown. It is interesting to observe the growth of the revenue from the consumption tax stands out clear among other taxes. To tide over the prolonged economic recession, enterprises have reduced equipment investment and inventories in a restructuring effort. Ironically enough, they have come to pay a larger amount of the consumption tax since the decline in their sales has been more than offset by the reduction in their deductible purchases. As of February 1994, the revenue from the consumption tax for fiscal year 1994 was 11.6% more as compared with the previous fiscal year. This recent development indicates that the revenue from the consumption tax is free from economic fluctuations. In contract, the revenue from corporation tax for the same period was 10.5 % less than that of a year ago. In this way, the revenue from corporation tax is subject to violent economic fluctuation. Thus, the consumption tax is a stable source of revenue especially for the coming aged society. It is estimated that an increase of the consumption tax rate by 1% will produce ravenue ranging from 2,300 billion to 2,400 billion yen. On other hand, during the discussions at the Tax Commission, the Ministry of Finance revealed its estimate that exemption of food from the consumption tax would reduce tax revenue by about 1 trillion yen.

	FY 1989 Settled amount	FY 1990 Settled amount	FY 1991 Settled amount	FY 1992 Settled amount	FY 1993
Total national tax revenues A	571,361	627,798	632,110	573,964	641,442
Total revenues from indirect taxes, etc. B	147,435	164,827	169,037	168,444	176,092
(B/A)	(25.8%)	(26.3%)	(26.7%)	(29.3%)	(27.5%)
Revenue from consumption tax C	40,874	57,784	62,204	65,511	68,220
(C/A)	(7.2%)	(9.2%)	(9.8%)	(11.4%)	(10.6%)
(C/B)	(27.7%)	(35.1%)	(36.8%)	(38.9%)	(38.7%)
Of which : General Account D (C−E)	32,699	46,227	49,763	52,409	54,580
Of which : Special Account E (C×20%=Consumption transfer tax)	8,175	11,557	12,441	13,102	13,640

Remark : The equivalent of 24% of the amount in the General Account (D) is granted to local governments as local allocation tax. Therefore, at the outlet, the share is 60.8% for the national and 39.2% for the local governments.

7. Problems of the Consumption Tax

(1) Regressivity

A common criticism or even allegation made against the consumption tax is its regressivity. Admittedly, by the very nature, the consumption tax is regressive. In recent years, all the successful tax reforms have been neutral in terms of revenues. This policy should be borne in mind also in introducing a new value-added tax. Low income groups who may suffer from the newly introduced tax should be relieved by other means such as income tax cut or an increase in welfare benefits.

In this connection, it may be interesting to observe the following recent change in the family expenditures as presented by the Ministry of Finance to the Tax Commission in September 1993. According to the Ministry's analysis of nationwide household survey, in 1992 while the average monthly expenditure amounting to 334, 000 yen, 'discretionary expenditures' for such as eating-out, remodeling and improvement of equipment, furniture, clothing, communications, culture, education, etc., totalling 123, 000 yen exceeded 'necessary expenditures' for such as food, rent, fuel, light, water, medical care, etc., totalling 121, 000 yen. Reflecting the diversification of expenditures and improvement of living standard, between 1981 and 1992, the 'discretionary expenditures' rose as much as 49% as against an only 25% rise in 'necessary expenditures'. This is an encouraging development to indicate the increased tax-bearing capability of the people in recent years.

(2) Financial Resources

a. Long-term

In the course of the review of the consumption tax, in November 1989 the government worked out a "Ten-year Strategy to Promote Health Care and Welfare for the Aged" (Gold Plan) starting from fiscal year 1991. To meet the financial needs of the forthcoming aged society, a hike of consumption tax rate is inevitable in the long run. Setting aside or earmarking revenues from the consumption tax for the welfare purpose may make the tax increase more easily acceptable to the taxpayers but make the expenditure budget less flexible and discretionary. Moreover, the welfare programs themselves will be limited to the revenue from such earmarked tax. Thus, it is a double-edged sword.

Later on March 28, 1994, the commission studying the aging society, which is an advisory body to the Minister of Health and Welfare published a final report which projects financial burden at 51% of national income by the year 2025. The paper says that by 2025 the nationwide financial burden of taxes and social security contributions could rise more than 300 trillion yen annually. The paper will fuel tax debate because it implies a certain amount of indirect tax revenue may be set aside for supporting senior citizens, especially improving mechanisms for providing them with care at their own houses instead of hospitals.

b. Short-term

One of the consequences of the deepest and longest recession after the war was a shortfall in tax revenues, which forced a series of revisions of the budget and bond issues. During 1993, the government offered two economic stimulus packages: one of 13. 2 trillion yen in April, another of 6. 15 trillion yen in September. The business community called for an early income tax cut as pump prime for economic recovery. But the government insisted that tax reform should not be implemented from a short-term perspective. The Tax Commission was also of the same view.

As will be explained later at some length, on November 19, 1993, the Tax Commission published a report on medium- and long-term tax system. It suggested that an income tax-cut cnd consumption tax hike should be handled in a single bill. But for the overriding necessity of economic turnaround, some urged that the reduction of income tax should be carried out in advance of the increase of consumption tax. This was a very controversial point.

(3) Tax Rates

As stated earlier, 3%, which has resulted from political compromise, is extremety low by any standards. It is so low that there is no room for reduced rates for policy purposes. The only point to be raised may be a zero rate for food. On the other hand, the advantage is that no or little incentive is provided for tax evasion because it would not pay off.

Since its stability as revenue source has been proved in this time of economic recession, the consumption tax is expected to play a major role in the coming aged society. It is estimated that any hike of the consumption tax rate by 1% would generate additional revenue of more than 2 trillion yen. For the time being, the current 3% will be raised to, for example, 5 to 10%.

(4) Special Measures for Small Businesses

In introducing the consumption tax, in order to obtain support from opposing groups especially in the retail and wholesale industries, various concessions were made in favor of small businesses. With a view to mitigating their tax burden and also taking into their limited book keeping ability consideration, (i) tax exemption, (ii) simplified method for calculation of taxable income and (iii) marginal deductions are provided for small businesses. They are giving rise to considerable distortions both in tax administration and compliance.

When taking advantage of these special treatments, tax exempt enterprises collect the consumption tax, that part of such tax on the value added as distinct from on purchasing price is not passed on to the tax authorities. Under the simplified method for computation of the tax, the deemed rates of purchasing costs don't necessarily reflect the actual costs of each individual enterprise. So some enterprises pay a smaller amount of the consumption tax than they should. Under the marginal deductions, the possibility of underpayment of tax cannot be precluded. Therefore, the reduced tax due for those enterprises whose sales are less than 50 million yen is not justified.

At the inception of the consumption tax in 1989, the Ministry of Finance estimated that tax revenue lost due to these three special measures would amount to 480 billion yen. The windfall gains of this sort are extremely difficult to identify. Some university professor says such profits now would total 800 billion and if the consumption tax rate is raised to 10%, they would exceed 2 trillion yen. By using the inter-industry relations table, some research institute has found 400 to 500 billion yen of such profits accrue every 1% of the consumption tax and hence now, the current tax rate being 3%, such profits probably amount to 1. 2 to 1. 5 trillion yen.

In addition, firms whose tax amount is 300, 000 yen or less are not required to file interim returns and pay the tax which they have already collected from customers. They can divert or invest such fund during the 'grace period' for other purposes. In this way, they enjoy cash-flow benefits.

It is to be noted that while tax exempt enterprises with annual sales of 30 million yen or less accounted for about two-thirds of the total number of enterprises, their share in the total sales is only a little less than 3%. It is true that in some foreign countries have also the simplified seheme for computation of tax but they are applicable only to small businesses. The criteria for qualification are, for example, in Germany DM 100, 000 (7, 200, 000 yen), in Canada (for goods and services tax) C$ 200, 000 (1, 780, 000 yen) and in France (under the *forfait* system) F.F. 500, 000 (10, 500, 000 yen). In Japan, the simplified method is applied to 64% of the total taxable enterprises in fiscal year 1991. Although named "special" measure, in reality it is not an exception but a rule. If the upper limit to be entitled to this method is lowered to 200 million yen, the percentage of eligible enterprises would be decreased to 56%.

The above-mentioned gains from special treatments are considered unfair by the general public. If the increase of the consumption tax is to be approved in the future, something should be done now to deal with this inequitable aspect and to improve the transparency of the system.

8. Tax Commission

(1) Coalition Government

In the election held on July 18, 1993, the Liberal Democratic Party lost its majority in the Lower House. Thus, the LDP's 38-year monopoly on power since 1955 was replaced by an unprecedented eight-party coalition, including the Social Democratic Party of Japan. On July 29, Mr. Morihiro Hosokawa, the leader of the Japan New Party founded just one year earlier was nominated as Prime Minister. The major policies which the eight parties agreed to pursue for the immediate future include an overall tax reform designed for well-balanced taxation on income, property and consumption.

On September 3, 1993, at the general session of the Tax Commission, Premier Hosokawa requested the study of a radical overhaul of the tax system with special reference to the correction of the ratio between direct and indirect taxes. The discussions of the Commission took place at a time when the Japanese economy was suffering from the prolonged recession after collapse of the bubble economy at home and criticized for its huge trade surpluses from abroad.

Another advisory panel to the Prime Minister headed by Mr. Gaishi Hiraiwa, chairman of the powerful Japan Federation of Economic Organizations (Keidanren) was drawing up a blueprint for shifting Japan's economic priorities from producers to consumers. The panel published an interim report on deregulation on November 8, 1993 and a final report on December 16. The final report, aimed at the improvement of the national standard of living and correction of international disequilibrium, made several proposals which include an overall tax reform to cope with imbalance between direct and indirect taxes and early implementation of income tax reduction as immediate economic stimulative measures.

(2) Debate of the Tax Commission

High on the agenda of the Tax Commission are realization of a more equitable tax burden than the present system by moderating the progressivity of current tax rates, attainment of a balance between direct and indirect taxation and construction of a tax system which would enable the government to provide appropriate public services, such as social welfare in a graying society. In the area of consumption tax, the rate hike is considered necessary to prepare for the coming aged society as well as to correct the government's overdependence on direct tax and the special measures which are giving rise to windfall gains should be carefully reviewed.

One of the subjects was the tax-credit method. Unlike the VAT of most countries, the Japanese consumption tax does not require use of invoice under the accounts method. This has caused various difficult problems in connection with crediting input tax. In an attempt to improve the situation, various ways to use the invoices were explored broadly according to the following types of the invoice: (A) invoice issued by a registered taxable firm, (B) invoice issued by a taxable firm and (C) invoice issued by any firm.

Another issue which has risen to the surface is creation of a new local transfer consumption tax. When the consumption tax was introduced in 1989, some local taxes were abolished and in exchange, 20% of the revenue from the consumption tax is allocated to local governments. But these local governments have lost their own revenue resources and come to rely on direct taxes to a greater extent. In addition, the prolonged economic recession dealt a hard blow to the local government finances. The local inhabitant tax is to be cut together with the national income tax as part of the economic stimulus parkage. Under the circumstances, the Ministry of Home Affairs is requesting establishment of a local transfer consumer tax as independent revenue source. Some local governments, including the Tokyo Metropolitan Government, are particularly keen for this to happen.

(3) Medium- and Long-term Report

After months of discussions on November 19, 1993, the Tax Commission submitted to Premier Hosokawa a report on the tax system in the medium- and long-term. It urged an income tax cut to lessen the burden primarily for middle-class taxpayers, coupled with a consumption tax hike. However, the report does not specify any timetable or size for proposed tax changes, leaving it up to the administration and politicians to decide.

With regard to the consumption tax, the report says the proposed hike should be carried out across-the-board, and the rate should be a uniform one. The categories of goods and services subjected to exemption will not be expanded. The present exemption applicable to small businesses with annual sales of 30 million yen or less should be reviewed. The ceiling for the simplified method for computation of tax, which is currently businesses with annual sales of 400 million yen should be lowered. The marginal deduction, which is of a transitional nature, should be also reassessed. In reviewing all these special measures, the book-keeping ability of small businesses should be duly taken into consideration. In connection of the input tax credit, the accounts method may be maintained but it should be made mandatory to keep invoices at the earliest opportunity whenever the book-keeping ability has been improved.

(4) **Short Term Issue**

Income tax reduction was urgently needed to spur the sagging economy. But heated discussions were going on how to make up for any shortfall in revenues from such tax cut. Eventually, for that purpose the consumption tax should be raised. The Ministry of Finance insisted that income tax cut and consumption tax hike be incorporated in the same bill. But others urged to float stop-gap deficit-covering bonds to finance the immediate tax reduction.

In the meantime, on February 3, 1994, Prime Minister Morihiro Hosokawa rather suddenly announced a 7% "national welfare tax" replacing the consumption tax to pay for a 6 trillion yen cuts in income and other taxes. However, the coalition parties split over this tax reform proposal and the angry Social Democrats, the biggest force in the grouping, threatened to leave the coalition. Thus, on the following day, Premier Hosokawa retracted the controversial proposal for the welfare tax. On the eve of his departure for the meeting with President Bill Clinton, the government adopted the largest-eves economic-stimulus package, a 15 trillion yen program including tax cuts by 6 trillion. Deficitcovering bonds will be issued to compensate for the cuts for one year and the coalition will continue to debate how to overhaul the tax system.

On February 9, the Tax Commission submitted a report on the tax reform for fiscal year 1994. It proposes among others reduction in income tax and local inhabitant tax for one year only in the amount of 5, 478 billion yen and abolition of the special corporation surtax of 2. 5% and special transitional consumption tax rate of 4. 5% on passenger cars. On the other hand, the liquor tax will be raised. As a result, the ratio of direct to indirect taxes in the draft fiscal 1994 budget will be 68. 1 for 31. 9.

On February 15, the government decided on the draft budget for fiscal year 1994 totalling 73, 081 billion yen in its general account expenditures. With 1. 0% increase from the previous fiscal year, austere as it is, it is intended to help stimulate the economy. Because of tax cuts based on the recommendations of the Tax Commission, the tax revenues are projected to be 53, 665 billion yen, or down 12. 5% as compared with the previous fiscal year. The difference will be mostly met by national bond issues in the amount of 13, 643 billion yen. As a result, the total outstanding of the government bonds at the end of fiscal year 1994 is estimated to be approximately 201 trillion yen.

9. Conclusions

Through the tax reform debate which has thus far taken place both inside and ontside the Tax Commission at least the problems involved seem to have been identified. High hopes may be placed on the consumption tax as the most reliable fund resource especially for the coming aged society. Emphasis should be shifted from the direct to indirect taxes. What is most important in taxation is equity. We should explore every avenue to secure the equity. For this purpose, it may be worthwhile to study a system of assigning an identification number—comparable to a U. S. social security number—to all taxpayers to help the government keep track of salary, bank accounts and other sources of income.

In connection with the consumption, the necessity of raising rate eventually to 6-7% is growingly recognized if certain conditions are met. The following changes in the special measures for small businesses may be suggested in the interest of fairer taxation. The threshold for exemption will be lowered from annual sales of 30 million yen to 20 million yen. The upper limit to entitle to the simplified scheme for computation of tax will be lowered from taxable sales of 400 million yen to 200 or 300 million yen. The marginal deductions will be abolished or their range of applicable sales will be reduced from 30 million yen or more but less than 50 million yen to 20 million yen or more but less than 30 million yen.

On April 8, 1994, at the Tax Commission, just before announcing his resignation, Prime Minister Morihiro Hosokawa urged to push for a consumption tax increase to finance the multi-year cut, as distinguished from one year cut fiscal 1994, in income tax. The Commission is expected to present options on the consumption tax based on the national welfare vision for the 21 st century made public on April 4 by an advisory body to the Health and Welfare Minister. It is reassuring that the Social Democratic Party which was adamantly opposed to the introduction of the consumption tax is now apparently changing its policy, although conditionally, toward accepting that tax.

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