

From Cash Handouts to Refundable Tax Credits

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Prime Minister Taro Aso has announced the distribution of around ¥2 trillion in cash benefits to all Japanese citizens. The purpose of these handouts remains unclear, though, and the argument is tangled over whether to set income limits for eligibility for them. Many decry the move as mere political largesse. How can this measure be made more effective in meeting the real needs of the people?

Refundable Tax Credits: The Better Choice

A number of developed Western nations have had great success with the introduction of a system of refundable tax credits aimed at providing economic support to lower- and middle-income taxpayers. Let me explain this system simply in terms of the proposed ¥2 trillion outlay for Japan's cash handouts. Divided equally among the roughly 10 million dependents aged 15 or younger in households with less than ¥6 million in annual income, this would come out to ¥200,000 per head, to be distributed to the households where those dependents live. A family with two eligible children would receive a credit of ¥400,000. If that family's tax bill for the year was higher than this amount, it would be deducted from the taxes due; if the tax bill was lower, or if the family's income was below the taxation threshold, the family would receive the difference, which makes the credits "refundable." This is an effective, efficient approach that combines the taxation and social security systems to achieve the same income-redistribution goals that they do, and it is in broad use in the other developed nations of the world.

The refundable tax credit systems in place in Western nations can be placed in four categories according to their policy aims.

The first of these is earned income tax credit (EITC) systems. These credits are granted in defined amounts to lower- to middle-income households where the taxpayers have worked at least a minimum number of hours. This system aims to prevent the moral hazard of the situation where it makes more economic sense to rely entirely on welfare benefits and to keep people from falling into the poverty trap. It is meant to encourage people's efforts to improve their job skills and live more self-reliant lives, and as such it is often implemented in concert with jobs training and education programs.

The second category is child tax credit (CTC) systems. These provide credits to households with children, with the amount increasing along with the number of minors. This approach helps to prevent poverty among single-parent households and to provide child-rearing support; in these ways it serves as a measure to counter dwindling birthrates as well.

Systems in the above two categories saw expanded use in Britain under Prime Minister Tony Blair and in the United States under President Bill Clinton. Based on the concept of "workfare," which helps people attain self-sufficiency through work, they are today fundamental parts of the UK and US taxation systems.

The third category is tax credits to offset social insurance costs. Here the aim is to reduce the burden on those in lower income brackets of taxation and social contributions. The Netherlands and South Korea have introduced systems along these lines, although the Dutch system merely offsets the contributions required of lower-income taxpayers and involves no rebates to them.

In the fourth category are tax credits to offset consumption tax liabilities. Such systems are in place in Canada and Singapore to reduce the regressive impact of consumption tax hikes on people in lower income brackets. They involve deductions and refunds of liabilities for consumption tax on basic necessities from the income tax amount. This approach is far more effective than straightforward tax rate reductions in countering the regressive nature of taxation.

Approaches in these categories have recently come to be viewed as potentially beneficial for Japan as well. The government's Tax Commission clearly stated in its recommendation report on tax reform for fiscal 2008 that exploring these options would be a meaningful task for Japan, as many nations were making use of these systems to provide "assistance to low-income people, particularly among the younger generations, childrearing assistance, employment assistance, and an approach to offset the regressivity of consumption tax. Some countries take the tax and social security regimes as a whole and use refundable tax credits to lessen the social insurance premium burden."

Two Issues to Tackle

There are a number of challenges to overcome if a refundable tax credit system is to be introduced in Japan. Below I examine two of the major challenges in detail.

The first of these is the need to create a framework for managing the system. In all the nations that offer refundable tax credits, a single taxation authority handles both the tax reductions and the provision of benefits. People who fall below the minimum income threshold apply directly to the tax authority for inclusion in the system and receive their benefits from that same authority after an examination of their situation. For salaried workers, it would be quite possible to follow the example of Britain when it first introduced its system and have their employers handle the necessary calculations in the year-end adjustment of payment records for taxation purposes.

The problem with this approach is that to include the self-employed in the system, the state must get an accurate picture of their income levels. The Japanese expression *kuroyon*, or "nine-six-four" taxation, expresses the difficulty faced here: the authorities are said to be able to monitor some nine-tenths of salaried workers' income, but just six-tenths of that of the self-employed and four-tenths of what farmers make. This leads to varying accuracy in assessing the incomes of those who make salaries and others, giving rise to unfairness in the system. Another problem is that calculating income on a household basis will require considerable extra work to square the current individual tax filing system. Overcoming these issues may require the introduction of a system of taxpayer identification numbers.

A November 2008 report issued by the National Commission on Social Security called for consideration of the introduction of a system of social security numbers. Giving each citizen a number for life would allow the centralized management of personal information connected with social security schemes, thus clarifying the balance between pension, medical care, and nursing care benefits and obligations. Ever

Whatever the end result, what Japan needs today is strong political leadership that can overcome the divisions between the bureaucratic organs in Kasumigaseki. In this sense, the achievement of a new structure for Japan's income taxation will represent a touchstone for Japan as a state whose political leaders are firmly in charge.