Dissecting the Tax Schemes of Japan's "Third Force"

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Osaka Mayor Toru Hashimoto's drive to transform public administration in Japan has drawn renewed attention since his party went national last September, but the economic policies of his Japan Restoration Party are difficult to pin down. Tokyo Foundation Senior Fellow Shigeki Morinobu uses his tax expertise to probe the substance behind the rhetoric of the party's much-debated but poorly understood platform.
http://www.tokyofoundation.org/en/t/gfxnf

At the end of August, the reform movement led by Osaka Mayor Toru Hashimoto released the final draft of its official platform preparatory to the national launch of Nippon Ishin no Kai (Japan Restoration Party). If the party makes a strong showing in the coming general election, as many predict it will, its reforms could have a profound impact on Japan's domestic economy and the lives of its people. And while Hashimoto has indicated that the Ishin Hassaku ("Eight-Point Restoration Plan") is not an election manifesto, it is all we have at this point to judge the economic policies advocated by a group that hopes to emerge as a "third force" in national politics.

Unfortunately, while the platform is long on such neoliberal principles as small government and individual self-reliance, it offers neither a clear economic vision nor specific measures for meeting Japan's immediate challenges. Nonetheless, my hope is to make use of the material available to shed some light on the substance and merit of the party's economic platform as it stands.

Overview

The Ishin Hassaku is strangely silent when it comes to numerical goals and concrete strategies for economic growth. The platform does call for boosting competitiveness on the supply side and promoting participation in free trade agreements, such as the Trans-Pacific Partnership. But the largest economic impact would doubtless come from the decentralization of public administration through a new regional system that would replace the 47 prefectures with about a dozen fiscally autonomous *doshu* jurisdictions.

Like the two major mainstream groups (one centered on the ruling Democratic Party of Japan and the other on the Liberal Democratic Party and its longtime partner, the New Komeito), the JRP seeks to set a timetable for achieving primary balance in the budget, to correct inequities in the tax burden between and within generations, to clarify the relationship between the burdens and benefits of public programs, and to rationalize and streamline social security disbursements. None of these ideas are particularly novel.

However, the platform does put forth some tax ideas that deserve closer scrutiny.

First, it calls for an "accurate tracking of personal income and assets (flow and stock) through a comprehensive national identification number system" to facilitate a new "emphasis on taxation of assets, not just flow." Under the heading of social security, it calls for "a guaranteed minimum calculated by income and assets combined" and "a limit on social security payments to individuals with income and assets." In these proposals the party sets itself apart with a commitment to rebuild the tax and social security systems with the help of a mechanism for accurately determining the value of each citizen's assets.

Also noteworthy under the categories of taxation and social security are its calls for "a negative income tax/basic income approach" and a "radically simplified tax system, i.e., a flat tax."

Finally, the document speaks of "turning the national consumption tax into a local tax and instituting an interregional fiscal adjustment system," while "abolishing the distribution of national tax revenues to local governments." The last two items are clearly oriented to the eventual adoption of a decentralized *doshu* system of regional administration.

These tax reforms, while not fully fleshed out, are by far the most concrete economic proposals the JRP offers. This reflects the basic thrust of the party's platform, which focuses on the adoption of a decentralized *doshu* system and the construction of a new tax system to raise the revenues required for such a system. In the following, I will examine these proposals one by one.

Negative Income Tax/Basic Income Approach

The term "basic income" calls to mind welfare systems that guarantee each individual a sum of money deemed necessary to maintain a basic standard of living. However, in the latest version of the Ishin Hassaku, the party makes clear that it is not proposing a new benefit but rather a system guaranteeing a minimum after-tax earned income.

The term "negative income tax" is potentially misleading as well. In its pure form, the negative income tax—as advocated by US economist Milton Friedman in conjunction with a flat tax—offers cash benefits to all those who earn less than the minimum taxable income, with the benefits calculated by applying the same tax rate to the shortfall. However, by inserting the qualification "income according to effort" in parentheses, the platform seems to suggest that this cash benefit would be available only to those who are gainfully employed. This suggests the party envisions a refundable tax credit, such as the US Earned Income Tax Credit (EITC) or the British Working Tax Credit (WTC).

As it happens, I have studied refundable tax credits, including the earned income tax credit, for over 10 years, and in 2010 I drew up a Tokyo Foundation policy proposal recommending the adoption such a tax credit. (See "From Cash Handouts to Refundable Tax Credits.") Today, with the working poor posing a growing problem for Japanese society, the nation must begin replacing its safety net with something akin to a springboard. When people slip and fall out of the market economy, we must not merely catch them but provide vocational and job training to return them to the economy again. Tax and welfare policies should also be instituted that provide incentives to work and ensure that those who do work can live decent lives (the workfare concept).

Flat Tax

While the term *flat tax* is sometimes used to refer to a single-rate income tax, scholars usually reserve it for something similar to the Hall-Rabushka flat tax. This system, which had a considerable influence on the US tax reforms implemented during the second term of President Ronald Reagan (1986–90) and continues to attract many proponents, is basically a single-rate consumption-based tax computed on the basis of value added. Since the Ishin Hassaku equates its "flat tax" with "a radically simplified tax system," it seems reasonable to assume that it is envisioning something along the lines of the Hall-Rabushka flat tax, rather than a single-rate income tax.

Let us examine how such a system works. Tax is levied on two types of added value generated by capital—individual wages (generated by human capital) on the one hand and corporate profits and interest income on the other. At the personal level, wages are taxed at a single rate, and at the corporate level, that same rate is applied to interest income and profits. Advocates claim that the system is simple enough to allow each American taxpayer to file a return using a single postcard.

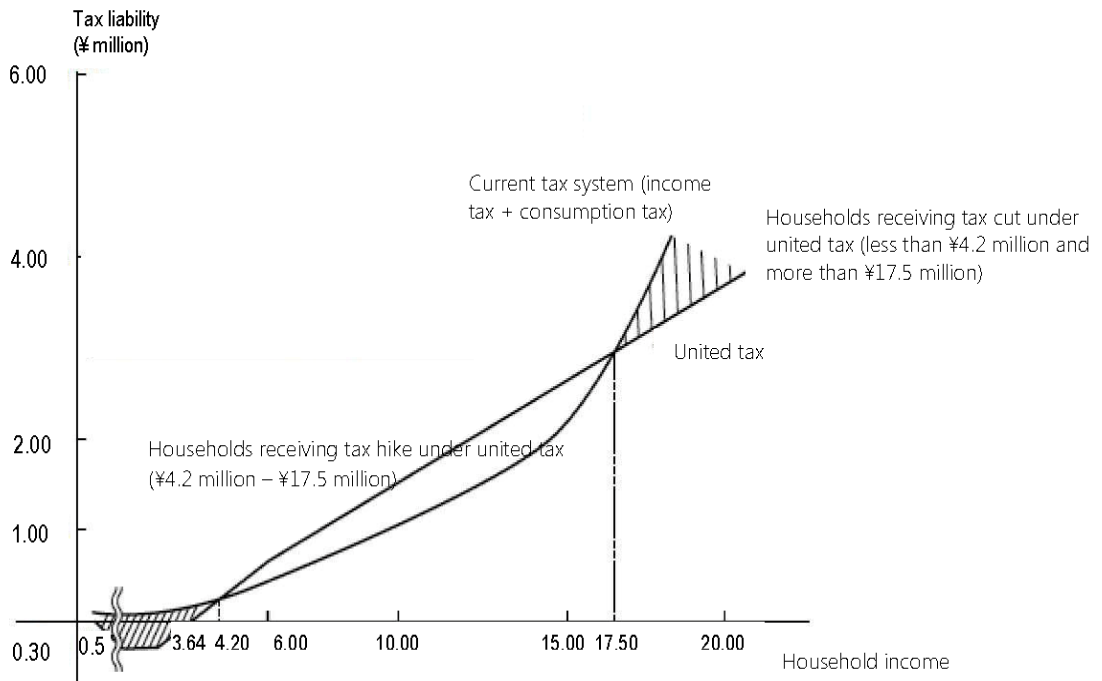
Under this system, individuals are not taxed on interest income, dividends, or capital gains. This eliminates the "double taxation" of the same earnings at the corporate level (as profits) and the personal level (as dividends). Exemptions based on household structure, together with a minimum taxable income, give it a degree of progressivity.

At the corporate level, businesses would compute their taxes by deducting employee wages and benefits, allowable purchases, and capital investment from business revenue. The system encourages capital investment by allowing businesses to deduct the full cost of plant and equipment purchases, doing away with complicated annual depreciation schedules. On the other hand, it does not treat interest payments as a deductible expense.

The basic objection to a flat tax is that a single tax rate can exacerbate income and wealth disparities. This is the rationale for pairing such a tax with a refundable tax credit that offers cash benefits for low-income individuals or households.

In 2008, I put forth just such a proposal, combining a flat tax with a refundable tax credit. I dubbed my tax system a "united tax," since it integrates the income and consumption taxes. The accompanying figure compares the annual taxes owed by households at different income levels under the current system and under the proposed united tax with the rate set so as to maintain the same level of tax revenues.

Tax Liability by Income under Current Tax System and United Tax (standard model for household of married couple and two children)



Note: Based on fiscal 2006 figures. United tax calculated on the basis of ¥3.64 million minimum taxable income (as compared with ¥3.25 million under current system), ¥70,000 personal exemption, and refundable tax credit, with no additional consumption tax levied. Current system includes consumption tax and income tax.

As the figure indicates, the united tax would reduce the overall tax bill for families with incomes up to 4.2 million yen (two-parent, two-child household), offering an incentive to work, even at lower income levels. Households earning more than 17.5 million yen annually would also benefit by a substantial reduction in the marginal tax rate, increasing their incentive to earn. However, families earning between 4.2 million yen and 17.5 million yen would see an increase in taxes. It can be anticipated that much of this added burden would be offset by the tax system's stimulatory effect on the economy. However, since the immediate result would be a tax increase for large numbers of middle-income households, winning support for such a reform could take some time.

Be that as it may, at a time of persistent economic stagnation, the JRP should be applauded for inserting a new perspective into the discussion.

Reality Check on Decentralization and Local Taxes

I agree with the JRP that Japan's highly centralized administrative structure is outdated and incapable of meeting the diversified needs of the nation, and that we need to strengthen the functions of municipal government and continue pursuing the devolution of power.

However, the JRP has called for a *doshu* system of regional administration without offering any details to clarify how such a system would operate. The Constitution of Japan establishes a unitary state and does not allow for partial transfer of the central government's legislative or judicial powers to local governments. When we talk about devolution, we must recognize that there are inherent limits to decentralization in Japan.

What Kind of Tax Should Finance Local Government?

The best tax for financing local government is one that provides stable revenues and minimizes regional disparities. It should also allow administrators and citizens to grasp the relationship between burdens and benefits. Ideally, if local residents want additional services, they should be able to make an informed choice between a tax increase and a cut in other services.

From this perspective, the taxes best suited to financing local government are direct taxes—that is, property taxes and local income taxes. Property taxes make sense to local citizens in that they place a larger burden on owners of large homes or extensive properties, who benefit more from such services as law enforcement, fire fighting, and garbage collection. In Britain, local governments rely exclusively on property taxes in the form of the council tax. Rates vary drastically, reflecting the level of services provided.

The generous social services provided by local governments in Sweden are financed exclusively by personal income taxes. In Germany, municipalities get two-thirds of their tax revenue from personal income taxes. In these countries it is clear to all that services are provided at the expense of the residents.

In this way, local tax systems should empower citizens to decide for themselves whether they want to live in a community that spends more on its police force, fire department, school system, and welfare services at the cost of higher taxes, or whether they prefer to pay lower taxes, even if it means a lower level of services.

Flaws in the Consumption Tax Proposal

What about transferring the consumption tax wholesale to the local governments, as advocated by the JRP? A local consumption tax is not an outlandish notion; indeed, Carl Shoup himself (regarded by many as the father of the value-added tax) recommended an income-based VAT as a source of local government revenue. However, the JRP's proposal for converting Japan's national consumption tax to a local tax has serious flaws.

Local fiscal responsibility requires that residents be able to grasp the relationship between burdens and benefits in any given local jurisdiction. This is not feasible with the Japanese consumption tax as it stands, since it is imposed at a uniform rate nationwide. As for allowing each local government to establish its own rate, this is impractical because—unlike the local sales taxes common in the United States—Japan's consumption tax is a multistage tax, imposed at each stage of distribution in localities around the country.

When businesses in Japan calculate the consumption tax they owe to the government, they deduct the consumption taxes they paid to suppliers from the taxes they received from customers. Let us suppose, then, that a Kanto (Tokyo area) local government adopted a consumption tax rate of 8%, while its Hokkaido counterpart set the consumption tax at 10%. A retailer in the Kanto region that purchased an item from a Hokkaido wholesaler for 400 yen (excluding tax) to sell for 500 yen would charge its customers 40 yen in consumption tax (500 yen × 8%). It would then owe the Kanto local government the difference between that 40 yen and the tax it paid to its Hokkaido supplier—namely, 40 yen (400 yen × 10%). In other words, the retailer would owe nothing to the Kanto local government, and the Kanto local government would receive no revenues from the consumption of this item, even though it was sold at a profit.

Regional differences in the consumption tax rate would also encourage businesses engaged in internet, mail-order, and telephone sales to relocate to jurisdictions with low consumption tax rates and encourage shoppers in jurisdictions with higher taxes to shop across the border where the tax was lower. These trends, in turn, could trigger a “race to the bottom” tax competition, with regions lowering their taxes in order to attract businesses, resulting in lower tax revenues for all districts. These issues help explain why only one industrial country in the world, Canada, currently uses a multilevel consumption tax as the primary source of local tax revenue.

The second problem with the JRP proposal is that the consumption tax is an important source of social security funding for the state, which has full responsibility for old-age pensions and must inevitably play a central role in healthcare as well. A portion of the revenues from the consumption tax are already shared with local governments through two systems: the so called local consumption tax and the local allocation tax. But given the soaring cost of pensions and healthcare in Japan's rapidly aging society, transferring all the revenues from the consumption tax to local governments simply is simply not a realistic option.

In fact, I have yet to hear a rational defense of the JRP's proposals for turning the consumption tax over to local governments wholesale. Surely this is the least realistic of the policies outlined in the Ishin Hassaku.

A Better Option for the Local Consumption Tax

If we approach the issue in terms of supporting a shift to greater local fiscal autonomy, a better solution presents itself. Under current law, one-fifth of the consumption tax is automatically transferred to the local governments as "local consumption tax." Under the present rate of 5%, therefore, the central government gets 4% (the "national consumption tax"), while local governments get 1% ("local consumption tax). This means that any increase in the national consumption tax automatically means an increase in the local consumption tax and that an independent increase in the local consumption tax is impossible.

The first step, then, is to separate the national and local consumption taxes, leaving them at their current rates (4% and 1%). That way, if local governments need more revenues, the rate for just the local tax can be raised to 2% or 3%. To avoid economic chaos, however, it would still be necessary to maintain a single rate nationwide and to keep the central government in charge of tax collection.

Once decentralization is a *fait accompli*, each local government would need to rely on direct taxes for the bulk of its revenues, as explained above. To supplement these, however, or to finance reductions in local corporate taxes to stimulate business activity, local governments might seek an across-the-board increase in the local consumption tax. Such choices would allow residents to more clearly grasp the relationship between burden and benefits. This is the proper role of national and local consumption taxes under a decentralized system.

Interregional Fiscal Adjustment Mechanism

The JRP calls for abolishing the system by which the central government shares tax revenues with local governments via the so-called local allocation tax, which is based on each jurisdiction's local finance plan. In conjunction with conversion of the consumption tax to a local tax, the platform also calls for an interregional mechanism for adjusting fiscal disparities. The basic goal underlying these policies is to make local governments fiscally independent from the central government in a manner consistent with a decentralized system. In this sense, the JRP is on the right track.

Problems with the Local Allocation Tax

The current local allocation tax system has a number of problems. Let us take a closer look at the system and its defects.

The ostensible purpose of the local allocation tax is to ensure that a minimum standard of government services is maintained nationwide. While guaranteeing each local government the necessary fiscal resources to maintain these standards, it also seeks to reduce regional disparities in fiscal resources by distributing funds on the basis of need. Need is determined by the Local Fiscal Plan drawn up by the central government (specifically, the Ministry of Internal Affairs and Communications). Through this mechanism, the central government intervenes in various areas of local government on the pretext of maintaining a national minimum standard in government services. In much the same way, individual ministries intervene in local government through the allocation of various grants.

This reliance on funds from the central government severs the link between burdens and benefits at the local level. Since neither the local government nor the local citizens feel the burden of the government services provided, there is little incentive to exercise fiscal responsibility, and local the budgets have a tendency to become bloated and inefficient.

The obvious answer is to transfer fiscal authority—including the raising of tax revenues—to the local governments. But without some mechanism to compensate for the interregional disparities in revenue-raising capacity, economic disparities are likely to increase. We need a system that can mitigate such inequities without heavy-handed interference by the central government. By calling for an "interregional fiscal adjustment system," the JRP appears to be proposing a method for sharing resources horizontally.

Challenges of Horizontal Equalization

Under Japan's current system of vertical transfers, the central government supplements the revenue of the less affluent prefectures and municipalities through the local allocation tax. However, this still leaves a jurisdiction like Tokyo Prefecture with a superabundance of tax resources compared with many rural prefectures, despite the fact that it receives no local allocation tax at all.

By contrast, under the horizontal equalization system used in Germany and Sweden, local governments pool their revenues and share them according to need. In Japan's case, this would mean taking Tokyo's abundant tax revenues and parceling them out among prefectures with fewer resources. Leaving aside the political feasibility of such a plan, the constitutionality of imposing local taxes on one jurisdiction to spend on another is open to question.

In 2008, the Japanese government introduced a "special local corporate tax," designed to help close the huge disparity in corporate tax revenues between Tokyo and the outlying prefectures, such as Okinawa. The way it works is that one-half of the prefectural enterprise tax is remitted to the central government, which redistributes it to the prefectural governments on the basis of demographic and economic factors. Despite the relatively small amount of revenue involved (about 2.5 trillion yen, or 1% of the revenue from the consumption tax), this provoked a backlash among the wealthier jurisdictions. In December 2011, the governors of Tokyo Metropolis and Osaka, Kanagawa, and Aichi prefectures submitted a letter to the government demanding that the new system be repealed. Among the signers was Toru Hashimoto, then governor of Osaka Prefecture.

If the wealthier jurisdictions (including Osaka) object to a transfer of resources on this order, one can hardly expect them to stand for a horizontal transfer scheme in which all local revenues are subject to redistribution.

The economic platform of the JRP is a work in progress. It raises important issues and suggests a way forward for the nation. Unfortunately, most of its proposals are excessively vague, and several—including the call to turn the consumption tax over to local governments—are impractical. The party should move as quickly as possible to refine its policies, draw up a realistic timetable for implementation, and let the debate begin in earnest.