

# Arguments Regarding the Japanese Consumption Tax and Reduced Tax Rates

An overview by **Professor Morinobu Shigeki**

## An Increase in the Consumption Tax Rate and Measures to Alleviate Its Effects on Low-Income Earners

The Japanese consumption tax will be raised in two stages: first, from its current rate of 5% to 8% in April 2014, and then from 8% to 10% in October 2015, as decided by law. The Act for a Partial Revision of the Local Tax Act and the Local Allocation Tax Act to Overhaul the Tax System to Secure a Stable Revenue Source for Social Security stipulates that “the upward revision of the consumption tax shall be executed on the condition that this action brings the economy out of its slump.” The Japanese government will be making a final decision on its tax rate revisions after observing economic conditions in the fall of 2013 and the spring of 2014, six months before each rate revision. Based on its economic policies, popularly known as Abenomics, the government is expected to raise the consumption tax rate to replenish public finances.

Measures to prevent the tax from being regressive (measures to alleviate its effects on low-income earners) are the greatest problem the government faces in raising the tax. As one measure, the Act stipulates that the government study three ideas in connection with this problem—namely, tax credit with benefits, multiple tax rates (reduced tax rates), and simple benefits—including when they should be introduced. Whether to introduce reduced tax rates when the consumption tax is raised to 10% is a particularly big point of contention. In February 2013, the government and the ruling Liberal

Democratic Party (LDP) agreed to “aim at introducing” a reduced tax rate “when the consumption tax rate is increased to 10%.” The government and the LDP are planning to resolve this issue in their discussions on tax system reforms at the end of 2013. In this article, I will make the following arguments for reduced tax rates, benefits, and tax credit with benefits.

## What Does Regressive Mean?

What is meant by regressive is the starting point for discussions. “Regressive” refers to the condition in which the ratio of the consumption tax burden to income falls as income rises, and rises as income falls. High-income and low-income earners bear the consumption tax at the same rate as their consumption. The amount of the consumption tax borne also increases as income rises. However, the phenomenon stated above occurs because, as the ratio of the consumption tax burden to income shows, high-income earners allocate a lower percentage of their income to consumption (show a lower consumption propensity). This phenomenon is considered to be a problem from the viewpoint of vertical equality, or from the perspective of “asking high-income earners to bear higher tax burdens,” which is the most important principle in a tax system.

So, what is the degree to which Japanese family budgets will actually bear the consumption tax? According to the materials submitted to the Japanese government’s Tax Commission, the ratio of the consumption tax burden to income certainly rises as earnings decrease. However,

progressivity, or the tendency for tax burdens to grow with the size of income, is secured when tax burdens with a progressive structure, such as income taxes and inheritance taxes, are additionally taken into consideration.

Furthermore, economists take the view that regressiveness is greatly overcome or there is little regressiveness when the lifetime tax burden, instead of the tax burden a family budget bears for a specific period, is considered. In other words, the lifetime consumption behaviors of individuals show that consumption tax burdens increase in proportion to the size of their lifetime income. Based on this tendency, economists believe that tax burdens become proportional, instead of regressive, on a lifetime basis.

This is certainly the case if we look at the lifetime of a given individual. He or she often borrows money for consumption during the periods when his or her income is small. The consumption tax burden becomes regressive in these periods. However, savings increases and the consumption tax burden decreases as income rises. We can therefore say that the consumption tax burden is proportional, instead of regressive, to income on a lifetime basis. Put another way, “the lifetime income of an individual equals his or her lifetime consumption” unless the property the individual leaves behind is taken into consideration.

As shown above, there are different ways of viewing how regressive the consumption tax is. However, measures to alleviate its effects on low-income earners are an extremely important political issue regardless of these views. Both when it first introduced the consumption tax and when it has revised the consumption tax rate upward, the

Japanese government has taken very generous measures to alleviate the effects on low-income earners in the areas of both annual expenditures and annual revenue.

There are two specific ways to alleviate the effects of a consumption tax increase on low-income earners. Phasing in reduced tax rates to the consumption tax is one approach. The second approach is to refund to low-income earners the consumption tax burden that corresponds to their basic consumption expenditures in the form of benefits. I will compare the advantages and disadvantages of these two methods next.

## The Problems of a Reduced Tax Rate

Reduced tax rates are burden-lightening measures that are easy for people to understand. In fact, all European countries apply reduced tax rates to food and the like, with the exception of Denmark. In other words, European countries impose reduced taxes, lower than standard taxes, on food and other daily necessities. Or they don't impose any taxes on these items at all (zero tax rate), as in Britain. This is a practice that was authorized under a European Union (EU) directive, which sets consumption tax guidelines for European countries. Major consumption items, to which the application of reduced tax rates is authorized under the EU directive, include food and beverages intended for human and animal consumption (excluding alcoholic beverages), water supplies, pharmaceuticals, passenger transportation, books, newspapers, periodicals, and admission fees and other charges to shows, theaters, circuses, special events, amusement parks, concerts, museums, zoos, movies, exhibitions, and similar cultural events and facilities.

However, many problems have emerged in the EU member states that have introduced reduced tax rates.

The scope of application of reduced tax rates is one problem. The disputes that arose between industries and tax authorities over the scope of application of reduced tax rates have led to lawsuits

The Japanese consumption tax will be raised from its current rate of 5% to 8% in April next year, and from 8% to 10% in October 2015. Pictured, a shopper in Tokyo looks for loose change.

and other issues.

To give an example of the disputed points, a reduced tax rate (or zero tax rate in the case of Britain) is applied when we order a hamburger to go at a McDonald's, because taking it out makes the order a foodstuff. However, a standard tax rate is applied to the hamburger if we order to eat it at the McDonald's store, because this action makes it food served at a fast-food restaurant. In Germany, McDonald's branches offer all their products to customers at the same price, even though different tax rates apply to takeout orders and orders eaten on the premises, because of the possibility that a consumer might buy a hamburger for takeout, but then change his or her mind and eat it on the premises (use the restaurant service) after ordering. In Britain, the state government introduced a concept called "hot food" to avoid this confusion, based on a criterion for classifying fast food. The criterion used to classify an applicable food as a foodstuff or a food served at a restaurant is whether it is hot or not (heated or not).

In another example, British tax authorities view the manufacture and sale of "children's clothing," which far and away outnumbers the children, as a problem, because a reduced tax rate is applied to kids' clothing.

Establishing a rational and specific scope for reduced tax rates has become difficult, as business categories have diversified and the distinction between providing services and supplying goods has become blurred. The cost of managing tax systems has risen as a result of these changes.

Doubts about the policy consequences of measures to alleviate the effects of a consumption tax hike on low-income earners is another problem. High-income earners not only enjoy the benefits of reduced tax rates, but they



also enjoy them in greater proportion, because the absolute amount they spend on food is higher.

In the Mirrlees Review, public finance scholars from around the world made a tax system proposal to the British government through a think tank called the Institute for Fiscal Studies (IFS), with James Mirrlees, a Nobel laureate in economics, at the center. The Review points out that the "income redistribution effects generated by reduced tax rates are limited" and that "reduced tax rates are nothing but political performance."

The biggest problem with reduced tax rates is the drop in revenue that results from their introduction. Standard tax rates must be raised sharply to make up for the lost revenue when reduced tax rates are introduced. For example, tax revenue matches revenue from taxes at the single rate of 9% if the standard tax rate is 10%, the reduced tax rate is 5%, and expenditures on food and the like make up 20% of all consumption in value ( $10\% \times 0.8 + 5\% \times 0.2 = 9\%$ ). There is a shortfall of 1% (2.5 trillion yen) in this case.

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### Benefits as an Alternative Measure to a Reduced Tax Rate

Countries that have recently introduced a consumption tax are making it a policy to avoid reduced tax rates as much as possible, due to the problems stated above.

For example, Canada's income tax system deducts and refunds to low-income earners an amount corresponding to the minimum required consumption expenditure. This practice is called the goods and services tax (GST) credit. Specifically, the basic design for the GST credit is to calculate the basic living expenses of low-income earners based on the results of family income and expenditure surveys, deduct an amount equivalent to 7% of these expenses (an amount corresponding to the consumption tax rate when it was introduced) from the amount of income taxes based on the family's structure, and refund the portion of expenses that can't be deducted in full.

The amount of tax credit is calculated based on a married couple's income, excluding social insurance premiums (or personal income if the person concerned is single), the presence or absence of a spouse, and the number of children. For example, a married couple with two children is entitled to a refund of up to C\$738 (approximately JPY 78,000 in fiscal 2007). The amount of tax refunded decreases if their income totals more than C\$32,514 (approximately JPY 3,450,000). (The amount of tax refunded falls in 5% increments to

zero, corresponding to the excess portion.) Taxpayers apply for the tax refund when they fill out their income tax return. The tax refund is split into four installments a year and is paid by check in January, April, July, and October. Singapore has also introduced a system that is similar to the Canadian GST credit.

The goods and services tax in New Zealand can also be cited as a successful example. New Zealand imposes a GST on all goods and services at a standard rate of 12.5%, without exception. This is a value-added tax, which has the widest tax base in the world. This is the GST that has the most neutral effect on the economy. However, New Zealand is alleviating the GST's effects on low-income earners through measures such as highly effective tax credit with benefits. The New Zealand government has introduced different tax credit with benefits, with the Working for Families Tax Credits (WfFTC) at the center. The WfFTC was painstakingly designed to vary according to the size of a family's annual income, its number of school-aged children, and their ages. The WfFTC consists of the Family Tax Credit, which supports families with dependent schoolchildren less than eighteen years of age, the In-work Tax Credit, which supports working families, and the Minimum Family Tax Credit, which guarantees a minimum income to working families with a small income. The WfFTC coexists with the Independent Earner's Tax Credit, aimed at reducing the individual burdens of middle-income earners. (The Independent Earner's Tax Credit

is a tax exemption through the withholding system. Using this credit in combination with the WfFTC is not allowed. The credit offers no tax refund.) The tax system and Social Security are designed in an integrated manner, as these multiple layers of different tax exemptions show.

As a result, a value-added tax (VAT), with a single tax rate, was able to be introduced under the conditions of a comprehensive tax base. The VAT is believed to have lowered the cost of carrying out tax affairs on the part of taxation authorities and to have reduced the cost of tax compliance on the part of taxpayers.

A taxation infrastructure that enables an accurate understanding of low-income earners is necessary to build such a system. Canada, New Zealand and Singapore have introduced taxpayer identification numbers (TINs) for this purpose. In Japan, taxation authorities have no information on non-taxpayers whose earnings are below the minimum taxable level. They must work closely with the Social Insurance Agency, the Ministry of Health, Labour and Welfare, and local governments, which know the income of these households and people, and exchange information with them using TINs. A TIN system must also be introduced to accurately determine family income. The Japanese government has successfully introduced the TIN system, applicable to six fields, including tax and Social Security. The government is expected to make the most of this system, which is scheduled for introduction in 2016.

As explained above, preferential tax rates present problems as measures for alleviating the effects of a consumption tax hike on low-income earners. The author believes that tax credit is more desirable than reduced tax rates, with a strong hint of political performance until the consumption tax rate reaches 10%. A more comprehensive tax base is one of the advantages the consumption tax has over income taxes. Japan should retain this advantage as much as possible. ■

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