Issues in Corporate Tax Reform

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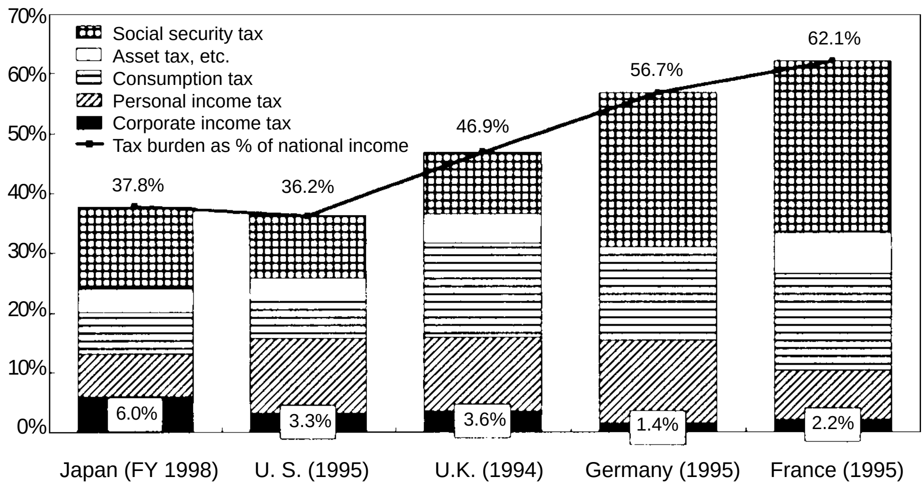
1. Introduction

Japan's economy is at a major turning point. Confronted on the one hand with a serious recession and bleak outlook, the economy is at the same time globalizing at a rapid pace as the Big Bang and other market oriented measures introduce greater international competition. Structural reforms to reinvigorate the economy are a top priority, and corporate tax reform is being addressed as the key to unlock the source of vitality, the corporate sector.

In this paper, we look at the present status of the corporate tax, which has been criticized as an impediment to corporate activity, examine international trends in corporate tax reform among leading economies that have successfully been reinvigorated, and suggest perspectives for corporate tax reform in Japan.

Figure 1 International Comparison of Tax Burdens



Note: Values in boxes denote corporate income tax as a proportion of national income.
Source: Government Tax Commission survey.

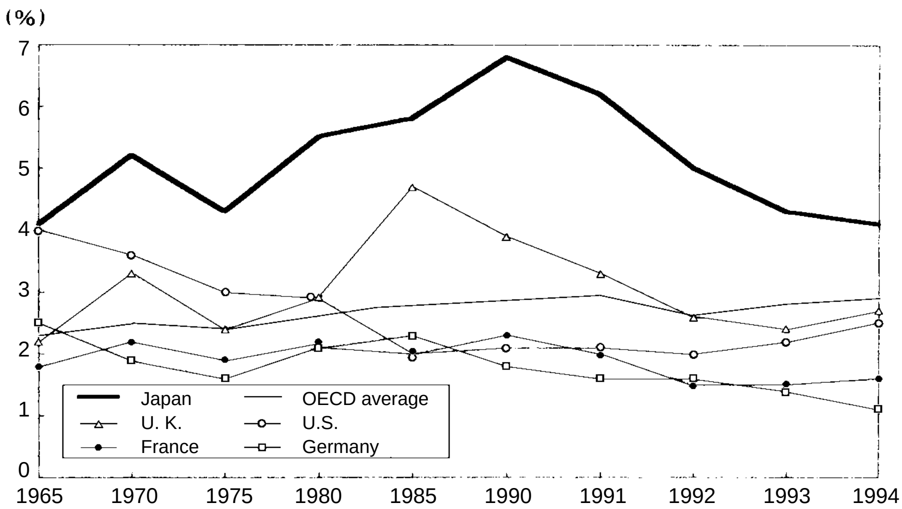
2. Present Status of Corporate Tax Burdens—An International Comparison

(1) The Macroeconomic Perspective

In addition to a tax burden, the general public also shoulders social security costs through pension premiums and the like. The public burden ratio compares all of these burdens against the national income. Japan's public burden ratio of 37.8 percent is low compared to other industrialized nations. On the other hand, the corporate tax burden in Japan comprises 6.0 percent of national income, which is extremely high by international standards—3.3 percent in the U.S., 3.6 percent in the U.K., 1.4 percent in Germany, and 2.2 percent in France.

This is also clear from looking at the ratio of corporate tax burden to nominal GDP. Since 1965, compared to the OECD average of 2 to 3 percent, Japan's ratio has ranged from 4 to 7 percent.

Figure 2 Corporate Tax Revenue as Percentage of Nominal GDP



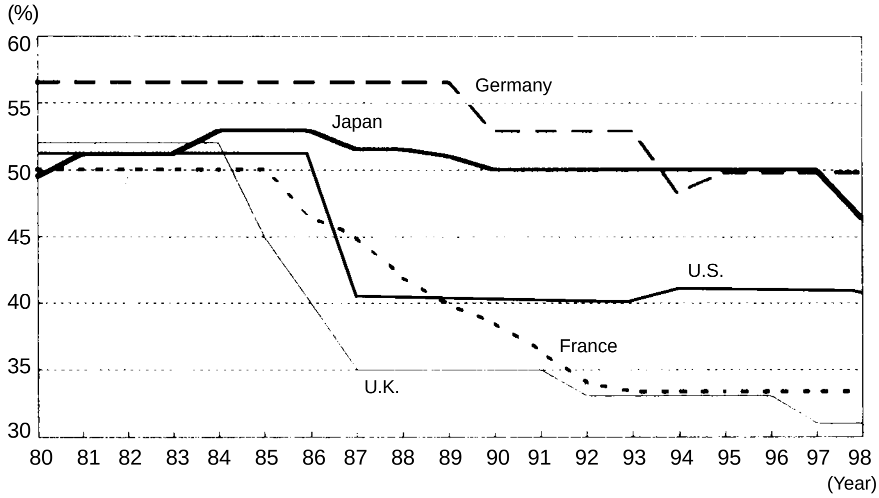
Source: Compiled from OECD, *Revenue Statistics 1965-1995.*

(2) The Microeconomic Perspective

Corporate income is taxed not only at the national level (corporate tax), but at the local level through corporate inhabitant taxes (prefectural and municipal) and the corporate enterprise tax. Thus to see the overall corporate tax burden, we must look at the effective tax rate resulting from taxation at all levels.

Until the early1980s, the effective tax rate was relatively low by international standards. But while corporate tax rates subsequently fell in other industrialized countries, Japan went in the opposite direction. Although the tax reform of fiscal 1998 trims the effective tax rate to 46.36 percent, it is still well above international levels.

Figure 3 Effective Corporate Tax Rates



Source: MOF, *Ministry of Finance Statistics Monthly.*

Thus the corporate tax burden in Japan substantially exceeds international levels both in macroeconomic and microeconomic terms. To encourage corporate activity, corporate tax reform is needed to bring the corporate tax burden in line with international levels.

3. Global Trends in Corporate Tax Reform

(1) Supply Side Economics

When the oil shocks of the 1970s brought both inflation and stagnation to industrialized economies, the limits of Keynesian policies in managing aggregate demand were recognized. Against this backdrop, there emerged a new approach claiming that economic stagnation was caused by supply side factors. Supply-siders argued that over-taxation and over-regulation by big government discouraged private investment and stifled economic activity. The solution was to reinvigorate the private sector by reducing the size and role of government through tax cuts, deregulation, and government spending cuts.

(2) Global Standards for Taxation

With regard to taxation, the emphasis was on reducing its impact on the private sector economy, and invigorating savings and investment on the supply side. This approach spread among the industrialized economies, from the Reagan administration, Thatcher government, and succeeded in revitalizing economic strength. The neutrality of taxation with respect to economic activity became a global standard, and Japan’s tax reforms were no exception.

Corporate tax reforms sought to reduce the impact of taxation on corporate activity by cutting tax rates and broadening the tax base, thereby enhancing the market's resource allocation function.

(3) The Lesson of Reaganomics

The Reagan administration sought to invigorate the private sector by implementing deep personal income tax cuts and preferential measures to encourage investment. Inflation was put under control, and during the extraordinary expansionary phase lasting seven and a half years from 1983, unemployment fell from 9 percent to 5 percent. Reaganomics was thus credited with being highly effective in building the economy's foundation for growth.

However, the tax revenue growth expected to come from the reinvigorated economy did not materialize, while growth in military spending frustrated attempts to reduce government spending. Consequently, the budget deficit shot up almost threefold from $79 billion in 1981 to $221.2 billion in 1986.

In the 1986 tax reform, along with reductions in both personal and corporate income tax rates, the tax base was expanded by eliminated preferential tax measures. Although the fiscal deficit improved to $149.8 billion in 1987, however, deficit problems persisted.

Japan today must address the issue of fiscal reform. The government must be scaled down, the private sector invigorated, and the fiscal deficit reduced. Discussions over tax cuts tend to overstate the impact of tax cuts in stimulating the economy, increasing tax revenue, and achieving fiscal balance. If we are to learn anything from Reagonomics, it is that we should focus relentlessly on reducing government spending and increasing the efficiency of spending.

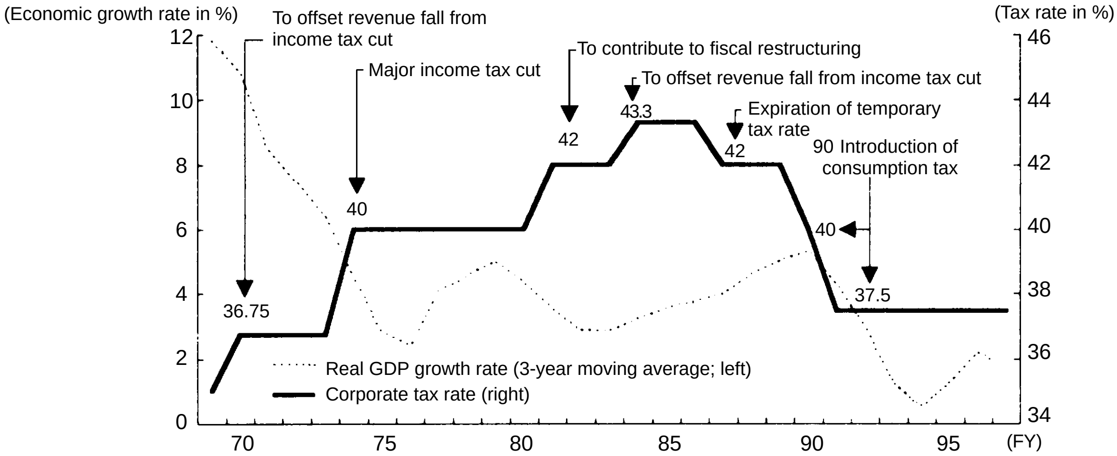
4. Key Points in Corporate Tax Reform

(1) Raising Awareness of the Corporate Tax Burden

Amid the global trend toward lower corporate tax rates, Japan's opposite trend has occurred against the backdrop of a weak concern over corporate tax hikes, which are less objectionable than raising the personal income tax and consumption tax, and strong economic growth that has enabled companies to shoulder the burden. The propensity to resort to corporate tax hikes is apparent in tax reforms since the 1970s, which have offset personal income tax cuts and fiscal restructuring costs by raising the corporate tax.

However, the high corporate tax burden does eventually affect the broader public when corporate growth becomes sluggish, dividends fall, and people lose jobs. It is thus critical that corporate tax reform be carried out with adequate public awareness of the corporate tax burden.

Figure 4 Economic Growth Rates and Basic Corporate Tax Rates

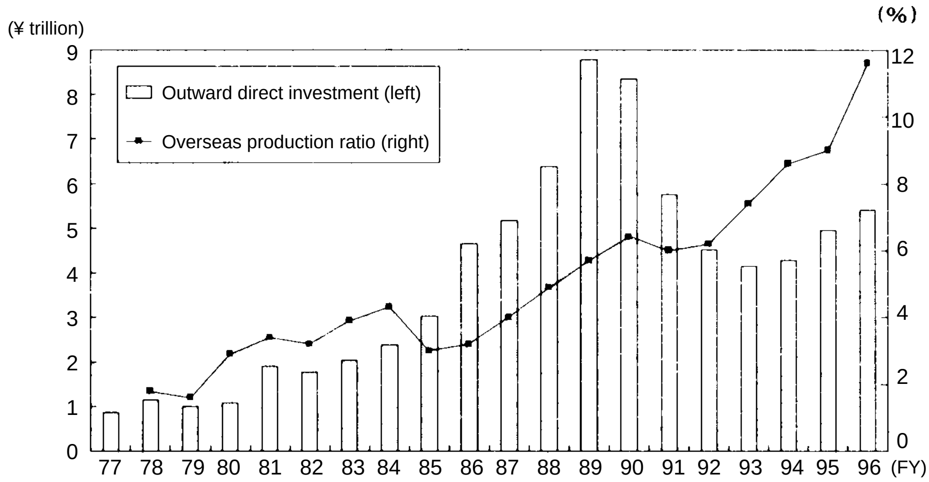


Note: Real GDP growth rate for FY 1997 is a forecast by NLI Research Institute.
Sources: Tax Commission; EPA, *Annual Report of National Accounts.*

(2) Aligning the Effective Tax Rate with International Levels

There is concern that Japan's high corporate tax burden is one cause of the economy's deindustrialization by encouraging companies to move operations overseas. Since the 1980s, the strong yen has encouraged direct investment and production overseas as companies move increasingly abroad. This is an inevitable aspect of the globalization of economic activity, and not necessarily caused by the corporate tax burden alone. However, unless the effective tax rate approaches the international level, Japan's market will continue to lose its appeal and the exodus will continue. There is an urgent need to create economic conditions that conform to international standards.

Figure 5 Outward Direct Investment and Overseas Production Ratio



Sources: MOF, *Reported Outward Direct Investment;* MITI, *Survey of Overseas Business Activities.*

Table 1 International Comparison of National and Local Effective Tax Rates

(Unit: %)

	National tax rate	Local tax rate	Total
Japan	31.08	15.28	46.36
U.S.	31.91	8.84	40.75
U.K.	31.00	–	31.00
Germany	34.18	15.61	49.79
France	33.33	–	33.33

Notes: 1. Japan's local tax rate consists of a corporate resident tax of 5.37% and corporate business tax of 9.91%.
2. California's tax rate is cited as a typical local tax rate for the U.S.
Source: Tax Commission

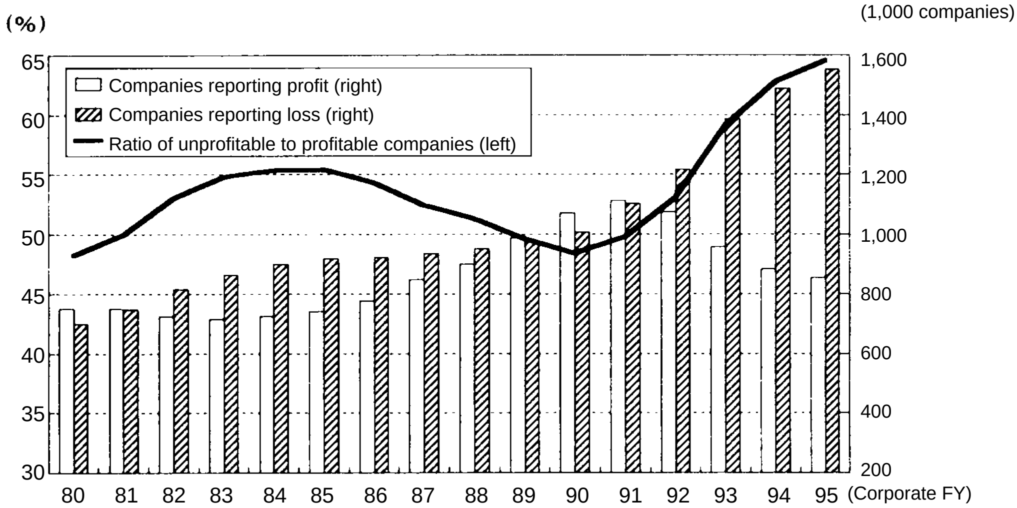
While the fiscal 1998 tax reform reduced the national corporate tax rate, local tax rates were unaffected. This is a matter that clearly needs to be addressed in future reforms, since local taxes are the main reason Japan's high effective tax rate remains high by international standards.

(3) Broadening the Tax Base

Companies are also hindered by the inequities in the corporate tax burden that arise from the tax base.

According to tax statistics, approximately 65 percent of corporations nationwide report a loss and thus do not pay any corporate tax. This means that the rest must shoulder the entire tax burden, even though all companies are entitled to the same public services. Such inequity encourages companies to manipulate their books to reduce their tax burden, while shifting the burden to the stronger companies being counted on to pull the economy out of its slump. To correct this inefficiency in tax collection, the Tax Commission is considering a corporate enterprise tax assessed on objective indicators of business size such as sales or number of employees.

Figure 6 Profit Status of Corporations



Source: National Tax Agency, *Condition of Incorporated Enterprises Based on Tax Statistics.*

Moreover, since some of the loss-reporting corporations are actually individual proprietorships claiming to be corporations, this issue needs to be studied in association with personal income tax reform.

Inequities also exist across industries due to industry-specific tax measures. Many of these preferential measures, which were derived from economic policies intended to alter resource allocation, are outdated and actually harmful to today's economy. These impediments must be eliminated from the tax system to broaden the tax base and allow the market to efficiently allocate resources.

5. Conclusion

To unblock the economy from its present stagnation, Japan urgently needs to follow the global trend in corporate tax reform while moving increasingly toward a market economy. These efforts are all the more important considering that EU integration is expected to accelerate global restructuring and intensify competition.