

# *AJISS-Commentary*

**The Association of Japanese Institutes of Strategic Studies**

**IIPS**

Institute for International  
Policy Studies

**JIIA**

The Japan Institute of  
International Affairs

**RIPS**

Research Institute for  
Peace and Security

Editorial Advisory Board:

Akio Watanabe (Chair)  
Masashi Nishihara  
Yoshiji Nogami  
Taizo Yakushiji

Editorial Committee:

Taizo Yakushiji  
Hisayoshi Ina  
Tsutomu Kikuchi  
Shujiro Urata and  
Toshiro Iijima

Editor & Online Publisher:

Yoshiji Nogami  
President, JIIA

No. 205

5 September 2014

## **TAX SYSTEM REFORM COMPATIBLE WITH FISCAL SOUNDNESS**

***Toshihiro Ihori***

The Japanese government confirmed its policy of pursuing fiscal soundness in its “Large-boned Policy 2014,” declaring that “the government will deliberate on the budgeting for FY2015 and other matters to present as soon as possible a concrete path toward achieving a primary balance (PB) surplus in FY2020.” It also established a policy direction of reducing effective corporate tax rates by “pursuing reforms to promote direct investment from abroad in Japan,” but did not venture any further details. Efforts will continue until the end of the year to work out the specifics with members of the ruling coalition concerned about lowering tax rates without ensuring stable revenue sources.

*The views expressed in this piece are the author’s own and should not be attributed to The Association of Japanese Institutes of Strategic Studies.*

Tax increases constitute the tax system reforms most directly tied to greater fiscal soundness. The consumption tax rate was raised from 5% to 8% in April of this year and is due to be raised to 10% in October 2015, but the final decision on this latter hike will be made sometime near the end of this year. Abenomics is simultaneously intent on flexible fiscal administration and fiscal reconstruction through higher consumption taxes. Indeed, it is extremely difficult to segregate fiscal reconstruction from flexible fiscal administration.

As it would be politically unviable to raise taxes if the macro-economy is not doing well, a supplemental budget exceeding 5 trillion yen was compiled at the end of last year when the decision was made to raise the rate to 8%. A similar substantial increase in expenditures in this fiscal year's supplemental budget could prove an effective short-term economic measure, but the end result would be a negative one for fiscal soundness and make it increasingly difficult to achieve the government's objective of balancing basic revenues and expenditures by 2020.

Medical costs and other social security expenses will rise sharply by the 2020s as the baby-boomer generation reaches its 80s, and further rises in the consumption tax rate and other tax increases appear unavoidable. Although improving the efficiency of social security benefit payments to restrain costs is an important option, of course, a necessary minimum tax increase is nonetheless inevitable.

It is true that corporate tax hikes are an impractical means of fiscal reconstruction. However, there is also strong political resistance to lowering corporate tax rates in order to stimulate the economy. Tax increases in Japan have traditionally focused on corporate taxes and taxes imposed on large companies. As income taxes were being lowered until the 1980s, corporate tax rates were being raised to secure revenues, and there is no guarantee that this "boost corporate taxes when times are tough" approach will not be repeated in future.

Given Japan's challenging fiscal circumstances, broadening the tax base while lowering corporate tax rates seems a realistic compromise to head off a decline in corporate tax revenues. However, simply lowering corporate tax rates

on the condition that corporate tax revenues be maintained is of limited effectiveness in stimulating the economy. If the emphasis is to be placed on the benefits of this approach for economic revitalization, then corporate tax rates will need to be drastically lowered and the rates for consumption tax and other taxes raised. Steps will also need to be taken to reform the tax system overall rather than just to secure revenues by increasing consumption taxes.

Although the weight of the tax burden will inevitably shift toward consumption tax, the tax base must also be expanded through income tax reform to secure tax revenues. An obvious choice is reconsidering the spousal deduction that gives tax benefits to full-time housewives so that the tax system can be made neutral vis-à-vis the social advancement of women. A major premise in tax increases is ensuring efficiency and fairness in fiscal matters. If the public can be persuaded that tax money is being put to good use, high consumption tax rates such as those in Scandinavia will enjoy public support. A taxpayer number system should be promptly introduced and an efficient and fair tax collection environment put into place. 

*Toshihiro Ihori is a professor of economics at the Faculty of Economics, University of Tokyo, and he is also a member of Fiscal System Council of the Ministry of Finance.*