

THE PROGRESS OF THE JAPANESE NATIONAL CONSUMPTION TAX



Vicki L Beyer

Assistant Professor of Law
Bond University
and

Koji Ishimura

Professor of Law
Asahi University
Japan

On 1 April 1989, a broad-based national consumption tax went into effect in Japan. The tax was unpopular, but is gradually being accepted. In the four years since its inception, the tax has undergone a few minor adjustments to facilitate its smooth operation, but, unlike consumption taxes in many jurisdictions, has yet to see a rate rise. This is partly because of public reluctance toward the tax. This article surveys the history of the Japan's national consumption tax, analyses the structure of the tax and its reception by taxpayers, and comments on its future.

History

The Consumption Tax Law,¹ which came into force on 1 April 1989, was not the first such law to be enacted in Japan. Introduction of a value added tax was one of the recommendations of the Shoup Mission, a group of seven American economists and tax specialists who spent four months in 1949 examining Japanese public finance.² The tax, a modification of the prefectural enterprise tax, was based on "total gross receipts minus all purchases from other firms, including purchase of capital equipment, land, and buildings".³ Although a law implementing the proposed tax was enacted in 1950,⁴ the tax was so unpopular with the business community that a

-
- 1 Shohizeiho (Law No 108, 1988). English translation in *Japan - National Consumption Tax Law*, CCH International, 1989. Hereafter cited as "Consumption Tax Law".
 - 2 Saburo Shiomu, *Japan's Finance and Taxation: 1940-1951* (Columbia University Press, New York, 1957) 79.
 - 3 Shoup Mission, *Report on Japanese Taxation, Vol II* (Tokyo 1949) 201. This is an income-type VAT, like the Single Business Tax currently in force in the State of Michigan. See, eg, Kasischke, "Computation of the Michigan Single Business Tax: Theory and Mechanics" (1976) 22 Wayne LR 1069.
 - 4 *Chiho Zeiho* (Regional Taxation Law) Law No 226, 1950.

moratorium was placed on its enforcement.⁵ In 1954, the untried law was repealed.⁶

The necessity of a broad-based consumption-type tax arose again in the 1970s, when the oil shocks slowed the Japanese economy and a need for "fiscal reconstruction" became apparent.⁷ The government was operating at a deficit and needed to either generate more revenue or spend less.

In 1979, a value added tax was proposed again.⁸ Once more it was opposed by the small business sector, which claimed that the proposed tax was both inequitable and unnecessary. Taxpayers felt the solution was for the government to spend less. Clearly a more cohesive package and a campaign to promote public acceptance were necessary.

From 1983 to 1986, a variety of studies and tax reform proposals were prepared by government, academia, trade unions and the business community. In general, the main problem recognised by all sectors was taxpayer dissatisfaction with the distortions created by the operation of the post-war tax system in the existing economic climate.

The studies agreed that the tax base needed to be broadened. Government, academia and business all advocated more indirect taxation. In particular, government and big business wanted a broadening of the tax base to include consumption of more and different types of commodities and possibly even services. The taxation of services, it was argued, would contribute to the creation of an equitable tax system, since consumption patterns had shifted from purchases of durable consumer goods to more diverse consumption of both goods and services.⁹

The trade unions were strongly opposed to any sort of broad-based consumption tax,¹⁰ doubtless because of its regressive nature.

In 1987, on the heels of these studies and reform proposals, the government of Yasuhiro Nakasone introduced tax reform legislation that included cuts in personal income taxation, elimination of the savings interest exemption, a reduction in the corporate taxation rate (accompanied by

5 Japan, Ministry of Finance, *An Outline of Japanese Taxes*, 1991 (hereafter cited as "MOF, 1991") 7.

6 *Chiho Zeiho no ichibu wo kaisei suru horitsu* (A law partially amending the Regional Taxation Law), Law No 95, 1954; cf, Hiroshi Kaneko, *Sozeiho* ("Taxation Law") (3rd ed, Tokyo: Kobundo, 1990) 67. Reflecting on this ill-fated tax, Dr Shoup said in 1988, "the value-added tax was a brand new concept, and perhaps it was asking too much of the prefectures to take it on": see "Japanese Taxation: The Shoup Mission in Retrospect, an Interview" *Japan Foundation Newsletter* Vol XVI, No 4, pp 3-4.

7 Hiromitsu Ishi, *The Japanese Tax System* (Oxford 1989) (hereafter cited as "Ishi, *System*"), p 272.

8 *Ibid*, p 273.

9 *Ibid*, p 284.

10 M Homma, T Maeda and K Hashimoto, "Japan", in Joseph A Pechman (ed), *Comparative Tax Systems* (1987) (hereafter cited as "HM&H"), p 432.

inclusion of capital reserves in the tax base), and the introduction of a 5% broad-based value added tax.¹¹

The value added tax, dubbed a sales tax, was to be calculated on a tax credit method. Firms maintained invoices to obtain credit for taxes already paid on the same goods by other firms.¹²

In spite of the studies and the public discussion they generated, the general public had not been convinced that tax reform was necessary. The reform package met with widespread opposition and was quickly withdrawn. Within a few months, Nakasone was no longer Prime Minister of Japan.

Tax reform remained an issue. Nakasone's successor, Noboru Takeshita, requested the Tax Advisory Commission to prepare proposals designed to deal with two problems: the need to secure stable revenues in light of the rapid ageing of Japanese society, and the need to produce a system that balanced taxation of income, consumption and property.¹³ Although this was a new approach, Takeshita's goals were no different from Nakasone's: to revamp the system to produce greater equity and secure long-term revenues.

When the Nakasone government was saying only that the existing tax system was inequitable, taxpayers fell into two camps: those who stood to gain from change and those who stood to lose. In focusing on the ageing society, the Takeshita government gave people a social cause to rally behind. Everyone stood to lose if the system was not changed.

While this strategy resulted in public acceptance of the necessity for reform, there still remained the task of constructing acceptable reforms. The goal was an equitable system that was simple to administer and produced an appropriate level of revenue. The inequity was seen largely as a horizontal failing; ie, like-situated people were not being taxed alike. The obvious solution was to broaden the tax base. In other words, the task was to find ways to tax wealth not presently subject to taxation.

The Tax Advisory Commission's solution was a fairly light tax on the consumption of a broad range of goods and services.¹⁴ The existing indirect tax system was limited in what it taxed, thereby severely distorting economic choices. To effect an improvement, the proposed broad-based tax would have to meet several criteria. It had to be simple, neutral with respect to economic activities, and have low administration and compliance costs.

The consumption tax that was ultimately adopted¹⁵ purported to meet these criteria. It was broad-based (with only a few exemptions), had a low rate, could be calculated by businesses using existing books of account, and contained some special measures to make it easier for small businesses.

11 Ishi, *System*, pp 280-281.

12 Ibid, p 308.

13 MOF, 1988 pp 271-272; Ishi, *System* pp 281-282.

14 Ishi, *System* pp 280-281.

15 Above n 1.

Many aspects of the structure of the tax represent compromises by the government in its attempt to win public favour.

The only taxes eliminated to make way for the Consumption Tax Law were a few excise taxes. Other compensation for the increased tax burden was by way of an increase in the personal tax exemption and a reduction in income tax rates.¹⁶

To prevent the public debate from heating up, as it had in the case of Nakasone's sales tax, the Consumption Tax was brought into existence quickly. The tax bill containing the Consumption Tax was introduced in July 1988 and passed in December.¹⁷ Barely four months later it was being implemented.

In spite of its rapid introduction and its sugar coating of compromises, the Consumption Tax has not fully achieved public acceptance.¹⁸ Further, on 1 October 1991, only two and a half years after its adoption, various amendments were made to the tax in an attempt to rectify some of the problems created by the various compromises.¹⁹

Principles and mechanics

The Consumption Tax is broadly based, applying in principle to all transfers of assets.²⁰ A transfer of assets is defined as "the loan or transfer of assets or the provision of services as a business for compensation"²¹ It also includes the importation of goods.²²

In principle, the Consumption Tax is levied at a single uniform rate of 3%.²³ As a transitional measure, the tax rate on passenger automobiles was 6% until 31 March 1992.²⁴ This rate was reduced to 4.5%, effective 1 April 1992. Exported goods and the cost of overseas travel are zero-rated.²⁵

16 MOF, 1990, p 291.

17 A newspaper survey on the day the law was passed showed that over 60% of those polled were opposed to the adoption of a consumption tax: see Koji Ishimura, "Introducing the New Japanese National Consumption Tax", in *Japan - National Consumption Tax Law*, above n 1, pp ix-x.

18 The introduction of the Consumption Tax has not silenced many voices advocating tax reform. In March 1991, a report by the Society for the Study of the Ideal Future Prefectural Enterprise Taxation Method (Kongo ni okeru Jigyozai no arikata ni kansuru Kenkyukai), a study group supported by the Ministry of Home Affairs, suggested that the current income tax be replaced with an income-type VAT. It is unlikely that this tax would receive widespread public support, however, as many would perceive it to be a reintroduction of Dr Shoup's unpopular value added tax.

19 *Shohizeiho wo ichibu wo kaisei suru horitsu* (a law partially amending the Consumption Tax: Law) Law No 73, 1991.

20 Consumption Tax Law, Art 4(1).

21 *Ibid*, Art 2(1)(8).

22 *Ibid*, Art 4(2).

23 *Ibid*, Art 29.

24 *Ibid*, Supplementary Provisions, Art 11.

25 Consumption Tax Law, Art 7.

The way in which the Consumption Tax is calculated is a rather unique hybrid between the subtraction and credit methods that are usually employed. The Consumption Tax liability of each taxpayer is calculated by first establishing gross taxable sales using the taxpayer's existing books of account. The intention is to avoid inconvenience or additional bookkeeping expense to the taxpayers.

Since the Consumption Tax applies to all "transfers of assets", there is a possibility of multiple taxation on the same item as it passes through several hands, and even several forms. To prevent this multiple taxation, taxpayers are allowed to deduct from their Consumption Tax liability a credit for tax paid on purchases.²⁶ Hence the Consumption Tax is levied only on the value added to the item, with the ultimate tax burden being borne by the consumer. The credit is also calculated using books of account. It is not based on the actual amount of consumption tax paid, but rather on the amount of taxable purchases shown on the books.

A number of "transfers of assets" are exempted from taxation:²⁷

- sale of land
- sale of securities
- transfer of notes/currency exchange
- money lending and other financial transactions
- pari-mutuel tickets
- fees for specified government documents
- postage stamps and cards, and government stamps
- medical fees (National Health Insurance approved only)
- specified social welfare fees
- school tuition and fees for entrance examinations.

Several items were added to the list as a result of the October 1991 amendments. Rent of housing, fees for childbirth, fees for burial and cremation services, goods specifically designed for the physically handicapped, matriculation fees, and textbooks were among them.²⁸ In addition, the list of social welfare services was expanded and certain pseudo-social welfare services, such as meals-on-wheels, were added. Food, one item whose taxation is undeniably regressive, has not yet been exempted in spite of hard lobbying, purportedly because the mechanics of exemption cannot be agreed upon.²⁹ The lobbies for certain interests, most notably health, education and welfare, have made themselves heard by the government. The government is sensitive to vociferous lobby groups, for it is keen to improve public acceptance of the tax.

26 Ibid, Art 30.

27 Ibid, Art 6(1) and Appendix I.

28 Above n 19.

29 Naoyuki Isono, "Some holes in consumption tax expected to be plugged" *Japan Economic Journal* 4 May 1991.

One difficulty of allowing exemptions to value added taxes is that those inputs used in producing the exempt item will have been taxed and the producer will have no tax credit available. Accordingly, the producer of the exempt item will probably pass on the charge for the tax by including it in the price.³⁰ The price distortion this causes ultimately negatively impacts on tax neutrality.

With Japan's Consumption Tax, since tax liability is calculated on the basis of books of account, if the books make no distinction between exempt items and taxable items, tax liability may occur, or a credit may be taken, where none is intended. Accordingly, the books of account must show the particulars of taxable purchases, so that, upon audit, they can be verified as taxable purchases. Alternatively, invoices can be kept. In either case, the records must be kept for seven years.³¹ It is not yet clear whether either price distortion or inadvertent taxation/crediting is occurring under the Consumption Tax.

The hybrid books of account method of tax calculation is sloppy. It is so imprecise and confusing that it is impossible, at this early stage, to even speculate as to its inefficiency or the amount of revenue it is failing to bring in.

When the Consumption Tax was being debated, there was some indication from the government that a proper invoice method of calculation might be adopted in the future if the hybrid books of account method proved impracticable. As yet, no moves have been made in this direction.

Instead, the government is considering the introduction of tax file numbers. The Government Tax Commission is studying the systems employed in various countries. If the Commission recommends the introduction of tax file numbers, it is highly likely that the government will plan to introduce a proper invoice method at the same time. This may be unpopular. Initial opposition to the tax by many small businesses was mitigated by the various windfall benefits created, among other things, by the hybrid method of calculation.

In one sense, the entire question of proper bookkeeping to ascertain both taxable sales and taxable purchases is avoided by those taxpayers who choose to employ the optional summary method of tax calculation. Under the optional summary method, taxpayers whose business is in wholesaling are allowed to deem their taxable purchases to be 90% of their taxable sales. Taxable purchases for all other taxpayers are 80% of taxable sales.³² This calculation method was originally available to taxpayers with annual taxable sales of 500 million Yen or less. Over 95% of all firms in Japan qualify.

30 Alan Schenk and Oliver Oldman, "Analysis of Tax Treatment of Financial Services under a Consumption-Style VAT" (1990-91) 44 Tax Lawyer 181, p 184.

31 Consumption Tax Law, Art 58; Consumption Tax Enforcement Order, Art 71.

32 Consumption Tax Law, Art 37.

The optional summary method is another aspect of the Consumption Tax that was amended from 1 October 1991.³³ The eligibility threshold was lowered to 400 million Yen. In addition, the deemed amounts of taxable purchases were also changed. While the 90% rate continued to apply to wholesalers, only retailers are eligible to deem their taxable purchases to be 80% of taxable sales. For those in businesses relating to agriculture, forestry, fisheries, mining, construction, manufacture and public utilities, the deeming rate became 70%. Taxpayers ineligible to apply the 70%, 80% or 90% rates are entitled to deem their taxable purchases to be 60% of taxable sales. Taxpayers choosing to employ the optional summary method must do so for a minimum of two years.

The optional summary method provides a means for the tax office to indirectly determine the amount of taxable purchases for any kind of business where the taxpayer has not kept sufficient books. Whether the tax office had authority to use such indirect methods of ascertaining the taxable purchases of taxpayers with inadequate books was not clear before the amendment.

Special measures for small business

Consumption Tax liability falls on all persons who sell goods.³⁴ In theory, these persons collect the tax from the purchaser and remit it to the tax administration. This tax liability creates a heavy burden on very small enterprises.

The drafters of the Consumption Tax sought to deal with this problem by exempting small-scale businesses from tax liability. In particular, any firm with annual taxable sales of 30 million Yen or less is completely outside the scope of the Consumption Tax system.³⁵ In 1989, when the tax was introduced, it was estimated that 70% of all businesses in Japan would qualify for exempt status.³⁶

Not only are these exempt taxpayers not liable to remit tax, they are also ineligible for credits on tax paid. This has the potential to inflate prices charged, in the same way as exempting items from taxation can.

For these reasons, exempt taxpayers can apply for voluntary taxable status.³⁷ Once such status is granted, however, it continues for a minimum of two years.³⁸

Small but growing firms may find themselves in the position of suddenly being liable for the Consumption Tax, in spite of possibly not

33 MOF, 1991, p 166.

34 Consumption Tax Law, Art 5.

35 *Ibid*, Art 9(1). Note that the relevant figure is the annual taxable sales of the period two years before the tax year in question.

36 Koji Ishimura, above n 17, p xiii.

37 Consumption Tax Law, Art 9(4).

38 *Ibid*, Art 9(6).

having collected the tax when goods were sold. Accordingly, "marginal relief" was created for those firms with sales between 30 million Yen and 60 million Yen.³⁹

To calculate the amount of marginal relief, the full amount of tax due is first calculated on the basis of the taxpayer's taxable sales and the amount of tax credit which the taxpayer can claim based on taxable purchases made. The amount of tax so calculated is then multiplied by the following ratio:

$$\frac{\text{60 million Yen} - \text{taxable sales}}{30 \text{ million Yen}}$$

The product is the amount of Consumption Tax liability.

The threshold for eligibility for marginal relief was amended to 50 million Yen in October 1991.⁴⁰ The ratio for calculating the marginal relief was also amended as follows:

$$\frac{\text{50 million Yen} - \text{taxable sales}}{20 \text{ million Yen}}$$

In so far as exempt status might be an attractive option for some enterprises, the law provides countermeasures to discourage business splitting.⁴¹ If a partition of a business occurs, resulting in the size of the business being reduced to such a degree that it is eligible for exempt status under Article 9, and certain other circumstances are present, the business becomes ineligible for exempt status. The circumstances are that:

- a parent newly incorporates a subsidiary in which it holds or is deemed to hold all of the issued shares or more than 50% of the paid up capital, and
- all or most of the business of the newly incorporated subsidiary is the same as that of the parent.

A particular problem with the exempt status is the fact that the Consumption Tax does not require exempt taxpayers to advertise their exempt status. This makes it possible for exempt taxpayers to charge the tax to consumers and pocket the money. Alternatively, exempt taxpayers can raise their prices 1% or 2% and still undercut the prices (plus tax) being charged by their competitors.

In addition, there is no requirement that taxpayers register with the tax authorities. Accordingly, the existence of a taxpayer only becomes known to the tax authorities at the time they receive a return from that taxpayer. Conceivably, a non-filing merchant could go undetected.

39 Ibid, Art 40.

40 Above n 19.

41 Ibid, Art 12.

Filing/payment

One of the many facets of the Consumption Tax adopted to encourage public acceptance of the tax was the tax period.⁴² For individual taxpayers it is the calendar year, which corresponds to the tax period for Income Tax purposes. For corporate taxpayers it is the fiscal year which corresponds to the tax period for Corporation Tax purposes.

Using these tax periods also facilitates cross checking and auditing by the tax authorities. This appears to be counterbalancing the potential problems arising from the lack of a registration requirement.

Consumption Tax returns are to be filed annually.⁴³ From the outset, interim tax returns were to be submitted halfway through the year by taxpayers whose provisional tax liability exceeded 300,000 Yen.⁴⁴ This was criticised, before implementation of the tax, as the infrequency of the return left collected tax in the hands of taxpayers who may then attempt to invest the funds.⁴⁵ The fears were realised and it has become necessary to amend the interim return schedule.

Effective 1 October 1991, tax returns must be filed quarterly by all taxpayers whose annual Consumption Tax liability for the previous year exceeded 5 million Yen.⁴⁶ Quarterly filing is expected to prevent taxpayers from making windfall profits by using the collected tax monies for their own purposes.⁴⁷

Remaining problems

When the Consumption Tax was introduced, many consumers complained that the 3% tax rate meant that more of their purchases would have to be paid using 1 and 2 Yen coins. In other words, prices would be in odd numbers rather than round numbers. In response, the government permitted merchants to round their prices up after calculating the tax.⁴⁸ While this may have saved consumers from having to dig into their purses for small change, it also presents one more opportunity for merchants to engage in price gouging at the expense of unsuspecting consumers.

Another measure taken to minimise inconvenience was to leave to the merchants the decision of whether prices are shown as inclusive or exclusive of the tax. Thus, the tax is largely hidden from public view, which also keeps the fact of the tax off the minds of the consumers.

42 MOF, 1991, p 137.

43 Consumption Tax Law, Art 45.

44 Consumption Tax Law, Art 42.

45 Ishimura, above n 17, p xxiii.

46 MOF, 1991, p 169.

47 "Japan Approves Bills on Retail Stores, Consumption Tax", in *Asian Wall Street Journal* 9 May 1991.

48 Ishimura, above n 17, p xxv.

The regressivity of the Consumption Tax has never been thoroughly addressed. Among the measures floated to reduce the regressivity of the tax are multiple rates, a zero-rate for necessities and an income tax credit for consumption tax paid. Each of these presents a new set of problems. Multiple rates raise a variety of administrative problems and increased costs. Zero-rating necessities could go a long way to reduce the regressivity of the tax, providing a definition of "necessity" could be established. The concept is highly subjective. The notion of an income tax credit raises similar problems.

The low tax rate of 3% was an attempt to appease those opposing the tax. It was felt that once people became accustomed to the tax the rate could be increased as fiscally necessary. The low rate, combined with Income Tax and Corporation Tax concessions made at the time the Consumption Tax was introduced, has resulted in less overall tax revenue for the government. Inevitably, the tax rate will have to be increased in the future.

There are other pressures for an increased rate. It is interesting that discussion of the Consumption Tax these days no longer focuses on the ageing society as a justification.

The government has recently been faced with a variety of new commitments, predominately generated by acquiescence to recent international demands that it increase spending. In particular, the government has committed itself to nearly double its public investment in infrastructure over the next 10 years. In its new role as a global partner, Japan is committed to make contributions to fund a variety of co-operative international efforts.

While the revenue for these expenditures could be raised from a variety of taxes, big business and other wealthy taxpayers argue that an increase in the Consumption Tax, even with its regressivity problems, is the most equitable means, as it spreads the burden among all those who benefit from the expenditures. But public opposition to such an increase may be too strong at present.

Conclusion

Japan's Consumption Tax was adopted quickly and was laced with compromise measures to enhance its public acceptability. In the short time that the tax has operated, some of these sweeteners have been amended in an attempt to improve the tax. Other measures, and the problems they have created, remain, as does the tax itself. Public acceptance of the tax has been slow and is not yet complete. Nonetheless, it can be expected that, in time, the tax will become less objectionable, in line with the New Zealand experience. Then, no doubt, the rate increases will flow.