

Tasks Facing the Taxation System in the Era of an Expanding Knowledge Economy and Increasing Longevity

Masatoshi KURATANI

Nomura Research Institute

Tasks Facing the Taxation System in the Era of an Expanding Knowledge Economy and Increasing Longevity

Masatoshi KURATANI

- I Examining the Tax Base as the First Step
- II Various Factors Making Tax Reform Difficult
 - 1 Understanding Tax Problems
 - 2 Implementation of Tax Reforms
- III Taxation Systems in the United States, Germany and Japan
 - 1 Discussions on Taxation after the Regan Tax Reform in the United States
 - 2 Background to Germany's Tax Reform Impasse in the 1990s
 - 3 Principles of the Shoup Recommendations and Changes in Japan's Taxation System
- IV Tax-Related Tasks under the Current of the Times
 - 1 Tax System Designed to Promote Research and Development
 - 2 Innovation and Taxes on Companies
 - 3 Enhancement of Human Capital Formation
 - 4 Intra-Family Gift and Inheritance Taxes
 - 5 Public and Corporate Pension Reforms and the Tax System
- V Relationship with Recent Discussions on Tax Reform

This paper overviews the tasks facing Japan's taxation system in the era of an expanding knowledge economy and increasing longevity. This analysis includes two basic prescriptions: (1) creating an environment in which individuals and companies can take an active approach to investment aimed at accumulating "intellectual property, organizational capital and human capital," and (2) encouraging individuals to adopt a forward-looking approach in making various choices and investments that are consistent with a comprehensive view of their longer life spans.

Specifically, the focus will be on five tasks: creating a taxation system that promotes research and development (R&D), examining innovation and taxes on companies, strengthening the creation of human capital, rethinking family and gift and inheritance taxes, and reforming the public and private pension schemes and the taxation system. In examining these five tasks, various economic models will be established with respect to the behavior of individuals and companies, and careful consideration will be given to the changes that take place in response to various tax levies. We will discuss an appropriate taxation system for this new environment on the basis of these studies.

Tax reform is a difficult undertaking. There are a host of reasons that account for this—chief among which are the following: (1) it is often impossible to reach a consensus even with respect to purely academic and technical discussions on the effects of various tax levies; (2) as the subject of taxation often carries with it considerable income-redistribution baggage, reform proposals invariably trigger arguments over trade-offs between competing interest groups; and (3) reforms are necessarily restricted by the need to secure reliable sources of tax revenues. The experience of tax reforms in the United States and Germany amply highlighted these hurdles, and recent discussions on tax reform in Japan indicate that similar difficulties can be expected in this country as well. As the achievements and well-considered ideas of specialists are important in examining tax reform proposals, however, it is hoped that academic and technical research drawing from the current thinking of professionals in this era can be accumulated in developing innovative and constructive reform proposals.

I Examining the Tax Base as the First Step

Among the long-term trends that are common to Japan and other advanced nations are a shift towards smaller-sized families and an increase in per-capita investment in knowledge and skills. These trends are also apparent in the recent progress towards an expanding knowledge economy (i.e., the growing importance of intellectual property, organizational capital and human capital as factors of production). At the same time, the globalization of our economy has advanced, and the dissemination and spread of knowledge on an international basis now constitutes an important engine for economic growth in both advanced and developing countries.

Against this backdrop of progress in advancing knowledge and the increasing complexity of our socioeconomies, however, we are seeing a widening gap in wages and employment between highly skilled and less-skilled workers. Furthermore, Japan in particular is experiencing a rapid aging of its population as increasing longevity continues to overlap a steady decline in family size. Many other factors are intermingled in the expanding instability of circumstances surrounding the life cycle of individuals.

This paper will study the tasks that Japan's taxation system must deal with in the future in the face of these current threats. Of course, the systems and policies of a nation are multi-faceted and the tax system simply constitutes only a part of the whole. Indeed, there is a wide variety of systems and policies that exert varying impacts on the actual socioeconomy over time and via myriad routes. Accordingly, in focusing on taxation while taking the current of the times into account, it is necessary to overview the overall effects of related systems and policies in considering the role of taxation within this comprehensive framework.

Generally, a nation's tax system is created in conformity with the country's history, and the system manifests a certain structure that embodies such pillars as "fairness." Therefore, in proposing what the future tasks should be and how they should be dealt with, such discussions must be started from the current taxation system while searching out the direction of proposed reforms that are consistent with the core elements of this inner structure.

As discussed later in this paper, however, there are a number of factors that would suggest that high expectations for tax reform are offset by the certainty that such reforms will be hard to realize. To begin with, tax systems are designed under complicated rules with respect to the tax base, rates, taxpayers, and the enforcement system. These various parameters make it difficult to even construct a comprehensive perspective of all the factors that will come into play.

The first step in this study requires that we turn our attention to the "tax base" (which is the most basic element of taxation systems) in examining the interaction between taxation and the socioeconomy. Essentially, there are four tax bases that can produce substantial revenues and which allow for considerations of fairness. These four tax bases are: incomes, wages, consumption and assets.¹

The approach adopted by this paper will be to first clarify how these tax bases have been used in the past, followed by an examination of the tax bases to which the greatest importance should be attached in the new era. This analysis will then be further refined by considering how these various tax bases should be approached on a more sophisticated basis so that they can be more effectively utilized.

Chapter II clarifies the various factors that make tax reform difficult, and Chapter III overviews the tax system in Japan in comparison to that in the United States and Germany. In Chapter IV, the future tasks facing tax systems in light of current trends are discussed. Chapter V concludes this paper by offering some comments regarding recent discussions on tax reform.

II Various Factors Making Tax Reform Difficult

1 Understanding Tax Problems

Untangling the Income Tax, a noteworthy book concerning tax theory by David F. Bradford (Princeton University), begins by citing Warren G. Harding, who served as 29th president of the United States (1921–1923). Said Harding:

"I can't make a damn thing out of this tax problem. I listen to one side and they seem right, and then—God!—I talk to the other side and they seem to be right... I know somewhere there is a book that will give me the truth, but I couldn't read the book. I know somewhere there is an economist who knows the truth, but I don't know where to find him and haven't the sense to know him and trust him when I find him. God! what a job."²

There are various factors behind such difficulties in understanding the issue of taxation. First of all, differing interpretations of "fairness," "economic efficiency" and "simplicity" are intricately involved in any discussions of taxation, and different judgments are the natural result of these differing values. In particular, no discussions on "fairness" are possible without drawing on value judgments.

As the tax system exerts an impact on many people with differing interests, moreover, even proposals with legitimate claims to benefiting all of society are often seen as leaning towards one special interest or another.³ Furthermore, there are many cases in which no consensus can be reached in terms of theory and proof even

with respect to academic and technical discussions that are totally removed from arguments over whose ox is being gored (e.g., discussions on the effects of specific levies). Despite the modern progress that has been made in economics, we have evidently not yet reached the stage in which even economists are fully equipped to deal with the unvarnished truth.

Let's consider this in more concrete terms. As shown in Figure 1, analyzing the effects of a tax means to consider "what behavioral changes occur if taxes are imposed on households and companies and how such changes influence the markets for goods and services and the markets for factors of production." While the effects of taxation are many and diverse, they can be classified into two broad categories from the standpoint of identifying their impact. One relates to hastening or delaying purchases when a decision is made on a change in a tax rate after a certain period. Under this category, the reaction to a tax levy can be immediately shown and its effects can be clearly identified to a considerable extent. The other category concerns cases in which the reaction to any levy is slow or unclear, or involves broadly divergent opinions. For example, the effects with respect to incentives to labor, consumption, savings and investment fall under this category.

What makes the matter complicated is that views in terms of the latter category often become a decisive factor in evaluating the relationship between the imposition of a tax and the actual economy. In the cases of increasing the consumption tax and reducing the income tax, for example, the primary matters of concern are whether a consumption restraint effect might be generated and what the effect on the labor incentive would be. Because of the nature of these types of taxes, however, the effects take time to emerge and are manifested via various channels—including a number of channels that have not yet been fully identified even by specialists.

Moreover, evaluating the effects of a tax differs depending on whether one is focusing on the supply-side

or demand-side effects. It is fully possible, for example, to assert that a certain tax reform will lead to an immediate reduction in the tax yield but an increase in revenues over time as the broader impact will lead to expanded economic growth (called the feed-back effect). However, it is not easy to marshal support for such an assertion by presenting substantiating evidence that can convince everyone. On the other hand, it is also eminently possible to assert a different type of tax reform will distort the taxation system over the long term but will have a positive effect in rehabilitating a struggling economy through immediate demand-side effects. In this case as well, it is not easy to persuade everyone of the validity of such arguments.

Furthermore, it is also reasonable to assert that the effects of any tax cannot be properly examined within the taxation framework alone, but must also be evaluated in linkage with budgetary and expenditure needs in the face of substantial financial deficits. Related discussions may include positions that it is more important to set appropriate levels of taxes to be borne as a whole, rather than tinkering with adjustments to the taxation system.

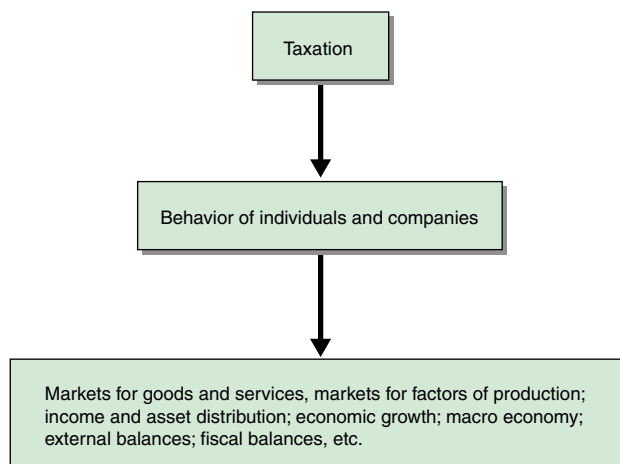
As the framework of such discussions expands, the range and scope as well as the gaps between various assertions concerning the effects of specific levies also expand. And if disputes over theory and evidence continue to dominate such discussions, the result may be to confuse rather than clarify proposals for tax reform.

2 Implementation of Tax Reforms

As most tax systems carry considerable income-redistribution baggage, reform proposals must deal with the problem of trade-offs between the interests of one group versus another. Except for cases in which large-scale tax reductions are implemented, most tax reforms invariably lead to the emergence of various groups who feel that the reform in question has resulted in a tax increase. It is only natural that such groups take up the cudgel and oppose such changes politically by claiming that the reform is unfair. Moreover, it is especially difficult to secure a positive evaluation from most taxpayers for reforms that have been prompted by the pressing need to generate additional revenues. This makes it doubly hard to implement tax reforms under most circumstances.

Furthermore, as taxation systems function as part of the socioeconomic infrastructure, it is desirable to design such systems from a long-term perspective. However, tax reforms are determined through the process of democratic government in most advanced countries, making it necessary to sometimes give priority in this process to decisions that have a positive political impact. And even when a consensus can be reached concerning the substantial positive effects of a tax reform for society as a whole over the long term, the possibility of

Figure 1. Routes by Which Tax Effects Are Exerted



implementing such a reform does not necessarily become high.

III Taxation Systems in the United States, Germany and Japan

In considering the taxation system in Japan, we may develop some useful approaches by making comparisons with the systems in other countries. A good reference in particular would be the policies in the United States and Germany, as both countries have exerted extensive influence on Japan in terms of legislation. Accordingly, I would like to cite some comments that were made to me during interviews with specialists, tax authorities and other scholars when I visited the United States and Europe in 1998.

In addition, it will be useful to look somewhat at the history behind the development of the Japanese taxation system to its present status. While tax reform is not an easy undertaking, we can see that the tax system nevertheless undergoes more than a little transformation when viewed over a time axis of ten-year intervals. As a major reform was implemented in Japan some 50 years ago on the basis of the Report on Japanese Taxation by the Shoup Mission (the so-called Shoup Recommendations), we can examine the present status of taxation in Japan by referencing this report.

Before this, I would like to outline the extent of the tax burdens borne by people in the United States,

Germany and Japan, as well as review a breakdown of these amounts in accordance with the tax bases. Figure 2 shows a comparison of the scale of tax revenues, etc., in terms of their ratios to national income.

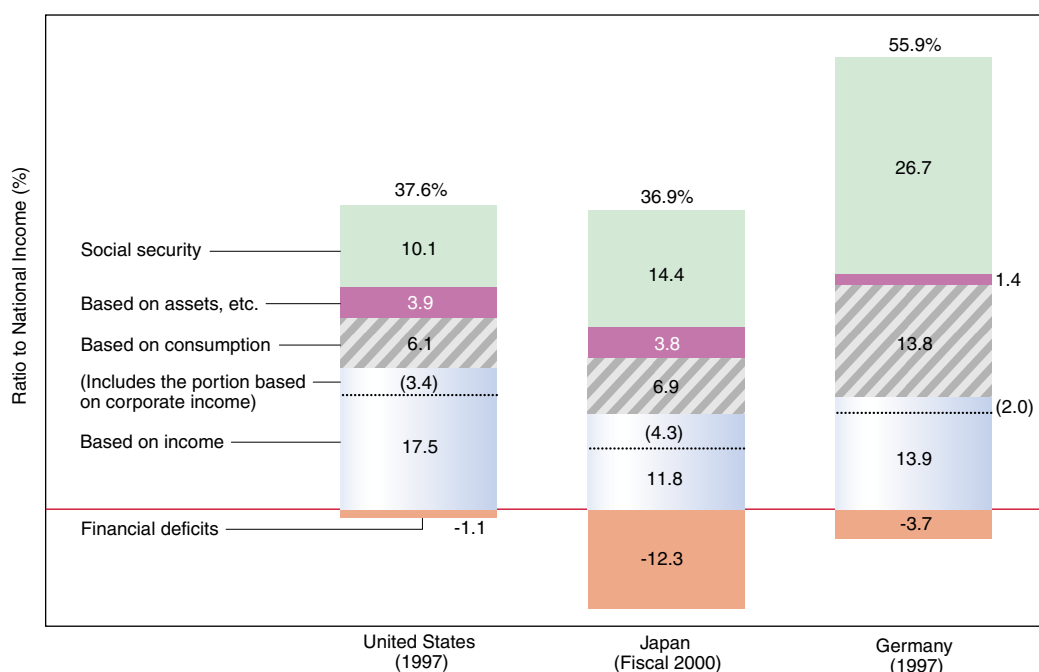
The tax base utilized by the United States is heavily weighted towards the “income” component (including both individual and corporate income). While the extent to which the German system focuses on the income base is less than that in the United States, it is nevertheless larger than that in Japan. Moreover, as compared to the United States and Japan, the scale of tax revenues based on the “consumption” component such as the value-added tax and the “wage” component such as social insurance premiums is markedly large in Germany.

The scale of tax revenues based on income is smaller in Japan than in the United States and Germany. The scale of tax revenues based on consumption and wages in Japan is smaller than in Germany, but larger than that in the United States. While the scale of tax revenues based on the “assets” component is small in all three countries, it is especially low in Germany.

1 Discussions on Taxation after the Regan Tax Reform in the United States

The Regan tax reform in 1986 expanded the tax base and reduced progressive tax rates on the grounds that “economic growth, which is the major target of a drastic tax reform proposal, is achieved by a tax that is neutral (i.e., a tax that does not hinder the growth potential that is inherent in a free market economy).”

Figure 2. The Burden on the People in the United States, Japan and Germany and Comparison by Tax Base



Source: “Current Status and Tasks of Taxation in Japan—Public Participation and Choices in the 21st Century,” prepared from data compiled by the Government Tax Commission, July 2000.

Although certain tax-base exemptions have since been increased and the maximum tax rate has been raised, there have been no major changes to the basic thrust established by the Regan tax reform.

Since the mid-1990s, however, a number of drastic tax reform plans have been proposed, including a flat tax put forward under the call for “tax simplification.” Common elements of the various plans have included: (1) moving from income to consumption taxes; (2) applying a flat-rate tax; and (3) cleaning up the tax base. The following statements come from interviews conducted during the period of enthusiastic discussions concerning the various fundamental tax reform proposals.

How was the Regan tax reform realized?

The reform was made possible as all people came together, with the Republican Party agreeing on cutting tax rates and the Democratic Party agreeing on the need to expand tax bases.

How would you evaluate the Regan tax reform?

The situation in the United States has largely changed over these 20 years. Progress has been made in deregulation and the labor market is continuing to maintain good flexibility compared to that in other countries. The reduction in the marginal tax rate provided a good incentive. This has also enhanced the overall infrastructure in the sense of promoting quick action by companies. However, it is difficult to show quantitatively the extent to which the Regan tax reform contributed to the good economic conditions in the 1990s.

What do you think of the “tax base vs. tax rate” concept?

President Clinton proposed an increase in tax rates in 1993, while introducing the investment tax credit to encourage new investment by companies. However, industries (including those in capital-intensive sectors) refused to go along. Basically, a posture that prefers low tax rates rather than exemptions in terms of the tax base has been clarified.

The issue of double taxation affecting companies and individuals still remains.

When either a partnership or joint-stock company format is adopted, taxes at present are essentially “passed through” (i.e., the tax is not imposed on the company itself, but rather in an individual capacity on the person who carries out business activities as an investor) as long as the securities are not traded among the general public. Even when starting with a partnership, then changing to a joint-stock company after the company has grown, and finally implementing an M&A through a stock swap, no tax is imposed unless the stocks are exchanged for cash. In about ten years in the future, there is a possibility that any company may adopt this pass-through format in order to avoid the issue of double taxation. It is presumed that a company will turn to

a joint-stock company format only when it is necessary to swap stocks or to offer shares to the public.

While the growth of small and mid-sized companies has been remarkable in the United States, what is the overall and tax background behind this?

In addition to such elements as the culture and open economy of the United States, it has stemmed from structural changes as the economy shifted from a dependence on national defense and chronic deficits to a competitive economy under low inflation. Furthermore, as a result of the restructuring carried out by large companies and progress in outsourcing, opportunities for small and mid-sized companies improved in terms of both human resources and demand. In terms of taxation, the pass-through system, stock options, and capital gains taxation also played important roles.

What is the possibility of realizing drastic tax reform proposals such as the flat tax?

There are many taxpayers who oppose the flat tax idea for reasons based on their individual circumstances. For example, the flat tax would eliminate various forms of preferential treatment such as the education credit. Moreover, many believe that even if the flat tax were not imposed on so-called capital income, the effect on increased savings would not be that substantial. Hence the possibility of realizing such proposals is not very high.

What are the interesting issues of the future in relation to taxation?

There is the issue of privatizing social security. Although projections for the future indicate the present system will be plagued with continuing and accumulating deficits, the main point of contention is whether or not the benefits to be derived from privatization would be substantial enough to justify the change. In addition, as social security is often seen as the “third rail” of American politics, reform will not be easy to realize. Nevertheless, the problems continue to mount as action is delayed, raising the high possibility that Congress will ultimately be forced to deal with this issue before the system implodes.

2 Background to Germany's Tax Reform Impasse in the 1990s

During the 1990s, Germany's Kohl administration set its sights in the same direction as those of the Regan tax reform in the United States. While this meant efforts aimed at “reducing tax rates by expanding tax bases,” the bill that tried to push these proposals forward as one big step was rejected by the Bundestag in 1997. The following comments come from interviews that were conducted immediately after the collapse of this reform proposal.

I understand that the major policies being pursued in Germany focus on “cutting expenditures and reducing taxes.”

This is the official stance and it is true that federal expenditures as a percentage of GNP (gross national product) are declining. However, expenditures by local governments and social insurance payments continue to increase. If these factors are taken into account, the actual situation does not conform to the announced objectives.

What was the objective behind expanding the base for corporate income taxes that was included in the 1997 tax reform proposal?

While the effective tax rate in Germany was not higher than that in other European countries when trial calculations included the various tax-base exemptions, it was considered necessary to reduce the nominal tax rate in order to make it easier to attract foreign capital. In addition, the trend among German companies to shift income to the Netherlands, etc., made it appropriate to reduce the tax rates and to expand the tax base.

What is the tax environment in terms of fostering small and medium-sized companies?

As the expansion of the tax base is advantages to small and medium-sized companies that have access to few exemptions, this measure would have had an important effect in fostering small and medium-sized companies (although the burden on large companies would have increased as they lost various tax exemptions). Moreover, the restrictions on individuals who start businesses are not necessarily capital gains taxes. If a partnership format is adopted, cash flow (offset by losses) and the business income tax rate become important. Accordingly, the expansion of the tax base and the reduction of tax rates should have created a good environment for small and medium-sized companies.

What was the background behind the failure to realize tax reform?

There were some 68 tax-base exemptions, and each of these groups worked hard to protect their vested interests. While there was general agreement on the overall framework for reform, the specific details proved to be the stumbling block.

What is the feeling about consumption-type taxes such as the VAT (value added tax)?

While consumption-type taxes such as the VAT are considered to be easy to collect, they are also seen to have the negative effect of restraining consumption—something that can have serious consequences in terms of policies aimed at promoting demand.

Germany’s VAT tax rate is low compared to that of other EU (European Union) members. Is there any chance that this rate may be raised?

Raising indirect taxes might just lead to expanding the black market. While the black market in Germany is already growing, it is not yet as large as that in Italy. In the case of the tobacco tax, for example, smuggling increased and tax revenues fell when the tax rate was raised.

What was the reason for raising the VAT rate instead of increasing social insurance premiums in 1998?

The burden that social insurance premiums impose on companies has the effect of cutting jobs, and this measure was aimed at alleviating the problem of increased unemployment. As to the question of whether there will be a large-scale substitution in the future between social insurance premiums and the VAT, however, I would say that this seems unlikely. This is because the link between insurance premiums and benefits is considered appropriate.

Do you think the social insurance burden on companies will be shifted to employees?

While the general view is that the burden will be shifted to employees in the long run, some companies will not be able to implement this shift smoothly. This will make it more difficult to compete and may become a factor that will lead to increased unemployment.

What are your views with respect to the tax effect on labor mobility?

Labor mobility is high among people with advanced skills, and also relatively high among certain low-skilled workers, such as in the construction field. Furthermore, labor mobility that transcends national boundaries is active near the border with the Netherlands. Accordingly, the tax effect on labor mobility is important.

Following the failure of the attempt to enact tax reform by the Kohl administration, the Schroeder administration passed a tax reform act in 2000 that would basically pursue the same direction as that of the previous proposal for the period from 2001 to 2005. Many attributed this success to a growing sense of disappointment and concern over the impasse created by the bickering between the ruling and opposition parties that had scuttled Kohl’s reform efforts. This rising tide of concern among the German people served as the mainspring that promoted the reform.

3 Principles of the Shoup Recommendations and Changes in Japan’s Taxation System

The Shoup Recommendations of 1949 can be seen as part of the Dodge Line that revitalized the free economy in Japan. The Dodge Line took a position that respected the free market mechanism by avoiding intervention and inducements.⁴ In his later years, Dr. C.

Shoup (then professor emeritus at Columbia University) observed in a press interview: “We pursued three concepts in approaching these measures. They were (1) promoting reforms that were rational and easy to implement, (2) making sure the taxpayers perceived the reforms as being fair, and (3) not imposing obstacles to economic activities. The most important point among the three was the concept of fairness.”⁵

In pursuit of these objectives, the Shoup Recommendations positioned a progressive tax on consolidated individual income as the core of Japan’s comprehensive taxation system. At the same time, measures were taken to avoid any excessive weakening or distortion of individual incentives. These efforts can be clearly seen in reducing the progressive rate on individuals through the creation of a wealth tax and in designing a cumulative acquisitions tax to be levied on assets acquired by gift or inheritance during the taxpayer’s lifetime.

However, Japan’s tax system subsequently saw a number of changes that largely distorted the provisions envisioned by the Shoup Recommendations. These changes included the following:

- (1) The individual income tax base was changed from comprehensive income to a range of income classifications. In particular, separate flat-rate taxes have largely been levied on major portions of capital income, while the progressive tax rate has been applied only to labor income.
- (2) Various credits and exemptions and separate rates have been increased under the labor income category and the tax bases have been reduced.
- (3) Many exemptions have been established under the corporate income tax and the tax bases have been reduced.
- (4) The wealth tax and the acquisitions tax that were created in accordance with the Shoup Recommendations were abolished at an early stage.
- (5) Moves to promote the expansion of the tax base and reduce the tax rates began in the latter half of the 1980s. So far, more has been accomplished in terms of reducing the tax rates than in expanding the tax bases, and consumption taxes have been adopted to make up for the drop in revenues.
- (6) Full-scale moves to establish a systematic approach to corporate organization taxation have been seen in recent years, such as taxes on mergers and spin-offs as well as a consolidated tax payment system.
- (7) Social insurance premiums (which are based on wages) have continued to increase to the point that the premium burden substantially exceeds the total in corporate and individual income taxes (including both the national and local government levies). While social insurance premiums are not formally considered “taxation” per se, the portion of the social insurance premiums that is imbued with the essential nature of taxation continues to grow as the

inter-generational support system consumes ever-larger outlays.

IV Tax-Related Tasks under the Current of the Times

I have previously pointed out some of the trends common to Japan and other advanced nations. These include the expanding knowledge economy, the swing towards globalization, the shift towards smaller-sized families, and the rise in longevity. In relation to these trends, I have also referred to the growing risks inherent in the aging of society and the increasing instability surrounding the life cycles of individuals.

Beside these factors, there are many other fragile aspects with respect to Japan’s socioeconomy. Examples include the lack of vitality in innovative activities that are the driving force of a knowledge economy, the failure to eliminate the functional disorders of the Tokyo financial capital markets (which are said to constitute some of the world’s most important financial hubs), and the prospects for substantial reductions in the working-age population with the inexorable decline in the birth rate.

The following section considers various tax-related tasks for the future in light of these circumstances. These objectives will be discussed on the basis of two basic prescriptions: (1) creating an environment that enables the full display of potential strength through active investment in the accumulation of “intellectual property, organizational capital and human capital” by individuals and companies; and (2) creating an environment that permits individuals to take a forward-looking attitude in making choices and investments over a long life span without distorting individual incentives by the tax system. In addition, linkages with other systems and policies will be taken into account in consideration of the tax measures involved.

Specifically, five items will be examined as the tasks corresponding to such trends as the expansion of the knowledge economy and increased longevity. While there is no special meaning behind the order in which these tasks are examined, let us first turn our attention to a tax system designed to promote research and development (R&D).

1 Tax System Designed to Promote Research and Development

How to strengthen intellectual property rights is becoming a matter of increasing importance as one of the present tasks of government policies. Intellectual property rights essentially means establishing ownership rights to newly created “intellectual assets.” With respect to a patent which is a typical intellectual property right, persons who are granted patents are entitled

to the exclusive use of such intellectual property rights for a designated period, as well as the right to grant licenses to others.

This guarantee of property rights is aimed at strengthening the incentive of companies to engage in R&D activities, considering the fact that intellectual property innovations can bring about substantial external economic effects to the socioeconomy. At the same time, however, such guarantees incur social costs such as the overlap of research and development activities through competition to acquire patent rights. Therefore, patent rights are not easily granted, nor are they granted for a long time.⁶

In this connection, there is also a method to increase a company's incentive for R&D activities by using tax measures to reduce the costs of R&D. This is the R&D tax credit, which is part of the corporate income tax system. Two approaches (full and incremental write-offs) are adopted in allowing this credit.

It is of course obvious that R&D tax credits involve the social costs of lost tax revenues. Accordingly, the following section overviews the advantages and disadvantages of these two approaches from the standpoint of whether the R&D tax credit can effectively promote R&D activities vis-à-vis the tax revenues lost due to such credit.⁷

(1) Incremental tax credits

This mechanism, which allows a company to take tax credits on additional R&D expenditures that exceed a base amount, is generally considered to be more likely to have a larger positive socioeconomic effect than the loss in tax revenues stemming from the fact that this tax measure focuses on marginal and selected R&D activities by a company. As there are two methods in setting the base, however, the resulting effect differs depending on which approach is adopted. One method uses what might be called an "averaged base," which is calculated according to the average R&D expenditures over the past several years (the current Japanese system uses the "average amount of testing and research expenses during the three out of five years with the greatest annual expenditures"). The other adopts a "fixed base" approach.

Under the averaged base system adopted by Japan, companies that increase R&D expenditures above the averaged base in any single year can receive a tax credit corresponding to the excess for that year. As the level of this averaged base is automatically increased for the following and subsequent years, however, the tax credit amounts that can be received in the following and subsequent years naturally decline. Accordingly, if the annual effect covering many years is seen as a whole, the net incentive effect might become extremely small.

In comparison to this, the United States uses standardized R&D expenditures calculated on the basis of

sales (R&D expenditures/sales) on a fixed basis for any specified year. As the base is fixed in this case, no minus effect is encountered in the following or subsequent years even if R&D expenditures/sales is increased for the given year.

A problem does arise with the elapse of time, however, as the base can become separate from actual corporate activities, which makes it difficult for companies to be rewarded with the appropriate incentives. While it may be possible to deal with this problem by resetting the base periodically, this may essentially mark a return to an averaged base system from the mid- and long-term viewpoint.

(2) Full tax credits

This method allows tax credits for all of a company's R&D expenditures. However, as this scheme has the practical effect of subsidizing any R&D activities implemented by a company even without tax measures, the lost tax revenues can loom large in comparison to the scale of the effect. On the other hand, there are some companies whose level of R&D expenditures/sales exceeds a certain level (i.e., companies whose weight of R&D activities is high) even in the face of generally declining R&D expenditures due to economic recessions, etc. When this factor is taken into consideration, this mechanism provides an advantage in that the incentives not available through the incremental approach become possible when full tax credits are allowed. From this standpoint, the United States provides a system that permits the selection of full tax credits for companies whose R&D expenditures/sales exceeds a certain level.

As such, there are many elements that must be taken into account in order to enable tax systems designed to promote R&D to efficiently generate a large effect. I look forward to the design of even more appropriate measures after carrying out expanded research and studies on such elements.

2 Innovation and Taxes on Companies

(1) Corporate income and organization taxes

While most large companies adopt a corporate format, the reason for this mainly relates to the fact that economies of scale can be utilized in such aspects as production organization and fund raising through incorporation. In terms of the income tax imposed on companies, however, the lower the tax rate, the smaller the effect with respect to restricting investment. Moreover, lower tax rates also allow for faster decision-making in choosing courses of action, as is seen in examples from the United States. Furthermore, when company activities have expanded to involve multiple countries as they do today, low corporate income tax rates prevent capital outflow to other countries and promote the inflow of capital. And with respect to the tax

base, the fewer the exemptions, the better the environment for growing companies as seen in examples from Germany. If these factors are taken into consideration, reducing corporate income tax rates and expanding the tax base can be said to constitute a task with growing importance in accommodating the knowledge economy and globalization.

From a historical viewpoint, many companies begin with a small-scale structure and develop into a complex organization. Accordingly, it is essential to view the overall life cycle of company activities. From this standpoint, tax measures that hinder a company's activities in terms of enhancing "organizational capital" are considered to have serious negative effects. For these reasons, the full-scale efforts to establish organizational tax systems for corporations (such as taxes on the establishment of a company, mergers and spin-offs, as well as consolidated tax payment systems) that have developed in recent years have a significant meaning.⁸

(2) Pass-through system

While I have previously noted that large companies that adopt a corporate format play a major role in terms of utilizing economies of scale, the impact of venture firms and small and mid-sized companies is rapidly growing in promoting innovation. Because of this, it is important to smoothly supply risk capital to small and mid-sized companies that start up new businesses with new technologies and knowledge. In focusing on this point, we can find that the pass-through system that is utilized in the United States and Germany merits our attention.⁹

Under the pass-through system, income and losses generated by a company that adopts a partnership format, etc., are directly passed through to the individual partners. If a company earns a return, taxes are levied on such profits as individual income, while any losses that are generated may be deducted from individual income. As a result, taxation plays the role as a type of insurance, and the degree of risk on invested capital can be reduced. When we take the benefits of such a system into account, it becomes clear that creating explicit regulations to establish such a pass-through system is an important task for Japan as well.

(3) Distortions of corporate income tax base

When the financial capital markets are viewed as a whole, the funding provided to the banking sector under the support of the deposit insurance system and public funds is still enormous. On the other hand, the demand and supply market for capital with varying degrees of risk is not yet fully developed. As a result, when the banking sector fails to function properly due to a cumulative increase in bad loans, a serious problem emerges because the channels that should assume the role of alternative financial intermediation are weak. At the same time, moreover, no progress can be

made in strengthening the infrastructure for risk capital to support innovation from a long-term viewpoint. Furthermore, delays in correcting these problems are also impairing the attractiveness of the Tokyo financial capital markets to provide high-performance asset management.

The background behind this situation includes the imbalanced tax base for corporate income taxes, whereby returns (such as interest payments) on debt (such as bank loans) can be deducted, while taxes are levied on returns (such as dividends or internal reserves) to equity. This distortion in the tax base for corporate income taxes and the fact that such distortions exert a range of disturbing effects have long been the subject of discussion in a number of countries. While a plethora of reform proposals have been presented, we have yet to see the adoption of sweeping solutions.

Realistic countermeasures that can be considered include: (1) because the corporate income tax levies individual income tax on returns to equity at the pre-dividend corporate level, adjustments should be made to coordinate the corporate income tax rate to the same level as that imposed on interest income under the income tax rates for individuals; (2) the organizational taxes on corporations should be further enhanced; and (3) steps should be taken towards targeting corporate income tax levies solely at corporate entities that are trying to utilize large economies of scale, and applying the pass-through system to other companies.

(4) Consumption taxes

The consumption-type VAT levy is a consumption tax that is imposed on companies. While it is natural for the purchase amounts of intermediate goods to be deducted under such a levy, one characteristic of this tax base is that all amounts invested in capital expenditures (not depreciation) are also deducted.¹⁰ When we consider that investments in capital expenditures are financed by raising funds in the market in the form of equity or debt, however, it is necessary to reward investors by adding the market-average return on the funds raised.

Let's examine this by focusing on the cash flow related to investment in capital expenditures and its return. While the tax base includes the cash flow that is allocated to dividends, interest payable and the repayment of principal (as a part of the cash flow received), the cash flow representing funds raised in the market is deducted (as an amount equivalent to capital expenditures). The former is equivalent to the funding allocated to capital investment plus the market-average return from among the returns that are generated by such funds. If this amount is discounted to its present value by the market-average yield, the resulting amount becomes the same as the funds raised in the latter case.

In other words, from among the returns generated by capital expenditures, no tax is imposed on amounts

equivalent to the market-average return. Conversely, if a company realizes a return on a capital investment that exceeds the market average, the excess portion becomes subject to taxation. As the mechanism does not permit the deduction of labor costs, the consumption tax essentially becomes a tax that is imposed on “labor income + excess return.”

In this connection, it must be pointed out that intellectual property, organizational capital and human capital are coming to assume a greater importance than capital expenditures as the factors of production in today’s economy. This means that greater attention should be paid to the fact that it is the excess return that companies generate by investment in such new factors of production that constitutes a major element in the increasing weight of “intangible assets” within the market value of a company.

With respect to the contents of intangible assets, while those derived from scarce factors of production may be important from a short-term viewpoint, those stemming from the factors of production that are created by company efforts will come to occupy the major portion from a long-term viewpoint. Accordingly, the consumption tax imposed on the excess return generated from such efforts is considered to pose a more than negligible hindrance to the value creation activities of a company with a large weight of intangible assets that is active in innovative activities.

3 Enhancement of Human Capital Formation

(1) Tax measures to help meet school expenses

Many higher education facilities in the United States such as universities, graduate schools, law schools, and business schools are private institutions and very competitive. In particular, the top schools in the United States are highly evaluated even by other countries for their high level of quality. At the same time, expenses for these institutions are so high that in many cases it is difficult for young people to raise money to attend such schools. In order to deal with this situation, various tax measures to support such students have been implemented.

These schemes include tax credits for school expenses such as tuition fees and tax-base measures to deduct the interest paid for student loans. The background behind such measures is the belief that because it is difficult to use such an intangible asset as education as collateral, adequate investments in human capital would not be made without a certain amount of support.

As the knowledge economy continues to expand in Japan, the need for highly educated and skilled human capital is increasing. In order to expand the supply to meet this growing demand, the reform of the higher education system is included among the key agenda of government policies. In addition, adequate tax treatment

for raising money to cover educational expenses is also important.

The route for human capital formation can be broadly divided into two categories: school education and in-company training. The role of in-company training has traditionally been more important in Japan than in the United States. Currently, however, the importance of human capital formation through institutions of higher education has been increasing in Japan in response to the greater motivation for education among the younger generation.

In the case of in-company training, a company and its employees share the burden of training costs. Tax deductions are applied for not only the time costs (opportunity costs) that employees need for training, but also the other monetary costs involved. In the case of school education, on the other hand, opportunity costs can be deducted from taxable income but no tax deductions are allowed for monetary costs such as tuition fees. In other words, school expenses must be paid via disposable income after taxation or by a student loan, on which interest payments are not tax deductible.

In view of the above imbalance in Japan and referring to case examples in the United States, I would hope that a better system of tax measures will be explored with the objective of enhancing the route of human capital formation via institutions of higher education in Japan.

(2) Reduction in marginal tax rates and human capital formation

Many taxation experts advocate an expansion of the tax base and a reduction in tax rates as a desirable course to pursue. There are two categories of expenses that can be deducted from the tax base. The first category involves medical expenses, as deducting such expenses from taxable income gives a clearer picture of an individual’s taxpaying capacity. The second is tax deductions for activities that provide considerable external economic effects. In principle, however, it is considered that tax deductions should be allowed only within stringent restrictions.

Let’s apply this principle to the individual income tax. Many conventional studies have focused on the issue of whether income taxes exert a substantial influence on the labor supply as measured by the hourly scale or employment rate. The mainstream opinion has concluded that changes in marginal tax rates do not influence the labor supply significantly. When the target of the study is limited to women, however, the influence is considered to be larger.¹¹ As for the male labor supply, some studies have indicated that men spend more time in work during the high-salary periods of their lifecycles. These analyses conclude that the labor supply clearly reacts to changes in marginal tax rates that influence take-home pay.¹²

There is, however, a more basic point of contention. The base of the individual income tax in Japan is mainly

geared to labor income. And the major part of labor income is compensation for human capital, which is acquired through education or training. Therefore, the issue to be examined is whether or not a reduction in tax rates by expanding the tax base will enhance the process of forming human capital.¹³

First of all, let's look back at the period of high growth in the Japanese economy. In-company training played a relatively important role during that time, and employees and their companies shared not only the costs of investment in knowledge and skills but also the rewards of this investment. As a result, incentives were created among both employers and employees to favor long-term employment. In addition, retirement allowances and the defined benefits of corporate pension plans encouraged long-term employment. As a result, the integration of a company and its employees moved forward smoothly, making it hard to find any routes through which the individual income tax directly influenced human capital formation.

As a result of changes in business management, compensation schemes, and the labor market, however, we today see a greater willingness on the part of individuals to improve their own human capital via school education, in-company training, and self-development programs in pursuit of a better job through promotions and career switches. This tendency to invest in knowledge and skills that are suitable for wider markets is getting stronger. It has thus become easier than before to find routes through which the individual income tax influences human capital formation.

Considering the comprehensive effects on labor hours and employment rates as well as on human capital formation, it can be said that a reduction in marginal tax rates generates beneficial effects that facilitate the supply of labor in terms of both quantity and quality. With respect to the individual income tax, the effort to expand the tax base and reduce the tax rates is a direction for tax reform that is highly significant and one that requires continued promotion.

4 Intra-Family Gift and Inheritance Taxes

In the case of designing gift and inheritance taxes, it is necessary to examine the motivation behind such transfers that make up the tax base in question.¹⁴ This section will therefore examine transfers from parents to children in the form of gifts and inheritances. It is assumed in this analysis that parents are motivated by altruism in providing for their children, which means that they take into consideration the consumption levels of their children as well as themselves in planning their lives. In this case, parents use their funds, which consist of assets formed by receiving gifts and inheritances from their own parents and their own income, for the following three purposes: (1) their own and their child's consumption; (2) investment in human capital formation

among their offspring; and (3) transfers to their children in the form of gifts and bequests.

By investing in human capital formation among their offspring, parents can expect support in their old age in accordance with the earning power of their children. In addition, parents who are able to transfer financial resources to their children through gifts and inheritances are able to use this ability to determine the extent of financial resources that can motivate their offspring to make forward-looking efforts in their lives, and to provide affectionately for the parents in the future.

Parents face uncertainty about the length of their own life spans. If they live longer than expected, they will have to start drawing on assets to meet living expenses. If they die earlier than anticipated, they can leave more assets to their children. When an altruistic relationship is assumed between parents and children, therefore, even an unexpectedly early death is compensated to some degree by utility to parents due to more assets left to their children.

Another important argument posits that the extent of contact between parents and their children will increase in accordance with the above transfers based on altruism. The more frequently they meet and talk, the more they care about each other. In the process, their concept of family values will be developed to a deeper level.¹⁵

Although it would appear that this kind of close relationship between parents and their children has been fading due to the geographical separation of family members, public assistance for education, and public pension programs, the relationship is sometimes functioning strongly even at present. Especially when the risks inherent in a rapidly aging society are increasing, it is necessary to review this system for mutual support among family members and the roles of family values.

In addition, the beneficial effects of altruism go beyond families and have a positive impact on society as a whole. The children of parents who have a strong sense of altruism tend to have a strong desire to improve themselves. Other families who become aware of this tendency will increase their sense of altruism. As a result, some scholars argue that the aspirations for self-improvement within all of society will rise to a higher level.¹⁶

Accordingly, it is preferable that gift and inheritance taxes are designed to the maximum extent possible to avoid impinging on altruistic relationships within the family and to encourage mutual support between parents and their children. In order to achieve this goal, it is necessary to expand the pertinent tax bases, to lower the overall tax rates, and to modify the tax structure to one that is closer to a flat-rate system. Of course, we must recognize that a high percentage of those with extremely high incomes and assets acquired their good fortune simply by luck rather than by making sound and prudent investment decisions independently. Taking this fact into consideration, even if high tax

rates are applied to this group, the distortional effects of such a policy may be small.

As for the relation between a gift and an inheritance, the timing of the transfer and the combinations in which they are applied vary within and between families. In these days when life spans are longer than ever before, we have a wider range of choices. This means that it is essential in designing gift and inheritance taxes to make it sure that one tax will not be notably more advantageous than the other. Accordingly, tax reform should be carried out by providing the option of integrating gift and inheritance taxes through the adoption of a cumulative taxation method—an approach that was included in the Shoup Recommendations and one that is actually used in the United States and Germany (based on a fixed cumulative period).

5 Public and Corporate Pension Reforms and the Tax System

(1) Establishing personal accounts in the public pension system and using consumption taxes for transitional funding

The pension system based on the pay-as-you-go financing plan is plagued by serious financial problems. It is estimated that premium rates will have to be increased to around 30 percent in the future. Even if the financial problems can be addressed by raising the rates, the following adverse effects on the real economy will not disappear because fatal flaws in the design of the current system will not be eliminated. These include a weakening of the mutual-support relationship between parents and children as noted above, a decline in the birthrate, an increase in the younger generation's real tax burden, more emphasis on the quantity of life (i.e., length of life) and less on the quality of life, and the suppression of entrepreneurial activities.¹⁷

Basically, eliminating the defects in the pension system based on the pay-as-you-go financing plan requires the introduction of some form of personal accounts into the system, such as a switch to a complete system of personal accounts¹⁸ or the partial introduction of personal accounts for an earnings-related component.^{19, 20}

One of the most difficult obstacles in this case is how to provide financing for the period of transition. It is a question of how funds can be raised to continue payments to retirees who have been receiving pension benefits. These retirees have paid premiums for their pensions, and the accumulated money consists of a portion of the underlying funds for current reserves. Under the intergenerational support system based on the pay-as-you-go financing plan, however, a large part of the funds for pension payment relies on premiums that the younger generation will pay in the future. If personal accounts are introduced into the system, it will not be able to depend on this reserve of incoming premium payments. As a result, the shortfall in funding

benefits to retirees will have to be made up by tax revenues.

The desirable approach in this scenario is to use the consumption tax as a way of raising the needed funds. In the case of increasing the consumption tax rate, it has already been noted that the burden will be shifted to taxes on labor income and the excess return on other factors of production. In addition, existing assets will also be taxed during the transition, as those who convert existing assets into cash for consumption would still have to pay the consumption tax, but at the higher rate. As a result, a considerable portion of the financing needed for the transitional period will be shouldered by retirees who have existing assets, including pension benefits.²¹ As the distortional effect of taxation on existing assets is small and most retirees are essentially unemployed, the higher consumption tax rate will have only a minor distortional effect on savings behavior and the labor supply as a whole.

Another important point is that this increase in the consumption tax rate is only for the transitional period of the pension system reform. One of the main reasons any increase in the consumption tax rate is approached with great caution is the fear that once the tax rate is allowed to rise, it will be used as a general means of collecting revenues and rates may be raised without restraint. However, the above method for using the consumption tax includes a distinct brake on further rate increases because the higher consumption tax rates will not be needed anymore in the ordinary course of things when the number of retirees declines in the future.

At this point, let's revisit the fundamental reasons why society needs a pension system. If all people had an ability to fully foresee the future (i.e., imagination capital), they would plan their lives by taking the distant future into consideration. Since they would also prepare for the days after their retirement, there is no possibility that problems specific to advanced age would develop when they reach old age. This ability to see through things is developed and honed by various considerations through family members, school education, and experience after they enter the work force.²²

In reality, however, there are those who can never achieve this capability or those who try but fail to develop it fully due to unexpected reversals of fortune such as unemployment and illness. If we neglect their existence, our society will be confronted with a large number of elderly people with little income and even less in assets. This situation will put these elderly people as well as their families and society itself in an extremely difficult situation.

The best public policy approach to prevent such a situation is to force people to save a certain portion of their income while they can work. In this way, those who lack the ability to foresee the future can still prepare for it. The plan for the introduction of personal accounts in public pensions is based on this concept.

(2) Corporate pension reform and exit/entry taxation

One of the measures for preventing the above situation is improving the corporate pension program. Japan has long relied on defined-benefit corporate pension systems, which emerged out of the retirement allowance plan of the high-growth period. But corporate pension systems are also plagued by financial problems. In addition, such schemes are now beginning to show the following adverse effects on the real economy: hampering restructuring programs and corporate reorganization, restraining expansion in employment, and inhibiting labor mobility.

As a result of these changes in the times, Japan has recently introduced a type of corporate pension plan that incorporates a defined-contribution system. One of the problems with this new system is that considerations for entry taxes (taxes at the time of contributing money to the system) are strictly limited, while the system is extremely generous in terms of exit taxes by allowing taxation on retirement pay to be correspondingly applied to pension benefits when plan holders reach a certain age and become eligible to receive benefits. In order to encourage those who do not have adequate ability to foresee the future to voluntarily join a defined-contribution pension system in spite of its restricted liquidity, focusing incentives on the entry tax is more effective than focusing them on the exit tax.

No matter whether we are considering personal accounts under public pension programs or defined-contribution corporate pension systems, participants are forced to design savings and asset management plans by continuously focusing on their own lives in the distant future. This built-in compulsion under either system will provide a suitable environment for people to foster their ability to plan for the future.

Reforms of the public and corporate pension systems are one of the most important policy matters we now face, as such reforms can stabilize the lives of retirees and alleviate a host of adverse effects on the real economy. In order to realize pension system reform, however, support via the tax system is essential. This makes it vital to expand the debate on appropriate ways for the tax system to endorse such reforms.

This chapter has examined five issues concerning the tax system from the viewpoint of responding to the continuing expansion of the knowledge economy and increasing longevity. Although we have discussed only an overview of the main arguments, the effects of taxation have been examined on the basis of economic models that take individual and corporate behavior into consideration. Obviously, there is more than one pertinent economic model; indeed, various models are competing for our attention on the strengths of analysis presented. Which model most appropriately fits the reality of the situation will be determined by the lucidity of its ideas, its compelling logic, and its empirical validation.

If a better economic model makes its debut, applying such a model to the analysis of the tax system may

make it possible to identify new routes through which the impact becomes manifest and clarify the effects to which insufficient attention has been paid in terms of the long existing tax bases and systems. Basing our examination on such an economic model will be useful in understanding the characteristics of various types of taxes and will offer a valuable framework for designing a better tax system.

V Relationship with Recent Discussions on Tax Reform

I noted in Chapter II that while expectations for tax reform are high, reforms are not easy to realize. Tax reforms do not always result in a zero sum gain, as they sometimes expand the economic pie for the entire socioeconomy over the long term. Even in such cases, however, another inevitability is that reforms will lead to many “losers” if the impact of a reform is analyzed by classifying those affected into various groups—and accompanied by the efforts of each of these groups to oppose the reforms.

While the tax reform ultimately adopted by Germany in 2000 has been highly evaluated as an undertaking that will contribute to growth and employment expansion within Germany as well as in other countries, it took a long time to finally realize this proposal mainly because general agreement on the broad principals of reform was overshadowed by fierce opposition to many of the particulars.

Moreover, the Regan tax reform in the United States is often cited in taxation discussions as a reform that contributed to the revitalization of the economy over the long term by expanding tax bases and reducing the progressive tax rates. At the time of Regan’s proposal, however, efforts were made to narrow down the targets because of concern that dealing with all structural problems without restrictions would result in an impasse. In actuality, we should give due attention to the role played by these efforts in developing the conditions that contributed to realizing the reform.

In other words, the various measures taken to narrow down the issues²³ included: (1) securing neutrality in tax revenues as a precondition; (2) ensuring that no major changes would upset the balance of taxes to be borne among the different income strata; and (3) creating a sense of “winners” among individuals by reducing the individual burden and increasing the corporate burden (as the issue of who ultimately pays the corporate tax is not fully clear to the public, the sense of the burden on individuals is perceived as small). After taking these various steps, the Republican Party agreed to a reduction in tax rates and the Democratic Party agreed to an expansion of the tax bases, thus making the reform possible.

At the same time, we should also note that the conceptual impetus for the Regan tax reform originated

from the ideas of specialists. Former secretary of state George Schultz recalled the situation as follows:

“When I was a staff member at the Council of Economic Advisors during the Eisenhower Administration, I was educated on tax matters by a wonderful colleague, the late Joe Pechman. In off-hours, he was calculating the amount by which marginal tax rates could be lowered without losing revenue if one or another or all tax exemptions were eliminated. His message stuck with me. I read additional economic studies on the improved efficiency of the economy that would result from such changes. As Secretary of the Treasury I persuaded Richard Nixon to propose a relatively modest tax reform. As Secretary of State, after talking it over with Milton Friedman—a source of wise and practical counsel over many years—I suggested the idea on a more radical basis to Ronald Reagan in December 1982. The result was the start in the Treasury of what became the bipartisan tax reform act of 1986. It was not perfect, but it was a tribute to Joe’s work, among others, and to the power of an important idea.”²⁴

Incidentally, recent discussions on tax reform in Japan have evolved into a more extensive format than before and expectations for a drastic reform are starting to take shape. Proposals have been made calling for the revitalization of the economy by such measures as gradually reducing the progressive rates on individual income taxes and reducing the effective tax rates of corporate income taxes. A view calling for large-scale tax reductions as a deflation countermeasure has also started to gain currency.

Despite these early signs, many foresee that the possibility of implementing a reform of individual and corporate income taxes accompanying any large-scale tax reductions at an early stage is not very high. The background behind such a prospect includes the following.²⁵

- (1) Under circumstances in which no national consensus has yet been established with respect to structural issues such as “appropriate fiscal discipline,” “effective deflation countermeasures,” and “appropriate policies to strengthen growth,” discussions on the role of a tax reform will not easily reach any conclusions.
- (2) It is difficult to secure adequate financial resources to implement large-scale tax reductions, as annual expenditures for the next and subsequent fiscal years are projected to increase year by year mainly due to substantial increases in expenses related to social security, etc. Moreover, there are fears that tax revenues may see natural decreases as effective tax rates decline with continuing deflation.
- (3) Any relaxation in progressive rates, which assume that tax revenues can be maintained by cutting individual income tax deductions, will raise a politically difficult problem of trade-offs, namely,

the shift of taxes from the high-income strata to the low-income strata. Similar problems would be involved in raising individual income taxes and reducing corporate tax rates.

Under these circumstances, some specific measures have come to the surface as matters of study for the time being—much like the case of tax incentives to promote R&D. One of these is the introduction of pro forma standard taxation. As I have not touched on this issue in this paper so far, I would like to consider the base for pro forma standard taxation as an addendum to the previous chapter.

The previous chapter explained that the tax base for corporate income taxes is the return on equity, and the tax base for the consumption-type VAT levy is the labor income and excess return on other factors of production. In comparison, the base for the pro forma standard tax is the addition-type VAT (labor costs + interest payable + profits, etc.) that targets only corporations if, for example, a business activity value base is adopted. As this means handling debt and equity on equal footing, it works in the direction of correcting the imbalance resulting from subjecting only the return on equity to taxation under the corporate income tax, as previously noted. This point constitutes an advantage of the levy.

However, when we look at company taxation from an overall perspective, we see that three different types of tax bases coexist. Furthermore, there are also differences between corporate and unincorporated businesses. It is difficult to escape the conclusion that tax policy vis-à-vis company activities and the economy as a whole is replete with excessive confusion.

In any case, it is hard to believe that the burden on the people will move in the direction of being lightened as a whole in view of the long-term outlook for Japan. Based on this precondition, the arguments should focus on which tax bases should be emphasized and how they should be utilized on a more sophisticated basis for more effective utilization in order to minimize the adverse effect exerted on Japan’s socioeconomy by the increasingly heavy burdens placed on the people.

With reference to the taxation tasks for the future that were discussed in the previous chapter, I should note that there are some topics on which discussions are being deepened under the current tax reform deliberations. However, some of these discussions include the problems noted above.

More importantly, a number of tasks remain for which full-scale studies have not yet been initiated. Included among them are appropriate taxation in relation to pension system reform and the utilization of consumption taxes. If the current temper of the times is taken into account, these issues will inevitably become the themes of political discussions sooner or later. It will be extremely important that specialists are included in these discussions and that all major academic and

technical issues be identified prior to moving on to a deliberation of the political ramifications.

As noted in Chapter II, the starting point of this analysis was: “What behavioral changes occur if taxes are imposed on households and companies and how such changes influence the markets for goods and services and the markets for factors of production.” I would hope that theoretical and empirical research in support of this analytical framework continues to be accumulated in the future and with due attention given to the changing current of the times. I further hope that the results of such research will be rich in ideas that serve as the basis for tax reform proposals that can overcome even the various factors that make tax reforms proposals so difficult to realize.

Acknowledgement: I wish to thank Masaki Iwasaki, a doctoral candidate in the Graduate School of Business and Commerce, at Keio University, for his research and cooperative efforts in the preparation of this paper.

Bibliography:

1. Michael J. Graetz, *The Decline (And Fall?) of the Income Tax*, W.W. Norton & Company, 1997.
2. David F. Bradford, *Untangling the Income Tax*, Harvard University Press, 1986.
3. John G. Matsusaka, “The Economic Approach to Democracy,” in *The New Economics of Human Behavior*, edited by Mariano Tommasi and Kathryn Ierulli, Cambridge University Press, 1995.
4. Shigeie Ito, “Taxation Neutrality and the Shoup Recommendations,” *Zeimu Daigakko Ronso*, No. 26, Zeimu Daigakko, March 1996.
5. Morning edition of the Tokyo Newspaper, May 27, 1995.
6. David D. Friedman, *Law’s Order*, Princeton University Press, 2000.
7. Nicholas Bloom, Rachel Griffith and Alexander Klemm, *Issues in the Design and Implementation of an R&D Tax Credit for UK Firms*, Briefing Note No. 15, London: Institute for Fiscal Studies, 2001.
8. Minoru Nakamura, Takeshi Murakami and Sadanori Otani, “Toward the Reform of Corporate Legislation and Taxation,” *Zaikai Kansoku*, November 1998.
9. Hugh J. Ault, *Comparative Income Taxation*, Kluwer Law International, 1997.
10. Gilbert E. Metcalf, “Value-Added Taxation; A Tax Whose Time Has Come?” *Journal of Economic Perspectives*, Winter 1995.
11. Joel Slemrod and Jon Bakija, *Taxing Ourselves*, MIT Press, 2001.
12. Casey B. Mulligan, *The Intertemporal Substitution of Work; What Does the Evidence Say?* University of Chicago, Population Research Center Discussion Paper Series #95-11, June 1995.
13. Toshihiro Ihuri, *How Taxes Paid by You Are Used*, Toyo Keizai Shinpo, 2001.
14. Louis Kaplow, “A Framework for Assessing Estate and Gift Taxation,” in *Rethinking Estate and Gift Taxation*, edited by William G. Gale, James Hines and Joel Slemrod, Brookings Institution Press, 2001.
15. Gary S. Becker and Kevin M. Murphy, “The Family and the State,” *Journal of Law and Economics*, April 1988.
16. Gary S. Becker, *A Treatise on the Family*, Harvard University Press, 1981.
17. Masatoshi Kuratani and Yukihiko Endo, “Designing Pension Systems for a Knowledge Economy,” *Knowledge Creation and Integration*, May 2001.
18. Laurence J. Kotlikoff, “Privatizing Social Security the Right Way,” Testimony to the Committee on Ways and Means, June 1998.
19. Takeshi Yamaguchi and Minoru Nakamura, “Structural Reform of Public Pensions with the Introduction of Personal Accounts,” *Economic Analysis Research Office Research Series No. 8*, Nomura Research Institute, May 2002.
20. Nomura Research Institute, *2004 Public Pension Reform*, Nomura Research Institute, 2002.
21. Laurence J. Kotlikoff, *Privatizing Social Security*, NCPA Policy Report, No. 217, July 1998.
22. Gary S. Becker and Casey B. Mulligan, “The Endogenous Determination of Time Preference,” *Quarterly Journal of Economics*, August 1997.
23. Joseph E. Stiglitz, *Economics of the Public Sector*, R.S. Means Company, 2000.
24. George P. Schultz, “Economics in Action: Ideas, Institutions, Policies,” *American Economic Review*, May 1995.
25. *Japanese Economy Monthly*, Issues for March, May, June and August 2002, Nomura Research Institute.

Masatoshi KURATANI holds a PhD in economics from Columbia University and is a counselor at NRI. His area of specialization is applied microeconomics.

As a leading think-tank and system integrator in Japan, Nomura Research Institute is opening new perspectives for the social paradigm by creating intellectual property for the benefit of all industries. NRI's services cover both public and private sectors around the world through knowledge creation and integration in the three creative spheres; "Research and Consulting," "Knowledge Solutions" and "Systems Solutions."

The world economy is facing thorough structural changes led by the dramatic growth of IT industries and the rapid expansion of worldwide Internet usage—the challenges of which require new concepts and improvement of current systems. NRI devotes all the efforts to equipping the clients with business strategies for success by providing the best in knowledge resources and solutions.

NRI Papers present selected works of NRI's 3,000 professionals through its worldwide research network. The mission of *NRI Papers* is to contribute new ideas and insights into business management and future policy planning that are indispensable for overcoming the obstacles to the structural changes in our society.

All copyrights to *NRI Papers* are reserved by NRI. No part of this publication may be reproduced in any form without the prior written consent of NRI.

Inquiries to: Corporate Communications Department
Nomura Research Institute, Ltd.
E-mail: nri-papers@nri.co.jp
FAX: +81-3-5255-9312