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LAND TAX REFORM IN JAPAN

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Abstract

Land tax reform in Japan was a most controversial issue in 1990, reflecting the problem of the sharp rise of land prices that began in the late 1980s. The Japanese government established the Sub-Committee on Land Taxation under the Tax Advisory Commission in April 1990 to promote a comprehensive study of the land tax system on the basis of such tax principles as equity, neutrality and simplicity. The final report was published in November after a very intensive seven months discussion, and in April 1991 the Land Tax Law was enacted in the Diet.

The aim of this article is to examine the movement of land tax reform and to clarify the contents of the reform package that the Sub-Committee presented as its basic recommendations. The main ideas of the proposals in the final report will perhaps continue to attract attention as a reference point for future reform of the land tax system.

A sharp rise in land prices began in the late 1980s, causing a number of land-related problems within the Japanese economy and societies. In 1990, heated arguments occurred in the government and the private sector in an attempt to seek any effective policy means with respect to reducing land prices. From the expectation that land taxes should play a substantial role in calming the increased tempo of land prices, particularly in the urban areas, land tax reform emerged as an important measure.

On October 30, 1990, the Tax Advisory Commission submitted to Prime Minister Toshiki Kaifu a tax report entitled on "Basic Recommendations on the Ideal Framework of Land Taxation." These recommendations have the ambitious target of restructuring the land tax system as a whole and draw its basic design in the coming decade or so. Allowing for political compromises that were made during deliberations in the LDP (Liberal Democratic Party) Tax Council, the proposal was presented to the 120th Diet session as the Land Tax Bill.

The main aim of this article is to clarify the fundamental nature of land tax reform that has been developed by the Tax Advisory Commission over the past year. It proceeds as follows: Section I traces the background of recent land tax reform. Section II reviews the existing land tax system and clarifies the necessity of restructuring land taxes in the Japanese tax system. Section III and IV outline the proposed reform package on land holding, land acquisition, capital gains from the sale of land and the special issues of agricultural

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land tax. Section V summarizes major points of the Land Tax Bill. Finally Section VI offers some conclusions.

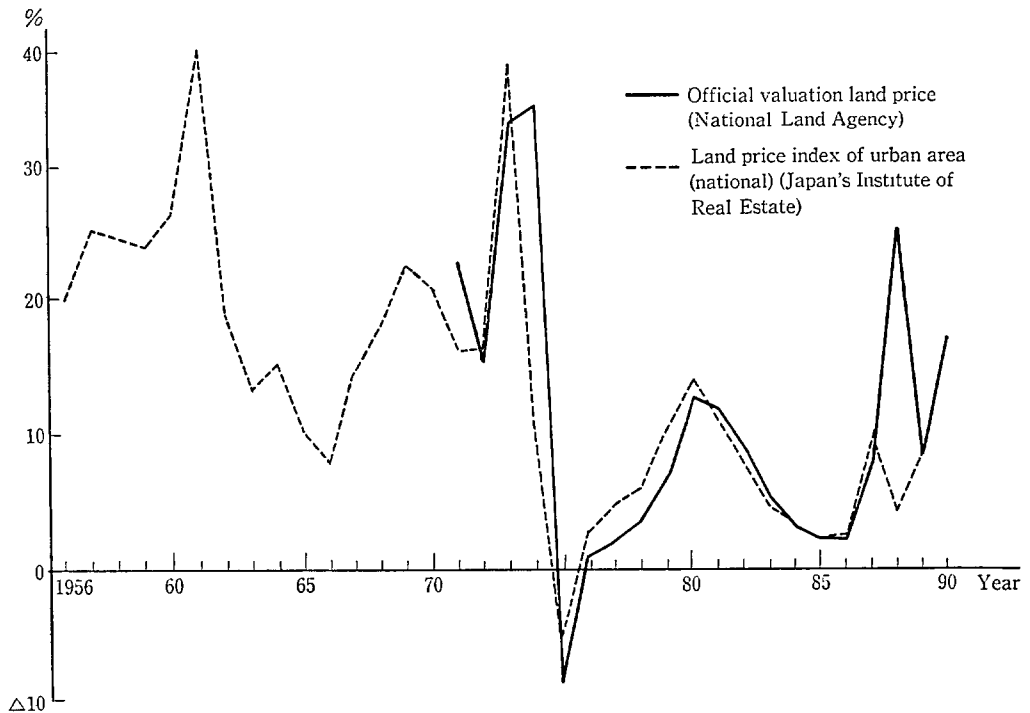
I. Background of Land Tax Reform

The recent increase in land prices marked the third run of steep hikes after World War II. As depicted in Figure 1, the first run occurred in the second half of the 1950s, reflecting the sustained, high-level rate of economic growth. Likewise, the second land price hike swept across the nation early in the 1970s, triggered by the grandiose vision of "Rebuilding Japan's Archipelago" which essentially induced large scale land speculation throughout the country.

Over the past 40 years, land prices have increased continuously with one exception in 1975 when a severe monetary restraint was intensively undertaken to reduce the sharp rise in land prices. Given the consistent rising tempo of land prices, a so-called "land myth" has gradually proliferated with the belief that land prices will never drop. Land itself is considered one of the most valuable assets in the capital market.

Behind the "land myth," land prices have increased at an annual rate far faster than basic economic indicators, such as nominal national income, real income of the working

FIG. 1. LONG-TERM TREND OF LAND PRICES TRANSITION OF THE AVERAGE RATE OF CHANGE IN LAND PRICE (nationwide, residential land)



household and the price level. For instance, the urban land price index of the six largest cities shot up 128 times between 1955 and 1989, while real income of the working household merely rose 17 times and the consumer price index 5 times during the same time span.

In particular, from 1985 to 1990 in urban areas land prices roughly tripled. This abnormal upswing of urban land prices has not necessarily been induced by changes in real economic activity. Instead it is widely acknowledged that a substantial part of these increased land prices reflect a "bubble" phenomenon due to the speculative expectation of further price increase.

Several problems emerged from such land price hikes, particularly in the metropolitan areas. First, the widening gap between the haves and have-nots (i.e., asset gap) became conspicuous and impaired the people's sense of social equality. Second, it became almost impossible for the average worker to purchase his own residence by earned income. Generally speaking, housing prices in 1988 were 7 times the annual salaried income of average workers, while counterpart figures were three to four times in the U.S., the U.K. and W. Germany. In large metropolitan areas where land prices are much higher than the national average, the possibility of becoming an owner occupier of one's own residence is becoming an unattainable dream for salaried workers. Third, land prices in the Tokyo metropolitan area are so excessively high that it is impossible for foreign, as well as local, firms to enter into that area for business activities. This was the reason why the U.S. raised the land problem as a non-tariff barrier during the recent Structural Impediments Initiative (SII) talks.

The key factor behind the land problem is that land is held for its asset value alone. This is unique to Japan, though it may hold true for Korea and Taiwan. Today, it is believed that land is the most profitable form of held asset. Thus, land provides the best opportunity of obtaining appreciation in asset value for individuals as well as corporations. Ideally, land is supposed to be used for housing, office space, factories, etc. Under such patterns of land use, the unit-land price theoretically represents a discounted value for its expected stream of annual returns over a stretch of a certain number of years. This may be called the rental value or net annual value. In Japan, however, market prices of urban land have far exceeded above this theoretical value, mainly because land is used as a means for speculation on its asset value apart from its use value.

Why did urban land take on such asset value? No doubt, the recent steep rise of urban land prices was primarily caused by the advantages of holding land as an asset. There are three reasons behind this fact [see, for instance, Noguchi (1990)].

First, the government's land use plan is ambiguous and too loosely regulated. In Western countries, land use is well-defined by category for commercial, industrial, housing or agricultural land usage. In addition, it is impossible to divert the established land use without the approval of relevant authorities. Land regulation is thereby strictly enforced. By contrast, in Japan the ill-defined character and ambiguous regulation of land use is prevalent. For example, commercial buildings can easily be constructed in residential areas officially designated for residential purposes only. Agricultural land within the city limits can also be converted into housing or commercial land. Obviously, such lenient regulations have contributed to promoting the huge asset value of urban lands.

Second, attention should be paid to the "easy money" that has persisted since the second half of the 1980s. Under the banner of easy money, financial institutions were encouraged to increase land-related lendings which boosted land prices. After monetary policy moved

into a tighter credit direction in 1990, urban land prices began to fall. This implies that an "easy money" policy has frequently promoted the sharp rise of land prices in the past.

The third factor is the very light tax burden on land. Currently land taxes are levied during the three stages of land acquisition, holding and transfer, but it is widely believed that these taxes have been borne lightly by landowners. No doubts, the generous treatment of land taxation has played a vital role in lifting the asset value of land.

Thus, various measures must be taken to resolve the beforementioned land problems, including regulations on land use, land-related lending activities and the land tax system. In other words, a comprehensive land policy is needed, which must be initiated by cooperation of the relevant ministries (e.g., Ministries of Construction and Finance, The National Land Agency, etc.).

It is important to stress that the land tax system alone cannot be the exclusive effective means to remedy land-related issues. The overall reform of land taxes should essentially be accompanied by other reforms of the legal aspects of land use and regulation. Accordingly the Basic Land Law which is generally believed to establish the framework of solving the land problem was enacted in December 1989. Of most importance, this law portends that all lands should be used to enhance public welfare, in spite of their being privately owned. This way of regarding land as a sort of "public good" would have a revolutionary impact on land ownership and might contribute to an increase in the land supply.

In Japan, private ownership of land has so far been protected from expropriation, and this encouraged the idea that one can do with his land at will. In contrast, land is thought of as public property in Western nations and cannot be sold freely in pieces by the initiative of private landowners. Moreover, buildings in these countries cannot be constructed in ways that do not fit into the neighboring surroundings. After establishing the Basic Land Law in Japan, the fundamental concept of landownership would essentially be changed. This will have a close bearing on the enforcement of land taxation in any new land policy.

Recognizing the need for curing these serious land issues, the government of Japan decided to establish the Sub-Committee on Land Taxation in April 1990 under the Tax Advisory Commission. Since then, a comprehensive study on the land tax system was conducted by this Sub-Committee on the basis of such tax principles as equity, neutrality and simplicity. This study was made in accordance with the ideas expressed by the Basic Land Law and with other land policies as noted before.

The Sub-Committee met at least once a week, including domestic and overseas research trips before finally proposing its tax report in October 1990. In this report accompanied by two earlier interim reports,¹ the Sub-Committee emphasized the following two points as central to the discussion of land tax reform.

First, it is necessary to levy an appropriate tax burden on land assets from a standpoint of tax equity. Consequently, this contributes to enhance the efficient utilization of land. Second, land taxation can play an important role, as a part of land policy, in promoting an increase in the land supply via more efficient land utilization. It is also believed that a heavier burden on land would perhaps prevent speculative land transactions.

¹ See, Sub-Committee on Land Taxation (1990a), (1990b). The first interim report clarified the major issues to be remedied in the course of reviewing the current land tax system while offering basic reform targets. The second one sorted out the views expressed by the Sub-Committee members concerning land tax reform.

In what follows, major proposals for land tax reform are presented with their related arguments, based on the final report of the Sub-Committee.

II. Review of the Existing Land Taxes

Before proceeding to the new tax reform plan, it is necessary to explain briefly the current land tax system and to clarify the shortcomings to be remedied. Table 1 outlines three types of land taxation; on acquisition, holding and transfer. Eight taxes in three separate categories are listed as a system of "land tax." Of these there are four that have in connection with the current tax reform debate.

The most important issue in the existing land tax system is the extremely light property tax burden levied by the municipal governments on land holdings. Such a light tax burden essentially reduces the cost of holding a piece of land, and in turn tends to cause the increased value of land as an asset. In addition, it tends to incur the insufficient use of land, reflecting the almost negligible cost of land holding. Therefore, many opinions support augmenting tax burden on land holding by any means.

TABLE 1. OUTLINE OF LAND TAXATION

Stage	Tax Item	Outline of the Tax		
		Tax Base	Tax Rate	Others
Acquisition	Land Acquisition Tax (Prefectural Tax)	Assessment value for the Property Tax	4/100	The tax is imposed on buildings besides land
	Special Land Holding Tax on Acquisition (Municipal Tax)	Acquisition cost	3/100	The amount corresponding to the Land Acquisition Tax is credited
	Registration and Licence Tax (National Tax)	Assessment value for the Property Tax	50/1000 (rate applied to sales and purchase)	
	Inheritance Tax (National Tax)	Assessment value for the Inheritance Tax	10~70% (progressive tax rate)	The tax is imposed on all inherited assets. The Gift Tax supplements the Inheritance Tax
Holding	Property Tax (Municipal Tax)	Assessment value the Property Tax for	Standard Rate 1.4/100 Ceiling Rate 2.1/100	The tax is imposed on buildings and depreciable assets in addition to land
	City Planning Tax (Municipal Tax)	Assessment value the Property Tax for	Ceiling Rate 0.3/100	The tax is imposed on buildings in addition to land
	Special Land Holding Tax on holding (Municipal Tax)	Acquisition cost	1.4/100	The amount corresponding to the Property Tax is credited
Transfer	Income Tax (National Tax) Corporation Tax (National Tax) Inhabitants Tax (Prefectural and Municipal Tax)	See the "Outline of land transfer taxation," in Table 4		

The current property tax offers an effective policy instrument for this purpose. Presently, the Japanese local property tax system imposes a main land holding tax, as well as a special land holding tax. The property tax is levied annually on the assessment value of three taxable assets (i.e., land, buildings and depreciable assets) at the rate of 1.4 percent.² There are two special reliefs for the tax base of residential land; that is, (1) a reduction of the tax base for residential use to one half, and (2) a reduction of the tax base of small scale land for residence (up to 200 m²) to a quarter.

Table 2 indicates the effective tax burden of the land holding tax from 1970 to 1988, in which effective tax rates are calculated relative to land assessment values in terms of the official valuation price set by the National Land Agency. Compared with the statutory rate of 1.4 percent, the property tax burden shows a range of 0.09 to 0.19 percent and has begun to decline since the start of the most recent land price hike in 1985. Even when the two other taxes are added to the property tax, the low tax burden of holding land remains almost the same.

How do we explain the gap between statutory and effective tax rates? This is mainly due to the underestimated land valuation for the property tax, as well as the special relief for residential land mentioned above. In recent years, the valuation of land has posed

TABLE 2. EFFECTIVE TAX BURDEN OF THE LAND HOLDING TAX

(%)

Year	The property tax (land)	Total land holding taxes
	Land assessment	Land assessment
1970	0.09	0.14
71	0.10	0.15
72	0.09	0.13
73	0.11	0.17
74	0.14	0.23
1975	0.13	0.21
76	0.15	0.23
77	0.16	0.24
78	0.16	0.25
79	0.15	0.23
1980	0.18	0.26
81	0.16	0.23
82	0.17	0.25
83	0.18	0.26
84	0.18	0.26
1985	0.19	0.26
86	0.17	0.24
87	0.13	0.18
88	0.12	0.17

Source: Economic Planning Agency, *Annual Report on National Accounts*, Ministry of Home Affairs, *Data on Local Taxes*, each year.

Note: Total land holding taxes include the city planning tax and the special land holding tax in addition to the first column. Land assessment value is set in accordance with the official valuation price.

² In addition to the standard rate of 1.4 percent, an upper limit of 2.1 percent was allowed as a surtax rate.

puzzling problems.³ The basic standard of land valuation is given by an official valuation price (*chika kōji kakaku*) which is calculated January 1 and published every year by the National Tax Agency. As seen in Table 3, the property tax assessment for land has produced a huge deviation from its official valuation price. Every three years the local authority has to attempt to reevaluate land prices on a nationwide basis (i.e., the number of properties are 160 million) in order to construct a new taxable base for the property tax.

In 1979, the property tax on land was assessed on the basis of 61.4 percent of its official valuation price, but the trend of undervaluation reached as low as 36.3 percent in 1991. Of course, as land prices rose, both the property tax assessment and the official valuation price were raised in conjunction with the rising tempo of land prices in the market. However, the former did not increase as rapidly as the latter.⁴ This is the reason why a gap has emerged between the two land prices, which in turn has lowered the property tax burden of land holding. An inspection of land valuations in individual spots at 47 prefectures revealed that the higher the land price hike by region, the lower the assessment for tax purposes. For instance, the ratios in 1991 are 21.9 percent in Tokyo special wards⁵ and 14.6 percent in Osaka-city, as compared with the 36.3 percent national average ratio used in Table 3 and a more than 50 percent ratio for other local cities. Given the fixed level of a 1.4 percent tax rate, this implies that local governments have made adjustments in order to avoid raising the property tax burden.⁶

The coefficient of variation in Table 3 moves upward from 16.9 to 34.2. The rising trend of coefficients shows the expansion of regional disparity in the undervaluation of property tax assessments for land, partly because land prices themselves have a diverse rising pattern regionally and thereby expand the bias of assessing the land value for tax purposes. Thus, the important targets in land tax reform are how to increase the land holding tax and how to reform the land assessment process in order to reduce the asset value of land and stimulate more efficient land utilization.

TABLE 3. THE RATIOS OF PROPERTY TAX ASSESSMENT TO OFFICIAL VALUATION OF LAND PRICE

Year	1979	1982	1985	1988	1991
National average (%)	61.4	67.4	52.1	47.2	36.3
Coefficient of variation	18.3	16.9	23.2	23.7	34.2

Source: Data prepared by the Ministry of Home Affairs for the Sub-committee on Land Taxation. Also, author's calculation.

Note: Ratios are calculated by using the highest land prices in major cities of 47 prefectures, and are simply averaged. Coefficient of variation is the ratio of variants to average value, based upon land prices in 47 prefectures.

³ See, for more expanded discussion, H. Ishi, "Land Valuation Issues in View of Land Tax Reform; A Case of Japan," *Hitotsubashi Journal of Economics* (forthcoming).

⁴ The official valuation price of land itself tends to be estimated at only 70 or 80 percent of its market price.

⁵ Tokyo is composed of two parts: the 23 special wards in the central area and the other suburban cities and towns.

⁶ It is widely acknowledged that the effective rate of the property tax (i.e., actual tax payment relative to market price of land) is extremely low, say 0.05–0.06 percent in the Tokyo metropolitan area. The comparable figures in New York and London are 0.8–1.0 percent for houses or flats and 2.5–4.3 percent for office and business space (see, data prepared for the Sub-Committee on Land Taxation).

The second problem in the existing land tax system is the inheritance tax. The inheritance tax itself is not a proper category of land taxation. However, since land is the most important form in inherited assets (i.e., about 70 percent of the estate total), the current structure of tax on inheritance has a close bearing on the land problem. As shown in Table 1, the inheritance tax is levied on land acquisition by taxing property transfers together with other inherited assets, such as stock, deposits, etc. Such a tax is paid by heirs, not decedants.⁷

The inheritance tax is based on the assessment value set by the National Tax Administration, and the tax rate is progressive from 10 percent to 70 percent with standard basic exemptions. Similar to the property tax, special reliefs are prepared for small scale land (up to 200 m²), where the residential-use assessment value is lowered to 50 percent and the business-use assessment value to 60 percent.

In relation to Japan's land problem, inheritance in the form of land benefits taxpayers to a great extent, because land is taxed for inheritance at 70 percent of its official valuation price which itself is believed to be only approximately 70 percent of its market price. Thus, the inheritance tax assessment for land would be about half of its market price, while inherited stock and bonds are subject to tax on the basis of their full market prices. Evidently, such tax benefit has in recent years played a role in accelerating the asset value of land. As a part of land tax reform, it is necessary to restore the "balance of valuation" between land and non-land inherited assets.

The third is the capital gains tax on the sale of land as a tax on land transfers. The current system of land transfer taxation is outlined in Table 4. There are three taxes levied on capital gains on land; the individual income tax, the corporate tax (both national taxes) and the inhabitants tax (prefectural and municipal taxes for both individuals and corporations).

The basic structure of capital gains tax on land is considerably complicated, reflecting a number of stopgap changes taken by the government in the past to achieve specific land policy targets. Essentially, taxation on capital gains from land sales depends on the length of the holding period of the transferred land. In the case of individuals, both short-term and long-term capital gains are taxed at specific flat rates, separate from other income. A heavier tax rate is levied on short-term capital gains from land held for 5 years or less than on long-term gains from land held for more than 5 years. Heavier taxation on short-term capital gains was implemented as a sort of penalty tax against speculative land transactions. When the gains fall on business income, say in the case of a real estate agency, super-short-term capital gains are subject to a larger penalty-type tax.

As to corporations, additional taxation on both short-term and super-short-term capital gains is applied at the rate of 20 percent and 30 percent respectively in addition to the ordinary corporate tax. On the other hand, long-term capital gains are aggregated with other income and the regular tax rate is applicable to the gains.

The current system has developed through trial and error over the past two decades. This holds particularly true in the case of individuals. Before 1968, capital gains on land were treated under the ordinary individual income tax code, although half-taxation of the

⁷ Japan's inheritance tax is a hybrid system of an estate tax and an inheritance tax, which is unique in comparison with other countries. See, for more detailed discussion, Ishi (1989), ch. 11.

TABLE 4. OUTLINE OF LAND TRANSFER TAXATION

Holding period (on Jan. 1st of the transfer year)		2 years or less	Over 2 years, 5 years or less	Over 5 years
Individual	(Category of Income) Capital Gain	Separate Taxation The tax amount is the larger of the followings a. gain \times 40% (12%) (Note the rate in () shows the Inhabitants Tax rate.) b. marginal tax amount as if treated as comprehensive taxation \times 110%		The gain after special deduction is separately taxed by applying the following rate. 20% (6%) to the part of the gain below ¥ 40 million 25% (7.5%) to the part of the gain over ¥ 40 million
	Business Income or Miscellaneous Income	Separate Taxation The tax amount is the larger of the followings a. gain \times 50% (15%) b. $\left(\begin{array}{l} \text{marginal tax} \\ \text{amount as if} \\ \text{treated as compre-} \\ \text{hensive taxation} \end{array} \right) \times 120\%$	Same as above	Ordinary comprehensive taxation
Corporation		The gain is taxed at the rate of 30% in addition to ordinary corporation tax	The gain is taxed at the rate of 20% in addition to ordinary corporation tax	Ordinary corporate taxation

gains was taken in favor of averaging irregular income. However, special provisions were introduced in the 1969 tax reform to promote the supply of land and to discourage speculation on land sales. Until 1975, the new tax rates were applied to capital gains on land, separate from other income; 10 percent in 1969–71, 15 percent in 1972–73 and 20 percent in 1974–75 respectively on long-term capital gains, and 40 percent on short-term gains. This provision of the 1969 tax reform had far-reaching effects on the transfer of landownership from individuals to corporations, but the total effect of promoting an increase in the land supply was not observed as markedly as had been expected. To make matters worse, the special treatment of capital gains on land substantially sacrificed tax equity [see, Ishi (1989, ch. 5)].

To appease the critical view of inequitable taxation, the government in 1976 began to make modifications towards heavier tax burdens in the individual income tax for long-term capital gains on land. Since then, taxable long-term capital gains have been divided into two classes; above and below ¥40 million, applying different flat rates to each, as seen in Table 4. As a result, although some modifications were generously made now and then, flat but higher rates of tax have been applied to long-term capital gains. Nonetheless, long-term capital gains have been taxed more lightly than other ordinary income, such as earned income. By contrast, the 40 percent penalty tax rate on short-term gains has remained unchanged since it was established in 1969.

Similarly, for corporations, additional taxation on short-term capital gains on land has continued in the same way as was introduced in 1973. In 1987 a new scheme of super-

short-term gains held for less than 2 years with the tax rate of 30 percent was installed.

One of the most controversial issues in the corporate tax on capital gains is that deficit-operating corporations can be totally exempt from the tax payment, even if they earned a huge amount of capital gains from land sales. It has been noted that some corporations intentionally avoid their corporate tax burden by turning themselves into such so-called deficit-operating businesses.⁸

In addition to the basic structures of capital gains tax on land for both individuals and corporations, tax relief has proliferated over the past two decades. Particular attention should be paid to the following two points. First, there are special deductions and reduced rates concerning transfers of residential land and buildings by individuals or transfers of land for specific policy targets. For instance, when residential land or buildings owned by individuals for over 10 years are transferred, reduced tax rates are applicable to the gains. Also, special deductions are available to land transferred for expropriation. The second point is that the special rule for "business assets rollover", where certain land or buildings are sold in place of other land or building by the same person or firm, is allowed with some limitations. This rollover rule has been adopted to promote decentralization and urban renewal. Under the special rule, the capital gains tax on the old asset can be deferred allowing the new asset to carry over the basis of the old asset.

The current system of capital gains tax on land is obviously far from satisfactory from a standpoint of tax fairness, neutrality and simplicity. Thus, the capital gains tax as well as the land holding tax have become important goal of land tax reform.

Last, the fourth problem of land taxation concerns the special treatment of taxes on agricultural land. Currently, agricultural land benefits greatly from the preferential treatment of both its property tax and inheritance tax. Table 5 summarizes the past records of the property tax in Urbanization Promotion Areas, from which we can observe a de facto state of neglect.

In principle, agricultural land within the Urbanization Promotion Area⁹ of the three Metropolitan areas is treated as residential land for property tax purposes. However, if farmland with more than 990 m² is operated continuously over a 10 year period, the tax due on residential land as an excess tax amount over the tax calculated for agricultural land is deferred. Thus, during the relevant period, the tax is calculated, based on the assessment of agricultural land, whose burden is almost negligible.¹⁰ Furthermore, such a de-

⁸ The ratio of deficit-operating corporations to total corporations in Japan has exceeded more than 50 percent for a long time (see, H. Ishi (1989), pp. 160-161). From the conventional view of ongoing concerns, this seems suspicious.

⁹ In 1971 when the City Planning Law was established, Urbanization Promotion Areas were demarcated from Urbanization Control Areas, and were regarded as urban areas where even the existing agricultural land therein should be converted to residential use within a 10 year period. However, backed by vested farmer interest groups the government of Japan has continued to preserve, until now, lenient treatment in favor of the land in question.

¹⁰ The Ministry of Finance presented the following prototypical case of agricultural land taxation within the Tokyo Urbanization Promotion Area.

Example, 3,600 m² of land site located in Setagaya-ward,

(a) An official valuation price: ¥3.42 billion

(b) Property tax assessment
for residential land: ¥576 million
for agricultural land: ¥2.32 million

TABLE 5. THE PROPERTY TAX ON THE AGRICULTURAL LAND IN URBANIZATION PROMOTION AREAS

	1971	1972	1973	1974	1975	1976~1981	1982~1991	
Area	Nationwide		Limited to the designated cities in the three metropolitan areas					
Type of Farm	Type "A" farm (applicable after 1971)	Not enforced	○ —————→ Many cities paid subsidies by their discretion			○ —————→ The tax can be reduced, by municipal ordinance to those farms that are actually cultivated and appropriate to be preserved as farms for more than 3 yaers		① Taxed as residential land except for land with value less than 30,000 yen per 3.3 m ² . ② Deferral of tax on farm continuing long-term agricultural operation was introduced, which applies farm actually cultivated and appropriate to be preserved as farm for more than 10 years
	Type "B" farm (applicable after 1972)		Not enforced	○ —————→ Many cities paid subsidies by their discretion				
	Type "C" farm (applicable after 1975)						Not enforced	

- Notes: 1 Type "A" farm: Farm with assessment value per 3.3 m² in 1972 over average price or ¥50,000.
Type "B" farm: Farm with assessment value per 3.3 m² in 1972 below and over average land price (except for farm less than 10,000 yen).
Type "C" farm: Farm with assessment value per 3.3 m² in 1972 below half of average land price or 10,000 yen.
- 2 Designated cities in the three Metropolitan areas (190 cities in 1988).
① Words in Tokyo, and 105 cities in Ibaragi, Saitama, Tokyo, Chiba and Kanagawa.
② 28 cities in Aichi and Mie.
③ 56 cities in Kyoto, Osaka, Hyogo and Nara.

ferred tax amount is entirely exempted if the continuation of the agricultural operation is confirmed every 5 years.

Likewise, the inheritance tax has a special tax deferral measure on agricultural land in general on the ground that the land should not be divided into small pieces in order to preserve the efficient operation of agriculture. Of course this measure is applicable only when the heir continues to be a farmer. The tax amount on the assessment value of the land above that of the invested capital for agriculture is deferred, and in addition the deferred amount is exempted if the heir continues to be a farmer for more than 20 years.

Both the property tax and the inheritance tax deferral systems of payment are considered as key factors in preventing the agricultural land particularly in the urban areas, from facilitating the planned conversion to residential land. In fact, there are many cases in the suburbs of Tokyo where ordinary land is "disguised" as agricultural land by the planting of trees, such as nut or persimmon. This attitude of farmers is motivated by speculation in anticipation of future price hike on their own land. Thus, in order to encourage the effective utilization of land as a means of solving the land problem, it is widely believed

(c) Property tax

for residential land: ¥4.03 million (effective tax rate 0.1%)

for agricultural land: ¥30,000 (effective tax rate 0.0009%)

The effective tax rate is calculated as the ratio of (c)/(a).

that the preferential treatment of taxes on agricultural land should be to a considerable extent be eliminated.

III. *A New Land Holding Tax and Several Reform Alternatives*

The members of the Sub-committee on Land Taxation all agreed from the start to increase the tax burden on land holding. It was thought desirable to levy a heavier burden on land holding based on its asset value mainly for two reasons; (1) to reduce the advantages of land as an asset and turn to secure equitable taxation on land holding, and (2) to encourage the efficient use of land via increasing the cost of holding land.

As regards the selection of policy measures for this purpose, there were basically two alternatives considered. They are:

1. The review and improvement of the existing tax system at the local government level.
 - (a) The property tax
 - (b) The special land holding tax
2. The creation of a new land holding tax at the national government level.
 - (a) A tax on idle or underutilized land
 - (b) A tax on unrealized capital gains on land
 - (c) A general tax on land holding

The Sub-Committee at an earlier stage of deliberation began with the examination of how well the existing tax system could be restructured in order to raise the tax burden on land holdings. However, the local authorities strongly maintained that the property tax should not be employed to levy a heavier burden on land holdings as a means to reduce the asset value of land. This reflected their basic attitude of benefit taxation. They believe that the property tax should be collected by municipal governments to cover the cost of local public services to the inhabitants. Such a tax has no direct bearing upon the increased asset value of land caused by price hikes. As a consequence, a lower value of property tax assessment has been rationalized on the ground that it should basically differ from either the market price or the official valuation price of land.¹¹

Similarly, with regard to the special land holding tax, it was pointed out that the government could not use this tax effectively in accordance with the initial objective of land holding tax as mentioned above. In 1973, the government had introduced the special land holding tax on idle and underutilized land for the particular policy goals of preventing speculative land transactions and promoting the efficient utilization of land. As time went by, however, the scope of tax-exempt exclusions has substantially expanded, and the revenues have continued to fall, despite the increasing trend of land prices. The most difficult aspect of the special land holding tax was obviously the strict definition of "idle or underutilized land." Arbitrary judgement essentially intervened into the actual enforcement of this

¹¹ Another weakness concerning increasing the land assessment value for property tax would produce a vast regional disparity of tax revenues between large cities like Tokyo, Osaka or Nagoya, and depopulated areas like Hokkaido where land prices have actually dropped. Since the current intergovernmental fiscal transfer system has no horizontal adjustment of equalization payments from rich to poor areas, there would be no means to restore such revenue disparity between the different areas.

tax. Thus, the Sub-Committee came to the conclusion that it would be impracticable to rely on such a specific policy-related tax to increase the cost of holding land in general. In the end, the first alternative for improving the existing tax system had to be abandoned.

Turning to the creation of a new tax on land holding, the Sub-Committee had three choices, as listed above. As for the first category of tax on idle or underutilized land which was greatly supported by business groups, the same problem existed as with the special land holding tax. No doubt, a technical difficulty emerges from setting objective standards for judging the degree of land utilization, chiefly because effective and clear-cut land-use planning is lacking under the current state. Therefore, the Sub-Committee had to drop the option of the first type of land holding tax at a relatively early stage in the discussion.

Concerning the choice of the second alternative, particular attention has been paid to the economic role of unrealized capital gains on land mainly owned by corporations. Such gains have expanded more rapidly than nominal GNP for the past 30 years, and the relative ratio of gains to GNP has continued to rise from 45 percent in 1960 to 115 percent in 1988.

It is often pointed out that corporations using the increased price of land have greatly benefited from the advantages of higher equity-financing. The Sub-Committee considered that a tax on unrealized capital gains on land would be one possible desirable land holding tax, but it was not finally accepted because of one drawback; i.e., only land held for a longer time period would be subject to tax while newly acquired land would be exempted from such a tax.

Accordingly, the third category of a general tax on land holding was selected by the Sub-Committee on the grounds that it would be most suitable to levy the tax on land based on the asset value regardless of utilization, location and so on. The tax was regarded as the best form to achieve the basic objective of ensuring equitable taxation on land holdings and a reduction of the advantages of land as an asset.

In the process of the Sub-Committee discussions concerning the introduction of a new tax, a detailed scheme in quantitative terms was not concretely prepared. The final decision of constructing a fundamental framework for the new tax was moved into the political arena of the LDP Tax Committee. The Sub-Committee on Land Taxation merely presented a basic design for the new general land holding tax as follows:

1. The tax should be national tax levied on land, based on a uniform assessment of the asset value itself in accordance with the landowners ability-to-pay.
2. For this purpose, the tax base should use the inheritance tax land valuation which is reassessed on a nationwide basis every year.
3. The tax rate should be set at a level adequate to diminish the asset value of land and, at the same time, to enable people to carry on business continuously without any serious damage.
4. Considering the nature of levying a tax on the asset value, as a basic exemption a tax threshold should be introduced.
5. Some exclusions from taxation should be set to include residential land in principle, small-scale stores, government-owned land and public-interest land used for hospitals, social welfare facilities, etc.
6. The number of taxpayers due to the tax threshold and exclusions mentioned above will be restricted mainly to corporations.

Evidently, the new tax in view of its basic goals and nature is different from the property tax which depending upon the principle of benefit taxation collects revenues to cover the cost of local public services. Moreover, the taxable scope of both taxes is quite different: the new tax is targeted for a specific type of valuable land while the property tax is uniformly imposed on the land of the entire country. Thus, one tax should basically be considered to be independent of the other.¹²

However, local authorities began to strongly protest the introduction of a new national tax on land holding, as the deliberation in the Sub-Committee was approaching an end. Obviously, they were afraid that the existing property tax at the municipal governments' level might be replaced in the future by such a new tax as the land holding tax. Thus, apart from their previous attitude, they affirmatively agreed to increase the local property tax burden by lifting up the assessment value of land for property tax purposes. Also, they consented that the special land holding tax should be increased to promote the efficient use of idle and underutilized land by lowering the tax threshold or extending the scope of taxable areas. In any event, the resolution of this conflict between the national and local governments was transferred to the political arena of the LDP tax committee.

IV. *Other Tax Reforms: The Inheritance Tax, The Capital Gains Tax on Land and Taxes on Agricultural Land*

Compared with the heated debate on land holding tax, other tax reforms were more simply concluded in the Sub-Committee without serious problem or conflict.

With regard to inheritance tax reform, it was decided that the assessment value of land should be raised to correct the imbalance between land and non-land inherited assets. As noted earlier, the lower valuation of land for the inheritance tax has clearly precipitated the rising trend of land prices. It is argued that the inheritance tax assessment on land should be enhanced to 80 percent of the official valuation price from the current 60–70 percent. On the other hand, since this produces a substantial increase in inheritance tax revenue, it is necessary to reduce the tax burden by widening the tax brackets of the steep progressive rates and lifting the tax threshold.

Taxation of capital gains on land was proposed in order to effect drastic changes in the present tax system. As indicated by the Basic Land Law, land whose value tends to be augmented by the effects of the external economy, such as road construction, transportation, etc., has the basic feature of serving the public welfare. Thus, it is equitable to levy a heavier burden on gains from the sales of land than on other income. The increase of such a tax is expected to restrain speculative land transactions and in turn put downward pressure on land prices.

Traditionally, mitigating the tax burden on capital gains has predominantly found support among many economists, as a means to promote an increase in the land supply.

¹² A two-tier taxation on land holding exists in the Australian tax system; one is the land value tax set by the state government while the other is rates, similar to the Japanese property tax, set by the municipal government. The justification for levying the same land holding tax at both upper and lower levels of government is the same for both countries. See, New South Wales Tax Task Force (1988), C. Walsh (1990), Land Tax Review Group (1990).

This has generally been believed since the 1969 tax reform in which capital gains on land were taxed at a low flat rate, separate from other income. As the Sub-Committee properly pointed out, however, such treatment impairs tax fairness among taxpayers and furthermore its policy effect is very questionable.

On the contrary, the lenient capital gains tax seems to be counter-productive, reflecting the fact that the demand for land rose and the advantages of land as an investment asset advanced due to the past generous treatment of capital gains. Previous frequent reforms of the capital gains tax induced any anticipation of easing the tax burden in the coming years. Thus, landowners tended to hold off the land sales, given the changeable state of the tax system.

After reconsidering this former policy stance, the Sub-Committee proposed to increase the tax burden on capital gains for individuals and corporations. As regards the gains from land transfers by individuals, from a tax equity point of view the rate applied to long-term capital gains on land should be raised to be comparable with the rate for earned income. On the other hand, to check speculative transactions the tax rate for short-term gains should remain the same.

Following the same reasoning, it is appropriate to levy a heavier tax burden on corporate long-term gains while the present penalty-like heavy taxation should be maintained concerning both super-short-term and short-term gains from land transfers. As mentioned above, there were arguments that corporate capital gains on land sales should be taxed perfectly separate from other income, in order to prevent deficit operating businesses from avoiding their tax payment. But the Sub-Committee's view was inconclusive, mainly because the deficit-operating corporations in question could not reasonably be distinguished from ordinary corporations that have to sell land inevitably.

In addition, the Sub-Committee proposed to curtail the level of special deductions in favor of capital gains on land, since a large part of gains tax is eroded by such special tax measures. This is important in making the tax burden more equitable and desirable. Also, it was proposed to be substantially eliminate the business asset rollover scheme. The rollover from long-term land holdings to depreciable assets has been criticized to stimulate speculative purchases of flats in the central part of the big cities. This, in turn, is detrimental to solving the land problem.

Before beginning any of the aforementioned discussion in the Sub-Committee, the thorough amendment of agricultural land tax was mostly concluded, in accordance with the "Comprehensive Land Policy Plan" proposed by the Japanese government during the US-Japan SII talks. The Sub-Committee decided to take measures to solve the very political issue that had been left pending for a long time.

Of these, it was recommended that the line between agricultural land within Urban Promotion Areas should basically be redrawn distinguishing (1) "agricultural land to be preserved" from (2) "agricultural land to be converted into residential use." The former should be taxed as agricultural, not residential, land to strengthen the measures to ensure its preservation. Of course, such demarcation should clearly be defined by city planning and the conversion into other land-uses be legally restricted. The inheritance tax deferment system should also be applicable to "agricultural land to be preserved," given both strict demarcation and conversion restrictions. It is necessary as well to tighten the eligibility requirements of "continuous agriculture activity" which is a prerequisite for this

preferential treatment.

On the other hand, land to be converted should be taxed as if it were residential land, implying that the property tax on such land will be increased sharply forcing "farmers" to discontinue agricultural activities within Urban Promotion Areas. Moreover, from the standpoint of tax equity, it is more important to eliminate the deferred inheritance tax payment exemption that is allowed on land used for agriculture for over 20 years.

Thus, if these reform proposals were carried out, they would be of great help in increasing the supply of land and dispelling the sense of unfairness among taxpayers. Farmers who have no intention of cultivating their land for agriculture will be persuaded to part with their land holdings. By contrast, those who choose to work their agricultural land on a permanent basis will find it very difficult to convert it to residential land. When they choose to quit their agricultural activity, they would be requested to sell their land to the local authority at a "reasonable" price.

V. Major Points of the Land Tax Reform Proposed by the Government

In accordance with the conventional tax process in Japan,¹³ the final detailed terms of the land tax reform were decided in December 1990 by the LDP Tax Committee, as a result of political compromises due to the pressure of vested interest groups. The Tax Advisory Commission merely proposed, in October 1990, the basic direction for land tax reform without referring to either the quantitative magnitude of tax rates, the exemption levels or other specific components. As usual, the Commission's proposals were forwarded to the LDP Tax Committee, and in turn the Japanese government submitted the necessary land tax reform legislation to the Diet in February 1991 after receiving the approval of the ruling political party.

The seven major points of land tax reform, which were formulated clearly in terms of the Tax Bill, are summarized below.

1. Introduction of a National Tax on Land Holding called the Land Value Tax

A new land holding tax held to be levied on the ownership or the leasehold of lands throughout the entire country will be introduced by the national government. Both individuals and corporations will have to pay the tax based on a uniform level of assessment corresponding to the inheritance tax land value.

Several exemptions will be admitted as follows; land held by the government and public corporations, land used directly for the purpose closely tied with public welfare (e.g., hospital, railways, social welfare facilities, etc.), agricultural and forest land, and land with an assessment value below ¥30,000 per square meter. Moreover, residential sites up to 1,000 m² (only primary dwelling) and buildings rented for residential use (excluding company houses for board directors) are also exempted.

¹³ Concerning the relationship between the Tax Advisory Commission and the LDP Tax Committee within the tax process, see Ishi (1989), pp. 11-17.

In addition to these exemptions, the larger of the following amount is allowed as a basic deduction; (1) ¥1 billion (¥1.5 billion for individuals and small- and medium-size firms), or (2) ¥30,000 multiplied by the area in square meters of land held, excluding the exemptions listed above. A tax rate of 0.3 percent (only 0.2 percent in 1992) will be applied to total amount of the assessment value of all land held (except exemptions) minus the basic deductions by a taxpayer on January 1, each year. The tax amount can be deducted as an expense when computing the taxable income for the individual income tax (in the case of business income) and the corporate tax.

The date of enforcement will be January 1, 1992, and a new land value tax will have to be reviewed at least every five years in connection with the possible increased level of land assessment as noted below.

2. Promotion of Increasing the Property Tax Land Valuation

To remedy the extremely low land valuation of the current property tax, land valuation enhancement will begin the periodic revaluation from fiscal 1994. However, the planned revaluation for fiscal 1991 will be implemented as usual. The basic aim of the new revaluation is to narrow the gap to within a certain margin of the official valuation price.¹⁴ However, a specific relief program will be required to mitigate the sudden tax increase on individual residential land.

Representative assessment points for the land valuation (i.e., the Road Rating Assessments) will be publicized as often as possible in fiscal 1991 in order to enhance transparency of assessing the land value for taxpayers. In addition, the number of publicized assessments points will be increased systematically from fiscal 1994. To mitigate tax increases arising from such as increased land assessment, a reduction in the inhabitants tax will be put into effect.

3. Improvement of the Special Land Holding Tax

The special land holding tax as well as the property tax, will be generally strengthened to promote the efficient utilization of land and to prevent speculative land transactions in two ways. First, the tax will be levied on idle land larger than 1,000 m² within areas designated in city planning as "District for Identifying and Promoting the Utilization of Idle Land." The tax rate will be 1.4 percent, applied to the land value in terms of the current price or acquisition price, whichever is higher.

Second, the scope of the special land holding tax will be extended, lowering the minimum threshold of the taxable area and excluding open-space parking lots, outdoor athletic facilities, etc., from being exempted. Furthermore, the exemption will be eliminated for lands within Urbanization Promotion Areas acquired on after April 1982 and held for over 10 years.

4. Increased Land Valuation for the Inheritance Tax

The land valuation for the inheritance tax will be raised in order to weaken the pre-

¹⁴ Implicitly, it is expected that the revaluation of land for the property tax assessment should reach a target of approximately 70 percent of the official valuation price.

ference for land as an asset. The target rate will be approximately 80 percent of the official valuation price, compared with the current rate of 60–70 percent. At the same time, the annual valuation date will be changed date from the present date of July 1 each year to January 1 for the official valuation. To compensate for the increased tax burden that will accompany the higher valuation of land, an inheritance tax reduction will be implemented by either mitigating progressive tax rates or lifting the tax threshold.

5. *Tax Increases on Capital Gains for Individuals and Corporations*

The individual income tax rates for long-term capital gains in cases of the transfer of land or buildings owned by individuals for longer than 5 years will be raised from 20 percent (6 percent) below ¥40 million and 25 percent (7.5 percent) above ¥40 million to flat rates of 30 percent (9 percent) on a uniform basis (percentage figures in parentheses are the inhabitants tax rates). Basically, this change aims at restoring a tax equity balance with earned income, while diminishing the preference for land. On the other hand, tax rates for short-term capital gains remains unchanged.

Likewise, the corporate tax on capital gains from land sales will be substantially changed from the present system. Super-short-term capital gains on land held not longer than 2 years will be taxed, separate from other income at the rate of 30 percent in addition to the ordinary percent and even deficit-operating firms will have to pay taxes under this method of separate taxation. This should help reduce the tax avoidance of firms “deemed” as deficit-operations.

As for long-term capital gains on land held longer than 5 years in addition to the application of ordinary corporate taxes, a rate of 10 percent will be levied. Such a new tax will also be applicable to deficit-operating firms in an effort to curtail tax avoidance. These changes in the capital gains tax on land aim at reducing the land asset value and at stopping speculative transactions.

6. *Other Changes Related to the Capital Gains Tax on Land*

Contrary to the proposals of the Tax Advisory Commission, the Land Reform Bill contains certain preferential treatments towards capital gains tax on land, as a means to promote an increase in the land supply. One reason behind this is the “lock-in effects” feared by the government which may result from a heavier tax burden on capital gains.

The scope of rollover relief will also be expanded in cases of industrial relocation and decentralization. When transferred land is used for this purpose, the rollover of business assets will be allowed at a deferment ratio of 90 percent instead of the ordinary 80 percent ratio. Moreover, the special deduction (¥50 million) for capital gains on expropriated land will be perpetuated, apart from the present temporary measures. The same treatment will be allowed for transfers of agricultural land to residential and commercial uses.

Special reduced tax rate measures will be applied to further encourage an increase in the land supply for residential use. To begin with, when individuals transfer land owned for longer than 5 years to the national or local governments for development projects, the flat tax rate on capital gains will be reduced to 15 percent (5 percent) from the present level of 20 percent (6 percent). When residential land or buildings owned by individuals for

longer than 10 years are transferred, a more preferential reduced tax rate on capital gains will be applied as follows; where the present tax rates are 10 percent (4 percent) below ¥40 million and 15 percent (5 percent) above ¥40 million, the new rate structure will be set for gains below or above ¥60 million.

7. Improvement of Taxation on Agricultural Land within Urbanization Promotion Areas

The special treatments of agricultural land in both the inheritance tax and the property tax will be abolished from the standpoint of tax equity and of promoting an increase in the land supply. For this purpose, not later than the end of 1992, agricultural land to be preserved within Urbanization Promotion Areas in the three Metropolitan areas will have to be designated in city planning under the Productive Green Tract Area System. At the same time, the conversion of this agricultural land into other uses will be restricted by law.

In such cases, the deferment system of the inheritance tax will not be applied to agricultural land that is not designated as Productive Green Tract Area, although some transitional measures will be available. By contrast, agricultural land to be preserved will be eligible for this deferment system, but the special treatment of exempting the deferred tax amount on agriculture activity which has continued for 20 years will be eliminated. The system for checking the continuity of agricultural activity will become more stringent.

Second, agricultural land that is not designated as Productive Green Tract Area will be treated as residential land, and be taxed as residential land for property tax purposes. Thus, the special property tax reduction measure concerning agricultural land suitable for long-term continuous agricultural operation will be abolished.

VI. Concluding Remarks

Since the LDP proposed its reform package on land taxation in December 1990 which automatically became the government's tax bill, there have been a number of criticism particularly from economists. Most of the criticism focuses on the new land holding tax (i.e., the land value tax), because the new tax compared with the original proposal of the Tax Advisory Commission has been quite watered down. On the other hand, the other land tax reform packages, such as the inheritance tax, capital gains tax on land, etc., were kept more or less similar to the Commission's proposals. Thus, to conclude the discussion in this article attention should be paid to comments concerning the LDP's land holding tax.

Simply speaking, the new land holding tax was emasculated by many modifications that were made for political reasons by the LDP Tax Committee. The original plan, embraced by the members of the Sub-Committee on Land Taxation, had sought a tax rate of 0.5–1.0 percent with a tax threshold of ¥100 million. According to the initial framework, this new land tax could collect about ¥1,000 billion from 300,000 individuals and corporations.

The LDP's new tax with an initial tax rate of 0.2 percent (0.3 percent after the first year) and much broader exemptions will apply mainly to corporations as was indicated previously.

Residential land 1,000 square meters or less, owned by individuals, will be excluded from the new land holding tax. The new tax will not apply to land valued below of ¥30,000 per square meter. Corporations capitalized at ¥100 million or less with land holdings valued at a minimum of ¥1.5 billion will be subject to tax, as will larger corporations with land valued at ¥1 billion.

Under the LDP plan, the tax rate will be much lower and exemption level much broader than had originally been planned. While the LDP plan was under deliberation, chairman M. Shiokawa suggested levying the new tax at an annual rate of 0.5 percent on land valued at ¥500 million or higher, regardless of the size of the business. This idea might have been acceptable, given the initial difficulty of introducing such a new tax. However, even that plan drew immediate criticism from many LDP members who said the tax burden would be too heavy for small and medium size businesses. Finally, the LDP members packed by several strong business lobbies, pressed for the abandonment of the chairman's proposal and for a reduction in the minimum floor level of the new tax.

The new land holding tax proposes to be so light and to include such broad exemptions that economists say it will not likely have much effect on resolving the land price hike problem in this country. As a result of political modifications, the new tax would apply only to 50,000 corporate and other larger landowners, producing only ¥300 billion to ¥400 billion in tax revenue annually at the 0.3 percent rate. In fact, it is said that the new tax comes as a relief to some in the financial and real-estate markets.

Many doubt the LDP's land holding tax will be effective in raising land ownership costs and discouraging speculation. In particular, the opposition parties called for stronger medicine to cope with land problems. Needless to say, the new land holding tax legislated is far from satisfactory. Although it is acceptable as a first step, further reform will absolutely be necessary in the future.

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