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JAPAN'S VAT AND ITS AFTERMATH

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Abstract

In Japan, the value added tax (VAT) was finally introduced in the tax structure in April, 1989, after long-standing trial and error by the government. The government has flirted with VAT since the late 1970s to stress the important role that the VAT could play in the tax system. Whenever attempts were frustrated to adopt VAT, different names were applied so as to diffuse political tension: i.e., the *general consumption tax* in 1979, the *sales tax* in 1987 and the *consumption tax* in 1989.

Towards the latter half of the 1980s, the first and the second sweeping tax reforms were proposed in succession and carried out by the initiatives of Nakasone and Takeshita Cabinets, respectively. Needless to say, the main reason for pursuing these reforms was to solve unsettled issues with the introduction of VAT. Japan's VAT, named the *consumption tax*, came into existence in the second round of sweeping tax reform along with the worldwide movement to adopt VAT.

The major aim of this article is to clarify a whole picture of Japan's VAT before and after its introduction. The paper is divided into six sections. Sections I and II are devoted to preliminary discussion in the key trend of VAT in the world and historical backgrounds of Japan's VAT. Section III deals with the main features of a new VAT in detail with relevant problems, followed by Section IV in which economic aspects and administrative consequences of VAT are discussed. Finally, recent amendments and further reform to improve VAT are summarized in Section V.

I. *The Key Trend of Introducing VAT*

Recent Developments

The first emergence of VAT in the modern history of taxation was in the French tax system in 1954. The VAT in France was introduced to take the place of turnover tax and levied at all stages of transactions to impede tax evasion and avoidance. It formed the basis of the EC-type VAT, and the VAT is now used not only in Europe but many other countries in the world as more or less a common form of broad-based consumption tax [Webber and Widavsky (1986, pp. 547–49)].

A. T. Tait (1988, p.3) emphasizes the key trend of introducing the VAT as follows:

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"The rise of value-added tax (VAT) is an unparalleled tax phenomenon. The history of taxation reveals no other tax that has swept the world in some thirty years, from theory to practice, and carried along with it academics who were once dismissive and countries that once rejected it."

The VAT has so far developed rapidly in many countries with a wide variety ranging from more complete VAT to less-than-complete VAT. Basically, fundamental forms of VAT are levied by first calculating value added (sales minus purchases) at all stages from manufacturers to retailers and then applying a tax rate to that value. This is, however, not necessarily the common case. For instance, some countries, particularly in Latin-America and Africa, do not apply VAT at the retail stage, and moreover other countries are using a VAT through the wholesale stage or are applying it only at the manufacturing level.

If we broaden the scope of VAT to cover such imperfect types, there are more than fifty countries in the world that have already introduced VAT in their tax structure.[1] Of most importance is the fact that there has been no country except south Vietnam where the VAT was abolished after being adopted [see Shoup (1990, p. 1)]. It is stressed that the VAT is not a sort of temporary or provisional tax but a well-established tax with permanent nature under the existing tax system of major countries.

Trends of OECD Member Countries

From a practical point of view, we are more interested in analyzing VAT in major industrialized countries. Table 1 summarizes permeative situation of adopting VAT in OECD. Depending upon the years of introducing VAT, twenty-four member countries are classified into three groups. Japan is grouped in the second category, as well as Canada.

Most countries in the first group adopted VAT around the year 1970 since they were committed to implement a VAT on entering the European Community (EC) as a member. The VAT is considered to be essential for border-tax adjustments. In the 1980s, many of the countries with no VAT have attempted to introduce such a form of tax. Greece, Portugal and Spain introduced it in 1986–87 as a prerequisite for entry into the European Community. Turkey did the same in 1985. In the Pacific countries, the pros and cons of a VAT have long been a major issue. Only New Zealand has successfully established

TABLE 1. PERMEATIVE SITUATION OF VAT AMONG OECD COUNTRIES

1. Advanced countries for VAT—12 countries—
   Austria (1973), Belgium (1971), Denmark (1967), France (1968), W. Germany (1968), Ireland (1972), Italy (1973), Luxembourg (1970), Netherlands (1969), Norway (1970), Sweden (1969), U.K. (1973)
2. Less Advanced Countries for VAT—7 countries—
   Canada (1991), Greece (1987), Japan (1989), New Zealand (1986), Portugal (1986), Spain (1986), Turkey (1985)
3. Non-VAT countries—5 countries—
   Australia, Finland, Iceland, Switzerland, U.S.

Source: OECD (1988), p. 30 and others.
Note: Figures in parentheses stand for years of introducing the VAT.

[1] Tnis would perhaps pose a conceptual problem for VAT. Of course, it is possible to define VAT to perfect form in a strict sense. [See Tait (1988, pp. 6–7)].

a form of VAT, the "goods and service tax" in 1986. During the U.S. tax reform of 1984–86 the possibility of introducing a VAT was discussed, but this was rejected and postponed. It seems that the U.S. government would have difficulty in instituting such a tax at the federal level because the state governments have employed the retail sales tax as a dominant tax.[2]

Similarly, in Australia, Canada and Japan, the governments have proposed introducing such a tax at various times, but such proposals have encountered strong opposition and rejection. However, Australia and Canada, as well as the USA, have already adopted a type of broad-based sales tax on manufacturers or wholesalers, and reform has meant trying to transform an incomplete sales tax into a more perfect alternative—i.e., the value-added tax (see Canada, 1987, Australia 1985). In a strict sense, Japan remained the only country that had no form of broad-based indirect tax until 1989. In this respect, Japan's tax reform has lagged behind the mainstream of the global reform.

Regardless of the fact that the timing in each country differs, why have VAT-countries adopted such a tax? Broadly speaking, there are four reasons for adopting VAT:

(1) The existing turnover tax was not satisfactory,
(2) Discriminatory border taxes were requested to be abolished by a custom union,
(3) Other taxes, such as income taxes, were to be cut mainly because relevant countries were dissatisfied with their existing tax structure.
(4) Accumulated fiscal deficits required necessary sources to be reduced.

(1) and (2) are good reasons for VAT-advanced countries to introduce such a tax earlier than the second group of countries. On the other hand, the reasons for adoption by VAT-less-developed countries seem to be more closely connected with (3) and (4). Japan originally attempted the introduction of VAT to make up for fiscal deficits, but later more stress tended to be placed on the fact that the evolution of the tax system would not keep pace with the development of the economy, say aging.

Worldwide Indirect Tax Reform

Generally speaking, in the 1980s there has been a trend among major industrial countries towards switching from a relative reliance on direct taxes to a reliance on indirect taxes. There were two trends. For one thing, the broad-based indirect tax has been introduced in countries with no VAT. The other is that, in a number of European countries where the VAT had already been implemented, the governments have raised the rate of VAT to offset part of the revenue loss from income tax changes.[3]

Such a key trend of reshaping the indirect tax system on a world scale had a close bearing upon Japan's sweeping tax reforms starting from mid-1980s. Of central importance to both the first and second stages of the tax reforms was an overall reform of the indirect tax structure in the form of a broad-based indirect tax. Japan's method of reforming the indirect tax system corresponds to tax reform movements abroad [see Messere and Owens (1986), OECD (1987)].

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[2] The tax levied on the value added at each stage of a transaction is proportional to the value of the final sale to the consumer. Thus, a retail sales tax would theoretically be equivalent to the value added tax.

[3] A typical example was observed in the UK tax reform of 1979 in which the rate of VAT increased from 8 to 15 percent in place of reducing income taxes with equal revenues.

Japan's indirect tax system had been characterized by reliance upon selective excise taxes until 1989. Why is indirect tax reform necessary in Japan, too?

The existing selective excise taxes posed several problems which needed to be remedied. First, the inherent arbitrariness of a tax on selective goods and services tended to discriminate between taxed items and non-taxed items and to produce distortions in consumer choices.[4] In addition, the tax base of such a tax was extremely narrow. This is the most important disadvantage of a selective excise tax system. The more broadly based the tax, the less distorting it becomes. Moreover, higher tax rates were required to raise needed revenue from a narrower tax base.

Second, the existing indirect tax system was outdated. Although the economy was becoming more service-oriented, the government could not fully tax service items. In fact, only a small portion of services were being taxed, i.e., the travel tax, the admission tax, entertainment tax, etc. Since consumption patterns were diversifying rapidly, it was almost impossible for selective taxes accurately to reflect tax paying capacity. It was difficult to correlate the income level of consumers and their purchase of sumptuous goods with higher tax rates.

Third, taxes levied on selected items were liable to be criticized from abroad, triggering international conflict. Typical examples were the complaints by various countries regarding the tax on imported whisky and wine and the commodity tax on watches and automobiles.

Fourth, selective excise taxes have failed to secure adequate revenue sources. The relative share of indirect taxes showed a long-run decline in total tax revenues. Thus, the tax system as a whole was placing too heavy a reliance on direct taxes.

Given the basic framework of the indirect tax system with no VAT, it would not be advisable to increase tax rates and tax items so as to secure more needed revenue in the future. This proposal would have yielded no substantial gains because it would have tended to worsen the distortions and arbitrariness of existing indirect taxes. In order to eliminate these problems, an overhaul of the indirect taxes proved desirable, along with the introduction of a new broad-based consumption tax.

II. *Historical Background of Japan's VAT*

Prehistory

Although there was no VAT in the Japanese tax system, we have experienced, or at least expected, the adoption of broad-based indirect taxes twice during the earlier postwar period.

The first case is the turnover tax of 1948–9, which was enacted to raise needed revenues at that time. The turnover tax became effective in September 1948, and was repealed in December 1949. Although it was short-lived, it is really Japan's only experience of a broad-based indirect tax. It was applied to the value of transactions (i.e., gross sales) at

[4] The following are typical examples of an arbitrary selection of taxed or untaxed items: furs, gold equipments, surfboards, water skis, ordinary furniture, coffee, and cocoa are all taxed, while deluxe textiles, tennis equipment, ordinary skis, high-quality apparel, and tea are no.

all levels—producing, wholesaling and retailing—at a rate of 1 percent. Some transactions were exempted from the tax: export transactions, sales of securities, transport, transactions involving staple foods, sales of agricultural forestry, livestock or marine products by the original producer, rental, and certain other less important items. Furthermore, small traders with gross sales of less than ¥30,000 per month were tax-exempt.

Until early 1949, the turnover tax was collected principally from the advance sale of stamps to the vendors. Since this advance payment raised a great deal of complaints among the taxpayers, the government was obliged to switch to cash payment on the basis of a return submitted by the taxpayer.

On theoretical and practical grounds, the turnover tax is the least refined category of the sales tax. If a business firm starts with its own raw materials and then produces and sells the finished goods, this vertically integrated firm greatly benefits from the turnover tax. On the other hand, an individual group of independent firms, which may include raw materials producers, manufacturers, wholesalers, and retailers, is at a disadvantage. While the vertically combined firm pays the tax only once, independent firms have to pay the tax at each turnover. This is a great defect, and it tends to induce the vertical integration of independent firms.

In addition to the presence of such theoretical shortcomings, there was strong criticism by taxpayers of the Japanese turnover tax initiated at that time. In the first place, it was claimed that the turnover tax, which required taxpayers to submit a statement of gross sales, assisted the government in imposing the income tax on self-assessed businessmen, since this feature enabled the tax authorities to make intelligent guesses as to taxpayers' net income. Second, knowledge of gross sales enabled the tax office to investigate the use of illegal pricing via the black market. Not surprisingly, taxpayers organized protest movements to express their complaints against the continuation of the turnover tax. As a result, the tax was repealed within 15 months of its enactment.[5]

The second case was a VAT recommended by the Shoup Mission in 1949 [see, for an expanded discussion, Shoup (1989)]. It was proposed as a prefectural tax, but its application was postponed several times, and in 1953 it was abolished without having ever been put in operation. Since it was an unusually rare and innovative idea at that time, it is interesting to study the outline of the VAT contained within the Shoup recommendations [see The Shoup Mission (1949, pp. 197–204)].

The main purpose of introducing a VAT was to replace the enterprise tax (prefectural and municipal), which it was feared placed too heavy a burden on the business firm. The enterprise tax was an independent prefectural tax, but its revenue was shared with municipalities, usually in a 50–50 ratio using a municipal surtax.[6] The tax was levied on the profits (i.e., net income) of the preceding year, and in principle the taxable profits were those computed for purposes of the national income tax. Thus, the enterprise tax was simply a surtax on the national tax.

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[5] The Shoup Mission also proposed the elimination of the turnover tax (the "transactions tax," as they called it): "Altogether, the transactions tax is one of the least promising members of the present Japanese tax system. It cannot be raised substantially without grave economic disadvantages. It is not likely to be taken very seriously by either tax administrator or taxpayer at its present rate, and thus may decay gradually into a tax that is largely unenforced" [The Shoup Mission (1949, pp. 167–8)].

[6] The standard tax rate was 7.5% for the prefectures and 7.5% for the municipalities, a total rate of 15%.

It appears that the enterprise tax was not intended to be shifted to consumers, because net income taxes were assumed to be non-shiftable. This implies that the business firm had to absorb the tax burden. The cumulative burden of the national and local tax system on the net income base was considered to be too heavy. The business proprietor of the unincorporated enterprise was assessed on the following three taxes:

1 a national income tax on his net income after basic exemption and credit for dependents;
2 a local income tax (i.e. a prefectural-municipal inhabitanst tax);
3 the enterprise tax;

The combined marginal rate of these three taxes reached nearly 70 per cent for proprietors even with a modest income.

The Shoup Mission proposed a new enterprise tax (i.e. the value-added tax) mainly in order to lower to some extent the cumulative burden on net income as a tax base. Accordingly, it recommended that the tax base be expanded to include the sum of profits, interest, rent and the payroll. Obviously, the scope of the propsed tax base was equivalent to that of the income type of VAT.

The income type of VAT shows a direct correspondence of the taxable value added to the economic activity of the year. The tax base can be computed by adding the factor rewards accruing to labor and capital. Instead of the addition method in computing the income type of VAT, we can also subtract all purchases from other firms from total gross sales and reach the same magnitude of tax base. Depreciation is subtracted, not the amount spent purchasing investment goods that year.

The Shoup recommendations pointed out two advantages of the value-added tax. First, it is free of the distorting effects of the turnover tax, which tends to stimulate the growth of vertical integration. Second, in comparison with the enterprise tax on a pure net profit base, the VAT does not discriminate against the use of capital, especially in the form of labor-saving equipments.

According to the tax proposals made by the Shoup Mission, the rate of VAT should be set somewhere around 4–6 percent to assure the prefectures a certain amount of revenue (i.e., ¥44 billion). The Mission also recommended that farmers and small business concerns be exempted from the VAT.

Why was the VAT rejected by the Japanese government and taxpayers? The reason was quite simple. The concept of "value-added" was very difficult to understand, and many could not imagine what type of tax it would be. Also, many taxpayers were wary of the Mission's suggestion of a VAT because "the new tax is a bad tax." Without understanding its basic nature and significance, people were sceptical of its rapid enforcement. The atmosphere in those days did not permit the acceptance of an innovative, new tax.

The general consumption tax

Either the turnover tax or Shoup's income type of VAT was noteworthy but premature in history. Controversial issues were caused by the undertaking of adopting a VAT-style "the general consumption tax" proposed by the Ohira Cabinet in 1979. Since then, there has been a great deal of argument on whether or not the broad-based indirect tax ought to be introduced. The history of Japan's VAT is full of turmoils. Before the VAT emerged in the tax structure, the Japanese government had tempted, shaken on the brink and succumbed several times. Whenever the attempts failed, it left only to return but the attraction of VAT eventually remained irresistible.[7]

Table 2 summarizes the historical process from the starting point of the first trial in 1978 until the implementation of a new VAT in 1989. The whole period can be divided into three sub-periods, based upon the different cabinets. First of all, let us pay attention to the *general consumption tax.* The need for introducing such a tax was induced to obtain necessary sources to reduce the rising fiscal deficits caused by the oil crisis of 1973 [see, for a detailed discussion, Ishi (1986a and 1989, ch. 14)].

Strategies to curtail fiscal deficits are based on tax increases, expenditure cuts, or a combination of both. Initially, the government and the Ministry of Finance (MOF) adopted a bold strategy of creating a new VAT. The new tax was named "the general consumption tax," which is a tax-credited type of VAT that has no invoice.

The Tax Advisory Commission proposed the introduction of a VAT in order to fill the fundamental structural gap between government expenditures and revenues in December 1978 [see The Tax Advisory Commission (1978)]. The new tax was designed in 1979 as follows. A uniform tax rate of 5 per cent would be levied on the amount of value-added (gross sales minus purchases) for all business firms, and the exemption level would be fixed at ¥20 million in sales volume, with estimated revenues accounting for ¥3,000 billion in fiscal 1980.

Whether or not a VAT tax should be adopted became a crucial point of dispute in the general election of the Lower House in October 1979. Prime Minister Masayoshi Ohira risked proposing the new indirect tax during the election campaign, but he was finally forced to back down because of strong opposition. As a result of the tax increase proposed by the Liberal Demoractic Party (LDP), the party lost a number of seats and received a major setback.

Why did this effort meet with such vigorous resistance? There seem to be two main reasons. First, although general taxpayers were not so hard set against the new tax, a great deal of opposition came from small businesses in the wholesale and retail trade, most of which are the main supporters of the LDP. . Small traders feared that the new tax would force them to reveal all of their transactions to the tax offices and that they would therefore be unable to avoid or evade the income tax as they had been doing. Second, there were major complaints regarding inequitable tax burdens and the wasteful use of government expenditures. Taxpayers asserted that these problems should be solved before the new tax was introduced.

After the political failure of Prime Minister Ohira (he died soon after, in 1980), the issue of adopting a broad-based indirect tax became a political taboo. Before proposing a new indirect tax again, steps had been taken to promote further reduction of the large deficits. Since major increases in taxes proved to be unacceptable, the government was obliged to alter its policy options. It was compelled to reduce the current fiscal deficits

[7] The behavior of the Japanese government is made in a comment compared with the Korean experience as follows:

> "The Korean VAT, introduced in July 1977, was the first VAT in Asia and as such was a major innovation; after all, the Japanese had toyed with the idea of a VAT since the 1953 Shoup Mission, but had nervously postponed such a dramatic change in taxation. The Korean experiment was a brave initiative." [Tait (1988, p. 204)].

TABLE 2. HISTORY OF TAX REFORM IN JAPAN

Date	Event
I. The Ohira Cabinet	
1978	
8 September	The Tax Advisory Commission proposed the introduction of broad-based indirect tax.
26 December	Named the *general consumption tax* in the LDP's Tax Reform Plan of 1979.
1979	
7 October	General election for the Lower House.
21 December	Both Upper and Lower Houses passed a resolution of abolishing the *general consumption tax.*
II. The Nakasone Cabinet	
1984	
19 December	The necessity of a sweeping tax reform in the near future was manifested by both the Tax Advisory Commission and the LDP Tax Council in their proposals for the annual tax reform for fiscal 1985.
1985	
20 September	Enquiry from Prime Minister Y. Nakasone to the Tax Advisory Commission on the first sweeping reform.
1986	
25 April	Interim report on the individual and corporate tax reform from the Tax Advisory Commission.
6 May	Basic reform on the individual and corporate tax endorsed by the LDP Tax Council.
6 July	General election for both the Lower and Upper Houses.
29 July	Three types of new indirect taxes proposed by a sub-committee of the Tax Advisory Commission.
28 October	Final report on a sweeping tax reform issued by the Tax Advisory Commission with the combined package of income tax reduction and a new VAT.
5 December	LDP Tax Councuil decides on the basic principle of tax reform. A new VAT was named the *sales tax.*
1987	
16 January	Cabinet approve bill on the fiscal 1987 tax reform, including the *sales tax.*
10 February	Tax bill sent to the 108th Diet session.
27 May	The Diet closed. Tax bill withdrawn and the *sales tax* turned to be abolished.
31 July	Revised bill on the individual tax reform presented to the Diet.
25 September	Diet passed revised bill incorporating income tax reductions and the elimination of the tax-free savings system.
III. The Takeshita Cabinet	
1987	
12 November	Enquiry from Prime Minister Takeshita to the Tax Advisory Commission on a second stage of the tax reform process.
1988	
Mid-February to early-March	Public hearings held by the Tax Advisory Commission in 20 places throughout the country.
25 March	Preliminary report from the Tax Advisory Commission.
28 April	Interim report from the Tax Advisory Commission to clarify basic forms of a new broad-based indirect tax.
14 June	Tax report from the LDP Tax Council named such a tax as the *consumption tax.*
15 June	Final report from the Tax Advisory Commission.
28 June	Cabinet approves "The Outline for Tax Reform."
29 July	Tax bill, including the *consumption tax,* sent to the 113rd provisional Diet session.
16 November	Tax bill passed by the Lower House with minor amendments (Japan Socialist and Communist Parties did not appear in the Diet).
24 December	Tax bill passed by the Upper House (a majority of opposition parties were absent for voting).
1989	
1 April	A new VAT, named the "consumption tax" introduced.

Source: Data submitted to the Tax Advisory Commission.

by cutting expenditures. This was a direct response to the complaints presented by the general taxpayers, who demanded spending cuts as a pre-condition for the *general consumption tax.*

The Emergence of Sweepng Tax Reforms

Since 1985, the question of sweeping tax reforms has become the most important political issue for the general public. The reform process began in September 1985, when Prime Minister Nakasone proposed an inquiry to initiate the most sweeping tax reform since the Shoup recommendations in 1950. This was the start of the first stage of sweeping tax reform process [see Ishi (1986b)]. A year and a half later, Naksone's tax proposals were frustrated by his political mistakes, and as will be argued below, he achieved only half of his original plan. His main ideas, however, were retained by Prime Minister Takeshita, and the basic framework of tax reform proposals remained almost untouched. Thereafter, nationwide interest focused on what could be called the second sweeping tax reform process.

No doubt, Nakasone's enthusiasm for tax reform was spurred by the successful example of US President Reagan's tax reform. He must have expected that the success of American tax reformers would accelerate the Japanese tax reform. He behaved very prudently in proceeding with the tax reform in the form of an overhaul of indirect taxation, because he decided to challenge a political taboo committed by former Prime Minister Ohira.

In fact, Nakasone did not permit the Tax Advisory Commission to deliberate a broad-based indirect tax until its interim report was issued in April 1986. Moreover, during the campaign before the general election in July 1986, he pledged not to institute a "large-scale indirect tax that cannot obtain the approval of the public." After a landslide victory for the LDP, he urged the Commission to construct a package of tax reforms including a new, broad-based indirect tax.

It is thus necessary to trace the general features of the various alternatives. A *sales tax* proposed in the first stage of the tax reform emerged as a combination of three types of new indirect taxes proposed by the sub-committee of the Tax Advisory Commission in July 1986. Great emphasis should be placed on examining the nature of these taxes, since they were regarded as possible alternatives of the broad-based indirect tax.

When the sub-committee members investigated alternative types of indirect taxes, several factors were taken into account: (1) conformity with Japanese business practices; (2) simplification of tax payment and administration; (3) elimination of accumulating tax burdens, and (4) the importance of fairness and neutrality. Based upon requirements, three types of new indirect taxes were proposed.

Type A: *Manufacturers' sales tax*

All manufactured goods would be subject to the tax, but raw materials, machinery and other goods used in the process of production would be tax-exempt. Two sub-categories were added, depending upon whether the taxpayer prepared a list of tax-exempt items.

Type B: *Retail sales tax* (officially called the *"sales tax with exemption for inter-firm transactions"*)

This tax would be levied once, when goods and services were sold at the retail stage to the consumers, because inter-firm transactions would be exempt in principle.

Type C: *The Japanese-style value-added tax*

This tax would be imposed on the value added to a good or service at every stage of processing from manufacture to retail—i.e. on the difference between the value of sales and the value of purchases. This would be a multistage sales tax similar to the EC-type VAT.

These three alternatives were considered to provide an outline for a broad-based indirect tax. Types A and B were both single-stage sales taxes, while type C was a form of multistage sales tax. Although the alternatives were designed to adhere to the four requirements mentioned above, they differed in several respects and have various merits and demerits.

After heated debates among the members of the Tax Advisory Commission, type C was finally selected, in the final report issued in October 1986, as the best form of broad-based indirect tax that could be adopted in Japan. This tax had two principal advantages over the two alternatives, in that it had a broader tax base and led to neutrality in resource allocation. Conversely, its main disadvantage was that it would involve more taxpayers than the altrnatives at every stage of transactions.

The LDP Tax Council also agreed, in December 1986, on the choice of type C, and named it the *sales tax* instead of "Japanese-style value-added tax." The details of *sales tax* were decided upon through political compromise. Its main features were:

1. a consumption type of VAT with the tax credits determined according to invoice;
2. a single 5 percent rate with a "zero-rating" on exports;
3. 51 tax-exempted items;
4. exemption of firms whose annual sales are less than ¥100 million.

In the process of shaping the detailed framework of the *sales tax*, tax-exempted items were greatly expanded from the original plan of seven items—as was the *general consumption tax* in 1979. Furthermore, the exemption level of certain firms was raised enormously, up to ¥ 100 million in terms of annual sales, because of strong political pressure from the small traders.[8]

These compromises greatly impaired the advantage of universality inherent in the broad-based indirect tax. Such special considerations incurred difficulties and complications in both administrating the tax and obtaining compliance from taxpayers. In the end, the contentions implementation issue prevented the government from obtaining general support for introducing the new tax.

From the beginning, there was a great deal of misgiving about the future success of this reform plan because of a key political mistake made by Nakasone. His LDP colleagues and groups of key supporters of the party felt betrayed, and they, as well as the opposition parties, accused Nakasone of cheating on his promise. Once the legislation reached the Diet in February 1987, dramatic opposition arose from all sides, including even strong supporters of the LDP, and Nakasone was forced to withdraw the bill in May 1987. Once again, the VAT proved as unacceptable as it was in 1979. Tax increases remained as politically taboo as ever.

[8] This exemption level was clearly much larger than other comparable cases, i.e. approximately 12–20 times in comparison to the counterpart figures in the EC countries and Korea. Even the "general consumption tax" in 1979 included merely ¥20 million in exemptions for certain firms.

III. *Main Features of the Consumption Tax as a New VAT*

Strong Anti-Movement

The second step of tax reform began with Prime Minister Takeshita's enquiry to the Tax Adviosry Commission in November 1987. Tax reform could have been the crowning achievement of Nakasone's term, but he failed. Thus, when he appointed Takeshita as his successor, he evidently wanted Takeshita to devote all his efforts towards achieving tax reform.

After accepting the Prime Minister's enquiry, the Tax Advisory Commission opened its deliberation for the second stage of the tax reform process and began to consider how to realize the postponed reform package. Since Nakasone was critizied for not offering the issue up for nationwide debate, the Commission endeavoured to attain public support by holding public hearings in twenty places throguhout the country in February and March 1988. A second stage of public hearings took place in five places in mid-April.

In April 1988, following the *sales tax*, another form of broad-based indirect tax was proposed, once again under the name of *"consumption tax."* Of the more controversial issues in the reform package, the most important concerned this tax. Ultimately, support for the Takeshita tax reform by the general public depended primarily upon the pros and cons of introducing the *consumption tax*, despite the fact that direct tax reductions substantially exceeded the increased tax burdens.

Evident from past experience, political considerations, rather than economic, was the deciding factor in obtaining public support to adopt VAT. However, as far as results of public poll are concerned, strong anti-sentiment against VAT has persistently been prevalent up to the final stage (see, Table 3). Although it is a bit difficult to compare the results of

TABLE 3. RESULTS OF PUBLIC POLL FOR OR AGAINST THE INTRODUCTION OF THE CONSUMPTION TAX BY MASS-MEDIA

		Responses (%)		
Dates	Source	Yes	No	Others
July 3, 1988	Nikkei	34	50	
July 8, 1988	NHK	20.8	52.6	26.6
Sep. 11, 1988	Mainichi	15	58	
Sep. 26, 1988	Nikkei	32	56	
Oct. 5, 1988	Asahi	16	65	
Dec. 19, 1988	Nikkei	27	62	
Feb. 23, 1989	Yomiuri	17	71	
Mar. 12, 1989	Nikkei	Should be introduced as scheduled 12% Not introduced 57% Should be postponed to introduce 24%		

Note: Responses are given to such a common enquiry as "whether or not the *consumption tax* should be introduced." The sum of the figures is not necessarily 100 percent because multiple choices are admitted in some polls.

the various poll because of the different ways of making the enquiries, the majority of respondents in the range of 50–70 percent responded "NO" to VAT. Reflecting such a mood, the opposition parties have strongly resisted to reject the *consumption tax* bill at the Diet and as a consequence the bill has just been passed with difficulty by a single-handed voting by the ruling LDP. Even after implementing the *consumption tax* from April 1, 1989, the opposition parties still promised to repeal it.

Engineering Details

Learning from their previous experience of the *sales tax* controversy, government officials widely believed that the key issue in selecting the best indirect tax form among reform alternatives was its breadth and uniformity of coverage. The most important advantage of making the new indirect tax base broad was that such coverage would make the tax simpler and less onerous to business. Moreover, a broad base would permit lower tax rates. In contrast, a narrower base would produce arbitrary distinctions in the tax system, which in turn tend to increase compliance costs, cause distortions, and make the tax burdens less transparent. This was true in the case of the *sales tax.*

The primary goal in shaping the new indirect tax was to make the tax base as broad as possible but with a single tax rate. From this viewpoint, the *consumption tax* was successfully designed in spite of political pressures.

1. Tax-exempted goods and services were limited to only a few items; i.e. some of the education, medical care, and welfare programs;
2. The exemption level for firms was lowered to as little as ¥30 million in terms of annual sales.

It is clear that the first point enables the new indirect tax to apply to almost all consumer goods and services. In general, it is difficult, for political reasons, to implement a new indirect tax without some exemptions. Even the broadest of VAT usually exempts some items, such as medical and educational services, residential rents, etc. No doubt, each exemption introduces distortions and makes the new indirect tax more complicated. The coverage of the *consumption tax* seems to be along the broadest in the world, bearing a closer resemblance to the *goods and services tax* in New Zealand. In this regard, the frame of the *consumption tax* should be highly appraised in view of its base-broadening effect and its neutrality, although the exemption level of firms is still higher than other cases.

Many VAT countries use multiple tax rates, but Japan's *consumption tax* has just one rate plus a zero rate on exports. Generally speaking, multiple-rate structures offer a greater opportunity to fit VAT to various social and political targets. Moreover, multiple rates help to improve administrative performance and enhance compliance.

If a single rate is employed, as in Japan's case, the advantages stemming from multiple rates are abandoned. Under the *consumption tax* introduced by the Takeshita tax reform, the rate is single one, and the world's lowest, at 3 percent. Obviously, such a low tax rate does not require any multiple-rate aid to achieve special ends. In some senses, the rate is too low to diversify the rate structure for commodity differentiation and improving tax compliance.

In contrast to the successful reformulation of the broad-based indirect tax, three disadvantages have emerged from the *consumption tax:*

1. No invoices (essential to the tax credit method) are provided for;

2. A special simplified scheme (similar to forfeit) for the computation of tax is built in;
3. A unique vanishing exemption with "marginal deduction" is adopted.

Invoices admit the use of the tax-credit method, universally preferred in all VAT countries. If invoices are compulsory, the sum of the taxes already paid by other firms on purchases by the firm in question can be found. Each invoice for a purchase from another firm indicates the total amount of an input tax. Firms collect all such invoices during each period (three months or one year) and aggregate the input tax shown on them. This is the amount credited against the firm's own gross tax in order to calculate VAT payable by the firm.

The *consumption tax* with no invoices, must rely on the accounts method on VAT. To compute a firm's VAT, one must subtract total purchases from total sales by using its bookkeeping records with one's own calculation. The balance by subtraction is then subject to the rate of VAT. Although the *sales tax* was proposed with the invoice-credit method, the *consumption tax* was designed with the accounts method, without use of invoices.

Since there is no requirement of issuing an invoice in Japan, how can the tax official be sure that the firm has not overstated its input tax? It is officially stated that, instead of investigating invoices on a transactional basis, administration can be accompanied via the audit of accounts which are usually kept for individual and corporate income taxes.

There seem to be two reasons behind this choice. In the first place, the accounts method was officially praised for enabling the simpler computation of tax. Second, this simpler method is sometimes preferred for not having a built-in incentive for cheating. It is also politically advantageous, in that it would obtain the support of small distributors who are threatened by the prospect of their income being exposed by invoices with no tax credit breaks. The tax credit method in the proposed *sales tax* was clearly rejected, because it was believed to be equipped with this built-in safeguard which tended to be disadvantageous to taxpayers.

Almost the same can be said for adopting the special simplified scheme for computing the tax, a measure that favours smaller firms. Firms whose annual sales are less than ¥500 million (now ¥400 million after amendment, as seen later) were allowed to employ this method to enhance tax compliance. Instead of directly calculating the total value of purchases from other firms, certain fixed percentages (i.e. 10 percent for wholesalers and 20 per cent for other traders) were multiplied by total sales values and the results deemed to be subject to a 3 per cent rate. For example, tax amounts of non-wholesalers can be computed for the total value of sales $\times 0.2 \times 0.03$, which is equivalent to the turnover tax with a rate of 0.6 per cent. The number of firms applicable to such special rules statistically amounted to 96.7 per cent of the total in 1986. The special simplified scheme for computation may unduly render the figure smaller than the true value added at each stage.

The turnover tax is not a true VAT. Thus, this may prove to be a flaw in a new VAT system, because the turnover tax liability can be diminished by vertical integration, as stressed above. This possibility, however, does not seem to be practically crucial at the moment, because the special simplified scheme was not available to bigger firms with annual sales of ¥500 million or more. Therefore, more importance might be placed on the reduction of administrative burden of the true VAT on small and medium-size firms. The option of turnover tax would certainly help them to calculate easily the tax due [see MOF (1990, p. 161)].

The vanishing exemption method was also introduced to give the relief provision to smaller traders. Those whose annual sales do not exceed the maximum limit of ¥60 million (now ¥50 million) above the exemption level of ¥30 million can benefit from this method in terms of tax credit. In this case, a reduction in the tax due is achieved gradually to zero by a "marginal deduction" that takes the form of tax credit. The calculation is as follows:

$$\text{Tax credit} = \frac{\text{¥60 million} - \text{annual sales}}{\text{¥30 million}} \times \text{tax otherwise due}$$

Let us assume a small trader at the retail stage with only ¥40 million of annua sales. Since he is eligible to use the special simplified scheme, the tax payable without "marginal deduction" would be 0.6 percent × ¥40 million, i.e. ¥240,000. Under the calculation described above, the tax credit is (¥60 million–¥40 million)÷¥30 million × ¥240,000, i.e. ¥160,000. Thus, the tax due is only ¥80,000 (i.e., ¥240,000–¥160,000), which is one-third of the tax amount without this relief. The tax due becomes equal to 0.2 percent of sales, not 0.6 percent.

In the case of a much smaller trader, say, with ¥30 million of sales, the tax vanishes at that level, because the tax credit is essentially equal to the tax otherwise due. The tax become negative at sales below ¥30 million, but there is no refund to the taxpayers.[9]

Taking account of these relief provisions for small and medium-size firms, various rates of the *consumption* tax can be applied to different level of annual sales. Table 4 shows five rates applicable to each stage of sales, depending upon special tax provisions in favor of smaller firms and traders.

TABLE 4. VARIOUS TAX RATES APPLICABLE TO DIFFERENT SALES
—THE CASE OF NON-WHOLESALE FIRMS—

Annual sales (¥ million)	Tax rate	Methods
above 500	3%	Regular rate
60–500	0.6%	Special simplified scheme
30–60	0-0.6%	Vanishing exemption due to "marginal deduction"
0–30	0%	Exemption

Note: Drawn from the explanation of C. Shoup (1990), p. 438.

[9] On this point, C. Shoup states that "So far as I am aware, this type of vanishing exemption is not found in other VATs, coupled with the tax-on-sales option, except, to a degree, in the new Canadian Goods and Services Tax." [Shoup (1990, p. 438)].

Relation to Existing Indirect Taxes

In conjunction with the creation of the *consumption tax*, the whole system of indirect taxes needs to be restructured to harmonize with the existing excise taxes and the allocation of revenue sources between the national and local governments.

As seen in Table 5, five national excise taxes,have been repealed as well as three local taxes. All these taxes are replaced by the new *consumption tax* on a nation-wide basis. Of most importance was the absorption of the commodity tax into a new tax. The multiple-rate structure of the commodity tax is thus changed into a single rate of 3 per cent on all taxable commodities; as a temporary measure, only passenger cars will be taxed at the higher rate of 6 per cent, during the transitional period.[10]

In addition, several other excise taxes are adjusted to coexist with the *consumption tax*. In principle, major commodities such as alcoholic beverages, tobacco and petroleum are subject to both selective excise and general consumption taxes in VAT countries. The same procedures are applied in restructuring the indirect tax structure in Japan. Alcohol and tobacco taxes are initially applied at specific rates only at the manufacturer's level, and then an advalorem rate of 3 per cent is levied as the *consumption tax* for distributors and retailers. Despite the combined taxes with different rates, total tax burdens are adjusted to remain unchanged. Taxes on petroleum, however, consist of both the existing and new taxes, causing a heavier tax burden. Also, the securities transaction tax was reduced because of the increased capital gains tax on the sale of securities.

Attention should also be paid to intergovernmental revenue transfers. Two measures were proposed when the *consumption tax* was introduced. In local taxes, several excise taxes have been repealed or amended, producing a substantial amount of revenue loss.

To compensate for revenue sources lost due to local tax cuts, one-fiftieth of the *consumption tax* is first handed over to local governments as a consumption transfer tax, which in turn is allocated regionally among prefectures and municipalities according to population.

TABLE 5. TAX VARIATIONS IN THE NATIONAL AND LOCAL TAX SYSTEM UNDER THE TAKESHITA TAX REFORM

Items	National	Local
Creation	*Consumption tax*	Consumption transfer tax
Repeal	Commodity tax, playing-cards tax, sugar excise tax, admission tax, travel tax	Electricity tax, gas tax, timber delivery tax
Amendment	Individual income tax, corporate tax, inheritance tax, liquor tax, tobacco excise tax, petroleum tax, bourse tax, securities transaction tax, stamp tax	Inhabitants' tax, enterprise tax, real property acquisition tax, entertainment tax, tax on consumption at hotels and restraurants

Source: Data from the MOF.

[10] This measure was taken to adjust for too sharp a tax cut on certain commodities: i.e., the commodity tax rate on passenger cars runs as high as 23%. Cutting such a high rate suddenly to 3% was regarded as too drastic a change. At first, this temporary measure is intended to expire by the end of fiscal 1991. However, it has been decided to postpone for two years at the reduced tax rate of 4.5 percent when revenue shortage was incurred at the budget compilation of fiscal 1992.

Second, 24 per cent of the *consumption tax* at the national level (exclusive of the consumption transfer tax) is appropriated for tax-sharing grants—the local allocation tax [see Ishi (1989, Chapter 13)].

The overhaul of Japan's tax structure has been nothing less than drastic. A reform of such magnitude has not been undertaken since the beginning of the Meiji period.

The Takeshita Tax Bill Amendments

The Takeshita Tax Bill, which had been proposed to the 113 Extraordinary Diet in July 29, 1988, was finally approved by the Lower and Upper Houses on November 16 and December 24, 1988, respectively. In order to pass the Tax Bill some amendments were made to the original plan as political compromises between the LDP and opposition parties, although they were minor and did not change the amount of tax reductions greatly.

The original proposal of the *consumption tax* was slightly altered as follows. Although the *consumption tax* became effective from April 1989, the first half a year up to September 30 was planned to be a period of preliminary enforcement. Reflecting a lack of familiarity with the new tax in Japan, the National Tax Administration was requested to enforce it less strictly, putting emphasis on public relations, guidance, and consultation for tax considerations.

IV. *Economic Aspects and Consequences*

Effects of VAT on Prices

In all countries the public and the government anticipate the increase in retail prices caused by the introduction of VAT with anxiety. Japan was not an exceptional case. On April 1, 1989, the VAT known as the *consumption tax* was introduced in Japan to replace eight excise taxes including the commodity tax. Since a new VAT is applied to the areas that were formerly exempted, in particular foodstuffs, the changeover to VAT was in itself conjectured to lift up price level to some extent.

In theory, the likely impact of VAT on prices would just induce the once and for all expected increase in retail prices due to the 3 per cent VAT rate. In practice, however, it is anticipated that traders might take advantage of the confusion to raise their prices unduly. Given such anticipation of price increases, the government started a couple of policy measures to introduce the *consumption tax* smoothly several months before the date of enforcement.

First, the Special Council on the Transition to a New Tax was established in the cabinet on January 6, 1989 to consider any transitional problems, such as price increases, arising from the implementation of such a tax. Through this council, each ministry and agency were requested to cooperate and to promote the enforcement of VAT.

Second, the government began to carry out an extensive advertising campaign in newspapers, poster, TV, VTR, and radio. Main purposes were to reduce the public's fear about price hikes and to restrain any possible cases of overcharging by traders. In addition, the government opened telephone service corners where taxpayers could make enquiries about the calculation and payment of the tax due, and consumers could report complaints about prices.[11]

Third, the Economic Planning Agency strengthened the operation of price monitoring system. Monitor's staffs were doubled, and prices of a wide range of commodities were monitored during the period before and after the introduction of VAT. In a word, it is noted that the government has tackled the smooth adoption of a new tax with strenuous exertion.

In order to observe the effect of the *consumption tax* on prices, percentage changes of the consumer price index (CPI) in a national area are presented in Table 6. The CPI in total rose by 2.9 per cent in fiscal 1989 which was substantially higher than 0.8 per cent in fiscal 1988. It appears that the new VAT can be regarded as responsible for a rise of some margin in the CPI during the period of fiscal 1989. An increase of a magnitude smaller than the VAT rate of 3 per cent was expected in advance, because previously exempted food and services were being taxes for the first time.

Special attention might be paid to the quarter of April–June or the month of April in 1989 when the new VAT came into effect. The CPI increased by 2.8 or 2.4 per cent relative to the same period in 1988 on a quarterly or monthly basis, respectively, but this was in part accounted for by foodstuffs. Basic trends of price hikes continued at a reasonable level until the end of 1989. In 1990, foodstuffs suddenly rose to a considerable extent, but this was not related to the implementation of VAT.

Increase in the general price level due to public utility, such as those for gas, electricity, transportation, tuition, etc., have been much lower than other items. This reflected that

TABLE 6. TRENDS OF THE CONSUMER PRICE INDEX (CPI) IN A NATION-WIDE AREA

(percent)

Period	Total	Major items		
		Foodstuffs	Public utility	General goods & service
Fiscal 1988	0.8	3.8	0.0	0.7
Fiscal 1989	2.9	3.1	1.5	3.2
1989				
Jan.–Mar.	1.1 (−0.1)	2.8 (−5.6)	0.4 (0.0)	1.0 (−0.3)
Apr.–June	2.8 (1.8)	4.1 (3.2)	1.3 (1.0)	2.9 (2.6)
Apr.	2.4 (1.2)	1.5 (1.0)	1.2 (0.9)	2.8 (2.0)
May	2.9 (0.5)	5.1 (2.6)	1.4 (0.2)	3.0 (0.6)
June	3.0 (0.2)	5.7 (−2.1)	1.4 (0.2)	3.2 (0.1)
July–Sep.	2.7 (0.5)	0.4 (0.1)	1.4 (0.3)	3.2 (0.2)
Oct.–Dec.	2.6 (0.5)	−1.8 (0.7)	1.5 (0.2)	3.3 (0.8)
1990				
Jan.–Mar.	3.3 (1.0)	9.9 (5.7)	1.6 (0.1)	3.5 (−0.1)
Apr.–June	2.4 (0.6)	8.8 (2.1)	1.5 (0.9)	2.3 (1.4)

Source: Economic Planning Agency, "On Price Trends after the Introduction of the *consumption* Tax," Oct. 7, 1990.

Note: Figures are percentage changes relative to the same period in the previous year. On the other hand, percentages in parentheses are those relative to previous quarter or month after seasonal adjustments.

[11] For the first four months from April 1989, the number of enquiries by telephone services on prices accounts for 4412 in April, 630 in May, 241 in June and 140 in July. A substantial part of complaints are related to overcharging and charges by tax-exempt traders [see Economic Planning Agency (1990a)].

related authorities including local government have been reluctant for a while to pass VAT on public utility prices, despite strong insistence by the national government for forward shifting.

Another information is derived from Table 7 in which we present the results of the 6th monitoring. Twenty nine items targeted for monitoring are grouped in two categories: (1) items that a VAT have taxed for the first time, and (2) items that the commodity tax has been levied no more. The first category was expected to increase prices, while the second must reduce prices at least in a margin of the gap between the commodity tax and VAT. Based upon some evidence of selected months following the changeover, food, general goods including clothing and services rose by 2.7–2.9 per cent for the first month, but they are less than the VAT rate of 3 per cent. By contrast, durable consumer goods decreased prices by 6.0 per cent. Within one year, the increasing rate of prices has varied as we anticipated in advance.

All in all, the Japanese experience may be considered as an example of a smooth changeover to VAT with little net effect on prices. Attention should be paid to a combination of government guidance on prices, official monitoring and moreover public awareness which may be behind this fact.

Forward Shifting

Another important issue is what is to be the assumption on shifting. Put in another way, to what extent should or could the VAT be passed on prices? Of course, the VAT does not need to be shifted forward. Depending upon macroeconomic conditions (i.e., restraint of money supply or sluggish aggregate demand), it is quite possible to take the alternative way that traders might be forced to absorb the burden of the VAT.

In Japan, however, it was proposed that the full amount of the VAT liability should be ultimately passed along to consumers by every trader, considering in principle the basic nature of Japan's VAT [see Tax Advisory Commission (1988)]. This idea implies that the enactment of VAT ought to be accompanied by repeal of the supply and demand in the markets. There was a general awareness that the VAT, as a broad-based indirect tax, should be bore by all the people in a similar faction, because the VAT was thought of as necessary revenue sources to be appropriated towards an aging society in the future.

TABLE 7. EFFECTS OF A VAT ON PRICES OF MAJOR COMMODITIES: RESULTS OF THE 6TH PRICE MONITOR

	1989					1990
	Apr.	May	June	Aug.	Nov.	Feb.
21 items chargeable under a new VAT						
Food (10)	2.7	0.3	0.1	0.1	0.1	0.1
General goods (6)	2.9	0.2	0.2	0.0	0.1	0.0
Services (5)	2.8	0.5	0.2	0.1	0.1	0.1
8 items with no Commodity tax						
Durable consumer goods (5)	−6.0	−0.3	−0.1	−0.2	0.0	−0.1
Others (3)	−1.4	−0.3	0.0	0.0	0.0	0.0

Source: The same as Table 6.
Note: The increasing rate of prices is percentage changes relative to previous month.

Apart from theoretical considerations, both traders and consumers expressed fears about shifting of the VAT. On the one side, traders, in particular smaller traders, constantly expressed their misgivings that they could not pass VAT in full amount, given competitive market conditions. If so, they must absorb some portion of VAT, reducing their profits or passing it backward in the form of lower factor rewards. On the other hand, consumers were likely to be aware of a major tax change and to expect the worst gloomily. They anticipated that traders might tend to raise prices exorbitantly resulting in price increases exceeding the rate of VAT. Moreover, they considered that even tax-exempted traders might pass VAT on prices.

Since the VAT was implemented in the midst of these mutual anxieties, it is of great interest to examine how perfectly or to what extent the VAT could be shifted forward. There are several kinds of research data available to us, which were mostly collected through a questionnaire method by several ministries and agencies.

The Ministry of International Trade and Industry (MITI), mainly in charge of industrial policy, was very keen to investigate effects of a new VAT on prices after the imposition of the *consumption tax*. MITI attempted to obtain monthly report about price changes affected by VAT from around 4,000 traders with major goods and services items of 147. Table 8 shows to what extent traders at each stage could pass forward the VAT. Enquiries are classified into three categories: "Almost shifting," "To some extent," and "Almost not shifting." As far as this enquete is concerned, 84.9 per cent of the total affirm the feasibility of forward shifting. In particular, nearly 100 per cent of manufacturers successfully pass the VAT burden on prices. Conversely, retailers have some difficulty in shifting it forward to consumers. As compared with the results of the month in parentheses, it is becoming easier for traders to pass on. From these evidences, MITI came to the conclusion that "forward shifting progressed almost smoothly."

It can easily be conjectured that the shifting would be different from larger traders to smaller traders. In particular, retailers must be affected by business size; the bigger retailers are, the easier it would be to shift the VAT to consumers. Table 9 is prepared for this purpose. Enquiries are the same as in Table 8, but retail traders are divided into three classes, depending upon the level of their taxable sales. Four selected months are taken

TABLE 8. EXTENT FORWARD SHIFTING
—AT THE TIME OF MAY 1989—

(Percent)

Stages	Extent of shifting a new VAT on Prices			Unknown	Number of respondent traders
	Almost shifting	To some extent	Almost not shifting		
Manufacturer	99.8 (98.6)	0.2 (0.4)	0 (0)	0.0 (1.0)	406
Wholesaler	98.8 (96.6)	0.6 (1.1)	0.5 (1.3)	0.1 (1.0)	1,119
Retailer	75.9 (73.0)	9.8 (10.0)	14.1 (16.6)	0.2 (0.4)	2,402
Total	84.9 (83.6)	6.2 (6.0)	8.8 (9.8)	0.2 (0.6)	3,927

Source: Ministry of International Trade and Industry (MITI), "On the Shifting of the *Consumption Tax* (at the time of May)" (in Japanese), July 28, 1989.

Note: Percentages are the relative share of respondents to the question "To what extent can you shift forward the consumption tax on prices?" Figures in parentheses indicate relevant results of April, 1989.

TABLE 9. EXTENT OF FORWARD SHIFTING BY FIRM SIZE AT THE RETAIL STAGE IN FISCAL 1989

(Percent)

Taxable sales (¥ million)	Time point	Extent of shifting a new VAT on prices			Unknown	Number of respondent traders
		Almost shifting	To some extent	Almost no shifting		
Traders with sales of more than 500	Apr.	84.8	5.2	9.4	0.6	672
	July	95.8	2.2	2.0	—	753
	Oct.	98.8	0.6	0.6	—	652
	Jan.	96.3	0.6	0.6	—	679
Traders with sales of 30–500	Apr.	73.0	10.8	15.8	0.4	1,102
	July	83.7	9.3	6.9	0.1	1,025
	Oct.	84.5	9.1	6.3	0.1	1,090
	Jan.	82.9	9.6	7.4	0.1	1,102
Traders with sales of less than 30	Apr.	60.0	14.0	25.9	0.1	609
	July	43.6	18.4	37.6	0.4	560
	Oct.	43.7	18.9	37.4	—	636
	Jan.	49.8	16.6	33.6	—	590

Source: MITI, "Actual Performance of Implementing the *Consumption Tax*" (in Japanese), Aug. 7, 1990.
Note: The same as Table 8.

to indicate the possible changes of responses from questionnaires. There are three interesting points worth noting.

First, large traders above ¥500 million taxable sales were able to pass on relatively easily and its tempo accelerated during the first half of the year. Second, medium-sizes traders felt the feasibility of shifting to a lesser extent, but more than 80 per cent of them were successful in passing on its VAT liability. Third, smaller traders found it more difficult to shift their VAT burden on prices. More importantly, the shifting has sharply been lowered from 60.0 per cent at the beginning to 43.6 per cent in July.

The Fair Trade Commission also published the results of monitoring the relationship between the rate of VAT and price changes.[12] Particular attention is paid to whether the 3 per cent of VAT rate can fully be passed on prices or not. In Table 10 three cases are illustrated as (1) full-shifting, (2) over-shifting and (3) under-shifting at the retail stages. It is interesting to find that 83.1 per cent of all retailers could pass on the full amount of VAT. Over-shifting accounts for only 7 per cent. Department stores shifted almost perfectly its VAT liability on prices while retail shops experienced under-shifting in substantial part (i.e. 20.9 per cent). Other types of businesses showed more or less similar phenomena in the patterns of shifting.

In Japan, the shifting of a new VAT might be concluded to be satisfactory as a whole with the exception of smaller traders, such as small-sized firms.

The ease or difficulty of shifting VAT on prices may have a closer bearing upon the alternative pricing methods. That is to say, the pricing issue is how goods and services

[12] Through 1,000 monitors, two researches were carried out (i.e. (1) March 19–25, and (2) April 19–25) about 20,000 commodities in order to investigate price changes and pricing method (i.e. VAT-quoted pricing or not). Whether or not 3 percent of VAT rate has been passed on was derived from the comparison of price level at two time points (see Fair Trade Commission, 1989).

TABLE 10. FULL, OVER AND UNDER-SHIFTING AT THE RETAIL STAGE BY BUSINESS TYPE—AT THE TIME OF APRIL, 1989—

Type	Number of goods & services			
	3% on prices	More than 3% on prices	Less than 3% on prices	Total
Department store	663 (90.0)	40 (5.4)	34 (4.6)	737 (100.0)
Large-scale super markets	5,819 (87.9)	420 (6.3)	378 (5.7)	6,617 (100.0)
Small and medium-size super markets	4,303 (90.5)	251 (5.3)	202 (4.2)	4,756 (100.0)
Small and medium-size retail shops	4,028 (68.9)	597 (10.2)	1,224 (20.9)	5,849 (100.0)
Coop & agricultural cooperatives	1,571 (89.6)	74 (4.2)	108 (6.2)	1,753 (100.0)
Others	166 (83.0)	14 (7.0)	20 (10.0)	200 (100.0)
Total	16,550 (83.1)	1,396 (7.0)	986 (5.0)	19,912 (100.0)

Source: Fair Trade Commission, "On the Results of Monitoring Price Changes and Pricing Methods after the Consumption Tax was Implemented," (in Japanese) May 23, 1989.
Note: Figures in parentheses are percent distribution in each column.

can be priced with or without VAT. If prices were without VAT (i.e., *Sotozei:* VAT-exclusive pricing), consumers are then exposed to the shock of VAT added (i.e., ¥100 plus ¥3 tax) when they pay, but traders can fully pass VAT on prices by agreement with consumers. By contrast, if prices were with VAT (i.e., *Uchizei:* VAT-inclusive pricing), the VAT is not clear to consumers, concealing the tax burden from the taxpayer (i.e., ¥103 including ¥3 tax). Overshifting may occur in this case.

Some people may like to know the VAT content of a price to be shown separately from the tax-free price in order to understand fully their tax liability. They prefer the *Sotozei.* On the other hand, others may choose to be aware of the full cost of a good including tax and may not want to be faced with an additional payment at the cashier. This is for the *Uchizei* case.

From the beginning of implementing the *consumption tax*, the government entrusted the choice of two different pricing methods to the traders themselves. Of great interest is which pricing is being adopted by majority of the traders. On this point. The Fair Trade Commission shows an interesting result from its investigation held in April 1989 [See Fair Trade Commission (1990)] as follows:

Total items	19,912 (100.0)
VAT-quoted price	17,412 (87.4)
Without VAT (*Sotozei*)	13,930
With VAT (*Uchizei*)	3,482
VAT-concealed price (no mention about VAT)	2,500 (12.6)

At the time of investigation, the relative share of pricing with vs. without VAT was 20:80. Most traders preferred a clear-cut pricing under the *Sotozei* case to convince consumers of forward shifting. Judging from my own experience, it seems, however, that the relative share has been reversed in recent years. This implies that consumers prefer paying the tax without noticing the tax burden, i.e., the Uchizei case.

Administration and Compliance

Evidently, the introduction of VAT has been a major upheaval in the tax system, causing both administrative and compliance considerations. The government was greatly concerned with the practical difficulties of administering VAT, while traders had the widespread perception that it would impose very heavy costs on those obliged to account for the tax.

In Japan, more importance has been placed on trader's compliance than tax administration of the VAT authorities. As noted above, a new VAT was introduced, eliminating the existing excise taxes (see Table 5). Thus, there was no need to establish a completely new authority for collecting VAT, and the existing tax staffs were empowered to administer the new tax. Since they are highly trained staffs, moving to a VAT was not bound to involve extensive retraining and recruitment. In general, the *consumption tax* organization was neither understaffed nor overburdened, and in turn tax administration as a whole has remained almost unchanged[13] to keep the pursuit effective after the implementation of VAT.

On the other hand, the trader's reaction posed more important problems that depended upon the businessman's feelings about compliance costs of the VAT. The traders anticipated that the VAT was the most serious burden that had been officially created on business. Thus before the new tax started, there were a number of fears about the likely burden of compliance costs among traders in general, including computer facilities.

Despite prevalent fears in advance, the implementation VAT seemed to have been much smoother than had been anticipated. Generally speaking, both traders and consumers behaved well and cooperated with the tax authorities, although anti-VAT sentiment still remained strong among the general public. Several facts became evident from reviews attempted by the National Tax Administration (NTA) to investigate actual performance of the *consumption tax* for the past one year.[14]

First, as to how taxpayers calculated the tax payable, 19.6 per cent of the respondents said that they paid the tax on a self-assessed basis without any help from tax professionals, because they could understand almost fully the details of VAT to be paid. By contrast, the remaining 80.4 per cent relied upon professional knowledge to compute the tax due. Obviously, there is a general tendency that the larger the firms are in terms of annual sales, the more likely they rely upon the skills of professionals. Thus, what it costs them to comply with government requirements became heavier than before.

Second, 72.0 per cent of total respondents complained about additional compliance costs for paying VAT, while 28.0 per cent responded no cost required to comply with tax offices. Inspecting more detailed items of new costs for the majority group, the top three accounts for (1) purchase of tax-related stationery goods, (2) the provision of information for customers and (3) the change of bookkeeping records. Computer hardware and software turn to be less costly than earlier considered.

Third, it is interesting to focus on how much special simplified scheme has been pre-

[13] In 1991, however, the organization of the National Tax Administration was reshuffled to a great extent, associating the administration of VAT with individual and corporate income taxes. In particular, this was promoted to enhance the expedience for filing tax returns from a standpoint of taxpayers to cover both the *consumption tax* and income taxes.

[14] The VAT attempted substantial amount of reviews to clarify actual consequences of VAT one year after its enforcement. [See NAT (1990a, 1990b)].

TABLE 11. SMALL AND MEDIUM TRADERS APPLICABLE TO SPECIAL SIMPLIFIED RULE AS A PERCENT OF TOTAL TAXPAYERS IN 1989

Taxable sales[a] ¥ million	Total taxpayers (1)	Traders with special simplified rule (2)	$\frac{(2)}{(1)}$ (3)
Less than 30	212,881	132,697	62.3
30– 60	546,900	442,882	81.0
60–100	363,063	279,435	77.0
100–200	342,924	256,337	74.8
200–300	134,238	95,848	71.4
300–400	73,510	49,147	66.9
400–500	46,871	27,523	58.7
Sub-total	1,507,506	1,151,172	76.4
More than 500	212,632	24,449	11.5[b]
Total	1,933,019	1,308,318	67.7

Source: Ministry of Finance, "On Data Collected to Investigate the Actual Performance of the Consumption Tax," Aug. 7, 1990.

Notes: a. Figures in 1988 (previous year).

b. Since traders applicable to special simplified scheme are registered during the base period (i.e. two years before the relevant tax period—in 1987), their taxable sales in 1988 exceeded the threshold of less than ¥500 million, reflecting a growing business activity in the past.

valent. Table 11 shows the relative share of using this special provision among VAT taxpayers for the first year—fiscal 1989. In total, 67.7 per cent of all traders applied for the use of special simplified scheme, a proportion smaller than we had expected. No doubt, smaller traders tended to employ this scheme more intensively. Even tax-exempt traders with less than ¥30 million in taxable sales made an entry as taxable firms so as to obtain tax-credit on purchases.[15]

Fourth, another attention is paid to what is in practice the realized ratio of value added in gross sales by type of industry. This is important because rough approximate percentages (i.e. 10 per cent for wholesalers and 20 per cent for the rest) are available to traders to compute deemed value added for tax vase, if they apply for such a special provision. As seen in Table 12, value added ratios spread in a wide range from 14.8 per cent of wholesale to 45.6 per cent of real estate. From this, it is evident that special simplified scheme impair the fairness of taxation by type of industry. In particular, service-related industries can greatly benefit from special relief in terms of deliberate shrinkage of taxable value added.

Lastly, it is of great interest to examine the consequences of using vanishing exemption system. As indicated in Table 11, the number of eligible traders in a range of ¥30–¥60 million in taxable sales accounted for 546,900 in 1989. Among them, 510,277 traders employ vanishing exemption whose ratio is 93.3 per cent. The average amount of tax credit with "marginal deduction" is ¥119,000 compared with average tax otherwise due in this range—¥135,000 (=¥45 million × 0.03). Obviously, the tax payable has been reduced to ¥16,000 (=¥135,000–¥119,000).

[15] Of course, another reason should be related to the gap of annual sales between the base and tax years (see Note b. in Table 11).

TABLE 12. VALUE ADDED RATIO BY TYPE OF INDUSTRY UNDER THE APPLICATION OF SPECIAL SIMPLIFIED SCHEME

Type	Ratio	Type	Ratio
Wholesale	14.8	Manufacturing	33.4
Retail	21.4	Services	39.3
Construction	23.1	Transformation & Telecommunication	45.2
Mining	29.0	Real Estate	45.6
Agricultural, Forest & Fishery	31.0		

Source: The same as Table 11.

V. *Amendments and Further Reform*

Towards Potential Amendments

Contrary to advanced fears and anti-sentiment against the *consumption tax*, the new tax has settled down smoothly in the Japanese tax system only a year after it was enacted by law. Politically, however, controversial arguments still continued between the opposition parties and the ruling LDP. The former has strongly persisted in repealing VAT as a political propaganda since the beginning of its implementation, while the latter gradually had to respond to such political attacks by rectifying some parts of the *consumption tax.*

What were controversial issues between the LDP and opposition parties on the original VAT? The three points in dispute were as follows:

1. Regressive tax burden among lower income earners.
2. Cash flow benefits for a period before tax revenues are handed over to the tax authorities.
3. Windfall revenue gains under the special simplified scheme with deemed value added.

All these are related to the major complaints of consumers when such a tax is implemented. As a consequence, these controversial issues provided a basic direction towards the amendments of the current *consumption tax* effected from April 1, 1989.

The first point concerning regressivity has remained predominant for a long time among the opposition parties supported politically by anti-VAT movement. Whenever Japan's VAT was proposed in the past tax reforms, the most critical points were concentrated on its basic nature of regressive tax burden and the distributional consequences. This was the important reason why the exempted items of the *sales tax* had to be enlarged from the original seven to fifty one to mitigate political pressure under the Nakasone cabinet. Generally speaking, it is widely acknowledged that regressivity could be lessened to some extent if some essential goods and services (e.g., food, education, health, housing, public transport, etc.) are exempted from taxation.

Needless to say, the enlarged scope of exemptions is clearly induced to distort the fundamental structure of VAT, impairing uniformity and width which is of great advantage to tax neutrality. The government persistently maintained that distributional issues could be better served by progressive income taxation and by carefully targeted transfer payments to the poorer households. Politically, however, the increased use of exemptions from VAT has been getting more popular support from consumers.

Second, greater attention has been put to cash flow advantages where traders have the use of tax revenues before passing them over to the tax authorities. Originally, traders were allowed to file a return and pay the tax due twice a year (including once for interim payment) if their tax payable in the previous year exceeded ¥600,000. Otherwise, tax payment was only once a year in the case of small traders. This rule implies that a specified "grace period" is substantially long enough to cover more than several months. During such a period, traders who collect the tax on behalf of the tax authorities and are allowed to retain it can obtain, in effect, interest-free loans. Perhaps, it would enable them to earn additional interests by investing retained cash flow in the portfolio market. The benefits that traders derive during the "grace period" have greatly been criticized by consumers in view of tax equity.

As a third point, great emphasis has been placed on inequitable aspects of windfall revenue gains caused by the application of special simplified scheme and vanishing exemption. In particular, deemed value added (i.e., 10 per cent for wholesalers and 20 per cent for the rest) poses a problematic underestimation of tax base. As seen in Table 12, big differences can be observed between the approximate ratio and the actual ratio of value added by type of industry. Evidently, service-oriented industries really enjoyed revenue gains as a result of the wide margin between the two relevant ratios. Similar to the second issue, such gains accruing to the traders were considered to be unfair by the general public.

Process of Amending the Original VAT

Reflecting strong anti-VAT protests in general, the government greatly concerned with how smoothly the new tax could be implemented. Particularly, the anticipated general elections of Upper and Lower Houses were very important to judge publicly the justification for the introduction of VAT. Table 13 tabulates events after the *consumption tax* was enforced in April 1989 until some amendments were finally made in October 1991. Successive events during the period in question occurred as a result of political struggles and compromises. When the election of Upper House was held in July 1989, the LDP's political powers were lessened to a great extent after it lost substantial seats. Throughout the campaign, existence or repeal of the *consumption tax* was truly a disputable issue between the LDP and opposition parties.[16] If the LDP had failed once again in the general election of the Lower House in February, 1990, the *consumption tax* would have disappeared from the Japanese tax system merely for political reasons. Fortunately, Japan's VAT was maintained as a result of a political victory of the LDP.

The process of rectifying the structure of consumption tax is divided into two stages. The first trial is derived from "Tax bill of the amendment of the *consumption tax*" approved by the cabinet in March, 1990, but it was not successful. Tle other is based upon "Amended tax bill of the *consumption tax* presented by the Joint Committee in April, 1991, which led the revised form of the present consumption tax. During this period, the opposition parties submitted twice "Tax bill of repealing the *consumption tax*" which was strongly against the continuation of VAT.

[16] Of course, there were other issues in dispute, such as scandal involving cabinet members and open-door policy to rice products, than the consumption tax.

TABLE 13. CHRONOLOGY OF EVENTS AFTER IMPLEMENTING THE CONSUMPTION TAX

1989	
1 April	The introduction of the *consumption tax.*
28 June	The Tax Advisory Commission established Sub-committee on a Follow-up of *Consumption Tax.*
23 July	The election of Upper House.
29 September	Opposition parties presented to the 116 Extraordinary Diet the first "Tax bill of repealing the *consumption tax.*"
24 November	Interim report from Sub-Committee of the Tax Advisory Commission.
1 December	LDP decided basic principle of amending the *consumption tax.*
16 December	The Diet was closed. Tax bill was withdrawn.
1990	
18 February	The general election of Lower House.
6 March	Cabinet approved "Tax bill for the amendment of the *consumption tax*" which was presented to the 118 Extraordinary Diet.
19 April	Opposition parties presented to the Diet the second "Tax bill of repealing the *consumption tax.*"
26 June	The Diet was closed, and two different types of tax bills were withdrawn. However, Joint Committee on Tax Issues was established at the Diet to discuss the future treatment of the *consumption tax* in cooperation with both the LDP and opposition parties.
1991	
25 April	Joint Committee presented to the Diet "Amended tax bill of the *consumption tax.*"
8 May	Amended tax bill passed the Diet.
1 October	A new *consumption tax* started.

Source: Data submitted to the Tax Advisory Commission.

The first amendment plan was mainly composed of three features as follows:

1. Food is fully exempted only at the retail level, while half of VAT rates (i.e., 1.5 per cent) is applied to inter-firms transactions on the same product.
2. The scope of exemptions is expanded to cover (1) birth expenses, (2) cremation and burial costs, (3) certain goods and services for disabled persons, (4) certain welfare services, (5) education, and (6) housing rents.
3. The annual number of tax returns and payments increases from once a year to four times in larger traders to shorten the "grace period."

As is evident from Table 13, the amended scheme of alternating VAT did not come into effect when the tax bill was withdrawn at the 118 Extraordinary Diet in June, 1990. We must conclude that this was really a good choice. If the revised form had passed the Diet, a very funny style of VAT would have been created. In fact, special treatment of food (i.e., the combination of zero rate and reduced rate on different stages of transactions) is not feasible compared with other VAT-countries. This strange idea resulted in a political conflict with the opposition parties that had constantly promised to repeal VAT or otherwise at least exempt food.

The next amendment, which was a successful trial, was derived from a joint agreement of the ruling and opposition parties. As a consequence, the *consumption tax* was altered to a considerable extent on the basis of the fundamental direction mentioned above.

Main features of the new VAT are summarized in the following three points.

1. A specified "grace period" is shortened by increasing the annual number of tax return and payment from twice a year to four times. This is applied to only large traders whose tax due exceed more than ¥5 million.

2. Windfall revenue gains are lessened by establishing new requirements;
   (1) Deemed ratio of value added is diversified into four categories;
   10%—wholesale
   20%—retail
   30%—agriculture, forestry, fishery, mining, construction and manufacturing
   40%—others, such as transport, telecommunication, real estate, restaurants, etc.
   (2) The maximum level applicable to the special simplified scheme is reduced from the current ¥500 million to ¥400 million in terms of taxable sales.
   (3) The same holds for the vanishing exemption whose maximum level is lowered to ¥50 million from the current ¥60 million.

However, the exemption level remained unchanged at ¥30 million, although many asserted the necessity of lowering it to as low as ¥10–20 million.

3. Exempted goods and services are expanded in a way similar to the first amendment plan listed above.

As a result, the new *consumption tax* had two-side effects. No doubt, the first and second points contributed towards the improvement of VAT, but the VAT turned to be worsened by the third point, eroding tax base. The new tax started in October 1991, which is to be kept unchanged for a whole. Perhaps the next biggest issue would obviously to be raise tax rates to the range of 5–10 per cent.

Reformulating Japan's VAT

Japan's VAT has once been amended, but there still remain a number of areas which need to be improved further in the future. In comparison with the most common type of VAT used in EC countries today,[17] the new *consumption tax* in Japan contains several special measures which are likely to impair the possible merits of such a tax. These measures are acknowledged as falling short of the full standard treatment under the usual type of VAT, but are rationalized by the existence of administrative and compliance problems. No doubt, political considerations were also involved, since it was necessary to obtain support from opposing groups in retail or wholesale industries who played a major role in the *sales tax* controversy noted previously. Special treatments should be phased out more in favor of the normal scheme of VAT.

First of all, the special simplified procedures for measuring the tax base will impair the advantages of broad-based indirect taxes. This special scheme may be justified to some extent in order to simplify the procedure for charging the tax, but the current scheme admits too wide coverage for using the special rule. Taxable traders whose annual sales are less than ¥400 million are eligible to apply the simplified procedures, and these firms make up as much as two-third of the total firms. The measure intended to simplify the procedures for computing the tax base may be of some help in mitigating the taxpayers' book-keeping burden, and so may be commended in view of tax simplicity; however, the simplified scheme using fixed percentages (i.e., 10–40 per cent) clearly impairs fairness in calculating the tax base to a lesser extent than actual and produces new distortions in economic activities.

[17] Shoup (1990) points out that the most common—indeed, almost universal—type of VAT contains the following characteristics: consumption type, destination principle, tax credit method, multiple rates that are tax-exclusive, and exemptions rather than zero-rating.

Thus, the coverage of eligible taxable traders should be narrowed to a great extent, say to ¥50 million in terms of annual sales.

Second, the *consumption tax* does not employ the tax-credit method which is used almost universally nowadays, although it is characterized by a very comprehensive VAT. This is one of the special treatments that the *consumption tax* permits. The invoice system is not required at all stages of transaction. Under the account method with no invoices, a firm's tax base is computed as the difference of total purchases from other firms from the sales of the firm in question. Like the special scheme of simplified procedures, the plan to drop the use of invoices has been adopted mainly for political reasons, to help dispel opposition to the introduction of the new tax. As a result, the tax-credit method could not be chosen.

The account method has a lot of demerits as compared with the tax credit method. For instance, without the aid of invoices there is no means to ascertain the chain of transaction from one stage to another. Thus, it is very difficult to assess the value of the tax base accurately, because a strong incentive for cheating will remain. In addition, although export sales are zero-rated in accordance with the destination principle, the account method cannot properly exempt exports since a tax return of all prior-stage VAT payments cannot be exactly measured without invoices. If the tax-credit method is employed, the exporter can calculate a tax return based on his purchase invoices, and can get a cash refund of that accumulated from earlier stages from tax authorities. If we seek the normal VAT scheme in the Japanese tax system, the proposed form of *consumption tax* should be replaced by a tax-credited, invoiced VAT.

Third, one of the unique features of the *consumption tax* is its extremely low rate. In fact, the proposed 3 per cent standard tax rate is the lowest among major VAT countries, Luxemburg being second lowest with a rate of 12 per cent. Moreover the *consumption tax* merely has one single tax rate (plus a zero rate on exports), rather than the multiple-rate structure prevailing in other countries.

Such a low tax rate was adopted as a political compromise; the 3 per cent rate is lower than the 5 per cent *sales tax* proposed in the Nakasone tax reform, and was chosen so as to be accepted more readily by taxpayers. However, while it proved successful in achieving acceptance, it could cause other troubles. For instance, in theory, the VAT should be passed on to the ultimate consumers, but taxable traders may find it difficult to increase their prices by such a minor amount. There may be the possibility of a failure of forward shifting at each stage of transactions. In order to pass on the tax burden more fully, the *consumption tax* rate might be increased, say to 5 per cent initially and 10 per cent later. Of course, such tax increases should be combined with a substantial reduction of direct taxes. Alternatively, earmarked taxes might be linked to expanding social welfare programmes, although this would be difficult to justify in theory.

If the tax rate is to be increased, it would be good to consider a multiple-rate structure for the *consumption tax*. Certain kinds of multiple rates improve administrative performance and enhance compliance. A prompt shift from commodity-differing rates in the existing indirect tax system to a single low tax rate tends to cause some difficulties to taxpayers attempting to adjust to the new situation. Since many still think that the tax rate on food ought to be less than that on motor cars, a uniform 3 per cent rate is likely to be considered unfair because tax burdens on luxuries are greatly reduced from rates as high as 20 and

30 per cent. The multiple-rate structure would aid in the removal of such difficulties.

Lastly, attention should be paid to the special treatment of freeing smaller undertakings from the *consumption tax*. All VAT countries admit problems in applying the normal tax scheme to small traders because of their specific business structure or activities. Thus, some exemption system is usually devised to free certain taxpayers from VAT. Under the proposed tax plan, the *consumption tax* fixes the exemption level at ¥30 million in terms of annual sales, but this is extremely large by international standards. The larger the level of exemption, the more the economy is distorted. For instance, some firms may split themselves into two or three smaller operations in order to escape paying taxes on their sales. To enhance economic neutrality, the tax-exempt level of the *consumption tax* should be lowered greatly, say, less than ¥10 million.

It is apparent that the Japanese *consumption tax* departs from the standard type of VAT in several respects. In fact, it may be called an intermediate or imperfect form of VAT. Since the *consumption tax* rectified in such an incomplete form, further reform will necessary to achieve greater economic neutrality.

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