Policy vs. Rhetoric:
The Political Economy of Taxes and Redistribution In Japan

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Abstract

The past decade has seen a highly polarized debate concerning the Japanese fiscal system, particularly the role of the income tax. Several authors argue that the Japanese income tax is grossly unfair to low and middle-income taxpayers, while others depict it as the most progressive in the industrialized world. Indeed, many critics claim that it is too progressive, and some even denounce it as "socialist." What is sorely lacking is a less tendentious account that places contemporary Japanese taxation, and the larger fiscal system, in a comparative and historical context. That is what this paper offers. We argue that Japan's distinctive feature is neither highly redistributive income taxation from the rich to the poor nor vice-versa. Rather, Japan stands out for the scale of its interregional redistribution and the debilitating politico-economic incentives that stem from it.

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Introduction

"The public finances are one of the best starting points for an investigation of society, especially…of its political life." (Schumpeter: 1954, 7).

Japanese studies include an extensive literature dominated by sweeping culturalist generalizations and ideological agendas. Taxation, too, attracts considerable attention but rarely gets much nuanced analysis. Mix the two highly reactive issues of Japan and taxes together and the result, not surprisingly, is a dense fog of conflicting claims. Thus in recent years, the Japanese tax system has been depicted as a critical ingredient in the country's economic miracle, a prime culprit in her economic decline, a socialist experiment in redistribution, and a regressive conspiracy that taxes the worker while concentrating wealth at the top.[1]

This paper seeks to provide a more accurate account of Japan's taxes and their role in the overall fiscal system. We first review the most salient images of Japanese taxation and then point out where they are wrong. We offer instead a comparative analysis of Japanese taxation, bolstered with data drawn from the OECD and other widely respected sources. On the basis of this more accurate picture of Japanese taxation, we argue that its distinctive feature is not large-scale redistribution between income classes. Rather, Japan stands out for the scale of its interregional redistribution and the debilitating politico-economic incentives that stem from it. In light of this fact, our final

[1] See, for example, Kato and Yokoyama, 1996; Okue, 1998; Reynolds, 1998; Strom, 2000, as well as other sources discussed below.

section discusses Japan's contemporary fiscal challenges. These challenges include coping with an unprecedented rate of ageing, the sociopolitical fallout of globalization and economic transformation, and an increasingly precarious level of public debt.

The Japanese Tax System Reviewed: Evaluating the Rhetoric

Until recently, few outsiders paid much attention to the Japanese tax system. The scant information that was available in English often characterized the Japanese tax system as an important part of postwar Japan's high economic growth machine. According to this model, Japanese fiscal authorities imposed a minimal overall burden and extended a generous array of deductions and exemptions in order to promote private savings, discourage private consumption and promote export-oriented Japanese manufacturing operations. This "capital accumulation tax system" (Johnson: 1982, 232-36) centralized control over the most fertile tax fields and used them to foster particular kinds of private savings and investment. The low tax burden and massive array of tax preferences (Kaizuka and Pechman, 1976: 371) were commensurate with an economic policy focus that strongly favored growth over equity (Yamamura, 1967).

The Japanese system was therefore an even more activist version of the fiscal systems developed in several European states, where tax policy was intentionally used as an instrument of economic management (Backhaus, 2001; Hansen, 1969; Steinmo, 1993).[2]

[2] There is much controversy about whether Japan's tax expenditures (or for that matter, any country's tax expenditures) were actually effective in increasing investment and steering it in more productive directions than the market might have on its own. Contending positions can be found in Johnson, 1982: 232-36; Kaizuka and Pechman, 1974; Komiya, 1973; McDaniel and Surrey, 1985; Ogura and Yoshino, 1988; Steinmo, 1986; Surrey, 1970; Tachibanaki, 1997. This is not the place to resolve the issue.

But without the Europeans' strongly welfarist commitment, Japan's fiscal authorities were able to keep the country's overall tax burden well below that of other rich capitalist nations. Until the mid-1970s, in fact, Japan's tax burden was kept below 20 percent of GDP, or about one-third less than the average in the other OECD states (see Table 1 below). Foreign observers were therefore most often impressed with what Peter Drucker called the "Japanese exception." Drucker argued that Japanese taxation stood out because it was both activist and minimalist at the same time. In other words, Japan used taxes to promote growth but did not build a large fiscal regime and try to redistribute income (Drucker, 1993: 129).

Several Japanese economists as well as Leftist scholars and public intellectuals have agreed with the pro-growth/anti-redistribution assessment of the Japanese tax system. But the latter often condemn this system for its lack of progressivity. One representative work in fact depicted the Japanese income tax as "the most unfair in the world" due to the preferences that it accords capital gains, interest, and the other forms of income common to wealthy individuals (Sumi, 1992: 84; see also Kato, 1989). Such arguments had a powerful influence on the domestic tax debate, and continue to be offered by the Communist Party, a large number of radical tax analysts, and to some extent the federations of trade unions (*Keizai*, 2000; Taniyama, 1998: 183-6; Uchiyama, 1996; Zenshoren, 2000).

Over the past decade, however, an alternative view has gained remarkable strength among many foreign and domestic analysts of the Japanese tax system. According to

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Rather, the important point is that the policy focus resulted in a broad array of exemptions and deductions that significantly narrowed the personal and corporate income-tax base.

this view Japan's taxes are too redistributive and play a large role in her economic malaise. For example, in 1994 the *Far Eastern Economic Review* declared that Japan's tax policymakers have a "special animus for Japan's most enterprising and dynamic people" (*Far Eastern Economic Review*, 1994: 5-6). More recently, economist Reuven Brenner announced that "Japan's downfall started with an extraordinary increase of [capital gains] taxes on real estate and increases in many other taxes" (in Luskin, 2001). Other observers similarly insist that Japan "has a history of high tax rates and high public spending" (*International Tax Review*, 1998), a "punitive tax structure" (Strom, 2000), and is "hostile to capital" and "embraces the tax and spending policies of Continental Europe and Scandinavia" (Reynolds, 1998).

Important figures in the Japanese government and its advisory commissions appear to side with these claims. In February of 1999, for example, former Finance Minister Miyazawa Kiichi remarked to the House of Councillors Budget Committee that he has "long regarded the Japanese income tax as akin to that of a socialist country."[3] Hamada Koichi, the head of the Japanese cabinet's new economic research institute, promotes Reagan-style tax cuts (Nikkei, 2000). And during his decade-long tenure as chief of the influential Government Tax Advisory Commission (*seifu zeisei chousakai*), Chiba University president Kato Hiroshi repeatedly denounced Japan's "excessive" commitment to equality and progressivity in the income tax as well as the "socialist" bureaucrats who, he alleges, are responsible for it (Kato and Moroi, 1994; Kato and Yokoyama: 1996; Nikkei, 1999).

[3] The comment was made to House of Councillors Budget Committee on February 23, 1999, and can be accessed via the internet at the following web site for the minutes of the Japanese Diet (*Kokkaigiroku*): http://kokkai.ndl.go.jp.

What accounts for the recent emergence of remarkably polarized and politicized views of the structure of the Japanese tax system? We argue that three forces are at work simultaneously. First, as is true of tax systems elsewhere, Japan's has changed considerably in recent years. Its role in the country's political economy and society is more complex than it was three decades ago, and thus requires a comparative reassessment. Second, the increased criticism of the Japanese fiscal system is part and parcel of the more general neo-liberal critique of the 'Japanese Model.' It is clear that the decade-long economic crisis hitting Japan is encouraging policymakers, academics, policy activists, and business interests to re-evaluate the country's fiscal system along with many other aspects of the Japanese political economy (cf. Hirano, 2001; Keidanren, 1999; Okue, 1998).

A third force impinging on the Japanese tax debate is the public debt. The debt has doubled as a share of GDP over the past decade, leaving Japan with the highest debt load in the industrialized world. This enormous accumulation of debt will have to be paid down even as Japan's very rapid rate of ageing increases the pressure for expanded social services.[4] There is little doubt that tax increases will be necessary in the near future, possibly on the order of several percent of GDP (OECD, 1999a: 117). It remains to be seen, however, which income class will bear the brunt of these expected tax increases. This looming policy challenge adds greatly to the incentives of various interests, on both the Left and the Right, to deploy rhetoric towards political ends rather than careful analysis to clarify the choices confronting Japan.

[4] Japan's public debt has increased from 59.3 percent of GDP in FY 1992 to 118.6 percent in FY 2001 (OECD, 2000e), an unprecedented rate of expansion for a peacetime economy. There is considerable doubt that this debt can be brought under control without massive structural reform (Jinno and Kaneko, 2000), and recent analyses have warned of the potential for an "unsustainable spiral of debt" (OECD, 2000d: 5-6; see

It is in this context that we present the current analysis. In the pages that follow we examine the most current evidence and provide a general overview of the Japanese tax system. We submit that one cannot responsibly answer the pressing questions about who should bear any potential tax burden increases, without somewhat dispassionately examining the current tax burden. We will pay particular attention to the distribution of effective tax burdens across income classes, and the ways in which the system has been used as instrument of public policy in the Japanese political economy. We specifically examine these questions in comparative context based on our conviction that whether Japan is "too progressive" or "not enough" depends, at least in part, on what other countries are doing.

Japanese Taxes in Comparative Perspective

As we see in table 1, Japan has historically imposed low tax burdens relative to other advanced industrial countries. Table 1 also demonstrates that, compared to the OECD average, Japanese taxes increased by approximately 10 percent of GDP between 1965 and 1985. In the wake of that, the Japanese fiscal system has followed the general OECD pattern and experienced little growth as a share of the economy.

(Table 1 about here)

Japan's overall tax burden is relatively low, but not all of Japan's taxes are low. We see this in tables 2 and 3, where revenues from the same countries' major taxes are presented both as a share of total taxes and of GDP. Note, in particular, that Japan's

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also Asher and Dugger, 2000).

taxes on corporate profits have long been heavier than in most other OECD countries. Japan’s corporate income taxes peaked at 6.7 percent of GDP in 1990, well above the OECD average of 2.7 percent for the same year. And as the tables show, taxes on corporate profits in 1998 - a year in which Japan was in recession - amounted to 13.3 percent of total taxes and 3.8 percent of GDP. The social-security burden in Japan is also high, a characteristic it shares with the European states. But at the same time, Japan's taxes on personal income and consumption are relatively low revenue producers. Both of them consistently take in about half or less than the OECD average.

(Table 2 about here)

(Table 3 about here)

Are Japan's Corporate Taxes Unduly High?

Japan’s comparatively high taxes on profits would seem to confirm the laments about excessive taxation and redistribution. But these figures can be misleading: Profits have long occupied a very large share of the Japanese economy, so it is difficult to argue that Japan’s taxation of profits is higher *as a percent of profits* than elsewhere.[5] There are a host of other factors to consider in this regard as well, and this has made it difficult for experts - as opposed to the pundits - to reach a consensus on the issue. This was the conclusion, for example, in a recent review of the major studies that had been undertaken to determine whether Japan’s corporate tax burden is in fact high by

[5] See Jinno (1996) in this regard. One should also note that the class distributional effects of corporate profits taxes are far from clear at any rate. One can, of course, assume that profits taxes are effectively paid by the shareholders (and thus this is an economically redistributive tax instrument) (Pechman and Okner 1974). Alternatively one can assume that this tax is in fact shifted to workers and/or consumers. Given the history of this particular tax in Japan we would argue that this the later is the more

international standards (Takahashi: 1997).

Is Japan's Personal Income Tax Unfair to the Rich?

Critics of Japan's "excessive equality" argue that the burden of the personal income tax falls far too heavily on the rich and upper-income salaried classes, posing powerful disincentives to work and invest (Hirano, 2001:39-47). Thus the following table (Table 4) compares the official tax payments for 1998 by income class for a worker with two children and a non-working spouse, the benchmark taxpayer in comparative tax tables.

(Table 4 about here)

Table 4 show that the burden of Japan's income tax is relatively modest at the lower end of the middle-class income scale. Note, for example, that the Japanese worker earning ¥5 million (approx. US $45,000) paid about the same in income tax as an equivalently situated taxpayer in France and Germany, but substantially less than in the UK and the US. The table also shows that income taxes levied on Japan's high-income classes are generally lower than what their counterparts pay elsewhere.

Comparative statistics for lower-income taxpayers are presented in table 5. Here we see that Japanese taxpayers with incomes of between 67 to 167 percent of the average production wage (APW) pay considerably less tax than do taxpayers in the other major OECD states.

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logical assumption in the Japanese case, see Akaishi and Steinmo, forthcoming.

(Table 5 about here)

Both tables 4 and 5 suggest that in comparison to other rich democratic nations, Japan's personal income tax imposes a comparatively low burden on lower income classes and an average tax burden on upper income groups.[6] The question is whether we can thereby conclude that the tax system is too progressive, as Kato Hiroshi (Nikkei, 1999) and many others continue to argue (Hirano, 2001). Before drawing this kind of conclusion, we would need to look beyond formal or statutory rates and tax payments, and focus on *effective* tax burdens.

Comparative statistics on effective tax burdens are difficult to come by, due to the complexity of tax laws,[7] the volatility in exchange rates, and other reasons. But there are good reasons to believe that Japan's burdens on upper-income taxpayers are even lower than the official figures indicate. This is because much of their income is not from labor, but from capital and investments. Even though many of Japan's formerly very generous tax breaks were curtailed or eliminated in the 1970s and 1980s, income streams from interest, dividends, retirement, and capital gains are still taxed separately and at lower rates than income from labor. For example, Japan's top rate on interest income is 20 percent, versus 50 percent on ordinary income.[8] Such influences led a recent and

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[6] Though uneven tax burdens among occupational groups was major theme in debates over Japanese taxes during the 1980s, it has since declined in significance. The numbers of farmers, small-businesses and other favoured interests has declined and compensating exemptions for salaried workers were also successively increased. These and other changes have greatly reduced the significance of gaps in inter-occupational tax burdens (Dalgaard and Kawagoe, 2000: 21-2; Ishi, 2001: 70-1: OECD, 1999: 171-2).

[7]These issues are discussed in detail in OECD, 2000c.

[8] For more detail on the scale of the tax relief for upper-income individuals, see

extensive OECD study of the Japanese tax system to conclude that its high statutory progressivity (ie, the progressivity suggested by tax rates alone) is misleading. Though Japan's appears to be "by far the most progressive system of the major economies," it has "relatively low" effective progressivity when one examines what the various income classes actually pay after they have taken advantage of various exemptions, deductions and so forth (OECD, 1999a: 164-5).

This is also the conclusion of Ishi Hiromitsu, Japan's most highly regarded public finance economist and the new head – since mid-September of 2000 – of the Government Tax Advisory Commission. One of his books, *The Japanese Tax System*, is in its third edition and has become the standard reference work for policy analysts and others seeking detailed and comprehensive academic study of Japanese taxation. In this work, Ishi presents increasingly rigorous empirical studies to bolster his argument that the Japanese income tax does not stand out as a tool for redistributing from one income class to another: "in terms of effective, not statutory tax rates, the income tax system in Japan is only mildly progressive and therefore has little effect on the relative distribution of income" (2001, 161).

(Table 6 about here)

Moreover, the degree of inter-class redistribution throughout the entire Japanese tax system (ie, not just income taxes) has generally declined over the past two decades. Table 6 presents data from the Japanese Ministry of Health and Welfare's own income studies. The first column includes the ministry's calculations of the Gini index, which

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Dalsgaard and Kawagoe, 2000: 21-2, 25.

increases with increasing income inequality, and the second column includes the ministry's index for measuring the reduction in inequality via tax payments. The data suggest that income inequality in Japan has increased markedly from 1981 while redistribution through the tax system has generally declined. Thus the rhetoric about Japan's excessive redistribution has gained in volume even though the tax system has in fact become less redistributive.

Is Japanese Public Spending Progressive?

It is widely understood in the international fiscal policy community that it can be a mistake to examine the redistributive effects of the tax system alone. This is because redistribution takes place on both sides of the budget. Taxes *and* spending must therefore be viewed together to get a picture of the real redistributive effects of state policies.[9] Unfortunately, examining the sum total of all taxing and spending programs on the distribution of income and wealth in a large number of countries is a virtually impossible task. We can, however, refer to a variety of data that may help us get some purchase on the issue of whether Japan has a more redistributive spending pattern than other OECD nations.

On the expenditure side, the first item to note concerning Japan is that a comparatively

[9] We might also add that much of Japan's redistribution takes place through regulations rather than taxes and direct spending per se. Recent research has begun to recognize the significance of the "regulatory welfare state" (Tanzi, 2000) as an arm of the state's redistributive role in general. The scale of redistribution via regulations in Japan is clearly immense (Iwata, 2000), as Japan's food, shelter and other costs are among the highest in the world. For example, in 1998 the consumer transfer, per person, to agriculture in Japan has been estimated as US$577, whereas in the EU it was US$189, and in the United States, US$15 (Economist, 2000a: 9). Moreover, the burden of these "hidden taxes" (*mienai zei*) is very regressive. But this issue is beyond the scope of this

low share of the country's expenditures is absorbed via defense or personnel costs. This reflects Japan's comparatively lean government and longstanding commitment to keep defense spending below 1 percent of GDP. In 1997, only 7 percent of Japan's employment was in the public sector, versus 31.8 percent in France, 17.1 percent in Germany, 14.4 percent in the US and (in 1993) 19.5 percent in the UK (OECD, 2000d: 145). In addition, as is evident in table 7, Japan's burden of social security and social welfare transfers, though growing, remains at the residualist level of the United States and far below those of the European countries. In short, Japan is less redistributive through normal welfare-state channels than most comparable nations.

(Table 7 about here)

If we look directly at income transfer programs, Japan stands out even further. For example, the average OECD country spends 2.7 percent of GDP on various labor market programs. These include unemployment insurance, job retraining, and related programmes. The Japanese government spends only 0.5 percent of GDP on such programs.[10] The following table (table 8) aggregates a number of income transfer programs in several OECD countries.[11] While each of these programs can be quite small individually, the table shows that they can add up to considerable sums. Moreover, these are precisely the kinds of programs that are directed at the most economically vulnerable. Once again, we see that Japan falls substantially behind in these kinds of

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paper.

[10] The only other country to spend less that 1 per cent of GDP on these programs is the United States, see Tanzi, 2000: Table II:10.

[11] These programs include disability, sickness, maternity, early retirement, occupational injury and disease, family benefits, and a number of other contingency programs including social assistance; see Tanzi, 2000: 43.

direct transfers. Indeed, Japan’s poorly developed “social safety net” has given rise to a great deal of concern that it poses a strong disincentive to economic restructuring (Kaneko, 1999; Katz, 1998; Ostrom, 1997a).

(Table 8 about here)

Overall, Japan’s inter-class redistribution appears to be quite modest when compared to other major OECD countries. Studies of the effect of taxes as well as transfers on inequality show that in the mid-1990s the German fiscal system reduced inequality by 35.3 percent, the American by 24.5 percent, but the Japanese by only 22 percent (OECD: 1999a, 165).

In sum, the evidence suggests that by a variety of measures Japan's tax system does not appear unduly redistributive between income classes -- nor is the country noticeably redistributive on the expenditure side. From the vantage point of ‘class’ it seems that the Japanese system is certainly not as generous or redistributive as, say, its Swedish counterpart (Steinmo, 2000). But it also appears that it is not hugely different from other countries within the OECD in this regard. In short, the evidence at this point does not appear to support the arguments on either side of the tax reform debate concerning Japan. As we shall see, however, the key to understanding the Japanese fiscal system has much less to do with redistribution between classes and much more to do with centrally-dominated redistribution between regions of the country.

Redistribution Japanese Style: Region not Class

Of course, just as all modern states redistribute among income classes, they redistribute among their national and subnational (hereafter "local")[12] levels of government. We have already seen that the advanced countries' regimes of inter-class or interpersonal redistribution vary greatly both in their scale and content; but an even greater variation is found in the regimes of intergovernmental redistribution. Intergovernmental fiscal relations is thus an exceedingly complex area of fiscal studies that has generally been left to specialists.

Over the past two decades, however, the mechanisms of intergovernmental redistribution have become a focus of broader political and academic interest.[13] This is due, in particular, to the increased politicization of funding the public sector. There is mounting pressure to deliver services more efficiently and accountably in order to control costs and better match the provision of services to the diversifying needs of local communities. One consequence of these trends is a massively expanding comparative literature on intergovernmental fiscal relations (Castles, 1999; Martinez-Vazquez and McNab, 2001; Oates, 1999).

This literature is giving us an increasingly detailed and comparative view of Japan's intergovernmental fiscal relations. In what follows, we shall show that the Japanese intergovernmental system is highly centralized in fiscal terms but less so in its political aspect. Japan's high fiscal centralization and relative political decentralization is significant because it creates a massive gap between the regional allocation of tax burdens and decisions over how to spend the revenues. This problem is magnified by

[12] In Japanese usage, for example, the "local authorities" (*chihou jichitai*) generally refers to both the prefectural and municipal levels of government.
[13] The OECD's new series of Tax Policy Studies on inter-governmental fiscal relations reflects this massive expansion of interest: "In many OECD countries, problems of multi-level government finance feature prominently in the political debate" (OECD, 1999b: 3).

the Japanese intergovernmental fiscal regime's heavy focus on public works.

In simple terms, the basis for interregional redistribution per se arises from the phenomenon of "vertical fiscal imbalance." The imbalance occurs because local governments generally spend more money on goods and services than they raise in taxes and other forms of revenue (eg., debt and user charges). In turn, the national level of government collects revenues in excess of its own direct spending and redistributes a portion to the local administrations. The national government's transfer of funds to the local governments thus seeks to support the latter's burden of spending. This redistribution also often involves efforts to ameliorate the per-capita income differentials, or "horizontal fiscal imbalance," among the local governments. Compared to their federal counterparts, unitary states tend to be more aggressive in equalizing inter-governmental differences in income (DETR, 1999).

A more concrete picture of inter-regional redistribution and how it varies among the major OECD states is available in the following two figures (Figures 1 and 2). Figure 1 compares local government expenditures using data for FY 1998, the most recent year of comprehensive comparative statistics. The data show that the expenditures of Japan's local governments, when measured as a percentage of total public expenditures (exclusive of interest and social security payments), are very high for a unitary state. Japan has a higher level of local expenditures than the US, a little less than Germany (both federal systems), and stands out in particular from the other unitary states, France and the UK.

(Figure 1 about here)

The federal regimes tend to provide ample room for their local governments to finance their own expenditures. This keeps the vertical fiscal imbalance at a relatively low level. The unitary systems, on the other hand, grant less fiscal autonomy to local governments and rely on large "fiscal transfers" (through various subsidies) to fill in the gap between local spending and tax revenues (OECD, 1997).

Figure 2 gives a clear picture of this by presenting the same countries' local expenditure burdens and fiscal transfers as a percent of GDP. In the column for "local expenditures," we see that Japan's local governments spend far more, in absolute terms, than those in the other unitary states and even more than the federal regimes. The column labeled "fiscal transfer" then measures, again in percent of GDP, the volume of funds that flow from the national level of government to the local administrations in order to support this spending. Japan has a relatively high rate of local tax collection, and hence the size of its fiscal transfer is not as large as is the case in the UK, where local governments collect an extremely low level of taxes. However, in comparative terms, Japan's local governments are clearly quite dependent on transfers from the central government. The Japanese intergovernmental system can thus be described as fiscally centralized.[14]

(Figure 2 about here)

Japan's high rate of fiscal transfer represents an enormous volume of funds. In FY 2000,

[14] Japan is even more fiscally centralized than these data suggest, as the central government controls local taxes as well as local debt issuance (Jinno, 1999; Boadway, et al., 2000: 28-30). But the precise, comparative degree of Japan's centralization has long been a highly contentious issue (Reed, 1982), and is beyond the scope of this paper. It is sufficient for our purposes here to show that Japan's intergovernmental fiscal

the transfers amounted to ¥34.4 trillion (US$313 billion). The general budget in the same fiscal year totaled about ¥85 trillion (Takeuchi, 2000: 119). In gross fiscal terms then, Japan's central government is largely a conduit for revenues that flow from taxpayers to local administrations.

For our purposes here, the most significant aspect of Japan's intergovernmental transfers is the high level of redistribution they achieve. This is due both to the means through which the central government raises revenues for the transfers as well as the mechanisms via which it distributes them. As to the former, note that a disproportionate share of the taxes that fund Japan's intergovernmental transfers is raised from urban areas. In 1998, the most recent year of comprehensive statistics, the central government collected a total of ¥52.34 trillion in taxes from all sources and regions. But the take from incomes, assets, and consumption in greater Tokyo and Osaka, Japan's two largest, most urbanized, and richest prefectures, was particularly striking. These two areas have a combined population of 20.1 million people, or about 16 percent of Japan's total population of 126 million. Personal and corporate income taxes collected by the national government in 1998 in Tokyo totaled ¥10.88 trillion and in Osaka ¥3.27 trillion, for a combined sum of ¥14.15 trillion. Nationwide, the national government collected ¥30.61 trillion in personal and corporate income taxes. This means that nearly half of Japan's key national taxes were collected in these two urban centres, though they account for only one-sixth of the country's entire population. Also, out of total national-level taxes of ¥52.34 trillion in 1998, Tokyo residents paid ¥16.37 trillion while their counterparts in Osaka paid ¥5.36 trillion. In other words, workers and businesses in these two centres paid 42 percent of all national taxes.

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system is highly centralized.

Inequity in Japanese Interregional Redistribution

We have seen that Japan's urban taxpayers pay the bulk of national taxes and that a large share of these taxes is redistributed, as various kinds of subsidies, to local governments. Because Japan's intergovernmental fiscal system is an explicitly redistributive system, the urban areas naturally receive less from central coffers than they pay into them. The purpose of the redistributive subsidies from the center is to support a standard level of public services and provision of infrastructure throughout the country. The subsidies allow local governments in regions with below-average per-capita incomes to provide a "national minimum" of services and infrastructure without having to raise their local tax rates to onerous levels (Boadway, et al., 2000: 41-2). In other words, the subsidies do not simply compensate for the vertical fiscal imbalance between the national and local governments; they are also designed to reduce the effects inter-regional differences in income.

(Table 9 about here)

However, an increasingly forceful critique argues that Japan's scheme has come to overcompensate for the differences among the local governments' fiscal capacity, or "ability to pay" (Boadway, et al. 2000; OECD, 2000; Tokyo Tax Commission, 2000). We see evidence of this overcompensation in Table 9, which shows per capita national and local tax burdens, plus the amount of subsidies received, for Japan's five most-taxed and five least-taxed prefectures in 1998. The national average is also included at the bottom of the table for comparison. The column labelled "National" under the heading "Tax Burden," records the central government's per-capita tax collection from the five richest urban prefectures versus their five most fiscally dependent rural counterparts. The column labelled "Local" shows the per capita amount of local taxes. These two amounts of tax are then totalled in the third column.

The second section of the table, grouped under the heading "Revenues," then shows the redistributive effect of the central government's subsidies on these prefectures' revenues. The column marked "Subsidies" aggregates the specific and general subsidies received by each of the prefectures. It clearly demonstrates that the rural areas receive sums that are well over triple their local tax effort and, in the case of Shimane Prefecture, quadruple what they pay in national taxes. By contrast, Tokyo receives, in subsidies, only 6.2 percent of what it pays in national taxes.

As Japan's is a deliberately redistributive system, merely comparing the volume of subsidies received versus the volume of national taxes paid is as misleading and inflammatory as much of the rhetoric concerning interpersonal redistribution via the income tax. A large provision of subsidies to the rural prefectures is suggestive of excess, but it is not sufficient evidence to indict the system. This is particularly true because much of the assistance from Japan's central state is allocated on the basis of extremely complex formulae that investigate local conditions in extraordinary detail. The calculations include not merely population characteristics, such as the number of schoolchildren and elderly, but also the length of roadways, particularly adverse weather conditions, and other factors. The distribution of subsidies is therefore skewed towards those areas that confront both limited fiscal capacity as well as high costs due to a large proportion of elderly, a widely dispersed population, and so forth (Ma, 1997:

21-33; Mochida, 2001).

Due consideration therefore has to be given to variations in prefectures' fiscal capacity, as is traditionally done when analysing inter-class differentials in the burdens imposed by the personal income tax. We would expect prefectural variations in per-capita national tax burdens to be wide because of the rich concentration of assets and high incomes in the wealthier regions, especially Tokyo,[15] and because the national taxes centre on income taxes whose burden increases progressively with income. Including the per capita local tax burden ("L. Tax") in the calculation of taxes paid and revenues received gives us a more balanced picture of what the individual prefectures and their respective taxpayers get out of the system.

Hence, by comparing the respective totals of tax burdens and revenues, as shown in columns A and B, we can see that the system exercises a powerful redistributive effect. The weaker prefectures receive, in per capita terms, far more money than even Tokyo raises from its local taxes. To quantify this effect, the third section of the table (labelled "Rate of Return") shows the ratio of subsidies received and local taxes paid to national and local taxes paid, per prefecture as well as on the average. The average for all 47 of Japan's prefectures is 0.789. This figure is less than unity, of course, because a significant share of the costs of the centre's non-redistributive spending (such as on national defence) comes out of national taxes imposed in the prefectures. The results in this column show that the five prefectures with the least fiscal capacity get a very good return indeed from the system, with Shimane Prefecture's ratio of 2.326 being almost triple the average ratio of return.

[15] Per capita income from employment in Tokyo is 7.3 million yen versus 4.5 million

The Construction State

We can greatly amplify this point about excessive redistribution by looking at the expenditure regime, as we did with interpersonal redistribution. We recall from data presented earlier that Japan’s local governments do just under 80 percent of all public-sector spending and that a comparatively low level of this spending is on direct services to individuals. As we see in table 10, much of the spending is in fact done on public works. The table presents data for government fixed capital formation (ie, public works) in 1998, and shows us that the Japanese public sector vastly outspent among the major OECD states.[16] Just as striking is the percentage of local spending devoted to such projects. The table shows that Japan's local governments concentrate 34.6 percent of their spending on public works, a figure that is again far higher than in the other major OECD states.

(Table 10 about here)

Table 11 gives us more detail on the problem. It presents the per-capita distribution of public works by prefecture, using the same prefectures in table 9. The data are for FY 1997, the most recent year for comprehensive statistics. This is a year previous to the tax burden and subsidy figures displayed in table 9. But the figures are consistent and give a striking account of the inequitable interregional distribution of public works

yen in rural Shimane (Tokyo Tax Commission: 2000b: 9).

[16] Japan’s figures are elevated by the effect of large supplementary public works projects to stimulate the economy during the 1990s, but OECD data show that Japan’s spending on public works has exceeded 5 percent of GDP for virtually all of the past 30 years (Numekata, 2001, Figure I-6).

expenditures.

(Table 11 about here)

This evidence lends strong support to the common assertion that Japan wastes significant sums of public money on unnecessary infrastructure, particularly in the rural areas.[17] The system for heavy investment in infrastructure has been dubbed the "public works state" (*doboku kokka*), or "construction state" (*kensetsu kokka*), by many Japanese and foreign analysts (Noguchi, 1995; Sakakibara, 1998). It is not a recent phenomenon. The use of infrastructure spending to prop up employment and stabilize the position of the old middle class in rural areas is rooted in the prewar years (Jinno, 1999; Kase, 1998; Kazahaya, 1937). Well over three decades ago Japan stood out from the other industrialized societies in its consistently high rate of public investment (Sato, 1966: 68). Since then, the gap between Japan and the other industrialized states has become even more striking, as levels of public investment have declined in the latter (Namekata, 2001).

At the same time, the character of Japan's public works projects has failed to keep pace with changing needs. In previous decades, expenditures on high-volume transportation networks and other infrastructures increased the efficiency of the economy, spurred growth, and sopped up excess labour during economic downturns. But the efficiency and effectiveness of Japan's public investment have declined greatly over the past two decades (Choy, 1998). It would thus have been wise, many argue, to shift the focus of

[17] Japan's wasteful public works are a staple of political research on the country. For example, see Woodall, 1996.

projects towards urban areas and information technology, in order to bolster Japan's competitiveness in a globalizing economy (Tokyo Tax Commission, 2001). Yet the politicians, bureaucrats and private interests who reap electoral and other benefits from the expenditures have maintained a strong bias towards the rural areas and projects that consume vast quantities of cement and steel (McCormack, 1996; Mertens and Jameson, 1999).[18] Thus, the FY 2001 budget commits the central government to subsidizing the construction of wasteful bullet train lines in rural areas, while neglecting Tokyo's pressing need for upgraded roadways (Tokyo Tax Commission, 2000: 13).

"Vertical Dominance"?

The old "vertical dominance" model of Japanese intergovernmental relations (cf. Steiner, 1965) would explain the construction state as a consequence of fiscal and administrative centralization. In this model, the central government makes the decisions and the local authorities dutifully implement them, constrained by a tight leash of fiscal and administrative controls. Yet over the past two decades, a revisionist view has argued, quite persuasively, that Japan's local governments have far more administrative autonomy than the old orthodoxy allowed (Muramatsu, 2001; Reed, 1986).

This revisionist work's emphasis on the considerable scope of local political and administrative choices has not, however, been adequately tempered with an analysis of the incentives embedded in the fiscal system. Fiscal centralization, in any country,

[18] As of this writing, the reormists around Prime Minister Koizumi Junichiro (who took office in late April of 2001) appears determined to reform much of the intergovernmental fiscal system along with the economy in general. But their capacity to do so remains questionable due to enormous opposition from vested interests, including many in the LDP (Economist, 2001).

allows the central government broad leeway to set the framework of fiscal policy and thus shape the tax and expenditure policies of the local authorities. This fiscal policy framework aids central spending ministries and their allied politicians in pursuing their organizational and electoral incentives.

In the Japanese case, the centre's fiscal influence on the locals is indeed powerful (Pascha and Robachick, 2001). The centre defines most of the local tax base and debt flotation. It also extends an array of specific and general subsidies that often work together with the rules governing local debt to frame local spending decisions (Ikegami, 1998). In some areas, such as road-building and the construction of facilities, over half the costs of local projects are borne by the centre. The net effect is that the centre can "lead" (*yuudou*) the expenditures of dependent local governments (Kaneko, 2001). Moreover, Japanese fiscal policy in the latter 1990s emphasized increasingly large fiscal stimulus packages that amplified these features of fiscal centralization.[19]

But the centre's incentives to spend on public works have a powerful reflection at the dependent local level. This is in part because fiscally dependent local governments tend themselves to represent the farmers, construction workers and contractors that directly benefit from public works spending (Mulgan, 1998). A related reason is found if we look at the obverse aspect of fiscal centralization. The central government can lead expenditures because the dependent recipients of porkbarrel subsidies bear only a fraction of the tax burden that pays for them. Indeed, in many project areas, the more public works that the locals initiate the more subsidies they receive (Ogura, 1995; Hirano, 2001: 51-8). Viewed from the vantage point of a dependent local government,

[19] On Japanese fiscal policy in the 1990s, see Katz, 2001.

the constraints of fiscal centralization appear more than balanced by its benefits.

Hence, local political and administrative clout dovetail with the incentives of spending agencies and political cliques in the central government. And all of these are channelled within the structure of fiscal centralization that funds the construction state. This debilitating interaction of incentives and finances explains, for example, why many local governments often determine their public works projects less on the basis of local needs and more with an eye to maximizing the receipt of subsidies from the central state.[20] The upshot, in fiscal terms, is that Japan's urban taxpayers are exploited by a coalition of rural politicians and voters, central agencies, and ruling-party politicians in the national government (DeWit, 2001; Fukui and Fukai, 1996).

Conclusion: Japanese Fiscal Policy Looking Toward the New Century

We have seen that the current tax debate in Japan largely defines the redistribution problem in terms of redistribution between income classes. We have argued in this paper that there is little empirical basis to the claim that the Japanese income tax (and the tax system generally) is unduly redistributive between income classes. On the contrary, we have shown that Japan's real redistribution problem, so far as taxes and expenditures go, is between the regions and particularly on public works. That public works and interregional redistribution play a powerful role in Japanese politics is not a novel observation. Many scholars have made this claim, but these issues rarely enter

[20] Some local governments even compile detailed guides based on the central government's menu of project financing options. They then determine their spending on local projects according to which type will maximize the amount of subsidies for a given share of local spending (December 2000 interview with an anonymous official in the Shimonoseki City office).

into the debate over equity and the tax burden. Instead, as we have seen, the tax debate has been notable for an abundance of rhetoric at the expense of clarity concerning the overall relationships between the various redistributive arms of the fiscal state.

The piecemeal character of the debate over reforming Japan’s tax system is particularly evident in the current focus on Japan’s comparatively low tax burden on the average wage. As we have seen, the Japanese income tax exempts about 10 to 20 percent of low-income workers and imposes minimal burdens on many of the rest. In contemporary Japan's tax debate, this problem is analyzed apart from the broader context that includes the redistributive effects of spending. The low income-tax burden on the lower- and middle-income classes has thus become a focus of intensely critical comment from major figures in Japanese academe, the media, politics, and so forth. These critics argue that exempting a large slice of wage earners from paying income taxes imperils Japanese democracy. They reason that those who pay little or no income tax have a correspondingly minimal stake in politics (Sakurai, 2000).

But this is specious logic. Lower-income earners already pay a substantial burden through other taxes as well as the high cost of regulations. Moreover, political participation does not vary according to whether individuals pay income taxes or not. All income tax systems exempt the lower-income classes to some degree, as applying income taxes to non-discretionary income is regarded as exceedingly unfair and injurious to public welfare. But tax policymakers rarely, if ever, worry that exempted individuals will lose their incentives to vote or otherwise participate in politics. In addition, Japan’s low income-tax burden on the middle and lower-income classes stems in large part from personal deductions and exemptions that were extended in lieu of welfare-state spending on a large share of the costs for education, health care, and the like (OECD, 1999a: 171-2). Talk of increasing taxes on these individuals should also address the issue of what services they ought to receive in return.

In other words, Japan needs a comprehensive debate on redistribution, rather than another round of rhetoric concerning the relative burdens borne by the various income classes. Japan confronts, as we noted in our introduction, enormous challenges through rapid aging, low growth prospects, and the mounting burden of public debt. The structure of the redistributive fiscal system that we have outlined makes it unwise simply to raise taxes, whether on the lower middle class (via raising the minimum income-tax tax threshold or hiking the consumption tax) or even on the wealthy (by higher income tax rates or the strengthened taxation of assets). Increased taxes will not resolve Japan's enormous problem of misallocation through the intergovernmental fiscal system. And piecemeal reform risks continuation of the moral hazard problem, as it fails to cut through the fiscal structure that encourages waste. This structure has so deepened distrust in the state's capacity to use revenues efficiently and equitably that any tax increase is likely to invite a backlash (Jinno and Kaneko, 2000: 107-8).

Rather than simply shift the tax burden onto lower-income earners, or any other class, the real challenge for Japan is to decentralize the tax state and thus reduce the scale of redistribution via fiscal transfers from the central government.[21] A more clear allocation of choices and burdens in the intergovernmental dimension is required. Having to pay a

[21] The need for fiscal decentralization in Japan has been obvious for some time (Jinno, 1999; Kaneko, 1998; OECD, 2000d: 17). But serious debate on how to envision such a policy change has only just begun within the advisory commissions of the central

larger share of the costs for public works would almost certainly dampen local interests' enthusiasm for wasteful spending. This reform would go a long way towards fixing Japan's increasingly fractious fiscal politics, as the comparative record shows that the more taxpayers perceive that they are getting value for their money, the less they grumble about their tax burden (Steinmo, 1993).

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government (see, e.g., Decentralization Promotion Committee, 2001).

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Tables and Figures:

Table 1
Total Tax Revenue as Percent of GDP, 1965-98

Year	1965	1975	1985	1990	1995	1998
Japan	**18.3**	**20.9**	**27.6**	**30.9**	**28.4**	**28.4**
France	34.5	36.9	43.6	43.0	44.0	45.2
Germany	31.6	36.0	32.9	32.6	38.2	37.0
Sweden	35.0	43.4	48.3	53.7	47.6	52.0
UK	30.4	35.4	37.7	36.0	35.2	37.2
US	25.0	26.9	26.1	26.7	27.6	28.9
OECD Avg.	**25.4**	**31.1**	**33.8**	**35.0**	**36.1**	**37.0**
Source: OECD, 2000.						

Table 2,
Revenues from Major Taxes as Percent of Total Taxation, 1998

	Income	Profits	Soc. Sec.	Property	Goods &Services
Japan	18.8	13.3	38.4	10.5	18.8
France	17.4	5.9	36.2	7.3	26.6
Germany	25.0	4.4	40.4	2.4	27.4
UK	27.5	11.0	17.6	10.7	32.6
USA	40.5	9.0	23.7	10.6	16.2
OECD avg.	27.1	8.9	24.7	5.4	31.3
Source: OECD Revenue Statistics, 1965-1999					

Table 3,
Revenues From Major Taxes as Percent of GDP, 1998

	Income	**Profits**	**Soc. Sec.**	**Property**	**Goods &Services**
Japan	5.3	3.8	10.9	3.0	5.3
France	7.8	2.7	16.4	3.3	12.0
Germany	9.3	1.6	14.9	0.9	10.1
UK	10.2	4.1	6.5	4.0	12.1
USA	11.7	2.6	6.9	3.1	4.7
OECD avg.	10.3	3.3	9.4	1.9	11.3
Source: OECD Revenue Statistics, 1965-1999					

Table 4
Personal Income Tax Payments by Income Class, 1999

	Income Class (units: ¥10,000)					
	500	**700**	**1000**	**3000**	**4000**	**5000**
Japan	11.5	32	86	890	1,365	1,840
France	24.5	54	123	1,055	1,558	2,060
Germany	53.2	125	250	1,268	1,780	2,291
UK	91.8	168	288	1,088	1,488	1,888
USA	54.0	97	202	1,011	1,464	1,913

Note: The data reflect tax payments for a worker with 2 children and a non-working spouse.
Source: Ministry of Finance, Japan http://www.mof.go.jp/jouhou/syuzei/siryou/028.htm

Table 5
Income Tax, by Family Type and Wage Level (as % of Gross Wages), 1998

	Single, no ch	**Single, no ch,**	**Married, 2 ch,**	**Married, 2 ch,**	**Married, no ch,**
Wage Level (% of APW)	67	167	100	167	133
Japan	4.8	11.8	0.7	4.3	5.2
France	9.7	18.9	7.6	9.9	10.5
Germany	15.4	28.3	1.3	13.2	15.4
UK	13.6	19.2	15.1	14.5	12.7
USA	16.0	24.1	10.2	15.5	16.6

Note: ch=children; APW is Average Production Wage; Column 3 refers to a single-earner household, whereas in columns 4 and 5 both spouses work, one earning 100 of the APW while the other earns 67 and 33 percent respectively of the APW. Source: OECD, 2000b, Table 2, p. 45.

Table 6
Income Redistribution via Taxes in Japan, 1984-1996

Year	**Gini Index**	**Redistribution Via Taxes**
1981	0.3301	5.4
1984	0.3824	3.8
1987	0.3879	4.2
1990	0.4207	2.9
1993	0.4255	3.2
1996	0.4338	1.7

Source: Ministry of Health and Welfare, Japan (2000)

Table 7
Public Sector Social Spending as a Percent of National Income

	Health	Pensions	Welfare/others	Total
Japan (1997)	6.5	9.3	2.0	17.8
France (1993)	9.2	18.4	10.2	37.7
Germany (1993)	8.7	14.3	10.3	33.3
UK (1993)	7.3	10.8	9.1	27.2
USA (1992)	6.8	8.4	3.5	18.7

Source: *Keizai* (2000), fig 2, p. 52.

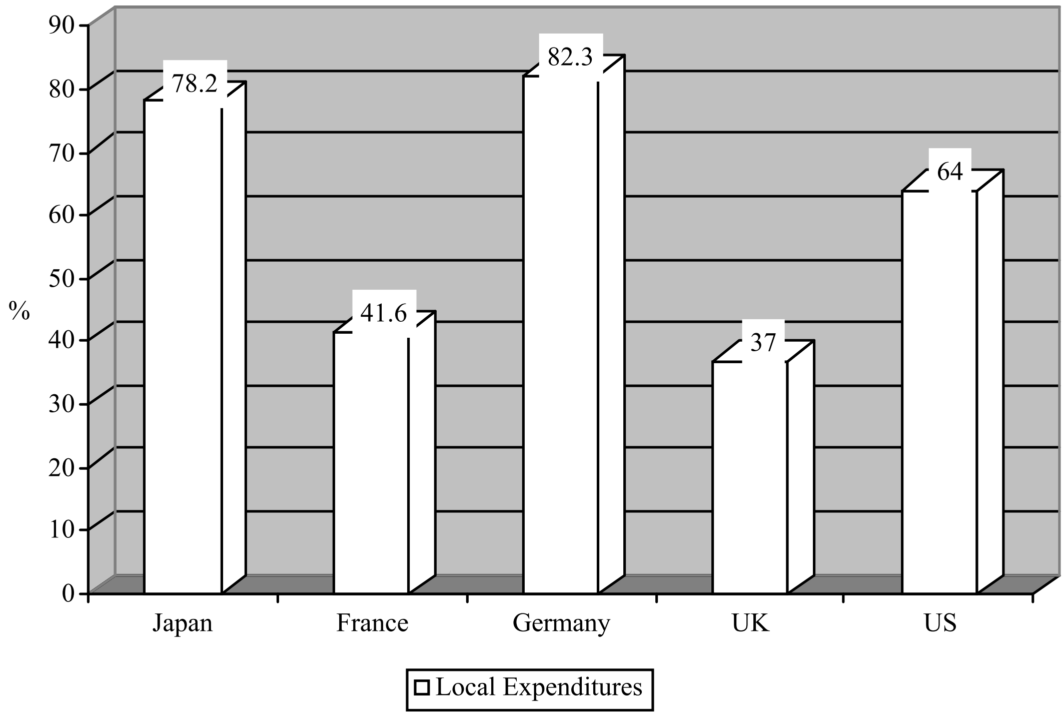
Table 8

Public Expenditure on Wage-Related Income-Transfer Programs, 1992 (Percent GDP)

Japan	0.91
France	5.39
Germany	6.31
UK	7.84
US	2.64

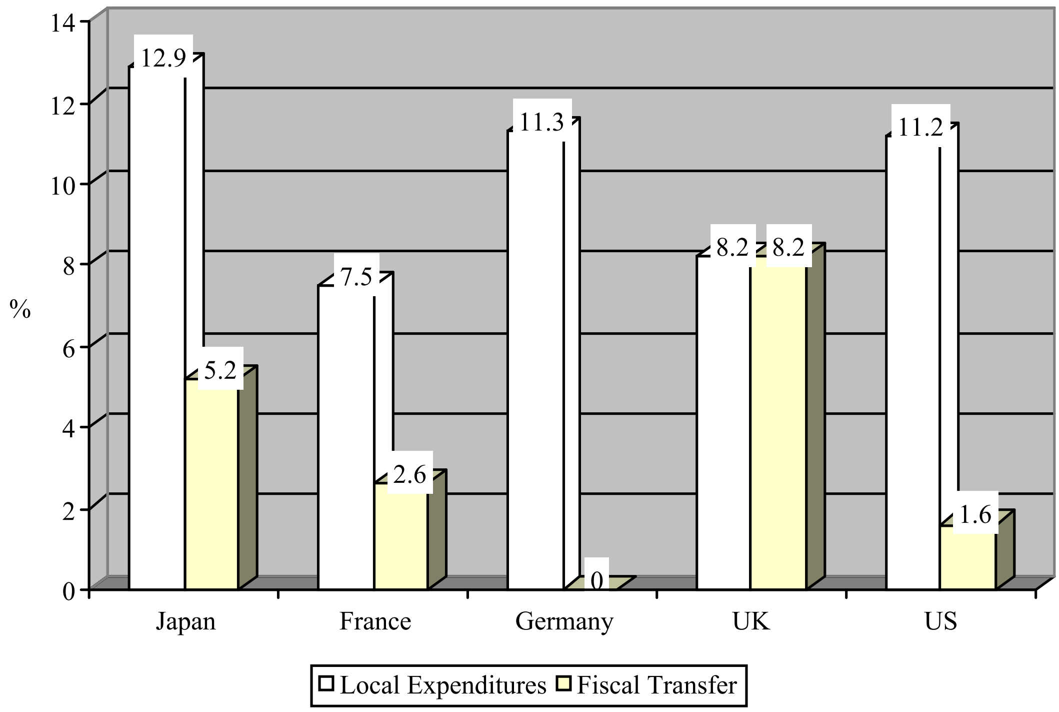
Source: Tanzi, 2000, Table II. 11, Unemployment payments excluded.

Figure 1,
Local Expenditures as a Percent of General Government Expenditures, 1998



Note: "Local Expenditures" are stated as a percent of general government non-interest expenditures on goods and services. "Local Tax Revenues" are calculated as a percent of general government tax revenues. Source: OECD, 2000d: Figure 32, p. 143.

Figure 2,
Local Expenditures and Fiscal Transfer as Percent of GDP, 1998



Note: "Local Expenditures" are government expenditures on goods and services and investment. The fiscal transfer is the net volume of revenues transferred from the national government to local administrations. Source: OECD, 2000d: Figure 32: 143.

Table 9, Prefectures' Per Capita Tax Burdens, Receipt of Subsidies, and Effective Rate of Return in 1998 (Units: ¥1000).

Prefecture	**Tax Burden**			**Revenues**			**Rate of Return**
	National	Local	Total(A)	L. Tax	Subsidies	Total(B)	B/A
Tokyo	1,410	533	1,943	533	87	628	0.323
Osaka	625	341	966	341	130	474	0.491
Aichi	515	351	866	351	45	460	0.531
Kanagawa	369	313	682	313	93	408	0.598
Chiba	274	267	541	267	133	404	0.747
Okinawa	199	145	344	145	560	709	2.061
Nagasaki	165	177	342	177	526	708	2.070
Kagoshima	172	175	347	176	653	737	2.124
Koichi	202	186	388	185	765	857	2.209
Shimane	197	211	408	211	729	949	2.326
National Average	**416**	**286**	**702**	**286**	**263**	**554**	**0.789**

Source: adapted from Tokyo Tax Commission, 2000, Reference Section, p. 18
Note: minor revenue sources are excluded, and hence the sum of local taxes and subsidies is slightly less than the total in B.

Table 10,
Government Fixed Capital Formation ("FCF"), 1998; Units: Per cent

	General Government FCF/GDP	Local FCF/Local Expenditures
Japan	**6.2 (1998)**	**34.6 (1997)**
France	2.8 (1997)	23.5 (1997)
Germany	2.0 (1997)	19.1 (1997)
UK	1.2 (1998)	7.1 (1997)
USA	1.9 (1997)	12.1 (1997)

Note: Local governments include regional and municipal governments..
Source: Column 1, Ministry of Finance, 2001; Column 2, General Affairs Ministry, 2001: 39.

Table 11,
Per Capita Public Works, By Prefecture, 1997 (Units: ¥1000).

Prefecture	Per Capita Public Works
Tokyo	325
Osaka	272
Aichi	276
Kanagawa	273
Chiba	245
Okinawa	439
Nagasaki	445
Kagoshima	455
Koichi	598
Shimane	691
National Average	**363**
Source: Gyousei Toushi, 1999: 26	