

Economic studies of taxation in Japan: The case of personal income taxes[☆]

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Abstract

We argue that tax policy in Japan is on a shaky empirical ground. First, until recently, no serious attempts had been made to estimate labour responses to taxation, especially with respect to prime-age male workers. Second, while there is some stock of empirical analysis on labour supply response of female workers, few studies have appropriately allowed for the budget constraint structure implied by the tax system. Third, as a corollary, there is not a reliable stock of empirical estimates to quantify the frequently employed concepts of “disincentives to work” or “distortion.” Given this state of the literature, we introduce our estimates, and calculate the degree of distortion using the concept of the marginal cost of public funds.

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1. Introduction

Tax reform involves winners and losers, and as such, frequently faces difficult political obstacles in democracy. However, sound reasoning and constructive dialogues should help making a progress toward better reform and economic policy. Economic theory seems to have contributed to policy dialogue concerning the reform of the Japanese tax system. For example, in the report submitted to the Prime Minister, the [Tax Commission \(2002\)](#) lists “five viewpoints for establishment of a desirable tax system” as follows:

- Taxation should not distort free economic activities.

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- Tax treatments that cause distortion and a sense of inequity in the tax system should be rationalized.
- Tax system should be simple and easily understandable for taxpayers.
- Tax system should provide stable revenue structure.
- Local taxation should meet needs of enhanced local autonomy.

With the word of “distortion” as a prime example, economic thinking is apparent in the statements above. In fact, the Japanese government has made flatter its personal income tax system in a series of tax reform. For example, the system of national personal income tax had 19 brackets with the top marginal tax rate of 0.75 in 1975.¹ After a series of tax “reforms,” the tax system is simplified. The number of brackets is reduced to as few as four, and the marginal tax rate of the top bracket is reduced to as low as 0.37. The detail of the tax system over time is provided in [Table 1](#). The key words for the series of tax reduction included “incentives to work” and “neutrality (no distortion)”.² As these phrases indicate, modern economic thoughts played a force.

Sound economic policy requires a proper understanding of economic theory as well as a rich stock of empirical analysis. One of the purposes of this paper is to examine if such condition holds for the case of Japanese personal income taxation. In other words, we will examine if policy debates concerning income tax reform in Japan were based on evidence substantiated by solid empirical studies on the Japanese economy. An easy way to do that is to survey what Japanese economists provided in the relevant areas of economic studies, which we will do in what follows.

We argue in this paper that the tax studies in Japan are characterized as follows. First, until recently, no serious attempts had been made to estimate labour responses to taxation, especially with respect to prime-age male workers. Second, while there is some stock of empirical analysis on female labour supply, no studies, except the recent study by [Akabayashi \(2003\)](#), have appropriately allowed for the budget constraint structure implied by the Japanese income tax system. Third, as a corollary of the first two, there is not a large and reliable stock of empirical estimates to quantify the frequently employed concepts of “disincentives to work” or “distortion.” This makes tax simulation studies in Japan necessarily rely on arbitrary values of labour response elasticities and other relevant parameters. We will therefore, claim that tax policy in Japan is on a rather shaky ground.

We further speculate that this would be due to a unique separation of labour economists and public economists in Japan. While many labour economists do not seriously consider how taxes affect the behaviour of consumers through changes in their budget constraints³, many public economists tend to believe that labour is responsive to taxes without confirming empirical evidence. Another contributing factor to this sad state of the art is a lack of reliable micro-data base. The central government does conduct large scale surveys regularly, but obtaining the permission to use original micro data set is difficult, if not possible, unless a researcher has a strong tie with the central government bureaucracy.⁴ Independently surveyed data sets are growing. But the size and scope of the data base might not be good enough to obtain reliable results.

¹ Note that this excludes local income taxes that shares the same personal income as a base, which made the effective top marginal tax rates hike up to 0.89.

² Another catch copy is “the vitalization of the economy”.

³ An exception would be [Akabayashi \(2003\)](#), who has also utilized the Hausman method we use in this paper.

⁴ Even if we do, obtaining the data requires cumbersome procedures and screening, as we actually did experience.

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