

THE VALUE-ADDED TAX IN JAPAN

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I. *The Shoup Mission and Tax Reform*

Tax reform in Japan this year is based on the *Report on Japanese Taxation by the Shoup Mission*, Tokyo, 1949, which affords an invaluable study on national and local taxation, and abounds with interesting suggestions. We cannot but feel deeply grateful to Prof. Shoup for the great labour and effort exerted by him and his distinguished colleagues in their investigations and compilation of this most comprehensive report. As is usual, however, on such occasions, many discussions have developed, and criticism levelled at the Shoup Report as well as the tax reform bill drafted by the Japanese Government, in political, industrial and academic circles since the Report was first made public. I have also expressed my own personal views on several occasions, in articles contributed to newspapers and magazines, in lectures and in other ways. Among such discourses, my testimony at the three following Committee hearings gives, I think, a comprehensive idea of my views on the whole sphere of tax reform at issue, namely: (1) the Budget Committee, House of Representatives, on the Supplementary Budget Bill for the fiscal year 1949/50, November 21, 1949; (2) the Finance Committee, House of Representatives, on the National Tax Reform Bill, March 2, 1950; and (3) the Local Administration Committee, House of Councillors, on the Local Tax Reform Bill, March 30, 1950. These opinions are contained in my *Public Finance*, revised and enlarged, published in July, 1950.

What I would like to discuss in this article does not of course cover the whole field of tax reform, but is limited to the value-added tax, which is the most controversial of all the taxes which have come to the fore in the present reform plan. It is, I think, well known that the value-added tax first came into question in academic circles in the United States after Thomas S. Adams' proposal¹ in 1921, which can be said to be the precursor

¹ The tax proposed by T. S. Adams is not such as the present value-added tax which is to be imposed on the amount of the total gross sales minus the value of commodities and services purchased from other businesses, but "the form of a sales tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the production of goods for sale." So that it is not a value-added tax in the strict sense of the word, but the principal objective of this proposal is to avoid the pyramiding effect of

of this tax. It should be noted, however, that there is no precedent for its enactment, the present attempt in Japan being the first anywhere in the world. Consequently, without any legislative precedent and experience in practice, which would be helpful in studying the tax, the drafting of the tax bill was confronted with many difficult problems. My investigation of literature on the study of this tax by experts abroad, especially in the United States, revealed that with the exception of a general outline to the extent given in the *Shoup Report*, there is nothing which treats minutely on a subject which has become an issue in Japan; for instance, how to calculate in a concrete manner the amount of value-added, when it is argued that the value-added is the total gross receipts of an enterprise minus all purchases from other firms; how to deal with the pyramiding of taxes; how to calculate value-added in such particular cases as banking, insurance and other businesses of a similar nature; how to deal with the value of capital equipment or inventories which were purchased before the tax is put into force and so on. There may be some studies on these problems, but so far my investigations have proved fruitless.

The main purport of this article is to clarify the points which are the subject of discussion on the value-added tax, and I will welcome criticisms and ideas from academic circles at large. For the sake of convenience, I will treat the subject in four parts, the first being the character and advantages of the tax; the second, the disadvantages; the third, suggestions for amendment, and the fourth gives an outline of the system to be followed in Japan.²

I would like to add that this article is based on the assumption that the general recommendations in the *Shoup Report* will be put into effect.

II. *Character and Advantages of the Value-Added Tax*

The value-added tax is an impost, the object of which is the value-added to an enterprise or the value of net products. It is the value or a part of the national income newly created by a business enterprise, which means the total gross sales and other gross receipts minus the total outlay to other enterprises, such as purchases of capital equipments, land, buildings,

taxes that is said to be a defect of the turnover tax; and, in this sense, the proposal can be regarded as the forerunner of a value-added tax. (Thomas S. Adams, "Fundamental Problems of Federal Income Taxation," *The Quarterly Journal of Economics*, August 1921, p. 553.)

² I stated my opinions in detail on various problems regarding the value-added tax at the first general meeting of the Japan Tax Association, November 25, 1949 and also at the sixth general conference of the Japan Association of Fiscal Science, November 27, 1949. The contents of the former are contained in the *Proceedings* (pp. 133-150) of the general meeting of the said association published February 1, 1950. Another treatise which is a revised and enlarged one of the above mentioned is shown in *Studies in Public Finance* (Tokyo, 1950), a collection of my essays written in Japanese.

commodities, materials, supplies, services and the like and expenses for power, insurance premium and other expenses of a similar nature. Briefly, the value-added is a value newly added to the materials and the like which an enterprise purchases from other enterprises. In other words, the value-added is composed of profits, interests, rents and payroll of an enterprise.

The idea and the term *value-added*, which is calculated by deducting the total outlay disbursed to other enterprises from the total gross receipts of an enterprise, are not new, for in the past this method of calculation was often used by economists and statisticians in the estimation of national income or industrial production. For instance, in expressing the idea of the value-added, A.W. Flux used the term "net value of products" in production statistics in 1913, and Gerhard Colm used the term "Mehrwert" in 1924 to which he gave the translation into English "value added by manufacture," and stated in his treatise that this method was popular among academic circles in Germany in making production statistics, quoting as examples of its use, studies of O. Most in 1907, A. Hesse in 1914, O. Nerschmann in 1916 and Fr. Žižek in 1923. There are many other examples³ but they all treat the subject from the standpoint of production statistics and not from the standpoint of taxation. The first introduction of the value-added tax is comparatively recent, dating back about twenty years.⁴

The value-added tax has an element of an enterprise tax or a business tax, on the one hand, since the tax payer is an entrepreneur, and has also an element of a sales tax, on the other hand, since it is assessed according to the volume of business transactions. The enterprise, therefore, cannot be free from the tax so far as there exists the value-added even when the enterprise suffers a loss. This is the idea of the value-added tax.

On what grounds then is the imposition of this tax justified? The levying of taxes on business enterprises can be justified on several grounds; for example, some say it is justified because an enterprise has an ability-to-pay or because some kinds of enterprise are protected by the State by being granted a privilege; some argue that an enterprise should be taxed in return for the benefits of public services rendered by the State. Studenski enumerates eight points as theoretical justifications for business taxation.⁵ The theoretical justification for the value-added tax can be sought in the fact that an enterprise receives benefits from the public services of a State and local bodies which are regarded as a factor in production, and the en-

³ A.W. Flux, "Gleanings from the Census of Production Report," *Journal of the Royal Statistical Society*, May 1913, pp. 557-598; Gerhard Colm, "Das 'Mehrwert'-Verfahren in der Produktionsstatistik," *Weltwirtschaftliches Archiv*, 1924, pp. 204-217.

⁴ Paul Studenski, "Toward a Theory of Business Taxation," *The Journal of Political Economy*, Oct. 1940, pp. 650-653. An historical description of the value-added tax in the United States is given in this treatise, according to which the first introduction of this tax in such a form as it is to-day was made in the 1930's apart from the aforementioned suggestion of Adams in 1921.

⁵ *Ibid.*, pp. 624-641.

terprise pays a tax in return for the benefits it receives. In a word, it is justified on the principle of benefits.⁶ What decides the compensation for the benefits is the cost of services or the utility of services. If the objective value theory is adopted, the cost should be regarded as compensation for the benefits, whereas, if the subjective value theory is adopted, the utility of public services should be taken instead. The answer, therefore, will differ according to the theory to be chosen. I would like to go a step further in my argument, adopting the objective value theory for the time being.

In short, the value-added tax is a kind of business taxation based on the benefit principle and also a kind of transformed sales tax. This is the intrinsic nature of the tax, and it is asserted that it has the following advantages:

(1) The extent of the public services received by an enterprise from a State or a local body is proportionate to the volume of its business activities. The ordinary sales tax is based on the total gross receipts or gross sales, while, in the case of the value-added tax, the value created by business activities of other enterprises such as purchases of commodities, materials and the like is excluded from the total gross receipts, and, consequently, the net volume of business activities of the enterprise itself, without any admixture of labour of other establishments, is represented more adequately and accurately.⁷

(2) Under the transactions tax, or the sales tax in the form of a turnover tax on all transactions, which was enforced until the end of 1949, the tax is imposed on business transactions at each stage of the whole process of transactions, with the consequent pyramiding effect of tax burdens. Meanwhile, in case of a vertically integrated firm which performs all the functions from production to retail sale within the concern, the transactions tax is imposed only once. Such unfairness is unavoidable under the transactions tax, while the value-added tax is free of a pyramiding of taxes and assures the economic neutrality of taxation.⁸

(3) Since the value-added tax is not imposed on net profits, and, there-

⁶ Cf. Final Report of the Committee of the National Tax Association on the Federal Taxation of Corporations, *Proceedings, N.T.A. 1939*, pp. 565-567; Paul Studenski, *loc. cit.*, pp. 648-649. The *Shoup Report* also admits the necessity of applying the benefit principle to the local business tax, as in the following: "Some kind of prefectural tax on enterprises is justifiable, in order that the businesses and their patrons shall help defray the cost of government services that are made necessary by the existence of the business and its employees in that local area" (p. 201).

⁷ Cf. for example, Paul Studenski, *loc. cit.*, p. 647.

⁸ This fact is pointed out by J. F. Zollar, in his statement before the N. T. A. on the Tax System of the State of New York, *Proceedings, N. T. A. 1929*, p. 126; Gerhard Colm, "Methods of Financing Unemployment Compensation," *Social Research*, 1935, p. 161; Final Report of the Committee of the N.T.A. on Federal Taxation of Corporations, *Proceedings, N. T. A. 1939*, p. 567; Paul Studenski, *loc. cit.*, pp. 647-648; Harold W. Groves, *Financing Government*, rev. ed. (N.Y., 1945), p. 255; Harold W. Groves, *Postwar Taxation and Economic Progress* (N.Y., 1946), pp. 107, 339; Alfred G. Buehler, *Public Finance*, 3rd ed. (N.Y., 1948), p. 571; *Shoup Report* (Tokyo, 1949), pp. 166, 202-203.

fore, needs no determination of net profits, it is much more simple than the net profits tax in computing the taxable basis and the amount of tax, and can be applied even to small business concerns whose accounting may be imperfect. To determine the net profits of an enterprise is an elaborate task requiring a vast knowledge of accounting, etc. Minor enterprises lack such knowledge and necessary data, but keep documents or records relating to sales and purchases. In the case of the value-added tax, even these documents or data are sufficient for deciding the amount of the tax.⁹ Furthermore, no inventory accounting in a business year is necessary under this tax, and no computation of depreciation needs to be made every year, since the full cost of capital equipments is deducted from the total gross receipts when they are purchased by the concern. This tax can also be said to be convenient in that, in case the outlay for purchases is too big to be deducted from the total gross receipts, the deficit or negative value-added can be brought forward to be offset against value-added amounts in succeeding years.¹⁰

(4) The value-added tax, contrary to the net profits tax, does not discriminate against enterprises which use more capital equipment, such as labour-saving machines, compared with those which use more labour, thereby encouraging the expansion of capital equipment without experiencing the difficulties of shortage of working capital that are often encountered by enterprises needing new capital goods. This is of great significance, particularly in Japan where modernization of plants and equipments is urgently needed at the present time.¹¹

(5) Another significant advantage is that it ensures a stable tax revenue. Since it is assessed in proportion to the volume of business activities, regardless of net profits either in prosperity or in depression, the tax revenue undergoes no violent changes as are witnessed in the case of income tax.¹²

III. *Disadvantages of the Value-Added Tax*

On the other side of the picture, the tax has the disadvantages enumerated below:

(1) It takes a value-added, or increased portion of national income, which as an object of tax is itself justifiable from the viewpoint of national economy, but from the viewpoint of private economy, it causes an unequit-

⁹ This is pointed out by Studenski, *loc. cit.*, p. 649. Alvin H. Hansen also refers to this point in his *Fiscal Policy and Business Cycles* (N.Y., 1941), p. 436, claiming that the value-added tax is considered to be superior to the sales tax in simplicity of administration, without adding, however, any reason for the statement.

¹⁰ This is pointed out in the *Shoup Report*, pp. 202, 204.

¹¹ This is pointed out in the *Shoup Report*, p. 203.

¹² This is noted in Final Report of the Committee of the N.T.A. on Federal Taxation of Corporations, *Proceedings*, N. T. A. 1939, p. 567; Studenski, *loc. cit.*, p. 650.

able distribution of tax burdens among different enterprises, since there is a great difference in the magnitude of the value-added amounts according to the kinds of enterprise. Even if the volume of business activities or the amount of invested capital is equal, the value-added (the object of the tax) is greater in an enterprise which disburses a bigger amount in wages on account of the character of the enterprise. The value-added amount in a manufacturing business is generally greater than in a sales or a brokerage business, and tax burdens in an enterprise which depends primarily on the operator's labour are also relatively great.

To lay down tax rate grades according to the type of business may be one of the countermeasures for remedying the said evils, but it would involve not a little complexity and resultant trouble in tax administration, because the grading would have to be very minute in order to secure fairness in tax burdens. Furthermore, it would be almost impossible to put such a measure into practice, should a business enterprise conduct a subsidiary business of a different nature. It may be argued that the value-added tax should finally be shifted to the consumers, thus eliminating the evil effects of unequity of tax burden among enterprises. But I do not agree with this opinion, because the shifting to consumers may not necessarily materialize under a free economy, where tax incidence, generally speaking, is likely to be determined by the equilibrium of economic influences in the broadest sense of the term, and it can scarcely be asserted that the incidence of this tax would always be on the consumers, though it might be otherwise under a strictly controlled economy.

Furthermore, even if a shifting of the tax burden to consumers is possible, there still is room for criticism because it is partial to enterprises and disregards the interests of consumers at large.

(2) As explained above, one advantage of this tax is said to be the avoidance of a pyramiding of taxation. However, it is undeniable that there is a fear of pyramiding or duplication of taxes in banking circles and the warehousing business on the one hand, and ordinary commerce and industrial enterprises on the other. For instance, interest received by a bank in return for loans to business enterprises constitutes a value-added for the bank; on the other hand, such interest is also included in the value-added of the outside enterprise. It can be said, therefore, that part of the value-added is a double tax which would apply also in a warehousing business, real estate and other enterprises.

The outlay of a concern, when it is of such a nature as to be included in the value-added of the other party who is a business operator, should be excluded from the total value-added in order to avoid double counting, but it should not be excluded if the other party is a non-business operator, otherwise it would result in leaving out this part of the value-added from taxation when viewed from the standpoint of national economy. Hence the

question arises how in tax administration to deal with such discriminatory treatment according to the status of the other party to the transaction? This is I think a problem of practical procedure. Admittedly it is not easy to devise a perfectly equitable method of computing the value-added and the most convenient way to enforce it in actual practice, so as to assure a just and fair distribution of tax burdens among various enterprises without duplication or omission of assessment, which are feared may arise in enforcing this tax.

Turning to academic circles abroad, there have been no studies conducive to satisfactory answers to the above question, apart from the presentation of questions. To cite a few examples, Studenski in his aforementioned treatise in 1940 says, "The tax (value-added tax) would be susceptible of successful operation especially in the case of manufacturing, wholesaling, retailing, transportation, and mining businesses. It would not operate as well in the case of agriculture and professions, where the value-added consists mainly of the rewards of the entrepreneurs for their own labors and of the interest payments on their mortgages or other debts. It may be necessary to exclude these fields of occupation from the operation of the tax" (*ibid.*, p. 649). Buehler also says, "The proposed basis for this tax has been variously defined and it is not clear how it would be determined, aside from manufacturing and merchandising, where it would apparently be the difference between sales and the costs of materials, supplies, and services purchased. Some of the advocates of the value-added tax think it would not be practicable in agriculture and in small ventures where accounting is inadequate, and its applicability in the financial and service industries is uncertain" (Buehler, *op. cit.*, p. 571):

This is tantamount to admitting that there are some enterprises to which the application of this tax is difficult, but they suggest no countermeasures to overcome the obstacles. How to solve this difficult problem was one of the questions with which we were confronted. To suggest merely to "exclude these fields from the operation of the tax," as stated by Studenski, is not sufficient to solve the problem. Does it imply that the business tax need not be imposed on these enterprises? If not, what is the reason? If the answer is in the affirmative, what is the best method to impose the tax on them? These are the questions which must be solved.

It is true that there have been some studies by economists and statisticians on duplication and omission in operation of the value-added in connection with the estimation of national income, but these studies are of little practical use, because their principal objective is to find a way to compute national income or net total production, and not to decide the method of applying the tax to various enterprises.

(3) The value of capital equipments, inventories, etc. purchased after the enactment of this tax is to be totally deducted from the value-added

during the year in which they are bought or during the succeeding years, but the value of properties purchased before the enactment of the tax is not to undergo such treatment. This seems also unfair. As a consequence, influential concerns who operate their business on a sound financial basis, and possess the ability to make great profits and expand capital equipments are liable to be taxed too lightly, while minor enterprises are likely to be burdened with heavy taxes. Enforcement of such a tax system under prevailing conditions in Japan, although modernization of plants and equipments is essential, would prove to favour big enterprises too much, resulting in the acceleration of the downfall of middle-and-minor enterprises which form at least at present, the backbone of Japanese economy, leading to serious social problems.¹³

(4) While it is argued that computation of the value-added tax is simple since it requires no determination of net profits, many accountants and businessmen, especially those who operate big enterprises, complain that they would have to keep special books and maintain a special accounting system for computing the value-added amount as the object of tax, which would involve a tremendous amount of work and trouble. They contend that since in big enterprises the calculation of net profits is anyway made for computing and paying the corporation tax or the individual income tax, it would be much more simple and more convenient to adopt a system that would allow them easily to utilize the data already prepared for the payment of the corporation tax or the individual income tax also in the case of assessment of the value-added tax as a tax on business. That is to say, their idea is to adopt the "adding system" instead of the "deducting system" as a method for computation of the value-added amount, to which I will refer later.

¹³ This criticism applies to the *Shoup Report* and to other advocacies of the value-added tax, which emphasize the economically advantageous effect of this tax for the capital-intensive industries. But the theory proposed by Colm in the early stage of discussion on this tax lays stress on the economically neutral characteristic of the tax. He proposed in his aforementioned treatise in 1935 to adopt the value-added tax in place of the payroll tax or the capital tax as a method of financing unemployment compensation. His theory was that since the assessment of the payroll tax is based on wages and capital tax on capital, entrepreneurs try to free themselves from either of these taxes by resorting to factors in production other than the objects of tax (for instance, in the case of the payroll tax, a business operator will prefer the use of machinery to the employment of workers), while tax evasion by such a means is impossible under the value-added tax system. Colm also points out that there is a question whether or not the amount spent for depreciation should be deducted in computing the value-added amount, to which point, however, he gives no answer. (*Ibid.*; pp. 158-161.)

Shoup asserts in his treatise in 1943 that, strictly speaking, deduction of depreciation is necessary in computing the value-added tax (Shoup, "Taxes Available to Avert Inflation," p. 90, in Shoup, Friedman and Mack, *Taxing to Prevent Inflation* [N.Y., 1943]), but proffers no concrete explanation on the method. In this connection, it is to be noted that Prof. Shoup, in his presidential address entitled "Tax Reform in Japan", delivered at the general conference of the National Tax Association, held on 21 Sept., 1949, characterized this tax as "the most economically neutral form of business taxation," pointing out among other things that: "It does not discriminate against the use of labor-saving devices (as does any tax on profits); it does not favor machinery over labor (as does a pay-roll tax)" (*Proceedings, N.T.A. 1949*, p. 412).

These features are disadvantages of the value-added tax, or questions still at issue.¹⁴

IV. *Proposals to Amend the Value-Added Tax*

Several proposals to amend the tax to remedy such disadvantages mentioned above have been forthcoming. My own idea is as follows:

(1) The difficulties mentioned are attributed to the fact that the value-added tax involves elements of two taxes, i.e. sales tax and business tax; in other words, it has a double character of taxation. Therein lies an advantage as well as a disadvantage. I would endeavour to make the best use of the special character of the tax, or its double character, in support of the spirit of the *Shoup Report*, but if the defects cannot possibly be removed, I would recommend its reform to something closer to either of the two, the sales tax or business tax, at the sacrifice of the other. If importance is attached to the element of avoidance of the pyramiding of taxes, it should be made to come closer to the retail sales tax; if importance is to be attached to the benefit-principle-taxation, it should approach closer to the business tax which takes external indicia as the taxable basis. In the latter case, the pyramiding of taxation should naturally be admitted. Of the two, which is preferable? In my opinion, the business tax is preferable to the retail sales tax which entails much more trouble in tax administration and also has the element of fear of devolving into mass taxation and regressive taxation as a result of shifting the taxes to consumers. I emphasize this point particularly, because of the unsatisfactory experience with the sales tax in Japan. To make it resemble the business tax answers more properly the fundamental purport of the tax, i.e., compensation for benefits.

Thus my proposal is to determine a taxable basis reasonable and suitable for each enterprise, making it a basic principle to adopt value-added as a taxable basis, and to admit the pyramiding of taxes if it is unavoidable by the necessity of rationalizing tax burdens, although it is desirable that every possible effort be made to avoid this.

Then what method should be adopted in order to compute the value-added amount in respective enterprises? It should be decided by taking into consideration the ground for the imposition of the tax, which is compensation for benefits received by an enterprise from public services, the extent of the benefits being considered to be proportionate to the volume of business done by the enterprise. Therefore, computation of the value-added amount can be realized by adopting a method which makes it possible to represent the

¹⁴ Hansen points out as one of the defects of the value-added tax that it is more likely to encourage price increases than in the case of the sales tax (Hansen, *op. cit.*, p. 436), but he adduces no evidence on this angle.

volume of operating activities of the enterprise as minutely and exactly as possible. Put more precisely, it should be obtained by deducting the operating expenses from the gross operating income of the business. Income and expenditure which are not directly related to the business activities should be eliminated. I think it is improper to deduct all the outlay of a business from all receipts with no regard to their nature, and if any question arises as to the method of calculating the value-added amount in some kinds of business, it should be determined by this general rule.

Deductions of outlay for capital equipment, instead of being done wholly at the time of purchase, should be carried out by depreciation as far as possible, by which the aforementioned defect (3) can be removed. In enterprises where it is technically difficult to adopt this method or the depreciable assets are intrinsically few, there is no alternative but to adopt a method of deducting the total amount of outlays at the time of purchase. This should be admitted as unavoidable for the convenience of assessment, though it lacks accuracy and detail.

(2) Reverting to opinions in academic circles in the United States, Colm and Studenski take a positive attitude in advocating the value-added tax, while some others recommend a retail sales tax instead, the arguments for which are not necessarily the same, though one common to them all is that the retail sales tax, like the value-added tax, involves no pyramiding of taxation. There arises no duplication of taxes with the retail sales tax, since it is levied only once at a time when a commodity is purchased by a consumer. Besides, it has the big advantage that this tax can be so applied as to give the consumer specific information on the amount of tax he is paying. It is also argued that the retail sales tax is a more simple and a surer means if it is considered desirable to impose it on consumers according to the volume of consumption. Shoup maintains this theory, also Groves and Buehler, though there is a difference in the points to which they attach importance. They do not contend, however, that the retail sales tax is the best of all taxes, but that it is the best of all kinds of sales taxes.¹⁵

Care must be exercised regarding this argument, for they believe the value-added tax, like the retail sales tax, involves no duplication of taxes. However, as I have already pointed out, I think there does arise a duplication of taxes even in the case of the value-added tax. If importance is to be attached to the avoidance of duplication, a theoretical conclusion would lead to the adoption of the retail sales tax which aims at imposition on the final consumer, though it is admitted that even this impost would be difficult to levy solely on sales to final consumers, because it is difficult in practice to distinguish them from sales to merchants and manufacturers, who should in principle be tax-free. Therefore, there is as a matter of course

¹⁵ Shoup, *Taxes Available to Avert Inflation* (1943), pp. 87-91; Groves, *Postwar Taxation and Economic Progress* (1946), pp. 109-110, 284; Buehler, *op. cit.*, p. 571.

the possibility of the pyramiding of taxes even in the case of the retail sales tax. But this is a question of practice and not theory.

The most outstanding opinion is contained in the treatise prepared by Prof. Shoup in 1943, in which he concludes that the retail sales tax is superior to the value-added tax or any other kind of sales tax, after a comparative study on the pros and cons of several types of sales tax—general sales tax or turnover tax on all transactions, manufacturers' sales tax, wholesale sales tax, retail sales tax, tax on value-added (*ibid.*, p. 91). He expressed the opinion also in a criticism of the abolished transactions tax in Japan in the *Shoup Report* of 1949, in which he says that it had the disadvantage of the pyramiding of taxes and favoured the vertically combined firm. On the contrary, he asserts "The retail sales tax and the value-added tax do not have this defect. A nation-wide retail sales tax is probably not practicable in Japan at the present time, in view of the large percentage of business done, especially outside the large cities, by small retail shops whose accounting records are inadequate or non-existent. Exemption of so many yen sales per month, if made high enough to eliminate retailers with inadequate records, would cut out a large part of the total tax base" (*Shoup Report* [1949], p. 166).

When I perused this part of the *Report*, bearing in mind his treatise of 1943, I presumed he might be of the opinion that the adoption of a retail sales tax is preferable to the value-added tax if accounting records are better prepared by businesses in Japan. It is not clear whether or not his real intention is such, since any tax that is regarded as a good tax at a certain time and place might possibly be a bad tax at another time and place. Be that as it may, I myself presume his opinion as such for the present.

(3) An amendment to the value-added tax proposed by professors of business management and accountancy as well as entrepreneurs in Japan is related to the method of computing the value-added. As suggested in the *Shoup Report*, there are two computing systems; one is the "deducting system," so called for the time being, under which value-added is to be obtained by deducting total outlays for purchases from the total gross income of a concern, and the other is the "adding system," also so called for the time being, under which value-added is to be obtained by adding up factor costs, i.e. profits, interests, rents and wages. Contrary to the *Shoup Report* and most of the advocates of the value-added tax in the United States who are in favour of the deducting system, some advocates in Japan prefer the adding system. The principal reason is that it is more convenient for big firms since, under it, the books and accounting prepared for the corporation tax are usable as they are for the value-added tax without necessitating the preparation of special books or other special procedure.¹⁶

¹⁶ An advocate of the adding system based on the most detailed arguments is Prof. Susumu Watanabe, "Computation and Taxation of Value-added," *Industry Management (Sangyo Keiri)*,

I cannot subscribe to this opinion, because it neglects the special character of the value-added tax in that it involves a double character of the business tax and the sales tax. Attaching importance to this special character, the adding system is out of the question, and as a natural consequence the deducting system should be adopted, because one of the main motives in advocating a new tax, the value-added tax, is to remove the defects inherent in the sales tax. Firstly, the sales tax, no matter what form it takes, is unfair since it is based on gross total income or gross sales, neglecting payments to other enterprises such as purchases of raw materials, merchandise, etc. Secondly, it causes a pyramiding of taxes and consequently favours vertically integrated firms, as it is imposed on all transactions every time one is conducted. To remove these evils, while keeping the form of a sales tax, is the point aimed at in adopting the value-added tax. This is why Prof. Colm called the value-added tax a "refined sales tax" in his treatise in 1935 (*ibid.*, p. 161).

If the adding system is adopted, under which the tax is imposed on the sum total of profits, interest, rents and wages in each enterprise, the value-added tax is no more a tax taking sales as the taxable basis, but becomes a tax resembling a pure business tax, losing the element characterized as a sales tax involved in the value-added tax. There are instances in this and foreign countries where the external indicia, such as rental value of real estates for business use, number of employees, gross sales, etc., were taken as the taxable basis for business tax in the past. The value-added tax computed by the adding system is in itself nothing more than a business tax assessed by such external indicia in an elaborate form, and, consequently, loses the characteristics of a value-added tax in which it has two elements of a sales tax and a business tax.

This theory was advocated with a view to eliminating several evil effects due to the special character of the value-added tax, which embodies elements of a sales tax as well as a business tax, and the preference conceded as a concrete countermeasure, of making the value-added tax closer to a business tax. I favour the spirit of this proposal, but it must be noted that the value-added tax, based on the adding system, loses entirely the element of a sales tax, turning thereby into a pure business tax, which is one very different from the so-called value-added tax recommended in the *Shoup Report*.

Furthermore, duplication of taxes between banks and similar institutions and other businesses can no better be avoided by the adding system than by the deducting system. In this respect there are opponents. Mr. Torao Nakanishi, who was the earliest advocate of the adding system in Japan, gave his opinion in a noteworthy treatise, in which he favoured the taking of the total of four factor costs, profits, rents, interests and wages, as a taxable basis for the value-added tax, asserting that interest received by
February 1950, pp. 24-27.

banks, or land and house rents received by real estate companies should not be taxed since they constitute a factor cost of other businesses which pay them.¹⁷ On the basis of his proposal, duplication of tax can admittedly be avoided, but the tax burdens of a banking business or a real estate lending business will become too light, resulting in an unjust distribution of this tax burden among enterprises. The pyramiding of tax is unavoidable if this kind of unfairness is to be eliminated.

Some advocate, instead of adopting the deducting system, the taking of the total wages and arbitrary or average rate of imputed return or profit on all operating capital of the enterprise as the taxable basis of the value-added tax. This is, however, a kind of adding system to which I cannot subscribe for the reasons mentioned above.

(4) Others favour continuing the net profits taxation hitherto enforced in Japan in opposition to the adoption of the value-added tax, one of the grounds for which is that, under the latter tax system, even an enterprise suffering a loss is taxed as a necessary consequence of taking the value-added as the object. This contention, however, neglects the fact that the value-added tax is not a tax based on the ability-to-pay principle, but on the benefit principle.

Besides, this form of business taxation has another advantage at present in Japan. According to our tax system, a business enterprise is taxed by three public bodies; individual income tax or corporation tax by the national government; business tax by prefecture and inhabitants' tax by municipalities (city, town and village). When these three public bodies impose taxes on enterprises adopting the same object, e.g. net profits or income as the taxable basis, the object of the tax, for instance, the part of the income which evades taxation by one public body escapes also assessment of taxation by other bodies. To avoid this defect in the tax system, it is desirable, I feel, to select a different standard as the taxable basis, by at least one of those public bodies. At present in Japan, in the assessment of individual income tax and the corporation tax by the national government, and the inhabitants' tax by the municipalities, the net profits or income are principally taken as the taxable basis. When a prefecture, existing between national government and a municipality levies taxes on the value-added, instead of on the net profit, such defects as mentioned above can be avoided, and at the same time the taxable basis of the prefectural tax can be made independent from that of the national tax. From the viewpoint of improving the whole system of national taxes, prefectural taxes and municipal taxes, the imposition of the value-added tax by prefectures can be said to be significant. The *Shoup Report* also explores the grounds for recommending the value-added tax as a prefectural tax on enterprises, instead of the net profit

¹⁷ Torao Nakanishi, "Revaluation of Assets and Value-Added in the Shoup Report," *Industry Management (Sangyo Keiri)*, November 1949, p. 9.

taxation, as follows: "We recommend that the enterprise tax be retained but that it be transformed to accomplish two aims; first, to relieve some of the cumulative pressure on net profits as a tax base; and second, to make the administration both more simple, and less dependent in principle upon what the national government's tax administrators do" (*Shoup Report*, p. 201).

V. *The Value-Added Tax System in Japan*

I have explained in the above chapters the general problems surrounding the value-added tax, the problems under discussion and countermeasures proposed to cope with them. The original draft for the value-added tax formulated by the Japanese Government, which was originally expected to be enforced from 1950, is the fruit of much work in an endeavour to solve the problems mentioned above. However, it cannot be claimed that the knotty problems at issue have all been solved even in this draft plan. Perhaps I should explain in outline the original draft.¹⁸

(1) The value-added tax is to be imposed on the value-added of the business, that value-added being the taxable basis, by the prefecture where the office or place of work is located, on individual and juridical operators of a business.

(2) There are to be three categories of businesses subject to this taxation, namely: the first comprises all trades and industries in a broad sense of the term, including the following 36 types: sales of goods, banking, mutual financing (*mujin*), trust, insurance, money lending, securities, the loan of goods, manufacturing, electricity supply, gas supply, stone-cutting, radio and broadcasting, transportation, motor roads, canals, piers, anchoring, stevedoring, warehousing, contracting, printing, publication, photographing, rooming houses, hotels, restaurants, intermediaries, agency, brokerage, commission agencies, money exchange, entertainment, indoor games, amusement parks and other businesses of a similar nature. Those in the second category are agricultural and fishery industries, including live-stock breeding, fishing and others of a similar nature. Those in the third are the liberal professions and other special activities, including the following 19: medical profession, dentists, pharmacists, midwives, veterinary surgeons, lawyers, judicial consultants, administrative consultants, notaries, patent lawyers, tax consultants, certified public accountants, public accountants, design supervisors, barbers and beauty parlors, art instruction, public bath-houses, newspapers, and others of a similar nature.

¹⁸ The original value-added tax plan was part of the Bill for Local Tax Reform. Rejected at the 7th Diet session in the spring of 1950, it was presented again at the 8th extraordinary session held in the summer of this year and passed by the Diet. It is to be noted, however, that the enforcement of this tax is postponed till January 1, 1952.

The following shall be exempt: a) businesses conducted by the State and local public bodies, b) businesses of the second and third categories conducted by academic juridical persons and the like, c) those conducted by the National Railway Corporation, Japan Monopoly Corporation, the Peoples' Finance Bank and other public corporations of a similar nature, d) agriculture, forestry, mining and placer mining, e) businesses of the second category conducted mainly by self-labour.

(3) The taxable basis shall be the value-added of the enterprise, calculated by deducting the amount of specific outlay from the total sales, the latter and the amount of specific outlay being computed as follows:

The total sales (total amount of gross income) is the total of sales of commodities or receipts of money in return for services related to the business and sales of fixed assets and other receipts incidental to the business (for instance, property insurance money, subsidies granted by national and local governments, etc.), excluding interest, stock dividends, land and house rents, in order to avoid duplication of taxation. Meanwhile, interest and stock dividends received by banks, mutual financing institutions, trust companies, insurance companies and money lenders shall be taxed, since they form the operating income of these businesses. In this respect, it can be said that there arises a duplication of taxes between these businesses and others which pay interest and dividends. As regards land and house rents, however, they are not taxed even when they are received by real estate lending businesses. Thus the aim to avoid duplication of taxation will be attained, but, as a consequence, it will bring about unfairness in that a building loan business, for example, will be exempted from this tax. The main ground for tax exemption on such a business is that the municipal property tax (real estate tax) is heavy on this kind of business, since it owns naturally a lot of real estate. Nevertheless, it can be said to be unequitable to let a building loan business be entirely exempt from enterprise tax. The tendency for tax pressure to become too much for this kind of business, since a heavy municipal property tax is imposed on it, should be avoided by some counter-measures, and it is desirable to impose an enterprise tax in the form of the value-added tax on this kind of business also in one way or another.

The specific outlay is the total expenditure proper to the enterprises, such as (a) outlay for the purchases of land, houses, depreciable fixed assets other than houses, merchandise, partly finished goods, materials, supplies and (b) the following outlay such as fees; storage charges; charges for utilization (excluding the land and house rent); interest disbursed by banks, mutual financing institutions, trust companies, insurance companies and money lenders; property insurance premium; repair and processing charges; advertising expenses; transport and communication outlay; charges for motive power, water, lighting and heat; taxes and public levies (excluding the individual income tax, corporation tax, net-worth tax, succession tax, inhabitants' tax,

finer, etc.); payments to the national treasury (e.g. price differential profit) and other expenses of a similar nature. Interest disbursed by a business other than banking and the like, and also all of land and house rents, are not deductible as outlay, because such interest and rents are regarded to constitute a value-added of the enterprise which disburses them and so they are to be taxed.

The above represents the calculation method for total gross sales and the total outlay, under which there arises such unreasonable results as: if the fixed assets or inventories which were purchased before the enforcement of the tax are sold after it becomes law, the receipts from the sales of the properties will be included in the value-added, while the outlay for the purchase of the properties in the past will not be deducted. To remedy this defect, either of the following two measures should be adopted: (a) the value of the total assets owned by the enterprise at the time of enforcement of the tax should be computed and then deducted as outlay in the computation of value-added, and the sales amount of the properties, if sold later, should be treated as receipts; (b) with the time of purchase as the line of demarcation, the sales amount of the properties of the enterprise, purchased before the enforcement of the tax, should not be regarded as receipts, when sold in levying the tax. Either of these two seems reasonable, but both methods are troublesome and difficult in computation as well as in the procedure for deciding the time when the properties were purchased in the past. Such unreasonable features in the Japanese system are due to expediency in tax administration.

(4) For the 1952/53 fiscal year only, the undermentioned enterprises can make a choice of the tax basis, either to have the amount calculated by the above-mentioned method or have it calculated by multiplying the total gross receipts by the following rates: 45% for banking; 45% for mutual financing; 100% for trust business;¹⁹ 17% for property insurance; 15% for life insurance; 50% for transportation; 40% for local railways and trams; 50% for warehousing. This exceptional measure aims at avoiding an excessive tax which might fall upon those enterprises by resorting to the ordinary method of calculating the value-added.

(5) Exemption from the tax shall be granted to those businesses with a yearly value-added of less than ninety thousand yen.

(6) The standard rate of the tax shall be 4% for the value-added of businesses in the first category, and 3% in the second and third categories.

¹⁹ The total gross receipts of a trust organization in this case are what is called "reward for trust," which is the total gross receipts from custody or disposition of trusted properties minus the interest on trust paid to the trusters. In banking, the taxable basis is the total gross receipts, which include interest on deposits paid to the depositors, while, in the case of trust business, on the contrary, the interest on trust is already deducted from the amount of the taxable basis. This is the reason why 100% of the reward for trust is made the taxable basis in a trust business.

However, in any case, the rate shall not exceed 8% and 6% respectively.

(7) Where the amount of the outlay exceeds the total amount of sales, the portion in excess, i. e. the negative value-added, shall be carried forward to be offset against the value-added amount in the succeeding five years.

(8) The tax shall be paid by self-assessment as in the cases of corporation tax, individual income tax, etc., by instalments.

(9) If the enterprise has offices or workshops, etc., in more than two prefectures, the total amount of the value-added shall be allocated to the prefectures concerned as a general rule according to payrolls, and the prefectures will determine the amount of the tax, except in manufacturing businesses, electricity supply, gas supply, motor roads, canals, piers, anchoring, and stevedoring businesses, where one half of the total value-added shall be allocated according to the payrolls and the other half according to the value of the fixed assets.

(10) Revenue from the value-added tax for the 1950/51 fiscal year, when the original tax plan was presented to the Diet in the spring of this year, was estimated at 41,964 million yen, which is a little less than receipts from the business tax (which is based on net profits) amounting to 43,174 million yen in 1949/50. Taking into consideration the reduction of tax burden under the national transactions tax, amounting to 45,100 million yen, which was abolished from January 1, 1950, the tax burden on enterprises was expected to be reduced in total by more than half that of the previous year. Needless to say, however, individually speaking, some of the enterprises would show an increase in tax burden. The budget estimate of the value-added tax for 1950/51 accounted for 59% of the total revenue from prefectural taxes amounting to 70,431 million yen for the same year, heading the list of all prefectural taxes.

I have dealt with various problems which have come to the front since the proposed enforcement of the value-added tax in Japan, but there may arise unexpected new problems following its promulgation. Actual conditions will have to be studied carefully from time to time after the new tax comes into effect.