

HISTORICAL BACKGROUND OF THE JAPANESE TAX SYSTEM

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In order to study the main features of a nation's tax system, it is important to explore its basic background from a historical perspective. The main issues in this paper are considered from two distinctive aspects. The first approaches tax issues in terms of the long-run trend of tax structure development. The second examines the starting point of the postwar tax system with particular attention given to the Shoup tax reform.

I. A Long-term View of Tax Structural Development

1.1. Generalization of Tax Structure Change

If we take a long and broad view back into time, our attention is drawn to the salient features of the tax structure during the process of economic development. In other words, how do tax structures appear to change during the transition from a traditional society to a modern one? Is there any theory to tie together common threads among tax systems in varying stages of development? Answering these questions would be important to achieve an understanding of the basic framework of the present tax system and to elucidate long-term changes in the size and composition of tax revenues. In fact, many studies to date have attempted to investigate tax structure change from a similar point of view.

Based on broad empirical findings with special attention to the size and structure of tax revenues over time, in past studies generalizations have made to incorporate these findings into a consistent framework [see, for instance, Hinrichs (1966)]. The purpose of generalization is to determine whether there is some economic law which, as Engel's law confirmed for consumption spending, reveals a relationship between tax revenues and the development process.¹ The basic nature of this study is to examine whether or not such generalizations can be applied to the Japanese experience. What is of more significance to this study is how the tax structure changes at different stages of economic development. Consequently, an ideal approach would be to examine the same countries at different levels of development, using time-series data rather than using cross-sectional data.² However, this approach

* I am grateful to David Gross for his editorial assistance in English.

¹ The necessity of constructing such a law is stressed by R.S. Thorn (1967) pp. 19-20.

² Most of the published studies, however, have focused on tax structure development in developed and developing countries, using cross-sectional data. This approach is the only one feasible in many cases, chiefly because there is a lack of reliable historical series data on GNP, its components, price levels and other related data in most countries. Yet a cross-sectional approach is necessarily very rough and appears to have several defects. See, for example, H.T. Oshima (1957), A. Martin and W.A. Lewis (1956), J.G. Williamson (1961), S.R. Lewis (1963).

presents several difficulties. For one thing, data for many countries is not available for the entire period of their economic development. The other difficulty is that few countries have completed all phases of economic development. Nevertheless, there are a few cases (e.g., the U.K., the U.S., West Germany) for which one can analyze the entire process of tax structure development from a long-term standpoint.³

The present study represents an effort to extend past analyses of developed and developing countries through an examination of Japan's experiences during the 100-year period of 1885–1985. Japan's experience is notable for two reasons. First, Japan is the only non-Western nation to have succeeded in attaining the level of economic development enjoyed by Western nations. This means that Japan has passed through all the levels of development within the past one hundred years. Second, in the process of economic development, Japan has not oriented itself too closely to the European pattern. It can be argued that the economic development of Japan was different from that of Western countries in many respects. Thus, Japan should prove an illuminating case study of tax structure change.⁴

We must now consider what empirical evidence in Japan's case supports the generalizations of tax structure development. There are two generalizations presented in past studies which will be investigated here:

- 1) That the size and composition of tax revenues tend to change over time, reflecting structural changes in the economy;
- 2) That forces (e.g., social, political and cultural) other than changes in economic structure also govern the determination of tax shares.

Here we seek the similarities or dissimilarities of Japan's experiences in terms of these generalizations.⁵ Fortunately, such an investigation is now feasible, through use of the long-term statistical data prepared by the Hitotsubashi University group.⁶

1.2. *A Model of Tax Structure Change*

Based upon empirical analyses, past studies have developed a general theory to explain and predict the size and composition of tax revenues in the process of economic development. Generally speaking, it is difficult to generalize the development of tax structures in different countries and time periods because tax structure change at first sight appears as a multicolored fabric containing numerous patterns. However, a general theoretical pattern of tax structure change emerges from the empirical and historical observations. This pattern was presented in the form of a "heuristic model" by Hinrich (1966) ch.6, which he derived from a cross-sectional analysis of countries at different levels of development. He uses a heuristic device

³ Some useful hypotheses emanated from such works as A.T. Peacock and J. Wiseman (1961), and R.A. Musgrave (1969).

⁴ For past studies of Japan, see H.H. Hinrich (1966) p. 49, R.A. Musgrave (1969) p. 137. Recently, R.J. Chelliah (1986) has attempted to compare the Indian experience with that of Japan with special reference to Ishi (1978).

⁵ More detailed analysis has already been attempted in Ishi (1978).

⁶ The Hitotsubashi group is engaged in the lengthy project of estimating economic statistics of Japan from 1868. See K. Ohkawa et al., (1966–1987). Twelve of fourteen volumes, including National Product, Capital Formation, Government Expenditure, have already been published. In particular, these three volumes are essential to our analysis. For other major statistical materials, see The Bank of Japan (1966), Economic Planning Agency (1987).

to establish a typology and an average picture to which individual cases can be compared.

It is helpful for the purpose of our investigation to compare the tax structure development of Japan with such a general pattern. According to Hinrich's model, tax structure generally develops through the shifting of the relative weights of land taxes, indirect taxes (divided into taxes on foreign and internal sectors), and income taxes as the economy advances through each phase of development (traditional, transitional and modern).

Fig. 1 illustrates the pattern of tax structure development in Japan for comparison with Hinrichs' heuristic model.⁷ Let us first pay attention to the lower part of Fig. 1. Here are illustrated three characteristics of Japan's experience.

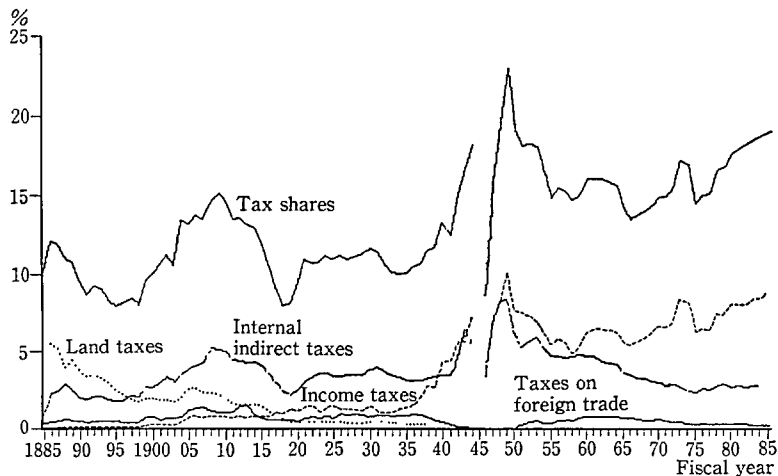
1) A shift from land taxes to indirect taxes, and to income taxes, can be seen over time. This is almost identical to Hinrich's ideal type of tax structure change.

2) However, taxes on foreign trade played no major role in the initial stage of Japan's development—a sharp contrast to the experience of many other countries. The chief reason for this is that tariff autonomy was not achieved until 1899, and even after that date only partial revision of tariff structure was undertaken [see Yamazawa (1975, p. 41)].

3) There is one more dissimilarity: the trend of internal indirect taxes tends to decline, not rise in postwar Japan. This reflects the sharp growth of personal and corporate income taxes in the fast-growing economy.

Next, we turn to the ratio of taxes to GNP (T/Y) at all levels of government, whose curve is depicted in the upper part of Fig. 1. The level of tax share provides an important indicator of the role of government and taxation during development. It represents the fiscal capability of the government to meet the increased need for public services. Also, it measures citizens' power or capacity to bear the burden of taxation.⁸

FIG. 1 TAX STRUCTURE CHANGE DURING DEVELOPMENT



⁷ H.H. Hinrichs (1966) p. 99. In his model, both the expenditures line and the Expenditure-Revenue gap are depicted clearly, in addition to each line of individual taxes as a percentage of GNP.

⁸ For more extensive discussion, see Bird (1964) pp. 303-04.

The tax-GNP ratio reveals six major swings, although four of them are not perfect. The first swing in 1885–1895 shows a large tax share of around 8–12 per cent, the same level as that reached in developing countries during the postwar period.⁹ The principal taxes were those collected on land and liquor and were used to meet extensive government needs while the country was still at a low level of national income.¹⁰ The second swing peaks around 1910 and bottoms in 1918. New or increased taxes on income, liquor, tobacco, sugar, textiles, and beverages, as well as custom duties, all contributed to the upswing. The third swing falling between 1918 and 1932 is a plateau at a fairly low level, reflecting the depression in the 1920s. The main revenue sources at that time were taxes on liquor and income. In the 1930s, the tax revenue share rapidly increases in the fourth swing with no downswing following. Direct taxes on personal and business incomes, including an excess profits tax instituted in 1935, rose tremendously during this period. Fifth, the highest peak emerges immediately after the end of World War II, followed by a relatively stable level of T/Y after 1952–1953. After reconstruction from the war was complete, the economy's rapid growth and the decision to stress private sector growth (partly through a tax reduction policy) lowered the tax share, and it remained between 14 and 17 per cent until about 1970. Lastly, since that time the tax share began to rise rapidly except for a sharp fall in the mid-1970s. This reflects the expansion of fiscal deficits without a tax cut during the past decade¹¹ and as a result the sixth swing is still continued.

1.3. *Tax Structure Change and Economic Development*

The major question to be answered here is how the size and composition of tax revenues have been determined; more specifically, what kinds of factors are most important in explaining the variation of both tax level and structure? Various studies have shown that the ratio of tax revenues to GNP increases with economic development and that the structural change of taxation reflects different levels of development between developed and developing countries.

In what follows, attention is given to tax structure change during development. Tax structure, of course, is greatly affected by institutional, economic, and socio-political factors.¹² Indeed, it can be regarded as a product of the historical interaction between such forces. Although changes in tax structure can, in principle, influence these economic, social and political forces over time, these changes have generally tended to be more determined than determining factor.

If one were to emphasize the passive nature of the evolving tax system, one could even say that the major determinant of tax structure change is the structural change in the economy itself during the process of economic development. There are several specific variables which have been employed in past studies to explain the size and structure of tax systems. Among them, the following three factors are pertinent to the case of Japan.

⁹ For data on the developing countries, see Musgrave (1969), appendix table 6.

¹⁰ H. Oshima notes the high level of Japan's tax burden in international comparison, see H. Oshima (1965) pp. 386–387.

¹¹ For the recent trend of fiscal deficits in Japan, see Ishi (1986).

¹² For the socio-political aspect of the problem, see K.W. Deutsch (1961).

- (1) $\frac{y}{N}$ = *Per capita* real GNP (y is real GNP in the prewar period at 1934–1936 prices and in the postwar period at 1960 prices, and N is total population).
- (2) $\frac{Ag}{Y}$ = Agricultural products' share in GNP (Y is nominal GNP, and Ag is output of the primary sector; i.e., agriculture, forestry and fishery).
- (3) $\frac{M}{Y}$ or $\frac{M+X}{Y}$ = Openness of the economy (M and X stand for imports and exports, respectively).

(1) and (2) are viewed as indices of economic development, while (3) measures the size of the foreign trade sector. This is used as an alternative to (1) and (2). All these indicators have been found to be significant variables in explaining variations in $\frac{T}{Y}$ and the composition of tax revenues, although a fuller explanation could be made by introducing additional factors.

Table 1 shows the correlation of these three variables with tax shares. The simple correlation coefficients during the prewar period are as high as would be expected from past empirical observation of developing countries on a cross-sectional basis, and we find that the estimated results of the postwar era are reasonable, too. This, therefore, constitutes a rough sketch of the interdependence between the variables. The results may be summarized as follows:

- 1) There is a significant correlation between $\frac{y}{N}$, $\frac{Ag}{Y}$ and $\frac{T}{Y}$, with reasonable positive or negative signs in the prewar period of 1885–1944.
- 2) No correlation exists between $\frac{Ag}{Y}$ and $\frac{T}{Y}$ for the postwar period of 1951–85, but $\frac{y}{N}$ and $\frac{T}{Y}$ are still significantly related.

TABLE 1. CORRELATION OF PER CAPITA REAL INCOME ($\frac{y}{N}$), OPENNESS ($\frac{M}{Y}$, $\frac{M+X}{Y}$) AND AGRICULTURAL PRODUCTS' SHARE ($\frac{Ag}{Y}$) WITH TAX SHARES ($\frac{T}{Y}$)

Period	Sample Size	Correlation Coefficient			
		$\frac{y}{N}$	$\frac{M}{Y}$	$\frac{M+X}{Y}$	$\frac{Ag}{Y}$
Prewar					
1) 1885–1944	60	0.281*	–0.030	–0.081	–0.307*
2) 1885–1909	25	0.337	0.458*	0.563**	–0.377
Postwar					
3) 1951–1985	35	0.340*	0.610**	0.682**	–0.121

* Significant at the 5 per cent level.

** Significant at the 1 per cent level.

- 3) Openness provides a better index than the other two variables mentioned above for the first 25 years of the prewar period. In addition, it becomes more significant in explaining the variation of $\frac{T}{Y}$ for the postwar period.

These findings are similar to the results of cross-sectional analysis which have been obtained from regression or correlation between $\frac{T}{Y}$ and various development variables.¹³

Another approach can be taken to pursue the same analytical objective. In addition to the investigation of $\frac{T}{Y}$ in Table 1, an equally important question to ask might be: Is there any systematic relation between the source of tax revenues and the level of income, or is tax structure influenced by institutional factors relatively independent of economic development? In this question, the focus shifts to changes in the composition of the tax structure.

Tax revenues T_n are disaggregated into three sources:

- 1) land taxes— T_l
- 2) indirect taxes, including profits of government monopolies¹⁴— T_i
- 3) income taxes on personal and business income— T_y

These figures, however, are limited to national government tax revenues because the data for classifying local taxes in such a manner is lacking.¹⁵ Therefore, for the dependent variables, we let $\frac{T_l}{T_n}$ stand for the relative share of land taxes, $\frac{T_i}{T_n}$ for the indirect tax share, and $\frac{T_y}{T_n}$ for the income tax share, respectively [for the same procedure see Williamson (1961, pp. 51–52)].

There are three reasons for stressing the relative importance of each tax share. First, it appears that the effects of economic development upon the tax structure are more a function of institutional change than they are inherently an economic matter. Thus, more emphasis should be placed on the various sources of tax revenues, as their change reflects the institutional setting of the tax system, which is relatively independent of changes in economic structure. Our “share-approach” seems to capture the effect of institutional factors.

Second, there is a high correlation between $\frac{T}{Y}$ and each share component of total national government taxes during the time period in which each constitutes the principal share of the total (e.g., land taxes for 1885–1898, indirect taxes for 1909–1935, and income taxes for

¹³ Another way of explaining the variation of T/Y uses the hypothesis that the existence of the *E-R* gap (i.e., discrepancy between government expenditure and revenue) necessarily stimulates a concomitant increase in tax burdens. This *E-R* gap hypothesis is tested by using statistical procedures in Ishi (1978), pp. 213–16.

¹⁴ If the share of foreign trade taxes is assumed to be high (not the case in Japan), it should be treated as one of the dependent variables, distinguished from domestic indirect taxes as in S.R. Lewis (1963).

¹⁵ In general, national government taxes dominated the tax composition of local taxes, since the latter was levied virtually as a sur-tax on national government taxes. A more complete coverage of tax revenues would not alter the conclusions presented here. This is inferred from data available for the prefectural level, not including the lower levels of local government (i.e., city and town).

1936–1985.¹⁶ Third, the relatively poor results of Table 1 must be reconsidered. They may be the result of aggregating all the taxes and using GNP as the divisor in tax revenues.

A simple regression model was constructed with regard to the development of tax structure. As shown in Table 2, all the coefficients of determination are statistically significant, although some are not high. The regression coefficients of all the independent variables in all the equations are also statistically significant. The conclusions from these estimations are as follows:

- 1) As $\frac{y}{N}$ (an index of development) increases, $\frac{Tl}{Tn}$ and $\frac{Ti}{Tn}$ decrease. The relative importance of these two taxes tends to decline over time, a result found in other studies.
- 2) The declining trend of $\frac{Tl}{Tn}$ is influenced by the decreasing share of $\frac{Ag}{Y}$.

TABLE 2. REGRESSION EQUATIONS FOR TAX SOURCES AS A FUNCTION OF ECONOMIC DEVELOPMENT VARIABLES

	Prewar Period (1885–1944)	Postwar Period (1951–1985)
Land Tax	$\frac{Tl}{Tn} = 31.687 + 0.180 \frac{Ag}{Y} - 0.108 \frac{y}{N}$ <p style="text-align: center;">(2.043) (-4.202)</p> $\bar{R}^2 = 0.333^{**} \quad dw = 1.499$	—
Indirect Tax	$\frac{Ti}{Tn} = 49.378 + 0.674 \frac{M}{Y} - 0.048 \frac{y}{N}$ <p style="text-align: center;">(3.254) (-2.045)</p> $\bar{R}^2 = 0.151^* \quad dw = 1.199$	$\frac{Ti}{Tn} = 52.757 - 0.361 \frac{M}{Y} - 3.147 \frac{y}{N}$ <p style="text-align: center;">(-2.09) (-7.935)</p> $\bar{R}^2 = 0.685^* \quad dw = 1.487$
	$\frac{Ti}{Tn} = 51.324 + 0.355 \frac{M+X}{Y} - 0.058 \frac{y}{N}$ <p style="text-align: center;">(3.101) (-2.299)</p> $\bar{R}^2 = 0.152^* \quad dw = 1.377$	$\frac{Ti}{Tn} = 53.249 - 0.224 \frac{M+X}{Y} - 3.002 \frac{y}{N}$ <p style="text-align: center;">(-2.024) (-6.292)</p> $\bar{R}^2 = 0.619^{**} \quad dw = 1.704$
Income Tax	$\frac{Tl}{Tn} = -15.671 + 0.162 \frac{y}{N}$ <p style="text-align: center;">(7.862)</p> $\bar{R}^2 = 0.525^{**} \quad dw = 1.931$	$\frac{Tl}{Tn} = 47.868 + 3.009 \frac{y}{N}$ <p style="text-align: center;">(32.855)</p> $\bar{R}^2 = 0.800^{**} \quad dw = 1.706$

Note: The generalized least square (GLS) method was used to generate all these equations. \bar{R}^2 is the coefficient of determination adjusted for degrees of freedom, ** and * indicate significance at the 1 and 5 percent levels, respectively, dw is the Durbin-Watson statistic, and the values in parentheses are t -statistic.

¹⁶ The correlation coefficients between $\frac{T}{Y}$ and each relative share of national government taxes are: 0.662 of land taxes for 1885–1898, 0.512 of land and indirect taxes (combined) for 1899–1935, and 0.492 of income taxes for 1936–1985. All the coefficients are significant at the 1 percent level.

- 3) "Openness" $\left(\frac{M}{Y} \text{ or } \frac{M+X}{Y}\right)$ can explain the variation in $\frac{Ti}{Tn}$ with opposite signs in prewar and the postwar periods.¹⁷
- 4) $\frac{Ty}{Tn}$ is dominantly affected by $\frac{y}{N}$. Obviously, the relative share of income taxes tends to rise in the course of development.

The purpose of the present study has been to examine the development of the tax structure in Japan during the period 1885–1985 in the context of generalizations made in previous published studies. The evidence of Japan presented here seems in full support of past generations. Since time-series analyses of tax structure change are relatively rare in the literature, Japan's case study is especially important if it provides support for these empirical generalizations. Although our findings indicate some divergence from those patterns, there can be found many similarities in Japan's experience. In particular, great emphasis should be put on the fact that Hinrichs' heuristic model fits Japan's case with only minor exceptions.

1.4. *Other Determinants of Tax Structural Development*

In addition to economic factors underlying tax structure development, there is another key factor in determining the growing ratio of tax revenue to GNP and the "proper" tax structure composition. In view of the results of various studies, attention should be directed toward the cultural-political preferences for adopting a specific size and composition of the tax system. When a country has reached a high income level and a large government sector share of GNP (say, between 20 and 40 per cent), these preferences appear to become much more important than at lower income levels. For instance, the level at which the government sector share settles between 20 and 40 per cent is likely to be determined by differing commitments toward "security and defense" and/or "welfare policy," rather than by change in economic structure [see Hinrich=Bird (1963, p. 433)]. In postwar Japan, such ideological commitments are probably among the determinants of tax structure development.

What is of great interest is the low level of the tax share in the postwar period. As we have seen in Table 3, Japan has the lowest level of tax burden among major advanced countries during three selected years. Japan's low ranking remains unchanged today, even though the tax share has rapidly increased to reduce the gap with other countries. This feature peculiar to postwar Japan needs to be explained.

Among explanatory factors, of most importance is the difference in the level of military expenses between the prewar and postwar years. If military expenses are shown relative to GNP during selected fiscal years (the relevant table is omitted), the ratio rises drastically during the war period (e.g., 8.44 per cent in 1894–1895, 22.97 per cent in 1904–1905, and 27.98 per cent in 1941–1944). Attention should, however, be directed toward the very low figures for the postwar period, in comparison to those of prewar Japan. Indeed, the per-

¹⁷ As is evident from the positive coefficient of the indirect taxes equations in the prewar period, the "openness" of the economy expanded the tax base for indirect taxation, through spillover effects which stimulated consumption, commercialism, transportation, etc. On the other hand, the sign of the "openness" coefficient in the postwar period is negative. It appears that "openness" was no longer effective in increasing the indirect tax base at this level of economic development and that the declining importance of indirect taxes happens to have a close bearing with the "openness" in a growing economy.

TABLE 3. TAX LEVELS IN OECD COUNTRIES; TAX REVENUES AS A PERCENT OF GDP

	1985	1975	1965
Sweden	51	44	36
Denmark	49	41	30
Norway	48	45	33
Belgium	47a	41	31
France	46	37	35
Netherlands	45	44	34
Austria	42	39	35
Italy	41a	29	27
Luxemburg	41a	38	30
U.K.	39	36	31
W. Germany	38	36	32
Ireland	38	32	26
Finland	37	35	30
Canada	34	33	26
Switzerland	32	30	21
Australia	31a	29	24
New Zealand	31a	30	23
Portugal	31	25	18
Greece	29a	25	21
U.S.	29a	30	26
Spain	28	20	15
Japan	27a	21	18
Turkey	16	21	15
Unweighted average	37	33	27

Source: OECD, *Taxation in Developed Countries* (Paris; 1987) p. 62.

Note: a...1984 figures are used for these countries.

Social security contributions are included.

centage of military expenditures as a part of GNP has been less than 1.00 per cent. The low level of military spending is also apparent in international comparisons of the military expenses-GNP ratio: between 1961-1970 this ratio averaged 8.5 per cent for the U.S., 6.3 per cent for the U.K., 3.8 per cent for West Germany and 4.9 per cent for France. The 1971-84 averages show 6.3% for the U.S., 5.1% for the U.K., 3.5% for West Germany and 3.8% for France, while Japan's figure is only 0.89%.

In addition to the role of military expenses, reference may also be made to the low level of Japan's welfare commitments. The average percentages of transfer payments to national income in 1961-1970 in various countries are as follows: 20.8 per cent in France, 16.9 per cent in West Germany, 9.5 per cent in U.K., 7.0 per cent in the U.S., and 5.0 per cent in Japan. These ratios have tended to rise in each country; that is, in 1984, the U.S. ratio had grown to 15.1%, the U.K.'s to 18.7%, West Germany's to 21.5% and France's to 35.2% in comparison with Japan's 14.0%. Japan still has the lowest ratio, although the ratio has shown a markedly faster rise during the last decade.¹⁸

¹⁸ These figures are derived from unpublished estimates by the Japanese Ministry of Finance.

Cultural-political factors also appear to have some influence on the pattern of tax composition in postwar Japan. It is widely acknowledged that there are typically two tax styles in the world, each reflecting the cultural determinants of the tax system. One is the direct tax style (or at least an even split between direct and indirect taxes), and the other is the indirect tax style. Japan has preserved the former style in the postwar era, partially due to the American influence during the occupation period, i.e., the tax recommendations of the Shoup Mission in 1949. Had there been no Shoup Mission, Japan's tax system might have moved toward a different type of system with a greater share of indirect taxation.

II. *The Dawn of the Postwar Tax System: The Shoup Tax Reform*

2.1. *The Shoup Mission*

As was described above, cultural, political and social forces are equally as important as economic ones in determining the nature of a nation's tax system. For this regard, we must stress the significant role of the Shoup Mission in shaping the style of the tax system in postwar Japan. It is widely acknowledged that the postwar tax system in Japan was based upon the recommendations of the Shoup Mission in 1949 [see, for a more expanded discussion, (Ishi, 1987)].

The Mission, headed by Professor Carl S. Shoup, visited Japan in April 1949 at the request of the Supreme Commander for Allied Powers (SCAP).¹⁹ They stayed in Japan for about four months and investigated the Japanese tax system as well as its economic and social background. As a result of intensive studies, they presented to SCAP *The Report on Japanese Taxation by the Shoup Mission* in August 1949. The Japanese government attempted to reorganize the entire system of national and local taxes in accordance with Shoup's recommendations. The new system went into force with the next supplementary budget in 1949.

What were the main reasons for the visit of the Shoup Mission? Two points should be stressed. The first concerns the chaotic conditions of the postwar economy. Rampant inflation was raising havoc among business accounts, tax assessments, and revenue collection. The tax system was truly in a mess.

Second, there was mutual understanding between the U.S. and Japan as to the necessity of overhauling the tax structure and its administration after implementing the "Dodge Line."²⁰ The Shoup tax reform was not the first reform of the Japanese tax system during the occupation period, but earlier tax reforms had proved far from satisfactory [see Shavell (1948a,

¹⁹ In regards to the process of inviting the Shoup Mission, see Moss (1948), MOF (1977a). The Mission was composed of seven members, including S.S. Surrey, W.S. Vickrey, J.B. Cohen, H.R. Bowen, R.F. Hatfield, W.C. Warren.

²⁰ The "Dodge Line" is the name of the anti-inflationary program conceived by Joseph Dodge, an American banker, who was invited by General MacArthur in 1948 to evolve a formula for arresting runaway inflation. Dodge aimed at stabilizing the yen value by establishing a true balance in the consolidated budget and by eliminating the subsidies which had been the prime cause for the continuing growth of fiscal deficits. It was greatly successful in halting inflation, although a great depression ensued. See Cohen (1950), Yamanura (1967).

1948b)]. Consequently, an authoritative tax plan was absolutely required to revise the Japanese tax system to attain greater equity and efficiency. It was not simply a political expedient.

In the earlier years of the occupation, the tax system had developed certain defects which the Shoup Mission was asked to remedy. The most important defects were the following:

- 1) Individual income taxes had become higher and more progressive with low exemption and broad coverage. Heavier tax collection overwhelmed tax administration and weakened tax morale. Revenues were collected by the "goal system," in which each tax office was assigned a goal or quota.
- 2) Corporate income and excess-profits tax rates were high, and businesses were not permitted to adjust depreciation allowances to allow for drastic price hikes.
- 3) Tax sources remained concentrated at the national government, although a great volume of public functions were allocated to local governments (prefectures and municipalities) in the name of strengthening "local autonomy."

In addition to trying to remedy these defects in the tax system, the Japanese government negotiated with SCAP to achieve a substantial tax reduction (especially of the individual income tax) on behalf of taxpayers. SCAP, however, did not want to verify the necessity of such tax cuts.²¹ Thus, tax reduction became a crucial issue before the Shoup report was published.

Fortunately, economic conditions which had been improving prior to the beginning of the Shoup Mission favored its recommendations; inflation had been halted as a result of Dodge stabilization policy of 1948. Nevertheless, there were still a number of difficulties in the wake of the Shoup Mission. For instance, in view of anti-tax and anti-inflation sentiments in Japan, it was necessary for the Mission to include tax cut without unbalancing the budget.

2.2. *Basic Framework of the Shoup Report*

Similar to the Carter Report in Canada and the Meade Report in the U.K., the Shoup Report has been highly evaluated by many tax experts and has received considerable attention for a long time especially for its theoretical and logical consistency [see, for example, Hicks (1951)].

The Shoup Report had epoch-making significance in the history of Japanese taxation. In contrast to the tax reports noted above, most of the Shoup recommendations were put into practice in Japan, although a movement toward modifying them began very soon after implementation. The contribution of the Shoup recommendation to Japanese taxation should not be underestimated; throughout the postwar period, the Shoup Report has served as the benchmark of a well-designed tax system whenever Japan discusses tax reform.

The Shoup Report is generally considered to contain new and advanced views long cherished by Shoup, Surrey, Vickrey and other tax experts. The Shoup Mission attempted to reconstruct the Japanese tax system along lines generally familiar to American tax experts, and a number of novel features were designed to make the Japanese tax system "the best tax system in the world" (Shoup Report, vol. 1, p. ii) in a so-called experimental manner.

²¹ For a Japanese view, see E.S.B. (Economic Stabilization Board) (1949). However, Dodge completely disagreed with the request of tax reductions from the Japanese side. See SCAP (1949).

There are three points which characterize the Shoup Report as a whole. First, the fundamental aim of the Shoup Report was to establish a permanent and stable tax system in Japan over the long-term.²² Needless to say, the goal of the Shoup Mission was to create a modern tax system based on direct taxation. Alternatively, it would have been possible to choose another form of taxation, based upon the indirect tax. Indeed, the Japanese government preferred the indirect tax system, mainly because the Japanese tax system had favored indirect taxation during the prewar period.²³

Second, the whole tax proposal was intended as a single integrated plan. The Shoup Mission felt very strongly that the whole plan would be destroyed if any parts were eliminated. On this point, the Shoup Report argued very strongly that "What we are recommending here is a tax system, not a number of isolated measures having no connection with one another" (Shoup Report, vol. 1, p. ii).

By referring to "a tax system," they placed strong emphasis on the interlinkage among individual taxes. The Mission carefully considered the effect of individual taxes on one another. For example, personal income and net worth taxes, and succession and real estate taxes (the land and house tax) were investigated jointly. Furthermore, the principle of full inclusion of capital gains and losses in income taxes was closely related to the interrelationship between personal and corporate income taxes. It is evident from the basic idea of the Shoup Report that the whole income tax structure would be seriously weakened without full inclusion of capital gains and losses.

Third, among various tax criteria, most importance was placed on tax equity throughout the whole Report. In the Press Interviews immediately after the Shoup Mission came to Japan (May 19, 1949), Shoup himself greatly emphasized the importance of restoring fairness in the Japanese tax system as one of five objectives for his tax reform. Thus, the basic philosophy in support of tax equity is repeatedly argued:

"A tax system can be successful only if it is equitable, and the taxpayers must realize that it is equitable.—We have often encountered surprise at the emphasis we place on the search for equity. But no one remains in the tax field for long without realizing that nothing he recommends will stand up unless it meets the test of fairness in the distribution of the tax burden." (Shoup Report vol. 1, p. 16).

Turning to major parts of the recommendations, several points are worth noting. First, of most importance is the fact that the progressive and broad-based personal income tax was retained as the mainstay of the Japanese tax system. In retrospect, the individual income tax proposed by the Shoup Mission was really an ideal form of a comprehensive tax base with a single progressive rate system in the true sense of the term. Of course, this was the first time that anything of the kind had been attempted in an Asian country, although Japan had

²² At the time, the Shoup Mission seems to have thought that their proposed tax system should be preserved for more than ten years. Shoup referred to this point in retrospect when he came to Japan in 1972. See MOF (1972). Furthermore, long-term tax reform was possible because there was not an immediate need for revenue. Accordingly, the Mission recommend a tax plan which would only bear fruits in the long run.

²³ The Shoup Mission gave two reasons for not recommending an indirect tax system: (1) Such a system could raise the required revenue, but it would perpetuate gross inequities among taxpayers, dull the sense of civic responsibility, keep the local governmental units in uneasy financial dependence on the national government, and give rise to undesired economic effects on production and distribution. (2) Moreover, the difficulties in obtaining fair and efficient administration of the tax laws, and a high degree of compliance by the taxpayer in Japan should not be seen as inevitable.

experienced schedular income taxes since 1887 on a smaller scale.²⁴

Second, a major concern of the Shoup Mission's recommendations was the improvement of tax administration, especially of the income tax. For instance, withholding taxes at sources from wage and salary incomes and self-assessment with universal filing of returns were recommended. Furthermore, the use of the "blue form" for tax returns was especially suited to encourage the proper keeping of accounts, particularly in the case of small business. Obviously, these efforts to improve assessment and administration were indispensable for an effective and equitable tax system.²⁵

Third, a general revaluation of all assets (i.e., land and fixed capital) was recommended as a prerequisite for the adoption of the Shoup tax plan. Since the value of the yen had depreciated on the order of 200 or 300 fold since the prewar period, such a process of a revaluation would stimulate private capital accumulation. In addition, it was proposed that a tax of 6 percent be imposed on the appreciation in written value of all assets, although it would consist almost wholly of paper gains in terms of book value.

Fourth, great emphasis was placed on the reform of local finance in order to educate the Japanese in democratic citizenship. The provision of a fiscal framework for "local autonomy" was an important element of the Shoup proposal. The general recommendation of the Shoup Mission was that local powers and duties should be substantially increased, and in particular, priority should be given to the lowest of the three levels of government (i.e., municipalities). For this purpose, local governments were given new tax resources (e.g., property tax and value-added tax), and at the same time intergovernmental transfers were overhauled to implement a new scheme for the equalization of local budgets called the Equalization Grant Scheme.

Finally, the Shoup tax plan contained several novel fiscal experiments. The Mission suggested these experiments for Japan to try without the benefit of any large scale applications in other countries. Special attention was given to three of these: the net worth tax, the accession tax and the value-added tax, although they were minor in size.

2.3. *The Aftermath of the Shoup Tax Reform*

It is rare in history that a tax report is enforced in practice. The Shoup Report was almost wholly enacted in both the 1949 supplementary budget and the 1950 budget. The Shoup tax reform is interesting to tax reform experts as a case study of the accomplishments of a tax mission in a short period under ideal conditions. In seeking the necessary conditions for a successful tax reform, there seem to be a number of relevant factors to learn from the impact of the Shoup Mission.

However, from the very beginning, some of the Shoup tax plans were criticized as being too theoretical to be carried out, given the state of socio-economic development in postwar Japan. No doubt, the Mission thought of tax reform primarily in terms of American practice

²⁴ U.K. Hicks argued that the income tax was introduced under rather primitive conditions, "It is not the sort of economy in which one might, on a priori grounds, expect to be able to recommend a very large sphere for income and profits taxes (Hicks (1951), pp. 200-201). Also, see Kimura (1952).

²⁵ In addition, the Shoup Mission attached great importance to the provision of regular training for tax assessors and collectors, the establishment of training colleges and the improvement of pay and conditions of the tax administration.

and experience. This was apparent in such matters as the treatment of capital gains taxation or the emphasis on "local autonomy." Accordingly, modifications to the "Shoup tax system" were implemented shortly after 1950.

Two tendencies emerged from these modifications of the Shoup tax system. One tendency was the revival of the old system. Equity was sacrificed for the convenience of efficiency and administration. The other tendency was the reduction of the tax burden of firms, especially of big business. The goal of this trend was to give priority to the restoration of the postwar economy and the promotion of capital accumulation. Tax equity, on which the Shoup Mission put utmost priority, began to be replaced by efficiency as the criterion of taxation.²⁶ As time has passed, essential features of the Shoup plan have been "eroded" or "patched and tattered" by the later tax reforms of the Japanese government (see Appendix Table).

The most symbolic modification of the Shoup system occurred with the repeal of full taxation on capital gains from sales of securities in 1953. It has often been pointed out that the Shoup Mission was well aware of the shortcomings of the American tax system in respect to capital gains taxation, and that they tried to introduce better treatment of capital gains as an experiment in the Japanese situation. As noted earlier, the Shoup Mission repeatedly insisted on the need for capital gains taxation. In spite of their strong appeals, the actual capital gains tax mostly disregarded proceeds from security sales since 1953, partly because the difficulties of administration were great, and because the promotion of capital accumulation became a national goal.

In addition, the innovative tax devices of the Shoup Report have disappeared from the Japanese tax system after brief or no trials. The net worth and accession taxes were abolished in 1953 because of inadequate revenues and poor administration. The value-added tax was not even brought into operation; its enactment date was postponed twice, and it was finally repealed in 1954 [see, Ito (1950), Bronfenbrenner (1950)].

When the Japanese government departed from the Shoup system, its departure was not in the direction of further experimentation, but towards a return to prewar traditions and practices which it considered particularly suitable to the Japanese economic situation.²⁷ Thus, the tax innovations advocated in the Shoup Report were disregarded.

2.4. *Necessary Conditions for a Successful Tax Reform*

As mentioned earlier, the Shoup proposals were modified by the Japanese government. These modifications were drastic in their later consequences. Consequently, it may be argued that the Shoup reforms achieved only a partial success, largely because modifications gradually made the tax system more inequitable and complicated.

In spite of these drawbacks, the Mission's contribution in reconstructing the postwar

²⁶ In general, these modifications of the Shoup tax reform were accepted as inevitable by the Japanese. For instance, Hanya Ito commented on this point; "However, it is to be observed that the tax system in practice is a product of historical development depending on the social, economic and political conditions of time and place. It would not be wise to condemn such a course of events merely from the standpoint of abstract theory." (Ito (1953), p. 382).

²⁷ See, Bronfenbrenner and Kogiku (1957a), p. 241. Ito (1953) also argues that "Judging from the development of tax reforms these last three years, Japanese taxation is showing a tendency to restore the old system which was in effect before the Shoup recommendation." (p. 358).

tax system in Japan was considerable. Throughout the postwar period, the Japanese tax system has retained substantial features of the Shoup framework. Thus, the Shoup tax reform can be considered one of the most successful tax reforms in the world.

To conclude the preceding discussion, we shall seek to explore the necessary conditions for the successful tax reform, which was a rare event in history. Particular attention should be paid to the following three points.

The first, and most important point, is that the foundations on which the Shoup Mission was to erect the new tax structure in Japan had made a complete break with the past by the events of World War II and postwar inflation. Prewar values had become irrelevant as a basis of postwar taxation, and any former injustices could not be disregarded in view of the sweeping change that had affected all values. Furthermore, the changes recommended by the Mission were far less drastic than the overhaul of values that the Japanese experienced during the war. These circumstances facilitated the work of the Mission and encouraged them to experiment with innovative tax reform. To use Feldstein's terms, a "tax design," rather than "tax reform" was implemented (Feldstein (1976), p. 77).

The second point is that circumstances greatly favored the Shoup Mission. Seldom has any advisory mission received instructions as broadly defined as in the case of the Shoup Mission.²⁸ In addition, the Mission's arrival coincided with the introduction of a national program for the redirection of the entire economy, which had become feasible since economically chaotic conditions had settled down to a considerable extent. Thus, the Mission was implicitly given leeway for wide and sweeping changes in forming the tax plan. Of utmost importance was the fact that the Mission was supported by SCAP and General MacArthur. Reflecting this support from the highest authorities, the recommendations of the Shoup Mission received high priority consideration from the Japanese government. These circumstances put the Shoup Mission in an exceptionally favorable position as to the enactment of recommendations. The Japanese government and Diet acted with vigor in accepting nearly all of the tax proposals.

Third, from a professional point of view, the Shoup Report itself has been rated as one of the best tax reports and of the highest quality. The academic specialists of the Mission first followed the basic principles of taxation as developed in textbooks. Thereafter, they tried to link these theoretical considerations with the institutions of Japan, although they were handicapped by unfamiliarity with the Japanese tax system. It is often pointed out that the Shoup proposals are not only logical and well-balanced in theory, but can also stand the test of practicability to some extent. In the case of tax missions to other countries, when results generally fall short of expectations, the host countries often tend to refuse to enforce the proposals wholeheartedly. As far as the Shoup proposals are concerned, this tendency appeared to a minimum in Japan. The Japanese people would not have accepted the proposals if the Shoup Mission had prepared a defeating set of recommendations. Instead, the Japanese understood that they were to benefit from some of the best thought on tax issues which the Shoup Mission provided.²⁹

²⁸ Shoup himself mentioned in retrospect that General MacArthur did not interfere with the work of Shoup Mission, and refrained from making any special requests or issuing any orders in when they were writing the Report. See, MOF (1972).

²⁹ For a the discussion of the relationship between the Shoup Mission and Japanese taxation, see, for instance, Sundelson (1950), Bronfenbrenner and Kogiku (1957a) (1975b).

It is obvious from the above discussion that the conditions under which the Mission created a "tax design" for Japan were exceptional. They would never reappear in the future.

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APPENDIX TABLE

Shoup Mission Recommendation and Its Modifications (Major items only)

I. Personal Income Tax

Shoup Recommendation

Japanese Legislation (1949-56)

(1) *Type of tax*

To be single on an aggregation basis, not schedular.

Carried out.

Subsequent Japanese moves toward schedular income tax; e.g., special treatment of bank interest, dividend, retirement income, etc.

(2) *Top bracket rate*

To be lowered to 55% from 85% with eight income brackets.

Carried out.

Top bracket rate raised to 65% (1953) when net worth tax repealed.

(3) *Exemption, deduction and credit*

Personal exemption, dependent and earned income deduction to be reviewed.

Carried out.

Social insurance payment deduction (1953) and life insurance payment deduction (1951). Medical deduction (1950).

(4) *Capital gains and losses*

To be included in or deducted fully from income, and treated as form of fluctuating income with averaging system.

Carried out.

Both gains and losses from security sales disregarded (1953). Instead of it, security transfer tax introduced.

(5) *Interest income*

Source collection (separately from other income) to be abolished.

Carried out, but old system revived at 50% rate (1951); rate cut to 10% (1953); bank interest income made tax free (1955).

II. Corporate Income Tax (and Asset Revaluation)

Shoup Recommendation

Japanese Legislation (1949-56)

(1) *Corporate income tax rate*

Not to be increased above 35%.
No progression to be imposed.

Carried out.

Raised to 42% (1952); lowered to 35% on first ¥500,000 of income, 40% on the remainder (1955).

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| (2) <i>Excess profit tax</i>
To be replaced. | Carried out. |
| (3) <i>Revaluation procedures</i>
Land and depreciable assets to be revalued as of July 1, 1949. | Four revaluations carried out (1950, 1951, 1953, 1954); last revaluation made compulsory for depreciable assets of large-scale corporations.
Farm land not to be revalued until sold. |
| (4) <i>Tax on revaluation gain</i>
To be set at 6% of gain.
Payable in installment over 3 years for depreciable assets.
Payable for non-depreciable property at time of sale. | Carried out.
Repealed in connection with 1954 revaluation. |
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| III. National Indirect Taxes
<i>Shoup Recommendation</i> | <i>Japanese Legislation</i>
(1949-56) |
| (1) <i>Turnover tax</i>
To be repealed as soon as revenues permit. | Repealed as of Jan. 1, 1950. |
| (2) <i>Textile consumption tax</i>
To be repealed. | Carried out. |
| (3) <i>Alcoholic beverage excises</i>
a) Rates to be raised to pre-May 1949 level, with further increases as local liquor taxes are repealed. | Partially carried out. |
| b) Liquor consumption tax to be repealed. | Carried out. |
| (4) <i>Tobacco taxes (Monopoly profits)</i>
Prices of cheapest (rationed) cigarettes and cut tobacco to be reduced. | Never carried out. Tobacco prices increased by local tobacco consumption excises (1954). |
| (5) <i>Commodity taxes</i>
Rates to be reduced. | Substantially carried out. |
| (6) <i>Minor excises to be repealed</i>
Soft drinks | Never carried out. Soft drinks included in items subject to commodity tax. |
| Travelling (on the 3rd travel) | Carried out. |
| Registration and stamp taxes | Never carried out. |
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| IV. Local Taxes and Intergovernmental Fiscal Relations
<i>Shoup Recommendation</i> | <i>Japanese Legislation</i>
(1949-56) |
| (1) <i>Value-added tax</i>
Enterprise tax to become income- | Never carried out. Effective date postponed |

- type VAT exclusively at prefectural level. annually through 1953; tax repealed (1954). Enterprise tax remained in effect.
- (2) *Inhabitants tax (local income tax)*
- a) Allocation
To be reserved for municipalities. Carried out. Made partially prefectural (1954).
- b) Variable element
To be based on income alone, not property or social status as formerly. Carried out. National income tax used as standard. Takes form of 18% surtax.
Base may be (i) income tax
(ii) taxable revenue, or (iii) the difference (ii)-(i).
- c) Corporation to be exempted. Carried out. Corporations made taxable (1951), tax taking form of 15% surtax on national corporate income tax. Surtax lowered to 12.5% (1952).
- (3) *Property tax*
- a) Allocation
To be reserved for municipalities. Carried out. Made partially prefectural (1954).
- b) Coverage
To be extended to depreciable assets as well as real property, but not to inventories. Carried out.
- c) Assessment
To be based on capital rather than on rental values of property. Carried out, with capital values determined by selling prices and volume of business. Rate originally set at 1.6% of base, subsequently lowered twice. In 1955, 1.4%.
- (4) *Equalization Grant*
- a) To be established as replacement for shared taxes and partial subsidies, but approximately double total amount of former. Carried out. Equalization Grant System abolished (1954); Instead, new tax shared program introduced.
- b) Distribution among local units to be based on algebraic formulae involving and needs, for major activities. Carried out for 90% of grants (1951-54).
- c) Distribution element of income taxes to be eliminated. Carried out. 20% of personal income, corporate income and liquor taxes distributed to local governments (1954). Percentage raised to 22% (1955).

- (5) *National subsidy of local activities*
 Methods to be changed:
- a) 100% subsidies to be replaced by National government performance. Partially carried out. (In some cases, subsidy reduced instead).
 - b) Partial subsidies to be replaced by Equalization Grant (except for promotional purposes). Never carried out.

Note: This table is constructed, making reference to Bronfenbrenner and Kogiku [1975].

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