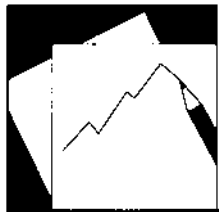


Working Paper

INTERNATIONAL MONETARY FUND



WP/08/70

IMF Working Paper

Japan's Corporate Income Tax— Overview and Challenges

Thomas Dalsgaard

IMF Working Paper

Fiscal Affairs Department

Japan's Corporate Income Tax—Overview and Challenges

Prepared by Thomas Dalsgaard¹

Authorized for distribution by Michael Keen

March 2008

Abstract

This Working Paper should not be reported as representing the views of the IMF.

The views expressed in this Working Paper are those of the author(s) and should not be attributed to the IMF, its Executive Board, or its management. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

The structure of Japan's corporate income tax system is broadly in line with those of other G7 countries. However, relatively high marginal and average effective tax rates prompt the question of whether adjustments should be considered to meet the objectives of promoting growth, investment and competitiveness in a revenue neutral manner. This paper discusses key issues and trade-off's related to changes in the corporate income tax system. It does not provide recommendations, but raises issues that could hopefully serve as useful inputs to the ongoing discussion and tax debate in Japan.

JEL Classification Numbers: H25

Keywords: Corporate tax; effective tax rates; investment location

Author's E-Mail Address: tdalsgaard@imf.org

¹ Senior economist at the International Monetary Fund. I would like to thank Michael Keen, Masaaki Iizuka and Ken Kang for helpful comments. All remaining errors are my own.

| Contents | Page |
|---|--------------------|
| I. Introduction | 3 |
| II. Macro-Fiscal Background..... | 3 |
| III. Key Features of Japan's Corporate Tax..... | 4 |
| IV. Diagnostics of the Corporate Income Tax | 6 |
| V. A Way Forward..... | 11 |
| VI. Conclusion | 18 |
| Figures | |
| 1. Tax Structure in the G7 Countries, 2004 | 4 |
| 2. Statutory Corporate Income Tax Rates in G7 Countries, 1990 and 2005 | 7 |
| 3. Present Discounted Value of Depreciation Allowances in G7 Countries, 2005..... | 8 |
| 4. Average Effective Tax Rates (AETRs) in G7 Countries, 1979–2005 | 9 |
| 5. Marginal Effective Tax Rates (METRs) in G7 Countries, 1979–2005 | 9 |
| 6. Composite Taxation of Dividend Income (Corporate plus Individual Tax), 2006..... | 10 |
| 7. METRs for Plant and Machinery in Manufacturing in G7 Countries, 2005 | 14 |
| 8. Tax Rates for Small- and Medium-Sized Enterprises in G7 Countries, 2006 | 15 |
| Boxes | |
| 1. The 2007 Tax Measures for Business and Capital Income..... | 5 |
| 2. Marginal and Average Effective Tax Rates..... | 7 |
| References..... | 19 |

I. INTRODUCTION

This paper reviews and discusses key features of Japan's corporate income tax as compared with those of the other G7 countries. The objective is not to provide a set of recommendations, but to raise issues that could hopefully serve as useful inputs to the ongoing discussion and tax debate in Japan.² Sections II and III outline the macro-fiscal background and provide a brief summary of main features of Japan's corporate income tax, while Section IV presents a set of diagnostics on the corporate income tax. Section V discusses key issues going forward and Section VI concludes.

II. MACRO-FISCAL BACKGROUND

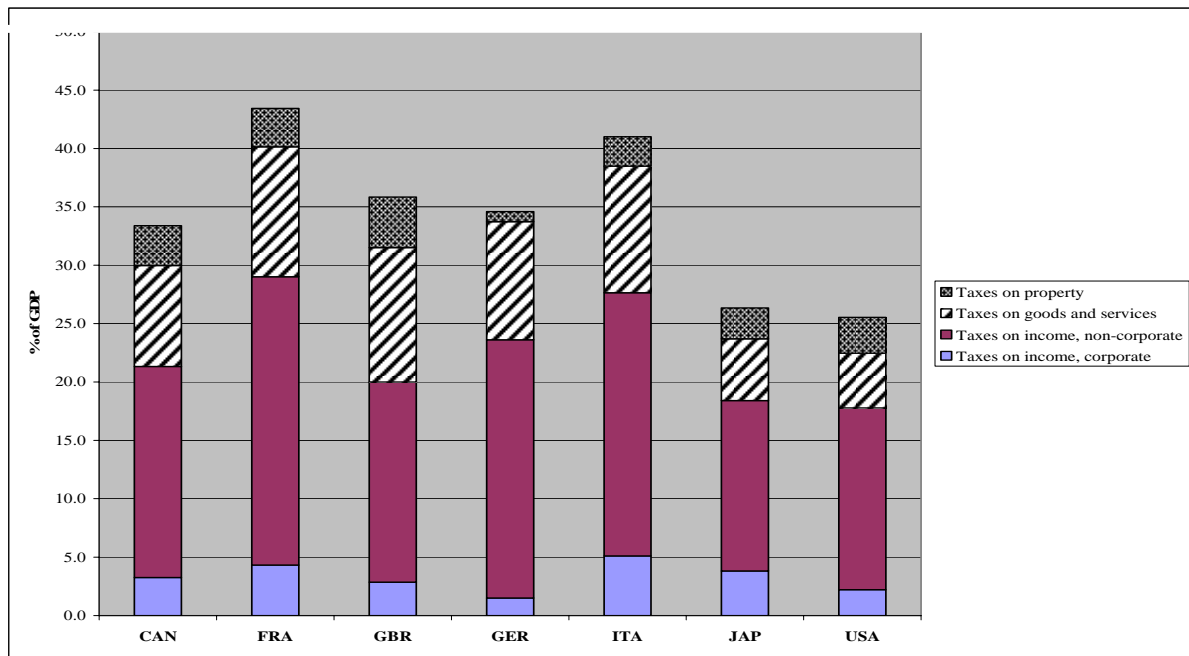
Despite recent improvements in the overall macroeconomic outlook, Japan continues to face substantial macroeconomic, structural, and fiscal challenges, as discussed in more detail in IMF (2007a). The latter, in particular, includes an urgent need for fiscal consolidation—after 15 consecutive years of budget deficits, government gross debt stood at about 180 percent of GDP by the end of 2006, much larger than any other OECD country. In addition, the fiscal burden from population aging is more substantial and will occur faster than in most OECD countries.

Tax revenues are low compared with other G7 countries, except for the United States (Figure 1). The main difference between Japan (and the U.S.), on the one hand, and the rest of the G7 countries, on the other, is that a much smaller amount of revenue is raised from consumption taxes. This primarily reflects that the VAT rate in Japan is one of the lowest in the world (5 percent compared with an average of 18 percent in the other G7s, excluding the United States and Canada³). Revenue from the corporate income tax, amounting to a little less than 4 percent of GDP, is broadly in line with that of the other G7 countries (and hence constitutes a larger share of total revenues in Japan).

² A broader overview of current tax policy issues and challenges in Japan is provided in IMF (2007b).

³ The VAT is partly a local tax in Canada, and rates vary considerably between provinces: the federal rate is 6 percent and the combined rate is 14 percent in three provinces in which federal government collects a combined Harmonized Sales Tax (HST) that includes provincial tax. Five provinces levy a provincial retail sales tax. Quebec imposes a VAT called the Quebec Sales Tax (QST). Alberta and the territories have no provincial sales tax.

Figure 1. Tax Structure in the G7 Countries, 2004



Source: OECD Revenue Statistics, 2006.

III. KEY FEATURES OF JAPAN'S CORPORATE TAX

The corporate income tax in Japan is relatively complex and has, in recent years, been characterized by temporary, often ad hoc, measures. The post World War II corporate income tax system was originally quite similar to that applied in West Germany, but changes over the past two decades have also reflected inspiration from other countries, notably the United States (Ishi, 2001).

The standard corporate income tax rate is 30 percent for the central government. In addition, there is a progressive prefectural scale, the so-called enterprise tax, with a standard top rate of 9.6 percent (deductible from the central government tax as well as from the enterprise tax itself) and the inhabitants tax, which is a surtax on the central government corporate tax levied at the prefectural and municipal levels (at 2006 standard rates of 5.0 and 12.3 percent, respectively). The all-in typical marginal rate is about 40 percent,⁴ but varies between different municipalities and prefectures: the enterprise tax may be increased by up to a factor of 1.1 and the inhabitants tax may be increased by up to 6.0 and 14.7 percent, respectively, in prefectures and municipalities. A reduced central rate of 22 percent applies to companies

⁴ The all-in marginal rate is calculated as $tc \cdot (1-te) \cdot (1+tip+tim) + te \cdot (1-te)$, where tc is the central government tax rate, te is the enterprise tax rate, tip is the prefectural inhabitants tax rate and tim is the municipal inhabitants tax rate.

with a capital of less than 100 million yen (and income below 8 million yen) and reduced local rates also apply to small- and medium-sized enterprises with capital less than 100 million yen.

Tax incentives are rather limited and often granted on a temporary basis.⁵ More long-standing incentives include a modestly accelerated depreciation scheme (consisting of the “increased initial depreciation” and the “accelerated depreciation”) for “blue return” taxpayers, i.e., those meeting minimum bookkeeping standard, and the “tax free reserves”— i.e., non-taxation of (part of) retained earnings for small family owned business and special projects. In addition, tax credits or other tax preferences are accorded to certain activities (R&D, energy conservation, pollution control) and to small- and medium-sized enterprises (SMEs).

The 2007 budget implemented a range of new tax relief’s for business, particularly aimed at improving the attractiveness of Japan’s depreciation system (Box 1).

Box 1. The 2007 Tax Measures for Business and Capital Income

The 2007 budget includes a number of tax measures. Key elements on corporate/capital income include: (1) increasing the depreciation rate used under the declining balance option (for instance the rate is increased from 20.6 percent to 25 percent for machinery with a 10 year life), thus improving the attractiveness of Japan’s depreciation system in comparison with the other G7 countries (the United States, for instance, applies a 20 percent declining balance on machinery with a 10 year life); (2) increasing the share of capital expenditures allowable for tax deduction from 95 to 100 percent; (3) extending temporary tax cuts for dividends and capital gains by one year; (4) shortening the depreciation period for high-tech manufacturing equipment (such as equipment used for production of semiconductors, plasma and liquid crystal display panels etc.) to 5 years; and (5) tax relief measures for small- and medium-sized businesses, including a full exemption from the taxation of internal reserves for businesses with total liabilities of less than 100 million yen, and a 2-year extension of existing tax breaks and incentives.

Buildings are currently subject to straight line depreciation only, while machinery and equipment can be depreciated using straight line, declining balance or any other approved method. The new 2007 depreciation rules place Japan ahead of most other G7 countries in terms of the generosity of the depreciation system for machinery (and some other items), while for buildings, Japan applies a useful tax life that is longer than in many other countries (Japan uses 50 years against e.g. 39 years in the United States). Other features of the corporate tax also seem a little less generous in Japan than for instance in the United States:

⁵ For instance, the FY2006 budget included an additional 5 percent tax credit for incremental research and development (R&D) investment and enhanced allowances for investment in information and communications technology, both measures which are limited to two years.

Japan allows for a 7 year carry-forward period (recently extended from 5 years), while the United States allows for 20 year carry forward; and Japan has stricter rules for tax consolidation within a group of companies, requiring 100 percent ownership, against 80 percent in the United States (allowing for tax consolidation at all is, however, a relatively recent feature in Japan, implemented by the FY2002 budget to alleviate the substantial lock-in of corporate capital at the time).

IV. DIAGNOSTICS OF THE CORPORATE INCOME TAX

The corporate income tax differs (moderately) in various respects from the mainstream G7 tax systems: the statutory rate, at about 40 percent, is on the high side, despite considerable reductions over the past two decades (Figure 2). Measures of the corporate tax base are more difficult to establish and compare across countries. A rough and ready indicator is the “revenue productivity,” which measures how much corporate tax revenue (as a percentage of GDP) is raised per percentage point of corporate income tax rate. High productivity indicates a relatively broad base, low productivity a relatively narrow base.⁶ Japan’s corporate revenue productivity, at about 0.096, is slightly above the G7 average of 0.092, indicating a base that is broader than average (United States and Germany displaying, by far, the lowest productivity numbers among G7 countries).⁷

Another indication that Japan’s corporate tax base is relatively broad is that depreciation allowances for buildings are less generous than elsewhere (Figure 3).

In combination with the relatively high statutory rate, this implies that both marginal and average effective tax rates (METRs and AETRs—see Box 2) are higher than in most other G7s (as shown below), thus representing more substantial distortions—i.e., disincentives to undertake marginal investments and barriers for multinational firms’ location decisions—than those of other G7 countries.

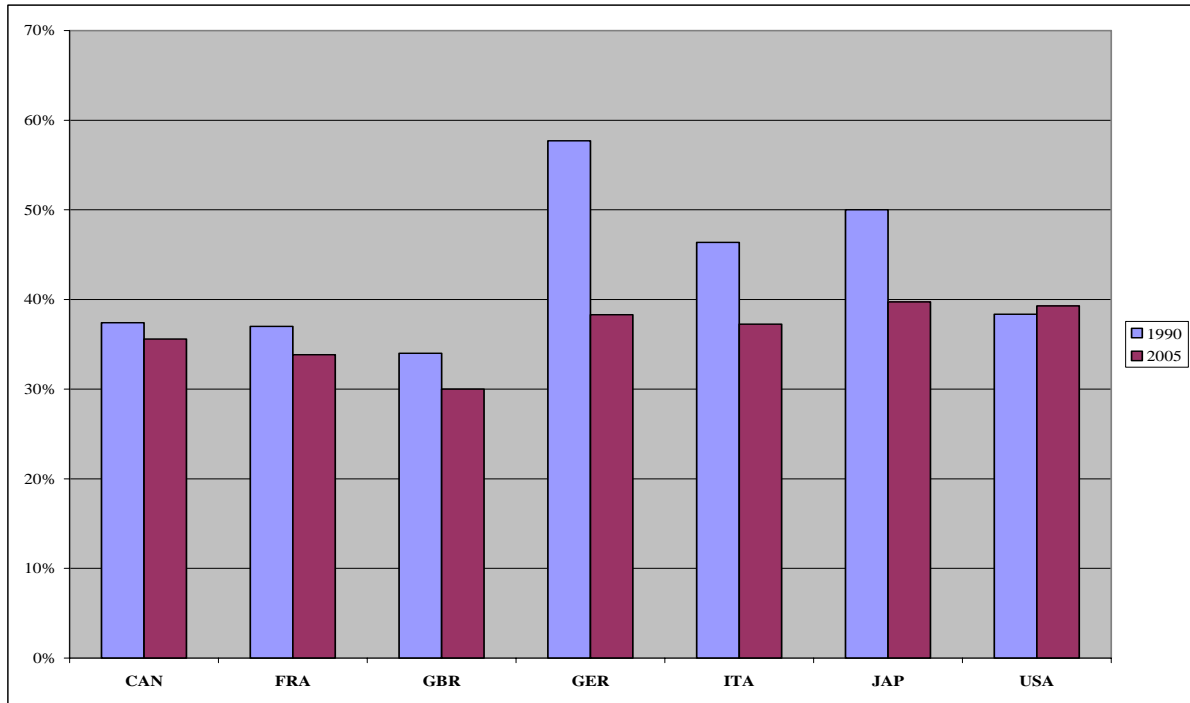
These issues are discussed in more detail in section V below, which also considers another aspect of corporate taxation and its effects on investment and location decisions, namely whether the tax system is based on the so-called residence principle (taxation of world wide

⁶ Comparisons based on such aggregate data should be interpreted with caution since they reflect not only the broadness of the base, but also the effectiveness of administration as well as a number of other factors such as the cyclical positions of the economies; their broader economic structures, as reflected in the composition of GDP; and the way business is organized (for instance, German firms are much less likely to be incorporated than firms in Japan and the United States. This means that Germany reports a lower share of tax revenue coming from corporate income tax—see Owens, 2006).

⁷ Note, however, that this might change in the future when accounting for the more generous depreciation rules implemented in 2007.

income, as applied by Japan, the United States and the United Kingdom) or the source principle (taxation of domestic income only, as applied by the other G7 countries).

Figure 2. Statutory Corporate Income Tax Rates in G7 Countries, 1990 and 2005



Source: Institute for Fiscal Studies' database. The rates include local taxes levied on corporate income, including the IRAP in Italy (though this is a value added tax that features a base that is broader than income). From 2008, the German federal corporate tax rate will be reduced from 25 to 19 percent, thus lowering the combined central and local rate to 33.6 percent.

Box 2. Marginal and Average Effective Tax Rates

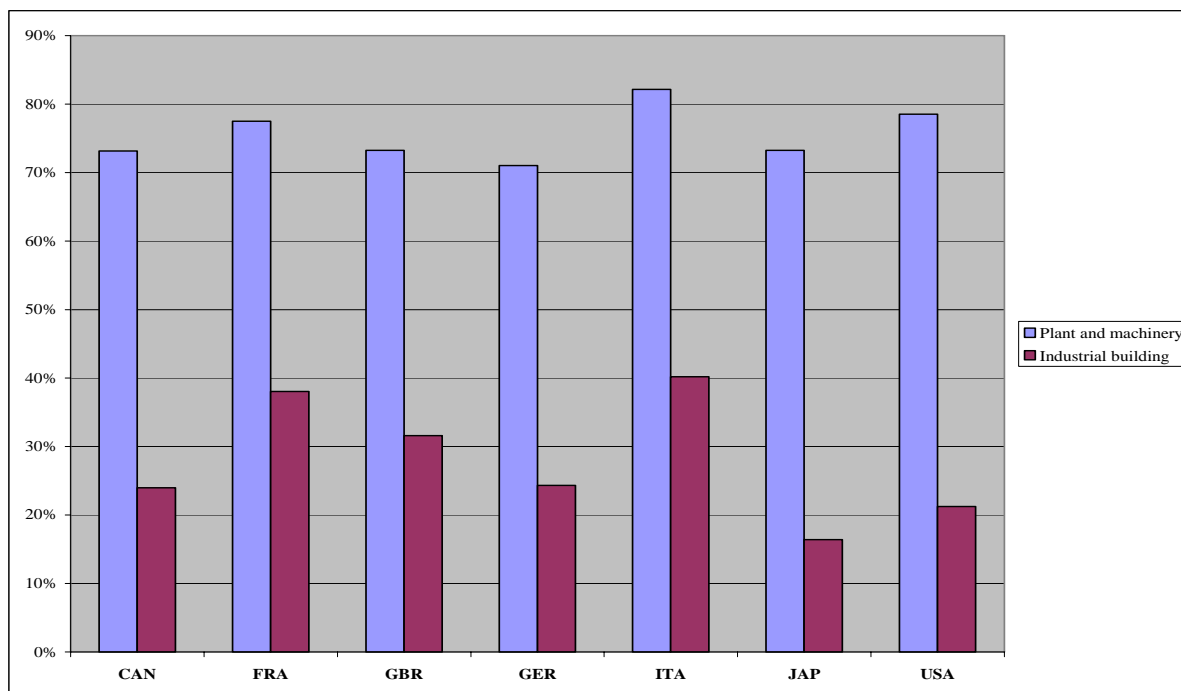
The **average effective tax rate** (AETR) is the ratio of the present value of the taxes that will be paid in relation to a particular project to the present value of the pre-tax profit it will yield.

The **marginal effective tax rate** (METR) is the proportionate difference between the pre-tax return on a project that just yields the required after-tax rate of return and that required return itself (expressed as a proportion of the former).

There is a straightforward relation between the AETR and the METR, which can be shown analytically: the AETR is a weighted average of the METR and the statutory rate.

Loosely speaking, one can think of the AETR as determining *where* an investment will be made—investors will obviously prefer to invest where the proportion of their pre-tax profit taken in tax is lowest—and the METR as determining *how much* investment will then take place (investors will invest less the higher the pre-tax return they have to earn in order to meet their required after-tax return).

Figure 3. Present Discounted Value of Depreciation Allowances in G7 Countries, 2005

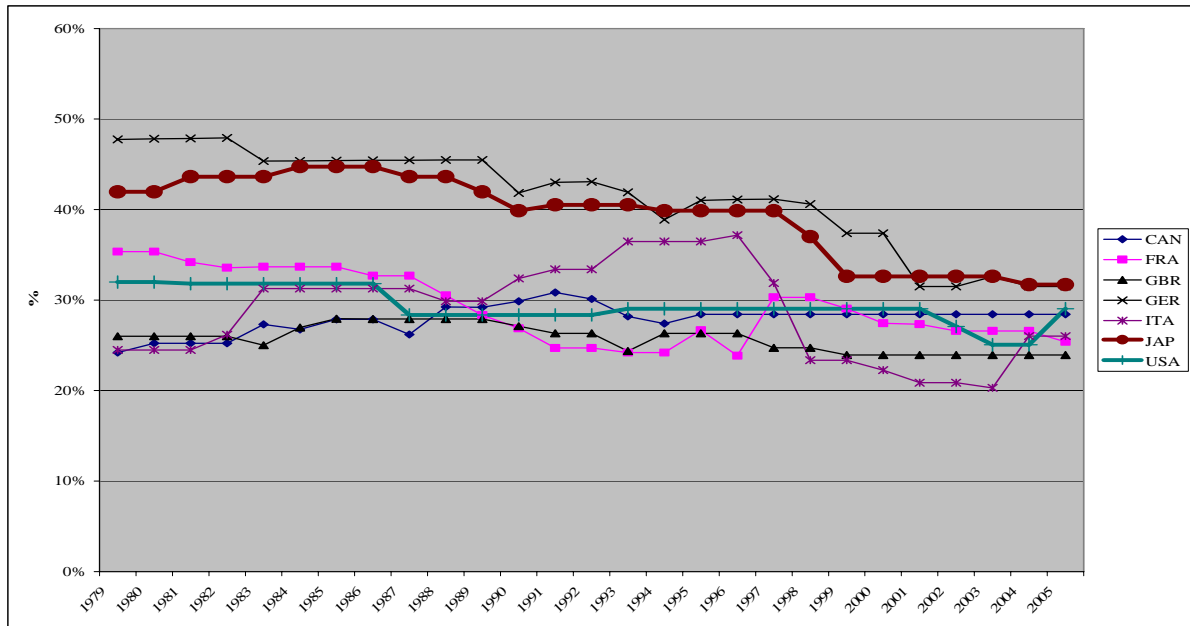


Source: Institute for Fiscal Studies' database. See Devereux, Griffith, and Klemm (2002) for definitions.

Looking at developments over the past two decades, Japan's corporate tax has changed in much the same way as those of other G7 countries, i.e., lower rates and broader bases – but also with a clear tendency for Japan (and Germany) to converge, from above, towards levels of AETRs and METRs found in the rest of the G7 countries (Figure 4 and 5).⁸ This mainly reflects the lowering of the top corporate tax rate from around 50 to around 40 percent in the late 1990s. One of the main base broadening efforts in Japan was the 1998 tightening of the rules for depreciation of industrial buildings (disallowing other methods of depreciation than straight line), while bases for plant and machinery remained largely unchanged.

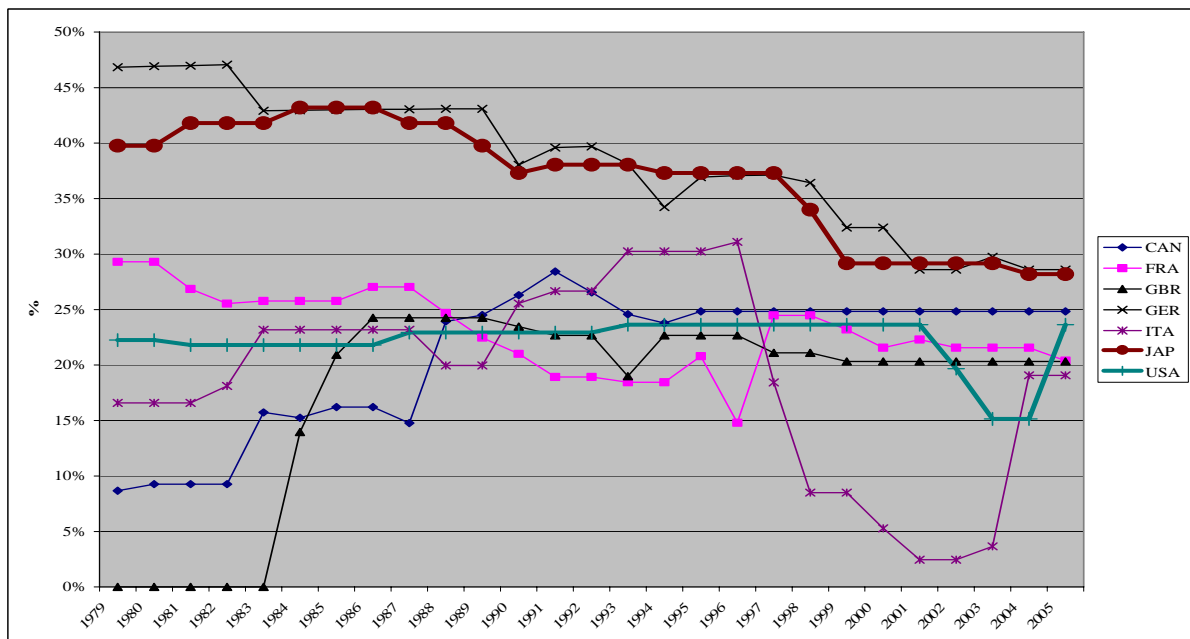
⁸ For a further discussion of METRs and AETRs, and a detailed exposition of their development in a larger cross country sample, see Devereux, Griffith and Klemm (2002).

Figure 4. Average Effective Tax Rates (AETRs) in G7 Countries, 1979–2005



Source: Institute for Fiscal Studies' database. See Devereux, Griffith, and Klemm (2002) for definitions. The AETRs are for plant and machinery financed by equity or retained earnings. Corporate taxes only.

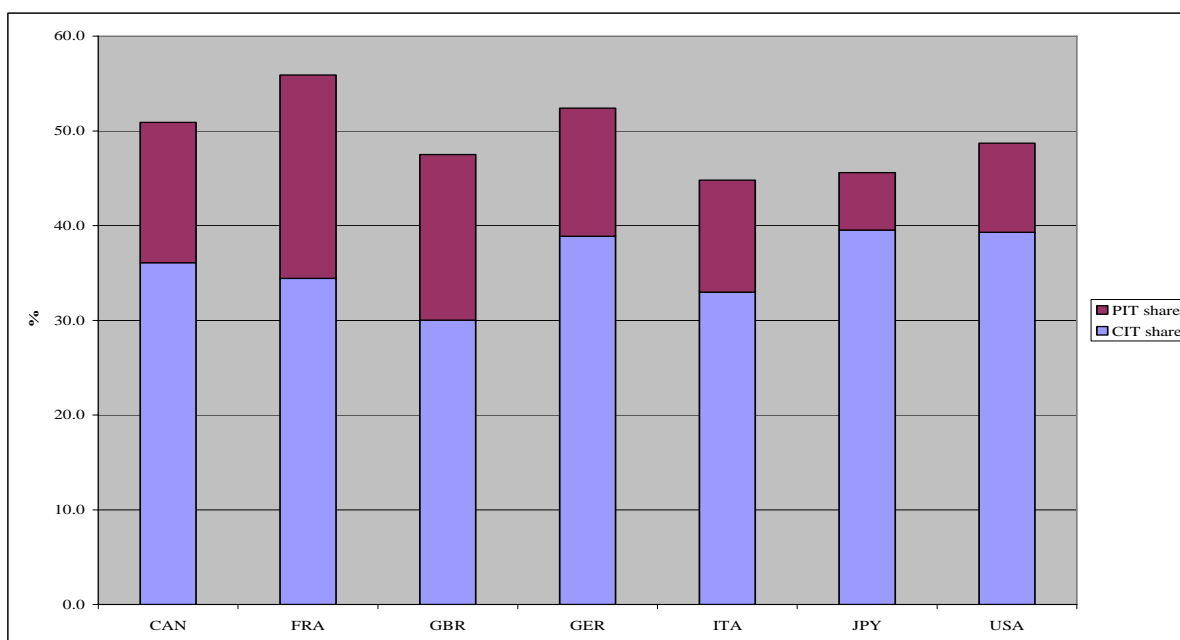
Figure 5. Marginal Effective Tax Rates (METRs) in G7 Countries, 1979–2005



Source: Institute for Fiscal Studies' database. See Devereux, Griffith, and Klemm (2002) for definitions. The METRs are for plant and machinery financed by equity or retained earnings. Corporate taxes only.

Considering also the personal side of capital income taxation, the composite corporate and individual taxation of dividends (also called the typical “all-in” rate on dividends) is not out of line with the rest of the G7 (Figure 6), but this is because the personal tax is lower than elsewhere (10 percent final withholding). Hence, the corporate share of total composite taxation of dividends, at 87 percent (the remaining 13 percent is personal income tax), is much higher than in other G7 countries, where the corporate share of the composite tax is about 70 percent on average (OECD Tax Database). To the extent investors are increasingly multinational or tax exempt entities (for instance pension funds), the corporate tax share of the total taxation of capital will gain importance and Japan’s relative position on overall taxation of dividends will deteriorate (except in cases where multinational investors receive a full tax credit in their home country for the underlying corporate tax paid in Japan).⁹

Figure 6. Composite Taxation of Dividend Income (Corporate plus Individual Tax), 2006



Source: OECD Tax database, 2006.

⁹ The tax rate on dividends and capital gains was temporarily lowered from 20 to 10 percent in 2003. The tax cut is set to expire in December 2007 (capital gains) and March 2008 (dividends), but the government has proposed a one year extension for both rates. When, and if, the dividend tax reverses back to 20 percent, Japan’s composite tax rate on dividends will increase from 46 to 52 percent. The United States currently also applies a temporarily lower rate (15 percent) on capital gains and dividends (through 2010).

V. A WAY FORWARD

Changes have been implemented in recent years, which overall have contributed to reducing distortions and bringing Japan's corporate income tax closer to that of other G7 countries (in particular by substantially reducing the statutory rate). Remaining differences—while not excessive—nevertheless suggest that there is scope for at least reviewing the corporate income tax system with a view to reducing distortions while not losing revenue. Some key issues are:

- What are the objectives for corporate income taxation?
- Is the tax rate/tax base nexus adequately designed to achieve these objectives?
- Is there a case for preferential treatment of SMEs?
- Should Japan consider moving away from residence based taxation?

Any change to the corporate tax system should also take into account the impact on local government finances, in particular given the large local element in the overall taxation of businesses.¹⁰ Reform plans might consider changes in the overall funding of local government (together with general tax increases, less reliance on corporate income taxes, for instance, could provide local governments with a more stable revenue stream, something that is often highlighted as a desirable feature of local government financing), but these issues are beyond the scope of this paper.

Objectives of the corporate income tax

The authorities have repeatedly stated that the key priority for the corporate income tax is to contribute to higher economic growth and productivity through promoting corporate investment and competitiveness.¹¹ Given Japan's need for fiscal consolidation, maintaining or even enhancing corporate income tax revenue could also be a priority. Straight tax cuts for corporations could potentially undermine efforts to increase public support for, and hence the likelihood of passing, tax increases in other areas.

¹⁰ The local corporate tax rate is about 11.5 percent on average (2006 data). Only Germany (17 percent) and Canada (14 percent) have higher subnational rates, while the other G7 countries apply somewhat lower rates (OECD Tax Database). The United Kingdom does not levy local corporate income taxes.

¹¹ These objectives are stated e.g. in the April 2007 report of the Council of Economic and Fiscal Policy (CEFP). Arguably, the corporate tax itself does not promote these goals, but since most countries find the corporate income tax indispensable for practical reasons, not least as a “backstopper” for the personal income tax, it could be argued that a more concise description of the goals of the corporate tax is to have as little adverse impact as possible on investment and competitiveness.

The question is, then, how to achieve these objectives in a revenue neutral manner. In order to answer that, some fundamental trade offs need to be considered. One concerns the choice between addressing the marginal versus the average tax rate, which are both relatively high in Japan, as shown above. It is unlikely that both could be reduced without losing revenue. Another trade off is whether all business and activities should be treated equally, or whether, in the pursuit of growth and competitiveness objectives, there should be some kind of specific treatment of SMEs. These, and other, issues are discussed below.

The tax rate/tax base nexus—addressing the METR or the AETR

Traditional investment theory emphasizes the importance of the METR in affecting the cost of capital and hence investment (see Jorgensen and Landau, 1993): reducing the METR will reduce the cost of capital and raise investment at the margin. In this model, the AETR has no effect on investment levels, since firms—and hence their investment—are assumed to be internationally immobile.¹²

However, a more recent branch of research has shown how investment levels can also be affected by the AETR in a world where businesses are internationally mobile and hence able to shift investment generating infra-marginal profits (or economic rent) to locations with lower average effective tax rates. In such a setting, it is often the AETR, rather than the METR, which determines the location decision (Haufler and Schjelderup, 2000). Empirical studies tend to find rather substantial effects of AETRs in determining location (Devereux and Griffith, 1998; Mooij and Ederveen, 2003), although these results are not uncontested and tend to vary considerably between studies (Hajkova and others, 2006).

To grasp the trade off involved, it might be instructive to consider the special case of capital expensing (100 percent deductibility in the year in which the capital expenditure is incurred): this would, in effect, be a cash-flow tax, lowering the METR to 0 (considering corporate tax only). No tax will hence be levied on normal returns and corporate tax revenue will only arise from infra-marginal returns. If firms are immobile, such returns can be taxed at high rates without adverse effects on investment, hence offsetting the revenue losses from the more generous investment allowances. However, if firms are internationally mobile, there would be a limit to the tax rate that can be applied to infra-marginal returns and base narrowing measures would likely be revenue reducing.¹³ It is exactly the competition for capital and tax revenue associated with the operations of multinational firms that is the likely

¹² A fundamental question, which will not be pursued further in this paper, is how sensitive investment is to tax induced changes in the cost of capital. Empirical studies from the United States find substantial variation in the elasticity of investment to tax changes (Chirinko, Fazzari and Meyer, 1999). Japanese studies generally seem to find relatively small elasticities (Tachibanaki, 1997), pointing instead to output-accelerator effects as the dominant explanation for investment behavior in Japan (Dalsgaard and Kawagoe, 2000).

¹³ An exception is where rents are location specific, but this is most likely to be the case in relation to extraction of natural resources and hence not relevant for Japan.

main driver of the trend towards broader bases and lower rates observed among the G7s (and most other OECD countries) over the past two decades (Devereux, Griffith and Klemm, 2002).

For Japan, these considerations provoke the question: can the current tax rate/tax base nexus be improved in order to better meet the government's objectives? The answer is not an easy one since lowering the METR through more generous allowances would require raising the statutory tax rate (and hence the AETR) and vice versa to keep revenue unchanged.¹⁴ Japan would hence need to decide whether the key issue is to retain and attract multinational investment (which would possibly require further base broadening and rate reduction), or whether to stimulate investment generated by "truly" domestic firms (which would possibly require more generous investment allowances).¹⁵

The room for further base narrowing measures (e.g. continuing relaxing depreciation rules following the 2007 changes) combined with higher tax rates to offset the revenue loss is limited, however, by the relatively high statutory tax rate. The real, or perhaps only, policy choice might hence be whether it is possible to find revenue-raising measures within the corporate tax system to pay for a moderate cut in the statutory rate. Since part of the effects of a rate cut would be to convey windfall gains to past investment (resulting in some government revenue loss without any behavioral effect), a rate cutting strategy could usefully be phased in over time to minimize revenue and deadweight losses.

Japan would also need to consider whether the current system excessively distorts investment and financing decisions. As in most other countries, and certainly all of the G7's, Japan's tax system favors debt financing over equity financing by allowing a deduction for interest costs but not for dividends or retained earnings (Figure 7).¹⁶ The system in Japan taxes plant and machinery, financed by equity or retained earnings, at marginal rates of about 28 percent, while marginal investment financed by debt is subsidized by a *negative* METR of about 40 percent. This implies not only a distortion of firms' financing decisions, making debt financing more attractive than equity financing for no other reason than taxation, but also

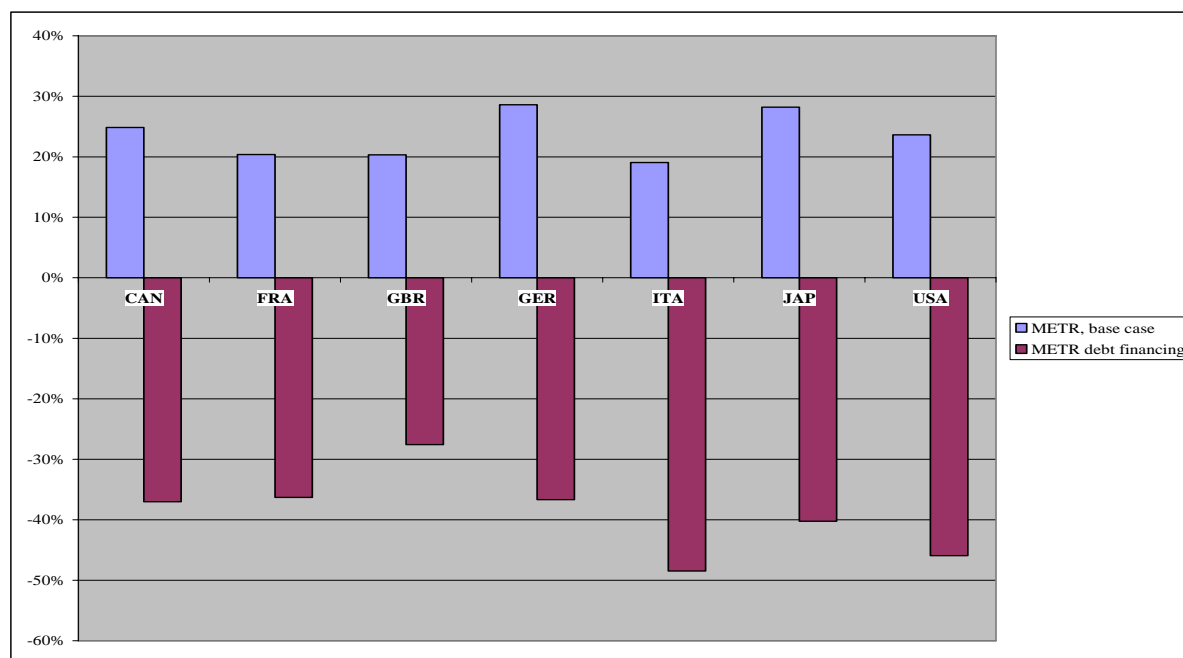
¹⁴ Reducing the statutory tax rate would obviously also tend to reduce the METR (at least on equity financed investment), but the base broadening measures needed to offset the revenue loss would weigh in the other direction.

¹⁵ One important aspect of this trade off is that the base broadening observed in Japan and the other G7s over the past two decades has happened in an environment of declining rates of inflation, which to some extent has moderated the impact on the cost of capital, and hence investment, of reduced investment allowances (high inflation, for instance, dilutes historical values of assets and hence the real tax value of depreciation allowances—thus, simultaneous falls in both inflation and tax rates have offsetting effects on the tax value of these allowances). Since inflation cannot be expected to fall further in the future, there is less scope for base expansion by reducing allowances without having a more noticeable impact on investment.

¹⁶ See The United States Congressional Budget Office (2005) for a recent comprehensive review of issues in corporate taxation and related distortions in the United States and internationally.

makes firms more vulnerable to adverse business cycle conditions (Feldstein, 2006). It might also discriminate against start-ups, which are often financed through new equity.¹⁷

Figure 7. METRs for Plant and Machinery in Manufacturing in G7 Countries, 2005



Source: Institute for Fiscal Studies' database. The base case refers to financing by equity or retained earnings. Corporate taxes only. See Devereux, Griffith, and Klemm (2002) for definitions.

Japan's corporate tax contains less of a subsidy for debt financed investment than in the United States and Italy, but slightly more than those in the other four G7 countries. Hence, overall, Japan does not seem to be out of line with other countries. It might nevertheless want to consider ways to mitigating this distortion (besides cutting the statutory CIT rate) —for instance by moving towards an allowance for corporate equity, or ACE system, as Belgium has recently done (see Klemm, 2006 for a recent review of country experience), or, less radically, by maintaining a relatively low personal tax rate on dividends and capital gains. Another approach could be to allow for integration of the corporate and personal income tax, i.e., allowing a tax credit at the individual level for any corporate taxes paid. Such a system, however, also involves difficult trade offs and might not be easily implementable, in particular because it raises international complications (Dalsgaard and Kawagoe, 2000). Internationally, there has been a tendency to move away from integrated taxation, in part driven by legal considerations within the EU. A final possibility is to pursue the approach

¹⁷ The subsidy to debt financed marginal investment would be reduced should Japan decide to lower its statutory corporate income tax rate. This would reduce distortions and likely also debt-financed investment.

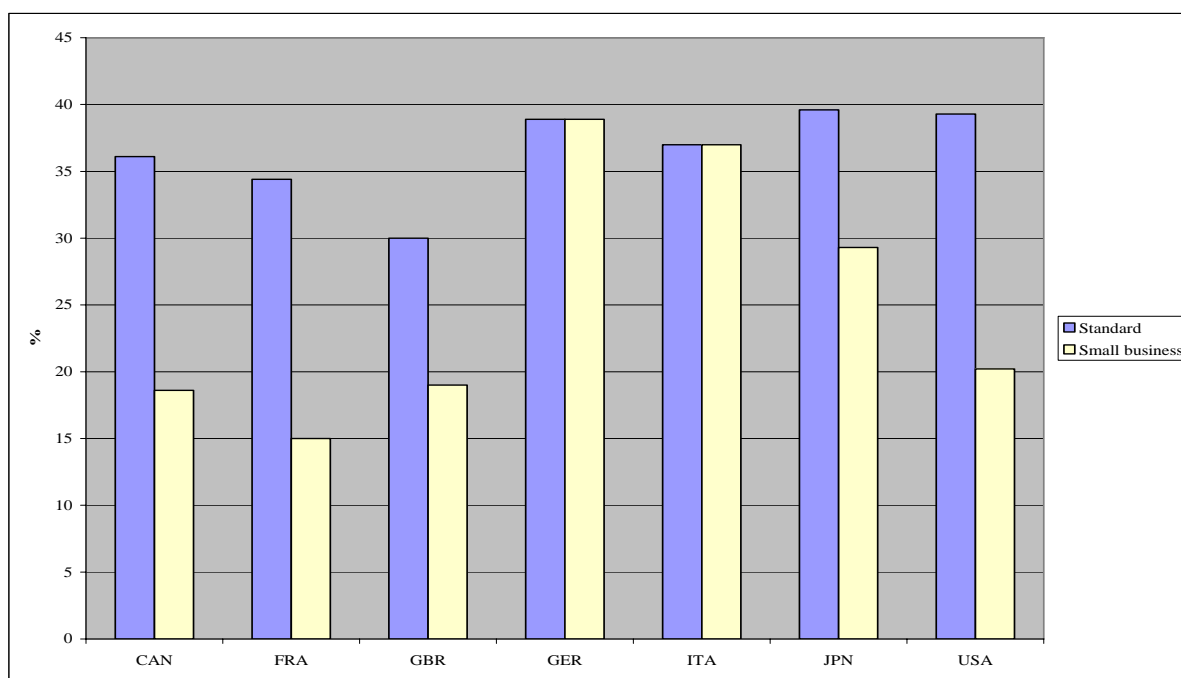
recently adopted by e.g., Germany and Denmark, where tighter limits are applied to interest deductions (i.e., a method that is “the opposite” of the ACE system).

Japan’s corporate tax also creates distortions across various kinds of investment, in particular by applying somewhat higher METRs on industrial buildings than on plant and machinery, but again, this is a feature shared with the other G7 countries (Dalsgaard and Kawagoe 2000). Possible solutions would be to allow for faster depreciation of buildings, but this would require revenue offsetting measures elsewhere.

Should SMEs receive preferential treatment?

The SMEs in Japan are taxed at about 30 percent, some 10 percentage points less than the standard rate (Figure 8). This tax rate incentive is less than that applied in the United States, Canada, France and the United Kingdom (Germany and Italy do not levy separate tax rates on SMEs).

Figure 8. Tax Rates for Small- and Medium-Sized Enterprises in G7 Countries, 2006



Source: OECD tax database, 2006.

In addition, the United States, for instance, applies a more narrow tax base to SMEs, which are allowed to write off some of their capital spending immediately within a limit of about US\$125,000 (a limit, which the Administrations FY2007 proposal envisage increasing

to US\$200,000).¹⁸ Japan also applies limited preferential tax treatment to investment of SMEs (in terms of accelerated depreciation and expensing of minor capital items).¹⁹

Encouraging SMEs to undertake investment is a key objective in many countries, since these firms are often perceived to be associated with growth and innovation.²⁰ They are typically also faced with constraints in their access to capital markets, which might provide some justification for measures to enhance their cash flows (at least temporarily).²¹

In any case, it might be worthwhile considering whether providing tax preferences to SMEs is most effectively done through tax rates rather than through more generous capital allowances. Following the discussion above, there could be a case for applying relatively high AETRs and relatively low METRs to business activity that is not mobile. It might hence be worthwhile for Japan to consider following the example of that recommended by the Tax Reform Panel on the United States and allow either significantly accelerated depreciation or immediate expensing of all SME capital spending (perhaps with the exception of land and buildings), while possibly also considering raising the tax rate to the standard rate.²² In other words, investment allowances, rather than low rates, may be a more efficient and better targeted tax strategy towards SMEs. A strategy of accelerated depreciation would also be in accordance with the potential need, noted above, to spur the immediate cash flow of these companies.

¹⁸ The presidential advisory panel on tax reform (2005) recommends unlimited expensing of most or all assets for businesses with an annual turnover of less than US\$ 1 million (in its most radical proposal, the Panel proposed full expensing of all capital spending by all enterprises, big and small).

¹⁹ The definition of SMEs in relation to taxation varies between countries. Japan generally defines SMEs as firms with capital less than 100 million yen. Canada's capital threshold is CAN\$ 15 million. France defines SMEs by turnover; the United Kingdom by profits; and the United States by various criteria, including capital, turnover, and employment.

²⁰ However, there is little firm evidence in the literature that subsidizing SMEs in general pays off in terms of social returns (i.e., no evidence that the cost of the subsidy is lower than any additional growth or employment effects created by the subsidy). Preferential tax treatment for SMEs might also act as a barrier for growth, since crossing the turnover or capital threshold implies a substantial hike in taxation. For a recent account of issues related to taxation of SMEs, see IMF (2007c).

²¹ Non-tax measures, such as subsidized loan programs, guarantees and grants, may also be applied to overcome capital market constraints for SME's. Such measures are widely used in Japan (Weichenrieder, 2007).

²² A complication for such a strategy is the local element of the business tax, which could spur additional competition for SME location in case the central rates are increased to standard levels (many SMEs might not be internationally mobile, but could still be capable of moving activities within Japan). On the other hand, an increase in the central government rate for SMEs could also force local governments to raise their rates in order to protect revenue (the base is likely to shrink when rates are increased). Such vertical externalities—i.e., the interplay between central and local rates—appear to be substantial in e.g., Germany (Buettner, Hauptmeier and Schwager, 2006) and should be taken duly into account when contemplating tax adjustments (Keen, 1998).

Revamping Japan's international tax regime?

Japan's tax system is currently based on the residence principle, i.e., individuals and businesses are taxed on their worldwide income and receive credits for income taxes paid abroad. The U.S. Tax Reform Panel (2005) has recently advocated a move to territoriality for U.S. corporations (implying that these would only be taxed on income sourced in the United States), mainly on grounds of simplicity—and to reflect that the residence based tax system, to a large extent, has been diluted by various loopholes—but also in an attempt to encourage repatriation of profits, which could then possibly spur domestic investment.

The issues discussed in the U.S. context are: what would such a move mean for investment (including FDI, both inward and outward); competitiveness of U.S. firms; tax avoidance (shifting profits abroad by such instruments as corporate inversions, transfer pricing, thin capitalization); and tax revenue (Mullins, 2006).

This debate might be relevant for Japan as well: the relatively high corporate tax rate in Japan places Japanese firms at a relative disadvantage in foreign markets (unless they choose not to repatriate profits). The discussion also needs to take into account that Japan, in contrast to the U.S., allows “tax sparing,” whereby tax incentives in the host country are fully absorbed by the Japanese company (i.e., it gets a tax credit for the full foreign tax, excluding any tax incentives). This implies that the FDI decisions of Japanese firms may be affected by tax conditions and incentives in the host country to a larger extent than are those of U.S. firms. This, in turn, has a significant effect on location decisions by Japanese firms (Hines, 2001).

The question arises as to whether turning to a source based tax system would pose more downward pressure on the statutory corporate rate in Japan – since it would then, at least in principle, become easier for firms to avoid domestic taxation by relocating activities overseas. Such pressures should be weighed against the potential benefits from increased competitiveness of Japanese firms in foreign markets.²³ Also, the international ramifications of adjustments in Japan's international tax regime would need to be taken into account: in particular, it might not be in the interest of other countries, in particular developing and emerging markets that are recipients of FDI, that Japan switch to a territorial system (as discussed in Mullins, 2006, this could lead to increased tax competition among these

²³ Some participants in the U.S. tax debate have also stressed the positive impact on repatriation of profits, claiming that moving to a territorial system would encourage repatriation and spur investment. Some of these arguments are based on the substantial increase in repatriation of profits observed in the United States during the 2005 temporary tax relief for repatriated profits (Mullins, 2006). However, it is much less clear that such a surge would be observed in case the change is permanent (possibly, there would be some first year effect resulting from the return to Japan of profits that have been “parked” overseas, but the effect would likely be smaller than that observed in the United States, which might also have included other kinds of reshuffling). In addition, it is not clear why repatriation as such, in a world of highly liquid and competitive capital markets, would provide a stimulus for investment.

countries), although the effects from a change in Japan's system would be smaller than a change in the United States, which does not allow for tax sparing.

VI. CONCLUSION

Japan's corporate tax system is broadly in line with those of the other G7 countries, distortions appears to be manageable and overall there seems to be little need for radical reform. However, average and marginal tax rates are slightly higher than in the other G7 countries, prompting the question of whether some adjustment should be considered. Such adjustments should be aimed at addressing, in a revenue neutral manner, the government's objectives of promoting growth, investment and competitiveness.

The tax measures for the 2007 budget contribute to lowering the tax burden on businesses and capital income and might well be warranted from a structural perspective, but they do not represent, and were not intended to represent (since more fundamental reform is still being deliberated), a coherent and comprehensive approach to changing the taxation of business income and capital.

This paper has raised a number of issues on Japan's corporate income tax system from an international perspective that might be useful when considering further reform of the system, including:

- Is there scope for changing the tax rate/tax base nexus to more effectively address the government's objectives without losing revenue?
- Should the main focus be on attracting multinationals or spurring domestic investment by SMEs—or could both be achieved at the same time?
- Could the tax rules be made more neutral in terms of corporate financing and investment?
- Should the international tax regime be reconsidered?

REFERENCES

- Buettner, Thiess, Sebastian Hauptmeier, and Robert Schwager, 2006, "Efficient Revenue sharing and Upper Level Governments: Theory and Application to Germany," CESifo Working Paper No. 1656.
- Chirinko, Robert S., Steven M. Fazzari, and Andrew P. Meyer, 1999, "How Responsive is Business Capital Formation to its User Cost: An Exploration with Micro Data," *Journal of Public Economics*, Vol. X.
- Dalsgaard, Thomas, and Masaaki Kawagoe, 2000, "The Tax System in Japan: A Need for Comprehensive Reform," OECD Economics Department, Working Paper No. 231.
- De Mooij, Ruud A., and Sjeff Ederveen, 2003, "Taxation of Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance*, Vol. 10 (November).
- Devereux, Michael P., and Rachel Griffith, 1998, "Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals," *Journal of Public Economics*, Vol. 68(3).
- , ———, and Alexander Klemm, 2002, "Corporate Income Tax Reforms and International Tax Competition," *Economic Policy*, Vol. 35 (October).
- Feldstein, Martin, 2006, "The Effects of Taxes on Efficiency and Growth," National Bureau of Economic Research, Working Paper No. 12201.
- Hajkova, Dana, Giuseppe Nicoletti, Laura Vartia, and Kwang-Yeol Yoo, 2006, "Taxation, Business Environment and FDI Location in OECD Countries," OECD Economics Department, Working Paper No. 502.
- Haufler, Andreas, and Guttorm Schjelderup, 2000, "Corporate Tax Systems and Cross-Country Profit Shifting," *Oxford Economic Papers*, Vol. 52.
- Hines, James R., 2001, "Tax Sparing and Direct Investment in Developing Countries," in *International Taxation and Multinational Activity*, ed. by James R. Hines (Chicago: University of Chicago Press).
- International Monetary Fund, 2007a, *Japan: 2007 Article IV Consultation: Staff Report, and Public Information Notice on the Executive Board Discussion*, IMF Country Report No. 07/280 (Washington).
- , 2007b, *Japan: Selected Issues*, IMF Country Report No. 07/281 (Washington: International Monetary Fund).
- , 2007c, *Taxation of Small- and Medium-Enterprises*, Background Paper for the International Tax Dialogue Conference, Buenos Aires, October 2007.

- Ishi, Hiromitsu, 2001, *The Japanese Tax System* (3rd edition) (New York: Oxford University Press).
- Jorgensen, Dale W., and Ralph Landau, 1993, *Tax Reform and the Cost of Capital: An International Comparison* (Washington: Brookings Institution).
- Keen, Michael, 1998, “Vertical Tax Externalities in the Theory of Fiscal Federalism,” Staff Papers, International Monetary Fund, Vol. 45, No. 3.
- Klemm, Alexander, 2006, “Allowance for Corporate Equity in Practice,” IMF Working Paper 06/259 (Washington: International Monetary Fund).
- Mullins, Peter, 2006, “Moving to Territoriality? Implications for the United States and the Rest of the World,” IMF Working Paper 06/161 (Washington: International Monetary Fund).
- Owens, Jeffrey, 2006, “Fundamental Tax Reform: An International Perspective,” memo, OECD’s Centre for Tax Policy and Administration, Paris.
- Tachibanaki, Toshiaki, 1997, *Public Policies and the Japanese Economy: Savings, Investment, Unemployment, Inequality* (London: Macmillan Press Ltd.).
- The President’s Advisory Panel on Federal Tax Reform, 2005, *Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System* (Washington: Government Printing Office).
- United States Congressional Budget Office, 2005, “Corporate Income Tax Rates: International Comparisons” (Washington: Government Printing Office).
- Weichenrieder, Alfons J, 2007, “Survey of Taxation of Small- and Medium-Sized Enterprises,” Center for Entrepreneurship, SME’s and Local Development, and Center for Tax Policy and Administration, Organisation for Economic Co-Operation and Development (Paris: OECD).