

THE JAPANESE CONSUMPTION TAX EXPERIENCE: LESSONS FOR AUSTRALIA?

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Great controversy has raged in Australia over the impact of the Goods and Services Tax at both the macro and microeconomic levels. In particular it has been argued that the tax imposes unacceptably high compliance costs on small businesses. Japan is said to be a country of small shopkeepers and so, not surprisingly, a similar controversy brewed when the Value Added Tax was first mooted for that country. To quell these concerns the Japanese consumption tax contains special features to minimize the impact on small business. This article explores whether there are any lessons for Australia from the Japanese experience.

1. INTRODUCTION

The history of the comprehensive Value Added Tax (“VAT”) dates from the late 1960s.¹ Since then it has become a global phenomenon. Australia has been one of the last industrialized nations to embrace it. Other recent conversions have been New Zealand in 1986, Canada in 1991 and Japan in 1989.

There has been little discussion of the relatively unique Japanese consumption tax from the Australian perspective notwithstanding that it was recently given a stamp of approval by the Organisation for Economic Cooperation and Development (“OECD”).² It is proposed to examine the features of the Japanese consumption tax, some of the

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¹ The history of the VAT is traced in CS Shoup, “Choosing Among Types of VATs” in M Gillis, CS Shoup and GP Sicat (eds), *Value-Added Taxation in Developing Countries* (1990).

² T Dalsgaard and M Kawagoe, *OECD Economics Department Working Paper No 231 – The Tax System in Japan: A Need For Comprehensive Reform* (2000).

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issues that arose at the time of its introduction, its subsequent history and the lessons, if any, for Australia.

2. THE JAPANESE INDIRECT TAX EXPERIENCE PRE-1989

Following World War II a turnover tax was implemented in September 1948. It applied to gross sales at the rate of 1% with some exemptions. However, this tax was repealed in 1949 due to its theoretical deficiencies in advantaging vertically integrated conglomerates over independent firms.

Soon after the Japanese taxation system was completely remodeled in accordance with the recommendations of the Shoup Mission.³ Whilst most of the recommendations of the Mission were adopted a recommendation in favour of a VAT was not taken up. The recommendation was rejected primarily because such a tax at that time was too innovative and the concept of value added was poorly understood.⁴ Had it been adopted then Japan would have been the first country to implement a VAT.

Rather until 1989 Japan persevered with a number of narrow based indirect taxes. The most significant of these was the commodity tax that was mainly a series of manufacturers' excises levied on specified goods. Taxable goods were divided into two categories, one group taxed at the retail stage and the other at the manufacturing stage. Different rates applied to each. Thus, as at 1988 ten products such as jewellery and furs were taxed at the retail stage at rates from 10 to 15% whilst 75 items including cars, cosmetics, cameras and electrical appliances were taxed at the manufacturing level at rates from 5 to 30%.⁵

³ *Report on Japanese Taxation by the Shoup Mission* (1949), republished by Japan Federation of Certified Public Tax Accountants Association in 1979.

⁴ Even Shoup subsequently appears to have accepted that the recommendation was flawed: CS Shoup, "The Tax Mission to Japan 1949-50" in M Gillis (ed), *Tax Reform in Developing Countries* (1989) 177.

⁵ See H Ishi, *The Japanese Tax System* (2nd ed, 1993) 13.

From the late 1970s the pressure to fund fiscal deficits induced the Japanese Government to consider the adoption of a broad based VAT. There was almost universal support for such a tax amongst academics and policy advisers.⁶ The narrow base of the existing indirect taxes was seen as creating distortions and, in particular, not taxing services. The taxes also tended to be discriminatory against imported products.

The first two modern attempts to introduce a VAT in 1979 and 1987 both failed for political reasons.⁷ The opposition to the tax came from those who feared revealing the information it would require⁸ and also from those concerned at the inequities contained within the tax system and the perceived wastefulness of government expenditure.

The second attempt was characterized by a more politically astute “Japanese style VAT” with many exemptions. This nevertheless gave rise to concerns regarding the administration of and compliance with the tax. These concerns, coupled with bribery

⁶ The support for the introduction of a VAT is illustrated in the survey of recommendations for reform in M Homma, T Maeda and K Hashimoto, “Japan” in JA Pechman (ed) *Comparative Tax Systems: Europe, Canada & Japan* (1987) 427. An exception is Toshiro Fuke who sees the introduction of the consumption tax, together with less progressivity in the income tax rates and the advent of the user pay fees, as generating a less fair tax system and damaging the egalitarian nature of Japanese society. He identifies the tax system as moving from an “ability to pay” principle to an “ability to buy” principle: “The Restructuring Phase of Tax Law in Japan. An Issue of Legitimacy Over a More Equitable and Fairer System Towards the 21st Century” in Y Zhang and T Fuke (eds), *Changing Tax Law in East and South East Asia - Towards the 21st Century* (1997) 163. The role of the consumption tax in contributing to a less equitable society is also acknowledged in T Tachibanaki, *Public Policies and the Japanese Economy: Savings, Investments, Unemployment, Inequality* (1996) ch 15.

⁷ For a detailed analysis of the political intrigue surrounding the introduction of the Japanese consumption tax see K Junko, *The Problem of Bureaucratic Rationality: Tax Politics in Japan* (1994). See also H Nagaharu, “A Tax Reform of Fraud?” (April-June 1989) 36 *Japan Quarterly* 127.

⁸ The 1987 version would have included a form of taxpayer identification number, a concept still highly controversial in Japan.

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scandals and other political misdemeanours, resulted in dramatic opposition to the tax and the Government was forced to withdraw it.

Whilst the political scandals resulted in the demise of the then Prime Minister the tax reform agenda continued. Public hearings took place and a redesigned and renamed consumption tax (“CT”) was proposed which would replace eight of the existing indirect taxes including the commodity tax. The list of exemptions was reduced with the resultant simplification of the tax and the lowering of the rate to 3%, the world’s lowest. The main exemptions retained were for only a few items such as education, medical care and welfare programs. Additionally small firms with annual sales of less than ¥30 million were to be exempt.⁹

An exemption for food was resisted primarily due to the difficult definitional issues that it would raise. The resultant regressivity of the tax was to be offset through increasing the income tax threshold and the progressivity of the income tax rates. In fact, there were very significant tax reductions so much so that tax reductions exceeded the additional tax revenue raised.

3. ISSUES SURROUNDING THE INTRODUCTION OF THE CT¹⁰

A number of issues pertaining to the introduction of the Japanese CT are relevant to the Australian experience.

⁹ There was to be no registration requirement although exempt taxpayers could apply for voluntary taxable status. There are, in fact, a number of reasons why small exempt businesses might wish to achieve taxable status. For example, input credits are then available, tax collected is available as an interest free loan until remittance and there is the potential for windfall gains from adopting the simplified scheme (described below).

¹⁰ For a detailed history and analysis of the tax see V Beyer and K Ishimura, “Consumption Tax (3) The Progress of the Japanese National Consumption Tax” [October 1993] *APTIRC Bulletin* 410; and V Beyer, “Japan’s Consumption Tax: Settled In To Stay” (2000) 10 *Revenue Law Journal* 98.

3.1 The Prime Minister Killer

It has been suggested that no other country has experienced such intense political turmoil as Japan when the CT was introduced.¹¹ In fact, the tax had been known as the “Prime Minister killer” as it had contributed to the demise of four Prime Ministers and, effectively, a change in government after 36 years. One study into this phenomenon identified that the CT was, in fact, championed by the bureaucracy who manipulated the politicians into endorsing it.¹² An alternative viewpoint is that the politicians played a courageous part in introducing a tax that they knew was unpopular yet necessary for the country’s economic well-being.¹³

The Government justified the introduction of the CT on the basis of the need to fund fiscal deficits and compensate for evasion and avoidance of the income tax. In contrast to the European Union (“EU”) countries it could not rely upon a EU directorate nor could it justify the tax as replacing an existing ineffective consumption tax. Furthermore, the timing was a mixed blessing because it was during a period when the US reform blue print was dominating world thinking and the US had rejected a national CT. However the so-called “bubble economy” of the late 1980s enabled the Government to introduce the tax at a time when the economy was seemingly prosperous.

This background explains many of the initial features of the Japanese CT designed to make the tax more palatable. The CT as initially introduced with its low rate and concessions for smaller businesses was designed to have a minimal compliance impact. In fact, initial opposition to the CT by small businesses and the self-employed quickly vanished when it was appreciated that a simplified calculation system and the infrequent remittance of tax to the Government provided them with windfall benefits. Furthermore, it

¹¹ Junko, above n 7, 3.

¹² Ibid.

¹³ JR Brown, *The Ministry of Finance: Bureaucratic Practices and the Transformation of the Japanese Economy* (1999).

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has been suggested that the absence of tax invoices ensured no opposition from those intent on evasion and loopholes in the income tax were deliberately perpetuated with a view to leveraging support.¹⁴

This did not go unnoticed. One commentator described the Japanese CT with its unique features as an “absurd mutation” which perpetuated inequities and estimated opposition to the tax at over 80% of the population. Nevertheless, backroom political deals ensured that the legislation was passed.¹⁵

However as the CT has become more entrenched in the community many of the compliance concessions contributing to the perceived inequities have been gradually wound back.¹⁶ The stage is now set for a more significant rate increase particularly as the Japanese community has been primed over the last few years for the need for such an increase in order to meet fiscal deficits.¹⁷

This gradual scaling up has prompted the suggestion that the initial introduction of a Japanese style CT might be a worthy consideration for those countries intending to ultimately establish a European style VAT.¹⁸

The Australian experience at introducing the tax was also traumatic. In 1985 the first proposal to introduce a VAT saw the then

¹⁴ Nagaharu, above n 7, 129.

¹⁵ Ibid 133.

¹⁶ Although the increase in the number of exemptions in 1991 was a retrograde step necessitated by the political reality of a coalition Government.

¹⁷ In a further effort to gain community acceptance for the Japanese CT there has been a suggestion to earmark the CT revenue to social welfare needs turning it into a virtual welfare tax: Y Noguchi, “Aging of Population, Social Security and Tax Reform” in T Ito and AO Krueger (eds), *The Political Economy of Tax Reform* (1992); and Japan’s Foreign Press Centre, *Japan A Pocket Guide, 2000 Edition* (2000) 115. This is not supported by the OECD: Dalsgaard and Kawagoe, above n 2. See also B Freiman, “The Japanese Consumption Tax: Value-added Model or Administrative Nightmare?” (1991) 40 *Am UL Rev* 1265, 1302-1303.

¹⁸ A Schenk, “Japanese Consumption Tax After Six Years: A Unique VAT Matures” [20 November 1995] *Tax Notes International* 1379.

Treasurer Paul Keating forced to withdraw it in the face of considerable public opposition. Subsequently in 1993 the tax was to win him the unwinnable election when the Opposition campaigned in support of the tax. It was only successfully introduced in 2000 after numerous exemptions, including an exemption for food, were negotiated by the opposition parties.

3.2 Inter-Governmental Fiscal Relations

Both jurisdictions did seek to obtain support from other government sectors by tying the consumption tax to inter-governmental revenue transfers. In Japan some of the excise taxes that were replaced by the CT had been prefecture and municipal taxes. To compensate for this lost source of revenue initially 20% of the CT was to be transferred to these local governments by means of a consumption transfer tax. Furthermore, 24% of the balance of the CT (ie of 80%) was to be appropriated to tax sharing grants paid to local governments. Thus in all 39.2% of the revenue from the tax was distributed to local governments.

In due course when the rate was increased to 4% this mechanism was altered such that a new local consumption tax of 25% of the national consumption tax was introduced. That is, a new local government consumption tax of 1%, replaced the transfer tax. The rationale for this was that the consumption tax was seen as an autonomous stable source of revenue for local government irrespective of economic circumstances.

In contrast, in Australia all Goods and Services Tax (“GST”) revenue is channeled to the States to compensate for the phasing out of a number of State taxes. Possibly such a politically astute move could have been justified in Japan given the plethora of local and prefecture taxes. Certainly the abolition of the Australian State taxes received wide support on the grounds of simplification and the reduction in the generation of economic distortions and collection costs. It also enabled the Federal Government to justify not conceding to calls for exemptions and where its hand was forced the shortfall in GST revenue was offset by a “deferral” in the phase out of some of the State taxes.

3.3 Effect on Prices

The Japanese Government was concerned at the potential for profiteering from the replacement of the excise taxes with the CT. Its response was threefold:

- A special council in Cabinet was established to consider any transitional problems, such as price increases, arising from the implementation of the tax.
- An advertising campaign was conducted and a telephone hotline opened to assist in an understanding of how to calculate the tax and to encourage consumers to lodge complaints about prices.
- A price monitoring system was implemented.

The evidence would suggest that these initiatives were successful and the change over to the CT had little net effect on prices. This was notwithstanding that there was almost a universal shifting of the tax on to consumers with the exception of some small businesses who, given the competitive market conditions, found it necessary to absorb a portion of the CT.¹⁹

Interestingly, the Japanese CT permits businesses a choice of whether prices are expressed inclusive of exclusive of CT. Studies at the time of the introduction of the tax indicated that only about 20% of businesses elected to price inclusive of CT.²⁰

The Australian Government was similarly concerned with the possibility of price exploitation. Specific legislation was enacted²¹ and the Australian Competition and Consumer Commission

¹⁹ Ishi, above n 5, 331-335.

²⁰ Ibid 335.

²¹ *Trade Practices Act 1974* (Cth), s 75AU; and the *New Tax System Price Exploitation Codes* enacted by State legislatures.

empowered to monitor and investigate price increases. Telephone hotlines and advertising campaigns also featured. Again, whilst there were cases of profiteering, in general the business community was compliant.

In contrast to the Japanese system it is mandatory for Australian businesses to price inclusive of GST.

3.4 Compliance Considerations

A major concern in both jurisdictions was the cost of complying with a consumption tax. As is discussed below, there are numerous features of the Japanese CT designed to alleviate this concern. Possibly as a result, the evidence was that the implementation of the tax was much smoother than had been anticipated. Even so surveys conducted soon after the introduction of the tax still identified that 72% of total respondents still complained about the compliance costs.²²

Compliance costs remain a major issue in Australia. Whilst the Government recently enacted measures to alleviate business concerns²³ the matter is likely to remain contentious. Thus the Japanese experience in this regard is of particular interest.

4. SPECIAL COMPLIANCE RELATED FEATURES OF THE JAPANESE CONSUMPTION TAX

As observed above, the subsequent reforms to the Japanese CT have mainly focused on scaling back the compliance cost minimizing features of the tax. Before considering how these features have evolved it is proposed to examine these features as originally enacted.

²² Ishi, above n 5, 336.

²³ *Taxation Laws Amendment Act (No 3) 2001* (Cth), which is discussed below.

4.1 Absence of Tax Invoices

On the basis that many Japanese businesses were either unfamiliar with sophisticated record keeping²⁴ and/or likely to oppose a record keeping requirement (because of the income tax implications) the tax was introduced without a requirement to rely on tax invoices to claim a tax credit. This departure from the European model was justified on the basis that the lack of tax invoices would minimize the compliance burden as the CT would only require that the same type of financial records be kept as required by the corporate and income taxes.

Thus the tax relies on an accounts method. That is, in order to compute CT reference is made to the purchases and sales figures recorded in the accounts.

4.2 Simplified Scheme for the Computation of the Tax

When introduced the legislation provided firms with annual sales less than ¥500 million the option to use a simplified method of computing the tax with a view to reducing compliance costs. Instead of calculating the total value of purchases, certain fixed percentages (10% for wholesalers and 20% for other businesses) were multiplied by total sales values and the result subjected to the CT rate.

Depending on the actual value added ratio enjoyed by a trader this scheme could be very advantageous. In particular the evidence was that service industries, which have a value added ratio of around 40%, benefited greatly from the simplified scheme as originally introduced. Studies identified that ¥400 to ¥500 billion of windfall gains accrued for every 1% of the CT. As this method was adopted by 64% of the total taxable enterprises in the 1991 fiscal year this

²⁴ Difficult to accept given the success of the “blue return” system designed to encourage the maintenance of records. See J Dabner, “Japan’s Income Tax System – Lessons for Australia” (2002) 12 *Revenue Law Journal* (forthcoming issue).

caused one commentator to refer to the measure as in reality not the exception but the rule.²⁵

4.3 Vanishing Exemption Method

Businesses whose annual sales do not exceed ¥30 million are not subject to CT. Whilst this is an extremely generous exemption threshold,²⁶ as originally enacted the exemption also gradually phased out up to annual sales of ¥60 million.²⁷

This shading out of the exemption has been justified on the basis that small but expanding businesses may not have considered themselves subject to CT and so may not have charged it but if at the end of the financial year their annual sales exceeded the threshold they would be liable for CT.²⁸ However this is difficult to accept given that the availability of the exemption was based on the annual taxable sales of the period two years before the tax year in question. Furthermore, businesses were exempt from CT during their first two years of operation.

In the absence of this mechanism there would arguably be an incentive for small businesses with annual sales approaching ¥30 million to elect to charge CT or, alternatively, under report their income.²⁹

4.4 Collection Periods

Businesses whose tax payable in the previous year was equal to or less than ¥600,000 were only required to pay the tax once a year.

²⁵ T Aoki, "Recent Developments Concerning Japan's Consumption Tax" (July/August 1994) 5(4) *International VAT Monitor* 197.202.

²⁶ In the OECD working paper it was observed that the ¥30 million tax exemption threshold far exceeded that of other OECD countries. It was recommended that the threshold be reduced: Dalsgaard and Kawagoe, above n 2. See also H Ishi. *The Japanese Tax System* (3rd ed, 2000) 393.

²⁷ This vanishing exemption was unique except for a similar regime in Canada.

²⁸ Beyer and Ishimura, above n 10, 412.

²⁹ Schenk, above n 18. 1385.

Larger businesses were required to pay the tax twice a year. This presented businesses with valuable interest free loans.

4.5 Subsequent Amendments

4.5.1 1991 Amendments³⁰

It was argued that the lack of tax invoices provided an avoidance opportunity whereas the simplified computation system, vanishing exemption and the opportunity for interest free loans contributed to the generation of inequities.

There was also concern with the general regressive nature of the tax prompting calls for further exemptions. The Government's argument that the distributional issues would best be served by a progressive income tax and carefully targeted transfer payments to poorer households was not convincing.

Major losses at the Upper House elections following the introduction of the CT induced the Government to implement reforms. Amendments in 1991 therefore included:

- Businesses whose tax liability exceeded ¥5 million were required to pay the tax four times a year.
- The deemed ratios of valued added under the simplified computation system were diversified into four categories: wholesalers (10%); retailers (20%); agricultural, fisheries, forestry, mining, construction and manufacturing (30%) and others (40%).³¹
- The threshold for the application of the simplified scheme was reduced from annual sales of ¥500 million to ¥400 million.

³⁰ For a detailed consideration of these amendments see Ishi, above n 5, 338-342.

³¹ There are special rules where business activities fall within two or more of the classifications which are discussed below.

- The threshold for the phasing out of the vanishing exemption was lowered from annual sales of ¥60 million to ¥50 million.
- The exemptions were expanded to cover birth expenses, cremation and burial costs, certain goods and services for disabled persons, certain welfare services, education and housing rents.³²

4.5.2 1994 Amendments³³

The period since the mid 1990s in Japan has been characterized by a slowing economy, falling government revenues and fiscal deficits. The Government has been caught between the need to reduce taxes to stimulate demand and the need to rein in the deficit. In November 1994 a compromise was attempted with the passing of amendments to increase the consumption tax rate but deferred until 1 April 1997 with the rate increase to be reviewed by 30 September 1996.³⁴

Amendments were also passed to further wind back the preferential treatment of small businesses.

Specifically:

- the effective rate was increased to 5%³⁵ with 1% being attributable to a new local consumption tax;³⁶

³² But not food as had been initially proposed in the amendment plan. Indeed one suggestion around this time was that in order to address the regressive nature of the Japanese tax and to make it more palatable to the growing Japanese consumer movement a credit system could be introduced whereby the CT paid on food purchases could be offset against income tax: Freiman, above n 17, 1303-1304.

³³ Generally see T Aoki, "Japan Recent Developments" [September 1996] *Asia Pacific Tax Bulletin* 278; and Y Ishizuka. "Japan Reforms Consumption Tax System" [4 November 1996] *Tax Notes International* 1515.

³⁴ On 21 June 1996 the Tax Commission finalized this rate increase. Subsequently on 26 June this was ratified by the Government.

³⁵ On 3 February 1994 the then Prime Minister Morihiro Hosokawa had announced that the rate would be increased to 7% and the tax dedicated as a welfare tax. On the following day he was forced to retract this proposal by his own party: Aoki, above n 25,203.

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- an exemption for the first two years of newly incorporated companies was effectively repealed; and
- the threshold for the application of the simplified scheme was further reduced to annual sales of ¥200 million.

Significantly the substantiation requirements to claim an input credit were also strengthened by requiring that businesses retain bills, receipts, invoices and other documents supporting any purchases. These were to be in addition to the existing requirement to maintain books that recorded particulars of purchases and delivery dockets and bills that identified these particulars. However invoices were not required for purchases less than ¥30,000 or where there was a reasonable justification for not retaining an invoice and the vendor's address was specified in the books of the business.

*4.5.3 1996 Amendments*³⁷

In a further reduction in the preferences for small businesses the following changes were made with effect from 1 April 1997:

- the deemed profit ratio for the services, transportation, communications and real estate industries was increased to 50%;
- the ¥5 million threshold for lodging quarterly returns was reduced to ¥4 million and the threshold for lodging six-monthly returns was reduced from ¥600,000 to ¥480,000; and
- the vanishing exemption was abolished.

³⁶ That is, 25% of the national tax of 4% Ishi identifies problems with this local consumption tax: Ishi, above n 26,299.

³⁷ See generally Aoki, above n 33.

5. TWO CONTROVERSIAL FEATURES

Prior to concluding and considering the lessons for Australia in the Japanese experience it is appropriate to further examine the two most contentious elements of the Japanese CT.

5.1 Tax Invoices v Accounts Method³⁸

As is often the case with tax policy, those aspects of the Japanese CT that simplify the tax and reduce compliance costs also create inequities and provide avoidance opportunities. This may especially be true of the lack of the requirement for tax invoices and, in particular, the opportunity for businesses to claim input credits upon purchases from exempt entities.

The lack of tax invoices has been criticised for reducing the neutrality of the CT between different enterprises and exports and home produced products.³⁹ Also it has been suggested that this feature makes enforcement of the CT difficult. The difficulty is that an audit trail cannot be traced to tax invoices but the veracity of the accounts must be relied upon.⁴⁰ It has been suggested therefore that the accounts method sacrifices ease of administration for ease of compliance. However the reality is that countries with a tax invoice system rarely carry out cross checking of invoices as this is impractical given scarce administrative resources.⁴¹

³⁸ For a discussion of the differences between these two approaches see A Schenk, "Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?" (1987) 7 *VA Tax Rev* 207; A Schenk, "Policy Issues in the Design of a Value Added Tax: Some Recent Developments in OECD Countries" [1989] *Tax Notes International* 111, 124; and A Turnier, "Designing an Efficient Value Added Tax" (1984) 39 *Tax L Rev* 435.

³⁹ K Messere, *Tax Policy in OECD Countries; Choices and Conflicts* (1993) 377. Ishi suggests that the accounts method is deficient particularly in its treatment of exports and the potential for cheating: Ishi, above n 26, 392.

⁴⁰ For example see M Homma, "Tax Reform in Japan" in T Ito and AO Krueger (eds), *The Political Economy of Tax Reform* (1992) 81. Homma's comments are echoed by Noguchi, above n 17.

⁴¹ Freiman, above n 17, 1285-1287.

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The lack of tax invoices does, however, make it difficult to distinguish between goods on which the tax was paid and goods that were acquired tax free. Input credits are calculated simply as a percentage of purchases. This provides the opportunity to claim credits on purchases from exempt small businesses. In this way the inequities created by the compliance cost reduction features build on each other.⁴² The accounts method will only be satisfactory in this respect where there are no exemptions and only a single rate of tax.

Notably the recent OECD working paper on the Japanese tax system suggested that the single tax rate and the requirement to keep trade documents meant that enforcement of the CT was probably not hampered much by a lack of tax invoices. Thus the introduction of tax invoices was not considered essential.⁴³

Whilst the substantiation requirements have been strengthened by the 1996 reforms there is still a difference between the compliance burden of the Japanese CT and a classic tax invoice model. Under the Japanese invoice rules the substantiation requirements are directed at proof of the amount of purchases rather than as to whether the purchases carried with them input credits.⁴⁴

There seems to be some confusion amongst commentators, however, whether a tax invoice is required since 1 April 1997 in order to claim an input credit.⁴⁵ The better view is, arguably, that an

⁴² However it is conceded that but for this deemed credit feature small exempt businesses might be coerced into paying the tax to enable them to pass on credits in order to placate their large business customers.

⁴³ Dalsgaard and Kawagoe, above n 2.

⁴⁴ See H Ishi, "Japan" in K Messere (ed), *The Tax System in Industrialised Countries* (1998) 256.

⁴⁵ Zolt suggests that prior to 1 April 1997 taxpayers had a choice to claim input credits by either relying on their books or producing invoices showing CT paid. After that date, however, invoices were necessary to claim a CT credit: EM Zolt, "Prospects for Fundamental Tax Reform: Comparisons Between the United States and Japan" [10 May 1999] *Tax Notes International* 1969. Similarly see International Bureau of Fiscal Documentation, *Taxes & Investment in Asia and the Pacific, Japan, 430 Consumption Tax* (1998) para 40.3. Contrast Schenk, above n 18, 1386.

invoice is not required. Whilst an invoice will be necessary to substantiate that a “taxable purchase” occurred a tax invoice in the strict sense of indicating or identifying the CT charge on the transaction is not required. Thus a “transfer of taxable assets” from an exempt small business will nevertheless enable the purchaser to claim an input credit even though no CT was charged on the transaction.⁴⁶

It has been suggested that a true tax invoice system will eventually be implemented.⁴⁷ In fact a 1993 Tax Commission report recommended its introduction at the earliest opportunity.⁴⁸ More recently the Ministry of Trade and Industry has supported the introduction of a true tax invoice system to address delinquencies in payment and the problem of CT windfalls upon purchases from exempt taxpayers. However the latter is not necessarily a feature of the lack of tax invoices as the accounts method could be modified to require that purchases from exempt taxpayers be separately accounted for. Admittedly, enforcement in the absence of tax invoices might be difficult.

In addition to reducing compliance costs a further possible benefit of the accounts method is that it probably allows a VAT to be more speedily implemented.⁴⁹ For example, the Japanese CT was implemented within three months of the enactment of the legislation.

Notably Canada flirted with the idea of not requiring tax invoices but ultimately adopted a European style VAT.⁵⁰ Thus the feature remains uniquely Japanese.

⁴⁶ See Y Gomi, *Guide to Japanese Taxes 2000-2001* (2000) para 8-530 and following; and Schenk, above n 18, 1386.

⁴⁷ Aoki, above n 25, 199.

⁴⁸ *Ibid* 203.

⁴⁹ Freiman, above n 17.

⁵⁰ Ministry of Finance, Canada, *Tax Reform 1987: Sales Tax Reform* (18 June 1987) 55.

5.2 Simplified Scheme

Although the threshold for the adoption of the simplified computation scheme has been reduced considerably from annual sales of ¥500 million to ¥200 million it remains a significant concession.⁵¹

As noted above, the scheme has been the subject of criticism in the potential for a windfall gain for businesses if the margin percentages are set too low and the amount of tax they levy exceeds the amount they pay. This is especially a possibility should they be purchasing goods from exempt businesses. As a result there have been calls to abolish the scheme or, at least, to scale back the benefits it provides and reduce the threshold for the small business exemption.⁵²

On the other hand, possibly there is merit in this scheme given that at the smaller business extreme the amount of foregone revenue may be insignificant, certainly relevant to the compliance effort that would otherwise be required.⁵³ This revenue loss might be minimized with careful selection and continuous monitoring of the margin percentages based on empirical analysis.

The compliance advantages of the simplified scheme arguably encourage small businesses to register and not to embark upon evasion activities. It might be suggested that whilst less tax revenue is raised this is better than none at all. On the other hand, it is to be conceded that this argument is dependent upon a low general rate

⁵¹ Over 95% of all firms in Japan initially qualified for the simplified scheme. It has been estimated that the percentage of eligible businesses declined to about 50% with the reduction of the eligibility threshold to ¥200 million: Schenk, above n 18, n 79.

⁵² Ibid 1393. He also recommends the reduction in a number of exemptions together with the introduction of specific valuation and timing rules. Aoki, above n 25, 197-205 and Homma, above n 40. Homma's comments are echoed by Noguchi, above n 17; and Ishi, above n 26, 391

⁵³ In 1993 approximately 60% of taxable businesses elected to use the simplified scheme. It has been estimated that the taxable sales made by these firms represented less than 10% of all taxable domestic sales: Schenk, above n 18, 1389-1390.

and the scheme does generate administrative complications. Nevertheless, these advantages have persuaded one commentator to recommend the Japanese style CT with its simplified scheme and accounts method for the US. It is seen as a good compromise between simplicity, efficiency and equity.⁵⁴

Finally, one effect of the simplified scheme is to turn the CT into a turnover tax at rates specific to the type of business. It has been suggested that it has the potential to encourage vertical integration by firms but as the feature only applies to small to medium businesses this is unlikely to be an issue in practice.⁵⁵

6. LESSONS FOR AUSTRALIA?

Compliance costs, particularly for small business, were and continue to be, a major issue in Australia and Japan. With this in mind the Japanese tax contains:

- a generous exemption threshold for small businesses (AUD\$460,000 turnover initially phased out up to AUD\$920,000);⁵⁶
- a simplified computation method for medium size businesses (AUD\$3 million turnover, down from AUD\$7.7 million);
- avoids the use of tax invoices; and
- quarterly returns are only required of businesses with an annual tax payable of AUD\$62,000 or more (down from AUD\$77,000 and initially not at all) otherwise six-monthly

⁵⁴ Freiman, above n 17. The availability of the accounts method would be restricted to small businesses.

⁵⁵ CS Shoup, "Tax Reform in Japan" (1990) 7 *Australian Tax Forum* 411. See also Homma, above n 40; and Noguchi, above n 17.

⁵⁶ All currency conversions are at a representative rate of ¥65 to AUD\$1 and rounded for ease of comparison. In 1992 the small business exemption was estimated to apply to about 60% of businesses in Japan although only accounting for 2 to 3% of total domestic taxable sales: Schenk, above n 18, 1384.

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returns are required for businesses with tax payable in excess of AUD\$7,400 (down from AUD\$9,200).

6.1 Exemption and Simplified Computation Scheme

Whilst the Australian tax provides an exemption for small businesses with GST supplies of less than \$50,000 and a simplified computation method these concessions are much more limited in comparison to the Japanese concessions. In particular, the Australian simplified computation method is limited to small food retailers to spare them the task of identifying products that fall within the definition of food. Food retailers who sell a mixture of food and other products and who do not have adequate point of sale equipment to record the mix of taxable and non-taxable sales may choose between one of three simplified accounting methods. Essentially these are to either apply the standard percentages of GST free and taxable sales and purchases set by the Australian Taxation Office, apply percentages derived from a snapshot of their business activities or, in some cases, GST free sales can be based upon the percentage of the GST free purchases.⁵⁷

Although these simplified methods were initially only available for a business with an annual turnover less than \$1 million it was recently announced that a transitional rule extending the concession to retailers with turnovers up to \$2 million was to be retained as a permanent feature.⁵⁸

The main compliance advantage of the Japanese simplified computation scheme would appear to be that purchases need not be accounted for, given that tax invoices are already not required and there is no requirement to prove the availability of input credits. For Australia it is the relaxation of a requirement to substantiate input credits that would have the greatest compliance impact.

⁵⁷ P McCouat, *GST Survival Guide* (2nd ed, 2000) para 1022.

⁵⁸ Media release by the Prime Minister of Australia dated 27 March 2001 and ATO media release Nat 01/22.

6.2 Tax Invoices

Even the introduction of the requirement to issue and retain tax invoices was, arguably, not a significant issue in Australia. Most businesses already maintained relatively sophisticated records and business documentation and simply refined their existing practices. Furthermore, a tax file number system had been in place for over a decade and so concerns as to the reporting of income were not as significant as in Japan.

In fact, one advantage of the record-keeping requirements of the GST that was promoted was how this would require improved stewardship of business operations and assistance in the enforcement of the income tax. It seems incredulous that features of the Japanese CT could be dictated by a desire to facilitate the activities of income tax avoiders.⁵⁹ This illustrates the intense political pressure the Japanese Government was under upon seeking to introduce the CT.

Whilst the requirement to issue and retain tax invoices on its own may not have been a big issue in Australia it was, however, another requirement in a mass of new compliance rules introduced by the Government during 2000. These rules have been poorly received by business and seen as overkill. Recently the Government was forced to scale them back in the face of considerable opposition.⁶⁰ If, as in other countries, the tracing of tax invoices is unlikely to occur in practice then the imposition of this further burden on business is open to challenge.

On the other hand, arguably tax invoices are necessary given the plethora of exemptions within the Australian GST. Admittedly there are not as many exempt taxpayers as in Japan but the Australian GST also lacks the feature of the Japanese CT that permits deemed input

⁵⁹ It has been suggested that the more rigorous record keeping and resultant reduction in leakage from the income tax system has been one of the most significant aspects of the Australian GST: "Want to Know the Worst Thing About the GST? No More IBFY", *The Australian Financial Review*, 24 April 2001, 48.

⁶⁰ See M Dirkis, "They Promised It Would Be Easy" (2001) 35 *Taxation in Australia* 414.

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credits to be taken into account regardless of whether they were actually available. Were Australia to dispense with the tax invoice requirement then this feature would also probably need to be adopted. This might significantly reduce the compliance effort.

This illustrates the trade-off between equity, simplicity and efficiency. Possibly the approach recommended by Freiman for the US of not requiring small businesses to issue or retain tax invoices, as well as permitting them to adopt a simplified scheme, might be adopted.⁶¹ However a relaxation of the requirement for one sector of the business community to issue tax invoices might merely disadvantage other (larger) businesses seeking to claim credits. Smaller businesses might find themselves forced to opt out of the concessional regime and issue tax invoices in order to satisfy the needs of their customers. There is evidence that small GST exempt Australian businesses have had to do just this under pressure from their large customers.

6.3 Collection Periods

Australian businesses with a turnover of \$20 million or more must remit GST monthly. For smaller businesses quarterly payment is required although following considerable criticism of the administrative burden the Government announced measures to simplify the calculation of the tax payable. These measures contain particular concessions for businesses with turnovers less than \$2 million whilst farmers and other taxpayers with irregular income patterns are to be permitted to pay twice a year in the third and fourth quarters by means of a 75% and a 25% instalment respectively.⁶²

⁶¹Freiman, above n 17.

⁶²*Taxation Laws Amendment Act (No 3) 2001* (Cth). For a discussion of these measures see Dirkis, above n 60.

6.4 Lessons for Australia in Relation to Compliance

Whilst compliance costs associated with the GST have been highly controversial,⁶³ the introduction of the GST in Australia has been allied with major changes to the income tax system with, in particular, the need for businesses to lodge business activity statements. Therefore it is difficult to disentangle the compliance issues associated purely with the GST from those associated with the business activity statement.

Nevertheless with the compliance cost issue for small businesses currently consideration might be given to providing Australian small businesses with compliance concessions similar to those available in the Japanese CT. However one difficulty with adopting the simplified computation scheme is that with the considerable number of exemptions in Australia, particularly for food, there may need to be a number of margin ratios depending on the mix of products in which the business deals.⁶⁴ Furthermore, as noted above, there would remain the pressure from large customers to issue tax invoices.

Notably the Australian Labor Party (“ALP”) proposed an optional ratio method for small businesses in their 2001 election campaign. The ratio to be applied to turnover was either to be an industry or individual norm. It was claimed that this would dispense with the need for reconciliations, justifying input credits and separately identifying every sale.⁶⁵ The proposal clearly had similarities to the Japanese simplified computation method.

⁶³The Government remains under pressure to address the issue. There is evidence that some small businesses may be turning to cash to avoid having to deal with the tax: K Marshall, “Cost of Compliance a Much Evaded Subject”, *The Australian Financial Review*, 8 May 2001, 18.

⁶⁴This could get complicated. The Japanese have rules for where a business carries on a mix of activities. Essentially satisfying a 75% threshold will permit access to the percentage for that activity. Otherwise different rates may have to be applied to the different activities of the business: see Schenk, above n 18, 1388-1390.

⁶⁵Joint statement by the Opposition Leader and the Shadow Treasurer, 12 October 2001.

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The proposal received some comment.⁶⁶ The difficulties of identifying the applicable ratio, the need to factor in non-taxable sales and the fact that some businesses would receive a GST windfall were some of the issues identified. In particular because some businesses would be winners and others losers it was thought likely that taxpayers would calculate their liability under each method in order to select that most advantageous.⁶⁷

Ultimately, of course, the ALP lost the election on much bigger issues.⁶⁸ Thus the proposal remains untested in the Australian environment.

6.5 Other Observations

In addition to considerations relating to compliance costs a number of other interesting observations for Australia can be drawn from the Japanese consumption tax experience:

- As in Australia the introduction of the consumption tax was politically charged and had a number of false starts. It has been suggested that one of the most important lessons from the Japanese experience is the need for an intense public relations campaign preceding the introduction of a VAT.⁶⁹ Whilst this lesson was taken up, Australia may still have benefited from adopting the Japanese technique of initially introducing the tax at a low rate with numerous compliance concessions in order to ensure community acceptance. This may have avoided the need for political compromises,

⁶⁶ For example, see A Ryan “Labor Plan Invites Tax Games”, *The Australian Financial Review*, 16 October 2001, 59.

⁶⁷ Of course this might be prevented by mandating that the election be made in the first year of operation of a business and that it be irreversible.

⁶⁸ Arguably policies on national security and asylum seekers.

⁶⁹ Freiman, above n 17, 1305.

particularly over food, that have rendered the GST less efficient and more complex.⁷⁰

- Whilst both taxes are broad based, political expediency has necessitated exemptions and there will continue to be pressure to extend the categories of exemptions.
- In Japan the rate commenced at a low 3% and was subsequently increased to an effective 5%.⁷¹ The massive fiscal deficits, the social security implications of the aging Japanese society, commitments to increase public investment and co-operative international efforts almost guarantee that a rate rise is inevitable.⁷² Indeed most commentators and policy analysts are calling for an increase in the CT rate⁷³ typically together with a broadening of the base.⁷⁴ Whilst there is a school of thought that a rate cut to stimulate the economy is needed, this is seen as only a short-term

⁷⁰ For a discussion of some of the recent difficulties regarding the definition of food see “ATO Arithmetic or Dim Sums” and “Life is Taxing for the Easter Bunny”, *The Australian Financial Review*, 27 March 2001, 24 and note the Australian Taxation Office Issues Register at:

http://www.taxreform.ato.gov.au/ind_partner/food/issues.htm.

⁷¹ In the OECD working paper it was observed that whilst the rate was the lowest amongst OECD nations the effective rate was close to the standard due to the relevant absence of exemptions: Dalsgaard and Kawagoe, above n 2, para 40.

⁷² Aoki, above n 25, 197-205. Probably after the 2001 upper house elections: D Yoost and A Zencak, “Japan Aims at Corporate Restructuring” (2000) 11 *International Tax Review* 33. It has been suggested that the rate would need to be raised to 31% for a decade in order to rectify Japan’s public finances: S Lunn, “Public Debt Has Japan On the Ropes”, *The Australian*, 9 March 2001, 7.

⁷³ See, for instance, Zolt, above n 45, 1983; and “IMF Encourages Japan to Continue Loose Fiscal Policies” [21 August 2000] *Tax Notes International* 828; “OECD Says Japan Needs Bold Tax Reform” [20 December 1999] *Tax Notes International* 2317; Dalsgaard and Kawagoe, above n 2 and Ishi, above n 26, 392. Ishi even favours a multiple rate system in pursuit of greater equity.

⁷⁴ “OECD’s 2000 Economic Survey of Japan Short on Tax Related Information” [18 December 2000] *Tax Notes International* 2776.

measure.⁷⁵ The Australian rate has been struck at a moderate 10% with undertakings by the Government to only increase it in exceptional circumstances. In fact, a mechanism has been implemented to render it difficult to effect a rate increase.⁷⁶ The Government may ultimately rue this undertaking.

- In both jurisdictions, prior to the introduction of the tax there was a concern as to potential profiteering by businesses. Probably this fear was overstated or, alternatively, government initiatives to combat it were effective. Notably the Australian provisions mandate that prices be expressed inclusive of GST in contrast to the Japanese choice in this regard. There is evidence that some Japanese businesses have used the resultant uncertainty to increase their prices⁷⁷ and so the Australian approach is probably to be preferred.⁷⁸ As the Japanese Government ponders the political ramifications of increasing the CT rate it too probably wishes that the Australian approach, which results in a less transparent tax, had been adopted.
- Following the introduction of the CT the Japanese economy entered into a decline. Some pundits could not resist drawing a connection notwithstanding that the income tax reductions at the time exceeded the amount of consumption tax revenue. Furthermore, whilst the 1997 rate increase was also coupled

⁷⁵ For example, "IMF Says Japan's Response to Crisis Has Fallen Short of What is Required" [31 August 1998] *Tax Notes International* 642; and "US Senate Finance Committee Holds Hearing on Japan's Role in International Trading System" [20 July 1998] *Tax Notes International* 160. Others see the low rate as significant from the perspective of equity: Freiman, above n 17.

⁷⁶ Agreement of both Houses of Parliament and the States and Territories is required: *A New Tax System (Commonwealth - State Financial Arrangements) Act 1999*.

⁷⁷ See Nagaharu, above n 7.

⁷⁸ Although compliance has been an issue: "Watchdog Warns of GST Snags", *The Australian*, 26 April 2001, 22.

with income tax reductions consumer spending dropped from the time of the increase further fuelling the argument that the consumption tax has contributed to, if not been the main cause of, the Japanese economic slump.⁷⁹

Similarly the GST has been blamed for the economic slowdown in Australia.⁸⁰ Whilst the tax has clearly created some cash flow and administrative difficulties much of the associated downturn can be attributed to the fall in building construction as it has been brought forward to beat the tax. However there is evidence that the tax is distorting economic decisions. In particular there appears to be a GST inspired substitution of products.⁸¹

- Revenues raised by the Japanese CT continued to increase during the 1990s notwithstanding difficult economic conditions in Japan. In fact, in terms of revenue raised it is now on par with the corporate tax.⁸² This should be welcome news for the Australian Treasury.

7. CONCLUSION

As the consumption tax phenomenon has spread more and more jurisdictions have had to face the political realities of introducing a new tax with a broad application. Both the Japanese and Australian experiences are sobering illustrations of the impact that the political process can have on the features of a tax.

⁷⁹“Japan Plans Tax Reform” (2000) 11 *International Tax Review* 5; and T Fumitoshi “Manipulations Behind the Consumption Tax Increase: The Ministry of Finance Prolongs Japan’s Recession” (1999) 25 *Journal of Japanese Studies* 91. Referred to but not endorsed by Messere, above n 44, 33. See also Zolt, above n 45, 1982.

⁸⁰ See, for instance, “GST Blamed for Slowdown”. *The Australian Financial Review*, 2 April 2001, 1; and “Reserve Bank Governor Defends GST”, *The Australian Financial Review*, 11 April 2001, 1.

⁸¹ “GST Still Causing Cash Flow Problems”, *The Australian Financial Review*, 26 March 2001, 5.

⁸² Ishi, above n 26, 341.

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Consumption taxes are generally lauded for their relative simplicity and their potential to limit avoidance and evasion opportunities, maintain competitive neutrality and achieve horizontal equity. However all these potential benefits can be compromised by the specifics of the tax hammered out through political horse-trading.

Such has been the Japanese and Australian experiences both resulting in mutant, although different, taxes. Notwithstanding some limitations with the Japanese compromise their focus on minimizing the compliance burden on, in particular, small taxpayers whilst ensuring a broad based, although low rate, tax with few exemptions are features that might improve the Australian tax.