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Ways to Offset Regressive Impact of Consumption Tax Hikes

On the regressive impact of consumption tax, refundable tax credits, and tax rate reductions

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Summary

- A bill to raise the consumption tax to 10% is currently being debated in the Diet. Consumption tax is a regressive form of taxation, taking a higher percentage of low incomes than high ones. As such, measures will be needed for low-income earners to counter the regressive impact of higher consumption tax.
- In this report, we use a Q&A format to explain the regressive impact of consumption tax, refundable tax credits, and tax rate reductions.

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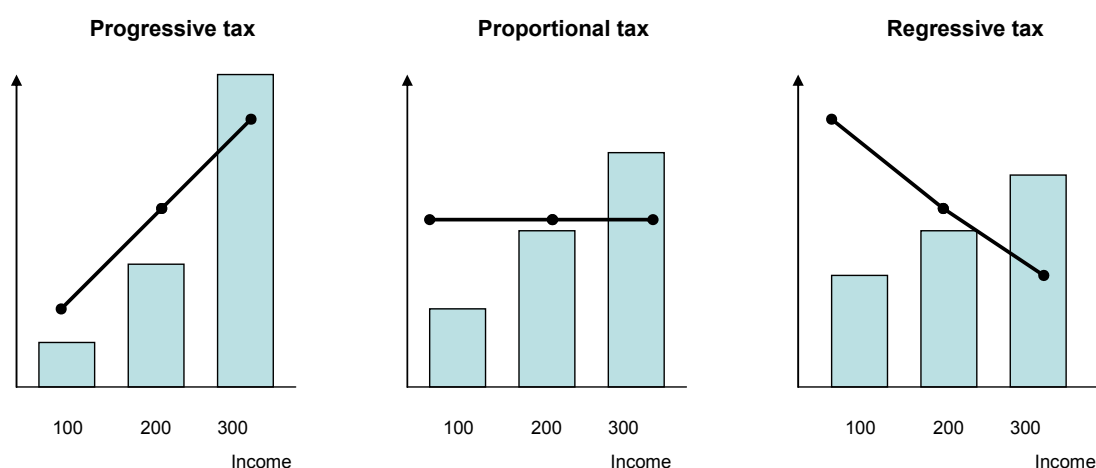
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Q1: Why is consumption tax regressive?

A1: Consumption tax places a heavier burden on low-income earners than higher-income ones. It is a regressive form of taxation because consumption tax accounts for a higher proportion of the annual income of a low-income earner than a higher-income one (proportion of income that can be saved thus declines for low-income earners).

- There are three forms of income¹ tax systems: progressive taxation, proportional taxation, and regressive taxation (Chart 1).
- Progressive tax is a form of taxation that takes a larger proportion of income from high-income groups than from low-income groups. Income that is subject to general taxation (employment income, business income) is progressively taxed, with a higher tax rate applied to those with larger income (or, to be precise, with higher taxable income).
- Proportional tax is an income tax that takes the same percentage of income from everyone regardless of how much an individual earns. Income that is subject to separated taxation (capital gains on land, equities, interest on deposits, bonds) is proportionally taxed, with the same percentage of income taken regardless of how much an individual earns.
- Regressive taxation places a heavier tax burden on low-income earners than higher-income ones. The per capita portion of individual residential taxes is reggressively taxed, with all citizens (excl. non tax payers) paying a uniform tax amount (standard tax rate of Y4,000/year for FY12).
- Generally speaking, even regressive taxation is designed so that those with higher incomes pay higher tax amounts or shoulder a uniform amount regardless of income. It is rare for a low-income earner to pay a higher amount of tax.²
- Consumption tax is applied uniformly to taxable consumption regardless of income. Therefore, in order to determine whether it is a progressive or regressive tax, we need to consider the relationship between income and the amount of tax paid on taxable consumption.

Progressive Tax, Proportional Tax, Regressive Tax **Chart 1**



Source: Compiled by DIR.

Note: Bars represent tax amount, lines show tax rate. Tax rate is percentage of income paid as tax.

¹ In tax law, gross income and net income (deducting necessary expense) are different concepts. However, we make no distinction in this respect in Q1.

² According to the Family Income and Expenditure Survey of the Ministry of Internal Affairs and Communication's Statistics Bureau, low-income earners consume more cigarettes than higher earners. As a result, low-income earners pay more cigarette tax than higher earners.

- Chart 2 is based on the Family Income and Expenditure Survey and shows consumption taxes paid and the figures as a percentage of annual incomes for households with different levels of income. Households are divided into five groups according to income, with group 1 being the lowest income group and group 5 the highest.

Consumption Tax Paid by Five Income Groups, % of Income (Y) Chart 2					
	Group 1	Group 2	Group 3	Group 4	Group 5
Avg. age of head of household	63.5	59.2	54.9	51.7	52.8
A Avg. income (Y)	1,710,000	3,150,000	4,400,000	6,170,000	10,640,000
B Taxable consumption (note 1)	1,369,104	2,143,308	2,552,724	3,011,604	4,189,956
C B / A	80.06%	68.04%	58.02%	48.81%	39.38%
D Consumption tax paid (note 2)	65,195	102,062	121,558	143,410	199,522
E D / A	3.81%	3.24%	2.76%	2.32%	1.88%

Source: Ministry of Internal Affairs and Communication's Family Income and Expenditure Survey (all households, 2010); compiled by DIR.

Notes: 1) Taxable consumption excludes expenditure on rent, healthcare, education.
2) B × (5 / 105), rounded.

- As Chart 2 shows, consumption tax paid by the lowest income group (group 1) amounted to 3.81% of annual income, while consumption tax paid by the highest income group (group 5) came to 1.88% of annual income.
- Taxable consumption claims a higher percentage of the incomes of lower income households. As a result, the percentage of their incomes that is spent on consumption tax tends to be higher. This explains why consumption tax is said to be regressive.

Q2: Why do some say consumption tax is not regressive?

A2: You could say that consumption tax is not regressive if you assume we spend all of the disposable income we earn in a lifetime and that the consumption tax rate remains constant throughout our lives, with consumption tax levied on all of our consumption. Under these conditions, the consumption tax we pay as a percentage of our income remains constant regardless of our (disposable) income.

- In Q1, we looked at the regressivity of consumption tax based on the relationship between income and consumption tax paid at one point in time (one year). Here, we examine the relationship between income and consumption tax paid throughout a lifetime.
- Instead of spending our income, we can put it into savings with the aim of spending it later in life. We only pay consumption tax at that future date, when we spend the money we saved.
- If we assume we spend all of the disposable income we earn in a lifetime and that the consumption tax rate remains constant throughout our lives, with consumption tax levied on all of our consumption, then the consumption tax we pay as a percentage of our income will remain constant regardless of our (disposable) income.
- We can explain this using the simplified model shown in Chart 3. We have divided the lives of three people into two periods, working life and old age. We assume they spend all of their disposable income in their lifetimes and that consumption tax is levied on all spending. Our model applies a consumption tax rate of 10% to the different disposable incomes for the three people during the two periods. We show the consumption tax burden as a percentage of lifetime disposable income for each of the three subjects.

Consumption Tax as % of Disposable Income Throughout Life (Y000)						Chart 3
	Mr. A		Mr. B		Mr. C	
	Working life	Old age	Working life	Old age	Working life	Old age
Disposable income	8,000	3,000	20,000	3,000	3,000	2,000
Savings spent		2,000		8,000		300
Spending	6,000	5,000	12,000	11,000	2,700	2,300
Consumption tax	545.5	454.5	1,090.9	1,000.0	245.5	209.1
Savings set aside	2,000		8,000		300	
Consumption tax as % of disposable income in each period	6.82%	15.15%	5.45%	33.33%	8.18%	10.45%
Consumption tax as % of disposable income throughout life	9.09%		9.09%		9.09%	

Source: Compiled by DIR.

Note: Life of subjects divided into working life and old age. All disposable income spent in lifetime, with consumption tax (10%) levied on all spending. Consumption tax amount based on $(10 / 110) \times$ spending. Assume no interest on savings. Figures rounded.

- Mr. A generates disposable income of Y8 million during his working life. He spends Y6 million and saves Y2 million for old age. In his old age, his disposable income amounts to Y3 million and he spends the Y2 million he set aside in savings, bringing total spending during this period of his life to Y5 million. The consumption tax he pays amounts to 6.82% of his disposable income during his working life, 15.15% during his old age, and 9.09% throughout his lifetime.
- Mr. B has more disposable income than Mr. A, while Mr. C has the least. The consumption tax each subject pays amounts to varying percentages of disposable income during each of the two periods. However, total consumption tax paid throughout each subject's lifetime amounts to 9.09% of disposable income in every case.

Q3: How can low-income earners offset the regressive impact of higher consumption tax?

A3: The main ways are refundable tax credits, tax rate reductions, and social security benefits.

- As seen in Q1, consumption tax is a regressive kind of taxation. It places a heavier tax burden on low-income earners than higher-income ones, accounting for a higher percentage of the income of a low-income earner. In Q2, we saw that consumption tax may also be considered to be a proportional tax, as it takes the same percentage of disposable income from high-income earners as low-income ones. Whether it is considered regressive or proportional, the fact that it hits low-income earners harder than progressive taxation (such as income tax) doesn't change. Therefore, when the consumption tax rate is hiked, we need to consider ways to ease the burden on low-income earners.
- We see three ways for low-income earners to offset the regressivity of consumption tax. These are refundable tax credits, tax rate reductions, and social security benefits. The current government leans more in favor of refundable tax credits and social security benefits.
- Refundable tax credits allow mainly low-income earners to deduct a fixed amount from their income and residential taxes. With non-refundable tax credits, people that pay no (or little) income or residential tax can make no (or little) deduction to their income or residential taxes. As such, low-income earners may receive no benefit from non-refundable tax credits. With refundable tax credits, however, people that pay no (or little) income or residential tax can receive cash payouts if their tax bill is lower than the amount allowed to be deducted.
- The idea of refundable tax credits is to lower income and residential taxes and provide cash benefits for low-income earners to reduce the burden imposed on them by having to pay significantly higher consumption tax.
- However, higher earners may also benefit from refundable tax credits if the government is unable to obtain accurate data on their incomes, which raises concerns about the fairness of the system.
- Tax rate reductions either reduce taxes or impose no taxes at all on daily necessities such as food and utilities.
- Chart 4 shows the Family Income and Expenditure Survey's breakdown of spending on food and utilities for different income brackets. The lower income brackets spend a higher percentage of their annual incomes on food and utilities. Lowering the tax rate or imposing no taxes on food and utilities would reduce the burden on low-income households.
- It seems that such tax rate reductions would lessen the burden of consumption tax on low-income earners.
- However, there are concerns that determining which goods or services should be subject to tax rate reductions could cause inequality among different industries and that this approach would entail a heavy administrative burden.

Spending on Food and Utilities by Five Income Groups						Chart 4
		Group 1	Group 2	Group 3	Group 4	Group 5
Food	Annual spending (Y)	408,516	604,944	709,368	806,148	989,124
	% of annual income	23.89%	19.20%	16.12%	13.07%	9.30%
Utilities	Annual spending (Y)	151,308	203,532	222,228	247,752	293,280
	% of annual income	8.85%	6.46%	5.05%	4.02%	2.76%

Source: Ministry of Internal Affairs and Communication's Family Income and Expenditure Survey (all households, 2010); compiled by DIR.

- The rise in the consumption tax could also be offset by higher social security benefits. Japan's current national and employees' pensions are indexed to consumer prices. If consumer prices rise in line with the hike in consumption tax, pension payments will also rise to incorporate the effect of the higher consumer prices.
- As shown in Chart 2, the average age of the head of the household in the first of the five income groups in the Family Income and Expenditure Survey is 63.5 years. This group includes many low-income households for which the old-age pension is the main income source. Pension payments for these households would rise if a higher consumption tax rate pushed up consumer prices. As such, the pension system incorporates a means for low-income earners to offset the regressivity of higher consumption tax.
- Furthermore, the DPJ, LDP, and New Komeito parties all claim that they will consider pension supplements for individuals on low pensions. They also say they will reduce medical and nursing care insurance costs and payments at hospitals for elderly people and low-income individuals. Such measures would also be a way for low-income earners to offset the regressivity of higher consumption tax.
- However, even if pension payments rise in line with the increase in the consumption tax due to the link to consumer prices, this could be offset by macroeconomic indexing, and pension payments could actually decline.³ Moreover, measures to uniformly reduce the tax burden for the elderly would also benefit high-income individuals, which could be considered unfair. Careful consideration needs to be paid to determine which level of society and which income bracket (or consumption level) to target when attempting to offset the rise in the consumption tax with higher social security benefits.
- Chart 5 summarizes ways for low-income earners to offset the regressivity of higher consumption tax. More detailed explanation is provided from Q4.

Ways for Low-income Earners to Offset Regressivity of Higher Consumption Tax		Chart 5		
		Refundable tax credits	Tax rate reductions	Social security benefits
Method		Lower income/residential taxes, provide cash benefits for low-income earners to reduce burden of higher consumption tax.	Lowering the tax rate or imposing no taxes on food and utilities would directly reduce the burden on low-income households.	Offset rise in consumption tax by increasing social security benefits for low-income individuals and other people in need.
Merits		- Probably less administrative burden than reduction in tax rates. - Scheme could include employment support, childrearing support.	Easy to gain acceptance as would benefit all citizens.	Possible to target those truly in need.
Problems	Can it be focused on low-income individuals?	Higher earners may benefit if government cannot obtain accurate data on income.	High-income individuals also benefit if they purchase the targeted goods/services.	High-income individuals could also benefit.
	Neutrality/fairness	Higher earners may also claim benefits if government cannot obtain accurate data on income.	Determining which goods or services should be subject to tax rate reductions could cause inequality among different industries.	Could be unfair if individuals on same income do not all receive higher benefits.
	Increase in expenditure (decline in tax revenue)	Relatively low increase in expenditure, as benefits focused on low-income individuals.	Relatively large decline in tax revenue, as high-income individuals also benefit from lower tax rate on targeted goods/services.	Relatively low increase in expenditure, as benefits focused on low-income individuals.
	Administrative burden	Little impact on private enterprises.	Administrative burden increases mainly for private enterprises.	Little impact on private enterprises.
Systems that could be introduced		Introduction of taxpayer ID number system should improve accuracy of measuring income (though launch of system and administration would be costly).	Invoice system is generally introduced when multiple tax rates are used.	- Standards for determining income ceiling vary in current social security system. - When increasing benefits, same standards should be applied for determining income (taxpayer ID number system could be used to obtain accurate data on income).

Source: Compiled by DIR.

³ DIR report *Japan's Medium-term Household Outlook* (Apr 2012, Japanese report) suggests macroeconomic indexing will offset the rise in pension payments owing to higher consumption tax from FY15.

Q4: What systems are in place for refundable tax credits?

A4: There are currently no examples of refundable tax credits in Japan. Nor do the bills currently being discussed in the Diet or the government's envisaged integrated reform of social security and taxation systems outline any specific schemes. Examples of political initiatives in other countries include working tax credits, which encourage low-income individuals to work, child tax credits, which support childrearing households, and social insurance premium tax credits, which reduce the burden of social insurance premiums for low-income individuals.

- Refundable tax credits allow mainly low-income earners to deduct a fixed amount from their income and residential taxes. With non-refundable tax credits, people that pay no (or little) income or residential tax can make no (or little) deduction to their income or residential taxes. As such, low-income earners may receive no benefit from non-refundable tax credits. With refundable tax credits, however, people that pay no (or little) income or residential tax can receive cash payouts if their tax bill is lower than the amount allowed to be deducted.
- A non-refundable tax credit of Y10,000 can be used to reduce income or residential tax. For example, if an individual's aggregate income and residential taxes amount to at least Y10,000, a non-refundable tax credit of Y10,000 can be used to reduce the tax burden by the same amount. However, if an individual's total income and residential taxes come to Y5,000, that person can only reduce his tax burden by Y5,000. An individual who pays no income or residential taxes would not benefit at all from a non-refundable tax credit.
- With a refundable tax credit of Y10,000, meanwhile, an individual who pays total income and residential taxes of Y5,000 can reduce his taxes by Y5,000 and receive a Y5,000 cash benefit. An individual who pays no income or residential taxes at all would receive a Y10,000 benefit.
- There are no specific refundable tax credit schemes outlined in the bills currently being discussed in the Diet. The government's envisaged integrated reform of social security and taxation systems only states that such tax credits will be considered.
- Other countries employ refundable tax credits for various reasons. As shown in Chart 6, a relatively large number of countries use working tax credits to encourage individuals to work and child tax credits to support childrearing households.
- Canada provides refundable tax credits (minimum income multiplied by consumption tax rate) to low-income households based on the belief that they should not have to shoulder the burden of consumption tax.
- Canada's system for returning consumption tax to low-income households is easy to understand as a measure to counter the regressive impact of such tax. Examples from other countries show refundable tax credits in use for other reasons. Such cases are also effective in countering the regressive impact of consumption tax by reducing the tax burden and providing benefits for low-income individuals.

Refundable Tax Credits in Other Countries		Chart 6
	Main aim	Country
Tax credits to reduce regressive impact of consumption tax	Reduce regressive impact of consumption tax on low-income households.	Canada
Working tax credits	Encourage individuals to work.	US, UK, France, Canada
Child tax credits	Support childrearing households.	US, UK, Germany, Canada
Social insurance premium tax credits	Reduce burden of social insurance premiums for low-income individuals.	Netherlands

Source: Compiled by DIR.

Q5: Could refundable tax credits also be applied to high-income earners?

A5. Refundable tax credits could be applied to high-income earners when the government is unable to obtain accurate data on taxpayers' income. A taxpayer identification number system would help enhance this accuracy.

- A refundable tax credit system is mainly designed to benefit low-income earners.
- However, the government cannot necessarily keep tabs on the taxpayers' entire income. Refundable tax credits could be applied to high-income earners when it is unable to obtain accurate data on the taxpayers' income.
- We see the following three factors as preventing the government from accurately tracking people's income.
- First, data on financial and other income subject to a separate withholding tax (particularly interest income) is not consolidated for a taxpayer. The withholding tax system helps prevent taxpayers from avoiding the taxes on this group of income, but does not identify the recipient of such income.
- A taxpayer identification number system would help the government consolidate income data for each taxpayer.⁴ The Japanese government and ruling parties plan to introduce a national ID system in January 2015, and are considering implementing refundable tax credits based on more accurate data on taxpayers' income obtained through the system.
- We also think a taxpayer identification number system is not necessarily a perfect scheme to keep tabs on taxpayers' income given the remaining two issues.
- The second factor is difficulty in tracking self-employed people's income (sales). It is also difficult to distinguish between personal and business expenses for this group of taxpayers even if accurate data on their overall income (sales) is obtained. Expenses that are essentially personal and should not be deducted from income are sometimes recognized as business expenses. For example, it is not easy to judge whether meals with a business partner are necessary business expenses or just part of personal consumption.
- A government could use a taxpayer identification number system and monitor a higher proportion of transactions to track self-employed workers' income more accurately. In South Korea, for example, the national tax agency has a scheme to track the value of and details of transactions by individual persons and businesses based on credit card transaction information and "cash receipts." Given the costs involved and the issue of personal information protection, it would not be easy for Japan to adopt such a system as is. Still, this system should serve as a reference for addressing the issue.
- Third, some may make false declarations or none at all. The government needs to tighten penalties in this issue, in our view.
- We believe a government must accurately keep tabs on people's income even without a taxpayer identification number system. In Japan, some income and tax credits have income limits (e.g., credits for spouses, dependents, housing loans). The tax authority approves tax credits depending on wage/salary levels and income included in a tax return filing. However, it should capture a completely accurate picture of the taxpayers' income before judging whether to apply tax credits.

⁴ While a taxpayer identification number system has not been introduced in Japan, personal payment and income records are sent to tax offices for some financial income, including income from dividends/sales of listed shares and income from futures trading. Although not currently in place, we believe such record submissions for interest income are necessary. The tax authority would therefore be able to aggregate information gathered from these records for a taxpayer and combine it with other income data to judge if the refundable tax credits are applicable for the taxpayer. However, the lack of an ID system would cause a huge administrative burden.

Q6: What goods and services would be subject to tax reductions?

A6. If tax reductions are meant to reduce the burden for low-income earners, the targets should be daily necessities. However, it would be hard to decide which goods and services should fall into that category. Also, the government could reduce taxes on some non-essential goods and services to protect certain industries.

➤ Chart 7 shows consumption tax rates in Japan and other countries.

Consumption Tax Rates in Japan and Other Countries (as of Jan 2012)				Chart 7
	Japan	UK	France	Germany
Standard-rated	5%	20%	19.6%	19%
Tax-exempt (principle of tax)*	Land sales/leasing**, financial transactions, insurance, etc.	Land sales/leasing, building sales/leasing, financial transactions/insurance, medical services, education, postal services, welfare, etc.	Real estate transactions, real estate leasing, financial transactions/insurance, medical services, education, postal services, etc.	Real estate transactions, real estate leasing, financial transactions/insurance, medical services, education, postal services, etc.
Tax-exempt (government strategy)*	Housing rentals**, medical services, education, welfare, etc.			
Zero-rated	None	Food, water supply, newspaper, magazine, books, domestic passenger transportation, medicines, residential building construction, equipment for disabled people, etc.	None	None
Reduced-rated	None	Household-use fuel, electric power, etc. (5%)	Books, passenger transportation, fertilizer, hotel bills, restaurant bills, etc. (7%) Food, etc. (5.5%) Newspapers, magazines, medicines, etc. (2.1%)	Food, water supply, newspaper, magazine, books, passenger transportation, hotel bills, etc. (7%)

Source: Ministry of Finance, National Tax Agency; compiled by DIR.

* Tax-exempt categories (principle of tax, government strategy) based on National Tax College Japan textbook.

** Consumption tax charged on building sales and business-use building leasing in Japan.

- The tax payment scheme is different for tax-exempt and zero-rated items. Businesses that sell tax-exempt items are supposed to bear the burden of consumption taxes paid on the inputs. On the other hand, those who sell zero-rated items can file a refund for the consumption taxes paid on the inputs.
- Tax-exempt items are divided into two categories: those exempt in light of the principle of the consumption tax and those exempt due to the government strategy. The former includes revenue from land sales/leasing, deposits/loans, and other transactions that are not regarded as “consumption” and do not fit in with the consumption taxation. Although housing rents, medical fees covered by health insurance, and school fees are regarded as “consumption,” these revenues are exempt from the consumption taxation based on the government strategy.
- Food, water supply, medicines, fuel for household use, electric power, and other daily necessities are zero- or reduced-rated in other countries. Domestic passenger transportation (UK) and hotel bills (France, Germany) are also included in these categories.
- It is difficult to determine which items are essentials and subject to reduced taxes, and what item category a product or service falls into. In addition, the government could apply reduced rates on some items to protect certain industries regardless of their necessity in everyday life.
- Also, setting non-uniform tax rates could result in more complex laws and guidelines, increased administrative workload, and business-government collusion.

Q7: Why should tax reductions be accompanied by an invoice system?

A7. We believe the government should introduce an invoice system to prevent fraud. Tax reductions are accompanied by an invoice system in Europe. Tax reductions could be implemented even without such a system, but this could lead to fraudulent tax deductions and returns.

- We first explain how an input consumption tax deduction scheme works.
- Businesses are entitled to deduct the consumption taxes paid on the inputs from the consumption taxes to be paid on the goods and services they sell—an input tax deduction.
- In Japan, businesses multiply the aggregate tax-inclusive purchase prices by 5/105 to derive the amount of the consumption taxes for input tax deductions.
- In Europe, however, businesses aggregate the consumption taxes paid on the inputs to calculate the amount for input tax deductions. With reduced tax rates applied to some items, they cannot derive the total amount of consumption taxes paid on the inputs by simply tracking the prices of these inputs. In the region, an invoice method is in place as a mechanism to give businesses proof of consumption taxes they paid.

Input Tax Deductions in Japan and Europe		Chart 8
	Japan	Europe
Consumption tax rates	Single	Multiple
Input tax deductions	Receipt-based	Invoice-based
Calculation of consumption tax to be paid	Percentage of aggregate prices of taxable outputs and inputs	Sum of consumption taxes received/paid for each output/input

Source: Compiled by DIR.

- Invoices are statements noting the applied rate and amount of consumption tax for a transaction.
- Under an invoice-based collection mechanism, businesses that pay the consumption tax issue an invoice when selling a good or service. This invoice is then required for the businesses to deduct the consumption tax paid on the inputs from the amount owed (or claim a refund).
- European countries adopt an invoice-based system along with reduced VAT tax rates on various categories of transactions.
- Japan has no such invoice system. Businesses are required to keep receipts or other relevant documentation when deducting (or claiming a refund of) consumption tax paid on the inputs. However, there is no obligation to note the applied rate or amount of consumption tax.
- When applying multiple rates (i.e., reducing the rate on some categories), invoices are needed to keep track of the tax rate that applies to the amount of consumption tax paid on the inputs.
- Introducing reduced consumption tax rates without an invoice system would spark concern of fraudulent deductions/refunds if the buyer and the seller report different tax rates. Even without the intent to commit fraud, the buyer and seller could report different rates on items for which it is difficult to determine eligibility for a reduced tax rate if they reach different conclusions.
- For example, assume Company A sells a product to Company B for Y100,000 (tax included). Company A, the seller, pays the government Y4,761 in consumption tax, assuming it as a reduced-rate item with a 5% tax rate (product price: Y95,239; consumption tax: Y4,761). Meanwhile, Company B, the buyer,

assumes it as a standard-rate item with a rate of 10% and as such deducts (or claims a refund of) Y9,090 from its consumption tax liability (product price: Y90,910; consumption tax: Y9,090). In that case, the difference of Y4,329 (Y9,090 – Y4,761) would end up either as lost tax revenue or improperly claimed as a refund.

- Without an invoice system, fraud like the above example would be difficult for the tax authorities to police, absent checking receipts against both the buyer and seller's books. Requiring invoices limits the investigative burden on the tax collector to checking whether the invoices are consistent with the buyer and seller's books.⁵
- Having lower consumption tax rates on some categories of goods and services is not impossible without an invoice system. As a means to prevent fraud, however, the government should implement one if it plans to go down this road.
- With a consumption tax, in addition to exempting some categories of transactions from taxation, it is also possible to create different categories of taxation or exemptions for businesses that meet certain criteria. An invoice system would help keep track of these businesses as well.
- Currently, the Japanese system exempts businesses with sales below a certain level from paying consumption tax.
- Japan allows input tax deductions for taxable transactions, regardless of whether the seller is subject to consumption tax. In Europe, on the other hand, invoices are issued (and hence input tax deductions are allowed) only for eligible transactions with businesses subject to the VAT (Chart 9).
- Businesses (buyers) in Japan are not required to keep track of whether sellers are in fact subject to consumption tax. So a tax-exempt seller benefits if a buyer pays to the seller an amount equivalent to consumption tax. On the other hand, a buyer that purchases from a tax-exempt business benefits when it files input tax deductions despite no consumption tax paid on the transaction. This is a well-known issue in Japan.
- Implementing an invoice system would prevent deductions for transactions conducted with exempt businesses, as the transactions would not generate invoices. This would end the problem of the purchasers paying tax-exempt sellers an amount equivalent to consumption tax.

Permissibility of Input Tax Deductions				Chart 9			
Japan		Seller		Europe		Seller	
		Taxable	Tax-exempt			Taxable	Tax-exempt
Goods/ services sold	Taxable	Yes	Yes	Goods/ services sold	Taxable	Yes	No
	Tax-exempt	No	No		Tax-exempt	No	No

Source: Compiled by DIR.

Note: 'Yes' where input tax deductions applicable for buyer, 'no' where deductions not applicable.

Shaded areas show status different between Japan and Europe.

⁵ Even with an invoice system, there is a possibility of fraudulent deductions/refund claims from falsified invoices. However, detecting fraud is easier under an invoice system.