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The Tax-Welfare Mix: Explaining Japan's Weak Extractive Capacity

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The tax-welfare mix: explaining Japan's weak extractive capacity

Gene Park and Eisaku Ide

Abstract Despite having the highest level of public debt in the Organisation for Economic Co-operation and Development (OECD), higher than Greece or Italy, Japan has one of the lowest aggregate tax burdens of the advanced industrial democracies. This paper asks why Japan, once described as a strong developmental state, has had such a weak extractive capacity, an inability to raise revenues to confront deficits and public debt? In contrast to the existing explanations that focus on political institutions, partisan preferences, or economic globalization, this article argues that Japan's 'tax–welfare mix' – the combination of taxes and redistributive welfare polices – undermined the state's long-term capacity to secure adequate tax revenue. More than just a source of revenue, taxes can be used directly to achieve redistributive goals, such as targeting low taxes and exemptions to specific groups. This study shows how Japan's tax–welfare mix diminished its extractive capacity through three mechanisms: the political lock-in of a redistributive social bargain struck around low taxes, the timing and sequencing of its tax policy and welfare development, and the erosion of public trust, which undermined tax consent. Beyond offering a new theory of extractive capacity, the tax–welfare mix explains aspects of Japan's tax structure that defy existing explanations and contributes to our understanding of the capitalist development state by highlighting the redistributive political function of tax policy and its long-term impact on state capacity.

Keywords taxes; welfare state; developmental state; public debt; budget deficits; Japan

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Introduction

After nearly two decades of research on the capitalist developmental state, a growing body of work has focused on the welfare state in East Asia (Aspalter, 2006; Holliday, 2000; Kim, 2010; Kwon, 2005, 2007; Lee and Ku, 2007). This work has sought to determine if there is in fact a distinctive East Asian welfare regime in addition to Esping-Andersen's (1990) three worlds of welfare. Much of this work concludes that there is an East Asian model characterized by low welfare spending, an emphasis on family, priority on work, and other characteristics (Aspalter, 2006; Holliday, 2000; Kim, 2010; Kwon, 2005, 2007; Lee and Ku, 2007). The shift to social policy has been a useful corrective to the preoccupation with industrial policy during the 1980s and 1990s. While offering the potential to better explain the politics of social protection in East Asian states, this work has not always escaped the shadow of the earlier work on the developmental state. Holliday (2000) and Kwon (2005), for instance, have viewed the nature of East Asian welfare as a function of strong developmental states that have prioritized economic growth over social policy. Thus, East Asian welfare states have been described as 'productivist welfare regimes' and 'developmental welfare states'. Low welfare spending and weak social rights have been equated with the prerogatives of the developmental state. Thus, the presumption of strong states persists, even though some of recent scholarship on the developmental state calls into question its contemporary relevance (for a review, see Stubbs, 2009).

The case of Japan highlights these contradictions. Although the Japanese state moderated welfare expenditures to pursue developmental goals, the Japanese state has shown weakness in other areas, very strikingly in the area of public finance. Japan is now the most indebted country in the Organisation for Economic Co-operation and Development (OECD) with higher gross debt than even Greece. Japan's bank bailouts during the 1990s and slow economic growth contributed to Japan's growing public debt, but even controlling for economic sluggishness, the government has run chronic structural deficits. Moreover, the Japanese state has been surprisingly weak vis-à-vis societal interests, trying but failing to raise adequate revenue, even though Japan has one of the lowest aggregate tax burdens of the industrialized democracies. While the Japanese government passed legislation in the summer of 2012 to raise the consumption tax from 5% to 10%, estimates suggest that the rate would have to rise to 17%–31% just to stabilize debt (Hoshi and Takatoshi, 2012). Moreover, the party that raised the tax suffered a resounding defeat and loss of power in December 2012 that has reinforced the view that tax hikes are electorally perilous. If a strong developmental state is one insulated from a weak society (Stubbs, 2009), then the Japanese state has been exceedingly weak when it comes to raising revenue. How can we explain Japan's weak extractive capacity?

This paper shows, in contrast to the view of the 'developmental welfare state', that Japan's weakness on the extractive side actually stems from its model of social policy, specifically its 'tax–welfare mix'. In principle, states can use taxes either as source of revenue for spending or more directly to achieve redistributive goals. In Japan, the government combined limited welfare spending with a redistributive tax policy and high levels of public investment after World War II. This specific tax–welfare mix initially helped the government keep expenditures low, but over the long-term, weakened extractive capacity by making it harder to broaden its tax base even as Japan moved to enhance its welfare policies.

The next section provides an overview of Japan's weak extractive capacity and highlights some of the limitations of the existing explanations. The paper then outlines Japan's specific tax–welfare mix that the government established after Japan's defeat in World War II and remained largely in place through the 1960s. The remainder of the paper, employing a historical institutionalist approach (Krauss and Pekkanen, 2011; Pierson, 2004; Thelen, 2004), explains how Japan's tax welfare-mix 'locked-in' weak extractive capacity through three mechanisms. First, the government's use of low taxes to achieve social goals became entrenched politically through interest group pressure, norms, and partisan competition. Second, the timing and sequencing of tax and social policy inhibited the government's attempt to raise revenue. In contrast to other industrialized democracies, the government deliberately chose to keep the tax burden low during a period of rapid economic growth during the 1950s and 1960s. Instead, the government moved to increase taxes when globalization and growing tax competition created downward pressure on taxes in the 1980s. The government did succeed in raising social security contributions, which tend to incur less opposition due to the tight link with the welfare state, but welfare retrenchment during the 1980s and 1990s hampered the government's effort to shift its tax base toward greater regressive taxation of consumption as tax competition produced downward pressure on taxation of corporate and personal income. Third, Japan's tax–welfare mix, which relied on heavy public investment and targeted taxes, fed a perception of an unfair tax burden and wasteful public spending that eroded public trust and tax consent, creating a systematic preference for cutting spending over tax hikes.

Japan's weak extractive capacity

While less striking since the Great Recession that has damaged the public finances of many countries, Japan's fiscal situation is outstanding for its chronic deficits and high levels of accumulated debt. Japan's current budget relies on bonds for nearly half of its revenue, and Japan has had budget deficits for nearly every year for the last 20 years. It is now the most indebted country in the OECD with gross debt in Japan in 2011 at 233.1%

of GDP; by comparison, Greece's was 165.6% (IMF, 2011). Even accounting for the Japanese government's assets, Japan's net debt too is highest in the OECD at 130.6% of GDP (IMF, 2011). This state of affairs is remarkable for a country that through the mid-1960s was one of the leanest and most fiscally disciplined.

Despite high debt, structural budget deficits, and a demographic profile (an old and rapidly aging population with low fertility) that will drive up government expenditures and shrink the tax base, the government has had difficulty raising revenue even though aggregate taxes are low. In fact, much of the postwar Japan had the lowest aggregate tax burden of the industrialized democracies, and only recently has it traded places with Australia and the USA for that distinction. As Figure 1 illustrates, while the government has stabilized its level of spending, even as its aging population has driven up social security expenditures, the government has not been able to raise adequate revenue.

The Japanese government's weak extractive capacity is surprising given the view of Japan as a strong capitalist developmental state (Johnson, 1982; Woo-Cumings, 1999). Moreover, while Campbell and Allen (1994) have found fiscal challenges or 'state imperatives' to be correlated with increases in income taxes in the USA, such imperatives have had weak effects on Japan's extractive capacity.

Japan's weak extractive capacity is also surprising in light of the fact that Japan has been long-ruled by a center-right party, the Liberal Democratic

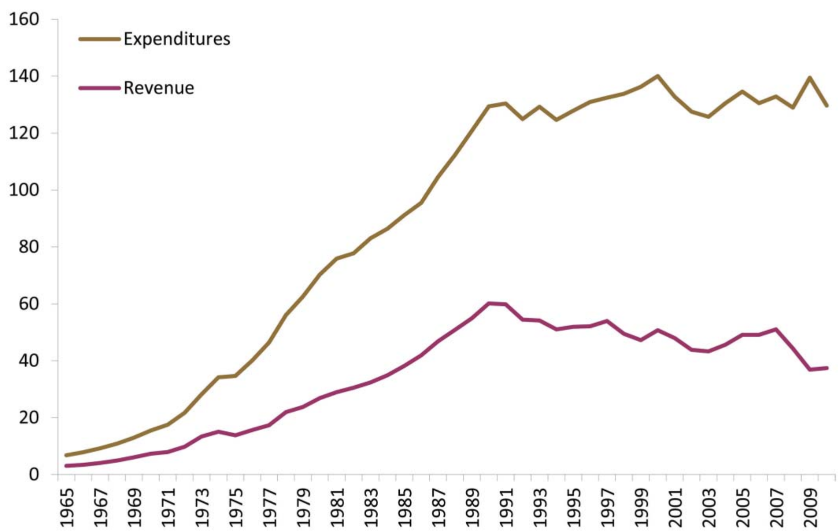

Figure 1 Japan's revenue gap (in trillions yen). *Source*: Japanese Ministry of Finance.

Party (LDP). While such parties tend to prefer low taxes, the conventional wisdom is that right parties also prefer fiscal discipline, yet the LDP, which ruled Japan with virtually no interruption from 1955 to 2009, presided over Japan's skyrocketing public debt and massive deficits.

Japan's political institutions could plausibly account for Japan's weak extractive capacity. Under Japan's electoral system until 1994 – the single non-transferrable vote (SNTV) – candidates from the same party were forced to compete against each other. This intra-party competition created factions and weakened the party and executive (Estevez-Abe, 2006; Mulgan, 2002). While not discounting the general significance of the electoral system, a weak executive has not prevented tax hikes. The government, for instance, introduced a new consumption tax in 1989 and then passed legislation in 1994 prior to electoral reform taking effect that increased the tax in 1997. Under the new electoral system, Prime Minister Hashimoto chose to implement the tax hike in 1997 (from the 1994 legislation), and then again in 2012, the Democratic Party of Japan (DPJ) passed legislation to gradually double the tax by 2015. The problem of extractive capacity runs deeper, in the public resistance, both unorganized and organized, to such measures and the electoral backlashes even in the wake of 'successful' increases in taxes. Thus, the political consequences, actual and anticipated, rather than the policy process, have been the real impediment to increasing taxes.

Economic globalization, some have suggested, can weaken the ability of states to tax. Greater capital mobility puts downward pressure on taxation of capital, corporate income, and wealthy individuals (Genschel, 2002; Gordon and Mackie-Mason, 1995; Razin and Sadka, 1991). In the case of Japan, though, the government's low tax burden, which dates back to the end of World War II, predates the rise of greater economic integration. Still, conceivably though, one could argue that the effects of globalization and more intense tax competition have constrained Japan's extractive capacity since the 1980s as the state attempted to raise revenue. In fact, there is evidence that this has been the case. As will be discussed in more detail, the Japanese government did attempt to keep taxes in line with other countries, most clearly the USA, as they lowered income and other corporate taxes.

Still, the case of Japan does not conform neatly to the globalization and tax competition argument. While such pressures should lead to lower corporate taxation and higher taxation of less mobile consumers, Japan relies disproportionately on corporate taxes for revenue. Japan has the highest corporate tax rates in the developed world, and compared with the USA, which also has a high corporate tax, fewer deductions. Corporate tax revenue as a share of GDP in 2008 was the 7th highest out of 33 countries (OECD, 2010), despite an overall low level of taxes as a share of GDP. By contrast, Japan has one of the lowest levels of taxation of consumption of all OECD countries (see Figures 2–4).

Figure 2 Corporate tax rate (percentage), OECD countries, 2011. *Source*: OECD Tax Database.

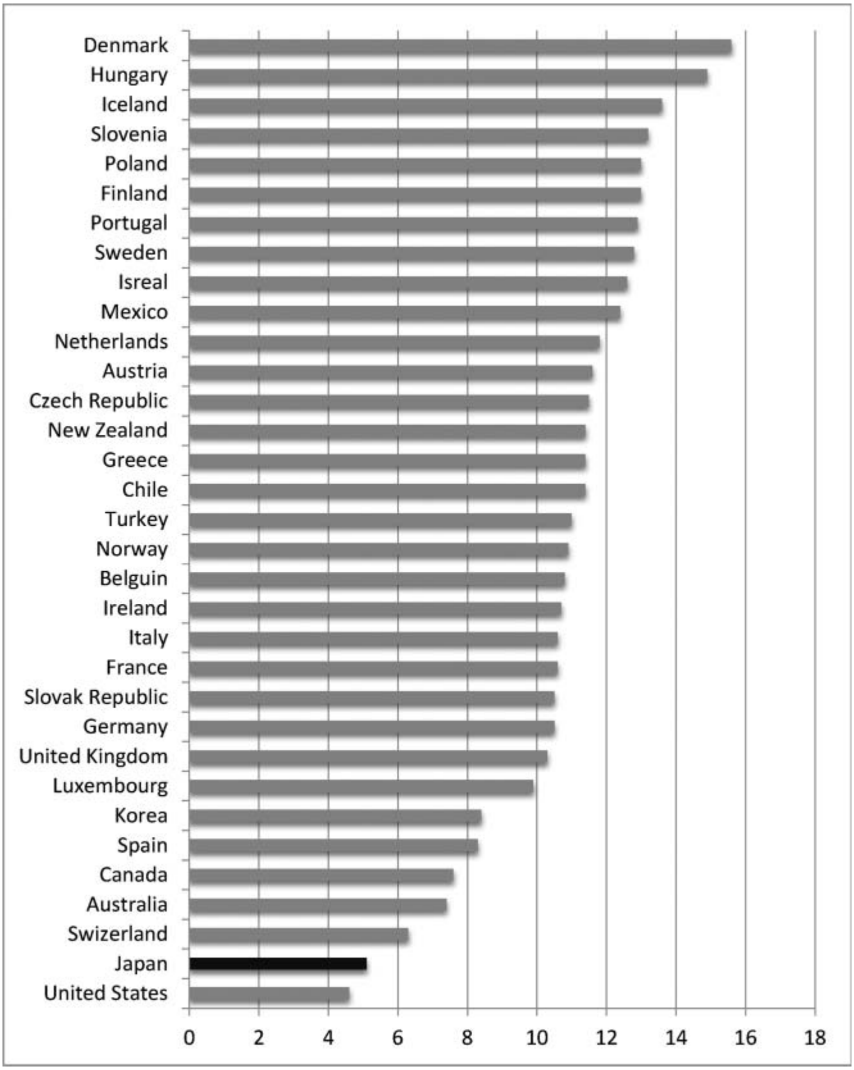

Figure 3 Taxation on goods and services as a share of GDP, OECD countries, 2008. *Source*: OECD, Revenue Statistics 2010, p. 90.

The Japanese government also has one of the highest top statutory personal income tax brackets in the OECD. The stickiness of Japan's tax structure is more in line with often-observed path dependence of tax policy and domestic politics (Ganghof, 2007; Garrett and Mitchell, 2001; Swank, 2002). The heavy taxation of corporations and the relatively light taxation of consumers and lower income households are also surprising given the long-ruling LDP's reputation as a party of big business and the weak

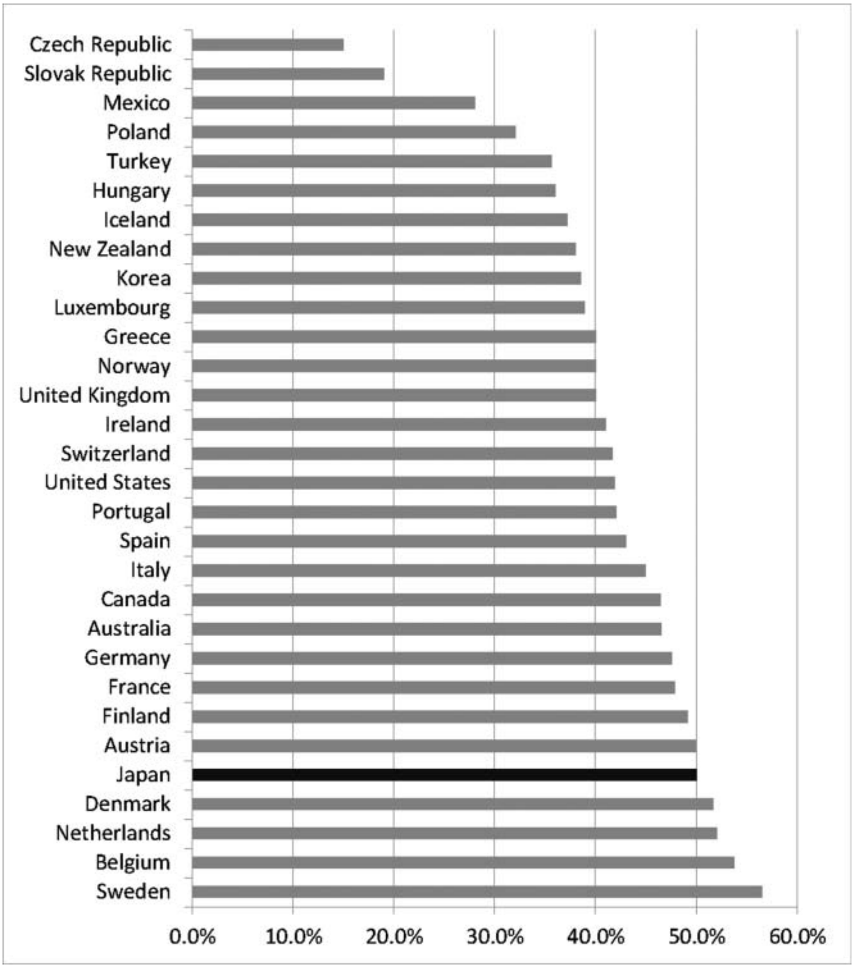

Figure 4 Top statutory income tax rates, OECD countries, 2009. *Source*: OECD Tax Database, Taxation of Wage Income.

position of labor in the country, which also suggests that the organization of interests is an inadequate explanatory variable.

The tax–welfare mix

Taxes are a source of revenue to finance public spending; indeed, this is one of their central functions. Governments, though, can use tax policy not only as revenue generators but also to achieve policy goals directly. Beyond the use of tax policy as an economic instrument, taxes can serve not only as revenue for the welfare state but also as a functional substitute for social spending. Howard (1997) and others have shown how tax expenditures in the USA form part of a hidden welfare state, creating incentives for the private provision of welfare and targeting tax relief to specific groups such as low-income workers through the earned income tax credit.

States may rely on taxes as revenue or as a constituent element of social protection. We can imagine a continuum with states employing a variety of tax–welfare mixes. Whereas large welfare states may rely on taxes primarily as revenue, countries with smaller welfare states might supplement social spending with a redistributive tax policy, as in the USA and Japan. (While taxes can be redistributive, spending typically has greater redistributive effects.)

Japan's tax–welfare mix

In broad strokes, Japan's tax–welfare mix from the end of World War II through the end of the 1960s can be described as having three components. The first pillar was Japan's formal welfare state. During this period, the government created a national healthcare system and a mandatory universal pension in 1960, but welfare costs were deliberately limited. The public pension was modest, and programs for the unemployed, childcare, and other social services were minimal. The government encouraged the private provision of welfare through corporations and family (Pempel, 1998; Verba, 1987). Thus, by 1960, of all the democracies in the OECD, Japan had the lowest spending on welfare as a share of GDP.

The second pillar was the tax system. In addition to keeping aggregate taxes low – indeed the lowest of the OECD democracies in 1965 (OECD, 2010)[1] – Japan also implemented a progressive tax policy. Japan's prewar tax system relied to a high degree on regressive taxation of consumption. After the war, the Japanese government used tax policy to relieve the tax burden on groups viewed as more economically vulnerable; in fact the government viewed lowering taxes as a part of its system of social security.[2] More specifically, the government created targeted and preferential tax treatment to reduce the burden on groups viewed as being left behind by Japan's economic development, such as farmers and small business, also the groups central to the ruling party's social coalition (Akaishi, 2005). The government also kept regressive indirect taxes on consumption to a minimum. As a result, in 1965, Japan had the lowest taxes on goods and services in the entire OECD at 4.8% of GDP, one-half of the OECD average (see Figure 5) (OECD, 2010).

The government also relieved the personal income tax burden on lower income salaried workers. After World War II, the income tax weighed heavily on these classes, a result of Occupation-era tax reform. To deliver tax relief, the government increased the personal exemption and the

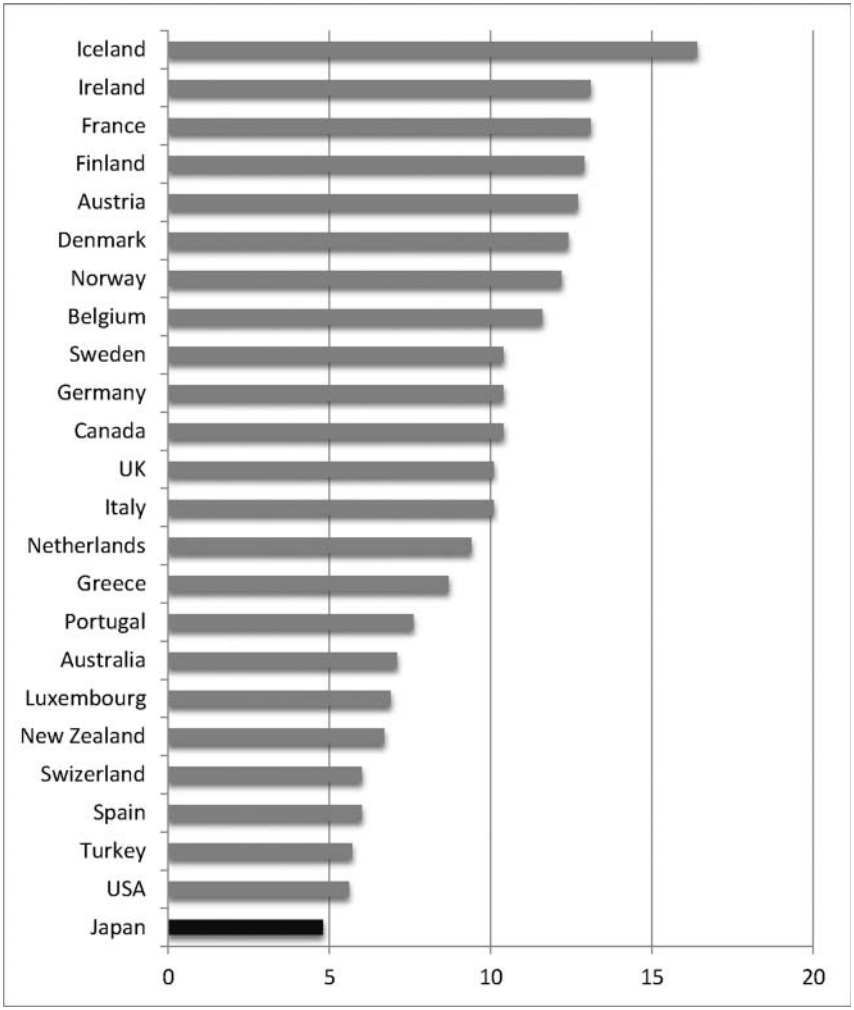

Figure 5 Indirect taxation – taxation on goods and services as a share of GDP, OECD countries. 1965. *Source*: OECD Tax Database.

dependent deduction, thereby raising the 'minimum taxable income', the income threshold below which income tax is not levied. Thus, by the 1956, Japan already had a high minimum taxable income that was 64% of the average annual income; by comparison the figures for the USA, UK, and Germany were 34.2%, 45.2%, and 50.3%, respectively (Zaimushō Zaimu Sōgō Seisaku Kenkyūjo, 1999). In subsequent decades, the government continued to increase the threshold rapidly (see Table 1), while also increasing the tax rates of upper end brackets. With a high minimum

Table 1 Minimum taxable income in Japan by household type (in thousands yen)

	Individual	Married couple	Married couple with one child	Married couple with two children
1950	29	43	57	71
1955	93	143	174	205
1960	118	210	250	289
1965	196	351	413	474
1970	344	580	728	880

Source: Japanese Ministry of Finance.

taxable income, the personal income tax generated low levels of revenue, despite its high top-end bracket rates.[3] In 1965, revenue from Japan's personal income tax was 3.9% of GDP, one of the lowest in the OECD and less than half that of the USA at 7.8% (OECD, 2010).

The third pillar was redistributive public investment. The government invested heavily in public works not only to provide valuable economic infrastructure but also to redistribute resources to rural regions and to create employment (DeWit and Steinmo, 2002; Ide, 2011; Park, 2011). Such spending was viewed as a deliberate alternative to the expansion of welfare policies, which were viewed as too costly and thus kept minimal. Public investment also had another advantage: it could be financed by an off-budget public finance system known as the Fiscal Investment Loan Program (FILP). FILP was financed primarily by postal savings and eventually pension reserves, allowing the Japanese government to keep public investment high and taxes low (Park, 2011).

Japan's tax–welfare mix – its combination of minimal welfare spending, low and preferential tax treatment, and redistributive public investment – was a reflection of the ruling party's economic strategy. The Japanese government maintained a strict policy of low taxes, low budget expenditures and balanced budgets after the end of World War II until the middle of the 1960s. This fiscal policy, originally a legacy of the US Occupation that imposed fiscal austerity on Japan, became a vital element of the government's larger growth strategy. Low taxes were intended to spur private savings and investment, while balanced budgets would help control inflation and complement the government's active use of monetary policy to stimulate growth. The government maintained a ceiling on its budget spending and aggregate tax burden of 20% of gross national income, and through the mid-1960s maintained balanced budgets. The fiscal constraints stemming from Japan's economic growth strategy dictated its approach to social protection. In contrast to governments that increased taxation and spending, particularly on social programs, the Japanese Government deliberately kept formal welfare spending low. The government complemented its minimal welfare state with its redistributive tax policy and public investment (Park, 2011).

Japan's mixture of low taxes, high public investment, and residual welfare policies was also the means by which the LDP used the public finance system to stay in power. Both tax policy and high public investment targeted groups that were critical to the LDP's social coalition: sole proprietors, small and medium enterprises (SMEs), rural voters, and farmers. Japan's electoral system created incentives for the government to deliver targeted redistributive benefits over broad programmatic welfare policies (Estévez-Abe, 2008). Regular income tax cuts were also central to the conservatives' approach to middle-class salaried urban workers, a group that tended to have weaker partisan affiliations but became increasingly pivotal as Japan urbanized.

Constraining extractive capacity

Through the middle of the 1960s, the Japanese government maintained remarkable fiscal discipline even while keeping taxes low, in part due to rapid growth but also through controlling expenditures using the particular tax–welfare mix described above. During this period, the government chose to limit its extractive capacity. This situation changed by the latter half of the 1960s, as the Japanese government faced its first deficits, which then grew sharply during the 1970s as the government increased spending on welfare and public works. From this period onward, the Japanese government faced challenges in raising additional revenue. While there have been some notable successes (discussed further below), the tax–welfare mix constrained the revenue-raising potential of the Japanese state in several ways. Specifically, Japan's tax–welfare mix weakened its extractive capacity through three mechanisms: politically narrowing the tax base, the timing and sequencing of its tax policy and welfare development, and the erosion of tax consent.

Politically narrowing the tax base

Relying more on targeted tax relief as part of its system of redistribution and social protection effectively narrows the possibilities for broadening the tax base, thereby weakening extractive capacity. The effect is largely a political one. Once a social bargain around tax relief is struck, it can be locked in politically through interest group pressure, norms, and party competition. In effect, this narrows the tax base by increasing the political hurdle of passing tax hikes that run counter to this redistributive compromise. Of course, a government can increase other taxes, but there are two problems with this approach. First, tax hikes concentrated on a narrower band of taxes can generate political backlash, as some groups are forced to bear the brunt of tax hikes. Second, increasing hikes on a narrow band of taxes has limited revenue-raising potential.

Political lock-in of low taxes

As deficits and debt increased starting in the second half of the 1960s, the government searched for new ways to raise revenue, but it was constrained by the need to keep low and preferential tax treatment for groups at the lower end of the economic hierarchy such as lower income-salaried households, small business, and farmers. Small business and farmers, beneficiaries of the government's tax policy, were highly organized interest groups and also constituencies critical to the support base of the LDP (Calder, 1988; Pempel, 1998). The ruling party largely refrained from even attempting to increase taxes on these groups. Official discussions of tax reform within all of the main tax policy-making bodies – the LDP's Tax System Research Council, the government's Tax System Research Council, and the Ministry of Finance's Tax Bureau – avoided discussion of increasing their tax burden (Mizuno, 2006).

As the government looked to increase revenue, it might have turned to the personal income tax. The income tax during the first decades after World War II evolved into a significant source of revenue for industrialized democracies. Inflation pushed incomes into higher personal income tax brackets, so revenue grew without any tax rate hikes. By contrast, in Japan, the government delivered regular tax cuts to keep the income tax burden low for lower income households as part of its model of social protection. The LDP always had trouble winning the support of urban salaried workers. As Japan urbanized, salaried workers with weaker partisan alignments grew increasingly important for winning elections, so too did the imperative of keeping taxes low.

The government's tax policy was more deeply rooted than the preferences of the ruling LDP: it was embedded within the party system. Opposition parties, including those to the left of the LDP, often called for lowering taxes on these same groups. The Japan Socialist Party (JSP), Clean Government Party (CGP), and the Democratic Socialist Party (DSP) frequently advocated lowering taxes. Backbenchers within the LDP and the LDP's short-lived coalition partner – the New Liberal Club (NLC) – which had splintered from the LDP – also pushed in some cases for tax cuts larger than those proposed by the government. The equilibrium around low taxes – from the left and right – exemplify how the tax–welfare model locked-in preferences toward tax policy.

The LDP continued to deliver tax cuts even as spending and deficits grew. To shore up dwindling support for the LDP, Prime Minister Tanaka (1972–1974) delivered large tax cuts even while sharply increasing spending for welfare programs and public works. Before a general election in 1972, the LDP reached out to sole proprietors by promising to set up a system that would allow them to deduct wages from income. Tanaka Kakuei then passed a 300 million yen cut in personal income taxes in 1973 and in 1974 a huge two trillion yen personal income tax cut (that lowered rates and raised the minimum taxable income), a sum equivalent to a whopping 12% of the budget (Mizuno, 2006).

Tanaka deliberately abandoned fiscal discipline, but even as the Japanese government turned toward fiscal consolidation, the government avoided tax hikes central to the fiscal bargain and in some cases, continued to lower taxes. For the fiscal years from 1978 to 1980, the government passed no significant income tax cuts, but came under intense criticism from opposition parties for not doing so. Despite the ongoing budget pressure and Prime Minister Suzuki's (1980–1982) commitment to fiscal consolidation, the government delivered an income tax cut and a tax cut for small business in 1981. Opponents and the media labeled the income tax cut derisively as the 'ramen tax cut' because it was just enough to buy a cheap bowl of noodles. In the run up to elections in 1983, the LDP promised a much larger income tax cut, which Prime Minister Nakasone – also an avowed fiscal hawk committed to fiscal consolidation – delivered for the 1984 fiscal year even though budget revenues would only cover 67% of expenditures (Mizuno, 2006).

The limits of a narrow tax base

The government did raise taxes, but those peripheral to Japan's tax–welfare mix. In particular, the government raised taxes on corporations. Even before the tax hikes, Japan's corporate tax was its largest revenue generator. In 1965, only New Zealand generated more revenue as a share of GDP of the OECD countries (OECD, 2010). Starting in the 1970s, the government began to increase corporate taxes steadily. In 1973, the Tanaka administration actually raised corporate taxes to partially offset the historic income tax cut that targeted the middle and lower middle class. After a succession of corporate tax hikes and the closing of deductions throughout the 1970s, the government passed a budget in 1981 that raised corporate taxes again. Japan's revenue from the taxation of corporate income as a share of GDP in 1985 was the third highest in the OECD, and corporate income taxation was 21% of all tax revenue, far higher than in any other OECD country (OECD, 2010).

Japan's heavy reliance on taxation of corporations may seem surprising given the widespread image of the LDP as party aligned closely with big business, but this was always only a partial description at best. While big business supplied the party with contributions, the LDP always had to rely on the support of groups large enough to deliver the vote, and its redistributive model reflected this need.

The government's approach to raising revenue also had two problems. First, narrow and rapid tax hikes engendered political backlash. Starting in the late 1970s, big business mobilized opposition through their business organizations, Keidanren and Keizai Doyukai. Big business argued that high corporate tax rates hurt competitiveness, an argument that gained traction as other countries began to lower corporate taxes. Big business also became more interested in tax reform, hoping to shift the tax structure in such a way that corporations would not bear the burden of future tax rises (Kimura, 2011).

The second limitation was that because the tax hikes were so narrow, they could not generate enough revenue to cover growing expenditures, a problem exacerbated by the fact that they were at times paired with income tax cuts. The government hiked corporate taxes, closed corporate income tax loopholes, and also raised very narrow indirect taxes, but this approach reached its revenue-generating limits. By the 1970s, the government began to look at ways to broaden its tax base, more specifically implementing a valued added tax (VAT), a move that big business supported as a way to limit its own tax burden. Issues of timing and sequencing as well as weak tax consent, however, have hampered the process of transition to the VAT.

Timing and sequencing of tax policy and welfare development

As a growing body of literature has shown, timing and sequencing matter (Pierson, 2004), and those working in the vein of the "new fiscal sociology" have explicitly called for more attention to these processes (Martin, Mehrotra and Prasad, 2009). Both decisively influenced Japan's extractive capacity. First, the Japanese government missed the window of raising taxes during an era of easy finance. Second, Japan began to raise taxes from a very low base at an inauspicious time: during a period of deficits and scarcity and as global economic integration, tax competition, and neoliberalism put downward pressure on the taxes that the Japanese government was most reliant on. Third, the timing and sequence of Japan's welfare expansion and tax policy impeded Japan's shift to a new tax structure that relied on greater indirect taxation.

Missing the era of easy finance

Japan's tax policy during the first decades after World War II through the end of the 1960s had a decisive impact on its long-term extractive capacity. By deciding to limit tax burden and return natural revenue increases to citizens and business in the form of tax cuts, the Japanese government effectively missed an opportune moment to increase revenues. After World War II, through the start of the 1970s, the global economy was buoyant, and Japan's economy grew at unprecedented rates. During this period, the Japanese government conceivably could have done nothing more than let growth and inflation generate higher levels of revenue without raising taxes. The additional revenue would have allowed it to finance higher levels of spending on welfare and other programs. In the USA, tax revenues, driven significantly by the income tax, rose with relatively little political opposition during the ‘era of easy finance’ (Brownlee, 2004). Inflation pushed people into higher income tax brackets, and the government kept the personal exemption low, effectively broadening the tax base as the income tax captured an ever-larger share of the population. Thus, the government was able to increase its tax burden not only without tax hikes but also in spite of tax cuts under Kennedy and Johnson. Japan, by contrast, deliberately kept its aggregate tax burden low, delivering popular tax cuts. Thus, Japan entered a period of relative fiscal scarcity and slower growth with a tax burden significantly lower than most other industrialized democracies. In 1975, Japan’s tax burden was 20.8% of GDP (the OECD average was 29.4%); by contrast in the low-spending USA, the tax burden was 25.6% of GDP (OECD, 2010).

Downward pressures on taxation: globalization and tax competition

Low taxes not only became entrenched politically, but the timing of the government’s attempt to increase revenue was an inauspicious one. First, during the 1970s, the global economy experienced two oil shocks and then Japan’s rate of growth, while still comparatively high, slowed during the 1980s. Second, increased global economic integration, tax competition, and the diffusion of neoliberal supply-side economic ideas all created downward pressure on taxes. This aspect of Japan’s timing was particularly troublesome for the Japanese government because of its heavy reliance on a highly progressive income tax and high corporate tax rates, the two taxes that faced the most downward pressure.

Just as the Japanese government embarked on fiscal consolidation starting in the early 1980s, the government came under increasing pressure to lower income tax progressivity and corporate tax rates. To compensate for the revenue loss from cuts to two key sources of revenue, the Japanese government shifted toward the idea of introducing a broad consumption tax. Many European countries embraced the VAT, and in Japan Prime Minister Ōhira had unsuccessfully tried to introduce one at the end of the 1970s. Big business embraced the idea of a consumption tax, hoping that the consumption tax could help finance a reduction in corporate tax rates (Kimura, 2011). Prime Minister Nakasone (1982–1987) attempted to bring these two strands – reducing tax progressivity and corporate taxes and introducing a regressive tax on consumption – together in a comprehensive tax reform. Nakasone succeeded with the first part. He lowered the corporate tax rate, reduced the number of personal income tax brackets, and brought down the highest marginal rate from 60% to 50%. The attempt to introduce a consumption tax, however, failed; a development discussed in more detail below.

By the time Nakasone passed his tax reform, the effects of globalization, tax competition, and neoliberalism were being felt around the world, as governments reduced income tax progressivity and lowered corporate tax rates. After having increased consistently since the end of World War II, the growth in the aggregate level of tax burden across the OECD largely remained steady from the 1980s, including in Japan.

Timing of welfare state development and tax policy

The sequencing of Japan's welfare state development and tax policy also weakened Japan's extractive capacity. Although Nakasone reduced its corporate tax rate and income tax progressivity, the government could have raised other taxes. In fact, Nakasone had tried to introduce a VAT. As powerful generators of revenue, a VAT would have enhanced the government's revenue capacity. Indeed the Ministry of Finance calculated that a 1% consumption tax, similar to a VAT, would have generated more revenue than all of Japan's indirect taxes in the early 1970s. Given the administrative burden, the Ministry of Finance advocated introducing a 5% VAT (Mizuno, 2006).

The government's deferment of welfare expansion and the use of tax policy as an element of its model of social protection hindered its efforts to introduce and raise a broad consumption tax. Until the early 1970s, the tax system was geared toward redistributing income in combination with its residual welfare state and high public investment. Consequently, a regressive tax like the VAT was particularly anathema to Japan's social bargain. Opposition to regressive indirect taxation ran deeply within the LDP, the Ministry of Finance's Tax Bureau, experts, the media, and population (Mizuno, 2006). Although the need for revenue eventually shifted the preferences of the LDP leadership and MOF, widespread opposition remained. The consumption tax and other versions of it were widely unpopular, and powerful interests, particularly retailers and small business, on whose support the LDP relied, actively mobilized to defeat it. The opposition parties, in particular the Socialists, were also avowed opponents to any tax on consumption, and at key moments, exploited the widespread unpopularity of the tax to their political advantage.

In virtually any context, the introduction or increase of a tax on consumption poses a profound political challenge. One means of demobilizing at least part of the opposition would have been to blunt the regressive effect through an expansion of the welfare state that redistributed income on the expenditure side. In many large welfare states, such as Sweden and France, governments have had much more success in increasing the regressive VAT as a means to finance redistributive welfare spending. In Japan, however, welfare expansion was largely delayed until the early 1970s.

When Prime Minister Tanaka moved to upgrade the nation's social policies, he paired expenditure hikes with large tax cuts as discussed earlier, a maneuver that sowed the seeds of ongoing fiscal problems and made the welfare state vulnerable to fiscal retrenchment.

Starting during the second-half of the 1970s, the government began to consider the use of a broad indirect tax as a means to pay for enhanced welfare. However, by the time the government started to plan for a possible tax hike the revenue was needed to close deficits not finance expand welfare, and in fact, starting in the 1980s, the welfare state experienced significant retrenchment. In 1982, the government abolished free medical care for the elderly, and in 1994, the pension eligibility age was raised from 60 to 65 years. More recently, there have been numerous proposals to link hikes in the consumption tax to welfare spending. The proposed tax hikes, however, are not to expand welfare programs but to reassure the public that funds will not be misused or wasted on pork barrel spending, an important point returned to below.

Despite these very high hurdles, LDP-controlled administrations persistently pursued the introduction of a consumption tax from the mid-1970s, and to some extent, they succeeded. A 3% consumption tax was eventually introduced in 1989, and then hiked to 5% in 1997. However, overall, the transition to indirect transition has been very slow and marked 0 by repeated defeats from the late 1970s until 1989. Even with the introduction and then hike of the consumption tax, compared to other OECD countries, Japan's VAT is quite low (see Figure 6).[4] More critically, these successes belie the political lesson learned from these events, namely that the consumption tax has a very high political cost. The first failed attempt led to a loss of its majority for the ruling party; the successful introduction of the VAT also played a key role in the LDP's loss of its majority in the Upper House and subsequent resignation of Prime Minister Takeshita; the hike of the consumption tax in 1997 was blamed for pushing the economy back into recession and contributed to the loss of control of the Upper House and the resignation of Prime Minister Hashimoto.

The DPJ has had similar experiences. Once in power, the mere mention of a consumption tax hike contributed to a rout in elections that led to loss of control of the Upper House in 2010. The loss gave momentum to an insurgency against Prime Minister Kan Naoto, leading to his resignation. The new prime minister, Noda Yoshihiko, however, persevered, and in the summer of 2012, the government passed a landmark hike in the consumption tax. The law will raise the consumption tax from 5% to 8% in 2014 and then 10% in 2015. However, the debate over the tax proved to be so divisive, that the DPJ has had 70 members of the party leave over the issue. As the government pushed through the tax and then passed it, the cabinet approval ratings dropped from over 65% to 19%.[5] The DPJ then lost in a landslide in December of 2012 going from 230 to 57 (of 480) seats in the House of Representatives. Moreover, to pass the law, the government included a provision that

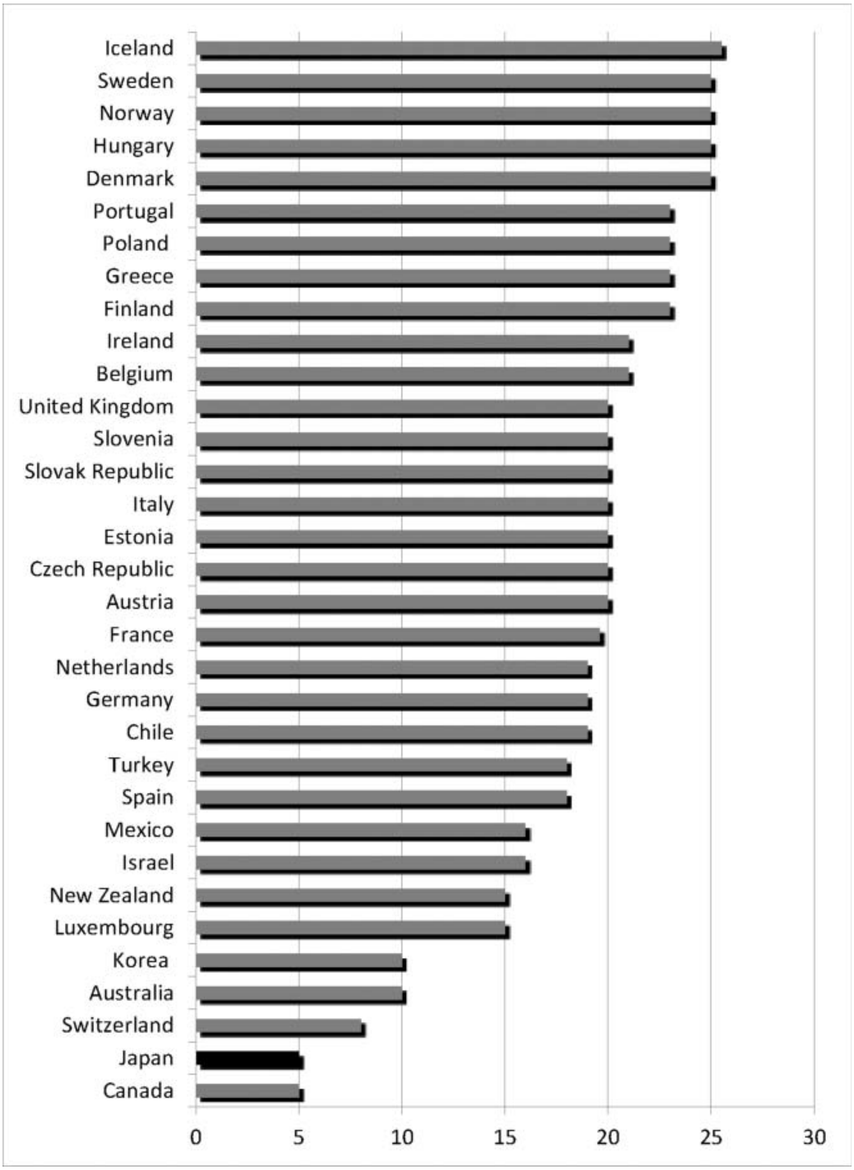

Figure 6 VAT rates (percentage), OECD countries, 2011. *Source*: OECD Tax Database.

will allow it to suspend the tax hike if the economy is still weak. The current Abe administration has committed to further fiscal stimulus, including passing a five trillion yen supplementary budget to be financed by borrowing. It has not yet, however, made a decision about the scheduled tax rise.

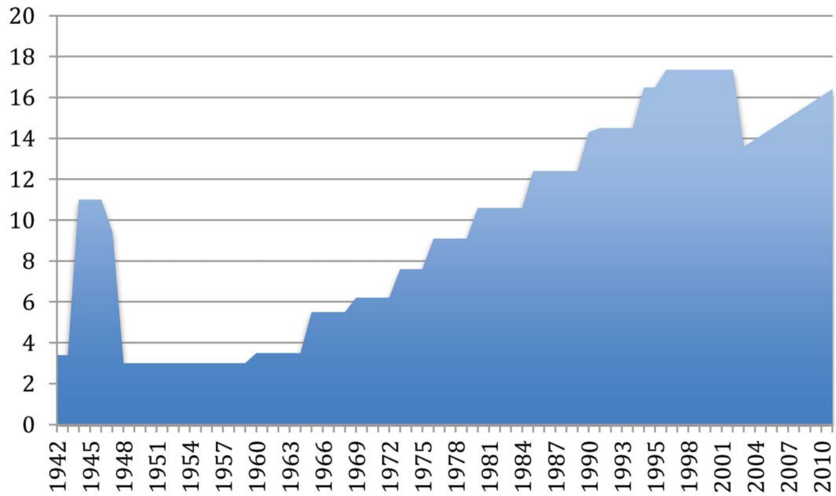

Figure 7 The employees' pension insurance contribution rate (percentage of wage; rate includes employee and employer contributions). *Source*: http://www.anshin-rougo.com/shiryou.html#02.

Both successes and failures with tax hikes for both the LDP and DPJ have reinforced the lesson that the consumption tax is the third rail in Japanese politics, something that politicians across party lines will continue to take to heart.

While Japan's delayed welfare state has weakened its extractive capacity, welfare state development itself has, as in other countries, facilitated raising revenue. Indeed, increased social insurance contributions have been the primary means by which the Japanese government has raised revenue. The government has steadily increased social insurance contributions – Figure 7 shows the trend in social insurance contributions for the Employee's Pension Insurance system, the second tier of Japan's pension system. Social security contributions in 2008 accounted for 38.6% of tax revenue, up from 21.8% in 1965 (Miyamoto, 2008).

The Japanese government's ability to raise rates so rapidly is in many ways remarkable. The hikes corresponded with a period of heightened tax competition, welfare retrenchment during the 1980s and early 1990s, and also periods of sharp economic downturn during Japan's lost decade. Furthermore, social security contributions are much more regressive than the personal income tax, with no exemptions for salaried workers and a cap on contributions for high-income workers. Social insurance contributions, though, are the exception that proves the rule. The tight link between payments and benefits make social insurance contributions one of the most politically palatable ways to raise revenue (Campbell, forthcoming), and exemplify how welfare can enhance the extractive capacity of the state.

Yet, while the government has in fact used social insurance to generate revenue, these hikes have not been able to offset revenue gap. There are also limits to social security contribution increases. Social insurance hikes raise the cost of labor, which can increase unemployment and the shadow economy (Campbell, forthcoming). To avoid reducing the incentive to hire workers, the government is attempting to curb the growth of social insurance contributions by shifting the burden of paying for public pensions away from social contributions and back to general revenue.

Undermining tax consent

The ability of a government to raise revenue from its population depends, in part, on the consent of taxpayers to pay (Levi, 1988; Martin Mehrotra and Prasad, 2009). The policies and actions of a government can both enhance or undermine the perceived legitimacy of its demands for revenue. Japan's tax–welfare mix had the unintended consequence of undermining its extractive capacity in two ways. First, preferential tax treatment eventually created the perception that Japan's tax system was not fair. Second, the use of high public investment, which helped transfer resources and create jobs in stagnant, often rural areas, fed a perception of waste. Both undermined trust in government, making it harder to justify tax increases.

The first effect is directly related to the government's use of tax cuts and preferential tax treatment as a form of social protection. As described earlier, sole proprietors, SMES, and farmers were taxed lightly. The light taxation of these groups was partly a function of low rates, targeted tax expenditures (such as exemptions or deductions), but also partly a function of weak enforcement, which in itself was the result of deliberate political decisions to shelter these groups. Salaried workers (or what the Japanese call 'salarymen'), by contrast, are taxed at the source and as a result, tax compliance is high, and additionally they have few opportunities to deduct expenses. Salaried workers, thus, have borne a disproportionate share of the tax burden. Indeed, the unevenness of the tax burden is captured by the expression '9–6–4' which emerged in the 1970s to capture the view that the government captures 90% of the taxes salaried workers owe, but only 60% for sole proprietors and 40% for farmers.[6] As the government's personal income tax cuts became less frequent, the rising burden on salaried workers sharpened discontent with the tax system during the 1980s (Ide and Steinmo, 2009). While the reality is that most salaried workers' income – particularly for the lower and middle-class – is taxed lightly, the view that salaried workers unfairly bear an inordinate amount of the burden has heightened resistance to higher income taxes as well as the consumption tax.

The government's reliance on high public investment to redistribute resources and create jobs also has eroded tax consent by creating the perception of widespread government waste. This form of economic redistribution complemented its socially oriented tax policy and residual welfare state, and as discussed earlier, public investment was viewed as a way to avoid the expansion of costly welfare policies. Under political pressure in the 1970s, the Japanese government expanded public works spending while also increasing welfare spending. Through the latter half of the 1970s and 1980s, public investment rose steadily, in part because the government found it increasingly difficult to deliver regular tax cuts (Ide and Steinmo, 2009). During the first part of the 1990s, the government sharply increased public investment to stimulate the economy and while below the peak of the middle of the decade, public investment remained high for the rest of Japan's 'lost decade'.

The perception of wasteful spending[7] has created a political bias that favors cutting spending as opposed to opting for tax hikes to raise revenue. Indeed, an international poll from 2006 shows that in comparative terms, there is particularly strong sentiment that government spending should be reduced (see Table 2).

Pursuing fiscal consolidation through controlling expenditures was codified in the political slogan 'fiscal reconstruction without tax hikes' that emerged in the 1980s. The slogan grew out of the debate to first introduce a broad consumption tax. Opposition and minority parties, exploiting the unpopularity of the tax, argued that rather than introducing a new tax the government should focus on reducing waste and improving administrative efficiency. At the end of 1979, opposition parties called for a non-binding resolution on fiscal consolidation in the Upper House that opposed the future introduction of a consumption tax. The Socialists were the first do so, and eventually their resolution passed, but other parties introduced similar resolutions.[8] The Socialist Party resolution stated that the consumption tax had not been adequately debated and that fiscal consolidation should focus on cutting expenditures, increasing administrative efficiency and making the tax system fairer (Ide, 2011). Under pressure, the LDP and Suzuki administration then embraced the formula, launching an administrative reform focused on fiscal consolidation through spending control and greater efficiency (and that abandoned the introduction of the consumption tax).

'Fiscal reconstruction without taxes' has been an enduring formula. Following the Suzuki administration, Prime Minister Nakasone (1982–1985) took up the slogan, and succeeded in restoring a degree of fiscal discipline. Prime Minister Takeshita (1987–1989) and later Hashimoto (1996–1998) departed from the formula by introducing and raising the VAT respectively, but their experiences, if anything, reinforced the political wisdom of focusing on expenditure side reforms. In his term, as prime minister in the first part of new century, Koizumi (2001–2006), aware of the public resistance to tax increases and concern over wasteful spending, continued to focus on expenditure side cuts to reduce deficits. In fact, he explicitly

Table 2 Public opinion on expenditure cuts, 2006. 'Here are some things the government might do for the economy. Please show which actions you are in favor of and which you are against. Cuts in government spending?'

Country	Strongly in favor of	In favor of
France	67.7	20.7
Poland	57.7	29.7
Japan	57.3	22.5
Germany-West	46.5	30.1
Germany-East	42.6	32.1
Portugal	39	45
Canada	36.8	31.8
New Zealand	28.1	34.9
United States	27.6	35.7
Norway	26.2	35.1
Taiwan	23.2	45.6
Netherlands	22.6	44
Sweden	20.4	35.4
Denmark	19.1	26
South Korea	17.6	37.7
Ireland	17.1	25.6
Australia	17.1	27.2
Spain	13.2	42.8
Great Britain	11.8	26.3
Switzerland	9.9	34.3
Finland	6.8	22.8

Source: International Social Survey Programme, 'Role of Government, Part IV', 2006.

revived and re-popularized 'fiscal reconstruction without tax hikes' and promised that he would not raise the consumption tax during his administration. In office, he focused on aggressive administrative reforms and cuts to public works spending, as part of a longer term strategy to win back public trust and prepare the ground for future tax hikes under a future administration. The MOF and LDP also floated various proposals, ones met skeptically by the public, to dedicate revenue from any tax hike to welfare spending so that voters would be reassured that revenue would not be wasted but would instead flow to worthy ends.

Initially the DPJ, which ended the LDP's long rule in 2009, largely kept to the same course. Prime Minister Hatoyama promised not to raise the consumption tax during his tenure, exactly as Koizumi had. The DPJ also committed to lower the still comparatively high corporate tax rate, while at the same time also increasing welfare spending with the introduction of a child allowance. Much like the LDP, the government sidestepped taxes and promised to restore fiscal balance by freeing up revenue through reducing waste. Upon taking power, the government set up a new Government Revitalization Unit (GRU) in the Cabinet Office to review public spending. The GRU, whose proceedings were streamed on the web, initially proved popular and won approval in the media, although the actual savings were very limited, underscoring the limits to the DPJ's approach to revenue (Park, 2010).

Since Hatoyama stepped down in 2010, as discussed earlier, the DPJ's approach to taxes shifted. In the summer of 2012, the government passed a tax hike that will raise the consumption tax incrementally from 5% to 10% by 2015. The government's determination on this issue is related to the scale of the Japan's fiscal problem, which is now reaching crisis proportion as Japan's population aging accelerates. Furthermore, the deficit and sovereign debt problems in Greece, Ireland, Portugal, and Spain have created a perception that the government must act, a sentiment that the government has encouraged to help make future tax increases seem inevitable. Still, the tax hike has been a very difficult sell. As mentioned earlier, the DPJ faced large defections, the cabinet approval rate fell dramatically below 20%, and then the party suffered a resounding defeat leading to a loss of power.

Conclusion

Analyzing the case of Japan, this article offers a new theory of extractive capacity. While the expansion of the welfare state has contributed to the revenue-raising capacity of the state, including in Japan, this view overlooks the variety of ways that states can integrate social and tax policy, i.e., the tax–welfare mix. Governments not only use taxes for revenue but also more directly as a means to achieve redistributive goals. How states do so, this paper shows, has long-term consequences for a state's extractive capacity.

The tax–welfare mix also helps explain a number of seeming peculiarities of the Japanese case. Despite having long rule by a center-right party that has relied on financial support from big business, the Japanese state has relied heavily on the taxation of corporations while keeping regressive taxation of consumption relatively low and tax treatment of low- and middle-income workers light. Moreover, Japan's tax structure, while clearly influenced by globalization, has not conformed to the globalization thesis. Tax competition and globalization create pressures to shift taxes away from mobile assets, such as corporate profits, to immobile assets (e.g., consumption), but comparatively Japan has one of the highest levels of reliance on corporate taxation and lowest levels of indirect taxation of consumption. This pattern only makes sense by understanding how the government has used redistributive tax policy as part of its system of social policy.

The tax–welfare argument also suggests an alternative explanation that goes beyond Japan's electoral rules. While Japan's old SNTV electoral system created incentives for particularistic spending and weakened the executive, Japan's weak extractive capacity is rooted more deeply in key historical choices about its tax and welfare policy. The dilemmas created by this historical legacy are likely to persist despite Japan's transition to a new electoral system in 1994. This finding underscores the utility of an historical institutionalist approach, which others such as Krauss and Pekkanen (2011) have applied to better illuminate Japanese politics.

Finally, the argument presented here helps us rethink the capitalist developmental state. As this paper shows, there is a problem in inferring a high degree of state autonomy from low levels of social spending. As the tax–welfare mix argument suggests, low spending does not mean a disregard for social policy or elite insulation from political pressure. The government was in reality highly responsive to political demands; it simply relied on a different tax–welfare mix that employed tax policy and targeted public investment. Thus, while in some ways low spending followed state goals, it also masked the political-redistributive logic of taxation that explains the Japanese state's weakness on the revenue side.

The case of Japan also suggests the need for greater attention to regime type and the timing of industrialization and social policy. Unlike Taiwan or South Korea through the early 1980s, postwar Japan was a democratic regime that faced political pressure while it pursued rapid industrialization. It was these competing tensions that contributed to Japan's particular tax–welfare mix. By contrast, Taiwan and South Korea industrialized under authoritarian regimes and then expanded the welfare state after democratization. More empirical work across these cases is needed, but the comparison of tax–welfare mixes suggests a potentially fruitful research avenue in explaining divergent fiscal outcomes. Given that Northeast Asian nations will face similar demographic changes that will strain their social welfare and budget systems, understanding how the 'East Asian welfare model' might influence the extractive capacity of states is an issue worthy of further study.

Notes

1. As measured by taxes (including social security contributions) as a share of GDP.
2. In fact, the government highlighted low taxes as part of social security in economic planning deliberations. See Park (2011) for details.
3. In 1975, Japan's top marginal personal income tax bracket was the fifth highest of the 22 OECD countries for which there is data. Only Sweden, the UK, and Ireland were higher.
4. The European Union has been an important driver of the diffusion and reliance on VAT in Europe.

5. Approval rate of the cabinet falls to record 19%. The Yomiuri Shimbun [online] (November 6, 2012) Available at: http://www.yomiuri.co.jp/dy/national/T121105003365.htm Accessed [November 8, 2012].
6. The ratio has changed recently to 100-50-30-10, with the final number representing the percentage of the total income of politicians that is known by the tax authorities.
7. Public perceptions have been fed in part by high levels of fixed public investment, but whether such spending is wasteful or not is a subjective perception. Widespread media accounts have fed this perception with stories of wasteful public works projects. This perception continues with stories of the misuse of public funds in the rebuilding of the Tohoku region after the earthquake, tsunami, and nuclear crisis.
8. Others include: the Clean Government Party (CGP), Kokumin Kaigi, Kokumin Rengo, Japan Communist Party, and Kakushi Kyodo.

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