The Compliance Gap Problem in Japan's Individual Income Tax and Estimates of the Compliance Gap in the U.S. Federal Individual Income Tax*

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I. The Gravity of the Compliance Gap Problem in Japan's Individual Income Tax

1. Background

In Japan, wage-earners whose employment income is fully subject to the withholding system have long complained about the administrative inequity of the individual income tax, because of the much publicized progression of "90 : 60 : 40" (or "100 : 50 : 30"). This progression designates the percentage of actually reported income to total amounts of income which should be reported to the tax office, for wages and salaries, non-farm proprietors' income and farm proprietors' income, respectively.

According to the public opinion poll concerning the consciousness of taxpayers, conducted by the Prime Minister's Office in October 1981, 29 percent of the respondents answered that they had heard of or seen the progression of "90 : 60 : 40". If we consider the wage-earner alone, this ratio would rise to almost 50 percent. In addition, 64 percent of the respondents answered that they believed in the inequity of the tax burden among the wage-earner, the non-farm proprietor and the farmer.[1] Consequently we must pay much attention to the differential gap of compliance by type of income or by type of taxpayer

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1) *Asahi Shinbun* (*The Asahi*), February 18, 1982.

indicated by the foregoing progression, even if there is a tendency to confuse tax avoidance with tax evasion. 2)

In spite of the widespread perception of the compliance gap problem, the Tax Bureau of the Ministry of Finance has not officially admitted the importance of this problem, nor, to date, has the National Tax Administration (NTA) initiated an investigation into the overall compliance with the individual income tax laws. Thus, the progression of "90 : 60: 40" still remains a matter of mere conjecture, inferred from fragmentary or ill-founded information on income tax evasion. 3) This information is disseminated widely particularly around the time when the deadline for filing the final return approaches (March 15 in Japan) and when correction or determination of tax liability is made by the tax office. Nevertheless, the compliance gap problem has recently become one of the focal issues of Japanese national tax policy.

A few years ago, when the Tax Commission (one of the advisory committees to the Cabinet) recommended the introduction of a "general consumption tax" (in effect, a value-added tax) as the best tax measure to balance the budget, it insisted that a VAT would be by no means less equitable than an individual income tax, primiarly on the grounds that the compliance gap was inherent in the income taxation and that to eliminate that gap would have been extremely difficult. The great majority of taxpayes (wage-earners), however, strongly favored innovative reforms of the existing income tax over the introduction of a new tax. In order to make the existing tax system more equitable and to raise additional tax revenues, they demanded that the Ministry of Finance should correct the compliance gap and eliminate a variety of tax preferences. 4)

As a result of the public debates concerning, and the temporary abandonment of plan to introduce the VAT, 5) the Tax Commission and the Ministry of Finance are now aware of the importance of the compliance gap problem in the individual income tax. The NTA has reportedly just begun an investigation into all of the issues surrounding this problem.

2. *Several Aspects of the Compliance Gap Problem*

Needless to say, the true issue of the compliance gap problem is not the existence of compliance gap itself, but its adverse effects on the equity and efficiency of the overall

2) For example, the deduction of wages of family employees, which is the most important privilege granted to a taxpayer filing a blue return, seemed to be discussed as a part of the compliance gap problem in the above article from the *Asahi Shinbun*.

3) Ironically, we can find a more relevant estimate in the joint paper by American tax scholars (Oldman and Holland [10], p. 296). According to their estimates based on V. Tanzi's data, the progression was "85 : 29 : 6" in 1965, the latest year for which estimates were available. It should be noted, however, that these estimates were derived simply by comparing personal income in the NIPA with income reported to the NTA as to wages and salaries, non-farm business income and agricultural income, respectively.

4) For example, to eliminate the following tax preferences: (a) the separate taxation of interest and dividends, (b) the exemption of capital gains from the sale of securities, (c) a variety of tax-free reserves, (d) some of the privileges granted to taxpayers filing blue returns, (e) the preferential treatment of expenses deduction for physicians.

5) The plan for adopting a VAT has been shelved for the present at least, because corporations, small businesses and farmers have also voiced strong objections to it. These groups are much concerned about a decrease in sales due to rising prices, increases in tax accounting costs and the uncertainty of shifting.

fiscal system, particularly the tax system. In the following survey, several aspects of the compliance gap problem are briefly examined with the assumption that there is a differential compliance gap by type of income or type of taxpayer.[6]

a. Tax Burden

First of all, the differential compliance gap produces an adverse effect on the equity of income tax burden, that is, the horizontal equity and the vertical equity, through the functions of the progressive rate schedule, the threshold income level (zero bracket amount) and the total-income (AGI)-linked deductions and credits. Without taking into consideration the compliance gap, therefore, an analysis of the tax burden would not be valid. For example, in the case of the effective tax rate, we must introduce three different conceptions of the effective tax rate by considering the compliance gap, and these are: "the ideal effective tax rate"—the effective tax rate with full compliance; the "nominal effective tax rate" —the percentage of tax paid divided by *reported* income; the "real effective tax rate" —the percentage of tax paid divided by *reportable* income.

Though the ideal effective rate and the nominal effective rate are most commonly used in theoretical analyses and quantitative analyses, respectively, it is the real effective rate that represents the most useful model of the "effective rate", for the first two conceptions

Figure 1. Ideal, Real and Nominal Effective Rate

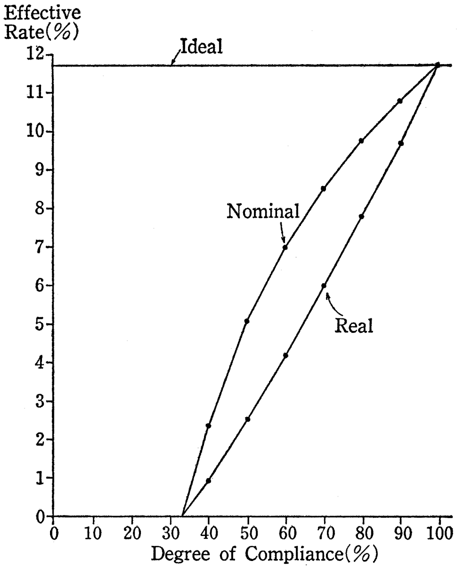
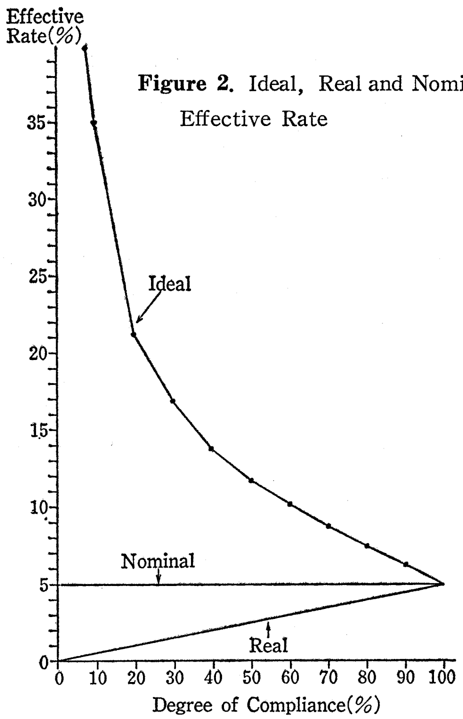


Figure 2. Ideal, Real and Nominal Effective Rate



6) In this paper, tax expenditures are not taken into consideration. I understand, however, that it is indispensable for examining the distribution of tax burden and the economic effect of tax policy to put tax expenditures and tax evasion together.

of the effective rate do not take into consideration the compliance gap. In short, a discussion about the substantial equity of the tax burden must be based on the real effective rate and its departure from the ideal and nominal effective rates. Similarly, an analysis of the actual economic effects of the individual income tax on the average propensity to consume or save, the disposable income and the like must be based on the real effective rate. The U. S. federal individual income tax shall be used to illustrate the above discussion.

Figure 1 shows the three effective rate curves for single individuals who have the same *reportable* tax table income, \$10,000, and who claim one exemption under the 1980 Tax Table A.[7] The Figure 1 indicates that as the degree of compliance declines, the real effective rate falls more quickly and departs sharply from the ideal effective rate under the progressive rate schedule with the threshold income level (zero bracket amount). One can also note that the nominal effective rate is higher than the real effective rate, except at the full compliance point and at the income level below the threshold amount, where the two rates are equal. While the foregoing illustrates the departure from horizontal equity, we can easily argue for the departure from vertical equity as well, when we take into consideration the compliance gap.

In Figure 2, three different effective rate curves are drawn for single individuals who have the same *reported* tax table income, \$5,000, and who claim one exemption under the 1980 Tax Table A. In this case, horizontal equity is attained in a nominal term, but not in a real term. Considering the ideal effective rate curve as a vertical equity curve, we can interpret Figure 2 as one specific case where the departure from vertical equity is caused by the compliance gap.

Likewise, with respect to the marginal tax rate, which is more useful than the effective tax rate in analyzing the economic effects of a individual income tax on the marginal propensity to consume or save, the labor supply and the like, we must use the "real marginal tax rate" as an analytical base, in order to develop more realistic and more significant arguments. Incidentally, the real marginal tax rate is defined as a fraction of the additional tax paid divided by additional reportable income.

As mentioned above, in addition to the function of the tax rate schedule, the compliance gap also affects the equity of the tax burden through the functions of tax deductions and tax credits that are linked with the total reported income (AGI). These deductions and credits are generally less important than the tax rate schedule in terms of the degree of their functions. Unlike the case of the tax rate schedule, an underreporting or an unreporting is not necessarily advantageous for taxpayers to reduce their tax liabilities as far as these deductions and credits are concerned. In the U. S. federal individual income tax, there are two deductions, the medical expenses deduction and the charitable contributions deduction, of which maximum deductible amounts depend on the amount of AGI. On the other hand, with respect to Japan's national individual income tax, there are two deductions— the casualty loss deduction and the medical expenses deduction, three credits—the dividends

7) Since the conception of the compliance gap applies to AGI, the reportable tax table income here is considered to be equivalent to the reportable AGI.

received credit, the credit for acquisition of house and the housing savings tax credit, and one accounting method for fluctuating income, all of which are linked with the total reported income.[8] It seems, therefore, that the effects of the compliance gap on the tax burden through the total-income(AGI)-linked deductions and credits are in all likelihood more serious in Japan's national individual income tax than in the U. S. federal individual income tax.

With respect to the effects of the compliance gap on the tax burden in Japan at least, we must never fail to refer to the local tax system, because Japan's local individual income taxes, such as the inhabitant tax at both the prefectural and municipal (city, town and village) levels and the individual enterprise tax at the prefectural level, are required, on administrative grounds, to adopt as their tax bases the total income in the national individual income tax, in principle. As a result, the compliance gap in the national individual income tax is necessarily reflected in the tax burden of the local individual income taxes as well.

b. Direct Benefit Payments

The departure from equity of the tax burden in national and local income taxation, however, is only one aspect of Japan's compliance gap problem from the standpoints of both equity and efficiency of the overall budget policy. It must be emphasized that the compliance gap is largely responsible for the unfairness of Japan's allocation of public expenditures among individuals as well. In an effort to maintain a certain fairness and efficiency in allocating direct benefit payments to individuals in such national and local programs as income security, social welfare, medical care, higher education, housing and the like, Japan has instituted an eligibility requirement based on the benefit recipient's "income". In many, but not all, cases, the total income reported to the tax office is used with little adjustment as the standard of "income".

The unfairness in the allocation of direct benefit payments, therefore, stems directly from the compliance gap in the national individual income tax. Under this eligibility test, based primiarly on total reported income, it is by no means rare that the compliance gap acts as a key determinant in selecting eligibles, and that taxpayers with the same reportable income are definitely divided between eligibles and non-eligibles on account of the differential compliance gap among taxpayers and on account of a certain level of border income for the eligibility test. This unfairness may, in general, be more intolerable than the inequity in the tax burden in terms of "all or nothing" quality and visibility.

c. Revenue Loss

From the fiscal point of view, the most important aspect of the compliance gap is, no doubt, the revenue loss. Since the total amounts of revenue loss due to tax evasion are generally a function of the total size of the compliance gap, the major aim of tax administration is usually focused on reducing the compliance gap as a whole. In this case, howe-

8) According to the national individual income tax law, the maximum deductible amounts of two deductions depend partly on total reported income. Similarly, the credit rate for dividends received and the eligibility to claim both tax credits and the averaging method are based on total reported income (see Gomi [3], Chapte IV).

ver, it should be noted that reducing the total compliance gap is not necessarily consistent with correcting the differential compliance gap by type of income. As will be examined in the next section, due to the unevenness in administrative practicability and effectiveness, it is absolutely difficult to reduce the compliance gap for every type of income to the same level of approximate zero. Thus, in an attempt to minimize the revenue loss by controlling tax evasion, we should pay close attention to the strong possibility that a reduction in the compliance gap as a whole would rather widen the differential compliance gap by type of income.[9]

The foregoing brief survey of various aspects of the compliance gap problem in Japan leads us to conclude that the most urgent need in Japan today is to correct the differential compliance gap by type of income or taxpayer, and that an evaluation of equity and efficiency in the contemporary national and local budget policies must include a thorough analysis of the total effects of the compliance gap on the tax burden itself, the allocation of direct benefit payments and revenue loss. As mentioned above, however, there has been no comprehensive and reliable estimate of the underlying compliance gap in Japan to date. For the present, at least, we must seek circumstantial evidence of the differential compliance gap by type of income in estimates and analyses in foreign countries, particularly the United States.

II. Estimates and Analyses of the Compliance Gap in the U.S. Federal Individual Income Tax

1. *Introduction of Two Estimates*

With respect to the compliance gap in an individual income taxation, thorough surveys by Oldman and Holland [10] and Holland and Oldman [6] (unpublished) have examined the definition, methodology, results and policy implications of various types of estimates and analyses that are available to us today. Among these studies,[10] two of the most recent estimates of the compliance gap in the U.S. federal individual income tax—the IRS' Report (Department of the Treasury, Internal Revenue Service [15]) and the Park's Estimate (Park 12]) which have been examined carefully by Holland and Oldman [6]—will be taken up in the following cross-section and time-series analyses of the differential compliance gap by type of income. Before proceeding to the main subject, we need to understand the major characteristics of the above two estimates.

In short, the IRS' Report is a cross-section estimate based on micro-data and the Park's Estimate is a time-series estimate based on macro-data. In the IRS' Report, estimates of the compliance gap for the single year 1976 were made on the basis of both the IRS' Taxpayer Compliance Measurement Program (TCMP) for tax return filers and the Exact Match File for non-filers. This report's strength lies, specifically, in its inclusion of all types of

9) This possibility has been suggested by Professors Holland and Oldman (Holland and Oldman [6], P. 22).
10) Their surveys have also included the examinations of estimates and analyses of the compliance gap in the U.S. state individual income taxes and income taxes in several foreign countries.

income which should have been reported on the tax returns and in its exclusion of incomes which did not need to be reported. 11) Though it is regretful that the compliance gap of non-farm and farm proprietors' income was estimated *en bloc*, this report is thought to be the best cross-section estimate of the differential compliance gap by type of income. 12)

In contrast, in the Park's Fstimate, estimates of the compliance gap were made by comparing the adjusted gross income of the IRS with the BEA(the Bureau of Economic Analysis)-derived adjusted gross income, the latter of which was derived from the BEA measure of personal income by adjusting differences in definitions and accounting procedures. His estimates were made for a long time, from 1947 through 1978. As Professors Holland and Oldman have pointed out, the Park's Estimate, made by means of consistent methodology, and over the course of thirty-two years, is extremely useful in evaluating the effects of administrative measures and tax policy on the compliance gap. 13) In addition, by using the Park's Estimate, we can confirm the reliability or the statistical significance of the IRS' Report, for the Park's Estimate completely dismisses the possibility that the single year 1976 could be an exceptional year for estimating the compliance gap. Though we can find some methodological flaws, such as the exclusion of capital gains by definition, the underestimates of incomes from moonlightings and informal activities, and the inclusion of incomes which were not required to be reported on the tax returns, the Park's Estimate is considered to be the best time-series estimate of the differential compliance gap by type of income.

In sum, I believe that both the IRS' Report and the Park's Estimate are the most reliable estimates of the differential compliance gap which are available today.

2. *Structure of the Differential Compliance Gap*

The results of both these estimates for 1976 are shown in Table 1. As mentioned above, it is difficult to make a strict comparison of the two estimates as to specific types of income, because of the differences in definition and classification of incomes between them. 14) Furthermore in view of the nature of the subject matter, it is unreasonable to expect that full accuracy in their estimates could be attained. The focus of our interest, however, is on the structure of the differential compliance gap by type of income. From the viewpoint of the tax administration, then, we can easily find some structural characteristics in the last columns of the two estimates, even though the degree of the compliance gap varies from income type to income type, and though there are considerable differences in the degree of the compliance gap for some specific types of income between the IRS' Report

11) In IRS' Report, estimates of unreported illegal-source incomes were made in addition to legal-source incomes, but they will be omitted in the following analyses.

12) However, the IRS' methods used to estimate non-filers' incomes were criticized by the U. S. General Accounting Office [16]. It is not clear, however, whether or not the GOP's recommendations to the IRS were fully reflected in the IRS' Report.

13) Holland and Oldman [6], pp. 8, 17.

14) In addition to the exclusion of capital gains in the Park's Estimate, incomes of partnerships, estates and trusts were allocated to farm proprietors' income, non-farm proprietors' income, rental income and interest income (Park [12], p. 26.)

and the Park's Estimate.[15)]

In the IRS' Report, the Commissioner of the Internal Revenue Service indeed concludes that,

> "This report confirms that voluntary reporting of income is very high where incomes are subject to withholding. Voluntary reporting is lower where payments are subject to information reporting but still considerably better than where incomes are subject to neither withholding nor information reporting."[16)]

Generally, this conclusion is affirmable, but so far as the information return applying to interest and dividends of $10 or more is concerned, this conclusion is not necessarily persuasive: we cannot find statistically definitive differences in the degree of the compliance gap between incomes subject to information returns and incomes not subject to information returns, such as pensions, annuities[17)] and capital gains.[18)] Thus, it is reasonable here to reserve a decisive judgment on the effects of information returns on the compliance gap.

In sum, the simplest and most definite structural characteristic which can be derived from Table 1 is that the degree of the compliance gap of incomes subject to withholding, that is, wages and salaries, is by far the lowest, and that, in spite of a wide variation, the degree of the compliance gap of other types of income not subject to withholding is generally far higher than that of wages and salaries. Incidentally, among specific types of income other than wages and salaries, we need to pay particular attention to farm proprietors' income, which shows by far the highest degree of compliance gap in the Park's Estimate.[19)] Finally, it must be noted that the schema of the differential degree of the compliance gap for wages and salaries, nonfarm proprietors' income and farm proprietors' income in the U. S. is generally coincident with that in Japan, as discussed in the previous section.

3. *Factors of the Differential Compliance Gap*

On what factors does the compliance gap for a specific type of income depend? To date, a wide variety of answers and suggestions has been given to this interesting but difficult question by legal scholars, economists and sociologists who study tax evasion.[20)]

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15) The causes of these differences, particularly for interest and pensions and annuities, are not necessarily clear. According to Park's comments, the higher degree of the compliance gap for interest was partly explained by the potentially substantial interest received by minors, who were not required to file in most cases (Park [12], p. 46).

16) Internal Revenue Service [15], p. iv.

17) Strictly, annuities, rent, compensations, premiums, remuneration, emoluments, etc. are, in principle, subject to information returns, as well. However, they are subject to information returns, only when their respective aggregate amounts are $600 or more.

18) With respect to capital gains, there are some estimates or information which indicate much higher degree of the compliance gap than that in the IRS' Report. For example, according to estimates made by H. H. Hinrichs concerning the corporate stock, the degree of the compliance gap was 37% in 1959 and 36% in 1961 (Hinrichs [6], p. 159). The IRS' Report, however, dismissed them as overestimates (Internal Revenue Service [15], PP. 114-115). The latest information about it was included in the address by Senator R. Dole, who pointed out that the degree of the compliance gap for capital gains was 44% according to the IRS (*Congressional Records Senate*, March 11, 1982, S. 2013).

19) Concerning the compliance gap for farm proprietors' income, a variety of interesting information was introduced in the article entitled "The Income Farmers Hide," *Business Week*, April 17, 1978, pp. 91, 94.

Table 1. Estimated Amount of Unreported Income for 1976, United States, As Percent of Reportable Amount, By Type of Legal-Source Income

(Amounts in Billions)

(A) The IRS' Report				(B) The Park's Estimate			
Type of Income	Reportable	Unreported	Unreported As Percentage of Reportable	Type of Income	Reportable	Unreported	Unreported As Percentage of Reportable
Self-Employment	$93–99	$33–39	36–40%	Self-Employment	$88.4	$28.3	32.0%
Farm	—	—	—	Farm	14.6	10.1	69.4
Non-Farm	—	—	—	Non-Farm	73.8	18.2	24.7
Wages and Salaries	902–908	21–27	2–3	Wages and Salaries	883.8	2.8	0.3
Interest	54–58	5–9	10–16	Interest	76.4	25.7	33.7
Dividends	27–30	2–5	8–16	Dividends	30.5	6.0	19.7
Rents and Royalties	9–12	3–6	35–50	Rents	11.3	5.0	43.9
Pensions, Annuities Estates and Trusts	31–33	4–6	12–16	Pensions and Annuities	35.0	10.4	29.8
Capital Gains	22–24	4–5	17–22	—	—	—	—
Other	9–10	2–3	25–30	—	—	—	—
Total	1,148–1,172	75–99	6–8	Total	1,132.1	78.2	6.9

Source: (A) Internal Revenue Service [15], pp. 7–8. (B) Park [12], pp. 26–28.

Some of the factors pointed out in these studies[21] are:

a. the difference in tax collection system,
b. the technical efficiency of tax administration,
c. the effectiveness of audit program,
d. the quantity and quality of information available to tax officials,
e. the leniency or severity of penalty,
f. the equity and efficiency of budget policy,
g. the equity of tax system as a whole,
h. the tax treatment of specific type of income,
i. the progressivity of tax rate schedule,
j. the so-called "bracket creep" caused by inflation,
k. the virtual depreciation of capital assets caused by taxing inflationary profits and gains,
l. the understandability of tax law,
m. the practice and accuracy of bookkeeping,

20) From the methodological viewpoint, these studies of tax evasion can be classified into several categories: (a) statistical measurements of tax evasion, based on economic and tax data, represented by Internal Revenue Service [15] and Park [12], (b) positive and empirical analyses of tax evasion, based on the examination of quantitative, institutional, socio-economic and policy factors, represented by Oldman and Holland [10], Herschel [4] and Holland and Oldman [6], (c) theoretical and econometric analyses of tax evasion, based on taxpayer's utility function, represented by Allingham and Sandmo [1] and Mork [9], (d) surveys of taxpayer's consciousness and behavior by interviews, represented by Vogel [17], Song and Yarbrough [13] and Dean, Keenan and Kenney [2]. The literatures referred to above are not necessarily studies concerning the U.S. federal individual income tax.

21) Holland and Oldman [6], pp. 11-12, Dean, Keenan and Kenney [2], pp. 30-31, Vogel [17], pp. 502-508, Song and Yarbrough [13], pp. 444-451 and Herschel [4], pp. 232-237.

n. the availability of opportunities for unreporting income, which is inherent in specific types of income,
o. the public perception of tax evasion as a crime.

Indeed, it may be significant to examine various factors influencing tax evasion, but, above all, it must be emphasized that, in general, the difference in tax collection (or payment) system is the decisive factor. Professors Oldman and Holland have argued: "The recipients of wages and salaries may not be any more honest or zealous at self-policing than the next man, but income tax being withheld from this source their opportunity to undertake evasive action (fail to report) is strongly curbed,"[22] and Professor Ilersic has also stressed: "Bearing in mind that tax evasion for the average employee whose earnings are charged to tax under the PAYE (pay-as-you-earn scheme of tax collection which covers some 25 million people) is virtually impossible ...,"[23]

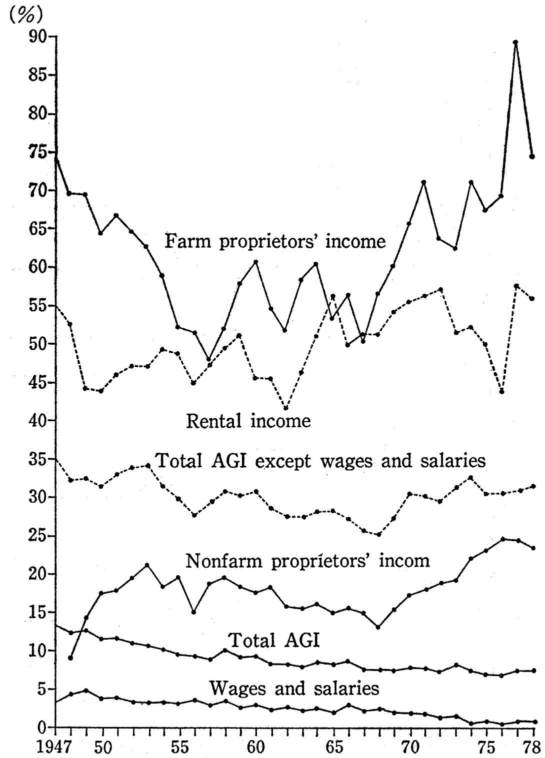
In short, discussions about various factors relating to the background, motive and means of tax evasion are almost worthless with respect to incomes which are subject to the withholding system, because the concept of voluntary compliance is virtually invalid. According to the Park's Estimate, this means that some three-fourths of the total reportable AGI in the U. S., that is, wages and salaries,[24] will be omitted in the following general discussions about the factors influencing tax evasion. It goes without saying that the compliance gap can be accounted for by the combined effects of all conceivable factors that influence tax evasion. It is, therefore, extremely difficult to single out one factor as a dominant determinant of the compliance gap of incomes other than wages and salaries. In the following, I will attempt to isolate some of the factors which seem to have been influential, by tracing the time-series estimates of the degree of compliance gap for specific types of income in the Park's Estimates (Figure 3 and 4).

As revealed in both of these Figures, the degree of the compliance gap for wages and salaries which was by far the lowest and which declined continuously in spite of remarkable changes in the economic situation and tax policy during this period, is in marked contrast to the degree of the compliance gap for other types of income, which was generally much higher and far more variable than the degree of the compliance gap for wages and salaries. When one considers incomes other than wages and salaries, this means, in general, that there are many opportunities for tax evasion, and that the degree of the compliance gap depends on a variety of factors.

It is safe to say that the level and variation of the degree of compliance gap are largely dependent upon the availability of opportunities to evade tax for specific types of income. This availability, in turn, is dependent upon various factors such as the nature and means of transactions, the practice and accuracy of bookkeeping, the efficiency and effectiveness of tax administration and the like.[25] In this respect, it is argued that the greatest oppor-

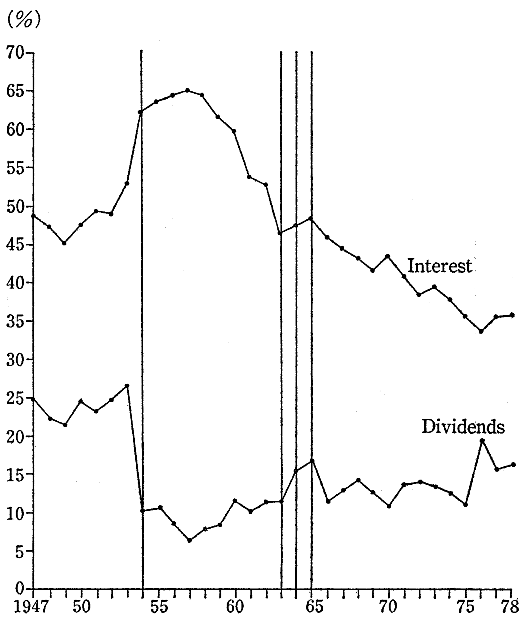
22) Oldman and Holland [10], p. 283.
23) Ilersic [7], p. 693.
24) According to the Park's Estimate, the ratio of reportable wages and salaries to total reportable AGI rose from about 70% in the latter half of the 1940s to about 78% in the 1970s (Park [12], p. 26).
25) See the following articles: "How Tax Cheaters Get Away with Billions," *U. S. News & World Report*,

Figure 3. Degree of Compliance Gap for Total AGI and Selected Type of Income, 1947—1978



Source: T. S. Park [12], pp. 26-28.

Figure 4. Degree of Complinace Gap for Interest and Dividends, 1947—1978



Source: T. S. Park [12], p. 28

tunities for unreporting income are inherent in farm proprietors' income.[26]

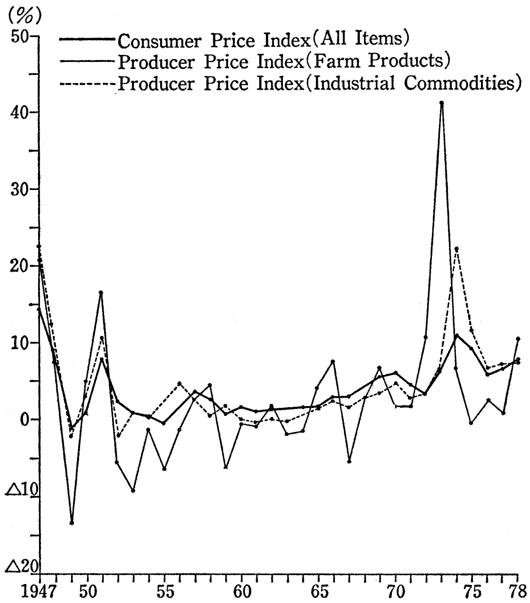
With respect to trend of the degree of the compliance gap during this period, we can generally find a significant correlation between it and the trend of changes in prices (Figure 5), but we cannot find a similar correlation between it and changes in the tax rate sehedule (Figure 6). Consequently, we can regard inflation producing a taxation of nominal incomes and gains as an influential factor in determining the trend of the degree of the compliance gap. As is widely known, tax evasion became a serious socio-economic problem as an "underground economy" in the latter half of the 1970s. In fact, the trend of the degree of the compliance gap for farm and non-farm proprietors' income, in particular, rose sharply, in coincidence with an increasing rate of inflation accelerated by the oil crisis. It need scarcely

March 27, 1981, pp. 102-105, "The Fast Growth of the Underground Economy," *Business Week*, March 13, 1978, pp. 73-74, I. Ross, "Why the Underground Economy," *Fortune*, October 9, 1978, pp. 92-95, 98, and R. Lenzner, "It's Tax and Temptation Time,", "Plenty of Loopholes for Tax Cheaters," and "Tax Cheats: Tipsters Alone Aren't Enough," *The Boston Globe*, April 11, 12, 13, 1982.

Y. Song and T. E. Yarbrough stressed the problem of tax ethics as the underlying factor for tax evasion. According to their survey, "the typical taxpayer apparently considers tax evasion only slightly more serious than "stealing a bicycle"," (Song and Yarbrough [13], p. 445).

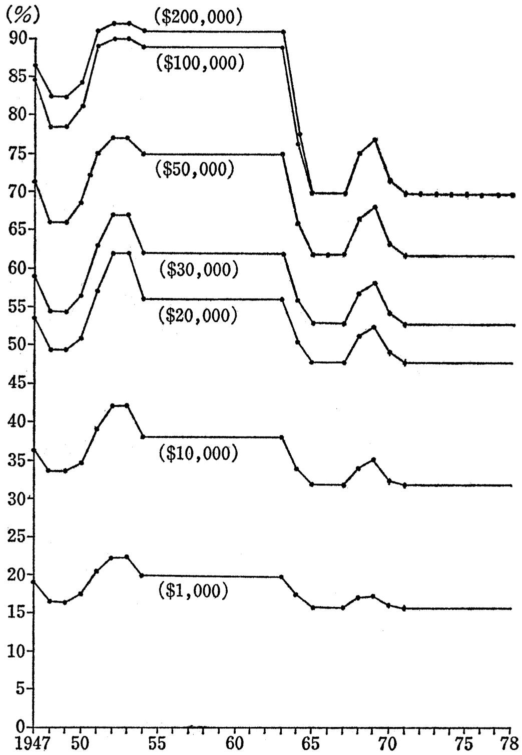
26) See "The Income Farmers Hide," *Business Week*, April 17, 1978, pp, 91, 94.

Figure 5. Changes in Consumer and Producer Price Indexes, Year to Year, 1947—1978



Source : *Economic Report of the President: Transmitted to the Congress, February 1982*, Washington, U.S. Government Printing Office, 1982, pp. 291, 300.

Figure 6. Federal Individual Income Tax Rate Schedules (Marginal Tax Rates Including Surcharge), 1947–1978



be said that the true sufferers of inflation were recipients of wages and salaries, because those who had already been subject to withholding had to undergo the so-called "bracket creep" and those who had not been subject to withholding before became subject to it, to a considerable extent.[27]

Finally, in this paragraph, we must examine two factors, information returns and tax avoidance, by tracing the trend of the degree of the compliance gap for interest and dividends (Figure 4). Regarding the effects of tax avoidance on tax evasion, F. J. Herschel has pointed out interesting correlations: "(a) both could be considered as alternative means to face extremely high rates; (b) on the other hand, a significant and well known tax avoidance could increase evasion, as people could be aware of the unfairness of the law,"[28] In short, while the latter is an indirect and positive correlation, the former is a direct and

27) T. S. Park has argued the cause of the persistent decline in the degree of compliance gap for wages and salaries as follows: "Rising income levels and minimum wages laws have reduced the relative importance of income earned below the withholding and filing requirements." (Park [12], pp. 27-28).

28) Herschel [4], p. 233. Professors Holland and Oldman have expressed the former correlation as a more specific term of "the greater the opportunities for tax avoidance, the more moderate the pressure for tax evasion," (Holland and Oldman [6], p. 11).

negative one. Thus, the focus here is on the former correlation.

The information return system for interest and dividends of $ 10 or more was enacted in the Revenue Act of 1962 and became effective with respect to payments made on or after January 1, 1963. However, we can find little effect of information returns on the trend of the degree of the compliance gap for interest and dividends. It is true that the degree of the compliance gap for interest declined sharply in 1963, but this occurred in the course of a long-term downward trend beginning in 1959. Furthermore, when it comes to dividends, we cannot find any apparent effect. Indeed it may be possible to interpret the following phenomena or hypothesis as evidence for the effectiveness of information returns: the phenomena of a sharp decline in the degree of the compliance gap for interest and a halt of the compliance gap's upward trend for dividends in 1963 at least, or the hypothesis that the degree of the compliance gap for both types of income must have been much higher without the introduction of information returns, but this interpretation, in either case, does not seem to be persuasive. [29]

Rather, we can find far more apparent and immediate effects of one factor in the trend of the degree of the compliance gap for dividends. As revealed by Figure 4, a sharp decline in 1954, a considerable rise in 1964 and a moderate rise in 1965 in the degree of the compliance gap for dividends were completely coincident with an introduction of the dividends received exclusion ($ 50) and credit (4%), a reduction in the credit rate (2%) and a repeal of the credit coupled with an increase in the exclusion ($ 100), respectively. [30] In sum, so far as the shift of the degree of the compliance gap for dividends was concerned, the negative correlation between tax avoidance and tax evasion seems to have been a dominant factor. Conversely, this evidences the weakness of the effects of information returns, even if, in fact, there were any. This negative correlation may also account for an unexpectedly low degree of the compliance gap for capital gains, 17–22%, estimated in the IRS' Report, for capital gains abounded with opportunities for tax avoidance, though they were subject neither to withholding nor to information returns, and though they suffered a taxation of nominal gains from inflation.

III. Concluding Remarks

It may be safe to say that the structure of the differential compliance gap for wages and salaries, non-farm proprietors' income and farm proprietors' income in Japan mentioned in [I] is basically verified by the analyses of the IRS' Report and the Park's Estimate in the previous section. However, we need to pay attention to the probable differences in the degree of the compliance gap for specific types of income between Japan and the U. S., for

29) Even the Assistant Commissioner of the IRS has admitted the limit of information returns. First, the IRS has not had sufficient resources to make most use of the informamion return system, and second, about 20% of information returns were filed without identifying numbers or with incorrect numbers (Owens [11], pp. 360-362.). The IRS continues to wrestle with these problems (see *Congressional Record*, *Senate*, March 11, 1982, S. 2013).

30) These coincidences were found or suggested by T. S. Park (Park [12], p. 28).

there are, of course, significant differences in some of the major factors influencing tax evasion between these two countries.

First, the coverage of the withholding system in Japan is wider than that in the U. S. so far as the various types of income are concerned.[31] In Japan, in addition to wages and salaries, annuities and pensions are also subject fully to withholding. Furthermore, interest, dividends, prizes, copyright royalties and remunerations, etc. for independent personal services, etc. are, in principle, subject to withholding at a flat rate.

Second, the opportunities for tax avoidance in Japan are probably greater than those in the U. S. with respect to interest, dividends, capital gains and non-farm proprietors' income. In Japan, interest on small deposits, postal savings, small savings for public bonds and small savings for the formation of employees' assets,[32] and capital gains from the sale of securities, in general, are all non-taxable incomes. In addition, the separate taxation (withholding), the tax credit,[33] and the separate taxation at preferential tax rates are granted to both interest and dividends, dividends, and long-term capital gains from the sale of real estate, respectively. Regarding non-farm proprietors' income, the individual taxpayer filing a blue return is allowed to make use of more than thirty privileges. Of these privileges, the deduction of family employee's wages and salaries, and the special deduction for blue return are particularly important. This blue return system is intended to increase compliance by encouraging the taxpayer, who is afforded tax privileges, to keep an accurate record.[34]

From the foregoing, we could expect a lower degree and a narrower differential of the compliance gap in Japan than those of the compliance gap in the U. S., other things being equal. As a matter of fact, however, other factors for controlling tax evasion in Japan are considered to be probably worse than those in the U. S.. Examples of these factors relating to the opportunities for tax evasion are: the higher weight[35] of typically small, family enterprises with their high degree of mixture of management and household, the administrative ineffectiveness in controlling the abuse of the tax-free small savings by false or anonymous names, which is primarily due to the lack of taxpayer identification numbers,[36] the lower consciousness of voluntary compliance stemmed from historical and social

31) Incidentally, this does not mean that the withholding system in Japan is weightier than that in the U. S. in terms of coverages of income amounts and tax revenues. According to Professor Ishi's estimates, the percentage of reported incomes subject to withholding to total reported incomes in Japan was slightly higher than that in the U. S. only by about 1% in 1972, and the percentage of tax revenues withheld to total tax revenues was conversely lower by no less than 15%. These results of estimates could be accounted for largely by the lower share of wages and salaries, the higher share of farm and non-farm proprietors' income and the lower effective tax rates of withholding in Japan (see Ishi [8], pp. 30-48).

32) The maximum of the tax-free small savings amounts to a total of 14 million yen (approximate 61,000 dollars) per capita.

33) The credit of dividends received is allowed to the taxpayer who does not select the separate taxation of dividends.

34) See Tanabe [14].

35) According to statistics on the sources of personal income, the share of the proprietors' income for Japan and the U. S. in 1980 was 15.7% and 6.0%, respectively.

36) The so-called "green-card system" is scheduled to be introduced in 1984 as a taxpayer identification number for interest and dividends. However, its enforcement is considered to be doubtful under the existing circumstances.

background of the self-assessment system, and so on. Consequently, we cannot confirm that the general situation of the compliance gap problem in Japan is better than that in the U. S.

Nevertheless, in Japan, not a few people do not see the compliance gap problem as a particularly serious one. First, farm and non-farm proprietors insist that they have to bear the costs of bookkeeping and return-filing unlike wage-earners, and that the employment income deduction is granted to wage-earners in virtual compensation for their full compliance. This view is not justifiable, first because the costs mentioned above and the special deduction for taxpayers filing blue returns are deductible as business expenses, and second because the most equitable treatment of wage-earners would be to switch over from withholding to self-assessment if non-compliance were justified on the ground of self-assessment costs. Second, wealthy savers insist, explicitly or implicitly, that the strength of Japan's economy is based primarily on the highest savings rate caused partly by the compliance gap for interest and dividends. This view is not justifiable, either, because the explicit tax measures should be taken if it were really necessary to increase the savings rate still further. Third, some economists point out that if there were a differential compliance gap by type of income, it would be virtually compensated, in the long-run, by the shift in the structure of the income distribution caused by job and career changes. This view is inappropriate, too, because it is based on the unrealistic assumption of the full mobility of job and career, and because it leads to deny any necessity of policies and measures by letting the so-called "invisible hand" work out. Finally, the crucial and common defects of these three views are the justification for tax evasion on economic grounds and the failure to take into consideration all aspects of the compliance gap problem.

The conclusions of this paper are as follows:

1. There is no justification for tax evasion.
2. The differential compliance gap by type of income, which stems primarily from the difference in the tax collection system, is probably inherent in Japan's individual income tax as well.[37)]
3. The differential compliance gap must be corrected to attain the equity and efficiency of the entire fiscal system.
4. The withholding system is by far the most effective means to reduce the compliance gap.
5. Unlike the federal individual income tax in the U. S., there is little room for extending the withholding system in Japan's individual income tax.
6. The strengthening of the existing withholding system, therefore, would rather widen the differential compliance gap, even though it could increase compliance as a whole.

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37) Afterward, I was informed of Professor Ishi's estimates of the degree of compliance for wages and salaries, non-farm proprietors' income and farm proprietors' income in Japan's national individual income tax. According to his estimates, based generally on the same method as that of Park's estimates, the progression of the degree of compliance from 1970 through 1978 was "90-100%:60-70%:20-30%" (Ishi, H., "Kazeishotoku-Hosoku-Ritsu no Gyoshu-Kan Kakusa (The Differential Degree of Compliance by Type of Taxable Income)", *Gendai Keizai* (*Contemporary Economics*, No. 42, Spring 1981.)

7. Thus, the administrative measure or tax policy for controlling tax evasion must be focused on assets income and business income. More specifically, the introduction of a type of the taxpayer identification number, the so-called "green-card system", and a quasi-type of withholding system, that is, the value-added tax with the invoice, would be necessary for controlling tax evasion of assets income and business income, respectively.

(May 20, 1982)

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