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The rise and fall of the land myth in Japan  
some implication to the Chinese land taxation

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The views expressed in this paper are those of the authors and not those of the Ministry of Finance or the Policy Research Institute.

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# **The rise and fall of the land myth in Japan**

## **- some implication to the Chinese land taxation**

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### 1. Introduction – the bubble economy and the land myth

#### (1) What is the bubble economy?

In Japan, the so-called bubble economy started from the latter half of the 1980s. Then the bubble burst and Japan entered the “lost decade” of the 90s — a long-lasting period of depression and deflation not experienced by any other country since World War II. In this paper, I try to pick out some lessons that should be learnt from Japan’s experiences, by studying the factors and political problems that powered the bubble economy.

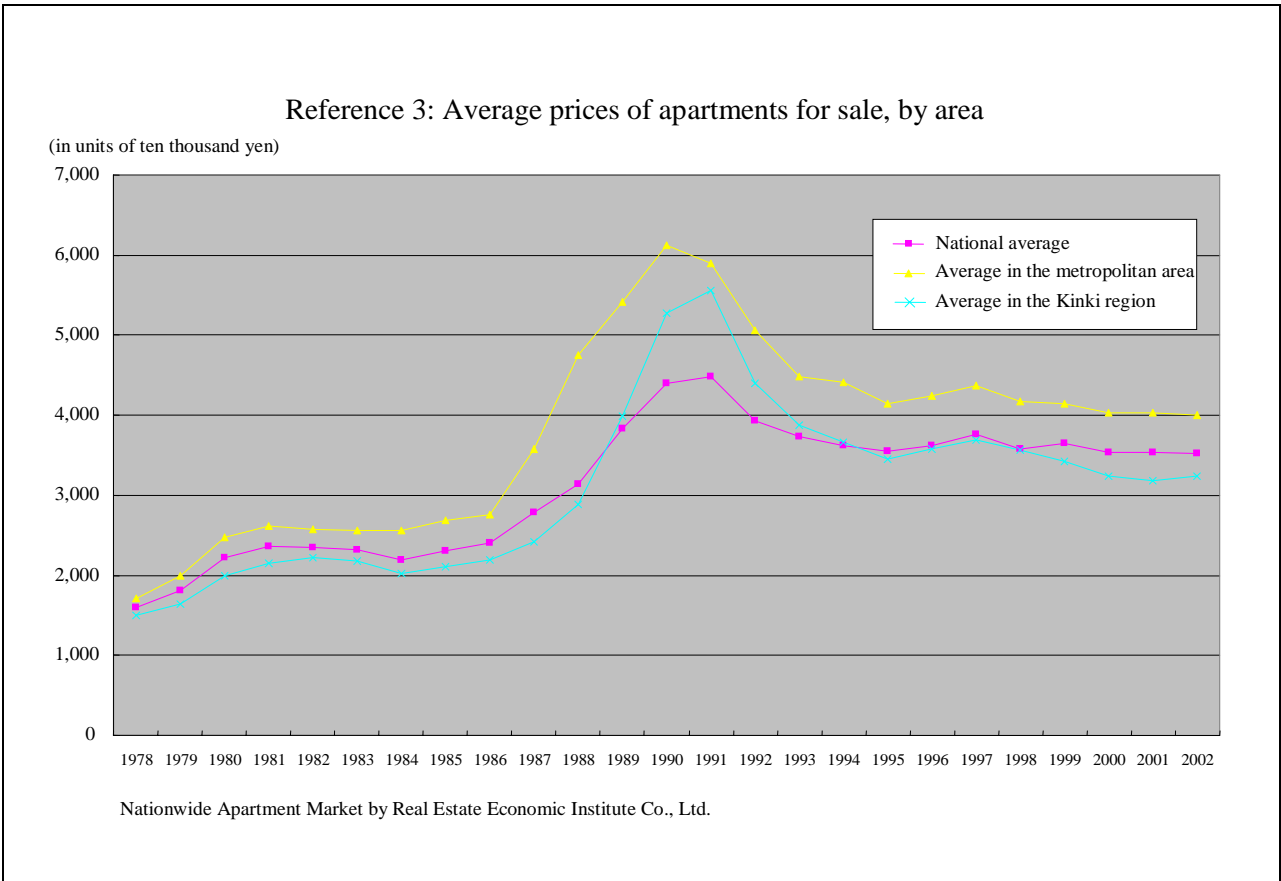
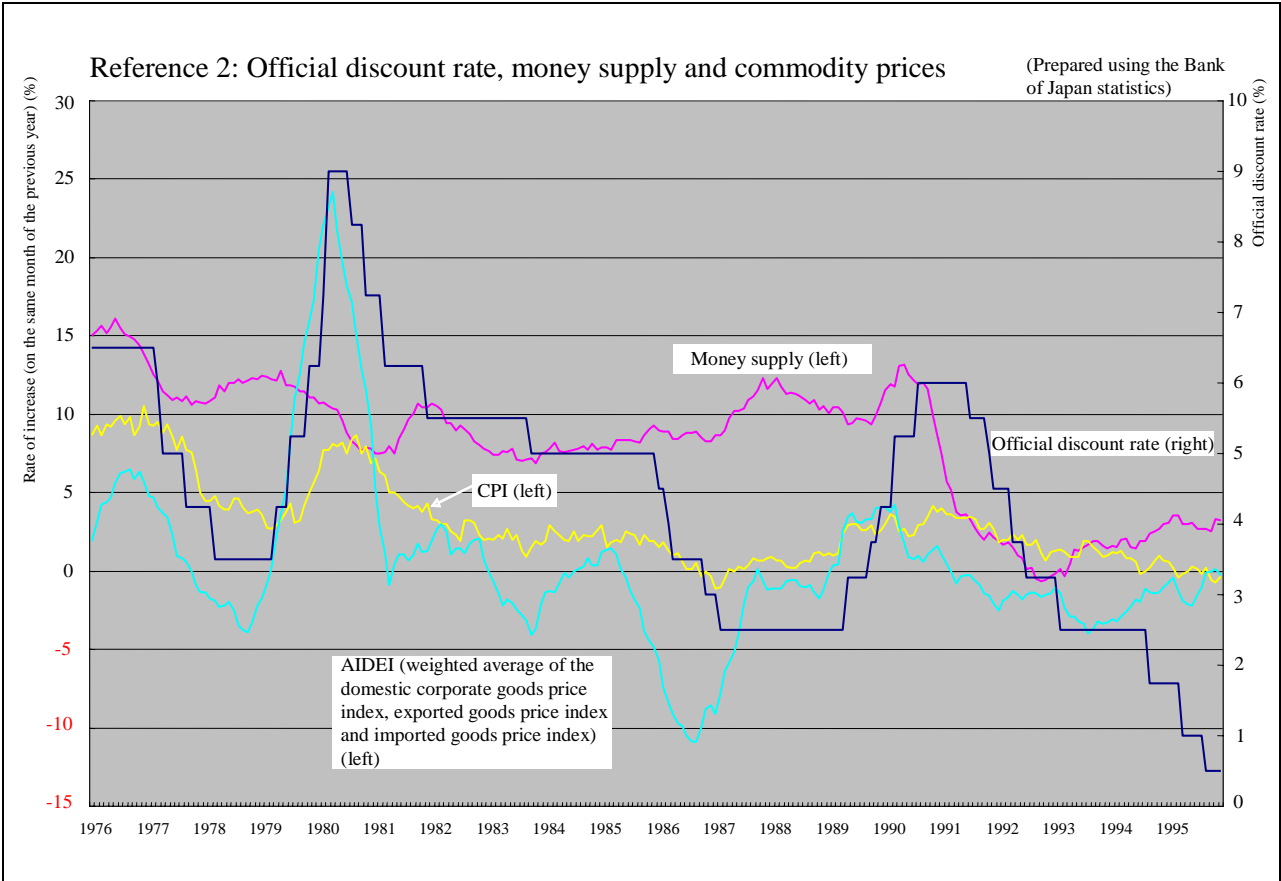
“Bubble” economy means a soaring of asset values not based on economic fundamentals. An important point to note is that the economic fundamentals were not abnormal during the bubble economy.

Asset values are generally determined in accordance with the following formula:

$$\text{Reference 1} \quad \text{Definition at asset values}$$
$$\text{asset value} = \frac{\text{profit}}{\text{long-term interest rate} + \text{risk premium}}$$

Three determinants of asset values are profit, the long-term interest rate and risk premium. It is part of the economic mechanism that the value of assets rises as the profit they generate rises and falls if long-term interest rates rise or the risk premium of the assets increases due to reasons such as uncertain economic outlook.

The following is an account of the economic situation in Japan in the latter half of the 80s corresponding to the mechanism described above. Long-term interest rates have been low under the lux monetary policy (particularly from 1986) — a measure employed to combat the depression caused by the strong yen — and the assumption was that rates would remain low for some time to come. Risk premiums were declining because land prices were expected to rise further, due to the belief in the land myth. Profits generated by assets (including expectations) were steady, underpinned by a general boom in business, so the steep rise in asset prices was caused mainly by the factors in the denominator.



## (2) The myth of land prices and the land standard

To understand land prices, it is necessary to explain the land myth which took root in Japan after World War II. This myth (that land prices would never fall) was also known as the “land standard”, which indicates that the Japanese economy is centered on land and land prices.

In principle, land prices should correspond to the use of land. In Japan, apart from the actual use of land itself, land also has a financial function such as security for bank loans — a situation in which land underpins the Japanese economy.

The monetary easing policy combined with speculation under the land myth gave rise to the bubble economy.

Japanese banks were lending money using land as collateral, which is known as the land standard. The land standard was the rule of life that enabled medium-sized and smaller companies with little credit to take out loans after the second world war when funds were in short supply. The land standard was one way to circulate a limited amount of funds efficiently.

The requirement to maintain the land standard was that land prices should never fall. The myth that land prices would never decline and would continue to rise was conceived under the circumstances described above, supported by sentiment based on the fact that there is only a limited amount of inhabitable land in Japan and the existence of firmly-rooted desire to own houses. Banks gradually started increasing loans by appraising the security taking into consideration the future rise of land prices (expectations).

The belief in the myth grew, partly because methods to objectively appraise land prices were not developed. Companies were able to operate based on long-term views by maintaining latent profit generated by rising land prices because land prices were appraised using book values in business accounting, which significantly contributed to business growth.

This “rule of life” conceived after the second world war continued to be used unchanged, even after the achievement of remarkable economic development. Then the financial liberalization that started in the latter half of the 80s intensified competition among financial institutions to make loans, leading to excessive lending with land as security which drove the price of land ever higher — the cause of the spiraling of land prices.

### (3) Land taxation system

Some people believe that the Japanese land taxation system caused the bubble. Land is usually taxed at three stages: on acquisition, while held and when transferred. In Japan, land is subject to three kinds of taxes at each stage, on acquisition: inheritance tax (national tax), registration and license tax (national tax) and real estate acquisition tax (prefectural tax); on land holding: fixed property tax (municipal tax), urban planning tax (municipal tax) and special land-holding tax (municipal tax, suspended in 1993); on land transfers: corporation tax, income tax (national tax) and inhabitant tax (local tax), imposed on capital gains.

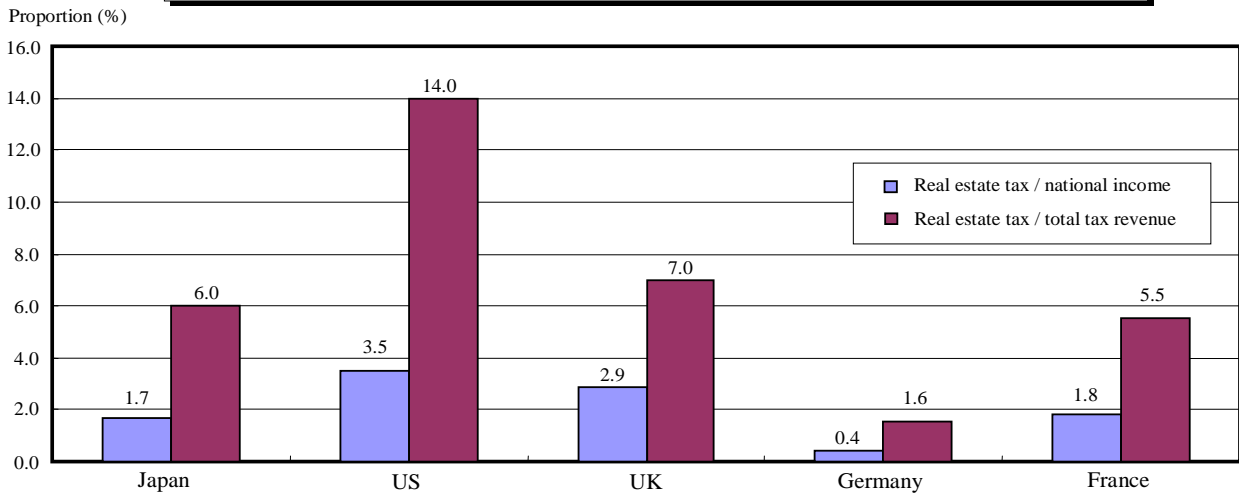
The low level of taxation on the holding of land is considered to be a cause of the bubble. The level of fixed property tax, which is the main tax imposed on the holding of land, has been kept low because it is a benefit tax to cover the costs of public services benefiting local residents. Let's look at five references that confirm this point.

Reference 4: Comparison of land taxation systems of Japan and China

		Japan			China		
		Acquisition	Holding	Transfer	Acquisition	Holding	Transfer
National tax	Individuals				-	-	-
	Companies				-	-	
Local tax	Individuals						
	Companies						

Note: A circle indicates existing taxes, a dash indicates taxes that do not exist, and a triangle indicates taxes that are currently suspended.

**Reference 5: International comparison of proportions of real estate tax (property tax) in national income and total tax revenue (1990)**

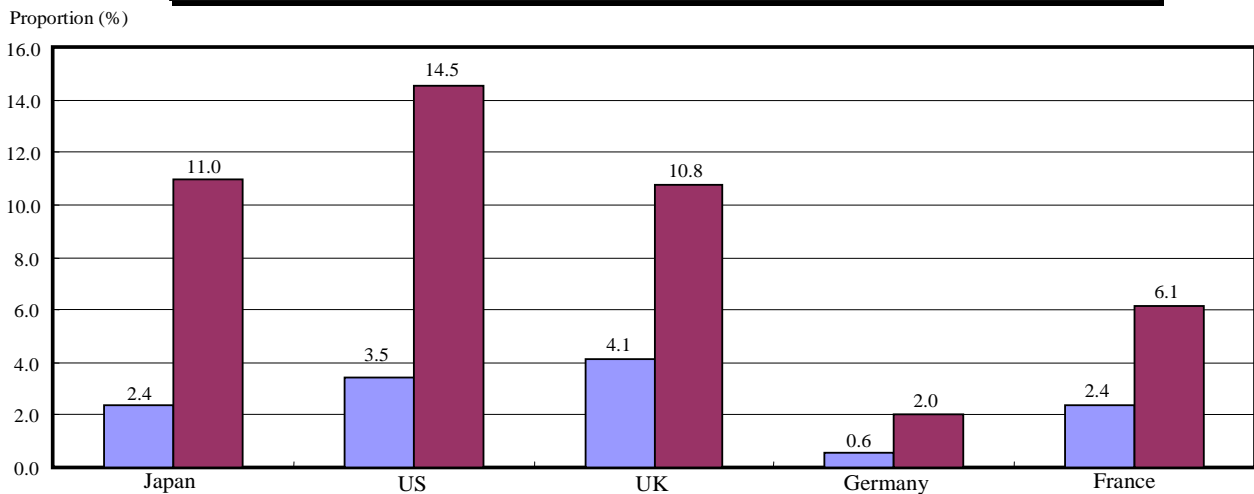


Note 1: Real estate tax (types of property tax)

Japan: fixed property tax (only on land and buildings, excludes depreciable assets)  
 US: property tax  
 UK: council tax and non-residential asset rates  
 Germany: grundsteuer  
 France: foncier bati, foncier non bati and tax d'habitation

Note 2: Taken from OECD Revenue Statistics 1965–2003, OECD National Accounts and national economic accounting by the Cabinet Office, the Government of Japan.

**Reference 6: International comparison of proportions of real estate tax (property tax) in national income and total tax revenue (2002)**



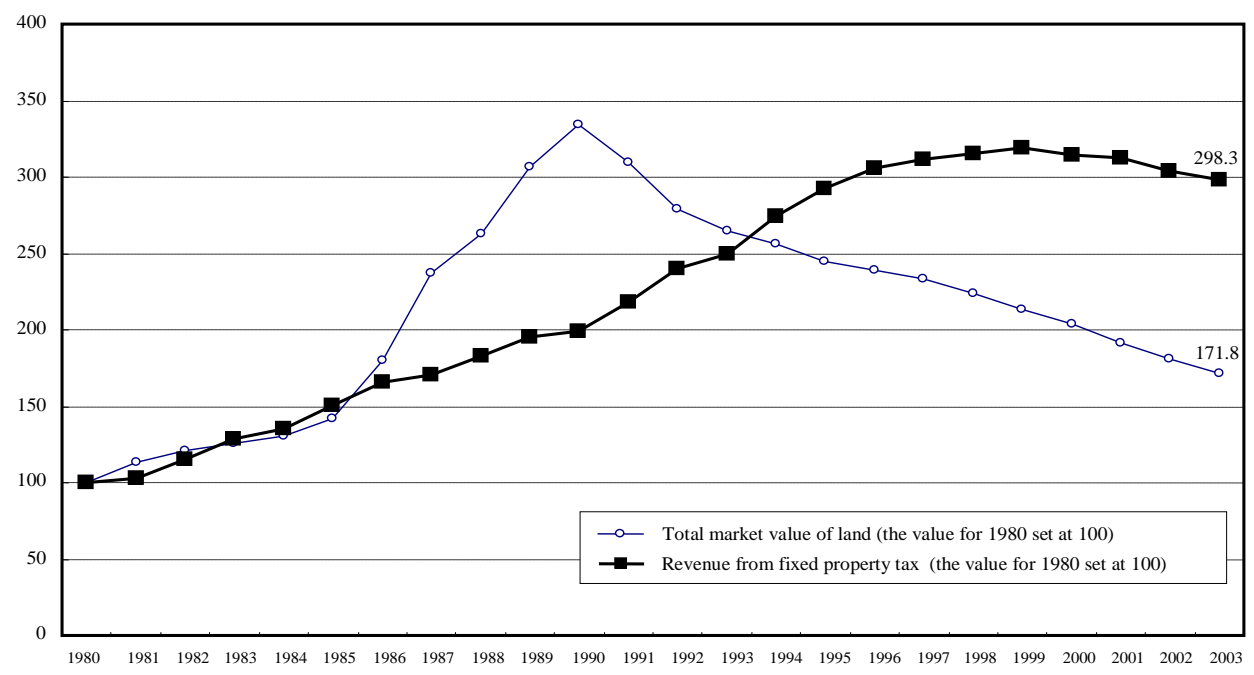
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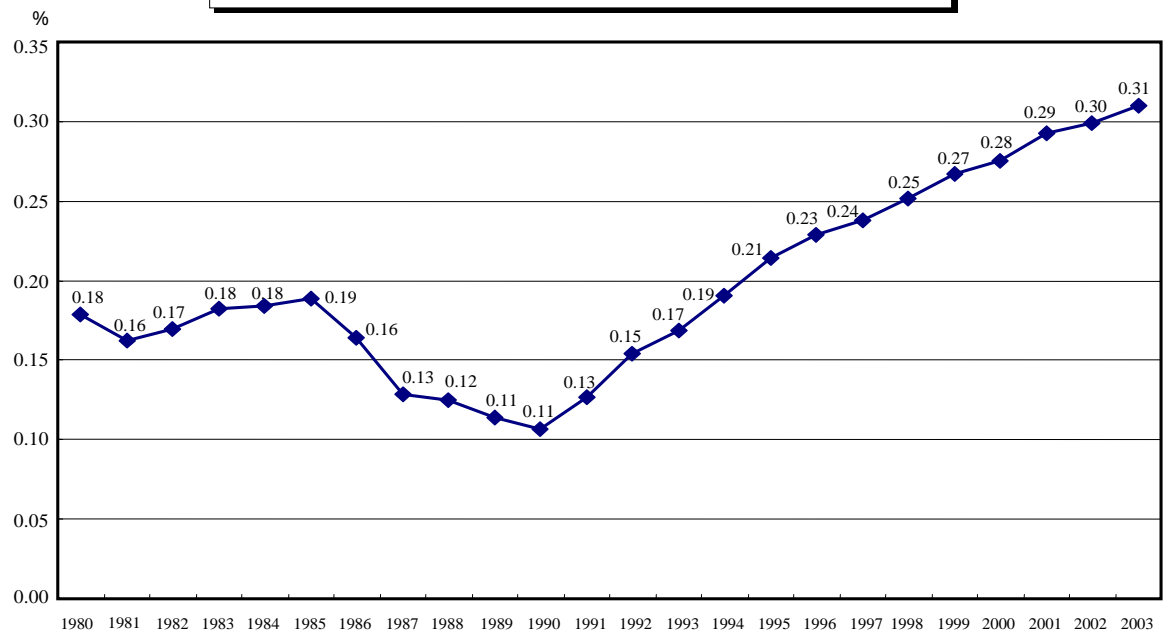
Note 3: The proportion of real estate tax including depreciable assets in national income and in total tax revenue for Japan is 2.9% and 13.2% respectively.

Reference 7: Revenue from fixed property tax (on land) and total market value of land



Note : The total market value of land is indicated as "land asset" of the private sector in national economic accounting by the Cabinet Office, the Government of Japan. The revenue from fixed property tax is stated as settled value in the local tax data by the Ministry of Internal Affairs and Communications.

Reference 8: Effective fixed property tax rate in Japan



Note : The effective tax rate was calculated by dividing fixed property tax revenue by the total market value of land. The total market value of land is indicated as "land asset" of the private sector in national economic accounting by the Cabinet Office, the Government of Japan. The revenue from fixed property tax on land is stated as settled value in the local tax data by the Ministry of Internal Affairs and Communications.

As the references show, tax imposed on the holding of land has been maintained at an extremely low level in Japan compared with other countries because of the low appraisals (valuation) and low tax rates. This is particularly true for agricultural land (agricultural green belt). The rate of tax imposed on the holding of agricultural land, even on land in urban outskirts, has been kept outstandingly low because of the special status of agriculture.

This low cost of the holding of land hinders the effective use of land, resulting in the inefficient use of land and land left unused, and makes holding land more advantageous than holding other assets, promoting speculative land transactions. In Japan, the price of land without buildings(idle land) is higher than with buildings, which also proves that land prices are based of asset values rather than utility values. This causes a social problem because the disparity in wealth between people who hold land and those who do not widens. Therefore, it is necessary to establish an appropriate land taxation system which raises the costs of holding land, suppresses speculative transactions and promotes the use of land.

Next, I will write about the tax imposed on capital gains realized by the transfer of land. Before the bubble, for individuals, an income tax of 20 percent was imposed on capital gains up to ¥40 million, and consolidated tax of 50 percent above that figure. For companies, apart from ordinary corporation tax, 20 percent of additional tax was imposed on capital gains obtained from land held for ten years or less. These capital gains taxes were not very effective in suppressing speculative transactions. A separate tax of 30 percent on capital gains realized by land held for two years or less was introduced in 1991 to suppress land speculation as a taxation measure against the bubble (more details below).

If people invested in land using borrowed funds, interest on the borrowing was deducted from their income. If a building was constructed on land, depreciation was accounted for as an annual loss. For the purpose of inheritance tax, land values were appraised advantageously lower than cash or shares. Therefore investments in one-room apartments (the interest on the loan and depreciation of the building were allowed to be deducted from earned income), etc., rose as a means of avoiding inheritance tax and income tax.

As described above, it is true that the taxation system was one of the major causes that generated advantages in holding land.



#### (4) Linkage of land prices and share prices

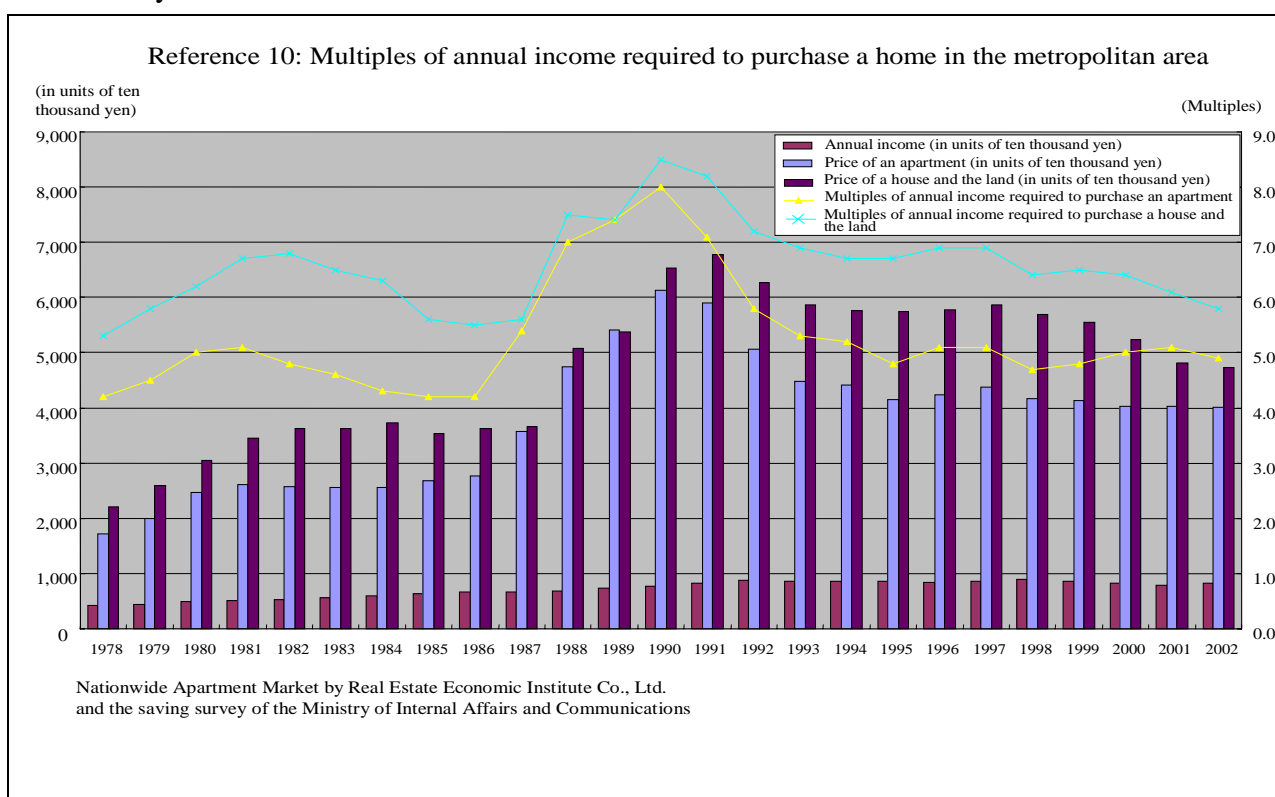
The soaring land prices from the latter half of 1980s affected share prices and then both began to increase affecting each other. The soaring of share prices was supported by a theory (a copy of Tobin's q theory) that if prices of real estate increase, then values of companies, in other words share prices, increase because companies hold real estate for factories, etc. It was thought that increasing share prices would cause no problem to anybody, unlike the rise in land prices, and that companies would be able to procure funds at relatively low cost because of high share prices. [This idea was wrong because the cost of dividends was not taken into consideration. Excess capital promoted excess investment which took a long time to adjust afterwards. It is important to understand the correct capital cost.] BIS regulations allowed banks to include latent profit generated by shares in their net worth. Under these circumstances, land prices and share prices continued to increase together.



## 2. Social problems of soaring land prices and the collapse of the bubble

### (1) Social problems and the collapse of the bubble

Soaring land prices, speculation and importunate demand of land caused various social problems. The prices of residential land and housing rose to several multiples of the annual income of white-collar staff, resulting in many people giving up their wish to own a house and widening the disparity in wealth between people who owned land and those who did not. High land prices prevented foreign companies from starting business in Japan. [The US criticized the high land prices in Japan at the meetings of the Structural Impediments Initiative — an example of pressure from foreign countries.] The balance was lost between flow economy and stock economy.

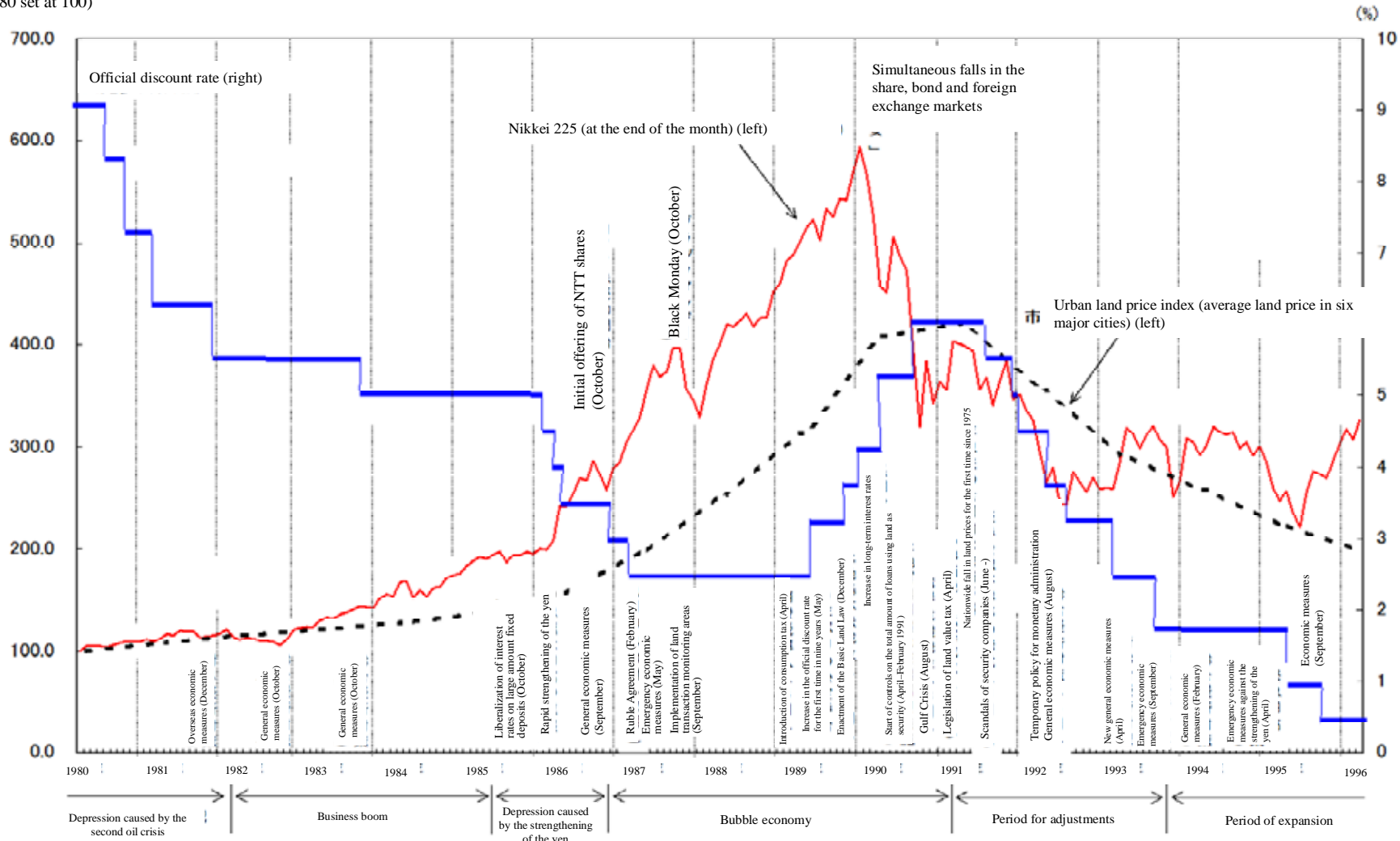


From around 1987, the media began to comment on the social problems arising from soaring land prices. An outline of general land measures was determined by the cabinet in June 1987. At the end of 1989, the Basic Land Law was enacted. This law focused on the public interest in land by ensuring appropriate planning, suppressing land speculation and taxing land appropriately according to the increase in value of land.

Under these circumstances, the government and the Bank of Japan raised the official discount rate in May 1989, introduced quantitative controls on the total amount of land related loans from April 1990, reformed the land taxation system, including establishing Land Value Tax, raising capital gains taxes and started rationalizing land appraisals in April 1992.

# Reference 11: Land prices, share prices and notable events

(the value for the end of March 1980 set at 100)



Data from the Urban Land Price Index by the research department of Japan Real Estate Institute and the White Paper on Economy for 1993 by the Economic Planning Agency

(2) Land tax system reform

The concept and outline of the reform of the land tax system are as follows. [“Basic Issues of Revisions in the Land Tax System” of the Land Tax System Subcommittee published May 29, 1990]

Reference 12: Land tax system reform

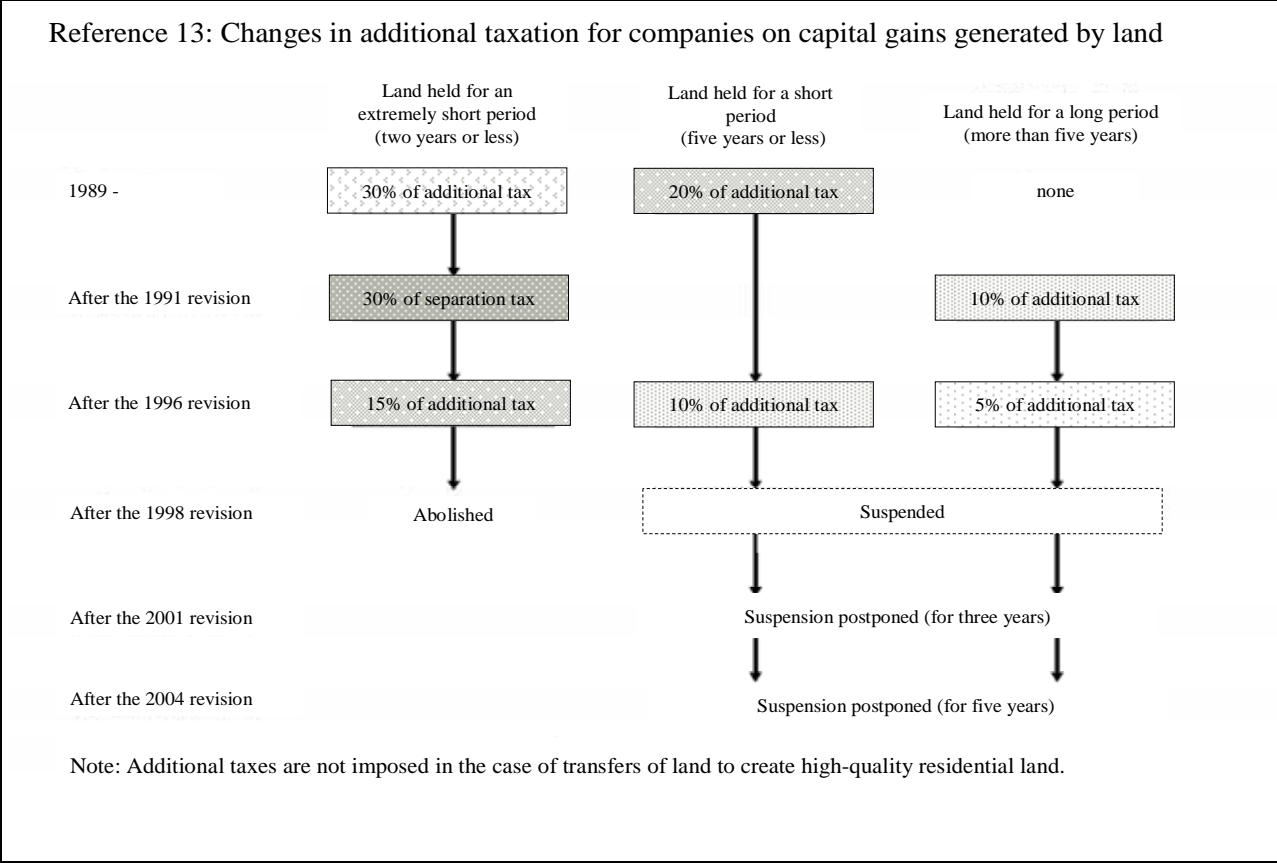
- Establishment of land value tax (January 1992)
- Higher capital gains tax  
Individuals: raising tax on capital gains from land held for more than five years (1991)  
Companies: raising tax on capital gains from land held for a very short period (two years or less) (1991)
- Rationalizing land appraisals for inheritance tax purposes (1992)
- Revision of exceptions for inheritance tax and fixed property tax of agricultural land in urban areas (1994)
- Measures against tax avoidance using land (1992)

The prime target of the reform was to eliminate the advantages of land as an asset, to suppress speculation and to promote the effective use of land. To do the latter, the rate of property tax was raised to an appropriate level and land value tax (national tax) was established (effective January 1992) to raise the burden of the land holdings. [These have the same financial effect as tax imposed on unrealized capital gains.] Refer to Reference 8.

The second target of the reform was to strengthen capital gains taxation. Capital gains had not been heavily taxed because it was believed that doing so would cause a lock-in effect (high capital gains tax suppressing sales of land, thereby suppressing the supply of land in the long term). The lock-in effect was not observed in land transactions during the bubble economy in Japan. Therefore, by raising capital gains tax on transactions of land which had been held only for short periods, speculation was suppressed.

It is a difficult question, which tax should be higher, tax on labor income or tax on capital income, in other words tax on income created from physical labor or tax on income realized without labor. This is a question of a trade-off between views of social equity and efficiency. The rises in land prices during the bubble economy are considered to be mostly the result of public works developments rather than the efforts of individual people, that part of the profits realized by increases of land prices should be returned to the government, and that people who

profited from the increases are able to bear taxes on such profits. A punitively high rate of tax imposed on capital gains realized from transactions of land held for a short period and for an extremely short period (two years or less) was effective in suppressing land speculation. [The proportion of land held by individuals for more than five years rose from 26 percent to 39 percent.]



The third target was revision of inheritance tax and of the deferment granted to agricultural land in urban areas. Fixed assets had been appraised low for tax purposes mainly because of cash-flow problems, but it was decided to impose an appropriate tax on the holding of assets. It was also decided to raise the appraisal values of land of inheritance tax, to raise tax on the holding of agricultural land in urban areas to the same level as on residential land and to implement other measures against tax evasion.

From 1992, losses relating to loans taken out to acquire land, which is part of the loss relating to real estate owned by individuals, became subject to limitation to be deducted from other income in order to suppress investments on so-called one-room apartments as a tax avoidance measure.

### 3. The end of the land myth, and depression and deflation

#### (1) The end of the myth of land prices

As a result of the policy described above, prices of land started to decline rapidly from 1988, and are still falling in most of local cities, so it may be considered that the myth of land prices has ended. The following are the factors that caused land prices to fall.

Firstly, the expectation that land prices would continue to rise forever vanished: one reason in particular being the decline in the population of Japan. Also, increases in imports of agricultural produce changed the view that land is a limited resource.

Secondly, banks' change of loans policy. After working on the elimination of bad debts, which took a long time, banks which usually accepted land as security for their loans, started to accept the appraised value of intangible property rights and business characteristics, etc.

Thirdly, the use of the discount value method, which is a method to appraise land based on the utility value of the land, means that capital gains cannot always be expected.

#### (2) Depression and deflation

The rapid decline in land prices that lasted for so long created new problems. Japan had an indirect financing system using land as security combined with the land myth. After burst of the bubble economy, the Japanese financial system was badly damaged as a lot of land related loans made by financial institutions turned into bad debts. The problem of bad debts affected the Japanese economy for a long time because this problem comes from asset side which is normally long term. And the government has been accused of the failure of the excess curving policy .

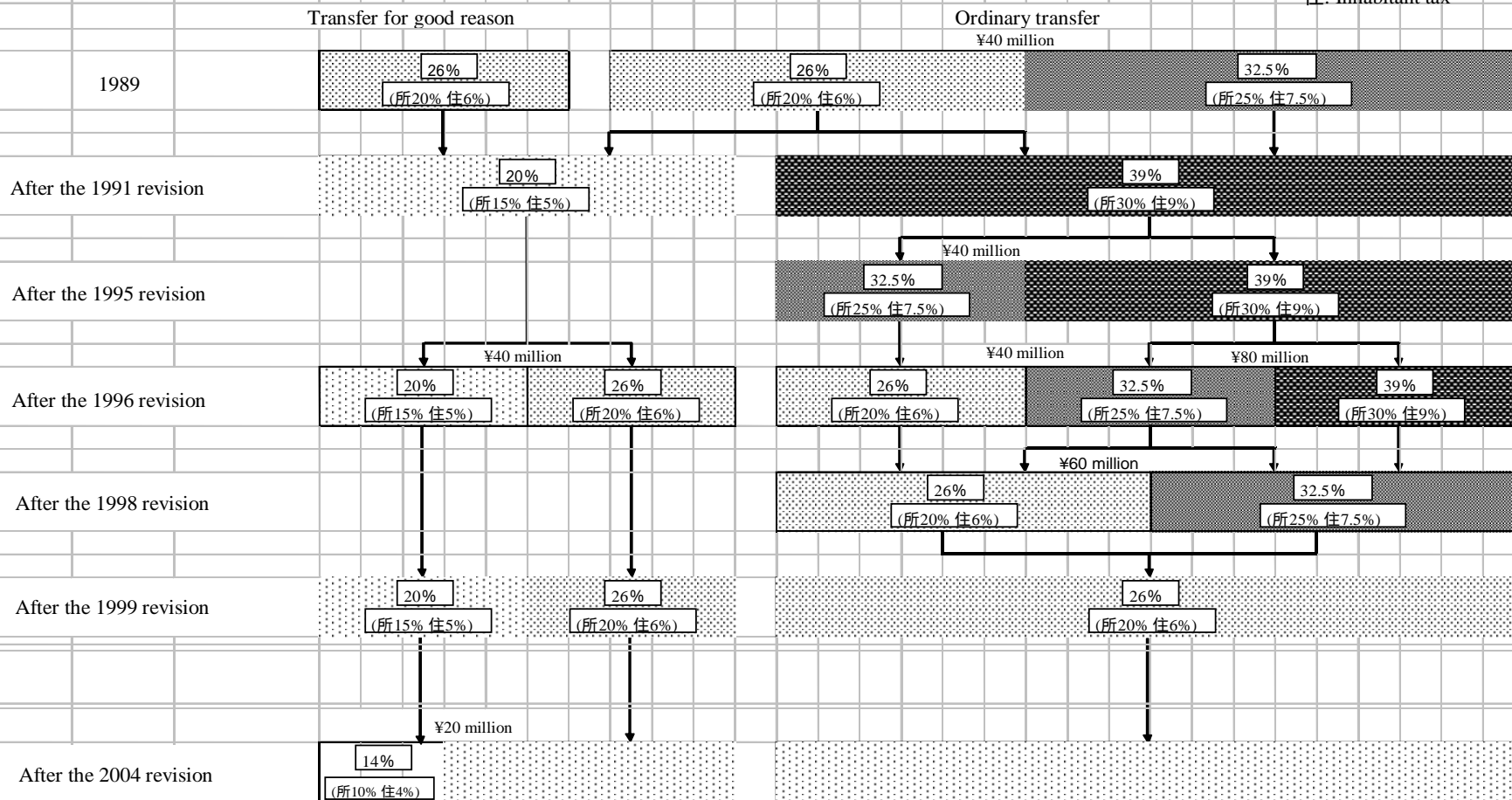
After the collapse of the bubble economy, deflation started despite the introduction of large income tax cut and additional investment in public works, etc., Some people believe that the cause was a failure to coordinate fiscal policy of the government and monetary policy of the BOJ.

The reflection of the land tax policy is the following point. The reform of the land tax system aimed at solving problems related to the bubble economy started in 1991 (land value tax in 1992), after speculation had already peaked out. The reason of the delay is that law has to be discussed in the diet under the democracy. Because of such delay, timing to introduce new law was delayed and affected land price decline too harshly. Therefore the government had to adopt a policy to freeze the land value tax and to relax capital gains tax in 1998.

What is important is to react the issue as quickly as possible.

### Reference 14: Capital gains tax on land for individuals

所: Income tax  
住: Inhabitant tax



Transfer for good reason: until December 31, 2008 (postponed for 5 years)

Ordinary transfer: for an unspecified period of time

Note: "Transfer for good reason" means a transfer of land to create high-quality residential land.