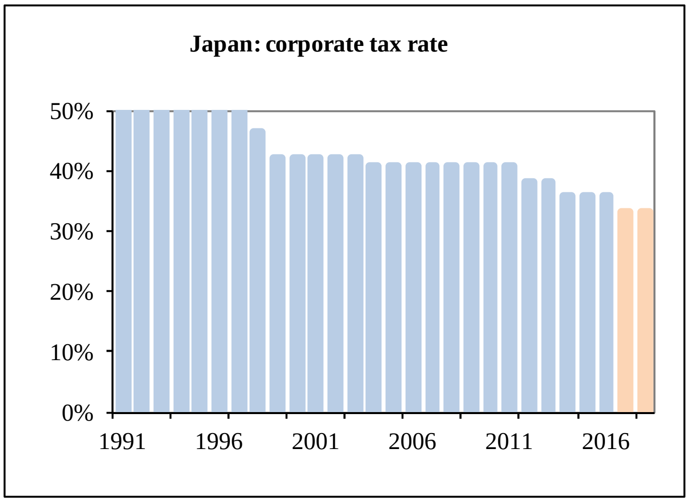
Classical Insights -- Japan

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Japan Bullet Points October 10, 2013

Shinzo Abe's much-anticipated changes to the corporate tax code have been announced. They are okay but not great. Abe has postponed discussion of deeper cuts in the corporate tax rate. Announced changes are:

- Ending the earthquake reconstruction surcharge (which was 2.5 percentage points on the corporate rate). It was going to end anyway in 2015, but this officially ends it on April 1, 2014. As such, the corporate tax rate as of April 1 will be 35.6%. I'm tentatively assuming they cut it further to 33% in fiscal 2017:



- Expanding the capex credit to include tools, furniture, buildings, etc. (and not just machinery), as long as capex rises 10% versus the previous year. For buildings and structures, a company can now expense the entire thing upfront through March 2016;

- The R&D tax credit rises from 5% to potentially as high as 30%. This credit is extended through 2017 (was set to expire this year). The R&D credit is aimed at pharma, biotech and auto companies;

- Tax credits for companies that boost wages by 2%/year (rising to 5% by 2016). The hurdle rate for this tax credit had been 5%, which is very hard to hit.

Thoughts:

<u>1) This package could be described as okay -- but certainly not great.</u> They should have just lopped another 5 or 10 points off the corporate tax rate right now. However, there was political opposition to such a move from politicians who argued that the VAT hike already was a knock on individuals, so a bigger corporate cut would have doubly tilted the code toward business.

<u>2) It's nice to see them officially bury the earthquake reconstruction tax.</u> These "surcharges" have a habit of hanging around after their expiration date.

<u>3) The credit for boosting wages is not terribly helpful.</u> The whole point of QE is to boost profit margins. Giving that back via wage gains defeats the purpose. Still, the fact that the hurdle rate for this credit has been cut to 2%/year (for a year at least) makes it modestly useful.

4) The construction industry stands to get a boost from the immediate depreciation of buildings and structures. That's a fairly substantial tax break and may lead to higher construction capex.

5) Perhaps the auto-parts makers will benefit from the R&D tax credit, as capex in that industry tends to run very high.

Bottom line: This tax package is okay, and may give a boost to construction firms and materials suppliers. But the big news would be a further cut in the corporate tax rate – and for that we'll have to wait. I still think it's coming. Tax revenue ought to climb in 2014/15, opening the door to further discussion of corporate rate cuts. Japan has the highest corporate tax rate in Asia so the business community does have a reasonable case that it needs to be reduced.

Mike Churchill

Churchill Research, Inc.
103 W. Broad St., Suite 220
Falls Church, VA
22046
(703) 241-0274
(703) 340-4726
mike@churchillresearch.com
www.churchillresearch.com