Japanese Road Rating System: Pros and Cons

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Abstract

The road rating system is a land valuation system created by national and local tax authorities to determine the basis for taxes on land. Each institution sets a road price/m^2 for each block mainly in urban areas. This is called the ‘road rating price’, and the value/m^2 of a plot of land is assessed by multiplying the road rating price for the road that the land in question faces by a certain adjustment factor, whose standard is set in accordance with the land use and conditions.

In addition to the above two types (national and local) of land price set by national and local tax authorities for tax purposes, two other prices are also set by public institutions, whose purpose is to provide appropriate indicators of land prices to the market. This means that at least four prices exist for a single plot of land.

Although the contribution of each price to its respective purpose cannot be ignored, it has been pointed out that it is ridiculous for different governmental organizations to value the same land in four ways with different price levels. Furthermore, road ratings are also subject to harsh criticism, including a distortional effect to the land market value and over/under-taxation for example. As a solution, this paper proposes unification of the four valuation agencies and valuation levels.

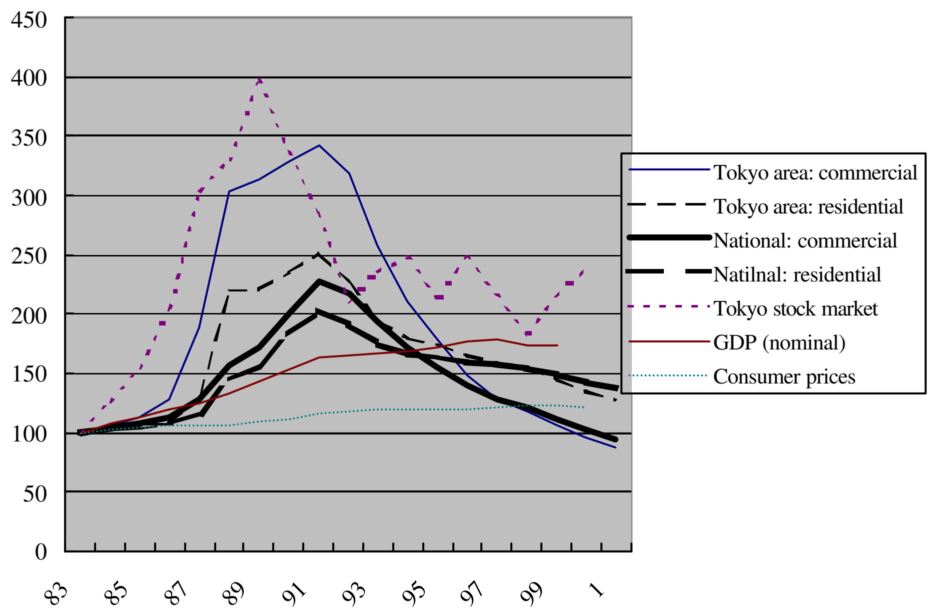
1. Background…Recent Trends in Land Price

Japan has experienced three booms in land price following World War II. The first boom was from 1955 to 1963, and the second occurred in the early 70s. The third boom, which was the last and the most drastic, started from 1984 and continued until 1991.

Excessive cash flow in the Japanese economy in the 80s created excess demand for office space and led to significant speculation in the Tokyo area, with subsequent speculation at time lags in other urban areas such as Osaka and Nagoya. Taking the 1983 figures as 100, residential and commercial land prices in the Tokyo area reached their peaks in 1991 at 341.3 and 250.2, respectively. The national average prices for residential and commercial land peaked at 202.1 and 199.3, respectively.

1991 marked the last and greatest peak in land price, and Japanese land prices have declined since then. A recent feature in land price that deserves mention is that land prices in residential areas, particularly urban areas, which offer easy access to business areas, and highly developed commercial areas that can be expected to make good profit have now stopped declining whereas the rest continues. See Figure 1 for more details.

(Figure 1. Land Price Index: 1983 = 100)



2. Overview of Existing Public Sector Land Valuation in Japan

There are four types of land price in Japan: 1) Road Rating by the National Tax Agency, 2) Road Rating by municipalities, 3) Official Announcement of Land Price by the Ministry of Land, Infrastructure and Transport, and 4) Standard Land Price by prefectural governments. Each organization insists that their land price represents fair market value, but the valuation levels differ because the purpose of each valuation is different. The former two are used for tax purposes, mainly for the convenience of both the taxpayers and tax administrators, while the latter two contribute to indicate an appropriate level of fair market value for land.

2.1. Official Announcement of Land Price by the Ministry of Land, Infrastructure and Transport (MLIT Price)

The MLIT releases prices for approximately 30,000 land sites[1] located within urban planning areas as of January 1 of each year. The purpose is to distribute land price information to the market as a reference for fair land transactions, and to assist the computation of compensations for the expropriation of land for public sites, etc. This valuation is based mainly on the comparative sales method.

The MLIT Price is considered to represent the fair market value (FMV) of land because valuation is based on the notion of "bidding and asking price" which are considered to be settled under normal circumstances during the free transaction of land. (In other words, it is the price established when land is bought and sold not in haste.)

2.2. Standard Land Price by Prefectural Governments (Standard Price)

Prefectural governments publish land prices for approximately 30,000 sites[2] as of July 1 of each year. The purpose is to provide indicators for regulations on land transactions as prescribed by the National Land Utilization Planning Law (Kokudo-Riyou-Keikaku-Hou)[3] and to distribute price information to the market for reference purposes as above. The valuation method also uses the comparative sales method.

2.3. Road Rating by the National Tax Agency (NTA Rating)

The NTA Rating is used for Inheritance/Gift Tax purposes. The NTA sets a standard of land value in consideration of the fact that finding the fair market value of land is difficult for both ordinary Inheritance/Gift Tax payers and tax officers under the self-assessment system.

The road rating valuation depends on the road that the land in question faces, so this method is applied mainly to privately owned residential sites located in urban districts[4]. The number of sites was approximately 450,000 points as of 2000. The road rating method involves appraisal of residential sites based on the respective Road Ratings, which are the prices as of January 1 of each year. The rating is done based on the MLIT Price, actual sale (and purchase) prices, and opinions from professional appraisers.

Inheritance/Gift Tax payers are able to appraise their own property for themselves under the self-assessment system. However, the Road Rating price published by the NTA is widely used by taxpayers since the level of valuation is set at 80% of the MLIT Price, which is

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[1] As of 2000, the number of the sites was 31,000 points.

[2] As of 2000, the number of the sites was 27,725 points.

[3] When a governor of a prefecture finds and specifies a certain area in his or her jurisdiction as an object of land speculation after due process, permission of the governor is required for the sale and purchase of land located in that area.

[4] With regard to residential sites located in other areas, land is valued using the multiplier method. This method entails multiplying the assessed value for municipal property tax purposes by a certain factor.

generally lower than the fair market value.

2.4. Road Rating by Municipalities (Municipal Rating)

Although nearly the same method as above is employed to assess local taxes on land values, which are set below the official assessment, Municipal Ratings are performed once every three years. The level of valuation is set at 70% of the MLIT Price.

2.5. Comparison

The features of each valuation system described above are summarized in the table below.

(Table 1. Features of Public Valuation Systems)

	Timing/frequency	Number of Sites (2000) and valuation level (%)	Scope	Purpose
MLIT Price	Jan. 1, Annually	31,000 sites 100% FMV	Urban planning areas	● Indicator for land transactions ● Compensation standard for expropriations
Standard Price	July 1, Annually	27,725 sites 100% FMV	All areas	● Indicator for land transactions ● Regulations on land transactions to prevent speculation
NTA Rating	Jan. 1, Annually	About 450,000 sites 80% FMV	Privately owned land	Self-assessment standard for Inheritance/Gift Tax
Municipal Rating	Jan. 1, every 3 years	About 440,000 sites 70% FMV	Privately owned land	Official Assessment for Fixed Asset Tax, Urban Planning Tax

3. Pros and Cons

3.1 Contributions of Each Valuation System

As explained above, each valuation system has its own scope and purpose, and it might be said that each system has been contributing very well to its purpose. In particular the roles and importance of the two road rating systems on both national and local property taxes cannot be ignored.

Without the NTA Rating, for example, Inheritance/Gift Tax payers would have difficulties in assessing their own property. Even the tax administration side enjoys the benefit of road ratings, which allow frontline officers to easily verify whether a valuation made by a taxpayer is proper or not. In other words, the NTA road rating system provides a standard both for taxpayers and tax officers to avoid unnecessary conflicts.

Municipal Ratings are also indispensable since they are used for official assessment of local property taxes such as the Fixed Asset Tax and Urban Planning Tax. Furthermore, insofar as the valuation level is set below the FMV, there should be no specific complaints from the taxpayers.[5]

The MLIT Price is a key indicator of land price since both national and local road ratings use it as a reference to determine the level of valuation. In addition, it is also utilized as important data for Japanese land policy. The Standard Price, which is a survey of land price as of July 1 by prefectures, supplies mid-year information that complements the data until the next year's MILT Price.

3.2. Problems

Despite the contributions of each valuation as noted above, there are still strong contentions against the land valuations of public sectors. The traditional and strongest contention is that it is ridiculous to have four prices assessed by national and local governments on the same land. On the other hand, a relatively new criticism is that the NTA road rating is becoming a price leader for the market and thus distorting the market.

3.2.1. Four prices on the same land

The public has criticized this situation for some time now. Concretely, there are two main arguments.

- Having different governmental organizations value the same land at different levels leads to a loss of public confidence.
- Unification of the four valuation systems would be more efficient than having four government organizations do the same thing.

In 1969, for example, reflecting the above criticisms, the Construction Committee of the House of Representatives attached its opinion to the Act of Official Announcement of Land Price when it passed the act. This opinion states that the NTA should make efforts to avoid an imbalance between the level of property valuation for Inheritance/Gift Tax purposes and that of the MLIT Price. Thus, it can be said that unification of the four systems was the main policy direction at least during the 60s and 70s. However, these efforts were in vain because of municipalities' fear of drastically increasing the taxpayer burden and thus earning taxpayer resentment as a result of increasing valuations to meet land value appreciation at that time.

After that, opinions divided into two main camps during the 80s, those insisting on unification and those opposed to it. Recognizing the dispute between the two sides, the Cabinet decided on the following measures in an attempt to establish a new balance between the four prices[6]:

- Both Road Rating valuations shall be coordinated and shall be based on the Official Announcement of Land Price.
- The date of valuation for the NTA Rating shall be changed from July 1 to January 1,

[5] Of course, general complaints against taxes cannot be avoided

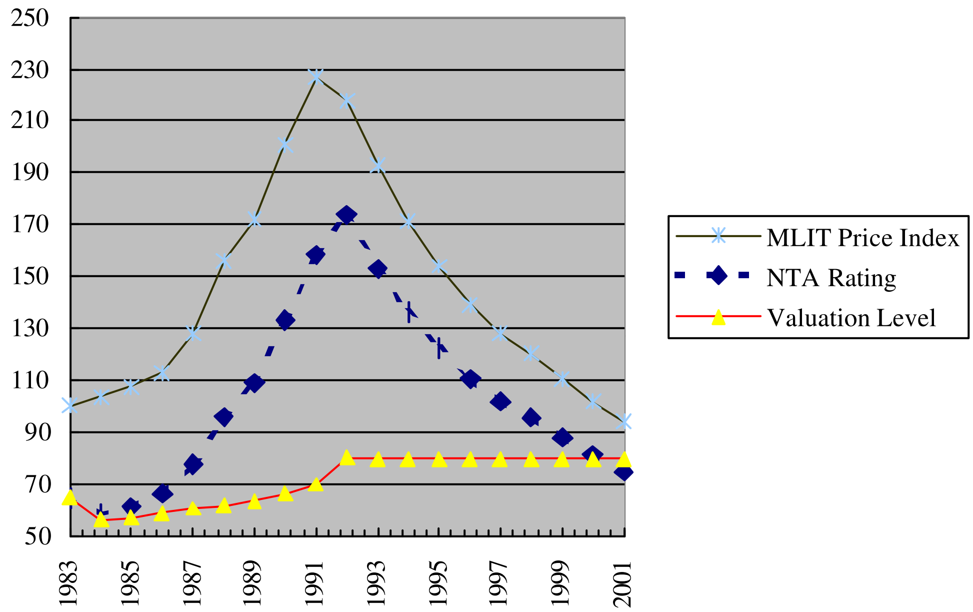
[6] Guideline of Total Land Policy Plan (Sougou-Tochiseisaku-Suishin-Youkou, Jan.25, 1991, Cabinet Agreement)

the same date as assessment of the MLIT Price.

- The level of the valuation shall be 80% of the MLIT valuation for the NTA Rating, and 70% for the Municipal Rating.

An estimation of the NTA valuation level compared to the MLIT Price in the past is as follows (Figure 2):

(Figure 2. MLIT Price Index and Valuation Level for NTA Rating)



* Source: NTA data. Valuation levels before 1994 are estimated by the author.

Prior to the above decision, valuation levels ranged from approximately 55 to 70% of the MLIT Price for the NTA Rating from approximately 30 to 50% for the Municipal Rating.

The MLIT Price was said to be restricted to around 80% of the FMV at that time because of the fear in late 80's that drastic appreciation of the MLIT Price would increase the risk of further land speculation. In consideration of this fact, the NTA Rating level was estimated to be 50 to 60% and the Municipal Rating level 25 to 40% of the FMV.

After the decision, arguments for unification have become more explicit as both the NTA Rating and the Municipal Rating are based on the MLIT Price anyway, and unification seems even more feasible than before.

3.2.2. NTA Rating as a price leader

This argument was raised by Mr. Yasuhiko Ohnishi, a certified tax accountant and estate surveyor[7]. According to Mr. Ohnishi, the NTA Rating is used prevalently as a standard of land price for other than tax purposes. For example, the Ministry of Finance uses it as one of the criteria for recognizing bad debts of banking institutions. The Japan CPA Association also regards the NTA Rating as a standard of real estate valuation for sales purpose at current basis. In addition, banking institutions never make loans if the assessment rate of collateral is more than 80% of the NTA Rating price. These examples show that the NTA Rating seems to have become a price list for land transactions.

Mr. Ohnishi contends that the prevalent use of the NTA Rating for other than tax purposes (mainly by financial institutions and the real estate industry) induces continuous depreciation of land prices, which is the main cause of the current sluggish economy in Japan. This mechanism is as follows:

1) The NTA Rating in Year 1 is set at the level of 80% of the MLIT Price in the same year in accordance with the 1991 Cabinet Decision.
2) After the announcement of the NTA Rating, market participants rely not on the MLIT Price but on the NTA Rating as a standard of land transactions until the next rating is announced.
3) As a result, actual sales and purchase prices, which later become the data for comparative sales prices, are set at the level of 80% of the MLIT Price in Year 1.
4) The MLIT, which is supposed to determine the FMV according to the comparative sales approach, refers to the actual sales prices, which were set at the level of 80% of Year 1 Price.
5) As a result, in Year 2 the MLIT sets the Land Price at the level of 80% of the MLIT Price for the previous year.
6) The NTA follows the MLIT and sets its rating at the level of 80% of the MLIT Price in Year 2, and so on.

The above vicious circle leads to a continuous depreciation in land value. Assuming this circle is repeated, land prices will decline by 20% each year and will be almost half the value in three years.

Although Mr. Ohnishi's argument is highly simplified, it appears correct under current real-estate market conditions where actual transactions are scarce and the only standard that provides precise information throughout the country is the NTA Rating. (The MLIT provides data for only 31,000 points, whereas the NTA provides data for about 450,000 points as seen in Table 1 above.) Under these conditions, the NTA Rating tends to act as a price leader in the land market.

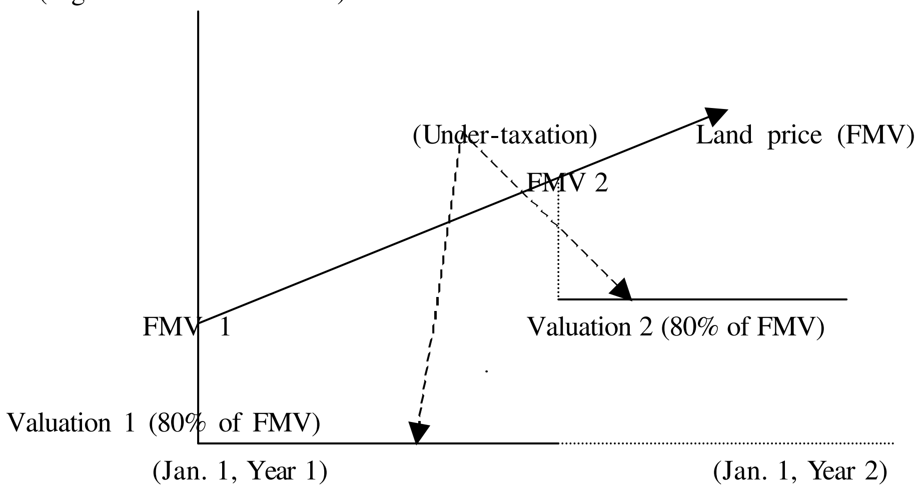
7 Yasuhiko Ohnishi, 'The Evils of Over-dependence on the Road Rating System', Zeiri Vol.44 No.10 pp24-28 (Gyosei, Oct.2001)

3.2.3. Over/under-taxation

The sharp rise and fall in land price in the 80s and 90s caused problems with both the NTA and Municipal Ratings.

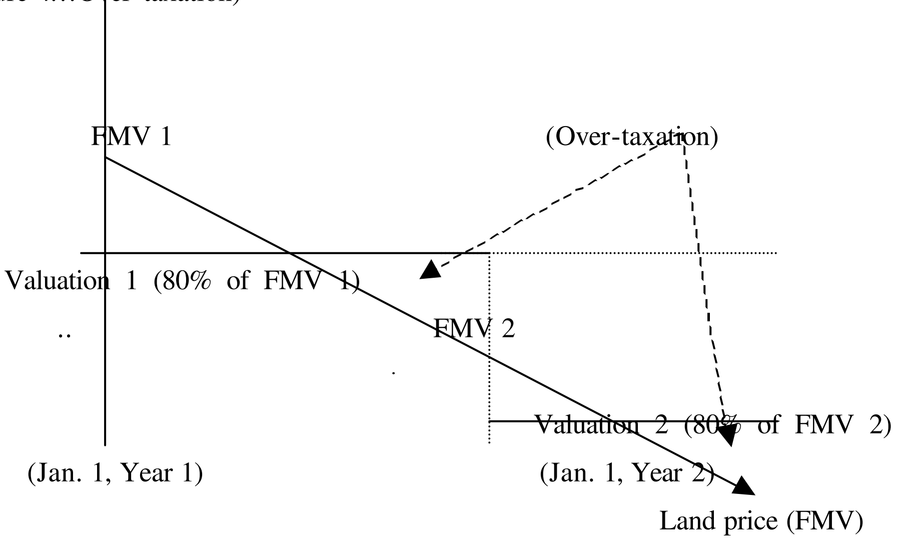
Taking the case of the NTA Rating, revaluation was performed as of July 1 (later altered to January 1 in 1991). In the late 80s, under-rating and under-taxation occurred because of sharp land price appreciation at that time (see Figure 1). Namely, the land price kept rising even immediately after the revaluation. The fact that valuation was restricted to the level of 30 to 40% of the MLIT Price (FMV) further spurred this tendency (see Figure 2), and this preferential treatment was one of the reasons that money flowed into land speculation. This was why the valuation level was raised to 80% of the MLIT Price (FMV) to correct the overwhelming inequality between landowners and non-landowners. However, this succeeded only in easing the degree of inequality, and the risk of under-taxation still remains.

(Figure 3…Under-taxation)



Land prices have declined since 1991 as mentioned in Section 2 (see Figure 1), so over-taxation has frequently occurred following the burst of the Bubble Economy due to the exact opposite mechanism as during the appreciation period. There were of course few complaints against the above-mentioned under-taxation. On the other hand, over-taxation has naturally evoked loud protests from taxpayers. The increase in the valuation level up to 80% of FMV in 1991 further increased the severity of this problem. Figure 4 shows this overrating mechanism. Note that this problem has much more serious impact on the Municipal Rating for the Fixed Asset Tax since the frequency of revaluation is only once every three years.

(Figure 4…Over-taxation)



4. Analysis

All of the above problems appear to stem from the fact that different public institutions value land at different levels. This can be divided into the following two issues:

- Valuation at different levels
  (Is it proper to value the same land at different levels?)
- Valuation by different public institutions
  (Is it necessary to have four systems of official (government) valuation?)

4.1. Valuation at Different Levels

With regard to the level of valuation, the first and foremost consideration should be placed on the Municipal Rating due to its nature as an assessment standard for local property tax which results in the lowest level of valuation among the four. As for the other types of valuation, both the MLIT Price and the Standard Price have already reached the full FMV level, which leaves only the NTA Rating, whose valuation level is 80% of FMV, to be discussed after verification of the Municipal Rating.

4.1.1. Traditional view on the Municipal Rating

The traditional view insists that deep consideration be given to the nature of municipal property taxes such as the Fixed Assets Tax and Urban Planning Tax. This view holds that the nature of the above taxes is as prices for local services rendered by a municipality, and that as such it is not always necessary for the Municipal Rating to be such a high level like the FMV which assumes sales and purchases and is valued based on comparable sales.

If the service-renderer/customer relationship at the municipal level is emphasized, the Fixed Assets Tax payment, for example, should be made not from sale of the property but instead from the annual profit or benefit derived from the property. Thus the valuation for municipal property tax purposes should be at least somewhat based on the income approach. That is why the valuation level was restricted at a much lower level (about 25 to 40% of the MLIT Price) than the FMV before 1991.

The language of the tax law also supports this view. Paragraph 6 of Article 341 of the Local Tax Law prescribes that the basis for the Fixed Asset Tax shall be 'Tekisei na Jika (proper current value)', whereas the rest of the official valuations aim for FMV[8]. That is to say, the Municipal Rating restricts FMV with the word 'proper'.

In this respect, it is better to make the Municipal Rating independent of the MLIT Rating, and the valuation method should instead be based on the income approach. This will result in a valuation level that is much lower than the present FMV, so there should be no problem of over-taxation.

4.1.2. Recent opinions

Many opponents of the above view point out the following problems:

1) Fractional valuation is frequently observed at the municipal level because the level of tax burden tends to be determined at the discretion of municipal administrations through assessment without changing tax rates. This situation often evokes criticism from the public that the process is not transparent.
2) The opaque process reduces the confidence of taxpayers in the Municipal Rating. Although I personally believe it not to be the case, it is often rumored that a lot owned by a politically influential person tends to be valued lower than normal. The problem here is not whether this is true, but that this notion causes taxpayers to lose confidence in the local tax system.

Mr. Mamoru Ozaki, President of the National Life Finance Corporation and former Vice-minister of Finance, is representative of these recent views. Mr. Ozaki contends that the burden should be determined by changing the tax rates rather than valuation. If one municipal government reduces the tax burden through lower valuation without changing the tax rates, inter-governmental transfer from the national government, which does not recognize the tax change, automatically supplements the reduced revenue of the municipality and the burden is shifted to the rest of the nation's taxpayers. The Municipal Rating should therefore follow the MLIT Price to ensure transparency of valuation and accountability to taxpayers.

4.1.3. Analysis

While recognizing the 1991 coordination among the four valuations as a certain

[8] Article 22 of the Inheritance Tax Law stipulates that the base is determined at the 'current value' of inheritance at the time of acquisition. Also, both the MLIT Price and Standard price seek 'the value which is thought to be realized through normal transaction. Clearly these three valuations point to FMV while the Municipal Rating restricts valuation with the word 'proper'.

achievement after the long discussion since the 60s, upholding the traditional view mentioned in 4.1.1 seems like a regression to the argument at that time. In this respect, the recent viewpoint should be supported when considering the Municipal Rating. The problem, however, is that even the latter viewpoint still does not solve the problems mentioned in 3.2. The causes of these problems are:

1) Current Municipal Rating valuation level of 70% of FMV.
2) Current revaluation frequency of every three years

Although the above causes can be supported from the standpoint of the traditional view of restricting the tax burden at a low level and stabilizing local government revenue, the situation created by the 1991 coordination is merely a compromise between the need to coordinate valuations (to prevent inequity between landowners and non-landowners) and the traditional view.

The above situation appears fair under the recent conditions of depreciating land value because the above inequity problem caused by under-taxation is inconspicuous. However, it is clear that when land value appreciates but retains the same valuation level for three years, as Japan experienced in the late 80s, the same inequity problem will arise once again.

If, as Mr. Ozaki argues, the tax burden should be determined through open democratic process rather than at the discretion of local authorities, then valuation levels must be determined objectively at the level of the FMV and the tax burden must be reduced by changing the tax rates. Furthermore, to avoid over/under-taxation, revaluation should be performed annually.

Although annual revaluation seems infeasible due to limitations in the current capacity of municipal governments, the fact that the NTA successfully values property on an annual basis clearly shows that it is possible.

4.1.4. NTA Rating

Among the various views concerning rationales for the Inheritance/Gift Tax, the most popular are:

1) Redistribution of accumulated wealth
2) Taxation on windfall income by inheritance or gift

Either of the above views leads to a FMV that includes a speculative factor for determining the tax base. That is to say, contrary to the notion of the Fixed Assets Tax, Inheritance/Gift Tax payers are supposed to sell their properties to pay the tax if necessary.

According to the language of Article 22 of the Inheritance Tax Law, the base is determined at the ‘Jika’ (current value) of inheritance at the time of acquisition, and this ‘current value’ is generally understood to be the fair market value. Then why is the NTA Rating 80% of the FMV? The NTA explains the rationale for a valuation level of 80% in the book “Practice of Property Valuation” (pp17-18, Director, Office of Property Valuation, NTA, Gyosei, 1995) as follows:

While property valuation for Inheritance/Gift Tax purposes is based on the fair market value of a property, its practice differs in accordance with the availability of information on comparative sales. Namely, for valuation of a property with much comparable sales information, the price formed through transactions can be regarded as the fair market value of the property. On the other hand, where marketability is small, even within the same kind of property, prices formed through transactions are diverse. Such prices can sometimes vary from half of a certain price to twice the price, for the impact of the balance between supply and demand is stronger than in the ordinary market……. A lesser availability of comparable sales information increases the difficulty of appraisal, so a certain margin must be taken into account for property valuation to avoid over-valuation, which will result in over-taxation……… With regard to land valuation, the NTA Rating is used for one full year for Inheritance/Gift Tax purposes. Therefore, to factor in the fluctuation of land prices during the course of a year for an inheritance or a gift, the land valuation is set at 80% of the MLIT Price.

The key points of the above explanation are follows:

1) Due to the lesser availability of comparable sales information, a certain margin must be established to avoid over-valuation.
2) To factor in the fluctuation of land prices during the course of a year, a certain margin must be established.

The above reasoning has an apparent weakness because the NTA Rating is rebuttable under the self-assessment principle. Indeed, when taxpayers think their land is over-valued, they can assess it for themselves. However, inequity caused by under-valuation, especially under conditions of land value appreciation, is more problematic than generous consideration for over-valuation, because no taxpayer valued below the FMV will complain and the reduced burden or revenue must be complemented somewhere else.

The solution that eliminates the above-mentioned over/under-taxation and price leader problems is for the NTA to value lade at the full level of FMV and to make the Inheritance/Gift Tax a rebuttable index-tax.

Concretely, in case of the Inheritance Tax, if a person having property exceeding the threshold dies during a given year, the land value should be determined by the ratio of the days in the year of death and the difference in the NTA Rating valuation between the year in question and the following year. Although in this case the due date of payment must be delayed by up to one year, the problem can be abolished.

4.2. Valuation by Different Institutions…Towards Unification

As discussed above, if all types of public valuation can be pegged at the full FMV, even though the valuation purposes differ, it is quite reasonable to unify the four valuations and have them performed by a single institution.

Obviously, unifying the valuations will greatly reduce administrative costs as long as no additional organization is created solely for this purpose. In addition, no coordination between institutions would be necessary, and taxpayers would be better able to understand the valuation. At the municipal level, the problem of the aforementioned fractional valuations could also be avoided.

The issue is who is to perform the land valuation. The most feasible option would be for the existing valuation office of the NTA to absorb other valuation operations, thus increasing the number of officers, including professional real estate surveyors, and the number of sample sites. In this case it might be necessary for the NTA to upgrade the valuation office to a valuation agency in order to ensure independence.

This reasoning is as follows:

1) The administration cost would be minimal. For the MLIT to perform a unified valuation, it would require new branch offices and personnel to assess land throughout the nation more precisely, since it maintains only a small number of staff. In the case of valuation by prefectural governments or municipalities, exchange of information and coordination would be necessary to avoid fractional valuation, which would also entail additional cost.
2) The NTA possesses sufficient data such as comparable sales through capital gains tax returns.
3) Fractional valuation can be avoided and thus fair and transparent taxation can be achieved.
4) Annual assessment by the NTA would help municipalities avoid the large gap produced by the present three-year valuations.

4.3. Difficulties of Unification

Although unification is quite reasonable, there are a number of obstacles for its implementation. For example, whereas unification can be seen as a movement in the direction of centralization of government, the concept of decentralization currently prevails in the field of public administration. Thus it would appear difficult to obtain a national consensus for unification. Another problem is that although the total administration cost would definitely be reduced, unification would result in an explicit cost increase at the national level. The national government would be reluctant to perform valuation for the sake of local governments even if it is not the sole purpose. In addition, unification would mean a reduction in MLIT authority due to the transfer of jurisdiction to the NTA, so reluctance and even resistance on the part of the MLIT can be easily anticipated.

However, all of the above difficulties are political, and the problems discussed in this paper will not be solved as long as each group holds steadfastly to its position. It is the author's view that eventually, the issue of unification must be given serious discussion and implemented.

5. Conclusion

As observed above, both valuation levels and the organizations performing valuation need to be unified, and the most feasible solution would be for the existing valuation office of the NTA to absorb other valuation operations and value land at the full level of the FMV. Furthermore, if there is a need to provide mid-year information, the current Standard Price, that is to say the land price information as of July 1, should be maintained under the NTA operation.

Unification can be expected to reduce overall administration costs for valuation and to eliminate fractional valuation among municipalities. In addition, annual assessment will eliminate or at least reduce the existing gap produced by the present three-year valuations. Although there still remains the traditional concept of income approach valuation for local property taxes, full assessment at FMV using the comparative sales method will solve the price leader problem as well as the problem of inequity caused by over/under-valuation. Regarding the Inheritance/Gift Tax, a transition to index taxation should be considered as a means for completely eliminating over/under-taxation.

There are a number of difficulties that must be overcome for the implementation of unification such as an explicit cost increase at the national level or the reluctance of the MLIT, but these difficulties seem more political in nature rather than economic or logistical. As such, although unification appears feasible, any plan for implementation must take into account these obstacles, and political commitment and leadership are expected in this regard.