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International Comparison of Local Revenue Structures and Japan's Local Tax and Finance Reform

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Summary

1. Japan is currently undergoing a reform of its local public finances in a bid to reinforce the autonomy of its local governments. The reform is dubbed the Trinity Reform Package given its three main pillars as follows: (1) the reduction of subsidies from the central to local governments, (2) the shifting of tax revenue sources (in effect the shifting of tax authority) from the central to local governments, and (3) the review of local allocation taxes.
2. The Trinity Reform Package will be implemented during a period of three years from FY2004 to FY2006. We shall draw upon the local finance systems of countries overseas in order to provide insight on the future system resulting from the reforms. We have chosen Britain, France, Germany, Canada and the United States of America (US) to compare the local revenue structures, with particular emphasis upon local taxes and financial adjustment systems.
3. Local tax systems may be classified broadly into the "single cohesive country model" and the "federal country model". In single cohesive country models such as Britain and France, local taxes only constitute a small percentage of local revenues. Furthermore, asset taxes comprise the main component of local taxes. In federal country models, local taxes make up a large proportion of local revenues. Income taxes on individuals and consumption taxes are the main tax items of local governments.
4. In Japan, the fiscal expenditures of local governments are comparatively higher than those of the national (central) government despite the fact that local tax revenues fall short of national tax revenues. This is leading to massive financial transfers from the national to local governments. Since Japan's local tax revenue structure is comprised of personal income taxes, corporate income taxes, consumption taxes and asset taxes, it differs from both the single cohesive country model and the federal country model. The suitability of corporate income taxes as

a local tax is a source of debate.

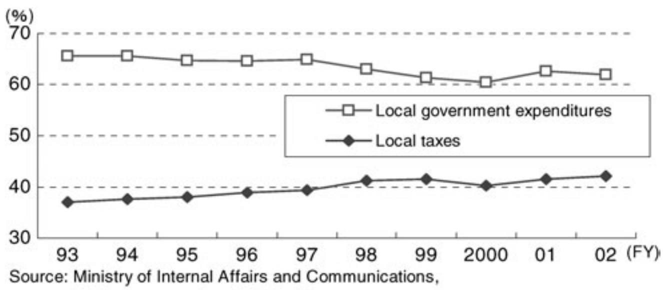
5. The intergovernmental financial adjustment systems of federal countries have mechanisms to keep the size of financial transfers from ballooning and enable the participation of local administrative bodies in decisions on financial allocation. Furthermore, with the exception of financial transfers in Germany to former East German areas, we did not come across financial transfers of such a massive scale that result in reversals of financial strength among local administrative bodies.
6. Given the reversal of financial strength among local administrative bodies in Japan stemming from financial transfers under its local allocation tax system, there are concerns regarding its runaway expansion. Moreover, the system is also under criticism for its complex method to calculate the amount of local allocation taxes and the insufficient participation it affords local administrative bodies in the allocation process. Japan must also draw upon the financial adjustment systems of federal countries to reform its local allocation tax system.
7. During its last stretch, the Trinity Reform Package will focus upon the transfer of tax revenue sources and the reform of the local allocation tax system. Japan needs a recipe for reform that contributes to a higher degree of revenue autonomy among its local administrative bodies.

Introduction

Japan is currently undergoing a reform of its local public finances in a bid to reinforce the autonomy of its local governments. The reform under the administration of Prime Minister Junichiro Koizumi is referred to as the Trinity Reform Package, given its simultaneous pursuit of: (1) the reduction of subsidies from the central to local governments, (2) the shifting of tax revenue sources (in effect the shifting of tax authority) from the central to local governments, and (3) the review of local allocation taxes. This program, which was started in FY2004, aims to reduce subsidies by approximately four trillion yen and shift tax revenue sources equivalent to approximately three trillion yen in the course of three years up to FY2006.

The need for such reform stems from the insufficient autonomy of Japan's local administrative bodies regarding its finances. This is shown most vividly by the wide gap between the amount of local government expenditures and local tax revenues. While the percentage of local government expenditures in total government expenditures (central government + local government) exceeds 60%, the percentage of local taxes in overall tax revenues is only around 40% (**Chart 1**). The shortage of local tax revenues to cover local expenditures is offset by the central government mainly by public finance transfers from the central to local governments. Public finance transfers are broadly classified into subsidies, which are limited in terms of usage, and local allocation taxes, which accords local governments with a higher degree of discretion regarding the purpose of its usage. The Trinity Reform Package aims to reinforce the autonomy of local public revenues through the increase of local tax revenues and the reduction of public finance transfers by (1) transferring part of the subsidies to local taxes and (2) reducing the size of local allocation taxes.

Chart 1: The percentage of local tax revenues and expenditures



Source: Ministry of Internal Affairs and Communications, *White Paper on Local Public Finance.*

Even though the Trinity Reform Package is already in its execution phase, a consensus is yet to be reached regarding the appropriate steps to address the local disparities in revenue bases resulting from the reform. There are remaining issues to be resolved such as how to reconfigure the components of local government revenues including local taxes and local allocation taxes.

In this report, we will map out the pending issues and tasks in order to provide an outlook on the final outcome of the Trinity Reform Package through a comparative study of the systems and actual state of local government revenues of countries overseas. In the process, we shall highlight the salient characteristics of Japan by classifying the public finance systems of various countries overseas and Japan in terms of tax revenue structure and the allocation of roles between the central and local governments. We will then attempt an overview of the method of intergovernmental financial adjustment in Germany, Canada and the US, which have a decentralized public finance system in a bid to indicate the problems of financial adjustment in Japan, which needs a higher degree of decentralization.

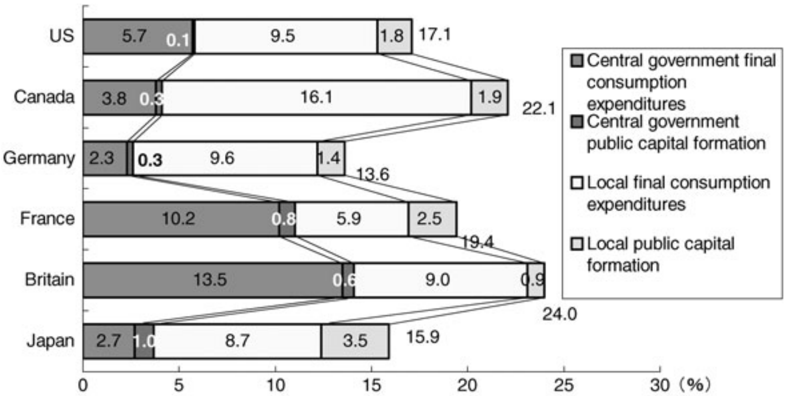
For the purpose of this study, we chose Britain and France, both single cohesive countries (non–federal countries) like Japan, and Germany, Canada and the US which are federal countries. We will also examine Sweden regarding its tax revenue structure.

1. Overview of public finance systems – the US, Canada, Germany, France, Britain and Japan

(1) Government expenditures

A comparison of the percentage of general government expenditures (excluding social security funds) to gross domestic product (GDP) reveals that Britain and Canada both have relatively "large governments" with the percentage exceeding 20% (**Chart 2**). Standing at 15.9%, Japan ranks second lowest after Germany (13.6%).

Chart 2: General government expenditures (excluding social security funds) as a percentage of GDP (2001)



Note: Data on Japan pertain to FY2002 and data on the US and Canada pertain to CY1997.
Sources: Cabinet Office, *Annual Report on National Accounts*, OECD, *National Accounts*.

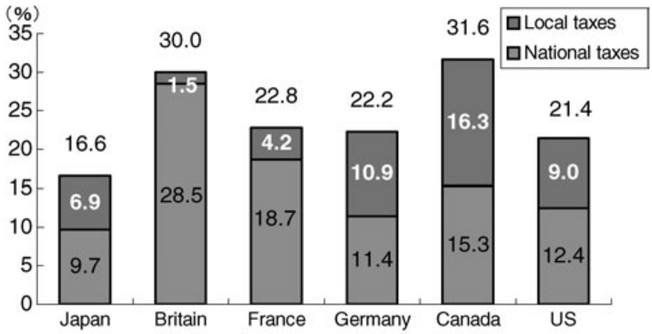
A further division of government expenditures into central government expenditures and local government expenditures shows a higher proportion of central government expenditures by a ratio of approximately 6:4 in Britain and France. On the other hand, the proportion of local government expenditures is larger in Germany, Canada and the US. In Germany and Canada in particular, the proportion of the local government surpasses 80%.

(2) Tax burden ratio

A comparison of the tax burden ratio – the percentage of national taxes (tax revenues of central or federal governments) and local taxes (tax revenues of state or local government bodies) in national income – reveals a high percentage in Canada (31.6%) and Britain

(30.0%). Japan ranked lowest (16.6%) among the six countries compared (**Chart 3**).

Chart 3: International comparison of tax burden ratios (as a percentage of national income, 2001)

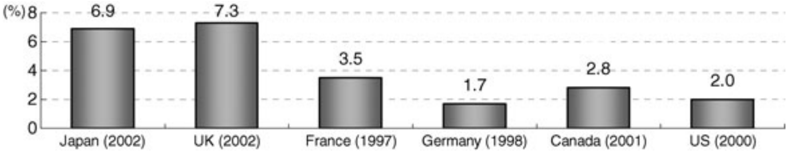


Sources: OECD, *National Accounts*、*Revenue Statistics 1965-2002.*

(3) Public finance transfers from the central government to local governments

We will then compare the size of public finance transfers from the central to local governments in terms of the amount of public funds (total of grants and subsidies) provided by the central government to local governments as a percentage of GDP. Japan and Germany rank high in this list, standing at around 7%. Germany and the US rank low around 2%. (**Chart 4**)

Chart 4: Grants and subsidies provided by the central government to local governments (as a percentage of GDP)



Sources: Ministry of Finance, Ministry of Internal Affairs and Communications, *White Paper on Local Public Finance,* OECD, *National Accounts,* US Census Bureau, *Statistical Abstract of the United States,* UK HM Treasury, *Public Expenditure Statistical Analysis,* Statistics Canada, *Canadian Statistics,* Ministry of Finance Policy Research Institute.

The foregoing illustrates how Japan, with an overall low tax burden, is implementing huge public finance transfers from the central to local governments to supplement the revenues of local governments, which have larger expenditures than the central government.

2. Local tax systems

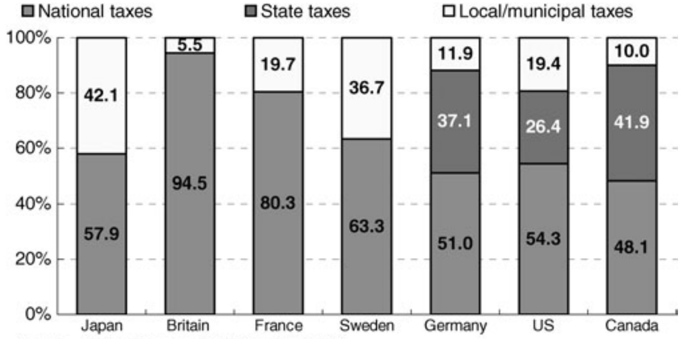
In the local government revenues examined in Section 1, we shall look closer at (1) local taxes, which are autonomous revenue sources for local governments, and (2) public finance transfers, which are dependent upon the central government. We will first compare and analyze the current state of local taxes in Britain, France, Germany and Canada. For the purpose of comparison, we will also examine Sweden because of its unique tax system among the industrialized countries of the world.

(1) The percentage of local taxes in total tax revenues

Firstly, we will compare the percentage of local tax revenues in total tax revenues (the central and local government tax revenues combined) (**Chart 5**).

Among the single cohesive countries, Japan has the highest percentage (42.1%) of local tax revenues. France stood at 19.7% and Britain ranked lowest at 5.5%. In the federal countries, local tax revenues (state and municipal tax revenues (Note 1) combined) in Canada ranked highest with its percentage surpassing 50%. The percentage in Germany and the US both exceeded 40%. As for the ratio of state taxes to municipal taxes, the proportion of municipal taxes was highest with a ratio of 3:2 in the US in contrast to the lowest ratio of 4:1 in Canada. Overall, the percentage of local taxes is higher in federal countries in comparison to single cohesive countries.

Chart 5: Percentage of state and local tax revenues in total tax revenues (2002)

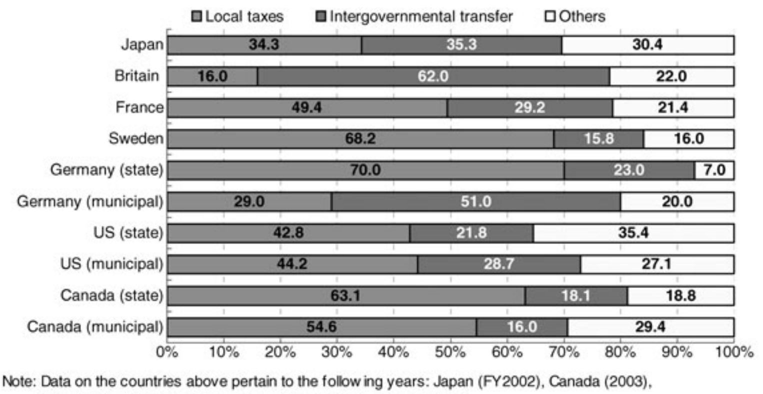


Source: OECD, *Revenue Statistics 1965-2003.*

(2) The percentage of tax revenues in local revenues

Chart 6 below sets forth the percentage of local taxes in local revenues.

Chart 6: Breakdown of local revenues



Note: Data on the countries above pertain to the following years: Japan (FY2002), Canada (2003), UK and Sweden (2001), Germany and US (2000), France (1998).

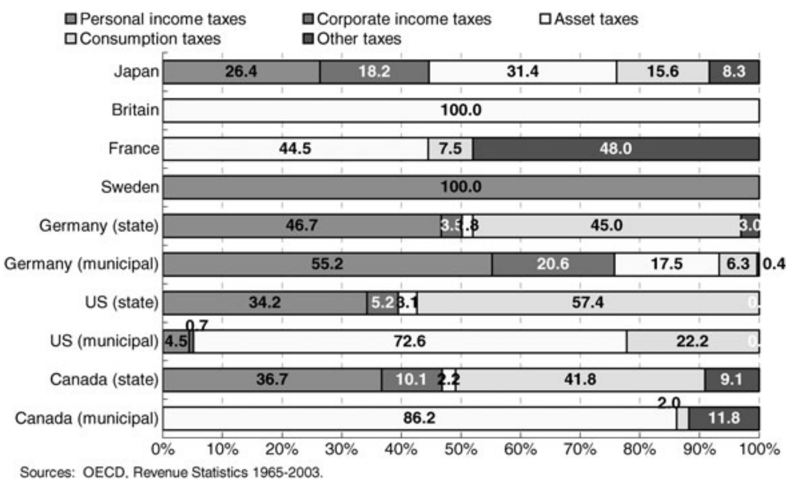
Sources: Ministry of Internal Affairs and Communications, *White Paper on Local Public Finance (2004),*
Izumi Hoshino, *"Igirisu no Bunkenka to Chiho Zeisei Kaikaku" (Decentralization and local tax reform in the UK), Toshimondai (2004).*
Masatoshi Katagiri, *"America Shu Cihozei no Genjo to Kadai" (The current state and challenges regarding US state and local taxes), Toshimondai (2004),*
Council of Local Authorities for International Relations, *"Furansu no Chihojichi" (Local autonomy in France) (2002), "Doitsu no Chihojichi" (Local autonomy in Germany) (2003), "Sweden no Chihojichi" (Local autonomy in Sweden" (2004), Statistics Canadian (2001).*

The percentage tends to be low among single cohesive countries as in Britain (16%), Japan (34.3%) and France (49.4%). In contrast, the percentage is higher among federal countries with the German and Canadian state government revenues at 60~70%. However, the municipalities in Germany fall below 30%. In the US, revenues at both the state and municipal levels exceed 40%. Even though Sweden is a single cohesive country, it has a high proportion of local tax revenues around 70%.

(3) Local tax base

The following is a comparison of the tax base by breaking down local taxes into personal income taxes (income taxes on individuals), corporate income taxes (income taxes on corporations), asset taxes and consumption taxes (**Chart 7**).

Chart 7: A breakdown of local taxes by tax base (2002)



Local taxes in Britain and France are comprised mainly of asset taxes. While France has a large proportion of "other taxes" (48%), the major part of this is comprised of professional taxes (*taxe* *professionnelle*) (Note 2). In Sweden, local taxes are comprised entirely of personal income taxes.

Local taxes in Germany, the US and Canada, which are federal countries, have a high proportion of personal income taxes and consumption taxes. A breakdown of local taxes into state and municipal taxes reveals a high proportion of personal income taxes and consumption taxes at the state level and a high proportion of asset taxes at the municipal level. However, personal income taxes comprise a large component of municipal level taxes in Germany. As for local taxes in Japan, personal income taxes, corporate income taxes, asset taxes and consumption taxes are all around 15~30%. In particular, note that the percentage of corporate income taxes is the highest among the seven countries compared (Note 3).

3. Local taxes in each of the countries – characteristics and models

On the basis of the foregoing international comparison, we have set forth the characteristics of the local tax systems in each of the six countries compared.

(1) Characteristics and historical backgrounds

a. Britain

The salient characteristic of local taxes in Britain is that they are based solely upon fixed asset taxes. Since the general account balance of local public finances is adjusted by means of the tax rate, the asset tax rate is changed every accounting period. Although local taxes were once levied upon business assets of corporate entities (business rate), business assets are now subject to national taxes.

b. France

While local taxes in France are levied on a wide array of tax items, asset taxes and professional taxes are the core components. These taxes are characterized by the stability of tax revenues and relative ease of geographic differentiation. Given the fundamental concept in France that local taxes should be levied upon tax items upon which local administrative bodies are able to exercise autonomy, value–added taxes (VAT), income taxes and corporation taxes are deemed unsuitable for local taxes.

c. Sweden

As in the case of Britain, local taxes in Sweden are based upon a single tax item – the difference being that the sole item taxed is personal income. Given its emphasis upon the benefit principle (Note 4), local taxes on personal income are levied at a fixed rate (the national income tax is levied at a progressive rate). Local governments are unable to levy taxes on items other than personal income. Thus, 96.7% of personal income taxes of the entire country is levied at the local level. Furthermore, the general account balance at the local government level is adjusted by the tax rate.

d. Germany

Germany takes a shared taxation method (Note 5) whereby the federal, state and municipal levels of government share taxes. Taxes at the state level are comprised mainly of personal income taxes and consumption taxes while municipal taxes are comprised mainly of personal income taxes. In 1955~1956, taxes upon income and corporations were transformed into shared taxes of the federal and state governments. Subsequently, in 1969 value–added taxes (consumption taxes) were added to shared taxes in a bid to ensure the stability of municipal tax revenues. Corporate income taxes at the local level are gradually being reduced.

e. US, Canada

While tax items differ according to states and municipalities in the US and Canada, the main tax items are personal income taxes and consumption taxes at the state level and fixed asset taxes at the municipal level. In both the US and Canada, many of the states and municipalities adjust the general account balance by local tax rates.

In the US, states have had autonomous authority to levy taxes even prior to enactment of the United States Constitution. Since the states' authority to levy taxes was not limited by the Constitution, tax systems differ from state to state. Although the Canadian Constitution only granted powers regarding direct taxes to the state, the powers have been widened through interpretation and amendment of the Constitution. At present, tax systems differ at the state level.

(2) Local taxation models

An overview of the patterns in the local tax systems of the countries examined in the foregoing section leads to three main models as follows: the "single cohesive country model", the "federal country model" and the "Swedish model" (an intermediate model between the former two models) (**Chart 8**).

a. Single cohesive country model

We shall look first at the "single cohesive country model" typified by Britain and France. This model is characterized by a low percentage of local tax revenues in total tax revenues of the entire country. Likewise, it also has a low percentage of local taxes in local government revenues. Thus, this model may be described as a centralized revenue structure, given the local government's weak autonomous revenue base.

As for the tax revenue structure, both Britain and France rely heavily upon asset taxes and emphasize both the benefit principle and the stability of tax revenues. Furthermore, there is a trend toward limiting local governments to levy taxes upon corporations, which do not possess voting rights. Hence, the percentage of corporate income tax is low.

Moreover, this model tends to stress the authority of local governments to set tax rates such as the adjustment of local fiscal balance by hiking or cutting tax rates. There is not much emphasis upon national uniform taxation of local taxes in both Britain and France. Thus, local disparities in tax revenue sources are not a major issue.

b. Federal country model

Next, we shall turn to the "federal country model" seen in Germany, Canada and the US. In all of the three countries, local taxes comprise a large percentage of total tax revenues. Since local taxes make up a large part of local government revenues, the weight of local finance transfers from the central to local government is small. Therefore, we may describe this model as a decentralized revenue structure. As for the local tax system, the core components at the state level are personal income taxes and consumption taxes. At the municipal level, consumption taxes comprise the main component (however, asset taxes do not comprise such a large part of local tax revenues in the German municipalities).

The local tax systems of these countries differ from those of single cohesive countries in the two following aspects. Firstly, local governments in federal countries have a high level of tax revenues generated by personal income taxes and thus do not rely solely upon asset taxes. Secondly, consumption taxes are levied as local taxes. This is most likely due to the stability of tax revenues in the case of consumption taxes.

c. Swedish model

Although Sweden is a single cohesive country, it differs from Britain and France given its (1) relatively large percentage of local taxes in overall taxes and also (2) large percentage of local taxes in local government revenues. The local tax system is based mainly upon personal income taxes. The Swedish model may be classified as an intermediate model possessing the characteristics of both the single cohesive country model and the federal country model.

Of the three models above, the federal country model is the most decentralized with a high proportion of local taxes.

Chart 8: Local taxation models

	① Single cohesive country model	② Swedish model	③ Federal country model	④ Japan
Tax structure	Centered upon taxes on assets	Centered upon personal income tax	Centered upon asset taxes and personal income tax	Well-balanced - personal income tax, corporate income tax, tax on assets and consumption tax
Consumption tax	Consumption taxes are deemed unsuitable for local taxes because of the difficulty for local governments to set the consumption tax rate		Consumption taxes are deemed local taxes in a bid to expand the local tax revenue base	
Corporate income tax	No corporate income tax		Limited corporate income tax	Corporate income tax is one of the main pillars
Uniform taxation	National uniform taxes are rare. Emphasis upon local government responsibility by granting the power to set tax rates			Nationwide uniform taxation as a general rule
Regional disparities	Regional disparities regarding tax revenues are not a major issue, given the fundamental view that tax rates should be set by local governments			Strong belief that regional disparities must be adjusted

4. Japan's local tax system

Where does Japan stand in terms of its local public finances in the light of the local revenue structures of the major countries compared in the foregoing sections?

Japan has a relatively high percentage of (1) local taxes in total tax revenues and (2) local government expenditures in total government expenditures. In this respect, it possesses characteristics similar to the federal country model. However, it also shares similarities with the single cohesive country model in terms of its (1) low percentage of local taxes in local government revenues and (2) large public finance transfers from the central to local governments. Japan's local tax system is a "unique system" which may not be defined solely by either of the two models above.

In the following section, we shall examine and recount the characteristics of Japan's local tax system.

Firstly, looking at the structural composition of tax revenues, Japan's local tax system is characterized by the absence of a significant concentration of taxation on any single tax item such as personal income, corporate income, consumption and assets.

The second characteristic is the high proportion of corporate income taxes, which comprise one of the core tax items in local taxes. Corporate income taxes are the largest component of prefecture taxes, comprising 18.2% of local government taxes as a whole and 30.3% of taxes at the prefecture level. Given the concentration of corporate business offices in metropolitan areas, there is a wide gap in corporate income tax revenues among local administrative bodies (**Chart 9**). Furthermore, the susceptibility of corporate income to business trends is a factor lending to the instability of local tax revenues. Thus, there are views that corporate income taxes are not necessarily best suited for local taxes because of the aforementioned characteristics.

Chart 9: Regional disparities in tax revenues among Japan's prefectures (FY2002)

		Amount of tax revenues	Regional disparities	Prefecture with highest tax revenue	Prefecture with lowest tax revenue
Personal income taxes	Inhabitant tax on individuals	2.3 trillion yen	2.44 times	Tokyo	Okinawa
Corporate income taxes	Inhabitant tax on corporations	0.7 trillion yen	5.84 times	Tokyo	Nara
	Enterprise tax on corporations	3.5 trillion yen	7.63 times	Tokyo	Nara
Consumption taxes	Local consumption tax	2.4 trillion yen	2.59 times	Tokyo	Okinawa
Other taxes	Tobacco tax	0.3 trillion yen	1.61 times	Tokyo	Nara
	Automobile tax	1.8 trillion yen	1.89 times	Gunma	Tokyo

Note: "Regional disparities" are derived by comparing the amount of per-capita tax revenues.
Source: Ministry of Internal Affairs and Communications.

Thirdly, the central government sets standard tax rates for a large part of Japan's local taxes. Despite provisions in the local tax law stipulating that local administrative bodies are not bound by standard tax rates in the event there are special circumstances regarding public finance, taxes in many cases are levied at the tax rate ceiling, giving local governments only limited discretionary powers.

Fourthly, in many cases, a surcharge surpassing the standard tax rate is levied upon corporate entities that have no voting rights. In terms of the municipal inhabitant's tax, surcharges on the corporate inhabitant tax (partly taxed on national corporation tax basis) are levied upon 1,426 organizations (as of April 1, 2003), providing a sharp contrast to the absence of local administrative bodies which levy surcharges on individual inhabitant taxes on an income basis.

5. Intergovernmental financial adjustment systems in federal countries

As shown in the previous sections, federal countries have more locally decentralized revenue structures. The public finance systems of federal countries would provide Japan with models and insights in its pursuit of the Trinity Reform Package, which seeks a more decentralized local public finance system. In the pursuit, the disparity among local administrative bodies resulting from the Trinity Reform Package would pose a major concern. While such local disparities would typically be addressed through public finance transfers, what are the options taken by federal countries possessing a highly decentralized system? The following is an overview of the mechanisms of the intergovernmental financial adjustment systems in Germany, Canada and the US.

(1) Germany

The major characteristic of the intergovernmental financial adjustment system in Germany is the existence of a mechanism, which directly transfers revenue sources from affluent to poor states without the intervention of the federal government. Hence, the proportion of both general purpose transfers (public finance transfers without limits upon usage) from the central to local governments and special purpose subsidies (public finance transfers with limits upon usage) in total local revenues are both low, standing at 3% and 5% respectively.

More specifically, the three main methods below are used to adjust the public finances of local governments.

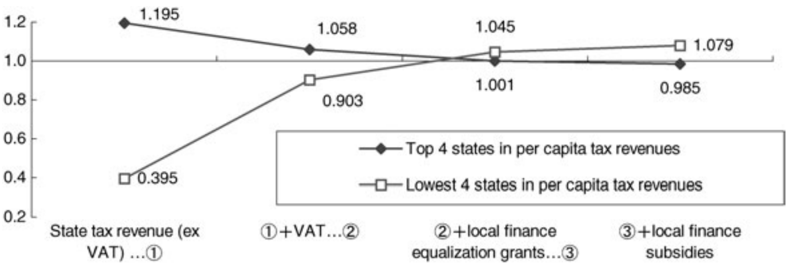
The first mechanism is the "allocation of value-added taxes". This is a type of horizontal adjustment (adjustment between local administrative bodies) funded by the state's share of value-added taxes which is a shared tax. States lacking in revenues (whose per capita tax revenues fall short of 92% of the average of all states) are supplied funds up to the 92% level, with a ceiling set at 25% of the total amount. The remainder is allotted in proportion to the population.

The second mechanism is "interstate adjustment". This is a type of horizontal adjustment where affluent states (states that have tax revenues exceeding the national average) provide poor states (below-average states) with adjustment transfers in order to eliminate interstate imbalances that remain even after the allocation of value-added taxes. By doing so, below-average states are supplied funds up to a level of 95% of the per capita revenue average of all states.

The third mechanism is a combination of general purpose transfers collectively referred to as "federal aid grants". These include the *Fehlbetrags-Bundeserganzungszuweisungen* (federal grants to cover revenue shortages) to supply financially weak states with up to 99.5% of the national average per capita revenues and special grants in former East Germany.

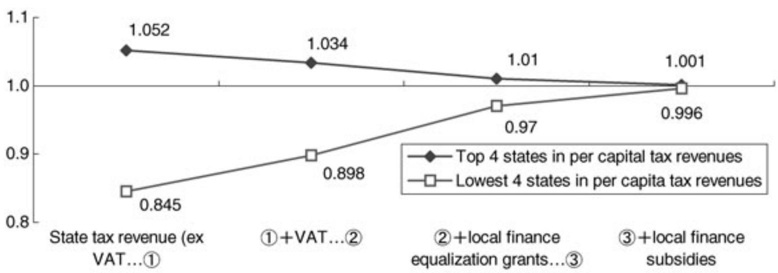
As a result of these financial adjustment mechanisms, interstate financial gaps are considerably narrowed and even reversed in some cases. **Chart 10** looks at how the per capita revenue (federal average of the per capita revenue = 1) have changed among the affluent states (top 4 states in per capita tax revenues) and poor states (bottom 4 states in per capita tax revenues). Given the three methods of public finance adjustment, per capita revenues in poor states (0.395→1.079) have surpassed those of affluent states (1.195→0.985), revealing a reversal of per capita financial strength as a result of financial adjustment. However, a note of mention is necessary that the generous assistance toward the weak economic areas of former East Germany even after the unification of Germany, is most likely a large factor to the reversal. For the purpose of reference, a reversal of this kind is not evident in a comparison including only the areas of former West Germany (**Chart 11**).

Chart 10: Interstate financial adjustment in Germany (1998)



Notes: 1. Excluding the three urban states (Berlin, Hamburg, Bremen).
2. Per capita revenue of entire population = 1.
Source: Ministry of Finance Policy Research Institute, *International Comparison of Local Finance Systems.*

Chart 11: Interstate financial adjustment in the areas of former West Germany (1998)



Notes: 1. Excluding the three urban states (Berlin, Hamburg, Bremen).
2. Per capita revenue of entire population = 1.
Source: Ministry of Finance Policy Research Institute, *International Comparison of Local Finance Systems.*

(2) Canada

Canada is a federal country comprised of 10 states and three territories (Note 6).

The percentage of public finance transfers from the central to local governments in local government revenues is a mere 17%. A breakdown of this figure is general purpose transfers (12%) and special purpose subsidies (5%), revealing that financial adjustment is conducted primarily by general purpose transfers. The following are the three main pillars of general purpose transfers.

The first is the Canada Health and Social Transfer ("CHST") (Note 7). In its allocation, there are mechanisms to ensure equal distribution on a per capita basis.

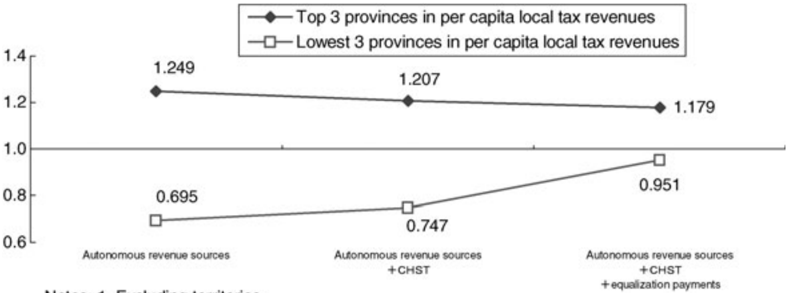
The second pillar is the "equalization payment". Equalization payments cover the 10 provinces excluding the territories and are paid to cover any shortfalls in the event the per capita revenue projection falls below the average of the five standard provinces (Note 8). Note that there is a ceiling stipulating that the rate of increase of the total amount of equalization payments may not surpass the rate of GDP growth.

Thirdly, there is "Territorial Formula Financing" which includes the three territories and covers the gap between the standard amount of demand and the standard amount of revenues.

A comparison of the intergovernmental financial adjustment method of Canada with Germany reveals a common characteristic that revenues comprise the main criteria for determination of the amount of allocation and that differences in administrative demand are not considered.

Meanwhile, given the absence of horizontal public finance transfers as in Germany, affluent states are able to retain above–average tax revenues. Thus, financial gaps are not reduced as much as they are in Germany even after intergovernmental financial adjustments (**Chart 12**).

Chart 12: Inter–province financial adjustment in Canada (1998)



Notes: 1. Excluding territories.
2. The average of the five standard provinces = 1.

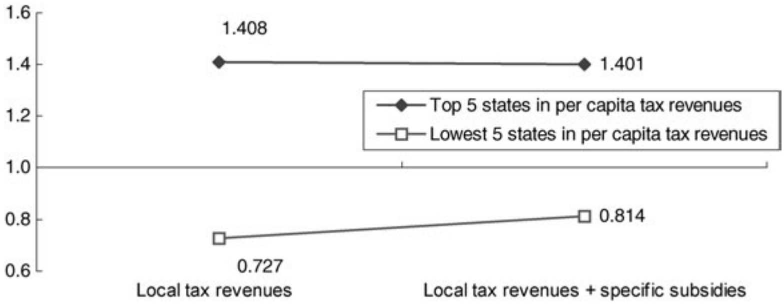
Sources: Statistics Canada, *Canadian Statistics,*
Ministry of Finance Policy Research Institute, *International Comparison of Local Finance Systems.*

(3) US

The US was once a federal country resting upon the cooperation of the federal, state and local governments. However, the adoption of competitive federalism under the Reagan administration since the 1980s led to stronger financial powers and responsibilities of the state government. Thus, while local governments have come to possess a high degree of autonomy without relying financially upon the federal government, they are also expected to exercise a high degree of self–responsibility and self–effort.

Special purpose grants, while limited in scope (approximately 20% of local government revenues), are used as a means for financial adjustment. There are various individual grants and broad–based block grants that are integrated with individual grants. The major characteristic of the US financial adjustment system is the absence of a financial adjustment system through general purpose transfers and horizontal financial adjustment (Note 9). As a result, gaping financial disparities remain among states even after financial adjustment (**Chart 13**).

Chart 13: Interstate financial adjustment in the US (1996)



Note: Average of all states = 1.
Source: Ministry of Finance Policy Research Institute, *International Comparison of Local Finance Systems*.

6. Perspectives toward the reform of Japan's local allocation tax system

This leads now to an assessment of Japan's current system of intergovernmental financial adjustment. Here, we shall set forth the characteristics and problems of Japan's system of financial adjustment, keeping in mind the federal countries in the previous section.

(1) Overview of the financial adjustment system in Japan

Japan currently has a centralized system of financial adjustment.

Financial adjustment funds comprise a large percentage of local government finances in terms of both general purpose transfers (22% of local government revenues) and special purpose grants (13%). At present, there are four methods of financial adjustment as follows.

The first is the "local allocation tax" which is a type of general purpose transfer. The total amount of local allocation taxes are capped at a percentage of the five main national taxes (income tax, corporation tax, liquor tax, consumption tax and tobacco tax). The amount of tax grants are ordinarily calculated by a "revenue–expenditure differential supplementation method" which covers the difference between the amount of basic financial demand (Note 10) and the amount of basic financial revenue (Note 11). The second is the "local transfer tax", a general purpose transfer which allocates taxes levied at the national government level on the basis of certain standards (population, extension of roads, areas etc.). The third is the "special local grant". This is a type of general purpose transfer to supplement the shortfall in local tax revenues as a result of the income tax cut in 1999. The fourth is the "national treasury disbursement", a collective term referring to special purpose grants which are as a general rule limited in terms of usage. These include contributions, expenditures for agential tasks and subsidies for the promotion of certain measures or financial assistance paid by the national government to local administrative bodies on the basis of expense burden allocations between the national and local governments.

(2) Problems of the local allocation tax system

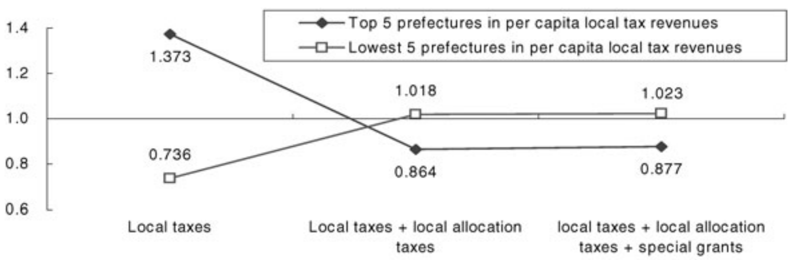
One of the characteristics of Japan's intergovernmental financial adjustment system is the heavy weight of not only general purpose transfers which are unlimited in terms of usage, but also of national treasury disbursements with specified purposes. In a bid to promote decentralization, Japan is under pressure to shift the main emphasis of revenues away from special purpose grants to local taxes, which are autonomous financial resources of local administrative bodies. As a matter of fact, the primary tasks of the Trinity Reform Package are the reduction of subsidies and the upgrading and expansion of local taxes as a substitute revenue source.

Turning to future financial adjustment methods amid the reduction of subsidies, the relative weight of local allocation taxes is predicted to rise. In comparison with the financial adjustment methods of federal countries mentioned before, there are three main problems with respect to Japan's local allocation tax system explained in more detail below.

a. The reversal of gaps in financial strength

The first problem is that large–scale financial adjustments are creating “reverse gaps” – a reversal of financial strength among local administrative bodies. **Chart 14** reveals the change in per capita revenue (the national average per prefecture is 1) as a result of general purpose transfers. The chart shows that as a result of financial adjustment by general purpose transfers, the prefectures with low per capita tax revenues (0.736→1.023) end up with higher per capita revenues than prefectures with high tax revenues (1.373→0.877).

Chart 14: Financial adjustment among prefectures in Japan (FY2001)



Notes: 1. Average of all prefectures = 1.
Tokyo tax revenues exclude the portion corresponding to minicipal taxes.
2. "Top 5 prefectures in per capita local tax revenues" = Tokyo, Aichi, Fukui, Shizuoka, Osaka.
"Lowest 5 prefectures in per capita local tax revenues" = Okinawa, Nagasaki, Miyazaki, Kagoshima, Nara.

Sources: Institute of Local Finance, Ministry of Internal Affairs and Communications, *Population Estimates*.

As mentioned earlier in this report, a similar reversal phenomenon may be observed in Germany. This, however, is due to generous assistance toward the areas of former East Germany after the unification of East and West Germany. Given the absence of such special circumstances in Japan, it would be necessary to reconsider the necessity of such a substantial financial adjustment leading to a reversal of financial strength among local administrative bodies.

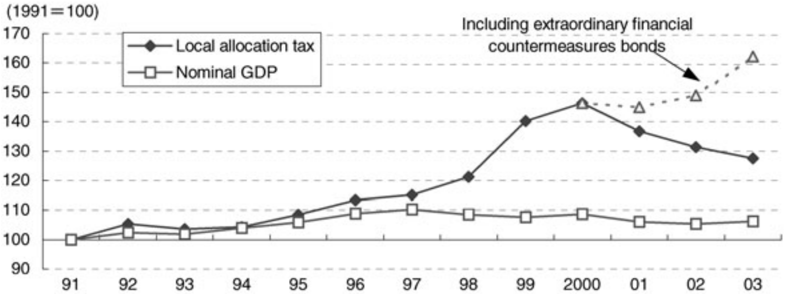
b. The negative effect stemming from the emphasis upon administrative demand

The second shortcoming is the complexity of the method to calculate the amount of allocation taxes stemming from the generous consideration for regional circumstances in administrative demand in the distribution of local allocation taxes.

As observed earlier, in the calculation of the amount of financial adjustment, Canada and Germany have adopted simple mechanisms with emphasis upon the correction of gaps in financial strength. In contrast, Japan's "revenue–expenditure differential supplementation method" provides adjustments for various factors such as "cold climate adjustments" in the assessment of administrative demand. As a result, the method and process of calculation is subject to criticism for being opaque and arbitrary.

Moreover, the cumulative method of adding distributions according to indigenous regional circumstances has the negative effect of bloating the total amount of local allocation taxes. In **Chart 15**, we have set forth the trends in total sum of local allocation taxes and nominal GDP, both indexed with 1991 as the base year (= 100). The chart reveals that local allocation taxes have surged at a pace surpassing nominal GDP. Although the amount of local allocation taxes is starting to decline since 2001, it is still following an upward curve when including the extraordinary financial countermeasures bonds (Note 12) devised to cover the shortfall of local allocation taxes.

Chart 15: Trends in Japan's local allocation taxes



Note: Based uopn settlement of accounts up to 2002 and upon local financial plans for the year 2003.
Sources: Ministry of Internal Affairs and Communications, *White Paper on Local Public Finance*, Cabinet Office, *Annual Report on National Accounts*.

c. The involvement of local administrative bodies in the allocation process

Thirdly, despite the fact that local allocation taxes are indigenous financial resources of local administrative bodies, the national government is empowered to determine its allocation. Local administrative bodies are only able to express their opinion. Looking overseas, in Germany for example, there is a public third–party body where representatives from state governments adjust interests between federal–state and state–state governments. Since the deep involvement of local administrative bodies in the allocation of financial adjustment is beneficial for the promotion of decentralization, Germany provides valuable insights for Japan.

Concluding remarks

Japan's Trinity Reform Package is already in motion since FY2004. Thus far, headway has been made in terms of reducing subsidies. Looking forward, the emphasis should shift toward the transfer of tax revenue sources from the national to local governments and the review of local allocation taxes. If, in such event, tax revenue sources having a high degree of local disparity are transferred, some local administrative bodies may face a shortage of revenues, thus compelling the government to increase the amount of local allocation taxes. If events should unravel in this direction, the Trinity Reform Package to reinforce the autonomy of local revenues will not be able to achieve its original purpose. Tax revenue sources must be transferred in an accurate and appropriate manner so as to raise the percentage of local taxes in revenues in as many local administrative bodies as possible.

The local tax systems of federal countries provide valuable lessons for Japan. As mentioned before, personal income taxes and consumption taxes comprise the main pillar of local tax revenues in these countries. Meanwhile, Japan is the only country where the local allocation of tax revenue sources is heavily skewed and a large percentage of local taxes is comprised of corporate income taxes which are a very volatile revenue source. In view of these circumstances, the predominant option would be to increase the weight of personal income taxes and consumption taxes in local taxes and reduce the weight of corporate income taxes in local taxes.

Moreover, the review of local allocation taxes is leading to discussions that the reform should not only stop at restraining the total sum but should strive to reform the "mechanism" such as the method of calculation and the increase of opportunities for local administrative bodies to participate in the allocation process. For example, steps such as the following would prove effective: (1) the simplification of complex adjustment methods taking heed of the examples set by the federal countries examined in this report, and (2) the establishment of ceilings as in Canada so that the rise of local allocation taxes do not surpass the rate of nominal GDP growth.

FY2006 is the final year of the Trinity Reform Package. Japan must step up its efforts to improve its local tax system and financial adjustment system to realize a more decentralized local autonomy system.

* * * * * * * * * *

Notes:

1. Local administrative bodies in federal countries under the state level are referred to as “municipalities” in Germany, while the term “local government” is used in the US and Canada. In this report, we shall use the term “municipalities” to refer to all administrative bodies under the state level.
2. Taxes levied upon business–purpose fixed assets and payrolls toward individual entrepreneurs and corporate entities. Classified as “others” under OECD tax statistics. The portion based upon payrolls was abolished as of 2003.
3. Although Germany has a high percentage of corporate income taxes (20.6%) at the municipal level, the percentage at the local level (total of state and municipal taxes) is only 7.7%, thus lower than Japan.
4. The concept that taxes should be levied in correspondence with the benefits received by residents from administrative bodies.
5. Shared taxes in Germany are attributed and allocated among the federal, state and municipal governments. These refer to income taxes, corporation taxes and value–added taxes.
6. Nominally, “territories” fall within the direct jurisdiction of the federal government. However, territories posses virtually the same degree of autonomy as provinces. For example, the power of legislation is delegated to the territorial assembly.
7. Although the purpose of usage of the CHST is predetermined, it is statistically classified as general purpose transfers given the wide scope of usage.
8. Refers to the five provinces with medium financial strength: Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.
9. Although there once was a system of General Revenue Sharing, a type of general purpose transfer, the system was abolished under the Reagan administration in a bid to introduce competitive federalism and reduce the federal government deficit.
10. The amount of basic financial demand is the administrative demand calculated by each local administrative body for the purpose of administrative management and/or maintenance of facilities.
11. The amount of basic financial revenue is the projected amount of tax revenues calculated under a certain method in order to gauge the financial strength of each local administrative body.
12. The “extraordinary financial countermeasures bonds” were introduced in FY2001 in lieu of the abolishment of borrowings under the special account for tax allocations. Under the new system, the national and local governments each issue equal shares of bonds to cover shortfalls of local allocation taxes.

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