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GOALS AND REFORMS OF CURRENT JAPANESE LOCAL TAX SYSTEM

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Abstract

This paper examines the structure of Japanese local revenue and the characteristics of the Japanese local tax system. Further, it examines the goal of financial autonomy in the Japanese context.

Local revenue is mainly composed of the general revenue resources in terms of quantity and quality. These revenue sources accounted for 55.2% of the total local revenue in fiscal year 2012. Moreover, they are not earmarked for specific purposes and are essential for local autonomy. The key elements of the general revenue resources are the local taxes, the local transfer tax, the special local grants, and the local allocation tax.

Local tax is the principal local revenue and the core method for the financial autonomy. However, the local tax system currently faces various issues. I identify several issues with the local tax system—disparity, sensitivity, overlap between national taxes and local taxes—and discuss the need to enrich local autonomy. These are architectural issues that are closely related to the characteristics of the Japanese local tax system.

Further, I examine the Japanese local tax reforms. The Japanese tax reform strategy involves two approaches—an urgent approach and a long-term approach. It would be preferable for the citizens to distinguish between these approaches when considering the local tax reforms.

Finally, I suggest three goals for the Japanese local tax system. The first is to reduce disparity. In a manner, this is the hottest issue at present. The national government enacted several very important reforms such as the foundation of the local corporate special tax in 2008. The second goal is to enrich autonomy. In order to achieve this, the Trinity Reform was implemented in Japan from 2004 to 2006. Moreover, the local governments will receive additional tax revenue in the form of an increase in consumption tax in 2014. However, the issue of the gap between revenue and expenditure has become rather remarkable. The third goal is to stabilize the tax revenue, which is a significant agenda. In this context, the local governments have made much of the asset tax and the consumption tax. Moreover, the expansion of local consumption tax in 2014 could contribute to stability. However, the taxes on corporate income (which amount to 3 trillion yen) are still principal local taxes and they are very elastic to economic situation. How to deal with those elastic local taxes and to procure more stability for the local tax system seems to be more crucial.

And as the concept of social values is becoming complicated, the reform of local tax system will be complex. But when we consider the future financial autonomy, the following point is significant. The local governments are required to be more and more sensitive to community needs in the framework of financial autonomy. And relationship between sensitivity

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and financial autonomy must be an indispensable combination in the contemporary society.

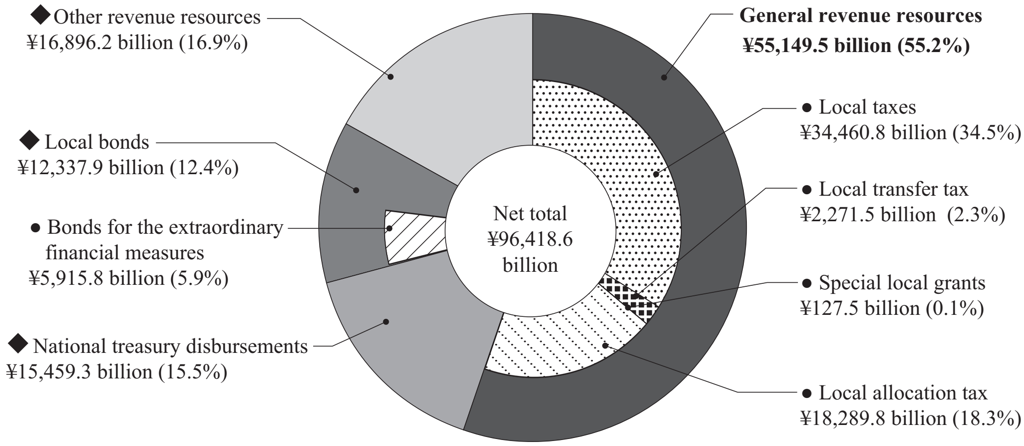
Introduction

In Japan, the local governments are given the authority to levy local taxes. The local tax revenue is the core revenue source among the various sources of local revenue. This paper examines the structure of Japanese local revenue and the framework of Japanese local tax. Further, it examines the characteristics of the local tax system and the relationship between national taxes and local taxes. Moreover, this paper examines the goal of financial autonomy in the context of Japan.

I. *Structure of Japanese Local Revenue*

1. Overview of Japanese Local Revenue

FIGURE 1. COMPOSITION OF LOCAL REVENUE (FY2012 Settlement)[1]



The local revenue resources are mainly composed of the general revenue resources in terms of quantity and quality. These general revenue resources account for 55.2% of the total local revenue (Figure 1). Moreover, they are not earmarked for specific purposes and are essential for local autonomy. The key elements are the local taxes, the local transfer tax, the special local grants, and the local allocation tax.

The local taxes include an assortment of public levies. The local governments have the right of taxation—the authority to levy, collect, receive, and use taxes. (The details are discussed later.)

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[1] *Source*: *White Paper on Local Public Finance, 2014*, Ministry of Internal Affairs and Communications (MIC)

The local transfer tax is a group of taxes that are collected as national taxes and directly transferred to the local governments. As a matter of taxation convenience, the national government acting on behalf of the local public bodies collects these taxes, which are regarded as local government revenue resources in the basic sense.

The special local grants are distributed for reducing the burden of local governments with regard to child allowance, compensation for a decrease in individual inhabitant tax according to the tax reduction for home loans, and so on.

The local allocation tax is an allocation of financial resources made by the national government to each local body in order to equalize the local revenue sources by reducing disparities and to guarantee the systematic management of local finances.

Among the various general revenue resources, the local taxes and the local allocation tax are the key resources. Before going into details about the local taxes, this treatise presents an outline of the local allocation tax in the next chapter.

2. Outline of the Local Allocation Tax

(1) Objective

The objective of the local allocation tax (LAT) is to strengthen the self-dependence of local governments by equalizing the financial resources and by ensuring the systematic operation of local administration through the establishment of allocation standards for LAT, without impairing the autonomy of such local public bodies.

The LAT has two functions:

(A) Financial equalization function

The LAT aims to rectify the disparities among the financial capabilities of local governments by distributing the local allocation tax appropriately.

(B) Financial resource guarantee function

This function can be divided into two levels.

①Macro-level financial resource guarantee function

The LAT guarantees revenue resources for local public bodies as a whole. The annual amount of LAT is set in such a manner as to guarantee the local financial revenue at the macro level through the national budgetary process.

②Micro-level financial resource guarantee function

The LAT guarantees financial resources for individual local public bodies. The LAT is distributed to those local bodies whose standard financial requirements exceed the standard financial revenue. A reasonable amount of financial resources for the performance of standard public services is secured through these distributions.

(2) Characteristics

The characteristics of the LAT are as follows:

(A) The LAT money constitutes revenue resources that are specifically intended for the local governments and are shared by them. The LAT can be thought of as a local tax collected by the national government on behalf of the local authorities. This tax constitutes financial resources that local public bodies share and that are specifically meant for their use.

(B) The LAT provides general revenue resources for the local governments. The national government does not decide how the funds are spent or does not impose any conditions regarding their use; the utilization of these funds is left to the independent decision of the local authorities.

The LAT is a scheme that corrects the gap between the scale of national tax revenues and that of local tax revenues. The former is larger than the latter; however, the local fiscal expenditure is greater than the national fiscal expenditure (see Figure 13). In this financial framework, the LAT has a crucial role as a financial transfer from the national government to the local governments.

(3) Mechanism and effect

The LAT is paid annually to the local bodies according to the formula given in Figure 2. The LAT is composed of a regular LAT and a special LAT. A regular LAT is a basic fund, and a special LAT is a complementary fund. These two funds are calculated separately for each local body. The amount of regular LAT of a local body can be obtained from the difference between its standard financial requirements and its standard financial revenue (Figure 2). In other words, this system is designed for "compensating for disparities in fiscal resources and needs" [Mochida].[2]

FIGURE 2. FORMULA OF A REGULAR LAT[3]

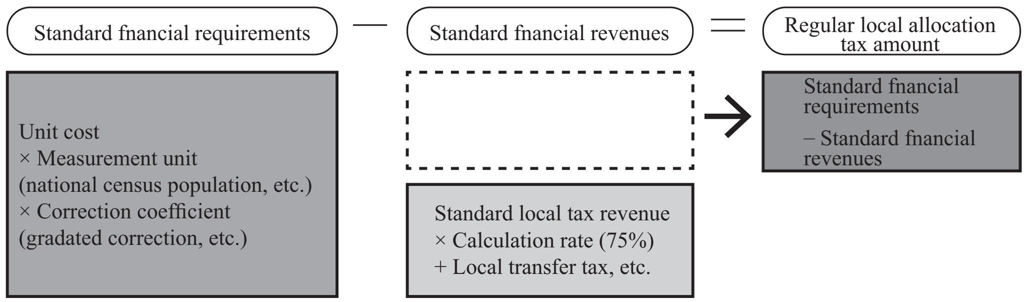


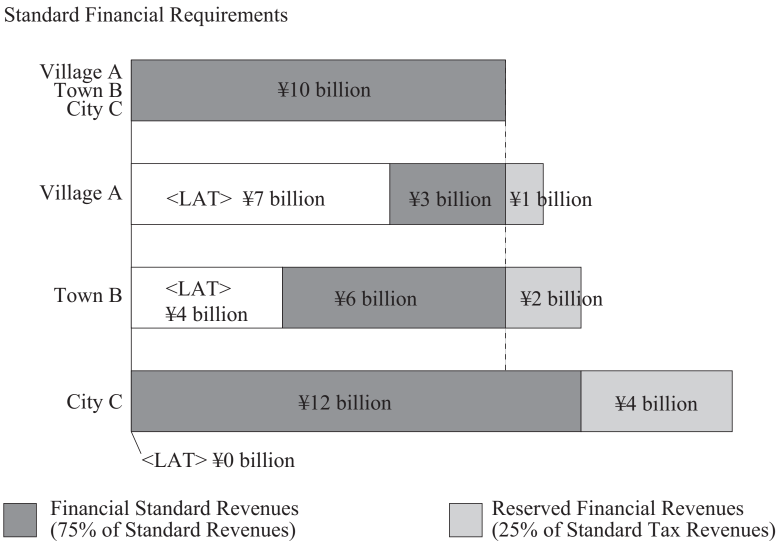
Figure 3 presents a model of the effects of the LAT. The standard financial requirements of village A, town B, and city C are 10 billion yen. The standard financial revenue of A is the smallest (3 billion yen), while that of B is 6 billion yen and that of C is the largest (12 billion yen). In this case, village A—the poorest local body—gets 7 billion yen, the largest amount of LAT. Conversely, city C, the richest body, receives no LAT.

This scheme is highly advantageous to those local bodies whose financial grounds are

[2] Nobuki Mochida, *Fiscal Decentralization and Local Public Finance in Japan* (N.Y., 2008) p. 103

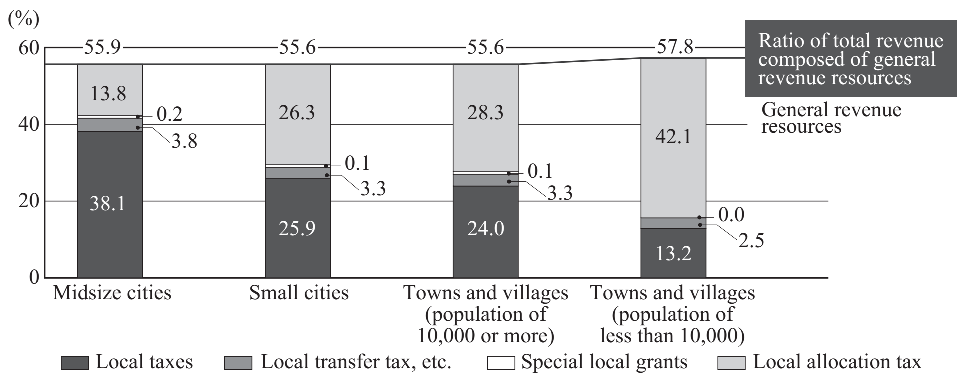
[3] *Source*: *White Paper on Local Public Finance, 2014*

Figure 3. Model of Effects of the LAT[4]



weak. Figure 4 shows the ratio of LAT to the total revenue in the municipalities. The ratio of LAT is 43.5% in the group of towns and villages whose population is less than ten thousand; this is the smallest group among the municipalities. This ratio is larger than that of any other group. This fact shows the importance of the role that the LAT plays, especially in the small local bodies. "Using this formula, the national government can transfer funds that will fill the gap between each region's fiscal need and fiscal capacity to ensure that an authority with reasonable tax effort will be able to provide a reasonable level of public services" [Mochida].[5]

Figure 4. Ratio of Total Revenue Composed of General Revenue Resources for Municipalities (FY2012 Settlement)[6]



[4] Figure 3 was created by the author.
[5] Mochida (2008) p. 103

In other words, the LAT has been an essential support for the Japanese national minimum for as much as 1,765 (as of Apr of 2014) local bodies with viable sizes and natural conditions.

II. *Framework of Japanese Local Tax*

1. Framework

(1) Legal framework

The legal framework of the Japanese local tax system is stipulated by the Japanese Constitution. Art. 94 of the Constitution stipulates that "[l] ocal public entities shall have the right to manage their property, affairs and administration and to act their own regulations within law."

Further, Art. 10, Sec. 2 of the Local Autonomy Law (LAL) stipulates the following: "According to the Law, inhabitants have their rights to receive equally public services offered by local public entities where they live and have their own shares of their community."

This article stipulates that inhabitants should share the cost of the public services that are provided by the local government. This is called the "burden-sharing" principle, and it is the key concept of Japanese local administration.

Based on this concept, Art. 223 stipulates the following: "According to the Law, ordinary local governments have their power to levy and collect local taxes." Under the Constitution and LAL, the Local Tax Law (LTL) regulates the local tax system. The LTL is the basic national law that stipulates the types of taxes and the means of taxation. Under this legal framework, both prefectures as well as municipalities are given the authority to levy and collect local taxes in Japan.

(2) Local tax and local autonomy

Why would the residents pay their share for their own community? Because they believe that they can place their trust in their local governments. Why would they believe that? One reason is that the local governments ensure that they have free will in deciding what public service they shall provide to the residents. The necessary financial revenue sources that are not earmarked are the key for ensuring free will.

This is the context of the relationship between local tax and local autonomy. For the local government to be able to function in accordance with the spirit of local autonomy, it is important that it has the authority to levy taxes and to acquire them on its own.

Without this authority, local governments would accept excessive interferences by the national government in exchange for financial aid. Therefore, the authority of a local government to levy taxes is an indispensable element of local autonomy. This can be termed the "principle of financial autonomy."

(3) Significance of local tax

The local tax has two essential features. The first is that the local tax belongs to the

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[6] *Source*: *White Paper on Local Public Finance, 2014*

general revenue sources among the various local revenue resources. The general revenue sources are not earmarked for any specific purpose and can be used for any kind of expense of the local governments. They comprise local tax, local allocation tax, local transfer tax, and several non-earmarked grants. The local tax is a core source among them.

The general revenue sources have two important advantages.

(A) The local government can use these funds for any use at its complete discretion.
The local government levies and collects all the tax under its authority. The national government has no influence on the local government's decision-making.

(B) The local government can make flexible use of the general revenue sources.
Japanese local governments have to respond to abrupt financial needs. They need to have additional funds for emergency restoration, appreciated cost of public works, and so on, even in the middle of a fiscal year. In such situations, the local government compiles the supplementary budget, and flexible sources such as the general revenue sources are actually essential in such cases.

The second feature is that the local tax belongs to the independent revenue sources among the local revenue resources. The independent revenue sources are the ones that the local governments can collect under their authority. They are local tax, rents, fees, donations and such. On the other hand, the dependent revenue sources are the ear-marked grant, the local allocation tax, the local transfer tax, local bond and so on.

The independent revenue sources have two important advantages.

(A) The authority to collect these revenues rests with the local governments.
Therefore, they can use them for any uses independently; there is no room for the influence of the national government.

(B) Independent sources bring in more stable revenue for the local governments as their revenue policies are not affected by the national government's fiscal policy.

These features are quite important for the local revenue. The local tax has all the advantages needed for the local revenue, and its revenue sizes are bigger than those of other kinds of local revenue. Therefore, the local tax plays a core role as both a general revenue source and an independent revenue source.

"Where local autonomy is the aim, local taxes should be the most important source of local revenue" [Steiner].[7] This indicates that there is an important relationship between local tax revenue and local autonomy. A local government should be able to finance its public needs. Given such a framework, the citizens can select the chief executive (governor/mayor) who is responsible for the quality of public services. Therefore, the size of the local tax revenue should be further expanded in order to advance local autonomy.

(4) Scheme of local tax system

(A) Local Tax Law

The Local Tax Law (LTL) specifies the kinds of taxes that local governments may levy,[8] the tax base, and the "standard rate," the "maximum rate," or the "fixed rate" of such taxes.

[7] Kurt Steiner, *Local Government in Japan* (California, 1965) p. 263

[8] See Figure 5.

FIGURE 5. SYSTEM OF THE LOCAL TAXES[9]

- Prefectural taxes
  - Ordinary taxes
    - Prefectural inhabitants tax
    - Business tax
    - Local consumption tax
    - Real property acquisition tax
    - Prefectural tobacco tax
    - Golf course utilization tax
    - Automobile tax
    - Mine-lot tax
    - Prefectural extra-legal ordinary taxes
    - Fixed assets tax (special case)
  - Special purpose taxes
    - Automobile acquisition tax
    - Light oil delivery tax
    - Hunting tax
    - Water and land utilization tax
    - Prefectural extra-legal special purpose taxes
- Municipal taxes
  - Ordinary taxes
    - Municipal inhabitants tax
    - Fixed assets tax
    - (Municipal charge on nationally owned assets)
    - (Municipal charge on assets owned by Japan Post)
    - Light vehicle tax
    - Municipal tobacco tax
    - Mineral products tax
    - Special landholding tax
    - Municipal extra-legal ordinary taxes
  - Special purpose taxes
    - Bathing tax
    - Business office tax
    - City planning tax
    - Water and land utilization tax
    - Public facilities tax
    - Land development tax
    - National health insurance tax
    - Municipal extra-legal special purpose taxes

Since the tax base is fixed in the LTL, the bases of such taxes are consistent across the country's various jurisdictions. The LTL stipulates the taxation requirements under the various tax headings and the procedures for levying and collecting tax in a uniform manner.

(B) Taxation bylaw

Local taxes must be levied and collected on the basis of the bylaws enacted by each local assembly. A taxation bylaw stipulates the tax headings, the objects of taxation, taxation criteria, rates of taxation, and other matters related to levying and collecting tax. The local government must act in accordance with the bylaws. The local governments in Japan must establish taxation bylaws and taxation regulations that are in accordance with the stipulations of the LTL, and they must levy and collect taxes based on these bylaws and regulations.

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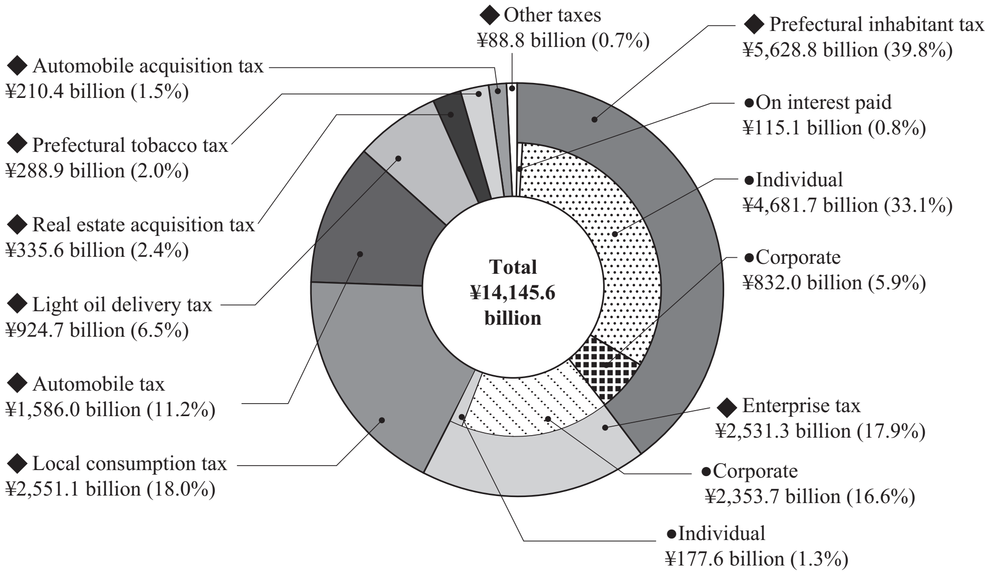
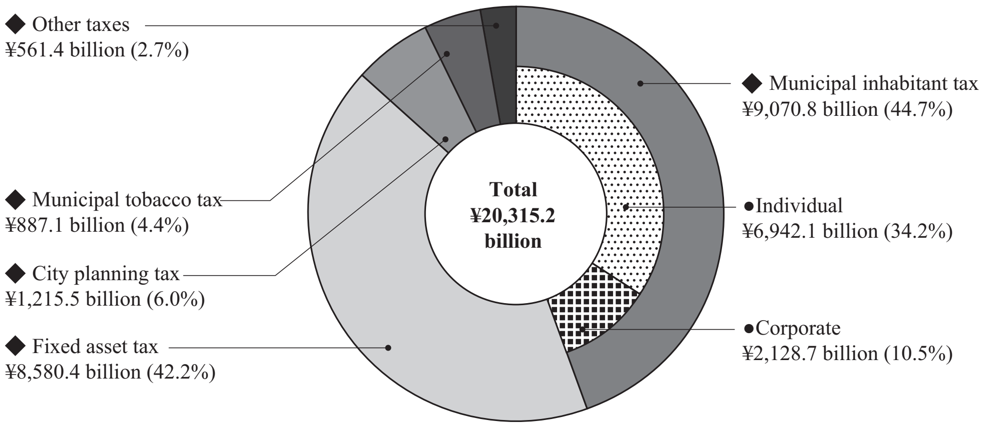
9 *Source*: Data of MIC

FIGURE 6. COMPOSITION OF THE LOCAL TAXES[10]

Composition of Revenue from Prefectural Taxes (FY2012 Settlement)



Composition of Revenue from Municipal Taxes (FY2012 Settlement)



(C) Setting tax rates

Given the principle of financial autonomy, it would be inappropriate for everything related to local taxation to be regulated in a uniform manner by national laws. Therefore, the most important matters including tax rates are decided by the tax bylaws.

On the assumption of that, standard tax rates are shown by the national government.

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[10] *Source*: *White Paper on Local Public Finance, 2014*

"Standard tax rates" are the rates that local governments should normally follow when levying taxes, but which do not necessarily have to be followed when financial circumstances or other necessary matters are taken into special consideration. These are the rates used as the basis for calculating the basic financial revenue when the amount of local allocation tax is determined by the Ministry for Internal Affairs and Communications.

Given that standard tax rates are the rates that are set when calculating the tax burden of the people as a whole (including national taxes and local taxes) or when considering matters such as the distribution of revenue sources between the national government and the local governments, these rates do have a significance. Due to these factors, standard tax rates have a considerable effect on the actual tax rates set by the local governments.

However, the local government can set a rate that exceeds the standard rates. This is called "tax levy in excess of the norm."

(5) Situation

As shown in Figure 5, there are various Japanese local taxes. Prefectures have the authority to collect prefectural taxes, and municipalities have the authority to collect municipal taxes.

Among the various taxes, inhabitant tax and enterprise tax are the principal taxes. These taxes constitute 57.7% of the total prefectural taxes (Figure 6).

2. Relationship between National Tax and Local Tax

In this chapter, we look at the relationship between Japanese national tax and local tax. An international comparison would help us understand the features of the Japanese tax system.

(1) Outline

(A) Tax levy system

In Japan, the national government, the prefectures, and the municipalities collect taxes independently.[11] Each agency has its own staff. The tax staff of the local governments are specialists/authorities on tax. Table 1 shows the number of tax staff. The ratio of tax staff to the total number of general administration staff in prefectures is 9.4%, and the ratio is 18.2% in municipalities. Distribution of local civil servants is shown in Figure 7. Thus, the sections that levy tax have significant roles, especially in municipalities. Therefore, cultivating human resources is a crucial issue for each local administration.

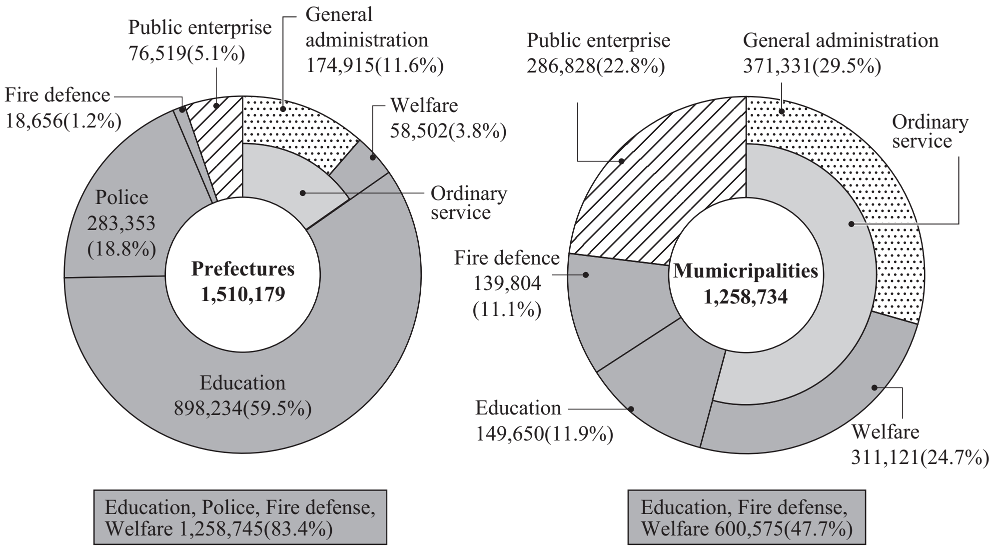
Table 1. Number of Staff (Apr 2012)

(person)

Organization	National Tax Administration Agency	Local Government	
		Prefecture	Municipality
Number	56,194	16,397	67,499

[11] The National Tax Administration Agency, Prefectures, and Municipalities are the independent tax agencies, but they cooperate with each other in sharing the information necessary for tax collection.

FIGURE 7. DISTRIBUTION OF LOCAL CIVIL SERVANTS IN REGULAR POSITIONS[12]
(as of April 1, 2012)



(B) Tax base structure

Table 2 presents the classification of Japanese national taxes and local taxes according to the types of tax bases. Japanese local taxes are quite well-encompassing, and the tax items levied on the three types of tax bases (income, asset, and consumption) are of an extensive range and the right combination.

There are various tax bases for the sub-national government taxes in different countries, such as income, social security contributions, payroll and workforce, property, goods and services, and so on (Figure 8). The local tax bases in Japan are income, asset, and consumption.

Figure 8 shows the structure of the sub-national taxes in countries belonging to the Organisation for Economic Co-operation and Development (OECD). This figure indicates that there are several models of taxation. Countries such as Germany and Finland have a structure in which taxes on income account for a large share of the total tax revenue. Countries such as the U.K. and New Zealand have a structure in which taxes on asset constitute the major portion of the total tax revenue.

Japan has the third taxation model; the tax bases are income, asset, and consumption of goods. "Industrialized countries with high local expenditure either diversify the local tax composition (as in the case of Japan) or rely heavily on local income tax (as in the case of Nordic states)" [Takahashi].[13] Following the recommendation of the Shoup mission,[14] which proposed the enrichment of local taxes in Japan in1949, the Japanese local tax system has

[12] *Source*: Data of MIC

[13] Masayuki Takahashi, *Fiscal Decentralization and Development* (Hampshire, 2012) p. 20

[14] Osamu Koike, *Local Governance and National Development* (Tokyo, 1998) p. 64

TABLE 2. NATIONAL TAXES AND LOCAL TAXES[15]

	National taxes	Local Taxes		National taxes	Local Taxes
Income taxation	Income tax	Individual resident tax	Consumption taxation	Consumption tax	Local consumption tax
	Corporation tax	Individual business tax		Liquor tax	Local tobacco tax
		Corporate resident tax		Tobacco tax	Light oil delivery tax
		Corprate business tax		Special tobacco tax	Automobile acquisition tax
		Interest-based prefectural inhabitant tax		Gasoline tax	Golf course utilization tax
				Local road tax	
		Dividend-based prefectural inbabitant tax		Liquefied petroleum gas tax	Bathing tax
					Automobile tax
		Prefetural inhabitant tax based on capital gain from stock transfer		Motor vehicle tonnage tax	Light vehicle tax
				Aviation fuel tax	Mineral products tax
Taxation on assets, etc.	Inheritance tax/ Gift tax	Real property acquisition tax		Petroleum and coal tax	Hunting tax
	Registration and licence tax	Fixed asset tax		Promotion of power-resources development tax	Mine-lot tax
	Stamp Tax	City planning tax		Customs duty	
		Business Office tax		Tonnage dues	
		Special landholding tax, etc.		Special tonnage dues	

shown signs of progress. One of the outcomes of this progress is the diversification of the tax bases. Such diversification would lead to a comprehensive tax system.

(2) Size of local tax revenue

Figure 9 shows the ratio of the state/local tax revenue to the total tax revenue. Figure 9 shows that Japanese local tax revenue accounts for 43% of the total tax revenue, which is much higher than the corresponding ratio in European countries. These data show that Japanese local tax revenue is a capital resource for the government's public services.

(3) Relationship between revenue and expenditure

Figure 10 shows the relationship between national expenditure and the expenditure of the local governments.

The size of local governmental expenditure is about two and a half times that of national

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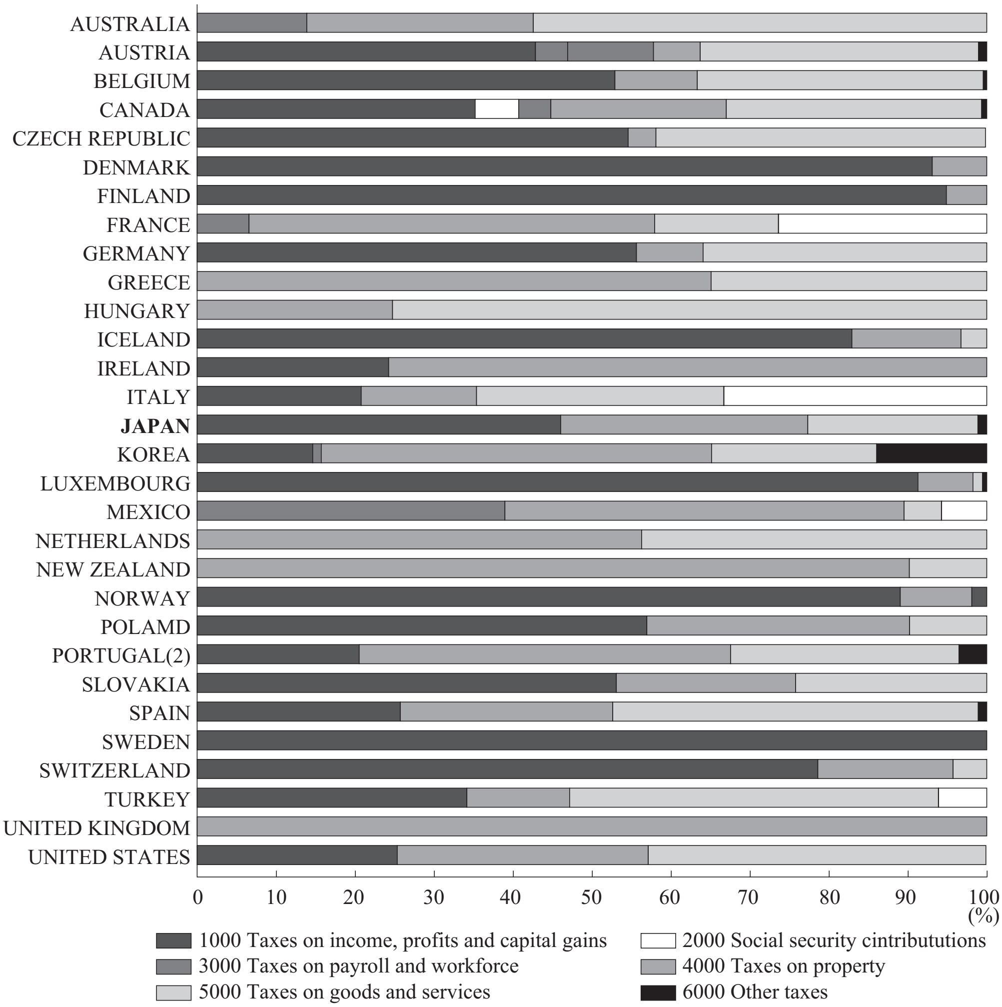
15 *Source*: Web site of the Ministry of Finance (MOF) (http://www.mof.go.jp/jouhou/syuzei/siryou/001.htm)

FIGURE 8. STRUCTURE OF STATE AND LOCAL GOVERNMENT TAX RECEIPTS, 2005[16]



Notes : 1. This refers to only those taxes which are classified as sub-central government taxes. Social security contributions paid to social security funds are excluded.
2. 2004 figures

expenditure.

The expenditure of Japanese local governments forms 15.4% of the country's GDP; this is much higher than the corresponding ratio in European countries. "In a comparison of OECD countries, Japan looks rather like a decentralized country" [Tajika]. This is a remarkable feature of the Japanese local finance system (Figure 11).

In fact, the expenditure of the Japanese local governments is remarkably large compared to

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[16] *Source*: Data of OECD

FIGURE 9. RATIO OF STATE/LOCAL TAX REVENUE TO TOTAL TAX REVENUE (2007)[17]

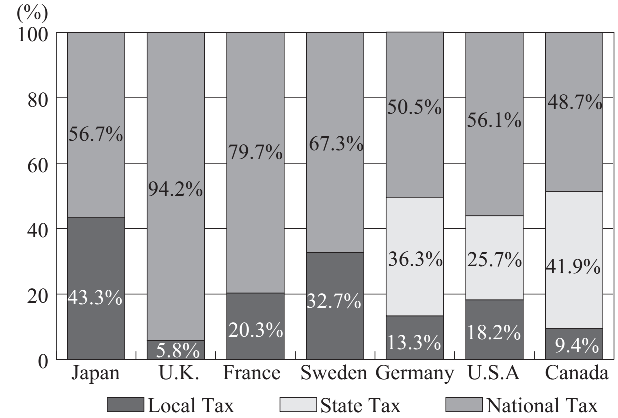
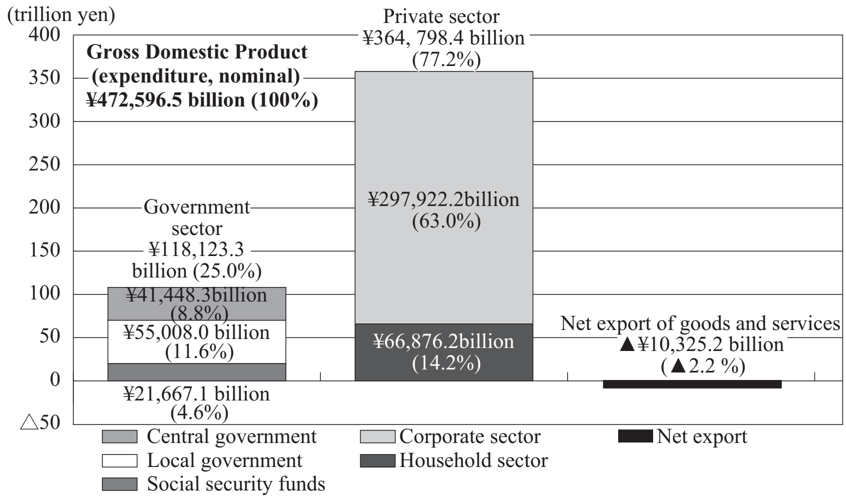


FIGURE 10. SIZE OF GOVERNMENTAL EXPENDITURE (FY2012 Settlement)[18]



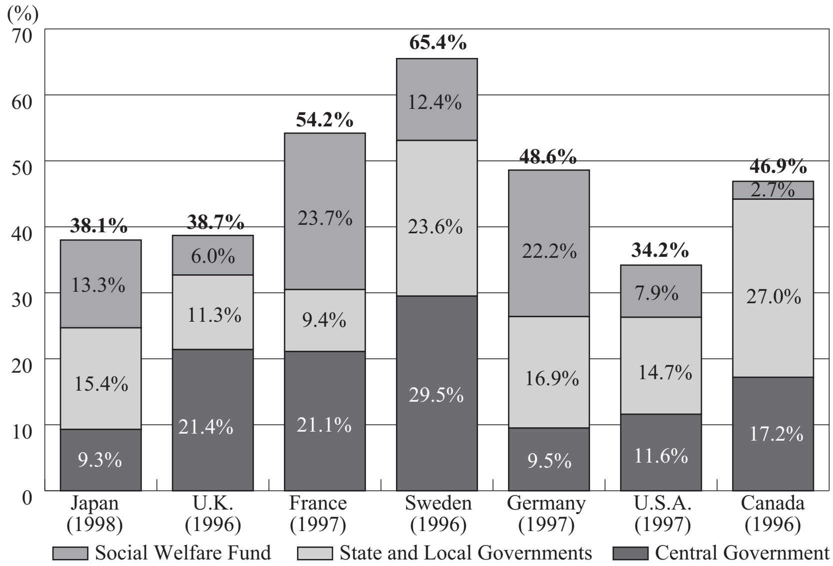
that of the national government. This is because the Japanese local governments are covering a very wide range of public services (as shown in Figure 12). "The majority of expenditures are done at the local level" [Mochida].[19]

The local governments' expenditure accounts for a large part of public services, especially in the field of school education, public welfare, and land development.

It is important to note the ratio of revenue and expenditure. Figure 13 shows this ratio in countries. Balanced ratio of revenue and expenditure would be ideal. However, when the

[17] *Source*: Data of MOF
[18] *Source*: *White Paper on Local Public Finance, 2014*
[19] Nobuki Mochida, *Fiscal Decentralization and Local Public Finance in Japan* (Oxford, 2008) p. 21

FIGURE 11. RATIO OF GOVERNMENT EXPENDITURE TO GDP[20]



expenditure exceeds the revenue, inter-governmental finance transfers (such as national grants and local allocation tax) are required.

Japan has a remarkable gap between revenue and expenditure compared to other countries. "Despite this high rate of spending through local governments, it would be inaccurate to characterize Japan as a decentralized system because a considerable amount of decision-making authority has tended to rest with central units" [Mochida].[21]

Figure 14 shows the Japanese finance structure in fiscal year (FY) 2011. The ratio of local expenditure to the combined total of national and local expenditure was 58.4%. The total tax revenues for the national and local governments was 78.7 trillion yen, of which the total local taxation was 35.1 trillion yen. This shows that local tax revenue accounts for no more than 45% of the total tax revenue.

What makes it possible for local government expenditures to exceed those of the national government despite the fact that local tax revenues take up no more than 45% of the total tax revenue? This can be explained by the transfer of funds from the national government to the local governments in the form of national treasury subsidies, local allocation tax, and local transfer tax. Of these financial transfers, national treasury subsidies are restricted in how they can be used; hence, the decision-making related to these subsidies is in the hands of national government.

In this kind of revenue structure, the relationship between the benefits and the burdens for local residents in terms of the administrative services of local governments is unclear. Moreover, cost consciousness becomes weaker. Therefore, it is very important to secure and

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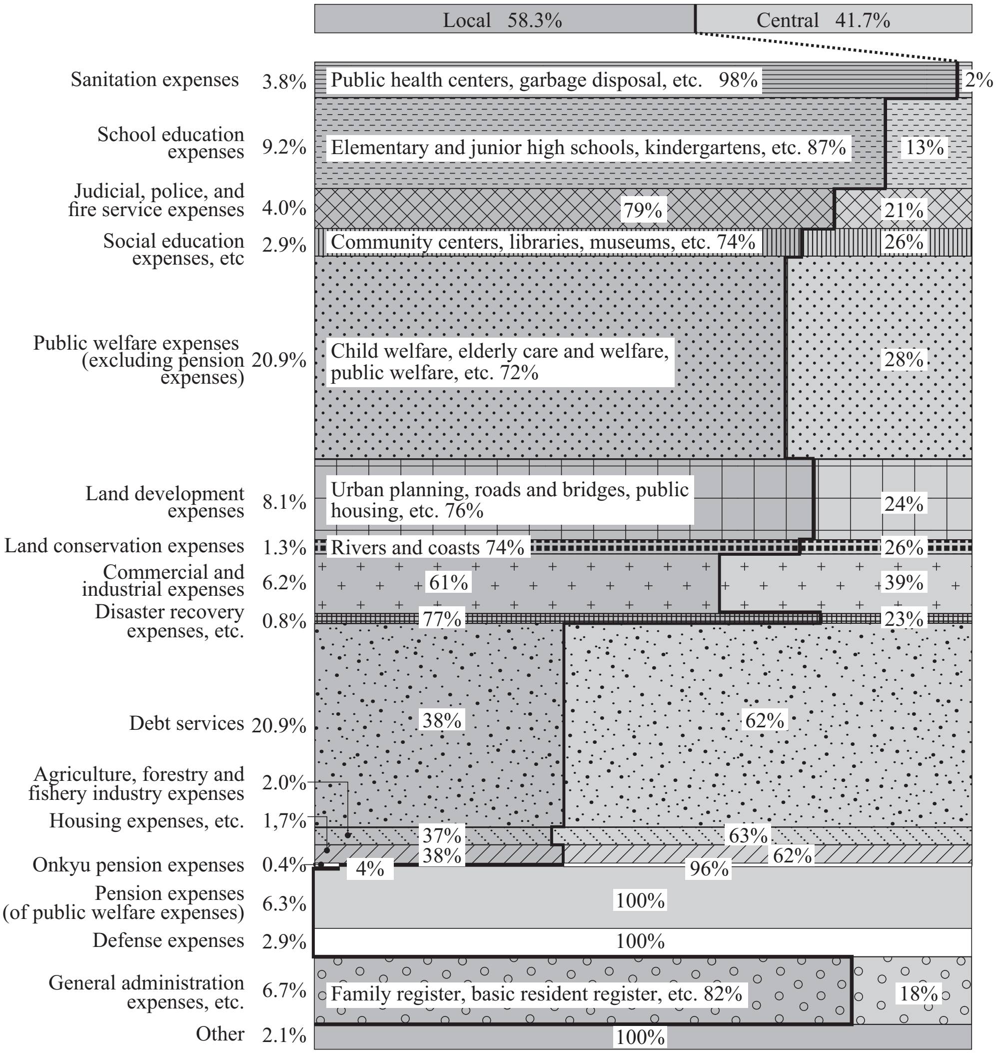
[20] *Source*: Data of MOF

[21] Nobuki Mochida, *Local Government Development in Post-war Japan* (N.Y., 2001) p. 86

FIGURE 12. SHARE OF EXPENDITURES BY FUNCTION OF CENTRAL AND LOCAL GOVERNMENTS (FY2012 Settlement)[22]



strengthen local taxation in order to minimize the gap between local expenditure and local tax revenues as far as possible.

In order to achieve this, the Trinity Reform was implemented from 2004 to 2006; 2 trillion yen was transferred from the national government to the local governments. (See Section 4.1 in the following chapter for further details.)

[22] *Source*: *White Paper on Local Public Finance, 2014*

FIGURE 13. RATIO OF NATIONAL GOVERNMENT AND STATE/LOCAL GOVERNMENT EXPENDITURE AND TAX REVENUE (1998)[23]

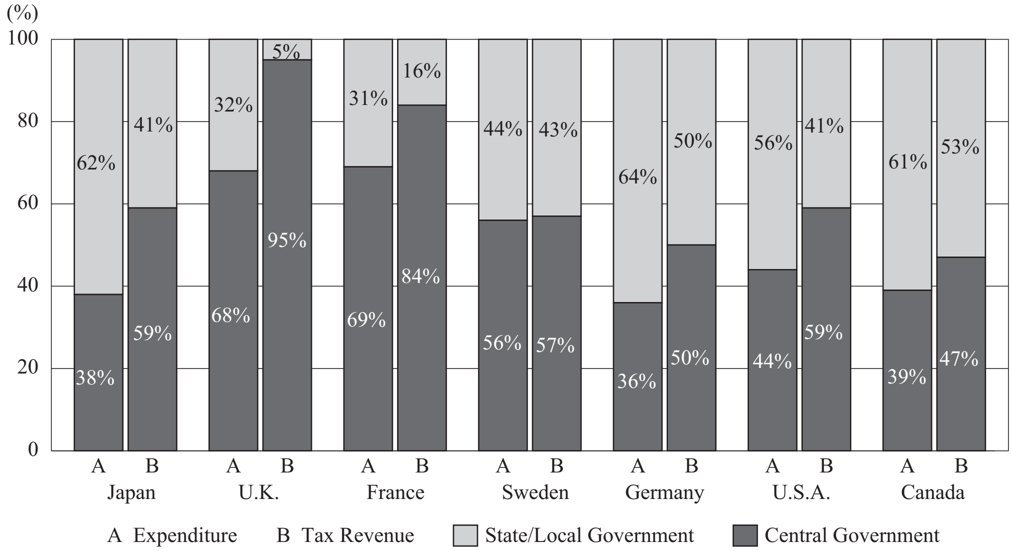
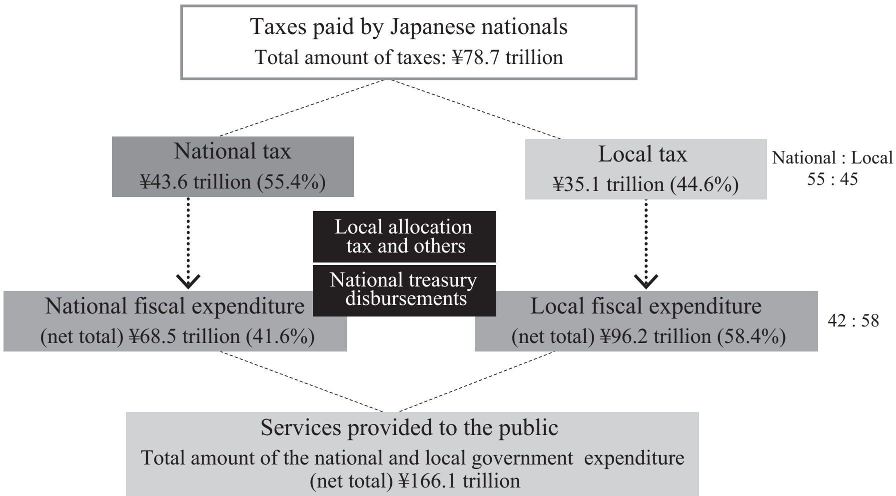


FIGURE 14. STRUCTURE OF FFSCAL GAPS (FY2011 Settlement)[24]



[23] *Source*: Data of MOF
[24] *Source*: Data of MIC

III. *Issues Related to Japanese Local Tax System*

In this chapter, the current hot issues related to the Japanese local tax system are identified. These are architectural issues and are closely related to the characteristics of the Japanese tax system.

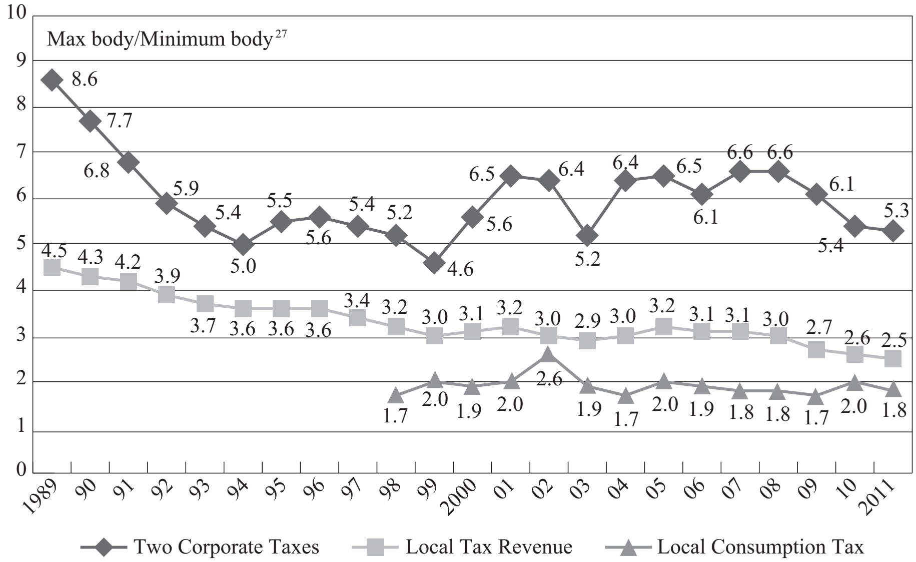
1. Disparity

In Japan, the disparity in taxes on the population and business establishments is remarkable. The local taxes on businesses are highly concentrated in urban areas in particular.[25] Figure 16 shows the disparities among the prefectural tax revenues per capita. Tokyo has a much larger amount of tax revenue compared to that of the other prefectures.

Figure 15 shows the change in the disparity in tax revenue. Over the years, as the economic situation became worse, the disparity reduced slightly; however, significant disparity continues to exist. Among the principal local taxes, the extent of the disparity between two corporate taxes—corporate business tax and corporate residential tax—is greater than the disparity involving the other taxes.

Figure 17 shows the change in disparity between corporate business tax and corporate

FIGURE 15. CHANGE IN DISPARITY IN TAX REVENUE PER CAPITA[26]

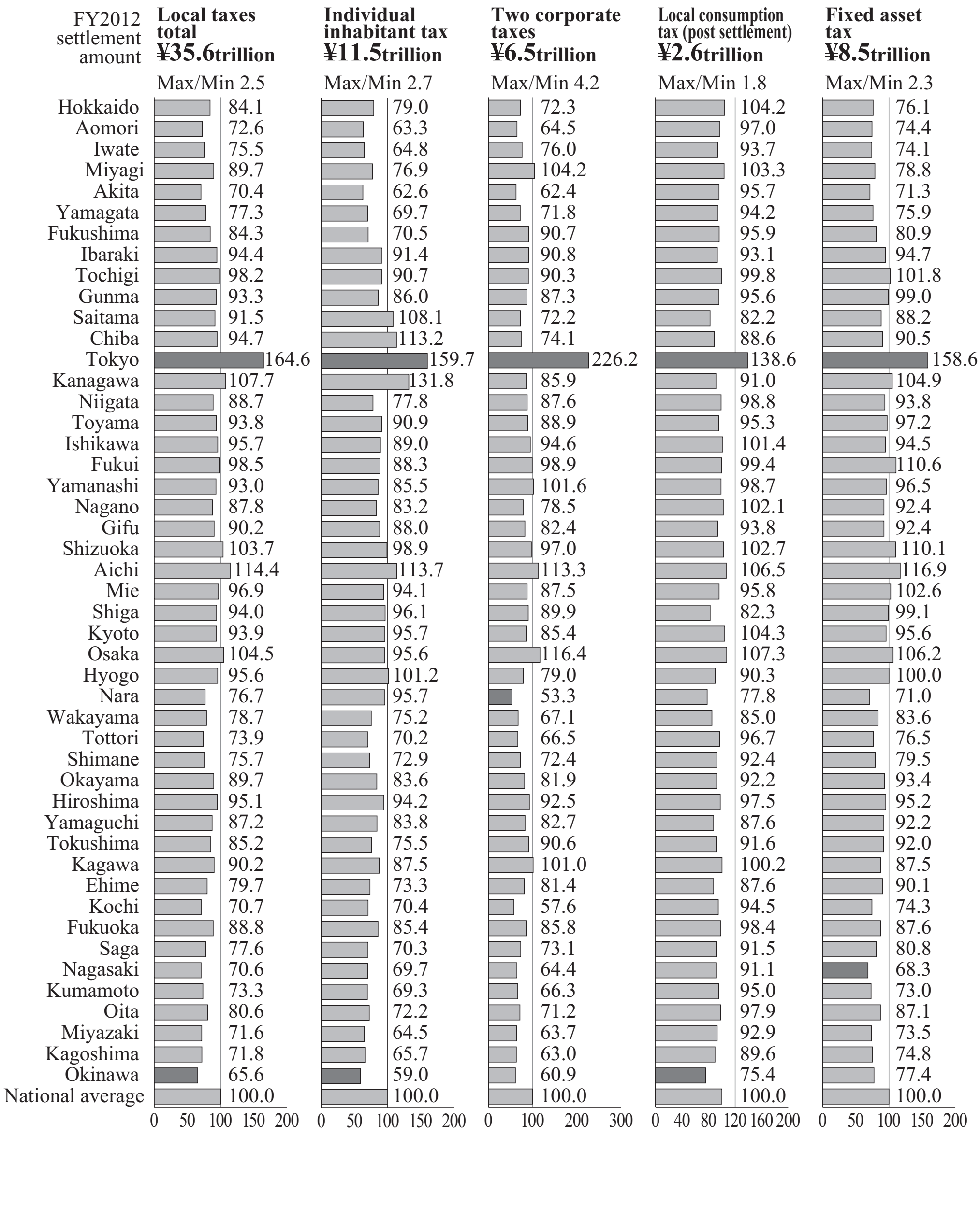


[25] Mochida, *Fiscal Decentralization and Local Public Finance in Japan*, p. 28

[26] Source of Figure 15 and Figure 17: *Report of Investigative Commission for Local Corporate Tax* (Dec. 2012, MIC)

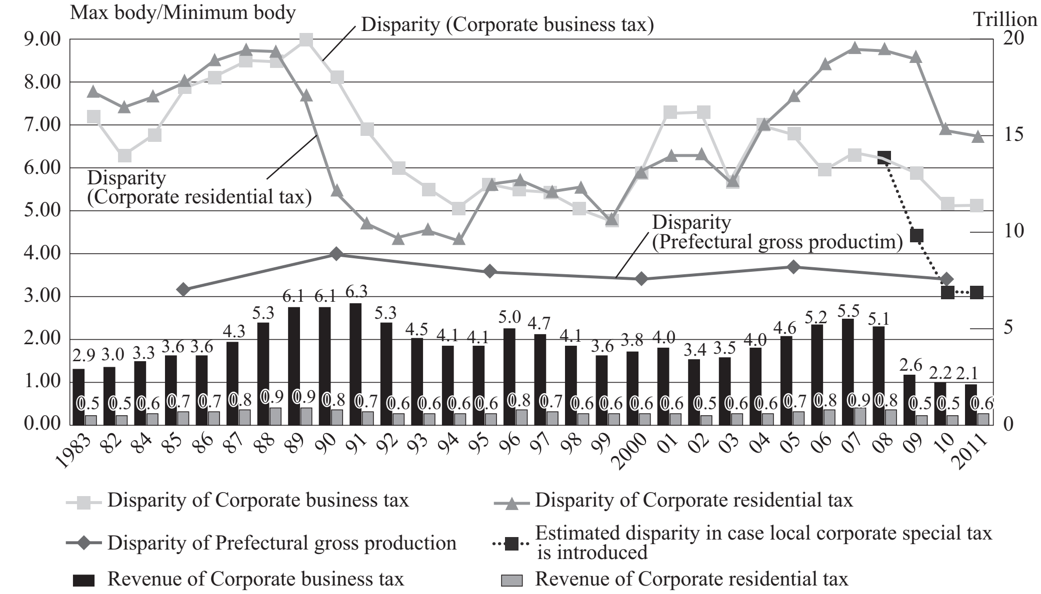
[27] The indices show the maximum of the prefecture's concerned local tax revenue divided by the minimum.

FIGURE 16. INDEX OF PER CAPITA REVENUE IN LOCAL TAX REVENUE (FY2012 Settlement)[28]



[28] *Source*: *White Paper on Local Public Finance, 2014*

FIGURE 17. CHANGE IN DISPARITY OF CORPORATE BUSINESS TAX AND CORPORATE RESIDENTIAL TAX[29]



residential tax. Following the 2008 reform, the extent of disparity of corporate business tax has become much smaller. Compared to this, the disparity of corporate residential tax has been greater than that of corporate business tax.

2. Sensitivity

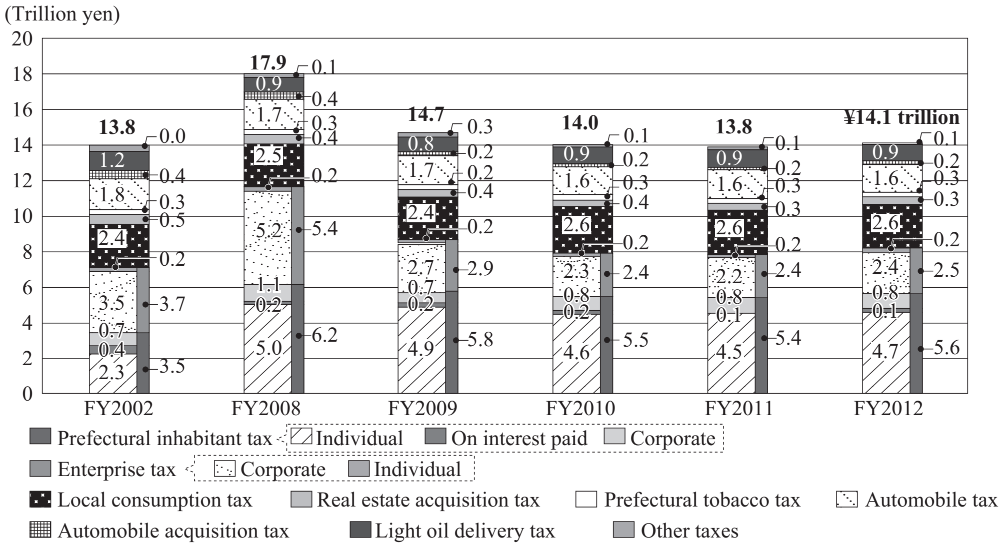
Figure 8 showed the tax structures of the sub-national governments. The tax bases of Japanese local taxes are of three types: tax on income, tax on property, and tax on goods.

We should pay attention to the fact that the tax on income has the largest ratio; the aggregate sum of the residential tax and corporate tax constitutes 57.7% of the total prefectural tax revenue in FY 2012 (Figure 6). Therefore, the amount of total local tax revenue is strongly affected by the local taxes on income. Thus, the local governments are highly concerned about their prospects.

Figure 18 shows the trends in the prefectural tax revenues. The enterprise tax was 2.5 trillion yen (17.7%) in 2012, and it was a key element of the tax revenue. In the good economic circumstances in FY 2008 in particular, it amounted to as much as 5.4 trillion yen (30.2%). However, after 2009 (when the "Lehman shock" occurred), the amount dropped suddenly. As shown in Figure18, this tax is very tensible and sensitive to the economic situation. Therefore, local governments are concerned about the prospects of this tax.

[29] The indices show the maximum of prefecture's corporate business tax divided by the minimum; the corporate residential tax and the prefectural gross production in a similar way.

FIGURE 18. TRENDS IN PREFECTURAL TAX REVENUES[31]



3. Overlap between National Taxes and Local Taxes

Table 2 indicated one issue: overlapping tax bases.[30] One characteristic of Japan's tax system is the frequent overlap of the tax bases of national taxes and local taxes. This overlap has its merits and demerits. The demerits are as follows:

① It might blur the benefit principle of taxation. "A problem with the overlapping tax-base system is that the tax payer has difficulty determining how much he or she is paying to the central government" [Mochida].

For example, when an individual who pays both the national income tax as well as the local resident tax that is levied on income has not paid considerable attention to the distinction between them, it might be difficult for her/him to determine how much public service they can expect. When people consider the benefit principle of taxation, a clear understanding of the tax burden is absolutely necessary.

② It could increase the fluctuation in tax revenues. The taxes on income account for a large portion of national tax as well as local tax. Figure 19 shows that the national government accounts for about 60% and the local government accounts for about 40% of the taxes on individual income and corporate income. However, these taxes on income depend on the economic situation. Figure 20 shows these outcomes. When the economic affairs become severe, national tax revenue and local tax revenue fell simultaneously. The fact that the fluctuation wave of each revenue stream is similar

[30] Mochida, *Local Governance in Industrial Countries* (N.Y., 2006) p. 161
[31] *Source*: *White Paper on Local Public Finance, 2014*

FIGURE 19. REVENUE RATIO OF EACH TYPE OF TAX BASE (1998)[32]

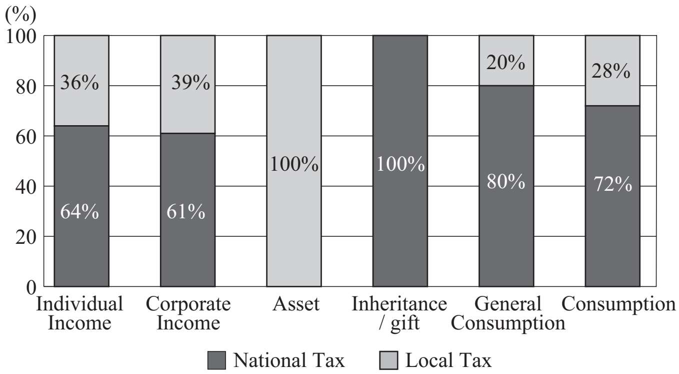
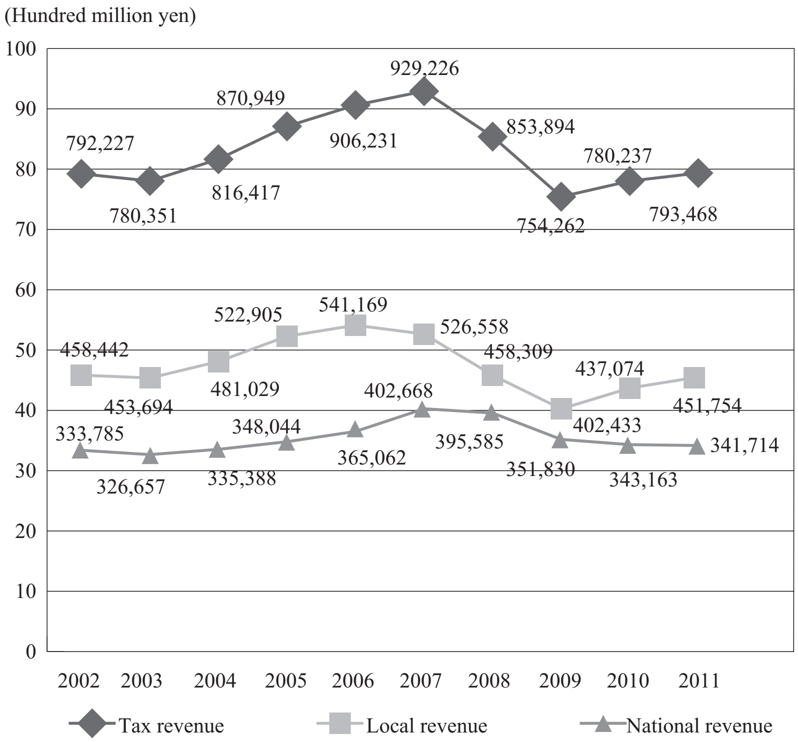


FIGURE 20. OVERVIEW OF TAX REVENUE[33]



32 *Source*: Data of MOF
33 *Source*: Data of MOF

affected the governmental financial situation and financial policies. When the economic situation worsens, the national government and the local governments frequently have handed in economic stimulus packages in Japan. The overlap in tax bases is thought to be one of the reasons for this.

On the other hand, overlapping tax bases have the following advantages:

① The administrative cost falls. For example, the national tax office collects the consumption tax, which includes the local consumption tax.
② The national government can more easily draft the reform of the tax system. For instance, the government transformed a part of the local corporate business tax into the local corporate special tax (which is a national tax)[34] in order to distribute the revenue as a local transfer tax for curbing the disparity in 2008.

Considering these factors, these overlapping structures could be maintained but would remain controversial. What we can expect is that the next principal tax reform, which aims at reducing local revenue disparities or enhancing revenue stability, would be closely connected to transforming this overlapping structure.

4. Need to Enrich Autonomy

(1) Tax transfers: The Trinity Reform experience

Japan has a structure of fiscal gaps, and expanding the local revenue has been a fundamental agenda for local autonomy. Closing the gap between the revenue ratio of the local government and its expenditure ratio has been a crucial agenda in Japan. Based on this concept, the Trinity Reform[35] was implemented in 2007. Through this reform (shown in Figure 21), 3 trillion yen of national tax resource was transferred to local taxes.

Figure 22 graphically represents tax resource transfer. A part of resource of income tax (a national tax) was transferred to the resource of individual resident tax (a local tax). At the same time, the progressive rate of individual resident tax was changed to a flat rate.

Figure 23 shows the changes in local revenue compositions. Compared to the composition in FY 2002, the ratio of local tax increased from 34.4% to 42.9% in FY 2008. These data show the remarkable outcome of this reform from the perspective of financial autonomy. However, the global financial crisis in 2008 hit the tax revenue, and the local tax revenue in 2012 came down to 34.5%.

We can conclude that this transferring has a high value attached. However, the gap between local revenue and local expenditure still exists, and greater enrichment of the local tax revenue would be preferable.

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[34] Referred to as such henceforward. The local corporate special tax has been forced since 2008 and the Cabinet has decided that it goes on in 2015.

[35] The Trinity Reform is a package consisting of three parts. The goals of this package were as follows: (1) transfer tax revenue sources from the national government to local governments; (2) reform the national treasury subsidies; and (3) reform the local allocation tax. See Hiroshi Ikawa, *Decentralization policies in Asian Development* (Singapore, 2009) p. 29.

FIGURE 21. STRUCTURE OF TRINITY REFORM[36]

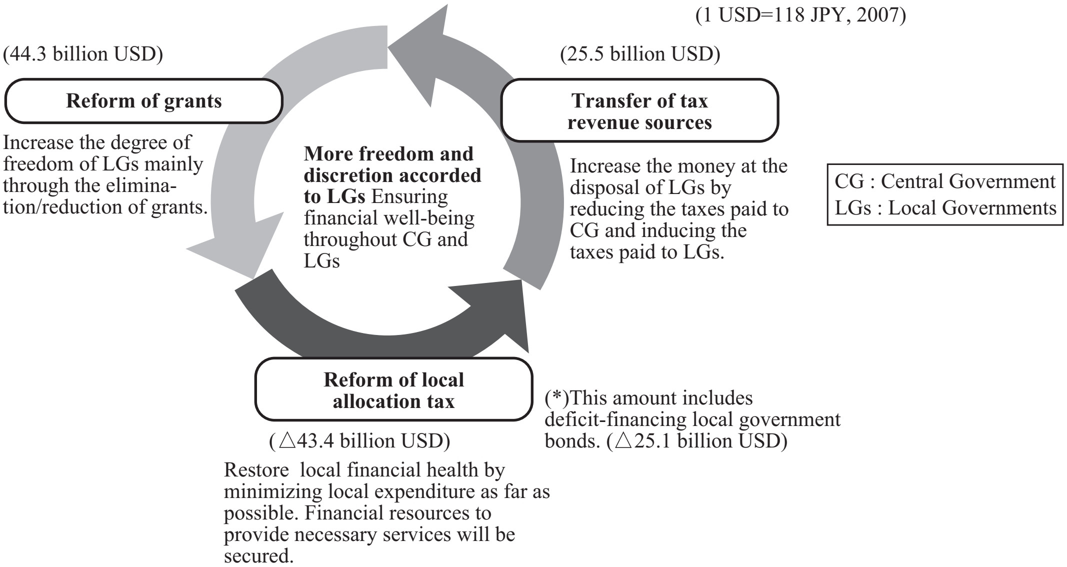
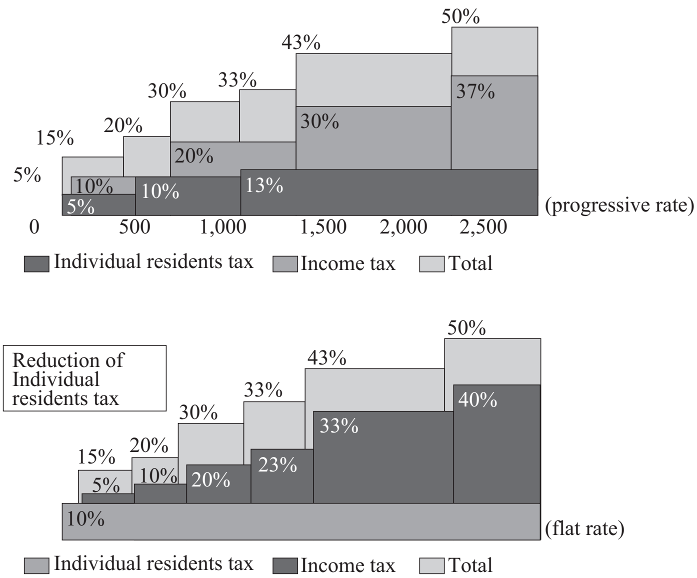


FIGURE 22. TAX RESOURCE TRANSFER[37]



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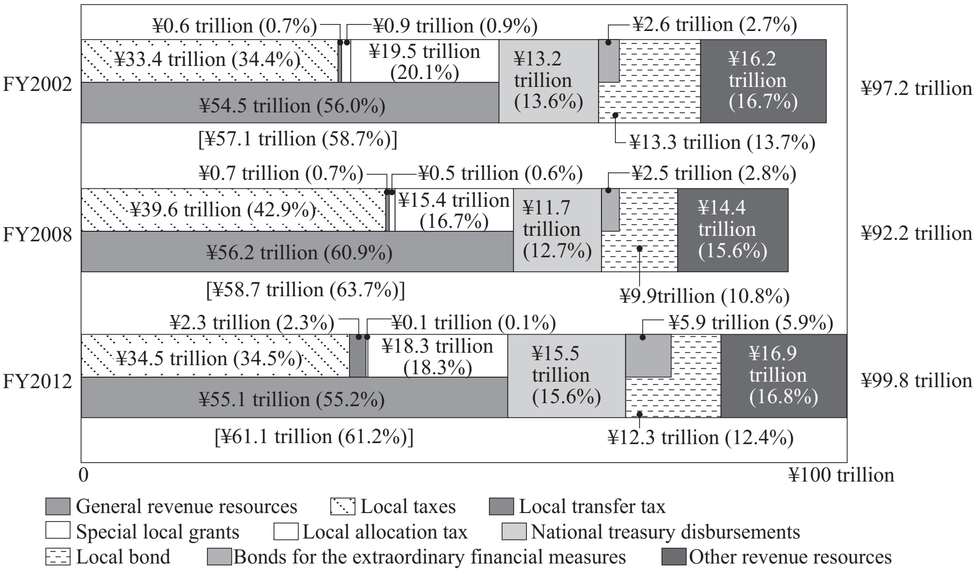
[36] *Source*: Data of MIC
[37] *Source*: Data of MIC

FIGURE 23. CHANGES IN LOCAL REVENUE COMPOSITIONS[38]



Note : [ ]shows general revenue resources + bond for temporary substitution for local allocation tax.

(2) Motivation to expand tax revenue

As a relevant issue, I note the fact that Japanese local governments have a strong incentive to their expand tax revenue. Table 3 shows the tax levied in excess of the norm in the 2011 settlement account. The total amount was 471.9 billion yen, which corresponds to 1.4% of the total local tax revenue. This revenue can be obtained only when the local government passes a bylaw that sets an exceeding rate at its discretion. The size of the excess itself is not so large; however, this excess indicates that the Japanese local governments have the motivation to expand tax revenue. In addition to this, the amount of extra-legal local taxes shown in Figure 5 is 51.6 billion yen in 2010; the number of local bodies that introduced extra-legal taxes amounts to 56. Most local governments are planning regional development policies for attracting enterprises in order to expand the local tax revenue. These facts show that local governments have a strong motivation to expand tax revenue.

[38] *Source*: *White Paper on Local Public Finance, 2014*

TABLE 3. TAX LEVIED IN EXCESS OF THE NORM (FY 2011 settlement)

Kinds of Tax		Number of local bodies levying tax	Tax Revenue (billion yen)
Prefectural inhabitants tax	Individual per capita rate	31	18.5
	Individual income rate	1	2.5
	Corporate per capita rate	31	9.4
	Cooperation-based tax	46	86
Corporate business tax		7	91.1
Automobile tax		1	13million yen
Prefectural tax total			207.4
Municipal inhabitant tax	Corporate per capita levy	2	1.6
	Corporate income rate	2	0.7
	Corporate per capita rate	402	15.4
	Corporate tax levy	1,004	210.9
Fixed assete tax		160	35.8
Light vehicle tax		33	0.7
Mining products tax		33	10million yen
Bathing tax		2	24million yen
Municipal tax total			264.5
Total of tax above the norm			471.9

IV. *Local Tax Reforms*

In recent years, Japan has implemented local tax reforms—reforms for closing the gap among the local bodies. These reforms are meant for corporate business tax and corporate residential tax.

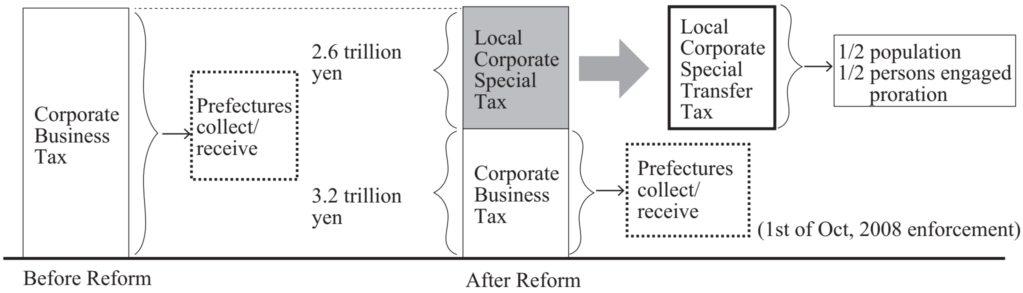
1. Reform of Corporate Taxes

In the face of the issues related to revenue disparity, the national government implemented two significant reforms.

(1) Reform of corporate business tax

As previously discussed, the government transformed a part of the local corporate business tax into the local corporate special tax in order to distribute the revenue as a local transfer tax for curbing the revenue differences in order to deal with revenue disparity in 2008. A part of the corporate business tax (which is a local tax) was transformed into local corporate special tax (which is a national tax). Subsequently, this was distributed to the local governments as local corporate special transfer tax based on the proportion of population and people engaged (as shown in Figure 24). By this method, the revenue can be more evenly distributed than by the income base. In a sense, the transformation from local tax to national tax is against the process of decentralization. However, this was adopted as a tentative measure. This trend indicates that eliminating revenue disparity is a pressing issue for the current local administration.

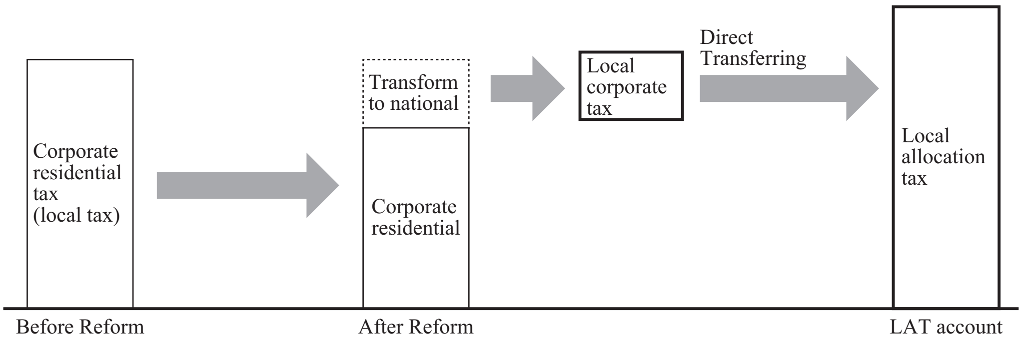
Figure 24. Local Corporate Special Tax



2. Reform of Corporate Residential Tax

After 2008, the extent of disparity of business corporate tax was remarkably reduced through the tax reform. However, the disparity of corporate business tax continued. Therefore, in 2014, the local corporate tax was reformed significantly. A part of the corporate resident tax will be transformed to national tax and will be directly transferred to the local allocation tax account. Through this process, this portion would be distributed as a resource for the local allocation tax in 2014. The local corporate tax was introduced in 2014, and it will be put into effect in full scale in 2015. (as shown in Figure 25)

Figure 25. Corporate Residential Tax



3. Characteristics of Japanese Tax Reform Strategy

Looking at the history of Japanese local tax reform, we can identify the characteristics of this strategy. The government has two approaches—an urgent approach and a long-term approach.

The urgent approach aims for early results. The reform of corporate business tax and corporate residential tax discussed earlier are representative of the urgent approach. Redressing

FIGURE 26. TRENDS OF LOCAL TAX REFORMS

Urgent Approach
○ Urgent correction of disparities
➡ Corporate taxes reforms

Long-term Approach
○ Fundamental correction of disparities
(Ideas) Enrichment of consumption tax
Local corporate special tax abandoned
Corporate resident tax transferred to LAT account
○ Stabilizing tax revenue
○ Enriching tax revenue

the differences in tax revenue has been a pressing issue in the Japanese tax and finance system. Why is this a pressing issue? There are three reasons. Firstly, this issue is closely related to the local government's finance currently. Secondly, disparities among the local bodies would have an adverse impact on the economic situation of the whole country. Thirdly, Japan has hiked the consumption tax rate, which could widen the disparities among the local bodies' finances. Facing this urgent issue, the government gave it higher priority. The consumption Reform Act in 2012 stated that "[l]ocal corporate special tax and local corporate special transfer tax are tentative measures and they are reexamined fundamentally. "

From a long-term perspective, stabilizing tax revenue and enriching tax revenue are important issues. Reexamining the current items of local taxes and the tax bases is required. Further financial decentralization would be required. The government would need to examine the current local tax system in the future.

In Japan, such a combination of an urgent approach and a long-term approach could be expected to continue. Tax reform is reviewed mainly by the associated ministries and parties; however, it would be preferable for the citizens to distinguish between the urgent tax issues and the long-term tax issues when we consider these reforms. (as shown in Figure 26)

V. *Local Financial Autonomy and Goals*

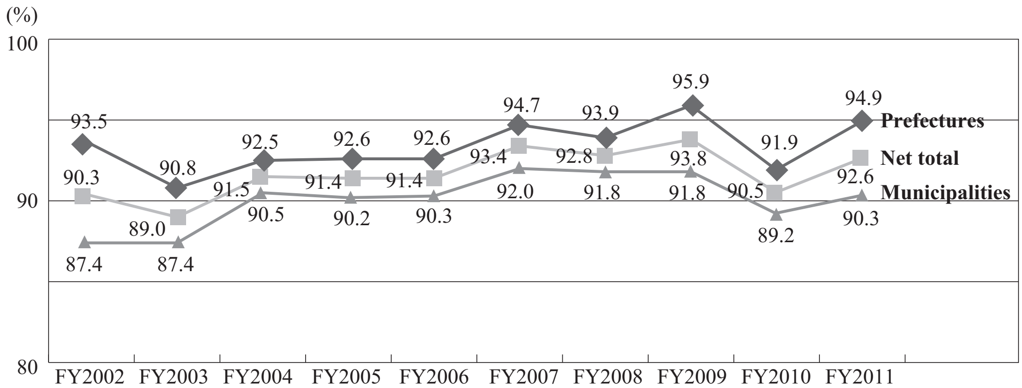
1. Financial Autonomy

Faced with the severe local financial situation, the government enacted the Local Finance Soundness Law in 2007. The objective of this law was set out as follows: " To establish a system of making public announcements concerning the ratios of local government finances, and to enable local governments to decide on a system for the speedy achievement of financial soundness and financial rebuilding as well as formulating plans aimed at promoting the sound management of publicly managed enterprises" (Art. 1).

By using four financial indicators, each local government would have financial self-control in order to avoid a dangerous situation. Seen in this light, such a system expects each local government to have financial autonomy. This law was fully enforced in 2009, and it had a marked effect on the local governments.

Figure 27 shows that the ordinary balance ratio[39] turned down.[40] Figure 28 also shows that the trend of personnel expenses, which was decreasing earlier, was driven up.

FIGURE 27. CHANGE IN THE ORDINARY BALANCE RATIO[41]



Based on these data, the local governments made efforts to attain self-control, and the spirit of financial autonomy seemed to function significantly.

As is shown in Figure 1, local tax is the principal source of local revenue and the primary method for financial autonomy. However, the local tax system faces various issues in the current society. I identify three goals for the Japanese local tax system as shown in Figure 29.

The first is to reduce disparity. In a way, this is the hottest issue at present. The national government enacted several very important reforms such as the foundation of the local corporate special tax in recent years. It seems that this agenda will remain a hot issue in the years ahead.

The second goal is to enrich autonomy. In this context, Japan implemented the Trinity Reform. The local governments will receive additional tax revenues in the form of an increase

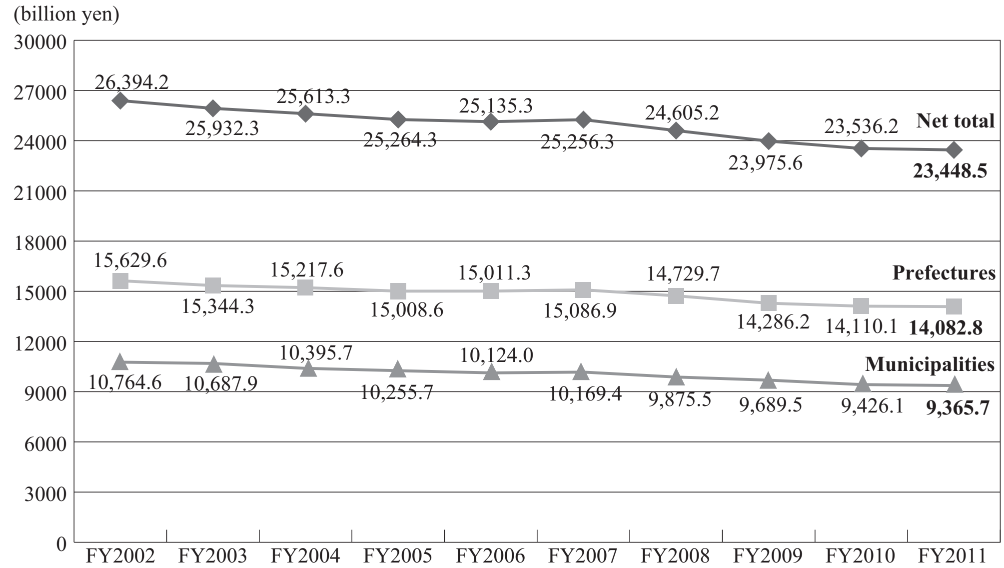
[39] The term "ordinary balance ratio" denotes an index for identifying the elasticity of the financial structure of local public bodies. It is calculated as a percentage of the amount of general revenue sources that are used for expenditures that are ordinarily disbursed every fiscal year (such as personnel expenses, social assistance expenditure, and debt service) in relation to the total amount of general revenue sources, represented by local taxes and ordinary local allocation tax (ordinary general revenue sources), a special share of revenue decrease compensation loan, and an extraordinary financial measures loan.

This index is used to see to what extent ordinary general revenue sources are appropriated for ordinary expenditures; it also shows that a higher ratio means less flexibility in the financial structure.

[40] In 2011, the amount of social assistance expenditure was increased because of the East Japan earthquake.

[41] *Source*: *White Paper on Local Finance, 2014*

FIGURE 28. CHANGE IN LOCAL PERSONNEL EXPENSES[42]



in consumption tax in 2014.[43] However, the agenda of reducing the gap between revenue and expenditure still exists.

The third goal is to stabilize the tax revenue. This is a significant agenda. The local governments have made much of the asset tax and the consumption tax. The increase in the local consumption tax in 2014 could contribute to stability. However, the taxes on corporate income (which amount to 3 trillion yen) are still principal local taxes, and they are very elastic to the economic situation. Dealing with those elastic local taxes and ensuring greater stability for the local tax system seem to be more crucial issues.

In this paper, I presented an overview of the characteristics of and the issues related to the Japanese local tax system. As the concept of social values is becoming increasingly complicated, the reform of local tax systems will be a complex process.

However, when we consider future financial autonomy, the following point is significant: "The power to determine the tax rate and base allows local variations in fiscal burdens to be sensitive to local preferences" [Mochida]. I suggest that we should pay attention to this finding. The local governments should be required to be increasingly sensitive to the needs of the community in the framework of financial autonomy. The relationship between sensitivity and financial autonomy must be an indispensable one in contemporary society.

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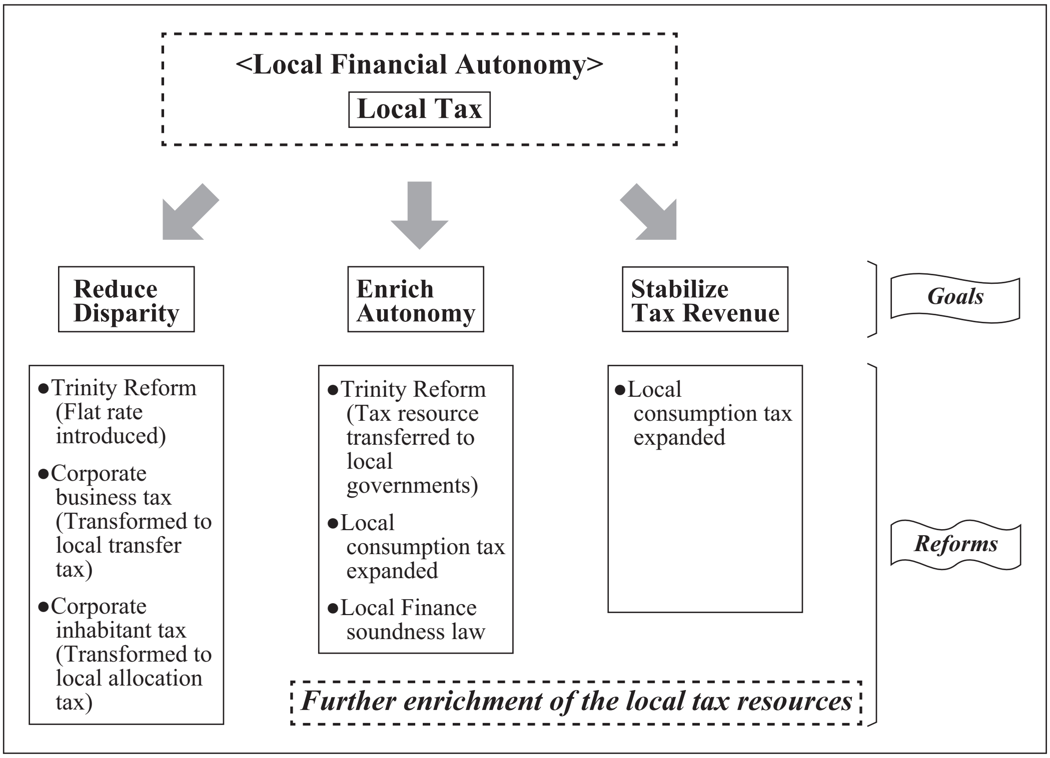
[42] *Source*: *White Paper on Local Finance, 2014*

[43] The local consumption tax rate was raised from 1% to 1.4% on 1 April, 2014.

Figure 29. Local Financial Autonomy and Goals



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