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on

**Japan's Experience in Fiscal Reforms – Analysis of Budgetary Impact of
Local Allocation Tax on the Local Governments in Japan and Comparison
with Statutory Tax-sharing in India.**

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PURPOSE

This research proposal aimed at investigating into the budgetary impact of the Local Allocation Tax (non-specified inter-governmental transfer) system in Japan on local governments with special reference to the Koizumi administration's "Trinity Reform Package" introduced in 2003. It may be observed that here "trinity" implies the decentralization reform process involving three factors, *viz.*, local tax, local allocation tax grant and national government disbursement. It was further proposed to make a comparative analysis of the impact of this reform package and the continuous reform process in India with regard to statutory devolution of central taxes on the sub-national governments.

This proposal was further so designed as to restrict the comparative analysis of the budgetary impact of Local Allocation Tax in Japan and the divisible pool of Central Taxes in India assuming that:

- (a) the share of States in Union Taxes is tantamount to the divisible pool of Union Taxes to all sub-national governments in India, and
- (b) the States further devolve funds to the local self-governments in their respective jurisdiction in India, in the form of equivalent grants which these local governments would have otherwise been receiving from the Union.

INTRODUCTION

Local government in Japan owes its basis to the Constitution of Japan adopted in 1946, which recognizes local government as essential to democracy and establishes it as part of the nation's system of governance. The Chapter Eight entitled "Local-Self Government" of the Constitution contains four Articles (92-95) describing the role of sub-national governments in the country.

Chapter Eight provides for a local government system and clearly establishes that local autonomy is one of the core principles of government. The system of local self-government, in accordance with the provisions of the Constitution is established through the following five fundamental laws: (a) Local Autonomy Law, (b) Local Public Service Law, (c) Local Finance Law, (d) Local Tax Law, and (e) Public Officials Election Law. The provisions of these statutes clearly vest the local authorities with a broad range of authority over a broad range of administrative functions and bestow upon the sub-national governments the corresponding degree of legislative powers. Accordingly, these laws were enacted concerning local government, but the core legislation for dealing with its

organization and management is the Local Autonomy Law which was promulgated in 1947. The provisions of the Local Autonomy Law deal mainly with residents' affairs, elected councils, and their executive bodies—all that which forms the core of local government. The Law also defines the status of local authorities, including their relationship with central government as well as with other local authorities, and has legal provisions for their financial affairs and other important administrative matters. As such, local government is clearly defined in Japan's Constitution and other national laws. When looked at fiscally, Japanese local public finances account for roughly 70 percent of general public expenditure and 80 percent of public capital formation. This suggests that, in implementation terms at least, local governments play an important role in the provision of public services. The efficiency and equity characteristics of the Japanese local government system are, therefore, likely to have an important effect on regional and national development.

The receipts of the sub-national governments are briefly discussed below:

Local taxes (*chihozei*), which constitute an autonomous sort of revenue for local governments, are collected by local administrations within the limits of their authority to levy taxes. There are both prefectural taxes and taxes levied by cities, towns, and villages. Both types of taxes are subcategorized into purpose-specific taxes which are tied to certain designated ends, and ordinary taxes, whose use is not specifically designated. A system of local consumption taxes was instituted in 1997 as a means of increasing local government financial resources in order to promote local autonomy. Local taxes funded only about 35.5% of total local government expenditures in 2001. Consequently, the financial gap

had to be covered by local government bonds (*chihosai*; 11.8%) and budgetary transfers from the central government, which included local allocation taxes (*chiho kofuzei*; 20.3%) and national treasury disbursements (*kokko shishutsukin*; 14.5%). Local allocation taxes are used by the central government as a means of adjusting local financial administration with a view to ensuring a certain level of administrative equality throughout the country. The monies are allocated as general revenues that local governments can utilize as for the purpose appearing appropriate to them. These funds account for a large portion of several types of taxes levied at the national level, namely, 25% of tobacco taxes, 29.5% of general consumption taxes, and 32% of the combined revenue derived from liquor taxes and corporation and income taxes. On the other hand, national treasury disbursements are made to local public entities by the government to defray the cost of specific programs. Local government reliance on the central government for financial resources has been criticized as severely restricting local autonomy. Responding to such concerns, the government is now considering reducing the local allocation tax and various other subsidies while at the same time transferring additional taxation authority to local governments so they can raise more funds locally.

Local Transfer Taxes is the generic name applied to the transfer of local roads, petroleum and gas, special tonnage, automobile weight, and aircraft fuel taxes. These constitute transfers of a fixed proportion of the relevant national taxes to local public entities. With the exception of the special tonnage transfer tax, the uses of such revenues are comprehensive but predetermined, such as for roads and airports and their surrounding areas. In fiscal 2004, a new income transfer tax was introduced as a provisional measure until the full-fledged transfer of tax

sources from income tax to individual resident tax. These transfers are conditional and, therefore, tied to specific purpose.

There are national treasury disbursements which include allotments disbursed by the national government to local public entities on the basis of the cost allotment classifications of the national government and local public entities; mandatory cost sharing; and subsidies for the promotion of specific policies and support for public finances, etc. Like the local transfer taxes, these disbursements are also tied to specific purpose.

Besides another source of revenue to the sub-national governments popularly called special local grants with the character of a substitute for local taxes, was introduced in the fiscal year 1999 to supplement a part of the decrease of local tax caused by a tax cut.

Even with central government transfers, over the past decade local governments have been faced with the growing problem of shortfalls in revenue receipts as a result of a local tax revenue decline aggravated by tax cuts made to stimulate the economy. This has prompted the sub-national governments to resort to borrowings by issuing local government bonds. The extent of such shortfalls can be judged by the fact that this gap was over 17 trillion Yen in 2003. Local government bonds issued to cover the deficits have greatly increased local government debt. Total local debt at the end of 2003 was projected to be 199 trillion Yen which is 40.0% of Japan's GDP. The issuance of local government bonds is, however, subject to various limitations imposed by the central government, including the need for formal permission granted by the Minister of Public Management, Home Affairs, Posts and Telecommunications.

The only component of the revenue receipts of sub-national governments whose importance has continued to rise over the years despite fiscal restraints is local allocation tax. Local Allocation Taxes form the core of the local financial adjustment system. The system is designed to sustain revenue sources necessary to correct fiscal imbalance among the local public entities, and thereby ensure that all such local entities are able to carry out a certain standard of administration. This general revenue source consists of grants to local public entities on the basis of a fixed calculation formula, which allocates a percentage of revenues collected nationally. The percentage of revenue allocated to the local entities is 35.8% of corporation tax, 32% of income tax, 32% of liquor tax, 29.5% of consumption tax and 25% of tobacco tax.

Local Allocation Tax

The kitty of local allocation taxes, therefore, consists of the specified proportion of the above taxes which may be summed up as under:

Sl. No.	Tax	Divisible pool (As % of total tax revenue)
1	Corporation Tax	35.80
2	Income Tax	32.00
3	Liquor Tax	32.00
4	Consumption Tax	29.50
5	Tobacco Tax	25.00

Method of calculation of ordinary local allocation tax for each sub-national government: The kitty of local allocation tax has the two components, namely, regular (or ordinary) local allocation tax and

special allocation tax. The regular allocation tax for each of the sub-national governments is worked out by calculating the gap between standard financial revenues and standard financial requirements. The formulae for working out the two are briefly enumerated as under:

A. Standard Financial Revenues =

Normal Local Tax Revenue \times Computing rate (80% for prefectures, 75% for municipalities) + Local Transfer Tax, etc.

B. Standard Financial Requirements =

Unit Cost \times Measured unit number /amount (national census, etc.) \times Adjustment Coefficient (scale modification, etc.)

C. Regular Allocation Tax Amount = B - A.

Standard financial requirements are calculated as the financial requirements of each local government based on rational and appropriate standards. It is a duty to include the local share of the national treasury projects, such as compulsory education, public assistance and public works, in calculating the standard financial requirements. From fiscal 2001 to fiscal 2003, part of the standard financial requirements is being transferred to special deficit-financing bonds (extraordinary financial countermeasures bonds) under Article 5 of the Local Finance Law.

Neither normal local tax revenue neither includes non-statutory ordinary taxes and non-statutory special purpose taxes taxed independently by the local government nor excess tax that exceeds the standard tax rate stipulated in the Local Tax Law. From fiscal 2003 the calculation rate for both the prefectural portion and the municipal portion is 75%.

Trinity Reform Package

Japan has become a mature society and the limitations in the ability of uniform policies at the central government level to grasp the detailed needs of each region are becoming more and more evident day by day. Against this backdrop, the reforms that have received the most attention in recent years are reforms of local public finances geared toward decentralization. Decentralization aims to create more efficient fiscal management and local governance by: (a) delegating authority and responsibility for raising revenue to local governments; (b) reducing the involvement of and regulation by the central government; and (c) introducing the principle of competition to local governments. The idea behind these reforms is that it is better to give authority and responsibility over matters that can be handled locally to local governments and allow the central government to deal only with policies that affect the country as a whole. Decentralization moved from the discussion stage to the implementation stage through the so-called Trinity Reforms that were to be carried out from 2004 to 2006. These reforms were hammered out by the cabinet of the then Prime Minister Junichiro Koizumi with a view to reforming local public finances, and are based on the idea of reforming three pillars of local government finance in one package: national treasury disbursements under the jurisdiction of individual government ministries and agencies, which subsidize a portion of the public services offered by local governments; local allocation taxes, which are disbursed to local governments under the jurisdiction of the Ministry of Internal Affairs and Communications; and the transfer of tax sources, which would allow local governments to collect taxes themselves.

Introduction to India's Devolution System

The Drafting Committee for the Constitution of India, 1950 described it as federal in structure but preferred to call it a 'Union of States' to indicate the two essential and distinct features of Indian federalism: (a) Indian federalism is not the result of an agreement by the units; and (b) The component units have no freedom to secede from it. The Government of India Act 1935 had brought into force with the following main features necessitating the scheme of devolution of funds to States: (a) federal scheme which prescribed federation for the first time, (b) provincial autonomy, and (c) the distribution of legislative powers. The system of divisible pool of Central Taxes has evolved through a gradual process of progressive devolution of finances from the Central government to the Provincial governments during the period 1858-1950. Government of India Act 1935 envisaged 'grants-in-aid' for needy Provinces and statutory devolution of net proceeds under estate duty, stamp duty, terminal taxes on railway freights and fares to the Provinces. The existing scheme of divisible pool of Central Taxes in India has essentially evolved from the gradual process of decentralization of functions even, of late, to the grass root level in India. It may be reiterated that since the extant proposal assumes that the (a) share of States in Union Taxes is tantamount to the divisible pool of Union Taxes to all sub-national governments in India, and (b) States further devolve funds to the local self-governments in their respective jurisdiction in India, in the form of equivalent grants which these local governments would have otherwise been receiving from the Union. The trends in divisible pool of Central taxes have been considered the counterpart of the kitty available for devolution under the Local Allocation Taxes in Japan. The Union of India, however, makes revenue transfers to the States in the form of (a) revenue deficit grants, (b) Plan grants, (c) grants for maintenance, and (d) other

grants. Besides, there are the Government of India loans to the States which are booked under the capital disbursements of the Union. As regards the criteria adopted for the ascertaining the share of each of twenty eight States, the Union Government acts on the advice of the Finance Commission which is constituted every five years by a Presidential Order. The Finance Commission, *inter alia*, under the Article 280 (3) (a) makes recommendations to the President of India in respect of the 'distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States of the respective shares of such proceeds'. The President of India has so far constituted thirteen Finance Commissions since the promulgation of the Constitution on 26th January 1950. The Thirteenth Finance Commission has been constituted in November 2007 and is expected to submit its report by October 2009. Depending on various considerations from time to time, the Finance Commissions have adopted varying criteria for recommending the share of each of the States in the divisible pool of Union Taxes. The report of the Twelfth Finance Commission submitted in the year 2004, being the latest, had adopted the following criterion for the sharing of Union tax revenue for the period of five years starting from 2005-06:

Sl. No.	Indicator	Weight (%)
1	Population	25.0
2	Income Distance	50.0
3	Area	10.0
4	Tax Effort	7.5
5	Fiscal Discipline	7.5

While the Non-Finance Commission transfers to the States have ranged between 40.33 and 34.94 per cent of the total expenditure of the State Governments during the Finance Commission periods starting from 1980-85 till 1995-00, the share of divisible pool of Central taxes in the total expenditure of the State Governments during those periods is given below:

Sl. No.	Year (Finance Commission Period Averages)	Central Taxes through Finance Commission (as % of total expenditure)
1	1980-85	22.39
2	1985-90	20.25
3	1990-95	21.37
4	1995-00	21.40

It may be seen that this share was 20.93% in the first two years of the Eleventh Finance Commission period. The actual share in the divisible pool of taxes of the State Governments in their total expenditure for the entire Eleventh Finance Commission period (2000-05) is being worked out from the Finance Accounts of the Union and that of the State Governments.

The year-wise Share of Central Taxes (SCT) and that of Local Allocation Taxes (LAT) in India and Japan respectively from the year 1993-94 to 2004-05 as percent of the total expenditure of the States as in case

of India and the total expenditure of all sub-national governments in case of Japan is given below:

Year	<i>(Rs. Crore)</i>			<i>(Billion Yens)</i>		
	India			Japan		
	Total State Government Expenditure	SCT	SCT as % of Total Local Government Expenditure	Total Local Government Expenditure	LAT	LAT as % of Total Local Government Expenditure
1993-94	134649	22622	16.80	93076	13950	14.99
1994-95	161554	25030	15.49	93818	12069	12.86
1995-96	177584	29403	16.56	98945	12302	12.43
1996-97	202769	35529	17.52	99026	13945	14.08
1997-98	206714	40724	19.70	97674	15481	15.85
1998-99	243355	39844	16.37	100198	14305	14.28
1999-00	289621	44278	15.29	101629	13084	12.87
2000-01	302150	51061	16.90	97616	15829	16.22
2001-02	335586	52474	15.64	97414	16766	17.21
2002-03	355030	55844	15.73	94839	16479	17.38
2003-04	422125	65766	15.58	92582	17399	18.79
2004-05	455415	78595	17.26	84667	17662	20.86

Preliminary analysis of the figures worked out above suggest that while the share of divisible pool of Central taxes in India indicates the constant trends over the period, the share of LAT as per cent of the total expenditure of sub national governments in Japan reveal increasing trends since 2000-01. The fiscal year 2004-05 was the first of the three of the implementation period of Trinity Reforms in Japan. However, the share of LAT in the total expenditure of sub-national governments rising to 20.86 per cent reveals the importance of the kitty under local allocation taxes. It may be observed that the details of tax revenues of the local governments are being collected from the sources available to examine the whether more autonomy to the local governments in Japan in the

sphere of taxation has actually reduced the relative importance of local allocation taxes. As regards India, the importance of the divisible pool of Central taxes cannot diminish since the Constitution of India itself provides for fiscal federalism. However Japan has been a rigidly centralized country until recently despite the Constitution had recognized the importance of local governments at the time of its inception itself.

Although requisite information and statistics on the divisible pool of India's federal taxes, in order to compare the trends with its counterpart in Japan, i.e., Local Allocation Tax (LAT) have been compiled, upon comparing the contents of the two different criteria for the allocation of divisible pool of Central Taxes in India and that for the allotment of LAT in Japan, it has been noticed that the two criteria themselves are not comparable. A view has, therefore, emerged that the devolution of taxes in the two countries is somehow not comparable, given the 'expenditure-gap' filling nature of LAT. In India, 'revenue deficit grant' seems more akin to LAT of Japan, barring the exclusion of capital expenditure which is not known to the criteria for allocation of LAT in Japan. This leads to an idea that that revenue deficit grants in India and local allocation tax in Japan need be compared in order to reach some logical conclusions. However, this would necessitate a comprehensive study of the history of the two dating back to their respective early periods of inception.

It is, therefore, felt that the scope of this study need be enlarged by incorporating the findings based on the historical perspective of the two. It is, therefore, proposed that a study of the two would be attempted in due course to look into gap-filling arrangements in the two countries.

