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Ending Dependence on Corporations for Local Tax Revenues

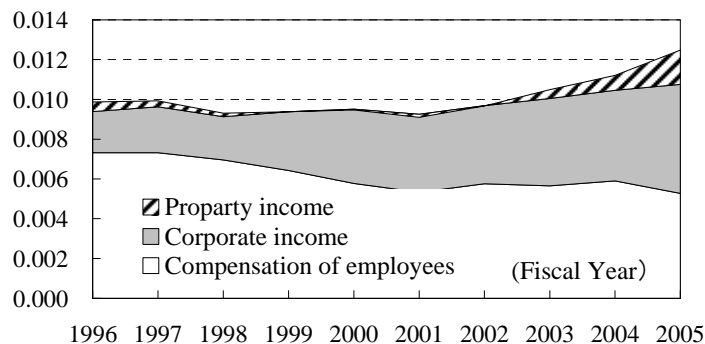
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One of the aims of Japan's 2008 tax reform is to reduce the disparities in local tax revenues between urban and rural regions by reviewing the structure of Enterprise tax on corporation—revenues from which diverge widely according to region—and instead securing a greater share of revenues from the consumption tax. As an initial step, in fiscal 2008 (April 2008 to March 2009) a portion of collected local corporate taxes will first be pooled by the central government for redistribution to poorer local authorities.

Corporate Taxes Exacerbate Revenue Gaps

Widening disparities in local tax revenues are caused by differences in economic strength. To measure these gaps, I used the Theil index, which enables an analysis of the constituent factors, instead of the more popular Gini coefficient or the coefficient of variation. A rising Theil index curve indicates greater disparity.

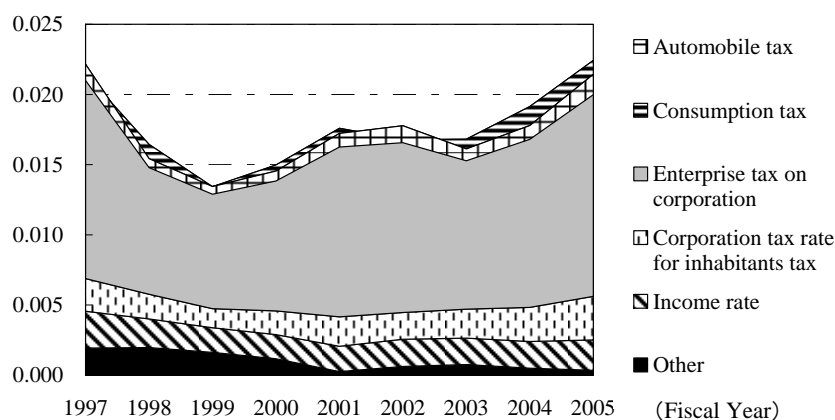
**Figure 1. Prefectural Disparities in Per Capita Income
(Decomposition of Theil's Index)**



Source: Cabinet Office, Kenmin Keizai Keisan Nenpo
(Annual Report on Prefectural Accounts)

To measure regional economic strength, per capita income at the prefectural level was used (Figure 1). The data shows that the widening disparities since the late 1990s have been caused mainly by corporate income. There were also notable differences among the prefectures in property income, including interest and dividends, but this did not have much bearing on overall inequality. And while worker earnings are a significant aspect of revenue disparities, their impact has actually declined over the past 10 years.

**Figure 2. Regional Disparities in Per Capita Prefectural Taxes
(Decomposition of Theil's Index)**



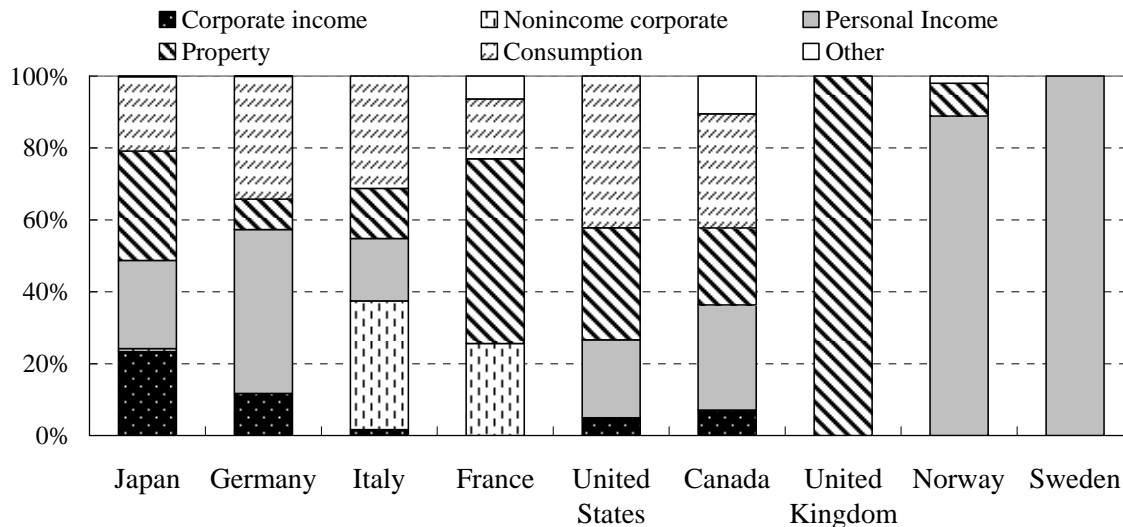
Source: Institute of Local Finance, Chiho Zaisei Tokei Nenpo
(Annual Report on Local Finance)

The reason for the disparity in corporate and property incomes is that the recent economic recovery has been driven mainly by exports, with benefits accruing principally to export-centered manufacturers and related industries. Another factor that has pushed up corporate earnings in urban areas is that returns on foreign direct investment are consolidated at the head office, which tends to be registered in major cities. A look at per capita prefectural tax revenues (Figure 2) corroborates this trend. There has been a sharp increase in corporate tax revenue disparities—which was unevenly distributed to begin with—since fiscal 1999. By contrast, revenues from the consumption tax and income rate have remained stable and have not contributed to the widening inequality.

Focus on Personal Income in Other Countries

The reliance on corporate taxes for local revenues is unique among the industrialized countries. A comparison of local tax structures (including at the state level) in major developed countries shows that reliance on corporate income tax in Japan is the highest (Figure 3). There are some countries, such as Britain, Norway, and Sweden, that do not have any local corporate taxes.

Some countries did rely heavily on corporate taxes in the past. According to the Japanese Ministry of Finance's Chiho zaisei shisutemu no kokusai hikaku (International Comparison of Local Finance Systems, 2002), such a reliance was identified as being problematic in Germany, which subsequently raised the share of revenue from personal income tax and consumption tax, for which distribution was more even. Britain once had a tax on company-owned real estate, but today only individuals pay such a levy. The reasoning behind this decision was that companies should not be subject to local taxation because they have no right to representation in the form of voting rights. In other words, local authorities could set corporate tax rates as they wished, unlike the rates for local residents, who as voters can voice their displeasure with the tax burden or level of public services provided.

Figure 3. Tax Revenues of Local Governments in Industrialized Countries

Note: Includes federal state revenues for Canada, Germany, and the United States.
 Source: OECD (2007), "Revenue Statistics 1965–2006"

Local taxes in Scandinavian countries are centered on personal income. In Sweden, for example, a high degree of decentralization has resulted in broad differences in levels of services provided by various local authorities, with clearly corresponding differences in the income tax burden. Sweden and Britain also share the fact that there is only one type of local tax. This has the benefit of making it far simpler for taxpayers to know how their taxes are being spent. Because they have only one source of local tax revenue, though, both countries have adopted relatively stable taxation structures to counteract the exposure to volatility.

Under the multilayered tax structure in Japan, it is difficult for taxpayers to know how their taxes are being spent. The Organization for Economic Cooperation and Development's Economic Survey of Japan 2008 pointed out that Japan's local tax system is exceptionally complicated. The resulting opacity in the relationship between taxes and public services may be one reason for the low level of interest in local autonomy in Japan. In Sweden, where there is only one type of local tax, by contrast, the voting rate for local elections is as high as 80% to 90%. It may thus also be necessary to shift the focus of local taxes from corporations to individuals as a way of enhancing voter interest in local autonomy.

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