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Fiscal Federalism in Practice, the Nordic Countries and Japan

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Abstract

The paper compares the decentralization of the public sector in Japan and in the Northern European countries. The background for this comparison is the strong similarities existing in the basic conditions for decentralization: both are countries with homogeneous populations, with shared values, and with strong preferences for equity. But some differences emerge. On the expenditure side, the decentralization in both cases seem to be moving toward the other of the present two systems. On the revenue side, the tax autonomy of local governments in the Northern European countries could perhaps be of some interest for Japan. It offers a way to combine local efficiency and differentiation with control by accountability.

Key words

Fiscal federalism, accountability, local tax, equalization arrangement, macroeconomic control, income tax, tax sharing.

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1. Introduction

In recent years decentralization has never been far from the top of Japan's political agenda. In 1993 the Upper and Lower Houses of the Diet passed a resolution calling for decentralization and the coalition cabinet in which the Social party and the Liberal Democratic Party took power has enacted "Promotion Law of Decentralization" in 1995. Also the Committee for Promotion of the Decentralization that was established on the bases of the Law took its interim recommendations to the Hashimoto Cabinet in 1997.

Of course these developments are all the more welcome nearly half a century after Prof. Carl Shoup in 1949 made his recommendations[1], a long period during which little significant progress has been made towards decentralization. However, there is a tendency today for people to jump on the decentralization bandwagon without asking either what tune the band is playing or where the wagon is heading[2]. For example, rich local authorities ask central government to transfer income elastic tax base to them while fiscally poor ones demand the center to maintain current specific grant or equalization transfer.

In the overall Japan's fiscal system, while the majority of expenditure are done at the local level, only very limited autonomy is available to local governments in their spending decisions. Also on the revenue side is decentralization limited, and the authority for tax base and rate determination lies with the central government. But the question have to be asked, whether the Japanese fiscal system, placing a high premium on tax and expenditure harmonization and on the control by higher level governments, neglects to utilize accountability to electorate as on instrument for better effectiveness, and fails to deliver the diversity in services accommodating different local preferences in the best possible way.

[1]Reports on the Japanese Tax System by Prof. Carl S. Shoup formed the basis of Japan's postwar tax system(See, Shoup Mission(1949)).

[2] For a review of the academic debate on decentralization in Japan, see Mochida, N,.(1995), (1997a).

While Japan is unique, certain general principles and experiences of other industrialized countries where basic conditions in relevant respects are similar, might be helpful. This article attempts to compare the development of fiscal federalism practice in Japan with those in the Nordic countries (NCs) of Europe[3].

Such a comparison becomes interesting because they – as Japan – are shown in the statistics as having a very high degree of decentralization. A high degree of decentralization is often assumed to depend on a homogeneous population with shared values, a condition being met similarly by Japan and by the NCs.

The Report by the Layfield Committee found that NC's were models of "local accountability": newly reorganized local authorities with widespread duties, including all social services, enjoying genuine autonomy, and meeting, by means of local income tax, a high portion of their expenses, supplemented by general block grant[4].

The NC's also seem to make a good score on Article 9 of the European Charter of Local Self Government[5] on the availability of financial resources of local authorities.

On this background we have found that it would be instructive for Japanese reformer to examine fiscal federalism principle and practice in NCs[6]. The purpose of this article is to (1) identify similarity and difference in Fiscal Federalism practice in both countries, (2) describe the reason why these similarity and difference have emerged, and (3) draw a policy implication for fiscal decentralization in each country.

Considered as alternatives the question is which system is better? But instead of being regarded as alternative we believe that the two models of decentralization should be seen as different stages in decentralization of the public sector.

2. The expenditure side.

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[3] The Nordic countries is a common denominator of the Scandinavian countries – Denmark, Norway and Sweden – and Finland and Iceland.

[4] Member of the Committee visited four foreign countries, The Netherlands, West Germany, Sweden and Denmark. On this subject, see Layfield committee, (1976),pp.64-79 for Sweden and pp.80-94 for Denmark.

[5] Information on the European Charter of Local Self Government is drawn from Council Europe(1986). As to implementation of the Charter in the countries which have ratified it, see Council of Europe(1997a), pp.57-72.

[6] This paper is a conflation, revision, and expansion of our studies, Lotz, J.,(1991),(1997) and Mochida, N.,(1997b),(1998). As to Earlier Japanese literature on general overview of this subject, see Takahashi(1978), Fujioka(1994), Iino(1995) and Council of Local Authorities for International Relations (1997).

The assignment of expenditure responsibilities

The countries having the most decentralized public sector anywhere are the Nordic countries. Local governments in NC's are assigned all services to the citizens: Primary and secondary schools, hospitals, health services, care for the elderly, social assistance. Only police, higher education and, the national schemes of old age pension and unemployment benefits stay at the central level.

Measures of the degree of decentralization, based on official statistics on local expenditure, show that also Japan ranks high together with the NCs. The role of local authorities is more important than in most other countries, see table 1. On the basis of disbursements roughly equal to the sum of current transfer and final consumption, there is a clear distinction between the NC's and central/southern European countries. In the former, local government spends between 17 per cent and 24 per cent of GDP, in the latter local government spends only between 4 per cent and 8 per cent. Japanese figure of capital expenditure is particularly high since it includes a large sum of public works. If we add these capital expenditure to disbursement, the Japanese figures appear closer to the NCs - 7 percentage points behind the Danish but similar to the Norwegian and nearly one and half times as large as France, Italy and Spain.

In Japan - like in the NCs - the central government itself is responsible for relatively few public functions such as national defense and pension-related public welfare expenditure. About 80 per cent of disbursement of the national government general accounts are transfers to other authorities of which local government comprises largest share. In Japan these are responsible for a major share of public spending, including on national land conservation and development expenditure, education expenditure, police and fire brigades, social welfare, sanitation and general administration.

Vertical imbalances and grants

Although the ratio of national to local public expenditure in Japan on a final disbursement base is 30.8 to 69.2, the ratio of the distribution of tax revenue is just reverse 63.5 to 36.5 in favor of national government. In Denmark – as an example of the NCs – the same pattern is observed, but the imbalance is less marked in the NCs than in Japan.

Such imbalances are known as vertical imbalances in the public sector and calls for grants as supplementary financing for the local government sector. A survey of the reliance on grants in different countries is given in the second column of table1 and Figure1. The table confirms that grants play a relatively minor role in the NCs (except Norway) than in most other countries, while relative magnitude of grants in Japan is high – 10 percentage above central/southern European countries and two times as large as Denmark and

Sweden. It should be noted, that this table is based on standard international statistics and counts tax sharing revenues as local taxes, though these in most respects are just another way of giving grants.

Table1 Local Government Expenditure as per cent of GDP.1995

	Disbursement[1]		Capital expenditure[3]	Relationship between grants and local taxes (per cent)	
		Consump-tion[2]		Grants[4]	Local taxes[5]
Australia	4.1	0.0		27.4	72.6
Austria	7.1	3.7	1.8	26.5	73.5
Belgium	7.0	4.4	0.7	62.0	38.0
Canada	11.2	8.9		54.0	46.0
Czech Rep.				40.2	59.8
Finland	18.4	14.4	1.2	n.a.	n.a.
Denmark	24.4	17.5	1.2	27.8	72.2
France	7.9	5.1	2.3	43.9	56.1
Germany	5.8	3.8	1.5	52.6	47.4
Greece (94)	3.8	3.2	0	n.a.	n.a.
Iceland	7.7	5.3	1.4	11.9	88.1
Ireland (94)	10.6	7.7	1.7	91.4	8.6
Italy	12.0	7.5	1.5	n.a.	n.a.
Japan	12.8	7.4	5.5	51.0	48.9
Korea	10.1	4.8	3.6	n.a.	n.a.
Mexico				4.2	95.8
Netherlands	14.0	6.9	1.9	91.0	9.0
Norway	16.9	12.6	1.7	47.8	52.2
Poland				44.7	55.3
Portugal (93)	3.9	2.9		n.a.	n.a.
Spain (94)	9.8	6.2	2.1	32.2	67.8
Sweden	22.2	17.8	1.7	21.4	78.6
UK	10.1	7.3	0.9	86.9	13.1
US (93)	13.7	9.5		48.5	51.5

Source: The table is based on OECD *National Accounts Statistics* and The definitions follow the NI-standards. The figures are net of fees and charges.The concept of local government includes provinces and regions but not the state level in federal countries, for Australia the OECD figures have been adjusted to exclude state finances.
1. *Disbursements* include: Transfers to households and enterprises, as well as service expenditure, for Denmark agent-type transfers has been deducted from the OECD figures.
2. *Consumption* is local government salaries and purchases.
3. *Capital expenditure* is gross capital formation and purchase of lands
4. datas of grant and local taxes are for FY1994. *Revenue Statistics 1965-95. OECD 1996.*
5. *local taxes* include tax-sharing.

Vertical imbalances are deficits at the local level which needs financing by central government grants, tax sharing or other transfers. To illustrate the importance of vertical imbalances in different countries it is therefore necessary to have figures on tax sharing revenues and local own tax revenues shown separately. It has just now for the first time been possible to make such a distinction and present the figures in table 2.

Table 2. Local own tax revenues 1995 in per cent of total general government tax revenues 1)

Country	Own local tax revenues 2)
Austria	1.5
Belgium	5.6
Denmark	38.1
Germany	3.7
Iceland	20.0
Japan	
Mexico	0.0
Netherlands	0.0
Norway	0.7
Poland	3.6
Spain	7.6
Switzerland	15.5

1) The data is derived from preliminary findings of the WP2 on Tax Policy Analysis and Tax Statistics of the OECD 26. october 1998
2) Taxes for which the sub central level sets tax rate and/or tax base.

The most interesting feature, however, is not the size of the grants financing but the way the grants are given. Grants in the NCs have increasingly been changed from sector-specific specific grants to general grants to be spent according to local priorities, but not so in Japan. In Japan the grants, the local allocation tax (and the control of local bonds) is used actively to control local spending priorities

Local discretion on the service provision

To develop a measure for comparing the degree of decentralization on the expenditure side over time or between countries is extremely complicated. The problem is that there are many ways for central authorities to influence functions delegated to the local governments sector, as comparison between Japan and the Scandinavian countries so clearly demonstrates. In Japan local provision is done by "agency delegated function" meaning that the national government remains heavily involved in almost every aspect of local public spending.

Unlike the current theories of today on "local public goods", but very much in line with contemporary thinking in the Nordic countries, there is in Japan no clear separation between central and local functions. As a result, major programs (education, health, public works) are formulated by national ministries and financed by many specific grants. Therefore, it shall be argued below, the issue for Japan is not so much to change/enlarge the expenditure assignments themselves, but to redefine responsibilities for designing, implementing, and financing these assignments. This also is expressed by the recent reexamination of agency-delegated functions (Kikan-Inin Jimu), and the reduction in the number and volume of specific purpose grants, which have in Japan become serious political issues.

The agency-delegated function (ADF) is a cornerstone for Japanese central-local relations. Before Second World War, local leaders were appointed by the central government. The Occupational Reform dismantled the Ministry of Interior and the post war Constitution of Japan introduced direct election for governor, mayor and member of local assembly. But the central government has been able to reestablish control by the ADF. In the ADF system, as stipulated by article 150 of Local autonomy Law, the chief executive of the local authority is acting as agents of the central government in implementing assigned functions. If the assigned tasks are purely national affairs, such as parliamentary election and registration of foreigner, the national government will finance full cost, but if they are local affairs, the costs will be shared between the national and local governments.

Agency-delegated functions have been supplemented by the mandamus proceedings, in which the minister of national government could order prefectural governor to carry out certain action. If the governor did not obey such order, the national minister could take over and execute the assigned function or remove the governor from office, though subject to certain legal appeals[7].

This was illustrated clearly by the recent case of the U.S. base in Okinawa. Under the U.S.- Japan Security Treaty, the Japanese government is responsible to provide the land for the U.S.base. If the landowners reject the lease to their land for such use, the government can make the leasing contract in place of landowners. This task is, however, delegated to the local chief executives. In case the executives fail to fulfill this function, the central government can execute that function by proxy, following the mandamus proceedings. In 1995, the governor of Okinawa prefecture rejected to fulfill this function and above mentioned mandamus proceedings started.

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[7] In response to strong criticism, the Local Autonomy Law was revised in 1991 so that the Prime Minister can no longer remove the governor or the mayor from the office.

Nordic public sector appears to leave more scope for local variation (Lotz, lesson p6) in the standard supplied for national services. Over recent decades local authorities have acquired more and more freedom to set their own standards in provision various services, i.e., "the right to differ." [8] The size of school classes, the supply of help for elderly people, the supply of medical facilities, the efforts to bring unemployed back to work – all this is done in different ways across the country.

However, recently some reactions from the parliaments have been seen and some re-centralization is seen these years, aiming at less variation. First of all in the supply of medical facilities and the variation in waiting time for medical treatments. One could say that there is a move in direction of the Japanese model, and knowledge of the Japanese system is of interest for the NCs. But these present trends will not change that the NCs will for a long time remain models for far-reaching decentralization of the public sector.

The two models, Japan and the NCs, are constantly under change, and they should probably not be considered as alternative, but rather as stages in development in different countries. Versions of Japanese ADF models may be the most effective model, until local political maturity and professional skills have developed, so that more responsibility can be placed with the local authorities. The systems of the NCs for not so many years ago did not differ very much from the ADF model (Lotz, lesson p7)

Why Fiscal Imbalances?

Table 1 demonstrated that grants and – implicitly - fiscal imbalances are found in every country, the grants to local governments financing vertical fiscal imbalances. But the reasons why there are vertical imbalances differ. In Sweden and Denmark, for example, the local tax capacity is unlimited, and the fiscal imbalance is caused by the grants, not by insufficient local tax capacity. In Japan, like in most other countries, the reason for fiscal imbalance is insufficient local tax capacity.

Several factors, including the national emphasis on local autonomy, have combined to enable the Nordic countries to restrict grants to a textbook role. Grants are not used to cover structural deficiencies in the taxation system or in other financial arrangements. Local taxes are the foundation of local finances; grants are supplementary, and are limited to a relatively modest level.

The outstanding points of interest about local tax is first of all the appreciably greater proportion of revenue which Danish, Finnish and Swedish local authorities derive from

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[8] The terminology of 'Right to differ' is derived from the national association of local authorities in Denmark, (1994) pp.20-22.

own taxes, i.e. taxes for which they can freely set their own rates, compared with their counterpart in Japan. Secondly it is the firmly established, productive local income tax in the Scandinavian countries. The opposite model is the English speaking countries where property tax dominates the local revenue.

In Japan, own revenue sources are mainly derived from revenues shares of central taxes on income, property and consumption, local authorities have very limited authority to vary tax rate, as shown in table 3. These arrangements have many similarities with the Central European tax sharing systems.

Table 3 Local [1] tax structures 1994 (unweighted averages)

Unweighted average, per cent	**English speaking** Canada USA New Zealand	**Nordic countries** Denmark Sweden Norway Finland	**Central and Southern Europe** Austria France Germany Italy Spain Switzerland Czech Rep. Hungary Poland	**Japan**
Taxes on income profits and capital gains	1	95	45[2]	53
Taxes on property	89	5	26	31
Other taxes	10	-	29	16
Total	100	100	100	100

1) All levels except central and federal state governments.

2) Includes tax sharing, in particular in German speaking countries.

On the surface Japanese local tax system seems to be differrent from continental tax-sharing because the major source of local own revenue is a kind of piggy-backing which are similar to surtax on national income tax base. However almost all localities use uniform rate for the same tax base as described in next part. McLure has argued that Piggy-backing with uniform rate would be tantamount to an institutionally clumsy form of tax-sharing.[9] We should add that even an elegant form of tax sharing is in terms of accountability inferior when compared to own local taxation.

Tax sharing is a well known in Continental Europe and also in Norway, but strong

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[9] For further details of piggy-backing with uniform rate, see McLure, C.E., (1983) p.103.

theoretical arguments can be made against tax sharing, namely:

- their lack of local accountability,
- that they tend to be distributed to the richest authorities, and
- that the development of the tax bases and revenue over time will depend on conjunctual developments which has nothing to do with the needs coming from for example demografic change. The latter problem has forced Japan to seek to expand on the number of taxes to be shared.

But there are more practical reasons why tax sharing is used in many countries. First of all, seen from Japan's experience, is its presumed revenue adequacy. The revenue of the local allocation tax changes over the years like national major taxes, because this is what is multiplied by the fixed tax-sharing ratio[10]. Because this tax-sharing ratio has been quite stable, an automatic increase in major national taxes has provided continuous increase in the financial pool of local allocation tax during rapid growth era. On the other, total fund of transfer is sensitive to business condition because major component of the fund consists of income-elastic national taxes.

The question to be asked, however, is whether a better revenue path could have been realized without tax sharing. One alternative would be a simple, general grant with clauses of negotiated annual increases. Or a system of powerful own local taxes so that local authorities themselves could have secured the missing revenue. In neither case there would today have been the need to discuss projects like expanding the number of taxes to be shared, or to increase Consumption Tax in the financial pool of equalization

In conclusion, the Japanese system seems to attempt combine Northern European expenditure decentralization with Continental style centralized methods of financing. This is a problematic match.

3. Local Taxes.

Uniform rate for the same tax base

A good local tax system, in general, should satisfy several criteria, see Table 4.
The *first criterion* is buoyancy[11]. Local authorities spend large money, and it has been argued that there is a case for them to raise some high yielding taxes. It is generally felt

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[10] The total amount of the local allocation tax is calculated as follows.

$$TT = 0.32*(NTy + NTc + NTa) + 0.29*NTv + 0.25*NTt$$

Where TT denotes total financial pool of transfer, NTy is the total yield of personal income tax, NTc is that of corporate income tax, NTa is that of alcoholic tax, NTv is consumption tax revenue, NTt is total yield of tobacco tax. This explanation is more fully developed in Mochida(1998), P.277.

that high yeilding/ buoyant taxes should relate to taxpayer's abilities to pay, and it is generally felt that incomes and spending levels are the best measure of ability to pay. On the other hand there might be a risk that local expenditure growth would be most rapid in countries with the most buoyant local taxes. But , as we will illustrate in the section 5 , there was no greater tendency for local spending to rise more rapidly in Denmark and Sweden, which had buoyant local income taxes, than it did in the United Kingdom which has generally had an inelastic property tax.

- Japan's local tax system makes a good score for buoyancy. This is mainly due to the fact that the major source of local own revenue is a kind of tax base sharing which are similar to surtax on national income tax base. Approximately 60 per cent of prefectural taxes revenue and 40 per cent of municipal taxes revenue are imposed on income of individual or corporation. There is good evidence to show that the elasticities of local taxes are fairly higher than unity. Table 4 indicates that elasticity of tax revenue to economic growth is 1.26 and 1.35 respectively, for prefecture and municipality during 1971-90. Contrary to the general belief, the responsiveness of property tax called the fixed assets tax by MOHA, is not less than unity. This is mainly due to sharp rise in market value of land in the late 1980s and assessment made at regular interval. According to these, the elasticity of the share of local tax in total tax revenue is relatively high in comparison with other unitary states except Nordic countries.
- The local income tax of the NCs also has scored well in this respect.

The *second criterion* is to have small revenue fluctuation over time. Strong fluctuations in revenue during business cycle can be regarded positively in a fiscal policy context, but local expenditure needs are fairly stable over time, and local revenue fluctuation make planning difficult.

In Japan, local tax revenues fluctuate strongly during business cycle, and when combined with large difference in tax base between localities, as in Japan, the local revenue problems cannot be solved by raising local tax rates.

- In Japan, the property tax (called by MOHA as "*fixed asset tax*") at a standard tax rate of 1.4 percent of the capital value of land, house and depreciable assets produces fairly stable revenue, as shown in the second column of Table 4. In contrast to this, two kinds of company taxes (*i.e.* corporation inhabitant's tax[12] and enterprise tax [13])

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[11]For detailed argument for 'buoyancy', see Council of Europe (1997b),pp.44-48.
[12] Prefectural corporation inhabitants tax consists of two parts: 1) standard per capita tax: ¥20,000-800,00 per corporation, depending on capital plus reserve fund. 2) Standard tax rate: 5percent of national corporation tax.
[13]Japan's enterprise tax on corporations is generally imposed on net income, not on sales or turnover.

fluctuate strongly with the business cycle because these taxes are generally imposed on net income, not on sales or turnover. Recently drastic shortfall of enterprise tax resulted in severe fiscal crisis of influential prefecture governments, such as Tokyo, Osaka and Kanagawa.

Shoup recommended[14] some kind of prefectural tax on enterprises from a benefit point of view, so that enterprises and their patrons should shoulder the cost of government services for the enterprises in that area. The enterprise tax in Japan will be transformed into value-added tax, not based on net income. In comparison with the enterprise tax on pure net income, using value-added as a base has some advantage that it has small revenue fluctuation over time and relatively balanced distribution of tax base among regions. It is, however, impossible to determine the proper location of business income, and the distribution of the value added over local authorities of large enterprises may remain a problem. In the NCs these problems have lead to the abolition of the local taxes on the income of enterprises.

- In the NCs the problem is smaller because the base of the tax is personal income and not primarily business incomes. Furthermore, the system secures - in different and not all equally good ways - that grants are regulated annually so as to compensate for shortfall of revenues and to confiscate windfall gains before they are turned into local expenditure.

In calculating the tax base of the corporate tax at national level, the prefectural enterprise tax is allowed as a deduction. The standard tax rates on corporations are 12 percent on taxable income over 7million. This point is argued by Ishi, H.,(1993), pp.259-260.

[14]Shoup Mission recommended that enterprise tax, using value-added as a base, be administered entirely by the prefectures. On this points, see Shoup Mission,(1949), pp.142-143.

Table4 Local Taxes in Japan

	Relative share (1995)	Criteria for local tax system				
		Buoyancy	Small fluctuation over time	Fiscal equivalence		
	percen tage	elasticity of tax revenue to economic growth during 1971-90 a)	Coefficient of variation in the rate of revenue increase	Actual range of tax rate		
				below standard tax rate	at standard tax rate	over standard tax rate
Prefectural Tax						
Inhabitants tax						
individual	19.1	1.43	0.88	0	47	0
interest rate	7.1	--	--	0	47	0
corporation rate	5.7	1.13	1.49	0	1	46
Enterprise tax	30.4	1.26	1.28	0	40	7
Prefectural tobacco tax	2.7	0.90	1.52	0	47	0
Light oil delivery tax	9.5	1.15	0.99	0	47	0
Automobile tax	11.4	1.08	0.86	0	40	0
property acquisition tax	5.6	1.27	1.05	0	47	0
Automobile tax	4.3	1.21	0.77	0	47	0
Sub-total (A)	100.0	1.26	0.74	--	--	--
Municipal tax						
Inhabitants tax						
Individual	33.0	1.74	0.75	0	3237 b)	0
					3208 c)	23
corporation rate	11.4	1.42	1.04	0	1785 d)	1237
					2645 e)	587
Municipal tobacco tax	3.3	0.90	1.50	0	3237	0
Fixed assets tax	42.6	1.40	0.52	0	2944	289
City planning tax	6.5	1.49	1.05	--	--	--
Sub-total (B)	100.0	1.35	0.61	--	--	--

Source: MOHA, *Chihozei ni kansuru Sankokeisusiryou,* (Statistical yearbook for local tax).
Note: a). Formula for elasticity is $E=(\Delta T/T)/(\Delta Y/Y)$, Y=nominal GNP, T=tax revenue. Actual tax change is adjusted for any change in tax law. b). Individual inhabitants tax levied on income. c) per capita component of individual inhabitants tax. d). Corporate inhabitants tax levied on the income per capita component of corporate inhabitants tax

The *third criterion* is local fiscal autonomy and 'fiscal equivalence'. The power to determine tax rate and base allows sensitive local variations in fiscal burdens to local preferences with the purpose of encouraging fiscal accountability.

- Despite strict uniformity, there are two options available to local government for setting tax rate and base in Japan. One is that central government sets fixed tax rates for a number of local taxes, but provides range for some other local taxes. But principle and practice differ, and there are no localities whose tax rate is below the standard tax rate because such localities would not under the Local Public Finance Law be able to issue local bonds. It is hard to find any tax competition among local governments in Japan. On the other hand, all except one prefecture raised corporate tax over standard tax rate, but they did not increase personal tax for fear of electoral consequences. As a result almost all localities use uniform rate for the same tax base, as shown in the last column of Table 4. For example, in FY1996, 2944 out of 3233 municipalities apply same standard tax rate on property tax base. The other option is concerned with the imposition of new taxes not listed in the law. Local government is given the authority to propose new taxes and must seek the approval of the MOHA and MOF. In FY 1996, only 14 prefectures and 21 municipalities are given permission to use a non-listed tax such as nuclear fuel tax on nuclear power plants. It is difficult to see how they can be accountable to their constituents at the margin, as both efficiency and local autonomy require.

- Among the NCs all but Norway have the right to set their own tax rate, and the resulting variation in rates across the country is quite significant, ranging in Denmark from 14 to 23 per cent of taxable income.

The Nordic Local Income Tax

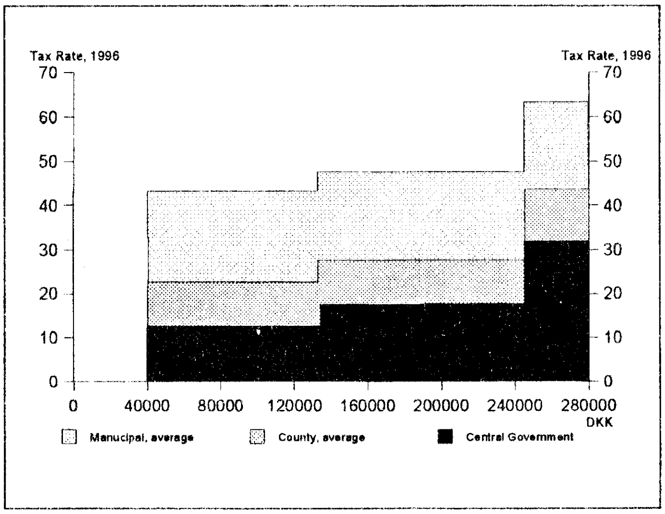
The NCs have a boyant piggy-back type of local income tax so that local authorities can secure the revenue needed by adjusting their tax rates. The major augument for local income tax in Nordic countries is local accountability. Though there are important practical differences, the Swedish and Danish systems are basically similar. The rate of the tax, which is proportional not progressive, is fixed by the local authorities. Assesment and collection are done by the central government in conjunction with the central progressive income tax; there is in effect one bill only for the tax payer. Some features are discussed below:

Piggy-backing with Flat rate. The taxable income for the local taxes is the same as defined for the national income tax, a so-called "piggy-back" arrangement. The tax base is personal income, wage income as well as return on capital. The method is illustrated by the survey of the Danish tax rate structure shown in figure 1.

The flat rate is preferred in the Nordic local income tax. In Denmark the local councils do not vote the tax rate. The local councils vote each expenditure item, they vote the estimated tax base for the following year, and all the other revenues including borrowing and changes in liquidity. After the vote, the mayor has to make the calculation: what is the tax rate needed to produce sufficient revenue for a budget balance, based on the voted estimate of the tax base. This legal procedure was designed to guarantee that the local budgets would always be balanced. In some American cities another model is used, as the local income tax is a locally decided per cent surcharge on the central government tax, introducing more progression in the local tax. The flat rate is preferred in the Nordic model because a surcharge on central tax liabilities would tend to lift the top marginal tax rates too much and give most revenue to the rich authorities.

In Japan's Local Inhabitant Tax, although the taxable income is for the most part the same as defined for the national income tax, the tax reliefs available to local taxpayers are not the same as those for national income tax. The rate structure is modest progressive, in the case of the municipal inhabitant tax starting from 3 per cent rising to 12 per cent in 3 brackets[15].

Figure 1. Income tax rates for central government and average rates for counties and municipalities in Denmark 1996



Authority of residence. The tax revenue in NCs belongs to the authority of residence, and not to the local authority of employment. The reason is that local services are dominated by the free welfare services mainly serving the family. Also in Japan the inhabitant tax is charged by the authority of residence.

Assessments. Tax assessment in the Nordic countries is - with one exemption - a central government function. Only Denmark has made the mistake to maintain local responsibility for tax assessments. The problem in Denmark has been that though the prospect of increased tax revenue should make it attractive for a local authority to strengthen controls of tax evasion, the extensive equalization schemes tend to reduce the gains and discourage efficient assessments. This built-in conflict between incentives and equalization has in Denmark been solved in 1995 with a new legislation. According to this law equalization is now related to a measure of income as recorded before the work of the local tax office begins. This way the results of the local work on assessing incomes for taxation purposes escape equalization. Most recently - as of the income year 1998 - the central government has taken over the income tax assessments of all companies.

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[15] As to academic debate on the reform of inhabitant tax, see Jinno, N. and M. Kaneko,(1998)chap.3.

Local tax on business income. The Nordic local income tax originally included the company tax. But companies were found moving their main offices from high tax authorities to low tax authorities, and for this reason the tax soon was changed into a shared tax.

But also sharing of the company tax involves complicated problems, not with the taxpayers, but with the local authorities. The central government had to solve numerous disputes between municipalities as to their share of the revenue, and as there are no logical variables to determine which authority should have the revenue, and the decisions tended to get political flavor.

Consequently, the local tax on company income now has been given up in Norway and in Sweden, only Denmark still struggles with a tax sharing arrangement (12 per cent of the total company tax revenue). The reform problem on this issue is the following. When you have a local share of company taxes it is hard to get rid of it because the large cities would lose a disproportionate share of the revenue. And the cities are always in great need for more money and tend to have considerable political influence.

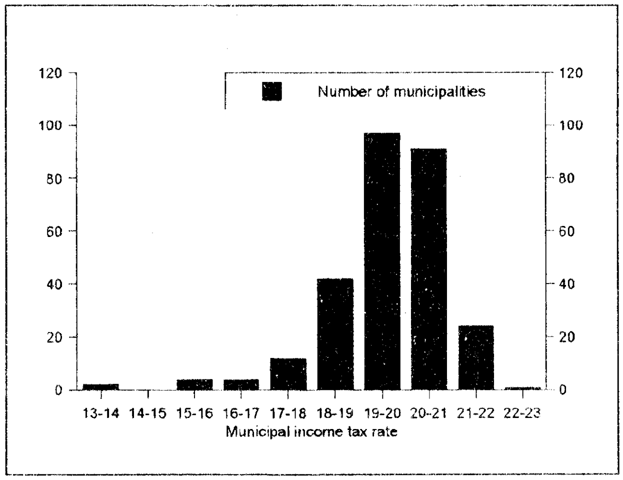
Accountability to their constituents at the margin

There is a considerable variation in the local tax rates, as shown by the figure 2, and the variation in Sweden and Finland is quite similar. We are convinced that this is one of the most striking differences in local income tax between NCs and Japan. There are several reasons for this variation. The important question is: does this make the local authorities accountable to their constituents at the margin?

The differences in tax rates indicates, that some authorities need more money related to their tax bases than others, and there are several reasons for this:

1. Equalization of differences in the tax base per capita and in expenditure needs is less than 100 per cent.
2. Differences in the demand for service levels regarding the local public services.
3. The efficiency in delivering value for money differs between local councils.

Figure2. Number of Danish municipalities according to municipal tax rate 1996.



1. Variation of the first kind is an indication of vertical inequality, among local authorities and among citizens. In the NCs much effort is made to reduce such inequalities. And the same is the case in Japan, also here there is some similarity. In Sweden, a very high degree of equalization (95 per cent of all deviations from average) has now been introduced, and consequently this source of tax variation will become very small in Sweden. In Denmark, the Parliament has been convinced - by powerful politicians from the rich authorities in the urban regions - that full equalization is not desirable. But there is still among the rich authorities 85 per cent equalization around a (high) metropolitan average.
2. To the extent that the differences in tax rates correspond to differences in the local service level, the tax differentials are in conformity with the principle of benefit taxation. Such differences are those needed for the Tiebout effect to work and improve welfare.
3. As to differences in efficiency, they may be regarded as desirable signals to the voters on how their local council is managing the local economy. There is a possible improvement in welfare because voters can dump inefficient mayors, though this is different from the Tieboutian voting with the feet.

It is a pertinent question how such differences in tax rates as exist in Denmark, Sweden, and Finland can remain in the face of the incentive to move into the low tax authorities? Differences as those discussed under (2) above should give rise to Tiebout-type location decisions improving welfare. Differences of group (3) may be deemed temporary but also potentially welfare improving. But differences in tax rates caused by insufficient equalization (1) could be expected to give rise to in-optimal migration decisions.

This has not been subject of actual empirical studies, but such migration has not been observed so as to present a political problem. And the lack of migration also suggests that Tiebout-effects are limited. Several explanations of the lack of migration responding to fiscal location factors may be suggested. Perhaps mobility is not as high as is frequently assumed in economic models; perhaps capitalization and differences in the composition of the supply of homes may contribute to an explanation. Also, it has been argued that the high rate of employment of married women makes it more difficult for families to change location.

The collection and organization of the local income tax – local revenue fluctuations over time

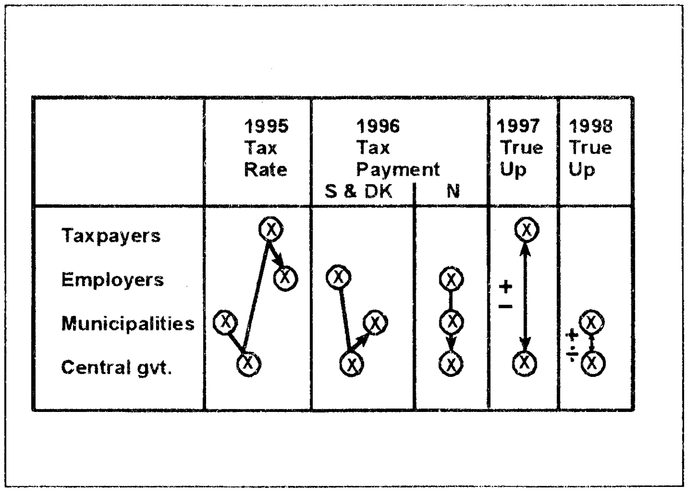
Based on the experience of the tax administrators in the NCs, the piggy-back type local income tax is smoothly working, free from major controversy and generally accepted. Anxieties about the future of public finance spring from the high burden of total taxation rather than from inherent defects in local taxation, though the central and local income taxes are recognized as having in combination reached high figures.

The experience of the Nordic countries has been that the design for how the local income tax revenue is collected and is transferred to the local authority is most important for the macroeconomic management of economy.

There are two model for the collection and the amount of the transfer of revenue to the local authorities during the budget year: Either the local authorities collect the tax and transfer the share of central government back. In this case local authorities immediatly gains acces to improved tax revenues – and the have to participate in shortfalls in revenue – this is the *Norwegian model*. Or the central government is the tax collector, and the amounts transferred to local authorities in a given year is related to local budgets, the connection to actuall collection is cut. This is in Denmark and Sweden followed by a "true-up" in subsequent year, the *Danish/Swedish model*. These two models are illustrated by the figure3[16].

[16] As to Collection from the taxpayer (The tax rate), see Table4 first column. The personal income tax is a withholding tax. Employers are obliged to withhold tax from all salaries and wages. The employers need information on the tax rate of each employee to be able to deduct the right amount of taxes. In order to make this information available the local governments must vote on their tax rates so early in the year, so that the local tax rates of each taxpayer is known when the year begins. In Denmark the local budgets for this purpose must be approved no later than 15th. October, in Sweden they can wait until the end of November. This makes it possible for the central government to communicate the information to taxpayers and employers information on the rates for taxpayers with different residence authority. This is done with a personal "tax card" issued to all tax payers. The tax card will also include information on the deductions which the taxpayer is eligible for. The employees deposit their card with their employer. Taxes from self-employed tax payers, from interest income, and the like which are not subject to PAYE are paid in ten annual installments according to estimates made before the year begins.

Figure 3. The nordic local income tax, payment flows



The Norwegian model.

In Norway employers transfer the total of their collected revenue to the local authorities where the business is located, and this local authority arrange for a current redistribution to the central level and to other municipalities. Norwegian local authorities in their budgeting have to include into their budgets the revenue they expect depending on their expectations as to the economic outlook. But the actual amount raised from its residents at that tax rate will often be significantly different from the revenue they expected in budget preparation.

Norwegian employers are with each transfer of taxes required to submit information about the authority of residence of the taxpayers. This information is claimed to be burdensome for business, but is needed for a system of current distribution of revenue to the final receiving authorities.

Recent Norwegian reports have criticized this model As the Norwegian economy was booming because of the oil-boom of the 1980ies, with economic growth and excessive inflation, the revenue and the derived spending boom of the local authorities exceeded levels deemed acceptable by macro-economic standards.

The business cycle seeped into local budgets, and the oil boom in the late 80ies this way led to large increases in the local spending in Norway, which were very difficult to redress the following years. Local budgets in Norway have to adjust to any economic fluctuations and have become a procyclical element in economic policy.

The tax collection system in Japan has some similarity to the Norwegian model. In spite of the uniformity enforced by the national government, employers transfer the total of prefectural inhabitants' tax together with their municipal inhabitants' tax directly to each municipal tax office rather than combining the payments with those made to the National tax office. This payment procedure is in Japan – like in Norway – among local officials believed to be important for the maintenance of local autonomy.

Danish/Swedish model.

In Sweden and Denmark the employers deposit the total collected tax revenue to the central government[17], but the central government transfer a predetermined amount to the local authorities quite disregarding what has actually been collected.

It is an important difference from the Norwegian model that the revenue transferred from the central authorities to the local is not in the same year related to the revenue actually collected from their citizens. The local authorities receive only the amount they have put in their budgets, no matter any unexpected changes in the overall economic activity. The system this way has cut the link between the fluctuations in the general economic activity and the current revenues for the local authorities.

The advantage of this system is that fluctuations in the general economic activity during the budget year will not influence the local financial situation, like is the case in Norway and Japan. It cannot cause unwanted fluctuations in the supply of local services like education, health, old age care etc. And the local budget becomes a stabilizing element in the economic policy. This brings us back to the question of the rules for the local budgeting of income tax revenue.

In *Denmark,* the local authorities are free to make their own estimate of taxable income on which to base their budgets for the following year. No matter what will be the actual collections, they will always be sure to receive the revenue they have assumed for their budgets.

The risk of the system is, of course, that some authorities in financial difficulties will base their budgets on too optimistic revenue estimates. Therefore, there has to be a "true-up" two years later when the actual tax collections are known and can be compared to the preliminary transfers. The true up may result in a repayment to the central government or an extra payment to the local authority. It actually goes both ways, but if a municipality has overestimated its tax revenues by more than 3 per cent a penalty rate of interest is levied.

The true-up secures that the local government sector gets the money. But central government gains two years to plan how to counteract the increase or declines in local

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[17] As to the transfer of revenue to the local authority (The tax payment), see table 4 second column. Local authorities have to vote their budget before the budget year begins, and for this purpose they need an estimate of their PIT revenue. The rules for the local estimation of income tax revenue to be included in the local budget are closely related to the organization of the transfer of revenue. The transfers from the employers may be deposited with the local authority in which the business is located (Norway), or with the central government (Sweden and Denmark).

revenues with proper cuts in the general grants. This gain in time permits to counteract the lasting effects of fluctuations in local spending.

In *Sweden* local authorities are not allowed to make their own estimates of the taxable incomes for the budget year. Instead the State Auditing Agency (Riksrevisionsverket) estimates each year an official expected general per cent increase in incomes, based on the current macroeconomic estimates, which has to be applied by each municipality. The local authorities do not make their own estimates of the economic development for the coming year like the Norwegian and Danish, they must base their budgets on this centrally regulated tax base.

There is also in Sweden a true-up two years after the budget year, but the true-up is not with the individual authorities, it is done over the general grants. It is furthermore being discussed to remove the true-up, so central government takes the full risk for the consequences of wrong estimates. Sweden has designed the best of the Scandinavian systems.

4. Grants and Equalization Arrangements[18]

Grants as instruments of control

European ministers have agreed in their "Charter of Local Self Government" of the Council of Europe[19] that central government grants should preferably not be given as conditional grants, but that they have to be given as general grants, distributed according to some objective measure.

Denmark was first among the NCs in this policy to change conditional grants into general grants with no strings attached. The most distorting specific (percentage) grants have been replaced by a general grant distributed in accordance with a formula based on objective criteria. The total of this general grant is revised in annual agreements between the government and the local government associations so as to regulate the balance between tax revenues (assuming no changes in the rates) and the expenditure agreed to be necessary.

The arguments have been that conditional grants encouraged irresponsible spending, that rich authorities received the biggest grant because they could afford to spend more, and that priorities became distorted, ("cash-thinking") it was called. However, the change to

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[18] For further details of equalization and grant in Nordic countries, see Lotz, j.,(1997)pp.192-209.
[19]Article 9-7 of the European Charter on Local Self-government. See Council of Europe(1986).

general grants removes an important instrument of control for ministries of the central government, and in particular in Norway this has delayed the switch.

It was explained above how the needs for grants to local authorities in Sweden and Denmark is not primarily to finance vertical fiscal imbalances, their local tax capacity is unlimited and the fiscal imbalance is caused by the grants, not by insufficient local tax capacity. This is very different from the situation in Japan and most other countries, where the reason for fiscal imbalance and grants is insufficient local tax capacity.

In this question, the differences between Japan and the NCs in controlling local government become very visible. In Japan, specific grants have swollen to a vast sum as a powerful mean to guide local governments towards common priorities. These grants are distributed under the condition that the recipient follow the directives issued by the national government. For example, changing the utilization of a vacant classroom in a primary or secondary school to social welfare programs requires approval of the Minister of Education, one by one. Against this background, the second report by Committee for Promotion of Decentralization, released mid-1997, recommended the national government to reduce specific purpose grants substantially and to limit national treasury obligatory conditions to a minimum.

The Choice of Solidarity Model or Grant Model

Horizontal imbalances are reduced by equalization arrangements. These can be designed applying one of two very different forms of techniques, we shall name them the grants method and the solidarity method. By far the most common model is a central government grant to the poor local authorities, so as to bring their revenue up to a certain national standard. The other method, the solidarity method – sometimes called the "Robin Hood" model, is used in Germany (among the länder), in Denmark, and in Sweden. It removes resources from the rich authorities and gives to the poor, no central funds are needed.

It should be understood that grants are used in all countries, also in the solidarity model-countries. They give grants to all local authorities – rich and poor – in a "neutral" way, that is: they are designed so as not to influence the equalization. The comparison between the two models is not on the question of grants or not, it is a question of financial resources of the central government and of fiscal illusions.

Discussing the two models, it can be mentioned first, that the solidarity method makes it difficult for local authorities to agree on demands for more equalization, and the central government finances therefore are better protected than under the grants system. This is seen from the point of view of the MOF a political advantage.

An argument for the solidarity model, seen from the point of view of the MOF, is its greater efficiency as a high degree of equalization can be achieved without central funds. The model, therefore, may be particular useful where the disparities in local taxable capacity are so great that equalization by grant becomes excessively expensive. Lack of central funds in many countries results in an insufficient equalization reaching only the poorest authorities, this way the more well to do authorities and their wealth remains outside the system. This explains why the solidarity model was preferred in Sweden. Sweden did not want the richest authorities to escape equalization and control.[20]

The argument against the solidarity model is that it creates conflicts among the regions, and it is inescapable that the rich and most influential authorities will fight it. This is amply illustrated by recent history:

- In Germany the system came under pressure when the low-income eastern länder were to become members of the scheme and the contributions of the rich were increased. The result was the introduction of dampers to hold down the contribution of the high-income länder.
- In Sweden the proposal for the solidarity model in the spring of 1995 was brought to the Supreme Court, who declared the method unconstitutional. Transfers between local authorities were deemed to be taxation by one authority of another, and this was deemed to be against the constitution. The law was changed so that the wording clearly relates to transfers to and from the central government.
- In Denmark the influential National Municipal Association was about to break up in 1987 because the rich municipalities around Copenhagen refused to pay to the equalization scheme. They convinced the government to switch to the grant model (though in 1995 the solidarity method was introduced again without much discussion).

It can be seen that this method is likely to create conflicts between regions, while the grant method contributes to "nation building" in countries where regional conflicts are very serious like in Canada - or perhaps China?

Adding to the popularity of the grants model is that it leaves the very rich authorities outside the equalization scheme, they most often receive no equalization grants. This is the reason why Sweden opted for the solidarity model.

Furthermore, it is easy to find majority support for grant model, therefore it is used by most countries, including Japan. This is because of a "fiscal illusion": Under the grants

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[20] Utjäming av kostnader och intäkter i kommuner och landsting. SOU 1994:144. Stockholm, Sweden 1994

model everybody seems to get something, and nobody to pay. But this is not true, of course, as the taxpayers in who live in the rich municipalities pay the major part of the central government taxes to finance the grant. In rich local authorities, such as Tokyo, Osaka, Aichi, Kanagawa prefectures, only half of the tax paid by the residents to both national and local governments would be "returned" as grants. Poor local authorities, such as Shimane, Kochi, Miyazaki and Kagoshima prefectures receive grants of more than double the tax paid by the residents[21]. But since the rich authority taxpayers pay their taxes to the central government, the real redistribution is less visible. If the solidarity model was used there would no such "fiscal illusion", and the critique of the equalization would increase.

The Argument against grant model, seen from Japan's experience, is that local politicians, civil servants and voters may take less care with money that is given as LAT than with money received from a solidarity model-fund. In principle LAT should make the national taxpayers living – in particular those living in the rich municipalities - accountable. But in practice accountability under the LAT seems low. The redistribution is less visible in LAT than that of solidarity model. In order to win national taxpayer's confidence, recipient local governments should spend the money efficiently and raise local taxes to the maximum rate.

The degree of Equalization

The choice is somewhat related to the implicit question of whether full degree of equalization is wanted. Probably, the strongest case for equalization transfer has been based on the premise of "horizontal equity among the citizens"[22]. Equity requires that the equalization should be full, and this appears to be the logic in Japan's Local Allocation Tax as well as for the extensive equalization schemes of the NCs.

As pointed out by the Recommendation by Prof. Carl S. Shoup [23],special support from the national government for the exceptionally poor areas is necessary, so that they are in fact, as well as in principle, free to vary the amount of services they supply their citizens with, through changes in their own tax rates. A poor locality that is already exacting the maximum in local taxes just in order to maintain the bare essentials of local government does not have effective local autonomy. Under the equalization grant, such a locality is given enough support so that it gains at least some degree of true freedom of action.

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[21]For further details of redistribution among regions, see Mochida(1993), pp.59-60.
[22]J. Buchanan was the first to show that horizontal equity among the citizens requires local government equalization. On this subject see Buchanan, J.,(1950),pp.538-99 and (1952),pp.208-17.
[23]On the relationship between full degree of equalization and local discretion over tax rate setting, see Shoup Mission(1949) ,Chapter 2, p.21.

In Sweden, nearly full equalization has now been introduced[24]. In Denmark there is also very strong equalization. The reason why there is not full equalization is the political hesitation to make too large changes in the existing relative financial situations of local authorities, as would follow should all those deserving greater subsidies have. Officially the reasoning is that the measure of expenditure needs for the extremes of needs – the big cities and the rural, small units – are not satisfactory, and that less than full equalization reduces the risk of exaggerations. There seems to be in such matters a fear in the NCs of aiming at an unrealizable exactness, which might be self-defeating. This has resulted in a certain acceptance of marginal variations and inequalities[25].

In Japan the thinking is very much in line with the NCs. Equal access to public goods and fair sharing of the burden to finance these goods are viewed as essential for economic and social development. The local allocation tax is annually paid to local governments, whose basic financial need exceed basic financial capacity, and varies directly with local fiscal needs and inversely with local fiscal capacity. The formula means that the national government transfer 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 – but not equal, like in the NCs – level of public services.

Such formula are the basis for the whole idea of delegation responsibilities to local government, this is the intellectual basis for the systems in Japan and the NCs as well as in countries like Australia, Korea and United Kingdom. This approach actually has corrected horizontal fiscal imbalance and ensured a minimum level of public service in all parts of Japan. The extent of the improvement (or deterioration) could be measured as the difference between the Gini coefficient of local tax per capita and that of general revenue(sum of local tax and LAT) divided by the former[26]. Table 5 indicates the change in the extent of improvement measured by the Equalization Coefficient.

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[24] There is some discussion as to whether a high degree of equalization has harmful effects for the local incentives to promote economic growth and employment. On this subject, see Söderström, L.,(1994).
[25] Layfield Committee,(1976), p.4.
[26] This measure can be expressed as the following equation.

$$\phi = (G_2 - G_1) / G_2$$

Where G_1 stands for the Gini coefficient of GFR, G_2 for the Gini coefficient of local tax. ϕ denotes the extent of the improvement; this we have termed the Equalization Coefficient in this paper. This explanation is more fully developed in Mochida(1998), pp.280-283.

Table 5 Redistributive effect of Local Allocation Tax

	Gini coefficient		Coefficient of equalization (%)
	Before LAT G_2	After LAT G_1	
1950	0.247	0.077	68.62%
1951	0.277	0.085	69.25%
1952	0.248	0.074	69.96%
1953	0.249	0.082	66.89%
1954	0.234	0.080	65.64%
1955	0.238	0.079	66.67%
1956	0.249	0.066	73.62%
1957	0.292	0.089	69.63%
1958	0.278	0.089	68.22%
1959	0.294	0.093	68.30%
1960	0.307	0.096	68.80%
1961	0.314	0.098	68.68%
1962	0.298	0.090	69.84%
1963	0.287	0.085	70.48%
1964	0.270	0.085	68.49%
1965	0.246	0.091	62.98%
1966	0.232	0.084	63.67%
1967	0.226	0.084	63.00%
1968	0.222	0.088	60.56%
1969	0.220	0.092	58.20%
1970	0.221	0.093	57.81%
1971	0.203	0.105	48.38%
1972	0.206	0.103	49.91%
1973	0.197	0.101	48.53%
1974	0.185	0.104	43.88%
1975	0.167	0.127	23.78%
1976	0.160	0.109	32.11%
1977	0.154	0.106	31.22%
1978	0.150	0.104	30.32%
1979	0.150	0.105	30.36%
1980	0.157	0.109	30.55%
1981	0.157	0.113	28.14%
1982	0.161	0.119	25.70%
1983	0.158	0.112	29.21%
1984	0.166	0.108	35.08%
1985	0.181	0.113	37.66%
1986	0.176	0.118	32.84%
1987	0.186	0.117	36.96%
1988	0.194	0.114	41.20%
1989	0.198	0.122	38.62%
1990	0.193	0.123	36.32%
1991	0.177	0.130	27.50%
1992	0.170	0.130	22.00%
1993	0.150	0.140	8.50%

Source: Mochida,N.[1993]. Updated by MOHA, *Annual Statistics of Local Government Finance* (Chiho Zaisei Tokei Nenpo).

- The first half of rapid growth era (1954 to 1964). Increase in pre-grant disparity is a peculiarity of this period. Local Allocation Tax served to reduce resources disparities quite extensively by 70 percent in each year.
- The latter half of the rapid growth era (1965 to 1974). There was sharp decrease in the pre-grant disparities among rich and poor districts. Nevertheless, the distribution of local allocation tax followed the principle of equalization all the more. This actually resulted in a reversal of the rank ordering of disparities among prefectures.
- Oil crises and thereafter (since the mid-1970 up to mid-1980). The disparities in per

capita local tax have begun to increase again as a result of migration to the Tokyo metropolitan area. The negative correlation between per capita tax revenue and per capita local allocation tax became to be weaker according to the shortage of financial pool LAT.

- Bubble economy' and its collapse (since 1985 up to the present). There was marked decrease in the pre-grant regional disparities. It is noteworthy that there is little difference between pre-grant disparities and area's resource disparities after the addition of local allocation tax.

In conclusion the actual degree of equalization was perhaps more important before the 1970s, when the transfer system contributed significantly to equality. Since then regional fiscal disparities have been reduced, there has so to speak been less "inequality" to fix through local allocation tax, and subsequently the intensity of the equalization effect has fallen. But this does not mean that equalization is no longer necessary, equalization is crucial for a country with a decentralized public sector as in Japan

Measuring Expenditure Needs

In the NCs as in Japan, equalization is based on carefully designed measures of local expenditure needs based on objective criteria. Only "demographic criteria (age groups)" and other "objective" criteria for measuring expenditure needs are accepted. The degree of complexity of this measure depends on the complexity of the functions delegated to local government. If local authorities have been given only few and uncomplicated functions, the demografic criteria is simple. However, as many of the services of the modern welfare states are made the responsibility of local authorities in both Japan and in the NCs, the number of demographic criteria becomes large.

The use of demographic and other objective criteria have the advantage of making it possible for the local authorities to estimate their grant with some certainty. It is also seen as an advantage that objective criteria prevents political discretion in deciding upon grants – politics only plays its role in the choice of criteria, which have to pass Parliament.

But not all expenditure needs are easily measured by demografic criteria. Different social condition of the clients should be considered by using social criteria. This is done by using so called "social criteria" like the relative importance of number of children with single parents, or of elderly people living alone. The social criteria are not linked to individual expense areas in the same way as the age derived criteria. On the contrary, the purpose is to take account of the more general aspects of the social burden municipalities have to carry. The choice and weighting of these social criteria, therefore, gives the measure of expenditure needs a political element and sets some limits to the degree of objectivity of the needs measures.

There is no substantial difference in methods of measuring expenditure needs among NCs and Japan. The method used to determine expenditure needs in Japan is to divide the expenditures of a local authority into many different categories, and for each category estimate the needs of this local authority, this way blending demography and social dimensions sector by sector. The total fiscal need of a local authority is the sum of the estimated needs for all these sectors. This method today has become universally accepted, and the concept of and methodology of assessing expenditure needs is not questioned today.

The method can be described referring to the method of Japan: Before calculating basic financial needs, public services for each prefecture and municipality are divided into some service items(gyosei-komoku). Regarding prefecture there are 24 service items such as police, road-bridge, primary school and as for municipality there are 24 service items such as city planning, park, garbage collection and so on. Basic financial needs for each service item is calculated as the number of measurement units by multiplying the unit cost, adjusted by modification coefficients[27] The total basic need in each locality is the sum of the amounts needed for all service items combined.

- First step is to select measurement units ('sokuteitani'). A measurement unit reflects in an objective way the weight of beneficiaries demanding a particular expenditure. For example, a measurement unit of demand for social welfare is population, the demand for capital expenditure on road is length of roads, and demand for primary school building depends on the number of children.
- Second step is to determine an unit cost ('tanihiyo'). Unit cost is a kind of net average cost per measurement unit for each service item. Assuming a certain local body with standard condition and scale, the unit cost for each service item could be calculated.
- Third step is to determine modification coefficients. Like the NCs 'social criteria', Japan's modification coefficients measure the social dimension of demand for public service. The function of mocification coefficient is to differentiate unit cost utilizing non-demographic criteria. Currently modification coefficients are classified according to eight categories[28]. The density modification coefficient, for example,

[27]Basic financial needs of ith local authority is calculated according to following formula.

$$N_i = \Sigma_k \left(I_{ik} * U_{ik} * M_{ik} \right)$$

Where I_{ik} is measurement unit for service K of ith region, U_{ik} is unit cost for service K of ith region, M_{ik} is modification coefficient for service K of ith region. This explanation is more fully developed in Mochida(1998), p277.

[28] The complete list of Japan's modification coefficients is

— Class modification coefficient — Size modification coefficient
— Density modification coefficient — Modification coefficient for special factors
— Modification coefficient for cold areas
— Modification coefficients to allow for rapid growth of population

reflects that it is more expensive to provide public service in sparsely populated regions than in densely populated regions. The size modification coefficient reflects economies of scale. These "social" criteria in Japan differs from the NCs in that they tend to reflect structural differences like size, climate etc., while the NCs rely more on expressions of personal differeneces[29] like share of population living alone or being uneducated.

It is worth noting that both the Japanese system and the system in the NCs are under political criticism for lack of transparency and objectivity – this does in our view support that these systems must be comploicated to serve their function well.

The revenue of the Japanese local allocation tax is distributed according to a uniform formula based on basic financial need and basic financial capacity. The application of the formula has contributed to remove intense negotiation and lobbying during the post war development[30].

However, a formula considering not only the equalization of fiscal capacity, but also adjust for the expenditure needs, is demanding in terms of data requirement, particularly those on expenditure needs. In Japan, a certain degree of discretion is given to MOHA, as it has the authority of determine modification coefficients of the LAT. In the NCs both the selection of social criteria and their weighting have to be approved by Parliament.

While surveys seem to suggest that in Denmark the local authorities are able to handle the calculation of the distribution of grants[31], it has in Japan become too complicated for local

— Modification coefficients related to rapid decrease in the units of measurement
— Modification coefficients related to financial capacity

For further details of Japan's modification coefficient, see Ishi, H.,(1993),pp.272-273 and Mochida(1996),pp13-16.

[29] As an example, the Danish social crieria is:
— Number of Children of single parents
— Outdated homes and modern apartments in nonprofit housing developments
— Number of rented homes vs owner occupied homes
— Number of Inhabitants 20-59 years old without employment
— Number of immigrant from poor countries
— Number of Inhabitants 25-49 years old without vocational education
— Inhabitants in subdistricts with severe social problems
— Number of single inhabitants over 65 years old

For further details of Danish social criteria, see Danish Ministry of Interior,(1996),pp.46-51.

[30] LAT is governed by "Local Allocation Tax Law". This law stipulates that LAT should be based on uniform formula; the final authority to approve the distribution lies with the National Assembly. According to the LAT Law, the Ministry of Home Affairs is responsibility for its operation (calculating the amount of LAT) of the transfer and determining modification coefficients. The fact that MOHA does not have the final authority to approve the formula and unit costs is an important mechanism to deter any attempt to manipulate distribution. On the other hand, a certain degree of discretion is given to MOHA as it has the authority of determine modification coefficients.
This point is argued by Mochida(1997b),pp.21-22.

[31] See Betænkning nr. 1250, May 1993, which pp. 231-34 summarizes a survey of the views of Danish local authorities.

governments to forecast their grants in order to prepare their budgets. Furthermore, borrowing from the Fiscal Investment and Loan Program of the MOF as well as deficit-covering bond issue are not determined on objective criteria, they are based on arbitrary political negotiation between MOHA and MOF.

We think that the formula should be more stable over time to improve the long-term planning at the local level. We also think that objectivity could be furthered by announcing the formula so that each local authority is able to forecast its own total revenue for budget purposes. Furthermore we think that the discretionary elements on the borrowing side in many cases could be replaced with objective rules. Finally fture reform could strengthen the transparency of present system.

Measuring Fiscal Capacity

In some cases the need for equalization of differences in the tax base not overwhelming. This depends on how important own local taxation and tax sharing is. The need for equalization grows stronger the more tax and tax-sharing revenues has replaced grants.

The choice of what to include in the equalization on the taxation side is not clear, different purposes call for different methods. A general concern is to design the system so as to preserve the local incentive to raise own tax rates and charges. The technical rules operating in NCs are the following:

- "Own taxes" (in Denmark the personal income tax, municipal land tax). Should be equalized based on the tax base per inhabitant.
- Shared taxes (company tax, county land tax) which are returned to the authority of derivation. The simplest way would be to return it to the local authorities according to expenditure needs, but the local feeling of having a right to these revenues is strong. Equalization is to take away x per cent of the revenue exceeding the national average per capita and supplementing for those whose revenue are below the national average.
- Fees and charges. When these cover full cost of services (utilities) there are no arguments for them being equalized, they involve no local government inequality. But if local authorities are free to collect a charge not covering all the costs, the costs net of average fees ought to be equalized.
- Interest payments. Another source of inequality among local authorities is that some have no debt and may even have some capital held in bonds, while others may be in deep debt. The first type has interest income, the other a burden. Though these differences are very real, they are rarely equalized in any country. The reason is that it would penalize those authorities that have saved and subsidize those authorities that have run into debt.

These considerations are found in design of the Japanese system as well.

- 80% in the case of prefectures (75% in the case of municipalities) of the sum of the yields of all regular local taxes (assuming that each is levied at the standard rate prescribed in the Local Tax Law and not the actual tax rate) is equalized – this way actually equalizing the tax base. Region with high tax effort are not penalized and regions with low tax effort are not encouraged.
- The sum of revenues from local transfer taxes ('chiho-joyozei') which is actually a tax sharing receipts[32] is equalized as well.

5. Macroeconomic Control

MOHA in the central bureaucracy in Japan

One thing is a legal text; another is the institutional set-up for the central-local relations in a country. In Japan, the conflict between the Ministry of Finance (MOF) and the Ministry of Home Affairs (MOHA) reflects one of the main points of Japan's central-local fiscal relations, the latter institution fighting for more fiscal and political power for the local authorities. The MOHA represents a vital counter power in the central bureaucracy against attempts by the MOF to restrict local freedom, and thus MOFA has become an indispensable institutional component in achieving and sustaining decentralization in Japan.

It is impossible for more than 3,500 local governments to lobby individually at the central level. It is MOHA, which is the agent to present the views of the local authorities so that they may be taken into account in coordinating government policies.

Local public finance program in Japan

Japan's intergovernmental system is well designed to enable the center to enforce local fiscal responsibility. The probability of a local government going bankrupt or getting itself in severe financial difficulties is less than in North American or Western Europe (it is for this same reason in many countries held, that local authorities are not permitted to declare bankruptcy). Reed correctly points out[33] that Japan resembles France in the sense that the central government takes responsibility for enforcing proper financial practices in

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[32] This is expressed following equation.

$$C_i = G \; (\Sigma_j B_{ij} * t_j \;) + LTT_i$$

Where G is 0.75 (case of municipality) and 0.80(case of prefecture), B_{ij} is ith region`s jth tax base, t_j is standard tax rate on the jth tax base, LTT_i is revenue from local transfer tax. This explanation is more fully developed in Mochida(1998), p278.

[33]This is the view of Reed in Reed, S.R.,(1990),pp.58-59.

local government, while Northern European countries rely more on accountability, and have this responsibility placed squarely with the local electorate (and the banking system).

In Japan, the instrument for carrying out the supervision of local finances is the Local Public Finance Program. The local public finance program serves as a tool to estimate annual aggregate local revenues, and to assess whether it may cover standardized total local spending. The MOHA formulates a local public finance program every year and is responsible that local governments have enough revenue to balance the program. On the expenditure side, the local public finance program covers the whole of local governments` standard activities (except for local public enterprise special accounts and a few other special accounts). The Local Public Finance Program in short ensures fiscal responsibility, and if the estimated program does not balance for the year, the MOHA has the responsibility to propose some measure such as local tax amendments, increase of Local Allocation Tax, or increase of local loans.

The NCs and their influential local government associations

It is in all countries a government concern control the development in government spending, employment and taxation. NCs have increasingly viewing local government as an important unit within a total economic system, which have to be taken into account when designing the overall economic policies. This can be easily understood glancing at table 1 showing that local governments in the NCs disburse expenditure equivalent to about 20 per cent of GDP.

However it is unthinkable that the Ministry of Interior would speak publicly against the Ministry of Finance defending local interest against the central government. This role is in the NCs played by the influential local government associations. In all the three Scandinavian countries it is the responsibility of the Ministry of Finance (MOF) that local policies are in accordance with the macroeconomic needs. This means that any step by the Ministry of Interior (MOI) regarding local government finances must be taken together with the MOF.

Formally, the grants policy were in Denmark and Sweden in the early 90s transferred to the MOF, but in Sweden it was again as of 1996 shared between the MOI and MOF. In all countries MOI and MOF may be said to work closely together in a cadre of big brother/little brother relationship, with shifting distribution of who plays which role.

It should be noted that the local government associations (one for the municipalities and one for the counties) are in the NCs unified, and they have the backing of the members. This explains why they can play their present important role, representing local governments in communications and negotiations with the central government and with central government agencies. They have managed to step in between the individual local authority and the ministries of social affairs, education and health, and they are involved in most new legislation with practical advise and estimates of economic consequences.

Though the chairmanships of these associations always represent the largest parties at the local elections, they never interfere in political questions. Their role is to defend local self-determination, to lobby for legislation which is operational for the people at the floor, to establish training programs, and to offer consulting for their members, in addition to their traditional "grab as much as possible grant money from the government"-role.

Their role is in this respect similar to the role of MOHA in Japan. Their staff sometimes is able to get promoted into jobs in the ministries, but reverse is rarely seen.

Voluntary agreement through negotiation

The basic instrument in Norway has - since 1911 - been tax ceilings. But all NCs have relied first of all on grants as the instrument for control of local government.

To supplement the grant instrument, however, Sweden has recently introduced a system of penalties for local tax increase.

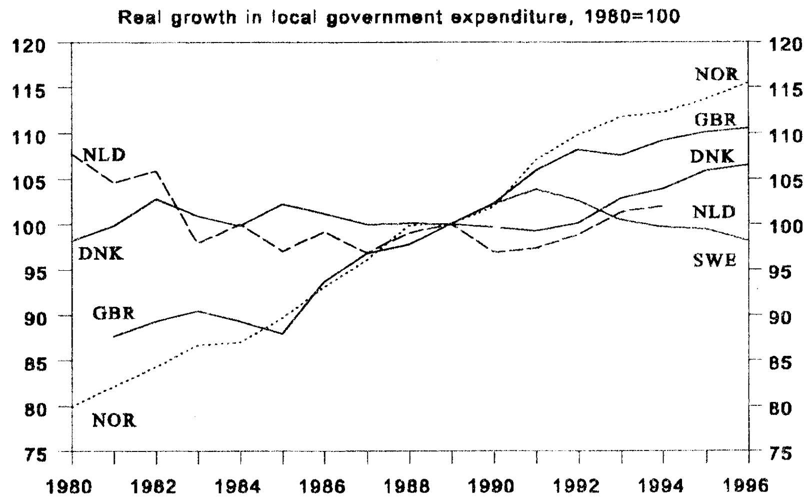
In Denmark there has been a particularly strong system of annual negotiations with the chairmanship of the local government associations, which has worked successfully for nearly 20 years. These negotiations are on the government side performed by the economic ministers, though the sector ministers join when agreements on reform of their sectors are negotiated.

The annual agreements include from the government side agreement to pay a certain amount of grants, and in return the local government associations agree to participate in joint recommendations to their members on the tax rates and the level of activity of the following year. The evaluation of the Danish negotiation system, of course, depends on whether the members follow these recommendations. But it may be difficult to evaluate the obedience of the members and hence the effectiveness such negotiation, the question is these years becoming very relevant.

However, difference in the success, as measured by the real rate of growth in local government spending, has shown that Norway did worst, and that the Danish system of voluntary agreement apparently has been quite effective in promoting accountability, at least during the 1980ies.

A recent Danish publication presented the real rate of growth in local government spending adjusted for changes in functions as shown in figure 4. England and Norway are both countries where control appear to be easy to apply because their local governments have no own taxation of any importance, but Denmark and Sweden, who rely on own taxation and local accountability, did better[34].

Figure 4 *



* On this point, see Danish Ministry of Finance (1997).

The figure suggest that even when local authorities are free to decide on their own income tax rate, it is through negotiations possible to have the necessary macroeconomic control. Sweden has had a bad performance forcing them to introduce a freeze on local taxes for three years 1994-96. When the freeze was lifted, a "tax" penalty on local tax increases (50 per cent of the extra revenue for the first two years) was introduced. Sweden did at the same time enter into negotiations - like the Danish - with local governments, in March 1996 an agreement was made for the years 1997 and 1998.

It is noteworthy that these two countries did better than England and Norway, countries where local government has no own taxation of any importance. This seems to confirm that own taxation results in local accountability, and it may also suggest that negotiations system is better than formal control through grants and tax ceiling[35].

6. Conclusions

The present paper has attempted to compare the decentralization of the public sector in

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[34] This explanation is more fully developed in Lotz, J.,(1991).

[35] Mihaljek, D.,(1997) estimates the relationship between historical changes in the degree of centralization and the size of the public sector in Japan.

Japan and in the Northern European countries (the NCs). The background for this comparison is that – in spite of the unique nature of the two, there are strong similarities in the basic conditions for decentralization, similarities which are often overlooked. But in spite of similarities in basic conditions, striking differences have developed.

One of the strongest similarities shaping the decentralization has been the strong collective preference for equal access to public goods.

The Japanese people and government after the World War were committing themselves to more independence for their newly defined local government sector. The NCs saw the administrative advantages of having the social welfare services supplied by local authorities.

However, equal access to public goods, and fair sharing of the burden to finance these goods was viewed as essential for economic and social development[36]. This has in Japan lead to the system of agency-delegated functions (ADFs), in the NCs more local differences in the service level of the mandatory services has developed, though it may be questioned whether it was really accepted.

In both cases the desire for equity has lead to the development of strong equalization schemes, interregional redistribution is central issues for Japan's as well as the NC's system of intergovernmental fiscal relation.

However, current system faces considerable challenge in the medium term, given the changing preference of the public with respect to local autonomy. In 1990's, Japan has been facing its second transitional phase after the World War. This means a shift away from a society, which emphasizes equal access to public services and equitable sharing of the burden of paying for them, toward a society, which gives priority to individual citizen's expressed preference. If this is to be implemented without endangering macroeconomic policies, accountability is the answer. And where local governments are unable to set their own tax rates of taxation, the Layfield Committee's concept of local accountability does not exist.

The survey brings out at least four significant differences:

1. Central-local relations are in both countries regulated by law. But legislation in Japan allows the central government to control local expenditure decisions discretionary through a large number of "delegated functions" financed by specific purpose grant. The local expenditure policies of the NCs are now controlled by legislation; no central civil servant can overrule a local politician if he keeps his action within the

[36] This points is also argued by Mihaljck, D.,(1997).

law. It is in the NCs held that this has contributed to a less bureaucratic and more flexible public sector than before.

2. The local taxation is quite different. The NCs employ a piggyback type of local income tax for which each local authority determines its own tax rate. In Japan, local tax revenues are mainly derived from a variety of on income, property and consumption with very limited authority to vary tax rate. This way the Japanese system combines a Continental style tax-sharing type of financing with a Northern European decentralization of expenditures. There are signs that this type of financing is not suited when expenditures are so highly decentralized. We tend to believe that present local tax system should be changed into more flexible system in which tax rate is determined at the discretion of local governments.

3. There are in Japan as well as in the NCs quite extensive formula based local equalization systems to reduce regional disparity in both fiscal capacity and needs. One difference is the discretionary element in equalization in Japan, which is much more controlled by parliaments in the NC's.
   Another difference is the in the system of equalization. In Japan, the Local Allocation Tax (LAT) plays a key role in fiscal equalization by which nearly one fourth of central revenue are transferred to local government for equalization purpose. In Denmark and Sweden a "Robin-Hood" type of model for equalization is employed. The law sets the rules for contributions by all rich authorities to contribute to finance the payment of subsidies to the poor authorities; no central resources are needed. It gives more equalization at lower costs for the MOF. This arrangement is supplemented with "neutral" general grants, neutral in the sense that they can be cut without consequences for the relative financial position of local authorities.

4. The organization of the way central control is exercised also differs. In Denmark – and now also in Sweden and Belgium among others – the system of control of local government is an example of cooperation and negotiation between central and local government. MOI (Ministry for Local Government) and the MOF represent the central government, while the local governments are represented by the Local Government Associations. In Japan it is not the local government organizations but the Ministry of Home Affairs represents the interests of local governments as a whole. The conflicts openly displayed in Japan between MOF and Ministry of Home Affairs would not be acceptable for the governments of the NCs, and would neither satisfy their local authorities.

5. Our conclusion is that the Japanese fiscal system places a high premium on tax and expenditure harmonization and on the control by higher level governments. In doing so, it neglects to utilize accountability to electorate as on instrument for better

effectiveness, and it fails to deliver a diversity in services which can accommodate different citizen preferences.

Where do these conclusion lead us? We do not answer the question which system is better when considered as alternatives. But instead of being regarded as alternatives, we believe that the two models of decentralization could be seen as different stages in decentralization of the public sector. On the expenditure side, both cases seem to be moving toward a new model in between the present two systems[37]. On the revenue side, the tax autonomy of local governments in the NC's could perhaps be of some interest for Japan. It offers a way to combine local efficiency and differentiation with control, if the latter is replaced with accountability.

[37] The Committee for Promotion of Decentralization in the national government has recommended the complete abolition of agency delegated function in the near future in its interim report at the end of 1997. Japan is moving in the decentralization direction.

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