

Tax Revenues of Local Budgets in Unitary States: a Case Study of Japan

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ABSTRACT

This article discusses municipal self-government in Japan by focusing on tax receipts of local budgets. Revenues and expenditures of local governments of unitary states, such as Japan, roughly corresponds to subnational budgets of federal states. In unitary frameworks, however, local authorities enjoy greater autonomy. In Japan, local governments account for a large share of public spending and tax revenues. Tax revenues are decentralised and taxes play a significant role in consolidated budget receipts. The centralised system of local administration and finance that evolved in late nineteenth-century Japan was based on arrangements prevailing in Germany at that time. In the second half of the twentieth century, the system of inter-governmental fiscal relations was rebuilt according to the Anglo-Saxon decentralised model, resulting in more autonomy (including tax administration) given to local authorities. The current version of the local public finance in Japan has several salient characteristics and combines both centralisation and decentralisation features. The tax base for the key prefectural and municipal taxes overlaps the tax base for the national income and consumption taxes. The main source of municipal revenue is the property tax. Financial equalisation is achieved through grants, essentially in the form of the local allocation tax (LAT), which is a percentage of national taxes that is channelled to prefectural and municipal budgets. Another important feature of local finance is that municipal governments cover a comparatively large share of expenditures by issuing local bonds. The reform of local governance and inter-governmental fiscal relations conducted in the early 2000s increased the financial autonomy and tax receipts of municipalities. The reform's results were positively received by the international community and may be interesting for several transitional and developing economies that are seeking to improve their system of local finance.

KEYWORDS

local budget, local finance, local taxes, tax revenues of local governments, Japan, prefectures, municipalities, tax allocation

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Налоговые доходы местных бюджетов унитарного государства: опыт Японии

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АННОТАЦИЯ

Целью данной статьи является характеристика организации местного самоуправления и формирования доходной части местных бюджетов в Японии. Доходы и расходы местных бюджетов унитарных государств, включая Японию, примерно соответствуют субнациональным бюджетам федеративных стран, в то время как полномочия органов самоуправления в унитарных образованиях обычно шире. Для местных бюджетов Японии характерны высокая доля осуществляемых расходов и налоговых доходов, децентрализация налоговых

поступлений и существенная роль налогов в совокупных бюджетных поступлениях. Система местных финансов Японии сформировалась в конце XIX в. по прусскому образцу и носила централизованный характер. Со второй половины XX в. местные органы власти получили существенную автономию, в том числе налоговую. Построение системы межбюджетных отношений происходило по рекомендациям, ориентированным на англо-саксонскую децентрализованную модель местных финансов. В настоящее время японский вариант организации местных бюджетов имеет несколько специфических черт, к которым относится, прежде всего, параллельное сосуществование централизации и децентрализации. Кроме того, налоговая база по ключевым налогам префектур и муниципалитетов пересекается с национальными налогами на доходы и потребление. Основу доходной базы муниципалитетов составляет налог на имущество. Выравнивание бюджетной обеспеченности производится путем зачисления в бюджеты префектур и муниципалитетов местного распределительного налога, который представляет собой трансферт из поступлений по национальным налогам. Важной особенностью местных финансов Японии является сравнительно высокая доля расходов, финансируемая за счет муниципальных облигаций. И наконец, в начале 2000-х гг. в Японии была проведена реформа местного самоуправления и межбюджетных отношений, которая привела к повышению финансовой самостоятельности и налоговой обеспеченности муниципальных образований. Результаты реформы получили высокую оценку международного сообщества и с этой точки зрения могут представлять интерес для всех стран, занимающихся укреплением финансовых основ деятельности местных органов власти.

КЛЮЧЕВЫЕ СЛОВА

местные бюджеты, местные финансы, местные налоги, налоговые доходы местных бюджетов, Япония, префектуры, муниципалитеты, разделение налогов

1. Introduction

The division of expenditures and revenues between the central and local governments in countries depends on a variety of historical, economic, and political factors. Analysis of the advantages and drawbacks of national budgeting provides valuable insight into the inner design of fiscal systems and enables recommendations regarding the best practices for possible endorsement. Description of national local finance usually starts with a cross-country assessment of several indicators, such as the local governments' tax revenues and expenditures related to GDP, the share of tax revenues of local governments as a proportion of total tax revenue, and the significance of taxes for local governments' revenues and for covering local expenditures. Table 1 compares the share of local budgets in different countries in 2018 (the data are sorted in descending order according to the share of local governments' tax revenues as a proportion of total tax revenue).

The Scandinavian countries and Japan have the largest share of public expenditure at the local level, whereas these figures are considerably lower in Hungary, Por-

tugal, Israel, and Greece. Countries with the largest share of local governments' expenditures are mostly those that have the highest percentage of tax revenues in their GDP. There are, however, some cases with differences between the share of expenditure and tax receipts of local budgets. For example, the share of local tax revenue in Denmark and the Czech Republic is virtually the same, but the latter has much higher local expenditure. Remarkably, local tax revenues in Switzerland are higher than in Germany, while the situation is the opposite for local expenditures.

Tax distribution and the number of local tasks determine the significance of tax revenues for local budgets. The share of non-tax revenues at the local level is comparatively small for most countries. Therefore, tax revenues of local governments have to be supplemented by transfers, which play an important role in local budgets.

The expenditures and revenues of local budgets in federal states are generally lower compared to unitary states. We can say that the data of unitary states corresponds better to the figures at sub-federal level that

comprises regional (provincial, prefectural, etc.) and local budgets. The indicators described above clearly show the difference between centralised and decentralised public finance systems. A decentralised system normally has a higher share of local expenditures and tax revenues as well as a higher share of local governments' tax revenues in total tax revenue. Taxes generally play an important role in local governments' receipts. Japan can serve as a model example of a decentralised local finance system with an important role played by local self-government.

Compared to other countries, Japan has the largest share of tax revenues transferred to local governments, which signifies a high level of commitment to their expenditures. What are the factors that shape the distribution of taxing powers among the governments of different levels in general, and local governments in particular? Which taxes are levied at the local level? What are the implications of this model of local finance? Our study aims to address these questions by describing the mechanisms of inter-governmental redistribution of tax revenues in Japan.

Table 1

Local governments' budgets in unitary and federal states in 2018

| Country | Local government expenditures, % GDP | Tax revenues of local governments, % GDP | Tax revenues of local governments, % of total tax revenue | Tax revenues of local governments, % of local governments' revenues | Grants, % of local governments' revenues |
|---|--------------------------------------|--|---|---|--|
| <i>1. Unitary states – local level</i> | | | | | |
| Japan | 14.7 | 7.5 | 38.6 | 45.4 | 40.4 |
| Sweden | 23.7 | 13.0 | 31.7 | 53.2 | 33.7 |
| Finland | 20.9 | 9.7 | 31.6 | 46.4 | 29.8 |
| France | 10.7 | 5.9 | 27.3 | 53.3 | 22.2 |
| Denmark | 33.4 | 12.1 | 27.0 | 36.1 | 57.6 |
| Czech Republic | 11.4 | 5.5 | 27.0 | 45.4 | 39.2 |
| Republic of Korea | 13.1 | 4.7 | 23.6 | 29.7 | 51.4 |
| Poland | 12.9 | 4.5 | 20.5 | 32.1 | 50.2 |
| Norway | 15.9 | 6.1 | 20.2 | 37.4 | 44.1 |
| Italy | 14.0 | 4.3 | 15.0 | 31.3 | 55.0 |
| Portugal | 5.9 | 2.5 | 10.2 | 43.0 | 31.8 |
| Israel | 5.5 | 2.4 | 9.6 | 41.5 | 41.4 |
| Hungary | 6.4 | 2.2 | 8.7 | 34.4 | 52.6 |
| United Kingdom | 9.2 | 1.7 | 6.0 | 17.9 | 63.9 |
| Netherlands | 13.0 | 1.3 | 5.5 | 10.5 | 72.1 |
| Greece | 3.5 | 0.9 | 3.4 | 23.6 | 63.4 |
| <i>2. Federal states – local level</i> | | | | | |
| Switzerland | 7.0 | 4.3 | 20.3 | 60.7 | 10.8 |
| Germany | 8.3 | 3.3 | 13.6 | 38.5 | 39.3 |
| Canada | 8.3 | 3.3 | 11.6 | 38.4 | 44.2 |
| Russia | 6.8 | 1.2 | 5.7 | 16.3 | 75.7 |
| Australia | 1.9 | 1.0 | 3.4 | 38.7 | 13.7 |
| <i>3. Federal states – subfederal level</i> | | | | | |
| Canada | 22.3 | 16.0 | 55.2 | 52.8 | – |
| Switzerland | 13.4 | 11.3 | 52.9 | 53.9 | – |
| Germany | 13.1 | 12.6 | 52.4 | 57.4 | – |
| Russia | 13.1 | 9.2 | 44.1 | 41.9 | – |
| Australia | 13.9 | 5.4 | 19.4 | 32.6 | – |

Note: the data for Republic of Korea are given as of 2017.

Source: authors' calculations according to International Monetary Fund. Government Finance Statistics Database. Available at: <http://data.imf.org/?sk=a0867067-d23c-4ebc-ad23-d3b015045405>.

Our study starts with a brief overview of the history of local self-government in Japan. The historical section is followed by analysis of the relevant legal acts and empirical data, provided by the Statistics Bureau of Japan, Ministry of Finance of Japan, Ministry of Internal Affairs and Communications (MIAC) of Japan, and the agencies this ministry comprises – the Local Public Finance Bureau and the Local Tax Bureau.

2. Local government and its tax revenues in Japan in the XIX and XX centuries

There is considerable research literature on the division of functions and sources of funding between different government levels in Japan. Although in this country institutions for self-governance existed as far back as in the feudal period (for more on this, see [1]), the Meiji era is widely considered to be the actual starting point for the development of the local government system [1–4]. Starting from 1871, there appeared a new administrative division system with prefectures as the key territorial units [3]. By 1888, the number of prefectures had been reduced significantly from more than 300 to the present-day number of 47. In the same period, prefectures and municipalities (cities, towns and villages) were included into the hierarchy of local governments.

The Meiji Constitution, which drew heavily on its Prussian counterpart, came in force in 1890. The Prussian Constitution presented a mixture of semi-feudalism and rigid bureaucracy, at the same time positioning the bourgeoisie as the key economic force. The Japanese elite were particularly taken with the Prussian constitution, which they saw as ideologically close [4]. Regulatory acts of the Meiji period were developed with the help of German specialists: Albert Mosse [5], a student of Lorenz von Stein and colleague of Rudolf von Gneist, was invited to Japan as a legal expert to participate in drafting the law on local self-governance (for more on this, see [6]). The second half of the nineteenth century saw a flourish-

ing financial science in Prussia [7]. The Prussian public finance model adopted by Japan was highly centralized, which resulted in the appearance of the system where local governments had little autonomy, the central government was in charge of tax administration, and local taxes were mostly stated as a percentage of national taxes.

During the post-WWII American occupation of Japan, a range of political, economic and social reforms were implemented, including reforms of the government system. The 1947 Constitution of Japan was based on democratic principles and promoted local autonomy: in particular, it required that local officials such as mayors and governors should be elected by direct popular vote.

In the late 1940s, a group headed by Prof. C.S. Shoup, a Columbia University economist and experienced taxation consultant working for the U.S. Treasury Department, were invited to Japan (for more on C.S. Shoup and the Shoup Mission in post-war Japan, see [8]). The aim of the Mission was to devise a system of taxation that would contribute to faster restoration of the economy and strengthening democracy in the country.

The Report on Japanese Taxation of the Shoup Mission published in 1949 described the principles of the local taxation system [9]. Although the Report mostly dealt with budget revenues, it also mentioned the division of powers between different government levels which determined the revenue needs of governments. Among other things, the Report proposed a clear delineation of the functions of the three government levels, with specific tasks being assigned to each of those levels. The priority was given to municipalities, then came the prefectures and the central government. The division of taxing powers was to follow several core principles [9]:

1. The tax system should be simple. The number of taxes should be reduced to a minimum and the taxation system should be transparent, understandable and convenient to taxpayers.

2. Local governments should be able to administer local taxes efficiently. The tax base should be allocated to specific jurisdictions.

3. Tax sources should be divided between the national government, prefectures and municipalities; governments on each level should have sufficient opportunities for efficient tax administration. Such division enables citizens to see the connection between the taxes they pay and the use of the corresponding tax revenues.

4. Local authorities should have the powers to change the tax rates in accordance with the needs and expectations of local inhabitants.

In order to provide more autonomy for local governments in post-war Japan, it was recommended to increase local revenues while simultaneously cutting local expenditures, divide tax bases and introduce municipal taxes administered on the local level. It was planned to increase the significance of local taxes while reducing the number of tax levies on the levels of prefectures and municipalities. The list of local taxes was expected to include the property tax, inhabitant tax, and enterprise tax. The inhabitant and property taxes were recommended for the municipal level; the enterprise tax, food and beverage tax, for the prefectural level.

The inhabitant tax introduced in the late 1940s combined the head tax and the tax that was calculated on the basis of the tax-paying capacity of citizens, primarily their income. The tax was levied both on the level of prefectures and municipalities. Its rate was adjusted annually depending on the fiscal needs. The Shoup Mission's Report suggested that the inhabitant tax should be levied on the income declared by the taxpayer and that it should be applied only on the municipal level. It was expected that the tax revenues would double as a result.

The Report also suggested changes in the approaches to tax base estimation, which would lead to an increase in the significance of the local property tax. The existing tax was calculated on the basis of

the annual rental value of the property tax, which led to the proliferation of tax evasion schemes. The Report recommended to calculate the property tax by using the market value, which would increase municipal tax revenues and enhance a more just distribution of tax burden in cities, towns and villages.

The significance of the entertainment tax and the tax on food and beverages was explained by the connection between their tax bases and population density. For the local level it was recommended to use a VAT-like enterprise tax with the tax base defined as 'total gross receipts minus all purchases from other firms, including purchase of capital equipment, land, and buildings' [10].

To a considerable degree, the recommendations of the Report were aimed at adapting the US federal taxation system for the needs of the Japanese unitary state. Some recommendations of the Report, in particular those concerning the local tax levied on value added, were innovative for that time [11].

The architecture of the tax system described in the Report was formally approved by the Japanese government. After the Report was published, Prime Minister Shigeru Yoshida announced that in order to build a rational and just system, it was necessary to follow precisely the recommendations of the Shoup Mission. The Minister of Finance Hayato Ikeda, however, expressed a more cautious attitude: he believed that although theoretically the recommendations were correct, it would be difficult to implement them [12]. It was planned to realize the Mission's recommendations in the middle term.

The introduction of a new enterprise tax (i.e. the value-added tax) was postponed until 1953–1954 and eventually the Japanese government abandoned the idea altogether. The inhabitant and property tax were allocated to municipalities but, starting from 1954, they were also partially transferred to the level of prefectures [13]. Thus, not all recommendations of the Shoup Mission were realized in the Japanese tax system.

Table 2

| Year | Local budgets' tax revenues in total tax revenues, % | | Share of local budgets' tax revenues (not taking into account financial equalization) in local budgets' revenues, % |
|------|--|------------------------------|---|
| | Before financial equalization | After financial equalization | |
| 1940 | 16 | 22 | 20.6 |
| 1950 | 30 | 44 | 34.6 |
| 1960 | 32 | 46 | 35.6 |
| 1970 | 32 | 49 | 35.4 |
| 1980 | 36 | 54 | 34.0 |
| 1990 | 35 | 53 | 41.6 |
| 2000 | 40 | 57 | 35.4 |
| 2010 | 44 | 67 | 39.6 |
| 2018 | 39 | 57 | 45.4 |

Note: In Japan, the fiscal year runs from 1 April until 31 March. Hereinafter, in our discussion of budgets in Japan, we will mean financial year and not calendar year when referring to a time period (for example, 2018 corresponds to the financial year from 01.04.2018 to 31.03.2019).

Source: compiled by the authors from *Financial Statistics of Japan*. Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan.); [14].

Table 2 illustrates the tax receipts of local governments in Japan and their significance starting from the mid-twentieth century. The division of tax revenues, on the one hand, reflected the growing tax autonomy of local authorities. On the other hand, the national tax revenues used as transfers to local governments were also growing in significance. Furthermore, the decentralization trends in the distribution of revenues went hand in hand with the centralization of certain functions.

The post-war system of public finance in Japan, combining elements of centralization and decentralization, which are usually seen as mutually exclusive, is best described by the term 'controlled decentralization' proposed by K. Akizuki [2]. After the Great East Japan Earthquake of 2011, the importance of centralization became more evident. Even though the vast majority of studies in the sphere of state governance focus on the advantages of financial decentralization, it is sometimes impossible to effectively deal with the consequences of large-scale or even global natural disasters and pandemics on the local level. Such situations usually require financial decisions on the part of the national government. Since the 2010s, the liquidation of the consequences of the Fukushima accident has been a major impe-

tus for centralization of the public finance in Japan (for more on this, see [15]).

Thus, the Japanese public finance system is a unique case for research of centralization and local autonomy, since it comprises both of these trends. The Japanese model of local public finance is difficult to compare with its counterparts in other countries. Studies of the state governance in contemporary Germany and Japan [16] and of the way the Shoup Mission's Report shaped Japan's tax system [9] emphasize the differences between the present-day situation and the principles of fiscal federalism that the Report proposed. Current peculiarities of the Japanese local finance system stem from the combination of the European centralized model and the Anglo-American decentralized model, although there are also some features that are unique to Japan.

In the 1990s, Japan launched a profound administrative and territorial reform, involving redistribution of powers between different levels of government¹. The key provisions of the reform were described in the Comprehensive Decen-

¹ For more on this, see: *Situation in Local Finances 2019*, MIC of Japan. Available at: http://www.soumu.go.jp/menu_news/s-news/01zaisei07_02000205.html (In Japan.), as well as [17; 18].

tralisation Act, which was adopted in 2000 and came into force in 2003. Municipal mergers were a part of the reform resulting in a fall in the number of municipalities from 3,229 in 1999 to 1,718 in 2017. The main reasons behind this step were the unprecedented rates of population ageing, changing fiscal needs, decreasing population density and other processes that required optimization on the municipal level².

In 2003, the beginning of the so-called ‘triple reform’ of local budgets was announced. The reform included, first, cuts in state subsidies, second, reduction in the LAT grants, and, third, a shift of tax sources from the central government to local governments. In the first three years of the reform (2003–2006), the sums of state subsidies and LAT grants were reduced in accordance with the plans. Nevertheless, since tax revenues came rather late to local budgets, prefectures and municipalities had to face a serious revenue shortfall [19; 20]. In the following decade, the tax revenues started growing but only on the level of prefectures. In 2006–2016, the share of tax revenues in the prefectural budgets rose from 30.2 to 39.3%. On the municipal level, however, the picture was quite different: the share of local taxes declined from 34.4 to 32.7%. At the same time, state subsidies accounted for a larger share of municipal revenues: there was an increase from 9.3 to 15.8%. As a result, prefectures became more autonomous in terms of revenues while cities, towns and villages, on the contrary, more dependent on the central government [21].

3. Tax assignment in Japan

Distribution of tax revenues in Japan is based on shared use of the tax base by the national and local governments and the relative autonomy of prefectures and municipalities in setting their tax rates within the limits of the national standard rates. Thus, C. Shoup’s main idea that each

tax should be levied only on one government level remained unrealized. Table 3 shows tax revenues of budgets of different levels in Japan in 2018.

Table 3

Allocation of tax revenues in Japan in 2018, bln yen

| Taxes | Central budget | Prefectural budget | Municipal budget |
|-------------------------|----------------|--------------------|------------------|
| Individual income taxes | 19420 | 4679 | 7674 |
| Corporate income taxes | 12820 | 5059 | 2301 |
| Consumption taxes | 17558 | 4707 | - |
| Excise duties | 8779 | 141 | 861 |
| Property taxes | - | 1526 | 8943 |
| Inheritance tax | 2240 | - | - |
| Other taxes | 2026 | 1581 | 2030 |

Source: authors’ calculations according to *Financial Statistics of Japan*. Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan.).

Most revenues are provided by the personal income taxes, which include the national progressive income tax and inhabitant tax³. To be more precise, in Japan these taxes have the same name but different ways of collecting, determined on the level of prefectures and municipalities. The inhabitant tax is levied on individual citizens and on businesses and is, therefore, a tax on the population and local businesses of a specific prefecture or municipality. Individual citizens pay a fixed sum of 1,500 yen to the prefectural budgets and a fixed sum of 3,500 yen to municipal budgets plus income tax with the flat rate of 10% (4% for prefectures and 6% for municipalities) levied on the taxpayer’s income in the prior year. The tax base for the inhabitant tax is the same

³ The names of taxes and instruments of revenue distribution in Japan usually reflect the economic rather than legal aspects of taxation. For example, the local corporation tax is a national tax and the word ‘local’ refers to the reason why it was introduced and its purpose. In fact, it was introduced to deal with the effects of the elimination of the prefectural tax that had been used before. The local allocation tax (LAT) is not a tax at all but a special kind of grant from the central budget to distribute some of the national tax revenues among the local budgets.

² *Local Autonomy in Japan. Current Situation & Future Shape*. Ministry of Internal Affairs and Communications of Japan; 2009. Available at: http://www.clair.or.jp/j/forum/other_data/pdf/20100216_soumu_e.pdf

as for the national income tax, although it does not take into account some allowances, which means that the tax base of the inhabitant tax is somewhat broader than the tax base of the national tax. These rates and amounts of payments are set by the central government but can be adjusted by local authorities. The local inhabitant tax is paid on the source income and is transferred to the budgets of the prefecture/municipality where the taxpayer resides by their withholding agents.

For business taxation on the subcentral level, several mandatory payments are used: the inhabitant tax (levied by prefectures and municipalities) and prefectural enterprise tax. The corporate inhabitant tax levied on businesses includes a fixed payment (its amount depends on the capital and staff number) and a payment calculated based on the national corporation tax by applying a progressive rate. All the components of the inhabitant tax are characterized by a heavier tax burden and larger taxing powers assigned to municipalities than to prefectures.

Prefectures gain revenues from the enterprise tax, which is levied at a comparatively low rate but has a wide range of tax bases: income, value added and capital. Small businesses are exempt from this tax. Since the 2010s, Japan has conducted a series of corporate tax reforms, which resulted in the elimination of the corresponding local taxes. Since tax revenues were unevenly distributed [22], it was decided to levy business taxes on the national level and transfer a part of these revenues to local governments in the form of grants.

The local consumption tax is a percentage included in the general consumption tax rate in addition to the national tax. A general increase in the consumption rate affected prefectural budgets: until October 2019, the local tax rate had been 1.7% (the total tax rate 8%) and since October 2019, the local tax rate rose to 2.2% (the total tax rate 10%) and 1.76% (of the reduced rate 8%). In setting the key parameters of the local consumption tax, prefectural governments have limited powers in comparison with other local taxes, where they enjoy greater autonomy.

The municipal property tax is a levy on the market value of land and property. In the theory of local taxation, it is considered that the property tax is best levied on the municipal level since this tax provides stable receipts and can be effectively administered by municipalities. A rise in the market value of land and property (the taxable value is revised every three years) leads to an increase in tax revenues.

Experts have mixed views about the effectiveness of the shared use of individual income, business profits and sales of goods by the central government, prefectures and municipalities in Japan. On the one hand, shared tax base on different levels of government works against the benefit principle of taxation (taxpayers do not see the connection between the mandatory payments they make and the specific government level that receives these payments). Moreover, such situation detrimental to the sustainability of public finance during recession, since in this period the two revenue sources may decline simultaneously [23]. On the other hand, if central and local governments share the same tax base, it helps cut administrative costs, prevents tax evasion (especially as far as indirect taxes are concerned), and facilitates tax reforms on the national level.

There are several criteria for evaluation of local taxes: evenness of distribution, stability and increasing revenue generation in response to economic growth. Viewed in the light of these criteria, the local taxation system in Japan shows mixed results. On the one hand, the most evenly distributed across the country's territory are the consumption tax (prefectures) and the property tax (municipalities). The individual inhabitant tax is also distributed quite evenly [22]. As far as the tax on local businesses and consumption tax are concerned, there is a certain balance between the stability of the tax revenues in the short term and the possibility of increase in the tax revenues in the medium term period [24]. K. Ishida has analyzed the statistics on tax revenues of local governments in Japan from 1980 to 2017 and showed that, despite the rise of land prices from the mid-1980s to the 2000s, the

system of municipal tax revenues was unstable while the revenues demonstrated low rates of growth [25]. T. Tran et al. in their analysis of the fiscal data of Tokyo Metropolitan Governments in 2010–2015 found statistically significant positive associations between the volatility of most local taxes and expenditure volatility, but negative associations between the volatility of grants and expenditure volatility [26]. Nevertheless, despite the problems faced by the Japanese local tax system, the country's government are wary of initiating reforms in this sphere and any adjustments of this system are made only after prolonged consultations and assessment of their possible impact on different aspects of local finance.

As for taxing powers, as it was shown above, the main elements of local taxes are determined on the national level while local authorities have the right to set their own tax rates (adhering to the restrictions set on the national level) and change certain parameters of taxation. Municipalities have slightly broader taxing powers than prefectures. There is, however, no unified approach to setting tax rates across Japanese territories. An increase in the local tax rate often leads to a reduction in the amount of financial support from other budgets [27; 28]. Nevertheless, many prefectures and municipalities can set the rate of the local inhabitant tax as long as it does not exceed the standard tax rate

[23]. Relatively high local tax rates can be explained by the fact that local authorities are not allowed to issue bonds if their tax rate is lower than the standard [29] while borrowing is a popular way used by local authorities in Japan to finance their expenses. Local governments are allowed to set new taxes not specified by the national legislation, but such decisions need to be approved by the Ministry of Internal Affairs and Communications.

In 2018, local governments were allocated a little bit less than 40% of total tax revenues. Since the mid-2000s, the share of national taxes has been growing due to the declining significance of municipal taxes (Fig. 1).

The share of tax receipts going to municipalities is larger than the share that goes to prefectures. Nevertheless, for a long time, the ratio of prefectural and municipal expenditures and revenues has remained virtually unchanged (Table 4). As a result of the decentralization reform in the early twenty-first century, the share of expenditures and revenues of municipalities grew in comparison with prefectures.

Municipalities fund a wide range of public services, including education, especially compulsory education (primary and secondary school), health care, city planning, fire services, housing and utility services, and social services. Powers granted to municipalities by the central government vary depending on the type

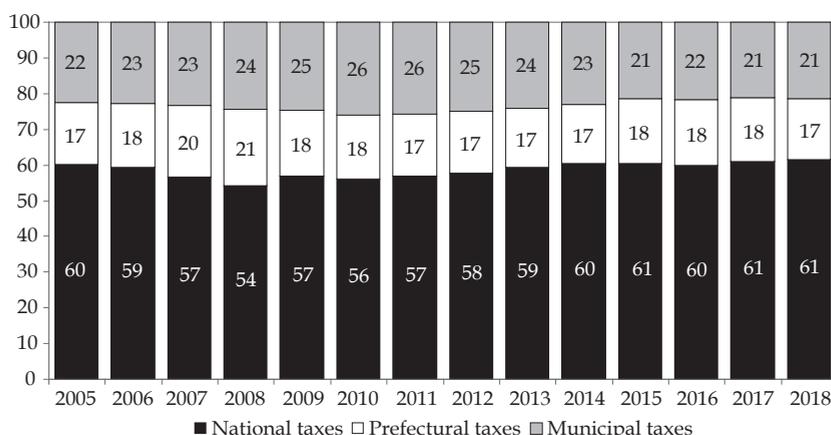


Fig. 1. Distribution of tax revenues between central and local budgets in Japan, %

Source: authors' calculations according to Financial Statistics of Japan. Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan.)

of municipalities (mostly depends on the number of inhabitants)⁴.

Table 4
Shares of prefectures and municipalities in total local budgets in Japan

| Year | Share in total revenues of local governments, % | | Share in total expenditures of local governments, % | |
|------|---|-----------------|---|-----------------|
| | Prefec-tures | Munici-palities | Prefec-tures | Munici-palities |
| 1985 | 50 | 50 | 51 | 49 |
| 1990 | 50 | 50 | 51 | 49 |
| 1995 | 50 | 50 | 50 | 50 |
| 2000 | 50 | 50 | 50 | 50 |
| 2005 | 48 | 52 | 49 | 51 |
| 2006 | 49 | 51 | 49 | 51 |
| 2007 | 49 | 51 | 49 | 51 |
| 2014 | 47 | 53 | 47 | 53 |
| 2015 | 47 | 53 | 47 | 53 |
| 2016 | 47 | 53 | 47 | 53 |

Source: authors' calculations according to *Japan Statistical Yearbook 2020*. Statistics Bureau, Ministry of Internal Affairs and Communications of Japan. Available at: <https://www.stat.go.jp/english/data/nenkan/69nenkan/index.html> (In Japan.).

Prefectures act as a link between municipalities and the central government. Services that extend beyond municipal areas are funded on the level of prefectures. The standards for these services are also set on the prefectural level.

4. Prefectural and municipal tax revenues

The key local tax in Japan which provides most revenues is the inhabitant tax. In prefectures, this tax accounts for a third of tax receipts and in municipalities, for up to 45% (Table 5). Receipts from the inhabitant tax paid by individuals are larger than those paid by the corporations. Nevertheless, if we consider the enterprise tax together with the tax on corporate inhabitants, it is easy to see that the amount of taxes paid by individuals and businesses to prefectural budgets is approximately the same.

⁴ *White Paper on Local Public Finance, 2019*. Ministry of Internal Affairs and Communications of Japan. Available at: https://www.soumu.go.jp/iken/zaisei/31data/chihouzaisei_2019_en.pdf (In Japan.).

Table 5
Structure of local budgets' tax revenues in Japan in 2016

| | Tax revenue, bln yen | Share in tax revenues of local governments, % | Share in tax revenues of prefectures / municipalities, % |
|---------------------------------------|----------------------|---|--|
| Local tax revenues, total | 39392 | 100 | - |
| 1. Local prefectural taxes | 18114 | 46 | 100 |
| 1.1. Prefectural inhabitant tax | 5891 | 15 | 32.5 |
| - paid by individuals | 5017 | 12.7 | 27.7 |
| - paid by corporations | 874 | 2.2 | 4.8 |
| 1.2. Local government consumption tax | 4703 | 11.9 | 26 |
| 1.3. Enterprise tax | 4261 | 10.8 | 23.5 |
| 1.4. Motor vehicle tax | 1535 | 3.9 | 8.5 |
| 1.5. Gas oil delivery tax | 933 | 2.4 | 5.2 |
| 1.6. Real estate acquisition tax | 397 | 1 | 2.2 |
| 1.7. Prefectural tobacco tax | 149 | 0.4 | 0.8 |
| 1.8. Automobile acquisition tax | 146 | 0.4 | 0.8 |
| 1.9. Other taxes | 99 | 0.3 | 0.5 |
| 2. Local municipal taxes | 21278 | 54 | 100 |
| 2.1. Municipal inhabitant tax | 9574 | 24.3 | 45 |
| - paid by individuals | 7365 | 18.7 | 34.6 |
| - paid by corporations | 2208 | 5.6 | 10.4 |
| 2.2. Property tax | 8893 | 22.6 | 41.8 |
| 2.3. Light motor vehicle tax | 238 | 0.6 | 1.1 |
| 2.4. City planning tax | 1262 | 3.2 | 5.9 |
| 2.5. Municipal tobacco tax | 911 | 2.3 | 4.3 |
| 2.6. Establishment tax | 366 | 0.9 | 1.7 |
| 2.7. Bathing tax | 22 | 0.1 | 0.1 |
| 2.8. Other taxes | 12 | 0.03 | 0.1 |

Source: authors' calculations according to *Japan Statistical Yearbook 2020*. Statistics Bureau, Ministry of Internal Affairs and Communications of Japan. Available at: <https://www.stat.go.jp/english/data/nenkan/69nenkan/index.html> (In Japan.).

The local consumption tax and enterprise tax rank second and third in terms of the amount of tax receipts to prefectural budgets. Figure 2 illustrates the consolidated structure of the main taxes as sources of prefectures' revenues since the early 2000s. In the 2000s, the enterprise tax accounted for about a third of tax revenues of prefectures but since 2009 its share has been steadily declining as a result of the introduction of the LAT. The LAT is set at a given percentage of the major national taxes and distributed in the form of grants

to local governments. The fall in enterprise tax revenues is compensated by the growing role of the inhabitant tax and local consumption tax. Since 2016, the main sources of tax revenues of prefectures have retained a similar proportion.

The motor vehicle tax, which has accounted for 8–12% of the total tax revenues of prefectures since the mid-2000s, is levied as a fixed amount depending on the engine size and how the vehicle is used (personal or business use). The motor vehicle tax is based both on vehicle

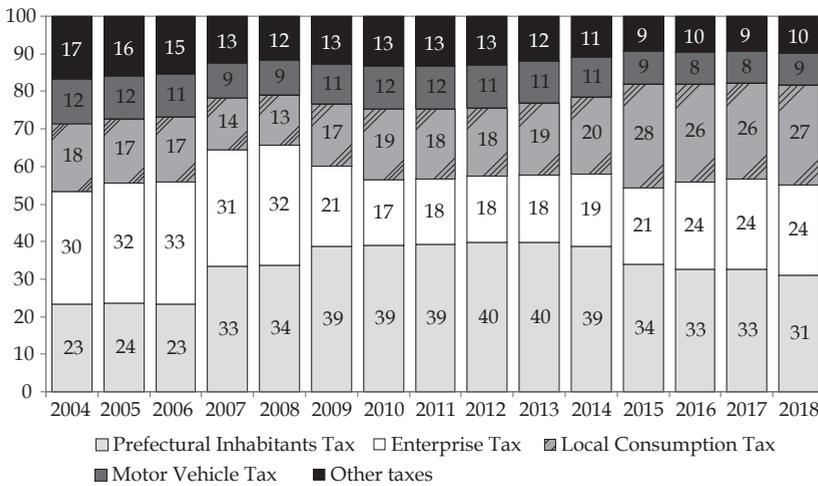


Fig. 2. Prefectural tax revenues in Japan in 2004–2018, %

Source: authors' calculations according to Financial Statistics of Japan.

Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan.)

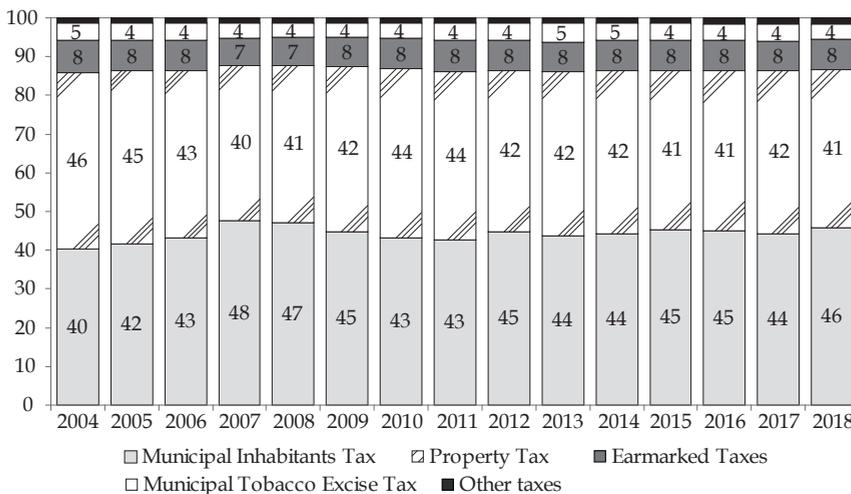


Fig. 3. Municipal tax revenues in Japan in 2004–2018, %

Source: authors' calculations according to Financial Statistics of Japan.

Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan.)

ownership and usage of roads. Since 2010, the motor vehicle tax revenues have been declining both in absolute values and in terms of total tax revenues of prefectures.

Municipal tax revenues come from the inhabitant tax and property tax. Until 2006, receipts from the property tax had exceeded those from the income tax but starting from the second half of the 2000s, the situation changed to the opposite. Receipts from the property tax are more stable and their year-to-year variation does not exceed 2–4%.

About 7–8% of municipal tax revenues come from special purpose taxes (hunting tax, city planning tax, onsen (bathing) tax) but the fiscal significance of each of these taxes is comparatively low. As far as special purpose taxes are concerned, local authorities enjoy the most autonomy: they have the right to set local taxes to address the needs of their respective territories.

Tax revenues of prefectures and municipalities are in general quite balanced: revenues of prefectures come from three main sources and those of municipalities, from two. Local taxes are levied on businesses and individuals and the taxation base comprises income, revenue, property and consumption.

Receipts from local taxes are more evenly distributed among prefectures than municipalities (Table 6), which can be explained by the significance of tax revenues in the capital's budgets: 79% of local expenditures of Tokyo Metropolis are covered by the receipts from local taxes.

If we compare budgets of municipalities and prefectures, including Tokyo, we will see that the average significance of local taxes for covering expenditures will be the same – 30%. A smaller share of tax receipts in the expenditures of local budgets in comparison with revenues is explained by the fact that a considerable part of expenditures is covered by the bonds issued by local authorities. This figure, however, varies across prefectures more significantly than across municipalities. Since tax revenues are not equally distributed among the territories, it becomes necessary to provide regular grants to local governments for fiscal equalization.

Table 6
Share of revenue sources in local budgets in 2016

| Indicator | Share in local budget expenditures, % | | |
|---|---------------------------------------|-----|-------------|
| | Local taxes | LAT | Local bonds |
| <i>1. Prefectural budgets (including Tokyo)</i> | | | |
| Maximum value | 79 | 40 | 18 |
| Minimum value | 13 | 0 | 2 |
| Mean value | 32 | 24 | 13 |
| Standard deviation | 13 | 10 | 3 |
| Covariance | 42 | 39 | 24 |
| <i>2. Prefectural budgets (excluding Tokyo)</i> | | | |
| Maximum value | 62 | 40 | 18 |
| Minimum value | 13 | 4 | 5 |
| Mean value | 30 | 25 | 13 |
| Standard deviation | 11 | 9 | 3 |
| Covariance | 37 | 36 | 20 |
| <i>3. Municipal budgets</i> | | | |
| Maximum value | 50 | 34 | 14 |
| Minimum value | 16 | 1 | 3 |
| Mean value | 30 | 19 | 9 |
| Standard deviation | 9 | 8 | 2 |
| Covariance | 29 | 43 | 21 |

Source: authors' calculations according to *Japan Statistical Yearbook 2020*. Statistics Bureau, Ministry of Internal Affairs and Communications of Japan. Available at: <https://www.stat.go.jp/english/data/nenkan/69nenkan/index.html> (In Japan.).

5. Redistribution of national tax receipts as grants to local governments

Even though the revenue base of local governments is considered quite balanced, a considerable part of the taxes is levied on the central level and then transferred to prefectures and municipalities in the form of financial assistance (grants). Grants are usually distinguished from tax revenue. But as most countries rely on taxes for the central government's revenues, transfers from higher level budgets are in fact also tax revenues; these revenues are for the most part independent of the territories that receive them. Although in many countries these considerations are of theoretical rather than practical nature, the Japanese system of local governments' revenues reveals the connection between grants from the central budget and the tax revenues of this budget.

The local allocation tax (LAT) is paid annually to the budgets of prefectures and municipalities to adjust the fiscal imbalance among local governments. Despite its name, the LAT is actually a transfer of a fixed sum from the central to the local budget. In 2017, this sum included 33.1% of the income tax and corporate tax revenues, 50% of the alcohol tax and 22.3% of the consumption tax⁵. Thus, local govern-

ments are provided with the basic level of revenues to maintain the level of public services according to the unified national standards. As a result, the revenues of local budgets are more or less equal regardless of the territories' population size.

Figures 4 and 5 show tax revenues and financial assistance per capita from the central budget to prefectural and municipal budgets in the ascending order.

Figures 4 and 5 demonstrate the results of fiscal equalization per capita. The biggest imbalance in terms of local tax revenues is characteristic of prefectural budgets (the ratio of the standard deviation to

⁵ *White Paper on Local Public Finance, 2019*. Ministry of Internal Affairs and Communications of Japan. Available at: https://www.soumu.go.jp/iken/zaisei/31data/chihouzaisei_2019_en.pdf (In Japan.)

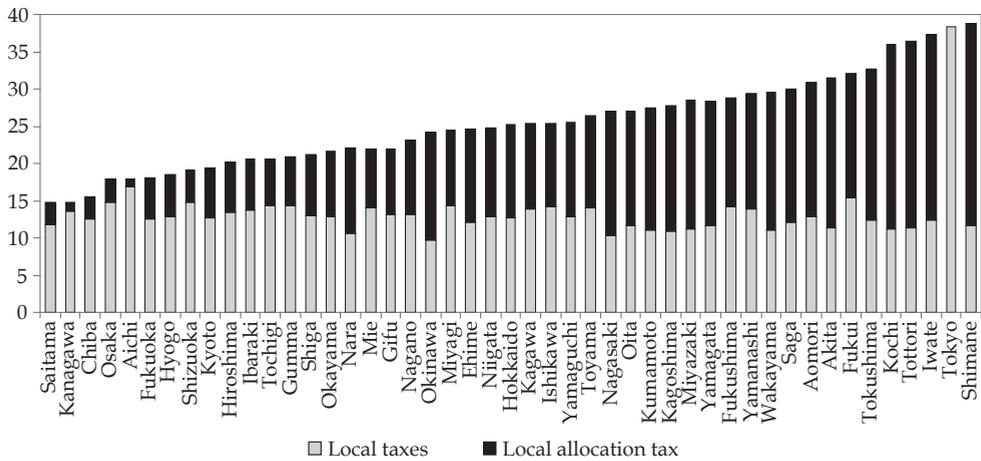


Fig. 4. Local taxes and LAT to prefectural budgets of Japan per capita, in 2016

Source: authors' calculations according to Japan Statistical Yearbook 2020. Statistics Bureau, Ministry of Internal Affairs and Communications of Japan. Available at: <https://www.stat.go.jp/english/data/nenkan/69nenkan/index.html> (In Japan.)

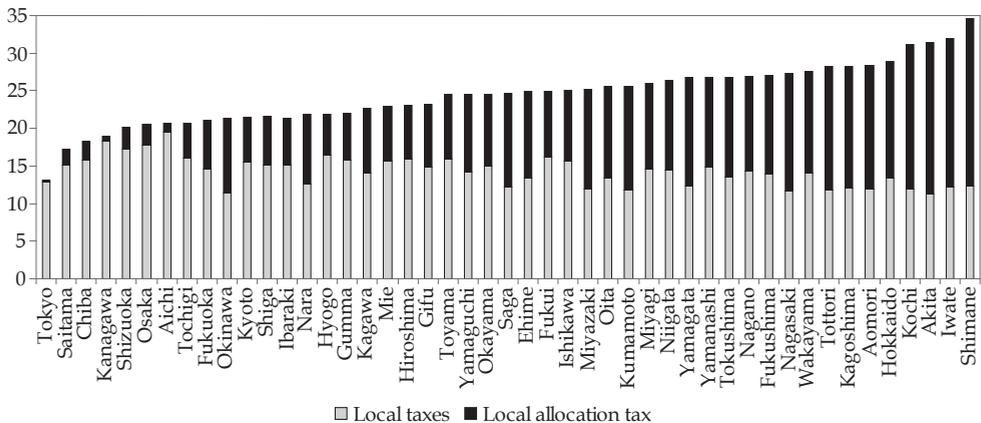


Fig. 5. Local taxes and LAT to municipal budgets of Japan per capita, in 2016

Source: authors' calculations according to Japan Statistical Yearbook 2020. Statistics Bureau, Ministry of Internal Affairs and Communications of Japan. Available at: <https://www.stat.go.jp/english/data/nenkan/69nenkan/index.html> (In Japan.)

the mean value per capita was 34% in 2016). After fiscal equalization, the corresponding per capita indicator, which takes into account local tax revenues, national tax revenues transferred to local governments and the LAT, was 23% for prefectures and 18% for local budgets in total.

Even though the LAT is more significant for prefectures than for municipalities (Table 6), the biggest differences in the share of expenditures covered from this source are characteristic of municipalities. This can be explained by the uneven distribution of revenues among cities, towns and villages.

In 15 prefectures, the LAT covered from 30 to 40% of local expenditures; in 14, from 10 to 20%. The budget of Tokyo Metropolitan Government does not rely on LAT grants. The share of the LAT in the expenditures of consolidated municipal budgets within one prefecture exceeded 30% only in three prefectures, while in 24 prefectures, it was less than 20%. These figures point to the fact that on average, in comparison with prefectures, in municipalities the LAT covers a smaller share of expenditures.

Table 7

National tax revenues transferred to local budgets in Japan

| Year | Share of the LAT in national tax revenues, % | Share of local tax revenues and tax revenues transferred to local budgets in total tax revenues (taking into account fiscal equalization), % |
|------|--|--|
| 2006 | 31.2 | 63.5 |
| 2007 | 28.9 | 60.5 |
| 2008 | 32.1 | 64.0 |
| 2009 | 33.1 | 63.7 |
| 2010 | 38.7 | 67.3 |
| 2011 | 38.5 | 67.4 |
| 2012 | 37.1 | 66.1 |
| 2013 | 34.5 | 64.0 |
| 2014 | 31.5 | 61.6 |
| 2015 | 27.9 | 58.4 |
| 2016 | 28.3 | 59.2 |
| 2017 | 26.6 | 57.6 |
| 2018 | 25.5 | 56.7 |

Source: authors' calculations according to *Financial Statistics of Japan*. Available at: https://www.mof.go.jp/english/pri/publication/financial_statistics_of_japan/index.htm (In Japan).

In 2008–2013, local governments received about a third of national tax revenues through LAT, and in 2018, a fourth. Table 1 showed that in comparison with other countries, Japan has the largest share of tax revenues going to local budgets. However, if we also take into account those tax revenues that are transferred to local governments as financial assistance, the distribution of tax revenues in Japan will appear even more decentralized: in the first half of the 2010s, the revenues of prefectures and municipalities exceeded 60% of the country's total tax revenue and in 2018, 56.7% (Table 7).

In addition, it should be noted that one more important source of revenues for prefectures and municipalities is local bonds.

6. Conclusions

The system of tax revenues of local governments in Japan has several salient characteristics related to a complex configuration of centralisation and decentralisation, which have taken different forms at different stages of historical development. In the second half of the twentieth century, the fiscal aspects of local governance underwent serious transformation. Specific functions were assigned to different levels of government, tax sources were allocated to local budgets, and the decentralised system of public finance was established. These arrangements, however, did not eliminate centralisation, since they also included instruments of administrative control over local authorities. In the post-war period, the expenditures and revenue figures for prefectures and municipalities were quite similar. In the early twenty-first century, after a round of municipal mergers, the share of municipalities' expenditures and revenues grew in comparison to prefectures. Eventually, Japan became a country with the largest share of tax revenues transferred to local governments, compared to other unitary states.

The financial endowments of local authorities in Japan are equalised through annual payments in the form of the LAT to local governments. The LAT comprises

approximately a fourth of prefectural and a fifth of municipal revenues. Such design of financial equalisation, combined with the active use of borrowing, explains why other grants play a comparatively small role in local tax revenues. This fact can also be regarded as an indirect evidence of the relative stability of local tax revenues in Japan.

In the early 2000s, the system of public finance faced serious challenges, such as slow economic growth, population decline and ageing, concentration of people in several large cities, and the outflow of population from most provincial territories. The results were a growing budget deficit and the shrinking capacity of the central government to subsidise local budgets. This situation led the government to rebuild the mechanism of budgeting, both at the national and local levels. The reform of inter-governmental fiscal relations that was finalised in 2003 addressed these problems by cutting central subsidies, reducing the amount of revenue redistribution, and enhancing the financial capacity of local governments. The goals of the reforms were achieved only at the level of prefectures while municipalities became even more dependent on national grants. Therefore, municipalities have had considerably fewer opportunities for strengthening their governing capacity and becoming more self-sufficient than prefectures. This implies that different approaches are necessary to reforming municipal and prefectural budget systems.

The natural disasters that hit Japan in the 2010s highlighted the need to preserve the centrally-controlled elements in the country's system of public finance. The choices that Japan made in the aftermath of these disasters regarding centralisation and decentralisation of state governance will affect, in all likelihood, the policies of other countries when faced with the threat of a global pandemic.

In Japan, the central and local governments share tax bases. The taxing powers of local governments are limited by the standard tax rates set at the national level. Such division of tax sources

creates vulnerabilities in periods of economic instability but helps in facilitating tax administration. Since the beginning of the 2010s, as part of tax reforms, some business taxes have been transferred from the local to national level due to the unequal distribution of the tax base across provinces.

For prefectures, the main sources of revenues are the inhabitant tax, local consumption tax, and enterprise tax. These taxes usually have the same significance for prefectural budgets. For municipalities, the primary sources are the local inhabitant tax and property tax. Tax revenues of prefectures are generally lower than those of municipal governments. Although local tax revenues have a similar average significance for prefectural and municipal budgets, prefectures have more substantial differences in terms of local tax revenues.

Financial assistance to local governments is mostly channelled through the LAT, which is a transfer of a fixed amount of national tax revenue to the budgets of prefectures and municipalities. The LAT provides effective equalisation of local revenues per capita and is more important for prefectures than for municipalities. Taking into account LAT payments, subnational budgets in Japan received about 60% of total tax revenues in the first half of the 2010s, with the reduction of this share in more recent years. In addition, prefectures and municipalities covered about 10% of their expenditures by issuing local bonds.

Even a limited endorsement of the Japanese tax system is hardly feasible in different national settings. At the same time, the experience of Japan is worth consideration, especially regarding the revenue base of local governments. An interesting subject is the set of limitations of local taxing powers by the national government, while another remarkable trend is that of municipal mergers aimed at ensuring a balanced regional development and equalising the distribution of tax revenues. The analysis of these matters can help show the theoretical and practical relevance of our study.

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