

DISTRIBUTIVE IMPACT AND EVALUATION OF DEVOLUTION PROPOSALS IN JAPANESE LOCAL PUBLIC FINANCE

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The purpose of this paper is to examine the redistributive effects of interregional transfer of local taxes and grants from central to local government. We also examine the redistributive impacts of change in the taxes and grants. Especially, we focus on the impacts of the devolution of tax items to local governments.

The devolution of tax items is a controversial issue to consider within the decentralization of Japanese local public finance. The local public sector, including the 47 prefectures and 3232 municipalities, spends 74.4% of the total public expenditure. On the other hand, the share of tax revenue in the local governments is 38.9%. The taxable items and their rates that can be chosen by the local governments are highly restricted by the Local Tax Law. Under this fixed local tax system, there is an imbalance between the local tax revenue and the expenditure in many local governments. These imbalances are compensated by the grants from the national government.

To decentralize the fiscal system, it has been pointed out that the tax item should devolve to the local government and that the grants from central to local governments should be reduced. In 1997, *The Second Recommendation Report* submitted by the Committee for the Promotion of Decentralization argued that the local taxes should be completed to reduce the imbalance between public expenditure and tax revenue in local governments.

However, the devolution of tax instruments, such as income tax, may increase the income inequality among the regions. The devolution of tax items involves the reduction of grants under the fixed tax burden. A decrease in the grants that are intended to equalize the fiscal capacity among regions will also increase inequality among local governments.

Therefore, it is necessary to identify the distributive aspects of various devolution proposals for local taxes and grants. Based on this identification, the impacts of the proposals should be evaluated in terms of equity.

To understand how the income distribution is affected by local taxes and grants, we compare the original pre-tax and -benefit income of individuals with their final income, including the net transfer induced by the taxes and grants. Redistributive effects are measured by the Reynolds-Smolensky index. According to Lambert (1993), we decompose the Reynolds-Smolensky index into Kakwani indices, average tax rates and the reranking term.

First of all, the Reynold-Smolensky index for 1994 data is computed as the bench mark, and is decomposed into the Kakwani indices and the reranking term. We find the following facts from these results: (1) the allocation of the grants and the national tax burden decreases inequality of the final income between the prefectures; (2) under the present allocation of the grants, there is the reranking effects which reduce the redistributive impact; and (3) the revenue and burden of the local taxes have negative impacts on the income inequality, which are mainly induced by the enterprise tax on corporation by the tax shifting.

Next, starting from the present situation, we consider the impacts of the following reforms: an increase in the local taxes, a change in the allocation scheme for grants, and decentralization caused an increase in local taxes and a decrease in grants. Our results show that the allocation scheme of the grants plays an important role in the evaluation of the devolution proposal. If we intend to devolve the tax items such a way that the redistributive impacts of the fiscal transfer system remain the same as under the present scheme, the present allocation of grants must be altered to strengthen the redistributive impact. However, an increase in the redistributive impact of grants may have negative effects on allocative efficiency due to the local governments' behavior. In this sense, we are faced with the trade-off between efficiency and equity.

Some empirical results related to the production efficiency of Japanese local governments suggest that the rich regions have higher efficiency than the poor regions. From these results, we can predict that the redistributive impacts may be smaller than the results presented in this paper. If a devolution proposal has an incentive to improve production efficiency in the poor regions, social welfare may be improved.

