THE GLOBAL URBAN ECONOMIC DIALOGUE SERIES

FISCAL DECENTRALIZATION
IN JAPAN

UN-HABITAT
FOR A BETTER URBAN FUTURE

FISCAL DECENTRALIZATION
IN JAPAN

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Fiscal Decentralisation in Japan

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P. O. Box 30030, 00100 Nairobi GPO KENYA
Tel: 254-020-7623120 (Central Office)
www.unhabitat.org

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Acknowledgements:

Director: Naison Mutizwa-Mangiza

Chief Editor and Manager: Xing Quan Zhang

Principal Author: Nobuki Mochida

Contributor: Jaana Mioch

English Editor: Roman Rollnick

Design and Layout: Peter Cheseret

FOREWORD

Urbanization is one of the most powerful, irreversible forces in the world. It is estimated that 93 percent of the future urban population growth will occur in the cities of Asia and Africa, and to a lesser extent, Latin America and the Caribbean.

We live in a new urban era with most of humanity now living in towns and cities.

Global poverty is moving into cities, mostly in developing countries, in a process we call the *urbanisation of poverty*.

The world's slums are growing and growing as are the global urban populations. Indeed, this is one of the greatest challenges we face in the new millennium.

The persistent problems of poverty and slums are in large part due to weak urban economies. Urban economic development is fundamental to UN-HABITAT's mandate. Cities act as engines of national economic development. Strong urban economies are essential for poverty reduction and the provision of adequate housing, infrastructure, education, health, safety, and basic services.

The *Global Urban Economic Dialogue* series presented here is a platform for all sectors of the society to address urban economic development and particularly its contribution to addressing housing issues. This work carries many new ideas, solutions and innovative best practices from some of the world's leading urban thinkers and practitioners from international organisations, national governments, local authorities, the private sector, and civil society.

This series also gives us an interesting insight and deeper understanding of the wide range of urban economic development and human settlements development issues. It will serve UN member States well in their quest for better policies and strategies to address increasing global challenges in these areas

Joan Clos
Under-Secretary-General of the United Nations, Executive Director, UN-Habitat

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CHAPTER 1 **STATUS OF LOCAL GOVERNMENT**

Virtually all countries in the world, whether explicitly federal or not, exhibit a degree of decentralization, and to that extent they share a number of common problems. How much responsibility for expenditure programmes should be given to sub-national governments? To what extent should they finance those responsibilities from own source revenues? How far should the central government go in equalizing disparities in sub-national fiscal capacities? What controls might be used to ensure responsible fiscal conduct, including with respect to borrowing obligations? While the answers to these questions are to some extent country-specific, there are a number of underlying principles that can be used to inform them. Indeed, while this paper is a case study of the evolution of multi-level fiscal decision-making in Japan, it would contains many lessons for other countries of different characteristics.

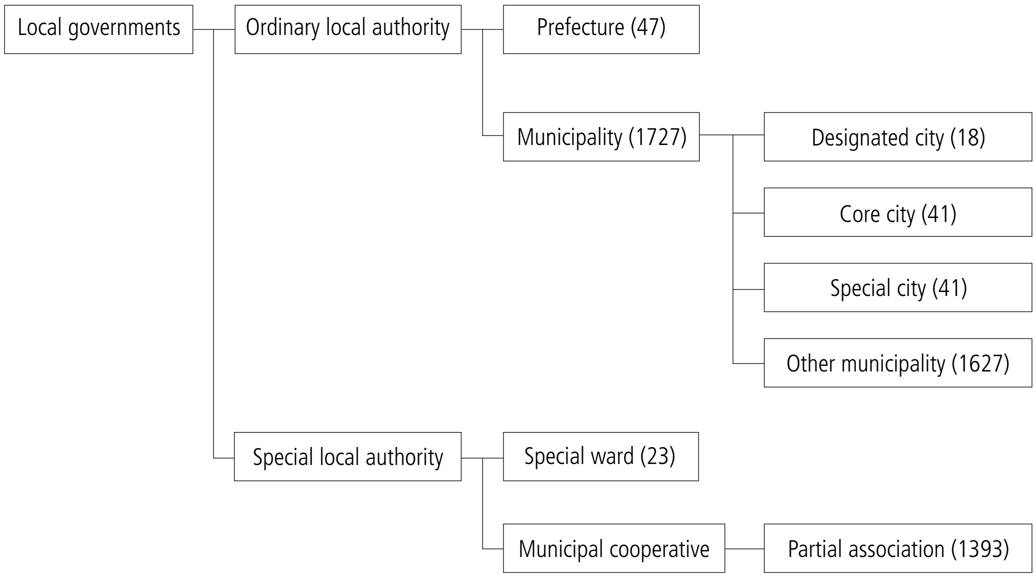
Jurisdictions

Japan's local autonomy has been guaranteed by the Constitution after the Second World War. The post-war Constitution of Japan has a chapter on local self government (Article 92). The chapter states that regulations concerning organization and operations of local public entities should be fixed by law in accordance with the principle of local autonomy. The new Constitution articulates the government's responsibility in maintaining the minimum standard of living and decent life. Especially, the modern development of redistributive policy in Japan is based on the following article 25 of the Constitution:

> *(1) All people have the right to maintain the minimum standards of wholesome and cultured living. (2) The state must make efforts to promote and expand social welfare, social security and public health services to cover every aspect of the life of the people. [Article 25]*

Normally, the constitution cannot specify details of tax and expenditure assignment to each level of government. This task is left for laws on local taxation, such as the Local Finance Law in Japan. Among many laws regarding fiscal issues, the Local Tax Law of Japan has been main piece that governs the division of taxing powers. The rules specified in these laws have ensured the stability and predictability of local budgetary expenditure.

Figure 1 Classification of local Governments



Source: Ministry of Home Affairs and Communicatio (2011) *White Paper on Local Public Finance*, table 1

In Japan the government sector is stratified into several levels, each having responsibility for a particular set of public functions. The main levels of the Japanese government are the national, the prefectural, and the municipal governments. The last two are called 'local governments', while the first is referred to as the 'national' or 'central' government. On the sub-national level, Japan has a so-called two-tier system of local governments. Figure 1 shows that the total number of prefecture, 47, has not changed since the prewar period except for the addition of Okinawa. On the other hand, there are 1727 municipalities, consisting of 785 cities, 750 towns and 192 villages (in March, 2011). The number of municipalities in Japan is much less than in France, Germany, USA, and Canada, but more than in United Kingdom and Sweden (Policy Research Institute, Ministry of Finance 2002). Average population per local authorities in Japan is 39,000, which is considerably in excess of the number found in average OECD countries, except for UK (Shah 2006:28-29). These numbers have been achieved by several waves of mass amalgamation. We often refer to prefectures and municipalities jointly as 'local public bodies'.

The origin of a modern local government system in Japan can be dated to 1890s. In about 1890, a highly centralized system was created in Meiji, Japan, which was based on the German model(Muramatsu and Iqubal 2001). Gradually, political parties mobilized the residents, using local councils to enhance local democracy and to express local interests to the central government in the 1920s. Despite the progress and attempt toward decentralization in 1920s, wartime mobilization completely recentralized the country.

The process of developing the local finance system in post-war Japan was initiated by the US. In this regard, we must stress the significant role of the 1949 Shoup Mission in shaping the local finance system in post war Japan. Thus, the entire intergovernmental fiscal relations were fully reconstructed, producing epoch-making changes. However, ideal local finance system achieved by the initiative of US influence was of temporary duration: many of the elements were modified soon after their enactment. For one thind, the US's proposed "layer cake" model, in which the functions of the central government and local governments are clearly demarcated, was not to be realized as it intended (Mochida 2008).

In this way, Japan mixed the pre-war centralized system with the decentralized in a distinct manner. On the whole, the intergovernmental system continued to feature strong centralized elements. However, local passive attitude were temporarily dropped in response to the urban congestion and environmental pollution. In the 1970s, Japan experienced a case of conflict between the central and local governments. Two factors defined this new era of central-local relations: the mushrooming of residents' movements, and the increase in opposition control of local government. Furthermore, local policy initiative had reverse impact on national policy outcomes during this time (Muramatsu and Iqbal 2001:12-15). Japanese local government responded by expanding its role as policymaker in environment, city planning, welfare on its own, as well as in its role as an agent of the central government.

In the 1980s, however, the Japanese government faced a new challenge: fiscal stress. Massive expansionary fiscal policy after oil shocks left fiscal deficit in its wake. The second reason explaining the increase in fiscal deficit relates welfare state construction. In the late 70s, Japan did catch up with the Western level of social welfare programme in public pension, medical care etc. The Second Provisional Administrative Reform Commission (SAPARC) assumed the responsibility for tackling this issue, and it succeeded to a significant degree in attaining its goal through the privatization of large government cooperation. In contrast to previous decades, they were now urged to prioritize and downsize public expenditures. The commission also recommended decentralization as a way to rationalize expenditures and reduce fiscal pressures (Muramatsu and Iqbal 2001:16-18).

On the other hand, public statement claim that Japan's centralised system of government eventually be unable to resolve issues generated by economic globalization and the fiscal stress caused by post-bubble economic blues. Reflecting these general outcries, the Murayama government finally enacted The Law for the Promotion of Decentralization, on May 15, 1995 and Koizumi government lauched an ambitious reform of the three components of local government financial resources - earmarked grants, local taxes and the local allocation tax – the so called "Trinity Reform" during 2004-2006. The question of decentralization and deregulation has developed into one of the most contentious political issues in Japan.

Economic Weight

In virtually every country, some amount of decentralized fiscal decision making is a fact of life. Lower-level jurisdiction- be they state or provinces, prefectures or regions, cities or municipapities- are typically given responsibility for delivering some of most important public services, such as schools, health service and social services. How important are local governments in Japan? Table 1.1 presents a quantitative approach to this question based on national account data for FY2008.

Table 1 Income and expenditures of Japan's local governments, 2008

	Amount (trillion yen)	percentage of GDP	percentage of general government
total expenditure	93.8	19.1%	54.20%
final consumption	26.5	5.4%	67.60%
social transfer in kind	40.1	8.2%	79.10%
social benefits	8.7	1.8%	16.60%
investment	12.3	2.5%	74.0%
total income	90.8	18.5%	40.40%
taxes	40.0	8.1%	46.10%
transfers, receivable	28.1	5.7%	60.90%
social contribution	20.1	4.1%	35.0%
balance	0.8	0.2%	-

Source: national accounting data
Note1:local government is defined as prefectures plus municipalities.
2: including national health insurance and long term-care insurance managed by municipalities.

Several important points emerge. First, subnational government income and expenditures represent about 19.1 per cent of gross domestic product(GDP) in Japan. Second, in expenditure terms, the weight of local governments is about half that of the general government. Third, local taxes cover about 44 of local government expenditures and represent, therefore, about 8.1 per cent of GDP. Fourth,as a cosequence, transfers from the central government to local government account for about 5.7 per cent of GDP and cover 30 per cent of local government resources. Fifth, local governments invest 74 per cent of general government's investments. Finally, local net lending is small relative to central governmet net lending, but indebteness is as much as the central government. Relying on these quantitative data, Japan does not seem to match the standard model of a centralized country at all, where relatively weak subnational governments are assigned limited expenditure and revenue responsibilities.

CHAPTER 2 **LOCAL GOVERNMENT FUNCTIONS**

EXPENDITURE BY FUNCTION

The efficiency arguments for decentralizing the provision of public services and targeted transfers are fairly strong: decentralization will enable public services, even those of national importance, to be tailored to local preference. The issue is the allocation of function between different level of governments. Which functions should the lower-level jurisdictions be responsible? Table 2 present expenditure by function at different level of governments in Japan. A standard classification of government expenditure by function in the IMF's *Government Finance Statistics Yearbook* framework is not available for Japan's local governments. Table 2 compiles such data on the basis of expenditure categories used in Japanese budgetary statistics. This table only illustrates an approximate order of magnitude of central and local expenditures shares.

Several important points emerge. First, the weight of local government's total spending exceed that of central government since FY1953. Second, local governments play a big role in infrastructure (roads, parks, bridge, port and harbours etc.), compared with other industrial coutries. Local governments spending on infrastructure has declined somewhat since the mid-1990s, but remains high by the standards of the Organisation for Economic Co-operation and Development (OECD). Third, a significant portion of local governments spending are not for public good but for quasi-private goods, what are referring to as 'public services'(Boadway, Shah 2009:138). Large-scale expenditure programmes involving education, health, social security, welfare and housing are of this sort.

Given the essentially private nature of these services, one cannot rely on traditional efficiency-type market failure arguments to justify public responsibility for their provision. Instead, the public sector assumes responsibility for providing public services largely for redistributive reasons. Public services are delivered to household on an individual basis. The case for decentralization rest on the argument that this delivery is more efficiently accomplished if it is the responsibility of a lower level of governments. However, there is tention between the desire to decentralize fiscal responsibility and the desire to maintain central control.

Table 2 Expenditure by function and level of government, FY2009 (JPY billions)

	gross expenditure		transfers		net expenditure			
total expenditure	Central[3] (A)	Local (B)	from Central (C)	from Local (D)	Central (A) - (C)	Local (B) - (D)	Central %	Local %
General public sevice, Public order, and Safety	5,074	16,516	1,769	0	3,305	16,516	17%	83%
Defence	4,831	0	32	0	4,799	0	100%	0%
Education	5,869	16,418	2,877	0	2,992	16,418	15%	85%
Health, welfare[1]	30,424	27,835	8,791	0	21,633	27,835	44%	56%
Industry	9,100	7,735	441	0	8,659	7,735	53%	47%
Infrastructure	9,433	14,642	2,914	1,283	6,519	13,359	33%	67%
Debt service	18,444	12,884	11	0	18,433	12,884	59%	41%
Local finance[2]	17,766	0	17,578	0	188	0	100%	0%
Other	4,757	76	4	0	4,752	75	98%	2%
Total	105,698	96,106	34,417	1,283	71,280	94,822	43%	57%

Notes: 1. excluding pension, health insurance, 2. Local Allocation Tax, 3. general account plus special accounts other than social security
Source: Ministry of Home Affairs and Communication(2011), *White paper on Local Public Finance*, table32.

EXPENDITURE RESPONSIBILITY

In most nations with multiple levels of government, some mechanisms are in place by which national governments can influence how lower-level gevernments design their programme. In Japan, the law allows the central government to influence lower-level government spending decisions through conditions imposed on transfer from central governments. The 1949 Shoup Mission's proposed "layer cake" model, in which the functions of the central government and local governments are clearly demarcated, was not to be realized as is. It is difficult to identify a policy area in which only one level of government is involved. The activities and finances of the central and local government have gradually become intertwined. The most important step away from layer cake model was the amendment of Local Finance Law in 1952, which established so-called "cost-sharing grants."

POLICE AND FIRE SERVICE

Prefectures are responsible for setting up police organization (Police Act 36). It is not delegated from the central government. It could be seen as 'local police' on the surface. However, at the center of Japan's police system is the National Police Agency, which is under the National Public Safety Commission, an extra-ministerial bureau of the Cabinet Office. The prefectural police headquarters are directed and supervised by the National Police Agency. Prefectural top official being ranking higher than Chief Superintendent is national government employee. In realty, the prefectural police is mixture of national police and local police. Municipalities are responsible for fire fighting (Fire Service Act 6). National government and prefectures do not assume responsibility for it, then have no regular authority over municipalities.

EDUCATION

All three levels of governments are very much involved in education. The basic division of labor is that municipal governments are responsible for developing and maintaining the physical stock of capital (namely, the school buildings), prefectural governments are responsible for labor (namely, for recruiting, monitoring, promoting, and paying for teacher's salary), whereas the central government is responsible for setting service standard and curriculum.

Specific grants are made conditional on local governments complying with strict and detailed operational standards. For one thing, salaries of teachers in Japan are born by the central government and prefectural governments with 50: 50 sharing ratio. Since allocation of teachers and the number of students per class are clearly spelled out in the national law, local governments face difficulties in hiring teachers of English. For another, under the law on State Subsidies on Expenditure on Facilities for Compulsory Education, half of the construction costs of school building are paid by the central government if the recipients comply with rather strict conditions, such as floor size, availability of various rooms, equipment and distance from the students' home.

INFRASTRUCTURE

Public investment in terms of GDP ratio is about twice as much as OECD average. Local governments have played major role in infrastructure investments, accounting for 73 per cent of general government's investment. Public investments at lower-level governments includes infrastructure, such as road, river management and sewers. But it is heavily used as a policy instrument for economic stabilization and redistribution of income among regions in Japan. Per-capita public investment in low-income prefectures is twice that of high-income prefectures, despite much higher rate of return in the latter (OECD 2005:113-114).

There are three sources of financing for public investment: budget income; the FILP programmes; and earmarked taxes. Fiscal equalization grants and specific purpose grants constitute budget income. The specific purpose grants are not only earmarked to specific areas (e.g. public works) but they are made conditional on local governments complying with strict and detailed operational standards. Mihaljek (1997) noted that in the case of public construction work in general, even the brands of construction material and parts were sometimes specified by the central government.

In addition, some programme, especially roads, has been financed directly by earmarked taxes since 1954. Taking road construction as an example, earmarked taxes such as the motor vehicle tonnage tax, local road transfer tax, light-oil delivery tax, and automobile acquisition tax are the main local revenue sources. Earmarked taxes could enhance efficiency if properly designed by making beneficiaries pay part of the cost, but is would result in resource misallocation if the level of investment is determined by such tax revenues. Actually, these earmarked taxes were abolished in FY2009 in view of resource misallocation problems.

HEALTH INSURANCE

Local governments manage the two type of social insurance: public health insurance and long-term care insurance. The National Health Insurance (*Kokumin kenkohoken*) is a system of regional based health insurance managed by municipalities. It was established in 1939 to cover the self-employed, farmers, workers of smaller firms and their families as the insured, accounting for about one-third of the total population. After being restructured in 1958, the NHI has played a fundamental role in providing universal medical insurance in Japan. Since the NHI covers relatively low-income earners and has no employer fund, one-half of its insurance benefits must be subsidized by the national government. Since municipalities have discretions over the premium schedule, the premiums for the NHI differs across municipalities, even though patients of comparable characteristics receive comparable medical services at identical out-of-pocket expenses.

LONG-TERM CARE INSURANCE

As Japan is rapidly aging, the number of elders who need care is expected to grow. The long-term care insurance system (*Kaigo-hoken*), which was introduced in 2000, is intended to insure against expenditures for the long-term care. Today, the number of persons insured and beneficiaries of the programme reaches 69 million and 3.9 million respectively. Insurers are municipalities. The LTCI covers those who are aged 65 or older (Type 1) and those who are aged 40 to 64 (Type 2). Insured persons belonging to Type 1 are qualified as beneficiaries. The municipalities determine the appropriate category based on the applicant's need and then notify the applicant of its decision. There are three source of financing for long-term care insurance: out-of-pocket expense, premium and budget income. Users are responsible for paying 10 per cent of cost. Half of the rest resources is financed by premiums paid by insured persons. Remaining 50 per cent of cost is funded by transfer from the central government (25 per cent), prefectural governments (12.5 per cent), and municipalities (12.5 per cent).

WELFARE ASSISTANCE

Public Assistance for the Poor (*Seikatsu-Hogo*) is major means-tested in-cash benefit available to households, whose income falls below the minimum standard of living. The minimum cost of living set by the central government is compared with applicant's income, and if income does not meet this standard, the difference is compensated by in-cash benefits. Minimum standard of living depends on a number of factors including household size, ages of household members, and location of residence. Caseworkers are responsible for conducting surveys of applicants' income and assets (means-test) and certifying them as being eligible for benefits. The applicants are required to full utilize or exhaust their resources available. Because of the recession after Lehman's fall, the number of recipients hits a post war record: 2 million. The central government takes on three-fourths of the total cost through grants, whereas local governments born remaining one-fourth by general revenue sources. Regional differences in take-up rate are large; however, it reflects economic and social factors such as unemployment rate, number of elderly, and divorce rate which are beyond the control of local governments themselves.

CHAPTER 3 **LOCAL OWN REVENUES**

GENERAL MATTERS

Japan's local governments collect about 8.1 per cent of GDP in taxes(see, table 1). There are about a dozen local taxes. Before discussing in turn the most important of these local taxes, we must consider a few general issues.

SHARED TAX BASES

Different level of governments have access to same tax bases. There are few 'shared taxes' in the sense of taxes shared between the central governments and sub-national governments. What are 'shared' here are not tax proceeds but tax bases. Both central government and local governments tax on personal income, corporate income and consumption. Consider, for instance, value added tax (*shohi-zei)*. Let us assume that tax base, here final consumption, is 100 of JPY. The central government will tax on a rate of 4 per cent, prefectures on a rate of 1 per cent. Then, consumer will pay 4 JPY to the central government and 1JPY to the prefecture at the cash register. In practice, however, there are probably few taxpayers who know which governments are receiving the local component of VAT they pay. This approach does not induce accountability.

As a result of shared tax bases, local taxes disperse its bases widely across income, consumption and property. This is apparent from table3.2. It contrasts sharply with single local tax system established in UK and Nordic countries etc. This system of tax base being dispersed has some advantages. First, to some extent it can alleviate regional disparity (Policy Research Institute, Ministry of Finance, 2002). Distribution of corporate income taxes is skewed toward urban areas,while the distribution of personal income and consumption tax is relatively even across localities. Second, it can also make cyclical fluctuation more smooth. Corporate income tax varies greatly in response to business cycles, however revenues from consumption and property tax are more stable (OECD, 2005; Mochida, 2001).

Third, the system of tax base being dispersed can make tax burden proportional to residents' income. Taxes on consumption tax and property for residences is relatively regressive to income, but it is mitigated by income tax with progressive rate structure. Boadway, Hobson and Mochida(2001) verified that residence-based local taxes are in proportional to income. However, dispersed tax bases is far from simple. The number of different taxes is too large, and the taxes levied is not a kind that can be readily understood by tax payers. The link between tax paid and public services received is less visible for the local residents in Japan (Mochida and Lotz, 1999).

TAXING POWER OF LOCAL GOVERNMENTS

Broadly speaking, local government can enjoy freedom in tax matters. The lower jurisdictions set their own tax rate either as surtax on national tax revenues or to apply to the national base, and a higher level of government does sets upper and lower lmits on the rate chosen. In fact, tax revenue share with full or partial discretion on tax rate setting amounts to more than 80 per cent (Blochlinger, Rabesona 2009; OECD 1999) . The share of piggy-backing taxes in terms of revenues is higher than OECD average.

However, local governments do not make good use of these flexibility. The rate of some local taxes are neary uniform across the countries. Personal inhabitant tax, local consumption tax and property taxes are in fact tax sharing.

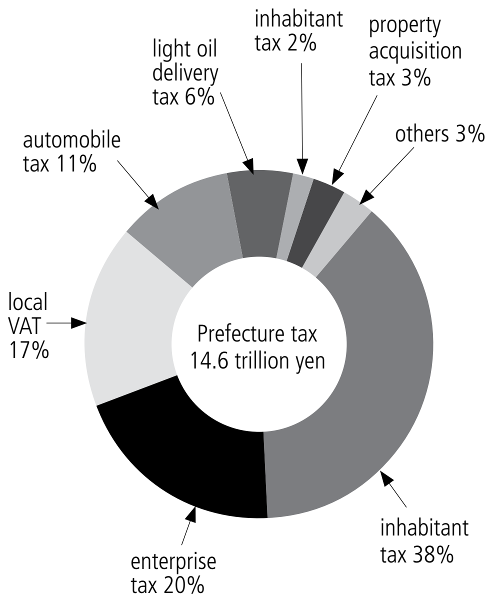
There are a few progress in enhancement of taxing power of subnational governments. First, flexibility of tax rate has been enhanced by the removal of the ceiling (upper limit) on the municipal inhabitant taxes on individuals in 1998 and of the maximum property tax rate in April 2004. Generally speaking, Japanese local governments' discretionary taxing power are higer than in Austratia, Germany, Italy and, until recently, Belgium and Spain. Second, tax autonomy of local governments has been further enhanced by the 2000 Amended Local Taxation Act which enable them to invent and create 'supra-legal taxes' (i.e. taxes not stipulated by national laws, but local ordinance) after consultation with Ministry of Internal Affairs and Communications. Many subnational governments introduce new taxes, including some on nuclear and industrial waste, hotel stays, fishing, holiday house etc. However, several tax experts point problem of 'supra-legal taxes'. These taxes often fall on non-residents or can be shifted on non-voting company and revenues are in many cases low, while obtaining the consent of local residents is time-consuming task.

INDIVIDUAL LOCAL TAXES

LOCAL BUSINESS TAX

Local business tax (*Jigyo zei*) has been the most important prefecture tax in Japan, and it still is, despite recent reform in its tax bases. Figure 2 shows that they constitute 30 per cent of prefectural tax revenues. Until 2004, local business tax has been imposed on income (profit) of firms and deducted from national corporate income taxes. Beginning in April 2004, the local tax imposed on corporations with capital of more than JPY 100 million will be altered to include both a value added component and a capital component. The value added tax bases is the sum of wages, net interest paid, net rents paid, and taxable income (profit) and the capital base consists of paid in capital plus capital surplus. The larger corporations subject to this new tax continue to be subject to local business tax based on their taxable income (profit), but at a reduced rate (maximum of 7.2 per cent, compared with the normal maximum of 9.6 per cent for the local enterprise tax). In addition, however, these larger corporations will now be taxed at rate of 0.48 per cent on value added and an additional 0.2 per cent on capital. The purpose of this new system was essentially to reduce the sensibility of local tax revenues to economic fluctuations, thereby insulating local finace from the effects of Japan's continuing reccesions.

Figure 2 Local taxes in Prefectures, FY2009



Source: Ministry of Home Affairs and Communications (2011) White paper on local public finance, figure29.

Advocates of this new tax support the idea of the 'benefit principle'. To the extent that particular local public service directly benefits business, those firms should pay tax on its value added which reflects business activities. This idea goes back to Shoup Recommendation in 1949. In the case of Japan, Hayashim (2008) estimates that on average close to 16 per cent of prefecture expenditures benefits commercial and industrial activities. This study concludes that the taxes imposed business constitute a higher share than benefits received by business. However, the original proposal was faced strong opposition from business to paying taxes when firms had no profit. Official tax statistics reveal that 1.7 million out of 2.5 million corporations report no profits. As a result of political backlash agaist pro-forma based local business tax, the scope of tax base on value added has been substantially eroded. Mochida (2008) estimates that only 1.1 per cent of total corporations (i.e. 29,000 out of 2.5million corporations) actually pay taxes on value added.

LOCAL CONSUMPITION TAX

Local comsumption tax is relatively new prefectural tax. But it has been third largest tax in prefectural budgets since 1997 as figure 2 demonstrates. Local comsumption tax is essentially local surtax on national VAT. Central government imposes VAT at rate of 4 per cent and local government at uniform rate of 1 per cent. Local component of VAT is collected by prefectures on origin basis. After collecting taxes, each prefecture transfers it among them in proportion to the amount of final consumption, thereby attributing the local VAT to prefectures on destination basis. Each prefecture, however, allocates half of tax received to its municipalities in proportion to the number of population and employees.

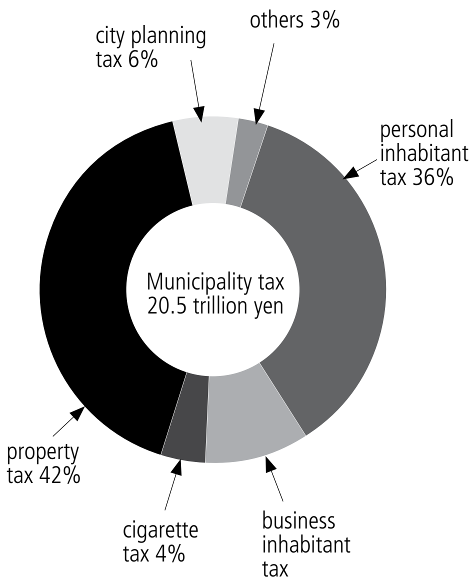
Opponents saw main problems of local comsumption tax to be lack of accountability. Because local comsumption tax relys collection on national tax administration and has no flexibility on tax rate setting, it looks like tax sharing. Local Tax Raw stipulates that tax rate of local comsumption tax is automatically peg to 25 per cent of national VAT rate. Prefectures are discouraged to from increasing tax rate, hoping that the central government will pay a high political price for implementing tax hike. In contrast, local consumption tax has several advantage. It has essentially low sensibility to economic fluctuations, thereby insulating local finace to some extent from the effects of Japan's continuing reccesions. In addition, distribution of tax revenue across the country is more even, compared with other taxes such as local business tax, inhabitant tax (Mochida, Horiba and Mochizuki 2010).

INHABITANT TAX

Inhabitant tax is a basic local tax on personal income for both municipalities and prefectures as figure 3 indicates. In 2009, tax revenue from individual prefectural inhabitant tax was 2,378 trillion yen, and tax revenue from personal municipal inhabitant tax was 5,583 trillion yen. Taken together, inhabitant taxes make up approximately 36 per cent of municipal tax and 38 per cent of prefecture tax respectively.

The inhabitant tax comprises three elements: an income base (tax rates of 10 per cent) levied on the previous fiscal year's income, a lump-sum base, and tax on interest, dividends, capital gains. The minimum amount of taxable income is set lower than that of the national income tax. Each month, a taxpayer pays income tax and personal inhabitant tax to their employer through tax withholding at the source. The employer then delivers the personal inhabitant tax to the municipality in which the employee resides.

Figure 3 Local taxes in Municipalities, FY2009



source: Ministry of Home Affairs and Communication(2011) White paper on local public finance, figure30.

PROPERTY TAX

Entire responsibility for the property tax rest in the cities, towns, and villages, and all the revenue should go to them. The tax is given to the municipalities rather than the prefectures, because the municipalities are more in need of revenue, and because this is one of the few taxes that even the smaller municipalities can administer with a reasonable degree of success. As figure 3 shows, property tax is largest one in own tax revenue of municipalities.

The tax is imposed on capital value instead of on annual rental value at present. One advantage is that the tax be extended to include all depreciable assets of business enterprises, that is, machinery, vats, ovens, and so on, instead of being restricted to land buildings. Such assets cannot well be included in the tax rolls on an annual rental basis. If they were valued on a capital basis and the land and buildings were continued on a rental basis, it would be necessary to distinguish between structures that are buildings (real estate) and those that are not between 'immovables' and 'movables'. This is often a difficult distinction to draw, and the difficulty is indeed one reason why property tax includes all depreciable assets in the tax base.

The other advantage is linked with the consideration for revaluation of business assets. To avoid gross overvaluation by taxpayers seeking to increase depreciation and decrease capital gains under the income taxes, it is desirable that the tax system contain automatic checks. One of these checks is obtained by requiring that the value set for purposes of the land and house tax shall not be less than the value recognized for revaluation under the income tax, minus subsequent depreciation. To obtain this check, the land and house tax must be imposed on capital value, not on real value.

Although the assessment of this tax is local, a uniform system of assessment is applied throughout the country. Almost 178 million lots of land and 61 millions of buildings are regularly reassessed every three years. Municipalities must impose at least a standard rate of 1.4 per cent of capital value, but if they wish can increase the rate up to 2.1 per cent. About 10 per cent of municipalities impose higher rates. The tax is imposed on the owner of the real estate, not the occupier.

CHAPTER 4 INTERGOVERNMENTAL TRANSFERS

TRANSFER TYPES

Japan's local governments receive from the central government about 5.7 per cent of GDP in transfers. There are about a dozen transfers. Table presents composition of transfers by type. Before discussing in turn the most important of these transfers, we must consider a few general issues.

VERTICAL FISCAL GAP

Given the differentials between expenditure responsibilities and revenue raising capacities, the lower level of governments would end up with a deficit and the central government with a surplus. Although the ratio of central to local government expenditure in Japan is 40 to 60, on a final disbursement basis, the ratio of central to local tax collections is the reverse: 60 to 40 for the central government. Table 3 presents a comparison of the intergovernmental transfers in different countries. It confirms that grants play a relatively minor role in the US, Germany, Canada, and Sweden, while its relative magnitude in UK, France, and Japan is high. In spite of access to an uncommonly wide range of revenue instruments, the Japanese system is characterized by a significant vertical fiscal gap.

Table 3 Revenue received by state and local government, FY2010

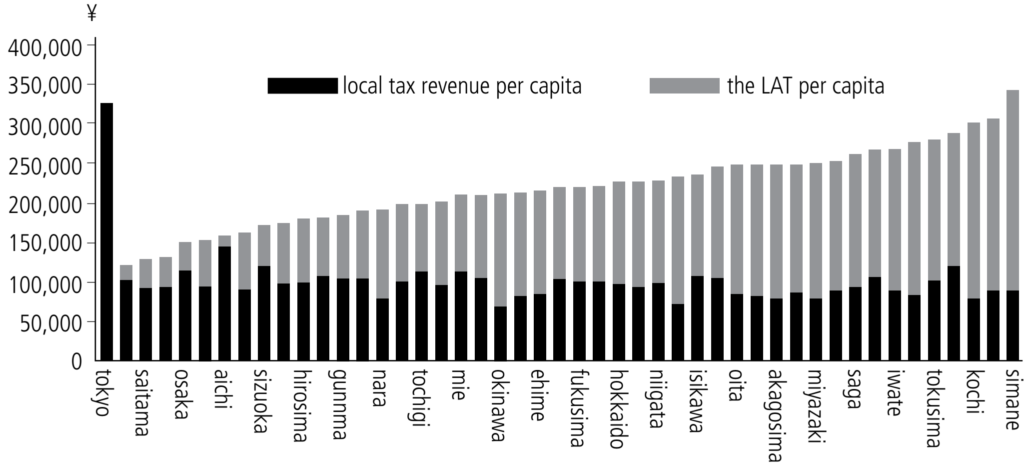
				as % of total revenue
	texes	user fees	grants	others
United kingdom	12	13	73	2
France	35	27	41	7
Japan[1]	45	6	36	13
United states[1]	49	21	24	6
Germany[2]	68	4	18	10
Canada	53	10	21	16
Sweden	62	10	25	3

Note: For federal countries, state governments only, excluding local governments.
1. data for Japan, United states correspons to 200 ; 2. including tax sharing.
Source: OECD and Korea Institute for Public Finance (2011) Institutional and Financial Relations across Levels of Government.

CONDITIONAL OR UNCODITIONAL

A large scale of transfers serves to close this 'fiscal gap'. This occurs explicitly through the Local Allocation Tax as well as Specific Purpose Grants. It also occurs indirectly as a result of local government's piggy-backing on the national VAT and, to all intents and purposes, on the national income tax. As a result of centralized collection but also, *de facto*, in the presence of decentralized collection, there is a significant degree of harmonization in both bases and rate structures.

Figure 4 Contribution of the LAT to reducing regional disparities (per capita, FY2003)



Source: Ministry of Internal Affairs and Communications (2005a) *Annual Report on Local Public Finance Statistics*

The Local Allocation Tax plays a key fiscal equalization role in the Japanese transfer system in Japan. The name of this transfer is somewhat misleading. LAT is not local tax, but essentially a kind of lump-sum unconditional grants. The name comes from common desire of local governments to view it to be 'shared resources'. It is funded out of a revenue pool based on fixed portions of five national taxes, and allocated according to formula based on differences in basic needs and fiscal capacities. The total size of equalization is a fixed portion of national taxes from individual, corporate income, alcoholic, tobacco taxes. The LAT is paid annually to local governments whose basic financial needs exceed basic financial revenues. Those rich localities whose revenue exceeds need are neither eligible for the grants nor liable to contribute money for fiscal adjustment. It is worth noting the extent in which the Japanese equalization system reduces territorial fiscal inequalities is very strong (see, figure 4).

Specific purpose grants are funded out of general revenues. It is essentially a kind of conditional matching grants. Some involve full payment by the national government for functions performed by local governments on behalf of the national government. Some involve substantial subsidies to local governments in recognition of large spillover effects. Some involve incentives for local governments to undertake specific projects. In total, central-local grants comprise almost one-third of local government revenues.

LOCAL ALLOCATION TAX

CASE FOR EQUALIZATION

The necessity for fiscal equalization arises from the fact that the financial resources, the need for services, and the cost of particular local activities vary widely among different local areas. For example, the per capita taxable capacity of some prefectures was 3 times that of others, and same holds true for the difference between the richest and poorest municipalities. Unfortunately, the areas requiring the most local service, namely, those in which there were more needs for education, health services, roads, welfare activities, were likely to be the precise areas having the least taxable capacity. These differences were not only unjust but undesirable in their effects on individual and national welfare.

FORMULA

The Local Allocation Tax plays a key fiscal equalization role in the Japanese transfer system in Japan. Let us in turn discuss the computation formula of LAT.

First, it is funded out of a revenue pool based on fixed portions of five national taxes.

$$TT = 0.32 \times (NT_y + NT_a) + 0.358 \times NT_c + 0.295 \times NT_v + 0.25 \times NT_t$$

Where TT denotes total financial pool of transfer, NT_y the personal income tax, NT_c the corporate income tax, NT_a the alcoholic tax, NT_v 80 per cent of value added tax revenue, and NT_t the tobacco tax.

Second, the revenue pool are allocated according to formula based on differences in basic needs and fiscal capacities, rather than being determined at the discretion of higher level governments. The LAT is paid annually to local governments whose basic financial needs exceed basic financial revenues.

$$LAT_i = N_i - C_i$$

Where LAT_i denotes local allocation tax to ith region, N_i basic need of ith region, and C_i fiscal capacity of ith region. Rich localities with revenue that exceeds need are neither eligible for the grants nor required to contribute money for fiscal adjustment, as is the case in some countries.

Third, national average costs and standards of services are used to equalize for needs. Basic need of N_i are calculated as the number of measurement units by multiplying the unit cost, adjusted by modification coefficients expressed as follows:

$$N_i = \sum_k (I_{ik} \times U_{ik} \times M_{ik})$$

Where I_{ik} is a measurement unit for service K of ith region, U_{ik} unit cost for service K of ith region, and M_{ik} a modification coefficient for service K of ith region. A measurement unit or "workloads" reflects the number or size of the beneficiaries of a particular expenditure. Unit cost is a kind of financial cost of providing a set of services. The unit cost, however, is uniform throughout the country, and no consideration is given to either the unique services or the special circumstances of localities. So an exceedingly complex adjustment is made of the unit cost applicable to such services.

Forth, fiscal capacity of C_i is the sum of 75 per cent of local tax revenue and tax sharing. Let us assume that local tax revenue is JPY 5 million. The locality will deceide to hike taxes by JPY 1 million. Hold basic needs constant. LAT will decrease by JPY 0.75 automatically, while additional JPY 0.25 million is retained in the pocket of localities, thereby giving incentive for local governments to collect their own taxes. In addition, national standard tax rate and bases are used to equalized tax capacities. Let us assume that tax base is JPY 100 million. The locality will decide to lift up the rate from standard of 5 per cent to 7 per cent. Tax revenue will increase by JPY 2 million, but 'fiscal capacity' remains unchanged, thereby insulating local autorities from loss of LAT. Local governments with high tax efforts will not be penalized, while local governments with low tax effort not encouraged.

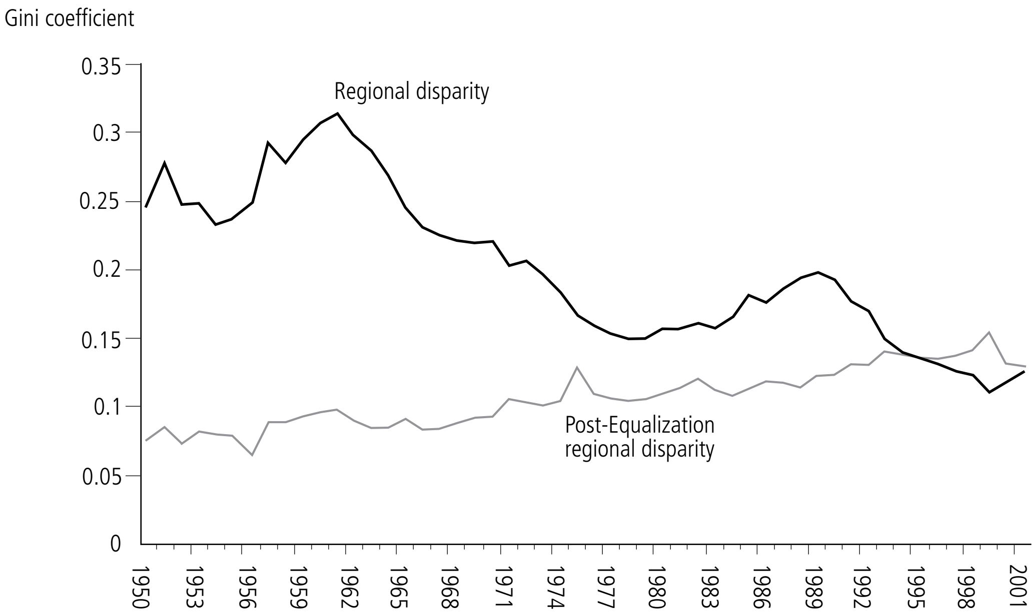
Finally, the funding pools do not necessarily match formula-driven entitlements for transfers. A way of resolving these conflicting demands is to fix the funding pool to a certain percentage of national revenue and to review this rate through regular negotiations. The Local Allocation Tax Law (Article 6, paragraph 3-2) indentifies a critical situation in which the gap comes to roughly 10 per cent or more of the LAT transfers, and this condition has continued for two years and is predicted to continue for another year or longer. The law stipulates that, in such critical situations, the tax-sharing ratio will be raised. Such critical situation has continued since 1996, however, the tax-sharing ratio has not been raised.

DISPARITY REDUCING EFFECTS

As for how Local Allocation Tax is being achieved, and how the impact of Equalization can or should be measured: The Local Allocation Tax Law identifies main purposes of it: ensuring to perform national standard service on a reasonable but minimal basis; and compensating for disparities in fiscal resources and needs.

On the second objective, disparity reducing effect of LAT is extremely high. For example, Aichi prefecture of industrial complex of big company like Toyota Motor collects local tax of JPY 143,000 per capita, while Shimane, a remote rural prefecture, collects only JPY 87,000. Looking at total resource from the LAT transfer and local tax, the latter's figure increases to JPY 341,000 compared to the former's JPY 158,000. Overall, some poor or remote jurisdictions end up having more financial resources than those available in the richest ones. Figure 5 gives an overview of fiscal capacity indicators of local governments before and after equalization. Regional disparity shown by Gini coefficient are virtually eliminated. In conclusion, the actual degree of equalization was perhaps more important before the 1970s, when the transfer system contributed significantly to equality (Mochida 2001:101-104). 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.

Figure 5 Degree of equalization (1950-2002)



Note: Regional disparity is defined by Gini Coefficient of per capita local tax in each prefecture and post equalization disparity is defined as Gini Coefficient of per capita LAT plus local tax in each prefecture.
Source: Mochida, N (2004) Fiscal *Decentralization and State-Local Finance* , table 1-6.

Another objective of LAT is guaranteeing adequate revenue to allow local governments to provide national standard level of public services(The Local Allocation Tax Act, article3). Taking primary education and long term care for the aged as a example, the central government requires/mandates local governments by law to provide these public services. Furthermore, the central government imposes strict and detailed operational standard of these responsibilities (students-teacher ratio, pay standard of teacher, benefit level of long term care etc.). Because of this, the central government has obligations to guarantee adequate revenues for local governments, thereby allowing them to fulfill these responsibilities. The upper level of government, however, does not pay full cost of providing the services. Instead, it gives conditional grants covering about one-half in general. Local governments having less tax capacity are eventually forced into using up own tax plus LAT revenues to cover remaing cost. Actually, the Local Finance Law requires that basic needs of LAT must include local cost associated with mandate responsibilities (article 11-2).

Overall, LAT focus is not on making sure all local governments have the fiscal capacity to deliver reasonably comparable service to their resident at reasonably comparable levels of taxation. Instead, it is designed to ensure that common standards in outcomes of public services are achieved. LAT is not textbook-like unconditional grants. Put it differently, the Local Allocation Tax is uniquely designed to reflect the Japanese reality where the central government has strong influence over local decision making, thorough detailed conditions attached specific purpose grants.

ISSUES

For the past decade, we listened to a wide range of opinions and ideas about the Local Allocation Tax and how it should be changed for the future. The following provides highlights of the key themes and issues identified (Mochida ed. 2006).

First, the coverage and costs of fiscal equalization scheme have increased over the past decades. Several factors have contributed to the upward pressures on the equalization system. The local allocation tax becomes asymmetric in adjusting for the business cycle (Mochida 2004; OECD 2005). The funding pool—namely, a set percentage of the national tax—expands when the economy is growing. Cyclical windfall tax revenue made it possible to upgrade national standard for local public services. However during downturns, it has been difficult to cut back these transfers.

Second, with respect to adverse incentive effects, Japan's equalization system has both strength and weakness. The formula contains some strong points that are intended to contain inefficient behavior. For one thing, it is calculated based on standardized tax revenue, the entitlements are not affected, even if the actual tax rate changes. Furthermore, 25 per cent of the estimated tax revenue is not included into fiscal capacity, thereby giving local governments the incentive to expand their tax base to some extent.

However, LAT transfer hinders local governments' incentive to provide efficient services in a number of areas. The main problematic points are as follows:

- The local debt service are often included in the basic need of the LAT. It is done through the modification coefficient for debt services. For example, in some regional development projects, 75 per cent of financial resources were procured by isuing local bonds, but 55 per cent of the debt service was by law added to the LAT entitlement in the future. Mochida(2004) estimate that 36 per cent of total local debt outstanding will be redeemed by the central government

(Mochida (2004)). To do so provided an adverse incentive for local governments to incur higher levels of debts.

- Local allocation tax gives premiums to small local governments (called *modification coefficients for local government size*). Originally, this adjustment is intended to take into account diseconomies of scale where fixed cost must be spread among a smaller population. However, these generous premiums are criticized by The Council of Economic and Fiscal Policy for obstructing efforts to merge. Consequently, the modification coefficients for local government size were scaled back in fiscal year 2002.
- As discussed before, quarter tax revenue is not included into fiscal capacity. This reserve gives local governments incentive to expand their tax base. However, facing with incredible debt accumulations, The Council of Economic and Fiscal Policy (CEFP) severely criticized it for creating 'poverty trap.' Consequently, central government had reluctantly lifted up the reservation rate for the prefectures from 20 per cent to 25 per cent in 2002. However, other observers argue that this criticism does not have sufficient empirical evidence (Horiba, Mochida, and Fukae 2003). They argue that it is systematically impossible for local governments to get more LAT transfer by lowering the effective tax rate or by making less effort to expand local economy, because they are not allowed wide range of discretion over setting rate or changing tax base.

SPECIFIC PURPOSE GRANTS

The central government remains heavily involved in almost every aspect of local public spending. This is so because, unlike the American or Canadian systems, there is no clear separation of central and local function. Major programmes (education, health, public works) are formulated by central ministries and financed by many specific grants. Therefore, 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.

With this respect, central control through specific purpose grants over local choice is of a critical importance. Specific purpose grants, called 'central government disbursement' (*kokko-sisyutukin*), accounts for 14.8 per cent of total local revenues. It seem to be given to local authorities for purpose relating to public works such as road and urban planning, for compulsory education, for social services such as welfare benefit to low income family. Several central government disbursements for specific purpose, in legal terms, can be grouped into three broad categories depending on the degree of central government' obligation; "payment for agency tasks", "obligatory share", "grant-in-aid".

The desirability to use specific purpose grants of first two seems to be almost self-evident. For instance, where local authorities act in reality as mere agents of central government, the latter should normally reimburse the full costs. "Payment for agency task" such as compiling national census, registration of foreigner, quarantine activities can be thought of in this way. For another, with regards to functions which have a large spill-over effect or in which central government seeks to standardize the level of activities, the cost should be borne or shared by higher level of government. "Obligatory shares" such as grant for expenditure on public works, education, health, welfare, narcotic controls can be justified by such reasons.

In contrast, the desirability to use "grant-in-aid" is now under critical review. This is so because, grant-in-aids are, by their very nature, privileged instruments for the central government to influence the expenditure patterns of local authorities and, therefore, to induce them to act in a manner which accords with its own priorities. The way in which this aim can be achieved as follows; first, a local government submits an application for a disbursement to central government. The application describes the project and explains the reasons for its importance. The central government then assesses all of the applications submitted by local governments and selects those projects to which payment will be given. During this selection process, the central government often requires modifications to projects so that it will conform to central governments standards. Needless to say, almost all local governments accept the conditions required. Conditions accompanying the allocation of grant-in-aid provide the central government with powerful method of control over the activities of the local governments. In general, in order not to undermine the local democratic process, government grants should be used as little as possible to restrict local discretion in providing services.

CHAPTER 5 LOCAL BORROWING AND BUDGET CONSTRAINTS

Japan plunged into a long-term recession subsequent to the collapse of the bubble economy. Japan's fiscal arrangements have been strained since then. The fiscal arrangements rely heavily on explicit revenue sharing arrangements between the national and local governments. As a result of the downturn, revenues to be shared have been significantly reduced. The growing gap between revenues and expenditures at the local level has led to an increase in equalization entitlements under the existing formula, while the revenue pool available for equalization purposes has been in decline.

The law stipulates that gap between entitlments and funding pool should be addressed by increase in tax-sharing ratio (The Local Allocation Tax Law 6-3-2). It is, however, difficult to raise tax sharing ratio of five national taxes during severe recession. Actually, LAT revenue shortage has been covered by: 1) 'ad hoc' transfer from general account of central governments, 2) financing by LAT special account borrowing, 3) 'extra' local bonds issuance. Let us turn our attention to local bonds and debts.

table 4 Local debt outstandings, trillion Yen

	local government bonds	borrowing from special account for LAT	local enterprise bonds	total local borrowing	as percentage of GDP
1991	54	0	14	68	14.7
1996	103	14	21	138	27.0
1997	111	15	23	149	28.8
1998	120	17	24	161	31.6
1999	125	22	25	172	34
2000	128	26	27	181	35.2
2001	130	28	28	186	37.4
2002	134	30	28	192	39.4
2005	140	33	27	200	40.0
2006	139	33	27	199	39.2
2007	138	33	26	197	38.5
2008	137	33	26	196	40.0
2009	139	33	25	197	41.8

Source: Ministry of Home Affairs and Communications (2011) White paper on local public finance.

DEBT SURGE

As table 4 demonstrates, local debts has soared rapidly since the early 1990s, reaching to 40 per cent of GDP in FY2000, from 15 per cent in FY1990. The trend has remained on a plateau in the 2000s. This is so because local governments were encouraged to issue bonds by the central government to cooperate with fiscal stimulus package. As a result, local debts hit a postwar record and this level is rare anywhere in the world at the time. While local government borrowing has largely used to finance infrastructure projects, local governments' ability to repay their debts is controversial matter.

LOCAL BONDS

In Japan, the Law limits subnational borrowing to investment purpose. Local Finance Law (article5) stipulates that bonds can only be used to finance: 1) expenditure for public enterprises (e.g.trasportation, gas, and water service, 2) investment in and lending to organizations involved in areas of publis interest(e.g.roads, airport, sports), 3) loan refinancing, 4) disaster restoration works ; and 5) expenditure on construction of public facilities and purchase of land for building public facilities. These bonds are called 'Construction Local Bond'(*kensetsu chihosai*).

However, the Diet can enact special law to allow the issuance of 'Special Local Bond' (*tokurei chihosai*) in a number of specific situations. These special local bonds are essentially deficit-covering bonds, intending make up for revenue shortfall of the LAT. These include; tax cut supplymentary bonds(6.1 trillion yen), temporary fiscal measure bonds(21.5 trillion yen), revenue decrease supplementary bonds(5.1 trillion yen) and retirement benefit bonds(1.4 trillion yen).

FISCAL RULE

In addition, National laws dictate a number of fiscal rules to be respected if a local government intends issuing local bonds. In order to maintain sound level fo bond issues, the effective debt service ratio is watched.The ratio of local debt service (excluding those though Local Allocation Tax) to the standard scale of local finance (the general purpose resource) is calculated as follows.

Ratio ={(A+B) - (C+D)}/(E - D)

A : Redemption of principal and interests of the concerned year

B : Provision to special account, which were used to service public enterprize bond

C : Special Revenue used for A

D : Debt service, which were included in the Standard Fiscal Need in the caluculation of the LAT

E : Standard scale of local finance (the general revenue estimated necessary to maintain ordinary administration standards)

When ratio reaches18 per cent, local governments are required to receive approval from the centralgovernment to issue bonds. When ratio reaches 25 per cent, most bond issues will not be approved.

INCENTIVE TO EXCESSIVE BORROWING

Why do local debts hit a postwar record and is the level rare anywhere in the world at the time ? There are several reasons. First, local governments have played big role in public investment projects in 1990s. They were expected to cooperate with stimulas package launched by the central governments since economic bubble popped. However, the central government could not afford to give conditional grants for infrastructure projects(city hall, parks, gymnasiums,sanatoriums etc), because of its financial distress. Instead, local governments were encouraged to issue bonds by the central government to cooperate with fiscal stimulus package.

In return, the central government gave a commitment to service local bond through future Local Allocation Tax. Dispite a rapid increase in local debt, fiscal rules on debt servicing costs has not yet become biding, since it deducts bond payment costs, which are financed through the LAT, from the total amount of local governments servicing costs. As a result, most local governments were almost under the illusion that their debts would be redeemed by the upper-level of government. Mochida (2004) estimates that local governmets could recognize only 47 per cent of debt outstanding as their own liabilities.

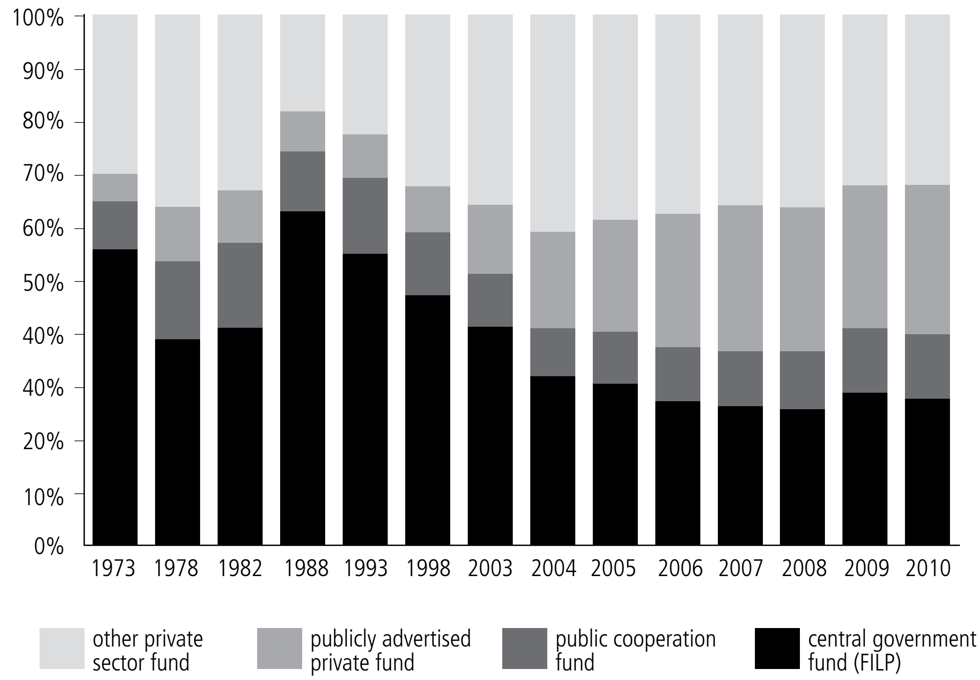
Second, the growing gap between revenues and expenditures at the local level has led to an increase in equalization entitlements under the existing LAT formula, while the revenue pool available for equalization purposes has been in decline. Since FY2001, the central government has gone halves the cost (gap between entitlments and funding pool) with the local governments, the latter covers its cost by issuing temporary bonds for fiscal gap (*rinzi zaisei taisakusai*). Cap on the issuance of this bond is allocated to each local government on the basis objective criteria. It is essentially deficit covering bonds.

While temporary bond for fiscal gap has been introduced as a temporary legislation with 3 year term limit, it has carried through to the present. These debts are estimated to reach 25 trillion yen in FY2008 (*i.e.* about 18 per cent of outstanding of local bonds). They have not be issued according to local own initiative. Rather, they should be considered as complementary to the Local Allocation Tax, which could not sufficiently fill the revenue shortfall in Local Finance Plan. In addition, local debts induced by the central government's policy goal, is estimated to reach about 54 trillion yen (*i.e.* 39 per cent of outstanding local bonds).On the contrary, local debts issued according to local own initiatives, is estimated to reach no more than 18 trillion yen (i.e. only 13 per cent of outstanding local bonds).

PRIVATE SECTOR CREDITORS

In Japan, the central government has implicitly guaranteed creditworthiness of local government bonds through 1) dominant role of public institution in underwriting, 2) bond approval system, and 3) fiscal reconstruction system. Under these administrative controls, both lenders and creditors have believed local governments would not fall into bankruptcy. However, recent reform initiatives could enhance greater self-responsibility of local governments.

Figure 6 **Main creditors of Local Bonds, in percent**



Source: Ministry of Home Affairs and Communication(2011) White paper on local public finance.

Who lends to local governments? The answer to this question is given in Figure 7. First, it appears that fund rasing from public and quiasi-public institution has been on a declining trend, falling to 27 per cent of GDP in FY2009, from 63 per cent in FY1989. The government has long history to collect a substantial amount of public fund through credit programmes such as postal saving and pension fund, and manage these fund to carry out national goals. So called 'Fiscal Investment and Loan Programme' (FILP) gave long term and low interest loan to local bond market. FILP, however, was almost dismantled in FY2001. In stead, the central government started to issue national bond to raise fund and sublease it to local governments. In addition, direct loan of postal savings and pension fund to local government sectors were terminated in FY2007. Dominant role of public institution in underwriting has gone out of the window.

Second, private sector has underwritten an increasing share of local government bonds. Private-sector funds cover about 60 per cent of total local bond issue—private bank buys 26 per cent and remaining 34 per cent are offered directly on the market. Private sector picture is dominated by publicly advertized bonds. 44 local governments issue publicly advertized bonds. International rating agency, Moody's expects the rating of its 12 rated prefectures and designated cities will remain at Aa2 with a negative outlook, the same rating level as Japanese government bonds, reflecting their belief that central government would step in to help any local government experiencing a fiscal risk.

For public advertized bonds, how are the issuing condition established? The issuing conditions are established through bilateral negotiations between individual local government and lenders since FY2006. In the past, the central government was responsible for negotiating with lenders, thereby the issuing conditions were uniform regardless of individual local government's creditworthness. However, reflecting the widening gap in secondary market prices, the central government allowed local governments to negotiate with creditor though its own marketing.

ADVANCE CONSULTATION SYSTEM

When a local government invisages to issue bond, it does no longer need to obtain approval from the central government since FY2006. Under the new system local governments should consult with MIC before issuing bonds. If MIC disagrees, they can still issue bonds, but repayment costs will not be accounted for in the LAT formula. This system could contribute to enhancing the role of financial markets in disciplining local government fiscal behaiviour, since the previous approval system has often been perceived as an implicit government gurantee by investors. Local bonds with agreement will continue to be guranteed by the central governments.

In order to maintain sound level fo bond issues, however, the effective debt service ratio is still watched. When ratio reaches18 per cent, local governments are required to receive approval from the centralgovernment to issue bonds. The central government says that 12 prefetures and 400 municipalities are required to receive approaval.

FISCAL REHABILITATION SYSTEM

Recent reform initiative could contribute enhancing the role of financial rehabilitation system, thereby enhancing safety net for fiscally distressed local governments. From a standpoint of enhancing fiscal discipline, 'Law on Restoring Fiscal Health of Local Governments' for early strengthening and recovery has been enacted in FY2007. This law revised drastically conventional 'Law on Special Measures for the Promotion of Local Financial Reconstruction' for the first time in half a century.

Under the previous law, a municipality running deficit exceeding 20 per cent of its general purpose revenue can still issue bonds if it has introduced financial rehabilitation plan approved by MIC. This entails measure to increase revenue by setting tax rate above standard tax rates and measures to cut spending by reducing number of government employees and their compensations. The problem of previous law is that fiscal deficit index monitors only general account's deficit and financial condition of liabilities is not watched. Fiscally collapsing of Yubari city in FY2007 exposed its problems.

Yubari city was designated by MIC as the local government under the fiscal rehabilitation scheme. This means its budget will be directly controlled by MIC, effectively stripping the city of its autonomy. Under the plan, rehabilitation will last through FY2024: slashing the number of municipal officials; raising utility fees; and shutting down public facilities to pay off its JPY 35.3 billion debt. The source of defaults is lack of the fiscal discipline, an excessive investment, and myopic fiscal management that covers deficit by floating debts. Until then, Yubari had hidden its snowballing debt by window dressing its account, making it difficult for the MIC to learn the truth.

Facing such criticisms and problems, in the new law, the brake to prevent local government from fiscally collapsing has been strengthened in two poits. First, under the new law local governments are required to report four financial indexes to local assembly and disclose them to the public. Detail about these indexes are shown in Box. With disclosure of financial indexes, moreover, it would be possible to get wide range of picture on financial status of local governments with fiscal stress. Did this new rule contribute enhancing fiscal decipline of local government? Table* shows that the average of effective deficit ratio and future burden ratio has fallen from FY2007 to FY2009, indicating restoring financial health of municipalities.

Early-Stage Fiscal Improvement Benchmark

1. 'effective fiscal deficit ratio'

Ratio = A/B

A : effective deficit of general account
B : Standard scale of local finance (the general revenue estimated necessary to maintain ordinary administration standards)

2. 'consolidated effective deficit ratio'

Ratio = {(A+B)-(C+D)}/E

A : effective deficit of general account
B : effective deficit of special account of public enterprises
C : surplus of general accounts that have surplus
D : surplus of special account of public enterprises that have surplus
E : Standard scale of local finance (the general revenue estimated necessary to maintain ordinary administration standards)

3. 'effective debt service ratio'

see, chapter4, fiscal rules

4.'future burden ratio'

Ratio ={(A-(B+C+D)}/(E-D)

A : local debts outstandings, consolidated effective deficit,
B : Reserve fund used for redemption of A
C : Special Revenue used for redemption of A
D : Debt service, which were included in the Standard Fiscal Need in the caluculation of the LAT
E : Standard scale of local finance (the general revenue estimated necessary to maintain ordinary administration standards)

Second, the rehabilitation proceses consists two stages, early stage fiscal improvement and fiscal rehabilitation. If four indexes reach 'early stage fiscal improvement benchmark', local government has to formulate fiscal improvement plan and MIC issue warning sign when the plans are insufficient. If four indexes reach 'fiscal rehabilitation benchmark', local govenrnments has to determine fiscal rehabilitation plan in consultation with MIC. This two stage approach could have served to encourage early recovery of local government via independent effort.

Table 5 **Number of SNG designated as 'early stage fiscal improvement'**

	FY2007	FY2008	FY2009
effective fiscal deficit ratio ≧ 11.25 ~ 15%	2	2	0
city	2	2	0
town	0	0	0
consolidated effective deficit ratio ≧ 16.25 ~ 20%	11	2	0
city	9	2	0
town	2	0	0
effective debt service ratio ≧ 25%	33	20	12
city	8	5	2
town	25	15	10
future burden ratio ≧ 350%	5	3	3
city	3	2	2
town	2	1	1
net total	**43**	**22**	**14**

Source: Watanabe (2011)

While it hasn't been long since enactment of new law, there is some evidence whether rehabilitation system prevents local governments from fiscally collapsing. It could be found in table 4 .Since FY2007, this table shows that all four financial index have been improved gradually, while drop in tax revenue after Reman shock will be emerged in FY2010. Compared to the Law for Special Measure to Promote Local Public Finance Reconstruction, the basis for the previous fiscal rehabilitation system, the brake to prevent local government from fiscally collapsing has been strengthened, and a structure for pomoting local government fiscal rehabilitation has been clearly presented.

CHAPTER 6 DRIVERS TO DECENTRALIZE THE PUBLIC SECTOR

FISCAL DECENTRALIZATION

The central government has traditionally defended its use of controls by noting that they help standardize welfare and health programmes, which ought to be uniform across the country, and further claims that without national government involvement, economically fragile localities may fail to provide adequate services for their residents. The central government also believes that equalization of different social services should take priority over local autonomy. Over the last few years, however, the public has increasingly called for deregulation and decentralization of Japan's centralized intergovernmental relations. Public statement claim that Japan's centralized system of government eventually be unable to resolve issues generated by economic globalization and the fiscal stress caused by post-bubble economic blues (see Box).

Some explanations why Japan wants to decentralize public sectors.

- There is increasing concern about inefficient spending decisions by the central government and the extensive regulations and uniform standards it imposes on local representatives. "One-size-fits-all" approach has failed.
- Faced with a gross debt accounting to 150 per cent of GDP, revamping fiscal relations across levels of government is of paramount importance. It requires cutting fiscal transfer and improving cost-effectiveness of local public spending.
- Since outlays on healthcare and other welfare programmes are largely under local government responsibility, population aging will change demand pattern for local public services, across both spending categories and jurisdictions.
- A new ideology of neo-liberalism has emerged among policy making elites. As a result, traditional policy goal of "promotion of balanced regional development with rural areas" has been increasingly eroded.

Source: Mochida (2004) *Fiscal Decentralization and State-Local Finance: Fundamental Perspectives*

ABOLISHMENT OF AGENCY DELEGATED FUNCTIONS

Reflecting these general outcries, the Murayama administration finally enacted The Law for the Promotion of Decentralization, on May 15, 1995 and established a committee, headed by a prominent businessman, to study different methods of decentralization. After intensive debate and investigation, the committee submitted its final conclusion in 1998. One of the concern was about so called 'agency delegated functions', which requires the chief excutive of local governments to act as an agent of the central governments. If elected leaders defied the central government order, he/she would be dismissed. Based on the committee's report, the government abolished 'agency delegated functions' completely. In FY1999, to implement the new pattern of central-local relationships, the national legislature eradicated 432 of the laws that formed the basis for agency delegated functions.

TRINITY REFORM DURING KOIZUMI ADMINISTRATION

Intergovernmental fiscal relations has also been reformed during 2000s, aiming at strengthening own revenue sources and shaking off reliance on grants. The prime minister Koizumi launched during FY 2004-2006 an ambitious reform of the three financial resources - earmarked grants, local taxes and the local allocation tax – the so called "Trinity Reform".

- Cutting earmarked grants by 4 trillion yen.
- Retrenchment of the Local Allocation Tax by 5 trillion yen.
- Transfering 3 trillion yen of income tax basis to local governments.

Figure 7 **Change in revenue component after Trinity Reform (2004-2006)**

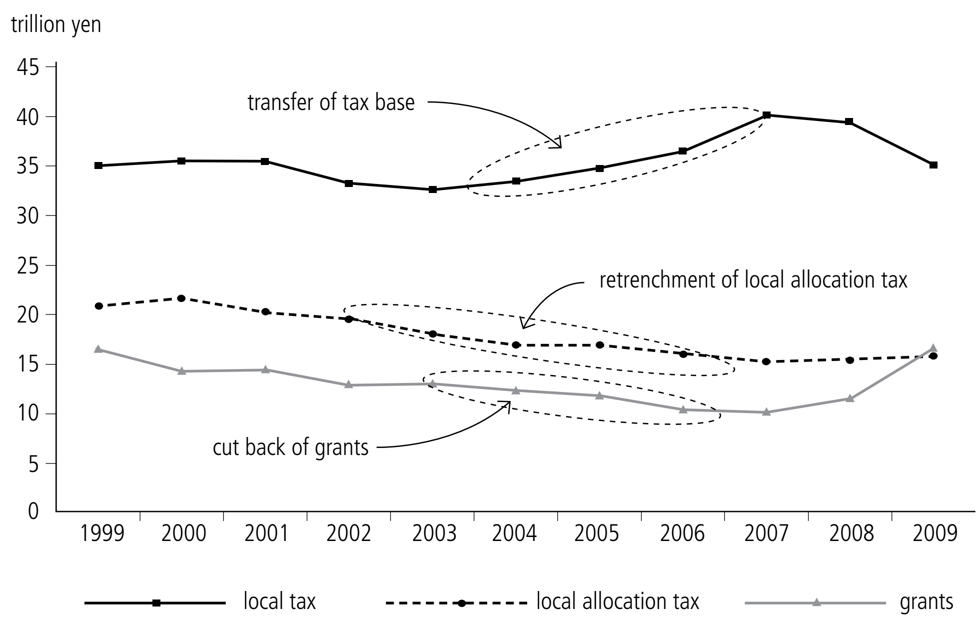


Figure 8 shows the impact of 'Trinity Reform' on the revenue components of local governments. It meets initial objectives, in the sense that own revenue source increased substantially and intergovernmental transfers- both conditional and unconditional- were reduced to a large extent, thereby making local government tailor its public services to theire residents' preferences.

But it failed to bring about a tangible result. First, cutting earmarked grants, whose use is strictly regulated by the central government, did not go smoothly. Norms and strict regulations imposed on the local public services remain almost constant. Second, while the Local Allocation Tax was slashed for the first time in the postwar era, transfer of tax revenue sources was insufficient. This has resulted in financial deterioration at local governments and widening gap between rich and poor regions. For example, tax revenue increase is greater than reduction of grant plus local allocation tax in urban area such as Kanagawa and Tokyo, while the opposite occurred in relatively poor areas, such as Kagoshima and Okinawa. This is so because regions with relatively high income tax payers reap a greater profit from tax base transfering, while reduction of grants and local allocation tax is detrimental to remote areas with small number of tax payers.

DPJ'S PLATFORM SINCE 2009

In the general election held in August 2009, the Democratic Party of Japan (DPJ) won a majority in the House of Representatives and achieved a change of government.The DPJ's platform advocates what it calls "regional sovereignty" to increase the amount of fund under local governments' control by replacing eamarkes grants from the central government with lump-sum block grant for regions to use as they see fit. The DPJ's proposal is in line with a trend toward support of decentralization in recent years. The decentralization initiative of the government replaces a previous initiative launched by its predecessor. This new initiative, like the last one, is expected to be slow moving, reflecting the deeply entrenched system. The author do not expect the DJP led government make any change to Japan's system and practice in near term. However, with DPJ's policies requiring increased expenditures despite the continued decline in tax revenues, the central government's finances are in more critical situation than local governments, thus giving rise to the possibility of a future change in the central government's support for the local governments.

AMALGAMATION

Big wave of amalgamation is now under way, so that number of municipalities would further be reduced from 3,229 in FY1999 to 1,727 in FY 2009. Why the central government in Japan favored municipal merger and amalgamation ? The number of municipalities has declined from just over 71,000 in 1883 to just over 3,000 in the end of 20th century, with big consolidations occurring at the turn of the century (so-called Meiji Amalgamation around 1883) and at mid-century (so-called Showa Amalgamation around 1950-60).

First, it guarantees residents saticfaction with public services. The Showa Amalgamation, for example, was carried out with the objective of ensuring the delivery, at the local level, of important public services. In deed the target size of amalgamated villages was chosen on the basis of the minimum population needed to make a secondary school practical and feasible, and the relatively uniform distribution of secondary schools all over Japan suggests that this objective was achieved.

Second, amalgamation exploite scale economies by redesigning the geographical coverage of local public services. The small size of municipalities has made it difficult to secure cost-effective local public services. Some empirical studies have revealed the existence of diseconomies of scale for small municipalities and congestion costs for the largest ones, which have high population density. Hayashi (2002) found that the unit costs of local public services follow a U-shape curve: they are high for the smallest municipalities, tend to decrease until around 120 thousand inhabitants, and increase as municipalities grow beyond this threshold.

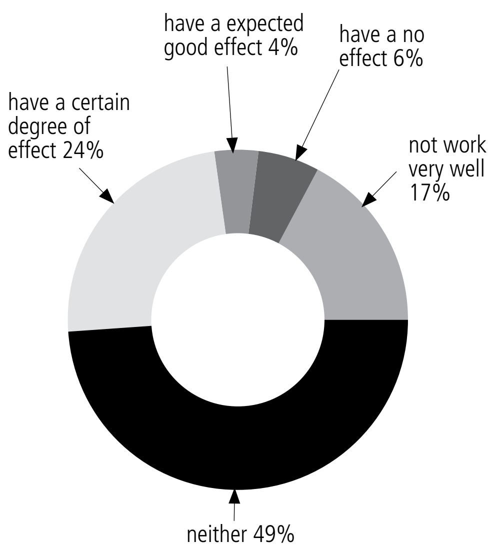
Third, amalgamation will lend to cost saving for the small towns and villages. According to MIC, it is expected to reach 1.8 trillion yen of saving after FY2016, and number of civil servants will decresse by 127 thousand which cut payroll cost by 54 billion yen per year.

The amalgamation process has also been supported by several political and financial measures (OECD 2005:109). The Special Law for Municipal Mergers was revised in

1999 to allow residents to take the initiative in proposing mergers. Municipal assemblies should decide whether to organize a council to consider amalgamation if at least 2 per cent of eligible voters in a municipalities sign a petition favoring such a step. To limit opposition by member of municipal councils, the number of seats in the first election following the merger can be up to twice the number allowed by law.

On the financial side, adjustments in the grant system were made so as to reduce disincentive to amalgamation, thereby strengthening the incentive for merging small units that are inefficient. In addition, the central government allows local governments to issue special amalgamation bonds for projects related to amalgamation, with 50 to 70 per cent of the redemption costs covered by the central government through grant system.

Figure 8 **Questionnaire survey on amalgamation, 2010**



Source: unpublished data

Does amalgamation get good result in Japan? The author participated a questionnaire survey in FY2008 and got answer from 30 prefectures (collection rate 63.8 per cent) and 1341 municipalities (collection rate 75 per cent). Figure 9 demonstrates these result. Sum of the answer “have a expected good effect” and “have a certain degree of effect” amounts to 27.9 per cent, while sum of the answer “not work very well” and “have a no effect” reaches 23.1 per cent. There is no difference between them. Largest group of responders is “neither” of 49 per cent, then opinion is devided. On the other hand, 80 per cent of responder with answer ‘yes’ points out cost saving as a merit of amalgamation, while negative responders point “lack of cost saving”, “reduction of service level”, “disjointed society” as a reason against amalgamation.

CHAPTER 7 **LESSONS**

The most remarkable feature of Japan's public sector can be found in its vertical fiscal gap. In the overall Japan's fiscal system, while the majority of expenditures 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. Put it another way, Japanese fiscal system is placing a high premium on tax and expenditure harmonization and on the control by higher level governments.

Over the course of decades, Japan has developed a robust system of decentralized governance with important lessons, both positive and negative for the rest of the world. Many of the lessons have been positive ones, such as the cooperative manner in which revenue decentralization has occurred and the way in which intergovernmental transfers have been structured.

- One of the strengths shaping the decentralization in Japan has been the strong collective preference for equal access to public goods. Equal access to public goods, and fair sharing of the burden to finance these goods was viewed as essential for economic and social development. The desire for equity has led to the development of strong equalization schemes; the local allocation tax is designed to ensure that common standards in quality or outcomes in public services are achieved.
- Of particular importance, decentralization necessarily creates disparities since some localities are much better endowed with fiscal capacity than others. Managing decentralization in a way that does not sacrifice important national objectives of efficiency and social citizenship entails an effective system of equalizing transfers that can only be sustained by societal consensus. Japan's experience is especially effective at elucidating the role of equalization alongside truly decentralized discretion-making and accountability.

Others remain works in progress, such as dealing with soft budget constraints and establishing true accountability of local governments to their constituents.

- Japan's local public finance system 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. In addition, some of repayment cost of local bond is secured by central governments.
- For another, the demand for reform strikes at some of the most critical prerogatives of the central government. The central agencies feel that deregulation and decentralization would reduce their power, which they are reluctant to relinquish. Reforming intergovernmental fiscal relation should be gradual.

Japanese local autonomy was totally destroyed during and after World War II, and people expected its restoration from the new Constitution and Shoup Recommendation formulated on the basis of the experience of Western countries. The problems that Japan was confronted with in this transitional period, such as growth and income disparities, lack of local government capacity, and undeveloped and confused legislation, had the same way of emerging as those that developing countries are faced with today.

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Japanese fiscal system is placing a high premium on tax and expenditure harmonization and on the control by higher level governments. Over the past decades, Japan has developed a robust system of decentralized the fiscal system. The fiscal system has both positive and negative experiences and lessons for the rest of the world. The report focuses on the cooperative manner in which revenue decentralization has occurred and the way in which intergovernmental transfers have been structured. It also addresses issues such as dealing with soft budget constraints and establishing true accountability of local government to their constituency. Against these background, recent reform initiatives, Trinity reform and mass amalgamation, try to address the negative side of Japan's intergovernmental fiscal relations. This report is to examine Japan's intergovernmental fiscal relations and discuss both positive and negative lessons.

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