PRI Discussion Paper Series (No.08A－04)

Decentralization and Intergovernmental Finance in Japan

Ichiro Aoki
Visiting Scholar
Policy Research Institute, Ministry of Finance

JUNE 2008

Research Department Policy Research Institute, MOF 3-1-1 Kasumigaseki, Chiyoda-ku, Tokyo 100-8940, Japan
TEL 03-3581-4111

Decentralization and Intergovernmental Finance in Japan

Ichiro Aoki*

Abstract

Japan's mid-nineteenth century "opening-up" to Western influence, the so-called "Meiji Restoration", drove political leaders to form a politically modern centralized country. Although Japan experienced a number of major decentralization processes under the post World War II Allied occupation, the Japanese government reviewed these reforms after the occupation. In fact during the post WWII era, the centralized system played a major role in establishing a national minimum standard of living.

While political trends in the 1990s favored government decentralization, promotion of decentralization became a challenge for successive Cabinets. In 1999, the Diet enacted the Package Promoting Decentralization Act; this law repealed the delegation system under which local governments are subordinate to the central government. In 2003, the Koizumi Administration created the "Trinity Reform" plan. "Trinity" means the decentralization reform process that involves three factors: 1) A local allocation tax grant; 2) A national subsidy for local governments, and 3) A local tax. The package included reducing national subsidies to local governments and transferring tax revenue sources from the central government to local governments.

Both Japan's central government and local governments are financially closely connected and both face severe fiscal conditions. Japan has an aging population and the coming increase of social security related expenditures is a huge fiscal challenge. It is financially questionable whether the central government can continue to provide the local allocation tax grants which guarantee financial resources to cover revenue shortfalls of local governments. The central and local governments have to review their budgets with a concerted effort to improve government efficiency.

The theorem on fiscal federalism argues that local governments can provide public services more efficiently and be more responsible to their residents through competition among local governments. However, decentralization in Japan contains two fundamental challenges: heavy duplication of roles and ambiguous fiscal responsibility across levels of government. What is necessary for decentralization in Japan is to narrow the role of the central governments. Furthermore, the central government revenue guarantee function should be limited; it is imperative to establish hard budget constraints at the local government level. The author would like to emphasize decentralization should be compatible with reconstruction of the public finance system.

In the first chapter, the author explores the historical background of the relationship between Japan's central government and local governments. Then, in the second chapter, the author introduces the recent Japanese government promotion of decentralization. Thereafter, the author provides an overview of financial relationships across levels of government in the third chapter. In the fourth chapter, the author surveys economic theories on fiscal federalism, whereby the author would like to clarify the advantages of decentralization. Then, in the fifth chapter, the author summarizes the two fundamental challenges between the central and local government in Japan: duplication of roles and ambiguous expenditure responsibility. Finally, the author makes suggestions for promoting Japanese government decentralization mainly focusing on the use of fiscal instruments.

Keywords: decentralization, fiscal federalism, financial reconstruction, hard budget constraints
JEL Classification: H61, H77, N45

* The author submitted an earlier draft of this paper to the Walter H. Shorenstein Asia-Pacific Research Center at Stanford University on June 2007. He is particularly grateful to Dr. Mike Armacost, the former ambassador to Japan, for his valuable comments on the draft. He would like to express deep gratitude to Dr. Masahiko Aoki for his helpful advice.

Table of Contents

1 Historical Background

This section provides the reader with the historical background of the relationship between Japan's central and local governments. Historically a unitary nation[1]; Japan's degree of government centralization has changed over time, as in other countries. We can find that intense international tension frequently led Japan to form a centralized system of government.

1.1 Ancient to Mid-Modern Period

During Japan's *Hakuho* Period (seventh century), one finds reference to the first formation of a centralized nation.[2] During this time, international tension around the Korean Peninsula motivated the surrounding countries to unify their own country.[3] Modeled after the Chinese emperor governing system of fixed codes [*ritsuryo*], the ancient Japanese Imperial Dynasty formed a centralized nation. However, political power passed onto the aristocracy and the fixed codes became less and less important; eventually the fixed codes [*ritsuryo*] turned in to a mere shell of itself in the tenth century.

Japan's medieval and early-modern times (the twelfth – nineteenth century) are known as the Feudal Period; during this period, military caste was at the top of the political hierarchy. The Imperial dynasty retained continuously; however, the emperor had been the titular head of Japan during that period. From the twelfth century through the nineteenth century, Japan had three successive feudal governments [*bakufu*][4]. To

---

[1] A unitary nation means a non-federal state.
[2] Ishii, Gomi, Sasayama, Takano, *Detailed Japanese History*, 2000, p. 32.
[3] In 598, Sui in China dispatched troops to Kokuryo in the northern part of Korean Peninsula. Moreover, in 644, Tang in China invaded Kokuryo.
[4] In 1192, Minamoto Yoritomo established the seat of the shogunate located in Kamakura (Kamakura shogunate). The second shogunate government followed the Kamakura shogunate was Ashikaga shogunate government located in Kyoto established in 1338.

discuss whether each of these three governments was centralized or decentralized is beyond the aim of this paper. However, a brief review of the last feudal government [the *Tokugawa bakufu*] provides an excellent overview of the process leading to a more centralized government system.

Under the Tokugawa government, there were over three hundred local entities, or feudal domains [*han*]; with only a few areas directly controlled by the central government. The Tokugawa government granted feudal lords [*daimyo*] local territories known as feudal domains; the central government authorized the feudal lords to rule their territory.[5] The financial system of the Tokugawa government and feudal domains heavily depended on land taxes imposed on farmers and paid in the form of rice. While officially, the feudal lords were under central government control; in reality, the rule of feudal domains was politically and financially independent of the central government.

During the mid 19th century, the Tokugawa government, which had developed a national isolation policy, began to suffer from global pressure to "open the country." The 19^{th} century opening of Japan to the West gave rise to antigovernment movements in Japan[6]. The Tokugawa government and several powerful feudal lords lapsed into civil war. Finally, in 1867, the feudal government returned political power to the Imperial Dynasty[7]. This was the beginning of the modern age, known as the "*Meiji*" Era.[8]

The last feudal government was the Tokugawa shogunate government located in Edo (Tokyo of today) established in 1603.

5 Feudal lords had to go up to Edo for an alternate-year attendance.

6 Some feudal lords engaged individually in a battle against foreign countries (The Kagoshima bombardment in 1963, The Shimonoseki bombardment in 1863-64).

7 Though Imperial Court continued from the ancient period, it did not have political power in feudal ages. In 1867, the Meiji emperor declared the restoration of imperial rule.

8 "Meiji" is derived from the Emperor of Meiji. The Meiji era is from 1868 to 1912.

1.2 Meiji Restoration to WWII

Japan's political and economic modernization began with the Meiji restoration. The Meiji government destroyed the feudalistic system and formed the modern unified nation in order to catch up with the western world powers.

1.2.1 Local Administration

In 1868, the Meiji government divided the territory into three categories: *hu*, *han* and *ken*. Important areas governed directly by the Tokugawa government were designated as *hu* and less important territories as *ken*. As each *han* were still under feudal lords, in 1869, the government decided to abolish *han* and resume directly control over the areas. Feudal lords were forced to offer their territories and populace to the government; they were appointed as governors of *han.*

Initially, tax collection and military affairs were under the control of each *han*. However, in 1871, the Meiji government replaced the *han* territories with prefectures [*ken*][9]. Feudal lords were dismissed; they were raised to the peerage under the nobility system.[10] Governors of prefectures were appointed by the central government.

In 1874, Taisuke Itagaki and his group submitted a landmark petition to establish a Diet composed of representatives selected by the people; this action triggered the beginning of Japan's civil right movements. In response, the central government pledged to form a Congress by 1890; and enacted three laws related to the development of local government systems. Under one law, the government developed a prefectural assembly regulation to establish local assemblies. In fact, the local assemblies were established prior to the National Congress.

---

[9] There were 3 *hun* and 302 *ken* in 1871.
[10] Japan introduced a system of nobility in 1869.

In 1888, the central government established the "city, town, and village systems [*shi-sei, cho-son sei*]" and in 1890 the "prefecture and county systems [*huken-sei, gun-sei*]."[11] These local systems were modeled on Bismarck's Germany governmental structure. The country was divided into prefectures and then prefectures were subdivided into counties and cities. Counties were divided into towns and villages. Prefectures were subordinate to the central government; the central government's Ministry of Home Affairs [*Naimu-syo*] officials were appointed as prefecture governors.[12]

In 1889, the Meiji Emperor established the Imperial Constitution, which aimed to form a centralized modern nation under the constitutional monarchy. The constitution contained no reference to local autonomy.

The central government granted legal personality to prefectures in 1889. The 1929 reform of the local system gave prefectures the power to enact ordinances, thus strengthen their prefectural autonomy.

1.2.2 Local Finance

Initially the Meiji government took over the Tokugawa government tax system. Hence the main financial resource of the early Meiji government was rice paid as land tax. The burden of farmers varied across regions; often a low rice harvest would negatively impact government tax revenues. Eventually, the central government decided to reform the land tax in order to stabilize the revenue. In 1873, land tax rate was fixed at the three percent of land price and the government required farmers to pay it in cash. To establish

---

[11] The Home Minister, Aritomo Yamagata, took charge of establishing these local systems according to advices of Mosse who was German foreign specialist.

[12] County heads were appointed. Mayors of cities were elected by the city council from pools of three candidates recommended by Home Affaires Minister. Mayors of towns and villages were elected by towns and villages councils.

land ownership, the central government issued a land certificate to every farmer.

In 1875, the government sorted taxes into national and local taxes; some taxes were abolished. In 1878, new local tax regulations established three types of local tax: 1) A surtax on the land tax (up to twenty percent of the land tax amount), 2) A business tax, and 3) A tax on households. Local taxes were composed of the surtax on the national tax and the independent local tax. The local government could decide the rate of the surtax within a cap. The local government had the right to decide the local tax rate.[13]

In 1887, the central government established a national individual income tax; while in 1896, the local business tax was transferred to a national tax. Finally, in 1889, the central government introduced the corporate income tax.

Japan's long-term stagnant economy after WWI caused financial drought in local government and impoverished conditions of rural communities. During this time, the central government studied the feasibility to transfer some national taxes to local governments; however, due to Parliamentary opposition, such tax transfers did not become reality.

After an opening of hostilities against China, the Japanese Diet passed the general National Mobilization Act in 1938. Under such pre- WWII regime, the central government drastically reformed the tax system with the goal of increasing revenue to meet increasing military expenditures. Individual income tax was divided into two parts: a progressive composite income tax and a proportionate classified income tax. Furthermore the withholding tax from wages was introduced in the classified income tax.[14] The main purpose for the tax reform was to raise revenue to meet expanding

[13] For example, business tax varied region by region.
[14] The introduction of withholding system was the first in the world.

expenditure through an increase of the tax rate of classified income.[15]

In 1940, a remarkable reform that established fiscal equalization scheme, known as the local distribution tax [*chiho-bunyozei*], was enacted. The local distribution tax was composed of the refund tax [*kanpu-zei*],[16] and the allocation tax [*haihu-zei*].[17] The central government was responsible for collecting the refund tax that was a local tax. The allocation tax was a financial resource to provide fiscal equalization among local governments. Jinno argues that this reform was the origin of the current centralized local finance system.[18]

1.3 Post WWII Era

Following WWII, the Allied Occupation carried out many reforms under the principle of Japan's democratization and demilitarization. Encouragement of local autonomy was one of the main issues related to democratization.

After the Allied Occupation Forces left Japan in 1952, the Japanese government reviewed many reforms and made necessary adjustments to best meet the economic and political needs.

1.3.1 Local Administration

---

[15] Noguchi, *1940 System*,1995, p. 56.

[16] Refund tax included land tax, business tax, and house tax [*kaoku-zei*]. Though these taxes were transferred from the national tax to local tax in 1940, the national government collected these taxes and distributed them to prefectures where taxes were collected.

[17] Allocation tax was composed of a certain portion of revenue from individual income tax, corporate income tax, amusement, eating, and drinking tax, and an admission tax.

[18] Jinno, '*Japanese-Style' Tax System and Finance System*, 1993.
Noguchi pointed out that transfer from the central government to local governments increased rapidly after the 1940 tax reform. Noguchi also contends "The aim of this system was to relieve impoverish rural communities. It was a considerably socialistic system." *1940 System*,1995, pp. 58-60.

In 1946, under the guidance of the Allied Occupation Forces, Japan's newly enacted Constitution established the principle of a government of the people, in contrast to a government loyal to the Emperor. A separate chapter on local autonomy stipulated that local government heads and local assembly members would be elective positions. The Allied Occupation Forces broke up the Ministry of Home Affaires [*Naimu-syo*], which had supervised local governments and appointed governors.[19]

Enacted in 1947, the Local Autonomy Law provided the details for the organization and management of local governments[20] specifically; local governments were to have a two-tier system, maintaining both the larger prefecture and the smaller municipality entities (city/town/village). During this period, the responsibility of municipalities became heavier;[21] thus, the government passed the 1953 Merger of Towns and Villages Act, which encouraged municipal mergers in order to improve administrative ability[22].

The reform of the Local Autonomy Law in 1956 made prefectures comprehend municipalities.

---

[19] Prewar Ministry of Home Affaires was *Naimusyo*. In 1955, Ministry of Home Affaires [*Jichisyo*] who was in charge of local administration was established. Ministry of Home Affaires (MOHA, *Jichisyo*) was transformed into Ministry of Internal Affaires and Communication (MIC) in 2001.

[20] The Local Autonomy Law established administrative tasks delegated by the national government to heads of local governments. The origin of this delegation system goes back to the system of '*Shisei, Choson Sei'* in Meiji era. See1.2.1.
In executing these tasks, heads of local governments were legally under control and supervision of the central government and the central government had the power of dismissing them until 1991.

[21] Provision of public goods and services such as an establishing and management of middle school, fire-fighting, policing, and social welfare were newly assigned to municipalities in a postwar period. However, the assignment of policing was transferred to prefecture by 1955 because of burden of great expenses.

[22] The total number of cities, towns, and villages that stood at 9,868 in 1953 reduced to 3,472 in 1961.

1.3.2 Local Finance

The Supreme Commander for the Allied Powers requested Carl Sumner Shoup[23] (hereafter "Shoup") to head an official mission to develop a report and recommendations on Japan's tax system and local finances. In this report, Shoup designated the individual income tax as a centerpiece of the national tax system. As for local finance, he emphasized the need for increased finance, streamlining national subsidies and a more rational distribution of functions between the national and local entities.[24]

Shoup recommended an increase of the municipality tax and a repeal of surtaxes[25]. He also suggested to simplify the local tax system and to reduce the number of taxed items. Furthermore, he recommended the local distribution tax grant be replaced with a local finance equalization grant (LFEG); this grant would cover the difference between the tax revenue under the standard tax rate and the minimum necessary expenditure. Shoup criticized the local distribution tax for its instability, which he claimed stemmed from the central government's fiscal situation. His idea was the amount of necessary minimum expenditure should be the sum of estimated costs to provide national minimum standard in local public services.

Local tax reform was implemented according to Shoup's recommendations. Value added tax[26], an admission tax, and an amusement, eating, and drinking tax constituted

---

[23] Carl S. Shoup (1902- 2000). Shoup was born in California in 1902 and graduated from Stanford University with a law degree in 1924. He began studying economics at Columbia, becoming an instructor in 1928, earning his doctoral degree in economics in 1930, and becoming a full professor in 1945.

[24] Purnendra, *Local Policies and Policy Making in Japan*, 1989, p. 37.

[25] Before WWⅡ, local taxes were mainly surtax on national taxes. After the war, national tax, and local tax were divided, however, municipal taxes were still surtax on prefecture taxes. Shoup stressed that prefecture tax and municipality tax should be independent.

[26] Though a turnover tax was introduced in 1948, it was repealed in 1949 because of

prefecture taxes. Main municipal taxes were individual income tax and a property tax. Though a value added prefectural tax was adopted, taxation was never enforced, thus resulting in it's abolishment after the Allied Occupation ended[27]. Although several new taxes were established after the Allied Occupation period, the basic framework of Japan's current local tax was established in the 1950 reform.

In 1952, the Allied occupation ended; the Japanese government began a review of reforms made by the occupation. The Local Finance Equalization Grant (LFEG), which had been established in 1950, was replaced by the Local Allocation Tax Grant (LATG). The source of the LATG was a certain percentage of tax revenue from three national taxes: 1) income tax, 2) corporate tax, and 3) the liquor tax. Conflict between the Ministry of Finance (MOF) and local governments as to the calculation of the minimum necessary expenditure for local governments was the main reason for replacing the old LFEG with the new LATG; the introduction of the LATG resolved this conflict. Thereafter, the portion of the earmarked three national taxes was gradually raised.

(Table 1 near here)

Rapid economic growth in the 1960s and the resulting natural increase in tax revenue meant little reform in local taxes or finance issues. However, after the 1970s oil crisis, Japan's economic growth slowed, resulting in the local and national government fiscal situation steadily worsening as tax revenues decreased. . In the 1980s, the LATG system began to depend on borrowing in addition to revenue from national taxes.

---

accumulation of tax.

[27] Instead of value added tax, business tax as national tax was transferred to prefecture tax in 1950.

2 Promotion of Decentralization

During Japan's post WWII rapid economic growth, the centralized government system played a significant role in 1) establishing a national minimum standard of living, and 2) promoting a well-balanced development of every region.

However, the economic slowdown after 1970 oil crises brought strained financial circumstances. Thus advisory organs of the Cabinet began to discuss decentralization with a focus on streamlining the government entities and functions. Slowly the political atmosphere began to support decentralization and it thus became a major challenge for the Cabinet.

2.1 The Early Argument

Japan's economy grew rapidly from 1955 to 1978. In the latter half of this growth period, several reformist local governments'[28] reforms focused on social welfare and pollution control issues.

Triggered by the 1970s oil crises, rapid economic growth slowed down and central and local government fiscal situations became worse. Reformist local governments especially struggled to maintain high-quality health service.

Reconstruction of public finance throughout the central and local level became an issue of great national importance. In 1979, the Local Government System Research Council, an advisory organ of the Prime Minister's Office, proposed the reform of intergovernmental finance. In 1981, the Suzuki administration[29] established the Ad Hoc

[28] For example, reformist local governments were born in Tokyo Metropolis government in 1967 and in Osaka prefecture in 1971.

[29] 1980-1982

Commission on Administrative Reform (CAR, *Rinji Gyosei Chosakai*)[30] headed by Toshio Doko; the commission's mission was to recommend a reform plan for the public sector. In the final report, the commission recommended that the cabinet be responsible for deciding the fundamental principles of decentralization and the actual decentralization process. The commission's final report on restructuring plans for the central and local government was submitted to the Nakasone Administration, under the slogan, "Financial reconstruction without tax increases." Some academics read an early sign of decentralization within the recommendations.

In 1983, the CAR was dissolved and the Council for the Promotion of Administrative Reform (CPAR, *Gyousei Kaiakaku Suishin Shingikai*) [31] was established, with the mission to monitor and promote administrative reform. The Council discussed the relationship between the national and local governments. In 1993, the third Council proposed to the Cabinet that the Cabinet should decide the fundamental principles of government decentralization, including doctrines, challenges, and processes of decentralization. The Council also recommended the government to enact a fundamental law for decentralization.

The author emphasizes that, in Japan, government decentralization plans stemmed from arguments to streamline the administration for the purpose of financial reconstruction. In contrast, in Europe, arguments over decentralization derived mainly

---

[30] In 1961, this first commission of this kind was established under the Ikeda administration (1959-1964). This commission was called the First Ad Hoc Commission on Administration Reform [*Daiichiji Rinji Gyousei Chosakai*]. The commission under the Suzuki administration (1980-1982) was called the Second Ad Hoc Commission on Administration Reform [*Dainiji Rinji Gyousei Chosakai*].

[31] '*Gyokakushin'* is short for this advisory organization. There were three series of sessions: the first (-1986) headed by Toshio Doko, the second (-1990) headed by Bunpei Otsuki, and, the third (-1993) headed by Eiji Suzuki.

from attempts to strengthen democracy.

In the early 1990s, the political atmosphere became supportive of decentralization. Proponents of decentralization argued that a conventional centralized system cannot adequately respond to the varied demands of local communities. Some heads of local governments stressed that excessive intervention of the central ministries in local government affairs actually spoiled the discretionary authority of local governments. The local government heads often pointed out the harmful effects of the centralized system; for example: Bureaucratic sectionalism within the central government often hampers local governments from taking adequate measures to respond to a complicatedly tangled problem.

Furthermore, the media heavily publicized what they termed wasteful spending of national subsidies to local governments. Local government officials often complained that it often required excessive efforts to apply for very small subsidies.

In the late 1980s, Japan experienced a historical asset boom, the so-called “bubble economy.” Regional income disparities were reduced prior to the bubble; however, they were expanded again in the bubble economy. The bubble economy also accelerated the unipolar concentration of business in Tokyo[32]. These economic factors fueled the clamor for revitalization of a local economy.

In 1993, the Resolution on the Promotion of Decentralization passed unanimously in both Houses of the Diet; this marked a huge political step forward for decentralization.

In the same year, the Liberal Democratic Party (LDP) that had been in power during most of the post WWII era lost office to a coalition of parties out of power, and the

---

32 Reallocation and redeployment of metropolitan functions were discussed lively in those days. In 1990, both Houses of the Diet passed a resolution of moving the Houses.

Hosokawa administration[33] was born. The Hosokawa administration tried to establish the fundamental principle to promote decentralization; this principle originated from the third CPAR [*Daisanji Gyousei Kaikaku Suishin Shingikai*] proposals in 1983. In 1994, the Murayama coalition government[34] decided the fundamental principle *(Taiko)* of decentralization. In 1995, the Diet passed the Decentralization Promotion Law, which obliged the Cabinet to develop a decentralization plan and establish a committee to advise the cabinet on decentralization and monitor progress. Based on this new law, in 1995, the Prime Minister appointed Ken Moroi to be head of the Decentralization Promotion Committee (DPC).

In 1996, the Hashimoto administration[35] came into existence. Prime Minister Hashimoto made a public commitment to reform initiatives with six major themes.[36] One theme, administrative reform using decentralization, became one of many challenges of successive cabinets.

2.2 Promotion of Decentralization

In 1997, the DPC advocated the principle of division of roles between the national and local governments in their first recommendation to the Cabinet. According to the recommendation, the national government should mainly take charge of 1) issues central to its existence in the international community, 2) making rules that are desirable to be

[33] 1993.8-1994.4. Hosokawa was the only prime minister who had experience as a governor of prefecture (Kumamoto); he was known as the governor who had been enthusiastic about decentralization. Before he obtained a seat in the House of Representative, he had been a member of the third CPAR.
[34] 1994.6-1996.1.
[35] 1996.1-1998.7.
[36] The Hashimoto administration addressed reforms in six areas: administration, fiscal structure, economic structure, social security, financial system, and education.

unified for the whole country, and, 3) executing national business. However, the centerpiece of the DPC recommendation was a proposal for repeal of administrative tasks delegated by the national government to the offices of governors and mayors (ATD, *kikan inin jimu*). [37] The origin of this delegation system goes back to the "the city, town, and village system" in Meiji era.[38] The Committee sorted the tasks delegated to heads of local governments into two categories: 1) self-governing functions (SGF) and 2) the statutory entrusted functions (SEF).[39] The SGF are defined as the original business tasks of local entities including tasks not described by the national law. To the contrary, the SEF are those tasks handled by local governments based on statutes; however, the central government should be the normatively responsible for handling of it. The Committee also proposed the rule of engagement of the national government to local governments. It asserted that the engagement with the SGF should be more restricted compared with that with the SEF.

In the committee's second recommendation, they stressed the importance of the LATG revenue guarantee function and required the cabinet to settle a plan to reduce government subsidies. As for local tax, the committee claimed to fill the gap between local tax revenue and local governments expenditure.[40] Then, the committee recommended to establish object taxes not stipulated in the Local Tax Law and to relax

[37] Governors and mayors act as agents for the central government in implementing the ATD. Local assemblies cannot get involved in the ATD. The number of tasks delegated to heads of local governments amounted to five hundred sixty-one as of 1996: three hundred seventeen-nine to governors of prefectures and one hindered eighty-two to mayors.

[38] See note #16.

[39] Self-governing function and statutory trusted functions are dubbed *jichi jimu* and *hotei jutaku jimu* respectively. Consequently, whole activities of local governments are classified into two categories: self-governing function and statutory trusted functions.

[40] The ratio of local tax revenue to local governments expenditure was 36.2 % in fiscal year 1997.

controls on ordinary taxes not stipulated in the Local Tax Law. Furthermore, they proposed to relax the permission system regarding the local government bond issue.

The author stresses that the committee discussed these issues under the assumption that decentralization should not affect the ratio of total national and local tax revenues to national income (Tax Burden Ratio).

In 1999, in response to the Committee recommendations, the government enacted the Comprehensive Decentralization Law. With the passage of this law, the system of local government delegation by the central government was finally repealed. This effectively meant no more legal systems to subordinate local governments to national government.

(Table 2 near here)

2.3 The Trinity Reform

The Koizumi administration, which emerged in 2001, also grappled with decentralization; the administration used the slogan: "Hand over what local governments can do to local governments." In 2001, the Cabinet established the Council for Decentralization Reform (CDR) as a succeeding body of the DPC. However, the concrete goal of the cabinet was discussed at the Council of Economic and Fiscal Policy (CEFP) in the Cabinet Office. The CEEP was formed in 2001 during the process of reorganizing national government ministries and agencies under the Hashimoto administration.

In 2002, the CEFP announced annual basic reform polices[41] including the principle that the cabinet should examine the issues of subsidies, the local allocation tax grant, and transfer of tax sources to local governments. This reform was called the "Trinity

[41] Basic Policies for Economic and Fiscal Management and Structural Reform 2002.

Reform." The CEEP advocated a drastic rectification of the current situation where over nineteen percent of local governments received the LATG. The CEFP mentioned that the revenue source guarantee function of the LATG should be reviewed to reduce the function.

In 2003, the CDR submitted an opinion paper to the prime minister, which proposed reducing national subsidies by several trillion yen and reviewing the LATG to make it in line with CEFP policies.

In 2003, the CEFP planed to reform national subsidies to local governments amounting to four trillion yen over three fiscal years (FY 2004 – FY 2006). The cabinet decided to transfer central government tax revenue sources corresponding to repealed subsidies provided that those subsidies were to be used for providing services that local governments were obliged to provide.[42] When repealed subsidies were used to provide services that local governments were not obliged to provide, the amount of tax revenue sources transferred was limited to eighty percent of that of repealed subsidies. Prime Minister Koizumi directed the responsible Ministries to reform national subsidies by one trillion yen in the fiscal year 2004 budget. As a result, in FY 2004, tax revenue sources amounting to four hundred twenty-five billion yen were transferred to local governments. Moreover, national subsidies amounting to around one trillion yen was reformed.

The 2004 CEFP basic policies declared to settle an overall reform plan of the Trinity Reform from FY2004 to FY2006 within 2004; the overall reform plan was expected to include 1) national subsidies reform amounting to about three trillion yen from FY2005 to FY2006, 2) the transfer of tax revenue sources amounting to around three trillion yen, and 3) the reform of the LATG. Prime Minister Koizumi asked the six

[42] Transferring tax revenue source means to reduce national tax and to increase local tax correspondingly. Total tax revenue including national and local tax remains unchanged.

major regional government associations[43] to propose the reform plan for national subsidies. While this gave local governments the opportunity to be involved in the Trinity Reform, the plan proposed by them was hard for the central ministries to swallow

Though there were severe conflicts of opinions among stakeholders, in November, 2004, the cabinet and the ruling party finally agreed upon an overall reform plan. The plan called for the reform of national subsidies amounting to about two trillion eight hundred billion yen and the transfer of tax revenue sources amounting to two trillion four hundred twenty billion yen from the national government to local governments in FY 2005 and FY 2006. In the fiscal year 2005 budget, the subsidies reform amounted to one trillion seven hundred seventy billion yen: the tax revenue transfer amounted to one trillion one hundred twenty billion yen. For the FY 2006 budget, the subsidies reform amounted to eight hundred ten billion yen: the tax revenue transfer amounted to about six hundred ten billion yen.

The 2006 tax reform included provisions to transfer tax revenue sources amounting to three trillion ten billion yen from the national government to local governments from FY 2007. The tax revenue sources transfer was provisionally enacted through distribution of national income tax revenue in FY 2006.

Tax revenue sources transfer was eventually enacted through reducing the national income tax and increasing the local income tax. Tax rates of local income tax before the revenue sources transfer were divided into three brackets: five, ten, and thirteen percent respectively for each bracket. After the revenue sources transfer, the rate of local income tax was flattened to ten percent. Prefecture and municipalities share the ten percent: four

[43] National Governor's Association, Japan Association of City, National Association of Towns and Villages, National Association of Chairpersons of Prefectural Assemblies, National Association of Chairpersons of City Councils, and National Association of Chairpersons of Towns and Villages Assemblies.

percent for prefectures and six percent for municipalities.[44] To avoid changes of each individual's tax burden, the maximum national income tax rate increased while minimum rate decreased. The number national income tax brackets were increased from four to six.

As for the LATG, in November 2004, reform plans existed, which included 1) the rationalization of local public finance programs[45], 2) the resolution of discrepancies in figures between local public finance programs and account settlements, and 3) the simplification and clarification of the calculation formula for standard fiscal needs. Though the government cut the amount of the LATG by around five trillion yen over three fiscal years (FY 2004 – FY 2006), no drastic reform was realized during the Trinity Reform.

(Table 3 near here)

Prime Minister Koizumi stepped down from his post in 2006. The succeeding Cabinet, the Abe administration, submitted a decentralization promotion bill to the Diet in October 2006, which was passed and enacted into law in December 2006.[46] Based on this law, the Decentralization Reform Promotion Committee headed by Uichiro Niwa was established.[47]

---

[44] The rate of prefecture individual income tax was two percent for a bracket of taxable income not exceeding seven hundred million yen, and three percent for a bracket exceeding it.
As to municipal individual income tax, the tax rate was three percent for the bracket of income not exceeding two hundred yen, eight percent for the bracket not exceeding seven hundred yen, and ten percent for those exceeding that.
Hence, the overall rate of local individual income tax including prefecture and municipal tax used to be five, ten and thirteen percent.
[45] See 3.2.1.
[46] This law is valid from April 2007 to March 2010.
[47] The mission of the committee is to recommend a concrete guideline to the cabinet for settling a plan for promoting decentralization.

3 Structure of Intergovernmental Finance Systems

In this chapter, the author describes the fiscal relationship between the center and local governments. Prior to discussing each fiscal instrument, the author provides a brief overview of the current local governments system.[48]

3.1 Organization

As the author reviewed in chapter two, there are two levels of local government in Japan: prefectures and municipalities. There are forty-seven prefectures composed of forty-three prefectures and four equivalent bodies (Tokyo, Osaka, Kyoto, and Hokkaido). The population of prefectures varies from over twelve million (Tokyo) to six hundred thousand million (Tottori).

Under the prefectures, as of April 1, 2007, there are two thousand three hundred ninety-nine municipalities including seven hundred thirty-nine cities, one thousand three hundred twenty towns, and three hundred forty villages. The population and area size among municipalities range largely; however, municipalities are basically in charge of the same spending responsibilities.

Prefectures and municipalities are mutually independent. Prefectures, having a wider regional viewpoint, can give various guidance and advice to municipalities.

Cities with population of five hundred thousand or more are designated by cabinet order as designated cities.[49] Designated cities are authorized the same power as

---

[48] A local government is prescribed legally as a local autonomous entity.
[49] A cabinet order based on the Local Autonomy Law prescribes the population standard of five hundred thousand. However, designated cities are actually those with population of over seven hundred thousand, taking into account of a balance between designated cities and special wards in Tokyo.

prefectures to provide some public services prescribed in the Local Autonomy Law.[50] Within the Local Autonomy Law, some cities are designated as “core cities”[51] and “special case cities”[52].

Prefectures and municipalities are called “ordinary local authorities.” There are also “special local authorities,” such as special wards in Tokyo, which have almost the same power as cities except provisions for plumbing and fire service.[53]

The Local Autonomy Law defines the basic structure and authorities of local governments, resulting in almost the same institutional set up in each local government. While the national government is based on a parliamentary system, local governments are based on a presidential system. Local assemblies determine budgets and enact legislation. The executive branch, including governors, mayors and administrative committees,[54] implements the policies enacted by the legislature. Governors and mayors are responsible

---

[50] Designated cities are entitled the same power as prefectures in nineteen policy areas including social welfare, public health, and urban planning by the Local Autonomy Law. Though designated cities can establish wards, they are not administrative wards.

[51] Cities with a population of over three hundred thousand and an area of over one hundred square kilometers are eligible for core cities. Those who are designated by cabinet order are called core cities. Core cities can undertake the functions delegated to the designated cities with some exceptions of those that may be more efficient if handled by prefectures.

[52] Cities with a population over two hundred are called special case cities after designation under cabinet order. Special cities are delegated the same functions as core cities with some exceptions of those which may be more efficiently handled by prefectures.

[53] Besides special wards, special local authorities as follows exist:
1) Municipal cooperatives that are formed by multiple municipalities to carry out functions that would be more efficient than if provided alone,
2) Property wards that are special authorities to manage property such as mountain forests,
3) Local development corporations that are set up to specifically to acquire and prepare for the sites for construction of public facilities.

[54] There are three types of administrative committees: Board of Education, Public Safety Committees, and Election Committees.

for consistency of local government public services.[55]

Governors and mayors have the right to veto any decision made by the local assembly and subsequently demand that the decision be reconsidered. If the governor or mayor cannot reach a compromise with the local assembly, the assembly can declare a vote of no confidence. If this is passed, the governor or mayor can dissolve the assembly and call for an election.[56]

Local governments do not have judicial power.

3.2 Financial Relationship across Government Levels

In Japan, the central government performs few direct functions. Central government expenditure accounts for about five percent, while local governments expenditure accounts for about fourteen percent of the gross domestic expenditure. Compared to other developed countries, Japan's share of local government expenditures, as a percentage of gross domestic expenditure, is relatively high.

(Table 4 near here)

Local government expenses constitute a major part of public spending. Expenses at the local level include education, welfare, public health, police and fire services, and public work construction such as roads and sewage systems. In many areas, prefectures and municipality government responsibilities overlap.

3.2.1 Local Public Finance Program

[55] Governors and mayors exercise general control over other executive organs such as administrative committees.

[56] It is a common phenomenon in Japan that different political parties back the same candidate in an election to decide heads of local governments. Some argues that this phenomenon results in the weakening of the assemblies' function of checking heads of local governments.

Based on the Local Allocation Tax Law,[57] each year, the cabinet must submit to the Diet official revenue and expenditure estimates for all local governments. This program is called the local public finance program (LPFP, *chihou zaisei keikaku*).

Academic literature stresses the important role that the LPFP plays in verifying that local governments have sufficient revenue to provide given public services.[58] If there is insufficient local revenue, the central government may consider measures to secure additional revenue. The LPFP provides a mechanism to achieve harmonization among national government finance, local government finance, and macro economic policy. The LPFP also provides local governments with fiscal management guidelines.[59]

On the expenditure side, the LPFP includes wages for local government employees, goods and services expenditures, capital outlays, interest and principal repayments, and public enterprise subsidies. The LPFP also includes expenditures for providing services, which local governments are obligated to provide, based on national laws; in addition, it includes expenditures for providing services not subsidized by the national government. On the other hand, it covers the expenditure for matching grant given by the central government.

On the revenue side, the LPFP covers revenue from local taxes, the LATG, local transfer tax,[60] national treasury disbursement,[61] local loans, and miscellaneous revenue.

The LPFP is a unique mechanism for coordinating national and local fiscal policies.[62] The revenue and expenditure in the LPFG are estimated on macro basis; they are not based on actual budget of each local government. The estimated amount of

[57] The Local Allocation Tax Law, Article 7.
[58] Ishihara, *The Local Public Finance System*, 1986, p. 151.
[59] Akai, Sato, and Yamashita *Economics of the local allocation tax* 2003, p. 55.
[60] See 3.2.6.
[61] See 3.2.5.
[62] Mihaljek, *Japan* in *Fiscal federalism in Theory and Practice*, 1997, p. 290.

revenue shortfalls of local governments in the LPFG results in the total amount of an ordinary local allocation tax grant[63]. While compiling the national budget, Ministry of Internal Affaires (MIC)[64] and Ministry of Finance (MOF) officials negotiate to secure revenue to balance the LPFP. In the budgeting process, the LPFP budget estimates are combined with estimates for many national policies and programs, e.g. the Fiscal Investment and Loan Program (FILP).

(Figure 1 near here)

In the early 2000s, financial discrepancies between the LPFP and settlement of accounts figures became a contested issue. This problem stemmed from the LPFP budgets which included excessive estimates of original local government investment expenses.

3.2.2 Local Taxes

The Local Tax Law is a national law that provides for prefecture taxes[65] and municipal taxes.[66] Though specific tax rates are determined by local government regulations (with some exceptions)[67], the Local Tax Law provides standard tax rates used to calculate standard fiscal revenue of the LATG. Furthermore, local governments can

---

[63] See 3.2.3.
[64] MIC is a successor of the former Ministry of Home Affaires (MOHA) established in 1955. See note #17.
[65] Prefecture taxes prescribed by the local tax law are as follows:
(Ordinary taxes) a prefectural inhabitants tax, an enterprise tax, a local consumption tax, an automobile tax, a property purchase tax, a prefectural tobacco tax, a golf course utilization tax, a mining tax, a hunter registration tax,
(Object taxes) an automobile purchase tax, a light-oil delivery tax, a hunting tax, a tax on utilization of water,
[66] Municipal taxes are as follows:
(Ordinary taxes) a municipal inhabitants tax, a property tax, a light automobile tax, a municipal tobacco tax, a mineral product tax, a special landholding tax,
(Objective taxes) a hot spring tax, an urban planning tax, a business office tax, a tax on utilization of water, a tax on development of housing land, a national health insurance tax.
[67] The Local Tax Law, Article 3.

introduce taxes (as an ordinary tax or an object tax) not stipulated in the Local Tax Law. Although the Local Tax Laws provide flexibility in setting tax rates[68], with the exception of high corporate tax rates, local governments have rarely taken advantage of this flexibility.

According to the LPFP for fiscal year 2007, local taxes account for forty-nine percent of total amount of local government revenue. Local taxes account for about forty one percent of central and local government tax revenue. The Trinity Reform turned this percentage upward.

(Table 5 near here)

One of the features of Japanese tax system is duplication of tax bases between national tax and local tax. For example, corporations are subject to a national corporate income tax, a prefectural inhabitant tax on corporate income, and a municipal inhabitant's tax on corporate income, and a prefectural enterprise tax.[69] Thus, individual income and corporations are taxed at the national, prefecture, and municipal level.[70] Private consumption is taxed at the national and prefectural level.[71]

A generally accepted theory in public finance is that it should not be possible to

---

[68] The Local Tax Law defines four types of tax rates according to tax.
1) standard rates (e.g. prefectrural inhabitant tax on individual income),
2) caps of tax rate (e.g. prefectural inhabitant tax on corporate income),
3) fixed rates (e.g. the local consumption tax), and
4) free rates: no provision on tax rate in the Local Tax Law.

[69] The amount of the enterprise tax is deductible from taxable income of corporation.

[70] Both the prefectural inhabitant tax and municipal inhabitant tax levied on an individual is collected by the municipal government.

[71] The national and local consumption tax is collected in the lump by national governments and revenue of the local consumption tax is redistributed among prefectures on an objective basis. Then each prefecture distributes half of revenue of the local consumption tax among municipalities in their jurisdiction.

export the tax to nonresidents.[72] Tax-export means that local governments shift the tax burden from its own residents to those in other jurisdictions. Though taxing power of local governments increased via the introduction of local taxes not stipulated by national law, it also gave rise to discussions of tax-export. For example, the Tokyo Metropolitan Government introduced the "hotel tax," paid by guests. Doi argues that it is illogical to levy tax on guests who enjoy only marginal benefits from public services.[73]

3.2.3 Local Allocation Tax Grant

The local allocation tax grant (LATG) is an unconditional block grant.[74] The Local Allocation Tax Law stipulates two main functions of the LATG[75]: 1) equalization of local government fiscal capacity to compensate for regional disparities in fiscal sources; and 2) revenue guarantees for local governments to provide public goods and services. Via the LATG, the central government can provide for revenue shortfalls within local governments, thus ensuring that local government fulfill spending responsibilities.[76]

A certain portion of revenue from the five national taxes is earmarked and allocated to a national special account for local allocation tax. The following equation illustrates

---

[72] Norregaard, *'Tax Assignment,' in Fiscal Federalism in Theory and Practice*, 1997, p. 54.

[73] Doi argues that, even though guests benefit from public services such as water supply, trains, and buses during their stay, water supply charges are already included in their accommodation bill and they also need to pay rail and bus fares. *A Missing Link in Decentralization Reform in Japan: Trinity Reform Package,* PRI Discussion Paper Series (No. 04A-08).

[74] Local allocation tax grant is unconditional; however, MOHA/MIC often took advantage of it as a tool for promoting regional development in combination of local bonds. MOHA/MIC is often criticized for exploiting the LATG as a sort of national subsidy.

[75] The Local Allocation Tax Law, Article 1.

[76] The Local Allocation Tax Law requires local governments to provide public goods and services at least to meet the legal obligation. Article 3.

how the taxes are earmarked; the revenue from earmarked taxes R that is allocated to the special account is decided as follows:

$$R = 0.32(I + L) + 0.358Cr + 0.295Cn + 0.25T \quad \text{where}$$

I is revenue from national income tax, L is revenue from liquor tax, Cr is revenue from national corporate tax,[77] Cn is revenue from national consumption tax, and T is revenue from national tobacco tax.

Ninety-four percent of the LATG is distributed as an ordinary local allocation tax grant to make up for local government revenue[78]; the remaining six percent is set aside as a special local allocation tax grant for unexpected extraordinary expenses[79]. The total amount of the ordinary allocation tax is fixed to an amount equal to revenue shortfalls in the LPFP.

The LATG is allocated to local governments from the national special account for local allocation tax. The ordinary local allocation tax grant is distributed among local governments proportionally to the difference between standard fiscal needs and standard fiscal revenues. The standard fiscal revenue and expenditure of individual local government is calculated according to the following formulas.

1) A formula for calculating standard fiscal needs of local government i (SFN_i) is as shown below:

$$SFN_i = \sum^{s} {}_iU_s * {}_iC_s * {}_iM_s$$

where ${}_iU_s$ is a measurement unit specified for public service s (e.g. number of students, teachers, and schools for education services). ${}_iC_s$ is a unit cost of services. This coefficient is uniform among prefectures and municipalities respectively. It is determined by using a

---

[77] The percentage decreased to 34 percent in fiscal year 2007.
[78] See 3.2.1.
[79] Special local allocation tax is used for expenses for natural disasters.

model prefecture and a model municipality. The model prefecture is that with a population of one million seven hundred thousand and an area of sixty-five hundred km^2: the model municipality is that with a population of one hundred thousand and an area of one hundred sixty km^2. ${}_iM_s$ is a modification coefficient reflecting region-specific conditions. (e.g. climate, density, population size)

2) A formula for calculating standard fiscal revenues of local government *i* (SFR_i) is as follows:

$$SFR_i = 0.75 \sum^{j} {}_iB_j * t_j + LTT_i$$

where B_j is estimated tax base for *j*th local tax and t_j is standard tax rate for *j*th local tax that is described in the Local Tax Law. Hence, $\sum^{j} {}_iB_j * t_j$ is the estimated tax revenue of local government *i* if it would apply standard tax rates. A coefficient of 0.75 is dubbed as "reservation ratio." [80] If a coefficient of one hundred percent is used, local governments may not be able to afford to respond to additional fiscal needs that are not included in the SFN. Furthermore, it may result in discouraging local governments from developing tax revenue sources because an increase in tax revenue would be offset by a decrease of the LATG in the coming year's calculation.

Local transfer tax (LTT) revenue[81] is collected nationally but redistributed to local governments on an objective basis. As of FY 2006, there were six types of the local transfer taxes.

The revenue shortfalls of local governments in the LPFP, which ought to be equal to the LATG, does not match necessarily the total revenue from earmarked five taxes, thus

[80] It used to be 0.8 for prefectures before fiscal year 2003.
[81] See 3.2.6. See note #97.

the central government has to make up for the financial gap.[82] To do so, MOF officials annually negotiate with MIC officials for a solution to fill the gap prior to the decision of national budget draft. These solutions are dubbed local finance measures (*chihou zaisei taisaku*).[83]

In the 1980s "bubble economy," revenue from earmarked taxes increased, resulting in the automatic increase of local allocation tax funds. The MOC revised the SFN upward and would not allow a LATG surplus[84]. However, after the bubble's collapse in 1989, revenue from earmarked taxes steeply declined. Consequently, local government revenue shortfalls significantly increased. The central government financed these revenue gaps through various management tools including borrowing.[85] Because this borrowing was included not in the general account budget but in the special account budget for local allocation tax, it was often dubbed "hidden debts." As of the 2006 fiscal year end, outstanding borrowing in the special account for local allocation tax was fifty three trillion yen.[86] This amounts to about ten percent of the 2006 gross domestic product.[87]

---

[82] There is an argument that, in the annual process of complication of a national budget, the local public finance program is estimated mainly focusing on its growth in comparison with that of the national budget. This process may lead to slight detailed examinations of the LATG. Izui, *Local Finance Data Book, FY2005*, p. 260.

[83] Annual local finance measures have no legal basis; however, balancing the LPFP is required politically. If the total revenue from earmarked five taxes differs widely over the years from the aggregate amount of differences between SFN and SFR in local governments, the central government have to review the local finance/administrative system or the earmarked tax rates of five national taxes.(The Local Allocation Tax Law, Article 6-3)

[84] Ihori, *Decentralization and Financial Reconstruction: Evaluation and perspective of the trinity reform*, 2004, p.121.

[85] Creditors are the Fiscal Investment and Loan Program (FILP) and financial institutions. The central government provides funds to local government through the FILP. See note #91. Another tool was special addition to revenue from earmarked five national taxes.

[86] The national and local governments owe 18.7 trillion yen and 34.2 trillion yen respectively. A ratio of duty to repay between national and local governments has been determined by the negotiations between MOHA/MIC and MOF. As the incidence of

Meanwhile, through the LATG and local bonds, the national government attempted to stimulate local governments' investment in original public works.[88] The national government used the LATG as a means to encourage particular programs, e.g. a comprehensive regional development program.

The author emphasizes that, in FY 2005, only a few local governments did not depend on the LATG, specifically only one prefecture (Tokyo) and one hundred thirty-eight municipalities.

3.2.4 Local Bonds

The principle of the Local Finance Law is that local governments finance their expenditure with revenue other than from local bonds; however, the Law allows them to issue bonds to finance capital expenditures.

Before 2005, MOHA/MIC supervised and controlled all local government borrowing. Prefectures and municipalities were required to obtain permission from the Minister of Home Affaires[89] and a prefectural governor respectively prior to any borrowing. Local authorities had to meet strict debt-service capacity criteria.[90] Furthermore, the central government subsidized most repayments of local bonds through the LATG. Consequently local bonds were treated like government-guaranteed bonds

burden stemmed from the borrowing is ambiguous, especially among local governments, borrowing in the special account was repealed in 2003. This resulted in increasing issue of local bonds.

87 Gross domestic product in 2006 is based on 'Economic Outlook and Basic Stance for Macroeconomic & Fiscal Management, FY2006' at the cabinet.

88 Repayment of local bonds issued to finance various kinds of public works are allowed to include in SFN.

89 The Minister of Internal Affaires and Communications (from 2001 to 2005).

90 Ter-Minassian, and Graig, '*Control of Subnational Government Borrowing*' in *Fiscal Federalism in theory and practice,* 1997, p. 160.

('tacit government-guaranteed bonds') and local governments enjoyed lower interest rates.

Under the permission system, the MOHA/MIC could determine who would underwrite local bonds; MOHA/MIC arranged who purchased the local bonds through negotiation with central government department in charge of government funds. Even if government funds were not available, local governments could easily persuade local banks to buy private placement bonds.[91] Local banks had suffered from finding private sectors borrowers through many years; they saw local bonds as risk-free assets backed by the national government.

The main creditors of local governments are the central government, government-managed financial institution (Japan Finance Corporation for Municipal Enterprises), and the private sector. The central government funds were provided through the Fiscal Investment and Loan Program (FILP). However, after the 2001 government reform and streamlining of the FILP,[92] the funding volume from the FILP was reduced to less than forty percent of its 1996 peak value. Historically, local government dependence on central government funds has steadily declined, from one hundred percent in the

---

91 Local governments usually specify banks as designated banks that are entitled to receive and pay money on behalf of local governments. Prefectures must specify their designated banks based on the Local Autonomy Law. To be designated banks used to be profitable and creditable; however, local banks claim that designated banks cannot cover costs these days because local governments came to introduce a bid system in financial transactions. 'Wishes to Local governments by Regional Banks Association of Japan,' June 2000.

92 The FILP prior to the reform in 2001 was a mechanism involving the mandatory deposit of funds from postal savings, pension reserves, and other sources to the national government managed by FILP agencies. However, there was the view that FILP funding was decided with priority on operational needs for increased funds rather than needs based on fiscal policy, thereby inducing the bloating of the financed projects of FILP agencies. In 2001 reform, obligation to deposit all postal savings and pension reserves eliminated.

1950s to below thirty percent in the early 2000s.[93] On the contrary, local government financing via the use of capital markets is gradually increasing.

The Comprehensive Decentralization Law established provisions for a local government "prior consultation system" versus the older permission system. Under this new system, the local governments can issue bonds without obtaining permission after 2005. However, local governments cannot include interest and principal in the SFN nor can they borrow central government funds if they issue bonds without approval of the Minister of Internal Affairs and Communication or that of a prefectural governor.[94]

Local governments who cannot satisfy specific financial criteria are required to obtain MIC's permission to issue bonds. Local governments with severe financial situations are restricted to issue bonds. This system has two major goals: 1) Help guarantee provision of public services for local governments, and 2) Maintain the creditworthiness of local bonds for whose risk weight is zero under BIS[95] regulation.[96]

3.2.5 National Government Disbursement

Although the Local Finance Law stipulates that a local government should bear all expenses for their operations,[97] there are three types of national treasury disbursements which are exceptions to this rule, specifically 1) national treasury obligatory shares, 2) national treasury subsidies (grants-in-aid), and 3) payment for agential tasks.

---

[93] In 2006, the ratio of government funds to total fund-raising is 27.6%. Banks underwrote 37.2% of local bonds. 25.1% of them was issued in the financial market. The remaining was underwritten by Japan Finance Corporation for Municipal Enterprises that is a government-managed financial institution.
[94] This means that repayment is not covered by LATG.
[95] 'BIS' is short for the Bank for International Settlements.
[96] The decentralization program in 1998.
[97] The Local Finance Law, Article 9.

National treasury obligatory shares are payable to local government for providing services under the joint responsibilities of the central and local governments (e.g. compulsory education expenses). National treasury subsidies are distributed for a specified purpose. Payment for agential tasks are payable for undertaking what are originally the responsibility of the central government, but are entrusted to local government for convenience and efficiency (e.g. election expenses for national elections).

Unlike the LATG, most national treasury subsidies are allocated among local governments at the discretion of the central government. These subsidies are designed mainly as cost-sharing programs: the central government shares a certain percentage of standard cost with local governments.[98] They have two main objectives: to secure uniformity in the provision of public goods and services, and to minimize the risk of the suboptimal provision of public goods and services where there are spillover effects.[99]

There have been huge arguments among local governments on the harm of national treasury subsidies.[100] Thus successive cabinets have struggled to reform and curtail these subsidies. In fact, under the Trinity Reform,[101] national government disbursements

---

98 Mihaljek, *Fiscal federalism in theory and practice*, 1997, p. 297.

99 If benefits of public goods and services extend beyond the jurisdiction, they have spillover effects. If community in the upper of a river constructs a sewage plant, community in downstream has a benefit. Economists refer to these externalities as spillover. Stiglitz, *Economics of the Public Sector*, 1986, p. 554.

100 The main harm of national treasury subsidies were as follows:
1) Excessively strict and detailed operational conditions leave no discretionary power of local governments.
2) Sectionalism of the central government impedes optimal decision of local governments.
3) The responsibility of providing public services between the central government and local governments become ambiguous.
4) The procedures to apply for national treasury subsidies are very complicated.

101 The figure includes subsidies from both the general account and special accounts of the central government.

declined from twenty trillion yen in fiscal year 2003 to nineteen trillion yen in FY year 2006. However, some national subsidies survived in weakened forms, e.g. grants with relaxed conditions.

In fiscal year 2006, total government (central and local) social welfare-related disbursements accounted for sixty-three percent of all expenses, while public works and education disbursements accounted for twenty-three and ten percent respectively.

(Figure 2 near here)

3.2.6 Local Transfer Tax

The local transfer tax is originally income of local governments, which, for convenience-sake, is collected as a national tax and redistributed to local governments Local governments share the revenue from local transfer tax on an objective basis. (e.g. area of roads).[102]

4 Theoretical Perspective on Intergovernmental Finance

In this chapter, the author provides an overview of academic theories of

[102] Six Local Allocation Taxes are as follows:

1) Income transfer tax: a certain portion of revenue from national income tax is unconditionally transferred on behalf of tax revenue transfer.
2) Local road transfer tax: total revenue from local road tax is distributed to prefectures, the designated cities, and municipalities for road expenses.
3) Petroleum gas transfer tax: half of revenue from petroleum gas is distributes to prefectures and the designated cities for road expenses.
4) Automobile weight transfer tax: one third of revenue from automobile weight tax is distributed to municipalities for road expenses.
5) Aircraft fuel transfer tax: two thirteenths of revenue from aircraft fuel transfer tax is distributed among airport-related local governments for expenses on noise prevention.

Special tonnage transfer tax: total revenue from Special tonnage tax is distributed unconditionally among municipalities with ports.

decentralization. The author focuses on economic aspects of decentralization, specifically theories on fiscal federalism. The fiscal relation between hierarchically ordered units is fiscal federalism and that between coordinate units is multi-unit finance.[103] In the study of fiscal federalism, academics explore the roles of the different levels of government and the problems that occur in expenditure assignment, revenue assignment, and vertical and horizontal imbalance. [104]

4.1 Traditional Theory of Fiscal Federalism

Musgrave argues that the traditional approach to fiscal theory has been in the context of unitary government. “Adam Smith’s work dealt with the fiscal needs of the prince, and the funding of national public works. ...The Keynesian renaissance in the economics of public finance focused on government finance as a tool of stabilization, thus directing attention once more to the central level.” [105]

However, many countries have a decentralized fiscal structure, thus the appropriate allocation of responsibility among various government levels is a critical issue. Fisher stated that “intergovernmental fiscal relations are at the forefront of public finance policy, both in the U.S. and other areas of the world.”[106]

The traditional theory of fiscal federalism lays out a general normative framework for the assignment of functions to different government levels and the appropriate fiscal

[103] Musgrave, *Essays in Fiscal Federalism*, 1965, p. 2.
[104] Rosen, *Public Finance* 2005, p.506.
Oates, *An Essay on Fiscal Federalism*, 1999, p. 1120.
[105] Musgrave, *Essays in Fiscal Federalism*, 1965, p. 2. According to Oates, “the bulk of Musgrave’s analysis is in terms of a system consisting of a private sector and a *single* level of government.” Oates, *Studies in Fiscal Federalism*, 1991, p. 3.
[106] Fisher, *Intergovernmental Fiscal Relations: Policy Development and Research Prospects* in *Intergovernmental Fiscal Relations*, 1997, p. 1.

instruments for carrying out these functions.[107] As local governments do not have monetary and exchange-rate prerogatives, they have limited powers over macroeconomic control. It naturally follows that the central government should be responsible for the macroeconomic stabilization function.

Furthermore, mobility of economic units can constrain local governments to attempt to redistribute income. For example, if local governments provide programs to support low-income households; it is likely to induce an inflow of the poor and an outflow of the rich who must bear the tax burden.[108]

Musgrave divided the public fiscal department into three branches: an Allocation, a Distribution, and Stabilization. He argues that the Distribution and Stabilization branches of the public fiscal department must perform their functions primarily at the central-government level.[109]

However, as Oates pointed out, these precepts should be regarded as general "guidelines" rather then firm "principles." Although local governments actually undertake a significant amount of redistributive activity, they do not offer a precise delineation of specific goods and services to be provided at each government level.[110]

Besides distribution and stabilization functions, the central government has to provide national public goods and services that affect entire country. The national defense is obviously this kind of public goods.

4.2 Tiebout Model

[107] Oates, *An Essay on Fiscal Federalism,* 1999, p. 1121.
[108] Id. p. 1121.
[109] Musgrave, *The Theory of Public Finance*, p. 181-2. Oates, *Studies in Fiscal Federalism*, 1991, p. 20.
[110] Oates, *An Essay on Fiscal Federalism*,1999, p. 1122.

Markets generally fail to provide public goods efficiently because individuals do not reveal their true preference for public goods. There is no effective way to exclude a free rider who has no incentive to pay for services voluntarily. [111]

Tiebout argued in his famous model that highly mobile individuals "vote with their feet." Individuals move among jurisdiction and locate in the community that offers the fiscal package (public services and taxes) best suited to their tastes. He argued that the mobility among jurisdictions may produce a market-like solution to the local public goods problem.[112]

There are some key conditions in the Tiebout model and it is clearly not a perfect description of the real world.[113] Oates argues that the Tiebout model is often viewed as a peculiarly U.S. construction. "The relatively footloose households that it envisions, responding to such things as local schools and taxes, seem to characterize the U.S. much better than, say, most European countries."[114]

---

[111] That is why individuals are forced to support public goods through taxation. Stiglitz, *Economics of Public Sector,* 1986, p. 100.

[112] Tiebout, *A Pure Theory of Local Expenditure*, 1956.

[113] According to Rosen, key conditions of the Tiebout model are as shown bellow.

- Government activities generate no externalities.
- Individuals are completely mobile.
- People have perfect information with respect to each community's public service and taxes.
- There are enough different communities so that each individual can find one with public services meeting her demands.
- The cost per units of public services is constant.
- Public services are financed by a proportional property tax. (Tiebout [1956] assumed finance by head taxes. The more realistic assumption of property taxation is from Hamilton [1975])
- Communities can enact exclusionary zoning laws.

See, Rosen, *Public Finance*, 2005, pp. 509-510.

[114] Oates, *An Essay on Fiscal Federalism,* 1999, p. 1124.

Moreover, there are more fundamental critical views to regional competition. In order to promote industry, local officials might tend to reduce tax rates, consequently, output of public services ("race to the bottom"). Local governments might compete by reducing local environmental standards to attract new business ("destructive intergovernmental competition") [115]

In the case of Japan where a lifetime employment system is dominant, individual moving is not easy. Moreover, based on the assumption that there are regional disparities, Kaneko argues that small-scale local governments with less financial power would be inevitably defeated in a competition. As welfare services motivate the poor who do not own houses to move rather the middle class and rich with their own houses, competition may drive local governments to reduce services.[116]

However, as Rosen argues, we should not dismiss the Tiebout mechanism too hastily.[117] Naturally, those who choose where to live will carefully evaluate each prospective community. In Japan, though mobility is much lower than in the U.S.,[118] the top reason people moved was 'housing.'[119] Moving for the purpose of acquiring a new home is increasing. There is no available statistic for this; however, it is easily presumed that public services such as education and welfare may also be an important decision

---

115 Oates, *An Essay on Fiscal Federalism*, 1999, p. 1134.

116 Kaneko, *Leave Tax Revenue Sources for Local Governments*, Jinno and Kaneko, eds. 1998, pp. 145-149.

117 Rosen, *Public Finance*, 2005, p. 511.

118 In Japan, number of intra-prefectural migrants and intra-municipal migrants amount to over two million and over five million respectively, in 2006. [Statistics Bureau, MIC, April 2007]
In the U.S, more than thirty-nine million Americans, or about fourteen percent of the population, changed addresses in 2004. [US Bureau of the Census, 2005]

119 The fifth migration survey, National Institute of Population and Social Security Research.

factor when people choose their home location.[120]

4.3 Decentralization Theorem

Oates straightforward normative proposition, “the Decentralization Theorem” states that, “in the absence of cost-saving from the centralized provision of a [local public] good and of inter jurisdictional externalities, the level of welfare will always be at least as high (and typically higher) in Pareto-efficient levels of consumption are provided in each jurisdiction than if *any* single, uniform level of consumption is maintained across all jurisdictions”

The theorem establishes, on grounds of economic efficiency, a presumption in favor of the decentralized provision of public goods with localized effects[121]. The government and individuals often differ as to the preference for public goods and services (“asymmetric information”). A centralized government is likely to be obligated to provide uniform goods and services. Meanwhile, local governments are much closer to the local people and thus possess more knowledge of local preferences and cost conditions than a central government. Consequently local governments can tailor goods and services to meet the needs of the local population. In fact, providing people with more or less of a public good than they desire is inefficient.

Oates theorem advocated a basic principle of fiscal decentralization: specifically “the presumption that the provision of public services should be located at the lowest

---

120 Some argues that high home ownership rate in Japan may be a cause of low mobility. However, home ownership rate in Japan is lower than that in the US. [Japan: 62.0%, US: 68.3%, UK: 70.0%, Germany: 43.6%, France: 56.2%, IMF, World Economic Outlook, September, 2004] One-size-fit-all services under centralized system may be one of reasons of low mobility.

121 Oates, *An Essay on Fiscal Federalism,* 1999, p. 1122.

level of government encompassing, in a spatial sense, the relevant benefits and costs."[122]

The principle of the decentralization of the provision of public services has been widely recognized in modern nations. For example, we can see it in the Maastricht Treaty under the name of "principle of subsidiary," which is a fundamental principle for European Union.

4.4 Leviathan Model

Brennan and Buchanan thought fiscal decentralization as a mechanism for controlling the size of the public sector. They modeled government as a so-called "Leviathan" that seeks its own aggrandizement through maximizing the extraction of tax revenues. According to their model, the constitution and associated institutions were designed with the objective to create government constraints to limit Leviathan's access to tax and other financial instruments. They felt that fiscal decentralization is the key to constraining public sector growth. They proposed that Leviathan's capacity to channel resources into the public sector is greatly limited by competition among decentralized governments for a mobile economic unit. "Intergovernmental competition for fiscal resources and inter-jurisdictional mobility of persons in pursuit of 'fiscal gains' can offer partial or possibly complete substitutes for explicit fiscal constraints on the taxing power." [123]

Brennan-Buchanan's view suggests the hypothesis that as taxes and expenditures are more and more decentralized, the overall size of the public sector should decrease.

---

[122] Oates, *An Essay on Fiscal Federalism*, 1999, p. 1122
[123] Brennan, and Buchanan, *The Power to Tax: Analytical Foundation of Fiscal Constitution*, 1980.
http://www.econlib.org/Library/Buchanan/buchCv9Contents.html

However, Oates argues that the evidence to support this hypothesis is mixed.[124]

Brennan and Buchanan assert that revenue-sharing is undesirable because it subverts the primary purpose of federalism, which is to create competition between jurisdictions. They emphasize that each jurisdiction must have responsibility for raising its own revenue and should be precluded from entering into explicit agreements with other jurisdictions on the determination of uniform rates.

4.5 Flypaper Effect

In the literature, academics emphasize three potential roles of intergovernmental grants: 1) the internalization of spillover benefits to other jurisdictions, 2) fiscal equalization across jurisdictions, and 3) an improved overall tax system. Conditional grants, in the form of matching grants (under which grantor finances a specified share of the recipient's expenditure) are employed when the provision of local services generates benefits for other jurisdictions. Unconditional grants are used for purposes of fiscal equalization across jurisdictions.[125]

Non-matching grants are theoretically assumed to alter income available to jurisdictions without altering the relative price of public goods, and hence assumed to have an effect on local spending similar to that of any other change in private income. On the other hand, matching grants cause relative prices to change and thus found to stimulate more spending per dollar of grant than a non-matching grant. [126]

A lump-sum grant to a group of people is fully equivalent in all its effects to a set

---

[124] Oates, *An Essay on Fiscal Federalism,* 1999, p. 1140.
[125] Id. pp. 1126-1127.
[126] Cournant, Gramlish, Rubinfeld *The Stimulative Effects OF Intergovernmental Grants: Or Why Money Sticks Where It Hits,* in *Fiscal Federalism and Grants-in-Aid.* 1979, p. 5.

of grants directly to the individuals in the group. This theorem is called “Bradford-Oates equivalent theorem” and is also known as the “veil hypothesis.” It implies that a grant to a community is fully equivalent to a central tax rebate to the individuals in the community; intergovernmental grants are simply a “veil” for a federal tax cut.[127]

However, empirical studies in the U.S. found that states and local government spending is much more responsive to increases in intergovernmental receipts than it is to increases in the community’s private income. This phenomenon has been dubbed the “Flypaper Effect” — money sticks where it hits.

The median voter theorem states that, as long as all preferences are single peaked, the outcome of the majority reflects the median voter.[128] Bureaucrats and elected officials seem to play a passive role in implementing the median voter’s wishes. However, the flypaper effect suggests that the bureaucrats’ role is not simply passive. There is now a large base of literature that tries to explain the flypaper effects.[129] One possible explanation is that bureaucrats exploit citizens’ incomplete information regarding the community budget constraint.[130]

Local governments had limited power to reduce the local tax rate, thus, there were many difficulties in conducting empirical studies of the “Flypaper Effect” in Japan. Despite these difficulties, Doi suggests that the “Flypaper Effect” does exist in Japanese local governments[131].

---

127 Oates, *An Essay on Fiscal Federalism*, 1999, p. 1129.
128 Define the median voter as the voter whose preference lie in the middle of the set of all voters’ preferences. Rosen, *Public Finance*, 2005, p. 117.
129 Oates, *An Essay on Fiscal Federalism*, 1999, p. 1129.
130 Rosen, *Public Finance*, 2005, p. 540.
131 Doi argues that cities whose revenue from property tax was smaller than that from the LATG showed flypaper effects. *Financial Review*, 1996.

4.6 Market-Preserving Fiscal Federalism

Weingast sees decentralization in terms of its capacity to sustain a productive and growing market economy. He lays out a set of conditions that help differentiate federal system, specifically:[132]

(1) Hierarchy. There exists a hierarchy of governments with a delineated *scope of authority.*

(2) Subnational autonomy. Do the subnational governments have primary *authority over public goods and services provision for the local economy?*

(3) Common market. Does the national government provide for and police a *common market that allows factor and product mobility?*

(4) Hard budget constraints. Do all governments, especially subnational ones, face hard budget constraints?

(5) Institutionalized authority. Is the allocation of political authority institutionalized?

Weingast argues that an ideal type of federalism, called *market-preserving federalism* or *market-enhancing federalism,* satisfies all five conditions.[133] Weignasts' attraction to federalism stems from its potential for providing a political system that can support an efficient system of markets.[134] He claims that competition gives subnational governments the incentives to foster local economic rather than having costly market intervention service to interest groups, and corruption.[135]

---

[132] Weingast, *Second generation fiscal federalism: Implications for Decentralized Democratis Governance and Economic Development*, 2006, p. 6.

[133] Weingast argues in historical terms that eighteenth century England and the United States in the nineteenth century were effectively such system of Market-Preserving Fiscal Federalism. Oates, *An Essay of Economic Literature*, 1999, p. 1139.

[134] Oates, *An Essay on Fiscal Federalism,* 1999, p. 1138.

[135] Weingast, *Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development,* Jun 2006, p. 6.

In his view, inter-jurisdictional competition provides political officials with strong incentives to pursue policies that provide for a healthy local economy. If governments fail to foster markets, they risk losing capital and labor – and hence valuable tax revenue – to other areas.[136]

Furthermore, Weingast asserts that hard budget constraints limit government borrowing and fiscal transfers among various government levels. These constraints require that subnational governments bear the financial consequences of policy decisions, precluding them from spending beyond their means or endlessly bailing out failing enterprises.[137] A hard budget constraint also precludes the national governments to use cash transfers or forgivable loans to bail out deficit-ridden subnational governments.

McKinnon also stresses the importance of a hard budget constraint. Local governments have no direct or indirect access to the central bank and then they are limited to fiscal instruments. If local governments initiate debt financing programs, they have to operate as private borrowers in private credit markets. If their credit rating drops, and if it continues, they face the threat of absolute capital rationing. These markets create an environment in which the fiscal authorities must behave in responsible ways.[138]

McKinnon contends that intergovernmental equalization grants or tax break for poor areas undermine fiscal independence. He argues that economic rise of the American South is unlikely to have occurred had it been subsidized by any government entities. He

---

136 Weingast, *Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development*. 2006, P.6. He advocates second generation fiscal federalism (SGFF) which compliments first generation fiscal federalism (FGFF). "FGFF is largely normative and assumes that public decision makers are benevolent maximizers of the social welfare. SGFF builds on FDFF but often systematically diverge from maximizing citizen welfare."

137 Id. pp. 7-8.

138 Oates, *An Essay on Fiscal Federalism,* 1999, pp. 1138-1139.

also questions financial transfer schemes where, within a rich country, money is transferred from a rich region to a poor region. He feels that such revenue transfers, e.g. in Canada and Italy, create dependency and a soft budget constraint. He asserts that, compared with the American South, countries with financial transfer schemes among local economies, are less likely to adapt to become vibrant national economies.[139]

As Oates indicates, Weignast and McKinnon remind us of the important discipline that stems from self-financing. Public authorities need to fund their own expenditure at the margin.[140] It is especially important that intergovernmental grants not be readily available to turn to bail them out of fiscal difficulties[141]

Aoki argues that, if Japan's local governments would have greater fiscal latitude, then the discipline of market-preserving federalism would be necessary. He emphasizes that the MIC should abolish a de facto guarantee to repay interest and principal of bonds issued by local governments.[142]

4.7 Implications

When we think of optimal federalism, bringing government closer to people seems desirable. Scholars point out three advantages of the decentralization system.[143] First,

---

[139] McKinnon argues "Although central government equation grants or tax relieves to middle- or lower-level political entities representing poorer areas often fail in the sense of discouraging disadvantaged regions from standing on their own feet in the long run, such interventions may still be tried by short-sighed politicians." *The logic of Market-Preserving Fiscal Federalism*, 1997, p. 1573.

[140] Oates, *An Essay on Fiscal Federalism*, 1999, p. 1139.

[141] Wildsin, *Externalities and Bailouts: Hard Budget Constraint in Intergovernmental Fiscal Relations*, World Bank Policy Research WP 1843.

[142] Aoki, '*The Introductory Chapter'* in *Fiscal Reform of Japan: Redesigning the Frame of the State*, 2004, p. 28.

[143] The frame of this section owes much to Rosen and Oates. Rosen, *Public Finance*, 2005, p. 512-516, Oates, *Toward A Second-Generation Theory of Fiscal Federalism* 2004,

local governments have the ability to adjust quality and quantity of public services to suit local tastes. Second, local governments try to provide public services more efficiently and be more responsive to their residents through local government competition. Third, a decentralized system enhances the chances for new solutions to the challenge. Some programs that begin as experiments in local governments may eventually become national policy. Decentralized system may promote experimentation and innovations within the public sector.

However, from the viewpoint of maximizing a national social welfare function that takes into account all citizens' utilities, we have to aware that there are some disadvantages of decentralized system, as shown below. The first four disadvantages are related to issues of efficiency. The last disadvantage is related to issues of equity.

1. Externalities Problem: If public goods provided by one community affect the well-being of people in another community, resources may be allocated inefficiently.
2. Economy of Scale Problem: For certain public goods, the cost per person decreases as the number of users increases.
3. Tax-export Problem: Communities are likely to select taxes on the basis of whether they can be exported to outsiders. If the community can shift the tax burden to other jurisdictions, the result is an efficiently large amount of local goods.
4. Scale Economies in Tax Collection Problem: Individual communities may not take advantage of scale economies in the collection of taxes.
5. Equity Problem: Redistributive programs of local government are difficult to implement because of the mobility of habitants.

Conventional economic theories suggest a fairly clean division of responsibility for

---

pp. 14-31.

public goods provisions. The central government has the responsibility for the macroeconomic stabilization function and for income distribution. Furthermore, the central government must provide a set of national public goods. However, economists also admit that there is considerable interplay between levels of government. Rosen argues that ‘allowing local communities to make their own decisions very likely enhances efficiency in the provision of local public goods. However, efficiency and equity are likely to require a significant central government economic role.’[144]

Oates observes that the new literature federalism focusing on the political economy of intergovernmental structure placed a strong emphasis on the importance of hard budget constraints. Fiscal decentralization can provide a vehicle through which local governments can exploit the “fiscal commons” by shifting the burdens of local programs onto the nation as a whole.[145] In the presence of soft budgets constraints, local governments have an irresistible incentive to expand their spending beyond their means. Local governments expect that their fiscal deficits will be covered by the central government: they need not keep their fiscal houses in order. These destructive behaviors are called “raiding of fiscal commons.” Oates argues that an economic setting of well developed and efficient market combined with fairly decentralized political system, characterized by healthy competition among jurisdictions, can go a long way to producing the hard budget constraint needed for local government to function well.

---

[144] Rosen, *Public Finance*, 2005, p. 539.

[145] Rodden illuminated ‘the dilemma of fiscal federalism.’ He argues that, for a variety of political perhaps even moral reasons, the center often get involved in the affaires of the subnational governments—so involved that it cannot credibly commit to ignore their fiscal problems. He refers a basic underlying institutional dilemma that can cause subnational officials to view public revenue as a common pool. Rodden *The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World,* 2001, pp. 3- 29.

However, Oates claims that these institutions may not always exist. [146]

5 Challenges of Decentralization in Japan

As we have already seen, common in fiscal federalism literature is the view that decentralization can fundamentally entail gains in government efficiency and social welfare. However, in Japan, conflicts of interests among stakeholders have impeded the promotion of decentralization. In fact, the goal of decentralization seems to vary among Japan's numerous interested parties and stakeholders. In this chapter, the author summarizes the fundamental challenges for decentralization in Japan.

5.1 Assignment of Functions

In Japan, although the central government performs relatively few direct functions it remains heavily involved in local government administration. Demarcation of roles between the central and local governments is institutionally unclear. In many fields, there is role duplication in various levels of the government. For example, even though public services are self-governing functions (SGF, *Jichi Jimu*);[147] the central government takes part in providing local public services via laws or through national subsidies.

An ideal decentralization should bring government closer to the people through narrowing the role of the central government. However, the central government in Japan is generally in charge of the administration and the minister of each department bears his/her share of responsibility under the parliamentary cabinet system. The cabinet, in

[146] Oates, *Toward A Second-Generation Theory of Fiscal Federalism* 2004, p. 21.
[147] Self-governing functions are categorized into two types: self-governing functions provided in the national law and those not provided in the national law.

exercise of executive power, shall be collectively responsible to the Diet.[148] Unlike the United States, Japan has no constitutional limitation of administrative power by the central government.[149]

As an example only, let us assume that a national ministry abolishes laws or national subsidies that provide for local public services. Some local governments may reduce provision of public services to suboptimal level. In the worst case scenario, the members of the Diet may condemn the national ministry. Every national ministry is usually reluctant to run such a risk; in addition the ministries do not favor cutbacks in their power over local governments and their budget.[150] Thus, the various national ministries have little incentive to promote decentralization. Even though the prime minister may take the lead in promoting decentralization, ministries would be quite passive in abolishing relevant laws and subsidies. Furthermore, it is a common observable fact that in Japan, Diet members are not so enthusiastic with meddling in their so-called fields of expertise.

Furthermore, local governments are in charge of the statutory entrusted functions (SEF). The SEF is a function based on national laws or cabinet orders and handling of them is originally the responsibility of the central government.[151] According to eight features (*Merkmal)* described in the decentralization enforcement program in 1998, administrative tasks delegated by the national government to heads of local governments

---

148 The Cabinet Law, Article 1.

149 Even in the US, 'Who should make laws on important social issues' seems to be a controversial. The Pew Research Center for The People and The Press, July 2006, people-press.org

150 It is an observable fact that officials of central ministries take a position in local governments as executives. A background of this personal exchange is assumed to be the reflection of the power and budget of the central government.

151 Some of statutory entrusted functions for municipalities are responsibilities of prefectural governments.

(ATD) was classified into two categories: the SGF and the SEF.[152] Various kinds of business based on the national laws fell into these two categories. In practice, taxpayers can hardly know the difference between the SEG and the SGF. The responsibility of the central versus local governments is a complicated manner, often resulting in discouraging levels of local government accountability.

The author acknowledges that decentralization in Japan has focused on reducing central government intervention in local governments rather than reviewing assignment of roles across levels.[153] What is necessary for further decentralization is to review assignments of functions and to reduce duplication of roles between the central and local government.

A key challenge for decentralization in Japan is the cabinet's continuous encouragement of national ministries to go a step further to promote devolution of their power to local governments. Moreover, the cabinet should address this challenge as one

---

152 See 2.2.
Eight features of the SEF described in the decentralization enforcement program were as follows.
1) Those closely related to rules over a country,
2) Those of which a country conducts directly the core: They include management of national assets, forestry conservancy, river improvement, a complement of environmental standard, supervision of financial institutions, regulation on manufacturing drugs, and narcotics control,
3) Some uniform systems: They involve livelihood protection, social insurance, and compensation by the state,
4) Prevention of spread of a contagious disease and regulation on circulation of drugs,
5) Involuntary admission to a mentally hospital,
6) Disaster relieves,
7) Parts of procedures prior to actions of the nation,
8) Those related to international agreements.

The number of laws including the ADT amounted four hundred thirty-two. The number of SGF and SEF amounted two hundred ninety-eight and two hundred forty-seven respectively. The sum of the number of SGF and SEF do not match the number of laws including the ADT because some laws include plural number of the ADT.

153 Jinno, *Leave Tax Revenue Source for Local Governments,* 1998, p. 220.

body.

5.2 Expenditure Responsibilities

In Japan, the central government guarantees local governments revenue, thus the expenditure responsibility between the central and local governments is ambiguous. Though there is consensus in the literature that decentralization of spending responsibilities can entail welfare gains, the view that local governments should shoulder expenditure responsibility is not politically prevalent. In the process of creating the Trinity Reform, local governments strongly insisted that the central government maintain the revenue guarantee function.

Local governments claim they need the revenue guarantee function because national laws obligate them to provide some public services.[154] The duplication of roles and the ambiguous spending responsibility are closely related.

The economic impact of the LATG that guarantees revenue sources for local governments (often known as the ‘equation impact’) is very strong. For example, the sum of per capita revenue from local tax and the LATG in Shimane, Kochi, and Tottori prefectures is higher than the per capita local tax revenue in Tokyo (which doe not receive the LATG). [155] In Okinawa, though the per capita local tax revenue[156] is about one forth of that in Tokyo, Okinawa’s sum of per capita revenue from local tax and the LATG is above seventy percent of local tax revenue in Tokyo.

After WWII, the LATG played an important role to establish national minimum of

[154] The LATG also guarantees revenue source for providing public services not prescribed by the laws.
[155] Tokyo is the wealthiest prefecture and the only prefecture that dose not receive LATG in fiscal year 2004.
[156] The per capita tax revenue in Okinawa is the lowest among prefectures.

standard living under the political slogan ‘a well-balanced development throughout national land,’ The current LATG is, however, criticized for guaranteeing not only national minimum, but also ‘national standards’ means ‘ideal level’ of services.[157] The experimental studies on flypaper effects in Japan suggest that local governments do not have incentives to save the LATG. The revenue guarantee entails ‘a soft budget constraint,’ resulting in inefficient local government expenditures.[158] Ambiguous spending responsibility is exasperated by local governments’ grant-dependency; turning to revenue transfers rather than increasing taxes. Ihori argues that the LATG has grown into ‘vested interests’ of local governments.[159]

What makes the situation difficult is Japan’s current serious fiscal situation. At the end of FY 2004, the ratio of total long-term debt of the central and local governments to GDP reached one hundred forty four percent. Japan is the most indebted country in the Organization for Economic Cooperation and Development (OECD). Furthermore, with Japan’s aging population, increases in social security related expenditures are inevitable. Under the current fiscal situation, local government revenue guarantee by the central government coupled with continuing huge deficit finance seems to be unsustainable. It is imperative that the central and local governments be required to reconstruct their fiscal structures.

Decentralization should be compatible with reconstruction of public finance. As we have already seen, decentralization with a hard budget constraint is theoretically helpful

---

[157] Ishihara, *The Local Public Finance System, Public Finance in Japan*, 1986, p. 150.

[158] Weingast argues, ‘Subnational governments facing a soft budget constraint have incentives to spend beyond their means, pursue costly market intervention, provide costly benefits to interest group, endlessly subsidize ailing enterprises, and engage in corruption.’ *Second Generation Fiscal Federalism: Implications for decentralized democratic governance and Economic Development*, June 2006, P. 8.

[159] Ihori, *About the trinity reform*, http://www.heri.or.jp/hyokei/hyokei82/82sanmi.htm

to restore fiscal soundness. A hard budget constraint implies that public authorities need to fund their own expenditure at the margin. It is especially important that intergovernmental grants not allow recipients to turn to the grant system to bail them out of fiscal difficulties.[160]

Provisions of the Trinity Reform that allow for the transfer of tax revenue sources to local governments may increase local government flexibility. However, aggregate central and local government tax revenue still not enough to finance expenditure at both government levels. From the taxpayer's perspective, it does not make sense for central and local government entities to fight to get bigger pieces of a small pie.

What is important for fiscal decentralization in Japan is to establish a hard budget constraint. This will inevitably require a review of the revenue guarantee function by the central government. Both the central and local governments must be more cost-conscious. Intergovernmental revenue transfer must not be too large in the sense of undermining fiscal discipline of local governments.

Finally, the central and local governments face a long-term challenge: to strengthen linkages between the assignment of functions and the expenditure responsibility. Under the current system, there is no strict linkage between the assignment of functions and expenditure responsibility. Hence, residents cannot recognize the costs and benefits of the SEG or the SFG respectively. The central government should normatively bear the SGF expenditure responsibility, while local governments should bear the SEG expenditure responsibility. Though the author realizes difficulties involved in establishing this principle, it should be the basic foundation for Japan's fiscal decentralization.

---

[160] Wildsin, *Externalities and Bail outs in Intergovernmental Fiscal Relations,* 1997.

6 Suggestions

In this chapter, the author would like to make some propositions to promote decentralization of Japan. The suggestions mainly focus on fiscal instruments.

6.1 Local Allocation Tax Grants

As the author discussed in the previous chapter, reform of the LATG may be the key for decentralization in Japan.

Though the Trinity Reform held back increases in the LATG, no drastic reform was realized in that period. In 2006, the central government introduced a new LATG, to be calculated by objective standards, such as population and land area. From fiscal year 2007, about ten percent of the total amount of the LATG is calculated according to this new standard. This reform stems from criticism that the current LATG is too complicated. Furthermore, some scholars point out a lack of the transparency in Japan's decision-making process on 'ideal level' of services.[161] In addition, there still remains stubborn criticism that MOHA/MIC has a certain amount of discretion in calculating the LATG[162].

The most difficult challenge is the reduction of the resource guarantee function of the LATG; reviewing revenue guarantee is the core issue of the LATG reform. As we have already seen, the current resource guarantee targets the ideal level for provision of

---

161 Ikegami, '*The Limits of General Revenue Source Principle and Challenges of General Revenue Source Principle*' in *Leave Tax Revenue Resources for Local Governments*, Jinno, and Kaneko eds. 1998, p. 121.

162 Many local governments accept officials of MOHA/MIC as executives. Some criticize that local governments might expect to receive benefits through these personal exchanges. The transparency of distribution in the special allocation tax grant is especially controversial. See note #75.

local public goods. The central government, however, should guarantee merely the national minimum level. Provision of services exceeding that level should be left to local governments.[163]

For decades, revenue from earmarked taxes has continuously fallen short of the amount necessary to fund the LATG. If there is no national consensus to raise taxes, the slimming of the LATG seems inevitable. Furthermore, the revenue guarantee entails 'a soft budget constraint.' Local governments have little incentive to spend the LATG by economizing.

The central government should openly review the coverage of revenue guarantee of the LATG to determine what extent the central government should cover local government revenue shortfalls. Local government officials often assert that the LATG is an inherent revenue resource for local governments and the fiscal situation of the central government should not affect the LATG. However, this political thinking is geared towards central government negotiations and not an explanation for the public citizens.

Another shortfall of the LATG is that, by nature of its structure, there is a low marginal incentive for local governments to foster local economic prosperity. Under the current system, local governments capture only twenty-five percent of an increase in revenue from inviting tax generators (enterprises). Setting the reservation ratio at a higher rate for tax revenue from corporations is worth consideration because it will provide an incentive to invite tax generators.

Furthermore, horizontal equalization is a controversial issue. Although Tokyo is too wealthy to receive the LATG; via the Trinity Reform, Tokyo began to enjoy additional tax

[163] There is a view that the local finance program is estimated mainly focusing on its growth in comparison with that of the national budget. See 3.2.1.
According to this view, what is necessary is to review the role of the local public finance program.

revenue from tax revenue sources transfer. While Tokyo seems to be planning tax cut, other local governments are considering claiming Tokyo's surplus revenue via a redistribution of revenue. Currently, there is no consensus how to deal with conflicts of interests among local governments. There is also no discussion on this issue among the central and local government. If the revenue guarantee function were to decrease, horizontal equalization between wealthy and poor regions of Japan would quickly develop into a major discussion topic. This is not only a problem of local finance but a problem which affects intergovernmental finance. If the central government revenue guarantee function shrinks, then, an equalization scheme, including tax system, in which revenue is transferred to remote or impoverished areas will likely be necessary.

6.2 Local Taxes

The literature suggests some criteria for good local taxes. The local tax base is not very mobile; moreover, local taxes should raise sufficient revenue for local governments. Local taxes should be visible to encourage local government accountability. Uneven regional distribution of the tax base is undesirable. Taxes based on the benefit principle are particularly suitable for assignment to the local level. It is generally acknowledged that the most obvious candidates as good local taxes are property tax and, to some extent, personal income tax.[164]

One of features of Japanese local tax is that business taxes make up a high share of total local tax revenue. As for prefectural taxes, the ratio of the two corporate taxes (enterprise tax and corporate prefectural inhabitants tax) amounts to above thirteen percent of total prefectural tax revenue. With various economic cycles, business taxes

[164] Norregaard, "*Tax Assignment," in Fiscal Federalism in theory and Practice,* 1997, p. 55.

fluctuate and thus cause tax revenue volatility. Another problem with business taxes is they are highly concentrated in urban areas.

Provisions in the 2004 tax reform introduced a pro forma taxation standard to enterprise tax; the goal was to yield stable revenue and impose tax on deficit-ridden corporations. [165] As a result, the tax base for the enterprise tax and the consumption tax partly overlap.[166] From the viewpoint of criteria for a good local tax, the author feels it is best to not depend too much on business tax for local government funding. High volatility of tax revenue and concentration of tax base in urban area are not desirable for local taxes.

As for municipal tax revenue funding, property and inhabitant tax play an important role and both are suitable at the local level. Since the inhabitant tax on a per capita basis is still fairly low[167], local governments have room to slightly increase this tax and thus create more revenue.

Tax sharing among the central and local level is a controversial issue. Japan's consumption tax is one of many kinds of tax sharing that exists throughout the world.[168] The central government collects both taxes and transfers a quarter of the tax revenue to

---

[165] The 2004 reform of the enterprise tax is expected to reduce the volatility by lowering an income component and introducing a value added component as well as a capital component. A formula for calculating a tax amount is as follows:

Before March 31, 2004 $T = 0.096I$

After April 1, 2004 $T = 0.072I + 0.0048V + 0.0002C$

T: a tax amount, I: taxable income, V: a value-added, C: a capital

As for companies with a capital less than one hundred million yen, the formula is as of old.

According to National Tax Agency, the ratio of number of companies in the black to the number of total companies is only 31.1% in 2002.

[166] The tax base of national consumption tax and local consumption tax is value added.

[167] Tax amount of prefectural and municipal individual inhabitant tax on a per capita basis is ten thousand yen and three thousand yen respectively.

[168] Japanese consumption tax is a variant of VAT; a credit mechanism depends not on invoices but books.

local governments.[169] Regional distribution of the tax base is relatively even, thus some argues that the consumption tax should play a more important role in the horizontal equalization process. Another research paper is necessary to fully discuss the earmarked ratio of national consumption tax for the LATG and the rate of local consumption tax. From a viewpoint of strengthening clear linkage between benefit and burden, local governments should take advantage of the local consumption tax rather than national consumption tax. Tanzi argues that, in view of border checks, value-added taxes are best left to national governments (especially in developing country). [170]

Moreover, local governments are expected increase tax collection efforts. In FY 2004, total unpaid prefectural and municipal tax amount to over two trillion yen. Some local governments are criticized for being too lenient on those who do not pay their tax. Local governments, especially at the municipality level, are often reluctant to execute compulsorily tax payments.

6.3 Local Bonds

In the last few years, the situation for local bonds has been changing. First, in 2005, as mentioned, the permission system was replaced by a prior consultation system. Second, within the last few years, the availability of government funds greatly declined. Third, the relationship between local governments and financial institutions seems to be changing slightly; some financial institutions see local bonds as less attractive then in prior

---

[169] The tax rate of national consumption tax is 4%; the tax amount of local consumption tax is 25% of that of national consumption tax. The overall tax rate of consumption tax is 5%.

[170] Tanzi, *Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects*. 1995, p. 313.

years.[171] Under financial deregulation, local banks became more profit-oriented. Fourth, local governments have begun to negotiate individually with underwriters. Since 2006, MIC's role as a representative of bond issuers has been limited to joint issues of local governments.

Some argues that local governments do not see local bonds as their debt because the central government subsidizes most of repayment through the LATG.[172] The current situation is far from a hard budget constraint. Market-based fund raising may urge further local government financial disclosure. The markets themselves, through the determination of credit ratings and tools to monitor fiscal performance, create an environment in which local governments must behave in responsible ways.[173]

As of mid-2007, some local government faces serious fiscal crisis. Yubari City in Hokkaido was designated as a deficit-ridden local government by MIC.[174] Yubari lost its autonomy and MIC controls the budget until economic rehabilitation is complete.[175] According to reports, there was illegal manipulation in settling accounts. A report on Yubari also induced an expansion of yield spread between national bonds and local bonds. However, Yubari still fulfilled its local obligations. The central government will support Yubari. From the perspective of market preserving fiscal federalism, the central government should not bail out local governments.[176]

---

[171] Doi, Hayashi, Suzuki, *Local Bonds and Local Financial Institute*, 2005.
[172] Doi, Bessho, *The System and Changes of Local Bond in Japan*, 2004, p. 18.
[173] Oates, *An Essay on Fiscal Federalism*, 1999, p. 1139.
[174] 'Yubari is a city of 13,000 residents in central Hokkaido, prospered from its coal mines until the 1980s, when oil replaced coal as the predominant energy source. Yubari tried to revive itself as a tourist spot by building amusement parks, ski resorts and sponsoring an international film festival, but these efforts failed.' The Japan Times, March 1, 2007.
[175] Local governments considered bankrupt are required to submit a financial reconstruction plan to MIC.
[176] Aoki, *The Introductory Chapter* in *Fiscal Reform of Japan: Redesigning the Frame of*

Japan has no legislation similar to "Chapter 9 bankruptcy in the United States," this was applied to the case of Orange County in December 1994.[177] In Japan, a city, town, or village is considered effectively bankrupt when its annual loss tops over twenty percent of its budget. In the case of prefectures, the figure is five percent, instead of twenty percent. The national government recently set about considering establishing legislation on insolvency of local governments; such legislation is necessary to abolish lenient measures for unrestrained local authorities.

6.4 Broad-Based Administration

While promoting decentralization, the Japanese central government strongly encouraged municipal mergers. There were three peaks of mergers after the Meiji Restoration. The first one is known as 'the great Meiji merger.' The number of municipalities decreased from over seventy hundred to fifteen hundred. The second is called 'the great Showa[178] merger.' The number of municipalities decreased to about thirty hundred. After the last 'great Heisei[179] merger,' the number dropped to less than twenty hundred.

The aim of mergers was to improve the efficiency and administrative ability of municipalities. Promoting municipal mergers appears desirable from the viewpoint of promoting decentralization. The devolution of power from prefectures to municipalities consequently became easier.

---

the State. 2004, p. 28.

[177] On December 6, 1994, Orange County declared Chapter 9 bankruptcy, from which it emerged in June 1995; this was the largest ever municipal bankruptcy in the U.S. The county lost about $1.6 billion through high-risk investments in derivatives.

[178] "Showa" is derived from the Emperor of Showa. The Showa era is from1926 to 1989.

[179] "Heisei" is derived from the Emperor of Heisei. The Heisei era is from1989 up to now.

On the other hand, prefectures remain relatively intact. As a result of the abolition of the ATD, prefectures are no longer legally subordinate agencies of the central government. Though the current relationship between the central government and prefectures is very intricate, a new framework of broad-based local administration may be more helpful to narrow central government roles. It may also be helpful to reduce the national subsidy to correct the externality across inter-prefectures. Furthermore, many administrative challenges, such as promoting industry and developing for tourism, often need broad-based administration beyond the prefectural jurisdiction. Each prefecture's ability to compete globally is controversial.

In 2006, the Local Administration Council[180] published a remarkable report that proposed how an introduction of a 'state and county' system in Japan might promote decentralization. As described in the report, styles of broad-based administration vary among disputants. Some advocate a 'state and country' system like in the US. Some image mergers of prefectures. Some argue the integration of prefectures and regional offices of the national government.

Anyhow, the author advocates considering the establishment of broad-based administration in view of its advantages as mentioned above. The government should continue to discuss and study the introduction of broad-based administration.

7 Conclusion

Globally, decentralization and globalization are the tide of the times.[181] Like many

---

[180] The mission of this council is to provide advice and suggestions on local administration to the prime minister as requested.

[181] As Rodden and Garrett discuss, globalization may strengthen the credibility of

other developed nation, Japan has been addressing this issue. However, a clash of interests among stakeholders increased the turmoil. Some argue that a great majority of people saw the Trinity Reform just as a political struggle between the central and local governments.

In this paper, the author explored economic theory to clarify advantages of fiscal decentralization. In Japan, some argue that decentralization is not for the purpose of fiscal reconstruction; however, decentralization and fiscal reconstruction is theoretically a win-win situation. Because of Japan's aging population, it is extremely important to restore fiscal soundness. Decentralization can play a key role in fiscal reconstruction. The principle of market-preserving fiscal federalism that strictly requires a hard budget constraint is a very thought-provoking theory to Japanese decentralization. What is desirable decentralization depends on a value judgment; however, the author would like to advocate "decentralization with a hard budget constraint."

The Mayor of Palo Alto, Ms. Yoriko Kishimoto, is a prominent mayor who leads a city in the center of the Silicon Valley; Palo Alto is an advanced environmental friendly community. During an interview, the Mayor told me that she was always conscious of competition with neighboring cities. Some contend that due to regional disparities, Japan cannot afford local competition. Furthermore, the prevalent view is that Japanese society is homogeneous and hence people expect uniform public services across the country. The author is well prepared to acknowledge that these expectations are very strong especially in the fields of education and welfare services. Nevertheless, the author believes that

---

regional autonomy movements and put pressure on central government to cede policy control to local officials. On the other hand, it may encourage regions that stay within countries to push for fiscal arrangement that better mitigate market risk for citizens. They stress that it is somewhat surprising that these conjectures have not made it into literature yet. Rodden and Garrett, *Globalization and Fiscal Decentralization,* March 2001, p. 32.

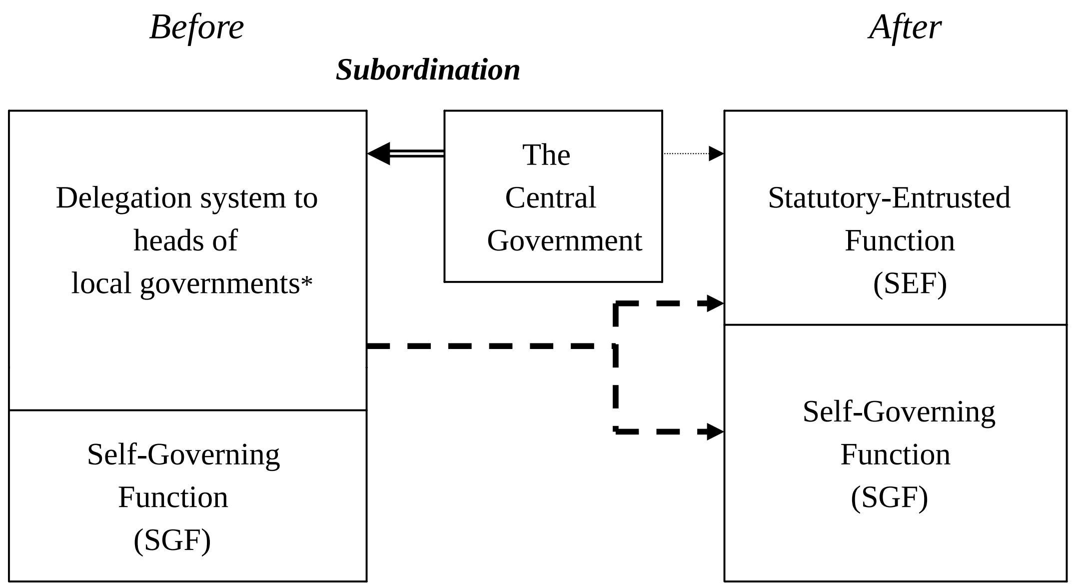
motivated and innovative local governments can enhance the quality of public services and improve the efficiency through decentralization.

Table 1 The Portion of Earmarked National Taxes (%)

FY	Income tax	Corporate tax	Liquor tax	Consumption tax	Tobacco tax
1954∗	22.0	22.0	22.0		
	(19.66)	(19.66)	(20.0)		
	(19.874)	(19.874)	(20.0)		
1955	22.0	22.0	22.0		
1956	25.0	25.0	25.0		
1957	26.0	26.0	26.0		
1958	27.5	27.5	27.5		
1959	28.5	28.5	28.5		
1960-61	28.5+0.3	28.5+0.3	28.5+0.3		
1962-64	28.9	28.9	28.9		
1965	29.5	29.5	29.5		
1966-88	32.0	32.0	32.0		
1989-96	32.0	32.0	32.0	24.0	25.0
1997-98	32.0	32.0	32.0	29.5	25.0
1999	32.0	32.5	32.0	29.5	25.0
2000-03	32.0	35.8	32.0	29.5	25.0
2004-06	32.0	35.8	32.0	29.5	25.0

∗ The first row shows the basic rate. The second row shows the figure in the initial budget. The third row shows the figure in the revised budget.

Table 2　Repeal of Delegation System to Heads of Local Governments



Functions of Local Governments
(Prefecture and Municipality)

* Administrative tasks are delegated by the national government to the offices of governors and mayors under this delegation system.

Table 3 Results of the Trinity Reform

(trillion yen)

Category	*the total amount* ⁎
Reform of national subsidies to local governments	4.7
Transferring tax revenue sources	3.0
Reduction of local allocation tax grants	-5.1

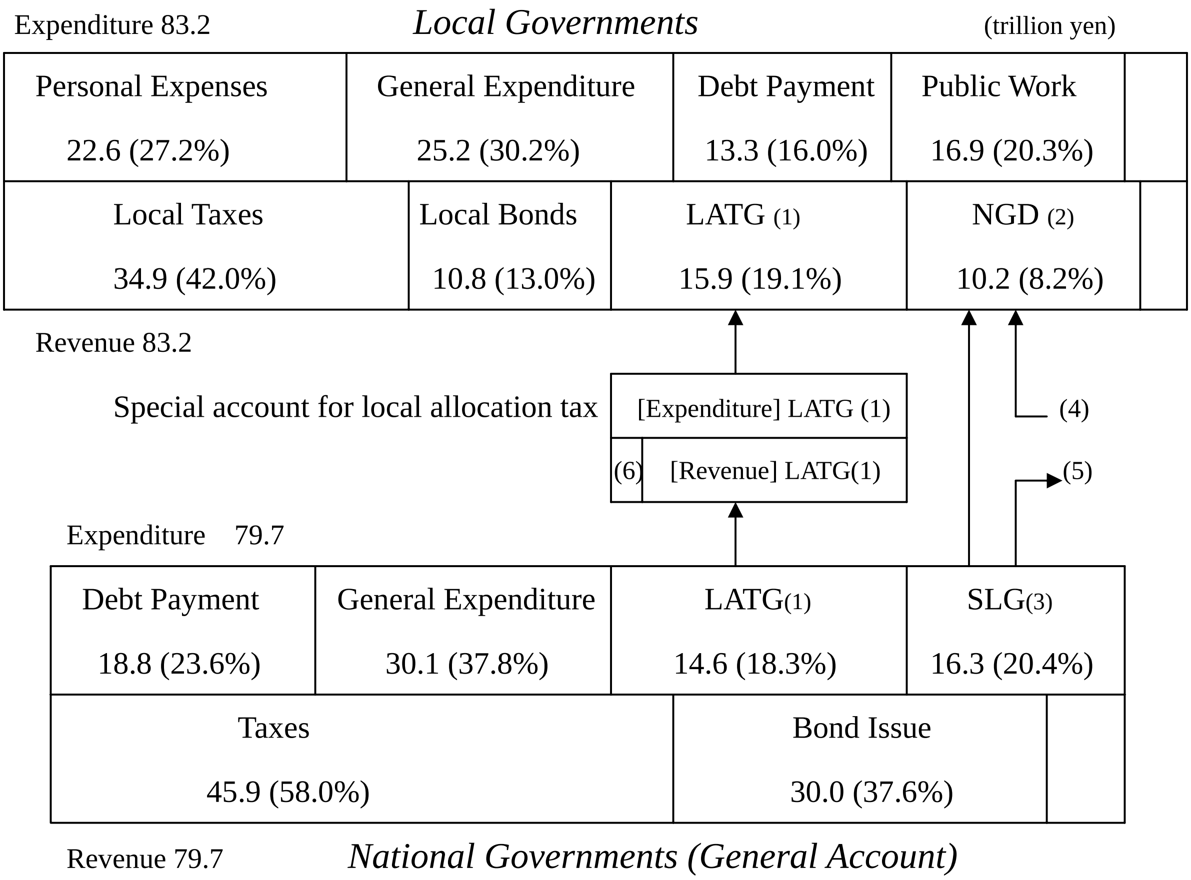
⁎ the total amount from FY2004 to FY2006

Table 4 Government Expenditure as Percentage of GDP (1997)

	The national government			*Local governments*			*Total*
	Investment	*Consumption*	*Total*	*Investment*	*Consumption*	*Total*	
Japan	1.0	2.3	3.3	5.6	7.4	12.9	16.2
US	0.1	5.7	5.9	1.8	9.5	11.2	17.1
UK	0.6	13.4	14.0	0.8	7.4	8.2	22.2
France	0.5	9.9	10.4	2.0	5.5	7.5	17.9
Germany	0.2	2.2	2.4	1.7	9.7	11.3	13.7
Italy	0.5	8.4	8.9	1.6	7.5	9.1	18.0
Canada	0.3	3.8	4.1	1.9	16.1	18.0	22.1

Source: Calculated from statistics of OECD; Data book on local public finance 2006, p167

Figure1 Relationship between the National and Local Governments (FY2004)



Source: Local Public Finance Program FY2004

(1) Local Allocation Tax Grants
(2) National Government Disbursement
(3) Subsidies to Local Governments
(4) From special accounts of the national government 2.4
(5) To special accounts of local governments 8.6
(6) Borrowing

Table 5 Tax Revenue (FY2004)

(100 million yen)

	Tax Item	*Tax Revenue*	*Percent of Total*
National Tax	individual income tax	150,954	31.4%
	corporate income tax	114,437	23.8%
	consumption tax	99,743	20.7%
	gasoline tax	28.892	6.0%
	liquor tax	16,599	3.5%
	inheritance tax	14,465	3.0%
	stamp revenue	11,350	2.4%
	automobile weight tax	12,233	2.3%
	national tobacco tax	9,097	1.9%
	customs duty	8,618	1.8%
	others	14,641	3.0%
total		481,029	100%
Prefecture Tax	enterprise tax	43,389	30.0%
	inhabitant tax(1)	33,987	23.5%
	local consumption tax	26,139	18.0%
	automobile tax	17,131	11.8%
	light-oil delivery tax	10,999	7.6%
	property purchase tax	4,564	3.2%
	automobile acquisition tax	4,509	3.1%
	prefectural tobacco tax	2,826	2.0%
	others	1,326	0.9%
total		144,870	100%
Municipality Tax	property tax(2)	88,061	46.2%
	inhabitant tax(1)	76,685	40.3%
	urban planning tax	12,361	6.5%
	municipal tobacco tax	8,680	4.6%
	business office tax	2,916	1.5%
	light automobile tax	1,459	0.7%
	others	356	0.2%
total		190,518	100%
Total		816,417	100%
National Tax		481,029	58.9%
Local Tax		335,388	41.1%

(1) Inhabitant tax includes 1) taxation on income of both individuals and corporations, and 2) taxation on per capita basis.

(2) Property tax is imposed on the assessed value of real estate (lands and houses) and fixed assets.

Figure 2　National Subsidies

Social Security Related 11.7 (62.5%)	Public Works 4.2 (22.5%)	Education Science, and Technology 2.0 (10.7%)	*

National Subsidies (FY2006)　18.7 trillion yen

* the others　0.8 (4.3%)

Reference

Akai, Nobuo; Sato, Motohiro; and Yamashita Koji. *Reform of Intergovernmental Transfers in Japan*, Japan: Yuhikaku 2003.

Aoki, Ichiro. *The Reform of Pension System in Japan***,** Research Paper**,** Shorenstein Asia-Pacific Research Center, Stanford University, 2006, unpublished paper.

Aoki, Masahiko. "*The Introductory Chapter* in *Fiscal Reform of Japan: Redesigning the Frame of the State."* Masahiko Aoki, and Kotaro, Tsuru eds. Japan: Toyo Keizai Shinpo Sha, 2004.

Brennan, Geoffrey, and Buchanan James M. *The Power to Tax: Analytical Foundation of Fiscal Constitution*, Cambridge: Cambridge University Press, 1980. http://www.econlib.org/Library/Buchanan/buchCv9Contents.html, 9.9.50.

Cournant, Paul N; Gramlish, Edward M; and Rubinfeld, **Daniel L.** *The Stimulative Effects of Intergovernmental Grants: Or Why Money Sticks Where It Hits, in Fiscal Federalism and Grants-in-Aid*. Peter Mieszkowski, and William H. Oakland, eds. Washington, DC: Urban Institute, 1979.

Doi, Takero. *Flypaper effects in Japanese urban public finance*, Japan: Ministry of Finance(MOF), Policy Research Institution Discussion Paper Series, September 1996.

Doi, Takero. *A Missing Link in Decentralization Reform in Japan: Trinity Reform Package*, Japan: Ministry of Finance (MOF), Policy Research Institute Discussion Paper Series (No. 04A-08)

Doi, Takero, and Bessho, Syunichiro. *The System and Changes of Local Bond in Japan,* Japan: Ministry of Finance (MOF), Policy Research Institution Discussion Paper Series, (No. 04A-15) 2004.

Doi, Takero; Hayashi, Tomoko; and Suzuki, Tomoyuki. *Local Bonds and Local*

Financial Institute, Japan: Economic and Social Research Institute, Cabinet Office, EDRI Discussion Paper Series No.154, September 2005.

Fisher, Ronald C. "*Intergovernmental Fiscal Relations: Policy Developments and Research Prospects,"* in *Intergovernmental Fiscal Relations*. Ronald Fisher ed. MA, Boston: Kluwer Academic Publishers, 1997.

Hamilton, Bruce. *Zoning and Property Taxation in a System of Local Governments,* Urban Studies 12 (June 1975), pp. 205-11.

Horie, Fukashi. "*Intergovernmental Relations in Japan: Historical and Legal Patterns of Power Distribution Between Central and Local Governments,"* in *Globalization and Decentralization: Institutional Contexts, Policy Issues, and Intergovernmental Relations in Japan and the United States.* Jong S. Jun and Deil S. Wright, ed. Washington, DC: Georgetown University Press, 1996.

Ishii, Susumu; Gomi, Humihiko; Sasayama, Haruo, and Takano, Toshihiko. *Detailed Japanese History*, Japan: Yamakawa Shuppan Sha, 2000

Ishihara, Nobuo. "*The Local Finance System,*" in *Public Finance in Japan.* Tokue Shibata, ed. Japan: University of Tokyo Press, 1986.

Izui, Nobuo, and the Inquiry Section under the Committee of General Affairs in

Konishi, Sachio. *Arguments on Reform of Local Public Finance*, Japan: Nihon Keizai Shinbun Sha, 2002.

House of Councilors, The National Diet of Japan, eds. *Data book on Local Public Finance FY2006* Japan: Gakuyo Shobo, 2006.

Ihori, Toshihiro. *About the Trinity Reform,* http://www.heri.or.jp/hyokei/hyokei82/82sanmi.htm

Ihori, Toshihiro. *Decentralization and Financial Reconstruction: Evaluation and* *perspective of the trinity reform,* Japan: Ministry of Finance (MOF), Financial Review, May 2004.

Jinno, Naohiko. "*Japanese-style Tax System and Finance System,*" in *The Origin of Contemporary Japanese Economic Systems.* Okazaki, Tetsuji, and Okuno, Masahiro. eds. Japan: Toyo Keizai Shinpo Sha, 1993.

Jinno, Naohiko, and Kaneko, Masaru. eds**.** *Leave Tax Revenue Sources for Local Governments,* Japan: Toyo Keizai Shinpo Sha, 1998.

Jorge Martinez-Vazquez; McLure, Charles; and Vaillancourt, François. "*Revenues and Expenditures in an Intergovernmental Framework,*" in *Perspective on Fiscal Federalism.* Richard Bird, and François Vaillancourt, eds. Washington, DC: The World Bank, 2006.

Joumard, Isabelle, and Yokoyama, Tadashi. *Getting the most out of public sector decentralisation in Japan,* Economic Department Working Papers No. 416 ECO/WKP(2005)3, OECD, 2005.

King, David N. "*Fiscal Tiers: The Economics of Multi-Level Government,*" London: George Allen & Unwin Ltd. 1984.

Mckinnon, Ronald I. *The Logic of Market-Preserving Fiscal Federalism,* 1997 http://www.jstor.org/view/00426601/ap030651/03a00120/0

Mihaljek, Dubravko. "*Japan,*" in *Fiscal Federalism in Theory and Practice.* Teresa Ter-Minassian, ed. Washington, DC: International Monetary Fund, 1997.

Musgrave, Richard A. *The Theory of Public Finance: a study in public economy,* NY, New York: McGrowhill, 1959.

Musgrave, Richard A. "*Introduction,*" in *Essays in Fiscal Federalism*. Richard Musgrave, ed. Washington, DC: The Brookings Institution, 1965.

Musgrave, Richard A. *Fiscal Systems,* CT and London: Yale University Press, 1969.

Musgrave, Richard A, and Musgrave, Peggy B. *Public Finance in Theory and Practice,* 2nd ed. NY: McGraw-Hill Book Company, 1973.

Noguchi, Yukio. *1940 System,* Japan: Toyo Keizai Shinpo Sha, 1995.

Norregaard, John. "*Tax Assignment," in Fiscal Federalism in theory and Practice*. Teresa Ter-Minassian, ed. Washington, D.C.: International Monetary Fund, 1997

Oates, Wallace, E. *Fiscal Federalism,* NY: Harcourt Brace Jovanovich, Inc. 1972

Oates, Wallace E, and Wallis, Joseph J. "*Decentralization in the Public Sector: An Empirical Study of State and Local Government,*" in *Fiscal Federalism: Quantitative Studies.* Harvey Rosen ed. Chicago: U. Chicago Press, 1988.

Oates, Wallace, E. *Studies in Fiscal Federalism,* England: Edward Elgar Publishing Limited, 1991.

Oates, Wallace E. *An Essay on Fiscal Federalism*, Journal of Economic Literature Vol.XXXVII, September 1999.

Oates, Wallace E. *Toward A Second-Generation Theory of Fiscal Federalism,* Preliminary Draft, January 2004.

Oates, Wallace *E.* *On The Theory and Practice of Fiscal Decentralization***,** IFIR Working Paper No. 2006-05, May 2006.

Ooyama, Shinsuke; Sugimoto, Takuya; and Tsukamoto, Mitsuru. *Spreads of Local Bonds against National Government Bonds and Recent Changes,* Working Paper Series, No. 06-J-23 Bank of Japan, 2006.

Purnendra, Jain *Local Politics and Policy Making in Japan,* India: Commonwealth Publishers, 1989.

Rodden, Jonathan, and Garrett, Geoffery *Globalization and Fiscal Decentralization,* March 2001, p. 32.

Rodden, Jonathan. *The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World*, 2001.

Rosen, Harvey S. *Public Finance*, 7th ed. NY: McGraw-Hill/Irwin, 2005.

Seidel, Bernhard, and Vesper, Dieter. "*Fiscal Federalism – An International Comparison*" in *Discussion Paper No. 183.* Germany, Berlin: Deutsches Institut für Wirtschaftsforschung, 1999.

Stiglitz, **Joseph E**. *Economics of the Public Sector,* New York · London: Norton, 1986

Tanzi, Vito. *Fiscal Federalism and Decentralization: "A Review of Some Efficiency and Macroeconomic Aspects*" in Annual World Bank Conference on Development Economics 1995. Washington, D.C.: World Bank.

Ter-Minassian, Teresa, and Craig, John. "*Control of Subnational Government Borrowing" in Fiscal Federalism in theory and Practice*. Teresa Ter-Minassian, ed. Washington, DC: International Monetary Fund, 1997.

Tiebout, Charles. *A Pure Theory of Local Expenditure,* Journal of Political Economy 64, October 1956, pp. 416-24.

Wallin, Bruce A. "*From Revenue Sharing to Deficit Sharing: General Revenue Sharing and Cities,"* Washington, DC: Georgetown University Press, 1998.

Weingast, Barry R. *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,* Journal of Law, Economics, & Organization, Vol. 11, No. 1. 1995.

Weingast, Barry R. *Second generation fiscal federalism: Implications for Decentralized Democratic Governance and Economic Development,* June 2006. http://polosci.stanford.edu/faculty/documents/Weigast-second%20generation%20fiscal%20federalism.pdf.

Wildsin, David E. *Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations*, 1997 World Bank Policy Research WP, 1843.

Yoshida, Kazuo *Reform of Local Public Finance for Promoting Decentralization*, Japan: Yuhikaku, 1998.