6 Prospects for a Self-Sustainable Local Fiscal System

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This chapter considers the financial problems currently facing local governments from the perspective of their root cause: the state of intergovernmental fiscal relations and the fiscal policy mix of the 1990s. Local governments' finances are in starkly worse shape than is, perhaps, generally recognized: Long-term central government debt is putting pressure on local governments' finances. This chapter investigates measures with which local governments will overcome financial crisis and further establish independence from the central government.

THE STRUCTURE OF LOCAL FINANCES

Together, local governments derive some 35 percent of their revenues from local taxes, with another 50 percent coming from grants, subsidies, and local bond issues (table 1). When the figure is broken down, one finds that the 47 prefectures secure more than half their tax revenue from inhabitant and enterprise taxes, which are unstable sources,

Table 1. Revenue Structure of Local Public Finance (¥100 mn, %)

	FY1998		FY1999		Fluctuation	
	Revenue Accounts	Per-centage	Revenue Accounts	Per-centage	Revenue Accounts	Per-centage
Local Tax (1)	359,222	34.9	350,261	33.7	−8,961	−2.5
Inhabitant tax	89,584	8.7	87,671	8.4	−1,913	−2.1
Corporate and enterprise tax	73,604	7.2	65,285	6.3	−8,319	−11.3
Consumption tax	25,504	2.5	24,793	2.4	−711	−2.8
Other taxes	170,530	16.6	172,512	16.6	1,982	1.2
Local transfer tax (2)	5,952	0.6	6,089	0.6	137	2.3
Local exceptional transfer (3)	–	–	6,399	0.6	–	–
Local Allocation Tax (4)	180,489	17.5	208,642	20.1	28,153	15.6
National treasury disbursements	157,451	15.3	165,990	16.0	8,539	5.4
Disbursement for Public Works	63,039	6.1	61,068	5.9	−1,971	−3.1
Local bond issues	151,356	14.7	130,733	12.6	−20,623	−13.6
Others	174,219	17.0	171,951	16.5	−2,268	−1.3
Total	1,028,689	100	1,040,065	100	−11,376	1.1
Ordinary expenditure = (1) + (2) + (3) + (4)	545,663	53.0	571,391	54.9	25,728	4.7

Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications (2001b).

Note: The category of disbursement known as local exceptional transfer was created in fiscal 1999 (ended March 31, 2000).

particularly given the current economic situation. Meanwhile, some 3,200 municipalities, towns, and villages derive most of their tax revenue from inhabitant, fixed asset, and local consumption taxes.[1] But local governments are beholden to the central government for their tax revenues by virtue of the Local Tax Law, which regulates the standard tax rate and the limited tax rate.

There are two main types of fiscal transfer from the center to local governments. One takes the form of the Local Allocation Tax, which is distributed according to established revenues and needs. It comprises a set proportion of the five national taxes—32 percent of income and alcohol, 35.8 percent of corporate, 29.5 percent of consumption, and 25 percent of tobacco tax—which is designated as local revenues and allocated according to an established formula designed to redress the differences in local tax revenues and allow freedom of local administration.

The second type of transfer comprises specific subsidies called

national treasury disbursements that are divided into three categories: payments for the central government's subcontract functions, such as national elections; payments for specific tasks for which the central government is responsible as provided by the Local Government Finance Act, such as those that support welfare benefits and compulsory education; and grants-in-aid to allow implementation of policies that the central government supports, encourages, or promotes.

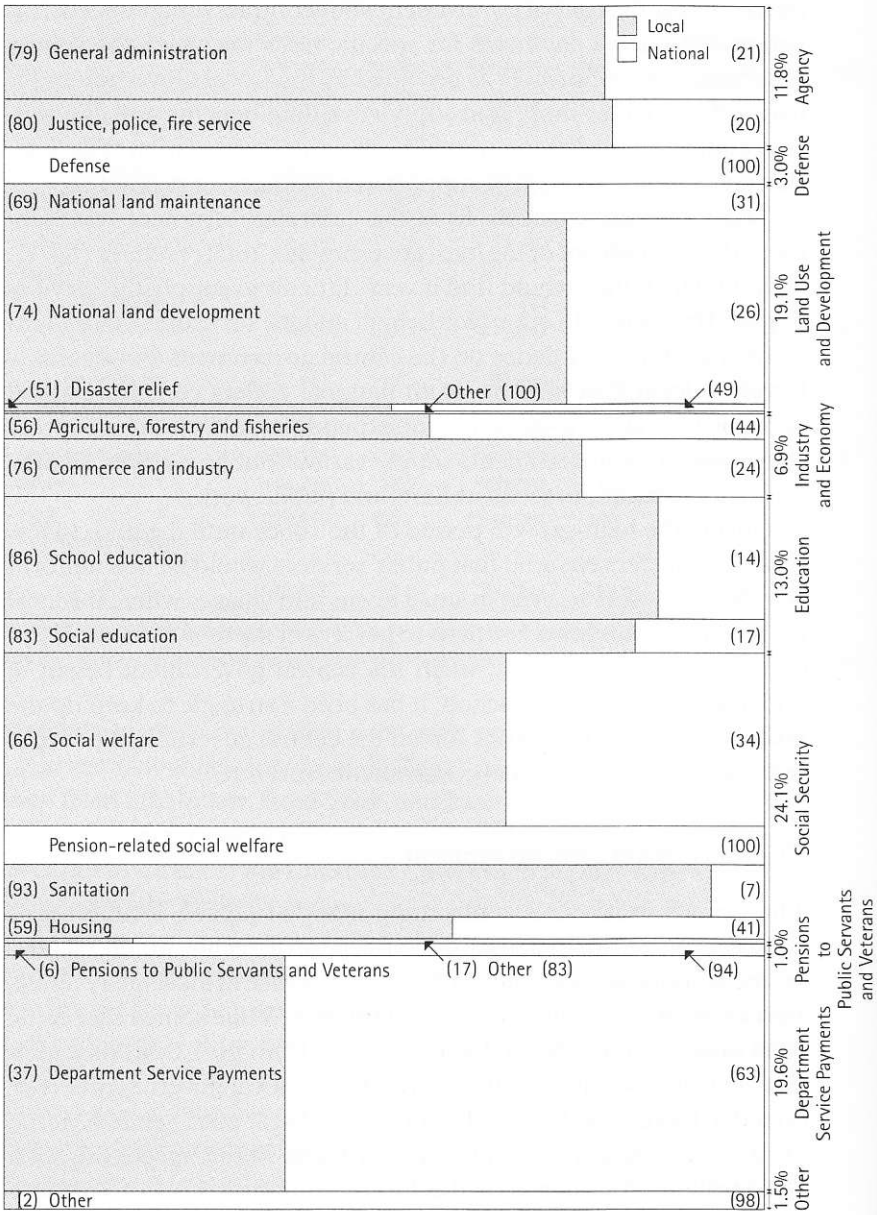
These revenue transfers from the central government represent more than 50 percent of the local governments' total revenues (fig. 1), without which they would find it very difficult to supply the services required by society. In other words, built into the structure of local public finance is a dependence on the central government. Funds transferred to local governments from national coffers constitute about two-thirds of all local-government expenditures. With these sources of revenue, local governments supply various public services, such as the police, education, social welfare, and public works.

During the high-growth period of the 1960s until the mid-1970s, revenue transfers ensured that public services would be of a uniform standard nationwide, even in small towns and villages where the local tax revenue represented less than 10 percent of the total revenue. However, since the mid-1980s, when the central government began to undertake fiscal reconstruction, it has been a struggle to keep up the revenue transfers, which has forced the central government to begin seeking ways to ensure local governments' revenue.

Financial Crisis of Local Government

The serious fiscal crisis confronting many of Japan's local governments became evident in the 1990s. Because of decline in central government subsidies, local tax cuts, and a decrease in local tax revenue, a growing shortage threatened local finance. While some relief came from municipal bonds and loans extended from the Local Allocation Tax special account, the cumulative debt of local governments continued to increase so that, at the end of fiscal year 2001 (ended March 31, 2002), local governments' unpaid loans were expected to total ¥187 trillion. The interest on this figure amounts to about 14 percent of all local governments' yearly budgets. As a result, ordinary expenditures—such as outlays for personnel, social assistance, and local

Figure 1. National and Local Government Expenditure



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications (2001b).

Note: Numbers in parentheses are percentages.

loans—represent some 87.5 percent of their total ordinary general revenue. Just in fiscal year 1999 (ended March 31, 2000), more than 60 percent of all local governments were saddled with a debt-expenditure ratio of at least 15 percent.

Behind the local government fiscal crisis lie three major factors: increased expenditures for the social security of a graying population; local spending policies in the wake of the tax cuts following the 1990s collapse of the bubble economy; and lax management of funds received from the central government through revenue transfers. In other words, even though the tax revenue has been decreasing annually, local expenditure has been expanding, particularly in the area of social capital and social aid.

Fiscal Relations between the Central and Local Governments

Certainly the fiscal problems of local governments have been compounded by lax management on their part and the decline of tax revenues, due to the prolonged recession. Nevertheless, the situation has been exacerbated by the degree to which local governments' authority vis-à-vis their fiscal affairs has been circumscribed, and the structure and operation of their finances are affected by the policies of the central government.

In comparison with other major industrial nations, Japan's fiscal policy at the local government level is characterized by an unusually high ration of spending to revenues and authority (Jinno and Kaneko 1998). While Japan has a unitary rather than federal form of government, local governments provide 60 percent to 70 percent of the services. And, given their lack of fiscal autonomy, it might well be said that prefectures and municipalities function more like local branches of the central government than as autonomous fiscal bodies.

In areas of public finance such as resource allocation, income redistribution, and macroeconomic stabilization, central and local governments operate under a unified system, with the central government guaranteeing the revenues required to provide a uniform level of government services and public goods nationwide, thereby redistributing income among the regions and leveling out economic performance. Andrew DeWit (2000) notes that, unlike in the United States, where

the leveling of the progressive structure of income taxes and the hiking of the minimum tax level since the 1980s have resulted in a major backlash from those in lower income brackets, there is no highly visible conflict between the different income groups in Japan. Bearing in mind the structure of local government finances and the Local Allocation Tax, he argues that Japan's system of income redistribution places greater store on interregional rather than interpersonal transfers. However, this system of unified income distribution has ceased to function properly and is replete with problems. In its wake have developed three overarching factors that have contributed to the crisis in local government finances: the impact of tax cuts, the transfer of operational authority from the center, and the redirection of local government spending to counter the recession. These are dealt with in turn below.

THE IMPACT OF TAX CUTS Japan's local government revenue structure is weak and unstable. The balance between local spending and local revenues is heavily skewed toward the former: While conducting some 70 percent of central and local government operations, local governments collect only about 40 percent of the taxes. Furthermore, even local governments' autonomy in imposing taxes is limited: They need central government agreement to adjust tax rates beyond predefined parameters and introduce new taxes.

In addition, local taxation is deficient in terms of proportionality to benefits, burden sharing, stability, and universality. The main taxes at the prefectural level are the inhabitant and enterprise taxes, both of which are linked to the central government's corporate tax, assessed on the basis of corporate income. The amounts collected vary considerably depending on the state of the economy,[2] and as a result may cause severe financial instability. Regardless of the state of the economy, prefectures face essential outlays—such as the payment of police and public school teachers' salaries—and can ill afford to lose revenue when a prolonged recession hits or the central government cuts its tax rates.

At the municipal level, the fixed asset tax and inhabitant tax are the revenue mainstays. But since the latter is assessed according to the amount of taxable income as determined by the national income tax,

any increase the central government might make in deductions to lower the income tax burden automatically causes municipal revenues to decline.

During the 1990s, local governments saw their revenues slip steadily as a result of the long recession following the bursting of the economic bubble, and this tendency was aggravated by the effects of countercyclical tax cuts by the central government. Every year from fiscal 1994 (ended March 31, 1995), the central government has implemented tax reductions to fight the recession, causing local revenues to decline further. In fiscal 1999, the central government introduced permanent reductions in income and corporate taxes, and lowered the maximum rate for the inhabitant tax and the basic enterprise tax rate, thereby reducing the local governments' revenues from the local inhabitant and enterprise taxes.

To offset the impact of these reductions, the central government transferred a portion of its revenues from the tobacco tax to the local governments, set up a new system of supplementary grants, and increased the percentage of the corporate tax distributed to the Local Allocation Tax designated for local governments. However, these were stopgap measures, designed to balance the books for that fiscal year, and were not consistent with the principles of proportionality to benefits, burden sharing, and stability in local taxation.

To date, local governments lack the authority to make decisions concerning the taxes that provide their fundamental sources of revenue, and the central government continues to use them as tools for its recession-fighting economic policies.

TRANSFER OF OPERATIONAL AUTHORITY FROM THE CENTRAL GOVERNMENT A second factor that has contributed to the crisis in local government finances is the cutting back of central government subsidies in the latter part of the 1980s. Previously, when a local government had undertaken social welfare– or social capital–related projects, the amount by which subsidies might have been curtailed had been included in the estimate of local needs to be covered by the Local Allocation Tax. However, as local fiscal demand gradually increased, the total amount could not be secured through this system due to the ceiling on local or central government revenue transfers. To cover the

shortfall, the Local Allocation Tax special account thus took out a loan, the principal and interest payments on which were split equally between the central and local governments.

But this was no long-term solution, as can be seen from the example of how the old-age welfare system was affected. For many years, the Welfare Law for the Elderly had required that the state assist the elderly in need. But, with the graying of the population and the increase in the number of nuclear, rather than extended, families, nursing care for the elderly had shifted from a system designed to assist needy individuals to one provided as a universal service. As the nature of the service changed, demands became more diverse and it was gradually felt that municipalities, being the level of government closest to residents, were best suited to providing the relevant services.

Thus, in the latter part of the 1980s, the concept of decentralization was taken up as a key direction for welfare reform and, in 1993, a major reform was undertaken: The authority over admission to old-age welfare facilities was transferred from prefectures to towns and villages. In addition, starting in 1993, municipalities were required to draw up old-age health and welfare plans and to survey the local demand for old-age services, based on which they had to draw up a plan for provision of these services and submit progress reports.

The decentralization of welfare administration was partly related to the central government's financial difficulties, as a result of which a move began in 1985 to reduce national treasury disbursements. In 1986, the subsidies for local spending on health care and welfare at facilities for the elderly was slashed to 50 percent of the total costs of projects. Moreover, when responsibility for institutionalized care of the elderly in towns and villages was shifted from the prefectural to the town and village level, it was decided that the cost burden which had previously been equally shared by the national government and the prefectures was to be covered by the national government, prefectures, as well as towns and villages in the ration of 2:1:1.

The municipalities, towns, and villages had to cover the additional fiscal burden out of their general revenues, but, according to a study by Takeda Hiroshi (1995), special supplementary payments under the Local Allocation Tax compensated for only about 20 percent of the increase. This was because, for example, the central government modified the basis according to which the Local Allocation Tax payments

for welfare services for the elderly were calculated by replacing some veteran employees with lower-paid workers so the overall level of Local Allocation Tax payments could be held down. In sum, the provision of revenues to cover the additional fiscal burden resulting from the decentralization of these government operations was insufficient.

LOCAL GOVERNMENT SPENDING TO FIGHT THE RECESSION The efficiency with which local governments have been introducing public works based on national programs is also, by hindsight, a cause of their fiscal crisis.

Local governments have vigorously promoted public works, such as the construction of roads, bridges, and sewers, partly as business-stimulating measures. Compared to other Organization for Economic Co-operation and Development (OECD) countries, Japan is the only country in which expenditure for social infrastructure has not, since the 1980s, decreased as a percentage of gross domestic product (GDP). Whereas in most OECD countries social infrastructure expenditure at the local level runs at 2 percent to 3 percent of GDP, it remains at the high level of 7 percent to 8 percent in Japan.

The reason can be traced to the period immediately after World War II, when there was an urgent need to build up the country's social infrastructure, to which end Japan's local governments were brought into play to ensure the well-balanced restructuring of the country's postwar economy. This system of public works development thrived no less as local economies began to falter with the collapse of agriculture, because regional incomes thus became increasingly dependent on the subsidies received from the central government for public works performed based on a central government plan. It was precisely through this local public works spending that the central government sought to fight the recession. However, the economic situation has changed so much that to do so now would mean certain financial ruin for local governments.

Currently, the financial picture at the prefectural level is extremely bleak, particularly in major metropolitan areas such as Tokyo and Osaka, which have devoted an especially high percentage of ordinary revenue to ordinary expenses. These two areas have been hit harder than others for two principal reasons: corporate and other tax revenues have decreased as a result of the prolonged recession; and the high cost

of interest and principal payments on bonds issued for major public works projects during the bubble years, besides which they have the added burden of having to maintain these facilities.

At the municipal level, the scene is no different. In addition to the increased cost of providing welfare services for an aging population, the burden of outlays for basic infrastructure, such as roads and sewer systems, has been a major underlying factor contributing to the financial crisis. Municipalities are bearing heavy costs for both servicing the debt incurred by the bonds issued to finance the construction, and maintaining this infrastructure.

How did this situation come about? During the 1989–1990 Japan-U.S. Structural Impediments Initiative (SII) talks, Washington insisted that the Japanese government raise the level of public investment in order to eliminate the surplus of savings over investment, which it identified as the cause of Japan's persistent tendency to export more than it imports. Because the United States feared that public investment aimed at improving the infrastructure for manufacturing would cause Japan's productivity to increase further and thereby make its trade surplus with the United States even bigger, Washington expected Tokyo to concentrate the increase in the area of quality-of-life investments in social overhead capital.

In 1991, Tokyo announced a ¥430 trillion Basic Plan for Public Investment covering the decade through fiscal 2000 (ended March 31, 2001), and in fiscal 1995 (ended on March 31, 1996) the total was increased to ¥630 trillion; this plan included projects—such as roads, sewage systems, waste treatment plants, and urban parks—to be implemented by local governments either independently or partly with subsidies from the central government. The Local Allocation Tax was used as one of the revenue sources.[3]

Essentially, the Local Allocation Tax is a system of vertical and horizontal revenue transfers. A certain portion of the national tax receipts is moved vertically to the Local Allocation Tax special account for distribution, horizontally, to local governments according to their estimated standard tax revenue and financial needs. Although the fiscal requirements of each local government are calculated according to population and area, should a local government be undertaking a project being promoted by the central government, that project would

come under the heading of estimated fiscal needs, and the local government in question would receive more revenue to cover those costs. Similarly, should projects the central government encourages be financed by floating local bonds, the central government would take both the expense and the cost of redeeming the bonds into consideration when estimating the Local Allocation Tax.

In 1992, the government began adopting a variety of stimulus measures, including those requiring additional public investment by local governments. Of the ¥100 trillion available in antirecessionary public investment, about ¥20 trillion was assigned to local governments. Then, in the late 1990s, the central government encouraged expenditure for public works by local governments by paying part of their costs through national disbursements or the Local Allocation Tax, and encouraging the flotation of local debt.

A local administrative official reported at that time: "The role of the Local Allocation Tax is changing. We can get more grants for certain projects for local needs. The more projects we do, the more grants we can get. This is local competition, and we are doing our best to win the race and get more grants and subsidies."[4] But most of the many local governments that utilized this system found their finances increasingly burdened by expenditures for public bonds and the maintenance of facilities constructed as public works projects.

Originally, the guarantee of revenues to local governments on the basis of the central government's blueprint for local finances was seen as an assurance of a national minimum level of public services regardless of regional economic strength or fiscal resources. But after the mid-1980s, when the basic social infrastructure was in place, the central government urged local governments to carry out public works projects that would meet local needs, as a result of which not a few governments built up their social infrastructure through bond flotations and the Local Allocation Tax. As the recession dragged on and the fiscal situation became critical, however, the national government became unable to provide the revenue to support local governments and borrowed increasingly through the Local Allocation Tax special account, which caused the volume of outstanding local government bonds to balloon.[5] In fiscal year 2000, the debt borne by the special account totaled ¥34 trillion.

Thus, the Ministry of Finance and the Ministry of Public Management, Home Affairs, Posts and Telecommunications both recently agreed on appropriate measures to deal with this shortfall in local finance: Loans from the Local Allocation Tax special account will not be increased, while the central government will periodically reconsider its revenue disbursements to local governments with a view to making up shortfall in local funds. But despite the agreement, the ministries appear still to be deliberating how best to proceed.

Another area feeling the brunt of the recessions is the local third sector, set up in the 1980s to develop recreational facilities. Some, saddled with huge debts, have failed. Although the local governments are the guarantors of their loans and so bear the liability when third-sector developments fail, it has been increasingly difficult for the central government to make up for the local shortfalls due to decreasing tax revenues and increasing expenditures for public bonds.

REFORM OF LOCAL GOVERNMENT FINANCES

Now that the central government has reached the limit of its ability to guarantee local government revenues, what sort of reforms are being sought to overcome the crisis in local public finances? Here we will consider and compare the reform proposals of the Committee for the Promotion of Decentralization and the Council on Economic and Fiscal Policy.

Committee for the Promotion of Decentralization

Under the 1995 Law for Promotion of Decentralization, the Committee for the Promotion of Decentralization was set up as an advisory organ reporting to the prime minister. The committee focused its attention mainly on the issues of eliminating intervention and regulation by the central government, and transferring revenue sources to local governments in order to avoid the evils of excessive centralization of power. Local governments were already handling many of the public sector's operations, but they did not have the authority to conduct these activities autonomously.

In its first set of recommendations, issued in December 1996, the Committee for the Promotion of Decentralization called for local governments to have broad responsibility for the conduct of administration in the regions on an independent, comprehensive basis, with the operations of the central government to be limited to: (1) operations involving Japan's existence as a state within the international community, (2) operations involving public activities better decided on a uniform basis at the national level, or basic rules concerning local self-government, and (3) measures and projects needing to be implemented on a nationwide scale or from a nationwide perspective.

In addition, as an exceptional category within the overall field of operations for which the central government is ultimately responsible, the council proposed the designation of both statutory delegated operations (those better entrusted to local governments for reasons of public convenience or administrative efficiency) and directly controlled operations (those directed by the central government).

In its second set of recommendations, the committee set forth proposals for the fiscal arrangements to accompany this new division of operational responsibilities. Initially, the committee came out with proposals that stuck to the concept of Article 9 of the Local Government Finance Act, which calls for local governments to pay the entire cost of the activities for which they are responsible. The committee's goal was to clarify the autonomy and responsibility of local governments in handling their own affairs, and to lessen the central government's involvement in and control over local government affairs through the consolidation and elimination of subsidies from the national treasury.

The committee sought to create a system whereby local governments would carry out their own operations on their own responsibility by maximizing the scope of autonomous activities funded by independent revenue sources; to this end it called for payments from the national treasury to be severely limited and for subsidized activities to be reduced. The committee also called for expansion of local governments' independent revenue through the transfer of tax sources from the central government, for elimination of the restrictions on local tax rates, and for a system respecting the autonomous decisions of local governments in connection with bond issues through the elimination of the requirement for central government approval. In addition, the

recommendations included a call for increased transfers of revenues under the Local Allocation Tax to guarantee revenues for those regions where local tax revenues could not be relied on because of such factors as depopulation.

But the committee ran into broad resistance from bureaucratic organs with respect to a number of its concepts, as a result of which it did not include many specific points in its formal recommendations. It did not make a single specific recommendation concerning the transfer of tax sources, and with respect to the consolidation and elimination of subsidies it offered concrete ideas only for a limited number of operations. The committee's proposals produced certain results, such as the elimination of the approval requirement for the creation of new local taxes and for local bond issues, but these have been utilized as a tool to promote the principle of local fiscal responsibility without the transfer of revenue sources.

The Committee for the Promotion of Decentralization disbanded in May 2001, but even in its final set of recommendations it noted the importance of transferring both operational authority and control of revenue sources to local governments, and urged the establishment of the principle of local responsibility based on local authority.

Council on Economic and Fiscal Policy

In June 2001, the government's Council on Economic and Fiscal Policy issued a set of recommendations titled "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management," which are often referred to as the solidly built (*honebuto*) reform policies. The council's basic position was one that stressed the need for an economy based on autonomy and self-reliance; in the area of local affairs, it called for a switch from the traditional approach of uniform, nationwide development to one that emphasizes the distinctive features of each region and that invigorates the regions through competition among them.

However, as the first step toward achieving regional autonomy, the council set forth the policy direction of merging municipalities into larger units from the perspective of the need for a stronger base of

local administration. Second, in order to allow local governments to exercise independent judgment, the council adopted the basic principle that authority over administrative services should be exercised at a level close to residents, calling for the reduction of involvement by the central government in local affairs and for the rebuilding of local government finances from the perspective of achieving greater efficiency in the use of public funds and clarifying benefits and burdens. To this end, the council proposed (1) reduction of subsidies and other payments from the national treasury, (2) review of the Local Allocation Tax, and (3) strengthening of local revenue sources.

In terms of the prescription for curing the crisis in local finances, the recommendations of this council look very similar to the vision of decentralized public administration and finances set forth by the Committee for the Promotion of Decentralization. However, the two bodies had different underlying philosophies.

The traditional system of local government in Japan was one in which all the local authorities had to do was follow the instructions they received from the central government and they would feel virtually no pain in covering the costs of social infrastructure projects, although this produced a break in the connection between benefits and burdens at the local level, causing local residents to develop a distorted view of fiscal affairs, which in turn led to lax management of local government finances.

The Council on Economic and Fiscal Policy thus adopted the position that, in order to cut out wasteful spending, the national subsidies and Local Allocation Tax should be reformed so as to achieve maximum congruence between benefits and burdens at the local level. In addition, since the large numbers of small municipalities meant duplication of facilities and other unnecessary costs, the council called for the construction of an efficient system of local administration through the amalgamation of municipalities into larger units with populations of 200,000 and 300,000 people, the level that empirical studies have shown to be the most efficient.

The council adopted a consistent position of following the principle of paying one's own way at the local level, both in economic and fiscal affairs. But it did not take up the issue of reviewing the division of functions between the central and local governments. Also, its main focus

was on addressing the problems in the finances of the central government, and for this reason it proposed cutting back on transfers of revenues to local governments and having them work harder at raising their own funds. The thinking behind this was that, were the subsidies and Local Allocation Tax payments from the central government cut successively because the central government was in a financial crisis, the situation at the local level, where the base of revenue sources is weak, would be even more critical.

The discussion of reform of local government finances is now being directed less at the issue of how revenue sources should be divided between the center and the regions, and more at the search for ways to have local governments bear fiscal burdens based on the principle of self-accountability. In the following section we will review the direction of the reforms being proposed.

FINANCIAL REFORMS IN THE INTERESTS OF LOCAL INDEPENDENCE

Reform of the local government system under the Omnibus Law of Decentralization started in April 2000. However, reform on the fiscal level has been slow, with the transfer from center to local governments of decisions regarding the tax base having been held off for future discussion. While the introduction of radical taxation reform may well take time, it is imperative that a degree of reform be immediately instituted in several areas as outlined below.

The Local Allocation Tax

In recent years, it has been argued that the Local Allocation Tax should be reduced in scale because it clouds the relationship between benefits and burdens, thereby promoting laxness in the management of local government finances. But if the scale of this revenue-sharing system is reduced without other arrangements being changed, it can be expected that even greater financial difficulties will face local governments, particularly in those regions where the potential tax base is small.

The Ministry of Public Management, Home Affairs, Posts and

Telecommunications is now working on reforming the Local Allocation Tax, with the focus on the current methods of adjusting the amounts in line with the circumstances of individual local governments.[6] One of the items to be revised is the system of second subsidies, namely, those payments supplementing the regular local allocation tax that account for 40 percent of the second subsidies as calculated by methods of adjusting the amounts.[7] These subsidies distort the fiscal adjustment function of the Local Allocation Tax, for which reason there have been calls for their review for some time.

A second item due for revision is the method of adjustment according to which more generous payments are provided to local jurisdictions with smaller populations, based on the view that their per-capita costs tend to be higher. The central government had already revised this system, adapting the uniform modification coefficient when calculating the specific needs of a depopulated district for the purposes of the Local Allocation Tax for municipalities with a population of less than 4,000. As a result, some of these small local governments are obliged to amalgamate because they cannot make financial ends meet on such meager subsidies.

Local Allocation Tax reforms are under way starting with the reduction of the supplementary portion for low-population municipalities. Given the ballooning of the special account for this system, however, we are likely to see calls emerging for a reduction of the total amount paid. Yet, if local governments assume responsibility for more operations, the gaps among the regions will naturally widen, and the role of the Local Allocation Tax in smoothing the differences will become even more important.

The Local Tax Base

If one takes the position that revenue sources should be apportioned between the center and the regions in a way that matches the division of operational responsibilities in order for local governments to be able to exercise autonomous decision-making authority, then it follows both that local governments must secure their own revenue sources and that a clear relationship between benefits and burdens must be established at the local level. As a way of achieving this, it has been proposed that the existing tax system be reformed so that, among

other things, the main taxes might be transferred from the center to the regions.

The main taxes in question are the income and consumption taxes. A typical suggestion involving income tax calls for the transfer of an amount, corresponding to the minimum tax rate (10 percent) to local governments as an inhabitant tax (Jinno and Kaneko 1998). One of the suggestions concerning the consumption tax (currently 5 percent, of which 1 percent goes to local governments), meanwhile, calls for modification of the existing apportionment of revenues between the center and local governments.

Proposals have also been advanced for reform of the existing local tax system. One plan calls for changing the corporate enterprise tax assessed by prefectures from a tax on corporate income (linked to the corporate tax at the national level) to one on operations (as measured by the size of the business). Since even corporations reporting losses in their financial statements are the beneficiaries of certain public services, it would seem only reasonable to have them, too, share the burden. At present, two thirds of all corporations are running deficits, meaning that they are paying no corporate income tax.

In July 1997, a subcommittee of the government's Tax Commission came up with four proposals to change the method of assessing the enterprise tax, the simplest of which would be to assess taxes on the basis of the amount of capital, although doing so on the basis of the value added from production is much more appropriate. Discussions have, however, come to a halt and shall have to be resumed before any proposal can be implemented. Meanwhile, small and medium-sized enterprises in the red have been getting special tax breaks, but there have been calls for these to be replaced with subsidies or other forms of income transfer.

Taxation Exceeding Standard Tax Rates

The Local Tax Law regulates the kind of local taxes, the tax base, and the tax rate. When there are special fiscal needs, such as to finance public works, the imposition of a tax at other than the standard rate is allowed, but permission from the Ministry of Public Management, Home Affairs, Posts and Telecommunications is required.

However, the central government makes it difficult for local

governments to assess taxes to cover basic fiscal needs on the grounds that the latter have already been compensated by the Local Allocation Tax. Moreover, tax cuts aimed at stimulating business are not allowable.

Adopting tax rates that exceed the standard rate is an effective way of raising funds to meet special local needs, so currently almost all prefectures are adding surcharges to their corporate inhabitant taxes, while municipalities are doing so to inhabitant taxes and fixed assets taxes. Bearing this in mind, it would seem worth considering giving local governments more leeway in applying tax rates that exceed the standard rate to cover ordinary expenses and achieve policy objectives.

Local Discretionary Taxes

Since April 2000, local governments have been allowed to impose discretionary taxes after consulting—rather than seeking permission from—the central government, so that each local government is now able to construct its own earmarked tax in addition to the ordinary tax. Another change since the start of fiscal 2000 concerns the requirements to be fulfilled for the tax to be applied. The tax had to satisfy five requirements, two of these—related to tax resources and fiscal needs—have been eliminated leaving three, namely: that the tax base should not be the same as the national tax or other local taxes, and the tax burden should not become too heavy; that the tax should not pose serious damage in physical distribution; and that the tax must be appropriate to national economic policy. So now, even in the absence of special fiscal needs, local governments are able to construct their own tax and, since applications of the revenue from the earmarked tax are possible, the relation between benefits and burdens is clear.

Be that as it may, local governments remain subject to constraints in terms of their ability to impose discretionary taxes, and in practice it is difficult for them to introduce such taxes as a means of raising general revenues. Thus, we are now seeing moves in various places to create new taxes either to supplement existing tax systems or to achieve specific policy objectives.

These new taxes can be classified into three categories. The first comprises environment-related taxes. These are imposed on goods, services, property, or facilities that place a burden on the environment

and include Mie prefecture's industrial waste landfill tax, the Tokyo city of Suginami's tax on plastic bags handed out by shops, and the water-source-conservation taxes under consideration in various locations.

The second category of taxes is aimed at promoting regional development, conservation, and disaster prevention. Such taxes, targeted mainly at tourists and residents from other areas, include the Shizuoka prefecture city of Atami's tax on vacation homes, the fishing taxes of municipalities bordering Lake Kawaguchi, in Yamanashi prefecture, Tokyo's hotel tax, and the mountain climbers' and hikers' taxes that various municipalities are considering.

The third category comprises taxes on corporations aimed at rectifying the instability of local tax bases that result from the heavy dependence of prefectures on the corporate enterprise tax, receipts from which fluctuate in response to economic conditions. One prominent example is Tokyo's so-called bank tax, which applies to the gross profits of major banks operating in the metropolis; there is also the temporary special corporate tax introduced by Kanagawa prefecture, according to which corporations are subject to taxation at a reduced rate on losses carried over from one business year to the next.

One of the effects resulting from the moves by local governments to introduce new taxes is the emergence of a degree of coordination among the tax and various other sections within local government bodies in considering tax affairs. Previously, when local governments had very little discretionary authority over their own tax systems, the linkage between taxation and policymaking was extremely tenuous. But now that the option of creating earmarked taxes has become available, local governments have room to consider taxation based on expected demand for revenues.

Another effect of the move by local governments to introduce new taxes is that coordination among them is becoming an important issue, since it is now technically possible for them to poach each other's revenue sources. For example, municipalities in major urban areas are likely to consider taxing emissions of industrial wastes, while municipalities in rural regions where the wastes are disposed of may well consider imposing disposal and landfill taxes. This is liable to mean taxation of wastes both at the source and at the location of final disposal which,

because it may violate the requirement for consent from the central government, means that some degree of coordination may be needed to resolve the issue.

THE DIRECTION OF REFORM

Local Competition for Tax Revenues

If local governments are to administer their affairs autonomously, they must be able to secure sufficient revenues to cover the costs of their expanding roles. Inasmuch as the ability of the Local Allocation Tax to guarantee the necessary revenues has reached its limit, it is necessary to change the system by transferring tax sources (such as a portion of the national income tax, or a larger share of the consumption tax), to the regions so that local governments will be able to independently consider the supply of services and the handling of the resulting burdens.

While local governments have taken steps toward administrative and fiscal reform and toward a more decentralized society, a new problem has surfaced. Conflicts between central and local government, and among local governments, have emerged. Anticipating tax reform, each is seeking ways to increase their respective tax revenues. Generally, when grants are reduced and local taxes are expanded, the areas that benefit are few and specific; Tokyo is an example. While local governments may find such negotiations with the central government difficult, the scramble for tax revenues is not diminished. Further, local governments in a weaker financial position usually fear that local tax reform will reduce their central government grants and subsidies. Such local authorities may wish to change the restriction placed on their authority over grants-in-aid but, needing the subsidies, they do not wish to rock the boat. Meanwhile, a big city that has a sufficient source of taxation may want to collect its own revenues and so remove the tax resource from the national to the local level.[8]

The movement for new taxes in many regions has had the effect of creating unexpected competition among governments. Thus, for example, Tokyo and Osaka have opted for imposition of a corporate enterprise tax system—based on such considerations as sales and salaries—on banking institutions, which will have the effect of decreasing

revenues from the corporate tax at the national level and the enterprise tax at the prefectural level.[9]

Efforts to Cut Costs of Local Services

In order to create a self-sustaining, local fiscal system, current intergovernmental fiscal relations must be reconsidered, and reforming the system for greater local autonomy is warranted. But it is also important that, through reform, local governments be made aware of their own responsibilities and work to achieve greater effectiveness. Moreover, local governments must allow citizen participation in their administrations.

Amidst the crisis in local government finances, there is little that local governments can do to increase their tax revenues given the present system, so the most practical way for them to deal with the crisis is to cut spending. One trend that is evident nationwide is that of holding down personnel costs. The share of such costs as a percentage of local government spending has decreased gradually since the mid-1980s, and since the mid-1990s has been held at a level of around 25 percent. Given that the rising demand for interpersonal services would ordinarily mean higher personnel expenses, the fact that spending in this category has been kept basically flat suggests that local authorities have been making efforts to hold the line by various means including staff reductions.

Besides staff cutbacks, efforts to cut costs fall into three main areas. First are reforms within local government organs based on policy and operational evaluations. This approach seeks not only to review whether activities are necessary, but also to select effective means of supplying administrative services by considering possible alternatives to existing methods.

Second are moves to privatize government operations or to tap private-sector energy in providing public services. These include use of private finance initiative (PFI) in constructing and operating facilities, and entrusting the management of existing operations to private-sector bodies.

Third are the moves to cut costs through citizens participation, examples of which include the cooperation of neighborhood associations, local volunteer groups, and nonprofit organizations to provide

interpersonal services through mutual aid at the grass-roots level. These efforts have been accompanied in some cases by moves to solidify the system of mutual aid through the introduction of a "community currency" as part of a local set of barter arrangements.

The Government-Citizen Relationship

Fiscal transfers from the central government account for a great portion of the local government revenues, and this tends to cloud the relationship between benefits and burdens with respect to government services. If revenue sources were shifted to local governments, the benefit-burden relationships would become more clear, and taxpayer perceptions would be likely to change. Local government needs to institute and enforce rules on accountability, and devise local fiscal systems that match the needs of society. Since citizen participation in the decision-making process is important, government should facilitate the dissemination of information by sponsoring forums for discussion or offering venues where they might take place. As part of the administrative reforms, the movement for information disclosure and citizen participation in municipal affairs has spread rapidly across the country. Many local governments have responded by being more open about their financial situation, some going so far as to prepare balance sheets, or revealing the cost per capita of city hall, or cost-benefit analyses for public examination. Citizens are thereby gaining a better understanding of not only the financial situation in their region, but also of the cost of the public services they receive.

Recently, many local government bodies have been making active use of the Internet on an interactive basis, and using websites to convey information and gather input from the public on government services. Since 1995, the Kanagawa prefecture city of Yamato used the Internet to encourage citizen participation in the drafting of a master urban plan that was finalized in 1997, as a result of which the municipal government revamped its internal decision-making system so as to be able to respond promptly to the opinions and queries of residents. An increasing number of local governments are also using their websites to conduct bidding for public works projects. The city of Kamakura, Kanagawa prefecture, has taken this a step further, disclosing not just the winning bid, but the names of the bidders and the amounts of their

bids.[10] Such an arrangement serves as a powerful deterrent to bid rigging.

Meanwhile, an increasing number of local governments are producing balance sheets and disclosing other fiscal information in an effort to present their financial situation in a form that is easily understood. Tokyo's Arakawa city has set up a website devoted to promoting residents' understanding of the city's finances, based on a policy of disclosing information and using indicators that will be clear to the general public.[11] The city uses it to disclose all the costs of operating its facilities, together with information on aspects of its finances, how the current critical economic situation is affecting it, and what countermeasures are planned; the emphasis is on presenting this information in a way that ward residents can readily grasp.

One other issue that local governments should address is rules of engagement for the supply of personal services in a municipality. For example, while nursing services can be supplied by various entities —the family, the municipality, private enterprise, and nonprofit organizations—it is important to study the situation locally, review the suppliers of services, and factor in the burden of expense. Some areas have already started to build nursing service systems using LETS (a local community exchange system) or time-saving systems. In these cases, the central government, regional groups, local companies, and communities have cooperated to build their own systems to supply local needs.

FUTURE PROSPECTS

As we have seen in this chapter, local government finances are in a critical state and the central government's ability to guarantee the required revenues has reached its limit. Moreover, the central government has used local governments as tools in its efforts to stimulate the economy through public works projects, thereby having caused their tax revenues to decrease as a result of its antirecessionary tax cuts, and leaving them to bear heavy debt burdens. The current reform drive aims to impose responsibility on local governments without giving them local decision-making authority, while at the same time cutting their subsidies and Local Allocation Tax payments, thereby

particularly aggravating the problems of those local governments already financially weak.

If our goal is to create a decentralized society in which the economic actors within each region will both make their own decisions about the quantity and quality of the public services they want to receive, and bear the corresponding burden, then we must create a system of local government finance in which the relationship between benefits and burdens is readily apparent. In this context, the division of revenue sources between the central government and local governments should, in principle, correspond to the division of operational authority. It is unreasonable to expect local governments to assume responsibility for their own affairs under the present setup, which requires them to carry out the bulk of the operations but allows them only weak tax bases.

There are also a host of issues that need to be addressed at the local level. Local governments will have to create systems of high transparency in the conduct of their administrative and financial affairs so as to gain the understanding of their citizens regarding proposed revenue-raising measures. In recognition of their accountability to taxpayers, local authorities must slash inefficient expenditures.

In a decentralized society, local governments have authority over their affairs and, within their respective jurisdictions, must form a positive relationship with their citizenry. To overcome the financial crisis, it is critical that there be a decision-making system involving all players in the local economy, so that the needs in terms of public services and the accompanying fiscal burden may be determined. It is only through the local decision-making system that financial decentralization can be viable, and the decentralization of government achieved.

NOTES

1. Local government in Japan has two administrative levels: 47 prefectures and their division into about 3,200 municipalities, towns, and villages.

2. Looking at revenues from the two corporate taxes, we find that during the bubble economy, the total increased by close to 20 percent year on year, but in fiscal 1992–1993, following the bursting of the bubble, the figure dropped 15 percent year on year. The enterprise tax is highly susceptible to changes in

economic conditions, making it difficult for local governments to forecast their tax revenues.

3. About the relations between the trend of public works and Japan's foreign diplomacy policy, see Kanazawa (2002, chapter 1).

4. Interviews at the local affairs section of the Nagano Prefecture Government Office in December 1990.

5. Borrowing through the special account of the Local Allocation Tax has been criticized for its lack of transparency and the fact that ultimate responsibility for the loans is not clearly defined. See Miyajima (1987, chapters 3 and 7).

6. Researchers have determined that the actual amounts paid under the Local Allocation Tax system correspond basically to amounts that can be theoretically derived from just two factors, population and area, and this has served as the basis for strong arguments in favor of simplification of the calculation method.

7. Calculated using data from Ministry of Public Management, Home Affairs, Posts and Telecommunications (2000a).

8. A number of governments, including those of Tokyo, Kanagawa prefecture, and Osaka, have set up their own research groups to study what sort of reform would be most desirable for them and have conducted simulations of the possible effects of revenue source transfers. The government bodies have felt compelled to do so as decentralization has progressed and the crisis in government finances has worsened.

9. There are also differences in the apportionment of enterprise taxes collected from corporations that have business establishments in multiple tax jurisdictions.

10. URL <http://www.city.kamakura.kanagawa.jp/keiyaku/index.htm> (in Japanese).

11. URL <http://www.city.arakawa.tokyo.jp/hakusho2000/index_hakusho2000.html> (in Japanese).

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