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POLITICAL ECONOMY OF INTERGOVERNMENTAL FISCAL RELATIONSHIP AND LOCAL GOVERNMENT DEFICIT IN JAPAN

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1. INTRODUCTION

One of the distinct facts about Japan's public debt in the 1990s and thereafter is that local government debt has been considerable in volume. Local government outstanding debt grew from 14.8% of GDP in FY1990 to 41.4% of GDP in FY2011 (including local public enterprises and local governments' liabilities for borrowing by Local Allocation Tax Special Account of central government). It is obvious that local government sector partly but significantly contributed to the accumulation of public sector debt in Japan, which now exceeds 200% of GDP.

Originating from pre-WWII period and evolving over time, intergovernmental fiscal relationship in Japan has retained a basic nature as the crucial backbone of 'Centralized-Deconcentrated' system (Jinno 1993:214–8, Jinno 1998:123–5) of Japanese public finance. Since such intergovernmental fiscal relationship characterizes fiscal institutions in Japan, we may well find systematic links among local government debt financing, intergovernmental fiscal relationship, and the nature of modern Japanese welfare state as a whole.

2. INTERGOVERNMENTAL FISCAL RELATIONSHIP AS A 'CENTRALIZED-DECONCENTRATED SYSTEM'

Controlled Centrally, Implemented Locally

Japan's local government sector is very large as compared to other major unitary states, which has been a persistent feature ever since pre-WWII period. Figure 1 shows that local government expenditure always exceeded that of the central government from the late 1950s to date. It should also be noted that local government expenditure grew rapidly and reached the level equivalent to the central government expenditure in the early 1930s. If we take the WWII and postwar reconstruction period as exceptional, we may find continuity from the early 1930s in terms of the expenditure balance between central and local governments.

There is a plenty of qualitative studies indicating this prewar—postwar continuity.

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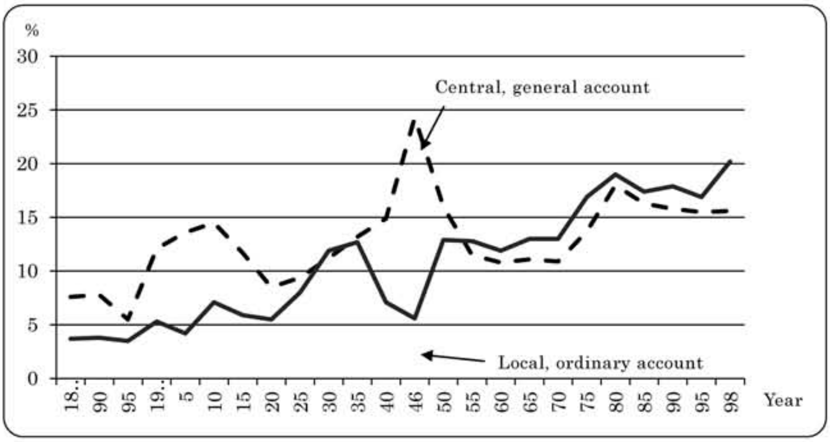

Source: "Nihon Zaisei Youran" (Handbook of Japanese Public Finance), 5th edition, University of Tokyo Press.

Figure 1. Central and Local Government Expenditures as % of GDP

Not only the expenditure size but main features of the system of central government intervention in local government financing were formed in the 1930s and the early 1940s. To mention a few, central government provided a considerable amount of specific grants for public works to local governments in order to counter depression in the early 1930s (so-called Takahashi Zaisei). In doing so, the central government eased control over local government bond issues, and national postal savings system (Yokin-bu) was mobilized to finance local governments by absorbing local bonds (Ide 2006, chapter 2). Throughout the 1930s the central government strengthened the ceilings on local tax rates, and meanwhile, they started considering the introduction of a non-earmarked fiscal equalization grant to support local government finance (Takeda 2003). After an attempt to decentralize tax assignment failed in the late 1920s, both the Ministry of Internal Affairs and academics began to focus on the possibility of a fiscal equalization grant (Takahashi 2010). Its actual introduction was only in 1940, when all income-based taxes became concentrated to the central level and local governments lost major sources of tax revenue.

All these measures culminated in the formation of 'Centralized- Deconcentrated' intergovernmental fiscal relationship. It is a historically rooted system under which the central government retains major sources of revenues while local governments must rely on fiscal transfers. It is 'centralized' in the sense that the central government exerts control over local affairs by utilizing the system, and is 'deconcentrated' as local governments are responsible for implementation of projects in various government functions, which makes them big spenders.

Components of the 'Centralized-Deconcentrated' system

1) Restrictions on local taxation

Local governments were largely deprived of autonomous power to create new taxes or determine tax rates for their own localities. Standard rates were set for major local taxes by national law, whereby any increase or decrease in the local tax rate tended to be perceived as 'deviation' from the standard rate. (Local governments' right to create new taxes were conditionally recognized in the 2000s, which led to the introduction of various earmarked (or virtually earmarked) taxes recently.)

2) Proliferation of earmarked grants

There were innumerable earmarked grant schemes to finance locally provided public services and projects. The main areas financed largely by earmarked grants were public works, social security and welfare, and compulsory education. Central government ministries attached strict rules and regulations on the use of funds, and they required counterpart fund from local governments which implement the project. (Local governments rely less on earmarked grant revenues after the rationalization and reduction of earmarked grants took place in the mid-2000s, and the reform is still on-going.)

3) Restrictions on local borrowing

Added to the general rule which prohibits local borrowing for current expenditures, local governments had to seek approval by the Ministry of Home Affairs (in cases of prefectures, the mid-tier local governments) or prefectures (in cases of municipalities, the lowest-tier local governments) for the issuance of local bonds. The examination for approval was implemented for each project with bond financing until 1995, after which only the total volume of bond issue by each local government was examined in terms of consistency with the Local Bond Plan formulated at the central level. (After the reform in the mid-2000s, local governments are only required to 'consult' with upper governments for their bond issues.)

4) Local Allocation Tax

The central government allocates parts of main national tax revenues (income tax, corporate tax, consumption tax, liquor tax and tobacco tax) to local governments in the form of Local Allocation Tax. The Local Allocation Tax functions as fiscal equalization scheme by allocating more to poorer local governments and less (or none) to richer ones.

According to the allocation formula, the fund is allocated so as to fill the gap between the estimated fiscal demand ('standard financial demand') and estimated revenue capacity ('standard financial revenues') of each local government. To estimate fiscal demand, 'measurement units' are assigned to each category of expenditure items (e.g., length of river for river management, and the number of pupils, classes and schools for compulsory education) and cost per a unit ('unit cost') is set to reflect actual cost of service delivery. 'Adjustment coefficients' are also applied to account for such factors as urban-rural differences and geographic conditions, which affect service cost per unit.

On the other hand, revenue capacity is calculated for each local government as 75% of the projected local tax revenues.

5) Local Public Finance Plan: the core instrument of central control

Local Public Finance Plan is formulated annually alongside the central government budget process. It is a projection of all expenditures and revenues in general accounts of local government sector as a whole in the next fiscal year. On the expenditure side, changes in rules and regulations of local projects effected by national legislation, socio-economic conditions, and other factors which are likely to affect the size of local expenditure are reflected. On the revenue side, local tax revenues, planned amount of earmarked grants, local borrowing, and Local Allocation Tax revenues are main components to be summed up.

The Plan lays the basis of central government intervention in local fiscal affairs. For our discussion, it should especially be noted that the total amount of Local Allocation Tax is determined in the formulation of the Plan. Once the certain total expenditure level is set, and local tax revenues and provision of earmarked grants by various ministries are determined, the remaining sources of financing the total expenditure are local borrowing and Local Allocation Tax. The macro volume of local borrowing is projected in the Local Bond Plan, and Local Allocation Tax fills the remaining gap.

The Local Public Finance Plan is an instrument with which MOF and MOHA negotiate over local government financing. When there is a conflict between MOF and MOHA about the total amount Local Allocation Tax, the will of the former usually prevails, reflecting the relative power of the two ministries. The same can be said about the formulation of the Plan as a whole, especially with regard to a decision on the size of total local expenditure.

How does it work as a system?

These components described above are closely related and bound to each other functionally, as a 'Centralized-Deconcentrated' system, which has primarily been criticized as hindering local autonomy. Since there are standard rates for major local taxes and limits to local borrowing, local governments tend to promote those projects funded by earmarked grants more than purely local projects. Local Allocation Tax is supposed to ensure the adequacy of local revenues, but its sufficiency fundamentally depends on the contents of the Local Public Finance Plan formulated at the national level.

3. LOCAL DEBT ACCUMULATION, 'CENTRALIZED-DECONCENTRATED' SYSTEM, AND LOCAL ALLOCATION TAX

Public works boom

Local governments increased their public works expenditures drastically in the 1990s, whereby shouldering the cost of 'post-bubble' pump priming policy. The 'Centralized-Deconcentrated' system of intergovernmental relationship was not even fully utilized but also adjusted to meet the purpose.

The practice of 'Local Allocation Tax measure' (Koufuzei-sochi) prevailed, which made a large part of future local expenditure for debt repayment to be included in 'standard financial requirements' in Local Allocation Tax formula. This effectively meant that the cost would partly be borne by the central government in the form of increase in future Local Allocation Tax. In this way, the central government did not even need to lure local governments into public works projects by giving earmarked grants and postponed its financial burden as future increase in Local Allocation Tax.

This clearly indicates that local debts have been accumulated in pursuit of national policy goal, which was made possible by 'Centralized-Deconcentrated' system of intergovernmental fiscal relationship.

Restructuring of debt-ridden local government sector

At the same time as the central government turned to expenditure cut in the 2000s, local government sector restructuring was pursued. The financial size of Local Public Finance Plan was reduced drastically in 2001, and reduction was repeated until 2007, which resulted in huge cuts in Local Allocation Tax. It also entailed the weakening of equalizing effect, as some changes in the formula effectively reduced allocation of fund to poorer local governments.

This did not mean the role of Local Allocation Tax was lessened, however. It can rather be argued that its function as a tool to support the national policy goals was enhanced. Along with expenditure cuts, the number of municipalities was reduced from 3232 in 1999 to 1724 in April 2011. To promote amalgamations, the central government allowed amalgamating municipalities to issue special bonds to finance their public works projects, and counted their future debt repayment costs in 'standard financial requirements' in Local Allocation Tax formula, as they did in the 1990s.

Cut in local government personnel expenditure was pursued by the central government intervention, too. MOHA issued a guideline called 'Intensive Reform Plan' (Shuchu-Kaikaku Plan) to restrain the replacement of retiring personnel and promote outsourcing of jobs at the local level. The guideline was not binding, but annual calculation of Local Allocation Tax had a signaling effect, as it reflected the planned reduction in local personnel costs so that local governments would expect respective decrease in Local Allocation Tax revenues.

In the same period, the effort to decentralize fiscal system, so-called 'Trinity Reform' proceeded, too. The name points to three main aspects of the reform, which are enhancement of local taxation, reduction and rationalization of earmarked grants, and the reform of Local Allocation Tax. It was intended to be a step toward transforming the 'Centralized-Deconcentrated' system to a more decentralized one but was only partly successful and resulted mainly in local revenue cut. What should be noted, moreover, is that the shock of the decrease in local revenue caused by reduction of earmarked grants was partly absorbed by Local Allocation Tax. Here again, the goal of the central government to rationalize and downsize local government sector was supported by Local Allocation Tax.

To summarize, we may argue that all these facts indicate the following. First, the 'Centralized-Decentralized' fiscal relationship worked not only for local debt accumulation but also for local government restructuring. This implies that the primary character of such an institutional setting can be found in its function to perpetuate national policy goals at the local level, and it is misleading to characterize it as only debt-prone. Second, given that the role of earmarked grants were reduced and the room for tax financing is still limited, the role of the Local Allocation Tax in terms of supporting fiscal capacity of local governments has gained even more importance. Third, for the same reasons, the dependence of the central government on Local Allocation Tax as a means to influence local fiscal affairs will possibly become more evident, especially in times of austerity.

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