The role of Japanese local governments in stabilisation policy

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The Role of Japanese Local Governments in Stabilisation Policy *

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Abstract

Local governments in Japan account for about 80 per cent of general government spending when excluding social security expenditures. Therefore, for the implementation of fiscal policy it is important how local governments will behave.

On the basis of the economic theories on fiscal federalism it is generally rational for local government entities, especially smaller ones, not to participate in the stabilisation policy of the central government and to take a free rider position. Such a behaviour would imply a substantial reduction or even an offsetting of the effects of a stabilisation policy of the central government. As for empirical evidence, a procyclical behaviour of local entities was observed in several countries, among them Germany. We show that in Japan this was not the case and that so far local governments do participate in the stabilisation efforts of the central government. In a second step we show the institutional arrangements that have enabled the central government to influence the fiscal behaviour of the local governments accordingly.

Will recent regulatory changes and the enourmous debt level have a significant impact? We argue that although from April 2000 some legal changes in the direction of decentralisation were enforced, many influence mechanisms remained intact and thus the changes weaken the established system, but did not break it up altogether.

Keywords

local government borrowing, intergovernmental fiscal relations, Japan, federalism, fiscal equalisation, fiscal policy, government debt, local allocation tax, local autonomy, public finance, stabilisation policy.

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Contents

1 Introduction

There has been a lot of discussion to what extent the relations between central and local government in Japan are dominated by the central government. Most of the contributions take a political science approach. While one stream of authors is arguing that there is only little autonomy of local governments (e.g. Steiner 1965, most recently Ishi 2000), others have been arguing that there is quite substantial autonomy of local governments (e.g. Aqua 1980, Muramatsu 1997, Reed 1979, 1982, 1986, Samuels 1983). Doi (1998) states that Japanese local finance is managed jointly by the control of the central government and the request of the local governments.

We try to take a fresh look at this issue by analysing a data set neglected so far: the responsiveness of regional government expenses to the (national) business cycle. The gist of the argument goes like this: it is ususally not in the interest of localities and regions to behave anti-cyclically. If, however, a considerable degree of pro-cyclical behaviour should be found, this can serve as a substantial evidence for influence from the central government, in whose interest it is to ensure countercyclicality of fiscal policy.

Depending on which view on the autonomy of local governments is right, this has considerable implications for the possibility of proactive countercyclical policy in Japan, where about 80 per cent of general government spending (excluding social security expenditures) are effected on a sub-national level. Under current reform measures, if local governments become more independent, they will follow the central fiscal policy less than before and reduce the possibility of effective countercyclical policy.

After giving an overview of the relevant literature on fiscal federalism, our major question is whether the revenues and expenditures of the local governments are procyclical, which would indicate a free rider behaviour of the local governments, or countercyclical, which would indicate that the stabilisation policy of the central government can dominate the fiscal behaviour of the local governments and thus signals a strong influence of the central government on the regions. Afterwards, we ask about the institutional reasons for the financial behaviour of the local governments. Then we discuss the likely effects of recent changes and reforms on the relationship between central and local government in Japan and close with an overall assessment of the effects of the system.

2 Literature review

The issue of fiscal federalism has been discussed widely (e.g. Thiebout 1956, Buchanan 1950, Oates 1972, Wellisch 1995, Feld/Kirchgässner 1998, Oates 1999). The major question is which level of government should be responsible for certain tasks. Following the analytical approach of Musgrave (1959), one can subdivide the tasks in question into allocation, distribution and stabilisation. In this paper, we concentrate on only one of these aspects - on stabilisation.

2.1 The normative view

While some case for a decentralised conduct of fiscal policy can be made (e.g. Gramlich 1987: 310-311), the traditional normative view underlines the disadvantages (e.g. Oates 1972: 21-30, Pommerehne 1977: 292). The main argument is the openness of small local entities. Even if, because of assymetrical shocks, a decentral conduct of fiscal policy would be desirable, it would be largely ineffective, because of large inter-regional trade interdependence. This causes low expenditure multipliers within the region concerned and positive spillovers to other regions.[1] Given the low expenditure multipliers it is rather questionable whether the expenses used for stabilisation purposes could be refinanced by increased tax revenues stemming from the results of the conduct of an active stabilisation policy. Therefore, at least in the short run, free rider attitudes can be expected to be dominant.

Moreover, usually there is a central government monopoly of monetary policy. If stabilisation is financed by debt, there may be spillovers on interest rates of the whole currency area.

Another traditional argument for a central conduct of fiscal policy, which is, however, becoming less important with the proceeding development of capital markets, is that it is usually more difficult for local governments to access debt finance.

All in all, the normative literature suggests that stabilisation policy is primarily the task of the central government. An alternative would be a coordinated stabilisation policy of local governments, but it is difficult to achieve such a coordination. Coordination could be enhanced by central government guidelines, subsidies, provision of access to the capital market, etc. ensuring the coordination if necessary. Therefore, if there is empirical evidence that local governments actually do participate in stabilisation efforts, this suggests the presence of effective central government influence.

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[1] If, however, larger entities (e.g. US-states, EU-countries) engage in stabilisation policy, there is some possibility of success for an own conduct of fiscal policy since the spillovers are smaller. Especially for smaller entities, however, given considerable spillovers to other regions, an uncoordinated conduct of fiscal policy may have undesired results.

2.2 Empirical studies

There have been quite a few studies on the question of whether the financial behaviour of local governments is procyclical or countercyclical (table 1). As for the United States, different conclusions are reached depending on the time period investigated and methodology used. In Germany, especially in the 1970s, there was an intensive discussion about how to avoid the adverse effects caused by the procyclical public investment activities of local governments, which were disturbing the attempts of the federal government at stabilisation.[2]

Table 1 Results of empirical studies on the cyclical behaviour of local governments

Author (Year)	Country/Region	Time period	Result
Hansen/Perloff (1944)	United States	1930s	Procyclical
Rafuse (1965)	United States	1945-61	Countercyclical in recessions
Bundesbank (1972)	Germany	1960s	Municipal investment procyclical
Snyder (1973)	Six countries	1955-65	Different from country to country and partly depends on the concept used
Kock (1975)	Germany	1960s	Municipal investment procyclical
Gramlich (1978)	New York	1955-74	Procyclical
Park (1990)	United States	1982-86	Countercyclical
Von Hagen (1992)	United States	1980-86	States: countercyclical effects of unemployment insurance

Source: Own compilation using Park 1990: 45-46.

As for Japan, the available literature concentrated more on case studies of political issues between central and local governments and added insights that subsidies do not necessarily imply an unlimited degree of control over local finance (e.g. Reed 1986, Samuels 1983). On the other hand, a study on taxation issues concerning local

[2] In addition to the general incentive for local governments not to participate in stabilisation policies, this tendency was further supported by the following: Generally, investment expenditures are more easily adjusted, while current expenditures are more inflexible. Given the existence of "deficit criteria" for municipalities decided by the states (*Länder*), using the surplus of the current account as the main criteria for the amount of allowed borrowing, municipalities, which account for the bulk of public investment in Germany, made their investments when there was a surplus in the current account. The situation for the states (*Länder*) was similar, only the extent of the countercyclical effects was smaller (Kock 1975: 23-29, similarly Vesper 1999: 182-83).

autonomy shows the interests of the Ministry of Finance (MOF) and the Ministry of Home Affairs (MHA)[3] to be important factors (Jinno/deWit 1996).

Hayashi (1998, 1999, 2000) deals explicitly with the importance of local governments in stabilisation policy in Japan, arguing that the "American theories" of Musgrave and Oates that stabilisation policy should be done by the central government (alone) do not hold for Japan where central and local government finance are not separated so clearly and the weight of local finance is much higher. There are also studies on intergovernmental fiscal relations (Imai 1993) and studies on the sustainability of government debt, including local debt (Doi/Nakazoto 1998, Doi 2000) which offer some related insights.

3 The importance of local government behaviour for stabilisation policy in Japan

First, let us ask whether the fiscal role of local governments is actually significant in Japan. In an international comparison (table 2), the share of local governments in total government expenditure in Germany, Canada and, indeed, Japan are particulary high. This is true both of consumption and investment expenditure. Therefore, if an active

Table 2 Share of local expenditure in total general government expenditure in 1997 (excluding social security expenses) in an international comparison

Country	Share of local expenditure in total expenditure
Germany	82.3%
Canada	81.4%
Japan	79.3%
United States	64.0%
Italy	50.5%
France	41.6%
United Kingdom	37.0%

Source: OECD, Data for Italy is of 1995, for the United Kingdom for 1996

[3] In 2001 the MHA has become part of the Ministry of Public Management, Home Affairs, Posts and Telecommunications.

stabilisation policy is implemented, for these countries it is more important that local governments follow the direction of the central government policy than for the United Kingdom, France or Italy.

Next, we ask to what extent observed differences in the behaviour of local governments actually have a significant impact. In table 3 we have prepared a simple simulation of government expenditures under different environments. Case one presents the situation during the strong stimulation of the economy by the Japanese government in fiscal year 1998/99 as compared to 1997/98, when local governments did follow the central government's stimulative policy. While central government public works expenditure was raised by 22%, prefectures and localities followed suit, and overall expenditure rose

Table 3 Simulation of annual changes of central and local government public works expenditures

	Assumptions			Total Public Work Expenditure [1]
	Central government (General Account)	Prefectures/ states (*Länder*)	Municipalities	
Case 1 (Japan 98/99)	22.5%	12.0%	2.4%	13.0%
Case 2 (Germany 67/66)	17.7%	-6.5%	-9.4%	-4.4%
Case 3 (Japan 98/99 *as if* Germany 66/67)	22.5%	-6.5%	-9.4%	3.4%

Note:

[1] The calculation for the total was made on the basis of the following formula:

Change for total expenditure =

= (share of central government expenditure[*]) x (1+change of central government expenditure) +

+ share of prefectural expenditure[*]) x (1+change of prefectural expenditure) +

+ share of municipal government expenditure[*]) x (1+change of municipal expenditure)) - 1

[*]) The shares of the different levels of government in total expenditure of the year before the change were used in the simulation.

In this simulation we did not consider double-counting between the different levels of government, since this is not important for demonstrating the potential of local governments to diminish the effects of central government stabilisation policy.

by some 13%. Case two presents the case of Germany in 1967 in comparison to 1966, when local governments wrecked all the effects of the central governments' attempt of a countercyclical stabilisation policy. The 17.7% increase of federal government investment expenditure was transformed into a -4.4% in total. Case three is a combination of case one and case two and shows what would have happened in Japan in 1998/99, *if* local governments had behaved like local governments in Germany in 1967. The simulation shows that in Japan also, local governments could have offset much of a central government effort for stabilisation. A meagre increase by 3.5% would have been effected, even if the central government had raised its expenditures by 22.5% as actually registered.

4 Assessment of the cyclical behaviour of local governments in Japan. Are the revenues and expenditures of the local governments pro- or countercyclical?

The studies quoted in part two used different methods for assessing whether the behaviour of the local governemnts are pro- or countercyclical. We will use a simple method and look at the share of local government expenditures/revenues in GNP. A rising level of expenditures and a falling level of tax revenues in a recession and a falling level of expenditures and a rising level of tax revenues during a business peak indicate a stabilising role of local governments, i.e. countercyclical behaviour. Accordingly, a falling level of expenditures and a rising level of tax revenues in a recession and a rising level of expenditures and a falling level of tax revenues during peak conditions indicate a destabilising role of local governments, i.e. procyclical behaviour.

We use the official dating of business cycles in Japan (Table 4). Although there are some problems – for example the dating of October 1993 as the end of a recession – this has the advantage that it closely reflects the official and thus the political perception of business cycles.

Table 4 Business Cycles in Japan since 1951

Cyc-les	lower turning point	upper turning point	Upswing (months)	Downturn (months)	Length of cycle (months)	Name
1.		June 1951		4		Korea boom
2.	Oct. 1951	Jan. 1954	27	10	37	Investment boom
3.	Nov. 1954	June 1957	31	12	43	Jimmu boom
4.	June 1958	Dec. 1961	42	10	52	Iwato boom
5.	Oct. 1962	Oct. 1964	24	12	36	Olympics
6.	Oct. 1965	July 1970	57	17	74	Izanagi boom
7.	Dec. 1971	Nov. 1973	23	16	39	Archipelago rebuilding boom/First oil crisis
8.	March 1975	Jan. 1977	22	9	31	
9.	Oct. 1977	Febr. 1980	28	36	64	Second oil crisis
10.	Febr. 1983	June 1985	28	17	45	Yen shock
11.	Nov. 1986	April 1991	51	32	83	Bubble economy/ Heisei recession
12.	Oct. 1993	March 1997	41	25	66	
13	April 1999					

Note: March 1997 and April 1999 are preliminary dates

Source: http://www.epa.go.jp/2000/f/0619f-hiduke-2.html, accessed on 3 July 2000

The data for revenues and expenditures of central and local governments is available only on a yearly basis, while the official dating of business cycles is done on a monthly basis. Therefore, we classify a year with at least six months of bad business conditions as a year of bad business conditions and a year with at least six months of good business conditions as a year of good business conditions.[4]

According to table 5, the expenditures of local governments in Japan clearly rose and were thus countercyclical during recessions. There are two exceptions, namely the minor recessions of 1980-1983 and 1985-86, which were dominated by the efforts of the

[4] Months with turning points were classified in neither category.

central government to reduce the deficit. In times of good business conditions, local government expenditures grew slowly when compared to the GNP (until 1969 and in 1983/84), or at least more slowly than during times of recessions (with the exception of the bubble period). In the 1970s, there was a rising trend of local government expenditures even in years of good business conditions. The same tendencies can be observed also for public works expenditures of local governments. The negative figure for the total of the fiscal years 1997/98 and 1998/99 is the result of the decrease of public work expenditures despite a starting downturn in fiscal year 1997/98. This was a

Table 5 Average annual growth rates of the share of local and central government expenditure in GNP in Japan (in per cent)

Fiscal Years	Uspwing/ Downturn	Local government expenditures	Local government public works expenditures	Central government expenditures	Central government public works expenditures
58-62	Upswing	-1.2	5.6	-1.1	5.2
1962/63	Downturn	9.1	14.0	12.0	15.7
1963-65	Upswing	-1.3	2.6	-2.4	-2.7
1965/66	Downturn	2.8	3.6	1.2	5.8
1966-70	Upswing	-1.1	2.3	-0.9	-4.7
1970-72	Downturn	7.8	10.2	4.1	10.2
1972-74	Upswing	2.0	-2.5	4.7	-2.4
1974/75	Downturn	10.6	2.0	9.2	1.3
1975-77	Upswing	1.0	-5.0	1.7	1.3
1977/78	Downturn	3.9	11.1	7.0	14.1
1978-80	Upswing	3.1	4.0	6.1	4.4
1980-83	Downturn	0.1	-1.1	0.1	-2.3
1983-85	Upswing	-2.9	-3.0	-1.3	-6.7
1985-87	Downturn	-1.1	0.8	-3.3	-5.6
1987-91	Upswing	0.8	2.5	-0.1	-6.4
1991-94	Downturn	2.9	5.9	-0.1	21.8
1994-97	Upswing	0.1	-2.2	-0.4	-5.3
1997-99	Downturn	1.2	-0.5	4.1	3.4
among it: 1997/98	Downturn	-4.0	-7.6	-3.1	-12.7
1998/99	Downturn	6.7	7.1	11.8	22.5

Notes: [1] The Japanese fiscal year starts in April and ends in March. For the central government, general account data was used.

[2] The average annual growth rates are derived by calculating the geometric mean of the annual growth rates of the share the relevant expenditure in GNP for the period concerned.

time which was dominated by discussions about the necessity of fiscal discipline and a corresponding law adopted by the central government. The ensuing fiscal restraint could not be fully compensated by the increase in fiscal 1998/99 after the law was frozen. However, in both fiscal years local governments followed the central government in the movement of their expenditure.

All in all, except for the second half of the 1980s, local government expenditure was countercyclical if one follows the official dating of business conditions in Japan.

Next, we look at the correlation of local government and central government expenditure. Interestingly, they show similar cyclical movements during the period under consideration. The correlation between the growth rates of the shares in GNP of central and local government expenditures was 0.72 for the period from 1955 to 1998.

Table 6 Correlation of growth rates of shares in GNP of central and local government expenditure by time period and state of business conditions

	All years of period	Years of upswing	Years of downturn
1955-69	0.71	0.22	0.97
1970s	0.59	0.60	0.48
1980s	0.54	0.57	0.74
1990-98	0.62	-0.01	0.68
whole period	0.72	0.55	0.81
1970-98	0.69	0.60	0.76

Note: 1) For the central government, general account data was used.

When we look at the cyclical behaviour of public works expenditures of the general account of the central government and of the local governments, we observe that local governments followed the central government in increasing public works expenditure in recession years (again with the exception of the recession 1980-83, but this exception holds for both central and local governments), but they did not always follow decreases of public works of the general account of the central government in years of good business conditions (to be sure, the public works expenditures of the general account also did not always decrease in times of good business conditions), namely in 1966-1970 and during the bubble period. However, they did follow the decrease after the two large recessions of 1971 and 1974 as well as in 1994, 1996 and in 1997 (which was a recession year). This tendency is also reflected in the lower correlation of growth rates of shares in GNP of central and local government public works expenditure during times of good business conditions compared to recessions (see Table 7).

This indicates that in times of scarce financial resources the local governments tend to follow the policy of the central government - this is also true for the times indicated as having had good business conditions after the recessions of 1971 and 1974 as well as the years 1994 and 1996 -, but they do spend more money for public works if there is enough money available (1966-1970 and during the bubble period).

Table 7 Correlation of growth rates of shares in GNP of central and local government public works expenditure by time period and state of business conditions

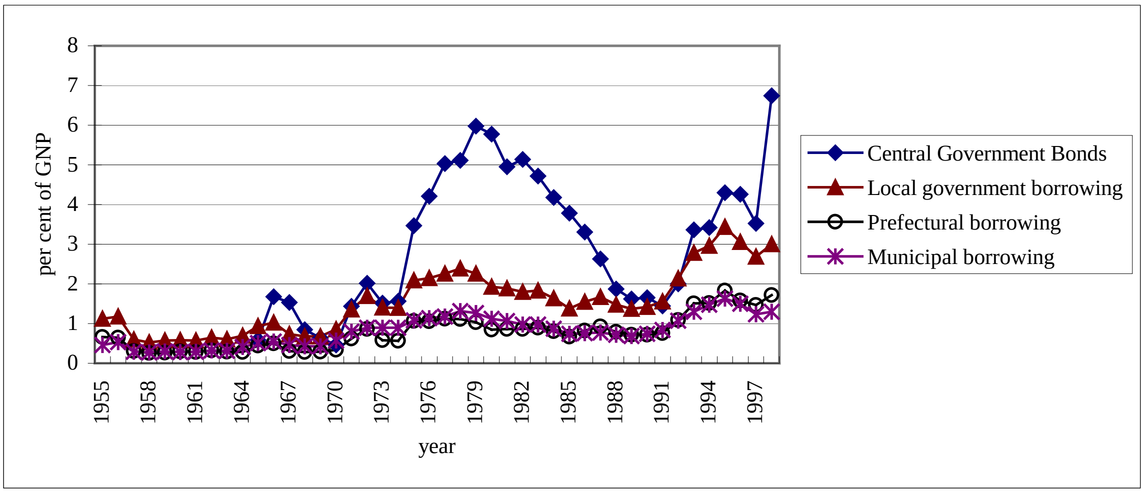
	Central and local			Central and prefectural			Central and municipal		
	all	up	down	all	up	down	all	up	down
1955-69	0.45	0.21	0.85	0.66	0.51	0.76	0.02	-0.14	0.99
1970s	0.74	0.72	0.80	0.79	0.79	0.81	0.49	0.33	0.48
1980s	0.54	0.66	-0.19	0.54	0.70	-0.48	0.49	0.53	0.27
1990-98	0.72	-0.10	0.73	0.78	0.28	0.79	0.55	-0.59	0.56
whole period	0.57	0.41	0.65	0.65	0.53	0.72	0.24	0.07	0.49
1970-98	0.66	0.53	0.68	0.68	0.53	0.75	0.51	0.34	0.49

Note: all - all years of period, up - years of upswing, down - years of downturn.

The total of local government revenues, being the financing side of the expenditures, behaved as the total of local government expenditures. When looking at the different types of revenues, no clear cyclical behaviour was observed for local government tax revenues and revenues from the Local Allocation Tax, which is a kind of general subsidy for fiscal equalisation (see part 5.2). Subsidies from the central government to local governments were inceased in all recessions except the smaller ones of the 1980s, while no clear cyclical behaviour is observable for times of good business conditions.

The revenue contributing most to the parallel countercyclical movement of central and local government expenditures is borrowing. Since the first issue of central government bonds after the end of the occupation in 1965, the borrowing of the general account and the local governments (with only some very minor exceptions) showed a similar cyclical behaviour. Only the magnitude of general account borrowing was greater, especially between 1966-68 and 1976-86. This is observable for both the flow of borrowing in the budgets and for the change of stock values of outstanding debt (see figures 1 and 10). Interestingly, local government borrowing followed the central government in the 1990s even more strongly than in the second half of the 1970s.

Figure 1 Central and local government borrowing in Japan



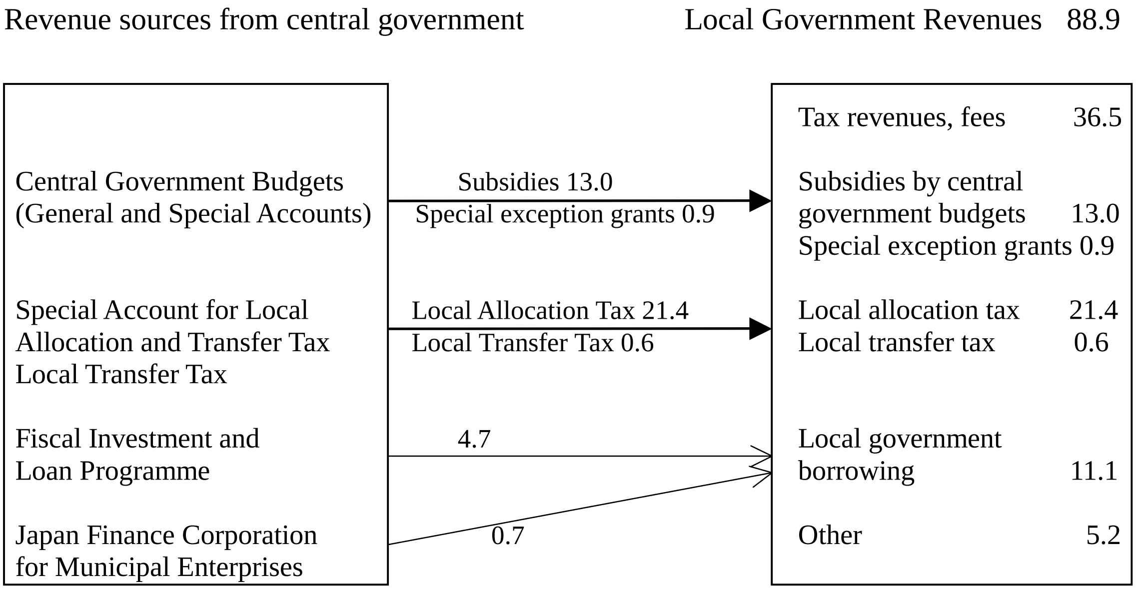
Source: Somucho Tokeikyoku, several years.

5 The institutional setting. Why have local governments been participating in the stabilisation policy of the central government?

We now try to explain the observed correlation by focusing on the fiscal mechanism involved. At the margin, expenditure decisions of governments depend on the availability of resources. Therefore, to explain the participation of local governments in the stabilisation policy of the central government, we have to look at the influence of the central government on the financing side, i.e. on the revenues of local governments.

The major components of local government revenue in Japan are own tax revenues, revenues from the local allocation tax as a general subsidy for fiscal equalisation, designated subsidies from the central government and local bonds. As depicted in figure 2, a large proportion of these revenues comes from the central government. Not all of them are conditioned in their use, but even then there may be other channels of central

Figure 2 Revenues of Local Governments in Japan from Central Government Soucrces
(Initial Budgets fiscal year 2000/2001; Trillions of Yen)



Notes:
→ subsidies → loans/investment

government influence. We discuss this in more detail on the following pages.

5.1 Central government influence on local taxation

Local governments are entirely free to use revenues from local taxes for any purpose they wish. Still, there are strong possibilities of central government influence even on local taxation (Reed 1979: 311, Ishi 1989: 242):

1) The major taxes a local government may impose are determined by central government law.
2) The tax rates are limited to a close range by central government regulation.

Local governments could impose additional taxes, but until March 2000 they had to seek the approval of the Ministry of Home Affairs (MHA) to levy such an additional tax (Ishi 1989: 244). In fiscal year 1998 altogether four types of such taxes, namely nuclear fuel tax (introduced by thirteen prefectures), crude oil price regulation tax (in one prefecture), gravel extraction tax (in five municipalities) and a villa property tax (in one municipality) were used by local governments, but the revenue from such taxes accounted for only 0.06% of total tax revenues of local governments in 1998. From April 2000, this approval system changed to a "consultation system", simplifying the approval procedures. The consent of the central government is still required, but a Dispute Settlement Committee (*Kuni Chihou Keisou Shori Iinkai*) has been established. Time will tell how much will change in reality.

In contrast to the traditional major tax revenues of the general account of the central government (income tax and corporation tax), the major tax revenues of local governments (such as the prefectural and municipal inhabitants taxes, property, tobacco and automobile taxes) do not show as much variation in the business cycle. The assignment of those taxes as the major revenues of local government itself has contributed to the relative cyclical stability of local, especially municipal, tax revenues. There have been reductions in local taxes, e.g. of inhabitants taxes in 1994, 1995 and 1999. The major tax cuts within the fiscal stimulation packages of the central government, however, have usually involved central government taxes (income tax and corporation tax) to a larger extent than local taxes. This, in turn, had consequences for the Local Allocation Tax, for which these national taxes serve as a major source of revenue.

5.2 The design of the Local Allocation Tax

The Local Allocation Tax, the largest portion in the flow of funds from the central government to local governments, is a means of fiscal equalisation. It takes the form of transfers from central to local governments according to a certain formula. Its objective is to balance the fiscal capacity between the different regions and to guarantee a standard level of public services all over the country. These revenues are not earmarked and the local governments are free in their use, but the central government (MHA) can reward local governments which follow central government policies, by changing the formula accordingly. Thus the formula itself reflects the objectives of the central government.

The major part of the local allocation tax (94% of the total[5]), the regular allocation tax (RAT), is calculated for each local entity according to the following formula:

RAT = Standard Financial Demand (SFD) – Standard Financial Revenue (SFR)

[5] The remaining six per cent are transferred to local governments as the special allocation tax.

with: SFD = amount of measuring units for service item ^{x} unit cost ^{x} adjust. coefficient

and: SFR = α ^{x} standard tax revenues of local entity + revenues from local transfer tax

where: α=0.8 for prefectures and α=0.75 for cities, towns and villages

The standard financial demand is the total "standard expenditure" of a local government necessary for fulfilling its functions, such as fire protection, police and education. The unit of measurement usually is local population, length and area of roads or similar units. Unit costs for public services are determined each year by the Local Finance Bureau of the MHA, taking into account price changes and changes in the demand for services. The adjustment coefficients are used in order to reflect the differences in administrative costs among the local governments and depend on population density, climate etc.

The standard financial revenue reflects the fiscal capacity of local governments and is calculated on the basis of the estimated amount of revenues from local taxes (assuming the "standard" tax rate which is set by the central government) and revenue from the local transfer tax. Thus the amount of the standard financial revenues does not depend on the actual tax rate set by the local government (within the range allowed by the central government). While the revenue from the local transfer tax is counted in full, only 80% (prefectures) and 75% (municipalities) of the tax revenues is counted in order to leave some incentive for local governments to increase their tax basis.

Based on this calculation, the difference between standard financial demand and standard financial revenue does not necessarily have to be equivalent to 94% of the tax revenues reserved for the LAT. Therefore, if the difference is minor, an adjustment is made by multiplying the standard financial demand by an adjustment factor.

If, however, the deficit is more severe, other steps have to be taken. In the 1950s and the

1960s, the share of the LAT in the three taxes (income tax, corporation tax and liquor tax) was raised several times (for details see table 8). In the twenty years between 1967 and 1987, however, despite demands for further rises from the side of the MHA, the central government did not raise the share. This was mainly due to the opposition from the MOF, which preferred temporary measures to raising the share of the LAT in these taxes. Only with the introduction of the consumption tax in 1988 and again in recent years, further tax revenues were allocated to the LAT.

Table 8 Changes of the share allocated to the Local Allocation Tax in the tax revenues from income, corporation and liquor tax

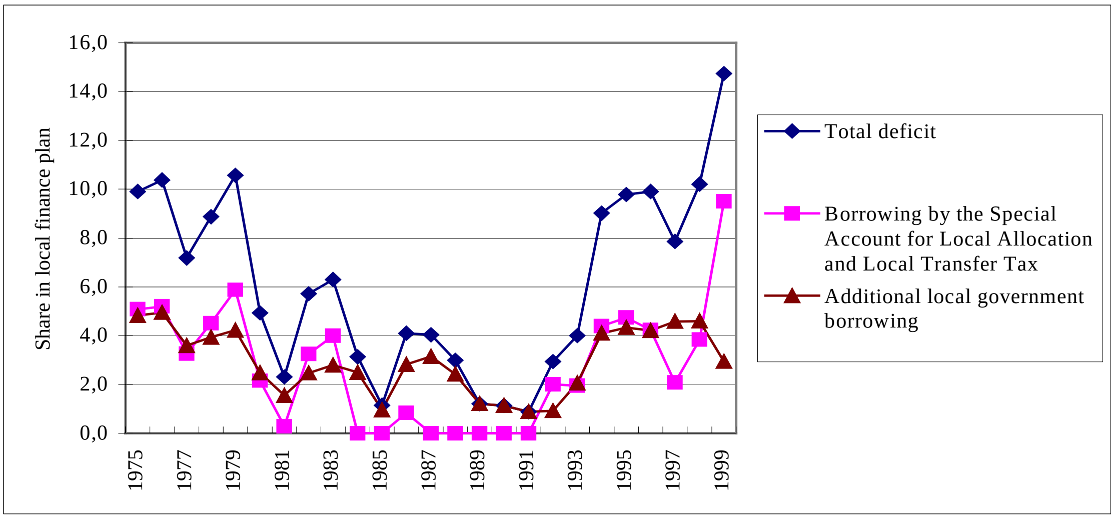
Year	Change of share	Reason
1956	22.0 -> 25.0	insufficient revenue
1957	25.0 -> 26.0	compensation for a tax cut by the central government
1958	26.0 -> 27.5	repayment of local government bonds, etc.
1959	27.5 -> 28.5	compensation for a tax cut by the central government
1962	28.5 -> 28.9	Introduction of a pension scheme for local public servants, etc.
1965	28.9 -> 29.5	compensation for a tax cut by the central government
1966	295 -> 32.0	compensation for a tax cut by the central government
1988	In addition: 24% of 4/5 of consumption tax and 25 % of tobacco tax	for mid-term consolidation of local government finance
1997	Share in consumption tax raised to 29.5% of 4/5	
1999	Share in corporation tax raised to 32.5%	compensation for a tax cut by the central government
2000	Share in corporation tax raised to 35.8%	compensation for a tax cut by the central government

Source: MHA 1999: 336, MHA 2000: 57-62

After 1966, instead of raising the share of the LAT in tax revenues, a policy of covering the deficit through additional borrowing by local governments and through borrowing by the Special Account for Local Allocation and Local Transfer Tax was taken. Figure 3 shows the scope of the deficit and the importance of the major ways it was covered.

This policy was combined with promising central government support for the repayment. In the 1970s and the early 1980s, the central government took on itself the

Figure 3   Major ways of covering the deficit of the Local Finance Programme

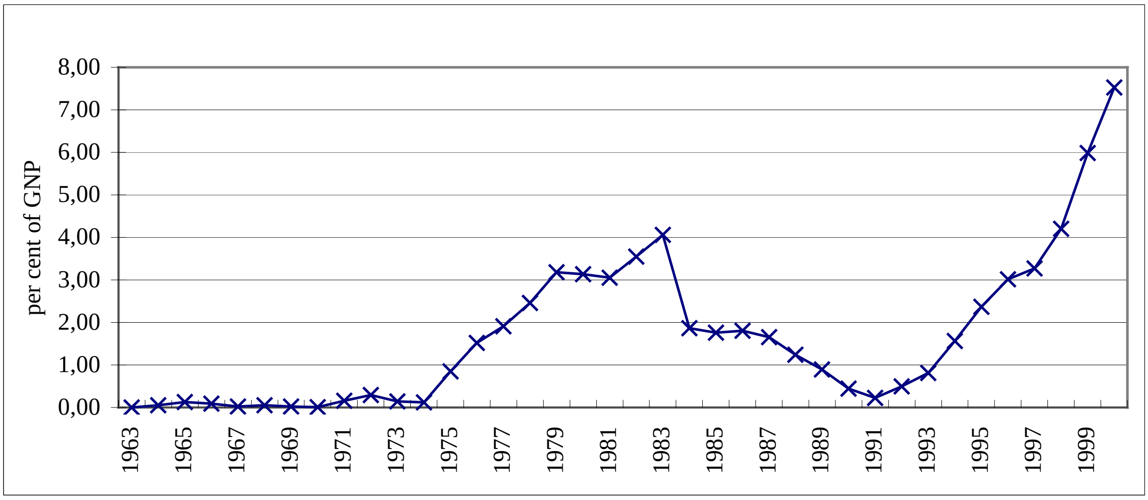


Source: MHA (2000): 84-85

responsibility for covering about 50 per cent of the borrowing from the Special Account for Local Allocation and Local Transfer Tax. At the end of FY 1983, the outstanding borrowing amounted to more than 10.5 trillion Yen. In 1984, it was decided to stop new borrowing from the special account and in the same year the central government repaid its part of the debt to the Trust Fund Bureau. Thanks to the bubble period, nearly the whole outstanding debt of the special account was repaid by 1991. However, after the burst of the bubble, borrowing from the special account was started once again and at the end of FY 1998 the outstanding debt was higher when compared to GNP than at the earlier peak in FY 1983 (see figure 4). While from 1992 to 1995 the responsibility for the borrowing was solely with the local governments, in the years 1996 to 1998, the central government too accepted the repayment responsibility for slightly less than a third of the new borrowings.

Another step taken by the central government with regard to tight revenues of the local governments was to provide incentives to increase local borrowing for certain purposes. For instance, payments necessary for repaying local debt and interest were included in

Figure 4 Outstanding borrowing from the Special Account for Local Allocation and Local Transfer Tax



Source: MOF (2000)

calculating standard financial demand. This will be dealt with below in some more detail.

This policy resulted in a growing share of debt service in standard financial demand between 1975 and 1985 and – after a fall during the bubble period – once again in the 1990s. The share in the total of standard financial demand has increased to 5.7% by 1998. Through the mechanism of calculating standard financial demand, it is also possible for the central government to change long-term incentives for local governments. A good example is changes in calculating standard expenses necessary for public works in the 1950s and 1960s (for details see Imai 1993: 69-71), which together with a general policy promoting public investment led to an increase of the weight of investment expenditures in the standard expenses from 6.9% in 1955 to 20.1% in 1965.

The inclusion of debt service and public works expenditures in standard financial demand and the existence of a number of adjustment factors have led to a situation where the LAT is not only often redistributing too much (see also OECD 1999a:127 and

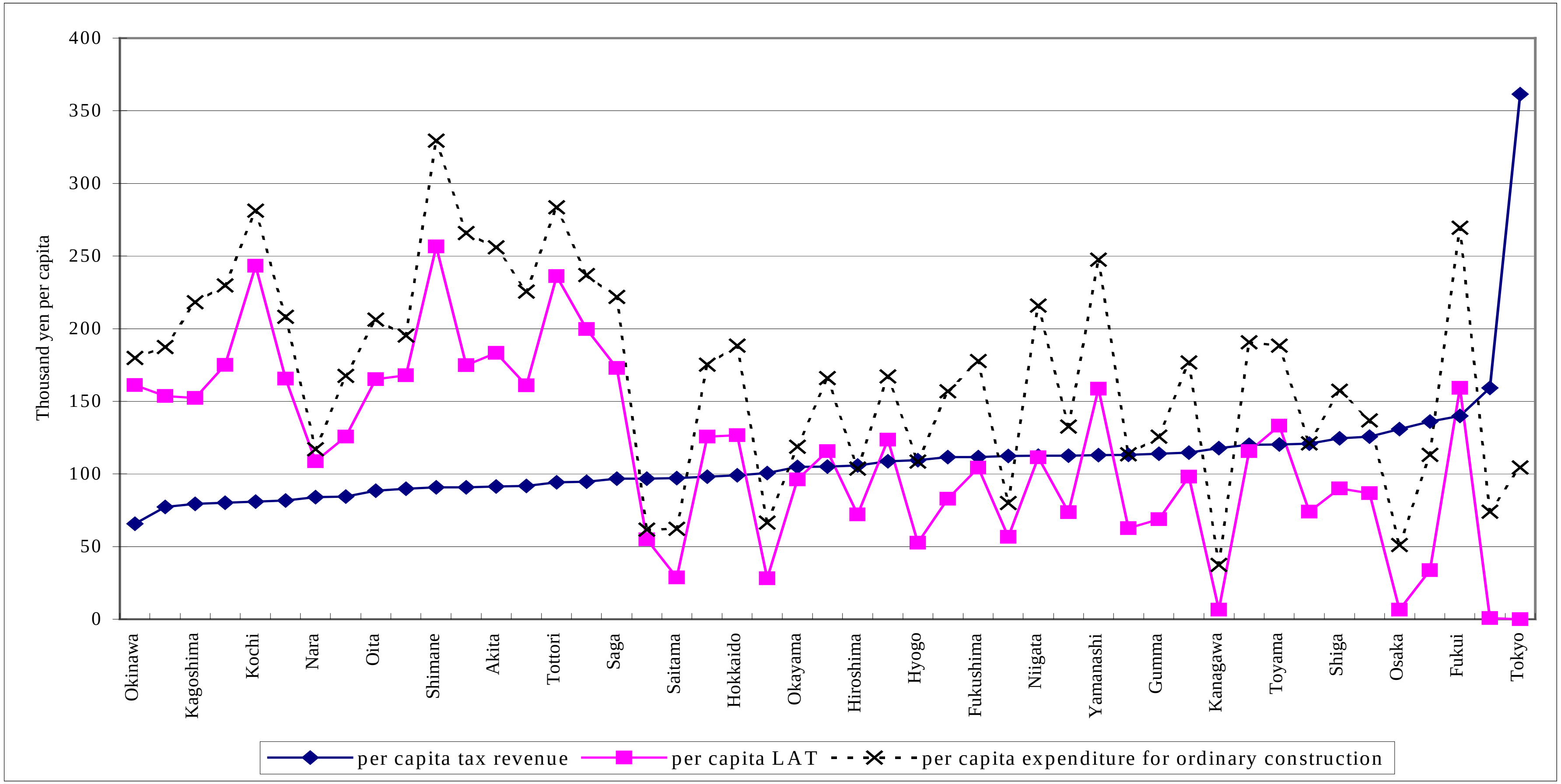
Hanai/Tajika/Yui 2000), but is also often quite unrelated to per capita tax revenues, depending on whether local governments are preferred by adjustment factors (which may well be justified in many cases) or follow the incentives of the LAT. Figure 5 demonstrates that the differences in the per capita amount of LAT that the prefectures receive depends more on the reimbursement for construction expenditures through the LAT than on the fiscal capacity of a prefecture.

5.3 Designated subsidies from the central government

Designated subsidies from the central government budgets (*kokko shishutsu kin*) are the second largest item of funds flowing from the central government to local governments. There are several kinds of designated subsidies, but they are all earmarked and can be used only for a certain well defined purpose. Although previous research by political scientists has shown that the influence of designated subsidies on the behaviour of the local governments may not be that high, we argue that the central government does possess the means to influence this item, either directly – for items subject to its discretion – or indirectly by changing rules on when subsidies are to be granted.

As we have seen, even so-called non-subsidised public works are often de facto subsidised. In the example featured in figure 6, it is sufficient for the local entity to provide 10% of own funds of the total necessary expenditure at the time the project is started, provided it is receiving funds from the LAT (on the prefectural level, only Tokyo is not receiving funds from the LAT). 15% come from the LAT and 75% are financed by local government borrowing, 30% to 55%, depending on the financial situation of the local entity concerned, being covered by the LAT in later years. For FY 1996/97 even the 15% to be covered by the LAT of the current year was replaced by

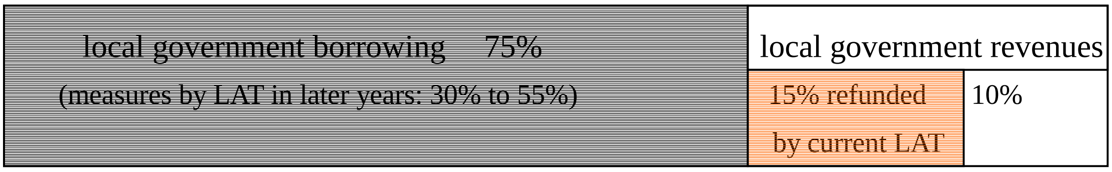
Figure 5 Redistribution effects of the Local Allocation Tax (LAT) in fiscal year 1997



Source: Somucho Tokeikyoku 1998, 2000, own calculations.

borrowing, later to be reimbursed by LAT.

Figure 6 Financing a "*furusatozukuri*"-project



Source: Chiho zaisei seido kenkyu kyokai (1996): 96

Due to the leverage effect, even projects with low expected benefits are implemented. It is rational for a local government to start projects where the expected benefit is larger than its own contribution to covering the costs. Obviously, apart from the aspect of cyclicality discussed before, such a situation has a very negative effect on the efficiency of resource allocation.[6]

Therefore, a better link between costs and benefits would be desirable on allocative grounds. This could be achieved by giving the local governments a larger percentage of the tax revenues, and instead reducing the subsidies through the LAT. We do not deny that there is a need for some kind of fiscal equalisation, but as could be seen in figure 5, the system possibly redistributes too much and too unrelated to the financial capacity of local governments, thus also reducing incentives to raise more own tax revenues.

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[6] Multiplier effects of public works may have also decreased in the last decades because of this factor. While some economists doubt this decrease, there is still the conspicious emphasis on public works in rural areas. Studies (e.g. by Yoshino/Nakata/Nakahigashi 2000) have shown that a redirection of public works away from rural to urban areas would raise the multiplier.
However, it remains to be seen whether the ruling Liberal Democratic Party (LDP), which has its electorate mainly in rural areas, will be willing to change this structure. This is especially doubtful since the electoral system, though to a lesser extent than before the electoral reform, favours rural areas, giving votes from rural areas a higher weight than votes from urban areas.

5.4 Central government influence on local government borrowing

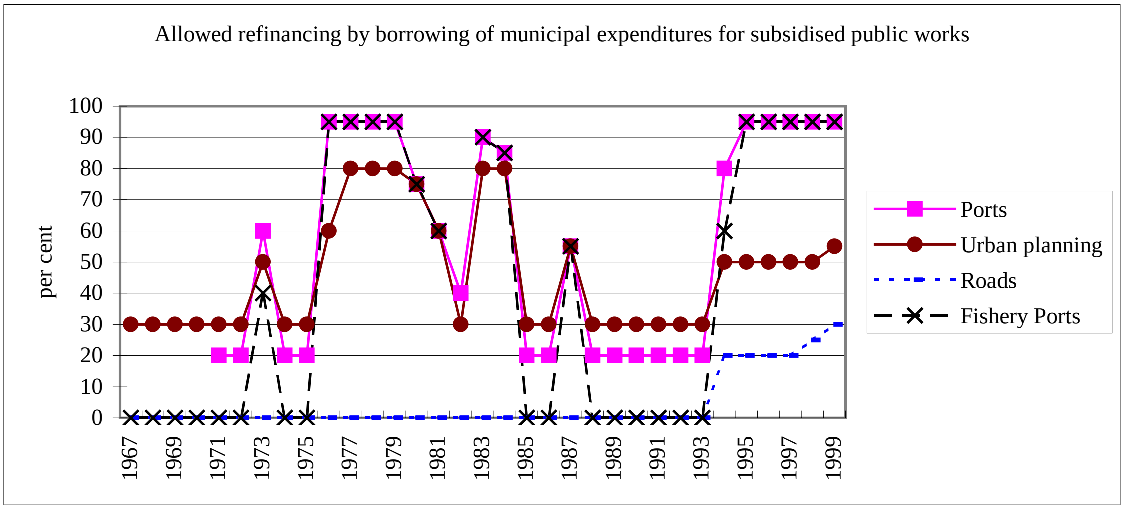
Concerning local government borrowing, there is a great deal of central government influence as well. The Local Finance Law (Article 5) allows the issue of local government bonds only for the financing of investment expenditure (public works) and for the financing of public enterprises. Moreover, it was obligatory for local governments to receive the approval for issuing local government bonds: for the prefectures, from the MHA, for municipalities, from the prefectural governor. The permission to issue bonds is enacted on the basis of general guidelines, not on a case by case basis. However, as we will see below, the guidelines themselves are subject to government discretion.

There are several methods enabling local governments to increase borrowing during recessions. One is deliberately changing the share of certain expenditures that can be refinanced by local bond issues (or the inclusion of new items). This is illustrated in figure 7 with respect to some typical subsidised general local public works expenditures. This policy tool was used in 1973, 1976-79, 1983-84, 1987 and after 1994. As Imai (1993:125) rightly pointed out, it is questionable whether this kind of policy has anything to do with future benefits from the investments or with the norm of healthy public finance. Rather, the general financial situation of local governments seems to have been decisive.

A second mechanism is to allow deficit borrowing in times of recessions. Many different denominations have been made use of - in Figure 8 they were all added up under the heading "deficit measure borrowing".

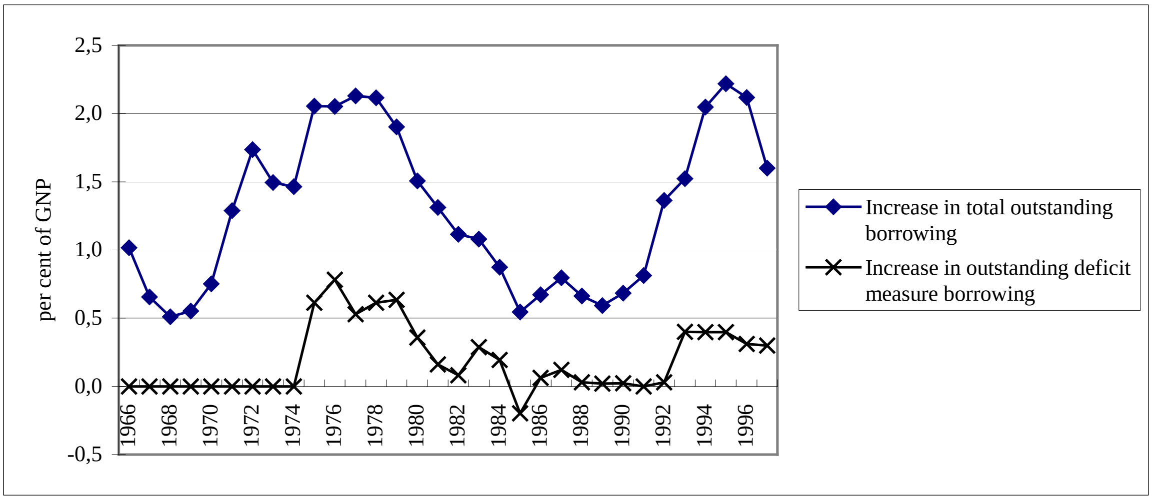
A third method is to allow the issuing of supplementary budget bonds. The major

Figure 7 Allowed refinancing of local expenditures through borrowing



Source: Chihosai Seido Kenkyukai, several years

Figure 8 Increase in outstanding local government deficit measure borrowing (share of GNP)



Source: Somucho Tokeikyoku, several years, estimate by the authors

technique used is revising the Local Finance Programme[7] during the fiscal year, further public works expenditures to be financed by additional local government bonds.

A fourth method is to include expenditures necessary for repaying bonds and for the

[7] The Local Finance Programme is drawn up by the MHA every year. It is the official estimate of revenues and expenditures of local governments and is negotiated with the MOF and the Cabinet.

payment of interest in the calculation of standard expenditures. For our purposes, it is interesting to present examples where there have been such changes in unit costs and adjustment coefficients.

As of FY 1995, such examples are adjustment coefficients for *"supplementary budget bonds"* (table 9), unit costs for *"revenue ensuring bonds"* (table 10), *"shortfall of local tax revenues compensation bonds"* (issued from 1978 until 1988, prefectures 80%, municipalities 75%), *"temporary fiscal special exemption bonds"* (issued 1993 - 1995, 100% for both prefectures and municipalities), and *"tax cut compensation bonds"* (issued 1994, 100%).

Table 9 Adjustment coefficients for *"supplementary budget bonds"* (1975-1994)

Year	Prefectures	Municipalities
1975	59%	42%
1976	65%	38%
1977	68%	48%
1978	69%	54%
1979-1985	-	-
1986	40%	33%
1987	78%	78%
1988-1991	-	-
1992-1994	80%	80%

Source: Kusu 1996: 711

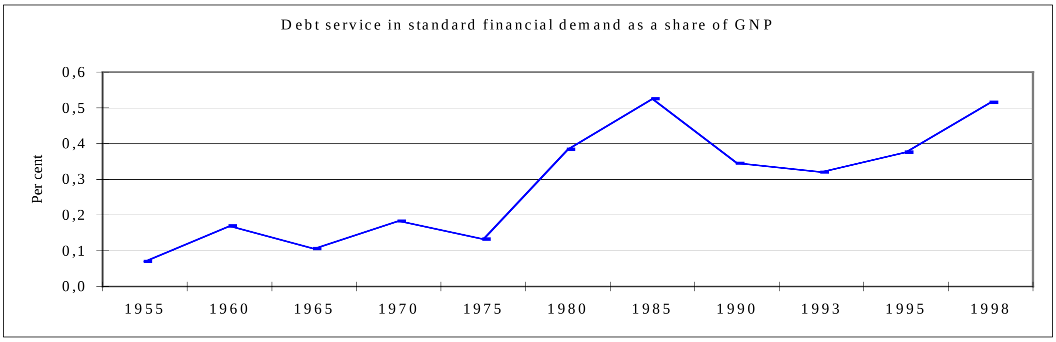
Table 10 Unit costs for *"revenue ensuring bonds"*

	A issued for compulsory education, etc.	B issued for public works for rivers and ports (1994 for general public works)	C issued for Expenditure apart from A and B	D Adjustment bonds
1978-1981	100%	80%	80%	
1983-1988		80%	20%	1985 65,7%
				1986 87,4%
				1987 75,2%
				1988 92,2%
1994-1995		80%	20%	

Source: Kusu 1996: 708

On a more general level, figure 9 shows how important debt service in the standard financial demand is. In 1998, more than half a per cent of GNP was paid for this purpose within the LAT, and the figure has risen since.

Figure 9 Debt service within standard financial demand



Source: MHA, several years, copies of the statistics were kindly provided by Dr. Takero Doi.

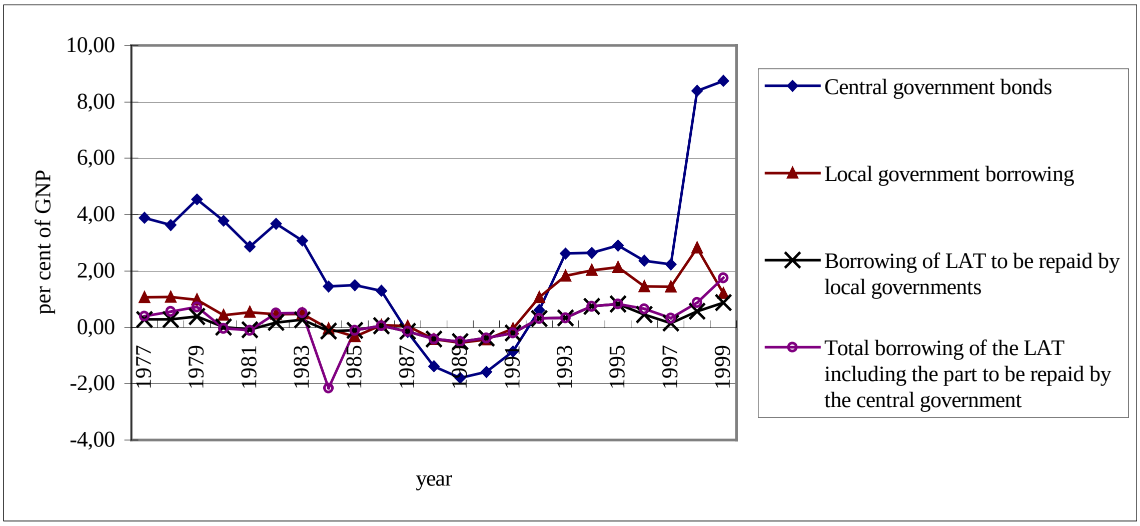
Yet another method is to take care of interest costs for local borrowing. Government funds, most importantly borrowing from the Trust Fund Bureau of the Ministry of Finance (TFB), have for a long time been the major source of local government borrowing. In the 1970s and the 1990s, however, a major part of new local borrowing was financed by private financial institutions such as commercial banks and security companies. In the 1970s, there was the problem that the interest rate of the private financial institutions was much higher than that of the TFB. In order to stimulate local government borrowing in a situation of financial shortage, the central government – given limitations in the availability of central government funds for lending – promised to pay for the difference in the interest rates. In the 1990s, there was no such problem, sometimes the interest rate of the private banks was even lower. Nevertheless, steps to cut interest costs were taken. For instance, the TFB allowed earlier repayment of high interest-rate loans to local governments meeting certain conditions in fiscal year 1999 (OECD 1999a: 104).

Parallel to this policy, the central government tried to increase the share of (cheap) government funds. Thus in the 1970s, the areas of lending from the Japan Finance

Corporation for Municipal Enterprises (JFCME) were expanded to some items of the ordinary accounts of local governments. This type of financing is being continued (see figure 1).

How successful the central government policies have been in influencing local borrowing can be seen when comparing the development of central and local government borrowing (see figure 1 and figure 10).

Figure 10   Yearly increase of outstanding debt



Source: Somucho Tokeikyoku, several years, MHA (2000), MOF (2000)

All in all, the policy instruments used in interjurisdictional relations in Japan are not directly forcing local governments to cooperate with the central government, they do, however, provide strong incentives to do so and thus account for the patterns observed before.

6 Recent changes and reforms: Will local government continue to follow the central government fiscal policy in a changed environment?

As shown above, local governments in Japan have usually followed the central government in its fiscal policies. However, recently there have been well publicised concerns about the level the local government debt has reached, forcing them to rethink fiscal consolidation (see, for example, Tett 1998, Ikeya/Suzuki 2001) and to consider the introduction of new taxes. Moreover, government reform measures aimed at decentralisation could be expected to lead to a more procyclical movement of local government revenues and a reduced willingness of local governments to follow the central government policies. Will this lead to a situation where local governments will no longer follow the central government, or is the established "system" strong enough to ensure a continuation of past patterns?

6.1. Alarmingly rising levels of local government indebtedness

As is well known, the indebtedness of the Japanese government has become alarmingly high. Among the G7 countries, only Italy has a higher ratio of outstanding gross financial liabilities of general government as a percentage of GDP. Even more alarming is the speed at which the Japanese public debt is rising (6.0% of GDP in 1998). Indebtedness has reached very high levels not only on the central, but also on the local level (see table 11).

One might suppose that for this reason local governments will hesitate to accumulate even more debt just to follow the policies of the central government. Indeed, there is ample anecdotical evidence for such a reluctance, which has sometimes even led to

Table 11 Central and local government finance: An international comparison of important fiscal indicators of G7 countries

		Gross financial liabilities [1]	Financial balance [1]		Outstanding debt/tax revenues by level of government			
Country	Year			Year	total	central	state	local
Japan	1970		+1.7	1970	0.60 [2]	0.49 [2]	0.56	1.16
Japan	1980	52.0	-4.4	1980	2.37 [2]	2.68 [2]	1.66	2.06
Japan	1990	61.5	+2.9	1990	2.40 [2]	2.82 [2]	1.53	1.78
Japan	1999	105.3	-7.0	1998	5.06 [2]	6.27 [2]	3.66	3.05
Japan	1998	97.3	-6.0	1998	4.66 [3]	5.22 [3]	3.66	3.05
US	1998	62.4	0.4	1997	2.08 [3]	2.44 [3]	0.97	1.90
Germany	1998	63.3	-1.7	1998	1.63 [3]	1.50 [3]	2.04	1.63
France	1998	64.9	-2.7	1997	n.a.	n.a.	n.a.	n.a.
Italy	1998	118.2	-2.7	1998	n.a.	n.a.	n.a.	n.a.
UK	1998	56.4	0.2	1997	1.46 [3]	1.35 [3]	n.a.	4.22
Canada	1998	91.7	0.9	1995	3.83 [3]	4.53 [3]	3.45	1.94

Note: 1) General government data, per cent of nominal GDP

2) Budgetary central government data (only general account)

3) Consolidated central government data

Source: OECD 1999b, IMF, for outstanding debt and tax revenues in Japan Japanese data was used.

open conflict between central and local governments (e.g. Tett 1998). However, interestingly and ironically, as we will show below, the lack of resources on the local government level actually strengthens most of the existing influence mechanisms of the central government on local government revenues and therefore does not weaken substantially the established system (see 7 and table 12). A general reduction of local government indebtedness, therefore, seems possible only if it is desired (deliberate consolidation) or, at least, tolerated (decentralisation) by the central government.

6.2. New local government taxes

As already mentioned, from April 2000 the approval system for the introduction of additional local taxes changed to a "consultation system", simplifying the approval procedures. Since the consent of the central government is still required, de facto it is still an approval system. In practice, consequences will depend on the actual "consultation" procedures and the handling of disputes by the newly established Dispute Settlement Committee (*Kuni Chihou Keisou Shori Iinkai*). Therefore, it is still too early to assess the importance of this change.

An important mechanism is to make use of a special provision of the corporate business tax in the Local Tax Law under which new taxes by a number of prefectures have been introduced, among them the well-publicised tax on banks of the Tokyo prefectural government. As from fiscal year 2000, Tokyo metropolitan government levies a 3 per cent tax on the gross operating profits of banks with assets of at least 5 trillion Yen. The revenue from this tax will be much larger and more stable than from the previously existing tax on banks. With an estimated annual revenue of 110 billion Yen it will be equivalent to about 2.7 per cent of Tokyo metropolitan government tax revenues or about 15.2 per cent of Tokyo's borrowing in fiscal year 1999. This new tax will not fundamentally change the fiscal situation of Tokyo, but it is much more than the FY 1998 total of 0.06% share of non-standard taxes introduced by local governments in total local tax revenues (see 5.1). Osaka followed Tokyo with a similar tax and other prefectures also have plans for new taxes.

6.3 Abolishment of the approval system for borrowing

From April 2000, a consultation system instead of an approval system was also introduced for borrowing, but at least until the year 2005, which was originally envisaged for the consolidation of government finance by the frozen public finance structural reform law, the approval system will be continued. Under the new consultation system, a local entity will be able to borrow even without the consent of the central government (or of the prefectural governor in the case of municipalities). However, a report by the governor or mayor about the planned borrowing to the relevant prefectural or municipal assembly is required in advance.

Even after the abolishment of the approval system for local borrowing, there will still be mechanisms left for the central government to discriminate between borrowing for which the consent of the central government or of the governor was received and borrowing where this was not the case:

1) Public funds can be lent only in cases where consent for the borrowing was received. This may imply a difference in interest rates, because often the interest rate of public funds is lower than that of private financial institutions. This is not that much of a problem for the larger and financially healthier prefectures, because they can borrow on the private capital markets at reasonable interest rates. It is, however important for financially weak local entities, since these would have to pay substantially higher interest rates or, in extreme cases, would be unable to borrow at all.
2) Only (redemption and interest) expenses for approved borrowing are included in the Local Finance Programme.
3) Only expenses for approved borrowing can be included in the LAT standard financial demand**.**

In addition, there will still be a number of general mechanisms of central government control over local government borrowing. Thus, in order to ensure the credibility of local government borrowing, in cases when the outstanding debt of a local entity is higher than a certain upper limit, further borrowing can only be done with the approval of the central government or the governor. Moreover, in case a local government has tax rates for standard taxes below the standard rate, it will have to obtain the approval for borrowing for certain defined items (up to now borrowing for these items was forbidden).

In this connection it is interesting to note that the lending by postal savings, postal life insurance and government pension funds to local governments will remain subject to a decision by the Diet. This is the only exlusion from the general abolishment of Diet approval for the investments and loans of these funds within the framework of the reform of the Fiscal Investment and Loan Programme (FILP), which came into force in April 2001. This indicates that the central government wants to keep control over this lending.

7 Overall assessment of the effects of the system and of its changes

As has been shown, there is a substantial number of mechanisms ensuring central government influence on local government revenues – both on the magnitude and – to a lesser extent – on the structure of local government expenditure. Table 12 presents an attempt to assess the importance of the various mechanisms discussed. During times of recession there is a number of mechanisms providing incentives and financial means for local governments to participate in countercyclical policy: supplementary budget/deficit borrowing, borrowing by the Special Account for Local Allocation and Local Transfer Tax as well as subsidies, discretionary increase and inclusion of new items that can be refinanced by local government borrowing, the inclusion of borrowing costs in the calculation of the Local Allocation Tax. Tax cuts reducing the financial burden on the private sector, but influencing local government revenues (mainly the LAT through central government income and enterprise taxes, but also local inhabitants taxes) are

Table 12 Influence mechanisms of the central government on local government revenues and their effects on countercyclical policy - a synoptic view

Mechanism	Effect in times of bad business conditions	Effect in times of favourable business conditions	Change in mechanism	Effect on mechanism by rising debt level	Effect on mechanism by more own taxes
I Subsidy	++	+	o	e	w
II Borrowing			from 2005		
a approval system	+	+/o	w	u	w
b refinancing coefficients	++	+/o	o/w	u	w
c supplementary budget/ deficit borrowing	+++	o	o/w	u	w
d lending by government funds	+	o/-	o	e	w
III Local Allocation Tax					
a Borrowing by the Special Account	+++	+++	o	e	w
b inclusion of borrowing costs	++	o/-	o	e	w
c inclusion of other items	+	o/-	o	e	w
IV Taxation					
a tax cuts (incl. LAT)	+++	o/-	o/w	o	u
b tax increases	o/-	+++	o/w	o	u

Notes:

e - enforcing w - weakening u - unclear o - no change

+ - positive - - negative o - no effect / no substantial effect

also used. During favourable business conditions, only a reduction of the borrowing through the special account and tax increases (including natural ones) seem well suited to achieve the goals of stabilisation and consolidation. All the other instruments become weak or ambiguous. Given the political problems when enforcing such tax increases, especially when they are explicit, this means that the mechanisms are much better suited for countercyclical policy in times of bad business conditions than in times of favourable business conditions. This can explain why the correlation between central and local government expenditure is lower during upswings than during downturns, as identified above (see table 6 and table 7).

The changes in the mechanisms weaken the established system, but not altogether. The weakening of the mechanisms is compensated to some extent through rising local government debt levels. These contribute to a shortage of funds at the local level. Thus, they strengthen the influence mechanisms of the central government which aim at control through the provision of funds. On the other hand, as already mentioned above, rising local government debt levels make local governments hesitant to accumulate even more debt just to follow stabilisation policies of the central government during recessions. Thus the effect of rising local government debt levels on the readiness of local governments to issue further debt for stabilisation purposes is unclear.

Further decentralisation, shrinking debt levels and more own tax revenues of local governments may eventually lead to a more procyclical behaviour of local governments. For the time being, however, it is likely that local governments will follow a central government countercyclical policy in times of bad business conditions provided the subsidies for local governments will be continued - there is no free lunch.

All in all, several mechanisms in the Japanese fiscal system make local governments follow the central government countercyclical policy, especially during recession periods. Recent, well-reported changes did not break up this system. While it is welcome from the viewpoint of stabilisation that local governments do not act procyclically, there are considerable negative side-effects of an allocation through the large subsidies from central to local governments. Due to the distorted incentive structures for utilising such strategies, partly inefficient public works expenditures have become unavoidable.

8 Summary

In this paper we have looked into whether local governments in Japan, which account for a large proportion of government expenditure, follow the countercyclical policy of the central government. Relevant mechanisms and recent changes were also explored. This allowed us to draw conclusions on the effectiveness of fiscal policy in Japan, on the degree of local autonomy and on the likelihood of (negative) side-effects on resource allocation.

While the theoretical literature on fiscal federalism would lead one to expect a procyclical behaviour of local governments, we observe a countercyclical development. Local governments do participate in the fiscal policy of the central government. This suggests that the central government can indeed exert significant influence on the activities of local governments.

The major mechanism for the participation of Japan's local governments in the central government's fiscal policy is making available financial means in times of recession at relatively low cost for the local governments. The major tools used are:

1) The assignment of tax revenues to the local level which are cyclically relatively stable during the business cycle.
2) The provision of additional financial means for the system of fiscal equalisation in times of financial shortage.
3) The increase of central government subsidies in times of recession.
4) Controlling and influencing local borrowing, especially supporting additional borrowing in recessions.

These mechanisms are more effective in bad than in favourable business conditions, and such a behaviour of local governments can indeed be shown.

Even though there were several improvements in the position of local governments –increased share in total tax revenues over time, rising amount of LAT, introduction of consultation systems for the introduction of new taxes and for local government borrowing that are less rigid than the systems used before – the central government retained important control mechanisms:

1) The mechanism of incentives through the design of the LAT and the possibility of borrowing from the special account
2) Even though there will be a new consultation system for local government borrowing instead of the old approval system, important tools in this area are left, among them parliamentary control over the lending by government funds, including postal savings, postal life insurance and government pension funds, to local governments
3) The consultation system for the introduction of new local taxes even needs agreement from the MHA.

While the system supports the fiscal goal of stabilisation – we do not discuss whether Keynesian-type countercyclical fiscal policy actually does work – it has significant negative effects on allocation and on interregional redistribution. Moreover, given the current level of influence of the central government on local government finance, one can hardly speak of a well developed fiscal decentralisation in Japan. Further decentralisation would probably improve the allocation of resources of local governments remarkably, but it would also make local governments less willing to follow the stabilisation policy of the central government.

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