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MEASURING FISCAL NEEDS: JAPAN'S EXPERIENCES

by

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Abstract

The Local Allocation Tax (LAT) plays important role in fiscal equalization in Japan. The purpose of this paper is twofold: reviewing the key themes and issues of the LAT; and considering package of reforms designed to revitalize Japan's fiscal equalization program and to establish a sustainable basis for the future. We argue that the addressing expenditure needs in equalization should be retained, to do so will require improvement in the way of addressing expenditure needs. In addition, The LAT formula should be redesigned so as to encourage local government to deliver services in the most cost-effective manner. *First*, it should be based more systematically on objective criteria (e.g. size of school age population, remoteness indices) rather than actual endowment, such as public infrastructure. *Second*, the reliance on discretionary elements, including special LAT and various aspects of modification coefficient used in the LAT calculation, should be reduced and, in general, the formula made more transparent.

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1. DECENTRALIZATION IN JAPAN

Japanese Model

In the overall Japan's fiscal system, while the majority of expenditure are done at the local level, only very limited autonomy is available to local governments in their spending decisions. Also on the revenue side is decentralization limited, and the authority for tax base and rate determination lies with the central government. The vertical financial imbalance can be seen from table1 which presents the relative share of all tax revenues and expenditures of the two level of government. As suggested by the table, the central government has collected more than 60 percent of the total tax revenues since 1970, while it has expended less than 45 percent of the total tax revenue spent.

Table1 Vertical Fiscal Imbalance (in percent)

	Tax revenue received by		Tax revenue spent by	
	Central	Local	Central	Local
1970	67.5	32.5	50.8	49.5
1980	64.1	35.9	46.0	54.0
1990	65.2	34.8	47.0	53.0
2000	59.7	40.3	43.0	57.0
2005	60.0	40.0	40.6	59.4

(source) Ministry of Internal Affairs and Communication (2005)

Mochida and Lotz (1999) compares the decentralization of the public sector in Japan and the Northern European countries as follows.

- Central-local relations are regulated by law. But legislation in Japan allows the central government to control local expenditure decisions discretionary through a large number of “delegated functions” financed by specific purpose grant. The local expenditure policies of the Nordic Countries are now controlled by legislation; no central civil servant can overrule a local politician if he keeps his action within the law.
- The Nordic Countries employ a piggyback type of local income tax for which each local authority determines its own tax rate. In Japan, local tax revenues are mainly derived from a variety of on income, property and consumption with very limited authority to vary tax rate. This way the Japanese system combines a Continental style tax-sharing type of financing with a Northern European decentralization of expenditures. There are signs that this type of financing is not suited when expenditures are so highly decentralized.

The central government defends its use of controls by noting that they help standardize welfare and health programs, which ought to be uniform across the country, and further claims that without national government involvement, economically fragile localities may fail to provide adequate services for their residents. The central government also believes that

equalization of different social services should take precedence over local autonomy and decentralization. Over the the last few years, however, the public has increasingly called for deregulation and decentralization of Japan's centralized intergovernmental relations. Public statement claim that Japan's centralized system of government eventually be unable to resolve issues generated by economic globalization and the fiscal stress caused by post-bubble economic blues (see Box).

Some explanations why Japan wants to decentralize public sectors.

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

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

Drive to decentralize

Reflecting these general outcries, the government finally enacted The Law for the Promotion of Decentralization, on May 15,1995 and established a committee, headed by a prominent businessman, to study different methods of decentralization. After intensive debate and investigation, the committee submitted its final conclusion in 1998. The report suggested virtual elimination of agency delegated function, and proposed to term a large portion of prefectural and municipal affairs as 'Local Government Services.' In 1999, to implement the new pattern of central-local relationships, the national legislature eradicated 432 of the laws that formed the basis for agency delegated functions.

In addition to deregulation of administrative control, intergovernmental financial relations has also been reformed recently, in order to strengthen local own revenues and to reduce heavy reliance on central government coffer. The prime minister Koizumi launched in FY 2002 an ambitious reform of the three main components of local government financial resources - earmarked grants, local taxes and the local allocation tax – the so called "Trinity Reform".

- A cut in earmarked grants to local governments by around 4 trillion yen over the period FY 2004-2006.

- A streamlining of the Local Allocation Tax. The Local Allocation tax has been cut 5 trillion yen for the first time since 1950s over the period FY 2001-2006.
- A transfer in tax resources from the central to local governments of about 3 trillion yen. The government cut the national personal income tax and increase local government reliance on the individual inhabitant tax by FY 2007. In the event, standard rates for the individual inhabitant tax on income will be flattened so as to strengthen the benefit principle and avoid a distribution of tax resources across local governments that would be too uneven.

As the foregoing indicates, the question of decentralization and deregulation has developed into one of the most contentious political issues in Japan. The demand for reform strike at some of the most critical prerogatives of the central government. The central agencies feel that deregulation and decentralization would reduce their power, which they are reluctant to relinquish. Changing some of Japan's most entrenched political practices, therefore, seems extremely difficult to accomplish.

2. INTERGOVERNMENTAL RELATIONS

Role of Ministry of Internal Affairs and Communications

The organization of the way central control is exercised differs from that of other countries. In Nordic countries, the system of control of local government is an example of cooperation and negotiation between central and local government. MOI (Ministry for Interior) and the MOF represent the central government, while the local governments are represented by the Local Government Associations (Lotz 2006). In Japan it is not the local government organizations but the Ministry of Home Affairs represents the interests of local governments as a whole. The conflicts openly displayed in Japan between MOF and Ministry of Home Affairs would not be acceptable for the governments of the Nordic Countries, and would neither satisfy their local authorities.

Understanding this unique aspect requires paying attention to the change in the role of the ministry-level unit that oversees administration (Akizuki 2001:65-68). The prewar Ministry of Interior (*Naimusho*), which had tremendous power covering all areas of domestic affairs, was broken up and replaced by the scaled-down Ministry of Home Affairs, or MOHA (*Jichisho*), in 1960. In 2001, MOHA was merged with the Ministry of Posts and Telecommunications to become the Ministry of Internal Affairs and Communications, or MIC. MIC engages in fiscal supervision of local bodies as a central government ministry, while at the same time representing the interests of local governments within central government departments.

Incentives for MIC and local governments to cooperate with one another are easy to understand. *First*, in all problems related to local governments—such as reduction of the local allocation tax—MIC protects the interests of local governments and engages in tough fights with other central government ministries (especially the Ministry of Finance) that want to get their hands on local government finances. Local governments, of course, want to maintain this mechanism. And, from MIC’s perspective, if it loses the support of local governments—which forms the main foundation of its authority—it cannot survive as a significant player in central bureaucracy. The relationship between MIC and local governments has become more and more interdependent with the passage of time.

Structural Reform

While the key strength of Japan’s “controlled decentralization” is its stability in the constitutional, legal, financial and administrative framework, one of the concerns with it is lack of flexibility (Akizuki 2001:79-84). Put it another way, politicians and bureaucrats have vital interest in the local finance system, it is tremendously difficult to change the status quo: (1) Ministry of Internal Affairs and Telecommunications (MIC), responsible for Local Allocation Tax, has opposed LAT reform; (2) Spending Ministries have resisted any attempt to reduce conditional grants; and (3) Ministry of Finance (MOF) stood against a transfer of tax revenue source from central to local government. Consequently, the local government finance system has been based on subtle political equilibrium among the main political actors (Kitamura 2006:16).

How can we explain why Prime Minister Koizumi could implement such a radical “Trinity” of local finance reform? Political scientist argues that both the introduction in 1994 of an electoral system combining single-member districts and proportional representation, and the reorganization of the central ministries and strengthening of the position of the prime minister and cabinet (implemented in 2001), have weakened the coalition of LDP politicians, bureaucrats, and interest groups that dominated post-war Japan (Kitamura 2006). Turning our attention to local finance reform under the Koizumi administration, two points are worth to mention in this regards.

- The Council of Economic and Fiscal Policy (CEFP) was to be established to investigate all government policies from a financial perspective. Koizumi administration succeeded in setting the macro targets at the CEFP, thereby forcing the MIC to reluctantly accept the simplification of the Local Allocation Tax system. The amount of the LAT was curtailed for the first time in fifty years.
- A tentative Consultative Council between central ministries and local representatives was to be set up to come up with the plan for the size of cut in specific purpose grants and transfer of tax resources. After painstaking debates and tough negotiations, both sides have successfully agreed upon the transfer of tax resources of 3 trillion yen via cut in grants of 4 trillion yen.

3. FISCAL EQUALIZATION

Argument for equalization

Japan needs strong equalisation systems for two reasons. Probably, the strongest case for equalization transfer has been based on the premise of “horizontal equity among the citizens”(Buchanan 1950). Equity requires that the equalization should be full, and this appears to be the logic in Japan’s Local Allocation Tax. As pointed out by the Recommendation by Prof. Carl S. Shoup of 1950, special support from the national government for the exceptionally poor areas is necessary, so that they are in fact, as well as in principle, free to vary the amount of services they supply their citizens with, through changes in their own tax rates (General Headquarters Supreme Commander for Allied Power 1949). Boadway, Hobson and Mochida (2001) also characterizes local residential taxes as being proportional to income and local expenditure being distributed on slightly progressive basis in Japan. The progressivity of local budgets leads to difference in net fiscal benefits and call for full or more than full equalization of residence-based taxes in Japan.

Another case for Japan’s equalization is guaranteeing adequate revenue to local governments to allow them to provide national standard level of public services. Its focus is not on making sure all local governments have the fiscal capacity to deliver reasonably comparable service to their resident at reasonably comparable levels of taxation like in Canada. Instead, it is designed to ensure that common standards in quality or outcomes in public services are achieved. Put it differently, the Local Allocation Tax is uniquely designed to reflect the Japanese reality where the law allows central government to control local expenditure decisions discretionary through a large number of “delegated functions” financed by specific purpose grant. During the 1950s and 1960s, Japan was an economically poor country. Depending on where one lived, there were significant gaps in schools and other educational facilities as well as in roads, hospitals, waterworks, and medical care for elderly people. The Japanese public strongly desired public services that conformed to uniform standards.

Two models: grant or solidarity model of equalization

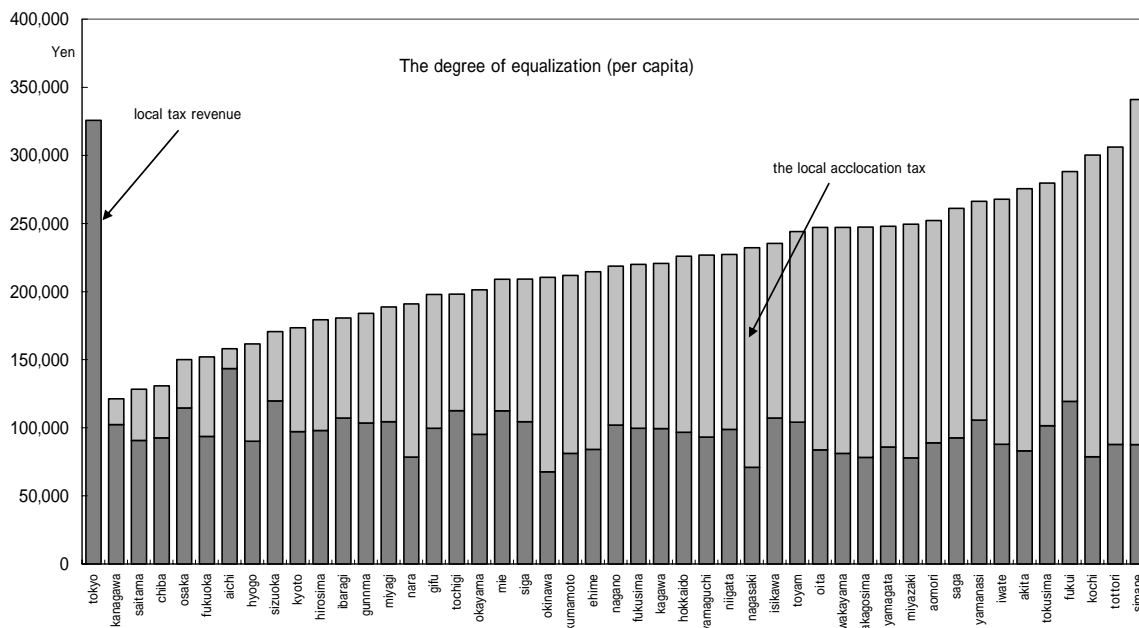
Horizontal imbalances are reduced by equalization arrangements. These can be designed applying one of two very different forms of techniques, we shall call them the grants method and the solidarity method (Mochida and Lotz 1999). By far the most common model is a central government grant to the poor local authorities, so as to bring their revenue up to a certain national standard like in Japan. The other method, the solidarity method – sometimes called the "Robin Hood" model, is used in Germany (among the länder), in Denmark, and in Sweden. It removes resources from the rich authorities and gives to the poor, no central funds are needed.

The Local Allocation Tax (LAT) plays a key role as the fiscal equalization transfer system in Japan. Revenue from LAT accounts for 21 percent of local revenues on average. The total size of equalization is a fixed portion of the national taxes on individual income, corporate income, and value added, as well as the alcohol and tobacco taxes. It is paid annually to local governments whose basic financial needs exceed basic financial revenues. Those rich localities whose revenue exceeds need are neither eligible for the grants nor obligated to contribute money for fiscal adjustment. Using this formula, the national government can transfer funds that will fill the gap between each region's fiscal need and fiscal capacity, thereby guaranteeing adequate revenue to local governments to allow them to provide national standard level of public services.

The grant model like in Japan would have some advantages over the solidarity model. It can be seen that the this model could contribute to "nation building" in countries where regional conflicts are very serious like in Canada, Korea, and Japan, while solidarity model is likely to create conflicts between regions as is evident with the experiences of Germany, Sweden and Denmark. However, there are, of course, serious concerns with the grant model. *First*, lack of central funds in many countries results in an insufficient equalization reaching only the poorest authorities, thereby the more well to do authorities and their wealth remain outside the system. For example, Tokyo metropolitan government whose revenue exceeds need are neither eligible for the grants nor obligated to contribute money for fifty years. *Second*, under the grants model everybody seems to get something and nobody seems to pay. But it is not true because real redistribution is less visible ("fiscal illusion") than in the solidarity model. Seeing from Japan's experiences, local politicians, civil servants and voters would take less care with money that is given as LAT.

Degree of equalization

In Japan there are some similarity in public thinking with the NCs. Equal access to public goods and fair sharing of the burden to finance these goods are viewed as essential for economic and social development. Reflecting these views, the formula means that the national government transfer will fill 100 percent of gap between each region's fiscal need and fiscal capacity. Such formula are the basis for the whole idea of delegation responsibilities to local government, this is the intellectual basis for the systems in Japan and the NCs as well as in countries like Australia, Korea and United Kingdom (Ma 1996). One difference, however, is a degree of equalization. The political hesitation to make full equalization would lead to a certain acceptance of marginal variations and inequalities in some countries. In Japan equalization would fill the full gap, aiming at guaranteeing adequate revenue to local government to allow them to provide uniform - but not just comparable, like in NCs or Canada, Australia - level of public services.



The degree of equalization is extremely high (see figure 1). For example, Aichi prefecture where Toyota Motor is located collects local tax of 143,000 yen per capita, while Shimane, a remote area of western part, collects only 87,000 yen. Looking at total resource from the LAT transfer and local tax, the latter's figure increases to 341,000 yen compared to the former's 158,000 yen. Overall, some poor and/or remote jurisdictions end up having more financial resources than those available in the richest ones.

In conclusion, the actual degree of equalization was perhaps more important before the 1970s, when the transfer system contributed significantly to equality (Mochida 2001:101-104). Since then regional fiscal disparities have been reduced, there has so to speak been less 'inequality' to fix through local allocation tax, and subsequently the intensity of the equalization effect has fallen. But this does not mean that equalization is no longer necessary, equalization is crucial for a country with a decentralized public sector as in Japan.

4. EXPENDITURE NEED

Formula for Local Allocation Tax

Local allocation tax has continued to the present with some minor alterations. Since 1954, the framework of the local allocation tax has been founded on the former distribution tax, enforced between 1940 and 1949, while retaining the formula used in the equalization grant for the distribution of funds to localities. In the local allocation tax system, the total amount

to be distributed to local authorities is a fraction of yields from major national taxes: funding pool = $0.32 \times (\text{personal tax} + \text{corporate tax}) + 0.358 \times \text{alcoholic tax} + 0.295 \times \text{VAT} + 0.25 \times \text{tobacco tax}$. These prescribed percentages of five major national taxes are apportioned among local bodies in proportion to the difference between standard fiscal need and standard fiscal capacity. It is annually paid to local governments whose basic financial needs exceed their basic financial revenues. Rich localities with revenue that exceeds need are neither eligible for the grants nor required to contribute money for fiscal adjustment, as is the case in some countries. For more detail of the formula, see appendix of this paper.

What is expenditure need?

One of the objectives for Japan's equalization is guaranteeing adequate revenue to local governments to allow them to provide national standard level of public services across the country. This objective means taking into account not only the difference in fiscal capacity of local governments, but also their expenditure needs. Aging and internal migration flows will affect individual local governments differently, reinforcing demands on equalization scheme. The share of population over the age of 65 varies significantly across prefectures, from 25 percent in Shimane to 13 percent in Saitama. The share even reaches 40 percent in some municipalities, with a clear urban/rural cleavage.

The concept of expenditure need encompasses two notions. *First* is the relative demand for public services. A local government with a larger proportion of elderly people requiring long term care or with a higher ratio of school age children has a great need for primary education. This is referred to as the "workload" facing their public services. It is usually measured by the socio-demographic and economic characteristics of local residents. The *second* dimension of expenditure need is the financial cost of providing a given set of services. The cost difference can be due to diseconomies of scale where fixed cost must be spread among a smaller population, higher cost of serving cold area (fuel expense) or sparsely populated area (wage expense), difference in cost for promotion of regional economy. However, the difference in the efficiency and effectiveness of government service delivery should not be taken into account when we measure expenditure need of a particular local government.

The complexity of measuring expenditure need

The next problem to be solved is how we should quantify expenditure need. The two schools of thinking suggest different approaches to quantifying expenditure need, though in practice the concepts may be muddled and methods mixed. The first approach points at the need for empirical work studying local authority needs as revealed in the local budgets and related to differences in some suitable objective indicators. The second approach leads to a more normative approach. The central government and Parliament decide what would be the "norm" or "standard" cost to fulfil the function of supplying a given delegated service to the criteria expected by Parliament to be met. Japan's fiscal equalization system has adopted the

latter approach for fifty years, reflecting Japanese reality where the law allows central government to control local expenditure decisions discretionary through a large number of “delegated functions” financed by specific purpose grant.

Like the system developed in Australia, measuring expenditure requires constructing and costing a standard for each spending area. Before the calculation of standard expenditure needs, public services for each prefecture and municipality are divided into particular service items by function (*gyôsei-kômoku*). In the prefectures, there are 24 service functions, such as police, roads and bridges, and primary school; for each municipality, there are 24 service functions, such as city planning, parks, and garbage collection. Standard expenditure needs are calculated as the number of measurement units by multiplying the unit cost, adjusted by modification coefficients: $\text{standard fiscal need} = \text{unit cost} \times \text{measurement unit} \times \text{adjustment coefficient}$. The total basic need in each locality is the sum of the amounts needed for all service items combined.

The following provides the numerical sample of major functions.

- Fire/ambulance: $10,800 \text{ yen} \times \text{population (person)} \times \text{modification coefficients}$
- Road improvement: $380,000 \text{ yen} \times \text{road length (km)} \times \text{modification coefficients}$
- Elementary school: $973,000 \text{ yen} \times \text{No. of classes (class)} \times \text{modification coefficients}$
- welfare for elderly: $72,100 \text{ yen} \times \text{population 65 years or older} \times \text{modification coefficients}$
- Waste treatment : $6,570 \text{ yen} \times \text{population (person)} \times \text{modification coefficients}$
- Agricultural promotion: $64,200 \text{ yen} \times \text{No. farming households} \times \text{modification coefficients}$
- Census registration: $1,670 \text{ yen} \times \text{No. registered families} \times \text{modification coefficients}$

All these steps require numerous judgement calls and adjustments in order to fairly measure the expenditure need for each local governments. The first step is to select measurement units. A measurement unit or “workloads” reflects the number or size of the beneficiaries of a particular expenditure. For example, a measurement unit for teachers salary is number of teachers, that of police is number of police officers, and that of roads is length of roads. The second step is to determine a unit cost. Unit cost is a kind of net standard cost per measurement unit for each service item. Assuming a representative local body with standard conditions and scale, the unit cost for each service item is determined by The Ministry of Internal Affairs and Telecommunications. The unit cost can be calculated by deducting earmarked revenue from gross cost and divided by the number of measurement units.

The unit cost, however, is uniform throughout the country, and no consideration is given to either the unique services or the special circumstances of localities. So an exceedingly complex adjustment is made of the unit cost applicable to such services. Modification coefficients are currently classified according to eight categories. For example, if a local government has a smaller population with diseconomies of scale, adjustment would have to

be made for the additional cost of public services. In conclusion, while there are continues to be strong support for addressing local expenditure needs in Japan, it adds some complexity to the program. This would call for simplification of the formula aiming at improving transparency, awareness, and understanding the Local Allocation Tax.

Figure 2 Local public finance programs (FY2005): 83.76 trillion yen

(Unit: 100 million yen)

Salary-related expense 227,240	Subsidised projects 66,463	National grants: 21,448	} Elementary and junior high school teachers } Police officers: 23,974 } Firefighters: 13,087 } High school teachers: 21,676
		Local burden: 45,015	
	Independent projects 160,777	58,737	
		Family register desks, welfare offices, healthcare centers, waste treatment, food service centers, etc. 102,040	
General administrative expense 231,307	Subsidised projects 100,538	National grants: 46,583	} Livelihood support, long-term care, medical care for the elderly, childcare, etc.
		Local burden: 53,955	
	Independent projects 122,403	Investments to national corporations, agencies, etc. 3,703	} Operational expenses for police and firefighting, waste treatment, management of roads and rivers, commercial and industrial loans, public health centers, school operation expense, private
		Social welfare system expenses 45,173	
	Other		
National insurance 8,366	Local burden		
Investment expense 196,761	Subsidised projects (Public works projects, etc.) 73,061	Amount borne for government-controlled projects: 11,351	} Temporary grants for maintenance of regional roads } Cleaning; agriculture, forestry, and fisheries, rivers and coasts, urban planning, education, etc.
		National grants: 32,675	
		Local burden: 29,035	
	Independent projects 123,700	13,380	
Other			
Public bond expense 133,803	Interest subsidies: 3	} Waterworks and sewerage, hospitals (advanced medical care, etc.)	
	Local bonds 133,800		
Public enterprise 28,659	Items related to redemption of principal and interest for enterprise loans 20,568		
	Other than the above 8,091		
Other 19,917			

Source: the Local Public Finance Bureau, Ministry of Internal Affairs and Communications (2005)

5. IDENTIFYING THE ISSUES

Objective criteria

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

Once a minimum level for welfare services was achieved, the definition of the level of standard fiscal need became increasingly ambiguous. As a result, the coverage and costs of fiscal equalization scheme have increased over the past decades. As a proportion of total central government spending, LAT transfer has ranged from a low of 16.8 percent in 1984 to a high of 25.5 percent in 1999 and most local governments are now eligible for this grants. Several factors have contributed to the upward pressures on the equalization system. *First*, the local allocation tax becomes asymmetric in adjusting for the business cycle (Mochida 2004; OECD 2005). The funding pool—namely, a set percentage of the national tax—expands when the economy is growing. Cyclical windfall tax revenue made it possible to upgrade national standard for local public services. However during a downturns, it has been difficult to cut back these transfers. The decline in funding pool for the LAT has largely been compensated by borrowing from the LAT special account or by encouraging local government to issue bonds whose future repayment costs are partly accounted for in the calculation of entitlement of the LAT. *Second*, several observers have argued that the vague definition of public service included in the standard fiscal needs has contributed to ballooning demand for transfers. Concerns have been expressed that the rapid expansion of standard fiscal needs over the past decades reflects effort to stimulate the economy through specific incentive, rather than expenditure needs *per se*.

The source of political influence or discretionary elements lies with the composition of the Local Public Finance Plan. It must be worthy to note that not only all of obligatory expenditure but also most of discretionary expenditures are involved in LPFP. As for the former, local government are obliged to provide by law, thereby there are objective criteria for them. Teacher's allocation and the number of students per class are clearly spelled out in the condition attached to specific purpose grant, and standards of public assistance is determined by central government. However, there is a room for manipulating the coverage and levels of 'national standard' for discretionary expenditure with which no condition attached. As can be seen from figure 2, while major composition of Local Public Finance Plan relates to obligatory expenditure painted over with dark grey, discretionary expenditures such as waste treatment, social welfare, independent public works are also involved in the LPFP with a substantial volume (painted over by light grey).

Policy neutrality and sound incentive

The fiscal equalization system should be as neutral as possible and should not distort the autonomous fiscal management of local governments. Most experts agree that, on the ground of policy neutrality, difference in expenditure need should be equalized only to the extent that they are beyond the control of government. Otherwise, equalization distorts incentives for sound public management. On the contrary, fiscal transfer that covers gaps between actual expenditure and actual revenue is not desirable because it gives rise to moral hazards in local governments. In this regards, Japan's equalization system has both strength and weakness. The calculation formula for the local allocation tax contains a number of attractive features that are intended to contain inefficient behavior. Because it is calculated based on standardised tax revenue, local allocation tax entitlements are not affected, even if the actual tax rate changes. Furthermore, 25 percent of the estimated tax revenue is not included into the fiscal equalization system. This gives local governments incentive to expand their tax base to some extent.

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

- The expenditures of repaying capital and interest on local bonds are included in the standard fiscal need of the local allocation tax. It is done through the modification coefficient for debt services (that is, through calculation of investment expense by converting population, area, and so forth as well as amount of local bonds issued into measurement units). For example, in comprehensive regional improvement projects, 75 percent of financial resources are procured through local bonds, but 55 percent of future repayment cost is included in the LAT entitlement. Mochida (2004) estimated that 36 percent of total local debt outstanding accounting to 130 trillions yen will be repaid by the central government. To do so provided an incentive for local governments to incur higher levels of debts.
- Local allocation tax gives premiums to small local governments (called *modification coefficients for local government size*). Originally, it is intended to take into account diseconomies of scale where fixed cost must be spread among a smaller population. However, these generous premiums are criticized by The Council of Economic and Fiscal Policy for obstructing efforts toward administrative reform and mergers. Consequently, the modification coefficients for local government size were scaled back in fiscal year 2002.
- As discussed before, prescribed percent of the estimated tax revenue is not included into the fiscal equalization system. The reservation rate gives local governments incentive to expand their tax base. However, facing with incredible debt accumulations, The Council of Economic and Fiscal Policy (CEFP) severely criticized it for creating 'poverty trap'

and establishing a permanent sense of entitlement to LAT. Consequently, central government had reluctantly lifted up the reservation rate for the prefectures from 20 percent to 25 percent in 2002. However, other observers argue that this criticism does not have sufficient empirical evidence (Horiba, Mochida, and Fukae 2003). We argue that it is systematically impossible for local governments to get more LAT transfer by lowering the effective tax rate or by making less effort to expand local economy, because they are not allowed wide range of discretion over setting rate or changing tax base.

Affordability and stability

The funding pool for fiscal equalization should be stable so that local governments can prepare their budgets appropriately. However, the funding pool must be combined with some degree of flexibility to ensure that nothing prevents macroeconomic stabilization. A way of resolving these conflicting demands is to fix the funding pool to a certain percentage of national revenue and to review this rate through regular negotiations (Litvack, Ahmad, and Bird 1998).

Japan's equalization has both strength and weakness. Approximately 32 percent of five national taxes (income tax on individuals, corporate income tax, value added tax, liquor tax, and cigarette tax) are secured by law as a funding pool for the local allocation tax. A merit of this method is that abundant resources are provided to the LAT transfer during periods of rapid economic growth in 1950-early70s. However, the funding pool is sensitive to economic fluctuations and, thus, tends to expand or contract. Unfortunately, the income tax on individuals and corporate income tax, which are part of the funding pool of the local allocation tax have overlapping tax bases with the inhabitant tax and enterprise tax, which are important taxes for local governments. All of these taxes have a truly correlative relationship with economic fluctuations. This problem gave rise to shortages in financial resources during the "lost decade" of 1990s.

Although rules for eliminating the gap between the funding pool and entitlements are established in law, those rules do not always function effectively. Article 6, paragraph 3-2, of the Local Allocation Tax Law (Law 211 of 1950) addresses a situation in which a shortage in financial resources in local fiscal planning comes to roughly 10 percent or more of the LAT transfers, and this condition has continued for two years and is predicted to continue for another year or longer. The law stipulates that, in such cases, the tax-sharing ratio will be raised. In actuality, the tax-sharing ratio has been gradually raised since 1954 when it was 20 percent. In 1966, the shares of three national taxes were raised to 32 percent to deal with financial resource shortages in local governments. In FY 1989, a portion of VAT and cigarette tax had been added to the funding pool. While the situation described in article 6 of the Local Allocation Tax Law has continued for eight consecutive years since 1996, the tax-sharing ratio has not been raised.

6. REVITALIZING EQUALIZATION SYSTEM

Improve the way of addressing expenditure needs, don't abandon it.

The fiscal equalization is clearly a Japanese conundrum. There is no perfect solution for equalization in Japan. Given the dynamics of Japan's intergovernmental relations and political equilibrium among the main political actors, perfections will not be expected. Nonetheless, we should have to pursue the goal of developing a sound and effective equalization system for Japan. What follows is a package of reforms designed to revitalize Japan's fiscal equalization program and to establish a sustainable basis for the future.

While there continues to be strong support for the purpose and principles underlying the LAT transfers, some commentators and analysts have called the program into question. The Council of Fiscal System set up by MOF argues that current LAT should be completely replaced by new equalization system, focusing only on revenue equalization, taking difference in expenditure needs into account by specific grants. In their view, budget deficit of the central government is higher than that of local governments; thereby this asymmetry requires cutting fiscal transfers including the LAT. They also argue that national minimum has already been achieved in most public services; local governments should tailor outputs of good and services to the particular preferences of their constituencies. In their view, the LAT obstructs efforts toward cutting wasteful spending, because it would fill the full gap between expenditure and revenues regardless of the difference in the efficiency and effectiveness of government service delivery.

We do not believe that complete replacement is appropriate for a number of reasons. *First*, primary balance of local government, by international comparison, is relatively high and its debt outstanding has soared rapidly over the past decade. If the government would cut fiscal transfers substantially, it would simply replace fiscal deficit at the central government with the local government's debts (the Council of Local Finance 2006). *Second*, if sub-national governments would have considerable autonomy and responsibility for the vast majority of public services like in Canada, the LAT's function of guaranteeing adequate revenue to provide uniform level of public services would be almost unnecessary. To the extent that the difference in tax rates corresponds to difference in the local service level, the tax differentials are in conformity with the principle of benefit taxation. However, the LAT's function of guaranteeing adequate revenue needs to be retained in the vast majority of public services including compulsory education, health, and social services in Japan, where equal access to public service and fair burden of it can be viewed as essential part of development.

Third, the LAT does not fill the gap between actual expenditure and actual revenues as critics comment; instead entitlement of the LAT transfer is basically determined by objective variable that is beyond the control of local government. In conclusion, the addressing

expenditure needs in equalization should be retained, to do so will require improvement in the way of addressing expenditure needs. In this way, all local governments continue to be strong supporters of the LAT, as are many academics and experts.

Formula driven transfer with simplicity and transparency

The longstanding upward drift in the coverage and costs of the LAT needs to be halted. The cut in the LAT of 5 trillion yen over the period FY 2001-2006 is a step in the right direction. Recognising that the quality of public services is now high in most part of the country, there is a need to reassess the coverage and generosity of the LAT against other major national policy objectives, in particular the need to restore fiscal sustainability.

The coverage of “standard fiscal need”, which enter in the calculation of grant entitlement, should be reviewed systematically and be open to public debate. Some commentators and analyst have estimated the ratio of discretionary expenditure as of total amount of Local Public Finance Plan, with the result ranging from 10 percent to 40 percent. In particular, the inclusion of some public infrastructure endowments, whose impacts on local resident welfare seems low, should be reconsidered. In parallel, the funding pool available for equalization should be raised as Article 6, paragraph 3-2, of the Local Allocation Tax Law (Law 211 of 1950) stipulates. This would help to avoid discretionary elements in determining the size of funding pool.

The LAT formula should be redesigned so as to encourage local government to deliver services in the most cost-effective manner. *First*, it should be based more systematically on objective criteria (e.g. size of school age population, remoteness indices) rather than actual endowment, such as public infrastructure. This would mitigate the incentives for local government to embark on spending with low economic returns or welfare impacts.

The reliance on discretionary elements, including special LAT and various aspects of modification coefficient used in the LAT calculation, should be reduced and, in general, the formula made more transparent. Since FY2007, 10 percent of total standard fiscal needs would be assigned to each local government on the basis of the number of population and the size of its area. The portion of so-called “new-model Local Allocation Tax” would increase to 30 percent in near future. This reform has an advantage to local government, because it would contribute to simplification of the formula. But the result of this ‘new formula’ would not always be precise, because they reflect only relative demand for public services or “workload” which is potentially different from the real pictures. Put it differently, new formula neglects the financial cost of providing a given set of services. For example, when population is used as an indicator, remote area with relatively high cost could not provide public services adequately.

Similarly, there is a need to remove existing incentives in the LAT system in favour of local bond issues, because they may hinder otherwise desirable adjustment in local tax rate or cuts in spending. The reduction in the LAT coverage of repayment costs for some public infrastructure made in FY 2002 is a step in the right direction, as is the increase in the share of local taxes retained by prefectures. A bolder reform, however, is needed since a large share (commonly between 35 and 100 percent) of local bond repayment costs is still paid back by the equalization scheme, while 75 percent of a rise in local tax revenues stemming from an increase in taxable income is given away of the equalization pool.

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