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by Yukiko Yamazaki and Andrew Dewit

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Japan is stuck between lots of rocks and several hard places. It confronts the escalating costs of the world's most rapid pace of ageing with a low and declining birthrate and virtually no support for mass immigration. Moreover, the country faces these costs while severely handicapped by a public debt 1.5 times its GDP plus dramatic declines in the high rate of savings that has hitherto financed it. In addition to all this, the poorly performing economy is in its fourth year of deflation with little hope of producing a recovery in tax revenues. Indeed, deflation and minimal economic growth have eroded national income-tax revenues to their lowest level since the collapse of the bubble economy.
Against this gloomy backdrop, having tried just about every other policy reform that is politically conceivable, the Japanese state finally appears ready to try fiscal decentralization. A process is in place to design and implement fiscal decentralization, according to the slogan "sanmi, ittai." Directly translated, this means "the trinity," and refers to cuts in the two main arms of subsidies from the central government with a compensating devolution of part of the national tax base. But as in the Christian theology that we generally associate with "the trinity," the correct interpretation of the slogan varies greatly among the many actors with an interest in intergovernmental finances. Indeed, the policy has already provoked an open and intense political fight and more is guaranteed to come. This article details the politics of fiscal decentralization in Japan by sketching the reform options that are on the agenda, explaining why they are important, and assessing the potential for them to be realized.

A Global Movement, But No "Global Standard"

But let us first put the issue in a broader context. Fiscal decentralization means devolving some of the central government's powers to tax, usually in exchange for cuts in the flow of subsidies that the centre transfers to the regional and local administrations. This kind of reform is common in both the developed and the developing countries. As the World Bank points out in numerous studies, the general trend of state finance around the developed world is towards an increasing provision of goods and services by local governments while central governments gradually pull back from their role in income redistribution through progessive taxation.

Fiscal decentralization generally involves shifting from reliance on the more progressive tax base of the central government to a heavier reliance on subnational sales, income, or property taxes, as well as user fees and other regressive or proportional means of finance. The policy therefore often has a poor image among progressive thinkers in Anglo-America, for whom the progressive income tax is the main pole of fiscal politics. Neoliberal interests have long championed the policy, in conjunction with an emphasis on downsizing the state through tax and expenditure cuts in favour of provision via the market or third sector. This combination of downsizing and tax shifting often results in poorer services and a heavier tax burden for middle and lower-income class residents, some of whom may become even more responsive to neoliberal politicians who call for further downsizing the state.

But decentralization does not have to be something only a market liberal would like. Many progressive analysts and activists recognize that the highly centralized fiscal state stifles the development of civil society and paralyze the political institutions that allow individuals to shape their communities' economic development and provision of public

services. A progressive fiscal decentralization thus looks less to shrinking the state and more towards shifting the tax base to the local level so that more of the decisions on taxation and spending are put in the hands of local voters and their representatives.

Thus the precise content of fiscal decentralization varies depending on the purposes of its implementation, the political complexion of the regime implementing it, and the strength of grassroots organization. It makes a big difference whether decentralization aims at fostering vibrant local communities, as in Sweden's massive fiscal decentralization in 1993, or merely expanding the role of the market for its own sake by shrinking transfers from the central government in order to induce further cuts at the subnational level. We see the latter in contemporary America, where a policy of cutting taxes to gut the finances of the public sector in general has had devastating effects on state and municipal services, including such essentials as health, education and welfare.

Japan's Turn

Japan's serious turn towards fiscal decentralization comes after decades of debate and nearly a decade of institutionalizing decentralization through the 1995 Council for the Promotion of Decentralization (now the "Council for Decentralization Reform"). There can be little doubt that a well-managed and full-scale reform would profoundly reshape the state and help revive Japan's once vaunted economic competitiveness. This is because it is an essential condition for cutting through the country's entrenched porkbarrel politics, which emphasizes wasteful and often environmentally damaging public works. Japan's highly centralized fiscal system was very adept at spreading around the fruits of the country's previously high economic growth. But over time, political, bureaucratic and business interests came to parasitize much of the enormous flow of funds from the centre to the subnational governments, leaving the fiscal system largely unable to adapt to the new needs of a rapidly changing economy and society. For example, even after some trimming under the current Koizumi regime, Japan's spending on public works tops 5% of GDP, which is at least double what one finds in most of the other OECD countries.

A brief review of the Japanese fiscal state highlights additional reasons for fiscal decentralization. Japan's subnational governments do most public spending - much at the behest of the central state - but generally do not exercise enough authority and responsibility over it. On the spending side, Japan is unusual among the unitary states. Roughly two-thirds (95.9 trillion yen) of Japan's total public sector spending of 153.3 trillion yen (Fiscal Year 2001) was performed by local governments, whereas most of the OECD's unitary states see about 20% to 30% of total spending done by subnational governments. Japan's local governments do raise about 36 percent of total tax revenues, which is higher than their counterparts in other unitary systems. But they generally lack the authority to set their own tax rates, at least outside of a narrow band, and their ability to implement new taxes is also restricted. Moreover, the enormous gap between revenues and expenditures also leaves Japan's local governments with a massive dependence on subsidies from the central government, which amounted to 37 trillion yen (US$ 310 billion) in FY 2001, or about 7.5 percent of GDP.

The degree of fiscal dependence is not, of course, the same for all prefectures and cities. Overall, local governments in Japan received 36.4 percent of their revenues in the form of subsidies from the centre in 2001. But some, such as Metropolitan Tokyo, are almost self-financing, in that they raise sufficient funds through the local tax base to cover almost all their expenditures. They can do this because the average level of income in Tokyo is very high and because it has the nation's most intense concentration of businesses. It is, in other words, rich. Other areas, such as Okinawa, Shimane Prefecture, and most of the Japan Sea coast, are relatively poor and receive well over half of their revenues from the central government's coffers. These dependent areas tend to have higher than average concentrations of the elderly, unemployed, low-wage workers, and small, low-revenue businesses. Without subsidies from the central government, they would not be able to deliver even minimal public services except by imposing damagingly high local tax rates.

Japan's intergovernmental system has - at least since 1940 - been aimed at evening out these interregional gaps in fiscal capacity. Thus it is a centralized system that imposes a comparatively uniform regime throughout the country. If local governments do decide to tax outside of the prescribed bands, or extend exemptions not specified in the tax law, they risk losing some of the funds delivered through subsidies. Most of the local governments also require approval for floating public debt, and come under strict central supervision in the event that their debt financing exceeds prescribed ratios of their overall revenues.

The Subsidies

Large-scale fiscal transfers from the central to the subnational governments are common to most industrialized countries, with the notable exception of Germany (where the redistribution is directly between the subnationals).

These transfers are composed of 2 types of subsidy: general and specific subsidies. Local governments are, in principle, free to spend general subsidies (also referred to as "block grants" or "unconditional grants") as they see fit, whereas specific subsidies ("conditional grants") are to be spent on projects designated by central-state agencies.

In the Japanese case, general subsidies are composed almost wholly of funds from what is called the Local Allocation Tax (Chihou Koufuzei). The local allocation tax (hereafter, "LAT") is a mechanism for intergovernmental revenue sharing in which fixed percentages of the revenues from five major national taxes are earmarked for a special account. The funds are then distributed to the local governments as general grants. In effect, the system takes income from all areas of the country, but especially the more wealthy ones such as Tokyo, pools them in a special account of the national budget, and redistributes them to needy local governments.

These funds distributed via the LAT totaled ï¿½21.9 trillion in FY 2001, or about 22% of total subnational revenues. The distribution of the funds is determined by a complex formula that measures local fiscal capacity and expenditure needs. The amount of grant transferred to any given local government depends on the gap between its revenue capacity and its expenditure needs. The aim is to ensure that all local governments are able to provide a minimum standard of public services and infrastructure without having to raise local taxes to onerous levels. This kind of revenue sharing arrangement is common among the industrialized states, but is conspicuously absent in America.

Specific subsidies, on the other hand, accounted for 14.5 trillion yen, or 14.5% of total local revenues. They are much liked by the line ministries that supervise education, health and public works, as the subsidies are the carrot that they use to control local administrations. Until about the mid-1980s, these subsidies were much larger - as a proportion of local revenues - than the LAT. But fiscal decentralization in those years saw a shift from specific to general subsidies. The policy was driven by the idea that untied subsidies would allow for greater choices at the local level and moderate the incentives for porkbarreling. However, general subsidies were themselves readily hijacked for use in funding public works, because the Japanese fiscal regime awards general subsidies - with certain restrictions - in order to finance the debt costs of public works. This unusual measure saw local governments in the 1990s given massive incentives to expand their share of public works - at least until the mountain of debt moderated these incentives.

All intergovernmental fiscal systems involve a trade off between the opportunities and risks of fiscal autonomy, on the one hand, and the constraints and protections of fiscal dependence on the other. In this respect, the United States and Japan can to a large extent be considered as the opposite ends of a spectrum. The former emphasizes local autonomy in finances whereas the latter stresses inter-regional equity. This equity approach still has considerable support in Japan where it is deeply entrenched in a broad network of administrative and political institutions. Metropolitan Tokyo may chafe at the restraints that the central government can impose on it, but poorer regions appreciate the flow of funds from the centre even if their spending patterns get skewed. An ideal form of fiscal decentralization would involve, as in the Swedish case, shifting the bulk of the income tax to the local level. Progressive public finance scholars have long argued in favour of this reform, as it would increase the fiscal discipline of local governments while still providing them with a guarantee of receiving sufficient finances in order to provide a minimum level of services. Redistribution from the centre would thus be scaled back, but not eliminated entirely. The outcome would thus sacrifice a degree of equity on the revenue side of the public sector as a whole in order to move towards more equity on the spending side.

The urgency of fiscal reform in the Japanese case is hard to exaggerate. This is because of the awesome and mounting fiscal crisis we noted earlier as well as the fact that Japanese citizens have lost faith in their state to cope with contemporary challenges in an equitable way. A recent crossnational PEW Research Center poll released on June 3, 2003 as "Views of a Changing World 2003" (http://people-press.org) confirmed other polls that suggest Japanese have a low level of trust in their government. Among other things, the PEW poll showed that only 26% of Japanese believed that "government is run for the benefit of all people." The next lowest result was in France, at 40%, whereas even Americans answered 65%. One can hardly be surprised by this outcome, since the past decade has featured often poor performance by the public sector and a singular zeal among politicians and the press to sensationalize it. Even so, allowing this level of distrust to remain unaddressed, especially in the midst of an economic crisis, is a recipe for increased tax evasion, political instability, and other undesirable outcomes..

But if handled ineptly, fiscal decentralization would almost certainly worsen this distrust by producing the sort of chaos now evident at the subnational level in the United States. The degree to which health care, education, policing and other essential services are being cut back is striking, as one can readily glean from a perusal of the American press. Apart from their enormous human costs, these drastic cuts are jeopardizing America's capacity to rebound from the recession and renew its leadership in the new industrial revolution. To mimic the Bush regime's neoliberal approach to local finances would cause a contraction in the subnational public sector and spell disaster for Japan.

The Obstacles

One of the main obstacles confronting progressive fiscal decentralization in Japan is the Ministry of Finance. The MOF is a central player and would prefer merely to cut subsidies rather than devolve the tax base. From its perspective, there is an enormous national debt burden to pay down, and all revenue sources are essential. This concern is reinforced by the fact that tax collections are at historically low levels. Moreover, coupled with the immobilism of the line ministries, MOF's pressure for cuts results in a bias towards maintaining the status quo or a compromise on cuts.

Sometimes the MOF's stinginess is simply hard to believe. This was the case with the June 6 report of the Fiscal System Research Commission, one of the ministry's in-house think tanks. The reports are generally taken as a reflection of the ministry's perspective. This most recent report proposed that, on top of cutting subsides to the localities, they be burdened with a share of the national debt. The localities already have their own debt of 200 trillion yen, so the proposal seemed nothing so much as an outrageous effort to construct a bargaining chip and blunt the move towards devolution.

Generally siding with the overall approach of the MOF are the many private sector analysts and neoliberal academics who have become an increasing presence on Japanese study commissions over the past several years. The Council for Decentralization Reform is no exception, as a majority of its 11 members side with MOF on the basis of neoliberal ideology or organizational ties. The commission also has several representatives from local government and the large progressive public finance wing of Japanese academe. This greatly divergent mix of perspectives proved to be beyond compromise, as the neoliberals and MOF-oriented representatives crafted a proposal that would cut subsidies now and leave shifting the tax base for later, once the economy is on a sustainable growth path.

The vote on this proposal took place on June 3rd, and was preceded by weeks of open criticism in the press. The Minister for General Affairs, whose ministry oversees the fiscal health of local governments, went so far as to call on the MOF-oriented head of the commission to resign as the outline of the proposal became clear. Moreover, on the day of the vote, four members of the commission called a news conference right afterwards and denounced its contents. Beyond the contents of the report, the reason for the extreme political friction is the fact that the report could set the agenda of subsequent policy reform unless there is contrary pressure in favour of real decentralization.

Since the vote, there has been a daily flood of reports in the press detailing local opposition to its approach. Throughout the country, the powerful organizations of prefectural governors, mayors, and other local representatives have called emergency meetings and made plain their opposition. This steady rain of negative reaction appears to be having some effect, as the minister of finance has been compelled to declare his support for fiscal decentralization in principle and some concrete shifting of the tax base in practice. But he is still insisting that only 70% of the monetary value of specific subsidies be funded through devolution of the tax base. This might seem generous but would in fact represent a net cut of over 4 trillion yen (US$ 33 billion) in transfers to local governments. The effect would be to offload onto local governments a large share of the increasing cost of ageing, education, security, and other challenges while denying them adequate tax room to pay for it.

With The Council for Decentralization Reform's report having been handed to Prime Minister Koizumi, the process moves on to the Economic and Fiscal Council. The council is chaired by Koizumi but run by Takenaka Heizo, the Fiscal Affairs Minister of State for Economic and Fiscal Policy, who is in turn advised by an influential neoliberal academic. The balance of forces within the institution would suggest continuing to move toward outright cuts, but it remains to be seen whether Koizumi has the stomach to take on an opposition that includes virtually all representatives of subnational government as well as the LDP heavyweights who represent the spending ministries. The opposition of the spending ministries can be considered a constant, as they and their affiliated interests are inevitable losers through decentralization. The choice therefore is whether to opt for MOF's position or that of the majority of local governments. Given the strength of anti-redistributive rhetoric in contemporary Japan, we may see the Koizumi's inner circle try to craft a proposal that is attractive enough to the big urban areas, such as Tokyo and Osaka, to persuade them to support it. This would leave the poorer rural administrations to absorb the bulk of any cuts due to their limited bases.

MOF's logic of more for them means less for us is simple to understand but short-sighted, as cuts in subsidies would lead to fiscal contraction of the local government sector. In an economy that is deflationary and probably already headed towards recession, this is not a good idea. Backed up by the half-baked neoliberalism of Koizumi's advisors, this approach may stymie any hopes for real reform as well as present the risk of fiscal chaos at the subnational level if introduced. Over the next few weeks, we will see if common sense can make a comeback.