

Good and Bad Fiscal Decentralization

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Abstract Japan's system of centralized public finance is changing. The independence and responsibility of local governments are increasing. What remains lacking is "marginal fiscal responsibility," which would see local residents bearing the costs of policies decided on by local governments themselves. The short chapters presented here deal with the status and problems of Japan's system of fiscal transfers and property tax reform based on the principle of levying a benefit tax on local residents. The two essential factors for good fiscal decentralization are reform of the existing local allocation tax grants and reorganization of the local tax system. These reforms would ensure the fiscal responsibility of local residents and enhance efficiency. This would also contribute to fiscal reconstruction at the national level.

Keywords Fiscal decentralization • Marginal fiscal responsibility • Local allocation tax • The guarantee of fiscal resources • Property tax • Benefit principle • Local residents • Local governments • Fiscal consolidation • Cost awareness

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Japan's centralized public finance is changing. As indicated by the designation "administrative decentralization system," local governments have previously functioned as little more than subsidiary organizations of the central government, implementing policies and projects formulated by, and for which financial resources are funded by (the guarantee of fiscal resources), the central government. However, the independence and responsibility of local governments is now increasing as a result of a number of factors. These include: (1) the enactment of the Comprehensive Decentralization Act, which, among other things, abolished the imposition of administrative functions on local governments by the national government, in April 2000; (2) the "Great Heisei Mergers" of municipalities, which has roughly halved the number of municipalities in the nation; (3) the "Trinity Reforms," which transferred sources of tax revenue amounting to some trillions of yen from the national government to local governments; and (4) "regional sovereignty reform" under the Democratic Party of Japan (DPJ), among the effects of which was to transform grants to local governments into lump sum payments. Numerous local governments are leading the way in putting administrative and fiscal reforms into effect, including public accounting reform and the evaluation of administrative procedures and projects.

However, the character of the system within which local public finance is organized remains unchanged. A number of points can be made in relation to this fact. (1) The guarantee of fiscal resources for local public finance plans, and the system of local allocation tax grants that actualize this guarantee, are subsidies predicated on the "administrative decentralization system" in which local governments implement policies (the expenditure allocated to local public finance plans) formulated by the national government. (2) Despite the system of local allocation tax grants, local governments are not displaying sufficient autonomy or creativity. Tax grants targeting regional revitalization seek to support advanced local government initiatives, but the decision as to which initiatives are advanced relies heavily on the judgment of the national government. This may induce local governments to create plans that look towards the central government's will rather than utilizing their own creativity and originality. (3) The central government's guarantee of fiscal resources also extends to local debt (municipal debt-covering bonds and bonds which the government has agreed to finance). This implicit credit guarantee has reduced the cost of issuing municipal bonds (interest) to a level similar to that of government bonds. This has been indicated as a factor impeding the more widespread use of Private and Public Partnership/Private Finance Initiative

(PPP/PFI) initiatives, the purpose of which is to make use of private sector funds and management expertise in the upgrading and operation of public facilities. The low interest rate on local government bonds renders the actual cost of public projects and public facilities (including risk) unclear. In addition, it can be seen to have adverse effects on independent municipal policy. The *furusato nozei* (“hometown tax”) is a competitive quid pro quo system in which municipalities send local products to taxpayers (donors) as expression of gratitude. Municipalities, mainly the financially well-off municipalities in the nation’s urban areas, are also waiving children’s medical fees and other costs. An element of excess competition to provide benefits can be found in these measures.

What is lacking in both the guarantee of fiscal resources and the initiatives of local governments is fiscal responsibility on the part of local residents. “Fiscal responsibility” here does not refer to the abolition of subsidies and a requirement for local governments to undertake fiscal management using only their own resources. It is rather a “marginal fiscal responsibility” in which local residents bear the costs of policies and projects (own projects, etc.) decided on by local governments themselves so as to make local residents cost conscious. This type of marginal fiscal responsibility is lacking in current decentralization measures. Taking the consolidation of public facilities as an example, decisions are not being made regarding the maintenance or scrapping of an existing public facility after ensuring that residents understand the additional tax burden that this would entail. For example, the Management Plans for Public Facilities being drawn up by municipalities at present include measures for the consolidation of public facilities. However, there is strong resistance among local residents to the closure or reduction in scale of facilities that benefit them without their having to shoulder any financial burden.

At the same time, disparities between municipalities are also a concern. Under a decentralized system, it would be the role of local allocation tax grants to even out disparities that are not based on the efforts towards self-assistance of the municipality concerned. However, the current system of allocation tax grants has actually weakened fiscal discipline in municipalities and promoted a sense of dependence. Local governments demand their allocation tax grant in all situations. If allocation tax grants are offered before reform efforts are launched, it is doubtful that the reforms will proceed (all the more so if no difficulties in management occur in cases where reforms are not implemented). There are numerous faults in the local taxes that are levied on residents. The exercise of local tax autonomy is weighted too heavily towards corporate taxes (corporate enterprise tax

and corporate inhabitant tax). The benefit principle is indicated as the grounds for this, but in practice municipalities are reluctant to levy benefit taxes, including individual inhabitant tax, on residents. Ultimately, taxes are extracted where it is easiest to do so. From a textbook perspective, we are far from the levying of true benefit taxes; for example, even as regards property tax, pointed to as “a good local tax,” relief measures exist for small-scale residences that reduce the tax standard by five-sixths.

Ultimately, the point of divergence between good fiscal decentralization and bad fiscal decentralization is the fiscal responsibility (cost awareness) of residents. When we talk about fiscal decentralization, the structure of confrontation between the national and local governments is sharply highlighted, but what is really at issue is the relationship between local governments and residents. How can we realize fiscal management that considers this relationship? Local residents who lack cost awareness have no interest in municipal fiscal management. As a result, they do not monitor fiscal management, and fiscal discipline becomes lax. The two essential factors for good fiscal decentralization are: (1) reform of the existing local allocation tax grants; and (2) reorganization of the local tax system. The short chapters in this section deal with the status and issues of Japan’s system of fiscal transfers (factor 1) and property tax reform based on the principle of levying a benefit tax on local residents (factor 2). In Chap. 18, Professor Wataru Kobayashi considers the scope and the level of the guarantee of fiscal resources, the measurement of the fiscal capability of a municipality, and the treatment of municipalities that do not receive the grants as three issues related to local allocation tax grants. In Chap. 19, Professor Tomomi Miyazaki looks at the reasons the property tax does not satisfy the benefit principle (the limits on local tax autonomy, the existence of a variety of preferential measures, and the possibility that the existing property tax is *de facto* a capital tax), and proposes reforms which will make the property tax a benefit tax. Naturally, while we may talk about “local governments” in general terms, there is a tremendous range among them in terms of fiscal and economic capability. Local governments also differ in terms of their capacity for independence and fiscal responsibility. In the sense that the same administrative duties and the same extent of autonomy have been applied to all local governments, Japan’s initiatives towards fiscal decentralization have been “centralized” or uniform. If it were possible to classify local governments into a number of groups based on factors including fiscal capability, fiscal transfers could be conducted and the local tax system (the allocation of tax revenue sources) could be organized based on these groups.

The government is currently seeking to achieve fiscal consolidation, balancing the primary fiscal balance by FY 2020, and is advancing Integrated Economic and Fiscal Reforms (the Plan to Advance Economic and Fiscal Revitalization) as part of its efforts. The realization of increased efficiency in local expenditure (including measures such as PPP/PFI, use of information technology in daily operations, and wide area administration) is positioned as an important axis of these measures. If fiscal decentralization stimulates cost awareness in local residents, resulting in a greater level of interest in and monitoring of the municipal administration, efficient fiscal management at the micro level (the level of each municipality) will be enhanced, which may in turn contribute to fiscal reconstruction at the macro level (the national or regional level) as well.

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