

**FUJITSU RESEARCH INSTITUTE
ECONOMIC RESEARCH CENTER**

1-16-1-11F Kaigan, Minato-ku

TOKYO 105-0022, Japan

Phone: +81 3 5401 8392

Fax: +81 3 5401 8438

schulz@fri.fujitsu.com

Dr. Martin Schulz

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**Sustainable Structural Reform of
Public Finance and Services:
Is Decentralization a Remedy?**

Martin Schulz, Senior Economist

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Decentralization and Public Finance

Martin Schulz, FRI

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1 Summary

The “Koizumi” reform plans for a sustainable revival of public finances do not only call for fiscal reform and austerity, they also ask for a general reorganization of public (financial) control by means of decentralization and local consolidation.

Ideally, and in strong contrast to the current situation, by means of decentralization local municipalities and entities would become largely independent from central government transfers, and would control public works and services in line with preferences of local taxpayers. Consequently, decentralization would not only relieve the strained national government’s finances, it would also reduce the shortcomings of centralized planning.

Unfortunately, however, the recent plans of financial restructuring and decentralization will rather result in the opposite. They focus on short-term financial gains by placing too much hope in economies of scale, and by ignoring the fact that decentralization can provide welfare gains only if local potentials and capacities are build up carefully.

As earlier examples for decentralization by means of local consolidation in Europe will demonstrate, the likely results of such policies (motivated by fiscal stress) are a higher degree of centralization, poor local control, and huge local debts. An example is the rather decentralized federal state of Germany, which unintentionally turned its independent municipalities and states into dependent, debt ridden, administrative units by not carefully separating political (income equilibration) and economic issues (efficiency) during its subsequent reform steps.

Building on these experiences, a better-sequenced approach to financial reform and decentralization will be proposed.

2 Introduction

Japan's system of public finance is currently under reform. Public debt, which was already regarded as too high in the mid-80s, exploded during the prolonged crisis of the 90s well beyond 130% of GDP today. This level easily marks a record for all OECD countries, and will require increasing public incomes to cover future credit service. To make things worse, most of the other uses of public finance – especially public works and services – seem not to satisfy the Japanese public anymore.

Starting from the cities, public support for the current system of public finance and centralized planning seems therefore to have broken down in the countryside and smaller communities as well. Indicating this change, local chapters of the ruling LDP overwhelmingly voted for the outsider Junichiro Koizumi although (or because) he promised to not only cut the general budget and fresh credit demand, but also to reduce public works transfers to the communities. Similarly, during the upper-house election in 2001, the ruling coalition was only able to secure a majority by promising significant changes in terms of fiscal austerity, bureaucratic reform, and overall decentralization under the Koizumi cabinet.

Such structural reforms of public finance will surely produce high social and dead loss costs at least in the short run – as the Koizumi government has already warned. Voters, however, after experiencing a decade-long crisis, seem to prefer facing the costs of restructuring now, rather than going on waiting for the success of “the old ways” of centralized planned debt finance. Given the difficulties from the supply and demand side of public finance and services, and the currently high esteem of reform in the Japanese, it seems therefore to be fortunate that the reform plans try to crack the two nuts of public finance and selection of public works at the same time, instead of concentrating on the consolidation of public finance only, while producing externalities and avoidable hardships for local finance and necessary public works.

But after a first leap of success, “painful” reforms with untested future payouts will be only able to secure continuous support if they are sufficiently clear, trans-

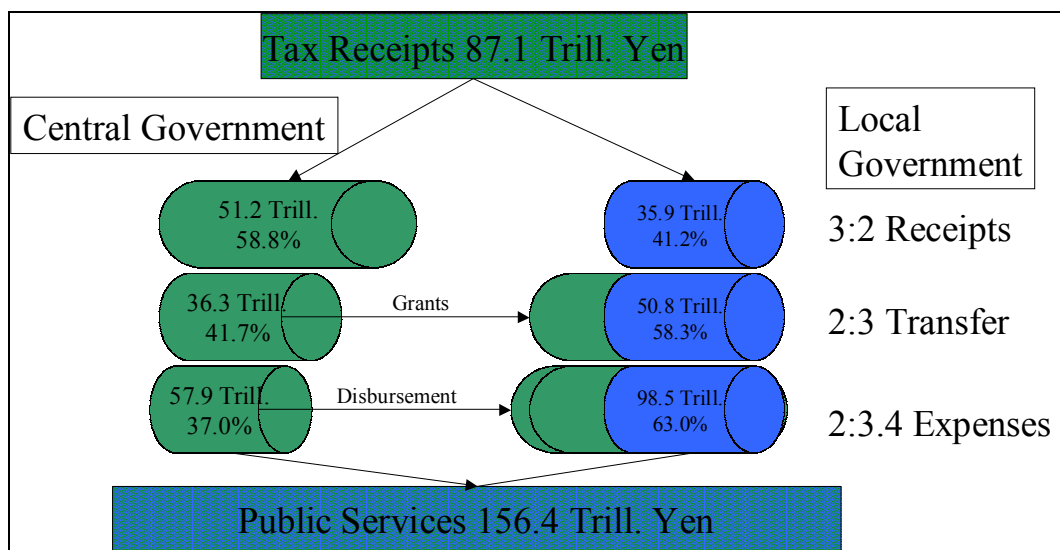
parent, and their construction promises positive results even after conditions deteriorate somewhat. Unfortunately, closer analysis will show that the current plans for fiscal reform and decentralization do not seem to be up to the requirements, as the following sections will show.

Section 3 provides a short overview of current problems of public finance in Japan. Section 4 outlines current theories and empirical studies on devolution and fiscal decentralization for hindsight to a successful solution. Sections 5 and 6 contrast this textbook knowledge with a review of the current reform plans to evaluate their prospects. Because the results of this analysis are rather negative, sections 7 and 8 will provide some comparison with the results of earlier “decentralization” approaches in Europe. Particularly the case of Germany, a country that severely targeted decentralization but ended up with a rather high level of centralization because of misguided fiscal and political reforms, is found to be useful to avoid similar failures in Japan. Section 9 will conclude and provide some recommendations for improvement.

3 The Problem of Local Public Finance in Japan

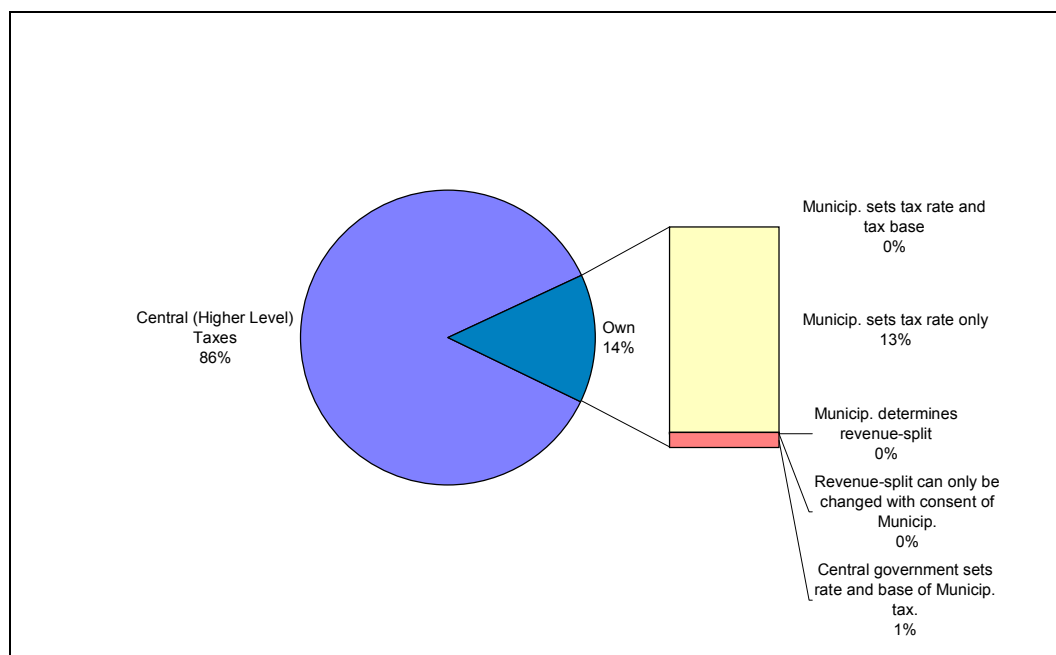
The current fiscal system concentrates governmental incomes at the central ministries, but allows local governments to spend most of public funds. As can be seen in Figure 1, local governments raise only about 40% of all tax receipts locally, but spend more than 60% of all expenditures. The difference is made up by the central government through transfers of the Local Allocation Tax and various other means.

Figure 1 Public Tax Receipts and Expenditure Transfer (1998)



Source: Ministry of Public Management, Home Affairs, Post and Telecommunications (2001).

The actual setup of responsibilities for incomes and expenditures is even more extreme. Even within the limits of their taxes and charges local governments are rarely free to decide about the scale and scope of their revenues. Most taxes are shared taxes, and if they are not, the base and rates of taxes and charges are usually set or regulated by norms. Figure 2 shows that the Municipalities only command 14% of all taxes, i.e. they are not allowed to choose and define the own tax base for most of their incomes.

Figure 2 Municipality Tax Share by Type of “Autonomy” (1995)

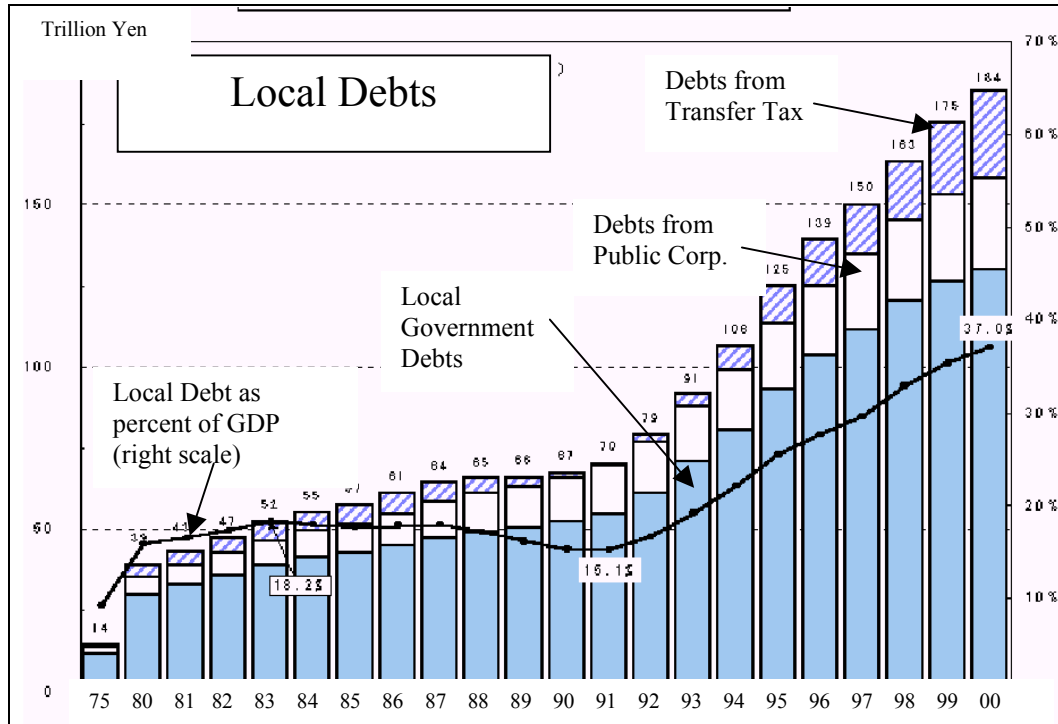
Source: © FRI 2001. Data from OECD (1999).

The local governments are only directly accountable for this 14% of tax incomes. On the expenditure side, at the same time, they do not only spend the aforementioned 60% of all government disbursements, they also command more than five times (about 550% in 1997) the amount of the central governments' capital expenditures (see Hanai, Kiyohito / Tajika, Eiji / Yui, Yui 2000). This separation of finance and production of public works and services does not only degenerate transparency and accountability, it also invites free-rider behavior at the municipalities.

To limit such possibilities within the current system, the center provides strict regulations on the amount, as well as the means, quality, and goals of local public works and services - although the major share of central grants and transfers is not directly allocated by the central government. As a consequence, local governments rarely try to adjust public works in line with local preferences. Instead, encouraged through a system of tax allocation that targets national equalization and support for the needy, municipalities seem to concentrate on the maximization of the overall amount of public transfers into their coffers. The results are high debt rates not

only at the center but also at the local communities (see Figure 3), and unsatisfactory public works with minuscule or negative returns.

Figure 3 Structure of Local Debts



Source: Ministry of Public Management, Home Affairs, Post and Telecommunications (2001).

Unfortunately, the accumulated high debt rates of Figure 3 will not only cause problems at some future date when repayment becomes urgent. Already today, it has become virtually impossible to substantially cut the grants and transfers to the local communities. Many local governments – due to long-term commitments and/or financing inabilities – would surely end up deep in the red with bankrupt and ineffective public projects, high unemployment and social unrest. Through the system of public guarantees, the center would then be required to bail out the communities with probably much inferior results compared to the former transfer system. Also, and not at least, the underlying idea of (largely) equivalent living conditions all over Japan would have to be sacrificed to a probably quite uneven development of local debts and incomes.

4 The Logic of Decentralization and the Role of Local Governments

Especially the Committee for the Promotion of Decentralization, but in the meantime also the Council on Economic and Fiscal Policies' Subcommittee for Fiscal Reform, have promoted the idea that the consolidation of public finance and works is best served by fiscally self-sufficient local entities. Such entities would become largely independent from central government transfers, and could control volume and quality of public works in line with the preferences of local taxpayers, lenders, and the recipients of public works and services.

Standard arguments in favor of decentralized governments claim that decentralized governments are better informed about the needs of individuals, and more responsive to their needs. Young (1988), for example, analyzed the local governmental role as central to representative democracies because it promotes pluralism, participation, and public choice. Recently, even the Council of Europe (1995) adopted a strong stance in favor of decentralization, and argued for the vital role of local governments:

1. They provide additional opportunities for voting.
2. They confer upon citizens other participatory rights, including pressure group activities.
3. Local government politicians tend to be more fully representative of the population than is central government, particularly in terms of the proportion of women holding political office.
4. They act as a training school for democracy.
5. They extend the instrumental concept of the individual consumer into a developmental concept of citizen in a wider community so that voting is not simply an expression of self-interest.
6. Local government represents subnational communities as territorial collectivities, for example, in the field of local economic development, and so provides a

counter to the supposed tendency for the nation state to be captured by producer interests.

7. Local communities are able to resolve their internal conflicts for themselves without recourse to central government, so enhancing the political stability of the nation state.

8. Decentralization is also likely to produce more diverse and innovative policies and ways of dealing with particular issues, piloted first at the locality. Mistakes at local level will be of lesser impact than those resulting from decisions of national government.

It is clear, however, that these arguments for decentralization are overwhelmingly based on political considerations that will most likely yield positive effects on economic issues (like full consumer sovereignty) only in the very long run. But they can easily be backed up by pure economic arguments as well. Economically, most arguments for stronger local governments follow the general lines of the liberal market model: smaller, less regulated units (in a perfect world the free individual) will produce better results in terms of allocation, or efficiency of supply and demand equilibration.

For the production of unavoidable public goods and services a local government is therefore better suited than a central government because local citizens have better control and discretion by directly voting on different tax/benefit packages during elections and polls, or by migrating to better fitting locations and package offers. Most prominently, arguing from the allocation function of local governments, Oates' decentralization theorem (Oates 1972) proposes local communities, shaped in a way that preferences vary little within localities but strongly between them.

Beyond this demand side considerations, however, economic efficiency is also bound by production costs from the supply side. Economies of scale, for example, work against an (small) optimum size of local governments as defined by local

preferences.¹ When accounting for economies of scale arguments, the optimum local size can be defined as the size where the losses from the inability to respond to local preferences equal the gains from economies of scale (marginal social cost equals benefit). Unfortunately, however, the difficulty to define this optimum is linked at least as much to the problems of measurement, as they depend on the closer specifications of the highly axiomatic theorems. Oates theorem, for example, requires identical preferences and low information asymmetries within a region, while economies of scale require highly standardized output and clearly definable output and costs.²

As a result, weighing the costs and benefits of decentralization requires careful empirical and historical considerations even if they ignore more complex political effects and focus on economic efficiencies only. The ambiguous results of recent empirical studies on the impact of fiscal decentralization support this theoretical result.

- Oates (1995), for example, claims that his empirical research for a group of 40 countries yielded a statistically significant and robust positive correlation between a measure of fiscal decentralization (sub-national government's share of public expenditures) and per capita economic growth. He also claimed to have found a statistically significant positive relationship between the change of a measure of self-reliance of sub-national governments (own revenues of sub-national governments as a share of total revenues) and per capita economic growth. This would indicate that a movement toward greater self-reliance of sub-national governments promotes economic performance.
- Thiessen (2000), in contrast, finds a positive correlation between per capita economic growth and its production function determinants (capital formation

¹ For further critique of Oates decentralization theorem, see Bailey 1999, p.21f.

² When measuring costs and benefits, Boyne (1995), for example, uses bivariate correlations between population size and service costs of local governments. He finds that per capita costs of service rise with population size. He also admits, however, that "there is, as yet, no useful evidence on the key questions concerning economies of scale (Boyne 1995, p. 220)."

and total factor productivity growth), and indicators of fiscal decentralization only for mid-income countries. His analysis suggests for high-income countries (in his study, Western European countries) a hump-shaped relation. This is because he claims that fiscal decentralization is indeed effective with respect to efficient public investment (in educational institutions, roads, utilities etc.), but becomes less important when major infrastructure projects are already completed at a latter stage of development.³ Diminishing returns on fiscal decentralization will therefore set in from a certain middle-income level and will deteriorate the positive correlation between fiscal decentralization and economic growth. In general, however, he agrees that there is a clear-cut trend for higher developed countries to be more fiscally decentralized, and that the only argument to limit the degree of fiscal decentralization in these countries is a relatively large income differential between households and regions that would emerge in the absence of redistributive policy, which can only be provided by centralized finance.

To sum up, the following factors relevant for Japan can be isolated from the empirical results of studies on the determinants of fiscal decentralization (see Panizza 1999 and Thiessen 2000):

- The lower the quality of central and local governments on either level, the less attractive becomes fiscal decentralization. Low quality and limited experience of local democracy will further reduce possible results and produce high training costs.

³ For low income countries, a bias to centralization can be explained by the high fixed costs to run the subnational administrations and control them. In low-income countries these fixed costs may consume a share of the total funds administered by subnational governments that is considered too large to justify decentralization (Prud'homme 1995). This point of a positive correlation between the income level and fiscal decentralization has also been made by Bahl and Linn (1992). The authors argue in favor of a high threshold of economic development at which fiscal decentralization becomes attractive. It can be explained not only with fixed costs of decentralization but also with the fact that at a relatively low per capita income level, the demands for public goods and services may be concentrated on very few goods and have a small variance (see Thiessen 2000).

- The higher income differentials between households and regions are, the more important becomes redistributive policy, which can be effectively implemented only by the central government.
- If, on the other hand, the differences in income and structure of tax bases between the communities are not regarded as too high, a diversified tax base in the regions and communities makes decentralization more attractive.
- The smaller the differences in preferences a country tends to be, the lower are the potential gains from decentralization.
- The more private markets are developed and accepted by the public, the less goods and services have to be supplied by local governments.

Judging from these results,⁴ the historically developed high administrative centralization, and low quality and limited experience of local democracy in Japan will surely produce high initial costs of decentralization. The high degree of income differentials and tax base differentiation between the regions, together with the currently strong emphasis on income equalization, will further diminish the incentives for extensive decentralization. The differences in preferences are more difficult to judge. Japan is geographically very diverse, the distances are long, and there are remarkable differences in local culture, not to mention the huge differences in lifestyles between major cities like Tokyo and the remote countryside. Ethnically, however, Japan remains to be quite homogenous, and communities in the countryside have a long tradition of preference adaptation to developments and fashions in Tokyo. Current dissatisfaction with the system of public works clearly asks for more decentralization to improve the results. The same improvements might be achieved, however, by enforcing another current trend: the privatization of many currently public goods and services.

⁴ For results in Asian economies, see Sato, Motohiro / Yamashige, Shinji (2000).

In the long run, however, the economic case for decentralization in Japan looks much more positive than the former results imply. The quoted empirical studies all show a clear correlation between decentralization and economic development, even if decentralization cannot always be regarded as a means to produce higher growth. The background of this finding most likely is, that decentralization can be regarded as a long-run overall development strategy for highly centralized nations. In a Rostow-type stage-concept of development, for example, decentralization would follow the earlier concentration of resources at the national level and in huge conglomerates after market sophistication, income, and skills have reached a certain level to advance to the next stage. Decentralization then follows the need to reduce inherent inefficiencies of centrally controlled systems, to facilitate privatization, and – last but not least – to relieve the strained finances of national governments from the earlier infrastructure and capital formation efforts. As such, this type of decentralization can be seen as a supply side strategy of national capacity building and institutional strengthening (Bailey 1999, p. 6).

5 Plans for Decentralization and Financial Reform in Japan

Following these theoretical and empirical considerations, it is small wonder that the Committee for the Promotion of Decentralization stresses the positive long-term prospects of decentralization. The central government, however, has adopted the promotion of decentralization rather for its short-term possibilities of cutting back on the transfers to the local governments, and as a means to actively target the unsatisfactory efficiency and selection of local public projects.

Unfortunately, both goals cannot be reached easily and might not even be compatible. During the current economic situation, public transfers to the regions cannot easily being cut back because of the long-term commitments of the local communities to public projects, and because of the already reached high debt levels of local governments (see section 3, and Figure 3). Almost the same is true for the much more unlikely case of the Committee for the Promotion of Decentralization to hand over major sources of income to the local communities to their discretion. In this case, the center would be left with the costs of an idle bureaucratic machinery for public decision making, regulation, and allocation, while the local governments would have to try to skillfully account and allocate their newly gained funds with almost no experience for doing so.

As a first step to decentralization, the central government therefore decided to target a realignment of municipalities by improving their efficiency: the "mergers of cities, towns and villages are essential to promote the devolution of power" from the national government to local bodies, as prime minister Junichiro Koizumi explained (May 30, 2001). To reach this goal as early as possible, the Council on Economic and Fiscal Policy under the guidance of Prime Minister Koizumi has enforced an earlier special law on municipal consolidation (enacted spring 2000), which promises fiscal incentives for the communities that go ahead before May 2005. The centerpiece of this plan is the geographical consolidation of some 3,200 existing municipalities into a much smaller number somewhere between 1,000 and 300.

Given the ambitious targets of major local restructurings and the underlying interest of cost cutting at the local communities, the local governments were at first fiercely opposed to the plan. In the meantime, however, many local governments have altered their position because the central government promised extensive financial support for communities, which agree to the mergers early and voluntarily. Today, already 1,247 or 38.7% of all 3,224 municipalities and communities are investigating, planning, or considering merger steps (Ministry of Public Management, Home Affairs, Post and Telecommunications (2001a)).⁵

⁵ According to a recent Nihon Keizai Shimbun survey, more than 60% of municipal leaders in Japan are considering mergers with other local governments before May 2005, when the special law on municipal consolidation expires, and almost 20% have already developed concrete plans (Nikkei, March 15, 2001).

6 Problems of the Japanese Decentralization Approach

Given the earlier theoretical considerations (see section 4), the governmental plans for decentralization appear to be much less straightforward than they looked at the first glance. Most importantly, the plans ask for local or regional centralization before an efficient devolution of powers from the center to the municipalities can be considered. Basically, they rather construct the case for “local centralization” than for “center decentralization,” at least in the short-run. As already mentioned, the basis of this idea is to elevate local communities on a higher level of efficiency by exploiting economies of scope and scale, and by internalizing more externalities by extending the limited tax and service basis of the communities. In central governments’ thinking this concept solves two problems at the same time: by increasing the efficiency of production of public services at the communities, even reduced levels of public spending will become sufficient to keep up supply, the new equilibrium of (decentralized) efficient powers can be reached with much less reduction of bureaucracy and cost cutting at the center.

In contrast to the possible long-run gains from decentralization, however, these plans are heavily influenced by short-run efficiency considerations and their goal seems to be a cutting of costs as early as possible. The concept therefore invites critique from all three levels of policy analysis:

- First, theoretically, the concept remains questionable because it intends to replace center-to-local centralization by local-to-local centralization, and by local-to-citizen centralization. Even in economic terms, the final result in terms overall centralization or citizen sovereignty remains indefinite as long as it cannot be shown that the marginal costs of control of a centralized body are increasing to the center, while the economies of scale are increasing from an individual producer to some regional level, but are decreasing from that level to the center. Furthermore, and probably most importantly, the entire concept focuses on immediate cost-efficiencies, instead of the important political and development implications of section 4.

- Second, empirically, the proposed gains from economies of scale at the future rather evenly shaped municipalities of about 300,000 inhabitants (as in the plan of only 300 local governments) are yet unproven, and the disadvantages of enforced centralization have yet not been weighed against it (see the empirical studies in section 4). Given the current bad shape of local finance, the promised incentives for local centralization will most likely induce local governments to seek community mergers, even if considerations of local efficiency and welfare optima would recommend otherwise.
- Third, historically, similar attempts in Europe seem to have brought some gains in terms of economies of scale in public services like waste management and schooling to the communities. They were, however, heavily criticized for their negative impact on consumer sovereignty, for results of poor local control in the historically diverse municipalities, and the strong trend of overall centralization, which developed in these projects of “decentralization” (see section 7).

This skepticism about the trend of current “decentralization” plans becomes stronger when evaluating the already implemented public reform steps. Especially the administrative reorganization that took effect on Jan. 6 created two new bureaucratic giants which do not look inviting to effective devolution steps. Although the reorganization of the ministries might have been an important step to increase efficiency and democratic control by passing some more power to the cabinet, such mergers are a bad start as far as regional devolution and decentralization of public works and services is concerned:

- The Ministry of Land, Infrastructure and Transport - the product of a four-way merger – now employs about 70,000 bureaucrats in bureaus inherited virtually intact from the three ministries and the agency that have been put under the same administrative roof. Controlling 80% of total public works spending, it is hard to see how this gargantuan ministry could develop a taste for decentralization and consolidation of public works.

- The Ministry of Public Management, Home Affairs, Posts and Telecommunications is the other giant directly in charge with the affairs of local communities. Among others, it succeeds the Home Affairs Ministry, which supervises local finances, and the Posts and Telecommunications Ministry, which alone had 280,000 employees and 360 trillion yen in postal savings and insurance funds. Problematic about this combination is that the rather uncontrolled use of the former Posts Ministry's enormous funds has been used to finance the massive public outlays that have driven government finances into the current dangerous situation during the past decade. In combination with the pending reorganization of the local governments on the verge of bankruptcy, the new ministry may be tempted to use the deep pool of postal savings for bailouts of its discretion. Such a policy would rather deteriorate instead of consolidate and improve the uses of public funds.

Another more long run and policy related aspect of local centralization is problematic in Japan. Given the long-standing tradition of functional (political and fiscal) centralization in combination with regionally rather diverse and politically inexperienced local communities, it is highly questionable if a new (intermediate) local level of consolidated municipalities with about 300,000 inhabitants will provide more accepted opportunities for participation by citizens. To be effective, local citizens need to develop an interest in controlling the upgraded but more distant and professional local governments. Instead, people might still focus on developments in their immediate neighborhood (because of experience and tradition) and on central government policy (because of media coverage and tradition). If so, they will feel alienated from the new level of local government, which – in turn – easily falls victim to the centralized political system (parties), and/or to well-organized local interest groups and lobbies. In such a case, the local centralization would lead to corruption and mismanagement instead of the development of a vital training ground for running a diversified democratic system.

It is still rather difficult to size up the most likely results of the current reform plans in empirical terms because there are still few examples for decentralization

in Japan. The following sections will therefore have a closer look at earlier decentralization projects in Europe.

7 “Decentralization” Experiences in Europe

During the 70s, Europe experienced a huge wave of territorial reforms and local consolidations. At the time public demands for improved and more diversified public services from social security to education and environmental enhancement met strained central government budgets from the earlier development of central infrastructures like highways. The central administrations therefore turned to the local governments to make them more efficient and responsible for the task. Unlike earlier more politically motivated moves to decentralization (to disintegrate absolutist or authoritarian structures), this process of “decentralization” clearly focused on the economic “allocation” function of local governments.

More far-reaching reforms like the devolution of governmental distribution, regulatory, or stabilization functions were also discussed, but disregarded as inappropriate because of their unwanted national distributional or migration effects. A further disincentive for “true” devolution beyond territorial reforms was the risk of local fiscal failures during a phase of a fast development of infrastructure and social capital. Finally, during the process, even this focus on the allocation function of local governments, which usually includes arguments of enhanced consumer sovereignty, deteriorated into quite limited considerations of economies of scale from the production of local public goods and services.

As in Japan today, the European way to decentralization and efficiency therefore started with “local centralization” (see Rosenfeld 1987). Table 1, for example, demonstrates that many countries reduced the numbers of their local governments by more than 60%. Even after the reforms, however, 6 of the 14 countries in Table 1 remained with more than half of their local communities inhabited by fewer than 1000 inhabitants, and more than half of the countries kept more than half of their communities smaller than 5000 citizens. The result of the reforms in most countries remained therefore remarkably below the goals of the current plans in Japan.

Table 1 Size, Number, and Change of Local Authorities Between 1950 and 1992

	Average Population Size 1990	Less than 5000 Inhabi- tants (%)	Total Number 1992	Change of Num- ber from 1950 (%)
Austria	3340	91.5	2301	-42
Belgium	16960	17.3	589	-78
Denmark	18760	7.0	275	-80
Finland	10870	49.5	460	-16
France	1580	95.2	3673	-5
W. Germany	4925	84	8077	-67
Italy	7130	72.9	8100	+4
Netherlands	23200	13.0	647	-36
Norway	9000	56.3	439	-41
Portugal	32300	8.5	305	+0.7
Spain	4930	86.2	8082	-12
Sweden	30040	3.1	286	-87
Swiss	2210	91.0	3021	-2
UK	118440	-	484	-76

Source: Council of Europe (1995a).

To pick one example, the German counties (Kreise) and communities (Gemeinden) were drastically reduced in the 70s. Here, as elsewhere, the background of the territorial reforms had been the will to “decentralize” to improve the efficiency of public “functions” and the overall maximization of economic welfare. During the process, however, shifting competence (the ability to perform functions) from the state (Länder) level to a lower level did not develop into full-fledged overall decentralization, however. Rather, the territorial centralization ended up as another step to overall centralization.

As already mentioned, the reason for this adverse result was the focus of the territorial reforms on cost-efficiency considerations. The broader concept of consumer sovereignty and the overall maximization of private welfare according to personal preferences only played a rather academic role at the time. Focal points in Germany’s regional centralization strategy, for example, were public services like waste disposal and schooling. The concentration was thought to reduce costs, and therefore improve local living standards and financial independence. But even within this limited focus of reforms on the allocation function, the efficiency con-

siderations for the production of public goods and services became dominated by a stance to reduce conversation costs by minimizing conflicts between the communities (horizontally), and between the communities and the newly structured counties (vertically; see Rosenfeld 1987). The functional reform therefore transformed many horizontal conflicts (between local units) into vertical conflicts or centralization, which often had to be absorbed by higher financial transfers (and dependency) from the center (Naschold 1978).

Concluding the results of studies on "communal territorial reforms" (focusing on Lower Saxony) in the 70s, which finally culminated in a series of 19 volumes, Engelhardt/Brockmann/Rosenfeld/Thiede (1986) for example show that the functional reforms tended to increase centralization. Due to the installation of new counties and community mergers, functions and expenditures became increasingly more concentrated at higher levels of administration (in Germany, this functional trend became much earlier coined "Popitz Law of the pull of superordinate budgets").⁶ The local concentration also increased the distance between decision-making administrations (and politicians) and local citizens (see p. 194-196).

As a result, the citizens of the communities were left rather alienated. Today, it has therefore become increasingly difficult to implement further territorial reforms, even if they are said to make economic sense. The planned amalgamation of Berlin and Brandenburg, for example, was refused by the Brandenburg voters (63.4% against) at a referendum held on 5 May 1996.

Similar experiences in other European countries led the Congress of Local and Regional Authorities of Europe (CLRAE - a part of the Council of Europe) to adopt an approach of great caution for the European Charter of Regional Self-

⁶ In Europe, central governments also tend to keep a firm grip on local debts. As a general rule, central government is responsible for over 80% - usually more than 90% - of government debt (see Figure 14 in the appendix). Two countries are exceptions to this rule: Luxembourg and Norway, where local government is responsible for 35% and 32% of total debt (but these countries are exceptional cases, considering their low level of indebtedness).

Government (ECSRSG), which rules out another try for far-reaching regional reforms alongside with European integration:

“It is more costly to have another tier of self-government alongside the local authorities. In this respect, it should be emphasised that the region must not form an additional bureaucratic agency; its proper function is as an additional service (subsidiary to the local authorities) provided for the citizens” (CLRAE 1999).

In general, the Congress’s fourth report on political monitoring of the implementation of the European Charter of Regional Self-Government (ECSRSG) highlighted the following shortcomings of centralized structures and earlier (de-)centralization attempts, which block local sovereignty in Europe:

- the limited proportion of revenue raised by genuine local taxation for which local authorities can set the rates: local authorities can boast a proportion of own resources equal to or greater than 50% of their total financial resources in only 8 Council of Europe member states;
- the trend towards fewer exclusive or joint local taxes and the tendency of central or regional authorities to replace these by transferred resources or shared taxation revenue, which, although they are not transfers as such, cannot be independently decided by the authorities receiving them;
- the predominant role now played by transfers as opposed to own resources, which, in some countries, is exacerbated by the major role played by earmarked as opposed to general grants;
- the relative lack of productivity of the taxes which local authorities are entitled to levy (land and property taxes continue to predominate, while taxes on economic activity are constantly being reduced in the name of free competition);
- a certain degree of confusion between the functions of funding local budgets, compensating for transferred responsibilities and ensuring financial equalisation;

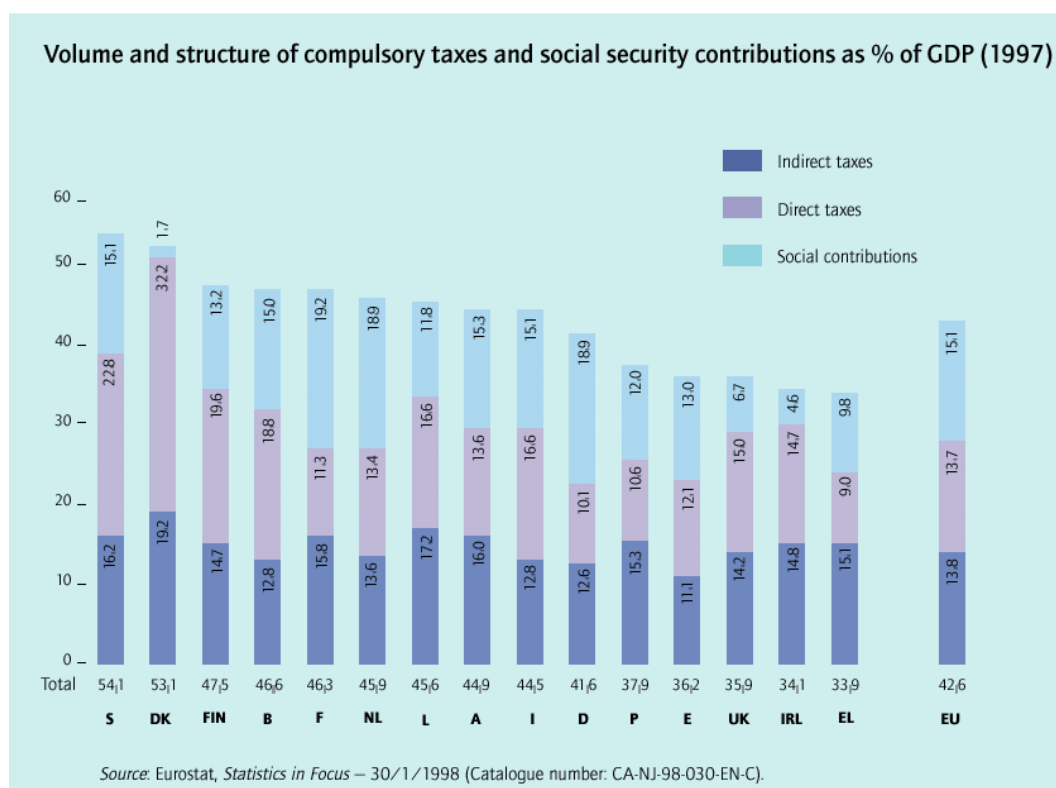
- the lack, in some countries, of established criteria governing the methods and objectives of financial equalisation, and the discretionary powers enjoyed by some central or regional authorities in this area;
- the instability and precariousness of the sources of local authority funding, together with the relatively limited use of capital raising by local authorities and the opportunity this gives to central government to continue exercising some form of supervision;
- the monitoring of local authorities' budgets by central or regional authorities, sometimes disguising prior supervision of the expediency of local authority decisions, in breach of the Charter;
- the consequences of national economic problems for local self-government, particularly in those countries obliged to adhere to the constraints imposed by implementation of the Maastricht Treaty budget restrictions. In the EMU, the need for a rigorous budgetary policy is often reflected in greater overall financial stringency, which also affects local authorities and may become increasingly used as a reason for removing their independence or lead to accusations that decentralisation itself is the cause of the increasing public deficit; this problem also exists in certain central and east European countries because the International Monetary Fund is advising greater centralisation of public funds;
- the shortcomings of the procedures for joint funding (central/local authorities) of public works projects.

Background of many of these later complaints and shortcomings of the territorial and functional reforms are the high public costs, which developed along with the reforms during the 70s. Engelhardt/Brockmann/Rosenfeld/Thiede (1986), claim that the reforms led to substantial increases in per capita expenditures of communities. They cannot conclude, however, that this development is the result of a tendency for larger communities to have higher expenditures (in Germany called "Brecht's Law of parallel progressivity of expenditure and population concentration"). It might also be due to the intentionally raising of public goods and services

standards during the seventies. It is clear, however, that the professionalization of politics and administration in the extended communities led to a decline of free voluntary services (see also Poschen 1983).

Still, the relatively high average tax to GDP ratio that we observe in Europe today is to a large extent due to the development in the 1970s when the overall tax burden in the EUR 9 went up by 4.2 percentage points of GDP from 34.4%(1970) to 38.6% of GDP (1979). In the 1980s, after the end of the reforms, the (EUR 15) increase was more moderate (+2.7 percentage points of GDP); moreover, the development was less homogeneous than in the 1970s. In the 1980s four countries (the Benelux countries and Germany) lowered the general tax level while in the decade before all countries apart from the United Kingdom had increased it. Partly owing to strong increases in Germany and Italy the European tax quota again went up more quickly in the early 1990s. In the late 1990s the overall trend of the general tax burden still seems to be pointing upwards. In 1997 the total level of taxation (including compulsory social security contributions) in the European Union increased slightly from 42.4%of GDP to 2.5%. Compared to 1980 the increase was 4.2 percentage points of GDP. In most countries, apart from Italy, the 1997 increases in total taxation were relatively small, i.e. less than one percentage point of GDP. The only countries to decrease the overall tax burden were Finland, Germany and Denmark (European Commission 1999).

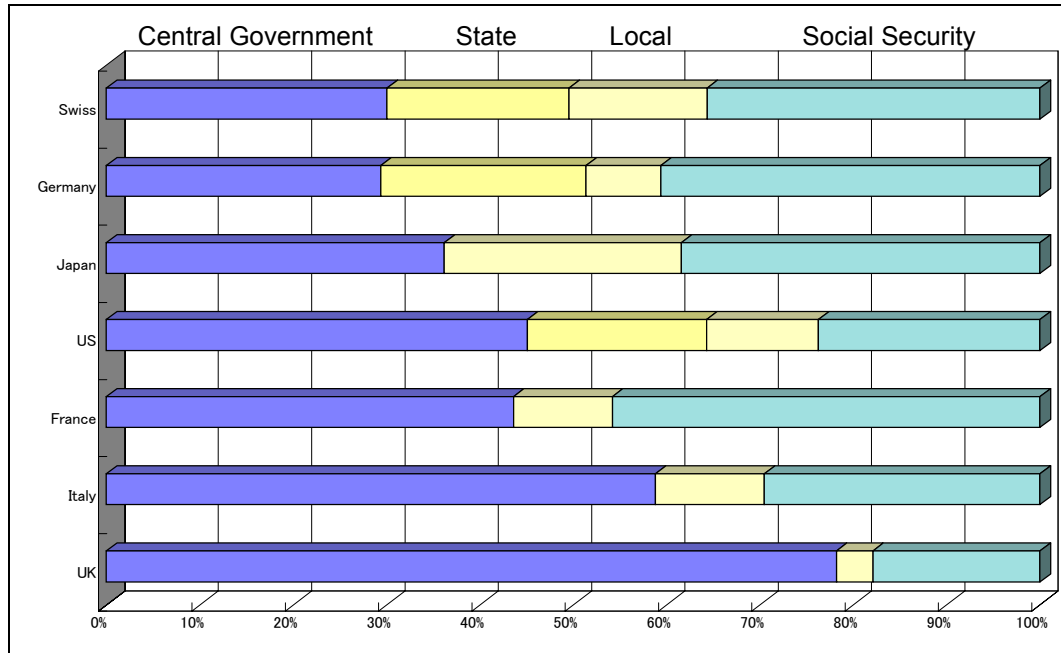
Figure 4 Volume and Structure of Taxes and Social Security in Europe (1997)



Source: EuroStat (1999)

As already mentioned, this development high tax rates and public debts in Europe developed along with the intended expansion of public works and services at the communities. The trend, however, is not related to a common stance to decentralization. On the contrary, European countries cover today almost the entire range from fiscally highly centralized to quite decentralized countries. As can be seen in Figure 5, Swiss and Germany have the lowest share of central government receipts, while Japan is quite close to these seemingly decentralized countries. The UK, on the other hand, seems to be extremely centralized with almost no incomes at the local level.

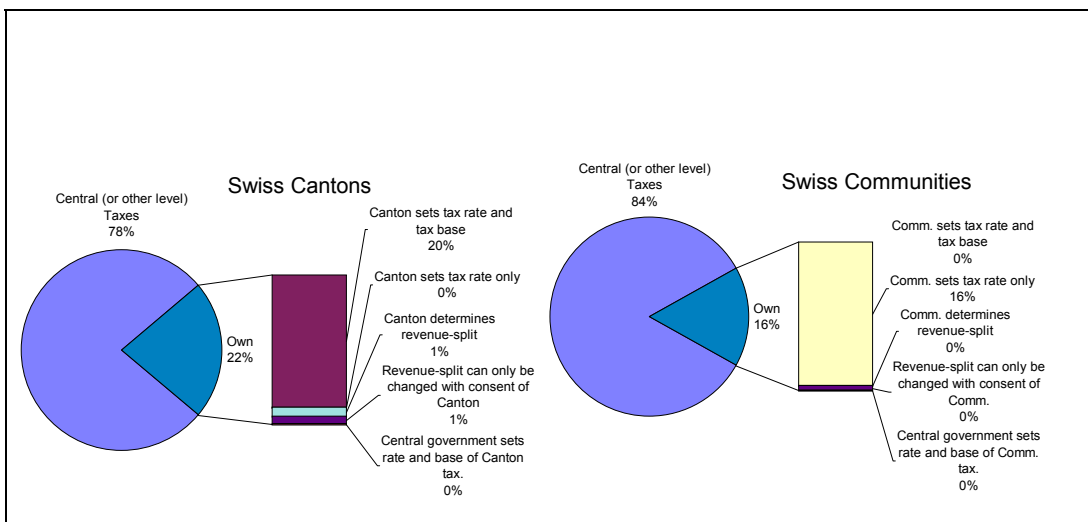
Figure 5 International Comparison of Receipts by Subsector (1996)



Source: OECD (2000).

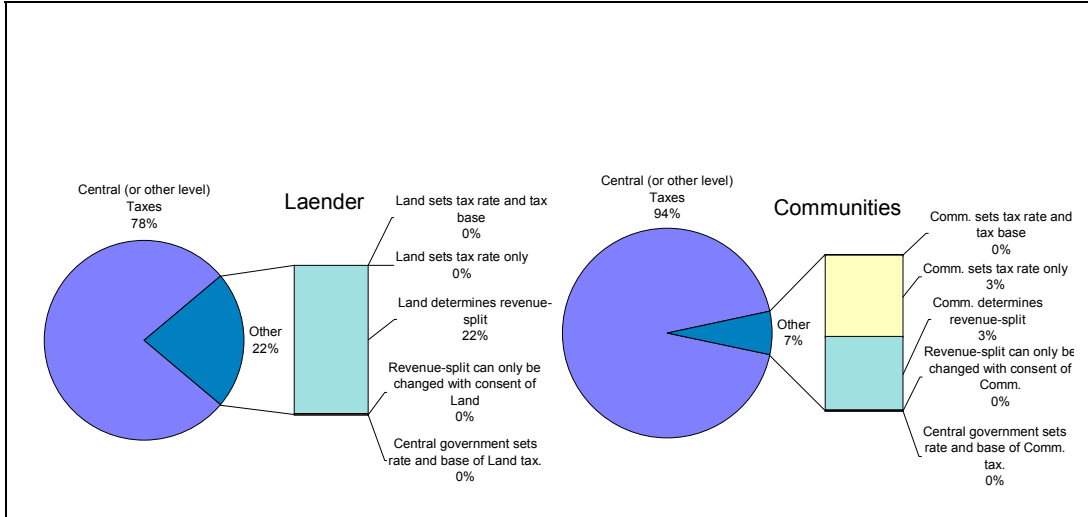
As in Japan, however, these statistics from the Revenue Statistics of OECD do not reveal the true picture of taxing powers and local independence, because most local governments are not free to allocate the money they collect directly. It is therefore important to distinguish between different types of fiscal "autonomy" in terms of income control, as the following figures will do on basis of the "Taxing Powers" data of the OECD (1999).

Figure 6 Swiss Canton and Community Tax Share by Type of "Autonomy" (1996)



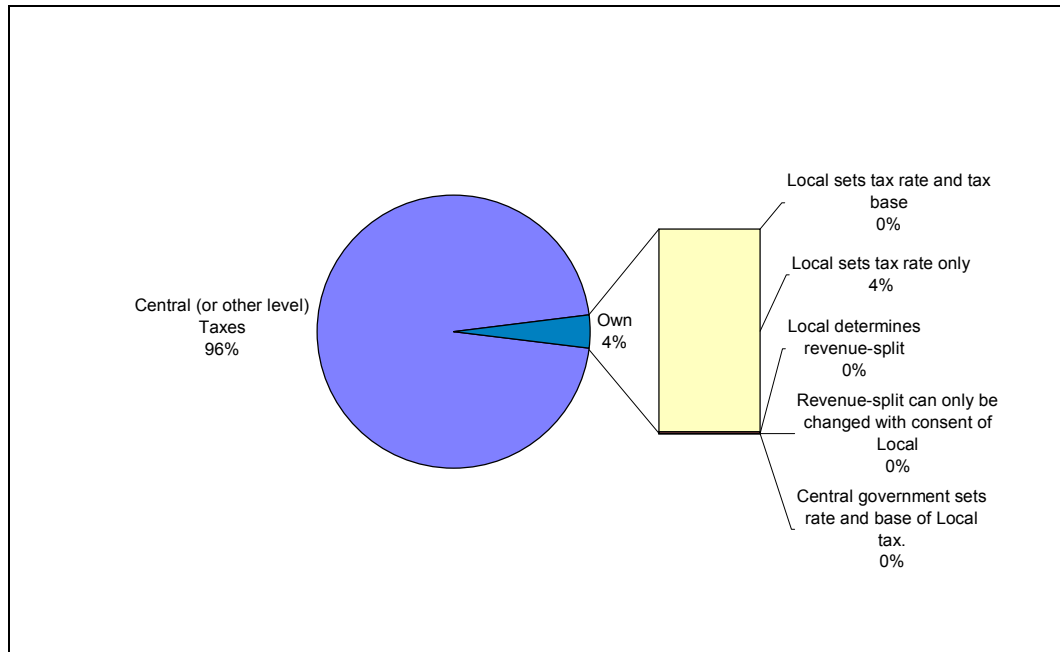
Source: © FRI 2001. Data from OECD (1999).

Figure 7 German Länder and Community Tax Share by Type of “Autonomy” (1995)



Source: © FRI 2001. Data from OECD (1999).

Figure 8 UK Länder and Community Tax Share by Type of “Autonomy” (1995)



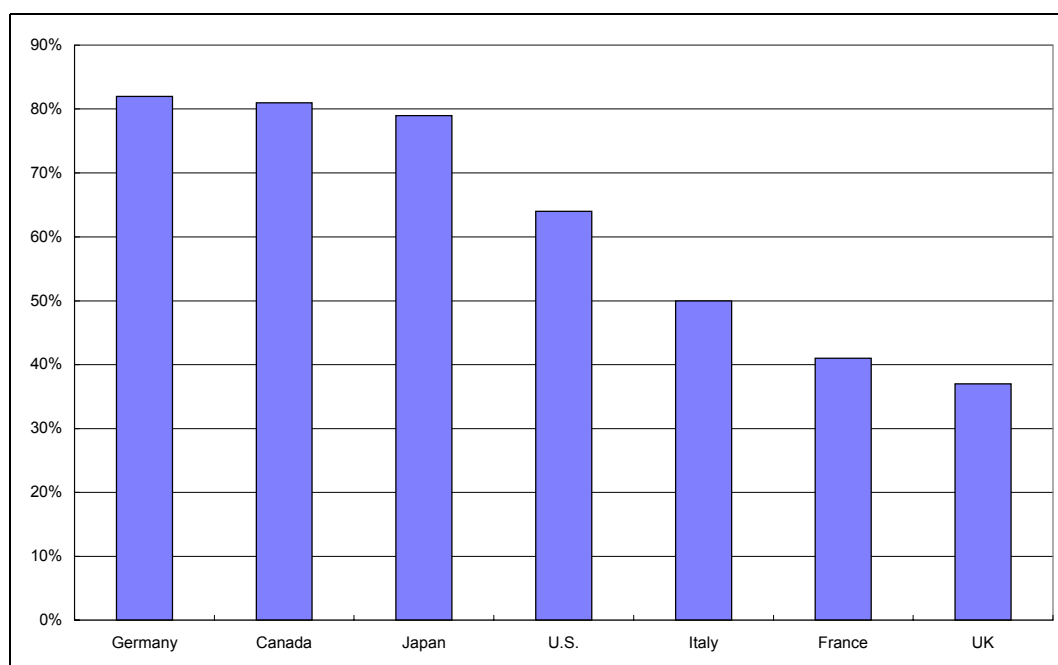
Source: © FRI 2001. Data from OECD (1999).

Judging from the figures, Switzerland is clearly the most decentralized country with 22% and 16% of all taxes under almost full control of the cantons (prefectures) and communities. In Germany only the “Länder” (states) are rather independent with 22% of own taxes, they are, however, much less able to determine

these taxes by themselves because they cannot determine the tax rates or bases. Much more dependent are the communities themselves because they only fully control 7% of their tax incomes. This level of command in seemingly decentralized Germany is even lower than in Japan, where communities control 14% of their own taxes at the local level. The UK, on the other hand, is not only a unitary country as Japan, it is also home to the least independent communities with only 4% of taxes under their control.

As already discussed for the case of Japan (see section 3), almost the reverse is true for expenditures in Japan and Germany (for Germany, see section 8). Both countries allow their local governments to spend about 80% of all government expenditures (not including social security). Canada and the U.S., on the other hand, which also have high expenditure rates at the local communities, make their communities responsible for their expenditures by allowing them to collect a bigger share of taxes by themselves.

Figure 9 International Comparisons of Local Government Expenditures as Percent of Total Government Expenditure (1997)



Source: OECD (1999). These figures do not include social security spending.

These results for the differences between seemingly decentralized structures, and “true” fiscal independency are supported by more detailed studies. Heylen (1987),

for example, finds only slightly differing results. When using the proportion of exclusive and competitive taxation in the total revenue of second-level governments as a measure of the degree of fiscal autonomy for five countries (Australia, Canada, Germany, Swiss, U.S.), he agrees that Switzerland is the most decentralized, and the UK is the most centralized country.⁷ For Germany, however, Heylen had to conclude that it has become one of the most centralized and not decentralized countries in fiscal terms.

To summarize, most territorial and bureaucratic reforms since the 70s rather catered a trend to fiscal centralization and local financial dependency. During the 90s, and especially along with the development of the EMU as a new powerful level of governance, an enforced movement for decentralization and regional independency evolved and became supported by the European Council. This time, however, the reforms intentionally do not target territorial reforms or local centralization, but transfers of more political power and own resources to the regions and communities.

As an example of what went wrong with the reforms in many European countries, the following section will present the case of the Federal Republic of Germany, which even managed to deteriorate from one of the legally most decentralized countries into one of the effectively (especially fiscally) most centralized countries.

⁷ Also in legal terms, because the UK has escaped any drive to decentralization until very recently, its “ultra vires” concept (“beyond powers,” local governments are prohibited to do anything that is not specifically authorized) defines easily the most centralized setup in Western Europe.

8 Adverse Experiences With Incomplete Decentralization in Germany⁸

Of the many examples for decentralization attempts in Europe, the case of Germany is probably the most interesting. As already analyzed in the last section, Germany gathered experience with territorial reforms by planning them as a precondition for “true” local decentralization with a strong emphasis on efficiency and cost-cutting. With this stance Germany is a forerunner to the currently planned reforms in Japan. Even more interestingly, in terms of the long term plans for effective devolution in economics and politics, Germany probably has been even more decentralized than Japan is planning to become, but it (unintentionally) turned into the opposite direction and is now drawing closer to the fiscally centralized situation in Japan. To avoid such failures of financial reform, a closer look at the German example is worthwhile.

After the war, Germany evolved with one of the most decentralized constitutional setups and most pronounced fiscal independencies for its states. Starting from the early 70s, however, the German states and communities gradually lost most of their independence because of some construction failures of the system and especially because of their strong focus on short-run funding requirements and economic efficiencies. A brief analysis of these failures might therefore be worthwhile to avoid the same problems during the decentralization in Japan.

It is easy to see that Germany is legally one of the most decentralized countries in the world. Due to a history of only loosely bound independent states until the last century, and because of extremely bad experiences with strong centralization during WWII, modern Germany developed a structure and constitution, which strongly favors decentralization and local independence.

⁸ Major parts of the legal overview heavily draw on: Congress of Local and Regional Authorities of Europe (1999).

8.1 Legal Local Independence

The position of local authorities in Germany stems from the particular structure of the Federation, which is governed by the principle of subsidiarity. There are three levels of government: the federation, sixteen federal states (Länder) and local authorities (14,808 municipalities and 322 Kreise). In principal, the Länder are completely independent in financial matters; they have their own constitution and enjoy administrative autonomy, particularly on budgetary matters, while being only bound by a duty of loyalty to the Federation. The federal Constitution also defines all local authorities as constituent entities of the Länder, not of the federation.

It follows from these provisions of the Basic Law that in theory, the Federation has no direct connection with the local authorities. Any federal law, which affects the interests of the Länder or their local authorities, requires the approval, ie the consent of the Bundesrat, which is the second house of Parliament and is made up of representatives of the Länder. The federal Constitution thus governs only relations between the Federation and the Länder whereas the constitutions of the Länder deal with relations between the Land and the local authorities and their relations with one another. Accordingly, each Land has its own legislation on the functioning of local authorities, including the funding aspect.

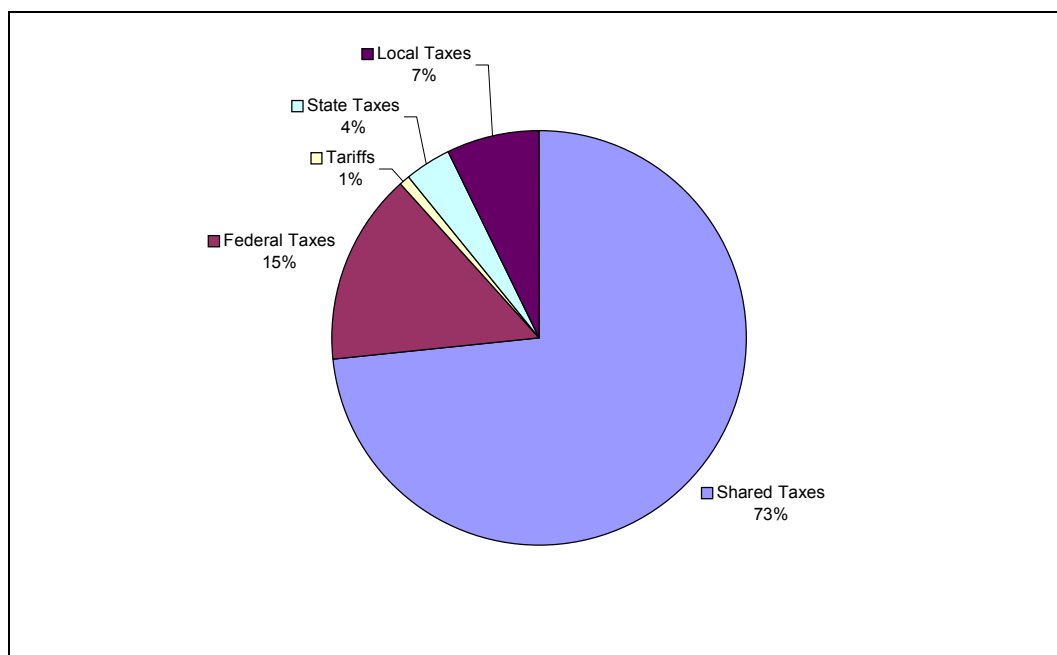
Consequently, the Federation does not even have a local and regional administration and most federal laws are implemented by the Länder, Kreise or municipalities. Furthermore, the Federal Constitution requires the Länder to guarantee in their legislation the autonomy of local authorities (Article 28 and 106). They must grant the municipalities (above and beyond their own administration) attributions in the field of culture, leisure and sport, nursery schools and certain activities in the social field. These tasks are devolved exclusively to local authorities. They may not be transferred to other institutions unless, in accordance with the principle of subsidiarity, a private non-profit making organisation (church, social institution, charity association) wishes to take responsibility for these tasks and is in a position to do so.

The principle of subsidiarity demands that only those functions which cannot be performed correctly and efficiently by a lower authority be transferred to a higher level of government. The underlying premise is that all functions should be performed at the lowest possible level, to ensure that the territory within which a particular activity is exercised corresponds as far as possible to the sphere of political competence of the administrative authority responsible for that activity.

8.2 Financial Structure and Dependence

Not too differently from the situation in Japan, in western Germany the local authorities' own income covers on average just 50% of their expenditure. However, quite differently from Japan, approximately 35% of local authorities' own resources come from charges for public services. As in Japan, a major source of financial dependency stems from transfer payments in the form of general and specific grants from the state or prefecture. In Germany, they contribute to local authority budgets approximately as much as the main local taxes - the business tax and the property tax – i.e. more than 27%. As in Japan, most of these grants are paid in the form of an overall allocation which local authorities are free to use as they wish. Only a very small percentage is awarded in the form of specific grants earmarked for particular purposes. The local authorities are not free, however, to determine their level due to their needs (see also section 12 in the appendix).⁹

⁹ Different cases are delegated powers. For services, which the local authorities carry out for the Länder, the local authority receives grants which very often do not cover expenditure. The authorities in Munich estimate that only 40% of these costs are compensated for by the Land. The association of municipalities reckons that average coverage of expenditure is 50%. The Ministry of the Interior and the Ministry of Finance do their calculations in a different way, controlled by the Auditor-General's Department, and claim that the cost of delegated tasks is covered at 100% if not more.

Figure 10 German Taxes by Type (2000)

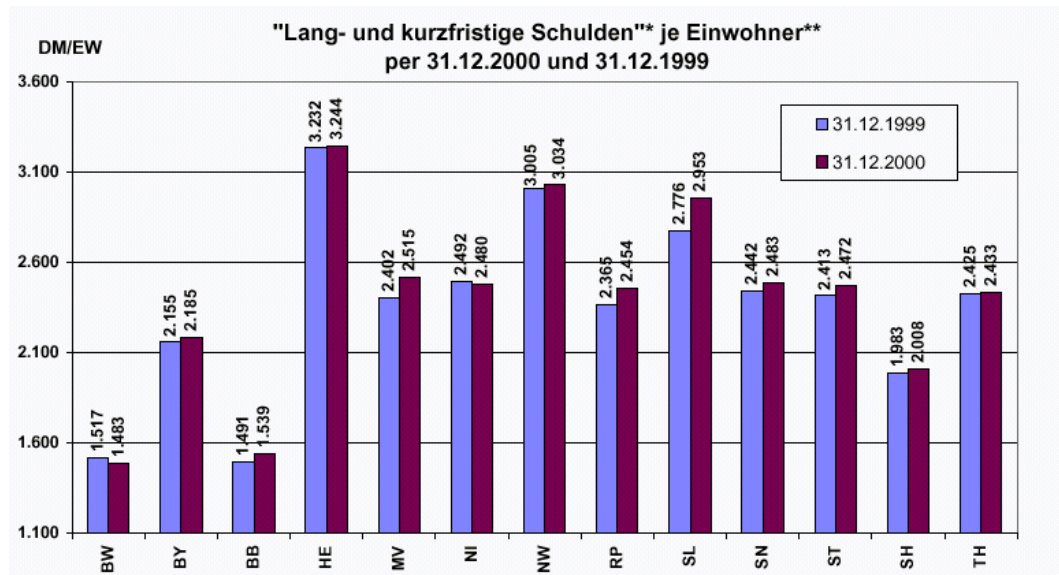
Source: © FRI 2001. Data from Deutscher Städte und Gemeindebund (2000).

8.3 Loans

Local authorities in Germany are allowed to finance part of their expenditure through loans. They are in principle entitled to borrow both from inside and from outside, in which case they are required to open an account with the Bundesbank. Small and medium-sized local authorities borrow mainly from local savings banks. Medium and long-term loans require the agreement of the Interior Minister of the Land concerned, however. To circumvent this regulation, recently, local authorities especially in the Länder of north and east Germany, prone by financial crisis, have started to finance part of their ordinary budget with more or less extensive use of short-term loans - with the tacit agreement of the supervisory authorities. In general, however, due to the danger of local authorities' insolvencies and the necessary bailouts, the Interior Ministry of the Land is exercising de facto if not de jure supervision. Borrowing is allowed only if other means of financing the local budget are unavailable and if the local authority will most likely be able to service the debt through its operating budget. Furthermore, loans are only considered justified if they serve to reorganize the debt or to finance high-yield in-

vestments, provided that the expected yield substantially offsets the investments costs.

Figure 11 German Community Debts per Inhabitant of Länder (1999/2000)



Source: Deutscher Städte und Gemeindebund (2000).

As shown in Figure 11, the level of debts in most communities of the Länder is not very high, yet.¹⁰ The peak of 3,244 Deutsche Mark in Hesse is just one average monthly income.

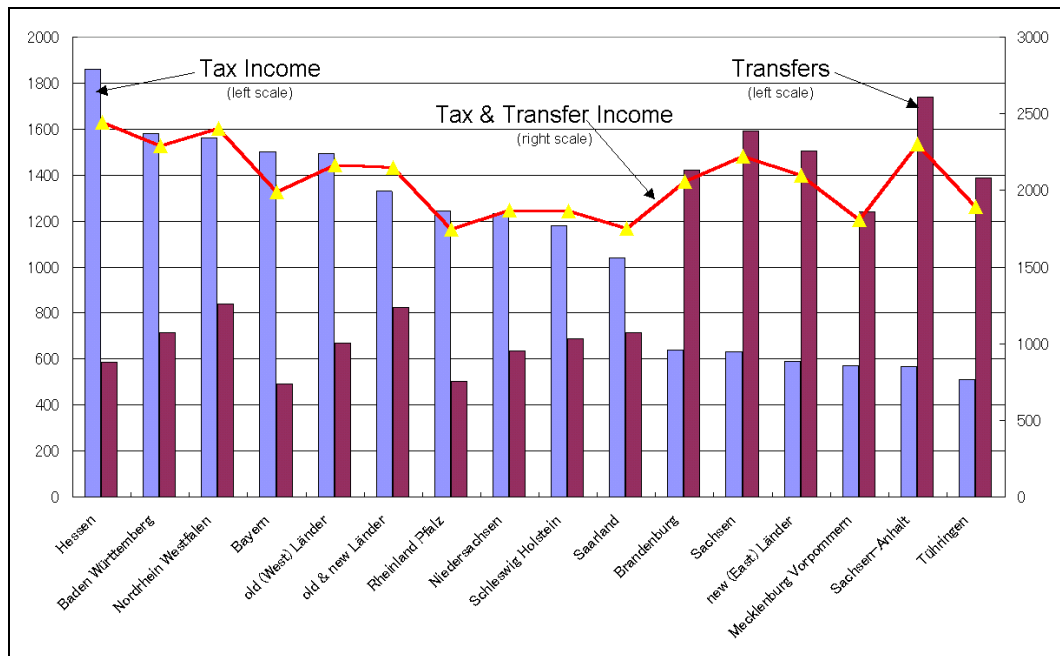
8.4 Inter-State (Horizontal) Financial Equalization

One important and specific aspects of the German fiscal system is the “horizontal equalization” between the Länder. Article 107.2 of German Basic Law requires that the financial powers of the Länder become almost equalized to guarantee equivalent living conditions all over Germany. In contrast to Japan, this horizontal equalization between the states or prefectures is not only implemented by the al-

¹⁰ In two cases of city-states, in Bremen and Berlin (not in the figure), and in the small Saarland (SL in the figure), the state governments themselves have become insolvent once and needed a bailout of the federal government. In the case of Bremen and the Saarland, the constitutional court decided that both countries have to be bailed out because their budget crises were due to exogenous shocks, and not self-inflicted. The current case of the (almost) insolvent capital Berlin, however, seems to be clearly due to mismanagement and free riding in the city. It is therefore yet not clear how the bailout will be handled. During

ready mentioned allocation of VAT from the Federation to the Länder, which not always manages to attain a targeted 90% rate of the average financial capacity for all Länder. By means of a fund financed by the wealthy states for the benefit of the less wealthy, the difference to the overall targeted rate of 95% equalization becomes filled up by direct (horizontal) state-transfers. The system is therefore an additional federal device to the somewhat more centralized system of local allocation taxes in Japan (see also section 12 in the appendix).

Figure 12 German Local Incomes per Head and Equalization Transfers (2000)



Source: © FRI 2001. Data from Deutscher Städte und Gemeinde Bund (2001).

Figure 12 demonstrates that the income equalization between the Länder works very efficiently. In the view of most outside observers and the richer German countries, it even works too efficiently. The extreme equalization leaves only limited incentives for the higher income countries to further improve efficiency and growth, while many low-income countries would even lose when moving to the middle. For this reason (and because of a law suite of Bavaria, one of the richest countries) the German constitutional court decided in November 1999 that the

the last years, Berlin has amassed 65 billion Deutsche Mark, about 20,000 Marks per capita, or ten times more than most other German states.

system has to be changed. The “differences between the Länder are allowed to be reduced, but not to be abandoned or over-compensated,” it ruled.

8.5 Effects of financial dependency

As a consequence of the trend to more shared and less own taxes at the local and Länder level, and as a result of extreme financial equilibration between the Länder and communities, local government autonomy and authority gradually diminished. From the late 60s, Länder governments started to trade authority against higher tax shares or direct contributions from the federal state. A defining development at the time was the high cost of the explosive development of the universities, which were under the unshared legislation of the Länder. The Länder agreed to share responsibility against 50% contributions for the construction of university buildings from the federal state. Unfortunately, the necessary change of the basic law (which made German universities almost unreformable ever after) marked only the start of a series of changes where the federal parliament and the Länder parliaments had a say, but the local communities remained outsiders.

However, from the viewpoint of the Länder governments, the deals did not look bad initially. The states did not only receive the necessary funds, they also kept some voting rights on common issues through the German federal second chamber, the Bundesrat. In the early 50s, for example, Länder governments had voting rights on less than 10% of federal laws. Today, because of shared rights, they have to be asked for agreement on about 60% of federal laws.

Unfortunately, however, the flipside of this development was, that the voting power of the Länder governments on federal laws in the Bundesrat did not cause real participation. The governments only retained the option to reject formulated laws. Furthermore, the Länder parliaments became more and more alienated from the process because only the Länder governments are represented in the Bundesrat, and have a say on federal laws without further consultation of their parliaments. For the local governments, the development became even worse. With the increasing involvement of the federal government as a partner of the Länder gov-

ernments they saw their say and influence diminished step by step. In the meantime, however, even the Länder governments – which joined into or even started the process – feel the drain on real decisive powers. In the five years to May 2000, for example, the NRW parliament only ruled on 97 new rules or regulations, and most of these were of pure technical nature along the lines of earlier laws of the federal parliament, the European parliament, or the European court. In May 2000, only 57% of all voters in this biggest German Land found it therefore worthwhile to participate in the state's election. For comparison, the participation in the federal election was 82%.

With the strongly diminished importance of local governments and the implicit competence shifts to the center, local democracy and participation became completely opaque. To citizens, it became impossible to differentiate between local, state, federal, or European policy, and they increasingly felt unable to decide at what level they might be able to interfere meaningfully and effectively. As a result, the lost public interest in the working of local governments became a clear-cut indicator for the shift of Germany to a rather centralized political and administrative system, which is now often dubbed a “Unitarian Cooperative Federal State.”

The solution to this situation has often been discussed during the last decade, and renewed efforts to return to a more decentralized setup have gained wide support from the public, the German constitutional court, and the European Community. As a result of these discussions, it seems as if more competition for competence at the local and Länder level and a less mixed finance system are at the heart of the problem. However, real reform was impossible until today because not only the federal government is not in favor of giving up the won competences. Also the indebted and weaker Länder fear any drive into the direction of fiscal independency, accountability, and “competitive federalism” (as in Switzerland or the U.S.), as long as they have huge debts in their books and will not be able to finance a competitive administration. Even a recent new agreement on a reformed equalization system (forced by the constitutional court) of June 2001 therefore ended up in

a compromise where the federal state will cover the payment shortfalls from the richer states to the poorer states. Just as before, however, such a financial involvement of the federal government will rather enhance than break the trend of gradual fiscal (and real) centralization.

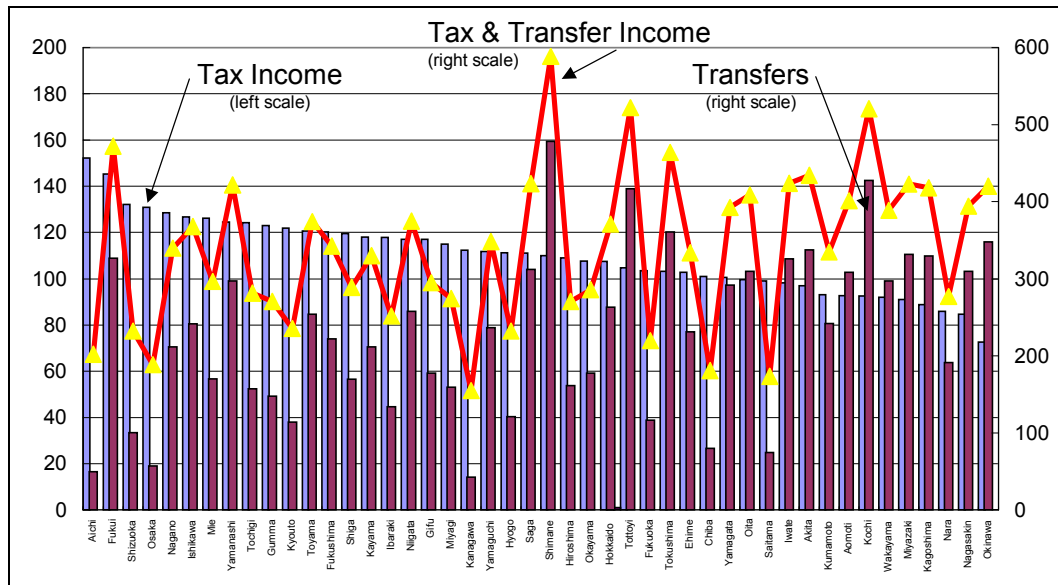
9 European Lessons for Japan

The strong stance for territorial reforms as a means for developing efficiency in Europe has not been very successful. Today, the Congress of Local and Regional Authorities of Europe seems to regard a strict stance to territorial reforms as a failure, and it rather recommends the development of a system of incentives alongside existing and historically grown local structures. To develop such incentive structures, the European Charter of Regional Self-Government basically recommends an early cleanup of high local debt rates (where they exist), the transfer of own sources of income to the local governments, the transfer of full responsibility for expenditures in a wide range of local works and services, and less income-equalization between competing communities.

These recommendations are strongly supported by the case study of Germany in the last section. Germany developed from a rather decentralized federal state into one of the fiscally most centralized states by implementing almost the opposite strategies. Especially the strong focus on economies of scale, short-term gains from local maximization of public transfers, and income equalization at the state-level resulted in these adverse effects, which have become quite difficult to solve today.

In Japan, an even stricter system of regional financial equalization than in any other country in Europe exists. It is highly likely, that any true shift to decentralization in Japan will become impossible or extremely costly without changing this interregional transfer system. Figure 13 demonstrates that the local communities in the prefectures at the lower end of Japan's per capita incomes currently even have disincentives to move up the income ladder because it would reduce their income after receiving the local allocation tax transfers.

Figure 13 Japanese Local Incomes per Head and Equalization Transfers (1999)



Source: © FRI 2001. Data from Soumusho, Statistical Year Book (2000).

Without such incentives for competition, however, the currently quite centralized regional structures will not be overcome by efforts of the local communities to reduce their dependency and to increase their efficiency, as the German case demonstrated.

Another lesson from Europe's experiments with decentralization has to be mentioned here. Few people still regard decentralization as a means of cost cutting or fiscal consolidation. In Europe as well, most countries shared the experience of section 4 that decentralization is hardly a concept of cost cutting and rarely mixes with times of fiscal stress in a positive way. Usually, after the implementation of decentralization, per capita disbursements in the municipalities increase considerably. Real efficiency gains, on the other hand, are most likely of the non-pecuniary type from improvements in the quality of services and local democracies.

Consequently, decentralization has to be regarded as a long-run concept, which will produce its fruits only a long time past any political business cycle. Any country in Europe, which was able to conserve or develop the autonomy of its local governments, like Switzerland, therefore started a tradition of decentralization a

long time ago, and retained a strong political will to preserve and nurture local autonomy during the last decades.

10 Conclusion

In its current fiscal reform plans, the Koizumi Cabinet did not only point out that public debts have reached unbearable highs, it also recognized that Japanese citizens have grown increasingly dissatisfied with the results of public works and services. Consequently, the plans for a sustainable revival of public finances do not only call for fiscal reform and austerity, they also ask for a general reorganization of public (financial) control by means of decentralization.

Especially the current centralized fiscal-transfer system seems to have provided to inefficiencies, strong centralization, and cronyism. Currently, the tax system provides the central government with 60% of public income, but allows the financially and politically rather inexperienced local governments to provide more than 60% of all governmental outlays and more than 500% of the central governments capital expenditures by means of public transfers and along bureaucratic guidelines. In a decentralized concept, in contrast, the local municipalities and entities would ideally become largely independent from central government transfers, and would control public works and services in line with the preferences of local taxpayers.

Approaching such an ideal, however, requires well-planned and carefully sequenced steps to avoid disaster. To provide to such a model for public finance reform, the paper summarized the most important points of public finance theory on decentralization, and outlined earlier experiences with fiscal consolidation and decentralization in Europe.

It became clear from the start, that in Japan (as well as in Europe), the most extreme approaches will not provide any remedy. Granting more independence by simply cutting transfers, for example, is no solution because many local governments – given their current level of efficiency, long-term commitments, and financing inabilities – would surely end belly up with ineffective public projects, high unemployment and social unrest. As a result, the necessary “bail out” transfers would probably produce much inferior results compared to the transfer system before. Almost the same is true for the (unlikely) opposite, when the center single-

handedly transfers major sources of income to local communities. In this case, the center would be left with the costs of an idle bureaucracy, while the local governments would have to account and allocate the funds of their new responsibilities with almost no experience and capacities for doing so. Furthermore, even if these change-over problems to a new level of consumer and voter sovereignty are successfully addressed, the new system would still need sufficient transfers to sustain the competing goal of (largely) equivalent living conditions all over Japan.

To avoid the pitfalls, the Council on Economic and Fiscal Policy plans to reorganize finance and decision-making with a general approach by

- building on the work of the Committee for the Promotion of Decentralization (starting 1995), which asks for lower transfers but more independent sources of income for the local governments,
- earlier incentives from the Collective Decentralization Law (April 1, 2000), which aims to improve local efficiency by mergers and consolidations of municipalities,
- and the Central Government Reform (effective January 6, 2001), which already restructured most central government ministries and agencies.

Unfortunately, however, judging on basis of theoretical considerations and earlier experiences in Europe, these reform plans developed from their promising starts rather disappointingly.

- The central government reform has produced two new bureaucratic giants, the Ministry of Land, Infrastructure and Transport, the product of a four-way merger that controls 80% of total public works spending, and the Ministry of Public Management, Home Affairs, Posts and Telecommunications, which is directly in charge of affairs of local communities, and controls – besides others – the 360 trillion yen in postal savings and insurance funds. It is very unlikely, that the effective devolution of powers will become any easier after such super-ministries have been created.

- The collective decentralization law and the council are planning to promote local efficiency through economies of scale by consolidating the existing 3,200 municipalities into less than 1000. The basic idea of this “decentralization” plan is, that the devolution of powers under difficult financial conditions will become much easier after local or regional centralization enables the municipalities to compete with the central government as well as with each other on more even terms. Experiences in European countries demonstrated, however, that such policies of “decentralization through regional centralization” will not only result in lower consumer sovereignty and poor local control, but also higher overall centralization.
- The drafts of fiscal reform plans have not yet produced any concrete plans to provide self-sustaining sources of income to local governments. It is very likely that the plans will proceed with simple cutbacks on fiscal transfers from central government. The resulting squeeze of local finances will later probably increase the dependency of local governments on centrally organized public projects and “bail out” transfers.

As an example for the prospects of these reform plans, the paper demonstrated that comparable half-hearted approaches to decentralization and financial reform in Germany had unplanned and quite unwelcome results in the long run. Especially the strong focus on economies of scale and short-term gains from cost-cutting resulted in a reverse development that turned the rather decentralized federal state of Germany in one of the fiscally most centralized states in Europe. This trend to financially induced (effective) centralization has not yet been reversed – largely because the strict German system of regional financial equilibration left the regional states with below-average incomes without incentives to reduce their dependency and increase their efficiency.

These European cases, and especially the German case, are important to recognize in Japan because comparable policies (especially strong income equalization, tax sharing, and emphasis on local economies of scale) did not only produce poor results for financial consolidation and decentralization, they even produced adverse

results by unintentionally centralizing the former decentralized structures in Germany. The insights for Japan from these developments are:

- Cost cutting and targeting of (short-run) economic efficiency have the tendency to increase centralization at all levels.
- Mixed finance (shared taxes) offers incentives to trade limited powers against improvements in funding positions.
- High local debts block decentralization efforts.
- Income equalization has to be carefully weighed against local autonomy and competition.
- Effective decentralization needs the political will and patience to build up (and preserve) local powers and structures beyond (short-run) economic considerations.

Applying these insights to the current fiscal reform and decentralization plans in Japan leads to the conclusion that they hardly avoid some important traps and shortfalls:

- First, the incentives for local financial and regional consolidation will lead to increased centralization, not decentralization.
- Second, the (soon to be) intended cutting of transfers to the local communities will damage local structures, and therefore provides a poor basis for sound decentralized structure building during the process.
- Third, decentralization is a costly concept for long-run nation building. It does not mix well with short-run economic consideration or crisis management.

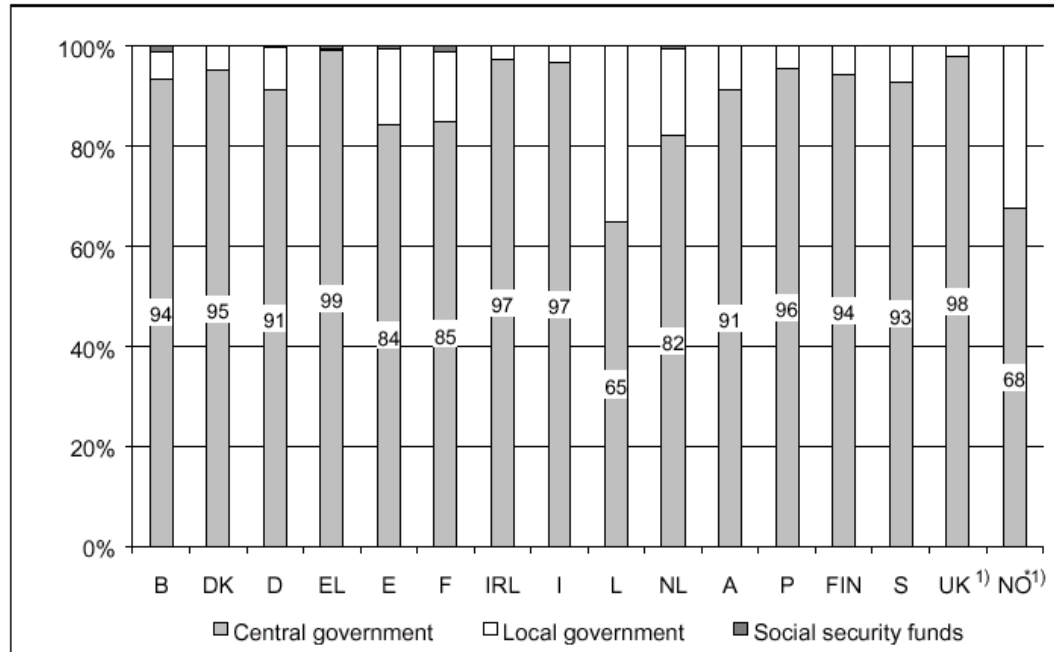
To sum up, the current plans for public finance reform in concert with decentralization seem to look positively ambitious and encouraging at the first glance. In practice, however, they will rather result in more centralization and higher debts at the local level.

Given these shortcomings, a more traditional, sequenced approach might be more appropriate for fiscal consolidation in Japan, even though such a plan would sound much less “reformist” and “encouraging” in the short-run.

- In a sequenced approach, the short-term problem of public debts would have to be targeted by expenditure cuts on basis of the current system.
- The mid-term problem of low local efficiency should be targeted – rather independently from current financial crisis considerations – on basis of local preferences by gradually transferring “own resources” and responsibilities to the local governments.
- The long-term approach to decentralization, however, needs to be targeted in a long-run context through strategies of careful capacity building and quality improvements in an economic, political, and social sense.

11 Appendix: Figures

Figure 14 General Government Debt by Subsector (1998)



Source: Eurostat (1999).

12 Appendix: Some Supplements to the German Tax System¹¹

Shared Taxes

The revenue from shared taxes is allocated as provided for in Art. 107 of the Constitution. Income tax and corporation tax are shared equally between the Federation and the Länder. The local authorities' share is fixed by federal law at 15%. The tax revenue is distributed among the various Länder according to the revenue collected in their respective territories. The flexible element of the system is the distribution of VAT, which endeavors to take account of the different rates of growth in financial requirements. Following German reunification, the Länder's share was significantly increased and since 1995 has represented about 44%. Since the Länder's share is distributed on a per capita basis and not on the basis of local yield, this already has some leveling effect among the Länder before for the powerful German "local equalization" schemes set in.

Despite duties and charges, the Kreis has virtually no funds of its own. In North Rhine/Westphalia, the taxes collected by the Kreis account for just 0.14% of its receipts, which partly explains the resentment felt by the Association of Kreise. The Kreise are financed mainly from compulsory contributions (Kreisumlage) made by the municipalities and, secondly, from the grants made by the Land. The contribution level for each municipality, on the other hand, is set by the Kreis assembly (Kreistag) based on the member municipalities' own resources (local taxes and general grants). The contribution made by the member municipalities varies between 35% and 75% of their fiscal capacity which is measured according to the financial capacity of the municipality concerned, normally defined on the basis of the yield from municipal and shared taxes. These contributions form part of the Kreis's own revenue and are assimilated to local taxes via a system of notional rates.

¹¹ These parts have been taken from: Congress of Local and Regional Authorities of Europe (1999).

The local governments originally received one own tax to their discretion, the trade tax. Subsequently, however, it was decided that part of the money generated by this tax would be paid back to the Federation and the Länder in equal proportions (20-30%). In 1970, to compensate, municipalities were allocated a percentage of the revenue from income tax (now 15%). On average, this shared income tax accounts for 45% of municipalities' own resources. In the 80s they also received 2.2% of VAT for the abolishment of another component of their own taxes.

Inter-State Horizontal Financial Equalization

One important and specific aspects of the German fiscal system is the "horizontal equalization" between the Länder. Article 107.2 of German Basic Law requires that the financial powers of the Länder become almost equalized to guarantee equivalent living conditions all over Germany.

Especially since reunification, the inter-Länder equalization fund has acquired major significance. Through the payments made by Länder with above-average fiscal capacity and the grants made to the rest, the aim is to ensure that every Land has a fiscal capacity of not less than 95% of the average. When calculating contributions to this fund, one compares the fiscal capacity per capita (the tax revenue of the Länder plus 50% of the revenue from trade tax) with their requirements (calculated according to the mean deviation per capita, adjusted to allow for port charges in the case of Bremen, Hamburg and Mecklenburg-Western Pomerania, and the charges arising from population density in the case of city-states only). The difference constitutes the equalization calculation basis and is assessed at a graduated rate of 15% for variations between 100 and 101%, 66% for variations between 101 and 110% and 80% thereafter.

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