Fiscal Retrenchment and Local Public Finance Reforms in Japan: In Search of Sustainable Local Public Finance

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Abstract

Discoursing on the institutional infrastructures and the surrounding explanatory environments, this paper provides a brief yet clear picture of Japan's complex local public finance system. Building on historical trends and practical motivations leading to its being as an Integrationist State, this paper establishes that Japan's decentralization and local public finance recent reforms, like all others, have efficiency and responsiveness to the society's growing demands as their core. By examining the events surrounding the first-ever local government bankruptcy case in Japan, the paper questions the capability and sustainability of local governments in Japan to balance both their revenues and expenditures in light of declining tax base and ascending expense demands. In finality, the paper concludes that while Japan's local public finance arrangements had been successful in providing a uniform standard of services to the constituents and attained policy consistency among and across levels of government, their flexibility to respond to new societal challenges remains to be desired.

1. Introduction

Since the welfare state policy started to decay decades ago, restructuring national government's role, and the promotion of decentralization to sub-national governments have become a political agenda in many countries. In Japan and in most countries, decentralization efforts gravitate on the conventional view that a transfer of authority from the central to local government units helps to increase both the values and stature of political system. This view is more salient among the emerging nations. International development assistant institutions, such as the UN, World Bank, Asian Development Bank, among others, promote decentralization based on the belief that it is a key area of democratic governance and is crucial to attaining human development. If carefully planned and effectively implemented, decentralization can lead to significant improvement in the welfare of people at the local level, the cumulative effect of which can lead to enhanced human development (Kikuchi 2005). Local governments are also keen to have more powers to exercise in dealing with increasing and diversified public demands for services.

These changing circumstances placed local governments under complex and even contradictory situations (Stoker 2003). While local governments are expected to have expanded services to fulfill increasing public demands with greater powers, financial deficit aggravated and local community cried for democratic participation.

To deal with these new challenges, local governments robustly promoted the transformation of governance arrangement with citizens, non-government actors, and its national counterpart, while reforming its relations with central government.

Japanese local governments are, of course, not the exception of these global trends. In the last couple of decades, local governments in Japan experienced decentralization reform and management transformation. These reforms and transformation aim to build more capacities and advance democratization (Nakamura 2002), New ideas from the Western experiences, such as New Public Management, Public Finance Initiative, Public Private Partnerships have been adopted in various policies and management areas. However, there is an imperative to elaborate on the challenges and issues faced by Japanese local public finance system. The elaboration must take into account the historical developments of both the local government system and the accompanying public policy process. It must take into context its unique central-local government integrative relational dynamics amidst the changing local societal context.

Against the background stated above, this chapter explains the Japanese local public finance system and the trend characterizing its reforms. The first section provides the basic structure and features of Japanese system. The second section explains the recent local public finance issues subjected to reforms and policy measures both in expenditure and revenue sides. The third section identifies the future prospects and implications.

2. Japanese Local Government System Overview

(1) *Basics: Local Government System in Japan*

Japan is a unitary state with three tiers of government. The first tier is the national government governed by the cabinet headed by the prime minister. The second and third tiers are regarded as local governments: the prefectural government as the upper tier and the municipalities (City, Town and Village) as the lower tier. The local government in Japan has its' basis in the constitution adopted in 1946 and recognized as the essential institution for democracy and overall governance system.

Local governments are legally classified as "ordinary local government" or "special local government" based on the Local Autonomy Law. Prefecture and municipalities are ordinary local governments, whereas special local governments include special district in the Tokyo Metropolitan Government, partial unions of local governments and others (CLAIR 2004). In most cases, prefectural governments and municipalities are regarded as representation of "local government" among Japanese public, hence, the chapter mainly discusses reforms around the prefectures and municipalities unless otherwise specified.

The total number of ordinary local government is 1828, as of January 1, 2009. Geopolitically, Japan is comprised of 47 prefectural governments and further divided into 1781 municipalities. The 1781 municipalities are sub categorized into 783 cities, 805 towns and 193 villages mostly based on population (Table 1). Every citizen in

Table 1 Number of Local Government in Japan

<table>
<tr><th colspan="2">Category</th><th>Sub Category</th><th>Number</th></tr>
<tr><td rowspan="4">Ordinary Local Government</td><td>Prefecture</td><td></td><td>47</td></tr>
<tr><td rowspan="3">Municipality</td><td>City</td><td>783</td></tr>
<tr><td>Town</td><td>805</td></tr>
<tr><td>Village</td><td>193</td></tr>
<tr><td colspan="3">Special Local Government including 23 special districts in Tokyo Metropolitan Government</td><td>1,559</td></tr>
<tr><td colspan="3">Total</td><td>3,387</td></tr>
</table>

Note: Number of prefecture and municipality is as of January 1st, 2009. Number of Special Local Government is as of March 31st, 2007.
Source: Ministry of Internal Affairs and Communications website and Ministry of Internal Affairs and Communications. (2008). *White Paper on Local Public Finance 2008*. [In Japanese]

Japan lives in one prefecture and one municipality. Although, there are certain number of special local government such as 23 special districts in Tokyo Metropolitan Government (one of 47 prefectures) or inter local government partial union, the prefectural government and municipality represent the local government in the eyes of the Japanese public.[1]

Each local government has executive and legislative branch. Elected mayors/governors head the executive branch and elected council members form the legislative branch. As the Japanese local government employs the "strong mayor system" or the presidential system in its government structure, elected mayor/governor has relatively strong and comprehensive powers over the executive branch. On the other hand, among the main functions of the local assembly are authorizing budget plan, monitoring executive branch activities, enacting local legislation, and making decisions on local policies. Creating a check and balance mechanism, the mayor/governor has the power to dissolve the council and the powers to veto council resolution. The council, on the other hand, can pass the no-confidence motion against the mayor/governor if necessary.

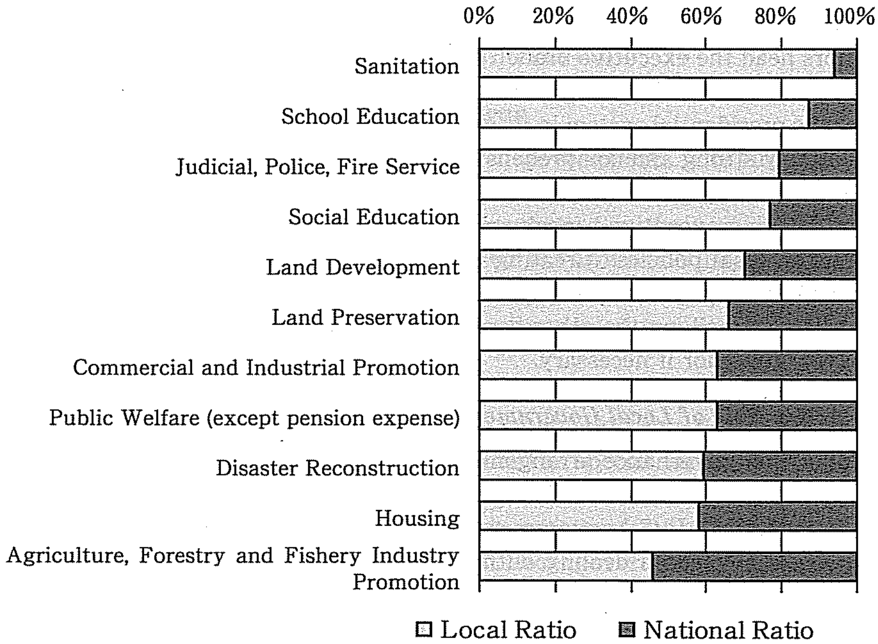
(2) *Active Role of Local Government*

Under this governance arrangement, the local government in Japan had long been providing an extensive list of social services much more than any other countries. Compared to U. S. government sharing of roles for instance, Japanese local governments have been dealing with social services while the national ministries have been in charge of economic development, for example, the Ministry of International Trade and Industry (MITI). This results to having the bulk of the local public finance share used for social services (Nakamura 2007).

This traditional demarcation of role and function of the government reflects the considerable size of local civil service and the bigger ratio of local public finance. The number of local civil service in Japan is around 3 million people and it accounts for more than 3 times of national civil service (national civil service is pegged at 945,000 and the local civil service accounts for 3,042,000 as of FY 2006). The scale of whole government expenditure excluding social security fund accounts for 16% of GDP in 2002. Of which, central government expenditure GDP ratio is 3.8%, while the ratio of local public finance expenditures GDP ratio is 12.2%. The latter accounts for more than thrice larger than the national expenditure. As Figure 1 indicates, local governments are central actors in various social services, including school education, welfare and public health, police and fire services, and the construction of sewerage systems.

From the nursery home, kindergarten, school education, to the Mobile Bathing Service for the Disabled Elderly (Bath in the Bus), the role and functions of local governments involve a close relationship with the daily life of citizen. They fulfill a major role in public life. Contrary to the declining role of national bureaucrats and their rarely seen activities, citizens have put bigger stake in their local governments. Local governments in Japan have succeeded in developing a sufficiently broad-based constituency for themselves. This account is partly verified by the fact that for the most ordinary citizens, civil service means the local civil service, not national bureaucrats or national civil service.

The National Personnel Authority released results of a 2005 survey on the citizen's perception to the civil service (NPA 2005). The survey aims to determine the



Source: Ministry of Internal Affairs and Communications. (2007). *White Paper on Local Public Finance, 2007 Illustrated.*

Figure 1 Shares of Local Governments in Main Expenditure (Final Expenditure Base, FY 2005) type and level of civil service recall among the respondents. The results reveal that, 35.5% of respondents have a high recall of the local civil service while 14% of respondents have anamnesis of the national civil service[2]. It would not be an exaggeration that for ordinary citizens, high expectation towards public administration rests on the active role of local governments, not on national bureaucrats. Citizens' high expectation on and the active role of local governments secure the level of government trusts in Japan. The promotion of decentralization, with the congruent transfer of more power to local level, would promote a more engaged role of local governments.

(3) *Local Government Revenue*

On the other end of the scale, Local tax revenue, defined as the revenue that the local government can generate on their own, accounts for roughly 40% of the total government sector revenue.

Table 2 represents the major types of taxes collected by national and local government. Major tax sources of the national government are Income Tax, Corporate Tax, Consumption Tax, Liquor Tax, and Gasoline Tax. Chief tax sources for Prefectures are Residential Tax and Enterprise Tax while main tax sources for municipalities are Residential Tax and Fixed Asset Tax.

Table 2 Major Taxes

National Tax	Local Tax	
	Prefectural Tax	Municipal Tax
Income Tax	Resident Tax (Individual Resident Tax) (Corporate Resident Tax)	Resident Tax (Individual Resident Tax) (Corporate Resident Tax)
Corporate Tax	Enterprise Tax	Fixed Asset Tax
Consumption Tax	Local Consumption Tax	City Planning Tax
Liquor Tax	Automobile Tax	Municipal Tobacco Tax
Gasoline Tax	Real Property Acquisition Tax	Spa Tax
	Automobile Acquisition Tax	
	Light Oil Delivery Tax	

From the perspective of local autonomy principle, it would be ideal that each local government fully finance the services that they provide. However, considering socio-economic diversities in each locality, particularly the degree of aging population, economic imbalance, and taxpaying capacity among regions are inevitable. Also in light of the belief that citizen have equal right and should have equal access to the government services regardless where they are, there is a need for a fiscal transfer scheme to secure the local government services based on fixed burden.

The gap between local government expenditure and revenue is therefore filled by various type of adjustment measures. Among these measures are Local Allocation Tax, National Treasury Disbursement (Subsidies), Local Government Bonds, and Local Transfer Tax. In the class of these measures, the most significant is the Local Allocation Tax system. The Local Allocation Tax system secures the revenue of local governments that are unable to collect sufficient revenue through the locally collected taxes due to the forecited regional imbalances. The Local Allocation Tax is sourced from some set percentages of five national taxes, namely, Income Tax, Corporate Tax, Liquor Tax, Consumption Tax, and Tobacco Tax. Proceeds are pooled and distributed based on individual local government financial needs[3]. In year fiscal year 2006, 17.5% of the cumulated total revenue of the aggregate local governments belongs to Local Allocation Tax.

The other fiscal measure available to local governments is the National Treasury Disbursement. Central government provides subsidies to local governments to defray specific costs. Examples are cost of works under the joint responsibility of central and local government, the cost to deploy specific policies promoted by central government such as road safety. Another example is the cost for national tasks entrusted to the local government for implementation such as maintaining family registration system or the expense for national parliament election. The share of National Treasury Disbursement in the cumulative local government revenue accounts for 11.4% in fiscal year 2006.

Local Bonds is the long-term borrowing by each local government to finance public facility construction and others. The share of Local Bonds in the total revenue for the aggregated local government reaches 10.5% in fiscal year 2006.

3. Decentralization Reform and Public Finance Reform in Local Government

(1) *Features of Central-Local Relations*

Japanese central-local government relations are characterized by central government interventional policies to the local government or the so-called integrated model of local policy implementations. Central government expresses intervention to the local government in two ways: administrative control and virtual control through personnel exchange.

"Agency Delegated Function" represented the administrative control of central government over local governments. The Agency Delegated Function was one of the central government controlling tools over local governments. While local governments are dealing with various services and tasks, most of these (around 80% in prefectural governments, around 50% in municipal governments) were primarily the central government functions such as foreign residents' registration, implementing national elections, and others. Although these are tasks of national ministries, central government delegated the implementation responsibilities to the respective heads of local governments as their subordinate agents. Notwithstanding that governors or mayors are elected to govern local affairs and represent citizens will in the community, they were regarded as subordinate agents of national government. This system contributed in the equalization of government services among local governments during the early decentralization period. The system had helped to secure the standard of various government services implemented by the local government, regardless where Japanese citizens live in the country.

Meanwhile, dispatched central government officials exercise virtual control over local governments. Through the practice of personnel exchange between central and local governments, they were able to do so because they usually hold senior management positions in local governments. Data shows that as of 1999, a total of 508 national civil service personnel was sent to the various senior positions in every prefectural governments. The sending ministry varied from the Ministry of Internal Affairs and Communications (former Ministry of Home Affairs), to the Ministry of Environment (former Environment Agency). Of these various ministries, the top rank as to the number of dispatches to local governments was the former Ministry of Construction (Akizuki 2005). This practice has been highly criticized as the symbol of centralization since the central government tried to maintain virtual centralization. Thus, ministries are able to maintain policy influences through the sent staff holding senior manager positions in the local government. It is however worth mentioning that under the integration model of central local government relations, this practice helped to make consistent and cohesive polices between central and local government due to knowledge sharing and inter-personnel network between them. The often-overlooked fact concerning the personnel exchange practice is that personnel exchange does not occur only from the central to the local governments. The local government has been also sending its staff to central ministries as a part of training and acquisition of skills and knowledge in policy making for their locality (Akizuki 2005).

To illustrate the context as an example of central government control, the Japanese central local government system is classified under the Integrationist model, to contrast it to the Separationist model (Muramatsu, Iqbal and Kume 2001). Under the Separationist model, the functions of the central and local governments are clearly defined by the national law and the local government tasks are clearly listed in a limited manner. The central government does not control local governments as long as the undertaking is in the listed tasks. On the contrary, the Integrationist model is characterized by intertwining and vague division of roles between central and local governments. The local government tasks are defined widely and loosely. Hence, central and local governments are closely related, especially in the service provision phase. The primary example was the "Agency Delegated Function" as explained earlier.

(2) *Decentralization Reform*

While the centralized features of government relations had continued with some fluctuation in the post war period, the public demands for the decentralization became strong in the 1980s and the 1990s. Practically in the 1990s, there had been strong demands to cope up with the changes brought about by internationalization and the aging society. Compounding these changes is the impetus to correct the uni-polar development concentration in Tokyo and to build local communities with individual character. There had been strong demands voiced for the re-examination of the existing centralized government system and the creation of a decentralized society where people can truly experience comfort and prosperity.

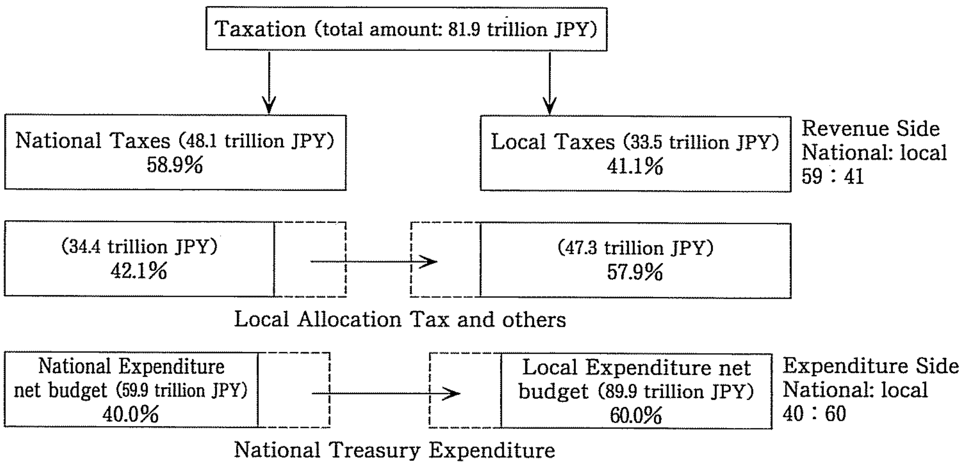
To respond to these demands, the Decentralization Promotion Law, aimed at promoting systematic and general advances in government decentralization, was legislated in 1995. The Decentralization Promotion Committee, formed under the law, examined specific guidelines in developing a decentralization plan and released five recommendations over a period, including the abolition of the "Agency Delegated Function System" that was seen as a symbol of central government control over the local governments. In 1999, the national legislature passed the Omnibus Decentralization Act. The act marked the transition from the centralized government scheme, developed in the late 19th century, to a decentralized scheme. It also held great significance in promoting the transfer of power to local governments.

There were four main points in the decentralization developments during the year 2000. The first was the clarification of the roles of central and local government. The second was the abolishment of the "Agency Delegated Function." The third was the re-examination of the central government control by legalizing the principles and types of central government intervention to the local government. And lastly is the promotion of central government authority delegation to the local government, referring to the release of regulatory obligations to the local government. These main points represent the main features of decentralization reforms in year 2000 as it relates to the legal or administrative aspects of central-local relations. To accelerate further decentralization in the aspect of public finance, and likewise deal with the severe shortage of financial resources in local governments, a financial decentralization reform took place in year 2006.

(3) *Trinity Reform: Local Public Finance Reforms*

Albeit central and local government relations reform came into being for the first time since the modern local government system was formed in the 1940s (through the establishment of present Japanese constitution and the enactment of Local Autonomy Law), the Japanese economy and its society had suffered from a long recession called the "lost decades" ever since the 1990s[4]. In order to deal with the recession, the national government implemented an economic stimulation package with the issuance of an unprecedented amount of public funds. Its purpose is to stabilize the economic systems and to cover the tax revenue shortage. The policy as a result both left the national and local governments with more than 800 million JPY (accounting for 160% of Japan's annual GDP) in debt. Thus, many local governments found themselves under debt-laden fiscal situation.

Confronted by these situations, a local public finance reform called "Trinity Reform" took place in 2006. The reform aims to promote further decentralization, increase the freedom of local governments to implement revenue and expenditure strategies, and to foster the local government fiscal independence from central government. The underlying rationale in the promotion of the "Trinity Reform" was the belief that the root cause of severe local government financial situation lies in the weak capacity of local government to generate its own tax revenue. Although the local governments are dealing with various government social services, the fiscal resources to implement those services has been dependent on the fiscal transfer from the central government in form of Local Allocation Tax, National Treasury Disbursement, and others. Of the total amount of collected tax, national government collection accounts to about 60%, while local government collections rest around 40%. The expenditure side, however, reflects the active role of local governments. The expenditure scale of local governments account to about 60% of the total government sector expenditures. The central government expenditure on the other hand is only around 40% (Figure 2). The financial transfer scheme has fulfilled the gap between the expenditure scale and the locally collected tax.



Source: Ministry of Internal Affairs and Communications. (2005). *White Paper on Local Public Finance, 2005.*
Note: Adopted and adjusted by the author.

Figure 2 Distribution of Financial Resources between National and Local Government both in Revenue and Expenditure Sides (Fiscal Year 2004)

In reducing the gap between the expenditure and revenue scale of local governments through the "Trinity Reform", fundamental strategies were set up to realize the desired revenue structure relying mainly on local taxes. To do this, the reform tried to revise the financial transfer scheme to strengthen the tax base of locally collected tax. The whole reform process, initiated in 2003, transferred and streamlined the tax sources of Local Allocation Tax and the National Treasury Disbursement to local tax base. In fiscal year 2006, national government transferred to local governments tax sources estimated to amount to 3 trillion JPY. This shift of the tax base, from the national to local, contributed to strengthen the financial autonomy of the local governments. Furthermore, to balance between the tax base transfer and the national government involvement in local finance, national government streamlined 4.7 trillion JPY in total national treasury disbursements to the local govern-

Table 3 Trinity eform Package: Sweeping Review of Local Public Finance

• Streamlining National Treasury Disbursement	Total Scale 4.7 trillion JPY
• Distribution of Tax Resources from the central to local	Total Scale 3.0 trillion JPY
• Restraint of Local Allocation Tax transfer	Total Scale 5.1 JPY

ment. At the same time, it restrained 5.1 trillion JPY of local allocation tax (Table 3).

Unlike the decentralization reform in 2000, political compromises among different parties realize the "Trinity Reform" of local public finance system. In the decentralization reform of 2000, local government side uniformly run the campaign to promote the reform in collaboration with the newly developed Decentralization Promotion Committee in the central government. In the case of "Trinity Reform", the central government led by the premier Mr. Koizumi first set the agenda. His administration sought for the "Structural Reform" aimed at economic vitalization. He consequently set up the reform doctrine "from the public to the private sector" and "from the national to the local governments." However, the "Trinity Reform" reform process was muddled as it goes through conflicting interests of central ministries fearing loose of controlling powers over local governments. The local government side also could not develop a united front for fiscal decentralization. Especially, local governments with small population in rural area expressed concerns that the reform would contribute more to their financial incapability after all. The critics argued that the "Trinity Reform" was deadlocked in a three-concern tie (Kitamura 2006).

Nonetheless, it is rather clear that the reform contributed to strengthening the overall fiscal capacities of local governments, thus, promoted financial autonomy. With regards to the streamlining of the national treasury disbursement, local government had long called for the abrogation of ministerial sectionalism in the central government, since the national treasury disbursement represent the "ear marked" subsidies. Although the central ministries reshuffling in 2001 eased inter-ministerial sectionalism to some degree, streamlining national treasurer disbursement made local government financially more independent from the central government. Transferring tax resources from the national tax base to local tax base resulted to increased local government responsibility to attain a balanced and equitable financial management.

(4) *Fiscal Deterioration and Crisis: The Yubari Shock*

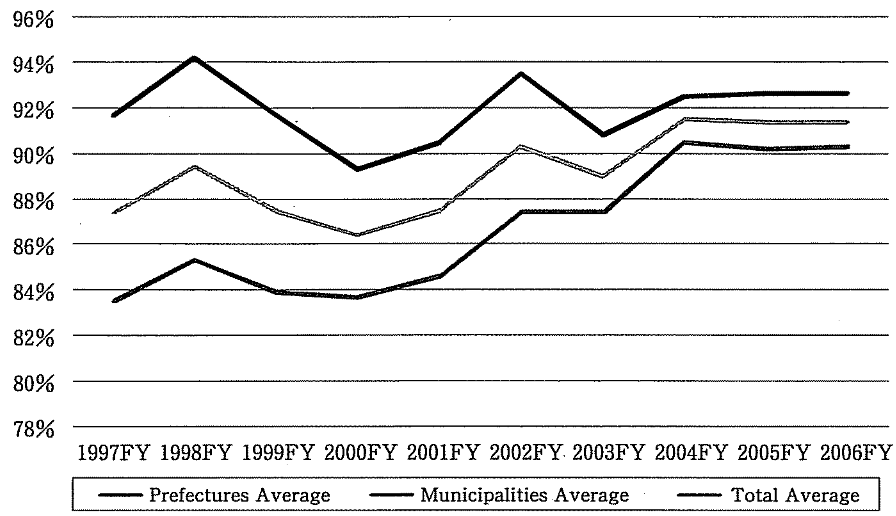
In spite of the continuous reform efforts in public finance, year 2005 saw the unprecedented fiscal deterioration in many local governments. Local public finance is suffering from severe imbalance of revenue resources vis-a vis its expenditures. In June 2006, the Mayor of Yubari City in Hokkaido prefecture, the northern island of Japan, distressly announced that the city would have to declare municipal bankruptcy and have to undergo the compulsory process of financial rehabilitation. The city was the first local government to fall into the bankruptcy within the last 14 years.

The City of Yubari once enjoyed economic prosperity being one of Japanese coal-mining centers. After the last coal mine closed in 1990, the population started to decline, down to 13,000 after reaching the apex in 1960 with 120,000 populations. After the city lost the main economic source of vitality, the city tried to revive the local economy through tourism promotion. The city deployed ski resort complex through public investment, thus, placed the city finances under heavy debt situation. The scale of accumulated debt reached more than fourteen times of the city average budget. The Yubari City had been hiding the growing debt by dressing its account, making it difficult for city assembly and the national ministries to check (*Japan Times* 2006, 2007).

In Japan, if a local government's debt service payment reached a certain percentage of its budget scale, the city will be required to undergo the process of compulsory financial rehabilitation scheme. The deficit criterion was 5 percent of the budget scale for a prefectural government and 20 percent for municipality. Since the short-term loans did not appear in the account settlement reports, Yubari City was able to hide its excessive indebtedness. In the case of Yubari, the Ministry of Internal Affairs and Communications stepped in the city's financial autonomy after it was designated as a "municipality under fiscal rehabilitation." The city was required to draft the rehabilitation plan under the guidance of ministry and the draft plan has to pass through the ministry's screening and the local assembly approval. According to the original plan, Yubari City will reduce its accumulated debt within 18 years, by slashing the number of city officials, raising utility fees, and shutting down public facilities, placing heavy burdens on citizens (*Japan Times* 2007). The ministry essentially controlled the budget until the plan is completed. The Yubari City lost the financial autonomy in the end. The excessive central government control has been often described in an anecdote that goes like "local government officials have to ask the permission of Tokyo (central ministry) even for a purchase of one single pencil."

The Yubari case made a big impact among other local governments and the Japanese public as well. Despite the slow nationwide economic recovery, not all local economies were in good shape. The speed of population decline and of aging population greatly varied between urban and rural area. Discrepancies of taxing capacity widens as each local government sought to fulfill its financial demands on the available resources in their locality. The fear of falling down to the "Second Yubari" swept among small local governments in rural area as the overall local financial situation loses its flexibility. Figure 3 indicates the trend of ordinary balance ratio.

The ordinary balance ratio is the index of the local finance flexibility. It is the ratio of ordinary revenue allotted to recurring expense (public debt payments, personnel expenses and other obligatory expense) to the total ordinary revenue in each year. In other words, the ratio indicates the degree of local public finance flexibility



Source: Ministry of Internal Affairs and Communications. (2008). *White Paper on Local Public Finance*, 2008.
Note: The figure is based on each year's settlement.

Figure 3 Fiscal Inflexibility: Trend of Ordinary Balance Ratio

per year.

If a local government has a 90% ratio in a given year, this means that 90% of its total revenue is already allocated to a pre-determined expense. This means also that it has only the remaining unencumbered 10% "free cash" for use to pursue other developmental policies. The ideal ratio should be around 70 to 80% to be deemed as financially sound. However, the total ratio remained relatively high playing at the level of more than 90% in recent years.

The total debts of local government - the outstanding local government borrowings — reached an approximately 140 trillion JPY accounting to 150% of total local government revenue. Considering the historical trend of each of the expenditure, welfare expense, especially for the elderly, and the public debt payments has been continuously in an increasing trend for the last 15 years. This trend reflects Japan's rapid aging society. General administration expenses and civic engineering expense, meanwhile, has been declining.

(5) *New Law on the Local Government Fiscal Rehabilitation*

To respond to the deteriorating fiscal conditions and the Yubari shockwave, the central government drastically revised the local government financial rehabilitation scheme for the first time in about 50 years. This leads to the enactment of the Law on Local Governments Financial Soundness. The Yubari case disclosed the problems of the former system. Foremost among the problems was the failure of monitoring system to cover local government's special accounts and stock conditions focusing solely on the ordinary account. The second major problem was that the former system is curative and does not have a preventive mechanism. It has standards and procedures in rehabilitating local governments in cases where it already faced bankruptcy but it does not sufficiently provides for standards and procedures to prevent local governments in sliding to bankruptcy.

The new law, however, provided and institutionalized an early warning system and a more thorough monitoring system of local public financial conditions. The law set-up three types of financial indices and mandates that each local government must report it to the local assembly and the citizens annually. These indices are the real deficit ratio covering ordinary account, consolidated real deficit ratio covering ordinary and special accounts, and real debt service ratio covering ordinary account, special accounts, other special local governments' accounts sharing expenditure, and public invested private companies. In addition to these, local government must disclose the future burden ratio throughout all related accounts as stock information. These indices will deliver a clearer picture of each local government's financial conditions.

The law set up certain standards and limits in each index to determine the financial conditions of each local government. If one of the four indices exceeds the preset limits depending on local financial scale, a local government will be determined to be either on Fiscal Alarm Stage or on financial rehabilitation level. The system is often compared to the traffic light order (Table 4). Stepping in each stage, the local government is required to prepare counter measures. In Fiscal Alarm Stage, the local government is asked to formulate the Fiscal Alarm plan for recovery and report the progress of implementation to the assembly and the public every year. In the Financial Rehabilitation Stage, the local government has to formulate the Financial Rehabilitation Plan and the plan must go through the consultation with the Ministry of Internal Affairs and Communications. The central government involvement gets stronger depending on each stage. The system will be fully implemented from April 2009, thus, expecting to establish a more stringent financial discipline in each local government.

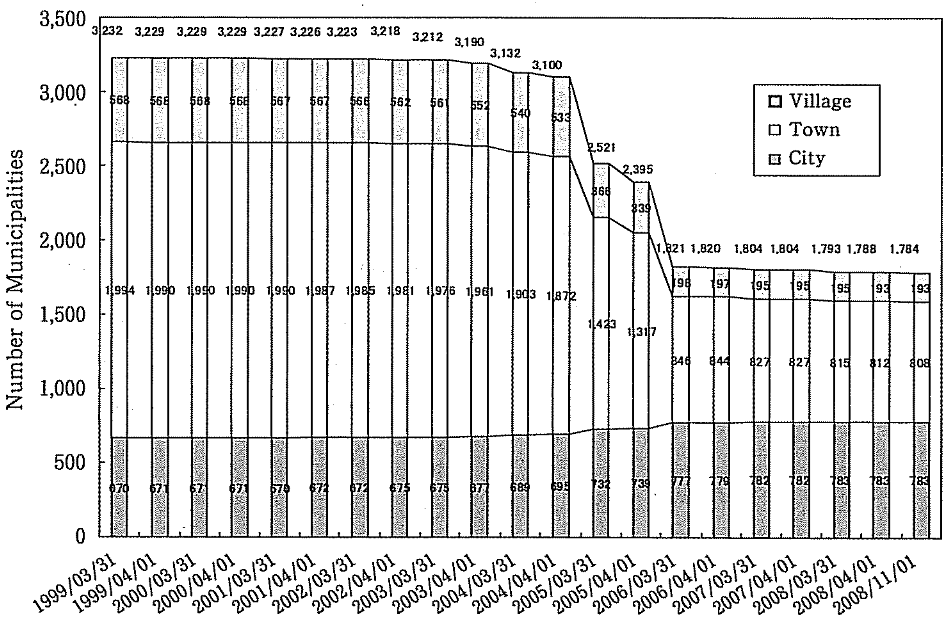
Table 4 Preventing Measures for Financial Soundness

	Sound Stage (Green)	**Early Financial Soundness Stage (Yellow)**	**Financial Rehabilitation Stage (Red)**
Necessary Measures		**Financial Soundness Plan required**	**Financial Rehabilitation Plan required**
Real Deficit Ratio			
Consolidated Real Deficit Ratio			
Real Debt Ratio	**Sound Finance**		**Financial Deterioration**
Real Service Debt Service Ratio			
Future Burden Ratio			

Note: The standard ratio and limits in each stage varies based on local government financial scale.

4. Conclusion: In Search of Sustainable Local Public Finance

Japanese society is currently entering depopulating society. Regional disparity in the magnitude and speed of ageing society and fewer children made the situation more complex. While urban area still enjoyed the vital economy with the influx of working population from the rural area, depopulation and aging society is growing at an accelerated pace in the rural area. Taking prominent examples, 39.6% of the total city's population in 2005 of the City of Yubari, an officially bankrupted city, belongs to aged populace. Nanmoku village in Gunma prefecture, which is about 200 kilometers away from downtown Tokyo, holds the most aged population. In 2005, 53.4% of the population is at the age 65 or more. Since most welfare policies are shouldered by local government, growing number of aging population in a locality with a limited financial resources undermines the self-sufficiency principle of local public finance. Facing these challenges, municipalities in rural area tried to promote municipal merger with their neighboring municipalities for a more sustainable local governance arrangement. As a result of active promotion of municipal merger, the total number of municipalities has decreased in the last 10 years from more than 3,000 to around 1,780 (Figure 4). Local governments are also keenly perusing more sustainable way to keep the service standards with the incorporation of New Public Management ethos reform and partnering with Non-Governmental Organizations as the "new partner" in service provision (Kikuchi 2008).



Source: Adopted from the Ministry of Internal Affairs and Communications website.

Figure 4 Number of Municipalities Historical Trend

The early experiences of Japanese local public finance have rich implications for other less developed countries. Interlaced central local relations and financial transfer system contributed to the equalization of service standards. The knowledge transfer between central government and local government brought relatively cohesive policy development. However, amidst the accelerating ageing population and congruent regional discrepancies, how to establish a sustainable local public finance in local government level is a new challenge. This is especially true for small local governments in rural Japan. Even urban areas that are enjoying sufficient resources at this moment would soon face the same challenge when the baby boomer starts to retire in near future. The recent local public finance reform for more financial autonomy and the Yubari case of bankruptcy would be a prelude for further reforms. Taking into account the fiscal self-reliance principle, national and local governments alike continuously find ways to advance effective approaches in prioritizing and responding to societal service demands in a democratic manner; for a more transparent and sound financial management; and to revitalize the potent power of the communities.

Notes

1 For details of other special local government, please refer Jacobs (2004) and CLAIR (2004).

2 The survey was conducted to the 500 registered policy monitors who were more than 20 years old.

3 The current percentage of National Five Tax for the source of Local Allocation Tax are as follows; 32% of Income Tax, 35.8% of Corporate Tax, 32% of Liquor Tax, 29.5% of Consumption Tax, and 25% of Tobacco Tax.

4 Post war Japanese constitution ensures the local autonomy with one chapter with the basic philosophy that the local autonomy is a basis for democracy. The chapter prescribes two principles: self-decision and self-responsibility.

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