A Systematic Analysis of Local Government Finance in Japan

LOCAL DEMOCRACY RESEARCH CENTRE

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Foreword

For the last ten years we have been asking council leaders, chief executives, cabinet members for finance and section 151 officers their opinions on how local services are financed in England.

We know from our survey this year that only 14% of senior council figures are confident in the sustainability of council finances. We know that around 8% say pressures on their finances could leave them unable to fulfil their statutory duties – meaning they will be incapable of providing the essential services relied on by local people across the country. We know they are doing everything in their power to make ends meet – raising taxes, cutting services, spending their finite reserves.

Over the last ten years, the evidence that there has been a major sustained failure to properly fund local services in England has become undeniable. The next question is: how could local government finance be different?

This paper, the fourth in a series of reports on international systems of local government finance by experts at the University of Northumbria, helps us to take the next vital step – examining how the local government finance system could be improved. By building our understanding of the different ways local services are funded across the world – especially outside of the English-speaking world – we can identify the most effective ways to ensure local governments work for their citizens.

This report is a fascinating assessment of local government finance in Japan. It covers the historical, legal and constitutional context, as well as some of the politics and peculiarities of the system. There are already very useful and illuminating lessons to draw for local government elsewhere. In due course we will release further reports looking at Scotland, Ireland, France and Spain. These will reveal more lessons and insight that will be of real interest not only to readers in England, but to anyone working in or interested in local government around the world.

Jonathan Carr-West
Chief Executive, LGIU

1. Research overview

There has been continual discussion about how the financing of local government works. Particular attention has been devoted to options for fiscal devolution; funding shortages, originating in the UK Government's 'austerity' policy of the early 2010s; and controversies over large-scale borrowing, resulting in a small, but growing, number of English local authorities experiencing severe financial difficulties. Analysis of these situations typically focus on a single element of the finance system, rather than a wider connected system approach to local government finance. For example, considerations of the local authority take place without consideration of its relationship with central government, or local government autonomy without consideration of equalisation between location. The aim of this research is to counter this situation by placing local government finance in a wider complex system perspective that includes the functions of local authorities; capital finance and its regulation; audit and budgeting practice; funding redistribution and socio-economic variations; and the often-uneven culture of central-local relations.

This *system* is made up of multiple agents: for example, local government officers, civil servants, politicians, thinktanks, audit authorities, lenders and financiers who all have their own objectives and decision-making frameworks. All of these elements interact with each over time to form a whole that is more than sum of its individual agent objectives. It is this complex system of actors, regulations and institutions that enables and constrains local government finance. Calls for additional funding or tax-raising powers, and more recent unorthodox borrowing practices, often emerge from, and are constrained by, this broader and connected context. However, the relationships between the different elements of the system are often disregarded, resulting in a partial understanding or misrepresentation of the local government finance challenge. This research maintains it is not possible to comprehend local government by focusing on one component, authority, or agent. A holistic approach is necessary.

Many of these individual aspects of the *system* are characterised by relatively minor procedural reforms that in turn impact and restrict other elements of the system, often disproportionately. It therefore follows that more considerable changes to individual features in that system – such as a new tax-raising power or a changed approach to redistribution – could have considerable knock-on effects elsewhere within the system. Witness the pains in 2013 when 50% Business Rate Retention was introduced in parallel with unreconciled Business Rate revaluations. Understanding local government finance as a *system* implies that significant changes, such as new taxation powers or a new redistribution formula, would be implemented and potentially restrained within that system, not in isolation. This also implies that the local government finance system consists not only of legal and bureaucratic authority, but also of embedded practices and cultural assumptions that influence how any substantial change is absorbed and managed. Therefore, the contention in this research is that the local government finance discussion, and indeed all of the agents involved in this complex arrangement – all of whom have a stake in resilient local government finance – would benefit from a whole system perspective.

1.1 The research project

In order to reflect upon this situation in England, this project aims to provide a more in-depth understanding of the systems of local government finance in three countries: Germany, Italy and Japan. These countries have been selected for two reasons. First, all feature local authorities with broad responsibilities, a wide range of revenue-raising powers, and an established role within the territorial governance of the state. Elements of practice within those countries are frequently presented as options for change in the English context. Second, these countries are all non-Anglophone. Local government and local government finance systems in Anglophone countries have a common ancestor in English practice and share many historical similarities. These include local revenue consisting primarily of property taxes; a lack of constitutional protection; limited functions; and more restrained legal or financial supervision by central officials. Non-Anglophone systems often feature different characteristics, but these too will be held together by embedded practices and assumptions. Ideas for reform that originate from these systems will benefit from a contextual understanding of how they operate in practice.

It is hoped that examining the operation of these alternative systems will provide new contextual information for future proposals to improve the resilience of the local government finance system in England. Examples of isolated practices that can be seen in each of the case studies have been featured at points in the English debate; for instance, tax powers and shared revenues in Japan (Kimura, 2015; Bessho, 2016; Breach, 2019), and redistribution in Germany (Werner, 2018; Thöne & Bullerjahn, 2020). However, we are not aware of any analysis (in English) of these systems *as systems*. Without such understanding, it is not easy to comprehend the role and significance of individual elements of these systems, how they interact and, in turn, how they could enhance the resilience of the local government finance system in England.

Previous examinations of international local government finance have typically drawn-out features that are exotic by Anglophone standards. That approach provides little sense of how those features operate in the originating national context and financial system, nor how they can be compared to the local government finance system in England. This project is the first known recursive application of such research to the system in England, to inform potential reform. The *system* focus will provide new understanding for practitioners, policy makers and academics engaged with the financing of local services and those seeking a broader understanding of sub-national governance systems and their relationship with the state and politics. The intention is that the insights in the research can be taken forward by local government practitioners and policy makers to help to articulate how new approaches to local government finances could be implemented effectively in England. In turn, the same insights have relevance for the international research locations, which may not have adopted a system-wide perspective before, and indeed any international location that is struggling to finance the increasing demand on local services.

This project examined the following features in each country:

- The structure of sub-national governance.
- Local authority functions.
- Local authority expenditure.

- Legal requirements regarding financial management.
- Sources and quantum of revenue, including central transfer grants.
- Powers concerning capital finance.
- Systems of equalising funding between territories.

2. Methodology

In order to examine this situation, a mixed research methodology has been developed and utilised within a cross-disciplinary perspective, blending insights from policy, territorial governance, finance, and real estate studies. Taken together, the empirical and secondary information products lay the foundation for creating a total system perspective of each location that is rarely seen in international literature.

The foundation of the empirical research is a multi-phase interview process. Respondents were identified in each study location (England, Germany, Italy, and Japan) based on their expert knowledge (derived from experience in various tiers of government, oversight organisations and academia) of the respective local government finance systems. Identifying respondents in each location was not straightforward due to the relative dearth of stakeholders with system-wide knowledge and the generally hidden nature of the sector. In order to overcome this issue, the research made use of knowledge brokers including the Local Government Information Unit, the Japan Local Government Centre in London and the Chartered Institute of Public Finance and Accountancy.

The interview process included:

- initial scoping interviews to provide context for the research and direction towards relevant resources and information on practice within the local government finance system in England.
- subsequent scoping interviews with local government finance experts in the study locations to provide context and direction to relevant information sources.
- the research team then returned to the respondents in the respective study locations with findings, to cross-reference and sense-check the evidence leading to a valuable process of draft refinement and gap analysis.

Alongside interaction with the stakeholders in each location, the research examined information from secondary academic literature, government documentation and legislation regarding the legal structures and institutions underlying local government finance systems in Germany, Italy, and Japan. Concurrently, data was sourced from government ministries and allied organisations to reflect the quantity and proportion of income sources in each location and to provide an opportunity for comparison. Reflective of the fragmented situation in England, obtaining detailed and accurate information on the operation of local government finance systems was complicated, with sources sometimes providing contradictory information. In such cases, the panel members were used as a validating mechanism for stress testing the information sources. The conceptual structure that features in each report was developed via a two-phase process. First, existing local government finance typologies were examined to determine the key issues and mechanisms that form the local government finance system, for example the OECD Making Decentralisation Work Handbook for Policy Makers (2019). This was then updated and validated with the respective panel of experts to form the interrogative structure of the reports.

3. Outputs

This report provides the third international analysis in this series of international local government finance publications – a system-wide analysis of the Japanese local government finance system. This is the first known enquiry into Japan, as it relates to the functioning of the local government finance system in England. This is significant because Japan is held up as a traditional exemplar of local government financial resilience and autonomy and therefore offers a rich comparative resource for similar considerations in England.

In England there is little research into how efficient fiscal decisions can be taken at different scale of government, particularly as they relate to fully harmonised funded mandates for local government responsibility. In recent years, English government has largely pursued a system of devolution and decentralisation without fully answering questions in relation to the nature of, and responsibility for, available sources of revenue, fiscal equalisation between locations, nor the various institutions that are commonly used to make fiscal decentralisation a success. This has led to related questions of democratic accountability, fiscal transparency, and scepticism in relation to the overall resilience of the local government finance system in England. Studying the local government finance system in Japan offers an original opportunity to understand how functions are divided into different tiers of government alongside appropriate financial resource, the tensions that manifest in intergovernmental relations as a result, and the institutions that manage this complex situation. It also offers an opportunity to understand the historical components and institutional journey that have led to the adoption and successful delivery of resilient local government finance systems.

4. Political context

In recent years, the Japanese local government finance system has had the following challenges:

- Japan has a long held demographic challenge associated with an ageing population and fewer young people entering the economy, leading to an increasing dependency ratio and increased concern around the sustainability of public finances.

- Japan is traditionally prone to a variety of natural disasters. The local government finance system must allocate resources to prepare for and manage the aftermath of such situations.

- There are significant disparities in localised revenue, particularly as it relates to the collection of local tax. The disparity is seen particularly between urban and rural areas, with the latter suffering from declining population and less buoyant tax bases. In addition, while Japan has access to several sources of local tax revenue (compared with England), the system itself is seen in some quarters as inflexible with central government defining the parameters of local taxation and also heavily reliant on property tax and local consumption tax. The result is a local government finance resources base that is very dependent on the local economy and its cyclical nature.

- Large fiscal transfers from central to local government are necessary to ensure uniform service provision (according to national baselines). Local sources of revenue play a limited role in balancing the inter-territorial budget as they are relatively fixed in relation to the overall composition of local government finance. In some quarters this equalisation procedure is seen as limiting fiscal autonomy and vulnerable to changing government priorities and politics. Even though there is a mature process of equalisation in place, the maintenance of an even and proportionate system of local government finance in Japan is an on-going challenge.

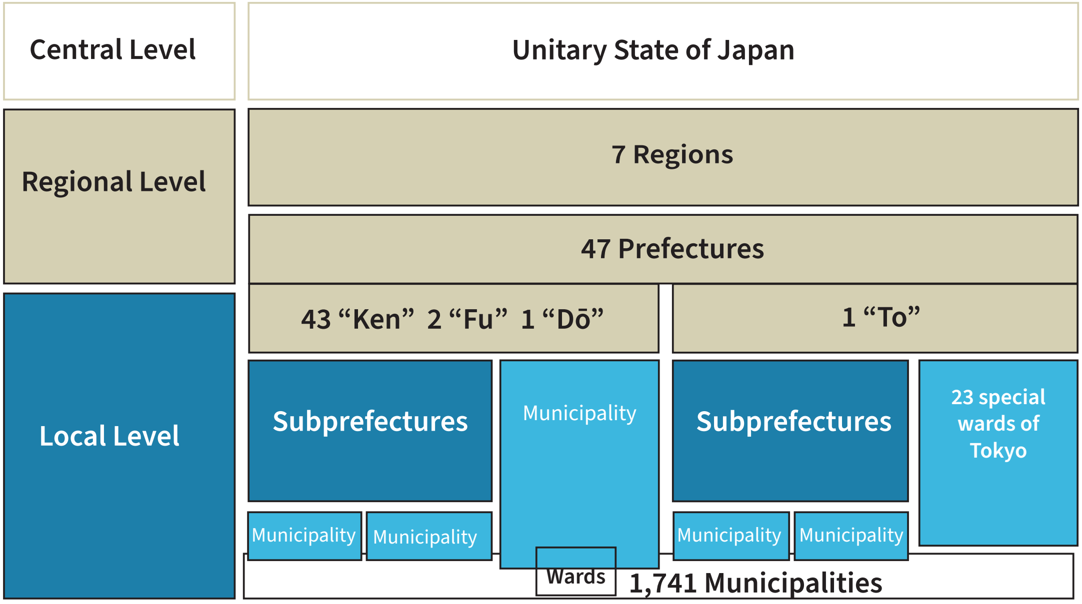
- When increases in local sources of revenue are evident, this can lead to a reduction in central transfer. The result is a potential disincentive for local authorities increasing their own local revenue, as central transfers can provide more certainty.

- Some local governments in Japan have significant debt burdens associated with historical investment in public infrastructure, social welfare programmes and the need to fund the demands of fiscal decentralisation (*Doshu-sei Kaikaku*) since the early 2000s. Coupled with declining revenue sources (particularly in rural areas), the servicing of debt while maintaining essential services is increasingly challenging. Japanese central government, led by the Ministry of Internal Affairs and Communication (MIC), has introduced debt consolidation initiatives, enhanced fiscal rules set out in the Local Finance Act (*Chihou Koukuu Hou*) and tighter central control measures.

5. Japanese subnational governance structure

The local government finance system in Japan is designed to provide essential public services, and promote local development while ensuring fiscal sustainability – balancing the constitutional emphasis on autonomy of local government with the requirement of central coordination, oversight, and overall financial resilience. Japan has a three-tier system of government (national, regional, and local) embedded in and supported by a multi-level sub-national governance system (see Figure 1). There are 47 Prefectures in Japan. These are divided into one *To* (Tokyo), one *Do* (Hokkaido), two *Fu* (Osaka and Kyoto) and the other 43 are referred to as *Ken*. They are the biggest administrative unit in Japan and have their own governor and elected assembly. Cities (*Shi*) are the second biggest administration unit and are traditionally classified (typically on the basis of population and economy) into designated cities (*Tokurei Shi*), core cities (*Chukan Shi*), special cities (*Tokubetsu Shi*), and ordinary cities (*Futsu Shi*) – each city has its own mayor and city council – more recently the classification of special cities and core cities have been merged. The lowest levels of administrative governance are found at the town (*Machi*) and village (*Mura*) – these smallest levels provide local governance to rural and less populated areas.

Figure 1: Structure of sub-national governance in Japan



Local autonomy in Japan is constitutionally protected and considered indispensable to democracy. Chapter 8 of the Constitution, adopted in 1946, contains four articles outlining the nature and guarantee of local autonomy:

- Article 92: outlines the basic "principle of local autonomy".
- Article 93: established legislative assemblies and the direct election of local officials.
- Article 94: details that local public entities shall have the right to manage their property, affairs, and administration and to enact their own regulations within law.
- Article 95: details the requirement of a referendum to apply a special law that is only applicable to one local public entity – the Local Autonomy Special Law.

Article 94 of the Constitution provides that "local public bodies shall have the right to enact local ordinances within the scope of the law" and guarantees local government's autonomous right to legislation (as long as it does not violate national law). Local government can enact two types of laws: ordinances and regulations. The relationship between local ordinances and national laws defines the local legal system. Local ordinances only apply within the local government's jurisdiction that enacted them and can be used to impose obligations or restrict residents' rights. The result is a highly differentiated and complex local government finance system.

Through the system of indirect democracy, residents can perform an oversight role of local authorities. These include:

Direct petition

1. Petition to enact, revise, or abolish local ordinances. Petitions related to local taxes and usage of charges are not allowed.

2. Petition to audit government activities. The petition compels the audit committee of the local government to determine whether or not the affairs of the local government in question are being properly carried out. Results must be announced publicly.

3. Petition for dissolution of the assembly. Requires the signatures of one-third or more of eligible voters.

4. Petition for removal of assembly members.

5. Petition for removal of the chief executive, etc.

Other forms of participation:

1. Referenda concerning local autonomy special laws: a local autonomy special law must be approved by a majority vote of residents.

2. Petition by residents for audit and lawsuit: residents can petition members of the audit committee to conduct audits seeking information on suspected illegal or improper disbursements of official funds, acquisition, management or disposition of properties, and execution of contracts by the staff of the local government. Residents who are unsatisfied with the audit outcome can bring a lawsuit. This can all be done by one person.

The guarantee to local government of the autonomous right to legislation in Japan allows local authorities to create and enforce their own laws, known as ordinances and regulations. The system allows for greater flexibility in making decisions on what impacts a local community. In England, local government has much less legislative authority, restricted mostly to the enactment of bylaws and some licensing powers.

The "Local Autonomy Law", which was adopted in 1947, is the cornerstone for the basic operation of local government in Japan, outlining matters such as types, powers, legislative assemblies, agencies, and financial affairs. It also outlines the vertical intergovernmental relationship between state and local government and also the horizontal relationship between respective local governments. The law came into effect in 1947, concurrently with the constitution.

The "Local Autonomy Law" specifies two basic types of local authorities: prefectures and municipalities. These are framed within a two-tier system of government, prefectures as regional government units and municipalities as the basic local government unit. Prefectures and municipalities operate as independent entities that carry out local public administration within their jurisdictions – both entities have democratically elected governing bodies and representatives. The system is centred on the comprehensive authorisation principle; prefectures and municipalities act as comprehensive administrative bodies and perform activities considered necessary for their residents.

Japan has seen a decrease in the number of municipalities since they were first introduced in 1888 (OECD, 2022). Broadly speaking, there have been three periods of merges, the first being the 'Great Meiji Consolidation' in which roughly 70,000 cities, towns and villages were merged into 15,000 entities. The second period, the 'Great Showa Consolidation', took place from 1953 to 1961 and reduced the number of municipalities by around twothirds. The most recent reform has been underway since 1999 in the midst of a background of local financial difficulties and Japan's attempt to become more decentralised. Between 1999 and 2020, the number of municipalities decreased from 3,229 to 1,718. As the number of municipalities decreased, their respective administrative and financial powers increased, as well as their capabilities necessary to deal with issues associated with social and economic development.

The Local Autonomy Law (1947) classifies local government into two categories: ordinary local government and special local government. Ordinary local governments, including prefectures and municipalities, are seen as the typical local government setup. Prefectures and municipalities are entities that operate independently without hierarchy. However, they have distinct functions: prefectures are large-scale governments covering multiple municipalities, while municipalities are smaller and more connected to residents' daily lives. Although prefectures offer advice and guidance to municipalities, they also perform licensing and permit functions from a regional perspective.

There is also a 'special local government' system. These do not exist everywhere and are entities with unusual geographic areas, organisational structures, or powers. The first entity under this principle is the 23 'special wards', which are all located within Tokyo. These wards carry out narrower duties than cities but serve the same function. In Tokyo, some functions that the city would usually carry out are the responsibility of the Tokyo Metropolitan Government. For example, firefighting, fresh water supply and sewage. The second type of specialised entity is called 'local public cooperatives', which are organisations formed by two or more local authorities to address a particular issue with greater efficiency and effectiveness. These are classified into two types: 'partial cooperatives', which manage waste disposal, fire services, etc., and 'wide-area cooperatives', which create plans for matters that span large areas. The last specialised entity is called 'property wards', which manage the property and facilities owned by a municipality. However, these are typically only found in agricultural or mountain villages.

In addition to the cooperatives, there is also a thriving range of local government associations in Japan that work towards cooperative interstate relations, work with national government to shape financial settlements, advocate the interests of local government regionally and nationally, share best practice and, more broadly, help to address common challenges around local government finance. For example, the Japan Association of City Mayors drives collaboration among major urban areas; the Japan Association of Prefectural Governors represents Japan's 47 prefectures and coordinates cooperation and response to national policy directives; the Japan Association of City Councils enhances cooperation between local government and advocates for the principles of local autonomy; the Council of Local Authorities for International Relations encourages and assists with international exchange and partnership working at the local level; at the lowest level of government there is the National Association of Chairpersons of Towns and Villages that promotes the interests of towns and villages in Japan and seeks partnership between the smallest scale of government.

Supporting all tiers of government, there is also the Japan Municipal Bond Council that helps advise the issuance of municipal bonds in Japan. It plays a key role in driving good practice and transparency in the municipal bond market. Finally, there is also a rich tradition of Municipal Research and Training Institutes (typically funded by prefectures and municipalities) that provide research and training for local government officials and overall capacity building for prefectures and municipalities.

The sub-national system of government in Japan can be described as a 'fusion-type system' (Machidori, 2023) in which central and local administrative entities are, at the same time, in a mutually dependent and mutually complementary relationship. Decentralisation in Japan is rooted in the Local Autonomy Law (*Chihou Jichi Hou*) and other relevant laws amended by the Comprehensive Local Autonomy Law enacted in July 1999. Previously the local government system in Japan could be compared to the current situation in England, dominated by a range of delegated agency functions. The reforms implemented:

1. Classification of roles to be carried out by national and sub-national governments: the central government should focus on international duties and matters requiring a unified approach, while local government should handle tasks more closely related to residents' daily lives.

2. Abolishment of the system of delegated functions and restrictions on involvement by national administrative agencies: the local government's chief executive is no longer seen as a lower administrative agency of the national government. National administrative agencies are also no longer allowed to interfere with local government unless permitted by law or ordinance (the "statutory involvement principle").

3. National powers were transferred to prefectures, and powers of prefectures were transferred to municipalities.

The Local Autonomy Act, that defines the relationship between national and local government provides an objective foundation for any dispute between the respective tiers of government. There is also a Local Autonomy Committee (*Chihou Jichi Chousaki*) hosted by the Ministry of Internal Affairs. This committee investigates (via referral) disputes between local and central government, providing a forum for their resolution. While this forum has no official powers (it is seen as an advisory body), it makes recommendations for efficient amelioration of problems and has significant standing in interstate relations in Japan. Similarly, to the provision in Germany, when resolution cannot be found, it is possible for local government (individually or collectively) to take legal action against central government through a system of judicial review.

6. Responsibilities (shared and exclusive)

While countries like Germany and Italy have codified lists of local government responsibilities in their constitution and associated legislation, Japan's constitution (*the Nihonkou Kenpo*) falls short in this respect. While it defines the structure of governance it does not specifically list respective functions. The Local Autonomy Act goes further, outlining responsibilities and functions and establishes the overall framework for local governance – acting as a fundamental law that outlines the principles of local government. However, it was not until more recently that local government responsibilities were given more clarity through the *Law for the Improvement of Relevant Laws for the Promotion of Decentralization*, enacted in July 1999 (also known as the *Omnibus Local Autonomy Law*). The law makes central government responsible for the following:

1. Affairs relating to Japan as a nation in the international community.

2. Affairs relating to various activities of the people that should be handled in a uniform, nationwide manner.

3. Executing policies and projects that must be performed from a nationwide viewpoint or on a nationwide scale.

The law stipulates that local government is primarily responsible for carrying out administrative tasks within their respective regions autonomously and comprehensively, with as much local autonomy as possible. Previously Japan operated around a system of delegated agency functions, but this was abolished with the 'Omnibus Local Autonomy Law' amendment.

The functions of local government are divided into two types. The first is 'statutory entrusted affairs'; these are functions entrusted to local government through legislation and were originally the responsibility of central government, which retains responsibility for ensuring proper implementation. These include issuing passports, management of national roads, and statistical affairs for central government. All functions which are not 'statutory entrusted' are known as 'local autonomy functions.' These 'autonomous functions' can be further categorised into 'statutory' and 'discretionary' responsibilities.

While subsidiarity is not explicitly mentioned in Japanese local government institutions, the principle can be seen as implicit in the allocation of responsibilities. The 'principle of municipal priority' lies at the heart of the allocation of functions between prefectures and municipalities. The Local Autonomy Law designates that prefectures, as a regional tier of government, oversee wide-scale regional affairs, communication and coordination relating to municipalities, and supplementary affairs for municipalities. Municipalities are then responsible for affairs not covered by prefectures. Fundamentally, functions are allocated first to municipalities, then prefectures and only then to the central government if the sub-national government cannot perform a task. However, the actual allocation of affairs is not always straightforward, prefectures and municipalities, in many cases, cannot completely separate out functions between the relevant entities. Hence why the approach to the allocation of affairs in Japan is referred to as the "fusion type" in the local autonomy system, as opposed to the "separation type" (Machidori, 2023).

The responsibilities of prefectures are as follows:

1. Wide-area affairs (e.g., prefectural roads, harbours, forest and river conservancy, public health centres, vocational training, police).

2. Communication and coordination affairs relating to municipalities (e.g., advice, recommendations and guidance concerning rationalisation of municipal organisation and operations).

3. Supplementary affairs for municipalities (e.g., high schools, museums, hospitals).

The responsibilities of municipalities are as follows:

1. Affairs relating to the fundamentals of residents' lives (e.g., family registers, resident registration, street addresses).

2. Affairs relating to ensuring the safety and health of residents (e.g., fire service, garbage disposal, water supply, sewage).

3. Affairs relating to the welfare of residents (e.g., public assistance (within the area

of cities), nursing insurance, national health insurance).

4. Affairs relating to urban development plans (e.g., urban design, municipal roads, parks).

5. Affairs relating to the establishment and management of various facilities (e.g., public halls, citizens' halls, day-care facilities, elementary and junior high schools, libraries).

7. The regulatory regime

The local government finance system in Japan is committed to providing stable public services regardless of regional differences (JFM, 2022; Clair, 2022). In order to achieve this, central government formulates the Local Government Finance Plan (LGFP) each year based on a needs assessment of local government finance and forecasts of overall revenue and expenditure in parallel with national budget plans. Under this initiative, all local government revenue sources (including Local Allocation Tax grants, bonds, and loans) are accounted for in such a way that uniform public services can be delivered (see Section 10 and 11 for further detail on the Local Allocation Tax). Historically, the Local Autonomy Act laid out the basis for matters relating to local government finance (Besho, 2016), establishing the framework for fiscal autonomy and local financial management. Other important acts include the Local Finance Law (*Chiho Zaisei Hou*), the Local Tax Law (*Chiho Zei*) and the Local Public Services Act (*Chiho Komuin*). Concurrently local government exists within a set of fiscal discipline rules and budgetary control measures.

Local government must prepare multi-year fiscal plans and publish annual financial statements and budgets detailing revenue, expenditure, and the overall financial state of play – this is a key facet of maintaining transparency and accountability to the general public. Independent Local Government Audit Boards (*Chihou Kyoukyoku Danntai Keisan Kansa Iinkai*) review the financial statements and the general system resilience of the local government finance operations ensuring that the local government finance system is adhering to fiscal laws and regulations – particularly in relation to budget, revenue collection and expenditure management. The boards are a key mechanism in proactively preventing local government insolvency and managing financial problems. While there is no legal basis for local government insolvency in Japan, it has occasionally happened (see the Yubari case in Hokkaido later in this section). However, insolvency is very rare with fiscal discipline and financial scrutiny preventing systemic insolvency. When problems are evident the Local Finance Law sets out the principles for collaborative solutions and responsible management, avoiding formal insolvency measures.

The legal basis for independent local government audit boards is set out in the Local Autonomy Law which details the composition, role, and the boards overall powers. The local audit boards operate in association with the national Board of Audit of Japan (*Chosaki*), that scrutinises the national financial position while supporting local audit boards in relation to auditing standards and conventions. The audit boards then share their assessment with the relevant local government entity and publish their findings and recommendations in the public domain. This represents another layer of public accountability in the local government system, ensuring that public funds are managed correctly and that investors have confidence in the soundness of a given local government entity.

In addition, central government, via the Ministry of Public Affairs and Communication and the Local Finance Law, police tight limits in relation to borrowing and fiscal planning. The Local Finance Law sets out the framework for fiscal discipline, transparency, and accountability. There are strict limits in relation to the quantity of debt, and its servicing, that can be held at any given time and specific rules for the issuance of bonds held under the overall principle of sustainable debt levels and excessive debt accumulation. There is quite a lot of flexibility in relation to the type of bonds available for issuance, including no obligation bonds, revenue bonds, and project specific bonds. However, before incurring any debt a given local government must get approval from their local assembly while the budget must clearly stipulate the purpose of debt, its quantity, and the repayment strategy.

Traditionally, the financial management of local government was conducted under the Law on Special Measures for the Promotion of Local Financial Reconstruction (*Chihou Zaisei Saiken Sokushin Tokubetsu Sochi Hou*) – known as the *former fiscal rule* it was the central framing legislation between 1955-2009 (Hiorota & Yonoue, 2022). The former fiscal rule only focused on the ordinary accounts of local government, ignoring debt and investment – only a partial picture of financial resilience was evident. In addition, some local governments could draw on their reserves (kept for the repayment of future debt) to make their accounts appear healthier, while there was capacity to move ordinary account fiscal deficits to extra governmental accounts.

Under the historical system, the Japanese Government operated a red card system for local governments in need of financial reconstruction based on a deficit index (*Jisshitsu Akaji Hiritsu*). Local governments falling under this definition had to operate under the control of central government (the Ministry of Internal Affairs and Communication) to recover financial health and were not allowed to issue bonds (Hiorota & Yonoue, 2022). The former process was criticised for having no graduated process (a yellow card system) that could avoid the need for 'fiscal reconstruction.' The result was a system that could only act once a given local government finance system was in a structural state of distress – lacking curative or preventative distress management mechanisms (Hiorota & Yonoue, 2022).

Following the insolvency of the city of Yubari in 2007, in 2008, the Law Relating to the Financial Soundness of Local Governments (*Chihou Koukyoudantai no Zaisei no Kenzenka ni Kansuru Houritsu*) was enacted, referred to as the new fiscal rule (Hiorota & Yonoue, 2022). Similarly to England, the Japanese system of insolvency does not recognise the bankruptcy of local government – however Yubari had debts of 35bn JPY against an annual budget of only 4bn JPY (Seaton, 2010). This new law is based on a revised and expanded set of financial indexes, a Deficit Index (covering ordinary accounts), a Consolidated Deficit Index (which includes the accounts of additional public enterprises), the Redemption Index (which includes local government debt) and the Future Burden Index (which includes all public entities in each municipality). Taken together these financial reporting tools attempt to create an overall picture of local government financial resilience while the Future Burden Index serves to understand the potential for financial distress in the future. This wider scrutiny has created the scope for a yellow card system, requiring local governments to put plans in place for financial recovery, and red cards which require local governments to be under central control while financial soundness is recovered.

Confronted by these situations, a local public finance reform called the "Trinity Reform" was introduced in 2006. The reform aimed to promote further decentralization, increase the freedom of local government to implement revenue and expenditure strategies, and to foster more local government fiscal independence from central government. The underlying rationale in the promotion of the "Trinity Reform" was the belief that one of the central root causes of severe local government financial distress lies in the weak capacity of local government to generate and/or have discretion over its own tax revenue and income. In order to respond to this criticism, the reform revised the financial transfer scheme to expand the local basket of revenue – including local taxes and assigned taxes traditionally held by central government. The whole reform process, initiated in 2003, transferred and streamlined the tax model for the Local Allocation Tax and the National Treasury Disbursement to local government. Capturing the magnitude of the new fiscal distribution, it is estimated that the Japanese Government transferred three trillion JPY to local government in 2006.

8. Capital finance

In relative terms, Japan's local government debt is second only to the USA in terms of size. According to Reuters (2023), total government borrowing in 2023 is likely to top 1,100 trillion JPY ($8.47 trillion). The three major sources of bonds/borrowing in Japan are the private sector, government bonds and those provided by the Japanese Finance Organisation for Municipalities (JFM). The Japan Finance Organisation for Municipalities is a joint fundraising organisation for local government which raises funds in the capital market, and then provides long-term loans at low interest rates to local government. Compared with England, the range of borrowing based activities is wider – for example bonds can be issued to cover expenses for things such as publicly owned corporations, disbursements, and loans, refinancing of local bonds, disaster emergency projects, and maintenance of public facilities. The potential to borrow in order to cover short-term revenue gaps (there is a similar provision in Germany) is a key difference to England, which is restricted to financing capital related investment expenses.

While the Japanese local government finance system does not have the same debt restrictions as those countries operating under the European Union fiscal rules, the Japanese Government does, in effect, guarantee any local government borrowing via a system of intergovernmental budget setting and associated scrutiny – they achieve this through the Local Government Finance Programme and the Local Allocation Tax.

The national government in Japan formulates the Local Government Finance Plan (LGFP) each year based on assessments and forecasts of overall revenue and expenditure in each municipality. Under this process all sources of local government revenue, including the current assignment of Local Allocation Tax as well as bonds and loans (including principal and interest payments as part of standard financial requirements) are accounted for in such a way that local government can deliver the uniform public service standard (Japanese Public Finance Fact Sheet, 2022). While the ideal situation would be for local government to cover its own expenditure via local income, in practice this is not possible due to uneven development. In response, and under the powers of the Law Relating to the Financial Soundness of Local Governments in Japan, national government adjusts the Local Allocation Tax (which is comprised of assigned portions of nationally collected personal and corporate income tax and consumption tax) – see Section 9 for a more detailed discussion of the Local Allocation Tax and Section 11 for a more detailed discussion of equalisation. A parallel Local Government Borrowing Plan provides further guidance each year and a reference point for decision making, detailing how much can be borrowed, restrictions on borrowing – for example any local governments with a debt payment ratio exceeding 17% (or those with prearranged levels) are prohibited from borrowing under the Local Government Finance Law.

9. Sources of income

In Japan there are at least 24 different local taxes, as well as those specifically created by individual local governments. This serves the purpose, compared with England, of orientating the balance of income from centre to local. Local government has full control over its independent financial operations. However, mechanisms exist to ensure balance with central government financial operations and to secure revenue sources. The accounts of local government are classified into 'general' and 'special accounts'; however, as the classification of these accounts varies across local government, they are grouped and classified into two categories to allow for comparison: 'ordinary' and 'other accounts.' General accounts are principally financed by tax revenues. Special accounts are ring-fenced for specific purposes, for example, public insurance contributions. Examples of special accounts include public enterprise accounts, national health insurance accounts and latter-stage elderly medical care accounts.

Table 1 describes the variety of tax available in Japan across the national and local scale.

Table 1: Local and National Tax in Japan

<table>
<tr><th></th><th>National taxes</th><th>Local taxes</th><th></th><th>National taxes</th><th>Local taxes</th></tr>
<tr><td>Income Taxation</td><td>Income tax
Corporation tax
Local corporation tax
Special corporate enterprise tax
Forest environment tax (FY2024)
Special income tax for reconstruction</td><td>Inhabitant tax
Enterprise tax</td><td rowspan="2">Consumption taxes</td><td rowspan="2">Consumption tax
Liquor tax
Tobacco tax
Special tobacco tax
Gasoline tax
Local gasoline tax
Liquified petroleum gas tax
Aviation fuel tax
Petroleum and coal tax
Promotion of power resources developmet tax
Motor vehicle tonnage tax
International tourist tax
Tariffs
Tonnage tax
Special tonnage tax</td><td rowspan="2">Local consumption tax
Local tobacco tax
Golf course utilization tax
Automobile acquisition tax
Light oil delivery tax
Automobile tax
Mine lot tax
Hunting tax
Mine production tax
Bathing tax</td></tr>
<tr><td>Asset taxation, etc</td><td>Inheritance/gift tax
Registration and license tax
Stamp tax</td><td>Real estate acquisition tax
Fixed asset tax
City planning tax
Establishment tax
Water utility and land profit tax
Common facilities tax
Housing land development tax
Special land possession tax
Discretionary tax earmarked for general use
Discretionary tax earmarked for special use
National health insurance tax</td></tr>
</table>

(Reproduced from information in Japanese Local Government White Paper 2022 and Japan Finance Organisation for Municipalities Annual Report 2022 and Council of Local Authorities for International Relations 2022).

Local income is complemented by the aforementioned Local Allocation Tax (LAT), which acts as a non-ringfenced general grant formulated and distributed by central government. The LAT assigns portions of national tax – national alcohol duty, tobacco tax and income, corporate and consumption tax, providing at times 20% of local government funding. Rather than focusing on property tax at the local level, Japanese local governments have a range of income streams associated with fixed assets, income, and consumption complemented by the LAT. This contrasts with England, where there has been a reliance, since 2013, on a complex system of business rate retention for fiscal devolution and redistribution purposes, essentially a single tax on commercial property. Tokyo Metropolis gets very little support from the LAT while Akita in the North of Japan gets nearly 70% of its income from the LAT (Breach, 2019).

In addition, National Treasury Disbursements (a collective term for the national obligatory share, commissioning expenses, incentives for specific policies, or financial assistance disbursed from central government to local governments) are also allocated to local government – however, this is 'ring-fenced' funding (Bessho, 2016, Japanese Local Government White Paper, 2022). These disbursements come in three forms: national treasury obligations, grants, and payments for delegated functions. National treasury obligations are paid when there is shared responsibility between central and local government in a project, i.e., central government finances the programme and local government implements it (Kameda et al, 2021). Payments for compulsory education are an example of this. National Treasury Grants are ringfenced allocations to local government to incentivise specific measures. Payments for delegated functions are disbursements made to cover programs originally the responsibility of central government, but which were entrusted to local government for convenience and efficiency, such as election expenses for members of the National Diet (Kemeda et al, 2021).

Finally, there is the possibility of a) local bonds where the debts of local government are to be repaid over a period of time in excess of one fiscal year and b) Bonds for Extraordinary Financial Measures, which are issued as an exception to Article 5 of the Local Finance Law to address shortages of general revenue resources of local governments (Clair, 2022). They can exercise this option following consultation with the Ministry of Internal Affairs and Communications (prefectures) or the prefectural governor (municipalities). Other sources of finance include local transfer taxes, usage charges and fees.

Taxes can be considered under income, fixed assets, and consumption. In the financial year of 2019, the total of local and national taxes collected amounted to 103,386.6 billion JPY. Of this 60.1% were national taxes, and the remaining 39.9% were local taxes. This comprised 22.1% municipal taxes and 17.7% prefectural taxes. The Local Tax Law also determines standard tax rates for local taxes on personal income, firms, fixed assets, tobacco, and consumption. **Enterprise Tax** and the **Local Inhabitant Tax** are the main local income related tax strands.

The **Enterprise Tax/Business Tax** is a tax levied by prefectures on the taxable corporate income base, levied on value-added and capital. This is based upon the pro-forma business size, such as the number of employees and amount of capital if larger than 100 million JPY. The **Inhabitant Tax** is the collective term for prefectural and municipal taxes on individual income. For individuals, there is a flat-rate component and an income-graded component which is assessed based on your income from the previous year. Corporations must pay corporate inhabitant tax to the prefecture and municipalities where they have offices. These taxes are computed as a percentage of the national Corporation Tax before tax credits and a per capita levy, which is determined based on the amount of capital and the number of employees. This is paid directly to prefectures and municipalities, which is then split between them.

The sources of income under fixed assets are more varied, ranging from real estate acquisition tax to national health insurance tax. For example, the **Fixed Asset Tax** is an annual tax levied by municipalities on real property and depreciable fixed assets used for business purposes. Real property is taxed at 1.7% of its appraised value, including city planning tax, while the depreciable fixed assets tax is assessed at 1.4% of its cost after statutory depreciation. In addition, the City Planning Tax is levied at a rate of 0.3% on land and structures within city planning zones.

Finally, **Local Consumption Tax** (VAT) is imposed on goods, services, and imports in Japan at a traditional rate of 8% (10% from October 2019). Some transactions, such as land sales, securities, and public services, are exempt from taxation. Businesses can claim credits or refunds for the consumption tax paid, subject to certain conditions. To simplify the process, an invoice system was introduced in October 2023. Lower tax rates of 8% apply to food and newspaper subscriptions, and a reverse-charge mechanism applies to cross-border digital services. Japanese sponsors of foreign entertainment providers are subject to a reverse-charge system - 2.2 % of the 10% consumption tax is allocated as local tax.

10. Degree of own budgeting and accounting

At the prefecture level the major revenue expenditures include education (20.6%), public welfare (16.6%), debt servicing (13.3%), civil engineering work (12.0%), general administration (6.3%), commerce and industry (6.1%) and agriculture, forestry, and fishery (4.9%). While at the municipal level, the major expenditures include public welfare (36.7%), education (12.6%), general administration (12.0%), civil engineering work (10.8%), debt servicing (9.3%), sanitation (8.3%), commerce and industry 3.0%, and agriculture, forestry, and fishery (2.3%).

According to the latest Local Finance White Paper (2023), total revenue of local government in the financial year 2019 was 103,245.9 billion JPY, total prefectural income totalled 50,914 billion JPY. Local taxes are the primary sources of total annual revenue. In 2019 prefecture taxes were 40.7% of the total annual revenue for prefectures. The figure for municipalities was slightly lower at 33.4% of total annual revenue. Table 2 describes the composition of revenue type for prefecture and municipality while Table 3 breaks down local tax into its major constituent parts.

Table 2: Composition of local revenue

Revenue Type	% of income	
Disbursements		
	Prefecture	Municipality
National Treasury Disbursement	11.7%	16.1%
Prefectural Disbursement	NA	6.8%
Special Local Grants		
	Prefecture	Municipality
	0.3%	0.5%
Local Allocation Tax (equalisation)		
	Prefecture	Municipality
	17%	13.2%
Local Taxes		
	Prefecture	Municipality
	40.7%	33.4%
Local Transfer Tax		
	Prefecture	Municipality
	4.3%	0.7%
Bonds		
	Prefecture	Municipality
Local Bonds	11%	8.6%
Bonds for Extraordinary Measures	3.5%	2.4%
Charges, income, and other sources		
	Prefecture	Municipality
	15.1%	16.3%

(Information based on adjusted numbers from Japanese Local Government White Paper 2022 and Japan Finance Organisation for Municipalities Annual Report 2022)

Table 3: Composition of local taxations

Composition of local taxes	
Prefecture	Municipality
Prefectural Inhabitant Tax 30.9%	Municipal Inhabitant Tax 49.6%
Local Consumption Tax 26.1 %	Fixed Asset Tax 40.6%
Enterprise Tax 25.1%	City Planning Tax 5.8%
Automobile Tax 8.7%	Municipal Tobacco Tax 3.7%
Light Oil Delivery Tax 5.2%	Other Taxes 3.0%
Real Estate Acquisition Tax 2.2%	
Prefectural Tobacco Tax 0.8%	
Other Taxes 0.6%	

(Information based on adjusted numbers from Japanese Local Government White Paper 2022 and Japan Finance Organisation for Municipalities Annual Report 2022)

The largest contribution to prefectural taxes by overall contribution was the prefectural inhabitant tax (30.9%), local consumption tax (26.1%), enterprise tax (25.1%), automobile tax (8.7%), light oil delivery tax (5.2%), real estate acquisition tax (2.2%), prefectural tobacco tax (0.8%), automobile acquisition tax (0.6%) and other taxes (0.6). Major municipal tax income was levied from a far smaller range of sources despite having a higher overall amount. Municipal income was made up of municipal inhabitant tax (46.9%), fixed asset tax (40.6%), city planning tax (5.8%), municipal tobacco tax (3.7%) and other taxes (3.0%). This indicates that many of the additional municipal taxes highlighted in Table 1 make a relatively peripheral overall contribution.

11. Territorial equalisation methodology

In Japan, equalisation strategies to manage the disparities between different local governments are primarily comprised of National Treasury Disbursements and the Local Allocation Tax. Similarly, to England, these centralised disbursements, or *grants,* are ring fenced for specific purposes and offer local government very little discretion. The most powerful tool is the Local Allocation Tax (LAT). The LAT is a mechanism created to compensate for tax-raising inequalities. The system guarantees that a portion of national tax revenue is a common financial resource for all local governments. The LAT is collected and administered by central government on behalf of local government. It is redistributed to compensate for financial imbalances and to maintain service provision – LAT based revenue is not ring-fenced or earmarked.

The total amount of the LAT is determined in accordance with estimates of standard revenue and expenditures in local public finance as a whole, based on a fixed percentage for national taxes (33.1% for income tax and corporate tax, 50% for liquor tax, 20.8% for consumption tax, and the total amount of local corporate tax). The LAT comprises ordinary and special allocation taxes – the ordinary tax covers 94% of all payments and is used to cover financial shortfalls by respective local governments. The special allocation tax accounts for 6% of all payments and covers exceptional cases such as disasters and unique circumstances. The distribution of the LAT centres around the 'funding shortfall' – the difference between base financial needs and revenue. Financial needs are calculated with a prescribed formula for each administrative cost, such as civil engineering or education costs, to measure the financial needs of an authority. The calculation begins with the cost to maintain services in a standard entity, adjusted based on population, area, and unique regional circumstances, to determine each entity's specific base financial need (Clair, 2022).

The base revenue amount is 75% of the estimated standard revenue for prefectures and municipalities, as extrapolated from recently collected tax revenue. The percentage is not 100% to avoid discouraging local government from increasing local taxes. This is because if the ordinary allocation tax is reduced by the same amount as any increase in local tax revenue, there would be no incentive for local government to increase taxes. It also leaves financial resources available for independent projects. If the total revenue shortfall for a local government is less than the ordinary allocation tax amount, the shortfall is adjusted to match the ordinary allocation tax amount. No distribution is made to areas such as Tokyo, whose base revenues far exceed their financial needs. These are known as 'non-receiving entities' and are a net contributor into the overall local government finance system in Japan. In the eventuality that LAT does not fully cover the total funding shortfall of a local government, central government can implement local financing measures including allowing the borrowing of additional funds or transfers from the General Account (Special Fund Transfers) to the LAT Special Account.

12. Conclusion

The local government finance system in Japan is designed to provide essential public services to at least a minimum standard, the promotion of local development while ensuring fiscal sustainability – balancing the constitutional emphasis on autonomy of local government with the requirement of central coordination, oversight, and overall financial resilience (see Section 5). The Local Autonomy Law is the cornerstone for the basic operation of local government, outlining matters such as types, powers, legislative assemblies, agencies, and financial affairs. It also outlines the vertical intergovernmental relationship between state and local government and the horizontal relationship between respective local governments. Like Germany and Italy (the other case studies in this series of reports), there is a thriving range of local government associations in Japan that work towards cooperative interstate relations, working with national government to shape financial settlements, advocate the interests of local government regionally and nationally, share best practice and, more broadly, help to address common challenges around local government finance (see Section 5 for more detail).

The following observations can be made about the Japanese local government finance system, as it relates to the potential for change in England:

- **Transition to financial resilience:** the 'Trinity Reform' in Japan initiated in the early 2000s, provides a legislative reference point for how a system heavily criticised for its centralised tendencies, and agency approach to local government, can reform relatively quickly. The underlying rationale in the promotion of the 'Trinity Reform' was the belief that one of the central root causes of severe local government financial distress lies in the weak capacity of local government to generate and/or have discretion over its own tax revenue and income.

- **Decentralisation and autonomy:** while decentralisation and autonomy feature heavily in the constitution and related legislation – the system of sub-national government is very heterogeneous meeting specific local requirements. It is important to note that this is part of a wider embedded interstate system of intergovernmental financial relations and scrutiny.

- **Variety of income:** like Germany and Italy, Japanese municipal revenue is much more diverse than England with prefectures and municipalities benefiting from more than 20 local taxes, income taxes, consumption taxes and national treasury disbursements. This creates a varied revenue base upon which to make decisions (a level of discretion currently unavailable in England) and a reference point for how the local government finance system could evolve in England. In England, there is often a binary debate between central allocation and fiscal devolution. The Japanese system demonstrates that national treasury disbursements (regularly seen in England) can exist alongside assigned revenue and locally sourced income.

- **Funded mandates and expenditure:** In Japan there is a systematic assessment of needs and available income which includes costs associated with debt management. Where there is shortfall in income at the local level, to cover expenditure, the LAT is adjusted to compensate. This interstate financial relationship minimises the risk of unfunded mandates that are currently seen in England and guarantees the delivery of minimum service levels.

- **Insolvency and turnaround management:** In parallel with the Trinity Reform, since the enactment of the Law Relating to the Financial Soundness of Local Governments, the number of local governments needing improvement measures has reduced markedly, with only a very small minority under either *red* or *yellow* card status. Enhanced financial reporting, early warning signals and improvement plans are now a proactive part of the local government finance system in Japan, targeting even the smallest signs of distress. This targeted process provides an important benchmark for turnaround management (Stevens, 2013) and a set of lessons for the development of a scrutiny system that could a) help counter the increasing number of Section 114 Notices in England and b) provide reassurance to central government that decentralisation can work hand in hand with an embedded process of system-based scrutiny (see Japanese White Paper on Local Public Finance for more detail on this topic). In addition, while a 'red card' system could tackle those local authorities in most distress, a 'yellow card' system could reveal the potentially much bigger problem of those local authorities who are just about remaining solvent but exist on the permanent margin of viability and increasingly constrained ability to deliver public services.

- **Scrutiny:** in addition to the thriving number of intergovernmental associations, the Local Autonomy Act defines the relationship between national and local government and provides an objective foundation for any dispute between the respective tiers of government. There is also a Local Autonomy Committee (*Chihou Jichi Chousaki*) hosted by the Ministry of Internal Affairs and Communications. This committee investigates (via referral) disputes between local government and the state, providing a forum for their resolution.

- **Equalisation measures:** Like many other countries Japan faces the challenge of how to balance the incentivisation of local economic activity through decentralisation of tax and redistribution of income between rich and poor locations. Japan achieves this through national treasury allocations, assignment of major national taxes, the LAT, and a diverse array of local tax options. This provides a case example of how England could move toward a more discretionary and resilient local government financial system – it currently relies on a mostly earmarked form of treasury disbursement, and a limited array of mostly property related taxes at the local level.

- **Devolution fatigue:** It is important to note that devolution is not a panacea for all of the challenges of local government. Respondents made clear that while devolution and decentralisation are important facets of local government finance in Japan, when tasks are devolved in isolation or in excessive quantum they can place to much burden on prefectures and municipalities. Rather, echoing the whole system approach advocated in this study, respondents indicated that tasks need to be assigned and funded at the appropriate tier of government.

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