

*Toward a Third Japanese Revolution:  
The Political Economy of Japanese Fiscal Decentralization*

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## ABSTRACT

The current Japanese intergovernmental fiscal relationship is problematic due to its significant, vertical fiscal imbalance. The heart of the problem is large scale fiscal distributions from the central government to local governments.

The current policy reform proposal insists on implementing fiscal decentralization in Japan, and hypothesizes that the current problematic Japanese intergovernmental fiscal relationship contributes to making some of Japan's most serious problems worse, such as the huge size of government expenditures, a lack of economic growth, and the accumulation of public debt.

In order to examine this hypothesis, this thesis carefully chooses empirical research that can be applicable to Japanese fiscal decentralization. Careful application of the most recent empirical and normative research from the world to the Japan's proposed fiscal decentralization policy indicates that Japanese fiscal decentralization, in the form of transfers of tax revenue sources in combination with decreasing grants, would reduce the total size of the Japanese government significantly, contribute to more active political participation, bring a greater degree of local autonomy, and create a more functional democracy. The application of additional empirical research to the proposed policy strongly suggests that fiscal decentralization in Japan would also contribute to higher economic growth. Finally, careful consideration of several issues suggests that Japanese fiscal decentralization would have favorable effects on public debt problems.

Japanese fiscal decentralization – large scale transfers of tax revenue sources – challenges the traditional theory of the allocation of economic functions of public finance between the central and local governments. A new theory asserts that in light of

globalization and the aging society, local governments in Japan need to play an important role in the process of not only resource allocation, but also parts of income redistribution.

Historically, the Japanese intergovernmental fiscal relationship has been under the power of bureaucrats in the central government. However, in the recent decade, there have been three major transitions in Japanese politics in terms of fiscal decentralization – 1) the demise of the Liberal Democratic Party’s one-party regime in 1993, 2) the administrative organizational reform in 2001, and 3) the emergence of powerful actors in the current Koizumi cabinet in 2001. These three changes have raised the debate over fiscal decentralization from the bureaucracy level to the ministerial level. Japanese fiscal decentralization may become the third Japanese revolution after 1) “the Meiji revolution” beginning in 1868 and 2) “the revolution after World War II.” It stands to create dramatically positive effects on the relationship between the central and local governments, as well as Japan’s whole governance style.

This is the first work to provide comprehensive analyses of the political and economic situation surrounding Japanese fiscal decentralization, and comprehensive predictions of its effects in both the economic and political contexts. It is, perhaps, the first application of the breadth of the recent research on the recent global fiscal decentralization trend to Japan’s current proposal for a fiscal decentralization policy.

This thesis provides strong support for the following policy changes: the Japanese government should implement its fiscal decentralization policy in the form of large scale transfers of tax revenue sources from the central government to local governments as soon as possible. The transfers should be first accompanied by sufficiently decreasing grants before examining the possibility of decreasing the Local Allocation Tax.

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