“Why Municipalities in Japan Refused Amalgamation?”

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1. Introduction

Since the 1980s, Japan has experienced significant reforms in several areas; governmental reform, decentralization reform, financial reform, electoral reform, social welfare reform, etc.[1] Among these reforms, the decentralization reform has significantly changed the intergovernmental relations between the central and local governments in Japan. In the first wave of the decentralization in 1998, the agency-delegated functions were wiped out. In addition, financial transfers from the central to local governments have been cut since 2001. To strengthen the financial basis of municipality governments, the central government has strongly promoted municipality amalgamations since the 1990s. This is called “Heisei no Dai Gappei (The “Heisei” Amalgamation)” (Radical Municipality Amalgamation in Heisei Era).

Japan has experienced radical municipality amalgamations three times since the Meiji Era. First, the municipality system, which consisted of towns and villages, was reorganized as cities, towns and villages in 1889. As a result of this reorganization, over 70,000 towns and villages were integrated into 39 cities, and 15,800 towns and villages. This reorganization aimed at developing municipalities’ administrative basis in dealing with education, family registration and taxation. Second, after World War II, several laws were enacted for promoting municipality amalgamations; in 1953, the Towns and Villages Merger Law (“Cho Son Gappei Suishin Ho”), and in 1956, the Law for Promoting the Establishment of New Municipalities (“Shin Shi Cho Son Kensetsu Suishin Ho”). The number of municipalities was reduced to about 3,400 after this amalgamation. Following these two waves, the “Heisei” amalgamation, the third wave, appeared as an initiative of the central government. To promote amalgamations, the Municipal Merger Law was renewed in 1995 as temporary legislation with a ten-year term limit.[2] However, the Municipal Merger Law was amended in 1999 before the end of the term limit. With this amendment, the central government in Japan has strongly forged ahead with municipal amalgamation with the target number set at 1,000 municipalities. As a result, most of the municipal governments have considered the possibility of amalgamation, and the number of municipalities has been reduced by about fifty percent. There are, however, still more than 1,800 municipalities now.

It is often said that the central government in Japan has overwhelming influence over local governments. Why then did the central government fail to accomplish its goal in this case? This paper answers this puzzle by focusing on the factor which determines the municipalities’ decision regarding amalgamation. As past research mentions, municipality amalgamation

[1] Concerning reforms in each area, see Campbell (1999), Toya (2003), and Peng (2004).
[2] The Municipality Merger Law was enacted in 1965 for the first time as temporary legislation with a ten-year term limit. This law had been updated twice in each of 1975 and 1985.

improves fiscal efficiency.[3] We examine how municipal governments make decisions on amalgamation, facing severe budgetary condition by using data covering all municipality governments in 1998 just before the "Heisei" amalgamation started and in 2006 when the amalgamation process was completed. Past research provided rich literature in case studies or qualitative perspective, but they did not deal with municipality amalgamations from the quantitative perspective. This paper supplements this gap by providing quantitative information. We will show that each municipality behaves strategically to improve its budgetary condition while trying to seize the initiative in administrative management after the amalgamation. This strategic behavior prevents the central government's plan from being achieved. In fact, municipal governments consider the amalgamation not as a goal to achieve but as a way to strengthen their financial base.

In section 2, we will briefly describe the intergovernmental system of Japan and mention the "Heisei" municipality amalgamations. Then, in the third section, we will review past studies and factors, which influence municipalities' decision over amalgamations. After that, in section 4, we describe the data and analyze how the factors evolved in the previous chapter affect the municipality amalgamation. In section 5, we will summarize arguments and draw conclusions.

2. Intergovernmental Relations in Japan and the "Heisei" amalgamation

Japan takes the unitary system with a three-layered structure: the central government, prefectures, and municipalities like cities, towns and villages. There is one important institutional setting which shapes this intergovernmental relation between the central and local governments in Japan. It is the financial transfer from the central government to local governments. This transfer takes two forms. One is the local allocation tax and another is a subsidy. First, to reallocate financial resources among local governments, the local allocation tax is determined based on the shortage of local governments' financial resource. Local governments can use this transfer for any purpose, so this transfer can be considered as one of the independent financial resource of local governments. This transfer has played a role in redistributing financial source to mainly support rural areas because local governments in rural areas are more likely to face severe financial condition than those in urban areas. Consequently, rural areas which have smaller populations have received more local allocation tax per capita.[4] Another transfer is a subsidy. This transfer has been mainly used for community development. In 2000, just before the start of the municipal amalgamation, financial transfers from the central government to municipal governments constituted about 28% of municipalities' revenue. Local Tax accounted for about 34%, municipal bonds consisted of 10%, and miscellaneous income accounted for about 20%.[5] There are strong constraints imposed by the central government on municipalities in issuing municipal bonds, and municipal governments cannot alter tax rates freely by their own authority.

In the following part of this section, we review the "Heisei" municipality amalgamation briefly.[6] The "Heisei" amalgamation started in 1999 when the Municipal Merger Law was amended. The Municipal Merger Law was originally enacted in 1965 as a temporary legislation with a ten-year term limit and this law has been renewed three times in 1975, 1985 and 1995. In

[3] See Yoshimura (1999, 2002); Konishi (2003); Yokomichi (2003b).
[4] See Mabuchi (2004).
[5] Data available from the Ministry of Internal Affairs and Communication.
[6] See Yamasaki (2003) for further details about the Municipal Merger Law.

the 1995 renewal, the spirit of the law was changed to promote amalgamations. As a result of this change, residents in a municipality obtained the initiative in proposing municipality amalgamations.

Furthermore, under the banner of decentralization reform in Japan in the 1990s, the central government delegated much more administrative power to municipalities. In the first stage of the reform, the Committee for the Promotion of Decentralization did not argue about municipality amalgamation, because it focused on terminating the agency-delegated functions.[7] After the first stage, the argument of municipality amalgamations appeared in the policy-making process. In 1998, the 25th Local Government System Research Council (Chiho Seido Chosa Kai) published a final report about municipality amalgamations. In this report, the Council suggested that it is necessary to reinforce the residents' initiative and the role of prefectures in municipality amalgamations, in order to promote amalgamations. Following this report, the central government of Japan increased financial and administrative supports to municipalities.[8] The Ministry of Home Affairs (MOHA)[9] set the promotion of municipality amalgamation as the policy with overriding priority in local finance and administration. MOHA started to consider the pattern of amalgamation in each prefecture, to expand the residents' initiative, and to offer financial supports to prefectures which stimulate municipality amalgamations. In August 1999, MOHA requested prefectures to decide the plan for amalgamation which stipulates the pattern of amalgamations in each prefecture in the Road Map for the Promotion of Municipality Amalgamations. In spite of these efforts by the central government, the number of amalgamations from 1995 to 1998 was only three. This made the central government amend the Municipality Merger Law in 1999. There are several changes regarding exceptional treatments for municipal amalgamation in this amendment.[10] First, it introduced the residents' initiative in creating a consultative body on municipality merger. Residents can play a more major role in municipality mergers as a result of this change. Second, it established a special exception regarding the number of members of the municipality assembly and the pension of the assembly members. Third, it relaxed the requirements to being a city, as an exceptional treatment. In the case of amalgamations, towns or villages can be a city with smaller numbers of residents.

However, even after the 1999 amendment, the number of amalgamations had not increased. There were 3,229 municipalities on April 1st 1999, and there were 3,218 municipalities after two years on April 1st 2001. The central government set the goal of the number of municipalities at 1,000 in *Outline of Administrative Reform* in 2000, but to accomplish this goal the central government had to take further measures, which promoted amalgamations. In this severe situation for the central government, Toranosuke Katayama, the Minister of Internal Affairs and Communications, suggested the "Katayama Plan" which aims at promoting municipal mergers much more strongly by cutting financial transfer from the central to prefectural and municipal governments.[11]

From 2001, under the Koizumi Administration, several structural reforms were carried out.[12] The "Trinity Reform" is one of such reforms in Japan.[13] Trinity means three reforms in

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7 See Nishio (1999).

8 The Cabinet approved the Plan for the Promotion of Decentralization in May 1998.

9 MOHA was reorganized as The Ministry of Internal Affairs and Communications in 2001.

10 See Matsumoto (1999) and Yamasaki (2003) for further details about the 1999 amendment.

11 See Kamo (2003) and Konishi (2003).

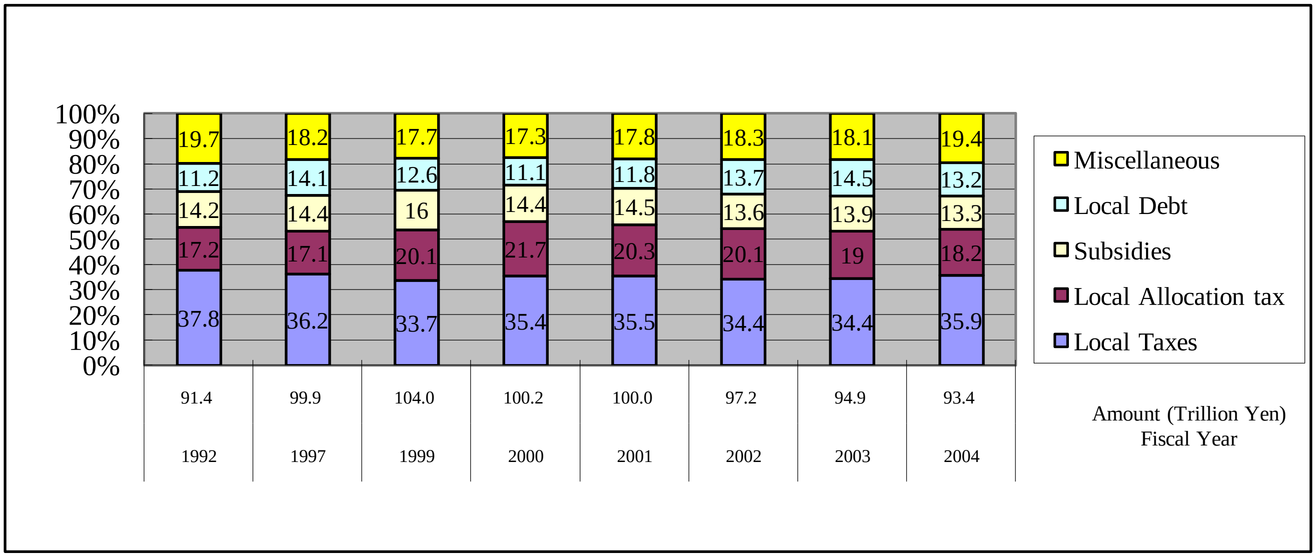
12 For example, privatization of post office, privatization of road construction agency and reforming budget making processes were carried out in the Koizumi Administration.

13 See Kitamura (2005) for further details about the trinity reform in Japan.

the local allocation tax, subsidies and tax revenue sources.[14] First, local allocation tax has been reduced from 2001 (see Figure 1). In 2000, the amounts of local allocation tax were 21.8 trillion Yen (shares 21.7% of annual revenue of local governments[15]), but it is decreased to 17.0 trillion Yen in 2004 (shares 18.2% of annual revenue). This is about a 20% reduction in four years.

Second, subsidies from the central to local governments were reduced by three trillion Yen from the 2005 to the 2007 fiscal year (about a 20% cut), and, at the same time a 3 trillion yen tax revenue source is going to be transferred from the central government to local governments (which is some parts of income tax based on population).

Figure 1 Annual Revenue of Local Governments



Source: White Paper on Local Public Finance 2006 [Chiho Zaisei Hakusho].

These reforms are considered as bringing a wider range of varieties among municipalities. In the past, differences or inequity among local governments were corrected by the local allocation tax and subsidies, but such redistribution is being eliminated and local governments have to rely more on their own resources.

Table 1 shows the fiscal power index of municipalities in Japan. This index indicates local governments' financial basis, in short, how much of a rate they have for their own financial resources. As indicated in this table, urban cities have stronger financial base than rural areas. On the other hand, rural municipalities like small cities, towns and villages have a limited amount of independent financial source. The fiscal power index of middle sized cities and larger is around 0.80, whereas the index of small size cities, towns and villages is less than 0.60. In particular, towns and villages with a population less than 10 thousand are facing severe conditions, and their index is only 0.25. This means that they have only a 25% standard independent revenue in relation to standard financial needs.

[14] Takero Doi points out that trinity reform is lacking local securities reform. He claims that it is important to establish a local governmental system based on market mechanisms (Doi 2003; 2004).

[15] This includes both prefectures and municipalities.

Table 1 Financial Capability Index (2004)

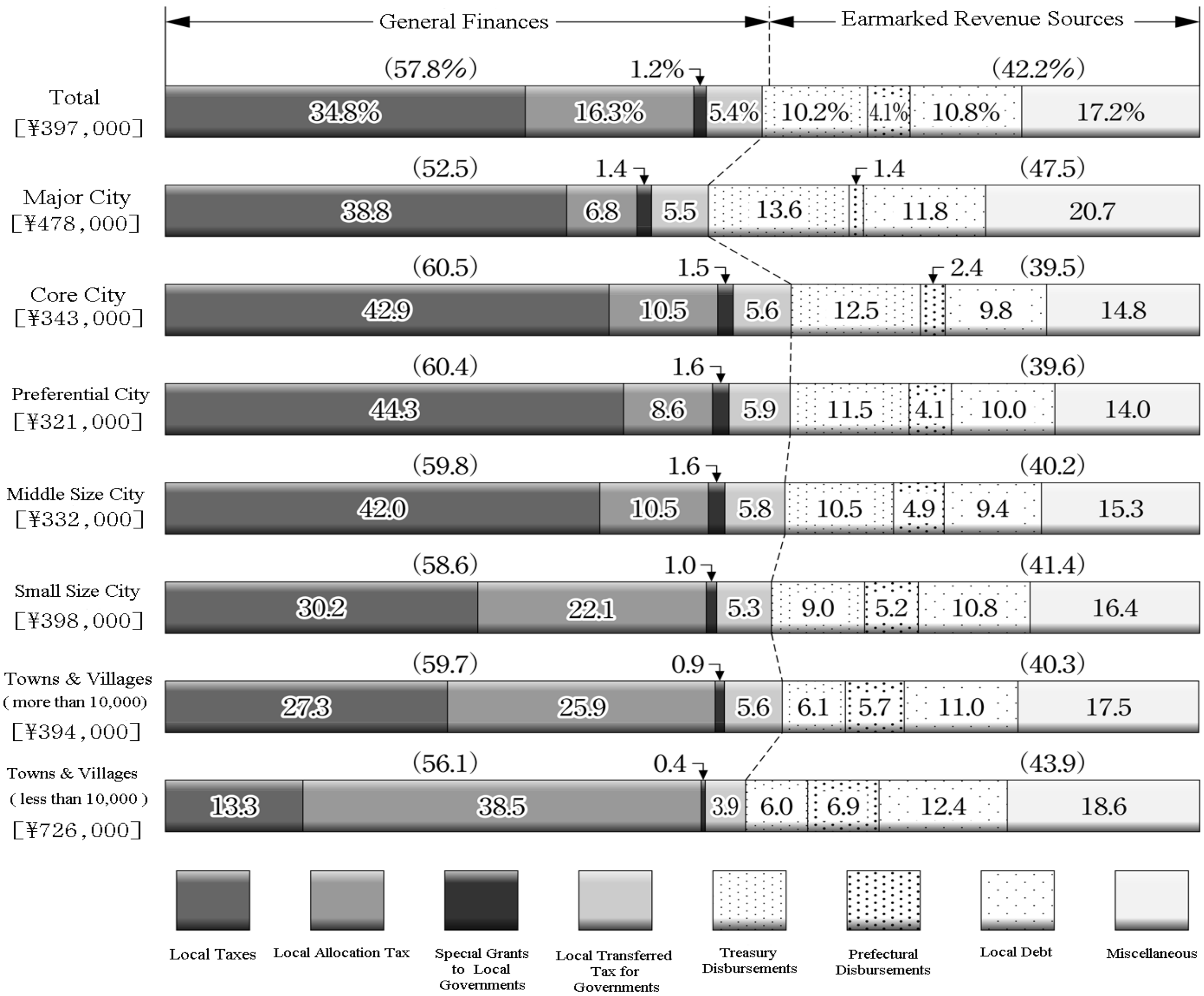
Classification	Financial Capability Index
Major City	0.81
Core City	0.81
Preferential City	0.85
Middle Size City	0.83
Small Size City	0.60
Towns and Villages (more than Ten Thousands population)	0.51
Towns and Villages (less than Ten Thousands population)	0.26

Source: White Paper on Local Public Finance 2006 [Chiho Zaisei Hakusho].

Figure 2 shows that smaller municipalities rely heavily on the local allocation tax and transfer from upper governments. While cities have local taxes which share more than 30% of annual revenue, towns and villages have local taxes which share less than 30% of revenue. Especially, small towns and villages, which have a population of less than 10 thousand, rely for only 12.3% of revenue on local taxes. This means that they have only a 12% tax basis and transfer from upper governments which accounts for more than 50%. Moreover, these small municipalities rely on 15.4% from local bonds. Local bonds are contemporally financed by the central government through the local allocation tax. However, as mentioned above, the local allocation tax will be reduced, so it will be more difficult for small municipalities to issue local bonds.[16] The amount of reduction of subsidies is equal to the transfer of tax source to local governments, so it seems that these reforms in subsidies and tax source transfer would not influence local governments' finance. However, as described above, small municipalities depend on such transfer from the central government, so small municipalities will be facing severer situations after the trinity reform.

[16] Local governments cannot issue local securities freely. Local governments, which have a financial deficit exceeding the allowable limits set by the central government, cannot issue local bonds.

Figure 2 Annual Revenue of Municipalities by size (2004)



Source: White Paper on Local Public Finance 2006 [Chiho Zaisei Hakusho].
Note: Total means the simple average of all municipalities. Annual Revenues per capita are in [ ].

3. Past Studies and Variables in Analysis

As mentioned above, the "Heisei" amalgamation is the third wave following the "Meiji" and "Showa" amalgamations. Among these amalgamations, the "Heisei" amalgamation aims at strengthening the fiscal base of municipal governments in a time of decreasing financial transfers from the central government.[17] During the "Heisei" amalgamation, the number of municipalities has decreased from over 3,000 to 1,819 as of September 1, 2006. Most of these amalgamations included small municipalities. However, not all small size municipalities choose amalgamations.

[17] Yokomichi (2003a); Kitahara (2006).

Why does this happen? What is the factor which determines whether one municipality chooses amalgamation or not?

A number of past studies deal with the "Heisei" amalgamation. Some of them provide a case study of each amalgamation, and others argue the reason of the amalgamation. However, there are few studies dealing with the question above. In the following part, we will examine the factor of the amalgamation.

A lot of research suggest that municipality amalgamations have a positive impact on strengthening the fiscal base and improving the efficiency of public services of municipality governments.[18] According to past literature, the per capita public expenditure is minimized for a population between 100,000 to 300,000.[19] In particular, for municipalities whose population is less than 10,000, the increase of population as a result of amalgamations improves the efficiency of public services dramatically. The Ministry of Internal Affairs and Communications also suggests that it is necessary for small sized municipalities to get amalgamated to provide public services to an aging society for decentralization.[20] In this sense, municipalities' financial base should be an important factor in amalgamations.

Masatoshi Kitagawa examines the process of the "Heisei" amalgamations (Kitagawa 2003). He points out that the population and fiscal base of municipalities have a strong influence on the decision about amalgamations. Especially, a small sized municipality with a weak fiscal base has a strong tendency to amalgamate with other municipalities.[21] However, his study does not deal with all amalgamations in the "Heisei" amalgamation. In order to illustrate the whole picture of the "Heisei" amalgamation, it is necessary to analyze every amalgamation in the "Heisei" amalgamation.

After reviewing past studies, we introduce independent variables in this research. The main independent variable is the financial base of each municipality. As past research reveals, the financial base of municipalities is the one of the key factors in municipality amalgamations. We adopt the Financial Power Index[22] as a variable for the financial base of municipalities. To measure the fiscal condition of each municipality, the Financial Capability Index is appropriate. Furthermore, we adapt another variable: Population. As mentioned above, population affects the efficiency in providing civil services. In particular, municipalities with small populations must try to improve their efficiency thorough amalgamation.

4. Data Analysis

Fiscal Environment

In this section, we will show how fiscal problems shape the behavior of Japanese local governments and the "Heisei" amalgamation. As reviewed above, the Ministry of Internal Affairs and Communications has strongly promoted small cities, towns and villages to merge, based on the idea that fiscal improvement by mergers is significant especially when their population is

[18] See Yoshimura (1999); (2002); Konishi(2003); Yokomichi(2003b).

[19] See Yoshimura(1999); (2002); Yokomichi (2003a).

[20] See the website of the Ministry of Internal Affairs and Communications. (http://www.soumu.go.jp/gapei/index.html).

[21] See Kitagawa (2003).

[22] This index indicates municipal governments' financial basis, in short, how much of a rate they have for their own financial resource.

smaller than ten thousand. Thus, we have the following two hypotheses from this point.

Hypothesis 1-a: Smaller municipal governments have a stronger incentive to merge.

Hypothesis 1-b: The incentive to amalgamate is much stronger especially when their population is less than ten thousand.

Next, it is said that financial difficulties due to the continuing reduction of the Local Allocation Tax forced local governments to merge.

Hypothesis 2-a: If a local government is heavily dependent on the local allocation tax, it has a stronger incentive to merge in order to reduce personnel costs and improve its fiscal base.

Hypothesis 2-b: The incentive is much stronger especially when their population is small because the improvement in personnel costs is more significant for the smaller local government.

The model 1 in Table 2 examines the effect of the population size. The coefficient is negative and significant. Therefore, the smaller the population is, the larger the probability to merge is. We added a dummy variable in the model 2, representing local governments whose population is smaller than ten thousand. It is also significant and the sign is positive.

We also included the Fiscal Power Index in the model 3. The result shows financially weak local governments have stronger tendencies to merge. After controlling the effect of the FPI, the coefficient of population size becomes insignificant. Thus, population itself may not be important.

The small population dummy variable and its interaction with the FPI are included in the model 4. This result shows that the small population dummy is insignificant after the inclusion of the interaction term. Thus, even if their populations are small, local governments can refuse to merge if their fiscal conditions are strong.

It is said that financially weak, smaller local governments had tendencies to merge because of the change in their financial environments. Our analysis, however, showed that the population size itself is not so important. It becomes important only when combined with the fiscal strength.

From this result, we understand the hypothesis 1 do not always hold while the hypothesis 2 is supported. Financial position is the crucial determinants concerning the decision to merge or not.

Table 2

	Model 1		Model 2	
	merger/ no merger		merger/ no merger	
Independent Variables	estimates	t-statistics	estimates	t-statistics
Constant Term	0.551	13.734	0.188	3.394
Pop	-0.003	-5.725	-0.002	-3.351
Pop<10000			0.688	8.819
# of OBS	3228		3228	
Log Likelihood	-2134.693		-2095.668	
LR-P value	0.000		0.000	
	Model 3		Model 4	
	merger/ no merger		merger/ no merger	
Independent Variables	estimates	t-statistics	estimates	t-statistics
Constant Term	1.197	17.087	1.140	9.035
FPI	-1.729	-11.673	-1.815	-8.958
Pop	0.000	-1.235		
Pop<10000			-0.079	-0.508
FPI*Pop<10000			1.022	2.915
# of OBS	3228		3228	
Log Likelihood	-2063.5942		-2056.0005	
LR-P value	0.000		0.000	

Strategic Interactions

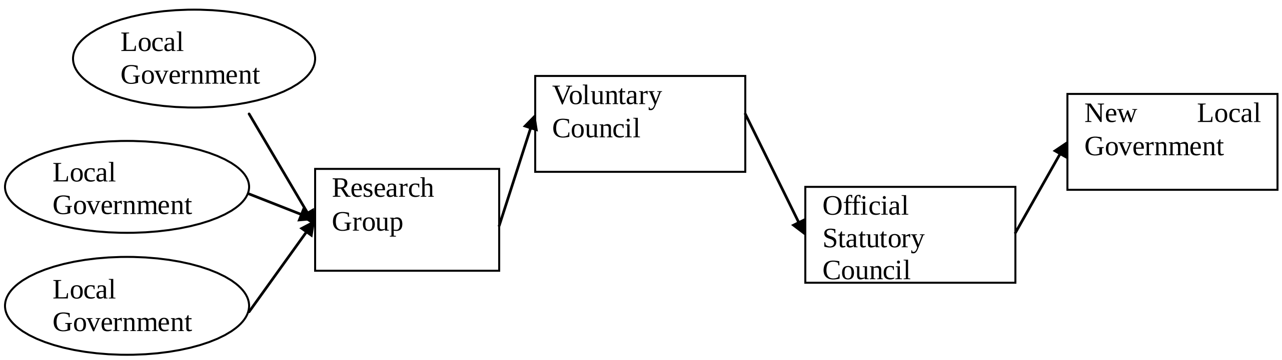
When does the population size become important? To understand the local governments' decision, we need to focus on the relationship among local governments. The amalgamation requires them to have partners. For example, fiscally weak local governments may have difficulties in finding partners to merge with. Financially strong local governments may have a free hand in choosing their partners when bargaining. This strategic relationship hindered financially weak local governments from merging. The population size in this context is crucial because population size represents the political power of the future. In short, local parliament members are elected according to the population size. After the amalgamation, each municipality becomes one part of new municipality. This suggests that a municipality whose population is larger has stronger influence after the amalgamation because of its population, and vice versa.

Hypothesis 3: Financially strong local governments with relatively small populations do not merge with fiscally problematic local governments with relatively large populations.

If wealthier but smaller in population, such local governments refuse to merge or find further smaller partners in order to keep their status of political majority in a new local government. Thus, if they try to keep the status of the majority and reject proposals from larger local governments, the largest local government will be the wealthiest local government among partners when they agree to merge. We examine this strategic behavior with data.

Before mergers, The Ministry of Internal Affairs and Communications ordered local governments to establish the Official Statutory Council ("Gappei Kyogi Kai"). In addition to the official statutory council, The Ministry of Internal Affairs and Communications proposed and supported for local governments to have several sessions among local governments.[23] According to the Ministry's model, ideally local governments would have three societies, from a research group on amalgamation, a voluntary council, to an official statutory council. Using the data on these societies, we can understand how negotiations among local governments proceed.

Figure 3 Processes to Merger



First, we understand how local governments strategically choose their partners by observing the changes of the numbers and compositions of local governments.

The first line in table 3 shows the ratio of the largest local government being the wealthiest among partners. As the negotiation proceeds from research groups, voluntary councils, official statutory councils to mergers, the number of local governments consisting of the societies reduces and the probability of consistency becomes higher. In this point, local governments have chosen their partners strategically. This relationship holds after controlling the number of local governments. Thus, we understand the process described above actually happened during the course of their negotiations. We also calculate two indexes, $\frac{\text{FPI of the largest in population}}{\sum \text{FPI}}$ and $\frac{\text{population of the largest}}{\sum \text{population}}$, for each society and calculate the correlation coefficients. This also becomes higher as the negotiation proceeds.

Table 3

	Reseach Groups	Voluntary Councils	Statutory Councils	New Governments
largest=wealthiest rati	0.6574	0.774	0.8228	0.8303
correlation	0.771	0.833	0.853	0.896
# of local gov	5.6395	4.2258	3.5786	3.5401
largest=wealthiest ratio				
# of local gov	Reseach Groups	Voluntary Councils	Statutory Councils	New Governments
2	0.822	0.845	0.885	0.886
3	0.798	0.766	0.805	0.811
4	0.576	0.759	0.735	0.744
5	0.542	0.677	0.775	0.816
6 and more	0.624	0.771	0.822	0.824

[23] Unfortunately, we still have not finished collecting all the data of the Research Group, The Voluntary Council and the Official Statutory Council. So far, we have collected data from September 2001, October 2002, January 2004, and January 2005 and removed redundancies.

Two Effects into One Model

Finally, we put the two effects, environmental and strategic effects, into one model. For a dyadic relationship, we assume

$$p(y_{ijp} = 1) = f(\text{local government i's incentive} + \text{j's incentive} + \text{strategic relationship})$$

where i and j represent local governments number and p represents the number of prefecture. Assume incentive to merge for i can be represented as

$$\alpha_p + \beta_1 FPI_i + \beta_2 Pop_i$$

Incentive for j can be represented by the same manner. Thus the following equation holds.

$$\text{local government i's incentive} + \text{j's incentive} = 2\alpha_p + \beta_1(FPI_i + FPI_j) + \beta_2(Pop_i + Pop_j).$$

In order to represent a strategic relationship, we add the relative measure of population and the fiscal power index. That is, we defined the population ratio and FPI ratio as

$$ratio_{pop} = \begin{cases} \dfrac{population_i}{population_j} & \textit{if } population_j > population_i \\ \dfrac{population_j}{population_i} & \textit{otherwise} \end{cases}$$

$$ratio_{FPI} = \begin{cases} \dfrac{FPI_i}{FPI_j} - 1 & \textit{if } population_j > population_i \\ \dfrac{FPI_j}{FPI_i} - 1 & \textit{otherwise} \end{cases}$$

and include these two measures and their interaction into the model.

Table 4

	model1		model2	
	merger / no merger		merger / no merger	
Environments	estimates	t-statistics	estimates	t-statistics
FPI	-1.711	-17.448	-1.806	-17.470
Pop	0.001	6.678	0.001	3.992
Pop<10000	0.220	5.681	0.263	6.495
Distance	-0.167	-62.117	-0.173	-62.244
Strategic				
Ratio_FPI			-1.002	-7.145
Ratio_Pop			-0.287	-2.323
Ratio_FPI*Ratio_Pop			1.551	8.038
(Coefficients of prefectural dummies are suppressed)				
	Log-Likelihood	LR-Ratio	Log-Likelihood	LR-Ratio
	-8524.78	9701.69	-8429.15	9892.95
	# of Obs	# of Variables	# of Obs	# of Variables
	60619	51	60619	54
	# of Zeros	# of Ones	# of Zeros	# of Ones
	57120	3499	57120	3499

Table 4 shows the estimated result of the determinants of the merger between two local governments.

As described above, environmental variables are significant and their signs are the same as shown in the model 1. One exception is the size of the population. The coefficients of the population are positive and significant although the effects are very small. The model 2 includes strategic variables. All coefficients are significant. If the population ratio becomes larger, which means the difference of population of two local governments becomes smaller, then the probability to merge two local governments becomes smaller. In addition, when the FPI of the larger town is small, then the probability to merge becomes smaller. The effects of population size are now clearer. It is actually positive in the environmental context but works negatively in the strategic context. These negative effects of the population and the FPI partially migrate when the ratio of population becomes larger and the difference of fiscal capacity is smaller.

5. Conclusion

So far, we have investigated how Japanese local governments behave during the “Heisei” amalgamation. Fiscal environmental change forced Japanese local governments to merge. However, during the course of the negotiations, they tried to keep their interests in terms of fiscal and political power. In this context, population, in other words politics, becomes a more important variable to shape their behaviors.

In this paper, we examined how the environment surrounding local governments has changed in Japan during the 1990’s and how municipal governments have reacted to the change. We examined the behavior of local governments in selecting the partner in amalgamation. As a result, we have clarified that municipalities behave strategically even when environmental conditions including the strong force by the central government have urged municipalities to amalgamate. This is one reason why the central government failed to accomplish its goal. In fact, the central government could promote amalgamations, but could not order municipalities to merge in the “Heisei” amalgamation.

Although the factor of amalgamations became clearer, we still have not explored several important variables. One example of such variables is the role of prefectural governors and officials. Some governors are very eager to promote mergers. In facts, prefectural difference of the rates of merger is significant. The effects of those variables should be examined in the future research.

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