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## 1. CHALLENGES AND POTENTIAL

### The national policy context: key issues

#### *Fragile economic recovery*

1. After a long period of economic stagnation, during which economic growth barely averaged 1% triggering a dramatic divergence between the Japanese economy and that of its major competitors, the Japanese economy appears to be moving forward. While recent growth has been pushed principally by growth in exports to China (which accounted for three-quarters of export growth in 2003 and which is now the second export market for Japanese goods after the US),<sup>1</sup> there is reason to believe that structural reforms are also having a positive impact, particularly with respect to stabilisation of the financial sector. Some of the major banks made profits last year for the first time since the early 1990s and non-performing loans, their principal liability, fell towards medium-term target levels. There are also signs that a broader recovery is underway with increased private sector investment, better export performance and some indications that domestic consumption is finally starting to strengthen. At the same time, even though growth forecasts are more optimistic for 2004 and 2005 than they have been for a decade, other indicators, such as land prices and bank lending, are still relatively weak.<sup>2</sup> Importantly, the level of unemployment has not started to fall significantly yet, though some reduction is expected.

2. Although at an early stage, there is a sense that the prolonged crisis affecting Japan's once dominant manufacturing industries is coming to an end and that the process of industrial restructuring is starting to bear fruit. The evidence that Japanese firms are consolidating their trade with China in key sectors is one indication that Japan's export industries have regained the international competitiveness that many had lost over the previous decade. This has been a result of a massive reorganisation of Japan's productive capacity, with a large share of its manufacturing industries moving overseas, leading to a collapse of previously stable production chains.<sup>3</sup> Some analysts argue that a new integrated economic system is developing in East Asia with a division of labour that fits with Japan's competitive strengths *vis-à-vis* other economies in the region. Schematically, in the emerging East Asian "system", Chinese companies, particularly in the machinery sector, are increasingly specialising in assembling final products, while other East Asian countries have become important parts suppliers. In the East Asian "division of labour", Japan develops innovative new products and exports high-quality, high-technology goods, thereby protecting the value of its share of mature export markets and also capitalising on growth of the Chinese market for high quality goods. Evidence of consolidation of high-end market segments by Japanese companies can be seen in the field of audiovisual equipment. For example, Japan has a 16% share of the US market for imported televisions, but represents only 3% in terms of quantity (numbers of TVs imported). The average unit value of imported TVs from Japan is around USD 1 000, whereas the corresponding unit values for China were less than USD 100 (Table 1.1). Moreover, between 1998 and 2002, export quantity increased by 33% and export value by over 60%, indicating that Japanese firms are strengthening their position in the quality end of the US market.

**Table 1.1. Market shares in value and quantity for TV exports to the United States**

| Exporter | Share of market value | Share of market in terms of units exported | Average value of units (USD) | Growth in share, in value terms (1998-2002) |
|----------|-----------------------|--------------------------------------------|------------------------------|---------------------------------------------|
| Mexico   | 48                    | 33                                         | 308                          | 2                                           |
| Japan    | 16                    | 3                                          | 1 034                        | 64                                          |
| Malaysia | 13                    | 20                                         | 137                          | 24                                          |
| China    | 9                     | 13                                         | 96                           | 75                                          |
| Thailand | 7                     | 13                                         | 118                          | 11                                          |
| Korea    | 3                     | 4                                          | 160                          | 29                                          |

Source: JETRO, ITC calculations/COMTRADE (ISIC classification 8528 Television receivers including monitors and video projectors).

3. This evolution of the balances and patterns in the East Asia regional economy is having an important impact on the orientation of thinking about economic strategies. In particular, the growth of China as an industrial/manufacturing power and the attractiveness of its internal market are likely to become the dominant forces in the region, providing serious challenges but also opportunities for Japanese firms. Already, even though Japan's direct investment in Asian countries has declined since FY 1998, direct investment in China has continued to increase. The number of Japanese companies to have merged with or acquired one of their Chinese counterparts has also increased. In addition, Asian enterprises are beginning to acquire, or invest in, Japanese companies, which was extremely rare in the past, and there has been a significant increase in the number of mergers among Japanese enterprises looking to build stronger export capacities.

4. The Northeast Asia region is now unusual in that no formal free trade area for its specific region has been established, despite the economic weight and potential of the region, which contains 25% of the world's population, produces 22% of world GDP, and accounts for approximately 24% of world trade. However, the absence of institutional integration instruments has not prevented trade intensity within the region from becoming as strong as or stronger than in other areas where regional agreements have been concluded (Table 1.2). The evolution of political and institutional ties alongside the increasing economic inter-relations within the northeast Asia region are only starting to gather pace. Japan's preference for multilateral frameworks, such as WTO and APEC has modified over the past few years with the conclusion of the first bilateral trade agreement with Singapore and others in perspective. The new economic environment has been recognised by local governments within Japan and both national and local economic development programmes are focused on identifying the high quality export potential within regional economies. The common target is China and several Japanese regions have already opened regional offices in Shanghai.

**Table 1.2. Intra-regional trade share (in percentage)**

| Regions                        | 1980 | 1985 | 1990 | 1995 | 2000 | 2001 |
|--------------------------------|------|------|------|------|------|------|
| East Asia 10 (including Japan) | 33.6 | 36.2 | 41.6 | 50.1 | 50.1 | 50.8 |
| East Asia 9                    | 22.6 | 26.3 | 32.8 | 38.4 | 39.5 | 41.0 |
| NIEs 4                         | 8.5  | 9.5  | 12.3 | 14.0 | 13.6 | 13.2 |
| ASEAN 4                        | 3.5  | 4.9  | 3.9  | 5.2  | 7.9  | 7.9  |
| NAFTA                          | --   | 36.6 | 36.8 | 41.9 | 46.5 | 46.3 |
| EU 15                          | 52.6 | 53.8 | 64.9 | 64.1 | 62.1 | 61.9 |

Source: "Regional Economic Integration and Cooperation in East Asia", Masahiro Kawai.

5. The result of this rationalisation of production processes across national borders has been that a large proportion of Japan's more labour intensive industries have disappeared. The machinery sector, for example, which accounts for a large share of Japan's total exports, lost over 750 000 manufacturing jobs and 12% of companies went out of business in the course of the 1990s.<sup>4</sup> This "hollowing out" of the economy has been a general phenomenon across the country, but has hit industries based outside the Tokyo-Osaka belt particularly hard. Among other things, it has seriously undermined Japan's traditional regional policy, which had relocation of industries to regional sites as one of its main pillars, and has left many enterprises isolated despite having strong technical capabilities and export potential.<sup>5</sup> Under the previous *keiretsu* system of vertical integration, large firms developed tightly woven networks of suppliers for whom the large firm was the only or one of very few customers (indeed the Ministry of Economy, Trade and Industry [METI] estimated that over 80% of small manufacturing firms had never changed their main customer). This system of long-term and relatively exclusive contractor-subcontractor relations encouraged the smaller firms to take on product development roles and invest in technology (the so-called banking *keiretsu* also allowed suppliers to access credit via the large firm). The collapse of the system has put many SMEs under significant pressure (paradoxically, there is evidence that some large companies in Japan are having increasing difficulty in finding small sub-contractors, many of whom have gone out of business, and are having to look further a field, specifically to the East Asia region, for component manufacturers).

6. The restructuring of the economy has had a major impact on the organisation of work in Japan. The recession and subsequent restructuring of firms brought unprecedented levels of unemployment to Japan. In 2003, the national unemployment rate stood at 5.3%, with regional rates as high as 7.8% in the outlying Okinawa prefecture and 6.6% in the core Kinki region around the metropolitan area of Osaka. In some industrial regions, long-term unemployment, which was once unheard of, is now relatively common and the lifetime employment system has eroded and is being replaced by more flexible working arrangements. For example, part-time employment now accounts for around 25% of total employment and the profile of those employed part time has evolved from principally women to encompass all segments of the labour force. In fact, demand for full-time contract employment has fallen below 50% of total employment contracts, in a labour market where, at least until recently, labour legislation (and social conventions) strongly favoured regular full-time engagement.

7. Although the Japanese labour market is evolving, it still demonstrates some marked differences from those of other OECD countries. The most obvious feature is the very small increase in participation rates over the past decades for both women and men and the high level of part-time employment, particularly for women (Table 1.3). The high level of part-time employment is closely linked to the pattern of female participation in the labour force, which is much more strongly influenced by child-bearing than is the case in other OECD countries. Figure 1.1 shows the M-shaped curve for female participation in the Japanese labour market, which contrasts with the employment pattern for women in the other countries. About 60% of Japanese female workers withdraw from the labour market after they have children, though financial pressures appear to be obliging increasing numbers to return via part-time employment.<sup>6</sup> As a result, mothers who return to work often end up in jobs below their capabilities. Even well-educated Japanese women have difficulty combining careers and motherhood: 65% of Japanese women with a university education work, compared to 95% of Japanese men with a similar level of education.<sup>7</sup> Other features of the Japanese labour market include the relatively high proportion of seniors in the labour force, although their participation rate has dropped in recent years. Another evolution is the emergence of tele-working. Because of the long commuting times encountered in metropolitan areas (Tokyo 68.2 minutes, Osaka 64.9 minutes), the tele-working population is increasing, particularly in areas surrounding central Tokyo, where tele-work accounts for 8.8% of the total workforce. Lastly, the number of foreign workers has increased (though from a low starting point). The foreign labour force ratio is 0.3%,<sup>8</sup> the smallest in OECD countries, due to Japan's relatively tight immigration policy.<sup>9</sup> However, it is increasing rapidly, particularly in the manufacturing and wholesale/retail/restaurant sectors. Even while the

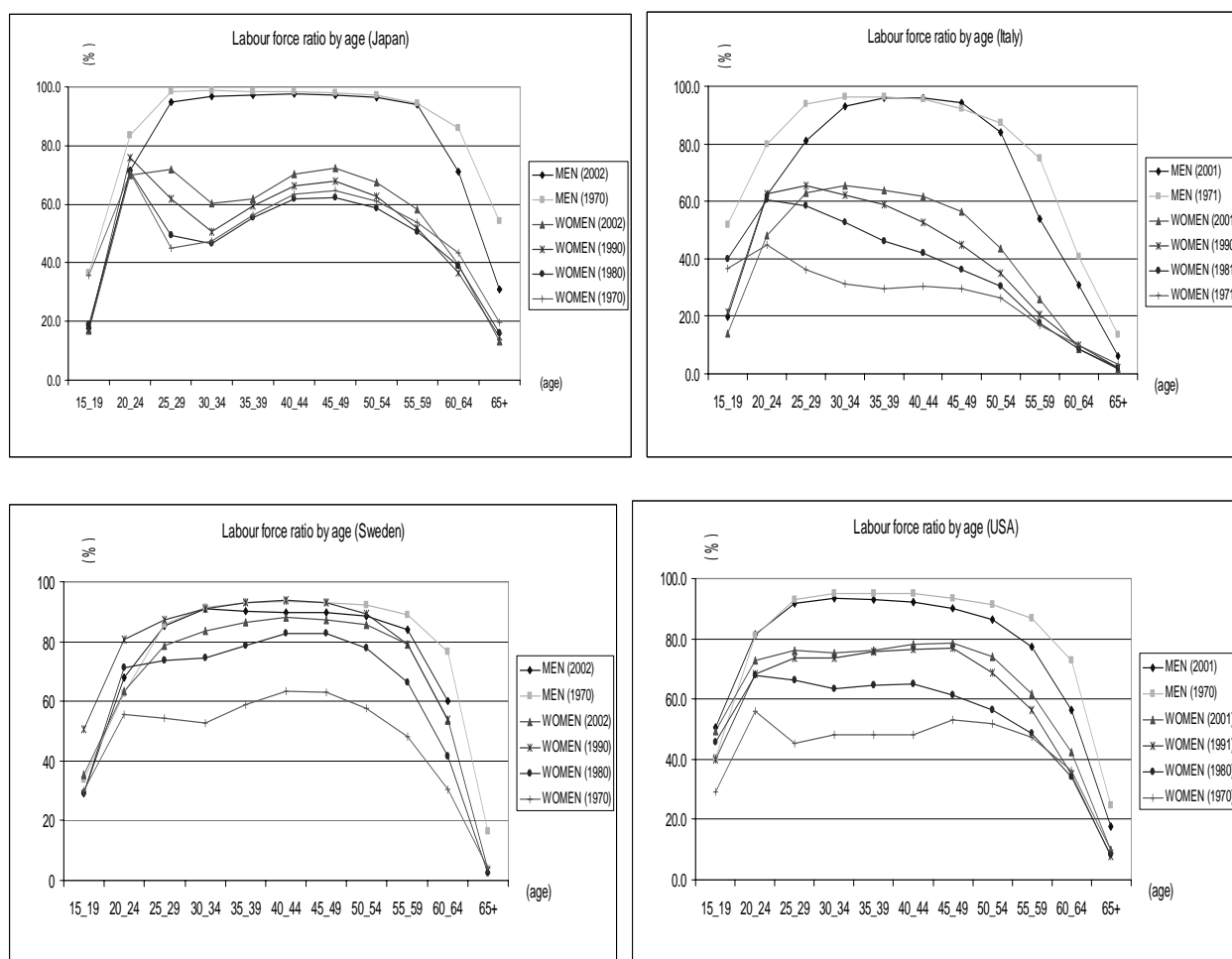
central government is urging firms to raise their maximum retirement ages in order to maintain participation rates and ease pressure on the pension system, firms themselves are still proposing early retirement with perks. Overall, the evolution in the labour market is a slow process, with rigidities in labour legislation and very low labour mobility appearing to cause an acute mismatch between labour supply and demand.<sup>10</sup> Moreover, while the government is urging firms to increase retirement ages in order to maintain participation rates, many firms, looking to restructure by reducing staff costs, continue to offer generous early retirement packages.

**Table 1.3. Labour force structure**

| Countries | Male part-time employment rate (%) |      | Female part-time employment rate (%) |      | Foreign labour force (%) |      |
|-----------|------------------------------------|------|--------------------------------------|------|--------------------------|------|
|           | 1993                               | 2003 | 1993                                 | 2003 | 1992                     | 2002 |
| Japan     | 11.4                               | 14.7 | 35.2                                 | 42.2 | 0.1                      | 0.3  |
| USA       | 9.4                                | 8.0  | 20.5                                 | 18.8 | 9.8                      | 14.1 |
| EU-15     | 4.7                                | 6.3  | 27.7                                 | 30.1 | -                        | -    |

Source: OECD Labour Force Statistics, OECD Database on Part-time Employment.

**Figure 1.1. Labour force ratio by age for Japan and other OECD countries**



Source: "Yearbook of Labour Statistics" (ILO).



8. The government's response to the array of economic and social challenges focuses on stabilising the financial sector and providing support for the restructuring and revitalisation of Japanese enterprises, while removing regulatory and other barriers that limit flexibility in the labour market and other factor markets. As a result of the government's initiatives in the financial sector, the proportion of non-performing loans has been reduced towards target levels. The government has also introduced a process of regulatory reform and measures to increase business investment and boost weak business confidence. The range of reforms can be broken down into the following main categories:

- *Deregulation*, such as improving access to publicly regulated sectors (e.g., employment services, agriculture, medical services, and education), establishing special zones with exemptions from national regulations, and easing planning and other regulations to promote regional growth.
- *Financial sector reform*, such as reinforcing capital adequacy provisions, strengthening supervision of loan assessment and provisioning procedures, encouraging non-performing loan resolution, and rehabilitating/consolidating public financial institutions and securities markets.
- *Improved human capital and a more flexible labour market*, such as introducing competition among universities, increasing labour mobility, introducing more skills training, lifelong learning and recurrent education.
- *Stronger competition, more openness and promotion of entrepreneurship*, such as negotiating free trade agreements, attracting FDI, increasing competition in network industries and regulated sectors, and reducing barriers for start ups.
- *Social security reform*, such as reforming pensions and health care, and improving the efficiency of medical service provision.
- *Changes in the budget process and better public management*, such as reducing public investment to early 1990s levels, introducing new budget practices, establishing a medium-term fiscal consolidation plan.
- *Devolution of power from central to local government*, such as reviewing intergovernmental transfers and promoting mergers of municipalities.
- *Closer integration with other countries in the region* to increase trade and measures to promote Japan as an investment location and as a tourist destination.

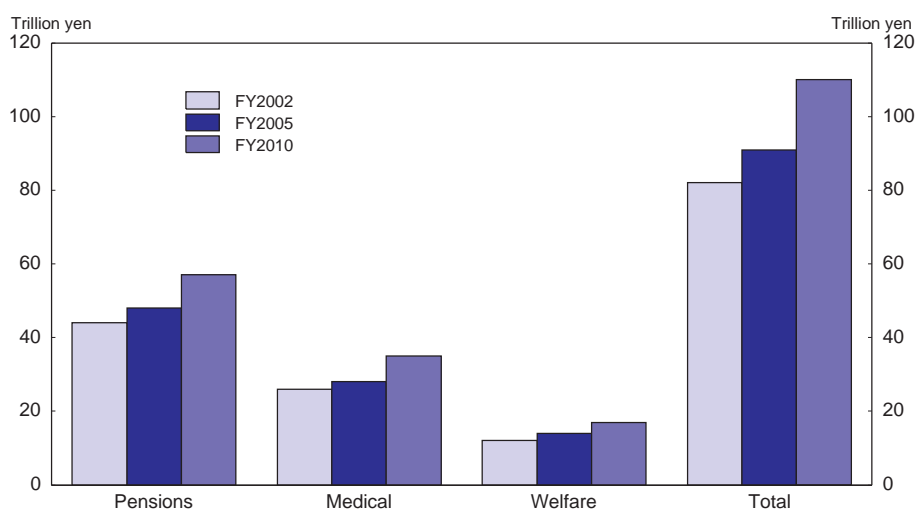
9. These reforms are all ongoing. The recent *OECD Economic Survey* rated the performance of the government in advancing its structural reform programme and concluded that while progress has been made in all fields (most in deregulation, least in social security and fiscal reform), the ratings for policy design were higher than the ratings for implementation and effectiveness, suggesting that the impact of many reforms has yet to be felt.<sup>11</sup> The assessment showed that many measures are still only partially implemented. The outcome depends on whether the government's programme of fiscal consolidation and structural reform is fully implemented. At the same time, the government's ability to achieve its structural reform and fiscal targets will also depend on external conditions, particularly demand conditions in the world economy. As is shown by the increasing reliance of Japanese industry on trading relations with China, the future health of the Japanese economy is more than ever linked to that of its wider region (and, of course, that of the wider region is strongly influenced by demand in the US economy). The reshaping of economic relations within Asia is increasingly determining Japan's overall economic prospects.

### *Fiscal challenges*

10. After the collapse of the so-called “bubble” economy, both central and local government accumulated debts estimated to amount to more than 150% of GDP, with the deficit estimated at nearly 8% of GDP in 2003 (OECD, 2004d). Government revenues as a percentage of GDP are low at 30% in comparison to the other OECD countries where the corresponding figure averaged 50% in 2002 (OECD, 2004e). As such, the Japanese government’s structural reform programme is also intended to improve resource allocation and revitalise business sector activity and, thereby, improve the fiscal balance over the medium term.

11. Concern about the current fiscal situation is strongly influenced by forecasts that suggest that progressive ageing and population decline are likely to put significant pressure on Japan’s fiscal balance in the future. The population of Japan will begin to shrink in about 2007, and between 2010 and 2015 the baby boom generation, which has been the core of the labour force, will move into retirement and become pension beneficiaries. The government would like the primary balance to be in surplus by then. Over the past decade, spending on the pension system has increased, from 5.4% of GDP to 8.5%. The active population is falling and Japan already has the largest elderly population among OECD countries. As a result, not only pension expenditures but also other social security costs – mainly health care and welfare – are expected to rise (Figure 1.2). Increases in social security spending linked with population ageing are likely to be compounded by falling tax revenues from a shrinking labour force.

**Figure 1.2. Projected social security spending**



Source: Ministry of Health, Labour and Welfare (2004).

12. These long-term fiscal balance concerns affect all aspects of public policy making. The government is obliged to adopt a more sustainable fiscal structure, while maintaining the levels of public service that taxpayers expect, avoiding revenue raising measures that would dampen economic growth, respecting long-term balanced regional development goals, and so on. The response of the government has a number of important strands. First, there are initiatives to improve the tax administration as a means of boosting revenues without major tax hikes. Second, pension contribution rates are being systematically

increased over a ten-year period in order to cover current short-falls and further reform is planned. Third, the *Reform and Perspectives FY 2003 Revision* has set a target of achieving a primary budget surplus sufficient to stabilise public debt by the early 2010s (the period during which transition into retirement by baby boomers will peak), while keeping general government expenditures at the FY 2002 level of 38% of GDP. Fourth, as will be discussed in detail in Chapter 3, local finance is currently being reformed, with a focus on reshaping the system of inter-governmental transfer to improve outcomes from public expenditures and reduce inefficiency, thereby reducing overall expenditures. Finally, government departments are introducing budget management and performance evaluation tools intended to improve the outcomes of public investment.

13. Overall, the challenge for Japan is to manage the transition of a socio-economic system that grew up during the period of economic and demographic expansion to a system that is better adapted to a society characterised by rapid ageing. As in most OECD countries, the margin of fiscal manoeuvre of the government over the coming decade is likely to be limited and it must promote reforms in such areas as medical care, nursing care and the pension system that are fiscally sustainable over the long term and that take into account the evolving balance between the working age population and the retired population.

### **Territorial development in Japan: challenges and opportunities**

14. The challenges facing the country as a whole have strong regional implications. For example:

- Population ageing and depopulation has more seriously affected rural and remote areas, with many local communities struggling to maintain public service provision in the face of shrinking economies. Constraints on public expenditure are forcing major reassessments of the organization of rural life.
- The urban land market crash has undermined the economies of Japan's three metropolitan areas. The ability of urban policy to stimulate growth in these "motor" regions will have an important impact on overall national growth prospects.
- Economic restructuring and reorientation of regional trading patterns are likely to create new patterns of polarization, new territorial dynamics, necessitating a rethinking of policy to support regional economies.
- "Hollowing out" of Japan's manufacturing has had a particularly devastating impact in regions in which labour-intensive industries were located, often as a result of industrial location policies, leading to high unemployment and high enterprise closure rates.
- New trading relationships in the East Asia region are likely to influence industry location within Japan, with proactive regions able to benefit from geographical proximity and direct interaction with regions in China, Korea and other emerging Asian economies.

15. Analysis of prefecture-level data indicates how these different phenomena are affecting GDP and employment patterns across the country, confirming some existing features and identifying emerging trends. Figure 1.3 presents prefectural GDP per capita relative to the national average and indicates the contribution of different components of GDP to the surplus or shortfall in the region's GDP per capita with respect to the national average.<sup>12</sup> Some key features of the pattern of regional GDP include:

- A clear core-periphery split in terms of GDP with low GDP prefectures found in the southern regions of Kyushu, Chugoku and Shikoku, as well as Okinawa, and the northern regions of Hokkaido (moderately low) and Tohoku, and high GDP prefectures found in the central regions

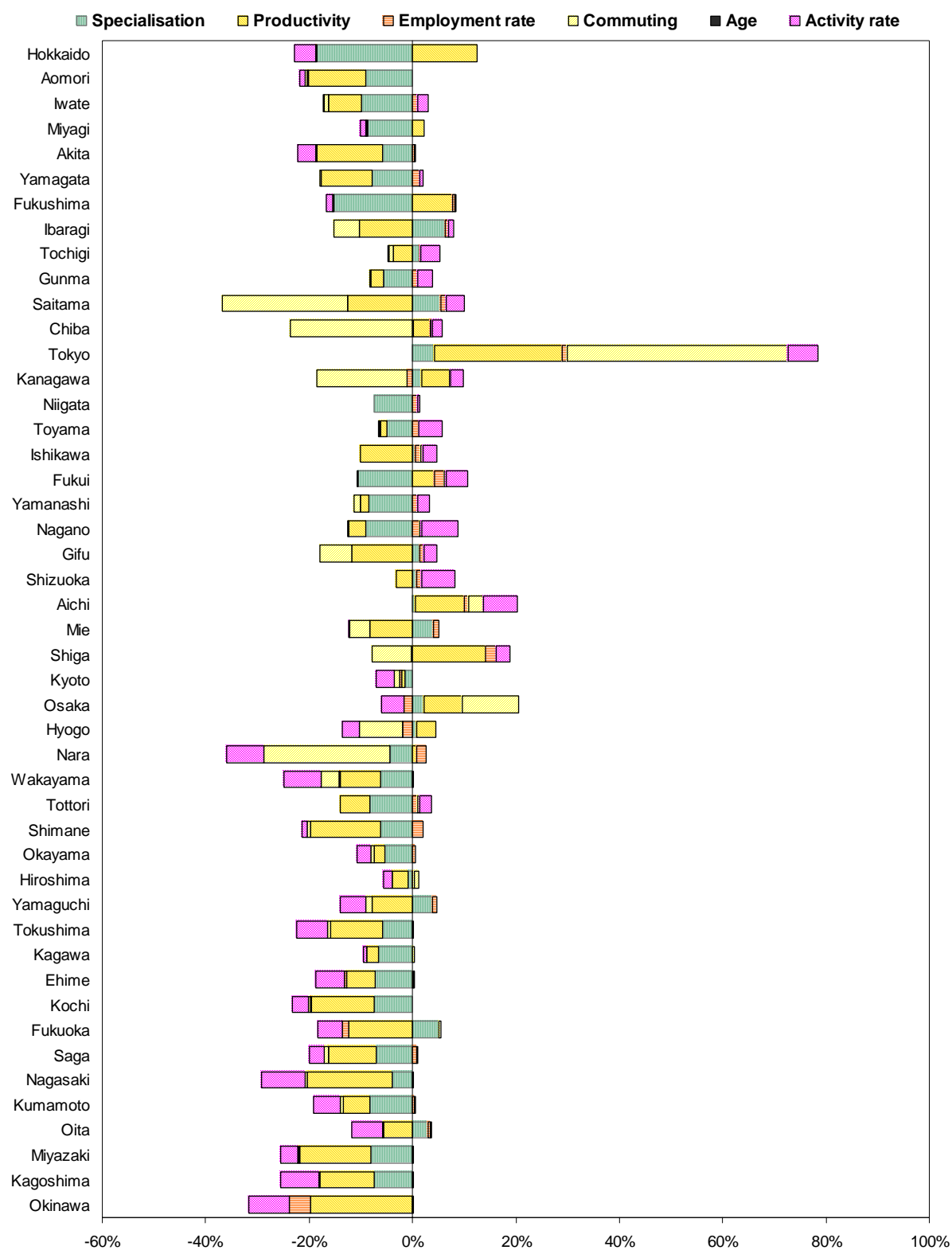
of Hokuriku (moderately high), Toukai, Kinki and, in particular, Kanto. (This is made more evident in the graph because the prefectures are organised from north to south, showing that low productivity regions tend to be those that are geographically more remote.)

- A relatively wide gap in GDP between the Tokyo region and the rest of the country, including the two other metropolitan regions around Osaka and Nagoya, both of which have lost ground relative to Tokyo over the past decade.<sup>13</sup>
- Evidence of the impact of ageing on GDP in a number of non-metropolitan prefectures concentrated in the southern regions of Kyushu and Shikoku, particularly noticeable in the more mountainous and isolated prefectures.
- Evidence of the impact of low participation rates not related to ageing on GDP in some urban prefectures around Osaka.

16. Some additional characteristics of regional economies were revealed through an analysis of employment rates:

- A central manufacturing belt running from Tokyo to Osaka in which the share of manufacturing in total employment exceeds 20% and in some prefectures is around 30%. This belt includes the three metropolitan centres, but also a number of prefectures categorised as intermediate, but with strong manufacturing bases, such as Gifu, Mie, Shizuoka and Shiga.
- A number of non-metropolitan prefectures with relatively high levels of manufacturing employment, particularly in the northern Tohoku region (*e.g.*, Akita, Yamagata and Fukushima) and Shimane in Chugoku. This manufacturing appears to be characterised by specialisation in low productivity sectors.
- Strong concentrations of agriculture and construction sector employment in most non-metropolitan regions, including Hokkaido, Tohoku, Kyushu, Chugoku and Shikoku; each sector accounts for around 10% of employment in most prefectures.

Figure 1.3. Decomposition of GDP per capita in Japanese prefectures (2000)



Note: Prefectures are organised, in broad terms, running from north to south.

Source: Identifying the Determinants of Regional Performances (Working Party on Territorial Indicators (2003).

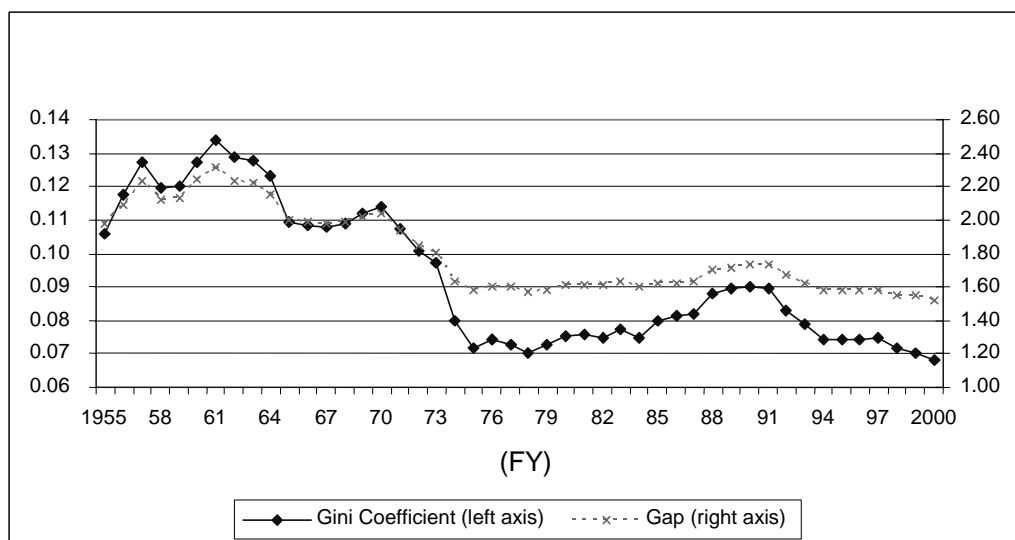
17. The data give an impression of the diversity of Japan's regional economies, strongly influenced as they are by geographical location and topographical conditions. It is clear from the data that the overall objective of balanced development is likely to remain an important policy issue – large areas of the country are at a significant disadvantage with respect to the more urban regions. At the same time, new challenges and opportunities are appearing as well. Currently, the main territorial issues can be grouped as follows:

- New dynamics of regional disparity;
- Growth in the capital region;
- Restructuring in core industrial regions;
- Accessibility in non-metropolitan regions;
- The spatial dimensions of ageing and depopulation ; and
- Revitalising city centres.

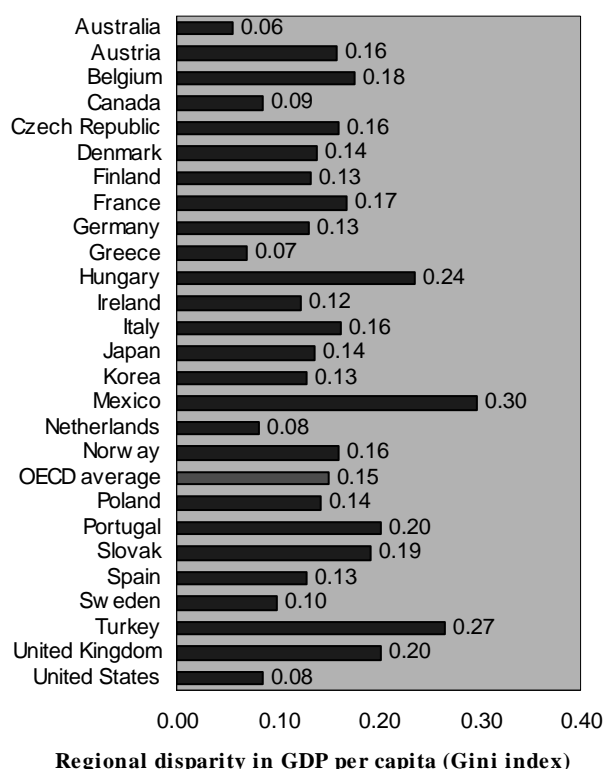
#### *New dynamics of regional disparity*

18. A basic objective of regional policy has been to reduce regional disparities by developing peripheral and less-developed regions while alleviating the pressures caused by agglomeration in the major urban/industrial areas. In some respects, this policy can be seen to have been successful; according to various measures, regional disparities are relatively low compared to other OECD countries. For example, the ratio between the highest 5 and lowest 5 prefectures in terms of income per capita has decreased from over 2 to around 1.5 over the past 30 years, a figure that compares favourably with other countries (Figure 1.4 and Figure 1.5). Only three prefectures, Okinawa, Nara and Saitama, have a GDP per capita below 75% of average GDP per head (the threshold used in the EU as a measure of relative regional under-development), and the latter two regions are commuting zones for Osaka and Tokyo respectively, therefore the GDP figures are somewhat misleading.

**Figure 1.4. Gini coefficient and income gap (between top 5 and bottom 5 prefectures)**



Source: Ministry of Land, Infrastructure and Transport (MLIT), Cabinet Office and Ministry of Internal Affairs and Communications (MIA).

**Figure 1.5. Regional disparity in GDP per capita (2001)**

Note: Data for Mexico, Norway and Turkey refer to years 1995 and 2000. Regional GDP is not available for Iceland, New Zealand and Switzerland.

Source: OECD Territorial Database.

19. However, these figures give an incomplete picture of the state of regional development in Japan. The decline in the absolute level of disparities does not necessarily mean that there is a robust process of catching up among the less developed regions. It can be argued that the level of disparities rose over the course of the 1980s mainly as a result of strong performance by metropolitan regions and fell during the 1990s when less developed regions performed slightly better than recession-hit metropolitan and industrial regions. Overall, the recorded decreases in disparities in output and income can be said to reflect the differential impact of recession on different types of regions, with metropolitan areas faring worst and non-metropolitan and less-industrial regions recording the smallest losses.

20. Another perspective on disparities is provided by looking at the performance of Japanese regions relative to other OECD regions over the period. Table 1.4 shows the general decline in the GDP per capita of all Japanese regions relative to that of other OECD regions over the second half of the 1990s. In other words, the decrease in disparities can be termed a “downward convergence”.<sup>14</sup> This puts the disparities issue into an international perspective, leading to the question whether the level of disparities within an individual country is relevant in a situation of recession in which all regions in the country are losing ground.

**Table 1.4. Changes in GDP per capita of Japanese regions compared to other OECD regions (TL2) between 1996 and 2001**

| TL2 unit | GDP per capita<br>1996<br>(OECD1996=100) | GDP per capita<br>2001<br>(OECD1996=100) | Change | Rank 1996 (out<br>of 300 OECD<br>regions) | Rank 2001(out of<br>300 OECD<br>regions) |
|----------|------------------------------------------|------------------------------------------|--------|-------------------------------------------|------------------------------------------|
| Kanto    | 125                                      | 141                                      | 17     | 59                                        | 75                                       |
| Toukai   | 126                                      | 140                                      | 14     | 52                                        | 78                                       |
| Hokuriku | 111                                      | 125                                      | 14     | 85                                        | 110                                      |
| Kinki    | 115                                      | 124                                      | 9      | 78                                        | 112                                      |
| Chugoku  | 105                                      | 120                                      | 15     | 98                                        | 120                                      |
| Hokkaido | 103                                      | 119                                      | 16     | 108                                       | 125                                      |
| Tohoku   | 96                                       | 110                                      | 14     | 132                                       | 157                                      |
| Shikoku  | 93                                       | 107                                      | 14     | 140                                       | 168                                      |
| Kyushu   | 91                                       | 104                                      | 13     | 150                                       | 173                                      |
| Okinawa  | 73                                       | 86                                       | 13     | 194                                       | 205                                      |
| OECD     | 100                                      | 121                                      | 21     | -                                         | -                                        |

Note: Data for Mexico, Norway and Turkey refer to years 1995 and 2000. Regional GDP is not available for Iceland, New Zealand and Switzerland.

Source: OECD Territorial Database. GDP is measured at current PPPs.

21. Clearly, measures of disparity hide more complex processes. The underlying question for policy makers is then how to balance the growth momentum that can develop in metropolitan regions with traditional objectives of supporting the development of other regions. While the overall level of disparity is low compared to other OECD countries, important disparities among prefectures persist (Figure 1.3.). If durable processes of development have not been generated in the non-metropolitan regions that have been the target of regional policy, then the potential for increased disparities remains. Given that there are strong signs of recovery in the Tokyo region, the possibility that the disparity between Tokyo and the rest of the country will widen cannot be discounted.

### *Growth in the capital region*

22. In spite of strong policy interventions over three decades, Japan's economy is still dominated by two regions, Kanto and Kinki, which cover most of the Tokyo-Nagoya-Osaka metropolitan axis. These two regions account for approximately half of the country's population (65 out of 127 million inhabitants) and produce around 60% of GDP. Table 1.5 gives an idea of the strong concentration of population and productive capacity, with stark contrasts between regions such as Hokkaido and Tohoku, which have relatively low population densities and output, and Kanto and Kinki. Japan's main productive regions are not only dominant domestically, they are also major production centres on an international scale. The GDPs adjusted for PPP of Kanto and Kinki are equivalent to those of Italy and Australia respectively.<sup>15</sup>



**Table 1.5. Japan's regional economies**

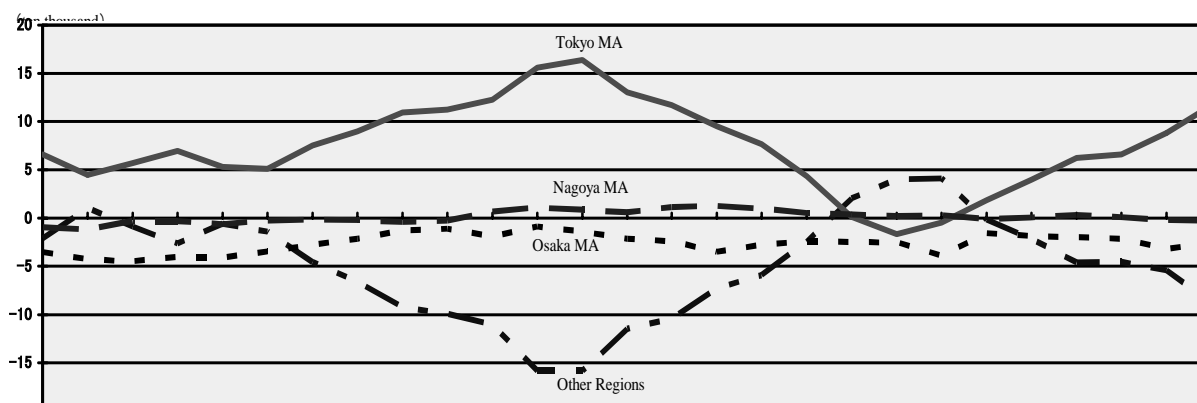
|          | Population share (%) | Area share (%) | Share of GDP (%) |
|----------|----------------------|----------------|------------------|
| Hokkaido | 4.5                  | 22.1           | 4                |
| Tohoku   | 7.8                  | 17.7           | 7                |
| Kanto    | 35.2                 | 15.4           | 39               |
| Hokuriku | 7.4                  | 6.7            | 7                |
| Toukai   | 7.7                  | 5.7            | 8                |
| Kinki    | 16.4                 | 7.2            | 16               |
| Chugoku  | 6.1                  | 8.4            | 6                |
| Shikoku  | 3.3                  | 5.0            | 3                |
| Kyushu   | 10.6                 | 11.2           | 9                |
| Okinawa  | 1.0                  | 0.6            | 1                |
|          | 100.0                | 100.0          | 100.0            |

Source: OECD territorial database; figures for 2000.

23. While all three metropolitan regions were strongly affected by recession, there are signs that the dominance of the Kanto region with respect to the other two metropolitan regions has become more pronounced over the period. Almost half of all high growth enterprises, those with rates of growth of over 10% for two consecutive years, were located in and around Tokyo (OECD, 2002). Over 60% of multinational enterprises have their headquarters in or around Tokyo and about 20% in the Osaka region. Among businesses capitalised at more than JPY 100 million, around half are located in the Tokyo region, with around 15% in the Osaka region. A similar pattern can be observed for other indicators of regional dynamism, such as the location of venture capital firms and foreign direct investment inflows. Measures of over-capacity in manufacturing (*e.g.*, ratios of turnover to capital) also suggest that firms in the Kanto region are healthier than those in other regions where excess plants and equipment appear to remain. Source: "Statistical Survey of Places of Business and Enterprises" Statistics Bureau, Japanese Government (2001)

24. The fact that land prices in central Tokyo are showing signs of stabilising, while they have continued to fall in the other metropolitan areas is another sign that differences in competitiveness might be widening between Kanto and other urban centres. Moreover, recent patterns of migration into the metropolitan areas reveal that Tokyo is once more becoming an attractive destination for migrants, in sharp contrast to the other metropolitan regions and non-metro regions. As is shown in the Figure 1.6., population inflow into Tokyo peaked around 1987 and then fell strongly with outflow exceeding inflow by the mid-1990s. Over the past few years, however, the trend to increasing concentration in and around Tokyo has re-emerged. By comparison, inflows into the other metropolitan regions are far lower, but their populations are nonetheless stable. The general trend is still for outflow from the countryside to regional cities and to the metropolitan areas.

Figure 1.6. Net migration into the three metropolitan areas



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications. Migration Census on Basic Residential Registers.

25. With respect to growth in the metropolitan areas, urban/metropolitan policy (discussed in Chapter 2) is designed to slow the decline in urban land markets and reverse the trend by means of targeted urban development investments and linked regulatory reforms and a reassessment of the competitive attributes of Japanese cities *vis-à-vis* other global cities. As will be discussed, strong interventions to support the metropolitan economies are now being complemented with initiatives to rejuvenate the economies of smaller, regional cities.

### ***Restructuring core industrial regions***

26. In the past, regional economies have been principally (mass) production sites in the context of a much larger national economic “project”. Many of the manufacturing activities that formed the basis for the “regions as production sites” model have been transferred overseas, increasingly to China, and the industrial structure of many regions has been “hollowed out”. Table 1.6 shows the impact that economic restructuring had on Japan’s main machinery manufacturing prefectures over the course of the 1990s. It is clear that the prefectures around Tokyo and those around Osaka have been especially hard hit by the contraction of the machinery sector. As well as losing employment and businesses, the declines in real output over the 1990s in the machinery sector in and around Tokyo and in non-machinery manufacturing in Osaka were double the national average. Nonetheless, both metropolitan areas have large and diverse economies and are endowed with strong R&D capacities and so on. However, some other regions, where the economies were more dependent on manufacturing, are still coming to terms with the extent of the restructuring of their regional economies. (One interesting feature of this table, in the context of the decline of the *keiretsu* system, is the relatively small declines recorded by the Aichi and Shizuoka prefectures, in which Toyota and Honda opted to retain their main operation centres in Toyota City and Hamamatsu respectively.) Although many of these regions still have a strong manufacturing sector, the share of these sectors has declined, business closures exceed rates for new firm start-ups and unemployment is high (particularly for young people and those nearing retirement age). Some evidence of the impact of recession on regional disparities is provided by income per capita data by prefecture. Overall, while there was significant variation among prefectures, the average income per capita in the less industrial prefectures remained static over the period. By contrast, per capita income for the manufacturing prefectures declined sharply.

**Table 1.6. The decline in manufacturing in Japan's main machinery manufacturing areas during the 1990s**

| Prefecture    | Machinery sector                         |                                     | Non machinery sector                     |                                     |
|---------------|------------------------------------------|-------------------------------------|------------------------------------------|-------------------------------------|
|               | % decline in number of firms (1990-1998) | % decline in employment (1990-1998) | % decline in number of firms (1990-1998) | % decline in employment (1990-1998) |
| Aichi         | 7.6                                      | 7.5                                 | 17.0                                     | 14.8                                |
| Kanagawa      | 14.6                                     | 23.1                                | 10.8                                     | 11.0                                |
| Shizuoka      | 6.4                                      | 6.7                                 | 10.3                                     | 9.6                                 |
| Tokyo         | 21.0                                     | 25.3                                | 12.5                                     | 14.2                                |
| Osaka         | 18.7                                     | 19.8                                | 12.6                                     | 17.3                                |
| Saitama       | 16.0                                     | 21.8                                | 13.3                                     | 9.1                                 |
| Hyogo         | 11.7                                     | 12.1                                | 20.1                                     | 18.3                                |
| Gumma         | 10.9                                     | 10.2                                | 12.2                                     | 7.2                                 |
| Nagano        | 19.0                                     | 14.6                                | 12.3                                     | 11.9                                |
| Tochigi       | 9.8                                      | 12.2                                | 11.6                                     | 9.1                                 |
| Mie           | 8.3                                      | 5.6                                 | 13.8                                     | 14.9                                |
| Hiroshima     | 6.7                                      | 13.0                                | 17.1                                     | 19.1                                |
| Ibaraki       | 10.3                                     | 13.8                                | 8.3                                      | 5.0                                 |
| Chiba         | 8.4                                      | 15.0                                | 7.2                                      | 9.6                                 |
| Fukuoka       | 2.5                                      | 10.4                                | 10.1                                     | 12.7                                |
| Rest of Japan | 8.5                                      | 8.7                                 | 14.4                                     | 13.7                                |
| JAPAN         | 12.3                                     | 13.1                                | 13.7                                     | 13.4                                |

Source: Cowling and Tomlinson (2001).

27. The challenge for the government is to re-orient its regional economic policy in order to support the restructuring of these regions. A recent Ministry of Finance report concluded that Total Factor Productivity has stagnated in many regions because industrial structures are too static and are not evolving sufficiently to allow better allocation of capital and labour resources (Ministry of finance, 2002). The problem is that while Japan has amassed great national scientific and technological strength, there has been relatively weak performance in the commercialisation of this knowledge to leverage new economic and business development in regions outside of the Tokyo agglomeration.

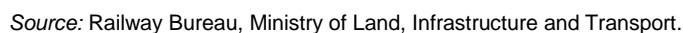
28. There are, however, new opportunities presented by the ongoing reshaping of economic relations in the East Asia region. Some of Japan's less industrialised regions and those badly hit by contraction of manufacturing are well placed geographically to take advantage of these opportunities. For example, some regions are likely to be able to capitalise on the growth of the Chinese market. A considerable share of exports in Osaka, Kobe and Nagoya ports are for Chinese markets, and in many cases these exports are produced in the same region (*e.g.*, motor related exports that pass through Nagoya port are produced in the Nagoya region). Moreover, some non-metropolitan regions have developed specialisations in high growth export industries, such as the integrated circuit cluster in Kyushu, and have also developed close commercial relations with Chinese and Korean companies.

29. With respect to restructuring industrial regions, the policy approach (discussed in Chapter 2) focuses on a regional economic policy with a strong urban component that emphasises the importance of regional clusters in generating agglomeration effects for knowledge creation and diffusion, and links between research and enterprise, and between the public and private sectors.

#### *Accessibility of non-metropolitan regions*

30. The topography of Japan – characterised by mountains, numerous islands and long coastlines – has had an important influence on development policy.<sup>16</sup> Over the past three decades, infrastructure investment has been a main objective of regional policy and at the same time an important driving force of

**Figure 1.7. Improvements in Shinkansen lines**



**Table 1.7. Reduction in travel times after the completion of the Shinkansen lines**

|                     | Section                                      | Length of track in service after completion (km) | Estimated travel time current → after completion (reduction in travel time) |
|---------------------|----------------------------------------------|--------------------------------------------------|-----------------------------------------------------------------------------|
| Tohoku Shinkansen   | Tokyo – Hachinohe<br>(opened in 2002)        | 590                                              | 3 hr 33 min → 2 hr 56 min<br>(37 minutes)                                   |
|                     | Tokyo - Shin Aomori                          | 670                                              | 3 hr 59 min → app. 3 hr 20 min<br>(app. 40 minutes)                         |
| Hokuriku Shinkansen | Tokyo – Nagano<br>(opened in 1997)           | 220                                              | 2 hr 39* min → 1 hr 19 min<br>(*Ueno - Nagano, 80 minutes)                  |
|                     | Tokyo – Toyama                               | 400                                              | 3 hr 12 min → app. 2 hr 10 min<br>(app. 60 minutes)                         |
| Kyushu Shinkansen   | ShinOsaka - NishiKagoshima                   | 810                                              | 6 hr 20 min → app. 3 hr 40 min<br>(app. 2 hour 40 minutes)                  |
|                     | Hakata - Nishi Kagoshima<br>(opened in 2004) | 260                                              | 3 hr 40 min → app. 1 hr 20 min<br>(app. 2 hour 20 minutes)                  |

Source: Ministry of Land, Infrastructure and Transport.

32. Another example of the emphasis on accessibility is provided by the most recent Japanese national development plan, the *Grand Design for the 21<sup>st</sup> Century*. This plan proposes the creation of a “one-day transportation network” that would make it possible to visit anywhere in Japan from anywhere else in just one day.<sup>17</sup> Complementing the overall concept of the one-day trip zone is the “half-day transportation network” which is designed to provide a framework for regional and cross-regional transport networks so as to facilitate journeys within regions or to and from regional centres. This has been achieved in more than 90% of the regions. Finally, and importantly from the rural development perspective, there are targets for travel times between rural peripheries and their core cities that are intended to measure the ease with which rural periphery dwellers can access urban services. At present, there is a very wide disparity across regions, with the rural-to-urban centre inland trip time averaging 90 minutes in Kanto, Kinki, and Chubu, two hours for Kyushu and up to three hours for southern cities such as Kagoshima and Miyazaki.

33. Despite continued improvement in rural infrastructures, out-migration from rural regions has continued. Initially, there was an assumption that improving quality of life in rural regions would at least slow the pace of out-migration. This has not happened, in Japan or elsewhere. Improving transportation networks is now seen from a broader perspective that emphasises mobility and urban-rural linkages. For example, improving accessibility may have an impact on people’s living arrangements. As baby-boomers reach retirement age, more people are spending time in rural areas. In the near future, as ageing and depopulation progress and improved infrastructure facilitates travel, living in both urban and rural areas could become more common. In European countries, owning a second home in a rural area and spending weekends and vacations there has become increasingly popular (Box 1.1.).

#### **Box 1.1. Second homes in European countries**

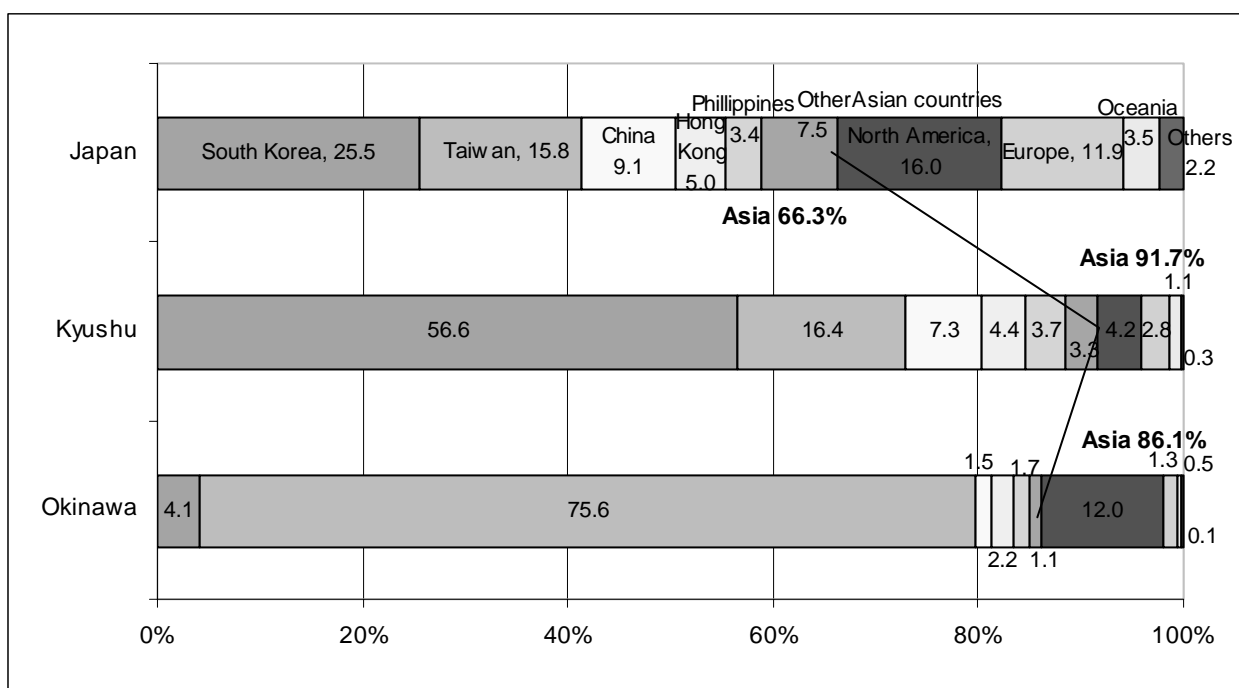
In France, second homes are increasingly being used as alternate residences. Whereas in the past long distances meant that most people only stayed in their second homes during vacations, improved transportation has made it easier for people to move back and forth between the city and their country residence. Instead of spending only a few months per year in their second homes, French people are beginning to resemble extremely mobile permanent villagers, spending increasing amounts of time in their second homes and playing an active part in local community organisations (Perrot and La Soudière, 1998). In January 2002, there were 3.0 million second homes and occasional homes (homes used occasionally for professional reasons) in France compared to 24.5 million permanent dwellings (INSEE, 2003).

**Box 1.1. Second homes in European countries (continued)**

In England, improved transportation has also had an impact on second home ownership. As low-cost airlines shrink travel times an increasing number of British people are acquiring homes in countries such as Spain and France. However, the main issue of concern in housing and planning terms for the British government is the tendency for second homes located in England to be concentrated in certain areas and to combine with retirement purchasing to push up the cost of entry-level homes, thereby making it more difficult for locals to purchase homes in the area. It is difficult to isolate the impact of second homes from that of retirement or commuting, and as a result their effects on housing prices and local services are unclear (Gallent *et al.*, 2004). In 2003/2004, approximately 295 000 English households had a second home in England,<sup>18</sup> although the increase between 1994 and 2004 has been relatively modest (Office of the Deputy Prime Minister, 2004).

34. The *Grand Design* also proposes an “East Asia one day transportation network”. One-day trips are currently possible between Japan’s three metropolitan cities (Narita/Tokyo, Kansai/Osaka and Nagoya) and Korea (Seoul and Busan) and Shanghai. However, it is practically impossible to travel between Japan’s non-metropolitan cities and these countries in just one day, and although a number of direct scheduled flights started over the past ten years, they operate infrequently. In addition, the fact that scheduled flights to western countries are basically limited to the airports of three metropolitan areas results in a regional disparity in terms of accessibility to the departure gate to western countries. Despite the absence of daily flights, the increasing number of charter flights connecting Japan’s non-metropolitan areas with Asian cities has reinforced international relationships. Moreover, ferries connect western Japan, particularly Kyushu areas, with East Asian cities. As seen in Figure 1.8., the nationalities of foreign visitors vary depending on the (air)ports where they entered. Kyushu Region has a higher ratio of Asian visitors, whose numbers have increased recently.

**Figure 1. 8. Percentage of immigration by nationality, Kyushu Region and Japan (2002)**



Source: Annual report of statistics on migrants, Ministry of Justice.

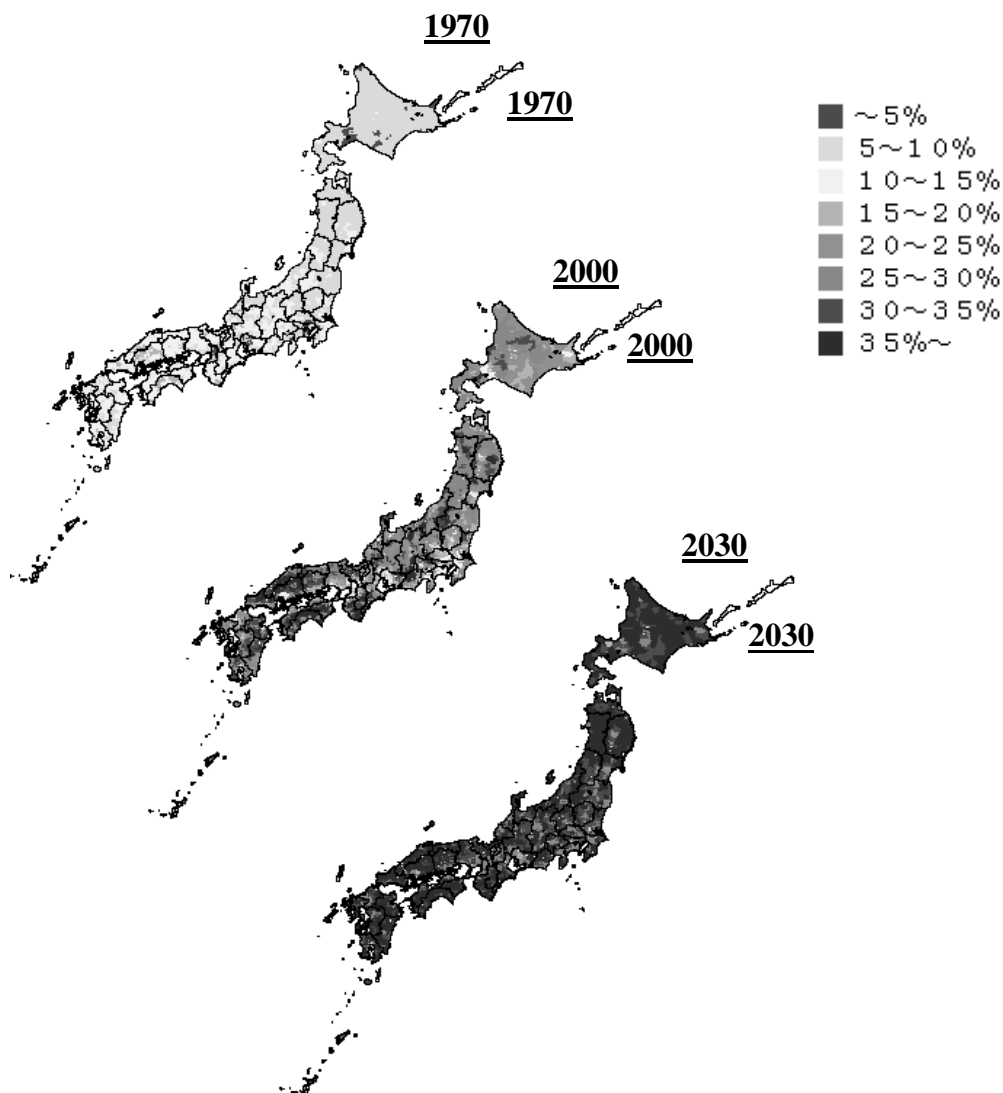
35. Improving the accessibility of regions, therefore, continues to be a priority in territorial policy. In terms of arterial roads, for example, MLIT contends that the network is significantly less dense than that of Germany which has a similar land area, though somewhat less challenging topography. However, financing the construction and maintenance of a more dense transportation network will be increasingly difficult. National and regional fiscal constraints will prevent the government from undertaking an extensive programme of infrastructure development. The rising cost of infrastructure maintenance and of construction combined with increasingly tight budget constraints means that continuing provision of infrastructure to improve travelling times will be more and more difficult to justify. This is particularly true given that the non-metro population of Japan will soon begin to decline, and many outlying areas already face severe depopulation problems. Thus, the issue of accessibility is tightly entwined with issues, such as the level of public investment, return on public investment, minimum levels of service and so on.

36. With respect to improving accessibility, the principal policy issues relate to the future level of infrastructure investment (discussed in Chapter 2), notably efforts to reduce costs and better target investment, and local finance reform (discussed in Chapter 3) which will have an important impact on the ability of local authorities to undertake local infrastructure development. At a more general level, the links between demographic projections in regions and the allocation of resources for development purposes will also come to the fore.

### *Countering the effects of ageing and depopulation*

37. The population of Japan is predicted to peak at 127.7 million in 2006 and then drop to 100.6 million by 2050 (according to medium-level estimations). The total fertility rate (TFR) in 2003 is 1.29 according to the recent Health, Labour and Welfare Ministry report, which is comparable to that of some European countries such as Italy, and appears to be similarly related to changes in social organisation and equally resistant to policy influence. Japan also has the highest ratio of elderly people in the population (17% in 2000) among OECD countries, and the longest life expectancy among OECD countries. In small municipalities (10 000 or fewer inhabitants), the elderly population is already approaching 30%, an increase from 10% in the 1970s. As in some other OECD countries, the decline in rural populations is forcing the government to rethink the organisation of public services in sparsely populated areas, how public services are delivered in such areas, what the role of rural communities is, etc. However, unlike most other OECD countries, the issue of ageing is no longer limited to rural areas. As shown in Figure 1.9, although most severe in remote regions, many core regions will also soon have very high elderly populations.

Figure 1.9. Evolution of the elderly population (over 65)



Data for 2030 are estimated by the National and Regional Bureau, MLIT, based on the middle trends of "Population Estimates (2002)" by the National Institute of Population and Social Security Research.

Source: Data for 1970 and 2000 are from "Population Census" Statistics Bureau, MIA.

38. One example of the extent of the ageing problem is the so-called "old new towns" around Tokyo. Japanese new towns were constructed during the economic expansion period (mainly in the 1960s and 1970s) to provide workers with decent dwellings in the suburbs of metropolitan areas, particularly in the outskirts of central Tokyo and Osaka. As real estate prices rose in central areas, these suburban cities grew rapidly, absorbing demand from young families. Now, however, the populations of these cities are



ageing, as the migrant workers of the 1960s and 1970s have moved into retirement and their children increasingly move to more central areas which have become more affordable and where cultural and other entertainment amenities are located. Partly as a result of these trends, town centres and housing stock are expected to deteriorate in the coming years. The emerging problem of the decline of the economic and social vitality of city centres is not limited to new town areas (discussed in Chapter 2).

39. As the data in Appendix 1 illustrate, rural GDP per capita is lower than that in urban regions and in many cases the impact of the age structure on output at the regional level is observable. Although the recession has reduced disparities between urban and rural regions temporarily, there are strong indications that the economies of Japan's urban regions will soon start to expand. Moreover, the enterprise base of many non-metropolitan regions is strongly dependent on agriculture, public works and construction projects (which produce over 10% of value added in some regions), all sectors/activities that are expected to contract in the future.<sup>19</sup>

40. The issue of ageing and depopulation in rural areas, which is currently most severe in outlying areas but will soon become a more or less general phenomenon is leading to a general pressure for reform of the way that public policy is organised. The links between changes in the structure of Japanese society and governance reforms – decentralisation, municipal mergers and so on are discussed in Chapter 3.

## 2. NEW PARADIGMS FOR TERRITORIAL POLICIES

### Territorial policy in Japan

41. Current thinking about regional policy in Japan is strongly influenced by the general context, described in Chapter 1. Of critical concern are the long-term economic and social implications of the rapid ageing of the population, depopulation and uncertainty surrounding the recovery of the Japanese economy. Debate over regional policy is also framed by a difficult budgetary environment. Japan's fiscal condition is characterised by a high level of government debt, declining tax revenues and a large budget deficit.<sup>20</sup> The medium-to-long term challenge for the government as it embarks on the process of fundamental reform is to constrain the large and rapidly increasing social security budget and bring it back into surplus during the next decade. These issues have focussed attention on the question of which public investments will have the greatest return for the economy as a whole and at the same time achieve conventional territorial policy objectives. Under these circumstances, policy makers are under increasing pressure to justify the outcomes of regional policy in terms of national objectives.

42. The country has pursued an active and consistent territorial policy over the past 40 years, conceived as an almost exclusively central government competence and encompassing a range of national sectoral policy areas (industrial policy, employment policy, education policy, environment policy, etc). Its primary tools were top-down land use planning, infrastructure investment and industrial relocation. This policy has had an impact on patterns of economic activity and employment, limiting polarisation pressures created by Japan's rapid post-war economic growth. The changed economic circumstances have, however, called into question both objectives and instruments of regional policy, and, as in many other OECD countries, the last decade has seen a shift in Japanese regional policy thinking, with regions playing a greater role in the formation of policies.

#### **Box.2.1. The evolution of regional development policy in OECD countries<sup>21</sup>**

Regional policy began in most member countries in the 1950s and 1960s, a period of relatively strong economic growth, fiscal expansion and low unemployment. The principal objective of the measures that were introduced was greater equity. The theoretical basis for government intervention assumed that government intervention *could* alter demand conditions in these regions. The main instruments used to influence demand were wealth redistribution through financial transfers by the national government, accompanied by large-scale public investments. The policy approach was strongly top-down. During the 1970s and early 1980s, successive economic shocks and changes in the global economy led to the emergence of geographical concentrations of unemployment in many countries and regional policy rapidly evolved to address this new challenge. The guiding theoretical assumption in this case was that public policy could alter supply conditions (essentially by changing production cost factors through production subsidies and incentives) and thereby influence industrial location. This brought a much stronger focus on direct supports to firms, either to support ongoing activities or to attract new jobs and investment to unemployment blackspots.<sup>22</sup> Over the past decade, the future of regional policy has been subject to debate, formal review and/or new legislation in many OECD countries. There is widespread evidence of new policy thinking and an identifiable shift in the "paradigm" of regional policy. The detailed nature of change is clearly country-specific, but there are common features. National governments are increasingly prioritising regional growth over redistribution, in pursuit of objectives of national or regional "competitiveness" and "balanced national development". Territorial development instruments are becoming broader in scope and adapted to the requirements of individual regions, as part of a policy approach involving decentralisation to

**Box 2.1. The evolution of regional development policy in OECD countries (continued)**

the regional levels. New policies are focusing more on regional capabilities, especially innovation systems, endeavouring to ensure more efficiency and effectiveness in the use of public and private resources as opposed to direct intervention. The selective targeting of government support (especially through enterprise aid) in designated areas is giving way to the encouragement of development in all regions. While some countries have long had policies aimed at economic development in all regions – e.g., France – this has become a more explicit goal in most OECD countries. For example:

- The 2001 UK White Paper (which applies only to regional development policy in England) stated that: "A strong national economy cannot function to its full capacity and individuals cannot realise their full potential if regions and localities are under performing. ... The new approach will be based on putting greater emphasis on growth within all regions and strengthening the building blocks of economic success by boosting regional capacity for innovation, enterprise and skills development."<sup>23</sup>
- In Finland, the new Regional Development Act which came into force at the start of 2003 shifted the emphasis of policy to stimulating regional competitiveness across the whole country; one of the main new programmes covers all regions with a view to creating a "balanced and properly planned regional structure in terms of the country as a whole".<sup>24</sup>
- In Sweden, previous regional policy laws have spoken of the importance of encouraging growth throughout the country, but the 2001 bill, entitled "A Policy for Growth and Viability throughout Sweden", is more explicit. Its preamble stated that: "Swedish regional policy has changed from including primarily prioritised areas to being a policy that in practice covers all parts of the country, although the main focus will remain on prioritised areas. ... Its aim is to establish a coherent policy covering the whole country that can be adapted to regional difference and conditions."<sup>25</sup>

43. The effects of this process of reform can be seen in the different policy areas that constitute territorial policy in Japan:

- *Territorial planning*: moving from a fairly rigid top-down strategic planning system to a new regionalised bottom-up planning system with multi-level governance mechanisms.
- *Regional economic policy*: moving from supporting the development of industrial activities in designated areas to measures that emphasise regional comparative advantages (innovation-led, cluster-based).
- *Infrastructure investment*: moving from large-scale infrastructure development (often supporting industrial strategies) to a regime of more selective, outcome-oriented and locally driven investments, and at the same time pursuing better use of existing infrastructure.
- *Metropolitan/urban policy*: the emergence of urban policy instruments to support local initiatives to regenerate urban areas and address the competitiveness of cities.
- *Rural development*: moving from rural policy based on direct and indirect sectoral supports to farmers to more integrated, endogenous and community-based measures.
- *Regulatory reform*: the introduction of place specific deregulations to help overcome regulation-based obstacles to private sector driven regional development.

44. Reforms of each of these domains include a package of policy instruments that together are intended to guide spatial development, easing concentration in highly urbanised regions while ensuring that rural areas are not neglected. In each case, the reform agenda seems to follow the same general directions: (1) an emphasis on competitiveness as an objective for all regions and on building regional assets rather than on redistribution and direct intervention by the centre; (2) the goal of achieving better outcomes with more limited levels of public resources, by means of better project selection and more targeted investment; (3) a strong focus on governance and, in particular, on clearer mechanisms for vertical

co-operation and collaboration across administrative boundaries; (4) an emphasis on building local capacity, independence and self-reliance; and (5) an emphasis on private investment.

45. An important dimension of the overall approach to achieving regional policy goals is efficient and effective fiscal transfers from central to local government. Central government transfers support a substantial proportion of regional development projects and finance for enterprise development, rural development and other initiatives that contribute to regional policy goals. As such, reform of the system of local finance and the intergovernmental transfer system will have important consequences for territorial development policy (see Chapter 3).

46. The following sections look at each of the above domains in turn: territorial planning, regional economic policy, infrastructure investment, policies for urban and rural areas and regulatory reform. In each case, the process of reform is having an important influence on how policy is formulated and implemented in Japanese regions.

### **Territorial planning**

47. Planning is usually the main instrument by which sectoral policies are co-ordinated and given a spatial articulation. Many of the legal powers and statutory obligations of central, regional and local governments are enshrined in the planning process, and territorial development plans themselves are among the main vehicles for co-ordination across levels of government. From a territorial policy perspective, spatial plans at different scales are the main expression of the concept of balanced development. Territorial planning has a particularly central role in organising and co-ordinating territorial development in Japan. At all levels, in all government departments and agencies, some form of territorial planning is used to orient investments and target actions. Territorial plans tend to be the instruments that bring together different sectoral plans, because they are primarily concerned with co-ordination rather than policy formulation or implementation *per se*. While other OECD countries have somewhat different planning mechanisms, territorial planning has always the same general function of providing a medium or long-term strategy incorporating different sectoral perspectives at different spatial scales.

48. Japanese authorities have elaborated a comprehensive approach to achieving balanced development across the country based on territorial planning. The main strategy for reducing regional disparities is to develop peripheral and less-developed regions while alleviating the pressures caused by agglomeration in the major urban/industrial areas. Successive national development plans, although separate from land use plans, have adopted a spatial focus to maintain economic growth and define a set of guiding principles for dealing with socio-economic changes.

### ***Evolution of territorial planning***

49. The principal planning instruments in Japan are the Comprehensive National Development Plan (CND Plan), which has provided a comprehensive spatial articulation of priorities, and the National Land Use Plan, which has been formulated to promote well-balanced and effective land use by each level of government. After World War II, in order to increase the country's capacity for growing population by building infrastructures for regional (mainly industrial) development, the Comprehensive National Land Development Act (1950) was enacted, which prescribes a four-level comprehensive national land development planning system (national, regional, prefectural and specified areas). The CND Plan is the umbrella document, providing the basic strategic direction for development and indicating investment priorities. The overall comprehensive development plans are supposed to be completed by a range of plans at the individual or multi-prefectural level; however, only national plans (CND Plans) and Specified Areas plans have ever been elaborated. Since 1962, the five CND Plans have sought to manage the territorial aspects of Japan's post-war industrialisation and urbanisation processes. These plans have emphasised the notion of balance, promoting a range of strategies to ease the polarisation pressure on metropolitan areas by promoting the re-location or development of industries in other regional centres. These plans have been closely integrated with industrial development and infrastructure development including road, rail and airport infrastructures, many of which were specifically designed to improve the accessibility and

attractiveness of regions designated as growth nodes. A review of the different Plans and their main objectives illustrates the evolution of Japan's territorial development priorities over the past 40 years; they also show how the response of the government changed as it became clear that some of the main trends with which it was being confronted continued or accelerated despite the initiatives of the public authorities enshrined in the development plans (Table 2.1 and Appendix 4).

**Table 2.1. Evolution of Comprehensive National Development Plans (CND Plans)**

|                                                  | CND Plan<br>(1962)                                                                                                                                              | New CND Plan<br>(1969)                                                                                                                        | 3 <sup>rd</sup> CND Plan<br>(1977)                                                                                     | 4 <sup>th</sup> CND Plan<br>(1987)                                                                                                                                                                          | 5 <sup>th</sup> CND Plan<br>(1998)                                                                                          |
|--------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|
| Target year                                      | 1970                                                                                                                                                            | 1985                                                                                                                                          | Around 1987                                                                                                            | Around 2000                                                                                                                                                                                                 | 2010-2015                                                                                                                   |
| Background<br>(socio-economic<br>transition)     | Transition to high<br>growth economy<br>Overpopulation<br>and income<br>disparity<br>"National<br>Income-Doubling<br>Plan" ("pacific<br>belt zone"<br>projects) | High growth<br>economy<br>Heavy<br>concentration of<br>population and<br>industry in<br>metropolitan<br>areas<br>IT, globali-<br>sation, etc. | Stable economic<br>growth<br>Decreasing<br>population inflow<br>to metropolitan<br>areas<br>Environmental<br>pollution | Economic growth<br>(toward bubble)<br>Concentration of<br>population and<br>high-level urban<br>functions in<br>Tokyo<br>Transformation<br>of industry<br>structure<br>Evolution of IT<br>and globalisation | After bubble<br>Depopulation<br>and ageing<br>Information-<br>oriented society<br>Globalisation                             |
| Policy targets                                   | Well-balanced<br>development                                                                                                                                    | Health and<br>productive<br>environment                                                                                                       | Improvement of<br>living<br>environment                                                                                | Multi-polar<br>country                                                                                                                                                                                      | Multi-axial<br>structure                                                                                                    |
| Major challenges                                 | Alleviation of<br>over-expansion<br>of urban areas<br>and mitigation of<br>regional<br>disparities<br>Appropriate<br>allocation of<br>resources                 | Environment<br>friendly<br>development<br>Efficient land use<br>that respects<br>regional<br>characteristics                                  | Stable settlement<br>Harmony<br>between human<br>beings and<br>nature<br>Conservation<br>and proper use<br>of the land | Revitalisation of<br>regions by<br>promoting<br>settlement and<br>urban-rural<br>interaction<br>Reorganisation<br>for globalisation                                                                         | Region-oriented<br>development<br>Globally<br>interacting<br>regions                                                        |
| Development<br>method                            | Regional<br>Industrial hubs                                                                                                                                     | Large-scale<br>projects                                                                                                                       | Stable settlement                                                                                                      | Interactive<br>network                                                                                                                                                                                      | Participation and<br>co-operation                                                                                           |
| Related policy<br>issues                         | 21 industrial<br>cities outside the<br>"pacific belt<br>zone"<br>Restriction on<br>the construction<br>of factories and<br>universities<br>(Tokyo and<br>Osaka) | "Shinkansen"<br>(bullet train)<br>network and<br>highway network                                                                              | Model<br>Settlement<br>Zones in non-<br>metropolitan<br>areas                                                          | Deconcentration<br>of national<br>administrative<br>bodies<br>Strategic<br>development<br>areas and<br>"business core<br>cities"                                                                            | Abolition of<br>development<br>laws (on<br>industrial cities<br>and the<br>restriction of<br>factories and<br>universities) |
| Investment<br>(accumulated<br>capital formation) | "National<br>Income-Doubling<br>Plan"<br>(JPY 16 trillion at<br>1960 prices)                                                                                    | JPY 130 trillion<br>to 170 trillion<br>(public<br>investment) at<br>1965 prices,<br>1966–1985                                                 | JPY 370 trillion<br>(public<br>investment) at<br>1975 prices,<br>1976–1990                                             | JPY 1 000 trillion<br>(public and<br>private<br>investment) at<br>1980 prices,<br>1986-2000                                                                                                                 | (no total amount<br>was provided)                                                                                           |

50. The other national plans are the National Land Use Plans, which provide basic long-term plans for land use. After 1955, rapid economic growth, industrialisation and urbanisation necessitated the creation of the National Land Use Planning Act, which was formulated in 1974, and provided a long-term, comprehensive plan for the balanced, effective utilisation of land. The Act calls for a hierarchical land use planning system and the creation of specific plans for prefectures and municipalities in addition to those developed at the national level. Three national plans have been formulated (in 1976, 1985 and 1996). They set out (1) concepts for land use; (2) goals for land use by category and by region; and (3) an outline of measures to achieve the goals. The National Land Use Planning Act stipulates that national land plans shall be formulated through full co-operation among the national, prefectural and municipal governments. The goals written in the plans are rather conceptual and neither restrictions nor penalties are provided.

51. In the current planning scheme, the CND Plans and the National Land Use Plans are formulated by MLIT on the basis of deliberation by the National Land Council, which is comprised of 10 Diet members and 20 experts, such as university professors (more than half), as well as hearings with related ministries. A CND Plan is adopted by the Cabinet based on a report submitted by the Council. In the past, drafting was mainly conducted by the Council and inter-ministerial co-ordination was managed by the National Land Agency, which was until recently a part of the Prime Minister's Office (as such, the Prime Minister formally conducted the Plans). The Council usually has a planning section and special committees for examining individual issues and responds to requests from the Minister for Land, Infrastructure and Transport for surveys of new issues. The deliberation process in the Council is usually open to the public and, in the process of drafting a plan, the Council provides heads of local public bodies, including prefectural governors and mayors of government-designated cities, as well as the general public with opportunities to voice their opinions. As for the National Land Use Plan, MLIT prepares a draft of the Plan on the basis of the opinions of the Council and the prefecture governors.

52. The development of a territorial plan involves all the relevant ministries and sub-national authorities. Since a specialised co-ordinating body at the national level was established under the Prime Minister's Office in 1972, the National Land Agency (which was merged into MLIT) has been in charge of the territorial plans and inter-ministerial co-ordination for development. The process of formulating the past plans required negotiation. Although line ministries were supposed to respect the plans when formulating their policies and budgets, at times, persistent sectionalism did not allow substantial integration of these measures and, as a result, most policies by line ministries have been conducted in their own way (e.g., they have their own medium-term plans). Nevertheless, the process of formulating territorial plans and the plans themselves have established a common notion of territorial policy and helped to create a network of local authorities and local actors. In an attempt to strengthen collaboration with sectoral ministries, a project co-ordinating fund, called the Comprehensive National Land Development Project Coordination Expenses, was introduced as a horizontal co-ordination tool for infrastructure development by sectoral authorities.

### *Challenges and reform in the planning system*

53. Over time, a number of weaknesses in the current planning system have become evident:

- The plans refer to so many measures that the order of priority is not clear;<sup>26</sup>
- The written objectives are somewhat abstract while the relationship between the objectives and the measures is not clear; and
- "Deadlines" are not indicated.<sup>27</sup>

54. As a result of these weaknesses, the relevance and impact of the national territorial plans has declined. Moreover, in the context of decentralisation and a policy focus on regional competitiveness and self-reliance, the logic of a top-down national policy planning instrument needs to be clarified.

55. In November 2002, the National Land Council proposed the following reforms to establish a new national land planning system for the 21<sup>st</sup> century. Its key recommendations included:

- Transition from planning for economic development to planning for sustainable use (*i.e.*, development plus conservation).
- Participation of local actors in the process of policy formulation (specifically with respect to the Regional Block Plan), and enhanced co-operation in national land planning between national and local governments based on a new, more equal relationship.
- Transition from a project oriented plan to an outcome oriented plan with a strong focus on accomplishments.
- Clarification of the role of Regional Block Plans at the local level (which will remain distinct from their role at the national level) and a stronger focus on the Regional Block Plans, in which local municipalities take initiatives and responsibilities based on their own decisions.<sup>28</sup>

56. The current reform of the territorial planning process is following in the same direction as a number of reforms in other OECD countries (Box 2.1.). In the new system the local government can take a more active role in setting policy objectives for the new Regional Block Plans. The key challenge is to strengthen the long-range strategic function of the planning system, which is still arguably a valid and important function, with mechanisms that allow for more flexible medium-term programming and that link it to short-term, budget-related implementation processes. This has a number of related aspects:

57. *1. Consolidating the long-term strategic function.* Long term territorial planning in Japan is organised according to a double procedure: the CND Plan and the National Land Use Plan, each of which contributes to land use concerns. Both plans set public decisions within a coherent, long-term framework, taking into account major social challenges (*e.g.*, the trend towards an ageing and demographically declining Japanese society) as well as crucial macroeconomic trends (*e.g.*, the shift to a service-based economy, embedded in an open global market). In this sense, the Land Use Plan is a necessary complement to the Comprehensive Development Plan, and efforts should be made to integrate the two plans in order to improve the sense of strategic coherence and reinforce the role of strategic planning which has been undermined in recent years.

58. *2. Improving the role of planning in sectoral co-ordination.* This will require much stronger cross-sectoral co-ordination among central government departments and between national and sub-national levels as well as a good co-ordination of public and private sectors. Despite recent efforts to reorganise departments, the administrative system still suffers from sectoral segmentation. Weaknesses in the current planning system – related, as mentioned above, to the lack of clear targets, allocations of responsibilities and deadlines – mean that it does not fully play the role of co-ordinating and giving spatial articulation to sectoral policies, objectives and choices, which the central government should aim to harmonise. The public body in charge of preparing the CND Plan and the National Land Use Plan, the National and Regional Planning Bureau, must enhance the cross-sectoral dimension of spatial development, making it more comprehensive, broader than the mere physical land use or infrastructure aspects. Contract-based planning mechanisms (discussed later) could provide one innovative means by which to reinforce the role of planning instruments in defining responsibilities, co-ordinating policy implementation and monitoring the coherence and effectiveness of policy implementation across sectors as well as on a regional basis.

59. *3. Increasing the role of planning in setting targets and monitoring policy.* There has been a discrepancy between policy design and policy implementation in Japanese policy making. Although territorial planning still contributes to defining territorial policy goals and providing frameworks, the formal monitoring scheme of policy implementation has not been embedded in the planning system. Territorial planning provides an important framework for co-ordination, but at the moment the planning system lacks the tools to monitor the implementation of policy. As such, the strategic lines are drawn in plans, but then implementation of policy takes place in a sectoral manner. While each ministry has its own method for evaluating its policies – and this is an area where the government is placing significant emphasis (*e.g.*, reform of infrastructure policy) – the targets are not necessarily coherent across policy fields. Each sectoral policy evaluation scheme is often undertaken through an internal body, even if the results are open to public scrutiny, which makes assessing outcomes and, in particular, comparing outcomes across sectors difficult. Given that reorganisation at the central level has not resolved the co-ordination issue from an institutional perspective, the question of evaluating policies is likely to become increasingly important as the government's reform programme moves forward.

60. In the absence of evaluation evidence, it is hard to demonstrate the effects of past policies. Setting more specific and measurable objectives, targets and indicators could contribute to more detailed evaluation of the efficiency or effectiveness of policy. In this respect, the goals of the new territorial planning system include a commitment to improving the evaluation of policies. A more detailed evaluation of the efficiency or effectiveness of policy has been constrained in the past by the lack of specific and measurable objectives, targets and indicators in the main planning instruments. For the future, the intention is that territorial policy programmes should involve:

- The use of outcome indicators;
- Setting measurable targets, with clear time frames for achievement;
- Establishing a monitoring system;
- Using the results as both as a policy tool (improving the policy measures) and for public accountability purposes.

61. The issue for policy makers in Japan is how to move from sector-specific evaluation to more cross-sectoral territorial monitoring and evaluation. The examples from the EU suggest that evaluation can become an important instrument for policy co-ordination that includes both the line ministries involved in policy formulation and implementation (infrastructure, transport, etc.) and those responsible for budgeting (Ministry of Finance/Treasury). A related issue is how policy evaluation mechanisms can adapt to more decentralised policy-making structures. With regional and local governments increasingly active in policy development and implementation, evaluation of territorial policy objectives and outcomes should include assessment of use of public resources at sub-national levels, and also build in mechanisms for policy learning and mainstreaming that include lessons learned at regional and local levels.

62. The interest in evaluation by Japanese territorial policy makers reflects similar trends in other OECD countries. The evaluation of territorial policy has become more important in the EU over the past decade (Bachtler, 2001). And this applies particularly to EU territorial policy, where there has been extensive investment in evaluation capacity, methodologies and systems. The EU regulations governing the implementation of Structural and Cohesion Funds have incorporated increasingly strict requirements for adequate monitoring and evaluation procedures. Over successive time periods, Member State authorities have been forced to become more accountable as to how EU regional development funds are utilised. It is clear that the importance accorded to evaluation under EU territorial policy has influenced the priority given to evaluation within national regional policies also. An important aspect of these evaluation



mechanisms is that they are directed principally at decentralised programmes, *i.e.*, the implementing bodies for these programmes are national ministries, but also regional and local governments and partnerships of different kinds.

### **Box.2.2. Territorial policy evaluation in EU countries**

Interest in evaluation among Japanese territorial policy makers reflects similar trends in other OECD countries. The evaluation of territorial policy has become more important in the EU over the past decade (Bachtler, 2001). This applies particularly to EU territorial policy, where there has been extensive investment in evaluation capacity, methodologies and systems. The EU regulations governing the implementation of Structural and Cohesion Funds have incorporated increasingly strict requirements for adequate monitoring and evaluation procedures. Over successive time periods, Member State authorities have been forced to become more accountable as to how EU regional development funds are utilised. It is clear that the importance accorded to evaluation under EU territorial policy has influenced the priority given to evaluation within national regional policies also.

With respect to methods for monitoring and evaluating territorial policy, the approach used within EU territorial policy is worth noting (Taylor, Bachtler and Polverari, 2001). EU-funded regional development programmes are required to include a hierarchy of monitoring indicators and targets (for the seven-year period of operation of the programme) at programme, priority and measure levels. This distinguishes between several types of indicator:

- Input indicators, relating to the finance committed or spent;
- Output indicators, relating to the goods or services produced, such as number of firms assisted or number of kilometres of road built;
- Result indicators, relating to the immediate or direct effects, such as additional business investment induced or the reduction in journey times;
- Impact indicators, relating to the longer term effects of the assistance, such as business employment or transportation flows.

Each of these indicators has a different purpose: for example, output indicators are relevant to the operational objectives of the policy programme or instrument, while impact indicators relate to the global objectives of the policy. A key lesson of monitoring under EU territorial policy is that a robust hierarchy of monitoring indicators needs to be complemented by investment in: (a) data collection arrangement that ensure accurate, timely and relevant data; (b) data collation, storage and analysis practices that can interpret and deliver information in the right form at the right time to support policy design and implementation decisions; and (c) human capacities, in the form of skills and expertise (since the best systems are undermined by poorly understood data requirements or handling methods).

Evaluation is also systematically conducted under EU territorial policy with a distinction drawn between:

- *Ex ante* evaluation, conducted at the outset of a policy or programme, to establish the validity of the objectives and targets set, as well as the feasibility of the management and delivery arrangements for achieving the targets;
- Interim or mid-term evaluation, conducted at the half-way stage in the lifetime of a policy or programme. This is intended as an opportunity for "taking stock" and reflection on the progress of the policy, focussing primarily on the process of implementation and (insofar as data permits) its initial effects, with a view to guiding a reorientation of the programme; and
- *Ex post* evaluation, conducted once the policy or programme is completed, to establish effectiveness (e.g. impacts on employment) and efficiency (e.g. value for money).

63. 4. *Linking national planning with decentralised decision making.* Given the wider process of decentralisation, the involvement of local government in a new territorial development planning system should be reviewed not only from the perspective of planning procedures, but also with respect to inter-government transfers. Local government should take a more active role in preparing the plans and the plans should be linked to budgetary mechanisms that provide incentives for local governments to participate.<sup>29</sup> For example, strategic “regional blocs” with decision-making and budgetary power in regional policy would meet expanding demand of beyond a single administrative area and achieve more effective and efficient investment (discussed in Chapter 4).

### **Regional industrial policy**

64. Regional economic policy was one of the key means by which balanced development across the national territory was to be maintained. The evolution of this policy over time illustrates a general evolution that has taken place in many OECD countries.

65. As noted in the previous section, the series of CND Plans were instrumental in organising major programmes to guide the nature and location of industrial development in Japan over the post-war period. Implementation of these regional industrial policies was directed principally by MITI (now METI) and supported by other major ministries such as Employment and Education, as well as a number of more specialised agencies such as JETRO, the Industrial Structure Improvement Fund, the Japan Development Bank and the Hokkaido-Tohoku Development Finance Corporation. In addition, the Japan Regional Development Corporation was responsible for providing funding for infrastructure projects related to industrial development such as science parks, new town developments linked to industrial development plans, and so on.

66. The first phase of regional industrial policy was focused on physical recovery of the four major industrial areas after the war (Tokyo, Nagoya, Osaka and Kyushu). Once this period of rehabilitation was complete and signs of over-concentration began to appear, the emphasis of policy shifted towards promotion of heavy industries (particularly chemicals) in the Pacific coastal zone. This included construction of new cities and accompanying infrastructure. The development of new industrial areas was supported by legislation restricting the location of factories in the major urban areas around Tokyo and Osaka (the Factory Restriction Laws).<sup>30</sup> Through the 1970s, the process of concentration in the major urban centres intensified, despite policy measures aiming to control this process. As a result, additional measures were introduced to increase the incentives for businesses to locate in non-metropolitan areas. Based on the 1972 Industrial Relocation Promotion Law, financial incentives promoted factories in restricted areas to relocate in designated areas or establish new factories there.<sup>31</sup> The financial incentives included direct subsidies provided by MITI (the Industrial Relocation Promotion Subsidy) and longer term loans by bodies such as the former Japan Development Bank (JDB) and the former Hokkaido/Tohoku Development Finance Corporation (NEF), which had attracted large numbers of enterprises to the priority regions.

67. In terms of impact, the policy was successful in some respects. The volume of industrial output accounted for Tokyo and Osaka declined over the period 1985-1992 from 18% to 15% and the corresponding figure for the target zones increased from 27% to 32%. Data by region suggests that some of the change in share in both output and employment was a result of spreading out within the Kanto and Kinki regions, *i.e.*, short distance relocations away from congested coastal areas to the inland part of the region. At the same time, the rapid industrialisation of the Tohoku region over the 1980s demonstrated the capacity of this bundle of policies to generate significant change in industrial location patterns.

68. Over the course of the 1980s, the focus of industrial policy moved away from heavy industry toward high-technology industries. During this period, the government introduced the Technopolis

programme which was an ambitious programme to, at the same time, relocate high technology industries away from the major metropolitan areas (particularly electronics and materials industries) and develop in the same areas high quality research and educational facilities.<sup>32</sup> The aim was to develop integrated production complexes in non-core areas that would develop self-propagating internal processes of innovation and technology development and transfer. From relatively small beginnings, the programme grew to encompass 26 sites around small or medium-sized cities in non-metropolitan areas of Japan. While clearly there was some success in terms of creating jobs and activity, success was achieved only in cases where a high-technology framework (as in Kyushu), research facilities and good accessibility (links with the capital) were already in existence. In other cases, the level of investment was high and returns modest. According to some economists, while the Technopolis programme was able to decentralise the least innovative portions of high-technology activities, its contribution to the equalisation of regional incomes has been highly uncertain. In order to increase the high innovation end of the industry spectrum to locate outside of Tokyo, the Brains-of-Industry programme was established in 1988 as a complement to the Technopolis programme, offering a range of incentives for the design and research functions of businesses to be relocated to technopolis sites or to similar zones. These earlier national policies had mixed success. On the one hand, national policy promoted – and indeed achieved – consistent conditions throughout Japanese regions for undertaking mass production. In particular, the employment system (with its pillars of stable employment, seniority-based promotion, and company-provided training) fostered a standard framework for highly-productivity factory work. On the other hand, there was less success in fostering dynamism and creative capabilities in Japanese localities outside of the Tokyo-Nagoya-Osaka agglomeration that could internally create successful new high technology complexes. Many new prestigious technology-oriented buildings have been constructed in the regions, but the rigidities of the personnel system and lack of venture capital and other soft systems have made it harder to find and support scientific and technological entrepreneurs able to take the risk of new venture start-up. Moreover, the industrial policy instruments frequently used (tax incentives, cheap loans, large-scale infrastructure investments) were most useful for large firms placing branches in the regions rather than stimulating new local start-up ventures.<sup>33</sup>

69. Economic changes over the course of the 1990s have, however, to some extent overtaken Japan's traditional regional industrial policy. In the 1990s, the pace of "off-shoring" and "deindustrialisation" accelerated in mature Japanese industries and many local areas have seen manufacturing employment declines and plant closures. There are now fewer chances for local areas to attract conventional mass-production branch plants. While there are still some opportunities here (including an increase in potential to attract foreign-owned plants), it is clear that different regional development strategies are needed. The hollowing out of manufacturing seems to have affected the new industrial zones created through regional development policies particularly hard and has led to a reorientation of policy thinking towards more sustainable development paths based on regional assets and accumulated specialisations, strengths and skills. The result of this evolution is that regions are now seen from a perspective of the "innovation systems" that they have developed over time, the capacities that are "embedded" in each region, rather than in physical production facilities themselves (many of which have downsized or even relocated). These innovation "assets" – sector specialisations, skilled labour, research facilities, networks and advanced supply chains – are now seen in economic policy circles as key drivers in the revival of Japan's competitiveness. The main policy issue is how to develop policies that will allow regions to develop the innovation systems to better seize emerging opportunities as well as to confront their current challenges. The policies for innovation and competitiveness that Japanese regions will need to develop in the coming period are fundamentally different from those that were implemented in the past.

70. Promoting local innovation is now a key priority for Japanese regional policy. These more recent programmes of business support tend to place knowledge rather than the firm in the centre of the process that determines productivity. This approach emphasises the importance of agglomeration effects for knowledge creation and diffusion and takes the view that in many cases the regional is the most

appropriate level to assure knowledge a favourable “diffusive” environment. Physical proximity, the shared “regional culture” that often comes with physical proximity – *i.e.*, shared practices, attitudes, expectations that facilitate the flow and sharing of tacit and other forms of proprietary knowledge – and the possibility of close interaction and joint working become the cornerstone of an implicitly “regional” system of innovation. The following sections will look at different aspects of developing an innovation-led regional policy:

- Development and support for clusters;
- Linking regional research and industry;
- Building institutional frameworks for regional innovation systems.

### ***Strengthening regional cluster development***

71. At the heart of a new approach to innovation and technology policy, and one of the prime justifications for a regional emphasis, are Japan’s small and medium-sized enterprises (SMEs).<sup>34</sup> Enhancing the contribution of small and mid-size enterprises (SMEs) to regional innovation and competitiveness is a priority that requires ongoing consideration by Japanese policy makers.<sup>35</sup> There are perhaps three key focal points for policy. A first policy thrust is to encourage *existing* SMEs to emphasise innovation. In the manufacturing sector, many Japanese SMEs have been organised into hierarchical vertical supply-chains led by larger companies. Long-term relationships in these vertical chains enabled SMEs to develop excellent technological and process capabilities in specific niches during Japan’s rapid growth phase and build-up of mass production beginning in the 1950s. But a shift away from this system is already underway: for example, SME subcontracting rates in the general machinery sector have declined from nearly 85% in 1981 to under 60% today.<sup>36</sup> The challenge now is to encourage and support more existing SMEs to develop new “market-oriented” horizontal and lateral linkages, to increase investments in R&D (non-subcontracting SMEs are twice as likely to undertake R&D as subcontracting SMEs), and develop new products for a new era of increased international competition and innovation. A second policy thrust is to stimulate the start-up of *new technology-based small businesses*, for example through the spin-out of commercial ventures from regional university research or the spin-off of new firms from existing large companies or consortia of small companies. New technology-based ventures may be in emerging fields (such as life sciences), lack cash flow and reputation, require further product development support, and need to obtain intellectual property protection. A third policy thrust is to encourage the formation and growth of entrepreneurial *knowledge-intensive small businesses* in regions. Such firms may target evolving opportunities in such fields as business services, information services, logistics, tourism, health, social services, and other local community business markets. Again, the characteristics and needs of such businesses differ from those of the other two categories, for example, requiring entrepreneurial and service innovation and having lower entry barriers. This third category of policy is important to improve growth in high quality services employment in Japanese regions.

72. One striking aspect of small business development policy in Japan, clear in the past but also visible today, is the focus on real estate based business development and the relative weakness of associated support services. As was noted in the recent OECD Economic Survey, Japan has the third largest number of business incubators behind the United States and Germany. At the same time, the average number of employees in these incubators is very low, suggesting that these are production sites, but that they are not geared to providing business services to companies located there. As an illustration, each US incubator has an average staff of 2.7 employees, while those in Japan have an average of 0.7 employees.<sup>37</sup> A JANBO survey of incubators found that one-third of public incubators and one-half of private ones provided no services at all. There is some similarity with the major weakness of past policies to support new businesses – such as the Technopolis programme – which was that they concentrated too

much on providing office space and not enough on providing support services, encouraging networking and linkages, etc.

73. An important development in the evolution of policies for regional small firms has been the emphasis on clusters, which has had an important impact on rethinking the approach to providing collective services to encourage regional and local business development. In the past, regional growth poles were mainly perceived in terms of co-location; in other words, industrial sites were prepared and businesses were brought in, thereby creating a concentration of firms, but not necessarily emphasising their complementarities or potential to work together and build producer chains or other types of network. In the last few years, attention has shifted to developing symbiotic clusters, *i.e.*, dense networks where expertise and skill can accumulate, there is significant knowledge exchange or spillover, new firm creation is stimulated, and processes of competition and co-operation generate innovation.<sup>38</sup> Over the past few years, the Japanese government has increasingly turned its attention to the potential of clusters as a key pillar of regional economic policy.

74. METI's Industrial Clusters Programme, introduced in 2001, endeavours to build on the specific structural assets of 19 wide regional areas, based on the regional R&D capabilities and industrial characteristics. Officials of the Regional Bureaus of Economy, Trade and Industry (approximately 500 persons) are closely co-operating with approximately 5 800 local small and medium enterprises and with researchers of more than 220 universities, and are implementing the following three measures in an integrated manner: (1) giving support to exchanges and co-operation between industry, academia, and government; (2) giving support to the development of technologies for practical use based on regional characteristics; and (3) establishment of facilities to provide training to entrepreneurs. In addition, a relatively large number of local governments participate in the METI Industrial Cluster Programme and operate different types of business incubator. At the same time, the dominance of real estate based industrial development policies in the past exert an influence, with local governments often providing office space, development sites, incentives to locate, but not fully appreciating the role that they can play in facilitating networking and closer co-operation among actors. The actions of METI regional office staff in acting as facilitators in the areas designated as regional clusters could have a strong impact depending on the capacity of the METI staff and the receptiveness of local actors to adopt new working methods that favour more joint working. Given that much of the financing within these clusters is local funding, the attitude and capacity of local government to take a more pro-active role in enterprise policy will also be crucial.

75. The process that led to the emergence of this new focus in policy can be illustrated with reference to the birth of one of the most prominent examples of the cluster principle, the TAMA (Technology Advanced Metropolitan Area) association. The area of TAMA is in a suburb of Tokyo and became industrialised as enterprises moved out of inner city and costal areas, partly due to the Factory Restriction Laws, to find less congested areas for industrial location. The area developed a strong accumulation of sub-contracting enterprises in the electronics, transportation, precision machinery and other technologically advanced branches. Despite sub-contractors for large firms, these SMEs developed strong product development capacities. As large firms moved overseas or contracted their operations during the 1990s, the smaller firms located in the TAMA region lost a part of their customer base. A 1996 White Paper on SMEs noted that firms with the characteristics of those in the TAMA region could maintain their competitiveness through networking with other similar producers and with research generators such as universities and labs.

76. TAMA is an association, founded with METI encouragement (particularly through the Kanto Regional Bureau). The association focuses on the revitalisation and development of industries located in the western parts of the Tokyo metropolis, creating new technologies, products and businesses. Between 1996 and 1998, the TAMA association was created to link almost 200 enterprises and a large number of other actors in a range of joint activities designed to enable these small or medium-sized

enterprises to access new technology, market information, product development facilities and export information, among other things. In establishing TAMA, its industrial and governmental founders, considering the local circumstances and potentials, referred to models elsewhere, including the Greater Washington Initiative (a public-private regional development organisation in Washington DC and parts of Virginia and Maryland). The TAMA region, which stretches over three prefectures and 74 municipalities, contains more than 300 000 small businesses and about 40 universities. Of these, about 300 area companies and 34 universities are members of the TAMA association. The association promotes industry interaction and seeks to strengthen traditionally poor industry-university linkages through exchange and joint R&D projects, with the broader goal of creating synergies that will foster new technological development and commercialisation. TAMA has established a Technology Licensing Office to assist in patenting, licensing, and R&D commercialisation. The TAMA region has significant strengths in mechatronics, instruments, and control systems. TAMA founders report that they have been successful in raising the concerns of companies in these sectors to policy makers, in catalysing academic-industry links (important because many of the region's universities are small and not experienced in technology transfer), and in creating a unifying hub in an otherwise fragmented region.

77. METI has encouraged cluster development organisations elsewhere in Japan. For example, in Hokkaido, a Super Cluster Promotion Project has been formed to promote IT and biotechnology industries. Whereas TAMA is focused around parts of a huge and industrially dense metropolitan region, the Hokkaido project has a networked character involving 16 universities, five public research institutes, and nearly 300 companies in four non-contiguous locations within the prefecture. The project's activities include database development, business exchange meetings, and the formation of business support networks also involving venture capital companies. In the Kinki region, which includes the cities of Osaka, Kyoto, and Nara, a Bio Cluster project has been established involving 36 universities, nine local governments, 14 public research institutes, and about 220 companies spread over multiple locations. In total, METI's industrial cluster initiative will spend about USD 350 million on its 19 regional projects over a period of years.<sup>39</sup>

78. Whereas the METI programme seems to concentrate on existing industrial complexes to help them to develop their technological strengths, the Knowledge Cluster Initiative of the Ministry of Education, Culture, Sports, Science and Technology (MEXT) (Office for the Promotion of Regional R&D Activities) focuses on universities with the aim of encouraging universities to work with area industries, as well as financiers, to commercialise new technologies. MEXT will invest about USD 410 million over five years in 18 designated cluster projects and five trial cluster projects. The aim of the programme is to reform and upgrade the R&D systems in regions and improve the flow of research by networking the principal actors and providing seed funding for joint activities. The concept of "Knowledge Clusters", as set out in the Science and Technology Basic Plan 2001-2005, is to give regional research organisations including universities a stronger role in R&D transfer in their local regions. The emphasis is on creating human resource based, or proximity based networks that encourage stronger face-to-face interaction between actors who are inadequately connected at present. The schema for each Knowledge Cluster is similar. The activities are managed by a Core organisation, usually a research institute or similar nominated by the local government to oversee implementation of the project. A team of Science and Technology Co-ordinators and experts such as patent lawyers animate the system by bringing the different actors into contact with each other through seminars, forums, etc. The Science and Technology Co-ordinators assist participants in establishing priorities, identifying areas for collaborative research and in identifying possible commercial or patent related activities and supporting R&D needs.

79. Japan's cluster programmes have a strong concentration on the development of new technology (which plays to an area where Japan is undoubtedly strong) and on industry-university links (an area where there is agreement that strengthening needs to occur). While Japan's cluster programmes are having impacts, it is uncertain whether the total effect will be as great as hoped. Central government investments

in cluster policies are relatively small (given the size of the Japanese economy) and only a tiny fraction of industry (well under 1% of Japanese industrial companies) is formally involved as members. Yet, the value of these projects could be significant in terms of establishing new models that can be replicated by local industrial cluster organisations throughout the country. It is not clear yet whether this potential is being realised. As a benchmark, Germany's BioRegio (which seems to have invested comparable amounts of funds over a five-year period) claims to have raised the number of biotechnology companies in Germany by several hundred new ventures, as well as giving a much needed boost to the regional dynamics of biotechnology in the country.<sup>40</sup>

80. One key area is co-ordination between sectoral ministries. It is true that the two programmes have different emphases: METI focus on industry and MEXT focus on universities and public research organisations, with MEXT supporting product and technology development and METI supporting downstream commercialisation. Nonetheless, the network-based approach is similar and the potential participants and beneficiaries of the two programmes overlap. It is important, therefore, that the regional cluster programmes are closely co-ordinated. The two programmes are new, and the channels of co-operation have only recently been established. At present, they consist of cluster forums at the national level and the establishment of regional Cluster Promotion Councils, of which 12 have been set up. The functional complementarity between the two programmes is also becoming more apparent. For example, the Sapporo IT Creation Project, one of the MEXT projects, and the METI-supported Hokkaido IT Industry Cluster Project have been active in developing new technologies and helping firms to incorporate these new processes respectively.

*New directions for cluster policies: supporting local agglomerations of firms*

81. While definitions of what constitutes a cluster can vary, it is clear that the Japanese economy is characterised by a large number of geographical concentrations of firms of the same or related sector(s). A 1996 survey by the SME Agency noted over 500 distinct, specialised industrial zones in Japan. Some of these were relatively small and based on artisanal production, others were of more recent origin and were involved in higher technology industries. Table 2.2 shows results of a questionnaire addressed to all 537 of the zones identified by the SMEA. The figures reflect the percentage of respondents in each industry that considered each potential advantage to be important for the zone. The results of the survey show that ease of procurement through the closeness of suppliers, specialisation and division of labour, and opportunities for technology diffusion and co-operation stand out as the main advantages for all industries. These results support analysis by METI showing that firms involved in networks based on local proximity have higher productivity than those without such linkages.<sup>41</sup>

**Table 2.2. Number and size of zones of specific industries identified by the SME Agency**

| Industry                     | Number of zones identified in Japan | Average number of firms in each zone | Average total employment in the zone | Average firm size |
|------------------------------|-------------------------------------|--------------------------------------|--------------------------------------|-------------------|
| Food processing              | 83                                  | 82                                   | 1 260                                | 15.4              |
| Textiles                     | 126                                 | 241                                  | 1 518                                | 6.3               |
| Clothing                     | 34                                  | 208                                  | 4 986                                | 24.0              |
| Wood products, furniture     | 78                                  | 102                                  | 823                                  | 8.1               |
| Ceramics, pottery, glassware | 62                                  | 125                                  | 920                                  | 7.4               |
| Machinery                    | 56                                  | 128                                  | 1 986                                | 15.5              |
| Diverse                      | 98                                  | 111                                  | 1 175                                | 10.6              |
| Total                        | 537                                 | 145                                  | 1 496                                | 10.3              |

Source: SMEA (1997), quoted in Yamawaki.

**Table 2.3. Survey of advantages linked with being in a zone**

| Advantage of being in the zone                         | All industries | Textiles and clothing | Wood products, furniture | Ceramics, pottery, glass-ware | Metal products and machinery |
|--------------------------------------------------------|----------------|-----------------------|--------------------------|-------------------------------|------------------------------|
| Ease of procurement                                    | 42.0           | 24.0                  | 51.0                     | 59.0                          | 50.0                         |
| Access to labour market                                | 6.8            | 5.1                   | 5.5                      | 3.7                           | 8.0                          |
| Skilled workers and engineers                          | 10.0           | 9.4                   | 13.7                     | 5.6                           | 8.0                          |
| Specialisation/division of labour                      | 42.6           | 53.6                  | 47.9                     | 31.5                          | 64.0                         |
| Access to suppliers/subcontractors                     | 24.2           | 30.4                  | 23.3                     | 13.0                          | 38.0                         |
| Competitive environment                                | 19.5           | 16.7                  | 20.5                     | 25.9                          | 14.0                         |
| Access to customer base                                | 10.8           | 11.6                  | 12.3                     | 13.0                          | 38.0                         |
| Diffusion of technology and technological co-operation | 31.2           | 37.6                  | 26.0                     | 46.4                          | 16.0                         |
| Opportunity for business alliances                     | 11.9           | 8.0                   | 13.7                     | 14.8                          | 10.0                         |
| Access to market information                           | 24.8           | 29.0                  | 16.4                     | 16.7                          | 24.6                         |
| Regional policy (incentives)                           | 27.4           | 26.8                  | 23.3                     | 20.4                          | 28.0                         |
| No advantage                                           | 2.8            | 2.9                   | 1.4                      | 1.9                           | 0.0                          |
| Total number of zones surveyed                         | 471.0          | 138.0                 | 73.0                     | 54.0                          | 50.0                         |

82. Given that many of these industries are in industries strongly affected by international competition, and located in areas where issues of industrial restructuring are a high priority, Japanese policy makers may wish to consider whether a more experimental and locally competitive strategy for local cluster formation could be introduced. Such an initiative would follow similar network development principles, but would probably emphasise the provision of collective services similar to those provided to firms in Italian industrial districts. The provision of collective services in areas where small firms are grouped and specialised has two objectives, both of which stress building and deepening network relations:

- To induce *learning*, *i.e.*, a learning process is activated within the customer company. Services must bring to light the unconscious, “hidden needs” of the companies; yet this learning is a process which is not appropriable to one single company, as labour mobility among SMEs is high. Learning is addressed to individuals and to the company culture.
- To generate *positive “externalities of consumption”*, in the sense that, also as a consequence of imitative mechanisms, higher standards are introduced within the companies and in inter-company relations. Again the collective level is of crucial importance for the success of the exercise.

#### **Box 2.3. The ERVET network in Emilia Romagna, Italy**

In Emilia Romagna there is a cradle of Real Service Centres, established by the regional development agency ERVET. The ERVET network consists of sectoral and theme-oriented centres, whose core objective is to disseminate information in the areas of market development, marketing and technology; they play a strong role in the creation of economic intelligence through the maintenance of databases and libraries and are considered as part of the explanation of the spectacular development of the region. The CITER (centre of textile information Emilia Romagna) is considered for instance as particularly successful in developing its specialisation in relation to the strategic needs of the sector and only through working with the firms in the sector it is able to identify which of the generic functions to develop (Rush *et al.*, 1996). The quality of the leadership and the business involvement are other factors explaining the success of CITER.



83. A more local variant of the cluster approach could also contribute to the development of a more integrated approach to economic development outside the main urban centres. Initiatives are needed to encourage more small and mid-size communities in Japanese regions to review and upgrade their economic development strategies. At present, the policies of METI and MEXT in the area of clusters and innovation more generally are strongly focussed on urban areas. The targets of METI's cluster programme, for example, are all relatively large urban centres. An approach for more rural enterprise networks that focuses on building the productivity of firms in smaller population centres could be an important complement to efforts to make less central regions more competitive. This is a central aspect of current interest in rural hubs, particularly in the United States but also in European countries. Yet, this is an area where small municipalities have little experience and need support.

### *Linking research and industry*

84. Japan has a very strong national research system.<sup>42</sup> The emphasis of the government, apparent for a number of years, is to ensure that this research and technical expertise are translated into commercial success for Japanese firms. There are, for example, concerns that too many researchers remain in the university/academic sector, with only a very small proportion working in the private sector. In addition, it is recognised that most Japanese universities are inadequately linked to local business, particularly with respect to small firms.

85. There are now greater prospects for Japanese public universities to play significant roles as regional hubs for innovation. In 2004, Japan's national universities – positioned as part of the central government for more than a century – were reformed as independent public corporations. University faculty members are now non-governmental employees, not civil servants as before. From 2004 onwards, it will also be possible for other public universities to be incorporated according to the judgement of the prefectural government concerned. Selective university mergers to create economies of scale and other changes in academic incentive and evaluation systems are also under way. Universities are also rapidly establishing Technology Licensing Offices, incubators, collaborative industry-research centres, and other programmes to promote research commercialisation and regional development.<sup>43</sup> The aim is to stimulate a more flexible, competitive and entrepreneurial university system in Japan that can not only undertake world-class research but also have significant impacts on regional innovation and development. Whether the latter goal is achieved will depend not only on the extent to which universities themselves embrace these reforms, but also on the ways in which regions and localities can build new linkages between universities, economic sectors, and territorial innovation strategies. Generally, universities (comprised of many independent faculty members) are slow to change traditional values and procedures. But such change can be accelerated by strategic university leadership and incentives to faculty to adopt innovation missions in research, education, and service. It needs to be made clear that taking leadership to promote regional innovation and development is an essential mission of publicly-sponsored universities, with appropriate systems of reward and accountability built into place. Moreover, possibilities should be explored to transform selected universities from research and teaching institutions into regional innovation hubs. This may involve adding functions (such as incubation, business technology outreach, and community development assistance) which are carried out by dedicated professionals within the university system rather than by university professors. There are also opportunities to encourage student engagement, including the development of new interdisciplinary curricula (for example in the management of innovation) and co-operative education where students get experience in business or undertake projects with business as part of their educational requirements.

86. The emphasis on bringing universities into closer and more regular contact with local industry is clearly an important priority. It requires a shift in the kinds of technological expertise that companies obtain from public institutions. For example, a study of small and mid-size firms in 127 clusters in Japan indicates that these firms are more than five times more likely to work with public research and testing

facilities (*kohsetsushi*) than with universities (SMEA, 1997, quoted in Yamawaki). Strong links with public testing facilities is highly desirable and should continue to be strengthened to support process technology, quality, training, and incremental product improvement. However, *kohsetsushi*, under the jurisdiction of METI, lacks collaboration with universities. It is also clearly desirable to encourage more SMEs to work with research universities, either individually or through joint-projects, to gain access to new research, faculty, and students to stimulate major innovations and ventures in emerging technologies. This is consistent with the drive to remove the regulatory and other obstacles that limit incentives for closer interaction between local enterprises and university research communities. It also underlines the importance of the current emphasis on clusters and networking, promoted by both METI and MEXT, which provide means for groupings of small firms to engage in projects with research institutions.

#### **Box 2.4. Emerging roles for universities – the US experience**

Drawing on performance benchmarking of scores of universities and nominations from economic development practitioners, the Southern Growth Policies Board identified 12 universities in the United States which were exemplary in the ways in which they comprehensively promoted innovation and economic development in their regions. Each of these "Innovation-U's" had strong practices, cultures, and partnerships in these areas:

- Industry research partnerships;
- Technology transfer;
- Industrial extension and technical assistance;
- Entrepreneurial development;
- Industry education and training partnerships;
- Career services and placement;
- Formal partnerships with economic development organisations;
- Industry/university advisory boards and councils;
- Faculty culture and rewards;
- Leadership/structures, policies and institutionalisation.

The top-ranked "Innovation-U" was Georgia Institute of Technology (Georgia Tech) in Atlanta. A prominent research university, Georgia Tech also works closely with Georgia state government, local communities, and businesses in a variety of technology-focussed initiatives. Economic development and technology transfer activities are housed in Georgia Tech's Economic Development Institute, which operates a network of regional technology transfer offices in 18 communities in the state, and in its parent organisation, the Office of Economic Development and Technology Ventures, which sponsors advanced technology incubators and faculty commercialisation programmes. Many other academic units, research centres, and the university's continuing education programme support regional innovation missions. "The Georgia Tech culture, from president to academic units, is pervasively oriented toward outreach and engagement with the external world", the study observes. Long-term results from Georgia Tech's regional innovation efforts include a massive expansion of industry-research partnerships, the development of cutting-edge technology-based economic development programmes, scores of new high-technology start-ups, ongoing technology and business support for thousands of existing firms, specialised industry training of thousands of people each year, and the fostering of systems for entrepreneurial development in the state.

**Box 2.4. Emerging roles for universities – the US experience** *(continued)*

Other “Innovation-U’s” highly ranked in the study were Carnegie-Mellon, North Carolina State, Ohio State, Pennsylvania State, Purdue, Stanford, Texas A&M, UC San Diego, Utah, Wisconsin, and Virginia Tech. The practices and partnerships of these innovative universities emerge from the “grass roots” – and not from the federal government or through a top-down standardised formula. “There are common practices”, the study authors conclude, “but no one model or approach is followed by all”.<sup>44</sup>

87. In stimulating universities to be more effective in regional development, Japanese policy makers can draw significant insights from international experience elsewhere in OECD. For example, in the United States, many public research universities have long-established missions to encourage community and business development. A recent study of the most successful US universities in promoting local and regional economic development and innovation highlighted the importance of university leadership (in championing economic development and innovation missions), faculty culture and rewards, active and well-organised technology transfer and entrepreneurship incentives throughout the university, and strong partnerships with private and other public organizations.<sup>45</sup> Similarly, in Sweden, universities have been given the formal mission (in 1996) of promoting regional innovation. In several locations in Sweden, universities have been active in forming new academic-business linkages, establishing regional technology partnerships, and offering new kinds of entrepreneurial training.<sup>46</sup>

88. The role of foreign direct investment in the revitalisation of local Japanese areas is likely to grow in the future, and universities have a critical role to play in building linkages between foreign companies and local enterprises. In the past, it was more difficult for foreign companies to enter the Japanese market, but today many barriers (including restrictions on mergers and acquisitions) are being removed. Foreign investment offers opportunities to bring in new ideas, people, methods, and linkages to local areas. There are understandable local concerns in Japan about the processes of transition that may accompany foreign investment. In some cases, necessary restructuring may occur, but it is most likely that increased foreign investment will bring growth to localities. There are already signs that foreign companies are willing to look to regions outside Tokyo to locate investments – although 87% of foreign firms are headquartered in Tokyo, Kanagawa and Osaka, over half of the facilities and jobs are located in other parts of Japan.<sup>47</sup> And, as is clear from the government’s FDI promotion strategy, a major incentive for locating in Japan is to access the research and innovation capacity that is found in both private companies and in the research community. However, to gain the most benefit from an innovation perspective, localities will need to take active steps to ensure that foreign companies are integrated into local and regional innovation systems, and in this respect foreign companies will be looking at the capacity of local research institutions to support their activities.

***Enhancing regional innovation systems***

89. There is strong interest on the part of the Japanese authorities in concepts such as “regional innovation systems” and “the learning region”, concepts that stress the linkages among national, regional and local government policies, research, technology development and diffusion and levels of innovation in local enterprises. A regional innovation system depends on a continuous flow of ideas around the system. This means not only user-producer interactions (for example, between R&D labs and large firms) but also knowledge shared among potential competitors, ideas generated by new firms, and innovations brought into the system through foreign direct investment, linkages between SMEs and regional technical colleges, etc. Territorial reviews demonstrate the importance of the different components of the innovation system and bear witness to the interest of national regional administrations in creating a coherent “system”, but also suggest that they are rarely combined effectively nor placed into a coherent policy framework. The common denominator in current thinking about clusters, networks and innovation systems is the emphasis

on place-specific externalities based on positive feedbacks, relational assets, interlinkages, etc. No matter which analytical approach is used, all have formal and informal multi-actor interaction as the basis for both the creation and the transfer of knowledge.

90. In order for such regional systems to operate effectively, the local authorities need to take a more pro-active role. Economic policy in Japan has traditionally been centrally directed. As a result, regions have little experience in driving their own regional policy agendas. Despite the extensive incentives offered by the national authorities including supports for new business, human resource development, networking, etc., it seems that many regions still remain unwilling to initiate new projects relating to competitiveness and growth. Nonetheless, it appears that prefectural governments are becoming more active in the innovation field. In response to an increase in the needs for science and technology measures based on regional characteristics and for industry-academia-government collaboration promotion measures, many prefectural governments have established councils to discuss science and technology promotion policies, and have taken other aggressive measures, including the formulation of outlines and guidelines for their science and technology policies individually. As of 2003, 37 local governments have established science and technology councils, and 50 have formulated science and technology promotion guidelines, etc.

91. As Japan moves from a standardised top-down regional planning approach to one that encourages innovation, decentralisation, and customisation, it will be important to substantially upgrade investments in benchmarking and learning. A central aim here is to share learning *across* regional boundaries and to provide opportunities for the testing and validation of different local approaches, leading to the wider diffusion of successful regional innovation practices. To stimulate this process, it is possible to create benchmarking groups of comparable localities, including small and medium-sized cities. In certain cases, it may be useful to add international dimensions to the comparisons. One example here is the Midsize Cities Technology Development Initiative which, with sponsorship of the State of Georgia in the southeast United States, established a benchmark and exchange group between four mid-sized cities in the state and four comparable cities in Europe. This transatlantic effort significantly increased awareness of leading-edge innovation strategies among all participants, and allowed individual cities to assess their own strengths and weaknesses.<sup>48</sup> It would be beneficial to encourage more efforts like this among Japanese cities, led by the localities involved with support from expert analysts.

92. These new approaches to innovation will require Japanese localities to more strongly assume catalytic roles. To be successful in transitioning regional development strategies from supply-chain development to innovation leadership, governmental, university, and other non-profit institutions working at local levels need to assume new functions and roles. In terms of technology, a sharper focus will be required on promoting R&D, product development, technology pioneering, technology fusion, and advanced science, technology and management training. Business support will need to focus increasingly on fostering risk capital, clustering and networking (horizontal as well as vertical), with increased incentives for labour mobility, new venture creation and internationalization. Most significantly, public policy will need to eschew prior administrative conventions to foster interventions and practices that can catalyse and leverage innovation. The latter is perhaps one of the biggest challenges facing Japanese government: it will require new modes of behaviour at both central and local levels, changes in personnel systems, improved flexibility and co-ordination, and a greater willingness to experiment.

93. Japan's public policy makers have recognised the importance of regional competitiveness and the development of effective regional systems of innovation to national economic growth and development. A series of policies and programmes are now underway to promote new kinds of regional growth and development. This is an exciting and welcome development. At the policy level, it reflects the recognition that conventional sector industrial policies, standardised human capital frameworks, and massive

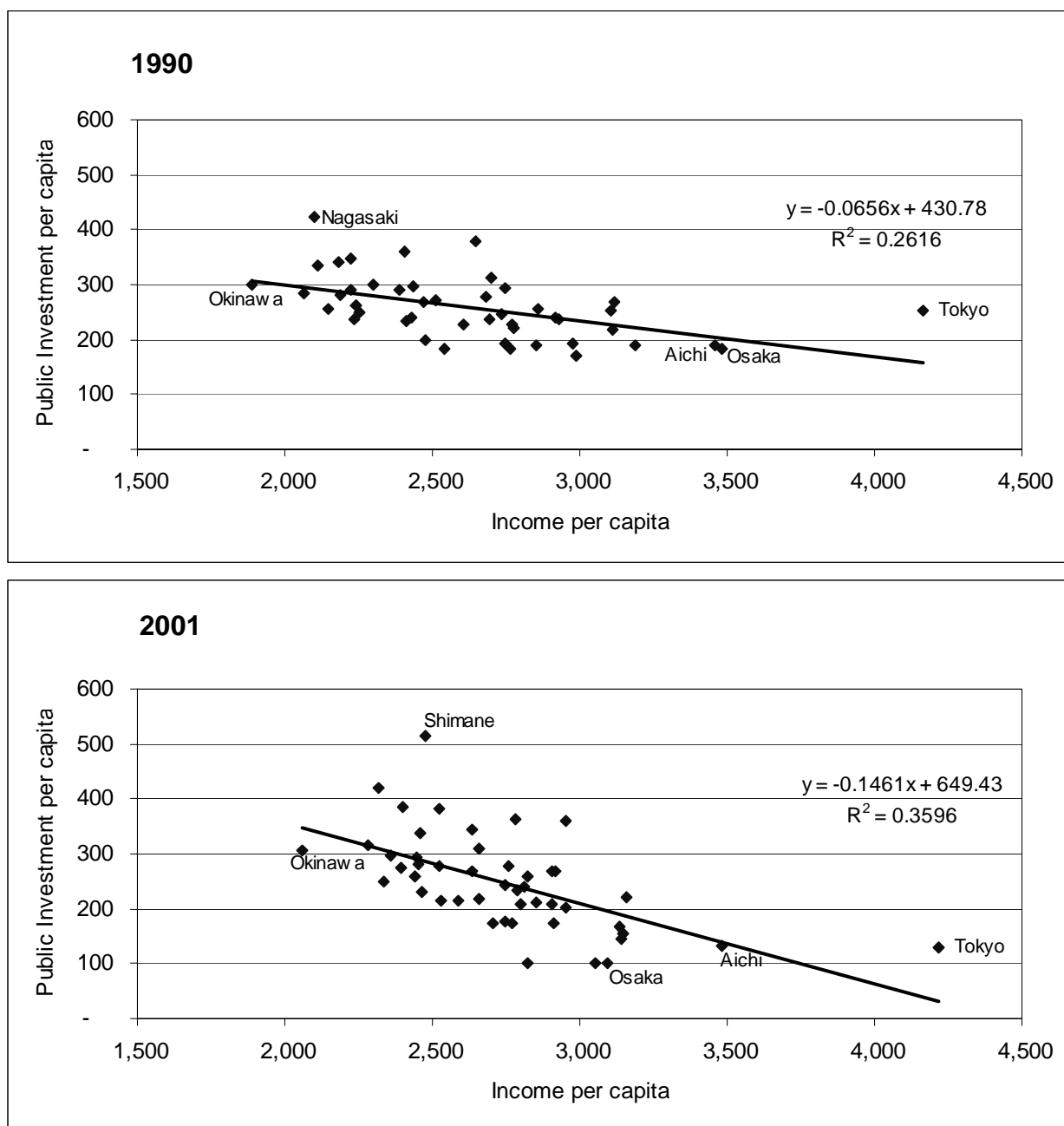
investments in local public infrastructures are now no longer adequate to the changed economic and international position that Japan now finds itself in.

### **Infrastructure investment policy**

94. Throughout the post-war period, infrastructure investment has been a principal tool by which to address the territorial development goals contained in the various development plans. Infrastructure development was an essential complement to the strong territorial economic policy described in the previous section.

95. As with other OECD countries undergoing rapid processes of industrial development and societal change, infrastructure development and public works in general became both an important national investment in the modernisation process and a significant source of economic activity in regions. As a result of sustained long-term investment in infrastructure, many of the geographical disadvantages that the country faced have been overcome. There are over 20 airports providing international connections (competitiveness issues will be discussed later), a high speed train network that is one of the most advanced in the world and a road system that has created an integrated national territory despite the challenges posed by the mountainous terrain and myriad islands. Japan's CND Plans and other development instruments continue to emphasise the importance of additional investment in infrastructure to overcome weaknesses in regional transport infrastructure. For example, as was mentioned in Chapter 1, several *Shinkansen* lines will be extended to northern cities and southern cities over the next few years, which will improve convenience. The most recent Japanese development plan, the *Grand Design for the 21<sup>st</sup> Century*, proposes as a principal target, the creation of a "one day transportation network" making it possible to visit anywhere in Japan from anywhere else in just one day. This emphasis on mobility suggests a continuing high level of investment in infrastructure.

96. In order to promote development in non-metropolitan regions, where population density is low, the government invested more in less developed areas. More public investment has been concentrated in regions where the income level was relatively low, promoting the equalisation of incomes among regions, as a result. Thus there is a close link between public investment on the one hand and the absolute level of regional disparities on the other. This bias in favour of rural regions is reinforced by the fiscal transfer system which also provides proportionately more funds for rural regions than for urban regions. There is evidence that the gap between public investment per capita in rural areas and urban areas is widening (see Chapter 3). In the early 1990s, the level of public investment increased across the country. It has since declined significantly in metropolitan areas, but has remained high in non-metropolitan areas. The inverse relationship between prefectural public investment and income per capita has become more evident in recent years, reflecting recent policy measures to stimulate the economy that focused investment in rural areas (Figure 2.1). A somewhat similar trend is observable with respect to fiscal transfers which have taken on an increasingly important role in rural regions. In contrast, during the main expansionary phase of the 1950s and 1960s, the relationship was the opposite: high income areas including Tokyo and Osaka had high levels of public investment, and vice versa, which implies that public investment at the time was intended to support rapidly growing private investment in metropolitan regions.<sup>49</sup>

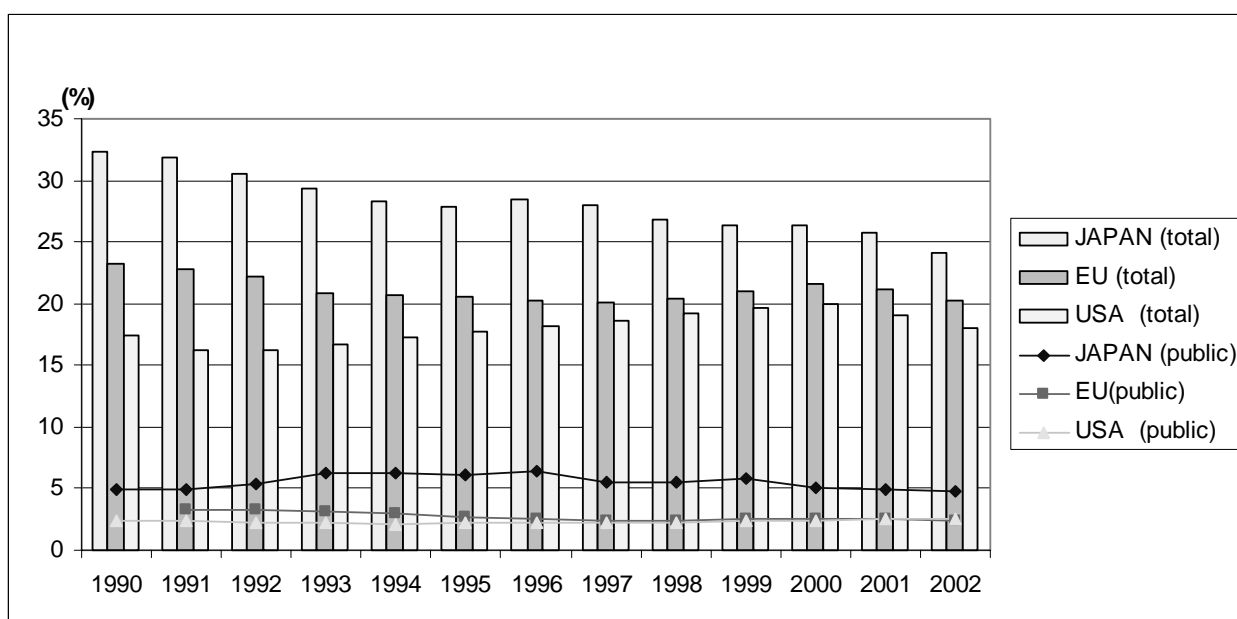
**Figure 2.1. Relationship between income and public investment by prefecture (1990 and 2001)**

Source: Annual Report on Prefectural Accounts, Cabinet Office.

97. However, national and regional fiscal constraints will no longer allow such an expensive option as a general policy, and reform of infrastructure policy and a general reduction of public works programmes is a high priority for the government. As a result of successive reductions by the current government, the rate has now returned to its early 1990 levels, but even the current levels are still high compared to those of the United States and EU (expressed as aggregates) (Figure 2.2). Topographic factors and vulnerability to natural disasters are partly responsible for this situation. However, the system is often

criticised for promoting waste and does not give adequate incentives for performance-oriented project selection and management. In a medium and long-term perspective, Japan's relatively low growth prospects suggest that financial constraints on infrastructure development will continue.

**Figure 2.2. Share of gross fixed capital formation (total and public) in GDP**



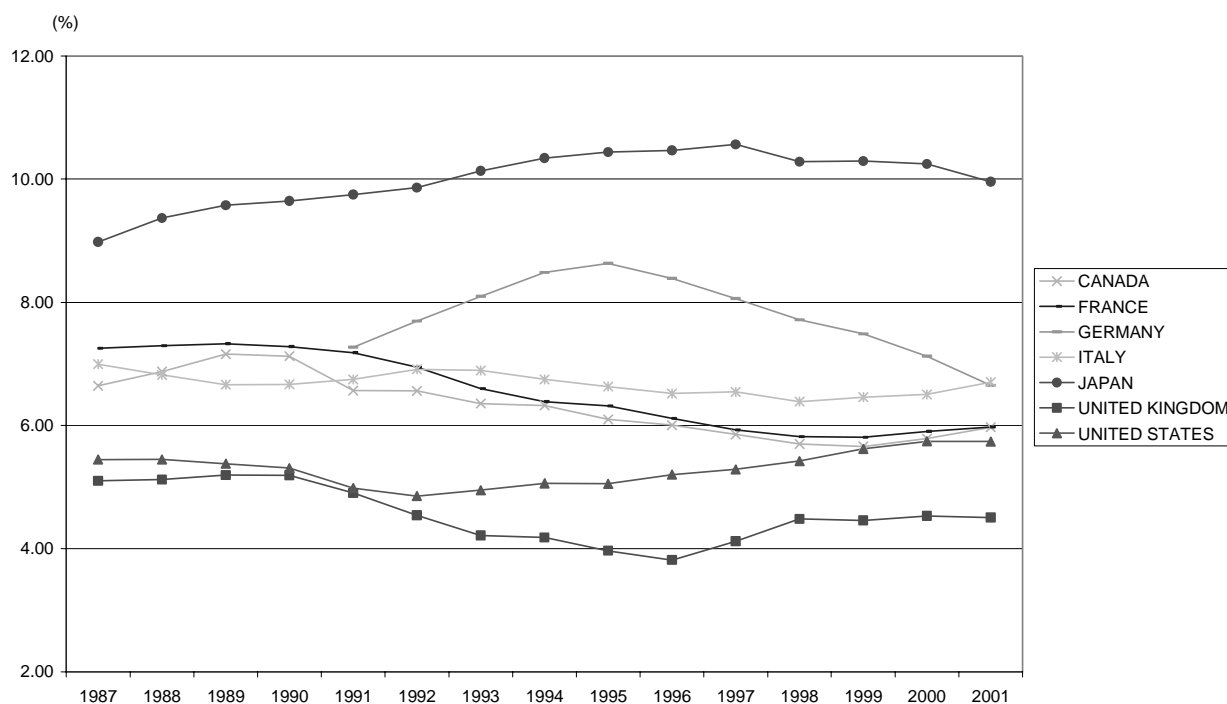
Source: National Accounts (OECD).

98. The major challenges facing infrastructure policy include:

- Prioritisation of infrastructure investment has involved very difficult political choices, as in other OECD countries. Despite government efforts to concentrate investment on growth centres, through, for example, the Act Concerning the Promotion of the Development of Local Core Areas and the Relocation of Facilities for Industrial Business (1992), there is a continuing tendency for investment to be “thinly and broadly” spread, which is likely to reduce overall returns and development impact.
- Projections regarding the proportion of total investment that will need to be spent on maintenance suggest that in the relatively near term, expenditures on renewal of infrastructure will equal expenditures on new facilities. Assuming limited increases in total spending, the maintenance budget is likely to overtake the budget for new construction in the next decade.
- Research has highlighted the diminishing returns on investment. In the 1975-1985 periods, increases in social capital infrastructure had a large impact on GDP. By 1998 the return had fallen dramatically to approximately half its original level.<sup>50</sup> The return on investment is particularly low in non-metropolitan areas, calling into question the territorial policy “balanced development” aspect of infrastructure development.

- The role of infrastructure development as a public works-type programme with employment creation objectives in non-urban regions appears to have increased in importance. According to a recent research report (Ministry of Finance, 2002), from around 1995, spending on public works declined overall, but remained high in outlying areas. As a result the gap between per capita expenditure in metropolitan and central areas and public investments in outlying areas has increased dramatically. There are two related assumptions. First, the level of dependence on public investment in rural regions is assumed to have increased as well (somewhat contrary to the government's preference for regional competitiveness which implies greater self reliance, autonomy and initiative). Figures from the research suggest that employment related to public sector activities in these regions (*e.g.*, Kochi, Okinawa, Shimane, and Hokkaido) is up to twice as high as in for Tokyo and other metropolitan prefectures. Second, that the return on public investment is assumed to have decreased because the return in terms of employment, productivity gain, and GDP increase, tends to be less in outlying regions than it was in central regions.
- The use of public investment to support the construction sector in regions has also been questioned. In general, the level of employment in the construction sector in Japan is high compared to levels in other OECD countries (though the construction industry's share in GDP has been decreasing rapidly since the end of the bubble economy). Even so, the rate of employment in the construction sector appears extremely high in many non-metropolitan areas, with the ratio particularly high in the Okinawa, Hokkaido, Tohoku, and Hokuriku regions (well over 10%). There is a strong correlation in such areas between the level of public investment and the level of employment in the construction sector, suggesting that public investment supports the sector to a significant degree.

Figure 2.3. Share of construction industry employment



Source: National Accounts, OECD.



99. Nonetheless, the continuing need to pay attention to regional imbalances and the importance of maintaining and upgrading infrastructures in an equitable manner will mean that infrastructure policy will remain a key tool for influencing development patterns. Against this background, and given the infrastructure development priorities set out in the latest CND Plan (though these plans contain many projects), initiatives to control expenditures and better target investments are crucial. Although the role of infrastructure in the development of regions with poor accessibility should not be overlooked, it is also clear that in the current fiscal climate, these types of investments need to be carefully assessed on the basis of their efficiency and linkages with other economic or social development objectives.

100. MLIT is currently refining its approach to infrastructure policy to concentrate on areas with the highest cost-benefit ratio, as measured by outcome indicators. MLIT has integrated nine conventional sector-specific medium-term infrastructure plans<sup>51</sup> into a single five-year “Long-term Plan for the Development of Social Infrastructure” since 2003. The new plan has several new features:

1. Using a new set of outcome indicators to measure the progress (instead of project costs) in the following areas: living environment, public safety, environmental protection, and “vitality” (tourism and transportation);
2. Collaborating closely with other ministries in charge of agriculture and the environment;
3. Implementing a consistent, transparent project evaluation mechanism from the selection of projects to after their completion;
4. Pursuing cost structure reform, including design processes and procurement, to achieve a general total cost reduction rate of 15% for five years from 2003;
5. Promoting Private Finance Initiatives (PFIs);
6. Promoting involvement of local government and community participation even from the conceptual and planning stages.

101. Overall, the intention of MLIT is that investment projects should be focused on the domains that contribute to improvement of economic productivity and enhancement of international competitiveness, for example, on development of high-speed transportation systems and urban regeneration. Moreover, there will be more emphasis on efficient supply of the region-oriented infrastructure and effective use of existing infrastructure (hence the focus on generating local input).

102. Assuming that they are fully implemented, these reforms will undoubtedly improve the focus of infrastructure investment. At the same time, the principal challenge for policy planners will remain; *i.e.*, how to find an equilibrium between the need to rein in expenditures and the need to ensure that regions have the physical infrastructure support they require in order to be competitive and self-reliant and that communities have an equitable level of service and access. In this respect, several interesting approaches are:

- Promoting a stronger service provision focus in investment; *i.e.*, looking at adaptation of existing services from a “level of service” perspective before assessing whether additional physical infrastructure is needed. The recent cross-sectoral “Long-term Plan for the Development of Social Infrastructure” is already a step in this direction.
- Developing outcome indicators that reflect the wider role of infrastructure development.
- Using contract-based planning instruments to improve the priority setting and targeting of investment, and give a stronger role to regional and local government.
- Reform of the intergovernmental transfer system for infrastructure (discussed in Chapter 4).

### **Policies for urban areas**

103. Most of Japan’s wealth and productive assets are concentrated in its metropolitan areas. In the post-war period, Japan experienced rapid urbanisation and the combined population of the major urban areas more than doubled. As the country entered the period of economic expansion, the major cities expanded rapidly and were the symbol of the Japan’s economic development. However, rapid urbanisation also generated a number of problems, for the most part connected to economic growth and over-concentration. During the most intense phases, the annual influx of population into the Tokyo region exceeded 300 000. As land prices in the city centres increased, this process of concentration was supplemented by processes of suburbanisation.

104. Over this period, planning for Japan’s metropolitan regions has endeavoured to control concentration in urban areas and promote deconcentration.<sup>52</sup> The evolution of these plans illustrates the changing metropolitan context. The first long-term development plan for the greater Tokyo area was formulated in 1959, modelled on the Greater London Plan. The Basic Development Plan for the National Capital Region proposed the creation of greenbelts along the urban periphery and the establishment of satellite towns. In the meanwhile, strong pressure to expand into and beyond the greenbelts necessitated a second Basic Plan (1968), which aimed to anticipate further expansion of the metropolitan area. The government proposed Suburban Development and Redevelopment Areas 50 km from the city centre and, even further away, Urban Development Areas that would attract industry from central areas in which industrial sites were increasingly restricted. The third Basic Plan (1976) introduced the concept of a multi-polar structure, and this was further developed in the fourth Basic Plan (1986) which promoted a multi-polar structure with self-sufficient “business core cities”. The most recent Basic Plan (1999) is based on a “distributed network structure”, a strongly polycentric metropolitan system. A similar transition from core-periphery to polycentric urban patterns is apparent in the other metropolitan areas as well (Table 2.4).

**Table 2.4. Evolution of long-term Development Plans for the Capital Region**

|                                              | 1 <sup>st</sup> Basic Plan<br>(1959)                                                                                                          | 2 <sup>nd</sup> Basic Plan<br>(1968)                                                                                                                                       | 3 <sup>rd</sup> Basic Plan<br>(1976)                                                                                        | 4 <sup>th</sup> Basic Plan<br>(1986)                                                                                 | 5 <sup>th</sup> Basic Plan<br>(1999)                                                                                                              |
|----------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
| Target year                                  | 1975                                                                                                                                          | 1975                                                                                                                                                                       | 1976-1986                                                                                                                   | 1986 to around<br>2000                                                                                               | 2000-2015                                                                                                                                         |
| Background<br>(socio-economic<br>transition) | Concentration of<br>population and<br>industry in Tokyo<br><br>Rehabilitation of<br>Tokyo as a centre<br>of policy,<br>economy and<br>culture | High growth<br>economy<br><br>Failure of Green<br>Belt concept<br>(very high<br>expansion<br>pressure)                                                                     | Turning point at<br>the 1 <sup>st</sup> Oil Crisis                                                                          | Moderate inflow of<br>population<br><br>Globalisation,<br>ageing, IT,<br>technology<br>innovation, etc.              | Transition from<br>period of growth<br>to mature<br>society                                                                                       |
| Policy targets                               | Green Belt<br>concept (control<br>of expansion)<br>with satellite<br>cities                                                                   | Development in<br>periphery (50 km<br>from the centre<br>and further)                                                                                                      | Multi-polar<br>structure                                                                                                    | Multi-polar<br>structure with self-<br>sufficient "business<br>core cities"                                          | Distributed<br>network<br>structure                                                                                                               |
| Challenges                                   | Halting over-<br>expansion of<br>urban areas and<br>mitigation of<br>regional<br>disparities<br><br>Appropriate<br>allocation of<br>resources | Allocation of<br>functions in the<br>region; central<br>management<br>functions in<br>central Tokyo,<br>and production<br>and distribution<br>functions in<br>whole region | Correction of uni-<br>polar structure<br><br>Self-supported<br>areas in<br>periphery                                        | Correction of uni-<br>polar structure<br><br>Promotion of<br>urban-rural<br>interaction and<br>regions' independence | Allocation of<br>functions and<br>interaction with<br>other areas                                                                                 |
| Development<br>method                        | Creation of<br>greenbelts along<br>the urban<br>periphery and the<br>establishment of<br>satellite towns                                      | Instead of green<br>belts, creation of<br>development<br>areas outside                                                                                                     | Development of<br>core cities<br>around the<br>centre and<br>independent<br>suburban cities                                 | Creation of<br>"business core<br>cities"<br><br>Transportation and<br>communication<br>network                       | Development of<br>core cities in<br>suburban areas<br>to interact with<br>other regions<br>and to create<br>greater regional<br>co-operation ring |
| Related policy<br>issues                     | Restriction on the<br>construction of<br>factories and<br>universities in<br>central Tokyo                                                    | Large-scale<br>infrastructure<br>projects                                                                                                                                  | Increased<br>restriction, on the<br>construction of<br>factories and<br>universities and<br>promotion of<br>deconcentration | Deconcentration of<br>national<br>administrative<br>bodies                                                           | Abolition of the<br>restriction on<br>construction in<br>central Tokyo                                                                            |

105. While strategic plans have had some impact on directing growth in and around the major metropolitan areas and inducing/controlling development at macro level, such as developing "business core cities" around central Tokyo, urban expansion has been characterised by inadequate controls on development at micro level in both city centres and suburban areas. This was partly a result of the sheer scale of the migration from rural areas to the major metropolitan areas. It was also due to the limited capacity of the urban planning system to influence the decisions of property holders, a problem made particularly difficult in Japanese cities where urban land markets are composed mainly of small private landowners. The system of urban development was effective, providing large numbers of housing units and commercial spaces rapidly, but is increasingly seen as having had a detrimental impact on the quality of

the urban built environment. Urban environments were placed under particular pressure during the bubble economy period. The surge in land prices in the 1980s and early 1990s was instrumental in encouraging unsustainable forms of urban development. In the main city cores, anticipation of land price rises covered development and building costs in many cases, leading to urban development driven by speculation rather than by an assessment of demand. When land prices crashed, many development projects were shown to have been unviable and represented burdensome bad assets for many private companies. The increase in land prices in urban cores also had the effect of pushing development outward. As the pace of sprawl accelerated, local municipalities had trouble dealing with development pressure and were poorly equipped from a legal or regulatory perspective to cope with rapid urbanisation. The result has been sub-optimal both in the centres and in the suburbs.

#### Box 2.5. Urban policy in Japan

A recent OECD report, *Japan: Urban Policy* (OECD, 2001), identified a number of priorities, including:

- The need for measures to strengthen urban cores and manage growth on the urban periphery, including regulatory instruments.
- A new land use system and incentives to encourage the agglomeration of small land parcels. Instruments for public authorities to redevelop non-utilised lands previously occupied by old industries. Greater flexibility in project planning at the urban level (to attract more investment, but also to encourage imaginative development and a long-term view).
- Greater recognition that environmental factors, including the quality of urban design, are important to the competitiveness of cities.
- Further investment in the period 2000-2010 to restructure urban areas to be attractive and competitive, since the ageing population will decrease economic capacity.
- Shifting of resource allocation to investment in urban areas, re-examining tax schemes, and introduction of fiscal measures and public-private partnerships.
- Reductions in delays in the design and execution of projects, re-regulation to redress the problems of overprotected private rights, based on the democratic process involving adequate discussion and majority decision; greater public participation in urban planning decisions.

The final recommendations were that the national government should play a greater role in producing a comprehensive approach to urban development that would take into account quality of life issues as well as infrastructure needs. The then newly created MLIT and its regional departments were encouraged to co-operation more with related departments in order to develop a more concerted, integrated urban development policy.

#### *Urban Renaissance*

106. Since the OECD report was presented, the Japanese government has put a high priority on addressing the problems of Japan's major urban centres, regarding urban areas as the "motors" of the national economy. The cornerstone of the government's policy is the Urban Renaissance programme, a group of measures designed to enhance the competitiveness of urban cities by improving urban environments and galvanising urban land markets. A particular feature of these measures is their emphasis on (1) private investment and the role of private sector initiatives; and (2) deregulation and the use of special exemptions to circumvent out-dated regulations that impede the functioning of property markets.

107. The target zones for urban redevelopment have three basic criteria: a high potential for growth and the capacity to catalyse further development, clear need of redevelopment, and prime sites in metropolitan areas. The intention is to draw investment back into key underused areas of major cities. Proposals have also come from the private sector and have been considered by the Urban Renaissance Authority on the basis of their viability as urban development projects and their potential impacts on neighbourhoods. Proposals from the private sector included improvements to administrative and regulatory frameworks: for example, projects have called for improvements to approval processes, clarification of waiting times and better information on standards relating to regulations. Proposals have also called for exemptions from regulations in cases where the regulation does not suit local contexts and for accelerated procedures for urban infrastructure development to support private investment. When approved, the Areas for Urgent Urban Renaissance Law establishes new urban planning regulations for the target zones, with greater freedom and exemption from certain outdated city planning regulations. In addition, the law provides special measures such as financial assistance (no interest loans, financing/purchasing corporate bonds, liability guarantees) and tax relief for approved projects within the designated areas. In July 2002, the first target zones were chosen mainly in Tokyo and Osaka. In October of the same year, additional zones mainly in ordinance-designated cities were chosen, and in July 2003 most of the newly-designated zones were prefectural capitals. Currently, a total of 53 areas have been designated, representing approximately 6 103 hectares. Construction investment by private companies within these areas is valued at approximately JPY 7 trillion, and the economic effects, including ripple effects, are expected to amount to approximately JPY 20 trillion.

**Table 2.5. Stages of the Urban Renaissance programme**

| Programme                                                                                                   | Summary                                                                                                                                                                                                                                  | Example projects                                                                                                                                                                                                                                                  | Main steps                                                                                                                                                                                |
|-------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>2001 -</b>                                                                                               |                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                   |                                                                                                                                                                                           |
| Urban Renaissance project                                                                                   | Original series of projects to improve urban environments. Government-led initiatives. Emphasis on re-using existing building stock, particularly public buildings. Focus on projects with environmental content and disaster prevention | Rescue Operation Centre in Tokyo-Bay Area<br>Non-waste-generation City<br>PFI (Reconstruction of government building, etc.)<br>Life Research Centre in Osaka area<br>International business centre in Ohtemachi, Tokyo<br>Redevelopment by PPP (Tokyo and Nagoya) | June – Basic strategy and 1 <sup>st</sup> designation of projects                                                                                                                         |
| <b>2002 -</b>                                                                                               |                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                   |                                                                                                                                                                                           |
| Emergency programme for promoting private urban development<br>Urban Renaissance Immediate Improvement Area | Emphasis on private sector led predevelopment projects. Government involvement through financial and fiscal supports plus regulatory exemptions                                                                                          | 1) Tokyo (Shinbashi/Akasaka/Rippongi area. etc.), Yokohama, Nagoya and Osaka<br>2) Big cities like Designated Cities, including Sapporo, Sendai, Kyoto, Fukuoka, etc.                                                                                             | June – Enactment of the Urban Renaissance Law<br>July – 1 <sup>st</sup> designation of immediate improvement areas<br>November – Establishment of task forces for the emergency programme |
| <b>2003 -</b>                                                                                               |                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                   |                                                                                                                                                                                           |
| Programme for Promoting Urban Renaissance across the nation<br>Community renovation grants                  | Support for local projects. Emphasis on projects outside the metropolitan areas                                                                                                                                                          | 3) Regional cities including prefecture capitals: Saitama, Shizuoka, Hiroshima, etc.                                                                                                                                                                              | June – 1 <sup>st</sup> invitation of proposals                                                                                                                                            |

108. The Urban Renaissance programme is co-ordinated through the Cabinet Office, with the Prime Minister chairing the inter-ministerial committee that manages the programme.<sup>53</sup> Recent reform of institutions included transformation of the Urban Development Corporation and the Regional Development Corporation, responsible for supplying and maintaining housing in urban areas, into the Urban Renaissance Agency in July 2004. This Urban Renaissance Agency will co-ordinate private sector projects and stimulate and support private sector investment by building public facilities, which are indispensable for the projects. Before Urban Renaissance Projects by the central government, some proactive public-private partnerships (PPPs) were created. One of the most successful examples is the committee for the redevelopment of the area around Tokyo station, which consists of land owners, a railway company and the local government (Tokyo Metropolitan Government and Chiyoda Ward Office).

**Box.2.6. An example Urban Renaissance project: Marunouchi Area Development**

Redevelopment of the Marunouchi neighbourhood around the main Tokyo station is a good illustration of the PPP approach that is central to the urban regeneration process in general and, more specifically, to the Urban Renaissance programme.

The area, which lies at the centre of inner city Tokyo, has contained a large number of office building, while its commercial function including shopping and dining had been increasingly overshadowed by other newer developments in the city. A landowner association was established in 1988, whose objectives were to promote urban redevelopment in the area. In 1999 this evolved into a PPP involving the local authorities and the railway company, which aims to trigger the development of a combined business and entertainment district in the area immediately surrounding the station and, through this catalyst, promote further renovation of adjacent blocks. The promotion of the area's amenities depended on creating a new urban landscape that was compatible with not only business premises, but also with restaurants, and cultural facilities, including meeting places in open areas. The success is illustrated by the fact that land prices in this area have been among the highest in Japan these past few years.

109. One of the main tasks of the Urban Renaissance Agency will be to transform the Urban Renaissance project from its current focus on the metropolitan areas to being a genuinely nationwide initiative. With this aim, a number of task forces have been established drawing on representatives from across the country. These thematic groups are assessing the need for policy in a range of policy areas that go beyond the original scope of the Urban Renaissance programme, such as crime prevention and issues relating to the elderly population, as well as the previous central concerns of Urban Renaissance such as disaster prevention and environmental sustainability.

110. Another key component of the expansion of the programme is the Urban Renaissance Local Model Projects initiative. Through this measure, support funding is provided for leading examples of urban renaissance type activities being undertaken or proposed by local governments. In 2004 over 600 proposals were received for the first designation, of which 171 were accepted for funding. Of these, 108 of the successful proposals came from local government and 63 from non-profit organisations. Illustrating the geographical expansion of the Urban Renaissance programme, only 51 of the projects are located in the Tokyo and Osaka metropolitan areas, and the majority are found in other regions.

111. One interesting new innovation is the Community Renovation Grant, a kind of block grant that allows municipalities to select and undertake projects from menus prepared by MLIT. The Grant requires municipalities to prepare development plans in advance and produce evaluations after completion of the projects. Although the grant is only for infrastructure related projects, this bottom-up approach, which also involves some horizontal co-ordination, could be a good start for introducing unconditional grants in a wider range of fields, such as welfare services and education, and expanding eligible areas beyond urban

areas. In many ways, the Community Renovation Grant could develop in a similar way to the Single Regeneration Budget, used for the past decade in the United Kingdom as a means of providing funding pooled from different sectoral sources for integrated urban redevelopment projects at local level.

**Box 2.7. Three approaches to urban regeneration: United Kingdom, France and the United States**

In developing urban regeneration programmes, OECD countries have increasingly recognised the necessity of taking advantage of local expertise and experience and taking into account the links between economic, social and environmental dimensions of development. However, developing urban regeneration programmes that have a sustainable impact on communities, will respond to the need for greater local participation, while also maintaining accountability and coherence with respect to national policy objectives is a complex process. Governments have approached the question in different ways.

*United Kingdom – National Strategy for Neighbourhood Renewal, the Single Regeneration Budget Programme and Sustainable Communities*

The National Strategy for Neighbourhood Renewal attempts to establish minimum standards below which no neighbourhood should fall, and endeavours to improve conditions in depressed areas, particularly in relation to crime, education, health, housing and the environment, and jobs. The strategy is committed to supporting: sustainable development, equality of opportunity, community cohesion, and local renewal partnerships and practitioners, as well as involving local people, and addressing both financial and civic exclusion.

Operating within the Neighbourhood Renewal Fund areas, the Single Regeneration Budget (SRB), which began in 1994 and brought together a number of programmes from several Government Departments, seeks to unite resources from four Government Departments – Environment, Transport, Education and Employment, and Trade and Industry – into a single flexible budget for implementation of programmes elaborated by local partnerships. SRB partnerships are expected to involve a diverse range of local organisations in the management of their scheme. In particular, they should harness the talent, resources and experience of local businesses, the voluntary sector and the local community. The types of programmes which receive support from SRB differ from place to place, and depend on local circumstances. To receive funding, projects must meet at least one of the programme's eligible objectives in areas such as education, employment, social exclusion, environmental protection, infrastructure, housing, local economies and businesses, crime and drug abuse and community safety. In London, the SRB is administered by the London Development Agency and at the regional level by the Regional Development Agencies.

Over the first six rounds of SRB, 1 027 bids have been approved, worth over GBP 5.7 billion in SRB support over their lifetime of up to seven years. It is estimated that these will attract almost GBP 8.6 billion of private sector investment and help to attract European funding. The SRB is expected to involve over GBP 23 billion from all sources of funding.

*France – Contrats de ville, national programme of urban regeneration, zones franches urbaine*

The *contrats de ville* are used to promote development in large urban areas as well as medium and small towns and cities. They provide a framework for establishing development objectives and key themes for action programmes such as: tackling social exclusion, transport, housing, economic development, crime prevention, etc. Within the framework of the *contrats de ville*, the national programme of urban regeneration focuses on deprived urban sites within the wider urban area. The programme aims to improve quality of life and to ensure equal access to amenities for the local residents by financing urban restructuring initiatives, developing public facilities, linking depressed neighbourhoods to the rest of the city, and also by providing training and improving access to jobs. Responding to the realities of the development of urban areas, the national government adapted the *contrats de ville* programme into *contrats d'agglomérations* to emphasise the need for co-operation among municipalities making up larger urban agglomerations. Both instruments involve the use of negotiated contracts as a means of managing the vertical administrative and financial co-ordination of locally driven initiatives.

The agglomeration contract procedure brings together the central government, the region and the *communauté d'agglomération* (a public inter-municipal co-operation body for urban areas of over 50 000 inhabitants grouped around a city centre of at least 15 000 inhabitants) or the *communauté urbaine* (a public inter-municipal co-operation institution for urban areas of over 500 000 inhabitants). The process has four main components:

**Box 2.7. Three approaches to urban regeneration: United Kingdom, France and the United States**  
(continued)

- *The Agglomeration Project* is the basic document that contains a diagnosis of the functioning of the agglomeration, identifies the issues as well as provides a statement of development policy options and an indication of the policies and measures to implement these choices, including a phased timetable and identification of priorities. The project must be socio-economic rather than infrastructure-based and originate from dialogue with the municipalities and the main actors involved in the area.
- *The Development Board* represents a variety of economic, social, cultural and association groups. They must be consulted during the preparation of the project and on the final project prior to signature of the contract. They can be associated with the elaboration of the contract.
- *The Agglomeration Contract* is the financial and programme document on the implementation of the project that identifies the partners, projects, pluri-annual financing and contractors.
- *The Regional Coherence Plan (SCOT)* is a spatial projection of the agglomeration project that translates the project initiatives into urban planning law.

*United States – Empowerment Zone/Enterprise Community programme*

Established in 1994, the Empowerment Zone/Enterprise Community programme takes an innovative bottom-up approach to rebuilding communities in poverty stricken areas, by insisting that residents play an active role in the decision-making process. The EZ/EC programme is based on three principles:

- Every community is different and no single renewal strategy is appropriate for all communities. Revitalisation strategies must be designed to meet the unique set of problems and needs of each neighbourhood.
- Both social and economic development is necessary for long-term neighbourhood renewal.
- Projects must be developed by the communities themselves, rather than imposed from above.

The programme involves multiple government agencies such as the departments of health, education, and housing, and includes activities focused on a range of initiatives such as improving education and assuring access to health care and affordable housing.

It also provides tax incentives, grants and loans to help develop employment opportunities and expand businesses in the designated communities. Organisations are eligible for wage-tax credits of up to USD 3 000 per year for each Empowerment Zone resident they employ. Businesses that invest in facilities located in the Empowerment Zone may also claim tax deductions and tax-exempt facility bonds are available for businesses located in EZ/EC neighbourhoods and seeking capital for expansion projects.

112. In addition to the broad approach of the Urban Renaissance programme, the main issues for the future appear to revolve around improving the quality of the urban environment. One important strand of current policy concern is the perceived unattractiveness of Japan's urban landscapes. Limited regulatory controls during the period of urban expansion have given many Japanese cities a poor physical appearance and left them without the common spaces and green spaces that are considered to be important in attracting residents and investors. Improving the landscape of Japanese cities will necessitate a concerted approach involving more careful redevelopment of sites through managed programmes such as Urban Renaissance, better/sustainable re-use of building stock, and initiatives to create attractive, mixed use areas (*e.g.*, through development of cultural facilities). In this respect, a number of new laws were recently introduced with the aim of improving and/or protecting urban and rural landscapes by strengthening regulations and financial measures in designated areas.



113. The initiatives to protect and upgrade traditional urban and rural landscapes should be seen in the context of Japan's broader reforms. For example, the Koizumi government has prioritised efforts to increase the flow of foreign visitors to Japan, with the Prime Minister himself appearing in a promotional video for the Visit Japan campaign. The tourism action plan recognises that the number of tourists to Japan and the average length of stay is comparatively low, and sets out a broad agenda of actions designed to make Japan more successful in competing in the international tourism market. The poor quality of Japan's urban landscapes and concern about deterioration of traditional rural landscapes are seen as important areas for action. The theme of improving scenery was also stressed in MLIT's "Beautiful Nation" policy announced in 2003. This policy included a number of actions designed to improve the built environment for both residents and tourists, such as:

- A scenery assessment system for public projects to evaluate the impact of public works on the scenery;
- A green corridor system and greenery "axes" in and around cities;
- Campaigns to remove illegal outdoor advertising materials;
- Selective burying of overhead electricity cable; and
- The establishment of bodies to undertake inspections and propose case specific measures to improve scenery.

114. In 2003 an additional impulse was provided by the City Revitalisation Vision of the Panel on Infrastructure Development, which makes the link between the attractiveness and sustainability of cities and their economic performance. Improving urban landscapes is considered to be a key element in a broad strategy to reinvigorate urban land markets, increase investment and bring residents back into central areas. As a result of this increased emphasis on urban landscapes, three laws relating to landscape were adopted or revised in June 2004: the Landscape Law, the Outdoor Advertising Materials Law and the Urban Green Space Protection Law.

#### **Box 2.8. Outline of the policy on Landscape and Greenery**

The basic intent with the promulgation of the new landscape laws was to make a clear statement about the importance of landscape in development policy. Past legislation focused on urban development from a planning regulation perspective, in which "landscape" is not a clearly defined concept. Moreover, available policy measures involved only "soft" penalties that were inadequate in a context of very dynamic land markets. In the absence of financial and tax-related support for the efforts of public bodies to counter projects that would adversely affect the landscape, local governments had few incentives to take strong action. Although the number of local authorities that have enacted local ordinances to designate historic zones has increased (as awareness of the importance of preservation has grown), only a minority of municipalities have done so. The new laws aim to clarify the concept of landscape and to affirm the commitment of the central government to protect and upgrade both urban and rural landscapes and to provide support for the efforts of local government. The laws also seek to clarify the shared responsibilities of citizens, businesses and central and local government in safeguarding landscapes: in other words, to make the link between actions by each party and possible consequences for the landscape. Finally, the laws intend to establish a system that combines, like the Urban Renaissance programme, a package of financial supports and incentives and targeted, case- or area-specific deregulations and ordinances. Through these laws, local governments, or partnerships involving government and non-government actors, can request that particular areas or "public facilities" (such as roads, rivers, beaches, etc.) be designated as scenic areas with special derogations and deregulations.

115. It is evident that the focus of Japan's urban policy has broadened significantly over the past few years, from real estate-based and top-down approach to a system that takes a broader definition of urban development and involves programmes that emphasise the role of the local government and of non government actors (the private sector, NPOs and local communities). The importance of a broader socio-economic approach to urban policy is prompted by recognition that urban problems have evolved and present more complex challenges for policy makers. The "new town-old town" issue exemplifies this complexity. As was mentioned in Chapter 1, the suburban settlements surrounding the metropolitan areas were built from the 1960s and 1970s onwards to house migrants moving into Tokyo and the other major cities from other regions. Many of these people are now reaching to a retirement age and their local governments are facing what has come to be known as the "new town – old town" problem. This has necessitated, for example, providing public transportation for the elderly, promoting "barrier free" living areas, and converting school facilities. The problem of maintaining the economic and social vitality of these "old" cities is similar to more prevalent problems occurring in context of rural regions and provincial towns and cities. Urban policy must respond to the evolving socio-economic needs of different types of urban settlements in Japan, in addition to the traditional urban development approaches, centred on "predict and provide" models of infrastructure development.

### ***Regional cities***

116. Another key shift in urban policy has been a new emphasis on regenerating Japan's smaller regional cities. These cities, relatively large by European standards, have been for a long time overshadowed by the demographic and economic expansion of the three metropolitan regions of Japan. Now, however, the importance of these cities both as sources of economic growth in their own right and as providers of high order services for rural areas is becoming clear. A number of factors have influenced this re-evaluation of the role of regional cities. First, the problems affecting the metropolitan areas over the past few years has called into question the notion that national growth can depend on continuing concentration in these regions. Second, some demographic evidence suggests that intermediate cities are benefiting from both continued in-migration from rural regions plus some out-migration from the metropolitan regions. This type of vision has become quite common in OECD countries since phenomena of "counter-urbanisation" appeared to suggest that in some cases smaller cities could develop into important economic centres on the basis of good transport linkages, economic specialisation, Greenfield development possibilities, etc., and that these regional cities can stabilise rural regions by providing both employment and services. These "regional" cities, as in other OECD countries, face particular challenges but also could possess some competitive advantages with respect to other settlements that offer them, or some of them some prospect for expansion in the context of the global economy. It is worth bearing in mind that some regional cities were the original sites of what are now major international corporations. There are several examples of cities that have developed alongside a particular enterprise or sector. The city of Hamamatsu, for example, is home to two of the world's largest motorcycle manufacturers and one of the largest producers of musical instruments.

117. The interest of policy makers in regional cities stems partly from their ability to provide basic and some advanced services for a large region, thereby supporting the quality of life of rural residents. As is discussed elsewhere in this report, the issue of cost effective service provision in rural areas is considered to be a crucial challenge for the government in the context of fiscal constraints. The government is seeking ways to guarantee minimum levels of access to higher order services (*e.g.*, higher education) as a means to maintain the attractiveness of non-metropolitan areas. Strong regional centres provide the principal means by which to offer the kind of social and economic infrastructures that can maintain population and retain and attract investment. The new direction that government policy is taking with respect to regional economic policy depends on the organisation of public investment and services in a way that provides maximum access to appropriate levels of service for all urban and rural residents in the most cost effective manner. This means, in essence, that functions will tend to concentrate at the settlement level that provides

the most cost-effective outcomes. In practice, regional cities are expected to play a key role in ensuring access to remote areas.

118. However, there is concern that many regional cities face severe challenges. Manufacturing activities have moved away, the populations are ageing, historic and retail city centres are declining. The issue, therefore, is how to target policies so as to help regional cities restructure. The ability of regional cities to attract and retain employment and attract new residents is very place specific and depends on a wide variety of factors such as geographical position *vis-à-vis* the main metropolitan areas, the sectoral structure and specialisation of the local economy and its employment creation capacity, quality of life and environmental assets, presence of institutions of higher education, road, rail and air connections, and so on. In accordance with the general principle of regional competitiveness that emphasises the identification of endogenous assets and competitive advantages, the future of regional cities depends strongly on the ability of local and regional actors to take advantage of opportunities. To date, many regional cities have pursued traditional development strategies. These include attempts to revitalise downtown retail districts, attract manufacturing branch plants to industrial parks, and secure transportation and infrastructure improvements. For some cities, such policies have had an impact. The example of Kakegawa city is illustrative of the local initiative that is at the core of the government's new approach to regional economic policy. Not all small Japanese cities have been as successful as Kakegawa.

#### **Box.2.9. A successful regional city: Kakegawa**

Kakegawa lies between Tokyo and Osaka on the main *Shinkansen* line and close to the main north-south motorway. It is close to other larger regional cities such as Hamamatsu and Shizuoka. The former is an industrial centre with a large employment base, the latter is the prefectural capital and is home to most local administrative services and functions. The local authority realised that the future of the city depended on being able to provide a similar level of service and access to that provided in other cities, while offering a similar or superior quality of life. The actions of the local authorities have included financing its own interchange to link it with the nearby motorway, lobbying for and financing its own stop on the *shinkansen* line from Tokyo to Kyushu, and undertaking a comprehensive redevelopment of the historic downtown of the city, including rebuilding the castle. All this was directed by the local authorities and was financed by means of collections and donations among the local population. The case of Kakegawa has become well known within Japan as an example of the kind of local initiative, in this case led by the mayor, that the government is attempting to promote through diverse decentralisation, financial measures, partnership building and other programmes designed to increase the independence of local areas with respect to economic development.

119. Yet, even for those cities which have seen results in the past, strategies that rely primarily on physical infrastructure and attracting outside manufacturing investment are likely to be less fruitful in the future. These regional cities face the challenge of identifying additional strategies that can stimulate growth from within and which take more advantage of knowledge-intensive economic opportunities. Here, there is a direct link with the challenge of encouraging entrepreneurship in regions. Small and mid-sized cities need to encourage and nurture initiatives to retain and transform existing small firms, generate new technology ventures, and create new service-oriented businesses. While these smaller cities typically have lower costs, they also lack the dense face-to-face communication opportunities found in larger agglomerations. This is a major challenge that links rural development with urban policy (the broadening of urban policies from a metropolitan focus to address the problems of smaller cities) and regional economic policy (how to make regional competitiveness an operational concept in areas with less-dense knowledge and innovation infrastructures).

120. In addition to building more stable economies, there is strong interest in increasing the attractiveness of smaller cities as residential locations. An important challenge for regional cities is to

maintain vibrant city centres. On the one hand, the centres of smaller cities, like many larger cities, have suffered from limited controls on urban development leading to an unattractive urban environment and the decay of historical and cultural landmarks. One of the main aims of the recent laws relating to Landscape and Greenery is to address the impact of a poor urban environment on the ability of a city to maintain population. On the other hand, the growth of out-of-town retail centres is blamed for a sharp decline in inner city businesses. This issue, apparent in many OECD countries has led the Japanese government to introduce controls designed to induce retailers to locate in city centre areas. However, as in other countries, restricting the location of private enterprises is not straightforward, both because many legal instruments contravene principles of free trade and competition, and also because the final decision often rests with local authorities who make their decision on the basis of an assessment of direct implications for their commune, but that do not necessarily take into account the likely negative consequences for adjacent cities.

**Box 2.10. Efforts to limit large retail outlets in other countries**

In Japan, the Large Store Law, which restricted stores with large floor space, was relaxed in 1994 and in 2000 was replaced by a new law that shifted responsibility for regulating large stores from the national government to the prefectures. The Large-Scale Retail Store Location Law gives prefectural governments wide latitude in implementing policies. However, restricting the development of large stores has protected inefficient small stores.

Amongst OECD countries there is a trend towards stricter legislation and a number of countries have introduced Store Size Caps (similar to Japan's large store law) in an attempt to prevent the proliferation of large-scale retail stores and malls, particularly in areas outside of city centres. These laws are intended to protect local retail districts, to halt urban sprawl and to reduce automobile dependency. However, restricting large-scale outlets can also slow down consolidation and modernisation of the sector; make it difficult for new competitors to enter the market; and reduce firms' market power over their suppliers (Høj *et al.*, 1995; Pellegrini, 2000; Boylaud and Nicoletti, 2001).

It is important to note that the number of large retail outlets in a given area is often only loosely related to national legislation. In many cases government officials and interest groups at the local level play a greater role than national legislation in deciding whether or not large retail outlets will be allowed to settle in a specific location (Pilat, 1997).

United States – Many local governments have enacted zoning rules that prevent stores over a certain size from settling in their neighbourhood or city. In some cases, zoning rules require new stores to locate in designated retail clusters or nodes around major intersections in order to prevent commercial strips from expanding for miles outside the city. Some retail clusters also integrate office and housing development with the large retail stores.

United Kingdom – Government planning policy encourages new retail to locate within or close to town centres. In order to choose another site, the developer must be able to demonstrate that no more central sites were available.

Ireland – In 1998, the government enacted a temporary cap on the size of retail stores which became permanent in 2001. Retail stores are also required to locate in town centres. In exceptional cases, when no sites are available and local authorities decide that the development is necessary, then the store may receive permission to locate on the edge of town.

Norway – In 1999, a new law halted the construction of retail centres larger than 3 000 m<sup>2</sup> for a five-year period.<sup>54</sup>

121. The Urban Renaissance programme, in co-operation with development programmes administered by other ministries, notably MLIT, could play a stronger role in reversing trends of regional cities in decline and supporting the growth of more dynamic smaller cities. At present, the Urban Renaissance programme provides regulatory exemptions in only relatively limited zones, even though zones have now been designated nationwide. As with the Special Zones programme, Urban Renaissance is still

concentrated in the largest urban areas, but the government is clearly recognising its potential as an instrument for regional cities as well.

### **Policies for rural regions**

122. Rural regions and especially those in more peripheral or remote areas pose a particular challenge for policy. As in many other OECD countries, the state of rural regions is high on the political agenda, influencing external trade and development assistance, as well as domestic policy making. Yet, despite this political prominence, most indicators suggest that processes of ageing, out-migration and economic decline are persistent. In the past, rural policy has been based mainly on two policies: (1) agricultural policy and related measures destined to ensure the food production (and increasingly the non-commodity) functions of agriculture, thereby supporting rural communities, and (2) regional policy instruments that aim to ensure balanced development (in other words, the instruments mentioned above relating to territorial planning, infrastructure development, regional industrial policy, and so on). In addition, a number of special programmes were introduced for regions with particular geographical or climatic handicaps, mostly, but not necessarily rural regions. Given the poor outcomes from past efforts to stem the economic and demographic decline of rural areas, and in light of likely reductions in the levels of direct and indirect supports for rural regions through regional and agricultural policies, new approaches are being introduced.

#### *Support for rural regions through agricultural policy and diversification into new activities*

123. Agricultural policy in Japan, more so than in most other OECD countries, emphasises the food supply function of rural regions. According to MAFF statistics, Japan has the lowest food self-sufficiency ratio of the major industrialised countries and the ratio has been declining. A recent report to the Prime Minister noted that, assuming stable population, diet and agricultural yields, Japan requires overseas farmland of 2.4 times its own cultivated land area. When combined with almost total dependence on imported energy, the significance in political terms becomes apparent. Thus, food security remains a guiding principle of agricultural policy and is central to how rural areas are perceived. In addition, Japan's agricultural policy reflects the concept of agriculture as having multifunctional roles, achieving a number of different societal objectives in addition to food production. Government policy makes a close link, for example, between agricultural production and prevention of natural disasters (flooding, landslides, etc.). There is also an explicit link between agricultural production and cultural heritage (*i.e.*, the cultural significance of landscapes such as terraced rice paddy fields). More generally, there is a close link made between agriculture and the vitality of rural communities, even where farmers make up a relatively small percentage of total employment in the area.<sup>55</sup> Multifunctionality in agriculture and rural amenities are both prominent in thinking about the future of rural areas in Japan.

124. Despite the political significance of rural areas, and despite having among the highest levels of production subsidies for agricultural products in the OECD, the fact remains that trends in the agricultural sector are gloomy – fewer and older farmers, lower incomes, preponderance of small farms, more out-migration, etc. There are a number of inter-related problems that undermine the productivity of the farming sector and make it vulnerable to competition. The most significant are:

125. *Ageing of farmers.* A large proportion of farmers are over 60 years old – in some areas over half of farmers are over 65 – and work relatively small farms. Productivity on these farms is low, both in international terms and in comparison with larger farms managed on more modern commercial lines. Among these older farmers, a certain proportion recently became farmers, in effect retiring from jobs in other sectors during the period of economic stagnation and becoming farmers. Many of these and other older farmers are essentially part-time farmers, working small plots without permanent full-time employees. A recent survey by the MAFF showed that around 70% of farms run by a farmer over 60 had

secured a succession but that the large majority of successors would work only part time and would have other off-farm income.

126. *Land tenure and farm structure.* Although a common problem in OECD countries, the issue of farm transfer is somewhat different in Japan. The most common form of family farm in Japan is the multi-generational or “extended family” farm, with often three generations of a family living and working the same land. Ownership passes to the oldest son, but this transfer is blurred by the informality of the overall system which assumes that assets are common. The system works when succeeding generations are active farmers, but when the next generation depends on off-farm activities, then the productivity of the farm is low and incentives to invest in improving productivity limited.

127. *Incentives to farm.* Over the past decades, several measures have been introduced to support the declining incomes of rural families and to provide financial incentives for existing farmers. These tax incentives mean that in some cases it is more economic to keep farmland unproductively or even not to cultivate at all, rather than to sell land, which may incur high taxation particularly when it involves transformation to other uses. Neither the traditional structure of farming households nor the tax and agricultural supports system are conducive to dynamic land markets. In order to free up land and encourage new entrants into agriculture, the government has introduced a range of measures to provide incentives and remove regulatory barriers to entry. The Special Zone initiative, for example (discussed in more detail below, makes it possible for entities other than farmers to engage in farming or farm management. As a result, for the first time private companies can engage in agriculture. The bottom-up Special Zone approach is welcomed by local government because of the impact that deregulations of this kind can have on improving land use. Other initiatives to promote new entrants into the sector include relaxing the minimum size of farmland, according to local circumstances, in the Special Zone. This kind of deregulation should be expanded nationwide.<sup>56</sup>

128. Reform of agricultural policy has important regional dimensions linked to the nature of each region’s agricultural sector. In the more fertile, flat-land areas, where agriculture is more profitable and where agricultural incomes play a larger role in total income, changes to systems of price support have a strong influence. In these areas, changes to production supports designed to encourage consolidation of farms and the introduction of new methods and machinery will have a significant impact. Given reliance on farming incomes, farmers have a strong motivation to restructure in the direction that the MAFF is advocating. Also, the sector becomes more attractive for younger farmers. In areas where farms are small, generally unprofitable and where farm incomes represent only a small proportion of total household incomes, reform of agricultural policies has less impact. Reductions in direct supports do not dramatically reduce household incomes, while incentives to modernise imply a capital investment by the farmer that is not economic, given that the farms are essentially worked part-time and in many regions enlargement of farm size and increase in yields are severely limited by geographical/topographical conditions.

129. As such, the restructuring of agriculture and the improvements in productivity that it will bring are likely to have uneven impacts across the territory. This underscores the importance of an approach that integrates both the sector-specific structural reforms that are required to make agriculture more productive, and rural development policies designed to support supplementary or complementary activities in rural regions.

#### *Rural development through regional policies*

130. As discussed above, the main aim of regional policy has been to counter over-concentration in metropolitan areas. Regional policy has tried to favour development in non-metropolitan areas, which has meant that rural areas have received significant (disproportionate) shares of public investment in order to overcome physical disadvantages *vis-à-vis* densely populated regions and to provide sufficient incentives

for economic activities and people to either remain in or move to rural regions. These measures were introduced in the 1960s as the major cities expanded and it became clear that Japan's outlying regions faced an uncertain economic future. The decision to migrate to the cities was partly attributed to employment opportunities but also to a perception that basic services in rural areas were under-developed and that living conditions were too harsh in comparison to the level of comfort that could now be found in the major cities. As such, these laws, at least originally tended to focus on infrastructure development.

131. The major regional development initiatives were contained in the Regional Development Acts and subsequent development plans established for each of the non-metropolitan areas, Tohoku, Hokuriku, Chugoku, Shikoku and Kyushu. These acts foresee regular development plans to be prepared by MLIT linked to projects and budgets from other relevant ministries. These development plans are currently constrained by tight budgets and their structure is being reviewed in the light of progressive decentralisation.<sup>57</sup> In addition, a number of laws have been enacted to target aid to specific types of regions including mountainous regions, snowy regions, peninsula regions, remote islands, and areas with special soil conditions (*e.g.* volcanic deposits). Most laws were proposed by legislators, not by the Cabinet, and were effective for a limited period. In general, these laws require that prefectural or municipal authorities draw up a development plan for the target region, which is then assessed and is used as the basis for funding of policy interventions in specified fields. For example:

- *The Law on Emergency Measures for Depopulated Areas*<sup>58</sup> mainly aimed at improving infrastructure and living conditions in the target regions. Despite helping to improve the standard of public infrastructure, the general trend in the depopulated areas has not been reversed. In recognition of this and the new role of rural regions in modern Japan, this Law lapsed in 2000 and was replaced the following year by a new law designed to "Promote the Independence of Depopulated Areas". This new approach emphasises the need for local communities to become more independent and to identify the assets that will help them to retain their populations, without expecting a dramatic reversal of demographic trends that is unlikely to occur.
- A similar targeted initiative was introduced in 1993 to help restructure agriculture in rural areas where agricultural production faces particularly harsh geographic conditions, mainly mountainous or upland areas. The Law Concerning the Promotion of Infrastructure Development for Vitalization of Agriculture and Forestry in Designated Areas includes a range of measures to help local communities improve the management of local agriculture through, for example, financing of infrastructure related to agriculture, support for inter-regional co-operation in agriculture management, and measures to improve ownership transfer mechanisms.

132. These initiatives play a role in supporting communities in areas where the pressures of out-migration and ageing are particularly severe, and where agriculture is generally unprofitable. In these areas, agricultural policy can play only a limited role in restructuring the rural economy, and other supplementary measures are necessary. As such, the future role of these targeted regional assistance programmes could be to support the development of non-agricultural or agriculture-related activities, which often depend more on soft supports like training and advisory services, marketing and so on, rather than on hard infrastructure.

#### *Promotion of new activities in rural areas*

133. The basic problem affecting rural areas in Japan is the same as in most advanced industrial countries. Inadequate employment opportunities in many rural areas lead to out-migration that undermines the viability of rural communities. At the heart of the problem facing rural areas is the transformation of the agricultural sector. Increasingly, therefore, public policy is looking for new activities in rural areas to complement or to replace primary sector activities.

134. The principal area of interest for Japan's rural policymakers is in rural amenities; specifically measures through which the amenity values of Japan's rural areas can be harnessed for economic development purposes, notably through tourism, benefiting from the expected increase in domestic tourism spurred by the increasing retired population and by increases in leisure time for Japanese workers. Overall, Japanese people take more holidays than in the past – though on average they still take only half of their allocated paid leave – and the five-day work week is now more common (57% of workers work a five-day week on a permanent basis, and 95% frequently). Moreover, a recent amendment made some national holidays fall each year on a Monday creating two confirmed three-day weekends for all workers. The result of this, plus a general increase in the number of retired people, has been an increase in the leisure time of the population. In a rural context, the interest of policy makers in rural tourism has been encouraged by reports suggesting that there has been a revival of interest in rural life and culture. Before this, there had been a sense that Japanese urban dwellers preferred taking holidays abroad and that rural areas had little to offer to compete with the attractions of overseas destinations. A resurgence of interest in rural tourism, green tourism, farm tourism, etc. would constitute an important avenue for developing new activities in rural communities, in harmony with the wider concerns about preserving cultural and environmental patrimony. A recent research report (Ohe, 2000) discussed the characteristics of rural tourists, noting that their motivations are somewhat similar to rural tourists in Europe and probably elsewhere in expecting some “outdoor” experience combined with local products or specialities. The rural tourism approach is, as in Europe, highly localised in terms of the asset or group of assets that can be drawn upon to attract visitors. The *Annual Report on Food, Agriculture and Rural Areas (2002)* emphasised, therefore, the importance of rural communities taking the initiative with respect to valorising their assets and building strategies, supported through national government programmes. For example, the Special Zones initiative offers an opportunity for municipalities to relax regulations relating to the establishment of guesthouses and other facilities to support tourism in areas where the tourism infrastructure is currently weak.

**Box.2.11. Rural amenities: the case of Miyama town<sup>59</sup>**

The concept of amenities has become an important element of rural policy in Japan over the past few years. An inter-ministerial project team has been established at vice minister level to assess how the needs of urban dwellers are changing and how rural areas can build on the assets that they have in responding to those needs. Miyama town is a good example of the rural amenities concept in practice, including rural-urban interaction.

Miyama is around two hours from Kyoto in the west of Japan, a forested and mountainous area with a low population density and a high elderly population. Most households consist of small farming families, with an average cultivated acreage per farmer of just 50 acres. Despite the difficult terrain and the limited facilities that the region can offer, it nonetheless corresponds to an image of rural life that makes it, like many other rural communities, attractive for urban residents.

Harnessing rural amenities in Miyama has involved combining aspects of the local culture and environment that were previously separated: (1) preservation of buildings, (2) the cultivated landscape and (3) local products.

- The main characteristic of the built environment in Miyama is the concentration of thatched roof houses. Miyama town has succeeded in developing links between Miyama and people living in Kyoto and Osaka who participate in the restoration of traditional thatched roof buildings.
- As in other rural areas, part of the appeal of the region is the landscape created by agricultural cultivation. A major problem in many remote areas is the abandonment of land and the difficulty of maintaining the quality of the environment in areas where the viability of agriculture is in decline. In these cases, structural reform of agricultural production, notably consolidation of farm holdings and the entry of younger farmers play an important role in maintaining the amenity value of the landscape. Improvement of the structure of local agriculture has helped to safeguard it. Visitors also participate in farm activities.



**Box 2.11. Rural amenities: the case of Miyama town** *(continued)*

- Finally, Miyama spring water has been developed as a brand name and contributes to the sense of a pure natural environment. Sales of the bottled water have grown from under 1 million bottles per year in 1996 to over 6 million in 2002.

These diverse activities have generated a strong sense of identity in the region and have even reversed the trend of out-migration with 500 new residents including young families.

135. In addition to tourism, social activities such as Non-Profit Activities are becoming common in Japan with increasing numbers of leisure hours and retirements. There are small but active grassroots activities to revitalise rural areas using local resources. A growing number of NPOs have been established since the Act for Non Profit Activities was enacted in 1998. Most NPOs are established locally with some flexibility, which enables them to be more efficient and collaborate better horizontally.

**Box.2.12. Enhancing urban-rural exchange – a proactive NPO in Tenryu city**

This not-for-profit organisation (NPO) has successfully revitalized farming and mountainous areas by utilising local resources and attracting outside people. The area was famous for its forest industry, which has been in decline since the middle of the 1950s leading to depopulation. The first activity started in 1976 by a local women's club to review local food culture and quality of life. The activity benefited from strong local leadership and the support of the local government and MAFF. Hand-made food and farm-fresh products have been produced in response to the demand of not only local people but also outside consumers, particularly in large consuming regions. In order to extend the "direct from the farm" business, a local association (the predecessor of the current NPO) was established with local full participation to receive subsidies for building facilities. The subsidised projects, as is often the case, required funding from the local government. To raise the necessary funds for pursuing their project, the local people decided to sell their co-own forest. This success story was reported in the media and many people visited, enhancing urban-rural exchange through agricultural products. In addition, conducting successful business by themselves has empowered local women and seniors.

136. The focus on rural amenities and tourism related activities as a complement to agriculture policy is clearly playing an increasingly important role in the general policy approach taken by MAFF. At the same time, other enterprise development approaches are less evident. While many rural areas are unlikely to become innovation centres, experience in other countries, for example, with rural cluster development and development of ICT-related activities, might provide promising areas for policies to complement amenity-related and sectoral initiatives. The section above on Regional Industrial Policy noted, in particular, the potential for an expansion of the policy focus on clusters to include smaller, more local agglomerations of firms. In rural areas, this could be based on groupings of firms in agro-food processing or in speciality foods and products. It could also include collective support for other activities based in rural areas such as tourism-related clusters, health care for the elderly, ICT-related industries, etc.

**Box 2.13. Rural clusters – summary of analysis by Michael Porter**

In the United States, the Economic Development Administration in the Department of Commerce recently funded a report on the economic needs of rural America. The report was prepared by Michael Porter and several other researchers at the Institute for Strategy and Competitiveness at Harvard Business School and a follow-up study is planned.

In *Competitiveness in Rural U.S. Regions: Learning and Research Agenda*, Porter reviews a selection of the literature concerning rural economies in the United States, looks at US policies towards rural regions and the institutional network serving them, and summarises the policy recommendations for rural regions in the literature.

The report draws a number of important conclusions concerning rural regions as a unit of analysis and policy. First, Porter finds that the same principals determine the economic success or failure of rural regions as other regions. Treating rural areas as different can detract attention away from fundamental drivers to peripheral issues. Second, rural regions are heterogeneous and their economic performance is driven by diverse factors. It is therefore a mistake to focus on shared characteristics between rural regions. Lastly, he states that rural regions often have strong links to metropolitan regions, and should not be viewed as self-contained economies.

Porter also notes that many policies have focused on common business environment weaknesses in rural areas (often associated with low population density) while ignoring specificities of particular areas. He argues that collectively, specificities of rural regions appear to explain rural economic performance better than commonalities.

According to Porter, current policies to improve economic performance in rural regions in the United States have not been effective. The report concludes with some recommendations concerning policy for economic development in rural regions: (1) economic development in rural areas must focus on the specific strengths of each area rather than on generic weaknesses. Porter argues that rural areas will never match urban infrastructure, services, and amenities anyway; (2) clusters are central to developing a better understanding of the competitiveness of rural economies and how they can be improved; (3) a number of economic opportunities exist in many rural areas including: hospitality and local tourism; outsourcing of services from labour constrained urban areas; specialty agriculture focused on serving urban markets; and the growing congestion and scarcity of land in urban areas.

Porter criticises the current institutional framework for rural policy in the United States for being fragmented and uncoordinated. In particular, he argues that agricultural policy should rely less on price supports and more on specialty products and serving nearby urban markets.

In addition, Porter argues that because rural areas are so diverse, policy should be set at the local and regional level, rather than at the state or national level.<sup>60</sup>

137. Another area of interest for policy makers is the link between small urban centres and rural regions, and more particularly the role that such small towns and cities can play in providing the services and activities that migrants from rural areas have been seeking. This emerging policy area underscores the links between rural development and urban policy in the sense that many small cities need to address their own problems before they can play a role in anchoring wider regions.

138. The Grand Design for the 21<sup>st</sup> Century regards small and medium-sized towns and surrounding rural communities as the potential basis for a new way of organising low density regions. According to the plan, further co-operation within regions between a core small or medium sized city and its rural hinterland will allow them to develop as independent “nature-rich residential areas”, that offer a rural lifestyle with urban services at close proximity.<sup>61</sup> On the one hand, rural communities could benefit from the advantages associated with the integration of economic, social and environment policies. On the other hand, a critical mass of key services should be provided in these regions through a more rational organisation of public service provision and on the basis of strong cross-jurisdictional co-operation. The towns provide the surrounding rural communities with basic medical and welfare services, educational and cultural facilities, and other urban services including retail services, together with employment opportunities.<sup>62</sup> The

government is seeking ways to guarantee minimum levels of access to higher order services (*e.g.*, higher education) as a means of maintaining the attractiveness of non-metropolitan areas. A recent comparison of urban and rural travel patterns by the UK Countryside Agency showed that rural and urban dwellers spend similar amounts of time travelling each day. Although rural journeys are longer, the number of trips and the commuting time are almost the same. The concept of the rural hub depends on good access to services, rather than actual distances.

### **Targeted regulatory reform**

139. Regulatory reform is a central element in the Japanese government's reform programme. Early in 2004, the Koizumi government agreed on its Three-Year Programme for Promoting Regulatory Reform and confirmed the mandate of the Council for the Promotion of Regulatory Reform (CPRR), an influential advisory body. CPRR, formerly known as the Council for the Regulatory Reform, focuses on private sector-led economic initiatives, makes proposals to the Cabinet and helps to garner support for the government's reform agenda in the field of regulatory reform.<sup>63</sup> The Three-Year Plan aims to consolidate progress made so far to improve the quality and efficiency of regulation in general, encourage competition, remove discriminatory practices, and increase access to publicly regulated sectors (such as employment services, agriculture, medical services, and education).<sup>64</sup> While the objectives of the Three-Year Programme and its antecedents are economy wide, the reform process has significant implications for territorial development policies, both in terms of regional competitiveness policies and with respect to governance.

140. The previous sections have underscored the potential of deregulation to improve outcomes from territorial policy in diverse areas. In both urban and rural regions, policy makers recognise that policies to improve the competitiveness of regions depend on creating an environment conducive to private sector initiative and investment. For example:

- In the field of innovation policy, the deregulation of research institutions and universities and relaxation of rules concerning professional links between researchers and private companies will have an important impact on efforts by METI and MEXT to promote regional innovation systems, in which research and industry are expected to participate in joint research and commercialisation activities and create informal, flexible networks at regional level.
- The Urban Renaissance programme, the principal instrument of urban policy at present, is based on providing targeted exemptions from regulations that appear to inhibit the investment that is needed to galvanise urban economies. Private firms can propose urban development projects that include requests for exemptions from regulations in specific fields and also identify areas in which the procedures followed by the public authorities can be improved.

141. More generally, the regulatory reform process exemplifies changes that are taking place in systems of public governance. The regulatory reform process illustrates a shift from an emphasis on administrative control and standardisation towards a more flexible system that encourages actors, particularly those at local level, to engage in new relationships and experiment. As such, regulatory reform is closely linked to the process of decentralisation, the accompanying reshaping of the relationship between the centre and prefectural and municipal governments and initiatives to solicit input from the private sector, NPOs and community groups. Place-based regulatory policies are an important means by which to enhance the competitive advantages of specific regions, responding to bottom-up requests, at the same time testing the feasibility of more general, nationwide reform.

142. A major initiative that exemplifies the close links between territorial policy and regulatory reform is the Programme of Special Zones for Regulatory Reform. The objective of this programme is to stimulate

private sector activity by exploiting targeted regulatory reforms that remove specific, localised development obstacles. The Zones are designated by local entities (mainly governmental but also local consortia) on the basis of an assessment of the geographical area that would benefit directly from revision of a particular national regulation or law. The underlying assumption is that many of the bottlenecks in the Japanese economy are localised and that relaxing national regulatory frameworks in certain specific cases could give a boost to both local and national economies. The philosophy of the programme is based on the assertion that local actors are best placed to define their needs in terms of special exemptions or special treatment. The national government presents no model in advance and local groups must compete with other localities to prove that their proposal will have both local and national impacts. Local actors must organise themselves before submitting a proposal, and whatever strains or pressures might be caused by the implementation of special measures in the zones (with respect to adjacent areas where the measures are not applicable) must be mediated/negotiated locally. As such, the programme is promoting at a pilot scale many of the governance/horizontal co-ordination mechanisms that decentralisation processes are trying to instil at national level over the long term.

#### **Box 2.14. Establishing Special Zones<sup>65</sup>**

The mechanisms in place to establish Special Zones include a mix of local initiative, informal consultations, and central approval and evaluation. As a first step, for a period of four to six weeks several times every year the Office for the Promotion of Special Zones (located in the Cabinet Office) solicits regulatory proposals from all interested parties: local governments, private firms, citizens and foreign companies. Next, during a two-week period, the Office accepts petitions (from local governments only) for special zone designation. Applications from local governments require the approval of a committee of cabinet ministers ("the Headquarters for the Promotion of Special Zones for Structural Reform") chaired by the Prime Minister as well as the consent of the responsible minister. Most of the officially tabled applications are approved, following a process of screening and informal consultations between local governments, involved central ministries and the Office for the Promotion of Special Zones. Proposals for reform as well as responses by ministries and agencies are made public on the Internet.

The Office for the Promotion of Special Zones regularly publishes a list of the type of regulations for which special measures *can* be established. The idea is to have local governments choose from among these measures when formulating special zone plans and proposals. The list is expanded and updated as new special measures are approved by the Headquarters. An *Evaluation Committee* established in July 2003 composed of academics, representatives from the private-sector, and people selected among applying institutions and local government must assess whether regulatory exemptions allowed for a particular special zone should be either: 1) implemented nationwide, 2) continued in the Special Zone only, or 3) discontinued. There is no fixed trial period of the special measures before they are assessed by the Evaluation Committee. Once a year the Cabinet submits a bill to the Diet in which it adds new special measures into a revised version of the law on Special Zones for Structural Reform.

There are no clear criteria for which deregulatory measures can and cannot be taken under the Special Zones initiative. The official government policy allows for "exceptions to regulations in a manner that is in line with respective special local characteristics", which, "through thorough assessments [...] will be extended to nationwide structural reform". Exemptions are essentially granted on a discretionary basis subject to negotiations between line ministries and the Cabinet Office.

143. From an economic perspective, the programme assumes that the regulatory reforms will tend to promote the special competitive advantages of each region, and thereby increase the complementarity of regional economies, rather than encouraging competition among them. The concentration of unique industries in each region and the creation of new industries will lead to the revitalisation of each region's economy. Examples of special zones created by the first and second proposals for Special Zones for Structural Reform include the following:

- *Special zones for education* providing diverse educational programmes that satisfy local needs, such as establishing schools by entities other than school corporations approving diversity in the educational curriculum, such as English immersion courses.
- *Special zones for international physical distribution*, in which port facilities such as customs clearance operate around the clock.
- *Special zones for agriculture*, in which private companies are permitted to lease agricultural land and run agriculture enterprises.
- *Special zones for international exchange* facilitating the entry of foreign engineers, tourists, and students into Japan by introducing regulatory exemptions to visa-related systems.
- *Special zones for collaboration between enterprises and universities*, in which diverse activities such as the use of government facilities for testing and restrictions on the involvement of researchers and institutions in private sector projects are relaxed.

144. It is hoped that these zones for structural reform will help to stimulate local economies through deregulation as well as demonstrate successful cases of regulatory reform that can then be expanded nationwide.<sup>66</sup> Municipalities can propose plans to establish special zones, based on requests for exemption from regulations on a list already pre-approved by central government ministries.<sup>67</sup> Since this system went into effect in April 2003, there have been four rounds of application and review of special zone applications, with 394 approved zones (as of September 2004). About one-third of the approved zones are related to education (especially changes to the English language curricula) or childcare. About 10% (or 37) zones are designated to permit particular kinds of industry-university collaborations which were previously disallowed.

**Table 2.6. Proposed and implemented deregulatory measures under the Special Zones initiative**

|         | Application period | Total number of proposals | Realised in special zones | Realised nation-wide |
|---------|--------------------|---------------------------|---------------------------|----------------------|
| Round 1 | August 2002        | 426                       | 93                        | 111                  |
| Round 2 | January 2003       | 651                       | 47                        | 77                   |
| Round 3 | June 2003          | 280                       | 19                        | 29                   |
| Round 4 | November 2003      | 338                       | 17                        | 33                   |
| Round 5 | June 2004          | 652                       | 12                        | 35                   |
| Total   |                    | 2 347                     | 188                       | 285                  |

Note: During Round 5, the government also asked for proposals for Regional Revitalisation Initiatives (Round 2), which included integration of some specific ear-marked grants, devolution of land use control, and introduction to private finance.

Source: OECD (2004), Japan: Progress in Implementing Regulatory Reform, p. 42.. data from the Government of Japan.

**Table 2.7. Number of approved Special Zones**

|         | Approval                  | Number of Special Zones |
|---------|---------------------------|-------------------------|
| Round 1 | April 21 and May 23, 2003 | 117                     |
| Round 2 | August 29, 2003           | 47                      |
| Round 3 | November 28, 2003         | 72                      |
| Round 4 | March 24, 2004            | 88                      |
| Round 5 | June 21, 2004             | 70                      |
| Total   |                           | 394                     |

Source: OECD (2004), Japan: Progress in Implementing Regulatory Reform, p. 42. , data from the Government of Japan.

145. This regulatory reform process, including the programme of special zones for regulatory reform, offers significant insights into the processes of creating improved incentives in Japan for regional development and, in particular, for local actors to be pro-active in economic development. The importance of regulatory reform is clearly demonstrated by the location of regulatory reform directly within the Prime Minister's office. Nevertheless, as noted by the recent OECD review of regulatory reform in Japan, the ability of special zones to act as the catalyst for national regulatory reform might be somewhat limited. First, the process of assessing the impact of reform at local and then at national level is likely to be long. And, second, the review process that is intended to assess the feasibility of expanding specific regulatory reforms, as currently organised, is relatively long (the first assessment was made in September 2004).<sup>68</sup>

146. At the same time, the demand for regulatory reform from localities is evident. It seems that there are good prospects for the zones for regulatory reform to show that selective reforms can be implemented without major problems. However, as currently implemented, it is unclear whether the zones will have major effects on stimulating local economies, particularly in poorer regions, for three reasons. First, many of the permissible reforms only have indirect impacts on the regional economy (although they are still worthwhile), while others are quite restricted in scope, often simply enabling activities that are common place in other developed countries. Second, the zones of structural reform do not appear to be adequately linked or integrated with other regional development strategies. Third, outside of Hokkaido (which is large geographically with many municipalities), it seems that the localities which are most active in obtaining special zone approvals are mostly in prefectures in the urbanised agglomerations and have higher per capita incomes on average. Peripheral prefectures (especially in Tohoku, Shikoku, and Kyushu) and poorer prefectures are less actively engaged.<sup>69</sup> If the Japanese government desires to use the zones of structural reform concept as an effective regional revitalisation tool – and it is not clear that this is or should be its primary purpose – it would need to review the operation and implementation of the programme. Among the parameters to consider would be the range of regulations that could be included directly related to economic and business development, employment, and innovation. Additionally, it would be important to go beyond regulatory relief, to consider specific accompanying incentives as well as linkages with other regional policies necessary to increase leveraging effects. In doing this, it would be worthwhile to review the experience of other countries with enterprise, trade, and empowerment zones and other forms of regulatory reform aimed at local development.<sup>70</sup>

### **Territorial policy: a framework for co-ordination**

147. The foregoing discussion illustrates the general direction that policy reform is taking in a number of areas that make up territorial policy. One central issue for the future is how to maintain coherence among these different policies, particularly with respect to decentralisation issues. Although Japanese authorities have invented a number of policy tools for co-ordinating sectoral policies, they have not fully achieved their targets ideally. Moreover, emerging socio-economic shifts have transformed the objectives of Japan's territorial policy and led to reforms in conventional policy methods, most of which were

introduced during the era of economic and demographic expansion. Future directions of territorial policy reform should include:

- Adapting territorial policy tools to the socio-economic changes facing Japan.
- Focusing more on regions by enhancing the individual characteristics and promoting competitiveness through a more decentralised approach.
- Implementing territorial policy more effectively (more focus on policy outcomes) and incorporating evaluation and monitoring schemes into the territorial policy framework.
- Maintaining territorial policy cohesion among the policies of different sectoral authorities: territorial plans encourage co-ordination across levels of government to orient their investments and target actions as well as formulate or implement policy.

### 3. IMPROVING THE EFFECTIVENESS OF POLICY

#### Regional development and territorial governance

148. In Japan responsibility for policy making at sub-national level is undergoing a gradual transformation that modifies the role of the centre and assigns new functions to regional bodies. Given that regional development strengths and weaknesses vary, as do local preferences for the quantity and quality of public services, regions themselves are, in principle, best placed to identify and respond to development opportunities and to provide an appropriate basket of public goods to local citizens. In turn, the traditional role of the centre as a direct sponsor of development, though still apparent, has been challenged. Prefectural and municipal authorities are taking a more active role and private sector and not-for-profit actors are becoming more prominent in some areas of policy making. Nevertheless, central government still has a fundamental role to play. As can be seen in other OECD countries,<sup>71</sup> national ministries and agencies increasingly act as partners in regional development, setting the framework or guidelines for policy and overseeing the co-ordination and evaluation mechanisms within which regions can formulate and implement their policy. In this direction, governance reform is taking place to modernise the traditional top-down structure of the public administration in Japan and to adapt it to a more decentralised system of government.

149. The reform has four main strands:

1. **Reorganisation of national government ministries**, involving the creation of a Cabinet Office and the consolidation of some ministries and agencies.
2. **Decentralisation**, involving reorganisation of the division of responsibilities between central and local governments, greater delegation of responsibilities to local governments, and reform of the system of local finance.
3. **Better horizontal co-ordination**, involving efforts to improve the organisation of policy making at sub-national level by consolidating municipalities and encouraging regional blocs of prefectures.
4. **Vertical co-ordination**, involving first steps to establish the mechanisms to manage decentralised policy making.

150. The following sections will look at each of these main strands in turn, referring to other countries' policy experiences. In each case, the reforms will have an important influence on the implementation of regional policies.

#### Reorganisation at the central level

151. In 2001, Japan reorganised cabinet level ministries and agencies in order to establish more effective political leadership, improve transparency, streamline the central government, and improve efficiency. There are three main domains that directly affect territorial development policy:



- The creation of the Cabinet Office which supports Councils and Headquarters for special policies under the Prime Minister's control with the specific remit of ensuring effective inter-ministerial co-ordination.
- The creation of the new Ministry of Land, Infrastructure and Transport (MLIT) by amalgamating four ministries and agencies (the National Land Agency, the Hokkaido Development Agency, and the Ministries of Transport and Construction).
- The introduction of several prime ministerial advisory panels, Councils and Headquarters, that are also supposed to bring a coherent approach to policy development in specific fields related to territorial policy: the special zones for structural reforms, urban renaissance, consolidation of municipalities, decentralisation reform, the privatisation of the four public highway corporations, and regional revitalisation.

### **Box 3.1. Policy co-ordination mechanisms in OECD countries**

Problems of policy co-ordination at national level are not unique to Japan and increasing horizontal co-operation at the centre has become a more important issue in most member countries. In part, this is because of external pressures arising from the need to manage relationships over a series of different policy areas with the regional level, not least in terms of providing a framework for the development of sub-national economic strategies and policy initiatives. However, it has also resulted from the increased focus on the regional dimension of policies in a variety of different government departments. Just as frameworks have been required at regional level to maximise policy efficiency by integrating different measures and bodies, similar co-ordinating mechanisms have been needed for the central government. Responding to these pressures, several governments have designated particular units to oversee regional development matters. In the UK, the Regional Co-ordination Unit – currently placed within the Office of the Deputy Prime Minister – was set up to implement cross-cutting initiatives, advise Departments on successful implementation strategies at regional and local level, and overall, to promote closer links between government activity in the regions and the centre. In Italy as well, the Department for Development and Cohesion Policies within the Ministry of Economy and Finance has general competence for economic and financial programming and co-ordinating the investments made for sectoral, territorial and cohesion development, with particular reference to the so-called "depressed areas". In Canada, the regional economic development agencies operate their own separate programmes and policies that reflect the specific circumstances of their respective regions. The agencies are also members of an industry portfolio umbrella that includes other related departments and organisations thereby providing a mechanism for policy co-ordination that ensures a consistent federal approach to issues and national initiatives.

152. Although reorganisation in these three domains of the central level of government has been significant, additional action could further improve effectiveness in policy making. First, although the Cabinet Office has been considerably strengthened in recent years, efforts to use it as an instrument to ensure effective inter-ministerial co-ordination and to conceive the Prime Minister and the Cabinet as a collective body should be made. Second, co-ordination in the area of territorial policy could be further enhanced. Within the MLIT there has not been a radical reallocation of responsibilities<sup>72</sup> and although MLIT was given specific regional development responsibilities, some important aspects of territorial policy are located in other line ministries. Third, co-ordination between the different domains of reorganisation could be strengthened. It is not clear at this stage how the different advisory panels, councils and headquarters interact with traditional bodies, such as ministries and agencies,<sup>73</sup> which maintain a significant amount of power over decision making and policy implementation.

153. Presently, the main instruments for integration across sectors remain the National Land Use Plans and Comprehensive National Development (CND) Plans. As was noted previously, the government recognises that these planning instruments still face challenges in integrating sectoral approaches and improving their relevance in this regard is a main objective of the current planning reform process. For example, the vast scope of each CND plan has made it difficult to match objectives with policies, providing very limited incentives for individual ministries to work towards their relatively abstract targets. As a result, these plans have become less central to the strategic thinking of individual ministries, undermining their effectiveness in policy co-ordination. The key question for the current reform process is whether, in a more decentralised territorial governance structure, these mechanisms can play a stronger role in ensuring a co-ordinated approach to regional development. In the context of decentralisation, the concept of a top-down, in theory mandatory, development plan is somewhat contradictory: if regional involvement is being sought, then the system needs the flexibility to allow local and regional actors to define targets as well as means. At the same time, there needs to be some coherence among the objectives and strategies of the sectoral ministries at national level.

154. Overall, the reform at the central level brings greater co-ordination and some rationalisation – a number of cost reductions arising from the merger of ministries and agencies – but does not resolve the issue of policy co-ordination. Moreover, given the changes in the balance between central and regional/local decision making, horizontal co-ordination at the central level is only one aspect of the overall issue. One interesting development in this respect is the preparation of a strategic five-year infrastructure development plan, bringing together a number of sectoral plans including road and rail transport, sanitation, land management and others (discussed in Chapter 2). This strategy involves close co-operation between MLIT, the Ministry of Agriculture and the Ministry of Environment, and is similar in some respects to the transport infrastructure *schema de service* developed in France, which was also designed to demonstrate cross-sectoral linkages. As with the *schema de service*, there is also an initiative to regionalise the strategy by means of “regional bloc meetings”. This initiative, built around the regional bloc concept, discussed later in this chapter, is designed to create a mechanism by which the sectoral and regional aspects of policy development are integrated. This is a first initiative, but could provide an indication of both how the planning process could evolve and how the regional bloc concept could be implemented over the longer term.

### **Decentralisation and reform of local finance**

155. Although in Japan the local government share of both total general public spending and revenue is high, inter-governmental relations have traditionally been based on control and, to some extent, discretionary support from the centre. As for spending, earmarked grants – often shaped by a rigid allocation process – have been used extensively to guide local public spending. Together with addressing local demand for public goods, they have often been used for macroeconomic purposes such as stimulating the economy in periods of recession and temporarily compensating regional income disparities via transfers from the centre. As for local revenue, a rather complex local tax system assigns flexibility to local governments in setting the rates and bases of several taxes.<sup>74</sup> However, the local governments have only rarely used their taxing powers and several of the so-called local taxes are in fact tax-sharing arrangements where the central government sets bases and rates as well as collects the taxes. In line with trends across the OECD,<sup>75</sup> from 1995 onwards Japan has undertaken a gradual decentralisation of power from the central government to the local government (Box 3.2.). The legislation of Decentralisation laws shows that the drive came largely from the centre, as seen from the other countries, leading the reform to be described as a top-down decentralisation.

### Box 3.2. The decentralisation process

The first step towards decentralisation took place in 1995 with the passage of the Decentralisation Promotion Law stating three main objectives:

- To clarify and better allocate the roles and responsibilities of central and local government;
- To revitalise regional communities across Japan; and
- To develop measures to increase the self-reliance of local government.

To this end, the law requested that the central government should review the current institutional structure and make proposals for reform and that the local governments should prepare themselves for additional functions.

Subsequently, within the Prime Minister's Office the Council on Decentralisation Reform was established to develop the specific recommendations for reform, which were adopted by the Diet. Following a three-year process of investigation by the Council and lengthy deliberation in the Diet, including numerous amendments and definitional changes, the recommendations of the Council were adopted by the Diet. The resulting framework law (the Decentralization Package Law), which supports the preparation and development of related laws to promote decentralisation, was enacted in 1999, and enforced in the following year. The law focussed on a number of key areas around which significant disagreement between the central and sub-national levels had emerged over time, including:

- Clarification of the respective roles of central and local government and re-examination of involvement of the central government in local administration; and
- Abolition of the system of delegation of national government administrative functions to local government<sup>76</sup> and reallocation of administrative work after the abolition either formally to local government or back to central government.

While in comparison to some countries, the level of decentralisation achieved does not seem particularly radical – and certainly has not gone as far as was proposed by the Council on Decentralisation Reform in its first report – the impact of the decentralisation process on public policy making in Japan is nonetheless very significant. Above all, it has established a new balance in central-local relations that represents a major break from the hierarchical structures that dominated policy making in Japan in the past. The role of prefectural and municipal government in policy formulation has increased dramatically, and ongoing reforms in areas such as infrastructure development and regional economic policies emphasise the role that sub-national governments should play in the future.

156. Although the recent movement to decentralise seems to have been motivated primarily by economic and fiscal concerns, it was also a response to increasing requests from citizens for a more diverse supply of public goods and increasing recognition of the enhanced capacity of local government.<sup>77</sup> On the economic front, the stagnation of the national economy and the impact of deflation generated demand for urgent fiscal reform, including pressure to review the scale and nature of the transfers to local governments that amount to 14.8% of the central government budget. This pressure led to general political agreement that decentralisation was a key element of the country's overall economic recovery strategy. This opinion was supported by a growing belief that decentralisation could be an important step in preparing the public administration for future economic and social challenges. There was increasing concern about inefficient spending decisions made by the government and the lack of legitimacy of local authorities. Moreover, there is a general recognition that the nature of the local government has changed, greatly diluting a common argument that underpowered local governments were not capable of taking on significant new responsibilities. Already beginning in the 1980s larger municipalities handled considerable public investments and were taking a more pro-active role in policy formulation. Their capacities were recognised

in 1994 when large cities, "Core Cities", were allowed to handle responsibilities usually assigned to prefecture government.<sup>78</sup>

### Box 3.3. Japan's regional structure

The territory of Japan is divided into 47 prefectures, the largest unit of local government. Each prefecture is further divided into basic local government units: *shi* (city), *cho* (town), and *mura* (village). Apart from the Tokyo prefecture, which contains 23 wards and has a different set of responsibilities and powers, the prefectural governments duties are those considered to be region-wide – infrastructure development, for instance – as well as ensuring communication between the central government and municipalities. There are over 3 000 municipalities of very different sizes (Yokohama City has a population of more than 3 million, while Aogashima (island) village in Tokyo has only 200; Ashoro town of Hokkaido has a surface area of 1 408 km<sup>2</sup>, while that of Takashima town in Nagasaki is only 1.34 km<sup>2</sup>). These local governments are responsible for local "daily" services such as health care, environmental conservation, planning, sanitation, etc. In order to take into account of regional evolution, there are special municipalities (31 government-designated cities, 35 core cities, and 40 special case cities) that are permitted by the central government to perform all or part of the tasks usually handled by prefectures.

157. The main purposes of fiscal decentralisation are twofold: streamlining the inter-governmental transfer scheme and increasing local fiscal autonomy. Streamlining the local finance system is one element of the government's overall fiscal stabilisation effort that intends to keep general government spending fixed as a share of GDP. Local government debt has moved from less than 15% of GDP in the early 1990s to 40% of GDP in 2003 and demographic pressures can further increase the burden on local budgets making it increasingly difficult to avoid excessive disparities in citizen access to local public services across jurisdictions. In fact, the share of population over the age of 65 varies significantly across prefectures. In particular, an urban/rural cleavage requires equalisation provisions from urban to rural regions. Greater local fiscal autonomy – to accompany greater administrative autonomy – is supposed to improve the targeting of public services at local level and thereby enable central government to reduce expenditures.

158. An ambitious fiscal decentralisation reform, often referred to as the "Trinity Reform" (the Reform Package of three issues), has been announced for FY 2004-2006. The reform includes measures to reduce earmarked grants from the centre to local authorities, compensate this by increasing the taxing power of local authorities and to review the unconditional transfer scheme, Local Allocation Tax (LAT).

159. The three main elements of the Trinity Reform are:

1. A decrease or abolishment of national subsidies, *i.e.* earmarked grants, by JPY 3.2 trillion for the period FY 2004-2006 (JPY 1 trillion in 2004).<sup>79</sup>
2. A decrease of block grant funds, allocated through the LAT (cut of JPY 1.2 trillion in 2004, total amount up to FY 2006 not yet specified).
3. An increase of sub-national taxing powers through the transfer of some national tax revenues to the local governments amounting to about JPY 3 trillion for FY 2004-2006 (JPY 0.4 trillion transfer of national personal income tax revenue in FY 2004).

160. As it currently stands, the reform has features that should increase the margin for most local governments to formulate more autonomous development strategies, both individually and in co-operation with other municipalities. At the same time, the reform, by reducing the level of transfers from the centre to the local government, and increasing taxing powers of the local government instead, is likely to provoke further reorganisation of the way public services are delivered across the territory, particularly among less financially sound local governments.

*Streamlining the intergovernmental transfer scheme*

161. A main fiscal reform target is to reduce the total amount of intergovernmental transfers. In 2003, intergovernmental transfers accounted for 37% of total local government revenue, a similar share to that raised through local taxes (38%). The intergovernmental transfers in Japan are divided into two main components: 1) block grants which are unconditional grants including LAT (57%), and 2) subsidies which are conditional or earmarked grants from the central government to cover specific functions such as education (43%).<sup>80</sup>

162. Despite its name, the Local Allocation Tax (LAT) is not a tax but rather a revenue sharing system with two main functions: 1) adjusting imbalances in revenue sources of the local governments, *i.e.* filling in the vertical fiscal imbalance; 2) ensuring that all the local governments can provide a standard level of administrative and public services, *i.e.* horizontal equalisation. The total amount of the LAT available to be distributed each year depends on the revenues generated by five national taxes.<sup>81</sup> Disbursement of the LAT to local government is made on the basis of estimates of standard revenue and standard expenditure of local government. LAT is allocated to those areas in which the standard expenditure exceeds the standard revenue. In FY 2003, out of the 47 prefectures and 3 190 municipalities, only the Tokyo Metropolitan Government and 114 municipalities did not receive a LAT.

163. The transfer system involves high levels of inter-regional redistribution. In essence, the LAT transfers important amounts of revenue from wealthy, mainly urban, areas to poor, generally rural areas, on the assumption that service provision in outlying areas is more expensive. The redistribution is particularly strong. Moreover other grants, *i.e.*, earmarked grants, are also redistributive in the sense that low income/non-metropolitan prefectures receive more than richer ones on a per capita basis. In addition, the LAT complements subsidised projects, including public investment, in line with the national policy. For example, the five rural (least-taxed) prefectures receive transfers that account for 75% or more of their revenues, with some getting transfers worth about four times as much as national taxes they pay (Table 3.1). Tokyo, on the other hand, receives transfers (LAT not included) that amount to only 6.4% of what it pays for national taxes (De Wit and Steinmo, 2002).

**Table 3.1 . Prefectures' per capita tax burdens, receipt of transfers and effective rate of return in 2002**

(Units: JPY 1 000)

| Prefectures      | National tax<br>(i) | Local tax (ii) | Transfer (iii) | Total tax<br>(A)=(i)+(ii) | Total revenue<br>(B)=(ii)+(iii) | Rate of return<br>(B/A) |
|------------------|---------------------|----------------|----------------|---------------------------|---------------------------------|-------------------------|
| Five most-taxed  |                     |                |                |                           |                                 |                         |
| Tokyo            | 1 270               | 461            | 82             | 1 731                     | 543                             | 0.314                   |
| Aichi            | 499                 | 329            | 110            | 828                       | 439                             | 0.531                   |
| Osaka            | 554                 | 297            | 171            | 851                       | 468                             | 0.55                    |
| Kanagawa         | 334                 | 288            | 99             | 622                       | 387                             | 0.622                   |
| Chiba            | 256                 | 246            | 140            | 502                       | 386                             | 0.768                   |
| Five least-taxed |                     |                |                |                           |                                 |                         |
| Tottori          | 160                 | 201            | 449            | 361                       | 650                             | 2.078                   |
| Akita            | 160                 | 179            | 531            | 339                       | 710                             | 2.097                   |
| Nagasaki         | 144                 | 174            | 509            | 318                       | 683                             | 2.148                   |
| Kochi            | 162                 | 184            | 628            | 346                       | 812                             | 2.346                   |
| Shimane          | 177                 | 198            | 690            | 375                       | 888                             | 2.365                   |
| National average | 375                 | 263            | 262            | 638                       | 525                             | 0.822                   |

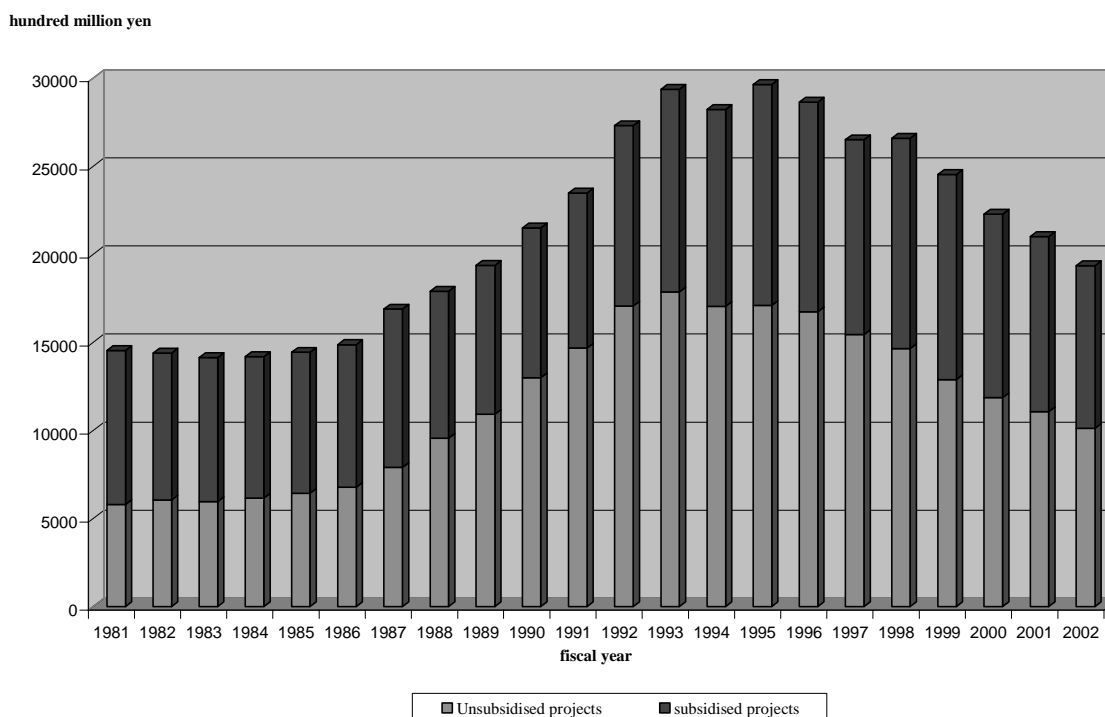
Note: "Local Tax" includes both prefectural tax and municipal tax. "Transfer" includes LAT, LTT and National Treasury Disbursement.

Source: De Wit and Yamazaki (2004), original data from Tokyo Metropolitan Government.

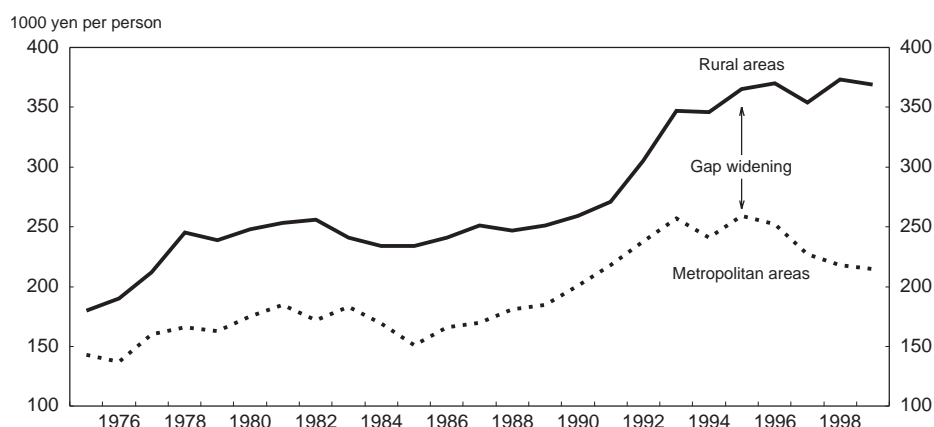
164. While the equalisation scheme has provided good quality public services throughout the country, the question is whether it is still justified on economic grounds. The fiscal cost of equalisation has increased from less than 3% of GDP in the 1980s to over 4%, while pre-transfer sub-national disparities in terms of per capita income have not increased over the past decades. At the same time, as in many OECD countries, concerns have been raised about the best way to orient public spending so as to enable less competitive regions to catch up and better stimulate the economy, especially its “growth engine” in and around Tokyo. The problem with reforming the system is twofold. On the one hand, it has to do with avoiding penalising non-metropolitan regions in which local areas find themselves in a vicious circle of declining revenues. On the other hand, it has to do with reducing dependence on the transfer system and promoting better use of public resources in helping to generate national growth.

165. This question directly affects the future of local public investments. As part of the government’s economic stimulus package in the early to mid-1990s, earmarked grants for employment-creating local public works increased substantially (Figure 3.1). In recent years, as with investment at national level, the levels of local public works spending have declined significantly, and line ministries are under pressure to justify outlays and cut back on costs. However, public works spending in rural areas has increased and the gap between metropolitan areas and rural areas has increased in the late 1990s (Figure 3.2). The proportion of people employed through government activities in many non-metropolitan prefectures such as Okinawa, Shimane and Hokkaido is well above 30%, while the level for more industrialised areas such as Aichi, Shizuoka and Tokyo is barely 20%, and the gap between rural and urban appears to be widening (Ministry of Finance, 2002) (see Chapter 2).

**Figure 3.1. Trends in public works spending**



Source : The State of Local Public Finance, MIA.

**Figure 3.2. Allocation of local public works between rural and metropolitan regions**

Source: Cabinet Office, Annual Report on Prefectural Accounts, MIA.

166. The concern for policy makers is that the increasing dependence of rural regions on public investment and other public supports is encouraged by a set of measures such as public investment programmes, and economic stimulus projects. These public investments are often pursued by earmarked grants and local government's own resources. In some circumstances, these measures, which are designed to support local investment, seem to have an impact in deciding whether an investment should go ahead, rather than being secondary to assessment of local need. Moreover, the LAT formula takes into account some elements of actual spending, as well as a standard assessment of need, so that some non-urgent investment can be covered by further LAT. Financing of local public works projects has also been encouraged through greater reliance by local authorities on local bonds because a good portion of debt service is considered as "standard fiscal needs" in the calculation of the LAT.<sup>82</sup>

167. The Trinity Reform provides a shift from conditional grants to unconditional grants and taxing powers. Such a shift will enhance local autonomy and allow greater choice at the local level. The local government is expected to make more efficient local spending decisions and to make its own choices in the provision of necessary public services. However, if the incentive schemes in the local finance system that encourage spending in public works are not modified, this shift may not produce the expected outcome. Past experiences suggest that the reductions in earmarked subsidies for public works were replaced by local independent public works with expenditures offset through LAT and FILP. The LAT reform should enhance the two primary functions of LAT, equalisation among local governments and guarantee of public services, and restrain other political interventions.

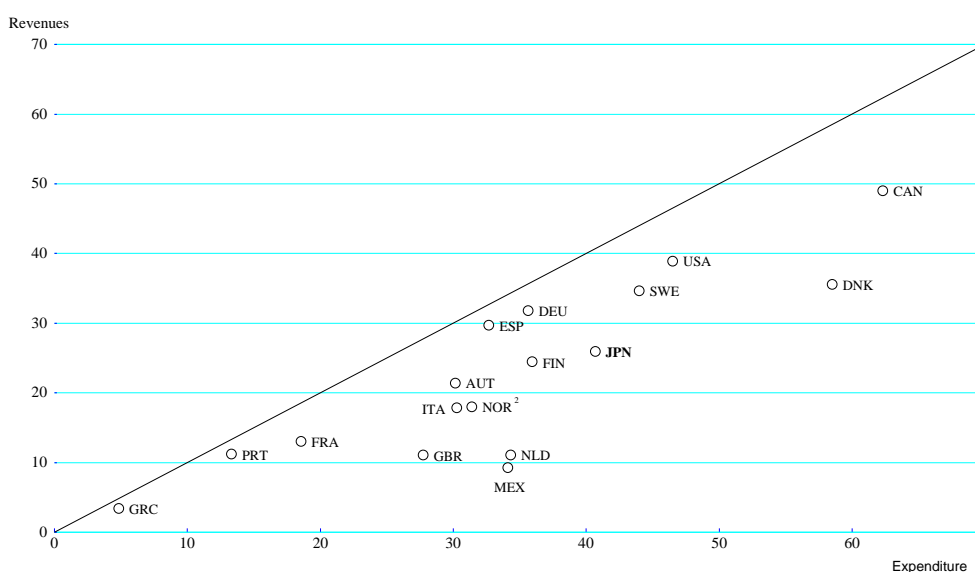
168. In June 2004, the Prime Minister requested the local governments to prepare a proposal for the earmarked grant reform that would be equivalent to the foreseen amount of tax transfer, JPY 3 trillion for FY 2005 and FY 2006. The associations of governors and mayors made a list of earmarked grants that should be replaced by tax transfers. The list covers a wide range of grants including ones related to compulsory education (JPY 0.8 trillion) and public works (about JPY 1 trillion). This is an interesting approach to identify the "demand" from the user side, however, the output does not seem quite rational. For example, public works for disaster prevention such as landslide protection and river improvements are included in the list of grants to be abolished (disaster recovery works are excluded). This would imply that from the perspective of local governments ensuring the safety and security of the nation is no longer the

responsibility of the central government. It is, thus, hard to identify what the local government expects from the central government. The central government has assured a minimum level of public services throughout the country through a system of earmarked grants with strict service standards, though it is true that the system has brought some waste. On the one hand, the central government should specify its primary policy objectives and maintain/create only necessary earmarked grants as a complement to the unconditional grants to achieve/promote such objectives. On the other hand, the challenge of local government under the new unconditional budget scheme is to achieve a balance between prioritising policy and achieving a national minimum of public service provision through a process of consensus and accountability.

### *Increasing local fiscal autonomy*

169. A main feature of Japan's fiscal system is its vertical imbalance between revenues and spending by local governments. As pointed out in the *2004 OECD Economic Survey of Japan*, sub-national governments account for a quite large percentage of Japan's total government spending (40.7% in 2001) compared to some other OECD countries, including federal countries. However, the sub-national governments' share in Japan's total government revenue is lower (26% in FY 2001), although still high by OECD standards (Figure 3.3). A main challenge of the fiscal reform is to increase local fiscal autonomy by securing local revenues and improving local accountability, without undermining the prospects of local authorities with lower fiscal capacities that have been accustomed to receiving transfers from central government.

**Figure 3.3. Indicators of fiscal decentralisation: sub-national government share in general government revenues and expenditures, percentages, 2002**



Note: Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments and are expressed as a share of revenues received by the general government. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure. Transfers between governments are netted out. The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of sub-national governments.

1. Or latest year available: 2000 for Japan, 2001 for France and Portugal.

2. Mainland only. Data exclude revenues from oil production.

Source: OECD, National Accounts database, Statistics Norway, Statistics Canada, US Bureau of Economic Analysis.



170. Although Japan's local governments rely on a wide range of taxes that they levy separately from national tax collection, direct and indirect limitations on their taxing powers also hinder their fiscal autonomy and accountability.<sup>83</sup> Until recently local discretion in introducing new taxes and setting tax bases and tax rates remained limited, but the recent Amended Local Taxation Act has granted local authorities more taxing powers.<sup>84</sup> In FY 2001, a total of JPY 471.2 billion was collected as extra revenue at local level by increasing standard tax rates. However, important factors continue to limit recourse to taxing power. Local governments are unlikely to decrease tax rates as this could affect their ability to issue local bonds. For similar reasons, they might not modify tax rates and bases because of the effect that this could have on central government's allocation of discretionary transfers (*i.e.*, earmarked grants and Special Allocation Tax which is a part of the LAT account).<sup>85</sup> Moreover, given a certain overlapping of responsibilities,<sup>86</sup> local governments have little incentive to increase taxes if they feel that some tasks can be carried out by central government. Overall, therefore, despite some recent reforms, systemic factors limit the incentives that local governments have to invest in economic development activities and maintain the relative dependence of the local government *vis-à-vis* transfer from the centre.

171. The other issue with respect to local fiscal autonomy is how to ensure that relative fiscal capacity is taken into account in the reform (Table 3.2). Differences in tax-raising capacity are currently compensated by a strong redistributive equalisation scheme, *i.e.*, LAT. If increased tax revenues are to be allocated to local governments in parallel with a reduction of inter-governmental transfers, it will be important to ensure that the allocation of taxes will not raise regional fiscal inequalities and have a detrimental impact on public service provision and quality of life in less-dynamic regions. Under the current system, local corporate tax is highly concentrated in urban areas, while local consumption tax and property tax, which tend to be more evenly distributed, represent a relatively small share of revenue. As a result, urban areas tend to generate high per capita revenues, and rural areas relatively low revenues. Under the reform programme, a portion of national income tax will be transferred to local authorities in order to compensate for new functions and reductions in grants. Because of changes in the tax brackets used, the outcome of this process is likely to be that overall tax payments by upper-income taxpayers (concentrated in urban areas) will decrease and those for lower-income taxpayers (who are over-represented in the small cities and towns outside the urban areas) will increase. In other words, the fiscal effect of the shift of national income tax to the local level may be to rebalance somewhat revenues among big cities and smaller administrations. Similarly, it will be important to assess the impact of the introduction of any new taxes by specific jurisdictions as the disparities in the tax base of local jurisdictions are high.

**Table 3.2. Per capita prefectural taxes in FY 2003 (top five and bottom five)**

|           | Per capita prefectural tax revenues | Index (average = 100) |
|-----------|-------------------------------------|-----------------------|
| Tokyo     | 342.3                               | 278                   |
| Aichi     | 143.5                               | 117                   |
| Fukui     | 122.1                               | 99                    |
| Shizuoka  | 116.6                               | 95                    |
| Osaka     | 116.6                               | 95                    |
| Miyazaki  | 78.4                                | 64                    |
| Kagoshima | 78.1                                | 64                    |
| Nara      | 75.2                                | 61                    |
| Nagasaki  | 72.3                                | 59                    |
| Okinawa   | 69.0                                | 56                    |

Source: Survey on the state of prefectures' settlement (MIA).

172. With the Trinity Reform, there is still some uncertainty on how much revenue will eventually be transferred to local government (which might be problematic for their planning budget), whether unfunded mandates will emerge at the local level, and if the size of cuts in earmarked grants and LAT will affect the over dependant regions' ability to deliver minimal public services. If serious cuts in government grants are implemented and the local authorities are required to collect more local taxes, the richer, urban localities will not be seriously affected, but some of the poor, rural localities may be forced to severely limit their level and quality of public service provision. Here again, it is important to make sure that over-dependant local governments will have the financial capacity to provide the sufficient minimum level of public services. In this context, efforts should be pursued to better exploit economies of scale, internalise territorial spillovers and improve policy cohesion, *e.g.*, through amalgamations of municipalities as well as through other forms of horizontal co-operation.

### **Horizontal co-ordination**

173. At the heart of the Japanese reforms of territorial governance is the creation of more self-sufficient sub-national administrative units, capable of functioning with greater autonomy from central government. As such, local governments could be a viable recipient of decentralised responsibilities and they could operate more as a "partner" with central government. In this context, the issue of horizontal co-ordination and co-operation at prefecture and municipal level, has come to the fore<sup>87</sup> and is being pursued partly through inter-municipal collaboration and partly through inter-prefectural collaboration, the so-called "regional blocs".

### ***Inter-municipal collaboration***

174. As the national government begins to reform the local finance system, some jurisdictions might not be able to meet the national minimum standards for different public services, such as compulsory education or welfare. Although the Trinity Reform compensates for the subsidy cuts by transferring tax resources to the local governments, the administrative costs of implementing and collecting local taxes can be extremely high for small rural jurisdictions. As a result, local jurisdictions will face larger fiscal imbalances and be forced to cut service provision levels. A plausible solution is to merge neighbouring small towns and villages to capitalise on possible economies of scale in local tax collection and in the provision of public services. Meanwhile, Japan has introduced other forms of horizontal co-operation, such as Partial Union, Wide-area Unions, to conduct certain types of public services which are more effective and efficient when provided by two or more municipalities. Japanese municipalities will have the choice to merge with other municipalities until the privileges temporarily accorded to mergers expire in March 2005.

### ***Mergers of municipalities***

175. Japan has experienced several big waves of municipal mergers. When the first municipalities were created in 1890, there were around 16 000. After World War II, the central government promoted the merger of municipalities with the objective of making their administrative work more efficient,<sup>88</sup> and the number of municipalities was reduced from more than 10 000 in 1945 to 3 472 in 1961. This figure did not change much until recent years. The present cost-efficiency argument for amalgamation is further supported by the weak fiscal situation of many small towns and villages. Many local governments in rural areas are considered to be below the critical size to provide public goods efficiently. Moreover, empirical studies have tried to demonstrate that the per capita cost of providing a given type and quantity of public services follows a U-shaped curve. The cost of service provision declines with the size of the population up to an "optimal" level before increasing beyond that point. Applying this approach to Japan, Hayashi determined that the optimal municipality size to obtain the lowest unit costs of public services is approximately 120 000 (based on 1990s figures). Using this figure as the benchmark, 80% of Japan's municipalities are under-populated (Hayashi, 2002).<sup>89</sup>

176. Recognising the difficulties that could result from the current reforms, the central government has changed the system of preferential subsidies to encourage local authorities to consider merging and the Law concerning Special Measures on the Merger of Municipalities has been amended and is effective until 31 March 2005.<sup>90</sup> To minimise the potential disadvantages and improve the financial attractiveness of municipal mergers, the government agreed to make adjustments in the calculation of the LAT for merged municipalities,<sup>91</sup> and consider issuing local government bonds to finance the costs of post-merger city planning (often linked to investment in joint infrastructures). The government's "Municipalities Merger Support Plan" provides preferential financial treatment for administrative issues before and after the merger, and priority for public works and subsidised projects. In addition, special provisions exist to allow the amalgamated municipality to organise its electoral districts in a manner that will not put the incumbent local assembly members in an unfavourable position (*e.g.*, by allowing a larger number of seats in the new municipal council than the maximum number established by law). Local electorates can play a role in the decision to merge with other municipalities: they have the power to petition and to request the organisation of a conference to bring together municipalities considering an amalgamation.

177. As of 1 April 2004, 1 891 municipalities have established 534 merger associations based on the legal system. Adding the 72 voluntary associations (composed of 197 municipalities) and the 121 other forms of association (composed of 247 municipalities), 75.3% of the total 3 100 Japanese municipalities are now engaged in some form of association. The process is relatively slow. Although the need for mergers is said to be widely recognised (by local government leaders as well), in many cases potential mergers are still at the discussion stage, and it is unlikely that the government party's target of 1 000 municipalities will be attained by 2005.

178. Merging municipalities is not, however, an easy process. Despite important fiscal and institutional tools to promote amalgamation, there is often some resistance from citizens due to a feeling of belonging but also from local politicians who might give up their power or who are reluctant to share resources with less wealthy neighbouring areas. While there are examples of entrepreneurial municipalities (such as Kakegawa City, to which two adjacent municipalities have requested to merge), it will take some time to change both attitudes and behaviour on the part of local government politicians and officials. Moreover, there is no central government "master plan" of optimal municipality size or configuration of boundaries. This means that the process of co-operation is uneven, and the resultant mergers may still be quite small.

#### *Other forms of municipal collaboration*

179. Besides amalgamations, other alternatives such as horizontal co-operation initiatives exist to deal with administrative difficulties, service provision, and other matters facing municipalities. For certain issues, complete amalgamation may not be necessary or may not be the quickest and most effective way for small towns and villages to correct the problem or increase their political and fiscal autonomy. To encourage effective and efficient administration at the local level, the Local Autonomy Law allows the following smaller scale methods for enhancing co-operation between local authorities:

- The executive branch of a local authority may ask that another authority dispatch personnel for the management and execution of tasks.
- Several local authorities of one accord may establish certain executive organs together.
- A local authority may, with mutual agreement, consign some of its tasks to another entity.
- Several local authorities may, upon mutual agreement, create a council for the purpose of joint administration, co-ordination of activities, and preparation of regional plans.

180. Besides legal co-operation methods laid out in the Local Autonomy Law, other co-operatives and voluntary inter-jurisdictional associations exist in Japan. For example, eight local governments (prefectures and designated cities) from the area surrounding Tokyo have formed an association to deal with pollution control and traffic congestion. Other forms of co-operative agreements and associations could be explored not only for joint public service provision but also for other strategic functions. For guidance, the smaller municipalities could look to the big cities which commonly use such co-operatives, associations and committees to tackle issues that extend beyond their administrative borders. The cities often prefer to first try forming networks with neighbouring municipalities before considering a more complex and official amalgamation. Apart from gains resulting from fiscal incentives, it is quite difficult to assess potential economies that could arise from amalgamation. Moreover, amalgamation remains a radical option that sacrifices the advantages of flexibility. Flexibility can combine both the advantages of co-operation and competition. More specifically, municipalities can enter into co-operation for providing more efficient public services and/or sharing relevant information for joint coherent territorial projects whilst competing to attract businesses.

181. The “Living areas” concept could be a useful organising concept for horizontal co-operation. The National Land Council recommended that living areas – consisting of multiple municipalities with populations of around 300 000 and internal travelling times of one hour – should be promoted as a means to ensure “life-related services”.

#### **Box 3.4. Inter-municipal co-operation programmes in OECD countries**

Municipal fragmentation and the dwindling resources of (rural) small towns facing depopulation have encouraged many governments to develop new strategies to foster more efficient municipal co-operation, such as providing financial incentives, introducing a more adequate legal framework, or involving a wider set of actors. Below are examples of some of the latest trends in local government co-operation.

*Territorial Pacts in Italy* – Based on the principal of participatory planning, Territorial Pacts bring together public and private actors to undertake ventures to promote local development at the sub-regional level. Territorial Pacts concern a large number of sectors, including industry, agriculture, services and tourism. Partners to the Territorial Pacts include local authorities and local development actors, although regions, provinces and financial institutions can be signatories. The Territorial Pacts have had a number of beneficial effects in the area of governance: a learning process among stakeholders concerning common problems across all areas, improved mutual understanding, dialogue between employers and trade unions, and the development of communication with civil society.

*"Pays" in France* – The "Pays" are small areas characterised by “geographical, economic, cultural or social cohesion”. Instead of following the traditional administrative boundaries around which co-operation previously took place, the "Pays" consist of voluntary groupings of municipalities, not necessarily belonging to the same "*département*" or "canton". The definition of the strategy and the projects of a "Pays" are decided through a local consultative process. Development Committees with members from civil society, NGOs and the business sector are directly involved in the implementation of the strategy and projects, as well as the monitoring and evaluation process. While the operational expenses of the "Pays" are ensured by member municipalities, they also receive national funding on a competitive basis depending on the coherence and merits of their local development strategy and projects. The "Pays" have fostered stronger co-operation between municipalities and have helped to associate civil society to a process of rural area development drawing on common identity and shared economic goals.

*Micro-regions in the Czech Republic* – In the Czech Republic a Law on Municipalities (1992) authorises co-operation between local governments, without drawing guidelines on their aims or functioning. As a result, more than 200 voluntary associations of municipalities or micro-regions existed in the Czech Republic as of 2003 and constitute a flexible answer to municipal fragmentation. The associations can co-operate in a wide variety of areas ranging from education, tourism and public order to infrastructure and transportation. Areas of co-operation and projects are decided by an assembly representing the members, for the most part on the basis of considerations linked to economies of scale.

**Box 3.4. Inter-municipal co-operation programmes in OECD countries (continued)**

*Canadian Rural Partnership* – The Canadian Rural Partnership is the key policy framework supporting federal rural policy efforts. Its main objectives are to assure consistency in policy formulation, and co-ordination with provincial and territorial governments in examining, piloting and testing new ways to provide access to public services in rural and remote areas and facilitating economic diversification. Its overall goal is to enhance the quality of life in rural communities and better equip the communities to compete in a global economy. The Partnership operates within the federal government to ensure that federal programmes, policies and activities provide support to rural communities. An **Inter-departmental Working Group**, consisting of representatives from 29 federal departments and agencies, and Rural Teams working in each province and territory, are responsible for implementing the Partnership. The **Rural Secretariat**, within Agriculture and Agri-Food Canada, provides the overall leadership and co-ordination for this cross-government approach. The Partnership has attempted to create a dialogue with Canadians living in rural and remote areas and to respond to their needs by building networks and providing support at the grassroots level. The dialogue with Canadians has helped the government build an overall rural strategy, the Framework for Action in Rural Canada, and define a vision and 11 priority areas to be addressed.

*The Micro-regions Strategy in Mexico* – The Micro-Regions Strategy was created in 2001 to overcome the important vertical divisions in Mexican administration that create a major obstacle to new cross-sector approaches. To remedy Mexico's serious problems of dispersion in rural areas, the Micro-regions Strategy employs service hubs in localities to promote the integration of 1 334 scattered dysfunctional rural municipalities into 263 micro-regions. The Strategy seeks to promote local initiative by involving a wider set of actors in a Community Assembly in charge of defining investment priorities and in the periodical organisation of 'Local Planning Workshops' to encourage local investment. A Programme of Regional Sustainable Development (PRSD) provides a rural infrastructure investment framework in which regional state authorities participate. Departments draw their own sectoral Programme for Regional Investment from the PRSD and integrate it into their annual budget.

*European Union policies, The LEADER Programme* – The European Union launched the LEADER Programme in 1991 with the aim of promoting rural development by encouraging local initiative, and the acquisition and dissemination of know how on local development. LEADER I (1992-1994), LEADER II (1995-2000) and LEADER + (2001-2007) have been employed in over 1 000 different rural territories in Europe. Over the years LEADER has been refined and the latest programme reinforces the notion of a small functional area by emphasising "territorial strategies for integrated development". The main features of the Leader programme are: an approach based around small areas; an active engagement by local actors; a capacity to develop and carry out strategic plans of integrated development; the participation of LAGs (Local Action Group) consisting of local actors in the European Network to share experience and knowledge; a system of multi-annual grants; and three systems of evaluation (evaluations by the central government and the European Union, continual administrative, technical, and financial evaluations, and incentives to develop auto-evaluation mechanisms within LAGs).

***Inter-prefectural collaboration***

182. As a result of the process of decentralisation, fiscal reform, as well as changes in the spatial-economic and demographic situations of many regions, the issue of horizontal co-ordination and co-operation at prefectural level has come to the fore. It still appears, however, that the regions are inadequately defined in political and administrative terms. Although the Japanese central government's ministries have regional branch offices, they are set up separately according to each ministry's objectives. There is no body that represents the central government as a whole in any region, that is, each local government acts as a comprehensive administrative body. Each successive CND Plan has divided the country into functional units conforming to the economic patterns of the time or anticipating new trends (favouring de-concentration or multi-polar/polycentric development, for example). These regions have largely been "planning" regions, and have been devised to facilitate strategic investment by the central government. As a result, they have not been instrumental in developing a real culture of horizontal co-ordination or mechanisms for joint working, resource sharing, etc.

183. For example, the non-metropolitan areas have regional plans that present a vision, objective, targets and specific policy measures for each region. The plans are drafted by MLIT and developed through a consultative process with the National Land Council, which consists of politicians, experts including academics, heads of local government and representatives of the business community. In addition MLIT can co-ordinate with local government and other sectoral government ministries in the drafting process. However, like other regional development plans, they present a relatively abstract framework, with objectives framed in aspirational and generalised terms, and lacking measurable targets or a clear link between an analysis of regional development problems and the priorities or measures proposed. The most important level of activity appears to be the individual project carried out by an individual government department, prefecture or municipality.

184. In the past, regional plans appear to have been developed "top down" by central government, which consults with local government and business interests. At present, the idea of promoting more inter-prefecture co-operation and the grouping of prefectures into administrative units is evolving, as seen in the new territorial planning system. The basic concept is that "regional blocs" with populations of 6 to 10 million or more should be established. In terms of population and economic weight, they would be equivalent to European countries such as Belgium, Sweden and Switzerland and should possess a full enough set of resources, functions and facilities to comprise fully-fledged, autonomous economic blocs active at the international as well as the national level. To facilitate intra-regional co-operation, the regions should correspond to functional living and economic areas and also share common historical and cultural backgrounds.<sup>92</sup>

185. The main issues relate to the powers and responsibilities of these regional blocs. If regional blocs in Japan are to be the basis for effective regional development strategies, the national and prefectural authorities will need to develop policy and institutional mechanisms that can make these blocs into a forum/conduit for integrated, strategic, coherent and co-ordinated economic development initiatives. It is not clear, however, how much experience sub-national authorities currently have with developing integrated development programmes across jurisdictions and in close co-ordination with the centre. As such, the regional blocs represent a serious challenge for all levels of government in terms of turning a concept into a useful formal or informal institution. Table 3.3 shows the range of regional bodies in OECD countries, ranging from powerful highly autonomous regions in federal countries to regions with limited jurisdiction. The regional blocs, at least in the initial stages, will resemble the planning regions of the United Kingdom and Ireland, but could evolve, as they are in the United Kingdom, into more influential bodies over time. For the moment, the principal issue is how regional blocs can be positioned within the formal administrative structure in order to play a role in improving policy co-ordination at a scale appropriate to the global economic context.

Table 3.3. Summary of types of state and regions and regional powers in OECD countries

| Type of state         | States                                 | Regions                                                                                                                     | Right of region to participate in national policy | Control over sub-national authorities | Representation, budgetary and legislative powers of regional institutions                                                                                                                                             |
|-----------------------|----------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------|---------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Federal               | Austria                                | 9 <i>Länder</i>                                                                                                             | Yes                                               | Yes (not absolute)                    | <i>Wide-ranging powers:</i> elected parliament; budgetary powers; legislative powers; right to levy taxes                                                                                                             |
|                       | Germany                                | 16 <i>Länder</i>                                                                                                            | Yes                                               | Yes (not absolute)                    |                                                                                                                                                                                                                       |
|                       | Belgium                                | 3 territorial regions and 3 communities                                                                                     | Yes                                               | No                                    | + judicial powers                                                                                                                                                                                                     |
|                       | Canada                                 | 10 provinces and 3 territories                                                                                              | Yes                                               | Yes (not absolute)                    |                                                                                                                                                                                                                       |
|                       | USA                                    | 50 states and 1 district                                                                                                    | Yes                                               | Yes (not absolute)                    |                                                                                                                                                                                                                       |
| Regionalised unitary  | Italy                                  | 5 autonomous regions, 2 regions with specific status and 16 ordinary regions                                                | No                                                | Yes                                   | <i>Advanced powers, political regionalisation:</i> elected parliament; limited budgetary powers; limited right to levy taxes                                                                                          |
|                       | France                                 | 26 regions                                                                                                                  | Consultative                                      | No                                    |                                                                                                                                                                                                                       |
|                       | Spain                                  | 17 autonomous regions                                                                                                       | Yes                                               | Yes                                   |                                                                                                                                                                                                                       |
|                       | UK (Scotland, Wales, Northern Ireland) | 3 autonomous regions (Scotland, Wales, Northern Ireland)                                                                    | Consultative                                      | Yes                                   |                                                                                                                                                                                                                       |
| Decentralised unitary | Finland                                | Regions have a district/ department/ county status. Groups of counties have regional administrative and planning functions. | No                                                | No (but seat on Nordic Council)       | <i>Limited powers, regional decentralisation:</i> elected parliament; limited budgetary powers and substantial financial transfers from central government; limited right to levy taxes.                              |
|                       | Netherlands                            |                                                                                                                             | Consultative                                      | No                                    |                                                                                                                                                                                                                       |
|                       | Norway                                 |                                                                                                                             | No                                                | No                                    |                                                                                                                                                                                                                       |
|                       | Sweden                                 |                                                                                                                             | No                                                | No                                    |                                                                                                                                                                                                                       |
| Centralised unitary   | Ireland                                | Non-regionalised state, regional planning authorities                                                                       | No                                                | No                                    | <i>No powers, regionalising without creating a regional government:</i> no elected parliament; no right to levy taxes; no budgetary powers and all powers and financial resources transferred from central government |
|                       | Portugal                               | Non-regionalised state, (except 2 autonomous regions)                                                                       | No                                                | No                                    |                                                                                                                                                                                                                       |
|                       | UK (England)                           | Non-regionalised state (one tier, two levels)                                                                               | No                                                | No                                    |                                                                                                                                                                                                                       |

Source: Loughlin (2000), Department of Canadian Heritage (2004), and U.S. Department of State (2004).

### Box 3.5. Strategic policy co-ordination at regional level in OECD countries

In a number of OECD countries, new co-ordination functions for regional development policy have emerged. In several countries, regionalised, contractual and planning arrangements have been put in place to co-ordinate regional development support and provide a more strategic approach. As part of national regional policy, designated regional-level bodies are responsible for developing consensus-based strategies for multi-year periods. Typically, these strategies allow – while at the same time, requiring – regional-level bodies to identify key development needs, outline the measures to be taken in response and allocate appropriate responsibilities for action. National government tends to be limited to a supervisory role, authorising, approving and co-funding the resulting strategies. For example, *Canada*: Federal Regional Councils, comprising the senior officials for the federal departments and agencies in each region, play an important role as an executive forum and in integrated and improved service delivery, two-way communication with the policy centre of the national government on regional perspectives and federal initiatives, and co-operation with other jurisdictions.

In a number of European states, the model for the strategy-building exercises has been the Structural Funds. As with the development of Single Programming Documents (that form the basis for EU regional policy), these regional strategies are usually developed on the basis of partnership with a range of stakeholders in local economic development. Consultation has formed the basis for subsequent policy co-ordination, demonstrating the need for integration of what has often hitherto been fragmented policy activities in regional development. Consequently, the strategies provide a framework in three key areas: the analysis and understanding of the regional economy; the measures and instruments to be used in regional development; and the key institutions with a role to play. The French *contrats de plan* between national and regional authorities – covering the distribution of the bulk of the national regional development budget – are a well-known and long-standing feature of regional policy (and indeed, were a significant influence on the Structural Funds SPDs). Other examples, introduced more recently are:

*Finland*: Since 1994, Regional Councils have been responsible for general regional economic development. Working together with the State authorities, they are tasked with drawing up a regional plan to indicate longer-term regional development priorities for each region, and they have received regional policy funding for initiatives such as developing regional business networks.

*Italy*: Introduced in 1995-1996, *Patti Territoriali* and *Contratti d'Area* are "bottom-up" initiatives involving employers' representatives and unions, private firms and local public authorities, and represent. They implement development policies based more on local economic conditions and the mobilisation of diverse local resources.

*Sweden*: Beginning in 1998, Swedish counties were required to produce Regional Growth Agreements (priorities and measures developed by broad partnerships in the regions and formulated into coherent regional programmes). These agreements were superseded by Regional Growth Programmes in 2004.

*The United Kingdom*: Regional Development Agencies have been established with a remit of drawing up and managing Regional Economic Strategies, which set out the main development goals and actions for the different English regions.

In addition to new bodies being created, partnership mechanisms have been developed to improve strategic co-ordination at sub-national level. In Sweden, the recent regional development policy Bill created two Delegations which will be responsible for developing a more strategic approach to economic development over wider spatial areas (e.g., the northern parts of the country). They have to co-ordinate and work with other government bodies, funding programmes and agencies already active in these areas. Similar partnership mechanisms can also involve national policy bodies operating regionally, as was the case with the creation of the T&E Centres in Finland and the Government Offices in the United Kingdom, both of which brought together the regional offices of several government ministries with regional representation (e.g., the regional offices of departments with trade, industry and labour market remits).



186. Apart from regional planning, the Japanese government has limited experience with regional co-operation, making it crucial to develop incentives for participation and define roles in the short term. In this respect, the financing of regional blocs is a key issue in determining whether such a scheme would have an impact in the already complex administrative geography of Japan. In order to establish these regions' autonomy and facilitate inter-jurisdictional co-operation, for example, strategic "regional blocs" could receive a kind of territorial block grant, closely linked to the regional bloc plans (drawn from funds pooled from relevant central ministries). Providing regional blocs with their own revenue source would help to consolidate their roles and could result in more effective and efficient investment and better policy co-ordination among the larger regions.

### **Vertical co-ordination: the potential of contracts across levels of government**

187. In general, decentralisation of responsibilities, reorganisation of relations at the municipal level and the establishment of "regional blocs" as an instrument of planning and policy co-ordination need to be supported by strong mechanisms of vertical co-ordination across levels of government. On the basis of the preceding chapters, a number of clear imperatives emerge:

- Develop a system that encourages initiative and capacity building among local authorities;
- Maintain scope for regional difference while maintaining links with strategic planning at national level;
- Develop clear links between policy and budgetary mechanisms;
- Define responsibilities among government actors;
- Promote cross-sectoral co-ordination in policy implementation;
- Develop mechanisms for evaluation and monitoring.

188. Inter-governmental contracts could be a source of inspiration for the national and prefectural authorities if they need to develop policy and institutional mechanisms that can facilitate integrated, strategic, coherent and co-ordinated economic development initiatives focusing on growth and competitiveness. Contracts present various advantages that relate directly to the direction that policy is evolving in Japan and to the observed weaknesses that are apparent in the current administrative system. For example, contracts can legitimate and clarify the role of local authorities in policy formulation. They also constitute a framework for learning and, thereby, contribute to the improvement of local competences. Because of their long time horizon, they can link long-term strategic planning with implementation, including a multi-annual budget programming framework. Finally, they can also improve horizontal co-ordination within the public administration of both central and local levels.

189. Contracts are an institutional tool which is used by various OECD countries to tackle some of these issues. The contract approach can be seen as a means to reach consensus, helping to reconcile government actors at different levels through negotiation. In general terms, decisions are generally taken at the local or regional level and policy cohesion is assured by the central level. The contracts aim primarily at organising vertical co-ordination among levels of government, but they also necessitate co-ordinated approaches from the different ministries that are concerned with the regional development policy. In effect, such "vertical" agreements bring into play "horizontal" agreements to the extent that they can cover various (if not all) areas within policies aimed at enhancing the attractiveness of the territory (in terms of taxation, logistical platforms, infrastructure), and also policies aimed at employment, research, higher education and vocational training, and culture. Horizontal collaboration in these policy fields is not limited

to the central level; but also occurs among a great variety of local stakeholders such as economic and social regional councils, local firms, various associations, chambers of commerce and industry, and university centres.

190. Contracts differ from country to country. In federal countries, they tend to be oriented towards achieving national policy coherence with respect regional decision-making.<sup>93</sup> In unitary countries, they are a way to manage the new assignment of decision-making powers to sub-national levels, while keeping national policy orientations as the main reference. In intermediary situations (“regionalized unitary” countries or “decentralized unitary” countries) a lot depends on the status and role of regions and it is possible to distinguish three main types:

- Planning and programme contracts (France, Poland).
- Implementation contracts (Netherlands).
- Co-operation contracts (Italy, Spain).<sup>94</sup>

191. France has a highly fragmented local government system and local self-government is protected by the constitution. Contracts here are a tool in negotiations between the central government and the regional government (which will be officially nominated in the new law on decentralisation as responsible for the co-ordination of the territorial development policy) for respecting national guidelines and linking local decisions to local decision makers. These contracts are used by many authorities for a variety of different purposes. In Spain, regions have a strong say in national policy although there is no institutionalised participation of regions in national policy making. The instruments filling this institutional gap are numerous councils (involving regions and the central level in key decisions affecting their fiscal, financial, health, and research policies), and contracts. Although in Italy, regions seem to be less involved in national policy making than their Spanish counterparts and contractual relations between the central government and the regions are less developed, many contractual arrangements are made below regional level. In both Spain and Italy, the proliferation of contracts is a consequence of the devolution of responsibility from the central government to the regions, making the state dependent on agreements with the regions and local governments to fulfil some of its duties. This would imply that contractual arrangements are being used to compensate for a lack of institutional integration in the decision-making process. Indeed, they tend to be more developed in fragmented systems than in integrated systems. For example, in France, Italy and Spain, which have fragmented systems, they have a tendency to turn into all purpose instruments for multilevel co-ordination, while in integrated systems, they tend to focus on specific purposes (Germany) or to contribute to a culture of “co-government” where policy making generally involves central government and local government in most policy fields (The Netherlands).

192. In many countries, contracts are financed by transfers from a higher level of government, complemented by regional funds. Through this type of financing, regions gain access to the decision-making process in fields that were previously almost entirely under the central government’s control (this was the case in France for instance, see Box 3.6). The conditions that accompany these transfers vary but, as with all types of contracts, they shape the incentives that influence the behaviour of local governments and give credence to the commitments contained in the contract.

### Box 3.6. Territorial policy through contracts: the state-region planning contract (CPER) in France

The State-region plan contract (*contrat de plan Etat-région*) became a key instrument of the regional development policy just a few years after its creation. Contracts have been passed with all regions for the periods 1984-1988, 1989-1993, 1994-1998 (postponed until the end of 1999) and 2000-2006. The contract is a detailed document, setting out a series of policies and programmes which will be carried out for a certain period. The central government and the region jointly finance the projects in the contract, and recent contracts have included contributions from other local governments and European Structural Funds. The contract includes a financial appendix stating the precise amount of the financial commitment of each party for the period covered by the contract. Contracts do not necessarily imply budgetary transfers between the central government and local governments; instead they usually stress the responsibilities and commitments of each party, while providing a detailed description of the purpose of each measure.

#### *Definition and evolution*

The decentralisation laws have had a significant impact on the State-region plan contracts. As regions have acquired more power over the decision-making process, the contracts have expanded to include new fields, often with larger budgets (increasingly financed by regional and local authorities) and new actors such as intra-regional public actors and representatives of civil society. As a result of this process, planning at the national level has been entirely replaced by State-region plan contracts, which provide the only framework for forward-looking and consultative policy making.

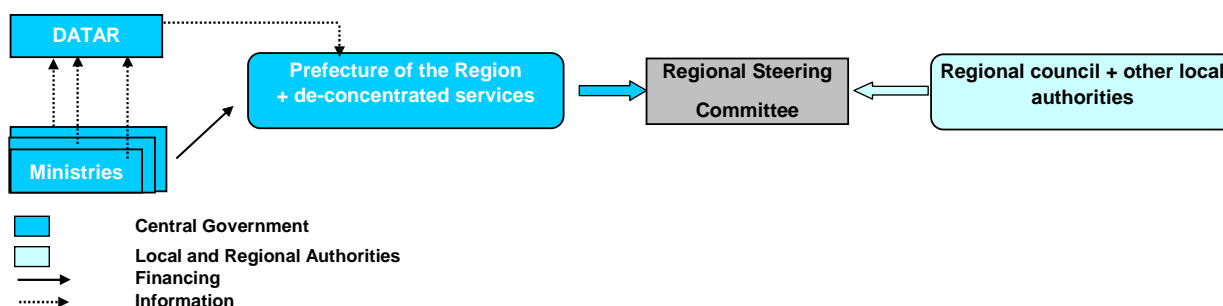
Although the first contracts were mainly devoted to infrastructure projects and the modernisation of industries, the second generation of contracts dealt with a broader range of issues, including regional innovation and urban planning. The third generation of contracts, which covered the period between 1994 and 1999, reflect the government's increasing enthusiasm for extending the scope of this instrument. During this period, the budget for these contracts increased dramatically by over 45%, partly as a result of contributions from new sources such as local authorities and the European funds, which now cover one-third of the budget, while the level of contributions from the regions approached that of the central government. In addition, the central government sought to enable poorer regions to compete on a more equal footing by providing them with a larger share of resources through the contracts (which was seen as an instrument for equalisation), depending on their rate of unemployment, employment perspectives and fiscal capacity indicators. The idea was to promote local development through the contract as a complement to other more traditional programmes using compensation subsidies. The current contract (2000-2006) reinforces this trend. Today the budget is more important and the regional contribution slightly exceeds that of the central government (the contributions of intra-regional entities and the European Structural Funds are about one-third and two-thirds respectively of the size of the regional contribution). Public investment under the contracts accounts for 15 to 20% of the central government budget and for 25 to 30% of the regional council budgets. For instance, in the *Ile de France* (Paris and its neighbouring region) the regional council contributes more than 60% and the central government 39%. Central government participation ranges from 39% (*Ile de France*) to more than 63% (Limousin), reflecting the government's attempts to enable less competitive regions to catch up. The ministries that contribute the most to regional programmes through the contracts are the ministry of infrastructure, transportation and housing (40%), followed by the ministry of education (17%) and the ministry of agriculture (9%). However, the great majority of the different ministries are now involved in State-region planning contracts.

The current planning contract is structured around four areas: sustainable development (which has led policy makers to favour investments in collective transportation and railways rather than roads), employment of all sectors, solidarity (which has led to urban renewal programmes, improvements in the delivery of public services, etc.) and "non-material functions" (such as education, research and development, ICT diffusion, etc.). The current contract contains a new system for classifying projects into the following categories: "regional matters" (*volet régional*), "territorial matters" (*volet territorial* for intra-regional issues), and "inter-regional matters". At least 25% of the contract's budget must be devoted to territorial matters.

**Box 3.6. Territorial policy through contracts: the state-region planning contract (CPER) in France**  
(continued)

*Organisational setting*

The implementation of the planning contract necessitates the participation of various actors; central, regional and local authorities, their representatives and some bodies for intermediation:



The planning contract is the result of a long process of mutual commitment between two different groups of actors: 1) the elected local and regional authorities, and the “development actors” in the region (firms, associations, etc.) under the co-ordination of the regional authority; and 2) the regional “prefect” who is not elected but designated by the state and an “actor of intermediation”. All the regional planned projects are co-ordinated by the Delegation for Territorial Management and Regional Action (DATAR, *délégation à l'aménagement du territoire et à l'action régionale*).<sup>95</sup> Different ministries form steering committees to co-ordinate the actions taken by the central and regional governments in different sectors at the regional level. The main drawback of a contractual method like this one is that it implies a process of negotiation which is often characterised by complex relations among actors and power plays. It is important to note that, under the current generation of contracts, when dealing with territorial development, inter-municipal structures direct transversal projects instead of the steering committees.

*Challenges and potentials*

An evaluation of the current contract will be available in Autumn 2004. The results of this evaluation will probably impact the evolution of the entire State-region planning contract system. Indeed, a number of important problems exist. Delays in the implementation of decisions contained in the contracts may necessitate their extension beyond 2006. In addition, various regional authorities have complained that the Central government is not honouring its financial commitments.

One way to improve the contract planning system would be to make it less dependent on administrative hierarchies and the strict divisions that exist between different fields and instead to develop a more integrative approach that would view territorial actions as a result of the co-ordination among local actors. This has led to a proposal to designate new areas: urban areas as “agglomerations” and rural or intermediate areas as the “pays”. These policies, aimed at developing new territorial structures, can be seen as an incentive for local actors to work towards enhancing local horizontal co-operation in order to create possibilities for bottom-up projects to emerge in accordance with the way in which people actually live in territories (*territoires vécus*). Co-operation between municipalities under these contracts is not just a means of obtaining an optimal size in the provision of local public services, but can also ensure the participation of all relevant local partners in the projects, which in turn benefit from local knowledge and proposals for new initiatives.

*Development initiatives focusing on growth and competitiveness*

193. Although contracts have certain drawbacks, they also present distinct advantages. By making the negotiation explicit, they legitimate local authorities and provide the basis for a joint policy framework. The lengthy period required for preparation, negotiation and the allocation of responsibilities to local decision makers, constitutes a learning process and contributes to the improvement of local competences. Because they often cover long periods of time they contribute to the stabilisation of relationships between levels of government and provide a multi-annual programming budget with a clear allocation of costs. As we have already mentioned they also improve horizontal co-ordination in public administration. Two conditions are necessary to achieve these results. First, only a true process of decentralisation will make it possible for contracts to encompass participative decision-making instead of becoming simply management contracts. Second, contractual arrangements should focus on key issues instead of branching out to cover many different areas (as is the case in Spain), or else, at the very least, a local intermediary body (such as a regional agency, as was recently proposed in Italy) should be introduced to improve co-ordination among the different contracts regarding the region.

194. Four issues remain to be discussed. First, while contracts have numerous advantages, their precise impacts are often difficult to evaluate. The goals of the new territorial development planning system in Japan include a commitment to improving the evaluation of policies. As such, any decision regarding the use of contractual mechanisms in Japan must be accompanied by the establishment of a clearer monitoring system that allows two rather intangible benefits of contract approaches to be evaluated: 1) the improvement of local competences; and 2) the creation of effective networks of decision making as a basis for future co-ordinated action. Second, the trend among countries that have adopted the contract system is to better adapt contracts to “economic and functional areas” rather than to administrative borders. In France for instance, future contracts will be “metropolitan contracts” or “*contrats de pays*”, where the “*pays*” represents an area of cultural and economic homogeneity rather than a strict administrative area (Box 3.6.). The regional blocs in Japan could conceivably play this role of “functional areas” if they have adequate local support and decision-making powers. Third, contracts are usually complex instruments necessitating long periods of negotiation, which can result in parties becoming locked into certain patterns of behaviour and a lack of transparency. It is therefore often more effective to preserve the existing contract and re-negotiate internally rather than to replace the entire contract. Lastly contracts are often presented as more flexible mechanisms than hierarchical co-ordination. However, because of their long-term commitments, it often becomes more difficult to respond to new circumstances. Thus it is necessary to plan “intermediate steps of evaluation and adaptation”, which may be made public, in order to improve the transparency and effectiveness of this instrument.

195. In the ongoing process of decentralisation in Japan, new institutional structures and agreements have developed that could be interpreted as a first step to more co-operative practices across levels of government. At the local level, there are some examples of strategic initiatives involving collaboration and integrated development (the urban-rural partnership programme, the community renovation grant scheme, etc.), but these initiatives remain very local and more oriented towards horizontal than vertical co-ordination. Nevertheless, as reforms progress in related fields such as territorial planning, decentralisation and local finance, and in the context of debate over the introduction of regional bloc structures, it seems clear that more formal mechanisms for vertical co-ordination will be required.

## APPENDIX 1: DECOMPOSITION OF GDP PER CAPITA

| Prefecture | Typology | % Difference in GDP per capita (%) | Labour Productivity (%) | Specialisation (%) | Capital stock (%) | Employment rate (%) | Commuting (%) | Activity rate (%) | Age (%) | Participation (%) |
|------------|----------|------------------------------------|-------------------------|--------------------|-------------------|---------------------|---------------|-------------------|---------|-------------------|
| Hokkaido   | PU       | -9.7                               | -6.4                    | -5.8               | -0.6              | -0.3                | -0.1          | -2.9              | -1.2    | -1.7              |
| Aomori     | PR       | -23.0                              | -22.7                   | -18.8              | -3.9              | -0.7                | 0.1           | 0.4               | -1.9    | 2.3               |
| Iwate      | PR       | -14.1                              | -17.6                   | -13.8              | -3.9              | 0.6                 | -0.6          | 3.6               | -7.0    | 10.6              |
| Miyagi     | PU       | -8.5                               | -6.6                    | -5.3               | -1.3              | -0.4                | -0.1          | -1.3              | 0.0     | -1.3              |
| Akita      | PR       | -21.3                              | -20.8                   | -14.8              | -6.0              | 0.7                 | -0.2          | -1.0              | 11.7    | -12.7             |
| Yamagata   | PR       | -15.2                              | -19.3                   | -11.3              | -7.9              | 1.6                 | 0.0           | 2.4               | -5.9    | 8.3               |
| Fukushima  | PR       | -7.4                               | -7.7                    | -3.5               | -4.2              | 0.3                 | -0.2          | 0.2               | -4.5    | 4.7               |
| Ibaraki    | IN       | -7.5                               | -4.1                    | -1.4               | -2.8              | 0.8                 | -4.7          | 0.5               | -0.3    | 0.9               |
| Tochigi    | IN       | 0.7                                | -2.4                    | 0.3                | -2.7              | 0.6                 | -1.1          | 3.6               | -0.6    | 4.3               |
| Gumma      | IN       | -4.5                               | -8.3                    | 20.3               | -28.6             | 0.7                 | 0.3           | 2.8               | -3.7    | 6.5               |
| Saitama    | PU       | -32.7                              | -8.2                    | -6.5               | -1.7              | -1.6                | -25.4         | 2.5               | 5.6     | -3.1              |
| Chiba      | PU       | -20.7                              | 3.7                     | 2.3                | 1.4               | -1.3                | -24.2         | 1.1               | 3.3     | -2.2              |
| Tokyo      | PU       | 56.5                               | 21.3                    | 5.6                | 15.8              | 1.2                 | 30.9          | 3.0               | 5.7     | -2.7              |
| Kanagawa   | PU       | -10.9                              | 7.5                     | 4.3                | 3.2               | -1.2                | -18.2         | 0.9               | 9.3     | -8.4              |
| Niigata    | IN       | -4.5                               | -7.6                    | -2.4               | -5.2              | 0.9                 | 0.1           | 2.1               | -8.0    | 10.0              |
| Toyama     | IN       | 0.6                                | -6.3                    | -13.0              | 6.8               | 1.1                 | -0.4          | 6.1               | -7.7    | 13.8              |
| Ishikawa   | IN       | -4.7                               | -9.8                    | 41.9               | -51.8             | 1.5                 | 0.4           | 3.3               | -0.9    | 4.2               |
| Fukui      | PR       | 0.8                                | -6.3                    | -12.8              | 6.4               | 1.5                 | 0.5           | 5.2               | -6.9    | 12.1              |
| Yamanashi  | PR       | -8.0                               | -10.4                   | -5.8               | -4.6              | 1.1                 | -1.3          | 2.6               | -3.2    | 5.8               |
| Nagano     | PR       | -3.5                               | -12.5                   | -7.7               | -4.8              | 1.7                 | 0.2           | 7.1               | -5.4    | 12.5              |
| Gifu       | IN       | -13.4                              | -11.1                   | -21.0              | 9.9               | 0.5                 | -6.4          | 3.6               | -1.5    | 5.1               |
| Shizuoka   | IN       | 5.3                                | -2.2                    | -4.1               | 1.9               | 1.4                 | 0.1           | 6.0               | -1.6    | 7.6               |
| Aichi      | PU       | 17.1                               | 9.2                     | 10.7               | -1.5              | 0.9                 | 2.4           | 4.6               | 3.3     | 1.3               |
| Mie        | IN       | -7.4                               | -4.5                    | -9.8               | 5.3               | 0.6                 | -3.6          | 0.2               | -0.4    | 0.6               |
| Shiga      | IN       | 7.4                                | 13.3                    | 18.1               | -4.9              | 0.8                 | -6.1          | -0.6              | 0.2     | -0.8              |
| Kyoto      | PU       | -6.7                               | -2.2                    | -1.3               | -1.0              | -0.1                | -1.2          | -3.1              | 0.5     | -3.6              |
| Osaka      | PU       | 14.6                               | 9.0                     | 5.6                | 3.4               | -1.4                | 10.4          | -3.4              | 3.4     | -6.8              |
| Hyogo      | PU       | -11.2                              | 4.7                     | 3.7                | 1.0               | -1.3                | -9.5          | -5.0              | -0.2    | -4.8              |
| Nara       | PU       | -40.4                              | -4.3                    | -3.7               | -0.6              | -1.8                | -25.8         | -8.6              | -0.4    | -8.2              |
| Wakayama   | IN       | -26.2                              | -16.1                   | -11.9              | -4.2              | -0.3                | -3.8          | -6.0              | -7.0    | 1.0               |
| Tottori    | IN       | -9.5                               | -14.7                   | -10.3              | -4.4              | 2.0                 | 0.3           | 2.8               | -8.6    | 11.4              |
| Shimane    | PR       | -19.0                              | -22.0                   | -15.2              | -6.8              | 1.5                 | -0.2          | 1.6               | -14.3   | 15.9              |
| Okayama    | IN       | -9.7                               | -7.9                    | -0.8               | -7.1              | 0.2                 | -0.5          | -1.5              | -6.7    | 5.2               |
| Hiroshima  | PU       | -3.3                               | -4.1                    | 0.5                | -4.6              | 0.5                 | 0.8           | -0.4              | -0.8    | 0.4               |
| Yamaguchi  | PR       | -6.8                               | -4.3                    | -2.0               | -2.3              | 0.1                 | -0.9          | -1.6              | -7.0    | 5.4               |
| Tokushima  | IN       | -23.1                              | -18.0                   | -13.3              | -4.7              | -0.6                | -0.4          | -4.0              | -5.6    | 1.6               |
| Kagawa     | IN       | -8.1                               | -9.3                    | -4.4               | -4.9              | 0.3                 | 0.4           | 0.4               | -15.5   | 15.9              |
| Ehime      | IN       | -18.2                              | -14.1                   | -9.8               | -4.3              | -0.8                | 0.2           | -3.5              | -6.0    | 2.5               |
| Kochi      | PR       | -24.9                              | -22.1                   | -18.9              | -3.3              | -0.9                | -0.2          | -1.6              | -14.6   | 13.0              |
| Fukuoka    | PU       | -14.4                              | -7.7                    | -8.1               | 0.4               | -1.1                | 0.2           | -5.8              | 0.4     | -6.2              |
| Saga       | PR       | -19.1                              | -17.9                   | -12.7              | -5.2              | 0.4                 | -0.4          | -1.2              | -4.8    | 3.6               |
| Nagasaki   | IN       | -31.2                              | -24.0                   | -18.8              | -5.2              | 0.1                 | -0.3          | -7.1              | -8.6    | 1.5               |
| Kumamoto   | IN       | -19.4                              | -14.8                   | -12.5              | -2.4              | 0.2                 | -0.6          | -4.2              | -6.0    | 1.8               |
| Oita       | IN       | -6.5                               | -2.7                    | -2.1               | -0.6              | 0.6                 | 0.0           | -4.4              | -7.2    | 2.9               |
| Miyazaki   | PR       | -27.7                              | -25.2                   | -20.9              | -4.3              | -0.4                | -0.1          | -1.9              | -5.5    | 3.5               |
| Kagoshima  | IN       | -27.4                              | -20.6                   | -16.8              | -3.8              | -0.3                | -0.1          | -6.4              | -8.4    | 1.9               |
| Okinawa    | IN       | -40.0                              | -23.7                   | -22.2              | -1.5              | -5.5                | 0.0           | -10.9             | -1.7    | -9.2              |

Source: Identifying the Determinants of Regional Performances (Working Party on Territorial Indicators, 2003)

## APPENDIX 2. IDENTIFYING THE DETERMINANTS OF REGIONAL PERFORMANCE (METHODOLOGY FOR APPENDIX 1)

GDP per capita (in logarithms) can be written as:

$$1. \quad \frac{GDP}{Population} = \frac{GDP}{Employment} + \frac{Employment}{Labour\ force} + \frac{Labour\ force}{Population}$$

GDP
Productiv
Employme
Activity  
per capita
ity
nt rate
rate

Therefore, the difference in GDP per capita between a give metropolitan region and the average of all metropolitan regions is equal to:

$$\begin{matrix} \text{Difference} & & \text{Difference} & & \text{Difference} & & \text{Difference} \\ \text{in GDP per} & & \text{in Productivity} & & \text{in} & & \text{in Activity rates} \\ \text{capita} & & & & \text{Unemployment} & & \\ & & & & \text{rates} & & \end{matrix}$$

### Decomposition of differences in productivity

Average labour productivity in region  $i$  is equal to a weighted average of sectoral productivity:

$$2. \quad \frac{GDP_i}{E_i} = \sum_j \frac{E_{ij}}{E_i} * \frac{GDP_{ij}}{E_{ij}}$$

where  $j$  indicates the sector.

From-the-average difference in productivity can be decomposed as:

$$3. \quad \left( \frac{GDP_i}{E_i} - \frac{GDP}{E} \right) = \sum_j \left( \frac{E_{ij}}{E_i} - \frac{E_j}{E} \right) * \frac{GDP_j}{E_j} + \sum_j \frac{E_{ij}}{E_i} * \left( \frac{GDP_{ij}}{E_{ij}} - \frac{GDP_j}{E_j} \right)$$

The first term on the right-hand of the equation measures the proportion of the difference in productivity due to regional specialisation.

### Decomposition of differences in activity rates

Activity rate in region  $i$  is equal to a weighted average of activity rates by age groups:

$$4. \quad \frac{LF_i}{P_i} = \sum_j \frac{P_{ij}}{P_i} * \frac{LF_{ij}}{P_{ij}}$$

where  $j$  indicates the age group.

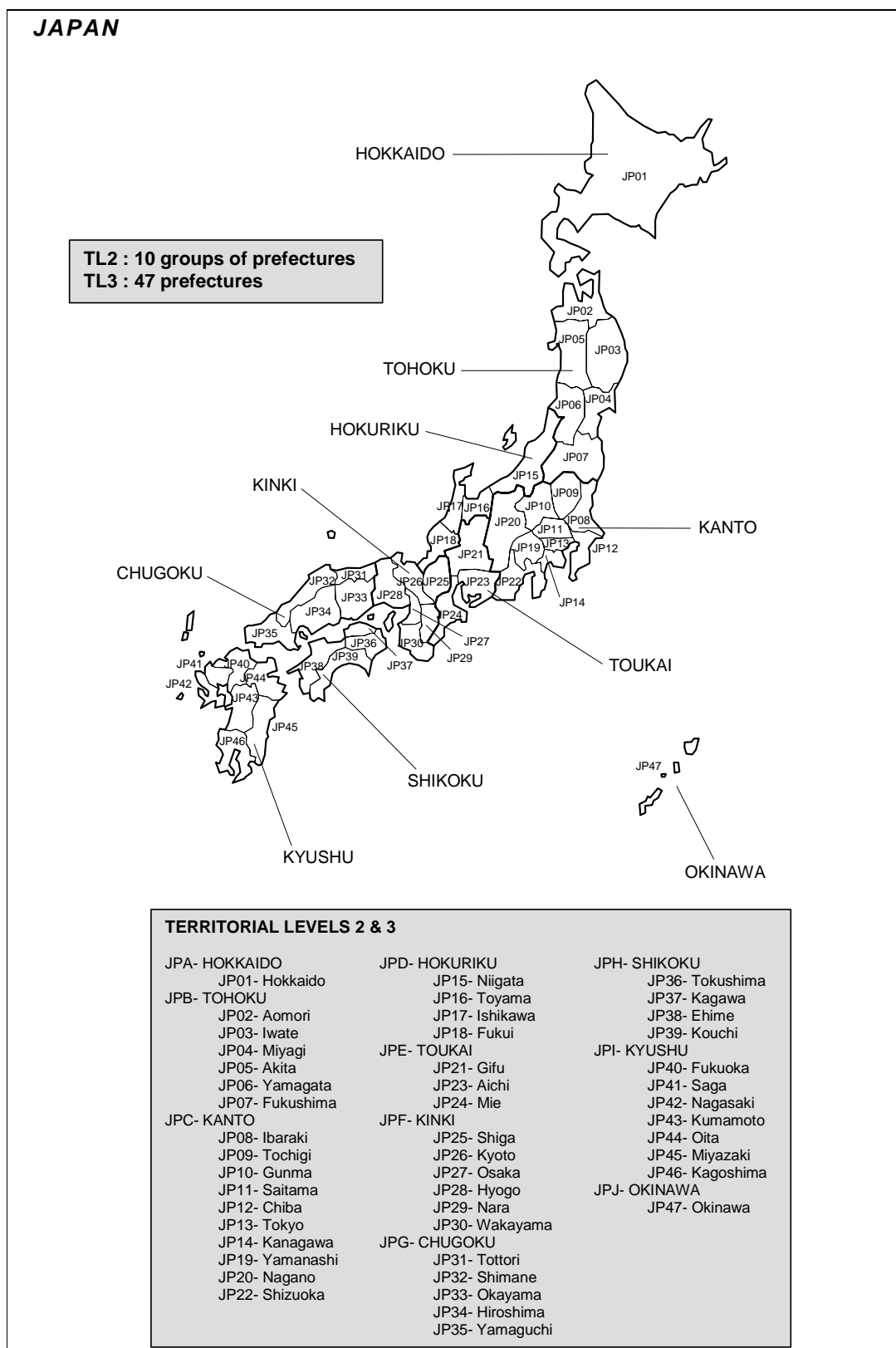
From-the-average difference in activity rates can be decomposed as:

$$5. \quad \left( \frac{LF_i}{P_i} - \frac{LF}{P} \right) = \sum_j \left( \frac{P_{ij}}{P_i} - \frac{P_j}{P} \right) * \frac{LF_j}{P_j} + \sum_j \frac{P_{ij}}{P_i} * \left( \frac{LF_{ij}}{P_{ij}} - \frac{LF_j}{P_j} \right)$$

The first term on the right-hand of the equation measures the proportion of the difference in activity rates due to the age-profile of the regional labour population.



## APPENDIX 3: TERRITORIAL GRID



Source: OECD Territorial Database.

## APPENDIX 4: OVERVIEW OF THE COMPREHENSIVE NATIONAL DEVELOPMENT PLANS

### (1) The 1<sup>st</sup> Comprehensive National Development Plan (1962)

196. After World War II, economic reconstruction, industrialisation and modernisation were priorities and the main focus of development was in the four largest industrial areas – Tokyo, Nagoya, Osaka and North-Kyushu, the so-called “Pacific Belt Zone”. In 1960, Prime Minister Ikeda introduced the “National Income-Doubling Plan”, which sought to double personal income in ten years. The first CND Plan developed to meet these targets, reduce over-concentration in metropolitan areas, particularly Tokyo and Osaka, and promote development in every region. Under the first Plan, the country was divided into three types of areas: over-concentrated areas (the four major cities), developed areas (Kanto, Tokai, Kinki, and Hokuriku) and developing areas (Hokkaido, Tohoku, Chugoku, Shikoku and Kyusyu). The main strategic measures proposed were to develop infrastructure for industry in non-metropolitan areas in order to counteract widening regional disparities, establish large-scale development cores and generate spillovers by linking these developed areas systematically with improved transportation links. The targets for reducing regional disparities included narrowing the range of the index income per capita index levels among regions, from the 1968 range (65 in Tohoku to 110 in Kinki) to the targeted range (79 in Tohoku to 106 in Kinki) with the Kanto region as index 100.

197. Two laws were enacted on the basis of this first CND plan, the New Industrial City Construction Promotion Act (1962) and the Act for the Promotion of Development of Special Areas for Industrial Development (1964). These laws were at the origin of the creation of huge new heavy industry complexes (such as steel and petrochemicals) in coastal areas. Fifteen cities from Hokkaido to Kyushu, most of which were outside the “pacific belt zone”, were designated as New Industrial Cities. In addition, investment in heavy industry became increasingly concentrated in six cities after they were designated as Special Areas for Industrial Development.<sup>96</sup> These measures were complemented by restrictions on the construction of factories and universities in regulated urban zones beginning in 1959 in the Tokyo region and after 1964 in the Osaka region, while construction of industrial parks took place in other suburban areas.<sup>97</sup>

### (2) The 2<sup>nd</sup> Comprehensive National Development Plan (1969)

198. Despite the efforts of the first CND Plan, over-concentration in metropolitan areas and depopulation in rural areas accelerated. The second CND Plan proposed nationwide networks of industrial cores. In this plan the territory was divided into seven blocs (Hokkaido, Tohoku, Capital area, Chubu, Kinki, Chugoku/Shikoku, Kyushu), linked by a transportation and communication network. The plan provided a development guideline for each region to mitigate uneven distribution on congested areas. In accordance with the 2<sup>nd</sup> CND plan, a “Shinkansen” (bullet train) network and a highway network were proposed, on which today’s transportation network is based, even though some routes were never constructed. The accumulated public capital formation written in the plan was estimated at JPY 130-170 trillion (at the price of 1965) and public investment was JPY 30-50 trillion (at the price of 1965) from 1966 to 1985. GNP was expected to reach JPY 130-150 trillion (at the price of 1965), four to five times the level of 1965.

### **(3) The 3<sup>rd</sup> Comprehensive National Development Plan (1977)**

199. In response to the decreasing population inflow to metropolitan areas and increasing levels of environmental pollution, the third CND Plan aimed to maintain and improve the living environment as well as control concentration of population and industry in metropolitan areas through regional development. According to the “Stable Settlement Concept” described that each settlement could fulfil a basic unit of regional development, linked together to other settlements by transportation and communication networks. Nationwide 200-300 settlements could contribute to balanced development. Model Settlement Zones were designated particularly in non-metropolitan areas, which has promoted settlement in non-metropolitan areas and prevented inflow to metropolitan areas. Adopting a pioneering approach to vertical collaboration, the governor of each prefecture collaborated with his municipalities to promote strategies for solving regional problems and formulate plans, while the government applied preferred measures. The accumulated public capital formation written in the plan was JPY 370 trillion (at 1975 prices) from 1976 to 1990.

### **(4) The 4<sup>th</sup> Comprehensive National Development Plan (1987)**

200. In the late 1980s, population inflow to the Tokyo area increased again while severe employment problems arose in many non-metropolitan areas. Under these circumstances, the fourth CND Plan prescribed continuous efforts to promote well-balanced development of national land through strategies described in the previous CND plans including industrial development, a nationwide network and improving living environment. The strategy is creating a multi-polar country, where population and high-level urban functions are not excessively concentrated in the Tokyo area and are shared by other areas. The plan promoted inter-bloc networks, which enabled regions to share functions and co-operate closely with strategic and prioritised development in non-metropolitan areas. In addition, in line with the same policy, the relocation of the Diet and other organisations was approved.<sup>98</sup>

201. Based on the fourth CND Plan, the Multi-polar Pattern National Land Formation Act (Multi-polar Act), which promotes the relocation of national administrative bodies and developing strategic development areas and “business core cities”, was enacted in 1988. Prefectural governments or governments of designated cities can draft basic plans for strategic development areas, and if such plans are approved by the central government, they can benefit from some financial measures such as preferred tax and a special allowance for local bonds. In addition, aiming to prioritise investment in selected local cores to improve urban function and living environment, the Act Concerning the Promotion of the Development of Local Core Areas and the Relocation of Facilities for Industrial Business was enacted 1992. The accumulated territorial infrastructure development by both private and public sectors between 1986 and 2000 was estimated at approximately JPY 1 000 trillion (at 1980 prices) from 1986 to 2000.

### **(5) The 5<sup>th</sup> Comprehensive National Development Plan "Grand Design for the 21<sup>st</sup> Century" (1998)**

202. The most recent CND Plan, entitled Grand Design for the 21<sup>st</sup> Century, and adopted in March 1998, differs somewhat from the previous plans in that it assumes declining pressure on land use over the coming decades, as the population begins to decline, and de-emphasises concerns over concentration in metropolitan areas. Instead it places greater emphasis on sustainable development and quality of life. The plan proposes an ecological network on a national scale including mitigation of the effects of infrastructure development and promotion of recycling, as well as water resource management focusing on “river basin spheres” and the hydrologic cycle. Management of forests and farm lands, where ageing and depopulation is more severely affected, is enhancing exchanges with outer areas, such as green tourism.

203. The plan stresses the importance of transforming the national territory from a "unipolar uniaxial" territorial structure into a multi-axial territory with regions designed on the basis of geographical homogeneity and regional characteristics. These four "axes" are complemented by concepts of mobility and "half-day" travel times within the regions which will have infrastructure development implications. The "Regional Co-operation Corridor" is an interesting idea of local-base collaboration strategies for the national territorial policies to promote a multi-axial structure by developing various corridors nationwide. Each corridor consists of municipalities co-operating with each other by sharing and utilising local resources, functions, and infrastructure, while maintaining and establishing the characteristics and identity of each region, with the common acknowledgement of objectives, which promotes inter-regional co-operation.

204. The Grand Design for the 21<sup>st</sup> Century is an important document because it was designed to respond to requests for clarification of the general philosophy of the planning process, as well as its relevance/links with other major changes taking place in Japan, including decentralisation of power and administrative reforms. The Grand Design accepts the need for a renewal of the planning system in order to ensure that it retains its relevance as the principal instrument for co-ordination and implementation.

## ANNEX

**The division of responsibilities in public service provision**

205. The basic framework for the division of responsibilities in public service provision between the central and the local governments is in the Local Autonomy Law. However, individual laws such as the School Education Law, Welfare Benefit Law and Road Act define a more complex sharing of responsibilities. In addition to the legislated functions, there are also functions that have been delegated from central to local government. As can be seen from the table below, it is common for all three levels of government to participate in the provision of services in a given locality.

|                    |                       | Security and basics                                             | Education                                                                                                                                                                                                      | Welfare and health                                                                                                                                                                                  | Social infrastructure                                                                                                                                                    | Industry and economy                                                                                                                    |
|--------------------|-----------------------|-----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|
| Central government |                       | Diplomacy<br>Defence<br>Judiciary<br>Punishment                 | University<br>Private university aid                                                                                                                                                                           | Pension<br>Social insurance<br>Licence for medical doctor and medicine                                                                                                                              | Highway<br>National road (designated zones)<br>1 <sup>st</sup> -class river<br>Airport                                                                                   | Currency and finance control<br>Tariff and trade<br>Transportation and tele-communication control<br>Economic policy<br>National forest |
| Local government   | <i>Prefectures</i>    | Police                                                          | High school<br>School for handicapped<br>Elementary school and junior high school (salary of teachers and personnel)<br>Private school aid (kindergarten ~ high school)<br>Sport facility<br>Cultural facility | Welfare benefit (town and village)<br>Child care<br>Elderly care<br>Public health centre                                                                                                            | National road (others)<br>Prefecture road<br>1 <sup>st</sup> -class river (designated zones)<br>2 <sup>nd</sup> -class river<br>Port<br>Public housing<br>Urban planning | Local economic development<br>Job training<br>SME consulting                                                                            |
|                    | <i>Municipalities</i> | Fire services<br>Census registration<br>Basic Resident Register | Compulsory education (management)<br>Kindergarten<br>Sport facility<br>Cultural facility                                                                                                                       | Welfare benefit (city)<br>Elderly care<br>Nursing-care insurance<br>Child care<br>National Health Insurance<br>Water and sewerage<br>Garbage and human waste<br>Public health centre (special city) | City planning project<br>Municipality road<br>Secondary river<br>Port<br>Public housing                                                                                  | Local economic development<br>Farmland co-ordination                                                                                    |

Source: Masakatsu Okamoto, "New Introduction to Local Administration", Jiji Press, LTD. (2003).

**Percentages of local and national expenditures by function**

| Activity                         | % expenditure by regional and local government | % expenditure by national government |
|----------------------------------|------------------------------------------------|--------------------------------------|
| Security                         |                                                |                                      |
| Judiciary, police, fire services | 80                                             | 20                                   |
| Welfare and health               |                                                |                                      |
| Health and sanitation            | 94                                             | 6                                    |
| Public welfare (except pension)  | 63                                             | 37                                   |
| Pension expenses                 | 0                                              | 100                                  |
| Education                        | 85                                             | 15                                   |
| Social infrastructure            | 72                                             | 28                                   |
| Land development expenses        |                                                |                                      |
| Industry and economy             |                                                |                                      |
| Local development                | 75                                             | 25                                   |
| Commerce and industry support    | 72                                             | 28                                   |
| Public debt service              | 37                                             | 63                                   |

Source: White Paper on Local Public Finance (2003). Illustrated - MIA.

## NOTES

1. China (including Hong Kong) has accounted for almost the same share of Japan's overall trade as the United States and has been its biggest trading partner since August 2003. As for Japan's imports, the amount from China (including Hong Kong) has also exceeded that of the United States since July 2002.
2. Land prices in January 2004 had fallen 6% from their levels of a year earlier, though it is perhaps significant that the fall in central Tokyo was lower than elsewhere. Bank lending excluding write offs of bad loans fell by 5%, despite increased lending to local government and to individuals.
3. The relocation of many, particularly mass production, facilities abroad triggered crises among medium and small contractors that depended on a small number of larger firms to be their main or sole customer.
4. Ministry of Economy, Trade and Industry (METI).
5. METI, presentation by Regional Economy and Industry Group on "revitalising the Japanese Economy through Innovation".
6. Government rules for health insurance and pensions, as well as companies' benefits for spouses, discourage women from earning more than a modest amount. As a result the central government has decided to abolish the special allowance for spouses in the national personal income tax from next fiscal year.
7. OECD (2003a).
8. Foreign residents with work permits, excluding permanent and long-term residents whose activity is not restricted. Overstayers (most of whom are believed to work illegally) are not included either (OECD, 2004g).
9. In the context of FTA negotiations with Thailand and the Philippines, there have been calls for liberalising the movement of temporary workers and professionals, including nurses, old-age care takers, etc. For this to occur liberalisation, fundamental reforms of labour market and immigration policies – and potentially social security systems – have to be pursued (Kawai, 2004).
10. In 2002, there were 2.8 million job openings and less than 1.6 million registered jobseekers.
11. *OECD (2004d) Economic Survey Japan*, Annex II.
12. See data in Appendix 1 and methodology in Appendix 2.
13. Although Tokyo prefecture's GDP per capita is more than 50% higher than the national average, this figure is somewhat misleading because the commuting factor inflates the city's GDP per capita. At the same time, prefectures surrounding Tokyo are negatively affected by the commuting factor (a similar situation exists, on a smaller scale, in the prefectures surrounding Osaka).
14. During the last decade Japan's output per capita using PPP measures has fallen from 83% of that of the United States down to less than 75% today, close to the OECD average.
15. In terms of nominal GDP, the output of the Kanto region rivals those of the United Kingdom, France and Italy, while that of Kinki is larger than the GDP of Spain, and those of Hokkaido, Chugoku and Kyushu island are equivalent to the GDPs of Denmark, Belgium and the Netherlands respectively. In addition, the emergence of new economies is putting such comparisons in a sharper context: China's GDP already exceeds that of the greater Osaka region and that of South Korea recently surpassed the GDP of the Kyushu region.

16. The territory consists of four major islands and 4 000 smaller islands, with a complex topography including small but steep-sided mountains enclosing areas of flat land, small river floodplains near the sea, and irregular coastlines. Nearly 70% of the territory is covered by forest and the rest is mainly shared by agricultural and urban uses. Although there have been many programmes of land reclamation and levelling, particularly in recent years, there continues to be strong competition for good land between different land uses.
17. The "ratio of people you can meet in one day" is the base measurement for the achievement of the target and is calculated by dividing the proportion of the population within a three-hour trip (one-way) by the total national population. This ratio was somewhat less than 30% between 1965 and 1974 (national average) but has doubled to approximately 60% in the 40 years since then. The disparity among regions is still large, as would be expected given the geography of the country. The ratio is higher than 75% in the three metropolitan areas and the Fukuoka city-area, while in 42% of the national territory and for 8% of the national population, the ratio is equal to or lower than 25%.
18. There were approximately 20.48 million households in England in 2003-2004 (Survey of English Housing, ODPM, 2004).
19. OECD (2002) *Economic Survey 2002*, p. 171.
20. The 2004 government budget contains reductions across most categories of expenditure with the exception of social security, science and SME promotion (*Current Japanese Fiscal Conditions*, Ministry of Finance, Budget Bureau, February 2004).
21. Bachtler and Raines (2002).
22. These evolutions are discussed in John Bachtler and Douglas Yuill (2001), "Policies and Strategies for Regional Development: A Shift in Paradigm?" Regional and Industrial Policy Research Paper, Number 46 (European Policies Research Centre, University of Strathclyde); and in OECD (2001), *OECD Territorial Outlook*, Chapters 1 and 5.
23. Department of Trade and Industry (DTI) and Department for Education and Employment (DfEE) (2001) *Opportunity for All in a World of Change*.
24. Government Decision 9 November 2000 on the Target Programme in accordance with the Regional Development Act 1135/1993.
25. En politik för tillväxt och livskraft i hela landet, 2001/02: 4.
26. The background to this problem is that the plans included requests by local government, often for large-scale infrastructure development, which induces financial transfers from the central government as well as local employment.
27. The background to the second and the third problems is that in a context of uncertainty regarding future socio-economic conditions, the plans specifies infrastructure development projects which are projected to go on for a longer period of time than any other infrastructure development plans and economic plans.
28. The Second Plan for Promoting Decentralization of Power, which the Cabinet adopted in March 1999, stated that a system for taking in account the opinions of local governments in the process of formulating a CND Plan and involving local governments in the formulation of Regional Block Plans should be established.
29. A recent report on the new territorial planning system however suggests a shift of the national goal toward "Enhancing regions' identity and improving competitiveness". A rebalancing of national and local government roles, with greater responsibility for regional and local administrations, is seen as desirable. Urban renaissance, urban-rural inter-relationships and territorial reforms are considered fundamental to this new agenda. More diversity in the economic development strategies and initiatives undertaken by regions



is considered to be the route to improved competitiveness, involving more emphasis on factors like tourism, culture and landscape and a more flexible use of social capital.

30. This policy was promoted through two major laws: the New Industrial City Construction Law and the Law on the Development of Special Regions for Industrial Development.
31. The designated areas covered almost all of non-metropolitan Japan (about 2 600 municipalities), with the relocation zones being Tokyo, Osaka and Nagoya, plus a few “neutral” zones where further industrial development was accepted but not actively encouraged.
32. The Technopolis programme was supported by the “Law for Accelerating Regional Development based on High Technology Industrial Complexes” introduced in 1983.
33. K. Cowling and P. Tomlinson, “The Problem of Regional ‘Hollowing-Out’ in Japan: Lessons for Regional Industrial Policy”, Warwick Economic Research Papers 625, University of Warwick, UK, 2001.
34. Japan has a relatively large SME sector, in comparison for example to that of the United States, and these small firms are a major source of employment and productive capability. About four-fifths of all workers in Japan are employed by SMEs, with more than half of all Japanese workers employed in medium-sized establishments. In manufacturing, Japanese SMEs employ about 72% of all workers and produce about 58% of value-added in the sector. However, the number of SMEs in Japan has declined over the last decade. In 2001, there were just under than 6.1 million small and medium-sized establishments across all sectors, down from about 6.6 million in 1989. Several factors have contributed to this decline, including the weak macro-economic situation in Japan during the 1990s and, in manufacturing, the restructuring of production by larger companies which has cut orders to small suppliers. Most troubling has been a long-term decline, since the 1970s, in start-up rates in Japan, with the rate for exits exceeding the rate for start-ups throughout the last decade.
35. Japan has a long-established and extensive system of small business support. This system provides an array of services including information supply, business and machinery credit insurance and loans, tax credits, R&D subsidies, management training, support for new business creation, assistance with technical upgrading and internationalisation, mutual insurance schemes, assistance with succession, mergers, and the avoidance of bankruptcy, and support for SMEs in specific industries (for example, in textiles). Administratively, the system is complex. There are a series of corporations established to provide SME finance, including the Japan Finance Corporation for Small Business, the National Life Finance Corporation, and Shoko Chukin Bank. The Japan Small and Medium Enterprise Corporation provides start-up, financing, and training support, overseeing more than 50 Credit Guarantee Corporations and nine Institutes for Small Business Management and Technology. SME Business Investment and Consultation companies have been established in Tokyo, Osaka, and Nagoya. A Small Business Innovation Research programme has been established to target parts of selected public research programmes to research commercialization and new venture creation. In conjunction with prefectures and municipalities, there are more than 180 Public Industrial Technology Research Institutes (*kohsetsushi*) for SMEs, 251 regional SME support centres, 54 prefectural SME support centres, and eight SME venture business support centres. Support organisations also include more than 500 local chambers of commerce and industry and thousands of other prefectural and local small business associations and societies. In recent years, many new facilities to foster small business exchange, incubation, and research have been built in Japan, along with local initiatives to form research and new product development consortia involving SMEs and encourage venture financing.
36. *White Paper on Small and Medium Enterprises in Japan 2003*, Fig. 2-4-1, Trends in subcontracting rates (main industries), p. 182.
37. OECD (2002) *Economic Survey Japan, 2002*, p. 172.
38. Although the advantages of industrial agglomeration had been noted in England in the 19<sup>th</sup> century, a string of new observations in the 1980s and 1990s, from the clustering of hi-tech firms in Northern California to

the rising competitiveness of traditional industrial districts in Northern Italy, Southern Germany and indeed leading localities in Japan triggered fresh interest in forms of spatial-industrial organisation where firms and industries gain advantage through intense interaction with each other and with their local environment. Michael Porter, among the most influential proponents, asserts that:

“firms gain competitive advantage where their home base allows and supports the rapid accumulation of specialised assets and skills...Nations succeed in particular industries because their home environment is the most dynamic....and the most challenging and stimulates and prods firms to upgrade and widen their advantages over time.”

Porter's much-cited development “diamond” structure contains four principal factors: 1) a supportive context for firm strategy and rivalry (*i.e.*, policies/regulations that encourage investment and technical upgrading; 2) robust demand conditions (a core of advanced, competitive and demanding customers; 3) related and supporting industries (capable, local suppliers, preferably organised in clusters); and 4) good factor/input conditions (human resources, physical infrastructure, etc.). The system should be animated by dynamic, open competition among locally based rivals. Ann Markusen has enlarged on these ideas by identifying several diverse cluster development patterns, including networked industrial districts, hub-and-spoke clusters, satellite clusters, and institutional clusters. Markusen reminds us that successful clusters can have varied forms, each involving different combinations of SMEs, large firms, and public institutions. These models emphasise that knowledge-based competitiveness is place-specific, depending on the ability of regions to develop and exploit their particular skills, technological-assets, and complementary linkages.

39. National Science Foundation, Tokyo Regional Office, “Third business-academia-government summit: Tokyo, Japan, 17 November 2003,” Report Memorandum No. 04-01.
40. While there is ongoing debate about the strengths of the many new biotech firms established in Germany during the BioRegio programme, at least the programme is associated with significant new firm development. See <http://www.bioregio.com/english/einf.htm>. Also, Nils Omland and Holger Ernst, “Vitalization of Industry through the Regional Promotion of Knowledge Intensive New Firms – The Case of German Biotechnology”, Wissenschaftliche Hochschule für Unternehmensführung, Koblenz, Germany. Paper presented at workshop of Japan Institute for Labor Policy and Training, 26 March 2004.
41. METI presentation.
42. Japan is well placed in aggregate terms, boasting an extremely dense “research infrastructure”. Combined government and private R&D expenditure for fiscal 2000-2001 was JPY 16.5 trillion – behind only the United States (JPY 42.5 trillion) and the EU (JPY 27.1 trillion). As a percentage of GDP this represents 3.29%, which is more than in the United States, Germany or France. Private enterprise led R&D is increasing, and as a result of recent Science and Technology Plans, government funding for research is also rising. Patent activity is very high and there is an extensive national base of productive researchers and advanced research institutions and labs. While the aggregate statistics for research in Japan look strong, there are concerns that these figures are not translating into effective outcomes in terms of commercialisation and enterprise growth in emerging sectors, and that despite high levels of investment, the outcomes from research are not matching those from investments made by other major industrialised nations. In particular there is concern that there is not enough interaction between government and industry in the R&D field, and that this means that important synergies and cost sharing opportunities are lost. For example, there is relatively little participation by private firms in research conducted in government research facilities – only around 3% of research in government labs and higher education institutions in financed by the private sector, which is less than half the OECD average. The range of regulations that restrict the ability of research institutions and their staff to work with the private sector considerably reduce incentives for co-operation, thereby reducing the development of the synergies that are expected to accrue from close links between the research community and industry.
43. The 1999 Industry Revitalization Law (also known as the “Japanese Bayh-Dole Act”) reduced obstacles to collaboration between universities and private enterprises and also allowed private firms to acquire intellectual property rights from publicly-funded research. This has given stimulus to the growth of Technology Transfer Offices in Japan, of which there are now 37. See also: J. Rissanen and J. Viitanen,

*Report on Japanese Technology Licensing Offices and R&D Intellectual Property Right Issues*, The Finnish Institute in Japan, 2001.

44. L. Tornatzky, P. Waugaman, D. Gray, *Innovation U: New University Roles in a Knowledge Economy*, Southern Growth Policies Board, Research Triangle Park, NC, 2002. <http://www.southern.org/pubs/innovationU/>.
45. Southern Growth Policies Board, *Innovation U.: New University Roles in a Knowledge Economy*, Research Triangle Park, NC, 2002.
46. Philip Cooke, "Regional Transformation and Regional Disequilibrium: New Knowledge Economies and their Discontents," in G. Fuchs and P. Shapira. *Rethinking Regional Innovation and Change: Path Dependency or Regional Breakthrough?* Kluwer, 2004.
47. Fukao Report, Executive Summary, p. 2.
48. See The Midsize Cities Technology Development Initiative, <http://www.cherry.gatech.edu/mid/>.
49. "Report on Local Economy and Public Investment", Policy Research Institute, Ministry of Finance (2001).
50. Various EPA models for different periods arrive at similar conclusions: 1<sup>st</sup> year multipliers for investment were between 2 and 2.5 in the early period (from the mid-1950s to approximately 1970) and have fallen to less than 1.5 for models simulating returns on GDP since 1970s.
51. Before the new integrated plan, nine sector-specific plans (on road improvement and management, traffic safety facilities, airports, ports, city parks, sewerage, flood control, erosion of slopes, and coastlines) were individually prepared. The old plans contained expenses for the fixed term, was and were criticised for not making sufficient efforts to reduce costs.
52. Japan's three metropolitan areas, the National Capital Region, the Kinki Region and the Chubu Region, have their own development laws, each of which describes a three-tier development planning system, a basic development plan (approximately 15 years), a development plan (five years) and an implementation programme (one year).
53. The Urban Renaissance Headquarter is chaired by the Prime Minister, with as vice-chairs the Chief Cabinet Secretary and the Minister for Land, Infrastructure and Transport. The other members include the ministers for Finance, Economic Policy, Regulatory Reform, Disaster Prevention, and Environment.
54. Bertrand and Kramarz (2000) "Does entry regulation hinder job creation? Commercial zoning and retailing employment in France", mimeo. Boyland and Nicoletti (2001) "Regulatory Reform in Retail Distribution" OECD Economic Studies, No. 32, Paris; Department of the Environment, Heritage and Local Government, Ireland; Høj *et al.* (1995) "Deregulation and privatization in the service sector", OECD Economic Studies, No. 25, Paris; The New Rules Project, "The Hometown Advantage: Reviving Locally Owned Business"; Pellegrini, (2000) "Regulations and the retail trade", in G. Galli and J. Pelkmans (eds.), *Regulatory Reform and Competitiveness in Europe, 2, Vertical Issues*, Edward Edgar Publishing Limited, Northampton, Massachusetts; Pilat, D. (1997), "Regulation and performance in the distribution sector", OECD Economics Department, Working Paper, No. 180, OECD, Paris.
55. MAFF calculates the external benefits of paddy field cultivation, using the substitute cost method, to be JPY 4 600 billion made up principally of the function of paddy field cultivation in preventing or mitigating flood damage (JPY 1 952 billion), regulating water flow (JPY 739 billion) and preserving rural landscapes as an amenity (JPY 1 711 billion).
56. Ministry of Agriculture Forestry and Fisheries (2002).
57. The Second Plan for the Promotion of Decentralization (adopted by the Cabinet in March 1999) pointed out that this top-down method has to be modified in a decentralised way along with reform of the CND plan: Under the new system, prefecture governments should prepare drafts of these development plans,

based on which Prime Minister (now Minister of Land, Infrastructure and Transport) should finalise the plans.

58. The Law on Emergency Measures for Depopulated Areas was enacted in 1970 for a 10-year period, revised as the Law on Special Measures for Depopulated Areas in 1980, and again as the Law on Special Measures for the Revitalisation of Depopulated Areas in 1990.
59. Case presented at the conference “New Approaches to Rural Policy: Lessons from around the World”, in March 2004.
60. The full report is available from the Economic Development Administration website at: <http://www.eda.gov/Research/ResearchReports.xml>. Porter, Michael E. *et al*, (2004) *Competitiveness in Rural U.S. Regions: Learning and Research Agenda*, Boston: Institute for Strategy and Competitiveness, Harvard Business School.
61. A recent comparison of urban and rural travel patterns by the UK Countryside Agency showed that rural and urban dwellers spend similar amounts of time travelling each day. Although rural journeys are longer, the number of trips and the commuting time are almost the same. The concept of the rural hub depends on good access to services, rather than actual distances.
62. This type of vision has become quite common in OECD countries since phenomena of “counter-urbanisation” appeared to suggest that in some cases smaller cities in rural areas could develop into important economic centres on the basis of good transport linkages, economic specialization, Greenfield development, etc. And that these regional cities can support a large number of rural communities by providing both employment and services.
63. CPRR has just introduced “Market Testing” (competitive tendering between the public and private sector) in various public service areas based on proposals from the private-sector, etc.
64. On 30 October 2002, the “Comprehensive Measures for the Acceleration of Reforms” was finalised, which included a range of structural reform measures to improve the functioning of markets, increase business and consumer confidence and encourage investment.
65. OECD (2004f).
66. Cabinet Secretariat, Office for the Promotion of Special Zones for Structural Reform, *Special Zones for Structural Reform*, Tokyo, August 2003. Presentation made to OECD review team on 7 April 2004.
67. About 30% of proposals for zones for structural reform come from private sector organizations (MLIT response to OECD review questions, February 2004).
68. In September 2004, the Evaluation Committee reviewed 38 of the reforms which have been introduced in the special zones during Round 1 (April and July in 2003). Twenty-six reforms were accepted for nationwide application while another 12 will be assessed in the second half of FY 2004 or the first half of FY 2005.
69. The 15 prefectures which had eight or more approved special zone plans account for 56% of all approved plans and had an average per capita annual income of JPY 3.32 million. The other 32 prefectures with seven or fewer approved zones, which account for 44% of all approved plans, had an average annual per capita income of JPY 2.78 million.
70. For example, on the US experience, see the Department of Housing and Urban Development bibliography of studies on enterprise and empowerment zones, at [http://www.huduser.org/publications/polleg/ez\\_bib/ez\\_bib.html](http://www.huduser.org/publications/polleg/ez_bib/ez_bib.html).
71. One of the main aims of the Regional Development Act in Finland is to encourage a range of central government policies to take account of regional needs and priorities, adapting measures and resources to the strengths and weakness of individual regions. The Dutch White Paper states that it is in the regions that “all the threads of policy meet (and)

can best be knotted together". The key characteristics of this action – as stressed by the Dutch White Paper – are: *flexibility*, in reacting dynamically to competitive challenges; *region-specific responses* that are tailor-made to the strengths of individual regions; and *coherence*, ensuring that the many elements of location policy are brought together at regional level. The UK White Paper recognises that the future requires "a bottom-up approach: the role of central government must be to ensure that all regions and communities have the resources and capability to be winners". The new approach builds on the new Regional Development Agencies and their regional strategies. This approach has been emulated in Sweden through the regional growth agreements and in plans for future regional development programmes.

72. The closest body to a co-ordinating body for territorial policy is the National and Regional Planning Bureau which has developed a new perspective of territorial/regional policy and provided a network for local authorities as well as other local actors. However, substantial integration of these measures and effective policy implementation has yet to be seen due to persistent compartmentalism.
73. An additional system of inter-ministerial consultation – the Policy Adjustment System – was launched recently to facilitate the exchange of opinions and information among departments.
74. Japanese local governments' discretionary taxing powers are higher than in Austria, Germany, Italy and, until recently, Belgium and Spain (See the forthcoming *OECD Economic Survey*, Japan 2004).
75. Among the more fundamental reallocations of policy responsibility are the devolution programmes carried out in the United Kingdom and Italy. In the United Kingdom, territorial devolution, through the creation of a Scottish Parliament, a Welsh Assembly and Northern Ireland Assembly, has transferred *inter alia* responsibility for regional development to Scotland, Wales and Northern Ireland respectively. In England, Regional Development Agencies have been established in each of the nine administrative regions of the country to manage economic development on behalf of the UK government, and there are proposals to set up regional assemblies that will be responsible for overseeing and directing RDA activities. In Italy, a series of constitutional and administrative reforms has had significant impacts on the allocation of regional policy tasks. The so-called Bassanini laws in the 1990s transferred a range of responsibilities and functions to regional and local government. This was followed in more recent years by a series of supplementary constitutional laws which have made subsidiarity – particularly in economic development matters – central to policy making. The transfer of competence is particularly significant in relation to regional development in that at least 40% of the administrative functions related to industrial support have moved from national ministries to sub-national administrations. As a result, the central government's policy powers are specified – or "reserved" – leaving the bulk of other policy powers allocated to regional and often local authorities.
76. From an original 128 assigned functions specified in the Local Autonomy Law, the number had grown to over 500 by 1995 (Barrett, 2000).
77. The decentralisation movements of the early 1990s were the product of three reforms; an administrative reform characterised by deregulation and decentralisation, a political reform including electoral changes, and a local administration reform (Nishino, 1992).
78. The Designated City system was the first large city system introduced in 1956, which allows the Designated Cities to administer the same level of governmental jurisdictions as prefecture government. A Core City System was introduced by 1994 Amendment of the Local Autonomy Law. To be eligible for the Designated City, a city must have a population of over half million. To be eligible for a Core City, a city must have a population of over 0.3 million population (a total area of over 100 km<sup>2</sup> is also a condition if the population is less than 0.5 million).
79. Cuts in earmarked grants are mainly for public works and education. Most of the reduced amount of earmarked grants for education is covered by newly created Special Local Grants and Income Tax Transfer to the local government.
80. Besides National Government Disbursements (17%), two additional local revenue sources are the Special Local Grants and the Local Transfer Tax (LTT), but they only accounted for 1.2% and 0.8% of total local

revenues respectively. The Special Local Grants were established in 1999 and then augmented in 2003 to supplement local revenue shortages caused by tax and subsidy cuts. The LTT is a portion of taxes collected by the central government and then later transferred to the local governments according to objective standards, such as road length in each local area. Its usage is generally specified.

81. A legally defined percentage of each tax is set aside for the LAT: 32% of the personal income tax, 32% of the liquor tax, 35.8% of the corporate income tax, 29.5% of the consumption tax and 25% of the tobacco tax. This system has made the LAT asymmetric to the business cycle; however, it is difficult to reduce LAT in a period of economic downturn.
82. Local government bonds have long been granted an implicit guarantee from the central governments, because most of the repayment costs (interest and principal) are covered by LAT and 27.4% of total local bonds are underwritten by the central government through the Fiscal and Investment Loan Programme (FILP). One criticism is that this has weakened the reliance on market discipline to ensure control of local borrowing, although the Japanese government has persuaded local governments to finance themselves on market principles. Moreover, as part of the objective to strengthen local autonomy, the MIA will abolish the approval system for fiscal loans from FY 2006. The FILP uses various interest-bearing public funds to issue FILP bonds in the financial market to implement infrastructure policies. The reforms to the FILP system have also been fairly extensive. The FILP disbursements have been declining every year for the past five years (to about JPY 20.5 trillion this fiscal year, a 21-year low). The FILP's underwriting of local debt for the 2003 and 2004 fiscal years also dropped from 27.4% of the total to 21.2% of the total. Public-sector loans (including the FILP, central government, postal deposit funds, life insurance funds, etc.) fell from 51.2% of the total to 41.3%, while private-sector purchases (banks and the bond markets) rose from 48.8% to 58.7%.
83. MIA has introduced some amendments to the Local Tax Law including a review of the standard tax rates and object tax (in FY 2004).
84. The new tax items shall include general tax not stipulated in Local Tax Law. The MIA shall give the approval unless the relevant case falls under either of the following categories: 1) the tax bases of such additional taxes are the same as those of national or other local taxes, and burdens to residents would be exceedingly heavy; 2) serious hindrance might arise in distribution among local governments, and 3) such additional taxes are considered inappropriate in the light of national economic policies.
85. The Special Allocation Tax accounts for 6% of total LAT payments and is allocated to jurisdictions suffering from special factors such as natural disasters. According to Akai *et al*, Special Allocation Tax has been used partly for redistributive purposes or to bail out jurisdictions facing financial difficulties (Akai *et al.*, 2004).
86. Even though the Decentralization Package Law provides for a clear separation between the public functions of the different levels of government, and the agency-delegated system was abolished, there are still some overlapping of responsibilities.
87. For example, a report submitted to the meeting of the Basic Policy Section of the National Land Council in November 2002, presented the issue in the following way:

"In order to promote regional development by taking various factors, such as depopulation, globalization and economic/social changes including the IT revolution, into consideration, it will be important to improve "mobility", such as the efficiency of transportation and the liquidity of regional resources, and to be able to respond on a wider level across existing administrative boundaries."

The explicit recommendation was that in promoting formal and informal co-ordination among municipalities and among prefectures, these two principles should be taken into account.

88. The target population of each town or village was over 8 000 in the old municipal merger law of 1953. The 1953 plan for municipal mergers prescribed that the target number of towns and villages be reduced to one third of their original number.
89. In Denmark, the Ministry of Interior has estimated the “economically optimal size” for a municipality (providing childcare, primary schools, elderly care and administrative functions) to be around 20 000 to 30 000 inhabitants. Although the Japanese government has not officially provided the target population of municipalities, the report by the Local Government System Research Council in 2003 states that the prefecture governments should continue to encourage municipal mergers, for example, toward designated cities, core cities and special case cities after April 2005, the date when the existing merger law expires. It also refers to mergers of small municipalities with populations below 10 000 with due attention to socio-economic conditions.
90. The Japanese government has further encouraged municipal mergers by introducing a new system of “Special Districts in Merged Municipalities”, which can be set up as units of old municipalities, and will retain most preferred measures except special bonds after April 2005.
91. Under the new municipal structure, the total amount of current LAT will be calculated as if the previously independent municipalities were not merged. This provision will apply for ten years and will decrease gradually for the following five years.
92. The idea of amalgamation of prefectures, known as *Do-shu-sei*, was first proposed by the Japanese government in the report on future local administration by the Local Government System Research Council in 2003. The basic concept is two-tiered local government with Do (*Shu*) and municipalities abolishing the present prefectures, and elected head and assembly members by popular vote. There is some dispute over the appropriate subdivision of Japan and the number of regional blocks that would be coherent economically and for policy purposes. The Japanese government announced in June 2004 that it would conduct research into the ways in which *Do-shu-sei* could be applied to a region and that a “Special zone for *Do-shu-sei*” should be promoted as a decentralisation model.
93. But for federal countries like Germany where the co-decision of Landers in federal policy is already secured through the Bundesrat and through the numerous inter-ministerial committees linking the Federation and the Lander, the (small) remaining place for contractual instrument is rather “task specific” and devoted to co-ordination issues at a very local level (between the Land authorities and the municipalities concerned by the project).
94. OECD, [GOV/TDPC/RD(2004)4], G. Marcou.
95. DATAR is an inter-ministerial body directly linked to the office of the Prime Minister (which co-ordinates national territorial policy and handles the planning contracts and the European Structural Funds) and receives the different ministries’ information regarding their regional priorities and the strategic objectives identified by the regional prefects. DATAR also plays an important role in the allocation of funds: every year it collects budget requests from the regional prefects and allocates the budget to related ministries, and if necessary organises inter-ministerial meetings with the prefects and the ministries. When the ministries decide the amount of money they will distribute, they inform DATAR which in turn informs the prefects.
96. Both of these laws and related measures were finally taken off the books in 2001.
97. Restrictions had been relaxed according to industrial structure transition and the socio-economic environment, and in 2002, these regulations were also abolished. This deregulation has triggered new industrial policy of private sectors in metropolitan areas.
98. Although most government offices in the plan have been relocated relatively short distance moves, within the Tokyo region or nearby, the relocation of Diet has been left for further discussion. This relocation policy has been controversial due to two opposite opinions on concentration in Tokyo: 1) recent economic

slowdown and progressive ageing may no longer trigger concentration in Tokyo; and 2) the mitigation of concentration is still at a minor level and the congestion level of commuting and traffic is over the capacity (see Chapter 4).



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