The Influence of Decentralization on Allocation of Resources and Government Size

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I. Introduction

The argument about decentralization has been repeated in our country since 1970s. Although the political background has changed recently, decentralization seems to be gaining support among many people. Namely, in 1970s, local government was a strategic footfold, but in 1980s the plot of conservatizm vs. progressivism collapsed, so that it was not a disputed point politically. However, at present, decentralization is highlighted again. The main reasons for this tendency are as follows. First of all, the size of government in our country during the postwar period has expanded rapidly. This is especially true for social security expenses. Therefore, the accumulative budget deficit has taken up as an embarassing problem. Secondly, powerful bureaucracy has emerged especially in central government as the size of government expands. Such an emergence of bureaucracy has deprived local government of its authority, so that each local government has standardized.

As everybody knows, decentralization denotes the transfer of authority from central government to local government. From the viewpoint of economics, however, it matters whether the size of government is controled by decentralization. Namely, whether decentralization give rise to the intergovernmental competition or not is a matter for argument.

The purpose of this paper is to survey the relations between economic theories and decentralization and to show the influence of decentralization on allocation of resources and government size. The paper is organized as follows. In section II we present the model that denotes the relationship between decentralization and allocation of resources. In sections III and IV we survey some theoretical and empirical studies for decentralization and government size. Finally, in section V we provide some conclusions.

II. Decentralization and Optimum Allocation of Resources

The decentralized economy which we will consider in this section is an economy that a
consumer can freely move among regions with seeking the higher level of utility. In this case, it matters whether the decentralized economy satisfies the Pareto optimum or not. If it satisfies the Pareto optimum, central government will not have to intervene local government. If not so, central government will provide ample room to intervene local government. In order to grasp the essence of this point, therefore, we would like to model formally the relationship between the decentralized economy and the Pareto optimum.

We will start from two symmetrical regions. The number of the population \((n)\) is assumed to be constant. The population of region 1 is represented by \(n_1\) and that of region 2 is represented by \(n_2\). The constrained condition of the population is:

\[
\begin{equation}
  n = n_1 + n_2
\end{equation}
\]

The production function of region \(i (i = 1, 2)\) is \(f(n_i) (i = 1, 2)\) and the marginal productivity of labour is assumed to diminish gradually. Moreover every resident living in regions 1 and 2 is homogeneous, he or she consumes private goods (the price is 1) and public goods (the marginal cost is 1) and has the same utility function \(u = u(c_i, g_i) (i = 1, 2)\). On the other hand, the constrained condition of resources is:

\[
\begin{align*}
  f(n_i) + f(n_i) &= n_1c_1 + g_1 + n_2c_2 + g_2 \\
  \text{If every resident can move freely, then the level of utility between regions 1 and 2 will be the same. Namely, this is shown by the following equation:} \\
  u(c_i, g_i) &= u(c_i, g_i)
\end{align*}
\]

Under the circumstances, the Pareto optimum conditions can be get by attempting the following optimum solution.

\[
\begin{align*}
  \text{max} & \quad u(c_1, g_1) \\
  \text{s. t.} & \quad n_1 + n_2 = n \\
  & \quad f(n_1) + f(n_2) = n_1c_1 + g_1 + n_2c_2 + g_2 \\
  & \quad u(c_1, g_1) = u(c_2, g_2)
\end{align*}
\]

The optimum solution of equation (4) can be solved with ease by the Lagrange’s method. This method can be formularized as follows:

\[
\begin{align*}
  \text{max} : L(c_1, c_2, g_1, g_2, n_1, n_2, \lambda_1, \lambda_2, \lambda_3) \\
  &= u(c_1, g_1) + \lambda_1 (n-n_1-n_2) + \lambda_2 (n-n_1-n_2)
\end{align*}
\]

(1) Tiebout (1954) pointed out that the provision of public goods can satisfy the Pareto optimum through “voting with your feet”. The framework of this section is mainly dependent on Mansoorian, A. and G.M. Myers (1997) and Richter, W.F. and D. Wellisch (1996).
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\[ +\lambda_1 f(n_1) + f(n_2) - n_1 c_1 - g_1 - n_2 c_2 - g_2 \]
\[ +\lambda_1 [u(c_1, g_1) - u(c_2, g_2)] \]

where \( \lambda_1, \lambda_2, \lambda_3 \) represent the Lagrange's undetermined multipliers. The first-order conditions of (5) can be shown by:

\[ \frac{\partial L}{\partial c_1} = \frac{\partial u}{\partial c_1} (1 + \lambda_3) - \lambda_1 n_1 = 0 \]  
(6)

\[ \frac{\partial L}{\partial c_2} = -\lambda_2 n_1 - \lambda_1 \frac{\partial u}{\partial c_2} = 0 \]  
(7)

\[ \frac{\partial L}{\partial g_1} = -\lambda_2 \frac{\partial u}{\partial g_1} (1 + \lambda_3) - \lambda_3 n_1 = 0 \]  
(8)

\[ \frac{\partial L}{\partial g_2} = -\lambda_2 \frac{\partial u}{\partial g_2} = 0 \]  
(9)

\[ \frac{\partial L}{\partial n_1} = -\lambda_1 \frac{\partial u}{\partial n_1} (1 + \lambda_3) - \lambda_3 n_2 = 0 \]  
(10)

\[ \frac{\partial L}{\partial n_2} = -\lambda_1 \frac{\partial u}{\partial n_2} (1 + \lambda_3) - \lambda_3 n_2 = 0 \]  
(11)

\[ \frac{\partial L}{\partial \lambda_1} = n - n_1 - n_1 = 0 \]  
(12)

\[ \frac{\partial L}{\partial \lambda_2} = f(n_1) + f(n_2) - n_1 c_1 - g_1 = 0 \]  
(13)

\[ \frac{\partial L}{\partial \lambda_3} = -n_2 c_2 - g_2 = 0 \]  
(14)

Putting eqs. (6) – (14) in order, we can get the Pareto optimum conditions as follows:

\[ 1 = n_1 \frac{\partial u}{\partial g_1} \]  
(15)

\[ 1 = n_2 \frac{\partial u}{\partial c_1} \]  
(16)

\[ \frac{df}{dn_1} - c_1 = \frac{df}{dn_2} - c_2 \]  
(17)

\[ n = n_1 + n_2 \]  
(18)

\[ f(n_1) + f(n_2) = n_1 c_1 + g_1 + n_2 c_2 + g_2 \]  
(19)

\[ u(c_1, g_1) = u(c_2, g_2) \]  
(20)

Equations (15) and (16) represent the optimum conditions of the provision of public goods. The left-hand side means the marginal cost of public goods and the right-hand side does the benefit of them. In equation (17), \( \frac{df}{dn_i} (i = 1, 2) - c_i (i = 1, 2) \) represents the marginal social net product of labor (=MSNPL) with respect to region \( i (=1, 2) \). It

(2) Eqs. (15) and (16) are the corresponding Samuelson Rule for the efficient provision of local public goods.

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Figure 1. The Size of Optimum Population

![Graph showing the size of optimum population.](image-url)

is the optimum condition of the population share that the value of MSNPL between two regions is the same. This is illustrated in Figure 1. In this Figure, if the MSNPL with respect to region 1 exceeds the MSMPL in region 2 as the location point $A$, the inflow of population from region 2 to 1 will take place. This process will continue till it comes to the point $E$. If the MSNPL with respect to region 2 exceeds the MSNPL in region 1, then the phenomenon to the contrary will take place and so that the population size will be equilibrated on the point $E$. As mentioned above, the Pareto optimum conditions in two symmetrical regions are represented by eqs. (15) – (20).

In this model, it is dependent upon the degree of utility whether the resident should move from one region to the other or not. Therefore, we should like to define the point at issue with the indirect utility function. If we assume that the labor will equal the rate of wage. Therefore, the total amount of wage can be represented by $n_i (df/dn_i)$. Further, let us define the rent as $f(n_i) - n_i(df/dn_i)$, as a simplifying assumption. The per capita income of the resident’s is represented by:

$$\frac{f(n_i)}{n_i} = \frac{df}{dn_i} + \frac{R}{n_i}$$  \hspace{1cm} (21)

where $R$ stands for the rent and we will assume that it is equally distributed to the residents. On the other hand, the budget constrained condition of the resident is:

$$\frac{f(n_i)}{n_i} = c_i + \frac{g_i}{n_i}$$  \hspace{1cm} (22)

Therefore, we can formulate the optimum question of the resident as follows:

$$\max : u(c_i, g_i)$$
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s. t. \( f(n_i)/n_i = c_i + g_i/n_i \) \( (i = 1, 2) \) \hspace{1cm} (23)

Solving the question (23), we can get:

\[
1 - \frac{\partial u/\partial g_i}{n_i} = \frac{\partial u/\partial c_i}{n_i} \quad (i = 1, 2)
\] \hspace{1cm} (24)

Equation (24) means that the per capita marginal cost of public goods equals the marginal rate of substitution of public goods for private goods. Therefore, we can get the optimum condition of the resident by adding equations (22) and (24), and thus the optimum amount of public goods \( (g^*_i) \) and private goods \( (c^*_i) \).

The optimum amount of public goods and private goods can be represented as a function with respect to the population \( (n_i) \) \( (i = 1, 2) \) as follows:

\[
c_i^* = c_i^* (n_i)
\] \hspace{1cm} (25)

\[
g_i^* = g_i^* (n_i)
\] \hspace{1cm} (26)

Equations (25) and (26) are called the demand function. Substituting these for the utility function, we can obtain the following equation:

\[
u = u \left\{ \frac{f(n_i) - g_i^* (n_i)}{n_i}, g_i \right\}
\] \hspace{1cm} (27)

Further, substituting (26) for (27), we can obtain the following indirect utility function \( (v) \):

\[
v(n_i) = \left\{ \frac{f(n_i) - g_i^* (n_i)}{n_i}, g_i \right\}
\] \hspace{1cm} (28)

\( V (\cdot) \) stands for the level of utility equivalent to each resident, when the optimum amount of public goods is supplied. Differentiating equation (28) with respect to the population \( (n_i) \), we can get the following equation:

\[
\frac{dv}{dn_i} = \frac{\partial u/\partial c_i}{n_i} \left( \frac{df}{dn_i} - c_i^* \right)
\] \hspace{1cm} (29)

This equation stands for the change in the utility for an additional resident and \( dv/dn_i \) stands for the slope of \( v (n_i) \). If it's value is negative, the population size in region \( i \) \( (i = 1, 2) \) will exceed the optimum population size. If positive, the population size will be less than the optimum size. Therefore, the optimum size must meet the condition: \( v (n_1) = v (n_2) \). This is shown by Figure 2. In this figure, the optimum population size is the point \( n^* \) equivalent for the point \( E \). If the population in region 1 changes to \( \bar{o_1} n_1 \) and that of region 2 changes to \( \bar{o_2} n_1 \), some residents in region 2 will move into region 1. Because the level of utility in region 1 is higher than that in region 2. This movement of population between two regions will last till the point \( E \) comes into existance. Namely, the point \( E \) is
the very equilibrium point and its condition satisfies \(v(n_1) = v(n_2)\).

Here, we would like to consider what implications the decentralized economy model has. Although the model we considered above has some impractical elements, it provides some useful points at issue in arguing about decentralization.

First of all, the movement of residents among regions results in allocation of resources in the sense of the Pareto optimum. Secondly, if residents move among regions with comparing the levels of utility, it will cause local governments to supply public goods of higher quality. Thirdly, Decentralization will be expected to bring about the keen competition among local governments. Therefore, the size of local governments will be smaller than what it is today. With respect to the government size, we would like to deal with in sections III and IV.

III. Decentralization and Public Choice

To estimate decentralization from the viewpoint of Public Choice is the main point at issue in considering politico-economics over decentralization. Because the Public Choice theory hopes to display its originality in the analysis of politico-economics.

Generally, the Public Choice theory tries to explain the activities of central government. In many cases, it emphasizes that the estrangement from the optimum provision of public goods is caused by the democratic system or organization and that the growth of

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(3) If each region is heterogeneous, this hypothesis will not be realized. For instance, it is true for a different production function and a different fixed amount of land among regions.
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government lasts over a long period. From the context of the Public Choice theory, it is
of importance whether this estrangement can be get rid of by decentralization.

Some of economists raise objections against whether the abuses of the political process
in this century — what we call political failure — are positive phenomena as the
Public Choice theory asserts extremely. This argument has some ideological colors.
Frankly speaking, the precausions against the growth of government in the Legan Govern­
ment, the Thatcher Government and the Nakasone Government were dependent on con­
servatism. On the other hand, the standpoint in opposition to conservatism was socialism
and in the European Continent the influence of social democracy on economic policies is
still intensified.

The way of economists’ looking at political failure are varied. The methods of the anal­
ysis — in particular, the positive analysis — which the public choice theory adopts
have been acknowleged within the academic world. But many economists belonging to
the Eastern States (for instance, in Harvard University, MIT, and so on) do not regard
political failure as questionable.

The purpose of this section is to take up political failure as a factor of excessive, ineffi­
cient activities of government and to examine whether decentralization can remove of
political failure or not.

It is said that one of the causes of political failure lies in the bias of bureacracy toward
the expansion of the public expenditure. Niskanen assumed that bureacrats would maxi­
mimize budgets as a way of maximizing utility. Pay, prestige, power and promotion are all
assumed to be positive utility sources and to be a direct function of the bureacrat’s
budget. The only constraint which the bureacrat is seen to face is that the total benefit of
public services to consumer-voters should not exceed the total cost.

The basic Niskanen model is shown in Figure 3. The total benefit function for the
median voter (TB) is given as:

\[ TB = aq - \frac{b}{2}q^2 \]  

(30)

where a and b are the parameters and q denotes the provision of public services. The
median voter’s marginal valuation (the marginal benefit) is given by V:

\[ V = \frac{d(TB)}{dq} = q - bq \]  

(31)

(4) Castle (1982) pointed out that parties of the right may be in favour of an increase in
expenditures on defence and education, while parties of the left may favour expenditures of
a social welfare character.

(5) See Niskanen (1971).
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The marginal valuation curve is also the median voter’s demand curve. The total cost \((TC)\) of providing public service output is:

\[
TC = cq + dq^2
\]

where \(c\) and \(d\) denote the parameters. Therefore, the marginal cost \((MC)\) is

\[
MC = c + 2dq
\]

The Niskanen-type bureaucrat will produce public output where \(TB = TC\), having negotiated as large a budget as possible. Output in this case is set where \(q = \frac{2(a - c)}{2d + b}\). This compares with the optimum level of output set at \(MB = MC\); that is, \(q' = \frac{a - c}{2d + b}\). A comparison of Figure 3-(a) and 3-(b) shows that the bureaucratic choice model results in levels of public output and hence public expenditure which are the Pareto inefficient.

By the way, if decentralization makes progress and the competition between local

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(6) If bureaucrats aim at maximizing residents’ net benefits, public output will be produced where \(MC = MB\).
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governments is aggravated, the officials of local government will take action towards a way of maximizing the net benefit of residents. The bias of bureaucracies in the Niskanen model would be relaxed by the competition between local governments. The official of a local government must be subject to the median voter's budget constraint \( w + tpq = y \)

where \( w \) = private goods consumed by the median voter; \( t \) = the tax share perceived by the median voter; \( p \) = the price of the goods; \( q \) = quantity of public services and \( y \) = the median voter's income). He also has no choice but to abide by the rule of budget that the revenue generated must at least cover his costs \( (pq \geq c) \) where \( c \) is the perunit cost of public services, which is assumed to be constant).

As the official will push the median voter's utility down to \( u^0 \) (\( u^0 \) suggests the utility associated with zero output and zero budget), the constraint

\[
u(w, q) \geq u^i
\]

will in fact be binding, so that the indifference curve for \( q \) (given \( w \) and \( u^i \)) is:

\[
q = q(w, u^i)
\]

As the median voter's budget constraint is \( w = y - tpq \), this can be substituted into \( (6) \) to give:

\[
q = q(y - tE, u^i)
\]

where \( E = pq \). Given the definition of the net benefit of the median voter \( (B) \),

\[
B = E - cq(y - tE, u^i)
\]

the slope is:

\[
\frac{\partial B}{\partial E} = 1 + ctq,
\]

where \( q_1 \) is the derivative with respect to \( E \).

Therefore, in Figure 4, a net benefit-maximizing official will be at the point:

\[
1 + ctq_1 = 0
\]

Figure 4. The Trade-Off between Net Benefit and Budget Size
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and a budget-maximizing Niskanen-type model as mentioned above will be shown by:

\[ E = cq(y - tE, u') \]  

(39)

In Figure 4, the initial equilibrium of the official is the point 1 on \( I_b \) (where \( I_b \) suggests the indifference curve of the official). As income increases, the net benefit budget function is pushed out. If the official's preferences are homothetic, then a location on the new equilibrium will be the point 2 on \( I_b \). This point cannot be optimum. Because the official can raise his utility by choosing the point 3 which is the point of intersection on the indifference curve and the net benefit budget function.

As mentioned above, in the assumption of maximizing the net benefit, there is the trade-off between the net benefit and budget size. If the official tries to maximize the net benefit of median voter's towards decentralization, the budget size will be smaller than the size of the Niskanen model. Namely, the public expenditure will be cut down by the competition among local governments. What we must refer to here is that smaller local governments are realized as the degree of decentralization intensifies.

IV. Decentralization and Government Size

Numerous studies have been devoted to the analysis of the relationship between decentralization and government size. The best known argument among them is the decentralization hypothesis of Oates. He suggests three points as effects of decentralization on government size. First of all, in the budgetary relationship between central government and local government, if the budgetary authority is concentrated on central government, the competition among local governments will be obstructed. Consequently, The size of local government would expand more and more as well as that of central government. This effect is called the centralism effect. Secondly, if individual local governments are divided on a small scale, their discretion and authority will be restricted by intergovernmental competitions. Therefore, the expansion of local government size would be controlled. This effect is called the fragmentation effect. Thirdly, the consolidation among local governments or the integration of subordinate government into upper government does not only cause the expansion of government unit but also the strength of the governmental authority. Namely, the size of local government will be expected to expand in a budgetary sense. This effect is called the consolidation effect.

The centralism effect as mentioned above indicates the extent to which budgetary


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authority concentrates on upper government and to which the size of government expands through it. For instance, the ratio of central government expenditure to general government expenditure is regarded as an index of the centralism effect. The higher this ratio is, the weaker the degree of decentralization become. Moreover, If the centralism effect is large, we will expect the budgetary size to tend to become large. The reasons for it are as follows:

(1) Since the competition does not exist in central government, it exhibits its authority and discretion as a monopolistic unit but not as a competitive unit.
(2) Central government has more authority over bond issue and taxation than local government has.
(3) Central government can impose the cost of providing local public goods on the whole of society, through logrolling in a political process. (Therefore, the excess provision of public goods will take place with ease.)

On the other hand, if local governments are subdivided into small units, the competition among local governments will be encouraged further. Consequently, each local government would lose control of its discretion and operate efficiently. This constrained effect of the division of local government on its size is called the fragmentation effect. In order to grasp this effect in a positive analysis, substituional variables such as the number and population size of local governments are often utilized.

Most of the positive analyses for the decentralization hypothesis introduce variables which represent the degree of fiscal concentration and fragmentation into ad hoc functions. For instance, Oates estimates the following regression equation by using cross section data on state governments in the United States.

\[ R = f(G, F, y, N, UR, S) \]  

where \( R \) is the ratio of the state and local governments revenue to the state citizen income, \( G \) is the ratio of the state expenditure to the state and local governments, \( F \) is the number of local governments, \( y \) is the per capita state income, \( N \) is the population size, \( UR \) is the degree of urbanization, and \( S \) is the ratio of the federal subsidies to the general funds in the state and local governments.

\( G \), the degree of fiscal concentration, in the above-mentioned equation it is taken to give the large size of state government, having a \([+]\) sign. If \( F \), the degree of fragmentation, represents a \([-]\) sign, the size of state governments will be restrained by the

\[ \text{(8) This regression equation is not derived from a theoretical framework. Such an ad hoc estimated equation seems not to be appropriate to testing a hypothesis.} \]

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Table 1. Empirical Examples for the Decentralization Hypothesis

<table>
<thead>
<tr>
<th>authors</th>
<th>data</th>
<th>dependent variables</th>
<th>centralism fragmenting effect</th>
<th>subsidiary effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oates (1985)</td>
<td>state cross section</td>
<td>LR/Sl</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Nelson (1986)</td>
<td>state cross section</td>
<td>LR/Sl</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Nelson (1987)</td>
<td>state cross section</td>
<td>LR/Sl</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Marlow (1988)</td>
<td>time series</td>
<td>GE/GNP</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Grossman (1989)</td>
<td>time series</td>
<td>GE/GNP</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Zax (1987)</td>
<td>county cross section</td>
<td>CE/CI</td>
<td>+</td>
<td>+</td>
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<tr>
<td>Zax (1989)</td>
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<td>-</td>
</tr>
<tr>
<td>Joulfaian &amp; Marlow (1990)</td>
<td>state cross section</td>
<td>GE/Sl</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes:
(*) LR is state + local governments revenue, SI is state income, GE is general government expenditure, GNP is gross national product, CE is county expenditure, and CI is county income.
(*) The affirmative (negative) result for each effect has a [+ | -] sign respectively.

Intergovernmental competition. Namely, the fragmentation effect could be recognized. The Oates estimation, however, has no its significance for either effect and represents the negative conclusion for the decentralization hypothesis.

Various approaches and their tests toward the decentralization hypothesis have been attempted since the Oates estimation. As noted in Table 1, those tests have a diversity of results. Because in taking the unit of governments or in quantifying the size of governments, the analysts respectively use a different index. As for the unit of governments, for instance, Nelson estimates the fiscal centralism effect with respect to the state and local governments. On the other hand, Marlow and Grossman estimate it with respect to the federal and state governments. Moreover, Zax proves it in connection with the borough and county governments. As for quantifying the size of governments, Zax and Nelson use the size of the state and local governments expenditures, in contrast to the Oates estimation.

As for the subsidiary effect which is represented by S, Grossman proves that the size of government expands through a decline of regularity in costs and benefits of public goods and services, if the ratio of the federal subsidies to the state and local governments revenues increases. Joulfaian and Marlow also conclude that the increase in the federal

(9) See Nelson (1986).
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Subsidies causes the expansion of government size through the intergovernmental competitions. As mentioned above, the analysts do take hold of explanatory and explained variables at a different level. As represented in Table 1, therefore, there is diversity in their empirical conclusions. However, the following points can be pointed out from this table. Firstly, the centralism effect tends to be supported in connection with the federal and state governments. In particular, this tendency can be seen in time series analyses. Secondly, the fragmentation effect tends to be supported in connection with the county and borough governments. We should say that the regional competition is easy to take place in a narrow area such as a county and borough, but not in a wide area such as a state and local government. Thirdly, the estimated results for the subsidy effect are not uniform. The reason for it will be because the analysts estimate it at various levels of governments.

V. Concluding Remarks

In this paper we considered the influence of decentralization on allocation of resources and government size. Then, we made the following points clear.

(1) If we assume that every region is symmetrical and every resident move freely for maximizing his utility, the efficient allocation of resources will be accomplished through the interregional competitions. If the above-mentioned assumptions are not be realized, the interventions of central government will be approved.

(2) From the viewpoint of Public Choice, if decentralized governments provide local public goods and services at the level of maximizing net benefit of residents, the size of government expenditures will be smaller than the case of centralized governments.

(3) According to the Oates-type models, the correlations between decentralization and government sizes at various levels are not similar by the analysts.

As mentioned above, we could complete the conclusion that decentralization controls the government expansion at the theoretical levels. However, we can not argue for and against this conclusion at this stage. Some empirical analyses which are presented in the final section are imposed various restrictions on data, and they involve embarassing questions in testing the hypothesis strictly. The tasks which ought to be imposed on us in the future, are to develop the theoretical analyses which can discriminate outward

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correlations from economic and constitutional mechanisms behind them.

References


