SUB MODULE 1  CENTRAL-LOCAL RELATIONS

Case Study 3 - “National financial support towards the mergers of municipalities”
In this case study, we will look at the financial support of the central government to promote mergers between municipalities.

Background (and Impact) of Mergers among Municipalities
According to the Ministry of Internal Affairs and Communications (MoIAC), the background (and impact) of the ongoing mergers among municipalities are stated as follows.

1. Promotion of decentralization
   - The Comprehensive Decentralization Law, (1999) has encouraged administrative systems to be based on independent decision-making and self-responsibility.
   - Local competition among local public bodies has been based on local independence
   - A certain level of size and capability (authority, financial resources, and human resources) are required to implement various unique administrative policies

2. Progression of an aging society
   - It is inevitable that Japan will be faced with an aging society. To maintain an adequate standard of services provided by municipalities, a certain level of population (within each municipality) is required.

3. Increasing demands on wide-area administration
   - With a widened scope and range of the lives of citizens, the demand increases for wider administration, extending beyond individual municipalities. A new unit for municipality management is required.

4. Promotion of structural reform
   - More simple and effective administrative management is required for central and local governments, in the midst of their tight financial situations.

5. Changes over time: 50 years after Showa’s mergers (from 1955)
   - For example, a new unit for municipality management is required to deal with fast developing transportation and communication matters.

Considering the above conditions, it is necessary to strengthen the financial foundations of the municipalities, which are the basic local government bodies. The most effective way to achieve this is by promoting the merger of municipalities.
Financial support to promote municipalities’ mergers

The MoIAC has offered four different forms of financial support for a limited period of time in order to promote mergers.

- **Through the Regular Allocation Tax (RAT)**
  1. **Special case for the RAT calculation**
     - For 10 years following the merger, the government will guarantee an amount of the RAT, which is calculated individually without considering the merger. In addition to this, the government will also provide emergency relief measures to ease drastic changes over the next five years.
  2. **Temporary expenses incurred for the merger**
     - Financial support will be provided for expenses necessary to integrate two or more administration systems (relating to designing and revising a basic concept, building a network, etc.)
  3. **Financial support for merger promotion projects by prefectures.**
     - Provide the RAT for expenses of the research and enlightenment/education projects for the merger.

- **Through the Special Allocation Tax (SAT)**
  1. **Financial support for merged municipalities**
     - Comprehensive measures and assistance in dealing with building the new town, financial adjustments to offset the difference in public utility charges and adjustments to deal with past bond issues between the municipalities involved in the merger, plus support for sound management of a land development public company.
  2. **Financial support for the expenses of merger preparation**
     - Assistance with the expenses incurred by the arranging committee for merger discussions, and for preparing the merger
  3. **Financial support for the expenses of conducting the merger**
     - Support for expenses to establish an integrated system, such as a computer system, in order to establish integrity between the merged municipalities
  4. **Financial support to even up the expenses of issued bonds**
     - Provide compensation for advanced redemptions in order to even up the expenses of past bond issues of each municipality before the merger
  5. **Measures supporting the subsidies offered by prefectures for the mergers**
     - Support for subsidies offered by prefectures to projects that are conducted by
the existing municipalities or by the merged municipalities in the recommended merger areas

* merged municipalities: municipalities newly installed after the merger or municipalities that include part or all of other municipalities.
** municipalities involved in a merger: a municipality, part or all of which will become another municipality after a merger.

- **Through Special Local Government Bonds for the Merger** (hereinafter referred to as a Special Bond)
  1. Financial support for construction projects for the merged municipalities
     - A Special Bond is issued to mature 10 years after the merger, to cover 95% of expenses of certain town planning projects. In the case of public enterprise projects, a special bond will cover up to 100% of the expenses. 70% of the redemption expenses of the issue of special bonds can be covered by the RAT.
  2. Financial support for creating funds to give life to the merged municipalities
     - A Special Bond (95%) can be applied towards the creation of funds to invigorate former municipalities and foster a sense of unity among their residents. RAT can also be applied to cover 70% of its redemption (interest and principle).
  3. Financial support for construction projects to promote mergers
     - "Local government bonds for promoting mergers" (hereinafter referred to as Promotion Bonds), are issued to cover 90% of project expenses to construct public facilities. These can be arranged by several municipalities involved in a merger within the recommended merger areas. The RAT may be applied to cover 50% of its redemption costs (interest and principal).
  4. Financial support for the projects offered by prefectures to promote a merger
     - Promotion Bonds are issued to cover 90% of construction expenses to build the infrastructure to integrate merged municipalities, such as streets and roads for agricultural purposes, in the recommended merger areas. The RAT may be applied to cover 50% of its redemption costs (interest and principle).
**Subsidy by national expenditure**

1. **Subsidy for merger preparation**
   - Municipalities that are members of a legal council (where merger issues are officially discussed) are entitled to receive a subsidy of JPY5 million (per municipality) for their merger preparation expenses.

2. **Subsidy to municipalities involved in a merger**
   - A subsidy is provided to the municipalities involved in mergers and in projects based on town planning. Subsidy amounts from JPY60 million to JPY300 million will be provided, depending on the size of the merger, for three fiscal years.

**Incentives of “Special Local Government Bonds for Merger” (Special Bond)**

Among the four forms of financial support mentioned above, the Special Bond provides the strongest incentive for municipalities. It is issued to provide financial support to the merged municipalities for their various projects based on town planning. Issued amounts of this bond can be up to 95% of the project expenditures. In addition, the central government offers the RAT in the following year for 70% of its redemption costs. [The RAT will be offered for 66.5% (i.e. 95%X70%) of the project expenditure]. This assumes that municipalities will be able to implement projects as long as they bear 33.5% of their expenditure, based on a zero interest rate environment. This gives small-sized municipalities with weaker financial foundations a strong incentive for merger.

**Picture**

![Diagram showing the financial support model for the Special Local Government Bonds for Merger](image)
**Examples**
The following newspaper articles discuss the impact of special local government bond issues on mergers.

<table>
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<th>Bubble economy brought by Special Bond Issues</th>
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<td>“Yellow light” for local finance immersed in debt</td>
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In July 1999, the Special Municipal Merger Law was revised. This revision introduced a new category of local government bond, called the "Special Local Government Bonds for Mergers"("Special Bonds" for short) for merged municipalities. This bond favors merged municipalities, since it practically guarantees that 70% of issued amounts will be paid by the central government. It is expected to ease the effort to build new towns. At the same time, it has been pointed out that new municipalities may be laden with huge debts.

Sasayama City in Hyogo prefecture, born in April 1999, has issued Special Bonds in order to construct its new city. Its Special Bonds issue is expected to reach an upper limit of JPY19.16 billion. The city has already begun projects worth JPY14.0 billion, which amounts to 73% of the total amount.

Its main projects are mostly construction related, such as the construction of a waterway at the Aono dam (JPY3.8 billion), construction of a crematorium (JPY1.9 billion), construction of a museum for children (JPY1.7 billion), construction of a library (JPY1.7 billion), and roads (JPY1.2 billion). The construction projects will be further extended to other needs, such as an athletic park with a heated pool and a hot spa center.

Such an amount of construction is frowned upon by the secretary-general of the Chamber of Commerce and Industry. “We call it a Merger Bubble. We were advised that mergers were necessary for decentralization. However, the results we see are construction of buildings. Although it is a favorable bond issue, 30% still remains our debt. We should be worried for our future.”

By the end of this fiscal year, the balance of issued bonds will reach around JPY53.3 billion. The restriction ratio on bond issues will reach 13.9%, dangerously close to the 14.0% threshold, recognized as the alert zone.

Kumamoto Nichi Nichi Sinbun, June 18th 2002
Criticizing a “knocked-up” settlement

“How many Special Bonds can be issued?”, “Is it guaranteed that funds can be used in Kodama town?” At the Kodama town assembly, on January 20th, questions and concerns raised in relation to the merger with Honjo City were all about Special Bonds. Both cities agreed to merge within 2 months, which is the shortest time on record in the prefecture. For Kodama City, the main reason for the merger were the Special Bonds.

In the last five years, Kodama town built several facilities, including a gymnasium (JPY1.9 billion) and an athletic park (JPY1 billion). As a result, its financial situation has been in bad shape. In FY2003, the ratio of local debt service (ratio of the cost of interest and principal to general revenue) went up to 14.0%, very close to the alert zone. Despite this situation, Kodama town still sought funding for the reconstruction of the Kodama junior high school. The school’s construction was not earthquake-proof and this issue had been shelved for more than seven years. Although the cost for reconstruction was estimated to be around JPY3 billion, the town faced the problem of funding the project. National subsidy could only be used for a very small part of the entire project.

Attention was then drawn to the Special Bonds. The town assembly said, “. . . the only way we can fund this reconstruction is through the Special Bonds.” By using the Special Bonds, the national government would subsidize 70% of the town’s expenses.

Merger, however, did not take place easily. Initially, six cities, towns, and villages started the discussion for merger, but it fell through after the residents in Misato town declined to participate in the merger. After this, Kodama town sought a merger with Shinkawa town, but a bribery incident by the chairman of the Kodama assembly foiled the plan. The assemblymen who supported a merger panicked and approached Honjo to discuss a merger.

Within the town assembly, some criticized the rush for a merger, but others who supported the merger were satisfied, since this meant the town has now found a source to fund its building infrastructure.

*The Asahi Shinbun, May 11th, 2005*
Survey showed only 20% would use Special Bonds

A survey conducted by *The Asahi Shinbun* revealed that only 20% of local governments would issue Special Bonds up to their limit. The Special Bonds are recognized as the “carrot” to encourage mergers for local governments with financial problems, since the national government would take care of two-thirds (maximum) of project expenses. However, local finance problems are so severe that local governments cannot even afford to pay their one-third portions.

This survey was sent out in mid-March to 189 cities, towns, and villages that were born from mergers between April 1999 and March 1st, 2005. 178 cities, towns, and villages responded. 36 towns, cities, and villages (20%) replied that they would issue Special Bonds to the maximum limit. 90 towns, cities, and villages (51%) said that they would not issue Special Bonds to the maximum limit. The last 30% responded, “Other”, indicating that they had not decided how much they would spend.

Most local governments who answered that they would not issue Special Bonds to the maximum. One said, “the more Special Bonds are issued, the bigger the future burden will be” (town in Aomori prefecture).

Imabari City, built in January this year following the merger of 12 towns, cities, and villages, was eligible to issue JPY55.5 billion worth of Special Bonds. However, the city decided to limit its issue to JPY30 billion as it recognized the debt burden associated with it, in spite of the advantages of special bond issues.

The Trinity reform\(^1\) conducted by the central government has adversely affected new cities and towns. In FY2004, the LAT for numerous local governments were reduced without replacement by any new sources of tax revenue. A repeat of the same situation can be expected in FY2005. Due to this loss of revenue, some local governments have had to reconsider their issue of Special Bonds. For example, Sado city in Niigata prefecture, born in March 2004, had planned to build gymnasiums and libraries, etc. by issuing Special Bonds up to the maximum of JPY49.5 billion over the next ten years. However, with LAT receipts lower than anticipated, the general account budget for FY2005 is JPY3.7 billion less than the year before. This forced the city to reduce its Special Bond issue and suspend the construction of new facilities, with the exception of school construction.

Other local governments, such as Tsushima city in Nagasaki prefecture, are trying to control the issue of normal local government bonds and utilize Special Bonds to yield greater benefits to the local government.

*The Asahi Shinbun*, April 2nd, 2005

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\(^1\) Decentralization measure started in 2003 by a) reducing National Treasury Disbursement, b) transferring source of tax to locality (to replace a and c), and c) reforming (reducing) local allocation tax.
Summary and Case Study Discussion

- The background that precipitated the creation of a national policy for mergers of cities, towns, and villages was characterized by “decentralization, expansion of living areas, and a worsening local finance”.
- Local governments that have decided to merge with others will be entitled by the system to receive assistance from the central government for certain merger expenses. It is advantageous to local governments to arrange financing through bond issues, as it provides an incentive for mergers to take place.
- Government financial inducements for mergers have caused merged local governments to borrow money through bond issues. This has become a source of controversy, as it often worsens local finance.