Sub-Module 5: The Local Bond System and its Role

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Section 1. Development of the Local Bond System

The fiscal resources of local governments include local taxes, grants/allocation taxes, and local bonds. Local bonds are the public debts of local governments. In many countries, local borrowing is an important source for financing long-term development projects such as roads, bridges, and waterworks. Local borrowing for such projects is justified on the ground that benefit of these projects often last decades and the cost of these projects should be borne by future tax payers.

However, the issuance of local bonds that leaves a burden on future residents and which might lead to macroeconomic instability cannot be permitted without limitation in decentralized local government. Looking at China, from 1994 to 1998, a significant degree of autonomy was granted to provincial governments. The provincial governments then engaged in excessive borrowing from the local branches of the central bank in order to meet fiscal demand. As a result, distortion began to occur in fiscal policy and the macro economy became destabilized. In the case of Brazil, the state governments borrowed so much from influential commercial banks that management of the macro economy fell into crisis (Rodden, Eskeland and Litvack, 2003).

If it is recognized that unlimited issuance of local bonds by decentralized local governments cannot be permitted, what controlling mechanisms should be used? Should control be left entirely to market discipline? Should control be implemented by using rules converted into numerical values? Or, should the central government control local bonds through a strict approval system? Sub-Module 5 will examine the role of local bonds and means of controlling them, using Japan’s experience as a reference.

1-1 Overview

Let’s begin by taking a comprehensive look at local bonds in Japan. First, a historical examination of the percentage of outstanding local debt against national income reveals the following. The figure and table show the ratio of outstanding local debt to GDP and the
weight of local bonds in revenue for the past 55 years.

In the 1910s and 1920s—i.e., in the years prior to World War II—local bonds were issued primarily by large cities as a source of revenue for infrastructure investment, such as roads and urban planning. Then, in the 1930s, local bonds were issued with the implementation of public works projects in rural areas as part of Japan’s first fiscal policy, known as Takahashi’s Fiscal Policy.

From the time immediately following World War II until 1974, local taxes and the local allocation tax using major national taxes as its funding pool, which were the fruits of rapid economic growth, were sufficient to cover expanding expenditures. Although local bonds were issued to develop the infrastructure demanded by economic growth (roads, bridges, ports and harbors), outstanding debt against GDP ratio fell to 5% or less during this 20-year period.

Local finances reached a major turning point with the oil crisis of 1974-75. The oil crisis and continuing austerity measures in its wake led to stagflation. The gap between expenditure and revenue widened, and this led to a dramatic increase in the relative level of outstanding local debt to 15-20%. This period marked the start of local bonds being used for the purpose of supplementing revenue sources, and the beginning of borrowing by the local allocation tax special account from the Trust Fund Bureau as a mainstay of local finance policy.

During the bubble economy of the late 1980s, the trend toward rising outstanding debt was stopped and debt incurred through the local allocation tax special account, which could be described as an adverse legacy of the oil crisis, was repaid.

However, entering the 1990s, the percentage of outstanding local debt against GDP once again reached a new high—from 14% to 36%—and shows no signs of falling. A level of 30% or more is high not only when looking at Japan’s history but also when compared to European and North American countries.
1-2 Unique aspects of Japan’s experience

What points does Japan’s experience offer when looked at from the perspectives of developing countries and economies in transition? Japan is currently entering a period of transition in which administrative controls in place since World War II are being reduced in favor of fiscal rules and market discipline.

In order to ensure that local governments do not go bankrupt in Japan, issuance of local bonds has traditionally been controlled by combining administrative control, which is typified by the bond-issuance approval system, and rule-based control, which sets upper limits for repayment of principal and interest. In other words, while permission from the Minister of Internal Affairs and Communications is required before local bonds can be issued, for local bonds that have received such permission, the entire amount of future expenditures for repayment of principal and interest is appropriated in local fiscal plans, and macro-level revenue sources are ensured through the local allocation tax framework, etc. Investors and financial institutions can lend to financially weak local governments without conducting individual examinations of credit risk. Furthermore, a framework is set up whereby the Ministry of Internal Affairs and Communications supervises the fiscal situation of individual local governments and grants them permission to issue bonds, while on the other hand prohibiting local governments whose debt expenditure ratio exceeds a certain limit from issuing bonds. In worst-case scenarios, a system of organizations for fiscal reconstruction is used to place local governments in danger of bankruptcy under the direct control of the
central government. Thus, it was generally accepted that local governments would not default on their loans under this "implicit government guarantee".

However, there was a side effect in "implicit government guarantee": the more the framework to prevent bankruptcy was developed, the weaker market discipline and the restraint by taxpayers became. The fact that this problem did not come to light is because of the following. Looking at a breakdown of the fund-raising structure of local bonds, while about 40% were private-sector funds, the total of Trust Fund Bureau funds and Japan Finance Corporation for Municipal Enterprises reached 60%; thus, the fund-raising structure was dependent upon public funds. And, approximately three-fourths of the so-called "private-sector funds" were private placement bonds that procured funds from designated local financial institutions through mutual negotiation. Thus, the share of publicly-advertised bonds that target a wide and unspecified number of investors through banks and securities companies was less than 9%. In other words, the structure was set up so that taxpayers and investors could not supervise local governments through issuance and distribution of local bonds even if they wanted to.

Despite this, the environment surrounding local bonds is changing through shifts in the fund flow to local governments resulting from reform of the central government's investment and loan programs, etc., and local bond system reform that is in line with the process of decentralization. From this standpoint, review of the "implicit government guarantee" system is inevitable.

First, the fund-raising structure of local governments must be changed from the traditional one centered on public funds to one centered on private-sector funds. As a result of the enactment of the Trust Fund Bureau Fund Law in April 2001, it was decided that the requirement to deposit the entire amount of postal savings and the pension reserve fund in the Trust Fund Bureau would be abolished, and that these funds would be managed autonomously in financial markets together with the postal life insurance reserve fund. Because of this, postal savings, the postal life insurance reserve fund, and "fiscal loan funds" (in which the central government issues national bonds and subleases them to local governments) are declining drastically.

Second, the fund-raising structure is not the only aspect that is changing in the environment surrounding local bonds. The Comprehensive Decentralization Law, which was enacted in 2000, calls for the abolition of the local bond approval system in FY2006 in favor of a “prior
consultation system”. At the heart of the consultation system is the fact that local governments would be allowed to issue bonds even without an agreement with the Ministry of Internal Affairs and Communications. However, unlike local bonds that were issued under the approval system, bonds that are issued without ministry approval following the shift to the consultation system would not be eligible for central government guarantees. In this way, “implicit government guarantee” is decreasing in line with abolition and reduction of administrative control. This change requires mechanisms—fiscal rules and market discipline—that will provide regional fiscal restraint in place of government guarantees.
Section 2. Grounds for Local Bonds and Fiscal Discipline

2-1 Justification of local bonds

At the foundation of local bonds is the philosophy that, while local residents should bear the expenditures of public services that benefit them, they should not have to bear the expenditures of those that do not. Put more specifically, this philosophy is made up of the following four points (Council of Europe, 1997).

Point 1: Local bonds are appropriate as a revenue source for capital expenditure. Capital expenditure provides benefits not only during the time of construction but also to future generations. If local bonds are used, the principal and interest can be paid back using future tax increases; thus, the users of public services bear the cost of the services, which is a fair approach. In Japan, Article 5 of the Local Finance Law provides a restrictive list of projects for which public bonds can be applied: a) revenue source for expenditures pertaining to transportation, gas, water supply, and other enterprises undertaken by local public enterprises; b) revenue source for investments and loans; c) revenue source necessary for renewal of local debts; d) revenue source for expenditures pertaining to temporary measures, recovery works, and relief measures in time of disaster; and e) revenue source pertaining to expenditures for construction works and procurement of land by governments whose local tax rate is above the standard tax rate. Of these, a) and e) are appropriate as local bonds for capital expenditure.

Point 2: Use of local bonds is not appropriate as a revenue source for current expenditure. This shifts the burden for benefits received by current residents to future residents who will not receive the same benefits, and therefore it is not fair. However, there are cases where use of public bonds to cover current expenditure is allowed. Local governments must sometimes implement emergency measures to deal with unforeseen circumstances. For example, it is never certain what kind of damage may be caused by such natural disasters as typhoons and earthquakes. Also, major incidents that require large police and medical expenditures to deal with terrorist activities may occur. Because local governments do not have the ability to raise taxes in a short amount of time, local bonds represent one of the few options they have to temporarily cover unanticipated expenditures.

In Japan, this standard is not strictly observed. “Temporary fiscal countermeasure bonds” (so-called “deficit local bonds”) were incorporated into local loan programs in 2001. Prior
to this, the central government’s allocation tax special account borrowed in lump sums to cover shortfalls in local allocation tax, and each local government came to procure shortfalls in their general revenue sources through deficit local bonds. The debt of each local government was ambiguous in lump-sum borrowing in the allocation tax special account; however, starting in 2001, each government’s amount of debt has become clear through the deficit local bonds.

Point 3: Local taxes should not be used as a revenue source for the capital expenditure of local governments. Here, only current residents bear the costs of capital expenditure, and thus it is unfair that the benefit of public services will be received by future residents. However, there are cases where surpluses in local taxes and current accounts (current expenditure minus current revenue) can be used to cover capital expenditure. For example, even though future residents cannot participate in decisions on the amount of local bonds to be issued, if current residents also take on the tax burden, the amount of bonds issued may not become excessive. Furthermore, lenders such as banks may feel it is desirable to cover some project expenditures with local tax after considering credit risk.

Point 4: Use of local taxes and usage fees as a revenue source for current expenditure can be permitted. Because current expenditure leads to benefits for current residents, current residents should bear the burden with taxes.

2-2 Maintaining fiscal discipline

Local bonds are vital in improving the infrastructure that is essential in community living. However, unrestricted issuance of local bonds by decentralized local governments cannot be permitted. The reasons are as follows (Rodden, Eskeland and Litvack, 2003; Council of Europe, 2002).

The first is that there is the possibility that local governments could go bankrupt. A merit of decentralization is that the level of local public goods is determined so that marginal benefit and marginal cost balance out in each region. However, because insufficient consideration is given to social costs in issuance of local bonds, the possibility exists that excessive public services will be provided. For example, there are cases where a local government borrows to cover current expenditure, but refuses to pay principal and interest at a point in the future. If the local government goes bankrupt, burdens are shifted to the lender (financial institution, etc.) through debt forgiveness. If a local government goes bankrupt when the
central government must guarantee the repayment of principal and interest, national taxpayers take on the burden of repaying principal and interest. The costs of public services for current residents should not be borne by non-residents or future residents. Occasions may occur when the failure of some local governments lowers market evaluation of sound local government finances, which then affects other local governments.

One of the rare cases of local bond default in Japan was in 1925, when Rumoi Town in Hokkaido defaulted on municipal bonds. In the postwar era, a financial crisis loomed during an economic recession that followed the Korean War (1954). At this time, 70% of prefectures and 40% of municipalities were running deficits. However, this crisis was averted in 1959 and no local governments defaulted on their local bonds. Nonetheless, at the present time, “third sector” bodies such as land development corporations that purchase land after receiving financing from financial institutions with debt guarantees from local governments are facing a crisis. “Third sector” public corporations having weak supervision by local government councils number 1,654. Of these, 47.2% are running current-account deficits, and 3.7% have fallen into excessive debt (2003). The number of public corporations whose debt is guaranteed by local governments is 1,017, and the outstanding debt of these corporations has reached 6,813,500,000,000 yen. For example, land development corporations own large amounts of idle land for long periods of time without having any clear ideas on how to use it; this situation is referred to as the local government “time bomb”. Disclosure of information on financial statements, etc., is required if sound fiscal management is to be achieved.

The second reason is that promises by the central government not to bail out local governments that are facing bankruptcy (i.e., the “non-bailout policy”) cannot always be credible. Local governments occasionally face bankruptcy after reckless projects that were implemented without proper thought fail. However, in the same way that promises not to engage in negotiations with hijackers who have taken hostages are frequently broken, central government promises not to engage in bailouts lack credibility. If local governments know beforehand that public promises by the central government cannot be credible, they will engage in excessive spending, put insufficient effort into taxation, and intentionally increase borrowing. Local governments come to depend on bailout measures by the central government, and thus moral hazard likely occurs in the form of lax fiscal management.

In Japan, the Local Fiscal Reconstruction Promotion Measures Law covers crisis
management pertaining to local bonds. The law involves a system that aims for fiscal reconstruction by managing local finances under the direction of the central government before local governments default on their local bonds. Here, it appears that, with the self-confidence it gained in using this scheme to overcome the local fiscal crises of the 1950s, the central government intends to ride out the current local fiscal crisis without designing any new systems. However, because of the framework through which the principal and interest of local bonds are repaid with the local allocation tax, it is estimated that the repayment obligation that local governments recognize as their own responsibility amounts to approximately half of their outstanding local bond loans (Mochida, 2004). When delays in repayment of local bonds emerge, or when local governments that refuse to make payment come to light, it is unclear whether the central government's commitment to its non-bailout policy can be sufficiently credible. Because of this, whether or not to establish laws that stipulate bankruptcy standard requiring local debt repayment will likely become a topic of study in the near future (Ishii, 2000).

2-3 Fiscal rules and market discipline

If it is recognized that unlimited issuance of local bonds by decentralized local governments cannot be permitted, what controlling mechanisms should be used? Methods for controlling local bonds in order to maintain fiscal discipline can be classified into four types (Ter-Minassian and Craig, 1997; Jourmard and Kongsrud, 2003): a) market discipline (Canada and, until recently, Brazil); b) coordination between central and local government (the Scandinavian countries, Australia, and Germany); c) fiscal rules (United States, Switzerland, and Spain); and d) administrative control (United Kingdom, France, and Japan).

Table: Strategies for ensuring fiscal discipline

<table>
<thead>
<tr>
<th>Administrative control</th>
<th>Central government-led rules</th>
<th>Institutionalized coordination</th>
<th>Market discipline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece, Ireland, Japan, South Korea, UK</td>
<td>Hungary, Italy, New Zealand</td>
<td>Australia, Belgium, Denmark</td>
<td>Canada, Mexico, US, Germany</td>
</tr>
</tbody>
</table>


Fiscal cooperation

In fiscal cooperation between central and local government, representatives of both sides sit down and determine the limits of local outstanding debt and fiscal deficit through consultation and negotiation, rather than the central government deciding these items in a one-way manner. Fiscal cooperation is employed in countries having federal governments and in the Stability and Growth Pact of the EU. An advantage of this method is that it raises
local commitment to maintenance of fiscal discipline. However, in many cases, there is no legal force obliging representatives of states and regions to have their individual governments put agreements into effect, and thus there is a limit to its effectiveness. The fiscal cooperation approach is not used in Japan.

**Administrative control**

Control of individual issuances of local bonds by the central government is referred to as administrative control. The forms most often used include setting the maximum amount that an individual local government can borrow and use of a bond-issuance approval system (including approval of repayment periods and issuance conditions). In general, unitary countries that are centralized, small-scale, and highly homogenous tend to depend on administrative control. Examples are the UK, France, Japan, and South Korea. Conversely, administrative control is not always successful in countries where local governments have access to a variety of credit (state-owned banks and public enterprises), the regulatory capacity of the central government is weak, and states and regions are large and diversified. Examples of failure are India and Brazil (Rodd, Eskeland and Litvack, 2003). Administrative control of local bonds tends to be abolished or scaled back in line with steps toward decentralization. Although the Japanese government has employed a bond-issuance approval system for more than half a century, in FY2006 this system will be abolished in accordance with the Comprehensive Decentralization Law (2000) in order to strengthen local autonomy and self-responsibility.

**Fiscal rules**

The “fiscal rules” method refers to the control of local bonds using objective numerical goals established by the central government. Typical fiscal rules include the balanced budget rule, “golden rule” that permits local bonds for investment only, and issuance limitation using the debt service ratio (ratio against the tax revenue of expenditure for public bonds). Even in countries that depend on market discipline, such as the United States and Canada, many states and provinces use the balanced budget rule in order to improve bond ratings. The most advantageous aspects of fiscal rules are their simplicity and comprehensibility to the all. Conversely, however, they have the apparent disadvantages of lacking ability to enforce execution of rules and of tending to invite attempts to find “loopholes”.

In Japan, if a local government’s debt expenditure ratio used at permission to issue local bonds is above a certain level, a portion or nearly all of its public bonds will not receive approval. Furthermore, if a local government’s fiscal deficit exceeds a certain size, it will be
designated as a “local government under a financial rehabilitation plan” and will not be allowed to issue local bonds unless it aims for fiscal rehabilitation under central government management. Because it is very humiliating for local governments to be classified as local governments under a financial rehabilitation plan, this framework can be interpreted as having some ability to force local governments to obey fiscal rules.

**Market discipline**

A method for offsetting the disadvantages of fiscal rules and ensuring sound fiscal management in local governments is market discipline. The United States and Canada do not have government offices with overall jurisdiction over local government finances, such as Japan’s Ministry of Internal Affairs and Communications. Thus, they do not have local bond approval systems and the central government does not participate in decisions pertaining to the issuance conditions of publicly offered local bonds. For loans, as well, public funds having longer terms and lower interest rates than private-sector loans—like Japan’s Trust Fund Bureau funds and treasury funds—are not offered. Consequently, local governments generally procure funds in capital markets based on their own creditworthiness. Issuers having low bond ratings also have high borrowing rates, and thus local governments are forced by the market to raise their creditworthiness.

In Japan, as well, the impact of “market discipline” on local finances has been gaining attention in recent years. One reason for this is the gap between the issuance conditions of local bonds and national bonds in the secondary market. Around the fall of 1998, a “declaration of fiscal emergency” in Osaka Prefecture was reported in newspapers, which led to spreading concerns in markets that the prefecture would default on its local bonds or that, in some cases, local governments would go bankrupt, thus impacting on debt repayment. This resulted in the emergence of a gap in the issuance conditions of local bonds and national bonds in the secondary market. Furthermore, looking at earnings yields in the local bond secondary market, the Tokyo metropolitan area had the lowest yield followed by Japan’s six largest cities, with Osaka and Hokkaido having slightly high yields. In the financial crisis of 1997, Hokkaido’s regional economy faced serious economic decline due to, among other factors, the failure of the Hokkaido Takushoku Bank. The Ministry of Internal Affairs and Communications has continually explained that this was caused by the low name recognition and local bond liquidity of local government bodies, and is working to convince institutional investors that default risk is not being reflected. However, there are those that feel that there is a gap in credit risk, as the period of time within which debt repayment is possible for Osaka Prefecture (a value obtained by dividing outstanding debt...
by local tax revenue) is 17.8 years while that of the Tokyo metropolitan area is 9.9 years (Mochida, 2004).

However, "market discipline" has its limits. Preconditions for the effective function of market discipline are: a) sufficient information disclosure on the borrower’s burden and repayment capacity is conducted; b) portfolio regulations on financial institutions (quotas on issuance of national bonds and local bonds, etc.) are not in place; c) the central government’s commitment not to bail out lenders when borrowers default on debts can be trusted; and d) borrowers can quickly take steps, including quick policymaking, that match market signals (worsening bond ratings, etc.) prior to their becoming unable to take on new loans (Ter-Minassian and Craig, 1997). Only a limited number of countries can meet all of these conditions. Thus, sole dependence on market discipline alone is not thought to be a wise option in developing countries and economies in transition.
Section 3. Japan’s Local Bond System

3-1 Issuance of local bonds

Local bond revenue accounts for around 12% of local government revenue. Since 1990, dependence on local bonds has been rising dramatically (see table).

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Share of settled revenue (%)</th>
<th>Fiscal year</th>
<th>Share of settled revenue (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1880</td>
<td>-</td>
<td>1950</td>
<td>6.0</td>
</tr>
<tr>
<td>1890</td>
<td>0.9</td>
<td>1960</td>
<td>4.6</td>
</tr>
<tr>
<td>1900</td>
<td>7.3</td>
<td>1970</td>
<td>6.5</td>
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<tr>
<td>1910</td>
<td>12.4</td>
<td>1980</td>
<td>9.8</td>
</tr>
<tr>
<td>1920</td>
<td>10.6</td>
<td>1990</td>
<td>7.5</td>
</tr>
<tr>
<td>1930</td>
<td>23.7</td>
<td>2000</td>
<td>12.5 (15.8)</td>
</tr>
<tr>
<td>1940</td>
<td>10.7</td>
<td>2004</td>
<td>11.8 (15.7)</td>
</tr>
</tbody>
</table>

Note: Figures in parentheses include extraordinary fiscal measures bonds and borrowing by the allocation tax special account.

Although ranked as exceptions to no-loan policies, the following are listed in law (Article 5 of the Local Finance Law) as being undertakings for which local bonds can be issued: a) revenue source for expenditures pertaining to transportation, gas, water supply, and other enterprises undertaken by local public enterprises; b) revenue source for investments and loans; c) revenue source necessary for refunding local debts; d) revenue source for expenditures pertaining to temporary measures, recovery works, and relief measures in time of disaster; and e) revenue source pertaining to expenditures for construction works and procurement of land by governments whose local tax rate is above the standard tax rate.

However, in addition to items based on Article 5 of the Local Finance Law, issuance of local bonds also includes exceptional bond issuances through a variety of special laws. These issuances are exceptions to the “golden rule” limiting local bonds to investment purposes and cover a wide range. Specifically, such issuances include revenue source bonds to cover revenue shortfalls in local fiscal plans; compensation bonds to make up for revenue lost due to economic fluctuations; extraordinary fiscal measures bonds that are issued in place of borrowing in the allocation tax special account; compensation bonds to make up for revenue lost due to local tax cut; and extraordinary fiscal measures bonds to alleviate the impact of reduced national treasury grants.
Abolition of the bond-issuance approval system

During the course of the half-century between the 1950s and 2005, prefectures have had to receive the central government’s approval to issue bonds, while municipalities have had to receive approval from prefectural governments. This setup is intended to prevent excessive local government debt as well as maldistribution of funds to affluent local governments. Although free bond issuance in which approval is not required legally exists in principle (Article 226 of the Local Government Law), Article 250 of the same law stipulates that the system requiring approval by the central government or prefectural governments should remain in place “for the time being”.

In order to strengthen the autonomy and self-responsibility of local governments, the “Comprehensive Decentralization Law” of 2000 calls for the abolition of the approval system for local bonds in FY2006 and a shift to a prior consultation system. Under the new system, the issuance of local bonds will not be determined based on authoritative approval but rather on consultations with the Minister of Internal Affairs and Communications and others. Local bonds that receive the consent of the Minister, etc., will continue to have public fund allocations and inclusion of principal and interest repayment in local fiscal plans guaranteed. However, local governments will be permitted to issue bonds simply by reporting this fact to their local councils beforehand, even if they do not receive the consent of the Minister, etc. In other words, a difference in the degree of central government responsibility to provide “implicit government guarantee” will emerge between local bonds issued under the current approval system and local bonds issued following the shift to the consultation system.

Regardless, the Ministry of Internal Affairs and Communications will continue to carefully supervise the financial situation of local governments in order to ensure that local governments do not default on their debts. The debt expenditure ratio used at permission to issue local bonds (kisaiseigen-hiritu) will be used as a judgmental criterion in such supervision. The debt expenditure ratio used at permission to issue local bonds is the average ratio of interest payment costs for public bonds (excluding those disposed of with the local allocation tax) against general revenue sources over the past three years. The definitional equation for this is as follows:
Debt expenditure ratio used at permission to issue local bonds

\[ \frac{A - (B + C + E)}{D - (C + E)} \]

A: Public bond cost  
B: Revenue earmarked for public bonds  
C: Bond repayment cost included in basic financial needs as disaster recovery expenditure in calculation of the ordinary local allocation tax  
D: General-purpose resources (i.e. mainly ordinary taxes, LAT and the Local Transfer Tax)  
E: Bond repayment cost included in basic financial needs through public works modification in calculation of the ordinary local allocation tax

If a local government’s debt expenditure ratio used at permission to issue local bonds exceeds 15%, it will be required to formulate a plan to rectify public bond burden, and will be obliged to lower its debt expenditure ratio to 13% within seven years by securing revenue and cutting expenditure for each fiscal year. Furthermore, if this ratio exceeds 20%, the range within which the local government can issue bonds will be significantly limited. In general, 15% is seen as the “warning line” and functions as the upper limit for absorbing public bond cost.

Financial rehabilitation plans

In the event that a local government’s fiscal deficit exceeds a certain level, it will be designated as a “local government under a financial rehabilitation plan” and will engage in fiscal rehabilitation under central government management. The definitional equation for this is as follows:

\[ \text{Net revenue and expenditure ratio} = \frac{\text{Revenue} - \text{expenditure} - \text{revenue sources to be carried over to the next fiscal year}}{\text{Local tax} + \text{local transfer tax} + \text{local allocation tax}} \]

In the event that a local government’s net revenue and expenditure ratio exceeds -5% (prefectural government) or -20% (municipal government), its issuance of bonds will be restricted. This restriction will be lifted if the financial rehabilitation plan submitted by the local government at this time is approved by the Ministry of Internal Affairs and Communications. However, local governments running deficits will be designated as a “local government under a financial rehabilitation plan” and will be placed under the management of the central government. Although short-term financing and a special local
allocation tax are provided to local governments under financial rehabilitation plans, these
governments are forced to reduce excessive personnel, cut salaries, raise their collection of
usage and handling fees, and take other measures under the jurisdiction of the central
government. Although a fiscal crisis occurred amid an economic downturn that followed
the Korean War (during which 70% of prefectures and 40% of municipalities ran deficits),
the fiscal rehabilitation system resulted in this crisis ending in 1959 with no defaults on local
bonds. The most recent example of a local government under a financial rehabilitation
plan is Akaike Town in Fukuoka Prefecture. Akaike became a local government under a
Currently, no local governments are designated as local governments under financial
rehabilitation plans.

Local governments are occasionally said to “fall” into the “local government under a financial
rehabilitation plan” designation. This expresses the fact that it is humiliating to receive
such designation, and local governments take great pains to avoid it. However, of course
local governments that “fall” into the “local government under a financial rehabilitation plan”
status are not broken up after settlement of their accounts. Rather, they are treated in a
similar manner to instances in which the Corporation Rehabilitation Law is applied.
Bankruptcy of local governments is avoided before it occurs through supervision using the
debt expenditure ratio used at permission to issue local bonds and the “local governments
under financial rehabilitation plan” system. Local bonds in Japan have the same high
creditworthiness as national bonds, and they have zero risk weight in BIS regulations.

3-2 Fund raising of local bonds

Traditionally, funds for local bonds depended on public funds. A look at sources shows that
while some 40% of funds came from private-sector funds, the total of Trust Fund
Bureau—which must secure targets for investment of funds that will flow in passively—and
Japan Finance Corporation for Municipal Enterprises reached 60%. And, approximately
three-fourths of the so-called “private-sector funds” were private placement bonds that
procured funds from designated local financial institutions through mutual negotiations.
Thus, the share of publicly-advertised bonds that target a wide and unspecified number of
investors through banks and securities companies did not exceed 10%. However, the
share of public funds was rapidly curtailed in line with reform of the central government’s
investment and loan program in 2000, and thus there is an increasing need to diversify
fund-raising means and to expand fund-raising routes from the private sector.
Public funds

Funds consumed by local bonds total approximately 15.5 trillion yen. This figure is made up of public funds (6.2 trillion yen) and private-sector funds (9.3 trillion yen). Public funds make up some 40% of local bond funds and are the most stable funds within local bond funds with their long life and low interest rates. Japan's local governments provide many administrative services that are required by national laws and whose levels are regulated, and that is why public funds have been allocated to local bonds. The repayment method involves payment of principal and interest, and is broken down into i) “fiscal loan funds” in which the central government issues national bonds and subleases them to local governments; ii) direct financing of postal savings and the postal life insurance reserve fund; and iii) funds of the Japan Finance Corporation for Municipal Enterprises.

Since the reform of the central government's investment and loan program (2000), public funds have been controlled and their weight has fallen rapidly.

Until FY2000, a system was in place whereby postal savings and pension funds had to be deposited in the Trust Fund Bureau. Then, using these deposits as a revenue source, funds were loosely allocated to local governments. However, following the central government's investment and loan program that started in April of 2001, the central government started issuing national bonds (investment-and-loan bonds) and procuring funds from the market, and then subleasing these bonds to local governments. As a result, central government financing to local governments came to be more controlled then before, and thus local governments now need to raise funds from the market on their own. Furthermore, although direct financing from postal savings and the postal life insurance reserve fund to local governments having poor financial strength is permitted, it is unclear whether or not direct financing to local governments will continue in the future, given the introduction of a framework for assessment and validation as well as talk about privatization of postal services. Thus, from the standpoint of ensuring stable funds, efforts are underway to diversify means for fund raising amid growing necessity to expand fund-raising routes from the private sector.
Private-sector funds

Private-sector funds make up approximately 60% of all local bond funds; these funds break down into publicly-advertised funds, which account for 3.3 trillion yen (approximately 21.2%), and funds underwritten by banks and other institutions, which account for 5.9 trillion yen (approximately 38.5%). Currently, 35 local governments (21 prefectural governments and 14 government-designated cities) in Japan issue publicly-advertised bonds, and it is likely that the majority of prefectures and government ordinance cities will issue publicly-advertised bonds in the future. Traditionally, issuance conditions were the same for all local governments that issue publicly-advertised bonds, including the Tokyo metropolitan area, because of the existence of “implicit government guarantee”. However, gaps in the secondary market have led to the problem of investors suffering from capital loss. In the interest of resolving this problem, the Tokyo metropolitan area (since April 2002) and Yokohama City (since April 2004) have been permitted to issue local bonds under conditions that differ from other local governments (issuance at low interest rates). This method—called the “two table method”—is a scheme that aims to reflect differences in the fiscal situation and liquidity of each local government on issuance conditions; it does not have the market assess default risk. In actuality, although the interest rates of local bonds grew in the beginning, the gap has been narrowing gradually. It should be mentioned that
the repayment method involves payment to be made by lump sum at maturity.

In general municipalities that have difficulty issuing publicly-advertised bonds to the entire country, “mini” publicly-advertised bonds based on resident participation are actively issued (300 billion yen; 88 local governments). These bonds, which are paid by lump sum at maturity, are local bonds in the form of securities that are targeted at individual investors. This method was established in 2001 as a means of elevating awareness of the public’s participation in government and to diversify fund-raising means.

Amid expanding fund-raising routes from the private sector, the central government began allowing joint issues whereby multiple numbers of local governments (excluding Tokyo) join together to assume debt burden in FY2003 (Article 5 Paragraph 7 of the Local Finance Law). This move was in the interest of avoiding rapid increases in fund-raising costs. Because debt under the joint issue method is assumed by collaborating participants, it has high creditworthiness in the market and serves as a benchmark. However, because local governments whose market assessment has declined due to worsening fiscal conditions can also participate in joint issues, there is incentive for affluent local governments to break away from joint issuance and to move to independent issuance with better conditions. Under the joint issue scheme, participating local governments accumulate an amortization fund in preparation for payment by lump sum at maturity, which they use to complement mobility.

In addition to publicly-advertised bonds, private placement bonds (borrowing on deeds) from designated financial institutions are also included in private-sector funds. Consumption through private placement bonds has risen to 5,983,600,000,000 yen (38.5%), which makes it the largest consumer. In general municipalities, the majority of such bonds take the form of financing (lending on deeds) from banks, and the setting of conditions is based on mutual negotiations. Because the “current value accounting” system was introduced in FY2000, there is a tendency for underwriting financial institutions to sell local bonds before they mature in order to avoid risks in holding on to them (current value loss). However, a considerable number of financial institutions have come to recognize their primary responsibility as designated financial institutions and are continuing to hold on to their bonds until maturity. When the deposit-to-loan ratio declines due to poor economic circumstances, city-type urban banks accept local bonds on the premise that they will hold on to them until maturity in regions where financing is sluggish, even if loan customers can be secured.
Section 4: Experience Assessment—Successes and Failures

4-1 Implicit government guarantee

Until now, “implicit government guarantee” (i.e., the local bond approval system, local bond plans that include public funds, debt expenditure ratio used at permission to issue local bonds, and local government under financial rehabilitation plan system) that protects local governments from bankruptcy has played a major role in Japan, while market discipline has had a limited role. Local bonds that are supported by “implicit government guarantee” have been used for such a long time because social and economic conditions made them necessary. They were not designed based on theory or specific “models”.

The first thing to consider here is the “integrated” intergovernmental relationship in which functions of the central government and local governments overlap. In Japan, the central government obligates local governments to implement public services and sets the standards for such services through law, regardless of the financial strength or weakness of the local government. “Implicit government guarantee” has thus been provided to ensure that local governments that issue few local bonds and that have low name recognition will not be shut out of the market. In the future, a framework will be required through which weak municipal governments can receive financing, without individual assessment of credit risk by investors and financial institutions and irrespective of its size or fiscal capacity, if it swiftly attempts to meet national standards required by the national government.

A second thing to consider is the fact that, while public investment makes up 8% of the GDP, which is high by international standards, 80% of such investments are implemented by local governments. In cases where counter cyclical fiscal policy is implemented, public investment cannot be pursued without conformity and cooperation with local government (Hayashi, 1998; Mihaljek, 1997). Means are in place by which the central government controls and guides all areas of local fiscal policy—e.g., the Local Tax Law, which can change tax laws throughout the country with a single law; local public finance programs, which seek conformity in macro-level economic policies for local governments; local bond plans that ensure fund allowances for local bonds; etc. While scaling back public investment and grants, the central government asked local governments to implement independent local public works to boost the economy. Local governments responded in kind by procuring revenue sources through local bonds with allocation tax measures.
However, “implicit government guarantee” had many side effects. From the end of World War II until today, most local governments in Japan have not been concerned about market discipline through the issuance of local bonds. This is because issuance conditions were basically uniform for all local governments, regardless of liquidity or creditworthiness. For example, the issuance conditions for publicly-advertised bonds were the same for all local governments that issue such bonds (including the Tokyo metropolitan area) until FY2000. This was because there were no disparities in the creditworthiness of local bonds due to "implicit government guarantee", and because of the thinking that local bonds were equal to national bonds. A number of positive analyses have been performed on factors behind determination of local bond value in the secondary market. Using data from December 2001, Mochida (2004) discovered that, although the major factor behind value gaps is difference in liquidity, credit risk cannot be completely discounted. Furthermore, because private-sector funds made up only 40% of the total amount of local bond funds, the public sector had a strong influence on determination of issuance conditions for publicly-advertised bonds and private placement bonds. Thus, a paradox emerged whereby, the more "implicit government guarantee" was developed, the weaker supervision of local governments by investors and taxpayers became.

4-2 Fiscal rules

Because the bond-issuance approval system will soon be abolished, the importance of related supervisory mechanisms—fiscal rules and market discipline—will grow. In Japan, if a local government’s debt expenditure ratio used at permission to issue local bonds exceeds a certain level, approval of a portion or almost all of its local bonds will not be granted. Also, if a local government has a fiscal deficit that exceeds a certain size, it will be designated a "local government under a financial rehabilitation plan" and will not be allowed to issue local bonds unless it aims for financial rehabilitation under central government supervision. Because “falling” to the status of ”local government under a financial rehabilitation plan” is humiliating for local governments, this system can be interpreted as a mechanism for enforcing execution of fiscal rules. Further, in its assessment of Japan for FY2005, the OECD recommended that short-term financing and the special local allocation tax to local governments under financial rehabilitation plans should be abolished in order to prevent moral hazard (OECD, 2005).
Table  Sharing the repayment costs of selected local government bonds  
FY 2001, billion yen

<table>
<thead>
<tr>
<th>Name of local bonds</th>
<th>Outstanding local bonds</th>
<th>Share of repayment costs accounted for in the LAT formula (per cent)</th>
<th>Estimated central government repayment costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>General public works</td>
<td>25,452</td>
<td>-</td>
<td>11,068</td>
</tr>
<tr>
<td>Temporary public works</td>
<td>13,835</td>
<td>80</td>
<td>11,068</td>
</tr>
<tr>
<td>General independent public works</td>
<td>52,487</td>
<td>-</td>
<td>10,249</td>
</tr>
<tr>
<td>General regional development</td>
<td>10,871</td>
<td>30-55</td>
<td>3,261</td>
</tr>
<tr>
<td>Temporary local road building</td>
<td>16,071</td>
<td>30-55</td>
<td>4,821</td>
</tr>
<tr>
<td>Temporary river related projects</td>
<td>2,147</td>
<td>30-55</td>
<td>644</td>
</tr>
<tr>
<td>Temporary economic package</td>
<td>2,051</td>
<td>45</td>
<td>923</td>
</tr>
<tr>
<td>Public housing construction</td>
<td>5,150</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Compulsory education facilities building</td>
<td>5,031</td>
<td>30-70, 100</td>
<td>1,509</td>
</tr>
<tr>
<td>Advance purchase of land for public facilities</td>
<td>2,226</td>
<td>Interest only</td>
<td>0</td>
</tr>
<tr>
<td>Natural disaster recovery</td>
<td>1,304</td>
<td>-</td>
<td>1,072</td>
</tr>
<tr>
<td>Tokyo metropolitan area development</td>
<td>1,178</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>General waste disposal</td>
<td>4,702</td>
<td>50/100</td>
<td>2,351</td>
</tr>
<tr>
<td>Depopulated area aid</td>
<td>2,418</td>
<td>70</td>
<td>1,693</td>
</tr>
<tr>
<td>National budget-related and government-affiliated organisation loans</td>
<td>1,203</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Financial support to fill local government financing gap</td>
<td>3,109</td>
<td>80</td>
<td>2,488</td>
</tr>
<tr>
<td>Temporary special fiscal</td>
<td>2,689</td>
<td>100</td>
<td>2,689</td>
</tr>
<tr>
<td>Tax cut supplement</td>
<td>6,227</td>
<td>100</td>
<td>6,227</td>
</tr>
<tr>
<td>Temporary tax cut supplement</td>
<td>1,265</td>
<td>100</td>
<td>1,265</td>
</tr>
<tr>
<td>Temporary fiscal aid</td>
<td>1,227</td>
<td>80</td>
<td>982</td>
</tr>
<tr>
<td><strong>Memorandum item:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total outstanding local bonds (excluding borrowing from LAT Special Account)</strong></td>
<td><strong>130,954</strong></td>
<td></td>
<td><strong>47,403</strong></td>
</tr>
</tbody>
</table>

Note: Repayment costs borne by the central government were calculated by multiplying the outstanding amounts of local bonds and the LAT compensation rate. When the LAT compensation rate varies with local government “fiscal strength”, the lower rate was used, leading to an underestimation of future repayment costs for the central government.

Fiscal rules will need to be made even stricter. This is because, despite the rapid accumulation of local bonds, existing fiscal rules pertaining to repayment of principal and interest do not always have binding authority.

The primary reason for this is that portions that are repaid through the local allocation tax are deducted from public bond expenditures that are included in the debt expenditure ratio used at permission to issue local bonds. Since the latter half of the 1980s, between 30% and 100% of the cost of repaying principal and interest (determined based on the type of local bond and the fiscal capacity of the issuing local government) has been included in the basic financial needs of the local allocation tax. Of 130.9 trillion yen in outstanding local bonds, the local allocation tax's burden for repayment of principal and interest has reached 47.4 trillion yen (see table). In today’s Japan, residents that benefit from the issuance of local bonds do not bear the debt that arises from such bonds. Thus, local governments have no incentive to engage in balanced budgets, and this in turn nurtures fiscal crisis at the local level. Accordingly, it will be necessary to abolish public works modification and to
more comprehensively define the cost of repaying principal and interest.

Another reason is that fiscal rules—whether anchored in the debt expenditure ratio used at permission to issue local bonds or actual balance—are based on flow-based accounting indices, and thus they have little binding authority against outstanding debt. Because outstanding debt is directly tied to the debt-servicing capacity of local governments, it is a fundamental factor in measuring credit risk. A correlation coefficient matrix is provided for 28 local governments that issued publicly-advertised bonds in FY2001. It shows no significant correlation between debt expenditure ratio used at permission to issue local bonds and the period of time within which debt repayment is possible. In order to ensure supervision by rules as well as market credibility, stock-based balance sheets that reflect actual fiscal conditions and consolidated financial statements that include the third sector should be prepared.

| Table: Correlation matrix of fiscal indices (FY2001, 28 local governments issuing publicly-advertised bonds) |
|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|
| Net revenue and expenditure ratio                | Debt expenditure ratio                           | Debt expenditure ratio used at permission to issue local bonds | Period of time within which debt repayment is possible |
| Net revenue and expenditure ratio                | 1,000                                           | 0.172                                           | 0.119                                           |
| Net revenue and expenditure ratio                | 0.172                                           | 1,000                                           | 0.950                                           |
| Debt expenditure ratio used at permission to issue local bonds | 0.119                                           | 0.950                                           | 1,000                                           |
| Period of time within which debt repayment is possible | -0.543                                          | -0.097                                          | 0.013                                           |

Source: Calculated from Todofuken Kessan Jokyo Shirabe and Shichoson Kessan Jokyo Shirabe, and Todofuken Zaisei Shisuhyo, Financial Management Division, Local Public Finance Bureau, Ministry of Internal Affairs and Communications. "Period of time within which debt repayment is possible" is calculated by dividing net outstanding debt (obtained by subtracting convertible assets from comprehensively defined outstanding debt) by general revenue sources that can be applied to future repayment.

Source: Mochida, 2004

Finally, the concept of net revenue, which is the basis for dropping local governments to “local government under financial rehabilitation plan” status, is too generous. Local governments can manipulate their net revenue flexibly by issuing more public bonds or liquidating funds. Thus, in order to measure net cash flow for individual fiscal years, local bonds and liquidated funds should be excluded from revenue when calculating net revenue. In its assessment of Japan for FY2005, the OECD recommended that the net revenue rule should be changed to a rule for balanced operating revenue and expenditure (OECD, 2005).
4-3 Prerequisites for market discipline

Until now, funds for local bonds depended on public funds. A look at sources shows that while the share of private-sector funds is approximately 40%, the total of Trust Fund Bureau—which must secure targets for investment of funds that will flow in passively—and the Japan Finance Corporation for Municipal Enterprises reached 60%. The share of public funds was rapidly curtailed in line with reform of the central government’s investment and loan program in 2000, and thus it is necessary to diversify fund-raising means and to expand fund-raising routes (especially publicly-advertised bonds) from the private sector.

A number of prerequisites must be satisfied if “market discipline” is to function effectively. First, sufficient information must be disclosed on the comprehensive amount of debt of the borrower as well as the borrower’s debt service capacity. Some 80 to 90% of local governments at the prefectural and government-designated city level supply balance sheets and account sheets showing the fiscal conditions of related organizations (local public corporations, third sector, etc.) and administrative costs to institutional investors. However, the fact that assets are not measured at fair value and the fact that few balance sheets include the third sector present a problem.

The second prerequisite is that portfolio regulations are not placed on financial institutions (quotas on issuance of national bonds and local bonds, etc.). In Japan, bidding systems and methods for forming syndicates are already gaining ground in the selection of financial institutions that underwrite not only publicly-advertised bonds but also private placement bonds.

The third prerequisite is that the central government’s commitment not to bailout local governments that default on their debts must be credible. In Japan, the central government does not assume the expense of repaying principal and interest of local governments that fall into “local government under a financial rehabilitation plan” status. However, because of borrowing in the local allocation tax special account and local allocation tax measures for repayment of principal and interest, the amount of burden that local governments principally recognize they must repay is less than half of their outstanding local loans. Because no bankruptcy laws for local governments exist in Japan, it is unclear whether or not the central government’s commitment to maintain a “no-bailout policy” will have sufficient credibility in the event that difficulties in repayment occur.
The final prerequisite is that borrowers can engage in quick policymaking that matches market signals (worsening bond ratings, etc.) prior to their becoming unable to take on new loans. Because the terms in office of local government leaders are short, there is a tendency for shortsightedness. It is often the case that local governments in Japan do not quickly respond to market signals (worsening bond ratings) and issue more local bonds despite financial institutions’ withdrawal from syndicates or refusal to underwrite bonds, etc.

As the above demonstrates, the conditions under which uniform dependence on “market discipline” functions are not completely in place in all instances. Consequently, efforts must be made to expand revenue source routes as well as fund routes from the private sector on the premise that the autonomous revenue sources of local governments will be reinforced.


