Toward Reform of Local Bond System in Japan

Takero Doi (Keio Univ. and ESRI)  
http://www.econ.keio.ac.jp/staff/tdoi/  
Tomoko Hayashi (CAO)
Figure I – 1
Outstanding Debt by Level of Government (Central and Local) in Major Countries

Source: Ministry of Finance “Wagakuni no Zaisei Jijo ni Tsuite” (Japan), Sachverständigenrat Homepage (Germany), DGCL “Les Collectivités locales en chiffres” (France), US Census Bureau “Statistical Abstract of the United States” (US), SCB “Statistics Sweden” (Sweden), others from IMF “Government Finance Statistics”
Outstanding Local Government Borrowing (Japan)

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Enterprise Bonds (borne by the ordinary account)</th>
<th>Borrowing in the Special Account for Allocation and Transfer Tax</th>
<th>Local Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1980</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1985</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>1990</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
Current Local Finance System

- Major revenue of Japanese local gov’ts
  - Local Taxes, Local Allocation Tax Grants, National Gov’t Disbursement, Local Bond
  - "Trinity Reform Package"
    - Local Taxes, Local Allocation Tax Grants, National Gov’t Disbursement
“Trinity Reform Package”
The Reform of Three Major Items

- Reducing National Government Disbursement to local governments
- Transferring some of its tax revenue sources to those local governments
- Reviewing the Local Allocation Tax (LAT) Grants

However, reform of local bond system is not included in this package
In This Paper

- Analyze defects in the current local finance system
- Compare local bond system among industrialized countries
- Derive implications for improvement of the Japanese local bond system
The Japanese system

System of Local Bond Permits

- Local governments cannot freely issue local bonds
- Local governments must obtain permission from the Minister of Internal Affairs and Communications (or prefectural governor) in advance when they issue local bonds

  ↓

- The permission of the central government as well as needs of local governments leads the above increase of local bonds
Local Bond System

- Local Bond Permits
  Ministry of Internal Affairs and Communications (MIC) decides lenders as well as amounts of local bonds

- Lenders of Local Bond
  FILP Funds: 60%, Borrowing from Private Financial Institutions: 30%, Publicly-offered Funds: 10%

  FILP Funds: longer-term, lower interest rates

- Borrowers of FILP Funds .. Decided by MIC local govt’s with few tax revenue
Figure II – 2
Structure of Subscribers of Local Bonds (Japan)

Source: Ministry of Internal Affairs and Communications, Annual Statistical Report on Local Government Finance
"Implied Government Guarantee" of Local Bonds

- Measures through Local Allocation Tax Grants for the Repayment of Principal and Interest of Local Bonds
- Local Bond Permits
- Local Public Financial Reconstruction Program

→ The MIC officially says “local governments will NEVER default on debts.”
Ratio of Borrowing from the FILP Funds to the Total Funds (Outstanding basis)

Effective Interest Rate and Borrowing from the FILP Funds
FY 1990～1997 (average)

Local Bond System (2)

Evaluation of the current system
… Doi (2002)

- The central government tends to distribute the FILP funds to a local government whose tax revenues are fewer.
- Local gov’ts in a rural area cannot issue publicly-offered bonds and doesn’t face a financial discipline in security markets.
- The permission of borrowings from the FILP funds doesn’t work for maintenance of fiscal discipline of local public finance.
Local Bond System (3)

- Measure through LAT Grants for the Repayment of Principal and Interest of Local Bonds

  a measure that increases LAT grant entitlements when spending on government bonds increases.