Defects of LAT Grants

- Computing the quota of the Local Allocation Tax Grants
  Quota of LAT Grants are in proportion to the Shortfall: “Standard Financial Need (SFN) minus Standard Financial Revenue (SFR)”
  Supply the Shortfall

- Fault of this computation
  LAT Grants decrease as SFN decreases
  LAT Grants decrease as SFR increases
  → Neglect efforts of cutting expenditure and increasing tax revenue
Soft Budget with LAT Grants

- Standard Financial Need (SFN)
  Including debt service expenditure (DSE)
  \[ \text{DSE} \uparrow \rightarrow \text{SFN} \uparrow \rightarrow \text{LAT Grants} \uparrow \]
- DSE supplied by the LAT Grants
  Shifting burdens of repayment to the central government
  “Soft budget constraint”
Ex. Expense of facilities for compulsory education

- Nat'l Gov't Disbursement: 50%
- Local bonds & debt service expenditure covered by LAT grants: 30%
- Local bonds without coverage of LAT grants: 15%
- General Revenue: 5%

2005/9/14
Amounts of Measures through LAT Grants for the Repayment of Principal and Interest of Local Bonds

①: Ratio of local bond repayment as a service item included in Standard Financial Need to total Standard Financial Need (SFN)
②: ① plus ratio of total amount of adjustment for project expenses included in Standard Financial Need to total SFN
③: ① plus ratio of only local bond repayment in adjustment for project expenses, which can be collected after fiscal 1993 to total SFN

Source) Doi and Bessho (2005)
Public Works in Local Net Total

- General Revenue
- Nat'l Gov't Disbursement
- Local Bond
- Appropriation percentage of local bonds

(trillion yen)
Net Burden of Prefectural Bonds on the taxpayer of Kyoto prefecture

<table>
<thead>
<tr>
<th></th>
<th>amount</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>582.6</td>
<td>Outstanding per residents of a prefecture: 227 thousand yen</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(Outstanding of the national debts per capita: 3,530 thousand yen)</td>
</tr>
<tr>
<td>Coverage by LAT grant</td>
<td>636.1</td>
<td>Total outstanding of prefectural bonds (1,218.7 billion yen)</td>
</tr>
</tbody>
</table>

Source) Kyoto Prefecture

Kyoto Prefectural government recognizes that prefectural bonds covered by (future) LAT grants are not its own debts (or excluded from "true" total debts)!
Very Simple Model for Comparative Institutional Analysis on Local Bonds

- J local governments
- Implement public investment with issuing local bonds
- The existence of the possibility of default of local governments if the central government does not relieve the local government
Characteristics of the US system

- Non-involvement of the federal government in the debt obligations of the local governments
- The existence of the possibility of default of local governments
- Rating agencies effectively play a role by reflecting the disparity in credibility existing between local governments
- Differing ratings are assigned to local governments reflecting their credibility
Figure III-2
Holdings of Municipal Bonds in the US

[Diagram showing the percentage distribution of municipal bonds holdings by different entities from 1980 to 2002]

Data: U.S. Census Bureau

2005/9/14
Two Equilibria

- An equilibrium in the US system
  A separating equilibrium with rating agency

- An equilibrium in the Japanese system
  A pooling equilibrium with LAT grants

➢ Under some conditions, social welfare in the US system is better than one in the Japanese system.
Current Local Bond System in Japan

- Minimizing burden: Local Gov't
- Maximizing profits: Banks
- Borrowing and repayment: No debt forgiveness
- LAT Grants, etc.: "Implied gov't guarantee"
- "Collusion" among local gov'ts and banks
- Taxpayers of national taxes (in particular residents in non-receiving bodies) bear the burden
Market-oriented Local Bond System

- Minimizing burden
- Maximizing profits

Local Gov'ts → Borrowing and repayment → Financial Market → Banks

"Implied gov't guarantee"

- Accept interest differences arising from the fiscal situations among municipalities with varying financial capacities.

The risk is shared among the participants in the financial market.
Implications for reform of the Japanese local bond system

- The origin of local fiscal discipline under decentralization is the existence of interest rate differences by market mechanisms
- A rigorous study of the repayment capacity of various actors in the market creates fiscal discipline
- The existence of various rules that support market mechanisms
Implications for reform of the Japanese local bond system (cont'd)

- Autonomous fiscal administration based on a mid-term capital commitment plan
- Establishing rules for debt liquidation through bankruptcy laws
- An adequate burdening of risk concerned with local bonds via market