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)

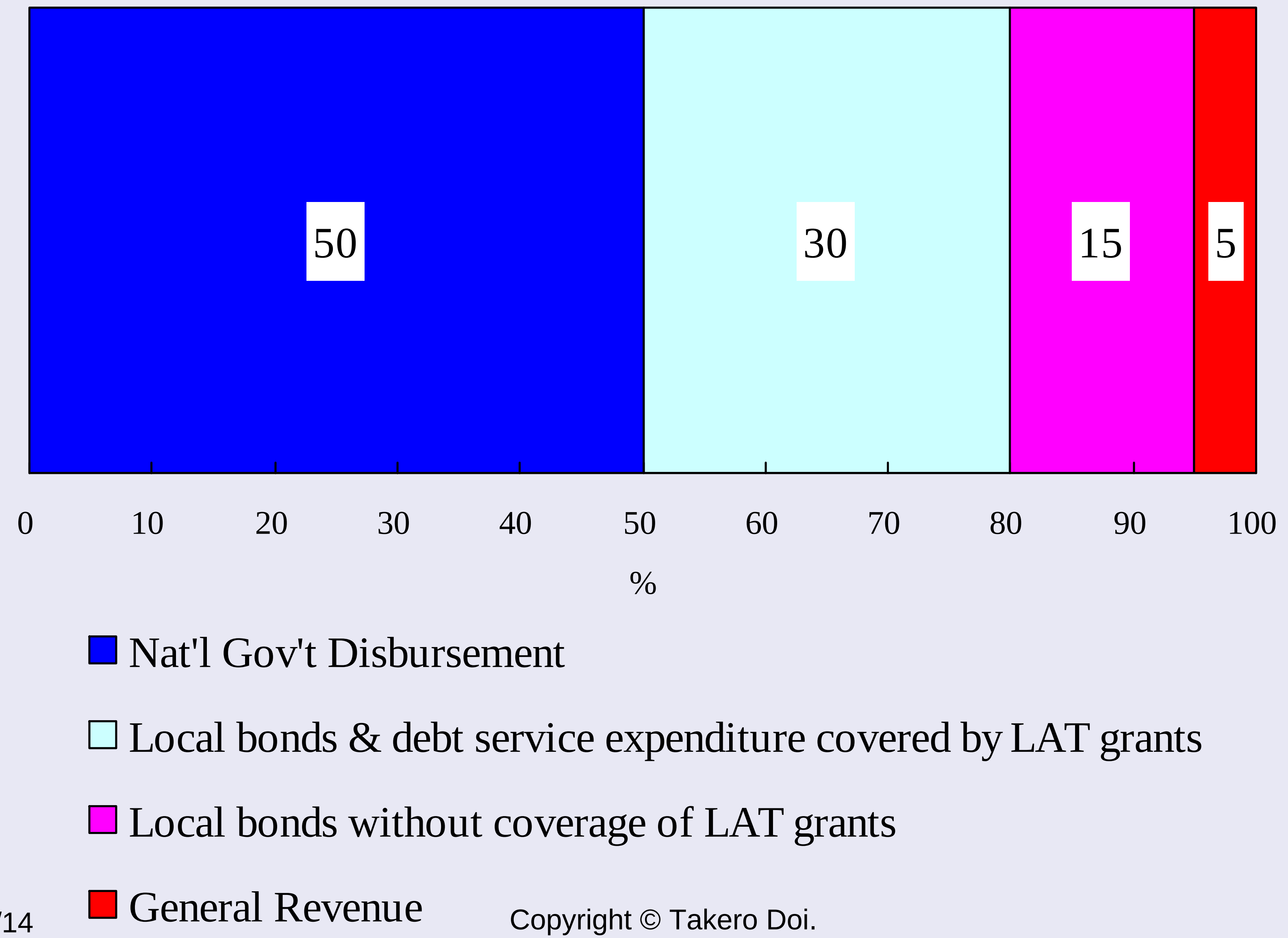
  Including debt service expenditure (DSE)

  DSE ↑ →SFN ↑ →LAT Grants ↑
- DSE supplied by the LAT Grants

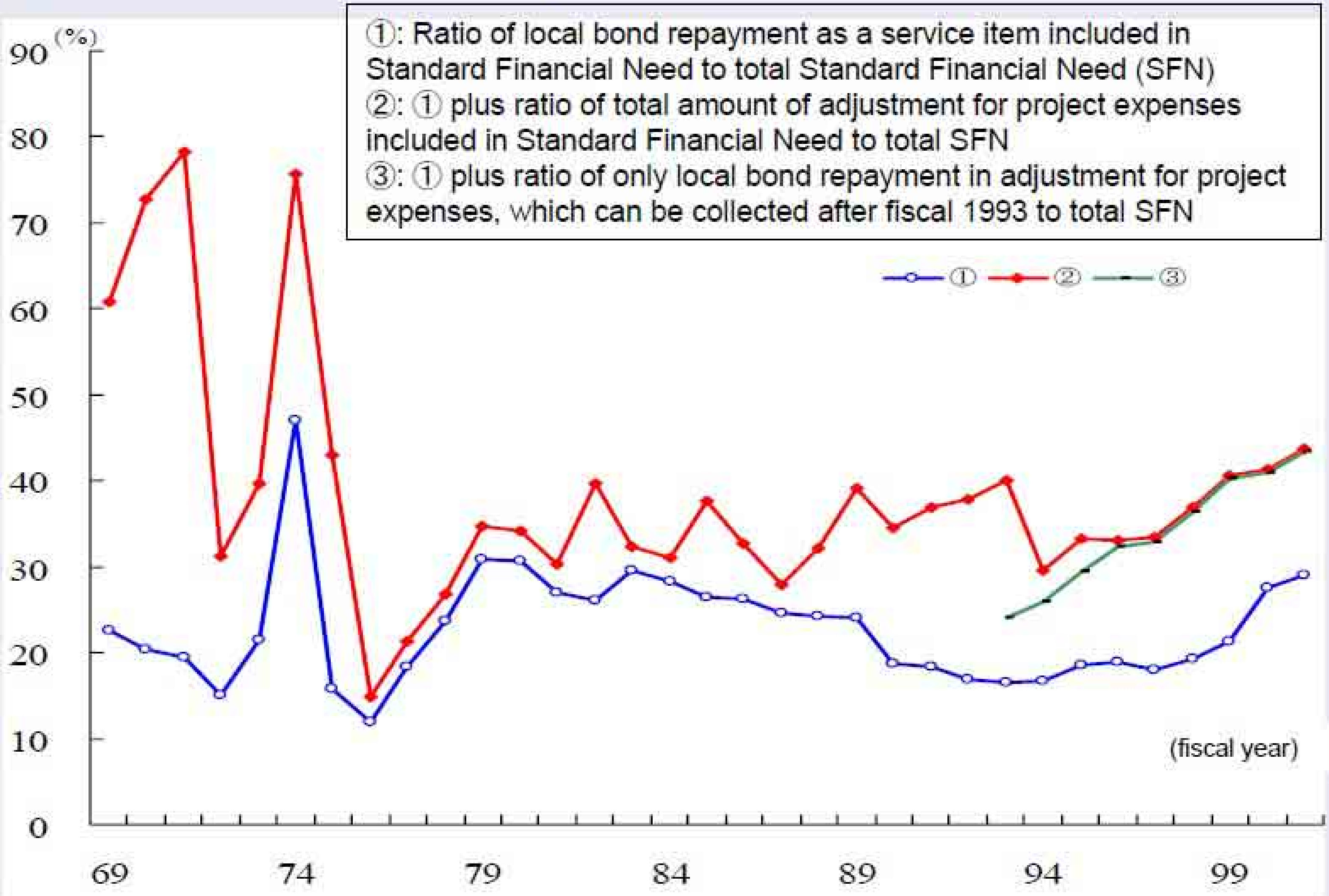
  Shifting burdens of repayment to the central government

  "Soft budget constraint"

Ex. Expense of facilities for compulsory education

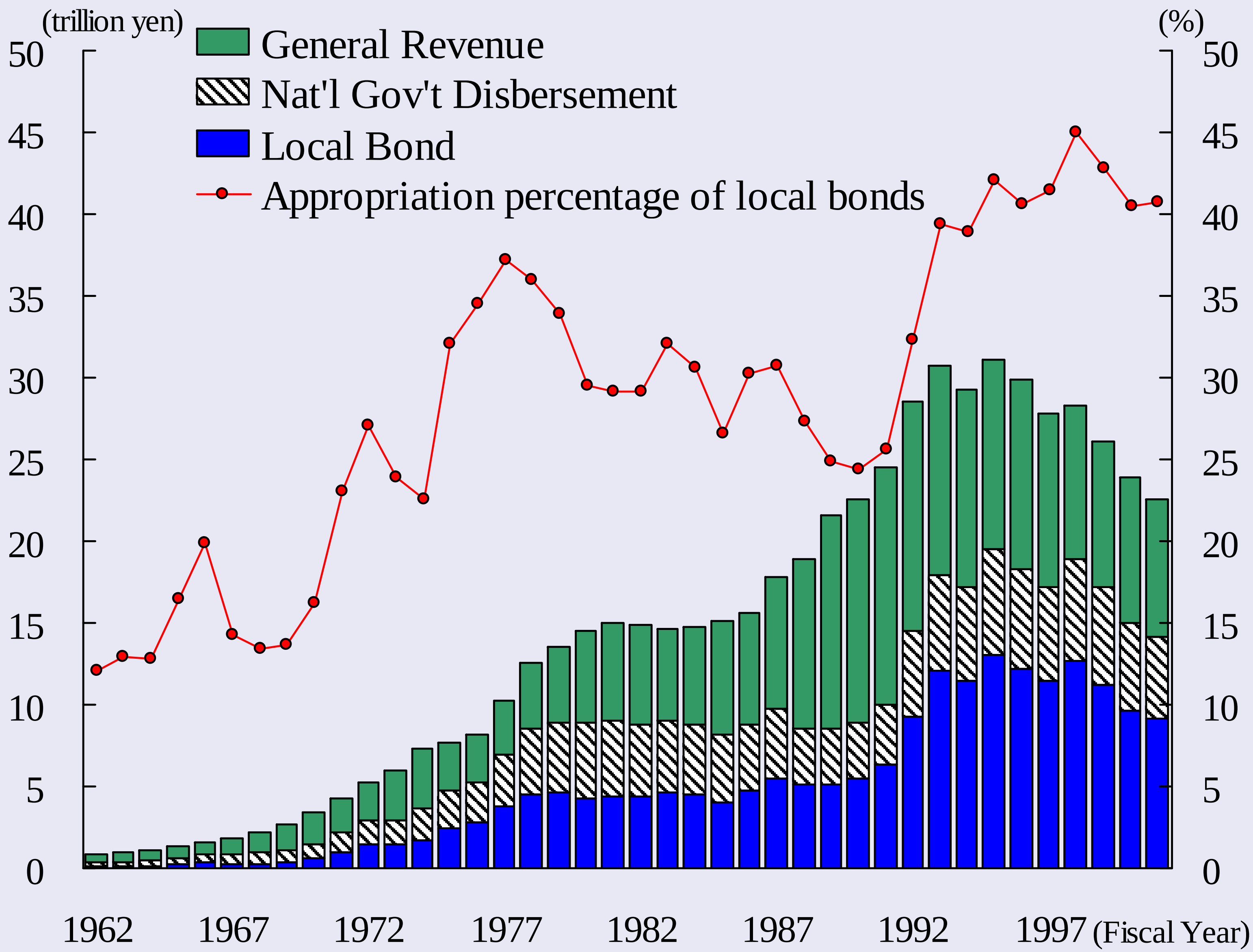


Amounts of Measures through LAT Grants for the Repayment of Principal and Interest of Local Bonds



Source) Doi and Bessho (2005)

Public Works in Local Net Total



Net Burden of Prefectural Bonds on the taxpayer of Kyoto prefecture

	amount	Explanation
Total	582.6	Outstanding per residents of a prefecture: 227 thousand yen (Outstanding of the national debts per capita: 3,530 thousand yen)

Coverage by LAT grant	636.1	Total outstanding of prefectural bonds (1,218.7 billion yen)

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)!

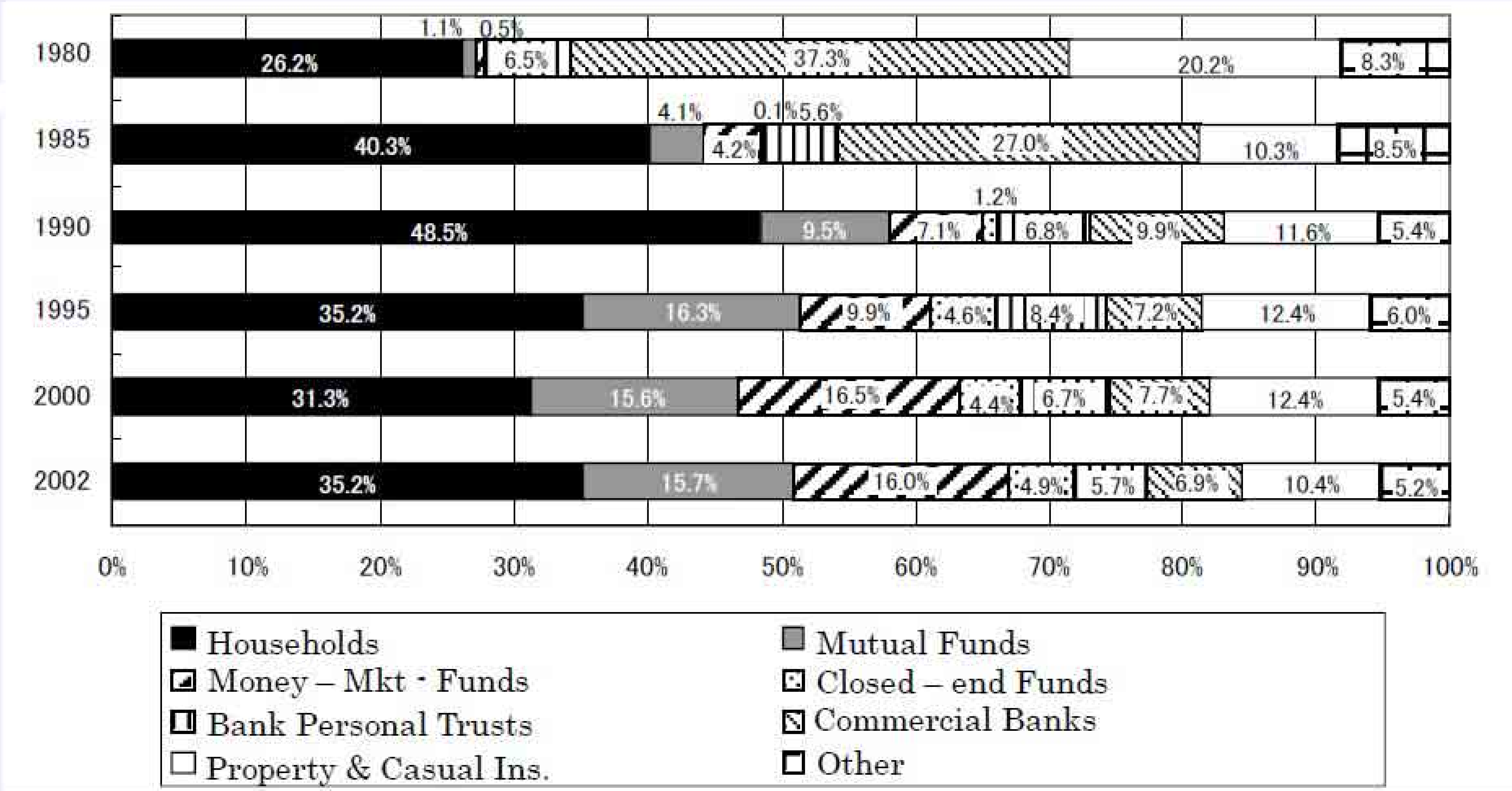
Very Simple Model for Comparative Institutional Analysis on Local Bonds

- 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



Data) U.S. Census Bureau

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

Maximizing profits

Local Gov't

Banks

Borrowing and repayment

No debt forgiveness

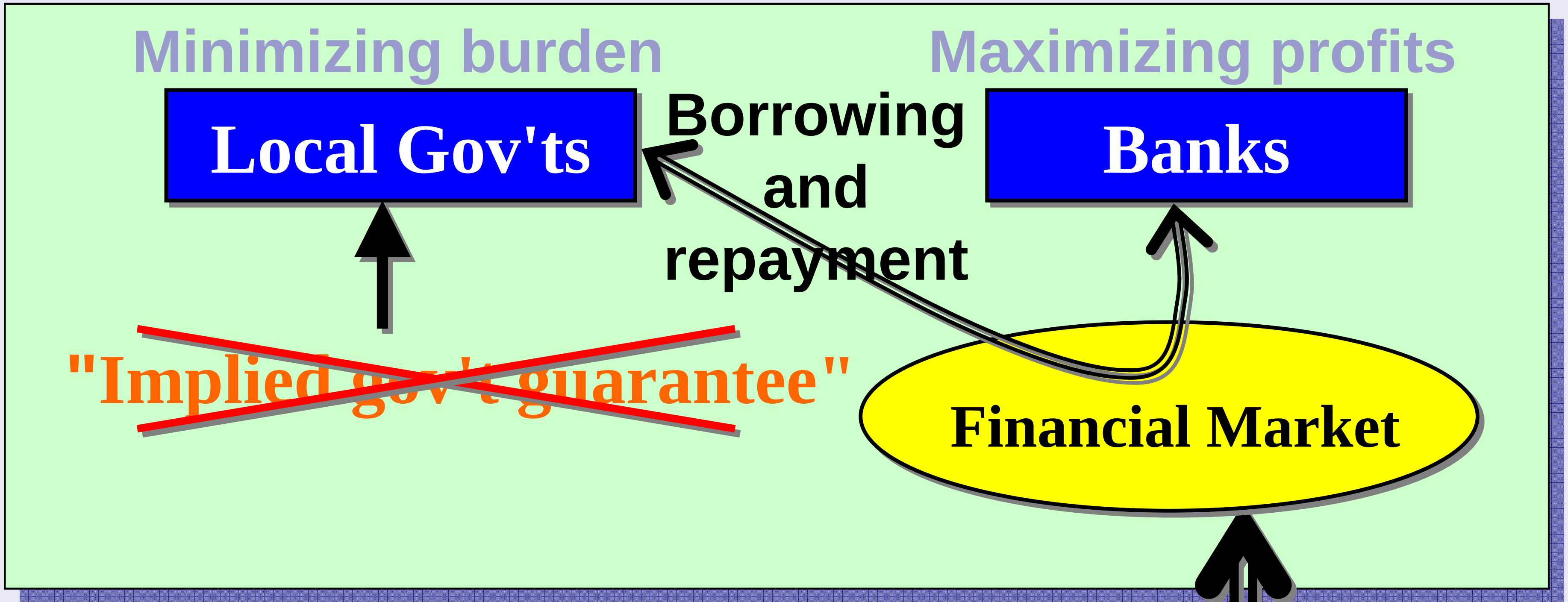
LAT Grants etc.

"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



- 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