

Local public finance



Public Finance

SPSE, Waseda, Fall 2024

Today's talk

□ Overview of local administration system

- The number of municipalities, types, ...
- Roles, fiscal sizes of local governments

□ Vertical fiscal imbalance

- Uniformity of government services
- Inflexible local tax system
- Uneven distribution of tax capacities

□ Intergovernmental fiscal transfers

- Central Government Subsidy
- Local Allocation Tax Grants

□ Local bond/borrowing

Local governments in Japan

□ Local government in Japan

- <https://www.clair.or.jp/e/pub/surveys.html>

□ Unitary or federal

- Legal status of “local” governments are different
- Unitary country
 - Lower governments do not have constitution and are less independent
 - Japan, China, France, ...
- Federal country
 - Lower governments (states) have constitutions and are more independent
 - United States, Canada, Germany, Belgium, ...
 - “State” is not a local government

Local governments in Japan

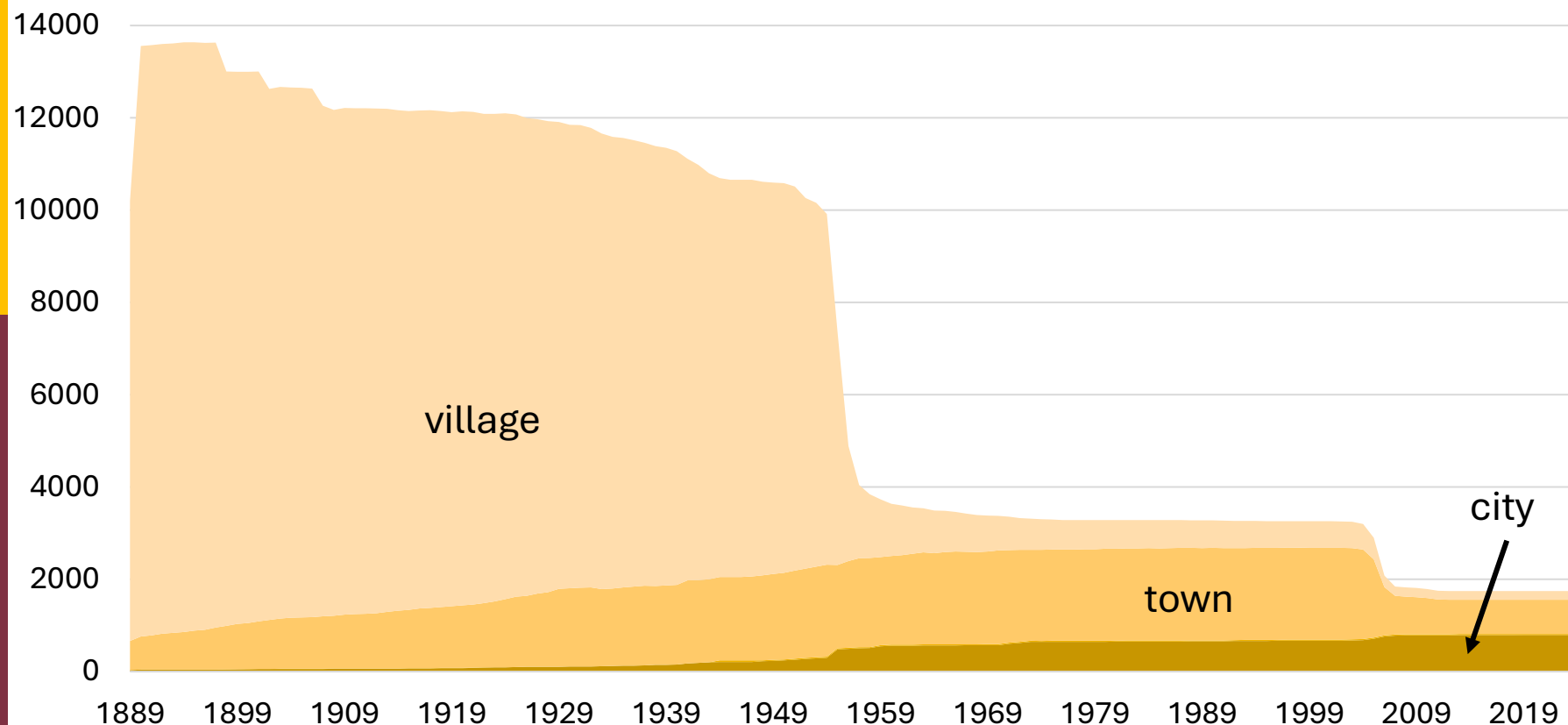
□ 2 tiers

- Basic local governments
 - Municipalities: 1,718 (792 cities, 743 towns, 183 villages) , 23 special wards (Tokyo)
- Broad local governments (To do fu ken)
 - Prefectures: 1 do, 1 to, 2 fu, 43 ken
 - Virtually no distinction across *do*, *fu* and *ken*
- No direct-controlled municipality
 - E.g.: Washington D.C. (US), Beijing (China)
 - All municipalities (incl. wards) are spatially covered by prefectures (upper governments)

The number of municipalities

Three great municipal mergers

- Meiji: 71,314→15,859
- Showa: 9,868→4,668
- Heisei: 3,229→1,821



Categories of local governments

□ Special local authorities

- Ordinary local authorities: Prefectures, municipalities
- Special local authorities: Wards (Tokyo), Partial-affairs association, Property wards

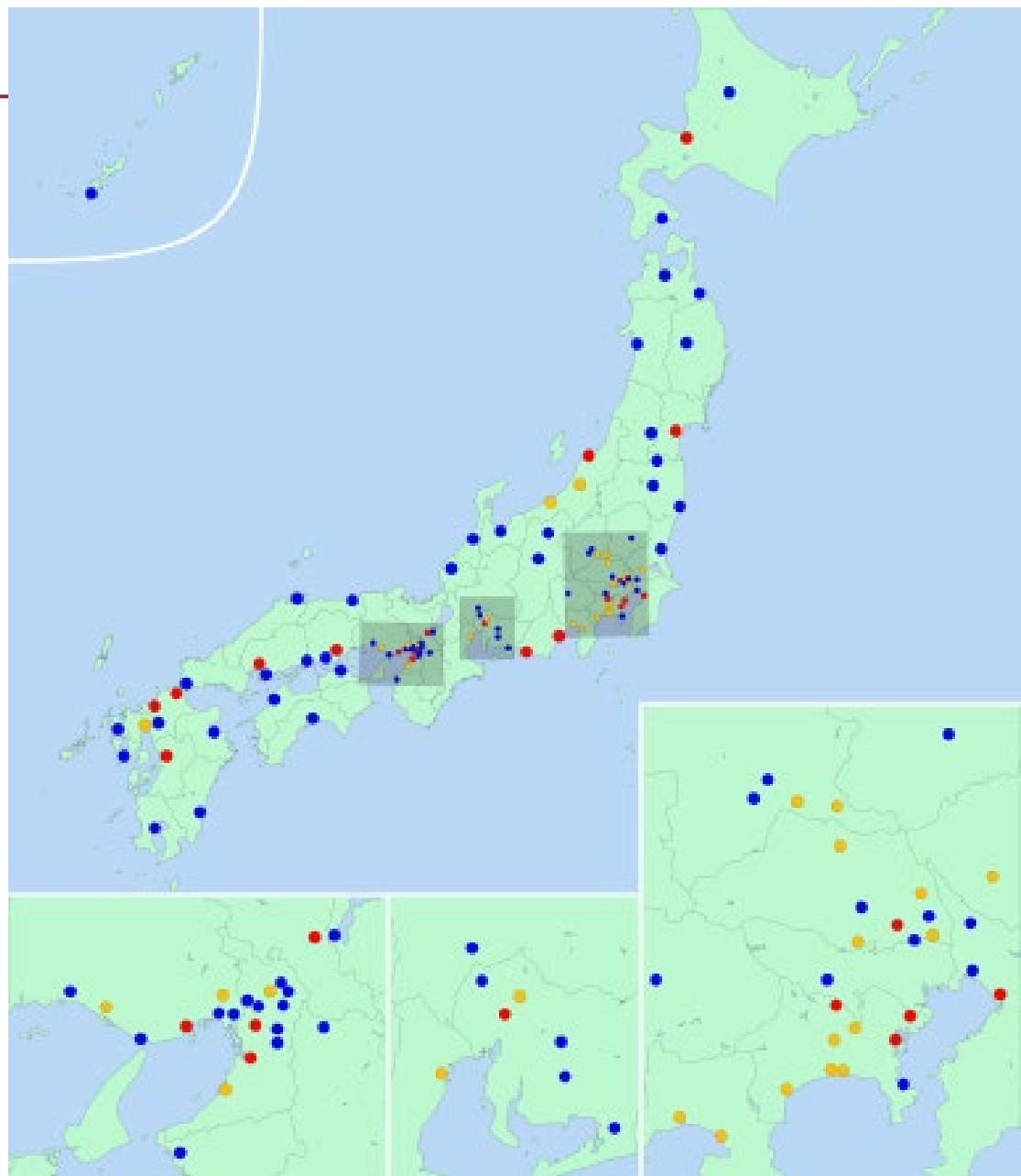
□ 4 categories of cities: Different authority

- Need to obtain permissions from prefecture governor
- Designated cities: 20 (*seirei-shitei toshi*)
 - Big cities with more than 500 thousands residents
 - Wards (ku, but different from Tokyo special wards)
- Core cities: 62 (*Chukaku shi*)
 - Big cities with more than 200 thousands residents
- Special cities: 23 (*Shikoji tokurei shi*)
- others
 - “City” requires 50K residents

Big cities

□ 4 types of cities

- Designated cities (Seirei Shitei Toshi): Red
- Core cities (Chukaku shi) Blue
- Special cities (Tokurei shi) Yellow



Dual representative

□ Dual representative system

- Both in prefectures and municipalities
- Both executive heads and council members are directly elected
 - Executive head: governor (prefs) mayor (muns)
 - Council: monitoring executive heads
- Power balance between executive head and council

□ If a conflict of opinion between head and council...

- Non-confidence resolution against head
 - Disqualification from office
 - Or dissolution of the council
- E.g.; Hyogo prefecture

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Roles of central and local govts

□ Local Autonomy Law

- Independent and comprehensive implementation of public policies
- Comprehensive local governments

□ The central government plays the roles related to...

- ① the existence of the state in the international community
 - ② basic rules that should be established in a unified manner throughout the country
 - ③ projects that should be carried out on a nationwide scale or from a nationwide perspective
- Plans and designs of projects or tasks of local governments
 - “in accordance with the principle of local autonomy”

Roles of central and local govts

- Tasks close to the inhabitants should be left to local governments as possible
- Municipalities
 - a wide range of public and personal services that are relevant to everyday life
- Prefectures
 - ① Tasks too large to be undertaken by municipalities
 - ② Coordination among municipalities
 - ③ Tasks that must not be undertaken by municipalities because of their scale or characteristics
- In general
 - Many tasks of government sector are implemented by municipalities (Large ones are by prefectures)
 - The central often plans / designs the tasks

Statutory entrusted functions, Local autonomy functions



□ Functions, tasks

- Administrative tasks/projects that prefectures and municipalities do
- 2 types: Difference in what the central can do / involve

□ Statutory entrusted functions

- Entrusted to local governments through laws or ordinances
- Originally responsibility of the central
- Mainly because of administration costs
- Passports, national elections, family registers etc.
- The central retains responsibility: subrogation

□ Local autonomy functions

- All other than statutory entrusted functions
- The central only can request correction
- 2 types: statutory or not
 - Examples of “statutory”: long-term care, public health insurance

Allocation of functions/tasks

Examples

	Central/national	Prefectures	Municipalities
Safety	Diplomacy, defense, judiciary	Police	Firefighting, family register
Infrastructure	Expressways, National highways, First-grade rivers	National highways, roads First- & second-grade rivers Ports, Urban planning Public housing	Urban planning Municipal roads, ports Public housing, water and sewerage
Education	National universities	Prefectural universities High schools Special schools HR for primary/junior high schools	City universities, high schools Primary/junior high schools Kindergarten
Welfare	Social insurance Licencing of MDs	Public assistance, child welfare, elderly welfare	Public assistance, long-term insurance, health insurance, garbage collection
Industry	Money, custom, postal services	Job training, regional development	regional development, Farmland policies

Population size of municipalities

□ Not very small

Towns and villages			Cities and wards		
		(%)			(%)
Total	926	100.0	Total	815	100.0
Under 5,000	290	31.3	Under 30,000	112	13.7
5,000--9,999	237	25.6	30,000--49,999	179	22.0
10,000--19,999	259	28.0	50,000--99,999	241	29.6
20,000--29,999	79	8.5	100,000--199,999	153	18.8
30,000--39,999	41	4.4	200,000--299,999	44	5.4
40,000--49,999	19	2.1	300,000--499,999	51	6.3
50,000 and over	1	0.1	500,000--999,999	24	2.9
			1,000,000 and over	11	1.3

Inflow and outflow

SNA 2019, Tri. JPY	Central	Local	Social security fund
Resources			
Taxes	61.5	41.4	0.0
Social contributions	0.5	1.8	72.0
Intergovt transfers	0.3	29.7	0.0
Other	4.4	1.1	4.9
Fiscal deficit	24.6	15.8	-4.2
Use			
Consumption	14.5	28.5	0.0
Investment	7.3	15.7	0.1
Transfers	3.5	8.0	0.4
Intergovt transfers	55.9	9.5	1.5
Social security	2.5	27.2	107.6
Interest payment	7.5	1.0	0.0

Local taxes are smaller than the central

Local highly depends on transfers from the central

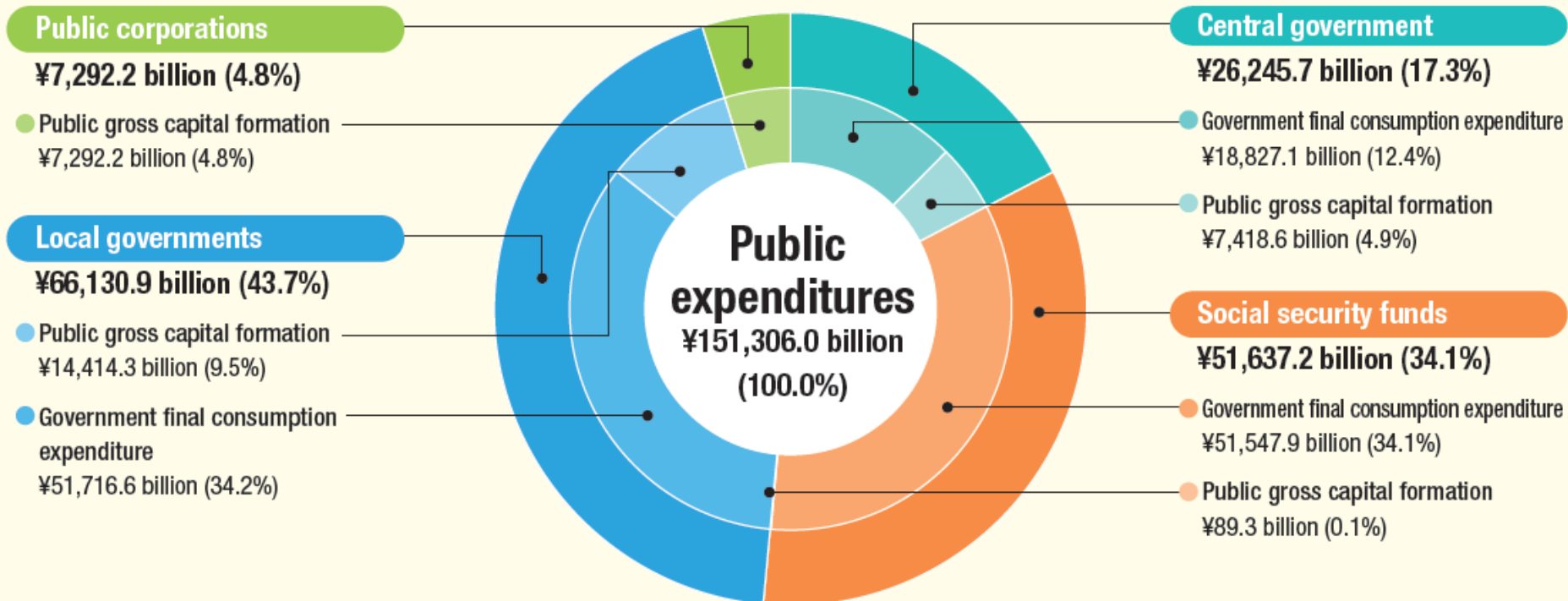
Local consumption and investment are larger than the central

Some parts of health insurance, long-term care, child benefits are paid by local govt.

Fiscal size

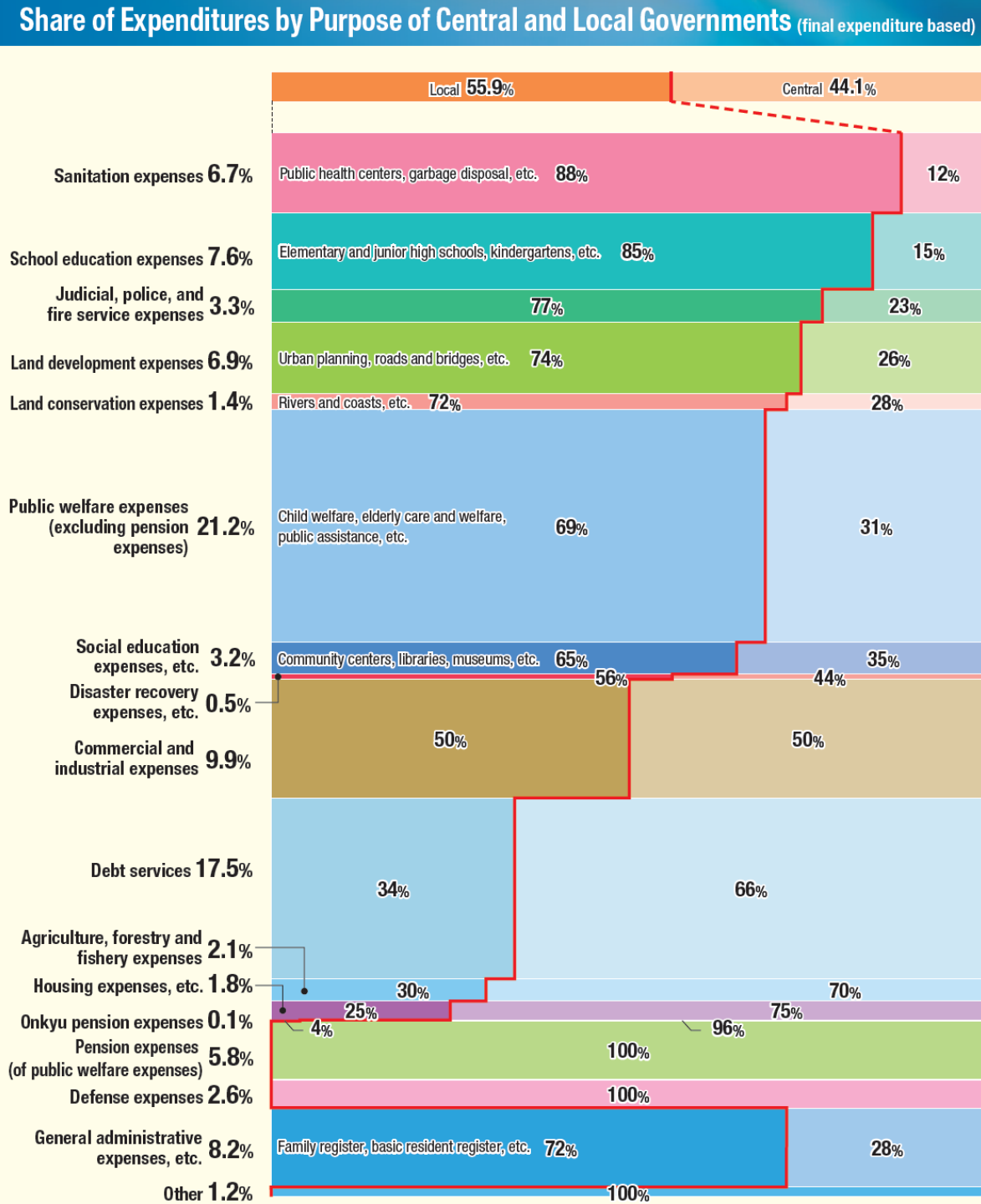
□ White Paper on Local Public Finance, 2024 ([pdf](#))

Breakdown of public expenditures



Expenditure

- White Paper on Local Public Finance, 2024 ([pdf](#))
 - Including General & special accounts of the central and ordinary accounts of local governments
 - Smaller than SNA's general government



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□ Vertical fiscal imbalance

- Uniformity of government services
- Inflexible local tax system
- Uneven distribution of tax capacities

□ Intergovernmental fiscal transfers

- Central Government Subsidy
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□ Local bond/borrowing

Vertical fiscal imbalance

- Fiscal imbalance between the central and local government (as a whole)
- Usually local's expenditures are larger, local's revenues are smaller
 - “Expenditures” & “revenues” do not include intergovt transfers
 - Revenues are tax, fees, etc, expenditures are service provision
 - [OECD Fiscal Decentralisation Database](#)

(% of GDP)		Canada	France	Germany	Italy	UK	US
Revenue	Central	19.1	44.7	29.2	41.7	38.7	19.9
	State	18.5		12.6			15.1
	Local	4.2	8.8	5.2	6.4	3.3	
Expenditure	Central	14.0	47.3	29.9	42.2	37.5	20.1
	State	19.6		11.2			19.1
	Local	8.2	11.0	8.5	13.9	9.2	
Difference	Central	5.1	-2.6	-0.7	-0.5	1.2	-0.3
	State	-1.1		1.5			-4.0
	Local	-3.9	-2.2	-3.3	-7.5	-5.9	

Fiscal imbalance in Japan

- Is it enough that govt that use the money collects the money?
 - Not necessarily true. Theoretical justification are...
 - Tax collection costs, fiscal externality, uneven distribution of tax capacities.

- Institutional backgrounds in Japan
 1. Uniformity of government services
 2. Inflexible local tax system
 3. Uneven distribution of tax capacities

1. Uniformity of services

□ Recall:

- Many tasks are **implemented** by municipalities
- Some local autonomy functions are statutory
 - Such statutory functions often have their standards
 - “National minimum”, “national standard”

□ Therefore

- Local govts must provide public services above a certain level
- Many tasks are redistributive
 - Compulsory education: primary 6 yrs, junior-high 3 yrs.
 - Social welfare: social assistance to the poor, the disadvantaged,
 - Public works as economic stimulus
- Local govts need money regardless their tax capacity
 - “We do not do it because we do not have money” is not allowed

2. Local tax system

□ “Local” taxes

- Restrictions by a national law “Local Tax Law”: tax items
- It restricts tax rates for some tax items

□ Prefectural taxes

- Ordinary: Inhabitant tax (PIT, CIT), enterprise tax, local consumption tax, automobile tax, light oil tax, ..
- For specific purposes: hunting tax, ...

2 corporate taxes

□ Municipal taxes

- Ordinary: Inhabitant tax (PIT, CIT), fixed asset tax, ..
- For specific purposes: city planning tax, Onsen tax, ...

□ (note) VAT 10% is national tax (7.8%) plus local tax (2.2%)

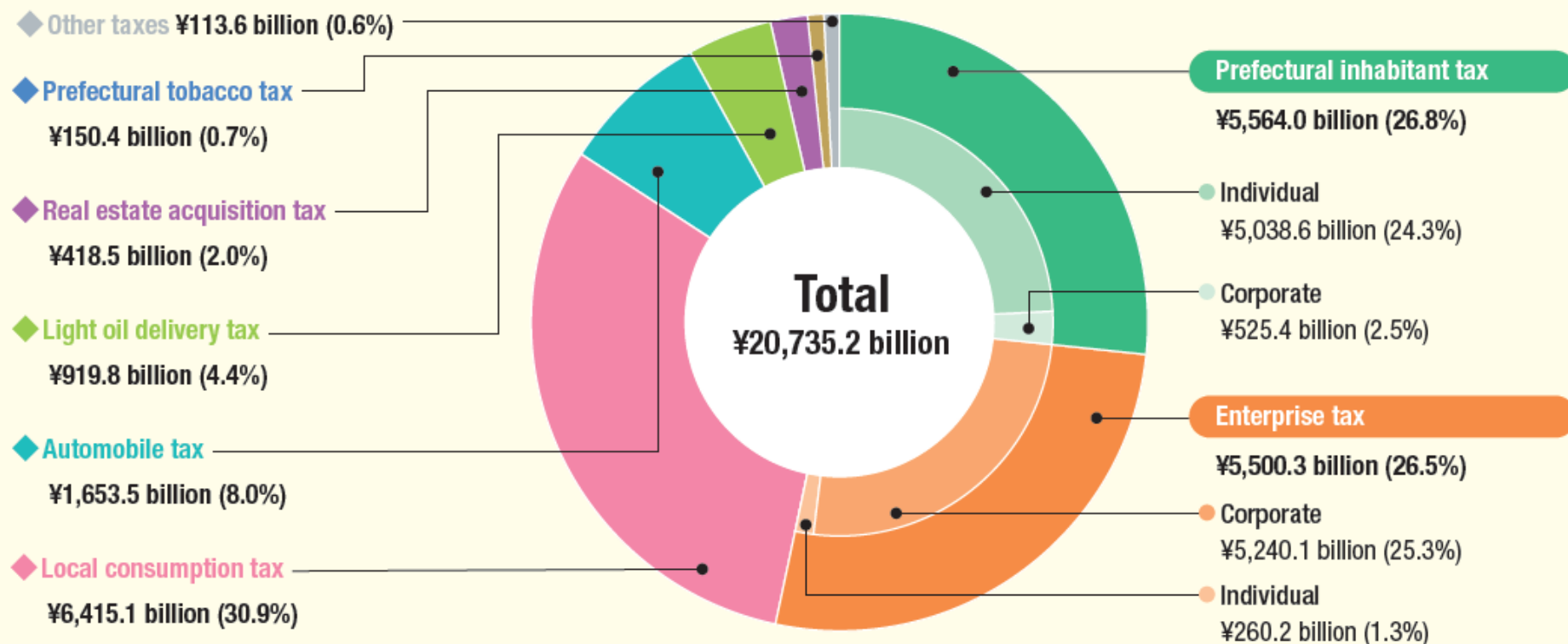
- $8\% = 6.24\% + 1.76\%$
- Local govts cannot change VAT rates

Local tax revenues

□ Prefectures

- Inhabitant taxes (PIT, CIT) + enterprise tax > 50%
- Local consumption tax (VAT) and automobile tax

Composition of Revenue from Prefectural Taxes (FY2022 settlement)

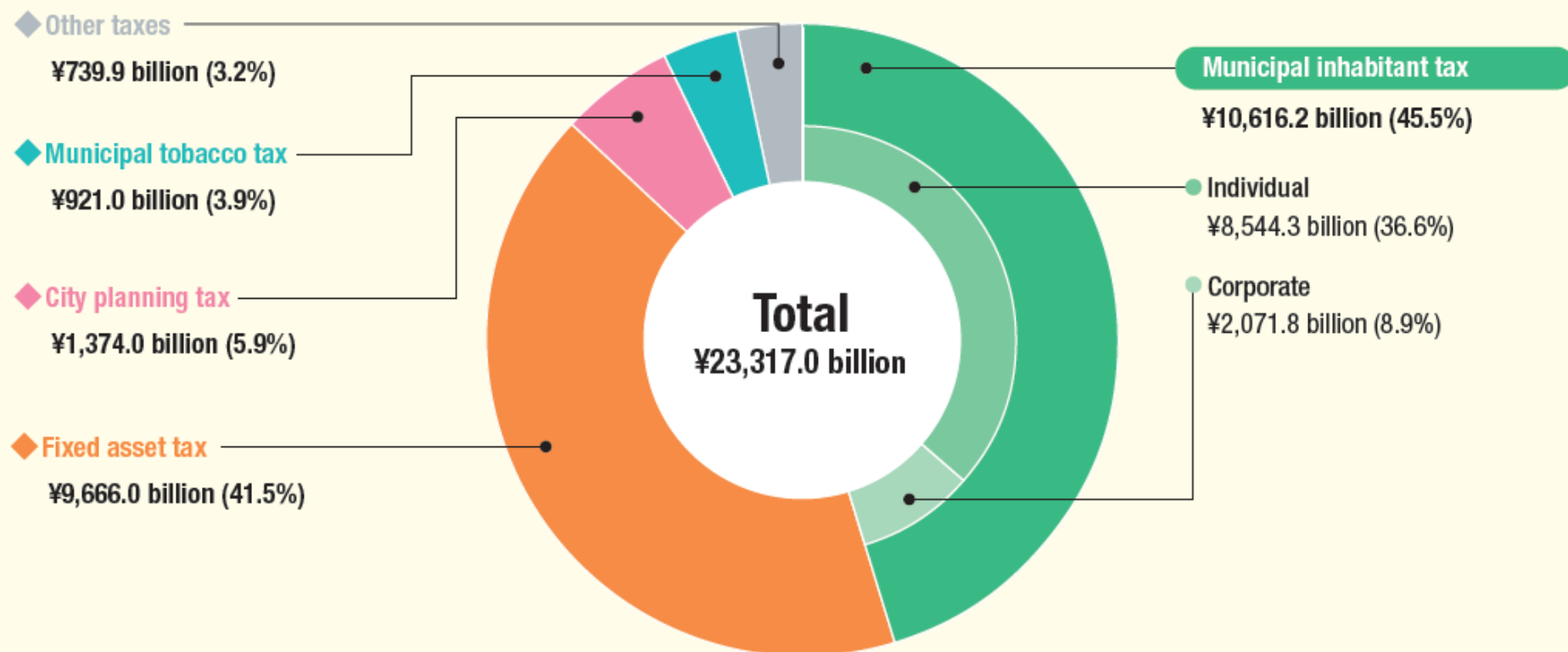


Local tax revenues

□ Municipalities

- Inhabitant taxes (PIT, CIT) = 50%
- Property taxes: Fixed asset tax and city planning tax

Composition of Revenue from Municipal Taxes (FY2022 settlement)



Local tax revenues

□ Revenues from various taxes

- International comparison
- A few countries have a large corporate income tax as a local tax
 - Income tax in Germany include the shared tax (federal, state and municipality) and municipal tax
 - Income tax in Sweden is only personal income tax
- Many depends on property tax

	Japan	US	UK	Germany	France	Canada	Sweden	Australia
Income	49.1	5.9	0.0	81.0	0.0	0.0	97.5	0.0
Consumption	23.8	22.5	0.0	8.0	47.5	1.7	0.0	0.0
Asset	27.1	71.6	100.0	10.9	52.5	98.3	2.5	100.0

Tax autonomy

□ Statutory and non-statutory tax

- Stipulated in Local Tax Law or not
 - The Law set standard tax rates or upper limit for some statutory taxes
 - Local govts need agreement of Minister of Internal Affairs to create non-statutory taxes
 - E.g.: nuclear fuel tax, industrial waste tax, hotel tax

□ Tax autonomy of local govts

- Excess tax rates: setting higher rates than standard rates
 - Often for corporate inhabitant tax, enterprise tax, fixed asset tax
 - E.g.: (FY2022) 192 bil JPY out of 4.6 tri. of enterprise tax
- Revenues from non-statutory taxes
 - 0.5% of total tax revenues

Tax autonomy

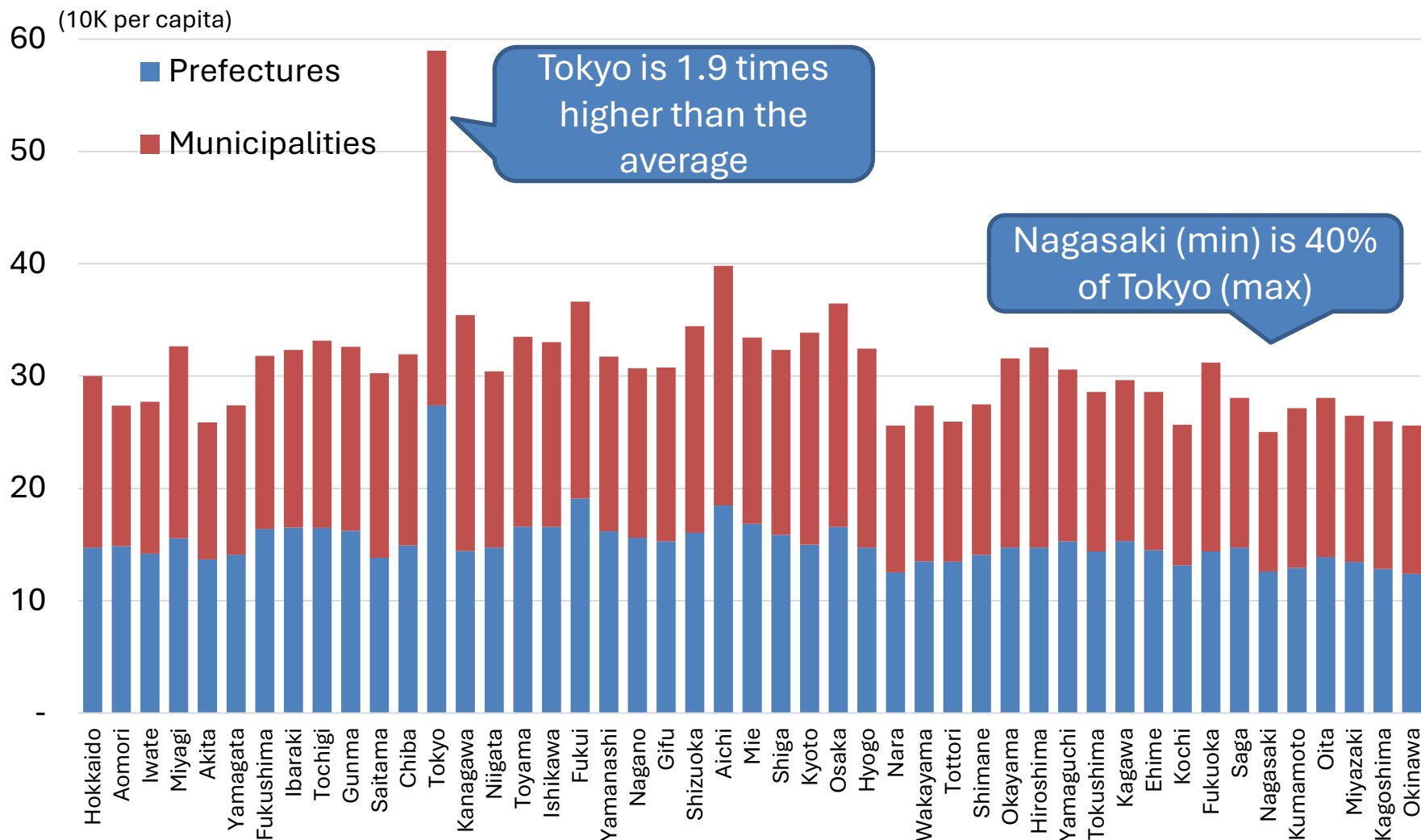
- Why so small differences in tax rates?
- Hypothesis: tax increase induces some trouble?
 - **Fiscal externality**: Residents and firms migrate to other regions
 - Price for richer public services...
 - If used for redistribution, not beneficial for non-beneficiaries
 - Local govts want to attract firms: even subsidies
 - “Keep up with the Joneses”
 - Mimicking peers: empirical analysis on policy diffusion
 - Decreases in central subsidies
 - Central subsidies designed so that this will not happen
 - Political reason: Depending on the central is easier than persuade voters (residents)
- After all, not flexible

Fiscal externality ([Dahlby 1996, ITAX](#))

- “A govt’s tax and expenditure decisions affect the well-being of taxpayers in other jurisdictions”
 - Directly by changing prices or public good provisions
 - Spillover: benefits, pollutions, ...
 - Indirectly by altering tax revenues or expenditures of other govts
 - Vertical: btn upper and lower govts
 - Horizontal: among govts at the same tier
 - Resource flow: migration of people and firms
 - Tax rates, welfare benefits, regulations,...
 - Welfare magnet
 - Information flow
 - Yardstick competition, mimicking, ...
 - Tax competition, policy competition

3. Uneven tax capacities

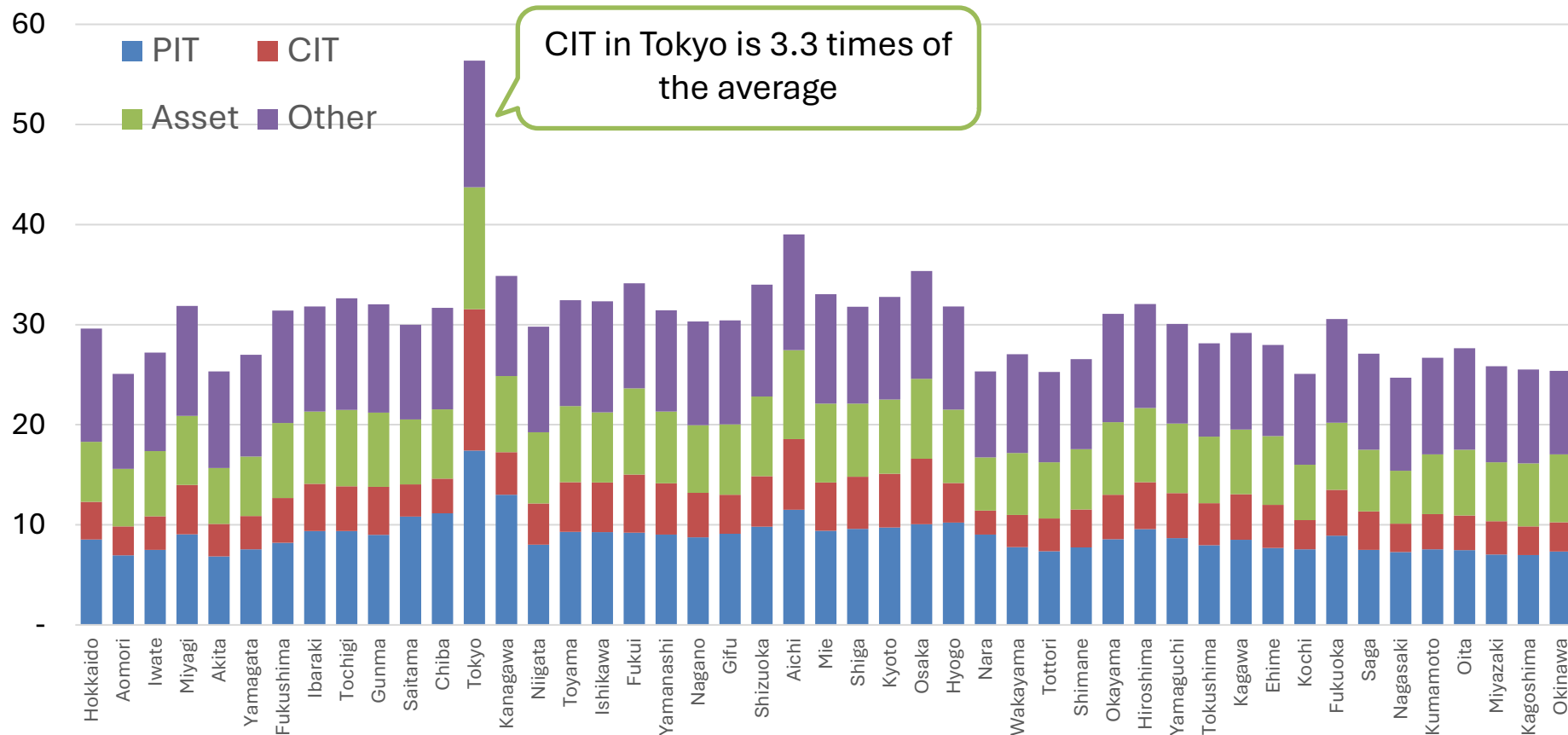
□ Tax revenues per capita(2022)



Uneven tax capacities

□ Tax revenues per capita, FY2022 settlement

- Excluding excess tax and non-statutory taxes
- “Tokyo problem”



Vertical fiscal imbalance

□ Institutional background in Japan

1. Uniformity of government services
 - Local govts must provide public services above a certain level
 2. Inflexible local tax system
 - (for any reasons) local govts do (can) not change tax rates
 3. Uneven tax capabilities
 - Concentration of tax base/revenues in Tokyo
 - (Because of local tax items)
- Localities with more demand for govt services have less tax revenues

□ Solutions are...

- Subsidies to local govts (**Intergovernmental transfer**)
- Subsidies are financed by national tax: vertical imbalance

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Fiscal transfers in Japan

- Central Government Subsidy (CGS)
 - a.k.a. National Treasury Disbursements
 - Categorical grants. Matching grants
 - Fixed portion of expenses are subsidized
 - Disbursed directly from the budget of central ministries
- Local Allocation Tax Grants (LAT)
 - General-purpose grants.
 - Disbursed through a special account. By MIC
 - A few localities do not receive LAT
- Local Transfer Tax Grants (LTT)
 - General-purpose grants (tax sharing).
 - Collected as a national tax and transferred to local governments according to specified rules.

Central Government Subsidy

□ 2 main purposes

- ① Helps local governments maintain uniform services in specific areas required by **national** laws
 - Public assistance and other social programs
 - Compulsory education
 - Public health
 - National elections, statistics,
 - ② Functions as an incentive for local governments to adopt specific projects that contribute to **national** objectives
 - Public works and infrastructure formation
- ## □ Emergency
- Disaster relief, disaster recovery

Local Allocation Tax Grants

□ General-purpose grants. Aims to

- “adjust imbalances in tax revenue among local governments”
- “guarantee revenue sources so that local governments in whatever region can provide a certain level of administrative services”
- “distinctive financial resource for all local governments, collected by the national government on their behalf.”

□ Portion of national taxes + negotiations

- The shares of the national taxes are earmarked for LAT
 - 33.1% of personal income and corporate income tax, 50% of liquor tax, 19.5% of consumption tax, 100% of local corporate income tax
- Ordinary LAT(94%): to cover financial shortfalls
- Special LAT (6%): In case of unexpected fiscal shocks (e.g., natural disasters)

LAT for individual local govts

□ Rule

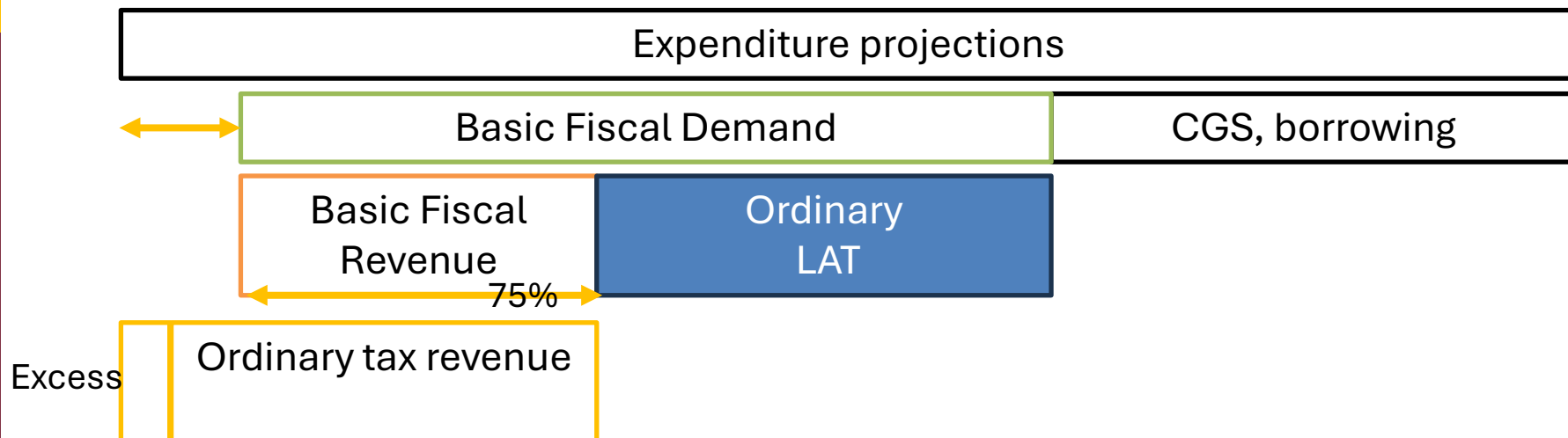
75% of ordinary local tax revenues, excluding
excess tax and non-statutory taxes

Non-
receiving

$\max (\text{Basic Fiscal Demand} - \text{Basic Fiscal Revenue}, 0)$

Estimates of necessary expenditures to implement
tasks at a rational and relevant level

□ In general,



Standard Fiscal Demand

- A reasonable estimate of the financial needs of each local government

$$SFD_i = \sum_j a_{ij} \cdot c_j \cdot x_{ij}$$

- Subscript j indexes specific service items (e.g., police, road maintenance, park, education)
- x_{ij} : Measuring unit (e.g., # of students for education).
- c_j : Unit cost. Obtained from a standard local government (with populations of 1.7 million for prefectures and 100 thousand for municipalities).
- a_{ij} : Adjustment coefficient. Accounts for unit cost differences (e.g., economies of scale, effects of socio-economic characteristics)

How LAT is computed

1. Total amount is determined in Local Fiscal Plan

1. Estimates of aggregated sum of expenditures and revenues of local governments by MIC
 - ▣ Different from actual ones: not considering excess taxes, etc.
2. Revenues from the national taxes earmarked for LAT
 - ▣ Usually smaller than necessary LAT computed above (1)
3. Negotiations (Local Fiscal Measures) on how to finance (2)
 - ▣ Transfers from the general account of the central govt
 - ▣ Borrowing in the special account for LAT
 - ▣ Borrowing by local govts

2. Allocate them to individual local govts following the rule

- Manipulation of unit costs and adjustment coefficients to make the sum of LATs to individual local govts meet the aggregated sum from Local Fiscal Plan

Remarks on LAT

□ General-purpose

■ Standard Fiscal Demand formula

- If a task is included in this formula, SFD increase
- If $SFD > SFR$, LAT grants may increase
- The increase may be perceived as grants for the task

□ Standard Fiscal Demand formula includes debt service

- Expenditures for paying back debt are “necessary”
- To promote local govts to issue such bonds / borrowing (?)

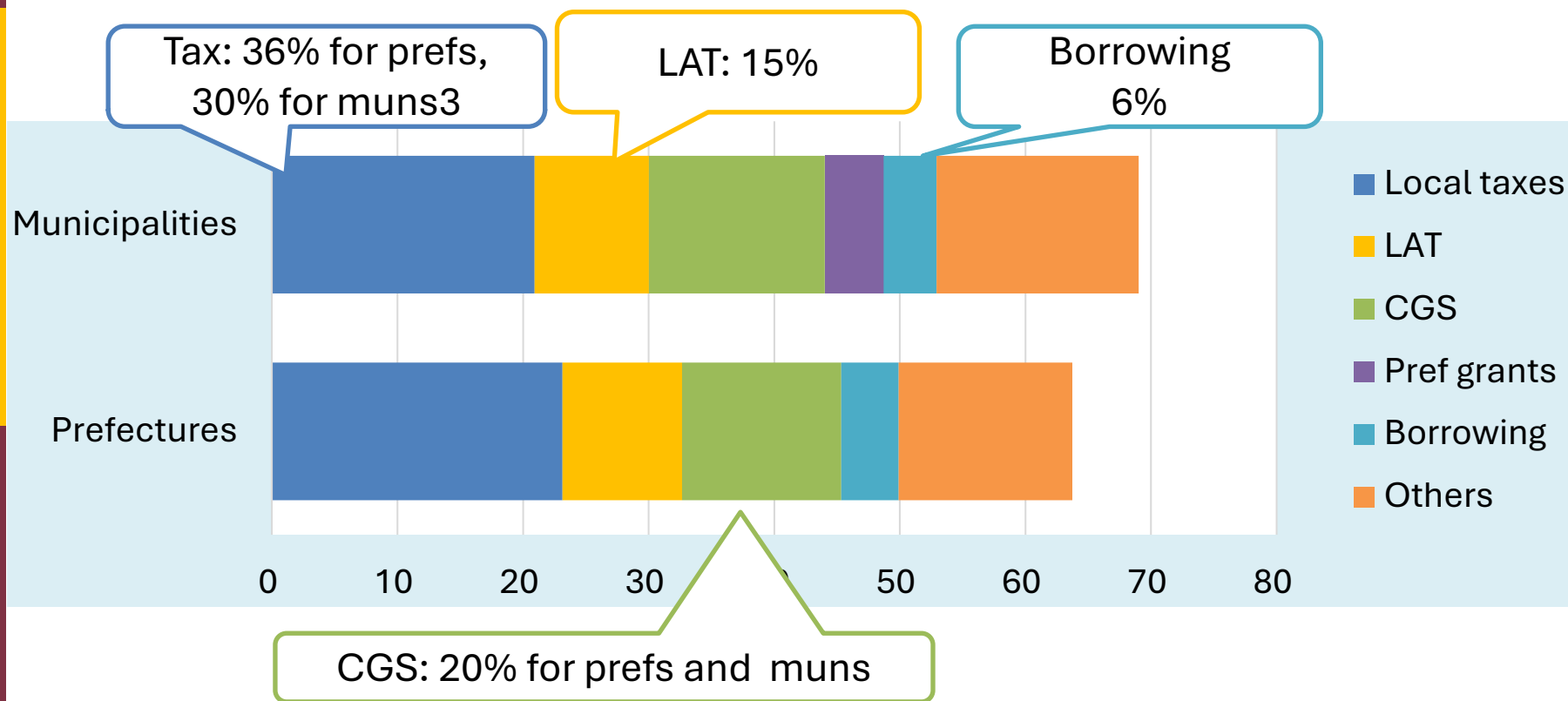
□ Only a small portion is non-receiving (FY2022)

- One prefecture: Tokyo
- 72 prefectures: Tomari, Rokkasho, Kariha, Toda, Ichikawa, Urayasu, Musashino, Mitaka, Kawasaki, Kamakura, Nagoya, Tobishima, ...

Revenue settlements

□ Settlement FY2022

■ Transfer revenues (CGS, LAT, LTT): 1/3



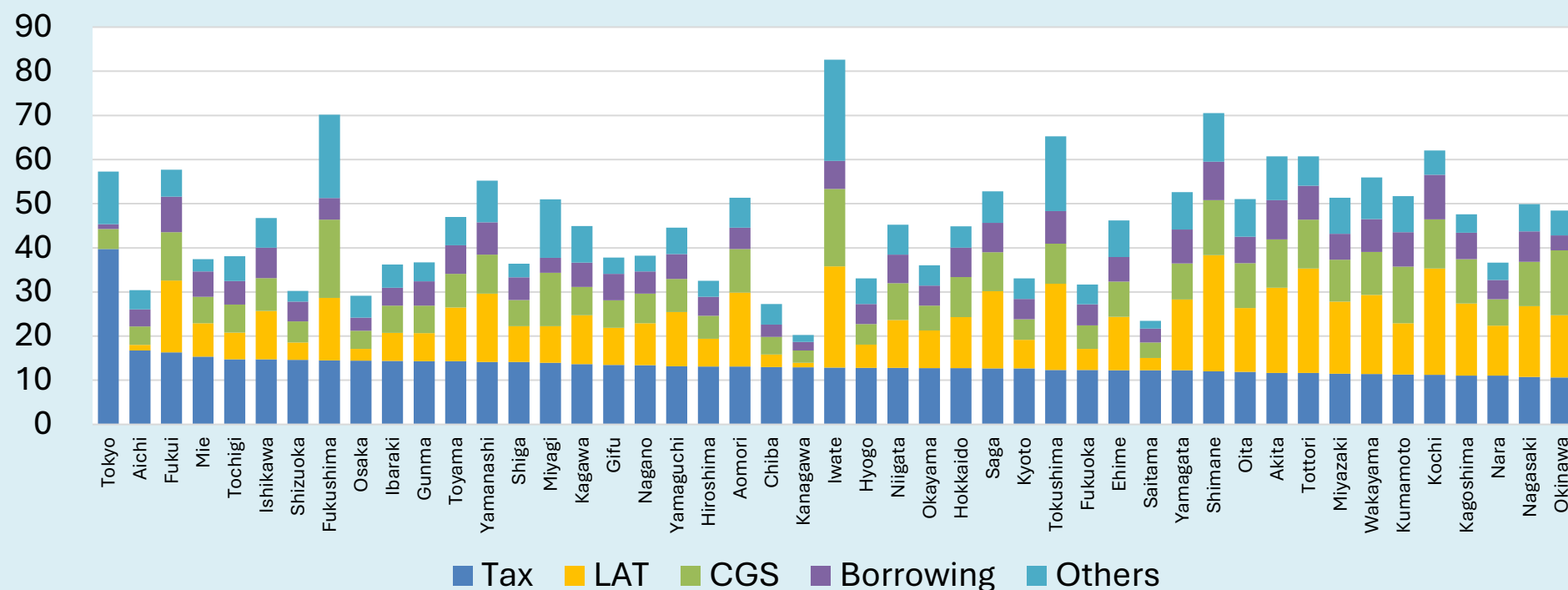
Reverse of revenues?

□ Prefecture governments

- Descending order of per capita tax revenues
- Small local tax revenues = Large transfers
- Sum of taxes and transfers?

□ Effects of scale economy?

(source) Settlement FY2018



Remarks: Vertical fiscal imbalance

- “Fiscal transfers as a solution” may be misleading
 - which comes first a chicken or egg
 - Fundamental solution: allocations of tasks and/or taxes
 - Excluding CIT from local taxes?
 - Stop “minimum standards”?

- Current CGS and LAT may not be the best
 - Transfers across local govts, not from the central
 - Negotiations among locals may not be settled
 - Automatic transfers or more simple formula
 - Tax sharing: Local Transfer Tax

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Local bonds

□ Purpose-specific

- Capital expenditure (infrastructure investment), disaster recovery, etc
- Bond issuance cap is set for each project, as % of expenditures

□ Consultation ex ante

- In principle, local govts must consult with upper govt
 - Prefectures and designated cities must consult with Minister of Internal Affairs, other municipalities with their governor
- If certain conditions are met, only notification is necessary
- If fiscal situations go bad, permissions are required (limitation)

□ Assistance from the central government

- Low rate, long term loan from FILP (public funds)
 - 4.8 tri out of 12 tri in Local Bond Plan FY
- (Virtually) subsidies for debt service costs
 - Inclusion in LAT calculation (Standard Fiscal Demands)

Defaults?

- Supports from central government
 - But local government should and can decide what to do (local autonomy)
 - Possibility “creative accounting” (cheating) : Yubari City
- Fiscal reconstruction law as a bail-out system since 2009
 - Early warning system based on a combination of fiscal indicators
 - If the alarm ring, the local government has to make fiscal adjustment plan.
 - Central government can advise the local on the plan (intervene, supervise)
 - Fiscal reconstruction is not assumed.

Municipal bond in US

□ Detroit defaults on some debt

- (Reuters, 14 June, 2013) *Detroit said on Friday [14, June] it would stop making payments on some of its about \$18.5 billion debt, which would put it in default, and the "insolvent" city called on most of its creditors to accept pennies on the dollar to help it avoid the largest municipal bankruptcy filing in U.S. history.*

□ Puerto Rico

- (Reuters, 8 August, 2015) *Puerto Rico has defaulted on its debt by paying only a fraction of what was due on bonds due Aug. 1, showing the depth of the island's economic and cashflow problems and potentially opening the door to litigation. The commonwealth paid only \$628,000 of a \$58 million payment due on its Public Finance Corp bonds, the head of its Government Development Bank said in a statement on Monday.*

Puerto Rico case...

□ Defaults on Constitutionally Guaranteed Debt

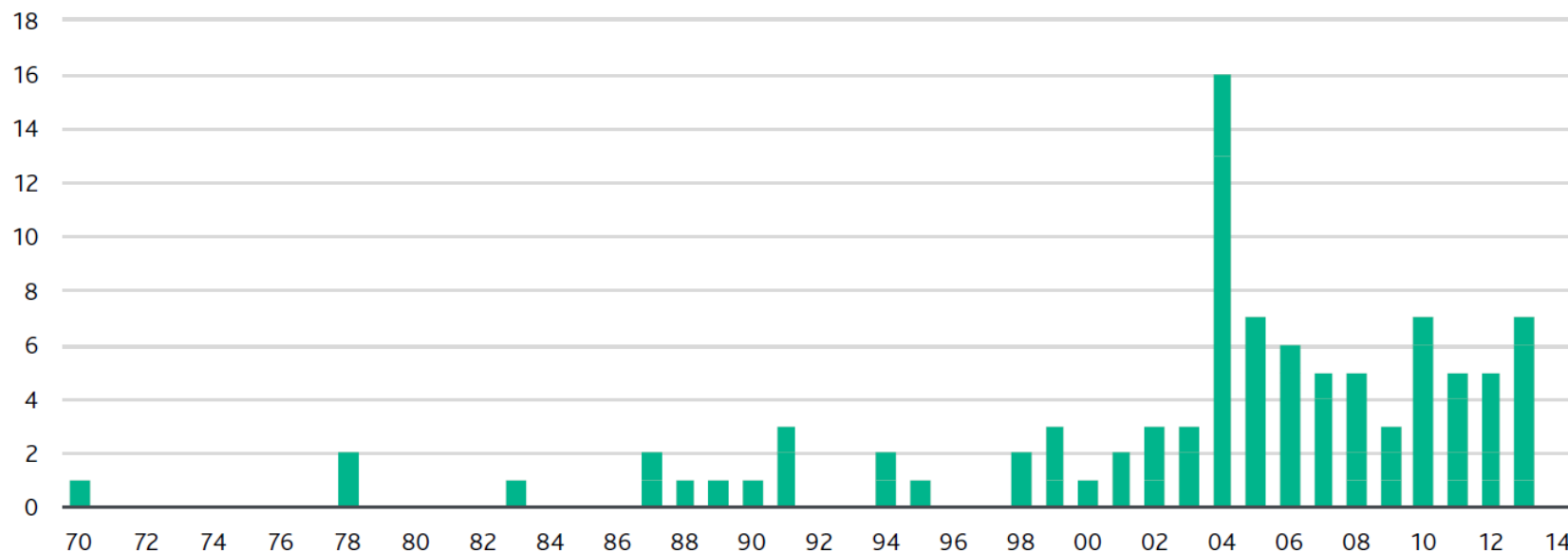
- (Wall Street Journal, July 1, 2016) The Puerto Rican government failed to pay almost half of \$2 billion in bond payments due Friday, marking the commonwealth's first-ever default on its constitutionally guaranteed debt.
- President Barack Obama signed legislation Thursday that addressed the island's debt crisis but didn't provide any mechanism to avoid Friday's default. Instead, the law gives the island a stay against creditor litigation.
- Of the \$779 million in general obligation debt the commonwealth failed to pay Friday, about half could translate into missed payments for bondholders.

Municipal bond defaults in US

- The one-year default rate still remains low
 - Moody's, "US Municipal Bond Defaults and Recoveries, 1970-2014"
 - Examples include: Jefferson County, Alabama (May 2012), Harrisburg, Pennsylvania (March 2012), Stockton, California (August 2012).

EXHIBIT 11

Number of Defaults per Calendar Year



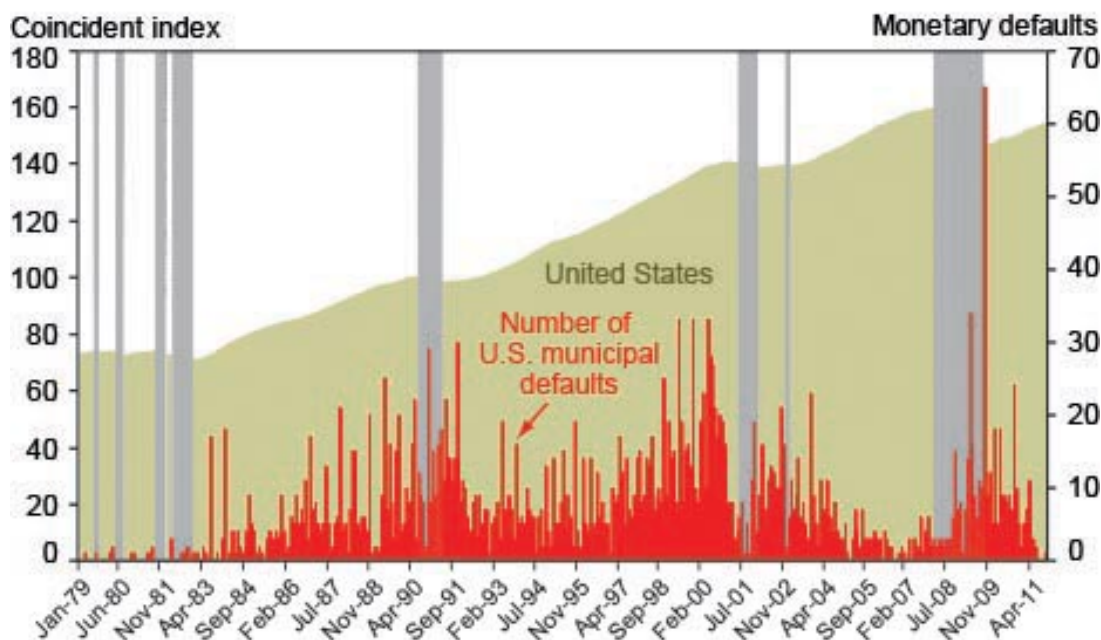
Municipal bond defaults in US

□ “The Untold Story of Municipal Bond Defaults”

- Source: NY Fed’s blog, <http://libertystreeteconomics.newyorkfed.org/2012/08/the-untold-story-of-municipal-bond-defaults.html>

- “Our database shows 2,521 defaults during [1970-2011]”
 - More than 60 defaults per year on average
 - Not all municipal bonds are rated. Moody’s counts only the defaults of rated bonds.

U.S. Coincident Index versus Municipal Defaults



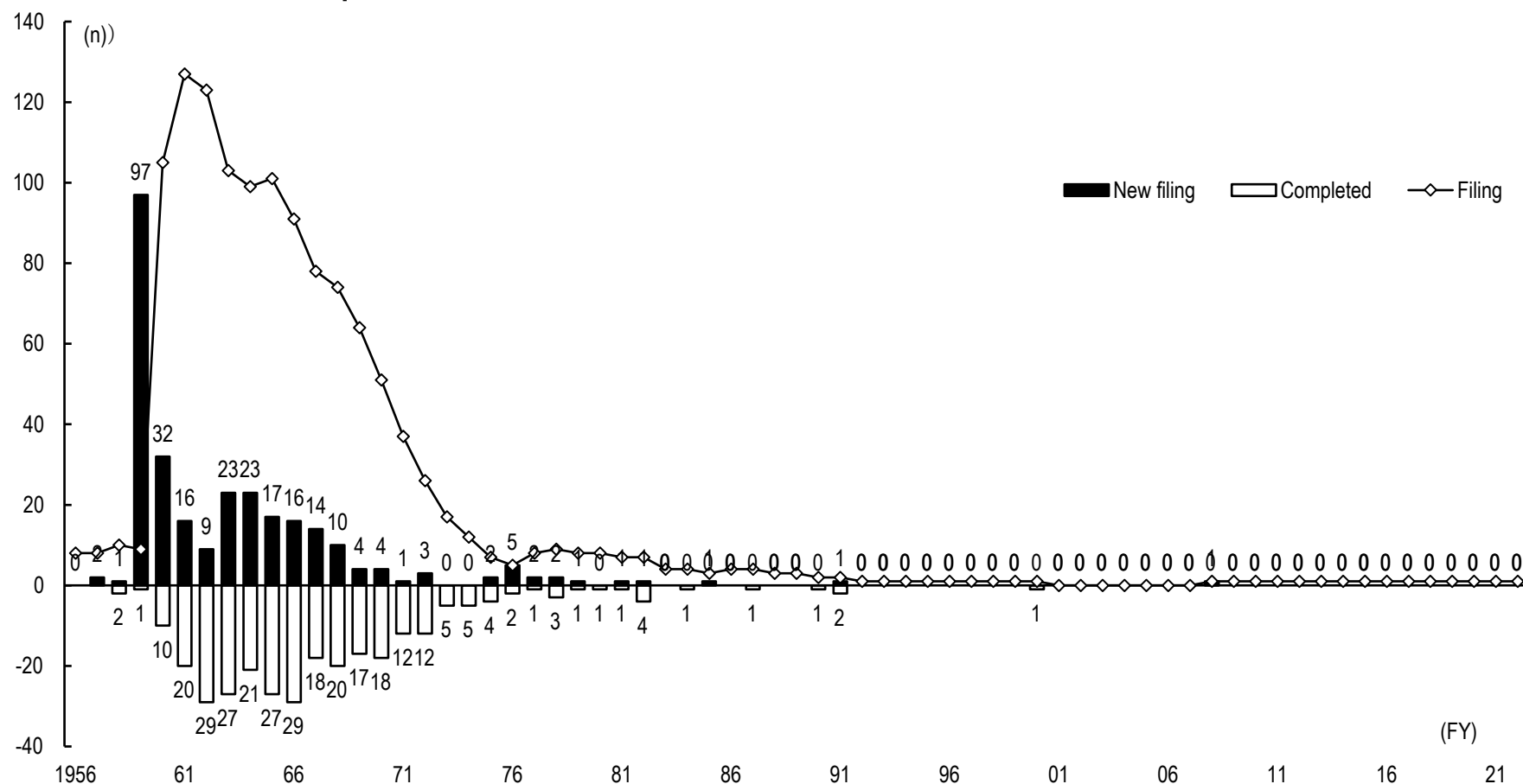
Sources: Federal Reserve Bank of Philadelphia; combined default database.

Note: Shaded areas indicate two or more consecutive months of contraction in the coincident index.

How about Japan?

Very rare cases: file a case for Fiscal Reconstruction

- Akaike town, Fukuoka (1992), Yubari city, Hokkaido (2007)
- 17 municipalities since 1975



Pros and Cons

□ Pros

- Residents need not care about “government shutdown”

□ Cons

- Moral hazard of local governments
- Risky investments, irresponsible expenditures...
- Pressures from others?: financial markets, voters?