The present condition and the problems for the local public finance in Japan

By Hidekazu Aoki (Nagoya City University)

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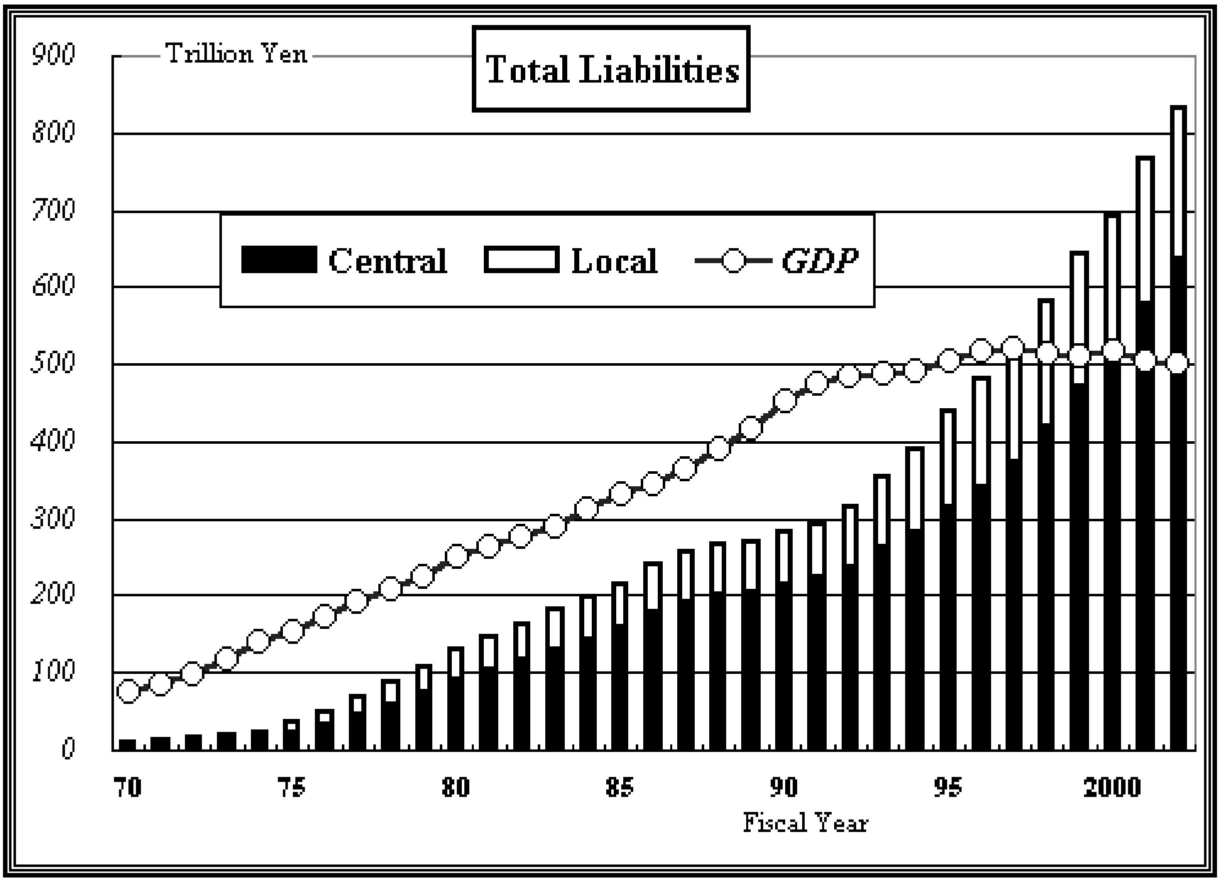
1 The Immensely Accumulated Debt

Japan's public finance of the central and the local governments in summation, has come to standstill because of the enormously accumulated debt, which is the largest in the postwar world and will remain as one of the worst records in the world history. The total outstanding debt for both the governments amounts to 832 trillion yen (6,900 billion US$ at the rate of 1US$ = 120 yen, the same as following), and has become 1.7 times as large as the GDP of 500 trillion yen (4,200 billion US$) at the end of the 2002 fiscal year.

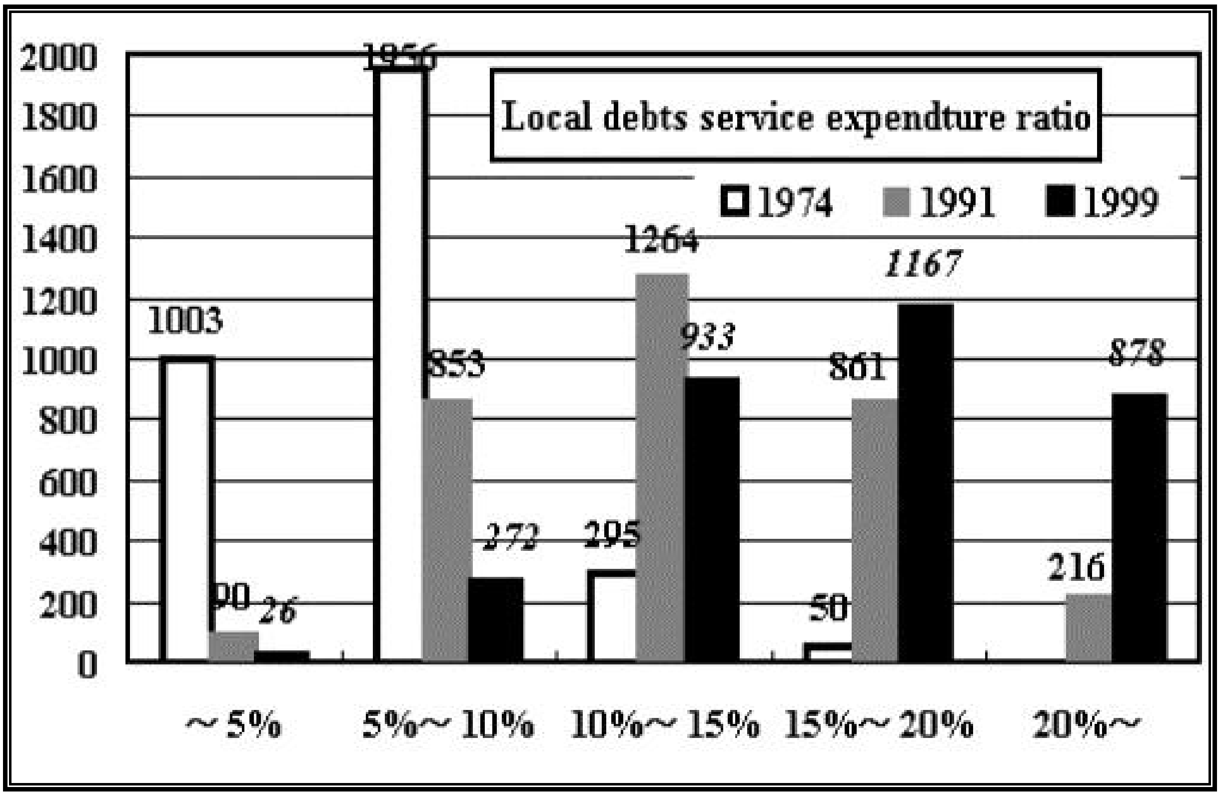


2 Local Public Finance is just before Collapse

It is very difficult for the local public finance to make a primary budget surplus. Moreover, where as the central government can make the central bank take over a public debt by means of the debt management policy, the local government can never do the similar policy. Therefore, the dissolution of debts is not easy especially when the local governments hold a budget deficit. In the United States, many state constitutions actually forbid holding a budget deficit in a state government. The Japanese local government is holding the debt balance of 194 trillion yen (1,600 billion US$) in total at the end of 2002 fiscal year. It has reached no less than 40% of Japanese GDP. The local public finance of Japan is in a very serious situation.

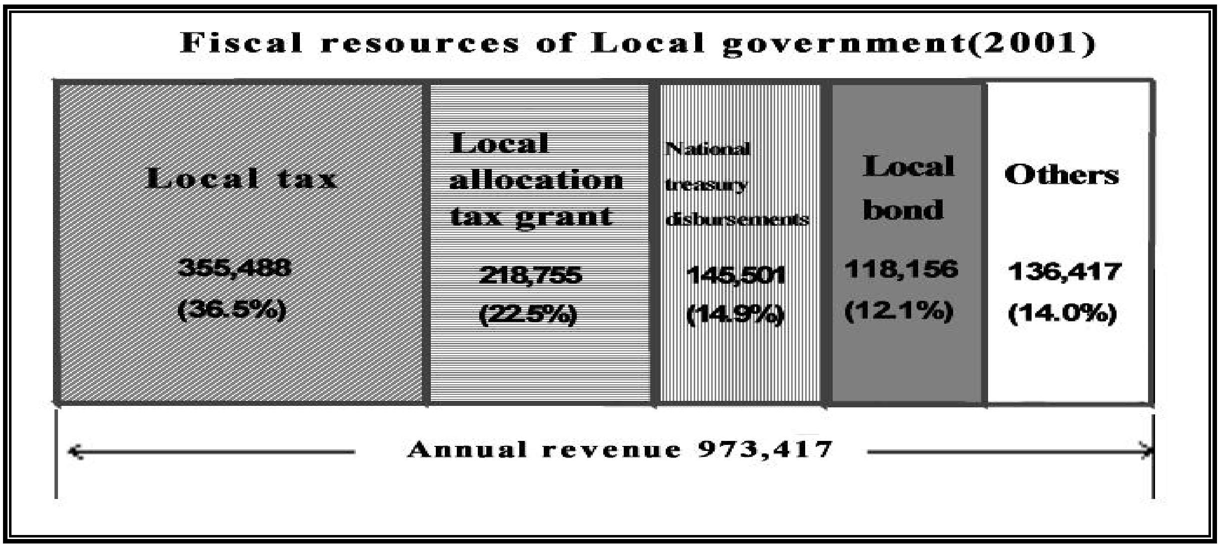
The funded debt balance of the whole local governments increased rapidly: up to 1.7 times in the 1980s and up to 2.6 times in the 1990s. If a debt expands so rapidly as this, naturally they will be at a serious loss for its payment. According to the "White Paper on the Local Public Finance" (2000Y editions), the "Local debt service expenditure ratio" at the end of the 1999 fiscal year was 17.2% in all local government averages. "Local debt service expenditure ratio" means the ratio of the debt service expense for a local bond to the source of revenue which local government can use freely such as local tax and local allocation tax grant. The higher this ratio becomes, the more the source of revenue will be taken by debt payment.

The critical line is said generally to be 15%. The 2045 local self-governing bodies are beyond the critical line. It shares 2/3 of the whole. If the ratio exceeds 20%, the body will be regarded as in a substantial "fiscal bankruptcy". No less than 878 organizations (15 prefectures and 863 cities, towns and villages) are in this dangerous situation. The very ordinary self-governing bodies are tortured by debt payment. One can say that local public finance is just before collapse.



3 Local Public Finances under the Control of the Central Government

The Japanese central government controls 50% of the district revenue source. The local allocation tax grants and the national treasury disbursements from the central government occupy 37.4% of the total public revenue. This exceeds the sum of district tax revenues (36.5%). Furthermore, when local governments issue a local bond, they have to get "permission" by the central government, which restricts the total amount of the local bond issue in the frame of a "local bond plan."



4 National Development Project and Local Governments

While the central government controls the local public finance in the said way, the former drew up the "National Development Project" several times in the past under the name of "well balanced development" of the country, and the local governments have been mobilized for the project. The local governments think that development of regional economies would be retarded if they should fail to join these development projects which provided subsidy premiums regarding public works, preferential dealing of local allocation tax grants, etc., and they have been competing fiercely for becoming a designated place region.

The project gradually became all-purpose oriented and increasingly burdensome for the local governments: the local public finances have come to share the source of revenue more and more. They have come to suffer such a financial burden through the series of the national plans in the course of time. For this reason, the local governments have failed to achieve the expected regional development. However, the assessment of effect/cost performance has not been made. Considering the financial deadlock of the local bodies, the very promoter of the national project, the Ministry of Public Management, Home Affairs, Posts and Telecommunications has to release an epoch-making change in their policy principle: they announced, on April 15, 2003, the necessity of "policy assessment" for developments of recreational facilities, admitting "that it needs to be based also on change in the situation of social economy, and it is necessary to perform radical reexamination of a policy".

Year	Name of Plan	Outline
1950	Comprehensive National Development Act	Revival policy after the war which imitated TVA ⇒Big river valley is specified to be a specific area.
1962	Comprehensive National Development Plan	Target annual: 1970 "Base development system" ⇒15 new industrial cities and 6 industrial special area are specified.
1969	New Comprehensive National Development Plan	Target annual: 1985 "Large-scale project design" ⇒The national Shinkansen and the national expressway network construction plan
1977	3rd Comprehensive National Development Plan	Target annual: Ten years after "Specification of the model settlement area"
1983	Technopolis Act	19 prefectures & 18 areas are specified
1987	4th Comprehensive National Development Plan	Target annual: 2000 "Multi-polar and decentralized society formation" ⇒The proposal of a new metropolis construction
1987	Resort Act (The Law for Development of Comprehensive Resort Areas)	41 prefectures & 42 areas are specified ⇒Adoption of the "third sector" system by the government and private enterprise joint investment
1990	Basic Plan for Public Investment	Target annual: 1991-2000 Gross-investment frame: 430 trillion yen
1994	New Basic Plan for Public Investment	Target annual: 1995-2004 Gross-investment frame: 630 trillion yen ⇒Extension will be determined in June, 1997 for three years (the total investment amount maintains).
1998	The grand design of the country in the 21st century (5th C.N.D.P)	Target annual: 2010-2015 "Multi-axes type country structure formation"

In addition, one can easily recognize the plight of the local governments on seeing Oita Prefecture which has succeeded in applying for all kinds of the past development projects yet has come to advocate "One Village, One Product" movement, a very plain and simple policy.

5 Localization of Public Works and Decisive Financial Aggravation

The central government has continued to take the policy to maintain or expand the total amount of public works, while suppressing their own expenditure for public works since the 1980s (when finances began to become tight) until the start of new century. In this policy, the part unable to be undertaken by the central government was inevitably transferred to the part to be undertaken by the local governments. This is the so-called "localization of public works." The central government urged the local governments to comply with the policy by utilizing "Local allocation tax grants", "Public-works national subsidies", and also "Bonds permission" in this policy.

The local sides also welcomed this policy. In fact buildup of infrastructures progressed and there was a remarkable political merit in that the policy brought local residents "clearly visible results" which were attributed to the political achievements of a local head, district assemblypersons, and governmental agencies.

However, this policy brought forth decisive aggravation to both the local and the central public finances. The local debt had been accumulated immensely. The distribution base for dealing local allocation tax grants also expanded in the central public finances. The tax revenue alone became too deficient, and they filled the gap by issuing "local bonds" distinct from the national bond on the special account. And this became ordinary. The debt of this special account is 46 trillion yen (380 billion US$) at the end of the 2002 fiscal year.

6 Public-Works Dependence of District Economies

In Japan, in comparison with many other countries, the income differential between people is relatively small. Public works in Japan have borne the role to mitigate the income differences that exist between metropolitan areas and the other districts, or the high-income and the low-income brackets. In this point of view, public works in Japan were also a kind of "welfare works" mainly sustained by the inter-regional income transfer through the public works.

However, many self-governing bodies have continued this policy without any restriction and, as a result, have come to make the public works the core of the regional economy or the only "key industry." Such local bodies have appeared nation wide. A certain level of Keynesian "multiplier effect" was obtained during the enforcement of public works, and, for this period, supply of investment funds followed in the regional economies. They might have anticipated that the industry to succeed these public works would appear and constitute a wing of the regional economic structure. However, the actual results were entirely against this expectation. Therefore, in order to maintain the income level upheld by the public works and to sustain the expanded scale of the regional economies, <further> public works were needed. In this way, not only administration but the whole residents and the whole regional economies came to depend on public works alone. "Public-works dependent structures" have been built up firmly.

7 Local Governments' Triple Distresses

Public works in Japan fatally depended on the public bond as the source of revenue. The reaction has appeared seriously. Although the central government and the local government have been continuing principal-and-interest payment of public bonds, in fact, they have repaid the old debt by a new debt. While repeating this, the interest payment burden has driven local finances to its verge of fiscal bankruptcy. At last they had to cut down the very expenditure for public works, i.e., the lifeline to the local economies.

If the multiplier effect really exists, then we have to consider the minus multiplier effect due to the decrease of expenditure. The more public works decrease, the more the obtainable income decreases. One can assume that it would cause a downward spiral. There is a very high possibility that the self-governing bodies fall into such situations especially where public works have become the key-industry. Reduction of residents' income spreads extensively in the every area. If this occurs, the regional economies will shrink at a rapid rate. It will rebound to self-governing bodies in the form of sharp decrease in tax revenues. Fiscal bankruptcy and an economic collapse will reinforce each other like "the ring of Mebius." One can easily see that the local governments tormented by the triple distresses: mutually entangled fiscal bankruptcy, economic collapse and high unemployment, occurring in a chain reaction.

8 Financial Boomerang Effect

The Japanese public investment got into stride since the last stage of the high economic-growth, distinct from the general impression. The central government began to utilize public works for leveling the inter-regional gap that had expanded during the period of the high economic growth. And the depression due to the first oil crisis arrived, the public works comprising the so-called the "Keynesian policy" came to occupy the major portion of government expenditure.

However, the central government fully depended on the "construction bond" for the source of revenue and has come to hold serious financial difficulties at the period of the second oil crisis. Then, the central government decided to adopt the policy that would transfer the fiscal burdens to the local governments. But, the local governments had no proper resource of revenue for managing the increasing burdens. The central government corresponded to the plight by easing the bond issuance permission to the local governments. The heavy debt dependence of the local governments began from this time. And the local public finance was unilaterally aggravated.

On the other hand, the financial system of Japan stands on a principle that the central government takes the final responsibility of the local government's budget deficits instead of giving independence and self-accountability. For this reason, the local governments' deficits counter-flow to the central government, and the central government has fallen into the situation of holding further increasing budget deficit.

The financial crisis of the Japanese central government and the local governments interrelated closely shows the grave result of "the debt leveraged finances." This analysis of Japan’s public financial crisis provides a more general model for the “together collapse” phenomenon on the both "supply side" and "demand side" of the finance. Just compare: the central government vs. the local ones; the financial industry vs. the construction industry in Japan’s bubble economy; the producer/ lender Japan vs. the consumer/ borrower U.S.; the "advanced nations" like Japan, the U.S. and Europe vs. "developing countries."

Anytime anywhere the only solution for the borrowers is to borrow more money until the lenders’ funds exhaust entirely. There is no exception for this frail policy principle. Worldwide and all time growing are the liabilities; of Japan’s governments from the nation; of the Asian countries from Japan; of the U.S. from the world; of the “developing countries” from the OECD. However, the final source of lenders’ money is the borrowers’ repayment. When borrowers go bankrupt, lenders will also go bankrupt. This is the very cause of together collapse. Just consider who borrows how much from whom. It alone explains the true state of Japan’s and the World’s economy and finance.