Local Bonds in Japan

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Foreword

The Council of Local Authorities for International Relations and the National Graduate Institute for Policy Studies have been working since FY 2005 on a “Project on the overseas dissemination of information on the local governance system of Japan and its operation”. On the basis of the recognition that the dissemination to overseas countries of information on the Japanese local governance system and its operation was insufficient, the objective of this project was defined as the pursuit of comparative studies on local governance by means of compiling in foreign languages materials on the Japanese local governance system and its implementation as well as by accumulating literature and reference materials on local governance in Japan and foreign countries.

In FY 2010, we will continue to compile “Statistics on Local Governance (Japanese/English)”, “Up-to-date Documents on Local Autonomy in Japan”, “Papers on the Local Governance System and its Implementation in Selected Fields in Japan” and “Historical Development of Japanese Local Governance”. We will also continue to conduct a search for literature and reference materials concerned with local governance in Japan and overseas to be stored in the Institute for Comparative Studies in Local Governance.

We would like to express our sincere appreciation to the members of research committee on “Project on the overseas dissemination of information on the local governance system of Japan and its operation” for their considerable efforts, and to all who offered valuable advice and cooperation to this project.

March 2011

Yoko Kimura
Chairperson of the Board of Directors
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Tatsuo Hatta
President
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Preface

This booklet is one of the results of research and dissemination activities conducted by the Institute for Comparative Studies in Local Governance (COSLOG), National Graduate Institute for Policy Studies (GRIPS) in FY 2010 as part of a project that started in FY 2005 entitled “Project on the overseas dissemination of information on the local governance system of Japan and its operation”, carried out in cooperation with the Council of Local Authorities for International Relations (CLAIR).

As an integral part of this project, within the framework of a series of documents entitled “Papers on the Local Governance System and its Implementation in Selected Fields in Japan”, first issued in FY 2006, individual booklets deal with key themes selected from systems and implementations in various fields of Local Autonomy in Japan. The 18 booklets listed below have been issued up to FY 2009.

FY2006
People and Local Government-Resident Participation in the Management of Local Governments
Training of Japanese Local Government Officials as a Policy of Human Resource Development
The Equalization of Fiscal Capacity and the Securing of Financial Resources for Local Public Bodies
Raising the Level of Efficiency of Public Services — Use of the Private Sector in such ways as the Designated Manager System for Public Facilities and Private Sector Consignment —

FY2007
Local Assemblies in Japan
Japanese Local Governments and ICT
Environmental Administration in Japan and the Role of Local Governments
Industry as the Driving Force of Regional Promotion
Educational Administration in Japan and the Role of Local Governments
Local Taxation in Japan

FY2008
The Organization of Local Government Administration in Japan
New Possibilities for Local Promotion through Tourism
The Development of a Health Insurance System for the Elderly and Associated Problem Areas
Evaluation in Local Governments in Japan

FY2009
Local Government Planning in Japan
Japanese Publicly Managed Gaming (Sports Gambling) and Local Government
The Position of Local Government in the National Health Insurance System and Associated Problem Areas
Administrative Reform in Japanese Local Governments
Volumes 19-20 of “Papers on the Local Governance System and its Implementation in Selected Fields in Japan” were written under the responsibility of the following members. (Title of members as of March 2011)

(Chief)
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(Deputy Chief)
Yutaka Tanaka, Professor, Graduate School of Management, Kagawa University

This booklet, the 19th volume in the series, is about local bonds in Japan, and was written by Prof. Tanaka.

This commentary deals with the significance and function of local bonds in Japan; the legislative system regarding local bonds, including the recent transition from the permission system to a negotiation system; specific trends in the form and funding of local bonds; the balance of local bonds and the current state of debt expenditure. This account was made as simple as possible, to aid understanding of the system of local bonds and how they are used.

Finally, I would like to express my appreciation to Prof. Tanaka, and also to other members of the research committee for their expert opinions and advice.

March 2011

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Local Bonds in Japan

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1 Introduction

Local governments carry out a variety of undertakings covering every area of administration in order to further the welfare of local residents—education, engineering works, industrial development, social welfare, sanitation, policing, fire-fighting, etc.

In principle, the cost of these undertakings normally is met from the income obtained during the year in question, from general revenue resources such as local taxes and the local allocation tax and from specific revenues such as the national treasury disbursements and the treasury obligatory shares.

However, when a local government carries out a special undertaking that necessitates considerable expense, such as large-scale construction work or disaster restoration works, or invests in a profit-making project such as a publicly-managed enterprise, the financial burden is carried over to later years that will share the use of the public facility in question; or in cases where it is appropriate for the cost to be paid out of future revenues, the project is financed from debts the burden of which is passed on to later years.

Local bonds, as the name indicates, are financial liabilities (debts) taken on by a local government to be repaid over a period of time in excess of one fiscal year.

What follows is an explanation of local bonds in Japan.

2 An overview of local government and local public finance in Japan

This paper deals with local bonds in Japan; but I will begin by first of all taking a simple look at a few points relating to local government and the general situation regarding local government finances.

(1) First of all, local government in Japan is a two-tier system of prefectures and municipalities (cities, towns and villages). As of the end of March 2010 there were 47 prefectures including Tokyo Metropolitan Government and 1779 municipalities (of which 19 are ordinance-designated cities that are granted the same authority as the prefectures).

The circumstances faced by each prefecture, from the largest, Tokyo, with a population of 12.61 million, to the smallest, Tottori, with a population of 595,000, are varied, as are the circumstances faced by the municipalities, the largest being Yokohama City with a population of 3.62 million and the smallest Aogashima Village, with a population of 165; needless to say, the scale of their finances also ranges from huge to tiny. (Figures as of March 31st, 2010: The total population of Japan is 127.058 million based on the Basic Resident Register)

(2) In Japan most of the administration closely connected to the life of the people, such as welfare, school education and fire-fighting as well as the maintenance of infrastructure such as roads and rivers...
is carried out by the local governments; local public finances occupy an extremely important position, on a level with and inseparable from the finances of the central government.

With regard to national and local government spending, the net total of national (the general account and 6 special accounts) and local (ordinary account) government expenditure minus duplication was 150.479 trillion yen; but if we divide the total net expenditure according to whether it was ultimately spent by the central government or local governments, we see that expenditure by the central government was 61.9729 trillion yen (41.2% of the total) while expenditure by local governments was 88.5061 trillion yen (58.8% of the total); the immensity of the role of the local governments is clearly apparent.

(3) The amount of tax collected, national taxes and local taxes combined, comes to 85.3894 trillion yen. If we separate this into national taxes and local taxes, national taxes amount to 45.8309 trillion yen and local taxes to 39.5585 trillion yen; proportionally, national taxes account for 53.7% of the whole, and local taxes for 46.3%.

There are those who argue strongly that based on the immensity of the role played by local government, the proportion of local taxes should be raised; but in fact the figure of 46.3% is an indicator that the local governments of Japan do possess a clear-cut authority to levy taxes.

(4) Below is an illustration of the position of local bonds in the revenues and expenditures of local governments.

Local bonds are debts that must in the future be repaid with interest; but as the accounting is done on a cash basis (whereby income is counted when cash is received and expenses are counted when cash is paid out), local bonds are calculated as income for the year in which new bonds are issued. Normally local bonds are set aside as part of capital expenditure (expenditure related to construction works). The repayment of local bonds, on the other hand, is ranked as expenditure for the year in which they are repaid.
(5) The revenues of local governments in Japan come, in order of weight, from local taxes (42.9%), local allocation tax (16.7%) and national treasury disbursements (12.6%), followed by local bonds. Local bonds account for roughly 10% (10.8%). Revenues are structured as shown in the pie graphs below.
Net total ¥89,691.5 billion

Obligatory expense ¥46,222.0 billion (51.5%)
Investment expenses ¥13,177.9 billion (14.7%)
Personnel expenses ¥24,605.2 billion (27.4%)
Social assistance expenses ¥8,483.6 billion (9.5%)
Public debt payments ¥13,133.2 billion (14.6%)
Ordinary construction expenses ¥12,987.9 billion (14.5%)
Subsidized ordinary construction expenses ¥5,366.0 billion (6.0%)
Unsubsidized ordinary construction expenses ¥6,441.9 billion (7.2%)
Other expenses ¥30,291.6 billion (33.8%)


[Note 1] General revenue resources: Revenue resources the use of which is not specified, such as local taxes and local allocation taxes, are called general revenue resources. Here, local taxes, local transfer taxes, local allocation taxes, local special grants etc., totaled together are taken to be the general revenue resources. If local governments are to respond appropriately to the many different administrative demands made on them, it is extremely important that they be assured of these general revenue resources.

[Note 2] A brief explanation of the different kinds of revenue
* Local allocation tax: A financial resource taken properly by the local governments, whereby a fixed proportion of the five types of national tax is distributed in order to adjust the imbalance in local government tax sources so that every local government is secured the sources of revenue needed to provide a certain level of administrative services.
* National treasury disbursements: The generic term for funds that the central government grants to a local government for a specific purpose.
* Local transfer tax: Taxes gathered as national taxes and transferred to the local governments; Local Road Transfer Tax, etc.
* Local special grants etc: Sources of revenue that have the character of being a substitute for local taxes; e.g. the Child Allowance Local Special Grant to address the increase in the local government financial burden brought on by the expansion of the child allowance system in 2006 and 2007.

(6) In terms of the nature of the expenditures, financial outgoings can be categorized into “obligatory expenditure” which are expenses for which the local government is liable, that cannot be reduced arbitrarily (personnel expenditure, maintenance allowances, debt expenditure etc.); “capital expenditure” allocated to ordinary construction expenditure, etc; and “other expenses”.

Debt expenditure, i.e. the repayment of local bonds, is the most obligatory expenditure, and accounts for roughly 15% (14.6%) of the total. Expenditures are as shown in the pie graphs above.

(7) The local public finance system in Japan is structured so as to secure the sources of local revenue by means of, in addition to local taxes, the drawing up of local public finance programs and the local allocation tax system as well as the local bond system, to enable the local governments to ensure a standard public administrative level. (See No.3 in this series)

Faced with the promotion of decentralization, the less children and aging society, the role the local governments will have to play in supporting care of the elderly, medical care and child care, together with the accompanying necessary financial measures, is becoming more and more important.
3 The significance and function of local bonds

What follows is an explanation of Japanese local bonds.

3.1 The definition of a local bond

As the name indicates, a local bond is a loan (debt) taken out by the local government; but neither the Local Autonomy Law nor the Local Finance Law provides a clear-cut definition.

Generally speaking, however, the term local bond refers to a debt taken on by the local government through the procurement from the private sector of necessary financial capital, the discharge of which is to take more than one fiscal year (debts to be repaid within the year are called “floating debts” and are different from local bonds). Local bonds have as their nature the following aspects.

1. A local bond is a debt incurred by the local government

   It follows that a loan made by an organization 100% financed by the local government is not called a local bond.

2. A local bond is a debt incurred in order to raise funds.

   Local bonds are issued in order to raise public finance funds and usually take the form of a transfer of funds. A rare exception to this is for example in relation to the cost of land purchase, when government compensation bonds may be allocated with the promise of payment in later years instead of the transfer of funds.

3. A local bond takes the form of a deed loan or the issue of securities.

4. A local bond is a debt for which the collateral in real terms is the authority of the local government to levy taxes.

   As a rule a local public enterprise has a self-supporting accounting system; the principal and interest on the local bonds it issues are repaid out of the income of the enterprise in question, so that the earning power of that enterprise is the collateral for the local bonds. However, a local public enterprise in name is in fact an administrative activity carried out by the local government, and the debt remains a local bond of the local government, so that ultimately the collateral in real terms is the authority to levy taxes wielded by the local government that operates that local public enterprise.

5. Discharge of the debt covers more than a single fiscal year.

   Like local bonds, floating debts are debts incurred to raise capital; but a floating debt is a loan taken out to cover a temporary shortage of cash within the current fiscal year in order to disburse the expenditure budget; it must be paid off out of the revenues of that accounting year, and thus is different from a local bond.

3.2 The functions of local bonds

The main functions of local bonds are as follows.

1. Adjustment of public finance expenditures and revenues between fiscal years

   The issue of local bonds makes it possible to coordinate public finance expenditure and revenue
between fiscal years.

That is to say, in the case of a project that requires considerable sources of revenue in a single fiscal year, such as a public building construction project or disaster recovery work, raising the necessary capital through the issue of local bonds makes it possible not only to ensure the smooth execution of the project in question, but also to spread out the financial burden of the project through the repayment of the principal with interest in later years. This makes possible planned financial management.

(2) Adjustment of the burden on the residents to produce equity between the generations

Procuring part of the sources of revenue for a public facility through the issuing of local bonds makes it possible to adjust the burden on the residents for greater equity between the generations.

That is to say, when a public facility is constructed, that facility will be of benefit over a considerably long period of time, depending on the statutory useful life of the public facility; the benefit from the building extends not only to the present residents but also to future residents; so instead of demanding that the residents at the time the facility is constructed bear the whole cost, it is logical and fair to the present residents that local bonds be made use of so that later generations who will benefit from the facility in the future should share some of the burden in the form of the repayment of the principal and interest. Issuing local bonds makes this possible.

This also means that it is consistent with the principle of fairness that the residents who bear the cost of repaying the principal and interest of the local bonds should be the same people who benefit from the facility. It follows that the term for redemption of a local bond must not be longer than the life of the public facility the construction of which was financed by that local bond.

(3) Supplementation of general revenue resources

The issue of local bonds makes it possible to supplement a shortfall in general revenue resources in a particular year.

That is to say, local bonds have the function of supplementing a shortage in general revenue resources from local taxes, local allocation tax, etc., for the year in which they are issued, and thus play an important role as a policy for securing sources of local revenue that has a certain degree of maneuverability and flexibility.

(4) Coordination with national economic policy

The issue of local bonds is used as a means of coordinating with national economic policy.

That is to say, since most administrative investment is carried out by the local governments, the economic policies of the central government are of little effect if they are not implemented in unison with local public finances; raising or lowering the amount of local bonds issued to finance the capital expenditure implemented through the local governments makes it possible to coordinate the volume of works, which serves an important function in economic measures, etc.
4 Legal system regarding local bonds

In order for the local governments to be able to ensure a standard level of public administration, Japan’s system of local public finance is structured so as to secure the sources of local revenue by means of the drawing up of local public finance programs and the local allocation tax system, and on top of that, the local bond system.

The legal system regarding local bonds is as follows.

4.1 Expenditures that may be financed by local bonds

Local bonds are debts taken on by the local government. If there is no limit to how many are issued, numerous problems could arise in terms of the future soundness of local public finance management, or equity in the residents’ tax burden. For this reason, Article 5 of the Local Finance Law states that in principle local government expenses must be financed from revenue other than local bonds.

However, since it can be said that making use of the primary function of local bonds to help the growth of the local economy or to help improve the welfare of local residents is if anything a good thing, a provisory clause lists those expenses which may be financed from local bonds.

In addition to these expenses, there are other cases in which local bonds may be used as a financial resource in accordance with the Special Law.

In short, the expenses that may be financed from local bonds are as follows.

(1) The expenses listed in the provisory clause to Article 5 of the Local Finance Law.

The following expenses are listed as expenses that may be financed from local bonds.

a) Expenses required for local public enterprises

Enterprises run by the local government, such as electricity supply, water supply, sewerage services etc., (local public enterprises) differ from private enterprises in that they are unable to issue shares; so that the only means of raising funds are by transfer from another account or through the issue of local bonds. Further, in accordance with the principle of the self-supporting accounting system, once capital outlay has been financed through local bonds it is possible in the future to redeem the principal and interest from fees and other incomes coming from business activities; and thus these are expenses that it is deemed may be financed from local bonds.

According to the provisory clause to Article 5 of the Local Finance Law, local bonds launched as funding for expenses required for local public enterprises may be issued to finance ordinary expenses such as personnel expenditure; but in real practice their use is in general limited to construction and improvement projects (including land acquisition).

b) Investments and loans

The reason local bonds are approved for investments and loans is that in the case of investments, the rights from the investments are reserved by the local government in question and have a capital value; and in the case of loans, recovery of the principal at least is secured.

For this reason, it is essential that with regard to investments, the existence of capital to be
recovered equivalent to the investment and its future maintenance can be objectively ascertained; and with regard to loans, that revenue resources for redemption can be ensured from the money recovered.

c) Expenses necessary for the refunding of local bonds

Local bonds issued for refunding are debts taken out in order to redeem local bonds that have already been taken out, and their issue is approved in the sense that no new debt is being assumed. However, there can be no approval of a refunding whereby the period of redemption of the new bonds and the bonds issued prior to the refunding added together would be longer than the statutory useful life of the public facilities the construction of which was financed from the local bonds.

d) Expenses for emergency measures, recovery works and relief measures in time of disaster

When a disaster occurs, large amounts of money must be disbursed for the restoration of public facilities, etc; and these expenses are unbudgeted for and urgent. At the same time tax exemption and reduction measures mean that revenues are reduced, so that there is no other way of obtaining a source of revenue other than local bonds. For this reason expenses related to disasters are deemed to be expenses that may be financed from local bonds.

However, these disaster-related expenses are neither a new investment that will produce a source of revenue to finance their future redemption nor of a character that their benefit extends to residents in the future with whom the burden should be shared; and so in principle a set amount of the cost of their redemption is included in the basic financial needs covered by the local allocation tax and thus measures to finance redemption of the bonds are adopted via the local allocation tax.

c) Expenses for the construction of public facilities and facilities for public use

Local bonds may be used to finance the cost of the construction of public facilities and facilities for public use and the cost of the purchase of land on which to build such facilities.

This can be said to be the most common purpose for which local bonds are used.

This is because it is judged that the execution of such projects will bring about economic development from which increased future tax revenues can be expected, thus ensuring a source of finance for redemption of the bonds; or that the impact of the project will extend to residents in the future, so that it is fair to take measures to spread the burden over a number of years.

Expenses for maintenance and repairs should be disbursed from the general revenues for that year, and are not financed from local bonds.

Expenses for construction projects that may be financed from local bonds include not only projects undertaken by the local government itself, but also the local government charges or grants towards construction projects carried out by organizations engaging in public activities or some corporations financed by the local government.

Further, it may be considered a prerequisite to the issue of local bonds to finance the construction of public facilities or facilities for public use that every effort be made to secure the financing that should rightfully be secured. Thus it needs to be noted that in view of this, a local government that has any one of the ordinary taxes at a rate lower than the standard tax rate requires
permission to issue this kind of local bond. (On this point, see 4.4(8) below)

(2) Local bonds for special measures under other laws

There are cases in which the raising of local bonds under special measures in accordance with a variety of laws may be approved.

These include for example depopulated area development bonds to fund measures for depopulated areas; extraordinary local public finance bonds to supplement a temporary shortfall in local allocation tax, for which the full amount of the principal and interest to be redeemed in later years is disbursed from the local allocation tax in later years; and retirement allowance bonds to cover a temporary increase in retirement allowances, which are a form of personnel expense.

As I will explain later, after the switchover to the negotiation system it became possible to issue bonds without the agreement of the Minister of Internal Affairs and Communications or the governor of the prefecture so long as they were negotiated; but it goes without saying that satisfying legal conditions such as the ones described above is a natural prerequisite.

The provisions of Article 5 of the Local Finance Law will be included at the end of this paper.

4.2 The negotiation system for local bonds

In Japan, for a long time the issue of local bonds by a local government always required the approval of the Minister of Internal Affairs and Communications or the governor of the prefecture.

However, with the enforcement of the Law concerning the Provisions of Laws concerned with the Promotion of Decentralization, from 2006 the system of approvals for local bonds was abolished from the standpoint of enhancing the autonomy of the local governments; instead the shift was made to a negotiation system with the Minister of Internal Affairs and Communications or the governor of the prefecture, with the aim of ensuring the smooth issue of local bonds, securing the sources of local revenue and ensuring the soundness of local public finances. Since the system of approvals had been in place for over a century, ever since the formation of the modern state in the Meiji Period, this changeover to a negotiation system with the Minister of Internal Affairs and Communications or the governor of the prefecture could be called a historic event.

In Japan, local bonds form part of sources of local revenue together with local taxes, the local allocation tax and national treasury disbursements; the money for the redemption of the principal and interest is appropriated in the local public finance program each year and the system is structured in such a way that the sources of revenue for redemption are secured via the local allocation tax system.

In other words, in the local public finances as a whole the debt expenditure (the money for the redemption of the principal and interest of the local bonds) is first appropriated in the local public finance program and the source of revenue is secured by ensuring the total amount of the local allocation tax on a macro base so that there is a balance between the total amount of expenditure including the local bonds, and the total amount of revenues. Further, on a macro base of each local government also, the local allocation tax is structured so that the shortfall after the normal financial income (basic financial revenues) has been subtracted from the normal financial demand (basic
financial needs) is granted as local allocation tax; so that adding the money for the redemption of the principal and interest on local bonds to this normal financial demand (basic financial needs) means effectively that the central government secures the sources of revenue needed for the redemption of the principal and interest on the local bonds of the local government in question.

However, when individual local governments issue local bonds at their own discretion, it is no longer possible to secure the sources of revenue through the local public finance program or the local allocation tax, so that when issuing local bonds it becomes necessary for a mechanism to be put in place whereby it is possible to incorporate in advance a system to secure the sources of revenue for the redemption of the bonds; and it is for this reason that the issue of local bonds necessitates negotiation.

This negotiation is not a negotiation that requires agreement; it does not presuppose that a settlement will necessarily be reached. Unlike the way things were before, local governments are now able to issue local bonds without obtaining the approval of the Minister of Internal Affairs and Communications.

However, there is a huge difference in the financial measures and procedures depending on whether or not approval through negotiation is obtained.

Specifically, the mechanism is as follows.

(1) Negotiation

A local government wishing to issue local bonds or to make changes (other than minor changes) to the way the bonds are issued, to the interest rate or to the method of redemption, must negotiate with the Minister of Internal Affairs and Communications or the governor of the prefecture. (Article 5-3, Clause 1 of the Local Finance Law)

The aim of the negotiation prescribed in the preceding paragraph is to clarify the purpose for the issue of the bonds; the maximum amount; the method of issue; the capital; the interest rate; the method of redemption; the total cost of the project for which the local bonds are to provide financing; a breakdown of the financial revenues for the project; the lender(s) of the capital for the bonds; the total amount of local bonds the local government in question plans to issue during the year in question; the financial status of the local government in question; and anything else that should be taken into consideration.

The method of issue of the bonds refers to whether the bonds are securities or deeds; the method of redemption refers to whether redemption is to be by regular periodic repayments or bullet redemption on maturity, whether repayment is by full amortization or principal redemption by straight line method; and the length (in years) of the redemption or grace period.

(2) Appropriation of public funds for approved local bonds

The local government may borrow public funds in relation only to local bonds that have gained approval through negotiation. (Article 5-3, Clause 3)

As will be explained later, “public funds” refers to fiscal loan funds, funds from the Japan Finance Organization for Municipalities and specific funds (loans from the central government budget, etc).

These public funds are limited and while they are of course not appropriated for unapproved local
bonds that is not to say that public funds will be appropriated for all approved local bonds.

(3) The reckoning into the local public finance program of the cost of the redemption of the principal and interest of approved local bonds

The cost of the redemption of the principal and interest of local bonds approved by the Minister of Internal Affairs and Communications is reckoned into the local public finance program. (Article 5-3, Clause 4)

That is to say, the mechanism is that the sources of revenue for the redemption of principal and interest of approved local bonds are secured at the macro level through the local public finance program, which results in the sources of revenue for redemption being secured on a micro base too, through the local allocation tax system.

I have already dealt with this in detail above, but what it means is that control at a macro level is implemented through this negotiation system.

(4) Reporting to the assembly when local bonds are issued without approval

When local bonds are to be issued without the approval of the Minister of Internal Affairs and Communications, the head of the local government must in principle report beforehand to the local assembly. (Article 5-3, Clause 5)

While approved local bonds have been settled through negotiation with the Minister of Internal Affairs and Communications and are in a manner of speaking ranked in the local public finance system as standard local bonds, unapproved local bonds are quite different; they are issued by the local government completely at its own discretion, no public funds are appropriated to them and the sources of revenue for them are not secured by the central government. This means there is a real risk of their exerting an impact on future financial management, and so when unapproved local bonds are to be issued a proper report must be made beforehand to the local assembly.

(5) Preparation / announcement of the criteria for approval and the local bond program

The Minister of Internal Affairs and Communications shall prepare and announce the criteria for approval through negotiation and the local bond program. (Article 5-3, Clause 6)

Under the former permission system, the policy for the permission of local bonds was determined by notification from the central government, but under the new negotiation system, in the interests of greater fairness and transparency both the criteria for permission and the local bond program determining the total amount to be approved are determined by law as concrete criteria in accordance with which the Minister of Internal Affairs and Communications will give approval on being negotiated, and must be made public.

With regard to the local bond program, please see Appendix 6.
4.3 The significance of central government involvement in the issue of local bonds

As I mentioned above, a local government wishing to issue local bonds or to make changes in the way the bonds are issued, in the interest rate or the method of redemption must consult with the Minister of Internal Affairs and Communications or the governor of the prefecture. The reasons for this kind of central government involvement in the issue of local bonds are as follows.

(1) Securing the sources of revenue for the redemption of local bonds

When individual local governments issue local bonds at their own discretion they become unable to secure sources of revenue by means of the local public finance program, so that prior to issuing the local bonds it is necessary to put in place a mechanism whereby they can be incorporated into a system that will guarantee the sources of revenue for the redemption of the bonds.

I have already given an account of this in 4.2.

(2) Ensuring financial stability

Local bonds leave a burden of payment for the future, which must be kept within reasonable limits. The involvement of the central government ensures that the issue of local bonds by individual local governments is kept within reasonable limits; coordination with the reasonable limits for local public finance as a whole is also necessary.

That is to say, since local bonds are an advance taken from future general revenue resources, individual local governments must hold negotiations prior to the issue of local bonds so as not to create a hindrance to the redemption of the principal and interest of the local bonds.

(3) Coordination of the demand for funds and fair allocation of funds

It is necessary for the demand for funds by local government as a whole to be worked into the
funding plan for the entire country, and to try to coordinate it with the demand for funds by the central government and the private sector. Further, there are disparities in the fund-raising capabilities of the local governments, so that it is necessary that funds be allocated fairly by means of permissions or agreement reached through negotiation.

For this reason the different kinds of funds are coordinated and managed uniformly and comprehensively by means of the negotiation system and also through the working out of the local bond program.

(4) Coordination with general revenue measures

The purpose of local bonds is to complement general revenue resources such as local taxes and the local allocation tax; local financial measures, including financial measures to deal with the fiscal burden of local government with regard to public works, are implemented by combining general revenue resources and local bonds, and it is necessary to ensure the consistency of the financial measures overall and fairness in the allocation of funds.

(5) Supplementation of the creditworthiness of local bonds

The fact that the sources of revenue for the redemption of the bonds are secured through the involvement of the central government means that there is no need for financial institutions to review the repayment capabilities of each individual local government and makes it possible for the issue of local bonds to be go ahead smoothly. This elevates the creditworthiness of the local bonds and fulfils a function akin to guaranteeing the local bonds.

Thus by means of the negotiation system in this context of securing sources of revenue, the creditworthiness of the local bonds is elevated and the security of the local bonds is protected.

This being the case, under the standardized approach of Basel II (the international standard with regard to net assets ratio) the risk weight of local bonds is deemed to be 0, the same as for central government bonds, and the bonds are considered to be safe assets.

4.4 Exceptions to interference of central government in the issue of local bonds

As an exception to the negotiation system described above, things are structured so that, from the perspective of taking early corrective measures, a local government that has a deficit above a certain level, or a local government whose expenses for the principal and interest on the local bonds are above a certain level, etc., requires permission to issue local bonds, in order not only to secure basic services for the residents of the local government in question but also to maintain the creditworthiness of local bonds as a whole.

Specifically, in the following instances the permission of the Minister of Internal Affairs and Communications is required.

a) local government whose deficit is in excess of a certain amount.

b) A local government whose real debt service ratio is in excess of a certain standard.

c) A local government that is in arrears with its payments for the principal and interest on the local bonds.
d) A local government that has in the past been in arrears with its payments for the principal and interest on the local bonds and has been designated by the Minister of Internal Affairs and Communications.

e) A local government that has issued local bonds without going through the negotiation system or obtaining permission and has been designated by the Minister of Internal Affairs and Communications.

f) A local government that has committed an act of fraud in the process of negotiation or the obtaining of permission and has been designated by the Minister of Internal Affairs and Communications.

g) A local public enterprise whose funding shortfall is in excess of a certain level.

h) A local government whose ordinary tax rate is less than the standard tax rate (Only in the case of local bonds to be financed from the expenses stipulated in Article 5-5 of the Local Finance Law).

First of all, the standard for a) is as follows. In the settlement of accounts for fiscal 2009 there were 19 local governments with a deficit, and the standard applied to 5 of these.

- Local governments whose deficit with respect to the standard financial scale was in excess of the following scales established on a sliding scale according to the standard financial scale.

  Standard financial scale of 50 billion yen or above: Standard financial scale × 1/40
  Standard financial scale of more than 20 billion yen and less than 50 billion yen:
  \[(\text{Standard financial scale } + 100 \text{ billion yen})/120\]
  Standard financial scale of more than 5 billion yen and less than 20 billion yen:
  \[(\text{Standard financial scale } + 10 \text{ billion yen})/30\]
  Standard financial scale of less than 5 billion yen: Standard financial scale /10

The standard for b) is a local government with a real debt service ratio of 18% or higher. In the settlement of accounts for fiscal 2009 this standard applied to 399 local governments (of which 4 local governments also came under a), so that in the final count the number of local governments requiring permission was 400).

Becoming a local public body requiring permission to issue local bonds and having the issue of local bonds restricted are two completely different things; becoming a local public body with permission to issue local bonds does not mean that the issue of local bonds is restricted.

Of course, whether a local government obtains permission to issue local bonds or issues them after
negotiation places it in a completely different legal position, and there are of course differences in the clerical procedures.

Specifically, a local government with a real deficit must draw up a real deficit resolution plan, and a local government that has become a body requiring permission to issue local bonds on account of its real debt service ratio being in excess of 18% must draw up a local loans normalization plan; the central government then grants permission on the basis of whether or not the content of the plan is appropriate and whether or not the plan is being steadily implemented.

If we look at the country as a whole, the number of local governments requiring permission on account of the real debt service ratio is overwhelmingly greater than the number requiring permission on account of a real deficit; so if we look at cases where a local loans normalization plan is drawn up, the plans are drawn up independently by the local governments that have come to require permission on account of their real debt service ratio being in excess of 18%, as a planned initiative aimed at the appropriate management of the local debt burden.

With regard to the policy for the drawing up of the plan, the greatest respect is given to the independence of the local government; as for the target debt service ratio or the duration of the plan, each local government may set appropriate targets in accordance with its own circumstances. There are no across-the-board guidelines imposed by the central government or anyone else.

Each local government is required to obtain a proper understanding of the future estimates of its debt service ratio and to prepare a local loans normalization plan in keeping with its own circumstances.

I would like to add several further points.

The first point is that in the case of b) above, that is, when the debt service ratio is in excess of 25%, restrictions are placed on the issue of some local bonds.

Another point is that in June 2007 the Law relating to the Financial Soundness of Local Governments was passed as a new system aimed at the early improvement and regeneration of public finance through the establishment and release of public finance indicators; this law has been in full-scale effect since April 2009. With respect to permission for the issue of local bonds, when, of the 5 ratios for the discernment of normalization specified by this law, the real debt service ratio (A), the real deficit ratio (B) or the consolidated real deficit ratio (C) is higher than the criterion for public finance regeneration, in accordance with this law a local finance regeneration plan is set up; if this plan then does not obtain the agreement of the Minister of Internal Affairs and Communications, the local government becomes unable to issue local bonds except for disaster recovery work.

Specifically, this applies when (A), the indicator that also appeared under b) above, is 35% or higher; when (B), the indicator that appeared under a) above, is 5% or higher in a prefecture or 20% or higher in a municipality; or when (C), the indicator that is the total of all the accounts under (C), is 25% or higher in a prefecture, 40% or higher in a municipality.

This law is deemed to bring together a solid local tax system (46.1% of all Japanese taxes are local taxes), the local allocation tax and a mechanism to secure both macro and micro sources of revenue
through the negotiation/permission system for local bonds, thus providing a system that makes the creditworthiness of local bonds more secure.

Next, g) applies to local public enterprises with a funding shortfall ratio or 10% or more. This criterion alone is applied not to the local government but to the accounts of the local public enterprise in question. In 2009, 232 accounts came under this criterion.

As for the connection with the Law relating to the Financial Soundness of Local Governments, when the funding shortfall ratio reaches 20% or higher, in accordance with this law a plan for the sound management of the public enterprise in question must be put in place.

The item listed under h), namely a local government whose ordinary tax rate is less than the standard tax rate (Only in the case of local bonds to be financed from the expenses stipulated in Article 5-5 of the Local Finance Law), differs substantially in character from the other items.

Under the old permission system, a local government below the standard tax rate, that is to say, a local government that levies taxes at a rate lower than that set down in the Local Tax Law as the standard tax rate for the whole country, was prohibited from issuing local construction project bonds. This was based on the fact that, seeing that the redemption of local bonds is ultimately covered from the taxes of residents, when local bonds are to be allocated as a financial resource for expenses related to a construction project, it was deemed necessary, from the perspective of ensuring the soundness of revenue sources and the equitable distribution of the burden over generations, to ensure as a prerequisite that revenue resources that should normally be ensured, namely local taxation on a par with other local governments, are ensured. Under the new negotiation system, prohibition was replaced by the permission system. In other words, while the rationality of the reasoning behind a local government below the standard tax rate being prohibited from issuing local construction bonds was still recognized after the switch to the negotiation system, from the point of view of respecting the self-taxing powers of the local governments, with regard to the issue of local construction bonds by local governments below the standard tax rate the switch was made from prohibition to the permission system, providing a system whereby local bonds can be issued if permission is obtained.

4.5 The relationship between local bonds, the budget and the assembly

By following the rules set out in the laws described above, local governments are able to issue local bonds, but of course the details of the bond issue must comply with what has been determined in the local government budget.

The budget of the local government is made up by the chief executive and must be approved by the assembly before the start of the fiscal year.

The central part of the budget that has to be approved is the revenues and expenditures budget that is an advance estimate of the income and outlay for the financial year in question, but also included in addition to that are items such as local bonds or floating debts.

Local bonds are nominally classed as income, but in the future the cost of the principal and interest on the local bonds will have to be included in the expenditures budget and will have to be paid;
so they need to be given careful consideration together with the revenues and expenditures budget.

In other words, the mechanism is that the local bonds are included in the revenues for the year in question, and then for each type of local bond a separate table is prepared indicating (A) the purpose for which the bonds are to be issued, (B) the maximum value to be issued, (C) the method of flotation (D) the interest rate and (E) the method of redemption, and the bonds are approved as a part of the budget.

However, under normal conditions it is usual for the approval to be expressed with a certain amount of leeway – “Method of floatation: deed loan or issue of securities”, “Interest rate: Not more than n %”, “Method of redemption: Redemption within n years by full amortization or other method”.

When the loan is to involve a review of interest rates, wording to that effect can be included.

Further, while it will not be put to a vote, it is required that an estimate of the local bonds to be issued and an estimate of the principal to be redeemed during the fiscal year in question, an estimate of the balance remaining at yearend, etc., be submitted as reference material for discussion of the budget.

In addition to this approval, when local bonds are to be issued without the approval of the Minister of Internal Affairs and Communications, the chief executive of the local government must in principle report beforehand to the local assembly, as has already been explained in 4.2(4) above.

Floating debts, on the other hand, are raised to provide temporary financing within a single financial year, and are repaid within that year; so while they are not added to the budget as revenue, the maximum limit of money to be borrowed is an item to be approved as part of the budget.

The provisions of the relevant laws are given at the end of this paper.

5 The funding and form of local bonds

5.1 The funding of local bonds

In terms of where they are underwritten, funding for local bonds can be divided first of all into two broad categories, domestic funding and overseas funding.

Domestic funding can be divided into fiscal loan funding, Japan Finance Organization for Municipalities funding, private sector funding, etc. Private sector funding can be further divided, according to who does the underwriting, into public offering funding, bank funding etc. (See the classification chart below)
The flow of these different kinds of funding is by and large as follows.

As I will explain later, in addition to drawing up the local bond program for each fiscal year, determining the estimated volume of local bonds to be issued and guaranteeing local bond funds, the central government apportions the limited funds for local bonds through clerical procedures such as the approval of the issue of bonds. The volume of funding in the 2010 local bond program (Ministry for Internal Affairs and Communications Notice No. 134, April 1st, 2010) broken down by category is as follows.
### Diagram 6  Volume of appropriated local bond funding by category (Local Bond Program)

(Unit: hundred million yen, %)

<table>
<thead>
<tr>
<th>Classification</th>
<th>FY2010 (A)</th>
<th>Component percentage</th>
<th>FY2009 (B)</th>
<th>Component percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public funding</td>
<td>64,980</td>
<td>40.9</td>
<td>57,670</td>
<td>40.7</td>
</tr>
<tr>
<td>Fiscal loan funding</td>
<td>43,390</td>
<td>27.3</td>
<td>39,340</td>
<td>27.7</td>
</tr>
<tr>
<td>Japan Finance Organization for Municipalities funding</td>
<td>21,590</td>
<td>13.6</td>
<td>18,330</td>
<td>12.9</td>
</tr>
<tr>
<td>(Loans from the national budget, etc.)</td>
<td>(1,185)</td>
<td>—</td>
<td>(1,819)</td>
<td>—</td>
</tr>
<tr>
<td>Private-sector funding</td>
<td>93,996</td>
<td>59.1</td>
<td>84,174</td>
<td>59.3</td>
</tr>
<tr>
<td>Public offering funding</td>
<td>43,000</td>
<td>27.0</td>
<td>36,700</td>
<td>25.9</td>
</tr>
<tr>
<td>Bank funding</td>
<td>50,996</td>
<td>32.1</td>
<td>47,474</td>
<td>33.5</td>
</tr>
<tr>
<td>Total</td>
<td>158,976</td>
<td>100.0</td>
<td>141,844</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance (A)-(B)</th>
<th>(C)</th>
<th>Percentage of change (C)/(B)×100</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,132</td>
<td>7,310</td>
<td>12.7</td>
</tr>
<tr>
<td>85,296</td>
<td>40,050</td>
<td>10.3</td>
</tr>
<tr>
<td>2,500</td>
<td>3,260</td>
<td>17.8</td>
</tr>
<tr>
<td>8,222</td>
<td>5,922</td>
<td>12.1</td>
</tr>
<tr>
<td>5,482</td>
<td>3,522</td>
<td>6.3</td>
</tr>
<tr>
<td>17,132</td>
<td>17,312</td>
<td>12.1</td>
</tr>
</tbody>
</table>

[Note] 1 Local bonds for public offering including refinanced bonds are expected to be 7.45 trillion yen (a 9.9% increase on the 6.7 trillion yen of the preceding year).

2 (Loans from the central government budget etc) are loans financed out of the central government budget, such as extraordinary loans for the improvement of local roads, disaster relief funds, etc., and are not included in the total.

(1) Fiscal loan funding

In the Local Bond Program for 2010 a total amount of 4.339 trillion yen was appropriated, accounting for 27.3% of the whole.

The funding for this is generally called government funding; as the name implies, the central government issues national government bonds (FILP bonds) in the treasury investment and loan special account and uses the capital procured from the markets as the funding for loans made to the local governments.

The fiscal loan funding planned amount for long-term investment (5 years or more) managed and invested by the Minister of Finance must be budgeted and approved in the Diet.

Of the various methods of funding for local bonds, this method of funding is generally the most stable of the long-term low-interest funds. At one time it accounted for more than 60% of local bonds and played a central role, but with the government policy of switching the flow of funding “from the public sector to the private sector” the trend is for it to play a lesser role.

Moreover, the terms of the loan are not negotiated with individual local governments; uniform loan terms determined by the government in line with market principles are imposed within the loan framework approved by the Diet. This means that basically the market distribution yield for national government bonds is set as the standard, according to the period of maturity.

Next, with regard to the period of maturity and grace period, as a result of attempts to extend these the period of maturity has lengthened from up to 5 years (including a grace period of up to 1 year) to up to 30 years (including a grace period of up to 5 years). This is quite a long time, but generally speaking can still be considered short in comparison with the statutory useful life of the fixed asset.

In addition, the method of lending for all fiscal loan funds is the deed loan method, and the method of redemption in principle is by full amortization. A choice can be made from a fixed interest
rate or an interest rate that is reviewed after the passage of a certain period of time.

The fixed interest rate over 30 years (including a grace period of 5 years), which is the maximum loan period, is 1.70%. (as of December 1st, 2010)

(2) Japan Finance Organization for Municipalities funding

In the Local Bond Program for 2010 a total amount of 2.159 trillion yen was appropriated, accounting for 13.6% of the whole.

This funding is capital loaned to the local government by the Japan Finance Organization for Municipalities, and as public funding ranks with fiscal loan funding in the importance of the role it plays in local bond funding.

The JFM was originally the Japan Finance Corporation for Municipal Enterprises, a special public corporation of the central government established in 1957 in accordance with legislation. It reached its present structure after undergoing reorganization, most recently on the October 1st, 2008 and June 1st, 2009.

A major lender, the Japan Finance Organization for Municipalities is a financial institution established by law, and ranks as an “organization for the procurement of local bond funding that is of the regions, by the regions, for the regions,” financing local governments throughout Japan. The JFM uses the funds raised from the market through the issue of bonds as capital to make long-term, low-interest loans to local governments. The bonds issued by the JFM are classified by investors as local bonds in a wide sense, and have the reputation of being bonds with an extremely high creditability; at the present time, while not at the level of Tokyo Metropolitan Government bonds, they are underwritten at lower interest rates than bonds issued by relatively unpopular prefectures.

With regard to the period of maturity and grace period, here too attempts to extend these have resulted in the period of maturity being lengthened from up to 5 years (including a grace period of up to 1 year) to up to 30 years (including a grace period of up to 5 years).

In addition, the method of lending for all JFM loans is the deed loan method, and the method of redemption in principle is by full amortization. A choice can be made from a fixed interest rate or an interest rate that is reviewed after the passage of a certain period of time.

The fixed interest rate over 30 years (including a grace period of 5 years), which is the maximum loan period, is 1.70%. (as of December 1st, 2010: most often applied special interest rate.)

(3) Earmarked funds (Loans from the national budget, etc.)

In the Local Bond Program for 2010 a total amount of 118.5 billion yen was appropriated.

These funds are loans from the central government’s general account or from government-related institutions, arranged so that the necessary amount is guaranteed in the budget of the various government ministries and agencies or government-related institutions according to the various respective laws. From the point of view of the local governments they are long-term loans and so are classified as funding for local bonds, but they are treated separately and not included in the total amount in the Local Bond Program.
In the Local Bond Program for 2010 a total amount of 4.3 trillion yen was appropriated, accounting for 27.0% of the whole. In addition to this, the issue of another 3.2 trillion yen is planned to cover refunding bonds.

This funding is capital raised by the local government of its own accord through public offering on the general bond market. It is further subdivided into a number of categories.

Nationwide publicly-offered local bonds form the main category, with a total amount of 4.05 trillion yen appropriated and 49 local governments (30 prefectures and 19 ordinance-designated cities) at present planning their issue. The trend is for the number of local governments issuing these bonds, and the amount of bonds issued, to increase year on year.

Normally, these 49 local governments would each issue bonds separately, but from 2003 there have also been issues of “Jointly-issued public offering local bonds”; in fiscal 2010, of the local governments issuing nationwide publicly-offered local bonds, 35 local governments (23 prefectures and 12 ordinance-designated cities) intend to participate and to issue 1.6 trillion yen in total (roughly 135 billion yen each month). The purpose in issuing bonds jointly is to raise funds profitably and stably in an environment where it is becoming more and more necessary to raise private-sector funding in line with market principles. In accordance with Article 5-7 of the Local Finance Law the bonds are issued in the joint names of the participants and under their joint liability, which makes it possible to ensure a higher market evaluation.

One more important point is the size of the issued lots. An individual local government cannot issue local bonds on the scale of over 100 billion yen per month, but a number of local governments working together makes it possible for the issued lots to be very large. This gives the advantage of scale, hopefully leading to greater fluidity.

It follows that the remaining 2.45 trillion yen of bonds are issued individually, as in the past.

Some short-term bonds (3, 5 or 7 years) are issued, as are some long-term bonds (15, 20 or 30 years); but most bonds issued have a 10-year period of maturity and are to be redeemed in bullet. Interest rates vary according to the issuing body. The state of the market at the time, the scale of the issue and the state of distribution all have a significant effect, but if we look at the situation with regard to issues in November 2010, the interest rate was 1.003~1.089%. In the case of jointly-issued local bonds, the interest rate was 1.036%.

Incidentally, if we look at the state of things over the past three years, Tokyo Metropolitan Government bonds and jointly-issued publicly-offered local bonds have been able to raise funds with a spread of roughly 0.1%, within 0.2%, over government bonds of the same type.

Finally, from 2002 local governments desiring to do so, including local governments other than those issuing the usual publicly-offered bonds, have been issuing “citizen-participation publicly-offered local bonds” intended for purchase by local residents or other citizens.

In the Local Bond Program for 2010, 250 billion yen was appropriated.
This started with the “Aiken-sai” (Cherish Our Prefecture Bonds) issued by Gunma Prefecture in March 2002; previous to that they had been called “Publicly-offered Minibonds”, but when the amount of a single issue is in excess of several tens of billions of yen, the term ‘mini’ no longer seems appropriate; and from 2006 they have been called ‘citizen-participation publicly-offered local bonds’.

The drive to issue citizen-participation publicly-offered local bonds is an attempt not only to enhance residents’ sense that they are participating in the administration and to promote PR for measures aimed at the residents; it is also an attempt to diversify fundraising through the public offering of local bonds and their placement to private investors.

These bonds have been received favorably by local residents, but the reason for their popularity is not only that they have attracted attention as a safe, profitable financial instrument for residents; the fact that the reason for their issue – the construction or improvement of hospitals, schools, libraries, parks, roads and other public facilities essential to the lives of the residents - is clearly indicated, is thought to play a large part in gaining the residents’ understanding and empathy. It seems that in many cases local bonds are purchased by people who, empathizing with the initiatives of the local government, wish to participate and give their support. The issue of these bonds has had a greater than expected effect in promoting resident participation in the administration, from which aspect it is seen as an extremely effective measure.

(B) Bank funding

In the Local Bond Program for 2010 a total amount of 5.0996 trillion yen was secured, accounting for 32.1% of the whole.

These are funds that the local governments borrow from financial institutions, various types of mutual aid society, etc. Negotiations are carried out individually, and in almost all cases the loan takes the form of a deed loan.

(C) Other funding

a) Government compensation bonds

Government compensation bonds are bonds that are issued in lieu of cash for, for example, payment for the buying and selling of land, with the promise of payment in later years. They differ from ordinary local bonds in that they are not issued in order to raise capital (cash) as a means of payment; instead the local bonds themselves become a means of payment, which makes them extremely exceptional.

b) Overseas funding

This can be divided into foreign currency-denominated funding and yen-denominated funding, but at the present time accounts for a very small part of the whole.

Local bonds that are paid in foreign currencies can under Japanese law be guaranteed by the central government within the budget, and both the projects for which they may be used and the organizations that may issue them are decided by Cabinet order. In the past the amount of foreign bonds planned for issue and guaranteed by the central government was mentioned for reference in the Local Bond Program, but it came to be included in the Local Bond Program in fiscal 2001; from
2001 on no local government has issued foreign bonds guaranteed by the central government, but from 2004 to 2007, the Tokyo Metropolitan Government has issued each year between 20 billion and 60 billion yen of foreign bonds that do not have the central government guarantee.

In addition, with regard to yen-denominated local bonds issued overseas, in January 2008 a system of tax exemption on the interest from local bonds held by overseas investors was introduced; with growing interest in local bonds as a whole among overseas investors, there was a strong demand from overseas investors and public offering groups for the issue of overseas-based yen-denominated bonds, and in September 2008 an amendment to the Cabinet Order Enforcement of the Local Finance Law made this possible.

Now, let us take another look at the changes in the amounts appropriated in the Local Bond Program for the different types of funding and the changes in their distribution ratios.
As we can see from Fig. 8, since the financial investment and loan reforms and decentralization reforms of fiscal 2001, basically the funding of local bonds has shifted from public-sector funding to private-sector funding. The drive towards further commercialization, brought about by the phased reduction and concentration of public-sector funding and the expansion from now on of publicly-offered local bonds, has now become the mainstream current of local bond funding.
Public-sector funding in fiscal 2000 accounted for roughly 60% of the Local Bond Program, and in fiscal 2008 for only 36.6%; there has been a drastic drop in the share of the program covered by public-sector funding.

However, in the Local Bond Program for fiscal 2010 there was a slight increase in the proportion accounted for by public sector funding to 40.9%, because of an increase in public-sector underwriting in response to the sharp increase in extraordinary public finance bonds due to the huge shortfalls in financial resources brought on by the worsening of the economic situation since last year.

Again, let us look at the changes in the balance of local bonds by type of funding.

![Diagram 8 Balance of local bonds by type of funding](image)


5.2 The form of local bonds

In terms of the form in which they are issued, local bonds can be divided into deed loans and security loans.

There is no particular law that determines in what form any local bond is issued; mainly the form of issue is determined according to the circumstances of the side providing the funding (the underwriter of the local bonds). Generally, if the provider of the funding for the local bonds intends to resell or float the local bonds, the bonds are issued in the form of securities.

The deed loan method is a method whereby the local government receives a loan of capital and presents an IOU to the lender; all fiscal loan funding and Japan Finance Organization for Municipalities funding use this method.

The majority of local bonds underwritten by banks, especially in the case of ordinary municipalities, are also issued using this method.
A security loan is a method whereby the local government raises capital by issuing local bond securities which are taken up by financial institutions or offered publicly in the market; in many cases the local bond securities are sold off by the financial institutions or investors that initially took purchased them and are floated on the market.

6 The Local Bond Program and other programs

6.1 The significance of the Local Bond Program

The Local Bond Program is the annual program relating to the issue of local bonds that is worked out each fiscal year by the central government (Ministry for Internal Affairs and Communications) on the basis of the provisions of Article 5-3-6 of the Local Finance Law. Prior to 2005, during the time of the permission system, there was no legal basis to the Local Bond Program, but after the shift to the negotiation system in fiscal 2006 the program became based in law. The program is closely linked to the Local Public Finance Program and the Treasury Investment and Loan Program, which are drawn up in parallel with the compilation of the national budget. With regard to the management of local public finances, in concrete terms it fulfills the following important roles.

(1) Application of approvals (permissions) based on the Local Bond Program

It is the Local Bond Program that indicates the scheduled total amount of approved (permitted) local bonds and the amount scheduled to be issued per project; as a general rule approval for local bonds is implemented on the basis of this program.

(2) Guarantee of funds for local bonds

It is the Local Bond Program that estimates the local bond funds for individual projects following an adjustment between the amount of local bonds required and the funds, and indicates the breakdown of where the funds will be provided from in the event the local bonds are approved.

(3) Guidance for financial management by the local governments

The Local Bond Program is officially announced in the same way as the local public finance program, and indicates the outlook for the approval (permission) of local bonds by project.

The Local Bond Program determines things like the amount planned depending on the content of the projects for which local bonds are to be issued, the amounts planned to be appropriated from the ordinary account or the other accounts such as the local public enterprise account to finance the redemption of the local bonds, and the amount planned according to type of funding.

Below is an outline of the Local Bond Program for 2010 (Ministry for Internal Affairs and Communications Notice No. 134. April 1st, 2010.)
### Diagram 9 Outline of the Local Bond Program
(Unit: hundred million yen, %)

<table>
<thead>
<tr>
<th>Classification</th>
<th>FY2010 (A)</th>
<th>FY2009 (B)</th>
<th>Change (A)−(B) (C)</th>
<th>Percentage of change (C) / (B)×100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary account portion</td>
<td>134,939</td>
<td>118,329</td>
<td>16,610</td>
<td>14.0</td>
</tr>
<tr>
<td>Regular portion</td>
<td>42,070</td>
<td>48,143</td>
<td>△ 6,073</td>
<td>△ 12.6</td>
</tr>
<tr>
<td>Special portion</td>
<td>92,869</td>
<td>70,186</td>
<td>22,683</td>
<td>32.3</td>
</tr>
<tr>
<td>Extraordinary local public finance bonds</td>
<td>77,069</td>
<td>51,486</td>
<td>25,583</td>
<td>49.7</td>
</tr>
<tr>
<td>Financial aid bonds</td>
<td>10,700</td>
<td>12,900</td>
<td>△ 2,200</td>
<td>△ 17.1</td>
</tr>
<tr>
<td>Retirement allowance bonds</td>
<td>4,900</td>
<td>5,700</td>
<td>△ 800</td>
<td>△ 14.0</td>
</tr>
<tr>
<td>Adjustment</td>
<td>200</td>
<td>100</td>
<td>100</td>
<td>100.0</td>
</tr>
<tr>
<td>Public enterprise account portion</td>
<td>24,037</td>
<td>23,515</td>
<td>522</td>
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<td>141,844</td>
<td>17,132</td>
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<td>66,107</td>
<td>71,658</td>
<td>△ 5,551</td>
<td>△ 7.7</td>
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<td>Special portion</td>
<td>92,869</td>
<td>70,186</td>
<td>22,683</td>
<td>32.3</td>
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</table>

[Note] The public enterprise account portion is all regular.

First of all, the planned amount is categorized according to the content of the projects for which the local bonds are to be issued.

With respect to the regular bonds which do not include special bonds, namely public enterprise refunding bonds, extraordinary local public finance bonds, retirement allowance bonds and adjustment bonds, while it is not shown in this chart in actual fact both the ordinary account portion and the public enterprise account portion are categorized in greater detail per project, and the amounts added in.

For the ordinary account portion, the money for the redemption of principal and interest is basically paid for out of income mainly from general revenue resources, such as local taxes and the local allocation tax, and thus refers to local bonds issued to finance such projects as the construction of port facilities, river works, parks and compulsory education facilities, disaster restoration works, etc.

For the public enterprise account portion, on the other hand, the money for the redemption of the principal and interest is basically paid for out of the income of the public enterprise in question (income from fees, sale receipts, etc) and so refers to local bonds issued to finance public enterprises such as water supply, traffic, hospitals etc.

When we look at it in this way, we can say that the ordinary account portion is secured in the main by the authority of the local government in question to levy taxes, and that the public enterprise portion is secured by the ability of the public enterprise in question to make a profit; but since the commercial activities are carried out by the local government, it can be said that even the public enterprise portion is ultimately secured by the authority to levy taxes wielded by the local government running the enterprise.

Further, the estimated amount of total revenues and expenditures of the local governments for the following fiscal year prepared each year in accordance with the provisions of Article 7 of the Local Allocation Tax Law is called the Local Public Finance Program; and the local bonds that are added to the Local Public Finance Program comprise this ordinary account portion.

In addition, the planned amounts are also added to the Local Bond Program according to their
funding category. An outline of this is given in Chart 1, but in actual fact both the ordinary account portion and the public enterprise account portion are categorized in greater detail per project before the amounts are added in; and the planned amount for each of these is then added in under the relevant funding category.

6.2 Other Programs connected with the Local Bond Program

(1) Treasury Investment and Loan Program

The Treasury Investment and Loan Program is a program drawn up each fiscal year by the Cabinet and submitted to the Diet in accordance with the provisions of Article 5 of the Act on the Special Measures on the Long-Term Investment of the Government Fiscal Loan Fund, in order to show the full picture of Treasury investments and loans which are the long-term investment and loan activities undertaken by the central government as part of its fiscal policy.

The local governments are one type of institution receiving treasury investments and loans, and the amount of the fiscal loan funding in the Local Bond Program is entered in the Treasury Investment and Loan Program as the “local government” portion.

(2) Local Public Finance Program

The Local Public Finance Program is drawn up each fiscal year by the Cabinet in accordance with the provisions of Article 7 of the Local Allocation Tax Law and is announced to the general public as well as being submitted to the Diet; it is a forecast of the total amount of revenues and expenditures in the ordinary account of the local governments. Under local bonds which are classed as revenue in the Local Public Finance Program is entered the amount of local bonds in the ordinary account in the Local Bond Program.

7 Circumstances surrounding local bonds and expenditure to repay public debt

Expenditure to repay public debt, with which local governments pay off loans and their interest, is an expense particularly lacking in flexibility, and thus necessitating constant vigilance.

The outstanding amount of local bonds, which are loans taken out by the local governments, stood at the end of fiscal 2008 at some 140 trillion yen, a huge amount equivalent to roughly 1.49 times total revenues and some 2.44 times total general revenue resources such as local taxes and the local allocation tax.

Further, generally speaking in Japan in addition to this outstanding amount of local bonds the total loan balance, including the local government fiscal burden of local allocation tax to cover shortfalls in local public finances and transfer tax distribution special account loans as well as the portion of public enterprise bonds redeemed by local public enterprises from the ordinary account, are deemed to be loans of the local government as a whole, and as of the end of fiscal 2008 this stood at some 197 trillion yen, a level that remains high.

This amount represents a value close to 40% of the (nominal) gross domestic product (GDP) of Japan and continues to be high. (For the central government itself, this figure is close to 140% of GDP;
the national debt of the country as a whole, local and central governments combined, is actually close to 180% of GDP.)

Diagram 10  Loan balance to be borne by the ordinary account and percentage of GDP


[Note 1] The outstanding amount of local bonds is the amount not including public investment project bonds with earmarked funding.

[Note 2] The outstanding amount of public enterprise bonds (ordinary account share) are values estimated on the basis of annual accounting statistics.

Further, generally used as indicators to judge the degree of burden imposed on the individual local governments by expenditure to repay public debt are the real debt service ratio and the debt service payment ratio used for permission to issue local bonds.
The real debt service ratio indicates the proportion of the standard financial scale (not including public bonds etc., reckoned into the basic financial needs in the calculation of the ordinary local allocation tax) taken up by the amount equivalent in real terms to the expenditure to repay public debt including expenditure based on monies transferred to other accounts for the redemption of the principal and interest of local bonds (not including advanced redemption) or for the redemption of the principal and interest of local public enterprise loans less the amount of the general revenue resources allocated for that purpose included in the basic financial needs in the calculation of the amount of grant of the ordinary local allocation tax. This is used in identifying which local governments need to hold consultations for the issuing of bonds and which local governments need to obtain permission; local governments with a real debt service ratio of 18% or higher require permission to issue local bonds, while a local government with a real debt service ratio of 25% or higher will suffer restrictions on the issue of some local bonds, and a local government with a real debt service ratio in excess of 35% will be subject to more severe restrictions.

As to the situation regarding the real debt service ratio according to the type of local government, average (weighted average) figures are 12.8% for prefectures, 13.8% for ordinance-designated cities, 10.8% for cities and wards and 14.4% for towns and villages.

Further, if we look at the distribution by level of the real debt service ratio, the number of local governments that exceed the criterion for transition to the permission system for local bonds (18%) totaled 399 (21.6%): three prefectural governments (6.4%), two ordinance-designated city governments (11.1%), 135 city or ward governments (17.1%) and 259 towns and villages (26.1%).

In addition, the Law relating to the Financial Soundness of Local Governments ranks the real debt service ratio as one indicator of the soundness of financial status, setting the criterion for early financial improvement at 25% and the criterion for financial reconstruction at 35%.

Of the 399 local governments mentioned earlier, a total of 19 (1.0%) have a real debt service ratio above the criterion for early financial improvement (25%) but below the criterion for financial reconstruction (35%); no prefectural or ordinance-designated city governments, 4 city or ward governments (0.5%) and 15 town or village governments (1.5%). One city or ward government (0.1%) has a real debt service ratio in excess of the criterion for financial reconstruction.

Next, the debt service payment ratio used for permission to issue local bonds. The debt service payment ratio used for permission to issue local bonds is an indicator of what proportion of the total amount of the general revenue resources is taken up by general revenue appropriated for debt service expenditure (i.e. general revenue resources appropriated to repay the principle and interest on local bonds). The flexibility of the financial structure is judged by looking at how much constraint expenditure to repay public debt is putting on the freedom of use of the general revenues.

The debt service payment ratios used for permission to issue local bonds are as shown below.
8 Other recent trends

8.1 The promotion of the appropriate and comprehensive management of local bonds

In recent years as both the volume of local bonds issued and the balance has become extremely large, the local government finances overall have become increasingly more strained.

In addition, with the trend being for the flow of funding to be switched from the public sector to the private sector, the weight of private-sector funding has increased; as the means of raising funds from local bonds becomes more diversified the types of local bonds being issued is increasing and becoming more complex. Furthermore, the permission system for local bonds has switched to the negotiation system.

If we consider this situation, we see that the individual local governments now need more than ever to take the initiative in tackling the comprehensive management of local bonds.

Starting with an analysis and understanding of the financial situation, they need to work out a long-term public finance program and as a part of that to establish firm plans for the issue of local bonds and for their redemption.

There are many different points that need to be considered: how to ensure that the issue of local bonds is stable and profitable, how to ensure the smooth redemption of local bonds in an increasingly severe financial environment, how to maintain market credibility as the weight of private-sector funding increases. Other major issues to consider include the provision of information on the financial situation and the establishment of a system the deal with the paperwork.

In concrete terms, for example, in order to make a smooth switchover to fund-raising mainly from the private sector, the challenge is to further improve transferability and diversify the means of fund-raising, through the promotion of more publicly-offered bonds, the use of the security loan method, bullet redemption on maturity, the issue of larger units, the leveling of the period of issue, and
diversification of the period of redemption.

Further, from the perspective of trying to ensure a planned source of revenues to cover future redemption, to improve funding liquidity and raise market confidence in the certainty of repayment, there are calls for each local government to set aside planned amounts in a sinking fund according to the situation with regard to the outstanding amount of its local bonds and the future outlook with regard to its local bond debt service burden.

Furthermore, in publishing financial information the local governments need not only to release actively and regularly information on every aspect of their own financial situation, including the soundness indicators based on the Law relating to the Financial Soundness of Local Governments, but also to work to maintain and improve confidence in local bonds in general, through the promotion of an accurate understanding regarding the safety of local bonds and their profitability as a financial instrument. In particular, with regard to local governments that issue public offering local bonds, their task is seen to be to cooperate in the stabilization of the local bond market as a whole, through the enthusiastic expansion of IR activities, such as the holding of regular explanatory meetings for investors.

From now on, it is extremely important that greater weight be given to initiatives for the appropriate and comprehensive management of local bonds.

8.2 A new debate regarding the negotiation system

In the election for the House of Representatives held in Japan in the summer of 2009, the Democratic Party of Japan won by a landslide; the Liberal Democratic Party, which had been the ruling party almost continually apart from a short period, experienced a dramatic fall from power and a new DPJ administration allied with non-LDP parties was born.

Then in September of this year, one outstanding feature of the second Cabinet shuffle undertaken by Prime Minister Kan under the DPJ administration was the appointment of Yoshihiro Katayama, a former bureaucrat in the Ministry of Internal Affairs and Communications and former Governor of Tottori Prefecture and currently a professor at a private university, to the post of Minister of Internal Affairs and Communications with jurisdiction over the system of local taxes and public finance policy, including of course local bonds.

Known throughout the country as a reformer from his time as governor, Katayama has been reported in interviews with the mass media since taking up his post to have shown a desire to review the present negotiation system and to give local governments a greater degree of freedom in the issuing of local bonds.

As I have described earlier, the current negotiation system has already been subjected to considerable debate and undergone drastic revision, reaching its current form after the switch in 2006 from the permission system to the negotiation system; but Katayama’s pet theory appears to be the reduction of the involvement of the central government still further through the tightening up of the pre-issue rules and application of a post-issue check.
On this point, what specific discussions will take place in the Cabinet and more importantly, what kind of conclusions will be reached, will attract a great deal of attention.

[Postscript]
Subsequently, on February 7th a meeting was held between the Six Associations of Local Governments, led by the National Governors’ Association, and Yoshihiro Katayama, the Minister of Internal Affairs and Communications. The main topic for discussion at this meeting was matters relating to the revision of the Local Autonomy Law, but there was also a report from Mr. Katayama on the subject of the review of the negotiation system for local bonds. This was the first time that the Ministry of Internal Affairs and Communications had made an external announcement on the current situation regarding the review of the negotiation system.

The Minister is said to have said that preparations were under way within the government with a view to reaching a Cabinet decision in the early part of March, and to have explained that the policy was to “carry out a partial review of the negotiation system for local bonds from the point of view of enhancing the autonomy and independence of the local governments; when a local government in a favorable financial situation planned to issue loans funded by the private sector, as a general rule there would be no need for negotiation, but only for prior notification.”

It seems that it is important to understand these two points - that the change is being considered only for local bonds funded by the private sector, and that while some local governments in favorable financial circumstances will not require negotiation but only prior notification, there is to be no drastic switch away from the actual negotiation system as it is at present.

[Notes]
1 The local government accounts are divided into the general account and the special account, but the local governments do not all separate their accounts in the same way; so in order both to clarify the financial situation of local governments as a whole and to enable a comparison to be made between local governments, for the above statistics I have classified accounts for the general administrative sector uniformly as the ordinary account, separate from other accounts (municipal trading accounts).

[References]
2010 White Paper on Local Government Finance (Ministry for Internal Affairs and Communications, 2010)
Nobuo Ishihara, Akira Shimazu, “A Concise Encyclopedia of Local Government Finance, Revision 5” (Gyosei, 2002)
Akihide Hirashima, Hiroshi Ueda, “Local Government Bonds (General Course on Local Autonomy)” (Gyosei, 2001)
[Laws referenced]
◎ Local Finance Law
(Limitations on Local Bonds)
Article 5 The annual expenditure of a local government must be financed out of its revenues other than local government bonds. However, local government bonds may be used to finance expenditures in the following circumstances.
1. To finance expenditures required for transportation, gas, water supply and other enterprises undertaken by the local government (hereinafter referred to as “public enterprise”);
2. To finance investments and loans (including the financing of expenditures required for the procurement of land or other properties for the purpose of investment or loan);
3. To finance expenditure required for the refunding of local government bonds;
4. To finance temporary measures, recovery work or relief work in time of disaster;
5. To finance construction works of public or government facilities, such as schools and other educational facilities, nurseries and other welfare facilities, civil engineering work on roads, rivers and harbors (including expenditure required for the local government share or subsidy for the construction of public facilities undertaken by Cabinet order by a public body or by a public organization financed by the central government or by the local government) or to finance the purchase of land for public or official use or as a substitute for the same (including the procurement of rights other than title rights to the land in question).

◎ Local Autonomy Law
Article 215 (Contents of the Budget)
The budget shall be divided into and comprise the following sections:
1. Budget for annual revenues and expenditures
2. Continued expenses
3. Brought forward approved by the budget
4. Debt liabilities
5. Local government bonds
6. Floating debt
7. Appropriation of monies between sections of the expenditures budget

Article 230 (Local Government Bonds)
An ordinary local government may issue local government bonds as provided in its budget, as prescribed elsewhere in law.
2 When local government bonds are to be issued in accordance with the preceding paragraph, the purpose of the issue, the maximum amount, the method of issue, rate of interest and method of redemption must be set out in the budget.

Article 235 Clause 3 (Floating Debt)
The chief executive of an ordinary local government may take out a floating debt in order to disburse expenses within the expenditure budget.
2 The maximum amount of floating debts taken out in accordance with the provision of the preceding paragraph must be determined in the budget.
3 A floating debt taken out in accordance with the provisions of Paragraph 1 must be redeemed from the revenues of the current fiscal year.
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*The interpretation of the following “words” and “phrases” is as follows.

○○○……...11(7, 8, Table 5, 19 x 3) means that the word ○○○ appears in 1 section on page 11 line 7, line 8, and Table 5, and appears in 3 sections on line 19 of the same page. As for counting the lines, we start from the top, but we do not take into account spaced lines, titles of Tables and Graphs, and notes or sources.*

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