
Administrative Order on the Law Relating to the Financial Soundness of Local Governments

Hiroki Miyake

I. Introduction

The FSLG Administrative Order was promulgated on 28 December 2007.

The FSLG Law, which is aimed at better understanding local governments' financial condition and providing a mechanism to enable early reform when that condition has deteriorated, was passed into law in June 2007 to replace the current Financial Reconstruction System.

The FSLG Administrative Order spells out in greater detail the content of the FSLG Law, while also reflecting to some extent input on the law from local governments. Its two primary objectives are to clearly define the financial indices and to establish the numerical standards used to assess the financial condition of local governments.

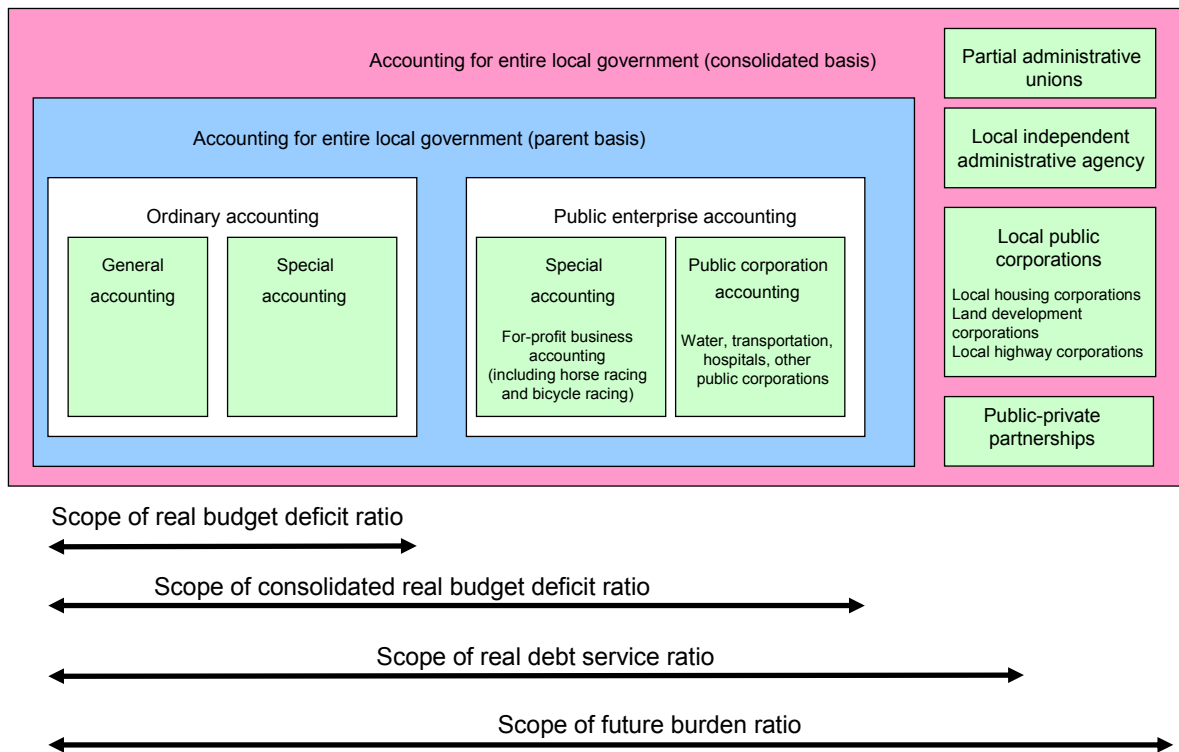
The objective of this paper is to summarize the content of the FSLG Law, primarily by focusing on key elements in its newly promulgated Administrative Order¹.

II. Clarifying the financial indices for local governments

The FSLG Law stipulates that four financial indices shall be used to properly gauge the financial condition of local governments: the real budget deficit ratio; the consolidated real budget deficit ratio; the real debt service ratio; and the future burden ratio. Its Administrative Order stipulates the scope of accounts upon which these four indices are based, as well as the specific method of their calculation (Figure 1).

1 For more on the current status of Japan's local government finances and municipal debt, see "*Henkakuki no Chihousai Shijou -- Chihousai no Genjou to Tenbou*" (Japan's changing municipal debt market -- current and future outlook), edited by the Nomura Institute of Capital Markets Research and published by the Kinzai Institute for Financial Affairs (2007).

Figure 1: Public accounting and financial indices for local governments



Source: Nomura Institute of Capital Markets Research

The real budget deficit ratio, which provides an overall picture of revenues versus expenses for the basic public services provided by local government, is calculated by dividing the actual deficit in the ordinary account by that government's general financial resources. Each local government's general financial resources are defined as the sum of revenue from financial sources, such as local taxes and local allocation taxes, that the local government has discretion to determine the use of. This is basically the same concept as the "real deficit ratio" that has been used thus far as a flow-based financial indicator for local governments.

The consolidated real budget deficit ratio, like the future burden ratio described below, is a new financial indicator introduced in the FSLG Law. Businesses operated by local governments include, in addition to the basic ones covered by their ordinary accounts, those businesses managed under special accounts and as well as businesses operated as public enterprises, including mass transit and hospitals. Until now, there has been no indicator that included these businesses when measuring local governments' fiscal balances. Nevertheless, because the general revenue source is ultimately used to pay back liabilities incurred outside of the ordinary account in some cases, the FSLG Law requires the calculation of a consolidated real budget deficit ratio, which is the real deficit of the ordinary account, the special account, and the public enterprise account combined, expressed as a percentage of general financial resources.

The real debt service ratio is an indicator that looks at the principal & interest payments on outstanding municipal debt each fiscal year that the local government is

responsible for, relative to its general financial resources, and has been calculated since 2006.

The future burden ratio is a stock-based (rather than flow-based) indicator that looks at the size of the burden that the local government is expected to bear in the future using its own financial resources. The future burden ratio covers not only municipal debt outstanding, but also expenditures planned starting with the following fiscal year, including the cost of acquiring land, the cost of building facilities, and planned expenditures on retirement benefits, as well as those debts that are incurred by local public corporations and public-private partnerships with which the local government has entered into indemnity agreements and that the local government is expected to pay.

All local governments must begin calculating and disclosing the four financial indices noted above beginning with their FY2007 results, and will also be required to undergo a review by their auditors prior to disclosure.

III. Standards for assessing financial condition

1. Classifying the financial condition of local governments based on financial indicators

Under the FSLG Law, these financial indices are used to categorize local governments' financial condition into one of three stages: the fiscally sound stage, the early intervention stage, and the fiscal reform stage.

If one or more of the four indices exceeds the criterion for early intervention, that local government's financial condition is deemed to be at the early intervention stage, thereby obligating the local government to create a plan to achieve early financial soundness (an "early-intervention plan"). This plan must include an analysis of the factors that caused deterioration in the financial condition, some basic guidelines and specific measures for reform, and an outlook on future financial reconstruction. The local government designated for early intervention must then launch financial reforms in accordance with its early-intervention plan, including targeting a real budget deficit ratio of 0% and values for the other three indicators below the criteria triggering an early intervention designation. At this stage, however, the central government's involvement is relatively minor, and there are no limits placed directly on that local government's issuance of municipal debt. Financial reform is thus essentially dependent upon the efforts of the individual local governments.

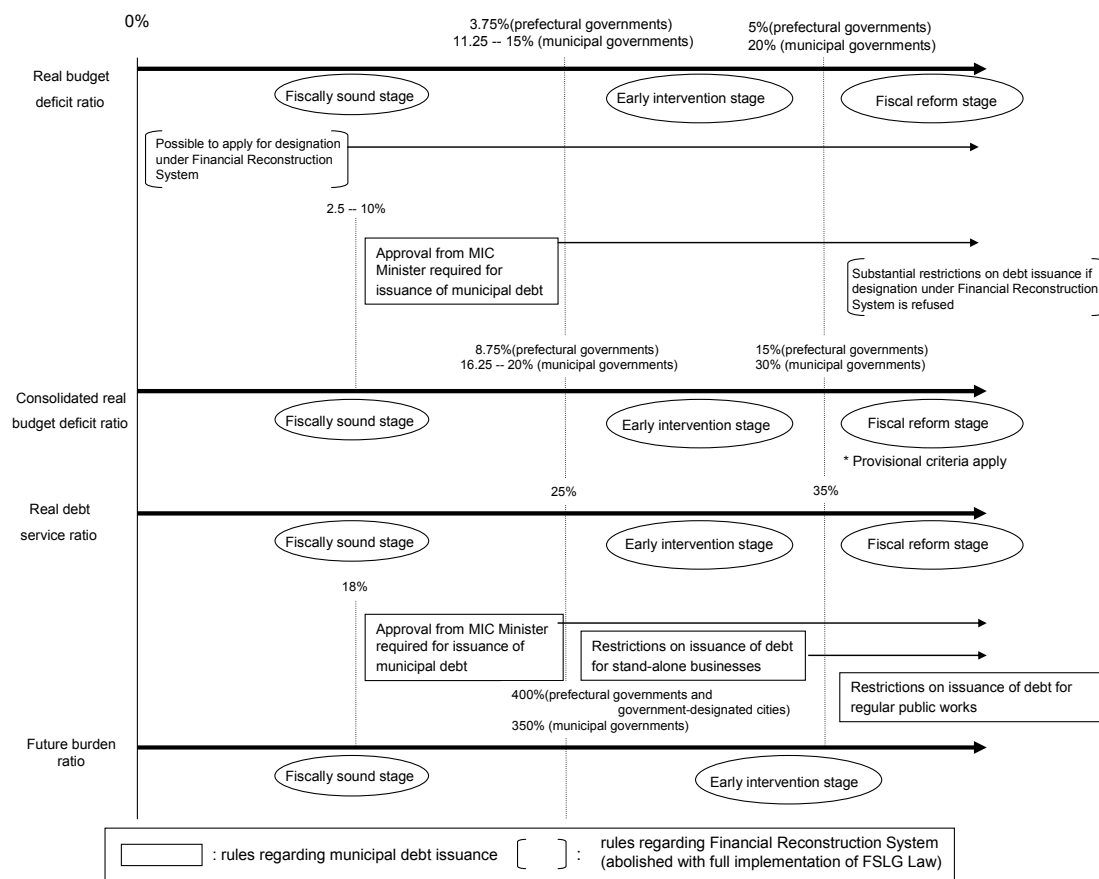
The fiscal reform stage is for local governments whose financial condition has worsened considerably despite their efforts at reform in the early intervention stage, and entails well-defined financial reform measures with the involvement of the central government. The fiscal reform designation is made based on only three financial indices, with the future burden ratio excluded. If any one of those three indices exceeds the maximum criteria for fiscal reform, that local government must formulate a fiscal reform plan, which essentially addresses the same items that were in the early

intervention plan, but with greater detail regarding implementation. The fiscal reform plan effectively requires the approval of the Minister of Internal Affairs and Communications (MIC). Fiscal reform-designated entities must target a real budget deficit ratio of 0% and a consolidated real budget deficit ratio and real debt service ratio below the criteria triggering early intervention designation.

2. Standards for assessing financial condition

The numerical criteria for triggering designation as an early-intervention or fiscal-reform entity stipulated in the FSLG Administrative Order were established so as to be consistent with the current Financial Reconstruction System and the municipal debt issuance rules now in place (Figure 2).

Figure 2: Level of financial indices triggering early intervention and fiscal reform designations



Source: Nomura Institute of Capital Markets Research

The real budget deficit ratio triggering designation as an early-intervention entity is set at 3.75% for prefectural governments and at 11.25-15% for municipalities, while the real budget deficit ratio triggering designation as a fiscal-reform entity is set at 5% for prefectural governments and 20% for municipalities. Although local governments

are in principle free to issue municipal debt, if they have a real budget deficit ratio that equals or exceeds 2.5% (for prefectural governments) or 2.5-10% (for municipalities), they must obtain approval for their debt issuance from the central government. Under the Financial Reconstruction System, the effective standard for entering the financial reconstruction process was a real budget deficit ratio of 5% (for prefectural governments) and 20% (for municipalities)². The criteria for fiscal reform designation under the FSLG Law is the same as that for entering the Financial Reconstruction System, while the criteria for early intervention designation is set midway between the criteria for entering financial reconstruction and the criteria for requiring central government approval for debt issuance.

The consolidated real budget deficit ratio triggering designation as an early intervention entity is set at 8.75% for prefectural governments and at 16.25-20% for municipalities, while that for designation as a fiscal reform entity is set at 15% for prefectural governments and 30% for municipalities. The criteria for the consolidated real deficit ratio is 5 percentage points higher than the (unconsolidated) real budget deficit ratio for early intervention designation and 10 percentage points higher for fiscal reform designation. Furthermore, because the consolidated real budget deficit ratio is a new indicator, as a provisional measure the fiscal reform standards are another 10 percentage points higher in FY2009 and FY2010, and another 5% higher in FY2011.

The criteria for the real debt service ratio are 25% for the early intervention stage and 35% for the fiscal reform stage. Under the current rules for issuing municipal debt, if the real debt service ratio exceeds 25%, that local government's ability to issue municipal debt for businesses it operates on its own is restricted, and if that ratio exceeds 35%, its ability to issue debt for regular public works is also restricted. The standards under the FSLG Law are set at the same level.

The future burden ratio for designation as an early-intervention entity is set at 400% (for prefectural governments and government-designated cities) and 350% (for municipalities). As noted above, the future burden ratio is not used for the fiscal reform designation.

3. Status of local government finances and standards for early intervention and fiscal reform designation

There is a question as to whether the recently set standards for early intervention and fiscal reform are effective for assessing the relative financial difficulties of each local government.

² Local governments that exceed these criteria but do not accept designation as a financial reconstruction entity have substantial constraints placed on their ability to issue municipal debt. The Financial Reconstruction System requires an application from the local government, however, and a local government cannot be subject to the reform process if it does not submit an application, even if its real budget deficit ratio exceeds the criteria. This marks a major difference between the current system and the FSLG Law.

Based on actual fiscal balances reported for FY2006, 25 of the roughly 1800 local government entities had a real budget deficit, and of these at least three had a real budget deficit ratio higher than the criteria for early intervention³.

The actual debt service ratios reported for FY2006 included three local government entities that had a ratio of at least 35%, and 43 entities that had a ratio of between 25% and 35%.

Although it will depend on future progress by local governments in implementing fiscal reforms, based on their financial status as of FY2006, we think it likely that several dozen local government entities have the potential for being designated as either early-intervention or fiscal-reform entities by April 2009, when the new law goes fully into effect.

IV. Future outlook

The two most significant aspects of the FSLG Law, in our opinion, are that it enables an understanding of local governments' financial condition from both a consolidated and stock perspective, and that it puts mechanisms in place that increase the likelihood of local governments beginning fiscal reform at an earlier stage.

The old financial indices all looked at financial condition on a flow basis, and were limited in principle to only the ordinary accounts. The FSLG Law includes a stock-basis financial indicator, the future burden ratio, and also enables assessment of local governments' financial condition on a consolidated basis, including special accounts and public enterprise accounts, as well as accounts for local development organizations (for land, roads, and housing) and for public-private partnerships.

The new law also includes an early intervention stage to encourage local governments to embark on fiscal reform on their own. The fiscal condition of local governments is assessed based on the actual values of their financial indices, and if a local government has indices that are higher than the allowable standard, it is obligated to submit a plan for either early intervention or fiscal reform, with no requirement for it to first submit an application. This makes the process of fiscal reform for local governments more objective, and facilitates the process of achieving a sounder financial footing.

The Administrative Order for the FSLG spells out in greater detail the content of the FSLG Law, provides definitions of, and formulas for, the financial indicators, and establishes the numerical criteria for designation as an early-intervention and fiscal-reform entity. In addition to maintaining consistency with the current rules governing local government finance, it also incorporated feedback from local governments, and in response introduced fiscal reform criteria on a phased-in basis.

³ This paper proceeds on the notion that the real deficit ratio and the real budget deficit ratio are equivalent. It is also limited in scope to the 15 of those 25 local government entities for which actual figures for the FY2006 real deficit ratio are available.

In our opinion, the FSLG Law does a good job of addressing problems under the current system, and should make it possible to put local governments on the right path toward financial soundness. In order to implement the FSLG Law in an effective manner, however, we think there is a need to further enhance the information infrastructure required to provide an accurate picture of local governments' financial condition, including the public sector accounting rules that provide the basis for calculating the financial indices, as well as the auditing system that guarantees the accuracy of the accounting data⁴. In October 2007, the Ministry of Internal Affairs and Communications unveiled two sets of public sector accounting standards for local governments, a standard model and a modified MIC model, and all local government entities are expected to base their accounting on one of these two models by FY2011. The auditing system should have at least as large a role as before under the FSLG Law, including by auditing the reported values of the financial indices, and the use of auditors, including external auditors, should enhance the content of financial reporting while also raising the level of expertise.

The definitions of, and numerical criteria for, the financial indices stipulated in the FSLG Administrative Order are not set in stone, and will probably have to be revised to reflect changes in the financial condition of local governments. For example, there are already voices calling for a modification of the formula for calculating the real debt service ratio for government-designated cities, given their large populations and consequent need for public works entailing large initial investments, which invariably pushes their debt service ratios higher. Furthermore, because both the consolidated real budget deficit ratio and the future burden ratio are new financial indices, there will probably be an ongoing need to debate the suitability of the formula for calculating the indices and of the numerical criteria against which reported values are assessed.

⁴ In this regard, it was widely reported on 30 December 2007 that Osaka City had been hiding its deficits, by borrowing from the sinking fund established to pay the P&I on municipal debt issued in the future, and also by refinancing that municipal debt that exceeded standards set forth in the MIC's guidelines (from an article in the 30 December 2007 morning edition of the *Asahi Shimbun*). In response, Osaka Prefecture delayed setting the issuance terms on a municipal debt issue scheduled in January 2008. This incident is worth noting as an example of how information disclosure relating to the fiscal management of local governments can be both inadequate and unsuitable at times.