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Rating Methodology for Local Public Bodies

This rating methodology applies to local public bodies in Japan.

1. Basic Concept

Creditworthiness of local public bodies is supported by the Japanese government's credit enhancement through the local public finance program, local government bond system, Act on Assurance of Sound Financial Status of Local Governments, etc. In rating a local public body, JCR assesses the tax-bearing capacity, fiscal conditions, fiscal management and so forth of individual local public bodies, along with credit enhancement provided by the government. That said, incorporating the effects of the government's credit enhancement into the rating does not mean assigning a uniform rating level.

2. Credit Enhancement by the Japanese Government

Even though the government's credit enhancement is strong, JCR verifies whether there have been any changes in factors supporting such credit enhancement, including local administrative and financial systems and the government's stance on fiscal management.

(1) Position of Local Public Bodies

In calculation of National Accounts of Japan, local governments are larger final consumption expenditure bodies than the central government. By body of final consumption expenditure, local governments account for approximately 40% of the government final consumption expenditure and approximately 50% of public gross fixed capital formation. As shown by these figures, local public finance has important status in the country's economy in parallel with national finance.

(2) Local Financial System

(i) Local Public Finance Program

The Japanese government guarantees revenue sources for local public bodies through local public finance program by way of local allocation tax and local bonds so that they can play their important roles, regardless of gaps among regions due to differences in population and industrial concentration and also differences in tax revenues from fiscal year to fiscal year. The total amount of fiscal transfer from the central government to local public governments primarily through local allocation tax is determined every fiscal year in the process of the central government's budgeting. As regards the total amount of general revenue sources, which consist of local tax, local allocation tax, local transfer tax, etc., JCR verifies whether a sufficient level is secured.

(ii) Local Government Bond System

The Japanese government guarantees sources for expenditure constituting the redemption of principal and interest on local government bonds, through formulation of local public finance program and calculation of local allocation tax. It also ensures safety of redemption of principal and interest on local government bonds by controlling bond issues in advance by a local public body whose debt service burdens exceed a certain limit, through a permission system of bond issuance as a prompt corrective system, in order for each local public body not to have difficulty in its principal redemption and interest payment.

(3) Act on Assurance of Sound Financial Status of Local Governments

Act on Assurance of Sound Financial Status of Local Governments provides a scheme whereby fiscal conditions of local public bodies are clarified with unified indicators and the Japanese government is able to promptly take action in cases where financial soundness or rebuilding is required. Any local public body whose soundness ratio exceeds a certain level is required to formulate a financial soundness plan (early financial soundness scheme). Any local public body whose ratio for determining rebuilding exceeds the financial rebuilding standards must establish a financial rebuilding plan (financial rebuilding scheme). Under the financial rebuilding scheme, the central government's strong involvement will effectively influence even the financial rebuilding body's budget compilation, to a greater extent than under the early financial soundness scheme. A local public body can issue local government bonds only with consultation with the Minister of Internal Affairs and Communications (the "Minister") under the early financial soundness scheme. The issuance of local government bonds is limited without the Minister's consent under the financial rebuilding scheme except in cases of disaster recovery or other emergencies. Furthermore, only if a local body has obtained the Minister's consent, it can issue rebuilding transfer special bonds within the range of its balance shortfall. In principle, the central government is to provide appropriate funds for the special bonds as far as the central government's fiscal situation permits it to do so.

(4) Local Administrative System

Administrative activities that are closely related to people's living such as development of social infrastructure including welfare, school education, fire protection, roads and rivers are mostly performed by local public bodies. Local administrative system and local financial system that supports the former are inextricably linked. As regards the local administrative system, JCR verifies whether the delegation of administrative duties and authority is conducted without accompanying financial measures and will not affect the management of local finance.

(5) Japanese Government's Fiscal Management Stance

Because it is necessary for the central government's fiscal deficit or debt level to remain at a sustainable level in order to maintain a sufficient level of fiscal transfer from the central government to local public bodies, the central government's fiscal conditions and its stance on fiscal management are also important. To address the shortage of funds for local allocation tax provided by the central government, the outstanding balance of extraordinary financial measures bonds, which are issued by local public bodies as a special measure, had been accumulating. It is stipulated that the central government shall transfer funds for the principal redemption and interest payment in full for the bonds in later fiscal years. Hence, JCR verifies whether the central government can secure redemption funds into the future. Attention is also paid to the impact of the revisions to the local tax system. In the event of tax reforms that lead to a decline in local tax revenue, JCR verifies whether stable alternative revenue sources commensurate with the lost revenue are secured at the same time.

3. Fiscal Conditions of Local Public Bodies

(1) Quantitative Assessment

A quantitative assessment is based primarily on the most recent already fixed financial results using 3 criteria: (i) tax-bearing capacity; (ii) ordinary account's status of income and expenditure; and (iii) conditions of liabilities (including public enterprises and auxiliary organizations such as 3 public corporations, etc.).

(i) Tax-bearing Capacity

In assessing tax-bearing capacity, JCR focuses on indicators such as financial capability indicator and per capital gross prefectural (municipal) domestic product. JCR also focuses on fixed property tax valuation prices, etc. for cities, towns and villages. The financial capability indicator is calculated as the past 3-year average of the figures derived from dividing basic financial revenues by basic financial needs. A higher figure of financial capability indicator means more revenue sources are reserved in the calculation of ordinary local allocation tax, and that the local public body can be said to have a greater margin for revenue sources.

(Key indicators)

- Financial capability indicator
- Per capita gross prefectural (municipal) domestic product
- Per capita fixed property tax valuation price (cities, towns and villages)

(ii) Ordinary Account's Status of Income and Expenditure

When assessing ordinary account's status of income and expenditure, JCR places a great value on factors including ordinary balance ratio, current conditions of deficit in revenue sources/ financial measures, and balance of available reserves for the fiscal management—in particular, appropriable funds for redemption of local government bonds and similar instruments. As for the ordinary balance ratio, ordinary general revenue sources with a special share of revenue decrease compensation bonds and also extraordinary financial measures bonds added to it is used as the denominator, and when the sinking fund to pay off bullet bonds is insufficient, the reserve method is modified if it is significantly different from that of other organizations. At a prefectural level, the ordinary balance ratio tends to fluctuate markedly every fiscal year due to trends in corporate and related taxes. Therefore, JCR thinks it is appropriate to use methods like moving averages to eliminate such fluctuations. JCR would deem a local government's income and expenditure being in a difficult state, if deficit in revenue sources/ financial measures need to be covered by various borrowings, such as borrowings from funds and other accounts, or through issuance of local administrative reform promotion bonds or other special bonds.

(Key Indicators)
- Ordinary balance ratio
- Appropriable funds for redemption of local government bonds

(iii) Conditions of Liabilities (including public enterprises and auxiliary organizations such as 3 public corporations, etc.)
As for conditions of liabilities, JCR looks at the future burden ratio and the basis of the calculation of this ratio. The future burden ratio, albeit subject to certain assumptions, is the only stock index in the calculation, which uses net indebtedness to be borne by all the accounts/ corporations of local public bodies including public enterprises and auxiliary organizations, etc. in the future.

Regarding auxiliary organizations such as local public enterprises, 3 local public corporations, third-sector enterprises, etc., it is necessary to consider how much transfers to other accounts and additional financing can cause burden on the ordinary account. After making analyses of management and fiscal conditions of individual public enterprises and major auxiliary organizations, JCR examines adequacy of calculation of burden on the ordinary account for each of them.

(Key Indicators)
- Future burden ratio

(2) Qualitative assessment
The important points in qualitative assessment are future financial prospects and the stance of the local public bodies on the fiscal management that forms the basis of the prospects. Even in qualitative assessment, JCR makes efforts to obtain as much quantitative information as possible that could help estimate the extent of an improvement or a worsening in the fiscal indicators, rather than simply try to determine the direction alone. The key points for assessment include: (i) review of expenditures and debt management and other efforts aimed at financial soundness; (ii) prospects of fiscal balance/ financial measures for the local public bodies' ordinary account, etc.; and (iii) efforts to strengthen management base of public enterprises, auxiliary organizations, etc. and their fiscal outlook.

JCR also considers it is necessary to verify the strength of the will of the local public bodies in achieving financial soundness, in addition to details of administrative and financial reform plans and other plans. This is because reforms could fail even with an outstanding plan, depending on views of the local assembly or local residents. If JCR can confirm the strength of the will of the local public body, while taking into account the trends in the local assembly, JCR would be able to incorporate into ratings the efforts made toward financial soundness at least during the existing administration. In such a case, JCR acquires as much quantitative information as possible on the prospects of improvement in fiscal indicators such as ordinary balance ratio and outstanding debt balance and incorporates its findings into the ratings.

As for the debt management, numerical targets for the outstanding balance and issue amount of local government bonds should be set as clearly as possible based on the future prospects of local government bond balance.

For the prospects of fiscal balance/ financial measures for the local public bodies' ordinary account, etc., JCR examines the details of the financial measures to find revenue sources for expected revenue shortfalls. Any reliance on borrowings from funds or issuance of special bonds due to failure in reducing annual expenditures will leave the burden into the future. Thus, this is not desirable. As the prospects of fiscal balance vary significantly depending on assumption of annual revenues and expenditures, JCR will verify whether the assumptions are appropriate.

JCR is particularly interested in future cash flows and outlook for debt repayment funds in assessing efforts to strengthen management base of public enterprises, auxiliary organizations, etc. and their fiscal outlook. Since the amount of burden on ordinary account from outstanding debt balance of these organizations is basically derived from the most recent financial results, JCR's quantitative assessment does not include effect of improvement in future management. An increase of cash flow from operating activities associated with improved management of these public enterprises, auxiliary organizations, etc. is expected to reduce the amount of burden related to their debt redemption on ordinary account.

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