

Government Financial Institutions: What and How to Reform

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A course of action to reform Japan's government financial institutions (GFIs) and Postal Savings System (PSS) is presented in this chapter. GFIs account for a large fraction of financial intermediation. The PSS is the world's largest financial institution, with ¥227 trillion of deposits (about 31% of total household deposits, as of March 2004). Both of these are financial sources of the Fiscal Investment and Loan Program (FILP).

FILP has been called "the second budget", using PSS deposits distributed through GFIs and Special Public Corporations (SPCs) to undertake projects the government was unable to budget in the general account and to make loans to borrowers in targeted areas. The FILP involved 391 trillion yen, equal to some 60% of gross domestic product (GDP), at the end of March 2003, and the program's total uses of funds statement totaled more than GDP.¹

In the 1990s, financial intermediation through the public sector increased. Figure 1 shows flow of funds in fiscal 2001 compared to fiscal 1990. In fiscal 1990, Japanese households deposited 328 trillion yen in the private financial institutions and invested 208 trillion yen in stocks and corporate bonds. Private financial institutions lent 412 trillion yen to private firms and invested 329 trillion yen in stocks and corporate bonds. In fiscal 2002, however, investment of household in shares and corporate bonds fell to 143 trillion yen, and investment of private financial institutions in them fell to 246 trillion yen. Private financial institutions also decreased loans outstanding to 326 trillion yen. On the other hand, households' deposits to PSS and public pension funds and investment of private financial institutions in government bonds were approximately doubled. Funds of Japanese households concentrated in the public sector.

This phenomenon is harmful to economic growth. A reason is that funds intervened by GFIs are not usually invested to areas that generate profits. Although GFIs lend to private companies, these companies often cannot borrow from private banks or gain less profits. Moreover, funds collected in the public sector tend to remain in the public sector (for example, SPCs like Japan Highway Public Corporation and Urban Development Corporation, and local governments) under the FILP. Hence, if the government does not reduce demand for funds by GFIs itself, it is difficult to resolve misallocation of funds.

The first part of the chapter provides overviews of government financial intermediation, and of the broad FILP reforms underway or that have been debated. Problems common to all GFIs (and other recipients of FILP funds) and ways for addressing them are then presented. The core of the chapter takes each GFI in turn and puts forth a course of action for its reform. In connection with this, an analysis of the

¹ Good descriptions of the FILP and PSS in English are Cargill and Yoshino (2000, 2003). Doi and Hoshi (2003) has a good summary, and provides estimates of the costs FILP has and might impose on Japanese taxpayers; its appendix provides a further review of the literature.

Studies more specific to GFIs in English include Cargill and Yoshino (2003).

The FILP Report, an annual publication available on the Ministry of Finance web site (<http://www.mof.go.jp/english>), is an official guide to FILP, with basic information and data.

financing arrangements between the central and local governments and how they should be changed also is presented.²

1 Government Financial Intermediation

The role of GFIs has been much discussed. The government can raise funds at a lower interest rate than a private intermediary, and thus offer those funds to borrowers at a lower rate than a private lender. This below-market financing is a subsidy that can be economically appropriate in situations where there are large externalities, and acceptable for some socially desirable activities. Note that the government need not lose money in such intermediation.

GFIs also play promoting social goals, as well as political roles. There are many previous studies on role of the Japan's GFIs, for example Mitsui and Ota (1995), Okina (1999), Iwamoto (2001, 2002), and Nishigaki, (2003). Iwamoto (2001, 2002) summarizes the economic reasons GFIs have been created in six points, mentioned by previous studies. These are: 1) improve the operational efficiency of private financial institutions through their competition with GFIs; 2) credit information produced by GFIs, rather than private financial institutions; 3) term-conversion (short-term deposits used to fund long-term projects); 4) externalities; 5) risk-bearing; and 6) asymmetric information. Among these, Iwamoto (2001, 2002) shows that only risk-bearing and asymmetric information are considered currently important.

Welfare losses due to asymmetric information are said to be mitigated by GFIs. Credit rationing takes place because lenders lack information about possible borrowers, and the costs of obtaining the information cannot reasonably be expected to be recovered. GFIs have been more willing to lend in the absence of information than private financial institutions. This can be economically appropriate, costless (at least directly) to taxpayers, and socially desirable. However, the lending also can be aimed at specific groups for political purposes.

GFIs clearly can claim a "double-complementary role" proposed by Iwamoto (2001) to private financial institutions. That is, they enhance both private intermediation and the functioning of capital markets. But there is a line between that and usurping the market's role. In Japan, the scope of GFI activities has expanded into fields that are arguably inappropriate. Thus, GFIs make loans to customers that private financial institutions could be lending to, and funding customers that should be financed in the capital market. Iwamoto (2001, 2002) shows that both of these can lead to welfare loss.

Quantitative comparisons between GFIs and private financial institutions are as follows. The amounts of loans and discounts outstanding of GFIs, analyzed in this paper, are shown in Figure 2. It also shows proportion of loans and discounts outstanding of GFIs to total (GFIs and private financial institutions) outstanding in Japan. Figure 2 suggests that the proportion of GFIs was increasing in the 1990s. The amounts of guarantee obligation outstanding of GFIs are shown in Figure 3.

More broadly, the functions and competitiveness of private financial institutions and capital markets have been changing in Japan as a result of domestic deregulation and global evolution of institutions and markets. It follows that the roles of GFIs should be required to change in accordance with these environmental changes. GFIs were part of a segmented-market system, filling gaps in the private part of that system. Now, the gaps are, or can be, filled by the private sector. As specific examples, large

² Local government refers to the 47 prefectures and the municipalities (cities, towns, etc) that comprise them.

Japan has a unitary system like France, rather than a federal system like the United States. This means local jurisdictions depend on the national government financially and administratively, even though the prefectures have their own governors and assemblies. Local tax revenues are almost entirely controlled by the central government, with the rates and sources of local taxes being basically determined by national laws such that local governments have limited discretion over them. Also the central government distributes to each local government large amounts of the Local Allocation Tax Grants (general grants) and National Government Disbursements (matching grants). Moreover, local governments must obtain permission from a minister of the central government in advance when they issue local bonds.

Japanese enterprises now tend to raise funds by direct finance, and the scope of the roles financial intermediaries should play is shrinking.

However, as a practical matter, the bad loan problems facing private financial institutions have contributed to their reluctance to lend. Thus, in the near-term there is room for complementary activity by GFIs in financing small and medium enterprises (SMEs). But, when the bad loan problem is resolved and the financial strength of private financial institutions improves, the scope of GFIs should naturally shrink.

2 Reforms Underway

The sheer size and ubiquity of FILP has created tremendous vested interests, which have complicated attempts to introduce even such basic things as transparency and accountability. However, slowly, recognition of the need for reforms spread, and the resolve to undertake them formed. Thus, a revamping of FILP took effect in April 2001. However, more needs to be done, and efforts are underway. (The reforms are summarized in Doi and Hoshi (2003, p 56-60), and the structure of the new FILP is illustrated as figure 2.2.)

The Koizumi cabinet put forth a “Plan for Reorganization and Unification of Special Public Corporations (SPCs; *tokusho hojin*, literally, special legal entities)” in December 2001. Under the overall principle of “from government control to privatization”, the plan initiated studies and reviews of the existing system.

It was planned that the Council on Economic and Fiscal Policy (CEFP) commence study at the beginning of 2002 and, based on the results, the Cabinet would have a clear view of the economic situation and be able to make specific proposals. The cabinet plan called for study of four specific topics: the technique used to evaluate policy-based financing; the policy costs including advanced redemption in GFIs; the decision-making under which the policy costs analysis is used to dispute the propriety of projects operated by SPCs; and review of the organizational form of each SPC (privatization, transformation into an independent administrative institution, or abolition). Although scheduled to be concluded no later than the end of 2002, the deadline was put off until the end of 2004.

The Koizumi cabinet made a public commitment to privatization of the postal businesses on assuming office in 2001. To that end a “Council to study the future modalities of the three postal businesses” was set up. (The three businesses are delivering the mail, operating Postal Savings, and operating a life insurance provider.) The Council presented three approaches to reform in September 2002, and they, along with various other proposals, have been hotly debated. Privatization of Postal Services continues to be discussed by the CEFP; its fate is beyond the scope of this paper. The chapter by Fukao addresses the life insurance industry.

In response to the discussion of privatization, this paper presents a proposal of GFI reform. It is stated herein that privatization is not the sole solution because if existing GFIs should simply be privatized without scaling down their scope of operation to become private financial institutions, the situation of over-banking already besetting existing private financial institutions would not be resolved, but, on the contrary, could even be aggravated. Consequently, in the proposal of GFI reform presented in this paper, it is stressed that GFIs that cannot be simply privatized or are not suited to privatization are to be retained as public institutions, though their scope of operation is to be scaled down and limited, while grants for unscrupulous subsidies from the government are definitely to be restrained. To be concrete, GFIs should withdrawal from businesses that private financial institutions can carry on. For this purpose, it is effective to promote securitization and assign their financial receivables to private financial institutions.

3 General Issues

FILP has been called “the second budget”, using PSS deposits as the equivalent of revenue to engage in activities that the government was unable to budget in the general account, which is financed primarily by

taxes. FILP agencies are the GFIs, SPCs, and Special Firms that FILP has funded. However, unlike taxes, the deposits have to be paid back, with interest. There have been many cases in which the revenue earned from the undertakings fall short of what is owed, and this must be covered by the general account. In such manner, significant subsidies have been provided to GFIs on an unplanned, ex post basis. Figure 4 shows the amounts of government subsidies to GFIs to compensate shortfall of their revenues. This phenomenon is nothing short of the soft budget constraint, which originally formulated by Kornai (1979). At a time when outstanding Japanese government debt exceeds 400 trillion yen, a historically high level, it is not allowable any longer to spend these subsidies inconsistently.

From such viewpoints, the important aims of the reform of GFIs are three points: clarification assignments of roles between the private and public sectors, increasing business efficiency in GFIs, and restraint of fiscal burden. In order to accomplish these goals, it is necessary for GFIs that the soft budget constraint problem should be fundamentally settled. Ways to address the problem — restructuring of FILP agencies including GFIs as "state-owned limited companies" to set limitation on liability concerning capital contribution by the government; committing a priori using objective indicators such as "grant element", and creation of bankruptcy procedures — are presented.

3.1 Limiting Liability of government capital contributions

The already very large, open-ended liability of the government (taxpayers) for FILP activities, an absence of transparency and clarity, and the slowness with which FILP agencies have shifted their funding sources are taken up in this section.

In effect, the government (ultimately, taxpayers) has assumed almost unlimited liability for GFIs. With the government standing ready to cover deficits, GFIs have little incentive to avoid creating deficits: the government bears the risks of their lending. Since the Japanese government has a huge amount of debt outstanding, such an ad hoc, open-ended commitment is not tolerable.

Moreover, proposed reforms seek to have PSS deposits flow into the private sector as much as possible. Currently, PSS funds are used mostly to purchase government bonds and FILP bonds. The central and local governments are issuing large amounts of bonds, and there continues to be a great demand for funds by GFIs and SPCs. Thus, demand for public funds must be restrained if more funds are to flow to the private sector. To that end, the government must reduce its deficit. (In their chapter, Broda and Weinstein are more sanguine about the budget deficit.)

Deficit or not, it is necessary to restrain the demand for funds from GFIs to make them more efficient and effective. That is, what is required in any meaningful reform of public finance is a hardening of budget constraints. In addition, the GFIs' roles need to be clarified and their operations limited to those in which public involvement is necessary, and their subsidies planned and limited within a framework with more comprehensive control of expenditures than now exists.

3.2 Creating a New Corporate Structure

Fiscal discipline of GFIs (and other SPCs) is necessary. To establish discipline requires ending the government's unlimited liability. A step in achieving this is a change in the organizational form of GFIs as well as other SPCs into "state-owned limited companies".³ Limited needs to mean just that: as the primary (usually, sole) shareholder, the government will not cover deficits ex post. The fiscal burden of the government needs to be clarified in advance, rather than remaining in its current ambiguous form. This is an important part of hardening the budget constraint.

"State-owned limited company" can function well. Existing examples are the regional spin-offs of the former Japan National Railways (JNR): JR Hokkaido, JR Shikoku, and JR Kyushu. These are "state-owned limited companies." Although they make not enough profits and are still not sure when their shares will be listed, they have never received subsidies from the government since 1987, when they were

³ It is usually called as a Special Firm (*Tokushu Kaisha*) in Japan.

“privatized” in Japanese. The government does not usually spend subsidies to such “privatized” firms. They are operated with much more consciousness of independence and self-support than in the age of JNR, which suffered massive losses and used to be covered them by the government. If the government imposed a hard budget constraint, GFIs would be more aggressive about collecting on loans, and more careful about making new ones, because they would know the government was not going to cover the losses.

3.3 Greater Transparency

Greater transparency and clarity in the activities of FILP agencies are important in their own right, and are essential element in hardening budget constraints. Thus, each fiscal year the government should publicly announce the details of its capital contributions to FILP agencies and other recipients. This includes disclosing the amount of any new capital contributions, and the cumulative amount of contributed capital, for each recipient. The level of disclosure phased in after the 2001 FILP reforms, which includes computing "policy costs" for each FILP recipient, are a first step toward this, do not go far enough.

Moreover, every fiscal year, the government would make a close examination of whether the GFI had a deficit, and whether payments to the national treasury can reasonably be made. The government would then take improving measures as the need arose.

As to making payments to the national treasury, the point is to keep the GFI from retaining profits to expand, or retaining cash flow to maintain, its activities beyond a level consistent with overall government budget priorities and fiscal constraints. Even with the 2001 reforms, any profits that might be recorded in the administrative costs statements the corporations are required to prepare using accounting principles accepted by private enterprises, or financial statements prepared under the Accounting Principles for Independent Administrative Agencies, can still be effectively hidden. This is done simply by setting off the profits under the principle of equivalence.

3.4 Using the Grant Element as an Indicator

In terms of medium- and long-term reform, it is necessary to ensure the principle that government contributions of capital are made according to standards applied consistently across all recipients, and is not simply done on an ad hoc basis to fill ex post deficits. When GFIs were created, there was an expectation that there would be a subsidy element. However, the level and distribution of subsidies is not being managed by the government to achieve its overall policies, or even to achieve the specific goals of each GFI in a cost-effective way. To ensure these finally are done, it is first necessary to establish a set of objective standards.

With objective standards, consistently applied across all GFI, the subsidy element will be explicit and a clear constraint will be imposed on the GFIs. The subsidy will be an explicit grant — hence it can be called the Grant Element (GE). The GE will be an indicator showing the degree of easing of terms and conditions of loans, which often are used in the context of the Official Development Assistance (ODA) budget.⁴

The Grant Element is defined as follows.

⁴ ODA is defined by the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD), as those flows to developing countries which are:

i. provided by official agencies, including state and local governments, or by their executing agencies; and
ii. each transaction of which:

a) is administered with the promotion of the economic development and welfare of developing countries as its main objective; and

b) is concessional in character and conveys the Grant Element of at least 25% (calculated at a discount rate of 10 % defined by DAC; however, the rate does not always have to be 10% under the situation described in this paper).

$$GE = \left(1 - \frac{R/A}{D}\right) \left(1 - \frac{\frac{1}{(1+D)^{A \times N}} - \frac{1}{(1+D)^{A \times M}}}{D(A \times M - A \times N)}\right)$$

Where GE is the Grant Element stated as a percentage of the loan, R is the annual interest rate of the loan, A is number of payments, M is maturity (the period expressed in years from when the loan is made to final repayment of principal), G is a grace period, N=G-1/A, I is a discount rate (DAC assumes it is 10% per annum), and $D=(1+I)^{1/A}-1$ is discount rate per repayment interval. (In the conversion formula used by DAC, GE is calculated by deeming a grace period equal to one less than the number of intervals from the date the loan is made to the date of the first payment of principal.)

The more favorable the conditions of a loan for the borrower, such as through a low interest rate or longer term than would be available in the private lending market, the greater GE. For example, in the case of a pure grant (no repayment expected), GE is 100%, and for a loan with a market rate of interest and other conditions, GE is 0%.

There is, of course, no obvious standard as to what the GE should be in each case. However, making loans through GFIs at a below-market rate is equivalent to granting a subsidy. A subsidy is redistribution of income, and as such is a policy issue that should be left in the hands of politicians — that is, it should be settled in the Diet. It is important to have an objective basis for such decisions, and the GE of a loan provides that. In making the subsidies transparent, GE also fills the need for policy-maker accountability to the public.

3.5 Funding

The current sources of funds for FILP agencies are a mix of capital (contributed almost entirely by the government) and borrowing. The latter includes government-guaranteed bonds and FILP bonds. As expressed in the Framework of Fundamental Reform, each agency should "make utmost effort" to issue its own bonds in the market (Ministry of Finance 2001, p 28). These are called FILP agency bonds. Government guarantees are available if the market is otherwise unreceptive, and FILP itself can issue bonds and distribute the proceeds to the agencies.

Most GFIs have issued both guaranteed and agency bonds (which are not guaranteed by the government). At present, private financial institutions buying GFI debt act as though the unguaranteed debt is in fact guaranteed. That is, they assume an implicit guarantee by the government to see that interest is paid and the bonds are redeemed at maturity. There thus is the problem that FILP agency bonds do not function effectively as indicators of the market's perception of the creditworthiness of the issuer.

A second problem is that the shift to FILP agency bonds has been slow. It has been easier to continue old practices, even within the new structural framework. To overcome this inertia, the government must decide a schedule for full phasing out of direct loans, and then for elimination of government-guaranteed bonds. Once decided, there also must be a credible commitment to the schedule.

3.6 Comparison among policy tools

The importance of comparison of administrative costs among alternative policy tools: loan, guarantee, subsidy, and tax reduction. Loan and guarantee have been mainly used by GFIs. However, the choice of policy tools may not be the best. For example, screening and monitoring costs are needed for loan and guarantee. Costs with examining for applications are needed for subsidy. Also distortion with taxes to keep up with these costs can be occurred for loan, guarantee, and subsidy. Costs with performing tax services are needed for tax reduction. The Japanese ministries have never compared among their costs.

In order to obtain the same result, the policy toll with the lowest cost should be selected. Loans or guarantees through GFIs should be implemented when their cost is the lowest. Gordon (2003) shows that state-owned banks may be justified when tax distortion with higher tax rate is relatively higher.

3.7 Bankruptcy

According to Yamamoto (2002), the legislation concerning incorporation of GFIs as well as other SPCs indicates provision for their dissolution is dealt with in other legislation that will be passed later as separate acts. However, that “other legislation” has never been established. Therefore, at present, strictly speaking, provisions for bankruptcy proceedings of GFIs are not specified in statute law.

This situation needs to be remedied. As a part of hard budgeting, there needs to be a clear procedure for GFIs to be deemed bankrupt. This means establishing both a definition of what “bankruptcy” is as it relates to a GFI as well as a SPC, and a procedure for dealing with the bankruptcy. Otherwise, the government could find itself in a situation of continuing to grant subsidies to cover deficits.

4 Reforming GFI

This section offers workable plans for the reform of individual GFIs in ways that address the problems common to all GFIs just presented, as well as more institution-specific issues. The Japan Finance Corporation for Municipal Enterprises is dealt with in a separate section in connection with an analysis of the financing arrangements between the central and local governments and how they should be changed.

4.1 Postal Savings System (PSS)

What PSS should be has been dealt with extensively (for example: Okina 2000, Inukai et al. 2001, Cargill and Yoshino 2003, Japanese Bankers Association 2004). Taking into account this research and the current status of PSS, I propose making Postal Savings a narrow bank, owned by the government, which invests its deposits in central and local government bonds. This proposal is almost the same as Hoshi (2003).

Let us first discuss the environment surrounding PSS. Hoshi and Kashyap (2000) explain the current situation of over-banking in the financial intermediary industry in Japan as follows. Corporate finance has been gradually liberalized. However, diversification of assets held by households and deregulation so that banks could adapt (develop into universal banks) lagged significantly behind during the 1980s, so an imbalanced liberalization ensued. Large banks lost their traditional customers, which were large enterprises, but the volume of their deposits was not reduced. Banks thus were forced to develop new customers. They increased loans to SMEs and real estate business. Thus, the bursting of the asset bubble in the early 1990s had a devastating impact on bank balance sheets.

Hoshi and Kashyap (2000 and in their chapter in this book) further insist that major enterprises will continue to move away from borrowing from banks, and that SMEs also will to some extent raise funds in the capital market. In other words the traditional banking business will be forced to shrink. They foresee the banking business shrinking to 30% to 50% of its current size.

Meanwhile, bad loan disposal is still not completed. Many banks simply lack the capital to offset bad-loan losses. Fukao (2003) examined the data and calculated that if the 15 major banks properly provisioned for nonperforming loans, did not count useless deferred tax credits as capital, and unwound the double-gearing with insurance companies, their net Tier 1 capital ratio as of the end of September 2002 is a mere 0.86%.

Why do banks have negligible net worth? Establishment of deposit insurance is an element. Without deposit insurance, runs on banks having negative net worth ought to weed them out. But, with insurance, depositors have not caused to stage a run. Phasing out the system has been deferred several times, with April 2005 the current date. This despite the fact the existence of deposit insurance gives banks with inadequate capital an incentive to take more risks.

In this environment, it is desirable for the government to protect Postal Savings by converting it to a narrow bank with assets limited to central and local government bonds. The PSS simply does not have the capability to do credit analysis, and there is no reason to believe it can be readily transformed from an open

conduit of funds to a sophisticated spigot.

Hoshi (2003) proposes abolishing deposit insurance and making all deposits of private financial institutions risky assets. In this way, the issue of moral hazard at private financial institutions is settled because the absence of insurance disciplines institutions through the possibility of a run by depositors. If it is unnecessary for banks to pay deposit insurance premiums, they can pay higher deposit interest rates.

On the other hand, as far as the fund management is concerned, PSS has already been investing a large part of its funds in government bonds. Particularly among existing financial products of PSS, fixed-amount postal savings (*Teigaku Chokin*) are similar in nature to that of government bonds for individuals. Therefore, even if PSS were to be shifted to a new system, it would hardly be necessary to drastically change its functions at present when the outstanding balance of government bonds already issued is enormous. If so, there would be little reason to painstakingly privatize it entirely, since it would be sufficient to turn it into an institution that specializes in handling government bonds.

A range of options for depositors results. Thus, Postal Savings will offer low risk but low return, while private financial institutions will offer high risk and high return.

A reformed PSS should not be able to hold FILP agency bonds or even government-guaranteed bonds. Cut-off from this source of funds, FILP agencies will be exposed to greater market discipline. Doi and Hoshi (2003, p 62-64) notes that the market does differentiate among FILP agency bonds. Agencies that find it difficult to raise funds by issuing bonds will have to reform, or they will be allowed to collapse. (This requires legislation to deal with agency bankruptcy.)

It may seem that PSS can be privatized. If PSS were to be privatized entirely, it would face competition with existing private financial institutions. Naturally, it would be desirable for PSS to be fully privatized, if it could be expected that Japan's financial system would take a more favorable turn through such competition. Under the current circumstances in Japan, there are, however, a growing number of problems facing private financial institutions, which must be resolved before privatizing PSS. As analyzed by Hoshi and Kashyap (2000 and in their chapter in this book), they are problems of over-banking and undercapitalized banks. While existing private financial institutions are already facing the over-banking problem, this problem could, on the contrary, even be exacerbated, rather than resolved, if PSS were, in addition, to be turned into a private financial institution. Until the over-banking problem is settled at least, PSS should not be completely privatized. It would sooner be more effective to confine it to a small area of the financial market, while keeping it a state-operated corporation, after turning it into a stock company with its due discipline and limiting its scope of operation to that of a narrow bank, allowed to own its entire financial assets only in the form of government bonds and local bonds.

4.2 Government Housing Loan Corporation (GHLC)

Under the "Plan for reorganization and unification of Special Public Corporations", GHLC is to be abolished within five years (that is, by 2006). More specifically, the plan states: GHLC's loan business is to shrink gradually from fiscal 2002 onward; interest subsidies should not be granted in principle; how the business is handled should be decided at the time of establishing a new, independent administrative agency, taking into account whether private financial institutions are smoothly taking over; and the new agency should assume the existing receivables of GHLC. At present the loan business is being rearranged and related agencies are being reorganized in line with this plan. However, shrinkage of new loans by GHLC has not progressed as much as expected.

Since fiscal 2001, GHLC has issued FILP agency bonds without government guarantee in the form of Mortgaged Backed Securities (MBS). However, these schemes do not aggressively enhance securitization of existing GHLC loans.

There are problems with how GHLC makes loans. Seko (1998) finds that GHLC decides the amount of a loan on the basis of floor area only. This means that the smaller the residence, the lower the interest rate. Therefore, there is a tendency to reduce floor area. Although this is partly offset by improving quality, Seko estimated the welfare loss caused by the distortion of resource distribution at 14% of the overall amount of GHLC loans.

As context for the specifics of how GHLC should be reformed, I have investigated the relationship between development of securitization and the role of GFIs. GFIs have shouldered the responsibility of supplying funds at a long-term fixed interest rate, which it was difficult for private financial institutions to shoulder. For example, although the housing-finance market needs funds at a long-term fixed interest rate, because private financial institutions have been able to raise only short-term funds, there has been a place for GFIs involvement.

Interest rate risk, and the related advanced-redemption risk, is borne by the GFIs, and thus in effect transferred widely to the public through taxation. If people can more or less equally bear such risk, an improvement in efficiency in fund allocation can be expected. However, if the capacity to bear these risks is significantly different among people, a system allowing voluntary disproportional risk-bearing is superior. Such a system is securitization. At present there is a strong indication that the capacity of bearing risk is significantly different among people tendency in Japan, as mentioned by Mitsui (2004). Accordingly, it is considered desirable from an efficiency standpoint to mitigate the burden that GFIs take on in intermediating loans by promoting securitization in the housing-finance market.

When the market for securitized mortgages is still undeveloped, government intervention to promote it is appropriate. This might even extend to granting government guarantees — although only after evaluating each specific case, rather than a blanket guarantee.

When the securitization market has been put in good order, continued public intervention at the same level as at the initial stage is an obstruction to the activities of private financial institutions. Moreover, even if the extent of public intervention is mitigated after the fact, because private financial institutions consider the possibility of public intervention continuing, their positively tackling securitization is obstructed. Accordingly, it is important to show clearly in advance the schedule for phasing out public intervention — presumably through proclaiming easily identified mileposts — in order that private financial institutions fully fulfill their function in the securitization market.

With this context, the steps to reforming the GHLC can be outlined. First, securitization of the existing finance receivables of GHLC should be promoted. Next, at the initial stage of securitization, the successor to GHLC stops direct loans but does provide credit guarantees for housing loans. The successor to the GHLC is abolished when two things have happened: securitization of existing GHLC receivables is completed, and the securitization market is deemed mature. The latter has occurred when the market readily accepts the absence of public guarantees and (as is happening already) private financial institutions can hedge the risk involved in term-mismatch, and the risk from a mismatch between variable- and fixed-rate interest. Finally all other GFIs pull completely out of the housing loan market.

4.3 GFIs for Small and Medium Enterprises

Three GFIs serve SMEs. They are Japan Finance Corporation for Small Business (JFS), National Life Finance Corporation (NLFC), and the Credit Guarantee Division of Japan Small and Medium Enterprise Corporation (JASMEC). Public funds for SMEs also come as direct subsidies and as direct finance from these GFIs.

Recently, loan outstandings to SMEs are decreasing, but share of GFIs for SMEs to total loans from financial institutions to SMEs are increasing.⁵ The total outstanding was about 350 trillion yen in the middle of 1990s, and then it drops to about 260 trillion yen. The share of GFIs was in the 8% range in the middle of 1990s, and then it rises up to 10.5% at the end of fiscal 2003.

The governments are involved in credit guarantee to SMEs in Japan. JASMC took over the credit insurance business operated until July 2001 by Small Business Credit Insurance Corporation (SBCIC), the loan business of Credit Guarantee Association, and a machinery credit insurance business. SBCIC had been a government-affiliated agency subject to Diet budget resolutions. JASMEC's credit insurance operations shifted to JFS in July 2004. The rest of JASMEC's activities became part of Independent Administrative Agency for Structural Improvement of Small and Medium Enterprises. Accordingly, JASMEC is dealt with

⁵ Total loans are those by all financial institutions, public and private, excluding from local governments.

as a part of JFS in this paper. The structure of the credit guarantee system can be outlined as follows. There are 52 credit-guarantee associations. They basically guarantee 100% of loans by private financial institutions that meet certain requirements. JASMEC underwrites, in a form of insurance, 70% to 80% of the liability for the guarantee. The fiscal burden involved includes central-government capital contributions to JASMEC and local-government subsidies. The central government also indirectly provides funds, including making good deficits, with subsidies to local governments and the Credit Guarantee Association.

A study of the overall fiscal burden, including local governments, reveals that during the 1990s economic malaise the debt burden of the government increased from 88.4 billion yen in fiscal 1992 to 579.2 billion yen in fiscal 2001. This reflects an increase in the amounts guaranteed, and a decline in the collection ratio of receivables being guaranteed. It also was affected by implementation of the special guarantee plan. The debt burden per a unit amount of liability for guarantee went from 0.39% to 1.49% of the amount guaranteed.

Takezawa, Matsuura, and Hori (2004) investigate the effectiveness of measures to facilitate funding for SMEs, especially credit guarantees and government-institution lending, in the late 1990s. They find Japanese SMEs are excessively indebted in terms of ability to repay borrowings from earnings. Their results suggest that fund-supply facilitation policies did nothing but delay the timing of small business bankruptcies, and added high social costs.

SME problems cannot be dissolved by temporary credits. I argue that what is really needed are measures to reorganize heavily indebted firms, not measures to promote unprofitable lending.

Based on all this, a financial structure for SMEs centered on indirect financing cannot be changed immediately without a recovery by the private banks. Under the current situation, a GFI role for SMEs remains, but is limited. To continue loans to SMEs by GFIs, GFIs should become state-owned limited company, as described earlier. Moreover, liquidation of their loans should be promoted. As private financial institutions settle their non-performing loans problem, any role for GFIs diminishes. To ensure this, sunset provisions should be included on new loans by GFIs.

Moreover, it is necessary to review the share of roles to be played by GFIs that controlled by the central government and local governments. Not only GFIs as mentioned above, but also local governments have been involved in the loans to SMEs. In other words, local governments have granted loans at low interest directly to SMEs. Loans from local governments amount about 10 trillion yen and make up 13% of total loans from all sectors at the end of fiscal 2003.

Recently, in particular, the announcement that the Tokyo Metropolitan Government would establish a new financial institution, called "New Bank Tokyo" to provide loans or credit guarantee to SMEs has attracted much attention. As the reasons for the Tokyo Metropolitan Government to establish a new bank, it cites that private financial institutions are often reluctant to lend money or GFIs make insufficient loans to SMEs located within the greater Tokyo Metropolis. However, is it essential for the Tokyo Metropolitan Government to be engaged in such a business? The reasons cited for the new establishment are applied not only to Tokyo, but also to other regions where similar situations can be observed. From such a perspective, it is considered that finance should, in many cases, be provided at the national level rather than at the level of local governments, if public involvement is required under such a situation of corporate finance. In addition, there is no robust evidence that the ability of a local government to conduct a loan business is particularly better than that of a GFI controlled by the central government or a private financial institution.

As we have seen, public involvement in finance for SMEs in Japan is actually being conducted, as led by political demand, without clearly defining the roles to be played by the central and local governments. Such a situation has to be improved. In principle, if the same benefit can be obtained from public involvement in any region, it is desirable for an institution of the central government rather than the regional government to provide it. In particular, when it is preferable to share the risk at the national level, a central government institution should bear such risk. On the other hand, when industrial structure and so forth are different among regions, and, therefore, the matter should be dealt with individually at each region, it is desirable to assign the business to a local government.

From that perspective, the financial business of not only GFIs, but also local governments should be scaled down or abolished, as required. If there is any section within such a business which recognizes the

need for public involvement and which can be conducted at the national level, the business of that section may be taken over by GFIs. Nevertheless, in view of the current status of the local governments' financial business, the majority of such business can be handled by regional financial institutions such as regional banks, Shinkin Banks, and Credit Cooperatives. As a consequence, local governments should make efforts to actively transfer credited loans to regional financial institutions and so forth to place such loans in their hands as far as possible.

4.4 Development Bank of Japan (DBJ)

DBJ was created in 1999 through a merger of the former Japan Development Bank and the former Hokkaido-Tohoku Development Finance Public Corporation. DBJ's business is centered on 3 objectives; namely the structural reform / creation of economic vitality (promotion of improvement in social capital / improvement in intellectual infrastructure), the creation of self-reliant regions (improvement of regional social infrastructure, creation of regional vitality and regional collaboration / support to regional self-reliance) and the creation of an affluent lifestyle (environmental / disaster prevention / welfare measures, traffic / distribution network and information / telecommunications network). DBJ invests in and provides support to DIP finance and the business rehabilitation fund in the business of creating economic vitality. It is engaged in business cooperation with more than 60 private financial institutions in the business of creating self-reliant regions. In Japanese, the name DBJ is literally translated as "the policy-based investment bank", showing that it is precisely an investment bank-oriented institution.

Indeed, under the economic conditions of recent years, the need for such types of business is high. However, many of the above-mentioned areas of business can readily be covered also by private investment banks. Likewise, many of them could probably be taken care of in the private sector, when private financial institutions grow into sounder entities. This is particularly true in the areas of business such as support to DIP finance, the business rehabilitation fund and business with private financial institutions with which business cooperation is being conducted.

Iwamoto (2004) finds that the current activities of DBJ are justified as supplementary activities of private financial institutions because private institutions cannot supply long-term funds. Further, private institutions are neither taking business risk nor making use of the most advanced financial technology. This can reasonably be considered a transitory problem, in part related to their holding huge amounts of bad loans, which makes them cautious in taking risk. When the private institutions have recovered, and improved the soundness of their management, the importance of the supplementary function of GFIs, including DBJ, will be reduced, and their role terminated.

Simply shutting down the DBJ is probably not practical, however. Therefore, if possible, it can be privatized. A step toward this is reorganizing it into a state-owned limited company that is taxable. Its activities would then be subject to the market. It is necessary to ensure fair competition between (former) GFIs and private financial institutions.

4.5 Japan Bank for International Corporation (JBIC)

JBIC has two distinct operations: International Financial Operations (IFO) and Overseas Economic Cooperation Operations (OEEO). In the beginning, the former Export-Import Bank of Japan and the former Overseas Economic Cooperation Fund merged into JBIC in 1999, IFO and OEEO succeeding the former and the latter, respectively. IFO promotes Japanese trade, as well as Japanese economic activities overseas, and contributes to the stability of the international financial order. OEEO provides ODA. These two operations are strictly separated in terms of financial sources and accounts.

IFO includes export loans, import loans, overseas investment loans, untied loans, and equity participation in overseas projects of Japanese corporations. In the face of the 1997-98 Asian currency crisis, JBIC extended untied loans to other Asian countries in order to stabilize the international financial order, and at the same time vigorously supported Japanese affiliates in the region, which faced difficulties from deteriorating business conditions and a credit squeeze. One important source of funds is FILP. Others

include bond issues in international capital markets and retained earnings (net interest income) from past loans.

OECO is the cornerstone of Japanese ODA policy, accounting for about 40% of Japan's ODA. The basic tenet of its operations is provision of concessionary long-term, low-interest funds for self-help efforts in developing countries, including social infrastructure development and economic stabilization. More specifically, it provides ODA loans in various forms attuned to local needs, private-sector investment finance support, and development-related research. ODA loans are a key form of financial assistance that are indispensable in putting in place socioeconomic infrastructure for the economic development of developing countries. The sources OECO funds are grants from the general account of the government, and borrowing from FILP and others.

With regard to the business of JBIC, the following policies were presented in the "Plan for reorganization and unification of Special Public Corporations." In IFO, it was decided that outstanding loans are to be reduced by promoting liquidation (including securitization) of credited loans and so forth. Among them, in the export finance business, it was decided to actively utilize the guarantee function and discontinue business related to developed countries, while in the import finance business, business not related to natural resources is to be discontinued, the guarantee system is to be utilized for a part of the business that must be continued, the guarantee function is to be actively utilized for general investment and the finance business, business related to developed countries is, in principle, to be eliminated to specialize in high risk business, and the refinance business is to be discontinued. In OECO, overseas investment and the loan business are to be eliminated, the investment and loan business is to be conducted in the fiscal 2002 onward only for those projects approved before the end of the fiscal 2001 or those of a continuous nature, and the yen credit business is to be reviewed in line with the review of the ODA with the aim of reducing business scale. Recently, the review of business is proceeding in such a direction.

Official development assistance must be operated by a government organization by definition, so the OECO part of JBIC cannot be privatized. Nonetheless, it is necessary to reorganize JBIC into a state-owned limited company in order to reduce the inefficiency of ODA. In International Financial Operations, JBIC should promote the liquidation of its loans and decrease outstanding loans, as mentioned in the "Plan for reorganization and unification of Special Public Corporations" advanced by the Koizumi cabinet. However, the cabinet has not committed to a schedule for the plan. The government should commit to a deadline for liquidation and reduction of outstanding loans. It is also useful to set sunset provisions on new business project operated by JBIC. Yet, for the investment business in the international financing business, it is necessary to clarify the intention so that it will not be degraded into interest-free loans and ex-post subsidies.

4.6 Agriculture, Forestry and Fisheries Finance Corporation (AFC)

AFC supplies enterprises in the agriculture, forestry, fishery, and food industries with the funds necessary to ensure maintenance and promotion of production in these industries, and to ensure a stable supply of food. It is difficult for the Central Corporative Bank for Agriculture and Forestry and other private institutions to supply long-term low-interest credit in this area.

Outstanding AFC loans were around 3.6 trillion yen at the end of March 2003. By industry, agriculture was 53%, forestry 27%, fisheries 3%, and food industry 17%. By type of borrower, 12.7% of overall loans were to individuals; 25.5% to corporations; 17.2% to land improvement districts; 24.7% to local governments and Forestry Public Corporation; 16.7% cooperatives (agricultural, forestry, and fishery); and 3.1% to others.⁶

⁶ Land improvement districts are corporations established by more than 15 farmers under the Land Improvement Law for the purpose of developing agricultural land, subject to approval of prefectural governors. The district has the authority to collect compulsorily dues. Forestry Public Corporation is a public utility corporation established by capital contributions from the prefectures that promotes reforestation and afforestation, including tree planting by owners of mountainland. AFC collects compensation for losses incurred by prefectures for loans of AFC to Forestry Public Corporation.

Because losses accrue as a matter of policy, AFC is subsidized by the general account to cover its deficit. In addition, local governments and various associations, including agricultural cooperatives, are subsidized or given tax concession through the general account and special accounts of the government.

Finance to these primary-sector industries is as follows. Outstanding loans to these primary-sector industries amounted to 25,705.8 billion yen at the end of March 2002. AFC accounted for 12.4%; agricultural cooperatives, 66.2%; prefectural Credit Federation of Agricultural Cooperatives, 5.0%; Central Agriculture and Forestry Finance Corporation, 5.0%; fishery cooperatives, 0.6%; prefectural Credit Federation of Fishery Cooperatives, 3.0%; banks and credit associations, 7.3%; and others 0.5%.

The various cooperatives are *private* organizations at the level of a municipality. As far as credit activities are concerned, for agriculture they are treated at the prefectural level as members of Prefectural Credit Federation of Agricultural Cooperatives, and at the national level they are controlled by Central Cooperative Bank for Agriculture and Forestry. Fishery cooperatives are members of Federal Credit Federation of Fishery Cooperatives at the level of prefectures, and at the national level are controlled by Central Cooperative Bank for Agriculture and Forestry.

Until 2000, joint-stock companies could not make capital contributions to an agricultural production corporation. There were limited-liability companies, agricultural cooperative corporations, general (unlimited) partnerships, and limited partnerships. This meant funds could not be raised by issuing stock. Restrictions remain on joint-stock company involvement in these industries, and it cannot be said that a lot of funds are supplied to them through share issue. Small-scale farming continues to be common in Japan, and much of it is inefficient. Even with large subsidies, rice farming on tracts under 2 hectares was unlikely to break even in 2000 according to a government study (Ministry of Agriculture, Forestry, and Fisheries 2002). More disturbing, at all farm sizes, break-even was less likely in 2000 than it had been in 1995 (when even the smallest farms as a group had small profits).

As mentioned previously, it is 40% of outstanding loans of AFC that AFC finances directly to farmers, foresters, fishers, and business corporations. AFC provides the majority of funds to various associations including the local governments and agricultural cooperatives.

Because of regional differences in what is appropriate to lend for, AFC obtains opinions on, or approval of, potential borrower's business plans from prefectural governors or municipalities. This means local governments are deeply involved in the lending process. In view of this, it can be said that the loan business that has been done by AFC can be carried on through the prefectures, agricultural cooperatives, or the Central Cooperative Bank for Agriculture and Forestry.

The central government has been directly subsidizing from the general account a program to train the next generation of farmers and strengthen the base of agricultural management. This money flows first into the Special Account for Strengthening the Bases of Agricultural Management, which loans the money on to AFC and special accounts of local governments, who lend to the farmers with lower interest rate. Consequently the central government spends interest subsidy.

On examination, no great reason is found for GFIs to finance the primary sector. Accordingly, AFC operations that do not need to be subsidized by the government should be assigned to the Central Cooperative Bank for Agriculture and Forestry or agricultural cooperatives. AFC operations that require subsidy should be transferred to local governments, and the central government will provide subsidies. In both cases, this includes existing outstanding receivables. After that, AFC itself should be abolished.

This reform necessitates a review of the extent to which the government should grant subsidies, and how the role should be shared between the central government and local government. In any case, it is extremely important to cope with the problems which Japan's primary sector is facing, such as the inefficiency of small scale, and to reduce subsidies as much as possible.

4.7 Okinawa Development Finance Corporation (ODFC)

ODFC is an agency that carries on, in a unified and comprehensive way in Okinawa, operations carried on by other agencies in the rest of the country, as shown in Table 2. That is, its activities are the same as the combined activities of the other GFI in other prefectures. This arrangement exists because Okinawa is a

special case: it is the poorest prefecture and, because of geography, has never been as fully integrated into the nation as the four main islands. In addition, it remained under Occupation much longer, reverting only in 1972, and continues to be a major base for United States forces.

ODFC also independently finances enterprises in order to support implementation of policies provided for in the Special Measures Act for Promoting Development of Okinawa. Some loans are made at a below-market rate that is even lower than in other prefectures. Some loans are subsidized from the general account. ODFC accounted for 33.5% of total outstanding loans in Okinawa at the end of 2002. (Total loans are those by all financial institutions, public and private.)

From a practical standpoint, although it independently makes loans, ODFC can be said to be the collective regional office of the other GFIs. Therefore it is not necessary to organize ODFC as one independent financial corporation. Rather, ODFC should be treated in the same manner as each financial institution elsewhere: activities that should continue to be performed by GFI should be continued as the Okinawa branch of the appropriate institution, and those that should be abolished should assign their receivables and promote securitization in the same manner as elsewhere. In short, it is desirable to break ODFC up.

5 Inter-Government Finance

This section looks at the financial arrangements between central and local governments. Proposals regarding Japan Finance Corporation for Municipal Enterprises (JFM) are then presented.

5.1 Some Reforms and Changes

The Koizumi cabinet has undertaken the "Trinity Reform Package" to address the fiscal relationship among levels of government. In this context, "trinity" means the decentralization reform process that involves three factors: local tax, Local Allocation Tax (LAT) Grant and National Government Disbursement.

As part of this, there has been a reduction in the LAT Grants applied to payment of interest and principal of local bonds.⁷ Since the LAT grant also covers local bond repayment expenditure, the system itself undermines the sound issuance of local bonds. SFN also includes repayment expenditure for depopulated area development bonds, revenue resource support bonds, and revenue decrease compensation bonds. This suggests that local governments can raise funds for applicable projects even without sufficient repayment ability. If they do so, they enjoy the benefits of these public projects and depend on future national tax revenue, including tax revenue collected in other communities (through the LAT Grant scheme) for debt repayment, rather than repaying the bonds using their own revenues. In addition, if they focus on these applicable projects, they will see greater SFN and receive more LAT Grant.

Therefore Doi (2004a) insists that there is a missing link in the "Trinity Reform Package". This is

⁷ LAT grant is a transfer scheme in which the central government allocates a certain percentage of national tax revenue to local governments without specifying the purpose of expenditure. A total of 94% of the total amount of LAT Grants determined according to the macro allocation rule is appropriated for ordinary LAT Grants, and 6% is appropriated for special LAT Grants (to be granted according to special circumstances such as in disaster). The rule determines how much ordinary LAT Grants should be allocated to which local governments. Upon allocating ordinary LAT Grants, the amount of the grants is calculated for every local government based on the difference between the standard financial need (SFN) and the standard financial revenue (SFR). Ordinary LAT grants are granted to only local governments whose SFR is less than their SFN. SFR is the amount of tax collectable in the usual situation calculated by Ministry of Public Management, Home Affairs, Posts and Telecommunications (MPMHAPT) according to a certain formula for every local government. SFN is the amount of expenses necessary for all local governments to carry out independently administrative work including *debt service* at an appropriate and rational level and that MPMHAPT calculates.

reform of local bond, which is one of major revenue source for local governments. In particular, system of local bond has a very close relationship with LAT system. LAT Grant implicitly covers debt service expenditure at the local level. Hence, the system itself undermines the sound issuance of local bonds. Moreover current local bond system does not result in awareness as debtors.

To solve this problem, it is necessary to enhance local bond reforms. The central government is deeply involved not only in local taxes, LAT grant and National Government Disbursement but in local bonds. In this sense, neglecting local bond problems in the reform package will result in unsuccessful decentralization. In other words, decentralization reform should involve four factors including local bonds.

5.2 Use of FILP Funds

When issuing local bonds, local governments in Japan need permission from the Minister of Public Management, Home Affairs, Posts and Telecommunications (for prefectures) or the prefectural governor (for municipalities). The permission process is more than mere permission because MPMHAPT grants permission for local bond issuance and, at the same time, determines bond buyers (creditors). About 60% of the total local bonds goes to FILP funds including funds of the Japan Finance Corporation for Municipal Enterprises, 30% goes to private financial institutions, and the remaining portion of local bonds is offered publicly on the market. Before granting permission, MOHA consults other government departments and determines who will buy the local bonds. After this process, MPMHAPT announces the Local Bond Plan.

In connection with the 2001 FILP reforms, the cabinet decided to raise FILP funds, including funds for loans to local governments, by issuing FILP bonds with the same face value as construction bonds and deficit-covering bonds in the general account. In the bond market, the increase in government bonds is identified with increases in FILP bonds. The implication is that FILP is borrowing to buy local government bonds.

Because of the 2001 FILP reform, funds no longer automatically flow into the general account under the deposit obligations of PSS and public pension funds. The government strongly desires that local government borrow FILP funds with lower interest rate and longer maturity than private funds. However, outstanding central and local government bonds have already reached historic levels. In such circumstances, it should not be easily permitted to increase government bond issue for the purpose of underwriting local government bonds under FILP.

FILP purchased around 60% of newly issued local bonds until fiscal 2000. This fell somewhat after the 2001 FILP reform, and has been reduced to around 50% for fiscal 2004 under the Local Bond Plan. Fiscal 2004 loans to local governments by FILP are to be reduced by 27% compared to fiscal 2003.

There is a tendency for FILP funds to be allocated relatively more to buying bonds of prefectures in rural areas than bonds of more urban prefectures. As a result, rural prefectures do not issue bonds in the market or borrow much from private financial institutions: they can obtain a lower interest rate borrowing from FILP. This means an implicit interest subsidy is being granted rural prefectures, and that there is income re-distribution toward them through allocation of FILP funds (Doi 2002).

If the administrative cost regarding FILP that issues bonds to obtain funds to lend to local governments is less than directly subsidizing local borrowing, it is justified in terms of cost. However, the extent to which local government has been subsidized in this way has not been examined closely in deciding policy. If financing at a below-market rate by the government is justified in terms of cost, after showing clearly how much Grant Element is involved, it is desirable to decide a policy clearly showing the income redistribution effect.

Another important problem in government finance is that, given how local government bonds are handled, it is difficult for the interest rate to become a signal of the financial condition of the local government.

5.3 Local Government Solvency

If a local government has been unable to curtail expenditure or ensure revenue in any manner, funds available

for payments could fall short in the ordinary account. Under Japan's local-government fiscal system, this situation takes the form of a net balance deficit. The net balance is the difference between the fiscal year's expenditures and revenue, after adjusting for items that should be carried over to the next fiscal year. This means it differs from the actual cash available for payments. For that reason, when the size of a year-end net balance deficit is small, payments for the year can nonetheless be completed by applying revenue properly attributable to the next fiscal year, but already received. In such a case, the local government is technically insolvent but, because it is not illiquid, it can continue to make payments. The time it takes to put receipts and expenditures in order and close the books after the fiscal year ends facilitates this.

However, when the scale of deficits is large, payment fall into arrears unless credit (liquidity) enough to make good such deficits is provided. Under the system of Local Bonds Permits, local governments cannot issue deficit-covering bonds. In addition, local governments have to obtain advance permission to issue any bonds, which takes time. As a result, except to the extent there is unused authorization for bond issue, a net deficit cannot be made up by issuing local bonds.

Where the deficit is considerable, the problem is usually dealt with by applying provisions of the Special Measures Law for Promoting Local Fiscal Reconstruction. But this law provides for only limited fiscal support, such as limiting the issue of local bonds or subsidizing interest on temporary borrowings with special LAT Grant.

5.4 Government Guarantees

It is important to note that the central government does not guarantee local bonds as a matter of an explicit legal requirement to accept liability. Rather, the government simply contends that it guarantees the cash flow of local governments. However, the cash flow from the central government to local governments is not entirely secure because budgets are drawn up for just a single fiscal year. Under the Trinity Reform, the cash flows of some local governments will not be subsidized by the central government to the extent they have been.

A similar situation exists as regards local governments on the one hand and the local public corporations and joint public-private ventures to which they have made capital contributions.

In particular, the government (the Financial Service Agency) issued a manual for use in the finance examinations of local governments and public corporations in July 1999. The manual strictly states that a corporation to which a local government has made a capital contribution is to be treated in the same manner as a general borrower, without specially treatment. This means there is no implicit guarantee of local public corporation debt. In April 2000 the (former) Ministry of Construction and (former) Ministry of Home Affairs jointly issued a notification that local governments give debt guarantees against new long-term borrowings of a corporation to which the local government had made capital contribution. This was apparently done to address reluctance of private financial institutions to lend to public corporations because a number of them were had fallen into financial difficulties. GFIs had been unable to borrow funds easily unless local governments gave binding guarantees of the debt of local public corporation to which the GFIs lent. This is something local governments had not previously done.

Although debt guarantees by local governments regarding local public corporations may not have been offered in a formally legal way, there are indications that local governments did offer an implied guarantee to persuade private financial institutions. The local government was not directly obligated because the local public corporations and joint public-private ventures had not borrowed money in the name of local government. Rather, as with the central government case, the guarantee was premised on ensuring cash flow to the actual borrower.

When local governments failed to maintain cash flow, forsaking the implicit guarantee, private financial institutions were forced to waive debt. Although the debtor is not the local government itself, there has been a great effect on the revenue and expenditure of local governments (the ordinary account).

Thus, the central government has used promised cash flow as an implied guarantee of local government debt, and local governments have done the same as regards local public-corporation debt. In both cases, the cash flows have proven insecure. Events suggest that, as sincere as the governments may

have been, when poverty comes in at the door, love flies out at the window: the stopping of cash flows led to non-performance of obligations.

5.5 The Mediation Law

Debt restructuring under the specific mediation law applies to a public corporation that is insolvent (illiquid) rather than completely bankrupt (has liabilities greater than its assets). However, as a legal concept, bankruptcy is simply being unable to pay one's debts as they come due. Because the specific mediation law applies to corporations that cannot meet their obligations on their own, it can be said that proceedings under the law are bankruptcy proceedings as a matter of fact.

Since 2003, a number of local public corporations — mostly prefectural housing corporations — have in effect declared bankruptcy by petitioning for debt restructuring under the specific mediation law. These are: in June 2003, Hokkaido Housing Corporation and three joint public-private ventures of Osaka city; in July 2003, Wakayama Land Development Corporation; in January 2004, Nagasaki Housing Corporation; and in February 2004, Chiba Housing Corporation.

Japan's ongoing economic difficulties have affected the revenues of local governments, with the result that they have been forced to cut financial back support of local public corporations and the joint public-private ventures. The situation is such that some local governments may petition for specific mediation proceedings.

Speed is important in debt restructuring, and specific mediation proceedings are generally quicker than a conventional bankruptcy proceeding. In cases so far, special mediation has taken about six months from the time of petition. However, this result may depend on the nature and results of any negotiations among the parties before a bankruptcy. A bankruptcy filing typically represents a failure of such discussions to resolve the problems, so the appropriate comparison may be between special mediation and pre-bankruptcy negotiations.

Special mediation also allows for debt forgiveness to be negotiated with greater flexibility than in a bankruptcy. This flexibility has an important drawback, however. Very often it means that local governments employ an "ability to absorb losses" principle and seek greater debt forgiveness from healthy creditors than from others. In fact, some private financial institutions have been asked to waive debt or to reduce interest payments exceeding 50% of the subject debt. There also is a possibility that settlement choices are fewer in special mediation in that creditors cannot force the local government to increase taxes. But the same applies to debt restructuring under civil rehabilitation law or voluntary negotiation.

5.6 Bankruptcy

The assurance of revenue from the central government is taken to mean that local governments will not become bankrupt. However, studying in detail the discussions in the course of actually budgeting suggests that "the implied government guarantee" is not enough to prevent "bankruptcy" of a local government. It is not desirable for a local government to become bankrupt, but the possibility exists.

There are no laws in which "bankruptcy" of a local government is explicitly defined. As its name implies, the Special Measures Act for Promoting Local Fiscal Reconstruction addresses some of the issues, but there are many things it does not provide for, so existing law needs to be supplemented. Doi (2004b) investigates the prerequisites for building a new system of law relating to bankruptcy of local governments.

The first step is to reduce the risk of bankruptcy by setting restrictions on the issuance of bonds so as to ensure their redemption. Whether it is good to impose a balanced-budget rule like that used by state governments in the United States is not self-evident. However, a rule prohibiting reducing the fiscal primary deficit by issuing local bonds is appropriate.

Further, the new system should make reasonable increases in local taxes a requirement when a local government seeks postponement or reduction of interest or principal payments. Just what "reasonable" means will be left to case-by-case determination. However, the increase should be made in line with the benefit principle as much as possible. Governments allowed debt relief will be required to give priority to

repayment of existing debt and face restraints on future bond issuance.

5.7 Japan Finance Corporation for Municipal Enterprises (JFM)

JFM supplies long-term funds at a below-market rate to municipal public enterprises managed by local governments. These include water supply, sewage, transportation, hospitals, and public housing, plus other borrowers that carry on operations deeply involved in life of residents. In addition, as part of the Local Bond Plan, JFM makes loans to local governments. Because the underlying obligator is the local government, JFM in effect substitutes for them in the bond market.

JFM raises the greater part its loanable funds by issuing bonds, including government-guaranteed and non-guaranteed FILP agency bonds. Most of these are 10-year bonds. Municipally operated gambling associations — which operate local horse racing, bicycle racing, motorcycle racing, and speedboat racing — also make payments to JFM.

If financing by the government at a subsidized interest rate is justified, then it is desirable to clearly show the income redistribution effects, using the Grant Element described earlier, and have an overall policy co-ordinating these effects. That would make the enterprise-related operations carried on by JFM meaningless.

However there is a role for JFM. Since fiscal 2001, FILP has lent funds to local governments, in principle at the same interest rate FILP pays on its bonds. JFM can be transformed into a joint-issuer of local-government bonds, eliminating the borrowing from FILP. (To the extent this increases the cost of the funds, the central government can provide explicit subsidies as part of the same comprehensive co-ordination of income distribution effects discussed earlier.) In addition, it can jointly issue bonds with the public enterprises it lends to now. As a joint issuer, JFM should be divided into independent regional entities.

6 Conclusion

A good deal of Japan's record debt is attributable to the actions taken by GFIs and SPCs, as well as local public corporations. Because of the way these activities are funded, there is essentially no overall control of their deficits, and thus of their ultimate cost to Japanese taxpayers. Such open-ended liability is intolerable. This chapter has looked specifically at GFIs to provide answers to the question of how to reform them. It has also offered some proposals regarding the related matter of the financial relationship between different levels of government.

Several things are necessary as part of undertaking reform of GFIs.

First is clarifying their role. All GFIs should have their activities significantly curtailed, and some should be closed completely. This is in keeping with the recognition (and Koizumi cabinet policy) that efficiency and equity are best achieved when markets are allowed to do most jobs. But not all jobs, because a place for GFIs, and their inherent subsidies, does exist. One justification for GFIs is that they can be “double complementary”: they can enhance private intermediation and the functioning of capital markets.

From such viewpoints, the important aims of the reform of GFIs are the following points: clarification assignments of roles between the private and public sectors, increasing business efficiency in GFIs, and restraint of fiscal burden.

Second, the soft budget constraint problem must be fundamentally settled to accomplish these goals.

As part of hardening the budget constraint, it is important to establish a law concerning bankruptcy of GFIs (and local governments). Absence of the possibility of bankruptcy causes a soft-budget constraint problem and a worsening of public finance. Agencies that continue to exist as GFIs should be reorganized with limits on future capital contributions. To this end, it is effective for GFIs to change into “state-owned limited companies” with scaling down their scope of operation.

Third, to the extent subsidies are deemed appropriate for a GFI's activities, they should be budgeted in advance as part of an explicit, comprehensive policy on income redistribution that policy makers can be held accountable for. Policy regarding income redistribution should be set by the Diet, as it is a political

matter.

Next, this paper has discussed an organization form of each institution. It is desirable that Postal Savings become a state-owned narrow bank. In other words, the government protects expressly Postal Savings and sets up a narrow bank of which assets are in full limited to the government bonds or local bonds.

Government Housing Loan Corporation is scheduled to be incorporated to an independent administrative agency in the future, but should further accelerate securitization which is at present promoted, and finally should securitize all housing loan claims and should pull out of housing loans. The small and medium enterprise-related GFIs should be incorporated as a special public corporation and should carry on operations that conform with roles of GFIs as mentioned previously. Further, it is important to pull out of operations which would be profitable even if transferring to private financial institutions among loans which were already set about gradually through assignment of claims or securitization. It should be avoided to expand new operations while continuing those which were initially set about without parting with them to the last.

On Development Bank of Japan (DBJ), it is necessary to ensure fair terms of competition between DBJ and private financial institutions, and to check an activity of DBJ by market test. For that purpose, it is required to reorganize DBJ into a state-owned limited company and taxable corporation. If possible, DBJ can be privatized. It is an important requirement to DBJ to ensure fair terms of competition. Since *Official Development Assistance* (ODA) must be operated by government organization by definition, the Overseas Economic Cooperation Operations of Japan Bank for International Corporation (JBIC) cannot be privatized. Nonetheless, it is necessary to reorganize JBIC into a state-owned company limited, in order to reduce inefficiency of ODA and to set sunset provision on new business project. Also JBIC should promote the liquidation of its loans and decrease outstanding loan.

Concerning operations for which it is hardly necessary to be subsidized by the government in the future, Agricultural, Forestry and Fisheries Finance Corporation (AFC) should restrain being subsidized by the government by assigning their claims to Central Cooperative Bank for Agriculture and Forestry or Agricultural Cooperative and transfers to the local government operations which needed a large amount of subsidy from the government. The said local government directly makes loans, and if any subsidies are needed, the central government grants them to the local government concerned and it is desirable to abolish AFC. Okinawa Development Finance Corporation (ODFC) should be treated in the same manner as agencies which carry on those operations in the mainland and if there is any section that is need to continue to exist, the section concerned should be left as Okinawa Branch of the agency concerned and ODFC itself should be abolished. Lastly, Japan Finance Corporation for Municipal Enterprises should be split by region and should be a joint issue agency of local bonds of the local government which cannot independently issue public issues at the market.

It is important to implement differentiated policies with regard to public involvement and competition. In the part of the business conducted now by GFIs to complement market failure, public involvement is required, though the government has to strictly monitor and restrain the operation. On the other hand, it is necessary to reduce government intervention in the business that can be managed by private enterprises. For this purpose, it is better to confine GFIs to a smaller area by limiting their business (or allow them to withdraw from the business, if private enterprises are now engaged in it), rather than to privatize the organization of GFIs themselves and allow them to compete with private enterprises on an equal footing. That is to say, the objective can be better attained by restraining the business of public organizations to allow private companies to operate freely than by transforming public organizations into private ones.

The reforms proposed here contribute to the sound development of Japan's financial system and the orderly operation of its public finances.

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Table 1
A list of GFIs and key aspects of their balance sheets
as of March 2003 (the end of fiscal 2002).

	Loans	Borrowings & Bonds	from	Capital	Policy Cost
			FILP		
Government Housing Loan Corporation	67200	68745	66346	-211	-543
National Life Finance Corporation	10311	10040	9512	-107	7
Japan Finance Corp. for Small Business	7528	7099	6890	105	234
Japan Small and Medium Enterprise Corporation, Credit Guarantee Division	512	0	0	1263	-
Agriculture, Forestry and Fisheries Finance Corporation	3527	3261	3129	245	308
Japan Finance Corporation for Municipal Enterprises	24948	23251	17831	1847	7
Okinawa Development Finance Corp.	1552	1499	1471	39	-16
Development Bank of Japan	15713	14261	13493	1609	59
Japan Bank for International Cooperation	20164	12808	12463	7518	590
Shoko Chukin Bank	10090	9353	229	636	1
Total	161545	150317	131364		

Source: Ministry of Finance, *FILP Report 2003, Zaisei Kin'yu Tōkei Geppo (Ministry of Finance Statistics Monthly)*, July, 2003, and the Administrative Cost Statements of each agency.

Note:

In most discussions (and data presentations) of FILP, Shoko Chukin Bank is listed as a Special Firm. It was formed in 1936 to provide financial services to unions at SMEs. The Japan Small and Medium Enterprise Corp is an SPC, but its Credit Guarantee Division is included in the analysis here. For sources of additional data, see footnote 1.

Policy costs (subsidy costs) are total present value (discounted present value) of future subsidies and other expenditures to be invested by the central government (General Account, etc.) in the future in conjunction with the implementation of projects using FILP funding. Policy costs are estimated by individual FILP agencies.

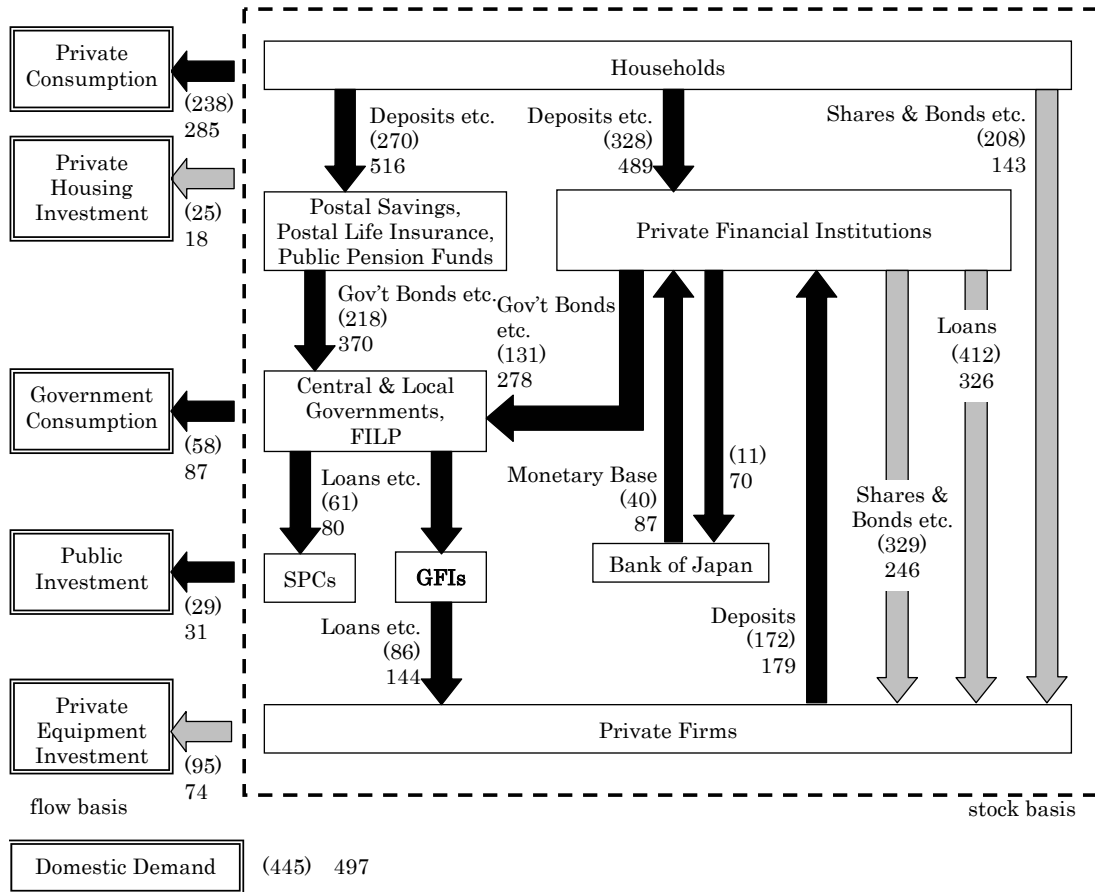
Table 2

Relation of Other Government Financial Institutions
to Okinawa Development Finance Corporation Operations

In ODFC	GFI that consigns operations
Industrial Development Fund	Development Bank of Japan
Funds for small & medium enterprises	Small Business Finance Corporation
Occupation fund; Public hygiene fund	National Life Finance Corporation
Fund for agriculture etc	Agriculture, Forestry, and Fisheries Financing Corp.
Housing fund	Government Housing Loan Corporation
Healthcare fund	Social Welfare and Medical Service Corporation

Source: ODFC.

Figure 1
Flow of Funds and Macroeconomy in fiscal 2001
(trillion yen, at current prices)



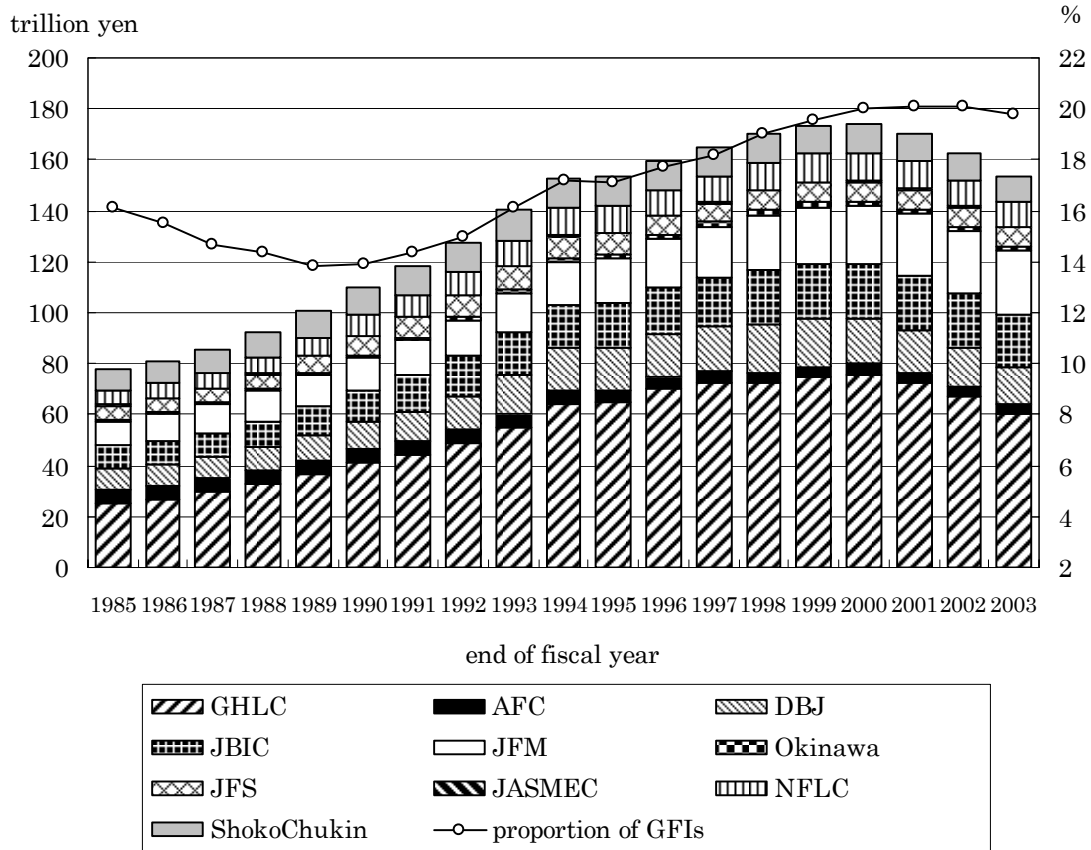
Source: the Council on Economic and Fiscal Policy

Note:

The values in parentheses indicate figures in fiscal 1990. The arrows indicate the direction of the movement of funds, with black lines indicating an increase in the amount in 2001 compared to 1990 and gray lines indicating a decrease in the amount in 2001 compared to 1990.

Figure 2

Loans and Discounts Outstanding of GFIs

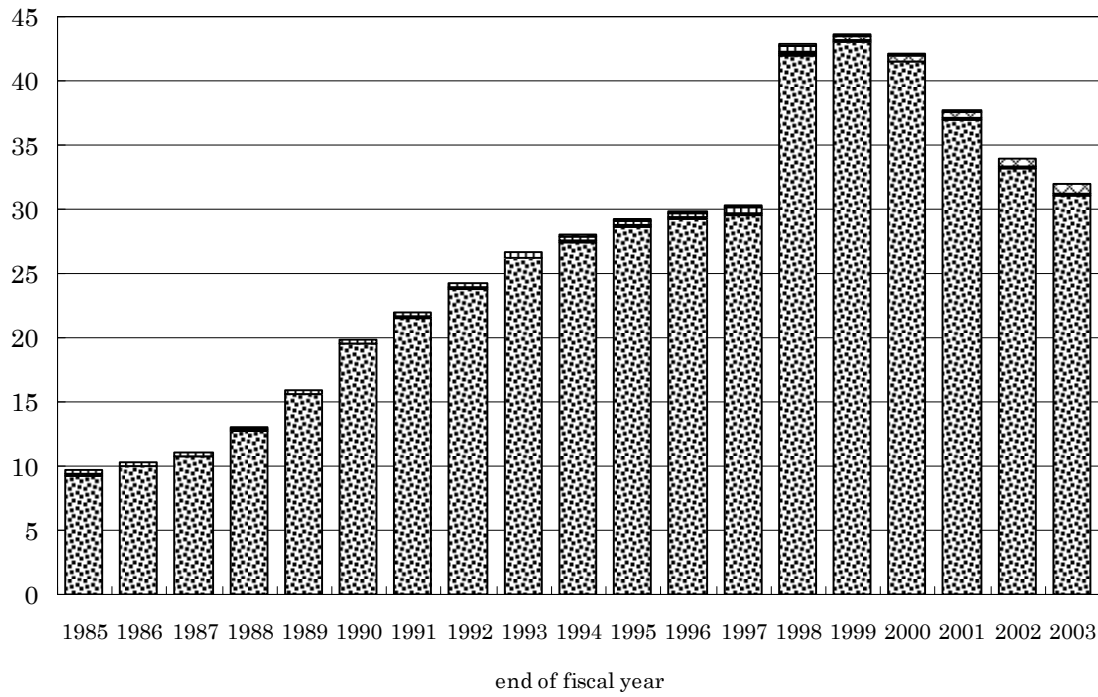


Source: Bank of Japan, Ministry of Finance

Figure 3

Guarantee Obligation Outstanding of GFIs

trillion yen



CGC DBJ JBIC NFLC Okinawa ShokoChukin

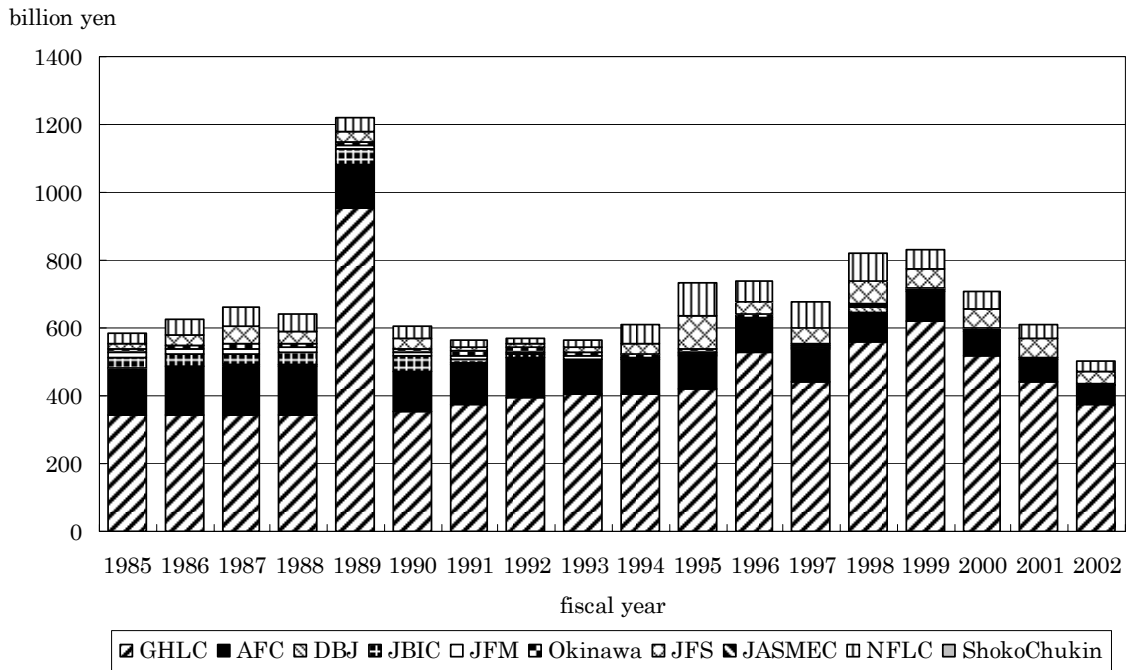
Source: Bank of Japan

Note:

CGC = Credit Guarantee Corporation

Figure 4

Government Subsidies to GFIs



Source: Ministry of Finance, Explanation of Settlement of Accounts, various issues.

