



R&I's Analytical Approach to Local Governments

(This report is an English translation of the original report in Japanese.)

General View

Municipalities are entities based in a specified area that have the objective of directly delivering administrative services with local residents as the constituent based on the right of self-government guaranteed under the constitution. There is a two-tier system of prefectures and cities, towns and villages, and local governments fulfill a function as government organizations in conjunction with the central government. Prefectures are wide-area local public bodies that encompass cities, towns and villages while cities, towns and villages are the basic local public bodies, which have close ties to residents, with each performing their share of administrative work. In addition, while there is no systemic relationship of superiority/inferiority between prefectures and cities, towns and villages, prefectures provide guidance, advice, and approvals and licenses for cities, towns and villages.

Although there is a rough national: local ratio of 2:3 in Japan's public finances on the final expenditure base, the national: local ratio for tax income paid by residents is roughly 3:2, and a substantial gap exists between final expenditure and sources of taxation. The main sources of revenue that fill the gap between local tax, which only account for 40% of local revenue and expenditure include municipal bonds and local allocation taxes and national treasury disbursements which are allocated by the central government. A fixed proportion of five national taxes (income tax, corporation tax, liquor tax, consumption tax, and tobacco tax) are allocated to local allocation tax.

Rating Points for the Local Governments

Rating Variations Considering Possibility of Changes in Central/Local Relationship

In the rating of municipalities, it is essential to have views on two broad factors, 1) Macro factors common for all the municipalities, such as credit enhancement to municipalities to be extended through national systems or customs such as the local government finance program or the nation's municipality system, and 2) individual factors which differs between municipalities such as regional economic power, financial situation, and debt levels, etc. R&I places a strong emphasis on credit

Main Indicators	
■	Independent revenue ratio (%)
■	Changes in taxable income (%)
■	Average land price (Yen / m ²)
■	Adjusted single fiscal year balance ratio (%)
■	Adjusted ordinary balance ratio (%)
■	Estimated years of debt redemption (Years)

enhancement to municipalities including (1) macro economic based revenue source guarantees based on local finance plans, (2) maintenance of financial balance between local governments and securing of necessary revenue sources through the local allocation tax system, (3) prompt corrective action schemes based on the real debt service ratio, etc., and (4) fiscal reconstruction law, a system provided in order to promptly restore the soundness of local government finance. Therefore, based on the fact that R&I has assigned the Japanese government an AAA rating, an rating of AA range or higher is assigned to municipalities with public issues of municipal bonds on national securities markets.

The total of newly issued municipal bonds issued by local governments and the total of principal and interest redemption (debt service) are included in revenue and expenditure respectively in the local finance plans which are formulated by the central government. Revenue source is secured on a macro base by balancing revenue and expenditure of municipalities. Specifically, the central government tries to balance the standard financial requirement (the financial needs of each local government calculated according to a certain formula) and the standard financial revenues (the amount of taxes etc. that would be levied under normal circumstances by the local governments calculated according to a certain formula) of a municipality through the formulation of the local finance plan. At this time, the portion of funds not provided by local revenue sources is adjusted based on local allocation tax. It can be argued that local allocation tax plays the two important roles in local finance of securing a source of revenue and balancing finances between local governments.

Meanwhile, the central government has started to steer in the direction of promoting independence for municipalities as seen in the so-called “trinity” reforms and decentralization reform. With the enforcement of the Comprehensive Decentralization Law, the municipal bond approval system has been abolished, and a new municipal bond consultation system that further increased the autonomy of municipalities was introduced in fiscal 2006. Although R&I assigns local government ratings in the narrow AA and higher zone, the ratings vary because R&I to some extent takes into account the gradual increase in autonomy in financial management resulting from the series of government reforms and the tendency toward variation in creditworthiness.

Focus on Intra-regional Economic Strength amidst Strengthening Autonomy and Self-responsibility for Local Governments

Bearing in mind that municipalities differ significantly from business corporations in that they are entities that do not seek to create profit, R&I takes into account the economic base and financial position of individual local governments in addition to the relationship between central and local government when assigning ratings. Specifically, R&I focuses on such points as (1) intra-regional economic strength and trends, which affect tax income, (2) the balance between the scale of debt and the funds that can be channeled to repayments, (3) financial structure and trends, and (4) administrative and financial management ability. In particular, the weight of the intra-regional economy in the evaluation has risen since 2003 as the autonomy and self-responsibility of

local governments has increased.

In terms of intra-regional economic strength, R&I evaluates the degree of industrial concentration and diversity, which leads to tax revenue. The major metropolitan areas, where industry is concentrated, have strong revenue bases, and they can also promote financial reform with the leverage of rising revenue. Industrial diversity is also one of the important factors in an evaluation. This is because there is a concern that if there is a concentration of a particular industry, tax revenue will be affected by trends in that industry making it unstable. Demographics and changes in the working population in particular, affect local inhabitant tax. Local governments with a persistent population decline may face difficult financial management in the future. In the case of municipalities, trends in fixed assets tax are also important, so R&I also pay attention to average land prices. R&I focuses on the ratio of independent revenue sources, calculated by dividing independent revenue sources such as local tax, charges and burdens, and handling charges by total revenue, as an indicator that determines economic strength.

Balance Between Outstanding Debt and Repayment Funds and Evaluation of Financial Management Ability

The balance between outstanding debt and repayment funds is one of the important factors in an evaluation. R&I focuses on the estimated years of debt redemption in the event that a local government poured all the funds it could theoretically secure into local bonds. From the perspective of the structure of and changes in the revenue and expenditure balance, R&I look at the stability of revenue sources, including a breakdown of tax income, and margin for reductions in expenditure. Local governments with a weak tax base and substantial investment in public enterprises as a proportion of expenditure tend to have inflexible finances with difficulties in reducing expenditure. Meanwhile, R&I believes, when it evaluates the financial balance, it is effective to see the ratio of adjusted annual financial balance, i.e., adjusted annual financial balance divided by standardized financial scale. Adjusted single fiscal year balance ratio is calculated after adjusting the increase and the decrease of debt and reserves, an effort to have a figure similar to the concept of free cash flow in corporate accounting. Amidst a continuing trend for economic activity to be concentrated in the major metropolitan areas, the financial disparity between local governments is widening. Nevertheless, R&I makes a positive evaluation if a provincial local government improves its balance sheet leading to a contraction in outstanding debt by securing stable finances through the promotion of administrative and financial reform.

Administrative and financial management ability is also a factor in the evaluation that cannot be ignored. In the rating, not only repayment ability, but also the intentions of the local government (leader, financial manager, and department in charge) are important. Whether a municipality with problematic finances can promote administrative and financial reforms and rebuild its finances depends on the management ability of the local government, beginning with the leader. In particular, the attitude and objectives of the leader on reform will have a substantial impact on the future shape of the local government.

R&I also checks on large scale project trends and plans, public business account and extragovernmental organizations. In addition to the local bonds of public business account, local government debt guarantees for land development public corporations and road public corporations are counted as direct debts of local government. Furthermore, the possibility of local government support for housing supply corporations and third sector enterprises is factored in separately.

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