

**Column A** **The Impact of the COVID-19 Pandemic on Local Government Finances***FUJIWARA, Yukinori*

## 1. Stagnation of Local Economies due to the COVID-19 Crisis

The spread of COVID-19 infections has restricted the entry of overseas visitors, including foreign tourists, and reduced socio-economic activities in Japan through stay-at-home requests and business suspension orders, which has significantly slowed down local economies. As a result of the widespread stagnation of local economies, local companies and business operators, particularly in the railroad, bus, hotels, Japanese inns, food and beverage, and retail industries, have unavoidably experienced a significant sales decline and difficulties in surviving.

In response to the COVID-19 crisis, local governments have been responsible for field-level measures, such as preventing the spread of infections, developing medical care provision systems, and supporting local economies and residents' lives.

In November 2021, the FY 2020 financial results for the ordinary accounts of prefectures and municipalities were released. FY 2020 was the first full year impacted by COVID-19. Therefore, I will consider the impact of the COVID-19 crisis on local government finances based on the FY 2020 financial results.

## 2. Local Government Finances in the First Year of the COVID-19 Crisis

### (1) Significant Decrease in Revenues from Two Corporate Taxes

Local taxes are major sources of finances for local governments. Tax revenues are greatly influenced by the income and earnings situation of individuals and corporations. In particular, shocks such as economic crises and natural disasters can lead to a significant decrease in local tax revenues.

In other words, if corporate earnings deteriorate, then within the local taxes paid by companies, corporate inhabitant tax and corporate enterprise tax that are levied on corporate income or profits will decrease.

If an employee's income decreases or employment is terminated, the individual inhabitant tax paid by that employee will also decrease. The deterioration in corporate earnings due to the COVID-19 crisis has an impact on the trends in tax revenues from two corporate taxes.

From this perspective, the many local governments that have tried to revitalize their local economies by attracting tourists from overseas to Japan in recent years will also see a decrease in local taxes due to the damage to the tourism industry.

As shown in [Table 3-CA-1](#) and [Table 3-CA-2](#), the financial results for FY 2020 saw significant decreases in two corporate taxes (corporate inhabitant tax and corporate enterprise tax), reflecting the worsening business conditions of business operators impacted by the COVID-19 crisis.

Although no decrease was seen in revenue from individual inhabitant tax, the impact of COVID-19 will become apparent in the FY 2021 financial results as individual inhabitant tax is imposed on that individual's income in the previous year.

**Table 3-CA-1** Prefectural tax revenue payment amount by tax item

(Unit: JPY 100 million, %)

Category	FY 2020 revenue	Amount change from the previous year	Percentage change from the previous year
Prefectural inhabitant tax on individuals	49,545	1,146	2.4
Prefectural inhabitant tax on corporations	5,480	-2,732	-33.3
Enterprise tax on corporations	40,823	-3,028	-6.9
Enterprise tax on individuals	2,160	45	2.1
Local consumption tax	54,238	6,282	13.1
Real estate acquisition tax	3,743	-299	-7.4
Prefectural tobacco tax	1,335	-61	-4.4
Motor vehicle tax	16,234	353	2.2
Light oil delivery tax	9,101	-347	-3.7
Others	1,028	-1,109	-51.9
Total	183,687	250	0.1

Source: Based on Summary of Prefectural Settlement Accounts of Ordinary Accounts by the Ministry of Internal Affairs and Communications (MIC).

**Table 3-CA-2** Municipal tax revenue payment amount by tax item

(Unit: JPY 100 million, %)

Category	FY 2020 revenue	Amount change from the previous year	Percentage change from the previous year
Municipal inhabitant tax on individuals	84,267	1,015	1.2
Municipal inhabitant tax on corporations	18,126	-5,826	-24.3
Fixed property tax	93,801	940	1.0
Municipal tobacco tax	8,171	-368	-4.3
City planning tax	13,296	119	0.9
Others	6,909	11	0.2
Total	224,570	-4,108	-1.8

Source: Based on Summary of Municipal Settlement Accounts of Ordinary Accounts by the Ministry of Internal Affairs and Communications (MIC)."

## (2) State Grants as Financial Resources for Spending

Local taxes are levied and collected in accordance with the rules stipulated in the Local Tax Act. Therefore, it is difficult to increase tax revenues by raising local tax rates in case of emergencies such as the COVID-19 crisis. Even while tax revenues decline from corporations in financial difficulty and economically distressed residents, such corporations and residents may benefit from a tax reduction, exemption, and even deferral.

On the other hand, local governments have been forced to increase expenditures to respond to COVID-19. The net settlement amounts in the ordinary accounts of local governments in FY 2020 increased significantly compared to in the previous year, with expenditures reaching a record high of JPY 125.5 trillion. According to the results of a survey of expenses related to the responses to COVID-19 in local governments' ordinary accounts in FY 2020 conducted by the Ministry of Internal Affairs and Communications (MIC), the relevant net expenses amounted to JPY 25.6 trillion, which is roughly equivalent to the year-on-year increase of JPY 26.4 trillion in the ordinary balance of the net amount of settlement amounts for expenditures in ordinary accounts.

For local governments with insufficient general financial resources<sup>1)</sup>,

1) Financial resources, such as local tax revenues, that can be freely used by local governments at their own discretion without restrictions.

special grants from the national government are playing a major role in securing the financial resources for expenses related to the responses to COVID-19. Special grants are intended to enable local governments to implement necessary projects in accordance with the actual situation of each region in order to support local economies and the lives of residents affected by the spread of the infections. A total of JPY 6.9 trillion was budgeted for FY 2020 by the national government.

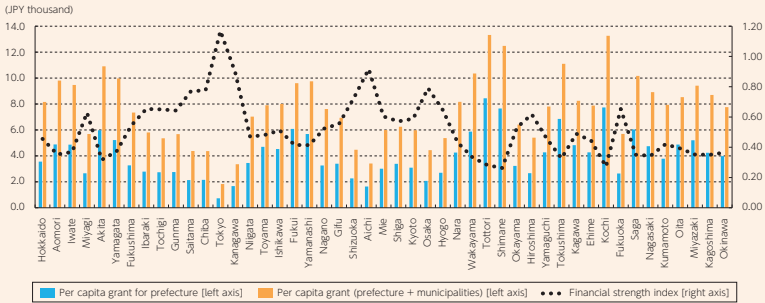
However, there was a gap in perception regarding special grants between the national government that determines the grant system and local governments that engage in field-level responses, and this has made it difficult to flexibly operate the system in line with the actual situations in the regions. As a notable example, the national government initially explained that special grants could not be used for compensation for the suspension of business operations, but later when faced with opposition from local governments, it approved the use of the grants as compensation for business suspension.

The bigger problem was that local governments with a high financial strength index<sup>2)</sup> received very low grants, despite having large financial demands for COVID-19 measures. The amount of special grants allocated to each local government is calculated based on population, infection status, and financial strength. As a result, the grant per capita is calculated with a higher weight for municipalities with a smaller population and lower financial strength.

This is confirmed by the data in [Figure 3-CA-1](#). This figure shows the relationships between the amount of special grants to each prefecture, the sum of special grants to each prefecture and municipalities in the prefecture, and the financial strength index (prefecture). Obviously, local governments with a high financial strength index received very small per capita grants, despite having a high number of cases and high financial demands for COVID-19 measures. The level of per capita grants received by Tokyo is the lowest among all the prefectures. The three neighboring prefectures of Tokyo, as well as Aichi, Kyoto, Osaka, and

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2) The financial strength index is an indicator that reflects the financial strength of a local government, which is calculated by dividing the amount of revenue required to operate the local government by the amount of expenditure. An index of 1.0 indicates that the revenue and expenditure are balanced, and an index above 1.0 indicates that financial resources exceed demand.



**Figure 3-CA-1** Amount of special grant allocation for regional revitalization to cope with COVID-19 (first supplementary budget in FY 2020)

Note 1: Grant amount per capita by prefecture

Note 2: The financial strength index is a three-year average between 2018 and 2020 on a prefectural basis.

Source: Based on Local Public Finance Survey by the Ministry of Internal Affairs and Communications (MIC), materials prepared by the Secretariat for Promotion of Regional Revitalization, Cabinet Office, and results of the 2020 National Census.

Hyogo, which have high numbers of infected people, also received low levels of grants.

Prefectural governments play major roles in COVID-19 measures. They provide a wide range of COVID-19 control measures, including providing loans and cooperative grants to business operators and assistance to medical institutions in securing hospital beds to receive infected patients. Given these roles of prefectural governments, it would not be desirable for local governments with large cities, such as Tokyo and Osaka, to receive a lower amount of grants even though they are rated high in the financial strength index.

An important question is whether it is acceptable for local governments with large cities in which large numbers of infected people concentrate, such as Tokyo and Osaka, to receive lower grant amounts. Given the trend of the spread of infections due to the flow of people from large cities to rural areas, the appropriate allocation of grants to areas with large numbers of infected people and large financial demands may have been effective in suppressing the spread of infections nationwide. Going forward, it will be necessary to review the grant allocation criteria for anti-infection measures, including the removal of adjustments based on the financial strength index, while verifying the effects of the current

grant system.

### 3. Challenges for Local Government Finances

In a crisis situation, such as the spread of COVID-19 infections, it is necessary for local governments to be able to take their own economic measures speedily and in accordance with their respective circumstances, without waiting for national government subsidies. The speedy implementation of economic measures by local governments will bring hope and motivation to local SMEs and individual business operators. Local governments' economic measures have a considerable effect on halting the collapse of local economies and in facilitating the resumption of local economic activities.

However, individual economic measures implemented by each local government can cause problems that may lead to regional disparities, depending on the financial strength of each local government. During the first state-of-emergency period in 2020, prefectural governments provided cooperation money to business operators that chose to follow the governors' requests to suspend operations, but there were large differences in the amounts of cooperation money paid as compensation for a business suspension even when considering the differences in prices and wages among the prefectures. It is not desirable that disparities in the financial strengths of local governments lead to policy differences, resulting in disparities in their economic recoveries.

There should be a discussion on the local financial base that is required for local governments to take swift economic measures when faced with a crisis, such as the spread of COVID-19 infections<sup>3)</sup>.

The measures that local governments should take are not limited to anti-infection measures, but they are also responsible for responding to various regional financial demands, including disaster countermeasures, education, welfare, medical care, nursing care, childcare support, measures for deteriorating social infrastructure, and the digitalization of public administration.

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3) HIRAOKA, Kazuhisa and MORI, Hiroyuki (2020) is informative as it points out issues relating to COVID-19 measures and municipal financial management in detail based on surveys of local government financial departments.

Therefore, I believe that the financial base of local governments needs to be fundamentally enhanced. As a measure to achieve this, I propose the expansion of general financial resources of local governments and the establishment of a local tax system that provides stable revenues with an even distribution of tax sources.

Finally, most of the local financial resources to address the current COVID-19 crisis have to rely on the issuance of additional government bonds, which imposes a heavy fiscal burden on the government. I would like to point out that the national fiscal situation that has further deteriorated should not be overlooked.

### References

- FUJIWARA, Yukinori (2020), “Local Financial Strength Disparities Observed in COVID-19 Measures: Correcting the Uneven Distribution of Local Taxes and Stabilizing Tax Revenues through Tax Revenue Exchange” (Japanese title: Shingata Korona Uirusu Taisaku de Mieta Chiho no Zaisei-ryoku Kakusa – Zeigen Kokan ni Yoru Chihozei no Henzai Zesei, Zeishu Anteika o -), APIR Trend Watch No.64, August 2020
- HIRAOKA, Kazuhisa and MORI, Hiroyuki (2020), “COVID-19 Countermeasures and Municipal Finance: Considerations from an Urgent Questionnaire” (Japanese title: Shingata Korona Taisaku to Jichitai Zaisei – Kinkyu Anketo kara Kangaeru-), Jichitai Kenkyusha, December 2020