

Budget Orthodoxy and Strategies for Deficit Reduction in Japan

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1. Introduction

Generally speaking, the government plays an important role in not only providing public goods and redistributing income, but stabilizing the economy in a non-inflationary environment. In order to execute the fiscal activities of the government sector, government expenditures, tax revenues and public debt are essentially employed as the main economic instruments. Apart from a balanced budget state, the budget frequently generates fiscal surpluses and deficits as a result of an expenditure-revenue gap, depending on the general level of economic expansion or contraction. Thus, fiscal deficits (or surpluses) provide us with a certain yardstick to express the basic nature of government fiscal activity.

It is noteworthy that large fiscal deficits have long persisted in most advanced countries, which in turn remain one of the most important problems to be solved in the years ahead. Many countries have begun to recognize the risks that continuing fiscal deficits entail in terms of exploding into an unsustainable debt accumulation, particularly in an environment of lower growth rates and high interest rates. In fact, a significant number of OECD countries have established fiscal targets in recent years to attain balanced or modest deficit positions in the general government account, as will be argued later.

Japan's fiscal position has sharply worsened since the early 1990s in terms of fiscal deficits and debt accumulation, reflecting the sluggishness of the eco-

conomic recovery since the post-bubble recession. In Japan, great care has officially been taken to restrain fiscal deficits from expanding by the fiscal authority, the MOF (Ministry of Finance), while Keynesian fiscal policies still remain predominant as an expansionary device. As a consequence, the central question addressed in this paper is how fiscal policy issues have been handled among all the parties concerned in relation to the expansion of fiscal deficits in the past.

This paper is divided into four parts. First, we consider briefly the recent development of Japan's fiscal deficits in comparison with those of other major countries. Second, we attempt to clarify the traditional budgetary rule adopted by the MOF in contrast to the Keynesian view. Third, we note the strategies of deficit reduction in the annual process of budgeting. Lastly, we investigate the effects of the bubble boom and its collapse on the budgetary behaviors. These considerations would be of great help to understanding the underlying conditions of Japan's fiscal policy.

2. Recent Trends of Fiscal Deficits in International Perspectives

2.1 Current State of Fiscal Positions in Major Countries

In Europe, the US and Japan, increasing importance has begun to be placed on the current level of fiscal deficits and accumulated debt in recent years. Policy makers tend not only to address policy management issues related to the immediate economic situation, but also to meet important medium-term policy goals to restore the annual balance of budgets. It is generally acknowledged that a stable fiscal environment would be essential to enhance the flexibility of the economy. For this purpose, well-designed macroeconomic and structural policies are requested to reduce fiscal deficits in major countries.

Among many OECD countries, the deficit-reduction programmes have already assisted in lowering real interest rates and easing the pressures on cur-

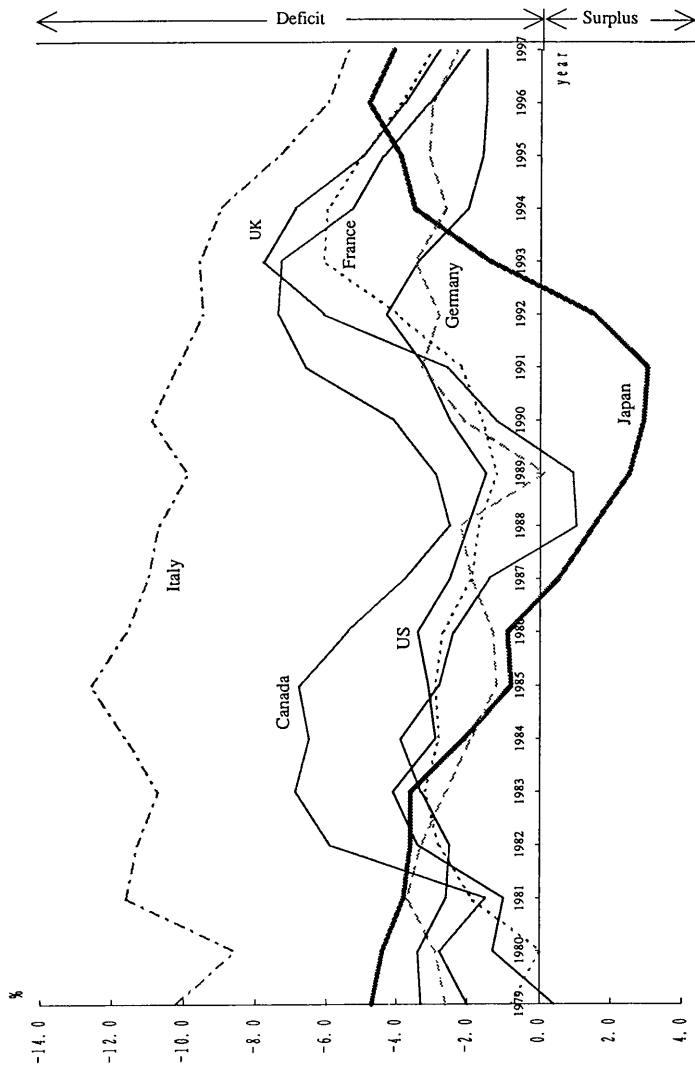
rency markets through the enhancement of the nation's credibility. Also, further beneficial effects are expected in the coming years through such an effort. However, in spite of fiscal consolidation efforts, large fiscal deficits and the rising public debt outstanding still remain serious problems in each country.

Figure 1 is prepared to indicate the past trends of fiscal deficits in the G7 countries for the period 1979–1997 along with future projections. In order to obtain an adequate measurement common to each country, the relative ratio of fiscal deficits to GDP is employed in accordance with the SNA concept. There are a couple of points unique to Japan. First of all, Japan had successfully eliminated in the 1980s the large fiscal deficits which occurred in the late 1970s, and then turned them into a surplus after the mid-1980s. As will be argued shortly, this restoration of fiscal soundness was mainly caused by massive tax increases during the bubble boom.

Second, however, the fiscal deficit-GDP ratio had begun to rise again after the early 1990s. This recent trend in Japan ought to be sharply contrasted to those of other major countries, because all of them except for Japan have been able to decrease the relative size of their fiscal deficits to a considerable extent for several years. Thus, it is noted that Japan's fiscal deficit surpassed in 1996 those of the five other countries with the exception of Italy, reaching the worst situation among the G5 countries.

As described earlier, the general government is composed of three components: central government, the local government, and the social security fund. Inspecting each component in detail, it can be noted that the social security fund in Japan still accumulates a substantial surplus even now, unlike that of other major countries except for the US. However, such fund surpluses are anticipated to disappear for some time to come as the population is aging, given that the current scheme is on a pay-as-you-go basis. Thus it might be better to

Figure 1 Fiscal Deficits (-) and Surpluses (+) among G7 countries as a Percentage of Nominal GDP



Source: OECD, *Economic Outlook*, June 1996.

Note: The scope of the general government in the national accounts is taken to include central and local governments and social security fund.

eliminate the ongoing accumulated surplus in the social security fund from the definition of fiscal deficits in the general government of both Japan and the US.

If we use such a revised deficit-GDP ratio, Japan's fiscal position becomes much more aggravated: 7.0 percent (3.5 percent) in 1994, 7.4 percent (3.9 percent) in 1995, 8.2 percent (4.8 percent) in 1996 and 7.5 percent (4.1 percent) in 1997. The percentages in parentheses are those including the surplus of the social security fund. This being the case, Japan's fiscal deficits could exceed even the Italian level in 1996 and 1997 (6.0 and 5.4 percent respectively).

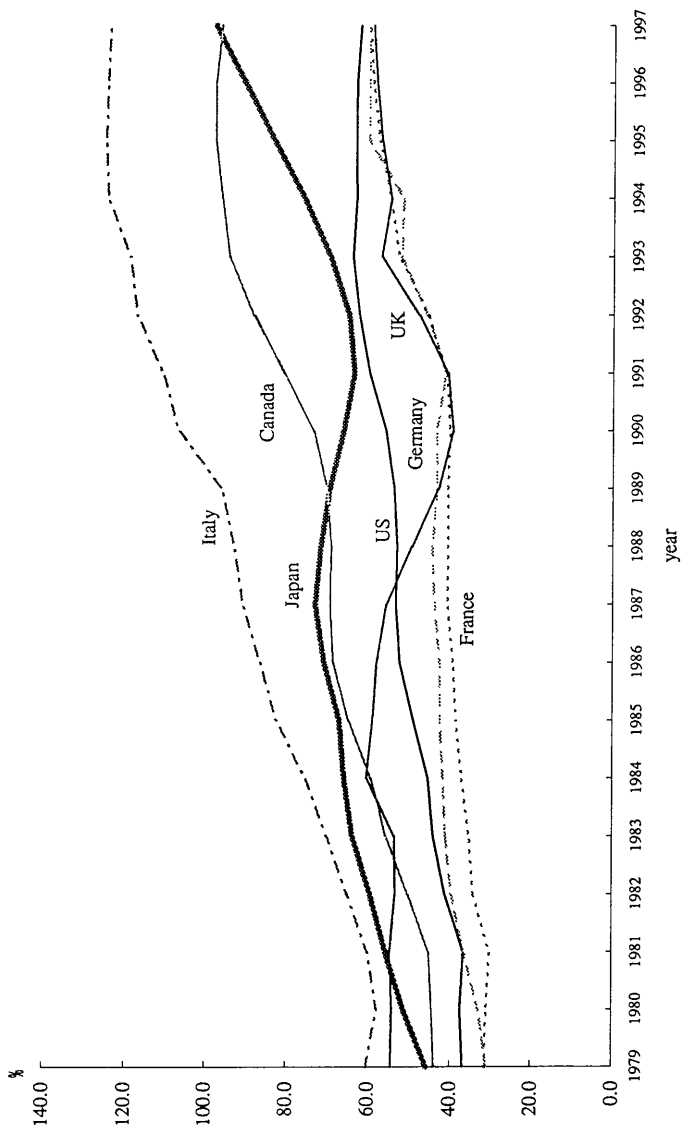
Turning to another measurement, we shall now pay attention to the accumulated debt-GDP ratios depicted in **Figure 2**. Current fiscal deficits continue to increase the gross debt outstanding on a stock basis over time. Once fiscal deficits are generated in the budgetary process, public indebtedness must accumulate over a stretch of time.

The debt-GDP ratio started increasing at a faster speed than that of other major countries except for Italy since the late 1970s. It slowed down once during the period of 1987–91, reflecting the effects of deficit reduction on a flow basis for the same period, but thereafter it turned upward again until the present. That is to say, it is projected to be 90.1 percent in 1996 and 97.3 percent in 1997, approaching 100 percent, as Japan may catch up with Italy in the future if the situation progresses as it is.

In retrospect, when have the fiscal deficit problems become evident in the major countries? Since the two oil crises in 1973 and 1979, the growth rate of the Japanese economy slowed down, and as a result, the nation's fiscal deficits expanded at a rapid pace. This story was, however, not at all unique to Japan, as many other countries of the world were plagued with similar problems.

Let us pay attention to the outstanding debts of central government as a percentage of GDP since 1972 in 13 industrial countries. The ratio in Japan

Figure 2 Gross Debt Outstanding among G7 Countries as a Percentage of Nominal GDP



Source and Note: The same as Figure 1.

started to surge in 1974, immediately after the first oil crisis in 1973. In 1974, the simple average of the rates among the G7 countries remained at 22% while Japan's debts as a percentage of GDP in 1974 were merely 9.7%, the second lowest next to 7% for West Germany. However, the average ratio among the G7 countries had soared to 45% by 1983, and the rate of increase in Japan was the fastest, increasing from 8.7% to 44.7%, reaching the second highest proportion after Italy's 78.6%.

A similar phenomenon can be observed in the smaller industrial countries of Europe. The national debts have mushroomed during the decade of the 1970s in almost all Western free economies. This situation may be called a "public debt explosion" (see, de Larosiere, 1984).

2.2 Japan's Fiscal Position

The "explosion" in Japan is particularly conspicuous. Naturally, the public debt issue has made it even more difficult for the government to compile the budget every year. **Table 1** represents the bond dependency ratio (ratio of national bond issues to total government expenditures) in the general account of the national government in order to observe the past patterns of fiscal deficits in the narrowest scope since 1965. Japan has traditionally placed the highest priority on this ratio among relevant indicators in measuring the soundness of fiscal performance or fiscal discipline, although this is not common to overseas countries. The bond dependency ratio originated in 1965 where the first debt-covering bonds were obliged to be floated to make up for the shortage of tax revenues in the supplementary budget of that year. Thus, the balanced budget position adopted by the MOF ended when the Japanese economy was faced with a depression and the MOF admitted to the necessity of stimulating the economy by generating fiscal deficits. However, after national bonds were issued on a sub-

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stantial scale in 1966, the government made a strenuous effort to curtail them each year until the early 1970s, at least placing no reliance on debt-covering bonds.

Table 1 Trends of Fiscal Deficits in Japan: Bond Dependency Ratio for 1965–96 (%)

Fiscal year	Total bonds		(Debt-covering bonds)	
	Initial	Settlement	Initial	Settlement
1965	-	5.4	-	(5.4) ¹⁾
1966	16.9	14.9	-	-
1967	16.2	13.9	-	-
1968	11.0	7.8	-	-
1969	7.3	6.0	-	-
1970	5.4	4.2	-	-
1971	4.6	12.4	-	-
1972	17.0	16.3	-	-
1973	16.4	12.0	-	-
1974	12.6	11.3	-	-
1975	9.4	25.3	-	10.0
1976	29.9	29.4	19.3	14.2
1977	29.7	32.9	17.8	15.6
1978	32.0	31.3	18.4	12.7
1979	39.6	34.7	27.1	16.3
1980	33.5	32.6	22.0	16.6
1981	26.2	27.5	14.4	12.5
1982	21.0	29.7	9.5	14.8
1983	26.5	26.6	16.6	13.2
1984	25.0	24.8	15.2	12.2
1985	22.2	23.2	12.8	11.3
1986	20.2	21.0	11.3	9.3
1987	19.4	16.3	10.6	4.4
1988	15.6	11.6	6.5	1.4
1989	11.8	10.1	2.6	0.3
1990	8.4	10.6	-	-
1991	7.6	9.5	-	-
1992	10.1	13.5	-	-
1993	11.2	21.5	-	-
1994	18.7	-	(5.2) ²⁾	-
1995	17.7	-	(4.8) ²⁾	-
1996	28.0	-	-	-

Source: Data from the Ministry of Finance.

Note: 1) Provisional bond issuance to make up for revenue shortage.

2) Bond issuance for income tax reduction to be compensated by a consumption tax rate increase.

The explosion of fiscal deficits in the general account of the national budget became serious after 1975. The harsh prolonged recession triggered by the oil shock produced an exorbitant deficit in the government sector, and the revenue shortage became evident during the implementation of the 1975 budget. Thus, a sharp increase in national bond flotation was necessary in the supplementary budget of 1975. The initial budget of 1975 planned to issue only ¥2,000 billion worth of bonds, but ¥3,400 billion more were added to the original plan as the large revenue shortage caused by the recession became more evident. Thus, debt-covering bonds had to be issued once again starting in fiscal 1975. In addition to the national government, local governments have also fallen into financial crises making it imperative for them to float local bonds in large amounts.

The bond dependency ratio reached 25.3 percent after supplementation in 1975, and this ratio rose to 29.4% in the 1976 budget. Furthermore, it continued to increase to reach a peak of 34.7 percent in 1979. These dependency ratios are surprisingly high, compared with the 10.4 percent average of 1965–74. After reaching a peak in 1979, the bond dependency ratio began a constant decline until 1986, mainly due to expenditure cuts. Thereafter, a further decreasing tempo in fiscal deficits can be observed during the period of 1986–1990. In particular, during this period, the bubble boom was spread widely to the economy as a whole, and contributed a lot to the generation of vast tax increases and to higher rates of nominal GDP. As will be argued below, such windfall type of tax increases greatly assisted in reducing fiscal deficits, leading to a successful achievement of the target of fiscal consolidation no issuance of deficit-covering bonds. However, once again, the bond dependency ratio began to rise sharply after 1991, mainly reflecting the stagnant state of the post-bubble recession.

Fiscal consolidation (in more fashionable terms, fiscal reconstruction) became increasingly important as a major policy target since the mid-1970s. The first objective of eliminating the issuance of debt-covering bonds as a slogan of fiscal consolidation was achieved in fiscal 1989 with a lot of budgetary maneuvers, mainly due to a massive amount of unintended increases in revenues from the bubble boom. After the collapse of the bubble, however, the fiscal deficit problem has grown worse once again, as mentioned repeatedly. The bond dependency ratio began to rise up, reaching 28 percent in fiscal 1996, the same level as in fiscal 1980.

As evident from the major fact findings described above, Japan's fiscal deficit poses a serious problems today. For example, a recent OECD report states the following:

“Once an economic recovery is under way, Japan's fiscal position will have to be greatly strengthened in order to arrest and reverse the rise of public debt to GDP. This requirement is particularly urgent in view of the expenditure pressures that will soon appear due to the ageing of the population” (OECD, 1995, p. xii).

This statement is certainly true. Japan's policy makers should follow this policy recommendation, although it is very difficult for them to determine when deficit-reduction measures can be embarked upon, given the weaker signs of economic recovery. No doubt, concerns that fiscal retrenchment may have a negative impact on economic activity and employment frequently lead them to act prudently. In addition, apart from such a difficult judgment, they will have to make politically hard decisions to restore a sound fiscal position because of unpopular policy such as expenditure cuts, tax increases or both. In Japan, however, the policy of aiming for a balance in the fiscal position will be an absolute requirement once the signs of economic recovery solidly appear.

One of the chief reasons behind the necessity for fiscal consolidation reflects the fact that the current situation of Japan's deficits has already deteriorated to a greater extent than that of other major countries, as stressed earlier. As a matter of fact, it would be almost impossible for Japan to satisfy the Maastricht criteria if it were a relevant target. In Europe, members of the European Union have made political decisions regarding two reference criteria, to keep fiscal deficits in line with a 3 percent or less for deficit-to-GDP ratio and a 60 percent or less debt outstanding-to-GDP ratio. Any European country that wishes to join the European Monetary Union (EMU) in 1999 will have to meet these Maastricht criteria. Thus, the Maastricht criteria are regarded as international standards of restricting fiscal deficits, but unfortunately the current situation of Japan's fiscal position is far from achieving such a standard.

Now each country in Europe is making assiduous efforts toward fiscal consolidation. The pace at which stronger fiscal positions could be established may vary from one country to another, and additional fiscal actions are clearly needed to implement concrete criteria. It is, however, generally believed that early, decisive fiscal actions have improved credibility, decreasing risk premia on interest rates and reducing the cost of debt servicing.

Japan has so far been the major exception in making progress to reduce fiscal deficits mainly for two reasons. For one thing, a hesitant recovery after the bottoming out of the post-bubble recession has repeatedly required additional expansionary packages. The other is that Keynesian fiscal policy still affects dominantly the policy-making process. No doubt, these have contributed to a deterioration of Japan's fiscal balance as described above.

3. The Balanced Budget Principle and Its Aftermath

3.1 Budget Orthodoxy and Fiscal Performance

It is very important to analyze how the fiscal authority has behaved to manage fiscal policy and control the level of fiscal deficits in view of government fiscal activity. On this point, great emphasis has been consistently placed on the balanced budget rule by the MOF from a standpoint of budget orthodoxy.

In the following discussion, let us focus on the definition of fiscal deficits in the general account of the national government budget, because fiscal behavior can be expressed very well in this scope of the budget. Prior to 1965, as seen in **Table 1**, no fiscal deficits had been incurred in the operation of fiscal policies. The MOF had strictly maintained a balanced budget policy.

The MOF's budgetary orthodoxy prior to 1965 seems to have been based upon the following three empirical rules (see, Ishi 1973):

- (1) a balanced budget
- (2) a tax policy with a constant ratio of tax burden relative to national income
- (3) an intended underestimation of the "natural increase in tax revenues" caused by a growing economy

The first rule, the balanced budget, has been the dominant characteristic of fiscal policy in postwar Japan accompanied by the additional two rules. The basis for this lies in the traditional view of "sound" finance, that is, all current expenditures must be financed by current revenues in the government sector. Following this axiom, the issuing of national bonds during the postwar period was restricted rigidly by a statutory limit to "construction bonds" by the Finance Law to prevent the easy use of deficit-covering bonds. This concern for a balanced budget had been the result of the extravagant government spending and the inflationary pressures which had been experienced in prewar Japan. At the

outset of the Dodge Plan,¹⁾ the balanced budget was actually implemented at all levels of the government, that is, not only in the general account of national government but also in its special accounts, in other accounts of government-affiliated agencies, and in local governments.

However, the balanced budget policy had to be altered with the passage of time. Indeed, government guaranteed bonds in the Fiscal Investment and Loan Programme (FILP) and local government bonds began to be issued gradually. It was not until 1965 that national bonds were issued and a deficit appeared in the general account. Not even “construction bonds” were issued prior to this date. Thus, we should note that the meaning of the term “balanced budget” has been slightly changed as the postwar period progressed. Nevertheless, it cannot be denied that the balanced budget should be emphasized as the most fundamental rule of government fiscal policy. Even after the budget became unbalanced after 1965, the MOF has constantly stuck to its desirable goal of restoring a balanced budget.

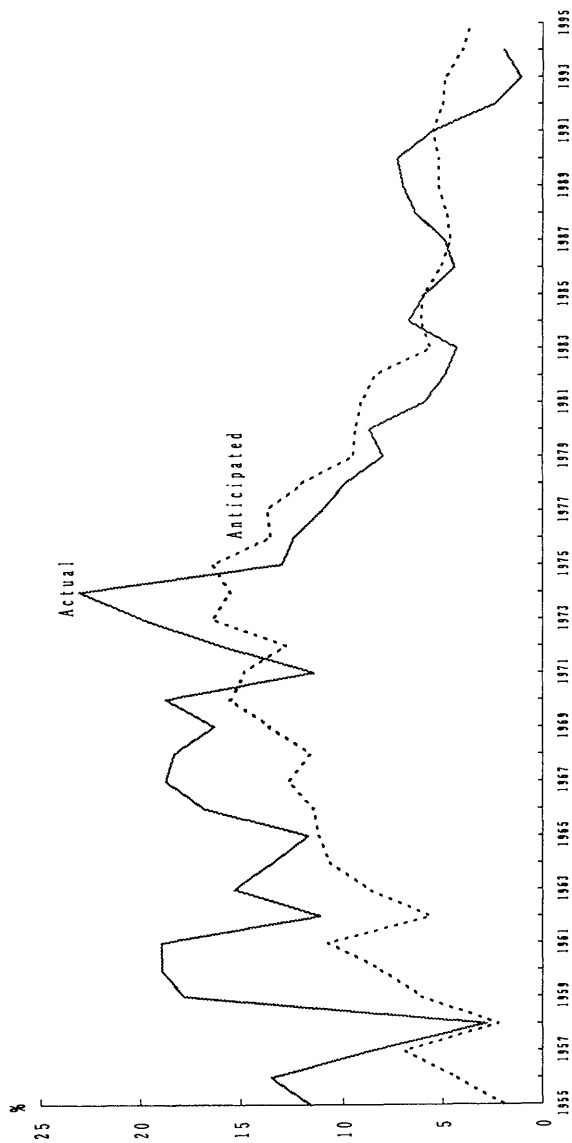
The second empirical rule has been to keep the ratio of tax yields to national income constant (i.e., 20 percent). This rule for tax policy had been adopted, especially in the period 1955–1965. In a growing economy like that of postwar Japan, this rule leads to a large amount of tax reductions. In particular, individual and corporate income taxes must be significantly reduced every year. Had tax reductions not been implemented, income taxation would have considerably overburdened the taxpayers. Therefore, to avoid the overburdening of taxpayers, income taxes had to be reduced successively almost every year (see, Ishi 1993, ch. 3).

1) The Dodge Plan was a program for economic policy drawn up by Joseph M. Dodge, then advisor to the Allied Forces in Japan. Its conservative and stringent recommendations which emphasized a balanced budget as an important measure to counter inflation were implemented for a few years after 1949.

In addition to these two rules, the intended underestimation of the natural increase in tax revenues must be referred to as the third empirical rule. It bears close relation to the two rules discussed above. Some tax revenues, such as that from the individual income tax, naturally register increases as the tax base expands with the growth of the economy even if there are no changes in the tax rate and exemptions. The higher the rate of economic growth, the larger the amount of natural increase in tax revenue that can be expected. In actuality, a large volume of natural tax increases was realized each fiscal year up to 1965 which provided a substantial amount of new financial resources in the preparation of the annual budget. That is to say, a portion of the natural tax increases was appropriated to the financing of tax reductions, and another was devoted to the financing of new expenditure programmes. Thus a big, expansion-minded budget was actually created by means of such a large natural increase in tax revenues, without creating the problem of fiscal deficits.

A question can be raised about the estimation of the natural tax increases. It is largely based on the anticipated rate of economic growth which is usually computed five or six months earlier than the beginning of fiscal year. For an illustration, let us suppose that the GDP will expand 12 percent in the next year. Based upon this anticipated rate, the MOF usually estimates what the natural tax increases will be; for instance, more than 500 billion yen. In doing so, some non-economic factors may be easily introduced into the calculation to bias the anticipated rate of economic growth. In most cases, an intentional underestimation of the GNP growth rate was proposed in order to decrease the expected amount of the natural tax increase used as a financial resource at this stage of budgetary preparations. Thus, since at the end of each fiscal year, the realized rate of growth was always much higher than the anticipated rate, (see, **Figure 3**), an enormous natural increase in tax revenues materialized during the

Figure 3 Actual and Anticipated Rates of Economic Growth for 1955–1995



Source: National Budget (MOF), Annual Report National Accounts (EPA).
 Note: In calculating the actual rate, the SNA data are used after 1965.

intermediate term after the implementation of a new budget.

To sum up, the MOF's balanced budget policy played a dominant role in fiscal activities prior to 1965. The most important reason for this was that a rapid growth in GDP had continued to provide constantly enough increasing tax revenues enough to keep the general account of the national budget balanced. As a consequence, the MOF did not need to issue national bonds and was successfully able to sustain budgetary orthodoxy.

The explosion phenomenon of Japan's fiscal deficits accelerated since the late 1970s, as evident from **Table 1**. When the government was compiling the national budget plan for fiscal 1977, there appeared to be a general consensus urging the need to achieve an economic balance at the sacrifice of fiscal balance. At that time, in order to stimulate the depressed state of the world economy, the so-called "three engine countries" scheme was adopted by the Japanese government as a result of its obligation to international policy coordination with the US and W. Germany.

On the other hand, the MOF was endeavoring to return to a balanced budget by stressing the importance of building the fiscal structure on the basis of sound fiscal operations. This policy is not a Japanese monopoly, and the fiscal authorities of the US, the UK, Germany and France have been adopting a similar stand. Why, then, are the fiscal authorities adhering to the principle of a balanced budget despite rising criticism?

The principle of a balanced budget is opposed to Keynesian fiscal policy in the phase of policy management. Under Keynesian policy, the government is called upon to manipulate the fiscal surplus or deficit for properly coping with the domestic business boom or slump. From this standpoint, a policy stance of the fiscal authority that attaches top importance to the balance of fiscal actions is considered excessively lukewarm. However, it also remains to be re-

examined whether the policy prerequisite called fiscal policy could function smoothly and efficiently in reality.

It is generally understood that the stabilizing effect of fiscal policy today is theoretically self-evident. Nevertheless, it seems that it has not been sufficiently utilized by fiscal authorities in any countries in actual policy performance. This is not because fiscal authorities have been ignorant of theories, but because fiscal policy itself lacks adaptability to the real aspect of fiscal performance.

The Japan's MOF has persistently entertained misgivings about the practical adaptability of fiscal policy in the following three phases. First, fiscal actions may be utilized as a measure for stimulating business. However, it may not be easily and effectively adopted reversely for tightening business. The fiscal tightening of business conditions inevitably invites the increase of taxes and the decrease of government expenditures. Such an unpopular policy cannot be adopted easily particularly when the political situation becomes extremely unstable.

Second, under the circumstances, an excessive fiscal deficit is feared to ensue. Some argue that a fiscal deficit caused by the program for stimulating business can be erased with the natural increase in tax revenue in times of good business. However, the timing and the size of such a natural increase are not guaranteed.

Third, the departure from a balanced budget is liable to obstruct the function of resource allocation, the intrinsic function of fiscal operations. This principal function of fiscal operations to allocate limited resources efficiently without extravagance takes precedence over the economic stabilizing function, except under extraordinary circumstances, such as an acute recession.

The principle of a balanced budget should not be unconditionally aban-

done as such adverse events take place, although it is stressed that the adjustment of business conditions through fiscal operations is extremely important.²⁾

3.2 Main Causes of Expanding Fiscal Deficits

Fiscal deficits began to expand rapidly since the first oil shock in 1973, and the situation worsened at the outbreak of the second oil crisis in 1979. The MOF made a great effort in restricting the bond dependency ratio to below 30 percent in preparing the initial budget, but finally the effort failed. It is clear that the MOF has been very reluctant to permit the pursuit of persistent deficit financing, as evident from the past trend of fiscal deficits (see, Ishi 1986). At the outset, national bonds were issued in accordance with the “construction bond rule” which was strictly adhered to in each year before 1975. However, with the massive amount of bond floatation described above, the government was compelled to abandon this rule. Debt-covering bonds began to be issued on a large scale in both the 1975 supplementary budget and the 1976 budget, as noted above. In addition, the floatation of debt-covering bonds has continued to expand as if they were a regular financial sources contrary to “the construction bond rule.”

Then, what were the main causes of the sharp rise in fiscal deficits in the past? Particular attention should be paid to two periods, 1975–79 and 1991–96,

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- 2) In this context, two compromise plans were advocated some time ago. The first plan calls for balancing fiscal operations on the basis of full employment. This is the important concept of full employment surplus. (See, for instance, Okun 1971, Okun and Teeters 1970.) The second plan aims at achieving a budget balance within a radius of one business cycle featured by a boom and a slump. The latter plan is considered to be a helpful suggestion for Japan. Generally called the “Swedish Formula,” this plan calls for erasing the deficit in the recession period with a surplus in the boom period. Whether this plan may function practically depends upon whether the fiscal operation may be applied for tightening business and whether the natural increase in tax income in the boom period may be reserved as a fiscal surplus. (See, Myrdal 1939, Hart 1961.).

when the bond dependency ratio expanded tremendously. A number of factors are considered to have been behind the rapid expansion of fiscal deficits in the relevant periods, but the following two are of most importance among them.

First of all, great emphasis should be placed upon the strong requirement of implementing fiscal expansionary policies to stimulate the conspicuous slow-down of Japanese economic growth, caused by the two oil shocks in the late 1970s and the collapse of bubble in the early 1990s. Massive expansionary measures in light of public investment have been triggered during the periods under consideration, leaving vast fiscal deficits in its wake. Also, prolonged recessions accompanied by lower growth rates tended to produce large revenue shortages in the budget, which in turn accelerated the increasing tempo of fiscal deficits (see, Ishi 1982).

As for the second factor explaining the large increases in fiscal deficits, we should take note of the expanded role that the Japanese government has played with respect to income maintenance, free health care, education etc. This is particularly related to the first hump in the dependency ratio which occurred in the late 1970s. In the early 1970s, important institutional reforms were completed in the social security system as apart of a slogan to construct a welfare state in Japan. The target was to catch up with the Western level of social welfare programmes through a public pension, medical care, etc. It was generally pointed out that Japan had lagged behind Western countries in the development of social welfare policies. Ironically, it was in 1973 that new social welfare programmes were launched and they were expanded as largely as those in other countries. Therefore, the year 1973 is often called “the first year for constructing the welfare state” (see Noguchi 1983).

Although many new social programmes were built in the system at that time, it had been expected that the high rate of growth would continue in the

future and would thus generate the additional resources needed to finance the higher public expenditure. Unfortunately, in the decade that followed 1973, the rate of growth fell considerably in Japan, as well as in most industrial countries.

Since 1973, in spite of reduced growth rates, the prevailing mood of the time created high expectations on the role that the government should play beyond public sector activity. The frontier of what was considered as justifying public sector intervention was progressively pushed outward. The greater subsidization of public services, or even their free provision, made them cheap to the users, thus increasing the demand for them. People came to feel that they had almost a natural right to use cheap or free public services. In a democratic society where election campaigns are constantly indispensable to be reelected, the political process generally favored the expansion of public provision.

If the cost of the public provision had been totally covered by ordinary revenues, there would have been no problem in providing increased public services. However, while the electorate pushed for higher spending, it was far less supportive of the tax increases that would have been needed to finance that spending. To make matters worse, as noted below, tax revenues were substantially reduced, reflecting the slowdown in economic growth. The gap between government spending and revenue grew, contributing eventually to the higher level of fiscal deficits.

It seems that these two factors to explain large increases in fiscal deficits are more or less common among major industrial countries, including the US and Japan. The question is how this problem should be solved in each country.

3.3 Fiscal Deficits Caused by Tax Shortages

In addition to the above two policy measures as explanatory factors of expanded deficits, we must pay special attention to tax revenue shortages which

automatically occurred during recessionary periods. Deficit financing is practically the only means available for dealing with revenue shortages. As a consequence, it is necessary to examine the nature and causes of the tax shortages in order to understand why deficits have been piling up since the debt explosion started in the 1970s.

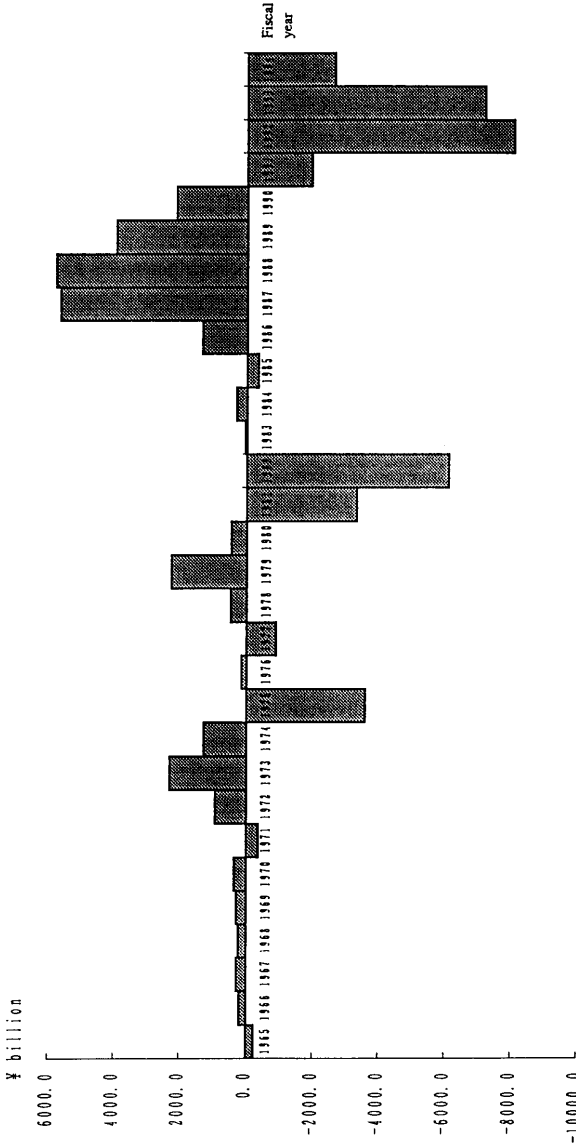
By definition, a tax shortage is a shortfall in the tax revenue at the end of the year as compared with the amount of revenue forecast in the year's initial budget. **Figure 4** shows the tax shortages and surpluses that have been recorded since fiscal 1965. Fiscal deficits were virtually not important in the period of rapid growth, which lasted until the early 1970s, so neither were tax revenue shortages. The only two exceptions were fiscal 1965 when a deficit of ¥238 billion was recorded, and fiscal 1971 when the shortfall amounted to ¥365 billion. These occurrences were closely tied with recessions.

During the mid-1970s, however, tax shortages began to take on serious proportions. The stagnation of the Japanese economy in fiscal 1975 following the first oil crisis resulted in a colossal shortfall of ¥3.6 trillion. Then the second oil crisis plunged Japan into economic recession again, bringing about the large revenue shortages of the early 1980s.

We can observe that huge tax surpluses have been incurred in the second half of the 1980s during the bubble boom, and that the situation turned to the reverse in the early 1990s as the bubble phenomenon burst. Evidently, tax revenue surpluses and shortages have been closely related to the variation in fiscal deficits, with a few exceptions.

Tax shortages have conventionally been attributed to a slowdown in the growth rate of the Japanese economy, but this interpretation is not entirely correct. The basic cause of shortages has been exaggerated predictions of the growth rate. Although separate estimates of revenue are compiled for each

Figure 4 Tax Revenue Shortages and Surpluses



Source: Ministry of Finance, Tax Bureau, *Primary Statistics of Taxation*, each year.

Note: Tax revenue shortages are defined as a negative gap between settlement revenues at the end of the fiscal year and the initial budget revenues, while a positive gap generates surpluses.

category of taxes, these estimates are based largely on the growth rate forecast in the economic outlook that the government releases at the end of every calendar year when it is almost finished compiling the next fiscal year's budget draft. Individual income and corporate taxes, which account for a major proportion of the revenue, are directly influenced by the growth rate. If the actual growth rate is lower than the forecast rate, the result is a tapering off of revenue during year.

Observing both **Figures 3** and **4** simultaneously, the unrealistically high growth expectations in 1971, 1975, 1977, 1981–82 and 1991–94 corresponded with years of a tax shortfall. The important issue here is that the government has consistently overestimated the growth rate since the mid-1970s except during the bubble period of 1987–90. We cannot gloss over this failure of the EPA's planners to estimate the growth rate accurately at the beginning each year. In view of the fact that exaggerated estimates of the growth rate are the prime cause of tax shortages, we must ask why this pattern has been repeated year after year.

Perhaps at times the forecasting problems have been purely technical in nature or due to unforeseen factors. However, if political motives are also involved, it would mean that past tax shortages were artificially created phenomena to some extent, not unavoidable and unpredictable deficits. For instance, we could conceive that this was the situation that arose during the process of compiling the budget for fiscal 1982. This view that exaggerated estimates of the growth rate by the government were politically motivated was beginning to gain a wide following. Unrealistic revenue estimates based on an excessively high growth rate made compilation of the fiscal 1982 budget easier, preserving a considerable amount of expenditures in areas of lower priority. Overestimation of revenue made it possible to avert demands for drastic expenditure cuts.

During the Diet debate on the 1982 budget, the opposition parties repeatedly pointed out that the revenue estimates were too high. Merely by recalling what happened in the Diet, we can see that revenue estimates for that year were considered excessive even when the budget was being compiled. Thus the fiscal 1982 revenue shortage was an anticipated result (see, Ishi, 1982, P. 10, Hollerman 1988, p. 95). The same phenomena have, more or less, occurred when anticipated rates of growth were higher than actual rates in the past years.

Obviously, the floatation of deficit-covering bonds is closely linked to tax shortages. Avoiding tax shortages is one of the means of reducing deficits. It will be, however, virtually impossible to eliminate shortfalls altogether because unenforceable movements in economic conditions occur from time to time. Still, it should be possible to reduce shortfalls to a considerable extent by breaking the chain linking the overly high economic growth predictions with unrealistic estimates of tax revenue.

Lower revenue estimates necessitate greater strictness in the compilation of budgets. This strictness is, in fact, exactly what is needed for fiscal consolidation. It might even be well advised that forecasts of economic growth be made to err on the low side and that the tax revenue be estimated conservatively. Even if the actual economic growth rate were to exceed the prediction, leading to a revenue surplus like during the 1960s, early 1970s, and the late 1980s, the extra funds could easily be used to reduce national bond issues.

3.4 Conflict between the Keynesian View and the MOF's View

Before 1973 when the first oil shock occurred, the government had almost never needed to employ expansionary fiscal policies in order to stimulate the Japanese economy. In fact, with a few exceptions, no Keynesian policies were required reflecting the buoyancy of aggregate demand. (see, Ackley and Ishi 1976.)

However, the oil shock caused real income to fall to a great extent not only in Japan but also in the rest of the world. Most countries fell into a depressed economic state with rampant inflation. The US, W. Germany and Japan were urged to take expansionary measures in accordance with the new idea of them being the “three locomotive countries”, as described earlier. In 1978, the Japanese government constructed a very stimulative budget in light of the large increases in public investment to expand the stagnant economy in the world. This experience is regarded as the first introduction of Keynesian fiscal policy to Japan.

With a background of prolonged recessions since the oil shock, fiscal activism in favor of stimulative measures began to emerge as a powerful device for attaining full employment. As a consequence, fiscal deficits became a means of achieving this objective. The same holds for the case of anti-recessionary policies after the collapse of bubble in the early 1990s. In parallel with the expansion of the welfare program as stated before, such fiscal activism clearly played a vital role in increasing the huge amount of fiscal deficits. Faced with the continued rise of national bond issues, the economists’ views were divided into two groups, one being Keynesian, and the other anti-Keynesian.

The Keynesian group is generally composed of specialists majoring in macroeconomics, or the staff at MITI, the MOC or the EPA. The Keynesians usually push the government to take on an expansionary budget, say, in the form of tax cuts and increases in public investment. Their target for achieving the rates of real growth is always higher than the government’s officially anticipated figure, mainly because they believe that the potential path of Japan’s economic growth must be higher. As a consequence, the Keynesian groups ignore too often the accumulative effects of a chain of fiscal deficits. They feel optimistic about debt accumulation, which would be naturally reduced by the gen-

eration of tax revenues in a growing economy. According to the Keynesian view in Japan, it is more important to achieve a higher rate of growth than to eliminate fiscal deficits.

On the other hand, a view contrary to the Keynesian view is strongly supported by public finance specialists or the MOF staff. They compose the anti-Keynesian group. Generally speaking, a traditional embarrassment of fiscal deficits and growing public debts seems to be quite common to this group. They place more emphasis on the traditional principles of sound finance—that is, no deficit is justified if associated with unproductive investments, or current expenditures, or if permanent differences between expenditure and revenues result. In the view of the anti-Keynesian group, a fiscal deficit may be beneficial with respect to this year's economic performance especially when the economy is working at less than full capacity, but it may be harmful with reference to future economic performance if it leads to excessive increases in public debt. Thus, they are usually worried about debt accumulation, and emphasize the necessity of reducing it.

These two views, which are quite different regarding debt accumulation, have conflicted with each other over the past decades. Relatively speaking, I myself support the anti-Keynesian position, although I admit the necessity of stimulating the economy by issuing national bonds in a severe depression. It seems to me that the present fiscal deficits are growing beyond acceptable cyclical deficits. If deficits were mostly cyclical, they would grow during recessions and swing into surpluses during recoveries. This being the case, the public debt would not accumulate over time. The present situation seems to be different; today's deficits are not cyclical but structural. Structural deficits would remain "high" even if full employment is achieved.

Also, the interest rate on national bonds has exceeded the nominal growth

rate of GDP for the past several years. For example, the latter is estimated to be 3.50 percent for 1996–2000 by the new economic plan of the EPA,³⁾ while the former has been fixed at about 5 percent in recent years in order that the bonds they sell well in the market. In accordance with the famous Domar model (see Domar 1944), from a theoretical consideration, the ratio of interest payments to nominal GNP will not converge if the present rates of economic growth or interest rates continue. This being the case, it may be argued that a large debt at present would eventually bankrupt the government.

4. Strategies for Deficit Reduction

4.1 Why is Deficit Reduction Necessary?

It is often argued that fiscal deficits need to be curtailed when accumulated, not only because of their harmful effect on the economic performance of a nation, but also because of the burden on the budget and future generations caused by interest payments on the public debt (see, for instance, OECD 1995).

Theoretically speaking, there are three negative effects on the macro side of the economy derived from the expansion of fiscal deficits.

1. Inflation
2. Crowding-out effect in the fund markets
3. Currency depreciation

These damages have in practice occurred during the past economic performance of major countries, such as the US, the UK, France, German, etc. For instance, Germany has been constantly concerned with potential inflation caused

3) In 1995, the EPA published a new economic plan entitled the *Social and Economic Plan for Structural Reforms* to cover the projection period of five years from 1996 to 2000. Two kinds of average growth rates of real and nominal GDP (both are estimated to be the same) are presented as follows: 3.50 percent with structural reforms, and 1.75 percent without structural reforms.

by accumulated debt in the past. France is suffering from a high rate of interest and crowding out in the fund markets after fiscal deficits have expanded rapidly. Moreover, all European countries are embarrassed about their currency depreciation due to a weakening of their credibility resulting from expanded debt. That is the reason why each country has been worried about the current debt accumulation and has embarked on its own deficit reduction, as argued earlier.⁴⁾

By contrast, in contemporary Japan, fiscal deficits are not likely to induce possible harmful effects on the economy as a whole. In particular, it has generally been argued that Japan is still maintaining the highest rate of saving among major countries. This argument would perhaps have been supported in the 1970s and 1980s. For instance, in terms of the personal saving rate in 1983, Japan had 17.3% while W. Germany had 11.4%, France 11.5%, the US 5.0%, and the UK 7.0%. The extent to which fiscal deficits crowd out private investment depend on the rate of personal saving of the country. A country like Japan with a high rate of personal saving that exceeds its domestic investment opportunities can easily finance its own investment as well as its fiscal deficit. This is to be contrasted with the US experience in which an increasing share of savings has been appropriated to fiscal deficits because of a very low saving rate.

However, Japan's advantage has begun to disappear in recent years. In fact, the personal saving rates in Japan, the UK, France and Germany excluding the US, ranged between a band of 13–15 percent in 1992. (See, Tachi eds. 1995, p. 304.) It is difficult to find evidence of Japan's superior position in terms of its personal saving rate in recent years. Furthermore, it is pointed out that Japan's saving rate will begin to diminish to a considerable extent from around 2005

4) See Ishi ed., 1996. In this literature, a number of interviews overseas, in which I myself have participated during 1995–96, are included.

when the baby-boomer begin to retire from their jobs (See, for example, Group of Ten.)⁵⁾

In addition, the sharp rise in debt redemption and interest payments caused by an accumulating debt poses serious problems to the performance of government fiscal activity. As observed in **Table 2**, large increases in national bond floatings have made national debt service and interest payments by far the fastest growing component of public expenditures. This was true at least until the burst of the bubble. If we examine the movement of interest payments as a percentage of public expenditures in the general account, we note that it has rapidly increased since the balanced budget principle had to be abandoned. In 1971, for example, interest payments were 2.2 percent of public expenditures, while by 1987 this payment increased over 7.5 fold, reaching 20.2 percent. Thereafter, this ratio has begun to slow down to 16.4 percent in 1995, reflecting both the effects of deficit reduction during the bubble period and the lower rates of interest. However, it will turn upward again, and will grow swiftly, given the continued accumulation of fiscal deficits in the future. The same holds for the long-run trend of national debt services, which has sharply expanded from 3.4 percent in 1971 to 21.8 per cent in 1996. This growth will swell public expenditures, increasing the relative portion of entitlements in the total, which will essentially make budgeting more rigid every year. In Japan, such rigidity in the budget is considered as a serious problems related to expanded deficits. No doubt, fiscal deficits are feeding upon themselves through the interest component of public expenditures, making their curtailment more difficult.

5) Furthermore, C. Horioka's analyses should be noted. He is trying to explain that Japan's high savings rate among household has so far been dependent on the younger age structure, but that it will decline as the population is ageing in favour of the life-cycle model. (See, Horioka 1995 and 1996, Horioka et al., 1996.) See, for another interesting paper, Kawasaki 1986.

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Table 2 National Debt Charges and Interest Payments

(¥ billion, %)

Fiscal year	Debt Services	Interest Payment	As a percentage of general account expenditure	
			Debt Services	Interest Payment
1971	319.3	203.0	3.4	2.2
1972	455.4	313.9	4.0	2.7
1973	704.5	448.1	4.9	3.1
1974	862.2	574.7	5.0	3.4
1975	1,039.4	733.5	4.9	3.4
1976	1,664.7	1,328.9	6.9	5.5
1977	2,348.7	1,931.6	8.2	6.8
1978	3,222.7	2,628.0	9.4	7.7
1979	4,078.4	3,339.8	10.6	8.7
1980	5,310.4	4,417.3	12.5	10.4
1981	6,654.2	5,565.3	14.2	11.9
1982	7,829.9	6,465.0	15.8	13.0
1983	8,192.5	7,905.0	16.3	15.7
1984	9,155.1	8,865.7	18.1	17.5
1985	10,224.1	9,878.5	19.5	18.8
1986	11,319.5	10,604.8	20.9	19.6
1987	11,333.5	10,942.8	20.9	20.2
1988	11,512.0	11,082.7	20.3	19.5
1989	11,664.9	11,132.1	19.3	18.4
1990	14,288.6	11,069.4	21.6	16.7
1991	16,036.0	11,930.1	22.8	17.0
1992	16,447.3	12,125.7	22.8	16.8
1993	15,442.3	11,661.4	21.3	16.1
1994	14,360.2	11,587.5	19.6	15.9
1995	13,221.3	11,650.5	18.6	16.4
1996	16,375.2	11,830.2	21.8	

Source: Data from the Ministry of Finance.

Note: Figures are all from the initial budget of each year. National debt charges contain both debt redemption and interest payments.

Apart from such in-budget difficulties, the expanded deficits tend to generate another issue, that of intergenerational inequity via future the tax burden arising from redemption and interest payments. Although controversial arguments have been repeated regarding the shifting of the public debt burden to future generations, it would not be unreasonable to conjecture that future generations should certainly bear the burden of public debt through possible tax increases (see, for example, Buchanan 1958, Wiseman 1984).

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In recent years, special attention has been paid to the generational accounting approach to answer how much future generations will have to pay in net burdens (i.e., tax and social security contributions) as compared to today's generation (see, Kotlikoff, 1992). The concept of generational accounting originally emerged as an alternative measure of the deficit, espousing that the current deficit measurement should be discarded and replaced by this new concept. Alternatively, generational accounting would be of great use in calculating the inter-generational burdens implied by the current tax and spending policies. Thus, relevant calculations have begun to appear in relation to a number of countries, such as Sweden (see, for instance, R. P. Hagemann and C. John, 1995).

In Japan, the EPA calculates the result of generational accounts, as seen in

Table 3 The Results of Generational Accounting in Japan

(¥ thousand)

Generational age in 1992	Present value of net burden	
	case 1	case 2
Over 60	-66,669	-52,526
50 - 59	-7,656	-15,221
40 - 49	9,625	9,976
30 - 39	20,734	26,490
20 - 29	26,266	37,322
Future generation	39,674	—
Difference from age 20 - 29	13,408	—

Source: Economic Planning Agency, *Economic Survey, Fiscal 1995*.

Note: The results in case 1 estimate merely the future net burden, excluding the past burden and benefit, while those in case 2 include them..

Table 3, broadening the coverage of estimation to include not only future but also past burden-benefit relations. There are a couple of interesting point worth noting. First, the size of the net burden varies with age, with the older generation over the ages of 50 and 60 enjoying a net benefit, rather than a net burden. On the other hand, the younger generation under the age of 40 must pay more taxes and social security contributions than they receive in public services over a lifetime to a great extent.

Second, the net burden on future generations would be the largest among all age groups, with future generations paying an additional ¥13,408 thousand as compared with that of the youngest current generation of age 20. This result is important in our context, because the accumulated debt is assumed to be borne by future generations. No doubt, it is conjectured that the public debt burden could be shifted to future generations in Japan, given the current budgetary system.

Given both the macro and micro effects, currently and in the future, of accumulated debt, it is very clear that the Japanese government should launch into a reduction of fiscal deficits and restrain the rise of the outstanding debt relative to general economic activity in the nation.

4.2 Strategy for Fiscal Consolidation

Since the public debts have begun to accumulate to some extent, greater importance has been placed on the establishment of specific targets for deficit reduction every year or at least within certain periods in major countries. For instance in the US, the federal government has recently enacted the Omnibus Budget Reconciliation Act (OBRA) in 1990 and in 1993 for expenditure cuts in which the so-called “caps” (upper ceilings) were put to restrain deliberate (non-entitlement) expenditures within a fixed limit (i.e., average growth rates of 0.1 per

cent in real terms). Furthermore, an attempt for restoring the budget balance by 2002 has been established in fiscal 1995 by the Presidential Budget Statement and Budget Resolution, although strategies for expenditure cuts are different among the Democrats and the Republicans. As a consequence, government shutdowns were incurred twice in 1995. In addition to setting forth caps on deliberate expenditures, the pay-as-you-go rule⁶ was permanently introduced to maintain a fixed level of entitlement expenditures for recovering the balance of the federal budget.

Likewise, the UK government has attempted to restrain the real growth rate of general government expenditures to less than 1.5 percent every year under the *control total scheme* which has been executed from 1993. In Germany, the ratio of general government expenditures to GDP is targeted for reduction to 46 percent (i.e., Germany's pre-unification level) by the year 2000 with a simultaneous reduction of 1 percent in the deficit-GDP ratio. In addition, the tax burden relative to GDP ought to be lowered to 23.5 percent by the year 2000. These targets are included in the *Mid-term Fiscal Strategy* of the Federal Ministry of Finance. The French government also constructed targets for reducing the deficit ratio by 1 percent each year by fiscal 1997 in order to satisfy the 3 percent target in the Maastricht criterion.

Similar to the strategies for deficit reduction in other major countries, the Japanese government established a target for fiscal consolidation; zero dependency on deficit-covering bonds by a specific year. The first target was set to eliminate deficit-covering bonds as a source of financial revenue by the end of fiscal 1980, reflecting the rapid expansion of fiscal deficits in the late 1970s.

6) Any increases in entitled-expenditures should be ensured by either relevant tax increases or across-the-board expenditure cuts. Thus the use of the term *pay as you go* indicates that we are using here quite a different concept from that implied by an unfounded pension fund.

However, the government failed to achieve its initial target for fiscal consolidation, given the state of over-expanded fiscal deficits. Thus, the government had to continue its efforts for expenditure cuts towards the second goal of fiscal 1984.

The second target was also unable to succeed in avoiding the issuance of deficit-covering bonds within the period, mainly because a massive revenue shortage emerged from the world recession after the second oil shock. Once again the government was forced to set a third target to restore the budget balance by fiscal 1990. The new goal was fortunately achieved in fiscal 1990 by employing a windfall increase of tax revenues due to the bubble boom, as will be argued in detail shortly.

In the process of fiscal consolidation, a guideline for budget requests was adopted from the second half of the 1970s. The guideline for expenditure cuts is the “ceiling” strategy. In the course of preparing the budget, usually at the end of August of the previous year, the MOF sets a maximum ceiling for the budget requests of all ministries and agencies for the next fiscal year. **Table 4** summarizes the guidelines in the 1980s when the ceiling strategy began to be applied strictly to government expenditures. A “zero ceiling” means that budget requests are to be frozen at the level of budget appropriations for the previous fiscal, and a “negative” ceiling means that the request must stay below the preceding year’s budget allocations. During the period of rapid economic growth in the 1960s, even 30–50% increases were sometimes allowed for budget requests as a whole, in sharp contrast to the situation in the 1980s.

With the full-fledged introduction of the ceiling strategy, some categories of government expenditures have been held to the levels of the previous budget from fiscal 1978, and furthermore no increase has been allowed for any non-entitlement spending categories since the fiscal 1982 budget under the zero ceil-

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Table 4 The Guideline of Ceilings for Budget Requests

Fiscal year	Ceiling		Ad hoc expenditure scheme (¥ billion)	NTT scheme (¥ billion)
	Current exp.	Investment exp.		
1982	0 % increase			
1983	5 % decrease	0 % increase		
1984 - 87	10 % decrease	5 % decrease		
1988 - 90	10 % decrease	0 % increase		1,300
1991	10 % decrease	0 % increase	Enhancement of the quality of life 200	
1992	10 % decrease	0 % increase	1) Enhancement of the quality of life 200 2) Promotion of public investment 200	1,300
1993	10 % decrease	0 % increase	3) Enhancement of the quality of life 250 4) Promotion of public investment 200 5) Improvement of R & D 110 6) Repayment to NTT scheme 80	1,300
1994	10 % decrease	5 % decrease	Repayment to NTT scheme 290	1,300
1995	10 % decrease	5 % decrease	Promotion of public investment 300	1,300
1996	10 % decrease	5 % decrease	1) Fundamentals of economic development and R & D 140 2) Promotion of public investment 300	1,300

ing. Finally, the negative ceiling was adopted in the fiscal 1983 and 1984 budgets. The 1985–91 budgets were drawn up under the negative ceiling strategy with some exceptional cases for investment expenditures.

While the zero and negative ceilings were introduced into current and investment expenditures, an ad hoc allotment scheme has been applied to specific areas of expenditure on items on which are generally considered to be of more importance, separate from other expenditures. For example, certain lump-sum funds were allocated to the expenditure for enhancing the quality of life in 1991–93 and for the promotion of public investment in 1992–96. As noted below, similar financial resources under the NTT scheme have been given to certain

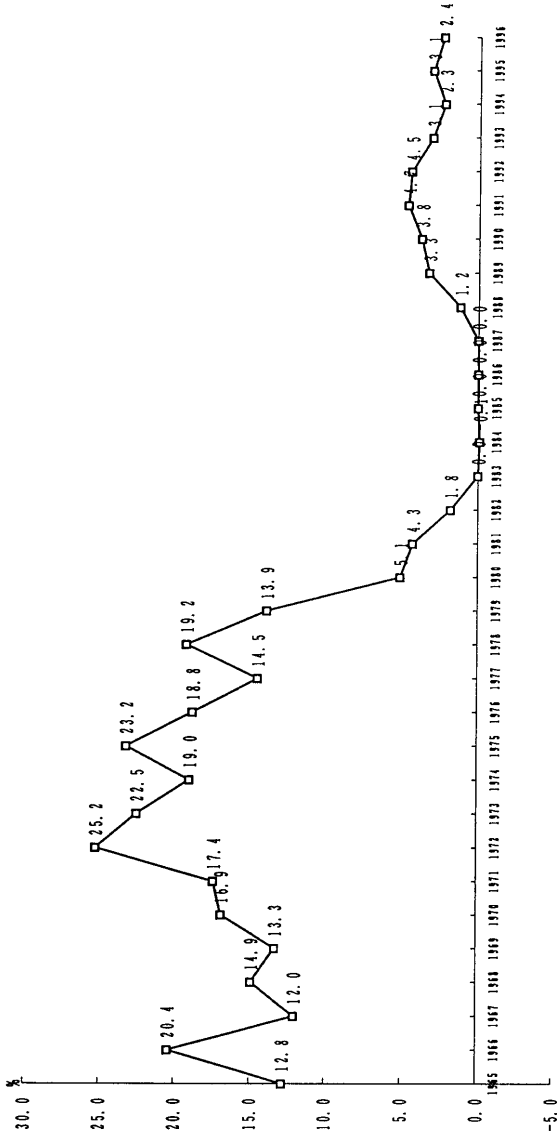
public work projects on an ad hoc basis since 1988.

Since the ceiling strategy was introduced in the budgetary process, the government has succeeded in keeping the budget from growing, despite strong requests for budget increases from political interest groups, many ministries and agencies.

As **Figure 5** depicts, the rise in non-entitlement government expenditures, which exceeded 20% per annum in some years during the rapid growth period, has slowed to less than 10% per year since fiscal 1981. Of the various expenditure categories, national debt services and tax-share grants to local governments are “entitled” or not subject to expenditure cuts. Thus, the targets of the MOF’s proposed expenditure cuts are other “non-entitlement” government expenditures. Indeed, these expenditures have shown virtually zero growth in the late 1980s, and thereafter their growth rates have been restrained to one-digit increases. However, a substantial rise in such expenditures have begun once again, reflecting the adoption of fiscal expansion in the early 1990s.

Figure 4 may be misleading. It is drawn using conventional non-entitlement government expenditures within the scope of the general account, but in the 1980s fiscal “window-dressing” became prevalent on the expenditure side of the budget. To restrain the growth rate of non-entitlement expenditures to zero, fiscal “window-dressing” on the expenditure side became more significant every year. It takes the form of excluding various categories of expenditure from the general account budget which should correctly be assigned there. For instance, a portion of the transfers to the social insurance accounts has been postponed, not appropriated. This represents borrowing which should be included in the expenditure side of the current fiscal year. In general, the MOF was successful in making the true expenditure position obscure and fostering the impression of adherence to “fiscal consolidation with expenditure cuts” to

Figure 5 Percentage Change of Non-entitlement Expenditures from the Preceding Fiscal Year: 1965–1996



Source: The same as Figure 4.

the public.

4.3 The Rincho and Administrative Reform

Since the deficits in Japan are largely structural, they have to be reduced through basic changes in the level and pattern of public expenditures and in the tax system. In this case, it seems that a Keynesian type of policy cannot be of any help in reducing fiscal deficits. Keynesian policies are merely temporary, stop-gap measures. Of course, stop-gap measures help in reducing debt accumulation, but they do not bring permanent solution to the fiscal unbalance. Permanent solutions require permanent measures. Structural reforms become necessary when debt accumulation results from structural deficits.

Keynesian policies may be able to bring about a short-run reduction in the public debt through the natural increase of taxes generated by a higher rate of growth. However, they will not cure the disease of debt accumulation. Furthermore, we must note that the economic realities since the oil shocks dictate that there would be no more continued high-speed expansion of business conditions. Given the future performance of the economy, tax revenues on a large enough scale to reduce automatically the accumulation of public debt could not be expected. The scenario drawn by the Keynesians is not likely to be realized.

Since the emergence of the public debt explosion in the late 1970s, the much needed reductions in Japan's huge fiscal deficits have progressed only at a snail's pace in the early 1980s because political considerations and other factors prevented the government from implementing either full-fledged tax increases or expenditure cuts. The fiscal deficits afflicting Japan and many of the advanced countries were caused by structural and not cyclical factors.

Structural fiscal deficits can be eliminated only by sweeping reforms in both the expenditure and revenue structures. On this point, the new strategy of

“administrative reform” which the government adopted in 1981 can be evaluated highly as the proper policy choice in Japan. At first, the government intended to contain the size of the fiscal deficits by tax increases, rather than expenditure cuts. In fact, the introduction of a new value-added tax (VAT), called the general consumption tax, was attempted by then Prime Minister Ohira in 1979, but it was a complete failure. As a result, it became politically very difficult to introduce enough tax increases to reduce the public debt, and the government had to change its policy stance from a reliance on tax increases to expenditure cuts (see, Lincoln 1988, Chapter 3, Ishi 1993, Chapter 15).

In particular, the Ad Hoc Committee for Administrative Reform (The Rinji Gyosei Kaikaku Chosakai—or Rincho in short), established in 1981, had been playing an important role, backed by nation-wide support, in preventing the government from growing further. The Rincho recommended expenditure cuts and reviewed the activities and functions of government-affiliated institutions under the slogan of “fiscal consolidation without tax increases”. As argued earlier, in accordance with the Rincho activities, the government set a maximum ceiling on the increase in public expenditures relative to the previous year for the compilation of the new budget every fiscal year. No doubt, this “ceiling” method was supported and intensified by the Rincho.

The main aim of the Rincho was to promote administrative reform in order to solve Japan’s fiscal crisis, which was at the core of the Rincho’s concerns. The Rincho embraced two other goals, that of restructuring the fiscal structure and reducing the size of the government, as expounded in yet another slogan, “small government.” When Prime Minister Zenko Suzuki established the Rincho in March 1981, he declared that he would stake his political life on the achievement of administrative reform, in particular pledging that he would restore a balanced budget by fiscal 1984. However, as previously mentioned, he

decided to resign as prime minister in July 1982, mainly due to his failure in attaining fiscal consolidation by the deadline under consideration.

Administrative reform was widely approved by the general public, but inside the government it was true that both the bureaucrats and the politicians did not really want administrative reform and tried to avoid any significant reform in substance. Strong resistance against such new reforms was persistently shown to the Rincho members. Needless to say, the Rincho proposed various fundamental reforms which threatened to curtail certain ministerial privileges, and also to shift the relative distribution of ministerial power. In turn, politicians and vested-interest groups related to the relevant ministries and agencies were also threatened by the Rincho movement. They became allies when pressure had to be placed on the government to maintain their individual interests, although it was difficult to protest overtly against administrative reform. In other words, the typical tactic was “to convey gestures of agreement in principle, but to disagree with the particulars” (*soron-sansei, kakuron-hantai*).

Despite such struggles among the individuals concerned, administrative reform played a vital role in restricting the rise of government expenditures since its debut. In total, the level of non-entitlement government expenditures began to show a sharply decreasing tempo, as seen in Figure 6.4. In fact, the government’s effort to restrict expenditures by imposing a strict ceiling strategy toward the ultimate goal of “fiscal consolidation without tax increases” performed well in achieving its initial objective. All ministries and agencies slashed their budget requests to the minimum tolerable level. The government was compelled to revise laws and institutional systems to reduce expenditure. For example, two fiscal reforms were important. First, in fiscal 1984, the national health insurance system was revised to cut medical expenses to a certain extent. Second, in fiscal 1985, some of the national government grant-in-aids to local governments were

scaled back. Both measures represented drastic fiscal reforms by traditional Japanese standards, and they seem to have been feasible only under the ceiling and the prevailing mood of administrative reform.

Although it sounds like an innocuous name, apart from the mere administrative formalities, administrative reform contained a broader scope for political and economic reforms as well. The most noteworthy accomplishments of the process of administrative reform evidently were to move in the direction of privatizing the three public corporations on the basis of recommendations presented by the Rincho in 1982. In April 1985, both the Nippon Telegraph and Telephone Public Corporation, and the Japan Tobacco and Salt Public Corporation were simultaneously privatized to become the privately incorporated companies of NTT and JT (Japan Tobacco Inc). Furthermore, in April 1987, the Japanese National Railroad (JNR) was also reorganized and split into seven regional companies for passenger transportation (JR).

In view of fiscal consolidation, great importance was attached to the JNR reform which was the Rincho's chief priority. The JNR had continued to accumulate deficits since 1970, which had to be compensated by tax revenues from the national budget. The accumulated deficit was largely attributed to labour struggles, inefficient management, unprofitable local lines and so on. Thus, the privatization of JNR into JR greatly contributed to restoring the budgetary balance (see, for an expanded discussion, Hollermmman 1988, ch. 4).

4.4 NTT Scheme and Public Investment

When the Nippon Telegraph and Telephone Public Corporation was privatized into NTT in April 1985, two-thirds of its stock could be sold in the market, with revenues to be appropriated for the redemption of national bonds issued by the government in the past. At the outset they were reverted into the Special

Account for the National Debt Consolidation Fund, and then a substantial amount of funds began to accumulate in this special account through the favourable sale of NTT stock in the market from fiscal 1986 to fiscal 1988.⁷⁾ Total revenues of about ¥10,000 billion were generated from the stock sales during these years.

Thus, a new scheme named the NTT programme was established by using the accumulated funds to promote the enhancement of social infrastructure in the fiscal 1988 budget. This was a device established to improve the level of social infrastructure in the midst of falling financial sources for public investment due to the ongoing process of fiscal consolidation. The revenues from the sale of NTT stock were appropriated for making interest-free loans, despite the fact that they were legally required to be employed for the redemption of national bonds. No doubt, the maturing loans need to be repaid to the Special Account described above, and the loans made were strictly restricted to safe opportunities.

The NTT scheme was composed of the following three types of loans A, B and C.

- Type A……Interest-free loans to the construction of public facilities yielding profits for repayment within 20 years. A typical example is highway construction on the basis of self-liquidation by the Japan Highway Public Corporation. In a word, this is a type of profitable public works.
- Type B……Loans were made to stimulate local governments to implement public works. However, these public works are not expected to produce any profits for repayment, and so the national government provides the

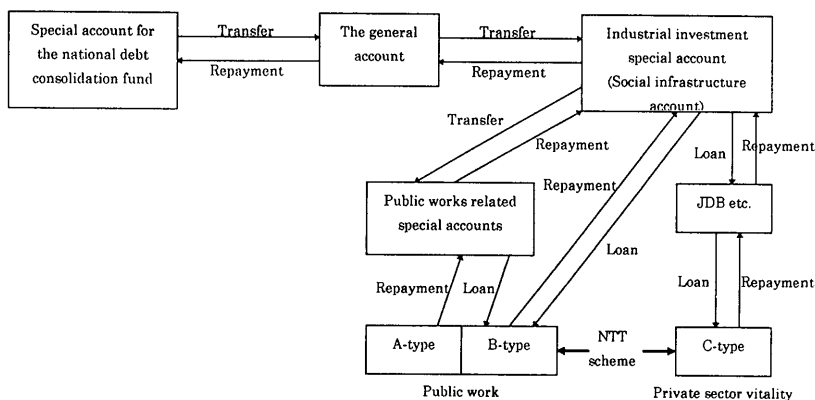
7) The price of NTT stock was first bid up to ¥1.6 million in the stock market when it was sold in 1986, and it sharply continued to rise to top ¥2.55 million in 1987, reflecting the stock boom in during the bubble.

subsidies necessary to repay the loans on maturity. This type of loan has to be repaid within 20 years. This is a kind of ordinary public works expenditure.

- Type C.....The loans made to the third sector had to be capitalized partly by local governments and/or other public corporations, such as the Japan Development Bank. The basic aim was to apply the projects to revitalize the private sector. This type of loans must be repaid within 15 years.

An outline of the NTT scheme is roughly delineated in **Figure 6**. A portion of the revenues from the sale of NTT stock which are deposited in the Special Account for the National Debt Fund, became interest-free loans that were picked up and transferred to the general account. Moreover, the funds for such a loan are transferred to the Industrial Investment Special Account (included inside the Social Infrastructure Account) in order to be administered on a consolidated basis. The NTT scheme provides interest-free loans of types A, B and C either directly or indirectly (i.e., via public works related special accounts or the Japan Development Bank, etc.) from the Industrial Investment Special Account.

Figure 6 The NTT Scheme



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