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# 13            Coping with Fiscal Stress:                   Illusion and Reality in Central                   Government Budgeting in                   Japan, 1975–1997

Maurice Wright

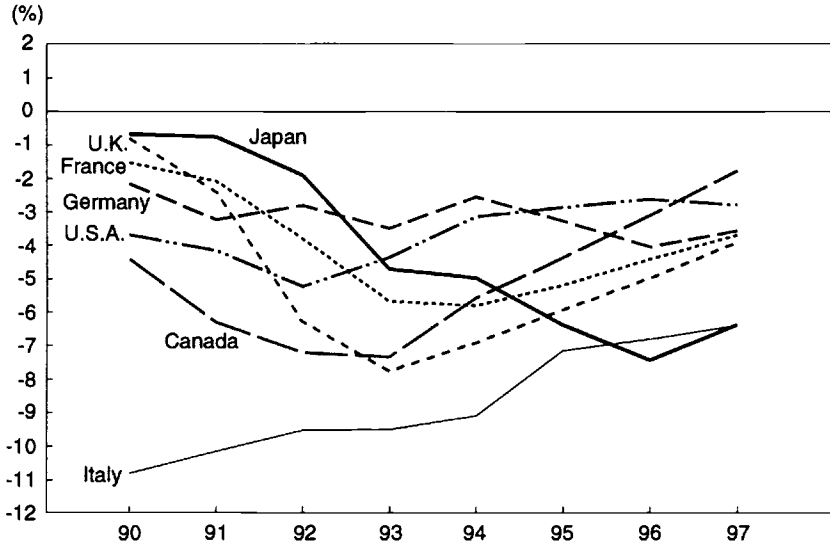
Most of the empirical studies in this volume present comparisons of budget rules and budget outcomes in different jurisdictions. Yet there are important insights to be gained by analyzing the detailed process of budgeting in a given nation in more detail than any cross-national or cross-jurisdictional study can allow. Detailed analysis of the factors that determine budget deficits can provide an empirical basis for evaluating models of deficit determination, such as the “common pool” model of Velasco (chap. 2 in this volume). This chapter focuses on the fiscal experience of the Japanese economy during the last two decades.

Japan’s fiscal situation in 1997 was the worst of any G7 country, having deteriorated rapidly with the collapse of the “bubble economy” in 1991 and the deep and prolonged period of economic recession that ensued, and from which recovery has been slow and modest. The deficit on the General Government financial balance in FY 1996 was 7.4 percent of GDP, with a gross debt of over 90 percent. The inclusion of the surplus on social security reduces that deficit to 4.8 percent, but even that figure is exceeded only by Italy among G7. More significantly, as figure 13.1 shows, all but Japan of the G7 countries have a trend from the early 1990s of improving financial balances. While gross debt continued to increase in all G7 countries, the rate slowed, leveling out in the early 1990s, but with the striking exception of Japan, as figure 13.2 shows.

Throughout most of the 1980s and 1990s, the governments of G7 countries experienced conditions of fiscal stress—budget deficits, accumulating debt,

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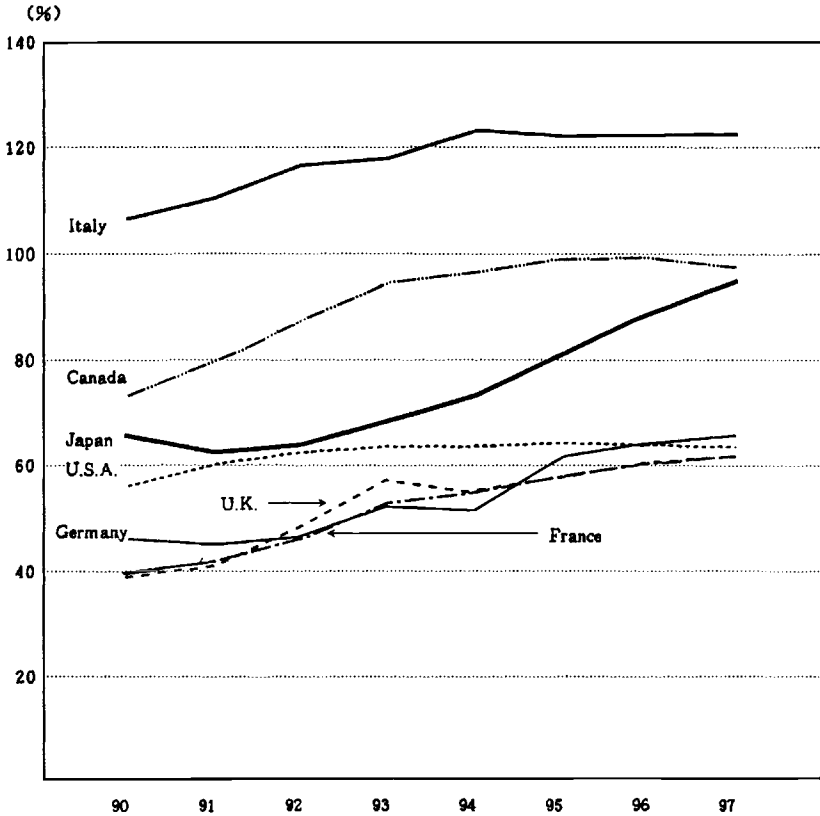
**Fig. 13.1** General government financial balance of G7, 1990–97 (% of GDP)

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

Note: Japan and U.S.A.: excludes social security.

and increasing costs of debt-servicing preempting increasing proportions of the total budget. Responding to those pressures, they attempted to reduce the level of deficit and debt and aspired to restore a balanced central/federal budget in the medium term. Many of the budget rules that are analyzed in other parts of this volume (see the summary in Alesina and Perotti, chap. 1 in this volume) have attracted attention precisely because they may affect deficit levels. This chapter explains how the Japanese central government coped with the conditions of continuing fiscal stress in the period 1975–97.

Analysts within Japan (e.g., Asako, Ito, and Sakamoto 1991; Shibata 1993; Kawai and Onitsuka 1996; Ihori 1996) and outside (OECD, *Japan Annual Survey*) attribute the improvement in Japan's financial balance on General Government expenditure that took place in the 1980s to the implementation of tough policies of fiscal reconstruction by Japan's Ministry of Finance (MOF). In doing so they fail to distinguish the appearance of discipline and control from the underlying reality. I shall argue that MOF was largely unsuccessful in reconstructing the fiscal system, and unable to control the growth of central government's spending, the primary cause of fiscal stress. After a brief introduction to the complexities of the Japanese budgetary system, and the various measures used to assess fiscal performance, the chapter traces the origins of the fiscal crisis of 1975. There follows an account of the aims and objectives of policies to "reconstruct" and "consolidate" the central government finances and an assessment of the effectiveness of their implementation. The concluding sections



**Fig. 13.2** General government gross debt of G7, 1990–97 (% of GDP)

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

explain why MOF failed to achieve its fiscal objectives, and compares it with the response of the U.K. and Canadian central/federal governments to similar conditions of fiscal stress.

### 13.1 Fiscal “Smoke and Mirrors”

Central government budgeting in Japan is complex, and the processes of making budgets opaque. Besides the main (General Account) budget, there is the Fiscal Investment Loan Program (FILP), the so-called second budget, and the budgets of 38 special accounts with hypothecated revenues and specific expenditures. Each year there is at least one, sometimes several supplementary budgets. In addition, there are 91 public corporations, part of whose capital expenditures and trading losses are defrayed from the main budget and FILP. Social security contributions are not counted as general revenues, but paid into

separate special accounts, which are, however, partly subsidized by transfers from the main budget. There are, annually, numerous complex cash-flow transfers of revenues and expenditures between the main budget, supplementary budgets, and FILP and between them and the 38 special accounts and the public corporations. There is a considerable potential for the manipulation of those transfers to relieve spending pressures on the main budget.

MOF and Japanese academic analysts tend to measure fiscal performance in terms of the central government's main budget, reflecting MOF's primary focus on fiscal objectives and targets set for it, rather than for General Government as a whole. In fact for a variety of fiscal and political reasons MOF emphasizes the limitations of analysis based on the concept of General Government as applied to Japan. System of National Accounts (SNA) calculations conventionally include the financial balances of social security funds. Japan's pension system is a partially funded system, accumulating funds in advance of payment of future benefits. MOF insists therefore that the accumulated surplus should be regarded as a debt owed to future beneficiaries and not as a source of revenue to offset expenditures elsewhere in the budget; and that with a rapidly aging population, the accumulated surplus will run down. MOF also argues that the conventional exclusion from calculations of General Government of the financial balances of public corporations gives a misleading picture because many of those corporations (especially the nine public finance corporations and two banks, like the Japan Development Bank) implement capital investment programs under the direct control of the central government, amounting to one-fifth of the total public fixed capital formation in Japan. They have been in deficit for most of the period 1979–97. The exclusion of the substantial surpluses on the social security fund, and the inclusion of public corporations' deficits therefore has a marked effect on the financial balance of General Government so defined. The resulting fiscal deficit is therefore much larger and more persistent than that of General Government measured according to the conventions of SNA. At various times in the 1980s and 1990s it was used by the Japanese Government as an important fiscal weapon with which to resist international pressures to stimulate the economy through additional public spending, allowing MOF to claim that apparent surpluses on General Government from 1987 to 1991 were in reality substantial deficits.

Leaving aside the argument about the inclusion of the deficits of public corporations, the exclusion of social security fund surpluses (which OECD concedes) qualifies the picture of progression from deficit to surplus on the overall General Government financial balance in the period of fiscal reconstruction in the 1980s. Thus defined, General Government remains in deficit throughout, although the size of that deficit was reduced.

A second qualification to the perception of successful fiscal reconstruction in the 1980s is that the reduction in the deficit on General Government calculated as a proportion of GDP is partly attributable to the growth of the latter,

especially in the period of the “economic bubble” from 1987 to 1991, when the greatest improvement in the deficit occurred.

To what extent was the (qualified) improvement in the overall financial balance of General Government directly attributable to the implementation of policies of fiscal reconstruction in central government’s budgeting? If we compare the contribution of the financial balances of central and local governments to the reduction of the deficit in General Government (excluding social security), the latter’s fiscal performance is superior. This was partly the result of the central government’s shifting the responsibility for the costs of fiscal reconstruction to subordinate levels of government. From 1977 local government’s deficit decreased annually from 1.8 percent of GDP, to achieve a surplus in 1988. Central government’s deficit on its financial balance increased until 1979, when it stood three times higher than that of local government. Thereafter it too decreased annually, but less rapidly; it never achieved surplus. More revealingly, central government borrowing increased faster than that of local government throughout the whole of the period of fiscal reconstruction, contributing more than three times as much to the overall gross debt of General Government. In 1974 central government’s gross debt was 16.9 trillion and local governments’ 9.9 trillion. By 1987, *before* the occurrence of the bubble economy, the figures were 211.5 trillion and 59 trillion respectively. As a proportion of GDP, central government’s gross debt increased from 12.2 percent in 1974 to 59.5 percent in 1987; local governments’, from 7.12 percent to 16.6 percent.

In the light of such evidence, how can we account for the persistence of the myth that MOF’s policies of reconstruction were succeeding in restoring fiscal discipline and control before the occurrence of the “bubble economy” in 1987 and the onset of the deep economic recession of 1991–95? The short answer is that through its rhetoric and the presentation of its fiscal performance, MOF *appeared* to have controlled central government spending, an image consistent with its reputation as a strong central organization, coordinating multiple political, economic, and bureaucratic interests in the budget process, able to impose firm discipline and control on the spending ministries and agencies. The reality was otherwise. The reduction that occurred in the overall deficit on General Government that is attributable directly to the improvement in the financial balance of the main budget controlled by MOF was more apparent than real. We shall now show that in the period of fiscal reconstruction during the 1980s (and beyond) it was unable to contain the pressures for more public spending or to reform the inadequate tax base. The underlying cause of fiscal stress—the continuous growth of public spending—remained throughout the 1980s and 1990s. The symptoms of that stress—deficits and debt—were exacerbated by the fiscal consequences of the “economic bubble” of the late 1980s and the collapse into recession that followed; but they were only the proximate cause of the sharp deterioration that occurred in the 1990s. The roots of that fiscal crisis lie much deeper, and it is to those that we turn first.

### 13.2 The Origins of the Fiscal Crisis of 1975

The fiscal crisis that emerged full-blown in FY 1975 had both long- and short-term causes. With transition to slower economic expansion, it had been apparent for some time that large annual increases in public expenditures could no longer be financed wholly from the revenues generated by economic expansion, as they had been in the era of high growth in the 1950s and 1960s. Secondly, the structure of the taxation system inherited from the U.S. Shoup Mission after the Second World War relied excessively on revenues from direct rather than indirect taxation, which were more affected by cyclical changes than the latter. Two shorter-term factors contributed to the emergence of the crisis in the middle of the 1970s. First, the ratcheting up of public spending at the beginning of the decade, as Japan entered upon its welfare era, encouraged the expectations of Liberal Democratic Party (LDP) politicians, special interest groups, and the electorate about its continued growth in the future. The other immediate and proximate cause of the crisis in 1975 was the fiscal consequences of the first oil crisis in 1973, which led to a sharp contraction of economic activity in Japan and a decline in GNP.

The significance of the growth of public spending in the 1970s was much less the growth of government and its absorption of GNP, which was still growing, albeit more slowly than in previous decades: rather it was the financing of that growth of public spending that caused MOF anxiety and was to create difficulties for the next 20 years. In 1975 the rapid increase in *current* spending could no longer be financed solely out of taxation and other revenues, and it became necessary to issue “special deficit bonds” in addition to the ordinary, so-called construction bonds to finance capital spending. The latter had been issued for the first time since the end of the American occupation when the budget became unbalanced in 1965. Thereafter deficit financing became the norm.

The growing imbalance and widening fiscal deficit that occurred between 1970 and the beginning of fiscal reconstruction in 1979 are shown in table 13.1. As deficits widened, the government borrowed larger amounts; the annual costs of servicing new government borrowing and the cost of accumulated debt rose steeply in the middle of the 1970s (table 13.1). By 1975 the symptoms of a major crisis in the national finances were fully exposed: fast-rising expenditure, inadequate revenue growth, burgeoning fiscal deficits, accumulating debt, and increasing budget rigidity. The latter was especially worrying for MOF. The anxiety expressed in the 1960s about the prospect of “fiscal rigidification” was now being realized as the fixed costs of servicing the debt began to squeeze the amount available in the budget to finance discretionary program expenditures, themselves subjected to the pressures of the new “welfare politics” inaugurated in 1970. To those difficulties was added the looming prospect of an increase in the number of elderly people in Japan in the early decades of the next century, threatening an additional burden on discretionary budgetary expenditures.

**Table 13.1 Japan's Central Government Budget: Deficit, Debt, and Debt-Service, 1970–96**

	Deficit		Debt Outstanding as % GDP (Nominal)	Debt-Service Costs as % Budget (Initial)
	% Budget (Settled)	% GDP (Nominal)		
1970	4.2	0.4	3.7	3.7
1971	12.4	1.4	4.8	3.4
1972	16.8	2.0	6.0	4.0
1973	12.0	1.5	6.5	4.9
1974	11.3	1.5	7.0	5.0
1975	25.3	3.5	9.8	4.9
1976	29.4	4.2	12.9	6.9
1977	32.9	5.0	16.8	8.2
1978	31.3	5.1	20.4	9.4
1979	34.7	6.0	25.0	10.6
1980	32.6	5.7	28.7	12.5
1981	27.5	4.9	31.6	14.2
1982	29.7	5.1	35.3	15.8
1983	26.6	4.7	38.4	16.3
1984	24.8	4.2	39.9	18.1
1985	23.2	3.8	41.5	19.5
1986	21.0	3.3	42.8	20.9
1987	16.3	2.6	42.7	20.9
1988	11.6	1.9	41.3	20.3
1989	10.1	1.6	39.6	19.3
1990	10.6	1.6	37.9	21.6
1991	9.5	1.4	37.0	22.8
1992	13.5	2.0	37.7	22.8
1993	21.5	3.4	40.4	21.3
1994	22.4	3.4	43.2	19.2
1995	28.0	4.4	46.0	18.6
1996	27.6	4.2	49.0	21.8

Source: Budget Bureau, MOF, Japan, 1997.

This in outline was the *problematique* with which MOF was confronted throughout the next 20 years. In the next section we examine the aims and objectives of policies to “reconstruct” and “consolidate” the central government finances.

### 13.3 Fiscal Reconstruction, 1979–87: Principles, Objectives, and Policies

MOF could not embark upon policies to reconstruct the national finances without first obtaining political recognition that there was a fiscal crisis and



that it was not a temporary phenomenon. Second, MOF had to convince the LDP leadership that fiscal reconstruction was a necessary and appropriate response to the underlying causes of the crisis; and to prescribe a set of guidelines broadly acceptable to it, but which crucially could be invoked subsequently to validate its policies and commit ministers to them. This was achieved by the public articulation of the underlying principles of “sound management” of the national finances.

The basic principle was a balanced budget, which the government pledged to restore at “the earliest possible opportunity.” The other principles were all contingent on the symptoms of annual budget deficits. Two related specifically to the management of the economy: first, the risk of “fiscally induced” inflation, and of “crowding out” private-sector investment through the increase and sale of government bonds; and, second, the costs of current expenditures as a burden on future generations of taxpayers, for example by the issue of government bonds to finance a deficit that arose from a shortfall of revenue. “Sound management” also required that the fiscal system should be operated flexibly.

None of these principles was wholly novel. Hitherto largely unstated or unemphasized, their public articulation, affirmation, and reiteration now served three purposes essential to MOF’s evolving strategy for dealing with the causes and consequences of the fiscal crisis. First, cabinet ministers and senior LDP politicians could not repudiate the implications for fiscal policy that followed logically from their acceptance of those principles, namely, the reconstruction of the expenditure and tax system that MOF advocated. Second, in order to attempt fiscal reconstruction MOF had to try to change political perceptions and expectations of the role of public spending in the economy. Here the principles provided a set of guidelines to which MOF officials and ministers could refer in the preparation, discussion, and presentation of the annual budgets. Repetition and reiteration helped in the process of “educating” politicians, bureaucrats in the spending ministries, interest groups, the media, and the public to acknowledge and accept the fiscal consequences of changed and changing economic circumstances. Third, the principles of sound management provided a set of broad contextual constraints within which annual bids for more spending, and demands for less taxation, from ministers, bureaucrats, local politicians, and special interest groups could be negotiated. There was of course no guarantee that in practice participants in the budgetary processes would exercise self-restraint when their own interests or those of their clients or supporters were threatened by MOF policies to cut spending or raise taxes. What is important to emphasize here is that by signing up publicly to the principles of “sound management” the LDP legitimized MOF’s reformulation of the fiscal agenda.

MOF repeatedly drew attention to the accumulating size of the national debt and its absorption of increasing amounts of GDP, and to the annual costs of servicing the total of the debt outstanding. The latter costs, it argued, led to fiscal rigidification; discretion to vary expenditures on programs to reflect

political priorities was being progressively eroded. The implication was clear. If LDP ministers and their back-bench supporters could deliver less to their constituents and clients because of the fixed costs of servicing the debt, they were more vulnerable politically. The LDP's electoral success, and its domination of the Diet had been built and then rebuilt on the politics of distribution to supporters and compensation for aggrieved or disaffected groups (Calder 1988). Fears and anxieties about future prosperity were also exploited skillfully by MOF as it warned repeatedly of the fiscal consequences of an aging population.

These longer-term implications of continuing fiscal deficits and consequential government borrowing were less persuasive arguments for LDP politicians than those where MOF was able to demonstrate that short- and medium-term effects of "fiscal rigidification" limited their discretion to adjust the amount and distribution of expenditure on favored programs, for example public works and agricultural subsidies and support. Nevertheless, both arguments were deployed with increasing sophistication and emphasis through the 1980s to justify MOF's policies of fiscal reconstruction.

### 13.3.1 Policy Objectives

The main objectives of fiscal reconstruction were unchanged throughout the period 1975–97: first to eliminate the issue of special deficit bonds. The second related objective, of reducing the overall bond-dependency ratio (the proportion of the total budget financed by the issue of government bonds), was broader in its intent, including not only the elimination of those bonds but a reduction in the issue of "ordinary" (construction) bonds as well. The restoration of the conditions of a balanced budget that prevailed until 1965 remained an aspiration, an unstated premise of its policies for fiscal reconstruction. Realistically, MOF accepted the argument for financing a proportion of capital investment by issuing ordinary (construction) government bonds. But nevertheless reduction in the issue of those bonds too was implicit in its third objective: to reduce the size and accumulating service costs of the total of outstanding government debt.

### 13.3.2 Policies for Reconstruction

These three objectives drove fiscal policy for the next 15 years. Alarmed by the huge revenue shortfall that occurred after the preparation of the initial budget for FY 1975, MOF began simultaneously to search for ways to raise additional revenue, and to cut expenditures to plug the gap. For the moment, these were mainly ad hoc, short-term measures, marginal adjustments to existing patterns of expenditure growth and sources of revenue.

The target date for the elimination of the issue of special deficit financing bonds was FY 1980, but continuing increases in expenditures and depressed revenues combined to produce a sharp increase in the number of bonds issued to raise more revenue to cover the deficit, and the bond-dependency ratio rose

from 29.7 percent in FY 1977 to 32 percent in 1978 and to a peak of 39.6 percent the year after. In January 1979, MOF was forced to concede that the aim of eliminating special bonds by the following year would not be achieved, and set a new target date of 1984. It also acknowledged publicly that the causes of the deficit were structural and could not be remedied by “natural increases” to revenue that would occur when (lower) economic growth was resumed. Short-term, ad hoc marginal adjustments to expenditures and to tax brackets had proved inadequate to deal with the rapid growth of the deficit, and failed completely to address its root cause. The structure of the tax system needed to be changed to increase the proportion and yield of indirect taxes compared with direct taxes, and MOF confidently committed itself to “introduce a new general consumption tax in FY 1980.” This provided the context and the rationale for the launch of the second of three such attempts to introduce such a tax in the period 1975–97. The first attempt in 1978 failed partly because of opposition within the LDP, but mainly because the proposed tax was universally unpopular. The poor showing of the LDP in the 1979 election for the House of Representatives was widely attributed to it.

Explicit confirmation that MOF was now thinking about reconstruction more strategically was apparent in the reorientation of its main policy objectives to a longer time horizon. This appeared in the new five-year national economic plan *Outlook and Guidelines for the Economic Society for the 1980s* prepared by the Economic Planning Agency under MOF’s guidance, and approved by the cabinet in August 1983. The hope that one of the main objectives of fiscal reconstruction could be achieved by 1984 with the elimination of special deficit bonds was dashed by the sharp downturn in economic activity the previous year that necessitated an increase in public spending financed by the issue of additional government bonds in a package of emergency economic measures. The target date was now revised a second time to 1990, and the budget for FY 1984 reflected this new concern for the longer term. Expenditure policy was aimed at securing more radical reforms of some expenditure programs to deliver cuts over several years ahead, for example medical insurance, pensions, and employment insurance. In the short term, the guidelines for budget requests for the coming fiscal year, FY 1984, were drawn more tightly still. Cuts in some categories of current expenditures were raised from 5 percent to 10 percent. Investment expenditures were cut for the first time by 5 percent. As a result, budget policy was now tighter than at any time since the emergence of the fiscal crisis in the mid-1970s. Fiscal austerity was (ostensibly) maintained for three successive years.

### **13.4 Policies for Fiscal Consolidation, 1987–91**

The transition from the policy of fiscal reconstruction to the resumption of a more expansionary, looser fiscal policy that MOF euphemistically dubbed “fiscal consolidation” occurred in the course of FY 1987, marked precisely by

the stimulus to domestic demand provided by the emergency economic measures introduced in May 1987, which added 5.0 trillion to public spending, and cut taxes by 1.0 trillion. Fiscal reconstruction evolved pragmatically and (at first) cautiously into fiscal expansion. Following the Plaza Accord of 1985 and the appreciation of the value of the yen that followed, Japan had come under increasing pressure from the international economic community to expand domestic demand to help generate more global economic activity. Domestically, after three years of tight budgets, the LDP was looking for more spending in the run-up to the general election of 1989. These measures effectively marked the end of the period of fiscal reconstruction.

The fiscal austerity associated with the objectives and policies of the ten years of reconstruction was over. However, despite *apparent* progress toward the main objectives of eliminating the issue of special deficit bonds and reducing the bond-dependency ratio, the broader objectives of restructuring the tax system and introducing more flexibility into the composition of the budget remained unfulfilled. MOF's second attempt to introduce a sales tax in 1987 was no more successful than the first, but for different reasons. However, the attempt served to politicize the wider issue of the reform of the tax structure, and to move it up the political agenda, paving the way for the third (successful) attempt in 1988. (On the politics of tax reform see Kato 1994.) The costs of servicing the national debt continued on a rising trend to absorb a fifth of the General Account budget, more than double the figure at the beginning of reconstruction a decade earlier. The total of debt outstanding continued to grow annually, and by 1987 was preempting nearly 43 percent of GNP, its highest ever level (table 13.1).

The cautious, modest fiscal expansion was soon overwhelmed by a tide of public spending as, first, the economy entered the frenetic period of the "bubble" and then collapsed into a deep and persistent recession. Revenues grew strongly throughout the period 1986–90, the direct consequence of the speculative appreciation of land and asset prices in the bubble economy. The short-lived period of unstable, higher economic growth provided the means and the political rationale for a rapid increase of public spending. In such circumstance, and with a general election for the lower house imminent, growth of the General Budget was irresistible. Nevertheless the fiscal deficit narrowed sufficiently (or more accurately, was narrowed by MOF's exploitation of off-budget resources, see below) for MOF to achieve its long-held objective of eliminating the issue of special deficit-financing bonds in 1990. It was also able to make steady progress in the reduction of the number of construction bonds issued. As a result, the bond-dependency ratio fell to 7.6 percent in the planned budget for FY 1991, the lowest level achieved by MOF for 20 years.

With the apparently successful elimination of the special deficit-financing bonds, MOF turned its attention to the "second stage" of reconstructing the national finances, a restatement of the existing objectives to constrain the growth of the massive national debt, and to restore flexibility in the allocation

of discretionary expenditures within the General Account budget. In the light of recent experience it was felt necessary to emphasize the need to make the budget more flexible so that it could be used to implement countercyclical economic policy without the need to resort to the issue of special deficit bonds. The bond-dependency ratio was to be progressively reduced below 5 percent, the first occasion that a target figure had been set by MOF since the emergence of the crisis in 1975. With the ratio set at 7.6 percent in the budget about to be proposed for FY 1991, this seemed a realistic target. FY 1995 was set as the date for its achievement.

### **13.5 The Reemergence of Fiscal Crisis, 1991–96**

MOF's public confidence that it would be able successfully to reconcile the competing demands of an expansionary economic policy to stimulate domestic demand with tight fiscal policy to consolidate the gains made in the period of reconstruction evaporated with the pricking of the "bubble economy." The imperatives of countercyclical economic policy quickly overrode the residual concern with the tight control of public spending, as the economy plunged into deep and prolonged recession. More severe than that which had prompted the policy of fiscal reconstruction in the late 1970s, it proved more enduring and intractable than those that had occurred briefly twice before in the 1980s when MOF was faced with a similar dilemma of reconciling contradictory policy aims.

The reemergence of the symptoms of acute fiscal crisis was the result simultaneously of a large and sustained shortfall in revenue and a rapid buildup of public spending. The sharp decline in revenues resulting from the slowdown in domestic economic activity yet again exposed the underlying, structural weakness of the tax system, to which MOF had repeatedly drawn attention during the past decade. While it had achieved some rebalancing of direct and indirect taxes, most notably the introduction of a general consumption tax in 1988, the shock to the tax system of the collapse of the economic bubble was severe. Revenues declined for six successive years, from FY 1991 to FY 1996. As they did so, the need to stimulate demand in the economy led to political and business pressures for tax reductions, and threatened still further loss of revenues.

As the means to finance additional public spending contracted, so the political-economic pressures for larger expenditure budgets and countercyclical packages of fiscal measures intensified. Responding to them, MOF was powerless to prevent a sudden and dramatic widening of the fiscal deficit. Despite this, for the moment the budgetary policies were aimed to slow down the growth of the General Account budget from 6.2 percent in FY 1991 to 2.7 percent, rather than to impose widespread real cuts. By the following year, the full impact of the fiscal crisis was felt. There was a shortfall of more than 5 trillion in the revised estimate for tax revenues for FY 1992. The eventual yield

proved even more disastrous: 8.1 trillion less than that planned. MOF had no alternative but to resume heavy borrowing through the issue of ordinary government bonds to finance the deficit. Within the space of two years, MOF had been obliged to resume borrowing at levels comparable to the worst years of fiscal crisis a decade earlier. The planned bond-dependency rate rose from a low point of 7.6 percent in FY 1991 (initial) to 18.7 percent in FY 1994 (initial). The reality was still worse. The implementation of countercyclical fiscal policy through supplementary budgets in-year led to further borrowing still, and the actual bond-dependency rate was more than 22 percent.

With the resumption of the issue of special deficit-financing bonds in 1994, the fiscal wheel had turned full circle. While MOF had treated some of the earlier symptoms successfully, the underlying causes of too little revenue and too much public spending remained. But this time around, the symptoms were more acute, the crisis deeper, and MOF's authority to deal with it weakened by its failure to constrain the growth of the General Account budget; by the paralysis of the governmental process that followed the breakup of the old political order in 1993; and by the progressive erosion of its own authority as the banking crisis (and other events) unfolded in the wake of the collapse of the bubble economy. The fiscal consequences of that collapse destroyed the credibility of MOF's medium-term strategy for achieving those fiscal objectives set out in the 1990 Medium-Term Fiscal Policy to rebalance revenue and expenditures, reduce the size and burden of the accumulated national debt, and restore flexibility in the allocation of budgetary expenditures. The budget was now less, not more, flexible as the growth of the cost of borrowing and accumulated debt exerted a tighter squeeze on discretionary general expenditure programs (table 13.2); it had proved impossible to implement countercyclical economic policy without resorting to the issue of special deficit-financing bonds; progress toward reducing the bond-dependency ratio to less than 5 percent had been reversed; and the redemption of special bonds had been deferred, as MOF sought to constrain the pressures on the General Account budget.

Yet again, the vicissitudes of economic activity had exposed the underlying structural weakness of the tax system. In times of recession revenue yields were unreliable and inadequate to cover the increasing costs of the major spending programs. The general consumption tax was too little and too late to address the fundamental cause of that weakness. Moreover, it soon became apparent that the recession that began officially in 1991 was different in kind and in duration from those that had preceded it in 1985–86, 1980–82, and 1974–75, which were largely consequential or contingent on global economic conditions.

This time round the Japanese economy proved stubbornly resistant to the improvement in international trade that helped deliver the U.S. and European economies from conditions of recession; moreover the appreciation of the yen—the “yen bubble”—and the large surplus on the current balance of trade made it more difficult than in earlier periods to stimulate the economy through

**Table 13.2**                    **Servicing the Debt of Japan's Central Government, 1975-96**  
**(initial budget)**

	Debt Service (trillion yen)	Debt Service/Budget (%)
FY 1975	1.03	4.9
FY 1976	1.66	6.9
FY 1977	2.34	8.2
FY 1978	3.22	9.4
FY 1979	4.07	10.6
FY 1980	5.31	12.5
FY 1981	6.65	14.2
FY 1982	7.82	15.8
FY 1983	8.19	16.3
FY 1984	9.15	18.1
FY 1985	10.22	19.5
FY 1986	11.31	20.9
FY 1987	11.33	20.9
FY 1988	11.51	20.3
FY 1989	11.66	19.3
FY 1990	14.28	21.6
FY 1991	16.03	22.8
FY 1992	16.44	22.8
FY 1993	15.44	21.3
FY 1994	14.36	19.6
FY 1995	13.32	18.6
FY 1996	16.37	21.8

*Source:* Budget Bureau, MOF, Japan, 1997.

the promotion of exports. Ever-larger packages of countercyclical economic and fiscal policies, in all totaling 63 trillion between 1992 and 1995, had little immediate effect on stimulating domestic demand.

The state of the national finances deteriorated rapidly throughout FY 1995 and FY 1996. MOF was forced to borrow 22.0 trillion to finance a deficit swollen by the large fiscal stimulus in September 1995, resulting in a bond-dependency ratio of 28.2 percent, its highest level since 1980. In FY 1996 the planned issue of 10.1 trillion of special deficit bonds exceeded all previous experience. By the end of FY 1997 the accumulated debt was expected to total 254 trillion, equal to 48 percent of GDP. The servicing of that debt absorbed more than a fifth of the total General Account budget. The principles of "sound management" were necessarily sacrificed to political-economic expediency. The achievement of the three policy objectives—the elimination of special deficit bonds, the reduction of the bond-dependency ratio to reduce fiscal deficits on the path to a balanced budget, and the reduction of the size and service costs of the accumulated debt—was more distant in 1997 than when they were formulated 20 years earlier. MOF had, however, succeeded at the third attempt in implementing its long-term aim of changing the tax structure; more accu-

rately, it had begun on the process of implementation. Once it had secured the principle of a consumption tax, it was able to exploit the circumstances of a continuing shortfall of revenue during the economic recession to persuade the coalition governments of 1994–96 led first by Murayama and then Hashimoto to agree to increase the rates levied. However, the benefits in the yield of gross revenues were offset in the short term by the costs of financing tax reductions in the recession; the longer-term significance would emerge only with the resumption of sustained economic growth.

Despite the gravity of the fiscal situation the planned budgets for FY 1996 and 1997 nevertheless provided for further increases of expenditure, of 5.8 percent and 3.0 percent. Not only were fixed costs rising, those for discretionary expenditures continued to rise as well. Limiting the latter to 1.5 percent in FY 1997 was claimed by the Government and MOF as a sign of new fiscal austerity. Whether the budget for FY 1998 will mark the beginning of a new realism in the control of public spending promised in PM Hashimoto's vision of fiscal reform will not be apparent for some time to come. There is a strong sense of *déjà vu* in his earlier declaration of FY 1997 as the first year of fiscal reconstruction.

### **13.6 Fiscal Reconstruction: Illusion and Reality**

How successful was MOF in its attempts to reconstruct the fiscal system after 1975? We look first at its claim to have made substantial progress toward the achievement of its policy aims by the end of the 1980s using its own preferred performance indicators, and then contrast that apparent progress with the underlying reality.

#### **13.6.1 Raising Revenue**

MOF's success in narrowing the fiscal gap in the period of fiscal reconstruction was partly the result of the buoyancy of revenues in conditions of sustained, albeit modest, economic growth, but also partly due to marginal changes in the tax structure and in tax rates and thresholds. Its longer-term aim to change the balance of direct to indirect taxation was almost wholly unsuccessful. Even the substantial increase in indirect taxes resulting from the introduction of a national consumption tax in 1988 did little more in the early 1990s than reverse the trend of increasing dependence on direct tax revenues, and to restore the 2.5:1 ratio that obtained in the late 1970s. In reality, the ratio was closer to 4:1, if we take the net tax revenues available (after the hypothecation of revenues to local governments) to finance the General Account budget. Finally, while the burden of national taxes as a proportion of both national income and GDP increased marginally year by year, the Japanese electorate remained lightly taxed compared with other G7 countries in the mid-1980s. Only the United States had a lower ratio than Japan.

As the economy moved into deep recession, total revenues fell for the first



**Table 13.3** Japan's Central Government Debt Outstanding, 1975–95 (settled budget)

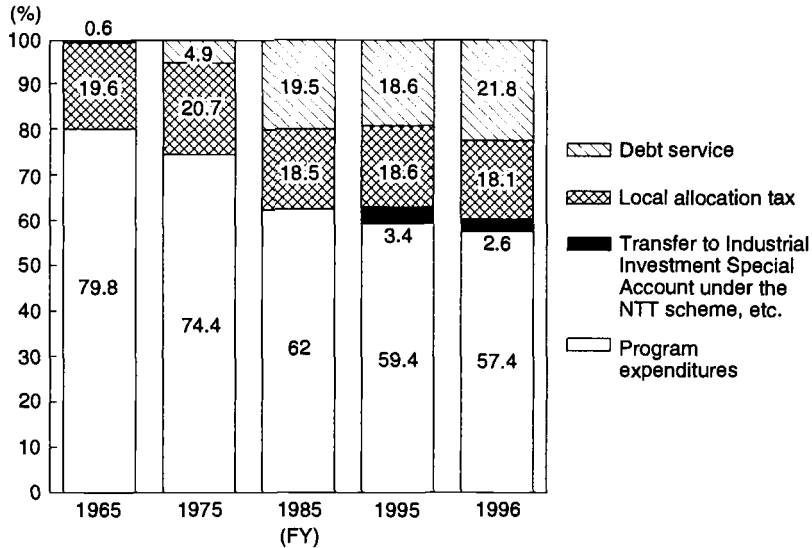
	Government Bonds Outstanding (trillion yen)	GDP %
FY 1975	14.9	9.8
FY 1976	22.0	12.9
FY 1977	31.9	16.8
FY 1978	42.6	20.4
FY 1979	56.2	25.0
FY 1980	70.5	28.7
FY 1981	82.2	31.6
FY 1982	96.4	35.3
FY 1983	109.6	38.4
FY 1984	121.6	39.9
FY 1985	134.4	41.5
FY 1986	145.1	42.8
FY 1987	151.8	42.7
FY 1988	156.7	41.3
FY 1989	160.9	39.6
FY 1990	166.3	37.9
FY 1991	171.6	37.0
FY 1992	178.3	37.7
FY 1993	192.5	40.4
FY 1994	206.6	43.2
FY 1995	225.2	46.0
FY 1996	244.7	49.0

*Source:* Budget Bureau, MOF, Japan, 1997.

time for over 25 years in FY 1992; tax revenues declined for six successive years. Without the revenues from the new consumption tax, the disastrous shortfall would have been still worse.

### 13.6.2 The Fiscal Deficit and Government Borrowing

MOF twice failed to achieve its main aim of eliminating special deficit bonds, succeeding on the third attempt in 1990. Their reissue in 1994 and their continuation thereafter represented a humiliating failure of MOF's reconstruction policies. It achieved steady progress in reducing the bond-dependency ratio, partly the result of improving control of total expenditure in the General Account budget and some modest success in revenue raising, but did not succeed in reducing it to less than 5 percent by the prescribed target date of 1995. Although it had come close to doing so in 1991, thereafter the ratio moved sharply upward. Both the size of the accumulated debt and the annual cost of servicing it grew inexorably through almost the whole of the period (tables 13.2 and 13.3). Debt outstanding during the period 1975–96 rose from a total of 14.9 trillion to 240.5 trillion (planned), an increase in the proportion of GDP



**Fig. 13.3 Japan's fiscal rigidity: The squeeze on program expenditures in the central government budget, 1965–96 (initial budget)**

from below 10 percent to nearly 50 percent. In the period of fiscal reconstruction, the volume of debt doubled, rising as a proportion of GDP from 31.5 percent to 42.7 percent. Throughout more than a decade of “fiscal reconstruction” and “consolidation,” debt-service costs continued to absorb a fifth or more of the total General Account budget, exerting a considerable and continuous squeeze on discretionary expenditures. “Fiscal rigidification” increased throughout the whole of the period 1975–96 (fig. 13.3).

### 13.6.3 Restraining the Growth of Public Expenditure

MOF's objective for public spending was set and constantly reaffirmed only in the broadest terms: to restrain the growth of public expenditures as much as possible. No numerical targets were prescribed, nor dates for the achievement of some desirable state of restraint. Assessment of performance is therefore more difficult to make, and is to a large extent inferred from the various time-series data that accompanied the presentation of the budget, and in MOF's selection of preferred performance indicators.

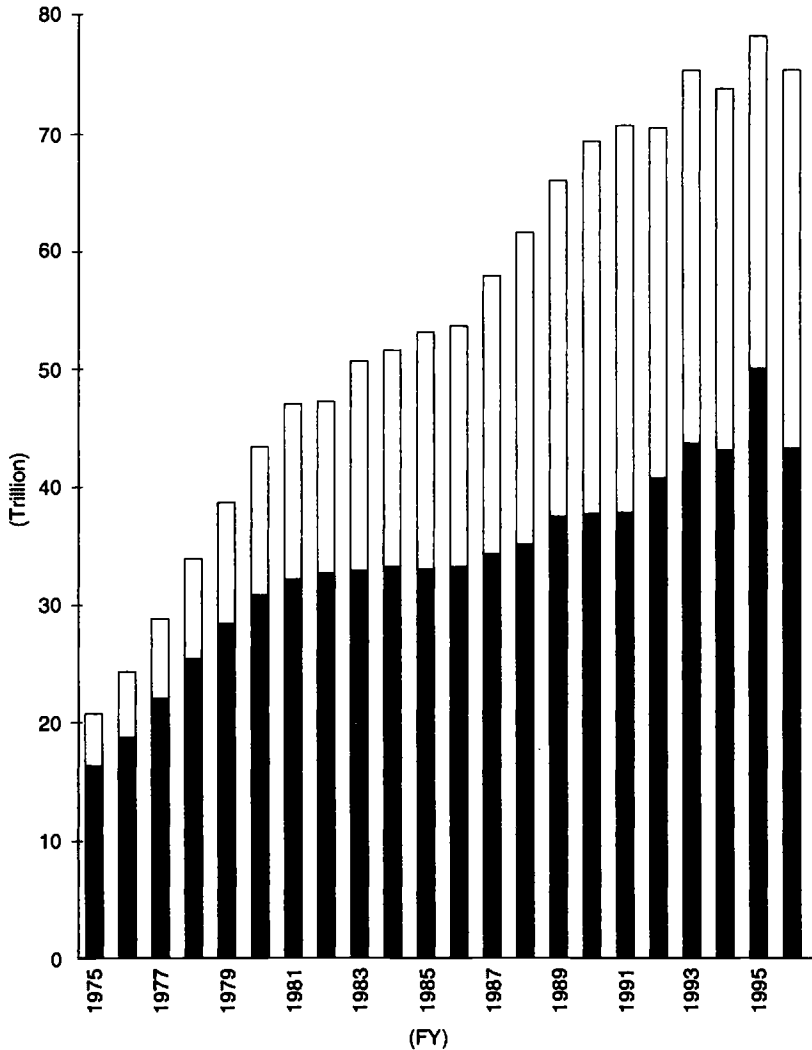
MOF claimed to have controlled the growth of expenditure in the General Account budget for much of the period of fiscal reconstruction and consolidation. While planned (initial) expenditure increased in every year from 1975 to 1995, the annual rate of increase slowed, especially in the period of fiscal reconstruction, declining steadily from a peak of 24.5 percent in 1975 to reach standstill in 1987. Thereafter, the economic growth of the bubble allowed,

and the conditions of recession which followed obliged, MOF to increase public spending substantially, and the annual percentage changes moved upward once again.

While after 1981 MOF managed to reduce only marginally the proportion of GDP absorbed by the General Account budget as a whole, its focus on the narrower definition of General Expenditure (excluding debt and other fixed costs) showed a much larger reduction in the GDP ratio from 12.6 percent in 1980 to 8.6 percent in 1995. The latter, it emphasized, represented “less than 67% of the FY 1980 peak,” approximately the same proportion as that of FY 1970. The inference that MOF wished to be drawn was clear: it had returned the public finances to the status quo ante that prevailed before the era of welfare spending began. That congratulatory self-assessment of its achievement in restraining the growth of public spending in the period of fiscal reconstruction is subject to qualification. First, it was able to make only small cuts in planned General Expenditure for a brief period; no such cuts were made in the totals for the General Account budget as a whole. Even that apparent restraint of the growth of General Expenditure is less impressive when the outcome (“settled”) rather than planned (“initial”) expenditure is measured (fig. 13.4). This shows that MOF was much less successful in controlling expenditure demands and pressures *in-year* than in the budget-making processes preceding the planned initial budget. This is partly because it was more willing to acquiesce in some of the demands for additional spending financed in supplementary budgets that were not subject to the strict controls of budget ceilings and guidelines and partly because the pressures to stimulate the economy in-year often proved irresistible. Thus the real cuts in the total of General Expenditure claimed for five successive years in the mid-1980s were cuts in *planned* expenditure that MOF was unable to deliver, in all but one of those years. Second, reductions in the General Expenditure/GDP ratio were achieved more as a result of the growth of GDP than a reduction of the level of General Expenditure. In such circumstances public spending can continue to rise (as it did), while simultaneously absorbing a smaller proportion of GDP. That combination was significant in the politics of the budgetary process in the period of fiscal reconstruction, allowing MOF to accommodate political-bureaucratic pressures for more spending without apparently sacrificing its fiscal objectives, measured by the General Expenditure/GDP ratio.

#### 13.6.4 Manipulating Budgets and Special Accounts and Managing the Presentation

MOF's claimed success in restraining the growth of public spending was only partly the result of the implementation of policies of tighter control, most notably in more tightly drawn guidelines for budget requests. It was mainly the result of the effective manipulation of revenues and expenditures between the General Account budget, FILP (“the second budget”), and the 38 special accounts, and by its management of the presentation of its fiscal performance.



**Fig. 13.4** The growth of Japan's central government budget, 1975–96 (settled budget)

*Note:* 1995, revised budget; 1996, initial budget. GDP: 1995, estimate; 1996, forecast. *Solid bars* are program expenditures; *open bars* are budget including program expenditures.

There were three main budgetary stratagems designed to relieve pressure on the General Account budget. First, MOF exploited the statutory provision for the “carry-forward” of surplus revenues at the end of the financial year to defer redemption of the national debt. In 1982 and for eight consecutive years it suspended the statutory requirement of the fixed-rate appropriation from the General Account budget to the National Debt Consolidation Fund. Payments

**Table 13.4** MOF's Deferred Liquidation of Japan's National Debt, 1982–96 (settlement—trillion yen)

	Deferred Payments
FY 1982	1.37
FY 1983	1.60
FY 1984	1.82
FY 1985	2.02
FY 1986	2.24
FY 1987	2.41
FY 1988	2.53
FY 1989	2.61
FY 1990	Payments resumed (2.49)
FY 1991	Payments resumed (2.56)
FY 1992	Payments resumed (2.63)
FY 1993	3.04
FY 1994	3.08
FY 1995	3.2
FY 1996	Payments resumed (4.54)

Sources: 1982–89: calculated from bonds outstanding at end of previous financial year, Budget Bureau, MOF, Japan, 1996; 1994–96: *The Japanese Budget in Brief*, Budget Bureau, MOF, 1994, 1995, 1996.

were resumed in FY 1990, but suspended again from 1993 to 1995. From time to time MOF also suspended the transfer to the fund of that surplus on the settlement of the General Account budget, the legislation permitting the priority of the allocation of that surplus to general-purpose funds over that of debt redemption. By these means throughout almost the whole of the period of fiscal reconstruction and consolidation MOF was able to relieve some of the pressures on the General Account budget by suspending the statutory arrangements for the liquidation of a part of the national debt by fixed-rate appropriations from the budget. The resulting “savings” from the suspension of the fixed-rate transfer alone were considerable, averaging annually between 1.5 and 2.5 trillion yen throughout the period of fiscal reconstruction (table 13.4). Added to other fixed costs in the budget, they would have had the effect of further squeezing the amount available for discretionary expenditures and hence exacerbating “fiscal rigidification”; or, if not offset, would have resulted in larger budget totals. Faced with the prospect of massive and recurring annual redemption costs as the (mainly ten-year) special deficit bonds issued in the crisis of 1975 matured, MOF began “refinancing” in FY 1984. From time to time MOF also reduced the proportion of nationally collected taxes statutorily assigned as hypothecated revenues to local governments, achieving a temporary reduction in the total of fixed costs in the budget.

Reducing the scale of the fixed costs, either that of the local assigned taxes or the debt redemption, or both was thus a very effective means of “cutting” public expenditure. It was also a useful means of partly financing the additional

expenditures in supplementary budgets. Suspending the arrangements for redeeming the national debt had the further short-term advantage for MOF, that (unlike the manipulation of local assigned taxes and some other “temporary special measures” for postponing payments) it was not required to make up repayments in subsequent years. But such suspension contributed to longer-term difficulties. MOF’s dilemma was that short-term budget reductions to achieve fiscal reconstruction were purchased at the expense of longer-term costs: unredeemed debt imposed a burden on future generations, a further example of the triumph of expediency over the principle of “sound management” of the national finances.

The second budget stratagem derived from the privatization of NTT in 1985, which provided MOF with another potential source of funds to relieve pressure on the General Account budget. Funds derived from the sale of shares were used in part to provide interest-free loans totaling 1.3 trillion per annum for specified projects of capital investment for the three years 1986–88. Those resources helped to relieve fiscal pressure on the General Account budget by enabling MOF to reduce expenditure on the public works programs financed through it: at the same time it provided a short-term “cost-free” means of sustaining support for the public works program as a whole, as the LDP wanted. For example, in FY 1988, a preelection year, general public works expenditure was increased by over 20 percent compared with the previous year.

Loans to finance the special capital investment projects through the “NTT scheme” had ultimately to be repaid from the General Account budget to the Special Account for National Debt Consolidation. MOF began to do so, just as the revenues on the General Account began to deteriorate as a result of the recession, thus exacerbating the emerging fiscal crisis.

### 13.6.5 The Manipulation of Special Accounts and FILP

The third budgetary stratagem involved the manipulation of cash flows between the General Account budget and other “off-budget” sources. From time to time during the period of fiscal reconstruction, MOF suspended some statutory annual payments from the General Account budgets into various special accounts, most notably those for welfare insurance and for national pensions. At the end of FY 1996 MOF estimated the size of these and other “hidden debts” that had accumulated from previous manipulations at 16 trillion yen, excluding the long-term debt of the privatized Japanese National Railways, 27 trillion.

More significant even than those “special temporary measures,” MOF used FILP, supplementary budgets, and some of the 38 special accounts as permanent alternative sources of “off-budget” funding for some public expenditure programs. The financing of public works programs is a classic example of illusion and reality in Japanese budgeting. The “headline” totals for public works in the planned General Account budget show a decline from annual increases of over 20 percent before 1979 to a position of standstill and then reduction of

about 2.5 percent per annum in the period of fiscal reconstruction. In reality the programs enjoyed continuous and substantial growth of between 50 and 100 percent between 1980 and 1996, financed through supplementary budgets, FILP, and ad hoc temporary schemes of investment. A similar phenomenon is observable in the budget allocations for small businesses.

FILP provided the main financial support for housing construction and loans for house purchase, and for agricultural infrastructure. By FY 1994 the government's housing program was financed mainly "off-budget" through FILP; at 13.205 trillion it was more than 12 times the share borne by the General Account budget. The total value of those and other less obvious substituted funds is impossible to calculate; but had the General Account budget been obliged to fund a greater share of the housing program and other public works projects and capital development schemes financed by FILP and designed to improve "social overhead capital," several trillion yen would have been added annually to the General Account budget through the period of fiscal reconstruction, and beyond. Besides the "second budget," MOF also used some special accounts as a substitute for the General Account budget to fund some kinds of capital development, for example the special accounts for road construction, hospitals, and schools. The validity of this growing practice was even more questionable and questioned than its exploitation of the potential of FILP. In short, as a result of these and other "temporary special measures," and the budget stratagems mentioned earlier, MOF was able to set each year a much smaller aggregate for the General Account budget, borrow less to cover a smaller deficit, and record and present apparent progress toward its policy objectives. One effect of the substitution of FILP for the General Account budget was that FILP grew faster and absorbed a rising share of GDP. By 1996 it was two-thirds the size of the General Account budget.

### **13.7 Explaining MOF's Failure**

For most of the period 1975–97, Japan had a stable, one-party, right-wing majority government, and a centralized budgetary system. Crucially, it had a "strong" Ministry of Finance with a formidable combination of formal constitutional and legal powers to raise taxes, control budget and off-budget expenditures, and regulate financial and monetary policies. It possessed hierarchical, organizational, and informational resources unmatched by any other ministry or agency; it was committed to the principle of a balanced budget and "sound financial management"; it prescribed and progressively tightened guidelines for determining the size of the budget and the relative priority of spending programs and set budget ceilings for each ministry and agency. Such a combination of institutional variables would appear to be favorable to the avoidance of fiscal stress, or to the relief of its symptoms. Yet as we have shown, MOF was largely unsuccessful in reconstructing the fiscal system and achieving its policy aims of reducing the deficit and level of accumulated debt. Why was an

apparently “strong” Ministry of Finance unable, unwilling, or frustrated in its attempts to implement agreed policies to constrain the growth of public spending, the main cause of fiscal stress?

The aging of the population, the “yoke of prior commitments,” and unsustainable rates of growth in debt, factors that help to explain the failure of industrialized countries to control long-term fiscal policy (Steuerle and Kawai 1996), all contributed to the increasing pressures in the budgetary system for more public spending. While they made it more difficult to restrain the growth of demand-led programs such as pensions, social security, and health and welfare programs for the elderly, and to cut back existing spending commitments in other programs, none was a major cause of MOF’s failure to control the growth of public spending. There were five main factors. First, MOF’s failure to win LDP politicians and business groups to its cause of radical tax reform until the late 1980s left it with an inadequate revenue base in an era in which a “decelerated economy” generated insufficient “natural increases” of revenues to accommodate the double burden of inescapable fixed costs and irresistible discretionary expenditures without recourse to regular heavy borrowing. The consequential costs of servicing the accumulating debt exacerbated that difficulty. Second, throughout the whole of the period 1975–97 MOF was faced with the dilemma of trying to reconcile the contradictory aims of economic policy, which frequently dictated the need for increased public spending and tax cuts (often in response to international pressures) to stimulate the economy with the narrower fiscal aims of reconstruction. The need to do so on several occasions in the period 1975–97 meant that that spending imperative dominated much of the period. It helps to explain and justify why faced with the conflicting policy aims, MOF resorted to temporary expedients, and the budget stratagems and manipulations mentioned earlier. While MOF was able to emerge from short bouts of countercyclical spending with its objectives for fiscal reconstruction still realistically attainable, even if progress toward them was deferred or delayed, as happened on three occasions for example with the target date set for the elimination of special deficit bonds, it could not reconcile them with the rapid, huge expansion of the General Account budget and FILP that the prolonged recession made inevitable.

The third factor inhibiting the effectiveness of its policies for fiscal reconstruction was the need to try to reconcile their implementation with the often conflicting political-electoral strategic aims of the LDP designed to sustain itself in power. Through government and party organizations, the LDP had begun to play a more active and interventionist role in policymaking generally from the early 1970s. The party was incorporated into the budgetary processes, both formally through such structures as the functional committees of its Policy Affairs Research Council, and informally through the intervention of senior party officials and members of special policy tribes (*zoku*). By such means the interests of the party and their clients were accommodated directly or by bureaucratic “anticipated reactions.” Spending programs for public works,



small businesses, and agriculture financed both through the General Account budget and FILP, implemented locally by local governments, and both locally and regionally through the aegis of Public Finance Corporations, provided a source of patronage and clientelistic distributive politics for the LDP, helping to nourish and sustain Dietmen's personal electoral-constituency networks. While the LDP acquiesced in the introduction of tougher budget guidelines in the mid-1980s, their effectiveness was tempered in practice by the exploitation of spending loopholes provided by the exemption of priority programs, and ad hoc dispensations for public investment and public works, and agricultural infrastructure and subsidies. These provided it with the means to continue to distribute substantial political favors and benefits in the outputs of expenditure programs, and to frustrate MOF's policies for fiscal reconstruction.

A transparent budget process is an oxymoronic concept. But even by conventional standards, Japan's is remarkably complex, opaque, and labyrinthine. However, the lack of transparency was not a major factor in the explanation of the continuance of deficits and debt. The underlying reality of Japan's fiscal situation was no secret. MOF did not conceal the details of its annual budget stratagems and manipulation; the size and composition of the "hidden debt" was public knowledge. More significantly, neither the LDP's own back-bench supporters nor the main opposition parties in the Diet were disposed to argue for less spending or more taxation to reduce the level of deficit and debt. Indeed, the wilder demands of the former were kept in check by the LDP leadership; the (then) Japan Socialist Party used its position as the official opposition in the lower house from time to time to obstruct the passage of budget bills as a means of extracting spending concessions from the government. While there was some support among Diet parties for clean government, there was none of any significance for smaller government. It is unlikely therefore that more transparency in the budget processes, for example by involving legislators in the determination of the size of the budget(s) and its distribution, or in the prescription of budget guidelines and targets, would have checked the growth of public spending.

The fourth factor was the nature of the budgetary process, through which the aggregate budget total was determined, and its distribution negotiated between the spending ministries and MOF's Budget Bureau. The aggregate or "ceiling" for the General Account budget and for FILP was set by MOF after discussion with senior LDP politicians and ministers; throughout the whole of the period 1975–97, even at times of crisis, the planned aggregate was always greater than that of the preceding fiscal year. The only attempt at a planned cut, in FY 1995, was made possible only by suspending the statutory payment of national debt redemption. Even so, the outcome total was several trillion greater than that planned. Top-down limits are a necessary condition of effective control of spending, but as Japan's experience shows, they are not sufficient. The "ceiling" for each ministry's budget was negotiated with the Budget Bureau, together with the distribution of new money allocated to priority pro-

grams. Although the prescription of budget guidelines nominally limited the amount of spending on each program, in practice categories of exception and exemption provided both the opportunity and incentive for ministers and their officials to argue for more spending in their annual negotiations with the Budget Bureau. Crucially, the budget guidelines did not apply to supplementary budgets, which provided a further annual opportunity for spending ministries to argue for more public spending.

Fifth, MOF is very much less powerful in the budget processes than is commonly supposed, or appears from an inspection of *formal* budget institutions and arrangements. The latter provide the basis of the framework within which budget decisions are made, but a more complete and informed guide to how and why particular budget outcomes occur requires an analysis of the *informal* politics of the budgetary process, the interaction among the participants in those processes—the roles and strategies of ministers, party officials, bureaucrats, and special interest groups, and the unwritten rules of the game that regulate their behavior in informal structures such as policy networks (Wright 1991; Thain and Wright 1995). As in the United Kingdom and Canada, MOF's exercise of the formal discretionary authority vested in it by the constitution and by statute is constrained in practice by the exercise of countervailing discretionary power by other participants. Like the Treasury and the Department of Finance/Treasury Board, MOF is locked into a system of mutually constrained power relationships, mainly with the LDP and the spending ministries, and rarely able to impose its constitutional and hierarchical authority on them and other participants, or to implement a directive strategy for determining the budget aggregate and its distribution. The paradigm of the politics of public spending is “negotiated discretion” (Thain and Wright 1995).

Finally, compared with other G7 countries, “how to pay for it” questions have not thus far been a central concern of the budgetary processes. Maturity in the public sector has developed more slowly, partly because experience of “welfare spending” came much later, and partly because of the tradition of high economic growth generating substantial revenue surpluses (Steuerle and Kawai 1996).

### 13.8 Coping with Fiscal Stress

MOF's pragmatic and expedient response to continuous fiscal stress throughout the period of fiscal reconstruction and beyond was understandable and from its perspective politically rational. By exploiting the potential of FILP as a “second budget”; by using it and several special accounts as alternative sources of finance to the General Account budget; by suspending statutory payments, by temporary “borrowings” and the manipulation of cash flows—by all these short-term expedients MOF was able to keep the fiscal ship afloat through the troubled waters of the early 1980s, and allowed it to present an illusion of public spending control consistent with apparent steady progress

toward the achievement of its main policy objectives. It not only avoided (or at least postponed) the breakdown of the fiscal system: it reasserted and reiterated the principles of “sound management.” Without the annual ceiling on the General Account budget and the imposition of ceilings on ministerial budgets, public spending would have grown at a still faster rate. Guidelines for determining the relative priority of competing spending programs at least obliged ministers and LDP back-benchers to talk the language of priority and the allocation of scarce(r) resources, even if in practice the application of those guidelines was less rigorous than MOF intended. In a period in which the internal spending pressures that resulted from the expansion of welfare spending in the 1970s was fueled by the expectations of LDP politicians, their clients, and aggrieved groups of still more public spending and lower taxes, this was no small achievement.

That said, any hopes that it had of making the surface appearance consistent with the underlying reality—in short to make a reality of reconstructing the fiscal system according to the principles of “sound management”—were destroyed by the fiscal effects of the bubble economy that ratcheted up levels of public spending insupportable by the recent historic trends of GDP growth and contingent revenue yields; and by the plunge into deep and prolonged economic recession in the years that followed. Whatever progress had been made was slowed, then halted, and ultimately reversed as the fiscal imperative of the recession dictated massive amounts of borrowing to finance countercyclical spending, and tax cuts and concessions. Any gains that accrued from implementation of the policies of reconstruction and consolidation evaporated. The status quo ante of 1975 was quickly restored. But this time around the fiscal crisis was much deeper and enveloped FILP, now swollen to two-thirds the size of the General Account budget and experiencing its own crisis of identity in the era of deregulated interest rates and liberalized capital markets. Fiscal reconstruction in the second half of the 1990s now had a much broader connotation than the earlier concern with the tax structure, the budget system, and the growth of the General Account budget: it touched all parts of the fiscal system. The crisis of the national finances was itself both a contributory cause and a symptom of a much broader crisis of the state, in which its role and that of the political, bureaucratic, and economic institutions that sustained it were the subject of sustained critical debate.

Were other G7 governments more successful than those of Japan in the period 1975–97 in achieving their objectives to relieve stress and bouts of acute crisis? To stem the tide of rising expenditure through the 1980s and 1990s, both U.K. and Canadian governments responded annually with budget policies designed to exert continuous downward pressure on the size and cost of departmental expenditures programs. In practice, in both countries until the early 1990s, bottom-up pressures for more spending regularly overwhelmed the top-down planned totals, as they did in Japan. In the United Kingdom, central government’s own spending, excluding local authorities and nationalized in-

dustries, grew in real terms by about a third between 1979 and 1992 (Thain and Wright 1995). The trend of General Government expenditure, apart from a dip in spending in the mid-1970s and the late 1980s, shows a steady and continuous rise in real spending. Conservative governments from 1979 failed to slow the trend rate of growth, roughly 2 percent per annum in real terms. As in Japan, they were able to achieve neither the heroic objectives set in 1980, nor the less ambitious revised ones set in the mid-1980s. What was stress in the second half of the 1980s collapsed into crisis after the general election of 1992, requiring urgent action to cap the budget aggregate and to change the budget machinery and processes for determining and delivering it. Despite that, public spending continued to grow annually in real terms at a faster rate than in any five-year period since 1979.

Unlike the United Kingdom or Japan, Canadian objectives for controlling public spending were in the early 1980s expressed more vaguely, normally without precise targets and dates for achievement. The Trudeau Government had pledged to hold the growth of spending of the federal budget to that of GNP and to reduce the deficit, and this had been achieved by 1978. However, after reelection, the recession of 1981–82 led to a rapid deterioration in federal finances, and from 1980–84, federal spending was rising above the trend line of GDP. From 1975–76 to 1982–83 federal spending as a proportion of GDP increased by 3.2 percent, and for the whole of the period to 1989–90, by an average of 10.4 percent per annum. Spending increased from 1987, deficits increased for five consecutive years from 1989 to 1993, and with higher interest rates, the costs of servicing the growing debt grew rapidly. Numerical targets for the progressive reduction of the deficit were prescribed annually in the federal budget, and revised as they were missed. But from 1994, federal spending and the deficit appeared to be set on a downward trend, and the medium-term objective of achieving a balanced budget a practical proposition. Canada's achievement of its fiscal objectives, both short-term control of the capped budget aggregate and the progressive reduction of the budget deficit and debt over the medium-term period were unmatched by either the United Kingdom or Japan or by other G7 countries. It is perhaps too early to say whether the apparent success of the last three years will endure and be sustained through the business and electoral cycles. But thus far, the federal government has treated not only the symptoms of fiscal stress, persistent deficit and rising debt, but through real cuts in programs and operating budgets begun to remedy the main cause of that stress, the growth of federal spending.

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