Japan's Fiscal Policy and Fiscal Reconstruction

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Toshihiro Ihori*

Abstract

The purpose of this paper is to analysis the Japanese fiscal policy particularly from the viewpoint of the fiscal reconstruction movement in Japan. We investigate the macroeconomic impact of government debt and fiscal difficulties of heavy dependency of debt finance in the public sector. We also explore political constraints to the fiscal reconstruction movements. In order to realize successful fiscal reconstruction, the central government needs to restrain lobbying activities of local political groups.

*: Department of Economics, University of Tokyo, Hongo, Tokyo 113-0033, Japan, (phone) 03-5841-5502, (fax) 03-5841-5521: E-mail: ihori@e.u-tokyo.ac.jp

I. Introduction

Japan's fiscal situation is the worst of the G7 counties now. This is partly due to a slowdown of economic growth in the 1990s. When national income does not grow much, tax revenue will not increase either. On the contrary, government spending has been gradually raised due to political pressures of interest groups, resulting in large budget deficits. In 1997, the Japanese government implemented the Fiscal Structural Reform (reducing budget deficits). However, in 1998, it stopped the reform and implemented tax reductions and increases in public investment (the traditional Keynesian counter-cyclical policy) because of severe economic and financial situation, and the defeat of the governing party (the Liberal Democratic Party; hereafter the LDP) in the upper house election. It is also noted that although the Japanese government bonds have been issued largely, their yields are the lowest among G7 countries in the bond market.

In such a situation, it would be useful to consider the following points. 1) What would cause a rapid increase in fiscal deficits? 2) What are the macroeconomic effects of government deficits? 3) How did the government raise revenue by issuing bonds in the 1990s? 4) Why would the yields of Japanese government bonds be so low in spite of their large issue? 5) What would be the crucial point of attaining successful fiscal reconstruction in the future? We intend to incorporate the political aspect of fiscal policy into these analyses. This paper will thus evaluate the current growing dependence on government bonds for covering financial deficits, the recent movements of Japanese fiscal reform and debt management policy.

This paper consists of seven sections. In Section II, we summarize Japanese fiscal policy in the recent years. In Section III, we investigate the macroeconomic effects of Japanese fiscal policy in the 1990s. Then, section IV discusses the soft-budget problem and political constraints in the intergovernmental finance between the local and central governments. Finally, concluding remarks follow in Section V.

II. Japanese Fiscal Policy in the 1990s

In this section let us first summarize briefly the movement of fiscal deficits and fiscal reform in Japan. See Ihori, Doi, and Kondo (2001). Traditionally, the Japanese government has followed a balanced budget policy. The balanced budget was maintained until 1965, when national bonds were first issued in the postwar period. The gap between government expenditures and tax revenues, which corresponds roughly to fiscal deficits, began to expand rapidly at the outbreak of the first oil shock in 1973. Asako et. al. (1991) presented good description of the rise and fall of deficits in the 1970s and the 1980s in Japan. They interpreted that the increase of deficits in the second half of 1970s as a combination of several factors. The larger fiscal deficits resulted from the major burst of new spending on social welfare programs in the first half of 1970s and on public investment in the second half of 1970s and the lack of tax revenues reflecting the slowdown of economic growth.

After a "bubble economy" was broken in 1991, natural tax decreases were incurred to generate revenue. At the same time, the politico-economic pressures for larger expenditure budgets and counter-cyclical packages of fiscal measures intensified. Responding to them, the MOF employed some measures for stimulating the aggregate demand. However, these counter-cyclical measures were not so effective, resulting in an increase in the fiscal deficit.

Also local government bonds rapidly increase in the 1990s. The increase of outstanding of local bonds was from 52 trillion yen at the end of FY 1990 to 130 trillion yen at the end of FY 1999. In addition, borrowing in the Special Account for Grants of Allocation Tax and Transfer Taxes increased. The increase was from 1.5 trillion yen at the end of FY 1990 to 30 trillion yen at the end of FY 1999. By the end of FY 1999, total outstanding of these bonds and borrowing was 506 trillion yen (222 trillion yen at the end of FY 1990).

The concern for sustainability of fiscal deficits is a background for the fiscal reconstruction and structural reform movement by the current Koizumi Administration. The "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Development" was decided upon after acceptance of the report compiled by the Council on Economic and Fiscal Policy, an advisory council to the Prime Minister. In this report the core of policies for the structural reform of the economic society was made clear. In part of the policies shown, a goal to limit the amount of government bond issues to less than 30 trillion yen in the FY 2002 budget, and afterwards achieve a primary surplus, was set to show that there exists a necessity to take on full-scale measures towards fiscal consolidation.

However, in order to cope with the bad situation of macro-economy, 1.8 trillion yen of the advance tax cuts was employed with a view to strengthening the competitiveness of industry, facilitating a smooth transference of assets to the next generation, promoting a shift from “saving to investment”, advancing effective land use, and so on. The goal to limit the amount of government bond issues to less than 30 trillion yen in the FY 2002 budget was finally abandoned. In the FY 2003, new government bond issues are 36.4 trillion yen and the bond dependency rises to 44.6%.

III. Macroeconomic Effects of Fiscal Policy

Based on the above discussions, we first examine the macroeconomic effects of fiscal policy empirically. There exist competing arguments on the efficacy of fiscal policy in the 1990s. One hypothesis is that the effects of fiscal policy were very large and hence recession would have deepened without fiscal expansion. On the contrary, alternative is that fiscal policy did not have an expansionary effect enough to push up the macroeconomic activity and hence unlimited public expenditures simply made the fiscal crisis worse. These opposing arguments, which lead to different policy implications, are mostly due to different understanding of the macroeconomic analytical framework. Namely, the former hypothesis is based on the conventional Keynesian model of liquidity-constrained agents, while the latter is based on the neoclassical model of rational agents.

Using the VAR method, Ihori, Nakazato, and Kawade (2003) showed that fiscal policies have generated limited effects on output in Japan. Namely, tax policies did not have a stronger effect than changes in government expenditure. Furthermore, the effect of fiscal policies was too marginal to recover macroeconomic activities, which is consistent with the latter view based on the neoclassical model of rational agents.

Therefore, we may say that the multiplier effect of public works has become very low in recent years, and hence the efficacy of stimulating aggregate demand by using public works is controversial. As the allocation of public works is not appropriately determined, it could not stimulate private consumption or investment. The resulting cost is a huge increase in government deficit in the 1990s. There are some empirical studies on the productivity effect of public capital in Japan; among others, see Ihori and Kondo (2001). They commonly conclude that public capital was productive but its productivity has declined recently. Results in 1990s suggest that the 'non-Keynesian' effect has some relevancy in Japan. When the fiscal situation becomes very serious, fiscal reconstruction may stimulate private consumption and investment due to the 'non-Keynesian' effect.

Some could argue that the central and local governments, although heavily indebted, also have credits and assets. The total value of the government-held tangible and financial assets – those of the central government, local governments and social security funds - is about ¥900 trillion, far more than the ¥700 trillion government debt. It is therefore argued that government debt is not a great concern because the net asset position is positive.

Public pension funds, in particular, now hold assets of about ¥200 trillion, a sum amounting to about two-thirds of the central government's outstanding debt load. The funds are creating net surpluses because contributions exceed payouts. So, in terms of the general government (the central and local governments plus the public pension funds), the fiscal deficit is not extremely large. The increasing reserves in the public pension funds help to offset, as it were, the increasing government debt. On balance, therefore, Japan's net fiscal position does not look so serious.

To be sure, the sale of government-held assets translates immediately into government revenue and thus reduces the debt, of the balance of the public bonds. However, the argument that debt is not much of a problem in net terms raises two questions.

One question is just how many government assets could actually be sold. Many government-held tangible assets exist in the form of public infrastructure, such as roads. These would be hard to sell. By the same token, many of the financial assets, held in pension funds, are also unsalable. The pension reserves, of course, are intended to be dedicated to future payments to pensioners. The pension insurance premiums collected from working people must be paid some time in the future, in the same way that public bonds must be redeemed as they mature. The pension fund is thud different from tax revenues, which the government can use freely.

Another question is how these public pension funds will develop over the long haul. The indicators are that balance of pension funds will deteriorate as the birthrate declines and the population ages. Perhaps 20 or 30 years from now, this could lead the overall government deficits to assume even more serious proportions.

In addition to the concern that the accumulation of public debts may well be unsustainable, the expansionary fiscal policy in the 1990s has another problem. Prolonged excessive budget deficits are harmful for the economy in the sense that excessive deficits today mean higher political privileges tomorrow, which results in delay of restructuring the fiscal system in a more efficient way in the long run.

IV. Local Interest Groups and Soft-Budget Problem

Politically speaking, since the Hosokawa coalition government decentralization became one of the main issues of the central government politics. During this period reforms towards political and fiscal decentralization gained much popularity. The Council for Decentralization Promotion recommended to reform subsidies from the national government to the local governments, and in 2000 the Decentralization Act was implemented to reform administrative duties. These measures were for the purpose of local decentralization.

In particular the current Koizumi administration intends to conduct the whole package of decentralization. The "Plan on the Reform of the Three Major Policies" will be promoted to realize the fundamental objective of local autonomy, which is to allow local government authority to make its own decisions. The decentralization process means that the governance of central government on local governments would weaken. However, the speed of fiscal decentralization has not been high so far. Although the idea of structural reforms is very popular among politicians and business people, the actual structure of intergovernmental financing does not change much.

In Japan, the central government provides heavy financial support to local governments, amounting to about 5% of GDP every fiscal year due to the soft-budget problem in the intergovernmental financing. Many local interest groups (or politicians) seek to obtain more money from the central and local governments through a variety of lobbying activities. They may be regarded as one of the most powerful interest groups in Japan. From the data on Japan's public works, in comparison with other countries' figures, we may say that local residents in Japan have larger privileges than in other countries, reflecting an influential role of their interest groups. In the 1990s, the government deficits in Japan increased rapidly because local interest groups living in the rural and agricultural area got a lot of transfers mainly in the form of public works. Agriculture-related public capitals and fishing ports and measures for flood control and conservation of forests are being accumulated too much due to lobbying activities of local interest groups.

The ratio of national taxes to local taxes within the total tax burden borne by Japanese citizens is approximately 2 to 1, but in order to achieve balanced finances among all prefectures, a fixed percentage of national taxes are provided as Local Allocation Tax Grants to local governments for unrestricted use. The national government reserves a certain ratio of national tax revenue in the General Account as a common fund for local governments. It distributes funds to each local government according to their fiscal needs and local revenue sources, based on a detailed equation determined by the national government. In the General Account of the national government, Local Allocation Tax Grants distribution amounts to a certain percentage of national tax revenues that are determined by the Local Allocation Tax Law. It includes 32% of the revenue from the personal income tax and the liquor tax, 35.8%of the revenue from the company income tax and 29.5% of the revenue from the consumption tax, and 25% of the revenue from the tobacco tax.

Furthermore, the national government uses subsidies to make disbursements to local governments for specific purposes. Consequently, the final ratio on an expenditure basis is the reverse: namely, approximately 1 to 2. In short, the financial resources needed by local bodies are transferred from the national government to local governments

Therefore, representatives of the Diet appeal to the cabinet or the central bureaucrats to distribute more in their own regions. Getting more grants is important for them to be reelected. Allocation of region-specific privileges in the form of subsidies or public works from the central government has been mainly determined by the political factor.

More representatives in the ruling party, the LDP for postwar period, have been seated for the rural regions. People in the rural regions have more representatives in the ruling party than in the urban regions. The ruling party exerts an influence to decide the national budget. So the representatives for the rural regions, who affected by local interest groups and voters, put political pressure to distribute more grants to the rural regions. A region where more representatives in the ruling party are elected for is distributed more subsidies from the central government throughout the period. It is hence important to incorporate political influence of local interest groups explicitly into the analytical framework.

Doi and Ihori (2002)'s empirical evidence indicates that lobbying activities of local interest groups was exaggerated in the 1990s, which is the main reason why fiscal reconstruction did not perform very well in the 1990s. Namely, an increase in local and/or national taxes may result in an increase in lobbying activities of local interest groups. In particular, an increase in the evaluation coefficient is relevant since it induces an increase in lobbying activities to seek for more privileges during transition and larger deficits, while it reduces national-wide public goods. Such movements were actually observed in the 1990s when the Japanese economy suffered from a slow-down of economic growth.

In order to realize successful fiscal reconstruction, the central government needs to restrain lobbying activities of local political groups. Seeking to enhance efficiency and transparency by a new re-assessment system of public works is important to reduce local privileges. Reforming the local allocation tax system so that each local government has to collect taxes to finance its own spending is crucial for solving the soft budget problem.

V. Concluding Remarks

The Japanese fiscal deficits are no longer sustainable, and hence that the Japanese government would face the severe fiscal situation in the near future. We should resume to reduce fiscal deficits as soon as possible. Before concluding the paper, let us finally examine the feasibility of fiscal consolidation in Japan. There seem to exist some political constraints to resume fiscal reconstruction attempts from the experience of the failure of the Fiscal Structural Reform Act in 1998. In Japan, the central government cannot resume to reduce fiscal deficits before recovering stable economic growth. In other words, it cannot politically change from the expansionary fiscal policy to the consolidation policy until the growth rate is held to plus without fiscal expenditure. In detail, we think that politicians can accept the idea of fiscal reconstruction only if the real GDP growth rate becomes more than 1% for 4 quarters continuously. Actually, the Japanese government planned such a change when the growth rates in the second and third quarters of 1999 were held to plus, but it could not obtain the policy goal because the growth rate became negative again.

Even though this condition is realized, the central government cannot purse fiscal reconstruction if another political condition is not satisfied. Namely, politicians can accept the idea of fiscal structural reform toward fiscal reconstruction only if the government party occupies majority stably in the Diet, and hence the probability of dropping power is low enough. Among others, Persson and Svensson (1989), and Alesina and Tabellini (1990) found that a stable government has an incentive to reduce government deficits. Also Alesina and Perotti (1995, 1996) reported that coalition governments in OECD countries delayed reducing fiscal deficits.

In Japan, the government party (the LDP) has been weakened and budget deficits have been increased since the late of 1970s. The LDP swept in the general elections of the House of Representatives, and began to reduce fiscal deficits (fiscal reconstruction) in the 1980s. In the 1990s, especially after 1993, several parties formed a coalition government, and fiscal deficits increased as mentioned above.

The progress in Japan fits the findings of the above theoretical and empirical works.

Even if it is needed to stimulate the aggregate demand, the traditional Keynesian policy seems ineffective. Furthermore, when the fiscal situation becomes very serious, fiscal reconstruction may stimulate private consumption and investment due to the 'non-Keynesian' effect. It seems that the 'non-Keynesian' effect has some relevancy in Japan.

Japan's fiscal condition has deteriorated markedly over the past ten years. It is therefore imperative that deficit be reduced over an extended period. More specifically, the budget gap should be reduced gradually over the next eight years, through 2013, to a level at which the budget balance – the balance including the interest and debt servicing – maintained. To this end, the deficit as a percentage of GDP needs to be cut by 1 percentage point each year. This target should be achieved through a combination of spending cuts and tax increases.

Finally, as the size of public spending cannot be raised any more, private resources become more important. We should coordinate public sector with private contribution of public goods such as NPOs. If public policy could crowd in more activities of private agents, it would help to stimulate the overall macroeconomic activities. The role of private initiatives in cooperation activities is becoming increasingly important in terms of providing the highly detailed assistance required to meet the diverse needs of people in the developed society, and promptly and flexibly implementing safety-net assistance activities.

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