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Framework for Fiscal Consolidation: Successes and Failures in Japan

by
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This article discusses selected historical developments of Japan's public finance system from 1947 through 2004, then analyses the successful efforts for fiscal consolidation in the 1980s and the unsuccessful attempt in the 1990s. The article concludes with a look at ongoing reform efforts and lessons for the future.

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Summary

Japan's experience in fiscal consolidation is dotted with successes and failures. The success in terminating deficit-financing bond issuance in 1990 has been played down as a mere by-product of the bubble economy. The role played by luck cannot be denied, but steady efforts for spending cuts and revenue increase in the late 1980s were equally important. The efforts made in the late 1990s were generally believed to have failed because they were implemented untimely. However, it has now been gradually accepted that the increase in the consumption tax rate in 1997 did not severely affect the economy by itself. If there was an error in judgment, it was the drive towards the enactment of the Fiscal Structural Reform Act, the structure of which was too rigid, in an economic environment where troubles could have been foreseen.

This article first traces the historic developments of Japan's fiscal conditions, and then analyses the factors that made the efforts in the 1980s a success and those in the 1990s a failure. It also looks at the ongoing reform efforts in a forward-looking manner.

1. Background: historical developments of Japan's public finance

1.1. Legal principle for balanced budget (1947-64)

The Public Finance Law (1947) stipulated that national expenditure must be financed by revenues other than government bonds or borrowings, and thereby establishes the principle of a balanced budget. The law, however, set exceptions: the government can issue bonds or borrow funds for the purpose of financing public works, investments (*e.g.* quota at the IMF) and loans. Among these exceptions, bond issuance for public works ("construction bonds") had by far the greatest implication for the subsequent fiscal developments.

The rationale behind this provision is that public works create assets for the nation which match the government's liability incurred by bonds/borrowing. Because the benefit of such assets would accrue for a long time, it would be reasonable to let the future generations share the burden of debt service. At the time when much of infrastructure had been destroyed by bombings during the war, it seems natural that policy makers wanted to keep the borrowing option open for public work projects so that reconstruction would proceed as fast as possible, given the depleted national coffer.

In practice, however, construction bonds were never issued until well into the 1960s. This is because the government's priority in the late 1940s was to reduce fiscal deficits, following the advice of a United States envoy, Joseph Dodge. After the Korean War of 1950-51, a tragic event that nevertheless gave an unexpected boost to Japanese industry, the economy began to expand very fast, which in turn increased tax revenues so much that it was unnecessary for the government to issue bonds to finance expenditures.

1.2. Deficit-financing bonds as an exception (1965-75)

The initial budget for FY 1965 was balanced, as had been the case for all previous post-war budgets, but it became clear in the course of the year that revenues would not meet the budgeted target, due to the stagnant economic situation. The government therefore decided to issue bonds to cover the revenue shortfall. In order to do so, a special law that enabled the government to issue deficit-financing bonds was required, because there was no legal basis to issue bonds to cover current expenditure (*i.e.* not for public works or investment).

The issuance of deficit-financing bonds in FY 1965 was regarded as a one-off event. In fact, deficit-financing bonds were not issued again between FY 1966 and FY 1974, though the government had to issue construction bonds every year. In other words, revenue shortfalls during this period were kept smaller in size than the public works expenditures.

The first oil crisis of 1973 was a turning point. The recession that followed the crisis resulted in prolonged stagnation of tax revenues, which obliged the government to issue deficit-financing bonds, based on another special law, in the course of FY 1975. Since then, such a special law was enacted every year, and outstanding government bonds accumulated (both construction bonds and deficit-financing bonds).

1.3. Exception turned to norm: accumulation of debt (1976-78)

As the government finance relied more on borrowing, the idea of Keynesian demand management became more widely accepted. Bonds were issued not only to cover tax shortfalls, but also to stimulate economic activity with the hope that the ensuing recovery would result in increased future tax revenues. The trouble was that, since the government expenditure programmes were on the increasing trend, revenue shortfalls became structural.[1] In addition, the memory of the high economic growth period (1950-60s) took hold of people's expectation so much that the real GDP growth rates of 4-6% in the late 1970s were deemed unsatisfactory, and the government was permanently under pressure to achieve higher growth through public expenditure and/or tax cuts. Thus, even though the 1974 recession following the oil crisis turned in late 1975 to a positive growth led by private-sector demand, the government continued to issue sizable amounts of both construction and deficit-financing bonds. If Keynesian demand management also involves government's retreat (and hence redemption of outstanding debt) during an upturn, Japanese fiscal policy since the 1970s could not be defined as such.

The problem was compounded by international policy co-ordination. At the 1977 G7 economic summit in London, Germany and Japan were pressured by the United States to implement measures to achieving higher economic growth. The Japanese government duly increased the FY 1978 budget expenditure by 20% and at the following summit meeting in Bonn, Prime Minister Fukuda promised to take appropriate measures as necessary for a 7% growth for that year.

Because of the failure to cut back expenditure, Japan's public finance had become totally dependent on bond issuance. In the budget of FY 1979, revenue raised through bonds amounted to 39.6% of total expenditure. The bonds outstanding were 25% of GDP, and the debt service cost exceeded 10% of the budget expenditure.

1.4. First attempt at fiscal consolidation that failed (1979-83)

Facing this severe fiscal condition, Prime Minister Ohira, who succeeded Fukuda in 1978, proposed to introduce a 5% general consumption tax. He included this idea in the campaign platform of the LDP (Liberal Democratic Party) for the 1979 general election, only to lose the majority in the House of Representatives (Lower House). Apparently, the general public, which was concerned about the economic outlook in view of the second oil crisis, preferred a lower tax burden in the short term to higher debt burden in the long run.

After abandoning the general consumption tax proposal, the Ohira government adopted in 1980 a policy goal of stopping deficit-financing bond issuance in 1984. Following Ohira's demise, the Suzuki government committed itself to "fiscal consolidation without tax increase". In order to achieve this objective, the so-called "zero ceiling" was introduced in 1982. It refers to the guideline that sets the maximum budget requests each spending ministry could submit to the Ministry of Finance (MOF): for the first time, spending ministries were not allowed to request a budget for the following year above and over the amounts authorised in the ongoing budget. From 1983, a "minus ceiling" – namely the spending ministries are only allowed to request an amount below the authorised amount for the ongoing budget – has been maintained to date with some variations.

Despite these efforts, because tax revenues fell far short of the budget in FY 1981 and FY 1982 and thus could not be expected to increase much afterwards, it became clear that it would be impossible to stop issuing deficit-financing bonds in FY 1984.

1.5. Second attempt at fiscal consolidation that succeeded (1984-90)

In 1983, a new target for forgoing deficit-financing bonds was set for 1990 and more vigorous efforts were made to contain expenditure. Through the "minus ceiling" system, the general expenditure[2] decreased slightly every year between FY 1983 and FY 1987. As a result, in FY 1987, the bond-to-expenditure ratio decreased to 16.3% and the general government fiscal balance recorded a surplus of 0.7% of GDP.[3]

That such an improvement in the fiscal condition was achieved without a tax increase was a great success by any standards. The various measures taken included privatisation of national railway and telecom companies, sale of government assets, and encouraging private sector initiatives for urban and resort developments. Contrary to those forward-looking measures, there were also measures that did not squarely tackle the problem. For instance, some transfer payments to special accounts, local authorities, etc., were simply postponed. The rationale behind the decision was that the recipients of these funds were rich in reserves, so that they could do without the payments from the national government for a while. However, most of these missed payments were not cancelled but simply deferred, so that the central government (general account) still owes them these liabilities plus interests, which contributed to fiscal sclerosis that has been developing since then.

An unexpected development from the fiscal consolidation efforts at the time was that the decrease in general government dis-saving led to an increase in the current account surplus, which invited much international criticism, especially from the United States. This set the stage for international policy co-ordination starting with the Plaza Agreement of 1985. Japan was requested to appreciate the yen and stimulate domestic demand. The request put the Japanese government in a bind: on the one hand, fiscal consolidation to which the government had been committed during the past ten years was gradually bearing fruit – benefits which could be lost forever if the austere policy stance was allowed to slip back even a little; on the other hand, stormy trade conflicts with the United States in the mid 1980s needed to be calmed at any cost, not least because of the fact that, in those days of renewed East-West tensions, Japan's national security depended almost exclusively on the United States.

The problem, however, turned out to be easier to solve. Because the rise of the yen was beyond any imagination in its magnitude and speed, the Japanese economy stagnated and the government did not have any other choice but to take expansionary measures. In 1987, the interest rate was lowered to the then historic low of 2.5%, while large-scale public investment programmes were adopted. The excessively lax policy stance led to an explosive recovery spurred by private sector consumption and investment. The euphoria pushed up stock markets and land prices, creating a huge bubble. Even the introduction of a consumption tax in 1989, with a tax rate of 3%, did not change the optimism that filled the air. Thus, the bubble economy increased tax revenues so much that in FY 1990 the government was able to stop issuing deficit-financing bonds. The bond-to-expenditure ratio reached 8.4% in the FY 1990 budget. It should be noted, however, that construction bonds were still issued in order to finance public investment programmes that were either ongoing or newly introduced. Given the favourable economic conditions at the time, it is clear that these programmes were not necessary from a demand management viewpoint.

In any event, the government's policy target of forgoing deficit-financing bonds in FY 1990 was achieved almost by default. It is undeniable that austere efforts during the mid 1980s prepared the ground for the subsequent success: but, to be fair, the main reason behind the success in the late 1980s was a windfall increase in tax revenues brought about by the bubble economy. Had there not been a boom, the efforts since the mid 1980s that focussed mostly on spending cuts would have failed just as similar efforts failed during the early 1980s. In other words, for all undesirable side-effects and long-lasting repercussions, without the help of the bubble economy, fiscal consolidation could not have been achieved in 1990.

1.6. Post-bubble blues (1991-96)

Hugely inflated stock prices began to fall in January 1990, while equally skyrocketed land prices started to decline in January 1991. The bubble was thus punctured. Still, people remained so bullish that they thought a downturn was merely a short-term phenomenon from which the economy would rebound strongly before long.

In this environment, tax revenues started to decline from 1992, though the decrease was offset by the reserves until 1993. Accordingly, the government could do without deficit-financing bonds until 1993.

In the hindsight, the first four years of the 1990s, when deficit-financing bond issuance was suspended, were but a short respite. As time progressed, it became quite obvious that the government was fighting a desperate battle to resist re-issuing deficit-financing bonds. Since 1992, the government had to increase construction bond issuance in order to finance public investment projects that were expected to add demand to the sinking economy. In addition, from 1994, major tax cuts were implemented, aiming at stimulating the economy, which was a last straw that made it unavoidable to issue deficit-financing bonds.[4]

Table 1. **Fiscal measures for stimulus, FY 1992-97**

Trillion yen, percentage

	FY 1992	FY 1993			FY 1994	FY 1995		FY 1996	FY 1997
	August	April	September	February		April	September		
Expenditure packages	10.7	13.2	6.0	9.4	–	7.0	14.2	–	–
(Per cent of GDP)	2.2	2.7	1.2	2.0	–	1.4	2.8	–	–
Tax changes compared to 1993	–	–			(3.8)	(3.8)		(3.8)	0.2
(Per cent of GDP)	–	–			0.8	0.8		0.7	0.0

Note: Figures in brackets show negative values.
Source: Ministry of Finance of Japan.

Although the highest national priority of the period was economic recovery, fiscal consolidation was not completely forgotten, if not by the public at large at least within the government. In 1994, the government decided that the consumption tax rate should be raised from 3% to 5%. To prepare the ground, taxes were cut for the three preceding years. Because the tax cuts were larger in size than the expected increase in consumption tax revenues, it was thought that the economic impact of the tax increase would be well offset. To ensure that the rate increase would not damage the recovery, it was also decided that a final decision for the increase would be made in FY 1996, looking at the economic conditions then. It was a desperate move, from the viewpoint of fiscal soundness, because in FY 1996 the bond-to-expenditure ratio rose to 28%, roughly the level of FY 1980.

1.7. Getting closer to deflationary spiral (1997-2004)

Indeed the economy duly recovered, apparently responding to the massive Keynesian stimuli. After shrinking by 1% in FY 1993, real GDP grew by 2.3%, 2.5% and 3.6% in the following three years.[5] Against this development, the rise in the consumption tax rate in April 1997 was confirmed in the autumn of 1996. As expected, demand was frontloaded in the first quarter of 1997, and household consumption turned negative in the second quarter of 1997 before recovering in the third quarter. Unexpectedly, however, the Asian crisis occurred in July 1997, which poured cold water on manufacturing companies' demand projections, followed by a severe crisis that exploded in the Japanese financial sector in the autumn, resulting in considerable retrenchment of credit by financial as well as non-financial companies. As a result, bankruptcies jumped to a level not seen since 1985, and the aggregate debts of the failed companies amounted to JPY 15 trillion, twice as much as the previous record. Companies reduced investment, while households, feeling insecure about jobs, decreased consumption.

Prime Minister Hashimoto, inaugurated in January 1996, was strongly committed to fiscal consolidation. He not only pressed forward with the rise in the consumption tax rate, but also wanted to install a mechanism that projected a path along which fiscal consolidation should move towards the final goal of fiscal soundness. While he achieved a primary balance in the FY 1997 budget, he also pushed the Fiscal Structural Reform Act through the Diet in November 1997. Although deterioration of confidence in the economic outlook was already apparent in late 1997, reversal of the single biggest agenda of the Hashimoto government was deemed a political suicide. Thus, the austere FY 1998 budget was formulated based on the Act, and submitted to the Diet in January 1998.

The economy, however, started to contract again; this time it was not a short-lived backlash. Real GDP contracted by 1% in 1998. In the hindsight, 1998 was probably the toughest year for the post-war Japanese economy. None dispute the fact that crises in the domestic banking sector (two of the largest banks were nationalised) and upheavals in international finance (Indonesia, Russia, LTCM, etc.) played a major role in this precipitation, but it seems also undeniable that the severely austere fiscal stance contributed to multiplying pessimism. As it happens, a large-scale expenditure package was announced just after the initial budget passed the Diet, the Act was relaxed in May, Hashimoto resigned in July after a defeat in an Upper House election, his successor Obuchi made a U-turn on the government's fiscal stance, and the Act was finally suspended in December 1998.

Obuchi, who called himself the greatest debtor king in the world, indeed borrowed to expand expenditures and cut taxes. The FY 2000 budget that he formulated before he passed away relied heavily on bond issuance, which financed 38.4% of the expenditure.

Prime Minister Koizumi, who took office in April 2001, first promised not to issue bonds for more than JPY 30 trillion for the FY 2002 initial budget. He kept the promise, but the sluggish economy in 2001-02 obliged him to increase bond issuance in the course of FY 2002. Because the Koizumi government was committed to cutting down the size of public works, towards which the public opinion had increasingly become hostile for their alleged wastefulness, larger and larger portions of the bonds issued became deficit-financing bonds. In FY 2003 and FY 2004, 44.6% of the expenditure was expected to be financed by bonds, and the total bonds outstanding reached 100% of GDP in FY 2004, but continued low interest rates enabled the government to keep the debt service burden under control. As the economy was firming up finally in 2004, tax revenues started to increase, so that the government had to issue fewer bonds than projected in the budget. The initial FY 2005 budget was the first in four years to incorporate fewer bond issuance, though the bond-to-expenditure ratio was still expected to be as high as 41.8%.

Table 2. **Fiscal measures for stimulus, FY 1998-2004**
Trillion yen, percentage

	FY 1998		FY 1999	FY 2000	FY 2001		FY 2002	FY 2003	FY 2004
	April	November	June	October	October	December	December		
Expenditure packages	16+	17+	17.0	11.0	1.3	4.1	4.4	–	–
(Per cent of GDP)	3.1	3.3	3.3	2.1	0.3	0.8	0.9	–	–
Tax changes compared to 1993	(2.6)		(4.5)	(4.5)	(4.5)		(4.5)	(6.0)	(7.0)
(Per cent of GDP)	0.5		0.9	0.9	0.9		0.9	1.2	1.4

Note: Figures in brackets show negative values.
Source: Ministry of Finance of Japan.

2. Case study of success: the 1980s

2.1. Spending cuts

Through the failure to introduce a general consumption tax in 1979, the government realised that popular resistance to a tax increase was so strong that another attempt would be counterproductive for the time being. On the other hand, there was popular support for spending cuts. Thus the government's option was limited: it had to pursue spending cuts with the hope that one day popular opinion would warm to the idea of increasing taxes.

The first technique used to cut spending was to limit the size of budget requests across the board. The "minus ceiling" system worked in such a way that, *e.g.* for the FY 1984 budget, requests for current expenditures were not allowed to exceed 90% of the amounts that were authorised in the ongoing FY 1983 budget, while requests for investment expenditures were not to exceed 95% of the amounts.

This method was quite effective, so much so that the pace of increase in general expenditure slowed considerably. Although it increased by 13.9% in FY 1979, the rate fell to 5.1% in FY 1980, 4.3% in FY 1981, 1.8% in FY 1982, and for five years since FY 1983 it did not increase at all. In real terms using CPI, the size of the FY 1987 general expenditure was 9% smaller than that of FY 1979.

The method had a shortcoming, however. Because the size of the requests was determined by the size of the ongoing expenditure in the same category, the share of a certain expenditure item in proportion to the total expenditure tended to be static. It was unlikely that one area of expenditure won a bold increase while others got drastically chopped.

The second technique to note was placing an emphasis on general expenditure[6] and thereby creating a target that was easy to understand and compare with previous years. Indeed, the fact that general expenditure hardly increased for nearly ten years bore a symbolic appeal, which might have helped the government address the deep-rooted resistance towards consumption tax.

However, because general expenditure in the initial budget became a point of reference with which the public judged the success of fiscal consolidation efforts, it became highest priority for the government to manage its size. Thus, as mentioned before, some expenditure was apparently shifted from general expenditure to special accounts, and sometimes transfer payments from general expenditure to other accounts were suspended. In addition, if there was a need to add spending, it was more likely done in the supplementary budget during the course of a fiscal year.

Although great efforts were made in this period to contain budget expenditures with these methods, a large budget deficit remained. The deficit in the FY 1980 budget was JPY 14.3 trillion (of which deficit-financing bonds amounted to JPY 7.5 trillion), while the deficit in the FY 1987 budget was JPY 10.5 trillion (of which deficit-financing bonds amounted to JPY 5 trillion).

In sum, the first serious attempt at fiscal consolidation focused much on spending cuts, but it had only a limited, though respectable, impact on denting the budget deficit.

The main reason for the limited success was that debt service costs and allocations to local governments, the two expenditure items outside general expenditure, continued to mark a double-digit growth for most of this period. The annual budget deficit in this period was about JPY 10-13 trillion while general expenditure was around JPY 32 trillion. In other words, if debt service costs and allocations to local governments could not be reduced, spending cuts needed to be as large as one-third of the total expenditure in order to balance the budget. It is debatable if the public could have been realistically expected to accept cuts of such magnitude.

Still, it should be noted that the "culture" of spending cuts was firmly embedded in this period. In fact, initial budgets would rarely increase by more than 5% (general account) or by more than 3% (general expenditure) for the past 20 years since then. This prepared the ground for successful fiscal consolidation when revenues started to rise.

2.2. Revenue increases

In the early 1980s, tax revenues fell short of the budget projections. However, since FY 1986, they began to exceed projections. The aggregate "windfall" revenues in the five years between FY 1986 and FY 1990 amounted to almost JPY 20 trillion, thanks to the booming economy.

The most noteworthy development, however, was the introduction of the consumption tax in 1989. Although the attempt at introducing a general consumption tax failed in 1979, the government remained convinced that the imbalance between direct taxes on income (which were heavy in Japan) and indirect taxes on consumption (which were light) needed to be rectified, in order to prepare for the ageing society while maintaining the vitality of the economy. Thus, soon after Prime Minister Nakasone and the LDP won a general election in 1986, promising that he did not intend to introduce "the kind of large-scale indirect taxes that were being discussed", a government panel proposed the introduction of sales tax. However, local elections in April 1987 returned devastating results to LDP candidates. Facing strong opposition, the government withdrew the bill in May. Late in 1987, Nakasone was succeeded by Takeshita, who restarted a debate on the need to reform the tax system. Eventually, after two failures in ten years, the consumption tax bill passed the Diet in December 1988.

Although the consumption tax (tax rate: 3%) did not make an instant impact on the revenue intake – because its introduction was simultaneously sweetened by cuts in income taxes and other taxes[7] – it was to be a building block on which subsequent efforts for fiscal consolidation could be built.

2.3. Key factors behind success

To sum up, a few key factors that brought about the successful realisation of the pre-set target, namely stopping deficit-financing bond issuance in FY 1990, may be listed as follows:

- **Political leadership:** Every prime minister who served during the 1980s was committed to fiscal consolidation. The fact that, influenced by the Reagan-Thatcher revolution, small-government conservatism also became a popular ideology in Japan's political circle seemed to play an important role. Administrative reforms including deregulation and privatisation were effective for winning popular support for the government policy as well as for improving government finance.
- **Economic conditions:** The Japanese economy had gone through a slump in the mid 1980s, due to a doubling of the yen's value against the dollar, but adjustment efforts by the corporate sector and accommodative monetary and fiscal policies led to a long boom from 1987. When there was no credible path to fill the remaining gap between revenues and expenditures, especially after fiscal stimuli had started to be applied, no one could have foreseen that an economic boom, the magnitude of which would dispel all worries about revenue shortage, was indeed in store.
- **Spending cut *versus* revenue increase:** Spending cuts were a necessary condition to promote fiscal consolidation. Without them, the public opinion would not accept even the need to raise taxes. This was a lesson the government learned from its failure to introduce a general consumption tax in 1979. However, it is also true that spending cuts alone could not

achieve the goal, if tax revenues did not increase, as was witnessed in the early 1980s.

The government was lucky, in a sense, that the boom arrived just when revenue enhancement was needed. But, the luck may have visited the government because it had been doing its homework, namely efforts to contain expenditure and to introduce an unpopular new tax.

3. Case study of failure: the Fiscal Structural Reform Act

3.1. Structure of the original Act

The Fiscal Structural Reform Act, enacted in 1997 after a year of deliberations, stipulated multi-frontal goals that were to circumscribe budgets for the subsequent years.

First, by FY 2003, the annual fiscal deficit[8] should fall below 3% of GDP. In addition, deficit-financing bond issuance should be reduced every year until FY 2003 when the issuance had to be terminated.

Second, the Act set numerical reduction targets for major expenditure categories. For instance, expenditure for social security, which was expected to continuously increase because of the rapid ageing, should not increase by more than JPY 300 billion in FY 1998 and by less than 2% thereafter. Public works should decrease at least by 7% in FY 1998, and stay below that amount thereafter.

Third, long-term plans for certain expenditures were revised downward. For example, a ten-year public investment basic plan was extended by three years, and the defence procurement plan was to make savings of as much as 10% of the planned cost.

Fourth, in addition, the Act listed a guideline for reform in each expenditure category.

3.2. Modifications to the Act

Soon after the Act was implemented, the economy deteriorated even further, making it unavoidable to modify the provisions of the Act. Thus, in May 1998, three amendments were made:

- One: the annual decrease in deficit-financing bond issuance might be suspended in case measures were needed to address extraordinary natural disaster and/or considerable stagnation of the economy.
- Two: the fiscal year by which the fiscal deficit needed to fall below 3% of GDP and deficit-financing bond issuance should be stopped was extended from FY 2003 to FY 2005.

- Three: social security expenditure for FY 1999 was allowed to increase by more than 2% so long as the increase was contained as far as possible.

The economic difficulty was such that these amendments were regarded as cosmetic, and therefore voices for a U-turn in fiscal policy grew louder day by day. When the new prime minister took office, the Act became virtually fictional. It was finally suspended in December 1998 by special legislation.

Two supplementary budgets in the course of FY 1998 saw an increase of the budget deficit for that year from JPY 16 trillion to JPY 34 trillion, of which deficit-financing bonds more than doubled from JPY 7 trillion to JPY 17 trillion. Since then, the annual budget deficit has exceeded JPY 30 trillion every year, leading to debt outstanding of over 100% of GDP. It was as if Pandora's Box had been opened and a pent-up appetite for borrowing had sprung out. Thus, the historic attempt at institutionalising fiscal consolidation ended up in failure and the backlash was so great, and the recession so severe, that it was only in 2004 that the government could talk again of a need for fiscal consolidation in a realistic setting.

3.3. Key factors behind failure

To understand why the efforts in the late 1990s were a bitter failure, while those in the 1980s were successful, it will be useful to analyse the key factors.

3.3.1. Political leadership

Prime Minister Hashimoto who pressed forward the Act was as strongly committed to fiscal consolidation, if not more, as prime ministers in the 1980s. He was also skilful in forging consensus within the governing parties: in early 1997 he set up a council that he chaired in order to discuss the ways to achieve fiscal consolidation. Members of the council included former prime ministers, finance ministers and executives of governing parties, so that dissenting voices within the parties could be pre-empted.

Unlike in the 1980s, when there were a number of small and divergent opposition parties, a large opposition party existed in 1997. However, because it was a united front of small parties that was a showcase of infighting, and because the policy stance of key executives was close to the governing parties in fiscal conservatism, the government was able to pursue its own agenda.

Thus it appears that political leadership in the 1990s was not weaker than that of the 1980s. If there was one difference, the government in the 1990s was a coalition among three parties, while the LDP was able to form the government on its own in the 1980s. However, there is no evidence that the coalition partners checked the prime minister's drive for fiscal reform.[9]

3.3.2. *Spending cut* versus *revenue increase*

Limits on requests from spending ministries were equally stringent both in the mid 1980s and the mid 1990s. Growth rates in general expenditure were contained to 1-5% during the few years in the run up to the zero-growth period starting in FY 1983, whereas the rates for the mid 1990s just before the implementation of the Act were about 1-3%. Cuts in spending that became obligatory thanks to the Act were of course much more severe: general expenditure decreased by 1.3% in FY 1998.[10] To sum up, it was not the case that spending cuts were less vigorous in the 1990s than in the 1980s. On paper at least, the 1990s had a more solid regime which set legally binding spending cut targets for ministries.

The increase in the consumption tax rate was decided in 1996, when the Act was still on the designing board. But there is little doubt that the increase was seen as a part of the ongoing fiscal consolidation package, though the effect of the rise was offset by income tax cuts that had been implemented previously. In the event, the rate rise brought about a one-off shock to the economy, which was shrugged off after a quarter, but the economy was heavily damaged by the following two shocks, *i.e.* the Asian crisis and the financial crisis at home, and a round of large-scale tax cuts began in 1998. Tax revenues collapsed since then. In contrast, as stated above, tax revenues jumped up in the late 1980s and early 1990s, thanks partly to the introduction of the consumption tax, but mainly to the bubble economy.

3.3.3. *Economic conditions*

The economic recovery began to be felt in the mid 1990s. Every quarter since the first quarter of 1995, real GDP continued to mark positive growth until the first quarter of 1997. Activity in 1996, when the Hashimoto government was formed, was particularly robust: real GDP grew by around 4-5% (annualised) in three out of four quarters. Naturally, this trend was expected to continue, and based on that assumption rigorous fiscal consolidation was planned. Negative growth in the second quarter of 1997 came as no surprise, due to the fact that the rise in the consumption tax rate took effect in April of that year. Private consumption, and real GDP as a whole, returned to a positive growth in the third quarter. However, due to the double shocks mentioned above, the economy dipped into recession: consumption turned to negative in the fourth quarter, and real GDP shrank for five quarters out of eight in 1998 and 1999.

3.3.4. *Shortcomings of the Act*

It cannot be denied that the Act had shortcomings. The size of spending cuts and the schedule for stopping deficit-financing bond issuance were stipulated in a very mechanical and rigid manner. The fatal error was that it did not include a clause which would make it possible to allow some flexibility depending on the external conditions. The Act and its supporters were therefore put into a very vulnerable position when the economic situation started to deteriorate.

The Act was belatedly amended in May 1998, by which time the economy had clearly been in a slump and a fiscal stimulus package had already been announced, to allow an increase in deficit-financing bond issuance at a time of considerable economic stagnation. Such a condition was defined as two successive quarters of less than one per cent real GDP growth.[11] This is a generous escape clause, considering the EU Stability and Growth Pact (SGP) that can be waived when a country's real GDP growth for a year was negative 2% or worse. Even though the Act took its idea from the SGP[12] it was originally much stricter than the model and then became much tamer, reflecting a growth-oriented public opinion and a panicky reaction to the severe deterioration of the economy.

4. Lessons for the future

4.1. Keys to success

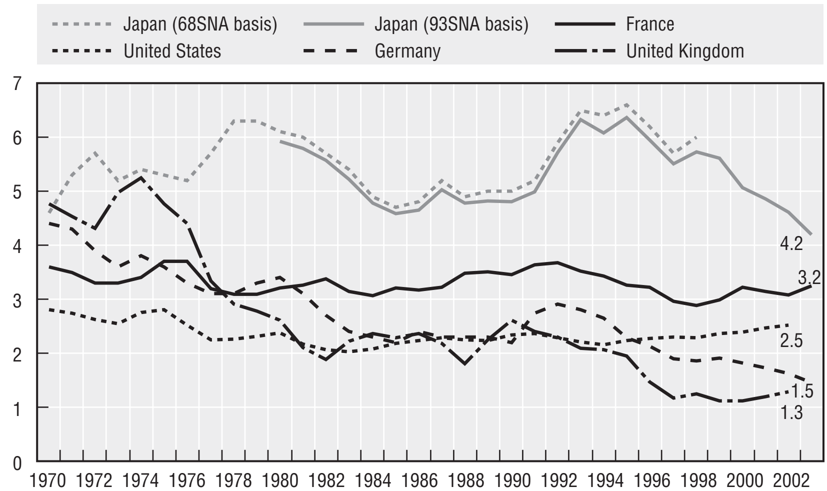
From Japan's experience since the 1960s, a few lessons for fiscal soundness may be distilled.

4.1.1. Addiction to demand management

When a catch-up period of fast growth ends, an economy usually moves to a more moderate growth path, reflecting a lower potential GDP growth. Japan was no exception. It is widely accepted among academics that Japan's potential growth rate refracted in the mid 1970s: two oil shocks made this shift more conspicuous. At least it should have been, but the general public tended to believe that high growth would continue if and when proper economic policies were implemented. This expectation led to a political culture that placed high priority on higher growth, which needed to be achieved almost at any cost. Thus, fiscal stimulus – which Keynes thought should be an exceptional measure at an exceptional time[13] – became a norm, mainly in the form of public investment projects. A popular notion that it was the government's responsibility to make high-grade infrastructure and a world-class social security system available throughout the country compounded the problem. Even during an upswing, fiscal withdrawal hardly took place. This trend was occasionally enhanced by international pressure for domestic demand stimuli, with a view to reducing Japan's current account surpluses.[14]

Because of such a bias towards higher growth and because of the expectation for government action to achieve the target, fiscal deficits accumulated. Since it is very difficult to uproot public expectation after it is

Figure 1. **International comparison of public investment (Ig) to GDP (per cent)**



Sources: For Japan: Ministry of Finance, *Annual Report on National Accounts* (FY basis). For the other countries: OECD, *National Accounts 2004* (CY basis).

strongly embedded in the national sentiment, it is critical not to unduly raise the expectation in the first place. The best recipe for fiscal consolidation is to forgo the need for it.

4.1.2. Political leadership

Without a strong will, it should be impossible to achieve fiscal consolidation, especially when fiscal stimulus is so strongly embedded in the political culture. Prime Minister Nakasone (1982-87), who pressed forward fiscal consolidation, was indeed a strong character, though his power base within the LDP was a small faction. There may be a different style of strong leadership: Takeshita (1987-89) valued consensus more than top-down decision making. Still, because he headed the largest faction within the LDP, his prestige and influence was peerless at that time.

Hashimoto (1996-98) was in a sense ideal, since his personality was strong-willed and he also had a power base in the largest faction that he had inherited from Takeshita. He did push forward many reforms ranging from the financial sector "big bang" to ministerial mergers, but failed in the fiscal field. Although he overcame any resistance to implement severe spending cuts and an increase in the consumption tax rate, he could not prevail over economic shocks. Sometimes quixotic charges by political leaders may indeed be indispensable for fiscal consolidation; but too strong leaders may become a liability if they do not pay attention to factors that may contradict their conviction, *e.g.* deteriorating external conditions. And it is always extremely difficult to choose between the two courses. If the goal is achieved, even a reckless leader with no qualms about adversities may be hailed as great, but if the goal is not achieved after all, collateral damage may be phenomenal. Those who stopped ongoing efforts by paying due attention to, *e.g.*, changing circumstances may be called cowards, but they may be the ones who are truly brave. Flexibility is a virtue, but luck plays a big role. In any event, when the economy sinks to recession, it would be extremely difficult to continue an austere fiscal stance in modern democracies. In sum, strong leadership alone is not a sufficient condition for success.[15]

If pursuing fiscal consolidation becomes unhelpful to achieving higher goods, just as in the late 1990s when salvaging the economy came before fiscal soundness, political leadership also plays an important role. Even if there is a bias towards accommodative fiscal policies, as in Japan, it is not an easy task to retrieve a previous position ("fiscal crisis should be averted through tough income/expenditure measures, which is good for the economy") to argue for a contradictory position ("given the economic environment, fiscal consolidation comes secondary"). Hashimoto swallowed pride and did it, which was no mean achievement.

4.1.3. Spending cuts and revenue increase

In the early 1980s, the attempt at containing expenditures was overwhelmed by a decrease of tax revenues. Similarly, in the late 1980s, spending cuts were pursued in earnest, but it was obvious that cuts alone could not balance the budget. The introduction of a consumption tax would help, but the economic boom increased tax revenues faster and more than the consumption tax would.

In the late 1990s, legal obligations for spending cuts were introduced, and the consumption tax rate was raised. However, tax revenues collapsed, due partly to the slump and partly to numerous tax cuts that were designed to stimulate economic activity. In order to add demand, expenditure increased dramatically. As a result, bond issuance exploded to finance the gap between the increased expenditure and decreasing revenue.

Thus, Japan's experience shows that simultaneous improvements on both revenue and expenditure sides increase chances of success in fiscal consolidation.

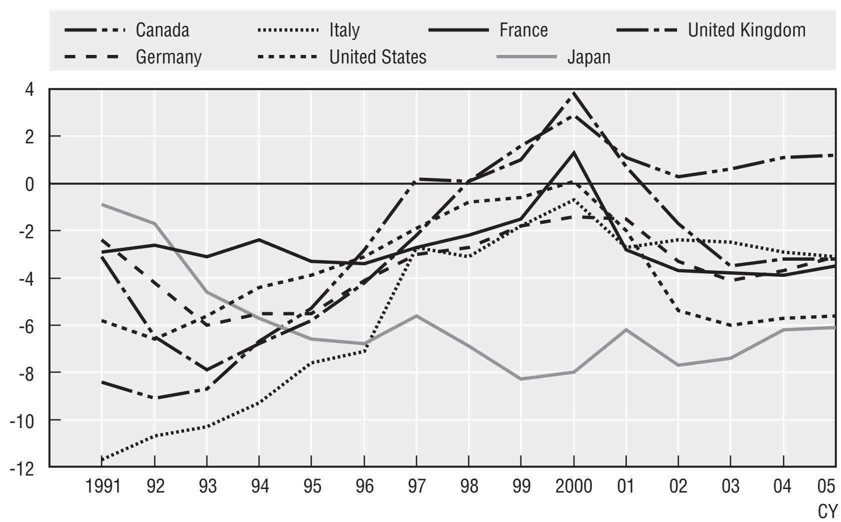
4.2. Renewed efforts

After marking negative real growth in 2001, influenced by the United States recession, the Japanese economy began to grow again in 2002. Against this background, the current Koizumi government (2001-) put fiscal structural reform back on its agenda. The need for it was obvious, since Japan's fiscal position had further deteriorated in the few years since the failure of the Fiscal Structural Reform Act. The general government fiscal balance remained negative while all other G7 countries scored impressive improvements in their fiscal conditions. As a result, the level of debt outstanding in Japan is by far the worst among the G7. However, given the still fragile state of the economy, the government's approach has been a cautious one.

4.2.1. Policy framework

The main target is to turn the primary balance[16] to surplus in the early 2010s. In the FY 2005 budget, the size of the primary deficit is projected as 4% of GDP: the central government deficit is 4.5%, while aggregate local governments score a surplus of 0.5%.[17]

Figure 2. **International comparison of general government balances (per cent of GDP)**

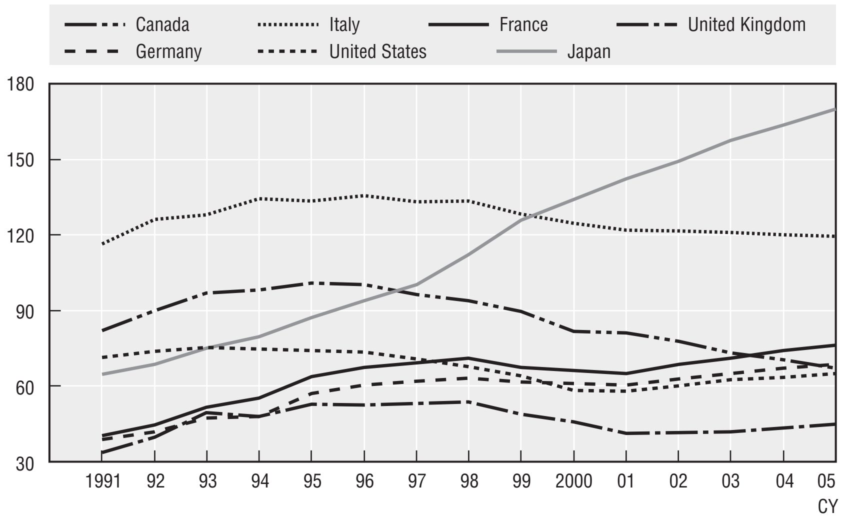


Note: Figures for Japan and the United States exclude social security funds.
Source: : OECD, *Economic Outlook No. 76*, December 2004.

To reach this goal, several guidelines have been put in place.

- First, until FY 2006, the size of the government (ratio of general government expenditure to GDP) will be equal or below its FY 2002 level. While the FY 2002 level was about 37.6%, the FY 2005 budget foresees 36.2%.
- Second, the amount of public investment by the central government should be streamlined, with a view to fall, by FY 2006, below the level that had been seen before stimulatory expenditure increases were introduced since 1990. In the FY 2005 budget, this level was almost within reach.

Figure 3. **International comparison of general government gross debt (per cent of GDP)**



Source: OECD, *Economic Outlook No. 76*, December 2004.

- Third, by FY 2006 the government is to judge what tax measures are required on the assumption that spending cuts are maintained and the economy is revitalised.

Following these guidelines, the FY 2005 budget was formulated, so that on the spending side every expenditure item except for social security and debt service has been reduced, and on the revenue side one half of the across-the-board income credit introduced in 1999 will be withdrawn from January 2006. As a result, the amount of deficit-financing bonds decreased for the first time since 2001.

4.2.2. Outlook for fiscal consolidation

Against this background, considerations should be made to judge if the current fiscal consolidation efforts will succeed.

First, among the key factors discussed above, political leadership is not in short supply.

Second, for the spending side, the key lies in whether social security expenditure can be contained when the massive baby-boomer generation is expected to move from the contributing side to the recipient side in the next few years. It is estimated that the pace of ageing in Japan is among the fastest in the world, which gives the government a sense of urgency in reforming social security systems. Another reason for hurry is the possibility that the

Table 3. **Age dependency ratio (percentage)**

	2000	2040
Australia	0.26	0.56
Belgium	0.37	0.71
Canada	0.26	0.63
France	0.34	0.69
Germany	0.38	0.72
Italy	0.40	1.03
Japan	0.39	1.00
Netherlands	0.29	0.69
Spain	0.35	0.99
Sweden	0.38	0.74
United Kingdom	0.34	0.65
United States	0.26	0.47

Note: Ratio of elderly adults aged 60 and over to working-age adults aged 15-59.
Source: Center for Strategic and International Studies.

ongoing extraordinarily low-interest environment may end before long, which could threaten to derail fiscal consolidation efforts.

Third, for the revenue side, two measures need to be taken. First: most, if not all, of the accumulated tax cuts since 1994 need to be withdrawn. Second: the consumption tax rate needs to be raised again. Both tasks are not easy even during boom years. However, the lesson from the past is that spending cuts alone will not achieve fiscal consolidation, because the expectations of the general public for the government's role cannot be deflated easily. Thus, unless the public can be persuaded that future levels of public services will be dramatically reduced, success in revenue increase is critical. This observation may be attested by an OECD calculation: Japan's cyclically adjusted general government fiscal balance has been constantly in deficit since 1993. It is clear that such chronic structural deficits can only be eradicated by a wholesale review of the government's role or an increase in tax and other burdens that the public should pay for the services they receive.[18, 19] Indeed, the balance between the benefits received from the public sector and the burden shouldered is very out of line in Japan compared with other industrialised countries.

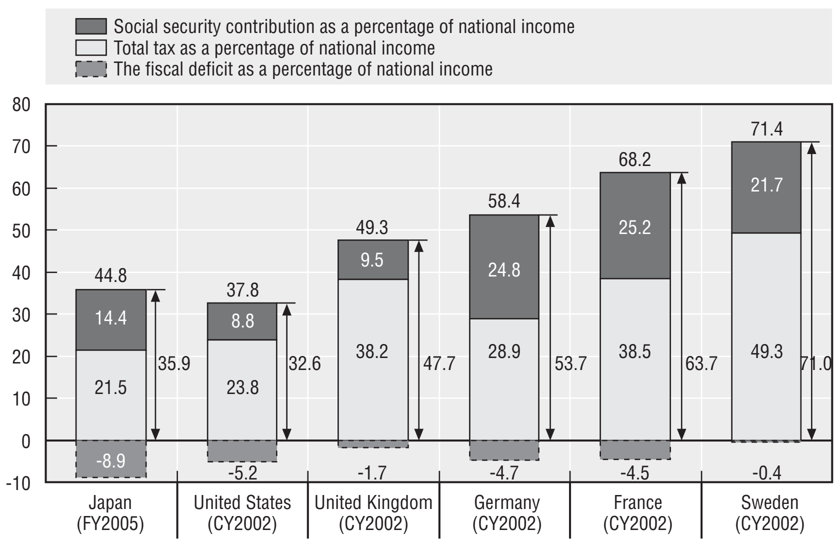
All these reforms will be indispensable. But, perhaps most importantly, for the reforms to succeed, a benign economic environment is a *sine qua non*. Because the economy, which slightly shrank in real terms in the second and third quarters of 2004, returned to the recovery path from the fourth quarter and marked significant growth (4.9%) in the first quarter of 2005, the time may be indeed ripe for renewing vigorous efforts.

5. Conclusion

There is no quick fix for fiscal consolidation. Although the bubble economy brought about an unexpected increase in tax revenues that enabled the government to stop issuing deficit-financing bonds, it will be wrong to hope its return, considering the lasting distortions and damages a bubble can inflict on the economy. It is as wrong as hoping for inflation to solve the fiscal problem.

Spending cuts and revenue increase are both important. The former is critical to constantly re-focus resources to priority areas in an efficient manner. It is also helpful in convincing the general public for the need to increase taxes. The latter is necessary especially when the public does not go too far down the road to a small government.

Figure 4. **International comparison of benefits and burdens (per cent)**

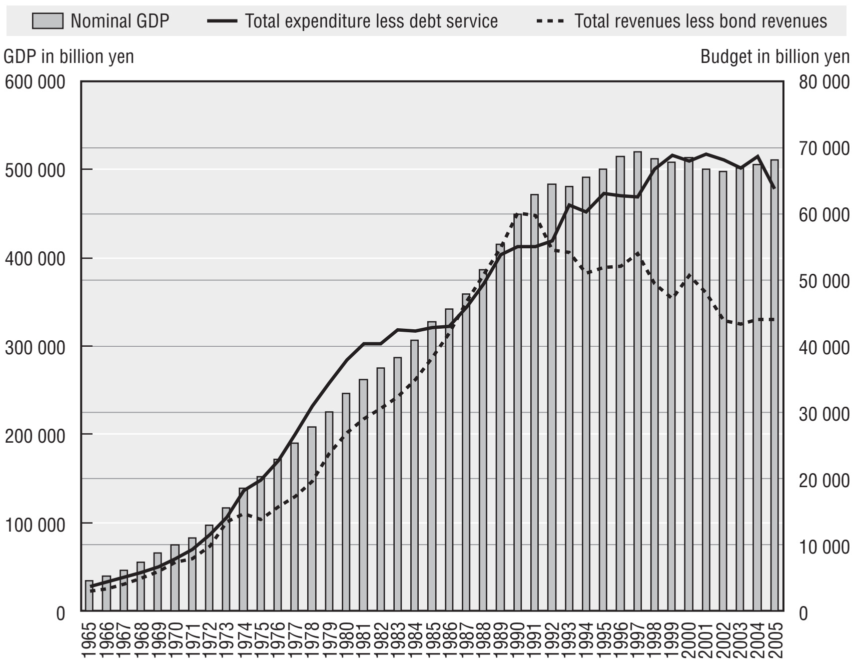


Notes: Japan: FY 2005 budget. United States, United Kingdom, Germany, France and Sweden: CY 2002 actual. The fiscal deficit as a percentage of national income for Japan and the United States excludes social security funds. Others are based on general government figures.

Source: Japanese government.

In Japan, economic conditions are improving, which will facilitate reforms including fiscal consolidation. The need for further spending cuts are widely shared, especially in fields of public investment. Financial arrangements of local governments should also require drastic changes, since the current system does not give sufficient incentive to individual local governments to improve their fiscal balances.[20] In addition, the need for reforms in the social security area is obvious, though public opinion may prefer keeping some of

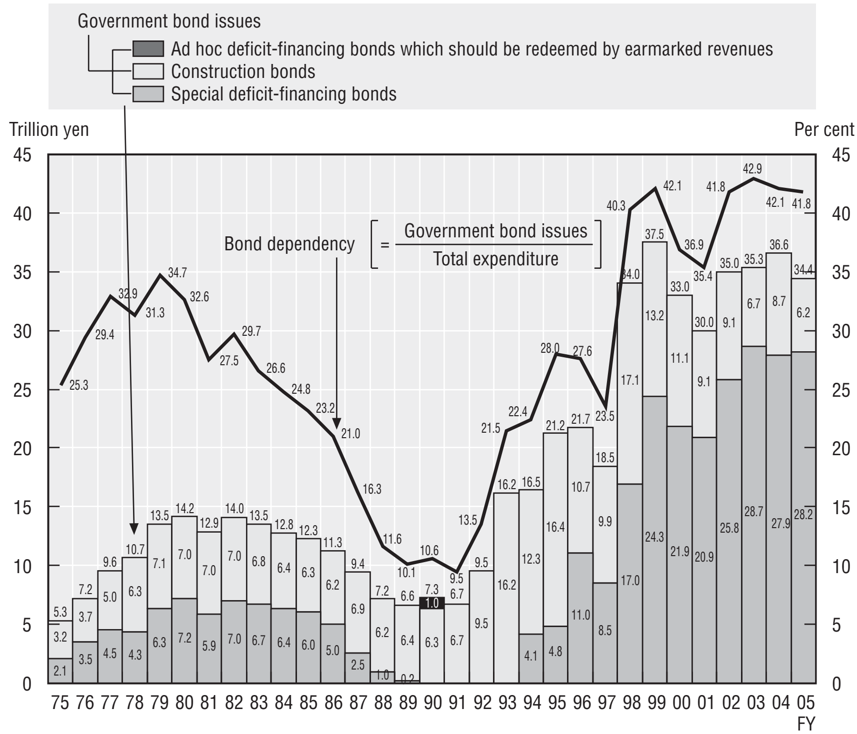
Figure 5. **Nominal GDP, budget expenditures and revenues**



Source: Japanese government.

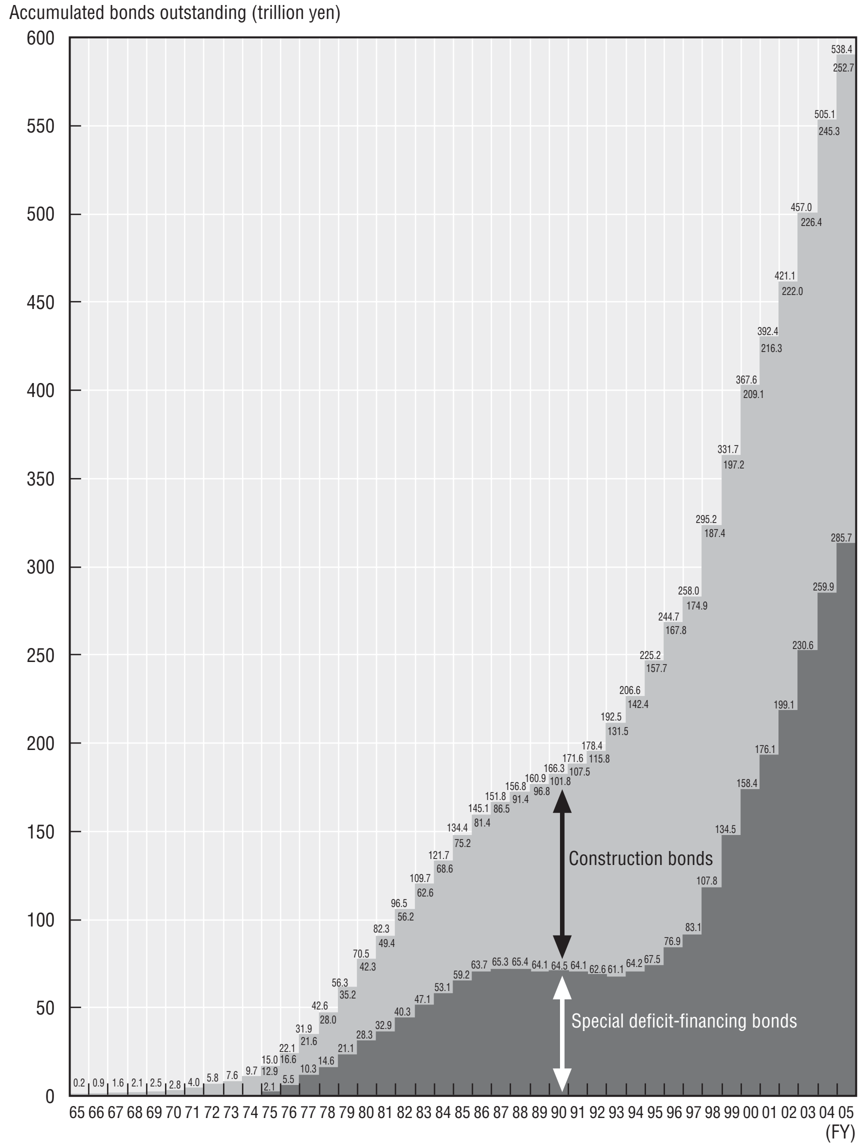
the current benefits, even if it results in a heavier tax burden, to making severe cutbacks with lighter burdens. It requires political leadership to strike the right balance, and it must be done very quickly. While long-term interest rates are relatively low, and while the baby-boomers are still in the workforce, the government needs to create a self-sustaining process of fiscal consolidation. Given the huge stockpile of past debts, the time left for Japan may be limited.

Figure 6. **Government bond issuance and bond-to-expenditure ratio**



Notes: FY 1975-2003: settlement. FY 2004: revised. FY 2005: budget.
Source: Ministry of Finance of Japan.

Figure 7. **Accumulated bonds outstanding (trillion yen)**



1. FY 1965-2003: actual. FY 2004 and FY 2005 are estimates.
2. The special deficit-financing bond amount includes refunding bonds for long-term debts transferred from JNR Corporation settlement and National Forest Service, etc.
3. The estimates for FY 2004 and FY 2005 (excluding front-loading issuance of refunding bonds) are approximately JPY 481 trillion and JPY 508 trillion respectively.

Source: Ministry of Finance of Japan.

Notes

1. Kakuei Tanaka became prime minister in July 1972. His two main domestic policy agendas were infrastructure development and more generous social security (social security is a wide-ranging concept that refers not only to public pension systems, but also to public medical insurance, unemployment benefit, subsistence allowance, etc.). These hugely popular programmes were introduced in law and institutions in the context of the budget for FY 1973, which became politically as well as institutionally difficult to curtail.
2. Total budget ("general account") expenditure less debt service and tax allocation grants to local governments.
3. The general government surplus was largely due to the surplus in the social security fund, however.
4. The figures in Tables 1 and 2 show the balance between tax revenues that can be expected under the 1993 regime and each fiscal year's estimated tax revenues after major tax cuts. The value does not take into consideration changes from inflation/deflation in subsequent years.
5. SNA data after FY 1995 are taken from the recently published revision that uses the chain-linking method.
6. Total expenditure (*i.e.*"general account") includes debt service costs and allocations to local governments, both of which cannot easily be cut even at a time of dire fiscal situation at the national level.
7. It was projected that the consumption tax would collect JPY 5.6 trillion. Together with other measures, the tax increase effect was expected to amount to JPY 6.8 trillion, while the effect of tax cuts (*e.g.* simplifying income tax rates, lowering the corporate tax rate, abolishing indirect taxes, etc.) was projected to reach JPY 9 trillion.
8. The targeted deficit was defined as the combined balances of central and local governments on the SNA basis. It did not take into account balances of the social security funds.
9. Coalition partners, social democrats and a new, small left-of-centre party called the Harbinger, may have realised their policy agendas in other fields: however, even the social democrats, who increased their representation in the Diet by campaigning against the consumption tax in the 1980s, supported the increase in the consumption tax rate within the government.
10. As said above, the decrease in the initial budget was more than offset by three supplementary budgets during the fiscal year.
11. Annualised and seasonally adjusted.
12. The final target for the Act was to limit the fiscal deficit (central and local governments on the SNA basis) to less than 3% of GDP, just like the target of the SGP.
13. It is argued that fiscal stimulus is a rather blunt tool, not least because of the unavoidable lags. "Normal" demand management should therefore be left to monetary policy and a built-in stabiliser function in the fiscal field.
14. The G7 argued for a locomotive theory in the late 1970s and domestic demand stimuli in the 1980s. The United States then argued that Japan's chronic current account surplus reflected "structural impediments" that existed in the Japanese economy. To address these, Japan promised to make public investment worth

JPY 430 trillion between 1991 and 2001, a plan which was revised upwards in 1994 to JPY 630 trillion for 1995-2004. To be fair, the United States also demanded deregulation to address Japan's structural impediments; still, it was intellectually interesting to hear that increased public works would solve structural problems.

15. A similar argument can be made regarding a rule-based approach to fiscal consolidation. Its advocates argue that following a pre-fixed fiscal rule regardless of external conditions is superior to an arbitrary approach, because it will work to people's expectations. However, it seems debatable if the rule-based approach is always more effective and less costly.
16. The primary balance is defined as the gap between "revenues excluding bond revenues" and "expenditures excluding debt service". The target figure is a combined primary balance of central and local governments on the SNA basis.
17. The advisory council to the finance minister published a simulation in May 2005. It said that in order for the central government's general account to achieve a primary surplus in 2015, while assuming no change in policies, either expenditures excluding debt service needed to be cut by 30% across the board, or tax revenues should increase by 40%. In the latter case, if all the increase was to be covered by the consumption tax, its tax rate would need to be as high as 19%, an increase of 14% from the current level.
18. See OECD, 2004. Because Japan has a big social security fund, and the fiscal condition of the local governments is better than that of the central government, the figures shown by the OECD almost certainly mask the true state of the central government fiscal conditions.
19. According to the same data, it is interesting to note that a number of countries, as well as the total euro area and the total OECD, continuously record deficits in cyclically adjusted balances. This suggests that the observation made here should apply not only to Japan but also to most industrialised countries.
20. Much of the gap between aggregate fiscal requirements and estimated revenues is almost automatically financed by the central government.

Reference

OECD (2004), *Economic Outlook No. 76, Volume 2004/2*, December, OECD Publishing, Paris.

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