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Fiscal Consolidation and Medium-term Fiscal Planning in Japan

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1. Introduction

The macroeconomic policy in Japan in the 1990s swung from fiscal expansion to fiscal consolidation and conversely. The efforts to restore soundness of public finance culminated in the Fiscal Structural Reform Act of 1997, which articulated several fiscal targets in the medium-term perspective. The act was however suspended after only a year due to economic slowdown, which threatened politicians with the possibility that fiscal consolidation might deteriorate the Japanese economy further. During the past decade, a number of economic packages to stimulate the return of the economy to a self-sustaining growth path totalled over 130 trillion yen in terms of project cost base.[2] However, the Japanese economy has not recovered. As a result, these discretionary fiscal policies made the fiscal balance dramatically worse and accumulated government debt to over 140% of GDP in 2002.

The new government under Prime Minister J. Koizumi was formed in April 2001. The government put structural reforms at the top of the agenda and included the fiscal consolidation plan to achieve a primary balance surplus in the early 2010s. While Japan is moving into an ageing society more rapidly than other countries, there is increasing pressure to restore public finances over the medium term. However, downside risk in the Japanese economy has been increasing since the middle of 2002 mainly due to serious deflationary pressure. Halting deflation is urgent in the short term for restoring economic growth. Japan is thus faced with considerable difficulties in achieving both the short-term objective of economic recovery and the medium-term objective of fiscal consolidation. In addition, Japan is in the extraordinary situation where there has been little incentive to enforce fiscal consolidation because huge domestic savings can finance huge government deficit, keeping the coupon rate of a ten-year Japanese Government bond to less than 1%.

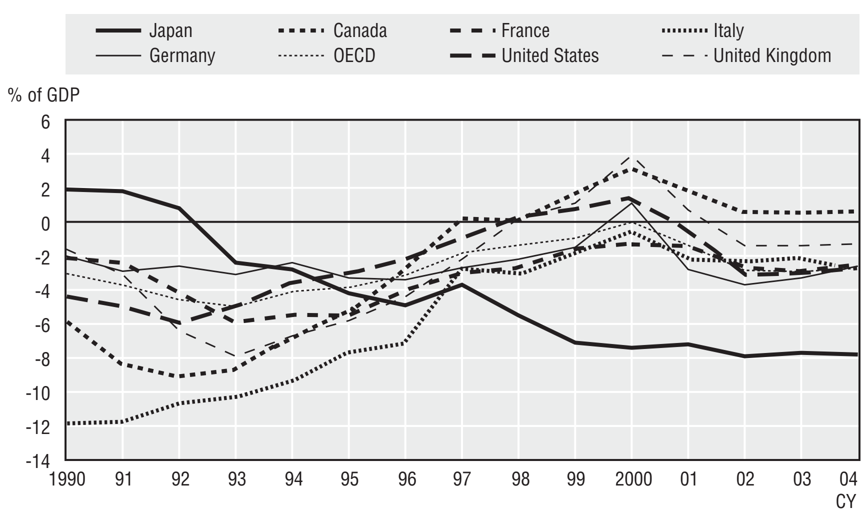
Although it is unfavourable to reduce public expenditure in the short term, it is possible to increase the efficiency of public expenditures particularly in welfare programmes, public works and grants to local governments. More importantly, it is necessary to strengthen the decision-making process within the government and to make it more transparent. The Administrative Reform 2001[3] created the Council on Economic and Fiscal Policy (CEFP) that is now expected to lead policy formulation, including budgeting, in Japan. But Japan is still in transition from a traditional policy-making process to a new one, because there are many disputes and conflicts between the government (the Cabinet) and the ruling parties. In particular budgeting deserves much attention: a considerable amount of literature from the political-economic point of view recently suggests that the budgeting process or budgeting institutions could influence fiscal performance significantly.[4] There is thus a need to consider the budgeting process and budgeting institutions in order to improve fiscal performance in Japan.

This paper discusses the development of medium-term fiscal planning and its future prospects in Japan, because it is one of the most important budgeting institutions for controlling public expenditure. Effective medium-term fiscal planning could definitely contribute to fiscal consolidation by increasing fiscal transparency and accountability. Section 2 follows recent developments in macroeconomic and fiscal policies. Section 3 briefly describes the structure of the budget. Section 4 explains the transformation of the budgeting process. Section 5 follows the development of medium-term fiscal planning in Japan. Section 6 discusses what is needed for restoring fiscal discipline. Finally Section 7 concludes.

2. Recent developments of the economy

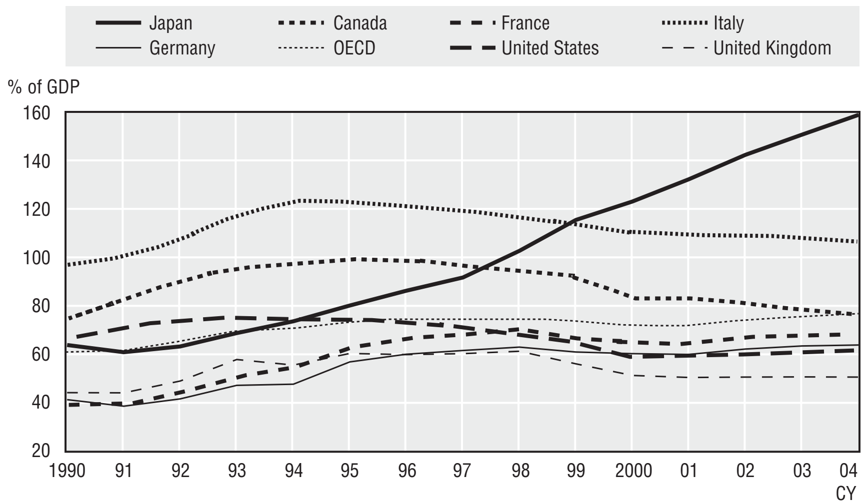
Japan enjoyed a relatively sound fiscal position in the beginning of the 1990s among G7 countries, as shown by the budget surplus which was about 2% of GDP in terms of general government in 1990 (Figures 1 and 2). The budget for fiscal year 1990 put an end to deficit-financing bonds[5] which had been issued continuously since FY1975. The government achieved the target

Figure 1. **General government financial balance in G7 countries**



Source: *OECD Economic Outlook*, No. 72.

Figure 2. **General government gross financial liabilities in G7 countries**



Source: OECD Economic Outlook, No. 72.

of formulating the budget without deficit-financing bonds. This success of fiscal consolidation was mainly due to an increase in tax revenue in the latter half of the 1980s as a result of the "bubble economy".

The burst of the bubble economy, however, caused a serious economic recession. Tax revenue fell short compared to the previous year for four consecutive years from FY1991 to FY1994. In 1994, a major tax reduction amounting to six trillion yen, or 1.3% of GDP, was carried out, with the gap financed by the deficit-financing bonds. Faced with such a serious economic condition, the government initiated various economic measures including a series of large-scale public work programmes from 1992 to 1995.

The government under then Prime Minister R. Hashimoto argued the necessity of fiscal structural reform, realising that increasing budget deficits would undermine the Japanese economy and society in the future. Restoring the sustainability of public finances was urgent due to population ageing which was creating new demands for public expenditures. In 1997, the government decided not to continue the temporary tax cut and instead raised the consumption tax rate from 3% to 5%. On the expenditure side, many expenditures were thoroughly examined and reviewed. To enable fiscal consolidation, the Fiscal Structural Reform Act was enacted in November 1997 (chronological events in the 1990s are shown in Box 1). The act set the target for reducing the general government deficit, excluding social security, to below 3% by FY2003.

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Box 1. **Chronology of main recent developments in public management**

1995	
June	The Decentralization Promotion Law was put into effect.
1996	
November	The Administrative Reform Council was established.
December	"Fiscal Restructuring Targets" decided by the Cabinet.
1997	
June	"Consolidation and Rationalization Plan of Public Corporations" was adopted by the Cabinet.
November	The Fiscal Structural Reform Act was enacted.
December	The final report was released by the Administrative Reform Council.
1998	
May	The Fiscal Structural Reform Act was amended.
June	The Basic Law on the Administrative Reform of the Central Government was put into effect.
December	The Fiscal Structural Reform Act was suspended.
1999	
March	"Second Decentralization Action Plan" was decided by the Cabinet.
2000	
April	The National Public Service Ethics Law was put into effect.
2001	
January	The Administrative Reform of the Central Government was put into effect.
April	Independent Administrative Institutions (IAIs) were established.
	The law Concerning Access to Information Held by Administrative Organs was put into effect.
June	"Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" was decided by the Cabinet.
December	"Consolidation and Rationalization Plan of Public Corporations" was decided by the Cabinet.
2002	
January	"Structural Reform and Medium-term Economic and Fiscal Perspective" was decided by the Cabinet.

Box 1. **Chronology of main recent developments in public management** *(cont.)*

June	"Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002" decided by the Cabinet.
2003	
January	FY2002 revision of "Structural Reform and Medium-term Economic and Fiscal Perspective".

Unfortunately, the severe economic downturn stemming mainly from the Asian financial crisis and Japan's own problems in the financial sector, which happened in the latter half of 1997, forced the government to call off the fiscal consolidation plan. The government announced two more economic packages in April and November 1998. To finance these large-scale packages, the government formulated successive supplementary budgets and issued additional bonds. Finally, then Prime Minister R. Hashimoto, who had a responsibility to pursue a policy of structural reform, was required to step down in the summer of 1998 because his party could not gain a majority in the Upper House election. In addition, the Fiscal Structural Reform Act was suspended in December 1998. This bitter experience created strong scepticism for fiscal consolidation in the minds of many politicians and academics in Japan. The momentum for restoring public finances disappeared, and then government debt increased astronomically in the latter half of the 1990s.

The outcomes of a number of active fiscal measures in the 1990s have been disappointing. The continuous deflation has been a major obstacle for economic recovery. Rapidly increasing government debt raised many doubts for the future in people's minds and reduced the credibility of conventional fiscal policy. Under these circumstances, Prime Minister J. Koizumi, who formed a new government in April 2001, shifted economic policy from economic recovery to structural reform. The new government released its policy guideline "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" (see Box 2) which was decided by the cabinet in June 2001. This guideline was drafted by the Council on Economic and Fiscal Policy (CEFP), a new institution created by the Administrative Reform 2001 at the beginning of 2001. Mr. Koizumi set a target to limit new borrowing by the government to 30 trillion yen in the FY2002 budget as regards the General Account.

The FY2002 budget was formulated to be a "budget committed to reform" which would conduct a fundamental review of expenditure and inaugurate a fiscal structural reform with the goal of keeping new government bond issuance

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Box 2. Summary of structural reform of the Japanese economy: basic policies for macroeconomic management

(decided by the Cabinet on 21 June 2001)

A. Policy objectives 2001-03

- *Implement seven reform programmes (throughout the period).*
  Reforms include promotion of privatisation, deregulation, assistance to business entrepreneurs and fiscal reform.
- *Resolve bad loan problems.*
  Measures include expanding Resolution Collection Corporation (RCC) and introducing new statistics to monitor progress of bad-loan disposals.
  Introduction of special inspections focused on large debtors.
  Ensuring provisions to reflect market signals.
  Flexibility in settling the purchase price of banks' non-performing loans by the RCC.
  Establishment of corporate reconstruction funds.
- *Improve unemployment insurance and retraining. Utilise special grants for job creation.*
- *Expect the Bank of Japan to make timely decision on quantitative credit easing.*
- *Limit new issue of Japanese government bonds (JGB) to 30 trillion yen from FY2002.*

Policy objectives from 2004

- *Turn primary balance of national budget into surplus.*
- *Achieve economic growth led by private sector demand.*
  Measures include promoting shift in resources to industries with higher productivity and policy reform which clarifies concerns about the future such as pensions.

B. Key points of seven structural reform programmes

1. *Privatisation and deregulation*

- Consider privatising postal savings, insurance and mail delivery services, special public corporations and state-run universities.
- Encourage competition in non-profit areas including medical treatment and nursing care.

2. Entrepreneurship

- Encouraging individual investors to participate in stock market by reviewing tax system.
- Expanding the tax base while avoiding negative effects on individual and corporate activities.

Box 2. **Summary of structural reform of the Japanese economy: basic policies for macroeconomic management** *(cont.)*

(decided by the Cabinet on 21 June 2001)

- Strengthening the Fair Trade Commission to enforce competition policy vigorously.
- Encouraging competition in telecommunications sector by imposing further regulations on Nippon Telegraph and Telephone Corp. earlier than scheduled.

3. Social insurance

- Introducing social security numbers and individual social security accounts.
- Streamlining premium payments for social insurance and unemployment insurance into one.
- Giving consideration to market prices and fiscal incentives in determining rewards for medical care and drug prices.
- Limiting growth of medical costs by setting growth-rate target.

4. Intellectual assets

- Focusing funds on four areas in allocating budget: life sciences, information technology, environment and nanotechnology.
- Introducing competition to foster world-class universities.

5. Quality of life

- Revitalising urban areas and improving commuting.
- Promoting barrier-free society.
- Boosting measures to eliminate waiting list for nurseries.
- Altering focus of taxation and employment rules from families to individuals.
- Abolishing gender discrimination in employment.

6. More responsible local government

- Promoting mergers of local governments.
- Reviewing central government's share of contribution to local government administrative costs.
- Allocating subsidies to local governments by setting objective standards.
- Considering adopting a corporate tax based on sales and other factors to deal with low tax revenues facing local governments.

7. Fiscal reform

- Reviewing long-term public works projects.
- Reallocating road taxes.
- Lowering public works spending in proportion to gross domestic product in the medium term.

to less than 30 trillion yen. After the budget proposal decided by the cabinet at the end of December 2001, the government approved its "Structural Reform and Medium-term Economic and Fiscal Perspective" (short name "Reform and Perspective") in January 2002. In this report, the government sets out its vision of the society and economy that Japan should build. It also sketches a picture of the government's intended medium-term macroeconomic and fiscal projections. The government expects a primary balance surplus in the early 2010s.

Since the second half of 2002, downside risks have been increasing due to continuous weakness of the economy. There have been a lot of arguments in setting priorities and achieving a necessary policy mix from the short-term economic perspective, although fiscal reform is necessary from the medium- and long-term perspective. Some maintain that structural reform cannot restore the Japanese economy in the short term; to the contrary, structural reform may increase deflationary pressure for the economy because the problem in Japan is mainly due to weak demand. Some propose a much more expansionary monetary policy, claiming that only such a policy could stop serious deflation in Japan. Others emphasise that non-performing loans of financial institutions need to be cleared because the current stagnation of the economy is essentially due to a credit crunch. In any event, an optimal sequencing and balance of policy measures needs to be undertaken.[6]

In these circumstances, the prospect of fiscal consolidation was again becoming unclear. The substantial shortage of tax revenue in FY2002 was evident in December 2002, and the government was required to propose a supplementary budget in January 2003 in order to finance the revenue shortfall by additional government bonds of approximately five trillion yen. This meant that the goal of keeping new government bond issuance to less than 30 trillion yen (which the government had set with highest priority at the time of the FY2002 budget formulation a year ago) was abandoned. The FY2003 budget which was tabled in Parliament in January 2003 also needed 34.6 trillion yen new government bonds. Fiscal consolidation efforts seemed to have lost credibility.

3. The structure of the budget

Under the Constitution of Japan, the Cabinet is solely responsible for preparing and submitting the budget to the Parliament every year. The fiscal year begins on 1 April. The Ministry of Finance (MOF) has general jurisdiction over public finances. Other government departments are also involved in formulating economic and fiscal policies. The Cabinet Office which was newly established in January 2001, consolidating several departments such as the former Economic Planning Agency, is in charge of overall policy planning and co-ordination in order to support the Cabinet's strategic function. The Council on Economic and Fiscal Policy (CEFP) under the Cabinet Office is also concerned with fiscal policy and budgeting (discussed later).

The national government budget consists of the General Account, 37 special accounts and government affiliated agencies' budgets.[7]

The General Account budget, commonly referred to as "the budget", includes major government programmes such as public works, social security, education, science, national defence, and economic co-operation. All national taxes are treated as revenue in the General Account except for several earmarked taxes, such as road taxes. General Account expenditures are shown in Table 1. In FY2003, general taxes finance approximately only half of the total General Account expenditure; the other half of the remaining revenues depends on government bonds.

Table 1. **General account budget by major expenditure programme**

Billions of yen

	FY2001 (Initial)	FY2002 (Initial)	FY2003 (Initial)	FY1999-FY2000	FY2000-FY2001	FF2001-FY2002
National Debt Service	17 171	16 671	16 798	10.8%	–21.8%	–2.9%
Local Allocation Tax Grants	16 823	17 012	17 399	10.4%	12.7%	1.1%
General expenditures	48 659	47 547	47 592	2.6%	1.2%	–2.3%
Social Security	17 555	18 277	18 990	4.1%	4.7%	3.8%
Education and Science	6 647	6 706	6 471	0.9%	1.8%	0.8%
Government Employee Pensions and others	1 356	1 273	1 203	–3.6%	–4.9%	–6.2%
National Defense	4 955	4 956	4 953	0.1%	0.4%	0.0%
Public Works	9 435	8 424	8 097	0.0%	0.0%	–10.7%
Economic Assistance	956	857	816	–0.4%	–2.8%	–10.4%
Small and Medium-sized Businesses	195	186	173	1.0%	0.2%	–5.0%
Energy Measures	614	569	557	–2.8%	–3.4%	–7.2%
Major Foodstuff Measures	695	730	688	16.7%	1.5%	5.0%
Transfer to the Industrial Investment	154	146	164	0.0%	–3.6%	–5.3%
Special Account						
Miscellaneous	5 446	5 075	5 131	2.2%	–8.0%	–5.7%
Contingencies for Public Works	300	0	0	0.0%	–40.0%	–
Contingencies	350	350	350	0.0%	0.0%	0.0%
Settlement for the Shortfall of Revenue	–	–	–	–	–	–
Total	82 652	81 230	81 789	3.8%	–2.7%	–1.7%

Note: Local allocation tax grants of FY2001, FY2002 and FY2003 include special local grants.

Source: Ministry of Finance, Japan.

A special account can be established by legislation when the government needs to carry out specific projects, to administer and manage specific funds, or to administer revenues and expenditures separately from the General Account. Each special account generally has its own distinct source of revenues, such as social insurance contributions. Some accounts can be financed by borrowing and receiving funds from the General Account. The government's loan and guarantee programme is managed through one of the special accounts under the name of "Fiscal Investment and Loan Program (FILP)". Special accounts expenditures are shown in Table 2.

There are a number of government affiliated agencies[8] which were established under special laws, separately from the government, in order to provide them with flexibility in personnel management and accounting as well as to achieve greater efficiency through corporate-style management. These agencies are fully capitalised by the government. In general, the budgets of these agencies are not approved by Parliament, although subsidies from the government can be appropriated through the General Account or special accounts. However, the budgets of seven public financial corporations and two banks among these agencies (see Table 3) are tabled in Parliament because their activities are closely linked to overall government policies.

The consolidated expenditures of the General Account, the 37 special accounts and these nine agencies are shown in Table 4.

The Japanese budget system is characterised by the comprehensiveness which covers almost all government activities and by a high degree of short-term parliamentary control.[9] Although a public corporation's budget is usually not authorised by Parliament in many countries, budgets of some corporations such as public financial institutions are authorised by Parliament in Japan. In some countries like the United States, expenditures for entitlements are decided by their own laws and are not appropriated in the government budget. Japan does not follow this tradition. Unlike that of many other countries, Japan's budget as submitted to Parliament is composed of both revenue and expenditure, and the revenue budget is formulated to clarify the resources necessary for programmes.[10] The sources of revenue include government bonds in addition to tax, so the total amount of revenues in the budget equals the total amount of expenditure every year.

There are a few extra-budget items among government activities. For example, exceptions are some special funds such as the "Fund for Redeeming Government Bonds and Borrowings" which is administered through one of the special accounts. These funds can be managed flexibly over the fiscal year.

All in all, the Japanese system of expenditure management puts its emphasis on legal and procedural compliance rather than on the assessment of performance. In addition, accounting in the public sector is complicated

Table 2. **Special accounts**
Billions of yen

	FY2002 (Initial)		FY2003 (Initial)	
	Revenues	Expenditures	Revenues	Expenditures
Fiscal Loan Program Funds	47 515	45 178	54 536	51 297
Government Bond Consolidation Fund	152 037	143 037	167 142	158 142
Foreign Exchange Fund	1 726	856	1 622	788
Local Allocation and Local Transfer Tax	64 487	64 327	67 308	67 126
Measures for Petroleum and the Advancement of Energy Demand and Supply Structure	668	628	1 589	1 571
National Schools	2 783	2 783	2 805	2 805
Welfare Insurances	42 958	41 958	42 610	42 244
Seamen’s Insurances	85	85	78	78
National Hospitals	1 025	1 025	980	980
National Pensions	21 698	21 697	22 169	22 139
Foodstuff Control	4 738	4 738	4 137	4 137
Agricultural Mutual Aid Reinsurance	132	120	127	116
National Forest Service	472	472	490	490
National Land Improvement	514	514	528	528
Trade Reinsurance	166	143	198	147
Compensation Reinsurance for Motor Vehicle Damages	914	849	837	773
Harbor Improvement	410	410	394	394
Airport Improvement	457	457	456	456
Postal Service	7 236	7 236	–	–
Postal Savings	12 633	10 932	–	–
Postal Life Insurance	19 444	19 444	–	–
Labor Insurance	8 699	8 359	8 330	8 125
Road Construction and Improvement	4 251	4 251	4 131	4 131
Registrations	190	184	187	179
Mint Bureau	32	32	–	–
Printing Bureau	102	98	–	–
Industrial Investment	307	307	336	336
Earthquake Damages Reinsurance	51	51	50	50
Promotion of Power Source Development	493	493	486	486
Designated National Properties Consolidation	280	280	105	105
Forest Insurance	17	6	17	6
Fishing Boat Reinsurance and Fishermen’s Mutual Aid	29	23	26	19
Agricultural Foundation Improvement Measures	90	90	64	64
Flood Control	1 376	1 376	1 324	1 324
Motor Vehicle Inspection and Registration	62	50	61	51
Urban Development Loan	105	105	98	98
Patent Registration	190	111	199	116
Total Revenues and Expenditures	398 373	382 664	383 418	369 298

Note: Adjustments for inter-account transactions have not been made.
Source: Ministry of Finance, Japan.

Table 3. **Government affiliated agencies**

Billions of yen

	FY2002 (Initial)		FY2003 (Initial)	
	Income	Outgo	Income	Outgo
Public finance corporations:				
National Life Finance Corporation	228	234	229	193
Government Housing Loan Corporation	2 838	2 882	2 559	2 587
Agriculture, Forestry and Fisheries Finance Corporation	158	162	142	144
Japan Finance Corporation for Small Business	177	180	156	158
Japan Finance Corporation for Municipal Enterprises	931	666	890	588
Okinawa Development Finance Corporation	51	54	46	49
Japan Small and Medium Enterprise Corporation (Credit Insurance Division)	525	1 077	682	1 222
Special banks:				
Japan Bank for International Cooperation	540	518	489	469
Development Bank of Japan	962	808	873	715

Source: Ministry of Finance, Japan.

Table 4. **Net expenditures of the general account, special accounts and government affiliated agencies**

Billions of yen, initial budget

	1999	2000	2001	2002	2003
General Account	81 860	84 987	82 652	81 230	81 789
Special Accounts[1]	311 590	313 689	373 015	382 664	369 298
Subtotal	393 450	403 676	455 667	463 894	451 087
Deduction for Offsetting Amounts	171 343	194 867	204 731	215 494	218 742
Subtotal after Deductions	222 107	208 809	250 935	248 400	232 345
Government-affiliated Agencies[2]	7 470	7 661	7 266	6 581	6 126
Subtotal	229 576	216 470	258 201	254 981	238 471
Deduction for Offsetting Receipts	5 759	5 569	5 129	4 436	3 819
Total Net Outlay	223 817	210 902	253 072	250 545	234 652

Notes:
1. There are 37 special accounts as of April FY2002.
2. There are nine government affiliated agencies, including the Japan Finance Corporation for Small Business and the Development Bank of Japan.

Source: Ministry of Finance, Japan.

and less transparent, as there are a lot of transfers and transactions between the General Account, special accounts and government affiliated agencies.

Principal budget rules in Japan stipulated in the Public Finance Law of 1947 are the balanced budget rule and the golden rule. Article 4 states that all expenditure of the state shall be financed by revenue other than public bonds or borrowing. However, public works, investment and loans can be financed by public bonds or borrowing within a specific amount approved by

Parliament as an exception. Expenditures which can be financed by bonds with the golden rule are listed in the budget. This is considered the exceptional clause in principle.

In spite of these principles, bonds to finance investments have been issued continuously since FY1966. Deficit-financing bonds to finance not investment but current expenditure were issued in the supplementary budget FY1975 in response to a drop in tax revenues caused by the recession following the first oil crisis. The special law that enables the government to finance current expenditures by public bonds and overrides the principle in the Public Finance Law must be enacted every year. In fact, deficit-financing bonds have been issued almost every year to make up for shortfalls of revenues over current expenditure, with some exceptions from FY1991 to FY1993. While the economy is continuously weak, the budget cannot be formulated without bonds for the time being. In other words, two fiscal rules articulated in the Public Finance Law do not actually function as a budget rule in Japan.

4. The budgeting process

The most striking event in recent public management reforms is the creation of the Council on Economic and Fiscal Policy (CEFP) in January 2001. It was a new institution set up through the Administrative Reform 2001, one of whose aims was to strengthen the political leadership of the Cabinet and the Prime Minister over public administration. The CEFP is an advisory board to research and deliberate on some key issues including policies on economic and fiscal management and guidelines for budget formulation. Details on the CEFP are shown in Box 3. The Finance Minister is one of the members of the CEFP and contributes to policy-making for economic and fiscal management. The CEFP played its first major role in formulating the budget for FY2002.

The current budgeting process in which the CEFP is involved is summarised in Box 4.

The fiscal year in Japan begins on 1 April. The budget formulation process starts in the summer season of the previous year, normally July, with the approval of guidelines for the next year's budget requests. At the initial stage, spending ministries submit their budget requests to the Ministry of Finance by the end of August. But before the submission of these requests, the Cabinet approves the "Guidelines for Budget Requests", which set out expenditure ceilings for major programmes such as public works and social security for the next fiscal year's budget requests. These ceilings are usually expressed in terms of absolute or percentage increases or decreases *vis-à-vis* the previous fiscal year's amount (see Table 5). The ceiling for budget requests has been the most important tool for controlling total expenditures in Japan. It is a top-down budgeting approach.

Box 3. **The Council on Economic and Fiscal Policy (CEFP)**

1. Characteristics

The CEFP is a representative council within the Cabinet Office set up at the time of the Administrative Reform 2001. The CEFP's purpose is to allow the Prime Minister to show full leadership on economic and fiscal policies, fully reflecting the opinions of knowledgeable persons.

2. Tasks

- To research and deliberate important matters of economic and fiscal policy, such as the basic policy on overall economic management, fiscal management and budget formulation, under the request of the Prime Minister.
- To research and deliberate important matters related to economic and fiscal policy, such as the "Comprehensive National Development Plan", to secure consistency between various policies from a general perspective on the economy, under the request of the Prime Minister or the ministers concerned.
- To give opinions on the above to the Prime Minister, etc.

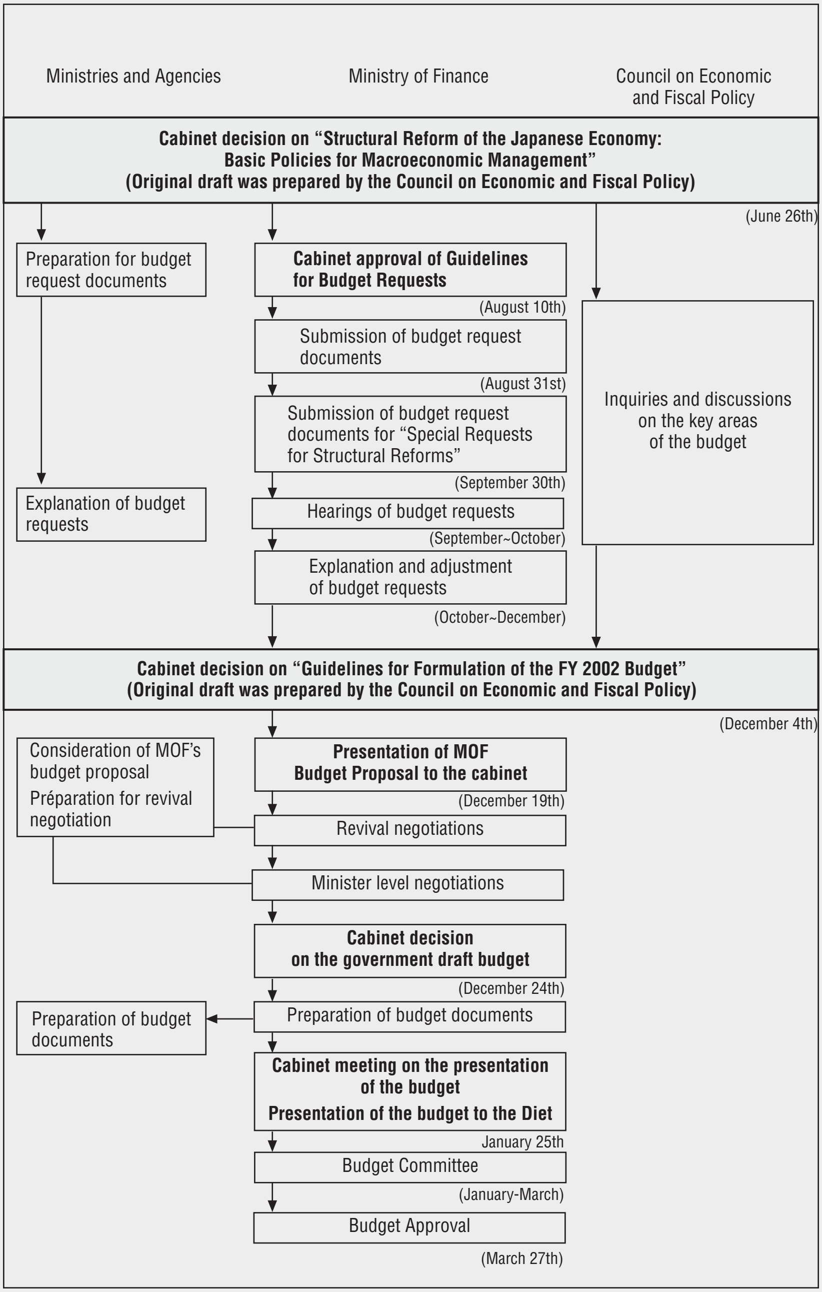
3. Membership

- Chairman: Prime Minister.
- Members: Cabinet Secretary, Minister of Economic and Fiscal Management, Minister of Finance, Minister of Economy and Finance, Minister of Public Management and Home Affairs, Governor of Bank of Japan, four people from private sector (two from business and two from academia).

4. Main outputs

- "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" (21 June 2001).
- "Reform Schedule" (21 September 2001).
- "Advanced-Reform Program" (26 October 2001).
- "Basic Policy of FY2002 Budget Formulation" (4 December 2001).
- "Structural Reform and Medium-term Economic and Fiscal Perspective" (18 January 2002).
- "Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002" (21 June 2002).
- FY2002 Revision of "Structural Reform and Medium-term Economic and Fiscal Perspective" (20 January 2003).

Box 4. **The budget process for FY2002**



Source: Ministry of Finance, Japan (2002), "Understanding the Japanese Budget 2002".

Table 5. **Recent guidelines for budget requests**

Fiscal Year	Summary		
1999	Public works spending	0% increase	Maximum
	Including		
	Improvement of distribution and transportation system	150 billion yen	
	Establishing a basis of economic development in the 21st century	100 billion yen	
	Living environment	250 billion yen	
	Science and technology promotion budget	5% increase	
	Social security spending	570 billion yen increase	
	Remainder (except for mandatory increase of personnel expenses)	0% increase	
	Special frame for economic recovery	4 000 billion yen	
	public works spending	2 700 billion yen	
	non-public works spending	1 300 billion yen	
	Special frame for establishing a basis for the 21st century	150 billion yen	
2000	Public works spending	0% increase	Maximum
	Including		
	Improving distribution efficiency, environment, telecommunication and town development (Special Category for Economic Rebirth)	250 billion yen	
	Improving living environment	300 billion yen	
	Social security spending	500 billion yen increase	
	Remainder (except for mandatory increase of personnel expenses)	0% increase	
	Special Category for Economic Rebirth for non-public works (telecommunication, science and technology)	250 billion yen	
2001	Public works spending	0% increase	Maximum
	Including		
	Special allocation category for the Rebirth of Japan (public works category)	300 billion yen	
	Special allocation category for the Rebirth of Japan reserved public works allocation	100 billion yen	
	Prioritised allocation category for public works related to improving the living environment	300 billion yen	
	Social security spending	750 billion yen	
	Remainder (deduct 1.9% of those items subject to prioritised allocation and add mandatory increase of personnel expenses)	0% increase	
	Special allocation category for the Rebirth of Japan (non-public works)	250 billion yen	
	Special allocation category for the Rebirth of Japan (reserved non-public works allocation)	50 billion yen	
2002	Request for public spending	0% increase	Maximum
	Social security spending (except for facility expenses)	700 billion yen increase	
	Mandatory spending (including annual increase of personnel expenses)	0% increase	
	Remainder (including 90% of General Policy Expenditure and Special Request for Structural Reform)	0% increase	
	Total public works expenditure	10% increase	
2003	Public investment related expenditures		
	A minimum of a 3% decrease from the level in the FY2002 budget		
	(Up to 120% of the Baseline for Requests which is 3% less than that in the FY2002 budget.)		
	Non-Discretionary Expenditures		
	Request for an increase will not be allowed except for 1) personnel expenses, 2) pension and medical care, and 3) special factors.		
	Discretionary expenditures		
	A minimum of a 2% decrease from the level in the FY2002 budget, except for Science and Technology Promotion Expenditures		
	(Up to 120% of the Baseline for Requests which is 2% less than that in the FY2002 budget except for Science and Technology Promotion Expenditures.)		

Source: Ministry of Finance, Japan (2002), "Understanding the Japanese Budget 2002".

The FY2002 budget formulation was a bit exceptional. The government first decided the "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" (see Box 2) at the end of June 2001, which was originally drafted by the CEFP. These "Basic Policies" identified seven key priority areas along with principles for reform of public works, the social security system and local government finance, and also set a target to restrict issuance of government bonds to a maximum of 30 trillion yen as regards the General Account. The Guidelines for FY2002 Budget Requests were formulated in August 2001 based on these "Basic Policies".

After spending ministries submit their next year's budget requests at the end of August, budget examiners of the Budget Bureau start a series of hearings with each spending ministry or agency on the details of its budget requests. From September to December, budget examiners review intensively whether or not the requests follow the Guidelines for Budget Requests.

At the beginning of December, the government decides "Guidelines for Formulation of the Budget", which are also drafted by the CEPF. Following these Guidelines, the Ministry of Finance finalises its draft budget and presents it to the cabinet for final consideration. It takes approximately a week for the negotiations between the Ministry of Finance and spending ministries. After some adjustments to the Ministry of Finance's draft, the government's draft budget for the next year is approved by the Cabinet, usually at the end of December.

The Cabinet tables its draft budget in Parliament in the latter half of January. The Japanese Constitution gives a certain superiority to the House of Representatives (the Lower House): for example, parliamentary discussions should take place first in the Lower House. After the budget speech by the Finance Minister in the House, the government's draft budget is deliberated by the Budget Committee, which includes statutory public hearings. Once the Budget Committee approves the draft, it is put to a vote in a plenary session of the Lower House. After the Lower House's deliberation, the session in the House of Councillors (the Upper House) takes place in almost the same manner. Normally the budget is enacted at the end of March before starting the new fiscal year. Importantly, the budget in Japan is treated not as a regular law but as a special legal status.

If the decision of the Upper House differs from that of the House of Representatives, a special joint committee comprised of selected members from both houses is convened for reconciliation. If the committee cannot come to an agreement, or if the Upper House does not make a final resolution within 30 days after receiving the draft budget approved by the Lower House, the resolution made by the Lower House shall be that of the Parliament.

In Japan, as well as in countries which follow the parliamentary system such as the United Kingdom, the government budget is almost always approved without any substantial amendments. There have been only four times since the end of World War II that amendments have been made. Although Parliament is given the power to amend the government budget proposal, the scope of amendment is limited to a large extent by general understandings.

The budgeting process in Japan is described as one of openness and competition. Spending ministries compete with each other for scarce resources in the "open game" – for example, the contents of the next year's budget requests by spending ministries are opened to the public at the end of August, and then the competition for getting more resources is continued until the end of December. Spending ministries, politicians and interested groups can see other ministries' requests and exchange information with each other. In other countries such as the United Kingdom, budget requests by spending ministries are not open to the public nor to the other ministries. Although the ceiling in Japan contributes to a large extent to keeping aggregate fiscal discipline, it is not a kind of "cap" that imposes the final strict limits on spending but rather a starting point for the competition.

5. Medium-term fiscal planning

The importance of medium-term fiscal planning[11] has been recognised in OECD member countries as an important tool for managing public expenditures with discipline, although the old version of it in the 1960s and 1970s had not always been successful in controlling government expenditures.[12] A number of countries have been developing medium-term fiscal planning, whose institutional characteristics vary from country to country.

Japan also has a long history in the development of medium-term fiscal planning. In the 1960s there were a lot of arguments for introducing medium-term fiscal planning among members of Parliament and academics as well as inside government. Then the first plan was published in 1976 by the Ministry of Finance and continued until 1980. These preliminary attempts were replaced by the "Medium-term Fiscal Projection" in 1981, which has basically survived until now although there were some changes in the style of presentation. The title of this projection was changed in 2002 to the "Projection of the FY2002 Budget's Effect on Expenditures and Revenues in the Coming Years" (hereafter called "Projection"), on the occasion of the introduction of the "Structural Reform and Medium-term Economic and Fiscal Perspective" in January 2002 which was released by the government with drafting by the CEFP (this "Reform and Perspective" is discussed later).

The latest "Projection" based on the FY2003 Budget shows how that budget will affect future expenditures and revenues up until FY2006 under the following conditions (some of the figures in the "Projection" are shown in Table 6): first, economic indicators for FY2004 and after are based on those assumed in the revised "Structural Reform and Medium-term Economic and Fiscal Perspective"; second, the projection is calculated on the basis of current services, assuming that the FY2003 budget policies and measures are to remain unchanged in the coming year.

Importantly, the "projection" is not a "baseline" which is supposed to be the basis of budget negotiations for the following year, but a simple "estimation" which provides Parliament with information on medium-term fiscal implications of the current budget. The "projection" is usually released at the end of January when the session in Parliament begins. In other words, it is not included in the budget papers which are presented at the end of December when the government decides its next year budget proposal.

In the past, the government has sometimes set a target of fiscal consolidation by specifying that the budget should be formulated without deficit-financing bonds within a certain timeframe. The latest target was set in 1983 to be achieved by 1990. The "projection" was useful for analysing by how much the amount of deficit-financing bonds should be reduced every year.

In discussing the prospect of medium-term fiscal planning in Japan, it is extremely important to understand the experience of introducing the Fiscal Structural Reform Act of 1997 and suspending it. The government under then Prime Minister R. Hashimoto argued the necessity for fiscal structural reform as well as economic structural reform and finally made the cabinet decision on the Fiscal Restructuring Targets in December 1996. In order to make this decision fully effective, the Fiscal Structural Reform Act was enacted in November 1997. The Act articulated specific fiscal targets and imposed caps on some individual expenditure lines, as shown in Box 5. It can be called a "medium-term consolidation plan", placing limits on future expenditures line by line with some clear fiscal targets.

Unfortunately, soon after the enactment of the Act, the Japanese economy encountered numerous unanticipated adversities from the latter half of 1997 to 1998. On the domestic scene, several financial institutions including some leading banks and securities companies went bankrupt, while on the international scene, some Asian economies encountered severe financial and economic turmoil. These shocks severely worsened the domestic economy, which was already ailing and unable to overcome the negative after-effects of the "bubble economy" era.

Table 6. **Reference estimates by the Cabinet Office: Highlights and comparison between FY2001 estimates and FY2002 estimates**

% or % of GDP, trillions of yen

		2001	2002	2003	2004	2005	2006	2007	2010
1.Macro-economy									
Growth rate of real GDP	FY2001	–1.0	0.0	0.6	1.5	1.5	1.6		1.9
	FY2002		0.9	0.6	0.9	1.3	1.5	1.6	1.9
GDP deflator	FY2001	–1.5	–0.9	0.0	0.8	1.0	1.1		1.0
	FY2002		–1.5	–0.9	–0.3	0.2	0.7	1.0	1.3
General government financial balance	FY2001	–6.9	–6.5	–6.3	–5.4	–4.7	–4.4		–2.9
	FY2002		–8.0	–8.3	–7.2	–6.5	–5.9	–5.7	–4.3
2.Fiscal conditions									
General government financial balance									
Central government	FY2001	–6.2	–5.4	–5.5	–5.0	–4.8	–4.4		
	FY2002		–6.6	–6.7	–6.3	–6.1	–5.6	–5.4	
Local government	FY2001	–0.7	–1.0	–0.5	–0.4	–0.1	–0.1		
	FY2002		–1.0	–1.0	–0.6	–0.3	–0.1	0.1	
Total	FY2001	–6.9	–6.3	–6.0	–5.4	–4.9	–4.5		
	FY2002		–7.6	–7.7	–6.9	–6.3	–5.7	–5.3	
General government primary balance									
Central government	FY2001	–4.6	–3.8	–4.0	–3.6	–3.4	–2.9		
	FY2002		–5.2	–5.3	–4.9	–4.7	–4.1	–3.7	
Local government	FY2001	0.3	–0.0	0.4	0.5	0.7	0.7		
	FY2002		–0.1	–0.1	0.3	0.5	0.7	0.8	
Total	FY2001	–4.3	–3.8	–3.6	–3.1	–2.7	–2.2		–0.4
	FY2002		–5.3	–5.4	–4.7	–4.2	–3.4	–2.9	–1.3
Debt outstanding (central and local)	FY2001	113.8	121.5	127.0	130.1	132.4	133.9		134.5
	FY2002		121.1	128.6	135.2	139.8	142.8	144.9	146.4
Expenditure of general government	FY2001	38.2	37.6	37.3	36.9	36.7	36.6		
	FY2002		38.1	36.9	37.0	36.6	36.7	36.7	
3. General account budget									
Expenditure	FY2001	82.7	81.2	84.0	87.0	88.7	89.7		
	FY2002		81.2	81.8	85.9	88.3	90.0	91.9	
General expenditure	FY2002		47.5	47.6	48.6	49.0	49.6	50.0	
Social security	FY2002		18.3	19.0	19.6	20.3	21.0	21.8	
Public Works	FY2002		8.4	8.1	7.9	7.6	7.4	7.2	
Others	FY2002		20.8	20.5	21.0	20.3	20.4	20.4	
Local allocation tax grants	FY2002		17.0	17.4	19.8	20.6	20.7	20.6	
National Debt Service	FY2002		16.7	16.8	17.4	18.7	19.7	21.2	
Revenue	FY2002		81.2	81.8	85.9	88.3	90.0	91.9	
Tax revenue	FY2001	50.7	46.8	46.4	47.6	49.0	50.6		
	FY2002		46.8	41.8	42.1	43.3	45.7	47.3	
Non-tax revenue	FY2001	3.6	4.4	3.5	3.6	3.7	3.8		
	FY2002		4.4	3.6	3.7	4.4	4.5	4.4	
Bond issues	FY2001	28.3	30.0	34.1	35.8	36.0	35.3		
	FY2002		30.0	36.4	40.0	40.6	39.8	40.1	

Table 6. **Reference estimates by the Cabinet Office: Highlights and comparison between FY2001 estimates and FY2002 estimates** *(cont.)*

% or % of GDP, trillions of yen

		2001	2002	2003	2004	2005	2006	2007	2010
		[General Account Budget Estimated by Ministry of Finance]							
Expenditure	FY2001	82.7	81.2	85.5	90.3	92.4			
	FY2002		82.1	81.8	87.2	89.9	91.6		
Tax Revenue	FY2001	50.7	46.8	46.4	46.1	46.1			
	FY2002		46.8	41.8	41.8	42.9	44.8		
Bond Issues	FY2001	28.3	30.0	35.6	39.8	42.0			
	FY2002		30.0	36.4	41.8	42.9	42.9		

Notes:

1. Growth rate of GDP and GDP deflator: percentage increase; others in fiscal condition: percentage of GDP; general account: trillion yen.
2. FY2001: figures released in January 2002 as regards FY2002 budget, initial budget base. FY2002: figures released in January 2003 as regards FY2003 budget (first revision), initial budget base.
3. These estimates are carried out on specific assumptions which are based on the policies presented in "Reform and Perspective". Each assumption is provisionally set up by the Cabinet Office and does not show the plan of the government for each fiscal year.

Source: Estimated by Ministry of Finance, Japan, "Projection of the FY2002 (or FY2003) Budget's Effect on Expenditures and Revenues".

Box 5. **Summary of the Fiscal Structural Reform Act 1997**

1. Fiscal deficit

The general government deficit excluding social security as a percentage of GDP, currently around 6%, should be brought down to 3% or less by FY2003 (Section 1, Article 4, Chapter 1).

2. Issuance of deficit-financing bonds

The amount of deficit-financing bonds should be reduced every fiscal year, and their issuance should be terminated by FY2003 (Section 2, Article 4, Chapter 1). (In other words this is to restore the "golden rule" by FY2003.)

3. Spending limits on major programmes

From FY1998 to FY2000 (defined as the intensive reform period), the amount of expenditures in major programmes is subject to a numerical "cap" (Chapter 2).

4. Guidelines for fiscal policy

Fiscal policy will be conducted in such a manner that the sum of taxes, payroll contributions and fiscal deficit as a percentage of national income will not exceed 50% (Section 1, Article 6, Chapter 1).

Notes:

1. The Act was amended in May 1998 to allow the issuance of deficit-financing bonds (as opposed to those issued to cover investment under the golden rule) in the event of a sharp downturn or where GDP expanded by less than 1%.
2. The Act was finally suspended in December 1998. (This is not an abolishment of the law. It can come into effect again in the future although a law will be necessary.)

Against this backdrop, in May 1998 Parliament amended the Act so as to enable the government to issue additional deficit-financing bonds in an emergency situation without contradiction with the Act. In addition, the fiscal consolidation target was amended. Finally, the Act was suspended in December 1998 because the government concluded that fiscal expansion was urgently needed to boost the extremely severe condition of the economy.

What are the lessons derived from the Fiscal Structural Reform Act of 1997? Two major shortcomings of the Act should be emphasised. First, the Act was less flexible in expenditure control at the time of economic downturn. It did not consider the change of macroeconomic situation seriously. Second, as the cap for each category's expenditure in the Act focused only on the initial budget, expenditure was increased significantly through the supplementary budget. That means the Act did not put strict budget constraints on expenditure and thus the credibility of the Act was undermined.

The newly formed government under Prime Minister J. Koizumi in April 2001 changed the overall macroeconomic policy from expansion to consolidation, asserting "no growth without structural reform". The new government's economic policy was embedded in the "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" (see Box 2) which was decided in June 2001. The most noticeable break with previous packages was the intention to limit new borrowing by the central government to 30 trillion yen in FY2002, which is projected by the OECD to lead to a tightening of 0.5% of GDP.[13]

The limit on new borrowing was considered to be largely effective in controlling government expenditure which was under extreme pressure to increase: for example, the government was able to achieve a cut of over one trillion yen in subsidies for public corporations in the budget for FY2002. However there were a lot of arguments about whether the use of nominal fiscal balance as a fiscal target was good for managing fiscal policy from the macroeconomic point of view, because other countries' experiences (such as the 1985 Gramm-Rudman-Hollings Act in the United States) showed the ineffectiveness of such targets. The FY2002 budget was formulated keeping the limit on new borrowing under 30 trillion yen on the surface. However, the deficiency of the nominal balance target must be pointed out. The government manipulated fiscal balance in the General Account which was under the constraint of the limit on new borrowing, using accounting techniques that transferred deficits from the General Account to some special accounts. The hidden borrowing was supposed to be about 1.5 trillion yen.

In the middle of FY2002, it became apparent that it was difficult to keep the limit on new borrowing to 30 trillion yen throughout the fiscal year 2002 due to tax shortfalls projected by the lower economic growth. In January 2003 the government proposed the FY2002 supplementary budget to finance about 2.5 trillion yen tax shortfall together with the budget for FY2003. As the government increased expenditure for the unemployed and for public works in the supplementary budget, the new borrowing in FY2002 totalled about 35 trillion yen, which exceeded by about five trillion yen the sum in the initial budget. The target of nominal balance was regarded as too inflexible during the economic downturn, thus the government did not follow this kind of target in the budget for FY2003.

The other prominent event of the current fiscal policy in Japan was the "Structural Reform and Medium-term Economic and Fiscal Perspective" (short name "Reform and Perspective") which was released by the government in January 2002. The "Reform and Perspective" sets out the government's vision of the future society and also sketches a picture of medium-term macroeconomic management policies, defining the five years from 2002 to 2006 as the periods targeted for structural reform.

In the "Reform and Perspective", it was projected that the central and local government primary balance deficit combined would decrease and its percentage of GDP would be approximately half of the current level (4.3% in FY2000) in the final year of the targeted periods, as a result of steady economic growth led by private demand and fiscal structural reforms. In addition, the "Reform and Perspective" sets out the expenditure target, that the ratio of general government expenditure to GDP would be held at or below its present level from FY2002 to FY2006. If efforts to decrease fiscal deficits continue even after the targeted periods of the "Reform and Perspective", a primary balance is expected to be surplus by the early 2010s, also considering the fact that the population will start to decrease by sometime around 2008 and that the baby-boomers who were the core of the working population will soon become pensioners.

The "Reform and Perspective" was supplemented by the "Reference Estimates" which were estimated by the Cabinet Office and presented to the CEFP for discussion. Although the "Reference Estimates" are not part of "Reform and Perspective" which was formally authorised by the Cabinet, they are based on calculations of the macroeconomic model. The "Reference Estimates" can almost be called the first attempt in Japan to project the medium-term fiscal balance using the macroeconomic model. The "Reference Estimates" do not show the government's strong commitment strictly speaking and do not bind future budgeting; therefore they are not like other countries' planning systems which are able to place strict limits on an individual expenditure for the following years based on integrated medium-term macroeconomic and fiscal forecasts with clear fiscal policy objectives.

There now seems a redundancy in medium-term fiscal planning in Japan. The Ministry of Finance has been producing plans since the mid-1970s. Thus there are two plans within the government. The plan produced by the Ministry of Finance covers three years of projections beyond the fiscal year; on the other hand the plan produced by the Cabinet Office covers four years of projections beyond the fiscal year. The most important difference between them is that the plan by the Cabinet Office is based on the macroeconomic scenario and some reform policies in the future budget to increase efficiency, while the plan by the Ministry of Finance is estimated on the basis of current services assuming that the policies and measures remain unchanged in the coming year. The amounts of expenditure in the plan by the Cabinet Office are therefore slightly smaller than those in the plan of the Ministry of Finance, reflecting policy changes.

The "Reform and Perspective" is to be updated every year in order to take into account macroeconomic and other changes. The first update was done in January 2003. The original "Reform and Perspective" assumed that deflation would come to an end in FY2003, but the updated one postponed the targeted year to FY2004 because the government realised that it was difficult to end serious deflation immediately. Thus the final year of the periods targeted for structural reform was also put off from FY2006 to FY2007, although the government kept the target year of primary balance surplus unchanged (the early 2010s). The "Reference Estimates" were also updated taking into account new macroeconomic assumptions (see Table 6). In short, the projection of the general government financial balance in 2010 was revised downward from 2.9% deficit to 4.3%. The main reason for downward revision is that tax revenue is significantly smaller than projected by the FY2001 Estimates (January 2002). For example, tax revenue in 2006 is projected downward from 50.6 trillion yen (FY2001 Estimates) to 45.7 trillion yen (FY2002 Estimates), while total expenditure in 2006 is projected almost unchanged.

6. Needs for further reform

There are a number of challenges in restoring fiscal discipline and soundness in Japan. What should be done? Should strict fiscal rules be introduced which impose disciplines on politicians or the government? The recent research along the lines of "public choice" theory suggest that deficits arise because the government's general tax fund is a "common pool resource" from which projects of public policy are being financed and then persistent budget deficits can be modelled as the result of a rational choice by self-interested political actors.[14] The research argues that if common pool problems are to be solved, there is a need for fiscal rules that lead participants in the budgeting process to internalise the costs of budget deficits. In short, the budgeting process has to be reformed strategically in order to control any increase of deficits. There are two critical elements to be kept in mind in reforming the budgeting process: the first is "centralisation" and the second is "transparency".[15] The former means the centralisation of decision-making processes in budgeting, and the latter means the provision of clear information on government fiscal policy.

Now the discussion will focus on how to reform the overall budgeting system in Japan, identifying problems from the two points of view of "centralisation" and "transparency".

The Administrative Reform 2001 created the Council on Economic and Fiscal Policy (CEFP) to deliberate and propose overall economic and fiscal policies including budgeting. The idea behind the creation of the CEFP was to restructure the decision-making process and strengthen the political leadership, in particular the authority of the prime minister. Since its inception the CEFP has produced several outputs such as "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management". The CEFP is now actually playing an important role in proposing numerous policies such as on tax reform and deregulation. The budgeting process as well as the policy-making process is however still fragmented in Japan because there are many players involved in the budgeting process and co-ordination among them is difficult in practice. For example, there are several key players involved in budgeting such as the Prime Minister's office, the Cabinet Office, the CEFP, the Ministry of Finance and three political parties in the coalition. In addition, 10 line ministries act as a strong pressure group in the budgeting process. In Japan, a Cabinet decision must be made by a unanimous vote of all ministers. Therefore the Ministry of Finance is required to persuade all ministries, who always make more budget requests, before the cabinet can decide on the next year's budget proposal. In Germany, the Finance Minister has a veto in the Cabinet meeting for the budget; on the other hand, in Japan line ministers seem to have a veto because of the unanimity principle.

Unlike other countries such as the United Kingdom, the decision-making bodies in Japan are separated into the executive government, which takes overall responsibilities through the Cabinet, and the ruling parties which have their own policy-making committees. Japan follows the parliamentary democratic system, but policy-making committees within parties have been playing a significant role in Japan. There are sometimes conflicts in policy-making between members of parliament in ruling parties and ministers in the government. Although at the moment the government of Japan is formed by the three-party coalition, for more than 40 years after World War II it was formed by a single party, namely the Liberal Democratic Party. At that time, there were very few prominent politicians who governed these committees, and it was therefore easy to reach a consensus between the government and the party. Furthermore, taxes were sufficient for allocating among the various spending areas. Ironically, the decision-making process in the past was less fragmented than the current process. This political arena was changed in the 1990s by the collapse of the Liberal Democratic Party in the election.[16]

What needs to be done in reforming the budgeting process is to clarify the relationship between the government and the parties, specifically to centralise the decision-making process both at the Cabinet level, using the CEFP for overall economic and fiscal policies, and at the ministerial level for individual policy issues such as social security and education. In order to strengthen political leadership, Japan introduced deputy ministers and parliamentary secretaries, who are similar to those of the United Kingdom, just before the Administrative Reform 2001, but they seem redundant because their roles in ministries are not always clear. The fact that each policy-making committee within the parties still has ability and power to formulate policies means that deputy ministers and parliamentary secretaries are usually excluded from policy formulation and decision-making. They should be nominated by their relevant ministers and become core members of the policy team led by the ministers. The first step for centralisation is that deputy ministers should chair the policy-making committees within the parties and all the relevant policies should be considered and formulated at each ministerial level first.

In addition, there seem some risks that the CEFP may undermine the role of the Cabinet, although the CEFP is currently playing an important role in promoting structural reforms which is the most important item on the government's agenda. Legally the CEFP is a kind of advisory board, but it is likely to be a decision-making body because it includes senior ministers as well as the Prime Minister. It must be kept in mind that the CEFP is not an institution that can take political responsibility with the government policy. Nearly half of the members of the CEFP (namely, those who come from the private sector) are not elected by the public.

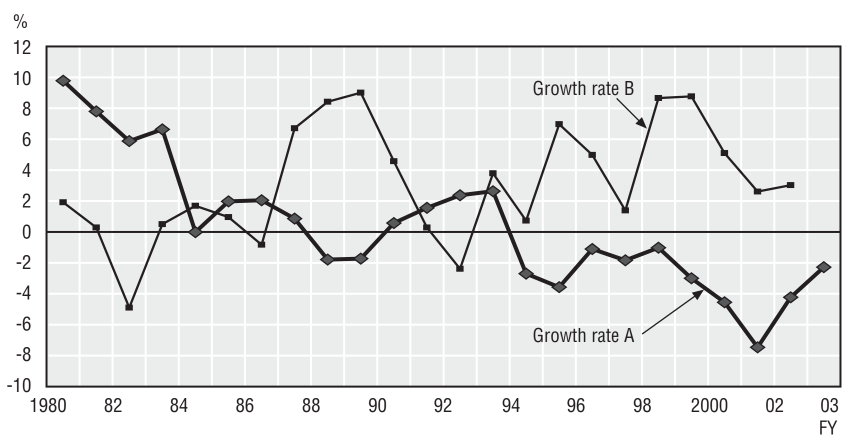
The budgeting process is the political process which solves disputes over scarce resource allocation; therefore without reforming the political decision-making process, the budgeting process itself cannot be reformed, as Aaron B. Wildavsky said.[17] The ultimate goal in Japan is to strengthen the governance of the cabinet with the Prime Minister's leadership.

The discussion now moves on to the second theme, "transparency". There has been a lot of criticism of budgeting in Japan. Three particular problems shall now be discussed from the macroeconomic point of view.

The first problem is that an annual budget is formulated in a short-sighted manner, often on an *ad hoc* basis focusing only on the budget year. The OECD (2000) says that Japan has no regular cycle of medium-term expenditure planning so that negotiations about expenditures focus almost exclusively on spending levels for the next fiscal year. There have been some reasons why effective medium-term fiscal planning is underdeveloped in Japan. Several ministries produce medium-term (normally five years) construction plans for roads, ports, airports, sewage and so on, which are authorised by the Cabinet. Concrete medium-term fiscal planning would have to accommodate all the expenditures for those public works because the cabinet endorses these plans. This may cause huge pressures for future expenditures. The "Medium-term Fiscal Projection" which the Ministry of Finance introduced in 1981 tried to avoid the accumulation of expenditures for public works, keeping them out of future estimates.

The second problem is that there was excessive reliance on supplementary budgets in the 1990s mainly because the government took Keynesian-style economic measures to boost the stagnant economy. For example, there were 20 supplementary budgets from FY1990 to FY2000 (twice a year on average). As a result, the final expenditure in the General Account was deviated significantly from the initial amount, the difference being around 5-10% (see Figure 3). The initial budget is likely to be formulated in contractionary stance compared with the previous year's final account and the final account is likely to become expansionary compared with the same year's initial budget. This is because supplementary budgets were formulated regularly to stimulate the economy. The tendency towards contractionary

Figure 3. **Trend of the general account**



Notes:
1. Growth rate A shows how much the initial budget increases from the previous year's final account.
2. Growth rate B shows how much the final account increases from the same year's initial budget.
3. As the FY2002 final account has not been settled yet, the growth rate A of FY2003 shows how much the initial budget increases from the FY2002 supplementary budget.

Source: Ministry of Finance, Japan.

initial budgets and expansionary final accounts may have a risk that fiscal policy becomes "stop and go". The International Monetary Fund (2001b) said that the frequent use of supplementary budgets has undermined confidence in the reliability of expenditure estimates in the initial budget and the value of the initial budget as an indicator of the stance of fiscal policy.

The third problem is that few fiscal data to measure the overall stance of fiscal policy are released when the government presents its budget proposal (normally in December). The budget consists of the General Account, special accounts and government affiliated agencies. The Ministry of Finance presents the consolidated expenditure and revenue of these three accounts, but the overall consolidated balance is not available. Thus the overall balance is not used as the main fiscal indicator for evaluating fiscal policy. What is used at the time of initial budget formulation is only the balance of the General Account. In other words, Japan does not normally analyse and discuss the stance of fiscal policy based on the System of National Accounts (SNA) in the budgeting process. The detailed fiscal data relating to the general government are presented a month after the government decides its budget proposal at the end of December.

Japan urgently needs medium-term fiscal planning in the budgeting process. It may contribute to increased transparency and thus enhance aggregate fiscal discipline. The annual budget should be formulated within a medium-term framework, assessing the past performance of fiscal policy and the impact of present policy on future performance. There is also a need for fiscal indicators showing an overall fiscal stance. The IMF (2001b) proposal that the current fiscal projections should be more systematic and comprehensive would be a quick way to develop an effective planning system. However, medium-term fiscal planning cannot be enforced effectively without clear fiscal policy objectives and quantitative fiscal targets which are endorsed by the highest level of the government including ruling parties.[18] The budgeting system in Japan is characterised by its fragmentation. Unless this deficiency is challenged, medium-term fiscal planning may undermine fiscal discipline in reality, because the budget authority is not able to effectively control spending ministries' strong pressure to increase their budget.

What kind of objectives and targets should be applied in restoring public finance in Japan? The "Structural Reform and Medium-term Economic and Fiscal Perspective" (short name "Reform and Perspective") released by the government in January 2002 expects a primary balance to be surplus by the early 2010s. This shows the government's intention for a future fiscal position, although strictly speaking this is not an explicitly defined commitment. In any event, the overall target to restore fiscal prudence should be to achieve a surplus of primary balance by around 2010 because baby-boomers will become eligible for social security benefits around that time. However it is not an easy task.

The latest *OECD Economic Outlook* (December 2002) estimates the nominal growth rate at minus 1.7%, the primary balance at minus 6.6% of GDP, the government debt at 142.7% of GDP and the long-term interest rate at 1.3% in 2002. If the interest rate and the growth rate remain at the current level and the government debt stabilises at about 150% of GDP, the primary balance required to stabilise government debt comes to 4.5%.[19] Thus in order to prevent the ratio of government debt to GDP from increasing, it is necessary to slash fiscal deficits by 11.1% (4.5 + 6.6). The OECD (2001) also estimates the necessary fiscal correction to achieve a zero primary balance by 2010 is 8.5% assuming 1% nominal growth, 3.5% interest rate and 150% debt-to-GDP ratio. Furthermore, if a primary surplus is to be achieved by 2010, fiscal deficits must be reduced by 1.39 percentage points every year (11.1/8 = 1.39%). This means about seven trillion yen deficit reduction every year if Japan's nominal GDP is roughly 500 trillion. These calculations are so simple. But it must be remembered that achieving a primary surplus by 2010 needs tremendous effort by the government. Some therefore argue that it would actually take about 15-20 years to achieve it.

The process of fiscal consolidation in Japan should be divided into stages. First a primary balance surplus should be achieved; and then government debt should be decreased to a sustainable level. Some sort of flexibility in fiscal rules and targets for consolidation is also needed, because inflexibility was demonstrated by the suspension of the Fiscal Structural Reform Act of 1997. The time schedule depends on various conditions such as the macroeconomic situation, ageing population and financial market prospects, although detailed calculation and simulation are beyond the scope of this paper.

7. Conclusion

Everyone understands that the delay in fiscal consolidation increases government debt further, and that the lack of fiscal sustainability undermines the potential economic growth of Japan. Several public opinion surveys show that the deterioration of public finances is motivating households to save more in circumstances of uncertainty caused by the prolonged recession and rapid ageing. Some economists argue that a non-Keynesian[20] effect is likely to happen in Japan although it has not been verified empirically so far. Prime Minister J. Koizumi brought Japan to the starting point of a long journey of fiscal consolidation which may require tremendous efforts. In order to enforce it, the decision-making process must be restructured and fiscal transparency must be increased. Effective medium-term fiscal planning serves both to show the actual fiscal condition as it is and to evaluate fiscal policy, thus becoming a "monitoring and evaluation" of fiscal policy. Having no such system is like sailing in the sea of uncertainty without a compass. The "Reform and Perspective" introduced in January 2002 is a small step towards defining a medium-term fiscal policy framework.[21] Many further efforts must be undertaken to achieve an effective and reliable system.

Even if the necessity of fiscal consolidation is recognised, it cannot be implemented without political will and public consensus. Unfortunately, there has been little incentive to enforce fiscal consolidation in Japan because huge household savings can finance huge government debt, keeping interest rates historically very low with a balance of payment surplus. In other words, astronomically increasing public debt has not caused visible problems such as crowding-out although the slow economic growth and deflation are causing the unemployment rate to reach historically high levels. Japan is the exceptional country in which public finances must be consolidated under conditions of excessive domestic savings. Other countries' experiences – such as New Zealand, Sweden and Italy which succeeded in fiscal consolidation – are good references, but the macroeconomic situation of Japan is totally different. Although the Maastricht Treaty functioned as a strong vehicle for fiscal consolidation in EU countries in the 1990s, Japan is not subject to that kind of pressure.

The economy seems to be slowing down since the latter half of 2002 mainly due to continuous deflationary pressure. Definitely, the government should take all measures to stop severe deflation in the short term, co-operating with the Bank of Japan. Without stopping deflation, it is extremely difficult to achieve fiscal consolidation. Uncertainty in the economy is now increasing while macroeconomic policy options, including fiscal policy and monetary policy, are very narrowed. It may take more time to put Japan onto a credible consolidation path.

Notes

1. The views expressed in this article are those of the author and do not necessarily reflect the views of the Ministry of Finance. The paper is presented not as policy, but with a view to inform and stimulate wider debate.
2. See OECD (2001), Table 8.
3. This is said to be the biggest administrative reform in the central government in several decades. The original idea of restructuring the central government was proposed by the Administrative Reform Council headed by then Prime Minister R. Hashimoto in December 1997.
4. See von Hagen (1992), von Hagen and Harden (1994), Alesina and Perotti (1999).
5. The Public Finance Law of Japan stipulates that all expenditure shall be financed by revenue other than public bonds or borrowing, and exceptionally public works,

investments and loans can be financed by public bonds with a specific amount approved by the Parliament. This is called the "golden rule". Therefore, the law prohibits current expenditure from being financed by public bonds. If tax revenue is not sufficient for financing current expenditure, a special law which enables the government to issue deficit-financing bonds is necessary to override the Public Finance Law.

6. See OECD (2001).
7. All of these three major financial activities are not classified into general government defined by the System of National Accounts (SNA). The institutional arrangements for Japanese public finances are difficult to understand; for example, only 18 of the 37 special accounts are defined as general government operations based on SNA. The remaining special accounts and business accounts cover the activities of the non-governmental public sector.
8. At the end of 2001, the government decided the consolidation plan of a large number of government affiliated agencies after reviewing their roles. In the plan, 17 agencies out of the total of 118 are to be abolished, 45 are to be privatised and 38 are to be changed to Independent Administrative Institutions which are similar to executive agencies in the United Kingdom. The transformation of corporate status is expected to mostly occur in 2003.
9. See OECD (2000).
10. See Ishi (2000).
11. There are several terms in English to express planning, such as medium-term budget framework, multi-year budgeting, medium-term expenditure. They are normally not multi-year appropriations which authorise spending legally, but rolling plans or estimates which a government decides and presents by itself.
12. OECD (1997) explains that there are three broad problems with the predecessors of medium-term fiscal planning. First, there was a tendency to overestimate the future growth of the economy. Second, ministers and departments viewed their forecast expenditure as an entitlement. Third, the multi-year budget frameworks were in real terms rather than in nominal terms.
13. See OECD (2001).
14. See Poterba and von Hagen (1999).
15. See Poterba and von Hagen (1999).
16. The Liberal Democratic Party is now the biggest one in the three-party coalition.
17. See Wildavsky (1992).
18. The IMF (2001a) shows some lessons including the importance of these objectives and targets, drawn from other countries' experience with regard to medium-term budget frameworks and they will only be effective if there is a real, stable, transparent, and well-publicised commitment to fiscal control.
19. The primary balance can be calculated as a proportion of GDP (= PB/GDP) required to stabilise the government debt ratio at a given target level using the following formula: $PB/GDP = (r - g) \times (\text{debt target}/GDP)$ where r is the interest rate and g is the economic growth rate.
20. See Giavazzi and Pagano (1995), Bertola and Drazen (1993) and Alesina and Perotti (1996).
21. See OECD (2002a).

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