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OVERVIEW OF FISCAL DEFICITS IN JAPAN WITH SPECIAL REFERENCE TO THE FISCAL POLICY DEBATE*

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I. *Introduction*

The objective of this study is twofold. First, it clarifies the basic concept of fiscal deficits conventionally used in Japan. Second, it investigates the state of official fiscal thinking, the well-known "MOF's view" (the term *MOF* is the Ministry of Finance), in conflict with Keynesian demand management. More emphasis is paid to the second point, while the first is only treated in the introductory discussion.

Thus, the central question addressed in this article is how Keynesian fiscal policies have not been adopted by the Japanese government, with particular emphasis on the role of the MOF. In examining the postwar policy debates, the attractions of budgetary orthodoxy with regard to fiscal deficits are investigated.

This study is divided into six parts. In section II, as a background, the basic structure of the budget system is surveyed. From this, alternative concepts of fiscal deficits are identified with special reference to the scope of the government sector.

The following four sections constitute the major part of this study in relation to the specific policy stance of each period. Section III summarizes the background on the balanced budget principle prior to 1965. In particular, it details how the financial position of the fiscal authority during a high-speed growing economy resulted in well-behaved balanced budget practices.

Section IV considers important changes in the role of the budget as a policy instrument after the first floating of national bond in 1965. It also investigates the main elements expanding fiscal deficits since then. Section V is devoted to explaining the conflict between Keynesian and the MOF's views. Even if the balanced budget rule had to be abandoned, the MOF remained strongly adhered to budgetary orthoxody.

In section VI, measures to solve the fiscal deficits are considered; that is, the struggle to reduce the large amount of accumulated fiscal deficits during the priod of "fiscal reconstruction" from the late 1970's is investigated. Finally, setion VII concludes our discussion in stressing the necessity to reduce debt accumulation. It shows that there is still little common ground between the MOF and keynesian views.

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II. *Basic Concepts of Fiscal Deficits*

In order to clarify the alternative concepts of fiscal deficits used for the analysis of budgetary policy, we must begin with the discussion of the budget system. In Japan, the government sector is stratified mainly into two levels; the national and local governments, each one having some responsibility for a particular set of public functions. Each level of governments has its own budget system, which is composed of more or less similar accounts.

Figure 1 illustrates the whole budget system covering the entire scope of government. The national government contains the General Account, special accounts and budgets of government-affiliated agencies. Among them, the General Accounts is the most fundamental budget. In fact, almost all national tax revenues except the local transfer tax belong to the General Account, as well as revenues of national bond issues. These revenues are appropriated to such expenditure items as is listed in Figure 1, but most of them are transfers and grants to various special accounts and to local governments. Only a few outlays are directly paid from the General Account, excluding wages and salaries of government employees.

The General Account of the national government can greatly affect the entire system of the budget including that of local governments, although it reflects only a part of the whole budget system. When we say merely "budget," it often means the "General Account Budget."

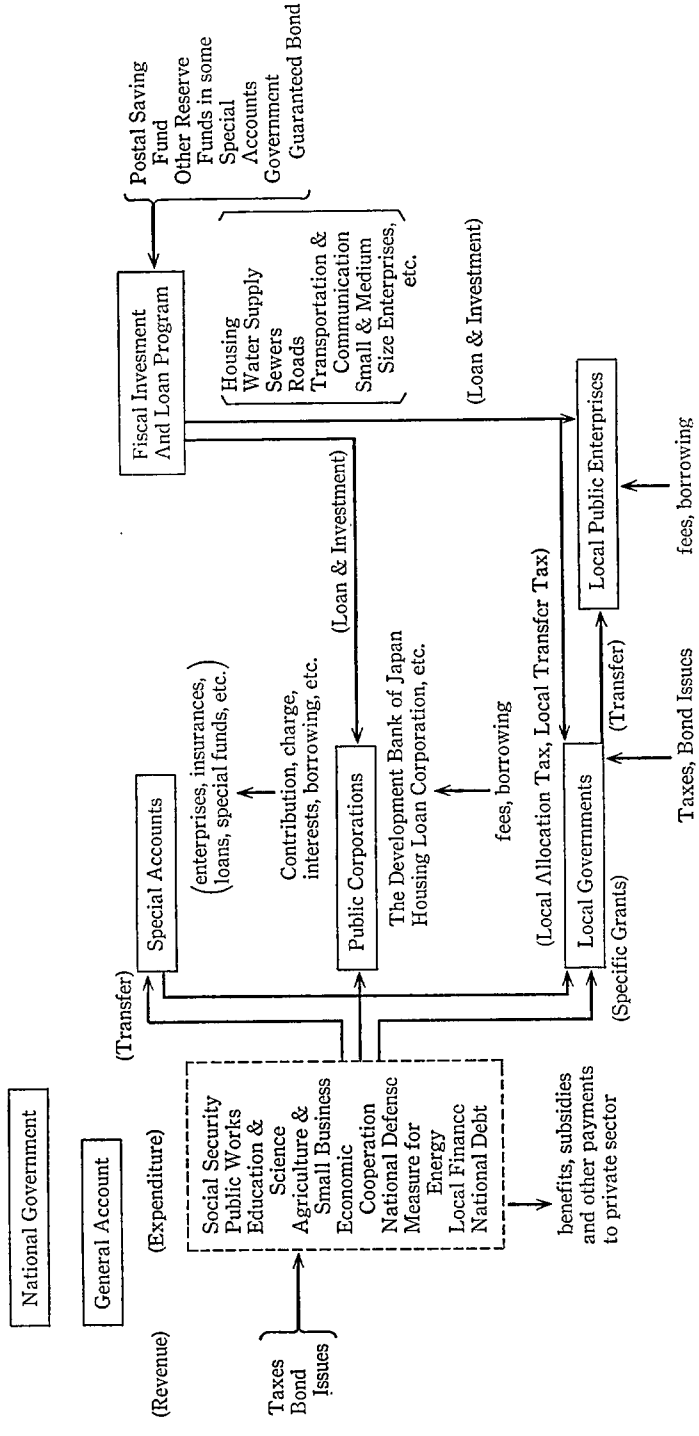
The special accounts are established when the national government needs to manage flows of specific funds to carry out the specific government activities. For instance, such activities as government enterprises, insurance, loans, etc., are managed by one of the related special account. Each special account has its own specific revenue source, such as contribution, charge, interests and borrowing. In addition to these revenues, transfers from the General Account is of great importance in operating the special accounts. For example, particular attention should be paid to the social insurance special accounts financed by both social security contributions and transfers from the General Account.

Government-affiliated agencies, granted special legal status from the government, also have their own budgets. The number of government-affiliated agencies are about 10 including the Development Bank of Japan, Housing Loan Corporation and so on. Since their activities are closely related to government policies, their budgets are included as a part of the national budget system. Thus, they must be submitted to the Diet for approval together with other budgets.

Furthermore, special note should be paid to the function of the Fiscal Investment and Loan Program (FILP). This is not a budget item, but a program of various investments and loans used by the national government. Mainly financed by the postal saving and public pension funds, loans are made to the activities of housing, water supply, roads and so on, through many public corporations. (e.g., the Urban Development and Housing Corporation and the Japan Highway Corporation) [see, for more detailed discussion, Ishi (1983), (1986)].

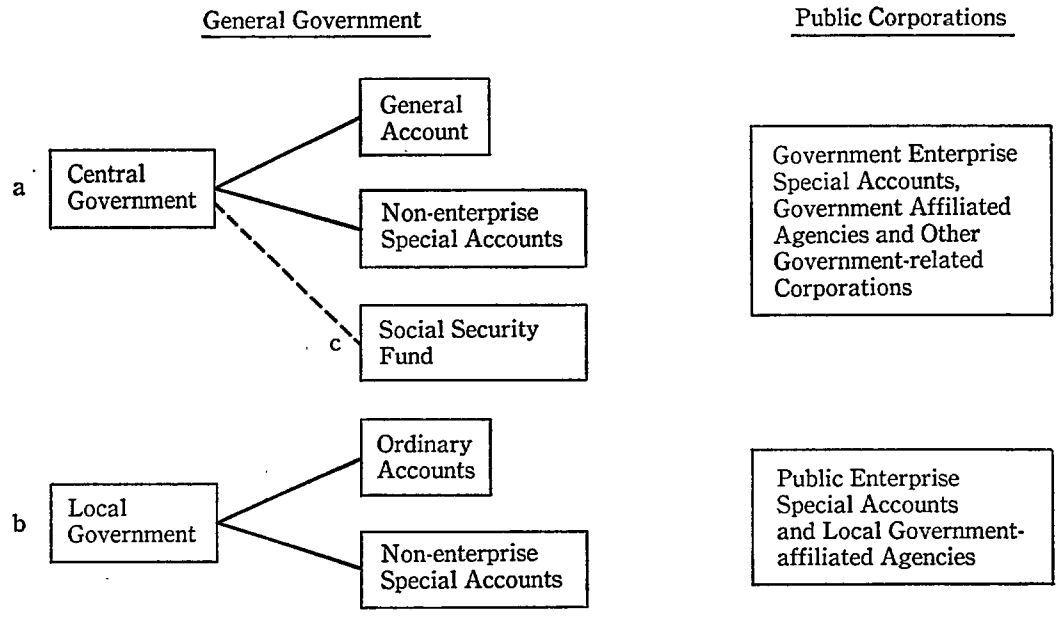
Likewise, the budget system of each local government is constituted by both the ordinary accounts and the public enterprise accounts. At the subnational level, each is relevant to general administration and enterprise activities [see, Ishi (1985b)].

FIGURE 1. WHOLE BUDGET SYSTEM



source: Ministry of Finance, *The Budget in Brief*, 1985.

FIGURE 2. THE GOVERNMENT SECTOR IN THE SNA



Source: Economic Planning Agency, *Annual Report on National Accounts*, 1985.

Given the budget system as described above, we define a narrower concept of fiscal deficits, based upon the data of the General Account in the national government (hereafter we call it the General Account deficit). This is the definition of the budget which we generally use to analyze the policy stance of MOF. Since the General Account can be thought of as representing the enitre picture of Japan's fiscal activities, the scope of its deficit seems to be very significant.

There are, however, two points worth noting in comparison with the fiscal deficits in the U.S. budget system. First, the General Account budget is comprised of both the expenditure and revenue budgets. The revenue budget includes long-term bond issues as well as taxes, and as a result the total amount of expenditures must be equal to that of revenues. This is true at least in the case of the initial budget but they could differ from each other at the settlement of the post-budget. By this definition, the amount of national bonds issued during the fiscal year, is generally called "fiscal deficits."

Second, social security contributions[1] (i.e., payroll tax in the U.S.) are not included in General Account revenues. As was seen in Figure 1, only transfers to social insurance special accounts appear on the expenditure budget of the General Account. Consequently, the General Account deficit is different from fiscal deficit in the U.S. federal budget in which

[1] The social insurance system in Japan contains programs in relation to health insurance, public pensions and unemployment compensation. The system is so complicated that it is a bit hard to explain briefly the mechanism of each program. For instance, in the case of public pensions, different groups of employees belong to different pension schemes; that is, employees of private companies belong to the Employees' Pension (Kosei Nenkin), government employees to the Cooperative Pension (Kyosai Nenkin) and the self-employed to the Peoples' Pension (Kokumin Nenkin).

total expenditures and revenues of social security programs are included [see, Noguchi (1985)]. To seek a U.S. counterpart figure, we must include total outlays and revenues of social insurance special accounts.

Another concept of fiscal deficits can be considered to make up for the deficit by the narrow sence of deficit in the General Account. This concept covers the entire scope of the government in the economy and depends on the SNA (System of National Account) framework. In figure 2, the government sector as defined in the SNA is illustrated as a contrast to the General Account definition of the national government. "Fiscal deficits" [in the SNA] is defined as the investment-saving gap within the scope of the general government dividing into (a) central government, (b) local government and (c) the social security fund. Obvious from Figure 2, the general government not only includes the general account of the national budget, but also local governments, non-enterprise special accounts and social insurance special accounts (i.e., Social Security fund). Needless to say, the general government deficit (i.e., SNA concept) is a broader definition than the general account deficit (i.e., fiscal concept), although the former is smaller than the latter in its size as shown below.

Table 1 summarizes the time trends of the two fiscal deficits (in percent of GNP) since 1970. The general account fiscal concept has continuously produced deficits, while the general government SNA concept began to incur deficits only since 1975. In recent years, the size of fiscal deficits in the general government has become smaller than those in the General Account. This is clearly due to the surpluses in the social security fund, reflecting the fact that the social securtiy system is not fully mature.

The SNA concept has more advantages in attempting international comparisons and

TABLE 1. TWO ALTERNATIVES OF FISCAL DEFICITS
—PERCENT RATIOS TO GNP—

%

	Fiscal concept	SNA concept			
Fiscal Year	General Account (1)	Central Govt. (2)	Local Govt. (3)	Social Security Fund (4)	General Govt. (2)+(3)+(4) (5)
1970	−0.462	0.234	−0.419	2.041	1.856
1971	−1.435	−0.629	−1.053	2.264	0.582
1972	−2.022	−0.767	−1.132	2.153	0.253
1973	−1.514	0.393	−0.982	2.670	2.081
1974	−1.565	−1.433	−1.257	2.744	0.054
1975	−3.479	−4.017	−2.149	2.534	−3.633
1976	−4.227	−4.338	−1.586	2.421	−3.504
1977	−5.064	−5.037	−1.826	2.765	−4.098
1978	−5.162	−4.882	−1.740	2.477	−4.145
1979	−6.067	−5.750	−1.377	2.698	−4.430
1980	−5.883	−5.503	−1.246	2.742	−4.008
1981	−5.064	−5.366	−1.287	2.942	−3.711
1982	−5.251	−5.355	−0.966	2.857	−3.464
1983	−4.841	−5.012	−0.690	2.652	−3.050

Source: Ministry of Finance, *Fiscal Statistics* (Government Printing Bureau: each year).
Economic Planning Agency: *Yearbook of National Account Statistics*, each year.

in macroeconomic discussions. However, most of the SNA data become available only since 1970, and in addition, they are lacking in detailed information of the sub-sector of the government. The SNA account are not useful in analyzing the behaviors of fiscal authority. On the other hand, the General Account deficit, based on fiscal data, is much more useful for discussions of fiscal policy. Since our attention is on the fiscal stance adopted by the MOF, it would be better to use the fiscal data even if the saving-investment gap in the SNA is different from the amount of national bond issues.

III. *Budgetary Orthodoxy on the Balanced Budget Principle*

In the following discussion, let us focus on the definition of fiscal deficits in the General Account of national budget. Prior to 1965, no fiscal deficits had been incurred in the operation of fiscal policies. The MOF had maintained a balanced budget policy.

A necessary first step is to investigate this policy stance, the MOF's budgetary orthodoxy. It seems to me that this basic position of the MOF was based upon the following three empirical rules [see, Ishi (1973)];

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

The first rule of a balanced budget has been the dominant characteristic of fiscal policy in postwar Japan. The basis for this lies in the traditional view of "sound" finance; i.e., all government expenditures must be financed by current revenues in the government sector. Following this axiom, the issuing of national bonds during the postwar period was restricted rigidly to a statutory limit of "construction bond" by the Finance Law to prevent the easy use of deficit-covering bonds. This concern for a balanced budget had been the result of a extravagant government spending and the inflationary pressures which had been experienced in prewar Japan. At the outset of the Dodge Plan,[2] the balanced budget was actually implemented at all levels of the government; that is, not only in the General Account of the national government but also in its special accounts, in other accounts of government-affiliated agencies, and in local governments.

However, the balanced budget policy had to be altered with the passage of time. Indeed, government guaranteed bonds in the FILP and local government bonds were issued. But it was not until 1965 that national bonds were issued and a deficit appeared in the General Account. Not even "construction bonds" were issued prior to this date. Thus, we should note that the meaning of the term "balanced budget" has been slightly altered as the postwar period has progressed. Nevertheless, it cannot be denied that the balanced budget should be emphasized as the most fundamental rule of government fiscal policy.

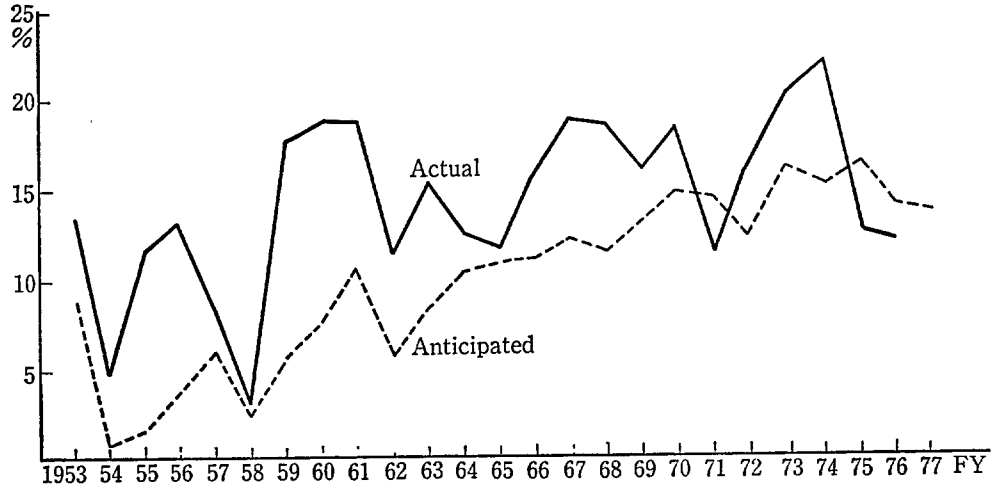
The second empirical rule has been to keep the ratio of tax yields to the national income constant (e.g., 20 per cent). This rule for tax policy has been adopted, especially in the period 1955–1965. In a growing economy like that of postwar Japan, this leads to

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

large amounts of tax reductions. In particular, the personal and corporate income taxes must significantly be reduced every year. If tax reductions had not been implemented, income taxation would have considerably overburdened the taxpayers. Therefore, to avoid overburdening the taxpayers, the income taxes had to be reduced successively almost every year.

In addition to these two rules, the intended underestimation of the natural increase in tax yields must be referred to as the third empirical rule. It bears close relation to the two rules discussed above. Some tax yields such as that from the personal income taxes naturally register increases as the tax base expands with the growth of the economy even if there are no changes in the tax rate and exemptions. The higher the rate of economic growth, the larger the amount of natural increase in tax yields that can be expected. In actuality, a large volume of natural tax increases was realized ecah fiscal year up to 1965 which provided a substantial amount of new financial resources in the preparation of the annual budget. That is to say, one portion of the natural tax increases was appropriated to the financing of tax reductions, and the other was devoted to the financing of new expenditure programs. Thus a big, expantion-minded budget was annually created by means of such large amounts of natural increase in tax yields, causing no problem of fiscal deficits. A question is raised about the estimation of the natural tax increase. It is largely based on the anticipated rate of economic growth which is usually computed five or six months earlier than the beginning of fiscal year. For an illustration let us suppose that the GNP will expand 12 per cent in the next year. Based upon this anticipated rate, the MOF usually estimates what the natural tax increases will be; for instance, more than 500 billion yen. In doing so, some non-economic factors of bias may be easily introduced into the calculation of the anticipated rate of economic growth. In most cases, it was proposed to underestimate the GNP growth rate intentionally in order to decrease the expected amount of natural

FIGURE 3. ACTUAL AND ANTICIPATED RATES OF ECONOMIC GROWTH



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

tax increase used as a financial resource at this stage of budgetary preparations. Thus, since at the end of each fiscal year, the realized rate of growth is always much higher than the anticipated rate, (see, Figure 3), an enormous natural increase in tax yields materializes during the intermediate term after the implementation of the new budget.

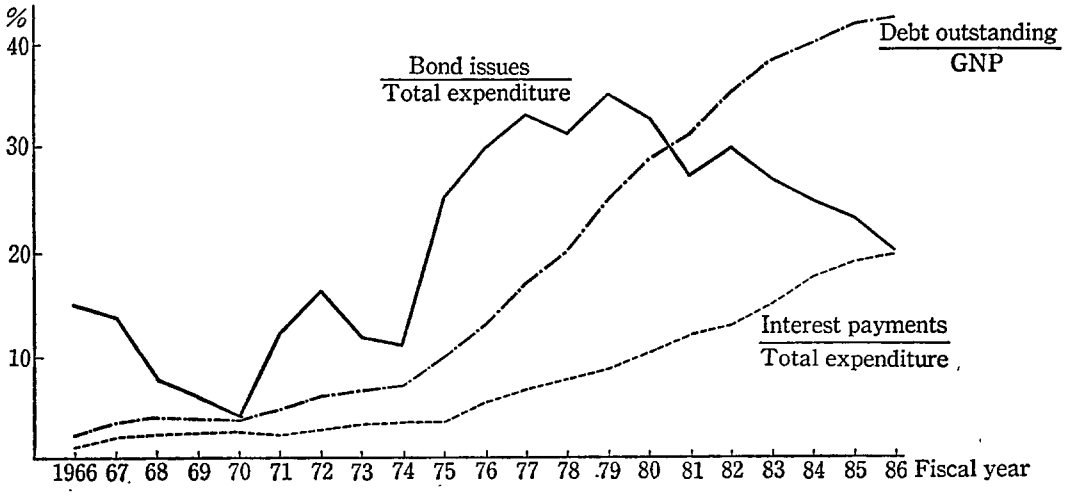
To sum up, the MOF's balanced budget policy played a dominant role in fiscal activities prior to 1965. The most important reason for this was that a rapid growth of GNP had continued to provide constantly increasing tax revenues enough to keep the General Account balanced. As a consequence, the MOF did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

IV. *Main Causes that Expand Fiscal Deficits*

The balanced budget position adopted by the MOF was ended when national bonds were first issued by a small amount in 1965. The Japanese economy was faced with a depression, and the MOF admitted the necessity of stimulating the economy by producing fiscal deficits.

There are a number of statistical data that show the growth of fiscal deficits. These three data are used in Figure 4. Of most significance is the ratio of national bond issues to total expenditures in the General Account; we often call this ratio, the "bond dependency ratio" in accordance with the MOF's terminology. Although ntaional bonds were issued, this ratio was gradually reduced for several years until 1970, and therefore it began to rise up to 15 percent. During the period prior to 1973, however, national bonds were not accumulated, posing no problem of fiscal deficits. Indeed, the ratio of debt outstanding to GNP still shows a lower level, and the same holds for the movement of the ratio of interest

FIGURE 4. GROWTH OF FISCAL DEFICITS



Source: Ministry of Finance, *op. cit.*
Note: All the figures are relevant to the General Account.

TABLE 2. FISCAL DEFICITS IN MAJOR COUNTRIES

(%)

	Bond issues / Total expenditues	Debt outstanding / GNP
Japan	20.2 (1986)	50.0 (1986)
U.S.	20.7 (1986)	36.5 (1985)
U.K.	7.0 (1984)	47.2 (1984)
W. Germany	9.1 (1986)	20.3 (1984)
France	13.7 (1986)	9.1 (1984)

Source: Figures collected by the MOF.

payments to total expenditures.

As is observed in Figure 4, fiscal deficits began to expand rapidly since the first oil shock in 1973, and the situation worsened at the outbreak of the second oil crisis in 1979. For several years, the MOF made a great effort in restricting the bond dependency ratio to below 30 percent in preparing the initial budget, but finally the effort failed. It is clear that the MOF has been very reluctant to permit the pursuit of persistent deficit finance, evident from the past trend of fiscal deficits [see, Ishi (1977)].

After reaching a peak in 1979, the bond dependency ratio has begun to decline constantly, mainly due to expenditure cuts. In Table 2, some attempt is made to compare the latest situation of fiscal deficits among major countries. It still appears that Japan has a higher level of bond dependency in the compilation of the budget.[3]

Before proceeding further, it is necessary to ask what are the causes for the sharp rise of fiscal deficits since 1973. Many factors are behind the rapid growth of fiscal deficits. Among them, of most importance are the following two.

First, emphasis should be put to the conspicuous slowdown of Japanese economic growth caused by the two oil crises. As a matter of fact, it was widely believed that the real growth rates were greatly reduced from 10% to 5% in 1973 and once again to 3% in 1979. Japan almost fully depends on the basic raw materials and energy sources of overseas market. Therefore, its economy is very vulnerable to the price hike of basic materials or an oil embargo. Immediately after the first oil shock in 1973, the quadruple rise of crude oil prices hit too heavily the Japanese economy, producing economic disorder. At that time inflation registered nearly 30% in both CPI and WPI, and the real growth rate turned into a minus which we had never experienced in the postwar period.

After the minus growth rate, the Japanese economy continued to experience "prolonged recession" for several years. From the worst recession in 1974 until 1978 immediately before the second oil crises, the Japanese economy never entered into a vigorous and strong process of business recovery. The most important factor is that private investment remained

[3] If we use the general government deficits (ratio to GDP) based on the SNA data, the fiscal deficits problem in Japan becomes less serious; in 1983 the deficits (ratios are 3.71 percent in Japan, 5.52 percent in the U.S., 3.46 percent in the U.K., 2.73 percent in W. Germany, and 3.07 percent in France.

stagnant and depressed, showing no conspicuous signs of its buoyancy. Probably businessmen became very prudent in undertaking investment as a result of losing the prosperous prospects in the future trend of Japan's economy.

Once again the second oil shock attacked the Japanese economy in 1979, and its growth rate was acknowledged to be lowered up to 3%. As a result, the Japanese economy had dipped into the doldrums for 3 years since the beginning of 1980.

What did the "prolonged recessions" with lower growth rates cause in the General Account budget? Needless to say, they tended to produce a large amount of revenue shortages which in turn contributed a lot to increase in fiscal deficits for the past decade [see, Ishi (1982)].

As the second factor in explaining large increases in fiscal deficits, we should take note of the expanded role that governments played with respect to income maintenance, free health care, education etc. In the early 1970s, important institutional reforms were completed in the social security system as "a slogan to construct the welfare state in Japan." The target was to catch up with the Western level of social welfare programs; say, public pension, medical care, etc. It was generally pointed out that Japan had lagged behind Western countries in the development of social welfare policies. Ironically, it was in 1973 that new social welfare programs were launched and they were expanded as largely as those in other countries. Therefore, the year 1973 is often called "the first year for constructing the welfare state."

Although many new social programs were launched at that time, it had been expected that high rate of growth would continue in the future and would thus generate the additional resources needed to finance the higher public expenditure. Unfortunately, in the decade that followed 1973, the rate of growth fell considerably in Japan, as well as in most industrial countries.

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

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

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

V. *Conflict between Keynesian and the MOF's Views*

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

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

In the background of prolonged recessions since the oil shock, fiscal activism in favor of stimulative measures began to emerge as a powerful device for attaining full employment. Fiscal deficits became a means as a consequence of achieving this objective.

In parallel with the expansion of the welfare program as was stated before, such fiscal activism clearly played a vital role in increasing the huge amount of fiscal deficits. Faced with the continued rise of national bonds, the economist views were divided into two groups. One is Keynesian, and the other anti-Keynesian.

The Keynesian group is composed of specialists majoring in macroeconomics, or the staffs in MITI, the Ministry of Construction or the Economic Planning Agency (EPA). The Keynesian usually push the government to take an expansionary budget; say, in the form of tax cuts or increases in public investment. Their target for achieving the rates of real growth is always higher (5–6%) than the governments officially anticipated (3–4%), mainly because they believe the potential path of Japan's ceonomic growth must be higher. As a consequence, the Keynesian groups ignore too often acumulative effect of a chain of fiscal deficits. They feel optimistic about debt accumulation, which will be naturally reduced by the generation of tax revenues in a growing economy. According to the Keynesian view in Japan, it is more important to achieve the higher rate of growth than to eliminate fiscal deficits. On the other hand, a view against the Keynesian view is strongly supported by public finance specialists or the MOF staff. They compose the anti-Keynesian group. Generally speaking, the traditional embarrassment toward fiscal deficits and growing public debts seems to be quite common to this group. They place more emphasis on traditional principles of sound finance—that is, no deficit is justified if associated with unproductive investments, or current expenditures, or if permanent differences between expenditure and revenues result.

In the view of the anti-Keynesian group, a fiscal deficit may be beneficial with respect to this year's economic performance especially when the economy is working at less than full capacity, but it may be harmful with reference to future economic performance if it leads to excessive increases in public debt. Thus, they are usually worried about debt accumulation, and emphasize the necessity of reducing it.

Two views, which are quite different about debt accumulation, have conflicted with each for the past decade. Relatively speaking, I support the anti-Keynesian position,

although I admit the necessity to stimulate the economy by issuing national bonds in a severe depression.

It seems to me that present fiscal deficits are growing beyond the acceptance of cyclical deficits. If deficits were mostly cyclical, they would grow in recessions, and swing into surpluses during recovery. This being the case, the public debt would not accumulate over time. The present situation seems to be different; today's deficits are not cyclical but structural. Structural deficits would remain "high" even if full employment is achieved.

Also, the interest rate of national bonds has exceeded the nominal growth rate of GNP for the past several years. For example, the latter is estimated to be 5.1 percent in 1986 by the EPA, while the former has been fixed at over 6 percent in recent years in order for the bond to sell well in the market. In accordance with the famous Domar model, from a theoretical consideration, the ratio of interest payments to nominal GNP will not converge if present rates of economic growth or interest rates continue. This being the case, it may be argued that a big debt at present would eventually bankrupt the government.

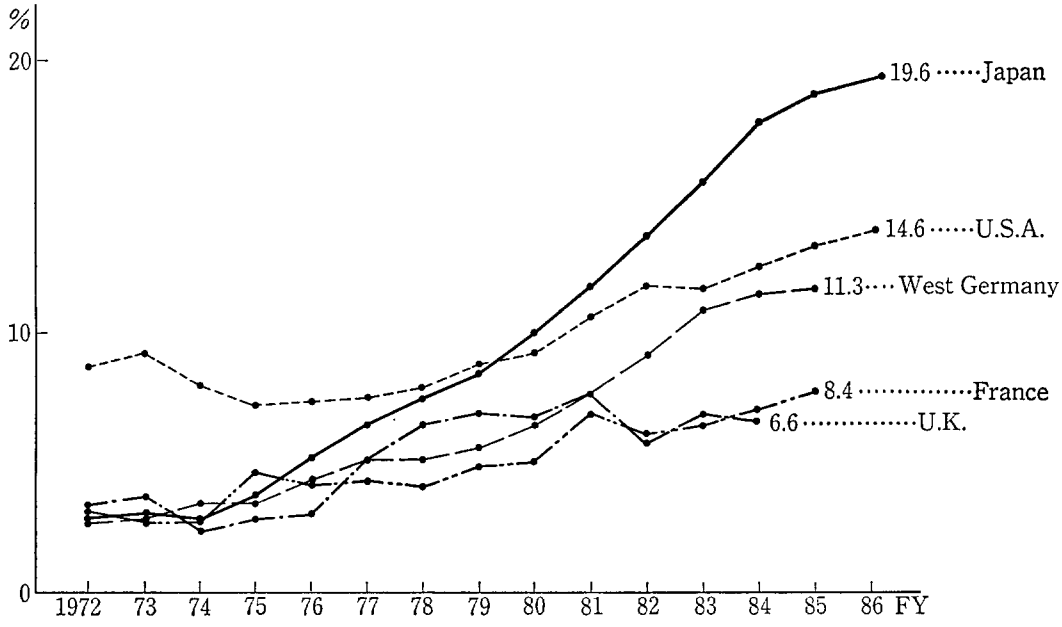
VI. *Measures to Solve Fiscal Deficits*

It is often argued that fiscal deficits need to be reduced when accumulated, not only because of the harmful effect on economic performance but also because of the burden on the budget caused by interest payments on national bonds. For now, fiscal deficits are not likely to induce inflation and crowding-out effects in the Japanese economy. The main reason for this is that Japan still keeps a high rate of saving. In terms of the household saving rate in 1983, Japan has 17.3% while W. Germany has 11.4%, France 11.5%, the U.S. 5.0%, and the U.K. 7.0% The extent to which the public debt will crowd out private investment will depend on the rate of saving of the country. A country like Japan with a high rate of saving that exceeds its domestic investment opportunities can easily finance its own investment as well as its fiscal deficit. This is to be contrasted with the recent experience in the U.S. where an increasing share of savings has been appropriated to fiscal deficits on the macro-economic performance.

However, the sharp rise in interest payments caused by an accumulating national bond poses serious problems in the performance of government fiscal activity. Large increases in national bonds have made interest payments by far the fastest growing component of public expenditure. Figure 5 depicts the rising movement of interest payments (as a percent of General Account expenditures) in international comparison. In 1972, for instance, interest payments were 2.7 percent of public expenditures in Japan. By 1986, this payment increased more than 7 times, reaching 19.6 percent. The U.S. case indicates an upward movement like Japan, but the speed of increasing interest payment is much slower. W. Germany, France and the U.K. in recent years have kept much lower levels. In Japan the growth of interest payments is likely to continue in the future. This growth will swell public expenditures and will make the curtailment of fiscal deficits more difficult. It appears that fiscal deficits are feeding upon themselves through the interest component of public expenditures.

Since recent deficits are largely structural, they have to be reduced through basic changes in the level and pattern of public expenditures and in the tax system. In this case, it seems

FIGURE 5. INTEREST PAYMENTS AS A PERCENTAGE OF GENERAL ACCOUNT EXPENDITURES



Source: The same as Figure 4.

to me that a Keynesian type of policy cannot be of any help in reducing fiscal deficits. Keynesian policies are merely temporary, stop-gap measures. Of course, stop-gap measures help in reducing debt accumulation, but they do not bring a permanent solution to the fiscal unbalance. Permanent solutions require permanent measures. Structural reforms become necessary when debt accumulation results from structural deficits.

Keynesian policies may be able to bring some short-run reduction of the public debt by natural increases of taxes generated by a higher rate of growth. However, they will not cure the disease of debt accumulation. Furthermore, we must note that the economic realities in the 1980s dictates that there will be no more continued expansion of business. Given such future performance of the economy, tax revenues on a scale large enough to reduce automatically the accumulation of public debt cannot be expected. The scenario drawn by the Keynesians is not likely to be realized.

On this point, a new strategy of "administrative reform" which the government has adopted since 1981 can be highly evaluated as a proper policy choice. At first, the government intended to contain the size of fiscal deficits by tax increases, rather than expenditure cuts. In fact, the introduction of a value-added tax (VAT) was attempted in 1979, but it was a complete failure. As a result, it became politically very difficult to introduce enough tax incresaes to reduce the public debt, and the government has changed its policy stance from tax increases to expenditure cuts. [see, Ishi (1985a)]

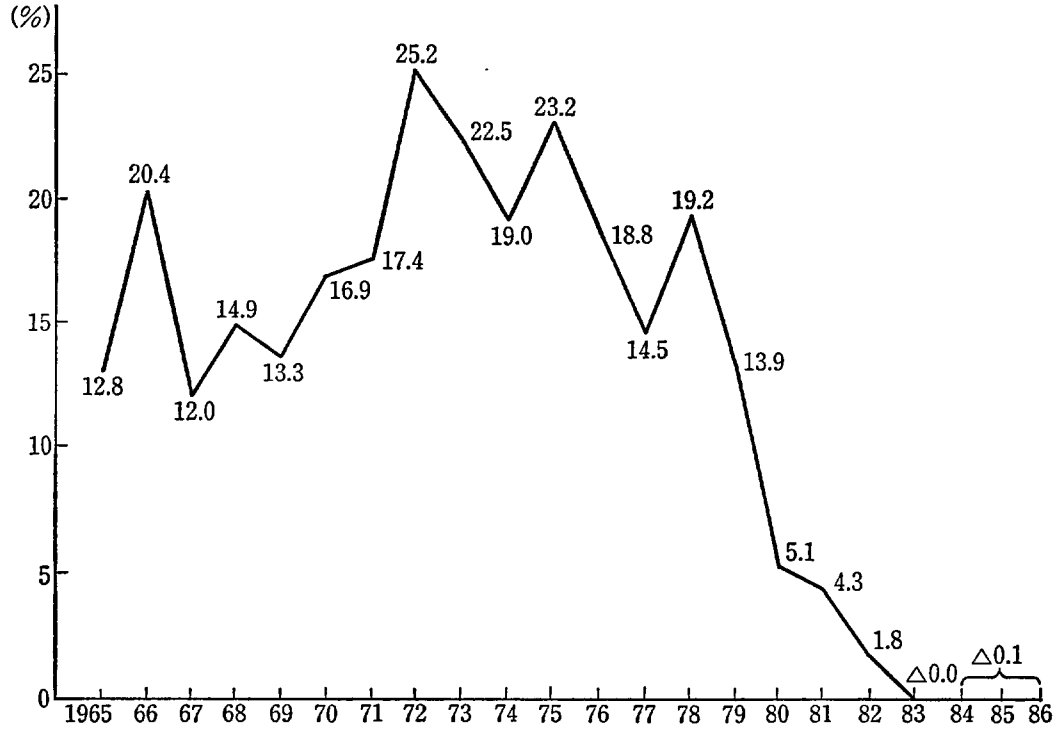
Public expenditures structually include a number of "entitlements" created mainly by the legislation of social welfare programs in the late 1960s and early 1970s. In addi-

tion, the interest component of public expenditures began to rise sharply. They all required progressively larger financial sources.

In 1981, an ad hoc committee for "administrative reform" was established to study and propose cuts in inefficient, unnecessary components of public expenditures. A slogan of "fiscal reconstruction without any tax increase" was prepared by the government and widely supported by the general public. The government began to set a maximum for requiring the increase in public expenditures relative to the previous year. It is called the "ceiling" method when the budget is compiled every year. The "ceiling" gradually turns into zero or minus in specific budget items. As a result, the growth of non-entitlement expenditures[4] in the national government is retarded. Since 1981, public expenditures grew under the guideline of zero ceiling and sometimes even minus ceiling while the same grew more than 20 percent in the 1970s (see Figure 6).

Figure 6 may be misleading, however. It is drawn using conventionally defined government expenditures, but in the 1980s, fiscal "window-dressing" becomes large on the expenditures side of the budget. To restrain the growth rate of non-entitlement expenditures

FIGURE 6. PERCENTAGE CHANGE OF NON-ENTITLEMENT EXPENDITURES FROM THE PRECEDING FISCAL YEAR



Source: The same as Figure 4.

[4] Non-entitlement expenditures, which are usually called "general expenditures," are defined as total expenditures minus two entitlements—i) debt services and ii) tax sharing grants (i.e., local allocation tax).

at zero, fiscal "window-dressing" on the expenditure side becomes more significant every year. It takes the form of excluding various categories of expenditure which more correctly should be assigned to the General Account budget. For instance, a portion of the transfers to the social insurance accounts has been postponed. This is borrowing whose amount should be included in the expenditure side in the current budget. In general, the fiscal authority is successful in obscuring its true expenditure position and covering the impression of adherence to "fiscal reconstruction with expenditure cuts" to the public.

VII. *Concluding Remarks*

In support of the MOF's policy stance, we have so far outlined the past trend of fiscal deficits. Major concerns were with two time-periods; one is that period prior to 1965 when fiscal policy was founded upon the balanced budget rule, and the other the post-1965 period when the appearance of deficits led to debt accumulation.

After the yen value was greatly appreciated against the U.S. dollar, it is widely acknowledged that the Japanese economy encountered a new inclination toward recessions. Many began to insist that fiscal policy should be more expansionary to stimulate domestic demands. In line with strong pressures from abroad to curtail the large amounts of trade surpluses, the MOF is pressumed to change its policy stance from budgetary orthodoxy to Keynesian stimulative policy. The fiscal policy debate is now again between the Keynesians and Anti-Keynesians, particularly from a short-run point of view.

It is, however, important that Japan make a great effort to reduce its debt accumulation, especially from a long-run standpoint. Although there are a number of reasons worth noting, the most important is the future trend of the aging of the population in Japan. Toward the 21 century, Japan will essentially become the world's fastest aging society.

The ratio of people 65 years old and over to the total population is about 10% in 1984, which is smaller than that in almost any other industrial country. However, this percentage is estimated to rise very rapidly to over 20% in 2020. In other countries, the same ratios are now 13–15%, which is considered to rise no more. The speed of aging that we are witnessing in Japan seems to be unprecedented.

The aging society requires a sharp increase in public expenditures, such as in welfare programs, especially in the area of public pensions and medical care. The tendency for large increases in welfare expenditures has started since the early 1970's when new programs were established in 1973. Reflecting such a tendency, the government share of GNP has expanded in the past decade. In 1970, the ratio of all government expenditures (including (perchases and transfers) to GNP was merely 19.5%, which means Japan had still a "smaller government." This ratio, however, rose sharply to 34.4% in 1982, and it will automatically rise up to 50% in the future as society ages. This being the case, we can conclude even now that Japan would have potentially a "very big government"; it is already as big as that in Scandinavian countries. Many people argue that Japan should avoid having a "big government." Many lessons are learned from countries with a big burdensome public sector.

In spite of strong requests to change its policy toward more expansionary measures, the MOF should be prudent. Given the future trend of aging and debt accumulation, it will be necessary to introduce the VAT in the future, taking the macro-economic effects

into consideration. Although the Keynesian view is important, demands for sound finance will appear from now on as a pervasive theme in Japanese government finance.

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