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Fiscal Reform of Japan: Redesigning the Frame of the State
Five proposals for complementary institutional reform: From a “compartmentalized” to a “cross-sectional” system

“Fiscal Reform Project”
Research Institute of Economy, Trade and Industry, IAA
Project leaders: Masahiko Aoki, Kotaro Tsuru

In December 2002, the Research Institute of Economy, Trade and Industry (RIETI), an independent administrative agency, launched a “fiscal reform project” founded on the recognition that fiscal reform is of the utmost importance for redesigning the “frame of the state” to shape a Japan for the 21st century. Discussions and analyses have taken place through a series of study sessions and workshops, and the findings of our research were presented at the RIETI Policy Symposium “Fiscal Reform of Japan: Redesigning the Frame of the State” held on March 11-12, 2004. The essence of the 14 reports that were submitted (see Appendix ii for a summary of each report) and the discussion hitherto held by project members from five perspectives (see Appendix i: “Brief”) has been distilled by the project leaders into the following policy proposals.

1. **Integrate and coordinate tax and social security systems to ensure long-term fiscal sustainability**
   - Step-by-step increase in consumption tax rate in conjunction with continuous efforts to improve labor productivity.
   - Introduction of a unified identification number system for tax and social security payments to improve the efficiency of tax collection and social insurance operations, in tandem with the integration of the Social Insurance Agency and the National Tax Agency.
   - Abolition of the Special Taxation Measure Law which has been a breeding ground for special interests.
   - Expansion of the scope of personal income subject to taxation and simplification of the personal income taxation system.

2. Introduce a multi-year budget system

- Initiation of top-down decision-making in the Cabinet (under the joint leadership of the prime minister and the finance minister) on a midterm budgetary framework (primary balance, etc) in accordance with designated rules and based on a prudent macroeconomic (baseline) forecast.
- Consideration of ex post facto flexibility (amendments to budget plan, etc) underpinned by the fulfillment of accountability.

3. Increase and prioritize budget allocations to cross-sectoral systems

- Greater budget allocations to cross-sectoral systems (social systems) involving multiple ministries and multiple industries based on a prioritization designated by the Cabinet Secretariat or the Cabinet Office (and budget formulation by the Ministry of Finance in line with this prioritization) – staffed by a group of capable mid-career bureaucrats from the relevant ministries and agencies – with a view to adding value to the final demand side.
- Greater discretion given to each ministry or agency over item-by-item budget allocation and execution.
- Provision of feedback by ex post facto evaluation for future budget plans.

4. Establish fiscal independence and responsibility in local governments

- Endowment of local governments with autonomous taxation powers and abolition of uniform subsidiaries in the distribution of local public goods.
- Strengthening of local governments' fiscal discipline by eliminating mechanisms under which the central government implicitly guarantees local government bonds (provision of state subsidies to cover the debt servicing costs of local governments, etc) and the enactment of a "regional revitalization law" that lays down rules and procedures for coping with bankrupt municipalities.

5. Hold common values on and share a sense of crisis regarding the issue of long-term fiscal sustainability (steps to push forward institutional reform)

- Provocation of public debates to make people aware of the crisis surrounding long-term fiscal sustainability and the key principles of tax reform (neutrality, transparency, flexibility, and simplification).
- Proposal of and discussion on various crisis solution models by specialist groups and political parties (assumptions behind the models, pertinent data, and structural transparency).
- Efforts to seek supra-partisan consensus on a basic framework for fiscal

reconstruction.

- Under this basic framework, encourage competition between the model-oriented policy proposals of political parties (routes toward achieving primary balance, ways to share social security burdens and benefits among the general public and different generations, prioritization of budget allocation among "social systems," etc) and selection of them by the electorate.

Appendix i

Fiscal Reform of Japan: Redesigning the Frame of the State
Five proposals for complementary institutional reform: From a "compartmentalized" to a "cross-sectional" system
– Brief –

Stance on fiscal reform: Redesigning the "frame of the state"

Japan's long-term fiscal sustainability is on the verge of a crisis. As long as Japan maintains its current "fiscal system," this crisis cannot be averted by economic recovery alone and Japan is destined to go bankrupt sooner or later. Fiddling with figures cannot provide any solution to the ongoing fiscal crisis because existing rules and organizational structures governing budget, tax, public bonds and social security (the "fiscal system"), whether they are formal or informal, no longer guarantee either the implementation of well-disciplined fiscal operations or the effective and efficient supply of public goods. In order to overcome the fiscal crisis, it is imperative to reform the "fiscal system." And this inevitably calls for redesigning the "frame of the state." The relationships between the government, the general public and private-sector entities, as well as the intra-governmental relationships among political parties, the Cabinet, and government ministries and agencies must face re-examination.

"Bureau-pluralism" and Japan's fiscal system: Inertia and rigidity

The so-called "common pool problem" – a free-riding problem in which politicians or spending ministries induce fiscal expenditures for the benefit of particular interest groups or regions without asking them to bear their appropriate share of the burden – is deemed the universal reason why fiscal expenditures rise. In considering Japan's fiscal problem, we would first like to examine how Japan has dealt with this common pool problem up until now. With regard to the budget formulation process, Japan has been implementing a buildup approach ("bureau-pluralism"), whereby the relevant ministries and agencies would first siphon up requests from various interest groups (industry associations). These requests would then be adjusted internally within each government ministry and be subjected to interventions by lawmakers representing the interests of particular industries or groups before being examined by the Ministry of Finance in the final stage of budget formulation. As a complementary mechanism to this budget formulation process, the ruling Liberal Democratic Party's Research

Commission on the Tax System – particularly its key senior members or those of the so-called "inner league" within the commission – has been presiding intensively over tax affairs. Meanwhile, local public finance has been taken care of by the Ministry of Public Management, Home Affairs, Posts and Telecommunications, whereas social security matters have been dealt with by the Ministry of Health, Labor and Welfare, each compartmentalized from the central government's fiscal management. On the other hand, the management of public debts (which is equal to expenditure minus revenue) is deemed simply as an outcome or residual of all these mechanisms (subordination and marginalization).

These mechanisms under bureau-pluralism used to function relatively well when Japan had sufficient fiscal resources and the Ministry of Finance's Budget Bureau and leading members of the Cabinet could demonstrate decisive arbitration power. However, inherent problems have gradually accumulated within each mechanism giving rise to the "common pool problem." With the economy becoming increasingly complex, the Ministry of Finance's examination of budgetary requests from other government ministries and agencies has lost substance and is now little more than a mere customary practice. This is exemplified by the very fact that the Ministry of Finance has been resorting to the so-called "ceiling" system, which imposes a uniform budgetary cap for curbing expenditures across the board, rather than setting priorities in accordance with the degree of importance. And while the formulation of supplementary budgets has ensured flexibility for making additional requests, it has further deteriorated Japan's fiscal problem. Bureau-pluralism has provided a breeding ground for the kind of incentive mechanism for bureaucrats witnessed today, under which grabbing a bigger slice of the budget pie for their respective ministries has become a self-serving objective, while allowing lobbyist politicians to hold and expand their own sphere of influence. By marginalizing public debt management, there has been a continued "exploitation of future generations," or passing of the buck from one generation to the next.

Institutions established under bureau-pluralism have difficulty in adapting to external changes such as those in the economic environment, and thus, they are embedded with a self-rigidifying mechanism. This is a major factor behind the loosening of fiscal discipline (moral hazard) which has undermined Japan's capability to take remedial actions by exposing the fiscal crisis. Exemplifying this are the following phenomena: 1) each "compartment" of the fiscal system has its inherent opacity, and specialists that do not belong to any particular "compartment" are hardly utilized; 2) personnel exchanges between different compartments are rare; 3) little consideration is given to the interests of future generations; 4) the central government implicitly guarantees the fiscal sustainability of local governments; 5) the general public lack awareness of their responsibility, as taxpayers, to monitor the nation's fiscal conditions because of the distorted tax system and the taxation authority's reduced tax collection ability.

Whether it is with regard to the central and local fiscal systems, the tax system, social security, or public debt management, a crisis cannot be avoided by implementing suboptimal reform policy within each domain or by fiddling with figures. All of these institutional systems are interdependent (institutional complementarity) and they need political leadership with the capacity to implement reform in each of these areas in a strategic, integrated and consistent manner. Such leadership can only be demonstrated when firmly underpinned by the support of the general public who, as voters and taxpayers, share an awareness of the fiscal crisis. Some signs of change have begun to emerge lately, as seen in the intention of the Cabinet of Prime Minister Junichiro Koizumi to address the problem of fiscal debts as well as in the so-called "big-boned policies" ("Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management") drawn up by the Council on Economic and Fiscal Policy (CEFP). To accelerate these positive steps and let signs of crisis surface thereby enabling Japan to adapt better to changes in the economic climate, what changes and reforms need to be made to the existing rules and organizational structures in each area of the fiscal system?

Five perspectives on fiscal reform

Firstly, integrated coordination between the tax and social security systems in such a way as to ensure long-term sustainability and maintenance of revenue sources are urgently needed for rapidly restoring Japan's long-term fiscal sustainability, which is now on the verge of crisis due in part to the swiftly aging population.

Secondly, it is necessary to change the focus in the macroeconomic management of fiscal expenditures, given the fact that a Keynesian-style of fiscal spending is declining in effectiveness and that the current buildup method of budget formulation is unable to cope sufficiently with today's increasingly complex economy. More specifically, a multi-year budget plan must be laid out by the Cabinet in top-down decisions, governed by a set of rules.

Thirdly, appropriate steps must be taken to address the needs brought on by the acceleration of technology innovation and the diversification of final demand. Already, walls between industrial sectors are being lowered and even collapsing. It is therefore important to secure sufficient budgetary allocations for "social systems" that provide value to the final demand side in a cross-sectoral manner (such as a "housing supply system" and a "system to promote the independence and self-reliance of the elderly") and to lay down an order of priority for the different "social systems."

Fourthly, it must be fully understood that the current centralized system, under which the central government implements uniform and standard control over the supply of local public goods, is coming to its limit and, based on this recognition, appropriate measures must be taken toward establishing the fiscal independence and self-responsibility of each local government.

Finally, focus must be placed on the political process as a procedure for rigorously promoting these reform initiatives. To create an environment where political leadership can be given full play, it is important that the general public hold common values on and share a sense of crisis regarding the issue of long-term fiscal sustainability of the country.

These five viewpoints listed above form the foundation of our policy proposals.

“Fiscal Reform Project”

Research Institute of Economy, Trade and Industry, IAA

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(Alphabetical order)

Appendix ii

RIETI Policy Symposium

"Fiscal Reform of Japan: Redesigning the Frame of the State"

- Summaries of Reports -

RIETI Discussion Paper Series 04-J-006

"Fiscal Problems of Japan: Toward Prescribing a Solution"

TSURU Kotaro

Behind the escalation of Japan's fiscal problems in the 1990s surely lies the government's enormous fiscal expenditure. Another major factor, however, is the rigidity of Japan's fiscal system which was unable to adjust to the changing macroeconomic structure during the post-bubble period. Also, there is no denying that the progression of "political fragmentation" – starting with the end of the many decades of single-party rule by the Liberal Democratic Party, followed by a shift to a coalition regime – served as yet another factor that contributed to fiscal expansion. Therefore, as a means to reduce fiscal deficits, an issue of the utmost importance, it is crucial to (1) centralize budgetary decision-making authority in an independent organization and (2) set numerical targets for a period of two to three years. These measures should serve as the "two wheels" to drive the reform that is needed. On the other hand, reform measures that need to be undertaken, based on a mid- to long-term perspective, to improve the efficiency of the budget system include: (1) implementation of lump sum budgetary allocation and ex post evaluation of budget execution vis-a-vis each government ministry, (2) introduction of a multi-year budget system, and (3) redefinition of deficit-covering bonds and construction (capital investment financing) bonds. When compared with the existing system, however, there undeniably exists a trade-off between "discipline" and "flexibility." It is thus necessary to create an environment where such a trade-off can be improved by, specifically, increasing the transparency of the budget system. With regard to the tax system, the government must, first and foremost, consolidate and rationalize the numerous deductions and special breaks that come under the Special Taxation Measure Law – the presence of which has been the prime cause for the complexity of Japan's tax system – to expand the scope of personal income that is subject to taxation. Only then, the government could and should seek people's understanding regarding the need to raise the consumption tax rate by sincerely explaining the current state and future prospect of Japan's fiscal condition thereby restoring public confidence in and support for the government.

RIETI Discussion Paper Series 04-J-007

"Two Aspects of Japan's Bureaucratic System as Seen in Fiscal Procedures"

IIO Jun

Japan's parliamentary cabinet system is characterized by the juxtaposition of two kinds of organization. The official government organization – a "bureaucratic cabinet system" as it may be called – is primarily composed of the bureaucratic system on one hand, and the "ruling party or parties" formed by politicians playing a supplementary role on the other. Under this mechanism, fiscal discipline has been maintained by means of the organizational processes of the former. However, as democracy has taken root in Japan, bureaucrats have lost their legitimacy as a governing entity. And with this has gone the fiscal discipline. In order to carry through fiscal reconstruction under such circumstances, it is necessary to establish an unwavering political will to restore the fiscal health underpinned by a multiparty agreement rather than simply pursuing reform of the administrative structure. When this is accomplished, the fiscal management system would have to be reformed into one that is more targeted-oriented. In carrying out such reform, some sort of built-in mechanism for controlling each ministry's authority – rather than simply transferring authority to each ministry through distributed management – must be implemented so as to prevent bureaucratic turf-building from worsening. This is because it is necessary, as a means of warranting the aforementioned multi-party agreement, for bureaucrats to suppress their disposition of being eager to represent social benefits under the existing mechanism of bureaucracy and, instead, emphasize their role as an autonomous body that pursues national interests.

RIETI Discussion Paper Series 04-J-008

"Why Does the Government's Budget Balloon and How Can it be Curbed?: Focusing on Incentives for Bureaucrats"

KADONO Nario / TAKIZAWA Hirokazu

This paper discusses the influence that Japan's bureaucracy and its personnel system has on the ongoing fiscal problem. The issue of bureaucrats' incentives which shape the decision-making process must be addressed when discussing fiscal reform. The common pool problem encountered in fiscal governance is generally observed in other countries where an add-up or bottom-up style of decision-making system is adopted for budget formulation. This paper, however, argues that the presence of Japan's unique bureaucratic personnel system – established during the high growth era and characterized by "compartmentalization" and "immobility" – has aggravated the common pool problem substantially. Based on this understanding, the paper says that a mechanism for restoring discipline needs to be internalized by utilizing the self-innovating ability of such an immobilized personnel system. For achieving this, the paper points to the need to reform the budget evaluation system, clarify responsibility for budget-related tasks, and increase the mobility of human resources.

RIETI Discussion Paper Series 04-J-009
"Political System and Fiscal Performance: Japan's Historical Experience"
OKAZAKI Tetsuji

This paper examines the relationships between the political system and fiscal performance of a country by focusing on prewar Japan. During the several decades following its establishment as a modern state, Japan experienced drastic changes both in its political system and fiscal performance. This provides valuable data for empirically examining the relationships between the two.
The Imperial Constitution of prewar Japan laid down a decentralized political system with two aspects. Firstly, state affairs and supreme command were clearly segregated. Secondly, in state affairs, a state minister was given the authority to single-handedly assist or give advice to the Emperor in matters requiring formal approval, under the "tandoku hohitsusei" ("sole assistance system"). Under this framework, the military, bureaucrats and political parties – components constituting the political system – began to have their own ways after the end of the Russo-Japanese War, imposing pressure to expand budget outlays. Prior to World War I, however, the extra-constitutional body of "genro" ("elderly statesmen") contributed to maintaining the unity of the country and fiscal discipline. In contrast, during and after the war, however, the function of the "genro" deteriorated and it became difficult to maintain fiscal discipline under a decentralized political system. It is quantitatively observable that the political-party cabinet system, which took root in the 1920s, has contributed to the overall expansion of the budget. The 1930s saw a substantial increase in the overall influence of the military. Not only that, the fragmentation of the decision-making authority within the military proceeded. Japan's fiscal primary balance, which had been basically in surplus during the years following the Russo-Japanese War, turned into chronic deficits from the 1920s onward. These changes in Japan's fiscal performance reflect the changes that took place

in the political system.

RIETI Discussion Paper Series 04-J-010
"The Role of Public Awareness in Fiscal Reform"
NAKABAYASHI Mieko

The causes of Japan's fiscal deficits are structural in nature rather than cyclical. Not only has Japan been logging the worst records in fiscal deficits among industrialized countries, but it is also confronted with major challenges such as the problem of an aging population. The presence of fiscal deficits, which has been destabilizing the economy, is also beginning to cause fiscal rigidity that undermines efficient resource allocation to important policy measures. Yet despite being beset from all sides, Japan needs to push forward with fiscal reform. The government needs to consider the best way to spend its limited resources, namely, taxpayers' money. At the same time, however, it cannot avoid the ordeal of raising taxes while trimming down on public services. The fate of fiscal reform carried out under such conditions hinges on how the people – as taxpayers and creditors – understand the situation and what choices they make regarding the future. Japan's decision-making process for fiscal policy has been extremely opaque in the eyes of the general public and it remains unclear where responsibility lies. Those with fiscal expertise, despite what they might have contributed to the government, have failed to sufficiently reach out to the general public. In order to increase the people's awareness regarding the need for fiscal reform, the presence of and public confidence in these specialists as a bridge between the government and the people are indispensable. The general public, for their part, need to deepen their understanding of fiscal affairs and make appropriate decisions over the policy agenda that politicians put forward in election campaigns. Fiscal reform is a touchstone with which to test the power of the Japanese society as a whole based on the shared foundation of knowledge of the government, the general public and the experts.

RIETI Discussion Paper Series 04-J-011
"Fiscal Discipline/Government Debt Management and Monetary Policy"
WATANABE Tsutomu

Just as the stock market functions as a disciplinary mechanism for corporate management and activities, the government bond market administers discipline to the government's fiscal management. This paper examines the mechanism of fiscal discipline through financial markets. The major findings of the study are as follows. First of all, there are two channels through which market discipline is provided – government bond prices and the value of national currency. When a country's fiscal condition deteriorates, the prices of government bonds issued by the country fall, while at the same time prices of goods go up and the value of the national currency goes down. These changes in prices put pressure on the government to restore fiscal health. Secondly, in order to give full play to such market discipline, active involvement by the central bank is indispensable. When the government's fiscal health continues to deteriorate, the central bank must send out a warning to the government by raising the target for nominal short-term rates, an instrumental variable of monetary policy. However, thirdly, market discipline has limitations which stem from being based on the principle of relative evaluation. The situation that has been continuing since the summer of 2000 – rising prices of government bonds, falling prices of goods, and the appreciation of the yen – can be interpreted as manifestations of such limitations.

RIETI Discussion Paper Series 04-J-012
"Tax Reform from the Perspective of Economic Revitalization"
SAKATA Ichiro

Given the presence of long-term budgetary constraints and the need to reconstruct the social security system, increases in tax and social security burdens are inevitable. There are concerns that increased burdens on the general public and companies may undermine the dynamism of the economy. However, without maintaining economic vitality, an increase in tax revenue – a prerequisite for the restoration of fiscal discipline – cannot be realized. Therefore, a tax reform for enhancing economic vitality must be implemented before increasing burdens. By focusing on corporate tax reform, this paper first of all shows that reform needs are changing from those reflecting the peculiarities of specific sectors to those of a cross-sectoral nature, which is accompanied by a major transformation in the decision-making process of the tax system. Based on this observation, the paper then calls for the introduction of new reform philosophies. Specifically, it recommends that two domains – "reform of tax system infrastructure" and "national strategy for inducing investment through the use of tax incentives" – be defined and established, that a notion called responsiveness to changes be introduced as a new guiding philosophy, and that the existing philosophies be clarified respectively and reorganized. The paper also discusses an ideal process for tax reform that suits the new philosophies. Finally, the paper presents concrete challenges that need to be addressed within the following three years with regard to each reform philosophy. For instance, it cites the need to drastically change the classification of business units and the implementation of institutional reform by taking a bird's eye view of the three key areas, namely, tax, accounting and the Commercial Code.

RIETI Discussion Paper Series 04-J-013
"The Political Economy of Tax Reform"
KUNIEDA Shigeki

The greatest problem with Japan's tax reform to date is the government's failure to realize a net increase in tax revenue as is required based on the inter-temporal budget constraint equation. Still, for many years, the administrative fiscal authorities and the centralized decision-making mechanism for tax reform within the Liberal Democratic Party had somehow resisted the temptation of implementing the kind of fiscal measures that would not fit into the equation and thus leave excessive burden on the future generations, for instance, implementing income tax cuts without compensatory financial resources. Drastic political change and an economy in the doldrums in the 1990s, however, broke the mold and temptations were succumbed to, turning Japan into the country most exploitative of future generations.

This paper analyzes past tax system reform processes based on recent theoretical analysis of political economics as well as on the results of empirical studies. Furthermore, it discusses rules for tax system reform and the reform process (or an institutional organization for undertaking reform) that would enable extreme generational disparities to be corrected through adequate tax reform to fulfill requirements imposed by inter-temporal budget constraints. Regarding the so-called "Voodoo Economics" that have been used to justify fiscal policies outside the budget constraints equation, the paper analyzes why such voodoo policy proposals influence actual fiscal policies. As to the generational disparities seen today, the paper calls for the establishment of a basic law to ensure generational equality by correcting the existing disparities that are so extreme that they could almost be described as "generational exploitation."

RIETI Discussion Paper Series 04-J-014
"Fiscal Rules/Targets and Budget Management Reform"
TANAKA Hideaki

During the 1990s, there was a striking difference between Japan and other major members of the Organisation for Economic Co-operation and Development in the planning, implementation and results of fiscal policies. Major OECD countries, other than Japan, implemented various measures to reform budget management including the introduction of fiscal rules and targets, consequently turning the fiscal balance into a surplus. From 2000 onward, however, some of these have countries maintained a surplus while others are once again suffering from the expansion of deficits. Such a difference cannot be explained entirely by economic conditions – budget management is relevant here. This paper derives lessons on fiscal rules and targets from the experiences of other OECD countries, including Britain, France, Germany, Sweden, the Netherlands, Australia, New Zealand and the United States.

Japan, too, made some attempts at fiscal reform in the 1990s, for example introducing the Fiscal Structural Reform Law. And the country continues to make reform efforts today, but not in a way that reflects on thorough examination of past failures. The greatest problem facing Japan, with regard to its fiscal management, is the lack of a framework for budget control, specifically, one that can predict and review the macroeconomic impact of fiscal policy measures and then reflect these results when formulating future budgets. To overcome the challenges poised by the rapidly aging population, it is imperative to restore government governance by reforming budget management. The key to achieving that end is the centralization of the political decision-making system and the introduction of a multi-year budget system.

RIETI Discussion Paper Series 04-J-015
"Fiscal Reform from the Perspective of Social System Design"
YOKOYAMA Yoshinori

It is fully understood that Japan needs fiscal reform. Despite this, however, no proactive actions to implement reform measures have been seen. Fiscal reform boils down to increasing revenue and cutting expenditures. But no one wants to face the pain this involves, hence the ongoing procrastination. A strategy is needed that can break this impasse and take specific action now. High goals must be set by focusing on "structural changes" and implementing measures through "social system design" to bridge the gap between present conditions and the goal. Specifically, regarding revenue, a "social system" could be introduced to increase the extent to which income is captured for taxation, systematic constraints preventing "structural changes" in the fields of health and medicine could be eliminated, asset management introduced, tourism utilized and a system designed to raise the consumption tax rate in a way that can benefit corporations, consumers and the government. Meanwhile, on the expenditure side, cross-sectoral measures – in contrast to the vertically compartmentalized administrative system and its idiosyncratic budget-grabbing game as seen today – should be implemented by focusing on the social system, thereby enabling the evaluation of policy measures in terms of their cost-benefit performance from the point of view of consumers. To achieve this end, bureaucrats in their 40s should be trained to mastermind operations and placed in the Cabinet Office.

RIETI Discussion Paper Series 04-J-016
"The Central and Local Governments: Redesigning Intergovernmental Fiscal Relations"
DOI Takero

On the basis of the government's "trinity" decentralization reform mapped out in June 2003, this paper clarifies the problems surrounding the current local public finance system and discusses concrete procedures for implementing decentralization and redesigning the fiscal relationships between the central and local governments. Drawbacks that the trinity reform may have are referred to. With regard to the transfer of tax sources from the central government to local governments, a step proposed under the government's scheme, the paper acknowledges that such a reinforcement of local taxes is needed to realize decentralization. At the same time, however, the paper calls for the (substantive) transfer of taxation authority and provides specific taxation items suitable for such transfer, noting that simply transferring tax resources is not enough to achieve its intended goal. Also, the paper discusses the reform of the local bond system, pointing out that the current system hardly makes local governments conscious of being lenders, thus effectively fomenting lax fiscal management. In addition, the paper refers to the need for legislation on local government bankruptcies. Furthermore, it discusses the reform of the local allocation tax system with regard to problems stemming from the mutually complementary relationships within the local bond system. Finally, the paper sets out concrete reform procedures necessary to promote decentralization in the future.

RIETI Discussion Paper Series 04-J-017
"Redesigning the Fiscal Structure of Local Governments: From the Point of View of Local Governance Reform"

KITAMI Tomitaro

This paper analyzes the major role played by local governments in relation to Japan's fiscal problems, based on the theoretical framework of corporate governance, while proposing a set of policy responses to facilitate local governments' shift over to a desirable model of governance. The first section of this paper explains the significance of utilizing corporate governance theory and its theoretical framework thereof. The second section empirically examines the effectiveness of having a governance mechanism for local governments by means of individual stakeholder monitoring, making distinctions between governance under ordinary conditions and that under cases of emergency. In the third section, the paper examines an ideal governance model for Japanese local governments and lays out a road map and strategic policy measures to be taken in adopting it.

RIETI Discussion Paper Series 04-J-018
"Simulation Analysis of Fiscal Crisis"
KAINOU Kazunari

Should the Japanese government's behavior with regard to fiscal management remain unchanged from that in the 1990s, what problems would the country face? And what policy changes need to be implemented to realize sustainable fiscal management? To find answers to these questions, an econometric model has been established to conduct numerical simulations. The actual results of the government's revenue, expenditures, outstanding balance of public debts, and reserve funds were first sorted out by institution – the central government, prefectural governments, municipal governments, and public pension programs. Assumed values concerning the macroeconomy, such as a real economic growth rate, were then used to analyze the structure of each of these institutions.

As a result, it was found that Japan's fiscal reconstruction cannot occur "naturally through economic recovery." More specifically, should Japan fail to correct its fiscal behavior, as developed in the 1990s, the primary balance would not improve even if high economic growth was maintained, and a recursive increase in the amount of outstanding government bonds would induce serious crowding-out effects. Furthermore, results of the analysis show that a decrease in economic growth would lead to further deterioration in the primary balance of the central and prefectural governments, while at the same time brining the nation's public pension program to a dead end.

Results show that in order to ensure sustainable fiscal management, the central government must implement revenue-restoration measures, such as raising the consumption tax rate, and relinquish policy that seeks to stimulate the economy by means of public works projects. The prefectural and municipal governments, for their part, are urged to take steps to reduce expenditures in return for the transfer of financial resources from the central government. With regard to the public pension program, results of the analysis point to the need to further curb the amount of pension benefits, rationalize the relevant administrative procedures, and make adequate changes to the pension system by, for instance, shifting the program governing the portion of basic pension from the current premium system to one funded by tax revenue. It was noted that the central, prefectural and municipal governments must act promptly to implement effective fiscal reconstruction measures.

RIETI Discussion Paper Series 04-J-019
"Stock Analysis of Fiscal Problems: Focusing on Burdens Brought to Future Generations"
TAKAHASHI Yoichi

Analysis of potential multiyear effects is often important when deciding upon government policy and this is the case with policy decisions concerning the public pension program and public works investments. In order to enable such long-term analysis, this paper offers methods for presenting stock data on fiscal conditions including future subsidies in a balance-sheet format and applies it to Japan's two pressing problems: those concerning the public pension program and public highway corporations.

With regard to the public pension program, the currently proposed changes to the pension program would introduce the so-called "macro slide" system, under which the value of pension benefits would be adjusted in line with macroeconomic parameters such as the gross wage amount and working population of the time, should the burden of pension premiums exceed the designated level. As a result, the sustainability of the program would be improved to some extent, reducing the amount of pension deficits from some ¥800 trillion to about ¥600 trillion. It is meaningless to discuss the manner in which pension fund contributions are collected, that is, whether they are taken in the form of premiums or tax. Instead, the Social Insurance Agency and the taxation authority should be integrated. Also, it must be remembered that the sustainability of Japan's public pension program – albeit improved under the proposed revisions – remains far from secure; the ratio of pension benefits to gross domestic product is as high as 1.2%, compared to 0.4% in the United States.

The four major public highway corporations are not in a state of capital deficit. The combined amount of assets for the four corporations exceeds that of liabilities by ¥3 – ¥5 trillion. Therefore, these four public corporations can be privatized with no burden placed on taxpayers. The huge scale of liabilities held by these companies is often cited as a problem but they do have assets of an equivalent size on the other side of their balance sheets. Therefore, it is not appropriate to hurriedly try to reduce the liabilities alone. The problem with Japanese highways is their expensive toll fees and thus the purpose of privatization should be to reduce these fees.