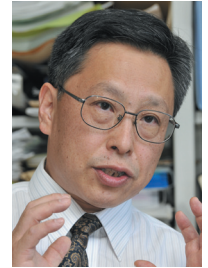


Japan's Budget Deficit: Product of Japanese-style Democracy & Governance Structure

By Naoto NONAKA



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Accumulation of Fiscal Deficit in Japan

Looking at the fiscal deficit of Japan, in terms of numerical comparison, we see a much worse situation in Japan than in any "marginal" country in Europe. According to Japan's Finance Ministry, Japan's accumulated debt to GDP is around 210% and has almost reached 1,000 trillion yen (approximately 15 trillion dollars), which is the same situation as at the end of World War II. (Charts 1 & 2)

Why and how has such a catastrophic situation come into being?

From the political aspect, we can point out two factors as the main culprits for this misery.

The first is a political decision-making style that has been developed over a long time in the period of Liberal Democratic Party (LDP)-rule politics, characterized as a bottom-up procedure and prioritizing specific sectoral interests represented by politicians' special-interest groups.

The second is a decision-making system that makes it difficult to create a final decision, which can be considered a fatal fallacy of the governing system.

Political Style During Long-lasting LDP Rule

The LDP long-run rule started in 1955 and, though it was interrupted once in 1993-94, continued until 2009 after the LDP's return to power in 1994.

As a result of the domestic political ideological confrontation being put on hold under the international cold war regime, the LDP, founded by a

coalition among the conservative parties, could rule over a long period as the permanent party in power. A stable administration through cooperation with bureaucrats and high economic growth supported the LDP in power.

During its long-run rule, the LDP built up its distinct system of governance.

I call this the LDP system. Under this system, by using increasing fiscal resources in accordance with economic growth and providing services through its supporting organizations and groups or industries, the LDP was eventually successful in creating a network of LDP supporters all over Japan. The severe and vitalized competition among the different LDP factions in the mid-sized electorates and also among the LDP candidates in each electorate had been integrated with such a network and the system of the network being in alliance with a bottom-up policy decision-making process through the party's policy-planning organizations was established.

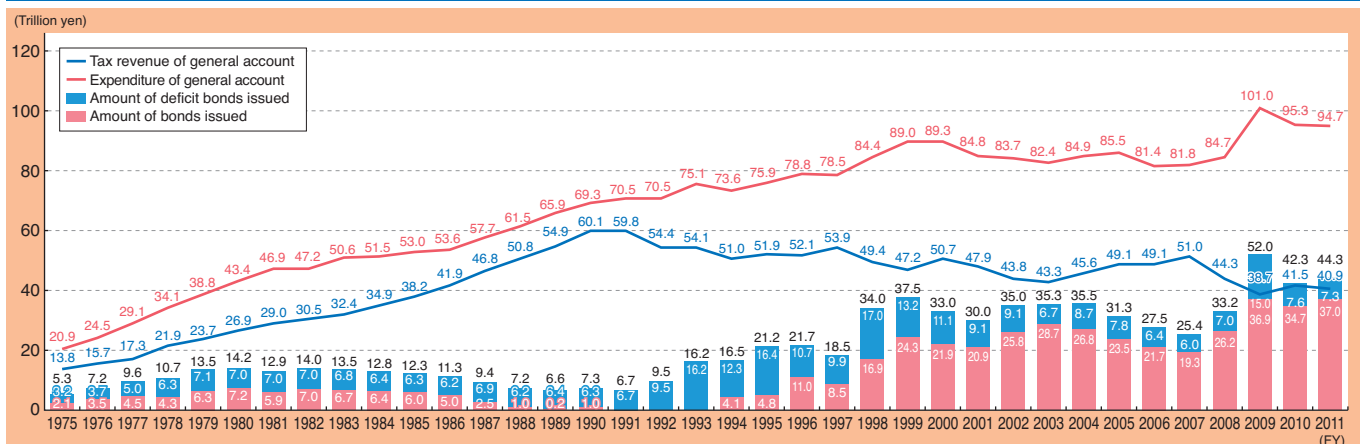
This system has brought us sometimes a corruption of politics and, more seriously, a failure of the administration to govern over the process of integration of policies. Then, it failed to run appropriate governance over public finance, since an interest group of politicians with strong specific interests in their respective electorate had the right to veto a policy decision in the party's policy-making process, and thus the policy-making process within the party ended up in only keeping or building measures without scrapping any of the old ones.

However, until the 1980s some politicians had enough courage to pay the inevitable cost to maintain the party in power, though it was painful for them. The introduction of the general consumption tax in 1989 was its outcome.

CHART 1

Balance sheet of general account budget

Japan's public finance continues to be in deficit (expenditure exceeding revenue). In recent years, the difference between expenditure and revenue has been on a decreasing trend, thanks to business recovery and fiscal rationalization efforts. However, after FY2008, it has been expanding due to the tax revenue decline caused by the recession. In particular, after FY 2009, revenue from public bonds has been exceeding tax revenue.



Notes: 1. Until FY2010, the figures used are those at the settlement of accounts. The figures for FY2011 are based on the supplementary budget.

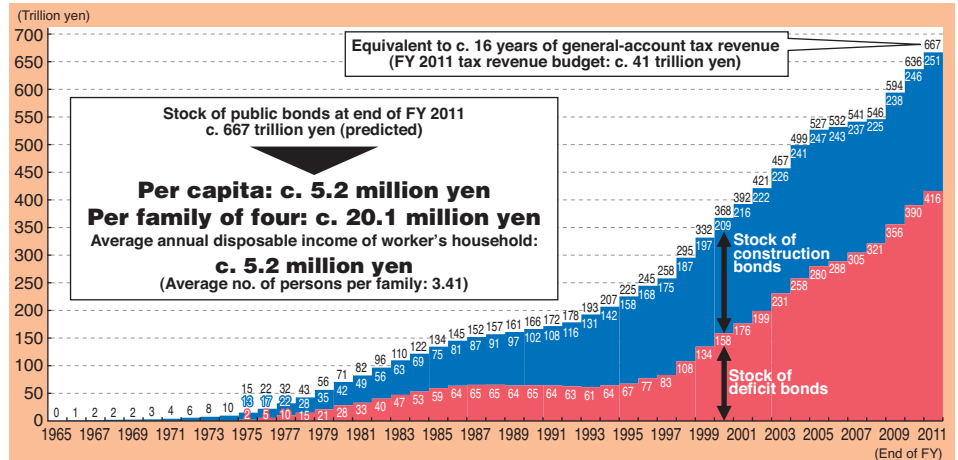
2. "Other revenues" are public-sector revenue and other miscellaneous revenue.

Source: Ministry of Finance Japan

CHART 2

Cumulated stock of public bonds

Japan's stock of public bonds has continued to increase year by year and is predicted to reach 667 trillion yen at the end of FY 2011, which corresponds to about 16 years' tax revenue and will eventually leave a heavy burden for future generations.



Notes: 1. Stock of public bonds at end of each financial year. The figure for the end of FY 2010 is a prediction and that for FY 2011 is a prediction after taking the supplementary budget into account.

2. The stock of deficit bonds includes the long-term debt of Japan National Railways, among others.

Source: Ministry of Finance Japan

Entering the 1990s, the situation got even worse. The LDP once left the governing administration and, even after its return to power, the governance within the LDP gradually became ineffective. The majority faction then lost the leadership and under strong pressure to change the party in charge of the administration, the seniority order that functioned as a rule during the ruling period in the party got lost. The governance structure in the party that enabled LDP's responsible policy administration had been rapidly collapsing. Former Prime Minister Koizumi's government finalized such a collapse and then the three prime ministers following Koizumi emerged at the final stage of this conventional LDP political game.

In other words, the LDP political governing system was originally of a high-cost nature that would need a great amount of budget expenditure and, in addition, the feasibility of a change in power and the collapse of governance within the LDP made it worse.

I would now like to point out another issue in regard to the Japanese Constitutional governing system that emerged in front then.

Constitution & Resulting Governing System

The LDP administration had been doing well and was successful in achieving stable economic performance for Japan during the more than 50 years when it was in power. Therefore, as some scholars and politicians argue, the constitutional governing system is not to be blamed for any possible shortcomings. However, I would like to point out that this good performance was made possible only by the extremely exceptional competitiveness of the LDP in the national election.

The LDP had been successful almost permanently in maintaining a majority since 1955 in both houses, the House of Representatives and the House of Councilors. There should not be many words necessary to tell readers how difficult and unusual it is for a single party to maintain a majority for such a long period among democratic nations where a liberalized election process is established.

As a result of the LDP's majority continuing to be kept in both houses, a fundamental defect that the Japanese Constitution and its governing institution since 1947 originally had might have been concealed. And then, after the collapse of the LDP ruling system in the 1990s, a variety of issues hidden in the original institution itself might have come out.

Two-house System in Japanese Diet: Strong Power Kept by House of Councilors

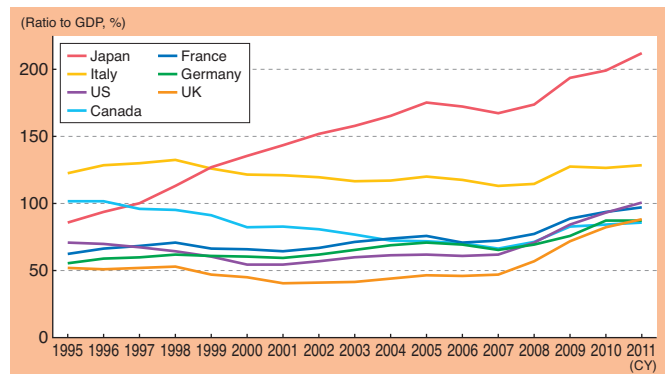
Among the issues mentioned above, the most important one concerns the two-house system in the Japanese Diet. The two-house system itself is not anything special, but depending on the roles shared between the houses and the ways of dealing with a possible confrontation between the two, there could be a wide range of different styles, and these differences could strongly influence the nature of the governing system.

In Japan, the House of Representatives is considered superior to the House of Councilors. The Constitution defines the issues of superiority

CHART 3

Ratio of debt stock to GDP in major countries

Japan is the worst among the major countries in terms of the ratio of debt stock to GDP, after rapidly worsening in the second half of the 1990s, in comparison with the other major countries engaged in the steady progress of rationalization.



Note: All figures are based on general government (comprising central government, local government, and social security fund) data.

Source: Ministry of Finance Japan

to be given to the House of Representatives, such as the nomination of the prime minister, adoption of the budget, and ratification of treaties. In the case of adoption of law draft proposals, even if the House of Councilors rejects what the House of Representatives has adopted, the House of Representatives can overrule the decision of the House of Councilors by a two-thirds majority. Therefore, it is certainly true that the House of Representatives is a primary body of the Diet and superior to the other house.

However, the critical issue is how much of a superior position is to be given to the House of Representatives. In the case of Japan, the superiority of the House of Representatives over the House of Councilors is limited and it is to be noted that the House of Councilors keeps strong power. In particular, on the question of public finance, its substantive influence is extremely strong, considering the Japanese political background.

First of all, in Japan law drafts are adopted as laws only if they are approved by both houses. As mentioned above, it is officially possible for the House of Representatives to overrule a decision made by the House of Councilors by a two-thirds majority. However, in real politics, it is extremely unusual for a single party in power to keep more than a two-thirds majority.

In short, in the normal political situation, the House of Councilors is almost endowed with the right of veto against any law draft proposal. There is also a reconciliation process existing for reaching a compromise between the two houses in the case of confrontation between them, which is called in Japan a joint conference of the two houses. However, it does not seem to be working well.

Fiscal Rules & Constraints

Fiscal rules and constraints in Japan also strengthen the substantive power of the House of Councilors. According to Japan's fiscal rules, what we call ordinary expenditure, excluding expenditure for public operations and investment, is not to be financed by public bonds (government borrowing) (Public Finance Act, Article 4). For example, in the budget of FY2011, the total budget expenditure is about 92 trillion yen, and the tax revenue predicted by existing tax laws is around 41 trillion yen, while other revenues reach about 7 trillion yen. Thus we need 44 trillion yen to be borrowed by public bonds from the public. Six trillion yen of this 44 trillion yen borrowing is to be considered part of construction bonds assigned for public operation expenditure. However, the rest of the borrowing, corresponding to 38 trillion yen, is considered part of deficit bonds and it is obligatory for the government to draft a special law to justify this exceptional issuance of public bonds.

The House of Councilors, in this context, could enact an extraordinary influence upon such a decision, because the adoption of this special law would need a consensus of the two houses, as in the case of other laws. In other words, as we saw above, unless the party in power keeps a two-thirds majority in the House of Representatives, the House of Councilors would have the right of veto. They could prevent the enforcement of almost half of the government expenditure. The implication of this is enormous for the administration. They can force the prime minister to quit.

Though the Constitution advocates the superiority of the House of Representatives in the adoption of a budget, assuming such a structural defect in the fiscal resources for its implementation, the power of the House of Councilors would be extremely strong. In addition, its influence would also affect the adoption of other laws or amendments that may become necessary for implementation of the budget, since the House of Councilors could veto the adoption of any law or amendment necessary for implementation of the budget.

Parliamentary System Favors Opposition Parties

There is a big question emerging. If such a serious issue of the government deficit is brought about by a structural shortage of tax revenue caused by an insufficient tax law, why has this been left untouched?

It would have been possible to avoid the above serious difficulty concerning the Public Finance Act by raising the consumption tax to around 20%, just like in Europe.

We can explain the reason as follows, by a fixed political system during the LDP era, and the following political movements including the transition to the coalition politics in the 1990s.

During the LDP era, since the relation between the party in power and the opposition parties was fixed, paradoxically, institutionalized practices in favor of the opposition parties got established in the Diet. Implicit institutions or customs for favoring the resistance of the opposition parties had been built up in the Diet.

Though it was possible for the party in power to enforce a piece of legislation firmly even if the opposition parties strongly opposed it, they

had to accept a concession, since the political cost of enforcement would be extremely large due to the possible increased criticism against them for coercing the opposition party to accept their policy, and the possible decline in public support for them. This is the essence of the political game during the LDP era. And this favorable treatment for the opposition parties was in exchange for the LDP being permanently in power and ruling over most of the major policies, including the allocation of fiscal resources. This implies that the opposition parties kept a strong influence in the Diet, which made it difficult to achieve any legislation for the LDP government during their rule.

What Has Change in Power Brought to Diet?

However, this balance with a fixed relation between the party in power and the opposition parties has been collapsing rapidly since 1990. The LDP lost its status as the party in power in 1993 after a serious internal conflict that ended up in a division of the party, and also, since 1989, when the LDP was badly defeated in the election of the House of Councilors, it has been unable to maintain a majority on its own in the House of Councilors. Then, even after coming back to power in 1994, the LDP needed a coalition with some other parties to keep its ruling administration. A compromise with its partners in the coalition government has become essential and, while a change of power has become feasible under the newly introduced electoral system comprising single-seat constituencies and proportionally represented multiple-seat constituencies, politicians in general increasingly tended to look at the policy issues only to win elections, rather than in the long-term perspective of social welfare and national interest. On the other hand, the rules of the game in favor of the opposition parties that had developed during the LDP era remained almost as before. Thus, a tax increase policy asking the nation to take on a greater burden has been avoided under these political circumstances. This is the fundamental background in which any earnest tax reform plan has been postponed.

Political Style & Governing System that Complicate Deciding & Implementing Policy Direction

A democratic government built upon the majority of the House of Representatives should make a policy decision and implement it. However, this is not the case in Japan.

The abovementioned political and institutional reality does seem to make people's adoption of a policy and an administration very ambiguous.

On average we have an election every three years for each house, without any pre-fixed coordination of timing among them, while the election of the party president for both the Democratic Party of Japan (DPJ) and the LDP takes place more often. So, in addition to the lack of a system for smooth decision-making and implementation of any policy, due to this extreme frequency of elections, the administration does not have enough time for making a policy decision and implementing it as they advocated in their manifesto. The situation is even worse under the circumstances in which they are exposed to strong pressure for a change in power. Any earnest policy decision would be difficult to make and unpopular policies like a tax increase or a tight fiscal policy must be postponed.

In general, it is true that a democracy tends to create a budget deficit. In Japan, in addition, our political customs and institutional problems could be considered the culprit for bringing about an enormous amount of government debt. **JS**

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