

# Public Finance & Democracy: Does Populism Pave the Road to Political Crisis?



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### Fiscal Democracy & Populism

Citizens won the “rule of law and “fiscal democracy” through the modern civil revolution. And fiscal democracy meant that citizens, not monarchs or nobles, would determine how they would be taxed and how the revenue would be used.

The United States, the United Kingdom, and France pioneered the modern civil revolution, but they are now in the throes of populism. Skepticism about democracy is spreading worldwide. Most fundamental in all of this is skepticism about the ability of the majority to make sound judgments. Is the voter capable of selecting appropriate policies? Won't democracy inevitably lead to populism and the inevitable demise of democracy itself?

In our recent book, whose title could be rendered in English as “Fiscal Policy and Democracy — Would Populism Be a Path Towards a Debt Crisis?” (ed. Sota Kato and Keiichiro Kobayashi, Nikkei Publishing Inc., 2017), we face these issues squarely, focusing on how democracy functions with regard to public finance.

Much of the recent debate around populism focuses on the backlash against immigration and other elements of anti-globalization. There, the rule of law has come under scrutiny as the human rights of immigrants are threatened. But populism is also spreading around fiscal democracy, the other outcome of the civil revolution from which citizens emerged victorious. Symbolic of this trend is the challenge from an ever-growing public debt that afflicts so many industrialized democracies. As this decade dawned, Italy and Greece, two countries in deepening fiscal crises, saw the birth of cabinets consisting solely of technocrats, sidelining politicians. They symbolize an emerging state of affairs that could be called a partial abandonment of “fiscal democracy”.

In our book, we take up Japan, where public finance is in particularly dire straits, to answer the question: Can democracy uphold fiscal discipline?

Japan's public debt per GDP has been growing consistently since the 1990s, reaching a level higher than those of Greece or Italy. Of course, the authorities and academics have not just stood by and idly watched this happen. Many simulations have been conducted

regarding the size of the tax revenues and/or expenditure cuts that would be needed to close the fiscal gap, leading to many policy proposals. We the co-authors also engaged in these simulations in the government and elsewhere.

The simulations come up with different numbers, but they all broadly point in the same direction: given Japan's low-birth rate, aging society that has no historical precedent, significant consumption tax hikes and spending cuts, a fundamental reform of the social security system in particular is necessary to close the fiscal gap.

These measures are not being taken; instead, the response has been to push back again and again. The biggest reason for this is that consumption tax hikes and expenditure cuts are unpopular, politically hard-to-achieve policies. What Japan today, and most likely many industrialized democracies, needs is more a political prescription than an economic one. In other words, the fiscal challenge is a matter of political science, not economics.

We, the authors worked in the government and the Bank of Japan on the nuts and bolts of economic policy before turning to academia. The experience made us realize that the prescription for the challenge from the burgeoning public debt cannot be effective unless the roles that politics and democracy play are taken into account. We remember the sense of powerlessness that we felt as politics proved to be an impenetrable wall against the best fiscal simulations that we could offer. Accordingly, our book focuses on analyzing the reasons why fiscal reconstitution does not pass the test of the democratic process from different perspectives in each chapter and explores the institutional makeup to avoid this happening.

### Political Factors that Push Up Expenditures

Since there is not enough space for an overview of the entire book, let me introduce some of the political factors and the means to deal with them that we took up throughout our book.

The most polemical and fundamental question is that voters may inherently favor fiscal profligacy, growing public expenditures. This is the skepticism about the ability of voters to make judgments that

I mentioned at the beginning. To state it more bluntly: “Are voters fools?”

Our book introduces the famous response from V. O. Key, a political scientist from the 1960s, that “Voters are not fools” and provides an overview of the results of past research. Our conclusion is that there are two sides to the voter, the rational and the irrational, and that the analysis of the question as well as the measures to be taken can be broadly divided into those that start with two different assumptions: the “rational voter” and the “irrational voter”.

If the point that the “irrational voter” invites growing public expenditures is emphasized, the response would take the form of constraints on the democratic involvement of this irrational voter. In other words, it is more likely to lean towards restricting or denying “fiscal democracy”. We show that the latest research in behavioral economics and political science has revealed that voters are in part inherently myopic. But since measures that place constraints on the democratic process are self-defeating for a democracy, we argue that analysis and measures predicated on the “rational voter” should be prioritized.

Thus, the main focus of our book is on matters predicated on the “rational voter”. If growing public expenditures is the rational choice of the “rational voter”, it should be possible to guide the voter towards closing the fiscal gap by providing incentives through appropriate designing of political institutions, since it is the voter who suffers the greatest harm when public finance breaks down as a result of the persistent growth of public expenditures.

The chapters take up “Information Asymmetry”, “Tragedy of the Commons”, “Collective Action” and other rational reasons why the rational voter prefers growing fiscal expenditures and provides specific proposals for systems to deal with them.

Among those varied factors that lead the rational voter to prefer growing finance, it is particularly difficult to find a fundamental solution for the so-called “silver democracy”. We have taken this up over two chapters to analyze the problem and propose solutions.

In a rapidly aging society with a low birth rate like Japan, the elderly are able to leverage their numerical superiority through the democratic process to force debt onto the shoulders of younger

generations. They can even bequeath the debts to those yet to be born.

As far as this problem is concerned, it is the logical conclusion derived by one of the co-authors that there is no systemic solution that makes a fundamental solution virtually possible in a democracy if we start with the assumption of a rational voter. What is required to resolve this problem is the irrational voter endowed with “intergenerational empathy” and “altruism”. The “cooperation between generations” that Edmund Burke, the conservative British philosopher, set forth requires the irrational voter.

When I entered a doctoral course in political science, I was taught that every major issue in politics had been thoroughly examined in Alexis de Tocqueville’s *Democracy in America*. In de Tocqueville’s day, the state did not have the capacity to borrow so much money that it would take generations if not forever to repay. That said, the dilemma that public finance and democracy poses today reminds us that de Tocqueville’s intermediate associations with their rich sense of community are necessary for democracy to function properly. Resolving the dilemma between public finance and democracy while sincerely dealing with the rational and irrational aspects of the voter is likely to lead to a fundamental response to the populism that is raging through the world today. **JS**

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