Reform of Japan's Fiscal Investment and Loan Program

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Introduction

The Fiscal Investment and Loan Program (FILP) has functioned as a policy tool to mitigate failures of long-term financial markets. Recently concern has emerged about the "political failures" of the program including whether the FILP has kept up with changes in the socio-economic situation and whether these programs have placed a burden on future generations. Reform of the FILP has begun, with a new system scheduled to go into effect from April 2001. Unfortunately, these reforms have confused the role of politics and the role of the market.

Under the new system the Ministry of Posts and Telecommunications and the Ministry of Health and Welfare will directly manage in the market the full amount of funds they collect through the postal savings and public pension systems. Such self-management of funds is quite normal and natural for private-sector firms, but there is a question whether it is appropriate to allow public funds that carry a government guarantee to be managed without political control. Under the new system with the ministries independently managing the funds they collect, government institutions financed by the Trust Fund Bureau through the FILP will need to find new sources of funds. Investors may be reluctant to purchase bonds issued by these government institutions (FILP institutions) because their government subsidies could be cut or they could be privatized at any time. These institutions will have to rely on government bonds, so-called 'FILP bonds', that would be issued by the Trust Fund Bureau under the control of the Diet.

The FILP reforms represent a new way of controlling for both market failure and political failure. Thus, they are a touchstone of the future market and political controls on public spending.

1. The Present System and the Need for Reform

In his annual budget message, the president of the United States called the U.S. Government the largest financial institution in the country because it operates the Federal Credit Program. At the end of 1998, the U.S. Federal Credit Program held 20.4 percent of the outstanding debt of the private non-financial sector. Similarly, the Japanese Government can be called the largest financial institution in Japan because it operates the Fiscal Investment and Loan Program (FILP). At the end of fiscal 1997 Japan's FILP held 23.5 percent of private non-financial debt outstanding, excluding the amount of postal savings and pension funds that are independently invested in the financial market.

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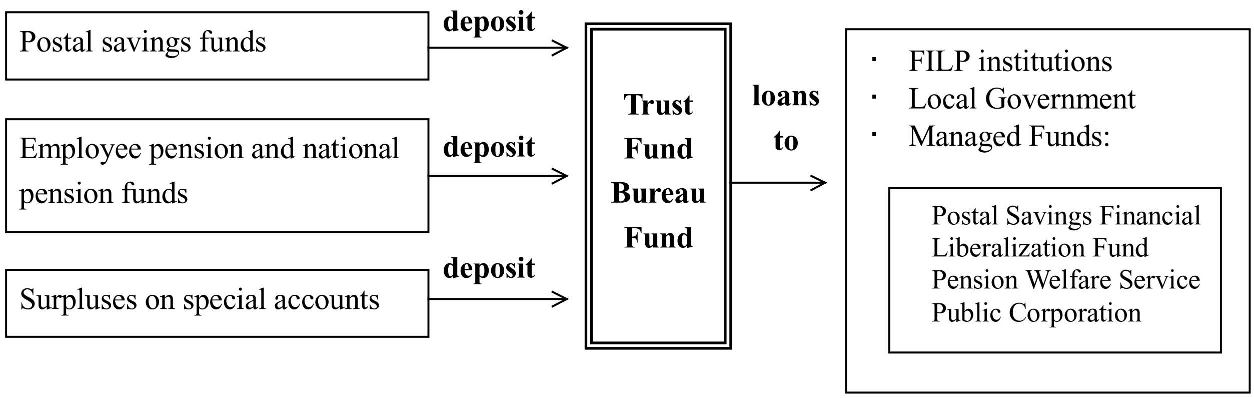
The FILP system can be described as follows. The FILP consists of four sources of public funds: the Trust Fund Bureau's funds, the Postal Life Insurance Fund, the Industrial Investment Special Account Fund, and government-guaranteed bonds. Among these four the Trust Fund Bureau Fund is the largest with deposits from postal savings, employee pension, and national pension funds and government special accounts surpluses. The exit of the Trust Fund Bureau Fund is comprised of loans to government institutions, such as the Government Housing Loan Corporation and the Highway Public Corporation. The core of the FILP is shown in Figure 1. The entrance and exit are bridged by the Trust Fund Bureau Fund, which is approved each fiscal year as the FILP.

Figure 1 Core of the FILP System



Note: In addition to the Trust Fund Bureau Fund, the financial resources of the FILP also include the Postal Life Insurance Fund, the Industrial Investment Special Account, and government-guaranteed bonds.
Source: "Summary of Discussions on the Fundamental Reform of the FILP," Sub-committee Study Group of the Trust Fund Council, August 30, 1999.

The mechanism of deposit and allocation of government funds originated in 1878 when postal savings were deposited with the Government Bond Bureau of the Ministry of Finance (MOF). The Law of the Trust Fund Bureau Fund, enacted in 1951 following World War II, provided for integrated fund management, which continues in effect today.

There are several arguments in favor of the integrated management of government funds.

First, combined with the budget process, integration of funds facilitates allocation in line with national policy objectives and macroeconomic policies.

Second, integrated management reduces costs compared to separate management by various government ministries and agencies.

Third, integration of funds creates a larger pool of funds and allows more efficient asset and liability management (ALM). This makes it easier to absorb interest-rate risk and makes it possible to provide funds for long-term social infrastructure investment.

Most major Western countries have implemented integrated management of postal savings, when it exists, and public pension reserves for these reasons. The system in Germany is somewhat different with local governments taking a stake in savings banks.

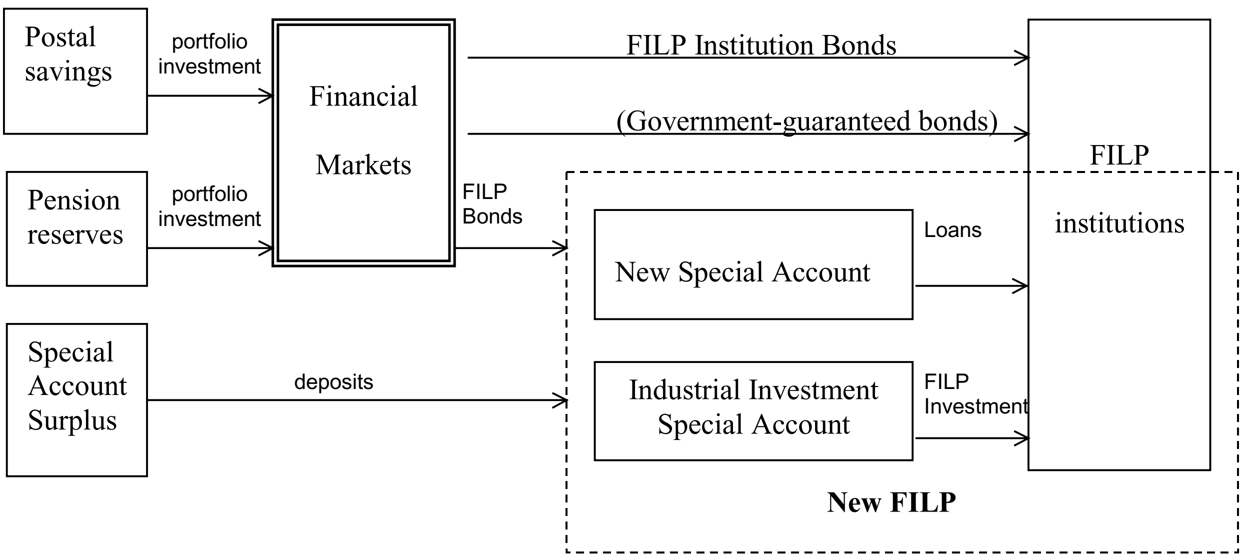
In Japan various groups over the last two decades have recommended continuing integrated fund management under the Trust Fund Bureau. These groups include the Ad Hoc Commission on Administrative Reform (final report March 1983), the Administrative Reform Council (report June 1986), the New Administrative Reform Council (final report April 1990), and the Third Administrative Reform Council (final report May 1993).

During Prime Minister Hashimoto's Cabinet (January 1996 to July 1998) it was pointed out repeatedly that integrated management may lead to excess lending to government institutions which may impose a larger burden on taxpayers in the future. Government institutions and politicians have developed a mentality of over-dependence on these FILP funds, which are collected automatically under the integrated fund management system. Indeed, the integrated management system may have helped preserve the inefficiency of FILP institutions. Thus, it is argued that integrated management has led to political, as opposed to market, failure and the opinion emerged that it is necessary to limit the financial resources of FLIP institutions to make the FILP system more efficient.

At the same time, the Ministry of Posts and Telecommunications (MOP) and the Ministry of Health and Welfare (MHW) were demanding that they should be allowed to manage the postal savings and public pension funds themselves rather than depositing them with the Trust Fund Bureau. Under pressure from these two arguments, the government adopted the Fundamental Law on the Reform of Government Ministries and Agencies, which came into effect on June 12, 1998. Article 20-2 of the law terminates the requirement to deposit postal savings and pension reserves with the Trust Find Bureau Fund, effectively ending the long-standing system of integrated fund management in April 2001.

The new FILP financing system subsequent to this law is depicted in Figure 2, although the exact details are not entirely clear. There are still no definite answers to the following fundamental questions. What form of political control will be placed on FILP institutions wholly owned by the government, and how will FILP institutions finance—by their own corporate bonds (similar to private corporate bonds), by government-guaranteed bonds, or by collective FILP bonds?

Figure 2 The FILP System after April 2001



Source: "Summary of Discussions on the Fundamental Reform of the FILP," Sub-committee Study Group of the Trust Fund Council, August 30, 1999.

What kind of FILP bonds will the Trust Fund Bureau issue and what controls will the national Diet exercise over new FILP bonds? What kind of control will be exercised over FILP plans and the self-management of the postal savings and pension reserve funds within the framework of a democratic society? These questions will have to be answered prior to April 2001 when postal savings and pension reserve funds are scheduled to be managed by the responsible ministry. FILP-related reform bills will be presented in the ordinary Diet session during 2000 and decisions will have to be made including specific rules on the management of these funds.

In FY00, the FILP will face another big problem. The financial resources of the Trust Fund Bureau Fund will decrease by ¥27.5 trillion due to a massive outflow of funds from postal savings as a large number of postal savings deposits come to maturity. If its financial resources determined the FILP's scale of lending, it would simply cut back significantly in FY00 to cope with this expected decrease in deposits. However, the outline budget for FY00 calls for ¥37.5 trillion in FILP loans, excluding fund management operations by the postal and welfare ministries (general FILP). This is only ¥1.9 trillion less than in FY99. How should the decline in deposits be dealt with without cutting back on lending?

This paper examines these problems based on three reports that strongly influenced the shape of the new FILP. These reports were issued by the Administrative Reform Council of Prime Minister Hashimoto, the LDP Administrative Reform Committee, and the Trust Fund Council prior to the adoption of the Fundamental Law on Reform of Government Ministries and Agencies.

Each of these three reports had its own specific emphasis. The Administrative Reform Council recommended terminating the requirement to deposit postal savings and pension reserves with the Trust Fund Bureau and starting to invest these funds in the market under a state-owned status. The LDP Administrative Reform Committee focused on the issuing of bonds by government institutions (so-called 'FILP institution bonds'), and the Trust Fund Council emphasized the introduction of cost analysis to examine lending to FILP institutions. The LDP Committee's plan for FILP institution bonds and the Trust Fund Council's proposals on cost analysis both had the same objective—to mitigate political failure by establishing discipline on government institutions. The LDP plan stressed discipline by the market through issuing bonds rather than by discipline by political examination. On the other hand, the Trust Fund Council proposed tightening discipline on government institutions by disclosing their future tax burden to the general public, in other words, through a political process or democratic means.

Since FILP is basically a measure to facilitate government intervention to make up for market failure in long-term financial markets, it should be controlled through the democratic process. However, democratic processes cannot completely prevent such political failures as inefficiency and the imposition of massive burdens on the general public. Thus, a major objective of FILP reform is to find ways to avoid such failures and prevent future occurrences. That is to say, FILP reform can be seen as a way of controlling for political, as well as market, failure. Thus, we can view the reform as a touchstone of the future when both political and market discipline prevail in Japan.

The next section examines the termination of the mandatory deposit of postal savings and pension reserves with the Trust Fund Bureau. The third section looks at the problems of

FILP institution bonds and FILP bonds. The fourth section looks at the implications of the coming maturation of a large volume of postal savings time deposits, an issue that will have to be dealt with before the FILP reforms. The fifth section looks at subsidy cost analysis as the key to the reform of FILP.

2. Terminating Mandatory Deposit of Postal Savings and Pension Reserves with the Trust Fund Bureau

(1) Problems with the Existing Mandatory Deposit System

Under the current FILP, public funds including postal savings, employee pensions, and national pension funds must be deposited with the Trust Fund Bureau Fund, which manages them by lending to government institutions and by investing in government bonds.

FILP reforms implemented in 1987 introduced the market rate into the determination of the deposit and lending rates of the Trust Fund Bureau (TFB). Instead of an explicit market mechanism, the entrance, intermediate stage, and exit of the FILP were linked to the interest rate on 10-year government bonds, which is determined in the market. Thus, the FILP system has been made subject to the discipline of the market as well as to political discipline through Diet deliberations. This system remains viable as long as the total cost of funds through postal savings is kept below the market rate on government bonds, an alternative fund-raising method used by the government.

Before the FILP system had to face the problem of the rising cost of procuring funds using postal savings, the linkage of FILP interest rates and the government bond interest rate was broken. The Ministry of Health and Welfare (MHW) argued that the nature pension funds is different from that of postal savings and demanded more independence in managing its pension reserves and a higher rate on its FILP deposits. In response, since the middle of the 1990s the interest rate on deposits with the TFB has been set 0.2% above the coupon rate on 10-year government bonds. Thus, the FILP interest rate that was supposed to be determined by a market mechanism reverted to being a policy-driven interest rate affected by opaque political decisions. If this state of affairs continues, the FILP institutions will face a rise in the cost of procuring funds, and the FILP will have ceased to perform its fundamental function of providing long-term funds at low interest rates.

If political intervention in the determination of FILP interest rates (a remnant of the controlled interest era) cannot be avoided, it may not be possible to maintain the current system. In the marketplace all participants are equal and interest rates do not differ based on the nature and objectives of the funds. Nevertheless, it is possible to find a market-based solution to the problem raised by the MHW without abolishing the mandatory deposit system and ending integrated management of employee and national pension reserves. If the MHW’s need is to be able to invest the pension funds for longer than the current seven-year Trust Fund Bureau deposit term, then the solution is to allow the interest paid on pension fund deposits to match the yield curve on a market-determined rate.

These inherent problems of the Trust Fund Bureau were not the main concern of the Administrative Reform Council or the LDP Administrative Reform Committee, however. Their proposals to abolish the mandatory deposit system and end the integrated management system grew out of quite different concerns.

(2) Administrative Reform Council Report: Investment Management by the Responsible Ministries

The Administrative Reform Council focused on the privatization of the postal system, which had been a symbol of the administrative reform movement. In its interim report, the Council called for both privatizing postal operations and abolishing the deposit system for postal savings. In its final report, however, the Council recommended nationalization rather than privatization of postal operations, but it continued to call for ending the deposit system for postal savings.

The Administrative Reform Council's interim report submitted on September 3, 1997 made five proposals regarding the national postal system:

- Postal life insurance operations should be privatized.
- Postal savings should begin putting in place the requisite conditions for a rapid transformation to privatization.
- The system of mandatory deposits with the Trust Fund Bureau should be abolished.
- Postal mail service should remain a state-run operation.
- State-run operation should be under an external agency of the Ministry of Post and Telecommunications and its operating surplus should be paid into the treasury.

In contrast, in its final report submitted on December 3, 1997 the Administrative Reform Council, called for a new Postal Operations Agency to integrate the three main services of the Ministry of Post and Telecommunications as an external agency of the Management and Coordination Agency. In five years, the Postal Operations Agency would be transformed into a public corporation, which would be self-supporting and it would operate autonomously and flexibly.

The corporation would be exempt from the limitation on the total number of officers under the Law for the Total Number of Civil Servants. However, its staff would have the status of government employees (public servants) as a special exception under the law regulating the establishment of new public corporations. The final report called for further studies to determine the desirability of requiring the corporation to pay any operating surplus funds to the Treasury. At the same time it proposed abolishing the requirement to deposit funds in the Trust Fund Bureau and giving the Postal Ministry full control over the management of its huge assets.

The passage of the final report relating to FILP reform stated:

> The major administrative functions of the new Ministry of the Treasury [Ministry of Finance (MOF)] will continue to include FILP along with the budget, taxation system and the national treasury. However, fundamental reforms will be made in FILP functions and policies including *abolition of deposit of postal savings* etc. in the Trust Fund Bureau. In addition, fund procurement of FILP will be in line with market mechanisms and a mechanism will be devised that is suitable for the new functions while taking into account the loans already made to FILP institutions.

The thinking behind the recommendations in the Administrative Reform Council's interim report had been that privatization of postal operations would entail abolition of the Trust Fund

Bureau deposit system. In the final report, however, the Council recommended that the mandatory deposit system be abolished while postal operations retained their nationalized status. Public discussion of the interim report focused on the whether or not postal operations should be privatized and did pay much attention to the postal savings deposit issue. State-operation with a mandatory deposit system versus privatization with self-management of funds did not emerge as dichotomy. Thus, the Council's final recommendation was for a state-operated postal corporation without mandatory deposit of postal savings.

(3) The LDP Proposal: Issuing FILP Institution Bonds

The LDP Administrative Reform Committee focused its attention on two areas: the FILP's role to support private enterprise projects and supplement areas that receive insufficient market funding and the tendency for the program to swell to massive proportions. The main objective of the Committee's FILP reform report published on November 21, 1997 was to cut in half the amount of FILP lending outstanding in ten years compared to the amount projected had reforms not been made. To achieve this objective, the report proposed reforming the fundraising methods of FILP institutions by having each FILP institution issue its own bonds. Thus, the LDP Committee appears to have concluded that it was necessary to abolish the mandatory deposit of postal savings and public pension funds in the Trust Fund Bureau and to adopt a system of ministry control of portfolio management.

The LDP Committee report recommended abolishing all mandatory deposits in the Trust Fund Bureau, including pension reserves as well as postal savings. The idea was to start self-management of new funds as they accumulated, although funds already deposited with the Trust Fund Bureau would be left in place until maturity. Thus, the report recommended that self-management of postal savings, postal life insurance, and public pension funds start around April 2001 after implementation of the Financial Big Bang that was advocated by Hashimoto's Cabinet in 1996.

In view of the fact that these are public funds and amount to a vast sum, the report stressed the need to devise a safe and secure fund management system that does not generate losses. The fund management system must be embodied in rules and these rules must be strictly adhered to. The LDP plan allowed an exception to the self-management of funds in the case of local governments. In addition to calling for individual FILP institutions to issue government agency bonds, the LDP called for the Trust Fund Bureau to raise funds in the market by issuing FILP bonds. Moreover, it recommended adopting the market rate on government bonds as the standard for determining the interest rate on loans and abolishing the practice of giving FILP institutions a mark-up over market interest rates. Consequently, direct loans from the postal savings system to local governments would be the only exception to the new FILP system based on market mechanisms.

Despite having proposed in November 1997 to halve the scale of the FILP, the LDP soon expanded the loan framework for state-run financial institutions by ¥23 trillion in order to ease the credit crisis facing the corporate sector. The measures to ease the credit crunch were expanded to include not only loan guarantees for medium-sized companies, but also major corporations direct loans to major corporations from the Japan Development Bank and Hokkaido-Tohoku Development Finance Corp. In addition, the Japan-Development Bank took over some syndicated loans that the private sector had intended to undertake.

(4) Trust Fund Council Report: Abolishing Mandatory Deposits too Risky

The report of the Trust Fund Council, published on November 27, 1997, warned against abolishing the mandatory deposit system and stressed the importance of safe and secure management of public funds.

The report pointed out a fundamental problem involved with the independent management of funds that are collected through government agencies and based on the government's credibility. The problem is the inconsistency between self-management of the funds and the responsibility of the government to guarantee public-sector funds. Even if the responsibility for management of the funds is clearly defined, in some way or another, the government will have to take responsibility as long as the manager is a public-sector entity. Indeed, the Pension Welfare Service Public Corporation, which already manages a portion of public pension funds, has posted a massive loss in its fund management operations.

The Trust Fund Council's comments on self-management are detailed in the following six points.

1) Regardless of who underwrites the risk of fund management in whatever form and regardless of who takes responsibility for the results of fund management operations, it is necessary to clarify the inherent problems. The public will not approve of any mechanism that maintains a status of special government accounts that may bring a loss to taxpayers by undertaking fund management independent from the Diet.
2) In order to ensure the sound management of postal savings and pension funds, the fundamental elements must be the safety and reliability of operations. To this end, some limitations should be imposed on the portfolio in which funds are managed.
3) In order to ensure safe and reliable management of public funds, it is essential to place risk-management safeguards on fund managers. Asset-Liability Management (ALM) and a mechanism to check the results of fund management operations are vital. So far, the interest paid on loans by the Trust Fund Bureau has served as such a check. Under the present partial self-management system, the Financial Liberalization Fund of the Postal Savings Special Account and the Pension Welfare Public Corporation borrow money from the TFB at 0.2% plus the rate on 10-year government bonds.[2] When the mandatory deposit system is abolished and they start to invest their funds in the market without considering the opportunity cost, a new system must be put in place to monitor their investment results. Thus, the responsibilities of the officers of the relevant ministries and agencies to control and manage the funds must be clearly defined. The same is true for the fund managers in the private-sector institutions that contract to manage part of these funds, in order to ensure that they exercise due care.
4) It is necessary to ensure that the management of public funds cannot adversely affect private-sector financial markets. It is also necessary to restrain the management of public funds from adversely affecting ongoing market reforms in the financial system.
5) When postal savings and public pension funds are invested in FILP institutions, the investment conditions must be absolutely the same as those in the financial market and a transparent system of market checks must be created.

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2 In 1987 the FILP started a Portfolio Investment Program which allows institutions to manage in financial markets funds they have borrowed from the FILP. Under the Financial Liberalization Fund of the Postal Savings Special Account and the Pension Welfare Service Public Corporation some portion of postal savings and pension funds are managed directly by the respective ministry to generate financial returns.

6) Fund management independent of Diet control must be subject to checks and controls through budgets and other means.

(5) Risks of Independent Fund Management

Before deciding to end the mandatory deposit system and allow the ministries to manage pension and postal savings funds, all of the implications and risks of this decision should be clearly spelled out and carefully weighed. The Public Pension Fund Management Study Group, a private advisory body to the Ministry of Health and Welfare, met on five occasions since April 21, 1997. In a report submitted on September 1, 1997 the study group recommended: "The system of mandatory deposit of pension reserves in the Trust Fund Bureau should be abolished, and a right and proper system should be created for management of pension reserve funds by the Ministry of Health and Welfare, which has the right and responsibility for overall management of the pension system as the custodian of these funds."

Unlike management by the Trust Fund Bureau, management of pension reserves by the ministries involves major credit and interest rate risks. Who should accept responsibility if equity investments perform more poorly than alternative bond investments? Should it be the people who currently pay pension contributions or should it be the future generations who cannot yet participate in this political decision? Using assets accumulated through employee and national pension contributions to invest in stocks raises many issues. For example, such investments might generate benefits for the general public by giving people the opportunity to invest in equities while widely dispersing the risk. However, this would force others who do not want to take on such risk into doing so.

Independently managed pension funds may yield higher returns through equity investments, but there is also greater risk. In order to cope with these problems, it is necessary to establish an ALM system for pension fund management. Double-entry bookkeeping must be introduced in the budget documents of the employee pension reserves. In addition, liability reserves should be entered as a deficit item, which means a reserve to cover current pension liabilities with current assets. Introducing these measures should place some limits on the risk.

The report of the Trust Fund Council pointed out that management of the national pension reserves should emphasize safety and security rather than efficiency, in order to avoid increasing the burden on participants from potential investment losses. The investment instruments should also be safe and secure. In addition, the report warned that committees set up to monitor fund management operations and to consult on overall management of pension reserves should not fudge over the responsibilities of the fund management and pass it to the nation.

The risks of independent management of public funds recently became an issue in the United States after U.S. President Clinton proposed in his January 19, 1999 State of the Union Message a version of independent fund management for U.S. public pension funds, which have been invested in non-marketable government bonds. He asked for 62% of the budget surplus expected over the next 15 years ($2.7 trillion) to be set aside for social security and for one-quarter or less of that amount to be invested in the stock market. The following day before the House Ways and Means Committee Federal Reserve Board Chairman Alan Greenspan voiced strong objections to this proposal. First, he argued that it is impossible to protect the management of trillions of dollars of social security funds from political motives.

Among the state-level public pension funds in the United States, the greater the number of political appointees as fund managers, the lower the return on investments. Second, he pointed out, if political motives were to influence the management of social security funds, the capital efficiency and productivity of the U.S. economy would decline, and so would the standard of living. At a Senate Budget Committee meeting on January 28, Chairman Greenspan added that stock investment operations conducted by social security funds inevitably risk harming the efficiency of the stock market and eventually the overall economy. If public-sector pension funds, which up to now have invested in U.S. bonds, were to start investing in equity, they would have to sell off government bonds, causing government interest rates to rise. This would adversely affect economic activity in general and Greenspan doubted that stock prices could continue to rise.

Despite the fact that Japan has not engaged in this kind of serious public debate over the risks of independent fund management, it has already decided to allow the full amount of employee and national pension reserves and the postal savings fund to be independently managed.

3. FILP Institution Bonds vs. FILP Bonds

(1) FILP Institutions without a Mandatory Deposit System

When postal savings and public pension reserves are no longer required to be deposited in the Trust Fund Bureau, the main source of funds for the FILP will eliminated. This plan could bring the activities of FILP institutions to a halt by cutting off the lifeblood of the FILP unless new ways are found for these institutions to raise funds.

The amount of funds that will be needed by FILP institutions can be determined from Table 1, which shows the FILP Plan for the 1999 fiscal year.

Table 1 FILP Plans for FY99

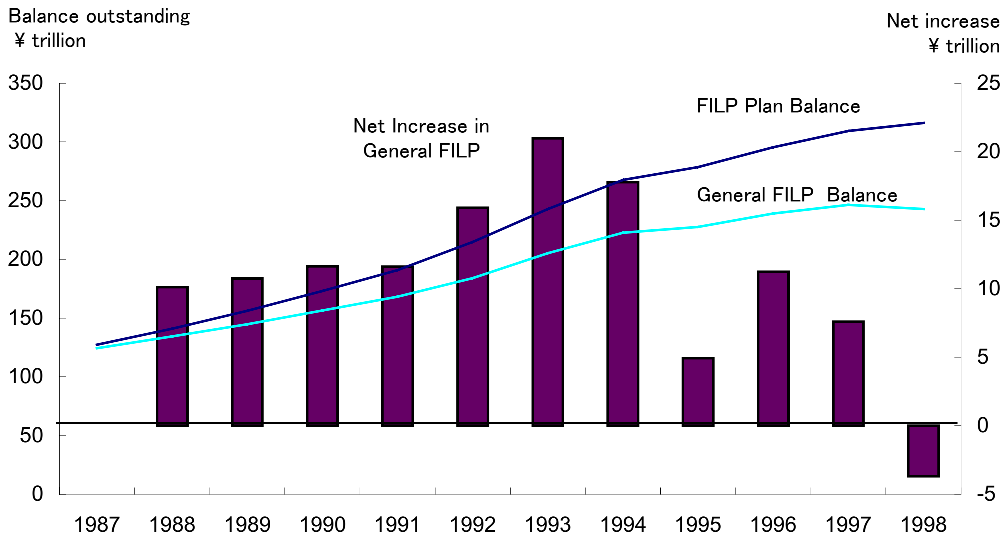
Loan Program			Financial Resources		
	Plan FY99 ¥ trillion	Outstanding end FY98 ¥ trillion		Plan FY99 ¥ trillion	Outstanding end FY98 ¥ trillion
General FILP lending	39.3	313.3	Trust Fund Bureau Fund	43.7	316.2
to local governments	9.4	93.6	Postal savings deposits	11.5	251.0
Fund management operations	13.6	87.5	Employee and national pension funds deposits	4.3	139.5
Postal savings	8.5	50.0	Loan redemptions	27.9	
Public pension	3.1	24.0	Postal Life Insurance Fund	6.6	60.1
Postal life insurance	2.0	13.0	Government-guaranteed bonds	2.5	21.4
			Industrial Investment Special Account	0.1	3.1
Total	*52.9*	*400.8*	*Total*	*52.9*	*400.8*

Source: "Budget and FILP Plan for FY99," MOF January 1999.

The Trust Fund Bureau Fund received a total of ¥15.8 trillion from postal savings and pension reserve accounts. Of this amount ¥5.6 trillion was loaned to postal savings and pension reserves that are already under self-management. The remaining ¥10.2 trillion is the contribution of postal savings and pension deposits to general FILP financial resources.[3] This is the amount that must be replaced when all postal savings and pension reserves are under self-management and mandatory deposits are terminated.

Figure 3 shows the net increase in the funds loaned to the FILP General Account since 1988.

Figure 3 FILP Plan and General Outstandings and Net Increase, Fiscal 1987-98



Note: General FILP outstanding balance is the FLIP plan balance after deducting loans to the Financial Liberalization Fund of the Postal Savings Special Account and the Pension Welfare Service Public Corporation.
Source: MOF, Monthly Statistical Report on Fiscal and Monetary Policy.

The net increase in FILP lending fluctuates greatly from year to year depending on the FILP Plan and the financial situation. The general FILP balance is the total plan balance after deducting funds loaned to the portfolio investment funds managed by the postal and welfare ministries. General FILP outstandings increased more than ¥20 trillion in FY93, because the Diet increased FILP Plan allocations to the Housing Loan Corporation three times (a total of ¥5.9 trillion) during the fiscal year to boost housing starts. The net increase in outstandings fell to ¥4 trillion in FY98 due to repayments to the Housing Loan Corporation. These amounted to about ¥6.6 trillion as people paid off their loans early due to decreases in market interest rates.

Thus, the net increase in FILP borrowings from the TFB, excluding fund management operations, has been about ¥10 trillion per year. On the other hand, the FILP Plan adopted by the Diet typically amounts to about ¥50 trillion per year. This discrepancy between borrowing and lending is possible because the redemption of past FILP loans is now the major source of FILP. That is to say, FILP is entering a mature stage.

3 See footnote 2.

When postal savings and pension reserves start full-scale self-management of all their assets, however, FILP institutions will have to find other ways to procure the funds they need. There are three options open to them: FILP institution bonds, government-guaranteed bonds, and FILP bonds.

(2) FILP Institution Bonds: Insufficient Confidence in Politicians and Over-confidence in the Market

The LDP Administrative Reform Committee report of November 21, 1997 stated: “In principle, the FILP institutions should procure the funds they need themselves.” Specifically, the Committee proposed

- that FILP institutions should first try to procure funds by issuing their own bonds with no government guarantees (FILP institution bonds);
- that, when this is difficult, they issue government-guaranteed bonds upon authorization of the government;
- and that institutions still having difficulty raising funds can borrow government-backed funds raised by issuing FILP bonds.

The basis of this LDP proposal was recognition of the need to reform the FILP institutions that are special public corporations. Special public corporations lack incentives to achieve efficiency and cut costs. They avoid extreme levels of inefficiency in order to protect their own organizations, but if they attempt to promote higher efficiency, they are told to privatize. Thus, they seek a minimum acceptable level of efficiency. They tend to engage in new operations that are unprofitable, expanding their organization and at the same time ensuring that they are not too efficient. In this way, they hope to avoid privatization and abolition. Thus, reform of special public corporations is necessary.

Many people point out that the problems with special public corporations originate within the FILP system. Through increases in postal savings and pension reserves, the FILP amassed a large amount of funds to support FILP institutions, among which are the special public corporations, allowing them to engage in inefficient operations. According to Hiroshi Katoh, Chairman of the Government Tax Council, “Thanks to the existence of FILP, the special public corporations continue to exist. . . . In order to topple special public corporations, it is necessary to cut off their funds.”

The problems of the special public corporations are not the same as the problems of the FILP system, however. The FILP merely provides the financing for special public corporations to realize their policy objectives. Japan has not made progress in resolving the problems of special public corporations because, up to now, it has neglected to investigate the actual state and specific problems of each special public corporation.

The use of market power to reform these institutions has been advocated by critics who doubt the ability of political entities to effect thorough checks on special public corporations. Such critics also recommended that FILP institutions procure the funds they need to finance their operations by issuing their own bonds in the market. This will encourage FILP institutions to become more efficient since the bonds issued by less efficient institutions require higher interest rates (coupons). Furthermore, these commentators insist that the market should decide whether or not a particular FILP institution should be privatized. This is tantamount to saying that FILP institutions that issue bonds nobody wants to buy should be closed down.

The idea of having the FILP institutions issue their own bonds arose from a lack of confidence in politicians and overconfidence in the power of the market to discipline the special public corporations. Ironically, this idea has become the core element in the LDP's proposal for reform of the FILP. However, we must question whether the market should really be given the power to decide on the continued existence FILP institutions. In other words, should the market decide whether the policy measures provided by the FILP institutions can be implemented?

(3) Simply Issuing FILP Institution Bonds will not Reform the Institutions

At present, financing for FILP institutions comes from government-guaranteed bonds as well as loans from the Trust Fund Bureau. Thus, FILP institutions already have some experience issuing a form of government-backed bonds. The issue amount is a political decision made at the time of the annual budget review. Government-guaranteed bonds were instituted to avoid imposing an immediate burden on taxpayers. Experience has shown, however, that access to government-guaranteed bonds tends to weaken an institution's fiscal discipline. Once an FILP institution gets a government guarantee, it tends to depend on this backing since the institution can raise funds easily and since the government's screening process tends to be lax. This distorts operational discipline, which increases the likelihood of imposing a burden on the general public in the future.

On the other hand, the various FILP institutions issue government-guaranteed bonds in such small lots that they carry a higher coupon than government bonds. The higher rate on these government-backed bonds limits the ability of the institutions using them to implement projects. Consequently, the issue of government-guaranteed FILP institution bonds must be severely restricted.

Hence, we need to consider what would happen if FILP institutions issued bonds that were not backed by a government guarantee. Would bond prices reflect the financial position of the individual FILP institutions, creating an incentive form them to improve their operational efficiency? If we consider the nature of FILP institutions and the perceptions of market investors, it appears unlikely that the market would exert effective discipline on these institutions.

The fundamental purpose of FILP institutions is to supply public goods to mitigate market failures. These institutions must bear risks because they supply public goods where private-sector firms cannot. Thus, if they are to attract investors any bonds they issue will need to carry a higher interest rate than private-sector corporate bonds. Any subsidy costs, such as interest payments, on FILP institution bonds would have to be paid out until the bonds reached maturity. Furthermore, in order for FILP institutions to be able to issue bonds, the Diet would have to authorize the disbursement of funds to cover any shortfall in advance of the fact. Such an authorization would circumvent the annual budget review, a basic discipline of democracy. Indeed, it would amount to an implicit government guarantee. Hence, because financial performance is not underlying objective of FILP institutions it is unlikely that they will face direct market pressure.

Even if the cost of issuing the bonds were subsidized by the general budget until they matured, FILP institutions could face the possibility of default due to a change in economic conditions. If investors expected the government to bail the institutions out in such a situation, then interest rates on their bonds would be about the same as on government-guaranteed bonds. Thus, the inefficient institutions would not face the higher interest rates that are believed to be required to discipline them. Moreover, efficiently run FILP institutions would be more likely to be privatized than inefficient ones. If the market assumed that inefficient, deficit-ridden FILP institutions would not be privatized, then efficiently run FILP institutions might even have to pay higher interest rates than the inefficient ones. Thus, the market would only reflect investors' speculations about political decisions, such as whether an institution will be privatized or whether the subsidies provided from the budget will be cut back. The market does not have the power to exert internal discipline on these institutions.

Indeed, in the spring of 1997, when the LDP Administrative Reform Committee was debating the fate of Shoko Chukin Bank the market speculated that the bank would be privatized. Interest rates on Shoko bonds issued by Shoko Chukin Bank (that is to say, FILP institution bonds) shot up compared rates on Industrial Bank of Japan bonds. When expectations of privatization receded after the spring holiday in May, the spread between the bonds of these two banks narrowed. This experience indicates how the price of FILP institution bonds is greatly influenced by political trends and how these bonds would become closely associated with political maneuvers. Consequently, it is evident that the market is incapable of imposing discipline on FILP institutions through their issuing of their own bonds.

We could infer from the previous analysis that if FILP institutions were to issue their own bonds, and if they attracted investors from a wide spectrum, there would be some mechanism in place to insulate investors from incurring a loss. This would become a drag on the bonds and it would become politically impossible to decide to privatize the issuing institution. Therefore the issuing of FILP institution bonds would wind up prolonging the life of these institutions.

When the postal savings and pension reserves commence full-scale self-management of all their funds they may become major investors in FILP institution bonds. Investors will likely demand that political support be extended to FILP institutions in order to prevent a drop in the price or a default. This could well lead to a situation where it is no longer possible to debate the privatization of FILP institutions. These apprehensions will not go away because politicians put a premium on the FILP rate, which, by a 1987 law, has to be determined by market forces.

(4) Trust Fund Council's View on FILP Institution Bonds

As we have seen, advocating issuance of FILP institution bonds as a way to reform special public corporations somewhat recklessly expects the market to take care of problems that really should be addressed by politicians. The issuance of FILP institution bonds may even be used to prolong the life of the issuing institution. In contrast, if FILP institutions were to issue corporate bonds or debentures after they had been privatized, the market would be able to evaluate the financial soundness of each institution. Once privatized, the pressure of market discipline would force these institutions to achieve improvements in operational efficiency, as is the case with private-sector firms.

Privatization as a means to reform special public corporations should be a political decision. This was the case when Japan National Railways and Nippon Telephone and Telegraph (NTT) were privatized and it was the case in the UK. Following the strong advocacy of then-Prime Minister Margaret Thatcher a wave of denationalization swept the UK from 1979. By 1995 the outstanding balance of loans to nationalized enterprises through the NLF (National Loan Fund), the UK version of FILP, had been cut to about one-fifth.

The Trust Fund Council's report summarized the problems inherent in FILP institution bonds. “When reviewing the areas where FILP loans are extended, there were major differences of opinion. These focused on the issue of which was better: to allow a process of natural selection powered by market forces to take place or to make political decisions based on the due processes of democracy. It was no easy task to reconcile these differences in perceptions as to which system to trust.”

The real problem is not a difference of perception, however, but the fact that there is considerable confusion surrounding the concept of FILP institution bonds per se. People are confused about what politics should have done and what the market can do. There is a degree of inconsistency in the concept of FILP institution bonds.

The report of the Trust Fund Council also commented, “In terms of future fundraising by the FILP institutions, there is a major difference between putting emphasis on issuing FILP institution bonds and issuing FILP bonds. However, in either case, the opinion that one or the other should be relied on is receding, and the council has more or less reached agreement that both of these instruments should be used.” The report made the following four specific points regarding FILP institution bonds.

1) As far as possible, special public corporations should quickly diversify fundraising by utilizing private-sector funds, for example. In addition, and again as far as possible, it is desirable to reduce dependence on government credit backing.
2) The various FILP institutions and the responsible ministries and agencies need to consider whether they can really issue FILP institution bonds in amounts sufficient to raise the funds needed to implement policies. FILP institutions that are candidates for privatization in the future should reduce their financial ties with the government. In addition, they should try to promote the issuance of FILP institution bonds.
3) It is inappropriate for FILP institutions to adopt the easy option of issuing bonds depending on implicit government guarantees. For example, there is a need to create a legal definition of failure in the case of FILP institutions that issue these bonds and to specify the subsequent requisite procedures. In fact, the conditions to enable the market to property evaluate FILP institution bonds, such as the handling of subsidies and disclosure procedures, must be created before such bonds can be issued.
4) One approach to issuing bonds not backed by the government is to utilize modern financial technologies. Thus, positive consideration should be given to issuing revenue bonds and asset-backed securities. For example, FILP institutions issuing these bonds could isolate one aspect of their operations from the rest and create measures to boost their creditworthiness and demonstrate that they are not bound by government ties in this isolated area of operations. This would be equivalent to a

revenue bond. This method can also be applied to the issuance of bonds backed by assets such as housing and small business loans, that is to say, asset-backed securities.

(5) Issuance of FILP Bonds

Since FILP institution bonds cannot replace the current FILP system of raising funds for FILP institutions, the only way for them to procure sufficient funds under the new FILP system is to rely heavily on FILP bonds. That means that under the new system the Trust Fund Bureau will need to issue a massive tranche of these bonds on the market. FILP bonds issued by the government's special account as Japanese Government Bonds are more creditworthy than bonds issued by individual FILP institutions. Moreover, they are more liquid than government-guaranteed bonds. Thus, having FILP institutions raise funds through FILP bonds minimizes the institutions' cost of procuring funds to implement policy measures and reduces the taxpayers' burden of providing subsidies to the institutions.

The Trust Fund Council's report states that "fund procurement using FILP institution bonds would mean that some institutions would not be able to meet their needs for operational funds and others would face sharply higher cost of fund procurement. However, as long as their policy measures are considered necessary, it is the responsibility of the government to ensure a stable supply of funds to such FILP institutions." The report also states that, "in terms of minimizing the burden on taxpayers, it is necessary to introduce FILP bonds as follows. The government would have to actively decide on the amount and maturity of funds to be raised. Based on the credibility of the Government, they would have to procure such funds in one integrated operation in accordance with market mechanisms."

"Regarding FILP bonds, it is necessary for the Government to engage in concrete considerations in terms of the legal aspects. At that time, it is vital to avoid a situation where FILP bonds are issued casually and avoid a massive expansion of the FILP system. The Diet should make a resolution on the amount of FILP bonds that can be issued each fiscal year. In addition, it is also vital that the Government should seriously consider ways of putting in place effective curbs on excesses."

Unlike government bonds used to make up for general account revenue shortfalls, FILP bonds are backed by the assets of FILP institutions. The collateral for interest payments on these bonds should be the revenue generated by the FILP institution operations. Under the system of national accounts (SNA), FILP bonds are used for the indebtedness of public corporations. They are not to be used to cover the liabilities of the general government. Thus, their nature is different from government bonds that depend on future tax revenues for redemption when they mature. If FILP plans are implemented based on subsidy cost analysis (discussed in Section 5), it would be possible to reduce the incidence of political failure compared to the current system and also compared to letting each FILP institution issue bonds in accordance with its needs.

Since FILP bonds are issued by the government's special account, the legal debtor is the Japanese Government and they have the nature of government bonds (sovereign debt). At present there are three forms of government bonds, construction bonds, deficit-covering bonds, and re-funding bonds. The market treats all three in exactly the same way. FILP bonds would add a fourth type. The proposed FILP bonds could use the existing infrastructure of the government bond market, including the bid-tendering issue system, the futures market, and the settlement system. The amount of FILP bonds issued is decided by a Diet resolution.

If the pension reserves and postal savings that are to be self-managed by the relevant ministries start to invest in FILP bonds through the market, they would not be able to demand the premium (20 basis points over the rate on 10-year Japanese government bonds) that they enjoy under the current FILP system. Deposits with the TFB, as well as investments in non-marketable bonds, insulate the self-managed portfolio from price fluctuation. But, unlike internal transactions implemented by the government through the deposit system, the FILP bonds in the self-managed portfolio would be influenced by market interest rates and exposed to the risk of price fluctuation.

The Trust Fund Bureau would continue to accept short-term deposits from the special accounts as now. It would function as the resource for all payments made by the Treasury. It could be used to supply long-term loans to FILP institutions by using asset-liability management (ALM). At present, the interest charged to FILP institutions is fixed without reference to the period of the loan (the interest rate on 10-year government bonds plus 0.2%). However, in the future the interest charged to borrowing institutions will vary depending on the yield curve on government bonds. This will apply to loans extended under the Diet-approved FILP Plan. Direct loans from self-managed postal savings funds to local governments should be posted in the FILP Plan. For this reason, loan conditions need to be uniform and based on market forces.

There is some anxiety about the effect of FILP bonds on market interest rates. Some market players state that FILP bonds should be differentiated from government bonds because FILP institutions hold non-performing (bad) loans. The existence of NPLs increases the risk to taxpayers and lowers the creditworthiness of FILP bonds compared to government bonds.

The assumption that FILP institutions hold large amounts of non-performing loans is based on the mountain of non-performing loans held by private-sector banks. This perception was formed when Japan's bubble economy burst and the huge amount of bad loans actually held became public knowledge. At the end of FY98 bad loans (loans in default plus arrears) comprised 9.8% of outstanding loans at Hokkaido-Tohoku Development Finance Corporation (3.6% excluding Tomato projects). At Japan Small Business Enterprise Finance Corporation the share stood at 3.5%, at People's Finance Corporation and Environmental Sanitation Business Finance Corp. it was 2.9%, at Export-Import Bank of Japan it was 2.0%, and Japan Development Bank it was 0.5%. The bad-debt ratios of these FILP institutions are low compared to the 6% average for private-sector banks. The difference is that government financial institutions may only make large-scale loans to the Tomato and Mutsu Ogawara projects, while private-sector banks are exposed to many major borrowers.

Subsidy cost analysis should be used to disclose the potential burden of FILP institution projects on taxpayers. In the case of public investment, FILP bonds may be preferable to government construction bonds, which do not generate revenues. Since construction bonds must rely on future tax revenues to redeem principal and interest, the entire amount of the bond issue has to be borne by the taxpayers. On the other hand, investments using FILP bonds are partially backed by future revenues (e.g., tolls) generated by the projects, so the full amount does not fall on the taxpayers' shoulders.

This is not to say that FILP institutions do not need reform. Obviously, it is necessary to identify the mission of each FILP institution and the guarantees in place to ensure efficient implementation of policy.

In view of these arguments, there is little basis for assuming that FILP bonds are necessarily less creditworthy than government bonds. The fundamental problem is the creditworthiness of the government per se. Under its present stance that any expenditure is justified in order to stimulate the Japanese economy, the government continues to issue more government bonds. It is this that has caused investors overseas to become concerned about sovereign risk.

The real concern is with independent fund management not with the issue of FILP bonds. Under the current mandatory deposit system, postal savings and pension reserves provided long-term funds. However, under self-management, if these funds are invested in marketable bonds and stocks the term of lending will be shortened, and we can expect the supply of funds for long-term financing in Japan would decline, leading to an increase in long-term interest rates.

4. Trust Fund Bureau Finances: Problems of Transition and Massive Redemption of Postal Savings

(1) Problems in the Transition Phase

From FY01 the TFB will issue FILP bonds as a source of financing to replace no-longer mandatory deposits of postal savings and pension reserves. The amount of FILP bonds that will be issued should be within the framework of the FILP Plan. Even so, the Trust Fund Bureau will face a major problem during the transition phase because of a mismatch of its inflows and outflows.

The loan period for FILP institutions averages 18 years, although it ranges up to 35 years in some cases. Repayments of these loans flow into the Trust Fund Bureau based on this time schedule. On the other hand, the Trust Fund Bureau must redeem deposits from the postal savings and pension reserves after only seven years. Thus, there is a big difference between the timing of the Fund's inflows from loan repayments and its outflows to redeem deposits. Table 2 shows a simplified version of the Trust Fund Bureau's balance sheet as of the end of FY98 to illustrate this mismatch.

Table 2 Trust Fund Bureau Balance Sheet, End FY98

Assets	¥ trillion	Liabilities	¥ trillion
FILP funds managed by Diet	316.2	7-year deposits	389.0
Local government amount	62.0	Postal savings	251.0
Self-managed by MOP and MHW	73.3	Public pension	129.1
Short-term loans	23.3	Short-term deposit fund	47.0
Government bonds	96.5		
Short-term investment	28.7		
Total	436.0	Total	436.0

Note: In addition to the funds managed by the MOP and MHW in the Financial Liberalization Fund and the Pension Welfare Service Public Corporation, the postal life insurance program independently manages ¥13.4 trillion under the FILP plan.

Source: MOF, July 1999 “Trust Fund Bureau Fund Management Report for FY98.”

On the liability side, the Trust Fund Bureau has long-term deposits of ¥389 trillion from postal savings and pension funds that will be maturing over the next seven years, meaning an average outflow of ¥55 trillion per year. On the asset side, of the ¥316 trillion of assets being managed under the FILP Plan only ¥18 trillion per year will flow back into the Trust Fund Bureau from loan repayments by FILP institutions, given the average loan period of 18 years. Up to now, when postal savings and pension reserve deposits matured, they were re-deposited with TFB. Under the reform plan, however, when deposit of postal savings and pension reserves ceases, the Trust Fund Bureau will have to offset the gap between the ¥18 trillion average annual inflow of funds and the ¥55 trillion average annual outflow. The Trust Fund Bureau will have to issue FILP bonds to finance this gap as well as to finance the annual net increase in the FILP Plan (estimated at about ¥10 trillion).

Such a large issue of government bonds can be expected to have a major destabilizing effect on the market. Article 20-2 of the Fundamental Law on the Reform of Government Ministries and Agencies states that due consideration must be paid to the financing of outstanding loans to FILP institutions. Consequently, a considerable portion of the postal savings and pension deposits that reach maturity over the next seven years must be earmarked for re-investment in FILP bonds. A considerable amount of newly acquired postal savings and pension reserves will also have to be channeled into FILP bonds. At the same time, investment in FILP bonds by postal savings and pension reserves is subject to market forces. If they require above-market interest rates, the FILP reform plan would not function adequately right from the start.

(2) Massive Amount of Postal Savings to Mature

This new method of financing the FILP plan will be implemented from April 2001. But the FILP plan must face a major problem even before then. Massive outflows from postal savings are expected in FY00 and FY01, and the FILP plan will have to find other financial resources to replace these funds.

According to a survey by the Ministry of Post and Telecommunications, ¥106 trillion will be paid out in FY00 and FY01. The represents mostly the redemption of the huge volume of time deposits that were entrusted to the post office just a decade ago. At that time, deposit interest rates were controlled and the rate on postal saving time deposits, which was the same as on 3-year bank deposits, made them more attractive than other financial instruments on maturity. Of the total, about ¥8.5 trillion will go to taxes on the interest earned and ¥16.5 trillion is in excess of the postal savings maximum deposit (¥10 million). Even if 70% of the remainder is re-deposited in postal savings accounts, ¥49 trillion will flow out from the postal savings system. At the same time, the system expects an increase in new deposits and in the interest on deposits. On balance, postal savings system deposits are expected to decrease by about ¥16 trillion in FY00 and by ¥15 trillion in FY01.

Whatever the exact amount of funds that are withdrawn, the main worry is the impact the withdrawal will have on the financial sector and on the economy in general. It might be expected that the economy would not be affected if the funds simply shift from the postal savings system to some other type of financial asset. However, the impact on the economy depends on the source of redemption of the matured postal savings deposits.

Up to now, postal savings have been deposited with the Trust Fund Bureau and the Bureau has loaned these funds in accordance with the FILP Plan to government financial institutions, public corporations, and the self-managed Postal Savings Financial Liberalization Fund. If these loans could be withdrawn, they could make up for the funds withdrawn from postal savings. The Financial Liberalization Fund balance outstanding has reached ¥60 trillion. These funds should have been invested in short-term government securities to compensate for the mismatch between the average length of individual postal savings deposits (about 4 years) and the required period for depositing postal savings funds with the TFB (7 years). Given that this fund was intended to ensure that postal savings could be managed soundly in the face of financial market deregulation, these funds should be used first of all to make up for the massive withdrawal of maturing postal savings deposits. If not, the problem will become more difficult because the Trust Fund Bureau will have to call early repayments by FILP institutions.

Some unnecessary or less urgent operations of FILP institutions will have to be put on the back burner and Trust Fund Bureau loans will have to be cut back. There would be a major impact on the national economy if the Trust Fund Bureau calls its loans to certain institutions. For example, reducing loans to the People’s Finance Corp. or the Housing Loan Corp. would cause credit problems for medium-sized and small firms and for the general public.[4]

One proposal was for the Trust Fund Bureau to sell off its holdings of government bonds, but this alone would push up long-term interest rates. An alternative proposal was for the Trust Fund Bureau to sell its government bonds with repurchase agreements in the *gensaki* (repo) market over a short period of time. However, this would only postpone the problem until the Trust Fund Bureau could raise long-term funds, and there would also be upward pressure on long-term interest rates if the market got wind of this operation. If the Trust Fund Bureau sold its holdings of government bonds to the Bank of Japan (BOJ), then the BOJ could pay off the matured postal savings funds by printing more money.

Not only is there a problem finding financial resources to pay off the maturing postal savings, but also there is a problem raising the ¥10 trillion or so to finance the expected net increase in the FILP Plan for FY00. FILP bonds cannot be issued until the necessary legislation has been promulgated. The only option appears to be to raise funds by selling off the government bonds held by the Trust Fund Bureau, and this will inevitably impact long-term interest rates. In fact, the interest on long-term government bonds has risen since the middle of December 1998 when the Trust Fund Bureau announced that it stopped buying government bonds. At that time the Trust Fund Bureau lacked the resources to purchase government bonds from the market, because the FILP Plan for FY99 was augmented in order to ease the credit crunch.

Together, the liquidation of government bonds held by TFB and the expansion of self-management of postal savings and pension reserve funds will inevitably affect interest rates on government bonds. Furthermore, the accumulation of government bonds on the market is

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4 In October 1999 People's Finance Corp. was merged with Environmental Sanitation Business Finance Corp. to create National Life Finance Corp.

approaching a volume that could put the credibility of the government itself into question. In fact, the market already demands a large risk premium when FILP institutions issue foreign currency-denominated bonds with a government guarantee. As a beneficiary of the government's good credit standing (through the government guarantee of postal savings accounts), the Post Office should contribute to maintain that creditworthiness. Therefore, one solution to counter the adverse impact of the upcoming changes is for the Post Office to increase its over-the-counter sales of government bonds and to introduce a new type of government savings certificate not only to cover the expected withdrawals but also to avoid problems arising from self-management of its funds.[5] Instead of managing its own portfolio the Post Office should utilize its network to promote the purchase of government bonds by individuals to alleviate this situation.

5. Introduction of Subsidy Cost Analysis

The FILP reforms described so far are merely changes in the methods for financing FILP institutions due to the shift to completely independent management of postal savings and pension reserves. In the summary of the discussions on FILP reforms, the working group study unit of the Trust Fund Council stated: "The purpose of these reforms is to effect a switchover from the government funds in the Trust Fund Bureau, such as postal savings and pension reserves, to investment and loan activities within a system based on actively procuring the required funds in the market." These reforms in financing should impose some market discipline on the FILP institutions. But FILP institutions that are totally owned by the government should be subjected to political discipline to ensure that their activities fulfill public policy objectives. Mere changes in financing methods cannot be seen as adequate to reform FILP institutions.

(1) Need to Ensure Redeemability and Clearly Visible Costs

As pointed out in the Trust Fund Council's summary report of November 27, 1997, estimation of subsidy costs (taxpayers' burden) is necessary to impose political discipline on the activities of FILP institutions. FILP is a method to implement social-economic policy using interest-bearing funds. As with other policy measures, government intervention can only be justified in cases of market failure. FILP-supported projects fall into three categories:

1) Recovery of principal and interest is possible through such means as charges to beneficiaries for the use of infrastructure facilities and repayment of principal and interest from borrowers from FILP institutions.
2) Recovery of principal and interest is not possible by passing the burden on to the beneficiaries and the overall social benefit is less than the investment costs.

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5 People tend to associate the idea of the Post Office selling government bonds with the sale of War Bonds by the Post Office in the difficult times before World War II. However, the Post Office has been selling about ¥500 billion in medium-term Japanese government bonds over the counter annually since fiscal 1988. Moreover, Western countries such as the United States, Germany, France, and the U.K., all issue small-denomination financial instruments, or government savings bonds, similar to Japan's postal savings certificates.

3) Recovery of principal and interest is not possible by passing the burden on to the beneficiaries, but the overall social benefit is greater than the investment costs.

Projects in category 1 can also be implemented by the private sector, and so the government should not intervene to undertake such operations. Investments and loans (infrastructure facilities projects) to projects in category 2 have no social value, and so not even the government should engage in such undertakings. Projects in category 3 have some social value and they cannot be undertaken by the private sector alone, so the government should carry out such projects. Thus, knowledge of a project's investment costs is an extremely important factor in determining whether FILP should be used as a policy implementation measure. That is to say, when the government intervenes and puts things on a public-sector basis allowing the use of FILP, several essential elements must be in place. These include thoroughgoing analysis of the likelihood of redemption, the subsidy cost of government involvement, a comparison of costs and benefits, the publication of relevant documents and post-project checks.

FILP institutions face a soft budget constraint when they can use both interest-bearing funds and tax funds to implement projects. They tend to over-invest because they can implement large projects with only a small amount of current expenditure by using huge amounts of interest-bearing funds. The budget constrains current expenditures, but it does not constrain the future expenditures (tax burden) that may arise from the current FILP Plan.

A typical example is the subsidized interest rates on housing finance, which amounted to ¥435 billion for the Housing Loan Corp. on a FY99 budget base. The future burden that this subsidy will impose on taxpayers is not disclosed when the annual FILP plan is decided. Hence, the decision to implement an FILP project needs to take into account its burden on both current and future taxpayers. To do this we need a new method for deciding whether or not a project is suitable.

A vital part of FILP reform is ensure that when FILP funds are used together with expenditures of the budget general account the policy decision would win public approval. This can be achieved by introducing measures to quantitatively analyze a project's anticipated tax burden on a present-value basis. Thus, FILP reforms must start with a detailed examination of FILP institutions, the exit of the FILP, and the policies behind the projects in question. In debating which policy measures are necessary the Diet decision-making process requires disclosure of the financial statements of the FILP institutions and the future burden on taxpayers. It also should involve comparing the tax burden of planned FILP institution projects under various alternatives such as privatization, disbursement of subsidies, and tax treatment.

(2) Subsidy Cost Analysis in the United States

The United States initiated such a project evaluation method with the Federal Credit Reform Act of 1990. Under the act, the U.S. Congress specified that the Federal Credit Program, which corresponds to Japan's FILP, should calculate the taxpayer burden separately from the fund's cash flow and that this subsidy cost should be posted as an authorization item in the federal budget.

Previously, budget postings were only made on a cash bas, so that direct loans were merely recorded as government expenditures with no accounting of future repayments. Furthermore, not only was the cost of providing debt guarantees not made clear in the budget, the revenues from the guarantees were posted. As a result, the Federal Credit Program expanded rapidly using loan guarantees because it was very difficult to obtain a clear picture of the actual subsidy cost burden on taxpayers.

Under the Federal Credit Reform Act of 1990, starting with the FY92 budget, federal agencies were required to calculate the subsidy cost of loans and guarantees, to show the difference between outflows and future cash flows including defaults, and to show the discounted present value of costs based on government bond rates. Although data limitations and other implementation problems are still being overcome, the new calculation method more or less eliminated a potentially serious problem concerning the marked increase in obligation guarantees.

Superficially, Japan's system resembles that in the United States after the Federal Credit Reform Act. Cash flow is shown as fund procurement and management plans of FILP institutions in the FILP Plan, and the expenditures and interest subsidies provided to FILP institutions are posted in the budget general account by major expense category in each fiscal year. However, these figures pertain only to expenditures in a fiscal year; they do not show the future costs of FILP.

(3) An Urgent Objective - Introduction of Subsidy Cost Analysis

Thus, the FILP reform movement in Japan needs to learn from the U.S. Federal Credit Reform Act. Each FILP institution needs disclose the potential future tax burden when it undertakes FILP projects by introducing quantitative methods to analyze future costs. This is extremely important both for the disclosure of information on the future burden on taxpayers and for the preservation of a sound and healthy financial basis. By clearly showing in advance the cost of policy measures it should be possible to avoid wasteful projects of FILP institutions, which have increased due to the fact that the future tax burden has been hidden. It will also be possible to compare the costs of proposed FILP projects with the cost of other policy measures such as taxation and subsidies. In July 1997, the Trust Fund Council proposed (through the comments of a working group leader) the need to introduce and improve the cost analysis methods for FILP projects.

In concrete terms, subsidy cost is the total discounted present value of subsidies from the general account, such as interest supplementation, expected until the end of a project using FILP funds. Calculating the subsidy cost involves:

1) Converting the inputs, such as subsidies, from the general account to the FILP institutions for each future year into present value.
2) Calculating the amount of capital investment and interest-free loans from the general account to FILP institutions that must be repaid at the end of the project. The opportunity cost on this amount is counted as a subsidy and converted into discounted present value.
3) Treating payments and dividends to the Treasury from FILP institutions as minus subsidies and converting them into discounted present values.
4) Totaling these estimated items.

Next, we will look at method of estimating the cost of individual FILP institutions.

1) The cost estimate applies to projects underway during a given fiscal year and projects expected to commence in or after that fiscal year.

2) The future cash inflow generated by these projects is estimated by interest revenue and principal in the case of financial institutions, and by the revenues from user charges in the case of institutions implementing projects. The assumptions for these projections, such as the probability of default and the price elasticity of demand from past trends and future economic outlook, must be clearly stated.

3) The cash inflow minus cash outflow (principal and interest repayments to lenders) is the required subsidy for each fiscal year.

4) The cost of a policy measure is calculated based on the discounted present value.

Table 3 shows the subsidy costs calculated in this way for five FILP institutions. These data were submitted to the Trust Fund Council at the end of August 1999.

Table 3 Subsidy Cost Analysis for Selected FILP Institutions (¥100 million)

	FILP Plan FY99	FILP outstanding end FY98	Period (years)	Subsidy cost[1]	Amount posted as subsidy in FY99	Private sector procurement cost from end FY99[2]	Reduction in subsidy costs from end FY99[3]
Government Housing Loan Corp.	101,176	735,317	31	12,383[4]	4,350	21,279	8,896
People's Finance Corp.	37,900	90,541	21	846[5]	426	1,934	1,088
Export-Import Bank of Japan	19,100	83,548	26	1,881	0	2,841	960
Japan Highway Public Corp.	21,063	214,352	43	33,513	2,884	40,931	7,418
Chubu Int'l Airport Co., Ltd.	80	266	35	-110	51	112	222

Notes (1) The analysis covers the institution's existing loans (or plans) and its project plans for FY99.
(2) Indicates cost if all FILP funds needed during the analysis period (from FY99 to the completion of the project) were raised under private enterprise status. 2Indicates reduction in subsidy cost by using all FILP funds (i.e., Subsidy Cost minus Private Procurement Cost).
(3) Based on the average rate of default over the past five years (7.7/1,000,000) and advanced redemptions estimated using past data. From the 11th year onward loans use a step-up interest rate
(4) Based on the average rate of advanced redemptions over the past five years (1.2%) and the average rate of transferring funds to the bad debt reserve over the past 20 years (3/1.000).

Source: Working Group Study Group of the Fund Operation Council "Analysis of the subsidy cost in FILP-related projects (rough calculation)" August 30, 1999.

The subsidy cost of the Government Housing Loan Corporation is estimated at ¥1.2 trillion. This is equivalent to about 3 times the amount of subsidies from the general account in FY99 and it is a relatively small amount compared to the ¥400 billion in subsidies that have been provided annually up to now. However, these subsidy costs relate to the cost level prior to the FILP Plan of FY99. The calculation in the table assumes that the Housing Loan Corporation makes no new housing loans after FY00. For loan repayments beyond 11 years, the step-up loan interest rate system assumed in the calculation is higher than the interest rate on funds raised by the Trust Fund Bureau. Thus, cash inflow will be greater than outflow from the eleventh year onward. Consequently, in the future not only will subsidies become unnecessary, but also the Government Housing Loan Corp. may even make payments into the Treasury if it stopped lending from FY00 onward.

The Government Housing Loan Corp. could provide housing construction funds at low long-term interest rates as a measure to meet the policy goal of supporting homeownership among the general public. Alternatively, the tax system could also be utilized to achieve this policy goal, for example, by reducing the tax on housing purchases. Therefore, the estimated ¥1.2 trillion subsidy cost of the Government Housing Loan Corp. should be compared to the size of the tax reduction that would generate the same effect. (The projected plan for FY99 is to build 550,000 homes.)

Furthermore, the same policy goal could be met by subsidizing the interest on housing loans provided by private-sector banks rather than using direct loans from government institutions. We need to calculate the cost of this alternative policy measure as well. If private-sector banks raised funds for housing starts at the long-term prime rate, the estimated subsidy cost is ¥2.1 trillion. Thus, the subsidy cost, that is, the taxpayers' burden, of subsidizing housing loans from private-sector banks (at the same loan interest rates as those from the Government Housing Loan Corp. would be ¥900 billion more than the cost of direct lending by the Government Housing Loan Corp.

Next, look at the case of Japan Highway Public Corp. The FILP plan amount for FY99 is only ¥2.1 trillion compared to the estimated subsidy cost of ¥3.3 trillion. This ¥3.3 trillion is about 12 times the amount of subsidies for Japan Highway Public Corp. in FY99 because a total of ¥49 trillion in new construction works were approved in FY99. The funds for these projects are scheduled to be returned to the government in 43 years. By that time, the construction works in progress prior to that time point will be completed and will be generating revenues in the form of user fees. Even taking these future cash inflows into account, the burden on taxpayers will still be quite heavy.

It is obvious that these subsidy costs should be reflected in the FILP plans of the Japan Highway Public Corp. In addition, it is necessary to provide a proper feedback to the National Development Arterial Expressway Construction Council, the body that actually makes decisions on the projects of the Japan Highway Public Corp. Another problem that has frequently been pointed out is the Japan Highway Public Corp's use of the highway toll pooling system when implementing new projects. The Japan Highway Public Corp. uses the revenues generated by an increase in users on a certain section of highway to build new sections of road where there are few users. This technique contravenes the basic principle of FILP that the beneficiaries should pay for a project. This issue would be clear and easily understandable if Japan Highway Public Corp published the subsidy cost analysis for each section of road, instead of the aggregate for all highways.

FILP institutions have tended to expand their operations up to now because the burden on future taxpayers has not been apparent. Subsidy cost analysis would strongly support the political process of reforming FILP institutions by improving or abolishing projects. Introducing a subsidy cost analysis system would make it possible not only to curb the activities of FILP institutions but also to compare the subsidy costs using FILP with alternatives such as tax subsidies and direct expenditures.

(4) Cost Analysis at the Center of Multi-faceted Discipline

By its very nature the analysis of subsidy cost involves a considerable margin of error because it is necessary to make assumptions on unknown elements such as future interest rates and future demand. As the experience of the U.S. Federal Credit Reform Act of 1990 shows it can take a long time to establish concrete methods.

In order for Japan to respond to these problems, it will be necessary to introduce cost analysis methods gradually starting with the more possible areas. These methods will require constant review and revision while continuing the analysis process and so create worthwhile measures.

Efforts to create an intellectual infrastructure, such as training human resources with specialist knowledge and skills, will be needed to introduce scientific and objective methods such as cost analysis and to achieve more appropriate screening processes for FILP.

Recently, a new concept of public management has come into active use in the West. It involves basing decision-making on performance results, utilizing multifaceted policy measures, creating a competitive environment, establishing accountability through the analysis of performance, and introducing accrual-basis accounting and corporate-sector operating systems. By adopting subsidy cost analysis and employing these new public management concepts as a reference point, it should be possible to impose discipline on Japan’s FILP institutions and other special public corporations.