Fiscal Debate over Japan's *Special Deficit-Financing Bond Act 2012*

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I. Introduction

Japan's *Special Deficit-Financing Bond Act 2012* ("the Act"), an important piece of legislation to enable the Japanese government to implement its budget for fiscal-year 2012, was passed by the Diet in November 2012[1]. The Act assumes that (1) expenditures will be overhauled in order to control the issuance of special deficit-bonds in fiscal-year 2012, (2) the issuance of special deficit-financing bonds will be capped in order to ensure longer-term fiscal stability, and then, (3) permits such bonds to be issued up to an amount agreed by the Diet as part of the budget approval process for each fiscal year from fiscal-year 2012 to fiscal-year 2015. (Figure 1).

Figure 1: Summary of the *Special Deficit-Financing Bond Act 2012*

1 Issuance of special deficit-financing bonds
In addition to public bonds issued in accordance with the proviso to Article 4, Paragraph 1 of the Public Finance Law of 1947, special deficit-financing bonds may be issued as part of the annual budgets for fiscal-year 2012 to fiscal-year 2015 within the limits approved by the Diet (¥38,335bn in the initial general account budget for fiscal-year 2012).

2 Capping the issuance of special deficit-financing bonds
If the government issues bonds under 1, it should strive to keep this to a minimum each fiscal year in order to achieve fiscal sustainability over the longer term.

3 Issuance of pension-related special deficit-financing bonds
1 The government may issue special deficit-financing bonds to cover the expenditures of raising the proportion of the basic pension funded by the state in fiscal-year 2012 and 2013 as part of the annual budgets for these years within the limits approved by the Diet (an estimated ¥2.6trn in fiscal-year 2012).
2 The principal and interest on the special deficit-financing bonds issued to cover the expenditures of raising the proportion of the basic pension funded by the state, including refinancing bonds, will be serviced until fiscal-year 2033 using the increase in tax revenue generated once the *Consumption Tax Act Amendment Act* is implemented in fiscal-year 2014.

4 Supplementary provisions
1 This law will come into effect on the day of its promulgation.
2 The government will review the expenditure in its supplementary budget for fiscal-year 2012, including spending on government policies, and seek to keep the issuance of bonds under 1 to a minimum in that fiscal year.

Source: Nomura Institute of Capital Markets Research, based on House of Councilors, "*Gian Jouhou, Dai181kai Kokkai (Rinjikai), Zaisei Un'ei ni Hitsuyou na Zaigen no Kakuho o Hakaru tame no Kousai no Hakkou no Tokurei ni Kansuru Houritsuan, Gian Youshi*," (Bills Submitted to the Diet, 181st (Extraordinary) Session, Summary of the *Special Deficit-Financing Bond Act 2012*
(http://www.sangiin.go.jp/japanese/joho1/kousei/gian/181/meisai/m18103181001.htm)

[1] House of Councilors, "*Special Deficit-Financing Bond Act 2012* passed," 16 November 2012.

On the back of the timing of budget implementation, special deficit-financing acts have tended to be passed before the start of each fiscal year, namely in April[2]. However, due to political complications such as the "divided Diet," the special deficit-financing acts for fiscal-year 2011and fiscal-year 2012 were passed after the start of the new fiscal year. Particularly in fiscal-year 2012, there was concern that the government might not be able to hold auctions of interest-bearing government bonds in a regular manner. Furthermore, there was a delay in transferring local allocation tax grants to local governments. The passage of the Act enables the government to issue special deficit-financing bonds as soon as the passage of the budget for each fiscal year until fiscal-year 2015 ensures that the necessary funds will be available from the start of each fiscal year.

The Act is likely to have a significant impact on the fiscal management of the government going forward. That said, the Act does not contain any specific measures to ensure fiscal discipline. In addition to examining the system and history of Japanese Government Bonds (JGBs), the paper analyses the Act from public finance perspectives. The paper also considers how Japan should manage its public finances in future.

II. Procedure for issuing government bonds in Japan

Article 85 of Japan's constitution states that "No money shall be expended, nor shall the State obligate itself, except as authorized by the Diet." In other words, all issuance of JGBs is stipulated by laws. There are two main types of JGB according to the purpose of their issue: (1) those whose redemption costs are funded by tax revenues ("general bonds") and (2) those whose redemption costs are funded by repayments by loans to agencies of Fiscal Investment and Loan Program (FILP) ("FILP bonds") (Figure 2). There are three types of general bonds: new financial resource bonds (construction bonds and special deficit-financing bonds),

Figure 2: JGBs by legal grounds of issuance

<table>
<tr><td rowspan="5">JGBs</td><td rowspan="4">General Bonds</td><td rowspan="2">New Financial Resource Bonds</td><td>Construction Bonds</td></tr>
<tr><td>Special Deficit-Financing Bonds</td></tr>
<tr><td colspan="2">Reconstruction Bonds</td></tr>
<tr><td colspan="2">Refunding Bonds</td></tr>
<tr><td colspan="3">Fiscal Investment and Loan Program Bonds (FILP Bonds)</td></tr>
</table>

Source: Ministry of Finance, Financial Bureau, *Debt Management Report 2012: The Government Debt Management and the State of Public Debt)*, 2012, p. 36. (http://www.mof.go.jp/english/jgbs/publication/debt_management_report/2012/)

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[2] Misumi, Masakatsu, "*Sengohatsu to Natta Daikibo na Yosan Shikkou Yokusei—Tokurei Kousai Houan o Meguru Keii to Ronten*," (The First Major Cap on Budget Spending in the Postwar Period: the Special Deficit-Financing Bond Bill), Rippo to Chosa, No. 335, Secretariat of the House of Councilors, December 2012, p. 35 (in Japanese).

reconstruction bonds, and refunding bonds. We briefly summarize the description of new financial resource bonds.

1. Construction bonds based on the construction bond rule

The Japanese government issued a large amount of JGBs before and during the Second World War to fund its military effort. At that time, a significant proportion of revenues was generated by government bonds and borrowing. Furthermore, since a large portion of JGBs were underwritten by the Bank of Japan (BoJ), it prompted a runaway inflation. Based on the experience, Japan's *Public Finance Law 1947* stipulates strict restrictions on the issuance of public debt.

Article 4, Paragraph 1 of the Law states that "National expenditures shall be compensated by the revenues excluding proceeds from public bonds or borrowings," to all intents and purposes basically prohibiting the issue of public bonds (Figure 3).

Figure 3: Article 4 of the *Public Finance Law 1947*

Article 4 (1) National expenditures shall be compensated by the revenue excluding those from public bonds or borrowings. However, for the source of public works expenditures, disbursements and loans, it shall be permissible to issue public bonds or make loans not exceeding the amount approved by the Diet resolution.
○(2) In the case where public bonds are issued or loans are made according to the proviso to the preceding paragraph, repayment plans shall be submitted to the Diet.
○(3) The range of public works expenses provided in Paragraph 1 shall be subject to the resolution of the Diet every fiscal year.

Source: Ministry of Internal Affairs and Communications, Administrative Management Bureau, "*Hourei Deeta Teikyou Shisutemu*," (Legal Data Access System) (in Japanese) (http://law.e-gov.go.jp/htmldata/S22/S22HO034.html)

However, the proviso to Paragraph 1 states that "… for the source of public works expenditures, disbursements and loans, it shall be permissible to issue public bonds or make loans not exceeding the amount approved by the Diet resolution," thereby allowing the issuance of public bonds to be a source of revenues in exceptional circumstances. The provisions of this proviso are referred to as the "construction bond rule."

This, in turn, is based on the pay-as-you-go principle, namely the view that investments such as public works help to increase social productivity and that their cost should therefore be borne by not only the present generation but also by future generations, namely in the form of tax payments for the redemption and servicing of the principal and interest of the public debt issued to finance those investments[3]. JGBs issued in accordance with the provisions of the proviso to Article 4, Paragraph 1 of the *Public Finance Law* are therefore called "construction bonds" or "Article 4 bonds."

The amount of construction bonds issued must be within the limit determined by the Diet and must be stated in the general provisions of the general account budget. In

3 Ehiro, Akira, "*Kousai to Kousai Kanri Seisaku*," (Public Bonds and Public Debt Management Policy), in Kanazawa, Fumio (ed.), "Zaiseigaku Shohan Dai5satsu," (Public Finance, 1st edition, 5th imprint), Yuhikaku, 2011, p. 141 (in Japanese).

addition, a year-by-year redemption schedule must be drawn up, showing the method and final redemption date of the bonds, and submitted to the Diet when the Diet is about to pass a resolution governing the amount of construction bonds that may be issued.

2. "Special deficit-financing bonds" issued in accordance with annual special deficit-financing bond acts

Because current expenditures including personnel expenses do not generate any lasting benefits for future generations (only the burden of the tax needed to redeem and service the principal and interest of the bonds issued to pay for them), the *Public Finance Law* does not allow government bonds to be issued for this purpose. However, there is provision (in the form of annual special deficit-financing bond acts) to allow current expenditures to be funded by the issuance of government bonds in cases where the issuance of construction bonds is insufficient to cover revenue shortfalls. JGBs issued for this purpose are called "special deficit-financing bonds."

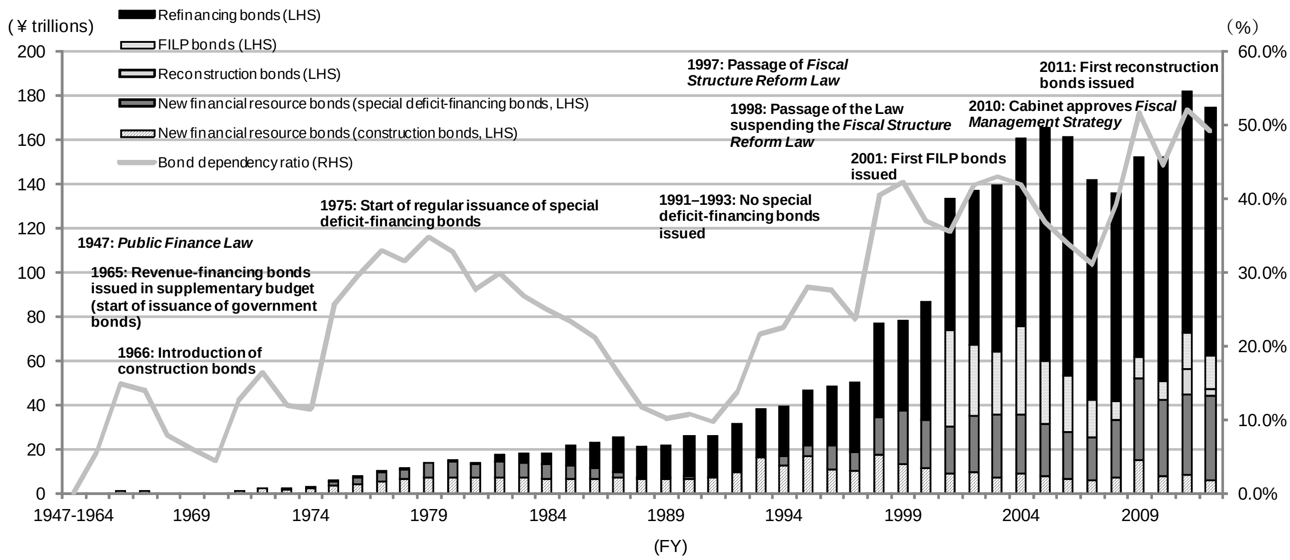
Annual special deficit-financing bond acts provide the government the authority to issue special deficit-financing bonds: the amount that may be issued has to be specified in the budget's general provisions. This is largely because the amount of government bonds that the government may issue each fiscal year is determined by the difference between government revenues and expenditures, and it is considered appropriate for the Diet to debate and vote on this as part of the budget procedure. As with construction bonds, the government is required to draw up a redemption schedule and submit it to the Diet when the Diet is about to pass a resolution governing the amount of special deficit-financing bonds that may be issued.

For reference, while special deficit-financing bonds cover shortfalls in the general budget, the government is supposed to issue only the minimum amount. As such, there is a system called account reconciliation period which enable the government to issue special deficit-financing bonds until the end of the June following the end of each fiscal year (1 April–31 March) based on the expected level of tax revenues at the end of the deadline.

III. History of government bond issuance in Japan since Second World War

The history of government bond issuance in Japan since the Second World War can be divided into three main periods: (1) the period from the passing of Article 4 of the *Public Finance Law* to the issuance of construction bonds; (2) the issuance of special deficit-financing bonds and moves to end the dependency on special deficit-financing bonds; and (3) a renewed dependency on special deficit-financing bonds (Figure 4).

Figure 4: Government bond issuance and main government debt management policies



Notes: 1. Issuance amounts are on a proceeds basis. Figures are actual through fiscal-year 2010, include the fourth supplementary budget for fiscal-year 2011, and for the initial budget for fiscal-year 2012. However, since the reconstruction bonds due to be issued in fiscal-year 2011 were due to be issued on the general account, total issuance of construction bonds, special deficit-financing bonds, and reconstruction bonds has been used as the figure for new financial resources bonds in fiscal-year 2011.

2. Treated the government bonds issued to cover the shortfall in revenues in fiscal-year 1965 as special deficit-financing bonds.

3. Bond dependency ratio = new public bond issuance/general account expenditures. Figures are actual through fiscal-year 2010, include the fourth supplementary budget for fiscal-year 2011, and are for the initial budget for fiscal-year 2012.

Source: Nomura Institute of Capital Markets Research, based on Ministry of Finance, Financial Bureau, *Debt Management Report 2012: The Government Debt Management and the State of Public Debt)*, 2012, pp.102 and 133. (http://www.mof.go.jp/english/jgbs/publication/debt_management_report/2012/)

1. Period from the passing of Article 4 of the *Public Finance Law* to the issuance of construction bonds

Previous studies revealed that when Japan legislated Japan's *Public Finance Law* in 1947, fiscal management and the dual budgeting system in Sweden had been referred as a model case[4]. The Swedish case influenced Japan, largely because the country has avoided war for more than 100 years and has consistently adhered to sound fiscal policies. Specifically, Sweden has government agencies and that fiscal policy has adhered to the principles that government should borrow only for productive purposes and that current expenditures, including non-profitable annual investment expenditures, should be financed by means of current revenues, thereby enabling the country to remain on a sound fiscal profile[5].

When the Public Finance Law was enacted in 1947, the government seemed to define "public works expenditures" in the proviso to Article 4, Paragraph 1 of the Law

[4] Iwanami, Kazuhiro, "*Kousai Seisaku to Zaiseihou Dai4jou*," (Public Bond Policy and Article 4 of the Public Finance Law), Keizai Gakuronsan, Vol. 32, Nos. 1 & 2 (double issue), Chuo University, March 1991, p. 94 (in Japanese).

[5] Iwanami, Kazuhiro, "*Kousai Seisaku to Zaiseihou Dai4jou*," (Public Bond Policy and Article 4 of the Public Finance Law), Keizai Gakuronsan, Vol. 32, Nos. 1 & 2 (double issue), Chuo University, March 1991, p. 94 (in Japanese).

not in the broad sense of public works investment but in a more narrow sense, namely that of "recoverable" investment[6]. During the 20 years from fiscal-year 1945 to fiscal-year 1964, the government did not issue government bonds and enjoyed a balanced budget. However, the recession of 1964 was caused by surplus capital stock and overproduction resulting from a surge in capital investment during Japan's period of rapid economic growth in the late 1950s and early 1960s. Seen by both government and industry as the country's most serious structural recession since the Second World War, the government's response was to try to stimulate the economy by increasing investment in public works and funding the increase by issuing government bonds[7]. As a result, in its supplementary budget of fiscal-year 1965 the Sato Cabinet (at that time) became the first in the post-war period to issue government bonds to finance a deficit.

The following year (fiscal-year 1966) construction bond issuance started in full swing. The then finance minister (at that time), Takeo Fukuda, justified the issuance of government bonds in fiscal-year 1966 by mentioning that in fiscal-year 1965 the government had issued public bonds as an emergency measure to deal with an exceptional situation and that this was therefore in accordance with the proviso to Article 4, Paragraph 1 of the *Public Finance Law 1947*. Furthermore, he explained that the government had decided to issue public bonds from fiscal-year 1966 onwards to reverse the deterioration in the country's fiscal position and that this was something it had been considering for some time[8]. As a result, the government began to issue construction bonds regularly in fiscal-year 1966 on the basis of the proviso to Article 4, Paragraph 1 of the *Public Finance Law*.

2. The issuance of special deficit-financing bonds and moves to exit from the dependency on special deficit-financing bonds

Once the government began issuing construction bonds, it made repeated efforts, helped by an increase in tax revenues generated by a revival in economic growth, to

6 For example, during the House of Representatives' debate on the *Public Finance Bill* in March 1947, the government delegate, Uichi Noda, gave the following explanation of Article 4 of the Act: "The first basic principle of fiscal procedure is fiscal propriety—not having to depend on revenue from debt issuance or borrowing. This is the principle that has been established. So long as this principle is adhered to, public bonds may be issued for the purpose and in the amount permitted. For example, public works or direct investments and loans that will be repaid and not simply spent. In other words, used productively or for capital expenditure. That is what the wording "public works expenses, disbursements and loans" means, and these are the purposes for which public bonds may be issued." (Source: Ministry of Finance, Budget Bureau, Legal Section, "Shouwa40nendo Hosei Yosan ni Okeru Kousai Hakkou ni Kansuru Kiroku," (Record of the Issue of Public Bonds as Part of the Fiscal-year 1965 Supplementary Budget), Part 2, 1966, p. 12) (in Japanese)).

7 Iwanami, Kazuhiro, "*Kousai Seisaku to Zaiseihou Dai4jou*," (Public Bond Policy and Article 4 of the Public Finance Law), Keizai Gakuronsan, Vol. 32, Nos. 1&2 (double issue), Chuo University, March 1991, p. 96 (in Japanese).

8 51st Session of the Diet, Finance Committee, No. 9 (15 February 1966) (Source: National Diet Library, Diet Proceedings Search Engine) (in Japanese).

reduce its bond dependency ratio[9]. However, tax revenues fell sharply after the First Oil Crisis of 1973, when economic growth stalled again. As a result, the government found itself obliged to issue more government bonds than permitted under Article 4 of the *Public Finance Law 1947* and had a special deficit-financing bond act passed by the Diet in fiscal-year 1975 to allow it to do this. Special deficit-financing bonds were then issued regularly every year after that, with construction bonds issued up to the permitted limit and special deficit-financing bonds issued to cover any shortfall[10].

It was against this background that moves were made to end this dependency and revert to the principle of fiscal propriety laid out in Article 4 of the *Public Finance Law 1947*.[11] Initially, in fiscal-year 1976, fiscal-year 1980 was set as the target year, and repeated efforts were made to reduce government expenditures. However, having committed Japan at the Bonn Summit of July 1978 to a growth rate of 7%, the government ended up issuing large amounts of special deficit-financing bonds to stimulate economic growth[12]. As a result, and with its bond dependency ratio rising, the government set a new target year of fiscal-year 1984 for ending this dependency.

However, it failed to achieve this objective as a result of a decline in tax revenue following an economic slowdown and its decision not to introduce a consumption tax as planned[13]. As a result, the government postponed its deadline for ending its dependency on special deficit-financing bonds yet again, to fiscal-year 1990.

In addition, in fiscal-year 1984, the rules governing special deficit-financing bonds were amended to extend their maturity. At present, all construction and special deficit-financing bonds, including refinancing bonds, are due to be redeemed within 60 years[14]. Initially, however, the view was that, since special deficit-financing bonds are used to finance current expenditures and therefore have no assets to match, they should not be redeemed by issuing refinancing bonds. However, as the fiscal-year

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9 Ministry of Finance, Financial Bureau*, Debt Management Report 2012: The Government Debt Management and the State of Public Debt)*, 2012, p. 133. (http://www.mof.go.jp/english/jgbs/publication/debt_management_report/2012/)

10 Nakajima, Masataka, "*Nihon no Kokusai wa Hontou ni Daijoubu ka*," (Are Japanese Government Bonds Really Sound?), Shouken Rebyuu, Vol. 4, No. 2011, Japan Securities Research Institute, April 2011, p. 3 (in Japanese).

11 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, pp. 67–68 (in Japanese).

12 Iwanami, Kazuhiro, "*Kousai Seisaku to Zaiseihou Dai4jou*," (Public Bond Policy and Article 4 of the Public Finance Law), Keizai Gakuronsan, Vol. 32, Nos. 1 & 2 (double issue), Chuo University, March 1991, p. 102 (in Japanese).

13 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 68 (in Japanese).

14 The rule stands on the fact that the average economic depreciation period of the assets purchased by the construction bonds is about 60 years. Deriving from this rule is the 1.6% ratio for fixed-rate transfer for each fiscal year, which is about equivalent to one-sixtieth. (Source: Ministry of Finance, *Financial Bureau, Debt Management Report 2012: The Government Debt Management and the State of Public Debt)*, 2012, p. 63. (http://www.mof.go.jp/english/jgbs/publication/debt_management_report/2012/))

1985 deadline for redeeming the special deficit-financing bonds issued since fiscal-year 1975 approached, the view gained ground that the country's fiscal position would make it difficult to redeem all of the bonds in cash. As such, it was decided in fiscal-year 1984 to amend the rules governing special deficit-financing bonds to allow them also to be redeemed by issuing refinancing bonds[15]. However, because of the view that special deficit-financing bonds, which have no assets to match, should be redeemed as soon as possible, annual special deficit-financing bond acts contain a provision to this effect.

The fiscal-year 1990 deadline for ending the dependency on special deficit-financing bonds was met by the initial budget for fiscal-year 1990. This was thanks mainly to the increased tax revenues generated by the asset boom of the late 1980s[16]. However, because of the decision to issue approximately ¥1 trillion in emergency special deficit-financing bonds as part of the supplementary budget for fiscal-year 1990 to help fund the peace-keeping operations during the Gulf War, the government failed to end its dependency on special deficit-financing bonds that year. Between fiscal-year 1991 and fiscal-year 1993, however, the government issued no special deficit-financing bonds, thereby achieving its objective.

3. A renewed dependency on special deficit-financing bonds

The government's ability to supple revenues without issuing special deficit-financing bonds lasted only these three years, partly as a result of the Kobe earthquake, which occurred in January 1995. In fiscal-year 1994 the government resumed issuing special deficit-financing bonds, starting with an issue to fund reconstruction after the Great Hanshin-Awaji Earthquake and an issue to cover a shortfall in tax revenues as a result of an income tax cut to revive the economy, and continued to issue them every year until the initial budget for fiscal-year 2012.

Yet, during this period, there was an effort by Hashimoto Cabinet (at that time) through the *Fiscal Structure Reform Law*, enacted in November 1997 to end its dependency on special deficit-financing bonds. Recognizing the government's responsibility to implement structural reforms of Japan's fiscal system, the *Fiscal Structure Reform Law* set out three near-term objectives: (1) to reduce the fiscal deficits of central and local government to not more than 3% of GDP by fiscal-year

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15 Misumi, Masakatsu, "*Yosan Henseishi ni Miru 'Zaisei Kiritsu no Paradokkusu'—Kibishii Zaisei Mokuhyou o Haikei ni Jisshi Sareta Kaikeijou no Tokurei Sochi*," (The Paradox of Fiscal Discipline as Revealed by the History of the Budget Process: Exceptional Accounting Measures as a Result of Strict Fiscal Targets), Keizai no Prizumu, No. 101, Secretariat of the House of Councilors, June 2012, p. 11 (in Japanese).

16 The elasticity of tax revenue (the rate of increase in general account tax and stamp duty revenue in proportion to the rate of increase in GDP) averaged roughly 1.1 in fiscal-year 1975–1985 but increased to 3.33 in fiscal-year 1987. (Source: Tanaka, Hideaki, "*Zaisei Ruuru-Mokuhyou to Yosan Manejimento no Kaikaku—Shogaikoku no Keiken to Wagakuni no Kadai*," (Fiscal Rules/Targets and the Reform of Budget Management: the Experience of Other Countries and the Challenges Facing Japan), RIETI Discussion Paper Series 04-J-014, Japan's Research Institute of Economy, Trade and Industry, March 2004, p. 64 (in Japanese))

2003; (2) to reduce the issuance of special deficit-financing bonds each year and to zero by fiscal-year 2003; and (3) to reduce the government's bond dependency ratio in fiscal-year 2003 to below the level of fiscal-year 1997. However, the passing of this law coincided with a sharp recession in Japan, which saw the collapse of a number of Japanese financial institutions, and the Asian Currency Crisis. As the law did not provide the government the flexibility to take action to stimulate the economy, it was amended to allow the government to do this. Specifically, a provision that allowed to make temporarily exemption of the law's requirement that it gradually reduce the issuance of special deficit-financing bonds each year, was added in 1998. In addition, the law was amended to defer the deadline for reducing the fiscal deficit as a percentage of GDP and ending the government's dependency on special deficit-financing bonds from fiscal-year 2003 to fiscal-year 2005.

Following a change of Cabinet from Hashimoto to Obuchi in July 1998, the Obuchi Cabinet announced an emergency economic package in November 1998 and submitted a bill, passed in December 1998, to suspend most of the provisions of the *Fiscal Structure Reform Law*.

As the issuance of government bonds continued to increase, the government's bond dependency ratio topped the 50% mark for the first time in the budget for fiscal-year 2009, revealing the seriousness of Japan's fiscal position. In response to this situation, the government issued a *Fiscal Management Strategy*[17] in June 2010 which set central and local governments the task of restoring fiscal propriety (e.g., by reducing the level of their debt as a percentage of GDP). This document sets out a medium-term policy framework for (1) controlling the issuance of government bonds, (2) radically reforming the tax system, and (3) improving Japan's primary balance. The framework, which is reviewed on a rolling basis every year, sets out general rules governing expenditure for the next three years. The latest version (published in August 2012[18]) states that the government will strive to keep public bond issuance (excluding the issuance of public bonds, such as those issued to fund extra pension costs, whose redemption will be funded by revenue specified elsewhere) within the amount allocated in the initial budget for fiscal-year 2012 (approximately ¥44 trillion) in fiscal-year 2013.

IV. Focal points of the Act

The two focal points of the *Special Deficit-Financing Bond Act 2012* revolve around (1) striking a balance between the Act and the principle that budgets are set for one fiscal year at a time, and (2) the significance and challenge of the construction bond rule.

17 Cabinet Decision " Fiscal Management Strategy," 22 June 2010.

18 Cabinet Decision "Medium-term Fiscal Framework (fiscal-year 2013–2015)," 31 August 2012.

1. Striking a balance between the Act and the principle that budgets are set for one fiscal year at a time

Japan's constitution gives the government the right to set the budget[19]. However, it requires the government to seek the approval of the Diet each fiscal year for the budget to be implemented[20]. In addition, under the principle of annuality, all expenditures in a given fiscal year must be covered by the revenues for that fiscal year. This principle ensures that expenditures for the current fiscal year is not influenced by the prospect of an increase in revenues the next fiscal year and that budgets are balanced. This is essential if fiscal propriety is to be maintained. However, exceptions such as the following are permitted: (1) the carrying forward of the expenditure budget (the approved carrying forward of expenditures to the following fiscal year and the carrying forward of amounts unspent as a result of unavoidable circumstances to the following fiscal year), and (2) the treatment of expenditures and revenues from past years as expenditures and revenues for the current fiscal year.

It has been suggested in the course of the Diet session related to the Act that the connection with the principle that budgets are set for one fiscal year at a time could be problematic. During the session, however, the view was expressed that the cap on the issuance of special deficit-financing bonds each fiscal year was stipulated in the general provisions of each annual budget and subject to approval by the Diet, and was therefore unlikely to be contradicted, while the existence of past cases was also pointed out (Figure 5).

2. The significance and challenge of the construction bond rule

The Act will allow special deficit-financing bonds, the proceeds of which are used to finance current expenses, to be issued every fiscal year until fiscal-year 2015 without the need for annual legislation. However, it has been said that, when Japan began to issue special deficit-financing bonds on a large scale in fiscal-year 1975 for the first time since the Second World War, the principle of matching expenditures and revenues incorporated in Article 4, Paragraph 1 of the *Public Finance Law 1947* and designed to control the issue of government bonds was lost. It has even been mentioned that the proviso to Article 4, Paragraph 1 controlling the issue of government bonds was actually ambiguous[21].

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19 Constitution of Japan, Article 73, Paragraph 5.
20 Constitution of Japan, Article 86.
21 Iwanami, Kazuhiro, "*Kousai Seisaku to Zaiseihou Dai4jou*," (Public Bond Policy and Article 4 of the Public Finance Law), Keizai Gakuronsan, Vol. 32, Nos. 1 & 2 (double issue), Chuo University, March 1991, p. 100 (in Japanese).

Figure 5: Main government responses in the Diet concerning striking a balance between the *Special Deficit-Financing Bond Act 2012* and Article 86 of Japan's constitution (extracts)

181st Session, House of Representatives, Finance Committee, No. 4 (14 November 2012)

○Koriki Jojima (government minister): As far as the first point (the connection with Article 86 of the Constitution) is concerned, I don't think there would be any conflict with the requirement in Article 86 of the Constitution that budgets be set for one fiscal year at a time since the amendments to the current bill also envisage limiting the amount of special deficit-financing bonds that could be issued each fiscal year by incorporating a provision in the general budget provisions that would have to be approved by the Diet.

181st Session, House of Councilors, Financial Affairs Committee, No. 1 (15 November 2012)

○Representative (Seiichiro Dokyu): I think the honorable member is concerned about the requirement in Article 86 of the Constitution that budgets be approved for one fiscal year at a time and whether it will be possible to maintain fiscal discipline.

First, let me address whether the bill is compatible with this requirement. For one thing, the *Special Deficit-Financing Bond Bill* stipulates that annual budgets must contain a provision on the amount of special deficit-financing bonds the government intends to issue in their general provisions and that this must be approved by the Diet. For another, I don't think that there is any constitutional problem since the current amendment to the Bill also requires that annual budgets contain a provision on the amount of special deficit-financing bonds the government intends to issue in their general provisions and that this be approved by the Diet, so it is clear that it will act as a robust annual check. Furthermore, as regards the honorable member's concern about allowing such matters to be decided for several fiscal years in a row at some point in the future, we intend to continue to strive to achieve our existing fiscal targets to ensure that fiscal discipline is maintained and the primary deficit halved as a percentage of GDP. Also, I think that, as we hope that Article 3 as amended will enable us to establish a sustainable fiscal structure in the longer term, we will succeed in controlling the issuance of special deficit-financing bonds and ensuring that it is not abused.

○Representative (Naokazu Takemoto): The view of the LDP is, of course, essentially the same as that expressed by the honorable member. Although there is concern that what is proposed will be inconsistent with an annual budget system, the fact that the proposed issuance amount will be incorporated in the general budget provisions every year will ensure that there is no abuse. (omitted)

○Government delegate (Tsuneyuki Yamamoto): Let me reply. The bill now being debated provides for special deficit-financing bonds, themselves an exception to Article 4 of the *Public Finance Law 1947*, to be issued over several fiscal years by way of exception. The issuance limit for each fiscal year would be incorporated every year in the budget's general provisions and would require the Diet's approval. I therefore see no particular reason for any constitutional problem, especially with regard to Article 86. In fact, there are two precedents.

The first was an act allowing the issuance of special deficit-financing bonds from fiscal-year 1994 to 1996 to offset a loss of tax revenue as a result of the implementation of the *Income Tax Act* and amendments to the *Consumption Tax Act* in 1994. The second was an exceptional provision to issue public bonds over a number of fiscal years contained in the *Special Measures Law of 2011* to secure the funding needed to implement policies to enable Japan to recover from the earthquake and tsunami of March 2011. (omitted)

Source: Nomura Institute of Capital Markets Research, based on National Diet Library, Diet Proceedings Search Engine

Concerns that the government was deviating increasingly from the construction bond rule of Article 4 of the *Public Finance Law 1947* were also voiced during the Diet debate on the *Special Deficit-Financing Bond Act 2012*. In response, the government argued (1) that it had no alternative but to continue to issue special deficit-financing bonds and that, even if a budget was passed, it was possible for a special deficit-financing bond act to be rejected, causing problems for local governments and citizens, and (2) that, although the Diet had permitted special deficit-financing bonds to be issued for more than one year, the legislation had been drawn up to allow the Diet to deal with the budget and special deficit-financing bonds at the same time as well as to ensure fiscal propriety (Figure 6).

Figure 6: Main government responses in the Diet concerning striking a balance between the *Special Deficit-Financing Bond Act 2012* and Article 4 of Japan's Constitution (extracts)

181st Session, House of Representatives, Finance Committee, No. 4 (14 November 2012)

○Koriki Jojima (government minister): (omitted) As far as the point made by the honorable member and the connection with Article 4 of the *Public Finance Law 1947* are concerned, it would be extremely difficult under the current straitened fiscal circumstances for the government to manage the country's finances without issuing other bonds besides construction bonds. We have therefore submitted the bill in order to be allowed to issue special deficit-financing bonds as an exception to Article 4, Paragraph 1 of the *Public Finance Law 1947*.

○Yoshihiko Noda (prime minister): (omitted) Unfortunately, the need to issue special deficit-financing bonds, which used to be an annual exception, has now become a permanent exception. Furthermore, these bonds now account for 40% of the general account budget.

Whoever forms the next government will have to rely on special deficit-financing bonds for the time being. While we must, of course, do all we can to keep that amount under control, the permanent nature of the current situation, unfortunately, means that, even if the budget is passed, it is very difficult to get the legislation through to fund it by issuing special deficit-financing bonds. This is also true of the current bill. As a result, there will inevitably be a negative impact on people's lives, including local bodies.

In order to overcome these problems, our fiscal management strategy has set itself the goal of returning the primary balance to surplus over the next 10 years and of halving the ratio of the primary deficit to GDP by 2015. In order to implement this policy and deal with deficit financing and the budget in a single package while maintaining fiscal discipline, we have put forward this proposal in the form of a private member's bill and are fully aware of the need to maintain fiscal discipline.

181st Session, House of Representatives, plenary session, No. 5 (15 November 2012)

○Representative (Takeshi Saiki): Takeshi Saiki, DPJ.

(omitted) It's now eight months since the budget for fiscal-year 2012 was passed. Hard though it may be to believe, the question of how to fund the budget is still unresolved even though 2012 is nearly over. Unable to fully implement their budgets, many local authorities have had to borrow in order to make ends meet.

We cannot continue to allow the passage of the bill to be used any more as a means of destabilizing the government. People's lives are being affected. I think the fact that we are voting on the bill today reflects the fact that many members of the House share this sense of crisis. (omitted)

I welcome the agreement that has been reached between the DPJ, the LDP and New Komeito on the issuance of special deficit-financing bonds.

These days Japan's public finances cannot do without issuing public bonds. This is a fact of life, no matter which political party is in government.

The agreement on the issuance of special deficit-financing bonds over the next three years is therefore a declaration by both government and opposition that their priority is national stability and that they will refrain from using the issuance of public bonds as a political football. I welcome this as a first step in dealing with the continuing deadlock in the Diet and ensuring that decisions that have to be taken are taken.

That said, we cannot allow endless amounts of public bonds to be issued, inflating the national debt even further.

The issuance of special deficit-financing bonds remains an exception to the *Public Finance Law 1947*, especially to Article 4 of that act; and, as members of the Diet, we cannot sit idly by while the national debt grows, simply because an agreement has been reached that covers several years. In order to maintain fiscal discipline, we need to remain alert, continue to monitor the country's fiscal position carefully, debate budgets properly, and approve the necessary funding as part of the budget package.

We must also ensure that the agreement to issue special deficit-financing bonds over several years is not seen as abandoning the attempt to achieve fiscal propriety.

It remains the DPJ government's objective to halve the ratio of Japan's primary deficit to GDP from its level in fiscal-year 2010 by fiscal-year 2015 and to return the primary balance to surplus by fiscal-year 2020. I am also aware that the LDP had a similarly objective when it submitted its *Fiscal Soundness Bill*.

I feel it is the government's duty to maintain strict fiscal management in order to achieve fiscal soundness and ensure that securing a stable source of funding for budgets does not lead to a lapse of fiscal propriety. (omitted)

Source: Nomura Institute of Capital Markets Research, based on National Diet Library, Diet Proceedings Search Engine

V. The treatment of government bonds in other countries—towards enhancement of fiscal discipline from the construction bond rule

Government bonds are treated differently overseas. Some countries do not differentiate the treatment between construction bonds and special deficit-financing bonds as in Japan. One of the members of an ad hoc House of Representatives' committee on fiscal structure reform mentioned at a meeting of the committee in October 1997 that, as far as he knew, Japan and Germany were the only countries that distinguished between construction bonds and special deficit-financing bonds and that, although the distinction was well established in Japan, it was time to reconsider it. He explains that it was misguided to treat that construction bonds were automatically fine and special deficit-financing bonds automatically not fine and that it would be better to abolish the distinction and debate the pros and cons of fiscal deficits and the national debt as a whole[22].

Furthermore, at a meeting of a House of Representatives' monetary and financial committee in November 2012, one of the committee members pointed out that Japan was probably the only country that required its parliament to approve the issue of special deficit-financing bonds separately from the budget. In reply it was said that in all the other member countries of the G5 (namely, the US, the UK, Germany and France) the funding of a budget would be automatically approved if the budget itself was approved and that, even if parliament was divided, they all had bicameral systems that were designed to allow a budget to be passed[23].

In modern times, two countries that tend to be given as examples of countries that have advocated the construction bond rule are Germany and the UK. In Germany the construction bond rule was set out in the previous version of Article 115 of the *Basic Law*, while in the UK it was set out as the "Golden Rule" by the Blair government in 1998[24]. However, as both countries now have different fiscal management systems, we will trace how this came about.

1. Amendments to Germany's *Basic Law*

When Germany's constitution, the *Basic Law*, was originally enacted, there was no provision (in the original version of Article 115) for the state to borrow. In 1969, however, the original version of Article 115 was amended, in the belief that the state should be allowed to issue special deficit-financing bonds to undertake public works investment during recessions, (1) to allow the state to generate revenues by borrowing

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22 141st Session of the Diet, Ad Hoc House of Representatives' Committee on Fiscal Structure Reform, No. 11 (30 October 1997) (in Japanese). (Source: National Diet Library, Diet Proceedings Search Engine)

23 181st Session of the Diet, Finance Committee, No. 2 (7 November 2012) (in Japanese). (Source: National Diet Library, Diet Proceedings Search Engine)

24 Ehiro, Akira, "*Kousai to Kousai Kanri Seisaku*," (Public Bonds and Public Debt Management Policy), in Kanazawa, Fumio (ed.), "Zaiseigaku Shohan Dai5satsu," (Public Finance, 1st edition, 5th imprint), Yuhikaku, 2011, p. 141-142 (in Japanese).

(previous version of Article 115, Paragraph 1) and (2) to set spending on public works investment as a cap on revenues generated by borrowing, in the belief that some sort of cap on the issuance of special deficit-financing bonds was necessary (previous version of Article 115, Paragraph 1, Clause 2)[25]. The section of the previous version of Article 115, Paragraph 1, Clause 2 that stated that "revenues generated by borrowing must not exceed the budget estimate of gross investment, with exceptions permitted only to prevent disruption to the economy as a whole" corresponded to the construction bond rule.

However, because the *Basic Law*'s previous provisions on fiscal propriety were considered to have failed to prevent the growth of a massive fiscal deficit over recent decades[26], they were amended and the amendments enacted in August 2009[27]. In particular, Article 109, which governs how the Federation and the Länder manage their budgets, and Article 115, which governs borrowing by the Federation on the basis of Article 109, were amended, and a new article (Article 143d), intended as an interim measure until 2020, was added[28].

As amended, Article 109, Paragraph 3 states (1) that, as a rule, federal and Land budgets should be balanced without having to raise revenues by borrowing (Clause 1), (2) that, by way of exception, the Federation and the Länder should be allowed to make exceptional provisions to reflect the economic situation during both booms and busts as well as in emergencies such as natural disasters and situations that threaten to

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[25] Europe/Russia/CIS section of JETRO's Düsseldorf office, "*Doitsu-Suisu no Saimu Bureeki Seido to EFSF Kakujuu ni Kansuru Doitsu Hoshou Hikiukehou Kaisei*," (The Balanced Budget Amendments in Germany and Switzerland, and Germany's Amendments to its Euro Stabilization Mechanism Act), 10 February 2012, pp. 4–5 (in Japanese).

[26] In particular, the previous provisions were seen to have a number of shortcomings, including the following: (1) the concept of "investment" in the previous version of Article 115, Paragraph 1, Clause 2 of the *Basic Law*, which deals with borrowing by the Federation (and is therefore the German equivalent of the construction bond rule), was seen as an inadequate standard for judging "increases in macroeconomic value"; (2) the existence of too many general exceptions in the event of economic difficulties; (3) a lack of coordination in enforcing discipline in both compiling and implementing budgets; and (4) a lack of a clear requirement to offset additional deficits resulting from action "to prevent damage to the economy as a whole" during recessions (previous version of Article 109, Paragraph 4) by surpluses during expansions. (Source: Yamaguchi, Kazuto, "*Doitsu no Dainiji Renpousei Kaikaku (Renpou to Shuu no Zaisei Kankei) (1) Kihonhou no Kaisei*," (Second Stage of the Reform of Germany's Federal System (Fiscal Relations between Federation and Länder) (1) Amendments to the Basic Law), Gaikoku no Rippo, No. 243, National Diet Library, Research and Legislative Reference Bureau, March 2010, pp. 6–7 (in Japanese))

[27] Yamaguchi, Kazuto, "*Doitsu no Dainiji Renpousei Kaikaku (Renpou to Shuu no Zaisei Kankei) (1) Kihonhou no Kaisei*," (Second Stage of the Reform of Germany's Federal System (Fiscal Relations between Federation and Länder) (1) Amendments to the Basic Law), Gaikoku no Rippo, No. 243, National Diet Library, Research and Legislative Reference Bureau, March 2010, pp. 3 and 6 (in Japanese).

[28] The new provision is due to come into effect in fiscal-year 2011. However, the provision limiting revenue from borrowing to 0.35% of GDP is not due to come into effect until 2016, while that forbidding Länder from borrowing is not due to come into effect until 2020. (Source: Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 75 (in Japanese))

get out of control and to severely damage the country's finances (Clause 2). In addition, it states (3) that provision must be made to repay the sums spent on the aforementioned exceptional provisions (Clause 3). In addition, with regard to the federal budget, the principle stated in Clause 1 was deemed to have been observed if the ratio of revenue raised by borrowing to GDP did not exceed 0.35%, while the exceptions allowed in Clause 2 and detailed provisions on fiscal propriety were inserted as Article 115, Paragraph 2, etc (Clause 4). With regard to Land budgets, however, only the natural disasters stated in Clause 2 were allowed as exceptions.

As far as Article 115 is concerned, the construction bond rule stated in the previous version of Article 115, Paragraph 1, Clause 2 and the provisions of Clause 3[29] were deleted and more stringent provisions inserted as Paragraph 2 in their place. More specifically Paragraph 2 (1) restates the principles of Article 109 (Clauses 1–3), (2) stipulates that any amount exceeding the cap on the borrowing allowed by the principles must be recorded in a control account and eliminated if the cumulative deficit exceeds 1.5% of nominal GDP, depending on the economic situation (Clause 4), (3) requires that detailed provisions for this be made in federal law (Clause 5), (4) allows for the cap on how much may be borrowed in emergencies such as natural disasters and situations that threaten to get of control and to severely damage the country's finances to be exceeded if this is approved by a majority in the Federal parliament (Clause 6), (5) requires that such an approval include a repayment plan (Clause 7), and (6) requires that the debt assumed under the provisions of Clause 6 be repaid within a reasonable time (Clause 8).

According to Kazuto Yamaguchi (Yamaguchi: 2010), the existing provisions on Federal borrowing were abolished and replaced by more stringent provisions based on the balanced budget principle, however it still allowed the government a certain degree of discretion in how much it borrowed[30].

The Europe/Russia/CIS section of JETRO's Düsseldorf office (JETRO: 2012) sees three implications for the requirement to record any amount exceeding the cyclically adjusted cap on borrowing in a control account[31]: (1) an ex post facto check function (because experience shows that, when a budget is implemented, the result can be different from what was planned and approved, just as actual GDP can be different from forecast GDP), (2) the ability to do calculations spanning more than one fiscal year (because, although the cap applies to single fiscal years, a control account allows one to calculate the extent to which cumulative debt has changed), and an incentive to observe fiscal propriety (because, whereas reducing cumulative debt in a single fiscal year gives the control account greater capacity to deal with future spending,

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29 The rule permits borrowing by means of special assets as an exception.

30 Yamaguchi, Kazuto, "*Doitsu no Dainiji Renpousei Kaikaku (Renpou to Shuu no Zaisei Kankei) (1) Kihonhou no Kaisei*," (Second Stage of the Reform of Germany's Federal System (Fiscal Relations between Federation and Länder) (1) Amendments to the Basic Law), Gaikoku no Rippo, No. 243, National Diet Library, Research and Legislative Reference Bureau, March 2010, p. 8 (in Japanese).

31 Europe/Russia/CIS section of JETRO's Düsseldorf office, "*Doitsu-Suisu no Saimu Bureeki Seido to EFSF Kakujuu ni Kansuru Doitsu Hoshou Hikiukehou Kaisei*," (The Balanced Budget Amendments in Germany and Switzerland, and Germany's Amendments to its Euro Stabilization Mechanism Act), 10 February 2012, pp. 10–11 (in Japanese).

increasing cumulative debt in a single fiscal year reduces that capacity, making it more likely that future budgets will be subject to severe constitutional and legal constraints, and giving those involved in approving a budget an incentive to observe fiscal propriety).

In summary, the amendments to Germany's *Basic Law* led to stricter fiscal controls in the form of (1) a rule that revenues from public bond issuance by the federal government should not, in general, exceed 0.35% of nominal GDP, although the construction bond rule was abolished, and (2) a rule that any amount exceeding the cap on the borrowing allowed by the principles must be recorded in a control account and eliminated if the cumulative deficit exceeds 1.5% of nominal GDP, depending on the economic situation.

2. The UK's Fiscal *Responsibility Act 2010* and *Charter for Budget Responsibility*

In the UK, under the *Finance Act 1998* and the *Code for Fiscal Stability*,[32] the government laid down (1) a "Golden Rule" (restricting government borrowing during a business cycle to investment and forbidding borrowing to pay for current expenditures) and (2) a "Sustainability Rule" (requiring the government to stabilize the ratio of government debt to GDP at a prudent level).[33]

However, following the subprime mortgage crisis in the US, many UK financial institutions found themselves in serious difficulty. In 2008, two housing finance-related institutions (Northern Rock and Bradford & Bingley) were nationalized, while three major banks received injections of public funds (totaling some £37 billion) and a credit guarantee scheme was introduced to guarantee bank debt.

During this period, the Golden Rule and Sustainability Rule were temporarily suspended[34].

Then, in February 2010, a new fiscal code (the *Fiscal Responsibility Act 2010*) was adopted. This act sought to ensure sound fiscal policy by requiring the government to

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32 Based on the *Finance Act 1998*, this lays down the rules for fiscal management.

33 Matsuura, Shigeru, "*Igirisu oyobi Furansu no Yosan-Kessan Seido*," (The Budgetary and Accounting Systems of the UK and France), Reference, Vol. 58, No. 5, National Diet Library, Research and Legislative Reference Bureau, May 2008, pp. 112–113 (in Japanese); Kondo, Toshiyuki, "Seiken Koutaigo no Eikoku no Keizai, Zaisei Un'ei ni Tsuite—Hoshu-Jimin Renritsu Seiken ni Yoru Aratana Yosan o Chuushin ni," (Great Britain's Economy and Public Finances since the Election: Focus on New Coalition Budget), Keizai no Purizumu, No. 81, Secretariat of the House of Councilors, August 2010, pp. 2–3 (in Japanese).

34 The Sustainability Rule required the government to maintain the ratio of net public debt to GDP at not more than 40% throughout the business cycle. However, in October 2008, the ratio rose to 42.9%. According to the UK Office for National Statistics, the ratio would probably have been 37.8% had it not been for the cost of nationalizing Northern Rock. This highlights the impact of the costs of dealing with the financial crisis on the UK's public finances. (Source: Cabinet Office, Director General for Economic and Fiscal Management, "*Sekai Keizai no Chouryuu 2008nen II—Sekai Kin'yuu Kiki to Kongo no Sekai Keizai*," (Global Economic Trends 2008 II: Global Financial Crisis and Future of Global Economy), December 2008; Ministry of Finance, "Nihon no Zaisei Kankei Shiryou," (Documents on Japanese Fiscal Policy), 2009, p. 14)

obtain parliamentary approval for its spending plans and to stick to those plans. Under the first of these plans (a "fiscal consolidation plan"), the government set itself the targets of (1) halving the ratio of the public sector fiscal deficit to GDP between fiscal-year 2009 and fiscal-year 2013, (2) reducing the ratio of the fiscal deficit to GDP every year from fiscal-year 2009 to fiscal-year 2015, and (3) placing the ratio of net public sector debt to GDP on a declining trajectory by fiscal-year 2015[35].

Shortly afterwards, in May 2010, a general election brought a change of the government, with the Conservative and Liberal Democrat parties forming a coalition. Then, in 2011, the *Budget Responsibility and National Audit Act 2011* was enacted by the new government in response to popular dissatisfaction with the recession triggered by the global financial crisis and in an attempt to adopt a different approach to fiscal consolidation from that of the previous government. This act then formed the basis for the *Charter for Budget Responsibility*, which laid out a new framework for fiscal policy and public debt management[36].

The charter set various objectives for fiscal policy, including (1) maintaining economic confidence, pursuing sustainable fiscal policies that ensured intergenerational equality, and ensuring the effectiveness of a wide range of government policies, and (2) maintaining and increasing the effectiveness of monetary policies designed to reduce economic volatility. In addition, in order to achieve these fiscal objectives, the charter advocated measures such as (1) eliminating the public sector (general government and state-owned company) cyclically adjusted current budget deficit[37] by the end of the rolling, five-year forecast period and (2) reducing (the ratio of) net public sector debt (to GDP) by fiscal-year 2015[38]. Also, the charter served as the basis for the *Financial Statement and Budget Report* which the UK Treasury is now required to submit to parliament and which sets out total planned public sector spending during the forecast period[39].

In summary, following the financial crisis, fiscal discipline was enacted in the UK (e.g., in the form of reducing net public sector debt), even though the Golden Rule corresponding to Japan's construction bond rule was suspended, by means of the previous government's *Fiscal Responsibility Act 2010* and the present government's

35 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 76 (in Japanese).

36 Azuma, Nobuo, "*Igirisu ni Okeru Hasseishugi Zaimujouhou no Katsuyou Joukyou—Zaisei Tousei ni Shouten o Atete*," (The Use of Accrual Basis Financial Information in the UK: Spotlight on Financial Governance), Kaikei Kensa Kenkyu, No. 45, Board of Audit of Japan, March 2012, pp. 161 and 169 (in Japanese).

37 The cyclically adjusted current balance (or structural balance) is derived by excluding the impact of the business cycle on the current balance, itself derived by deducting current expenditure (less expenditure on capital such as public works) from current revenue such as tax revenues.

38 Ministry of Finance, "*Nihon no Zaisei Kankei Shiryou*," (Documents on Japanese Fiscal Policy), September 2012, p. 36.

39 Azuma, Nobuo, "*Igirisu ni Okeru Hasseishugi Zaimujouhou no Katsuyou Joukyou—Zaisei Tousei ni Shouten o Atete*," (The Use of Accrual Basis Financial Information in the UK: Spotlight on Financial Governance), Kaikei Kensa Kenkyu, No. 45, Board of Audit of Japan, March 2012, p. 169 (in Japanese).

Charter for Budget Responsibility, which is based on its *Budget Responsibility and National Audit Act 2011*.

3. Similarities between amendments to Germany's *Basic Law* and the UK's *Fiscal Responsibility Act 2010* and *Charter for Budget Responsibility*

The passage of Japan's latest special deficit-financing bond act indicates that the focus of attention in Japan has tended to be on the fact that the existing distinction between construction bonds and special deficit-financing bonds has facilitated the issue of special deficit-financing bonds. In both Germany and the UK, on the other hand, the focus of attention with regard to the changes in their approach to fiscal management appears to have been on the structure of their overall fiscal profile and on achieving fiscal discipline while keeping one eye on economic developments rather than simply the construction bond rule.

VI. Approach to fiscal management needed in Japan

Based on the enactment of the *Special Deficit-Financing Bond Act,* the Japanese government will be able to issue special deficit-financing bonds as soon as the budget for each fiscal year is passed up to fiscal-year 2015. As the Act ensures the necessary funds will be available from the start of each fiscal year, politics, people's lives, and regional administration and finance in Japan will no longer be disrupted by the fate of annual special deficit-financing bond acts. However, not only does the Act show that the government is seeking to cap the issuance of special deficit-financing bonds in order to ensure that fiscal policy is sustainable in the longer term, but a supplementary resolution also contains a number of conditions constraining annual issuance of special deficit-financing bonds: (1) fiscal management must be conducted in such a way as to ensure that fiscal discipline is not compromised and that the green light is not given to uncontrolled issuance of these bonds; (2) the Diet must be fully accountable for its debates on the issuance of special deficit-financing bonds from fiscal-year 2012 to fiscal-year 2015; and (3) consideration must be given to measures, including legislation, to put Japan's public finances in order in the longer term. At the moment, however, no detailed discussion of such measures has taken place (Figure 7). In other words, the Act does not contain any specific measures to ensure that fiscal discipline is exercised, with precedence having been given to "the carrot" rather than "the stick."

It is very clear that the Japanese government urgently needs to introduce specific and effective legislation in order to show its citizens, financial markets, and other countries that it also has a stick with which to enforce fiscal discipline. With regard to the possibility of multi-year legislation on special deficit-financing bonds, Kazuyuki Sugimoto (Sugimoto: 2011) argues (1) that, while the requirement for annual legislation on special deficit-financing bonds may be intended to emphasize the exceptional nature of the departure from the construction bond rule, consideration

Figure 7: (Draft) supplementary resolution accompanying the *Special Deficit-Financing Bond Act 2012*

The government must give due consideration to the following.

1 The Committee's amendment enables the government to issue special deficit-financing bonds from fiscal-year 2012 to fiscal-year 2015. However, it is a temporary measure to enable budgets that have been enacted to be implemented smoothly, to ensure national stability, and to avoid disruption to the economy. In the spirit of the amendment, the government shall manage the public finances to avoid any lapse of fiscal discipline or irresponsible issuance of special deficit-financing bonds. In particular, it must comply with Paragraph 2 of the amended supplementary provisions.

1 Since maintaining fiscal discipline and keeping the issuance of special deficit-financing bonds under control is the responsibility and prerogative of the Diet, and especially this House when it comes to voting on budgets, the government shall be fully accountable for maintaining fiscal discipline when it issues special deficit-financing bonds from fiscal-year 2012 to fiscal-year 2015 and shall endeavor to ensure that budget bills are debated in a prudent and accurate manner.

1 The government shall do everything in its power to achieve its objective of halving the ratio of Japan's primary deficit to GDP from its level in fiscal-year 2010 by fiscal-year 2015 and returning the primary balance to surplus by fiscal-year 2020, including legislating to have a roadmap of fiscal consolidation for mid- and long-term future .

Note: 181st Session of the Diet, Finance Committee, No. 4 (14 November 2012) (in Japanese).
Source: National Diet Library, Diet Proceedings Search Engine

should be given to multi-year legislation in view of the likelihood that special deficit-financing bonds will have to be issued for the foreseeable future, and (2) that this issue should be dealt with as part of a medium-term framework that could serve either as legislation to put Japan's public finances in order or as a fiscal management mechanism allowing for what in practice would be multi-year fiscal periods[40].

As the International Monetary Fund (IMF: 2009) has pointed out, governments generally adopt fiscal propriety rules once they have made a certain degree of progress towards fiscal consolidation and stabilizing the economy —as a means of consolidating that progress—rather than at the beginning of this process[41]. Sugimoto points out the problem of asymmetry (namely, that, while it is easy in practice to ease fiscal discipline, it is difficult to tighten it)[42] and that, while governments are unlikely to face much opposition to action to increase fiscal deficits by, for example, increasing fiscal spending or cutting taxes, they can be sure to expect fierce opposition to action to reduce them by, for example, slashing spending or raising taxes as this will require people to make sacrifices. In this connection, he also mentions the problem of fiscal

40 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 69 (in Japanese).

41 Manmohan Kumar et al., Fiscal Rules－*Anchoring Expectations for Sustainable Public Finances*, paper prepared by the Fiscal Affairs Department, International Monetary Fund, December 16 2009, p.31.

42 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei*," (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 78 (in Japanese).

drag, which occurs if governments try to reverse fiscal policy, pointing out that governments have tended to do this when it is too late[43].

Nevertheless, as part of their fiscal response to the financial crisis and the resulting deterioration in their fiscal position, a number of countries have set about reducing their fiscal deficits, establishing effective frameworks and enacting legislation to achieve this in view of the need to retain the confidence of the markets and pursue sustainable fiscal policies that will enable them to achieve stable economic growth[44]. Indeed, some major industrialized economies have even gone as far as trying to incorporate fiscal discipline in their constitutions as well as in law[45].

These movements are largely on the back of the trends of both corporates and sovereigns that when creditworthiness deteriorates, the situation often quickly develops into a negative spiral where the fiscal position deteriorates increasingly rapidly unless action is taken swiftly. As such, we expect that to establish a law to show a roadmap of fiscal consolidation will likely be a key to alleviate downward pressures for Japan sovereign’s credit ratings.

The IMF (in IMF: 2009) has analyzed the fiscal rules of its member countries and examined the property between these rules and these countries' fiscal targets. Each country's fiscal rules differ, but the construction bond rule in Article 4 of Japan's *Public Finance Law* is classified as an expenditure rule[46].

According to the IMF's analysis, each fiscal rule, including expenditure rules, has a different affinity to each fiscal target. In addition, the number of countries applying a number of fiscal rules closely related to fiscal sustainability instead of just one rule increased between the early 1990s and 2009[47]. This suggests that countries hope to achieve balanced fiscal management by using an appropriate combination of rules.

In Japan's case, the government's *Fiscal Management Strategy* of June 2010 (i.e., after the publication of the IMF's analysis), which sets fiscal consolidation targets, contains a fiscal (primary) balance rule and a public debt to GDP rule (central and

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43 Sugimoto, Kazuyuki, "*Towareru Kokka Shinnin (Keizai Kyoushitsu)*," (Government Credibility on the Line (in *Keizai Kyoushitsu* section), *Nikkei*, 29 August 2011 (in Japanese).

44 Cabinet Office, Director General for Economic and Fiscal Management, "*Sekai Keizai no Chouryuu 2011nen II—Gensoku Suru Sekai Keizai, Sebamaru Seisaku Yochi*," (Global Economic Trends 2011 II: The Slowing Global Economy and Governments' Dwindling Policy Options), December 2011 (http://www5.cao.go.jp/j-j/sekai_chouryuu/sa11-02/s2_11_1_2/s2_11_1_2_2.html) (in Japanese)

45 Sugimoto, Kazuyuki, "*Zaisei to Houteki Kiritsu—Zaisei Kiritsu no Kakuho ni Kansuru Houteki Wakugumi to Zaisei Un'ei,*" (Public Finance and Legal Discipline: Fiscal Management and the Legal Framework for Ensuring Fiscal Discipline), Financial Review, No. 103, Ministry of Finance, Policy Research Institute, January 2011, p. 76 (in Japanese).

46 Manmohan Kumar et al., Fiscal Rules－*Anchoring Expectations for Sustainable Public Finances*, paper prepared by the Fiscal Affairs Department, International Monetary Fund, December 16 2009, p.63; Ministry of Finance, "Shiryou," (Documents), Documents Related to the Second Meeting of the Committee on Medium-Term Fiscal Management, 12 February 2010, p. 23 (in Japanese).

47 Manmohan Kumar et al., Fiscal Rules－*Anchoring Expectations for Sustainable Public Finances*, paper prepared by the Fiscal Affairs Department, International Monetary Fund, December 16 2009, p.9.

local government debt as a percentage of GDP) in addition to the construction bond rule in Article 4 of the *Public Finance Law*, which is classified as an expenditure rule. However, incorporating a fiscal consolidation target in law (in combination with the construction bond rule), rather than simply stating it as a government policy, might commit the government more strongly to achieving the target[48].

In addition, as exemplified by Germany's establishment of control accounts following amendments to its *Basic Law*, monitoring any deviation between fiscal soundness targets and actual performance (e.g., by means of the PDCA cycle[49]) strikes us as an effective way of achieving fiscal propriety.

In summary, we believe that the enactment of the Act was significant in that Japan's political complexities are likely to continue for the foreseeable future and that it may help government administration and finance to function better without politics, people's lives, and local government administration and finance having to be disrupted by the fate of annual special deficit-financing bond acts, at least until fiscal-year 2015. Nevertheless, we see an urgent need to enforce fiscal discipline. Specifically, the urgent action, such as (1) incorporating in law more stringent and comprehensive fiscal propriety rules than Article 4 of the *Public Finance Law* and (2) creating mechanisms, such as a PDCA cycle, to ensure that fiscal discipline is enforced effectively, is essential, in our view.

48 The Legislative Bureau of the House of Councilors explains the difference between government policy in the form of a cabinet decision and in the form of legislation as follows: (1) "Cabinet decisions are decisions about matters for which the government has responsibility taken at meetings of the cabinet, consisting of the prime minister and ministers of state. Constitutional and legal matters that obviously require a cabinet decision (for example, bills and government ordinances) are always decided in this way. In addition, matters related to important government policies are often decided in this way even if this is not required in law." (2) "The advantages of legislating a policy that has been decided by the cabinet will probably vary but are generally likely to be that, whereas policies decided by the cabinet are implemented by administrative guidance, laws that are voted on by the Diet have a certain legal force as well as being the responsibility of the cabinet to implement. As the corollary of this, they probably also have the advantage of being published in the official gazette and made widely known to the public." (Source: House of Councilors, Legislative Bureau, "*Housei Shikkou Koramushuu—Roppou ni Kakarete Inai Juuyou Jikou?*," (Housei Shikkou Koramushuu: Key Items Not Included in Japan's Six Major Laws?) (in Japanese))

49 PDCA cycle: a management cycle and an approach to management that seeks to continuously maintain and improve quality by following a four-step (plan, do, check, act) model and using the evaluation of the final improvement as the basis for the next plan.

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