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JAPAN CHAIR PLATFORM

August 4, 2010

Japan's Other Spending Problem

Gene Park

Since the collapse of the bubble economy in the early 1990s, a combination of declining revenue growth, fiscal stimulus, and growing budget commitments have made Japan the most indebted country of the Organization for Economic Cooperation and Development (OECD). Attention to Japan's growing public debt problem increased in the wake of Greece's sovereign debt crisis, and the issue of how to go about fixing Japan's finances shot to the forefront during July's Upper House election as competing political parties put forth ideas from trimming wasteful spending to increasing taxes to reducing budget deficits and debt. But until just a short while ago, a different kind of public spending problem consumed the domestic agenda. From the 1990s, various administrations expended a remarkable amount of energy and political capital trimming back public works spending, rationalizing and abolishing a panoply of public corporations, and privatizing the enormous postal savings system. The target of these reforms was not the formal budget, but a large off-budget system known as the Fiscal Investment Loan Program (FILP). After more than a decade of reform, FILP has died down as a political issue but deserves a fresh look as the government begins to address larger fiscal issues.

Reforming FILP

The Fiscal Investment Loan Program is in essence a system for mobilizing savings for publicly directed loans and investments. Until 2001, the system was financed primarily with reserves from Japan's large postal savings system and the public pension system. Numerous public and quasi-public bodies, called FILP agencies, used these funds to finance public works or to provide policy loans for housing, small enterprises, and other ends. FILP provided the government with a politically expedient form of public finance, one that would allow it to finance critical public goods, such as infrastructure, without having to rely on taxes.

The problem for FILP, however, is that the funds need to be repaid, since they are borrowed. As investments grew increasingly irrational, reflecting the political priorities of the ruling party and the reluctance of the Ministry of Finance to use the formal budget to pay for these priorities, bad loans accumulated in the system. Projects such as the Honshu-Shikoku Bridge failed to generate projected revenue and quickly fell into the red attracting widespread criticism. FILP, which grew dramatically in size over the course of the postwar period, drawing on the equivalent of nearly \$4 trillion at its peak in the 1990s, also drew the opposition of private financial institutions with which it competed.

During the mid-1990s, Prime Minister Ryutaro Hashimoto targeted the FILP system for reform, passing legislation that would introduce important structural changes that took effect in 2001. Hashimoto's reform had two aims: break up the FILP system and introduce greater market competition. The rationale for the first aim was that the FILP system's size was largely determined by the supply of funds that automatically poured into the system from postal savings and pensions, rather than by a specific assessment of need. This, some critics argued, contributed to weaker financial discipline, excessive growth in the size of FILP, and a temptation to misuse the funds. To address this issue, Hashimoto's reform broke the link between postal savings and pension reserves and the FILP system: neither would be required to be transferred into the FILP system. The second aim focused on bonds as fundraising tools to expose FILP agencies to market signals. FILP agencies would issue bonds to raise capital, and those that did not run their operations soundly would face higher interest rates. For FILP agencies that could not raise funds on their own at a reasonable rate, the Ministry of Finance would issue bonds with a government guarantee—called "FILP bonds" (as opposed to "FILP agency bonds" issued by the agencies themselves)—that would procure low-cost capital and then provide these funds to the FILP agencies.

Ultimately Hashimoto's efforts did not succeed in introducing greater market pressure into the FILP system. Reformers argued that there must be a process that would allow FILP agencies to go bankrupt; otherwise, there would be an implicit government guarantee even for FILP agency bonds, which in turn would undermine the intended aim of the reform. But it soon became clear that just the discussion of allowing FILP agencies to go bankrupt caused investors to shy away from FILP agency bonds. Consequently, the government was forced to abandon this element of its reform, and FILP agency bonds now carry an implicit government guarantee.

In 2001, at the start of his administration, Prime Minister Junichiro Koizumi had a go at reforming the FILP system. Koizumi shrank the size of the system and abolished or merged many of the various FILP agencies that used FILP funds. He passed a bill to privatize the enormous Japan Highway Public Corporation, which had become symbolic of rampant and wasteful pork barrel spending. Koizumi also targeted Japan Post, which had remained under government control even after the Hashimoto reform, in order to shrink the size of the state and to remove the postal savings system from government control. Despite heavy opposition from his own party, Koizumi passed a bill in 2005 to privatize the Japan Post, but the subject remains controversial and the current government led by the Democratic Party of Japan (DPJ) has drafted legislation to scale back the Koizumi reforms.

Policy Directions

Despite extensive reform efforts, a number of outstanding policy issues remain with FILP. Annual FILP allocations are still large, and there is nothing to prevent FILP from expanding yet again. Indeed, FILP has grown in size with the onset of the global financial crisis; FILP allocations jumped more than 14 percent from 2007 to 2008, and then an astonishing 72 percent from 2008 to 2009. There also have been calls from Shizuka Kamei of the People's New Party (PNP) and the DPJ (for example with the party's New Growth Strategy) to rely more actively on FILP and postal savings. The management of FILP remains subject to excessive political influence, and FILP continues to act as a fiscal crutch to take pressure off the budget and in some cases to defer dealing with its budgetary problems.

To address these concerns, the government should consider some of the following courses of action. First, the government should clarify its priorities for FILP, deciding on the appropriate uses for FILP versus the budget. The FILP system evolved over time, slowly expanding as funds flowed into the system. While reformers have trimmed the FILP system, the government still lacks a clear framework for deciding on the appropriate uses of FILP. To establish this framework, the government should form a commission to determine what should be financed by FILP and what should be financed by the budget. Clarifying this ambiguity will help draw a clear line between the two and prevent abuses of FILP. It can also serve as a basis for reviewing existing projects and realigning FILP with current policy priorities.

Second, the government should insulate the management of the FILP system from political pressure. The key justification for FILP is that it can help overcome market failures and benefit the greater good, but if investment decisions are guided by narrow particularistic political goals, this justification is undermined. To this end, the government should work to centralize cabinet control over the FILP system. To some extent, the new DPJ government already has done this for the budget, which now has two new bodies—the National Policy Unit and the Government Revitalization Unit—that have given the cabinet greater means to control the budget process, but neither body has exerted control over FILP. The government should consider going further by creating an independent board to oversee FILP-financed public spending.

Third, the government should consider the use of alternative ways to finance its priorities, such as loan guarantees and private finance initiatives. Moving to these kinds of financing mechanisms would reduce the need for FILP agencies, which have suffered from undue political influence and weak transparency. To provide low-cost financing to homeowners or small businesses, the government could rely on private financial institutions and provide subsidies via the budget. To build public works projects or finance public investments, the government could expand its use of private finance initiatives as it has done recently with Haneda International Airport, whose maintenance and management are now handled by a private firm.

Fourth, for any of this to be feasible, the government must deal with its chronic budget deficits and public debt problem. The scarcity of budget funds is precisely why the government has leaned so often on the FILP system. At the same time, since the presence of FILP and also postal savings continue to serve as a fiscal crutch, reducing both could help advance budget reform as well. Even more than postal privatization, gradually shrinking the size of the postal savings system would effectively diminish this crutch, since the government, even after partial privatization, could continue to exert influence over postal savings.

Conclusion

In recent months, fixing Japan's budget and debt problems has shot to the top of the political agenda, although there is no consensus about how to go about doing this. Raising taxes and cutting spending will be part of any future fiscal consolidation plan, but it behooves policymakers not to lose sight of the larger fiscal picture, especially FILP and the postal saving system. In the past, during the 1980s, the government successfully restored fiscal discipline, but part of that success was achieved on the back of FILP. Going forward, the government would be advised not to "fix" the budget by expanding FILP and blurring its distinction with the budget. Now more than ever is the time to take the broader view of Japan's public finances.

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The Japan Chair invites other essays for the Platform. Please contact Eri Hirano at (202) 775-3144 or by e-mail at ehirano@csis.org.

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