Sammelrezension: Japan's Reform Policies in the "lost decade"

Thomas F. Cargill, Takayuki Sakamoto: Japan since 1980

New York: Cambridge University Press. 2008, 314 S., USD 25,00

Takero Doi, Toshihiro Ihori: The Public Sector in Japan

Cheltenham, UK: Edward Elgar 2009, 320 S., USD 150,00

In Japan infamously a burst asset speculation boom was followed by a lost decade of 13 reflation programmes undertaken during 1992-2002. Much as Japan had been able to do right as a global role model during her high growth era, including her mastery of the two oil crises in the 1970es, during this fateful decade seemingly Japan managed to get everything wrong. Yet the lost decade was also one of intense policy reform and debate with more profound results than imaginable during the era of complacency and self-congratulation of the prior period of success. Although Japan has attracted much less academic and public interest since, the world being more fascinated by the new "success stories" of China and latterly India, the thrust of Japan's reform policies, the trials and errors of her economic policies and their political consequences – the near dismantling of the iron triangle which held and controlled political, economic and administrative power for so long – holds interesting lessons about the political dos and don'ts in saturated mature democracies, worthwhile to study and to read - provided that there is readable literature on the subject.

Thomas F. Cargill and Takayuki Sakamoto, professors at the universities of Nevada and Kitakyushu respectively, essentially follow a historical sequencing of Japanese policies, as they reacted to changing economic circumstances and political events. During 1980-85 Japan avoided stagflation which dodged other western economies after the 2nd oil shock. Large savings were transferred from the private to the corporate sector. By 1985 Japan – like China today – had become the largest creditor nation on earth. Her banks were the largest and appeared sound and stable.

In September 1985 infamously the US enforced the Plaza Accord, depressing the value of the $ and appreciating the Yen. In response to the threat of an economic depression, following its feared export contraction the Bank of Japan (BOJ) embarked on an expansionary monetary policy, which fuelled the asset inflation, as abundant capital chased limited worthwhile domestic outlets.

When the BOJ increased the discount rate in May 1989 the asset bubble started deflating and economic growth slowed. When stock exchange and real estate prices collapsed by 1990-1 the economic consequences were initially only misread as temporary down cycle move. Reflation packages would do the trick without major corporate restructuring or banking reforms, policy makers and corporate chieftains thought. After a brief and mismanaged recovery – during which the government tried to reconsolidate its battered finances and to increase taxes – in 1995-6, the economy went into a more serious recession. This time corporate restructuring was undertaken seriously. Equally public money was spent on an ever grander and reckless scale. Only once export demand rescued the economy and Koizumi appeared as prime minister (2001-6), fiscal reconsolidation, privatization and administrative reform was restarted. Koizumi wanted quicker deregulation, the solution of the delayed nonperforming loans problem and the effective restructuring of the de facto bankrupt "zombie" corporations, all measures hopefully leading to a more competitive economy (p. 18). His reform plans clearly overrode the consensus of the collusive "iron triangle", which made him politically dependent on the approval of public opinion, a test of strength passed successfully during the 2005 electoral landslide.

By 1975 Japan's financial system had been "the most regulated, isolated and administratively controlled of the industrialized economies" (p. 36). The kereitsu system of business conglomerates prevented bankruptcies of major firms through mutual support. Credit allocation by the keiretsu and public banks was not always justified by economic fundamentals, but the system, with its non-transparent cooperation of financial institutions, firms and politicians – facilitated stable, low risk economic growth. In a convoy system the weaker keiretsu members were supported by the strong. This fitted well into the Asian tradition of risk minimization – in contrast to the Anglo-American habit of Schumpeterian creative destruction. While the Ministry of Finance controlled the banks which controlled their respective keiretsu, non-group shareholders were excluded from corporate control and monitoring (p. 39). In the 1990es bust this system with its unwillingness to penalize poor performance was no longer sustainable.

The much heralded liberalization under PM Nakasone (1982-7) in the authors' view constituted in fact more of a "bonsai liberalization". Things remained under ministerial control. Financial freedoms only came in a miniature variant. Yet as companies were flush with cash, they wanted better returns for their savings. At the same time banks needed to venture into new uses for their deposits. Consumer credits and housing loans (yusen) were the new avenues, thus fuelling the bubble. Notably the reckless lending facilities of these banking subsidiaries and of the prefectural agricultural credit cooperatives went entirely unsupervised (p. 87). Their sole collateral was real estate at highly inflated values with little concern to the economic viability of the funded projects. With former MOF officials on their corporate boards as amakudari post-retirement appointees moral hazard abounded (p. 106). Worried about the irrational exuberance of the real estate market the Bank of Japan increased its basic lending rate from 2,5% (May 1989) to 6% (August 1990). This effectively deflated the bubble. Until 2007 shares and real estate values fell to 45% of their 1991 prices.

During 1991-2003 the economy grew by only 1,2 % per annum, with the years 1998-9 experiencing real shrinkage. Though by 1994 the deposit insurance had become bankrupt, and with 25% of loans turning non-performing zombie firms were kept alive by banks and the government through creative accounting and debt forgiveness. Until 1994 the dominant assessment was one of a temporary recession, with a recovery just around the corner. Hence when asset prices improved around 1995-6 Ryotaro Hashimoto as new prime minister felt emboldened to commence fiscal reconsolidation by increasing the sales tax from 3% to 5%, by cutting expenses (for the military, agriculture, development aid and local governments), and by increasing health contributions. This policy famously misfired. Fearing further tax increases and expecting more deflationary price cuts, consumers cut spending further. Output fell, worsened by the Asian crisis of 1998 spreading from Thailand and Indonesia to Korea and Russia. By 1997 most yusen and major banks and securities houses likethe Hokkaido Development Bank and Yamaichi Securities failed. After an Upper House election defeat Hashimoto's successors Obuchi and Mori relaunched ever more aggressive reflation programmes (p. 186) while tackling the restructuring of corporate and financial institutions in earnest. Yet massive capital injections into the 21 major banks – all were given equal amounts – was done without due diligence (p. 156). With Koizumi's advent in 2001 banking reform in the form of forcible mergers and deregulation was accelerated. Most keiretsu with their collusive moral hazard breeding practices disintegrated. Koizumi also started to withdraw public support for the stagnant industries (construction, transport, distribution, agriculture) forming the LDP's electoral base (p. 145) and rather supported future industries through research and development funding instead (p. 188). Also, spending for social security continued to rise.

The price to be paid for this restructuring were increased social disparities, with the number of underpaid temporary workers growing from 9,7 million (1994) to 15,6 million (2004), representing one third of total jobs. Disposable average incomes and savings shrank dramatically. Disparities between metropolitan and rural regions, and among employees of big export industries and the rest grew perceptively. After a few years among OECD countries only socially underdeveloped countries like the US, Mexico and Turkey still had a larger degree of inequality (p. 251). Voters began registering their protest against impoverishment and disparities first during the Upper House elections of 2007 (p. 254), as well as – at an even more massive scale - during the Lower House elections of August 2009, thus triggering a backlash against market reforms and pushing for more redistributive politics which the DPJ has promised to deliver (p. 282).

Cargill and Sakamoto have written a good and useful reference work on Japan's crisis mis-management during the lost decade of 1992-2002, and on the reform policies recommended by conventional economic wisdom and their consequences. There is surely no shortage of lessons on the utility of reflation packages and on the consequences of flexible labour markets to be learned by Europe as well.

The somewhat pricey volume by **Takero Doi and Toshihiro Ihori** covers Japan's public finance, privatization, public sector reform and decentralization attempts. Professors Doi and Ihori hail from Keio University and from Todai respectively. They clearly know their complicated subject matter, but they also explain it in a complicated way. The fact that good half of the volume consists of econometric calculations aiming to prove the assertions of the descriptive texts does not really add to reading pleasure either.

Japan's public sector counts for only 22% of GDP, but its indebtedness is huge. The cumulative fiscal deficit grew from 70% in 1990, when the budget was last balanced, to 180% (2005) and probably 200% today – much worse than Europe's worst pre-crisis offenders Italy (115%) or Belgium (95%). The Central Budget is distributed through a general account, 21 special accounts, and seven agency accounts. There is also a second public budget in shape of the Federal Insurance and Loans Programme (FILP) which accounts for some 10% of GDP. It is managed by MOF's Trust Fund Bureau and spent on SME promotion, housing, regional development and for local governments. Unlike the normal tax based budget these monies are loans raised mostly from pension funds and the Post Office's savings deposits and life insurance premia. They hence need to earn interest and be paid back in time. Then there are the budgets of local and prefectural governments and of local public enterprises dealing with hospitals, medical care, water and sewage and public transport (p. 15). Funds are shuffled widely and confusingly between the various public spenders, but all seem to be drenched in dark red ink. Also public-private partnerships, which as a "third sector" were active in regional development during 1981-92, produced mostly white elephants which, after the bubble burst, turned out to be major loss makers. Already in 1996 debt service for local governments accounted for more than 20% of their regular budget (p. 27). Increasing shares have also to be spent for the maintenance of the oversized and unneeded public infrastructure which the reflationary building programmes bequeathed.

30% of the general budget has to be covered by deficit financing bonds. Debt service with 24% will soon be bypassing social spending (at 26%) as the largest budgetary item (p.

40). This is despite Japan's ultra-low interest rates, which currently hover around 0,1% for ordinary deposits.

Worse, the authors convincingly argue that in a mature economy with a fully developed infrastructure new public investments in roads, harbours, airports, agricultural facilities, flood control and forestry do little to enhance productivity (p. 56). They rather crowd out private investment and discourage private consumption (as the public fears future tax increases and uncertain old age provisions).

In the health sector Japan has surely a more impressive record than most Western countries. In return for the world's highest life expectancy – probably the most reliable health indicator – of 82 years, only 8% of the country's GDP are spent on health. In contrast, the US for a life expectancy of only 77,8 years spend 15,3% of GDP (p. 68). Germany occupies the middle ground with 79 years and 10,7% of GDP. Yet the authors criticize the misallocation of medical doctors. Too few are working as underpaid hospital doctors, and courtesy of the powerful Japan Medical Association, too many are running their own little and expensive clinics. Free medical care for the elderly above 70 had led to "bed blockers". For lack of domestic care they are sent to hospitals as long-term patients.

The pension system is similarly misconstrued. As of April 2008 the average pension contribution stands at Yen 14.400. Half of the amount of pensions currently paid out is paid from taxes. For current pensioners, like those born around 1935, the authors calculate an average advantage of $ 500.000 as gain, for those born in 2000 an average lifetime loss of $ 250.000. They estimate the $ 750.000 difference as "not actuarially fair" (p. 102), but see it somehow as a compensation of the war and post-war hardship of the old generation, from whose sacrifice and hard work the young generation benefits.

Japan's tax history is briefly reviewed. In the 1880es when the country was being monetarized, the land tax constituted 80% of revenues. Around WWI indirect taxes, like on liquor, and customs duties were the major source of public finance. As one of the first countries Japan in 1887 introduced an income tax, which then amounted to 3% for peak incomes. Since 1935 it had become Japan's most important tax base. Until the 1990es underreporting of income tax by the self-employed and farmers had become notorious. The tax authorities were estimated to capture 100% of employees' revenues, but only 50% of the self-employed and 30% of the farming incomes. Since 2000 their capture went up to 70% of self-employed and 40% for farmers (p. 136). Corporate tax rates at 40% are very high in international comparison, but generous depreciation rules and allowances permitted for bonus payments and pension reserves and for price fluctuations reduce this to 30% in real life (and are thus comparable to Germany and the UK). The tax reform of 1988 for the first time introduced a general sales tax of 3% (previously only the sales of alcohol, tobacco, mineral oil and luxury items were taxed), to be increased to 5% in 1997. For this stabilization of the tax base the LDP paid dearly.

Localities have no independent right to raise taxes. As an incentive to locate nuclear power stations and gravel pits they are only allowed to raise a nuclear fuel tax and one on gravel digging. For the rest the rates are fixed centrally. For municipalities the fixed asset tax is most important (45% of revenues), followed by an inhabitants tax, which is also the most important direct tax base for the prefectures. More important are local transfer taxes, which the central government raises for the municipalities and prefectures, and the local allocation tax (some 25-34% of the income and consumption taxes). As national disbursements the latter are distributed locally according to complicated formula to cover equitable public services (schools, police, public works, social services etc) nationwide irrespective of the local and prefectural tax base. Hence the rural and peripheral prefectures benefit most and the rich metropolitan districts of Kanto, Tokai and Kansai never get anything from this reallocation. For politically more interesting projects however municipalities and prefectures in their financial straightjacket rely on discretionary central subsidies which are forthcoming only with the goodwill of the ruling party and its local deputy. In a cause celebre the town of Yubari in Hokkaido, until the 1960es a thriving coal mining centre with 106.000 inhabitants, went bankrupt with $ 600 million in unserviced debts. Having shrunk to 14.000 people after the closure of its mines, the town had diversified with unsecured credits into amusement parks, subsidized melon growing, an international film festival and into a coal and a melon museum – an eclectic mixture which failed to attract the desired flow of tourists (pp. 178).

As a standard practice all municipalities need prefectural or central approval for their bond issuance covering their usual deficits. Most bonds (60%) are purchased by FILP, the rest by financial institutions (30%) and by private investors.

Since the Meiji days official Japan believed in the virtue of centralized structures for national development. This implied also the central sourcing and allocation of taxes and the central control of spending (p. 202). The fact that this stood in contradiction to often professed values of decentralization and the subsidiarity principle, with decisions over local needs being best done at local level, mattered little. The absence of local tax autonomy also did little to enhance the fiscal responsabilization of local politicians. When the redistribution of the local allocation tax and central subsidies to local projects were cut after 2003, local indebtedness simply went up. Equally the FILP system with its preference for local bond financing reduced interest costs and aided the erosion of local fiscal discipline (p. 222).

The authors consequently discuss the "debt trap" of Japan's public sector. The main risks are increased interest costs (worsened by deflation) and the moral hazard, the expectation of the central government bailing out major economic and public actors, thus delaying structural reform and self help in the 1990es (p. 267). Further, excessive debt levels and wasteful spending have managed to crowd out capital for more productive private investments. (p. 299).

In a concluding chapter on public sector reform they welcome Koizumi's privatizations (the Post Office, the highway corporations, Narita airport and the Tokyo subways). As public institutions JNR and the Post office essentially had suffered from overstaffing and were subjected to economically unsound political decisions (p. 283). Equally laudable were the merger and transformation of 152 public corporations (2001) into 85 (2008), of ten governmental financial institutions into three, and the reform of the FILP system, whose cumulative loans and investment amounted to $ 3,5 billion (or 83% of GDP), and was equally subjected to MOF control and political machinations (p. 276). Reforms have moved in the right direction, but a lot of work needs to be done to disentangle excessive complicated public bookkeeping, with an overlapping general account, dozens of special accounts and the FILP and a myriad of transactions in-between. In the authors plausible view this is done purposefully in order to camouflage the recipients of public subsidies and to avoid comparability and public scrutiny (p. 294).

Both books cover valuable ground in exploring the complex world of Japan's public finances and public sector operations. Although no easy reading matter, with repetitions and often unspoken assumptions abounding in both volumes, ultimately the publications appear as valuable in teaching pitfalls to avoid in the aftermath of the 2009 global euphoria for public deficit spending and on the long hard road towards saner and more effective public structures.

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