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Tanaka, Hideaki

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An Analysis of Fiscal Governance: Why Japan's Fiscal Consolidation Fails?

Hideaki Tanaka

Meiji University

Abstract

To date, Japan has failed in every attempt to consolidate its public finances, leaving the balance of government debt moving in an upward direction in terms of GDP. Among several reasons, weak budgetary institutions and insufficient fiscal transparency are the most possible candidates for explaining why Japan fails. This can be also applied to other countries, because some countries are successful in maintaining fiscal discipline while others are not, and thus such differences can be explained by budgetary institutions. Budgetary institutions include many things, but those which could strengthen fiscal governance matter; in particular, fiscal rules, a medium-term fiscal framework, and independent fiscal institutions. Thus, the objective of this paper is to analyze Japan's fiscal governance by comparison with other OECD countries. This type of assessment cannot exclude arbitrariness, but the analysis provides the evidence that, among advanced countries, fiscal governance is at a low level in Japan. The problem with Japan's budgetary institutions, in particular, is the lack of a mechanism for the oversight and observance of rules as well as the absence of post hoc evaluation and verification. Reforms of budgetary institutions are urgent to strengthen fiscal governance, but policymakers are always reluctant to implement such reforms. In Japan, efforts have been made for reforms intended to strengthen its political and administrative governance, such as the overhaul of the electoral system and the restructuring of ministries and agencies since the collapse of the bubble economy. It is now possible for a prime minister to exercise political power much more than in the past, but this power is not utilized for strengthening fiscal governance. Ultimately, this is one of Japan's greatest political problems.

1. Introduction

Japan's economic and fiscal landscapes have changed radically since the bubble economy burst early in the 1990s. Moreover, the government's already swollen debt has further expanded as it bumped up fiscal spending to battle an economic slump caused by the coronavirus disease (COVID-19) that began to hit Japan in early 2020. These developments are more or less common to major industrial countries. Yet Japan has a singularity among developed countries, particularly in connection with its fiscal soundness. To date, Japan has failed in every attempt to consolidate its public finances, leaving the balance of government debt moving in an upward direction in terms of GDP.

Why has Japan failed to restore balance in public finance? Firstly, the author thinks there are problems in budgetary institutions. Fiscal consolidation has thus far hit a snag halfway because Japan cannot undertake fiscal management in a manner that responds to economic cycles and shocks.

Also problematic are repeated makeshift accounting manipulations that leave the national budget low in transparency. Secondly, the country's macroeconomic environment lacks incentives that encourage fiscal consolidation. International organizations such as the International Monetary Fund (IMF) have issued warnings over Japan's fiscal conditions time and again (including one by the IMF in 2014). Under the current circumstances, however, Japan has not faced a trade-off between economic stability through fiscal stimulus (reflationary measures) and sustainability of continued borrowing¹.

Needless to say, fiscal rehabilitation is not the final goal. The immediate question faced by Japan is how to overcome the issue of rapid birthrate decline and fast population aging. The question concerns the contents of public finances. According to Ministry of Finance (2020), expenditure in the initial General Account budget for FY2020 represents an increase of 36.5 trillion yen (including 24.2 trillion yen in social security expenses and 9.1 trillion yen in national debt-servicing costs) compared with FY1990. The increased spending is covered by 26.9 trillion yen in government bond issues, 5.5 trillion yen in tax revenue, and 4.0 trillion yen in other revenue. Almost all of the increment in the social security budget is financed by borrowing. Is debt-based social security sustainable? Furthermore, Japan's social security budget is over-allocated to pension and healthcare programs. Both programs are based on insurance, but enormous amounts of money are channeled into them from the General Account budget, ending up in a scheme assisting high-income earners, since they are also covered by the insurance programs. On the other hand, the budget for human resource investment, such as education and occupational training, is insufficient. It will be difficult to tide over the issue of fewer children and a graying population if such a distribution of resources is left unattended. In order to resolve the problem of fiscal contents, the budgetary system that creates them and allocates resources is critically important.

It is "fiscal governance," the theme of this paper, which the author thinks is important to overcome this and other problems. In a narrow sense, it is to maintain fiscal discipline, but it is also important that fiscal spending constitutes a means of improving national welfare. At the time of the European debt crisis involving Greece and other countries, heavily indebted nations were required to take stringent measures for fiscal consolidation. But these policies brought about adverse side effects, deterring economic growth and generating socioeconomic confusion. "Fiscal reconstruction considering economic growth as well" was what was necessary. Required today are fiscal policy management that can address various shocks, and greater efficiency in the execution of the details of fiscal programs such as the social security system.

Problems associated with budgetary institutions are not limited to Japan. Foreign countries also face them. Some countries are successful in retaining fiscal discipline while others are not. What makes difference between them? Reforms of budgetary institutions have made progress over the past 30 years. The author will also discuss this on the basis of the latest developments. The objective of this paper is to analyze Japan's public finances in a quantitative manner from the perspective of fiscal governance. The next section overviews the track record of Japan's fiscal management and the reform of budgetary institutions conducted thus far. Section 3 provides the framework of analysis, followed by Section 4, which looks into fiscal governance based on this framework. Finally, Section 5 concludes the analysis and discussions.

2. Developments in Japan's fiscal management

¹ Konzelmann (2019) says "In 2017, for example, Japan's debt-to-GDP ratio was the highest in the world, at around 240 percent. But Japan was in no danger of default because the debt was mostly held by its own citizens; and since Japan has control over its currency, it can both issue debt in that currency and print more to pay it off"(p.49).

(1) From the collapse of the bubble economy to the DPJ government

Japan achieved a long-cherished halt to the flotation of deficit-financing bonds in the settlement of accounts for FY1991 owing to an increase in tax revenue generated by the bubble economy. However, the country's fiscal conditions have since gone from bad to worse². It was the administration of Prime Minister Ryutaro Hashimoto that strove to improve the public finances that were in bad shape. In this connection, FY1997 was positioned as “the first year of fiscal structural reform.” In the first place, the Hashimoto administration took a cabinet decision in December 1996 on the targets for restoring fiscal soundness, including one calling for the fiscal deficit of the central and local governments to be held down to not more than 3% in proportion to GDP by FY2005, as well as FY1997 budget compilation guidelines. Secondly, the consumption tax was raised from 3% to 5%, effective April 1997. Thirdly, a fiscal structural reform conference comprising leaders of the government and ruling party was established in January 1997. Based on discussions at the conference, the Fiscal Structural Reform Act³ was voted into law in November. The law called for the fiscal deficit of the central and local governments to be curtailed to not more than 3% of GDP by FY2003. Among other targets listed by the law was the termination of dependence on deficit-financing bonds.

Efforts for fiscal consolidation were thus kicked off, but the economy entered a recessionary phase in May 1999. Since the autumn of that year, the financial system became unstable amid a spate of failures of financial institutions coupled with the impact of the Asian currency crisis. These developments prompted the government to compile a supplementary budget and a stimulus package to bolster economic activity. At the same time, the government revised the Fiscal Structural Reform Act, putting off the fiscal consolidation target to FY2005.

The law was an ambitious attempt, incorporating specific numerical targets based on experiences in foreign countries, among other things, but became ineffective in only a little more than a year. However, this was not an unfortunate outcome affected by economic downturn but because the law itself had major problems such as no consideration for economic cycles.

It was the administration of Prime Minister Junichiro Koizumi, inaugurated in April 2001, that launched fresh efforts to restore worsened fiscal soundness. The Koizumi administration undertook the privatization of postal services and other reforms on the strength of the Council on Economic and Fiscal Policy⁴, newly established as part of the overhaul of central government administration. The Koizumi Cabinet also mapped out the “Basic Policies 2002” stipulating fundamental policies on economic and fiscal management, setting targets for bringing the primary balance of the central and local governments into the surplus in the early 2010s in a renewed attempt at spending cuts. The total expenditure of the General Account (on an account settlement basis) in FY2006 decreased 2.7% from FY2002⁵, representing a rare spending drop in fiscal management to date. The budget deficit in the general government sector shrank to 2.8% of GDP in 2007.

² The departure from deficit-financing bonds was not due to “fiscal consolidation without tax hikes” advocated by the government's second ad hoc council for the promotion of administrative reform, or the so-called *Doko* task force (headed by business leader *Toshio Doko*), set up in 1981. Fiscal spending swelled in the bubble economy period as well.

³ Officially, the law is known as the “Act on Special Measures concerning Promotion of Fiscal Structural Reform.”

⁴ The Council on Economic and Fiscal Policy is a research and deliberation body based on the Act for Establishment of the Cabinet Office, comprising the prime minister (chairman) and ten members. The members are the Chief Cabinet Secretary and the Minister of State for Special Missions (the Minister of State for Economic and Fiscal Policy) as well as the Minister of Finance; the Minister of Economy, Trade and Industry; Governor of the Bank of Japan, and four private-sector members who are academics and corporate executives.

⁵ Some areas of expenditure showed increases in FY2006, including social security-related expenses (up 4.7%), debt-servicing costs (up 15.6%), and general allocation funds to local governments (up 2.0%), but other areas saw decreases, including education and science expenses (down 20.8%), defense spending (down 2.1%), and public works expenditure (down 15.9%).

It was the “Integrated Expenditure and Revenue Reform” that emerged as a program putting the final touches on the Koizumi administration’s structural reform policy in order to clear the path of fiscal structural reforms pursued amid economic recovery. In his “Basic Policies 2006,” Koizumi included the target of bringing the primary balance of the central and local governments into the surplus in FY2011 and specified the amount of an expenditure cut in each area, such as social security, to achieve that target. The integrated reform committed Liberal Democratic Party (LDP) lawmakers, who had thus far tended to seek increased expenditure and lower taxation, to fiscal consolidation under Prime Minister Koizumi’s strong leadership. But the proposed fiscal consolidation soon ended in failure. In the face of the 2007–2008 global financial crisis, the government issued extra national bonds for economic measures, doubling the amount of their flotations from 25.4 trillion yen in FY2007 to 52.0 trillion yen in FY2009 (on an account settlement basis). As for the target of restoring fiscal soundness in the integrated reform drive, the government of Prime Minister *Taro Aso* postponed by ten years the target of bringing the primary balance into the surplus in “Basic Policies 2009.”

It is the administration of the Democratic Party of Japan (DPJ), which assumed the reins of government in September 2009, that took over the legacies of an economic slump triggered by the financial crisis (Lehman shock) and subsequent expansion of the budget deficit. What the DPJ government championed was “politician-led policymaking.” It sought to implement this in budget compilation as well as in fiscal management, using the newly established National Strategic Bureau as a core. This, however, was a continuation of trial and error, leaving both bad aspects as well as good aspects intact⁶.

The budget deficit in the general government sector stood at 9.8% of GDP in 2009, only slightly falling to 9.1% in 2010 and 2011, while the primary balance, after adjustment for economic cycles, worsened from -7.0% in 2009 to -7.9% in 2010, and -7.5% in 2011 based on OECD statistics. The DPJ is not to blame for reduced tax revenue stemming from economic stagnation and the shocking impact of the Great East Japan Earthquake. After all, expenditure swelled as the party sought to meet promises in its election manifesto, such as the payment of child allowances⁷.

On the other hand, the DPJ administration performed better than the second cabinet of Prime Minister Shinzo Abe in terms of restoring fiscal discipline. In the first place, it reformed the budgetary institutions, introducing a medium-term fiscal framework and fiscal management strategy (on which a cabinet decision was made in June 2010)⁸. The strategy called for the deficit in the primary balance of the central and local governments to be halved from the FY2010 level by FY2015 and to be reduced to zero by FY2020. It also proposed the formulation of a medium-term fiscal framework covering three years from FY2011. Another favorable factor is the imposition of a special tax levy (income, residential, and corporate taxation) for reconstruction from the Great East Japan Earthquake. The author thinks the DPJ deserves appreciation for the legislation securing financial resources for post-disaster reconstruction realized after revision talks between the ruling and

⁶ As for problems in economic and fiscal policies of the DPJ administration, refer to Tanaka (2013).

⁷ The DPJ administration set up a manifesto review committee in 2011 to analyze the reasons for failing to secure sufficient revenue sources and realize policy measures. As such reasons, it cited the following, among others: (1) a revenue decrease (9.2 trillion yen) caused by a sharp economic downturn following the Lehman shock, (2) the National Diet divided, with the upper house controlled by the opposition camp, and (3) the need to change policy priorities due to the devastating earthquake. But (1) is not justifiable at all because the DPJ had asserted in its election manifesto that it would realize child allowances and other policy measures by replacing budgetary allocations for other programs. For a detailed analysis, refer to Tanaka (2013).

⁸ In order to discuss the budgetary institution reform, the DPJ set up a panel in September 2009 to discuss how to compile the budget in a better manner, and another in January 2010 to look into medium-term fiscal management. The author participated in both panels.

opposition sides. Thirdly, worthy of attention are the integrated reform of social security and taxation, and its main pillar, the consumption tax increase. The DPJ faced rough going in winning Diet approval of a package of bills related to the integrated reform, encountering stiff objection from within the party and the departure of some member lawmakers led by maverick kingmaker Ichiro Ozawa. What was unprecedented, however, was that the ruling and opposition camps came to terms on a tax increase. However, the DPJ had to pay a high price for the successful legislation, losing a general election in December 2012 held on its promise to finalize the law. It cost the party dearly indeed.

(2) Second Abe Cabinet & thereafter

In contrast to the DPJ government management failure, it was the second Abe administration that succeeded thereafter. Testimony to this is the number of days in office as prime minister (both successive and cumulative totals), which was a historical record high. Political stability is worthy of commendation, but more important are the prime minister's government performances in economic, fiscal, and other terms.

Characterizing the Abe administration was emphasis on economic issues such as a breakaway from deflation. The average nominal economic growth (during Abe's seven years in power from 2012 to 2019) was 1.62%, higher than the DPJ administration's 0.37% (in the three years from 2009 to 2012), but the real growth rate of 1.03% was lower than the DPJ government's 1.84%⁹. This was the outcome of the so-called Abenomics, although simple comparison is impossible due to different economic and other conditions at the time of each administration's inauguration. Also, the Abe administration was unable to achieve its goal of emerging out of deflation within two years¹⁰.

As for fiscal management, the Abe administration took over the DPJ government's target of fiscal consolidation. Namely, in its "Medium-term Fiscal Plan" authorized by the cabinet in August 2013, the Abe administration pledged to "halve the deficit in the primary deficit of the central and local governments in proportion to GDP by FY2015 from the FY2010 level and bring the balance into the surplus by FY2020." However, the target of fiscal consolidation was not attained, as in the past. It was postponed in the "Basic Policy on Economic and Fiscal Management and Reform 2018" (approved by a cabinet decision in June 2018), in which the government said it would seek to bring the primary balance into the surplus in FY2025. It will be safe to say that the Abenomics policy of restoring fiscal soundness through economic growth has ended in failure.

In reviewing the target, the Cabinet Office conducted the "interim review on Integrated Economic and Fiscal Reforms" (issued by the Committee for Promoting the Integrated Economic and Fiscal Reforms in March 2018) and explained the reasons for failing to achieve the target. The ratio of the primary balance deficit to GDP in FY2018 was around 1.7% on a trial calculation basis in July 2015, which worsened to around 2.9% in a January 2018 estimate. As reasons for the deterioration, the Cabinet Office assessment cited the following four factors: (1) efforts were exerted to make spending more efficient in line with expenditure guidelines (improving the primary balance 0.7% or 3.9 trillion yen), (2) there were adverse effects of a supplementary budget (a deterioration of 0.4% or 2.5 trillion yen), (3) tax revenue decreased due to slower economic growth (a deterioration of 0.8% or 4.3 trillion yen), and (4) the planned consumption tax hike was postponed (a deterioration of 0.7% or 4.1 trillion yen). After all, the presumed growth rate (3% nominally and

⁹ The figures are based on data by National Accounts of Japan in April–June 2020.

¹⁰ In a joint statement issued in January 2013 by the government (more precisely, the Cabinet Office and the Ministry of Finance) and the Bank of Japan, the bank incorporated the target of price stability in the form of an annual consumer price increase of 2%, among other things.

2% in real terms) was too optimistic¹¹. The interim assessment explained that expenditure-cutting efforts were made, but this cannot be said to be a precise description. Estimated expenditure was excessive from the beginning because it was based on higher consumer prices right from the start (in reality, prices did not rise, ending up in less expenditure than estimated), and efforts for spending cuts were made only in a small number of budget programs, resulting in limited progress in such endeavors.

Next, the author will analyze the General Account. On an account settlement basis, expenditure almost leveled off from FY2012 (97.1 trillion yen) to FY2018 (99.0 trillion yen) while the amount of new government bonds issued fell from 47.5 trillion yen to 34.4 trillion yen in the same period as tax revenue increased from 43.9 trillion yen to 60.4 trillion yen. Japan's public finances appear to have improved, but attention is necessary. This is because expenditure snowballed in the wake of the global financial crisis and the Great East Japan Earthquake (reaching 101 trillion yen in FY2009 and 107 trillion yen in FY2011), almost maintaining the same swollen level in the following years¹².

A comparison of the initial budget for FY2019 with FY2012 as a base (Table 1) shows a 20.1 trillion yen rise in tax revenue. With 11.6 trillion yen earmarked for reduction in government bond flotations, the total expenditure increased by 11.1 trillion yen. Although tax revenue expanded, each fiscal year's tax system revision resulted in lower taxation in most cases. It is therefore considered that almost no tax increase efforts were made except for consumption tax hikes. Budget items showing expenditure increases were social security expenses, up 7.7 trillion yen, public works spending, up 2.3 trillion yen, and debt-servicing costs, up 1.6 trillion yen, with expenses for other items remaining the same or being decreased. A look at funding in each fiscal year's initial budget shows that tax revenue gains used to reduce debt-servicing costs were limited, except in FY2015 and FY2016, and that cases of allocating such higher revenue to increased expenditure are conspicuous.

Table 1: Change in the General Account (FY2012-FY2019)

	Change (trillion yen)
Total revenue	11.1
Tax revenue	20.1
Borrowings*	-10.9
Total spending	11.1
Social welfare	7.7
Public works	2.3
Debt service	1.6
Defense	0.5
Education and science	0.2

Source: Author's estimates based on data from MOF Japan.

Note: "Borrowing" includes transfers from special accounts, since it signifies a reduction in reserves.

¹¹ In the "Economic and Fiscal Projections for Medium to Long Term Analysis" (July 2018), announced after the interim evaluation, nominal GDP growth rates of 2.8%–3.5% (1.5%–2.1% in real terms) were forecast for FY2019–2027 in the case of growth achieved (2.8%–1.6% nominally and 1.5%–1.1% in real terms in the baseline case), representing the usual optimistic forecasts. Setting optimistic preconditions is the globally common reason for failing in fiscal consolidation (Tanaka 2011). Japan is a country that never learns lessons.

¹² A special account for reconstruction from the Great East Japan Earthquake was set up in the national budget in FY2012, and the allocations for expenses related to the disaster that were listed in the General Account in FY2011 have been excluded from the account since FY2012.

Even though bond issues were reduced, often special account reserves were transferred to the General Account and other makeshift funding measures taken, in effect covering portions of expenditure with deficit-financing bonds (as in FY2013, FY2017, and FY2019). The increased portion of tax revenue was used to make childcare services and education free, render national land resilient, and earmarked for supplementary budgetary allocations.

3. Definition and measurement of fiscal governance

In the first place, preceding studies regarding the definition of “fiscal governance” are examined here. Hallerberg et al. (2009) defined fiscal governance as “the package of rules, norms, and institutions that structure the way governments make a budget” (p.199), pointing out that its configuration depends on the political structure existing in the country concerned. The European Commission defines it as “the institutional side of fiscal policy as it comprises the set of rules and procedures that determine how public budgets are prepared, executed and monitored” (European Commission 2008:128). These definitions represent almost the same meaning as a budgetary institution. Based on the fact that the budgetary institution influences fiscal performance, this paper will focus on “a package” that improves fiscal performance. It should be added in this connection that fiscal performance is a concept that includes not only simple restrictions on deficit or debt but also strategic resource distribution, efficient execution, and the like¹³.

Next, the author will consider what sort of package is important. According to Hallerberg et al. (2009), indices representing fiscal governance have been developed. Specifically, the indices include fiscal targets, the structure of negotiations, the structure of the parliamentary process, budget execution, information on the budget draft, and the relationship between national and subnational governments. As four aspects of fiscal governance, Giosi et al. (2014) cite numerical fiscal rules, independent fiscal institutions, medium-term budgetary frameworks, budgeting procedures (prudent economic assumptions, transparency, centralization of the budget process, and focus on results). As particularly important elements of fiscal governance, the European Commission cites numerical fiscal rules, independent fiscal institutions, and medium-term fiscal frameworks. Tanaka (2011) cites four points, namely, fiscal rules, a medium-term fiscal framework, transparency, and a decision-making system.

In order to truly strengthen fiscal governance, institutions, procedures and other contents, as well as their quality, are important. This is because numerical rules are not always maintained even if they are stipulated in a constitution or law, as typically shown in the failure of fiscal deficit criteria under the Maastricht Treaty. The author discusses details of important aspects constituting fiscal governance. From the perspective of beefing up fiscal governance, the author will look into the three aspects of numerical rules, a medium-term fiscal framework, and an independent fiscal institution, as exemplified by the European Commission, sort out their contents and quality, and, later on, consider decision-making and transparency.

The first point of the package is fiscal rules. Kopits and Symansky (1998) define fiscal rules as “a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance” (p.2). The European Commission suggests “a well-defined fiscal rule, namely (1) a permanent character, (2) specification in terms of an overall fiscal performance indicator; and (3) the provision of a numerical ceiling or target” (EC website). In a broader sense, fiscal rules impose restrictions on budget compilation and fiscal policy

¹³ As the objective of fiscal governance, the European Commission cites the following (on its website): 1. attaining sound budgetary positions in particular by containing the deficit bias, i.e. tackling the tendency to conduct unsustainable fiscal policies giving rise to high deficits and increasing debt ratios, 2. reducing the cyclicalities of fiscal policymaking and 3. improving the efficiency of public spending.

planning/implementation (Tanaka 2011).

What matters is the quality of rules. Tanaka (2011) cites the following as standards for evaluating fiscal rules: (1) clearly defined, (2) permanent, (3) comprehensive coverage, (4) accurately measured, (5) reasonable and proper, (6) procyclical consideration, (7) explicitly stipulated exceptions, (8) status of their observance projected and verified, (9) provisions in place that would address their violation, and (10) status of their actual observance.

Auerbach (2012) cites ten items as preconditions for fiscal rules to function. In particular, the following are important: (1) an understanding that budget rules can have an impact on fiscal policies and the economy, (2) sensible design of fiscal rules requires a clear statement of underlying objectives, (3) an understanding that cyclical flexibility is important because countercyclical stabilization policy can be effective, (4) budget rules should be forward looking, but should discount the future. As details of the fiscal rule strength index, the EU cites the following: Statutory/legal base of the rule, room for setting or revising objectives, nature of the body in charge of rule monitoring and the correction mechanism, correction mechanisms in case of deviation from the rule, resilience to shocks or events outside the control of the government¹⁴. Similarly, the IMF has come up with its own fiscal rule index comprising such items as legal basis, coverage (central government, general government), enforcement, supporting procedures and institutions (multi-year expenditure ceilings, fiscal responsibility law, independent body), and flexibility (clearly-defined escape clauses, fiscal balance defined in cyclically adjusted terms) (Schaechter et al., 2012).

Fiscal rules are generally of four types: balance, expenditure, revenue, and debt. Among them, the expenditure rule is singled out as the most important¹⁵. Cordes et al. (2017) state as follows: (1) the compliance rate for expenditure rules is greater than that for budget balance rules, particularly if the expenditure rule is directly under the control of the government and the rule is enshrined in law or in a coalition agreement, (2) the presence of expenditure rules is associated with stronger fiscal performance, that is, a higher primary balance—after taking into account conventional determinants—and countercyclical policies, (3) expenditure rules are associated with lower levels of public investment in emerging market economies, where weaker PFM [Public Financial Management] systems may be less effective at preventing policymakers from deferring high-quality discretionary spending for the sake of complying with the rule (p.317).

The second point of the package is a medium-term fiscal framework. For the “medium-term fiscal framework,” wording is expressed in various ways, including a multi-year budget, medium-term fiscal plan, and medium-term estimate¹⁶. It is a framework for bypassing the legally mandatory single-year budgetary system and allowing budget policy to be planned, discussed and decided over a number of years, and thus shows medium-term estimates or projections of major fiscal policy indicators such as expenditure, revenue, balance and outstanding debt (Tanaka 2011). Using the term “medium-term budget framework (MTBF),” the European Commission says that “a single year perspective provides a poor basis for sound fiscal planning. MTBFs usually cover the preparation, execution, and monitoring of multiannual budget plans and contain both expenditure and revenue projections as well as the resulting budget balances”¹⁷.

The IMF (2007:41) refers to the following as requirements for a good medium-term fiscal framework: (1) fiscal policy objectives and quantitative fiscal targets need to be articulated and

¹⁴ See European Commission webpage titled “Numerical fiscal rules in EU member countries”.

¹⁵ Anderson and Minarik (2006) analyze the benefits and defects of the deficit and expenditure rules.

¹⁶ In English, the term is described as a medium-term fiscal framework, medium-term expenditure framework, etc. The IMF (2007) classifies the medium-term fiscal framework into general government, budget, expenditure, and the like, depending on coverage.

¹⁷ See European Commission webpage titled “Medium-term budgetary frameworks”.

defended at the highest level of government; (2) robust revenue forecasts are critical, and the target levels of expenditure must be rigorously related to the macroeconomic prospects over the medium term; (3) budget and forward estimates are better set in nominal terms to ensure that program managers respond to price changes; (4) the framework should be based on clearly defined and fully costed policy proposals; and (5) the medium-term budget framework should be accompanied by strengthened measures to review individual expenditure policies and their institutional delivery mechanisms.

The index constructed by the European Commission captures the quality of the national medium-term budgetary framework through five criteria: (1) coverage of the targets/ceilings included in the national medium-term fiscal plans; (2) connectedness between the targets/ceilings included in the national medium-term fiscal plans and the annual budgets; (3) involvement of national parliament in the preparation of the national medium-term fiscal plans; (4) involvement of independent fiscal institutions in the preparation of the national medium-term fiscal plans; and (5) level of detail included in the national medium-term fiscal plans¹⁸. Meanwhile, Tanaka (2011) cites the following: (1) legal basis, (2) coverage, (3) restrictiveness, (4) evaluation of preconditions for growth rates, (5) verification of actual results, (6) independent assessment, (7) parliamentary involvement, and (8) coordination with local government finances.

The third point is independent fiscal institutions (IFIs). These are also called independent parliamentary budget offices or fiscal councils¹⁹. The OECD (2015) defines IFIs as “independent parliamentary budget offices or fiscal councils, independent fiscal institutions (IFIs) [that] are publicly funded, independent bodies with a mandate to provide non-partisan oversight and analysis of, and in some cases advice on, fiscal policy and performance” (p.4). Hagemann (2011) defines a fiscal council as “a publicly-funded entity staffed by non-elected professionals mandated to provide nonpartisan oversight of fiscal performance and/or advice and guidance – from either a positive or normative perspective – on key aspects of fiscal policy” (p.76). The European Commission defines IFIs as “non-partisan public bodies, other than the central bank, government or parliament aimed at promoting sustainable public finances through various functions, including monitoring compliance with fiscal rules, production or endorsement of macroeconomic forecasts for the budget, and/or advising the government on fiscal policy matters”²⁰.

Even if established, organizations do not always function. Therefore, it becomes important to identify their duties and set up a mechanism for ensuring that they are carried out. Jankovics and Sherwood (2017) say, based on their analysis of the performance of IFIs in Europe, that two points are crucial: official macroeconomic forecasts used for fiscal planning, and their assessment of national compliance with numerical fiscal rules. To improve the role of IFIs, they point out the need to ensure more appropriate safeguards of independence, improve the forecast endorsement process, and conduct more timely and comprehensive monitoring of numerical rules. Beetsma and Debrun (2017), and Beetsma et al. (2018) similarly emphasize the two functions of IFIs.

As indicators that measure the functions of IFIs specifically, the European Commission lists the following six items: (1) monitoring compliance with fiscal rules; (2) macroeconomic forecasting; (3) budgetary forecasting and policy costing; (4) analysis of long-run sustainability of public finances; (5) promotion of fiscal transparency; and (6) normative recommendations on fiscal policy²¹.

¹⁸ See footnote No.17.

¹⁹ Debrun et al. (2009) classify “fiscal agencies” into an “Independent Fiscal Authority” and a “Fiscal Council,” sorting out the functions of each. Definitions of independent fiscal institutions are described in detail by Ueno (2015).

²⁰ See European Commission webpage titled “Independent fiscal institutions”. Based on the “Council Directive 2011/85,” EU member countries were required to set up IFIs as organizations monitoring the observance of fiscal rules.

²¹ This is the Scope Index of Fiscal Institutions (SIFI). See European Commission webpage titled “Independent fiscal institutions”.

The IMF has developed a signal enhancement capacity index, which is assessed based on the following issues:

- (1) Independence and governance: Legal independence, safeguards on budget, composition, appointment, and term of high-level staff, size of the council, staff commensurate to tasks
- (2) Remit of fiscal councils: Forecasts provision/assessment, costing of measures, long-term sustainability analysis, positive analysis, normative analysis or recommendations
- (3) Tasks and Channels of Influence: Public reports, high media impact, binding forecasts, formal consultation or hearings, stalling the budget process, compliance or explanation²².

The fourth point is decision-making regarding fiscal policy and budget compilation. Referring to negotiating forms of the cabinets of European countries, Hallerberg et al. (2009) analyze negotiation in cabinets: General constraint, agenda setting, budget norms, structure of negotiation. Tanaka (2011) compares the degree of centralization of budget-compiling authority among 11 OECD member countries in terms of the finance minister's positioning, the form of budget negotiations, the method of dispute settlement, parliamentary modification, decisions on the budget outline in parliament, etc.

The fifth point is the transparency of a budget and fiscal management. As standards for budgetary transparency, Alt and Lassen (2006) cite the following 11 points: (1) non-financial performance data included in the budget documentation presented to the legislature; (2) special reports on the fiscal outlook prior to an election; (3) a report on the long term (10–40 years) outlook for public finances; (4) report on contingent liabilities; (5) more than one supplementary budget to the legislature in each fiscal year; (6) auditing of in-year financial reports; (7) subjecting economic assumptions to independent review; (8) accrual accounting in its financial statements; (9) a legal requirement that the budget documentation contains a projection of expenditure beyond the next fiscal year; (10) a legal requirement that the budget include an ex post comparison between projected expenditure in future years and the actual expenditures in those years; (11) the impact that variations in the key economic assumptions would have on the budget outcome. Hameed (2005) has developed a set of indices of fiscal transparency using information obtained from the IMF's Fiscal Transparency Code²³. The indices include independent assessment of forecasts, budget realism, projections guided by a medium-term quantitative framework, and new policy costs. Tanaka (2011) looks into 20 pieces of budgetary information, including fiscal rules, sensitivity analysis, tax expenditure, and financial statements, regarding Japan's budget to see if they are submitted by the government to the National Diet when compared with overseas examples. Focusing on the government's budget analysis ability, Kasperskaya and Xifr (2019) measure budgetary analytical capacity (BAC) based on three dimensions: Reliability of projections, openness to legislative scrutiny, and transparency.

As a system related to transparency, some experts point out the importance of a framework, such as a fiscal responsibility law, under which fiscal targets and rules are introduced, and verification of their observance is laid down. New Zealand introduced such legislation in 1994²⁴, with many countries later adopting a similar law. The law mandates a new government set up after an election to introduce a medium- to long-term fiscal strategy and fiscal rules/targets, among other things, based on the law's principles. Fiscal responsibility legislation is designed to provide a statutory framework for future governments to be accountable for discretionary changes in policies

²² For details, see Debrun and Kinda (2014). Referring to the Netherlands' CPB, or Bureau for Economic Policy Analysis, Debrun et al. [2017:418] say, "Although it is difficult to identify a robust causal link between the activities of the CPB and improved fiscal performance in the Netherlands, the CPB's media visibility supports the idea that it actively contributes to the quality of the public debate and reduces information asymmetries between decision makers and the public."

²³ This refers to the IMF's "Code of Good Practices on Fiscal Transparency -- Declaration on Principles".

²⁴ Through a legal amendment in 2004, the law was absorbed into the Public Finance Act.

(Cangiano 1996:22).

Van Eden et al. (2013) define a fiscal responsibility law as “legal frameworks that embed in law an agreed-on set of policies, processes, or arrangements intended to improve fiscal outcomes, discipline, transparency, and accountability by requiring governments to commit to fiscal objectives and strategies that can be monitored” (p.80). The authors say there are three types, depending on what is given priority: The principle of transparency (e.g. New Zealand), rules regarding procedures, and rules regarding fiscal policy.

As reasons for the fiscal responsibility law having been successful in observing fiscal discipline in New Zealand through different governments despite the lack of legally binding power, Gill (2019) cites the following: (1) first, there is suprapartisan recognition of the importance of fiscal discipline, thus constituting a mechanism of ensuring political commitment; (2) secondly, the Treasury is an independent organization, undertaking various fiscal analyses and drawing up fiscal reports (beforehand/afterward, short- and long-term), thus boosting fiscal transparency.

4. Fiscal governance in Japan

Based on the analyses and discussions thus far, the author will sort out fundamental problems underlying fiscal management in Japan. As six important elements of “sound fiscal policy” advocated by the IMF, Heller (2003) singles out the following: (1) pursuing an appropriate short-term fiscal policy stance; (2) placing fiscal policy in a medium-term framework, and with an eye to the long-term; (3) an emphasis on fiscal sustainability; (4) having the capacity to ensure the successful implementation of a country’s fiscal policy objectives; (5) the importance of the structural content of fiscal policies; (6) the importance of high quality, transparent budget process, good governance, and a well-managed expenditure and revenue administration. In light of these, we can classify themes subject to fiscal policy assessment into two groups: Fiscal policy and distribution of resources [(1), (2), (3) & (5)] and the budgetary institutions that plan and execute them [(4) & (6)]. Japan’s problems associated with the former group include the following: Few attempts at fiscal reconstruction have succeeded; fiscal policy based on economic cycles is not established; the budget is lopsidedly focused on social security, particularly pension and healthcare, while investment in human resources is insufficient as to childrearing and education. But such issues will not be discussed further here. Among the latter group’s specific problems are: a balanced budget rule under the public finance law is not functioning; the expenditure ceiling is applied only to part of the initial General Account budget, lacking in a mechanism to hold down expenditure in the medium term; with supplementary budgets used repeatedly, the budgetary system has become inefficient; accounting manipulations are conducted between general and special accounts; the transparency of budget and fiscal management is low; economic growth rates used for the budget for the new fiscal year and for the medium-term fiscal framework are optimistic; with the finance minister’s power weak, decision-making is fragmented²⁵; and there is almost no fiscal policy-assessing function in the government and the Diet.

In short, Japan’s fiscal governance is extremely weak. To confirm this through international comparison, the author will take up fiscal governance in Japan and other advanced countries, comparing that of both sides in a quantitative manner based on preceding studies concerning measurement of fiscal governance, reviewed in the previous chapter. Subjects covered for analysis are fiscal rules, medium-term fiscal frameworks, independent fiscal institutions, and the budgetary institutions in general including the accounting system, decision-making, etc. as well as fiscal rules.

²⁵ This is due to the Liberal Democratic Party’s involvement in budget compilation; refer to Campbell (1977), Meyer and Naka (1998), and Wright (2002), among other papers.

As for fiscal rules, the author formulates an index of fiscal rules for each country, using the IMF database on fiscal rules (2015) and its EU version (2018). Regarding the IMF dataset, the author selects OECD countries and develops an overall fiscal rules index which consists of a fiscal rules score (number of domestic rules, monitoring, formal enforcement, coverage, legal basis, clearly-defined escape clauses, fiscal balances defined in cyclically adjusted terms) and a supporting procedures score (multi-year expenditure ceiling, fiscal responsibility law, independent fiscal body)²⁶. The subsequent outcome is as shown by Figure 1. Japan is ranked 29th in the score for fiscal rules among 35 countries. As for the EU, the author calculates the total score of each country by evaluation based on such standards as statutory/legal base of the rule, room for setting or revising objectives, nature of the body in charge of rule monitoring and the correction mechanism, correction mechanisms in case of deviation from the rule, clearly defined escape clauses, and targets defined in cyclically-adjusted terms. Since Japan is not included in the EU database, the author assesses the country's items concerned. Not all countries have the three fiscal rules in place. Accordingly, the number of countries covered differs according to the rules. Japan is ranked last for this index (see Figure 2).

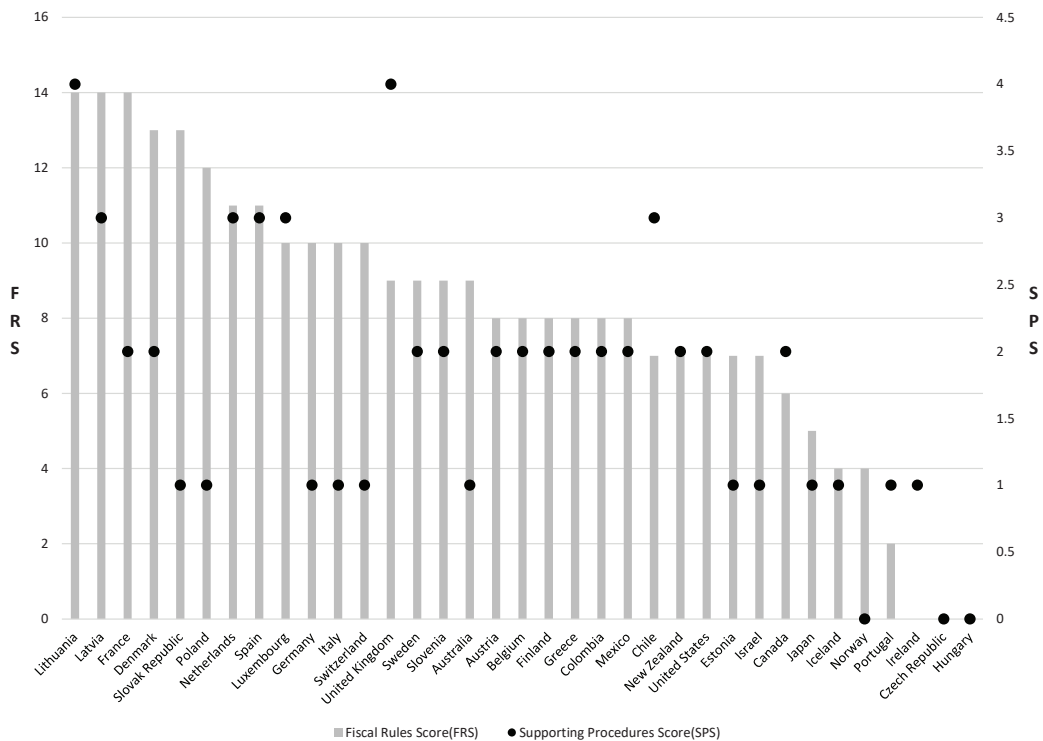


Figure 1: Fiscal Rules Score and Supporting Procedures Score

Source: Author's assessments based on IMF Fiscal Rules Database.

²⁶ Basically, a country scores one point when it corresponds to a given item and earns no points when it does not. That country's total points are turned into an index (as is the case with other indices). As for standards such as oversight (except for the rule-reinforcing system and stabilization mechanism), countries are assessed according to different types of fiscal rules, including expenditure and fiscal balance.

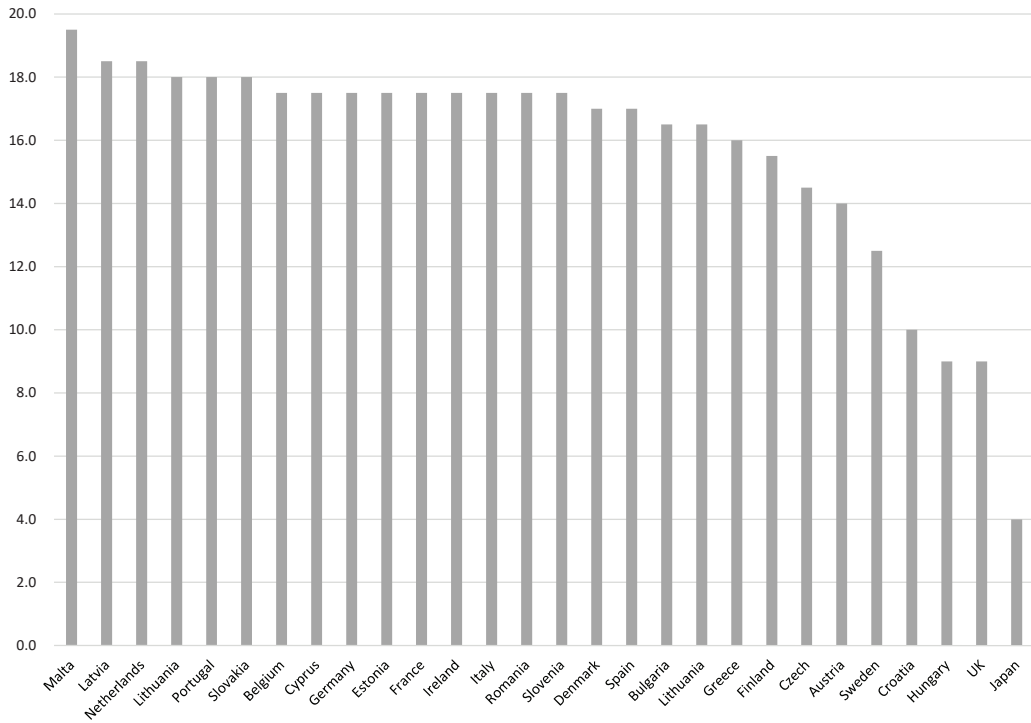


Figure 2: Fiscal Rules Index

Source: Author's assessments based on Fiscal Rules Database of European Commission.

Regarding the medium-term fiscal framework, the EU database (2018) was used (the author's evaluation being used for Japan). A "medium-term fiscal framework score" was calculated on the basis of five standards: Coverage of the targets/ceilings included in the national medium-term fiscal plans (C1), connectedness between the targets/ceilings included in the national medium-term fiscal plans and the annual budgets (C2), involvement of national parliament or use of a coalition agreement in the preparation of the national medium-term fiscal plans (C3), involvement of independent fiscal institutions in the preparation of the national medium-term fiscal plans (C4), and level of detail included in the national medium-term fiscal plans (C5). Of the 25 countries covered, Japan's rating was the lowest (Figure 3).

The IMF and EU databases are used for independent fiscal institutions. An independent fiscal institution in the true sense of a general definition does not exist in Japan, but the IMF database (2014) covers as such the Fiscal System Council in the case of Japan, which is under the Ministry of Finance. Each independent fiscal institution is assessed regarding independence, governance, functions, transparency, and information dissemination. Based on these standards, Figure 4 compares the "index of authority of an independent fiscal institution"²⁷. As for the EU (2018), Figure

²⁷ Beetsma and Debrun (2017) made a similar analysis based on IMF data, ranking Japan in 29th place among 30 independent fiscal institutions. At the bottom is Chile, while the top five are the UK, Portugal, Slovenia (IMAD), the Netherlands, and Germany.

5 compares the “index of authority of an independent fiscal institution” based on the following six standards: monitoring compliance with fiscal rules (TK1); macroeconomic forecasting (TK2); budgetary forecasting and policy costing (TK3); analysis of long-run sustainability of public finances (TK4); promotion of fiscal transparency (TK5); normative recommendations on fiscal policy (TK6)²⁸. Japan is ranked low in all standards.

The OECD database (2018) includes various budget-related data. The author selected ten areas from the data, standardized them and prepared rankings (see Table 2). The areas covered are budget-related reports; important budget reports; a fiscal framework, including fiscal rules; a medium-term fiscal framework; transparency and openness; participation, inclusiveness and data; comprehensive accounting; effective budget execution; fiscal risk; and audit and independent fiscal institutions. Japan's average rank in the ten areas is 29.1 among the 34 countries involved.

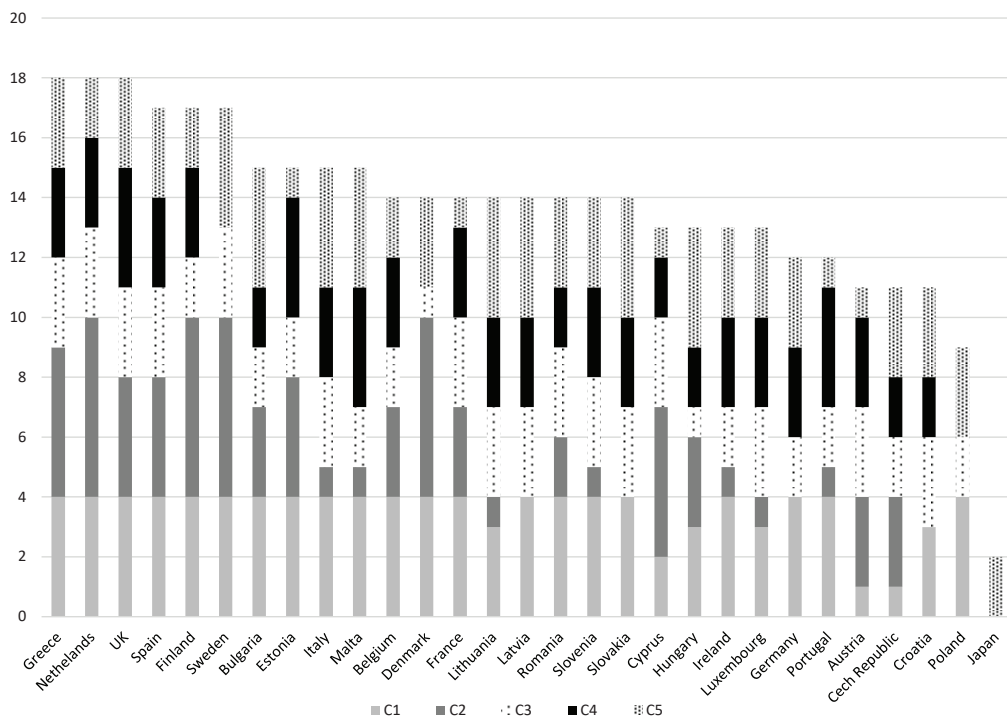


Figure 3: Index of Medium-term Fiscal Framework

Source: Author's assessments based on MTBF Database of European Commission.

²⁸ In case a country has two or more institutions, one given the highest standing is selected.

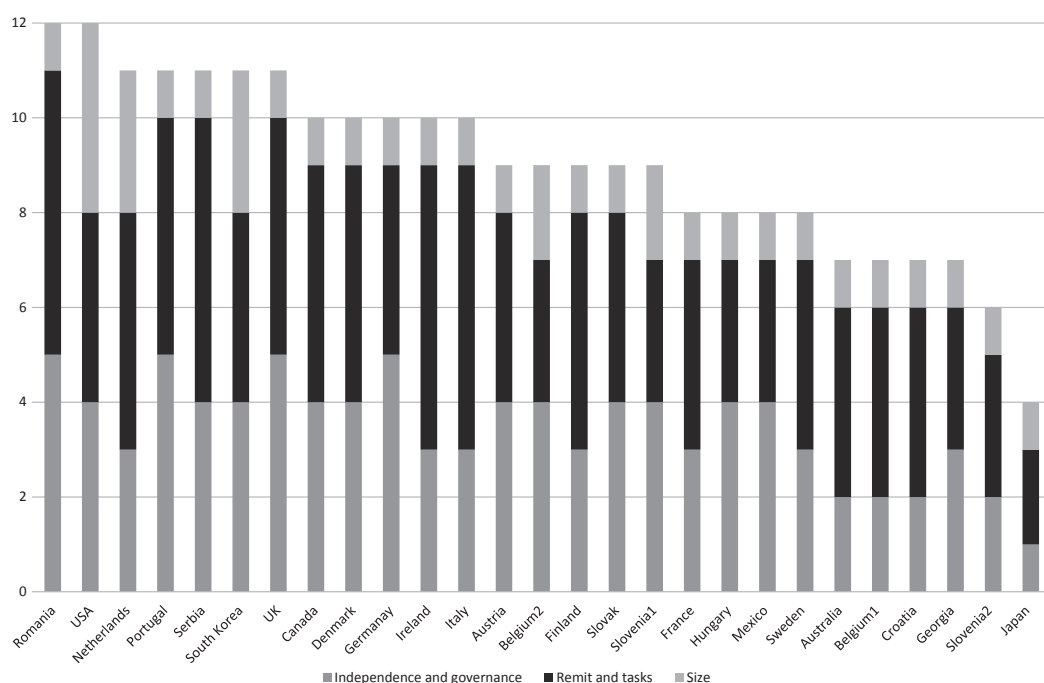


Figure 4: Index of Independent Fiscal Institutions

Source: Author's assessments based on Fiscal Council Database of IMF.

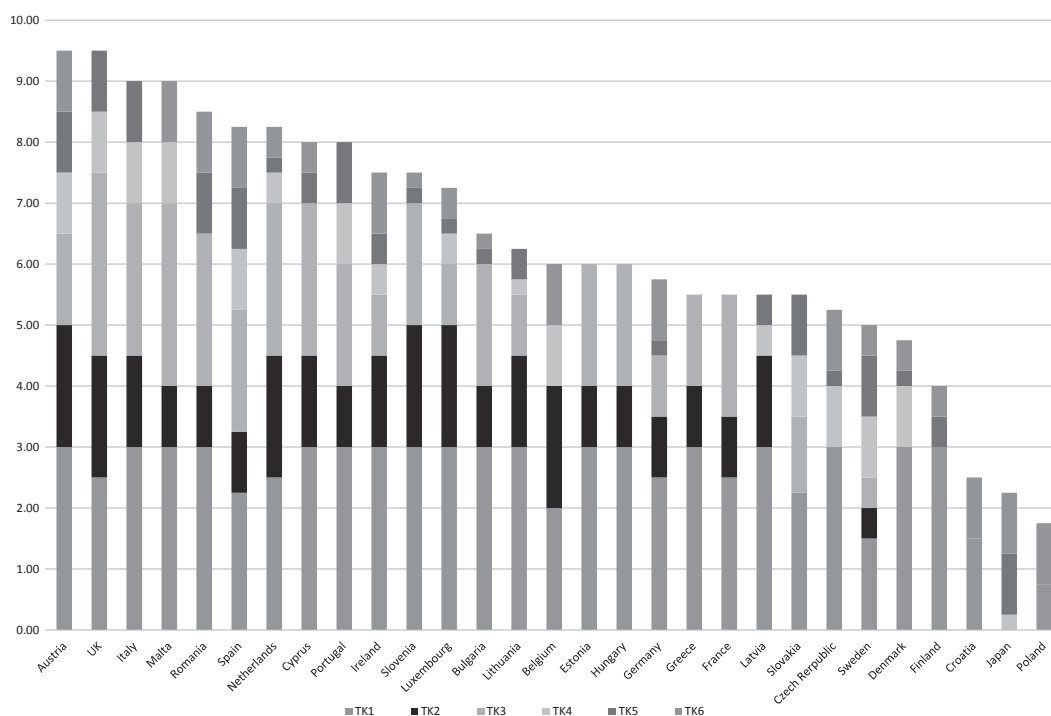


Figure 5: Index of Independent Fiscal Institutions

Source: Author's assessments based on IFIs Database of European Commission.

Table 2: Comprehensive Assessment of Budgetary Institutions by Ranking

	Budget reports	Key budget reports	Fiscal framework	Medium-term fiscal framework	Transparency and openness	Participation, Inclusiveness and data	Comprehensive accounting	Effective budget execution	Fiscal risks	Audit and IFIs	Average ranking
Australia	22	11	34	27	22	1	2	1	3	30	15.3
Austria	25	23	24	19	9	22	13	28	1	15	16.4
Belgium	16	16	6	34	26	21	22	30	29	3	19.7
Canada	19	17	26	21	17	3	12	17	1	28	16.1
Chile	17	18	30	22	10	13	27	27	25	24	18.7
Czech Republic	7	7	18	5	5	16	23	16	1	23	13.6
Denmark	31	30	2	13	24	33	19	19	10	29	21.0
Estonia	33	32	17	24	27	31	15	26	30	3	23.8
Finland	1	1	14	3	8	27	7	23	4	16	10.4
France	14	22	8	1	25	7	24	15	15	12	16.2
Germany	23	18	20	15	21	25	31	27	18	11	20.9
Greece	11	23	4	26	32	24	20	1	1	16	16.5
Hungary	8	9	23	18	34	15	5	5	10	5	14.2
Iceland	34	34	25	4	7	9	8	27	21	32	20.1
Ireland	27	28	5	9	6	4	21	10	19	22	15.1
Israel	24	25	27	16	5	30	33	16	31	34	24.1
Italy	2	2	15	5	28	3	22	2	1	8	9.2
Japan	26	29	33	31	14	34	34	31	33	26	29.1
Korea	18	21	29	11	4	2	14	10	32	8	14.9
Latvia	10	10	13	7	19	20	16	19	9	19	14.2
Luxembourg	9	11	5	17	31	10	25	16	16	29	23
Mexico	5	7	7	32	1	23	4	21	13	3	11.6
Netherlands	13	11	3	2	13	14	28	33	3	6	12.5
New Zealand	21	14	32	14	30	12	3	10	12	31	18.7
Norway	30	33	31	33	12	19	26	23	23	20	25.0
Poland	20	15	21	25	27	29	32	10	26	24	22.9
Portugal	28	26	12	20	18	8	17	34	26	14	20.3
Slovak Republic	14	13	9	30	23	26	18	21	21	7	19.3
Slovenia	12	18	1	29	6	11	11	1	1	23	14.0
Spain	2	2	9	8	2	17	9	1	14	18	8.2
Sweden	6	6	16	12	11	11	10	23	2	7	10.4
Switzerland	29	27	19	23	23	28	29	29	22	27	24.8
Turkey	4	4	28	10	20	18	1	1	12	13	11.1
United Kingdom	32	31	22	6	33	32	6	32	1	21	21.6

Source: Author's assessments based on OECD International Budget Practices and Procedures Database

5. Conclusion

Fiscal governance, namely a package of budgetary institutions for improving fiscal performance were analyzed in this paper. This sort of assessment cannot exclude arbitrariness, but it is true that, among advanced countries, fiscal governance is at a low level in Japan. The problem with Japan's budgetary institutions, in particular, is the lack of a mechanism for the oversight and observance of rules as well as the absence of post hoc evaluation and verification (Tanaka 2011).

Even if problems lie in Japanese fiscal governance, it is, after all, a question of the political process over scarce resources. Hallerberg et al. (2009) state as follows: "An important insight is that the effectiveness of a given form of fiscal governance depends crucially upon the underlying political system. If parties disagree on basic policy issues about how much should be spent where or how much a given group in society should be taxed, they are unlikely to allow a finance minister to make decisions on the budget for all of them. This discussion suggests that strengthening the formal powers of a finance minister where there are great ideological difference among the policymakers who are needed to approve the budget will have little practical effect, while a similar strengthening of the finance minister should have a large effect where there is little ideological discord in government, so long as the party or parties are running together in the next election" (p. 5).

In Japan, efforts have been made for reforms intended to strengthen political and administrative governance, such as the overhaul of the electoral system and the restructuring of ministries and agencies since the collapse of the bubble economy. Put simply, these are reforms at the initiative of politicians or the cabinet in a departure from a consensus model of the Liberal Democratic Party's 1955 regime.²⁹ It will be safe to say that they have been established to a certain extent by way of the Junichiro Koizumi administration, the Democratic Party of Japan government, and the Shinzo Abe administration (his second Cabinet and thereafter). However, the policymaking process deteriorated drastically under the second Abe administration, with Abe retiring after becoming Japan's longest serving prime minister. This is because important government policies were shaped in advance by a limited number of officials at the Prime Minister's Office without scientific analysis or in the absence of agreement among the people concerned.³⁰ Tanaka (2019b) analyzes governance of the policymaking process from the perspective of contestability by comparing and looking into the analysis and verification functions of policies in developed countries, including Japan, which is remarkably weak in such functions. Especially, there are few independent organizations within the government, while the Diet does not have sufficient government-supervising functions.

Leeper (2017) argues the importance of social contracts by saying, "Modern societies are grounded in social contracts between the people and their government. To an extent that is underappreciated, fiscal policies are an essential aspect of social contracts. Social contracts in many countries are under threat. Our societies do face long-run fiscal stresses" (p.61). In the wake of the novel coronavirus pandemic, this stress is expanding globally, and it is particularly remarkable in Japan where birthrate decline and population aging are progressing rapidly. We know what is necessary to improve fiscal governance. The question is how to implement what is necessary. It depends on whether democracy will or will not function in Japan.

²⁹ See Iio (2007), Takenaka (2006), etc.

³⁰ For details, see Tanaka (2019a).

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