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Introduction

Everyone likes spending, although no one likes to pay. Governments are the same. While they would like to deliver popular goods and benefits to voters, paying for such spending requires unpleasant choices, levying taxes or running budget deficits. Because they cannot have high spending, low taxes, and balanced budgets, they have to make difficult political choices. Governments, thus, face a "fiscal trilemma." But what would happen if a government found a means of spending without taxation? This book contends that this is precisely what Japan did. The ruling party, the Liberal Democratic Party (LDP), used a system of public finance that did not rely on taxes—the Fiscal Investment Loan Program (FILP)—and allowed it to do the seemingly impossible: keep taxes low and budgets balanced, all without having to restrain public spending. This combination was at the core of a distinctive postwar political bargain: one that eschewed high budget spending and taxation, expansion of the welfare state, and Keynesian-inspired fiscal stimulus. By doing so, though, it was striking a Faustian bargain that eventually undermined the political settlement that it helped underwrite.

By focusing on FILP, this study presents several novel findings. First, it demonstrates that a *financial* mechanism, FILP, enabled the Japanese government to run a distinctive neoclassical fiscal policy based on low budget spending from the end of the 1940s through 1970. This ran directly counter to the postwar trend in other industrial democracies, where governments increased budget spending and taxation to finance the expansion of the welfare state and in many cases employed fiscal stimulus to maintain full employment. Second, it shows that the government's policy of budget restraint *and* pork barrel spending were two sides of the FILP coin. This finding resolves the contradiction between the view that the LDP has stayed in power through profligate public spending and the reality of low budget spending in Japan. Third, this study reveals that, while the government's early commitment to budget restraint initially delivered economic benefits, it came at a very high long-term cost: heavy state intervention in finance, deferred fiscal burden, and the political challenge of reforming the mechanism that made it all possible.

In comparative perspective, the Japanese case illustrates a larger point about the politics of public spending. While most comparative studies focus on budget spending, taxation, and budget deficits, the experience of Japan demonstrates that governments can finance their activities not only through taxes but also through the allocation of *credit* and other *financial* mechanisms. Ignoring the role of such "policy finance" comes at the risk of underestimating or mischaracterizing the size and scope of the state, a point often overlooked by studies focused on explaining fiscal outcomes. Comparing Japan's experience with several minor cases, this study finds that three factors contribute to extensive use of policy finance: external budget restraint, strong domestic political support for policy finance, and the centralization of policy finance within the budget-making apparatus.

Fiscal Choices and Policy Finance

Public spending choices are at the heart of how governments attempt to reconcile the competing demands of democratic politics and the market system. After the Great Depression and continuing after World War II, higher taxes, higher spending, and, in many cases, fiscal stimulus through deficit financing were central features of the postwar political settlement throughout the industrialized democracies. The expansion of welfare programs led to a larger and more redistributive state, and Keynesianism-inspired fiscal stimulus dampened the effects of cyclical economic downturns by maintaining employment. Along with the Bretton Woods institutions and a new trading and financial regime, these changes established the foundation for what Shonfield called "modern capitalism" and what Gourevitch and Hall observed served as an historic compromise between capital and labor.[1] The expansion of the state and Keynesianism were defining features of postwar political economy across the industrialized democracies.

This bargain was not without political trade-offs and costs. Deficits strained budgetary resources, and, as taxation rose, so did opposition to it. Since the 1970s, the renegotiation of the terms of the postwar settlement has been one of the central political dramas unfolding throughout the industrialized world. A new economic orthodoxy challenged the utility of fiscal stimulus and called for reductions in public spending, including retrenchment of the welfare state. Since the 1990s, the acceleration of economic globalization has sharpened the fiscal trade-offs confronting governments. Global financial integration has increased the costs of deficits and certain forms of taxation. This has not, however, eliminated government choices. As Carles Boix has argued, governments can still choose between two supply-side economic strategies, a public investment strategy and a private investment strategy. Governments run by left parties favor the former in an "attempt to raise directly the productivity of capital and labor through more expenditure on infrastructures and education and, sometimes, through the creation of a public business sector."[2] By contrast, right parties attempt to lower taxes to increase savings and private investment, that is, the private investment strategy. Each strategy, though, creates distinct electoral dilemmas. Excessive spending cuts may alienate many middle-class voters. On the other hand, high public investment requires high taxes, which may lead to a political backlash.

This formulation, while parsimonious and useful, overlooks that governments can finance public investment not only through taxes or borrowing but also through financial mechanisms to steer credit and investment, what this study calls policy finance.[3] Policy finance is the use of *credit* and other *financial mechanisms* to achieve public policy purposes. In a deliberate attempt to avoid making difficult fiscal choices, the Japanese government mobilized and deployed a system of policy finance—the FILP—that did not rely on taxes, providing the government, at least initially, with a form of "spending without taxation." While often overlooked, policy finance is an important component of many states' systems of public finance. Comparatively, though, the size of Japan's system of policy finance and its structure have given it a particular salience in Japan's political economy. Until reforms that took effect in 2001, the state-run postal savings system, public pensions, and several other smaller sources provided funds to FILP. Established in 1953, FILP grew rapidly; at its peak, FILP drew on approximately four trillion dollars of funds, and annual allocations reached 80 percent of the size of annual general account budget expenditures. None of the other major industrial countries have had a policy finance system nearly as large nor one as closely connected to the management of the formal budget (see the next chapter for specific comparisons).

The Argument

This study contends that the state's mobilization of policy finance was central to the postwar political bargain in Japan, first by enabling the ruling party to forge a political settlement that delivered economic growth and political stability and then by sowing the seeds of its own unraveling. Initially, FILP allowed the government to maintain budget restraint without having to sacrifice spending. This combination of otherwise contradictory policies was vital to the ruling party. Low budget spending was a pillar of the government's economic growth strategy, allowing the government to keep taxes low and budgets balanced through the start of the 1970s. Low taxes would promote savings and private investment. A small public sector would unleash the dynamism of the private sector. Suppressing budget spending would enable the government to maintain a balanced budget, which in turn would prevent private sector crowding out,[4] help stabilize Japan's international balance of payments, curb inflation, and allow the government to run a more activist monetary policy.[5] Limiting budget spending also meant that the Japanese government could deliver popular tax cuts, an often-overlooked yet significant pillar of the ruling LDP's political strategy, without running up deficits.

Yet contrary to the view that Japan's fiscal conservatism reflected the social coalition or ideological orientation of the political party, budget restraint was unpopular within the conservative camp and conflicted with its political strategy of delivering political pork to its constituents. FILP allowed the government to square the circle. The Japanese government established and then deployed FILP as a means to limit budget spending *and* to pay for the priorities of the ruling coalition. FILP not only helped finance the government's industrialization policies but also kept the ruling party in power and the conservative coalition unified. FILP financed the government's economic development priorities by providing credit to strategic industries and funds for critical economic infrastructure. The ruling Liberal Democratic Party also used FILP along with the budget to provide generous material compensation to its supporters, channeling funds to its conservative base—farmers, small and medium-size enterprises (SMEs), rural areas, and big business—and over time to new constituencies.[6] These allocations via FILP translated into electoral support for the LDP, as the statistical analysis presented in this study demonstrates. By serving as a supplement to the budget, FILP also helped keep budget expenditures down, allowing the government to deliver tax cuts and extend tax exemptions to supporters (small business and agriculture and rural workers) without sacrificing budget balance.[7] FILP thus linked the government's fiscal policy, industrialization strategy, and the ruling party's political strategy.

Although FILP helped forge Japan's stable postwar political settlement, it also embodied the limitations of this arrangement. The government could use FILP to broker a larger political settlement because it is a *financial* system, which drew on the nation's large pool of savings rather than taxes. Yet precisely because FILP is a financial system, it could not sustain this compromise over the long term. Unlike the budget, FILP allocates finance capital in the form of *loans and investments* that must be repaid. The government, however, subordinated the financial management of FILP to two competing goals, minimizing budget spending and funding the LDP's political strategy. This practice intensified from the 1970s as political pressure on the LDP mounted, the budget fell into deficit, and industrialization declined as a national priority. During the 1980s, the government restored budget discipline by pushing items that should have been funded by the budget onto FILP. While exploiting FILP helped the LDP stay in power and solved the political problem of balancing competing interests in the conservative camp, it weakened the finances of FILP as the quality of its investments and loans deteriorated.

Over time, FILP's capacity to paper over differences between fiscal hawks and the pork-barrel wing in the LDP deteriorated. The government was forced to use budget funds to cover losses from failed FILP-financed projects. Moreover, reform of the FILP system emerged as a highly divisive issue within the ruling party. The expansion of FILP conflicted with the government's goal of financial liberalization and drew opposition from private banks that argued that the system competed with them. The rapid growth of FILP also fed into the perception of a state apparatus that had grown out of control. Finally, failures of FILP-financed projects and stories of mismanagement and corruption increased public opposition, leading to calls for reform. In short, the features of FILP that had made it so useful to the ruling coalition caused FILP to become a political liability over time.

The issue of FILP reform came to a head with Prime Minister Koizumi, who launched an attack on the entire FILP apparatus after coming to office in 2001. Battling opposition from his own party and the bureaucracy, Koizumi passed numerous reforms by, among other methods, even expelling members of his own party. Despite the political drama, the reforms are relatively modest in aim, rationalizing the FILP system rather than abolish it. Reforms have limited abuse of the FILP system by making it harder for the government to use FILP as a substitute for the budget. As a result, the reform will force the government to confront its fiscal trade-offs more squarely. In the end, FILP ironically exacerbated the fiscal options confronting the government. FILP not only has left behind significant debt, but it has created powerful constituents that rely on public largesse. Balancing Japan's need for fiscal reconstruction, budget spending, and taxes will be one of the central constraints as political parties, both the DPJ and LDP, attempt to build an alternative to the postwar settlement that FILP had made possible.

Public Spending and Japanese Political Economy

This book clarifies several issues central to understanding Japan's political economy. First, by focusing on the role of FILP, it helps resolve a central debate in the study of Japanese political economy: how the economic and political sides of Japanese political economy fit together. On the one hand, liberal public spending is widely cited as one of the primary means by which the ruling LDP has stayed in power.[8] The LDP is often portrayed as a pork-barrel machine that lavishes spending on its supporters, an image bolstered by its high level of spending on public works, which was five times higher than other Organisation for Economic Co-operation and Development (OECD) countries.[9] Yet this has never squared well with the reality of low budget spending in Japan, which formed a critical element of its economic growth strategy. Even in recent years, despite large deficits, Japanese spending has remained low despite very high public investment and increasing welfare commitments.

The role of public spending is also tied to two very different views of the nature of Japanese politics. In the work on the developmental state, the Ministry of Finance (MOF), along with the former Ministry of International

Trade and Industry (MITI),[10] is cited as the paradigm of state autonomy, and MOF's supposed ironlike grip over the budget and ability to limit budget spending one of the best expressions of this autonomy.[11] Yet those focusing on the clientelist aspects of Japanese politics have pointed to the ruling party's liberal use of state spending to reward supporters and extend their political base.[12] According to Scheiner, pork-barrel spending combined with clientelist politics and high fiscal centralization undermines the development of a viable opposition and thus supports ruling party domination. Others have pointed out how under Japan's former single non-transferable vote electoral system (SNTV), the LDP used pork-barrel spending to split the vote share in electoral districts allowing them to win a higher number of seats.[13] As this book shows, FILP was the critical link between the developmental and clientelist sides of Japan's political economy that made it possible for the LDP to spend liberally *and* restrain budget outlays.

Second, this book helps better situate Japan's spending choices in comparative perspective. Japan has long stood out among the advanced industrial democracies for its low budget spending, a point noted and commented on by others.[14] Japan's budget restraint was particularly striking until the early 1970s. During this time the government kept budget spending and taxes low, and with only minor exception budgets balanced. In 1960, Japan's government outlays were the second lowest in the OECD. Only Switzerland, whose constitution imposes limits on the government's power to tax, had lower outlays.[15] By 1970 Japan had the lowest level of taxation and budget outlays of all OECD countries, including countries at a lower level of economic development as well nondemocratic ones (see Figures 1.1 and 1.2). The government deliberately suppressed budget spending as part of a distinctive economic growth strategy. By contrast, governments of other advanced industrial democracies embraced higher taxes and higher public spending; many governments also employed fiscal stimulus to maintain full employment. More than just a fiscal policy, a larger and more activist state represented a political accommodation that helped balance the competing demands of the market system and democratic demands for social protections.[16] The Japanese government, however, eschewed the expansion of the state and activist fiscal policy. To keep spending low, the government limited welfare spending until the early 1970s, which helped it keep taxes low and budgets balanced (see Tables 1.1 and 1.2).