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8. Japanese Fiscal Policy: A Bridge to Nowhere?

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Executive Summary

After 1990, Japan's economy slowed sharply following decades of strong performance. In response, the Japanese government undertook substantial fiscal stimulus. The evidence suggests that Japan's fiscal policy did provide some short-term macroeconomic support, and in the absence of that stimulus, Japan likely would have experienced an even deeper economic downturn. Nevertheless, since its initial slowdown, the Japanese economy neither recovered its earlier pace of growth nor achieved sustained positive inflation. Some of the failure can be attributed to factors beyond the immediate control of the authorities, including the fallout from the previous "bubble economy," the Asian financial crisis, and population dynamics leading to a slowing of potential output growth. In addition, there were problems with the mix and implementation of the fiscal policies, including the failure to maintain fiscal stimulus on a sustained basis. Finally, and more fundamental to Japan's "lost decade," was the country's inability to quickly address weaknesses in the corporate and banking sectors. Without a pickup in the private sector, fiscal policy was essentially "a bridge to nowhere."

This note provides an overview of the Japanese fiscal effort during the past 1½ decades, briefly analyses its effectiveness, and discusses key lessons for the United States. Not surprisingly, these lessons are that in the face of deep economic disruption, fiscal stimulus is likely to be more effective if it is large and sustained, coordinated with significant monetary policy action, and implemented in tandem with policies to address underlying structural weaknesses in the economy.

Overview of Japan's Fiscal Effort

From 1990 to 1995, Japanese real GDP growth averaged less than 1½ percent per year, a third of its pace in the previous five years. In the face of this slowing, the Japanese government began announcing fiscal stimulus plans in 1992. The increases in government spending were sizable. Government expenditure as a share of GDP rose almost 5 percentage points from 1991 to 1995 and was up an additional 2 percentage points by the end of the decade (see exhibit). In addition, revenue as a share of GDP fell 2½ percentage points from 1990 to the mid-1990s. In large part, this drop reflected a cyclical decline in revenue collection – only in 1994 did the government's fiscal stimulus packages contain a sizable tax reduction. The magnitude of the stimulus efforts, together with the impact of the recession on tax revenue, can be seen in the increase in government debt – which doubled as a share of GDP over the decade of the 1990s – and

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in the cyclically adjusted budget balance – which swung from roughly 2 percent to -6 percent of potential GDP over the same period.

Japan's significant fiscal stimulus efforts were concentrated in two periods – August 1992 to September 1995 and April 1998 to October 2000. In terms of the fiscal impulse, measured here as the change in the cyclically adjusted budget balance, the initial effort began small, but over the next several years the impulse averaged 1½ percent of GDP per year. The second period's boost was somewhat smaller in magnitude and duration. In both phases of fiscal expansion, the government concentrated its expenditure effort in public investment, with a majority of the announced spending for infrastructure projects. Most of the remainder was allocated toward purchases of land and to loans to the financial and housing sectors (Muhleisen, 2000).

The government was less aggressive with tax policy until later in the decade. Explicit tax reduction was included in the April 1993 stimulus package, but the magnitude was negligible. A large policy tax reduction was included in the February 1994 stimulus package. Income taxes were reduced by 5.9 trillion yen (1.2 percent of GDP), with the anticipation that the losses in revenue would later be made up by higher value-added taxes (VAT). The expectation of higher future consumption taxes shifted consumption forward and provided short-run stimulus – output growth averaged 4½ percent at an annual rate in the two quarters preceding the VAT increase. However, the timing of the VAT tax hike in April 1997, just prior to the Asian Crisis, was unfortunate and likely exacerbated effects of the crisis. In the face of the largest decline in output since the 1950s, in 1999 the government provided tax relief in the form of temporary reductions in corporate and income taxes as part of a broader stimulus package.

After 2000, Japan's experiment with fiscal stimulus largely ended as rising levels of government indebtedness prompted the government to forego further expansions of the deficit. Notwithstanding a steep recession in 2001, the cyclically adjusted primary deficit remained roughly unchanged at a bit over 5 percent of GDP until 2005, even as the Bank of Japan was entering a novel phase of “quantitative easing” designed to boost inflation back to positive rates. As the economy started to visibly revive in 2006, a sharp cutback in government expenditures and a recovery in revenue collection caused the deficit to narrow substantially.

Policy Effectiveness

Although the fiscal stimulus policy of the 1990s failed to return the growth of the Japanese economy to its previous high rate, the stimulus efforts did appear to have some positive macroeconomic effects (Bayoumi, 2000). Consumption relative to output rose over the 1990s, consistent with support from fiscal policy. As discussed above, consumption appeared particularly responsive to tax measures. Moreover, during the 1990s, the Japanese household saving rate declined on balance and interest rates remained low, suggesting that “Ricardian” considerations regarding the rising debt were not undoing the effect of the stimulus. The fiscal effort also appeared to provide some

boost to employment. The employment-to-population ratio remained relatively high through the early 1990s, with sizable gains in construction and, to a lesser extent, government employment. Accordingly, in the absence of the fiscal stimulus programs, the Japanese economy likely would have experienced an even deeper slowdown (Kuttner and Posen, 2001; Ahearne et al., 2002).

The fiscal effort appeared to have had little long-run positive impact, however. Private investment fell relative to output at the beginning of the 1990s and did not recover. Until the mid-1990s, a rise in public investment offset a fraction of this decline, but it, too, dropped off and the employment-to-population ratio began a steep and sustained decline as the fiscal impetus waned. Indeed, only after 2002 did Japanese per capita GDP resume a steady upward climb.

To some extent, flaws in the mix and implementation of the fiscal policies undermined their effectiveness. Infrastructure spending was often wasteful, politically determined, and ineffective at raising the marginal product of investment (Ihsii and Wada, 1998). Less effort was made at increasing direct transfers to individuals or firms or to strengthening Japan's relatively weak social safety net. Some evidence suggests that Japan's policies could have been better designed so as to have offered more effective stimulus (Kuttner and Posen, 2001). Finally, the impact of the fiscal stimulus was also marred by the stop-go nature of the policies, best illustrated by the ill-timed increase in consumption taxes on the eve of the Asian Crisis.

As a related point, the authorities failed to coordinate fiscal and monetary policies so as to achieve maximum impact on economic activity. During Japan's first period of fiscal stimulus, from 1992 to 1995, the Bank of Japan (BOJ) was reducing policy interest rates only slowly. Conversely, by the 2001-2006 period, when the BOJ was offering substantially greater monetary accommodation through its zero interest rates and quantitative easing, fiscal policy had retreated toward essentially a neutral stance.

Finally, and most importantly, underlying structural problems with the Japanese economy were not faced quickly enough. Investment languished as problems with corporate and bank balance sheets went unrecognized, or, at least, unaddressed, until the late 1990s. Instead, firms slowly worked down their debt burden through repayments out of profits, which constrained investment and growth in the corporate sector for years. Consumption was also weighed down by declining real estate wealth, deflation, and adverse population dynamics. By the time the financial problems were being addressed in the late 1990s and early 2000s, and the Bank of Japan was initiating its quantitative easing policy, the country's fiscal effort was spent, and debt levels made additional fiscal impetus difficult.

Lessons for the United States

Despite differences in economic structure and global conditions, Japan's earlier fiscal policy experience offers some lessons for the United States today. First, given the ultimate depth and magnitude of the Japanese economic slowdown, the fiscal effort was

too small and too sporadic. While few observers at the time foresaw the decade-long slowdown to follow, in retrospect, Japan's concern with debt sustainability led policy makers to quickly reverse policy stimulus, to focus on temporary measures, and to consistently signal an imminent return to fiscal restraint.

Second, the fiscal and monetary efforts could have been better synchronized. Had the BOJ's significant monetary policy measures of the late 1990s and early 2000s been implemented in coordination with fiscal policy stimulus, they would have stood a better chance of supporting growth and preventing deflation.

Finally, as long as the underlying impediments to growth went unaddressed, both monetary and fiscal policies were unlikely to "bridge" to a recovery in private-sector performance. Quickly recognizing and dealing with the problems in the banking and corporate sector would have provided a firmer foundation for long-term growth.

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Exhibit 1

