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JAPAN

Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module

Prepared by the Fiscal Affairs Department
(In consultation with the Asia and Pacific Department)

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July 12, 2001

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in Japan in relation to the IMF *Code of Good Practices on Fiscal Transparency* based on the authorities' response to the IMF fiscal transparency questionnaire and additional information provided by the authorities.

The fiscal system in Japan is characterized by a multitude of budget accounts that link the finances of the national government, local governments, government financial institutions, and public corporations. Many of these accounts relate to the operations of the Fiscal Investment and Loan Program (FILP), a large public financial intermediation program which channels funds to finance public investment projects. Although the fiscal system is complicated, the budget process meets a high standard of transparency: it has a solid legal basis and establishes clear administrative accountability; the budget documentation is comprehensive; and there is regular reporting on budget execution. There are some other strong points, related to the legal and administrative basis for taxation, ethical standards for government employees, and independent audit. Recent initiatives have improved fiscal transparency.

However, there is a need for major progress in key areas.

- Attention should be paid to providing timely information on the overall stance of fiscal policy. This requires: more comprehensive measures of the fiscal position, with a focus on the finances of the general government; regular reporting on fiscal developments, including the provision of a detailed mid-year budget report; and less reliance on supplementary budgets, in particular by formulating initial budgets to reflect the desired stance of fiscal policy.

- Fiscal policy should be examined in a longer-term context. This requires: development of a medium-term budget framework which would allow the annual budget to be formulated in a forward-looking manner; and projections of social security and health spending which are integrated with budget projections as a basis for assessing long-term fiscal sustainability.

- The role of public financial intermediation should be clarified. Specifically, the objectives of the FILP should be reviewed and restated, and more information should be provided about the contingent liabilities arising out of the FILP.

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ABBREVIATIONS AND ACRONYMS

BoJ	Bank of Japan
FILP	Fiscal Investment and Loan Program
FSRA	Fiscal Structural Reform Act
GFS	Government Finance Statistics
JGBs	Japanese Government Bonds
SDDS	Special Data Dissemination Standard
SNA	System of National Accounts

I. INTRODUCTION[1]

1. This draft report provides an assessment of fiscal transparency practices in Japan against the requirements of the IMF *Code of Good Practices on Fiscal Transparency.* The authorities have completed the fiscal transparency questionnaire. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of the questionnaire response and additional information provided by the authorities. The second part is an IMF staff commentary on fiscal transparency in Japan.

2. **It is necessary to recognize at the outset certain distinctive features of the fiscal system in Japan.** The primary focus in domestic discussion of fiscal policy is the national government general account budget. However, the Diet approves the general account budget together with the budgets for 38 special accounts which are controlled by government ministries. Most general account spending takes place through special accounts, and the general account and special accounts together constitute the national budget. The Diet also approves the budgets for nine government financial institutions and the large Fiscal Investment and Loan Program (FILP).[2] In addition, it reviews the local public finance program (which outlines the financing needs of 47 prefectures and over 3,200 municipalities), and the profit and loss statements and balance sheets of the 62 largest public corporations. The links between these various agencies and programs, and their relationship with the national budget (they are financed to varying degrees from special accounts), complicate the fiscal system and have a significant impact on fiscal transparency.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

3. **Institutional arrangements for undertaking fiscal activity differ from those in many other countries.** The constitution, the public finance and public accounts laws, and laws specific to individual government agencies provide a clear legal framework for fiscal

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[1] This report has been drafted by Messrs. Richard Hemming, Noriaki Kinoshita (both FAD), Sanjay Kalra (APD), and Murray Petrie (FAD panel expert). Discussions on fiscal transparency were held with officials from the Ministry of Finance, the Ministry of Public Management, Home Affairs, Posts and Telecommunications, the Board of Audit, the Cabinet Office, the Council on Economic and Fiscal Policy, and the Tax Commission during an April 3-14, 2001 mission to Tokyo.

[2] The nine government financial institutions (which are also referred to as government-affiliated agencies) are the Japan Bank for International Cooperation, the Development Bank of Japan, the National Life Finance Corporation, the Japan Finance Corporation for Small Business, the Japan Small and Medium Enterprise Corporation, the Government Housing Loan Corporation, the Agriculture, Forestry, and Fisheries Finance Corporation, the Japan Finance Corporation for Municipal Enterprises, and the Okinawa Development Finance Corporation.

activity.[3] Nevertheless, current institutional arrangements are not easy to understand, primarily because they are difficult to interpret in terms of central government or general government operations as conventionally defined. While the general account clearly relates to central government operations, based on the System of National Accounts (SNA) classification methodology this is the case for only 18 of the 38 special accounts. These include accounts for infrastructure development and transfers to local governments. Special accounts for social security funds, together with the ordinary accounts of local governments (equivalent to the general account) and a few of their business accounts (equivalent to special accounts), relate to general government operations. Remaining special accounts and business accounts cover the activities of the nongovernment public sector (i.e., government financial institutions and public corporations).[4]

4. **The responsibilities of different levels of government, and of the separate branches of government, are well defined.** The constitution provides for local self-government within the context of a unitary state. Intergovernmental fiscal relations are governed by specific laws on local autonomy and finances which result in a clear allocation of taxation powers and expenditure responsibilities, supported by open, formula-based sharing of centrally collected taxes. Transfers to local governments are determined in the context of the national budget. Local governments have to seek permission to borrow, and can only do so for specific purposes.[5] These arrangements, together with submission of the local public finance program to the Diet, provide the framework for oversight of local government finances by the national government. The constitution also lays out a clear separation of powers across the executive, legislative, and judicial branches of government along traditional lines.

5. **The coordination and management of fiscal activity is fairly effective.** The Diet either approves or is informed about budgets and programs covering all fiscal activity. The general account receives most tax and nontax revenue, as well as proceeds from issuing Japanese Government Bonds (JGBs). These receipts are either spent directly or transferred to special accounts. Only certain earmarked taxes are deposited directly into special accounts. The Ministry of Finance and the spending ministries monitor all special accounts, together with agencies and programs financed from the budget, to ensure that approved budgets are implemented. Thus there is strong central oversight and control of fiscal activity. However,

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[3] The various laws referred to in this report are published only in Japanese. The public finance and public accounts laws are *zaiseiho* and *kaikeiho* respectively. The constitution is available in English.

[4] In addition to the government financial institutions, there are a few public corporations that engage in financial activities.

[5] These purposes are primarily the financing of capital investment and public works. The minister of public management, home affairs, posts and telecommunications approves borrowing by prefectures, and prefecture governors approve borrowing by municipalities.

insufficient attention is paid to the overall financial position of the central government or general government.

6. **The main responsibility of the Bank of Japan (BoJ) is to achieve monetary policy objectives.** The BoJ was given effective independence in 1998. The public finance law prevents the BoJ from lending to the government, although it purchases JGBs for monetary management purposes and, in special circumstances, the BoJ can lend to the government with the approval of the Diet. The BoJ administers the national treasury accounts, which cover the general account and the special accounts. It can also lend to the government when there is a temporary shortage of national treasury funds, again with the approval of the Diet.

7. **Public financial institutions are used extensively for fiscal policy purposes.** This occurs primarily in connection with the FILP, which channels funds to finance public investment projects and other priority spending. The postal savings system has in the past been an important source of these funds. Specifically, prior to April 2001, the Postal Savings Bureau was obliged to automatically transfer the deposits it received to the Trust Fund Bureau. FILP agencies—which comprise local governments, government financial institutions, public corporations, and certain special accounts—then borrowed from the Trust Fund Bureau to finance onlending and direct spending in connection with a variety of activities, such as housing, infrastructure investment, and small business development. Directed lending for FILP projects that the private sector would not finance given their low rates of return makes the FILP quasi-fiscal in nature. The postal savings system and government financial institutions also have public policy obligations which are quasi-fiscal activities in their own right.[6]

8. **The FILP reforms that came into effect in April 2001 are intended to address problems with the program**. A key objective is to expose FILP agencies to market discipline by gradually breaking the automatic link between postal savings deposits and FILP financing. There will also be greater use of policy cost analysis to assess projects.[7] The new Postal Savings Department will gradually gain full control over the investment of postal savings deposits (the current plan envisages a transition period of seven years, with corporatization of the Postal Savings Department in 2003). At the same time, FILP agencies will be increasingly required to obtain project financing from the market. However, the Postal

[6] The main public policy obligation of the postal savings system is to provide nationwide basic financial services. Its other obligations include offering a preferential interest rate on deposits of welfare beneficiaries, providing low interest loans to people requiring nursing care, and promoting international voluntary aid and local community activities. Government financial institutions lend on preferential terms, and in all but two cases their losses are covered from the general account. The Japan Bank for International Cooperation and the Development Bank of Japan are required to break even.

[7] Policy cost analysis identifies that part of the cost of projects falling on the government. It is therefore less rigorous than cost-benefit analysis.

Savings Department will invest mainly in low risk securities, including FILP bonds issued through the new Fiscal Loan Fund, which are government guaranteed and therefore identical to JGBs, and FILP agency bonds, which are assumed to be backed by the government (i.e., they carry an implicit government guarantee). Postal savings will therefore continue to be a source of financing for FILP projects.

9. **The responsibilities of nonfinancial public corporations are clearly defined.** The objectives and scope of the activities of each corporation are specified in its establishment law. Funds provided by the government in the form of capital subscriptions, loans, and transfers are reported in the national budget, and in the profit and loss statements and balance sheets of the 62 largest public corporations that are submitted to the Diet. Public corporations, and some privatized companies in which the government retains an equity interest, have public policy obligations related to the provision of universal services and other noncommercial objectives.

10. **Regulation of private sector activity is becoming more transparent.** Closing the gap between domestic and international regulatory practices, and thereby promoting a more efficient and innovative private sector, is a key element of the government's strategy for economic recovery and long-term growth. Steps taken to increase regulatory transparency include publishing criteria for judging license applications, explaining reasons for the rejection of applications, and holding hearings if applicants believe that administrative powers have been exceeded. However, the OECD has suggested that there should be a central registry of regulations.[8] Consultation on new regulations has also been made wider and more systematic, with the implementation in 1999 of open public comment procedures in place of consultation with specialized advisory councils.

11. **The commitment and expenditure of public funds is governed by law, and there is a comprehensive legal framework for public expenditure management.** The constitution requires that all expenditures, and all obligations entered into by the government, must be authorized by the Diet. Obligations include both debt and potential liabilities such as guarantees. The public finance law stipulates that the budget should cover all spending from national treasury accounts, including multi-year continuing expenses, approved expenses to be carried over from the previous year, and forward commitments under government contracts. The public finance and public accounts laws give the minister of finance the authority to: coordinate and manage budget preparation and implementation; provide that all income is to be paid into the national treasury accounts; hold the head of each ministry or agency accountable for the funds they collect or use; specify clear provisions for the expenditure of the budget contingency reserve; and require that independently audited final accounts are prepared.

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[8] An extensive discussion of regulation is provided in *Regulatory Reform in Japan*, OECD (Paris, 1999).

12. **Taxes, duties, fees, and charges have an explicit legal basis.** The constitution stipulates that no new taxes should be imposed or existing taxes modified except by law, while the public finance law provides that nontax revenue should be determined in accordance with law or by resolution of the Diet.[9] Tax laws, and the corresponding regulations and procedures, are clear. There is limited discretion for tax officials, and guidelines on the exercise of administrative discretion are publicly available. Taxpayers are entitled to have their tax liabilities reassessed, and they have the right of appeal to a tax tribunal and ultimately to the courts. Explanatory material on all taxes is available to the public at local tax offices and libraries, and on the Ministry of Finance website. Tax bills are placed on the website once they are submitted to the Diet. The tax commissioner is legally independent.

13. **Public officials are bound by a code of conduct.** Standards of conduct are described in a code which is derived from an ethics law for public officials. In addition, there are specific standards for employees of ministries and agencies with direct responsibility for receiving and spending government funds.

B. Public Availability of Information

14. **Comprehensive budget documentation and supporting information is provided to the Diet and the public.** The fiscal year is April 1–March 31. The *General Account Budget* and the *Special Account Budgets* are the main budget documents. After approval of the national budget by the cabinet in December, briefing material is provided to the press. The main budget documents are submitted to the Diet in January and are discussed by the budget committees of the lower and upper houses. They are accompanied by: the budgets of government financial institutions; explanatory documents which include details of tax changes and revenue forecasts, and of the FILP; and a reference document which includes information that has to be provided under the public finance law and other relevant laws.[10] At the same time, final accounts are submitted to the Diet for discussion by the settlement of accounts committees of both houses. Upon approval of the national budget by the Diet, summary budget information is released specifically for the public, some of which is in English. Less comprehensive but still extensive documentation is provided in connection with supplementary budgets.

15. **Detailed information is provided on the general account and the special accounts.** The budget documentation provides disaggregated revenue and expenditure data for the general account and each special account, and summary tables for the consolidated

[9] This provision covers nearly all monopolistic prices or charges for state services.

[10] The reference document includes details relating to the general account and the special accounts, the national treasury accounts, borrowing and government debt, and some information on financial and nonfinancial assets. It also includes the financial statements of the 62 largest public corporations.

general account and special accounts (i.e., the national budget). Detailed budget data are compared to the outturn for the previous year, while aggregate data for the budget and the previous two years are presented in a comparable form in the reference document. Projections of general account revenue and expenditure for the three years following the budget are provided in a *Medium-Term Fiscal Projections* document, which is submitted to the Diet separately from the budget documentation. A ceiling is specified for new guarantees that can be extended each year. Information on gross debt is detailed, and includes total guarantees outstanding. The budget documentation provides an aggregate figure for government holdings of securities (stocks, bonds, and equity investment), while loans are reported in the final accounts. Information on financial assets is subject to considerable uncertainty in the absence of information about the market value of securities and the quality of the government's loan portfolio (which is dominated by loans to FILP agencies).

16. **The consolidated fiscal positions of the central government and general government are not included in the budget documentation.** Discussion of the national budget focuses instead on JGB issues to finance the general account (which are reported as a revenue item). Fiscal information is no longer compiled and reported on a Government Finance Statistics (GFS) basis.[11] While the *Annual Report on the National Account Statistics* is published with a lag of a year, the Cabinet Office (which is responsible for compilation of the national accounts) makes the fiscal accounts on an SNA basis and the rest of the national accounts publicly available after eight months. The Ministry of Finance provides its own estimates of the deficits and debt of the central government and general government (excluding social security funds) in the briefing material for the press and the information for the public, but does not include them as part of the budget documentation.

17. **The government published a trial balance sheet in October 2000.** This was done with the aim of presenting an overview to the public of the government's asset and liability position. The general account and special accounts are covered. Assets include financial and nonfinancial assets. Marketable securities are recorded at market value. Liabilities include public pension liabilities, and a range of contingent liabilities are reported in an annex. Long-term social security projections are published every five years by the Ministry of Health, Labour and Welfare, and generational accounts were prepared and published on a one-off basis in 1995.

18. **The publication of fiscal information is an obligation of the government.** The constitution stipulates that the cabinet should report regularly to the Diet on the fiscal situation. The public finance law provides that the content of the national budget, and supporting information, should be made available to the public as soon as it passes the Diet. Quarterly reporting on budget implementation is also a legal requirement. More generally,

[11] The last year for which data for Japan are reported in the 2000 *GFS Yearbook* published by the IMF is 1993.

freedom of information legislation came into effect in 2001, and a wide range of information has subsequently been requested from ministries.

19. **Japan subscribes to the SDDS.** Advance release date calendars are available for data covered by the SDDS. For a broader range of fiscal information, regular publication has established a clear timetable for its release. Japan does not meet SDDS requirements related to the timeliness and periodicity of central government data and the timeliness of general government data. Flexibility options have been taken with respect to these requirements.

C. Budget Preparation, Execution, and Reporting

20. **The initial budget is presented and discussed in a broader context.** The *Economic Outlook and Basic Policy Stance on Economic Management* issued by the cabinet and the *Fiscal Policy Speech of the Finance Minister* to the Diet provide background information on the state of the economy, international economic conditions, and the outlook and policy stance for the current fiscal year. These documents also provide information on the macroeconomic framework underlying the budget and the uncertainties impinging on it (although the fiscal implications of these uncertainties and other fiscal risks are not discussed). Prior to finalization, there is opportunity for external input into the formulation of the budget through various policy councils (e.g., the Tax Commission and the Fiscal System Council). Supplementary budgets are accompanied by information giving their justification.

21. **The government is not currently bound by formal fiscal rules, nor are there medium-term fiscal targets.** Up until 1975, a version of the golden rule, which limited borrowing to construction bonds issued to finance investment spending, was in effect. Since 1975, with the exception of 1991–93, the government has issued special deficit financing bonds in addition to construction bonds. The Fiscal Structural Reform Act (FSRA) of 1997 set a medium-term fiscal target of reducing the general government deficit (excluding social security) to 3 percent of GDP by the year 2003 (later amended to 2005). The FSRA was suspended in 1998 in response to weak economic conditions.

22. **Continuing costs of existing government programs are distinguished from the costs of new initiatives**. The public finance law requires that the costs of multiyear projects are identified. The law also permits the government, subject to Diet approval, to disburse funds in connection with such projects for up to five years. The estimated costs of new initiatives are identified separately in the initial and supplementary budgets.

23. **The classification of budget data does not fully conform with widely accepted standards.** The public finance law requires that budget data are reported on a gross basis. Data are provided ministry by ministry for both the general account and the special accounts, with a partial economic classification of expenditure, and a more detailed but mixed program and functional classification for each ministry and in aggregate. Budget transactions are recorded primarily on a modified cash basis, with the treasury accounts remaining open for

two months after the end of the fiscal year for the recording of that year's transactions. Accrual accounting is used for certain special accounts associated with commercial activities.

24. **There are explicit standards for procurement and tendering.** These are contained in the public accounts law. Additional legislation complements the provisions of this law. Recent changes are intended to make procurement and tendering processes more open and competitive in response to concerns about a lack of transparency in decision-making criteria. Government employment regulations are clearly specified in the public service law.

25. **Financial control mechanisms are strong, but internal audit is not fully effective.** Internal audit procedures are set out in the administrative guidelines of individual ministries, and internal audits are subject to review by the Board of Audit. However, insufficient resources are devoted to internal audit, which limits its coverage and thoroughness.

26. **Government agencies are preparing clearer statements of objectives and more attention is being devoted to evaluating results.** To assess the effectiveness of government programs, there have been regular and ad hoc reviews and performance audits by the Board of Audit. Cost-benefit analysis is now required for major public investment projects. In addition, since 1998 there has been systematic reevaluation of projects that have not started after a period of 5 years, have not been completed after 5–10 years, or may no longer be appropriate given social and economic circumstances, with a view to identifying projects for termination. Government-wide policy evaluation has been introduced in 2001. All ministries are now required to evaluate their policies, and the Ministry of Public Management, Home Affairs, Posts and Telecommunications is responsible for ensuring the comprehensiveness and objectivity of the evaluations. The mission statement of the Ministry of Finance indicates that the policy evaluations by ministries will be used in designing the national budget and the FILP.

27. **There is quarterly reporting to the Diet on the execution of the budget, with a one quarter lag.** There is also monthly reporting of the receipts and outlays of national treasury accounts, with a two-month lag. Final accounts are available within a year.

D. Assurances of Integrity

28. **Budget data are based on fairly reliable revenue forecasts, but there are problems with expenditure estimates.** Revenue forecasts are derived from figures for major taxes estimated by collectors based on their own enquiries and calculations which are then checked against macroeconomic data. Expenditure estimates in initial budgets reflect a process whereby each ministry makes a preliminary request based on the previous year's initial budget, program commitments, and cabinet-approved guidelines on program ceilings and priorities. Preliminary requests are then adjusted during discussions with the Ministry of Finance. However, the heavy reliance on supplementary budgets undermines the significance of the resulting estimates, and of the initial budget as a measure of fiscal stance. Moreover, it is difficult to apportion new spending in supplementary budgets to the current and subsequent

fiscal year, and to identify that part of new spending which has a direct demand impact (i.e., its so-called 'real water' content).

29. **Final accounts are fully reconciled with the budget and with the accounting report from the BoJ on the national treasury accounts.** At the close of the fiscal year, each ministry accounts for its expenditure and presents a statement of account to the Ministry of Finance, which then compiles a total statement of accounts. After authorization by the cabinet, the statement is sent to the Board of Audit around the end of September. In January, the cabinet submits the statement to the Diet, with the audit report attached.

30. **Fiscal information is subject to effective independent audit.** The constitution provides that final accounts are audited annually by the Board of Audit, while a separate law establishes the board as independent of the cabinet. The board's audit report is submitted to the cabinet at the end of November, and by the cabinet to the Diet in January. A summary is released to the press at the time reports are sent to the cabinet. The three audit commissioners are appointed by the cabinet, but with the consent of the Diet. They hold office for seven years and can only be removed from office in strictly limited circumstances specified in law. There are special provisions giving the Board of Audit greater than usual powers to set its own budget and to determine its staffing. While it mainly decides its work program, the board can also carry out an audit upon specific request of the Diet and report the results directly to the Diet. The board has the legal authority to require that improprieties it identifies be rectified. It also specifically indicates in its annual report the actions audited agencies have taken based on the findings in past audit reports.

31. **Information is provided with the budget documentation on the macroeconomic assumptions and forecasts on which the budget is based.** Detailed information is provided on the revenue changes in the annual budget, and it covers the macroeconomic basis of revenue forecasts. Less information is available on the assumptions and methods used to prepare expenditure estimates. There is active Diet debate on changes to macroeconomic forecasts, and discrepancies between budget data and outturns are explained in the commentary accompanying the final accounts. However, comparisons of macroeconomic and fiscal forecasts against final outcomes are not made available.

32. **Japan has a decentralized system for compiling government finance statistics.** The national accounts are prepared in the Economic and Social Research Institute of the Cabinet Office, the Budget Bureau of the Ministry of Finance is responsible for national government finance statistics, and the Local Public Finance Bureau of the Ministry of Public Management, Home Affairs, Posts and Telecommunications is responsible for local public finance statistics. These offices have technical independence in compiling statistics.

III. IMF Staff Commentary

33. **There are many respects in which Japan meets high standards of fiscal transparency.** These relate primarily to various aspects of the budget process, including the

information that is made available to the Diet and the public. This applies in particular to the national budget, which has a solid legal basis and establishes clear administrative accountability. Detailed information is provided in comprehensive budget documentation, which extends beyond the national budget and covers agencies and programs financed from the budget. There is also regular reporting on budget execution to the Diet. Other strong points include the clear legal and administrative basis for taxation, high ethical standards for government employees, and effective independent audit. Japan not only performs well against the IMF *Code of Good Practices on Fiscal Transparency* in these areas, but also against the OECD *Best Practices for Budget Transparency*.

34. **Recent initiatives have improved fiscal transparency.** Enactment of freedom of information legislation reflects heightened public expectations of the right to be informed about government activities. One of the objectives of the administrative reform of national government is to make public administration more transparent. Initiatives in this area include the publication of mission statements by ministries, which themselves contain commitments to openness. The mission statements not only clarify the goals of government but also provide a basis for systematic assessment of success in achieving these goals. The deliberations of policy councils are to be opened up for greater public input, and their independence from the executive is to be strengthened. The publication of a balance sheet is a best practice which offers a useful perspective on government finances. However, closer attention should be paid to asset valuation, especially as regards the government's loan portfolio. Finally, recent reforms provide a basis for increasing market discipline on FILP agencies and projects.

35. **There is nevertheless room for major progress in key areas.** First, concerns about the effectiveness of short-term macroeconomic management indicate that there is an urgent need to pay more attention to providing timely information on the overall stance of fiscal policy. This requires more comprehensive measures of the fiscal position, regular reporting on fiscal developments, and less reliance on supplementary budgets. Second, in view of concerns about fiscal sustainability, it is important to place fiscal policy in a longer-term context. This requires the development of a medium-term budget framework that is a systematic basis for formulating and implementing fiscal policy, and long-term fiscal projections that provide a clear identification of emerging fiscal pressures. Third, with the increasing market orientation of the economy, the role and consequences of public financial intermediation through the FILP should be clarified.

A. Overall Stance of Fiscal Policy

Measures of the fiscal position

36. **Budget data for the central government, and in particular for the general government, should be provided.** Estimates of the deficits and debt of the central and general government are currently produced by the Ministry of Finance and included as part of information on the budget provided to the press and the public. While they are also made

available to the Diet, these estimates are not part of the budget documentation. If the deficits and debt of the central and general government on an SNA basis were reported as part of the budget documentation, along with revenue and expenditure breakdowns on a GFS basis, this would provide for a better informed debate about the structure and macroeconomic impact of fiscal policy, including by reference to comparable cross-country data. It would also meet the requirement of the suspended FSRA that fiscal policy should target the general government deficit.

37. **Timely consolidation of fiscal data for the national government, local governments, and the social security system is required.** This should not be a major problem at the national government level, given the timely availability of information on the general account and the special accounts. But it could be a challenge to consolidate data on the budgets and outturns for local governments. This requires that existing technical and staffing constraints are relieved at ministry and local government levels. The standardization of accounting practices and reporting requirements also needs to be ensured. [12] There is also a need for an appropriate assignment of responsibilities and coordination between the different agencies responsible for compiling government finance statistics.

38. **Additional information on government finances should be included in the budget documentation with a view to achieving full coverage of fiscal activities**. Currently, the national budget provides data on new guarantees that are extended. This should be supplemented by information on other contingent liabilities and details should be disclosed about past calls on the government to meet all contingent liabilities.[13] Particular attention should be paid to contingent liabilities in the financial sector given the potential fiscal costs involved. The estimated revenue costs of tax expenditures should also be reported. To the extent that the Postal Savings Department, government financial institutions, and public corporations have public policy obligations, the nature and if possible the financial implications of these quasi-fiscal activities should be reported, together with the basis for quantification and budget support that is provided to compensate for such activities.

Reporting fiscal developments

39. **The fiscal performance of the central and general government should be reported on a regular basis.** Fiscal data for the central government should be released on a quarterly basis, with a lag of no more than a quarter. Provisional data on the general

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[12] Consolidation should be based on the methodology and bridge tables used to construct the fiscal data in the national accounts. For the national government, revenue and expenditure data are coded in great detail and producing breakdowns on a GFS basis should be straightforward.

[13] The government balance sheet reports the outstanding stock of guarantees and loss compensation contracts; claims for damages in legal action against the government; and other major contingent liabilities. These should all be reported in the budget documentation.

government, based on information provided by prefectures and a sample of municipalities, should be provided at the same time. These changes would allow Japan to comply fully with the fiscal data requirements of the SDDS.[14] In addition, given the important fiscal policy roles played by government financial institutions and public corporations in Japan, and their quasi-fiscal role, there would also be merit in making an effort to provide consolidated public sector accounts on a more timely basis.[15]

40. **A detailed mid-year budget report should be provided to the Diet.** This should provide a comprehensive update on budget implementation, a review of the assumptions underlying the budget, details of all government decisions and other factors that have affected the budget, a revised forecast of the budget outturn, and the rationale for and details of any policy change to the budget.

Supplementary budgets

41. **There is excessive reliance on supplementary budgets from both a budgetary and a macroeconomic standpoint.** The implementation of sizable supplementary budgets reflects a tension between a traditionally conservative approach to fiscal management and the need in recent years for fiscal stimulus given the weakness of the economy. However, the frequent use of supplementary budgets has undermined confidence in the reliability of expenditure estimates in the initial budget and the value of the initial budget as an indicator of the stance of fiscal policy. Two things would help to remedy this situation.

42. **Initial budgets should be formulated on the basis of overall judgments about the appropriate stance of fiscal policy from a macroeconomic perspective.** Specifically, attention should be paid to the fiscal stimulus that the initial budget should provide or withdraw compared to the previous year's estimated outturn given projected economic developments. The assumption should be that supplementary budgets will be implemented to address only unanticipated developments that require a sizable discretionary fiscal response. Adjustments of a more technical nature should be covered from the contingency reserve, which could be larger if this is necessary to minimize the need for supplementary budgets.

43. **Initial budgets could also be formulated in a more flexible manner.** In view of the unusually high degree of uncertainty about the way the economy is developing, and the possible need to provide mid-year fiscal stimulus, contingency spending on certain programs and projects could be identified during the budget discussions between spending ministries and the Ministry of Finance. Contingency spending would be included with the initial budget

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[14] Quarterly reporting of general government data exceeds SDDS requirements, but is important given the significance of local governments and the need to track a broad measure of fiscal policy from a macroeconomic perspective.

[15] These are also provided annually with an eight-month lag in the national accounts.

for approval by the Diet, and would be executed in a clearly specified manner in response to economic developments. This has the advantage that the government will have an increased capacity to respond promptly to such developments, which is important given relatively weak automatic stabilizers and the usual implementation lags. From a transparency perspective, if contingency spending is clearly related to an assessment of fiscal risks affecting the budget, the fiscal stance for the year will be clearer. The execution of contingency spending should be addressed in detail in the mid-year report to the Diet.[16]

B. Longer-Term Context

Medium-term budget framework

44. **The current three-year fiscal projections should be more systematic and comprehensive.** Specifically, they should be produced as part of an integrated approach to forecasting macroeconomic and fiscal developments, they should cover all budget activity, and they should provide more detailed information about revenue and expenditure components. They should also be accompanied by projections of the main macroeconomic and fiscal aggregates for 5–10 years ahead. For both sets of projections, alternative macroeconomic scenarios should be developed, and their implications for fiscal policy assessed.[17] If the annual budget is formulated in a forward-looking manner, this provides for a clearer statement of the likely consequences of maintaining current policies and a more complete basis for assessing the implications of proposed new policies and the overall fiscal stance. It also provides a firmer basis for establishing accountability and paves the way for a more results-oriented approach to budget formulation and implementation.

45. **Credibility could be enhanced by a formal commitment to a medium-term approach to managing fiscal policy.** One possibility would be to reformulate the FSRA so that it provides a clear legal framework for fiscal consolidation, although new, tailor-made, legislation would be preferable. This legislation should cover broad principles only (a medium-term debt target, general directions of tax and expenditure policies, social security reform priorities, etc.).[18] Short-term targets and policy detail should be provided with annual

[16] Economic recovery and a return to the process of fiscal consolidation might argue for a symmetric approach whereby there are contingent spending reductions if the economy performs better than expected. However, the aim under such circumstances should be to set an appropriate fiscal policy from the outset and to let automatic stabilizers (which could be made more effective as tax and expenditure policies are restructured) respond to cyclical developments.

[17] The macroeconomic model of the Japanese economy being prepared by the Cabinet Office could be used to underpin the medium-term budget framework, and as a basis for formulating approaches to fiscal consolidation and to structural reform in the fiscal area over the coming years. The model, along with macroeconomic and fiscal forecasts, should be made available for scrutiny by independent experts.

[18] The formulation of a medium-term debt target will have to address whether gross or net debt should be targeted and, in the case of the latter, issues related to asset valuation will have to be addressed.

budgets, both to preserve the credibility of the medium-term framework and to provide the flexibility to respond to economic and other needs as they arise. The new Council on Economic and Fiscal Policy could consider such an approach in connection with its recent call for a more medium-term orientation to fiscal policy.

Long-term projections

46. **Periodic long-term projections of social security and health spending should be produced.** These should be based on alternative demographic scenarios, and take into account other sources of uncertainty, including labor market developments and rising health care costs. Social security and health care spending projections should be integrated with budget projections to provide a basis for assessing the long-term fiscal sustainability and the impact of alternative policy responses to fiscal pressures that are building up.[19]

C. Public Financial Intermediation

The FILP

47. **The justification for such a large public financial intermediation program as the FILP should be clarified.** Since the market failures that have in the past been used to rationalize the FILP may no longer provide such a justification given the evolution of private financial markets, the objectives of the program should be reviewed and restated. There is also a need to provide more information about the financial implications of the FILP. While the increased market orientation of the FILP should lead to greater financial disclosure, one area that should be explicitly addressed concerns nonperforming loans. Government financial institutions report nonperforming loans as required under banking law.[20] However, these relate to only part of the lending for FILP projects that gives rise to contingent liabilities of the government associated with guarantees it provides. The quality of FILP lending and associated contingent liabilities should be assessed and reported on as part of a more forward-looking approach to budget formulation.

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[19] The current five year interval for the preparation of social security projections is appropriate.

[20] Two institutions, the Japan Small and Medium Enterprise Corporation and the Japan Finance Corporation for Municipal Enterprises, do not have any nonperforming loans.