Chapter 2 Budget

2.1 Introduction[1]

A significant development in the intellectual history of the 20th century has been the explicit recognition by economists, politicians and the public at large of the importance of government in the operation of the economy[2]. The public budget generally reflects the policy of the government toward the economy[3]. Public budget is a forecast of governmental expenditures and revenues for the ensuing fiscal year, which may or may not correspond to the calendar year. Except for primitive economies, the budget is the key instrument for the expression and execution of government economic policy. Public budgets have wide implications for the national economy. By budgets governments exercise their allocative, stabilization and distributive functions[4]. They are, therefore, political as well as economic documents and are products of the political processes by which competing interests in any nation achieve agreement.

Although the major budgetary decisions that effect the performance of the economy and the national debt are usually made by the central government, most countries have local or state (provincial) governments. These are responsible for the provision of various services and have the authority to raise revenues through taxation or to borrow on their own account. This devolution of authority is greatest in the United States, where the majority of provision of civilian services is carried out at state or local levels and where states have a tradition of being individual decision-making units. In the United Kingdom, by contrast, local authority spending is constrained by rules set by the central government. Local authorities are also limited in their ability to borrow and to raise taxes, which are set by the central government (The budget of the European Union is an example where authority for major spending, particularly for agricultural support, has devolved to a transnational body).

The difficulty of discussing *budgeting as a policy process* lies basically in the difference between discussing private sector companies or individuals and government budgeting. Although the process of preparing and discussing a public budget has progressed considerably during the 20th century, it is in a number of senses still inferior to the way budgeting is carried out by private sector companies or indeed by individuals. Commercial practice is governed by a series of well-defined rules, and firms are required to produce a balance sheet, a profit and loss account and to monitor their cash flow carefully. The total indebtedness of a company is monitored closely by its shareholders, who are also critical of future forecasts of profits and growth. Individuals who fail to budget adequately are equally closely monitored by bank managers and credit agencies, and those with complicated affairs can draw upon skilled professional help.

The *accountability of government*, even in a well-developed democracy, is in reality considerably less acute, or certainly less clear, than that of companies to their shareholders or individuals to their various creditors. As a result, public budgeting is frequently of lower quality than is the norm in the private sector. Forecasts of receipts and expenditures are often wildly at variance with reality; changes to accounting practices are sometimes made for

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1 This section draws from Högye (2004, chapter 1)

2 Issues discussed here relate to any level of government existing in a system.

3 A distinction should be made between a budget and a budget system. Whereas the *budget* refers only to the documents within which financial proposals are contained, the *budget system* refers to the relationship between the stages to be followed in order to compile the budget documents (Thornhill, 1984).

4 For a comprehensive description of these functions, see Musgrave (1959).

cosmetic political purposes and certain distinction, such as those between capital and current expenditures, are frequently blurred deliberately. These criticisms of the public budgetary process are more valid in some countries than in others.

According to Aronson and Schwartz (1981) the extent of the budget amounts and the operating programs on which they are based is the dividing line between the private and the public sectors. The budget stipulates which goods and services are to be supplied to the public by the authorities and which are to be supplied by the private sector. The decision on who is to supply what and who is to receive what should be a reflection of the community's values, preferences and priorities. Therefore, the budget is a political document through which money is appropriated accounting to value judgments and the budget process is a political process that takes place within a political area (Gildenhuys, 1997).

Thornhill (1984) summarizes the most important features of a public budget as follows[5]:

- The budget, after its approval by the legislative authority, is enforceable.
- The results of most of the objectives to be realized by the budget are not quantifiable.
- The budget brings together a variety of considerations.
- As the objectives of action taken by public institution differ widely from those of private organizations, the processes for determining the content of a public budget are therefore unique.
- Authorities do not always adapt their expenditure to fit their available revenue.

It may therefore be stated that a public budget is an instrument at the disporsal of the legislative authority. It enables to guide the economic, social, political and other activities of a community in a certain direction in order to realize predetermined goals and objectives, the results of which are not always quantifiable. The budget also contains all of the measures needed to subordinate the executive authority to the legislative authority as the representative of the voters and taxpayers. The features of a public budget ensure the unique foundation on which its preparation, approval and execution are based. In public administration the budget serves as a decision-making instrument by which priorities are set, goals and objective are established, operating programs are compiled and control exercised. A budget document is the final product in the budget process and it should be suitable for consideration and approval by the legislative authority, while the execution of its contents should realize public objectives. The quality of the budget depends on the accuracy of the supporting data, the quality of the methods used and the expertise as well as the integrity with which it has been compiled. As a result of the broad spectrum of services that an authority has to render, however, budgets can offer only a synoptic picture of their financial implications. Therefore, a compromise has to be made in the budget document between the requirements for adequate, accurate information and for manageability (Kotzé, 1979)[6].

Gildenhuys (1997) recognizes the functions of a public budget as follows:

- The budget is a policy statement declaring the goals and specific objectives and authority wishes to achieve by means of the expenditure concerned. It is public policy expressed in amounts of money and is the actual embodiment of policy and of implied policy objective. In policy-making, realization of the most important objectives and aims should receive priority. As a policy-making document, the budget generally contains a definition of both the quantity and te quality of the envisaged service delivery. However, no normative guidelines exist by which priorities may be scientifically determined, thus that is the result of political expendience.
- The redistribution of wealth is one of the most important functions of a public budget. It requires that total integration should exist between the two sides of the

[5] In Gildenhuys, 1997, p.394.

[6] In Gildenhuys, 1997, p.395.

budget – revenue policy and expenditure policy – in order to comply with a fiscal policy for the redistribution of wealth.

- For the administrative authority, the budget is a work program on which each department can base its own operational work program. This function of the budget demands that the structure of objectives, the activity schedule, the resource schedule and the financial schedule is clearly expounded in the budget documents.
- The budget serves as a source of information for everyone concerned; the information contained in the draft budget document is necessary for its consideration and, after approval, serves as the most important source of information to the administrative authority for executing its functions.
- The budget also serves as a coordinating instrument by which government activities can be integrated, because it is supposed to contain all the information on the policies, objectives and activities of the government in one document.
- The budget is also a control instrument to be used by the legislative authority over the executive authority and by the executive authority over the administrative authority and even for internal control within a single component of the administrative authority. Two types of administration control are important in this regard, namely, *a priori* control and *ex post* control.

2.2 Rules and Norms for Public Budgeting[7]

The recent experience of budgeting and policy-making has left behind a substantial body of rules, norms and practices, which are routinely applied or pursued in most countries, because they are widely recognized as workable and reasonably efficient and are required by international organizations and/or financial markets (Lacasse, 1996). Budget norms are explicitly formulated; their compliance or non-compliance is easily observable and, often sanctioned by financial markets.

Mikesell (1991) has also stated that new budget reform techniques are consistent with the classical principles for appraising budgets[8].

1) Comprehensiveness. The budget should include all receipts and outlays of the government. The single process would thus include all activities of the government.
2) Unity. All spending and revenue-collecting parts should be related to each other. Consistent evaluation criteria should be applied to any expenditure, regardless of the government area in which it is located.
3) Exclusiveness. Only financial matters should be in the budget (Modern analysts recognize, however, that almost every governmental action has financial implications).
4) Specification. The budget should be executed as it is enacted. Cavalier changes should not be made during the budget year.
5) Annuality. The budget should be prepared every year for the next year of agency existence.
6) Accuracy. Forecasts should be as reasonable as possible and the document should be internally consistent.
7) Clarity. The budget should describe what is proposed in understandable fashion. The document, in an effort to encompass all, should not bury policy intent in line-item detail.
8) Publicity. The budget in a representative democracy should not be secret. The budget contains the expenditure plan (as well as the revenue estimates) of the government. It is clearly contrary to the underlying principles of a democracy that

[7] This section draws from Högye (2004, chapter 1)

[8] Howard (1973), pp.5-8, Quoted by J. Mikesell (1991) p.121.

such important choices are made without complete public consideration.

According to Lacasse (1996), the three most important budget related rules are: compenhensiveness and a multi-year perspective in budget elaboration, and the capability for monitoring implementation so as to further accountability and timely adjustments (The two latter partly correspond with specification, clarity and publicity). These issues in budget office-center relations all fall under the three categories of *harmonization, complementarity and co-responsibility*, as discussed above.

On the other hand, Wildavsky and Caiden (1997), argue that to understand what was happenedto budgeting in our time consider the radical changes in the norms of desirable behavior that used to guide budgeters. According to them, budgets emerged at the beginning of the nineteenth century as the result of reforms that replaced centuries of muddle and mismanagement with expenditure control based on norms of annularity, comprehensiveness, legislative appropriation, audit and balance. *Public budgets today are evaluated against their long-term implications*, they consist of many different kinds of spending, and they are unbalanced, uncertain and dependent on circumstances beyond their control.

As far as the norm of *comprehensiveness* concerns, the rule could be rewritten as: every penny whose allocation is made via the political process, not the market, should be recorded and presented for assessment in the budget. Very little dispute has arisen around this rule at the theoretical level, however, in practice this is a much more demanding rule. This rule has been broken by direct loans, loan guarantees, tax preferences, off-budget companies, open-ended entitlements and other devices (Wildavsky and Caiden, 1997).

For instance, over the last two decades, the reintegration of special funds into a "normal" budgetary perspective has been one of the biggest changes in implementing this rule. There is also an increasing tendency to treat commercial activities carried by departments and public enterprises for what they are – in other words, the distinctions between commercial and public policy functions have been sharpened (Privatization has helped on this front).

Other categories like tax expenditures, guaranties and regulations are not likely to be overcome soon. Implicit guaranties, such as unfunded pension obligations or guranties to the banking and financial system institutions remain outside the budgetary purview. It is not even clear how they could be included. As well, debate is still going on the very legitimacy of the concept of tax expenditures. The attempts to design and use a regulatory budget have also failed. On the other hand, one can argue that tidying these "loose ends" up might increase the complexity of the budget to such a degree, that it could defeat its very objective of improving transparency and accountability (Lacasse, 1996).

The issue between budgeting and policy-making is more than a straightforward problem of disharmony. The key to the solution – that is to the continuation of the last decades' evolution towards really comprehensive budgets – probably lies in rigorous budgetary laws and rules.

Apart from the temptations to go off-budget, the other important issues seem linked to the choices between regulations and expenditures or between direct expenditures and tax expenditures. Budgeting of tax expenditures, even in a primitive fashion, is rare, while regulatory budgeting has not traveled far from the textbooks and amounts to little more than good intentions (Lacasse, 1996).

The chronological counterpart of the comprehensiveness rule is the *annuality* versus *multi-year budgeting*. The latter demands to reconcile the annual budget with multi-year policy commitments. This apparently contradictory injunction is important in two respects: for new or reformed policies, and for the cross-impacts of policies. In both cases, the elaboration of the current budget demands accurate cost forecasts.

The consensus over the fact that the budget office is a key instrument of control and should play an important role in supplying implementation feedback – indeed, in controlling implementation – is as strong as it is traditional and vague. This somewhat paradoxical situation has a variety of sources. First, institutions vary markedly between countries.

Second, the very content of "implementation feedback" is a mixed-bag, ranging from compliance and integrity controls to impact evaluations. Third, basic strategies as to who should be responsible for providing such feedback to whom also vary from country to country, and substantial overlap in responsibilities exists between institutions within countries.

It is assumed that the implementation of the budget routinely and rapidly generates information as to whether the monies voted are indeed being spent within the legislated framework provided by the budget. Such implementation monitoring exists in most countries, but this basic feedback on policy implementation is often limited to financial information and is used almost exclusively by the budget office. This is rarely felt to be enough by the policy-making center, whose attention is obviously oriented towards the future, towards new policies or revised ones (Lacasse, 1996). This is the reason why analysts state that the *control of spending* has declined along with the norm of comprehensiveness (Wildavsky and Caiden, 1997).

The important issues of implementation are related to the systems, institutions and methods aimed at answering simple and age-old questions such as: Is the money being spent efficiently? Is the money reaching those for whom it was intended? Is the policy having the intended results? Is the policy generating unwanted and undesirable effects?

The most difficult and controversial subject addressed by the above questions – namely, whether policies have had the expected impact on society and at a reasonable cost – curiously attracts the strongest consensus.

The subject of efficiency in public management – i.e., of maximizing productivity and minimizing costs in delivering existing policies – is a very political subject in which many budget offices have played a key role in the last decade, essentially as promoters of the so-called "new public management", a concept incorporating business management styles and practices into the public sector. This reform is based on the conjunction of two elements: first, the delegation of financial authority to lower level –including in some cases virtually all aspects of personnel policy, flexibility as to the timing of expenditures, permission to substitute capital for labor and vice-versa – and, second, the introduction of performance commitments and incentives, appropriately backed up by performance measurements and sufficient power at the center to ensure accountability and control. It should be noted however that this evolution is far from being uniform among countries.

That the budget should further accountability and provide a key instrument of transparency on government action, is such a staple of budget theory that it has acquired a quasi-theological aura. Nobody is against virtue. However, the practical meaning of this principle has often remained obscure (Lacasse, 1996). The instruments used to make the budget choices and their implementation transparent differ widely from country to country. There is not any unique system likely to be applicable to all countries.

Other phenomena that used to be confined mainly to poor countries – repetitive budgeting, remaking the budget several times a year – have now become standard practices in relatively rich nations as well (Wildavsky and Caiden, 1997).

Why did the norms erode? Answering this question is not easy. The old politics of the Budgetary Process could focus on incremental differenced because the base was largely agreed. When there is a disagreement about the starting point as well as the desirable outcome of budgetary negotiation, incremental change is in trouble. Schick (1988) holds another view: prosperity declined, incrementalism has gone with it. Both budgetary norms and spending practices change together. The purpose of norms is to justify practices. The importance of budgetary norms can be seen indirectly in new practices and proporsals for reform (budget resolutions, constitutional spending limits, etc).

2.3 Some Simple Model Economics[9]

In the Musgrave tradition, we might ask how the problem would look in a simple model economy, consisting of two people; let us call them A and B.

1) Taxes and Transfers: Intratemporal

To capture the basic distributive problem, consider a world with just one private good – call it X – in addition to labor. Each person *i* acquires a quantity x_i of X by working l_i units of time subject to a budget constraint determined by his productivity (assumed equal to his wage), w_i, less a lump-sum tax paid to the government, Ta_i, plus a lump-sum transfer received from the government, Tr_i:

$$x_A = w_A l_A - Ta_A + Tr_A \quad (1)$$
$$x_B = w_B l_B - Ta_B + Tr_B \quad (2)$$
$$Ta_A = Ta_B - Tr_A + Tr_B \quad (3)$$

where (3) expresses the government's budget constraint.

Note that the aggregates of taxes and transfers are uninformative about the distributive properties of the budget. They could both be large but each person's tax could exactly equal his transfer. To describe the government's program in this economy, it suffices to record the net tax paid or net transfer received by each of the two citizens; let us call the net tax Tan_i. Then all we need to know about the government's policy is captured unambiguously by the pair (Tan_A, Tan_B)[10].

2) Taxes and Transfers: Intertemporal

Bringing in time poses serious challenges to meaningful budgetary language. To isolate the key issues, consider a two-period world. Now we need to add period superscripts, 1 or 2, to everything in sight. The following system describes the budget constraints as of period 1 in terms of the basic economic system plus net taxes:

$$x_i^1 + \delta x_i^2 = w_i(l_i^1 + \delta l_i^2) - (Tan_i^1 + \delta Tan_i^2) \quad \text{for } i = A, B \quad (4)$$
$$Tan_A^1 + Tan_B^1 + \delta(Tan_A^2 + Tan_B^2) = 0 \quad (5)$$

where the wage rates are presumed the same in both periods and where δ is the discount factor in the model economy.

In this depiction, I have taken for granted that the budgetary information will have dealt with the netting of taxes and transfers. Specification of the net transfers in period 1 is, however, uninformative about the impact of the fiscal plan on the two people in the economy. Thus, we could give everyone a "tax cut" in period 1, so that both Tan_A^1 and Tan_B^1 are negative. This would accord with usage in policy debates in the United States today. The government's budget constraint tells us, however, that this is, at best, an incomplete description of policy.

In the intertemporal framework, one needs to specify the full set of net taxes through time, or,

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[9] This section draws heavily from Bradford (2003) pp.101-9.

[10] Because of the government's budget constraint, we only need to specify *n*-1 of these, where *n* is the number of people. When, as in the example, there are just two people, this makes a big difference. In the more general case, with large *n*, the government's budget constraint will provide very little information.

sufficiently, their discounted value, to capture the distributive impact of the budget. Here, that would mean specifying the discounted net transfers to each taxpayer (or class of taxpayers), $Tan_A^1 + \delta Tan_A^2$ and $Tan_B^1 + \delta Tan_B^2$. (In this case, the government's budget constraint makes one of the two redundant but, as before, this is an artifact of the two-person example.)

In a real-world setting, with an indefinite horizon, policy is never projected through time in a way consistent with the government's intertemporal budget constraint. More practically, one could hope to specify some sort of current projection of the future net taxes, say in the form $Tan_A^1 + \delta Tan_A^{2,projected}$ and $Tan_B^1 + \delta Tan_B^{2,projected}$. Some summary of the unresolved intertemporal budget requirement would be needed to complete the budgetary description. In our simple economy, it could be a statement of the net tax in the aggregate that remains to be assigned to the two people in the next period, $Tan_{aggregate}^{2,residual}$. Using the intertemporal budget constraint, we relate this quantity to the known and projected net taxes by

$$Tan_{aggregate}^{2,residual} = \frac{Tan_A^1 + Tan_B^1 + \delta(Tan_A^{2,projected} + Tan_B^{2,projected})}{\delta} \qquad (6)$$

The idea generalizes to the setting of an indefinite horizon, except that some way is needed to normalize, in order to express the net tax residual on an annual basis. For example, one could ask what uniform annual aggregate net tax, starting next period, $Tan_{aggregate}^{starting\ in\ 2,residual}$, would be sufficient to satisfy the intertemporal budget constraint. This quantity would be related to the projected net taxes by

$$Tan_{aggregate}^{starting\ in\ 2,residual} = -r\sum_{j=0}^{\infty} \delta j(Tan_A^{j+1,projected} + Tan_B^{j+1,projected}) \qquad (7)$$

where *r* is the discount rate implicit in the discount factor, δ. Alternatively, and perhaps more helpfully, one could express the undetermined residual as the constant per capita amount, or as the constant fraction of some measure of per capita income, that would do the job.

3) Public Goods

Returning to the single-period context, let us add a public good, G. Assume it is measured in units of its cost in the private good forgone to produce it; in these units, the production possibility frontier of G and X, given labor inputs, is linear with slope – 1. The budget constraints of the two citizens would be the same as in the previous case, but the outcome that they would value would now be expressed in terms of a quantity of the private good and the level of provision, *g*, of the public good. The government's budget constraint would become

$$Ta_A + Ta_B = Tr_A + Tr_B + g \qquad (8)$$

Now, to describe the impact of the government on the two citizens, we need the three items (Tan_A, Tan_B, g). In other words, we need to add to the net (private good) distributive impacts of the budget the amount of the public good provided.

One might, in addition, be interested in the *valuation* placed on the public good. Public good provision would be the province of the Allocation Branch in Musgrave's scheme. He conceived of the Allocation Branch as assessing the amount citizens would be willing to pay for the public good. In his illustrative analysis, in my notation, the Allocation Branch sets a tax on

citizen *i* of Ta_i^a. These taxes would be set to balance the Allocation Branch budget:

$$Ta_A^a + Ta_B^a = g \tag{9}$$

A perhaps minor matter: The surplus generated by optimizing the choice of *g* drops out of this account. (Also omitted are the shortfalls that might be generated for one or another citizen if the level of the public good is inefficient or if the willingness to pay is incorrectly estimated in setting the Allocation Branch taxes.)

We would then need to put a Distribution Branch superscript on the net taxes charged by that branch, and they would always satisfy

$$Ta_A^d + Ta_B^d = 0 \tag{10}$$

By construction, the Distribution Branch net taxes would capture the idea of "true" redistribution of the consumption equivalent generated by the economy.

Musgrave's ideal Allocation Branch taxes raise an interesting philosophical issue about the purpose of budgetary data. One might argue that the objective of the budgetary figures is to give us "the facts" about the policies of the government, leaving it to further, and more controversial, analyses to decide on the valuation of what government does or proposes. By contrast, Musgrave's Allocation Branch's further step of estimating the value placed on public goods requires a higher order of analysis that is, indeed, "utopian", relative to today's practice which, at best, stops at accounting for the level *g* of the public good provided.

4) Distorting Commodity Taxes and Subsides

A further set of issues arises when we have more than one private good, with the possibility of taxes and subsidies applied to them. Let the second good be Y. To simplify, let us maintain the linearity of the production possibility frontier and choose the units of Y so that the marginal rate of transformation between X and Y is always one. Let the rate of tax on purchases of commodity *j* be t_j and the rate of subsidy be s_j. With these new policy instruments (and abandoning the separate Allocation and Distribution Branch distinction), the three budget constraints of our little one-period economy become

$$(1+t_x-s_x)x_A + (1+t_y-s_y)y_A = w_A l_A - Tan_A \tag{11}$$

$$(1+t_x-s_x)x_B + (1+t_y-s_y)y_B = w_B l_B - Tan_B \tag{12}$$

$$Tan_A + Tan_B + t_x(x_A+x_B) + t_y(y_A+y_B) = s_x(x_A+x_B) + s_y(y_A+y_B) + g \tag{13}$$

where the previously defined tax and transfer terms refer now just to the lump-sum components of the government's program.

An obvious point to make about this system is that it is redundant in policy instruments. Present budgetary language would, however, attach significance to the separate pieces. The bits labeled "subsidies" would be identified as expenditures, characterized not by the rates but rather by the product of rates and quantities. So the expenditure on the subsidy to good X would be recorded as $s_x(x_A+x_B)$ and the subsidy to Y as $s_y(y_A+y_B)$.

It seems that the distinction between a subsidy and a tax in the conventional sense is a matter of intent. A subsidy in the conventional sense is "on purpose" and a tax in the conventional sense (apart from a Pigouvian offset to an externality is an unfortunate necessity. It is unclear, however, whether one can construct a satisfactory accounting distinction based on intent. If

consumers and producers are looking only at real trade-offs, rather than labels, the economically significant quantities are the net tax (or subsidy) rates. If we normalize on earnings and denote the net tax on good X by tn_x and so forth, the system of budget constraints becomes

$$(1+tn_x)x_A + (1+tn_y)y_A = w_A l_A - Tan_A, \tag{14}$$

$$(1+tn_x)x_B + (1+tn_y)y_B = w_B l_B - Tan_B, \tag{15}$$

$$Tan_A + Tan_B + tn_x(x_A + x_B) + tn_y(y_A + y_B) = g, \tag{16}$$

The key budgetary information, expressed in revenue terms, would be the net tax revenue totals, $tn_x(x_A + x_B)$ and $tn_y(y_A + y_B)$. Typically, such net tax revenue quantities would include both positive and negative (i.e., net subsidy) values. Note that this accounting would neglect the deadweight loss that might be due to the distorting taxes. Including estimates of these distortionary effects raises the same philosophical and analytical issues as does including estimates of the valuation of public goods.

Even with normalization on earnings along the lines described (so there is no tax or subsidy on working), there remains a question of how to summarize the impact of the government budget when there are many commodities. How do we summarize the set of effective taxes that come between the producer prices (unity, by choice of units) and the prices facing the consumer or worker? I have not tried to identify an answer, but perhaps one could choose some reasonable aggregates of goods and services (say, food, housing, transportation, all others) and use an aggregation of their before-and after-tax/subsidy prices derived from the index number literature.

Some thought needs to be given to how best to characterize the distributive impact of net commodity taxes on individuals. In the illustrative case, if there were no lump-sum taxes, we would have no obvious distributive information. The budget situation of the individual would nonetheless be changed by the policy compared with the situation of no net taxes and no public good provision. The impact of the policy on each individual would be captured, from a formal perspective, by the statement that the net price of X is increased by tn_x, the net price of Y by tn_y, and the level of the public good by *g*. All three of the measures have, in this case, the quality of public goods. But this is too much information. A useful budgetary convention would be based on a measure of the incidence of the policy package, a measure I have not tried to derive here.

5) Taxes on Earnings

The big enchilada of distorting taxes is the tax on labor supply. Suppose only a labor income tax and lump-sum taxes are used, and that the labor income tax rate applied to person *i* is τ_i. Then, for the single-commodity case, our budget constraints become

$$x_i = (1-\tau_i)w_i l_i - Tan_i \text{ for } i = A, B, \tag{17}$$

$$Tan_A + \tau_A w_A l_A + Tan_B + \tau_B w_B l_B = g. \tag{18}$$

Present practice in this case would be to define the net tax on citizen *i* as $\tau w_i l_i + Ta_i$. This gets the story wrong, in the first place by failing to net taxes and transfers, to make it $\tau w_i l_i + Tan_i$. Further, the "proper" sign convention would call for treating the tax on labor as a negative net tax (subsidy) on non-market time that we conventionally call leisure. Consistency with the suggested description of commodity taxes and subsidies would suggest

describing the budget in terms of the net lump-sum tax elements plus the leisure subsidies. (Also, although not strictly speaking an element of budgetary aggregates, the common characterization assigns an incidence to one transaction tax instrument – the tax on labor – that neglects proper treatment of leisure forgone as well as general equilibrium effects.)

An approach that I find intriguing is a normalizing convention such that all distorting taxes are expressed as what we conventionally call commodity taxes. This would capture the idea of a fundamental trade-off between work and various desired goods. So a 10 percent tax on earnings would be expressed, instead, as a uniform 11 percent (i.e., 1/(1-0.1)) tax on goods. Where the earnings tax rate varies from worker to worker, such net taxes on goods would be person-specific, an awkward but accurate description of economic substance. Note, however, that the approach would require identifying not simply earnings in general, but earnings at a specific time (e.g., the present), if this idea were extended to an income tax context. In that setting, there would typically be a different rate of tax on the same good at different distances into the future. Thus the rate of tax on a standard consumption good at successive dates in the future, expressed in terms of current earnings, would be higher and higher, reflecting the penalty on saving imposed by an income tax. Such a way of describing the budget's impact might affect people's attitudes toward an income tax.

Alternatively, one could normalize on some standard private good. To illustrate, consider A's budget constraint with an earnings tax and a pair of net commodity taxes, as discussed earlier:

$$(1+tn_x)x_A + (1+tn_x)y_A = (1-\tau_A)w_A l_A - Tan_A \tag{19}$$

Suppose we were to take good X as numeraire. Then the normalized budget constraint would be

$$x_A + \frac{1+tn_y}{1+tn_x} y_A = \frac{1-\tau_A}{1+tn_x} w_A l_A - \frac{Tan_A}{1+tn_x} \tag{20}$$

The normalization would need to be carried through all the budget constraints, including the government's. Let me describe the resulting net tax rates, and so forth, by putting a superscript on them, so the new budget constraint looks like

$$x_A + (1+tn_y^x)y_A = (1-\tau_A^x)w_A l_A - Tan_A^x \tag{21}$$

where

$$tn_y^x \equiv \frac{1+tn_y}{1+tn_x} - 1 \tag{22}$$

$$\tau_A^x \equiv 1 - \frac{1-\tau_A}{1+tn_x} \tag{23}$$

$$Tan_A^x \equiv \frac{Tan_A}{1+tn_x} \tag{24}$$

A normalization of this kind can reveal some surprises. To put some illustrative numbers on the story, suppose taxpayer A is paying a 25 percent tax on earnings and getting a $1,000 net transfer; there is a 20 percent tax on commodity X and a 10 percent tax on commodity Y.

Such magnitudes might well be encountered in a system with a VAT and an income or a payroll tax. With the suggested normalization, we would say that taxpayer A faces an earnings tax of 37.5 percent (reflecting the impact of the system on his ability to trade working for the numeraire good, X) and gets a net transfer of 833 units of X, with a subsidy of his purchases of Y at a rate of 8.33 percent.

Of course, the choice of numeraire good is arbitrary. More plausible than a single commodity, a standard bundle of consumer goods – purchasing power – would be a more natural choice in a real application. Thus if, in this example, we had chosen to normalize the net-of-commodity-tax prices of the goods based on some bundle of X and Y, instead of on X alone, the story would imply some small (less than the 20 percent nominal rate) net tax on X and a smaller than 8.33 percent net subsidy of purchases of Y.

Before leaving this set of issues, I might add yet one more complicating factor: If the linearity assumption about the production system is invalid, specifying for each person the applicable rate of earnings tax, the appropriate net commodity taxes, and the lump-sum tax (together with the level of public goods provided) is, in principle, no longer sufficient to determine the impact of the government's program on that person. That is because the program overall will generally affect wage rates, quite possibly the most important way a program affect wage rates, quite possibly the most important way a program affects a person. Allen (1982) provides a striking example in which "standard" views about the progressivity of a tax are overturned by general equilibrium effects on skill-related wages.

6) Tax Expenditures

Finally, this setup of the problem may yield some insight into the problem of tax expenditures. Returning to the two-commodity example, take the case in which the taxes and subsidies on X are zero (or where we have normalized on commodity X), but a deduction is allowed from the earnings tax base for the purchase of Y. Then the budget constraints become

$$x_A + (1 + t_y - s_y) y_A = (1 - \tau_A)[w_A l_A - (1 + t_y - s_y) y_A] - Ta_A + Tr_A, \tag{25}$$

$$x_B + (1 + t_y - s_y) y_B = (1 - \tau_B)[w_B l_B - (1 + t_y - s_y) y_B] - Ta_B + Tr_B, \tag{26}$$

where I have neglected the government's budget constraint in the interest of reducing the clutter. These budget constraints can be reduced to a "canonical" form (prices times quantities of goods on the left, and after-tax wage times labor supply plus lump-sum transfer on the right) by some algebra. I reproduce here A's budget constraint:

$$x_A + [1 + t_y - s_y + (1 - \tau_A)(1 + t_y - s_y)] y_A = (1 - \tau_A) w_A l_A - Tan_A. \tag{27}$$

One way to describe this constraint is to say it involves a net tax, $tn_{y,i}$, on Y, specific to person *i*, which is defined (for the case of person A) by

$$tn_{y,A} \equiv t_y - s_y + (1 - \tau_A)(1 + t_y - s_y). \tag{28}$$

If we wanted to describe the resulting government program as "spending" on Y (e.g., as a subsidy program for housing), we could multiply the implicit subsidy rates and quantities, to obtain a total:

$$tn_{y,A} y_A + tn_{y,B} y_B. \tag{29}$$

2.4 A Framework for Analyzing Budget Rules[11]

Two recent development have stimulated growing interest in fiscal institutions. First, there are evident differences in the size and persistence of budget deficits across nations. These do not seem obviously related to short-term spending needs, such as wars, or to intertemporal variation in the marginal cost of raising revenue, as theories of optimal debt policy such as Barro (1979) would suggest. The inability to explain cross-national differences solely in terms of economic factors has led to a search for other factors, notably politicoeconomic explanations for deficit policies. Roubini and Sachs (1989) wrote one of the first studies in the modern revival to explore how political institutions such as the presence or absence of divided government affect fiscal policy outcomes.

The second factor driving recent interest in fiscal institutions is the rise of large peacetime budget deficits in the United States during the late 1970s and even more during the 1980s. The possibility that fiscal policy is biased toward deficit finance, and toward spending that yields concentrated benefits and diverse costs that nevertheless exceed the benefits, has been recognized for decades. Buchanan and Wagner (1977) and Weingast, Shepsle, and Johnsen (1981) are relatively recent statements of these central points. Yet until the early 1980s, fiscal deficits in the United States and most other developed nations had been relatively small except during wars or deep economic downturns. As Poterba (1994a) and others have noted, the substantial tax cuts of 1981 and the failure to achieve the spending reductions that President Reagan had promised would coincide with these tax reductions led to unprecedented peacetime deficits. The rise of such deficits was the proximate cause of the discussion, beginning in the mid-1980s, of a federal balanced budget amendment and of the related enactment of the Gramm-Rudman-Hollings antideficit legislation. To evaluate the potential effects of such fiscal rules, public finance and macroeconomists have embarked on new research programs that draw substantially on previous work in positive political theory and in public administration.

What Role Do Budgets Play?

Economic research on budget institutions has taken three forms. The oldest line of inquiry asks, What are budgets for? and considers issues of budget measurement and definition. Budgets can serve at least three functions: to inform the fiscal policy debate, to structure the debate on government programs, and to affect fiscal policy outcomes. With respect to information provision, it is possible to envision budgets defined over various horizons, with the nearest-term measuring the government's expenditures and revenues in only the current period and the longest-horizon measure describing the present discounted value of government outlays and revenues under current or projected policies. The current horizon for most aspects of the federal budget process is five years, although political maneuvering in 1996 involved promises of budget balance by 2002. There are examples, such as the annual report produced by the trustees of the social security system, of much longer budget horizons. In the social security case, projections of cash flows and account balances for seventy-five years are presented each year.

With regard to structuring debate, the budget has important effects along many dimensions. Many features of actual budgets, such as the distinction between on- and off-budget programs, the categorization of spending into mandatory and discretionary, the "pay as you go" requirement that certain programs be fully funded when enacted, and even the sequencing of approval of overall budget targets (the budget resolution) and individual appropriation measures, affect the debate on government programs and revenue sources. The information provision

[11] This section draws from Poterba (1997) pp.56-9, pp.62-4.

and debate-structuring role of budgets are clearly linked together, in that with multi-year budgets it is possible to consider a wider range of budget balance concepts than with a single year's account.

The final role of budgets, to affect fiscal policy outcomes, has attracted the most attention in recent policy discussions of balanced budget rules. The central objective of such reforms is to affect the relative likelihood of some budget outcomes rather than others. Tax limitation laws and requirements for popular approval of debt issues at the state level are examples of similar budgeting rules that are explicitly designed to reduce spending and tax levels relative to the size of the private economy.

How Do Budget Rules Affect Outcomes?

A second line of research on budgets has built on the recent advances in positive political economy to provide theoretical insights into the effect of budget institutions. This literature is directed toward a range of questions relating to the "industrial organization" of the legislature and the budget process, such as whether it matters if legislators vote first on the size of the budget and then on its allocation across spending programs, or vice versa. The findings of this literature are often sensitive to modeling assumptions. Ferejohn and Krehbiel (1987) illustrate this difficulty with respect to the timing of votes on budget size and allocation. They show that provided legislators form rational expectations about the allocative stage of the budget game, reversing the timing of the budget votes will not have any effect on fiscal policy outcomes. Masia (1995) presents a related analysis of how budget institutions can alter the political power of the executive and thus affect the nature of budgetary bargains.

One explanation of the role of budget ruses, which has not been emphasized in the political economy literature to date, is that these rules provide a form of "self-control" for political actors. If society exhibits dynamically inconsistent preferences with respect to fiscal policy, always preferring a larger budget deficit in the current period than it would have agreed to in previous periods, then budget rules may provide a mechanism for constraining the discretion of future budget deliberations. Laibson (1994) discusses a similar set of issues with respect to individual saving behavior. He suggests that in the presence of hyperbolic discounting, individual preferences with respect to saving will be time inconsistent and that individuals may develop institutions that restrict their future ability to consume. Formal analysis of budget rules in a framework such as this, while promising, remains an issue for future research.

Empirical Evidence on the Effects of Budget Rules

The final strand of research on budget institutions has taken an empirical tack, analyzing how various rules for developing, enacting, and enforcing budgets affect the nature of fiscal policy. This work has exploited differences across nations, across states within nations, and within nations over time to search for effects of budget rules on fiscal outcomes. A number of studies in this tradition have identified substantial effects of fiscal rules; this is the primary subject of this chapter.

The central empirical problem in the research program on fiscal institutions and their effects is the potential endogeneity of budget institutions. Riker (1980) argues that essentially all political institutions reflect the "congealed preferences" of the electorate. In this view, institutions that no longer suit a majority of the electorate will be overturned, and the institutional structure of a nation or state contains no information other than some aggregation of information on current voter preferences. Skidmore and Alm (1994) demonstrate that state fiscal conditions, notably the level of state taxes, are related to the probability that voters will pass a tax limitation law; this finding underscores the institutional endogeneity problem for budget rules.

The institutional endogeneity problem with respect to budget deficits is similar to the problem that has plagued the macroeconomic research program on the effects of central bank

independence. Posen (1995) argues that whether a central bank is independent is largely explained by the degree of opposition to inflation in the financial community within a nation. This suggests that the independence of the central bank cannot be viewed as an exogenous variable for explaining outcomes such as a nation's inflation rate.

With respect to budget institutions, the counterargument to the institutional endogeneity view emphasizes the difficulty of changing these institutions and the costs of revising fiscal rules. Alesina and Perotti (1996) argue that at least some of the international differences in budget rules should be viewed as exogenous. The difficulty associated with changing the federal budget process is evidence for this view, as is the fact that in many of the U.S. states, the current budget institutions are those that were established when the state joined the union.

There are at least two ways to reduce, if not solve, the problem of endogenous fiscal institutions. One strategy is to control for some measure of voter preferences, such as the political party of elected officials, or an objective index of voter preferences on the political spectrum. This reduces the potential for observed correlations between budget rules and fiscal outcomes to reflect a correlation of both of these variables with an omitted third variable, voter tastes for fiscal outcomes. The difficulty with this approach is that any set of control variables may not completely capture the potential omitted variables that underlie spurious findings.

A second approach involves modeling the evolution of budget rules and using variables that affect budget rules but not fiscal policy as instrumental variables in a simultaneous equations econometric framework. The difficulty with this approach is finding valid instrument. Although it is unlikely that any instruments will be beyond dispute, this approach provides a potentially promising method of addressing the institutional endogeneity problem. Exploiting these strategies represents an important part of the empirical agenda for research on budget institutions.

The Balanced Budget Amendment and the Passage of Gramm-Rudman-Hollings

The shift from near balance in fiscal policy to persistent peacetime federal deficits starting in the mid-1970s led to emerging policy concern about fiscal policy. This concern first reached a critical juncture in August 1982, when the Senate passed the balanced budget amendment (BBA) by a 69-31 margin, two votes more than the two-thirds majority needed for a constitutional amendment. The proposed amendment required Congress to adopt a balanced budget before the start of each fiscal year, although it incorporated limited override provisions for deficits in wartime or if approved by 60 percent of Congress. Despite support from the White House, the BBA did not pass the House of Representatives by the required two-thirds majority.

Although the BBA could not command sufficient legislative support for passage, it indicated a desire to alter the budget process in ways that would reduce the chance of future deficits. As chronicled in Poterba (1994a), this desire surfaced again in late 1985, when the senate took up legislation to raise the federal debt limit from $1.8 trillion to $2.1 trillion. The expansion in debt authority was needed to avoid a federal financial crisis, since increased borrowing was required to make federal interest payments. During the debate on the debt ceiling bill, Senators Phil Gramm, Ernest Hollings, and Warren Rudman took the initiative on broad deficit issues and introduced a bill requiring a phased-in program of deficit reduction, leading to budget balance in fiscal 1991.

The Gramm-Rudman-Hollings (GRH) bill that passed the Senate by a wide majority had two components. The first altered the timing of the federal budget process, accelerating budget discussions and placing deadlines earlier in the calendar year in an effort to permit more deliberation before the start of the fiscal year. The second objective was to introduce a set of deficit targets and a mechanism for ensuring that actual deficits did not exceed them. There were five central provisions in the bill:

1) The president would be required to submit budgets with forecast deficits no greater

than the target for a given year.

2) The office of Management and Budget (OMB) nad Congressional Budget Office (CBO) would prepare estimates of the projected deficit from the enaceted budget and tax legislation.
3) If the average of the CBO and OMB deficit computations exceeded the target, then the president would have two weeks to issue a sequester order, requiring permanent reductions in budget authority for all outlays other than a set of exempt programs, which included means-tested entitlement programs, interest on the federal debt, government pensions, and existing contractual obligations.
4) Half of the sequester cuts would come from entitlement programs with automatic spending increases, such as Medicaid, Aid to Families with Department Children, and food stamps, while the other half would come from other discretionary programs.
5) A suspension clause rendered the need for spending cuts inoperative if the economy was in recession. This would occur if actual economic growth fell below 1 percent for two consecutive quarters, or if the CBO or OMB projected negative growth for two quarters. The suspension clause would also apply in periods when there was a war declared by Congress or whenever a three-fifths majority of Congress voted for such suspension.

The Gramm-Rudman-Hollings bill represented a substantial change in the rules governing budgetary politics in the United States. The conference bill that President Reagan signed called for a deficit target of $171.9 billion in fiscal 1986, declining to zero by fiscal 1991. Half of the automatic cuts would come from defense and half from nonexempt nonmilitary programs, including AFDC, Medicaid, and social security. All programs would have to be cut proportionally, thereby limiting presidential discretion. A key provision required the General Accounting Office (GAO) to calculate the average of the OMB and CBO deficit estimates and transmit an estimate of the needed sequester to the president. AFDC, Medical, and social security were excluded from the sequestration process.

The GAO provision was the basis for a constitutional challenge to GRH. In July 1986, the Supreme Court declared GRH unconstitutional, on the grounds that because Congress can dismiss the head of the GAO, the bill provided executive authority to an organization under legislative control. The Supreme Court decision derailed the first GRH deficit limitation plan. A year later, the Senate passed new legislation, sponsored by Senators Gramm, Chiles, and Comenici, in which the final step in the sequester process required GAO to submit its report to OMB, an executive agency. OMB would review the GAO report, and the president would then issue an order based on it to enforce spending cuts. The deficit targets were loosened from levels in the previous year's legislation to require a deficit of $144 billion in fiscal 1988, declining to zero in fiscal 1993. In addition, the law permitted a $10 billion margin of error in all years until 1993. President Reagan signed this bill in September 1987. Although it was technically different from the original Gramm-Rudman-Hollings bill, this legislation is frequently referred to as Gramm-Rudman or Gramm-Rudman-Hollings, and it shll be referred to as GRH in what follows.

2.5 Empirical Facts in Japan[12]

Structure of Budget

In Japan, under the Constitution, the cabinet is solely responsible for preparing and submitting the budget to the parliament every year. Fiscal year begins on 1st April. The

[12] This section draws from Tanaka (2002, Chapter 3-5).

Ministry of Finance (MOF) has general jurisdiction over public finance. Other government departments are also involved in formulating economic and fiscal policies. The Cabinet Office which was established in January 2001 consolidating several government departments such as the Economic Planning Agency is in charge of overall policy-planning and coordination in order to support the cabinet's strategic function. The Council of Economic and Fiscal Policy (CEFP) under the Cabinet Office is also important (discuss later).

The national government budget consists of the General Account, 37 special accounts and government affiliated agency budget.

The General Account budget, commonly referred to as "the budget", accounts major government's programs such as public works, social security, education, science, national defense, and economic cooperation. All national taxes are treated as the revenue of the General Account except for several earmarked taxes, such as road taxes. In FY2002 general taxes finance approximately only 60 per cent of the total General Account expenditure, 40 per cent of the remaining revenues depend on government bonds.

Special accounts could be established by legislation when the government needs to carry out specific projects, to administer and manage specific funds, or to administer revenues and expenditures separately form the General Accounts. Each special account generally has its own distinct source of revenues, such as social insurance contributions. Some accounts can finance balance by borrowing and received funds from the General Account. The government's loan and guarantee program is managed through one of special accounts under the name of "Fiscal Investment and Loan Program (FILP)".

There are a number of government affiliated agencies which established under special laws, separately from the government, in order to provide them with flexibility in personnel management and accounting, as well as to achieve greater efficiency through corporate-style management. These agencies are fully capitalized by the government. In general budgets of these agencies are not to be approved by the parliament, although subsidies from the government are to be appropriated on the General Account or special accounts. Budgets of seven public financial corporations and two banks among agencies are however to be tabled on the parliament because their activities are closely to overall government policies.

The Japanese budget system is characterized by the comprehensiveness which covers almost all government activities and high degree of parliamentary control. There are few extra-budget items among government activities. Exceptions are budgets of some government affiliated agencies such as the National Highway Agency. Some countries put expenditure of entitlements which benefits are decided by their own laws outside of the government budget and the amount of revenues are not usually that of approved by the parliament. Japan does not follow these traditions.

Unlike that of many other countries, Japan's budget to be submitted to the parliament is composed of both revenue and expenditure side and the revenue budget is formulated to clarify resource necessary for programs[13]. The sources of revenues include government bonds in addition to tax so that the total amount of revenues in the budget equals to the total amount of expenditure ever year.

Principal budget rules in Japan stipulated in the Public Finance Law of 1947 are the balanced budget rule and so-called the golden rule. Article IV prescribes any expenditure of the state shall be financed by revenue other than public bonds or borrowing. However, public works, investment and loans can be financed by public bonds or borrowing within a specific amount approved by the parliament as an exception. This is considered the exceptional clause in principle.

In spite of these principles, bonds to finance investments have been issued continuously since FY1966. Deficit-financing bonds to finance not investments but current expenditure

[13] See Ishi (2000).

were issued in the supplementary budget FY 1975 in response to a drop in tax revenues caused by the recession following the first oil crisis. The special law that enables the government to finance current expenditures by public bonds overriding the principle in the Public Finance Law is required to enact every year. Since then, deficit-financing bonds have been issued almost every year to make up for shortfalls of revenues over current expenditure with some exception of from FY 1991 to FY 1993.

Budgeting Process

The most striking event in recent financial management reforms is the creation of the Council of Economic and Fiscal Policy (CEFP) in January 2001. It was a new institution set up through the Administrative Reform 2001 in which one of agendas was to strengthen the political leadership of the cabinet and the prime minister over public administration. CEFP is an advisory board to research and deliberate on some key issues including policies on economic and fiscal management and guideline for budget formulation. The detail of CEFP is shown on Box 3. The Finance Minister is one of members of CEFP and contributes to policy-making for economic and fiscal management. CEFP played a major role in formulating FY 2002 budget for the first time.

The latest budgeting process in Japan, which was realized in 2001 is summarized as follows.

The Fiscal Year in Japan begins on April 1st. The budget formulation process starts in summer season of previous year, normally July, with the approval of guideline for the next year budget request. At the initial stage, spending ministries submit their next year budget request to the Ministry of Finance by the end of August. Before request submission, the Cabinet approves the "Guideline for Budget Request", which sets out expenditure ceiling for major programs such as public works and social security for the next fiscal year's budget request. These ceilings are usually expressed in terms of absolute or percentage increase or decrease vis-á-vis the previous fiscal year's amount. The ceiling for budget request has been functioning as the most important institution to control total expenditure in the annual term in Japan. We may call it the top-down approach in the budgeting.

The last year's, namely FY 2002 budget formation was a little bit exceptional. The government first decided 'Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" on the end of June in 2001, which originally drafted by CEFP. This "Basic Policies" presents seven key priority areas along with principles for reforms of public works, social security system and local government finance, and it also sets a target to restrict issues of government bonds to a maximum of 30 trillion yen. The Guideline of FY2002 Budget Request was formulated in August 2001 based on this "Basic Policies".

After spending ministry submits its next year budget request at the end of August, budget examiners of the Budget Bureau start a series of hearing with each spending ministry or agency on details of its budget request. Budget examiners review intensively whether its request follows the Guideline of Budget Request or not from September to December.

At the beginning of December 2001, the government decides "Guidelines for Foundation of FY 2002 Budget, which is also drafted through CEPF. Following this Guidelines, Ministry of Finance finalizes its Draft Budget and presents it to the cabinet for final considerations. In actual it takes approximately a week to have negotiations between Ministry of Finance and spending ministries. After some adjustments to the Ministry of Finance's Draft, the government's next year draft budget is approved by the cabinet, usually at the end of December.

The cabinet tables its draft budget to the parliament in the latter half of January. The Japanese Constitution gives some sort of superiority to the House of Representatives (the Lower House), for example parliamentary discussions should take place first in the Lower House. After the budget speech by the Finance Minister at the House, government's draft budget is deliberated by the Budget Committee, which includes statutory public hearings. Once the

budget committee approves the draft, it put to a vote at a plenary session of the Lower House. After the Lower House's deliberation, then is a session in the House of Councilors (the Upper House) in almost same manner of the Lower House. Normally the budget is enacted at the end of March before starting the new fiscal year.

When the decision of the Upper House differs from that of the House of Representatives, a special joint committee comprised of selected members from both houses in convened for reconciliation. If the committee cannot come to an agreement, or if the Upper House does not make a final resolution within 30 days after receiving the draft budget approved by the Lowe House, the resolution made by the Lower House shall be that of the parliament.

In Japan, as well as countries of the parliamentary system such as the UK, the government budget is almost always approved without any substantial amendments. There have been only four times of amendments since the end of the World War II, although the parliament is given the authority to amend the government budget proposal in a certain scope.

Medium-term Fiscal Planning

Medium-term fiscal planning[14] has been realized again in OECD member countries as an important tool to increase fiscal discipline over budget although the old version of medium-term fiscal planning in 1960s and 1970s had been not necessarily successful in controlling government expenditures[15]. A number of countries have been exercising medium-term fiscal planning although its institutional characteristics vary from country to country.

Japan has also a long history to develop medium-term fiscal planning. There were a lot of arguments in 1960s for introducing medium-term fiscal planning among the parliament, academics as well as the inside of government. Then the first one was published in 1976 by the Ministry of Finance, and it was continuing until 1980. These preliminary attempts were replaced by the "Medium-term Fiscal Projection" in 1981, which basically survives until now although there were some changes in the style of presentation. The title of this projection was changed to the "Projection of the FY2002 Budget's Effect on Expenditures and Revenues in the Coming Years" in 2002 on an occasion of introduction of the "Structural Reform and Medium-Term Economic and Fiscal Perspectives" in January of 2002 which was released by the government through drafting by CEFP.

The "Projection of the FY2002 Budget's Effect on Expenditures and Revenues in the Coming Years" (hereafter called "Projection") shows how the FY2002 budget will affect future expenditures and revenues up until FY 2005 under the following conditions. First, economic indicators for FY2003 and after are based on those assumed in the "Structural Reform and Medium-Term Economic and Fiscal Perspectives". Second, the projection is calculated on current services basis assuming that the FY2002 budget policies and measures are to remain unchanged in the coming year.

Importantly, the "Projection" is not a so-called "baseline" which is supposed to be the basis of budget negotiations for the following year, but a simple "estimation" which provides the parliament with information on medium-term fiscal implications of the current budget. In the past, the government sometimes set a target of fiscal consolidation that budget should be formulated without deficit-financing bonds within certain timeframe. The latest one was set in

[14] There are several terms to express planning, such as medium-term budget framework, multi-year budgeting, medium-term expenditure. They are normally not multi-year appropriations which authorize spending legally but rolling plans or estimates which a government decides and presents by itsself.

[15] OECD (1997) explains that there are three broad problems in predecessors of medium-term fiscal planning. First, there was a tendency to overestimate the future growth of the economy. Second, ministers and departments viewed their forecast expenditure as an entitlement. Third, the multi-year budget frameworks were in real terms rather than in nominal terms.

1983 with the targeted year of 1990. The "Projection" was useful for analyzing how much deficit-financing bonds should be decreased every year.

When we discuss the prospect of medium-term fiscal planning in Japan, it is extremely important to understand the experience of introducing the Fiscal Structural Reform Act of 1997 and suspending it.

The government under then Prime Minister R. Hashimoto argued the necessity for fiscal structural reform as well as economic structural reform and finally made the cabinet decision on Fiscal Restructuring Targets on December 1996. In order to make this decision fully effective, the Fiscal Structural Reform Act was enacted in November 1997. The Act articulated specific fiscal targets and imposed caps on some individual expenditure lines. We can call it "medium-term consolidation plan" placing limits on future expenditures line by line with clear fiscal targets.

Unfortunately, soon after the enactment of the Act the Japanese economy encountered numerous unanticipated adversities from the latter half of 1997 to 1998. On the domestic side, several financial institutions including some leading banks and securities companies in Japan went bankrupt, while on the international side, some Asian economies encountered severe financial an economic turmoil. These shocks had severely worsened the domestic economy, which was already ailing unable to overcome the negative aftereffects of the bubble era.

Against this backdrop, in May 1998 the Parliament amended the Act so as to enable government to issue additional deficit-financing bonds in an emergency situation without contradiction with the Act which tightly disciplines the issuance of deficit-financing bonds. In addition, the fiscal consolidation target was amended as well. Finally, the Act was suspended in December 1998 because the government concluded that the fiscal expansion was urgent to counter extremely severe conditions of its economy.

The newly formed government under the Prime Minister J. Koizumi in April 2001 has changed the overall macroeconomic policy from expansion to consolidation, asserting "no growth without structural reform". The new government's economic policy was embedded in the "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" which was decided in June 2001. The most noticeable break with this reform packages is the intention to limit new borrowing by the central government to 30 trillion yen in FY2002, which is projected by the OECD to lead to a tightening of 1/2 per cent of GDP[16].

The limit of new borrowing was considered to be to large extent effective in controlling government expenditure which was extremely under pressure for increasing, for example, the government achieved over 1 trillion Yen cut in subsidies for public corporations. However there were a lot of arguments of whether using nominal fiscal balance as a fiscal target was good at managing fiscal policy from the macroeconomic point of view. Because other countries experiences such as the 1985 Gramm-Rudman-Hollings Act in the U.S. showed ineffectiveness of targets such kinds. FY2002 Budget was formulated keeping the limit of new borrowing under 30 trillion yen, some economists however criticized that the government manipulated fiscal balance in the General Account which was under constraint of the limit of new borrowing, using accounting technique which transferred deficits from the General Account to some special accounts. The hidden borrowing was supposed to be about 1.5 trillion Yen.

In the middle of FY2002, it becomes almost difficult to keep the limit of new borrowing to 30 trillion yen through the fiscal year 2002 due to tax shortfalls projected by the lower economic growth. The supplementary budget for FY2002 is expected to be tabled in the beginning of 2003 in order to finance some revenue shortages with an additional issue of bonds.

The other prominent event of the current fiscal policy in Japan was the "Structural Reform and Medium-term Economic and Perspectives" (shortly called "Reform and Perspectives") which was released by the government in January 2002. The "Reform and Perspectives" sets

[16] See OECD (2001).

out the government's vision of the future society and also sketches a picture of medium-term macroeconomic management policies, defining the five years from 2002 to 2006 as the periods targeted for structural reform.

In the "Reform and Perspectives", it is projected that the central and local government primary balance deficit combines will decrease and its percentage of GDP will be approximately half of the current level (4.3 per cent in FY2000) in the final year of targeted periods, as a result of steady economic growth led by private demand and fiscal structural reforms. Furthermore, if efforts to decrease fiscal deficits continue beven after the targeted periods of the "Reform and Perspectives", a primary balance is expected to be surplus by the early 2010s. Considering the fact that our population will start to decrease by sometimes around 2008, and the fact that the baby-boomers who were the core of the working population will soon become pensioners, it is hoped that a primary balance surplus is to be achieved by the beginning of the 2010s.

The "Reform and Perspectives" was supplemented by the "Reference Estimates" which was estimated by the Cabinet Office and presented to the CEFP for discussion. Although the "Reference Estimates" are not part of "Reform and Perspectives" which was formally authorized by the cabinet, they are based on calculations of the macroeconomic model. We can call the "Reference Estimates" almost the first attempt which projects the medium-term fiscal balance using macroeconomic model. The "Reference Estimates" do not show the government's policy targets and do not bind coming years' budgeting, therefore it is not a kind of other countries' planning system which is able to place limits on an individual expenditure for a following years based on integrated medium-term macroeconomic and fiscal forecast with clear fiscal policy objectives.

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