Japan's national budget
Procedure and the public debt burden

SUMMARY
Japan's budget is compiled by its Ministry of Finance based on estimates from other ministries and guidance from the Cabinet, before being approved by the Diet. In Japan's parliamentary system, the executive is drawn from the majority in the House of Representatives, the Diet's lower house, which generally prevails in budgetary matters over the upper House of Councillors. However, bills for what are known as 'special deficit-financing bonds' require the approval of the House of Councillors, which can delay the budgetary procedure if that house is dominated by the opposition.

Budget-makers are formally constrained by the 1947 Public Finance Act (PFA), Article 4 of which stipulates that the government may only issue 'construction bonds' to finance investment in infrastructure, as opposed to covering ongoing social security spending. This constraint is belied by two major, and interlinked, fiscal challenges facing Japan: the increasing share of social transfers in the budget, which is connected to the ageing of the population and a structural decline in Japan's economic capacity; and an ever-growing gross national debt that, at 246% of GDP, in relative terms already dwarfs that of any other G7 nation.

Almost every year since 1975, governments have circumvented the strictures of the PFA by enacting a law empowering them to issue special deficit-financing bonds, which have since grown to make up the lion's share of the national debt. The current government, led by Shinzō Abe of the Liberal Democratic Party, has set out a plan to arrest the growth in the debt pile by 2020.

In this briefing:
- Size and composition of the budget
- Trends in the budget for the 2016 fiscal year
- Approval of the budget
- After the budget has been adopted
- The public debt burden
- Efforts to reform the budgetary procedure
- Main references
Size and composition of the budget

Article 12 of Japan’s Public Finance Act (PFA) establishes the principle of a balanced budget, in which expenditure is offset by revenues and borrowing: 'The expenditure of each fiscal year shall be defrayed by the revenue of said year'.

The General Account budget for the 2015 fiscal year (1 April 2015 to 31 March 2016) was ¥96.3 trillion¹ (€723.6 billion), making it the largest amount in Japanese history. It amounts to 19.2% of the country’s GDP of around ¥500 trillion. The budget for the 2014 fiscal year was ¥95.88 trillion.²

One quarter of expenditure (¥23.5 trillion, €180 billion) is spent on servicing the public debt, which is the highest³ in the OECD (246% of GDP in 2014), although interest payments on the debt amount to only 14% of GDP.⁴ Social security (¥31.5 trillion, €240 billion) is by far the biggest envelope. Some ¥1 trillion every year is needed to bridge the gap between social security-related spending and receipts. The third main item of expenditure is represented by 'Local Allocation Tax Grants' (¥15.5 trillion, €120 billion). They are distributed to local governments to pay for basic administrative services.

On the revenue side, almost 40% of expenditure is financed by government bonds, which is high by international comparison. ‘Special deficit financing bonds’ and ‘construction bonds’ together yield some ¥36.9 trillion (€280 million), or 38.2% of revenue. This is due to the growing gap between total expenditure and tax receipts, and represents a burden for future Japanese generations. However, fiscal consolidation efforts have seen the amount of new debt issued fall to a six-year low: in the 2014 financial year, for instance, it was ¥41.3 trillion.

Trends in the Japanese budget for the 2016 fiscal year

On 24 July 2015, the Cabinet adopted the Guidelines for General Expenditure Budget Requests for the forthcoming 2016 fiscal year (FY2016) beginning on 1 April. The General

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Account budget requests for FY2016 from government ministries and agencies amounted to the record figure of ¥102.41 trillion.\(^5\) However, the draft budget adopted by the Cabinet on 24 December 2015 and presented to the Diet on 22 January 2016 amounts to ¥96.72 trillion.\(^6\) In comparison to FY2015, the Government wants to limit the growth of the budget in order to meet its fiscal consolidation targets (see below).

The Health, Labour and Welfare Ministry had set the objective of capping the increase in social security costs at ¥674.3 billion, down from the ¥830 billion cap for FY2015.\(^7\) However, the Cabinet further restricted the increase to ¥441 billion, to a total of ¥31.97 trillion. For the defence budget, the gradual increase of the past three years will continue: the Government decided to meet almost in full the Ministry of Defence's request for a 2.2% increase for 2016.\(^8\)

The defence budget is to amount to ¥5.05 trillion (€40 billion), the highest in the post-war period.\(^9\) At the same time, Japan is to increase its official development assistance (ODA) spending by 1.8% to ¥551.9 billion (€4.3 billion), and the budget of the Japan Tourism Agency (JTA) has been doubled to ¥20 billion.

On the revenue side, the Cabinet set a target of ¥57.6 trillion, the highest in the past 25 years, based on the assumption of a 1.7% GDP increase (though the Bank of Japan growth forecast is lower: 1.4%). This may allow the number of government bonds issued to fall further to ¥34.43 trillion, or 35.6% of receipts – the smallest share in nine years.

### The General Account and the Special Accounts

Although this briefing focuses on the General Account, it is important to understand that the majority of national public sector spending is channelled through 14 Special Accounts.\(^10\) The gross value of these accounts was ¥403.6 trillion (net ¥195.1 trillion, excluding transfers between the accounts) in the 2015 fiscal year, or more than four times the General Account. The Special Accounts are designed to clearly illustrate the balance of 'benefits and burdens', or the relationship between specific sources of revenue (such as pension contributions) and government liabilities (such as future pension payments). In the 2015 fiscal year, the four biggest Special Accounts – interest payment and debt redemption (¥90 trillion); the Government Pension Investment Fund (¥60.8 trillion); the local allocation tax grant (¥19.3 trillion); and the FILP, (¥14.6 trillion) – account for some 94.7% of the net value of all the Special Accounts. The Government Pension Investment Fund (GPIF), for example, is the world's biggest pension fund, and invests in an asset mix of domestic and international bonds and stocks.

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### Three kinds of budget and the FILP

The national government budget is split into three types of budget:

1. the General Account budgets – commonly referred to as ‘the budget,’ is the basic account of the government;
2. the Special Account budgets – established by legislation under specific conditions (for instance, the national pension system is operated as a special account);
3. the budgets of government-affiliated agencies.

All three types of budget are submitted to the Diet for approval, along with the Fiscal Investment and Loan Programme (FILP). The FILP is a long-term, low-interest investment and loan initiative by the government that aims to achieve policy objectives including financial support for small and medium-sized enterprises (SMEs), construction of welfare facilities, and provision of scholarship loans. The capital for such financial tools is procured through the issuing of FILP bonds – similar to the Japanese Government Bond.

Although the budget is meant to reflect the principle of universality, with all revenue and expenditure incorporated into the annual budget, the above-mentioned division into three types of budget – each separately submitted to the Diet – means that the principle of unity is not fully respected. This is despite the fact that revenues and expenditures are consolidated.
Approval of the budget

The government stage

Under Article 73 of Japan's Constitution, the procedure to adopt the budget is initiated by the Cabinet. The Ministry of Finance (MoF) is the authority in charge of preparing the draft budget. The PFA establishes the principle of an annual budget for the fiscal year running from 1 April to 31 March. The process begins in the summer of the previous year, when the Cabinet approves the Guidelines for General Expenditure Budget Requests in July.

Next, each ministry must submit its budget request to the MoF by 31 August, but in practice they already start preparing their requests in April. Subsequent hearings between the MoF Budget Bureau and each ministry provide an opportunity to explain budget requests in greater detail.

In December, the Cabinet issues the 'Basic Principles of Budget Compilation'. On this basis, the MoF prepares a draft budget and presents it to each ministry and agency. Discussions take place for one week, before the Cabinet authorises the Final Draft Budget, which is meant to be published by 31 December.

The parliamentary stage

The Cabinet typically submits the draft budget to the Diet by the end of January. Between the Diet's two branches – the upper House of Councillors and the lower House of Representatives – the latter prevails in the case of disagreement on the draft budget. Each house is given three to four weeks to examine the budget, so that it can enter into force by the beginning of the next fiscal year on 1 April. The draft budget – tabled in the Diet by the Minister of Finance – is first examined and voted on by the Budget Committee of the House of Representatives, before being put to a vote in plenary session. Subsequently, it is sent for approval to the House of Councillors, whose Budget Committee deliberates, before submitting it to the House of Councillors plenary for adoption. If the two houses vote to approve the same text, the process is concluded and there is no need for promulgation, as would be required for a piece of law.

Should the amendments to the draft budget by the two branches of the Diet differ, a joint committee composed of ten members of each house is brought together to find an agreement within 30 days. If they cannot agree, the House of Representatives' decision becomes the entire Diet's decision. Similarly, if the House of Councillors fails to adopt a decision, the lower house's decision will take effect (Article 60 of the Constitution). This system is meant to ensure that a decision can be taken by the beginning of the fiscal year, without triggering a stop-gap measure comparable to the EU's system of 'provisional twelfths', applied in cases where the Council of the EU and the Parliament
do not agree on a budget in time; and avoiding the risk of a sovereign default run by the United States in recent years.\textsuperscript{17} In Japan, all transactions are estimated for the one fiscal year, with the exception of payments for projects, for which the Diet can approve multi-annual appropriations.

The procedure also gives the Cabinet the right to express its view when an amendment increasing the total size of the budget is tabled, whether at committee or house level. While the Cabinet has no formal power of veto, the Diet is unlikely to substantially amend the draft budget or raise the amount of expenditure proposed by the executive. The Cabinet can also submit draft supplementary budgets to the Diet to amend the initial budget.

**After the budget has been adopted**

**Budget execution**

Following adoption, the Cabinet allocates the due departmental budget to the heads of the various ministries and agencies, who are responsible for implementing it. Ministries must prepare a draft disbursement plan and submit it to the Ministry of Finance for approval. It is not possible to cancel appropriations; if the Cabinet wishes to do so, it must table a supplementary budget in the Diet.

Within ministries, expenditure items are subdivided into articles. Other ministries are not permitted to shift appropriations between items, unless the Diet has already approved this in principle, and the Ministry of Finance approves it on a case-by-case basis. Other ministries may transfer appropriations within items only after obtaining the approval of the Ministry of Finance. However, if they wish to transfer resources between different items, the Diet's approval is required.

Article 87 of the Constitution provides for a reserve fund to be authorised by the Diet to cover unforeseen shortfalls in the budget, due to circumstances such as natural disasters (to which Japan, as a country, is especially prone) or unexpected economic instability. The amount is determined by the Cabinet (there is no specific legal provision on this) and authorised by the Diet; the Cabinet is responsible for spending the fund, but it must obtain the approval of the Diet for all payments.

**Audit**

The Ministry of Finance has the authority to require other ministries to carry out wide-ranging surveys of budget implementation in their policy area. However, in practice it has preferred to audit the budgetary implementation of selected projects.

Article 90 of the Constitution establishes the principle of accountability: each year the Cabinet must submit to the Diet the final accounts of the state's expenditure and revenue. Prior to this, an external audit is carried out by the Board of Audit (BOA), whose establishment is also provided for in the Constitution (Article 90). It is composed of an Audit Commission consisting of three Commissioners, and a General Executive Bureau. The BOA audits all financial and non-financial policies and activities of the **Two bodies to advise the Government**

The Council on Economic and Fiscal Policy (CEFP) is composed of senior ministers, including the prime minister and the finance minister, the governor of the Bank of Japan, university professors, and business executives. It researches and deliberates on key issues, including basic economic and fiscal management policies, and guidelines for budget formulation, in order to support the prime minister's decisions. Among other documents, it produces the first draft 'Guidelines for General Expenditure Budget Requests'.

The Fiscal System Council is an organ of the Ministry of Finance. Its members are scholars, journalists and business executives. The Council researches and discusses important topics related to the budget, the settlement, and the accounting system of the national government.
central government, as well as of public corporations. The BOA is independent from the Cabinet, the legislature (unlike in other countries) and the judiciary. Its three commissioners are appointed by the Cabinet with the consent of the Diet. The Diet reviews whether the budget was properly executed and approves the final accounts audited by the BOA.

**The public debt burden**

Japan's level of gross public debt-to-GDP has been growing almost without interruption since the 1960s, swelling from 51% in 1980 to 246% in 2015, and a projected\(^{18}\) 252% in 2020; with the most dramatic increase occurring since 1990. A significant part of the Japanese budget – some 10% of government revenue – is spent on interest payments each year, while debt servicing in general, which includes both interest payments and debt redemption, accounts for approximately a quarter of the budget. Although net public debt is much lower, at 134% in 2013, it still represents a substantial burden.\(^{19}\)

Japanese governments striving to achieve fiscal consolidation face a formidable demographic headwind: Japan's population is ageing more quickly than that of any other country. As an ever greater number of pensioners are supported by a proportionally ever smaller working-age population, tax revenue is projected to dwindle, while fiscal pressures, in the form of increasing demand for public services such as health and elderly care, are expected to worsen. Prior to 1990, primary government spending (before interest payments and debt redemption) was stable at approximately 30% of GDP, but by 2010 it had grown to some 40%. This presents the Japanese exchequer with a structural challenge.

On top of these unpromising economic fundamentals, Japan continues to grapple with two recent fiscal shocks: the lingering effects of the financial crisis and global economic downturn since 2008, and the Great East Japan Earthquake of 2011, to which the Naoto Kan government (Democratic Party of Japan – DPJ) in power at the time responded by creating an emergency ¥19 trillion fund for the first five years of reconstruction. In fact, one reason for the surge in debt-to-GDP is that, since 1992, when Japan began to consistently run primary fiscal deficits (an excess of government spending over revenue, excluding interest payments), governments have responded to periodic crises by borrowing more to stimulate the economy, while failing to adequately correct for this at other times given the structural pressures facing the budget, as the dependency ratio between the working and non-working populations worsened. A recent Organisation for Economic Co-operation and Development (OECD) report warned that, if left on its current trajectory, gross government debt-to-GDP would exceed 400% by 2040.\(^{20}\)

A superficial view of the debt-to-GDP trend would suggest that reducing the debt burden, whether by reining in spending, boosting tax revenue or monetising the debt, is
imperative if Japan is to avoid the sort of sovereign debt crisis witnessed in some EU Member States since 2008. Sugimoto and Ueda (2013) calculate that the worldwide volume of bonds and equity increased by a factor of 5.5 between 1990 and 2020, while global GDP increased only 3.4 times. They see a surge in the world’s money supply as enabling increased government deficit financing by advanced economies, while simultaneously encouraging ‘surges and stops’ in financing from yield-hungry creditors, and amplifying the shocks caused by a loss of confidence in sovereign debt. In fact, yields on 10-year JGBs have broadly tracked downwards since 2007, from below 2% in 2007 to under 0.1% in January 2016 (below the current 0.35% rate on 10-year German Bunds, and well below the current 1.6% rate on 10-year United Kingdom Gilts).

The explanation may lie in an important feature of Japanese government debt that mitigates the apparent risk: approximately 91% of JGBs are held by domestic creditors, both households and, increasingly, businesses, which turn to what are perceived as ‘safe’ JGBs instead of investing amid an uncertain economic climate. Since only 9% of JGBs are held by foreign creditors, Japan is less exposed to the sort of sudden loss of confidence seen in the EU since 2008. This has given the Japanese exchequer more breathing room than its European counterparts, but it has also encouraged Japanese governments to delay fiscal consolidation.

The Abe government’s plan for fiscal consolidation

On 30 June 2015 the Shinzō Abe-led government unveiled its Basic Policy on Economic and Fiscal Management and Reform 2015, which includes measures to arrest the growth in the public debt pile. The policy involves increasing Consumption Tax from 8 to 10% in 2017, coupled with reduction of past stimuli and reconstruction spending, while at the same time revitalising Japan’s moribund economy, in the hope that stronger growth will boost tax receipts. The specific targets are a reduction in the primary deficit to 1% of GDP by 2018, and a primary surplus by FY2020. It is said that the document reflects an ongoing debate within the ruling Liberal Democratic Party of Japan (LDP) about the correct strategy for stabilising the country’s finances, with ‘fiscal hawks’ emphasising spending cuts, against a 'rising tide' group who advocate prioritising measures to boost the economy.

Debt management policy

At the end of each year, the Japanese Ministry of Finance issues a JGB Issuance Plan for the forthcoming fiscal year, tracking the total stock of debt and setting out the Ministry’s bond management policy for that year. The objective is to achieve ‘stable and smooth’ issuance of JGBs, and provide for the Ministry of Finance’s day-to-day liquidity needs. The debt is made up of a mix of JGBs (comprising general bonds, loans under the Fiscal Investment and Loan Programme (FILP), and others) and other borrowing; financing bills to cover day-to-day Treasury operations; government-guaranteed debt for local government and public financial institutions; local government bonds; and the debt of special agencies.

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<th>Japanese public debt</th>
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<td>Debt of special agencies</td>
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Source: Japanese Ministry of Finance.
Under Article 4 of the 1947 Public Finance Act, the government is only meant to issue bonds to finance specific public works, investments or loans, such bonds being referred to as 'construction bonds'. Since 1975, however, governments have routinely circumvented this formal constraint by enacting a law empowering them to issue 'special deficit-financing bonds'. Thus, what was initially intended as an emergency measure to respond to the worldwide recession triggered by the first oil crisis, has hardened into an annual convention. With the exception of the brief 1990-1993 period, the Diet has passed this 'special law' every year. Special Deficit Financing Bonds have since become the primary form of borrowing by the Japanese exchequer, accounting for ¥30.9 trillion (32% of total revenue) of the FY2015 budget, compared with ¥6 trillion (6.2%) in Construction Bonds. Sugimoto and Ueda (2013) suggest that the 'complexity of the fiscal system', with its sundry debt financing mechanisms, government-affiliated agencies, and contribution-based social security accounts, obscures the scale of the burden in the eyes of the public, thus weakening public support for fiscal consolidation.

Efforts to reform the budgetary procedure

Although Japan's debt burden may not be as immediately unsustainable or perilous as it appears, recent governments have nevertheless promised to reduce deficits and tackle the debt pile, albeit with different strategies. The current government headed by Shinzō Abe of the LDP entered office in 2012 promising to shift the emphasis away from tax rises and spending cuts, and towards stimulating inflation and stronger economic growth. However, the debt-to-GDP ratio still appears to be growing inexorably, despite promises by governments in recent years to cut 'wasteful' government spending, and despite an increase in the consumption tax rate from 5% to 8% in 2014. In the FY2015 budget, primary expenditure and interest payments amount to approximately ¥83 trillion, against some ¥59.5 trillion in tax and other receipts. The ¥23.5 trillion shortfall equates to a deficit of almost 40%, which will be covered by additional borrowing.

Hideaki Tanaka ascribes the steep rise in government debt to a 'weak' budget institution, something the Democratic Party of Japan (DPJ) sought to reform when it governed for the first time between 2009 and 2012. Declaring in its 2009 Lower House election manifesto that 'True politics means setting priorities in policy-making and spending', the DPJ promised to redirect spending on infrastructure towards public services, cut 'wasteful' spending, and bring greater transparency to budget compilation, with the Diet playing a stronger role. A National Strategy Unit (NSU) and an Administrative Reform Council were set up to assess all departmental budgets and programmes, while cabinet committees were meant to take over from bureaucrats and enable 'politician-led' budget formulation. The DPJ also said it would rationalise and unify the Japanese budget, by reducing the number of special accounts, independent administrative institutions and public service corporations.

A Summary of Issues released in October 2009 by a government review council set up to consider budget institution reform identified the following priorities:

- Introduce a top-down (i.e. cabinet-led) approach to budget compilation, with a medium-term perspective;
- Make budget compilation and implementation more transparent;
- Cut 'wasteful' spending; and
- Focus on results by setting clear policy targets.
According to Tanaka, although the DPJ did fulfill its manifesto commitment to redirect spending away from infrastructure and towards social security spending, and although a far-reaching programme review was underpinned by a well-received public consultation, the complexity of the national accounts, with their recourse to 'accounting gimmicks', remained largely unchanged. In fact, lending via the FILP increased under the DPJ. A 2010 bill formalising the National Strategy Unit's position as a sort of office of budget responsibility vis-a-vis the Ministry of Finance, was delayed in the Diet, and ultimately abandoned by the government.

Main references


Endnotes

1 On 24 November 2015 the Cabinet proposed a supplementary budget for FY2015 to increase support to farmers and rice growers following the signature on 5 October 2015 of the Trans-Pacific Partnership Agreement (TPP) with the US and 10 other countries. This supplementary budget was adopted by the Diet on 20 January 2016. It includes around ¥800 billion of social welfare spending, including ¥360 billion in special allowances for low-income pensioners. This measure aims at supporting a sector of the population not able to benefit from wage increases being pushed for by the administration and provides for the distribution of a lump sum of ¥30 000 (€235) to them. *Budgeting ahead of an election*, in the Japan Times, 25 December 2015.

2 This was the initial budget, to which it is necessary to add a supplementary budget of ¥3.12 trillion adopted by the Diet on the basis of a Cabinet proposal, aimed at boosting internal demand.

3 While being the highest among OECD countries, interest payments on the debt are low.

4 Source: OECD.


8 ‘Japan’s Defense Ministry Wants Record Military Budget for 2016’, The Diplomat, 1 September 2015.

9 ‘Japan’s New Defense Budget: Fact Vs Fiction’, The Diplomat, 5 September 2015. This increase is intended to allow the country to face ongoing strategic challenges in the Pacific area, taking into account the new role the Japan Self-Defence Forces will play following defence policy reforms and the current US government’s ‘pivot to Asia’. See ‘Japan’s Strategic Challenge’, Fernando Betancor, 26 July 2015; ‘Don’t Expect Too Much of Japan’s Defense Reforms’, The Diplomat, 9 October 2015; and Explaining the US ‘Pivot’ to Asia, Kurt Campbell and Brian Andrews, Chatham House, January 2013.

10 For a detailed list of the Special Accounts (in Japanese), see the first table on page 184 of this Ministry of Finance report. The proposed amounts for the 2016 fiscal year can also be found on the Ministry of Finance site.

11 The Public Finance Act, the Public Accounts Act, the Diet Act and the Board of Audit Act, all enacted in 1947, complete the legislative background. The Public Finance Act contains the general principles of the budgeting and accounting system and provides several instructions for the Minister of Finance, the Cabinet and spending ministries. The Public Accounts Act specifies the principles consolidating national treasury funds and the technical procedures for keeping accounts in line ministries. The composition and the role of the budget committees are described in the Diet Act. At local level, various acts give local governments the power to prepare their own budgets: the Local Autonomy Act, the Local Finance Act, the Local Tax Act, the Local Allocation Transfer Act and various Transfer Tax Acts, all enacted between 1947 and 1955.

12 The Cabinet may prepare a provisional budget to cover part of the fiscal year when it expects that the regular budget cannot be approved by 1 April, for instance in the case of an ongoing general election. The provisional budget is replaced by the regular budget once the latter is approved by the Diet.

13 Article 11 of the PFA. This has consequences on some aspects of Japanese life. For instance the universities, whose academic year coincides with the fiscal year, may find it hard to attract international students. In 2013 the University of Tokyo had to drop a plan aimed at starting its academic year in autumn.
The guidelines may set out different issues, according to the on-going administration's policy. As of FY2015 and FY2016, they define the expenditure ceilings for: Local Allocation Tax Grants, social security; discretionary expenditures; and non-discretionary expenditures. The ceilings are expressed in relation to the previous FY, as an increase or decrease in percentage or as an absolute amount. The guidelines may also set out priority measures.

Constitutional organisations (like the two chambers of the Diet and the Supreme Court) have the authority to prepare their budget estimates and submit them directly to Cabinet, with the Cabinet coordinating all budget proposals. The Minister of Finance then makes the necessary adjustments to the estimated amounts proposed by those constitutional organisations, subject to Cabinet decision.


The risk that America will default on its debts is now higher than ever’, in the Washington Post, 23 October 2015.

In order for the budget to be implemented, as opposed to merely adopted, the Diet must also pass a special bill for deficit-financing bonds (see the section on 'Debt management policy'), over which the House of Representatives does not have an effective veto. This can delay the budgetary process if the upper House of Councillors is controlled by the opposition.

Data from the International Monetary Fund (IMF).

OECD Economic Surveys: Japan, April 2015.


The Liberal Democratic Party (LDP) has governed Japan for all but six of the past 50 years.


According to the Japanese Ministry of Finance, 'Others' includes Subsidy Bonds, Subscription/Contribution Bonds, government bonds issued to the Development Bank of Japan, government bonds issued to provide compensation for nuclear damage, and government bonds issued to the Decommissioning Facilitation Corporation.


Comparable to value added tax (VAT) in the European Union.

The consumption tax rate was originally scheduled to increase to 10% on 1 October 2015, in line with legislation introduced by the previous DPJ administration. However, this increase was postponed to 2017 by the current LDP-led government of Shinzō Abe.

Tanaka, H., 'Economic and fiscal management under the Democratic Party of Japan (DPJ) administration', in the OECD Journal on Budgeting, Volume 2014/1.

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