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Welfare State Retrenchment – The Case of Japan

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ABSTRACT

The purpose of this article is to examine the implications for welfare state retrenchment of central-local financial relations. In the post-war period, welfare state expansion has been a dominant theme in the development of central-local government relations in advanced industrial democracies. By the 1980s, however, nearly all OECD member countries had resorted to deficit financing as stagnant tax revenues combined with political pressure for increased public services. Faced with the urgent necessity of fiscal reconstruction, conservatives in advanced industrial democracies have favoured cutting public services throughout the 1990s. As always in times of retrenchment, elected officials have needed to win the goodwill of voters and interest groups for these unpopular cutbacks. There is no doubt that the politics of retrenchment is distinctively different from that of growth. Despite this new stage in the development of the welfare state, few systematic attempts have been made to analyse the impact of retrenchment politics on central-local financial arrangements. This article contributes to the new debate on comparative theories of retrenchment by analysing the impact of welfare state retrenchment in the context of Japan's recent fiscal reconstruction.

From the mid-1950s to 1970, Japan enjoyed a high economic growth, yet it managed to stabilise the size of national and local government expenditure at slightly less than 20 per cent of GNP. However, the patterns of public spending changed over time. The ratio to GNP rose steadily from 20·7 per cent in1971 to a high of 30·0 per cent in 1983. This fundamental change was primarily due to the rapid growth of social security expenditures caused by major changes in social policy in the early 1970s (EPA 1995, 417; Noguchi 1987, 204–9; OECD 1987, 162). The Japanese government therefore launched the 'zero-ceiling' policy from 1983 to 1987, which was a freeze on government spending. In fact, since 1984 the ratio of national and local government expenditure to GNP has held stable again, remaining between 27·6 per cent and 28·7 per cent (except for 29·7 per cent in 1993).[1]

Despite this seemingly successful use of austerity measures, the ratio of social security expenditures to GNP continues to increase with no sigh of a downturn. Indeed, it is evident that the government austerity campaign in Japan is not necessarily related to social program cutbacks. Social security expenditures as a percentage of GNP rose from 11·7 per cent in 1980, to 12·5 per cent in 1985, to 14·7 per cent in 1993, and to a project figure of 17·4 per cent in 2000.[2] This would seem to signal the difficult government enterprise of welfare state retrenchment.

There are two main reasons why one would expect that Japan should have an effective retrenchment policy. The first reason is derived from a salient feature of local government spending in Japan. In relative terms, Japan spends on local government more than any other major OECD member country; however, its local authorities are also among the most regulated in the world. According to the 1992 National Accounts of OECD, local government spending in Japan was a high of 68·8 per cent of general government expenditure, as compared with France's 31·0 per cent, United Kingdom's 31·9 per cent, and Sweden's 46·6 per cent. The Japanese ratio was even higher than those in federal systems, including the US (51·5 per cent), Germany (55·9 per cent), and Canada (60·1 per cent). Despite high spending, Japan's local governments collect a disproportionately small percentage of total tax receipts. This is mainly due to the state-mandated local tax rates and assessment methods. In the same fiscal year, they collected only 37·6 per cent of such revenue, relying on national funds and local loans for 44.7 per cent of its total revenue. This unusually high yet heavily regulated level of local government spending would seem to make it relatively easy for the central government to have spending or programs cut.

The second reason that Japan should have an effective retrenchment policy is related, but in some senses even more fundamental, and concerns an ideological consensus that values self-reliance. According to the Revenue Statistics of OECD Member Countries for 1991, for example, Japan's ratio of taxes and social security contribution to national income was 39·2 per cent, comparable to the US of 36·3 per cent but much lower than the UK (50·0 per cent), Germany (51·0 per cent), France 61·8 per cent), and Sweden (74·3 per cent). This reflects a deeply held tradition of self-help in Japanese society that sees assistance as a form of interference or even personal defeat. These values are reflected in the very framing of Japan's social legislation. Under the Livelihood Protection Law, for example, the Welfare Minister determines the minimum standard of living as an incentive to 'self-sufficiency'. The law implicitly assumes that too much direct relief may create disincentives to personal achievement.[3] These values are also reflected in high savings rates in Japanese households. Despite a sluggish growth in income and a hike in taxes, the proportion of disposable income saved by Japanese households was 13·7 per cent in 1997, well above the G-7 average of 9·6 per cent, according to the OECD Economic Outlook of June 1998. Primary motives for household savings remain precautionary ones to provide for accidents, illness, and unemployment.[4] Given this emphasis on traditional values of self-sufficiency, Japan continues to hold a weak ideological consensus on the legitimacy of government help.

For both of these reasons, one would expect Japan to have developed a strong retrenchment policy in a bid to scale back government's commitments to social programs. But do such expectations really hold up under close examination? We need to remember that retrenchment takes place in the specific context of politics (Garrett 1998; Huber and Ray 1999; Swank 1999), and is inevitably carried out within an organisational framework that is distinctively different from that of welfare state expansion (Weaver 1986; Pierson 1996). In a bid to formulate a comparative theory of retrenchment that takes account of such factors, the present study will examine the underlying political framework in which retrenchment is carried out in contemporary Japan, with particular emphasis on the salience of the central-local government relations.

1. Retrenchment in central-local government relations

In this article, retrenchment refers to a reordering of priorities in national policy that moves toward economic rationalism. This policy orientation derives from fiscal conservatism, which argues that a high level of public expenditure for social welfare will reduce capital investment and employment, while promoting inflation. Fiscal conservatism emphasises the direct connection between greater social spending and government deficits. In welfare state retrenchment, the utmost priority of fiscal policy in many OECD countries has indeed been deficit reduction.

Borrowing should not exceed the net investment of the public sector if future generations of taxpayers are to be spared higher taxes for debt-servicing costs. But do politicians stick to this rule? There is little reason to expect them to, especially if it entails unpopular policies, such as tax increases and program cuts. In a democratic sense, government should spend as its population desires. In practice, however, the preferences of voters are some what contradictory. Most voters wish to reduce their taxation and social security contributions, but they do not want to have programs cut (e.g., Peacock and Wiseman 1961). How can central government bring policy closer to economic rationalism? Deficit reduction can be achieved either by tax increases or program cutbacks, i.e. retrenchment. Yet neither measure is politically feasible.

The financial institution of central-local government relations may help central government ease the dilemma. At the structural level, salient features of fiscal rules between levels of government provide central government with potential for manoeuvring beyond the limits of these political difficulties; manipulating or even changing the institution of public finance is one way to 'sell' the policy – to win the goodwill of government organisations and to restrict voters' ability to scrutinise program cutbacks. According to retrenchment patterns observed by Pierson (1994, 15) this dimension may be called *systemic* retrenchment. In such a way, blame avoidance can be achieved, not by directly targeting specific programs for spending cutbacks (which Pierson defines as *programmatic* retrenchment), but rather by changing fiscal rules between levels of government.

A related component of economic rationalism is the belief that central government should coordinate local government finance in a bid to balance the general government budget and stabilise the economy. Patterns of central-local government relations are thus more likely to be affected by systemic fiscal constraints and incentives than ever before. Variations in central-local government relations may be accounted for by contextual differences, ranging from the political entrepreneurship of a particular leader to the peculiarities of historical tradition. At a time of massive retrenchment attempts, however, it is argued that systemic fiscal constraints will narrow the range of these differences, creating a new political landscape.

In what forms do central-local financial relations facilitate retrenchment? Under what circumstances? With what effects? This study attempts to answer these questions by examining a recent reshuffling of financial relations between central and local government in Japan. It supports a number of claims.

The manipulation of central-local financial arrangements may help to 'hide' cutbacks and their implications from the scrutiny of individual taxpayers and interest groups. The political difficulty of programmatic retrenchment makes this an attractive measure for spending cutbacks. Financing programs through local governments may remove or restrict taxpayers' ability to see a relationship between their contribution and public service offering, while insulating elected officials from political accountability. The manipulation of central-local financial arrangements make it increasingly difficult for ordinary taxpayers to trace responsibility for retrenchment effects.

Resources other than financial ones may be mobilised to reach an agreement between interests for reducing expenditures. Cutbacks in financial resources do not necessarily entail a significant loss of political power. A case in point is turf wars among central bureaucracies which transfer their funds to local governments in which maintaining the volume of approval and permission by bureaucrats may be one way of hushing up the loss sustained by cutbacks. Despite fiscal constraints, bureaucrats retain the power to allocate national funds to local governments within the diminished limit.

In retrenchment, central government may seek to limit the total expenditure of all local governments for economic stabilisation. As government deficits increase, the public sector becomes a net demander of funds in markets. For economic stabilisation, government deficits must be financed by savings within the private sector. Yet managing such deficits without driving up interest rates is nearly impossible in the absence of high savings rates in the private sector. The need to prevent public deficit causing adverse effects on the economy may induce central government to coordinate with local government in order to control the latter's spending levels. In welfare state expansion, by contrast, central authority tends to regulate how to spend and how much to spend on specific items. It is concerned mainly with the allocation of resources, not with their total size, as long as increased resources can meet public demand.

Retrenchment politics is less likely to be an exercise of local autonomy in which decision by local government are accountable to local residents, and more likely to entail manipulation behind closed doors. Struggles over retrenchment are likely to be dominated by a limited range of interests. At the administrative level, policy makers, such as Diet members, bureaucrats, big business, labour unions, and local authorities in the case of Japan, reconcile conflicting interest within the retrenchment bandwagon.

Targeting local government for spending cutbacks is an ineffective means of addressing the problem of rising costs associated with the advanced welfare state. The distinctive institution of local finance may allow central government to manoeuvre beyond the limits of welfare state retrenchment without facing the scrutiny of taxpayers or voters; however, this strategy will fail to produce radical changes in social welfare systems.

2. *Programmatic retrenchment and new taxes in the case of Japan*

In Japan, a 1973 policy decision to dramatically increase social security benefits has had critical implications for the current and future management of fiscal policy. In that year, public pension benefits for employees were raised from 20 per cent of the average salary to 43 per cent; free medical care for the elderly and subsidies for expensive treatments were introduced; and the government's health insurance coverage for the self-employed increased from 50 per cent to 70 per cent. In the wake of this sudden surge of social benefits, the locomotive powering welfare spending became the automatic incremental expansion of already broad and relatively generous entitlements. At the same time, general income levels continued to grow, welfare pensions were indexed to keep pace with inflation, and Japanese society was ageing faster than any other advanced industrialised society. The radical reform of 1973, compounded by these factors, created a fast-growing vested interest in the welfare sector. Outlays of public pension programs rose from 177 billion yen in 1969 to 2,331 billion yen in 1975. Social welfare expenditures for the elderly increased from 21 billion yen in 1969 to 429 billion yen in 1976.

Once in place, such expansionary systems were destined to face cutbacks in one way or another. In the mid-1970s, the need to rethink existing welfare programs began to be widely acknowledged among conservative forces (such as the Finance Ministry, conservative LDP politicians, and business leaders), who worried about the long-term growth of state welfare expenditures and higher taxes.[5] But their attempts to radically restructure these programs failed. In the end, only two significant changes were implemented: the replacement in 1983 of free medical care for the elderly with a patient copayment system, and the establishment in 1985 of the National Pension, which unified two major pension systems into a single fund.

Despite these reforms, since 1973 the growth of social security expenditures as a percentage of GNP roughly correlated with the growth in the elderly over 65 as a percentage of population. The GNP ratio for social security expenditures rose from 8·8 per cent in 1975 to 12·4 per cent in 1990, keeping pace with the growth in elderly population from 7·9 per cent to 12·1 per cent over the same period. In Japan, tax burden to national income has also been correlated with social security expenditures since the mid-1970s, reflecting the close relationship between welfare state expansion and tax increases. From the mid-1960s to the mid-1970s, the ratio of taxes to national income remained almost intact with a low of about 18 per cent. Once the ratio exceeded 20 per cent in 1979 (i.e., 21·4 per cent), it continued to rise to a high of 28·1 per cent in 1990. Yet the increase in tax revenue has proved to be unhelpful in managing the expansion of social benefits. As a result, outstanding national and local government debt as a percentage of nominal GDP has continued to mount and shows no sign of levelling off. Japan's public debt, according to OECD sources, reached 97·3 per cent of nominal GDP in 1997 – second only to Italy's 123·4 percent in 1997 among OECD countries.

By 1980, the intense weight of pressure by the Finance Ministry successfully persuaded the reluctant Welfare Ministry to pursue a patient copayment system in place of a free medical-care program for the elderly. After a series of negotiations within the LDP government, the Health Care for the Aged Law was passed in the Diet in August 1982, requiring people aged 70 or over to pay 400 yen at their first visit to the doctor each month and 300 yen a day for hospital stays for a maximum of two months. Although LDP Dietmembers endorsed the principle copayment, these nominal adjustments resulting form the political process were hardly a solution to the shortage of resources for medical care (Campbell 1984). Retrenchment of free medical-care paralleled that of pension systems. At the time of the 1982 budget process, with the media publicising a 'zero ceiling' on budget growth, the Provisional Commission on Administrative Reform, (attached to the Prime Minister's office), successfully pressed the LDP to agree to a consolidation of government pension systems (Collick 1988). In a 1984 cabinet decision, existing pensions were unified to create the new National Pension. Yet the 1985 pension reform failed to raise the eligible age and thereby failed to provide a real solution to the expansion of subsidies to public pension programs. It did, however, slightly increase the contribution rate of individuals to the pension fund.

Despite the rhetoric of 'small government' during the 1980s, popular entitlement programs remained largely intact. The Finance Ministry was desperately concerned with the resulting budget deficit. The ministry had attempted to introduce a new consumption tax (VAT) in 1977. Following a recommendation from the Tax Council, Prime Minister Ohira Masayoshi announced that his administration would start collecting a consumption tax in FY 1980. In the general election of 1979, however, the LDP failed to secure a stable majority in the Diet and the proposal quickly disappeared from sight. Ohira was not alone. Prime Minister Nakasone Yasuhiro failed equally badly in a 1987 drive for the introduction of a VAT, facing intense opposition from small-size business groups, a traditional supporter of the LDP. The Finance Ministry had learned from these earlier attempts and finally succeeded, through the Takeshita Noboru government, in introducing the new consumption tax in April 1989. This legislation was passed at the end of 1988, when public opinion was overwhelmed by the headline-grabbing inside stories of the Recruit bribery scandal.[6] While exemptions and reduced rates for small businesses made the VAT more acceptable to this interest group, the 'unfair' new tax with its same rate for both wealthy and poor aroused the indignation of the average taxpayer (Ito 1989). According to a 1988 NHK (Japan Broadcasting Association) survey, 82·9 per cent of respondents believed that the central government needed to be more accountable for the tax reform. In the election of July 1989, the LDP lost its upper house majority for the first time in its party's history, a devastating loss which was said to result from resentment against the new tax.

Ever since, the issues surrounding the 1989 consumption tax have continued to undergo scrutiny by politicians and interest groups. Nor did the end of the LDP's 38-year rule in 1993 necessarily provide easier access to fiscal reconstruction. Although the Finance Ministry successfully persuaded Prime Minister Hosokawa Morihiro to propose an increase in the consumption tax rate, without consensus within the non-LDP coalition, he was forced to retreat under pressure. In summer 1994, the LDP came back to office by forming a coalition government with the SDPJ and Sakigake.[7] By this time, Japan's economic slump had increased political pressure for tax cuts. The Finance Ministry used this as an opportunity for fiscal conservatism. It conceded the necessity of income tax cuts, so long as they were offset by consumption tax increases. The LDP saw this approach as politically feasible, since the proposed tax cut package would precede by some three years the 3 to 5 percent VAT increase mooted for 1997 (Kato 1997). After pushing through this controversial consumption tax increase, the Welfare Ministry introduced a publicly subsidised home care scheme for the elderly, which passed into law in December 1997. This scheme had public support, since it was seen as necessary in an ageing society. Yet the new program has been added to the social security apparatus in a piecemeal fashion, and no one seems to know for certain what government provides and what is the extent of taxpayers' contribution. There is consensus on only one issue: no one believes that the consumption tax increase will eliminate the outstanding debt of central and local government.

3. Japanese local government and systemic retrenchment

In postwar Japan, national ministries have vied with one another to create new grant programs and increase supervisory power in the form of approvals and permissions. This turf war has contributed to divided national control over local government spending though the uncoordinated growth of national funds transferred as specific grants from national ministries to local governments. The grant system, which has been perceived as favouring coalitions of ministries, politicians, and interest groups (Hirose 1981; Imamura 1978), has sparked fears that total local expenditure could get out of control (SPCAR, 30 July 1982;

FSC, 21 December 1984). From 1981 to the mid-1980s, alliances of top LDP politicians, led by Prime Minister Nakasone Yasuhiro, joined forces with big business leaders to attack the central bureaucracy for 'mindless' growth in government spending. One of the most important goals in this campaign was to target uncoordinated specific grants for massive reductions in national government spending. Since then, the political climate has forced the central government to impose tight controls on ministerial spending. Even the most politicised line ministries, such as Agriculture, Construction and Transportation, have had to accept that they are not exempt from these fiscal constraints.

An understanding of such organisational struggles requires a knowledge of the sources of local revenue. The revenue of Japanese local government can be divided broadly into four categories: direct local tax (covering 33·2 per cent of total local government revenue in 1995); general grants (representing 15·9 per cent of total local government revenue in 1995); specific grants (accounting for 14·9 per cent of total local government revenue in 1995; and local public loans constituting 16·8 per cent of total local government revenue in 1995). National law prescribes the legal basis for local tax items, objectives, bases, rates, and other details. The revenue source of direct local tax is heavily regulated. On the other hand, national grants are relatively versatile, although their reshaping is subject to political pressure. More efficient steering of national grant programs has become a central strategy of the central government to reduce the high level of its deficit. An equally important target for manipulation was the heavily regulated system of local loans. The central government annually sets a limit on total local loans and issues permission within that limit. Therefore, changes in the amount and nature of the transfer payments and local loans can be seen as a reflection of the reordering of policy priorities for fiscal reconstruction.

3.1 Political strategies

The Japanese local government system provides central authority with three key manoeuvres for spending cutbacks. The first is the flotation of local loans for which the central government issues permission. The financial imbalance between central and local government requires the central government to guarantee financial resources to local governments. Yet increases in local loans discharge central government from the burden of covering the shortage of local government revenue. In this way, the central government is able to increase national fiscal elasticity by substituting local loans for national taxes. This strategy makes it very hard for taxpayers to trace responsibility. The second manoeuvre is a policy of across-the-board cutbacks of specific grants in

TABLE 1: *National Fiscal Elasticity and Transfer Payments to Local Government, 1981–1995.*

(%)

	Debt-Servicing Costs		National Transfers	
	Composition[a]	Rate of Change[b]	Composition[c]	Rate of Change[b]
1981	11·9	36·8	64·8	−7·7
1983	15·7	31·9	57·6	−11·1
1985	18·8	19·7	50·7	−12·0
1987	20·2	7·4	44·0	−13·2
1989	18·4	−8·9	41·4	−5·5
1991	17·0	−7·6	41·2	−0·1
1993	16·0	−5·9	50·1	21·6
1995	13·9	−13·1	55·0	9·9

Note: National Transfers = general grants (Local Allocation Tax) + sepecific grants (National Treasury Disbursements).
(a) = % of national government expenditure (General Account Expenditure). (b) = % of change compared with the growth rate of two years ago.(c) = % of national government tax revenue.
Sources: Figures are calculated from Japan, Finance Ministry, *Zaisei Kin'yu Tokei Geppo* (Statistical Monthlies of Budget and Finance), various issues, and Japan, Home Affairs Ministry, *Chiho Zaisei Hakusko* (White Paper of Local Finance), various issues.

an attempt to avoid the issuance of additional national bonds. Across-the-board reductions may allow elected officials to evade the scrutiny of interest groups while ensuring that bureaucrats save face. At the same time, such indiscriminate measures may prevent voters from assessing the actual impact on different programs. The third central government manoeuvre for spending cutbacks is the transfer of national funds to local governments in the form of general grants. The general grant, although it comes with no strings attached, operates as an effective means to control total local government expenditure. Because a significant part of local government services are financed by the centrally fixed grants, local authorities with a higher ratio of general grants are likely to contribute to national fiscal policy by limiting their total expenditure. This large ratio of general grants to local government revenue tends to obscure the relationship between the level of local taxes and the level of local services.

According to Table 1, national transfers to local governments as a percentage of national tax revenue have dropped from 64·8 per cent in 1981, to 50·7 per cent in 1985, and to 41·2 per cent in 1991. During the 'bubble' period of 1988 to 1991, the relative ratio of change in those transfers was temporarily stabilised. Between 1991 and 1993, the central government managed to avoid issuing deficit-covering bonds as the bubble-generated boom had created a larger income tax base. As the table indicates, national fiscal elastically and transfer payments have strongly aligned during the period 1981–1995.[8] Accordingly, the inverse relationship between the rates of change in debt-servicing costs

TABLE 2: *National Transfers to and Local Loans of Local Revenue, 1984–1995*

(% of nominal GDP)

	Specific Grants (National Treasury Dis.)	General Grants (Local Allocation Tax)	Local Loans
1984	3·5	2·8	1·6
1985	3·2	2·9	1·4
1986	3·1	2·9	1·6
1987	2·9	3·0	1·7
1988	2·6	3·0	1·5
1989	2·6	3·3	1·4
1990	2·4	3·3	1·4
1991	2·4	3·2	1·6
1992	2·7	3·3	2·2
1993	2·9	3·2	2·8
1994	2·9	3·2	3·0
1995	3·1	3·3	3·5

Source: Figures are calculated from Japan, Home Affairs Ministry, *Chiho Zaisei Hakusho* various issues.

and those in national transfers between 1981 and 1995 is very strong. In other words, the high debt-servicing costs, the less national funds are transferred to local government.

To examine this trend, it is necessary to analyse two key items of national transfers: Local Allocation Tax (general grants) and National Treasury Disbursements (specific grants). During the period 1980–1990, local government revenue and general grants rose in parallel, increasing 1·72 times and 1·77 times respectively. By contrast, specific grants expanded more slowly, rising only 1·01 times over the same period. The fiscal squeeze of the central government, as Table 2 indicates, exerted strong pressure on specific grants. There are two major categories of specific grants: National Treasury Share (or partial subsidies), which pay the legally promised share of the central government in the costs of functions, and Subsidies (or promotional subsidies), which encourage local government to improve the quality of their services. Partial subsidies as a percentage of local government revenue declined rapidly from 19·5 per cent in 1980 to 10·6 per cent in 1996, while promotional subsidies fluctuated between 4·3 per cent and 4·7 per cent during the same period. This implies that the central government has depended heavily on the obligatory shares for the implementation of spending cutbacks. Thus the LDP has successfully avoided a much needed reform of promotional subsidies programs that have been criticised as sources of LDP patronage politics.

Under the slogan of 'fiscal reconstruction without tax increases', the LDP-national government hammered out an across-the-board policy of 'zero ceiling', which excluded both general grants and bond expenditures. In 1982 the Finance Ministry began to impose the principle of zero growth on budget requests and in 1983 that of minus growth. It also suggested a predetermined budget size for individual national ministries. Although subject to negotiations, these guidelines set a framework for each ministry's budget request. In order to maintain the scale and scope of their turf, national ministries have had no choice but to reduce their contribution ratios of partial subsidies, thus transferring the financial burden to local governments.

The decline of partial subsidies has resulted from a variety of cutback tactics: reduction of share ratios; incorporation of those subsidies into general grants; and increases in local projects without national aid. LDP leaders feared that a priority ranking for grant cuts would threaten their power base by cutting material benefits to their political support groups (Hirose 1981a; Shindo 1985). Instead, the central government in 1985 implemented an across-the-board 10 per cent reduction of share rations in all partial subsidies that covered more than 50 per cent of expenses. Nonetheless, the grant cuts heavily influenced a single policy sector – namely, welfare, where pressure groups were neither strongly organised nor supportive of the LDP. The cuts targeted 19 welfare-sector grant programs, representing 46·3 per cent of the total of designated programs and about 80 per cent of the total value of spending cuts. Until 1988 the central government continued to reduce various share ratios. Between 1985 and 1994, the total reduction amounted to 9·3 trillion yen. In FY 1988 alone it reached a high of 1·8 trillion yen, representing 2·7 per cent of total local government revenue.

To achieve the targeted ceilings, the Finance Ministry mobilised a variety of 'special account manipulations'. As a result, budgeting techniques and detailed data became so complex that only finance bureaucrats in the Finance and Home Affair Ministries could fully understand them. The new techniques and gimmicks presented taxpayers with a black box. Equally important, the purpose of the share ratio cuts was never made explicit; consequently the re-distribution of functions between central and local government remained conveniently unclear. In reality, of course, the grant reduction heavily influenced national contributions to social benefits, dispersing obligations between levels of government.

But why did line ministries accept grant cuts without any serious opposition? In fact, specific-purpose grants reached a high of 3,515 programs in 1981 and gradually fell to 2,250 programs in 1995. However, the number of approval, permission and report duties rose from 3,075 in 1985 to 3,333 in 1995. Despite changes in the sources of funding, the ministries were able to preserve the network of grants-in-aid

TABLE 3: *Purpose-Specific Grants by National Ministries, 1996.*

(in billions of yen)

	Ministry's Total	Purpose-Specific Grant Programs		
	Expenditure (a)	Number	Value (b)	b/a (%)
Prime Minister's Office	9,083	597	1,216	14·1
Justice	567	16	64	11·2
Foreign Affairs	756	29	203	26·8
Finance	19,010	17	206	2·7
Education	5,754	197	3,918	68·1
Welfare	14,378	356	8,351	58·3
Agriculture	3,127	486	1,888	66·2
Intl. Trade & Industry	921	208	228	25·0
Transporation	949	65	255	28·9
Telecommunication	63	10	16	25·2
Labour	498	37	69	13·9
Construction	5,821	157	2,181	42·2
Home Affairs	13,710	29	95	0·7

Source: Adopted from Zaisei chosakai, ed., *Kuni no Yosan* (National Government Budget) (Tokyo: Hase Shobo, 1996), p. 58

through which to direct the administration of specific local government departments (Hirose 1984; Maki 1982; Ogita 1985). The grant programs, whose administration entails a large number of approvals and permissions, assure that line ministries retain effective control over local authorities. As table 3 indicates, in 1996 the most politicised ministry, Agriculture, handled an astonishing 486 grant programs; however, the total value of these grant programs was disproportionately low. Indeed, in absolute terms, specific grants by the Agriculture Ministry dropped by 25·1 per cent between 1983 and 1988. During this same period, grants by the Welfare Ministry increased by 14·6 per cent – a striking contrast suggesting that the needs of Japan's ageing society have prohibited a fiscal squeeze on social benefits. It is hardly surprising that specific grants for these benefits remain at the heart of the problem of financial reform.

Unlike line ministries, the staff ministry, Home Affairs, sought to reform the grants-in-aid system itself. In response to the across—the-board 10 per cent share ratio cut – a measure that would impose an estimated financial burden of 580 billion yen on local governments – the Home Affairs Ministry proposed boosting local financial discretion through the incorporation of specific grants into general grants. This would have dealt a fatal blow to both line ministries and to locally elected LDP Dietmembers. In the end, the Chairman of the Policy Affairs Research Council of the LDP intervened with an eleventh-hour compromise, granting 100 billion yen in special general grants and by giving approval for local construction loans totalling 480 billion yen. Because both Finance and Home Affairs Ministers confirmed the tem-

TABLE 4: *Purpose-Specific Grants in Number, 1991–96*

	New Programs	Incorporation into General Grants	Integration in Unified Programs	Total Number of Specific Grant Programs
1991	58	n/a	26	2,300
1992	74	4	2	2,297
1993	55	7	3	2,292
1994	46	13	6	2,266
1995	94	15	13	2,250
1996	77	15	12	2,223

Source: Materials are provided by Japan, Budget Bureau, Finance Ministry on 1 February 1996.

porary nature of share ratio cuts, extensive incorporation was not deemed acceptable. However, line ministries admitted that a limited incorporation was needed. The budget ceiling set by the Finance Ministry was contributing to the pressure on ministerial expenses. As Table 4 shows, these ministries consequently began to transfer some specific grants to general grants, in order to make up for the shortfall between available resources and their obligations. In December 1992, for example, the incorporation into general grants of partial subsidies for public day-care was proposed abruptly by the Welfare Ministry to meet the ceiling for the following fiscal year. Between 1985 and 1996, the number of specific grants incorporated in this scheme reached only 83, i.e., 3·7 per cent of total specific grants, and the affected partial subsidies included in the formula for general grants amounted to 401·7 billion yen.

3.2 Retrenchment impact

The impact of grant cuts and reforms on overall social security expenditures merits discussion. In Japan, local government finance has rapidly become an important tool for organising retrenchment policy on the national level. Is a reshuffling of central-local financial relations really the solution to a host of fiscal problems in the welfare state?

In Japan, welfare state retrenchment has dramatically changed the nature of national aid to local governments. National grants remain important, but ever-increasing social benefits have opened the grants-in-aid system to the scrutiny of fiscal conservative forces in Japan. Bureaucrats' ability to strengthen themselves by expanding national grant programs has had an increasingly dysfunctional impact on welfare state retrenchment. Fiscal conservatism has thus targeted national grant programs for spending cutbacks. Across-the-board grant cuts have been particularly effective in persuading various political interests to focus on retrenchment policy. The Japanese government has indeed reduced

Table 5: *Public Welfare by Local Government, 1980–95*

	Expenditure		Revenue (%)		
	in billions of yen	% of GNP	General Revenue	Specific Grants	Others
1980	5,028	2·0	44·9	44·7	10·4
1985	6,252	1·9	54·6	35·0	10·4
1990	8,228	1·9	61·0	27·9	11·1
1991	9,032	2·0	61·5	26·8	11·7
1992	9,935	2·1	61·9	26·2	11·9
1993	10,612	2·3	61·4	25·2	13·4
1994	11,074	2·3	60·6	26·4	13·0
1995	11,980	2·4	59·7	27·1	13·2

Note: Public Welfare Expenditure = Public Aid + Children's Welfare + Welfare for the Aged + Social Welfare + Disaster Relief.
Source: Figures are calculated from Japan, Home Affairs Ministry, *Chiho Zaisei Hakusho*, various issues.

the number of grant programs and undergone some structural changes in national transfers to local governments.

But the growth in social security expenditures has been more resilient than first anticipated. The grant program cuts have not made significant changes in the local spending level of social benefits. These cuts, as Table 5 indicates, have certainly hit welfare expenditures hard; the ratio of specific grant contributions to local government's public welfare (i.e., public aid, children's welfare, welfare for the aged, social welfare, and disaster relief) dropped rapidly from 44·7 per cent in 1980 to 25·2 per cent in 1993. But, on the other hand, despite this grant reduction, overall public welfare expenditures by local governments increased incrementally over the same period. This implies that local governments preserved and strengthened the spending levels of social programs by bearing the brunt of the extra financial burden.

Why then did this happen? The central government contributed a reduced percentage of a legally standardised cost, not the actual cost, for each spending item of public welfare. Even worse, it often failed to live up to its legal commitments to local governments (Takao 1999, 109–14). This was called 'overburdening' on local government. Nonetheless, local governments essentially tended to provide welfare services in accordance with actual needs. Take, for example, the construction of day-care centres. The central government set national standards for the construction of day-care centres (e.g., 5 m^2 per child and 32,100 yen per m^2), but local governments, i.e., municipalities, continually established much higher standards than those of the central government. This was caused primarily by the failure of the central government's payment to provide the proper conditions to meet public demand (Takao 1998). These activities may be significantly related to differences in budgeting practices between central and local government, which play a crucial role in undermining the implementation of spending cutbacks. For local government, the total budget figure is likely to reflect the weight of changes in public demand (e.g., Clark and Ferguson 1983). At the national level, however, it is likely to reflect projections of how fiscal policy will affect economic conditions in the next financial year (although each decision is subject to various political pressures) (e.g., Heclo and Wildavsky, 1974).

A broader perspective can be seen by exploring the patterns of overall social security expenditures, while drawing on sources of the Social Security Advisory Council Bureau, Prime Minister's Office. How big is local government spending on public welfare? In 1995, for example, local government spent on public welfare 16·0 per cent of Japan's total expenditure for social security (i.e., social security net expenditure – 75,040 billion yen).[9] But the largest expenditure was on pension insurance. Pension insurance payments as a percentage of social security net expenditure had the largest rise, ranging from 30·4 per cent in 1980 to 43·2 per cent in 1995. The second largest expenditure was on health insurance. Health insurance payments as a percentage of social security net expenditure dropped from 37·0 per cent in 1980 to 32·2 per cent in 1995. In 1995, reflecting the progress of Japan's ageing society, the payments of benefits related to the elderly accounted for 60·4 per cent for all social security benefits. It was the central government that contributed its substantial share of social insurance expenses such as health and pension insurance. Therefore, the grant program cuts in public welfare alone are less likely to lead to a radical solution to 'uncontrollable' social security expenditures.

However, it is important to note that in Japan the role of local governments in restructuring the social security system has become more important than ever before. In 1989 the Golden Plan, a ten-year strategy to promote health care and welfare for the elderly, was established. In 1990 the welfare service administration was transferred to municipalities, and the establishment of the Local Health and Welfare Plan for the Elderly became state-mandatory. Later, in a bid to meet the expanded needs, Finance, Home Affairs, and Welfare Ministries agreed further to established a New Golden Plan, which would start in 1995 with the budget of 9,000 billion yen over the next five years. Equally important, it is municipal government that will begin to implement in 2000 the publicly subsidised home care scheme for the elderly, which is mentioned above.

3.3 Local financial burden

The effect of these changes on individual local governments has been a source of irritation to local authorities. The salient features of specific

TABLE 6: *Prefectural Finance Coordination, 1995*

(in thousand of yen)

	Per Capita Local Tax	Per Capita General Grants	Per Capita Specific Grants	Total
Group A	114	6	39	159
Group B	94	53	64	211
Group C	98	108	89	295
Group D	83	132	116	331
Group E	72	170	148	390

Note: Financial strength index* of Group A (3 prefectures) = above 1·0
Financial strength index of Group B (14 prefectures) = between 0·5 and 1·0
Financial strength index of Group C (10 prefectures) = between 0·4 and 0·5
Financial strength index of Group D (8 prefectures) = between 0·3 and 0·4
Financial strength index of Group E (11 prefectures) = under 0·3
Tokyo is excluded.
*Financial strength index = simple arithmetic average during three fiscal years including the fiscal year stated of the figures, obtained by dividing the total value of basic financial revenue by basic financial demand value.
Source: Calculated from materials provided by Japan, Home Affairs Ministry.

grant allocation have remained unchanged in principle; Japanese public policy on aid had concentrated on rural prefectures, such as financially poor Shimane and Tottori, that are categorised, according to their financial health (i.e., financial strength index), as Group E in Table 6. As a result, per capita specific grants in rural prefectures are much higher than those in urban prefectures. In 1995 each resident of Group E was paid nearly four times as much as a person living in Group A, such as the rich urban prefectures of Osaka and Aichi. Of course, this gap does not directly reflect differentials of service provision among prefectures. Rural prefectures need more money per capita to provide the same service level as urban ones, since they have to improve their living infrastructure. Nonetheless, the structure of selective regional aid has provided a breeding ground for LDP patronage politics (Hirose 1981b).

In future, the weight of changes in public demand will inevitably influence the grants-in-aid system. In recent years, as the population aged 65 and over has grown, individualised social services, such as visiting nurse, home care, and other social aid programs for the elderly, have also expanded dramatically. Unlike public works for infrastructure, which are relatively independent of population size, individualised service delivery in urban areas is more expensive than it is in sparsely populated areas. Urban prefectures, such as Tokyo and Osaka, have become quite vocal about the lack of funds in the form of specific grants for such services.

Despite the across-the-board ratio cut, the 1985 grant reduction hit social benefits particularly hard. This was especially the case for individualised social services, which represented 92 per cent of the affected amount. Urban prefectures were not happy; at a September 1994 general meeting of the National Association of Governors, they called for the plan to be withdrawn. As Tokyo Governor Suzuki Shun'ichi observed, 'Even in times of fiscal difficulty, the national government should not take measures its own way (cited in Hirose 1984, 15)'. Even worse, financially rigid cities, such as those in Fukuoka and Hokkaido prefectures (including the closed coal-mining region, which had spend extensively on direct relief), bore the greatest financial burden. Municipal assemblies in Fukuoka and Hokkaido, which were to assume extra financial responsibility of 20·3 billion yen and 16·9 billion yen respectively, petitioned the Cabinet to alleviate the burden.

Interestingly, however, while the small towns and villages wanted more aid money and less complicated allocation procedures, they did not wish to see this system abolished (Sankei, 8 January 1996). In particular, conservative assembly members who organised local support for LDP Diet members had no desire to lose this channel for voter mobilisation. In large municipalities, by contrast, chief executives tended to support the incorporation of specific grants into general grants to enable fiscal coordination among city departments (Ibid.). From the point of view of the departments themselves, however, the proposal had few advantages. Their interest were looked after by corresponding line ministries, and they depended on the grants-in-aid system for expertise and information, in addition, specific grants allowed the departments to avoid political turf wars for budgetary shares (Muramatsu 1981).

The grant cutbacks also heavily affected the financing of public works. Between 1980 and 1991, the operation costs of grant-supported projects fluctuated between 8·0 and 9·0 trillion yen. By contrast, those of projects without grant support rose sharply – form 5·4 trillion yen in 1980 to 17·9 trillion yen in 1993. By the mid-1980s, local governments began to experience project delays as grant support was squeezed and were encouraged to resort to carrying out their projects without national grants. Equally important, between 1992 and 1994 the Finance Ministry further promoted non-grant-supported projects by granting permission for sharply increased levels of local loans, in order to stimulate the 'post-bubble' economy. As seen in Table 2, local loans as a percentage of GDP jumped from 1·6 per cent in 1991 to 3·5 per cent in 1995. The servicing costs of these loans were included in the calculation of general grants, thus providing an incentive to local governments to set up their projects without national grants. In FY 1996, while national public works represented only 9·7 trillion yen, local public works without national grants amounted to 20·1 trillion yen. In this way, the Finance Ministry, while maintaining the existing scale of public works, tried to reduce the financial burden of the central government and, at the same time, boost Japan's drop in domestic demand that public works would create.

Between 1985 and 1996, partial subsidies as a percentage of local government revenue declined by 31·6 per cent. To compensate, general grants were expected to rise. However, the shortage of revenue sources for general grants had been apparent since 1975. The shortage as a percentage of local government revenue averaged 6·0 per cent during the period 1975–87, dropping to 1·6 per cent between 1988–91 (the period of the 'bubble' economy), and rising again to 6.9 per cent between 1992–96. The revenue sources of general grants are drawn from three national taxes (income tax, corporation tax, and liquor tax); 32 per cent of these taxes are transferred as general grants to local governments. Although the declining fiscal capacity of local governments has increased the necessity for general grants, the parallel decline of national tax revenue has resulted in a fall of general grants revenue. Despite the continuous shortage, the 32 per cent formula of main revenue sources has remained intact (although supplementary sources, i.e., 24 per cent – 29·5 per cent in 1994 – of consumption tax and 25 per cent of tobacco tax, were added to general grants revenue in 1989). The Finance Ministry has thus been forced to resort to borrowing; in particular, between 1975 and 1995, local loans have covered 52·7 per cent of the shortage.

3.4 Macroeconomic implications

In practise, the size of general grants, i.e., Local Allocation Tax, is determined through negotiations between Home Affairs and Finance officials. Local authorities spend the money; however, they cannot directly participate in the negotiations. Instead, they must simply trust Home Affairs officials to represent their interests. With the shortage of revenue for general grants in 1975, the Home Affairs Ministry assumed the role of adjuster, obtaining comprehensive information on local finance. Meanwhile, as national fiscal capacity became more rigid, the benefits of general grants in which the Home Ministry had predominant interest began to spill over to the Finance Ministry and line ministries. Line ministries, which were responsible for implementing government programs, tried to meet reduction targets by incorporating parts of specific grants into general grants, while the Finance Ministry issued special permission for local loans to cover the shortage of revenue sources for general grants. In this way, general grants failed to fulfil a stabilising function for local financial resources.

In the early 1980s, when national bond expenditures increased dramatically, the Finance Ministry had been already concerned about the limits of its fiscal strategy in the sense that the financial burden had been transferred from central to local government yet the total amount of spending remained unchanged. So too did the problem of high bond-dependence. Since 1991, the Finance Ministry has recognised the necessity of reducing overall central and local spending (LDPC, 19 September 1996). Coordination between central and local governments over expenditures is now seen as crucial to the achievement of macroeconomic goals. The attitude of Home Affairs officials also has changed, and there is now an admission that a reduction of general grants is necessary (Yamaguchi 1993, 11–13; Yokota 1992, 34–36). To maintain Home Affairs' jurisdiction, however, the existing allocation ratio of the three national taxes for general grants (i.e., 32 per cent, which was fixed in 1966) must be retained. To achieve this, the Home Affairs Ministry, while maintaining the allocation ratio, has admitted a reduction in the total amount of actual spending on general grants. This reduction amounted to 450 billion yen in 1991, 850 billion yen in 1992, and 400 billion yen in 1993, thus contributing to the stagnation of general grants. As illustrated in Table 2, between 1989 and 1995, general grants as a percentage of GDP fluctuated between 3·2 per cent and 3·3 per cent. (cf. They rose continually from 2.8 per cent in 1984 to 3.3 per cent in 1989.) This fluctuation is due primarily to a mixture of plus growth factors (i.e., incorporation of specific grants into general grants and local debt servicing costs included in the calculation of general grants) on the one hand and minus growth factors (i.e., the reduction noted above) on the other hand. In the process, the Finance Ministry has shifted its policy focus from the transfer of financial burden to the control of total local government expenditure.

To control total local government expenditure for macroeconomic purposes, the Finance Ministry depends largely on general grants, which are less politicised than specific grants. This interest by the Finance Ministry has had important implications for individual local governments. Since general grants are allocated according to the fiscal need of individual local governments, a number of Japan's 3,300 local governments are not eligible to receive any money at all. Tokyo, Kanagawa, Aichi, and Osaka, for example, have been non-allocation prefectures since 1985. The number of non-allocation municipalities has averaged about 150 in the 1990s, after reaching a low of 48 in 1978 and climbing to a peak of 192 in 1990. If specific grant programs are completely integrated into a general grant program, then some local governments may be forced to depend solely on their own direct resources for revenue. Nevertheless, at the present they remain content – thanks to the painfully slow progress of grant reorganisation. Even local governments at large have not become vocal about the management of general grant allocation, as the Finance and Home Affairs

TABLE 7: *Municipal Finance Coordination, 1995*

(%)

	Local Tax as % of Total Revenue	General Grants as % of Total Revenue	Specific Grants as % of Total Revenue	Per Capitia Revenue (in thousands of yen)
Big Cities	36·0	4·7	12·6	586
Medium Cities	46·3	5·9	9·8	335
Small Cities	34·1	18·5	9·5	376
Towns & Villages	20·1	32·8	6·9	508

Note: Big cities = government-designated municipalities.
Medium cities = population: above 0·1 million, except for big cities
Small cities = population: under 0·1 million.
Source: Japan, Home Affairs Ministry, *Chiho Zaisei Hakusho*, 1997 ed..

Ministries have agreed to provide them with abundant funds in the form of local loans more than sufficient to redress the shortage (Mainichi, 9 January 1996; Nikkei, 3 May 1996). On the other hand, from the viewpoint of local autonomy, direct local tax yields must be increased to solve the problem of loan dependence. But this solution is not practical, under the existing territorial system. Nearly 50 per cent of municipalities, towns and villages have a financial strength index of only 0·3 or under. No matter how they increase local taxes, the effect on the fiscal capacity will remain negligible. They will thus have to depend on national transfer payments. Even rich municipalities may be hesitant to increase their tax yields, and thereby face the scrutiny of local voters (Takahashi and Yorimoto 1985, 30–31). They would rather receive national funds whose changes are less visible to local residents.

In essence, general grants function as a common source of tax revenue for local governments. In practice, this trend has enabled the Finance Ministry to inject some elasticity into the fiscal structure of central government. The major concern with local finance measures has focused on the Finance Ministry's ability to mobilise general grants. Because of the common nature of general grants, their allocation can be both fairly objective and politically neutral, with decision-making based on the computation of the complex fiscal needs of individual local governments, rather than on simple criteria such as area and population. The allocation procedures and practices are thus so complex that professional finance bureaucrats make technical decisions behind closed doors. Although information on the itemised fiscal need of individual local governments is available to the public through the Home Affairs Ministry, only the bureaucrats in charge can figure it out (Endo 1984; Narumi 1983, 180; Takahashi and Yorimoto 1985, 36). Tactically, in other words, the system has become a means for national fiscal control.

TABLE 8: *Saving-Investment Identity, 1980–94.*

(annual % of nominal GNP)

	1980–82	1983–87	1988–91	1992–94
Non-financial incorporated entreprises	−5·31	−3·95	−8·02	−2·24
Financial institutions	0·08	−0·51	−0·42	−0·09
General government	−3·72	−1·03	2·90	−1·30
Non-profit organisations	0·21	0·14	0·16	0·23
Households	8·96	8·68	7·47	6·42
Net lending to the rest of the world	0·24	3·27	2·02	2·91

Source: Calculated from Japan, Economic Planning Agency, *Annual Report on National Accounts*, 1996 ed.

Despite this enhanced control, however, increases in central and local bond expenditure and debt-servicing costs have exceeded reductions in general government spending and will continue to grow faster than national income. Deficit reduction has become one of the most important goals of economic policy. As yet, budget deficits in general government have not dealt a serious blow to the Japanese macroeconomy. The high saving rate of Japanese households (see table 8) sustained a high level of private investment in a high growth period, e.g. 1988–91, yet financed government deficits during the period of a fiscal squeeze, e.g. 1980–82. Between 1983 and 1987, as government deficits were restrained, this saving rate made Japan a world-leading lender by expanding capital outflow with no corresponding increase in interest rates. The phenomenon of 'crowding-out', in which a bond-pushing high interest rate restricts private investment, has yet to occur in Japan. These indications suggest a stable macroeconomy.

However, it is important to note that household savings as a percentage of GNP dropped continuously from 9·78 per cent in 1980 to 5·09 per cent in 1994. Provided that the ageing of the population continues to reduce the Japanese saving rate, this decline will eventually cause serious economic problems. As a countermeasure, deficit reduction must be carried out prior to other objectives in economic policy, doubly so since the Japanese government has frozen its campaign to cut budget deficits but drastically increased the deficits for economic stimulus packages. To this end, government obviously needs to reform taxes and restructure social benefit programs. The urgent necessity of deficit reduction may facilitate structural reform and cutbacks despite political pressure. Indeed, it could render major cutbacks acceptable to the population at large and therefore politically legitimate. Under such circumstances, the Finance Ministry would be in a strategic position to play a key role in limiting total central and local government spending for macroeconomic reasons.

Conclusion

In recent years, demographic and economic changes have been forcing the Japanese government to shift its policy focus toward retrenchment. This shift betokens the obvious tightening of fiscal constraints on government, a reality it has not been easy for political players and interest groups to accept. A better understanding of welfare state retrenchment can be achieved by examining the following relationships: welfare state expansion and the administrative difficulties that social policy expansion raises; macroeconomic problems and welfare state expansion that could produce adverse effects on the economic structure; and welfare state retrenchment and political pressures that make it difficult to carry out unpopular retrenchment in social policy.

This article has focused on the impact of retrenchment of the Japanese local government system. In comparative perspective, the institutional environment of public finance will affect the role of local government in a process of welfare state retrenchment. Japanese local finance is the most regulated of all OECD countries. Japanese local government is also the most fully integrated into central government in both financial and functional terms. Therefore, the Japanese national government should be in a particularly strong position to target local government for retrenchment initiatives. But this study shows that, despite this close integration, the central government was able to implement retrenchment policy only to the extent to which it successfully concealed the actual effects on specific groups of voters or to which it won the goodwill of affected interests for cooperation.

Public finance manipulation

Welfare state growth is limited by struggles to restore a balanced budget. In such struggles, programmatic retrenchment that targets specific programs for spending cutbacks typically imposes material losses on specific groups of voters. Proretrenchment coalitions must persuade the affected politicians with an electorally acceptable proposal. Yet the weight of pressure by politicians to avoid the blame for material losses makes it politically difficult to target programs themselves. The coalitions thus seek to manoeuvre in ways other than programmatic retrenchment in order to avoid the scrutiny of voters. The present analysis shows that the distinctive institution of central-local finance in Japan allowed the central government more room for retrenchment. Targeting national transfer payments that indirectly finance programs lowered the visibility of program cutbacks and the traceability of responsibility, as implied by Pierson's theory of the visibility and traceability of negative consequences (Pierson 1996, 177). In the 1990s, local governments in Japan collectively expended about 75 per cent of public expenditure, while receiving about 35 per cent of local government revenue in the form of national transfer payments. In the case of Japan, therefore, this type of manipulation has had a significant effect on retrenchment.

Non-financial manipulation

Even if program cutbacks are disguised in such a way, reduction in transfers to local government may still affect the interests of specific branches of the state apparatus. Advocates of retrenchment must persuade affected officials to transcend their special interests for the good of common goals. In this study, the central government protected line ministries' interests by substituting administrative control measures for financial ones. The central government effectively dropped promotional subsidies, which have bred LDP patronage politics. Instead, it primarily targeted legally promised shares transferred from national ministries to local governments. The implementation of this target required the manipulation of incentives to affected bureaucrats. Maintaining the volume of approvals and permissions issued by these bureaucrats was one way of ensuring compliance between different bureaucratic interests for reducing expenditures. The politics of retrenchment, although revolving around financial losses, acknowledged that financial resources were only one among a variety of possible power resources.

Institutional change in public finance

As an increasing range of social benefits causes government deficits, the necessity of reducing the deficit, i.e., controlling total public spending, becomes urgent. The systemic constraints of public finance have thus tended to emphasise questions of how much to spend rather than those of specifying how to spend. Political leadership needs to shift strongly towards financial burden-sharing rather than financial credit-sharing. In the 1980s, the LDP government altered the institutional rules of budgeting by introducing the principles of 'zero ceilings' and 'minus ceilings'. In the early 1990s, the Finance Ministry acknowledged the necessity of controlling overall central and local spending for macroeconomic purposes. Alliances of top LDP politicians and Finance bureaucrats joined forces with big business leaders to attack the line ministries for 'mindless growth' in specific grant programs. The interest of the Finance Ministry did not lie in its ability to allocate specific grants to line ministries, but rather in its ability to determine levels of general grants, which are less politicised by politicians and their interest groups. In recent years, the abolition of specific grants has been on Japan's political agenda. Political leadership in this matter has yet to be tested. In postwar Japan, the national grants system lay at the heart of public finance. Now its foundation has began to crumble under conditions of budgetary crisis. Government deficit financing has inevitably involved attempts at institutional change, i.e., a reshuffling of transfers of national funds to local governments.

Political accountability

The major political challenge of retrenchment policy is to disguise or hide the actual effects of spending cutbacks on specific groups of voters. The present findings demonstrate that changes in central-local financial arrangements can allow a central government to manoeuvre beyond the limits of political difficulties. This study suggests that retrenchment politics is not a matter of participatory autonomy in which decisions by local government are accountable to local residents, but rather that of manipulation behind closed doors. In the case study presented, it was increasingly difficult for ordinary voters to trace responsibility for retrenchment effects. Retrenchment strategies, such as the use of budgetary technicalities and the mobilisation of national transfer payments not tied to specific programs, undermined taxpayers' ability to see a relationship between their contribution and the public service offering, and helped insulate central and local officials from political accountability. Equally important, rather than creating incentives for local tax-collecting efforts, the inherent incentives of national transfer payments created dependency traps for local governments. Local chief executives were less responsive to the extent to which national transfer payments determined levels of local government spending.

Non-decision making

The task of restructuring a social welfare system for retrenchment purposes is a hazardous political activity, which may be derailed by any of a multitude of factors. Perhaps the most influential factor of these involves a voter mobilisation strategy for electoral success or a turf war within the state apparatus. This has proved to be true in Japan's attempt to restructure the social welfare system in a radical way. The central government has been able to make only peripheral headway in programmatic retrenchment. Nor has its attempt to restructure the social welfare system been represented in any strong ruling body;

instead policy elites have tended to maintain their vested interests against new proposals of retrenchment. At the same time, the central government has continued to attempt some forms of systemic retrenchment, although the effort has been far from easy. In this study, we have seen that Japan's public finance underwent significant institutional change, placing local authorities and other organisations under tighter constraints. However, we have also seen that the central government has been able to contain local government spending only to the extent that it has minimised retrenchment politics. Targeting local government for retrenchment allowed the central government to avoid political difficulties, yet it failed to solve the problem of rising costs associated with expanding social benefits.

Perhaps the most fundamental condition for effective retrenchment is changes in basic social values – in particular, views on the limits to welfare state expansion itself. There are as yet no studies in the literature on such value changes in Japanese society. Nonetheless, an ideological consensus on the legitimacy of retrenchment to facilitate welfare reforms seems, at least intuitively, to be a necessary condition for everything else. It is likely that the frequent coverage of the 'Who will bear the burden in the ageing society?' issue in the mass media will help shape public opinion on reform. Government's repeated campaigns for deficit reduction may make the 'crisis' of government spending and management more visible to the public and thereby set the political stage for retrenchment. The role of public opinion in the implementation of retrenchment policy is an obvious next step for analysis.

NOTES

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1. During the final stages of this research project, new developments began taking place with regard to fiscal reconstruction. To stimulate its ailing economy, Japan has now launched an economic stimulus policy, which has scaled up the ratio of general government expenditure to GNP again to a high of 33·1 per cent in FY 1998. While amending the 1997 Fiscal Structural Reform Law, which initially required the Japanese government to reduce government deficits to no more than 3 per cent of GDP by FY 2003, Japan has actually increased the ratio to 8·6 per cent in 1998 and to a project figure of 10·0 per cent in 1999. Japan's fiscal reconsolidation time table has been pushed back to boost domestic demand. The 1998 proportion of Japan's government deficits to GDP is exceptionally higher than those in OECD countries, including the United States (+0·5 per cent), the United Kingdom (0·4 per cent), Germany (2·4 per cent), France (2·9 per cent), Italy (2·6 per cent), and Canada (+2·0 per cent). See OECD (1988).

2. The total expenditure for social security consists of the following categories: medical care and health for the aged, public aid, public health, public pension, social insurance, and social welfare. In the late 1980s, the ratio of social security expenditures to GNP was stagnant (e.g., 12·4 per cent in 1990); however, this was basically achieved by a rapid increase in government revenues that the 'bubble' economy created in the second half of the 1980s.
3. In Japan, as in other advanced democratic societies, government seeks not only to promote allocative efficiency, but also social equity. However, direct relief (i.e., public aid) as a percentage of the total cost of social security dropped continuously from 8·1 per cent in 1960 to 2·5 per cent in 1990, while the ratio of health and pension insurance rose from 55·6 per cent in 1960 to 78·2 per cent in 1990. In Japan, per captia welfare-state expenditures on universal social insurance for all citizens (e.g., 0·4 million yen in 1990) has grown to a comparable level with those of the United States (e.g., 0·62 million yen in 1990) and the United Kingdom (e.g., 0·55 million yen in 1990), yet direct relief has failed to keep pace with this growth rate.
4. The latest figures, provided by Japan, Ministry of Posts and Telecommunications, for example, show that Japanese workers are saving more of their salaries as they face wage cuts and job losses. While Japan's unemployment rate remained at a postwar record high of over 4 per cent, postal savings, the world's largest reservoir of deposit, increased by 6·9 per cent from November 1997 to November 1998.
5. The Liberal Democratic Party (LDP) was founded in 1955 as a result of a merger of two conservative parties. In July 1993 the thirty-eight years of its continuous rule came to an end. In September 1997 the LDP regained a Lower House majority when a member of the opposition returned to its ranks.
6. The scandal involving the Recruit Co. first broke in 1988, dominating the newspaper headlines for more than a year. The Recruit executive provided most LDP faction leaders and at least 13 high ranking bureaucrats with low priced stocks. The story disclosed a breeding ground for political corruption.
7. The Social Democratic Party of Japan (SDPJ) was formerly known as the Japan Socialist Party (JSP). Sakigake (Harbinger Party) is a new independent party that a former LDP Diet member, Takemura Masyoshi, created in 1993.
8. The Japanese government plans to issue national bonds equivalent to about 15 per cent of GNP in 1998 and about 14 per cent of projected GNP in 1999, in order to spend more on economic stimulus packages of public works and tax cuts. This may have an adverse effect on a growth in national transfer payments to local government.
9. In 1995, however, local governments contributed the smallest share of 9·4 per cent to social security net revenue (i.e., 88,765 billion yen), as compared with insurance premiums (54·7 per cent), national treasury shares (22·6 per cent), and operating income (10·9 per cent).

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