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THE ORIGINS OF MACRO-BUDGETING AND THE FOUNDATIONS OF JAPANESE PUBLIC FINANCE: DRASTIC FISCAL REFORM IN OCCUPATION ERA

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Abstract: Japan has one of the largest national debts among developed nations. At the root of this the massive economic policy was implemented in the 1990s and it is widely known that this policy laid particular emphasis on public works, tax cuts and mobilization of central banking to fiscal policy. This paper clarifies historical origins and systematic characteristics of Japanese fiscal system focusing on radical institutional revisions in "occupation era." Particularly we look at the interaction of Macro Budgeting, which constituted policy for the period from the 1930s until the war, and policy management during the occupation period, in order to shed light on the cause of the current unprecedented national debt.

Key words: Macro Budgeting, Shoup Report, Dodge Line, Financial Investment and Loan Program Bank of Japan.

JEL Classification Number: M48, N45

Japan has long been noted for having a governmental tradition that draws little distinction between public finance and finance more generally. The government has viewed budgeting, macroeconomic policy, economic planning and financial policy as related parts of a larger whole. Some scholars have argued that this blurring of the distinction between finance (monetary policy) and public finance (fiscal policy) has contributed to Japan's large public debt, which now exceeds that of any other OECD country. But few studies have explored the origins of budgeting became integrated into economic planning giving rise to integrated macro-budgeting and how this development has shaped fiscal management. This paper traces the origins of macro-budgeting and argues that it evolved during the period from 1930s through the 1950s, spanning the wartime period through the US Occupation.

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From the 1930s until the war period, the biggest issues for Japan's fiscal policy were the fulfillment of military demand, and the control of inflation. In order to meet these objectives, the government, while prioritizing military expenditure, controlled the total budget through reductions in support funding to local government and national administrative spending. At the same time, they formulated plans for the distribution of goods and fund, while the central bank implemented credit controls. The government gave first priority on stabilizing prices and it incorporated the budgetary policy into the national economic plan[1] (Ide 2006; Oshima & Ide 2006; Ide 2004).

Finally Japan was faced with defeat in the war. The government was put under rule of the occupying forces, and General Headquarters (GHQ)'s authorization was required for budget composition. The early removal of wartime controls was desirable, but this would bring back a danger of price-hike pressure. To deal with this, they continued prewar monetary controls and economic plan after the war. The overall framework for the budget was decided in view of its fit with this plan. However, with reconstruction financing and price differential subsidies, known as the two "legs" of an inflation economy, along with credit supply from the Bank of Japan (BOJ) to support these, the Japanese economy didn't manage to meet its aim of a resolution to inflation. Its reconstruction proceeded very slowly.

On the other hand, in 1948, the democratization measures and occupation policies that the Government Section (GS) of GHQ was leading receded into the background. The focal point of the occupation became transforming Japan's economy so that it could stand alone and form a breakwater against communism (Nakamura 1979). Taking on board this mission, which emanated from Washington, J. M. Dodge came to Japan in March of 1949. The Dodge Line, known for its surplus-generating balanced fiscal policy, also adhered to the Nine Economic Principles put out by GHQ. Not just stopping at Japan's general ledger, the realization of an all-encompassing balanced budget was required of the Japanese government (Suzuki 1960).

In May of 1949, on the back of these rigid budgetary restraints, C. S. Shoup came to Japan as temporary council from GHQ with the aim of advising on the creation of a modern taxation system. He headed the Shoup Mission, which recommended the introduction of comprehensive income taxation, the expansion of local taxes, along with the establishment of a regional fiscal equalization grant, which would be a blueprint for tax allocation to local governments. It also proposed, among other things, the setting up of a local public finance committee, in which regional representatives would carry out decision-making. Taxation and fiscal reforms based on these proposals were included in the budgeting process of 1950, and at this point, the modernization steps that the Japanese taxation system had taken led to a temporary hiatus. However, from the FY1951–52 budget, Shoup's policy ideas were gradually remodeled. A Japanese-style system began to take hold. It had unique characteristics such as income tax and corporate tax with high maximum taxation rates, many special taxation measures for small and medium companies, and separate taxation for banking income.

[1] It is known that inflation had not been serious until the second half of 1944 in Japan (Hara 1995).

The foregoing is an outline of Japanese fiscal policy, from prewar Japan until the occupation period. With respect to research into fiscal policy during the occupancy, until now, existing works have only shed light on the big picture. These are exemplified by each book of "Showa Zaiseishi (Fiscal History in Sowa era)," published by Okurasho Showa Zaiseishi Shitsu, "Gendai Nihon Zaiseishi (Modern Fiscal History in Japan)" by Takeo Suzuki, and others. However, because of limitations in the time period and issues covered, there is not much said about the relationship with prewar and wartime fiscal systems, or how these lead to suggestions about modern fiscal policy. Regarding the large body of research encompassed in the Shoup Report[2], scholars have largely neglected to talk about the relationship of Shoup Report, Dodge Line to Japanese macro-level fiscal management including central banking policy and intergovernmental fiscal relations. This paper attempts to comprehensively evaluate the formulation process of modern Japanese fiscal system in the occupation, in light of Japanese historical events during and prior to the war.

1. THE FORMATION OF MACRO-BUDGETING IN JAPAN

1.1. The Ministry of Finance: Taking Society as a Mechanism

In December 1931, at the behest of Prime Minister Tsuyoshi Inukai, Korekiyo Takahashi, who took office as Minister of Finance for the fifth time, implemented bold public spending policies to mitigate the economic stagnation of the Showa Panic and address the Manchurian Incident that broke out in 1931. These are referred to as the Takahashi Economic Policy. Directly after taking office, Takahashi declared a departure from the gold standard, and in 1932 while making reforms to the note issue system, took concerted steps to migrate to a controlled currency system. The fund were sourced through a new bond issue, underwritten by the BOJ, and he boldly budgeted for military and public works expenses. Through these actions, Japan was able to come through the Panic ahead of the rest of the world. Further, from about 1934, when the recovery from the recession became more pronounced, a reduction in bond issue commensurate with the natural increase in revenues was targeted in the FY1936–37 budget and by doing this they were able to smoothly migrate to a more austere fiscal policy.

One of the more important roles that the Takahashi Economic Policy played for Japan's fiscal management lies in the idea that, in terms of "the soundness" of fiscal management, Japan was released from the old precepts of "revenue/expenditure balancing." (Ide 2006; 2003) With the migration to a managed currency system, the supply of credit to the Japanese government, underwritten by the BOJ, utterly transformed the quantitative position of fiscal policy in the national economy. At the same time, due to the move to a controlled currency system and regulation of capital flows, Japan was released from restrictions on financing from internal and external financial markets. Therefore, maintaining financial discipline became quite difficult (Shizume 2009). After the Manchurian Incident, the power of the Diet diminished, and under circumstances

[2] There are a lot of researches in Japan regarding the Shoup Report. See Suzuki1960; Miyajima1972; Hayashi1974; Sato & Miyajima1978; Jinnno1984; Sekiguchi1998; 2000; 2005.

where fiscal deficits were successfully being supported by credit from the BOJ, it became difficult to deny the budget requests of the military. However, it was also obvious that fiscal management would fall into difficulties if they acquiesced too easily. The Ministry of Finance (MOF) bureaucrats changed the standards for determination of financial soundness from "traditional income and expenditure balancing" to "tight control of the general account to maintain a level where it doesn't cause inflation or a drop in bond prices." They used this as a shield behind which they applied pressure on the military budget.

The above selection shows precisely that macro-budgeting was being used as an important ideology in budget composition. Macro-budgeting is a method for budget composition, which includes 1) central and top-down decision making for income and expenditure, total debt, and appropriate budget allocation, and 2) decision on total value of budget and the scale of public investment through the estimation and operation of appropriate target values for the macro economy (Yokota 1996, p. 7; LeLoup 1988, p. 19). These two changes can be clearly observed during the Takahashi Economic Policy period as follows.

First point is the centralization of decision making. Subsequent to the assignation of the Prime Minister on May 15 of 1932, the influence of the political parties and the Diet weakened. Conversely, the cabinet and bureaucrats strengthened their political power base (Ito 1980). Due to the rapid increase in the influence of the army and navy, anything related to military expenses came to be pre-negotiated between ministers (Omae 2006, pp. 133–135, 150–152). Furthermore, the Cabinet set up the Five Minister Meeting and the bureaucrats also set up a closed-door Permanent Vice Ministerial Meeting. Important policies were deliberated on beforehand and the top-down budget formation function was clearly strengthened. In addition, with regard to negotiations between the military and the MOF, which were at the center of budget making, MOF powers were concentrated internally in the head of the Budget Bureau, the head of the Tax Bureau, and the Financial Bureau. These members started to conduct pre-negotiations with the Army executives and the Navy executives (Okurasho Showa Zaiseishi Henshu Shitsu 1956, p. 33). As a result, the involvement of general ministries and agencies in budget composition weakened, and political decision-making power became concentrated within the MOF and the government.

Next, let's take a look at budget composition focusing on its relationship with macro economy. At the time, the biggest concern at the MOF and the BOJ was crowding out due to increasing issue of government bonds (Ide 2006, Chapter 4). In order to prevent this, the BOJ estimated the macro consumption vs. savings balance, and around 1935, was able to figure out that the issue of bonds was approaching its limit. This calculation was shared with the Finance Bureau of the MOF, and ended up providing support for the MOF's plan for a change to fiscal austerity, as seen earlier. The process for the implementation of fiscal austerity was as follows: 1) Set a reduction in bond issue pursuant to the natural increase in tax revenues. 2) Reduce the total of spending on redemption of the debt that should be run out of the general ledger, through transferring surpluses from the special account to the general ledger. 3) While drastically reducing support funding to local authorities, implement freestanding regional public works projects through lending Deposit Bureau Fund[3]. 4) Utilize continued expense and postpone expenditures into the future (Ide 2003). In this manner, the general ledger, the special account, and regional financing were organically tied together. The concept of public finance as a link in the chain of the macro economy began to take hold.

Thus, during the Takahashi Fiscal Policy period, there were sweeping changes in the MOF's budgetary control. In that process, a centralized decision making system was formed that relied heavily on the high discretionary powers of the bureaucrats. In terms of policy management also, the main thrust was on harmonizing the scale of public finance with the national economy and for this purpose policy coordination with the BOJ was strengthen. Accordingly, the MOF's bureaucrats are said to have learned that "society should be seen as a mechanism and the sum of all of its relationships." (Ito 1980, p. 177) Also, with the advent of the war, this trend which put importance on the macro variables accelerated on three different fronts[4].

1.2. Planned Economy and Macro-budgeting during Wartime

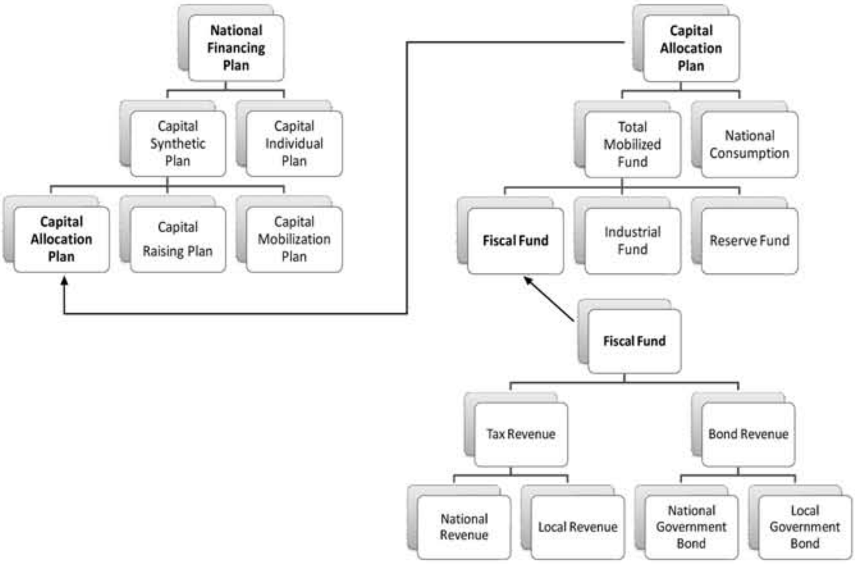
The first front is the further strengthening of the relationship between the budget and the macro economy, using a controlled economy as a medium.

What decides the fate of wartime fiscal policy is whether once can obtain the materials to execute the budget. And so, with the FY1938–39 budget, to better understand whether each ministry could actually execute on their requested budget, the MOF requested submission of a "budget for materials." From this point, in addition to the traditionally requested estimates, it was now the duty of the ministries to create and submit a "record on material demands," relating to important goods, to the Budget Bureau. Further, in 1939, the creation of the Outline of Materials Mobilization Plan was agreed on in a ministerial meeting, and the Planning Authority, which we describe later, created a macro demand and supply plan relating to goods. In this way, while taking into account the possibility of the planned production of military materials, the government was forced to form a budget to the best of their ability (Oshima & Ide 2006).

On the other hand, even from a monetary perspective, control was tightened, and restrictions on budget formation were reinforced. Since the cabinet decided on the "Capital Controls Plan of the 14th Year of the Showa Period" in July 1939 (Ishikawa 1975), the government started to make estimates of capital demand and savings for the whole economy. The objective was to restrain capital demand within the sphere of capital supply. The total for public bond issue was contained as a part of capital demand; this subsequently set the limit for the fiscal deficit. Later, in 1941, under the newly created "Public Financing Basic Plan," the Capital Controls Plan was expanded

[3] The government fund centered on the Deposit Bureau Fund mainly sourced from postal savings. After the war, the Fund were called the Financial Management Department Fund. The policy to lend these Fund to governmental organizations and local governments is called Financial Investment and Loan Program. For more detail, see 2–2.

[4] It is noteworthy that the above mentioned changes had been achieved prior to the publication of Keynes' "General Theory."



Graph 1. Structure of the National Financing Plan

and strengthened into a "National Financing Plan" (Ishikawa 1976). As is shown in Graph 1, separate from the national consumption figures, a Total Mobilized Fund was decided and, this was divided into Fiscal Fund and Industrial Fund. With the former as the maximum amount, the central and local public finances were included inside and, tax revenue and bond issuance were fixed. In a manner of speaking, in order to control inflation that was the most fearful cause, the government determined the maximum budget amount through the National Financing Plan, and cut down completely public finance expenditures so that budget would be within the range.

The second major front was that, in the process of the military increasing its political influence, the power to decide on the budget became more concentrated. At the same time, the MOF was also able to maintain and strengthen its influence.

In October 1937, the Planning Authority (Kikakuin) was set up as an institution for planning and coordinating economic policies between organizations. From that point on, when it came to budget composition, the MOF would first send a proposal for the budget to the Planning Authority. The budget would then be negotiated and decided on by permanent vice ministers of the MOF and the Planning Authority. In addition, from the following year,

each ministry's budget proposal had to be sent to the Planning Authority so that they could make sure that supply/demand figures for goods included in budget requests would fit with the economic plan they were creating. In this way, the framework of the budget came to be concentrated around the MOF, the Planning Authority, and the military. The Cabinet's ability to intercede in the budgeting process drastically decreased (Oshima & Ide 2006).

As a matter of course, if we look at the above facts from another angle, we can see that the MOF's budgeting powers moved away from being a monopoly, and they had to share this role with the Planning Authority. In practice, there was a persistent political movement to reduce the powers of the MOF. For example, in May 1936, there was an agreement that important policies would be deliberated on ahead of time in cabinet. After this, the power of the cabinet increased. Another is that, as a part of organizational rationalization, there was a political battle to move the jurisdiction of the MOF's Budgeting Bureau to the cabinet.

However, in the end, the powers of the MOF were undiminished. First, when any policy topics presented to cabinet were up for review, the Budget Bureau at the MOF played a definitive role (Omae 2006, pp. 198–199). Also, with the introduction of budget appraisal using "the budget for materials" and "proposal on supply/demand of goods," the MOF extended its supervisory role from not only a monetary front, but also to the goods and supplies front (Ibid., pp. 254–259). At any rate, these system changes themselves were proposed by the MOF. Furthermore, talking about the Budgeting Bureau's change of jurisdiction problem, the motion was denied (Oshima & Ide 2006). This was because the MOF and the BOJ were not able to accept only the Budget Division going to cabinet for the following two reasons; first, it is necessary to make the budget through dealing with expenditures and incomes as a whole; and second, in order to control inflation, it was necessary to harmonize policies of public finance and banking, and it was expected that the separation of budgetary function from the MOF would disturb this harmony. After this, towards the end of the Pacific War, there was more flexibility in the execution of the budget, and there were organizational reforms. The MOF's budgetary control weakened. However, when you compare this with the fact that the Planning Authority was merged with the Ministry of Munitions in November of 1943, the skeleton for macro-budgeting of the MOF was retained, even despite the confusion in the last stages of the war[5].

In this way, while conducting disciplined public financing through macroeconomic planning of goods and fund, the budgeting powers of the MOF reformed into an appropriate vehicle for wartime public finance. However, as the third front, it is necessary to point out that planned economies, with respect to the process of the MOF's modern budget controls gaining traction, had the opposite effect on two parties: Local governments and the Central Bank.

With respect to local public financing, system revisions were conducted during this

[5] This was because the Planning Authority was a hurriedly constructed organization, of which research and planning abilities were not as good as ones of the MOF. Furthermore, the Authority consisted of motley personnel including a lot of persons dispatched from the MOF. Okinori Kaya, who was an inventor of "the budget for materials" and involved in the establishment of the Planning Agency, a predecessor of the Planning Authority, pointed out a limit of the Planning Authority as a newly constructed general government office, saying "Persons collected from various ministries go back where they originally belong some years later. To be more specific, such an authority is a motley collection of persons who originally come from the MOF and the Ministry of Commerce." (Kaya 1975, p. 18).

period, which linked to the postwar Local Public Finance Plan (Ide 2004)[6]. It is understood that the local budget, in the same way as the central public finance budget, had maximum amounts set through the National Financing Plan. On top of this, it's important to take a look at the fact that, with tax reforms in 1940, tax collection and distribution became systematized through the centralization of tax resource and the foundation of the Local Distribution Tax Grant[7]. Through these system revisions, local public finance came to be placed under the control of national public finance, as discussed below.

First, the upper limit of annual expenditures was determined by the national budget plan. Next, from an income point of view, tax revenue is the foundation of local public finance. However, because this is not enough of a source of fund, Japan learned to control the size of the local budget through the following two means: providing a source of lending through a ratified bond issue system, and the distribution of national tax using the Local Distribution Tax Grant[8]. Furthermore, for the bond issues that were ratified, government fund, centering around the Deposit Bureau Fund, were appropriated. This is very much a case where plans from this period act as blueprints for the modern day Local Public Finance Plan.

On the other hand, in the case of the BOJ, in contrast to local public finance, the point of interest lies in the fact that the autonomy of its policy was strengthened (Oshima & Ide 2006). As we have already pointed out, the scale of public finance was regulated by the savings total for the whole national economy. However, the supply and demand for military goods could not be met by public financing and industrial fund. And so, from 1942, outside the bounds of the National Financing Plan, the BOJ drastically expanded its private lending activities. In this way, it was able to support the supply and demand for fund during wartime. In the same year, the BOJ's Law was enacted, and similar to the German Reichsbank, the BOJ, at the behest of the government, was regulated so that it was devoted to wartime financing. However, the BOJ experience of aggressively supplying fund to the private sector, at the same time as strengthening its influence over financial institutions, lead to its control of postwar financial policy. To summarize, along with coordinating with the government to set fiscal policy for repaying the deficit, the BOJ also strengthened its financial adjustment function through a concentration of powers resulting from credit rationing and negotiated transactions.

[6] The estimated total revenues and expenditures in general account related to all local governments are formulated and submitted to the Diet every fiscal year. This estimation is called "local government budget proposals", and the central government is obliged to cover the shortfall of revenues with local allocation tax (Article 3, Local Allocation Tax Act).

[7] Local Distribution Tax Grant consists of Tax Refund in which tax revenues collected conveniently by the central government for local governments are returned to them, and Distribution Tax Grant in which a certain proportion of national tax revenue is distributed to local governments as a financial adjustment. It is necessary to note that it is a local independent financial resource although named "tax".

[8] As for Distribution Tax Grant, the proportion of provision from national tax revenue was frequently changed. From this fact, it can be seen that Distribution Tax Grant had a function to adjust the shortfall in local financial resources (Ishihara 2000, p. 40).

2. ESTABLISHMENT OF MACRO-BUDGETING IN THE OCCUPATION ERA

2.1. Macro-budgeting Inherited after the War

As stated above, for public financing in the postwar period, the control mechanism for the total amount of the budget was strengthened through coordination with the central bank on fiscal policy, control of local public finance, refinement of the planned economy, and so on. At the same time, there was a hollowing out of control from the Diet, and the resource allocation function was halted. Correctly speaking, the Takahashi Economic Policy and the wartime fiscal policies are different in nature. However, there is a bold line connecting the two when you think of it from the perspective that, due to the role of fiscal policy growing larger through the move to a managed currency system, a rational budget management system was built to harmonize the national economy and fiscal scale.

On the other hand, when the occupation period came about, the framework of the running of public finance was regulated through America's occupation policies towards Japan, particularly the democratization policies of the GS of GHQ. However, a point of interest is that while there were successive bold reforms in areas like the dissolution of Zaibatsu and land reform, as for budget control of the MOF, on the other hand, the prewar and wartime macro-budgeting was continued, and was actually legally and operationally strengthened.

Very early after the war, the MOF entered into work on forming the Public Finance Act (Okurasho Zaiseishi Shitsu 1977, pp. 116–121). After that, the debate within the Ministry came to the forefront from June of 1946, when a memo entitled "Deliberation Relating to Revisions on the Budget System Draft" indicated the following sorts of items; 1) It is necessary to determine the role of public finance towards the national economy. Thus, it needs to arrange another opportunity to investigate this matter. 2) Budget formulation rights and the right to present the budget to the Diet should go to the government. Whether government should be defined specifically as the MOF, or cabinet, should be raised as another investigation topic. 3) Make a clear distinction between the budget and the law.

The most important point of discussion here was the distinction between the budget and the law. Japan has distinguished budget from law under the Meiji Constitution framework which had regarded the Emperor as important (Kato 1980). If the budget is not treated as law, in actuality, budgeting rights belong to the executive branch. The cabinet is the top of the executive branch, and because they don't have the capability to formulate the budget, the issue of whether to give budgeting rights to the cabinet or to the MOF is a non sequitur for the MOF. Rather, it was decidedly important that, same as before the war, when the budget was not seen as law, the MOF continued to play a central role in budget formation. However, there was a proposal to give public finance rights to the legislative branch in a January 1946 basic guideline made by the

US government, which was called "Reform of the Japanese Government System[9]." The MOF was faced with a situation where its very existence was being questioned.

However, one fortunate thing for the MOF was that there was a gap between the US government line and the GHQ line. Subsequent to a February 1, Japan-side new constitutional draft being picked up by the Mainichi Newspaper, MacArthur, who was exasperated at the overly amenable content, specified "Three basic points stated by Supreme Commander to be 'musts' in constitutional revision (McArthur Note)[10]" to be included as important discussion points in the constitution revisions. Noted in this document, at the end of the third clause, it is concisely stated that out of the English style and the American style, "Pattern budget after British system." Under these guidelines, the GS was asked to make a tentative draft. The second draft records that the multiple powers of budgeting for public finance "will be exercised through the Diet." The GHQ draft following from this records that "Each year, cabinet will formulate a budget and must present this to the Diet.[11]" From there on, the MOF was able to enter into ongoing negotiations with GHQ using their budget formulation rights under the parliamentary cabinet system as a shield[12]. The position of the budget under the Meiji Constitutional framework was succeeded by the Public Finance Act in the postwar period. The rights of budget formulation were held with the executive branch, and this revision was a definitive event in Japan's public finance history.

In addition to continuity allowed by a legal framework, the fact that budget continued to be formulated while limited by capital controls is important. From about the end of 1944, inflation, which had begun to become apparent, picked up its steam along with the defeat in the war. Seen from an official price base, from the period between fall 1945 and spring 1949, the consumer goods price index had risen roughly 100 times. In August 1946, under such circumstances, the Economic and Scientific Section (ESS) of GHQ came up with a plan, and created the Economic Stabilization Board (ESB) in order to do the necessary planning and policy formulation to take on the postwar rebuilding of Japan's economy (Okurasho Zaiseishi Shitsu 1977, pp. 397–399).

[9] GHQ/SCAP Records; Top Secret Records of Various Sections. Administrative Division; Box No. CHS-1:"SWNCC 228: Reform of the Japanese Governmental System" <Sheet No. TS00124–00125>, National Diet Library (NDL).

[10] SCAP Files of Commander Alfred R. Hussey, Doc. No. 5, NDL.

[11] The reason why McArthur supported the English Style against the instruction from America has not been clearly known. However, in SWNCC228, it is pointed out that initiative of the Japanese government should be respected as much as possible in the revision of the Constitution, and the coordination with SCAP is required in order not to disturb it. Furthermore, C. Whitney, a director of GS, informed McArthur of his opinion that, as with other issues, the discretion on issues related to the Japanese constitutions attributes to McArthur ("Memorandum for the Supreme Commander: Subject: Constitutional Reform," SCAP Files of Commander Alfred R. Hussey, Doc. No. 3, NDL). The above-mentioned McArthur Note was prepared two days after this memorandum was submitted.

[12] In the process of negotiations related to rights of budget formulation of independent three organizations (the Diet, the Court, and the Board of Audit), the MOF asserted that those rights exclusively attributed to Cabinet, sheltering behind traditional usage of the law and spirits of parliamentary cabinet system in the new constitution (Okurasho Zaiseishi Shitsu 1977, pp. 124–128).

In August of 1946, under "Orders of the Economic Stabilization Board," the following were added to its duties: "Emergency measures for economic stabilization related to the production and distribution of supplies, consumption, labor, prices, finance, transport of goods, etc." In December, to overcome the economic crisis, a priority production system was employed by the first Yoshida cabinet. From there, more comprehensive authority was necessitated for the ESB to carry out planning of capital controls and supply/demand plans. The ESS proposed organizational expansion, and in May 1947, Orders of the Economic Stabilization Board were revised on all fronts. From there on, the management of public finance was added to the ESB's duties, while a Public Administration and Finance Bureau was also established (Ibid., pp. 399–403).

The Public Administration and Finance Bureau formulated plans and fundamental policy for public finance, money in circulation, and currency. It also coordinated with financial institutions on operations and was responsible for the formulation of national financing plans[13]. The ESB very much expected the same role of them as was expected of the Planning Authority during the war period. However, one thing that differs from wartime was that the BOJ's supply of capital was incorporated in the national financing plan (Oshima & Ide 2006). In that respect, the ESB had more effective executive power than the Planning Authority. It is important to think about the competitive relationship of these powers and the powers of the MOF, when evaluating macro-budgeting. Let's defer this point until later, and note here that while on one hand the micro distribution of resources was placed under the GHQ ratification system, on the other hand, from an inflation control perspective, in the same way as was done during wartime, macro capital controls were implemented and the budget was formed within these restrictions. The framework of Japan's budget control system, which centers around macro-budgeting, is a postwar carry-over of the two fronts of the Public Finance Act and capital controls.

2.2. *The Combination of Dodge Line and Macro-budgeting*

From 1948, the drive of American occupation policies relating to Japan shifted from democratization to a focus on economic reconstruction. Under intermediate orders from the US government to GHQ, a letter was sent from MacArthur addressed to Prime Minister Shigeru Yoshida, and on December 18 of the same year, the "Nine Economic Principles" were announced. Under the Nine Economic Principles, objectives were set up relating to, among other things, balancing of the general budget, strengthening of tax collection, control of finance, and wage stability. In order to quickly mollify inflation, it was clearly indicated to move in the direction of reconstructing the Japanese economy. Also, in America, due to the large burden on American taxpayers, criticism of support for Japan became a growing political problem. In order to solve these problems, J. Dodge was sent from Washington, with sweeping authority, including the ability to reorganize GHQ staff (Watanabe 1966, p. 189).

[13] This institutional revision had significant impacts on the authority of the MOF. This is because "matters concerning establishment of general fund plan" administered by the Financial Bureau were transferred to the Public Administration and Finance Bureau of ESB, and at the same time, transfer of staff was implemented (Okurasho Zaiseishi Shitsu 1977, p. 402).

A characteristic of what was called the Dodge Line was that in the FY1949–50 budget, they were asked to find "a true balance for the general budget." In other words Japanese government needed to take all of the following for the country and finance them: general ledger, the special account, budgets for government-related organizations, and local budgets. Also, regarding the entirety of the budget, there should be no dependence on external fund, public bonds issued using reserve fund, and surpluses. This is the principle that was employed. The scale of the budget increased in 1948 due to inflation, and there was a huge fiscal surplus. The net redemption amount from debt, inclusive of government-related institutional budgets, reached 125.9 billion yen (Suzuki 1960, p. 90). This gets to the very root of what a "super balanced budget" is. Furthermore, this debt redemption fund was called "Dodge's Capital Accumulation," which was expected that this fund would be used for investments and loans through financial institutions.

The above-mentioned Dodge Line itself was an inflation control measure implemented based on strong demands from the US government. It is said that the proposal from Dodge, who was a classic liberalist, "was entirely focused on "Monetary Stabilization Policy." (Ibid., p. 51) There was almost no visible evidence of any specific measures on the substantive and physical sides to the economy following from that. In other words, the Dodge Line, from a quantitative theory of money standpoint, focused on income and expenditure to the private sector from the government and the Central Bank. But what kind of impact did this Dodge strategy have on the MOF's macro-budgeting? Below, we break it down to three large categories and take a look.

First, we can say that the complimentary relationship between public finance and banking strengthened. From July 1949, when the deflationary impact of the Dodge budget became clear, there were measures called "Stringency Measures" and proactive financial easing was implemented. At the center of that was the BOJ. The BOJ constructively facilitated funding activities, eased high interest tier on lending, and implemented measures to allow lending vigorously. They also implemented a buying operation for Recovery Financial Fund bonds (Fukkin-sai) and government bonds, and relaxed funding regulation, amongst other things. Again, from the end of 1949 to the beginning of 1950, they also carried out steps such as setting aside Deposit Bureau Fund for private sector financial institutions, and operations for the unconditional purchase of government bonds (Nihon Ginko Hyakunenshi 1985, Chapter3-(5))[14].

The idea of counter-balancing the deflationary impacts, vis-a-vis public finance, with financial easing is an interesting step from a policy mix viewpoint. However, what we would like to focus on here is that, on June 3, 1949, a "Law which partially revises the Bank of Japan Act" was enacted, and under the charge of Dodge, a Policy Control Board was established within the BOJ. The Bank of Japan Act revision was rooted in the Cagle

[14] As a result, in 1949, there was a significant excess of withdrawals over expenditures about 84.9 billion in public finance. However, an increase in financial receipts and payments with private sectors was offset as the increased amount of lending of BOJ and the excess amount of government bond purchase reached to 82.2 billion.

Plan[15]. The Cagle Plan was the name given to an unofficial document presented by the ESS Public Finance and Banking Bureau in August of 1948, called "Overall Revision of the Banking Structure Through Enactment of New Legislation[16]." To the "Banking Board," which was independent from the MOF, the Cagle Plan gave supervisory powers over all financial institutions, including the BOJ. It proposed organizational reforms along the lines of an American central banking system, where the decision making body of the BOJ would change to be a Board of Directors, made up from representative from other financial institutions (Ibid., pp. 286–287).

With respect to this concept of a Banking Board, the MOF stated clear arguments opposing it, making a point of emphasizing the differences between the Federal Reserve System and Japan's banking system (Ibid., p. 288). However, the discrepancy of opinions between the Japanese government and the ESS Public Finance and Banking Bureau confused the situation. In October 1948, the "Reverse Course" trend became clear[17], and the Department of War in the US put forward a plan suggesting that, with economic rebuilding as the prerequisite for financial institution reorganization, Japan should bring forward full-blown reforms, and the existing central bank function should be strengthened. In response to this, Cagle stated that the very establishment of the Banking Board was the precondition for financial institutional reform, and strongly opposed the idea (Ibid., pp. 296–297). After that, the head of the Public Finance and Banking Bureau, W. K. LeCount, presented a compromise proposal, which suggest setting up the "Policy Control Board" as a policy decision organization within the BOJ. Fortunately, Cagel returned home for a visit at the same time as Dodge, who had heard the wishes of the Japanese government, came to Japan. Consensus building continued centering around this LeCount plan and the problem was resolved[18].

Ultimately, many of the powers the MOF held, such as the power to decide and alter discount rates and loan interest, and the authority to decide on conditions for public market operation, were transferred to the Policy Control Board within the BOJ. However, in practice, to the point that it was ridiculed as the Sleeping Board, this organization had very little influence. One reason was that representatives of the MOF formed a part of the Board members. For reasons like this, it was difficult to eliminate completely the influence of the Ministry. However, more than this, Director General Hisato Ichimada of the BOJ consistently insisted to Dodge that the Chairman of the Board should be the

[15] C. E. Cagle was a member of Board of Governors of the Federal Reserve System and expert on financial problems, who came to Japan at the request of GHQ.

[16] Nihon Ginko Hyakunenshi 1985, pp. 286–287.

[17] As for reorganization of the financial system, GHQ's stance related to the negotiation with the MOF had become soften from around the middle of October 1948. The personnel in charge informed a director of Banking Bureau of the view that GHQ does not intend to force the reform as understanding that many days are required for institutional reform (Okurasho Zaiseishi Shitsu 1977, p. 536).

[18] SCAP (Dodge) to Dept. Army (Draper) C68011 "Bank Reform," February 21, 1949 (in Nihon Ginko Hyakunenshi 1985).

Director General of the BOJ[19]. He hated the dualism of decision making between the existing board and this new one, and planned to take the teeth out of the latter (Funayama 1973)[20]. Particularly from his wartime experiences, Ichimada had maintained a cooperative relationship with the MOF and by having a lot to do with fundraising in the private sector, he aimed to strengthen the powers of the BOJ (Mabuchi 1994, pp. 125–133)[21]. Therefore, he strongly opposed the establishment of the Policy Control Board, which included representatives from the private sector[22]. As a result of the above happenings, the political independence of the central bank that the US government and GHQ had respectively pushed for became little more than a dead piece of paper. Rather, the cooperative division of labor relationship between the BOJ and the MOF was strengthened. In fact, a new direction of financial easing, different to the Dodge Line, was implemented from July 1949. It is clear that the content was agreed on based on a certain agreement in cooperation with the MOF[23].

If we look from a standpoint of the complementary relationship between public finance and monetary policy, it is necessary to take a look at the relationship of the MOF and the ESB with respect to financial planning. As we saw at the end of the previous section, in 1947, a Public Administration and Finance Bureau was set up within the ESB and all operations pertaining to the National Finance Plan were transferred to the same Bureau. However, the ESB planned to expand their powers through aligning themselves with a small group within the ESS called the New Dealers. To counter this, the MOF could align themselves with the main group within the ESS, called the Conservatives. Since its inception, the Ministry had held the posts of Bureau Deputy Director and Section Chief of the Public Administration and Financial Bureau of the ESB. After that, in

[19] J. M. Dodge, Memorandum "Summary of Meeting with Mr. Ichimada, Thursday 7 April from 2:30 until 4 pm," April 12, 1949 (in Nihon Ginko Hyakunenshi 1985).

[20] However, in the Diet, there was strong criticism that limiting a chairman of Policy Control Board to a director general of the BOJ would cause the fundamental sense of the institutional reform to become a mere façde (Ibid., pp. 312–314).

[21] Mr. Ichimada served as a manager of examination department in 1942, and was actively involved in industrial finance policy which was unorthodox as the Central Bank. He assumed his post as the Minister of Finance in 1954 and 1957. The Minister of Finance, Mr. Ikeda, also planned to transfer fund collected from private sectors with financial policies to the BOJ through debt redemption and designated deposit, and supply them to industries. Mr. Ikeda called this segregation of duties "integration of public finance and banking."(Ikeda 1999, pp. 17–18).

[22] J. M. Dodge, Memorandum, "Summary of meeting with Mr. Ichimada, Governor of BOJ, from 1100 to 1200 March 30th," April 1, 1949 (in Nihon Ginko Hyakunenshi 1985).

[23] In "Recent monetary infarction and its countermeasures: June 15, 1950" by the the MOF (NIRA 1995b), it was stated that a flexible credit policy is expected to be implemented through active operation of the Policy Committee. Furthermore, almost same contents as the easy monetary policy which was carried out by the BOJ later were also stated. In addition, while the MOF prepared "monetary policies to be taken in April-June" in April 1950, and required to promote these easy monetary policies, the BOJ sought further easy monetary policies to absorb impacts of deflation of the budget for 1950. As Dodge fiercely criticized the management of these monetary policies, the BOJ was forced to turn in monetary squeeze. From this fact, it is found that the policies different from the direction of Dodge Line were implemented in cooperation of the MOF and the BOJ.

June 1948, the post of Director of the Bureau was held by an ex MOF official. Ultimately, when the supplementary budget of 1948 became a mess in the Diet, because the ESS Director, W. F. Marquat, supported the conservatives, who noticed change of the US government policy and were promoting a stringent budget, the MOF took decisive leadership (Murai 2008, Chap 4; Okurasho Zaiseishi Shitsu 1977, p. 418)[24].

After that, along with the progression of the Dodge Line, economic controls were gradually eased and abolished. Additionally, when it became clear that inflation was coming to an end, the necessity for the Financial Plan also weakened. In light of this, in June 1949 and June 1950, there was restructuring to shrink the function of the ESB, and the unwavering position of the MOF with respect to macro-budgeting was established. During the occupancy, GHQ authorization for micro budget allocation was required and there were strong restrictions. On the other side of the coin, a commitment to planned control of prices through control of total budget amount, was an experience that was continued from wartime. In this way, the general framework for macro-budgeting settled into shape for the MOF.

Next, let's take a look at the second impact of the Dodge Line. That would be the relationship between long-term supply of fund to the private sector, and the Fiscal Investment and Loan Program (FILP)[25], which conducts fundraising activities for local governments and governmental financial institutions. Difficulty in obtaining fund was a serious problem during the occupancy, for both the private sector and the government. At the time, the Japanese government would use fund gained from selling American relief supplies as a financial resource. They carried out a policy whereby, through a trade fund special account, they would purchase exports at relatively high prices, and dispose of imports at relatively low prices. However, GHQ and US government increasingly saw these practices as implicit trade subsidies. Because of this criticism, Dodge set up a Special Account for the Counterpart Fund. Sales proceeds from relief supplies to Japan were collected in this account, and it was decided that the money would be used for the redemption of government bonds, and lending to public and private firms[26].

Furthermore, Dodge set about making reforms to Deposit Bureau Fund also. For the 1949 fiscal year, the biggest discussion point surrounding the operation method of the Deposit Bureau Fund was whether to supply these fund to industry and for operation towards bank bonds. GHQ gave permission for some of these, such as loan to public corporations, but on the whole took a strong stance against this direction. However,

24 From the viewpoint of concentrating decision making authority related to budget compilation on the MOF, the dissolution of the Interior Ministry should be argued. It is said that C. L. Kades of GS did not initially consider the dissolution of the Interior Ministry, but suddenly changed his mind and targeted the Interior Ministry for achievement of democratization. The MOF was confronted with similar dissolution crisis. However, it was successfully avoided the crisis by replacing staff with ones from other ministries and establishing a political channel with ESS. Finally, the Interior Ministry was abolished in 1947 and the Local Autonomy Agency was established in 1949. See Soeda 2007; Hirano 1990; Kusayanagi 1987.

25 For FILP in detail, see Park 2011.

26 It is considered that Dodge aimed to adjust economic impacts of deflation from super balanced finance with monetary methods while placing management of the Counterpart Fund under supervision of GHQ (Watanabe 1966, pp. 201–202).

with the breakout of the Korean War, concerns about inflation raised their head again in October 1950. Dodge, who had just come back to Japan again, wanted to use the national postal savings as a source of fund and was eyeing up the low inflation risk Deposit Bureau Fund as a supply source for plant and equipment fund (Okurasho Zaiseishi Shitsu 1980, p. 861). However, because using the Deposit Bureau Fund meant using the deposits of the public, Dodge was very particular about safe and sure management of the program. Consequently, conditions were imposed, for example, postal savings, special account reserves and surpluses were integrated, and if any loss resulted then this would be guaranteed by the general ledger. The Trust Fund Bureau Fund, which was appropriated for government bonds, municipal bonds, government-related institution lending, and underwriting of back bonds, was set up in 1951 instead of the Deposit Bureau Fund (Ibid., pp. 882–887).

On one hand, the ESB was the one that created the fundamental principles of running the Counterpart Fund. Based on a document[27] created in February 1950 by the ESB Economic Planning Room, if you look at the circumstances with fund management, the managed total was 150.8 billion yen, and of that, 41% was debt redemption centering around Recovery Financial Fund bonds, 25% was lending to public and private companies, 18% was lending to Japan National Railways and underwriting of telecommunications public loans, and the rest came under the heading "Other." When you compare this with the management plan indicated by GHQ, one can see that the ratio of redemption fund for Recovery Financial Fund bonds is decreasing[28], and that they were thinking of changing the Counterpart Fund could play substitutional role for the Recovery Financial Fund as a new source of fund for public finance investment[29].

The ESB, who lost their leadership in financial planning and budget composition, became devoted to investment and loans for private companies[30]. However, before and after FY1951 budget, assistance towards Japan came under pressure. The industry fund supply, which relied on the Counterpart Fund, became more difficult to work with. Even within the ESB, it was debated whether to move the supply source for industrial funding from the Counterpart Fund to the Deposit Bureau Fund[31]. Thus, the Counterpart Fund Special Account was reorganized into an Industrial Investment Special Account in

27 "The Japan Aid Collateral Fund of the United States in FY1949" prepared by ESB Economic Planning Room in February 1950 (NIRA 1995a).

28 Total management fund planned by GHQ was 140 billion, and of that, 62.4 billion was for redemption of Recovery Financial Fund bonds, 27 billion for lending from Japan National Railways and underwriting of telecommunications public loans, 25 billion for lending to private companies, and 25 billion for reserve fund.

29 Actually, the Minister of Finance, Mr. Ikeda required the Counterpart Fund Special Account to expand further financial loan. It is said that he asked GHQ to allow them to use reserve fund of this account for underwriting corporate bonds and bank bonds, as well as construction of houses and roads (Watanabe 1966, p. 240).

30 Starting from formulation of "Plan for investment and loan of Counterpart Fund to private companies and its management policy in FY1950" by Finance and Monetary Section on February 21, 1950 (NIRA 1995a), a lot of loan plans were established.

31 "Investment of the Counterpart Fund to private companies and industrial investment with underwriting of bank bonds by Deposit Bureau" by ESB Finance and Monetary Section on December 11, 1950 (NIRA 1995a).

1953. This was combined with fund from the Trust Fund Bureau Fund and FILP became officially launched. As we will talk about later, apart from the general ledger budget, FILP, which lends government fund to companies and local governments, became a powerful financial foundation supporting the pork barrel state from the 1970s. When we consider this point while thinking about the necessity to absorb the deflationary impact of Dodge's super balanced budget, you could say that it is fairly meaningful that without increasing taxation, a method became established whereby pubic finance investment occurred through utilizing the savings of the public.

As the third impact of the Dodge Line, we have to touch on the fact that the transfer of financial resources from the central government to the local governments was drastically reduced (Okurasho Zaiseishi Shitsu 1978, Chap 2). The FY1949–50 budget, known as the Dodge budget was a super balanced budget, but with inflation in the background, the absolute value itself largely increased. Regardless, the proposal from GHQ was to reduce the Distribution Tax[32], which was the method to transfer public finance to local governments (72 billion yen → 57 billion yen), and to reduce public works projects as well (75 billion yen → 50 billion yen).

Insufficient income obviously increases lending, but regarding the issue of bonds, the 42.7 billion yen requested by the Local Public Finance Committee[33] was, needless to say, not accepted, and a first year budget of just 23.3 billion yen, which was less than the 24.6 billion yen from the previous financial year budget, was accepted. The burden of what was called the austerity budget was concentrated on local public finance such as a reduction in transfer of public finance to local governments, and control of public works and bond issues restrictions[34]. In order to reduce the central government budget, the local public finance was used as a buffer. This kind of method of controlling the source of finances was exactly the same method that was used during prewar and wartime in Japan and in the Takahashi Economic Policy Period.

With respect to relations between governments on public finance, we will talk later about the link with the Shoup Report. However, here, we would like to point out the fact that the poverty of local public finance had more than just a small number of influences on the Shoup Report. The reduction pressure on Distribution Tax Grant put remarkable strain on local public finance, and extreme opposition to this was directed towards GHQ. Because GHQ was trying to address this through total tax system reforms, Shoup was able to get an opportunity to meet with many representatives from the local authorities. In that process, people appealed about the distress in the regions, and it was said that

[32] Local Distribution Tax Grant was revised and became Distribution Tax Grant in 1950. See Imai 1993.

[33] After the dissolution of the Interior Ministry, the Local Public Finance Committee was tentatively in charge of matters concerning to local governments. It is a different organization from the Local Public Finance Committee which was recommended by Shoup later.

[34] Mr. Seisuke Okuno, an official of the Interior Ministry, said, "The MOF's way of thinking penetrated into ESS of GHQ, but its assertion was reversely declined. I remember that, at the national meeting of chiefs of general affairs, I was talking about the relevant process and our ideas for the future in tears." ("Memory around the time of the Shoup Recommendations" in round-table talk in "Tax" on October 1965.)

this had caused unignorable degree of influence on Shoup[35].

3. THE DODGE LINE AND THE SHOUP REPORT

3.1. The Political Situation during Shoup's Japan Visit and the Concept of The Shoup Report

Under the Dodge Line, the MOF built cooperative relations with the BOJ and, through winning the political battle with the ESB, established an absolute position with respect to the budgeting process. Also, with the unification of the macro financial plan and budget composition, exemplified by the implementation of FILP controls and control of financing sourcing in the regions, the cumulative experiences gained in macro-budgeting by the MOF, which came about during prewar and wartime Japan, began to add up. In this section, we will ponder on the influences on the MOF's macro-budgeting that the Shoup Report, which was born under these circumstances, created. First, after taking a general view of the political situation when Shoup came to Japan, we will look at the concept of the Shoup Report.

In 1949, when Shoup visited Japan, the general elections were being held in January, and as a result, the Democratic Liberal Party took control with an absolute majority of 264 elected candidates. The second party, the Democratic Party, only had 86, so it should have been called an overwhelming victory, but the President, Shigeru Yoshida, planned to link with the Democrats, and as a result, conservative coalition was realized (Imamura 1968, pp. 168–169)[36]. At the time, the Yoshida administration was facing a big problem: on one hand, while they had been instructed to follow a very austere budget by US government through the Nine Principles of Economic Stabilization, on the other hand, the Democratic Liberal Party had pledged reductions in income tax and the abolishment of turnover tax in order to ensure a win in the elections. According to the Finance Minister of the time, Hayato Ikeda's memoirs, there was no way to avoid the large increase in living costs if they reduced subsidies to offset price differentials, in line with American instructions. To ease this problem, tax reductions were an unavoidable option. However, Dodge was extremely passive regarding tax reductions, and the Yoshida administration was in a tight spot with respect to following through on its election pledges (Ikeda 1999, pp. 223–225).

The position that the administration had been put in was extremely difficult but there was also salvation. That is because it seems that Dodge did not have sufficient understanding of the specific mechanism of the tax system, so he recommended that they

[35] Mr. Tamotsu Ogita, an official of the Interior Ministry, pointed out as follows: "As a result of final report, municipal tax was decided to increase by 40 billion. Consequently, local public finance was driven to the deep end by Dodge Plan in 1949. I think it might intend to try to remedy Distribution Tax which had been decreased 50%, to some extents" ("Local Tax and Finance in the Occupation" in "Record of Round-table Talk" published by Jichi Daigakko).

[36] Imamura pointed out the following facts as the reason: Mr. Yoshida tended to adopt bureaucrat-turned-politicians as an aide, and fell into disfavor with dyed-in-the wool politicians in the party. Furthermore, GHQ desired the establishment of conservative and stable government (Imamura 1968, p. 169).

would wait until the Shoup Mission came to Japan[37]. Therefore, the government appealed to the society that tax reductions would become possible when the Shoup Mission came to Japan, and took a strategy of raising public expectation of the possibility of fulfilling their election pledges (Jichi Daigakko 1978, p. 4).

Of course, it was not the case that there was absolutely no sound basis to this kind of strategy. In fact, H. Moss, who was the newly appointed ESS Department Head of the Revenue Department, held a rivalry with the Public Finance Department's Section Head, E. M. Reed, who had strong relations with the MOF. In light of this rivalry, he actually showed a proactive attitude to the repeated tax reduction demands of the Japanese government. Moss, on top of accepting the necessity of tax reductions, earnestly admitted that he did not have the power to move the US government himself, and so decided to get council and called on a taxation expert to help with tax reductions. Ikeda's group used this situation skillfully (Ibid., pp. 22–23; Ikeda 1999, p. 258)[38].

In this way, under orders from the top Commander of the Allied Forces, the Mission with Shoup as the head came to Japan on May 10, 1949 to take the realization of tax reductions upon their own shoulders. The Mission went to the towns and villages to observe and continued a high-energy survey. In September, they publicly released a proposal on the reform of the tax system, which should be called the framework of the postwar Japanese tax system. The report was called "Report on Japanese Taxation" ("Shoup Report"). One thing we should be aware of here is that, on one hand, while it impressed tax reforms to decrease taxes, on the other hand, the plan for taxation system reform also had to be a part of the Nine Principles of Economic Stabilization emanating from Washington. The reform draft had to make recommendations within the framework of the super balanced fiscal policy, which was the Dodge Line.

The Shoup Mission was no more than a temporary employee of the ESS, and the importance of its duties were fundamentally different from Dodge, who came to Japan charged with all rights relating to occupation policies towards Japan from the US government. And so, it is said that there were several differences of opinion surrounding the lightening of the tax burden (Imamura 1968, p. 234), but the Shoup Report could not help but being regulated within Dodge's austerity hardline. However, on the other side of the coin, in the background of Shoup's visit to Japan, there were problems with political splits within the ESS and the Japanese government's election pledges. In addition, most importantly, the roots of the Shoup's recommendations were highly theoretical, and were independent ideas of the Mission, so it was difficult for Dodge to intervene in the tax system reform plan (Hayashi 1974)[39].

In this way, within a difficult contextual situation, while staying faithful to the Dodge

[37] Asahi Newspaper, February 26, 1949.

[38] Mr. Ikeda asserted that Shoup Mission was created at Moss's and his whim and fancy (Ikeda 1999, p. 259). Meanwhile, Brownlee revealed the facts that McArthur left selection of personnel to Moss's discretion because Moss shared the same belief with McArthur that democratization and an expansion in revenues are not contradictory (Brownlee 2011).

[39] In terms of economic thought, it is important that Shoup intended to stimulate public purchasing power with tax reduction from Keynesian viewpoint (Brownlee 2009).

austerity line, on the other hand, Shoup was strongly aware of the need for tax decreases through observing rural areas, and went through negations with the Dodge camp in Washington through telephone conferences[40]. Then Shoup ultimately created a plan that advised tax reductions of 5 billion yen in 1949, and 59 billion yen in the following year (Jichi Daigakko 1978, p. 90)[41]. So, what kinds of recommendations on tax reductions were made in this plan? The specific content of recommendations conceded to other research, and can be divided into three characteristics, which we would like to go into next[42].

First, in the Shoup Report, there were recommendations for a permanent taxation system, with income tax at the center, as well as a skillful system design, which allowed for a mutual check function on each tax item. For example, on one hand, while proposing wide sweeping discounts on the maximum income taxation rate, at the same time, they created a wealth tax. By expanding the scope of what is taxable for property taxes, until then defined as land tax and house tax, to taxation of multiple depreciable business assets. While compensating for the excessive depreciation with respect to income and corporate tax, they linked to increase of property tax. In addition, from a corporate fictional theory perspective, they reduced tax on companies, and at the same time, on a personal level, they charged the full amount on capital gains, and exempted the whole amount on capital losses. This balancing act had the same mutual check objectives.

Second, the recommendations particularly focused on tax collection. With regards to income tax, they reduced earned income tax credits from the viewpoint of fairness between farming income and business income. As we saw previously, recommendations were made on wealth tax, and the taxation of the whole amount for capital gains tax. Inheritance tax and gift tax were both reformed, and they were changed to an acquisition tax that promoted the dispersion of assets and the fair allocation of the tax collection burden. Another example is that they looked at tobacco and alcohol as luxury items and increased tax, while on the other hand, they decreased direct tax on things that were regarded as living expenses, such as textiles and sugar.

Third, they recommended the strengthening of the administrative and fiscal foundations for the local governments, from the standpoint of the development of democracy and local autonomy. At the center of this was the enrichment of local taxes. They recommended fixed-asset tax and resident tax as an independent source of finance for the cities, towns and villages. At the prefectural level, instead of the existing business tax, they recommended a value-added tax. Also, while proceeding with reorganization of subsidies, it is important that they asked for the introduction of a Local Public Finance Equalization Grant. Under the existing regional Distribution Tax Grant, the government

40 In this meeting, the argument whether current Japanese economy is too deflated or still has risk of inflation was mainly developed. It is said that there was significant perception gap between Dodge and Shoup (Brownlee 2009).

41 As Shoup investigated and inspected around the nation, people's expectations for tax reduction increased. Mr. Ikeda pointed out that it was difficult for Dodge to ignore the growing importance of the Mission (Ikeda 1999, pp. 259–261).

42 For specific contents of Shoup Report, see Sekiguchi 1998; Sato & Miyajima 1979; Suzuki 1960.

calculated the relevant amounts. The grant money was calculated as a fixed portion of national tax revenue but with the equalization grant, under standards set in law, regional representatives is to calculate administrative finance demand and financing power, and allot the difference from the country's fund. In addition, they recommended that the Regional Tax Deliberation Council and Local Autonomy Agency be disbanded, and a Local Public Finance Committee made up from representatives from the regions be created to coordinate the relationship between central government and the regions[43].

These recommendations, also took into account political considerations, and from the tax system reforms of FY1950–51, most of the local public finance reforms from the recommendations were implemented (Sato & Miyajima 1979, p. 23). In this way, from the perspective of systemization of the tax collection system and the improvement of tax administration, the Shoup tax system, often spoken of as "the arrival point of the post war reform for the tax system" (Ibid., p. 3) was implemented[44].

3.2. The Shoup Report and Macro-budgeting

According to research up until now, with the advent of peace in 1951, the ideas expressed in these tax system reform plans are adopted one after the other from the tax and public finance reforms of the same year. Of course, if we look just at the tax system then these indications are correct. However, The Shoup Report was not only tax reforms, but also made all encompassing recommendations, including public finance relations between governments. Also, from around 1950, concerning the fact that an epoch tax reform was once accepted and then revised, it is necessary to investigate what kind of influence Shoup tax system had on Japanese public finance history though ties with the prewar public finance system.

First, looking at the relationship with the full-scale tax incentives from 1961[45], we would like to look into the Shoup tax system. In the Shoup Report, as a result of influences from the austerity policies of the Dodge Line, and the need to secure fiscal revenue, they were unable to achieve a more than 7% reduction in the total of income tax in 1950 compared to the previous year (Report on Japanese Taxation by Carl Shoup (RJT) 1949, p. 56). The Shoup Report was often criticized for being far too idealistic, but Shoup was pressed to make several compromises with respect to this tax reduction limit.

For example, income tax reductions on the highest tax rate were introduced as a set with the introduction of wealth tax. However, the wealth tax was reasonably rare wherever you look in the world and so they were only able to recommend its introduction at a low tax rate (Ibid., pp. 77–79). As a result, they were only able to drop the highest

[43] In Japan, the organization with the same name was already established in January 1948 with a temporary legislation. The local public finance committee set up after the Shoup Recommendation is officially called the second local public finance committee.

[44] The proposed recommendation on tax reduction was good news to the government. However, in ESS of GHQ, it was partly criticized that tax reduction was recommended by a mere non-regular personnel in advance. Therefore, Mr. Ikeda strongly encouraged Prime Minister Yoshida to announce that the tax reform would be implemented as stated in the recommendation (Ikeda 1999, p. 261).

[45] For details of tax incentives which had been implemented every year from 1961 to 1975, see section 4.

income tax rate to 55%. Also, because the total pool of tax cuts was limited, if they tried to do tax cuts across the board, there wasn't much room to drop each rate very much (Ibid., pp. 64–65). In the income band from 100,000 yen to 200,000 yen, the marginal tax rate became remarkably high (Ibid., p. 78). As a result, tax burden on the middle class was fairly high, and tax revenue would also rise sharply with any rise in income. In this sense, we can argue that the full-scale tax incentives from 1961 were inevitable.

By the way, Ikeda was skeptical about tax system recommendations from foreigners (Ikeda 1999, p. 256), and for the administration what was important was whether it was a recommendation on tax cuts or not. To put it frankly, as long as the recommendation was a tax reduction then the actual reduction amount after that would become a negotiation item with GHQ. In the Shoup Report, they estimated 59 billion yen in tax reductions for FY1950–51. In response to this, Ikeda declared that 110 billion yen in cuts was possible[46]. This kind of gap was related to the fact that Ikeda wanted to create a source of fund for tax reductions through a reduction in expenditure, but more than this, the differences in calculation method for tax reduction amounts were larger. In other words, with respect to Shoup saying that the increase or decrease in tax revenue compared to the previous year was the focus, that is, the increase in tax burden on the tax payers based on the institutional change was the focus. Ikeda raised his estimates of macro tax revenue, applying tax law of those days to FY1950 and considering the rate of inflation and economic growth.

The above method of comparing the actual tax revenues for the previous year and a estimated next year's tax revenues taking account of its natural increase by the economic growth, and calculating a reduction amount is to reduce a portion of automatic increases in revenue by giving it back to the public, which took the initiative in the tax reduction during high economic growth era (Jichi Daigakko 1975, pp. 97–98). This was combined with the Shoup tax system that had a high possibility of dramatically increasing the tax burden on the middle layers. In the 1960's, one could say that the tax reductions implemented every year were, so to speak, built in systematically during this period. The Shoup Mission itself said that "in creating the revised taxation rate for income tax, we were to a degree restrained by the restrictions we imposed ourselves" (RJT 1949, pp. 56–57). However with respect to the above, this statement is very much as they point out.

Next, let's take a look at the problem of public finance relations between governments. The Shoup Mission recommended the introduction of a Local Public Finance Equalization Grant. However, within that, relating to existing subsidies, they proposed a plan that would transfer subsidies, except for public works subsidies and partial subsidies, to the Equalization Grant. According to this plan, in the FY1950–51 budget, they proposed total subsidies abolishment (10 billion yen), massive reductions in partial subsidies (from 40 billion yen to 15 billion yen), and along with this, the abolishment

46 Asahi Newspaper, August 27, 1949.

of 58 billion yen of Distribution Tax. In its place, an Equalization Grant of 120 billion yen would be newly earmarked[47]. After that, there were departments within GHQ that wanted to continue specific subsidies. Centering around the Ministry of Health and Welfare's budget, 24 billion yen of subsidies were decided on to remain, and so there was a partial reduction in the amount to be abolished. However, ultimately, 105 billion yen was earmarked for the Equalization Grant and a bold reorganization of subsidies was realized.

However, the importance of the Shoup Report didn't just stop at reductions in subsidies. It recommended the central government to introduce fiscal system equalizing tax burden and quality of administration in the local governments. This is the role of the Equalization Grant and it was of a very similar system design to the Local Allocation Tax Grant that came out afterwards. Of particular note is that Basic Fiscal Demand (BFD) and Basic Fiscal Revenue (BFR) were newly developed and introduced as indexes. BFD was calculated by multiplying a unit expense by each measurement unit in each local government. Also, Adjustment Coefficient, which adjusts geographical/fiscal differences in each local government, was also systematized. BFR was set at 70% of the amount taxed through standardized tax rates[48]. The duty of making up the balance of both of these fell on the central government.

The problem was the calculation method of the grant amount. With the Equalization Grant, Shoup recommended an "accumulation method" whereby the grant amount was calculated by totaling the excess amount of BFD over BFR. This is the largest point of difference with the Local Allocation Tax Grant, where the funding amount was decided in advance through a fixed part of national tax revenue. The Local Autonomy Agency showed strong opposition to this kind of "accumulation method" due to the reason that it was expensive both politically and administratively (Oral History of the Jichi Daigakko "Local Tax and Finance in the Occupation").

However, the reason that the Shoup Mission proposed this plan is because they were also proposing the establishment of a Local Public Finance Committee made up of representatives from the local governments. This was so that they could estimate the total amount of grant, and make recommendations on how those grants should be distributed. In other words, on one hand, while local financing was strengthened through the reorganization of subsidies in the name of the Equalization Grant, on the other hand, the Mission was aiming to strengthen the power of the local governments through giving

47 As 84% of the entire subsidies were supposed to be absorbed into equalization grants in the appraisal policy submitted to a cabinet meeting after that, it can be considered as a quite adventurous reform proposal (Okurasho Zaiseishi Shitsu 1978, p. 399).

48 It is said that Shoup showed his approval for this Japanese unique proposal (Round-table talk "Memory around the time of the Shoup Recommendations"). These calculation methods were taken on, as is, with the later Local Allocation Tax.

the Local Public Finance Committee the duties to calculate and distribute[49].

In May 1950, the Local Public Finance Committee kicked off. However, in debate about its establishment, there were arguments about whether the committee should be a part of cabinet, or whether it should be an independent organization with a responsibility to report directly to the Diet. Once again, there was strong antagonism between the MOF and the Local Autonomy Agency, and also between the ESS and GS within GHQ (Okurasho Zaiseishi Shitsu 1978, p. 389). Ultimately, MacArthur made a decision and it was decided to accept the plan to be an independent organization. However, of interest is that the MOF strongly insisted that placing the committee outside of the MOF would invite inconsistencies in the running of public finance for the central government and regions (Jichi Daigakko 1975, pp. 344–345). From the viewpoint of macro-budgeting, with the end of the war, to the MOF, who saw a continuing strengthening of supervisory rights in the regions (Ide 2004, pp. 117–118), the establishment of the Local Public Finance Committee was a big problem that could lead to a defect when creating the national budget.

However, these warnings of the MOF ended up being groundless fears. Certainly, surrounding the calculation of the total amount for the Equalization Grant, each year the antagonism between the Local Public Finance Committee and the MOF became a big political problem. However, in practice, due to the power play between the Local Public Finance Committee and the MOF, underhand tricks were used by the latter, such as unit costs being under calculated, and excessive taxation was embedded in BFR. This lead to insufficient public finances being transferred to the local governments. As a result, local governments lost a lot of trust in the Local Public Finance Committee and the Equalization Grant system. In 1953, the committee was dissolved, and from the 1954 budget, the system was revised to one where the total grant amount was a Local Allocation Tax Grant linked to national tax revenue (Ishihara 2000, pp. 64–65).

This kind of history created a problem over and above just the simple system revisions. The "accumulation method" was the strongest measure to ensure local public finance. However, whether this was the case or not, this created a backlash on the budget control of the MOF.

First, the above process became the momentum for "a guarantee of macro funding by the local public finance plan" to gain traction. As we have already stated, in the wartime, a local public finance plan was created and the central government was employing a supplementing method for macro deficits in local financing. They allowed this through an Local Distribution Tax Grant and bond issues. On one hand, after the war, the work to decide total grants through the accumulation method led to extreme confusion. On the

[49] Correctly speaking, the Equalization Grant recommended in the Shoup Report was devised by H. R. Bowen who was a member of the Shoup Mission. He derived some lessons from English experience with grants-in-aid and tried to propose a concrete equalization formula to the US in 1939. He also applied this formula to the Japanese local finance, but Sumio Hara, the Chief of Taxation of the MOF, mentioned to Bowen that his idea might be a bit too ideal. In reality, the proposal for the Fiscal Equalization Grant was too novel and it is said that all interested parties were stupefied by this proposal (Sekiguchi 2005; Jichi Daigakko 1975, p. 74–75).

other hand, for the MOF and local governments, using a local public finance plan and earmarking the macro deficit amount through grants was a much more simple option. This was one of the main factors in the establishment of the culture of supplementing macro financing deficits with Local Allocation Tax Grant (Ishihara 2000, p. 216).

Second, aside from the abolishment of the Local Public Finance Committee, the method of using BFD and BFR as the basis for calculation of financing deficits with each local government remained the same. Although it was different from the original intentions of Shoup, this meant that the necessary calculations to figure out this Local Allocation Tax Grant were conducted by the central government, that is, the Local Autonomy Agency. Moreover, the total amount for the Local Allocation Tax was linked to the total financing deficit for all of the local governments, and as we mentioned before, the MOF was involved in that estimate[50]. Thus, the Local Autonomy Agency (and afterwards, the Ministry of Home Affairs and the Ministry of Internal Affairs and Communications) was unable to avoid consulting with the MOF on budget composition. In this way, local budget formulation was placed under the control of the central government. The position of local public finance as a part of macro-budgeting became important.

Third, as we have already mentioned, nearly parallel to the above process, the full-scale rollout of FILP was proceeding, and the framework for mobilization of local governments for public works was fixed. During the wartime, the Deposit Bureau Fund was almost totally used as central government bond backing fund. However, during the occupancy, fund shortages due to outgoings of postal savings became a problem and Deposit Bureau had lost their ability to underwrite government bond sufficiently (Okurasho Zaiseishi Shitsu 1980, p. 753)[51]. In other words, the factors were in place for Deposit Bureau Fund and Trust Fund Bureau Fund to be concentratedly invested in the regions. Because FILP and the local financial plan gained traction together, when the central government was faced with fiscal hardship, local governments could supplement financing deficits with bond issues, and through FILP, fund could be loaned to local governments. And so recessionary measures became possible. At the same time, by calculating bond redemptions in the BFD, it was possible to delay the occurrence of burdens to the local governments until the nation's tax revenues increased again. In the 1990s the fiscal base that supported public works was these two very things.

4. CONCLUSION

In this manner, the blueprint of the postwar financial system was formed. However, the management of this system focusing on macro-budgeting didn't proceed in a straight

[50] The total amount of local grant tax was linked to a certain ratio of national tax. Meanwhile, the MOF calculated a macro amount of shortfall in financial resources. If both figures are the same, there is no problem. However, the former one may be smaller than latter one when business deteriorates. In this case, as the MOF underestimates a shortfall in financial resources by intentionally depressing BFD, the shortfall can be restrained to be at a certain ratio of the national tax. This method was used in the 2000s.

[51] The amount of bonds issued exceeded 25.8 billion yen, against the resource which decreased to 2 billion yen as of August 1947.

line. Particularly one of the reasons for the rapid increase of fiscal deficit in 1990s is intimately involved with the limits of macro-budgeting that formed starting from prewar days.

The reason that current huge unparalleled deficit was formed is not because of excessive expenditure. Rather, it is the tax deductions that were implemented in the 1990s. We cannot ignore the tax reduction policies starting from the Shoup Report as a background to how this tax reduction through public finance management came about. Since Shoup tax reform, Japan's nation's income tax system maintained a strong progression. The income increases during the high economic growth period caused Bracket Creep. In response to that, from 1961, a middle-class-directed tax incentive was implemented. At the center of the tax incentive was a raising of the human income deductions. Every year, the adjustment of the tax burden became more and more detailed. In addition, through income tax reductions to small and medium firms, small business owners, and workers in the agriculture and fisheries industries, the political profits were shared (Akaishi 2005). Therefore the impact of stopping these tax reductions since 1975, which had continuously occurred over more than a 15 year period, was obviously big. This fact, when faced with a public finance crisis after the oil crisis, was the background to not increasing income tax but actually introducing a value-added tax (Mizuno 2006, Chapter 4). However, for the Ohira and Nakasone cabinets, the efforts to introduce value-added tax ended in failure, and due to this reason, consecutive drubbings in the elections led to a precursor for tax increases being refused in the 1990s (Ide & Steinmo 2009; Kato 1994).

If we think about the harsh public finance limitations in the 1970s, while avoiding tax increases, the fact that FILP was leveraged to implement public works, and through this, expenditure was increased to the LDP's support base in regional areas, one see that there is a level of political astuteness (Miyamoto 2008). However, these experiences had a very important impact on Japanese society. Certainly, through using FILP, they were able to activate regional economies without relying on tax increases (Park 2011). However, FILP, at the end of the day, is financing, and cannot be diverted to a social expenditure. Thus, saying that FILP allowed us to avoid tax increases also means that we were unable to enrich social welfare at the same time. In other words, opting to use FILP for planning of social integration also eliminated the option of increasing the welfare state through tax increases.

With these as a historical background, in the 1990s, large scale public works were implemented. However, regardless of this unparalleled positive financing, the growth trend of the general ledger was less than that of the 1980s. Why? Of course one edge of that answer is the expansion of FILP. However, another reason is that local public finance was able to be mobilized for public works. Traditionally, when a central government makes the local governments engage in public works, various types of assistance fund are necessary. However, in Japan, the regions implement public works through an increase in regional bond issues. The central government moves the burden of these into the future every year through guaranteeing the necessary fund for bond redemption by the Local Allocation Tax Grant. With respect to the macro-budgeting done by the MOF, a public finance plan is created through negotiation between the various central ministries. FILP fund and Local Allocation Tax Grant are used to skillfully supplement resource shortage amounts, and local governments are made into public works execution organizations. These measures would not be able to be implemented without the system base we have talked about in this paper.

One of the things that researchers in and out of Japan feel a miracle is that, regardless of the unprecedented fiscal deficit, long-term interest rates are extremely stable. The quantitative easing policy that the BOJ implemented in the five years from March of 2001 until March of 2006 was a big influence. Quantitative easing is a financial easing measure whereby every month large quantities of bonds are purchased by the BOJ to increase the supply of liquidity to the market. These measures, in practice, are a government bonds price stabilization policy and these enabled the government to issue bonds at an unprecedented scale. The act of the BOJ purchasing massive amounts of government bonds jacks up bond prices. The financial institutions feel at ease with this and so proceed with buying more bonds, and thus long-term interest rates decrease. From March 2006, the BOJ halted quantitative easing policy, but the amount of bonds purchased by them actually increased. So, in order to manage the bonds, the BOJ is an essential actor.

The above facts show a problem revolving around the nature of Japan's macro-budgeting, which was born from a close relationship between the central bank and the government. The "public finance effect" of quantitative easing was in a class of its own. The financial institutions which reaped profits from trading bonds were able to come to grips with outstanding issues relating to bad debt from the collapse of the bubble. With the unparalleled low interest policy, the government was able to obtain yen fund easily, and from 2003 to 2004, through a large-scale dollar intermediary, they were able to effect a high yen. You could say that these measures were an implicit assistance to financial institutions and exporters and this undoubtedly supported the longest economic boom in the postwar period from 2002 to 2006. Coupled with policy collaboration with respect to bond management policy, the BOJ continues to succeed in an alternative role for fiscal policy that has its roots in strict budget limitations. We should not forget that this kind of close relationship between the BOJ and government was implemented, in the context of strengthening the independence of the central bank, through a revision to the Japan Banking Act in 1997.

In this way, the taxation and public finance foundations that support Japan's pork barrel state were formed from a chain of many policies, in a long and winding history starting from the 1930s. Also, if we take a glance at J. Shumpeter's statement that, "The fiscal history of a people is above all an essential part of its general history," (Schumpeter 1954) we can see that the crisis of public finance management overladen with macro-budgeting is also a crisis that faces Japanese society. Along with the removal of vested interests with the Koizumi reforms, the micro distribution function of resources is weakening. Also, because the middle class are unable to hope for any benefits to themselves from social welfare due to the public finance deficit, there is rising criticism of public works and tax increases, and trust in the government is declining[52]. In Japan, calls for changes to the socio-economic system have been happening for a long time. From here, at the same time as figuring out how to strengthen micro resource distribution, we also have to figure out how to amalgamate that with macro-budgeting. There are calls to rebuild the Japanese-style public finance system that has been forming since before the war.

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