In the Red

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Published by University of Michigan Press


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Fiscal Discord in Closed Economies

Greece and Japan

Greece and Japan arguably present the two most prominent object lessons about the dangers of sustained excessive debt accumulation. For decades, the two countries failed to properly deal with their fiscal imbalances, which resulted in deleterious debt levels. Greece is now bankrupt, economically destroyed, and at the mercy of foreign lenders, who dictate its policy choices. Japan—currently burdened with a debt stock reaching 250 percent of the gross domestic product—has been severely constrained for the last two decades in its efforts to reorganize its economy and restart growth by a significant debt stock and major fiscal imbalances inherited from the 1970s and 1980s. (Figure 5.1 shows the evolution of the two countries debt stocks since the 1970s.) The comparison of the Greek and Japanese cases highlights the significance of fiscal polarization and limited pressures from international competition in explaining sustained excessive debt accumulation in two countries characterized by very large differences in economic structure and political institutions.

This chapter highlights that, despite very large economic and political differences, the two countries display remarkable similarities in their fiscal patterns. In both countries, fiscal imbalances were initially triggered by politically motivated expansion of spending. Parties in power targeted previously disadvantaged voter groups with new, tailor-made benefits to ensure electoral dominance without counterbalancing the new spending
with additional taxes or spending cuts elsewhere to avoid alienating the beneficiaries of existing spending and tax arrangements. In Greece, the new left-wing government extended access to public sector jobs, pension entitlements, and state aid to previously “underprivileged” groups in the 1980s, but it failed to curtail access to these benefits for old beneficiaries or to reform taxes and improve tax collection to raise the necessary revenues to pay for the explosion in spending. In Japan, the dominant Liberal Democrats introduced new welfare benefits in the late 1970s to expand their voter base to the urban working class—in response to the shrinking of their rural constituency of farmers and small producers—but they also zealously guarded the tax advantages and the pork-barrel benefits that guaranteed the continued support of their traditional rural supporters. The large structural imbalances created by the new policies were subsequently greatly magnified by economic and demographic shocks in both countries.

In the face of debt growth, successive governments attempted to address the obvious unsustainability of the fiscal trends early on. There were repeated attempts at fiscal reform starting from the mid-1980s in both countries, but politicians retreated and reforms were abandoned in the face of resistance from the groups whose electoral allegiance was crucial to retaining political power. In Greece, successive governments abandoned their efforts to reverse the expansion of the public sector and

Fig. 5.1. Gross consolidated general government debt in Greece and Japan from 1970 to 2015. Source: Ameco.
pensions after it became clear that such attempts meant electoral suicide; and policy makers never even seriously attempted to address the evasion of taxes and social security contributions. In Japan, repeated attempts to introduce and then raise consumption taxes triggered intense resistance and generated significant electoral costs, while attempts to retrench welfare or to rein in the flow of funds that kept the rural economy alive were regularly defeated by resistance from within the long-governing Liberal Democratic Party. Unable to make major adjustments to existing fiscal patterns, political actors tried to proceed in piecemeal fashion and were ready to retreat at the first sign of discontent. This, however, meant that adjustments could not keep pace with the speed of debt accumulation. In the face of ever-growing problems, policy makers resorted to accounting tricks and gimmickry in an effort to conceal at least some of the true proportion of their fiscal issues in both countries.

The electoral price of hurting established vested interest groups proved inhibitive in both countries because of the combined effects of fiscal polarization and relative insulation from the pressures of international competition. The existing fiscal structure, which targeted the benefits of significant spending and tax arrangements closely to specific socioeconomic groups, offered many different avenues for rebalancing the budget and gave strong incentives to different voter groups to punish any political force that proposed to solve the fiscal problem at the price of adjusting policies they had vested interests in. At the same time, the promise of fiscal stability failed to generate countervailing electoral gains since the large majority of both societies were insulated from the negative side effects of growing debt. In Greece, most enterprises were oriented towards the domestic markets, where their competitiveness was maintained by exchange rate flexibility and fiscal benefits, such as state aid, tax exemptions, and the tacit toleration of tax evasion. In Japan, the world famous export sector made up a very small part of the economy and was increasingly moving its production capacities abroad. Furthermore, strict control over inflation and policies to counteract the appreciation of the yen neutralized the possible negative side effects of fiscal problems on international competitiveness (Pempel 2010). Domestic markets, on the other hand, were protected by a complex set of regulatory practices. Under these conditions, the overwhelming majority of society had little immediate stake in fiscal stabilization.

Similar levels of fiscal polarization and relative insulation from the pressures of international competition explain the strong similarities of fiscal patterns in these two otherwise so different countries, which alternative explanations cannot account for. Since Greece and Japan drastically
differ in virtually every political institution widely considered central to adjustment capacity and/or to fiscal discipline, one or the other case contradicts the predictions of various theories focused on domestic political institutions. Greece is characterized by “strikingly majoritarian” political institutions, which are usually associated with decisive decision-making and strong adjustment capacities\(^1\) (Lijphart et al. 1988, 21; Spolaore 2004) as well as with strong fiscal discipline (Roubini and Sachs 1989; Grilli et al. 1991). Yet, Greece has been remarkably and persistently unable to adjust economic and fiscal policies in the face of obvious challenges in the past four decades, and it has been considered to be one of the most profligate developed countries. Japan’s political system has provided more room to the representation of particularistic interests and has, therefore, been more liable to gridlock and to the subjugation of fiscal balance to particularistic demands for benefits and tax advantages.\(^2\) On the other hand, Japan has had a powerful and autonomous state bureaucracy (Johnson 1982), which makes decisive counteraction against debt growth more likely. Moreover, Japan’s strong ministry of finance, famous for its fiscal conservatism, has kept strong, centralized control over spending, enforcing strict limits on the demands of different ministries (Wright 1999; Suzuki 2000; van Hagen 2006). In contrast, the state in Greece has traditionally had limited autonomy from societal forces due to the colonization of the bureaucracy by the parties and the entrenched practice of political appointments in a system of “bureaucratic clientelism” (Mavrogordatos 1997). Prior to the mid-1990s, it also had weak finance ministers, who had trouble enforcing spending ceilings (Hallerberg 2004).

The persistence and scope of the two countries’ fiscal problems cannot be fully attributed to economic factors either. In Japan, the collapse of growth in the early 1990s created an immensely difficult context for adjustment, as fiscal tightening threatened to undermine growth and make the debt problem worse. However, there are two reasons to consider debt accumulation a policy failure in its own right, rather than just the corollary of economic problems. On the one hand, the fiscal imbalances that produced such deleterious consequences in combination with weak growth since the mid-1990s had persisted throughout the high-growth years of the late 1970s and 1980s, and only subsided slightly in the exuberant bubble-years of the late 1980s, leaving Japan with a fairly high debt-to-GDP ratio by the time the economy turned for the worse. On the other hand, persistent inability to adjust the entrenched policies that fueled the imbalances of the 1970s and 1980s hamstrung efforts to stimulate the economy in the 1990s and 2000s because existing policies channeled stimulus spending into uses that held little promise of kick-starting the economy (Pem-
pel 2010). From that perspective, fiscal issues contributed to, rather than simply resulted from, Japan’s stubborn growth problems in the 1990s and 2000s. In Greece, the debt-to-GDP ratio grew dramatically during the 1980s and approximately stabilized at a very high level from the 1990s onwards despite high nominal growth rates and despite a considerable influx of funds from the European Union, much of which directly boosted government revenues.

Finally, although both Japan and Greece were at times liable to international diplomatic pressures regarding their fiscal policies, these pressures pointed to opposite directions in the two cases and seem to have made little difference for policy outcomes in either case. Due to its position as one of the major economic powerhouses of the global economy, Japan has repeatedly come under diplomatic pressure to stimulate its economy and act as a “locomotive” for global growth. However, while policy makers

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showed willingness to succumb to such pressures in the 1970s, they firmly resisted them in the 1980s and instead used accounting tricks to seemingly comply with the wishes of their G7 partners (Wright 1999; Suzuki 2000). Greece, a small, peripheral economy never faced pressures for fiscal expansion. Instead, in the run-up to euro accession and then within EMU, it was to restrain its fiscal deficits in compliance with the Maastricht criteria, but it covertly and overtly violated these constraints. (For an overview of all alternative explanations, see Table 5.1.)

This chapter argues that it is the similarly polarizing nature of the existing fiscal regimes in the two polities and the similarly limited exposure of the two economies that produced such similar fiscal patterns in both countries despite the immense differences in their political systems, economic structures, and international positions. The first half of the chapter explores the Greek case to explain why successive Greek governments were reluctant to use the institutional advantages provided by strong unitary governments and failed to exploit external pressure for fiscal stabilization to enact meaningful reform. It shows that although the two major political parties seemed content to take turns at exploiting state resources to further their electoral goals (Pappas 2013), both initiated significant adjustments to the public wage bill and pensions in the 1980s and 1990s. However, both sides encountered such intense electoral backlash that they abandoned the cause of adjustment. The welfare of populous groups of public employees, farmers, and the owners and employees of SMEs depended more heavily on specific fiscal features—large public employment, various tax favors, opportunities for evasion, subsidies, and specially targeted pension arrangements—than on the macroeconomic fitness of the country. As a consequence, no social coalition emerged that could help a radical adjustment package to succeed—and allow the government that put it into place to survive—in the face of the ire of the negatively affected vested interest groups. The second half of the chapter describes a very similar pattern in Japan. There, attempts by the Ministry of Finance to enact fiscal reform regularly foundered on the resistance of different factions within the long-governing Liberal Democratic Party. Some factions defended pork-barrel spending and tax advantages central to the livelihood of large rural constituencies, others resisted initiatives to retrench welfare or increase tax pressure on the urban population. As none of these societal groups could be discounted from an electoral perspective and neither could be expected to find a positive trade-off between fiscal sacrifices and strengthening public finances, taking on either side had a very steep electoral price that policy makers were unwilling to pay.
Greece’s March into Bankruptcy

Greece’s fiscal problems started in the early 1980s when the Panhellenic Socialist Movement (PASOK) won its first landslide victory and set out to transform Greek politics and society using the resources of the state. The previous three decades had been characterized by fiscal rigor, which had kept the debt-to-GDP ratio under 20 percent, but policy took a radical turn after PASOK’s election to power in 1981. Spending grew one and a half times relative to GDP as public employment was dramatically expanded, welfare entitlements grew, and ailing nationalized companies and banks received generous support (Alogoskoufis 1992). The number of public employees rose by more than a half (OECD 1996). Pension entitlements—which made up the overwhelming majority of total social spending—were made considerably more generous, while eligibility was extended to new social groups, for example, farmers and the self-employed (Close 2002). Public investment was booming, partly thanks to the influx of European funds, while large capital transfers were regularly made to companies in the public sector to make up for their losses and allow them to keep their employees (OECD 1996). The explosion in public spending was compounded by a growing interest burden on an accumulating debt stock. By 1990, interest amounted to almost a tenth of the gross domestic product (Ameco 2008).

In the same period, revenues grew at a much lower rate. Although the newly introduced pension schemes augmented the social security contributions to be collected and consumption taxes grew with the introduction of VAT in 1987—making social security contributions and consumption taxes the overwhelming majority of total revenues at three quarters of the total by the 1990s—revenues could not keep pace with the explosion of expenditure, to a great extent because of large and increasing problems with evasion (OECD 2007). By 1990, the deficit stood at 14 percent of GDP (Ameco 2008; OECD 2001). Debt had grown from 20 to almost 70 percent of GDP, despite high nominal growth (due to high inflation as real growth averaged less than 1 percent over the decade), and it was still on a steeply increasing trajectory.

The alarming trend did not escape the attention of policy makers. After the elections of 1985, the government announced a stabilization plan, which sought to control the rise of the public wage bill through draconian incomes policy and an adjustment to wage indexation, and planned to increase revenues (Alogoskoufis 1992). However, limiting public wage growth failed in the face of a series of public sector strikes, and the political
will to push ahead with austerity ran out altogether after PASOK suffered painful losses in the municipal elections of October 1986 (Close 2002; Nicolacopoulos 2005). Although VAT was still successfully introduced in 1987, further adjustment was not pursued and by November 1987, the Minister of National Economy, the architect of the austerity program, was forced to resign.

The 1990s gave a respite from the escalating problems of the 1980s under successive New Democracy and PASOK governments. Yet, Greece arguably squandered an important opportunity in this period to regain control over its alarming debt problem. The headline deficit improved significantly from 14 percent of the GDP in 1990 to (ostensibly) 2.5 percent in 1999 (the revised figures are closer to 6 percent). This led to the approximate stabilization of the debt-to-GDP ratio around 100 percent (or, more accurately, the oscillation of the debt-to-GDP ratio around a slightly increasing trajectory) and earned Greece the right to join the Economic and Monetary Union in 2001. However, much of the improvement was thanks to windfall gains, which provided an important opportunity for reversing, not only roughly stabilizing debt growth. In this period, the influx of funds under the various European structural, cohesion, and agricultural policies tripled, boosting revenues by around 3 percent of the GDP (Saravelos 2007) and stimulating growth to well above the EU average (giving rise to around 3 percent real growth per year on average) in the second half of the decade. At the same time, the interest burden dropped precipitously (from a high of over 12 percent of GDP in 1994 to a little over 7 percent by 2000). Adjustment of the trends that had produced such alarming results in the 1980s played a relatively minor role in the favorable developments of the 1990s.

Spending remained virtually unadjusted. Limits placed on new hiring in the public sector in the early 1990s only managed to slow, but not stop or reverse, the growth of public employment, as regional and local governments were expanded and health and education were explicitly exempted from constraints; whereas other public entities increasingly resorted to hiring “temporary” personnel to circumvent caps (OECD 1996). Similarly, austere incomes policy in the public sector was undermined by special bonuses (OECD 1996). As a result, the public wage bill grew further as a share of GDP. Pension payments also continued to rise despite a pension reform in 1992 that changed the indexation mechanism, tightened eligibility, and somewhat limited the generosity of the system. Capital transfers to loss-making enterprises decreased somewhat on paper, but this was likely due to the adoption of new accounting standards, which took such trans-
action “below the line” (OECD 1996). Privatization proceeded hesitantly throughout the decade and the government maintained majority shares in companies (OECD 1996 and 2001).

Revenues, on the other hand, did increase significantly, primarily due to bracket creep. Tax brackets were not indexed to inflation from 1992, which doubled direct tax revenues as a percent of GDP in the course of the decade. This boost was reinforced by some successes in the fight against tax evasion; the elimination of certain tax expenditures; and the introduction of a new stock market transaction tax, a withholding tax on government bonds, a new form of property tax, and a progressive income tax on pensions (OECD 2001). Social security contributions grew as a result of the pension reform of 1992, which increased contribution rates for workers in both the private and the public sector, introduced the obligation for civil servants to contribute to their own pension funds, and increased the minimum contribution for the self-employed. The rise of social security contributions was also fueled by the decline in the number of farmers, who make no pension contributions, and their entry into professions that do. At the same time, indirect taxes were lowered to reduce inflation.

By the 2000s, the improvements fizzled out. The primary balance declined precipitously as successive governments used the room to move created by the continued significant drop in the interest burden (3 percent of the GDP between 2000 and 2007 and 8 percentage points from the high of 1994) to compensate society for some of the losses it suffered in the 1990s. Tax brackets were finally corrected to reflect the inflationary effects of the 1990s and rates were cut in 2001 and 2004, causing revenues to fall by more than 5 percentage points (OECD 2001 and 2007). Primary expenditure continued to drift up. In the absence of further corrections, pensions and the public wage bill grew (OECD 2007, Ameco 2008). Capital transfers paid to public companies reached the levels seen in the early 1990s, despite the fact that the accounting changes adopted then still kept most of these transactions below the line. Just as in the case of the improvement of the 1990s, government partisanship seemed to make little difference to the general trends of relapse in the 2000s, as New Democracy and PASOK governments oversaw the fiscal deterioration in turns. The worsening was so pronounced that the primary balance was in the negative by 2004, and the overall deficit hit a low of 7.5 percent. The debt-to-GDP ratio grew above 100 percent. By the time the first effects of the global financial and economic crisis manifested themselves, Greece was in a vulnerable fiscal state, which eventually led to the fiscal disaster well-known to all.

Many characteristics of Greek fiscal policy in the decades between 1980
and 2010 conform to the “fiscal indiscipline” hypothesis. It seems clear that successive governments placed their electoral success ahead of the fiscal stability of the country and pursued policies that would secure votes but eventually led Greece into fiscal disaster. However, repeated attempts, by both PASOK and New Democracy, to initiate major corrections in spending and revenues suggest that governments of both parties were acutely aware of the issue and were willing to take some risks to address it. Some of these attempts (e.g., the introduction of VAT in 1987, the increase in direct tax revenues through bracket creep, or the limited pension reforms of 1992) even yielded considerable results, whereas others were abandoned in the face of electoral backlash. Furthermore, the question remains why fiscal laxity was electorally so consistently successful despite the magnitude of the debt problem, which triggered painful adjustments elsewhere. The next section argues that it was because such a small share of Greek society was exposed to international economic competition and such a large section drew large parts of their income from the government budget. Vested interests in existing policies were strong, while the counterbalancing interests in improving economic fundamentals were weak. At the same time, existing policies were so closely targeted to specific groups that each group could claim that it was possible (and desirable) to stabilize public finances without touching the policies they had vested interests in.

The Dangers of Targeted Populism:
The Societal Bases of Fiscal Laxity in Greece

Political analyses of the past decades of Greek history often focus on the enormous impact of the ascendancy of PASOK to power on the way politics has been conducted since the 1980s. They underline that PASOK instituted a new politics of “bureaucratic clientelism” (Mavrogordatos 1997), “populist democracy” (Pappas 2013), and mass polarization (Kalyvas 1997). What has received less explicit attention, however, is how PASOK’s policies in the 1980s transformed the socioeconomic bases of Greek politics using state resources and European funds to nurture large constituencies of state spending, while allowing groups dependent on markets to protect themselves from mounting fiscal pressure. As Mavrogordatos (1997) points out, the practice of building clientelistic relationships through awarding public employment and state aid was a well-entrenched tradition under all of the right-wing and center-right governments in the postwar decades, but PASOK took it to a new level when the party made it the center of its
political strategy to extend the privileges enjoyed by the few to the previously “unprivileged” (Kalyvas 1997). This left a profound mark on the structure of fiscal interests by increasing the part of society dependent on income from the state and by generating strong incentives and opportunities for tax evasion.

The proportion of society fully or partially dependent on income from the government surged dramatically. Public employment grew more than one and a half times by the end of the 1980s due to the enlargement of the civil service and the increase in the number of workers in nationalized banks and companies (OECD 1996). Although pay in the public sector was relatively low, such jobs were considered very attractive because of the security of employment and pay (wages were indexed to inflation; promotion and salary increases were independent of performance), the generosity of pension benefits, and the shortness of working hours, which allowed public employees to draw further income from secondary jobs or independent economic activity (Close 2002). The populous group of farmers (still around 25 percent of the population in 1990) added to these dependents of the state as they gained half of their income from national and new European agricultural subsidies (OECD 2001). Many firms were in receipt of state aid: as a percentage of gross value added, public support to manufacturing was the second highest in the European Union (OECD 2001). Finally, the pension system was also extended in the 1980s, making benefits much more generous and granting eligibility to previously uncovered groups, increasing the number of pensioners.

At the same time, the policies of the 1980s also significantly increased the incentives and opportunities for tax and contribution evasion among those who had some flexibility in reporting their earnings. This group includes small- and medium-sized enterprises, their employees, the self-employed, and those de facto dependent employees who are officially registered as self-employed to have more room for maneuver in reporting their income. Together, these groups represent the majority of society. The incentives for evasion increased not only due to the growth of fiscal pressure (e.g., due to the introduction of VAT in 1987) but also due to the design of the extended pension system, which created excellent opportunity for sizeable sections of society to win future welfare entitlements without making the corresponding contribution in the present. The specific eligibility rules, replacement rates, and minimum pensions of the pension funds for private sector employees and the self-employed generated strong incentives for these groups to maximize their lifetime income by evading contributions or paying them strategically along their careers and retiring.
just at the right time (typically: early) to achieve the most favorable lifetime benefit-contribution ratio. The significance of the phenomenon of evasion is demonstrated by the fact that the loss of public revenue caused by evasion was estimated to amount to 15 percent of GDP by the 2000s (OECD 2007). While this behavior obviously remained nominally illegal, its potential legal consequences were diminished by periodically granted tax amnesties. Furthermore, many enterprises also had recourse to sectorally and regionally targeted tax exemptions to legally reduce their tax exposure (OECD 2001).

This policy regime—which mixed populism (the extension of fiscal favors to everyone) with targeting (favoring different groups in different ways)—delineated five major clusters of fiscal interests. Public sector employees—who made up approximately a quarter of the workforce—were attached to their secure jobs and wages as well as to their generous pension arrangements, which allowed them to retire early with decent replacement rates (OECD 1996). They bore the brunt of the tax burden not only because they constituted the largest section in society that was unable to evade taxes and social security contributions but also because they could not avail of the exemptions that higher income groups legally had recourse to (OECD 2001). Farmers received special help from the state to counterbalance their very low primary income. They received large subsidies from domestic sources as well as from the funds secured by the European Common Agricultural Policy, and they were not even legally required to contribute to their pension fund, which provided rather low pensions. Enterprises of all sizes were adamant to hold onto state aid and to preserve the relatively low effective corporate tax rates and a variety of sectorally and regionally based exemptions in an environment where their competitiveness suffered from inflexible regulations and labor market policies. Some major industries, like shipping, were fully tax-exempt (OECD 2001). At the same time, smaller enterprises (which make up a large part of the economy) also had an interest in the tacit toleration of evasion. The employees of smaller enterprises and the populous stratum of the self-employed also had a strong interest in the condonation of evasion as well as in those features of the pension system that allowed them to minimize their contributions while still receiving benefits. Finally, those private sector employees who worked in jobs that did not allow for evasion (primarily employees of large private companies) were the relatively least favored group. They bore similar tax pressure as public sector employees: although they had higher average incomes, they were protected from the effects of progressivity of taxation by a complicated system of deductions and allowances only avail-
able above a certain income. At the same time, they received somewhat less generous pension benefits (OECD 1996 and 2001).

When the unsustainability of the policies of the 1980s was exposed, adjustment was bound to hurt some of these groups. External observers identified a number of ways in which the fiscal problem could be attacked, singling out the largest spending items and the biggest culprits for revenue shortfall: retrenching public employment, pension reform, privatization, broadening the tax base for income taxation, and fighting tax evasion (OECD 1996, 2001, 2007, and 2013). The choice between these measures was bound to be highly contentious, though, because each entailed wildly different incidence of the fiscal pain across powerful groups in society. Cuts in the public wage bill and privatization would have obviously hurt public employees. Scrapping exemptions to widen the tax base and to increase the _de facto_ corporate tax rate would have burdened most private enterprises. Broadening the personal tax base through the discontinuation of deductions and allowances would have disadvantaged the employees of large private sector companies. The fight against evasion would have gone against the interests of the large group of people involved in the small-scale economy. Pension reform could potentially have very diverse distributive effects across the different groups, depending on which one of the different pension funds would be most radically reformed.

All of the groups wielded considerable power they could mobilize in defense of their interests. Public sector employees were a numerous voter group and they also demonstrated strong strike potential. From the mid-1980s to the mid-1990s, their strikes led to the highest number of days lost among all OECD countries (Close 2002). Moreover, they also had considerable power to sabotage the policies they disliked from within the state: efforts to limit the public wage bill were repeatedly undermined when wage ceilings and hiring constraints were circumvented by practices such as “temporary” jobs and “special bonuses” (OECD 1996; Mavrogiorgos 1997). The self-employed and small business owners represented the single largest electoral group, which made it dangerous to tamper with their pension entitlements or to crack down on tax evasion without easing the _de jure_ tax pressure on these parts of society. Farmers constituted a fairly large electoral group, too, and they also regularly resorted to road blockages and other disruptive acts whenever they sought to express their misgivings (Close 2002). Large businesses could mostly count on their political connections, but the big shipping companies could also threaten to move their fleets under different flags when policy conditions were not in their favor (Lavdas 2005). The ability of these powerful groups to stand
up for their vested interests meant that decisive fiscal stabilization required overwhelming societal support in order to succeed.

Garnering such support was made difficult by the fact that austerity did not offer immediate benefits to most of society because the overwhelming majority were unconcerned about the potential negative side effects of debt accumulation on the economy. A considerable share of society (public employees, farmers, and companies dependent on state aid) drew part or all of their income from the government. Of those groups that were mostly dependent on the market for their earnings, a large majority were indirectly interested in government largesse because they were oriented towards domestic markets and, thus, had a stake in the maintenance of domestic purchasing power. The populous group of farmers and other self-employed groups in real estate, retail, construction, and small-scale manufacturing, as well as the owners and employees of small- and medium-sized enterprises in the same sectors, were not too concerned about the effects of inflation and overspending on competitiveness. They anyway had little chance of success in export markets due to their perennial productivity problems, while in the domestic markets, their competitiveness and their profit margins were shielded through state aid and large-scale evasion of taxes and social security contributions (EU KLEMS; OECD 1996 and 2001).

The rest of the economy—the owners and employees of large private manufacturing firms, large shipping businesses, and enterprises engaged in tourism—were exposed to the international economy. However, they remained mostly unconcerned about the inflationary effects of budgetary problems because the crawling peg mechanism (which was adopted in the 1970s, made more flexible in 1985, and maintained until 1999) accommodated inflation differentials with main trading partners (Alogoskoufis 1992). Smaller firms and employees had recourse to tax and social contribution evasion, whereas larger firms benefited from export subsidies, often in combination with European structural funds, direct grants, loans, and tax incentives, which contributed to their ability to maintain reasonable competitiveness and profit margins.

In the absence of immediate economic pressures on any of these groups, they had few incentives to voluntarily give in to any adjustment measures that would directly affect their income or to support radical austerity, even if the direct fiscal pain affected other groups. Neither did they have an interest in sacrificing any benefits they received from their political connections in a profoundly clientelistic political system in order to support stabilization-minded political actors. The next section
shows that this constellation of societal interests rendered adjustment attempts politically unfeasible.

**Parties, Unions, Elections, and the Inability to Adjust**

Although it was PASOK whose fiscal policy choices set off the escalation of problems in the 1980s, which eventually culminated in the disaster of the Greek debt crisis, the underlying social interests that were so fundamentally shaped by the policies of the 1980s constrained New Democracy and PASOK equally in their ability to deal with the problems. Both parties attempted to adjust existing policies, and both ran into the same difficulties in dealing with public sector unions, farmers’ protests, and, most importantly, voter disapproval.

Due to the genesis of the Greek party system and especially the clientelistic nature of the ties between voters and parties, there is no clear one-to-one correspondence between any of the four large vested interest groups and the two parties. The PASOK-New Democracy opposition has never been based on traditional social cleavages. Given Greece’s underdevelopment at the time of the return to democracy in the second half of the 1970s, the industrial base and the industrial working class was too small to structure politics along classical class lines, and there existed no deep religious or regional divisions to shape the party system (Kalyvas 1997). Conflicts about the monarchy and past civil wars still lingered, but the former was put to rest with the referendum of 1974. The latter was used by PASOK in symbolic ways to define itself as an opposition to New Democracy. At the time of its formation in 1974, New Democracy had a vague right-wing or center-right profile defined by its links to business (reflected in its business-friendly macroeconomic policies), its constituency among civil servants, and its support among conservative farmers (Kalyvas 1997; Lyrintzis 2005). These groups had mostly been beneficiaries of the postwar political system under various right-wing governments, as well as the junta that governed the country between 1967 and 1974 (Close 2002; Lavdas 2005). PASOK defined itself as the negation of the postwar years, as the advocate of the losers of that system and as the antithesis of New Democracy (Kalyvas 1997; Lyrintzis 2005). As a result, its policies were directed at distributing the types of benefits—jobs in the civil service and in publicly owned companies, welfare benefits, and state aid—that its supporters had previously had limited access to, via a newly constructed system of “bureaucratic clientelism” (Mavrogordatos 1997).

Consequently, by the time fiscal problems started to manifest them-
selves in earnest, both parties had important constituencies in all of the major vested interest groups. New Democracy was still the major advocate for business interests and had important support among managerial private sector employees (Lanza and Lavdas 2000; Lavdas 2005); but it also had a crucial base among the old civil servants and public employees, who resented the dilution of their privileges among the masses of new political appointees (Mavrogordatos 1997), and it could also count on the vote of the majority of farmers and the self-employed (Nicolacopoulos 2005). PASOK had a very similar supporter base, although the weights were slightly different. Its strongest base was in the public sector and among lower level private employees, but it also received decent voter backing from farmers and the self-employed (Nicolacopoulos 2005). After the worst years of hostility in the first half of the 1980s, it made peace with the peak business organization (SEV) and engaged in limited concertation with business in the course of the first stabilization package between 1985 and 1987 (Lanza and Lavdas 2000).

This distribution of voter support made it very risky for both parties to move decisively to cut spending on public employees, to reform pension arrangements or to fight tax evasion, because upsetting any of the major groups was likely to cause their vote share to drop enough to make them lose the next election. Furthermore, in the case of policy reforms affecting public sector employees, governments of either color had to count on major confrontations with unions. Even though public sector worker representation was fully colonized by the two parties, who organized their own partisan unions and turned union elections into spheres of partisan competition (Mavrogordatos 1997; Kalyvas 1997), neither party could count on union complacency in the face of policies aimed at reducing public sector incomes. Public sector unions invariably showed remarkable unity and extraordinary militancy when it came to defending the vested interest of public sector workers (Close 2002; Lavdas 2005).

Despite this, public sector employees were the most likely target for adjustment. On the one hand, their wages, pensions, and the capital transfers paid to the loss-making companies that employed them added up to a very large share of the budget. On the other hand, they represented a relatively smaller (albeit still very significant) share of the electoral force than all the other groups that would be hurt by reforms reducing tax evasion, the other major problem undermining fiscal sustainability. However, the electoral repercussions of taking on public employees could only have been ignored if there had been hope that fiscal improvements were going to yield electoral rewards from other groups. Since no groups had an immedi-
ate stake in restoring fiscal balance, none could be expected to give up its clientelistic ties to their party and switch electoral camps just to support fiscal stabilization, as both parties had to learn the hard way.

When PASOK attempted to restrain public sector wage expenses in 1985, it got into a major showdown with public sector unions over the issue, which immediately led to its defeat in the municipal elections of October 1986 in its most important strongholds with the largest populations of public sector employees in Athens, Piraeus, and Thessaloniki. Although the government immediately abandoned its resolve to keep the public wage bill down, it went ahead with the introduction of VAT in 1987, which again disproportionately affected those for whom evasion was not an option. PASOK lost the next parliamentary elections in 1989, hemorrhaging votes (almost 7 percentage points compared to the previous elections) to small leftist parties and to New Democracy (Nicolopoulos 2005).

New Democracy also failed to survive attempting to radically restructure the public sector. It entered government on a program that harked back to its role in the 1970s as a protector of business interests and advocated cuts in public expenditure, privatization, and a reform of the civil service. As a start, it froze public sector pay and attempted to privatize some of the largest public sector firms (e.g., the telecommunications monopoly). It met fierce opposition from public sector unions (Kornelakis 2011). In 1992, the government introduced a pension reform, which afflicted tangible losses on current and retired public sector employees and, to a smaller extent, on private sector employees, despite being a heavily watered-down version of the original proposal. These triggered renewed union protests (Featherstone 2005). After barely a year in power, the party plunged in the polls and lost an important by-election in Athens in 1992. By 1993, it split; the government fell and lost the 1993 elections by a large margin before it could make any headway in achieving any restructuring of the public sector, although the pension reforms stayed in effect and turned out to be the only reasonably meaningful adjustment to the pension system for the next two decades (Nicolopoulos 2005).

The fiscal corrections that did not immediately cause the electoral demise of the political side that initiated them were the ones that made no full frontal attack on any one vested interest group, but obfuscated, diluted, and slowly introduced changes. Bracket creep between 1992 and 2000—when successive PASOK governments failed to index tax brackets to inflation—resulted in the single biggest fiscal adjustment from the start of fiscal problems until the debt crisis, increasing revenues by 5 percentage points of GDP. Yet, this covert adjustment did not interfere with
the electoral success of the party: PASOK was reelected twice (in 1996 and 2000). Similarly, the “gradualist” approach to privatization under the Simitis government in the second half of the 1990s resulted in significant revenues (around 4 percent of the GDP in 1999) but avoided raising the ire of unions because the government only sold minority shares and kept controlling majorities in public companies, thereby retaining responsibility for employment (OECD 2001, Kornelakis 2011). PASOK even managed to introduce two marginal pension reforms (in 1998 and 2002) after retreating on two more meaningful proposals in the face of union opposition in 1997 and 2001 (Featherstone 2005), and pass a minor tax reform in 1997 that selectively weeded out certain tax exemptions and introduced an income tax on government bonds and a real estate tax (which was admittedly difficult to enforce in the absence of a land registry, OECD 2001).

However, such piecemeal, partial, and covert adjustments had very significant limitations. First of all, the corrections they could achieve were too gradual and insufficient in size to deal with the existing imbalances. Second, they did not make a lasting impact on the general fiscal trends since they never even attempted to correct any of the fundamental imbalances of the system. Public sector employment stayed high, the pension system remained excessively fragmented and had the worst problems with underfunding in the OECD, and tax evasion still accounted for a very large share of GDP (OECD 2007). These structural features of public finances constituted fatal flaws in the face of the first effects of population aging, pressure to ensure the purchasing power of public sector pay, and demands to ease the fiscal burden of those who do pay taxes and contributions. In the first half of the 2000s, as the pressure on public finances eased up due to high growth, low interest rates, and the high rate of the flow of funds from the European Union, all of these factors were allowed to exert deleterious influence on public finances. On the eve of the global financial and economic crisis in 2007, at the end of a period of decent growth, the deficit stood at 7 percent of the GDP, higher than in any other developed country. The large deficit, the significant debt stock, and the revelations about accounting manipulations made Greece a prime candidate for market panic and a debt crisis when the crisis hit.

The Formidable Obstacle of Fiscal Polarization: Greek Public Finances after Default

The political events since the start of the Greek debt crisis further confirm just how intractable the political obstacles created by fiscal polarization are.
The foregoing analysis of the fiscal politics of the 1980s, 1990s, and 2000s emphasized the joint role of the polarization of vested fiscal interests and the weakness of economic pressures on large parts of society in preventing the emergence of the necessary social support to strengthen the hands of reformers. The developments of the past seven years, however, show that conflicts of vested interests generate formidable political obstacles to fiscal adjustment even in the face of considerable economic pressures.

Since Greece went officially bankrupt, it has been economically and financially at the mercy of the troika of the European Commission, the European Central Bank, and the International Monetary Fund. The troika provides the necessary funds to avoid complete collapse, but it has also demanded neoliberal reforms to the public sector, to pensions, and to the tax system as a condition for continued funding. For six years since the first bailout, the troika repeatedly issued ultimatums that it will discontinue funding. This would plunge Greece into an even greater economic disaster than it is already in, triggering not only its exit from the common currency but also the crumbling of its banking system, major interruptions in trade, and a collapse of domestic demand. Yet, whichever political actor accepts the troika’s demands is ejected from government in the next elections. The old dominant parties have taken turns at and joined forces in implementing the reforms dictated by the troika but faced enormous social unrest with waves of strikes, demonstrations, and deadly riots and were ousted from power. In early 2015, Syriza won the elections on the promise to resist reform ultimatums from the troika.

The enduring resistance to fiscal pain even in the face of direct threats of devastating economic and financial consequences highlights the immense stakes involved in choosing between different adjustment packages in Greece. Fiscal polarization causes vested interests to trump economic exigencies because it concentrates large losses to specific sections of society. For example, public employment has always been a very attractive candidate for adjustment in Greece because the public wage bill and public sector pensions tied down a very considerable share of public spending already in the mid-2000s (more than a third of primary spending, around 13 percent of GDP), which grew to a much larger share in the midst of the economic collapse. However, cuts large enough to make a difference for the budget would fall entirely on a circumscribed part of the population, which has few alternative employment opportunities and would consequently see its income drop drastically if public sector employment was cut and/or public sector pay was slashed. Similarly, tax evasion is an obvious target for reform in Greece. Estimated to amount to around 15 percent of
the GDP (OECD 2007), it is an immense drain on revenues. However, it also secures a large part of the income of the sections of society engaged in the small-scale sector. Stakes of these magnitudes are significant enough to matter even in the face of explicit ultimatums and imminent threats of disaster, especially in situations where vested interest groups already suffer from economic hard times.

How Japan became the Most Indebted Country in the World

Intense fiscal polarization has played a similar role in Japan’s fiscal troubles despite enormous differences between the two countries in economic structure, political institutions, and even in the main features of the fiscal regimes. Unlike Greece, Japan never formally tied down unusually large amounts of public resources in entitlements or public employment. Both the public wage bill and welfare spending remained modest in international comparison. Tax evasion was not a conspicuous problem either. However, decades of policy practice institutionalized considerable transfers of public funds to geographically and sectorally delineable groups in society and differentiated tax standards along similar lines. The differentiated policies generated very strong conflicts of vested interests between urban and rural areas and high- and low-productivity sectors. They fostered dependency on preferential policies in low-productivity rural areas and fueled resistance to sacrifices in the high-productivity urban groups, especially as economic conditions worsened. Intense societal conflict over fiscal policy gave rise to incessant infighting within the long-governing Liberal Democratic Party (LDP), which housed factions representing opposing societal groups. Factions needed the support of their particular constituencies to maintain their influence within the party, while the party as a whole ultimately needed the votes of both rural and urban populations to stay in power. This power dynamic tied the hands of successive governments for four decades and prevented them from eliciting major fiscal sacrifices from any group for the sake of rebalancing the budget, despite the insistence of the Ministry of Finance on the urgency of fiscal stabilization from the late-1970s.

A Brief Digression on the Difficulties of Assessing Japan’s Public Debt Problems

Before discussing the fiscal trends in Japan in the past four decades and analyzing their political origins, it is necessary to briefly touch on the difficul-
ties involved in assessing Japan’s fiscal situation at any point in time. These difficulties arise from two sources. On the one hand, Japan’s outstanding debt is partly counterbalanced by an unusually large stock of government assets, diminishing the applicability of gross debt indicators. On the other hand, the practice of government accounting diverges from international standards due to the proliferation of special accounts, which decrease the overall transparency of fiscal transactions (Wright 1999; Suzuki 2000).

Its gross debt-to-GDP ratio of almost 250 percent in 2015 makes Japan by far the most indebted country in the world. However, the gross debt indicator is somewhat misleading because the Japanese government disposes over a much larger asset stock than usual. The net debt-to-GDP ratio is only around 130 percent, which is comparable to Italy’s or Portugal’s debt ratio in 2015 (IMF WEO Database April 2016). Even in net terms, though, the ratio is obviously still quite high. After all, Italy needed the intervention of the European Central Bank to avert a brewing debt crisis at a significantly lower debt level in 2011, and Greece had similar levels of debt in 2009 before events started to spiral towards default. Nevertheless, markets for Japan’s sovereign debt have so far failed to show signs of stress similar to those of Italy or Greece, and the yield on bonds is significantly lower than on many developed country bonds.

Tranquility in the markets for Japanese sovereign debt is usually attributed to the fact that government bonds are predominantly in the hands of domestic investors. While domestic financing currently generates favorable financing conditions, its longer term implications are less benign. Government debt is an attractive investment opportunity for Japanese private banks and government financial institutions, given the abundance of domestic savings, the aversion of these institutions to foreign exchange and credit risk, and the lack of alternative lucrative investment opportunities domestically (Hoshi and Ito 2012; Horioka et al. 2014). However, as the domestic savings stock is expected to decline due to stagnating incomes and population aging, this pool of funds is likely to dry up in the long term. Furthermore, the current equilibrium is highly vulnerable to shocks that change the demand of domestic investors for government debt even in the short term. Even otherwise favorable changes, like a boost in investment opportunities upon an improvement in the Japanese or the global economy, could lead to tighter financing conditions for the government (Hoshi and Ito 2012). Analysts warn that if Japanese banks started to divest of government bonds and the government ran into financing difficulties, the resulting drop in the value of government debt would have devastating consequences for the financial assets of households and banks and, as
a result, for the domestic banking system, for the economy, and for society (Ibid.). In this sense, Japan’s government debt overhang creates even more daunting risks than the internationally more diversified debt stocks of other highly indebted countries. Although Japan is less exposed to short-term changes in investor sentiments than countries where footloose foreign investors hold the debt, if domestic creditors change their behavior in response to developments already underway, the consequences of a debt crisis will likely be even more devastating than elsewhere, as the losses will have to be practically fully absorbed by the domestic economy.

While it is fairly clear that Japan is by now dangerously indebted even in net terms, the large discrepancy between gross and net debt creates some ambiguity about when the country’s fiscal problems turned serious. The gross debt ratio was rapidly rising—from around 10 to more than 70 percent—in the 1970s and 1980s (Ameco), but the net debt ratio never reached 30 percent in this period and only started growing significantly in the mid-1990s after the collapse of economic growth. This suggests—along with relatively low deficit figures for the earlier period—that the fiscal imbalances of the second half of the 1970s and the 1980s were negligible, and Japan’s debt problem originates from the economic problems of the last two decades.

However, there are two important reasons not to discount the fiscal problems preceding the economic crisis as minor or inconsequential. First, net debt and deficit figures paint a rosier picture than the reality. They overstate the extent to which the rapid growth of gross debt was counterbalanced by the acquisition of valuable assets due to extensive accounting manipulations increasingly used from the 1980s to disguise pork-barrel spending and subsidies as investment and lending and to move deficits around to various special accounts in the 1980s (Wright 1999; Suzuki 2000). As a consequence, deficits and net debt were likely higher than officially accounted for already in the 1980s. Second, the fiscal problems of the 1980s were seen as serious and pressing at the time. The Ministry of Finance repeatedly warned of a “budgetary crisis,” advocated the adoption of principles of “sound management,” and put forward one plan for administrative and fiscal reform after another (Wright 1999; van Hagen 2006). The message was not lost on the wider public. Newspapers covered the issue extensively, while public opinion polls showed that “fiscal reconstruction” was considered one of the main policy priorities of the public at the time. As a result, several prime ministers publically pledged to resign if they were unable to eliminate borrowing by a certain deadline (Suzuki 2000). Although the fiscal problems of the 1980s were later dwarfed by the cata-
strophic debt buildup of the 1990s and 2000s when the economy turned for the worse, rapid debt accumulation in times of high growth was clearly seen as a major problem in the 1980s.

Four Decades of Imbalances: From the 1970s to the 2010s

The first fiscal imbalances appeared in the 1970s as economic growth slowed considerably and welfare policies were expanded. While double-digit growth had created exceptionally favorable fiscal conditions during the 1960s, budgetary constraints became much tighter in the 1970s. Gone were the years when governments could increase spending and cut taxes at the same time. At the same time, the governing Liberal Democratic Party came under pressure to increase welfare spending. Pensions and unemployment were upgraded, and free medical care for the elderly and child allowance were introduced. As there was no attempt to cut back traditionally large spending items like public construction projects and subsidies, spending increased considerably. To counterbalance the growing spending pressures, the tax bureau made the first in a long row of attempts to introduce a consumption tax in 1976 but failed in the face of resistance from within the LDP, the opposition parties, and the public (Suzuki 2000; DeWit and Steinmo 2002; Akaishi and Steinmo 2006). A few minor taxes were increased, but they made little difference for the widening fiscal imbalances (Suzuki 2000). As a result, for the first time since the Second World War, the government started to borrow significantly to cover current expenses (Suzuki 2000; Chopel et al. 2005; Estevez-Abe 2008).

Discouraged by its failed attempt to introduce a major new revenue source, the Ministry of Finance embraced “consolidation without tax increases” in the early 1980s and announced that deficits would be eliminated by 1984 through spending control. The new approach received strong support from the business community and the broader public, and a committee made up of central bureaucrats as well as the representatives of business and labor, called Rincho, was set up to draft a major fiscal reform (Suzuki 2000). However, the committee’s recommendations to cut the largest expenditure items—welfare expenses, farm subsidies, and public works projects—were never actually implemented (Suzuki 2000). Welfare and health care reforms were initiated, but most of these reforms were watered down to an extent that they made little difference to spending or revenues.7 The Ministry of Finance imposed ever-stronger limits on spending growth, but while these were adhered to in the budgeting process, repeated supplementary budgets, ad hoc authorizations, and exemptions undermined
their effectiveness in keeping spending under control (van Hagen 2006). Public works spending continued to increase despite repeated budgetary plans to reduce it, while farm subsidies only declined slightly due to a drop in production costs (Suzuki 2000).

Unable to keep its own targets throughout the 1980s, the ministry increasingly resorted to accounting tricks, postponing obligatory payments to special accounts and lower levels of government, cross-subsidizing funds in deficit from funds in surplus, and borrowing heavily from the Fiscal Investment and Loan Program and the Postal Savings System to reduce the discrepancy between plans and outcomes (Wright 1999; Suzuki 2000). Subsidies to local governments for locally provided health care, education, and social services were cut to reduce the deficit of the central government, but since the relevant legislation remained unchanged, local governments had to borrow more to be able to provide the same guaranteed services with lower funding (Suzuki 2000).

Revenue growth helped to partially counterbalance the lack of spending control by the end of the 1980s. Tax revenues grew mostly endogenously as a result of bracket creep of income taxes, especially in the years of exuberant growth in the midst of the real estate and stock market bubble of the late 1980s. Corporate tax rates were also slightly increased—from 40 to 42 percent in 1981 and to 43.3 percent in 1984—and some tax breaks were eliminated (Wright 1999; Suzuki 2000; Estevez-Abe 2008). Although the consumption tax was finally enacted in 1988—after yet another failed attempt in 1986—it made little immediate difference for revenues. It was much lower than originally planned (3 percent instead of 7), it was counterbalanced by income tax cuts meant to soften opposition, and small businesses were allowed to keep the tax (Akaishi and Steinmo 2006). Receipts from the privatization of the telecommunications company, the tobacco monopoly, and the railway system were also used to cover the deficit. The original intention was to use the revenue to reduce outstanding debt, but the incoming funds were eventually used to finance public works and subsidized loans (Wright 1999; Ishi 2000). As a result of privatization and tax buoyancy, the fiscal situation improved considerably and the debt-to-GDP ratio stabilized by the early 1990s, even in the absence of significant spending correction.

However, the fiscal balance proved only momentary. After the asset price bubble burst and growth stalled in the early 1990s, the debt-to-GDP ratio started to grow rapidly. The immediate years after the stock market crash of 1991 brought a series of stimulus packages made up of public works spending, loans, and tax cuts (Suzuki 2000). Simultaneously, social welfare
expenditure—hitherto largely stable as a percentage of GDP—started to increase rapidly while income taxes plummeted due to the economic downturn. By the middle of the decade, the debt-to-GDP ratio surpassed 100 percent. Therefore, as growth picked up somewhat by the middle of the decade, consolidation became the priority. The Ministry of Finance argued strongly for the need of tax reform—the introduction of a new, 7-percent consumption tax to replace the one enacted in 1988—and general “fiscal restructuring” of spending in order to bring the deficit below 3 percent and eliminate borrowing by 2005 (Suzuki 2000; van Hagen 2006). The proposal for the new consumption tax was dropped in the face of strong intragovernmental opposition, but the old consumption tax was raised to 5 percent in 1995. As growth turned sharply down, however, further consolidation was postponed and public works expenditure remained at the level of the stimulus years. It was only at the turn of the decade that fiscal reform was back on the agenda.

In the 2000s, the fiscal effort proved more successful. As a first step, the government committed to keeping spending as a percentage of GDP at a constant level. This required major efforts in terms of cuts in public works spending or in terms of social security and health care reform because of the fast growth of social benefit spending due to rapid population aging (van Hagen 2006; Takahashi and Tokuoka 2011). Although the government missed its targets several times, major improvements were achieved in this period. Public works spending—although still high in international comparison—dropped to historically low levels. The share of in-kind social benefits as a percentage of GDP stabilized due to the increase of health-care co-payments while the steep increase of the not-in-kind benefits slowed due to pension benefit cuts (Estevez-Abe 2008). As a result of these measures and thanks to a drop in interest expenses on outstanding debt, spending actually declined as a share of GDP. On the revenue side, social contributions were raised in 2004, while income taxes also picked up somewhat due to the improvement of the economy. By the middle of the decade, the rate of debt accumulation slowed and the debt-to-GDP ratio temporarily stabilized slightly under 190 percent before the global financial and economic crisis derailed Japan’s consolidation efforts once again.

This discussion of four decades of Japan’s fiscal history highlights that fiscal adjustment efforts were rather timid until the 2000s, despite the persistent discourse of fiscal emergency among bureaucrats in charge of fiscal policy making since the mid-1970s and despite the commitment of political leaders to consolidation. Although favorable economic conditions allowed the fiscal gap to temporarily close at the end of the 1980s, explicit policy
measures aimed at correcting the underlying structural imbalances of public finances achieved little before the 2000s. Initiatives to assert control over spending were unsuccessful. Reforms on entitlement benefits were invariably watered down in the face of opposition. Public works spending also conspicuously escaped major cuts before the 2000s. This expenditure item was much larger in Japan than in any other developed country throughout the past decades, both as a percentage of GDP and, especially, as a share of spending. It remained remarkably immune to savings pressures apart from the early 2000s, whereas in most countries, gross fixed capital formation is the first item that suffers at times of fiscal tightening. At the same time, it has consistently been the primary avenue for fiscal expansion when stimulus was deemed necessary.

On the revenue side, the most conspicuous feature of the past four decades has been the consistency of the efforts of the Ministry of Finance to generate more revenues through the taxation on consumption and the failure of these efforts. Although the consumption tax was eventually introduced in 1989—fifteen years after it was initially proposed—and then slightly increased in 1995, the share of consumption taxes has stayed very low. On the other hand, attempts to explicitly increase revenues from personal income taxation are conspicuous by their absence. Corporate tax rates and social security contributions were slightly increased in the 1980s, but they made relatively little difference. Increases in revenues in the past four decades have mostly been driven by favorable phases in business cycles and bracket creep. No matter how adamant about “fiscal reconstruction,” policy makers had been mostly unable to assert control over fiscal developments in the past four decades.

The Catch-22 of Fiscal Adjustment in a Polarized Fiscal Regime and a Closed Economy

The persistent inability of policy makers to change important features of Japan’s fiscal regime in the past forty years is rooted in the polarized structure of fiscal interests within Japanese society and in the lack of a compelling force for compromise in Japan’s closed economy. Failure to retrench welfare benefits, rein in public works spending, or significantly increase revenues through tax reform are all manifestations of the paralyzing effect of strong conflicts of vested interests in the fiscal regime whose main contours were solidified by the mid-1970s. Under that regime, a large share of
the population engaged in small-scale, inefficient agriculture, industry, or service—mostly in rural areas of the country—came to crucially depend on a mix of subsidies, public works, targeted welfare policies, and tax advantages for their livelihood. These fiscal benefits have been largely subsidized by high-productivity businesses and labor in urban areas. High productivity businesses have been burdened with very heavy corporate taxes and relatively onerous social security contributions in international comparison. Labor employed in these businesses has born a fiscal burden comparable to the international average, but it has received disproportionately more limited public welfare protection than labor elsewhere. These fiscal relations created irreconcilable conflicts of interests among the low-productivity rural population, high-productivity urban businesses and their workers when it came to fiscal adjustment. Subsidies and public works spending are sacrosanct to the rural population, along with the welfare policies and tax advantages targeted at them. Productive businesses resist further increases in corporate tax pressure, while urban workers are opposed both to cuts in welfare spending and to increased income or consumption taxes.

These conflicts have been all the more difficult to resolve as none of the three groups has an economic stake in fiscal consolidation to make it worthwhile to sacrifice fiscal interests for the sake of stabilization. Fiscal problems have not spilled over into macroeconomic problems like inflation or high interest rates. Therefore, their elimination yields no immediate economic benefit. On the contrary, given the extraordinary significance of domestic demand in Japan’s closed economy, fiscal consolidation is likely to damage the livelihood of large sections of society by contracting domestic demand.

Given the conflict surrounding fiscal issues and the lack of incentives for compromise, politicians have always had strong motivation to uncompromisingly defend the fiscal interests of the social groups they were beholden to, lest they be punished with the withdrawal of electoral or financial support. As the electoral power of rural and urban populations has been fairly balanced in the past forty years, the LDP needed the support of both constituencies to stay in power. The fiscal fault line has run across the party, where different factions made sure that there was no attempt to impose fiscal sacrifices on the group whose support they relied on. Therefore, even before the LDP was forced to govern together with other political forces, the hands of LDP governments were tied by the irresolvable conflict between rural and urban Japan. This resulted in a four-decade-long inability to put into place fiscal reforms to stop debt accumulation.
Better understanding the highly polarizing fiscal regime and the balance of power that freezes it into place requires briefly investigating the economic roots and political origins of fiscal policies that constitute the regime. The array of fiscal benefits that sustain much of the rural economy originate from the period of rapid economic development in the 1950s and 1960s. In this period of economic take-off, aggregate national income expanded at an astonishing pace, but the large majority of the population was still engaged in low-productivity, small-scale agricultural, industrial, and service activities of limited profitability. This part of the population constituted an incredibly attractive constituency, given its overwhelming electoral power, partly due to the distortion of an electoral system that favored rural constituencies at the expense of urban ones, but mostly by virtue of its still large numerical majority (Estevez-Abe 2008; Steinmo 2010). Political actors were bound to court this constituency by offering ways to benefit from the economic bonanza. Strongly incentivized by the logic of the multi-member electoral system, individual politicians sought to buy electoral support from different sections of the rural population and businesses with closely targeted policies. Liberal Democrats made it a centerpiece of their political strategy to lavish subsidies, public works, and tax benefits on various low-efficiency producer groups such as farmers, the construction industry, and distribution or financial services. They also secured earmarked public pension schemes for farmers and the self-employed. Although highly targeted, together this patchwork of policies became an important pillar of economic well-being for entire geographic areas dominated by low-efficiency sectors (Pempel 2010). It became a deeply entrenched part of the policy structure, not only because the target population came to depend on it but also because it enabled the low-economy sector to thrive and thereby greatly slowed the decline of the political weight of the low-productivity constituency.

Sustained public transfers to rural areas caused neither fiscal nor political problems in the 1950s and 1960s, given the electoral dominance of the population engaged in the low-productivity sectors and the rapid growth of the economy. The necessary funds could be extracted from the high-productivity sectors, which had limited political clout. Workers in these sectors did not constitute a sufficiently large electoral force yet to influence policy making, and their unions only exerted power at the enterprise level (Pempel 1998). Enterprises had considerable lobbying power but not
strong enough to countervail the electoral appeal of the low-productivity sectors (Estevez-Abe 2008). Furthermore, the combined effect of rapid economic growth and the lack of extensive public welfare provisions kept fiscal pressure on high-productivity enterprises moderate. Paradoxically, low fiscal pressure also helped to temporarily preempt labor demands for public welfare because enterprises lobbed for—and received—generous tax allowances for providing fringe benefits to their core workers, which appealed the most powerful section of urban labor (Ibid.).

Both the political balance of power and fiscal equilibrium was upset in the early 1970s as a result of population shifts, the changing characteristics of the labor market, and, crucially, the slowing of economic growth. With the expansion of the urban population employed in high-productivity industries, urban labor became a more serious electoral force to be reckoned with (Suzuki 2000). Simultaneously, the tightening of industrial labor markets also gave labor greater market power to demand better fringe benefits from employers. The escalation of fringe benefit costs made large companies more sympathetic to—and ready to lobby for—public welfare and social insurance schemes to supplement some of their private fringe benefits (Estevez-Abe 2008). The combined effect of these changes led to the considerable expansion of public welfare policies. But these large spending commitments were taken on at a time when growth slowed in the wake of the first oil crisis and fiscal constraints became tighter. As the flow of funds to rural areas continued unabated, the budget went into deficit.

The new balance of political power entrenched fiscal imbalances for the next four decades to come, as adjustment either to the spending or the revenue side became politically impossible for the governing Liberal Democrats who relied on the electoral support of both urban and rural populations by the end of the 1970s. Significantly cutting back on public works spending, subsidies, tax exemptions, and welfare benefits threatened electoral backlash from the rural constituencies. Appreciably retrenching recently created welfare programs spelled electoral penalties from urban labor. Explicitly increasing personal income taxes on lower income groups or on consumption threatened with electoral repercussions from both groups. Consumption taxes, in particular, were a sensitive issue in Japan, where market protection and the tacit toleration of collusion already kept prices at very high levels as a way to support domestic producers at the expense of consumers (Katz 2002; DeWit and Steinmo 2002). At the same time, high-productivity, internationally competitive businesses started to more vehemently resist the idea of paying higher taxes as profit margins declined (Akaishi and Steinmo 2006). Although
they could transfer tax expenses to consumers through price increases in the protected domestics markets, high fiscal pressure dented their international profits (Estevez-Abe 2008). When their lobbying against increases in corporate taxes and social security contributions proved ineffective in the 1970s and early 1980s, high-productivity internationally competitive businesses increasingly chose to relocate their production abroad and use transfer-pricing techniques to escape high corporate taxes in Japan (Katz 2002; Pempel 2010).

The political constraints arising from the conflicting interests of the three disparate socioeconomic groups were impossible to soften because no group could benefit enough from fiscal consolidation to counterbalance the loss they would suffer from tax increases and spending cuts, and, therefore, none had an incentive to soften its resistance to fiscal pain. On the contrary, beyond its effect on taxes to be paid and benefits received, fiscal adjustment would also impose short-term economic losses on different socioeconomic groups in the mostly closed Japanese economy through contracting domestic demand. Inflation was initially a serious side effect in the 1970s, which caused considerable concern in the famously savings-oriented Japanese society, but it was quickly brought under control by the early 1980s without major fiscal tightening and remained low from then on until the mid-1990s when it turned into dangerous deflation. Although the dynamic, high-productivity, export-oriented sector suffered from the strengthening of the yen, this development was more the consequence of international developments—first the collapse of the Bretton Woods system at the beginning of the 1970s and then the Plaza Accord of 1985—and had little to do with the fiscal stance (Pempel 2010). The prosperity of the 1970s and 1980s—characterized by relatively fast growth, very low unemployment, and sustained current account surpluses—generated no pressures for fiscal correction, whereas the collapse of growth in the mid-1990s generated pressure for stimulus.

Under these circumstances, it was impossible to count on substantial social support for significant fiscal adjustment. Fiscal imbalances remained a problem for bureaucrats to worry about, despite the alarmist discourse, the great public salience of the issue, and the pledges of prime ministers to restrain borrowing. LDP politicians and their factions could not be counted on to compromise the interests of their constituencies for the sake of fiscal consolidation because they had good reason to believe that the electoral punishment would be significant and immediate. They scuttled repeated attempts to significantly retrench welfare, to reduce public works spending, or to significantly increase the taxation of consumption. As poli-
ticians went in the direction of least electoral resistance and raised taxes on corporations, businesses relocated. The next section discusses in more detail how societal resistance to fiscal pain was manifested in the partisan-electoral sphere.

Partisanship and Electoral Pressures in a Polarized Fiscal Regime

Since the postwar political history of Japan is practically the story of the Liberal Democratic Party—with various lesser parties, interest groups, and the elite bureaucracy in the supporting cast—the LDP naturally played the central role in the politics of fiscal policy. It was the LDP that mobilized, united, and exploited the electoral potential of the mostly rural, low-productivity sectors from the end of the allied occupation to the present day. It was partially the LDP that channeled the demands of an increasingly powerful labor electorate into policy making, and it was the LDP that furthered the interests of the dynamic, high-efficiency businesses in return for generous financial support. In other words, the conflicts of the three major socioeconomic groups whose interests governed fiscal policy making in the decades since the Second World War played out for the most part through the intraparty power dynamics and strategic choices of the LDP.

Progressive parties played a secondary, limited role in the politics of policy making from the 1950s up to the global financial and economic crisis. They shaped the strategic decisions of the LDP through articulating labor demands, through putting those demands on the agenda, and by demonstrating their electoral appeal—first in local elections and later also on the national stage—and through expressing labor opposition to certain policy changes. However, progressive parties exercised little independent effect on policy choice until the 1990s. From the 1990s, they had a more significant parliamentary and governmental role to directly influence decisions, but—apart from a very brief period when the LDP was out of government in 1993 and 1994—they were minor partners in decision-making until the sweeping electoral victory of the Democratic Party of Japan in 2009.

Similarly, interest groups exerted influence mostly through their connections to LDP, rather than through independent institutional roles. The strong peak associations in business were invited to consult on policy proposals, for example, in the framework of the administrative reform committee, Rincho (Suzuki 2000). However, policy proposals rarely survived the political process in their original form. Therefore, business's effective policy influence depended much more on its capacity to lobby the LDP,
and this was often more effectively done by particular industry groups than by the umbrella organizations (Estevez-Abe 2008). Trade unions were also invited to committees like Rincho but had a relatively low weight even in those consultative fora (Suzuki 2000). Unions lacked policy influence for most of the postwar era because they were mostly focused on the enterprise level, and they were strongly divided at the national level (Pempel 2010). Only after the formation of a unified organization (Rengo) in 1987 did unions start to exert more substantial influence, mainly through progressive parties. Even then, unions represented a relatively small share of workers, mostly the most privileged, core workforce, leaving the representation of a considerable cohort of unorganized wage-earners to smaller political parties.

In a similar vein, Japan’s famously influential bureaucratic elite was able to shape policy outcomes only within the constraints of the LDP’s electoral considerations. Although the Japanese bureaucratic corps had strong organizational autonomy, a strong sense of coherence, a large array of formal and informal powers, and strong networks with powerful politicians, their discretion in policy making was clearly circumscribed by the political needs of LDP Diet members (Suzuki 2000). Although the Ministry of Finance had exclusive authority in compiling the budget, the LDP was incorporated into the budgetary processes, both formally through the so-called Policy Affairs Research Councils and informally through the intervention of senior party officials and members (Wright 1999). Consequently, the Ministry’s policy proposals always incorporated the preferences of the party and its clients either as a result of direct intervention or because “anticipated reactions” were taken into consideration in advance (Ibid.).

The Liberal Democratic Party took center stage in politics and gained control of policy making in the years following the allied occupation by tapping into the enormous electoral potential of the population engaged in the low-productivity sector.9 The LDP developed a network of clientelistic ties that secured the electoral support of diverse rural interest groups through subsidies, tax exemptions, public works contracts, and, later, welfare benefits. Although divided into factions beholden to different interests, the LDP was sufficiently cohesive to provide consistently powerful representation to the interests of the low-productivity sector. Once securely established in power, the LDP was also the natural partner for large, powerful businesses to liaise with, to rely on for keeping tax pressures generally low, and to extract important tax concessions from (Estevez-Abe 2008). When the electoral balance of power started to shift toward urban labor from the late 1960s and early 1970s, the LDP became amenable to
woosing labor. As the party lost control over large cities to progressive candidates and suffered setbacks in the Diet elections, the influence of the factions representing urban labor strengthened, which led to the significant extension of public welfare nationwide\textsuperscript{10} (Estevez-Abe 2008). By the mid-1970s, half of the LDP support came from labor (Suzuki 2000). This shift toward urban labor effectively turned the LDP into the political umbrella for a “social grand-coalition” of various segments of both the low- and high-productivity sectors of the dualistic Japanese economy.

Relying equally on the electoral support of the population in the low-productivity sector and labor in the high-productivity sector had a paralyzing effect on the LDP when it came to dealing with fiscal problems. In the 1980s, successive LDP governments experimented with a variety of reforms proposed by bureaucrats alarmed by the accumulation of debt. However, the labor faction—often in alliance with opposition parties—watered down measures intended to retrench benefits to wage earners. Simultaneously, rural factions blocked attempts to cut benefits to or increase contributions from farmers and the self-employed (Estevez-Abe 2008). Cutbacks on public works spending and subsidies were sabotaged by supplementary budgets and \textit{ad hoc} authorizations demanded by rural factions (van Hagen 2006). Increases in corporate taxes and social contributions proved to be the path of least electoral—and therefore intraparty—resistance, but they provoked strong resistance from the party’s biggest funders and also had their price in terms of encouraging the relocation of competitive companies, which foreshadowed grave economic and employment problems for the future (Akaishi and Steinmo 2006). Introducing a consumption tax would have been closest to a compromise between the different LDP factions because it would have spread the burden of adjustment across the rural and urban populations, but exactly for that reason, it was the electorally most costly option for the party as a whole. Already proposing it in the mid-1970s cost the LDP dearly in local elections. When the consumption tax was finally introduced in 1989—at a much lower rate than originally envisaged and more than counterbalanced by tax cuts elsewhere to soften the blow—it led to the loss of almost a third of the LDP’s seats in the 1989 upper house elections and to the loss of the LDP majority (Akaishi and Steinmo 2006).

The policy-making paralysis only intensified as the LDP lost control of the government in the 1990s. As severe economic problems compounded the fiscal ones, intraparty conflict over scarce resources ended in the secession of a large urban faction of LDP Diet members from the party in 1993, leading to the ejection of the party from power for the first time since 1955 (Suzuki 2000). Although the LDP was back in government by
1994, it had to put up with more progressive, urban-oriented parties—the Social Democratic Party and Sakigake—as coalition partners until 1998. This only aggravated the paralyzing effect of the electoral balance between high- and low-productivity sectors on fiscal policy making. Rural policy preferences were briefly excluded from policy making while the LDP was out of government—in this short period, public works spending was cut back—but as soon as the LDP was back in power, they regained their earlier central importance, evidenced by the launching of major new public projects and the reinforcement of farm subsidies (Estevez-Abe 2008). Welfare retrenchment was off the table due to the strong representation of urban labor interests by LDP factions as well as the progressive parties. In fact, the welfare state was expanded in these years (Estevez-Abe 2008). Slightly increasing the consumption tax—offset by large income tax cuts—was the only compromise solution once again. However, just like before, the loss of revenue from income taxes far outweighed the gain from the limited increase of the indirect tax revenue, and even this limited compromise cost the progressive parties dearly in the next election (Akaishi and Steinmo 2006).

In the late 1990s, politics and policies took a new turn that temporarily seemed to resolve the stalemate between the interests of the rural low-productivity sector, urban labor, and high-productivity corporations. The electoral reforms of 1994 increased the need for parties to appeal to broad nationwide constituencies, rather than to particularistic local communities. The LDP responded to these changes with internal reforms that shifted power from factions to the leader of the party, who was now able to provide a clear and unified policy platform to appeal to a broad cross section of voters. Governmental decision-making was also centralized to enable the prime minister to adhere to a clear policy platform (Estevez-Abe 2008). These reforms shifted the intra-party balance of power toward the urban constituencies, whose support was crucial under the new electoral rules and especially in light of the emergence and consolidation of a serious progressive competitor, the Democratic Party of Japan (DPJ), which appealed mostly to unorganized urban voters. Consecutive prime ministers from Hashimoto to Obuchi and Koizumi undertook reforms that improved fiscal balance at the expense of the low-productivity constituencies of the LDP. They reduced public works spending to historically low levels, cut farm subsidies, and reformed health care, but they steered clear of a renewed attempt to increase consumption taxes and even offered limited new social protection schemes to unorganized urban voters (Estevez-Abe 2008). These reform efforts led to the gradual closing of the deficit and the slowing of debt growth.
However, this shift in LDP strategy around the turn of the millennium did not imply that the societal conflict over fiscal resources was definitively resolved. On the one hand, the shift was predicated on the strategic outlook of the leader in whose hands intra-party and intragovernmental power was centralized. When leaders tied to factions with low-productivity constituencies gained the upper hand, the enthusiasm about fiscal adjustment at the expense of rural constituencies waned (Pempel 2010). On the other hand, the LDP’s willingness to compromise rural interests had a steep electoral price, and it created an opening that its rivals were ready to exploit. The DPJ—which had originally threatened to outflank the LDP from the left by campaigning consistently with promises of reforms that appealed to the urban electorate—began to exploit rural discontent with the LDP’s reforms and tried to capture the LDP’s rural constituencies (Lipscy and Scheiner 2012). In the 2007 elections, the DPJ overtook the upper house, and by 2009, they were in government. Despite winning the elections on a platform of change, the DPJ has essentially continued the LDP’s old policies, including the restoration of the fiscal position of the rural constituencies through farming subsidies and budgetary support for rural localities (Lipscy and Scheiner 2012). As the global financial and economic crisis sent debt on a path of explosive growth again, the DPJ tried—just as the LDP did several times before—to avoid choosing between its different constituencies by raising the consumption tax as a way of dealing with the country’s enormous fiscal imbalances. At the next elections, it was ejected from government. Once back in power, the LDP went back to its old ways of redoubling public works spending in the name of fiscal stimulus (The Economist, Jan 12, 2013).

**Political and Economic Change and Enduring Conflicts of Fiscal Polarization**

Although electoral reform significantly changed the Japanese party system and the Liberal Democratic Party itself, it did not resolve the underlying societal conflict that has tied the hands of policy makers in dealing with Japan’s fiscal imbalances for decades. Albeit they were temporarily suppressed within the LDP, the intense conflicts among the urban and rural populations quickly resurfaced through other channels to prevent meaningful policy adjustment as disgruntled groups found new champions to defend their interests. Just as in the case of Greece, the stakes involved in choosing between specific avenues of fiscal adjustment are too high for
different sections of society (and their political representatives) to relax their opposition to unfavorable reforms of spending or taxation, especially since fiscal consolidation does not offer a way out of the severe economic problems of the past more than two decades.

Conclusion

The Greek and Japanese stories demonstrate the paralyzing effect of fiscal polarization on policy reform, especially in conjunction with the insulation of the livelihood of the majority of society from the effects of fiscal imbalances on international competitiveness. Albeit the persistent willingness of policy makers to subordinate the goal of fiscal stabilization to electoral considerations make the two cases seem like textbook examples of “fiscal indiscipline,” the profound differences between the two countries—in terms of political and budgetary institutions, ideologies, policy paradigms, the economy, and their position in the economic system—raises the question why it is in these two countries that “fiscal indiscipline” is so unusually persistent and policy makers are so extraordinarily wary of imposing fiscal sacrifices on the electorate. This chapter argued that the electoral price of fiscal pain is prohibitive in both countries because existing fiscal policies generate very strong incentives for large groups in society to resist reforms that negatively affect them, while the economic structure fails to generate incentives for compromise.

Even though existing fiscal policies could hardly be more different in the two countries—in terms of the size of government spending as a share of the economy, the structure of taxation, and the allocation of revenues across spending items—they are very similar in the degree to which they closely target the benefits of public spending and the costs of taxation to specific groups within society. Targeted policies imply that any policy reform is necessarily a targeted assault on the interests of a specific group. Every group has a strong incentive to use its electoral leverage to try to deflect such assaults, especially when stabilization fails to offer hope for compensating improvements in their economic position. Moreover, in the absence of a likely positive impact on the economy, policy makers cannot hope for counterbalancing electoral gains from groups that get to “free ride” on other groups’ fiscal sacrifices. Under these conditions, conservative governments in Japan suffered just as serious electoral setbacks after attempts at stabilization as left-wing and right-wing governments did in Greece; Greece’s strong, centralized unitary governments
were just as timid in attempting reforms as were divided governments in Japan, and Japan’s strong bureaucracy and centralized budgetary institutions failed just as manifestly at enforcing fiscal targets in the face of political pressures as the weak Greek bureaucrats did. As a result, Japan borrowed just as relentlessly as Greece, even in the period when its economy was one of the world’s strongest and Greece still lagged far behind other developed countries.

The next, concluding chapter revisits all the cases discussed in this book to recapitulate the ways in which fiscal polarization and international exposure influenced the fiscal track records of Belgium, Greece, Ireland, Italy, and Japan. It underlines the variation in the ways in which existing fiscal policies fuel or dampen conflicts between various social groups within different polities and analyzes the ways in which the demands of international economic competition exercise their effects in different political and policy settings. Finally, it ties into broader theoretical debates by investigating the lessons of the case studies about the role of political entrepreneurship as well as institutional and ideational innovations in fostering fiscal adjustment.