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Over the past three years, much of the Japanese public and many students of its political economy have grown used to being disappointed by the Koizumi style of reform. Koizumi came to office through internal party selection on April 26, 2001, his candidacy largely driven by the desperation of local Liberal Democratic Party chapters facing defeat in Upper House elections. Koizumi was supposed to be the Japanese equivalent of "Mr. Smith Goes to Washington," and in his first year became akin to a rock star for his willingness to talk about as well as take on taboos and sacred cows. His talk of painful fiscal and economic reform would have scared off electors in any other society not gripped by a sense of foreboding and the need for drastic change.

In this article, we argue that this potential was not realized because Koizumi proved himself incapable of moving beyond a critique of investing in things (i.e. public works) to mobilizing the public finances to more productive ends, especially investment in people. His promises of a painful remake of politics and society have not evolved into a vision that includes much more beyond a few pet obsessions. Rather than offering strategic or "smart" governance, the Koizumi style of reform centres on tactics. We first sketch recent appraisals of Koizumi's approach as well as the main thrust of his administration's reforms, then show how his governance style has stymied fiscal decentralization, threatening yet another lost opportunity for Japan.

Professional observers are generally split on their evaluations of Koizumi's governing style and policy-making approach. One of the best students of Japanese economic reform, Richard Katz, makes the telling point in his Japanese Phoenix that Koizumi is a transitional figure more interested in politics than economics. Koizumi in fact studied economics at Keio University and was appointed to fiscal-policy related positions early in his LDP career, but he expresses surprisingly little interest in complex fiscal and economic issues. His real passion, according to Katz, is in gutting the network of finances that sustains porkbarrel politicians and their supporters. The main problem with this approach, for Katz, is that Koizumi's political objectives do not dovetail with Japan's objective needs and thus threaten to impair the country's opportunity to reform as well as recover. Katz sees smart reform as dealing with Japan's costly bad debt problem first, and then engineering fiscal and other reforms to streamline the operation of the state and free up the allocative function of markets. In his view, the Koizumi regime has only achieved partial reduction of bad debts among the biggest firms, while smaller firms generally languish in a limbo of low interest rates that allows them effectively not to repay debts that they could not in any case. In a July 5 2004 article in Time, Katz believes that the much-touted economic recovery of 2004 has no legs. Indeed, being largely dependent on exports rather than a revitalized domestic economy, the recovery seems likely to weaken in the pattern that has become familiar over the past decade and a half.

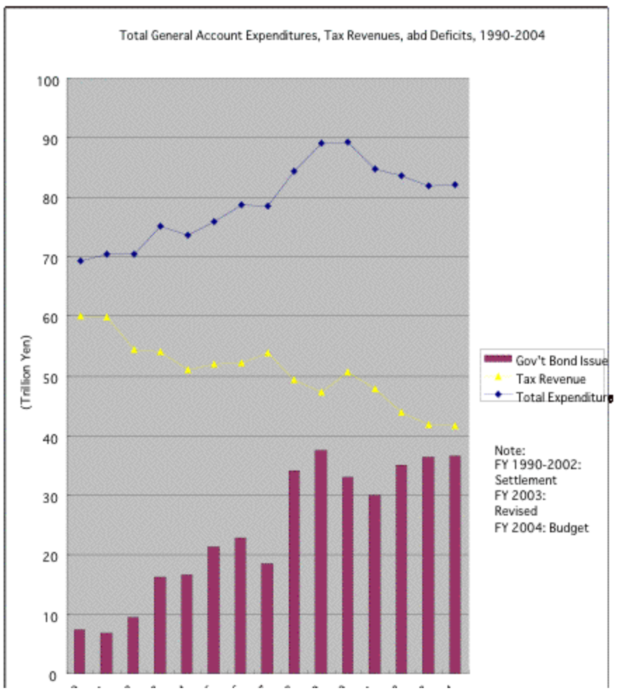
On the other hand, Morgan Stanley Japan's economic analyst Robert Feldman has fulsome praise for Koizumi. Commenting in the September 30, 2004 edition of Morgan Stanley's Global Economic Forum (http://www.morganstanley.com/GEFdata/digests/digests.html), Feldman suggested Koizumi is likely to be seen as "one of Japan's greatest postwar leaders" and argued that "even if tactical blunders ultimately bring down the Koizumi government, any ensuing government will only be able to win the hearts and minds of voters by continuing his policy of pushing reforms that promote the economic efficiency needed to maintain living standards."

That two generally mainstream and well-informed American economists can come to such divergent conclusions concerning Koizumi's approach and his likely legacy is striking. One would expect at most some disagreement on a few details rather than the overall approach per se. And with such wide divergence in assessing the thrust of Koizumi's reformism, one of the positions has to be profoundly wrong. On the whole, Katz' account is the more persuasive because it is not -- as we see in Feldman's and others' arguments -- largely the sigh of relief that more and more decisions are being left to the market. Katz recognizes that smart reform asks what the priorities are in a world where not everything can be down at once and where rushing willy-nilly into mistakes can have serious consequences. We can strengthen Katz's case by examining how Koizumi and his allies have approached the issue of reforming Japan's dangerously outdated structure of intergovernmental finances.

Diminishing Returns from Investing in Things

Koizumi grasped one essential fact years ago, when it was still heretical, and rode the idea into power when it became common sense in the public debate. While his LDP colleagues talked vaguely of a crisis, Koizumi clearly recognized that the Japanese fiscal and financial system's devotion to investing in things -- i.e. public works -- was corrupting its politics and helping to ruin its economy. The party Koizumi rose to power in, the LDP, had been built on investing in things once high-speed growth gave it the wherewithal to redistribute the goods from booming urban areas to declining rural areas. The father of much of this bias towards public spending was Tanaka Kakuei, the Prime Minister from 1972 to 1974. Even as a young Diet member just after the Pacific War and Occupation, Tanaka's genius with public finances was such that he got a quarter of the gasoline tax earmarked for road construction, overcoming the furious opposition of the Ministry of Finance. Tanaka's legacy of porkbarrel politics is richly detailed by many authors, including Jacob Schlesinger in his book The Shadow Shoguns. Indeed, Tanaka's policies of regionally balanced economic development are still a handy target on which to hang the blame for Japan's current misfortunes, as documented in a recent book-length study from a senior analyst at HSBC Securities Japan (Masuda, 2004).

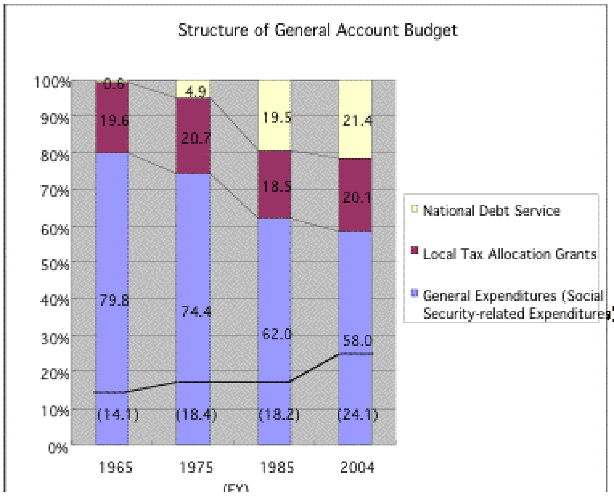
The LDP's devotion to pork barrel spending, and the pecuniary and electoral rewards that derive from it, made Koizumi an unlikely prospect to win the LDP presidency (and thus become Prime Minister) in 2001. Not only was he an oddball among the conservative old guard at the core of the LDP, but his longstanding desire to privatize the postal system was anathema. The postal service is, after all, a mainstay of LDP support, with a vast network of often virtually hereditary local offices. The banking system it manages is the world's largest and has long been a ready source of low-cost funds for public works. But over a decade after the collapse of the late 1980s bubble economy, and after a series of increasingly large-scale pump-priming with public works, the country was deeply in debt and the economy moribund. Discussion of the key facets of the postwar economic model (protectionism, public works, etc) had gone from being the focus of disparaged "revisionists"- often dismissed as "Japan bashers" -- to front-page news in the country's media. With the old system so clearly bankrupt, its old guard had to yield to the pressure from local offices for a new, reformist face that offered some hope of surviving the impending July 2001 upper house elections.



Source: Ministry of Financeï¼ˆhttp://www.mof.go.jp/jouhou/syukei/sy014.htmï¼‰

Koizumi came into office with a sketchy program of market-oriented reform and a pledge to keep the annual deficit below 30 trillion yen (about US $300 billion). He was also committed to reforming spending on public works, which in that year still consumed over 6% of GDP in spite of the clear failure of the Keynesian spending policies of the late 1990s. As shown in figure 1, after one year of success with the Fiscal Year 2001 budget Koizumi had to abandon his 30 trillion yen cap on the deficit when tax revenues plunged from 47.9 trillion yen in Fiscal Year 2001 to 43.8 trillion yen the next year. This sudden drop in tax revenues was followed by further, albeit less dramatic, declines in the following two years, pushing the deficit over Koizumi's self-imposed ceiling. In Fiscal Year 2002, the deficit came in at 35 trillion yen before rising to 36.4 trillion and then to 36.6 trillion yen.

Another reason Koizumi was unable to keep the debt under control was that the budget could not be cut as much as he and his fellow market-oriented reformists wanted. As we see again in figure 1, total central government spending on the general budget in Fiscal Year 2001 was 84.8 trillion yen, and this only declined to 83.7 trillion yen the next year, followed by 81.9 trillion yen in 2003 and a budgeted 82.1 trillion yen in 2004. Hence the central government was caught in the squeeze of escalating costs due to ageing and declining revenues due to previous tax cuts as well as the failure to get the economy back onto a sustainable growth track.



Source: Ministry of Financeï¼ˆhttp://www.mof.go.jp/jouhou/syukei/sy014.htmï¼‰

Figure 2 shows that the Japanese central government has gradually lost its room for fiscal maneouvre as expenditure shares increasingly go to social security, debt service and local block subsidies (ï¿½local allocation tax grantsï¿½). Though block subsidies have not increased as a share of the budget over the years, they do take up a full fifth of it. Moreover, a slightly smaller share of the budget also goes to subnational governments in the form of targeted subsidies drawn from the general expenditure accounts for central-government ministries. Thus Japanï¿½s central government was also constrained by its role as a redistributive conduit between the subnational governments. Just as the central or federal government budget in many countries is increasingly becoming a huge insurance scheme through which revenues are transferred to individuals for health care, pensions and other programmes, it is also a means through which revenues are collected and redistributed among lower levels of government.

Japan's fiscal system is especially notable for intergovernmental redistribution as over 2/3 of all public spending (e.g. in health, education, welfare, public works and the like) is performed at the local level while only 1/3 of all taxes are collected locally. Richer local governments such as Tokyo and other big urban areas are able to finance most of their spending through local taxes, as their residents' incomes are higher, they host most corporate head offices, their regional economic activity is fairly intense, and so on. By contrast, the weaker rural areas and smaller municipalities are heavily dependent on various kinds of subsidies from the central government. These subsidies from the centre have a powerful redistributive effect, as we see in Table 1. The table shows that in 2002 the big urban prefectures were heavily taxed by the central government (ï¿½Nationalï¿½ in the tax burden column) but received relatively little in return via subsidies (ï¿½Subsidiesï¿½ in the revenues column). The national tax burden shows the per capita amount of taxes that the central government collected from the prefecture, the subsidy column shows the amount of subsidies per capita (block grants plus targeted grants) that the prefecture received from the central government, and the ï¿½rate of returnï¿½ shows what taxpayers in the most and least-taxed prefectures received, so to speak, for what they were paying to the prefecture and the central government. As we can see, the heavy per-capita shift of subsidies to rural areas meant the least-taxed prefectures were getting about 3 to 4 times in subsidies what they paid in national taxes. The redistribution from the urban prefectures was generally the reverse, and in the case of Tokyo the national tax burden was nearly 15 times the per capita receipt of subsidies. Some poorer localities received more in subsidies than was collected in national taxes.

Table 1. Prefectures' per capita Tax Burdens, Receipt of Subsidies and Effective Rate of Return in 2002 (units: ï¿½1,000)

Prefectures	Tax Burden			Revenues			Rate of Return
	National	Local	Total (A)	Local Tax	Subsidies	Total (B)	B/A
Five most-taxed							
Tokyo	1,270	461	1,731	461	82	543	0.314
Aichi	499	329	828	329	110	439	0.531
Osaka	554	297	851	297	171	468	0.55
Kanagawa	334	288	622	288	99	387	0.622
Chiba	256	246	502	246	140	386	0.768
Five least-taxed							
Tottori	160	201	361	201	449	650	2.078
Akita	160	179	339	179	531	710	2.097
Nagasaki	144	174	318	174	509	683	2.148
Kochi	162	184	346	184	628	812	2.346
Shimane	177	198	375	198	690	888	2.365
National average	375	263	638	263	262	525	0.822

Cutting Spending on Things

Koizumi's commitment to reforming this structure of spending centred first on cutting public works, which have long been a target of criticism due to waste, environmental destruction and other problems. The goal of cutting public works has in fact been achieved to a significant extent, with annual cuts in spending having reduced public works expenditures by about 20 percent, or approximately 1% of GDP (Koll, 2004). But because so much spending is performed subnationally in Japan, there are limits to how far cutbacks can be made in selected areas of public spending without getting at the structure of intergovernmental finances. In the Japanese intergovernmental finance system, even block grants are partially used to pay for public works because they pick up a share of the interest costs for local debt floated to implement projects (DeWit, 2002). The system was tailored to maintain political stability in an era of high economic growth, but this bias towards stability rather than effectiveness and efficiency needs to be revised in order to foster stronger regional economies throughout Japan. The old days of attracting business to the hinterland via heavy investment in such things as roads and bridges are gone, due to massive debt and the shift towards people-centred services. Moreover, local economic development is best done at the regional level, with urban centres acting as the anchors of "competitive regions" (OECD, 2004a). That is the backdrop against which Koizumi decided to implement what are known as the "Trinity reforms" (sanmi ittai). These reforms comprise cuts to the central government's targeted and block subsidies to subnational governments and transfer of tax room (eg., a portion of the income tax) from the central to the subnational governments.

The Koizumi regime's record on crafting these reforms has been abysmal. First, in June of 2003 the Koizumi administration proposed to 1) cut targeted subsidies to local governments by 4 trillion yen over three years, 2) transfer 80% to 100% of unspecified tax room from the central government to local governments in order to make up for the cuts, and 3) review the distribution of general subsidies (or block grants) with an eye to reducing the level of redistribution (Yagi, 2004). This brought forth massive opposition from dependent local governments, who naturally feared a huge loss of revenues. In addition, spending ministries worried that cuts would shrink their administrative authority. The Koizumi regime exacerbated the usual problem of making reforms to any fiscal system by dumping his proposal into the public debate without much apparent thought to orchestrating the politics of selling it to enough people and interests to move it through the policymaking process. Well over a year later, there is still no clear idea of what subsidies should be cut or will be cut and exactly how much control over fiscal resources will be decentralized.

Little Vision of Positive-Sum Decentralization and Investment in People

Here again we encounter the problem of Koizumi's political style. His approach centres on political maneouvering, and playing conflicting interests off one against the other, rather than drafting an overall vision of society and using that as a means to attract support and perhaps even persuade doubters. Organizing fiscal and administrative decentralization in Japan should be a positive-sum politics in which the central government is seen as facilitating the transition to a new kind of society. More than a decade ago, the ill-fated coalition government under PM

Hosokawa Morioka was intent on instituting this kind of reform. And the rump of the Socialist Party that brought the LDP back to power in 1994 -- with Socialist leader Murayama Tomiichi becoming Prime Minister from June 1994 to January 1996 -- compelled the LDP to set up a blue-ribbon commission of inquiry into decentralization. Even prior to these developments, decentralization was largely seen by the attentive public as a desirable area for policy reform. Indeed, decentralization had been a progressive policy platform for decades in Japan, in reaction to the centralization of the state under conservative elites. The left and most centrists in Japan, like their counterparts in Korea and other developmental states, sought to foster local democracy in the face of the social, environmental and other costs imposed by the policies of the central regime. Moreover, in recent years, business elites and others have come on-side as their own faith in centralized developmentalism eroded with the collapse of the bubble economy and onset of the current era of low growth and high deficits. This dramatic erosion of even tacit support for the old model of centralized governance offers an enormous opportunity to craft a persuasive alternative.

Compare, for example, the Japanese case with that of Sweden, after the latter experienced fiscal and economic crisis in the early 1990s. The governing Social Democrats determined that the crisis was systemic and required redrafting the fiscal and welfare state (Loughlin and Martin, 2004). But instead of playing zero-sum politics by employing a rhetoric of "pain" while having interests fight with each other over a shrinking pie, the authorities put together a reform designed to address the challenges and opportunities afforded by globalization and the shift to post-industrial society. Overall, the Swedish approach emphasized shifting the fiscal regime towards a highly decentralized "knowledge society" that incorporated ample incentives for retraining and higher education (Jinno, 2002). The key point is that the governing Social Democrats crafted a far-reaching revenue and spending reform agenda that presented a credible and equitable picture of where they wanted to go. The reform thus gained broad public support and brought even the relatively neoliberal Liberal Party onside. In the wake of these reforms -- which included a massive write-off of non-performing loans (Backstrom, 1997) -- Sweden has recovered its economic dynamism. Sweden now regularly scores among the top five countries in international rankings of economic competitiveness and IT (ITU, 2003; World Economic Forum, 2004).

By contrast, Koizumi's focus on the zero-sum politics of battling with the old guard inside his own party has clearly left him and his closest colleagues incapable of imaging that the big picture might be more important than simple tactics. When governing is conducted as a zero-sum and intensely partisan affair, there is likely something wrong with the agenda or the process. When it comes to decentralization, which Japan sorely needs, subsidy cuts and tax transfers to the local level do not have to entail a zero-sum outcome if the focus is put on maximizing smart spending and improved governance. There are decades of overseas experience of poorly conceived as well as very constructive decentralization reforms for the Koizumi regime to draw on. As we saw in the Swedish case, and as is true of the EU in general (Cleaver, 2002), there is also a clear paradigm of reinforcing learning while doing decentralization. Education is increasingly recognized as the key to competitiveness in a post-industrial order, and the Koizumi regime could have emphasized building a knowledge society in order to make fiscal decentralization more focused, productive and politically compelling.

Indeed, Japan requires greatly enhanced productivity if it is to fund the future burdens of pensions, health care and other spending without engendering generational conflicts and severely straitened economic circumstances. It also has to maintain a technological edge if it is to compete effectively with India and China, whose workforces are set to expand by 140 million people over the next several years. This number is more than the entire population of Japan, whose workforce will likely shrink by 3 million (Xie and Chetan, 2004). Japan in short has to emphasize human capital for growth as well as for fostering an equitable society. Yet OECD data for 2001 indicate that Japan's expenditures on tertiary education are, at 0.5 percent of GDP, the lowest among the large members of the OECD and a sharp contrast with the 2 percent in Sweden and 1.5 percent in the US (OECD, 2004b). And the Koizumi regime has no comprehensive programme for education and no vision of how education and training might be used to facilitate the transition to a more equitable and decentralized post-industrial society.

The great risk here is that the Trinity Reform process ends in outright failure or merely marginal reform dominated by cuts to the subsidies -- such as those for social welfare -- that have the politically weakest advocates. After years of debate and political struggle over the terms of fiscal decentralization, failure to produce a systemic reform would not only mean a lost opportunity but would likely impair any future effort. As in health care policy in the United States under the Clinton regime (Starr, 1995), failure would mean an attentive public tired of the issue and thoroughly exposed to the counter-arguments of the vested interests. Moreover, in the process of fighting and defeating or compromising reform, the vested interests forge new institutional bonds and rationales for the status quo. These are ready to hand should another reform proposal be put on the agenda. But the outlook is not good. Koizumi has already picked a cabinet dedicated to his singular obsession, the privatization of the post office. This will deflect much of his administration's energies over at least the next year or two, so it is entirely possible that fiscal decentralization will end up hardly even half-baked.

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