

ARTICLE

The “Trinity Reform” and the Problem on General Revenue*

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Summery

The “Trinity Reform” in Japan has been carried out with different ideas by the Ministries, Local Bodies, and each local government. Several contentions have been presented with regard to the reform and they are realized to converge in the problem on general revenue. Though the official controversy of “the imbalance in the amounts between the Local Public Finance Program and actual expenditures” in general revenue resources has not paid attention to the real fiscal managements of local governments, the case studies in this paper indicates that local governments skillfully spend the general revenue resources to their prioritized public services and to infrastructure-related services such as deficit charge and repair and maintenance that are not supported financially by the central government.

. On the “Trinity Reform”

In Japan, the “Trinity Reform” which means that transfer of tax revenue sources from central to local governments, reduction in central government subsidies tied to certain uses (categorical grants) and reform of local allocation tax (general revenue resource) should be implemented at the same time has been differently interpreted by local governments, the central governments and each ministry in it. While local governments have thought of it as the crucial means for decentralization reform through which they would strengthen their substantially self-decisive power, the central government as a whole has made efforts to decrease local budgets for the aim of fiscal restoration via the “Trinity Reform.” The “Trinity Reform” has been certainly under the dissimilar objectives.

The objective for expanding self-decisive power of local governments prefers the simultaneous reform of tax transfer to local governments, reduction in subsidies, and correction of fiscal imbalance among local governments by adjustment function of local allocation tax through guaranteeing the cost burden of standard level as to public service at local level. However, the objective for fiscal restoration requires not tax transfer but local autonomous taxation, just cutbacks in amounts or ratios of subsidies, and restriction of fiscal guarantee function in local allocation tax.

The fiscal budget of 2004 illuminated this divergence. The government decreased the amounts of subsidies by 1.0 trillion yen, cut the local allocation tax by 2.9 trillion yen¹⁾, and transferred tax resources by only 0.5 trillion yen. Totally, the fiscal resource of local governments as a whole was diminished by 3.4 trillion yen, approximately 4% decrease from the Local Public Finance Program of FY 2003. As a result, most of local governments faced the government-made fiscal difficulties and took emergent measures like transferring fund money to general accounts. Some of them were forced to compile a substantially deficit budget that was legally prohibited in principle. The dominant reason of their fiscal difficulties is undoubtedly the drastic reduction in local allocation tax.

The local allied bodies such as the National Governors’ Association, the Japan Association for City Mayors, and the National Association of Towns & Villages resisted such a disadvantageous trend of the “Trinity Reform” for them and drew

* This paper is basically originated in joint studies with my colleague professor Kazuhisa Hiraoka at Kochi University. Our study papers thus far are, for example, Mori and Hiraoka (2005) and Hiraoka and Mori (2005).

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up the reform plan of reduction in subsidy and other fiscal and administrative systems. Although the Cabinet stated to respect their reform plan, the Ministries prepared for utterly different reform plans beneficial for them. The Ministry of Finance insisted to shrink the local allocation tax as an established official agreement and fail to transfer tax resource in exchange for cut in subsidies for infrastructure construction on the ground that they were financed through issuing national bonds and no tax resource would be generated by cutting these subsidies. Such Ministries responsible for infrastructure improvement as the Ministry of Land Infrastructure and Transport and the Ministry of Agriculture, Forestry and Fisheries seized this reasoning of the Ministry of Finance to avoid their subsidy cuts. The Ministry of Health, Labor and the Welfare and the Ministry of Education, Culture, Sports, Science and Technology tried to reduce the ratios of their subsidies in order to keep their authorized powers through the subsidies in spite of reducing their amounts. The Ministry of Internal Affairs and Communications, on the whole, struggled to ensure local fiscal revenues necessary for sustainable fiscal operation in local governments. Through these official discussions, the government finally distributed the overall plan "On the Trinity Reform" in November 2004.

The major points of "On the Trinity Reform" are as follows. Firstly, the main subsidies subject to reduction were those for the national health insurance and for compulsory education that were not listed or lowly ranked in the reform plan of the local bodies. Besides, integration of separate subsidies and subsidy reductions without substitute fiscal resources were adopted. Secondly, the amount of transfer of tax resources was interpreted to be 3 trillion yen including that amount of FY 2004. This means that total reduction in subsidies 4.5 trillion yen since FY 2003 in exchange for 3 trillion yen of tax resources. Considering the reduction in 2.9 trillion yen of local allocation tax, local governments would lose 7.4 trillion yen and get 3 trillion yen in turn. This calculation indicates that the central government's aim to reduce local financial resources for recovering national fiscal health will be contributed to a large extent by the "Trinity Reform." Thirdly, the amounts of local allocation tax would be sequentially decreased by lessening the fiscal estimation level of the Local Public Finance Program, which shows the financial balance of local governments through computing the standard level of revenues and expenditures by the central government.

In the fiscal budget of 2005 and the Local Public Finance Program for FY 2005, the sum of general revenue resources (local tax, local allocation tax, and deficit bond) was made equal to that of FY 2004. However, a lot of local governments certainly have to manage fiscal conditions with much further expenditures for social welfare, redemption of borrowings, retirement allowance and so forth.

. The Crucial Point of the "Trinity Reform" Arguments: Local General Revenue

Although there seem to be several contentions on the "Trinity Reform", they are converged to general revenue problem of local governments. For instance, even if such subsidies as for compulsory education and life support are remained, it is difficult to maintain these services without matching general revenue resources of local governments. Since the concurrent implementation of reduction in subsidies and tax transfer from central to local governments is sure to expand imbalanced fiscal powers among local governments, the function of local allocation tax should be expected to fill them so as to keep equalized levels of local public services throughout Japanese society. It obviously depends on adequate and stable local general revenues through local allocation tax whether or not the "Trinity Reform" will be successful for local governments as a whole. As for the central government, however, the unchanged system of guaranteeing general revenue resources by local allocation tax denotes a failure in fiscal restoration through a decrease in local expenditures. Explicitly, general revenue issue is the crucial point in the "Trinity Reform" and was taken in advance in some official discussions. The opening on this issue was made by private sector staff of the Council on Economic and Fiscal Policy through their report "Toward the progress of the Trinity Reform" in August 2004, insisting that the scale of the Local Public Finance

Program and the amount of local allocation tax should be diminished. The Ministry of Finance also maintained to carry out drastic reduction in local allocation tax in its report "On the urgent reform on the Local Public Finance Program" in October 2004, contending to require (1) correcting and reducing improper "excess appropriation" (7-8 trillion yen) through the Local Public Finance Plan in FY 2005 and FY 2006, (2) vanishing the shortage of local fiscal resources (7.8 trillion yen) in the Local Public Finance Program, and (3) reorganizing local finance system toward being not dependent on local allocation tax.

The center of these arguments was the inappropriate "excess appropriation" in the Local Public Finance Program and diverting of these fiscal resources to other services than the central government expected for local governments to perform. The Ministry of Finance showed the samples of "excess appropriation" like non-subsidized capital expenditure ("excess appropriation" greater than actual expenditure), salary of local public officials (its level in excess of those of the central government and local private employees), transfers to local public enterprises (unreasonable fiscal burden in a portion to be covered by fees or charges), and general administration expenditure (increase in the amounts without their sound realities). In terms of the last point, the Ministry pointed out supports for individual assets (child seats in cars, raw garbage disposal machines, and so forth), recreation-related expenditures (domestic and international travels), rewards for marriage mediation, several kinds of celebration benefits (childbirth, school entrance and graduation, employment, marriage, respect for the elderly and so forth), subsidies for medical expenses for the infant and child and the seriously disabled. The Ministry regarded them as diverting general revenue resources to improper purposes. Moreover, the "warm reception problems" of public officials in the City of Osaka, some of which certainly seemed impermissible to the public, were widely paid attention to and criticized by both citizens and the central government, and turned much severer eyes on the uses of general revenue resources by local governments.

On the "excess appropriation" problem, the Ministry of Internal Affairs and Communications observed that since the excess amount of capital expenditure is approximately equivalent to the shortage amount of current expenditure, the claim that the amount of capital expenditure in the Local Public Finance Program was simply too much was not acceptable. The Ministry, in addition, suggested that these excess and shortage amounts were not huge in terms of general revenue resources in reality because they included such specific revenue resources as local borrowings and subsidies (**Table 1**). That is, though the Ministry also recognized the "imbalances in the amounts between the Local Public Finance Program and actual expenditures," it did not consider them as just improper "excess appropriation" and criticized the decrease of local allocation tax on this ground. Besides, the local allied bodies have required the central government to correct the imbalances for a few years.

Table 1. The Imbalance between the Local Public Finance Program and the Actual Expenditure in FY 2002

	Program	Actual Expenditure	Imbalance	(trillion yen) (general revenue)
Salary	24.5	25.9	1.4	-
General Administration Expenditure	20.0	26.9	6.9	2.9
Unsubsidized Capital Expenditure	15.6	10.6	5.0	2.6

Source: Ministry of Internal Affairs and Communications

These official discussions on this topic were not presented from the real managements of public finance in local governments and failed to seize how they made actual use of general revenue resources in their regions. Hence, the remainder of this paper mainly focuses on the analysis of this point.

. “The imbalance in the amounts between the Local Public Finance Program and actual expenditures” in general revenue resources

In this section, the “excess appropriation” or “the imbalance in the amounts between the Local Public Finance Program and actual expenditures” in general revenue resources is analyzed by examining the official data of some specific local governments, considering that the managements or uses of general revenue resources are assumed to be varied according to their scale and competence.

1. The Case of Small Local Governments

(1) Motoyama Town (Kochi Prefecture)

Motoyama Town is located in the mountain area of the center in Shikoku District and approximately 4 thousand people live there. The dominant character of Motoyama’s administration has been to put high priority on local medical and welfare policy. Motoyama has owned and managed its public hospital and performed its original welfare services for the elderly such as the subsidies for caring them at home and for taxies and buses for welfare use. As for the fiscal aspect of Motoyama, it is heavily dependent on local allocation tax from the central government as typical of small local governments. The core of general revenue resources in FY 2003 is composed of local tax 310 million yen and local allocation tax 1,920 million yen (1,530 million yen of regular allocation tax, 150 million yen of special allocation tax and 240 million yen of deficit bond).

“The imbalance in the amounts between the Local Public Finance Program and actual expenditures” in general revenue resources is possible to be examined to a great extent by comparing the amounts of “Standard Financial Need” (SFN) and actual general revenue expenditure, and the result of this analysis in the Motoyama case is shown in **Figure 1**. There are mainly two characteristic points to be suggested. First, while SFN on capital expenditures in public works and agriculture, forestry and fishery are much more excessive than their actual general revenue expenditures, much the same amount of general revenue shortage is seen in debt charges. The prevailing view in the government is that the excess amount of general revenue in capital expenditure is spent for general administrative expenditures including those

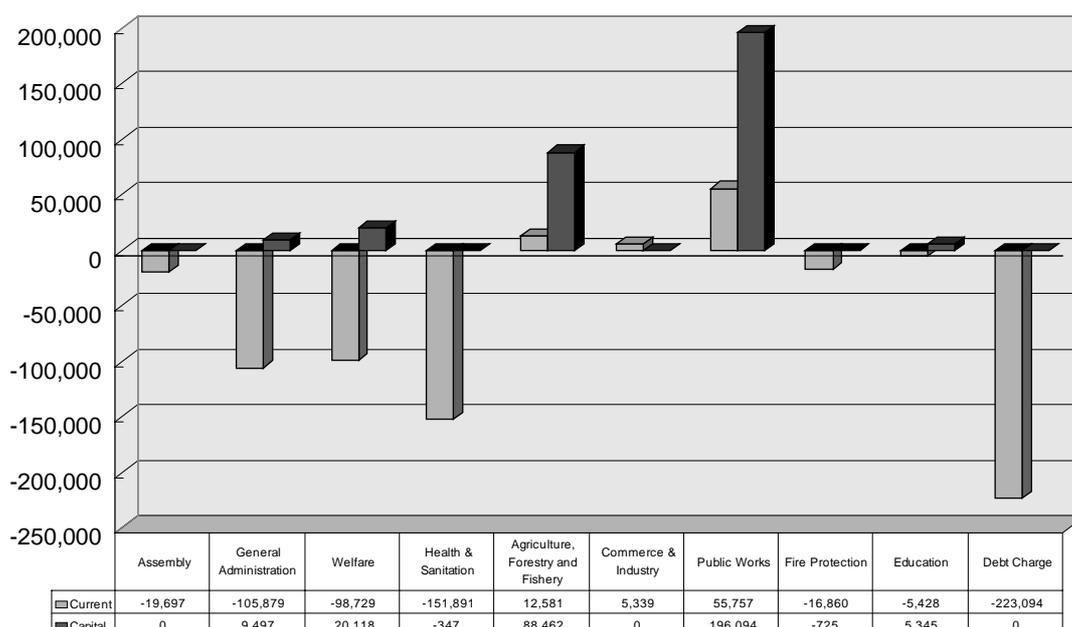


Figure 1 The Imbalance in the Amounts of SFN and the Actual Expenditure of Motoyama (FY 2003) (thousand yen)

considered unsuitable as the Ministry of Finance and the Council on Economic and Fiscal Policy exemplified. However, this result indicates that the excess of general revenue in capital expenditures is spent for the repayment for previous capital expenditures in monetary term. Second, current expenditures for such general public services as general administration, welfare, and health & sanitation suffer from serious general revenue shortage. This implies that most of public services in small local governments like Motoyama are poorly financed through the system of guaranteeing general revenue resources via the Local Public Finance Program computed by the central government.

For the detail analysis, specific expenditures in which the amount of actual expenditure exceeds SFN should be broken down. As for social welfare & security, though the current expenditure for the elderly is well covered by SFN, other current expenditures for child welfare and social welfare (excluding that for the elderly) are in serious shortage of general revenue resources. One of the dominant factors is excessive fiscal burden for expenses in salaries of public officials engaged in child day nursery. This fiscal burden is widespread over all the local governments in Japan. On the other hand, the celebration benefit for childbirth which is criticized as inappropriate by the Ministry of Finance occupies just 0.2% (2.5 million yen) of the total general revenue expenditure for child welfare. As for health & sanitation, the hospital-related current expenditure is the largest item in terms of general revenue in reflection of managing the public hospital, and the environment-related current expenditure with general revenue resources is also huge in the form of the sanitation center expenses. There is the subsidy for medical expenses for the infant and child in health & sanitation expenditure, but it comprises only 1.3% (3.4 million yen) of general revenue in this item.

It is summarized in the case of Motoyama that fiscal demands in welfare, medical, and environmental current expenditures are not covered by SFN and it is hard to regard them as improper diverting of general revenue resources to other purposes in general. On the contrary, it is reasonable to recognize that Motoyama makes ingenious use of general revenue resources to develop local medical and welfare services corresponding to their priority.

(2) Achi Village (Nagano Prefecture)

Achi Village has approximately 6 thousand residents and is in the mountain near Iida city. Achi has laid stress on tourist promotion with famous hot spring resort Hirugami area. In its master plan published in 2004, tourism-related industrial promotion with organizational relations to other industries is placed in the center of local economic policy. Like Motoyama, Achi heavily depends on transfer of financial resources from the central government and the ratio of local allocation tax in total fiscal revenue takes up more than 50%. In its general revenue, local tax accounts for 640 million yen and local allocation tax (including deficit bonds) 2,080 million yen in FY 2003.

The imbalance in the amounts of SFN and actual expenditures of Achi is shown in **Figure 2**, indicating the same sort of characters as the Motoyama case. However it should be notable that the actual current expenditure in commerce & industry is much larger than SFN for it. This is intensely related with industrial promotion policy of Achi. In this expenditure, the general revenue resources are spent for a tourist association and other industrial-related works that are supposed to be essential for tourist promotion policy. In short, Achi also spends the general revenue resources corresponding to their policy priority set.

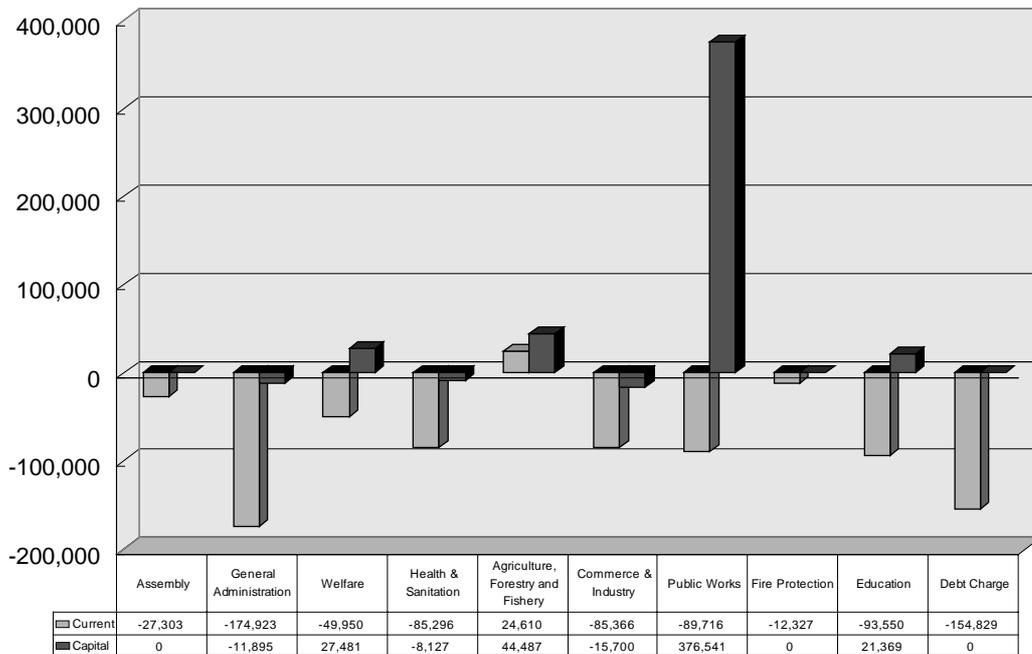


Figure 2 The Imbalance in the Amounts of SFN and the Actual Expenditure of Achi (FY 2003) (thousand yen)

2. The Case of City government (Sakai City)

As a case of city government on the imbalance situation in general revenue, the city of Sakai at Osaka is examined here.

Sakai is the old and second biggest city of Osaka with nearly 790 thousand citizens at the end of FY 2004. The financial condition of Sakai has been recently deteriorated and so the ratio of local allocation tax in total revenue accounts for more than 15%. The main general revenue in FY 2003 comprises local tax 114 billion yen and local allocation tax 42.2 billion yen.

Figure 3 shows the imbalance in the amount between SFN and actual expenditures in Sakai. There are several characteristic points described as follows. First, in capital expenditure for public works SFN is much more than actual expenditure like the case of small local governments and this imbalance in the amount of public works exceeds the

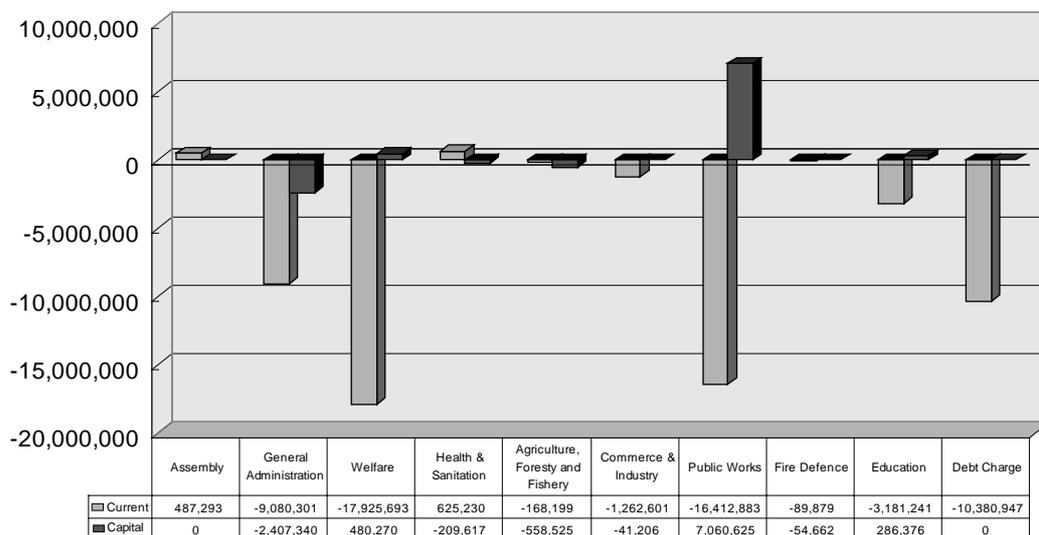


Figure 3 The Imbalance in the Amounts of SFN and the Actual Expenditure of Sakai (FY 2003) (thousand yen)

shortage amount of general revenue in debt charge to a great deal. Second, the current expenditure in public works suffers from a serious shortfall of general revenue resources. This distinguishing feature is not seen in small government cases²⁾. From the breakdown of this expenditure item, the shortage of general revenue is caused by the expenditures for sewerage service, town planning & park, and road and bridge. The general revenue shortage in the current expenditure in public works greatly exceeds the general revenue surplus in the capital expenditure of them. This reason is that the repair and maintenance related costs and the transfer to debt charges for sewerage service suffer from scarce general revenue resources. In this regard, it should be emphasized that the present estimation of SFN is by no means appropriate for the fiscal demands of repair and maintenance necessary for constructed infrastructures, and the general revenue excess of capital expenditure in public works also corresponds to that shortage of current expenditure in them like that in deficit charges. In short, current expenditures in public works as well as deficit charges are assumed to be struggled in making both ends meet within the general revenue funds of public works. Third, the enormous amount of general revenue shortage is observed in the current expenditure of welfare. The breakdown of it indicates the major factors of the shortage are connected to welfare expenditures for the disabled and children. Besides, with regard to current expenditure in welfare for the elderly, Sakai faces the general revenue scarcity, too. In summary, big city governments like Sakai are assumed to suffer from the current general revenue shortfall in general.

. Concluding Remarks

From the case analysis mentioned above, some overlooked or mistaken points on the issue of the "excess appropriation" through the Local Public Finance Program are proposed. First, the important function of general revenue to enable "local autonomy" in public administration is overlooked. As is typically observed in the case of small ones, local governments perform administrative policies on their own initiative with general revenue resources. Welfare and medical administrations in Motoyama and industrial administration in Achi are the examples and they are extremely hard to be captured by the standardized computation and distribution of financial resources by the central government. By means of skillful uses of general revenue resources in local governments, regional societies can be satisfied with proper sets of their own public administrations. Second, on the contention of excessively guaranteeing general revenue resources for capital expenditures, taking into account the shortage of them for current expenditures in debt charges and repair and maintenance costs caused by improved infrastructures, they are presumed to be diverted to public works themselves as well as other general administrative services. The official controversy in the government completely fails to notice this point, although a recent great expansion of local capital expenditures was certainly led by the central government so that it is supposed to be considerably responsible for these shortages. Third, while any type of local governments suffer from a structural shortage of general revenue resources in current welfare expenditure, the shortages of them are suffered by small local governments in health & sanitation expenditure and by city governments in current expenditure for public works. These general revenue scarcities are insufficiently covered by SFN and no specific examination has been carried out in the course of the discussion on "excess appropriation" problem. Fourth, as for the diverting of general revenue resources to inappropriate purposes as the Ministry of Finance emphasizes, it is not deniable that this issue seems to be remarkably exaggerated, considering the total amount of general revenue resources in local governments. In addition, it should be deliberately judged whether such diverting purposes are sound or not in the light of administrative needs by respective residents, since "general revenue" means that the freedom of local governments in carrying out their functions with it is not impaired in principle.

Although the Local Public Finance Program is supposed to be indispensable for sustaining fiscal management and public service supply by local governments, a drastic curtailment in its scale on the ground of the "imbalance" should be

avoided. The primary way for the betterment of the Program is to correct the “imbalance” in both shortage and excess items simultaneously through strict investigation in the realities of local governments by type. Since such local public services as welfare, environment, and health are quite less adequate than public infrastructures, it is inevitable to divert the fiscal funds on infrastructure to those general public services. The fiscal reform in this direction should be expanded over the total characteristic of Japan’s public finance. The current “Trinity Reform” may be the touchstone of the entire fiscal reform in the age of mature and sustainable society.

NOTES

- 1) In this paper, I include in local allocation tax the deficit bond “Rinji Zaisei Taisakusai” that has been introduced as a substitution for a portion of local allocation tax since FY 2001.
- 2) The same fiscal condition is seen in other big cities like Kyoto.

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