

China's Fiscal Position and Policy: Current Status of Local Government Debt Problems and Challenges

Jiro Naito

Vice President, Daito Bunka University/Professor, Faculty of Economics

Abstract

As for China's fiscal position, the central government's fiscal position is relatively sound, while local governments' fiscal position is threatened by growing risks, mainly the expansion of debts and bad loans. This is clear from the results of the audit by the National Audit Office of the People's Republic of China (which is the Chinese equivalent of the Board of Audit of Japan). Given that China still maintains a high economic growth rate of around 7.5%, holds a huge amount of foreign currency reserves and is recording a large amount of current account surplus, government debts are unlikely to cause major disruptions to the Chinese economy as a whole in the short term. However, if fiscal problems arise in some regions and the impact spills over into other parts of the country, or if the impact stalls reform and delays resolution of problems, a serious crisis will occur sooner or later. To prevent such a situation, China needs to overcome a pile of challenges, including tax and fiscal system reforms, enhancement of the fiscal transfer system, the development of laws and regulations related to local fiscal policy and appropriate fiscal management based thereon, and appropriate allocation of administrative powers, revenues and responsibilities between the central and local governments. These are challenges that can in no way be skirted if the current government is to achieve its goal of carrying out economic structural adjustments and reforming the functions of government, so actions to overcome them must not be postponed. Amid the growing signs of a slowdown of the economy, fiscal policy has an increasingly important role to play, and the time left for reform is limited.

Keywords: local government debts, intergovernmental fiscal relations, administrative and fiscal policies

JEL Classification: H6, H7, O2

I. Introduction

Since the new administration was launched, China has continued its positive fiscal policies, but has adopted a conservative stance toward massive public projects. The problems of excessive production capacity and real estate market heating up followed by a large-scale economic package after the Lehman fall explain China's current stance. A clear picture has emerged of central government finances being relatively healthy, while local governments have serious debt problems. The audit findings published by the National Audit Office

(equivalent to the Board of Audit in Japan, the Audit Office thereafter) at the end of 2013 also revealed the situation. The issues involved in China's finance include a variety of problems, such as tax and fiscal system reform, the reform of the local administration control system, the coordination of central and local relations, and local debt. These have been the pending issues for many years, but have not reached fundamental reforms.

In the Third Plenary Session of the 18th Chinese Communist Party Congress (the Third Plenum of the 18th Party Congress) in 2013, the reform of the tax and fiscal system was addressed as an important issue in economic policies. In addition, in the National People's Congress in 2014, specific problems and issues were pointed out. The implementation of the reform of the tax and fiscal system will be imperative in the transformation of government functions, which is the aim of the current administration. At the same time, coordination of the allocation of administrative duties, authority, and financial resources in intergovernmental fiscal relations was set to be an important issue, stressing the need for tax and fiscal system reform more than ever. Without simultaneous implementation of these related reforms, the government can neither play its role of stabilizing macroeconomics nor solve the local debt problem.

Here, I will ascertain China's fiscal status using recent data, and identify the complete picture of China's fiscal situation, including fiscal structure and balance sheet trends. In addition, I will analyze the audit findings published by the Audit Office at the end of 2013, and examine the current status and problems of local debt in detail. Furthermore, I will discuss various reform trends and challenges, such as the taxation system, coordination of central and local fiscal relations as well as urbanization and fiscal problems

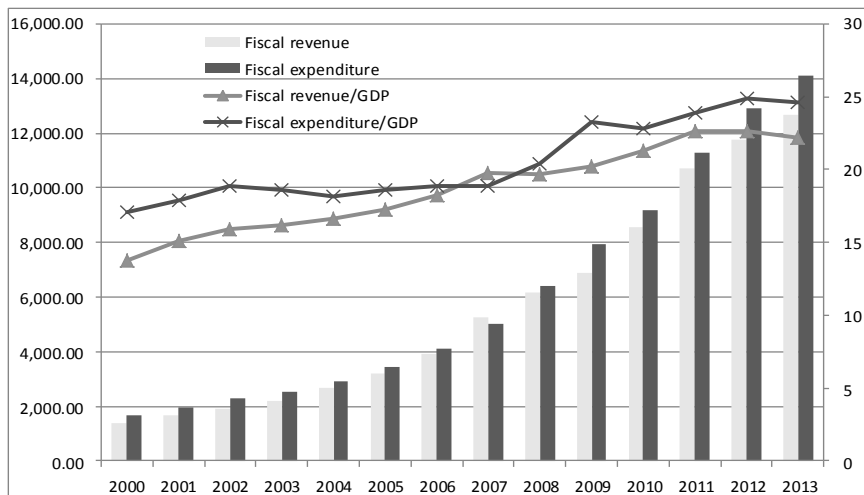
II. Verification

Through the index for fiscal year 2013, I will look into the circumstances of fiscal balances, the income and expenditure structure, and the current status of fiscal deficits.

II-1. Fiscal Balances

China's national fiscal revenues for fiscal year 2013 climbed 10.1 percent (1.18 trillion yuan) compared to the previous fiscal year, reaching 12.9143 trillion yuan. Of the total fiscal revenues, approximately 6 trillion (+7.1%) and 6.9 trillion yuan (12.9%) belonged to the central government and local governments, respectively. China's fiscal expenditures, on the other hand, increased about 1.37 trillion yuan (+10.9%) compared to the previous fiscal year, reaching 13.9744 trillion yuan, of which about 2 trillion (+9.1%) and 11.9 trillion (+11.3%) belonged to the central government and local governments, respectively.

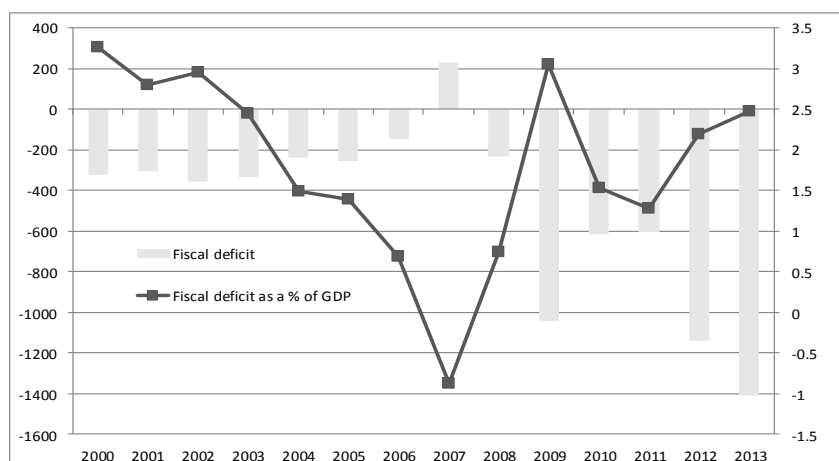
Figure 1. Transition in Fiscal Balances (Unit: 100 million/%)



(Source) Ministry of Finance of the People's Republic of China, National Bureau of Statistics

China's fiscal scale has grown along with its economic growth, multiplying tenfold in the period from 2000 to 2012, and has witnessed average annual growth rates of 20 percent or more. Although the fiscal revenue-to-GDP ratio in 2000 was about 14%, occupying quite a small portion, it became about 23% in 2012, the same level as the ratios in Thailand and South Korea. Talking about the ratios between the central and local governments, fiscal revenues are evenly contributed by both parties, while 15% and 85% of the expenditures are accounted for by the central government and local governments, respectively. The ratios have remained almost at the same level for the last few years.

Figure 2. Transition in Fiscal Deficit (Unit: 100 million/%)



(Source) Ministry of Finance of the People's Republic of China, National Bureau of Statistics

The fiscal deficit has climbed to approximately 1.6 trillion yuan in 2013, and the deficit-to-GDP ratio increased to 2%, from 1.6% in 2012. The issuance of bonds by local governments increased by 100 billion yuan to 350 billion yuan in 2013 compared to 250 billion yuan in 2012. The fiscal deficit in 2014 is expected to be at the same level, but some say that the amount of bond issuance by local governments will increase by an additional 50 billion to 400 billion yuan.

II-2. Important points and challenges

As to China's fiscal situation, while the central government is in a relatively healthy financial condition, the debt status of local governments has always been ambiguous and their financial health often raises concerns. Overall, the fiscal revenue and expenditure of the central government was stable in 2013, maintaining a relatively healthy condition. With respect to the local fiscal situation, however, there is increasing concern about local debt problems as the amount of bond issuing increases. A picture which describes the central government as having relatively healthy financial conditions while there is increasing concern about risk in local government finances has been evident. Under these circumstances, China has continued its positive fiscal policies, but has adopted a conservative stance in massive public projects for the purpose of stimulating the economy, without any big changes in the expenditure patterns.

It should be noted that non-tax revenues have grown extensively. The non-tax revenue in 2013 was 1.86 trillion yuan, up by 12.1% from the previous year. While the non-tax revenue of the central government reaped an increase of 22.9% to 354 billion yuan, that of local governments increased by 9.8% to about 1.51 trillion yuan. Above all, government-managed funds expanded remarkably and the revenue from national government-managed funds grew by 39.2% to about 5.22 trillion yuan. Of the funds, the central-government-managed funds increased by 27.5 percent to about 432 billion yuan, especially in the area of energy and environmental taxation. The revenue from local-government-managed funds reaped an increase of 40.3% to 4.8 trillion yuan, especially in land- and resource-related areas. The expenditure of the national government-managed funds increased by 37.9% to approximately 5 trillion yuan; the expenditure of central-government-managed funds increased by 26.9% to 276 billion yuan, and that of local-government-managed funds increased by 38.6% to about 4.736 trillion yuan. The expansion of governmental funds is a recent characteristic, and an increase in resource- and property-related funds is prominent.

In this context, the revenue from property-related funds increased significantly. The business tax increased by 9.3% to about 1.72 trillion yuan, the property business tax increased by 33.6% to about 540 billion yuan, the construction business tax increased by 16.5% to about 430 billion yuan, the property contract tax (local) increased by 33.8% to about 380 billion yuan, the land appreciation tax (local) increased by 21.1% to about 330 billion yuan, the agricultural land occupation tax increased by 11.6% to about 180 billion yuan, and the township land usage tax increased by 11.5% to 172 billion yuan, meaning that the increase in

tax revenues related to land and real estate was significant. In 2013, in fact, the transfer of revenue from governmental funds from the central government to local governments increased by about 56%, and at the same time, land transfer revenue of local governments increased by about 45%, accounting for about 35.3% of temporary revenue and about 24.6% of total revenue after the transfer.

As just described, China's fiscal status has depended heavily on land and real estate, and the trend is more prominent, especially in local governments. Because of this, local government finances might be subject to influence from the real estate market, causing financial instability. As the fall of real estate prices and control of land transaction might lead to a decrease in revenue, it makes it difficult for local governments to adopt tightening policies on the real estate market, such as restrictive monetary policies related to real estate and restriction of transactions. For financial stabilization and especially for fiscal soundness of local governments, drastic tax reform will be extremely important to reduce dependence on revenues related to land and real estate, and to ensure stable revenues.

Table 1. Financial Dependence on Land Transfer Revenue (Unit: 100 million)

	Central		Local		Nationwide	
	2012	2013	2012	2013	2012	2013
Publicfiscal revenue	56133	60174	61077	68969	117210	129143
Central→Local	-45383	-48857	45383	48857	0	0
Government-managed fund revenue	3313	4232	34204	48007	37517	52239
Central→Local	-1180	-1836	1180	1836	0	0
Primary revenue	59446	64406	95281	116976	-	-
Revenue after the transfer	12883	13713	141844	167669	154727	181382
Land transfer revenue of local governments in 2013			28517	41250	35.3% (*1)	24.6% (*2)
	*1 (as a % of temporary revenue)					
	*2 (as a % of revenue after the transfer)					

(Source) Ministry of Finance

III. Local-government Debt

Local-government debt has attracted remarkable attention since the publication of the investigation and audit by the Audit Office in June 2011. Local-government debt has expanded rapidly, underscoring growing concerns about the situation. In August 2013, the Audit Office once again conducted a nationwide investigation and released the results in December of the same year. Here, I will look at the current status and problems of China's local-government debt by examining the results of the reinvestigation.

III-1. The Status of Local-government Debt

As shown in Table 2, a large-scale extensive investigation into each level of sections and organizations of local governments was conducted all over China from June to August 2013. Since poor transparency in the local fiscal situation was pointed out as a huge risk factor, it has been urgent to increase the transparency. Unless the problems of local governments are addressed urgently, they might have a serious impact on the entire Chinese economy. For this reason, the large-scale investigation reveals a sense of crisis in the central government about local-government debt.

Table 2. Brief Summary of 2013 Investigation by the Audit Office

Investigation period	June-August 2013
The number of investigators	The number of investigators: Total of 54,400 investigators
Areas investigated	Central and provincial level: 31, Government-designated cities: 5 City level: 391, County level: 2,778, Township level: 33,091
Organizations investigated	Government sectors and organizations: 62,215, Local Government Financing Vehicles: 7,170, Expense-Subsidized business units: 68,621, Public business units: 2,235, Others: 14,219
The number of items investigated	730, 065
Debts investigated	2454635

(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

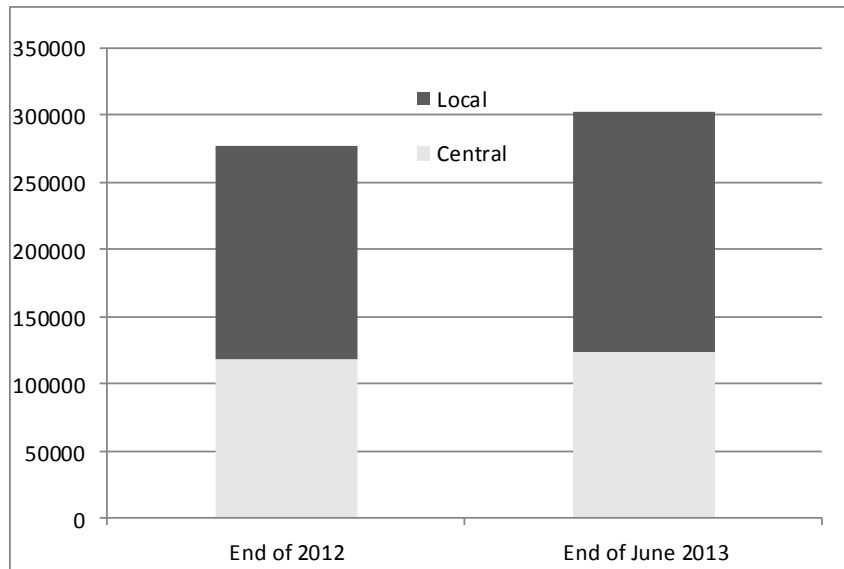
When comparing the scale of governmental debt, the central government and local governments accounted for about 11.9 trillion yuan and about 15.9 trillion yuan at the end of 2012, respectively, and 12.4 trillion yuan and 17.9 trillion yuan at the end of June 2013, respectively. Both the scale and growth became huge in local government sectors.

Table 3. The Scale of Central and Local Government Debts

	End of 2012	End of June 2013
Central	11.883 trillion yuan	12.384 trillion yuan
Local	15.885 trillion yuan	17.890 trillion yuan

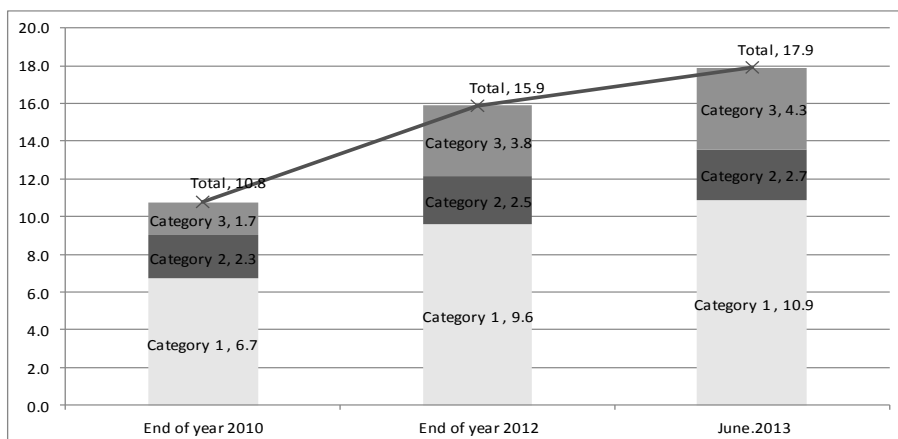
(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

Figure 3. Scale of Balance of Debt between Central and Local Governments (Unit: 100 million yuan)



(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

Figure 4. Transition in Total Amount of Local Debt (Unit: trillion yuan)

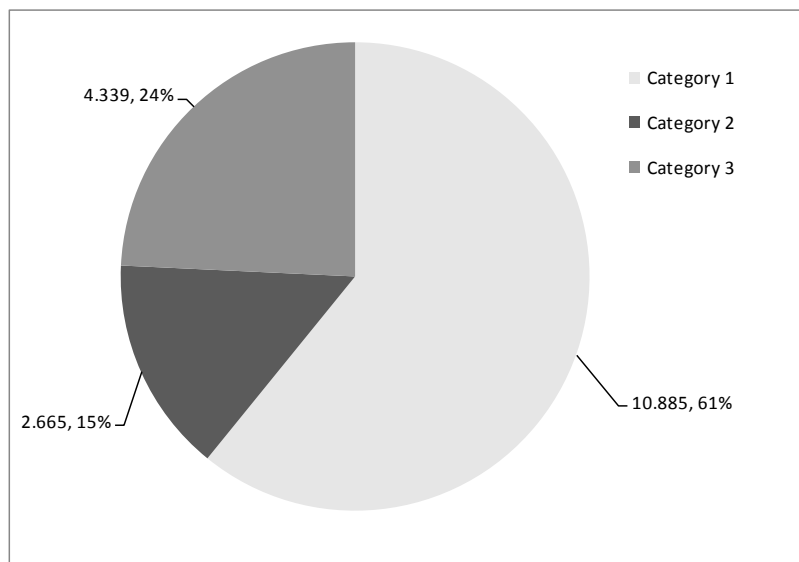


Category 1	Direct debt of governments, who borrow and must repay out of fiscal funds
Category 2	Debt guaranteed by governments, who assume responsibility if the borrower defaults
Category 3	Other related debt, for which governments won't assume responsibility unless the borrower defaults (including loans borrowed by public institutions and enterprises for public welfare projects)

(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

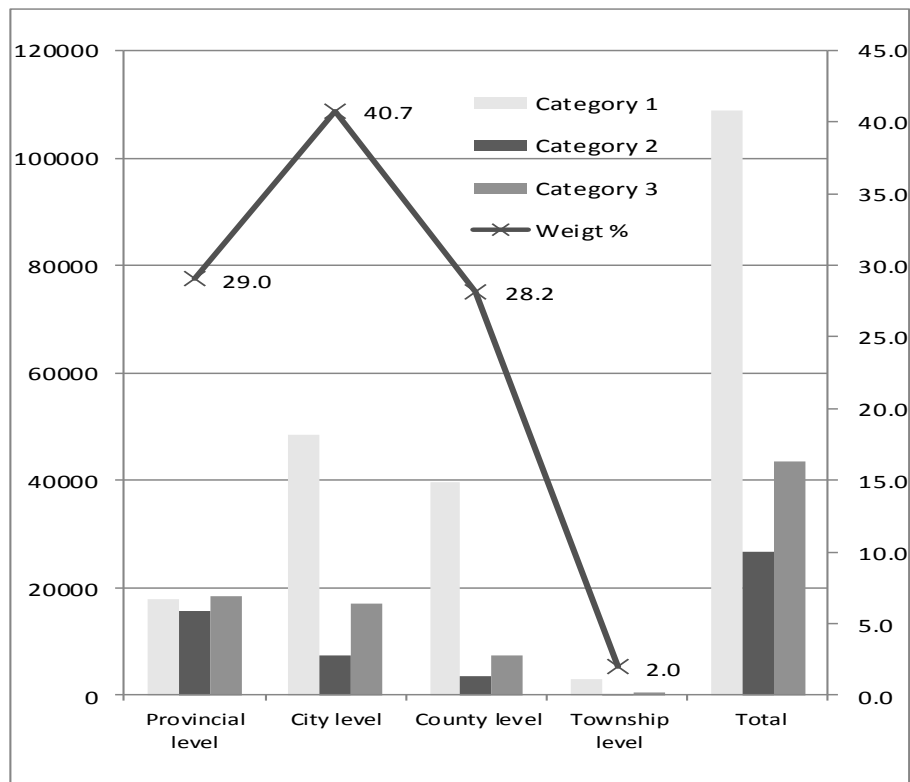
Total debt of local governments accounted for 15.9 trillion yuan at the end of 2012, and continued to increase to 17.9 trillion yuan at the end of 2013, which is an increase of about 67% compared to the 10.8 trillion yuan at the end of 2010. While the debt-to-GDP ratio at the end of October was 27%, the one at the end of June 2013 accounted for 32%, which includes about 10.9 trillion yuan of Category 1 (61%), about 2.7 trillion yuan of Category 2 (15%), and about 4.3 trillion yuan of Category 3 (24%). The ratio does not show any remarkable change compared to the past.

Figure 5. The Debt Scale of Local Governments (end of June 2013)
(Unit: Trillion yuan)



(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

Figure 6. The Debt Balance of Each Administrative Level of Governments
(Unit: 100 million/%)



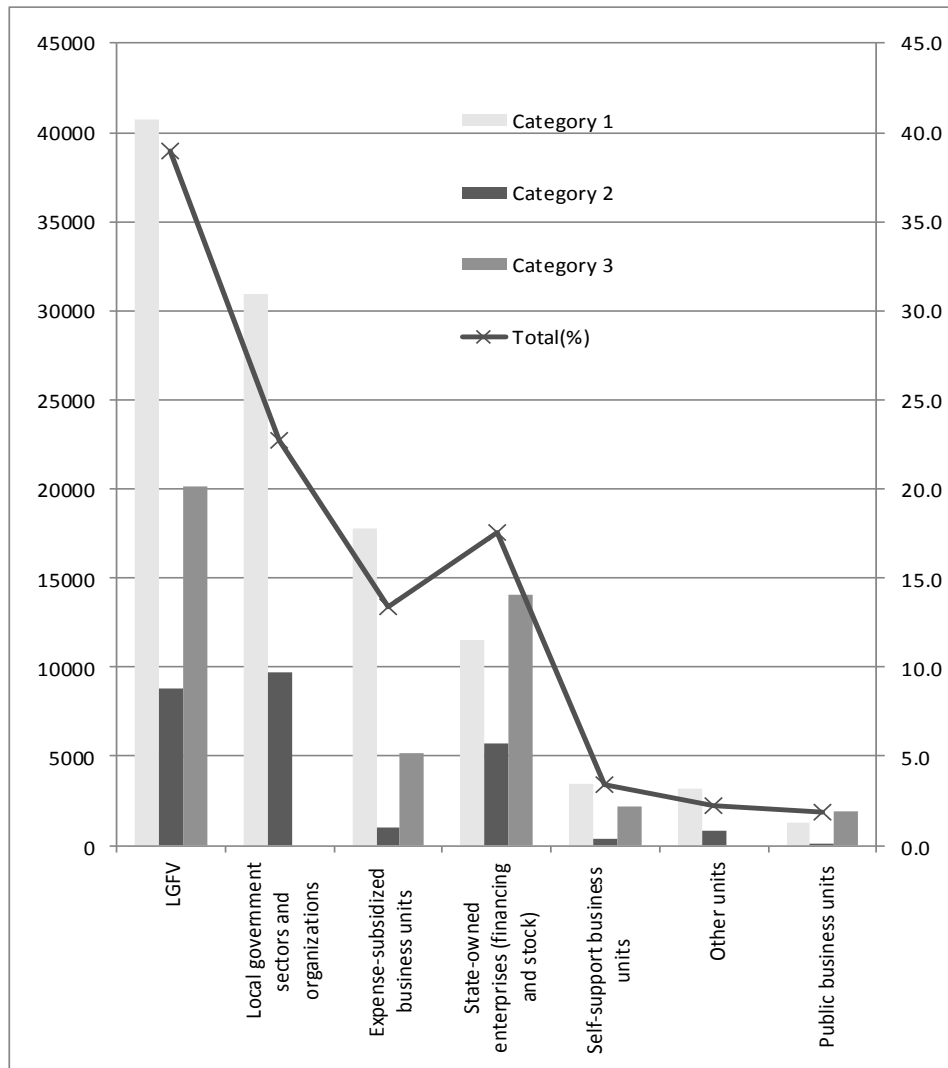
(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

As to the total debt for each administrative level of government, although the percentage of city (district) level government decreased to about 40% from the end of October, it remains high. This is because there is a relatively bigger scale of areas in some city (district) level governments, and the numbers of units increased due to the administrative reform. It should be noted that the debts of relatively small county and township governments include many hidden contingent liabilities, such as unpaid government employees' salary and project costs, lack of social security funds caused by uncollected and misappropriated money, misappropriate use of the agricultural cooperation fund, loss from bad debt, as well as debt-guaranteed loans.

As to the debt balance by borrower, the percentage of Local Government Financing Vehicles (LGFV) accounted for 39% of the total debt. Although the percentage decreased compared to 46% at the end of 2010, LGFV dominates a large portion of the debt. A big difference from the previous investigation is that borrowings by state-owned enterprises (financing and stock system) have been revealed. The debt balance was 3.1 trillion yuan, accounting for 17.5% of the total debt. After the previous investigation, concern about the

local debt problem has increased, leading to the decreased borrowings by LGFV as the result of strengthening control for it. Because of this, procurement of funds through state-owned enterprises increased. There is a concern that the diversification of borrowing entities, which are related to local governments, creates opaqueness and complicated local debt.

Figure 7. The Debt Balance by Borrower (Unit: 100 million/%)

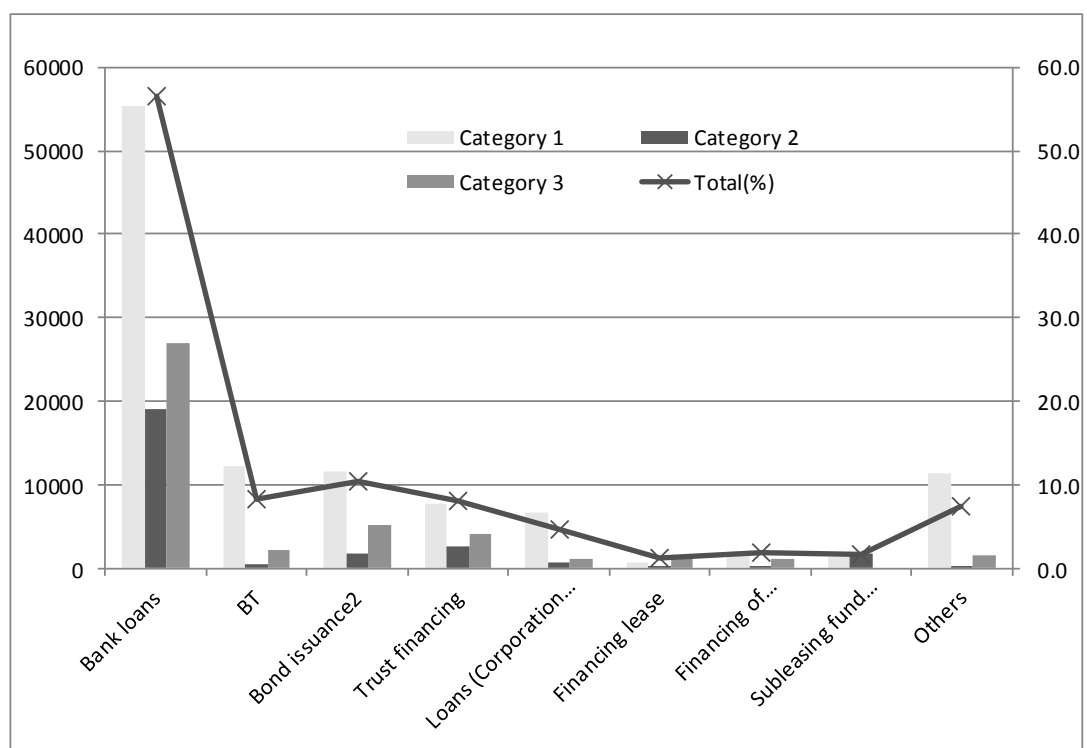


(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

Although bank loans are still the main routes for financing, their share has decreased to 57% from the 80% at the end of 2010, with the percentage of bond issuance increasing. Especially after 2012 the amount of bond issuance climbed to 3.2 trillion yuan, compared to

the 2.1 trillion yuan in the previous year. The amount includes many urban construction bonds issued by LGFV. It is noted that financing routes except for bank loans or bond issuance such as BT (Build and Transfer System), trust financing, financing lease, and financing of financial institutes, have become diverse. These routes are considered to be closely related to shadow banking.¹ As to shadow banking, off-balance-sheets for Wealth Management Products (fund management products) of commercial banks without guarantee of principal are sometimes used as bypass loans to avoid regulations on financing. Strengthening regulations and control on LGFV has greatly influenced the increase of shadow banks.

Figure 8. Debt Balance by Fund Procurement Method (Unit: 100 million/%)

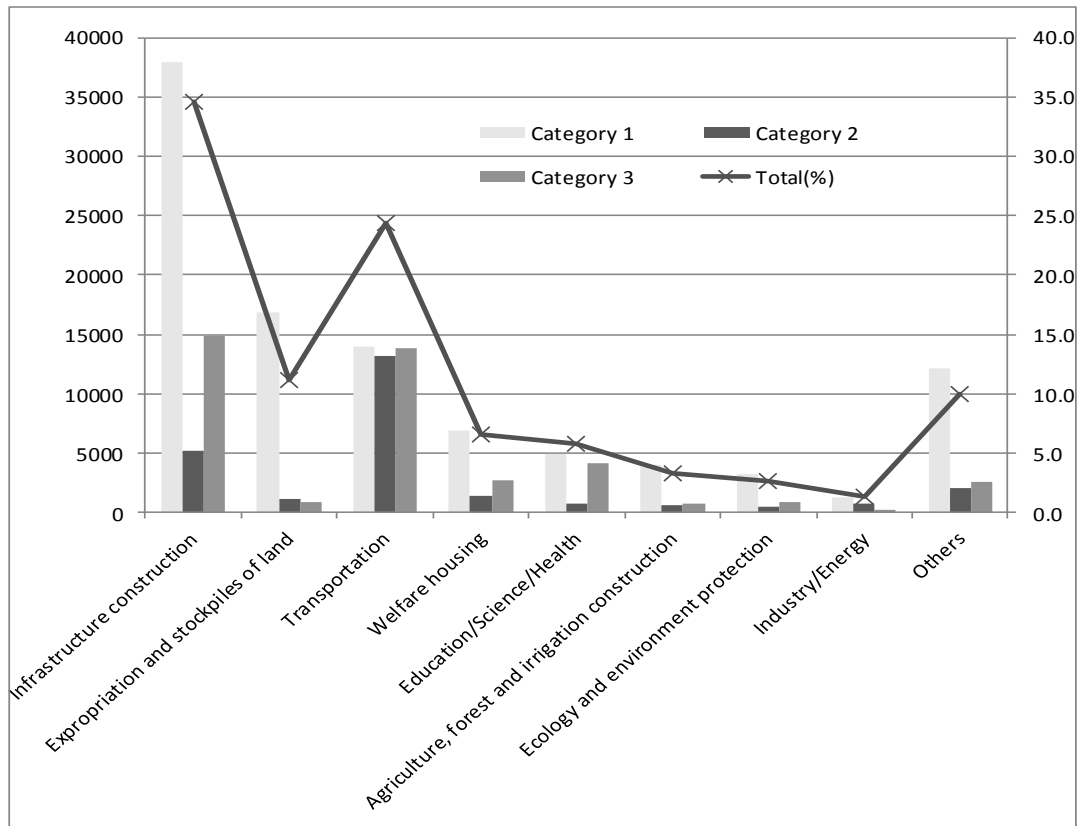


(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

¹ The funds raised by trust companies, investment funds and moneylending businesses by selling Wealth Management Products (fund management products) are invested in projects for real-estate development or infrastructure construction as well as public projects of local governments on a large scale, creating concerns about risk

The use of funds provided by local governments mainly includes development-related investments such as infrastructure and transportation as well as expropriation and stockpiles of land, and the trend has not change greatly. In particular, debt related to expressway construction is acknowledged as a problem. The amount of debt repayment for construction of expressways reached 1.94 trillion yuan at the end of June 2013, accounting for about 13% of total local debt related to expressways if the 440 billion yuan is added, causing a fiscal burden on local governments.

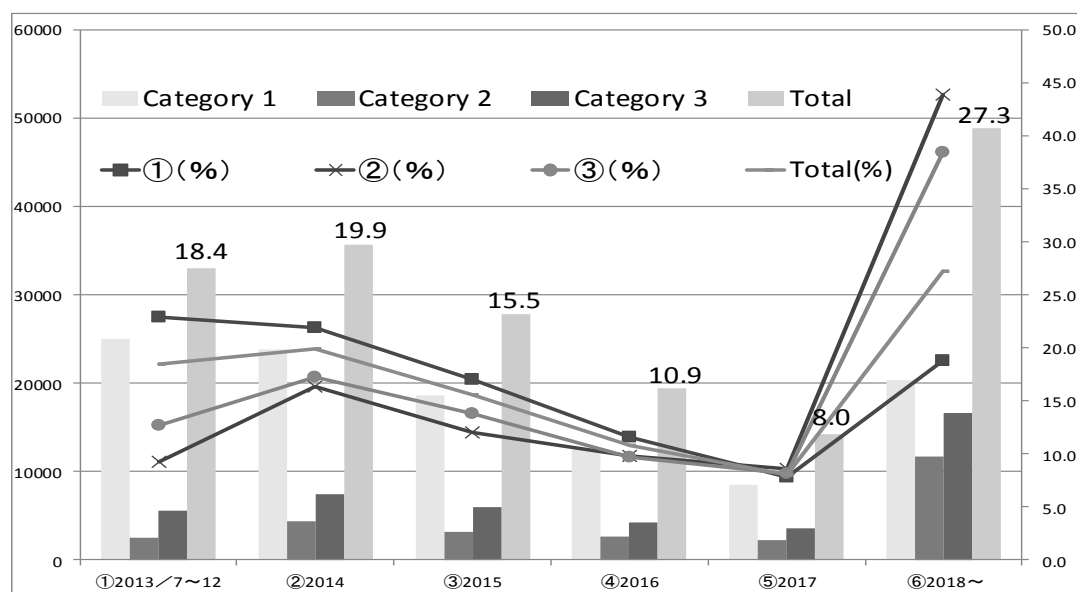
Figure 9. The Use of Procured Funds (Unit: 100 million/%)



(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

Under the current situation of local debt, debt redemption is another concern. About half of the total debt will mature before the end of 2015 and about 65% before the end of 2016. The pressure for debt redemption is growing every year. More than 20% of new debt has been used for past debt repayment, making new debt issuance in 2012 twice as much as that in 2011. The situation causes a vicious cycle in which redemption of past debt leads to the expansion of new debt issuance.

Figure 10. The Debt Balance/Percentage by Redemption Period (Unit: 100 million/%)



(Source) Audit Results of Nationwide Governmental Debts by the National Audit Office (2013)

III-2. Analysis and Evaluation

Concerning the status of local-government debt, the Audit Office mentions that the government debt-to-GDP ratio is below 60%, which is the international standard,² and evaluates the risk as being controllable. If we look in detail, however, there are some problems and challenges to point out.

The first problem is the grounds that the Audit Office claims. The Audit insists that the government debt-to-GDP ratio at the end of 2012 should be 39.4%; however, that is an underestimation because only the debt actually repaid by government funds out of the national total debt has been calculated as a percentage of debt. Therefore, some calculations put total debt as about 54% of GDP, while others estimate that the percentage will be over 60% if the debts of the China Railway Corporation, policy banks, and the National Asset Management Company are added.³ The second problem is that the funding routes are dominated by bank loans, and that most borrowers are LGFV. The third problem is that the

² The criteria of the European monetary union regarding fiscal deficits are the same as international criteria. According to the criteria, a single-year's fiscal deficit should be less than 3% of GDP, and accrued debt balance should not be more than 60% of GDP. The level of fiscal deficit is supposed to be determined on the basis of the criteria.

³ Calculated as the total debt balance as of the end of June 2013.

debt is heavily dependent on land-related revenue. In particular, debt redemption by land-transfer revenue increased greatly to 37% at the end of 2012 compared to the 24% at the end of 2010, showing a profound affect by the real estate market. The fourth problem is that debt has increased so rapidly. Total debt at the end of June 2013 increased by about 20% compared to that at the end of 2010, and the division was about 14.4% for the provincial level, about 17.4% for the city (district) level, and about 26.6% for county-level governments, indicating a more remarkable increase among lower-level governments. The fifth problem is the disparity in the debt status. As mentioned previously, the debt ratio of the expressway division has expanded. At the end of 2012, three districts at the provincial level had a debt ratio over 100%, as did 31 at the city (district) level and 3,465 county-level governments, putting a greater burden of debt on some areas or industries. There are big differences in the debt ratio between districts. For instance, the debt balance is about 1.48 trillion yuan for Jiangsu province and about 1 trillion yuan for Guangdong province, and the debt-to-GDP ratio is about 79% for Guizhou province and about 62% for Chongqing. Although China's economy is on a decelerating trend, it is highly unlikely that government debt will have a strong impact on its economy thanks to economic growth between 7 and 8%, about 3.8 trillion dollars of foreign reserves, and over 180 billion dollars of current account surplus. However, if the problems rise to the surface, their influence will spread to other places and cause economic and social confusion. It is needless to say that full attention to such issues as strengthening control, securing transparency, and consolidating systems is necessary. There are piles of problems concerning local debt, and managing them will not be easy.

III-3. Short-Term Challenges

Because local debt problems are deeply related to shadow banking problems, risk management is extremely important. In order to adequately control debt, qualified screening, limiting debt increase by strengthening control and steady repayment will be needed.

A scheme for debt management using an asset management company is one idea. In China, asset management companies were established one after the other for the purpose of disposing the bad loans of four big national commercial banks from the late 1990's to the early 2000's and attained certain progress. If the bonds of borrowers, such as LGFV, become non-performing loans and grow in the future, loan disposal by the asset management companies will be expected. Moreover, it will be necessary to sell state-owned assets that the local governments possess. The capacities of the companies are limited; therefore, if nonperforming loans expand ultimately, the central government will have to compensate for the loss.

On the other hand, as a funding route for local governments, the expansion of the local bond system is indispensable. Under the strict control of the central government,⁴ China lifted a ban on local bonds in a very revolutionary way, in which the Ministry of Finance issued them as a proxy to secure 4 trillion yuan for economic measures after the Lehman fall and for the continuation of fiscal policies. At the beginning, economic measures by securing

financial resources were the main purpose; therefore, the discretion of local governments was limited. In October 2011, the Ministry of Finance announced the experimental issuance of ‘self-issued local government bonds’ for which local governments do the practical work. If the issuance of local bonds increases, the whereabouts of debts might be revealed. It is expected that the discretion and responsibility of local governments on the fiscal front will be strengthened and that transparency in the debt situation will be increased. In order to expand the procurement of financial resources by issuing local bonds, it is urgent to secure an original funding source for local governments by increasing local tax revenues, and to develop legislation, including a local tax law and local fiscal law.

As a matter of course, it is important to limit the increase of local debt for the fiscal soundness of local governments. To that end, building a structure to overcome investment-dependent growth will be indispensable.

In 2014, the Local People’s Congress launched a reform for a performance assessment system and announced that the performance, including support for the environment and energy conservation, the resolution of excessive plants and equipment, and investment control and chaotic investment reduction will be comprehensively judged, and that local debt status will be utilized as an important index for evaluation. This is major progress and it will be an ongoing challenge to control local debt by revising the performance review.

IV. Related Reforms

In association with the problem of local debt, there are many challenges from tax and fiscal aspects. In this section, I will review the situation of tax system reform, including the ongoing ‘Business Tax to Value-added Tax transformation’ reform,⁵ an issue concerning the fiscal relationship between the central and local governments, and the problem of urbanization and fiscal burden, regarding which, a policy to address it is regarded as one of the most important.

IV-1. Trends and Challenges in Tax System Reform

In order to achieve fiscal soundness and clarify the role of the government to enable steady implementation, fiscal resources are necessary and tax system reform will be indispensable. In China, the tax structure is mainly dominated by indirect tax. The value-

⁴ The local bonds should be issued under the strict control of the central government, the permission of the State Council is needed, the issuance and repayment should be performed only by provincial-level governments, and the Ministry of Finance substitutes the issuance (the yield is basically the same as that of government bonds). These measures may limit the increase of local bond issuance, but they do not reflect the financial power, credit, or risks of local governments.

⁵ The reform to simplify the tax system by integrating the business tax into the value-added tax. The value-added tax is equivalent to Japanese consumption tax, and the businesses incur a consumption tax imposed on service.

added tax (equivalent to consumption tax in Japan) is the main tax, accounting for about 50% of tax revenue. If the consumption tax and the business tax (value-added tax on service) are included, it will account for about 70% of tax revenue. On the other hand, the corporate income tax and personal income tax account for only 25% of tax revenue in total, and other taxes, such as the resource tax, the property act tax and the specific purpose tax account for the remaining approximately 10%. Although the problems and necessary reforms concerning the tax system have been continuously mentioned, radical reforms have not yet been achieved. As the resolution of income disparity is a big issue in China, it is necessary to reconsider the direct/indirect tax ratio to increase the percentage of direct tax with a higher redistributing function. Concerning that point, some challenges about tax system reform can be pointed out.

For instance, personal income tax consists of 11 categories of income. An excess progressive taxation system is applied to employment income, and a separate taxation system is applied to other income categories. Since the tax rates for other income and the transfer income tax are fixed at 20%, affluent people take a tax-reduction strategy by increasing income in these categories, inviting a sense of unfairness due to the flaws in income capture and tax collection. It is an urgent task to capture income and properly impose tax at the same time as well as to simplify the personal income tax. On the other hand, the number of income-tax payers decrease because of rapid hikes in the minimum income tax as the economy and wages grow. It may adversely influence the fiscal resources which support ballooning social security expenses, including medication and pensions, and education expenses. In order to secure the taxation base, the entire picture of the personal income tax should be reviewed. Introducing the system of Japanese resident and business taxes could be one idea to strengthen local government finance.

It is an urgent task to introduce an inheritance tax, gift tax, and fixed property tax in conjunction with income tax reforms. These taxes have been a focus of discussion and implemented on a trial basis, but they have not achieved full-scale introduction. As to the introduction of the inheritance tax, it is important to strengthen the tracking of assets to prevent hiding them. At the same time, it is necessary to guarantee fairness in taxation. It will be indispensable to strengthen control over assets in conjunction with the problems of financial outflow to overseas. In light of the stance of the current government—strengthening the crackdown on corruption—it is a good chance to introduce an inheritance tax and gift tax. Although the fixed property tax has been implemented on a trial basis in the city of Shanghai and Chongqing, they have not achieved full-scale introduction. While the real estate bubble is criticized, there are concerns that the revenues of local governments in particular highly depend on land, and non-performing loans might expand because of falling real estate prices. These are the factors which postpone the introduction of a fixed property tax. Since fixed property tax is a corrective measure for disparity as well as an important financial resource of local governments, it will be necessary to introduce it on high-grade property at first, and then expand the taxation base gradually.

On the other hand, ‘Business Tax to Value-added Tax Transformation’ reform, in which

the business tax will be incorporated into the value-added tax as an important reform for the tax system, is currently in progress. It was started in traffic and transport businesses and some modern service businesses in the city of Shanghai on a trial basis from 2012, and later extended to the city of Beijing, Chiangu, Anhui, Fujian, Guangdong (including Shenzhen), the city of Tianjin, Zhejiang, and Hubei. Finally, after August 2013, it was implemented nationwide on a trial basis. The importance was underscored in the Third Plenum of the 18th Party Congress in 2013. The purposes of ‘Business Tax to Value-added Tax Transformation’ are to reduce the burden of business tax on smaller businesses and solve overlapping taxation problems by applying a tax exemption. In addition to the effect of tax burden reduction and tax system simplification, the ‘Business Tax to Value-added Tax Transformation’ reform will have a big impact on the allocation of tax sources between the central and local governments. Currently, business tax is regarded as local tax, and value-added tax is shared between the central and local governments (central : local = 75 : 25). By merely changing the business tax to the value-added tax as a pilot operation, the allocation of tax sources will act as a disadvantage for local public finance. Unless the whole allocation system for the value-added tax is reviewed, strong resistance from local governments will be expected, and the system will not be effective. Adversely, it might be used as priming to promote a proper fiscal relationship between the central and local governments, or between each administrative level of governments in which the burden of administrative duties and allocation of financial resources and authorities are not properly worked. In terms of this point, it is expected to deepen the ‘Business Tax to Value-added Tax Transformation’ reform.

As stated above, the tax system reform, which has progressed extremely slowly, eventually started. The tax system plays an important function in appropriate fiscal relations between governments and fiscal adjustment between individuals. On the other hand, since the main premise of the reform is sticking the knife into vested interests, there will be considerable difficulties in the reform, which is why fundamental reforms have never been realized. As a favorable treatment for state-owned enterprises, it has been decided to increase the ratio of payment to the national treasury⁶ to about 30%. However, the deadline is set to be by 2020, and the speed of the reform seems extremely slow. In order to make the reform function as a fundamental measure for disparity problems, it is necessary to cut to the core of the problems. The future movement of tax system reform can be a valuable indication to judge whether the leadership of the current government can solve the challenges of economic policies or not.

IV-2. Challenges of the Fiscal Relations between the Central and Local Governments

In order to strengthen and stabilize financial capability, it is essential to make proper

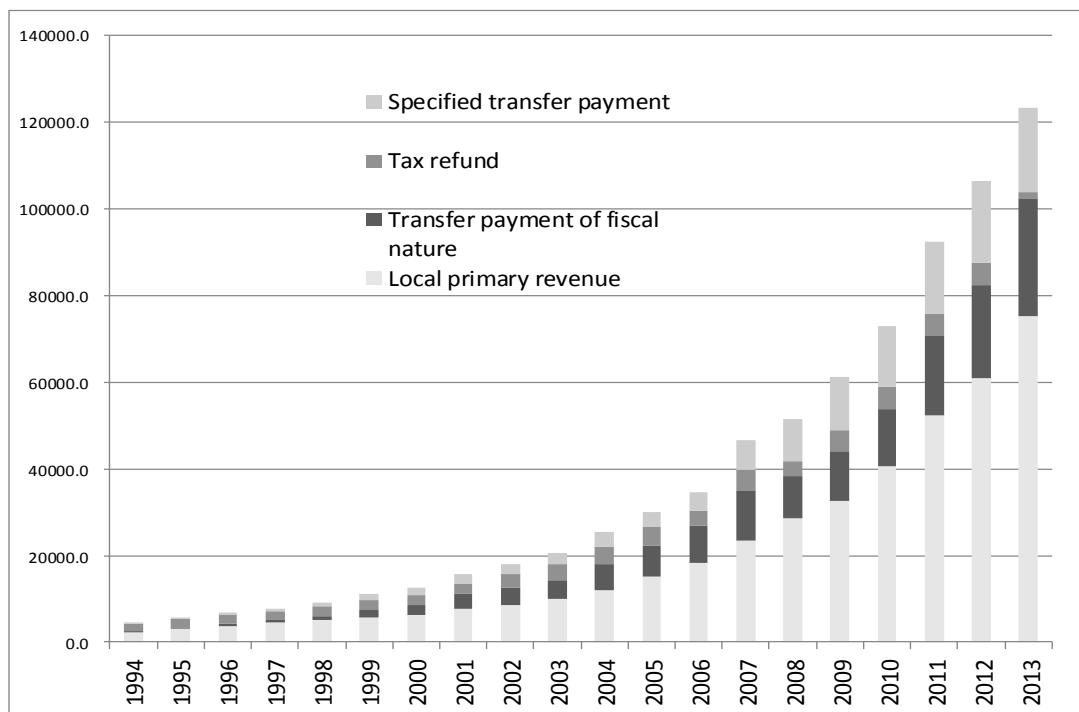
⁶ A payment to the national treasury by state-owned enterprises is equivalent to a dividend from a stock corporation, and is paid to the state-owned capital management budget.

fiscal relations between the central and local governments. Thanks to the tax-sharing system reform in 1994, classifications of the central and local fiscal role as well as arrangement of financial sources were prepared to a certain extent, but it is undeniable that there are still many insufficiencies.

When we think about the fiscal relationships between the central and local governments as well as those between local governments, there is a big difference in authority concerning finance, such as tax autonomy depending on the national system— centralized or decentralized— or the structure of local governments. But in both cases, financial sources and authority as well as associated responsibilities are properly arranged based on clarification of the administrative duties and division of roles. In fiscal relations between governments in China, administrative duties, roles and authority, financial sources, and responsibilities are not necessarily properly arranged among the central government or four administrative levels of local governments. Overlapping and orientation are observed, and there is much uncertainty in roles and management. These problems were not solved even with the tax-sharing system, and fundamental reforms have never been achieved. It is indispensable for each government to define its work and role, and clarify its responsibility by allocating financial sources and authorities for them. Without it, it will be difficult to restore fiscal soundness. In the Third Plenum of the 18th Party Congress, it was underscored that rational establishment of the central and local authorities and responsibilities for payment, as well as budget system reforms for the establishment of the present fiscal system, was needed. It is an inevitable challenge for controlling local debt. At the same time, the authority and responsibilities of central and local governments should be clarified by preparing and properly operating the Local Finance Act and Local Autonomy Act. As to this point, since local governments in China are not actually local autonomous bodies, that is, they do not possess the power of autonomy in various aspects, including legislative process and policy implementation, it might be practically impossible to achieve substantive reforms. However, it is not that progress cannot be made in reforms without political system reform. China should seek to restructure the fiscal system on the premise of the current national system. Considering the scale and function of current local governments, it would be reasonable to consider giving some financial authority from the central to provincial-level governments to reduce the fiscal scale by cutting down the administrative duties of lower-level governments and construct a financial system mainly operated by provincial-level governments.

Another important issue concerning the fiscal relationships between governments is to improve the fiscal transfer system. Since various disparity problems are brought to the fore at present, redistribution functions will have more significance. Broadened fiscal adjustment functions between governments are expected.

Figure 11. The status of Fiscal Transfer (Unit: 100 million yuan)



(Source) Li (2006), Li (2010), based on material from the Ministry of Finance

The fiscal transfer system was arranged by the tax-sharing system to a certain degree, and subsequently through several reforms, the current system mainly consists of general transfer payments (including transfer payment for balancing, which is equivalent to tax allocations, transfer payment to ethnic group areas, transfer for the reform of agricultural village fees and taxes, and fixed subsidies, specified subsidies, and tax refunds).⁷ Looking at the situations of local fiscal revenue and each fiscal transfer, the scale of general transfer payments was extremely small at first and subsequently increased gradually to account for about 40% of the total amount of transfer in 2010. The specified subsidies also continue to expand and increase in percentage terms in order to transfer revenue of provincial-level governments. For redistribution between districts, upper-level governments promoted certain projects by subsidizing them.

⁷ The general transfer payment is equivalent to local allocation tax in Japan, and the specified subsidies are distributed to each project, for example, infrastructure instruction, social security, and a countermeasure for the issue of agriculture, farmers and rural areas. Tax revenue return is a system in which the central government refunds a certain percentage of tax revenue to local governments. Its redistribution function is limited as tax revenue tends to be refunded more to rich areas.

‘The Western Development Strategy’ and subsequent regional development strategies, such as ‘northern promotion’ and ‘midland promotion’ represent the method. Also the central government has expanded business by resource allocation and subsidization in the form of projects, aiming at harmonization of inter-region, industrial structure, and quantity and quality of development. Although the tax revenue return⁸ was about 180 billion yuan in 1994, accounting for about 75% of the total amount of transfer to provincial level governments, it decreased to about 30% in 2006 owing to the progress of coordinating reform of fiscal transfer.

As to fiscal transfer, it is desirable to increase the general transfer payment, which is equivalent to the local allocation tax and possesses more redistribution functions. The tax return system, on the other hand, is the system in which as whole tax revenue increases, tax revenue of the central government also increases gradually. Since the system strengthens the fiscal capability of the central government, it plays its role in a transition period. However, since it is the system which guarantees vested interests and refunds the tax revenue more to the economically developed districts, it should continue to be reduced gradually. While the specified subsidies play an important role as a regional development investment, they are often used in large-scale public projects or land development, possibly leading to ineffective investments or overcapacity in local areas. In addition, some of the subsidies are exploited by the local governments under the pretext of research and administrative expenses as well as some expenditure related to approval and license. It might cause corruption; therefore, strict control will be needed. When three types of fiscal transfer in 2012 and 2013 are compared, the trend seems favorable: the total amount of fiscal transfer increased 8.1%, of which the general transfer payment increased by 14%, and the specified subsidies showed a slight increase of 2.5%, with the tax return decreasing by 1.3%.

Although specific data on the fiscal transfer system was lacking and extremely uncertain, publication of data has been progressing since the fiscal report released in the National People’s Congress in 2009. In order to establish a more transparent and confident system, data should continue to be published on the process of system reforms. In the system reforms, clear criteria including standard fiscal revenue and standard fiscal demand of each district should be developed. Based on the criteria, basic policy management to implement fiscal control in a proper way and at an appropriate scale will be necessary. That is, proper redistribution will not function without the design and operation of the system being based on objective criteria. This is also a common challenge in the social security system including pensions and medicine. In addition, the structure of vested interests should be conquered before the expansion of fiscal control functions. If redistribution is expanded without solving the problem of vested interests among governments, state-owned enterprises, and the high-income class, then the risk of expanding and solidifying disparity will increase. In order to

⁸ The tax refund system to guarantee the revenue of each district before the reform of the tax-sharing system (basically 1993) and refund the decline caused by the introduction of the tax-sharing system from the central to local governments.

properly operate the fiscal control system and correct various disparities, it will be an inevitable challenge to resolve the structure of vested interests, which is detrimental to different kinds of reforms.

IV-3. Urbanization and Fiscal Burden

In the process of changing development and economic structural reform, promoting urbanization is of particular interest as an important challenge. Since Premier Li Keqiang announced the National New-Type Urbanization Plan—which promotes a human-centered and environmentally friendly path—during the central work conference at the end of 2012, the urbanization drive has accelerated. China’s urbanization rate has reached about 53%.⁹ The purpose of the new urbanization is a shift toward a consumer-driven economic structure. It is essential to arouse consumption in agricultural areas with huge potential, so the aim is to realize an increase in income and expand farmers’ consumption. The purposes of promoting urbanization include correction of the various disparities between cities and agricultural areas, and between urban residents and farmers, as well as well-balanced development of national land. Current urbanization will be promoted by well-balanced construction of smaller cities around larger cities and by controlling rapid urban congestion and environmental degradation. In addition, as a development strategy, the method of constructing residential houses and commercial facilities by expropriating land from farmers is mainly used. The aim is to distribute apartments to farmers, ensuring employment by attracting companies to development districts, and realizing regional development and improvement of lives.

These urbanization policies, however, are associated with many problems, especially that of how to secure financial resources for urbanization. Promoting urbanization is accompanied by a variety of infrastructure construction, such as housing and life infrastructure including roads, hospitals, schools, and commercial facilities. Therefore, there is a risk that local governments will expand investment with a plea for urbanization despite severer local financial conditions. This might lead to overdevelopment, expand ineffective investment, and cause environmental degradation. In addition, if fund raising through LGFV or shadow banking increases, the fear of the local debt problem becoming exacerbated will arise at once. The next problem is the destabilizing real-estate market. If land transactions are activated by promoting rapid urbanization, real estate values will soar. However, if the real-estate market becomes saturated or fund-raising becomes difficult, accompanied by a drop in the value of real-estate, then the risk of burdening banks and households with a large amount of non-performing loans will increase. Since such a situation would be like the bursting of a

⁹ The proportion of permanent urban residents of China’s total population. However, these residents do not necessarily have non-agricultural household registries. Substantive promotion of urbanization should be accompanied by the provision of non-agricultural household registries and related public services, but in reality there is quite a number of cases without the provision. Therefore, the true urbanization rate is likely to be far less than 50%.

bubble and directly linked to the local debt problem, it might even cause an anti-market move to maintain real-estate values.

On the other hand, there may be some doubts about the effectiveness of urbanization. In reality, the outcome of reform has not been achieved as simulated. For instance, as a result of urbanization policies, even if farmers receive houses, they would lose farms for their livelihoods and become poorer. They would temporarily gain income by selling land, but would subsequently often not be able to find jobs due to a lack of skills and knowledge. At the same time, the advance of companies by the development may not be achieved as well as expected, and an increase of employment offers can often be limited.

The construction of housing and commercial facilities cannot catch up with the rapid pace of urbanization, causing a temporary housing loss and default of agreement. Moreover, problems concerning benefits are still unsolved. With urbanization, better benefits for farmers should be secured. The new-type urbanization policies are associated with the reform of the household registration system. The policies granting non-agricultural registries are now spread to various areas, and the farmers forced to move to new cities are granted with non-agricultural registries to be urban residents. Even though non-agricultural registries are granted, the benefits related to medical care, old age pensions, education, and other public services have not been improved. The basic problem of disparity between farmers and their urban counterparts is still unsolved.

From this viewpoint, the problem of migrant workers is significant. The number of migrant workers in urban areas is said to reach 260 million people. Among them, only an extremely small number own houses and receive public services such as social security and education for urban residents. Providing public services and building an infrastructure including housing are important challenges. To that end, huge financial resources are necessary, and the financial capability of small and medium cities should be strengthened to realize that.

In this way, concerning the promotion of urbanization, there is a big difference between the destination and current reality. A particularly-problematic issue is that a huge financial burden will be indispensable in any reform. It is inevitable that the financial pressure on local governments will increase; therefore, the feasibility of reform in districts with poor financial capability will be low.

The direction of reform heading toward the solution of the disparity and the shift to the economic structure led by consumption is not necessarily wrong, and the promotion of urbanization itself can be a useful reform. However, there are still a lot more challenges left to conquer. The problem of fiscal burden in particular is the most serious. If China cannot expand the fiscal transfer system to strengthen local government finance and cannot force through drastic tax and fiscal reform in a comprehensive way, such as through redevelopment of the local administrative and fiscal system and the tax and fiscal system for securing finances, then it will be impossible to promote “real urbanization” with improvement of urban infrastructure and provision of public services. It is not too much to say that the success of urbanization reform under the sponsorship of the Xi Jinping and Li Keqiang administration

depends on the outcome of fiscal reform.

V. Conclusion: Challenges Surrounding Financial Status

Although the challenges surrounding the fiscal status have been pointed out repeatedly, the pace seems too slow to realize drastic reforms. Forcing through a tax and fiscal reform always causes a conflict with vested interests. While strengthening taxation imposed on companies often faces resistance from vested interests, such as state-owned enterprises, organizing and strengthening individual income taxes might cause dissatisfaction among low-income earners and opposition from high-income individuals. In addition, if centralized reforms for financial capabilities are strengthened, opposition from local governments will be stronger. The big question is whether the reforms can be promoted while suppressing these various vested interests and resistance forces. In other words, whether the tax and fiscal reform can be implemented thoroughly or not is the true test to judge what the current administration can deliver.

Since an annual goal for economic growth was set to be 7.5% in the National People's Congress in 2014, the attitude of the current administration toward reform has begun to be questioned. Amid an economic slowdown, the expansion policy of investment for infrastructure was introduced at the standing committee of the State Council held in April 2014. It mainly consists of railways and housing, such as new railway construction covering 6,600 km, old housing reconstruction for low-income earners, and new housing construction. For these projects, private funds are said to be introduced by raising loans from the establishment of a foundation, but eventually they might become part of government loans, making government expenditure expand. Moreover, since corporate income tax reduction for small and tiny companies will be implemented simultaneously, fiscal pressure will be bigger. The problem is that implementation of these policies will shake the government's policies, the biggest aim of which is to change the method of economic development. The major policy at the start of the current administration was to promote economic structure adjustment thoroughly while sacrificing a certain level of economic slowdown to some extent. If the government uses traditional methods to implement the stimulus measures to support the economic slowdown, it could bring about serious damage to China's economy. The decision made at the Third Plenum of the 18th Party Congress to make the market play a definitive role in resource allocation promises a big transformation in China's economic system. To that end, however, it is necessary to review the government function itself, establish an economic system based on the function, build institutions and policies, and implement them adequately. Before the transformation of the government function, it is necessary to clarify the roles of the government and market, rearrange the roles that the public sector should play, and promote regulatory reforms to make an effective government. While ensuring transparency, it is important to enhance the development of institutions and clarify legal grounds to allow each level of government to share policies properly and become an effective public service provider. As the roles of tax and fiscal reform become bigger and bigger, the fate of urgent

reform will attract more attention than ever.

References

- 田中修（2011）『2011～2015年の中国経済』 蒼蒼社
- 内藤二郎（2011）「財政体制改革の再検証と評価」 中兼和津次編『改革開放以後の
経済制度・政策の変遷とその評価』 所収 早稲田大学現代中国研究所
- 高培勇編（2010）『中国財政發展報告2010／2011 “十二五”時期的中国財政改革』
中国財政經濟出版社
- 河北大学予算管理研究所編（2007）『中国政府間財政關係研究』 經濟管理出版社
- 李冬梅（2006）『中国地方政府債務問題研究』 中国財政經濟出版社
- 廖曉軍主編（2010）『財稅改革縱論』 中国科学出版社
- 劉尚希（2010）「地方政府融資熱：乱象還是創新」『人民論壇』 2010年總第277期
- 王劍・李靖娜・羅廷婷（2009）「2000億地方債發行的實施与評價」『商業文化』 2009
年第8期
- 中華人民共和國国家稅務總局「関与貫徹執行修改后的個人所得稅法有関問題公告」
（2011年第46号）
- 鐘曉敏・叶寧（2010）『中国地方財政体制改革研究』 中国財政經濟出版社
- 中南財經政法大學・湖北財政与發展研究中心・中国地方財政研究中心（2010）『中
国地方財政發展報告－省管県財政体制研究』 經濟科学出版社
- 中南財經政法大學・湖北財政与發展研究中心・中国地方財政研究中心（2012）『中
国地方財政發展報告－地方政府融資平台發展研究』 經濟科学出版社
- 楊小雲（2011）『新中国 中央与地方關係沿革』 世界知識出版社
- 郝竜航・王駿編著（2012）『“營改增”－機遇与挑戰』 中国財政經濟出版社
- 周沅帆（2011）『城投債－中国式市政債券』 中信出版社
- 陳均平（2010）『中国地方政府債務的確定，計量和報告』 中国財政經濟出版社
- 敬志紅（2011）『地方政府性債務管理研究兼論地方投融資平台管理』 中国農業出版
社
- 寇鉄軍（2011）『地方財政与体制創新』 東北財經大學出版社
- 田志剛（2010）『地方政府間財政支出責任划分研究』 中国財政經濟出版社
- 胡德仁（2011）『中国地区間財政均等化問題研究』 人民出版社
- 上海財經大學公共政策研究中心・曾軍平・劉小兵主編（2012）『2012中国財政發展
報告－經濟社会轉型中的財政公平分析』 北京大学出版社
- 上海財經大學中国公共財政研究院・胡怡建主編『2013中国財政發展報告』 北京大
学出版社
- 繆匡華（2013）『福建“省直管県”体制改革实践与探索』 厦門大學出版社
- 中華人民共和國財政部（2012）「2011年中央对地方稅收返還和轉移支付決算表」
- 中華人民共和國財政部（2012）「省直管県和郷財県管改革情況」
- 中華人民共和國財政部（2013）「关于2012年中央对地方稅收返還和轉移支付決算的
說明」
- 中華人民共和國財政部（2013）「2012年中央对地方稅收返還和轉移支付決算表」

- 中華人民共和國財政部 (2013)「関与2013年中央公共財政收入予算の説明」
- 中華人民共和國財政部 (2014)「2013年財政収支情況」
- 中華人民共和國審計署 (2013)「2013年第32号公告：全国政府性債務審計結果」
- 中華人民共和國審計署 (2011)「2011年第35号：全国地方政府性債務審計結果」
- 中華人民共和國審計署 (2012)「2012年第26号公告：54個県財政性資金審計調查結果」
- 中華人民共和國審計署 (2013)「2013年第24号公告：36个地方政府本級政府性債務審計結果」
- 中国人民共和国国家统计局『中国統計年鑑』各年版 中国統計出版社
- 中華人民共和國財政部『中国財政年鑑』各年版 中国財政雜誌社
- 中華人民共和國国家统计局 <http://www.stats.gov.cn/>
- 中華人民共和國財政部 <http://www.mof.gov.cn/index.htm>
- 中華人民共和國商務部 <http://www.mofcom.gov.cn/>
- 中華人民共和國審計署 <http://www.audit.gov.cn/n1992130/index.html>

