

Fiscal System and Policy in China* — Transition and Tasks of Thirty-year-Reform and Opening policy —

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I. Introduction

The purpose of this paper is to analyze the fiscal trend and challenges in China which is going to mark its 30th anniversary of the reform and opening-up, by re-examining the developments around the reform of China's fiscal system since its 'open-door reform' policies. It seeks to put together the issues already resolved and those remaining to be resolved with regard to the fiscal system in China that have gone through various repeated enhancements and revisions as it moved ahead with the market economy, and examine the current challenges in order to investigate the issues for the future.

The global economic crisis also coincided with the 30th anniversary of China's reform and opening-up. The crisis has led to an increase of the debates to re-consider the limitation of the market system and the role of the governments on a global scale. Setting the direction of its economic policy has of course become an extremely important task in China too. In the midst of many countries across the globe, led by the G-20 countries, working on large fiscal spending, China also has the initiatives to revive the economy through massive public investment in progress. In a bid to make these problems clear, this paper analyzes the transition of China's administrative and fiscal policies, and details and features of the present economic policy. Interpreting the latest global crisis as an opportunity to promote discussions beyond the past frameworks, this report attempts to specify problems in China's fiscal system and policy and to indicate the direction in which China should go.

* This article is based on a study first reported in the Naito (2009), 'Chuugoku no Zaisei Seido to Seisaku', *Financial Review*, Vol.96, pp.71-104 (in Japanese).

II. Developments related to Fiscal Reforms after the Reform and Opening-up¹⁾

II.1. Introduction of Fiscal Contracting System²⁾

The fiscal system reform of China since the “open-door reform” policies started with the introduction of the Fiscal Contracting System, which was a major feature. The Fiscal Contracting System is a framework which respective local governments are responsible for tax collection in accordance with the contract with the central government and they will be able to retain the remaining as their autonomous fiscal resource as far as they transfer tax revenue in the amount which they are contracted to the central government. It moved away from the situation³⁾ where the fiscal matters had been controlled centrally since the establishment of the People’s Republic of China and sought to proceed in a direction that more discretion would be given to the individual local governments and enterprises in conjunction with the introduction of market economy. The details of the contract method for each local government varied depending on time and regions. Wu (1996) categorized it into two broad groups of the first phase of the fiscal reform from 1980 to 1987 and the second phase from 1988 to 1993, and further separated the first phase into two sub-groups with 1985 as a cutoff point as the scope of the contract system which was changed. Table 1 categorizes and summarizes the changes in the framework of the fiscal contract responsibility from 1980 to 1993 into three periods based on Wu’s categorization.

It started with a shift to the mechanism of “contract responsibility for revenue and expenditure by the central and local governments.”⁴⁾ It can be broadly categorized into the “total amount allocation method” used from

¹⁾This section incorporates and reorganizes the revisions to Chapter 5 by Naito (2004). The contents in each section of the paper first appeared in the documents below. They have added and revised the contents considerably. It was also re-organized and re-compiled.

II, III: “*True State of and Responses to the Inter-Governmental Fiscal Relations in China – Summary of 1980’s and 1990’s*,” 2004, Nihontosho Center Co., Ltd

IV, V: “*The Central -Local Relationships from Fiscal and Administrative Perspectives*,” in No. 2 of Vol. 5 of “*Chinese Economic Studies*,” 2008, Japanese Research Association for Chinese Economy

VI, VII: “*Chinese Economy Facing a Turning Point – Developments around Reforms in Financial Crisis*,” (2009 Japan-Taiwan East Asia Forum – Crisis or Turning Point: East Asia Regional Security – Taiwan National Chengchi University’s International Relations Main Reports)

²⁾Under the fiscal system in the 80’s since the “open-door reform” policies, it became a challenge how to coordinate the divisions between the central and local governments, and between the nation and enterprises and, at the same time, in order to increase the incentives for the local governments and enterprises with a view to promoting efficient economic development, de-centralization of the authorities accelerated. As part of such movement, the Fiscal Contracting System which the local governments are responsible for fiscal revenue and expenditure was implemented. The details of the contracting system vary considerably, depending on the regions and timing. Please refer to Wu (1996), Nambu (1995) and others for further detail.

³⁾It refers to the situation of “consolidated revenue and consolidated expenditure.” In China before the ‘open-door reform’ policies, the fiscal system which the revenues of the local governments had, in principle, been all transferred uniformly to the central government and then transferred back to the local governments, which had been in place for many years. As a result, the budgetary control had been highly concentrated in the central government and, with budgetary authorities given to the local governments, the incentives for the local governments and enterprises had been jeopardized.

⁴⁾A method by which fiscal revenues and expenditures are grouped into the portions for the central and local governments. Both of them are individually responsible for their own pre-determined shares of the revenues and expenditures. Please refer to Takaya (1998) and Wu (1996) for detailed descriptions on the contract responsibility methods, etc., of the Fiscal Contracting System.

1980 to 1987 and the “packaged contract responsibility method” employed from 1988 to 1993. The total amount allocation method can further be broken down into the period of the “contract responsibility for revenue and expenditure by the central and local governments” from 1980 to 1984 and that of the “total amount allocation” from 1985 to 1987. During the period of contract responsibility for revenue and expenditure by the central and local governments, fiscal revenues were grouped into the three categories of the fixed revenue for the central government, the fixed revenue for the local governments, and the shared revenues for the central and local governments, while the fiscal expenditures were split into the expenditure for that for the local governments. More specifically, there were five patterns of 1) fixed revenues and proportional allocation, 2) shared revenues and proportional allocation, 3) fixed amount subsidy, 4) minority regions subsidy, and 5) packaged contract responsibility. In addition, the term which those arrangements were to be applied extended from a year to date, to five years without modifications. It meant to achieve more stability in running the system. However, on the other hand, since the local governments resisted to those arrangements claiming that the ratio of the shared revenue retained by the local governments was too low, the total amount allocation method was effectively used after 1985. This is a method by which a sum of the fixed revenues for the local governments and the shared revenues are considered as a total amount, based on which they assume contract responsibility⁵⁾. Since the Fiscal Contracting System was not a method based on clearly defined rules, to start with, and rather a system that was put in place based on arrangements through negotiations between the central and respective local governments, the corresponding conflicts of interests caused complaints and difficulties in running it smoothly, resulting in frequent changes to it. As a result, to the contrary to the intention of increasing the incentives for the local governments on tax collection, which was the original objective of the contracting system, it gave rise to the lack of transparency of ‘negations and conflicts of interests’ between the central and local governments, as well as the deterioration of fiscal situations to both of the central and local governments. Therefore, the “packaged contract responsibility method” was then adopted across the country after 1988, with a view to improve the fiscal situations of the local governments. The packaged contract responsibility method had five patterns of 1) total amount allocation and contract responsibility, 2) gradually increasing revenue and contract responsibility, 3) total amount allocation and sharing in incremental revenue, 4) gradually increasing transfer amount and contract responsibility, and 5) fixed amount transfer, and remained in use through 1993. This was meant to provide allocation systems that would better reflect differing situations of individual regions, but it turned out to work to make the standards more ambiguous, ending up with contributing to decentralization trends that discretion at the local governments increased.

⁵⁾The reality was that even this framework could not suppress complaints from wealthy areas about inequality in sharing fiscal burden among geographical areas.

Table 1: Details of and the Areas Subject to the Fiscal Contracting System

		Contract method	Details	Applicable areas
Total allocation period	1980-1984: Period of contract responsibility for revenue and expenditure by the central and local governments	Fixed revenue and proportional allocation	Allocate any surplus of the local government's finance to the central and local governments at a certain ratio	Hebei, Liaoning, Shandong, Jiangsu
		Fixed amount subsidy	The central government to provide certain fiscal support to the local governments (to increase by 10% every year)	Jilin, Heilongjiang, Jiangxi
		Shared revenue and proportional allocation	Allocate shared revenues to the central and local governments at a certain ratio	Shanxi, Hunan, Zhejiang, Sichuan, Anhui, Shanxi, Henan, Gansu, Hubei
		Gradually increasing subsidy	The subsidy from the central government to the local governments to increase gradually	Inner Mongol, Qinghai, Guangxi, Tibet, Guizhou, Ningxia, Yunnan, Xinjiang
		Packaged contract responsibility	Include shared revenues for the central and local governments as fixed revenues for the local governments. The local governments to pay certain transfer amounts and retain the remaining	Guangdong, Fujian
	1985 to 1987: Period of total amount allocation	Total amount allocation	Sum the amount of fixed revenues for the local governments and that of shared revenues by the central and local governments. Apply a certain retention rate to the sum	Beijing, Luoyang, Tianjin, Dalian, Hebei, Anhui, Shanxi, Shandong, Liaoning, Henan, Jiangsu, Wuhan, Zhejiang, Hunan, Chongqing, Shanghai, Harbin
		Fixed amount transfer	Pay a pre-determined transfer amount	Heilongjiang
		Fixed amount subsidy	The central government to provide fiscal support in a certain amount for the local governments (to increase by 10% annually)	Jilin, Jiangxi, Shanxi, Gansu, Hebei (excluding Wuhan), Sichuan (excluding Chongqing)
		Gradually increasing subsidy	Increase the amount of the support by the central government to the local governments	Inner Mongol, Tibet, Guangxi, Qinghai, Guizhou, Ningxia, Yunnan, Xinjiang
		Packaged contract responsibility	Include shared revenues for the central and local governments as fixed revenues for the local governments. The local governments to pay certain transfer amounts and retain the remaining	Guangdong, Fujian

Packaged contract responsibility period	1988 to 1993: Packaged contract responsibility period	Total amount allocation and contract responsibility	Determine the retention rate for the local governments based on the past 2 years' track records of revenue and expenditure as well as the ratio of expenditure to revenue	Tianjin, Anhui, Shanxi
		Total amount allocation and sharing in incremental revenue	Total amount allocation and contract responsibility for the base amount as determined based on the previous year's revenue, and allocate any excess at the incremental revenue allocation rate	Qinghai, Wuhan, Dalian
		Fixed amount transfer	Pay a pre-determined transfer amount	Shanghai, Shandong (excluding Tsingtao), Heilongjiang (excluding Harbin)
		Gradually increasing revenue and contract responsibility	Determine the rate for gradual increase in the local governments' fiscal revenue and the retention rate based on the actual result in 1987. Use the fixed retention rate to allocate the revenue up to the level as calculated at the rate for gradual increase, and any excess above the rate for gradual increase to be fully retained by the local governments	Beijing, Hebei, Liaoning (excluding Luoyang and Dalian), Shenyang, Harbin, Jiangsu, Ningbo, Zhejiang (excluding Ningbo), Henan, Chongqing
		Fixed amount subsidy & assistance	The central government to provide certain fiscal subsidy and assistance for the local governments	Jilin, Gansu, Jiangxi, Hebei (excluding Wuhan), Shanxi, Sichuan (excluding Chongqing), Inner Mongol, Qinghai, Guangxi, Tibet, Guizhou, Ningxia, Yunnan, Xinjiang, Hainan, Fujian
		Gradually increasing transfer amount and contract responsibility	Determine the fixed transfer amount and the rate for gradual increase, based on the actual transfer amount in 1987	Hunan, Guangdong

(Source) Takaya (1990) and Wu (1996)

II.2. *Reform of Tax for Profit*⁶⁾

An important reform implemented during this period is a reform of tax for profit. It was to convert the transfer of profit by state-owned enterprises to the tax system and represented a new mechanism of collecting it as enterprise income tax.

This can be considered as the first step to the tax system which is in line with the shift toward market economies. In the market economy, based on the principle of private ownership right system and in accordance with an agreement with the owners of private properties, it stands to a reason that natural that the government collect some of it as tax to fund the expenses of public services. However, under the public ownership of production elements such as in China prior to the reform and opening-up, the government obtains funds by having some of the profit transferred by state-owned enterprises, not through collecting tax. The ‘open-door reform’ policies for implementation promoted reforms in a direction to that the competition on the marketplace would be introduced and enterprises would have increased autonomy at the same time, while they assume responsibility for the management themselves. It not only promoted the separation of ownership and management for the enterprises, but also imposed the role of sharing tax responsibilities.

During the first phase that started in 1983, it was still a dual system that the transfer of profit remained in use, while tax collection started. Mid-sized to large state-owned enterprises paid 55% of the profit attained as enterprise income tax and transferred a portion of the profit after tax to the state finance, with the remaining retained by them. With regard to the transfer, there were several criteria but their actual application was not based on a consistent set of rules, so that it was mainly driven by negotiation between the government and an enterprise. On the other hand, small enterprises were subject to enterprise income tax with eight different tax buckets based on the amount of profit, and were supposed to take responsibility for profit and loss after tax themselves, with subsidy from the fiscal account discontinued. It was expected that this would not only clarify the independent status of an enterprise by separating the national finance and the finance of the enterprise, but also enhance the incentive for an enterprise to work on efficient management by allowing the retention by the enterprise.

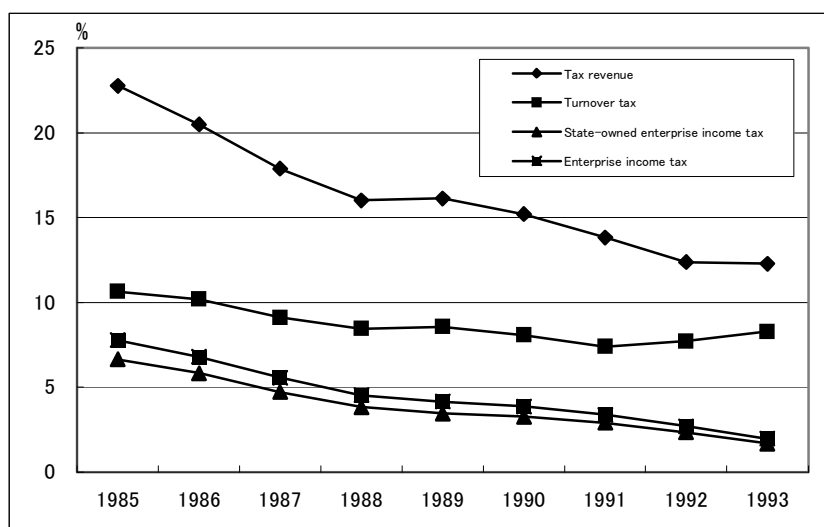
Next, the system of tax for profit moved on to the second phase in 1984. It involved a shift to the complete tax system from the dual system of transfer of profit and tax payment that was used under the tax for profit system during the first phase. The tax for profit system acted as a trigger to increase the incentive for enterprises, but an issue was emerged as inequality in tax burden due to disparities in the profit levels across enterprises and industry sectors and other reasons as a result of delay in the price reform. Furthermore, the separation between the national finance and enterprises was insufficient since the method of proportional allocation continued to be used for the profit after tax. Thus, industrial and commercial tax was categorized into product tax, value-added

⁶⁾The system by which state-owned enterprises transferred their profit to the nation was converted into state-owned enterprises income tax such that profit and tax were collected separately. It was expected not only to separate the functions of the governments and enterprises but also to increase the incentives for the enterprises by allowing the profit after income tax to be retained by them.

tax and business tax, while adjustment tax was established together with enterprise income tax⁷⁾. This not only stipulated the separation of the national finance and enterprises clearly by law but also helped to reduce the disparities across enterprises through adjustment tax. It also resulted in a decrease in intervention by the administration to enterprises.

However, since no reasonable explanation why 1983 was determined as a base year was provided in the first place, the concern for inequality among the enterprises was not resolved. Furthermore, the introduction of opaque adjustment tax in addition to enterprise income tax often caused negotiations to get entangled and collusions between the administration and enterprises. In addition, due to the repayment of borrowings prior to tax payment⁸⁾ called “repayment prior to tax payment,” many enterprises had borrowings increased substantially, which led to a decrease in the fiscal revenue. As such, the tax for profit reform which was implemented with a view to giving more autonomy to enterprises and enhancing the incentives ended half way through.

Figure 1: Ratio of Tax Revenue to GDP



(Source) Prepared based on annual *Chinese Public Finance Yearbooks*

⁷⁾ A key characteristic of adjustment tax was to base on the actual profit for each enterprise in 1983 to determine the profit at the time of assessment, and subtract 55% of enterprise income tax and a reasonable level of retained earnings in 1983 from it, and use a ratio of the remainder to the profit at the time of assessment as the assessment adjustment tax rate.

⁸⁾ A method to determine a tax amount based on the income of an enterprise, after allowing for deduction of depreciation and borrowings further.

II.3. Decline of ‘Two Weights’

In this section, we confirm the situation that was brought by the implementation of the Fiscal Contracting System and the tax for profit reform. First, Figure 1 illustrates the changes in the ratio of tax revenue to GDP.

The ratio of tax revenue to GDP declined from 22.8% in 1985 to 12.3% in 1993. While turnover tax remained almost unchanged, enterprise income tax decreased significantly to 1.7% in 1993 from 6.6% in 1985. This is mainly driven by a decrease in the enterprise income tax from state-owned enterprises. As a result, the declining trend of the ratio of tax revenue to GDP continued. Meanwhile, the introduction of adjustment tax allowed for a relative relief on tax burden if you generated a profit in excess of the base amount as determined by the profit in 1983, and you were allowed to repay the borrowings prior to tax payment. These contributed to a substantial decrease in tax revenue. With regard to the decrease in enterprise income tax, there was an issue inherent in the framework itself: Since it was the total amount of revenues that the local governments assumed a contract responsibility for and the contract amount for individual taxes were not specified⁹⁾, there was an incentive to increase other revenues that were subject to contract responsibility than enterprise income tax from the viewpoint of the local governments and it resulted in a decline in enterprise income tax.

It was associated with the declining trend in the size of the state finance. Table 2 and Figure 2 show the changes in the ratio of the state’s fiscal revenue and expenditure to GDP during the same period.

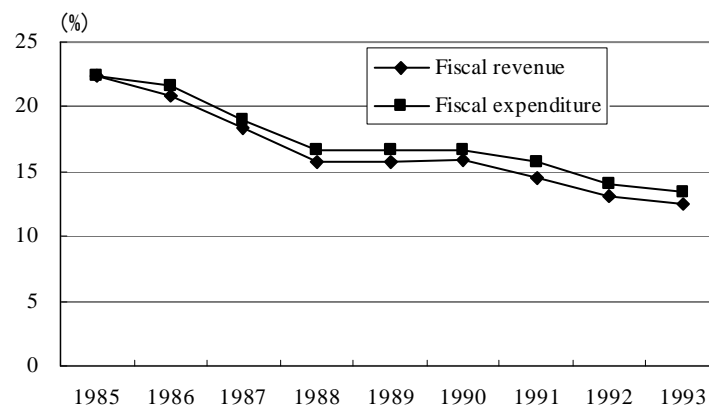
Table 2: State’s Fiscal Revenue and Expenditure (in 100 millions Yuan)

	Fiscal revenue	Fiscal expenditure	GDP
1985	2004.82	2004.25	8964.4
1986	2122.01	2204.91	10202.2
1987	2199.35	2262.18	11962.5
1988	2357.24	2491.21	14928.3
1989	2664.90	2823.78	16909.2
1990	2937.10	3083.59	18547.9
1991	3149.48	3386.62	21617.8
1992	3483.37	3742.20	26638.1
1993	4348.95	4642.3	34634.4

(Source) Prepared from the annual *Chinese Public Finance Yearbooks*

⁹⁾ Under the Contracting System, it is not all of the revenues for the local governments that are within the scope of contract responsibility. Instead, it is supposed to make the transfer based on the tax revenues for which they enter into a contract with the central government. Since the amounts for respective taxes which they are responsible are not specified, an incentive would work for the local governments to reduce enterprise income tax for the state-owned enterprises that are under control by them as much as possible, and achieve the contract responsibility through other taxes.

Figure 2: Ratio of the Fiscal Revenue and Expenditure to GDP



(Source) Prepared from the annual *Chinese Public Finance Yearbooks*

As it is seen from the figures clearly, the ratio of public finance to GDP continued to decline consistently since 1985. Significant decline in the weight of the state finance is a feature that was brought by the Fiscal Contracting System and the tax for profit reform whose objective was to generate incentives for enterprises and local governments. It was caused not because the government sector shrank as a result of the movement toward market economy, but because of the weakening of tax collection system and ambiguous frameworks.

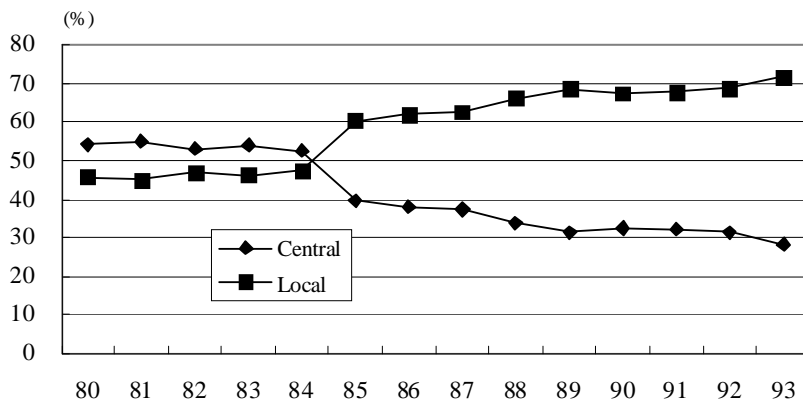
Furthermore, when we separate the state finance into the central and local governments, we can see that the decline in the weight of the central government's finance is noticeable since 1985, as shown in Table 3 and Figure 3. In particular, the ratio of fiscal revenue for the central government declined considerably.

Table 3: Weights of the Central Government's Fiscal Revenue & Expenditure to Local Governments' Fiscal Revenue & Expenditure

	Amount (in 100 millions Yuan)			Weight (%)	
	Nation	Central	Local	Central	Local
1980	1228.83	666.81	562.02	54.3	45.7
1981	1138.42	625.65	512.77	55.0	45.0
1982	1229.98	651.81	578.17	53.0	47.0
1983	1409.52	759.60	649.92	53.9	46.1
1984	1701.02	893.33	807.69	52.5	47.5
1985	2004.25	795.25	1209.00	39.7	60.3
1986	2204.91	836.36	1368.55	37.9	62.1
1987	2262.18	845.63	1416.55	37.4	62.6
1988	2491.21	845.04	1646.17	33.9	66.1
1989	2823.78	888.77	1935.01	31.5	68.5
1990	3083.59	1004.47	2079.12	32.6	67.4
1991	3386.62	1090.81	2295.81	32.2	67.8
1992	3742.20	1170.44	2571.76	31.3	68.7
1993	4642.30	1312.06	3330.24	28.3	71.7

(Source) Prepared from annual *Chinese Public Finance Yearbooks*

Figure 3: Ratio of the Central Government vs. Local Governments in Terms of Fiscal Revenue & Expenditure Prior to Tax-sharing System



(Source) Prepared from annual *Chinese Public Finance Yearbooks*

From the above we see that, as a result of the implementation of the Fiscal Contracting System and the tax for profit reform, the ‘two weights’ declined: The weights of the state finance to GDP and the financial power of the central government were decreased substantially. This is a major characteristic that was brought by the fiscal system reform since the reform and opening-up. It became an important task to enhance the financial power of the central government.

As another issue, it is worth pointing out that the rules around the terms of contract responsibility under the Fiscal Contracting System were vague, leaving much room for inter-governmental negotiations between the central and local governments. It promoted the local governments to give preferential treatment to local enterprises and tax relief by underestimating the income of an enterprise at their discretion. Likewise, there is the regionalism called the “dukedom economics¹⁰⁾” spreading. It caused the local governments to intervene more in the local enterprises’ affairs and strengthen their mutual dependence with them. It was a loose framework and worked favorably to the local governments.

These are not only the issues brought by the implementation of the Fiscal Contracting System and the tax for profit reform, but also represent the limitations of both of the systems. It became an urgent task to build a new framework.

¹⁰⁾ As a result of de-centralization since the ‘open-door reform’ policies, regionalism that refers to much of local interests only spread everywhere, leading to blockage of a region and overlapping in the construction, etc. Particularly in wealthy areas on the coastal regions, regionalism was induced further, which affected the central government’s finance to weaken, along with the widening of the economic disparities across regions.

III. Shift to Tax-sharing System

III.1. Details of the Tax-sharing System

As a result of the emergence of the serious issues of the “decline of two weights” and “dukedom economics,” it became urgently required to secure fiscal revenue which was in proportion to economic growth, as well as enhancing the central government’s finance power and macro control function. This led to the introduction of the tax-sharing system in 1994.

The following two points are its key characteristics. First, it was to coordinate inter-governmental fiscal relationships. In order to establish the separation of the roles between the central and local governments, the fiscal revenues were grouped into three categories of the fixed revenue for the central government, fixed revenue for the local governments, and common revenue shared by the central and local governments. The expenditure also had certain categories as provided. Furthermore, as the budgetary frameworks for the central and local governments were articulated, the mechanism for fiscal transfer was established. In terms of tax collection authorities, they were also classified into the central taxation bureau and local taxation bureaus¹¹⁾. Specifically, it was defined that the main roles of the central governments were in national defense, diplomacy, the control and management of national agencies, and the control of macro economy. On the other hand, the roles of the local governments were stipulated to be in the control and management of local governmental agencies as well as the promotion of respective region’s economic development. In conjunction with this, the expense items for the central and local governments were sorted and reorganized, and assigned to the expense items for the central government were national defense expense, the expense for armed police, outlays for priority construction projects, outlays for diplomacy & external assistance, projects managed by the central government, payment of the principal and interests for domestic and overseas loans and others. The expense items for the local governments included the local administrative management expense, outlays for local projects, agricultural subsidies, outlays for city maintenance and construction, and price subsidies.

The second point was the large-scale tax system reform. It sought to streamline the types of taxes by consolidating and abolishing some of taxes. In particular, the reform of industrial and commercial tax which had been the core of China’s tax system was substantial, resulting in 33 types of tax items reduced to 18. Specific details of the reform are as bellow:

(1) Taxes adjusted were value-added tax, business tax, resource tax, city maintenance and construction tax, house property tax, and vehicle and vessel usage tax.

¹¹⁾ Tax collection authorities were also separated at the same time of the establishment of tax system. However, in reality, its benefits were not realized due to backwardness of the tax administration. In addition that the practical side was lagged due to insufficient human resources such as the lack of knowledge, it is said to have existed various types of fraudulence which ranged from collusion between the administration and enterprises to forgery of documents. Meanwhile, there was little awareness for tax payment on the taxpayers’ side, which was an obstacle to the tax administration. Similar issues remain even today and it is an important challenge to improve the quality of the tax administration and develop human resources.

- (2) Tax items newly established were consumption tax, land appreciation tax, securities exchange tax, and inheritance tax.
- (3) Tax items abolished were unified industrial and commercial tax, state-owned enterprise adjustment tax, market transaction tax, enterprise bonus tax, state-owned enterprise salaries adjustment tax, urban property tax, and vessel usage license tax.
- (4) In respect of consolidated tax items, produce and product taxes were merged with consumption and value-added taxes, while state-owned enterprise income tax, group enterprise income tax, and privately owned enterprise income tax were streamlined into enterprise income tax. The income tax for proprietors in cities and townships & villages and individual income adjustment tax were consolidated into individual income tax. Moreover, salt tax was merged into resource tax while special consumption tax and fuel consumption tax were absorbed into consumption tax.
- (5) Slaughter tax and banquet tax were transferred to the local governments.

Under this circumstance, China's industrial and commercial tax framework were re-built by turnover tax and enterprise income tax as core taxes and resource tax, special purpose tax and behavioral taxes as supplementary taxes. In terms of turnover tax, the conventional product tax, value-added tax and business tax were reformed such that the new value-added tax would act as a core tax with business tax serving in a supplementary role. Though there was no change to value-added tax, consumption tax and business tax charged to foreign enterprises and 'Sanzi Corporation' (those with foreign investment in China), the unified industrial & commercial tax that had been charged to those enterprises were abolished. As for the specific details of value-added tax, the scope of taxation ran from production through retailing and its tax rate was uniformly at 17%. The tax amount was calculated in a way similar to Japan's consumption tax, assessed on an amount that was subtracted total purchase cost from total sales. In order to ensure that tax is also transferred and can be attributed to, the invoice method was adopted for deducting purchase cost. There were other changes to part of the mechanisms of enterprise income tax, individual income tax, supplementary taxes of business tax, consumption tax and value-added tax.

As described above, the reform of the tax-sharing system was a reform that not only sought to solve the major issue of strengthening the fiscal power of the central government but also marked the first step toward building and establishing the administrative and fiscal systems that were in line with the movement toward market economy, through the adjustments from the two aspects of re-construction of the inter-governmental fiscal relationships and tax reform. It can be said that it was the most important tax and fiscal reform since the reform and opening-up. However, while the reform of tax-sharing system brought some improvements, it is the fact that various problems remained unsolved. Therefore, it is questionable if we can call it a drastic, groundbreaking reform of the tax and fiscal systems in China after the reform and opening-up. Below, we analyze the achievements generated and challenges posed by the tax-sharing system.

Table 4: Outline of Fiscal Revenue & Expenditure Responsibilities by the Central and Local Governments after the Tax-sharing System

Fiscal expenditure of the Central Government	Fiscal expenditure of the local governments
National defense expense	Administrative expenditures for the local governments
Expense for armed police	Outlays on various projects by the local governments
Outlays on priority construction projects	Outlays on basic construction and technical improvement (of locally owned enterprises)
Administrative cost for the central bank	Expenditure for agricultural support
Outlays on various projects by the central government	Expenses for urban maintenance and construction
Repayment of domestic and foreign public debts	Price subsidies and others

(Source) Edited by the Office of the Central Leading Group on Financial and Economic Affairs (1994)

III.2. Merits and Demerits of the Tax-sharing system

The objectives of the tax-sharing system were to stop the declining trend in the weight of public finance and to enhance the fiscal power of the central government, in particular. In relation to these points, we first look at how the fiscal powers of the central and local governments changed before and after the tax-sharing system, as illustrated in Figure 4.

A feature is that the ratio of the central government's finance increased considerably as a result of the reform of the tax-sharing system. In terms of fiscal revenue, the ratio of the central government to the local governments stood at 4 to 6 in 1984 and the gap continued to widen since then, with the ratio being at 2 to 8 in 1993 just prior to the tax-sharing system. However, it decreased from 5.5 to 4.5 in 1994 after the implementation of the tax-sharing system, resulting in the ratio of the central government's revenue going up at one stroke. The ratio of the central government to the local governments continues to stay at around 5 to 5 since then. On the other hand, in terms of expenditure, the local governments consistently weigh more without much change seen in the trend even after the tax-sharing system since the ratio of the local governments exceeded that of the central government in 1984. The ratio stood at around 3 to 7 in 1993, just prior to the implementation of the tax-sharing system, and continues to stay approximately at 3 to 7 in 1994 and onward. Therefore, the introduction of the tax-sharing system increased the weight of the central government's finance in respect of revenue, although it was not the case with expenditure. Therefore, it is possible to come to recognition that the financial control power of the central government has been strengthened to some extent, given that its revenue increased significantly as a result of the reform of the tax-sharing system. However, whether the central government was able to enhance its macro control function or not depends on the method and detail of fiscal transfer between the central and local governments as the local governments, have more weight on the expenditure side. Since the mechanism of fiscal transfer from the central government to the local governments in China at that point was limited in its scale and the local governments retain their vested interests, its fiscal adjustment function through re-distribution of income did not work sufficiently and it worked only to protect the local governments' vested interests. Therefore, it is common assessment that the macro control function by the central government's finance was not necessarily strengthened.

Figure 4: Changes in the Ratio of Fiscal Revenue & Expenditure between the Central and Local Governments after the Reform and Opening-up

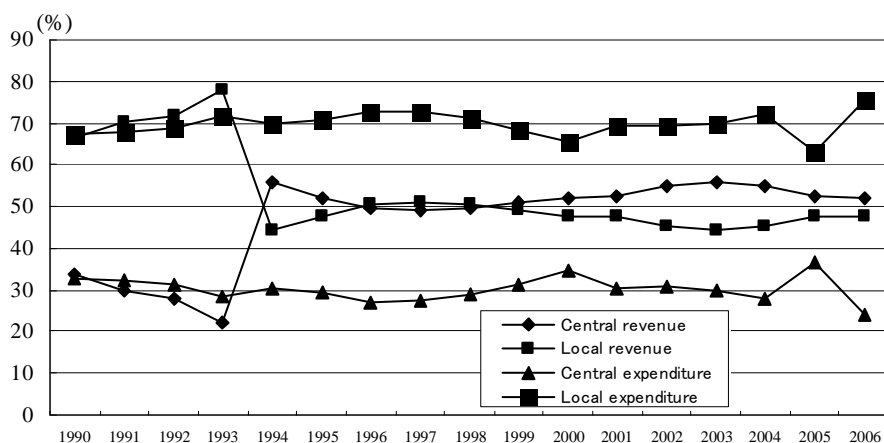
(Source) *Chinese Public Finance Yearbooks*

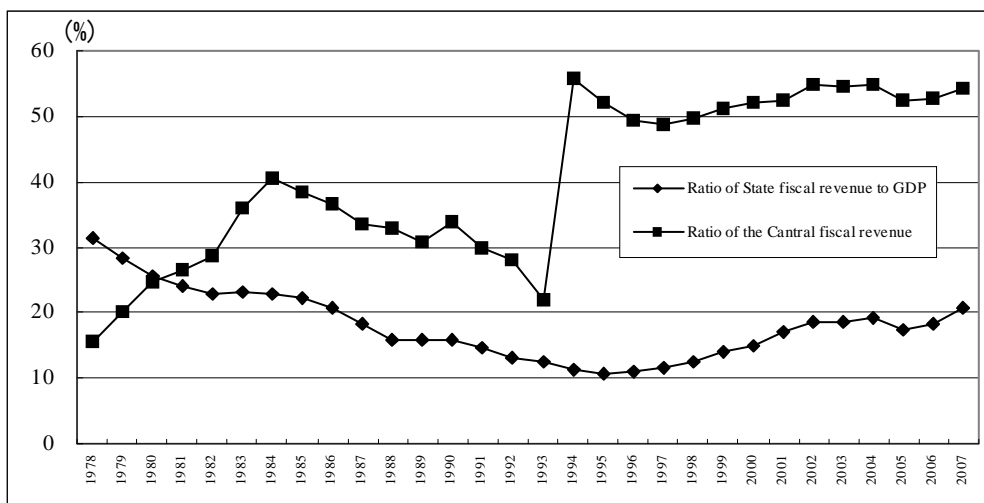
Table 5: Fiscal Revenue & Expenditure of the Central and Local Governments

(100 millions Yuan / %)

Year	Central revenue	%	Local revenue	%	Central expenditure	%	Local expenditure	%
1990	992.42	33.8	1,944.68	66.2	1,004.47	32.6	2,079.12	67.4
1991	938.25	29.8	2,211.23	70.2	1,090.81	32.2	2,295.81	67.8
1992	979.51	28.1	2,503.86	71.9	1,170.44	31.3	2,571.76	68.7
1993	957.51	22	3,391.44	78	1,312.06	28.3	3,330.24	71.7
1994	2,906.50	55.7	2,311.60	44.3	1,754.43	30.3	4,038.19	69.7
1995	3,256.62	52.2	2,985.58	47.8	1,995.39	29.2	4,828.33	70.8
1996	3,661.07	49.4	3,746.92	50.6	2,151.27	27.1	5,786.28	72.9
1997	4,226.92	48.9	4,424.22	51.1	2,532.50	27.4	6,701.06	72.6
1998	4,892.00	49.5	4,983.95	50.5	3,125.60	28.9	7,672.58	71.1
1999	5,849.21	51.1	5,594.87	48.9	4,152.33	31.5	9,035.34	68.5
2000	6,989.17	52.2	6,393.97	47.8	5,514.34	34.7	10,365.10	65.3
2001	8,582.74	52.4	7,803.30	47.6	5,768.02	30.5	13,134.56	69.5
2002	10,388.64	55	8,515.00	45	6,771.70	30.7	15,281.45	69.3
2003	11,865.27	55.8	9,389.84	44.2	7,406.96	30	17,242.99	70
2004	14,476.12	54.9	11,879.76	45.1	7,895.62	27.8	20,465.17	72.2
2005	16,535.94	52.3	15,092.04	47.7	8,775.73	36.8	15,092.04	63.2
2006	20,456.62	52.8	18,303.58	47.2	9,991.40	24.7	30,431.33	75.3
2007	27,738.99	54.1	23,565.04	45.9	11,445.04	23.1	38,120.36	76.9
2008	33,611.00	54.0	28,644.00	46	13,374.00	21.1	49,992.00	78.9

(Source) Prepared from annual *Chinese Statistics Almanac*, *Public Finance Yearbooks*, and others

Figure 5: Ratio of State Fiscal Revenue to GDP and the Ratio of the Central government's Fiscal Revenue



(Source) Prepared from annual *Chinese Statistics Almanac*, *Public Finance Yearbooks*, and others

Next, in terms of the changes in the ratio of the state finance to GDP, it increased gradually after the tax-sharing system. However, its growth is limited when compared to economic growth rate. It can also be said that part of the initial objectives was accomplished to the extent that the weight of the central government's fiscal revenue increased, although the weight of the local governments has a rather rising trend. In addition that the re-distribution function for fiscal adjustment is not working sufficiently due to the inadequate mechanism for fiscal transfer, local finance at the respective levels of province, prefecture-level city, county and township & village in China do not have corresponding tax categories such as province tax, city tax, county tax and township & village tax and there is an issue that the tax-sharing system is not rigorously implemented at the level of local governments of province or below. Therefore, the sources of tax continue to be unclear and opaque at the respective local governments of province or below. There are not a few local governments which effectively continue to use so-called contracting systems, like 'proportional payment' based on the 'base value method' and the 'fixed amount method'.^{12),13)}

From the above, we have to conclude that limited results were achieved toward the original objectives of strengthening the state finance and improving the fiscal power and macro control function of the central power through the implementation of the tax-sharing system.

¹²⁾ For details of those methods for contracting system, please refer to Zhang (2001).

¹³⁾ The survey conducted in 2004 to 2005 in China revealed that such a situation exists in Laisui County in Hebei Province, Xiamen City in Fujian Province, Hefei City, Yaohai District in Anhui Province, Changzhou City, Jintan City in Jiangsu Province and others.

IV. Administrative and Tax Reforms after the Tax-sharing System

While the overall framework for the relationship between the central finance and the local finance were established after the implementation of the tax-sharing system, many issues remained, including shortcomings and opaqueness in the operation, inadequate setup at the levels of province or below, and imperfect redistribution function. Therefore, the fiscal system reforms were carried out repeatedly even after the tax-sharing system. In this section, we focus on the reforms of the budgetary system and administration based on which the fiscal system is to be established, to examine the reforms since the tax-sharing system.

IV.1. Reforms of the Budgetary System

With regard to the relationship of the central and local governments in respect of the tax and fiscal systems in China, various authorities and legal bases are given to the central government and, when taking into consideration the current framework of the state and the system design, we would expect the central government's control function to work at respective local governments. However, the reality is that the central government's control may not necessarily work well. From the viewpoint of the budget, there is the tendency of de-centralization tendency again. China's fiscal system represents a single budget principle, but the actual state in respect of the accounts of publicly-owned businesses and fiscal investment & loan is not clear with opaque accounting treatment remaining, which worsens the problems such as local governments' debts and excessive investment at their discretion. It is a phenomenon due to the constraints in the 'soft' budgets of the local governments which has been an issue. Such a situation becomes a cause of economic overheating as a result of excessive investment in the local governments and would give negative impacts on the entire macro economy. Therefore, in order to contain the local governments' debt problem and their excessive investment and overcome collusion and abuse of authorities, the system of a single national treasury account and others have been implemented. Together with the establishment of the mechanism that the central government's fiscal revenue increases significantly owing to the tax-sharing system, the proper functioning of the single account system would lead to fiscal concentration into upper government levels. Since the conventional national treasury system was not centralized given many levels associated with it, fiscal revenue did not go into the treasury directly and, on the outlay side, the funds went through to no respective administrative sections in some cases. It can be attributed to an issue that there were many intermediary organizations and steps in the budget execution process¹⁴⁾, which not only prevented agile operation but also created even an issue of leading to larger room for embezzlement and diversion. As a result, since 2002 the national treasury central receipt and payment system has been put in place for budget control and management purposes. This system allowed the account system of the national treasury to be centralized and all of the fiscal funds to be incorporated into its single account system. Under the new framework fiscal revenues are now supposed to flow into the national treasury or the fiscal special account directly, while expenditure is allocated directly to the administrative sections

¹⁴⁾Typical examples are own funds (small coffer) maintained by respective agencies and organizations (units).

through the national treasury's single account system. As a result, the control of expenses of subordinate governments by upper governments has been strengthened and the salaries of civil servants, etc., not to mention of various specific subsidies, are controlled centrally through banks. This is a natural mechanism for fiscal operation and indispensable to build an efficient fiscal system. However, the very fact that the reform to control the budgets centrally through the single account system was carried out at this point illustrates that the consolidated management of the budgets had not been available in China, with the lack of transparency in operation, and that fraudulence and corruption had been prevalent in the meantime. With regard to the government's procurement, the new government procurement act that was implemented in 2003 and onward also helped secure transparency through public announcement of the base prices and procurement via auction. Furthermore, putting more rigorous control in place for extra budgetary funds had been one of the characteristics of public finance in China, implementing so-called "reform of fees and taxes". As the examples of reducing the various fees and funds that governments and respective organizations had been collecting and levying them as taxes instead, and creating a new fund for the central government and ensuring the most strict control and management on it, they pushed ahead for the development of a new framework.

From 2004 and onward, the exemption of agricultural tax started one by one in 28 provinces including Hebei Province and the agricultural tax was abolished in 2006 in principle. In light of this, and in townships and villages which shifted to the single account system of the national treasury at the same time, some saw a substantial decrease in the administrative work of its fiscal division even complete elimination in the extreme cases¹⁵⁾. That is, the abolishment of the fiscal division of townships and villages were in progress in parallel with the budgetary system reforms and, in fact, some government-ruled cities had the budgets at sub-district offices (at the same level as townships) abolished, claiming that fiscal authorities could effectively go down to district level. On the other hand, as a result of the fiscal authorities repealed, some movements toward expanded autonomy have been witnessed at the levels of sub-district offices and communities¹⁶⁾. This is noteworthy as a new framework in China, in areas without fiscal authorities that would take advantage of the communities' dynamism to facilitate the offering of public and administrative services in the local governments, while they depend on their upper governments in terms of funding.

IV.2. Administrative Reforms

IV.2.1. Establishment of the Administrative systems

It is indispensable to establish an efficient administrative system in order to establish an efficient fiscal system. In China too, the administrative reforms have been in progress over the last several years.

¹⁵⁾ These points were revealed by interviews conducted at the Shi Ting Town fiscal office in Laisui County in Hebei Province and other places during the summer of 2004.

¹⁶⁾ It can be said that the 'Big Community' reform implemented at Lugu sub-district office of Shijingshan District in Beijing in October 2003 highlights such developments toward the establishment of autonomy at the local governments and in regions in China.

The administrative system in China has four layers of local governments: province level, district (city) level, county level, township and village level, below the central government. Together with those four layers of local governments, there are ‘specifically planned cities’ and vice province-level cities¹⁷⁾ whose fiscal budget sizes tend to increase recently as well. In addition, while the number of districts decreases, prefecture-level cities increases in number and there are increasing cases of establishing districts governed by cities. An example is Shijingshan District in Beijing City. Administrative categories vary considerably across regions in China; in addition to the traditionally common four-pillar system, a mixture is seen more frequently recently, with the three-pillar system as often seen in cities directly governed by the central government and minority autonomous regions and the two-pillar system as frequently observed in the former. Moreover, the budgetary system reform has pushed the public finance at townships and villages a lot into the direction of being abolished and, as a result, the townships and villages with their fiscal authorities taken away are being positioned as local agents of respective counties at various places. At the same time, the review of the relationship between the administration and public finance is in progress too. Historically, the fiscal and administrative units at local levels were the same in China. That means, all the governments at each level, from province level to those at lowest-rank, were given budgets. However, since there emerged a need to re-establish the system and balance fiscal resources with administrative work to promote efficiency in the administrations and public finance, the review of local administrative and fiscal units is ongoing under new frameworks such as ‘township finance controlled by county,’ ‘province-controlled county’ (province to control county’s finance directly), ‘city-controlled county’ (prefecture-level city to have a complete fiscal authority), and ‘province-controlled city’ (province to control city’s finance). It is noteworthy developments toward establishing and enhancing the administrative system and enhancing the soundness of the administrative work, and further achieving the efficiency in the fiscal operation.

IV.2.2. Coordination of the Administrative Duties and Financial Resources

Another important issue, as well as the reform of the administrative system, is the inter-governmental allocation of administrative work and fiscal resources. While the tax-sharing system brought some clarity, it is still left opaque and remains as an issue in China. In terms of the expense sharing between the central and local governments, there are expense items common to both of them in many areas. Therefore, a local government with a relatively large share in the expenses would face a gap in fiscal revenue and expenditure. Even though the shortage is supposed to be made good through fiscal transfer, the fiscal transfer system itself has own deficiencies, not necessarily being successful in bringing equalization. The lower the rank of a government is, the more its fiscal revenue has decreased since the divisional tax system and the more severe gap in the revenue and expenditure it will be suffering. As a result of such an ambiguous situation around the allocation of the administrative work and fiscal resources, there will be negative effects that the local governments increase extra-budgetary or off-the-system funds, or that their hidden debts increase sharply. Under the reform of the tax-sharing system, the focus was to review the allocation between the central and local governments from the

¹⁷⁾They refer to Guangzhou, Shenzhen, Suzhou, Hangzhou, Wuxi, Foshan, Ningbo, Nanjing, Dongguan, Wuhan, and Dalian.

perspective of splitting revenues clearly with a view that the central government secures fiscal resources, and the split on the expenditure side was left unclear. It created imbalance in the distribution of the administrative work and fiscal resources, resulting in distortion. On the other hand, while it is increasingly more important how the local governments that play a fundamental role (equivalent to basic municipalities in Japan) provide services such as compulsory education, child-raising and nursing care as it sees more social and economic developments and the aging of the society, it is not decided yet which government will be responsible for that role, causing social anxiety. It is one of serious issues that the social security fund that poses the most important challenge does not have a uniform mechanism in place across regions¹⁸⁾, as the society experiences the acceleration of low birth rate and aging society and a rapidly widening gap.

What has been pointed out, in particular, is that there are many deficiencies in the fiscal systems of the governments at a county level or below. Looking at the sizes of the local governments, many of the provinces have geographical areas and populations whose sizes are equivalent to a country's, while the counties are relatively small. Because of the imbalance between the allocation of administrative work and those of authorities and fiscal resources there, inefficiencies in the local governments' public finance as a whole are amplified. On the other hand, the ratio of tax revenues for the central government vs. the local governments stands at 16:62:22 in terms of the central tax to shared tax to local tax, with the weight of shared tax being highest¹⁹⁾. When the objective of the tax-sharing system to strengthen the central public finance is considered, the weight of the central tax need to be increased and it would also lead to improving re-distribution. It would force subordinate governments to assume more administrative burden without corresponding fiscal resources.

Meanwhile, from the viewpoint of efficiency, the next challenge would be around a reform to delegate certain authorities to the local governments, with the presumption of clarifying the responsibilities including fully specifying the budget constraints. This is because giving more discretion to the local governments sometimes turns out to be rather effective. Though there will be extremely strong resistance to a shift to a de-centralized fiscal system in consideration of the current organization in China, you cannot help but allow some level of de-centralization when taking into account the sustainability of the public finance. That means that it is indispensable to articulate how the authorities and fiscal resources are allocated and where resulting responsibilities lie, and the local governments will be required an ability to run the public finance that would withstand them.

¹⁸⁾ From Taniguchi (2007)

¹⁹⁾ It is only business tax, which accounts for about 13%, whose composition is more than 10% among the local tax items.

Table 6: Allocation of the expenditure between the central and local governments

Central tax	Shared tax	Local tax
Consumption tax	Value-added tax	Township land usage tax
Vehicle purchase tax	Business tax	Property tax
Custom duty	Enterprise income tax	Urban property tax
Vessel ton tax	Income tax for enterprises with foreign capital and investment	Agricultural land occupation tax
Value-added tax and consumption tax collected by customs on behalf	Individual income tax	Land appreciation tax
	Resource tax	Vehicle & vessel license usage tax
	City maintenance & construction tax	Vehicle & vessel usage tax
	Stamp duty	Contract tax
		Agriculture & livestock raising tax
		Slaughter tax
		Fixed asset investment direction adjustment tax

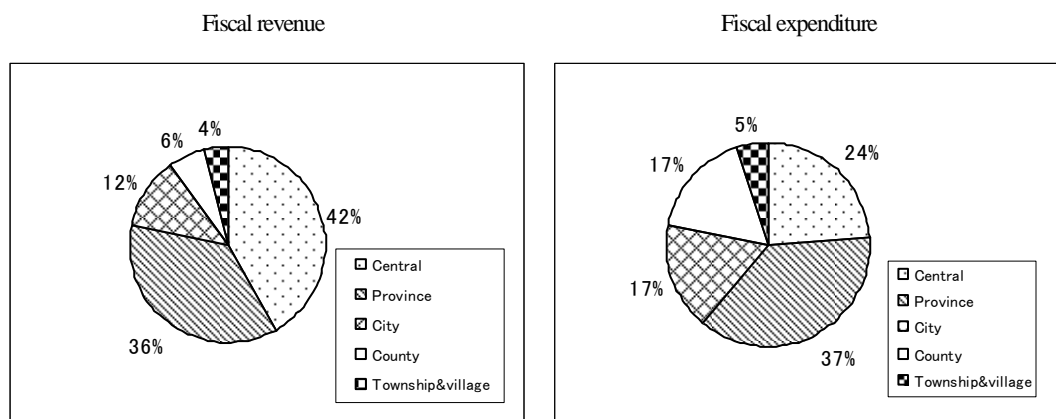
(Source) Prepared from Ni Hong ri (2005) (partly modified)

Table 7: Allocation of the administrative duties between the central and local governments

Administrative duties	Central	Province level	District level	County level	Township & village level
National defense	○				
Diplomacy	○				
Advanced education	○	○	○		
Secondary education		○	○		○
Compulsory education				○	○
Cultural projects	○	○	○	○	○
Scientific research projects	○	○	○		
Medical insurance		○	○	○	○
Population containment			○	○	○
Administrative management	○	○	○	○	○
Government & legal expenditure	○	○	○	○	○
Social security	○	○	○	○	○

(Source) Prepared from Ni Hong ri (2005)

Figure 6: Ratio of the fiscal revenue & expenditure by administrative level



(Source) Prepared from Li Ping (2006) and others

V. Fiscal Relationships between the Central and Local governments - Primarily around Fiscal Transfer

V.1. Necessity and Background to Strengthen Re-distribution

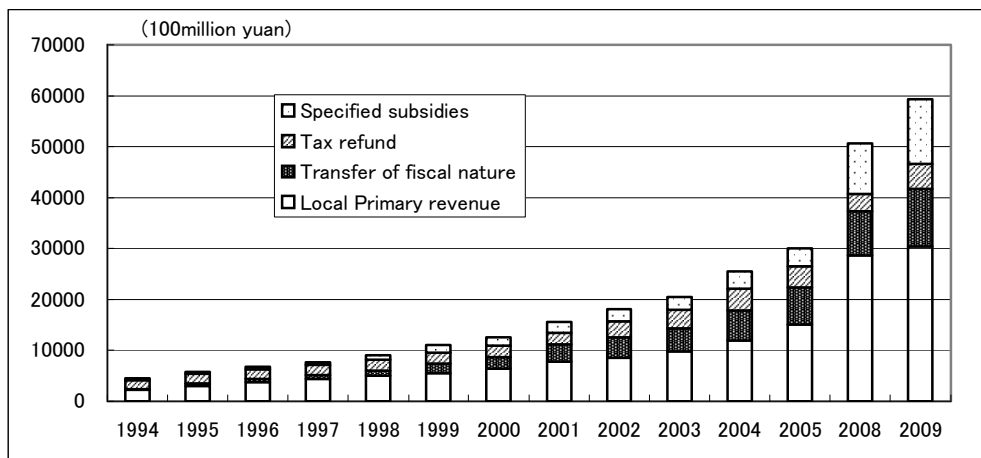
The background behind the reason why it is urgently required to build an efficient administrative and fiscal system lies in increasing severity of various gaps within China. As widely known, there exist various kinds of gaps including economic gaps between coastal and midland/inland areas, income gaps between urban areas and farming villages, and further, hierarchical gaps within urban and inland areas, respectively. Against this backdrop, President Hu Jintao in his second term has been accelerating the efforts by setting the ‘construction of a harmonious society’. That is the development of balanced economic and social systems, as its important goal and under the guiding principles of the ‘Scientific concept of development’ that focuses on the solution of the issues of agriculture, farmer, and rural as well as energy and environmental issues. Specifically, with regard to the measures to rectify the inter-regional economic gaps, for example, the development policy of limiting to the traditionally important areas of the midland & western areas has veered, and the western major development, northeastern promotion and midland promotion strategies have been re-positioned as a comprehensive development strategy. In addition, as it is recognized that it is important to resolve so-called ‘three imbalances,’ the imbalances in respect of ‘inter-regions, industrial structures, and quantity & quality’ and that the improvement of the quality of foreign investment is indispensable to that end, the foreign investment selection process has become noticeably selective with a view to improving on those points. The pillars of the policies around the use of foreign capital include the continuation of aggressive and effective use of foreign capital, the promotion of high technology, environmental, highly value-added, energy conservation areas, the expansion of service area, preferential treatment to midland, inland and northeastern regions, and the promotion of technology transfer. Toward the accomplishment of those goals, it has been declared that they would not only accelerate on improving the investment environment, but also demand social responsibility from foreign capital. By reducing or repealing the preferential measures to extensive (with wasteful spending of energy), labor intensive, low value-added industries as been pointed out for some time, it seeks to downsize or reduce relevant industries and enterprises. Given that energy-saving and environmental measures are part of the key challenges in the eleventh five-year plan but the goals have not been met to date, it is an imminent task for the current administration to step up the environmental and energy measures through the conversion of industrial structure. In addition to those structural changes, in terms of the reduction of the gaps which is arguably the biggest challenge to build a harmonious society, they went ahead with the policies to protect the rights of laborers through the promulgation and implementation of the new ‘Labor Contract Law’ and are working to improve the employment environment, by raising the minimum wages and through other measures as well. Moreover, there are initiatives to attract investments to the suburbs of the coastal areas, midland and the west. This seeks to revitalize the economy of the lagged areas by getting enterprises relocated, as well as promoting the attraction to and development of new industries in the advanced areas.

As above, China saw such structural adjustments in terms of industrial structures and employment environment to take place rapidly over the several years. These initiatives entailed aspects that are favorable to the development of Chinese economy and society. However, too rapid changes may lead to the deterioration of the operating environment for domestic enterprises (export-related enterprises and SMEs, in particular) and investment environment for foreign affiliated enterprises, and ultimately, potentially worsening the gap issue. Therefore, since it would face certain limits to rely on resource allocation by the governments in the form of projects and drastic industrial policies, it is indispensable to build re-distribution systems across regions and individuals in order to redress the gaps and accomplish a balanced society. The social demand for it is ever increasing.

V.2. Trends in Fiscal Transfer and Challenges

With regard to re-distribution from the central government to the local governments, the reform of the tax-sharing system put a certain structure to the fiscal transfer system. Initially, there were such items as transitional period transfer payments (equivalent to local allocation tax), specified subsidies, return of tax revenue, system subsidy, and year-end adjustment. Out of these, it is the return of tax revenue system that has been most problematic. It was introduced as a kind of measure to preserve vested interests so as to suppress the resistance from the local governments upon the introduction of the tax-sharing system. It is a system by which tax revenue would be refunded by the central government to the local governments as per designated mechanism in such a way that it provides the minimum guarantee to the tax revenue of a relevant region in 1993, in case that the region sees a reduction in its tax revenue in 1994 and afterwards as a result of the introduction of the tax-sharing system. Therefore, a region with more tax revenue in 1993 would have more taxes refunded. It had been an issue that the weight of this return of tax revenue in the fiscal transfer was too large. It is because the effect of re-distribution through fiscal transfer would be limited under such a system. In addition, since an area with relatively developed economy would have higher compositions by value-added tax and consumption tax (called the 'two taxes'), which are subject to the return of tax revenue, wealthy areas mainly in the eastern coastal region would receive larger refund. In other words, this system works to protect the vested interests of the wealthy areas, leading to promoting inequality.

Figure 7: Local Governments' Fiscal Revenue and Fiscal Transfer



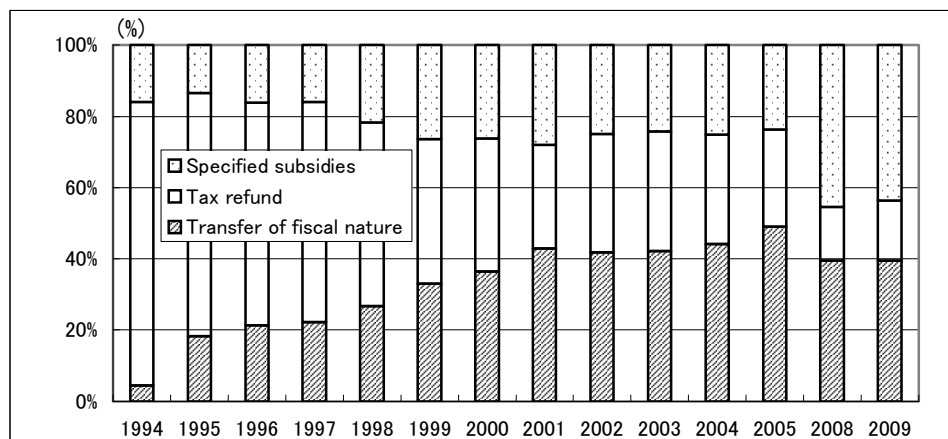
(Source) Prepared from Li Ping (2006), Fiscal Reports and others

*Notes: Transfer payments of fiscal nature: an aggregate of fiscal transfer whose purpose is to redress the gap issue.

Tax refund: Provides guarantees to the revenue for respective local governments at the levels prior to the reform of the tax-sharing system, and any decrease as a result of the tax-sharing system would be refunded by the central government to the local governments.

Specified subsidies: Subsidies which are allocated to each project for social security, education and infrastructure.

Figure 8: Changes in the Weights of Respective Fiscal Transfers



(Source) Prepared from Li Ping (2006), Fiscal Reports and others

With regard to the return of tax revenue, it totaled at 179.9 billion Yuan and accounted for 75.3% of the total transfer amount paid to the province-level governments in 1994, immediately after the introduction of the tax-sharing system. As more reforms to the overall framework of the fiscal transfer system were gradually carried out, there have been changes to the return of tax revenue and other transfer payments and their detail and composition have also been changing over time with an increase in the amount of fiscal transfer. Specifically, while the amount of transitional period transfer payment was mere 2.1 billion Yuan in 1995, it saw steady and large increases to 13.8 billion Yuan in 2001, 38.0 billion Yuan in 2003, 112.0 billion Yuan in 2005 and 152.7 billion Yuan in 2006. (Its name was changed to 'general transfer payments' in 2002.) However, when looked at the case for the fiscal year 2006, general transfer payment stood only at about 10% of the total transfer amount and is expected to grow considerably more in the future. In the meantime, the composition of the return of tax revenue decreased to around 40% in 2005, and subsequently, to roughly 30% in 2006. It still has to be said that it is too slow compared to the speed of economic growth, demanding further reforms. It is also required to pay attention to the mechanism, inherent in the system itself, which will have the revenue of the central government increase gradually as tax revenue increases²⁰⁾. On the other hand, the composition of the specified subsidies (equivalent to subsidies) is on the rise, there is a shift toward stronger fiscal equalization function. Specified subsidies are specific subsidies to respective projects relating to the enhancement of infrastructure, social security, measures for issues of agriculture, farmer, and rural, and more policies are being executed in the form of projects to deal with the issues of aging society and uneasiness for the future, and further, widening the gaps. They have been increasing considerably in size from 36.1 billion Yuan in 1994, to 136.0 billion Yuan in 1999, 240.0 billion Yuan in 2002, 323.8 billion Yuan in 2004, and then to 352.9 billion Yuan in 2005. In addition, specified subsidies accounted for 15% out of the supplementary revenues for province-level governments in 1994, which has increased to 36.5% in 1999 and 31.7% in 2002. Accordingly, the fact that enterprise income tax which used to be the revenue for the respective government in charge as well as individual income tax which had been the revenue for the local governments were converted into shared tax and made available for general transfer payments consists part of the measures to step up the efforts for reducing the gaps.

Since the re-distribution function would be strengthened if the ratio of the tax revenue return decreases under the fiscal transfer system and the transfer payments of fiscal nature (general transfer payments) increases as above, it can be said that the current developments are welcomed. However, the fact continues to be there still

²⁰⁾ Main characteristics of the tax refund system (return of tax revenue) since the tax-sharing system were as follows: Out of the amount of tax revenue return from the central government to the local governments, a 'net transfer payment amount' to the central government in 1993 was considered as the central government's revenue. 'Revenue allocation to the central government' had consumption tax, income taxes of foreign banks and non-bank financial institutions, 75% of value-added tax, and 50% of securities exchange tax which had been a revenue for the local governments as the central government's revenue -1). 'Revenue allocation to the local governments' had the central government's share of urban land usage tax, agricultural land occupation tax, and revenue from nationally-owned land paid use which had been a revenue for the central government as the local governments' revenue -2). It is considered that 1) - 2) to be 'net transfer payment to the central government.' This tax refund represents a system by which 30% of the increase will be returned to the local governments (with 70% retained by the central government) and which allows the tax revenue for the central government to surely grow. According to the estimate by Professor Zhang Zhong ren (the University of Shimane), when looked at time series data for each of the growth rate assumptions of 10%, 20% and 30% for the two taxes, it is revealed that the refund rate to the local governments will decrease gradually, with the fiscal revenue for the central government increasing. This is quoted from p.36 of Naito (2008).

remain lots of tax revenue returns, while it is gradually declining, and that the low ratio of direct taxes prevents the re-distribution function from working fully. It requires further improvements.

In the meantime, new developments in relation to these points have started to be seen in fiscal year 2009. During the public account reporting at National People's Congress in 2009, more details regarding fiscal transfer relative to before were disclosed, which revealed some points that should be noted.

Firstly, the amount of general transfer payment increased. General transfer payment represents transfer payment that corresponds to local allocation tax in Japan. As such, it should be desirable to see an increase in the transfer that has re-distribution function. However, 'general transfer payment' for this purpose has been changed its name from the previous 'transfer payment of fiscal nature' in the current fiscal year. The previous 'general transfer payment' has also changed to 'transfer payment for balancing purpose,' and thus the definitions of these terms are different from up to the last year. Therefore, we cannot conclude from this point only that the re-distribution function has been strengthened and it is necessary to examine closely while paying attention to the changes in the names and details.

Secondly, the amount of the return of tax revenue is on the rise again. Since the return of tax revenue has an element of preserving so called vested interests, more tax is refunded to a wealthy area, limiting its ability to re-distribute. While the amount of the tax revenue return had been on the decline over the past several years, it would go up as part of an increase in product and petroleum consumption tax becomes subject to the return of tax revenue from this year. Thirdly, the content and amounts of fiscal transfer were provided in more detail compared to the previous years. From this, I assume they sought to appeal the fact that the income re-distribution function by the central government had been strengthened. However, when taken into account the effects from the naming changes to the fiscal transfer items and switch-over of their contents, etc., with ambiguity in many respects, it is not necessarily the case that the re-distribution function has been truly enhanced and the effects are to be confirmed. Even though we can recognize more disclosure of the details and the increase in the amount general transfer payment, it is strongly suggested that the authorities publish data which are comparable continuously and maintain the stance of ensuring transparency, as there are concerns around the intention behind opaque operation such as the changes to the definitions.

Allocation percentages of the two taxes

Growth rate	5years later	10 years later	20years later	30years later
30%	11.19	4.46	0.8	0.14
20%	14.52	7.81	2.26	0.65
10%	19.44	13.99	7.25	3.76

Table 8: Details of Fiscal Transfer during FY 2008

	FY 2009 budget	FY 2008 actual (estimate)	Growth rate
Total transfer payment	23954.81	18663.42	28.4
General transfer payment	11374.93	8696.49	30.8
Transfer payment for balancing purpose	3918.00	3510.52	11.6
Transfer payment to ethnic group areas	280.00	275.19	1.5
Fund for county & township basic fiscal strength protection & promotion support	550.00	438.18	25.5
Transfer payment for salary adjustments	2365.63	2392.30	-1.1
Transfer payment for the reform of agricultural village fees and taxes	770.22	762.54	1
Transfer payment for urban area fiscal strength with depleted resources	50.00	25.00	100
Fixed amount subsidies (system support)	138.14	136.14	1.5
Transfer support by enterprise & business unit	348.00	335.00	3.9
Support for accounting & fiscal strength	344.51	354.66	-2.9
Transfer payment to discontinue collecting the two fees from the industrial and commercial sectors	80.00	47.00	70.2
Fund to encourage village-level public works	10.00		
Transfer payment for general public services	45.00		
Transfer payment for public safety	332.90		
Transfer payment for education	908.49	419.36	116.6
Transfer payment for social security & employment	1234.04		
Specified transfer payment	12579.88	9966.93	26.2
Education	448.86	687.53	-34.7
Science & technology	32.79	85.88	-61.8
Social security & employment	1816.17	2399.31	-24.3
Hygiene & medical	1124.28	800.49	40.4
Environment preservation	1199.27	974.09	23.1
Agriculture, forestry & fishery	3143.19	2387.81	31.6
Return of tax revenue	4934.19	3342.26	47.6
Return of the two taxes (value-added tax & consumption tax)	3476.00	3372	3.1
Return of income taxes	910.19	910.19	
Return of product & petroleum taxes and the revenue from the reform of fees and taxes	1530.00		
Transfer by the local governments	-982.00	-939.93	4.5
Total	28889.00	22005.68	31.3

(Source) Based on the Public Finance Reporting at National People's Congress in 2009

More importantly, a significant issue remains, which is to strengthen re-distribution with keeping vested interested as they are. If only the fund flows through with the vested interested remaining, it may actually cause inefficiencies through exploitation during the intermediate steps, potentially resulting in worsening the issues of widening and fixing gaps. Regarding this point, the issue of the local governments is extremely important. Accordingly, we examine the issues and challenges for the local governments' public finance.

V.3. Challenges for the Local governments' Public Finance

V.3.1. Debt Issue

An issue which may be considered to be most serious in terms of China's fiscal problems is the trend and operation of the local governments' public finance. They deeply relate to the structural problems of the local governments, including insufficient disclosure of information about the operation of public finance and opaqueness, and fraudulence and corruption, as well as the issues of the local governments' debts and non-

performing loans. Since it had not been permitted to issue a municipal bond²¹⁾, the debts which would be brought to the fore were extremely rare. However, it has been pointed out that there exist a considerable amount of hidden debts behind the scene²²⁾. It primarily consists of 1) bank loans to enterprises to which the local governments provided guarantee, 2) unpaid salaries to civil servants (teachers and staff members at elementary and junior high schools, in particular), 3) shortage in tax collection, or shortage in funding of social security fund caused by misappropriation of the fund, 4) unpaid expenses, etc., for construction projects by the local governments, 5) misappropriation of the money of the agricultural cooperation fund and credit losses from food-related enterprises, and 6) the fund allocated by the central government as fund to be re-lent. In addition, there was so-called 'land public finance'²³⁾ under which the local governments sought to increase fiscal revenues by making use of land particularly in recent years. Though it brought a considerable increase in the fiscal revenues for respective local governments up to around mid 2007, the economic slowdown in the second half of 2007 and after saw some developers got into financial difficulties and incurred bad loans while there emerged frequent cases of individuals delaying the payments under mortgage loans on purpose and violating the contracts. These increased bad loans for banks, which caused a substantial blow - by not only a decrease in the revenues but also an increase in bad debts - to the local finance. Furthermore, in cases where they tried to ride on the bubbles and the fund management became lenient, there were reports of the local governments even providing guarantee to buyers whose own money was insufficient. These are the causes of increased debts by the local governments. As a result of such behaviors together with banks and developers, the risk of bad loans for the local governments has heightened, which is giving even a danger to the entire financial system. In this way, the issue of the local finance always exists as a constraint in terms of China's fiscal system and operation. Furthermore, it is an issue that the disclosure of the information regarding these situations is very limited and that the actual state is extremely opaque. There is a big question about how far and accurate the central government understands the actual state of the local finance. It is possible that deterioration in the local finance gives negative impacts to a local economy, leading to management difficulties at local financial institutions and enterprises which have deep relationships with the government. If such a situation occurs, it would cause some enterprise to go bankrupt and the unemployment issue to worsen, a decrease in the laborer's pay may lead to widening in the gap, giving so much negative impacts to Chinese economy as a whole. However, it would create moral hazard if the central government continues to act on their behalf to deal with the fiscal deficit of the local governments and the bad debt issue of financial institutions. Under the current system in China, the deterioration in the local finance would also constrain the behaviors by the central government which is

²¹⁾ In fiscal year 2009, the ban on the issuance of municipal bonds was lifted. There are not many differences from the national government's bonds in terms of issuance method, target and coupon. It is also pointed out that the integrated management of municipal bonds would be easier because you would be able to leverage the channels through which government bonds are sold. However, there will remain an issue that such issuance terms would not reflect the risk of municipal bonds. In addition to hidden debts so far, you will then have to monitor the official amount of debts for the local governments' official debts.

²²⁾ According to the survey result by the Research Institute for Fiscal Science, Ministry of China, there was an estimate that the hidden debts by the local finance totaled 12 to 15 trillion Yuan (based on the interview with China Institute of Social Research).

²³⁾ It is a mechanism where a local government provides guarantee to source funding from banks and expropriates land from farmers and local residents to develop and resell it, with a view to obtaining capital gain and increased tax revenues.

responsible for controlling macro economy and impact the operation of its economic policies negatively. While it is appreciated that China's fiscal deficit is reasonably sound at this moment in light of the standards by EU²⁴⁾ as stipulated in the Maastricht agreement, municipal bonds whose issuance have been lifted a ban, together with the debts of the local finance including the hidden debts, puts a significant risk to the state finance and this situation cannot be overlooked.

V.3.2. *Regionalism and Governance of the Governments*

As already examined in this paper too, the fact that the local governments used their discretion to expand the autonomy through the Contracting System and the reform of tax for profit since the reform and opening-up resulted in a substantial decrease in the ratio of fiscal revenue and expenditure to GDP, which further led to the expansion of regionalism. Because the trend of tax revenues flowing more into the central government was strengthened since the tax-sharing system, the local governments made further efforts to secure own fiscal resources by expanding off-budgetary and off-the-system funds. In addition, re-distribution is not functioning well due to the preservation of vested interests with regard to the return of tax revenue and the inadequate fiscal transfer system at the levels of province or below, and fiscal operation is not being carried out in accordance with the central government's policies. Moreover, as a feature of the 80's since the reform and opening-up, while the governments themselves got engaged in businesses as if they were enterprises, by deeply participating in economic activities in coordination with state-owned banks and enterprises, they created mechanisms by which they could obtain profit through various regulations and used it to protect enterprises and enhance the infrastructure in order to invigorate local economies. This is a kind of regionalism. The result was that excessive investment was made in respective regions. It also caused excessive heating of the whole Chinese economy. Such behaviors by the local governments are not gone away yet. There is a mechanism working by which the economic growth rate of a relevant region is given the highest importance for the purpose of performance evaluation of a leader of the region, making him/her consider that maintaining the growth rate is an absolute priority and feel incentivized to achieve the goal. However, as we went into the 90's, such trend changed its shape to the mechanism of 'land public finance' to provide a means for the local governments to obtain revenues partly because the land system changed considerably as part of the changes to the property right system. As a result, local farmers and residents who sold their land to secure one-time revenue ended up with losing their bread and butter, an increase in the number of the unemployed became a cause for amplifying social uneasiness, and the gap issue also worsened. It means that the central government has a reason to be hesitant to regulate it aggressively, since it allows the local governments to acquire own revenue.

The background behind the above situations may include two potential elements. Firstly, fiscal equalization across governments is not working properly. It is already mentioned that the imbalance between the work and fiscal resources, combined with the effect of the tax-sharing system, put the lower-level governments into a more financially strapped position. It has major influence on this respect, too, and requires being rectified soon

²⁴⁾The standards provide that the level of fiscal deficit be 3% or less of GDP on an annual basis and that the outstanding of government bonds issued be 60% or less of GDP.

by pushing through an administrative and financial reform. Other than that, the fiscal transfer systems at the levels of province or below vary considerably from one province to another. In a situation that legal grounds and authorities around public finance are concentrated into the central system-wise. In reality, lots of discretions are left to the local governments, particularly to the province-level governments, so that you actually have to rely on their discretion as public finance at the province's level or below is opaque with extremely limited information. As a result of the de-centralization trend of the authorities to the local governments, you cannot prevent the efficiency and fairness of public finance from getting deteriorated. They could also lead to an increase in fiscal risk. If we take an example of municipal bonds whose issuance was lifted the ban, it requires financial resource which can support the issuance as a major premise. However, the local tax law, local autonomy law, local allocation tax law, etc. are established only inadequately in China. Therefore, lifting a ban on the issuance of municipal bonds in the current environment where the fiscal right and autonomy have not been established may give rise to moral hazard.²⁵⁾

Secondly, there is the governance issue of the local governments. It has been pointed out that administrative inefficiency is a large issue in the current system in China, since it not only prevents the intention of the residents from being reflected but also the checking function from working. It can even be said that it is difficult to enhance the governance of a local government under the current setup, unless you do it through the control and supervision by the central government. In order to strengthen the governance of a government and achieve fair administrative & fiscal policies, it will ultimately be required to establish a democratic government. However, in the current situation where a change in the system in China is not realistic in the short run, we cannot but help explore a way to strengthen the function of the government by taking the current framework as given. As a hint to that, it is important to think about the roles of residents (community), social enterprises, NPO/NGO, volunteers and others. The role of those new forces comes to the fore in the midst of failures by the governments and markets, and they are indeed working as new players in the social economic system. As globalization and informatization are advancing rapidly, it is apparent that the governments cannot hold much longer on self-righteous policy operation without considering the benefits of enterprises, residents and so on. It is shown in a sharp increase in the number of demonstrations and riots by residents in recent years in China. Therefore, it becomes a major challenge for the governments themselves how they carry out policy operation toward the aim of strengthening their governance while engaging new constituents in the society, and at the same time, it is not only a feasible measure given the maintenance of the current system but also arguably the only measure that you can rely on. It is an imminent task to clarify the role of the government sector and build a system that allows functional operation while taking advantage of such social inclusion.

VI. New Developments in Fiscal Policies – Fiscal Policies under Financial Crisis

Chinese economy took a sharp turn from high-speed economic growth to slowdown accelerating. Of course, there have been not a few impacts from the global economic crisis brought by U.S. originated financial

²⁵⁾Unlike in Japan and other countries, local governments in China cannot be considered as 'autonomous communities.'

crash as an external driver, but it can be also considered that a rather larger issue is that the impacts from multiple structural reforms concurrently pushed through in the country at one go have become as influential blow as it, worsening the real economy. In this section I examine the trend and details of the governments' countermeasures which are currently being taken in such a situation as well as the challenges.

VI.1. *Aggressive Fiscal Policies – Initiatives Toward Domestic Demand Driven Economy*

Chinese economy is hammering out various countermeasures with a view to coming out of the economic crisis. Table 9 lists 'comprehensive economic measures' announced in November 2008. The contents of the economic measures mainly focus, together with the development of the infrastructure, on the issues of agriculture, farmer, and rural (improvement in agricultural productivity, increase in the income of farmers, and upgrading and consumption expansion in rural areas), safety of the society, and public welfare. They not only emphasize the 'Scientific concept of development' as advocated by the Hu Jintao administration and but also reflect the notion that it is important to change the format of reforms substantially, not going back to the situation in 1998 to 2000 after Asian financial & currency crises.

Table 9: 10 Items of Economic Measures by Chinese Government

<ol style="list-style-type: none"> 1) Housing construction that is of social security nature 2) Construction of infrastructure in rural areas 3) Construction of key infrastructures such as railway, public road and airports 4) Promotion of medical, hygienic, cultural and education projects, etc. 5) Enhancement to biological and environmental measures 6) Unique innovation and structural adjustment 7) Disaster restoration in the areas which suffered from earthquakes 8) Improvement in the income of the residents in urban cities and rural areas 9) Lowering of value-added tax across the country (enhancement of enterprises' vigor) 10) Strengthening of financial support
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(Source) Based on the statistical publications by the National Bureau of Statistics, etc.

Specifically, the major part is consisted of the measures for the issues of agriculture, farmer, and rural, including the improvement of infrastructure and substantial increases in subsidies to social security, etc., for rural areas, the hike of the purchase prices of crops and agricultural subsidy, and the improvement of the minimum life security. There are also emphases on the measures for the weak and the public welfare policies such as the addition to housing for people with low income, the increase of pension payment to the retired and livelihood protection subsidy, and the expansion of medical, hygienic and cultural & educational projects. Furthermore, many countermeasures for enterprises are included such as reducing the burden on enterprises through the value-added tax reform (worth about 120 billion Yuan), repealing the lending limits of commercial banks, and lowering interest rates. The principles of the macro economic policies are defined as 'aggressive fiscal policies and appropriately loose monetary policy,' which emphasizes on the balance of policy mix. Its core starts and ends with how domestic demand is expanded. In the meantime, in terms of the composition of domestic

demand, the focus of the government has changed. It is the expansion of consumption which was emphasized as of the summer of 2008, although it was again advocated to step up investment at the Standing Committee of the State Council in October of the same year. There was no mention to consumption at the Central Economic Work Convention either, jointly held by State Council and the CPC's Central Committee in December that year, where the importance of investment was stressed, going back to the earlier direction. China then faces the fundamental challenge. The expansion of consumption is indispensable to grow domestic demand and it would require the solution of the issues of agriculture, farmer, and rural as a major premise. However, many issues should be solved before consumption can provide a strong support to economic growth, which would take a considerable amount of time. Therefore, you will have to rely on investment and external demand to put the economy back on track, particularly in a tough economic environment like the current one. However, when you cannot rely on external demand any longer, there is reality that it is difficult to change a structure where you cannot help but depend on investment. Since it is the government's key task to get back to the economic growth trend soon by all means, all you can do is to show aggressive initiatives domestically and internationally. The only measure to stimulate consumption which is worth attention is a measure to encourage the sale of home electric appliances ('Home Electric Appliances Replacement Program') in the rural areas. It is a policy measure that the purchase of eligible products which include a color TV, refrigerator, washing machine and cell phone at specified places in the rural areas over the next four years (with the amount capped) will receive a subsidy of 13% based on the purchase price of these products. This policy measure is expected to contribute to not only the expansion of domestic demand but also the reduction of the gaps between urban cities and rural areas and bring the consumption expansion effect worth of 900 billion Yuan during the effective period of four years. There is a similar policy measure called 'Automobile Replacement Program' implemented for the purchase of a car. It is expanded to cover the urban areas with a view to invigorating consumption.

It is one of the most important tasks currently in China to maintain the economic growth rate of 8%. It is a rate of growth that is required to maintain employment in order to keep the economy and society stable. Economic growth which slowed down considerably to 6.8% during the fourth quarter of 2008 and 6.1% during the first quarter of 2009 has to be revived whatever it would take. With that, large-scale policy measures as steps to grow domestic demand are hammered out one after another, such as tax reduction of 500 billion Yuan in size, subsidy payment to rural areas of 400 billion Yuan, and new loans by banks of 5 trillion Yuan, in addition to public investment of 4 trillion Yuan. For enterprises which are suffering from severe deterioration in the performance, such measures as roughly doubling lending to SME's to 9.6 billion Yuan from the previous year and making subsidy payment of 20 billion Yuan to promote technology innovation. Further, in respect of employment and public welfare, it was determined to pay 42 billion Yuan for employment measures, 293 billion Yuan for social security expenses, and 850 billion Yuan for medical and hygienic need in rural areas (for three years). A view that these policy measures are effective in maintaining 8% growth rate is spreading, with an assessment that the effect is starting to be seen. As a matter of fact the economic growth rate recovered to the 7% handle during the first half of fiscal year 2009, and there emerges heightened expectation in international community that Chinese economy will support global economy going forward. On the other hand, there is an opinion calling for the need for additional investment, resulting in differing assessments. The trend in the

economic recovery during the second half of the year will validate the effectiveness of the current economic measures as an indicator. However, export which has been underpinning Chinese economy remains sluggish and consumption continues to be weak. We are not in a position to be very optimistic. Therefore, additional steps are being taken, including those to extend the measures to stimulate consumptions which were implemented in the rural areas to the urban cities and expanding tax reduction for export. However, it is the fact that it is still a difficult situation.

VI.2. Details of Public Investment and Funding Issue

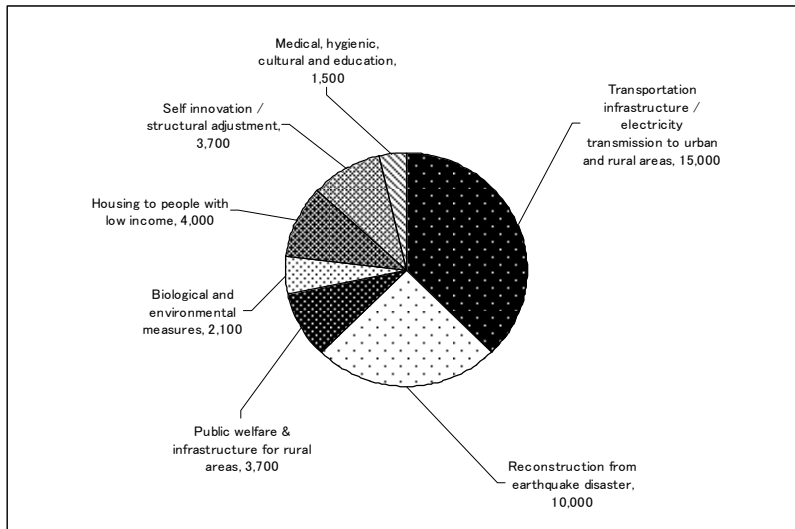
It is public investment worth 4 trillion Yuan in total that is noteworthy as a highlight of the comprehensive economic package in such a situation and attracts expectations from the international community. Table 10 shows the details of additional investment and Figure 9 illustrates the breakdown of the 4 trillion Yuan.

Table 10: Additional investment by the central government
(Breakdown of additional investment of 100 billion Yuan by the central government (in 100 millions Yuan))

Housing stability project	100
Public welfare and infrastructure for rural areas	340
Railway, public road, airports, etc.	250
Medical, hygienic, cultural and education projects	130
Energy saving, environment and biology	120
Innovation and structural adjustment	60

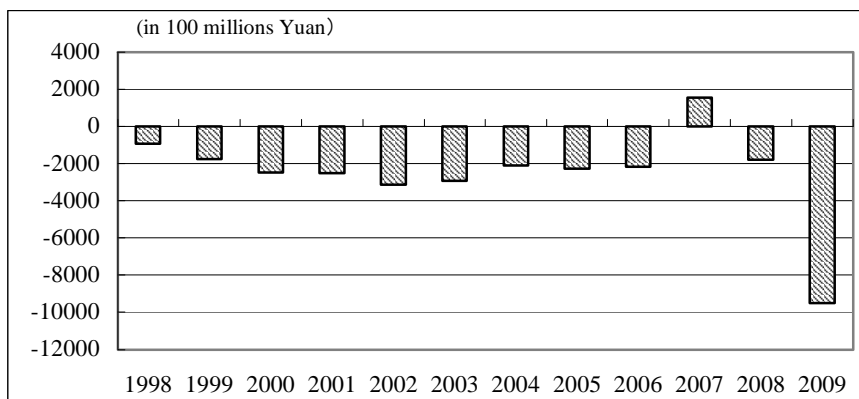
(Source) Based on the announcements in various media reports

Figure 9: Breakdown of the Economic Measures of 4 Trillion Yuan
(Announcement at the National People’s Congress in 2009)



(Source) Based on the announcement by the National Development Reform and Reform Commission

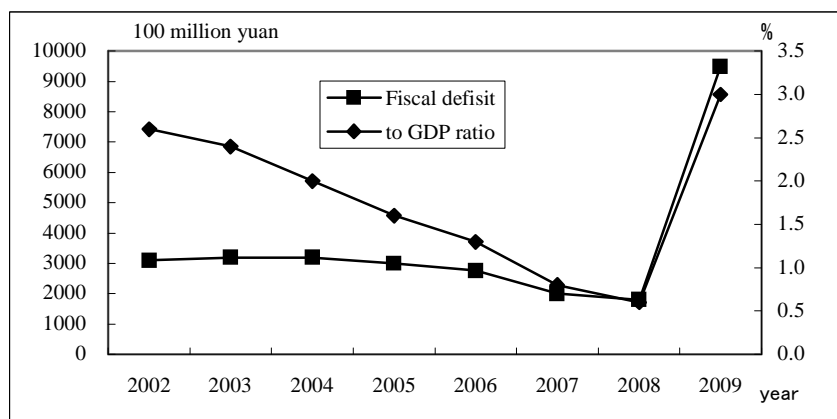
Figure 10: Trend in the Fiscal Revenue & Expenditure in China



(Source) Based on the announcements by the National Bureau of Statistics

* Note : Numbers for fiscal year 2009 are on a budget basis.

Figure 11: Trend in the Fiscal Deficit



(Source) Prepared from *Chinese Public Finance Yearbooks*, Fiscal Reports and others

It has been announced to make public investment of 4 trillion Yuan over the two-year period from 2009, which is currently in progress. Meanwhile, prior to this, investment of 400 billion Yuan (out of which 100 billion Yuan was additional investment by the central government) was added in 2008. Out of 4 trillion Yuan, 1.18 trillion Yuan will be borne by the central government while the rest will be assumed by the local governments and financial institutions.

A major issue here is the funding source for the investment and investment efficiency. The portion by the central government will be financed by the issuance of national debt and the fiscal deficit totals to 950 billion

Yuan, largest ever, in the fiscal year 2009 budget²⁶). The fiscal situation in China maintains certain soundness thanks to the increases in tax revenues during rapid growth over the last several years, as shown in the fact that it had surplus in 2007 on an annual basis, and it has been relatively stable. When looked at the ratio to GDP, it stood at approximately 3% for 2009 on a single year basis while the ratio of national debt balance was at around 21%. These are supported by huge domestic savings. However, in the midst of rapid progresses in the expansion of the economic measures and the deterioration of enterprises' business performance, further decline in tax revenues would cause fiscal deficit to increase, which requires monitoring.

Investment by the central government totaled 230 billion Yuan as of April, when combined with the 100 billion Yuan for 2008, and covers all of the seven items initially presented. There emerges evaluation that the effect of those economic measures is being seen. Moreover, the fiscal sources are said to have been identified mostly and the investment by the central government appears to have been progressing generally smoothly.

VI.3. Trend in the Local Governments' Public Finance – Permission of the Issuance of Municipal debt

On the other hand, it is the local governments' public finance that is rather problematic. It has been the case historically that, the lower the rank of a local government is, the larger gap between its fiscal revenue and expenditure it has, suffering more from the shortage of fiscal resources. They worked to secure the sources of funding through various approaches since the reform and opening-up, by obtaining profit through techniques of 'local state corporatism' in the 80's and then 'land public finance' in the 90's. However, property prices have dropped significantly since the economic crisis and it has not only become difficult to secure revenues through such a technique but also posed a larger risk of an increase bad debt of corporations. Meanwhile, the issuance of municipal debt had not been allowed in principle in China. But it was determined by National People's Congress that a ban on the issuance of municipal debt would be lifted in fiscal year 2009 given the shortage in the fiscal resources for the local governments due to the recent economic slowdown²⁷). The issuance of 200 billion Yuan is planned for 2009. Municipal debt has been issued by 23 provinces, cities and autonomy districts as of May, with an aggregate amount of 111.8 billion Yuan.

²⁶) The size of fiscal deficit had been estimated to be less than 300 billion Yuan in November 2008 at the time of the announcement of the comprehensive economic package but, with deepening economic crisis, additional economic measures were required. As a result of several modifications, it ultimately ballooned to 950 billion Yuan (750 billion Yuan for the central government and 200 billion Yuan for the local governments).

²⁷) A mechanism issued by the central government was adopted, which is on behalf of a local government, underwritten by a state-owned bank. It is considered to have a purpose of curbing the expansion of municipal debt issuance. Since it became difficult to secure fiscal resources for public works projects for the economic package, it seems to be inevitable but was decided to lift a ban.

Table 11: Issuance of Municipal Debt during Fiscal Year 2009 (as of May)

	100million yuan		100million yuan
Sichuan	180	Guangxi	35
Henan	88	Xinjiang	30
Jiangsu	84	Liaoning	30
Yunnan	84	Shandong	30
Hubei	81	Jilin	30
Chongqing	58	Inner Mongola	30
Beijing	56	Heilongjiang	30
Anhui	40	Qinghai	29
Hebei	40	Tianjin	26
Zhejiang	40		
Shanghai	40	Tsingtao City	11
Xianxi	36	Dalian City	10

(Source) Based on various media reports

However, there are many issues. The tax and legal systems which would provide a legal basis to the issuance of municipal debt is inadequate and credit strength of the local governments' public finance is unknown. It would be a reasonable approach to find a fiscal resource for the local governments if you have them with relatively strong fiscal capacity issue municipal debt, and provide them with relatively weak fiscal capacity be given enhanced transfer from the central government. However, it is not necessarily the case in reality. It is necessary to respond with taking into account differing fiscal capacity of local governments. A rapid expansion of the municipal debt issuance would entail large risk. Potentially for that reason, there may be cases where no underwriter appears when municipal debt is actually issued. In this way, the amount of the fund that can be appropriated by the local governments for public works projects is extremely limited and there is a possibility that they end up with using the 're-loan system' by which the central government re-lend the fund obtained through the issuance of national debt, too. While this is a method which has been used historically, it may give rise to an issue that it is extremely difficult to identify who is obliged to it again, since the re-lent fund would not appear as deficit to the central government's public finance. It is assumed that they decided to permit the issuance of municipal debt partly because of this reason. However, the coupon rate is supposed to be set at the same level as the one on national debt to prevent excessive issuance by the local governments, leaving the risk of municipal debt not reflected properly and the difference from the 're-lent fund' unclear, while it makes possible to identify who is obliged to it. In this way, it is not easy for the local governments to secure fiscal resources. Meanwhile, as soon as the central government announced the economic package, each local government also announces large-scale investment plans one after another, with an aggregate amount of more than 20 trillion Yuan²⁸⁾. However, it is not clear how to locate fiscal resources that would endorse the plans and it is feared that a situation of them resorting to the fund by the central government might occur in the end. It is also concerned that they may go back to the conventional pattern of such competitions in expanding investments

²⁸⁾ It was reported to be 19-20 trillion Yuan in China, according to Nikkei's report (December 8), although it was 30 trillion Yuan.

leading to inefficient excessive investments. Moreover, if the local finance whose challenges are deepening ultimately end up with failing to repay the re-lent fund from the central government, it is highly likely that all of them will become non-performing debt. It is also pointed out that a considerable portion of the local governments' 20 trillion plus Yuan of public investment overlaps with the 4 trillion Yuan, making the investment effect over-estimated. In addition, in terms of operations in investing money, other problems that the fund sourced was not actually invested, false reports were made, and the money was misappropriated are already being pointed out. Fraudulence and corruption by the local governments are being surfaced again.

An extraordinary stance of Chinese government to do everything in its power has been shown domestically and internationally. China's economic recovery attracts the attention and expectation of not only China but also other countries now. Therefore, decisive economic policies and appropriate operation are required for the large-scale public investment to increase effective demand and for the investment effect to achieve rapid economic recovery. The local governments are the wild card and its movements would have lots of influence.

Table 12: Fiscal Budget during Fiscal Year 2009

Fiscal year 2009 budget			
	Fiscal year 2009 budget	Growth rate	Fiscal year 2008 actual
Total revenue by the central government	36,365		34,711
Fiscal revenue by the central government	35,860	+9.8	33,611
Transfer from the central budget stabilization adjustment fund	505		1,100
Total expenditure by the central government	43,865	+24	36,511
Fiscal expenditure by the central government	43,865	+24	36,319
Expenditure by the central government	14,976	+12	13,374
Fiscal transfer	28,889	+31.3	22,945
Return of tax revenue	4,934	+47.6	3,342
General transfer payment	11,374	+30.8	8,696
Specified transfer payment	12,579	+26.2	9,966
Transfer to the central budget stabilization adjustment fund			192
Fiscal deficit by the central government	7,500		1,800
Balance of national debt	62,708		53,270
Fiscal revenue by the local governments	59,259	+17	51,590
Revenue by the local governments	30,307	+6	28,644
Transfer from the central government	28,889	+31.3	22,945
Municipal debt	2,000		
Fiscal expenditure by the local government	61,259	+24.9	49,992
Surplus · carry forward			1,597
Nation revenue	66,230	+8	61,316
Nation expenditure	76,235	+22.1	62,427
Difference	9,500		

(Source) Prepared from the fiscal report for 2009

VII. Conclusion – Future Challenges

As examined in this paper, the fiscal system and policy measures in China which welcomed 30th anniversary since the reform and opening-up had gone through various repeated enhancements to the system to promote reforms. It can be said that the system has been advancing. However, we cannot conclude that an efficient and functional system for fiscal operation has been in place since, on the other hand, there are issues remained in terms of fairness and transparency on the operational side. This challenge has been pointed out and requires prompt improvement. However, in the midst of lots of questions in the global community under financial crisis around how the market system and the role of governments should be, we should consider this as a kind of opportunity to re-think about the role of the government in China in the light of further developments toward market-oriented economy, too.

VII.1. Increasing Constraints

VII.1.1. Reignited Discussion on Political Reforms

On the back of questions around capitalism and how market economy in itself should be, faced by a global economic crisis, the debate on political reforms has also become active between the conservatives and reformists. Since the report by Hu Jintao at the 17th National Congress of Communist Party of China in 2007, the phrase of ‘democracy’ has been used frequently, and it reignited the discussion around political reforms. So-called conservatives’ side positions the ‘universal values’ argument as a theory of capitalism and argues that China should not accept it easily. In reaching the 30th anniversary since the reform and opening-up, considerable controversy is being created whether they should re-emphasize the ‘Chinese values’ and ‘Chinese characteristics,’ or see the ‘universal values’ right and accept democratization, freedom, human rights and private ownership,. The proposition of the conservatives claims that some of the forces use the ‘universal values’ (democratization, freedom, human rights and private ownership) as grounds to push the ideas of capitalism and change the socialism system. It is argued that the rapid growth and development of Chinese economy since the reform and opening-up are the very fruits of socialism with Chinese characteristics and that they should continue to adhere to it. On the other hand, people who are called the reformists stress the accomplishments over the thirty years since the reform and opening-up at every occasion to appeal that they should not retrace their steps in terms of the direction and speed of the reforms²⁹⁾.

Meanwhile, the rapid spread of the discussions around such ‘universal values’ formed a channel to get the ‘08 Constitution’ circulated over the Internet. Initially, it was signed by 303 people who believe that freedom, equality and human rights are universal rights common to human beings. The third signature list as

²⁹⁾ You can see how unstable the administration might be and how strongly they are concerned about the emergence of the conservatives from the facts that President Hu Jintao, who used the term of ‘democracy’ more than sixty times during the 17th National Congress of CPC, has been emphasizing the accomplishments of the ‘open-door reform’ policies repeatedly. He had to continue to argue for adherence to the ‘Scientific concept of development.’

published on December 13 had 1,200 or more, and the eighth signature list as of 23rd was reported to list 6,191 people who signed. The movement remained on a limited scale without spreading meaningfully, but it still represents an event which is worth the attention.

The background behind why such debates are growing appears to lie in the fact that the global economic crisis rooted in the financial crisis originated in the U.S. informatization raised questions around the roles of capitalism and market economy themselves from various quarters and it is expected to gain momentum further in the midst of rapid slowdown in the domestic economy, above all, and have more anxieties of the society in a situation where the trend of economic protectionism is increasing contrary to the responses by respective countries. Out of the notion that they have to avoid the understanding (or the impression) that the reform is being retreated from spreading across international community by all means, the Hu Jintao administration emphasizes the accomplishments of the reform and opening-up and the scientific concept of development to the forces which were a try to take advantage of the economic crisis as an excuse to slow down the reforms. They are also pressured to tighten the control while pointing out the existence of contradictions and issues which are yet to be resolved in the country. It is been speculated that they would definitely require more caution in running the administration in the year of 2009, according to the fact that it represents a symbolic year for various events in the past, including the 90th anniversary from May Fourth Movement, 60th anniversary from the national foundation, 50th anniversary from riots in Tibet, and 20th anniversary from Tiananmen Square Incident. While there are no major disruptions surfaced so far, it is believed that magma is being accumulated.

One of the points requiring attention is the position of Premier Wen Jiabao. Firstly, it is the criticism from the conservatives. Against Wen Jiabao's representation that 'science, democracy, legal system, freedom and human rights are not unique to capitalism, rather the values which human beings have been seeking for together and the accomplishments of the civilization,³⁰⁾ the conservatives protests to argue that it is inducing the people to democratization and causing demonstrations and riots. In addition, they were reported to be more critical once, claiming that it is the 'open-door reform' policies that brought widening gaps, and fraudulence and corruption by politicians and bureaucrats. Meanwhile, there is another aspect that Premier Wen Jiabao may not necessarily have the tightest support. For example, you can recall an occasion which he had a disagreement with Wang Yang, Secretary of CPC's Provincial Committee of Guangdong Province. When Premier Wen Jiabao visited Guangzhou Province which is the heart of the reform and opening-up, he emphasized on the importance of controlling the negative effect from structural adjustment, against the situation where the impact from the financial crisis was enormous and the bankruptcies of SMEs and unemployment were rapidly spreading. Secretary Wang Yang countered that it was necessary to see the shakeout of enterprises of obsolete nature as a result of structural adjustment (consolidation of labor-intensive enterprises, increased sophistication of the industrial structure and the advancement of high technology), and emphasized the necessity in pushing through the structural reforms based on the Scientific concept of development. In this way, a picture of a disagreement between Secretary Wang Yang of Provincial Committee of Guangdong Province, the most economically advanced region, Premier Wen Jiabao implies that there exist differences in the opinions on policy measures

³⁰⁾Based on an article on "People's Daily" dated February 27, 2007.

within the administration's leadership, and similar debates that occurred subsequently several times has been provoking controversy. It is an indication that the Hu Jintao administration is being required to manage extremely difficult steering to curb over the dissatisfaction of the people against the government and seek the stability of the society while deterring the emergence of the conservatives, and it seems that Premier Wen Jiabao is on the frontline. 2009 is the year when they are to start drafting the next five-year plan and summarize the results of the 11th five-year plan. In addition to that the energy saving and environmental objectives are not achieved, the domestic economy slowed down significantly and social anxiety such as bankruptcy and unemployment has been heightened, despite they were affected by the global economic crisis. It is possible that the issue of the administration's responsibility may emerge and, in particular, the responsibility of Premier Wen Jiabao may be questioned, which demands monitoring of the future developments.

In addition to this matter, it is difficult to judge if the current administration is the core of the reformists in the debates on political reform. While the Hu Jintao administration puts up the adherence to the reform and opening-up and the 'universal values' as public pledge to international community, it does not necessarily appear to be proactive on political reform, including democratization. In other words, everything presumes the maintenance of one-party regime by the Communist Party. The '08 Constitution' mentioned in the above claims that 'freedom, equality and human rights are universal values shared by human beings' and demands the separation of three branches, freedom of gathering and association, democratization (public election system), freedom of speech and religion, private ownership, and others, which obviously differs from the stance of the current administration. In a situation that the environment surrounding the current administration lies in the emergence of both 'conservatives' and 'radical reformists who call for democratization and a change in the system,' I cannot help feeling somewhat worried about the resurgence of the debate around political reform. Putting it in an extreme manner, it would end up with leading to an ultimate issue of which of 'national unity' and 'one-party dictatorship' would be given a higher priority. Neither of the scenarios that the current economic crisis causes the conservatives to gain power and retrace on the reforms and that it stimulates the radical reformists to occur a change in the system radically would be desired. In order to achieve soft landing to 'national unity,' there is no other way than continuing gradual reforms. In this sense, it would be important points of note going forward how much the political reform would be incorporated in the process of drafting the next five-year plan which should start from this autumn or after and discussing the policy agenda for the next administrant from 2012.

VII.1.2. Reform of Rural Areas Would be a Key

The issue of the rural areas is extremely serious as one of potential factors that may constrain the development of China and harm the stability of the society, as well as representing a factor which would incur increased fiscal burden in the future. Out of various issues piled up, there are several points for which larger issues are particularly surfacing in the recent years. The first point is widening in the gaps. The geographical factor is typically mentioned first as a reason why the rural areas are poor. There is more land used for agricultural production located in the inconvenient inland areas out of the vast national territory of 9.6 million

square kilometers, but the cultivated acreage accounts for mere 11% of 1.2 million square kilometers. In addition, much of it is not very fertile. Moreover, water resource is extremely limited and it is reported that the shortage amounts to as much as 4 million ton a year. Next, as a political factor, the rural areas which are far from the markets have become poorer, causing a gap between farmers to widen while the dismantlement of people's commune, the Contracting system, etc., since the reform and opening-up made the farmers near urban areas wealthier. It followed that the gap continued to widen with movements toward market-oriented economy. The gap between urban cities and rural areas kept widening as a result of the construction of urban cities and industrialization which made use of rural areas. Moreover, it is problematic that the issue of the extremely poor treatment of farmers due to restrictions such as land transaction system and census registration system remains unsolved. Secondly, it is the governance issue of the local governments. There are serious issues with the fiscal situation of the local governments and their ability to manage the execution of policies. While a township and village became a unit with administrative power as a result of the dismantlement of People's Commune since the reform and opening-up, more subordinate governments are financially more strapped and suffer from excessive burden to farmers. In addition, the corruption structure got rooted more deeply with executive officers in poor regions exploiting farmers and misappropriating subsidies. It is also related to imperfect separation of the three powers in China. In local areas, in particular, governments, the party, judicial branch of the governments, public security sections, etc. are in collusive relationships, giving a cause for graft and corruption. Further, there is no system that works to check such a situation. The third point concerns hygiene, environment, food safety and so on. Poor regions in the local areas cannot afford to spend money in the countermeasures for pollution and hygienic issues, and polluted water and contaminated substances from factories cause cancer and pollution-related diseases. In terms of the safety of food which also provoked lots of controversy in Japan, there are many migrant workers at factories near rural areas who work in a poor working environment with extremely low levels of knowledge and morale and it entails considerable risk for hygiene and the safety of food. On such an aspect, the lack of the governance of the local governments is a factor too. The fourth point is the energy issue. Regions and rural areas which suffer from chronic shortage of electrical power depend on inefficient thermal power plant (coal-fired) and the harm to the environment as well as poor energy efficiency has become serious issues. Another serious issue is back-bearing work and large accidents at coal mining sites. The fifth point concerns ethnic problems. Most of the minority ethnic groups live in the rural parts of midland/inland areas. As symbolized by recent Tibet and Uighur problems, conflicts originated from the ethnic autonomy issue have been intensified and spread more. It also involves the issue of economic gaps, providing a destabilizing element of the society.

As above, it is not an exaggeration to say that various issues faced by today's China are consolidated into the issue of the rural areas. Under such circumstances, the Central Committee of the Communist Party and State Council have widely discussed about the reform of the rural areas that incorporates reforms such as the construction of new agricultural villages, which revolve around the enhancement to the measures for the issues of agriculture, farmer, and rural areas, the reform of census registration system and the moderation of restrictions on land transactions since 2004. They have been working hard on it as a priority policy agenda. However, the unemployment issue of migrant workers from the rural areas has recently surfaced due to the impact of the

economic crisis and there is concern for the negative effect to the reform of the rural areas. It can be said that the conversion to domestic demand-driven economy and the stability of the economy and society cannot be achieved without the reform of the rural areas. Now that the premise of Deng Xiaoping's theory of "some areas must get rich before others" is accomplished, it is the largest task to achieve "shared richness." In other words, in China that has been pushing for market-oriented economy, how social welfare is accomplished, or the issue of distribution, became the key. China is at a major crossroad in terms of whether this challenge can be resolved under the current system or it cannot be done without a change to the system associated with the political reform. However, there is no other option than responding to those issues with fiscal steps in the meantime. It also creates considerable fiscal burden while the expectation for the reform for more functional public finance is increasing. On the other way around, in case a local government falls behind on its fiscal burden, it would create a cause for social insecurity. It is apparent from this sense too that the solution of the rural areas' problems is an extremely important task. At the same time, if the reform does not progress smoothly, it would be a major constraint for the sustainability of the development of Chinese economy and public finance.

VII.2. Increasing Role of Public Finance in the Macro Economic Policies

As examined so far, Chinese economy is in a major crisis, attacked by the financial crisis when it was slowing down due to the structural adjustment and sharp tightening measures within China. As the economic slowdown is worsening concurrently across the globe, it is necessary for China to come out of the crisis. At the same time, it is expected to be the driving force for global economic recovery. At the National People's Congress which was held for 9 days from March 5, 2009 in such a situation, representations were made around various initiatives revolving around the economic package and the resolution during many reports. Here I analyze the economic principles, mainly from the political activity reports, to forecast a trend and outlook for future economic policies and conclude this paper.

It is not surprising that the National People's Congress of this year which was convened under the global economic crisis triggered by the financial crisis emphasized the 'stability of the economy and society' more than before. It is shown that rather holistic and abstract nuance that advocates the 'harmonious society' and seeks to build a balanced economy and society in the form of very concrete measures, unlike the conventional. At the same time, as it illustrates how serious the deterioration in Chinese economy has been due to the sharp economic slowdown, it indicates the degree of sense of crisis by the government and the leadership. Several key points as highlighted are listed below.

Firstly, there is aggressive fiscal policy toward the current economic crisis. The aggressive fiscal policy was expanded as the economic package was imminently required. As a result, the central government's budget deficit which decreased by about 60 billion Yuan during fiscal year 2008 showed a substantial increase to 750 billion Yuan during fiscal year 2009. The amount of fiscal deficit has been modified four times since the first figure was announced last December and finally increased to 950 billion Yuan, nearly 3% handle vs. GDP. In addition, the point of note this time is lifting a ban on the issuance of municipal debt (200 billion Yuan during fiscal year 2009). It is assumed to have an element of circumventing criticism to the sharp increase in the central

government's fiscal deficit. However, since the fiscal sources for the local governments are not clear and it involves a risk of abusive issuance by the local governments, a scheme of the Central Fiscal Department issuing on the behalf. An important point is that local governments' debt will be clearly identified, unlike the 're-lent funds' (a scheme by which the central government issues long-term national debt and re-lend to the local governments; it not only made the grounds for the obligations unclear but also resulted in the majority going bad due to the failure of timely payments by the local governments). However, the difference from the re-lent funds is not necessarily clear since 1) the risk of the local governments would not be reflected as the coupon rate on municipal debt would be set at the same level as the one on national debt, 2) there is a possibility that it will not be repaid depending on the local governments' repayment ability and due to failure to repay, and other reasons. Moreover, there is a view that 200 billion Yuan is far from sufficient to cover a shortage in the local governments' financial resources and that it has to be used together with loans of policy nature and the issuance of bonds by local enterprises. On the occasion of lifting a ban on the issuance of municipal debt, it is concerned that the International Trust and Investment Corporation (ITIC) bankruptcy issue which caused serious bad debt problems as a result of widespread lax investments across the country in the 90's might reappear.

Secondly, it concerns movements regarding the monetary policy. Although a 'reasonably easy monetary policy' is currently adopted and the National People's Congress this time also mentioned the importance of the monetary policy together with finance, the principles may not necessarily be clear. Put it on the other way around, the reality may be that they cannot make it clear. The monetary policy was converted to be the reasonable easing mode for one goes from tightening until last year. Stock markets bounced sharply as well, owing to sudden easing since the beginning of the year. On the other hand, capital injection and the measures to rescue financial systems which are being implemented across the globe would result in an increase in currency circulation and a rapid increase in fiscal deficit, heightening a risk for future inflation. The concern for inflation has not been wiped out completely in China, either. The impression is that there are more conflicts in the opinions and bargaining regarding the monetary policy within the government. In addition, with regard to the exchange rate policy, it is difficult to accept further strengthening in Yuan in the current situation of sharp decline in the export, while weaker Yuan can lead to deterioration in the economy and interest rate reduction, possibly causing the outflow of the funds to accelerate rapidly. Thus the exchange rate policy seems to reach a deadlock. Premier Wen Jiabao stressed the soundness of the financial sector in China and pointed out that public finance should not be used to cover the deficit by financial institutions. However, as it will continue to be difficult to show the direction of the monetary policy in the midst of increasing uncertainty, the developments around the monetary policy is an important challenge to monitor most closely among future economic packages and economic policies in China. In such a situation, a significant monetary easing policy has been in place since the beginning of 2009, which has increased liquidity sharply as well as leading to increases in the prices of real estate and stocks. A rapid increase in liquidity can be a pressure for future inflation. It would also induce the local governments to expand investment and create a cause for excessive production as a result of excessive facilities along with the current aggressive fiscal policies.

Thirdly, it concerns balanced between structural adjustment and economic package. It cannot be avoided to slow down the speed of structural adjustment in the short run in order to maintain employment, which is an

important task. However, Premier Wen Jiabao argues that additional investment should not be used in general processing industries by any chance, which indicates that the government has intention to actually take advantage of the ongoing crisis and push for structural adjustment. Moreover, the objectives for energy saving and environment in the eleventh five-year plan have not been met and the responsibility of the leadership could be questioned in summarizing the results to prepare a draft next five-year plan which is scheduled to start this autumn. Therefore, taking a balance is extremely difficult, as they cannot put structural adjustment on halt. However, pushing for structural adjustment could lead to bankruptcies of SMEs and more unemployment, resulting in heightened social insecurity. It has become a political issue, rather than an economic issue. In addition, there is a possibility that the local governments try to take advantage of the aggressive fiscal policy to accelerate their public works sharply. Of course there would be beneficial investments, but if they rush for abusive and excessive investment, they may go back to the old state of inefficient economic structure. It would ignite another bargaining between the central and local governments and, thus, the central government has arguably been put in an extremely difficult position.

As above, the National People's Congress in 2009 was dominated by domestic economic packages and the importance of 'maintenance of 8%' and employment measure was stressed again. It cannot be helped given the current situation. However, there are many ambiguities around the effect of the economic packages and, as additional economic measures have already been shown, it weighs more on quantity, rather than quality, giving an impression that they may have reached limits under such tough circumstances. On the other hand, it will be a critical period this autumn in terms of drafting the next five-year plan, although the use of political consideration could be intensified behind scene in deciding the future economic policies and their operation. The current leadership is supposed to respond to the ongoing economic crisis as well as facing the challenge of domestic political battle. Therefore, the current administration seems to have a motivation to show its policies and leadership power by leveraging the economic crisis to show off its responses to economic recovery at home and abroad. The mirror side of it is that it can be interpreted as an indication of its sense of crisis. In a situation where the element of political battle on top of domestic and international economic circumstances generates increased uncertainty and more complexity in the responses, it might be possible to lead that the instability of the current administration started to surface gradually.

It is possible that the relationship between the party and government may emerge as an important factor going forward in order to reach a final solution on them: the clarification of the role of the governments, those of the central and respective local governments and their authorities, allocation of financial resources and, for efficient administrative and fiscal systems, which can possibly be required to build a decentralized system. The current administrative and fiscal systems in China are not decentralized due to the issues with the structure and it does not look likely that it moves in that direction in the near future. However, it is many countries' experiences that the movements toward democratization will accelerated gradually as the economic standards improve with further movements toward market-oriented economy. China has reached \$3,000 in terms of GDP per capita and there is a view that it is finally getting to that stage. As a matter of fact we started seeing individuals, communities and enterprises which show heightened awareness for rights and participate in policy-making. On the other hand, social insecurity as suggested in the deterioration of the gap issue and spreading of the ethnic

group issue has been amplifying and they can act as one of the triggers to raise a question on how the national framework should be. If the governing method of the nation becomes a subject of discussion, it would ultimately lead to an issue of which of national unity or one-party dictatorship should take precedence. If a shift to market-oriented economy advances further in China, the positioning and role of a government that correspond with it would be required more strongly domestically and internationally, making the political reform a very real important issue. The 30th anniversary of the reform and opening-up has come with extremely large contradiction remaining under the objective of prioritizing economic growth more than anything else. In the midst of environment changes in progress, a fresh question is cast over the role of the governments which are in charge of running the economy and society, how the inter-governmental relationships should be, regarding the reform of administrative and fiscal systems.

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