



研究レポート

No.302 November 2007

Intergovernmental Relation from the Fiscal
Aspect in China
-Reform movements and Tasks Compared to Japanese Experience-

Visiting Senior Fellow Jiro Naito

富士通総研（FRI）経済研究所

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ABSTRACT

Amid the progress of diversification of the economy and society, review of the role of the government has become important challenge, and how each country rebuild the form of state is also a very important issue. To solve this problem is a common task between China and Japan. Under these circumstances, the administrative and financial reform is being promoted in Japan. From the aspect of efficiency and decentralization, this movement is considerable, and also really suggestive for the reform in China. Above all, establishment of a “common local tax system” and “local administration and finance council” (where the central government and local governments hold joint deliberations on an equal footing) are notable. On the other hand, to increase transparency of public finance (especially in a local level) is indicated as an essential issue in China. To summarize this issue, ①promotion of enhancement of financial base, ②creation of a revenue source allocation system to ensure consistency in policies between central – local government, ③early clarification of the division of roles are indispensable for both China and Japan. In other words, how the so-called “autonomous and self-responsibility” system should be created is the key and urgent need. How the form of state should be established under development and diversification of the economy/society is a major task, and amid the widening of disparities as a more serious problem for both countries, it is important to realize the independence and autonomy of local governments, while ensuring the national minimum.

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1. Preface

Amid the progress of diversification of the economy and society, review of the role of the government has become an important task, and the significance of new organizations, including volunteer groups and NPOs/NGOs, also attracts people's attention. This is true of Japan and China. There are considerable differences in the economic and social structures and situations between both countries, so both countries cannot necessarily be understood uniformly, but they have the common task, namely, how they should rebuild the form of state amid diversification of the economy and society. In both Japan and China, new discussions and actual movements have occurred in various areas, including discussions about the desirable relation between the public sectors and markets, and cooperation between the government and private organizations/non-governmental organizations. It can be said, however, that the desirable form of state, which is the base for such movements, is now at a turning point. To this end, it is necessary to review the positions and roles of the central government and local governments in the administration and finance system.

This article discusses the intergovernmental relation between both countries from the fiscal aspect, and analyzes the ongoing reform movements and challenges in both countries, while understanding the current state of relations between the central government and local governments. For China, I will focus on the period after the "1994 Tax & Financial System Reform"¹ among others, to analyze the current state of central-local fiscal balances and fiscal transfer, as well as to examine reform challenges from the budget system reform to administrative reform. For Japan, I will clarify the central-local fiscal relation before and after the trinity reform and related issues, and examine the current state and challenges of decentralization reform. It is considered very important through such analysis to clarify the position of reform that can be identified from the similarity in the issues that both countries are facing.

Chinese tax and fiscal reforms have continued in various forms, with the "1994 Tax & Financial System Reform" being a turning point. However, the reality is that individual reforms have not brought results as intended. There still remain significant tasks involving the entire state system, including the political balance between the central government and local governments and the desirable government functions. Therefore, I will here examine the actual state of insufficiency of the functions as well as problems with the systems and structure causing such deficiency, while focusing on the actual state

¹ This reform is comprised by ①tax consolidation,②tax segmentation between Central-Local government,③Separation of tax office between Central-Local government. It is called "Fen Shui-Zhi" in Chinese.

of central-local relation from the fiscal aspect. I will then analyze the current reform movements, primarily focusing on the 11th five-year plan and government activities reported at 2007 National People's Congress.

Figure 1 Situation of Public Finance in China (Unit : Hundred Million Yuen/%)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP	34634	46759	58478	67885	74463	78345	82068	89404	95933	102648	117390.2	136875.9	182321.0
Fiscal revenues	4349	5218	6242	7408	8651	9876	11444	13395	16371	18015	21715	26356	31628
Ratio to GDP (%)	12.6	11.2	10.7	10.9	11.6	12.6	13.9	15.0	17.1	17.6	18.5	19.3	17.3
Growth rate (%)	24.8	20	19.6	18.7	16.8	14.2	15.9	17.0	22.2	15.4	14.9	21.4	20.0
Debt revenues	739	1175	1550	1967	2477	3311	3715	4180	4604	5679	6154	6871	na
Ratio to GDP (%)	2.1	2.5	2.7	2.9	3.3	4.2	4.5	4.7	4.8	5.5	5.2	5	
Fiscal spending	4642	5793	6824	7938	9234	10798	13188	15887	18840	21113	24650	28361	33708
Ratio to GDP (%)	13.4	12.4	11.7	11.7	12.4	13.8	16.1	17.8	19.6	20.6	21.0	20.7	18.5
Growth rate (%)	24.1	24.8	17.8	16.3	16.3	16.9	22.1	20.5	18.6	16.7	11.8	15.1	18.9
Debt expenditures	336	499	883	1355	1918	2353	1911	1580	1999	2581	2952	3672	na
Ratio to GDP (%)	1.0	1.1	1.5	2.0	2.6	3.0	2.3	1.8	2.1	2.5	2.5	2.7	
Fiscal balance	-293	-575	-582	-530	-582	-922	-1744	-2491	-2473	-3098	-2935	-2005	-2080
Ratio to GDP (%)	-0.8	-1.2	-1.0	-0.8	-0.8	-1.2	-2.1	-2.8	-2.6	-5.5	-2.5	-1.5	-1.1
Outstanding government bond issues				4361	5509	7766	10542	13674	15608	17108	18500	19600	20400

Source : Prepared from China Statistical Yearbook and China Fiscal Yearbook (edition for each fiscal year)

2. Central-local relation from the fiscal aspect

2.1 State of the fiscal balance

Figure 2 shows the state of the fiscal balance. For the trend in the central-local relation in terms of fiscal balance, it can be said to be a characteristic that the central government's budget has obtained a much greater share after the "1994 Tax & Financial System Reform". In addition, in China, as represented by the fact that the local tax law, local autonomy law, and law for tax allocation to local governments have not yet been developed, various legal grounds and authority involving public finance have been assigned to the central government in most cases as systems. However, local governments (province level governments, among others) have considerable levels of discretion, and public finances of province or lower level governments are not transparent, resulting in spread of authority to local governments.

With the introduction of the "Tax reform" in 1994, a percentage of revenues of the central government sharply increased to 55.7%. The ratio of national revenues to GDP was 11.2% in 1994 and fell to 10.7% in 1995. While the ratio began to rise from 1996, it still stood at as low as 15.0% in 2000. The ratio then went up sharply in 2001, reaching 17.6% in 2002 and peaked at 19.3% in 2004, but fell to 18.1% (ratio of amount of taxes to

national income was 16.9%) in 2005, with national revenues exceeding 3 trillion yuan. On the other hand, the expenditure ratio between the central government and local governments almost remains the same at about 3:7, leading to some reallocation from the central government to local governments.

Figure 2 State of Fiscal Balance (Unit : Hundred Million Yuen/%)

FY	Central revenues	%	Local revenues	%	Central expenditures	%	Local expenditures	%
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	18,502.30	52.2	16,921.08	47.8	9,295.00	24.2	29,078.38	75.8

Source : Prepared from China Fiscal Yearbook (edition for each fiscal year)

What matters is the content of fiscal transfer, that is, transfer is still in the form of return of tax revenues in many cases² although there are fewer cases, and the redistribution system through direct taxes has not yet been developed, resulting in imperfect work of redistribution mechanism which will contribute to correction of disparities. For this reason, it cannot necessarily be said that the national fiscal position has been enhanced through the “1994 Tax & Financial System Reform”, and especially, the initial purpose of enhancing the central government’s financial strength cannot be said to be achieved.

In addition, changes in the ratio of national revenues to GDP deeply relate to changes in the inflation rate in China, and the ratio of national revenues to GDP tends to go up in

² For the fiscal transfer, details are shown in Section 2 of this writing.

fiscal years in which the growth rate of national revenues exceeds the nominal GDP growth rate. This trend was particularly obvious during seven years from July 1998 to the end of 2004, in which active fiscal policies were taken. At the same time, during the period, deflation continued to rise. That is, it is considered that the rise in the ratio of national revenues to GDP in China arises not only from systems and policies but also from deflation as a factor. Accordingly, this indicator sharply declined when China eliminated deflation to some extent in 2005. Judging from this, fragility of tax base (tax system and tax collection system) in China can be recognized, and conversely, if inflation rises in China, it is feared that the ratio of national revenues to GDP may fall again³.

On the other hand, a sharp rise in tax revenues can be recognized as characteristic for 2006. Especially in the first half of 2006 (especially between January and April), public revenues grew to more than 1.5 trillion yuan (up 22%), reaching a half of public revenues of 2005. Tax revenues significantly increased by about 23% in 2006 on a full-year basis, which caused excess production in the industrial sector or rises in home prices in provinces and cities with large government revenues. In addition, excess investments under the leadership of local governments have become more conspicuous than soft restrictions on budget, thereby causing serious overheated economy, and this is also a challenge for establishing the concept of desirable public finances⁴.

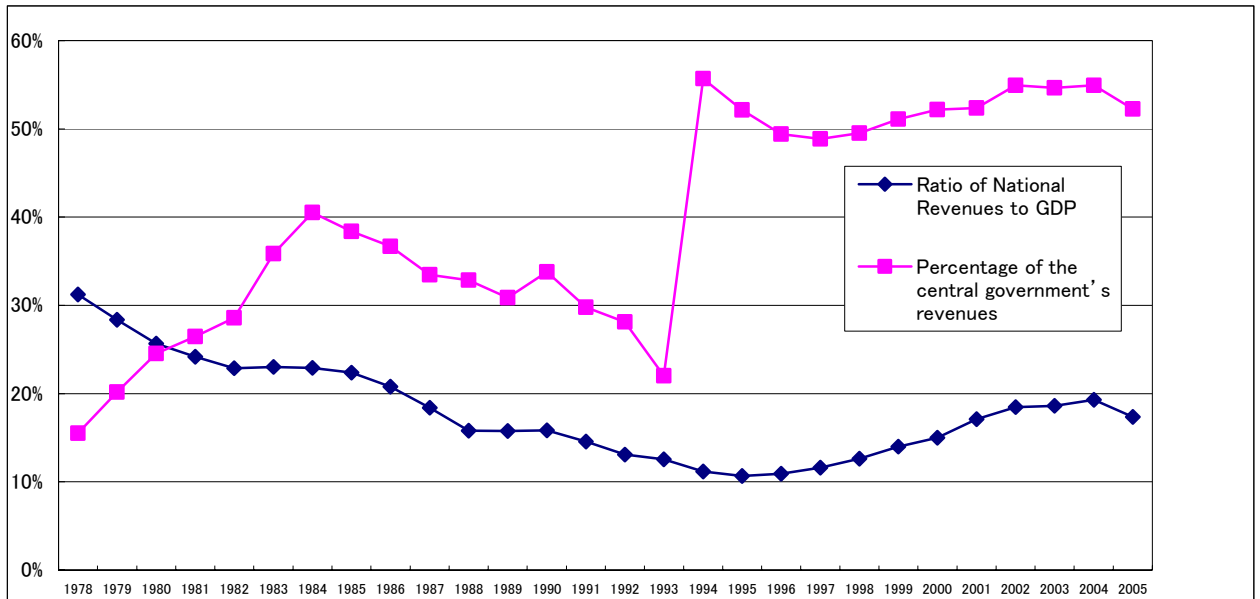
2.2 State of fiscal transfer

Figure 3 shows the state of fiscal transfer in China. To correct disparities in financial strength between areas, a new general grant called “a grant for transfer during the transitory period” was established in 1995, which stood at only 2.1 billion yuan in that year. The grant thereafter increased in steps, and was renamed “general transfer expenditure” in 2002, and reached 112.1 billion yuan in 2005. In the process of increases in the fiscal transfer amount, the percentage of return of tax revenues of such transfer fell to a 40% level, while percentages of special grants and general grants increased.

³ There is a view that in the finance contract system period (1980-1993), the lower ratio of national revenues to GDP was caused not only by the finance contract system but also by inflation (refer to P.147 of “Intergovernmental fiscal relation in modern China” by Zhongren Zhang, published by Ochanomizu Shobo in 2001).

⁴ In this regard, details are shown in section 3-3 of this writing.

Figure 3 Trends in two ratios in China (1978-2005)



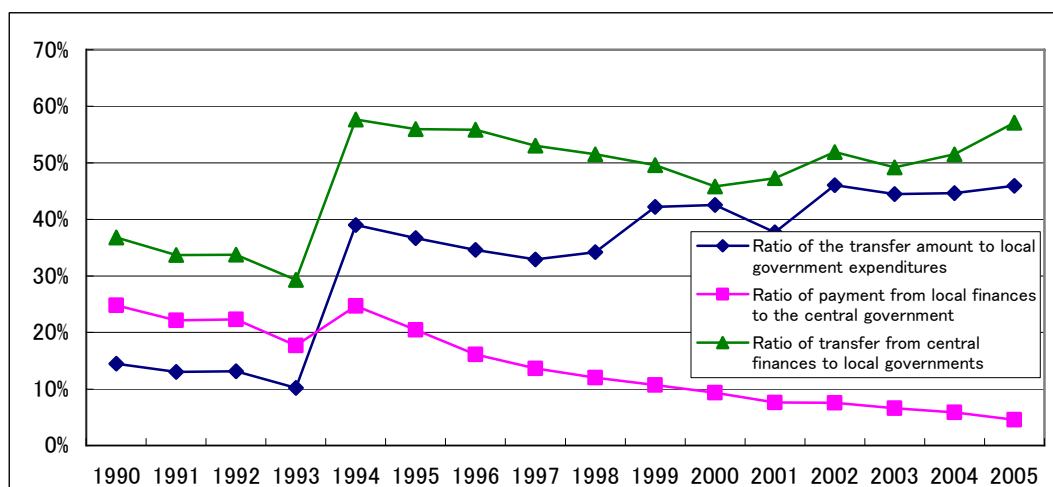
Source : Prepared from China Fiscal Yearbook (edition for each fiscal year)

Namely, it can be recognized as recent trend that general transfer expenditures have increased sharply. Such expenditures are those with a fiscal-equalizing function to correct disparities in financial strength by setting a standard fiscal demand, and increases in those expenditures are favorable developments and can be highly regarded. However, of the transfer total of 1,580 billion yuan in 2006, general transfer expenditures stood at as small as 190 billion yuan. On the other hand, return of tax revenues amounted to 450 billion yuan of fiscal transfer total of 1,120 billion yuan in 2005 on an actual basis, and the problem is that such return continued to account for a large portion. This return generally refers to a system of tax refund to wealthy areas, and can be said to be protection of vested interests of wealthy areas, with no function of correcting disparities in financial strength between areas. Reducing the percentage of this return has been a conventional challenge, and has not yet been achieved.

In addition, the fiscal transfer system sharply varies from province to province, and there are areas where local governments smaller than province governments maintain the actual “finance commission system” arranging “proportional distribution” or “straight-line method” based on the “cardinal number method” (typical examples include Hebei Province/Lai Shui County, Fujian Province/Xiamen City, Anhui Province/Hefei City, Jiangsu Province/Changzhou City)⁵.

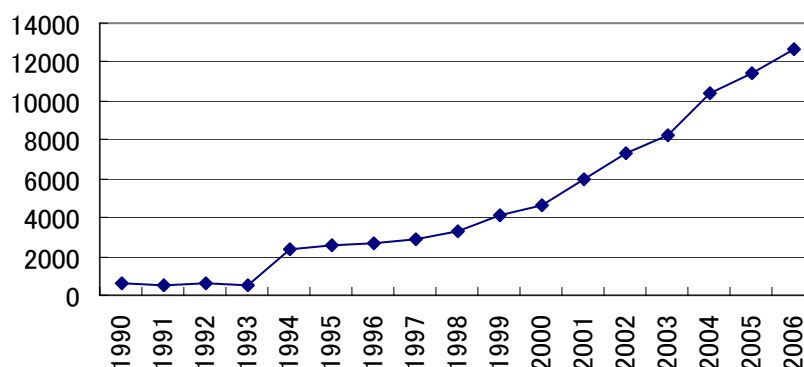
⁵ This is primarily the result of onsite research of local finances conducted in China since 2005.

Figure 4 Fiscal transfer relation between the central government and local governments



Source : Prepared from China Fiscal Yearbook (edition for each fiscal year)

Figure 5 Trend in total amount of transfer (amount of return of tax revenues/grants)



Source : Prepared from China Fiscal Yearbook (edition for each fiscal year)

3. Issues surrounding public finances

3.1 Current state of measures to correct disparities and tasks

China faces serious tasks of economic gaps between areas and correction of income disparity. Gaps between areas are widening, as evidenced by the fact that the gap in per capital GDP between Shanghai City and Guizhou Province turned to 15:1. In addition, the Gini coefficient, indicator showing gaps, came to 0.47 in 2005, which means that income distribution has become increasingly unequal. In addition, considering the discriminative treatment and unequal opportunities between cities and rural communities, it can be said that there are serious disparities between areas and between individuals.

To cope with this, recent increases in general transfers can be highly regarded as fiscal policy as previously described. However, it is problematic that return of tax revenues to protect wealthy areas still accounts for a large portion. Especially after 2002, when the tax segmentation system was introduced with respect to income taxes⁶, the tax revenue return system guaranteeing income tax revenues for 2001 was adopted, which rather caused the widening of the gap in financial strength. Unless such portion is reduced, it is impossible to contain the widening of the gap. While this is a problem already pointed out, this problem is considerably affected by the political power in the relation between the central government and local governments, and also the problem to be resolved under the leadership of the central government's executive body.

On the other hand, as regards the tax system, while the income tax reform is being promoted, there remain various types of personal income and respective tax rates, resulting in inequality in understanding of income and taxation. In addition, there is a significant difference in tax allowances between cities and rural communities (especially for taxation on cash receipts of salaried employees and farmers), and cities are in a advantageous position under the system, so the income tax system is not necessarily designed to contribute to redistribution of income. Furthermore, while the agricultural tax was abolished, respective local governments (lower level of local governments, among others) independently collect various costs (charges other than taxes) to make up for reduced tax revenues resulting from such abolishment, causing payment burdens in rural sectors. Recently, off-budget funds, which is a characteristic of public finances in China, are falling, which is not the result of inclusion of conventional off-budget funds in the budget, but which has rather caused an increase in funds collected by each local government as "funds not subject to the tax system" at its own discretion. These are measures taken by local governments in response to changes in the system toward centralization, and such funds are less transparent than off-budget funds, and are not desirable. As other efforts, reform of the social security system is also being promoted, but such problems as gaps in systems between cities and rural communities and insufficient social security for migrant labor remain serious. There is another problem at present that the insurance premium collection system has not been sufficiently developed in response to diversification of type of employment and labor. In addition, given sharp increases in medical cost as well as nursing care cost for the aged following rapid aging of the population, financial sources to cover such costs have not been secured satisfactorily. Moreover, as influence of further internationalization, social

⁶ Ratio of division of income taxes between the central government and local governments is 5:5 in 2002, and 6:4 after 2003.

insurance premiums become a significant drag on development of less competitive corporations including state-owned enterprises, and measures to help the unemployed, which occur as a result of shake-out of companies, become an important task, thereby making it indispensable to design a system for this purpose.

3.2 Vicious cycle of inefficient allocation of resources

In China, with the introduction of market economy, economy of cities has developed significantly, and people in rural communities have also escaped from poverty, thus realizing a certain level of affluence. On the other hand, however, China faces a serious problem of widening disparities. In response to such situation, the central government is promoting redistribution of income through grants, fiscal transfer including general transfer expenditures, income tax reform, and reform of the social security system. In reality, however, the ongoing system reforms have not necessarily eliminated disparities. The root cause lies in government functions.

Investments have recently increased as measures to correct disparities under the government project. As a result, the government's involvement in economic activities is enhancing, such as the increase in public sector investments and more commitment to state-owned enterprises. In China, which is in a development stage, demand for social infrastructure is strong, so the need of public sector investments is reasonable to some extent. However, if the government's economic activities increase, efficiency of allocation of resources will decline under economic management led by the government. On the other hand, in the current situation of China, as evidenced by the fact that there are restrictions on movement of production factors; there are inequalities in economic transactions due to the government's monopoly in some sectors; market mechanism does not necessarily work due to the existence of government-related corporations and their vested interests; and production factors themselves belong to the government, the government controls most of social infrastructure and resources through unequal transactions (contrary to the market economy, in a sense). This means that the worsening of regional economies due to inefficient allocation of resources will further increase the need of public sector investments. Following this, it will become necessary to secure the source of funds for public investments, thereby creating grounds for the government to take additional measures to obtain revenues. As a result, a "big government" will appear, thus plunging into a vicious cycle of bringing inefficiency of allocation of resources again. That is, in addition to the reality that the reallocation system does not work well, public sector investments will be justified due to the need of social infrastructure, and public

investment under the government's programs as measures to correct disparities between areas will tend to increase. Although this will contribute to correction of disparities, allocation of resources under the leadership of the government will lead to inefficiency, and if a local government acts as a main body, there will be bargaining between the central government and local government, which will also have adverse effects on allocation of resources. It can be said that real estate and regional development policies under the leadership of local governments called "land finances"⁷, which are now regarded as a problem, are a typical example showing such inefficiency. In addition, expansion of public investment led by local governments will prevent the government's original fiscal policies, including adjustment of government spending and tax system, from functioning. Thus, government functions have become unclear in a situation where investment (I) and government spending (G) as means of increasing demand side in macro economy are ambiguous, which has created distortions in market economy in a sense, and this can be said to be the essential cause of the increase in disparities in China.

3.3 Local finance issues

In considering public finance issues in China, local finance issues have become increasingly important. The debt problems and nonperforming loan problems that local governments are facing have become serious.

3.3.1 Implicit debt problem of local governments

Research report of Treasury Department of China, Finance Science Institute shows an estimate that the implicit debts held by local governments total 12-15 trillion yuan. The primary details are as follows:

- a. Debts guaranteed by local governments when corporations take out loans from banks;
- b. Wages not paid to government employees, especially teachers and other staff of elementary and junior high schools;
- c. Lack of reserves for social security funds arising from insufficient collection or use of funds for other purposes;
- d. Accrued expenses for construction projects of local governments;
- e. Use of rural cooperative funds for other purposes and bad debt losses involving food-related corporations;
- f. Funds allocated by the central government as funds for loans.

⁷ For land finances, details are shown in 3.3.3 of this writing.

(While data exists, it is unknown who is finally responsible for debts.)

Especially, the problem of abuse of social security funds in (c) above is a problem resulting in the disposition of dismissal of the first secretary of Shanghai City Communist Party Member Society, and similar cases are reported in many areas. Such debt problem of local governments shows instability of public finances, and the lack of transparency of public finances poses a very serious risk. If the worsening of local public finances has adverse effects on regional economies, state-owned enterprises which have strong relationships with the government may likely fail, leading to more serious unemployment problem. If this occurs, there will be more fiscal deficits as well as increase in nonperforming loans held by financial institutions, leading to serious adverse effects on the Chinese economy as a whole. At the same time, this will also restrict the central government's policies under which macro economy is controlled, and may have adverse effects on the central government's policies toward healthier public finances. Short-term task for China's public finances is to create a system of allocating revenue sources whereby policies of the central government and local government are consistent, while promoting enhancement of financial resources, and to early clarify the division of roles. That is, it becomes the urgent need to create a so-called "autonomous and self-responsibility" system: classification and assignment of administrative operations → related assignment of authority/revenue sources → clarification of the responsibility. In this regard, some measures to increase transparency of local public finances have been indicated, including reflection of concealment of debts in performance evaluation of managers of local governments as means to understand the actual state of local public finances and partial authorization of issue of municipal bonds under conditions that the actual state of local public finances be disclosed. Thus, the local public finance issue cannot be overlooked, and is a task in which system design including the local government system and functions is important.

3.3.2 Economic management under the leadership of the government – investment and loan issue

While China maintains rapid economic growth, it is very important to display the stability of economy and society internally and externally so as to stress the stability/strength of the government and also to increase its international presence, and it is indispensable to maintain/continue economic growth. To achieve this, investments and loans made primarily for local state-owned corporations under the leadership of local

governments are increasing in respective areas in addition to investments under government projects. Such investments are those to maintain employment and regional economic growth, rather than those based on the market mechanism, and are considerably problematic in terms of efficiency. At the same time, if a series of structures in which excess liquidity (money supply and bank loans) generates excess investments, which cause excess production, resulting in a trend toward overheated economy, continue, deflationary pressure will increase and also, deterioration of corporate earnings or failure of corporations may increase. As China continues its economic growth while having such contradictions, without experiencing correction, once the economy deteriorates, corporate earnings will fall, leading to higher unemployment rate and surfacing of bad debts, and financial crisis, deterioration in credit of yuan, and stock market turbulence will occur as a result. Thus, there are many factors causing turbulence.

As one of causes of this, performance evaluation of leaders of local governments is raised. Performance evaluation of local governments includes some evaluation items, of which the most emphasized item is regional economic growth. For this reason, maintenance of economic growth in the area is most important to leaders of the local government, and motivates those leaders to perform such activities as increasing investment under the leadership of the local government, provision of support to corporations in raising funds, and grant of guarantee of debt. Although more emphasis has been recently placed on the environmental indicator or educational/social security indicator as evaluation items, economic growth continues to be an important item, so it is necessary to review the concept of performance evaluation itself. Especially, 2007 is an important year because the 17th Party Congress will be held in autumn. As it is most likely at this stage that Hu Jintao's second administration is to start, various movements and rumors concerning human affairs already began to appear in respective areas. Ahead of international events, including Beijing Olympics in 2008 and Shanghai Expo in 2010, China's economy is in an environment where investment will continue to increase in the future, so it is necessary to monitor the trend in investments and loans by local governments as a serious risk factor.

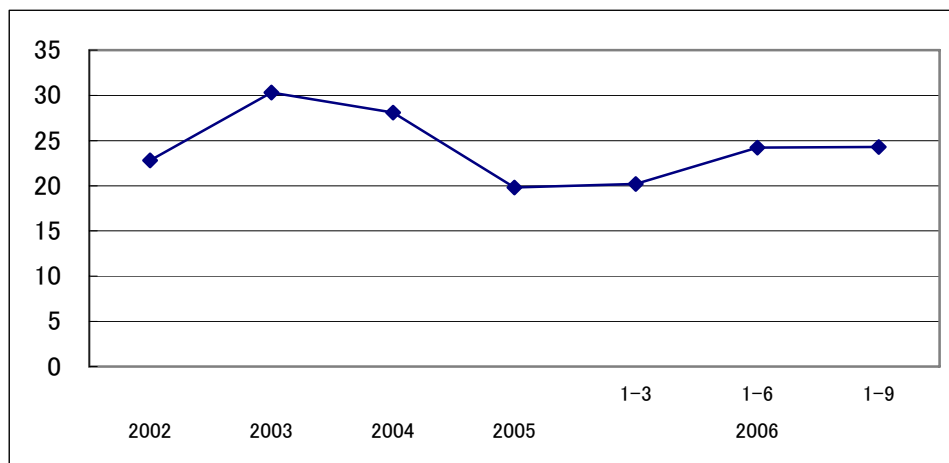
3.3.3 "Land finances" issue

In China, real estate investments have shown high growth in last few years. While such investments slightly declined after the peak in June 2006, investments began to go up again, resulting in a rise in real estate prices as well⁸.

⁸ Since April 2006, there has been at least two-digit growth in respective areas, such as 15.2% in Dalian,

As cause of such increase in real estate investments and rise in prices, there is a “land finances” issue in local cities. This is a system whereby the local government obtains income by dispossessing land from a farmer at a low price, changing the land category, and selling the right to use of the land to a developer. There is a series of structure in which the developer develops the land and then sells it to a wealthy person to obtain profit as a result of “land finances,” thus creating a cause of higher prices. Especially, in areas of local farm villages where public finances are weak, there is a mechanism whereby the local government purchases land from farmers at low prices by leading the villager committee, commissions development of land to a developer with know-how for development/construction purposes, and sells the land to obtain cash income.

Figure 6 State of real estate investments (by year) (growth rate = %)



Source : China National Bureau of Statistics HP

On the other hand, farmers who had their land taken away lost arable land, a means of livelihood, and will face difficulties in living if they continue to be thrown out of work. In addition, some farmers have not actually received the promised compensation money, thus causing protests. Although the central government tries to take more restrictive measures by conducting stricter controls, the central government cannot do so immediately because such mechanism leads to the securing of income by local governments as source of public finances at this stage. This becomes a factor in causing excess investments or overheated economy in local areas. Problem with the “land finances” developed to the extent that it is called a “real estate bubble” in some cases must be recognized as serious risk factor for China’s economy, considering the social unrest arising from discriminative treatment in

13.7% in Shenzhen, 11.4% in Hohhot, and 10.3% in Fuzhou.

rural communities as well as the influence on the economy after the burst of bubble.

3.3.4 Issue of municipal bonds

In China, issue of municipal bonds is not approved at this stage. If a local government records a deficit⁹, such deficit is financed by a subsidy from the central government or loan funds. In the process of the implicit debt problem in local finance becoming severer, issue of municipal bonds is now discussed at academic meetings and unofficial meetings. However such discussions are not official discussions or policies. To eliminate the lack of transparency of local finance, among others, a plan that issue of municipal bonds is approved only in areas where economic development has been relatively achieved, and report on the state of local finance is required instead was presented. However, it is no doubt necessary to secure a financing source underlying such issue as principle. Under the current local tax system in China, shared taxes with the central government are main taxes, and fundamental taxes are weak, so existing taxes must be considered insufficient as base for issue of municipal bonds. Whether municipal bonds are issued or not, as a basic issue of local finance in China, it is necessary as an initial step to develop laws, including a local finance law and local tax law, and create a system for objective management purposes. Without this, it will be difficult to discuss the framework for the state system in which respective roles and authority are clarified in the central-local relation.

4. Reform movements in Japan – trinity reform as primary issue

4.1 Changes in the postwar Japanese economy and financial conditions

The Japanese economy, which was in turmoil due to World War II, faced explosive inflation due to the increase in government spending as well as the Bank of Japan's purchase of reconstruction bonds for postwar reconstruction of the nation. However, the Japanese economy began to pick up thanks to special procurements related to the Korean War in 1950 through anti-inflation policies under the Dodge Plan¹⁰ of 1949, and entered the rapid economic growth path as represented by the Iwato boom of 1958-1961 and the

⁹ This simply involves the fiscal budget, and does not include implicit debts.

¹⁰ One of the implementation programs under the nine principles for economic stabilization provided by GHQ in December 1948 was a tight money policy implemented on March 7, 1949 for independence and stability of the Japanese economy. Control of inflation/consumption and promotion of exports were primary measures, and Joseph Dodge (President of Detroit Bank), economic adviser to GHQ, devised and recommended this. With this, inflation decelerated, but conversely, economic slump occurred due to deflation.

Izanagi boom of 1965-1970. During this period, deficit financing bonds¹¹ were issued in 1966 for the first time after World War II to make up for the tax revenue shortage caused by the 1965 recession and to create effective demand toward economic expansion, thus beginning the shift from conventional commitment to a balanced budget to dependence on bond financing in Japan. The fourth Middle East War broke out in 1973, and double-digit inflation called “skyrocketing prices” occurred, which caused disruption in the Japanese economy. In addition, in 1978, the second oil crisis occurred due to the effect of the Iranian Revolution, but the Japanese economy, which overcame these two oil crises shifted to a stable growth period in which the nation’s economy grew between 2 and 5% annually. During this period, emphasis was placed on the business adjustment function through fiscal policy measures, and there was a sharp increase in bond issues, resulting in excess over ratio of reliance on bond issues to the national budget¹² of 30% in 1980. After that, in the 1980s, efforts to reduce budget deficits were promoted under the slogan “fiscal reconstruction without tax increase” and by displaying “medium-term prospects for government budget,” but the goal was not reached in the end, resulting in the continuation of the issuance of deficit financing bonds.

Such financial conditions were improved dramatically during the economic bubble period. The “Plaza Accord”¹³ of 1985 triggered sharp appreciation of the yen, and the Japanese economy went into a high yen-caused recession, but the competitiveness of the nation’s economy was strong as evidenced by rapid development of manufacturers at the time, making it possible to continue growth exceeding 5%. Amid such flow, there was a delay in the change of the easing policy in relation to the high yen-caused recession, and Asian countries achieved rapid growth at the time, from which massive low-priced consumer goods were imported into Japan backed by the high yen, thereby increasing liquidity sharply. As a result, there was a massive flow of funds into the stock and real

¹¹ Bonds issued to make up for the shortage of revenues, and the issuance of such bonds was prohibited because there is no stipulation in the Finance Act, but those bonds can be issued under a special law. In recent years these bonds have been issued on a regular basis under such a special law.

¹² The value showing to what extent the general account budget for a country depends on government bonds in the current year.

¹³ Accord on exchange rates at the G5 summit meeting (meeting of finance ministers and presidents of central banks of five advanced countries) held at the Plaza Hotel in New York in 1985. This is the accord on coordinated intervention to improve the U.S. external position, and especially the accord on the strong-yen/weak-dollar policy to reduce trade deficits with Japan, which caused the yen’s appreciation by about ¥20 from the level of ¥235 against the dollar and after that by more than ¥100 in a year.

estate markets, thereby causing an economic bubble. In this period, tax income grew significantly, and the goal of escape from the issuance of deficit-financing bonds was achieved in 1990. However, with the economy peaking in February 1991, the Japanese economy rapidly entered the recessionary phase, and went into a long-term recession with the burst of the economic bubble. In such a situation, the issuance of deficit financing bonds was restricted until 1993, but public sector investments as economic stimulus measures as well as employment measures were increased sharply, while tax revenues fell significantly due to economic slump and stimulatory package (tax reduction), and because of this, the structure of dependence on bond financing was revived in 1994.

The burst of the economic bubble caused serious damage to the Japanese economy, and subsequently, economic slump and confusion of the economic community, as evidenced by the increase in nonperforming loans, successive failures of financial institutions, higher unemployment, and collapse of Japanese employment system, continued in the long term. During this period, there was a sharp increase in budget deficit due to the expansion of budget outlays and lower tax income, and the outstanding bond issues reached ¥200 trillion at the end of FY1994, with even the “fiscal crisis declaration” being issued the following year.

The Japanese economy, in which fiscal structure reform became a pressing need, was forced to face a significant increase in national burden, including a consumption tax increase from 3% to 5%, elimination of the temporary income tax cut (¥2 trillion), and higher national contribution to health insurance (¥2 trillion) under the leadership of the Hashimoto cabinet in 1997. In addition, during the same period, the Asian financial and currency crises occurred, resulting in further worsening of the Japanese economy, so public spending expanded as economic stimulus measures, and there was no alternative but to turn the fiscal structure reform path around sharply. Emergency economic measures based on public investment and tax reductions increased the outstanding bond issues to more than ¥300 trillion in 1999, with the rate of reliance on bond issues being at a high level of over 40%.

As stated above, the Japanese economy slowed in the long term after the burst of the economic bubble. Restructuring accelerated due to the worsening of performance of corporations, among others, and unemployment became a serious social problem. In addition, expenditure and income of not only corporations but also households deteriorated, and demands including capital investment and consumption weakened, leading to a more apparent deflationary trend. With the worsening of deflation, debt burdens increased on the part of households and corporations, and total demand of the

entire macro economy declined. In the government sector, the real value of debt balance grew, while tax income dropped sharply, resulting in a further increase in budget deficit.

Figure 7 Trends in primary fiscal indicators of Japan

(Unit: Hundred million yen, %)

	Expenditure of general accounts	Tax & stamp revenue	Tax revenue ratio (%)	Bond issue amount			Ratio of reliance on bond issues to national budget(%)	Outstanding bond issues	
				Construction bond	Deficit financing bond	Total		Year-end balance	Bond issues to GDP ratio (%)
1965	37,230	30,496	81.9	0	1,972	1,972	5.3	2,000	0.6
1970	81,877	72,958	89.1	3,472	0	3,472	4.2	28,112	3.7
1975	208,609	137,527	65.9	31,900	20,905	52,805	25.3	149,731	9.8
1980	434,050	268,687	61.9	69,550	72,152	141,702	32.6	705,098	28.6
1985	530,045	381,988	72.1	63,030	60,050	123,080	23.2	1,344,314	41.1
1986	536,404	418,768	78.1	62,489	50,060	112,549	21.0	1,451,267	42.4
1987	577,311	467,979	81.1	68,800	25,382	94,182	16.3	1,518,093	42.2
1988	614,711	508,265	82.7	61,960	9,565	71,525	11.6	1,567,803	40.5
1989	658,589	549,218	83.4	64,300	2,085	66,385	10.1	1,609,100	38.8
1990	692,687	601,059	86.8	63,432	9,689	73,121	10.6	1,663,379	37.0
1991	705,472	598,204	84.8	67,300	0	67,300	9.5	1,716,473	36.3
1992	704,974	544,453	77.2	95,360	0	95,360	13.5	1,783,681	36.9
1993	751,025	541,262	72.1	161,740	0	161,740	21.5	1,925,393	40.1
1994	736,136	510,300	69.3	123,457	41,443	164,900	22.4	2,066,046	42.4
1995	759,385	519,308	68.4	164,401	48,069	212,470	28.0	2,251,847	45.4
1996	788,479	520,601	66.0	107,070	110,413	217,483	27.6	2,446,581	48.1
1997	784,703	539,415	68.7	99,400	85,180	184,580	23.5	2,579,875	50.3
1998	843,918	494,319	58.6	170,500	169,500	340,000	40.3	2,952,491	58.7
1999	890,374	472,345	53.1	131,660	243,476	375,136	42.1	3,316,687	66.4
2000	893,210	507,125	56.8	111,380	218,660	330,040	36.9	3,675,547	72.9
2001	848,111	479,481	56.5	90,760	209,240	300,000	35.4	3,924,341	79.5
2002	836,743	438,332	52.4	91,480	258,200	349,680	41.8	4,210,991	86.0
2003	824,160	432,824	52.5	66,930	286,520	353,450	42.9	4,569,736	92.6
2004	848,968	455,890	53.7	87,040	267,860	354,900	41.8	4,990,137	100.1
2005	855,196	490,654	57.4	77,620	235,070	312,690	36.6	5,269,279	104.7
2006	834,583	504,680	60.5	64,150	210,550	274,700	32.9	5,369,302	105.3
2007	829,088	534,670	64.5	52,310	202,010	254,320	30.7	5,470,722	104.8

Source: Prepared based on the “National Accounts” of Cabinet Office and “Explanation of Accounts” of the Ministry of Finance, etc.

Note: 1. Bonds here represent only ordinary government bonds (excluding government compensation bonds and borrowings).

2. Amount of supplementary budget for 2006, and the amount of initial budget for 2007.

3. Tax revenue ratio = tax & stamp revenue/expenditure of general accounts

At this stage, fiscal reconstruction became a more urgent and important policy task than before. However, “containment of issuance of government bonds below ¥30 trillion” targeted by Prime Minister Koizumi’s structural reform was not achieved after the initial

budget for 2002, and bond issues continued to increase. The Japanese Government had to realize a very difficult package, namely economic growth and fiscal reconstruction.

4.2 Current state of Japanese fiscal structure

4.2.1 Size and characteristics of public finance

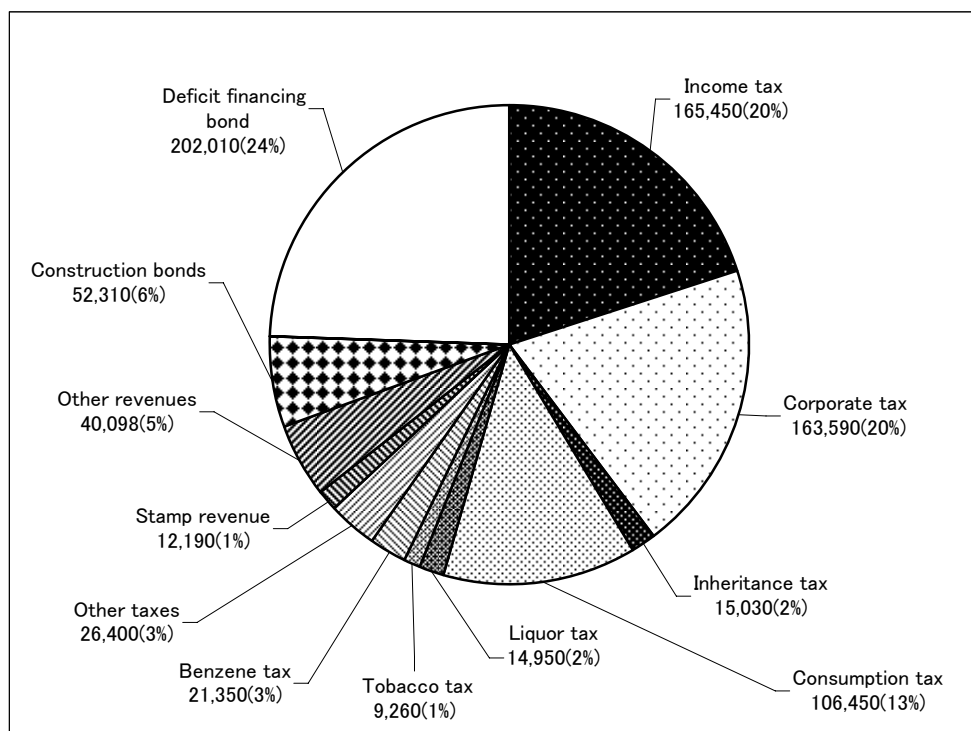
For the structure and characteristics of Japanese public finance of ¥80 trillion, the size and characteristics of Japanese public finance are surveyed here through the 2007 budget. After the burst of the economic bubble, public finance deteriorated sharply due to the expansion of government spending and a significant decline in tax revenues. While public finance slightly improved backed by the recent economic recovery, Japanese public finance continues to be in a very serious condition.

Figure 8 Revenue and expenditure of Japan (FY2007 general account budget)

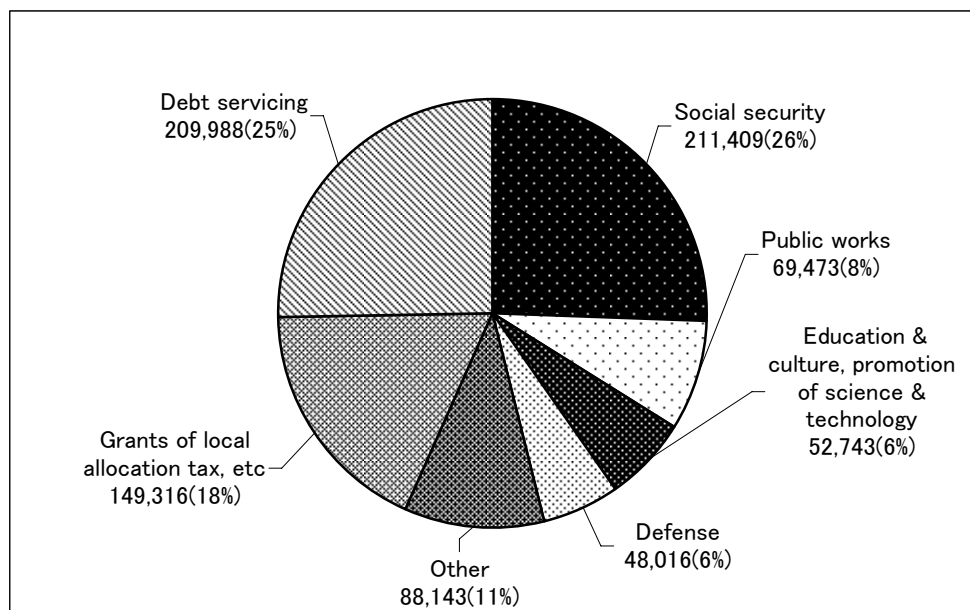
(Unit: Hundred million yen, %)

《Total revenues and expenditures: ¥82,908,800 million》

[1] Revenues



[2] Expenditures



Source : Prepared based on the economic and fiscal white paper.

In regards to revenues, improvement of the nation's economy increased tax revenues, including revenues from income and corporate taxes, and the tax revenue ratio came to about 65%. On the other hand, while the amount of new government bond issues was reduced by about 15%, the ratio of reliance on bond issues to the national budget remains at high levels of over 30%, with severe conditions continuing.

For expenditures, the total of social security expenses, redemption of principal and interest on government bonds, and local allocation tax account for as high as two-thirds of expenditures. With the aging of the population, social security spending increased sharply, having exceeded ¥20 trillion for three consecutive years. Pressure for an annual increase of about ¥1 trillion in social security spending is expected to further increase with the progress of the aging of the population with a declining birth rate. In addition, for government debt expenses, if the current level of budget deficit continues, the increase will likely exceed ¥400 billion each year, and a 1% rise in interest rates, for example, increases in interest payments by about ¥5 trillion, thus creating very heavy pressure. For local allocation taxes, since about 30% of national tax revenues are allocated, an increase in national tax revenues is to increase the amount of local allocation taxes. In recent years, reduction of expenditures has become an important policy task, and it is now necessary to finance social security spending, which is increasing more rapidly than other expenditures, by reducing expenditures in other areas. Judging from the rapid aging of the population, continued redemption of principal and interest on government debts, and pressure for the

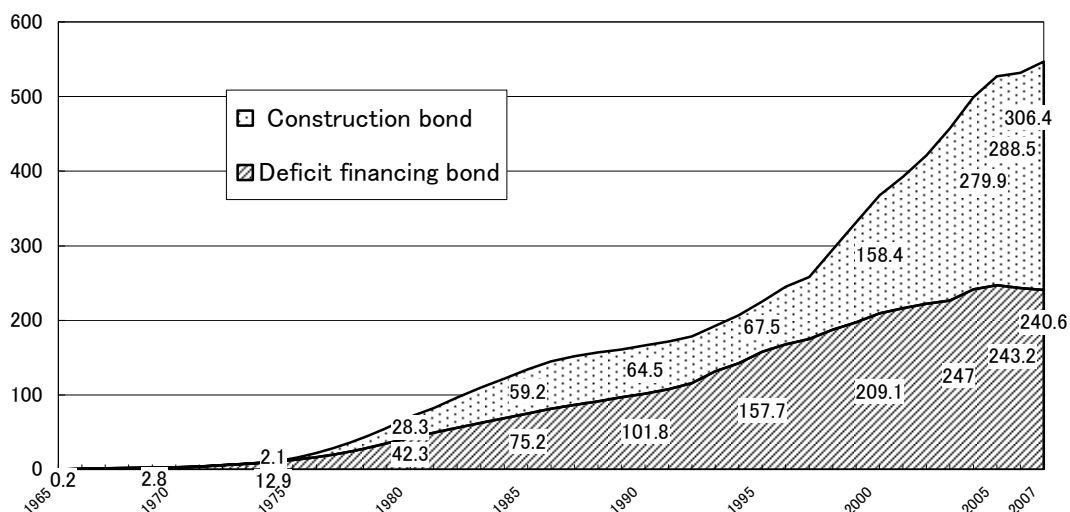
increase in local allocation taxes accounting for 30% of tax revenues, however, it is difficult to even maintain the current level of expenditures.

4.2.2 Budget deficit problem

Next, looking at budget deficits, the largest concern about public finance, is that the balance of ordinary government bonds will likely reach ¥547 trillion at the end of FY2007, a huge amount corresponding to tax revenues for about ten years, which means that Japan is in the worst condition among 30 OECD countries.

Figure 9 Trend in the balance of ordinary Japanese government bonds

(Unit: Trillion yen)



Source : Prepared based on the “National Accounts” of Cabinet Office and “Explanation of Accounts” of the Ministry of Finance, etc.

This is primarily because of long-term recession after the burst of the economic bubble as well as the rapid progress of the aging of the population with a declining birth rate, and budget deficits increased less than ¥400 trillion after the burst of the economic bubble. In addition, another reason is that repayment of debts was insufficient during the bubble economy period in which there were sharp increases in tax revenues. Furthermore, even in the current situation where the nation’s economy is in the longest recovery phase since World War II, which exceeds the Izanagi boom period, the outstanding bond issues are increasing, thus facing a tough situation. Compared with international levels, it is required in the fiscal convergence criteria provided in the Maastricht Treaty for EU membership, for example, that the ratio of outstanding bond issues to GDP should not

exceed 60%, and it can be said without doubt that Japanese public finance, in which the ratio of long-term debts of the central and local governments to GDP is more than 140%, is abnormal.

It is no doubt a pressing need to escape from such a very severe financial condition. However, the largest difference between Japan and other advanced nations lies in interest rate levels. Although Japan already abandoned the zero interest rate policy, Japan's interest rate levels remain low, and even if Japan's public finance improves, such improvement will not necessarily improve the economic conditions because there is less room for lower interest rates than current levels, thereby reducing the incentive for healthier public finance. If the current levels of budget deficits continue, however, interest rates will rise sooner or later, thus creating serious concerns regarding recession. To avoid such a situation, a plan to set a goal toward healthier public finance and to achieve the goal has been established. The goal of fiscal reconstruction comprises two pillars, namely registering the positive primary balance by 2011 and reducing the ratio of balance of debts to GDP at a steady pace by the middle of the 2010s. To this end, the margin of reduction of deficits is set at ¥16.5 trillion in total for both the central and local governments, and ¥11-14 trillion, about 70-90% of ¥16.5 trillion, will be financed by reducing expenditures. To achieve this, it is necessary to drastically review social security spending, personnel expenses, and public works spending. However, restricting social security spending is actually impossible amid the rapid aging of the population with a declining birth rate, so significant control of personnel and administrative expenses and a sharp reduction of public works spending by streamlining the government sector will be the important key. At the same time, to realize such a challenge, how to keep the balance in public finances between the central and local governments becomes important. This can be said to be the essential issue to determine what type of nation Japan should target.

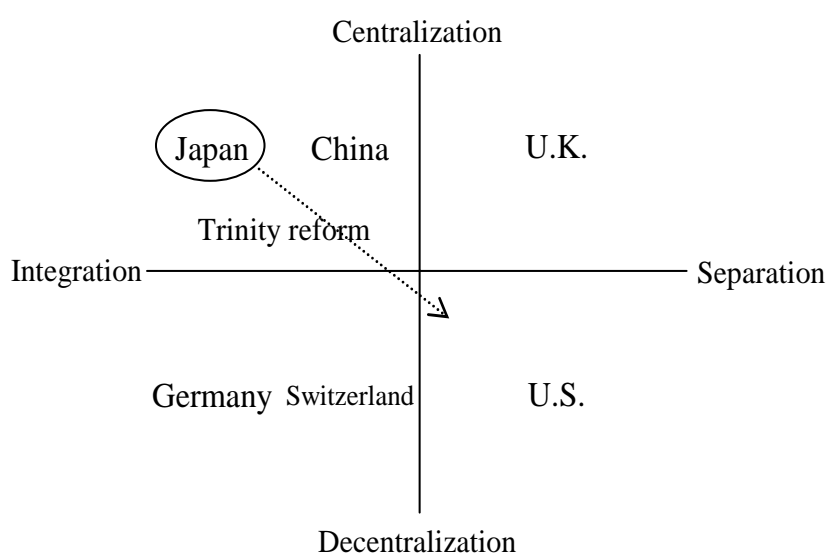
4.3 Characteristics of the intergovernmental fiscal relation in Japan

In discussing the form of state, there are two types, namely the unitary state system as represented by the U.K. and Japan and federal state system as represented by the U.S., Canada, and Switzerland. Looking at these two systems from the aspect of intergovernmental administrative and financial relations, they can be classified into two categories: "centralization – decentralization" and "integration – separation."

"Centralization" refers to centralization of administrative and financial authority as well as financial resources in the central government, and decisions on local governments' administrative and financial affairs are also basically made by the central government.

On the other hand, “decentralization” refers to delegation of administrative and financial authority as well as financial resources to local governments, and local governments (and residents) independently make decisions, with less opportunities of the central government’s intervention. Looking at another element, while “integration” refers to assumption of administrative functions of the central government by local governments, “separation” refers to independent implementation of administrative functions by local agencies of the central government stationed in local governments.

Figure 10 Classification of the form of state



Source : Prepared based on Zhang (2005)

Characteristics of the intergovernmental fiscal relation in Japan lie in that, in terms of revenues and expenditures, expenses are assumed by the central government by 40% and local governments by 60%, while taxes are collected by the central government by 60% and local governments by 40%, thus showing an inverse relation. Like in China, fiscal transfer¹⁴ exists here. In Japan, a centralized system was adopted after the Meiji era, and a new centralized system as represented by the agency delegated function has been

¹⁴ Subsidies to local governments comprise national treasury payments, treasury money in trust, and incentive subsidies, which are collectively called national treasury disbursements. In addition to such disbursements, there is a local allocation tax with function of fiscal equalization, and those funds are supplied by the central government to local governments.

established during high-growth years after World War II, and continues until now. Such long-standing centralized system came to a turning point in 2000 when the Comprehensive Decentralization Law was enacted. With this Law, the agency delegated function was abolished and divided into the autonomous work and legally delegated work. However, since the centralized system was not essentially reformed with respect to finances, reforms including reduction of financial burdens on the part of the central government were strongly requested. That is, it became indispensable to shift the form of state of Japan from the conventional centralization form to the decentralization form, which has become the target of trinity reform.

4.4 Trinity reform

Trinity reform refers to a reform simultaneously promoting (a) transfer of tax revenue sources from the central government to local governments, (b) reorganization/reduction of treasury charges, and (c) reorganization and containment of local tax allocation. This reform will likely change the intergovernmental fiscal relation in Japan sharply. The primary purpose of the reform is to reduce financial burdens of the central government, which runs huge deficits, and to promote dramatic decentralization for this purpose. However, this has had a serious impact on compilation of the budget by local governments for three years from 2004 to 2006. As governmental subsidy reform, one of the trinity reform objectives, about ¥4.7 trillion was reduced. In addition, as local allocation tax reform, about ¥5.1 trillion including extraordinary fiscal policy bonds was reduced. As the local tax allocation system works to correct disparities in public finance between areas as local fiscal equalization system, such reforms become a serious blow to local governments with weak financial strength, in particular. On the other hand, transfer of tax revenue sources from the central government to local governments came to about ¥3 trillion, which cannot make up for the reduced amount of subsidies to local governments, and remains therefore in an insufficient level of transfer of tax revenue sources. In addition, control of local tax allocation which has important functions of city-rural community fiscal equalization and security of financial sources for smaller local governments has significantly strained finances of smaller local governments, especially those in depopulated areas.

While total local allocation taxes reached ¥15.9 trillion in 2006, borrowings to finance local tax allocation came to as large as about ¥53 trillion. For containment of local tax allocation totaling ¥5.1 trillion, the smaller the local government is, the larger the amount

of reduction is required, through the phased correction measures¹⁵. In such situation, many local governments are forced to review administrative services to reduce financial burdens, and this also causes a more serious damage to smaller local governments. Under the reform promoted in the name of decentralization, large local governments (with a large population) can obtain a larger amount of tax revenues than the reduced amount of subsidies, thereby improving the financial position, while smaller local governments (with a small population) obtain a smaller amount of tax revenues than the reduced amount of subsidies, leading to weaker finances. In the end, such treatment is a matter of life and death to local governments with weak financial power. Accordingly, this will generate a situation where large administrative reorganization through consolidation of municipalities cannot be avoided¹⁶.

There is a conventional opinion that the tax allocation system leads to inflexibility of public finance (causing a moral hazard in the local tax allocation system in Japan due to financing of adjustment of working expenses to promote public works and payment of principal and interest on depopulation bonds, isolated district bonds with local tax allocation for the following year), and there is significant room for improvement in this regard. However, there are many problems with reforms which sharply reduce the original role of the local allocation tax, namely the fiscal equalization function contributing to the important task of eliminating the gap in financial strength between local governments. Especially, as a series of reforms assume restoration of soundness of public finance of the central government as main purpose, local governments are forced to manage financing in a stricter manner, and suffer further disadvantage in the intergovernmental fiscal relation. Accordingly, in the process of promoting the trinity reform, there remain many tasks, including review of central – local division of roles, corresponding allocation of revenue sources, and enhancement and review of taxes as revenue sources.

5. Common tasks – state of administrative reform

5.1 Situation in China

5.1.1 Budget system reform

In China, the conventional national treasury system was divided, and there are several stages before revenues are accepted in the national treasury, and also for expenditures,

¹⁵ For the ratios of reduction of public works for 2003 and 2005, for example, the ratio stood at about 15% in municipalities with population of 200,000 or more, while the ratio reached as high as 40% in municipalities with population of less than 10,000 (Asahi Shimbun July 3, 2006).

¹⁶ For consolidation of municipalities, details are shown in 5-2 of this writing.

there are too many intermediate stages until funds are available at the user division, which caused fraud or misappropriation. From 2002, with the spread of a national treasury central receipt and payment system, the national treasury account system was integrated, and as a result, all treasury funds are registered in the single national treasury account management system; revenues are “directly” registered in the national treasury or special treasury account; and expenditures are directly available to the provider of goods and services or the user division through the single national treasury account management system. This has enhanced control of expenditures by the upper level of the governments over lower level of governments, and payments of subsidies for specified purposes of use, as well as payments of wages of government employees are now centralized through banks, etc. Such changes help to control unauthorized use or misappropriation of funds at intermediate stages to some extent.

On the other hand, a new “central budget stability and adjustment fund” is to be created for 2007 budget. This is a new scheme whereby a fund is established using 50 billion yuan of excess revenues, and if there occurs a tax revenue shortage, the shortage is covered by this fund. It is expected that by establishing this scheme, the budget system allowing wide discretion in which corrections and adjustments occur frequently during the year will be revised, and more reasonable budgeting and stricter checking functions in book-closing will be brought about.

5.1.2 Administrative reform

In China, a large-scale administrative reform is now being promoted toward the ensuring of enhancement and transparency of fiscal functions, in tandem with budget system and fiscal transfer reforms. From 2004, exemption of agricultural taxes began in 28 provinces, and the agricultural tax was abolished in 2006. At the same time, in townships where the agricultural tax was abolished and single national treasury account system was established, clerical operations were reduced or cut at the treasury division. This is a reform which may lead to the closure of the treasury division of townships. In fact, the public finance right is exercised at the district level in each city under direct control of the central government, and neighborhood office which are at the same level as townships do not have any budget. On the other hand, there are some neighborhood offices where resident autonomy has been relatively developed although no public finance right is assigned¹⁷. In addition, “Big Community” reform means that no public finances are held,

¹⁷ Reform of the “Big Community” at the Lugu neighborhood office at Shi Jing Shan district, Beijing in October 2003 can be said to show the progress of local autonomy in China.

and it has become gradually apparent that local administration can be smoothly performed at the township level even though no public finances are conducted.

As regards the relation between the local administrative units and public finances in China, the number of such units is increasingly falling. In China's cities under direct control of the central government, two-layer system (city and district) and three-layer system (city, district or county, township or town) are mixed together, and in other provinces and minority autonomous districts, three-layer system (province, prefecture-level city, and district) and four-layer system (province, prefecture or prefecture-level city, county or county-level city, and township or town) are mixed together. Previously, when local finances are established, local administration is also established in China. That is, budgets were established for respective governments from the province to townships, the smallest unit of administration. However, in some provinces where township governments are not abolished, a "county-controlled township treasury"¹⁸ system has already been enforced, and while the "township treasury office" remains in some cases, townships effectively no longer have the public finance right. In addition, in some provinces, a "province-controlled county"¹⁹ system has been enforced since the 1980s. Some provinces have adopted the "county-controlled township treasury" system and "province-controlled county" system at the same time. In such provinces, the four-layer administrative system and two-layer public finance system coexist. Those movements of transfer of the public finance right of townships to the county and transfer of the public finance right of cities to the province represent a kind of centralization of the public finance right to upper levels of governments. In response, a reform movement toward a system in which local finances do not actually correspond to local administration on a one-to-one basis has become more apparent at each level of local governments. As a result, there occurs a possibility that agencies of prefecture-level city and township levels of governments will become local agencies of upper levels of governments, respectively. In addition, administrative reform at counties and lower levels of administrative units advances, resulting in a sharp decrease in the number of administrative units through consolidations of counties/townships.

Promotion of such movement of adjustment of the local administrative and financial systems can be highly regarded in terms of the administrative and financial streamlining,

¹⁸ This means that public finance of a township is controlled by the county, and it is intended that as part of the current administrative and financial reforms, administrative operations will be reduced by effectively abolishing public finance by townships, and placing such public finance under the control of the county.

¹⁹ By making public finance of prefecture-level cities fictitious, public finance of the province directly controls public finance of prefecture-level cities and counties.

and future reform movements should be noted. At the same time, since it is effective in some cases to rather increase discretion of local governments to some extent from the aspect of efficiency, it will be the future task to study measures to promote delegation of authority after clarifying responsibilities, including stricter budget control. This can be said to be an important path meaning a shift from “diversification” to “decentralization” to local governments.

5.2 Situation in Japan

Also in Japan, administrative reform is being promoted. As a result of trinity reform, especially as the effect of local tax allocation, the smaller local governments, the larger the amount of reduction, so such governments have no choice but to promote consolidation so as to ensure a certain scale of public finance. In Japan comprising two-step local governments, namely prefectures and municipalities, the trinity reform has brought significant consolidations of municipalities. Through the so-called “mega consolidation in Heisei,” the number of municipalities was reduced from about 3,300 to about 1,700. Such consolidations have also been caused by the effects of recession after the burst of economic bubble and resultant sharp deterioration in the financial position. As rough progress, the Special Law of Merger of Municipalities was revised in 1995, and such measures as creation of a special bond for post-merger projects and extension of period for revaluation due to merger were taken. Then, in 1997, the “Special Law of Merger” was revised for the purpose of streamlining and improvement of efficiency of administrative and financial management, development of social infrastructure, and public works²⁰, and in 1998, a “decentralization promotion plan” was issued. In 2000, with the enforcement of the Comprehensive Decentralization Law, decentralization and consolidation of municipalities advanced dramatically. For such consolidation of municipalities, various special measures, including (1) issue of special bonds for post-merger projects (ten years after merger), (2) addition of ordinary allocation taxes (total in five years, up to ¥3 billion), (3) special allocation tax measures (total in three years), and (4) grants to merged municipalities (up to three years), were taken. Purpose of these measures is to improve administrative and financial functions of smaller local governments, as well as to promote more efficient public investment and administrative systems. In reality, however, it is considered that the actual purpose is to restore the health of finances of the central government facing huge deficits by reducing fiscal transfer, primarily reducing local allocation taxes. As a result, in a local government which has become larger through

²⁰ The Law has thereafter been revised several times on a continual basis.

merger, for example, contact offices for public works and services are centralized in urban areas, thereby producing an “internal disparity” between those areas and surrounding areas, or an increase in special bonds raises the ratio of public debt issues to total revenue, thus generating new problems in the environment surrounding local governments. Furthermore, response to the collapse of local communities and redevelopment of welfare and life services will be more critical. Thus, local governments had rather no choice but to promote consolidation of municipalities in the process of trinity reform, and the need of further reform has been indicated for reform of the form of state in the original meaning, that is, decentralization reform. This is discussion on the so-called “Do-Shu system (regional system: mergers of cities and prefectures to form larger administrative blocks),” namely the idea of dividing the entire Japan into 6-13 blocs through consolidation/merger of a prefecture level of governments. This reform means a dramatic shift of the form of state of Japan from conventional centralized state to decentralized state. For this purpose, there are many tasks, including how the administrative authority or financial authority should be guaranteed and what relation between local governments and the central government should be created. These are necessary, important tasks for the future of Japan, and can be said to be the reform requiring a considerable period of time.

As stated above, the trinity reform in Japan has many tasks to be achieved in the medium to long term, including how the local finance problem should be resolved and how the shift from consolidation of municipalities to establishment of the Do-Shu system should be promoted. It can be identified in this process that requests of local governments tend to be disregarded, while the central government continues to have advantage. In such situation, this cannot be said to be the decentralization reform in the original meaning. So, I would like to indicate two points as new efforts which are being promoted to improve the situation. First, establishment of a “common local tax system.” This tax is a unique and common revenue source of local governments, and is of the nature of a kind of adjustment by the indirect charge method. With the income tax, corporate tax, liquor tax, inheritance tax, and consumption tax being revenue sources, while the tax amount and tax rate are determined by the central government, local governments participate in the decision-making process, and revenues are directly transferred to special accounts, rather than through general finances. Grant style as local allocation tax is as if the central government provides financial support, whereas the common local tax is for local governments to share and enhance the spirit of independence and solidarity through mutual financing. Second, establishment of a “local administration and finance council” where the central government and local governments hold joint deliberations on an equal

footing. The central government has so far controlled local governments, so opinions and proposals of local governments have not been reflected satisfactorily, and local governments have been in a kind of moral hazard due to the fact that they can receive more sufficient grants by adapting their systems to those of the central government. This council is for the central government and local governments to have common ground to discuss the division of roles between the central government and local governments, reorganization of the local tax finance system, involvement of the central government in local governments' administration and finance, and how subsidies should be used, and is considered to be a very important scheme toward decentralization.

Based on those efforts, it is necessary to comprehensively review the form of state toward realization of decentralization with respect to the roles and positions of the central government and local governments.

6. Conclusion

I have analyzed characteristics and current state/challenges of intergovernmental fiscal relation both in Japan and China, and compared them in this writing. While the current state of both countries cannot necessarily be examined uniformly due to differences in the form of state and development stages, there are common issues. Summarizing such issues, they are promotion of enhancement of financial base; creation of a revenue source allocation system to ensure consistency in policies between the central government and local government; early clarification of the division of roles. That is, how the so-called "autonomous and self-responsibility" system should be created is the key and urgent need. This system refers to the following elements: classification and allocation of administrative operations → resulting allocation of authority/revenue sources → clarification of responsibility. Issues widely reported in recent years, such as "Food safety," "corruption case," "Japan's pension/Social Insurance Agency problem," "political funds issue," "*amakudari* (retiring high-ranking government officials taking a lucrative job in a private or semi-private corporation) postretirement jobs issue," and "environmental issue," are very indication of less awareness of "autonomous and self-responsibility."

In this regard, some measures to increase transparency of local finances, including, for example, reflection of the implicit debt problem in performance evaluation of local government officers as a means of understanding the actual state of local finances and partial approval of issue of municipal bonds on condition that the actual state of local finances be disclosed, are indicated in China. In Japan, as can be seen in reform of the

public service personnel system, discussions on dissolution of the Social Insurance Agency, and review of the Political Funds Control Law, political/administrative system reforms are taken as serious, urgent tasks. In any case, the local administrative and financial issues cannot be overlooked, and design of systems including the local government system and functions is an important task. In addition, how political/administrative governance should be restored is a common task to Japan and China, and drastic system reform is required.

Ahead of Hu Jintao's second administration, the Chinese government has emphasized the stability priority policy. The economic growth target has been set at about 8% for this year, setting at a lower level relative to 10% growth for four straight years. Considering the meaning of such setting, the intention to make the administration's policy of containing overheated economy and stabilizing the economy and society by daring to set a lower target than can actually be achieved is recognized. In addition, ahead of the 17th Party Congress in this fall, various movements and rumors concerning human affairs already began to appear in respective areas. As economic results are assigned priority in personnel evaluation of local governments, such situation has a substantial impact on performance of leaders of local governments. Accordingly, in this period, incentives for leaders of local governments to take measures to activate regional economies by increasing investments and loans tend to increase. This causes excess investments/production, thereby posing a significant risk of overheated economy, and if this situation occurs, it will be difficult to achieve the goal itself of the entire 11th five-year plan, including energy saving, environment protection, and correction of disparities. Given such background, the setting of a growth target at 8% can also be interpreted as desire to check local governments toward stable growth. For specific budgets, 339.7 billion yuan (up 42.2 billion yuan year on year) is allocated to three agricultural issues (agriculture, farmers, and farming villages), 77.4 billion yuan (up 29.2%) to science and technology, 53.6 billion yuan (up 39.4%) to educational cost, 13.8 billion yuan (up 65.4%) to hygiene cost, and 13.6 billion yuan (up 2.4 billion yuan) to city minimum social security subsidies. On the other hand, revenues for 2006 came to about 3,900 billion yuan (up 23.3% year on year), while the amount of issue of government bonds stood at 60 billion yuan (down 20 billion yuan), thus showing the results of an increase in tax revenues and "moderate fiscal policies." In 2007 budget, continuation of the "moderate fiscal policies" is declared, while the size of actual public finance is increasing, so the importance of stability is emphasized by showing active policies of the central government. Specifically, budget deficits of the central government are set at 245 billion yuan (down 5 billion yuan year on year), and the

amount of issue of government bonds is set at 50 billion yuan (down 10 billion yuan). As regards fiscal spending, the amount of public investments within the budget of the central government (no reliance on government bonds) was increased by 25 billion yuan, and total public investment amount grew to 130.4 billion yuan (up 15 billion yuan year on year). Setting of economic growth at about 8% as well as the “moderate fiscal policies” can be said to be the declaration of intent to shift from conventional “volume growth” to “quality improvement.” Major policy tasks of realization of the “*sanwa* principle” and “harmonized society” shown in the 11th five-year plan are specifically embodied. On the other hand, the central government is forced to take very difficult initiatives to deal with various disparity problems while controlling economic overheating, and to ease domestic dissatisfaction. Especially, how local governments should be controlled is a major task. The central government has established a policy to place the top priority on stability ahead of the 17th Party Congress where Hu Jintao’s second administration will start, and also there will be such events as the 2008 Beijing Olympics and 2010 Shanghai Expo, so the central government strongly desires to eliminate factors that cause any political/economic turmoil both at home and abroad, and to show the stability of China, as well as increasing its global presence. With too much emphasis on those matters, however, various risk factors are in fact increasing, attention should be given. Now that Hu Jintao’s second administration will most likely to start, it is very important to emphasize the stability of economy and society both at home and abroad, so as to stress the stability/enhancement of the administration, as well as to increase its global presence, and it is indispensable to maintain/continue economic growth. However, there are many problems, including excess investments due to excess liquidity (money supply plus bank loans) and resulting excess production/economic overheating trend, deterioration of corporate earnings, and increase in bankruptcies. In addition, energy/environmental problems have become more serious, leading to the fear of adverse effects on economic growth. More government’s involvement in economic activities in such situation will lead to the inefficiency of allocation of resources by a large government. In any case, those are efforts to achieve very difficult tasks, namely “stability” and “growth,” at the same time, and the government will face a challenge of promotion of establishment of real market economy toward realization of those challenges. The Hu Jintao administration will here have to display how it can strongly achieve the political power and initiatives against its most important theme of the governing ability, including controlling local governments, as well as execution of economic policy to realize sustainable growth. This will no doubt significantly affect the direction of future Chinese economy. In other words, the role of public finance toward

stable growth of Chinese economy is increasing, and it is indispensable to create a system whereby fiscal policies function. In this regard, establishment of an underlying central-local fiscal relation becomes important.

To resolve such issues, the concept of “new public finance,” including not only issues within the public sector but also the size and role of the government and creation of a relation with the market, is being discussed more actively. In addition, more attention has been given to the meaning of cooperation with NPOs/NGOs and volunteer groups, rather than to the dualism, namely either the government or market, and those organizations are expected to achieve a function to monitor the government’s policy management and governance, while performing their own activities.

For both Japan and China, how the form of state should be established under development and diversification of the economy/society is a major task, and amid the widening of disparities as a more serious problem for both countries, it is important to realize the independence and autonomy of local governments, while ensuring the national minimum. This is a very task of what functions should be assigned to decentralization and local autonomy. From such aspect as well, it is the immediate important task to be reviewed to further compare and examine the central-local relation and local administration and finance so that both Japan and China facing the common problems can advance reform of the form of state.

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