The Financial Situation in China: Issues and Challenges

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Summary

In the Chinese economy, whose growth is gradually slowing down, it is necessary to promote structural reform, which is an important policy challenge, and implement measures to stimulate the economy for the immediate moment at the same time. The contents and direction of fiscal policy are of great concern. As for the fiscal position, it cannot be said at the moment that fiscal risk is extremely high when we take a comprehensive look at the budget balance situation and debt problems. However, pressure on the fiscal position is gradually growing. As China is currently shifting its fiscal policy emphasis to economic stimulus measures, such as large-scale tax reduction and expansion of public investments, there are concerns that the structural reform may stall. Although the fiscal relationship between the central and local governments has undergone several adjustments since the introduction of the tax-sharing system, there are still some unresolved issues. In particular, the mutual dependence between governments, financial institutions and companies at the local level are aggravating regional debt problems. When we consider China's fiscal policy, the lack of transparency over the fiscal position is also posing a significant risk. In this respect, the results of a survey conducted by a research group at Shanghai University of Finance and Economics are very interesting. The group pointed out that although disclosure of fiscal data is gradually improving, many problems remain. It is necessary to reform the government-market relationship, which has been a pending challenge. Getting over the situation of *guo jin min tui* (the state advances as the private sector retreats) by promoting the reform of state-owned enterprises is also important for maintaining fiscal sustainability. At the same time, it is essential to clarify the division of administrative work and roles, authorities, responsibilities, and resource allocations between the central and local governments and between local governments. There is no doubt that social security expenditure will increase steeply as the aging of society with a low birthrate advances rapidly in the future. In addition, as China is implementing new urbanization measures intended to achieve a balanced national development and resolve inequality, it is inevitable that the pressure on the fiscal position will grow further in the near future. It is very important to minimize future fiscal risks by promoting the structural reform while China has sufficient fiscal capacity and before the aging advances further.

Keywords: fiscal situation, inter-governmental fiscal relationship, fiscal sustainability
JEL Classification: H1, H6, H7, O2

I. Introduction

China's growth rate declined 2% in 2018 from 6.6% in 2017, exposing the deceleration of the country's economy. Following this reported decline, a growth rate target was set for 2019 of "between 6% and 6.5%," the first reduction in two years from the previous goal of "around 6.5%." Forty years since the beginning of the reform and opening-up policy, high economic growth is finally stalling. With it comes the need to switch the pattern of economic development from quantity to quality, and structural reform becomes the country's most important political challenge.

Amid growing uncertainty around the global economy and various issues, both in domestic and foreign territories, China is now forced into a situation requiring tough economic policy management, finding itself divided between long-overdue structural reform and economic measures designed to curb the slowdown in growth. Given the impact of a recession in China on the global economy, economic measures are important in the short term, but if the structural reform stagnates or breaks down because of those measures, the problems will only be postponed, and the situation in the country will further deteriorate in the medium to long term. This situation makes the role of public finances in China even more relevant, attracting attention from all around the world.

This paper focuses on the current situation of public finances – the pillar of economic policies – and analyzes the future direction of fiscal policies and system reforms. Then, based on a set of factors that add pressure to Chinese public finances, it analyzes the risks involved and presents the existing problems and issues that must be addressed to keep the country financially sustainable.

II. Financial conditions and the structure of public finances

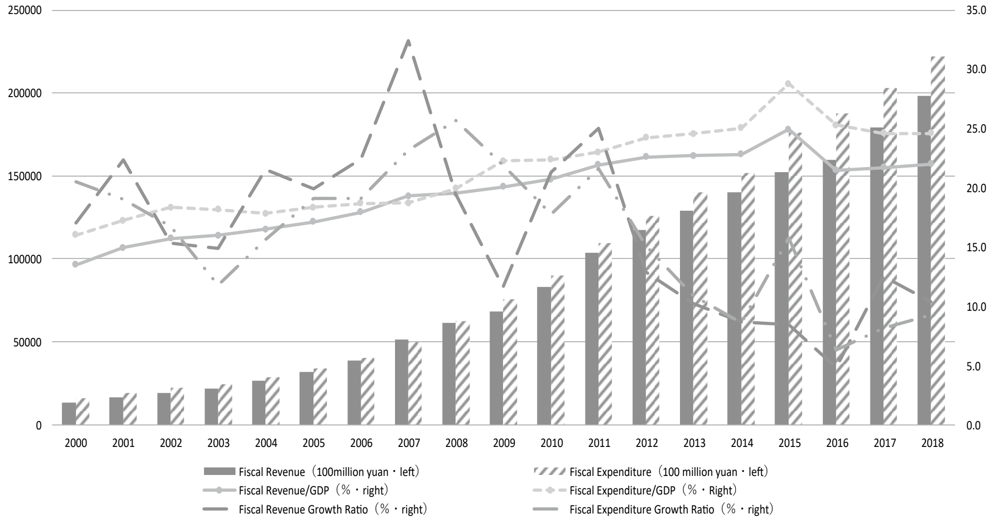
II-1. The revenue and expenditure situation

The decline in the growth rate in 2018 and its lower-than-expected performance that continued into 2019 have accentuated the need for economic measures. The economic policy stance was defined as "strengthening active fiscal policies and increasing effectiveness" and "keeping the balance between tightening and loosening with moderate fiscal policies." Fiscal revenues (public budget revenues) in 2018 were 18.34 trillion yuan (+6.2% over the same period of the previous year),[1] of which 8.54 trillion yuan came from the central government (+5.3%) and 9.79 trillion yuan came from local governments (+7%).

Tax revenues were 15.64 trillion yuan (+8.3%) and non-tax revenues were 2.7 trillion yuan (-4.7%). Meanwhile, government expenditure (public budget expenditure) was 22.9 trillion yuan (+8.7%), with 3.27 trillion yuan (+8.8%) coming from the central government

[1] If the budget adjustment stability fund, the government fund, state-owned capital management budget transfer funds are included, the total amount reaches 19 trillion 812 billion 461 million yuan.

Figure 1. Fiscal Balance Trends (unit: 100 million yuan/%)



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and about 18.82 trillion yuan (+8.7%) coming from local governments. As for the management of the state-owned capital budget, in 2017, state-owned companies and stock companies had operating revenues of 53.8 trillion yuan, net profit of 2.35 trillion yuan, total assets of 183.5 trillion yuan, and a total debt of about 118.5 trillion yuan at the end of the year. The revenues and expenditures of state-owned capital management were 290 billion yuan (+9.8%) and 216 billion yuan (+6.7%), respectively, in 2018. Regarding social security, there exist social insurance funds, which are the financial source of social insurance. The revenues of social insurance funds come from the fees and operating profits from endowment insurance (pension), medical insurance, industrial accident insurance, unemployment insurance, and maternity insurance, as well as the financial support system. The social insurance fund budget revenues and expenditures both increased significantly to 7.27 trillion yuan (+24.3%) and 6.46 trillion yuan (+32.7%), respectively, in 2018.

II-2. Tax revenue structure

The tax revenues from 2018 of approximately 15.64 trillion yuan account for 85.3% of public revenues. In terms of structure, the main indirect taxes combined – domestic value-added tax, consum ption tax, and value-added tax and consumption tax on imported goods (collected by customs) – account for around 57% of the tax revenues from 2018. Meanwhile, the direct taxes – corporate and personal income taxes – correspond to 31.5% of the total, which indicates that despite the growth in income taxes and direct taxes in recent years, the tax structure is still centered on indirect taxes. The circulation tax and income tax combined correspond to around 90% of the tax revenues.

The main tax revenues of the central government were 3.75 trillion yuan from domestic value-added tax, 1.63 trillion yuan from domestic consumption tax, 1.69 trillion yuan from value-added tax and consumption tax on imported goods, 284.8 billion yuan from customs duties, 2.22 trillion yuan from corporate income tax, and 832.4 billion yuan from personal income tax. The national general public budget expenditure was 22.91 trillion yuan, of which 3.27 trillion yuan (14.8% of the total) came from the central government and 18.82 trillion yuan (85.2%) came from local governments. The main expenditure items were to do with education-related affairs (3.22 trillion yuan, 14.6% of the total), social security and employment-related affairs (2.71 trillion yuan, 12.3%), urban and rural community services (2.27 trillion yuan, 10.3%), agriculture, forestry, and water (2.79 trillion yuan, 9.4%), medical care sanitation (1.57 trillion yuan, 7.1%), defense expenditure (1.11 trillion yuan, 5.0%), transportation (1.11 trillion yuan, 5.0%), science and technology (832 billion yuan, 3.8%), culture, physical education, and media-related affairs (352 billion yuan, 1.6%), energy saving and environmental protection (635 billion yuan, 2.9%), stockpiling of food and supplies (1.38 trillion yuan, 0.6%), diplomacy (58.3 billion yuan, 0.3%), and government bond redemption and interest payment (735 billion yuan, 3.3%).

II-3. Fiscal deficit trends

The Chinese government's revenue and expenditure balance has deteriorated in recent years, which has resulted in the gradual increase of the country's fiscal deficit. The amount of deficit in the general public budget in 2018, after subtracting fiscal revenues from government expenditure, was 3.76 trillion yuan, which is roughly 4.17% of gross domestic product (GDP). However, the central government's fiscal revenues include money transferred from the budget stability adjustment fund and the central government fund, and the local government's fiscal revenues include surplus carried forward from the previous year. If these are excluded, the deficit exceeds 5% of GDP. The debt balance has also increased gradually, reaching 30 trillion yuan when the central and local governments amounts are combined. The debts of local governments, which surpass those of the central government, continue to add to concerns about their deteriorating financial health.

II-4. Conditions of government funds

The revenues from national government funds, which correspond to special accounts, were 7.54 trillion yuan (+22.6% over the same period of the previous year), which reaches 8.93 trillion yuan (+32.1%) if surplus from the previous year and revenues from local government-issued special bonds are added. While the total amount of central government funds was 441.82 billion yuan (+8.4%), the revenues from local government funds grew significantly, reaching a total of 8.88 trillion yuan (+32.9%).[2]

[2] The situation of local government funds is peculiar, as detailed in section III-2 of this paper.

Figure 2. Fiscal Deficit Trends (unit: 100 million yuan/%)

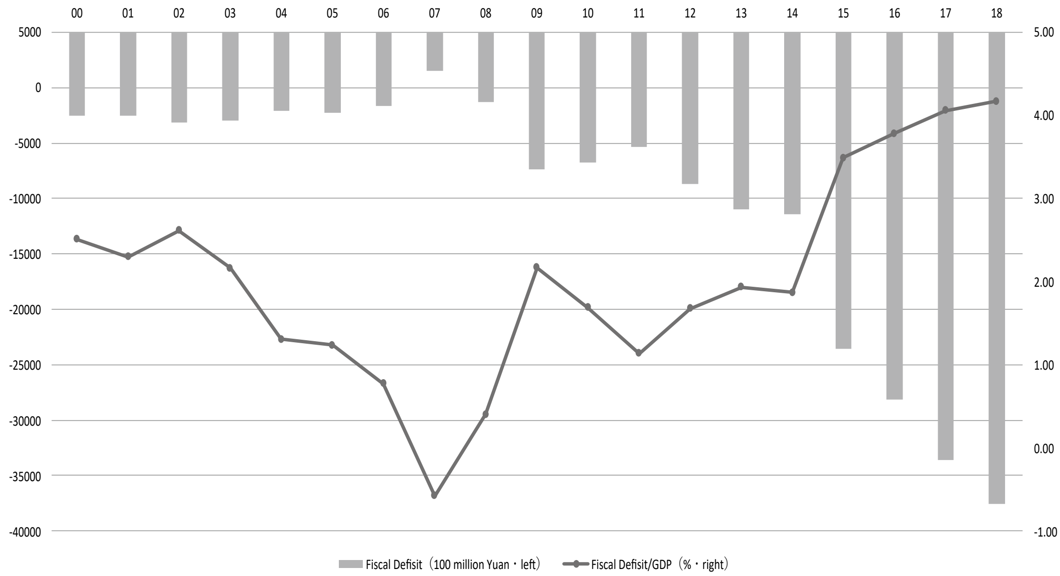

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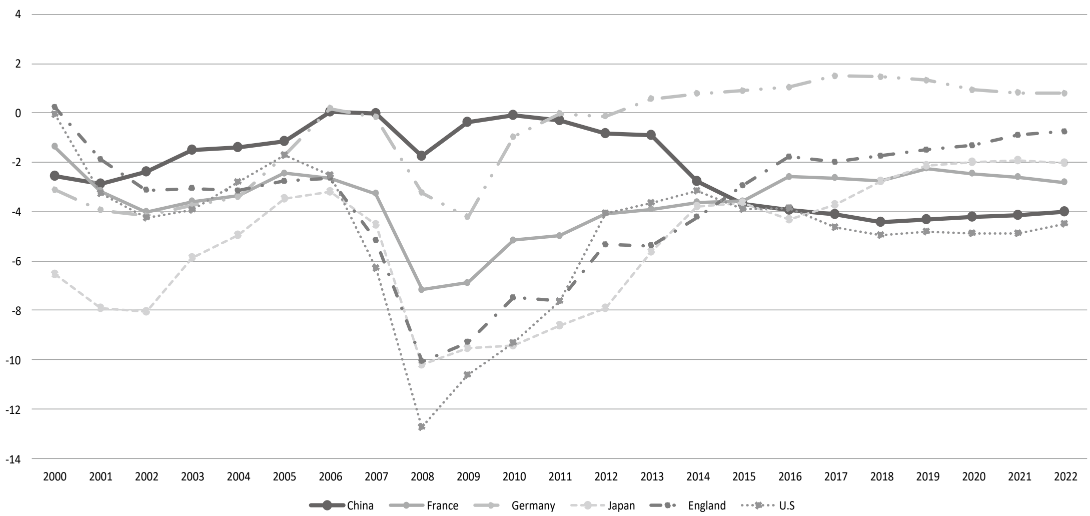
Table 1. Debt Balance of Central and Local Governments (unit: trillion yuan)

	2014	2015	2016	2017	2018
Debt Balance (Central)	9.6	10.7	12	13.5	15
Debt Balance (Local)	15.4	14.8	15.4	16.5	18.4
Total	25	25.5	27.4	30	33.4

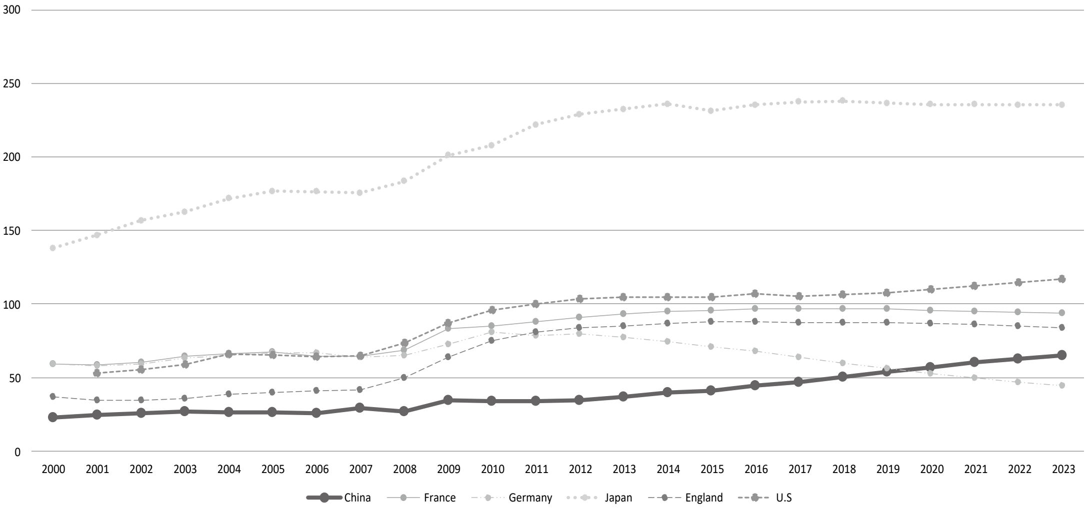
(Source) Created based on the document "Financial Statistics" from China's Finance Department

Figure 3. International Comparison of Fiscal Deficit (against GDP) (unit: %)



(Source) Created based on a document from the International Monetary Fund (2018)

Figure 4. International Comparison of Government Debt Balance (against GDP) (unit: %)



(Source) Created based on a document from the International Monetary Fund (2018)

III. Financial problems of the local governments

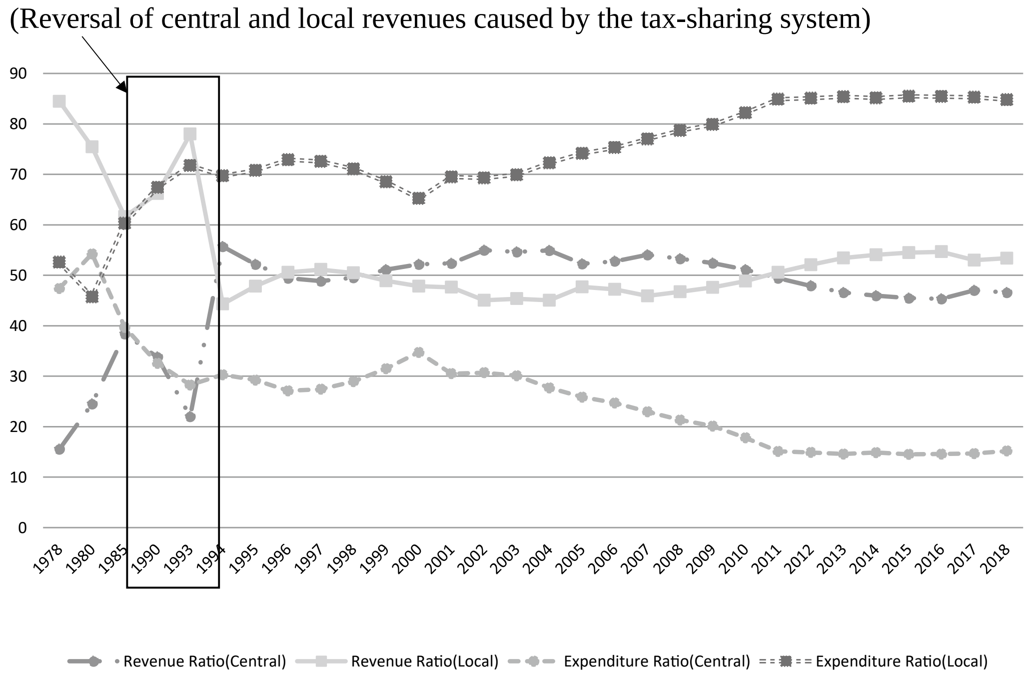
The financial situation faced by local governments in China plays a vital role in the country's financial risk. While the central government is relatively healthy in financial terms, the situation for local governments is aggravating, and its lack of transparency has long been a problem. These issues gained significant attention when the results of a survey conducted by the National Audit Office of the People's Republic of China (which corresponds to the Board of Audit in Japan) were published in 2013. At the same time, however, it was a major turning point for the Chinese government, which promptly introduced initiatives designed to strengthen and consolidate the finances of local governments.

III-1. Financial relationship between central and local governments

Fig. 5 shows the trends in the fiscal balances of the central and local governments. The adjustment in the intergovernmental financial relationship following the tax-sharing system reform of 1994 drastically changed the financial structures of both central and local governments. With the fiscal contracting system adopted after the reform and opening-up policy, the ratio of fiscal balance to GDP and the weight of the finance of the central government decreased significantly, but since 1994, when central and local taxes were re-divided and the ratio of shared taxes was adjusted, the ratio of central-to-local fiscal revenues was reversed, with a sharp increase in the former and a decrease in the latter. In percentage terms, while the local fiscal revenues are only slightly higher than the central government's, the expenditure of the central government represents 15% of the total finance, compared to 85% of the local governments. This situation has continued for more than ten years.

The system of financial transfer behind the structure of revenues and expenditures of the central and local governments has also changed several times. When the tax-sharing system was introduced, the financial transfer system was small. Besides, as seen in tax revenue repayment systems, where the amount of tax reduction generated by the tax-sharing system is paid back (with a weak redistribution effect), the vested interests of local governments were still protected. As a result, the finance adjustment function was not effective. At that time, there were multiple transfer systems, such as transitional transfer expenditure, special assistance expenditure (specific subsidy), ethnic district transfer expenditure, structural assistance, and agricultural fixed-amount assistance. After a revision, the system was simplified into a partial tax return rule consisting of general transfer expenditures (equivalent to local government-allocated taxes) and special assistance expenditures (equivalent to specific subsidies).

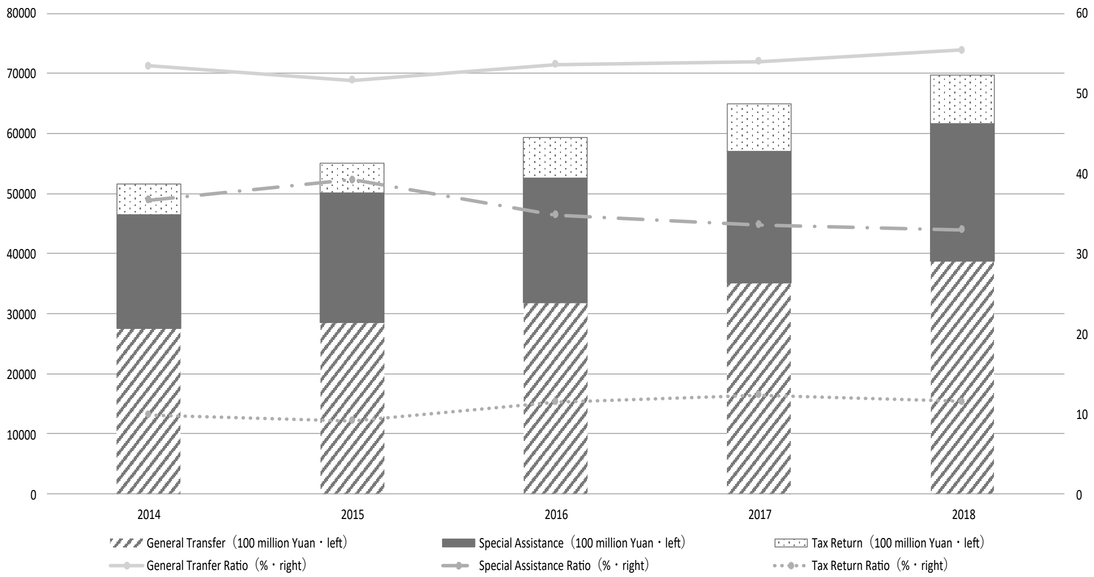
Figure 5. Trends in the Percentage of the Fiscal Balance of Central and Local Governments (unit: %)



In recent years, the ratio of general transfer expenditure has increased, while the ratio of tax returns has decreased following the government's plans. In 2017, general transfer expenditures and special assistance, respectively, accounted for 62% and 38% of the total financial transfers (excluding tax returns). If the tax returns are included, general transfer expenditures account for 54%, special assistance for 34%, and tax returns for 12%.

In the 2018 budget, the financial transfers (excluding tax returns) account for approximately 29.5% of the local fiscal revenues. The general transfer expenditures were around

Figure 6. Financial Transfer Trends (unit: 100 million yuan/%)



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3.88 trillion yuan, accounting for 55.4%; special assistance was 2.29 trillion yuan, or 33%; and tax returns were 800 billion yuan, or 11.6%. However, the system as a whole is still not based on the standard financial demand and revenue conditions of each region, and its standards are ambiguous and unclear, which calls for deeper reform that seeks objective system design.

III-2. Financial structure of local governments and government funds

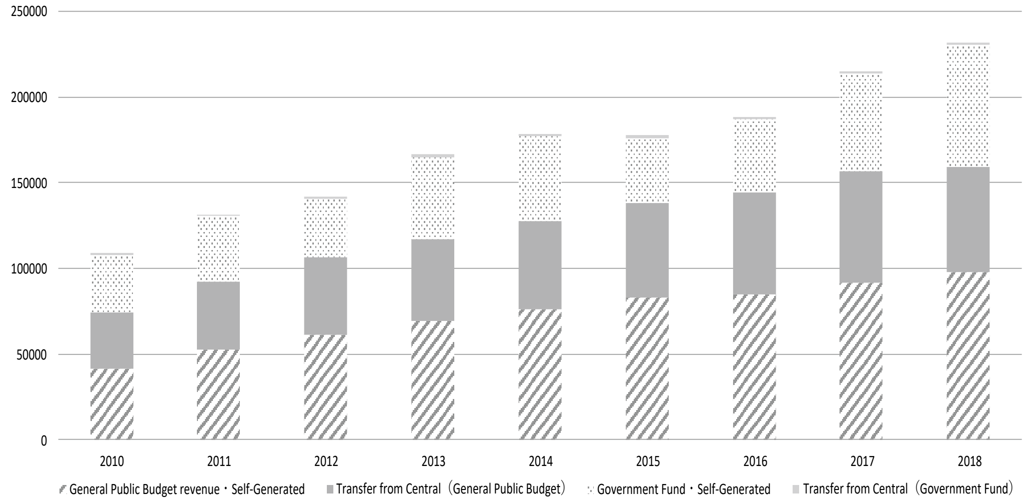
III-2-1. The financial structure of local governments

Local fiscal revenues consist of general public budget revenues and government funds, with a ratio that hovers around 7:3. Additionally, the revenues are classified into self-generated local revenues and revenues transferred from the central government, which, respectively, accounted for 58.4% and 41.6% of the local general budget revenues in 2018. Most of the government fund revenues are self-generated, with only around 1% to 3% being transferred from the central government. Self-generated revenues in the general budget account for around 40% of the total local fiscal revenues, and revenues transferred from the central government account for around 30%. In addition, revenues generated from government funds account for around 20%, and between 0.5% and 1% are transferred from the central government.

III-2-2. Financial problems with government funds and land

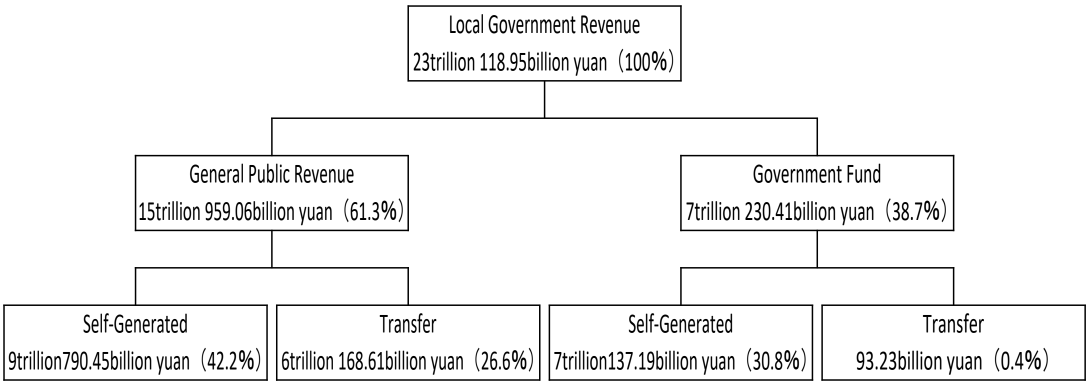
When analyzing the finances of local governments, it is necessary to look at government funds. In the 2018 budget, local general public budget revenues and government fund reve-

Figure 7. The Structure of Local Government Revenues (unit: 100 million yuan)



(Source) Created based on the document “Financial Statistics” from China’s Finance Department

Figure 8. Revenue Structure of Local Governments (based on the 2018 budget)

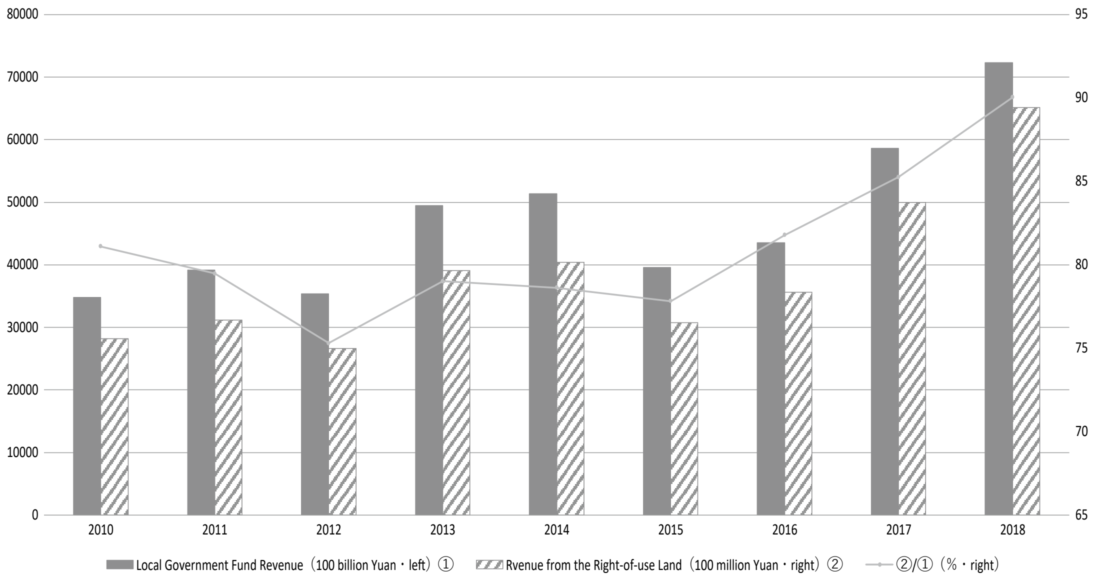


(Source) Created based on the document “Financial Statistics” from China’s Finance Department

nues, respectively, accounted for 61.3% and 38.7% of the local fiscal revenues, or a ratio of around 6:4. An important topic is the revenues from land transfer, which is an item of government funds.

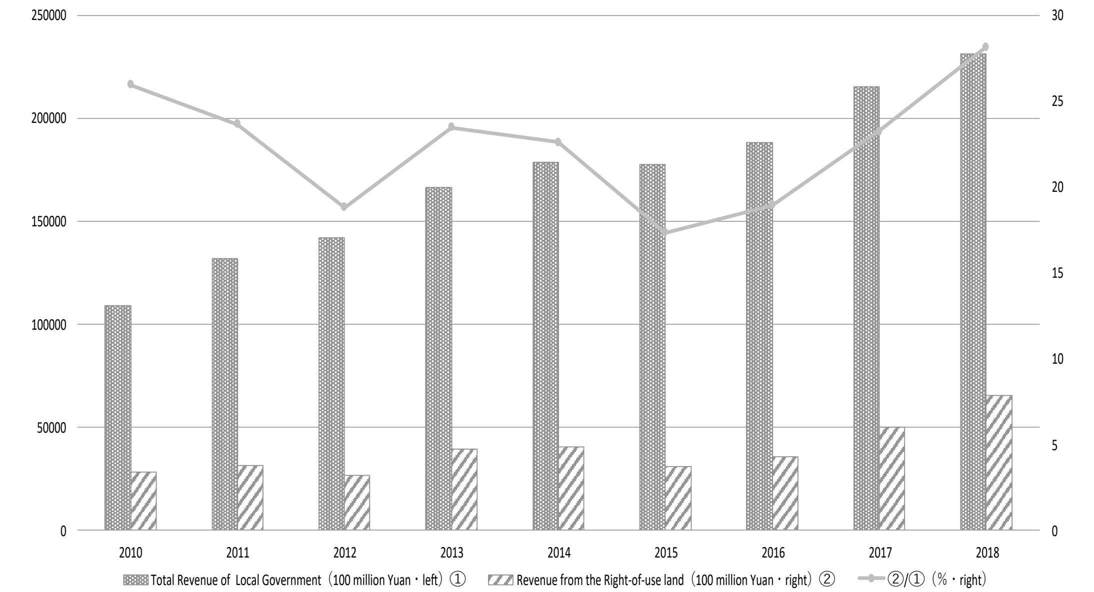
The amount transferred from the central government accounts for as little as 0.4% of the revenues from government funds, and the remainder was generated locally. Meanwhile, the land transfer revenues of local governments, which accounted for less than 80% of government funds (revenues after the transfer) in 2014 and 2015, increased to 85% in 2017 and around 90% in 2018. Additionally, the ratio of land transfer revenues to primary revenues of local governments was 33.5% in 2017 and 38.5% in 2018. Although this ratio decreased to less than 30% in both 2015 and 2016, it is on the rise again. Even in terms of total revenues after the transfer, this ratio decreased to less than 20% in both 2015 and 2016 but increased

Figure 9. Trends of the Land Transfer Revenues of Local Governments (ratio to revenues from local government funds) (unit: 100 million yuan/%)



(Source) Created based on the document “Financial Statistics” from China’s Finance Department

Figure 10. Trends of the Land Transfer Revenues of Local Governments (ratio to total revenues of local governments) (unit: 100 million yuan/%)



(Source) Created based on the document “Financial Statistics” from China’s Finance Department

Table 2. Ratio of the Land Transfer Revenues of Local Governments (unit: %)

	①/②	①/③	①/④	①/⑤
2014	80.8	78.6	32.1	22.6
15	80.5	77.8	25.4	17.3
16	83.9	81.8	27.5	18.7
17	86.7	85.3	33.5	23.2
18	91.2	90.0	38.5	27.1

Revenue of the transfer of the right-of-use land	①
Local Government Fund (Self-Generated)	②
Local Government Fund (After Transfer)	③
Local Government Total Revenue (Self-Generated)	④
Local Government Total Revenue (After Transfer)	⑤

(Source) Created based on the document “Financial Statistics” from China’s Finance Department

again to 23.2% in 2017 and 27.1% in 2018.

Therefore, the structure of local public finances in China is heavily dependent on revenues from the transfer of right-to-use land. It is also a major factor behind the high land prices in the country. On the other hand, considering how tough it would be for local governments to manage their public finances if land prices fell, this dependence also works as an incentive for local authorities to prevent a price crash. Some sources point out that local governments may have maintained the land value by adjusting and controlling the volume and price of real estate transactions since the late 1990s, when many rights involved in real estate transactions were transferred to them. For this reason, it is said that the surge in real estate prices in China contains elements of a government-made bubble. Even though local governments are aware of their need to break away from their excessive dependence on real estate to achieve financial independence and sustainability, land prices have gone up rapidly again from 2016, increasing the risks surrounding their public finances.

III-3. The problem of debt in the public finances of local governments

III-3-1. Trends in local government debt

Local government debt is the main problem for China’s financial health. Table 5 shows the debt situation before the issuance of local government bonds was officially authorized. It reveals that local governments had a significant amount of debt, even when the issuance of bonds was prohibited and the fiscal deficit was not officially authorized. In addition to debts with direct repayment liability, some of these debts were guaranteed by the government, despite not being officially authorized, and others were highly obscure debts that the government did not guarantee but had to repay in the end. This situation, combined with the objectives of providing more transparency for better fiscal discipline and alleviating the burden on local public finances, led to the issuance of local government bonds being officially authorized in 2015.

Table 3. Structure of Local Government Debt (unit: trillion yuan)

	Responsibility of Local Government		
	Direct Responsibility	Loan Guarantee	Risk of Taking Responsibility
End of 2012	9.6	2.5	3.8
End of June/2013	10.9	2.7	4.3
Local Government Financial Platform	4.1	0.9	2
Government Sector	4.9	1.1	0.5
SOE's	1.2	0.6	1.4
Others	0.8	0.1	0.4
End of 2014	15.4	3.1	5.5

(Source) Created based on Audit Commission documents (2013)

With this policy change, the cost of financing was drastically reduced, debt repayment could be postponed by replacing existing debts with local government bonds (and thereby level the burden onto local governments), and fairness between generations could be ensured through the development of social infrastructure. Most of all, this change allowed public finances to be managed appropriately, based on their actual situation. The debt balance of local governments in late December 2018 was 18.38 trillion yuan (the limit ratified by the National People's Congress (NPC) was 21 trillion yuan), of which 11 trillion yuan was general debt (NPC-ratified limit: 12.38 trillion yuan), and 7.39 trillion yuan was special debt (NPC-ratified limit: 8.62 trillion yuan). Also, the volume of newly issued bonds reached 2.17 trillion yuan, which corresponded to 99.6% of the NPC-ratified limit.

However, there are still many issues to be resolved. For example, since the yield of local government bonds is equivalent to that of federal bonds, they do not necessarily reflect the financial capability or creditworthiness of local governments. Also, the fact that most of the underwriters of government bonds are state-owned banks offers a high risk of falling into a moral hazard of the indiscriminate issuance of bonds. The implementation of local taxes, which serve as the basis for issuing local government bonds, is also behind schedule. In order to maintain and grow the regional economy, it is necessary to avoid the situation where local governments are unable to break away from the traditional investment-driven structure and, as a result, over-issue local bonds as financial resources.

However, the fact that the People's Bank of China (the country's central bank) is part of the State Council – and, therefore, not independent – and commercial banks are also state-owned represents a huge challenge for a system that intends to maintain fiscal discipline and may well lead to an increase in local bonds. In the fall of 2014, the central government prohibited local governments from raising funds through their financing platforms and promoted transparency of debt through refinancing bonds after receiving official approval to issue local bonds. Later, the NPC established a limit for local debt as part of a series of measures intended to provide tighter debt control.

Meanwhile, as the economic deceleration deepens, the local government debts have already surpassed those of the central government, which actively pushes for stronger fiscal policies along with a large tax reduction. Also, investments in infrastructure, such as urban railway maintenance services, have been approved in some regions. The central government has also expressed an intention to actively issue local government special bonds to raise more funds for profitable projects.[3] However, if more public services, designed to stimulate the local economy, are implemented without fiscal discipline, and more local government bonds are issued as a means to finance those services, local public finances will inevitably deteriorate very quickly. For this reason, the debt management policies adopted by local governments in the coming years, including the issuance of bonds, need to be watched even more closely.

III-3-2. The problem of hidden debt

From the perspective of financial risk, the hidden debt of local governments also represents a serious problem. Besides, the fact that hidden debt exists in many different forms with a complete lack of transparency is not a new problem. Typical examples include the government guarantee given to local government financing platforms and local governments providing a guarantee to private companies that participate in local investment projects using Public-Private-Partnership (PPP). In such cases, the local government bears risks that would otherwise be borne by the company, and if the businesses do not perform well, the local government takes over their debt. This form of hidden debt, which is not officially allowed, is expanding. In the case of PPP, specifically, the central government often introduces private methods to make the investment projects of local governments more efficient and actively promotes the development of social infrastructure and the regional economy as means to improve their financial conditions. As a result, the number of local governments that use PPP to launch projects as an alternative for local government financing platforms, which is more tightly controlled, has increased.

However, in practice, there has been an increase in the number of projects that deviate from the purpose of PPP, such as investments in real estate development and the construction of commercial facilities. In fact, many of these projects are based on questionable methods, such as local governments granting guarantees, offering real estate as collateral, or even providing investment capital to private companies when they receive bank loans for investment projects, as a government procurement service.[4] These are all different forms of the hidden debt of local governments. The fact that neither the magnitude nor actual situation of

[3] This refers to special local government bonds issued for each project.

this kind of hidden debt are known is also a serious problem. For this reason, the regulations concerning the use of local government financing platforms and PPP have been strengthened in an attempt to reduce the hidden debt of local governments. On the other hand, making financing more difficult also has a side effect of drastically reducing infrastructure investments and hurting the local economy.[5]

While it is crucial to solve the problem of the hidden debt of local governments as quickly as possible, the most pressing matter is to understand their actual situation and take the most appropriate measures. In addition to debt guarantees, there are also incidental debts that are not immediately visible, especially in lower-level governments. Such examples include unpaid salaries of public servants and teachers, accrued expenses related to local government projects, lack of social security funds due to insufficient collection and appropriation of funds, as well as losses from bad debts. These all represent concealed financial risks of local governments.

III-3-3. The relationship between public finances, financial institutions, and companies

When analyzing the public finances of local governments in China, it is necessary to consider the debts of state-owned companies classified as non-financial enterprises and local government-affiliated companies, including financing platforms.[6] These kinds of companies often rely on government guarantees to increase their debts. The financial institutions also use government guarantees as an opportunity to increase their lending. At the same time, as the main underwriter of local bonds, the financial institutions are important for local governments. For this reason, local governments often support them by providing them with a debt guarantee. This kind of mutual dependence between the government, financial institutions, and companies aggravates the problem of debt and non-performing loans even further. It is said that in order to break this relationship, it is crucial to eliminate implicit guarantees granted by the government,[7] such as debt guarantees, unclear subsidies, and permission to issue corporate bonds with the principal guaranteed.

Since the opening-up of China, public finances have been decentralized, and local governments have gained further discretionary powers under the fiscal contracting system. This

[4] According to Sano (2018), more severe data estimates that the domestic hidden debt in China reached 35 trillion yuan in 2015 and surpassed 30 trillion yuan in both 2016 and 2017, which is around two times higher than the official local government debt balance.

[5] Faced with this situation, the central government implemented stronger economic measures, such as demanding local governments use surplus funds and demanding financial institutions deal with the demand for funds from local government financing platforms. However, rather than solving the hidden debt problem, such measures result in revenue decline (due to tax cuts) and issuance of more local bonds, adding even more pressure to public finances. Instead, it is necessary to carry out a fundamental reform that streamlines the expenditure responsibility and financial resources of both central and local governments and expands the financial transfer system.

[6] The debt of households, governments, and non-financial corporate sectors is analyzed in section V. of this paper.

[7] This is according to Okazaki (2017) and Seki (2018). Okazaki (2017) calls the implicit guarantees granted by governments and financial institutions unreasonable and says that it is important to distribute resources based on market mechanisms but does not see this happening. He also adds that default and bankruptcy rules are required to solve this problem. Seki (2018) emphasizes that the implicit guarantees granted by the government are causing distortions in the market and, therefore, must be stopped.

new movement gave birth to a form of local protectionism called the “feudal economy,” which would underestimate corporate profits to reduce taxes and provide local companies with excessively preferential treatment to prioritize local profits. With this rise in regionalism, combined with the tax-sharing system reform of 1994 – which was implemented to restore the macro-control function of the central government that had become relatively weak – some of the goals were achieved; the financial relationship between central and local governments was adjusted and organized, and the fiscal revenues of the central government increased drastically. Meanwhile, the duties, roles, and financial resources remain poorly distributed among the governments, with local governments struggling even further with insufficient funds. This is another factor contributing to the creation of the regional relationship of mutual support between government, financial institutions, and companies. To eliminate this kind of cloudy relationship, it is necessary to build a mechanism that can provide the required financial resources to local governments according to their respective duties and roles. This can be achieved by expanding local taxes, which includes revising the distribution of financial resources among central and local governments and further expanding the financial transfer system.

IV. Factors that increase financial pressure

IV-1. Economic measures and priority policies

The economic goals for 2019, based on the reinforcement of proactive fiscal policies and moderate monetary policies, were presented at the NPC in March 2019. The fiscal deficit was marginally increased to 2.8% of GDP (up from 2.6% in 2018) to 2.76 trillion yuan. Government spending was set to 23 trillion yuan (+6.5% over the same period of the previous year), in a move intended to further stimulate the national economy. The Chinese government also expressed its intention to add 11 million new workers in urban areas, reduce the poor population by 10 million, and set income growth to the same level as the growth rate of between 6% and 6.5%. Pursuing these goals is set to increase government spending substantially. At the same time, a policy aimed at further tax reduction was also announced; it included reducing the tax burden on the manufacturing industry and micro, small, and medium companies, as well as lowering value-added tax from 16% to 13% in the manufacturing industry and from 10% to 9% in the transportation, logistics, and construction-related industries. Regarding local bonds, the Congress announced massive investments in infrastructure projects for railways, roads, and water transportation of 2.15 trillion yuan, an increase of 800 billion yuan from 1.35 trillion yuan in 2018. It also declared its support for the participation of private capital in infrastructure developments. Both represent large expansions of public services and successive tax cuts, mainly in provincial areas, which can be considered a return to traditional economic measures with excessive dependence on investments. While the need for immediate economic measures is not being questioned, there is strong concern that if this situation spreads and extends, it may cause the stagnation of structural reform. Therefore, the current policies, which are centered on large public investments and significant tax cuts to stimulate the economy, are set to contribute to further deterioration of the fiscal balance for a while to come.

Another factor that adds further financial burden is the continuation of the “three cuts, one reduction, one strengthening” reform,[8] known as the “big three strategy,”[9] which was indicated in the government activity report of 2018. There has also been an economic slowdown brought about by the heavy retaliatory tariffs imposed on Chinese goods by the USA, to which China has already responded with the announcement of concrete plans. These include, for example, income tax reductions, further issuance of special local bonds, the acceleration and expansion of investments in infrastructure projects, and further investment in research and development. While major economic measures like those that followed the collapse of Lehman Brothers in 2008 are not expected, the risk of yet another expansion in local-level investments is certainly increasing.

IV-2. The aggravating population problem

Among the many factors that add pressure to the public finances in China, the most pressing is the country’s demographic structure. The problem with China’s declining birth rate and aging population is the speed at which they are happening. The working-age population has been declining since 2010, and according to estimates from the United Nations, in 2025, the Chinese elderly population will surpass 200 million and account for around 15% of the total. By 2030, the total population should start to decline and become smaller than the current population by 2045. In 2050, the elderly population is expected to account for over 30% of the total.[10]

These projections are strongly impacted by the one-child policy, which was implemented in 1979 and ended in 2016. However, in practice, the birth rate increased to 1.3% in 2016, up from 1.2% in the previous year, but fell to 1.24% in 2017 and 1.09% in 2018. Compared to the same period of the previous year, the number of births decreased by around 2 million to 152.3 million. This is due to the rising economic burden resulting from the imbalance of marriageable and childbearing-age men and women caused by the one-child policy, as well as soaring house and commodity prices, the need to care for parents, and the rising costs of education. With the quick advancement of birth-rate decline and population aging, the working-age population is also declining, along with tax revenues. At the same time, the social security costs associated with medical care, pensions, and care for the elder-

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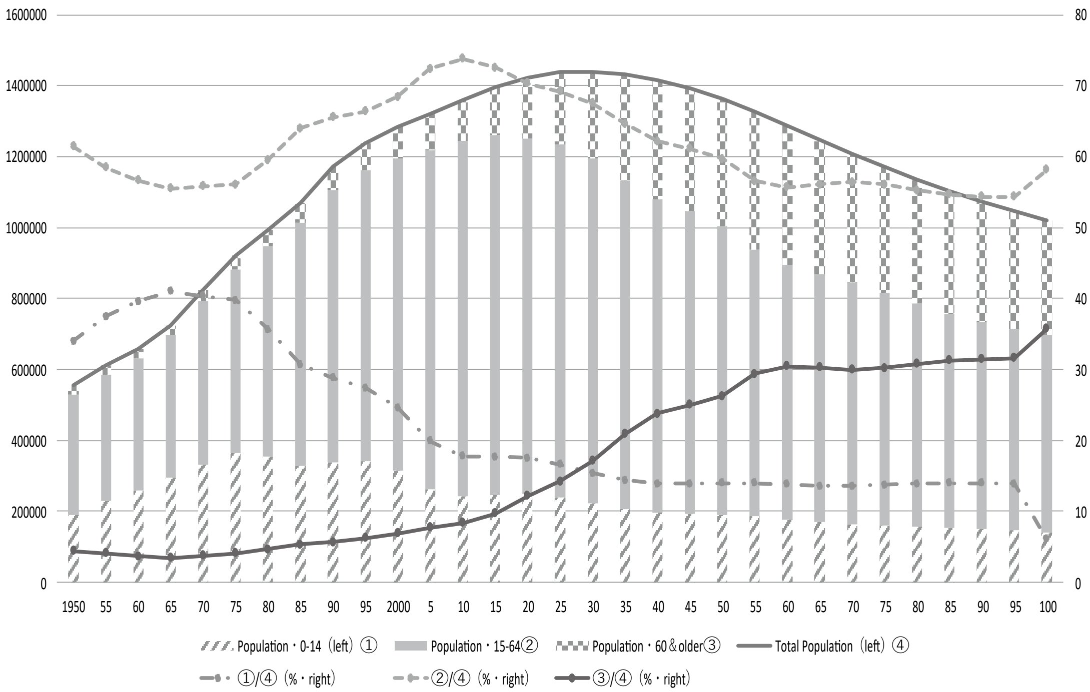
[8] “Three cuts” refers to the elimination of excessive manufacturing equipment, various types of inventory, such as real estate, and excessive debts; “one reduction” refers to the reduction of various costs; “one strengthening” refers to the reinforcing of underdeveloped fields.

[9] This is a new strategy that includes prevention of serious risks, poverty (further redistribution of wealth), and environmental issues. Serious risks refer to tighter control and supervision of financial institutions; anti-poverty measures are concerned with the gradual reduction and complete elimination of the poor population in rural areas by 2020; environmental measures relate to significant improvements in air and water pollution.

[10] According to the United Nations (2017).

Figure 11. Trends of the Chinese Population Structure (unit: 100 million yuan/%)



(Source) Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: Created based on the 2017 Revision

ly are also expected to increase, posing a huge burden on public finances.

Social security-related costs, which have seen double-digit growth for the last few years,[11] represent the biggest challenge of all. In 2013, the total amount reached 2.28 trillion yuan (+14.8% over the same period of the previous year), then 2.61 trillion yuan (+14.8%) in 2014, 3.97 trillion yuan (+18.5%) in 2015, 3.48 trillion yuan (+12.2%) in 2016, and 3.91 trillion yuan (+12.4%) in 2017. Also, the revenues from insurance premiums in 2018 reached 5.25 trillion yuan, which corresponded to 72.3% of the total social security-related revenues, and the deficit covering reached 1.68 trillion yuan, or 23% of the total. Since 2014, the social insurance funds can no longer be covered by insurance premiums alone; as a result, dependence on financial assistance saw a two-fold increase over the five-year period between 2013 and 2017.[12] The amount destined to cover deficits in the pension system, specifically, accounts for around 60% of the total, and close to 40% of this amount is dedicated to the pension systems of company employees in urban areas.

Social security-related costs will inevitably increase significantly over the coming years,

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[11] The details and current situation of China's social security system are based on Katayama (2019). In his view, China's social security-related costs are social security and employment expenses (social aid, social insurance (excluding medical care and maternity), social welfare, and military personnel security), and medical hygiene and planned delivery costs (social insurance (medical care, maternity)). These calculations were based on this definition.

[12] According to Katayama (2019).

imposing an even heavier burden on public finances. In addition, the nursing-care insurance system, which is gradually being introduced, and the development of community and welfare-related facilities also demand huge financial resources. The rising expenses associated with the social security system, which is essentially managed by the local (provincial) governments, have a massive impact on their public finances, and the fact that the application range and burden of this social security system vary among regions is also a problem. Moreover, how the end of the one-child policy will affect China's demographics is still unclear, but either way, it will take many years for the structure to improve. Even if the number of births increases, those children will increase the social burden as non-working dependents for 15 years until they reach a productive age. The declining birth rate and the aging population in China already represent serious challenges for the country's economic growth, and the rising cost of social security will certainly add even more financial pressure over the coming years.

IV-3. Other factors

Another factor that may impact public finances is the urbanization policy. Since the start of the current administration, urbanization has been given top priority, with the "New-Type Urbanization Plan (2014-2020)" announced in March 2014. In 2012, China's urbanization rate had already surpassed 50%, and it reached 57.3% in 2016, 58.2% in 2017, and 59.6% in 2018. The new type of urbanization was designed based on long-standing issues, such as the elimination of social inequalities and household registration system reform, balanced development of the nation, and the necessity to prioritize urbanization centered on people, which emerged when the pattern of economic development was changed from quantitative to qualitative improvement.[13] Okamoto (2018) splits the urbanization process in China into spatial urbanization and institutional urbanization,[14] and summarizes the respective details and problems. According to this theory, when spatial urbanization progresses and farmers migrate to urban areas, they elevate the industrial structure and stimulate large investment in urban development, which contributes to economic growth. Also, with institutional urbanization, the establishment of the migrating population in the cities pushes for reforms in the household registration control system and contributes to eliminating inequality and preferential treatment in land and public services. Meanwhile, both types of urbanization face China-specific problems; in spatial urbanization, urbanization lags industrialization, and urban construction has not kept pace with urbanization. In institutional urbanization, the urbanization of the population lags the urbanization of land, and the changes in the household register are behind occupational changes. On top of that, it is said that these issues can only be solved with the government intervention of stepping back, as an attempt to reduce exces-

[13] This refers to an urbanization process that emphasizes increasing living standards and welfare to improve the quality of life of the population.

[14] Okamoto (2018) defines spatial urbanization as the aspect of efficient use of urban space to receive the population that is concentrated in the cities, and institutional urbanization as how to settle the new residents that have entered the cities and eliminate the disparity between growing cities and depopulated rural areas.

Table 4. Urban and Rural Population and the Number of Rural Migrants

Total Population	139,008	139,538
Urban Population	81,374	83,137
Rural Population	57,661	56,401
Rural Migrants	28,652	28,836
From Another Province	17,185	17,266
Within The Same Province	11,467	11,570

(Source) Created based on the National Bureau of Statistics data (2017 and 2018)

sive management control.

To realize urbanization centered on people, it is important to eliminate the harmful effects caused by the dual structure of cities and rural areas and push for further privatization. Some of the roles involved in the construction of that base must be played by the government. Developing hard infrastructure, such as roads, houses, hospitals, schools, commercial facilities, and office buildings, is a crucial task in urbanization. However, the implementation of soft systems, such as education and social security (e.g., pensions, medical care) is equally important, and both are essential responsibilities of the government as the supplier of public services.

In this regard, expanding various public services aims to develop hard infrastructure in lagging regions and eliminate unequal treatment, but with it comes an enormous financial burden. Another issue, which relates particularly to the soft side of things, is that of citizens without access to satisfactory public services, despite living in urban areas. These are migrant workers known as rural migrants. According to the demographic data of the National Bureau of Statistics,[15] the number of rural migrants continues to rise, albeit slowly; there were 286.52 million in 2017 (of which 171.85 million moved from other provinces and 114.67 million lived within the same province) and 288.36 million in 2018 (respectively 172.66 million and 115.70 million). In providing rural migrants with public services, it is crucial to implement effective household registration system reform and, thereby, eliminate discriminatory treatment by the family register.

In connection with these issues, in the Third Plenary Session of the 18th Communist Party of China (CPC) Central Committee of 2013, the NPC expressed its intention to further speed up household registration system reform. In the government activity report of 2014, the NPC announced its goal of “three 100-million people,” which consists of turning 100 million agricultural households into non-agricultural households, moving 100 million people from barrack districts, and employing 100 million farmers in Midwest China in nearby cities before 2020. While these are essential reforms that must be implemented, they also pose the problem of high costs. For example, if 100 million rural migrants are granted family registers in urban areas, the sum of additional expenses incurred from the public services

[15] The National Bureau of Statistics of China (2017 and 2018).

provided to the new urban residents could exceed 10 trillion yuan. In other words, when the number of rural migrants is considered, it becomes clear that implementing the reform is not an easy task.[16] Therefore, the new type of urbanization that the current administration pushes so strongly requires the development of both hard and soft bases that will incur extremely large government spending. Also, while urbanization offers many advantages, including positive effects brought about by the optimization of the economy, the increase in tax revenues that follows, and reduction in public investment through commercialization, these benefits will not be visible for many years, adding more burden to the public finances.

Next, let us analyze the issues concerning one of the most important policies of the Xi Jinping administration, the Belt and Road Initiative (BRI). So far, it has divided the opinions of the countries involved, with Europe and North America expressing concerns over a possible leak of technological knowledge and that it may pose a challenge to the liberal order. Also, there is a growing sense of opposition in Central Asia and countries belonging to the Association of Southeast Asian Nations, which see the strategy as a debt trap and Chinese-style dominance. India and Australia have also expressed a strong distrust of possible geopolitical threats and issues related to information and communication technology. For these reasons, it is beginning to look as though the BRI may not advance as well as China had envisioned, and it will likely have to be developed over the medium-to-long term.

Meanwhile, China is by far the largest investor in the Asia Infrastructure Investment Bank, one of the main funding sources of the BIR, and the Silk Road Fund was independently founded by China with the specific purpose of providing financial support to the BRI project. Therefore, if the progress of the BRI slows down and takes longer than planned, it may negatively impact the performance of the Silk Road Fund, which was mainly formed using a portion of China's foreign currency reserves and contributions from policy banks and government funds, and may, eventually, lead to a financial crisis. Also, along with the political intent behind expanding China's international influence and hegemony through the use of its economic and financial power, the BRI has an economic objective of increasing external loans and direct investments using surplus funds, such as foreign currency reserves, and eliminating excesses in the country through market expansion. Moreover, it is also a domestic development strategy designed to foster the economy of western China, which lags behind the rest of the country. It seeks to eliminate inequalities and develop the country integrally through the implementation of a wide transportation infrastructure and logistics base.[17] For this reason, many extensive projects for construction of domestic infrastructure and regional development have been implemented as part of the BRI, and others

[16] Considering a social security cost of around 100,000 yuan per person to supply housing to the low-income population (known as security houses), education, medical care, and social insurance, the total cost for 100 million rural migrants would reach 10 trillion yuan. The number of rural migrants in 2018 was 172.66 million, which would demand 17 trillion yuan (with a conversion rate of 16.2 yen per yuan, this corresponds to approximately 275 trillion yen).

[17] Xu (2015) states that although the BRI is often seen as an international power game, its content is based on Chinese regional policies. Xu points out that the regional development associated with the BRI is increasing the financial burden (especially of local governments) and fostering the use of PPP (Public-Private-Partnership). While PPP may make business more efficient, it is also causing an expansion of investments in unprofitable sectors and projects, which may increase financial risks in the future.

are scheduled for the coming years. In other words, pushing the BRI forward will inevitably involve massive spending.

As described above, China faces numerous factors that could pressure its public finances. Nevertheless, the country set its defense spending for 2019 (in the central government budget plan) at 1.19 trillion yuan (+8.1% over the same period of the previous year), which is a slightly lower increase than the previous year, but still higher than the country's growth rate. This decision reveals China's path to strengthening its military power and building a strong nation.[18] The activity report presented at the Chinese People's Political Consultative Conference, which was held before the NPC of 2019, indicated the country's intention to promote the BRI, having closer cooperation through its "major-country diplomacy," as well as its firm opposition to Taiwan's independence, suggesting that China is strengthening its position to build a military power, which would add even more pressure to its finances.

V. Analysis of financial risks in China

V-1. The scope of public finances and government activities in China

When analyzing financial risks, it is important to consider how the scopes of public finances and the government are defined. Naturally, when looking at a fiscal deficit, where government expenditures exceed revenues, its scale varies a lot depending on whether the scope is limited to the central government or if local governments and social security costs are included. Normally, the fiscal balance is defined as the difference between the revenues and expenditures of the general government sectors (central government, local government, and social security costs). However, this also relates to how the scope of government activities is defined, which involves whether the social security fund is included or not and how the activities of public companies are dealt with. For example, if the social security fund has a surplus, and if it is included in the balance, the deficit of the general government is reduced; if public companies are included, and if the business conditions and finances of those companies change because of subsidies, the public finances are affected. For these reasons, when analyzing China's public finances, it is necessary to consider the balance of the general public budget (equivalent to general accounts in Japan), the government funds (equivalent to special accounts), the state-owned capital management budget, the state-owned companies funds, and the social security fund, along with the country's primary balance.

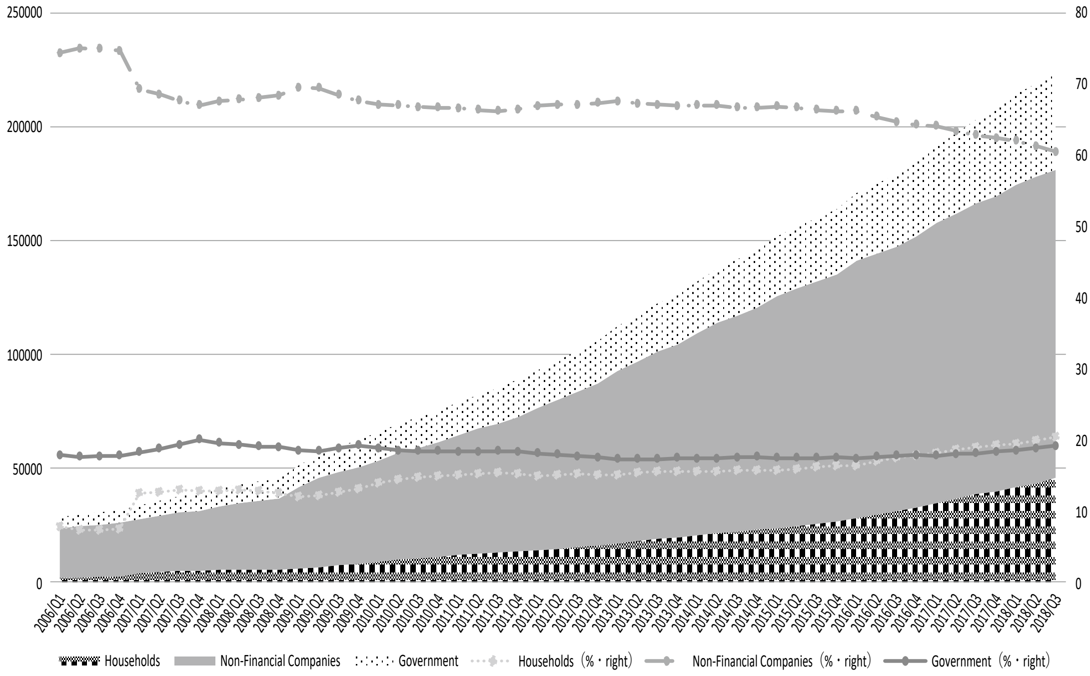
In the case of China, however, some aspects must be considered to be part of government activities and treated as financial issues. The relationship between corporate debt and public finances and the problem of incidental debts are important examples. The debt problem of non-financial companies, along with government and household sector debts, is be-

[18] According to the Annual Defense White Paper (2018), the defense spending announced by China represents only part of the actual amount spent on military affairs. For example, the costs of equipment purchased from abroad and R&D expenses are not included in the official defense spending. Also, according to the Office of the Secretary of Defense (2015), China's official defense spending is actually around 1.25 times higher.

coming so serious that it has been listed as one of the priorities in the policy objective to eliminate excesses.

In terms of finance, it is important to look at the scope of corporate debts rather than government debt itself. The weight of debts of the non-financial corporate sectors has been huge, at 64.5% in 2016 and 62.7% in 2017. In late March 2018, the debt balance reached 138.7 trillion yuan, exceeding 164% of GDP. However, the problem lies in the identity of those non-financial companies. In China, the government has a very close relationship with its affiliated companies (the relationship is even closer between local governments and state-owned companies under their control), which creates ambiguous and unclear aspects regarding authority and responsibility. It is believed that a considerable number of companies categorized as non-financial are, in fact, local government-affiliated companies, including state-owned companies and financing platforms.

Figure 12. Debt Trends of Households, Non-financial Companies, and the Government (unit: 100 million yuan/%)



(Source) "Debt Securities Statistics" from the Bank for International Settlements (BIS) website

For this reason, there is a risk that the debts held by such companies will eventually become government debts. In fact, besides the debts that local governments are obliged to repay, there are debts that are guaranteed by the government and those that, while not guaranteed, in the end, may have to be borne by the government. If these are included in the scope of public finances as part of government activities, the government debt soars. Also, as detailed in section III of this paper, this problem is closely related to the issue of implicit guarantees taken by local governments as an attempt to maintain the stability of the local economy. However, if the government compresses its apparent debt using these methods, not only does it become more difficult to understand the actual situation, but problems are postponed and future risks increase. Therefore, when discussing the financial risks under the current system in China, it is important to clarify how the scope of the government and its affiliated companies is determined, in order to make correct judgments.

V-2. Other related topics

Financial risk analyses are normally premised on the understanding that the financial conditions are based on official data, but it is also important to confirm how well the situation is known before any analysis is considered. In many cases, especially at provincial levels, the level of access to financial data is not standardized, and their content is ambiguous. The fact that their situation is unclear is also not a negligible risk. Additionally, when thinking about financial sustainability in the future, the capacity to secure financial resources is as relevant as understanding the current financial situation. Under the Communist Party's totalitarianism, almost any policy can be implemented if the party decides to do so. Systems and policies related to tax finance and social security, for example, are no exception, and it looks as though there is still a lot of room for a tax increase. However, since the Chinese political system is ruled by a single party and has no principles of tax democracy or fiscal democracy, resistance to taxation tends to increase. If there is no expansion of public services or reduction of inequalities in exchange for the taxes paid, the morale of taxpayers will not improve, and if the government unilaterally raises taxes to increase revenues, this prompts a strong backlash. Therefore, in practice, there is a limit to tax increases. Also, in this globalized economy, excessive taxation creates the risk of several companies and capital being transferred abroad. With tax reduction policies being reinforced to prioritize social stability and stimulate the economy, it is difficult to shift to policies designed to improve the fiscal balance, while maintaining or increasing revenues is certainly challenging.

For this reason, at the moment, the issuance of government bonds has increased, as has financing through local bonds (mainly refinancing bonds) after their official issuance. However, this situation also faces the problem of the relationship between fiscal and financial affairs. If the central bank and state-owned banks actively purchase government bonds and local bonds based on the economic policies of the party or government, fiscal discipline is greatly loosened, and the risk of debt expansion increases. These elements also need to be considered in the analysis of financial risks.

VI. Conclusion - Required reforms

Building an adequate financial structure is a basic condition for the sustainability of China's public finances. To this end, it is necessary to guarantee revenues and review annual expenditure, correct the ratio of direct-to-indirect taxes and implement tax reform, rebuild the relationship between central and local governments, and readjust the government-market relationship.

VI-1. Guarantee of revenues

In China's tax system, the ratio of indirect taxes is much higher than that of direct taxes, at a proportion of around 7:3. Although the percentage of direct taxes is gradually increasing, the ratio of revenues from corporate and personal income taxes (the two main sources) remains low, which maintains a high dependence on indirect taxes, such as domestic value-added tax and consumption tax. This is due to some irregularities in tax collection, such as difficulty in determining the exact income of the population and problems in tax administration standards, as well as the fact that the tax system for the wealthy class is not well-developed. As a result, the government has to rely mainly on indirect taxes on the circulation of money and services.

One of the most pressing issues in this regard is the strengthening of taxation on the wealthy class, which requires not only imposing heavier taxes on high incomes, but also implementing real estate (property) taxes, inheritance taxes, and gift taxes. Although these are already being tested in cities, such as Shanghai and Chongqing, a full-scale introduction is still a long way away. For now, many discussions have been held over and again, but the implementation has been repeatedly postponed.[19]

Meanwhile, the introduction of resident taxes and corporate business taxes – the main financial resources of local governments – is also pending. The introduction of real estate taxes, inheritance taxes, and gift taxes also faces a fundamental problem. These types of taxes require an advance evaluation of personal assets, but neither the standards nor the systems for this evaluation have been defined so far, which is set to delay their introduction for a long time. This issue also faces a structural problem, in which the creators of systems and laws, many of whom belong to the wealthy class, are not willing to design a system that increases their own burden.

In China, where securing tax revenues and reducing inequality are serious issues, increasing the direct tax ratio, which would redistribute wealth more effectively, represents an important political challenge. In addition, such a measure must also lead to improved tax morale, which necessarily requires providing better public services in exchange for the taxes paid. At the same time, in terms of income distribution, it is believed that taxing the fast-growing middle class is more efficient than imposing heavier taxes on wealthy citizens, who are small in number.

Two of the main tax system reforms in recent years have been the "B2V Reform," which integrates business tax to value-added tax,[20] and the personal income tax reform. The former

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[19] In the government activity report of 2018, the Deputy Finance Minister of China explained that a real estate tax bill is being drafted, but so far there has been no concrete development.

[20] This is a reform that integrates business tax, which is a form of value-added tax applied mainly to services, into value-added tax. Since the business tax is levied on total sales, companies would often struggle with a heavy tax burden or be double-taxed by value-added taxes. For this reason, this reform is designed to alleviate the tax burden on companies by unifying the value-added taxes.

was implemented to reduce the corporate tax burden and foster competitiveness, while the latter came into effect in the fall of 2018. With the personal income tax reform, there was a substantial change from the conventional separate taxation to a comprehensive taxation system. With the new system, salary and wages, service remuneration, manuscript fees, and patent fees are taxed together, and the estimated deduction and payment was newly introduced to the tax withholding at the source. Moreover, the basic deduction was raised from 3,500 yuan to 5,000 yuan, and the deduction system was expanded to specific deductions, specific additional deductions, and others, if necessary. The taxable income of 3% to 25% was also raised, reducing the taxes on low and middle incomes, and so was the standard of taxable income for individual businesses, resulting in a significant tax cut. Therefore, this series of income tax reforms can be considered a large-scale tax cut policy.

The government activity report of the NPC of 2019 also contains a wide range of measures aimed at alleviating the burden on businesses. These include large-scale tax cuts and tax burden alleviation through value-added tax reform for companies, reducing public utility charges (e.g., electricity charges and communication fees), and reducing the social insurance premiums of companies. While tax reduction policies for micro-, small-, and medium-sized companies, and the lower and middle classes may contribute to the reduction of inequality, if only mitigation measures designed to stimulate the economy are taken, the sustainability of public finances is put at risk. To maintain and improve the fiscal balance, it is essential to review expenditure and secure the appropriate amount of revenue. In addition, it is necessary to examine the national burden ratio and corporate burden, revise the ratio of direct-to-indirect taxes, develop a tax system for the wealthy, and implement a drastic and comprehensive tax and financial revision that encompasses even the relationship between the benefits and burdens of social security.

VI-2. Reconstruction of the relationship between central and local governments

Reconstructing the financial relationship between central and local governments is another issue that must be resolved before the migration to a more efficient and adequate financial system. The necessity of this reform is also mentioned in the government activity report of 2018, which emphasizes the importance of clarifying the fiscal authority and liabilities of the central and local governments, making the budget more binding and transparent, distributing financial resources more efficiently, and enacting a revenue division reform plan as soon as possible to optimize the financial transfer system and make it more transparent.[21] Naturally, there are functions that overlap between governments, but the division of work and roles has to consider comparative advantage in the role and function of

[21] In Japan, for example, both the social capital for the development and management of roads and rivers and the roles and responsibilities involved in education and welfare administration are distributed among the federal, prefectural, and municipal governments, and authority and financial resources are allocated based on this division.

In the case of China, in addition to the relationship between the central and local governments, there are four levels of local government, which makes the distribution of work, responsibilities, and financial resources unclear.

each policy, and financial resources must be allocated as necessary. Naturally, local governments are responsible for welfare and education, safety-related affairs (e.g., police and firefighting), the development of local roads and rivers, and other administrative services that are closer to the daily lives of the residents.

In the current Chinese system, local governments are divided into four levels: provinces, cities (prefectures), counties, and townships. However, work and responsibilities are not properly divided across these government levels, which results in ambiguous hierarchies and financial resources and many cases of administrative inefficiency. For this reason, it is currently difficult to investigate whether financial transfer between governments is based on appropriate systems and standards. As previously mentioned, this situation creates a vicious circle, where the subsidy system becomes less transparent, increasing the number of inefficient investments by local governments. While much-needed reform is not being carried out, Chinese society is changing rapidly, especially with its declining birth rate and aging population. Moreover, the new type of urbanization being pushed forward by the government is drastically changing the role of each government level, and it is unquestionable that the administrative and financial reforms have not been able to keep pace with those changes. To consolidate public finances, it is imperative for China to solve the long-standing issue of reconstructing the financial relationship between the central and local governments.

VI-3. Breaking away from "the state enterprises advance, the private sector retreats"

Along with the adjustment of intragovernmental relationships, the question of how to perceive and adjust the relationship between government and the market from a broader perspective remains unsolved. Looking back, a "decision" made in the Third Plenary Session of the 18th CPC Central Committee of 2013 to "let the market play a decisive role in resource allocation" greatly stressed the importance of market functions and created expectations for further privatization.

However, in practice, while some small and medium state-owned companies were privatized, the reform of large state-owned companies is a long way behind schedule. Instead, there is even a movement to make those companies even bigger through mergers and acquisitions supervised by the party.[22] As a result, even though the number of state-owned companies reduced with unification and reorganization, many inefficient and large state-owned companies remain active. These companies have become even more predominant, and the problem of the so-called "zombie companies," or inefficient state-owned companies preserved with government support, remains unsolved.

Since the start of its second term, the Xi Jinping administration has declared the intention to shift the focus of its policies from corporate management to capital management using the expression "reinforcement of state-owned assets," but it continues to prioritize state-

[22] Large state-owned companies are merging, especially in the fields of railways, shipbuilding, marine transportation, and energy.

owned sectors. Faced with such a situation, the government gathered private entrepreneurs for round-table discussions to assess the role and purpose of private companies. It also announced support measures for private companies, as an attempt to emphasize its interest in the private sector. The problem, however, is that because of various policies that give preferential treatment and protection to state-owned companies, the market does not work in a fair manner. Even though the government approved the participation of private capital in state-owned sectors and is advancing a mixed-ownership economy reform, building a fair market that encourages the participation of private companies and foreign capital requires profound ownership reform, and privatizing state-owned companies is likely to be the only way to achieve this goal.

The situation called “the state enterprises advance, the private sector retreats” refers to inefficient state-owned companies that push the private companies aside and cause inefficiency in the entire macroeconomy. This, combined with the fact that preserving inefficient companies requires support, such as subsidies, results in a considerable financial burden. The after-effects of the massive investments made after the real-estate crisis of 2008, designed to eliminate excesses, can still be felt. Also, even though there have been policies dedicated to making state-owned companies more efficient (e.g., by increasing the return on capital), these are still rare.

Meanwhile, the rapid expansion of deleveraging, designed to reduce excessive debts, made it more difficult for private companies to raise funds. Ironically, this situation hit the administration of private companies harder than the state-owned companies that were in trouble. In addition, some state-owned companies have been granted government guarantees in the form of debt guarantees and subsidies, indicating that “the state enterprises advance, the private sector retreats” situation also exists in public finance. Therefore, pushing for ownership reforms and eliminating different types of government guarantees to build a fair and just market system (and thereby break away from “the state enterprises advance, the private sector retreats”) not only makes the entire Chinese economy more efficient, but is also an essential issue for the financial sustainability of the country.

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