

China's Fiscal Situation and Policy Challenges - Fiscal Risk Considerations*

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Executive Summary

As the economy continues to stagnate, the direction of economic policy is becoming increasingly important. The tax and fiscal system, as well as policy management, are being widely questioned. Local fiscal risks have also increased significantly amid the ongoing turmoil in the real estate market. The continuation of “aggressive fiscal policy” has been announced, and government policies are being implemented, but drastic measures have yet to be implemented, and there are concerns that the central government in particular is taking a cautious stance. Measures are needed from relatively sound central finances. The fact that the 20th Plenary Session of the Central Committee of the Communist Party of China (hereinafter referred to as the 3rd Plenary Session of the 20th CPC), held under these circumstances, put forward measures to restructure local government finances by adjusting inter-governmental fiscal relations and strengthening the transfer of some powers to local governments can be appreciated to a certain extent. However, the specific details are not necessarily clear, and there is some uncertainty about how they will be realized. It is essential that the reforms outlined in the Conference’s “Decision” be carried out appropriately and promptly, and future developments will be closely monitored. At the same time, central and local governments continue to fight each other and compete for a share of the fiscal pie, and it is necessary to address issues such as the expansion of financial resources to increase revenue and the thoroughness of tax collection. Public finance challenges are piling up, including the accelerating population decline and aging of society, the expansion of military spending and “Advancing State-owned Sector and Retreating Private Sector” while giving top priority to “national security,” and the inefficient management of economic policies due to policy inconsistencies. The Xi Jinping administration, which has concentrated power in the hands of the Party and itself, will be held accountable for major results. The future course of fiscal reform and policy management will be closely watched.

Keywords: fiscal situation, fiscal policy, local government finance, fiscal risk

JEL Classification: H1, H6, H7, O2

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I. Introduction

As China's economy continues to stagnate, the role of macroeconomic policy has become increasingly important, and attention has focused on the direction of economic policy and the government's response. In this paper, we focus on public finances, taking into account the social and economic changes in China, summarizing and highlighting the current situation and challenges, and then discussing the risks involved. We then add our analysis of the necessary reforms, their direction, and the required responses.

Regarding China's public finances, it has been pointed out that while the central government's finances remain relatively sound, local government finances are more severe than ever. One aspect of this is the growing sluggishness of local economies, which has contributed to the deterioration of local public finances. But there are also institutional and policy management effects, such as incomplete tax and fiscal systems and unbalanced central-local fiscal relations, as well as ambiguous government roles and responses in macroeconomic management. In addition, the current situation is significant in that the "Tax sharing system" introduced in 1994 has become dysfunctional in some respects, and the so-called "Land finance" has reached its limits, and local finances are in dire straits as a result of the significant decline in land-related revenues, including revenues from the transfer of land use rights, on which local finances have relied heavily, due to the sluggish real estate market.

While the Xi administration has taken a stronger stance on the promotion of advanced technology and innovation under the slogan of "new quality productive forces" and "high-quality development" under the conditions of drastic economic and social changes, many issues that were previously considered problems to be solved, such as population decline, an aging society with fewer children, inequality, the need to promote urbanization, and the "Three Rural Issues," have been left unresolved. All these issues require a large financial burden. As high economic growth comes to an end and the economy as a whole is forced to shift to medium to low growth, and a change in the pattern of economic development is inevitable, in addition to the development of an environment that better utilizes the role of the market, it is strongly required that to reevaluate the role of the government and establish a system that allows for appropriate management. Reforming the tax and fiscal systems and adjusting operations to respond appropriately and flexibly to the economic situation is indeed an urgent issue. In particular, it is important to develop and restructure the financial system of local governments and reorganize management policies and systems so that the role of local governments is clarified, making their actions commensurate with their roles. In China, which advocates a socialist market economy under a one-party dictatorship, the relationship between the government and the market, and the role of public finance in this relationship, is once again being questioned.

II. Trends in Fiscal Conditions

II-1. Trends in Fiscal Balance

Looking at trends in China's fiscal balance, there have been no major changes since 2000, and both fiscal revenue and expenditure have remained at a level of about 20%-30% of GDP (see Figure 1). In 2023, after the coronavirus pandemic, the ratios of fiscal revenue to GDP were 24.8% and 27.4% for fiscal expenditure. The growth rate of fiscal revenue and expenditure has been gradually declining in recent years in line with the diminishing rate of economic growth, but it remained above 5% in 2023 and is expected to remain at the same level in the 2024 budget (see Figure 2).

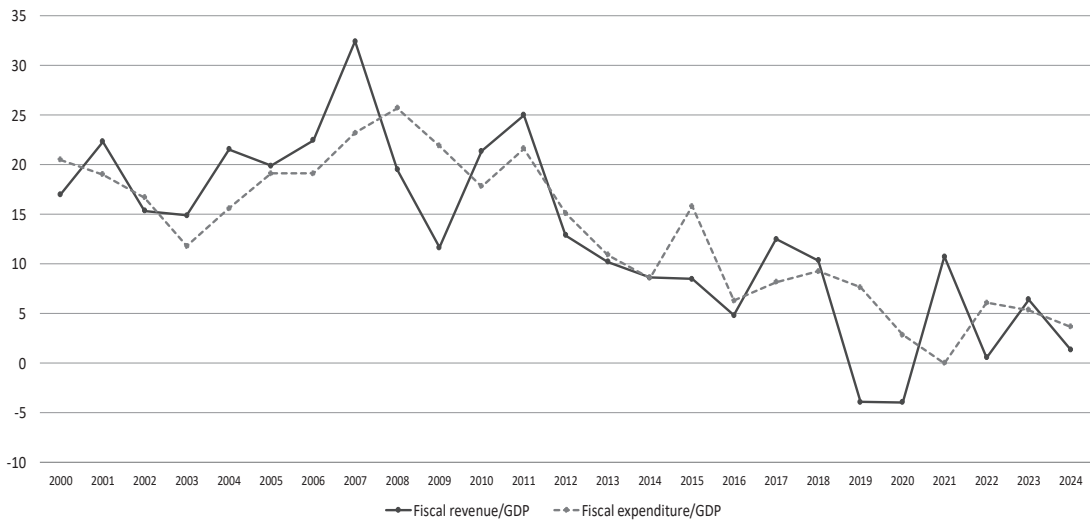
In 2023, total national fiscal revenue was RMB23,362.505 billion, with general public budget revenue of RMB21,678.437 billion and RMB168.068 billion in transferred funds and carry-over and surplus funds, etc. China's public finances are roughly divided into the general public budget and governmental funds (equivalent to special accounts), with national governmental fund revenue in 2023 amounting to RMB7,070.5 billion, of which general public budget revenue accounted for about 75.4% and governmental fund revenue about 24.6%. Tax revenues totaled RMB18,112.936 trillion, accounting for 83.6% of general public budget revenues, and non-tax revenues totaled RMB3,565.5 billion, accounting for 16.4%. Meanwhile, in terms of expenditures, total national fiscal expenditure was RMB28,242.505 trillion, general budget expenditure was RMB27,457.381 billion, the Central Budget Stabilization and Adjustment Fund was replenished with RMB285.124 billion, and RMB500 billion was carried over to FY2024. Governmental fund expenditures totaled RMB10,133.859 billion, with the ratio of general public budget expenditures to governmental fund expenditures at about 73% and 23%, respectively. In addition to this, national state-owned capital management budget revenue for 2023 was RMB674.4 billion (+18.4% y/y), while expenditure was RMB334.5 billion (-1.5% y/y). National Social Security Fund revenues totaled RMB11,149.97 billion, while expenditures totaled RMB9,928.13 billion.

As for tax revenues, which account for about 84% of general public budget revenues, value-added taxes account for 30%, and the ratio between direct and indirect taxes is almost 4:6, indicating that indirect taxes continue to be the dominant source. As the correction of inequality continues to be an important policy issue, it will be necessary to consider tax reforms to increase the share of direct taxes, which have a greater redistributive effect. On the other hand, social security spending has expanded due to the aging of the population, and employment-related spending has increased in proportion to the severe employment situation. Overall, however, there has been no significant change from the past.

II-2. Trends in Fiscal Deficits

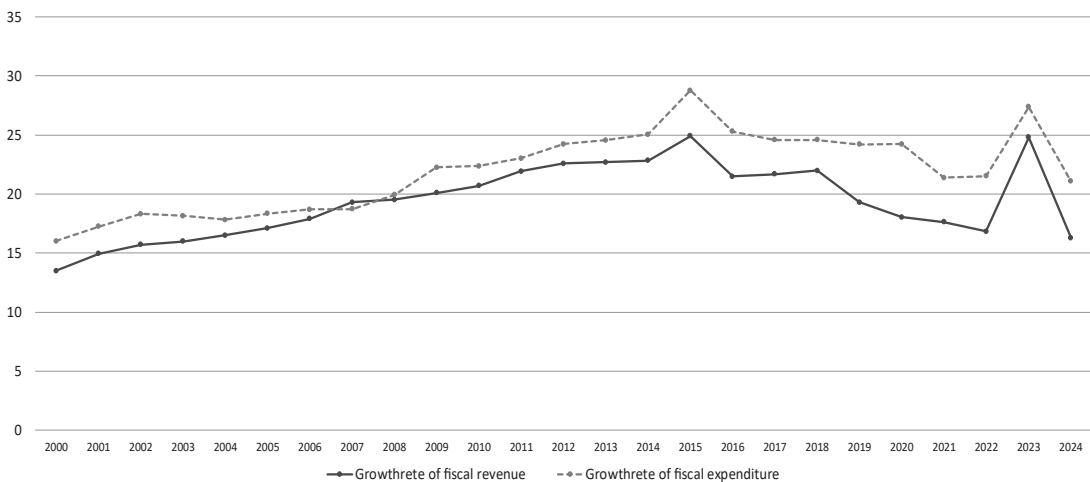
In China, the trend of fiscal deficit continues. The budget deficit for FY2012 is estimated to be RMB4.06 trillion, an increase of RMB180 billion from 2023, or 3% of GDP. The bud-

Figure 1: Fiscal Revenues and Expenditures as a Percentage of GDP (%)



(Source: Ministry of Finance of the People's Republic of China)

Figure 2: Growth Rate of Fiscal Revenue and Expenditure (%)

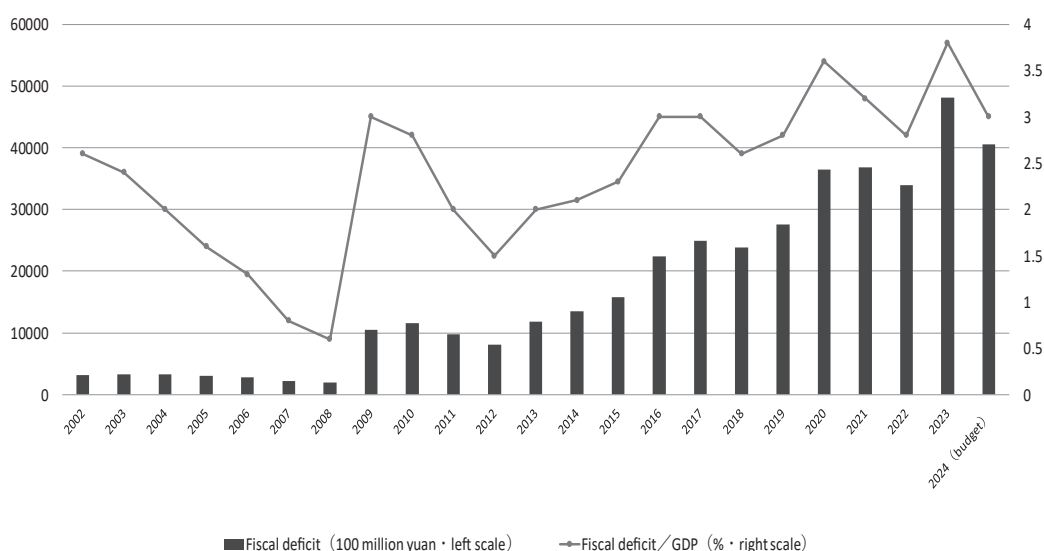


(Source: Ministry of Finance of the People's Republic of China)

get deficit for FY 2012 was set at RMB4.06 trillion, up RMB180 billion from 2023, or 3% of GDP (see Figure 3).

In particular, central government finances appear to be relatively sound. On the other hand, local public finances have deteriorated markedly, and risks are rising. This is largely due to the real estate market, which has slowed sharply and continues to stagnate. Local government finances, which have been heavily dependent on land use rights transfer revenues and other land-related revenues, are naturally becoming more severe as other basic financial resources are scarce, while government affairs and roles are expanding more than

Figure 3: Fiscal Deficit (RMB billion/%)



(Source: Ministry of Finance of the People's Republic of China)

ever before. Another major concern is the significant expansion of the debt of the Local Government Financing Platform (hereinafter referred to as “Local Government Financing Platform”), an investment company that plays a financing role under the local government, and the spillover effect this has had on the shadow banking problem.

When considering the fiscal deficit, it is necessary to take into account not only the central government finances, but also the status and size of debts, especially hidden debts, of local government finances and enterprises under the government. At the same time, the contents of government-owned funds, which are equivalent to special accounts in Japan, must also be scrutinized. As shown in Table 1, China's household, corporate (nonfinancial sector), and government sectors all have growing debts. The expansion of government sector debt is also significant, and in particular, the debt problem of local government finances has emerged as a major risk factor.¹ Among these, the size and growing trend of debt in the local government financing flat is of particular concern.

II-3. Central-Local Fiscal Relations

With regard to the central-local balance of fiscal revenue and expenditure, the implementation of the “Tax sharing system” in 1994 led to a reversal in the ratio of central and local fiscal revenues, with the share of central revenues expanding significantly, exceeding 50% at one point. Subsequently, after some adjustments, the ratio of central and local reve-

¹ The debt situation of households, firms, and the government sector, according to IMF data, is shown in Table 1. The debt situation, including local government finances and local government loan parities, is discussed in detail in Section III of this report.

Table 1: Debt Situation of Household, Corporate, and Government Sectors (RMB trillion/%)

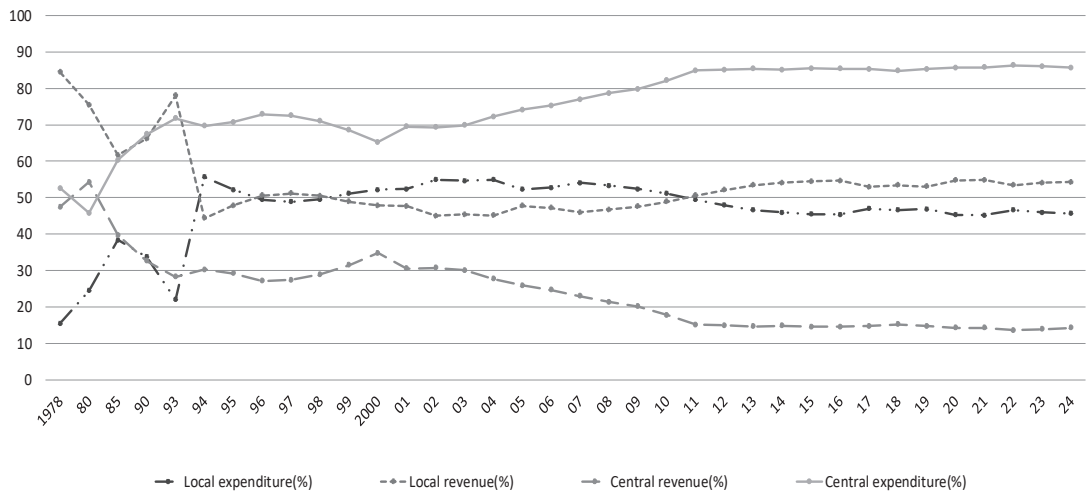
	2019		2020		2021		2022		2023		2024	
	Amount (trillion yuan)	Ratio to GDP (%)	Amount (trillion yuan)	Ratio to GDP (%)	Amount (trillion yuan)	Ratio to GDP (%)	Amount (trillion yuan)	Ratio to GDP (%)	Amount (trillion yuan)	Ratio to GDP (%)	Amount (trillion yuan)	Ratio to GDP (%)
Non-Financial sector Total	252	254	285	278	315	275	345	287	380	302	413	312
Central government	17	17	21	20	23	20	26	22	30	24	35	26
Local government	21	22	26	25	30	27	35	29	41	32	45	34
Local Government Financing Vehicle	40	40	45	44	50	44	55	46	60	48	66	50
Government fund	7	7	9	9	12	10	14	11	16	13	18	14
Government sector Total	85	86	101	98	115	101	130	108	147	117	164	124
Household economy	55	56	63	62	71	62	75	62	80	64	85	64
Enterprises (excluding LGFV)	105	106	115	112	122	106	134	112	147	116	157	119
	6	6	6	6	6	5	6	5	6	5	7	5

(Source: IMF (2024))

nues reached about 47% and 53%, respectively, and remains at these levels today.

In terms of expenditures, the central share was about 30% in 1994, immediately after the “Tax sharing system” was introduced, but it has gradually declined since then to a level of about 14% for the central government and about 86% for the local governments. In other words, in terms of revenue, the ratio of central and local governments is roughly 50-50, but in terms of expenditure, the ratio of local governments is overwhelmingly higher. Expenditures were RMB3,821.939 billion (13.9%) for the central government and RMB23,635.442 billion (86.1%) for the local governments. As for government funds, the central government accounted for RMB441.754 billion (6.2%) of revenues and RMB6,628.731 billion (93.8%) of expenditures, while the central government accounted for RMB485.123 billion (4.8%) and RMB9,648.736 billion (95.2%) of expenditures (see Figure 4).

Figure 4: Balance of Fiscal Revenue and Expenditure Between Central and Local Governments (%)



(Source: Ministry of Finance of the People's Republic of China)

Despite this situation of central-local balance of fiscal revenue and expenditure, the allocation of administrative tasks tends to be tilted in favor of local governments, and the lack of coordination in the allocation of financial resources has been a problem. This situation has remained unimproved to the present, and it must be said that reforms to optimize inter-governmental relations in public finance have stalled.

Such a balance between central and local fiscal balance requires transfer disbursements from the central government to local governments. The current fiscal transfer system can be broadly divided into General transfer expenses and Specialized transfer expenses. Tax revenue repatriation, which was separate until 2018, was integrated into General transfer expenses. Since then, dedicated subsidies have been significantly reduced and general transfer payments have been expanded (see Figure 5-1 and 5-2).

The dedicated subsidies are mainly for infrastructure construction and other local projects, and there is little transparency regarding the basis and scale of these subsidies, which has been considered problematic in terms of both efficiency and fairness. The integration of these subsidies into general transfer payments is a positive development. However, there are still many unknowns regarding the appropriateness and effectiveness of the system, as the basis for the overall fiscal transfers, including general transfers, is unclear, there are restrictions on the use of many of the items in general transfers, and there is little transparency regarding the actual status of the transfers. It is necessary to grasp the fiscal situation of each locality, establish a system that appropriately reflects this situation, and operate the system in a transparent manner.

III. Fiscal Policy Trends

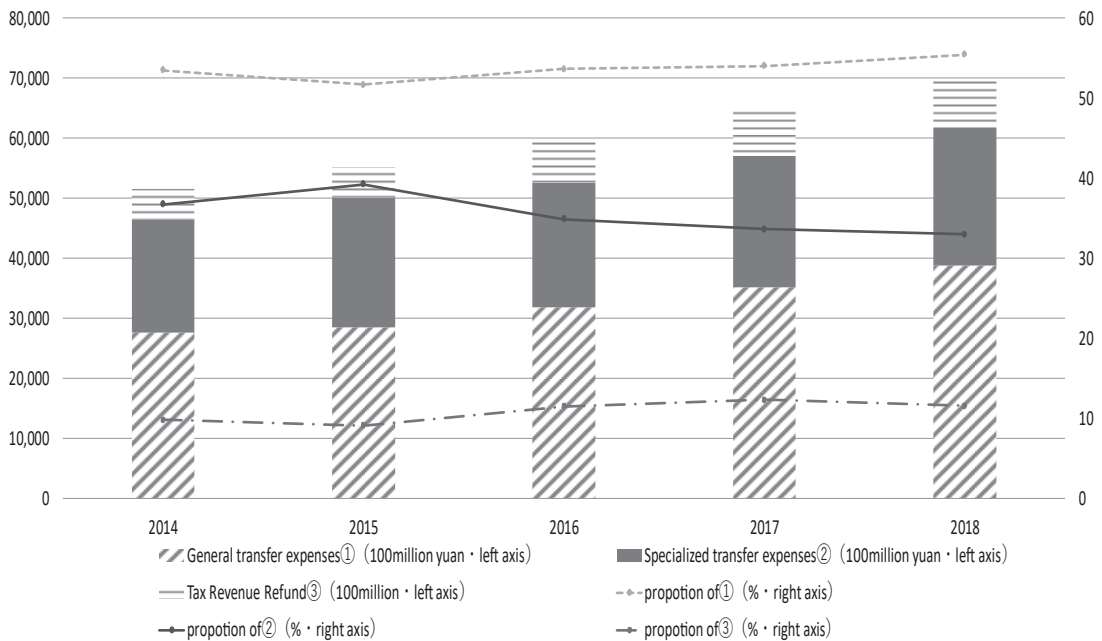
III-1. Actual Conditions of Aggressive Fiscal Policy²

“Aggressive fiscal policy” and “moderate monetary policy” continue to be pursued, and the same direction and policy were indicated in the “Central Economic Work Conference” held in December 2023 and the “Government Work Report” of the National People’s Congress (hereinafter referred to as the “National People’s Congress”) held in March 2024.³ In addition, the 3rd Plenary Session of the 20th Central Committee of CPC, which had been

² See Naito (2024) for a discussion of these contents (with additions and corrections of relevant items).

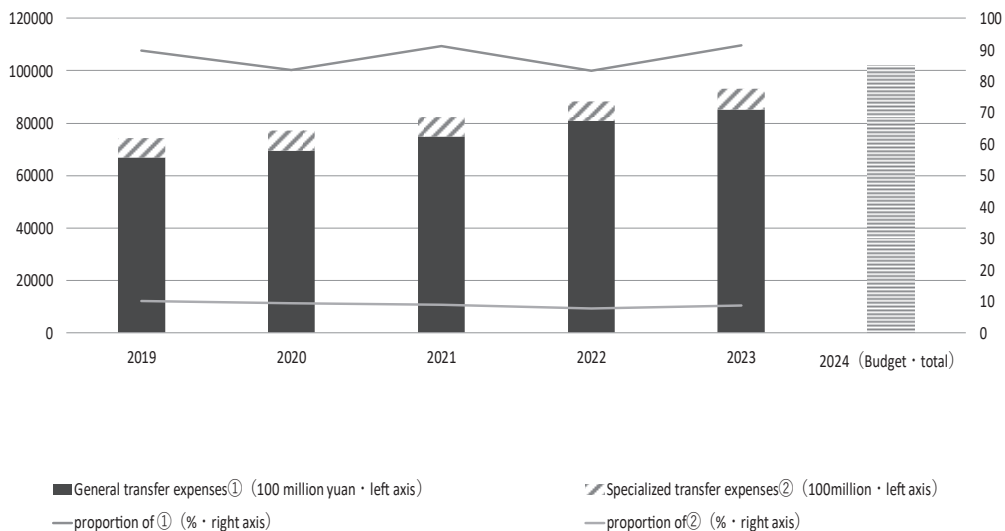
³ The 20th Three-China Plenum, at which economic policy and other matters were to be decided, was expected to be held in the fall of 2023. However, the meeting was not held until the beginning of 2024, and even the schedule had not been announced. Therefore, the contents of the “Central Economic Work Conference” held in December 2023 and the contents and data of the “Report on Government Activities” of the National People’s Congress in March 2024 have been important clues in determining the macroeconomic situation in general and the policy direction of economic policy for the time being. Although the “aggressive fiscal policy” policy was continued in the report, it did not necessarily indicate the decisive implementation of bold and aggressive measures, and in particular, there was a strong impression that the role of central government finances was restrained. Subsequently, the 20th Three-China Plenum was held from July 15 to 18, 2024, and a new fiscal policy direction was presented. On the 18th, a communiqué was released, entitled “Decision on the CPC Central Government’s Involvement in Step-by-step All-round Deepening Reforms and Promoting Chinese-style Modernization” (hereinafter referred to as the “Decision”), as well as an “Explanation” by General Secretary Xi. The new fiscal policy and direction will be discussed in detail in Section III.-2.

Figure 5-1: Trends in Fiscal Transfers (-2018) (RMB billion/%)



(Source: Ministry of Finance of the People's Republic of China)

Figure 5-2: Trends in Fiscal Transfers (2019-) (RMB billion/%)



(Source: Ministry of Finance of the People's Republic of China)

pending, was held in July 2024, and new policies and directions on fiscal policy were presented.

In the CPC's "Government Work Report," the policy and numerical targets for economic policy in 2024 clearly stated that the government would moderately strengthen "aggressive

fiscal policy,” improve the quality and effectiveness of public finances, and optimize the policy mix. The budget deficit was increased by RMB180 billion to RMB4.06 trillion from 2023, but kept at the same level of 3% of GDP. In addition, the general government budget expenditure was set at RMB28.5 trillion, an increase of RMB1.1 trillion from the previous year, to be financed by the expected increase in fiscal revenue and carry-over funds. In addition, it was decided to issue RMB3.9 trillion of special local government bonds, an increase of only RMB100 billion over the previous year. Furthermore, RMB1 trillion of very long-term special bonds were to be issued annually for several years to be used for the development of national key strategies and security capabilities in key areas. In May 2024, the Ministry of Finance issued the “Notice on the Issuance of General Government Bonds and Very Long-Term Special Government Bonds in 2024,” which detailed the issuance period of the Very Long-Term Special Government Bonds.⁴ According to the notice, it has been decided that RMB1 trillion of very long-term special government bonds will be issued as planned in 2024, and the amount will be allocated to the central government fund and divided equally among central and local governments (see Table 2 and 3).

Thus, the content of “aggressive fiscal policy” indicates the central government’s willingness to aggressively issue government bonds to support the economy. In this regard, it follows the policy indicated at the “Central Economic Work Conference” held in December 2023 that “there is policy space for fiscal matters, and we will make good use of it to improve the efficiency of funds and the effectiveness of policies, while optimizing the fiscal expenditure structure and strengthening the securing of financial resources for the nation’s major strategic tasks.”

The expansion of the scope of capital allocation for special local government bonds was specified, and it was also noted that the three bottom lines of “basic civilian, wage and management” would be maintained. In October 2023, RMB1 trillion of new government bonds were issued for public works, mainly to support disaster-stricken areas and strengthen disaster response capacity.⁵ This raised the fiscal deficit to 3.8% of GDP in 2023, up from the original target of 3% for that year.

However, this is only about 8% of GDP. In particular, it is too small to overcome the economic stagnation caused by the property recession and put the economy on a recovery path, and its impact must be seen as limited. In fact, it also emphasizes the need for the party and government agencies to accept austerity as a basic principle, and it also clearly states that general expenditures will be strictly controlled to strengthen fiscal sustainability, emphasizing fiscal discipline.

The actual situation is not what one would call large-scale, and the central government has not been particularly active in stimulating demand, which can be seen as a cautious policy stance. Overall, the stance of the central government is not necessarily aggressive.

Partly due to the effects of these fiscal policies and their actual operation, the Chinese

⁴ According to the Ministry of Finance (2024), the breakdown is RMB300 billion for 20-year bonds (issued 7 times), RMB600 billion for 30-year bonds (12 times), and RMB100 billion for 50-year bonds (3 times).

⁵ See Ministry of Finance of the People’s Republic of China (2023).

Table 2: Performance and Targets of Major Economic Indicators

	2023 Target	2023 Actual	2024 Target	2024 Actual	2025 Target
Economic growth rate (real)	Around 5%	5.20%	Around 5%	5%	Around 5%
Consumer Price Index (CPI)	Around 3%	0.20%	Around 3%	Around 0.2%	Around 2%
General public budget expenditure scale	—	27.4 trillion yuan	28.5 trillion yuan	28.46 trillion yuan	29.7 trillion yuan
Fiscal deficit (% of GDP)	3%	3.80%	3%	Around 3%(Forsee)	Around 4%
Scale of Local government bond issuance	3.8 trillion yuan	3.8 trillion yuan	3.9 trillion yuan	3.10 trillion yuan	4.4 trillion yuan
Very Long-term Bonds (to be issued annually)	—	—	1 trillion yuan	1 trillion yuan	1.3 trillion yuan
Scale of Local government bond issuance	3.8 trillion yuan	3.8 trillion yuan	3.9 trillion yuan	9.74 trillion yuan	3.9 trillion yuan
National defense expenditure (growth rate)	1.55 trillion yuan(+7.2%)	1.537 trillion yuan(+7.2%)	1.67 trillion yuan(+7.2%)	—	1.78 trillion yuan(+7.2%)

(Source: 2024 Quadrennial Government Work Report)

(Source: People's Government of the People's Republic of China (2024a))

Table 3: Fiscal Policy Priorities for FY2024 (from Ministry of Finance press conference)

Fiscal Policy Direction for FY2024
The key is “Moderate strengthening” of “Aggressive Fiscal policy”
Appropriate spending = aggressiveness
Increase the scale of government investment
Strengthen Balanced transfer spending
Reform of tax expenditures: optimization, policy precision, and precise and effective policy management
* Seven policy directions
Establish and support a modernized industrial system: science and technology innovation, etc.
Expansion of domestic demand (investment and consumption): stimulate consumer spending, Issuance of government bonds and special local government bonds
Deepening the strategy of “science education to make the country great” high-quality education Securing funding for major science technology
Securing and improving the livelihood: securing employment, social security assistance, etc.
Promoting comprehensive rural revitalization: Improving food production food security capabilities
Promoting urban, rural and regional development: developing fiscal and tax policies for new-style urbanization
Strengthening ecological civilization construction: green, low-carbon development, “Beautiful China”

(Source: Ministry of Finance of the People's Republic of China (2024b, 2024c))

economy will not be able to return to a significant recovery path in 2024. Indeed, the effects of the economic policies have not been obtained, with economic growth in the second quarter of 2024 coming in at +4.7%, down from +5.3% in the first quarter and also below the an-

nual target of +5.0%. Perhaps as a result, it was announced in July that RMB300 billion of ultra-long term government bonds would be issued to finance the replacement of automobiles and home appliances, subsidies for the purchase of new energy vehicles, and the renovation and renewal of equipment, mainly for small and medium-sized enterprises. In addition, the State-owned Assets Management Committee announced a plan to invest more than RMB3 trillion over the next five years in large-scale equipment upgrades at 97 major state-owned enterprises under the central government.

As described above, while the Xi administration's policies on immediate issues and priority policies refer to what it considers to be important issues, they appear to be overly broad and lack concrete measures for actual policy management and implementation. In this context, the government also seems to be taking a more cautious stance on "aggressive fiscal policy." In other words, we are getting a glimpse of a situation in which the government has not yet been able to determine a policy direction in response to the increasingly slowing economic situation.

In the ambiguous relationship between fiscal and monetary policies in macroeconomic adjustment, the role of fiscal policy has not been clarified, and the economy has generally been supported by securing liquidity through aggressive monetary measures.⁶ This seems to have been caused by the bitter experience of the after-effects of economic stagnation caused by the excesses and problems⁷ that followed the massive RMB4 trillion stimulus package implemented after the Lehman shock in 2008. In addition, the government has been extremely cautious about large-scale fiscal stimulus as it has sharply worsened local government finances and increased fiscal risk by raising uncertainty. In addition, there is the political challenge that maintaining the fiscal health of the central government is extremely important under the current regime. In other words, it is the policy of the Party and the government that maintaining fiscal soundness under a one-party dictatorship is essential to maintaining social stability and, in particular, to ensuring the fiscal strength of the central government. Therefore, in intergovernmental fiscal relations, there has been an increasing tendency to shift the burden to local governments in order to maintain the soundness of central government finances, and measures have been taken to reduce and equalize the fiscal burden by financing the burden through the issuance of local government bonds and the refinancing of these bonds. At the same time, the government seems to be promoting normalization by increasing the supply of funds from financial markets to ensure liquidity.

Thus, the reality of "aggressive fiscal policy" is that economic policy has tended to lean

⁶ Under China's current system, the central bank, the People's Bank of China, is an organ of the State Council (equivalent to the Japanese cabinet), and the central bank's independence is largely lacking in the system. This creates the risk that the People's Bank of China (PBC) will finance the public finances, which could loosen fiscal discipline and lead to the sustained expansion of government bond issuance, increasing fiscal risk and further constraining the central bank's monetary policy, which could lead to fiscal dominance.

⁷ After the collapse of Lehman Brothers in 2008, a large-scale stimulus package of RMB4 trillion was implemented. The central government was responsible for RMB1.18 trillion, while local governments and the private sector were to bear RMB2.82 trillion of the total cost. As a result, the economy recovered rapidly, but at the same time, there was a major backlash, resulting in excess production capacity, which led to excess production (especially real estate) and inventory problems, and excess debt among households, companies, and local governments. This has been a major constraint on the Chinese economy.

more toward monetary policy than fiscal policy, and fiscal policy has tended to lean more toward the local level. However, it goes without saying that the role of central government finances is important for China to emerge from the real estate recession, achieve economic recovery, and stabilize the macroeconomy. As of June 2023, China's government debt ratio is around 80%, which is low compared to G7 and Organisation for Economic Co-operation and Development (OECD) countries, and the central government's finances are relatively sound. The ratio of outstanding government debt to GDP has remained in the 20% range, and the budget deficit has remained at around 3%.⁸ China is a net creditor nation and maintains a balance of payments surplus. At this point in time, when there is room for fiscal expansion, including room to issue government bonds, an important policy task is to stabilize the economy by implementing an appropriate fiscal policy led by the central government. In doing so, it is only natural that the strategy should not be merely a quantitative expansion of public investment, but one that fully takes into account the scale, sector, and even the quality of public investment. In rural areas and small towns in rural areas, there are many areas where the housing infrastructure is underdeveloped, and the provision of basic infrastructure, public housing, and the improvement of the basic educational environment could be appropriate targets for public works projects. Expanding appropriate fiscal spending to these areas is justified and should be considered at an early stage.

III-2. Direction of Fiscal and Financial Policies at The 3rd Plenary Session of the 20th Central Committee of CPC

The 3rd Plenary Session of the 20th Central Committee of CPC finally convened in July amid a protracted real estate recession and a gradually widening sense of macroeconomic policy limbo, making it difficult to foresee an economic recovery. There has been much speculation about the significant delay in holding the 3rd Plenary Session of the 20th Central Committee of CPC and the fact that it was held at this time. Among them are: (1) the fact that it was difficult to hold the meeting due to concerns that criticism of the Xi administration would increase as a result of the successive disciplinary actions taken against key ministers and military officials amid the intensification of the anti-corruption fight; (2) the real estate recession and the resulting prolonged economic stagnation, and some opposition to the Xi administration's response to this situation; and (3) the fact that the direction of economic policy has yet to be determined. In addition to the fact that these issues have been resolved to some extent, the drafting process of the "Decision" indicates that the reform tasks outlined in the "Decision" will be completed by 2029, the 80th anniversary of the founding of the People's Republic of China, and it is possible that the meeting was not held in 2011 in anticipation of the 80th anniversary. It is also possible that the 2023 meeting was not held in anticipation of the 80th anniversary of the founding of the ROC. In any case, the fact that the important meeting was held at all is significant, and it drew much attention to the content of the immediate stimulus measures and the medium- to long-term policy direction of the

⁸ See Naito (2024).

economy.

The “Decisions” consisted of three blocks and 15 sections (60 items). As a whole, the Decisions cover a wide range of reform issues and actively express the Party’s awareness of the problems and its commitment to address them properly. The emphasis on “new quality production capacity” and “high-quality development” becomes clearer, and the Party also expresses its determination to strengthen domestic technological and economic power, with a focus on its strategy toward the United States. While the expansion of domestic demand is an important theme, and there are some indications of a policy to expand domestic demand through macroeconomic policies, the emphasis is more on supply-side policies. In addition, it reiterates the importance of promoting openness in external economic relations and the importance of private and foreign-funded enterprises in marketization. However, it clearly indicates the strengthening of Party control and management and appears to be based on the premise of proceeding according to Chinese-style rules and methods, including the interpretation of laws.⁹

It is interesting to note that tax and fiscal policy was identified as an important element of macroeconomic policy. The improvement of the budget system was indicated as strengthening the integration of financial resources and the budget, and incorporating all revenues, including administrative authority, revenues from state loans, and revenues from state-owned resources and assets, into the state budget management. With regard to improving the budget and performance evaluation system of state-owned capital management, the report also indicated that the government should strengthen the state’s key strategic tasks and financial resources guarantee for basic livelihood, strengthen guidance on budgeting and fiscal policy, strengthen performance management and prior functional evaluation of public services, deepen zero-based budgeting reform, unify budget allocation authority, unify and standardize budget management, improve the budget disclosure and supervision system, and improve the government’s comprehensive financial reporting system on an accrual basis. Also mentioned are reforms of the tax structure, including improvements in quality development, social equity and market-integrated taxation, and consideration of a tax system better suited to new business models. Related to this, the report presents a wide range of taxation and tax measures, including the full implementation of statutory tax principles; regulation of tax incentives; improvement of support mechanisms for priority and key sectors; sound direct taxation; development of the personal income tax system through a combination of comprehensive and separate taxation; regulation of the tax system for business income, capital income, and property income; implementation of unified taxation of labor income; and

⁹ The “Decision” states that “a high-level socialist market economy system is an important guarantee of Chinese-style modernization” and that “the role of the market mechanism will be better exercised to create a fairer and more dynamic market environment, to achieve efficiency and optimization in resource allocation, and to maximize effectiveness,” while at the same time “laissez-faire” (free). The report also states that “by managing the market, the government (or rather the Party) will better maintain market order, supplement market failures, facilitate the circulation of the national economy, and stimulate the internal drive and innovative vitality of the society as a whole,” indicating the importance of government (or rather Party) control and management, such as strengthening market control, maintaining order, and supplementing market failures. The report also emphasizes the importance of government (or rather, Party) control and management to strengthen market management, maintain order, and supplement market failures.

deepening of tax administration reform. In the area of public finance, there are issues of both institutional reform and operational improvement, and it was emphasized that reforms such as redesigning the system, ensuring fair and equitable operation, and restoring soundness are urgently needed.¹⁰

Proposals for reforming the fiscal relationship between the central government and local governments were also clearly stated. It was pointed out that the establishment of a balanced central-local fiscal relationship among the regions should be promoted by clarifying the authority and responsibility for fiscal and tax matters, expanding local autonomy in adjusting financial resources, expanding local tax resources, and appropriately expanding local authority over tax administration. This is considered to be a very important point. In addition, measures to improve the fiscal transfer system include: consolidating and standardizing special transfers (specific subsidies) and the resulting increase in general transfers; strengthening fiscal coordination among local governments (cities, provinces, etc.), establishing mechanisms for incentives and constraints on fiscal transfers, steadily promoting the devolution of consumption tax collection to the regions,¹¹ deducting and refunding value-added taxes; improving policy coordination, optimizing the tax sharing ratio; considering the integration of additional taxes such as urban maintenance and construction tax, education cost supplement, and local education supplement into local additional taxes; and granting local governments the authority to set specific applicable tax rates within certain limits. A number of such measures to strengthen local finance have been put forward. In addition, the following measures have been taken to strengthen local government finances: appropriately expanding the areas, size, and percentage of local government debt used as capital; improving the government debt management system; establishing a comprehensive local debt monitoring and supervision system; establishing a mechanism for preventing and resolving long-term hidden debt risks; accelerating the reform and transformation of the local government financing platform; strengthening the management and regulation of non-tax revenues; and partially delegating the management of non-tax revenues to local governments. In addition, the following measures have been taken to strengthen local government finances: appropriately expanding the areas, size, and percentage of local government debt used as capital; improving the government debt management system; establishing a comprehensive local debt monitoring and supervision system; establishing a mechanism for preventing and resolving long-term hidden debt risks; accelerating the reform and transformation of the local government financing platform; strengthening the management and regulation of non-tax revenues; and partially delegating the management of non-tax revenues to local governments. The imple-

¹⁰ Income taxes account for only about 8% of total tax revenues, and the degree of progression and thoroughness of tax collection are required to increase income tax revenues. Strengthening asset taxation is also important, but it requires resolving the contradiction that the policymakers and decision-makers are those in the segment of the population whose tax burden is expected to increase as a result of such a change. To do so, we must face the difficult problem of breaking down vested interests, and it is unclear whether this can be accomplished.

¹¹ Allocating a portion of the consumption tax, which is currently all central fiscal revenue, to local governments is commendable in terms of expanding local financial resources. However, the consumption tax accounts for less than 10% of total tax revenues, and its effect is expected to be limited.

mentation of policies focused on local government finances has been an important issue for some time, and this is a positive step in the right direction. This can be interpreted as a further elaboration of the “planning of new reforms of the fiscal and tax system” specified in the 2024 Government Work Report. However, it can also be interpreted that the government was forced to issue this policy due to the urgent need to secure revenues for local government finances and the urgent need to quickly restore local government finances. Therefore, the report only covers the necessary reform issues and does not provide specific procedures or measures, which raises questions about the effectiveness of the reforms.

On the other hand, with regard to central government finances, the reform proposal focuses on the appropriate strengthening of central government authority, including the expansion of the central government expenditure ratio, the centralization (in principle) of central government administrative expenditures, the reduction of central government affairs to be transferred to the regions, the elimination of illegal local fundraising, the delegation of authority to the regions, and the financing of measures through a special transfer fund. These reforms are seen as a response to the growing need for fiscal stimulus and the need to increase central government spending, which is seen as relatively healthy.

As described above, the tax and fiscal policies and reforms of the 20th TPC Plenum are relatively detailed, including the reorganization of fiscal relations between the central and local governments and the reform and restructuring of local government finances, which are becoming increasingly severe. However, a review of the key points shows that although a wide range of items are listed as important reform issues, many of them lack specificity, and some of the core issues are not even mentioned. One is to address the debt problem. China’s household, corporate and government debt is increasing, and the local government debt problem in particular is a major risk.¹² Although there are references to establishing a mechanism for preventing and resolving long-term hidden debt risks and accelerating the reform and transformation of the local government financing platform, no concrete measures have been provided. Regarding local government fiscal reform, the report mentions the transfer of some central taxes to local governments as shared taxes to compensate for the decline in land-related revenues, the expansion of fiscal transfers, and the transfer of some authority to local governments, but it does not specify how to deal with the fundamental issue of local core taxes other than transferring an increase in consumption tax to local governments, nor does it specify what to do about the transfer of authority. From another perspective, it could be said that the central government is asking local governments to maintain their own finances against the backdrop of transferring some financial resources and powers from the central government to local governments. This would force each locality to secure tax revenue in its own way, which could lead to the expansion of regional protectionism as each locality implements its own policies in a piecemeal manner, and widen the fiscal gap among localities depending on the level of economic development. In terms of reforming the bud-

¹² See Table 1 for the debt situation of the household, corporate, and government (including local government financing flatbeds) sectors.

get system and optimizing the tax system, there has been little discussion on how to secure and expand financial resources, and only minor adjustments have been made between central and local governments based on the current fiscal situation. There is also a risk of a “pie fight” between the central and local governments or among local governments, and this has not led to fundamental reforms such as expanding the scope of taxation, strengthening tax collection, or reforming the degree of progressivity. In addition, fiscal redistribution among regions remains unclear. Under these circumstances, the strong emphasis on strengthening the management of tax and fiscal aspects, apart from the objective of improving fiscal soundness, has focused on strengthening the Party and central management and control in the field of tax and fiscal affairs, giving priority to maintaining the soundness of central finances, and has not led to fundamental reforms to review and improve the operation of the tax and fiscal system. This has not led to fundamental reforms to revise and improve the operation of the tax and fiscal system, and it is even feared that this will place an even greater burden on local governments, which are in a difficult financial situation.¹³

III-3. Trends in Economic Policy

In order to recover from the ongoing economic slump, the Chinese Communist Party and the Chinese government have been taking a series of measures centered on fiscal and monetary policy. In particular, since the fall of 2024, these measures have been rapidly gaining momentum.

In the fiscal area, following the 3rd Plenary Session of the 20th CPC of the CCP Central Committee held in July 20-24, policies were announced to strengthen proactive fiscal policy, promote tax and fiscal reform, and strengthen local government finances. Alongside an increase in fiscal spending in key areas, special emphasis was placed on strengthening local government finances, and measures such as expanding local tax sources, expanding local tax-related powers, and standardizing the management of non-tax revenue were proposed.

At the Central Political Bureau meeting held on September 26th, it was also decided that it would be important to issue RMB10 trillion worth of government bonds over the next one to two years to facilitate the disposal of real estate, to strengthen financial support for social security and welfare of migrant workers and other areas, and step up infrastructure investment and measures to combat unemployment.

In addition, the urgent need for reform to rebuild the finances of local governments in financial difficulty was raised. It was also indicated that the implementation of such policies

¹³ Following the “Decision” of the 20th Three-China Plenum and the “Party Central Political Bureau Meeting” held on July 30, a press conference was held by senior officials of the Ministry of Finance (Wang Dongwei, Deputy Director General; Lin Zechang, Director General; Wang Jianben, Director General of Budget; and Fu Jinling, Director General of Economic Construction). The press conference also emphasized policy trends and results regarding the effects of fiscal macroeconomic control, local fiscal reform (expansion of financial resources and authority, coordination of central-local relations, etc.), and future fiscal policy, indicating the government’s commitment to promoting fiscal reform as an important policy in line with the Party’s policy. However, the specific details and methods of the reforms remain unclear in many respects. The content and direction of the required reforms will be discussed in detail in section VI of this report.

would be financed through the issuance of special government bonds and local government special bonds. In addition, the National Development and Reform Commission announced in early October that it would continue to issue super-long term special government bonds after 2025, that it would advance two projects worth RMB100 billion in the central budget investment plan for 2025 and implement them in 2024, and that it would expand the scope and scale of the use of local government special bonds.

Moreover, the Ministry of Finance also announced that it would expand the issuance limit for local government bonds to help resolve local governments' hidden debt through measures such as refinancing local government bonds, and that it would actively use public finances to support the real estate market. It was also decided to issue special government bonds to inject capital into major state-owned banks.

Later, at the Standing Committee of the National People's Congress held in November, a new local government special bond issuance limit of RMB10 trillion was approved to refinance local government debt[4]. At the same time, it was decided that the potential debt of RMB2 trillion for the renovation of slums (barracks areas) that will come due after 2029 will be repaid as originally contracted. By combining these policies, the total amount of hidden debt that local governments will have to clear by 2028 will be greatly reduced from RMB14.3 trillion to RMB2.3 trillion, and the average annual amount of debt to be cleared will also be reduced from RMB286 billion to RMB460 billion, or about one-sixth, greatly easing the pressure of debt clearance.

As we have seen, the Party and the government have shown their willingness to proactively deal with risks by taking a series of fiscal measures to alleviate the local government debt problem and solve the real estate issue.

At the same time, the People's Bank of China announced that it would cut the reserve requirement ratio by 0.5 percentage point in September 2024, injecting RMB1 trillion into the market, while cutting the benchmark interest rate by 0.2 percentage points. After that, it was announced that the reserve requirement ratio and interest rate would be further reduced after a meeting of the Central Political Bureau of the Communist Party of China, showing a strong monetary easing stance. With regard to housing loans, administrative instructions are being issued to reduce interest rates on existing loans to the new level, and interest rate reductions are being promoted. In addition, the minimum down payment ratio for housing loans has been unified, and the down payment ratio for the purchase of a second home has also been reduced to 15%. With regard to the stock market, several new policy tools have been created, including a swap system to support the stable development of securities, funds, etc., a special refinancing system for share repurchases and capital increases, and a system to promote lending to listed companies and major shareholders.

Furthermore, the Central Economic Work Conference was held on December 11th and 12th, 2024 to strengthen the momentum of economic measures. Regarding the environment surrounding the economy, it was acknowledged that economic management is in a difficult situation due to the influence of the external environment, and there are many problems and risks, such as lack of domestic demand, poor corporate management, and difficulties in in-

Table 4: Nine Key Tasks of the Central Economic Work Conference (2025)

1	Expanding domestic demand
2	Improving productivity and modernizing industry through science and technology innovation
3	Economic system reform
4	Promoting external openness and stabilizing trade and investment
5	Preventing and mitigating risks in key areas
6	Promoting new forms of urbanization and rural revitalization (integrated development)
7	Promoting regional development and strategic regional strategies
8	Promoting green growth, pollution reduction, decarbonization, etc. (GX)
9	Ensuring and improving people's livelihoods

(Source: Compiled from People's Daily Online (2024))

creasing employment and income (see Table 4).

With regard to macroeconomic policy, the government has indicated its intention to adopt a more proactive and powerful approach than previously employed. In terms of fiscal policy, the implementation of “more proactive fiscal policy” has been decided, and this policy has been elevated to a higher level than before. The primary objectives of this policy are as follows: first, to raise the ratio of the fiscal deficit to GDP through the issuance of government bonds; second, to strengthen the security of priority areas through the expansion of fiscal spending; and third, to implement major national strategies and build security capabilities in priority areas (two important points), and promoting large-scale equipment renewal and the replacement of consumer goods (two new points) through the increased issuance of super-long-term special government bonds; and expanding investment and projects through the increased issuance of local government special bonds (special bonds); and adjusting the structure of fiscal spending (expanding investment within the central budget, etc.). The budget deficit has remained at approximately 3% up until now. However, a substantial increase is projected for 2025, with some projections suggesting it may exceed 4%.

Meanwhile, with regard to monetary policy, the previous “moderate monetary policy” was changed to the implementation of a “moderately relaxed monetary policy,” and further monetary easing was indicated. It was reiterated that liquidity would be ensured sufficiently through the implementation of measures such as the reduction of the reserve requirement ratio and interest rates and the linking of the money supply to economic growth and prices. The exchange rate of the RMB would be stabilized and maintained at a reasonable and balanced level, and the People's Bank of China would strengthen its macroprudential functions and financial stability by expanding the use of renewed (non-traditional) financial instruments to further strengthen the easing measures.

In this way, the economic policy management situation from the autumn of 2024 onward conveys a profound sense of the Party and government's sense of crisis regarding the current state of the economy. Moreover, as in previous years, key tasks were set out, and it was asserted that the concentrated and unified leadership of the Central Committee was the foun-

dation of economic policy. The National Development and Reform Commission, a pivotal entity in economic policy implementation, is reported to be meticulously executing the pivotal instructions and directives of General Secretary Xi Jinping. It is asserted that the Commission is resolute in its commitment to the effective implementation of the decisions and arrangements of the Central Committee. The persistent operation of economic policy under the Party's leadership was accentuated.

Despite the successful attainment of the annual growth rate target in 2024, the Chinese economy continues to face challenges even after the onset of 2025. The economic measures implemented all at once are naturally expected to have a certain degree of effect in the short term. In particular, while the emphasis has been on growth strategies, the measures have been heavily slanted towards the supply side, but beginning in autumn 2024, there has been a certain degree of rationality in the shift towards focusing on economic measures that also take into account the demand side. However, the current situation is that the series of policies have not yet led to fundamental reform centered on structural reform. For instance, the implementation of national strategies and investment to expand safety capabilities in key areas (two important points) and the implementation of stimulus measures to renew large-scale equipment and replace consumer goods (two new points) have been identified as important economic measures. Furthermore, policies that focus on the supply side, such as subsidies, are ongoing. Consequently, excesses—defined as excess capacity, investment, and production—have escalated in some sectors, intensifying deflationary pressures. This phenomenon has also affected the decline in the prices of exported goods, prompting concerns and criticism from Europe, the United States, and emerging countries regarding the so-called “export of deflation,” which is the expansion of inexpensive product exports from China. While there has been a promotion of supply-side facilities and efficiency improvements, improvements in employment have not been observed. Notably, the unemployment problem among the youth and the highly educated remains a significant social concern. The real estate market is also experiencing significant challenges, with real estate investment in 2024 decreasing by 10.6%, and all indicators continue to show a decline, including housing sales area, real estate sales (floor area basis), new construction area (floor area basis), and funds procured by real estate developers. In addition to the ongoing decline in new housing prices, which reached -5.3% in 70 cities in December, prices continue to demonstrate a downward trend. The severity of the situation is clear, as these problems have arisen despite the government taking various measures, such as deregulation for purchases, reductions in mortgage interest rates, subsidies for developers, and the purchase of surplus real estate by the government. Furthermore, the ongoing decline in population has led to a concomitant decline in actual demand for housing, exacerbating the already critical situation in the real estate market. This deterioration has had far-reaching consequences, including a marked decline in local finances, which have historically relied heavily on “Land use rights transfer income.” The resulting decline in essential public services, such as social security, medical care, and public goods, is both quantitative and qualitative in nature. In the household sector, where there is a strong tendency to own and manage assets in the form of real estate, the

reverse asset effect caused by falling asset prices is also a factor that is greatly reducing consumer sentiment.

IV. Local Public Finance Issues

IV-1. The Continuing Slump in the Real Estate Market: The Limits of “Land finance”

As articulated in the “Decision” of the 3rd Plenary Session of the 20th Central Committee of CPC, there is an escalating concern regarding China’s public finances, with a focal point being the escalating severity of the environment surrounding local government finances and the concomitant increase in risk. A contributing factor to this situation is the precipitous slowdown and protracted slump in the real estate market. Since the 1990s, local finances in China have been heavily dependent on land-related revenues, particularly following the reform and opening-up of the country, which led to significant expansion in regional protectional economic development in the 1980s due to the “Fiscal contracting undertaking system” and the shift to regional lordship economies. The adverse effects of this led to repeated discussions of measures to curb regional protectionism and strengthen central government finances, leading to the implementation of the “tax-sharing” reform in 1994. The “Tax sharing system” greatly reduced local fiscal revenues, and local public finances faced a relatively difficult situation. At the same time, land reforms were implemented during this period, which greatly expanded the authority of local governments over land use, and local governments became more inclined to use land to secure revenue. This is the expansion of so-called “Land finance.” Local governments began to secure and increase revenue by expropriating land use rights from farmers and residents and selling them to real estate developers, and this became an important pillar of local government finance. Real estate-related tax revenue, such as value-added tax and contract tax on land transactions, land use tax, and arable land use tax, also became an important source of revenue for local governments. In particular, local government finances became highly dependent on revenues from the transfer of land use rights. The background to the rise in Chinese real estate prices is the RMB4 trillion stimulus package after the Lehman shock and the People’s Bank of China’s large reduction in lending rates, which led to a massive inflow of funds into the real estate market. In addition, real estate became the subject of speculation, and the situation of increased investment and continuous and repeated increases in real estate prices led to a situation known as a real estate bubble. Subsequently, the monetary easing in response to the sharp decline in the stock market in 2015 and the large-scale monetary easing measures implemented to counter the new coronavirus infection in 2020 led to a further rise in real estate prices, further exacerbating the overheated situation in the real estate market. On the other hand, it cannot be overlooked that soaring real estate prices have also made it more convenient for local governments to sell land use rights at higher prices. This led to a significant and continuous rise in Chinese real estate prices, which then became a factor in the increasing ten-

dency for prices to remain high.¹⁴

Against this backdrop, the soft landing of the property market, which continued to overheat, became an important policy issue for the Chinese government. In addition, the “common prosperity” slogan in August 2021 triggered a sudden tightening of regulations on the real estate market, in response to President Xi’s own statement that “housing is for living, not for speculation” until then. As a result, the real estate market cooled rapidly, and the negative impact on the overall macroeconomy increased as the performance of real estate developers deteriorated, nonperforming loans of financial institutions increased, and the burden on real estate buyers increased. At the same time, concerns about a sharp deterioration in local government finances have become widespread. For example, the rapid deterioration of the real estate market has greatly reduced the room for securing land-related revenues, and local government finances are rapidly deteriorating. The structure of local government finances, which is heavily dependent on land-related revenues, is unstable, and getting out of this situation has been considered a major challenge. In this regard, the government’s policy of curbing speculative real estate investment and preventing bubbles is probably justified in itself. However, what was supposed to be a soft landing in the real estate market turned out to be an extremely hard landing, and can be seen as the result of a kind of misadventure caused by the abrupt and one-dimensional implementation of the government’s measures. The property market was severely disrupted, and the “Land finance” system, an important mechanism for local governments to secure revenue, reached its limits. The mechanism by which the sluggish property market has had an extremely large impact on local government finances, as mentioned earlier, is the fact that local government finances have been heavily dependent on land-related revenues, including revenues from the transfer of land use rights. As shown in Figure 6-1, the revenue structure of local government finances in 2020 shows that revenues from the transfer of land use rights account for about 30.4% of total local government finance revenues. This is equivalent to about 91.3% of government funds (equivalent to special accounts), which account for about 32.9% of local government fiscal revenue. In other words, “Land use rights transfer income” is an extremely important source of revenue for local government finance.

The stagnation of real estate transactions due to the sluggish real estate market, in addi-

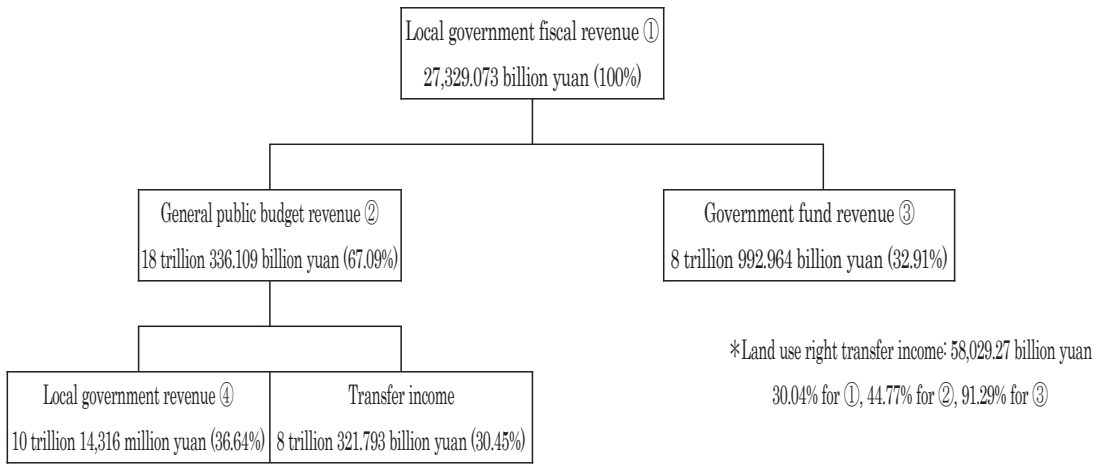
¹⁴ Specifically, in August 2020, the People’s Bank of China and the Ministry of Housing and Urban-Rural Construction established and announced the so-called “three red lines” (Three red lines), which were directed to real estate development companies, making financing for real estate-related companies extremely difficult. The “three red lines” directly restrict real estate developers’ financing, depending on how many of the three red lines they fall under. At the same time, in January 2021, it was also decided to restrict the total amount of bank mortgages and loans to real estate developers.

The “Three Red Lines” of Real Estate Regulation (issued in August 2020)

(1) Keep the ratio of total liabilities to total assets (after deducting advance payments received) below 70%
(2) Keep the ratio of liabilities to equity below 100%
(3) Hold more cash than short-term liabilities

(Source: Compiled from various media reports, etc.)

Figure 6-1: Structure of Local Government Fiscal Revenues (2020)

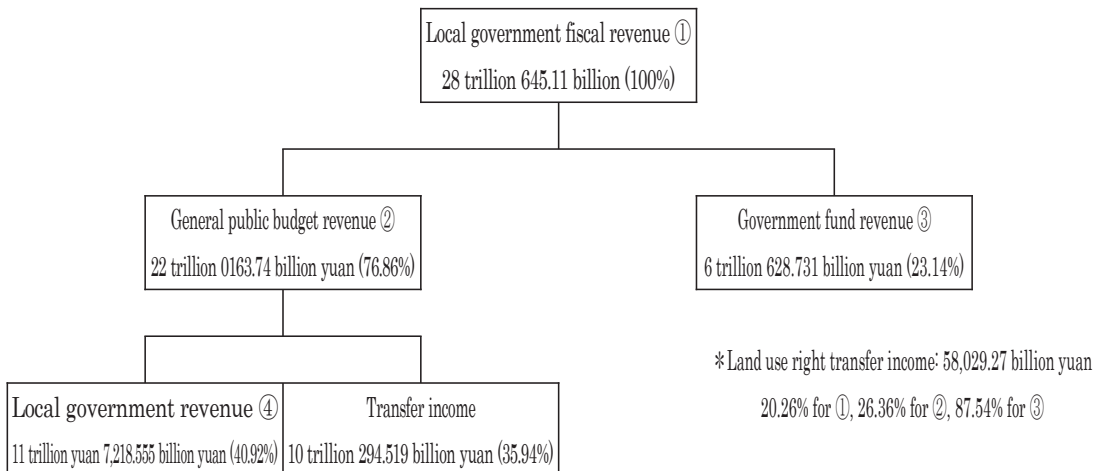


(Source: Ministry of Finance of the People's Republic of China)

tion to the sharp decline in transaction prices, has led to a sharp decline in land use right transfer revenues and a significant decrease in related revenues, which has been extremely detrimental to local government finances.

Figure 6-2 shows the situation in 2023. Governmental fund revenues have declined to 23.1% of local government fiscal revenues, with land use right transfer revenues declining to approximately 20.3% of total local government fiscal revenues and 87.5% of governmental fund revenues. In addition, since the tightening of real estate regulations by the government, the year-on-year growth rate of land use right transfer revenues has dropped sharply from +6.0% in 2021 to -23.2% in 2022 and -13.2% in 2023. It is clear that if land use rights

Figure 6-2: Structure of Local Government Fiscal Revenues (2023)



(Source: Ministry of Finance of the People's Republic of China)

transfer revenues, which have been an important source of local government finances, fall to this level, it is inevitable that the situation for local government finances will rapidly become more difficult (see Table 5, Figure 7 and 8).

On the other hand, looking back at the state of local government finances, they have not always been healthy, and debt problems have existed. This situation was concretely demonstrated in the reports on the results of accounting inspections conducted by the Office of the Comptroller of the People's Republic of China in 2010 and 2013. The reality surfaced that local government finances were in a state of over-indebtedness, and that the contingent debt problem was particularly serious. Prior to 2015, local government bonds were not allowed to be issued in China, and the central government issued government bonds and sub-loaned them to local governments.

However, even during the period when deficit financing was not officially recognized, local governments had substantial debts, which consisted of not only debts for which they were directly responsible for repayment, but also debt guarantees that were not officially authorized by local governments and less transparent debts that the government may eventually be forced to repay. Partly due to this situation, the issuance of local government bonds was formally allowed in 2015 with the aim of ensuring transparency to enhance fiscal discipline and reduce the burden on local finances. This is a positive direction as a measure to promote transparency in local government finances. However, local government debt has already continued to rise amid a growing economic slowdown, and local finances with limited financial resources continue to face a difficult situation. In addition, one of the most serious problems surrounding local government debt is the existence of “hidden debt” held by local government financing vehicles (LGFV), which are investment companies under the jurisdiction of local governments. LGFVs are responsible for raising funds for infrastructure projects on behalf of local governments that have no other means of raising funds other than issuing bonds, and they increase borrowing on the basis of “implicit guarantees” by local

Table 5: Revenues from Governmental Funds and Transfer of Land Use Rights

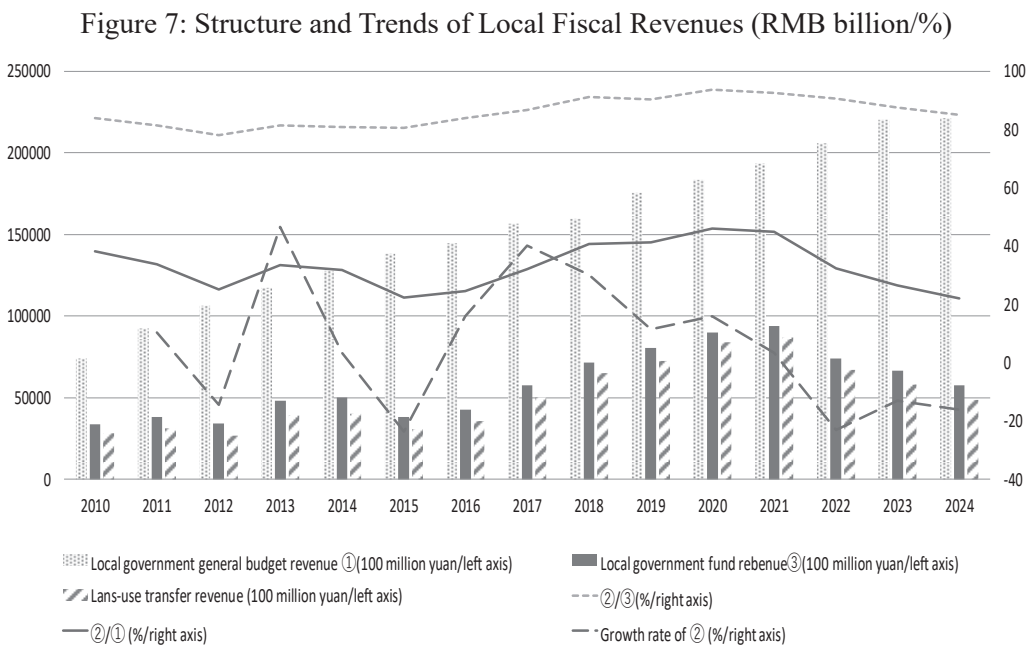
	Central		Local		National	
	2022	2023	2022	2023	2022	2023
General public budget revenue	94,887.1	99,565.8	108,762.2	117,218.6	203,649.3	233,625.1
Central → Local	-96,942	-105,945.2	96,941.8	105,945.2	0	0
Government fund revenue	4,124.0	4,417.5	73,772.4	66,287.3	77,896.4	70,704.9
Central → Local	-786.7	-893.2	786.7	893.2	0	0
Primary revenue	99,011.1	103,983.4	182,534.5	183,505.9		
Transferred revenue	1,282.6	-2,855.0	280,263.0	290,344.2	281,545.7	287,489.2
2023 Local Government Land use right transfer income			65,326.0		35.6%	22.5%
					(compared to primary revenue)	(compared to transferred revenue)

(Source: Ministry of Finance of the People's Republic of China)

governments, which leads to increased public investment in local areas, which in turn leads to further new borrowing and worsens local government finances.

IV-2. Reemergence of Structural Problems Surrounding Local Regions¹⁵

As “Land finance” reaches its limits, local governments face a major problem: how to rebuild local finances, and especially how to finance them. There is an urgent need to establish systems that allow local finance to function. Now that the system in which local finances rely heavily on “Land use rights transfer income” has collapsed, a major issue is how local governments can secure revenue.

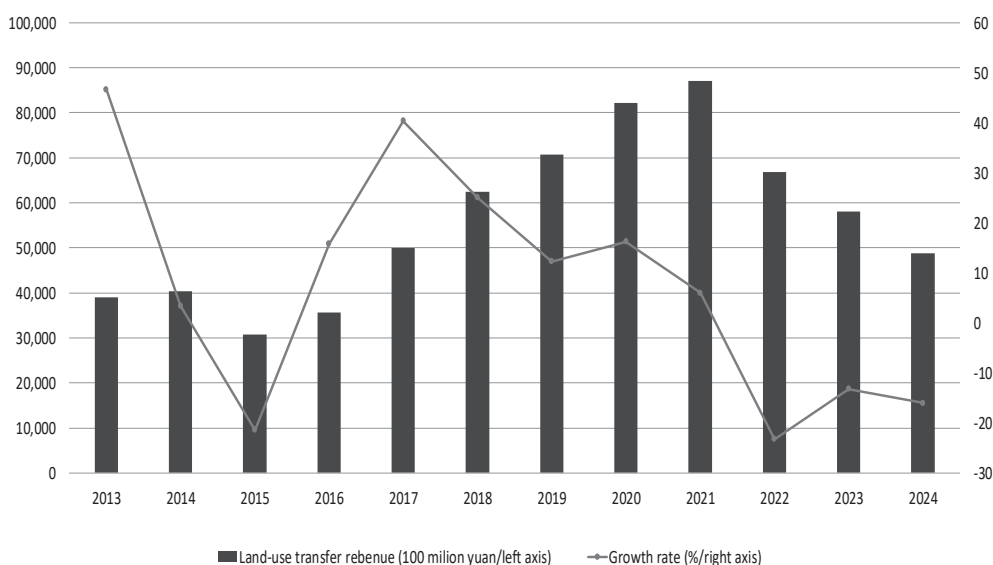


(Source: Ministry of Finance of the People's Republic of China)

In the current central-local relationship in China, local finance has limited financial resources, while the role and burden are increasingly shifted to local governments. 1994 saw the implementation of a “Tax sharing system,” which greatly increased the central government’s share of total fiscal revenue, while local financial resources decreased. This trend has continued since then. Thus, local finances, which played a role and bore a heavy burden in the absence of sufficient financial resources, were forced to secure financial resources on their own, which formed a system of securing revenue through the use of land, and this

¹⁵ The relationship between the government, financial institutions, and businesses at the local level, and the situation of local protectionism, etc. that this brought about were also seen in the fiscal contracting system of the 1980s, which led to the introduction of the “tax sharing” system in 1994. See Naito (2019) for details. This composition was rekindled under the “land finance” system.

Figure 8: Changes in Local Land Use Rights Transfer Income (RMB/%)



(Source: Ministry of Finance of the People's Republic of China)

structure has since become the norm and has expanded greatly. In a sense, this is also an indication that the “Tax sharing system” has become dysfunctional, as the “fiscal contracting undertaking system” period of the 1980s saw an increasing trend toward fiscal decentralization and the expansion of local government discretionary authority. This led to, for example, tax reductions and exemptions based on underestimating corporate profits and the protection of local businesses through preferential policies that could be considered excessive. This resulted in the spread of local (protectionist) principles known as the “economy of the lords.” As a result, the “Tax sharing system” was implemented to restore the relatively weak macroeconomic control function of central government finances. This had the effect of adjusting and reorganizing the fiscal relationship between the central and local governments, and significantly increasing the central government’s fiscal revenue. At the same time, however, the situation of inadequate coordination between the affairs, roles, and responsibilities of the various governments and the allocation of financial resources continued, and the situation of local governments falling short of financial resources grew. Local governments were therefore forced to respond by utilizing the “Land finance” mechanism. This mechanism has now collapsed, and the crisis in local government finances has increased significantly. The urgent task is to establish a mechanism to secure the necessary local financial resources while at the same time optimizing the division of roles and allocation of financial resources between the central and local governments in public finances.

The situation of deteriorating local government finances appears to be causing changes in the behavior of local governments, and the effects of these changes appear to be spreading. At the local level, the government-business-financial institution rivalry is once again spreading. For example, implicit government guarantees are being extended in various

forms, such as the de facto provision of government guarantees by local governments for bonds¹⁶ issued by local government financing vehicles (LGFV), which are not normally guaranteed by the government, and the backing of lower-level governments by higher-level governments at the local level. This is a harmful effect of credit risk assessment based on market principles. As a result, wealthy private investors, corporations, local financial institutions, and others become interdependent and mutually supportive, which in turn encourages moral hazard and excessive behavior by market participants, such as overborrowing, overinvestment, and overproduction. On the other hand, local financial institutions, while underwriting local government bonds, will increasingly tend to increase their lending to local firms, especially to local government financing vehicles (LGFV), as if they have been given a de facto government guarantee for their lending to firms. In a sense, this is lending without regard to credit, which naturally entails risk. In addition, investment in high-risk financial products, such as high-yield financial products, is also increasing, which will spread to the “shadow banking” problem and further increase financial risk. A major problem is that this relationship between government, financial institutions, and corporations makes it easier for corporations to raise funds, even those with inefficient operations and poor financial conditions. This leads to the continuation and expansion of inefficient corporate operations and the preservation of so-called “zombie companies.” In addition, excessive corporate borrowing exacerbates overinvestment and overcapacity, while at the same time significantly increasing corporate debt.¹⁷ Moreover, this situation will lead to the problem of “Advancing State-owned Sector and Retreating Private Sector,”¹⁸ where state-owned enterprises, especially those under the control of local governments, are given preferential treatment. This kind of relationship between the government, financial institutions and companies at the local level was seen during the period of increasing regional protectionism in the 1980s. Now that the environment surrounding local government finances has become more severe and “Land finance” has reached its limits, this “negative triangle” structure has resurfaced. While this has played a certain role in supporting local economies and finances, it is only a temporary measure, and falls far short of fundamental reforms that would ensure the sustainability of local finances and revitalize local economies. Instead, the problem is that it will rather spread negative effects by increasing the risk of preserving inefficient local enterprises, worsening local finances, and increasing hidden local debts. On the other hand, even

¹⁶ Bonds issued by local government financing flat terrains, which are investment companies under local government, primarily for infrastructure construction and other purposes (distinguished from corporate bonds by the fact that they are guaranteed by the local government).

¹⁷ The problem is not confined to the domestic market, as overinvestment in manufacturing in China has led to overproduction and the export of cheap goods from China. The so-called “export of deflation” has been pointed out and criticized by the G7 and G20 countries, the IMF, and other organizations as a “deflationary export”.

¹⁸ The “Decision” of the 20th Three-China Plenum also emphasizes the importance of both state-owned and privately-owned economies, but also emphasizes that state-owned enterprises should be “stronger, better, and bigger” and that state-owned capital should be concentrated in national security, key areas of the national economy, and strategic new industries. There is concern that the Party’s policy may further encourage “national progress and national regression” in these local areas. In addition to subsidies, China’s state-owned sector also enjoys a variety of other incentives, such as access to low-interest loans from state-owned banks, preferential tax treatment, more favorable land conditions, and access to materials and energy at lower prices.

before reform and opening-up, and even during the period of growing regional protectionism, there was a widespread trend for local governments to set and collect their own costs and fees or create funds to raise money in order to secure revenues, which also led to an expansion of off-budget funds¹⁹ for local governments, causing a major problem. This is the so-called “miscellaneous expenses”²⁰ problem. As local government finances have become increasingly strained, the “miscellaneous expenses” problem has resurfaced.²¹ The expansion of such independent actions by local governments, which are not based on the law or the system, may impede the soundness of local government finances and lead to widening disparities among regions, which would be counterproductive to the improvement of the local government finance system and the restoration of local government finances.

At the same time, the expansion of such local government actions under the powerful Xi administration has also led to the problem of widespread local government cover-ups and false reporting. For example, according to a 2023 report by the Audit Bureau, local governments and local government financing vehicles (LGFV) have been involved in such activities as purchasing and recording their own issued as assets their own issued municipal bonds, raising new funds under the pretense of increasing their own capital, and having local governments purchase their own assets from their local government financing vehicles (LGFV) to pad their fiscal revenues. At the time of the report, such incidents were reported to have reached 70 local governments nationwide, amounting to a total of about RMB86 billion. In addition, local governments are increasingly making false reports on their financial situations, perhaps out of fear of being held accountable or punished for the deterioration of local government finances.²² In addition, under Xi’s strong control, local governments are struggling to cope and are unable to make decisions flexibly, and “Lying flat-ism” (Tang ping (Chinese: 躺平))²³ is spreading among bureaucrats at the local level, leading to a lack of proactivity and a growing tendency to do nothing or only what they are told, which in turn leads to administrative inefficiencies. There is no way to solve the structural and constitutional problems surrounding local governments other than to restructure the local fiscal system and fundamentally reform the structure of the local administrative and fiscal system.

¹⁹ Although it is a fiscal fund, it is not included in the national budget (the sum of the central and local budgets) and is a highly discretionary fund that can be used independently by each government and government-related department, and was greatly expanded at the local level. The source of these funds was the collection of independently set fees and charges, as well as excessive tax collection. “Excessive tax collection,” “excessive revenue collection,” and “excessive penalties” were the “Three Rebellions,” which became a problem for local government finances.

²⁰ The term refers to excessive revenue-raising practices, such as local governments charging their own fees, charges, or tax challenge collections. This has become a source of highly discretionary off-budgeted funds for local government finances, a structure that has supported local government finances. Now it has reemerged.

²¹ In fact, a case was reported in which a child company was ordered to pay RMB85 million in taxes by the local tax authorities after being found to have evaded taxes by failing to file a tax return between January 1, 1994 and October 31, 2009 (public notice by Weiwei Food & Beverage (Hubei Province)). It is reported that the local government has organized a joint police and taxation bureau center called the “Police-Tax Synthesis Operation Center” to crack down on illegal activities related to tax payment, but in reality there is a widespread trend to forcibly collect fines and surcharges. According to various media reports, including The Tokyo Shimbun (July 10, 2024).

²² According to a June 2023 report by the Bureau of Audit and Accounting, there are 70 local governments nationwide that have attempted to pad their fiscal revenues by having their own assets purchased by government financing platforms under their control, amounting to approximately RMB86 billion. According to the Office of the Comptroller General of the People’s Republic of China (2023).

Since the reform and opening up, local government finance has been maintained and managed by special methods developed by local governments, such as local government corporatism in the 1980s and “Land finance” in the 1990s and beyond. Now that this approach is no longer viable, we are once again faced with the essential task of implementing fundamental reforms and establishing and operating an appropriate system. This is an issue that has been pending for many years and one that cannot be avoided. The question is whether or not substantial reforms can be made here, and the ability to implement them.

V. Fiscal Risk Considerations

V-1. Factors Contributing to Fiscal Expansion

V-1-1. Expanding Social Security Expenditures

The increasing role required of public finances in the face of drastic changes in economic and social conditions is at the same time a factor in the expansion of public finances. The factors contributing to fiscal expansion are too many to enumerate.

Above all, demographic changes and the rapid aging of society with declining birthrates have become a major fiscal burden.²⁴ The total population at the end of 2022 was 1,411,750,000 (male: 722,060,000, female: 689,690,000; male/female ratio 104.69), a decrease of about 850,000 from the previous year. The number of births per year also remained at 9,560,000, and the “general fertility rate” (the number of births divided by the total population) was 0.677%, the natural population growth rate was -0.06% . Compared to 2021, the number of women aged 15-49 has decreased by over 4 million, and the number of women aged 21-35 has decreased by around 5 million, and there are concerns that this will accelerate the decline in the number of births in the future. In addition, the total population at the end of 2023 was 1,409,670,000 (720,320,000 males and 689,350,000 females), a significant decrease of 2,080,000 compared to the previous year. The annual number of births was 9,020,000, a decrease of 540,000 from the previous year, and for the second consecutive year the number did not reach 10 million. The population aged 65 and over was 216.76 million, and the aging rate was 15.4% (up 0.2 points from the previous year).

The total fertility rate was also around 1.3% , at the same low level as in Japan, and the country has become a society with a declining population in both name and reality. Another characteristic problem in China is “aging before well-off” (the aging of society progresses

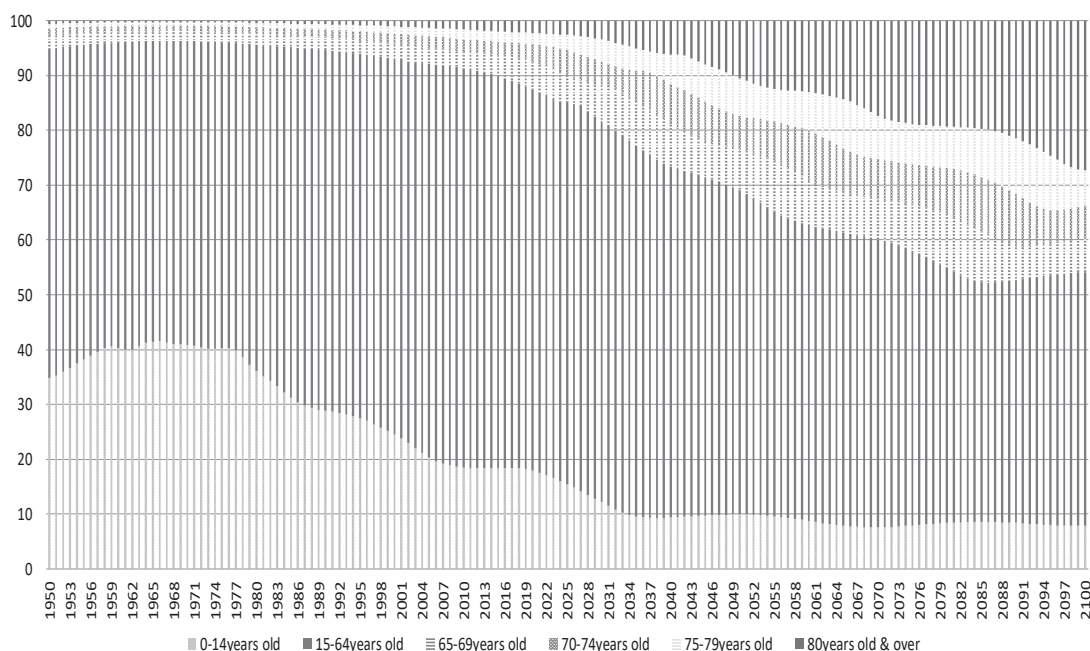
²³ “Lying flat” (Tang ping (Chinese: 躺平)) is a Chinese word meaning “to lie down.” It refers to the growing trend, especially among young people, of not being proactive (not finding a job, not getting married, not having children, not buying a car, not buying a house, etc.) amid the recent severe economic and social conditions. Some see it as a kind of resistance by people dissatisfied with their current environment and circumstances. This is said to be a widespread movement to refrain from proactive actions and wait for instructions, fearing stricter evaluations and disciplinary actions, as the Party’s tightening of management and control permeates the administrative department’s strengthening of management and supervision. It is possible that this trend is spreading even to local government officials in order to protect themselves from being held accountable or punished. See Naito (2024).

²⁴ Katayama (2023) has more information on the operational challenges of pensions and their relationship to local government finances.

before the economy grows and society becomes affluent) (see Figure 9). This rapid progress of the declining birthrate and aging society will have a double impact on the economy in terms of macroeconomics: a decrease in the supply of labor and a decrease in consumer demand. In addition, the number of children supporting the elderly is decreasing, and the burden on the working generation to support the elderly is becoming extremely heavy. This is also leading to an increase in the number of young people who are reluctant to get married or have children, and is spurring a trend toward refraining from large-scale consumption (big-ticket consumption) such as housing and cars. There is no doubt that one of the causes of the declining birthrate in China is the one-child policy. However, although the one-child policy was relaxed from around 2015 and then abolished, it is undeniable that it was a case of being too late. On the other hand, the modern factors that have already spread in Chinese society, such as the transformation of the economy and society around the uncertainty of the future and changes in lifestyle, which are spreading to developed countries including Japan, are changing people's attitudes toward marriage and having children, and this is also a more serious problem.

Needless to say, the declining birthrate and the aging society will put significant fiscal pressure on both the supply and demand sides. In this regard, Katayama (2023) shows that social security-related expenditures have been rising steadily, with medical and pension-related expenditures being particularly large. Furthermore, although the way fiscal expenditure should be handled to respond to the further progression of the aging of society should be ex-

Figure 9: China's Population Composition by Age Group (%)



(Source: United Nations (2024))

amined, since the Xi Jinping administration, there have only been trial announcements of things like system integration and the introduction of new systems, and there has been no proactive financial input from the government. In addition, the problem is that the finances of local governments that operate social security systems are becoming increasingly tight, and the reason for this is the imbalance between the financial resources and burdens of the central and local governments due to the “Tax sharing system.” It has been pointed out that it is necessary to rebuild the foundations of local government finances by correcting the problems created by the “Tax sharing system.”²⁵ On the other hand, Katayama (2024) points out that as the number of elderly people is expected to exceed 400 million, or around 30% of the population, by 2035, there is a risk that pension funds will be running out, and as pension reform is lagging behind, insurance premium income is expected to decline, so the transfer of pension funds between regions and fiscal transfers from the central government will become even more important.²⁶

There is no doubt that the financial burden associated with the declining birthrate and the aging society will become more and more serious in the future. The declining birthrate and aging society are not something that can be solved in the short term, and it may take an extremely long time to resolve, so it is a serious problem that could become a major financial risk in the medium to long term.

V-1-2. Addressing the issue of disparity

As represented by the “Common prosperity”²⁷ policy advocated by the Xi administration, the issue of disparity is also an important issue that needs to be further addressed. Along with the promotion of urbanization, it is also inevitable to address the important issue of the “Three Rural Issues,” which focus on rural development and strengthening agriculture. In addition to developing infrastructure, it is also necessary to industrialize agriculture, solve the problem of farmers finding jobs, improve living conditions in rural and urban areas, including the provision of water and sewage systems and public housing for people with low income, and expand education. The Xi administration has emphasized the importance of the third distribution²⁸ to reduce inequality, but before this can be done, the mechanisms and functions of redistribution, which is the role of the government, must be improved, which will also involve a significant financial burden. In China today, the role of government finances is focused on the function of macro-economic stabilization, and it is highly questionable whether the important functions of government in resource allocation (provision of public goods) and income redistribution are sufficiently discussed and implemented. While over-investment by the government must be avoided, resource allocation for the country’s

²⁵ By Katayama (2023).

²⁶ By Katayama (2024).

²⁷ Since the spring of 2012, the expression “Common prosperity” itself has not been used as often as before, and was used only once in the “Decision” of the 20th Three-China Plenum. However, the correction of inequality remains an important reform issue, and the Xi administration seems to be well aware of this point.

²⁸ Refers to distributions by corporations and wealthy individuals whose primary source of funding is donations and philanthropy.

overall development must be carried out appropriately. However, the trend is for this role to be increasingly taken on by local governments, and the burden on local governments with limited financial resources is increasing, leading to a situation of dysfunction. This is not only a cause of inequality, but also a cause of wide disparities among regions. The government is strongly urged to promote the provision of necessary public goods and the strengthening of the redistribution function, as well as macroeconomic stabilization policies. This will be difficult to achieve without securing the necessary financial resources. While there are many issues that the government needs to address, these are precisely the important roles that the central government should play. If the bias towards local governments (and the imposition of policies on them) continues to increase, the pressure on government finances will only intensify, and this will increase the overall risk to government finances.

V-1-3. The Harms of Centralized Power

President Xi Jinping, having secured a third term, is continuing to strengthen and expand the system of party-led leadership, control, and management by concentrating power in the Party and in himself through thorough ideological education and organizational reform (establishment and expansion of Party groups, Party committees, etc.). This is becoming increasingly prominent in policy planning and management in the economic field, and its influence is spreading. In the economic sphere, there is an observable trend of the Party's increasing direct leadership and control, which appears to be at the expense of the State Council's status and role.²⁹ While this shift may facilitate flexible decision-making, it concomitantly engenders policies that become rigid, leading to inefficiency and stagnation in management. This dynamic impedes the flow of accurate information and perspectives to the Party leadership, hindering the ability to adjust or revise policies. A salient illustration of this contradiction is the simultaneous strengthening of support for foreign capital and private enterprises alongside the imposition of increasingly stringent regulations, management, and control. Conversely, the system and policies that favor state-owned enterprises persist and even expand, perpetuating inefficiency by preserving vested interests. This phenomenon, marked by the coexistence of state advancement and private sector retreat, exemplifies a pronounced discrepancy between the policies advocated by the Party and the actual policies in place, resulting in conflicting and incompatible objectives. The concentration of power can also lead to adverse consequences, such as local governments and bureaucrats avoiding resistance to absolute power, engaging in false reporting and cover-ups for the sake of discretion and self-protection, and becoming less proactive and independent due to fear of being held accountable and punished. The Party's strategic allocation of subsidies to piv-

²⁹ The press conference by the Premier of the State Council at the close of the National People's Congress, which is usually held in March, was suddenly canceled for fiscal year 2024. In preparation for the 20th Three-China Plenum to be held in July, it was announced at the Central Political Bureau meeting last November that the composition of the production team responsible for drafting the draft was decided, with Xi appointed as the team leader and Politburo Standing Committee members Wang Haining (4th in the party hierarchy), Cai Qi (5th), and Ding Xuexiang (6th) as vice leaders. The new deputy heads are the State Council Premier and the State Council President. In other words, Li Qiang (No. 2), Premier of the State Council, has been removed. This is a clear indication that the Party and Mr. Xi will manage, supervise, and lead all aspects of the economy.

otal sectors has given rise to a state of overcapacity and overproduction, thereby disrupting the supply-demand equilibrium and engendering inefficiencies.³⁰ Furthermore, the intensification of oversight and management has led to the curtailment of autonomous economic activity, impeding the operations of private and foreign enterprises and thus exacerbating the fiscal imbalance. It is salient to observe that the consolidation of power under President Xi Jinping's leadership is accompanied by a pronounced emphasis on "national security." This has led to a notable strengthening of military capabilities, which contributes significantly to the financial burden. The national defense budget (central government) for 2024 was about RMB1.66 trillion, marking a 7.2% increase from the previous year and the third consecutive year of growth exceeding 7%. Since 1989, there has been a consistent trend of double-digit growth in the defense budget, with the exception of a brief period following the 2015 economic downturn. Notably, the rate of growth in defense spending has consistently exceeded that of the overall economy, with a compound annual growth rate (CAGR) of approximately 2.4% over the decade spanning from 2010 to 2020. This persistent commitment to augmenting military expenditures, irrespective of prevailing economic conditions, is underscored by this trend. However, it should be noted that the defense budget figures disclosed by the government do not fully capture the comprehensive picture of the situation. There are concerns that additional defense-related expenditures, not included in the budget, may be even more substantial in magnitude. This is particularly salient in light of the intensification of the US-China conflict and the Taiwan issue, which, despite their external environmental context, indicate a high probability of sustained expansion in military spending. This, in turn, is likely to impose a substantial financial burden. The prioritization of "national security" and the concentration of power that accompanies this policy, as well as the growing contradictions that result from it, serve as obstacles to the management of economic policy, thereby casting doubt on the sustainability of the country's finances. There is even the possibility of perceiving an apparent neglect of economic policy, which is particularly problematic for the Chinese economy, which is in a hurry to recover and achieve new growth.

V-2. Severe Situation at the Base Level of Government

In order to understand the severity of local government finances, it is also necessary to look at the financial situation at the base level, which is below the provincial level. In this context, the fiscal strength and debt dependence of local governments in the background are likely to have a significant impact. In addition, attention should be paid to regional disparities in local debt problems. Regions with lower gross regional product tend to have relatively higher fiscal deficits. This means that the debt risk of regions with strong economies is relatively low, while the debt risk of regions with weak economies is high. There is thus a

³⁰ While support for priority sectors is being expanded, including the expansion of subsidies mainly for EVs and solar panels, deflation is increasing due to a lack of domestic demand, and inexpensive goods are being exported to China through exchange rate adjustments (yuan depreciation) and price adjustments (export price reductions), leading to increased criticism from the G7, led by the U.S., and EU countries. This has been increasingly criticized by the G7, led by the U.S., and the EU countries.

risk of fiscal failure in some regions with weak economies, and this is a factor that is widening economic disparities among regions. As noted above, there are concerns that basic public services such as education, medical care, long-term care, and other social security services in economically backward regions may also be severely affected because fiscal transfers are inadequate and the functioning mechanisms do not work properly. According to Yu (2023), a comparison of local government debt ratios and the level of economic development at the end of 2022 shows that 20 regions have debt ratios that exceed the national average in the narrow sense, with Qinghai, Guizhou, Jilin and Tianjin having high debt ratios of 84.3%, 61.8%, 54.3%, and 53.0%, respectively, while the debt ratio in the broad sense exceeds 100% in Tianjin, Guizhou, and Sichuan, with debt ratios of 130.2%, 114.4% and 104.4%, respectively.

In addition, a comparison of regional GDP, the total financial strength of local governments, and the amount of interest-bearing debt of local government financing vehicle (LGFVs) shows that in 23 regions, the amount of interest-bearing debt of local government financing vehicle exceeds the amount of total financial strength of local governments. A comparison of these regions shows that debt dependency tends to increase in regions with lower levels of economic development and relatively weaker overall local government fiscal strength.

As a result, the disparity in fiscal strength among provincial-level governments has a significant impact on the finances of lower-level governments below the provincial level. Various problems related to government administration, such as salary cuts and unpaid wages for teachers and civil servants, salary and bonus cuts and late payments by state-owned banks and other state-owned sectors, teacher shortages due to cost-cutting, cuts in public transportation services such as buses, and late pension payments for retired employees, have been reported and surfaced in rapid succession, spreading their effects.

In addition, unjustified fines and unfounded surcharges, such as those mentioned above, and that are not based on any evidence, are increasing, causing the “Disarrayed excessive fee” problem. As these are serious problems directly related to the daily lives of ordinary people, there is concern that the continuation of these situations will lead to the expansion of social unrest.

VI. Required Responses

VI-1. Restructuring the Tax and Fiscal System

In order to deal with the mountain of problems, the tax and fiscal system must be reformed to change its structure. For example, from the perspective of reducing inequality, it is necessary to review the ratio of direct to indirect taxes from the current structure, which is dominated by indirect taxes, and reform the proportion of direct taxes, which have a greater redistributive effect, to increase the proportion of direct taxes. It is also necessary to review the degree of progressivity of income taxes and make the system more effective in its redis-

tributive function. It is also necessary to review fiscal transfers to equalize fiscal strength among regions, and it is important to establish a mechanism to measure each region's standard fiscal needs and other data to clarify the basis for such transfers and to operate transparently. With regard to the matter of redistribution, in addition to vertical redistribution between the central and local governments, it is imperative to strengthen horizontal redistribution to ensure equitable conditions among regions. To this end, the authority of local governments should be expanded. In this regard, the ongoing reform of the fiscal transfer system is of particular significance. Many regions have adopted a system of inter-regional support through "Counterpart Support,"³¹ and the reform of the fiscal transfer system is underway. The "Decision" of the 3rd Plenary Session of the 20th Central Committee of CPC also includes the improvement of fiscal transfers and the expansion of local governments' authority in public finance. Nevertheless, challenges persist, including the absence of transparency in the system's content and operation, as well as disparities in implementation across regions.

At the same time, the expansion of financial resources is important. In the ongoing discourse on the fiscal relationship between the central government and local governments, the Party has taken the lead in presenting a variety of measures to restore local government finances. However, there has been limited discourse of how to secure revenue, and the two sides are competing for it. In addition, the transfer of authority to local governments has been only partial and has not yet led to fundamental reforms aimed at restoring local government finances. Thus, intergovernmental bargaining appears to be intensifying.³²

As part of measures to expand tax revenue sources, the establishment of novel taxes, such as an inheritance tax and a property tax, is also being urged. This issue has been repeatedly discussed and even experimented with in some places, but it has not been formally introduced. This may be due to the fact that Party and government leaders and policymakers are in the position to be most affected by the introduction of these new taxes, and the relationship between policy formulation and implementation and vested interests is a conflicting structure that has prevented their implementation. As President Xi himself has focused on fighting corruption and fraud during his first term, reform will be difficult to achieve without eliminating vested interests. Moreover, administrative functions related to taxation and public finance need to be strengthened to increase tax collection, and a mechanism needs to be

³¹ It is a system of pairing among local governments and various institutions and organizations, whereby economically strong and well-conditioned areas provide assistance to economically weaker areas. This system was originally introduced as a support measure for disaster-stricken areas. This mechanism has been applied to correcting fiscal disparities and is used as a mechanism for rich regions to financially support regions with weaker economies.

³² In fact, in the decisions of the 20th Three-China Plenum, it was clearly stated that the Party would take the lead in reforms, including "issue and appropriately use very long-term special government bonds as soon as possible, and speed up the issuance and use of local government bonds," "strengthen support for the real economy by utilizing policy measures such as interest rates and the deposit reserve ratio," "consider policy measures to optimize the digestion of existing properties and housing growth in a unified way," and "promote the reform of the real economy by taking the initiative." The party-led reforms will be implemented in a unified manner to optimize the digestion of existing real estate and the growth of housing. As a measure to leverage the real estate market, the State Council requested local governments to purchase unsold completed properties through state-owned enterprises (but not loan flats) and convert them to guaranteed housing in response to demand, while 21 state-owned banks will provide RMB500 billion in financial support, of which RMB300 billion will be provided by the People's Bank of China. However, the scale of this support is inadequate, and the overall policy is conspicuous for increasing the role and burden of local governments.

established to ensure that income is collected from both individuals and enterprises. With regard to these points, the first step is to proceed with the development of the system and the establishment of an operational system in accordance with the policies outlined in the “Decision” of the 3rd Plenary Session of the 20th Central Committee of the Communist Party of China as the result of concrete reforms.

In addition, in order to ensure stable financial resources and increase tax revenue, it is imperative to expand taxpayers. The key to this expansion is the presence of enterprises and individuals who are not only capable of driving it, but can also be the bearers of this expansion. That is to say, it is crucial to increase the number of prosperous companies, managers, and affluent individuals by creating a market environment that guarantees free, fair, and equitable economic activities. This will stimulate economic growth and contribute to increased tax revenues. We must shift away from the paradigm of “Advancing State-owned Sector and Retreating Private Sector” towards the establishment of a fair, just, and equitable market environment, one in which individuals and enterprises can engage in economic activities without impediment. However, the current policy management of the Party and the government is rather retrograde mode and extremely irrational, raising concerns that it may impede economic growth and development.

VI-2. Restructuring the Local Finance System: Local Finance without Local Autonomy

The fact that tax and fiscal reform was made a priority policy at the 3rd Plenary Session of the 20th Central Committee, and especially that the “Decision” to transfer some financial resources and powers to strengthen local public finance was clearly stated at the same meeting, is some progress and can be regarded as a positive development.

The pivotal element in implementing tax and fiscal reform is the establishment and effective operation of local fiscal systems. As previously indicated, in China after reform and opening up, the “fiscal contract system” increased the weight of local public finances, which led to the expansion of local (protectionist) policies, and in 1994 the government decided to implement a “Tax sharing system” to increase the weight of central finances and strengthen the macro-control function. However, a review of the role of local government finance in this transition process reveals that the roles, powers, financial resources, and responsibilities of the central and local governments remain ambiguous and imbalanced, and that the local government finance system itself has not yet been adequately established. The weight of local government revenue has declined significantly since the “Tax sharing system” was introduced. And local government finance, which initially has no core tax and limited financial resources, has come to rely heavily on “land use rights transfer income” for management. In a sense, the central government tacitly endorsed this structure, expanding local discretion in land use and creating a system of “land public finance.” This structure collapsed due to the rapid slowdown of the real estate market, and “land public finance” reached its limits.

It can be said that the necessity for the establishment of a legitimate local finance system has become imperative, and then we also urgently need to properly manage the local finance

system. From a slightly different perspective, the stalemate of the “fiscal contract system” and the dysfunction of the “Tax sharing system” have strangely forced a review of the local finance system, and paradoxically, precipitated a reexamination of the local finance system. In a sense, this state of affairs can be regarded as a fortuitous opportunity.

However, the question pertains to the feasibility of establishing a local fiscal system within the context of China’s prevailing system. The enhancement of the local fiscal system and its operation will inevitably give rise to the issue of autonomy. Nevertheless, the discussion of local autonomy in China is not possible at this time. The challenge of, so to speak, “building local government finance without local autonomy” is, in essence, unprecedented, and the response to it will be a significant test. Local government finance is based on democracy and local autonomy.³³ In China’s current one-party dictatorship, local governments do not have autonomy, and the concept of local autonomy does not even exist. In other words, from the time of reform and opening up to the present, local government finance in China has not been the original local finance with autonomy, but local governments have only been in charge of carrying out administrative and fiscal affairs under the control of central finance. This situation, in which local governments were forced to manage their finances while securing their own sources of revenue without clarifying the fiscal roles between the central and local governments, was indeed a practical measure for local governments.

On the other hand, this situation was also favorable to the central government. If the roles and responsibilities of local government finance were clarified, this would require local governments to raise their own funds, and if such reforms proceeded, they would eventually run into the fundamental problem, that is local autonomy. For this reason, it can be seen that, the Party and the central government have avoided reforming the establishment and operation of a full-fledged local government finance system. Restructuring the local finance system is an extremely difficult issue for the Party and the central government to deal with. The vision of local finance without local autonomy remains to be seen.

VII. Conclusion

This paper has examined China’s fiscal risks through an understanding of the current fiscal situation and an analysis of the content and operation of policies. The current state of China’s public finances is not, in relative terms, in a state of crisis or at increased risk of fiscal collapse. In particular, central finances remain relatively sound and there is room for additional fiscal pressures. However, it is also true that there is a mountain of issues that need to be reformed. These issues have been highlighted repeatedly over the years. The bottom line is whether or not they can be implemented.

China’s economy has a lot of potential for growth and development in the future. This is evidenced by the abundance of state-owned assets, a large external asset base of nearly

³³ In this regard, Hiraoka et al. (2023) point out that the local finance system is inseparable from local autonomy, stating that “local finance, as an institution, supports local autonomy and is also the economic aspect of the inner reality of local autonomy.”

USD3 trillion, a current account surplus, and a PPP (purchasing power parity) GDP share of about 18%, a level higher than that of the United States. In addition, China is a leader in advanced technology sectors such as AI and ICT, vaccines, medical countermeasures, biotechnology, space exploration, and robotics, and its strength in advanced fields is growing to the point where the risk of technological monopoly has been raised. In addition, China's population of more than 1.4 billion people remains the world's largest and most attractive market, despite the many challenges it faces. The fact that the urbanization rate has not yet reached 70% is also a source of growth, especially in rural areas and farming villages, as it indicates that they have potential for development.

In order to take advantage of these elements of development and potential, it is essential to change the policymaking and management system and steer it toward a policy and direction that emphasizes market functions, as indicated during the first term of the Xi administration. The role of the state in a market economy also needs to be reconsidered, and the restructuring of central-local relations in public finance needs to be promoted as soon as possible. In the area of resource allocation, which is the primary role of public finance, it is essential to promote the provision of basic local infrastructure, public housing, education, and so on. In the area of redistribution policy, it is important to review the direct ratio, strengthen progressive taxation, and introduce new taxes such as inheritance and real estate taxes mainly for the wealthy. This is the same as we have already confirmed in the previous section. The establishment of a local government finance system is another reform issue that cannot wait, and it will be interesting to see how local government finance reform will be addressed under the current political system.³⁴

A major concern in the face of these issues is that the meaning of the word "reform" in the "Decisions" of the 3rd Plenary Session of the 20th Central Committee of CPC and in President Xi's "statements" is very different from that of previous administrations since Deng Xiaoping. The word "reform" was used more than 50 times in the "Decisions" of the 3rd Plenary Session of the 20th Central Committee of CPC, and some have argued that this indicates the current administration's policy of emphasizing and continuing reform. In reality, however, the message seems to be that it is important to realize a party-controlled and led society under the policy of giving top priority to "national security," and to grow and maintain the economy within this framework. In other words, the Communist Party has always been a "controlling entity," and one-party dictatorship is the basis of the Party's rule, and "reform" is to achieve "Chinese-style modernization" by strengthening control. Moreover, even Deng Xiaoping's "reform and opening up" was justified because it was positive and supported the maintenance of the one-party dictatorship, but it was also a transitional measure. Now that the economy has achieved significant growth, Xi Jinping's "reform" would be to strengthen the movement toward the socialist powerhouse that the original People's

³⁴ The question is how to position the fiscal roles, authority, and responsibilities of local governments without autonomy, and whether this can lead to sound local fiscal management. While strengthening the centralized system led by the party and the central government may encourage inefficiency, it is also necessary to avoid a return to the state of local (protectionism) that existed during the period of fiscal contracting, and the future of reform is not clear.

Republic of China aspired to be. However, it will be extremely difficult for the Party-led government to place the highest priority on “national security” and at the same time expand distribution to correct disparities and realize a “shared prosperity” society. It is clear that distribution cannot take place without economic growth, and it is precisely because the first-term Xi administration was aware of this that it began its first term by emphasizing the role of the market in allocating resources and making strengthening a system in which the market mechanism functions a key issue.

Again, the concentration of power can have the advantage of making important decisions boldly and flexibly. But it can also lead to rigidity in decision-making and stagnation in political management. The more serious problem is that the leadership with absolute power is less likely to receive accurate information and opinions, and is less able to correct unfavorable decisions. In the current situation, the negative effects have become more pronounced, causing confusion in economic policymaking and management. The challenges facing the Xi Jinping administration in its third term are enormous. The actual movement of economic reform and policy management in the face of the mountain of difficult issues will be the focus of attention in the future.

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