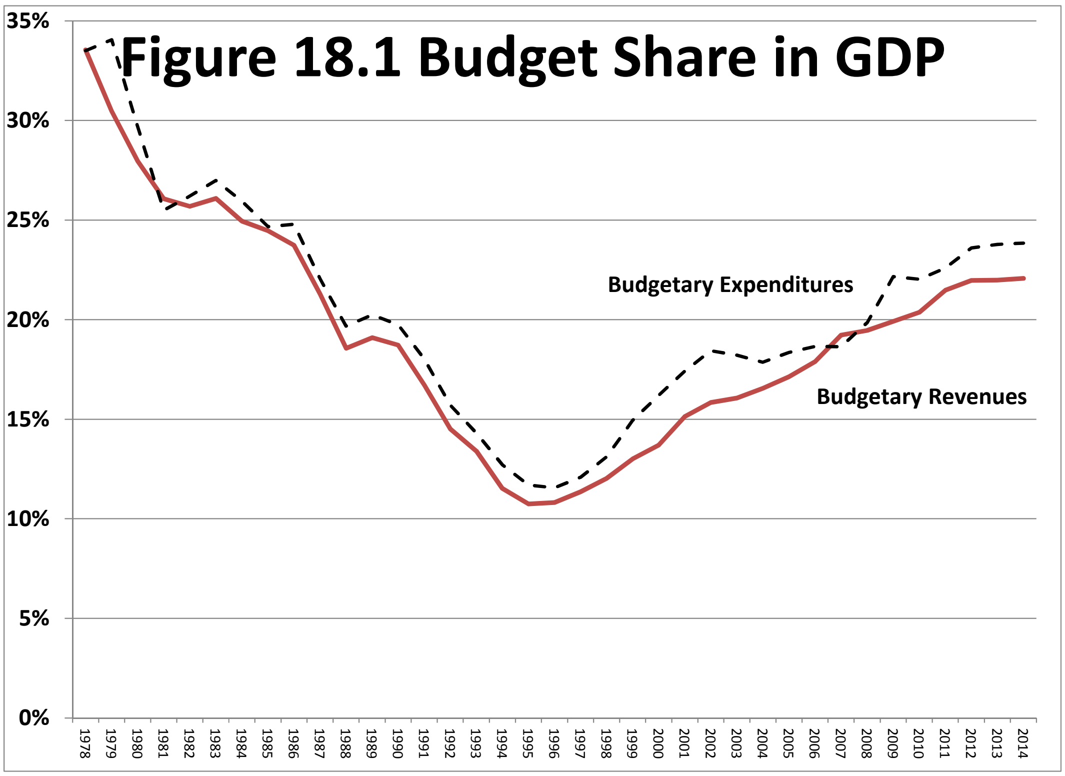
18 The Fiscal System

The fiscal budget is the most direct instrument a government has for influencing a market economy and achieving its social and economic goals. In developed market economies, there are generally no “plans,” just budgets. Budgets are the focus of intense politicking and lobbying, and there are multiple access points in the executive and legislative branches, through which different social groups and interests seek to influence budgetary outcomes. In centrally planned economies, by contrast, the budget was almost irrelevant: The most important decisions were made in the plan, and the budget simply accommodated those decisions by assigning financial flows that were consistent with the plan. As China has transitioned out of the planned economy model, it has improvised a fiscal system in response to obvious needs and immediate challenges, and the trajectory has been nothing short of remarkable.

The reform process in China began in 1978 with the government controlling one-third of GDP in the form of budgetary revenues, a substantial share. Economic reform led to the gradual erosion, and ultimately the virtual collapse, of the command economy budgetary arrangements. By the early 1990s, China was in deep fiscal crisis. Then, beginning with the fiscal reform of 1994, the budgetary system was reconstructed on a completely new basis, compatible with a market system. This reconstruction was remarkably successful: Chinese official budget revenues increased steadily after 1995 and *doubled* as a share of GDP by 2011 (Figure 18.1), then leveled off at around 22% of GDP. When the doubling of the budget’s take of GDP is put into the context of rapid GDP growth, we find that real budgetary revenues were about *fifteen* times in 2014 what they had been in 1995. The US dollar value of Chinese budgetary revenues (taking into account RMB appreciation) increased from $113 billion in 1995 to $2.2 *trillion* in 2014. For comparison, U.S. federal government on-budget revenues, excluding social security, were $1.97 trillion for 2012. Less than two decades after the country faced a potential crisis of state capacity, the Chinese system was awash in cash. This remarkable record is the foundation for our discussion of the Chinese fiscal system.

Despite this achievement, the Chinese fiscal system still faces tremendous challenges and had deep built-in defects. The discussion of the fiscal system begins with three questions about fiscal systems. Each of these questions asks what qualities are desirable in a fiscal system, and each helps put China’s fiscal challenges in comparative perspective and show how fiscal systems typically evolve with development. The fiscal reform of 1994 solved the most immediately pressing issues facing China, but twenty years later, the same fiscal system has been adapted and re-purposed but not fundamentally restructured, and it is now looking somewhat dilapidated and structurally unsound. The most fundamental problems revolve around the division of resources and responsibilities between central and local governments. As discussed below, China’s fiscal system has a peculiar, and paradoxical, characteristic: formally highly centralized, it is highly decentralized when it comes to actual expenditures. Local governments never had a really adequate revenue base after the 1994 fiscal reform, but the problem has been become steadily more serious in recent years. These challenges have led budgetary officials to push for a major new round of fiscal reforms beginning in 2015. This chapter examines these critical issues and concludes by asking whether China's taxes are too high, and where the next round of fiscal reforms will go.



18.1 How does a government fund the goods and services it provides?

How does a government raise sufficient revenue to provide the goods and services its people demand? This is a formidable problem, particularly early in the development process. Governments in under-developed economies have little capacity to collect revenues in economies that are rural and overwhelmingly small-scale; they typically rely on taxes collected on foreign trade or a few monopoly goods (such as salt in traditional China), or on printing money (seignorage). The Chinese system under the command economy should be seen from this perspective: almost all budgetary revenues were raised from tens of thousands of state enterprises with monopoly powers (rather than hundreds of millions of households). State-owned enterprises were profitable because they had *de facto* monopolies in given markets, government control of the price system was used to concentrate revenues in those firms, and government then harvested revenues from there, and entry and competition were prohibited. .

The details of tax rates and the non-existence of a professional tax administration were irrelevant. It was this system that eroded and then essentially collapsed between 1978 and 1994: with new firms entering the most lucrative markets, competition spread rapidly through the economy. However, this competition was almost never "fair." Some entrants, particularly township and village enterprises, were almost tax-exempt; some SOEs received subsidies and tax exemptions, while others paid high tax rates; tax rates—which hadn't really mattered when they were first set—now mattered and varied widely across sectors and firms for no discernable reason. In any case, monopoly profits were steadily competed away, and without state monopoly profits, there was no money to run the government.

China in the 1990s had to build a modern fiscal system more-or-less from scratch. The first question therefore is: How do we achieve an effective and fare tax system that is compatible with a market economy. The economics of public finance provides some answers to this question: The tax base should be broad; tax rates should be as even as possible; and the system should be feasible given the country's level of development. A broad tax base is important because it (a) permits tax rates to be as low as possible for a given level of need; and (b) spreads tax over as many taxpayers as possible, so that it's more fair. These two traits are desirable in themselves—taxes are low and fair—but also contribute to the economic efficiency of a tax system. Any system for funding government activity imposes direct and indirect costs on the economy. The direct cost of taxation is simply that we have to pay the taxes; we don't get any government services for free. To this we add the indirect cost—the excess burden—which comes from the fact that taxation drives a wedge between a good's cost and its price, and therefore discourages (disproportionately) the consumption of that good. Occasionally, this is a desirable outcome: high cigarette taxes discourage smoking. More often, it is an unintended cost that comes from taxing something that is relatively visible, and hard to move or conceal: thus, most societies tax work, because employment relations are usually well documented, and almost everybody has to work.[1]

As countries develop, they collect more in taxes. Poor countries today collect 10-11% of GDP in taxes, while developed countries collect about 25% of GDP in taxes, or around 35% when social security contributions are included. To do this, they collect two important types of taxes introduced during the early twentieth century: personal income tax (with tax withholding) and value-added tax (in every developed country except the United States). These two taxes effectively broaden the tax base, but they are quite difficult to implement before a certain stage of development: not until most workers have regular jobs and payments are made through the banking system, does it begin to be cost-effective to collect these taxes. Capacity to collect fiscal revenues grows along with economic development.

18.1.1 The Tax Reform of 1994

[1] It is peculiar that almost all governments tax work (a good), but are generally resistant to taxing, for example, carbon emissions (a bad),

The Chinese government in 1994 enacted a sweeping reform of the fiscal system. The new system created important new taxes, dramatically broadened the tax base, assigned different categories of taxes to the central and local governments respectively, and increased the center's share of primary tax collection. (Central-local relations are discussed below in Section 18.3). The 1994 fiscal reform was a substantial achievement, not only in putting China's finances on a sustainable basis, but in laying the groundwork for the profound reform program that Zhu Rongji pushed through in the mid- to-late-90s. This is because the fiscal reform allowed enterprises to compete on a more equal footing; reduced the scope of government involvement in the productive sector, and allowed the government to focus more on the delivery of public goods and services.

The reforms standardized the taxation system, creating a nearly uniform value-added tax and a profit tax that applied equally to all ownership forms. The fiscal reform had three crucial elements: new taxes, a tax assignment and sharing system, and a new central government taxation agency. The most important of the new taxes was the value-added tax (VAT) levied on most manufactured goods at the uniform rate of 17%. Very small private enterprises without regular bookkeeping systems were to pay a tax of 6% of gross sales in lieu of VAT. In addition, a 33% profit tax was introduced, with uniform rates for state, collective and private enterprises. The system of personal income taxes was unified and made slightly more rigorous. A "consumption tax" (actually a luxury or excise tax) was introduced for cigarettes, alcohol and a few other luxuries. A number of minor local taxes were introduced (or more accurately, regularized). In return, the previous system of industrial and commercial taxes was abolished, and the SOE profit contract system was eliminated.

The merging of the bases of the product tax and much of the business tax into the VAT, with the adoption of only two rates for the VAT, significantly reduced the variation in tax burdens due to differential tax rates. The movement of the VAT to the central government level improved the uniformity of application of the tax and improves horizontal equity. Local governments no longer are able to give VAT tax relief to favored enterprises.[2] These changes make the tax system more transparent: it is less costly to administer because it is simpler, it permits a reallocation of the time of tax administration officers toward the more important issues of assessment, collection, and audit; and it improves popular understanding of the tax system.

The 1994 reform attacked all four major sources of horizontal inequity in the old system: differential treatment according to ownership, the practice of contracting, legal rate and base structure, and administrative procedures. The pre-reform system treated enterprises differently under the profits tax, depending on their ownership. Tax burdens differed among SOEs, collectives, and private firms. Unification of the enterprise income tax to a single system for all domestic firms significantly improved the fairness of the system. Even within the SOE sector, tax burdens varied widely depending on whether an enterprise had a contract, the type of contract

[2] Roy Bahl, Fiscal Policy in China, The 1990 Institute, p. 37-45.

written, and the financial position of the local government that wrote the contract. The elimination of contracting substituted a transparent tax system for a negotiated one and placed enterprises on a more equal footing.

Most crucial, perhaps, is that the fiscal reform worked. That is, as the opening section of this chapter showed, the tax reform provided the foundation for a sustained growth in budgetary revenues, as a share of the economy and, even more so, in absolute terms. At the same time, as detailed below, it improved the fiscal standing of the central government. The fiscal reform of 1994, given time, solved the fiscal crisis that China had faced at the beginning of the decade.

18.1.2 Revenues Today

Table 18.1: 2014 Fiscal Revenues by type

(Percent of Total Revenues)

Tax Revenues	**85%**
VAT	22%
Other business & service taxes	21%
Product and Trade taxes	4%
Land & Resources taxes	10%
Stamp and contract duties	4%
Profit Tax	18%
Personal Income Tax	5%
Non-tax Revenues	**15%**

In the two decades since the 1994 fiscal reform, China's revenue base has changed relatively little. As Table 18.1 shows, China relies on a broad array of taxes. Although the VAT is the largest single source of revenue, it is by no means predominant. A very large share of taxes is levied on transactions. Even the several taxes listed as "land and resource" taxes are primarily levied only when land or resources are sold. Annual property taxes exist only in two pilot cities. Thus, China relies primarily on "indirect" taxes, that are collected on one party of a transaction, not necessarily the person ultimately paying the tax.

"Direct taxes"—those levied directly on the person ultimately paying—are a correspondingly small part. Most striking, personal income tax accounts for only 5% of budgetary revenues, in contrast to the 40% income tax contributes in most developed countries. The income tax is small because (a) it is levied on was income after a monthly deduction of 3,500 RMB, which was the average urban wage in 2011; thus only about half of wage-earners are affected; (b) little effort is made to collect income tax on non-wage income. These features mean that income tax plays almost no role in equalizing income (Chapter 9).

18.2 What Goods and Services Should the Fiscal System Provide?

A good fiscal system is one that provides the goods and services that a society demands at the least possible cost. In a market economy, we can rely on private individuals and companies to produce ordinary goods. Generally speaking, governments should provide three kinds of outlays for situations in which the market does not provide efficient or socially desirable supply: public goods; goods with positive externalities; and socially favored redistribution. P**ublic goods** are goods and services that are "non-excludable" and "non-rival." Because public goods are “non-excludable,” citizens cannot be charged user fees and “excluded” from enjoying the good if they do not pay. The clearest example is national defense. Because public goods are “non-rival,” one additional person enjoying the good does not detract from other people’s enjoyment, so there is no real social cost to providing an extra unit (and the price should be zero). Personal security is a good example: my increased sense of personal security does not detract from yours (and may add to it). Therefore, government should provide collective and individual security to its citizens without charging them directly for the service.

Second, government may provide goods when there are clear positive externalities. For example, research and development may provide new technologies that benefit society, for which the researcher cannot appropriate all the benefits. Without government intervention, research will be under-provided, and government subsidies or funding may be in order.

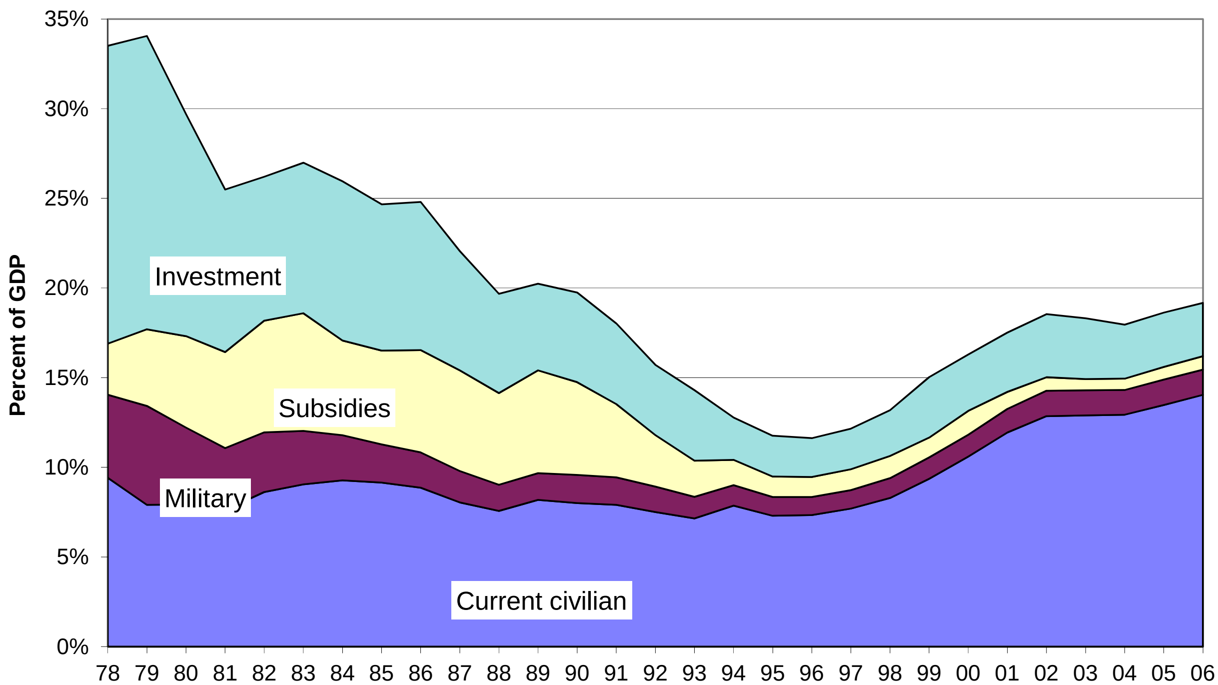
Third, government can redistribute income. Redistribution occurs not just from rich to poor, but also from healthy to sick, and from working people to the young and to retirees. Indeed, in virtually all societies, the largest component of redistribution is from the currently working to the currently retired.

These categories sometimes overlap or shade into each other; and there are semi-public goods that can be partially excludable or partially rival. Different political systems make different decisions about how different goods and services are treated, and particularly on the degree of redistribution that they prefer. Take government funding of education, for example. Education is not a public good, since most of the benefits go to the individual receiving the education, and it is excludable and at least partially rival. However, all governments fund education, for two basic reasons. First, they want to redistribute resources to the young, who consume most education before starting their working lives; and second, because education has positive externalities by enabling more sophisticated cooperation in the work place and in society as a whole. The highly skilled worker is even more productive when she has a cohort of skilled co-workers and a set of educated customers, and it becomes easier for society to adapt more productive technologies. Different societies emphasize to a different degree equality of initial access (which ends up providing low cost goods to families who would be able to afford paying full prices) or cost-recovery from those receiving education (which ends up burdening graduates with repayment responsibilities).

18.2.1 Restructuring Budget Expenditures

From this perspective, it is immediately apparent that Chinese budgetary outlays in the command economy period were profoundly irrational. In the pre-reform era, the Chinese government tried to everything. The largest component of outlays was investment, but this was by no means restricted to investment in public goods. Most investment went to ordinary industrial facilities, like steel mills and machinery plants. Thus, the government spent an enormous amount of time and resources doing things that the free market could do with minimal intervention; organizing sectors of the economy that really didn't need organizing. Thus, during the reform the Chinese government developed a way to stop trying to do everything, and focus government resources on the things that only government can do well. In fact, as Figure 18.2 shows, that transition occurred in two stages, as outlays declined and then recovered.

Figure 18.2. Types of Budgetary Outlay



From 1978 through the low point in 1995-96, government expenditures in investment, subsidies and the military were cut back. Investment in non-public goods sectors was turned over to the public and private enterprise sector. Subsidies were an especially regressive form of expenditure since they went predominantly to relatively high-income urban workers, protecting them from the impact of increased food prices. Military outlays were heavy on an economy the size of China's in 1978.[3] Over the next 18 years, these were all cut back, but the core government outlays for administration and social services were successfully protected ("current civilian" in Figure 18.2). The recovery in overall expenditure since 1995 has been accompanied by a remarkable shift in the composition of expenditure. Outlays for administration, education, and pensions and social security have all increased rapidly, while outlays for investment, subsidies and the military were all held constant as a share of GDP. Thus, after the 1994 tax reform led to China raising revenues in forms increasingly resembling a developed market

[3] Most analysts believe that officially classified military expenditures in China understate the full investment of resources into the defense sector, with substantial outlays classified into administration, science and technology, and investment.

economy, its budgetary expenditures also began to fund activities in ways that converge to the government's roles in other market economies.

18.2.2 Is China Becoming a Welfare State?

Still, through about 2006, even after this reallocation, the Chinese government was spending relatively little on social services. (The classification of budgetary expenditures changes after 2006, so it is impossible to directly compare pre- and post-2006 outcomes). In part, this was the legacy of the period of budgetary privation and the influence of the relatively young population. As Table 18.2 shows, budgetary expenditure on education in 2006 was still quite low in comparative terms (2.5% of GDP) and health even further below global norms (0.7% of GDP). If we add basic pension outlays, which are not fully integrated into the budget, another 2.2% of GDP went to this quasi-fiscal social service spending, for a total of only 5.4% of GDP. By 2014, the situation had begun to change. Basic pension outlays rose from 2.2% to 3.7% of GDP. To be sure, this was partly driven by the beginning of population aging, but two important policy decisions also contributed. First was the acceptance of universal early retirement among the urban population (Chapters 7,8); second, a new program of pension coverage for urban and rural workers not integrated into the main worker-staff retirement program was adopted. The result was rapid increase in coverage of urban pension programs, although the benefits available in the new program are far less generous than in the core program. The numbers covered jumped from 188 million in 2006 (in the core program only) to 341 million in the core program plus 501 million in the secondary program (in 2014). The number of retirees enjoying a full pension doubled to 86 million. If we put together pensions plus the three categories of social programs shown in Table 18.2, we see total outlays go from 5.4% of GDP in 2006 to 9.7% of GDP in 2014.

Table 18.2: Budgetary Expenditure on Social Services

	2006	2010	2012	2014
	Billion RMB (Percent of GDP)			
Education	546.4 (2.5%)	1,245.0 (3.0%)	2,124.2 (4.0%)	2,290.6 (3.6%)
Health	142.1 (0.7%	474.5 (1.1%)	724.5 (1.4%)	1,008.6 (1.6%)
Public Housing	n.a.	81.1 (0.2%)	448.0 (0.8%)	504.4 (0.8%)

These numbers are still too low to consider China a "welfare state." Nevertheless, it is crystal clear that the increase in current outlays has been accompanied by a dramatic expansion in entitlements (or, at least, eligibility). Generous entitlements combined with a rapidly aging population clearly indicate that China is on track to become a welfare state within a decade or two.

However, this system of social welfare still does very little to distribute resources to the poorer members of society. The system is still highly dualistic, providing generous benefits to urban workers, who now typically retire in their mid-1950s, while providing little to rural residents or urban-rural migrants. To be sure, an important change has been made in the basic conditions of eligibility for social welfare benefits. The programs of "resident" insurance, both old age insurance and health insurance, are now seeking to enroll all Chinese working citizens. Moreover, the generous traditional urban system is being opened to migrant workers in some firms (such that 54.7 million migrants are said to be participating in the program: MOHRSS 2015). These important changes have begun those with rural *hukou* into the system of social service provision. Currently, almost all workers are incorporated into pension systems, and almost all households are incorporated into basic health insurance systems. However, these are still very much "dual track" systems, and the actual outlay of resources has just begun to trickle over to people with rural residence permits. Indeed, given the rapid aging of the urban population, it is fair to say that the urban pension program would eventually have gone bankrupt without the incorporation of rural people (even today, before rapid aging has really begun, there are only 3 current workers in the core urban system for each retiree).

18.3 How should revenue and expenditure responsibilities be divided?

Every large country faces difficult choices between centralization and decentralization of government functions. In the assignment of fiscal responsibilities, there is a fundamental trade-off between centralized and local responsibility. Management should be "as local as possible," so that government can respond easily to citizens preferences and values. Exactly what public goods should be delivered and in what amounts? Is the marginal value of tax equal to the marginal value of benefits? (That is: Are we "over-taxed" or "under-provided with public goods"?) With full local responsibility, local governments should be responsible both for the provision of public goods like education and personal security, and for taxation so that citizens can see the link between their tax payments and the services they receive. This is especially important if different regions have different preferences for the level and quality of public services they demand.

However, it should be noted that effective decentralization makes extensive demands on the quality of local governance. Effective decentralization requires (a) accountability of local government; (b) autonomy of local government operation; (c) clarity and transparency of central government mandates and entitlements given to local government; and (d) capacity of local government to collect revenues and deliver services efficiently, combined with central government capacity to monitor and audit (Bahl 1993). Each of these areas presents substantial challenges for China.

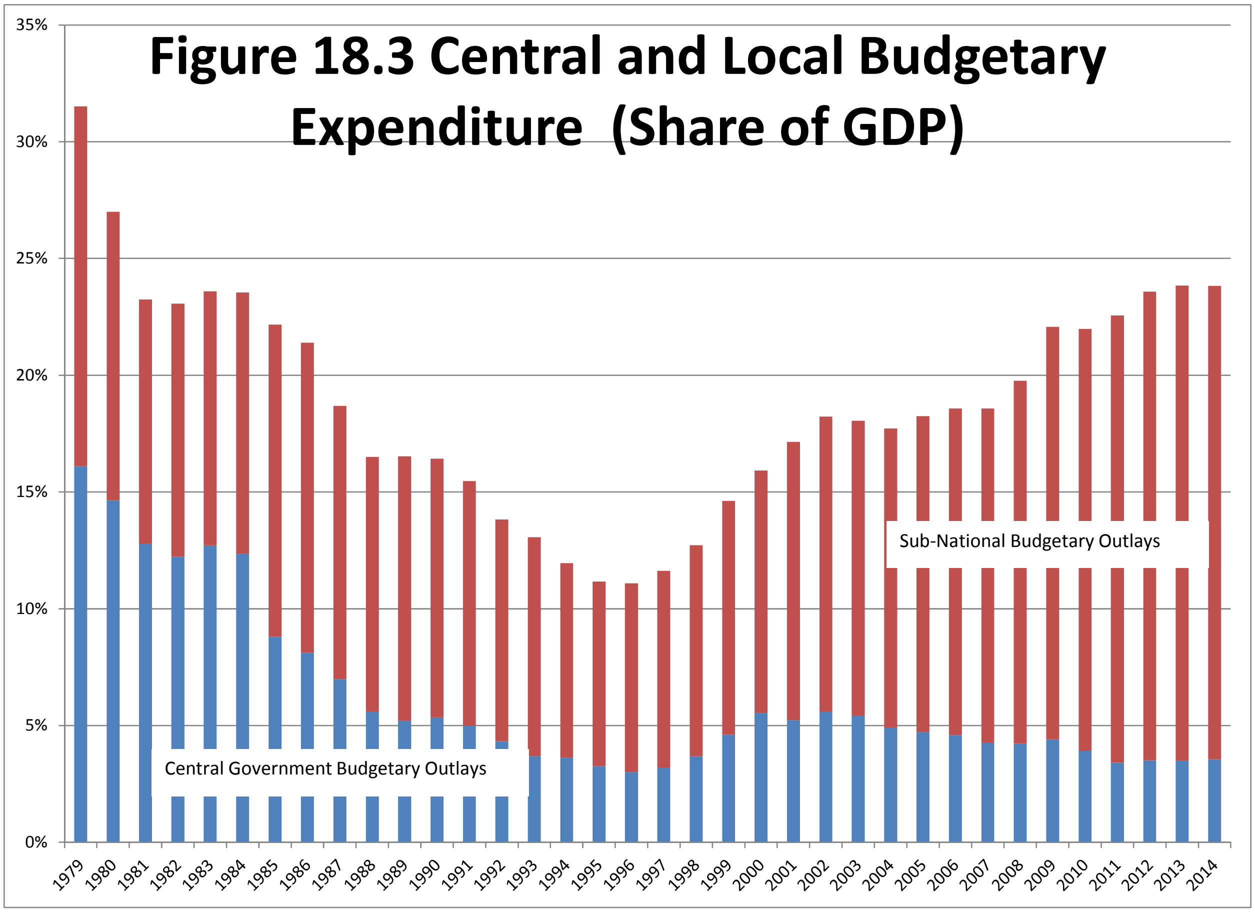
Certain public goods, by their very nature, involve central government provision. The most obvious example is national defense. However, the legal and regulatory framework that governs the country is a fundamental public good that should be applied with uniform principles nationwide. Some public services, such as social security, may rely on a minimum standard of provision that should be the same everywhere. Finally, only the central government has the ability to redistribute resources fairly across regions. For all these reasons, central government provision of services will be preferred to local control in certain policy areas.

Finally, each level of government should have control of sufficient revenue to cover the expenditures for which they are responsible. The central government can achieve some of these competing objectives by maintaining a system of inter-governmental transfers. In that case, these transfers should be predictable, transparent, and rule-driven. Otherwise, conflicts between levels of government are inevitable, politicking and lobbying will be incessant, and unsustainable fiscal arrangements with unclear responsibility are likely to emerge. In the US, these arrangements have evolved over more than two centuries of a federalist system. The national and local governments each have their own independent powers, (incompletely) specified in the Constitution, and each level is accountable directly (and separately) to the electorate. Even so, there are many highly contested areas of inter-governmental responsibility. In areas such as education and health insurance, there are ongoing debates both about federal expenditures and about unfunded mandates. China faces parallel issues, but under a very different governmental system. How can China achieve an assignment of revenues and expenditure responsibilities that is efficient and compatible with the goods and services it wants to deliver?

18.4 Center and Local: The Paradox of China's Fiscal System

The Chinese fiscal system—indeed, the entire governmental system—is integrated and hierarchical. Government is organized into five levels: nation, province, prefecture, county, and township. These are relations of hierarchy and subordination: superior levels of government generally have the right and ability to issue instructions to subordinate levels. Local governments have no autonomous rights to levy taxes and, until recently, were forbidden to borrow (although they did so anyway). The central government sets all tax types and tax rates. Moreover, the central government provides the local levels with a detailed set of budgetary guidelines and instructions, and prepares an integrated set of budget accounts that consolidate central and local revenues and expenditures. All of the data presented thus far in this chapter have been for the consolidated national budget, integrating central and local government accounts. By all these indicators, China's fiscal system is highly centralized. Moreover, the centralization of the fiscal system is reinforced by the centralization of the political system. Heads of provinces are appointed by the central government, or, more precisely, by the central Communist Party. Performance indicators are set by the central Communist Party Organization Department, and career paths are clearly in the hands of superiors. The rules and parameters of the fiscal system are set in a highly centralized fashion.

It is surprising, then, to discover that the Chinese fiscal system is, in terms of expenditure, one of the most decentralized in the world. In 2014, the central government performed only 15% of total expenditures. The remaining 85% of expenditure was carried out by the four sub-national levels of government (Figure 18.3): province, prefecture, county and township. Expenditure is more decentralized than, for example, India, where during the 1990s, the central government accounted for a little more than half of total expenditures (Goyal, Khundrakpam and Ray 2004).[4] Along with the expenditure comes responsibility: China depends on local governments to execute many national policies. Thus, local governments in China dispose of a lot of resources, but have even more responsibilities and power. Local governments are not accountable to local electorates, since they are appointed from above. Although an effort has been made to increase transparency of local budgets, these still fall far short of democratic accountability. Accountability is upward, not downward. Inevitably, this means substantial "agency loss." Local governments have their own interests and diverge from the instructions of their central government principals in greater and lesser ways. This feeds into problems of



corruption and abuse of power. At the same time, though, local governments have legitimate needs and responsibilities that cannot be adequately covered by existing revenue assignments.

[4] In the US, the federal government collects over 40% of revenues, plus Social Security, which accounts for over 20% of revenues. Expenditures generally follow revenue collections, although state governments receive about 20% of their revenues from transfers from the federal government (OECD 2014).

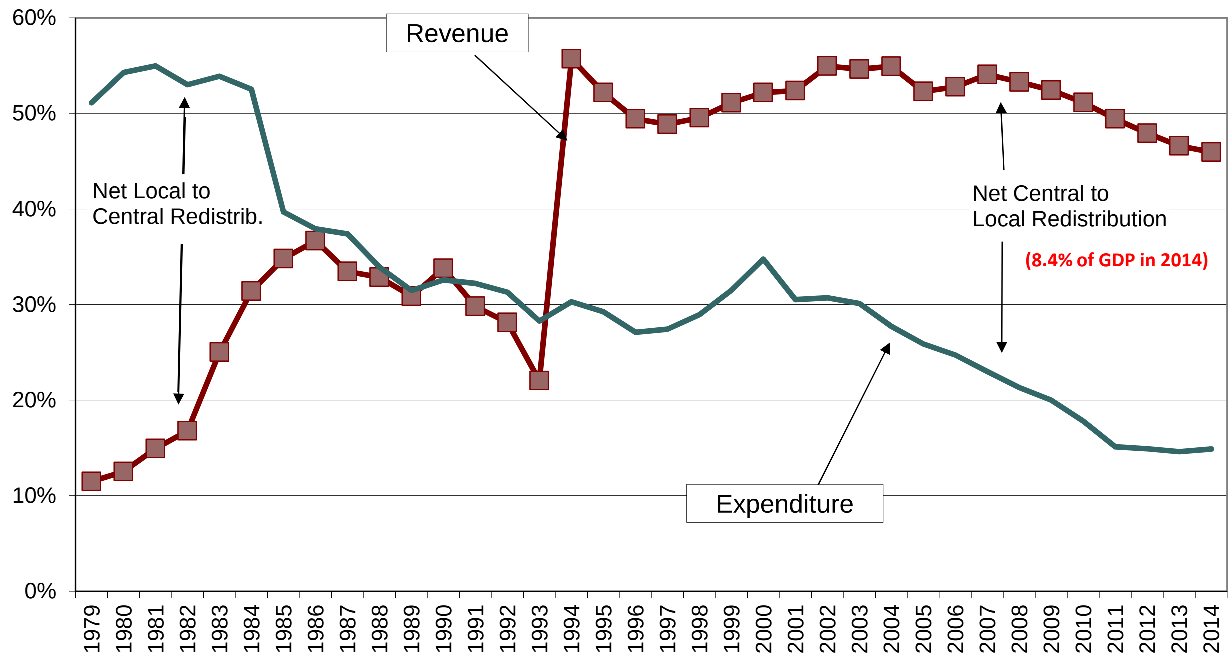
Local government leaders are under intense pressure to increase their economic resources and resolve problems. These pressures (and temptations) are increased by the fact that not all governmental functions are incorporated into the formal budget. The paradox of China's fiscal system is that it is formally highly centralized, but at the same time highly decentralized in practice.

The tension between centralization and decentralization in the Chinese budgetary system today is particularly affected by two historical legacies. First, when the 1994 fiscal reform was enacted, the most critical challenge facing the government was the erosion of budgetary revenues. Thus, one of the most critical policy objectives of the reform was to restore the central government's solvency by giving the center much greater direct revenue-raising power. This was done by the creation of a centrally controlled State Administration of Taxation (SAT), and the grant to the SAT of the power to collect some of the most important taxes, including the VAT. These measures undoubtedly succeeded in resolving the center's budgetary problems, but at the cost of substantially weakening the local government revenue base. After 1994, the fiscal system was not only formally highly centralized; it was also relatively centralized in the way in which revenues were collected. Second, the shift in the direction of a welfare state has increased the expenditure responsibility of local governments. Traditionally, local governments in China had responsibility for all local government services, including health, education, police and courts. As these expenditures have become relatively more important, local government expenditure responsibility naturally increased, in the absence of a fundamental "rethink" of expenditure assignment. Particularly surprising is that local government have responsibility for administering retirement and social security programs, something that is a central government responsibility virtually everywhere else in the world. For both these reasons, post-1994 developments have increased the paradoxical nature of the Chinese fiscal system, and increased the tension between center and local in the revenue and expenditure sides of the equation.

18.5. Central-Local Fiscal Relations

The 1994 fiscal reform created a system in which transfers from the central to the local government were fundamental to the operation of the fiscal system. The reform dramatically boosted the center's share of revenue collected, and made local governments depend on the center for revenue. As shown in Figure 18.4, China has had three different systems linking central and local budgets since the beginning of the reform era. At first, the central government was dependent on revenues transferred from local governments, a legacy of the Maoist decentralization of the Cultural Revolution period. Note that this peculiar system followed rather logically from the fact that budgetary revenues at that time depended mainly on state-owned enterprises, and most state-owned enterprises were controlled by local governments. It was thought that local governments had more local information that would assist in the collection of these taxes (and even today, profit tax of local enterprises goes to the local government). During an intermediate period, 1985- 1993, the central government spent about the same share of outlays as the share of revenues it took in. There were transfers in both directions between center and localities, but they balanced out almost exactly. The 1994 reform initiated the contemporary period in which the central government is largely in control of initial tax collections, collecting about half of all revenues. The center then transfers *most* of these revenues to local governments, with transfers amounting to 8.4% of GDP in 2014. This arrangement enhances the central government's overall financial position, and also gives it a strong bargaining position vis-à-vis local governments.

Figure 18.4 Central Government Share of Budgetary Revenue and Expenditure



The means through which this system was created was a "tax assignment" system. The central government had complete claim on the consumption tax, customs duties, and most direct and indirect taxes on central government-controlled sectors (i.e., railroads, financial institutions, and some large centrally controlled enterprises). Provincial governments had direct control over direct taxes on local enterprises, as well as a number of relatively modest taxes, including real estate and property taxes, and pollution and resource fees. The key provision was the designation of most VAT revenues as "shared income," with 75% going to the central government, and 25% to the local government. Under this system, the new central SAT first collected the bulk of revenues--including all VAT revenues--and then shared them with the provinces.

A system of inter-governmental transfers gradually evolved to rectify the "vertical imbalance," i.e., the disequilibrium between the activities assigned to each level of government and the resources available to that level of government. At first, the inter-governmental transfers were dominated by VAT rebates. The 1994 fiscal reform had literally taken revenues away from local governments, so in the first few years after the reform, the central government promised to rebate enough of the VAT revenues to make each province whole again. Over the subsequent two decades, this improvised system has been gradually expanded to include a large number of policy-driven and earmarked transfers. Remarkably, there has never been a systematic overhaul of the system of transfers, and there is no set of rules or principles that governs the transfer process. This is a serious problem that has only recent (as of 2014), pushed its way to the top of the policy agenda (see below). This situation also contributes to a common misunderstanding: it is often said that local government revenues are inadequate. As we discuss below, there is a sense in which this is true. However, there is nothing fundamentally wrong with having local governments be dependent on transfers from higher levels of government. Germany, for example, runs just such a system. The problem rather is that such a system should be clear, transparent, and predictable. Before continuing the discussion of inter-governmental fiscal relations, we examine the situation of local government finances more closely.

18.6 Local Government Budgets: Rural

In China, rural areas have always had a thinner revenue base than urban areas. Poorer to begin with, rural command of resources was further reduced by policies of urban bias that kept the price of rural goods low and concentrated revenues in urban industries (Chapter 5). For most of the command economy period, rural public goods were provided by agricultural collectives which were not even part of the formal governmental or fiscal system (Chapter 10). However, after the rural collectives dissolved in the 1980s, a rural fiscal system was gradually put together. In richer suburban areas, money-making TVEs were an acceptable source of revenue, but areas without TVEs had few regular sources of income. Local governments at first responded by raising a dizzying variety of extra-budgetary funds and irregular fees; but gradually the center stepped in with earmarked transfers.

18.6.1 Fees and Extra-Budgetary Funds

Local governments initially proliferated fees and levies on farmers. Some of these were user fees and others were tied to the provision of an important local public good or service. However, given the fact that these funds were irregular and imposed at local discretion, there was little to prevent a corrupt local official from arbitrarily imposing a new fee to fund his own administrative expenses. One survey in Hunan Province found that TVEs were subjected to more than one hundred types of fees, paid to sixty-odd administrative units and agencies (Furusawa 1990). The central government tried for years to address these issues by abolishing specific items of illegal and unjustified fees, but this ad hoc approach was never effective. By the late 1990s, collection of taxes, fees and charges in rural areas had become the major source of peasants' discontent. Although some fees are unreasonable, others go to the improvement of services, like schools and hospitals, and it is difficult for rural residents to tell which fees are actually going to the intended purpose. Other purposes may be quite unpopular, such as (coercive) family planning operations. The best solution would be to make finances transparent and involve rural residents in decisions with regard to township finances, including what kind of services peasants want, and how they are going to share the burden. Indeed, this objective is a significant motive behind the Chinese government's otherwise rather grudging support for village-level democracy.

18.6.2 Abolishing local fees and taxes.

In the early 2000s, the central government's struggle against fees and exactions reached a new level. The government decreed that all fees were illegal except for those on a short approved list. Fees for education, family planning, road-building and welfare were all declared illegal. The old system of rural collectives setting aside funds for investment and welfare—which had been maintained by some local governments even after the collectives disbanded—was finally abolished. More importantly, as government revenues recovered from the mid-1990s low point, the central government began to be receptive to providing inter-budgetary transfers to compensate local governments for the fees they were surrendering. At first, these policies were adopted as part of regional development policies. When in 1999-2000 the central government adopted the Western Development Program (WDP), it began providing direct subsidies for administrative personnel and education to poor counties in the Western regions. This type of ad hoc redistribution gradually expanded to cover broader regions (such as central provinces) and an increasing list of social objectives.

The central government declared a set of objectives for rural policy that it was increasingly willing to fund (again, initially in the Western provinces). The pioneering effort was to make six years of education available nation-wide without tuition charges. Along with education, the government began to contemplate a series of policies grouped together as the "New Socialist Countryside." These included, for the first time, extension to the countryside of a nearly uniform, but barebones, system of social welfare services.   A uniform system of minimum welfare payments was extended nation-wide; a basic health insurance package was adopted; and some very basic retirement programs were established. Each of these had in common the characteristic that they were funded at very modest levels (in terms of *per capita* benefits), but with funding provided from the central government in most provinces.

During 2004, a major policy initiative emerged with the abolition of agricultural taxes in several Chinese provinces. Within only two years, the agricultural tax had been eliminated nationwide. In principle, it was not difficult to eliminate, since the tax only accounted for 2.2% of budgetary revenues. However, for local level governments, the agricultural tax was the bulk of their resources, and it was not necessarily easy to ensure that central government money actually reached its intended target. This was a momentous policy change. The agricultural tax had been in place for millennia. For the first time, the Chinese government was able to finance its activities without putting the cost on the farmers, the poorest class of society.

18.6.3 New Structure of Power at Rural Grass-roots

These changes created fundamental changes in the role of different institutions in the countryside. County authorities collected less revenues on their own, but were much richer overall because they were the conduit through which central government money flowed. The county share of total expenditures increased to 31% by 2004, while revenues declined to 17% of total revenues, with the gap financed from above. County governments in turn redistributed the revenues downward to townships and villages, increasing the voice of county-level officials. Below the county level, changes were even more extreme, but varied more from region to region. In poor regions, townships and villages frequently had no local revenues at all. In those areas, the education department, securely funded through inter-governmental transfers, became a relatively wealthy and influential sector of government. In general, townships and villages saw their tax bases shrink, and they were more subject to the influence of superior county-level governments. Village democracy became less salient to the lives of villagers, because the oversight over village budgets that their elected councils exercised were less important. At the village level, an increasingly centralized budgetary system meant more resources, but less local control.

18.7 Local Government Budgets: Urban

The budgetary position of urban governments was quite different from that of rural governments. Cities can be at any level of the Chinese governmental hierarchy: there are four province-level cities (Beijing, Shanghai, Tianjin and Chongqing); thirty-some “vice-provincial” and prefecture-level cities (Wuhan, Fuzhou, Qingdao, etc.); hundreds of county-level cities; and thousands of township-level towns. The general rule is that the higher in the hierarchy, the greater the budgetary resources and the higher the managerial autonomy. Cities have traditionally had resources because they had control over profitable local state-owned firms, and because most of the traditional tax bases were in cities. Moreover, those resources were adequate in an era when city governments refrained from large-scale redevelopment and cautiously maintained the traditional urban city-scape.

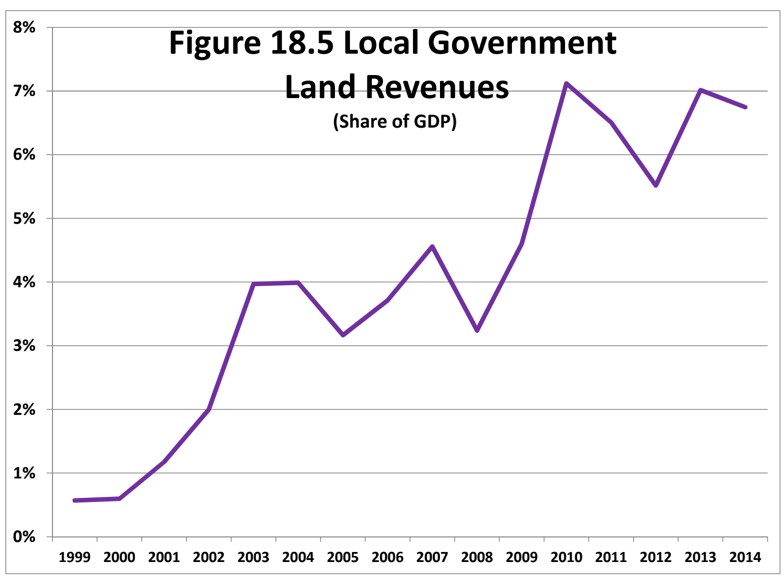
18.7.1 Municipal Governments and the Challenge of Urbanization

Municipal governments faced formidable challenges after the 1994 fiscal reform. They had to surrender a substantial portion of their existing revenues. Moreover, the local SOEs that remained under their control were predominantly medium-sized enterprises that were exposed to the brunt of competition and were not profitable. In exchange for control over revenues, municipal governments in the 1990s were given substantial autonomy. They had to struggle with the restructuring and down-sizing of SOEs in the late 1990s, and some cities had to grapple with major unemployment problems. In the course of resolving those problems, city managers gained valuable experience.

Urban governments were unprepared, however, for the demands and opportunities that the wave of urbanization in the 2000s brought. Indeed, the Chinese fiscal system has never been adapted to provide the resources needed for urbanization. While the central government was focused on providing resources in the countryside to permit the expansion of social programs, city governments were left more-or-less on their own to develop the resources for urbanization.

18.7.2 Land-driven Local Government

The means that city governments discovered to generate resources was to rely on their control of urban land. Chapter 5 described the way that urban governments had control of land. As the representative of the "state" that formally owns all urban land, city governments were in an advantageous position to begin with. However, the really crucial lever of control—and source of resources—comes from the city government's monopoly control of the process by which rural land is converted to urban status and opened up for development. Rural people are strictly forbidden from developing their land for urban uses. They must instead sell their land and the only entity authorized to purchase that land is the city government. In practice, then, city governments purchase developable land from farmers (exploiting their monopsonistic position to get a good price), install infrastructure, and sell the land-use rights to developers (exploiting their monopolistic position to get a good price).



This key structural position has meant that local governments have been able to consistently raise substantial sums of money from the sale of land. Figure 18.5 shows that local governments generated 7% of GDP in land revenues after 2010 (revenues grew rapidly but data coverage in earlier years may also have been incomplete). For many cities, these land revenues—which are not incorporated into their formal budgets—are as big as or bigger than all other forms of locally generated revenue put together. City governments in China have become land developers: their resources and achievements are inseparable from their success in developing land.

This system has many disadvantages. Most clearly, it continuously involves local government officials in direct, microeconomic interventions in the economy. Local government have strong interests. Since local governments *also* have strong regulatory and policy responsibilities, the potential for conflict of interest is great. Moreover, the dependence on land inevitably makes it more difficult for the city government to development a clear arms-length relationship with the market. Local government entrepreneurship has been a crucial characteristic of China's economic reform from the very beginning. But with land dependence, this entrepreneurship takes on an extremely unhealthy form.

Local government officials respond to the incentives they face. Land revenues loom large in the total resources available to them; and land development is perhaps the one area in which an energetic local official can substantially increase the volume of resources available to him. What objectives do local officials seek to achieve? Crucially, local officials must think of their careers within the context of a hierarchical, centrally-managed bureaucratic system. That system provides strong and explicit incentives, for both short-term rewards and long-term career success. Local officials are strongly incentivized to grow local GDP and increase local budgetary revenues. By contrast, local officials have no direct accountability to local residents, other than making sure that they are reasonably content and unwilling to disturb social order. Thus, local officials are strongly incentivized to develop, and only very weakly incentivized to provide high quality services to urban residents. (This is the reverse of the system for local officials in the US, although they are incentivized to support development by the interests of their supporters with a private interest in development). An obsessive focus on land development by local officials is thus an entirely rational response to the incentive system which they face. Moreover, as discussed in Chapter 5, city officials gain nothing from incorporating migrants into the city economy. Thus they over-emphasize the urbanization of land, and obstruct the urbanization of people.

The land-based municipal finance system "works," in the sense that it has provided adequate resources for urban development. At the same time, it has multiple disadvantages. It fosters government intervention in and distortion of the local economy. For this reason, it also encourages corruption and insider dealing. It distorts the urbanization process, by encouraging physical over-expansion and human under-expansion of the city fabric. Finally, it creates an undesirable pro-cyclical pattern in municipal finances: when times are good, city coffers are full and city expenditures grow rapidly; but when times are bad, city revenues drop disproportionately and it is difficult for cities to help the local economy. It was in the face of a situation like this that a serious problem of local government debt emerged in China.

18.8 Local Government Debt

Local governments in China, until very recently, have had no legal power to borrow money and go into debt. Despite the clear legal prohibition, local governments have always borrowed money. The most common way for local governments to circumvent prohibitions has been to set up local investment companies or development funds, and then have the government guarantee their debts. Indeed, it is hard to imagine local governments playing the kind of entrepreneurial and developmental roles that local governments routinely play in China, without seeing them set up some kind of corporate entities to raise funds and carry out development activities. (State-owned enterprises are certainly legal in China, so the legitimacy of such vehicles is not in itself in question, but the practice of local governments guaranteeing their debts has no legal basis.) Such operations have a long history in China, but during most periods the central government has at least made an effort to restrain such activities.

During the global financial crisis (GFC: 2008-9), the attitude of the central government shifted from cautiously restraining local government investment vehicles to actively promoting them. A new term, "local government funding vehicles" (LGFV 融资平台) was coined to describe the entities. Eager to prevent the global crisis from spilling over into China, central government leaders ordered local governments to accelerate investment as quickly as possible. Restrictions on LGFVs were dropped and state-owned banks were urged to lend generously and keep the money flowing. These steps let to a rapid explosion of in LGFV debt, by one estimate, doubling from year-end 2007 to 2009, from 4.5 trillion RMB to 9 trillion, with over 80% of the funds coming from the banking system (Fan and Yan 2012). Almost overnight, a serious local government debt problem was created. The National Audit Office conducted a thorough study of local government debt as of June 30, 2013, and discovered a total of 10.89 trillion for which local government had direct repayment obligations, and a further 2.7 trillion in debt that the government had guaranteed, plus 4.3 trillion of potential or contingent liability (NAO 2013). The NAO estimates are conservative, covering documented and verifiable debts, but lead to an alarming conclusion: direct local government debt is 18.5% of 2013 GDP, and all three categories together were 30% of GDP.

It is not so much the total volume of this debt that is alarming, but rather the fact that the debt exists in a kind of legal Neverland. Local governments cannot borrow and cannot guarantee debt, yet here the NAO has published detailed figures on the borrowing and guarantees of local government. Responsibility for the debt is diffuse (the central government encouraged it at the time); procedures for managing debt are weak to non-existent; and procedures for sorting out debt and declaring default are unknown. In the NAO accounting, just under 40% of the debt is held by LGFVs, and just under 30% by local government departments themselves. The underlying income-earning potential of the assets held is dubious. A very small proportion of LGFVs own projects that generate a steady revenue stream (such as toll highways or water treatment plants). About half hope to repay debt through land sales: LGFVs are the instruments through which local government land-dependence is realized. If the value of land drops, then these debts will be extremely difficult or impossible to repay. Acknowledged local government debt exceeds the volume of central government Treasury bonds circulating in China: together they amount to at least 35% of GDP. There are additional debts beyond these liabilities, but estimates of their total magnitude vary enormously.

18.9 Fiscal Reform and Overall Economic Reform

On the surface, China's fiscal system seems to have been successful because the dramatic increase in government revenues since 1995 tends to obscure any problems. However, beneath the surface, the fiscal system looks increasingly cobbled together, with numerous ad hoc adaptations having been made to a system that was itself rushed into place in response to crisis in 1994. Remarkably, twenty years later, despite massive growth, rapid urbanization, and dramatic shifts in the composition of budgetary expenditures, the same system is still in place. We can identify three *immediate* issues that are likely to drive current reforms.

What must a thorough fiscal reform program accomplish? At a minimum, it must include:

1. Deal with local government debt. This is not simply a matter of restructuring or remitting current debt, but rather a longer-term problem of clarifying local government borrowing rights. A start was made with the passage of a new Budget Law in 2014 which for the first time gave local governments the formal right to borrow. The hope is that this will be followed by the creation of a "municipal bond" market in China, with greater transparency for the risks and returns to individual borrowing decisions. To achieve this daunting task, there are two fundamental, interrelated requirements:

    a. Clear mechanisms of accountability need to be established for local government officials. If local officials are not accountable to local voters, what kind of oversight is necessary to ensure good outcomes?

    b. Efficient bond markets need to be developed quickly, in order that market participants can choose among different debt instruments. This means that debt defaults must be allowed, and market participants have the right and responsibility to sort through different debt issues.

2. Put the system of inter-governmental transfers onto a relatively transparent and rule-driven basis. As described earlier, the central government's system of transfers grew gradually over the years as the government's financial position improved, and new expenditure objectives were taken on. The result has been a dizzying array of inter-governmental transfers, some once-off and some according to various bargained formulas. Initially, transfers were dominated by rebates of taxes. Gradually these have become less important. "General transfers" were only 4% of transfers in 2002, but had increased to 50% by 2012; while "earmarked transfers" were 55% of total transfers in 2002, but had

eased off to 39% by 2012 (Wong 2004, MOF 2013). However, even within categories like "general transfers," there are multiple different items and formulas, including ad hoc differences between Western and coastal provinces. This system has a number of disadvantages, two of which are most significant. First, since the transfers are not guided by an overall developmental framework, they do not, on balance, transfer income to lower income regions. The impact of transfers to poor regions is swamped by the impact of other special purposes and tax rebates to richer areas (Wong 2005). Second, because transfers are not rule-driven, they have perverse incentive effects. Local government officials have strong incentives to be seen as needy by upper levels of government. They do not have the confidence that they will continue to receive budgetary support if they improve the governance and living conditions of their populations.

3. Put local government finances on a sustainable basis. Sustainable local government finances can include inter-governmental transfers, once those have themselves been rationalized. However, it is difficult to see how continued dependence on land development revenues can be consistent with sustainable local government finances. As China becomes middle income and slower growing, the development bonanza that fueled land revenues will certainly moderate, and in the meantime the system is far too vulnerable to boom and bust cycles. More broadly, the grey zone between government revenues and various investment funds and development corporations is a breeding ground for micro-economic interventions, corruption, and financial fragility.

In 2014, the Minister of Finance, Lou Jiwei, proposed in outline a comprehensive fiscal reform program that would begin to address some of the main issues in the current system. Even in outline, the program was ambitious. Lou envisioned a preliminary phase of reform in which procedures for borrowing and inter-governmental transfers were improved, and greater transparency established. A second phase would follow in which new taxes would be introduced. Many of the existing transaction taxes would be cancelled, and a greater reliance on direct taxes--income tax and property tax—would replace them. Finally, on the basis of these new taxes, a new revenue and expenditure-sharing system would be developed between center and locality. This new system would potentially have scope for new revenues at the local level, and for the central government to take over certain expenditure responsibilities currently at the local level, such as social security and, perhaps, education. These changes, if carried through, would amount to a fundamental restructuring of the Chinese fiscal system.

In the longer run, decisions made about the budgetary system today will determine the nature of the interaction between government and the market. Now that China's fiscal crisis of the 1990s has been overcome, it is apparent that government officials in fact command an extraordinary volume of resources. The many "grey zones" where officials control funds, corporations and off-budget resources give immense power over the economy. Strikingly, local officials even have operational control over social security contributions, and the responsibility to pay pensions to local residents. When these revenues are consolidated, they add up to a remarkable sum. Table 18.3 performs the simplest possible version of this exercise, and shows that an expanded version of budgetary revenues under government control easily reaches 37% of GDP. This is an extraordinarily high figure by any standard. Yet even with this revenue base, local officials *still* ran up 20% of GDP in debts in the last few years!

Table 18.3 2014 Fiscal and Quasi-Fiscal Revenues

	Billion RMB	% of GDP
Total Budgetary Revenues	15,179	24%
Local Government Land Revenues	4,294	7%
Social Security Revenues	2,272	4%
SOE Profits (After Tax)	1,635	3%
Total	23,380	37%

NB: Fiscal subsidy to social security fund deducted to avoid double-counting.

China's fiscal system has performed remarkably, summoned from nothing in the wake of economic reform, and providing adequate revenues to build China into a middle income economy. Now that system is too large, too inefficient, and too opaque to serve the upper-middle income society that China has now become. We should anticipate a major new round of reforms that will restructure the fiscal system and re-define the relationship between government and the economy.

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Figure 18.1

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