

Overview

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China has moved toward the market and integrated more deeply with the world economy over the past 25 years. Having grown at more than 9 percent a year during that period, it is now the world's fourth-largest economy and third-largest exporter; and it is poised to continue growing at a rapid pace. Structural reform and economic growth have brought about an unprecedented rise in average living standards and a dramatic reduction in rural poverty. The changes have lifted 400 million Chinese out of poverty since 1980. Once rural, closed, and command driven, China's economy is now open, market oriented, and based on manufacturing and services.

But China's growth model faces tough challenges. The changes that brought prosperity have also eroded inherited social and institutional arrangements and structures and created new issues. These include urban poverty, open unemployment, out-migration from rural areas, and sharp income inequalities between rich and poor, urban and rural, and coastal and inland. Access to such basic public services as education and health care remains uneven. Addressing these issues requires further restructuring and rebalancing of the state and rethinking government priorities for financing and spending.

Guided by the concept of scientific development, in 2003 the government of China put forward the goal of building a harmonious society, shifting from an overriding priority on the pursuit of growth to more balanced development. The aim is to balance economic and social development—to devote more attention to the composition and nature of growth, to environmental sustainability, and to a more equal distribution of the benefits of growth. The 11th Five-Year Plan (2006–10) addresses this balance, with special emphasis on harmony with society and the environment. It also emphasizes maintaining growth. For this rapid and balanced growth, reforming and strengthening public finance is crucial.

The Role of the State and Public Finances

Profound structural changes in China during the last quarter of the 20th century transformed the economy, society, and state. China's public finance, among the main forces driving change, has also been reshaped (see chapter 2, by Hussain and Stern).

Government Spending

Changes in government spending reflect the structural transformation of the Chinese economy and society over the reform period, particularly the transition from plan to market (see chapter 3, by Dollar and Hofman). Before the reform period, it made little difference to public finances whether an expenditure item was financed by enterprises or directly by the government. After China embarked on reform, particularly after the separation of enterprise budgets from government budgets, the division of financing between enterprises and government assumed major importance, because expenditure liabilities carry with them the responsibilities for financing them.

As structural reform deepened, government investment in industrial and other economic activities fell sharply. The share of capital construction financed by the government budget shrank, from more than 40 percent in 1978 to 12 percent in 2004, and the share of expenditure devoted to culture, education, and health rose steadily. This change was in line with the shift in responsibility for providing social goods from enterprises and other units to the governments. The process has been far from smooth. In 2004 spending on pensions, social welfare, subsidies on consumer goods, and off-budget expenditures for social insurance represented 13 percent of gross domestic product (GDP).

China's public spending of 3.1 percent of GDP on education and 1.8 percent on health (in 2005) is lower than the 5.9 percent and 6.7 percent for high-income countries and the 4.6 percent and 3.8 percent for upper-middle-income countries (Dahlman, Zeng, and Wang 2007). These low levels explain the slow improvement in China's health and social services in the past quarter century. Similar discrepancies exist in social insurance, which by design targets urban residents in regular employment and the state sector. The urban labor force in small business and services, including rural migrants, and the large rural population are not covered by formal social insurance.

General government revenues rose from less than 10 percent of GDP in the mid-1990s to 18 percent in 2005. The overall fiscal envelop may have reached 25 percent of GDP in 2006, if extrabudgetary revenues of 3 percent, social security contributions of 2–2.5 percent, and a deficit of 2–3 percent of GDP are included. But China still confronts significant contingent liabilities, and further spending pressures are likely to arise from the pension system, especially as the population ages, and from government programs to address regional disparities, including spending for health, education, and environmental protection (see chapter 4, by Ter-Minassian and Fedelino).

Fiscal Reform and Revenue Assignments

In chapter 5, Martinez-Vazquez, Qiao, Wang, and Zou maintain that expenditure reform should focus on education, health, and social security, particularly in rural areas, to boost participation in growth and domestic consumption. Primary and

secondary education should be free, with higher education financed by fees and loans, and medical insurance and social security should be universal.

China's current tax system is the outcome of successive fiscal reforms starting in the early 1980s. A consistent feature of these reforms has been the emphasis on improving revenue assignments and transfers. One major success was the tax-sharing reform, introduced in 1994, to increase the share of government spending in GDP and the share of central budgetary revenues in total budgetary revenues. The reform introduced clear and stable assignments of tax revenues between the central and provincial governments. It also created separate tax administrations at both levels of government. And it introduced the value added tax (VAT) as the major source of government revenue. Several subsequent policy changes—such as the rural tax-for-fee reform and the abolition of agricultural taxes, reducing the tax burden on farmers—have supplemented the tax-sharing system.

The current tax system requires further reforms to enhance revenue elasticity and address gaps and distortions (see chapter 6, by Ahmad). Sound principles of tax design—broadening the tax base, moving to taxes with the potential for revenue growth, seeking the smallest possible distortion, promoting fairness, and simplifying and keeping down the costs of administration and compliance—will have to be respected (Feldstein 2006).

Tax reform could take a variety of directions:

- Increase personal income taxes, now only about 7 percent of revenue and 1 percent of GDP, by increasing the base of the personal income tax to include all forms of cash income and payment for housing and by increasing the payroll tax, to collect more revenue with lower tax rates.
- Increase consumption or excise taxes on goods with negative externalities, particularly alcohol and tobacco.
- Raise taxes on energy use that damages the environment, particularly coal and gasoline.
- Shift the base of the VAT from production to consumption and extend it to services, to align it with international practices, and rationalize its administration and refund system.
- Unify the enterprise income tax regime for domestic and foreign firms to streamline tax incentives.
- Rationalize tax attribution mechanisms with tax sources to avoid unequal distributions of interregional revenues and to minimize harmful interregional tax competition.
- Review revenue-sharing formulas to ensure adequate vertical and horizontal balances among and within different levels of government.

Intergovernmental Relations and Fiscal Transfers

China is more decentralized than member countries of the Organisation for Economic Co-operation and Development (OECD) and other large middle-income

countries, particularly on the spending side. The country's sheer size explains some decentralization, but the structure of government and some unusual expenditure assignments also give rise to this spending pattern. In most countries, social security, education, public health, and justice are centralized. In China they are largely decentralized. Among subnational governments, subprovincial governments account for more than half of government expenditures. Such decentralization can improve the public sector's efficiency by using the information advantage of local governments to match the needs and preferences of local residents. But the mismatch between expenditure and revenue assignments has opened vertical financing gaps in lower tiers of government, increased regional disparities, and left basic public and social goods underprovided.

Intergovernmental fiscal transfers to correct vertical and horizontal imbalances produce interjurisdictional spillovers and promote national objectives. Equalization grants and special-purpose transfers can reduce vertical imbalances and the mismatch between expenditure responsibilities and own revenues for subnational governments. The fiscal transfer system transfers large sums of money objectively to the four tiers of subnational governments, enabling provincial and local governments to deliver public goods and services better than most developing and emerging market economies. Yet the system has limitations.

With more modern taxes, particularly the VAT, and with a more integrated and mobile economy, the reform of the tax-sharing system in the mid-1990s reversed the downward trend in government revenues and the central government's share. But local tiers kept many expenditure responsibilities, despite falling shares of local revenue. This produced large disparities in the distribution of local public services and social security across regions and between urban and rural areas. The current system of transfers does not sufficiently reduce the disparities between rich and poor areas. Special-purpose programs emphasize input controls, with few incentives for service delivery or accountability for results (see chapter 7, by Shah and Shen).

China's approach to reforming the system of transfers is evolutionary. It focuses on redistributing incremental revenues above a "hold harmless" transfer equivalent to all transfers before the reform in order to avoid major disruptions and ensure buy-in from local governments. This approach appears to have worked well (see chapter 8, by Lou). Reform of tax-sharing below the provincial level could bring further change to almost all aspects of the intergovernmental fiscal system.

Intergovernmental fiscal relations will require reform if public finance is to support the 11th plan's objectives for growth and harmony. Local governments require the resources to match their responsibilities. They also require discretion to adapt to local conditions and be accountable to their communities. This would imply reforms in the following areas:

- Pass more revenue downward—that is, reform the system of transfers from higher to lower levels of government to increase the resources available to lower tiers, particularly the poor and rural areas.

- Pass some financing responsibilities upward—that is, reallocate some responsibilities for financing basic services from lower to higher government tiers.
- Within the limits implied by tax coordination between government tiers, extend the powers of lower government to levy taxes—including “piggy backing” on top of central taxes and poverty taxation—and to set own tax rates within a defined band.
- Establish a framework for fiscal transparency, responsibility, and accountability.
- Rationalize and simplify the fiscal equalization programs.
- Institute national minimum standards grants for such merit goods as education, health, and infrastructure.

One loophole that loosens the budget constraint on subnational governments requires early attention. The 1994 budget law forbids subnational governments from borrowing on capital markets. However, through local enterprises (public utility companies, special purpose vehicles, and urban development corporations that provide public services) they can still borrow indirectly from banks and on the capital market to finance infrastructure and much other subnational spending. This creates contingent liabilities for subnational governments, and it may compromise the central budget, possibly jeopardizing macroeconomic and financial stability. And given the lack of transparency, it is less easily controlled than explicit government borrowing. The ban on subnational borrowing has not worked, and cross-country experience shows that allowing subnational governments to borrow can confer benefits only under an effective framework to discipline borrowing (see chapter 9, by Liu).

Instead of implicit off-budget borrowing, China could move to an effective regulatory framework with well spelled-out rules to govern borrowing (purpose, information disclosure, insolvency mechanisms). Such a framework would enable subnational governments to borrow while mitigating the risks. Subnational borrowing can expand the fiscal space for infrastructure investment to support China’s rapid urbanization while facilitating efficient and equitable financing. The rationalization of subnational borrowing would also enhance transparency and increase the role of markets in fiscal surveillance.

Provision and Delivery of Public Services

Subnational expenditure responsibilities in education, health, and social security are the legacy of the industrial restructuring process, as traditional responsibilities in education, health care, and pensions were shifted from state-owned enterprises to local governments. China’s performance in delivering these services compares favorably with other developing and transition economies, but many areas still need to be improved.

Public Education

China has expanded access to education at all levels, improved adult literacy, and provided training and retraining to rural migrants and urban workers laid off by

state-owned enterprises. Primary enrollment is now virtually universal. The gross enrollment rate is 94 percent at the junior-secondary level, 47 percent at the senior-secondary level, and 21 percent at the tertiary level. In 2005 China produced 3.4 million graduates, including 151,000 with postgraduate degrees (National Bureau of Statistics 2005). This prodigious growth in graduates presages a significant increase in China's share of world skills and its competitive advantage in producing skill-intensive products (Winters and Yusuf 2006).

But educational attainment is still low by OECD standards. This constrains China's ability to absorb the new knowledge necessary to maintain and increase competitiveness and to redeploy workers from low-productivity jobs and sectors to higher-productivity ones. And educational disparities are widening among and within provinces, and between rural and urban areas. Unbalanced regional development and differences in the fiscal strength and revenue capacity of subnational governments are part of the reason. Another part is the way education and training are financed (Dahlman, Zeng, and Wang 2007).

At 3.2 percent of GDP in 2001–03 and 2.8 percent in 2004, government spending on education, though growing, is still much less than in developed and other comparator countries. Public spending per student improved significantly during the past decade, especially in the tertiary sector, but it remains low compared with developed countries, and it failed to reach the government's objective of 4 percent of GDP for 2005. Counties and townships together account for 70 percent of budgetary expenditures on education, and many of these lower tier governments end up with expenditure responsibilities far in excess of the revenue at their disposal. The limited public funding has shifted financing responsibilities to families (see chapter 10, by Dahlman, Zeng, and Wang).

In 2006 China took steps to improve compulsory education in rural areas in the poor western regions. It abolished tuition fees and increased appropriations of budgetary rural funds for education in accordance with the student per capita standards stipulated by each province or municipality. It also shifted the management of primary and middle schools from townships to counties. China is considering further financial measures to fully implement nine-year compulsory education and expand vocational education for young farmers and migrant workers.

These are positive developments. But turning the ostensible burden of a large population into a strategic advantage is a daunting challenge. Financing the expansion and improvement of China's education, training, and retraining system entails about 6–9 percent of GDP, far beyond the scope of government finance. Current education spending is about 4.9 percent of GDP, with the government share at about 3 percent, less than half of what is required. The government should focus on the public good aspects of education and training—compulsory education and some aspects of higher education and training. It should build broad partnerships and multiple pathways to tap different financial sources. It should also move from being the controller and sole provider to being the architect, coordinator, facilitator, integrator, monitor, innovator, and quality assurer.

Innovation for Growth

Relying heavily on vast inputs of capital and labor, China's investment rate is close to 46 percent of GDP, more than 20 percentage points higher than the global average and higher than any other country. The allocative efficiency and the quality of investment are still relatively low. An analysis of the sources of growth indicates that 60–75 percent is from factor inputs, mainly capital, and 25–40 percent from total factor productivity. This resource-intensive growth pattern cannot be sustained. Water and air pollution and land degradation and desertification are severe. Moreover, the share of high-value-added products produced by new and high-tech industries is low. In 2005 processing accounted for 57 percent of the country's total foreign trade, and few exported goods were proprietary products: 80 percent of the garments exported by China carry foreign brand names.

In the medium and long runs, China's growth and the competitiveness of its firms will be linked to innovation and technological capability. How this capability evolves will depend on investments in research and development (R&D), science and technology workers, information technology, and complementary institutions—investments in a national innovation system (Sigurdson 2005). Tax credits and depreciation allowances affect the readiness to conduct research and commercialize findings, so fiscal policy can shape the innovation system (Yusuf, Nabeshima, and Wang 2007).

China could considerably improve the allocation and efficiency of its rapidly growing investments in R&D and to strengthen the mechanisms to speed the transfer of research results into effective economic application. This requires better allocation and monitoring of direct public R&D and commercialization. It also requires effective mechanisms to support private R&D and commercialization. In this China has much to learn from the United States, Europe, and Japan, which have longer track records of financing and creating new knowledge and turning it into economic and social advances (Dahlman 2007).

Research at universities will be encouraged both by the availability of funding and by the strengthening of institutions that assign and safeguard intellectual property. The allocation of funds needs to be competitive, with multiple providers, public and private. The protection of property rights should not stifle innovation or unleash a wave of litigation. For companies, tax credits and depreciation allowances are proven inducements. In some cases, government procurement might ease the risk of embarking on costly research.

While large companies will be the major investors in research, smaller ones are more likely to come up with creative ideas that can change the direction of or even transform an industry or market. These firms benefit from intermediaries that can help them bridge information gaps and link them to researchers in universities. They also need venture capitalists to screen research offerings and help commercialize the most promising ones. Policies that establish such intermediaries

and encourage private venture capitalists have a vital role in building a dynamic innovation system (see chapter 11, by Yusuf and Nabeshima).

Public Health and Health Care

The decline of public spending on health over the past decade sharply increased out-of-pocket spending and reduced health insurance coverage. China's health care system, once a beacon for developing economies, now suffers from inequality and other new challenges. Why is health care so unaffordable? What happened to health insurance and to public health programs?

Designing and operating the health system and medical insurance represent big challenges. Spending rose in response to the outbreak of SARS (severe acute respiratory syndrome) in 2003, but it still leaves a large shortfall. Rapidly growing private expenditures now make up nearly 60 percent of total health expenditures—worrisome for both equity and efficiency.

The government recently embarked on a new rural health insurance scheme, a new medical expense safety net for rural residents, and a network of centers for disease control to improve access and to reduce the risk of a financial catastrophe. These policy actions and institutional arrangements have been accompanied by an increase in government spending on public health, both capital and recurrent (Gao 2006).

A universal basic medical care system that covers all citizens is essential to safeguard health and reduce health risks—and to build a harmonious society. That will require additional and better-targeted resources for public health and for new cooperative medical schemes in rural areas (see chapter 12, by Evans and Xu). Reducing inefficiency in service delivery and aligning care with medical needs and the resources available in poor rural areas are other key challenges (see chapter 13, by Wagstaff and Lindelow).

Pension Reform

Addressing the needs of older people requires a well-designed social security system and proper handling of the system's transition and legacy costs. Industrial restructuring and market reform initiated in the late 1970s dismantled formal and informal social security, requiring the creation of a new system. The reform effort started only in the early 1990s. In the late 1990s, a two-tiered partially funded pension system combined social pooling with individual accounts. Social pooling is done through a mandatory pay-as-you-go defined benefit system. The individual account is a funded defined contribution. Inspired by reforms in other countries, China adopted the basic framework in line with the requirements of a market economy and consistent with the global trends in the development of pension systems (see chapter 14, by Li, Dorfman, and Wang). Some foreign researchers see the new system as attractive because it combines basic social pooling and personal accounts. But the reform is far from complete. As some Chinese experts recognize, the system is characterized by regional segregation and narrow

coverage, and it has trouble paying benefits. The implicit pension debt is very large, and there is no clear strategy for financing that debt. The deficit in the general pension pool thus has to be offset with funds contributed to individual accounts, leaving them empty.

Some basic principles should govern the social security system. Programs should be based not on poverty but on age, ill health, and unemployment, while fiscal policies should aim to reduce poverty but not inequality. Complex programs of social security should be tailored to local economic conditions and stages of development. Comprehensive programs financed by the government through high taxes could weaken economic growth and employment and so must be avoided.

Legacy costs and implicit pension debts are so large that dealing with them will affect the choice of the social security model. Legacy costs in China represent nearly all current expenditures—that is, payments to former employees of state-owned enterprises. One option would be to separate the legacy costs, treat them as a part of the national debt, and finance them at a low current cost (see chapter 15, by Feldstein and Liebman). Because the benefits of the transition of the social security would be shared by future generations, the costs of transition and the legacy costs should be shared over many generations, too. China may not need to finance this debt as obligations come due. It has alternative revenue sources to reduce the debt, such as selling state assets, including state-owned enterprises and land, and drawing on foreign reserves.

Retirement age is another issue that needs to be addressed. China's life expectancy is similar to that in developed countries, but its employees retire earlier—at 55 for women and 60 for men. One concern of Chinese policy makers is the impact on the labor market of increasing the retirement age. Would it reduce job creation? In theory, the number of jobs would respond to the availability of labor, and a flexible wage mechanism would allow the labor market to reach equilibrium in the medium and long runs.

The government is now striving to establish a sustainable social security system commensurate with its economic development. Its efforts are restoring the integrity of individual accounts without affecting the payment of current pensioners; lifting fund pooling to the provincial level to balance income and expenditure in the pension system; and developing and extending the coverage of social security to rural areas, particularly for landless farmers and migrant workers.

Maintaining Growth and Addressing Inequality

With the economy growing at more than 9 percent a year, China has witnessed an almost continuous increase in income inequality. The Gini coefficient rose from 0.30 in the early 1980s to 0.47 in 2006 (0.42 if corrected for different price levels across regions). Urban-rural, intra-rural, intra-urban, and coastal-inland inequalities have all been on the rise since the 1990s. In many aspects China's experience is similar to that of the Western developed nations in their initial growth stage. The increase in inequality during the first stage of growth—during which individuals

move from lower-productivity and -income activities to higher-productivity and -income activities—is fully consistent with Kuznets’ theory of growth.

Whether inequality eventually declines on its own during the next stage of growth or some kind of redistribution policy needs to be put into place remains an open question. A policy challenge is to avoid the worst exclusions while maintaining the incentives to accumulate income and take risks. China could combat the increase in inequality and inequity with instruments similar to those used in the Nordic countries while exploring innovative policies appropriate to its circumstances.

The *Di Bao* program is an urban minimum living standard guarantee program that helps move people out of poverty. It is a good starting point from which to create a full social insurance system that preserves market incentives (see chapter 16, by Ravallion, Chen, and Wang). Redistribution should be only part of the overall strategy. China should try to increase equity by guaranteeing equal access—to education, health care, credit, and decision making about public goods—to all citizens, so that they can fully realize their economic potential. Other policy actions may include easing restrictions on migration, supporting rural development, increasing the progressivity of the tax system, and reallocating spending. By ensuring equal opportunity, China will continue to enjoy rapid growth, with inequality stabilizing and even declining over time (see chapter 17, by Bourguignon).

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