

Budget reform in China: Progress and prospects in the Xi Jinping era

by
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Fiscal reforms were central to the comprehensive programme of reforms announced at the Third Plenum of the 18th Party Congress in November 2013, during the first year of the Xi Jinping administration. One of the significant reforms on focus is public financial management (PFM). The urgency of PFM reform can be traced, paradoxically, to the extraordinary growth experienced by the Chinese economy during the first decade of this century, when easy money and weak accountability gave rise to unprecedented waste, corruption, and a mountain of local government debt.

The proposed fiscal reforms are aimed at fixing these problems. They are ambitious and comprehensive, and are well designed to improve PFM, and the quick rollout of legislation has provided strong legal support. However, they face significant obstacles to successful implementation, among them the challenge of finding a resolution to the local government debt crisis while maintaining stable economic growth.

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1. Introduction

After three decades of remarkable growth and development, the Chinese leadership is confronted with a very different set of challenges to those faced by its predecessors at the outset of embarking on market-oriented reforms. China was then a poor but relatively well-educated and egalitarian country, with an abundance of surplus labour in the rural sector and very little interaction with the global market. A series of measures to increase the scope of the market and facilitate the transfer of labour from agriculture to industry were all it took to launch China's economic lift-off. Now, China is an upper-middle income country with emerging shortages of manual labour and dominates the global supply of low to mid-end manufactured goods and global demand for most commodities, but the traditional model of extensive growth dependent on exports and investment appears to be running out of steam.

The Xi Jinping administration has acknowledged that a major shift is required by announcing a new era of 'comprehensively deepening reforms' that was endorsed at the Third Plenum of the Chinese Communist Party's 18th Congress in November 2013. The 60-point "Decision on Several Major Questions about Deepening Reform"¹ spelt out an ambitious, comprehensive agenda containing 336 reform initiatives under 16 broad headings that cover all parts of the economy, society, the political system and its institutions. Together, the measures are aimed at restructuring the roles of government and the market, with modernising governance being the ultimate goal of the programme.

The Third Plenum Decisions (TPD) identified fiscal reform as a key priority. Writing in the Party journal *Qiushi*, the Finance Minister Lou Jiwei explained that China's fiscal system has not kept up with the needs of the growing and increasingly complex economy, and "... the defects have become increasingly apparent: the budget management system is not standardised, transparent, or suited to the requirements of modern governance; the tax system... is not conducive to supporting the shift to the new development paradigm,² social fairness, or market integration. The division of responsibilities between the central and local governments is unclear and unreasonable... These problems affect not only the stability and sustainability of the fiscal system itself, they also (adversely) affect the national development strategy and the effectiveness of macroeconomic policy."³ He argued that "in this round of reform, small patches and fixes will no longer suffice", but that a fundamental reform of the fiscal system is needed to build the foundation able to support the modernisation of governance called for by the TPD.

Fiscal reforms have led the way in the TPD reforms, with many measures and initiatives rolled out in quick order. In June 2014, the Politburo approved the "Overall Programme for Deepening Reform of the Fiscal System", authorising comprehensive reform of the fiscal system. In August 2014, the Standing Committee of the National People's Congress approved a revised Budget Law that sets out provisions mandating numerous changes and, for the first time, authorises local governments to borrow for capital investments.⁴

Working at the compressed pace set out in the TPD, which called for the whole reform programme to be implemented by the year 2020, Minister Lou announced at a press conference in mid-2014 that the first phase of reform would focus on budget and public financial management reforms, Phase 2 would begin in 2015 with a focus on reforms of the tax system, and Phase 3 would begin in 2016 to focus on intergovernmental fiscal reform (Han Ji, Gao Li, and He Yuxin, 2014).

This paper examines the state of the budget in China today and reviews the proposed reforms in public financial management to offer a preliminary assessment of their prospects. The rest of the paper is organised as follows: Section 2 reviews the fiscal reforms implemented in the 1990s through the first decade of the current century. Section 3 discusses the current situation and the proposed reform programme in public financial management (PFM). Section 4 provides a preliminary assessment of the programme's prospects and a brief conclusion.

2. The fits and starts of fiscal reforms through 2010

The first major reform of the fiscal system was enacted in 1994, when the Tax Sharing System brought in a new system of taxes centred around the value-added tax (VAT), a business tax, a corporate income tax, a personal income tax, and several taxes on property, land transactions, and land use. These are broad-based taxes with uniform rates of levy. They replaced the complex system with hundreds of product-specific industrial-commercial taxes transplanted from the Soviet economic system, and began to separate government finances from those of state-owned enterprises (SOEs), by introducing an income tax on profits to replace the previous negotiated profit remittances. While the new tax system was far from perfect, it represented a huge improvement in simplifying the tax structure, eliminating distortionary elements and increasing transparency, and it greatly facilitated tax administration and the monitoring of tax capacity across regions. Along with the creation of a new national tax administration, this system restored the government's revenue mechanism and reversed the steep fiscal decline that had characterised the first two decades of market reform (Wong and Bird, 2008).⁵

Under the planned economy, the budget was not a significant policy instrument. It was simply the financial counterpart to the economic (physical) plan where the government's allocative decisions were embedded. Budget preparation simply followed the plan, and financial performance was of secondary importance. Even as the budget gained increasing importance when the planned economy and its allocative instruments were gradually phased out in the 1980s and 1990s, the government was slow to recognise the urgency for installing a public financial management system to manage the government's finances, as all attention was focused on finding a way to revive the revenue mechanism.

Public financial management reform finally began in 1999, when the government introduced a broad package over the following 3-4 years that included reforms in budget preparation, budget classification, treasury management, government procurement, and the installation of new fiscal information systems (Wong, 2005). New procedures were introduced for budget preparation and approval, and budget reporting to the National People's Congress was strengthened. Departmental budgets were introduced alongside the traditional functional allocations (e.g. appropriations for "education" were distributed to all ministries and agencies with responsibility for education and training), aimed at clearly

identifying all resources and expenditures for each government department, as the first step toward building a system whereby spending units could be held accountable for the public monies they receive.

A treasury single account was created to manage the government's cash receipts and payments. To support treasury reform and improved budgeting, the MOF began work on a new government financial management information system. A new budget classification system was rolled out in 2006 to improve the tracking of expenditure by functional categories. Standardised procedures for government procurement were introduced to improve cost efficiencies and reduce the scope for corruption, adopting many of the procedures of international organisations for tendering large-scale purchases of equipment and services. With these reforms, China had begun to put in place the basic infrastructure for a modern system of budget management, but the real work was just starting. Many of the reform measures require extensive training and dissemination to be put in place, with full implementation often taking a decade or more. In China, the biggest task was to ensure implementation of the reforms at the subnational levels, where 85% of China's public expenditures take place.

By 2004-05, however, it appeared that these reforms in PFM had stalled across-the-board. From the outside, it is hard to know exactly why this happened, but a compelling narrative can be put together from the macroeconomic trends over this period to show that reform efforts were likely to have been overwhelmed by the sheer size of the ramp-up in public expenditures.

In economic growth terms, the first decade of the 21st Century was a golden era for China. Joining the World Trade Organization had opened up wider access to global markets, and China rode the exceptionally buoyant global trade and investment to achieve double-digit growth rates in per capita GDP. Even when the global financial crisis hit in 2007, and while much of the world struggled through years of recession and stagnation in its wake, China continued to race ahead with only a brief slowdown in 2009 thanks to its massive stimulus programme. As a result, per capita GDP growth averaged an astonishing 13.2% p.a. during 2000-12.⁶

During this growth spurt, government revenues grew even faster, at an annual rate of 22%! By mid-decade, the government coffers were overflowing, and the government spent lavishly. This fitted well with the populist stance adopted by the government from 2003 onwards, when Hu Jintao and Wen Jiabao came into office vowing to rebalance public spending to improve services, and especially to "tilt" in favour of the rural areas to reduce their shortfall in provision. Under the banner of the "harmonious society" adopted at the fourth plenum of the 16th Communist Party Central Committee in September 2004, Beijing began to pump resources into expanding the social safety net to include rural citizens and into improving the provision of social services (Wong, 2010).

Many new programmes were introduced with central government subsidies, including the rural fee reform, the free rural education reform, the rural co-operative medical schemes, income support for farmers under the rural minimum living stipend scheme (*dibao*), and the universal rural pension (World Bank, 2007). Lin and Wong (2012) counted the introduction of no fewer than 12 programmes of subsidies that were aimed directly at farm families between 2001 and 2007, from seed subsidies to farm machinery subsidies to crop insurance subsidies to subsidies for buying household appliances.

Typically the programmes began modestly, but were often ratcheted upwards rapidly as more revenues became available. For example, the free rural education programme began in 2001 as a small programme providing subsidies to finance free textbooks and offset school fees and boarding subsidies for children from impoverished households in the designated poor counties, and was unexpectedly expanded in 2006 to cover all school fees for all students in rural primary and middle schools (Brock, Hu and Wong, 2008). Likewise, the rural health insurance scheme started in 2003 with an annual subsidy of CNY 20, which grew 15-fold within a decade to CNY 300 for each of the programme's 800 million-plus participants.

Many of these 'harmonious society' programmes are huge in size: providing free rural education covers some 140 million students, the rural co-operative medical scheme had, at its peak, more than 830 million participants, and the universal rural pension scheme likewise has a potential beneficiary pool of more than 800 million.⁷ These programmes have added hugely to budgetary expenditures at the county level – the level responsible for the provision of rural services – agricultural services, education, health care, social welfare and pensions. As a result, the vertical share of total national budgetary expenditures at the county level has risen from 26% to 43% during 2000-10, compared to just 18% for the central government. On the ground, this means that an "average" county has seen its budget grow ten-fold within a decade, from CNY 200 million to CNY 2 billion by 2010!⁸

2.1. Sleepwalking into a quagmire

A salient feature of the policies of the Hu-Wen administration was that they were implemented with no adjustment to the central-local revenue-sharing arrangements. Instead, all the burden of financing was put on the use of transfers. During the decade, central government transfers to local governments grew from CNY 254 billion in 2000 to CNY 2.73 trillion in 2010 (*China Statistical Yearbook*). Moreover, in China's fiscal system, these transfers have to be passed down level by level – from Beijing to the provinces, from provinces to the municipalities, and from municipalities to the counties. The administrative burden of managing the proliferation of new programmes and the rapidly growing transfers to fund them must have created an extraordinary strain on the bureaucracy at all levels. Studies such as Wong (2010) and Lin and Wong (2012) have pointed to the government's lack of capacity to monitor and evaluate the programmes as a constraint to achieving desired policy outcomes, citing problems that ranged from poor programme design to coarse financial management to unresponsive services. While many benefits have accrued from the new programmes, they were also marred by wastefulness, programme capture, cost inflation, and even ghost teachers and ghost schools, etc. Another side effect of this onslaught of new programmes and new monies raining down from higher levels was probably that efforts to implement reform were shunted aside as everyone just tried to cope with the flows.

The neglect of institutional reform over the past decade was even more damaging in the cities (Wong, 2013a, 2013b). Since market reforms began 35 years ago, people have flocked to the cities. As China's urbanisation rate rose from 20% to more than 50%, more than 500 million new urban residents have been added. During the decade of 2000-10 alone, the urban population grew by 210 million.

Around the world, governments struggle with the task of providing infrastructure and public services in the course of urbanisation (Bahl, Linn and Wetzel, 2013). In China, amidst the steep and prolonged fiscal decline in the 1980s and 1990s, the government simply had

few resources to devote to the needs of urbanisation. Instead, political leaders tolerated and indeed encouraged the use of informal, backdoor practices that enabled cities to obtain the resources needed, and so China's municipalities came to rely overwhelmingly on extra-budgetary resources (Wong, 2009, 2013a). With rapid urbanisation pushing up the price of land, land quickly became the biggest source of extra-budgetary revenue. In recent years, receipts from land sales⁹ have accounted for a third to a half of all revenues for first- and second-tier cities.¹⁰

To finance infrastructure needed to support urban growth (schools, public transport and urban facilities), Chinese cities – like their counterparts around the world, also borrowed. Since they were, until the recent change, prohibited from direct borrowing, cities borrowed off-budget, through quasi-public financial entities set up as enterprises under government departments. These local investment corporations (LICs) – variously named City X Development Corporation, etc., undertook to co-ordinate and finance the construction of facilities such as water supply, sewerage, roads, and utility hook-ups. Typically, they raised and bundled together bank loans and other financing, using a variety of municipal assets including budgetary and off-budget revenues as equity and collateral, with land playing a principal role in providing the financing as well as collateral (Wong, 2013a).

This extra-budgetary financing from land sales and off-budget borrowing developed largely outside the purview of government financial oversight.¹¹ While it helped greatly to expand the financial resources available and was instrumental to enabling the dynamic urbanisation that took place over the past two decades, it also sowed the seeds for some of the most intractable problems facing the Xi Jinping administration today. The symbiotic relationship between land sales and LICs led inexorably to the overuse of both, resulting in excessive land takings, urban sprawl, and the creation of excess capacity in industry as cities competed for job-creating investment to raise land values. And the easy access to money from land and LICs also led inexorably to wasteful and inefficient investments and even ghost cities, along with graft and corruption on an unprecedented scale.

3. The current reform programme

Paradoxically, then, even as it appears that China is at a pinnacle of economic success after a decade that saw it claiming a number of world-beating accomplishments – when it became the world's largest manufacturer in 2008, the largest exporter in 2010, and passed Japan in 2012 to become the second largest economy behind the US, etc., the view from the top leadership is that the country is facing unprecedented challenges. The programme of sweeping reform endorsed by the Party Congress in November 2013 was manifestation of that view.

Many of the provisions in the revised Budget Law (BL) and associated documents are aimed at correcting the problems just described: to rein in local government debt, rein in extra-budgetary revenues and regain macroeconomic oversight of fiscal resources, improve transparency of the budget, and strengthen accountability by, among other things, providing better legal foundations and oversight by the National People's Congress. The BL also sought to improve the efficiency and efficacy of intergovernmental transfers by specifying the principles and objectives for their establishment and their budgeting methodology, as well as the timing of provision (Articles 16, 38 and 52). To limit the use of earmarked transfers, the BL emphasises the need to conduct regular appraisal and set exit mechanisms for them.

In a press conference just after the Law's passage, Minister Lou Jiwei explained that one of the key provisions in the budget law states that budget management should be **comprehensive**: "All revenues and expenditures of government should be included in the budget" (Article 4), and that government expenditures must include all government activities, including local government debt, and that this comprehensive budget must be supervised by the people's congress. To combat corruption, Minister Lou noted that the new budget law emphasises budget transparency, to stem the problem at the source. For the first time the BL make comprehensive provisions on "**budget openness**", with clear rules on the scope, timing and specifics of disclosure requirements for key items such as transfer payments, government debt, and departmental budgets for public agencies (Article 14). It also specifies legal liabilities for the breach of these budget disclosure norms (Article 92).

Among the most important provisions in the BL is the authorisation given to provincial governments to borrow, but under tight supervision by the central government as well as the provincial people's congress. Under the call to "open the front door, lock the back door, and build walls around it", the BL stipulates that local governments must report on the purpose, size, mode of debt, along with specifying the mechanisms of supervision and legal liabilities (Articles 35 and 94). The BL was followed a month later by the issuance of *State Council Document No. 43*, which laid out an ambitious plan to tackle the stock of existing debt and to lay out a structure for managing local government borrowing, starting with separating LICs from local government finance.¹²

In this first phase of reform, the efforts are all focused on PFM and regaining control over the budget and allocative processes. It is only in phase 3 that reforms will turn to addressing issues of the intergovernmental fiscal system. This sequencing makes sense in light of the severity of the problems of local government debt and extent of extra-budgetary financing. The progress of these reforms, though, may be hindered by some potential sources of resistance. I will note just three below.

The first and most immediate source of resistance is aimed at the effort to shut off bank lending to LICs and move it into the more transparent and regulated channel of debt issuance, which is seen as an important step toward bringing local debt under control and regaining fiscal discipline. The dilemma is that in recent years local governments have grown reliant on land revenues and LICs to finance public infrastructure at very robust levels, and these investments have been a big part of China's investment-driven growth dynamic. Weaning local governments off these sources of finance is to force them to deleverage – a necessary step for rebalancing the economy, but one that risks setting off a fiscal crunch as local governments cut back on investment. The on-again, off-again clampdown on LICs in the past 3 years has already helped to deflate the housing market and significantly raised the threat of defaults since local governments and LICs are perilously dependent on land sales to service their debt. Unease with the slowing growth has already led to some provisions of the reform being reversed. On 15 May 2015, the State Council ordered banks to continue lending to LICs that have projects under construction, substantially reversing the earlier edict (Anderlini, 2015).

Effective PFM requires that the budget be comprehensive, and include all fiscal revenues, expenditures and liabilities. In the past, PFM reform efforts had focused only on the budget execution aspects of financial management – expenditure control, treasury, accounting and procurement), and paid insufficient attention to debt and the financial

risks, especially at the subnational levels. The current reform aims to fix this gap, and the new BL and the State Council Document No. 63 that followed in December laid down a mandate for governments at all levels to compile and release to the public a comprehensive government financial report to include not only on-budget revenues, expenditures and direct debts, but also a balance sheet of government assets, liabilities and a statement of cash flows.

The new government financial reporting system (GFRS) is called upon to provide an accurate and comprehensive reflection of government financial outcomes, as a basis for strengthening public resource management, increase efficiency, and guard against fiscal risks. The new GFRS will be built on modified accrual accounting rules, and will have much expanded coverage in both reporting entities and contents. It will be far more demanding of the bureaucracy and require many methodological changes. Some of the changes will likely affect the relationship between government and the reporting entities in fundamental ways, starting with the selection and classification of entities, which moves budget reform immediately into politically contentious territory.

Under the principle that government finance reporting must include all entities that have material impact on the government's fiscal position (IMF 2015), all state-owned enterprises (SOEs) – including LICs – must be included. The exclusion of SOEs has long been a blind spot in budget reporting in China given that their financial interaction with government has remained fluid and fuzzy, especially at local levels. The SOE sector is huge. Nationwide there are hundreds of thousands of SOEs; in 2013 more than 18 000 large ones had annual revenue of more than CNY 20 million in their main activity.¹³ They had assets totalling CNY 34 trillion, and were distributed across all provinces. In Beijing alone there were 790 of these large SOEs, with assets of CNY 2.3 trillion and debt of CNY 1.2 trillion.¹⁴ Given their size and potential impact on government finances, a reform to include them in government accounting is long overdue. Resistance to letting go of SOEs has made SOE reform among the slowest-moving components of the Xi Jinping reform programme, however, and the effort to incorporate SOEs in budget reporting is more likely to be bogged down than act as a spur to the much needed debate on state-market relations.

Finally, given the highly decentralised pattern of public expenditures in China, where the central government accounts for only 15% of public expenditures, PFM reform depends critically on its implementation at the subnational levels. As PFM reforms aim to curb extra-budgetary resources and activities, they are seen as depriving local governments of autonomy, and will be met with much foot-dragging. History from the 1990s is not encouraging, when the take-up of the new PFM processes was slow and uneven at subnational levels. More than 15 years after the first round of PFM reform called for increasing transparency and adopting uniform reporting standards, for example, information on local budgets remains spotty and uneven, and few provinces release information on transfers to lower levels (Wong, 2013a). In China's hierarchical but delegated system of level-by-level administration, the central government has only attenuated control over subordinates.

4. Summary

In summary, this brief review of the fiscal reform being implemented has found much to praise in the package of proposed reforms – it is ambitious and comprehensive, addresses many of the key problems in the existing system of public financial

management, and the measures are well designed to build the foundation for good governance. The quick rollout of legislation and regulations from the State Council has to date provided strong support to implementing PFM reforms in the first phase. At the same time, I have also identified some key obstacles to the implementation of these measures. Building a robust system of public financial management is but the first (and critical) step in fiscal reform. The key part is yet to come, which is to realign and rationalise the system of intergovernmental fiscal relations, the linchpin of effective management of a large, multi-level fiscal system that has for so long been missing in the Chinese economy. To push through implementation of these critical PFM reforms against fierce headwinds, Minister Lou will need a forceful intervention from the top, and soon, to maintain the current momentum.

Notes

1. “Decision of the Chinese Communist Party Central Committee on Several Major Questions about Deepening Reform” (中共中央关于全面深化改革若干重大问题的决定), http://news.xinhuanet.com/politics/2013-11/15/c_118164235.htm.
2. As early as 2002, the government announced its goal of shifting to a development paradigm that promotes services and consumption in place of industry and investment (Wong, 2010).
3. Lou Jiwei (2014), “Deepening Reform of the Fiscal and Tax System to Build a Modern System of Public Finance” (深化财税体制改革, 建立现代财政制度), *Qiushi* 2014/20, 13 October.
4. National People Congress Standing Committee, “Decision on revising the ‘People’s Republic of China Budget Law’”, 31 August 2014, accessed www.npc.gov.cn/npc/xinwen/2014-09/01/content_1877061.htm.
5. Like other former planned economies, China’s budget went into a steep decline when market reforms eroded the “pillars” of the government revenue mechanism: state monopoly over industrial ownership, administratively fixed prices favouring industry, and compulsory procurement and delivery of raw materials. At its trough in 1996, China’s budget was 11% of GDP, one-third the level under the planned economy (Wong and Bird, 2008).
6. Unless otherwise noted, all growth calculations are in real terms after deflating by CPI.
7. Premier Wen Jiabao cited a figure of 835 million participants in the rural health insurance scheme (NCMS) in his work report to the National People’s Congress in 2011. This is much larger than the number of rural residents, but many migrant workers were enrolled in NCMS since they are ineligible for urban schemes. In recent years many NCMS programmes have been merged with a similar urban basic medical scheme.
8. Figures are in nominal RMB, based on estimated shares of revenues by tier of government. This was equal to an average growth of nearly 24% p.a. in nominal terms, or 21% p.a. in real terms.
9. Strictly speaking, land ownership remains with the state, but the right of use can be sold.
10. Estimates from Wong (2013a).
11. For an early account of how the central government was kept largely in the dark on the development of LICs and the extent of local government borrowing, see Wong (2011).
12. See (Naughton, 2015) for a brief discussion of Document 43 and how it is designed to work.
13. These are classified as “above scale” enterprises, *China Statistical Yearbook* 2014.
14. *China Statistical Yearbook* 2014, Table 13-1.

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