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Reforming Public Finance for the New Era

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With the war in Ukraine, growing geopolitical tensions, and the spread of the COVID Omicron variant crippling the economy at mid-year, 2022 is shaping up to be China's *annus horribilis*. The sharp slowdown in growth so alarmed the top leadership that Premier Li Keqiang convened a 100,000-person meeting on 25 May to exhort local government officials to do all they can to support growth and jobs.[1]

Against all expectations, the fiscal policy response has been anaemic. There are multiple causes for this, but at the heart is a fiscal system in crisis, hobbled by internal contradictions left by decades of piecemeal, incremental reform that have left local governments underfunded and tied down by contradictory policies. During the COVID pandemic the fiscal system has repeatedly failed fully to deliver the intended stimulus approved by the National People's Congress, underspending the budget by three per cent of GDP in both 2020 and 2021 (Wong 2022).

This underspending has translated into a shortfall in services on the ground. In one egregious example, despite repeated promises by top leaders, the government provided little assistance to those suffering economic hardship through the lockdowns in 2020 and its aftermath (Wong and Qian 2020a and 2020b). In 2021, the most salient failure was to leave untouched RMB 1.2 trillion in special project bonds (SPBs), one-third of the quota for local government borrowing intended for growth-supporting investment in infrastructure.[2]

The biggest bottleneck is at the county level.[3] In a recent article in the journal *Party Building*, Finance Minister Liu Kun noted that "The central government attaches great importance to the fiscal challenges faced by the county and district

governments", and vowed to direct more resources towards them (Liu 2022). According to Premier Li Keqiang, the 2022 budget provides a one-time transfer of RMB 800 billion for grassroots local governments to help meet "increased pressure from expenditures for ensuring people's basic wellbeing, payment of salaries, and normal government functioning" (Xinhua 2022). The special transfer is a concrete but miniscule step towards resolving a problem whose size is one order of magnitude bigger, with China's budget due to spend an estimated RMB 40 trillion in 2022, roughly half of it by counties.[4]

Genesis of the problem

Since embarking on the transition to a market-oriented economy in 1978, China has substantially overhauled and rebuilt its public finances. Under the strategy of "crossing the river by feeling the stones", fiscal reforms have been incremental and reactive, relying on small fixes to alleviate the most urgent problem of the day. One exception was the Tax Sharing System (TSS) reform in 1994, which radically overhauled revenue-sharing arrangements between central and local governments. Even then, this sweeping set of reforms was focused on reversing the decline of government revenue, and especially the share controlled by central government. Less pressing (or regime-threatening) issues such as how the transition affected government expenditures and their intergovernmental assignment were deferred (Wong and Bird 2008).

Since the TSS reforms, China's economy has grown and prospered. At the official exchange rate, its GDP has grown from a tiny fraction of the U.S. GDP to more than two-thirds, and annual per capita GDP from USD 375 to over USD 10,000. The country has urbanised. Almost half of the labour force is now employed in services, with a majority in the "gig economy". These structural changes have required changes in government spending and public services, such as meeting increased demands for social spending and moving their provision out of the old work units, creating pension schemes, unemployment insurance and social assistance programmes, including, for the first time, rural residents (Wong 2021).

Because these services are overwhelmingly delivered at the county level, the expansion of social spending significantly shifted the locus of budget expenditures to local governments, whose share of expenditures rose from 65 per cent of the total in 2000 to 85 per cent in 2012, and the county-share from 26 per cent to 45 per cent. Since revenue-sharing remained largely unchanged from 1994, transfers from the central government grew to fill the gap. By 2012, they were financing nearly 40 per cent of subnational spending.

As China exited its miracle growth phase (see the chapter by Barry Naughton in this volume), economic growth has slowed since 2010, along with government revenues (Table 1). The combination of slower growth, tax cuts since 2015 and a waning willingness of the central government to provide transfers has put local finances under growing strain. While the Hu Jintao-Wen Jiabao administration had seemed willing to provide transfers as needed, this has changed under the Xi Jinping administration. Instead, local governments are encouraged to find efficiency savings and make fuller utilisation of their resources. By 2019, transfers were funding only 31 per cent of local spending (Wong 2021).

Table 1. Changes in revenue, expenditure and transfers (annual growth)

	Revenues			**Expenditures**			**Net transfers**
	Total	**Central**	**Local**	**Total**	**Central**	**Local**	
2000–2010	20.0%	19.8%	20.3%	18.9%	11.2%	21.7%	26.8%
2010–2015	12.9%	10.3%	15.4%	14.4%	9.8%	15.3%	13.1%
2015–2019	5.7%	6.6%	5.0%	8.0%	8.3%	709%	5.6%
2019–2020	**–3.9%**	**–7.3%**	**–0.9%**	**2.9%**	**–0.1%**	**3.4%**	**14.0%**
2020–2021	**10.7%**	**10.5%**	**10.9%**	**1.6%**	**–0.1%**	**1.8%**	**–0.8%**

Source: calculated from China Ministry of Finance data.

The squeeze on transfers has intensified the struggle for resources among the subnational levels of government, all of which have significant expenditure responsibilities and face fiscal gaps of their own (Table 2).

Table 2. The changing shares of the budget across levels of government (% of total)

Revenues	**2000**	**2002**	**2006**	**2010**	**2016**
Central	52.2	55.0	52.8	51.1	45.3
Provincial	10.7	11.7	12.1	10.6	11.2
Prefectural	17.4	16.3	16.5	15.8	17.5
County	19.7	17.1	18.6	22.5	26.0
Expenditures					
Central	34.7	30.7	24.7	17.8	14.6
Provincial	19.1	19.6	18.3	17.1	14.4
Prefectural	20.0	21.0	22.5	22.5	24.5
County	26.2	28.6	34.4	42.6	46.5

Source: Caizheng bu (China Ministry of Finance), various years.

Information on the division of expenditures by administrative level has ceased to be published after 2016, but the dilemma is illustrated by these figures: if counties were to maintain their 2016 revenue- and expenditure-shares, in 2019 their fiscal gap of RMB 6.17 trillion would have been equal to 98 per cent of central transfers for the year. The likely outcome is that the share of county spending was trimmed to save resources for provinces and prefectures, leaving some expenditure needs unfunded. This is apparent in the overall decline in social spending (almost all of which is made at the county level) from 8.5 per cent of GDP in 2016 to 7.6 per cent in 2019 (Wong 2021).[5]

Deleveraging pressures

Local governments faced two additional challenges in 2021. One was the campaign to reduce financial risks in the economy, of which a principal target is local government debt, especially off-budget, hidden debt. This began in 2016 when the State Council ordered a classification system for local government debt risks and set "redlines" for triggering fiscal consolidation. This was followed by debt audits, tightened control over bank lending and imposition of rules assigning responsibilities for direct and contingent debt to leading officials and tying their performance to their personnel records.

Through 2019, the multi-pronged campaign had succeeded in slowing the growth of hidden local government debt until the COVID pandemic interrupted. In 2021, the campaign was resumed, with the Ministry of Finance calling on local governments to pay down and restructure their hidden debt, and to establish market-based, legal mechanisms for resolving their debt in the so-called financing vehicles, enterprises created as workarounds to borrow on behalf of local governments.

Amidst the intensifying pressure to deleverage came the housing market downturn set off by the Evergrande default (itself an outcome of the deleveraging campaign),[6] which delivered a big hit on construction and real estate-related activities that account for one-third or more of local tax revenues. It also hit land lease sales, the principal source of revenue for financing local infrastructure as well as debt servicing.

The confluence of these challenges caused a dramatic shrinking of spending in 2021. Evidence of curbs on local spending is rife, including widespread reports of cuts or cancellation of bonuses and allowances, including in rich local governments in Shanghai, Guangdong and Zhejiang.[7] Through November, local governments were collectively underspending the budget by 6.5 per cent, with deep cuts in public investment across sectors. Even though a last-minute burst of spending in December brought the total to just 1.3 per cent short of the

budget, the intended stimulus had shrunk even as growth was slowing, with a consolidated deficit that was smaller than in pre-COVID 2019 (Wong 2022).

The urgent case for intergovernmental fiscal reform

Fiscal reform was high on the agenda at the outset of Xi Jinping's administration, when a plan for comprehensive reform of the fiscal system was introduced in 2013 that promised a significant realignment of the central-local relationship as the end goal, to be completed by 2020. Reforms to date have focused on building institutions of financial control but without any significant realignment of revenues or expenditures (Wong 2021). Although intergovernmental reform is said to be continuing and now extends to the subnational levels, this re-iterates past reforms that have to date shown little effect. To restore the vitality of local finance will require a wholesale reform of the intergovernmental system.

Through four decades of rapid economic growth and structural change, China has muddled through with piecemeal, incremental tweaks to a fiscal system that has grown increasingly off-balance, with local governments unable fully to meet their assigned responsibilities. While pausing the campaign to reduce local government debt would lift some of the pressure off local finance and improve the prospects for implementing the 2022 budget, longer term improvements will depend on reform of the intergovernmental fiscal system, not only at the central-local level but also among subnational levels, that ensures that local governments are provided with appropriate funding and incentives.

To start with, a long-neglected but urgent reform is to specify clearly the role of provinces in the fiscal and administrative hierarchy. Over the past two decades, as social spending ramped up and transfers increased, provinces acquired more responsibilities for programme implementation in their jurisdictions, including the equalisation of public services. While provinces have the authority to determine revenue-sharing with lower levels, they have also been pressed to push more resources to the grassroots levels. Given such conflicting mandates and demands, many provinces have chosen to "lie flat", simply passing resources on to the counties.

The passive option has now been decisively closed under the deleveraging campaign. Under the budget law, provinces are the legal entities for all local government borrowing. Although much is on-lent to lower-level governments, provinces retain the responsibility for managing the associated fiscal risks. More specifically, the 2016 policy makes provinces the unit of account for risk classification, as well as first responder to "local government debt risk events" (Guowuyuan bangongting [General Office of the State Council] 2016).

When even a single municipality or county default can put the whole province under tightened scrutiny and restriction, provinces hold back resources to hedge against such events. This was likely a source of the fiscal contraction in 2021 discussed earlier, which occurred while treasury accounts were abnormally flush with cash.[8] An active role for provinces will require more resources to be placed under provincial allocation, which in turn requires a wholesale rejigging of revenue- and expenditure assignments across all levels of governments.

Another area where reform is urgently needed is the financing of investment in infrastructure, a key driver of economic growth in China and an area in which the gap between local government responsibilities and resources is huge. Through the fiscal decline in the 1980s and 1990s, investment expenditures were spun off the budget and decentralised to local governments. Over the past decade, local governments have accounted for up to 90 per cent of China's massive investment in infrastructure (Wong 2013, 2014). In 2017, the last year for which data is available, budget resources accounted for only 17 per cent of total infrastructural investment, with the rest financed through debt and non-budgetary resources, largely by local governments (Guojia tongji ju, *China Statistical Yearbook* 2018).

Due to the functional split where capital spending is managed by the National Development and Reform Commission and not the Ministry of Finance, capital needs are not well-integrated into budgeting considerations. Even the 2018 State Council document that laid out the division of central-local responsibilities in public services made no mention of capital needs (Guowuyuan bangongting [General Office of the State Council] 2018). The financing costs of building schools, clinics, roads, etc. and restrictions on borrowing had, in past decades, driven local governments to reach outside the budget to rely on land revenues and hidden borrowing through financial vehicles (Wong 2013).

Reforms to clarify and set limits to the scope of local government responsibility for financing infrastructure are a necessary step towards finding a sustainable resolution of the local government debt problem going forward. With fiscal policy compromised by problems of local finance, the experience of the past two years shows that China may be at the proverbial "end of the road", where "kicking the can" is no longer an option for deferring the difficult task of intergovernmental fiscal reform.

To design a good intergovernmental fiscal system fit for an advanced, prosperous China, reforms might start with a review of all the current tasks performed by government and streamline them by asking the classic questions of *why* (whether they belong in the public sector), *how* (whether by direct provision or through subsidy to supplier or consumer), *and by whom* (which level of

government). This would be followed by designing a system to finance the tasks efficiently and equitably.

Unfortunately, a bold reform is unlikely to happen under the current leadership, which seems to prefer keeping local governments on a tight leash through doling out transfers. It also seems intent on holding the overall budget deficit to less than three percent of GDP even while urging local governments to take on debt under the special project bonds.

Notes

[1] Christine Wong, *Wen jingji dapan jianghua luyin* 稳经济大盘讲话录音 [(Personal) Recording of Speech at the Economic Stability Conference], 25 May 2022, on file with the author.

[2] Special project bonds are a vehicle introduced in 2015 to allow local governments to borrow against their government fund budget (almost entirely based on land revenues) for capital spending.

[3] In this chapter, "county" refers to the administrative level that includes counties, county level cities and urban districts.

[4] The estimated RMB 40 trillion is the sum of general budget expenditure and government fund expenditure, net of transfers between them.

[5] Social spending is calculated as the sum of budget expenditure on education, health and social security and employment net of public sector pensions and support for demobilised soldiers.

[6] Evergrande was the biggest property developer to default on a loan repayment in 2021, after the government imposed tougher financing standards on the real estate sector that curbed the flow of credit to developers and forced many to retrench.

[7] Fieldwork information, December 2021–January 2022. See also Katsuji Nakazawa, "Analysis: China's Mandarins Face 25% Pay Cut as 'Alchemy' Fades", *NikkeiAsia,* 30 Dec, 2021; available at https://asia.nikkei.com/Editor-s-Picks/China-up-close/Analysis-China-s-mandarins-face-25-pay-cut-as-alchemy-fades (accessed 10 May 2022).

[8] Fieldwork information, Beijing, December 2021.

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