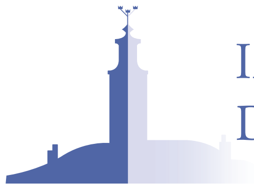

Institute for Security & Development Policy

Policy Brief
No. 151 April 17, 2014

Rebalancing Act: China's Fiscal Reform Challenge

Per Olsson

This policy brief examines China's inter-connected economic challenges of structural and fiscal reform, arguing that promotion of domestic consumption away from fixed-asset investment could further exacerbate the fiscal mismatch between the central and local levels of government—with increasing local government indebtedness and potential for social unrest if not appropriately addressed.

The Chinese economy is currently facing two long-term challenges: the first, a structural imbalance which favors investment in infrastructure, construction, and machinery at the expense of domestic household consumption, an imbalance which the Chinese government is attempting to redress; and, second, a fiscal mismatch between central and local levels of government, which favors the former at the expense of the latter. Both of these issues have received wide attention within the academic and public debate.

However, the connection between the two has been largely overlooked. The two challenges intersect in the distribution of consumption-related taxes (including value-added tax or VAT and consumption tax), which are mainly revenue items accruing to the central government. This creates a situation where the promotion of structural rebalancing from investment to consumption would mainly benefit the central government, meaning that local governments—which rely on investment, land sales, and property development for revenue—have few incentives to promote structural reform, while the fiscal mismatch risks being further exacerbated. Failure to deal with the dual nature of this challenge will put further financial strain on local governments, already heavily indebted with rising expenditures, as well as could bring attendant dangers of social unrest.

Structural Imbalance, Fiscal Mismatch

The structural imbalance has emerged as a result of China's investment-driven growth model. Low real interest rates and favorable legislation promoted fixed asset investments such as land, infrastructure, property, factories, and machinery. Consequently, the investment share of GDP has risen steadily since the late 1990s. The 2008 global financial crisis put severe pressure on the Chinese export sector and the government launched a massive stimulus package to offset falling external demand. This helped to avert mass unemployment but the consequential boom in investment further exacerbated the structural imbalance. The following year capital formation accounted for 48 percent of GDP, compared to household consumption at merely 35 percent. This development has led to surging bad debt and increased risk of property bubbles. In the aftermath of the stimulus, a consensus has emerged within the Chinese government that the investment-driven growth model is unsustainable, and rebalancing a growth model where domestic consumption has a larger share currently tops the reform agenda.

The fiscal mismatch, on the other hand, dates back to the 1994 fiscal reform, which was introduced with the purpose to amend several fiscal problems which had emerged during market-oriented reforms. The 1994 reform introduced VAT, consumption tax, business tax, and unified income tax together with a revenue-sharing system which set total revenue at a fifty-fifty relationship between the central and local government. Meanwhile most social expenditure items remained at the local level—expenditure which has increased steadily over time. Indeed, local governments covered 85 percent of expenditure in 2011, the center only covering the remaining 15 percent. Furthermore, while the central government transfers funds to local authorities, taxes and financial transfers cover only about 90 percent of local expenditure, leaving a sizable deficit and so seriously straining the financial situation of provinces and counties.

With the 2008 stimulus package indebtedness soared as local governments rushed to shore up dwindling growth. Local financing platforms were created to enable further stimulus lending. By 2013 local government debt reached

17.9 trillion Yuan, bringing total government debt up to 58 percent of GDP. Further, if expenditure continues to outstrip revenue, the fiscal mismatch risks creating a permanent debt trap for local governments. This could spur further off-budget funding, such as land sales. Land is not only an unsustainable source of local revenue but has been a major source of social unrest in China as villagers are often inadequately compensated. Additionally, continued massive lending could see the already troublesome amount of non-performing loans turn into a serious financial threat.

The Chinese government has by no means ignored fiscal reform. In recent years, business tax has been converted to VAT for several services and property tax has been introduced in several cities. Nonetheless, the Chinese leadership is currently focused on rebalancing economic growth away from fixed investments toward consumption, with the result that the impact on the fiscal mismatch between central and local levels of governments has yet to be properly addressed.

Revenues and Stakes

Consumption-related taxes, namely VAT and consumption tax, connect the challenges of structural imbalance and fiscal mismatch. These large revenue items are mainly collected by the central government, 75 percent in the case of VAT and 100 percent for consumption tax. Meanwhile, local governments rely heavily on property development and land sales for revenue, which benefit from high levels of investment. Rebalancing toward consumption will further skew the fiscal relationship in favor of the center. Thus, local governments have few incentives to support structural rebalancing under the current revenue-sharing arrangement. There is thus a risk that they will ignore the central government's reform efforts and keep supporting local property developers and real estate companies which depend on continued favorable conditions for investment. The central government could force compliance, but only with the consequence that local revenue will be further eroded and the fiscal mismatch exacerbated.

By adjusting revenue sharing, however, the central government could make local authorities stakeholders in the effort to rebalance China's economic growth structure. For instance, an increased local share of VAT (currently 25 percent), consumption tax (0 percent), and income tax (40 percent) would encourage local governments to promote consumption and service sector development while simultaneously decreasing their reliance on investment, land sales, and property development. Such an approach would not be unprecedented. Providing incentives for local governments played an important role in earlier Chinese reforms, most notably in the transition from the socialist command economy to market-oriented economy. During the 1980s, local governments had entrenched interests in state-owned and collective enterprises, but by receiving a larger share of business taxes they were given a stake in market reforms.

Doing so is not without its risks, however. Granting local governments a larger share of taxes in effect implies revenue decentralizion, a process which carries several dangers, not least increased corruption. Such a move could also diminish Beijing's ability to maintain redistributional transfers and alleviate regional inequalities. Therefore, equally important in addressing the fiscal mismatch would be clear definitions of responsibilities and transparency of local accounting practices.

In sum, under the current revenue-sharing system local governments have few incentives to support a move away from fixed asset investment toward domestic consumption. And yet, by granting local governments an increased share of consumption related taxes, this could not only help address the fiscal mismatch but also make local governments stakeholders in the much-needed process of structural rebalancing.

Per Olsson has an MSc in International Economics with a Focus on China from Lund University. He was a former Intern at ISDP.

The opinions expressed in this Policy Brief are those of the author and do not necessarily reflect the views of the Institute for Security and Development Policy or its sponsors.

© The Institute for Security and Development Policy, 2014. This Policy Brief can be freely reproduced provided that ISDP is informed.

About ISDP

The Institute for Security and Development Policy is a Stockholm-based independent and non-profit research and policy institute. The Institute is dedicated to expanding understanding of international affairs, particularly the interrelationship between the issue areas of conflict, security and development. The Institute's primary areas of geographic focus are Asia and Europe's neighborhood.

Website: www.isdp.eu