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Can a Modern System of Governance Work Under Xi?

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Under President Xi Jinping, China has embarked on an ambitious, comprehensive round of fiscal reform that aims to reshape the public finances and lay the foundation for a modern system of governance.

Spearheaded by Lou Jiwei, the plain-speaking finance minister, a series of far-reaching measures has been announced by the highest authorities. These include the "Overall Program for Deepening Reform of the Fiscal System" which was approved by the Politburo in June 2014, a revised budget law approved by the standing committee of the National People's Congress in August, and numerous other measures from the State Council, China's cabinet.

Support from the various official institutions will be needed as the reforms aim to shake up business-as-usual in government and realign resources and authority between the central and local governments.

Plenty needs fixing. Topping the list is the need to rein in local government borrowing and the use of shadowy financing vehicles, which have blown a big hole in fiscal discipline and exposed the banking sector to financial risks. Weaning local governments off their addiction to land sales and plugging the leaks from their dodgy accounting practices are all part of the clean-up needed to stem graft and corruption. In the ongoing first phase of reform, the aim is to install a new system of public financial management, to pave the way for deeper reforms in which the centrepiece will be an overhaul of the long-troubled intergovernmental fiscal system, which has determined the division of revenues and responsibilities between Beijing and the regions for two decades. Fixing the system will be no picnic, and so far Lou has offered few clues on its future configuration.

China is a vast country, with 1.36 billion people and great regional diversity, where the per capita income of the richest province is four to five times that of the poorest.

Administratively, China has five levels of government, with some 44,000 local governments at the provincial, prefectural, county and township levels.

The central government is surprisingly small, with 60,000 civil servants in the core ministries managing a bureaucracy of 41 million employees nationwide. To implement policies, the central government employs a system of extensive delegation.

The central government delegates to the provinces and relies on them to implement national policies in their territories. The provinces, whose bureaucracies are also small, must in turn delegate to prefectures and depend on them to deliver, and so on. Each level "manages" only the next layer of subordinates. The result is a nested pyramid, where policies and resources are transmitted downward level-by-level, and most public employees are located at the bottom. China's fiscal system follows the same bottom-heavy hierarchical structure, albeit only down to the country level.

This set-up suggests that a good intergovernmental fiscal system – one that provides local governments with both resources and incentives – would be the key to effective policy implementation. But China's intergovernmental fiscal system was "broken" when a tax-sharing-system reform in 1994 reassigned a majority of revenues to the central government and left the bulk of expenditure at the local levels.

Land revenues

From then until the early years of this century, transfers were simply inadequate to fill the gap, and local governments in poorer regions were unable to implement policies. In the cities, local governments turned increasingly to extra-budgetary resources to make ends meet as demand for services such as schools and hospitals took off amid urbanisation and economic growth. With land prices rising rapidly, land revenues came to be the mainstay for many municipal governments, and financing vehicles were set up as workarounds to borrow on behalf of local governments for investment in infrastructure.

Paradoxically, the problems of the intergovernmental fiscal system were exacerbated as China entered its golden era of growth in the 21st century, when per capita income grew at an astonishing average of 13.2% per annum between 2000 and 2012, and government revenues at 22%.

During this growth spurt, the government financed a massive rebalancing of public spending. With the introduction of free rural basic education, subsidised universal health care and rural pensions, China began to put in place a basic welfare system that provides coverage for all citizens, albeit not equally. However, the rickety administrative system was not up to the task of managing these programs and the flood of money flowing through.

Many of the government's "harmonious society" programs are huge: There are 140 million people in rural education, more than 800 million in the rural cooperative medical program, and a universal rural pension plan will cover as many as 800 million. These programs have added hugely to expenditures at the county level, where they are delivered, raising their combined share from 26% of the national budget in 2000 to 45% in 2012. In concrete terms, an "average" county saw its budget grow ten-fold within a decade, from 200 million yuan to 2 billion yuan.

These programs put an extraordinary strain on the bureaucracy at all levels. Implemented without any adjustment to revenue sharing arrangements, all the burden of financing was put on central government transfers, which grew from 246 million yuan to 4 trillion yuan between 2000 and 2012. More problematically, these transfers have to be passed down level by level -- from Beijing to the provinces, from the provinces to the municipalities, and from the municipalities to the counties. The process of managing these new programs strained the bureaucracy and exposed the unsuitability of the administrative structure for China's aspiration to build a modern welfare state.

The neglect of institutional reform over the past decade has been even more damaging in the cities, where extra-budgetary financing from land and borrowing by financing vehicles had been tolerated and even praised as a growth-enhancing innovation. But it has cost the government – and the economy – dearly in macro and fiduciary control.

Today, the Chinese government budget is equal in size to the U.S. federal government budget, when social security and land revenues are included. Going forward, will fiscal reforms try to graft an improved financial management system onto the existing administrative structure, or will Xi revisit the choice that Mao Zedong considered and rejected in the 1950s – to build a Soviet-sized bureaucracy at the central level? On this, Lou is keeping mum.

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