Fiscal reform

Paying for the harmonious society

by Christine Wong

One of the defining motifs of the Hu Jintao and Wen Jiabao administration is its pledge not only to safeguard China's rapid growth but also to rebalance the economy, improve public services, reduce regional inequalities and promote fairness. China's leaders agree they need to shift investment from capital-intensive industry toward services, and boost domestic consumption. Under the banner of the "harmonious society," adopted at the fourth plenum of the 16th Communist Party Central Committee in September 2004, Beijing has pumped resources into expanding the social safety net to include rural citizens and into improving social services provision – both crucial moves if China is to become a more consumption-driven economy.

Fiscal transfers to local governments have risen more than five-fold since 2009 ...

The reforms have been impressive. To reduce the burden on farmers, all rural fees were eliminated in 2003, and agricultural taxes abolished in 2006. Basic education is now offered free of charge, and more than 90% of the rural populace is covered by health insurance. Urban citizens, too, are beneficiaries of expanded health insurance coverage and free basic education, with some benefits being gradually extended to rural migrants. To improve health care provision, a comprehensive health reform program was launched in April 2009 with initial funding of Rmb850 bn. These policies have been supported by massive subsidies from the central government: fiscal transfers (excluding tax rebates) from the center to local governments increased from Rmb435 bn in 2002 to Rmb2.4 trn in 2009. By any measure, this is a laudable effort to reshape the nation in a more humane image.

Yet the efficacy of these ambitious policies is threatened by China's dysfunctional fiscal system, which is unsuited to financing social expenditures in a reliable and equitable way, and is itself the root cause of the inequalities and under-provision of public services that Beijing wants to reverse. The attempt to build a "harmonious society" will not succeed without wholesale fiscal reform. Today, the constraint to improving public services in China is no longer predominantly a shortage of funds; the main challenge is how to channel resources effectively to where they are needed. China needs to build an inter-governmental fiscal system with the capacity to assign fiscal responsibilities to the appropriate level of government, and then to coordinate the flow of resources to meet expenditure needs.

... but remain far from being big enough to meet local expenditure needs

Lots of unfunded mandates

As in most countries, many public services in China are provided by local governments. For the majority of the Chinese population, services such as basic education, health care and social welfare (including pensions) are provided by rural local governments at the county and township levels.

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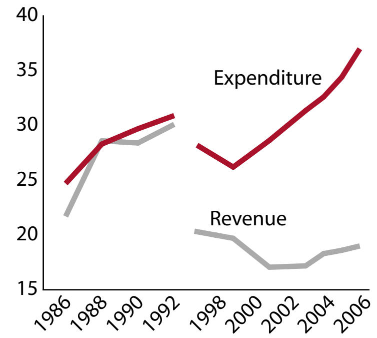
The flaw in China's system is that, in theory, local governments are also supposed to *finance* these vital and costly services – yet the revenues they are assigned come nowhere close to meeting their expenditure burden. Fiscal transfers from central government, which are supposed to alleviate revenue disparities across regions and to fill local financing gaps, do not perform these functions well. Local governments finance 80% or more of basic health and education expenditures.

The financial responsibility for costly social services was thrust on local governments as an unintended byproduct of reforms to shore up central government revenues during the first half of China's market transition. Government revenues fell from one-third of GDP in the late 1970s to just 10% by 1995, as lifting price controls and entry barriers to industry destroyed profits at state-owned enterprises. This crisis forced the central government to make changes to all components of the fiscal system, from tax policy and tax administration to budgeting and treasury management. Because the fiscal picture was so dominated by the steep decline of revenues during these years, fixing the system focused on reviving central revenue collections. The fiscal needs of local governments were often overlooked. Previously, under the planned economy, costly basic services were assigned to lower tiers of government but financed by higher level governments through the revenue-sharing system. But reforms aimed at improving revenue mobilization and hardening budget constraints for local governments delinked revenue assignments and local spending requirements.

When the so-called "tax sharing system" was introduced in 1994, it ended negotiated revenue-sharing and most of the taxes collected locally were sent to the central coffers. To ensure that local governments could carry

Less cash, bigger bills

Fiscal trends of rural county and township governments, % of national total



Source: Ministry of Finance

How to build a harmonious society

Program	Launched	Policy objective	Policy content
Rural minimum living stipend (*dibao*)	2005	Provide income support for the poor	All households with incomes below the local stipulated minimum can apply for a top-up. (Potential beneficiaries: 37m)
New rural cooperative medical scheme	2005	Provide insurance for rural , families to reduce financial risks caused by illness	Designed mainly for inpatient services; risk-pooling is at the county level. Minimum funding was initially set at Rmb30 annually per participant, and ratcheted up to Rmb100 by 2009. Central government pays 40%; local governments pay 40%; and participants pay 20%. (Potential beneficiaries: 700m)
Free rural compulsory education	2006	Eliminate out-of-pocket costs of basic education and boost rural school spending	Government provides funding to replace school revenues previously collected from miscellaneous fees, and provides a subsidy to boarding students from poor families. (Potential beneficiaries: 148m)
Comprehensive health reform program	2009	To provide medical insurance to at least 90% of the population by 2011	The urban benefit cap will be raised to 6x average per capita income, up from current 3-5x. Annual rural per capita subsidies will rise from Rmb60 to Rmb100. (Potential beneficiaries: 1.3 bn)

Source: Author

The fat get fatter

Richest and poorest provinces share of national total, %

	1990	1998	2006
Five richest provinces			
Population	13	12	13
GDP	21	23	28
Fiscal revenue	18	12	16
Fiscal expenditure	12	15	18
Five poorest provinces			
Population	17	17	17
GDP	11	10	9
Fiscal revenue	8	6	4
Fiscal expenditure	10	10	9

Five richest: Shanghai, Beijing, Tianjin, Zhejiang and Jiangsu
Five poorest: Guizhou, Gansu, Yunnan, Anhui and Guangxi
Source: China Compendium of Statistics (1949-2004), China Statistical Yearbook (2007)

on their work, the central government created a system of tax rebates, to give back the bulk of the "recentralized" revenues. Because the rebates are returned to localities where the taxes were collected, however, they accrued more to rich regions. Transfers intended to help poor regions were, in contrast, greatly reduced. During the mid-1990s, when transfers excluding tax rebates fell to 1% of GDP, poor regions were essentially left on their own. As China's coastal provinces grew faster than inland provinces and income differences widened, the fiscal system played no palliative role. The result was large and growing regional disparities in public service provision. In 2004, per-student spending in primary schools was nine times as high in Shanghai, the richest province, as in Guizhou, the poorest. Even within a single province, the disparities could be large: in 2003 the richest county in Liaoning spent 14 times as much as the poorest.

Through the 1990s, China spent too little on education, health and social welfare

Throughout the 1990s, local fiscal restraints meant that China spent too little on education, health and social welfare. The World Bank estimated the shortfall in China's social expenditures at more than 5% of GDP in the mid-1990s. In education, public expenditures were below 3% of GDP throughout the 1990s, compared to 4.5% in Vietnam. The failings of the intergovernmental fiscal system doomed citizens in poor regions and rural areas to low quality and inadequate public services. Nearly two decades after the 1986 Education Law mandated nine years of compulsory education, a 2004 Ministry of Education survey found that 17% of China's rural counties could not provide it. Cash-strapped local governments and public institutions increasingly turned to user charges, penalties and fines to plug the gap in budgetary shortfalls, leaving citizens to pay for schooling, health care and even police services out of their own pocket. In the 1990s, with public finance covering only half the costs of public education, school fees were a heavy burden, especially for rural families.

The price of harmony

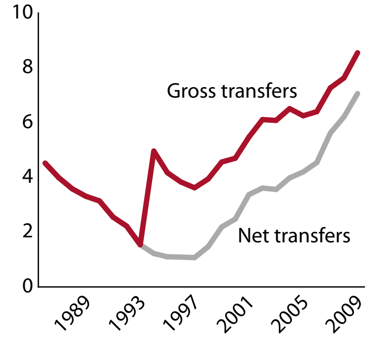
The harmonious society program intends to reverse or alleviate many of the problems created in the 1980s and 1990s: inequalities and underinvestment in social services, exorbitant user charges, weaknesses in safety nets, etc. The targets are ambitious. They affect huge numbers of people, and they mostly aim to benefit low income households. The problem is that they are being implemented under the existing intergovernmental fiscal system, which means they blow big holes in local budgets.

Take the policy to promote free rural compulsory education, under which the central government abolished miscellaneous fees for the first nine years of education in rural schools in 2006. New funds are injected from central and provincial coffers to replace revenues previously collected from fees. But the vast majority of the costs still fall on county budgets, which must fund the biggest component of costs – teachers' salaries. Since the new policy calls for upgrading the quality of teachers, counties must take on an additional burden. In 2007, county governments paid Rmb227 bn to finance the new system, a 37% increase on the year before. The picture is similar for other social programs. Under the new national health insurance scheme county governments bear the costs of collecting premium contributions from several hundred million households and managing their individual accounts. Since they also bear the financial risk of reimbursements exceeding contributions, at the outset many counties limited reimbursement rates. Following a central government edict in 2009 that counties must disburse a minimum of 85% of contributions, some counties reportedly ran a deficit in the first quarter of 2010.

Since their introduction, harmonious society policies have brought substantial and tangible benefits to the populace. The benefits reach well into the poorest regions and over the most vulnerable populations. These are remarkable achievements in such a short time. But policy makers' refusal to reform the dysfunctional intergovernmental fiscal system means that programs intended to reverse the underfunding of rural services have, paradoxically, created additional financial strains on rural local governments. The combined share of revenues for county and township governments has remained flat over the past decade, while their share of expenditures has grown steeply. Central transfers fail to provide enough funds where they are really needed.

Fiscal hole

Fiscal transfers, % share of GDP



Source: Ministry of Finance

Transferring responsibility

Transfers play many important and indispensible functions, and are used in all countries, but they have well-known adverse effects on incentives and efficiency. Because the 1994 tax sharing system locks in such a huge discrepancy between local revenues and local expenditures, China has relied on central-local transfers to an extent far greater than in other countries. In 2009, transfers (excluding rebates) were equal to 7% of GDP, absorbing two-thirds of central government revenues, and they funded fully 40% of sub-national expenditures in aggregate. At the provincial level, the share of expenditures funded by transfers ranges from below 10% to more than 70%; at the county level, the dependence on transfers is even higher. Other countries shy away from relying too much on transfers because of their high administrative costs. The reliance on transfers, especially those earmarked to achieve a particular objective, is

China relies on center-to-local transfers far more than most countries

County burden

Distribution of fiscal expenditures for rural compulsory education

	2006 Rmb bn	Share	2007 Rmb bn	Share
Total	198		284	
Central	15	8%	37	13%
Province	16	8%	21*	7%
County	166	84%	227	80%

*Estimated, based on 2006 proportion of provincial funding.
Source: Chinese Statistical Yearbook for Education Finance, 2006; Chinese Statistical Yearbook 2008, China Finance Yearbook 2008, and Xie Xuren, Budget Report to the NPC, March 2009

China's long chain of government means many funds are diverted from their intended final user

especially costly, with stringent requirements for information, monitoring and supervision.

The heavy reliance on transfers is ill-suited to China's highly decentralized administrative structure, where the central government is unusually small and so has limited capacity to ensure transfers are distributed equitably and are used for their intended purpose. The Ministry of Finance has only 1,000 or so staff. In 2006, only 15 people looked after subnational finance – an extraordinarily small number given the size of the country, the highly decentralized fiscal system and the huge program of transfers. Fine-tuned control is well-nigh impossible for the earmarked grants, which totaled more than Rmb1.2 trn in 2009. Instead, the central government relies on provinces to implement national policies in their territory. Provincial bureaucracies are themselves small, and must delegate authorities downward to the next level – municipalities. The result of this "nested hierarchy" is that once central transfers reach the provincial treasuries, the central government has no ability to monitor the use of the funds.

Under this set-up, the central government's ability to influence outcomes is attenuated. When it injects resources to support rural local services, these resources pass through the provinces and municipalities, then to the counties and, finally, to the service providers. Relying on arms-length, level-by-level transmission and lacking the staff and mechanisms for monitoring and enforcement, the system is prone to leakages and policy distortions, as documented each year in the National Audit reports. For example, an audit of 54 counties in 16 provinces for the period 2006 and first half of 2007 found that, in 29 counties, some 45% of the funding allocated for a subsidy program was diverted or withheld by the education departments. While corruption and malfeasance were sometimes involved, these problems probably also reflected divergent central and local objectives.

A better way to budget

Fundamental reform of the fiscal system is long overdue. The current expenditure assignments are largely inherited from the planned economy, and many are unsuited to the highly decentralized, mixed economy that China has become. With growing population mobility, many formerly local public goods have taken on significant inter-local or even national characteristics, so the responsibility for providing them should be moved to higher levels of government. For example, the assignment of health care, education and pensions to local governments hinders their provision to China's 170m migrant workers. Indeed, the recent extension of some benefits to migrant populations required central government funding – ie a partial recentralization of these functions. Because local governments have insufficient revenues to fulfill all the tasks assigned to them, they rely excessively on central transfers. But the transfer system lacks mechanisms for financing social expenditures reliably and equitably.

Reforming the intergovernmental fiscal system will require fixing three interrelated problems. First, some expenditure assignments need to be moved to higher levels of government. This process should start with refocusing government expenditure on "public goods" and key national objectives. County and city-level governments should not be responsible for financing cyclical expenditures on safety net functions, such as pensions and welfare, and costly services that exceed the financing capacities of local governments, such as education. Second, revenue streams need to be reassigned so that local government revenues more closely match local expenditures. Increasing revenue autonomy would improve incentives and accountability for local governments, including allowing responsible local borrowing (transparently via direct bond issuance and bank borrowing, as distinct from the current opaque and indirect system of local government investment companies). Finally, central-local transfers need to be distributed more equitably and effectively. The solution is to reduce local governments' reliance on transfers, improve the transfer mechanism, and increase the monitoring and reporting capacity of government at both the central and the provincial levels.

Central and provincial government should finance social welfare, pensions and education directly