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Rumbling of Reform in China's Fiscal Foundations

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Fiscal reforms were to be the lynchpin of the ambitious, comprehensive program announced at the Third Plenum of the Chinese Communist Party's 18th Party Congress in November 2013. This was underlined by the decision to bring back the hard-charging reformer Lou Jiwei to head the Finance Ministry.

Fiscal reforms were off to a fast start in 2014 with far-reaching measures issued in quick succession including the 'Overall Program for Deepening Reform of the Fiscal System', the revised Budget Law and other documents that approved the comprehensive overhaul of public finances. Working at the compressed pace set out in the Third Plenum Decisions, which called for the whole reform program to be implemented by 2020, Lou announced that fiscal reform would start with budget and public financial management reform in 2014. Then it would turn to reforms of the tax system in 2015, and to intergovernmental fiscal reform beginning in 2016. But by November 2016, Lou was out — retired six weeks shy of his 66th birthday. Is this the end of China's fiscal reform?

At the outset, the biggest problems to tackle were local government debt, reliance on land finance and excessive investment in infrastructure. Three years on, these problems have only moderated somewhat, and the reforms Lou outlined are behind schedule. Critics also point to the lack of progress on state-owned enterprise (SOE) reform as evidence of total failure of the promise of the reforms to redraw the boundary between the state and the market. But behind these headlines, significant progress is being made towards building the foundations of a fiscal system to undergird rule-based governance. By far the most important driver of change is the Budget Law and associated documents, whose provisions are aimed at fixing the root causes of unrestrained local government borrowing, extra-budgetary activities and weak accountability.

Under the call to 'open the front door and close the back door', the Budget Law authorised provincial governments to borrow under supervision by the central government and the provincial people's congress. State Council Document 43 laid out a plan to tackle the stock of existing debt and a structure for managing it, starting with classifying the debt stock and delinking local government financial vehicles from local government finance.

A national registry of local government debt has been created, and the aggregate amount is monitored by the National People's Congress. A program was introduced in 2015 to swap government bonds for local government bank debt. To date, it has swapped more than 8 trillion RMB (US$1.16 trillion), improving the term structure of local government debt and reducing servicing costs to local budgets.

Along with the Budget Law, State Council Document 63 laid down a mandate for governments at all levels to compile and release to the public a comprehensive government financial report. This includes not only on-budget revenues, expenditures and direct debts as in the past, but also a balance sheet of government assets, liabilities and cash flows. The new government financial reporting system will adopt modified accrual accounting rules, which require that all entities with claims on public resources be shown. Many SOEs will have to be included, with the level of detail determined by the nature of their financial links to government.

This has set in motion some fundamental changes that are just starting to be implemented. For starters, making the changes in accounting and reporting to comply with accrual accounting requirements is a process that takes upwards of a decade in many countries. In China, the construction of a balance sheet is forcing governments at all levels to scrutinise their entities to determine how to include them in budget reporting — not only SOEs but also public service units. At the local level, the incentive to qualify for new debt issuance and reduce reporting burdens is leading to severing financial ties to many SOEs. It has also led to a new policy to put all non-strategic public services under procurement by 2020, potentially ending the monopoly of public institutions in many services and opening up provision by private and civil society organisations.

Another big change is the muscular enforcement of budget transparency. The Budget Law contained clear rules on the disclosure for key items such as transfer payments, government debt and departmental budgets for public agencies. Unlike previous attempts that had little penetration at local levels, the Ministry of Finance Supervision Department is auditing hundreds of thousands of spending units down to the county level. The National Audit Office has expanded powers and resources to conduct regular rather than random audits of key departments and projects that include, for the first time, earmarked funds controlled by top leaders.

This is only a partial list of the key reforms that are underway to build a framework for fiscal management, paving the way for revamping central–local relations. State Council Document 49, which was released in August 2016, laid out guiding principles for intergovernmental reforms that promise a radical realignment of revenues and responsibilities, and called on the functional ministries to work out assignments at the subnational levels. The 13th Five Year Plan for Promoting Equalizing Basic Services, which was released in January 2017, provided targets for provision standards for 12 vital services. This should facilitate the formulation of specific expenditure assignments.

Having embedded his vision of fiscal reform in the Budget Law, Lou Jiwei may take comfort in handing the reins to a quieter colleague to smooth the way toward inter-agency cooperation in filling in the details of implementation, and hope that a rules-based fiscal system will nudge the rest of government toward clarifying its role in a modernising China.

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