

China's Public Finance and Intergovernmental Fiscal System

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Research Team

- Lead Researcher : Senior Fellow Hyun-A Kim
- Research Team : Yun-shil Cha and Nari Kim

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I. Introduction

- China is the world's second largest economy (G2). Although its GDP growth is likely to decelerate, its trade volume and influence in the world economy are expected to gradually increase.
 - The Chinese economy has grown rapidly since the economic reforms in 1978. China is now the largest trading nation in the world.
 - According to the outlook by the IMF in 2011, China will account for 18 percent of global GDP by 2016, surpassing the U.S. at 17.7 percent. The OECD, the World Bank, and Goldman Sachs forecast China to surpass the U.S. in 2016, 2020, and 2027, respectively.
- The growth of the Chinese economy has spurred continuing interest in changes in the global financial markets and real sector. International organizations and Korean research institutions alike are now heavily engaged in research on the Chinese economy, including the overall economy, finance, and specific industries.
- Not much research is being conducted on China's public finance, however. What little is done seems to be limited to understanding the size of central and local government finance.
 - Interest in China's government finance is not high for several reasons: first, the role of the public finance authorities in China's central government is very limited and the details of system-based government finance management are unclear. Politically, the 'two meetings' such as the National Congress of the Communist Party of China make the key decisions. The administrative role of state functions (welfare, environmental protection, national land, and transportation, etc.) is actually performed by local governments. Local governments are, in fact, considered to be the key players in public expenditures such as pensions and healthcare - expenditures for public welfare.



- Second, it was only in 1994 when China began to recognize the public finance of the central government and launched public finance reform. Therefore, understanding the size of public finance and the scope, structure, and amount of government expenditures was possible only after 1994. There were also no sufficiently available databases, and data analysis based on consistent criteria would have been challenging, to say the least.
 - Third, China is a growing economy. The public's demand for government spending on welfare has not been high yet, precluding any pressing reason to study it.
-
- In fact, in research concerning China's public finance, analysis has focused on local governments and local government finance.
 - This study aims to examine the functions of China's public finance and the roles of government (mainly local governments) and compile relevant data for use as basic data to understand China's public finance system and its issues.
 - This study also intends to analyze the application of China's subsidy program for local area economic development and its problems to provide developing countries guidance on setting intergovernmental roles and relations in public finance.

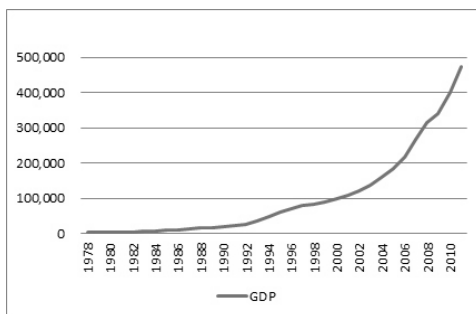
II. China's Economy and General Information

1. Overview

- (China's GDP and its growth rate) According to the *China Statistical Yearbook*, China's GDP in 2011 was about CNY 50 trillion.
- In terms of purchasing power parity, the IMF estimated U.S. GDP at USD 15.2 trillion and China's GDP at USD 11.2 trillion.¹⁾
- The Chinese economy has grown rapidly over the past 35 years but at a decelerating rate since 2008. The world is watching China closely to see whether the country will be able to maintain its growth at the 8~9 percent level.

[Figure II-1] China's GDP

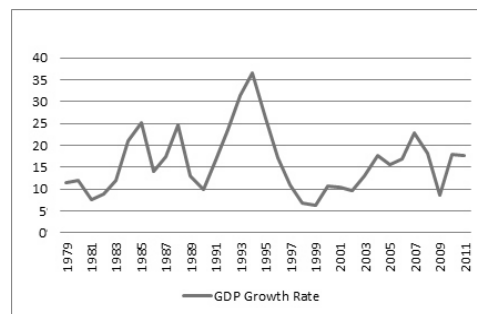
(Unit: CNY 100 million)



Source: *China Statistical Yearbook*, 2012.

[Figure II-2] China's GDP Growth Rate

(Unit: %)



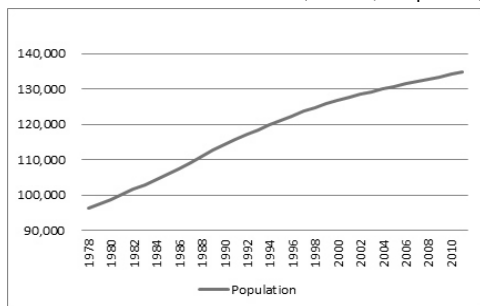
Source: *China Statistical Yearbook*, 2012.
IMF, *World Economic Outlook*, 2013.

- (China's population and its growth rate) According to the *China Economic Weekly*, China's population in 2012 was about 1.354 billion. The country's population growth rate has been steadily declining since the late 1980s.

1) Because the Chinese government pegs the Chinese yuan at a certain artificially low rate to the U.S. dollar, some consider comparing the size of the Chinese economy to others based on exchange rates to be meaningless (Quoted from the U.S. business and finance information website: www.marketwatch.com).

[Figure 11-3] China's Population

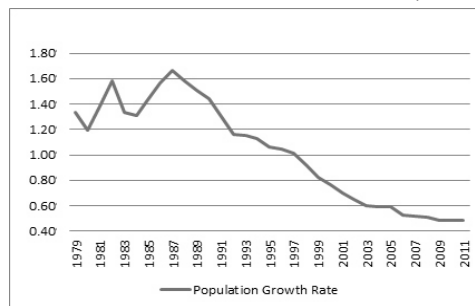
(Unit: 10,000 persons)



Source: China Statistical Yearbook, 2012.

[Figure 11-4] China's Population Growth Rate

(Unit: %)

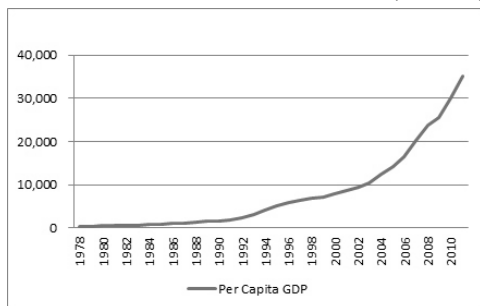


Source: China Statistical Yearbook, 2012.

- (Per capita GDP) GDP growth has outpaced population growth since the 1990s, so per capita GDP has risen steadily.

[Figure 11-5] China's Per Capita GDP

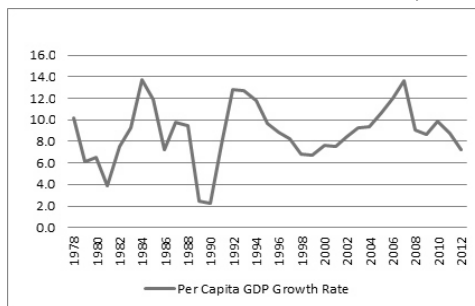
(Unit: CNY)



Source: China Statistical Yearbook, 2012.
IMF, World Economic Outlook, 2013.

[Figure 11-6] China's Per Capita GDP Growth Rate

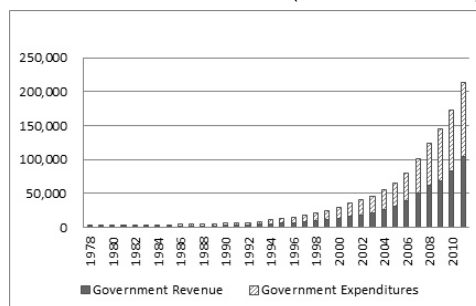
(Unit: %)



Source: China Statistical Yearbook, 2012.
IMF, World Economic Outlook, 2013.

[Figure 11-7] China's Government Finance

(Unit: CNY 100 million)



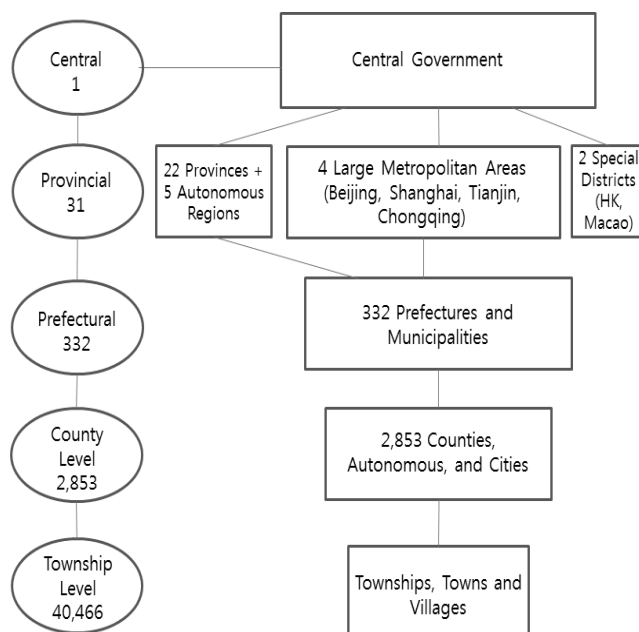
Source: China Statistical Yearbook, 2012.

- (Government finance) Since introducing the tax-sharing system in 1994 for sharing the revenue of local governments with the central government, both government revenue and expenditures have risen sharply.

2. Overview of China's Administrative System (Based on China Statistical Yearbook)

- There are five (or seven) levels of administrative districts in China: central - provincial - prefectural - county - town and village
 - Provincial-level governments mostly have jurisdiction over areas with populations of over 10 million people. Provincial-level governments include 22 provinces, five autonomous regions, four municipalities (Beijing, Shanghai, Tianjin, and Chongqing), and two special administrative regions (Hong Kong and Macau).

[Figure II-8] China's Administrative System



Source: *China Statistical Yearbook*, 2012.



- Administrative districts were reorganized in 1986, when the Chinese government re-defined 'city' in the Administration Act.²⁾
 - Given that the administrative district reform was made at the county-level, the county government is the smallest unit for decision-making. A county usually has a population of about five million.
- The fact that the effects of fiscal reform at the county-level had been discussed in preceding research indicates that the central government attempted fiscal balance at the town-level.³⁾

2) Chan, Kam Wing, "Urbanization and Urban Infrastructure Services in the PRC," in Wong, Christine (ed.), *Financing Local Government in the People's Republic of China*, Oxford University Press, 1997, pp. 83-125.

3) Bird, Richard, Loren Brandt, Scott Rozelle, and Linxiu Zhang, "Fiscal Reform and Rural Public Finance," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.

III. Overview of China's Public Finance and Local Finance

1. Overview of China's Public Finance and Intergovernmental Fiscal System

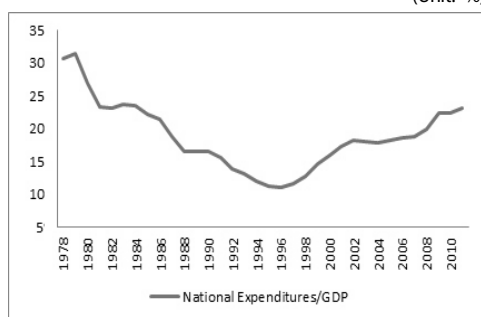
A. China's Public Finance

- (Slowdown in the growth of China's government revenue) China's government revenue is no longer rising at high rates of 20~30 percent per annum and is instead rising much more slowly.⁴⁾
 - As of 2011, China's national fiscal revenue totaled CNY 10.3874 trillion, up 24.8 percent from 2010. It grew 12.8 percent in 2012 and 6.9 percent in the first quarter of 2013. In 2013, estimated revenue is CNY 12.6630 trillion and the fiscal deficit is CNY 1.2 trillion (two percent of GDP).
 - As of 2011, tax revenue was CNY 8.9738 trillion, accounting for roughly 87 percent of total revenue.
- (Fiscal expenditure growth on the rise) Fiscal expenditures are soaring sharply as investment in public welfare continues.
 - As of 2011, government expenditures totaled CNY 10.9247 trillion. Government expenditures in the first quarter of 2013 were CNY 2.7037 trillion, up 12.1 percent year-on-year.
- Since the tax-sharing reform in 1994, local government revenue has been absorbed into the public sector, so total national finance increased. As a result, the ratio of government finance as a share of GDP went up (=government expenditure/GDP).

4) Jeong, Seok-kyu, "Key Issues in China's Public Finance Reform and Reform Prospects," Presentation at the PEMNA Center Seminar, Jun. 19, 2013.

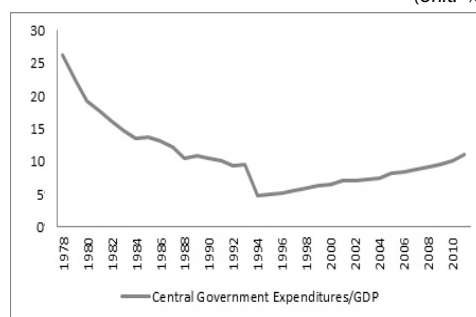
- The tax-sharing system in 1994 represents the re-centralization of public finance as a certain part of local government revenue has been returned to the central government. Since then, the national finance has increased sharply, and based on the reform, the 'legalization of tax revenue' was achieved.
- Accordingly, public finance increased along with GDP, so government revenue and expenditures increased gradually. Government expenditures currently total about 20~25 percent of GDP; government revenue is slightly lower, at about 20 percent.

[Figure III-1] National (Central + Local)
Expenditures as a Share of GDP
(Unit: %)



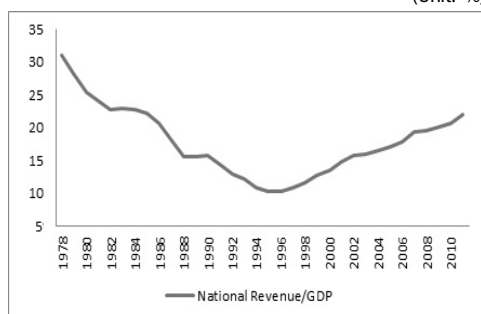
Source: China Statistical Yearbook, 2012.

[Figure III-2] Central Government
Expenditures as a Share of GDP
(Unit: %)



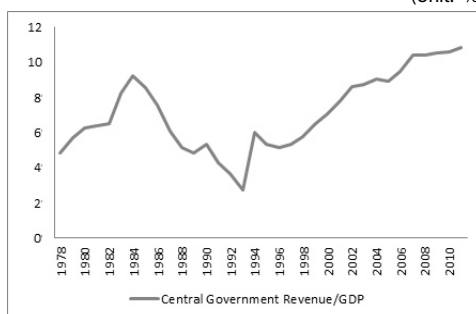
Source: China Statistical Yearbook, 2012.

[Figure III-3] National (Central + Local)
Revenue as a Share of GDP
(Unit: %)



Source: China Statistical Yearbook, 2012.

[Figure III-4] Central Government
Revenue as a Share of GDP
(Unit: %)



Source: China Statistical Yearbook, 2012.



□ Fiscal expenditures by area (Central + Local)

- Education accounts for 15.1 percent of fiscal expenditures, followed by general public services and the social safety net at 10 percent each, medical and healthcare at 5.9 percent, and science and technology at 3.5 percent.
 - The share of expenditures in public aid and welfare, including medical and healthcare, is relatively low.
 - When the welfare system begins to expand in full swing in the future due to rising income levels and population aging, the demand for government finance should increase sharply.
- The ratio between central government expenditures and local government expenditures in major areas shows that the share of local government expenditures is high except in national defense, armed police, and interest payments on domestic and foreign debt.
 - In particular, local governments' share of expenditures on the social safety net and employment, which may be seen as expenditures for income redistribution, is about 95.5 percent, and their shares in medical and healthcare and education are 99 percent and 94 percent, respectively. Local governments also account for high shares of expenditures in transportation and infrastructure, environment, and commerce, which are heavily subsidized by the central government due to their high spillover effects.

<Table III-1> National Government Expenditure by Area (2011)

(Unit: CNY 100 million, %)

Total	General public services	Defense	Public safety	Education	Science and technology	Social safety net	Medical and healthcare	Environmental protection	Agriculture, forestry and water	Other
109,248 (100.0)	10,988 (10.1)	6,028 (5.5)	6,304 (5.8)	16,497 (15.1%)	3,828 (3.5)	11,109 (10.2)	6,430 (5.9)	2,641 (2.4)	9,938 (9.1)	35,485 (32.5)

Source: National Bureau of Statistics of China

<Table III-2> National Government Expenditures and Shares by Area (2011)

(Unit: CNY 100 million, %)

Area		National government expenditures	Central government	Local governments
Total		109,247.79 (100)	16,514.11 (100)	92,733.68 (100)
General public services		10,987.78 (10.1)	903.01 (5.5)	10,084.77 (10.9)
	Foreign affairs	309.58 (0.3)	306.83 (1.9)	2.75 (0.0)
External assistance		159.09 (0.1)	158.98 (1.0)	0.11 (0.0)
Defense		6,027.91 (5.5)	5,829.62 (35.3)	198.29 (0.2)
Public security		6,304.27 (5.8)	1,037.01 (6.3)	5,267.26 (5.7)
	Law enforcement	1,082.02 (1.0)	789.57 (4.8)	292.45 (0.3)
Education		16,497.33 (15.1)	999.05 (6.0)	15,498.28 (16.7)
Science and technology		3,828.02 (3.5)	1,942.14 (11.8)	1,885.88 (2.0)
Culture, sports, and media		1,893.36 (1.7)	188.72 (1.1)	1,704.64 (1.8)
Social safety net and employment		11,109.40 (10.2)	502.48 (3.0)	10,606.92 (11.4)
Medical and healthcare		6,429.51 (5.9)	71.32 (0.4)	6,358.19 (6.9)
Environmental protection		2,640.98 (2.4)	74.19 (0.4)	2,566.79 (2.8)
Urban and rural community affairs		7,620.55 (7.0)	11.62 (0.1)	7,608.93 (8.2)
Agriculture, forestry, and water conservancy		9,937.55 (9.1)	416.56 (2.5)	9,520.99 (10.3)
Transportation		7,497.80 (6.9)	331.11 (2.0)	7,166.69 (7.7)
	Purchasing vehicles	2,314.60 (2.1)	73.48 (0.4)	2,241.12 (2.4)



<Table III-2> Continued

Area	National government expenditures	Central government	Local governments
Affairs of exploration, power, and information	4,011.38 (3.7)	464.12 (2.8)	3,547.26 (3.8)
Commerce and service	1,421.72 (1.3)	26.93 (0.2)	1,394.79 (1.5)
Financial supervision	649.28 (0.6)	413.94 (2.5)	235.34 (0.3)
Earthquake recovery and reconstruction	174.45 (0.2)		174.45 (0.2)
Land and weather forecasting	1,521.35 (1.4)	231.61 (1.4)	1,289.74 (1.4)
Housing security	3,820.69 (3.5)	328.82 (2.0)	3,491.87 (3.8)
Management of grains and oil reserves	1,269.57 (1.2)	540.08 (3.3)	729.48 (0.8)
Interest payments for domestic and foreign debt	2,384.08 (2.2)	1,819.96 (11.0)	564.12 (0.6)
Other	2,911.24 (2.7)	74.99 (0.5)	2,836.25 (3.1)

Source: *China Statistical Yearbook*, 2012.

B. Intergovernmental Function-sharing and Revenue Items

□ Revenue items of the central government

- The revenue of the central government largely consists of its own revenue, fiscal transfer revenue, debt revenue, and other revenue.
- Most of its own revenue is derived from taxes. Fiscal transfer revenue refers to financial transfers from local governments. Debt revenue includes revenue from the issuance of government bonds, foreign loans, issuance of public bonds in China, treasury bonds, and the purchase of finance bonds issued by state-owned banks.
- As for the fiscal transfer revenue, local governments transfer a certain part of value added taxes and income taxes to the central government.



☐ Revenue items of local governments

- The revenue of local governments largely consists of tax revenue (local tax revenue, a part of shared tax), non-tax revenue (various charges and fees, etc.), and fiscal transfer revenue. In principle, local governments are not allowed to issue bonds.

☐ Function-sharing between central government and local governments

- The central government holds the primary responsibilities for defense, foreign affairs, capital investment, and construction.
- Local governments are in charge of various functions closely associated with daily living, including the establishment and operation of local public companies, technological development, agriculture, education, culture, healthcare, social welfare, public security, public facilities, and public services.

☐ (Mismatch in authority and fiscal share) Responsibility and authority on revenue and expenditures are defined only at the central and provincial levels of government. No clear regulations are found for governments below the provincial level.⁵⁾

- Responsibility on revenue is relatively clearly defined, but expenditures are not clearly assigned between central and local government. This fact indicates that there will likely be significant inefficiencies in total government expenditures.
- While revenue is concentrated on high-level governments, accountability for expenditures lies with low-level governments, resulting in mismatch. Low-level governments are more likely to suffer fiscal deficits as a result.

C. Overview of Intergovernmental Finance

☐ Overview of intergovernmental finance in China

- The central government's revenue accounts for 50% of total government revenue. However, 35 percent is transferred to local governments and the

5) Jang, No-sun and Hwa Kim, "Transition and Development of China's Public Finance Reform - Focusing on the Tax-sharing System," *Social Science Studies*, Vol. 48, 2009.

other 15 percent remains as central government revenue.

- Local governments account for about 85 percent of total public expenditures.

<Table III-3> Revenue and Expenditures by Central and Local Governments

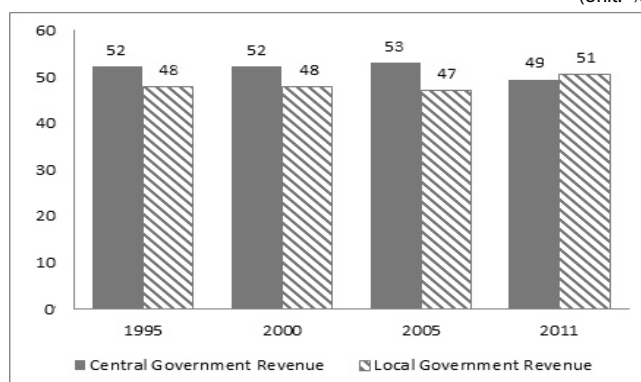
(Unit: CNY 100 million, %)

Government revenue	Central government revenue	Transfer to local	Local government revenue	Actual expenditure by central	Actual expenditure by local
103,874	51,327(49.4)	39,921	52,547(50.6)	16,514(15.1)	92,733(84.9)

Source: China Ministry of Finance, 2011.

[Figure III-5] Central-Local Revenue Ratio

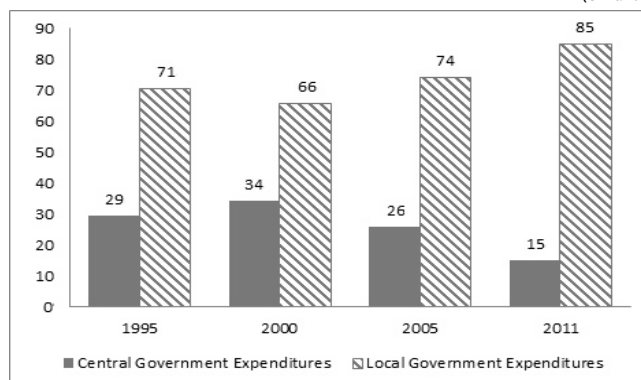
(Unit: %)



Source: China Statistical Yearbook (Relevant Years)

[Figure III-6] Central-Local Expenditure Ratio

(Unit: %)



Source: China Statistical Yearbook (Relevant Years)

□ Tax revenue of central and local governments since the 1994 tax-sharing reform

- While the central government's tax revenue tripled from CNY 95.7 billion in 1993 to CNY 290.6 billion in 1994, local governments' tax revenue decreased by one-third from CNY 339.1 billion to CNY 231.1 billion over the same period.

<Table III-4> Tax Revenue and Expenditures of Central and Local Governments Before and After the 1994 Tax-Sharing Reform

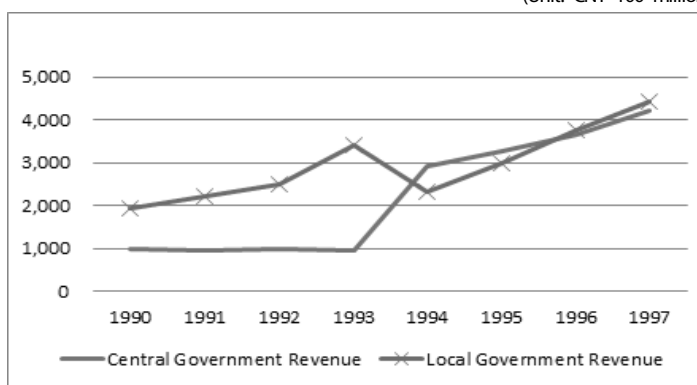
(Unit: CNY 100 million)

	Tax revenue		Expenditure	
	Central	Local	Central	Local
1993	957.51	3,391.44	1,312.06	3,330.24
1994	2,906.50	2,311.60	1,754.43	4,038.19
1995	3,256.62	2,985.58	1,995.39	4,828.33

Source: *China Statistical Yearbook*, 2012.

[Figure. III-7] Central and Local Government Revenue Before and After Tax-sharing Reform

(Unit: CNY 100 million)



Source: *China Statistical Yearbook*, 2012.

D. China's National Tax and Local Tax System

- (The background and objectives of tax-sharing system for the adjustment of national tax and local tax and the sharing of tax revenue)

- Background of tax-sharing reform: Introduced in 1994 to optimize tax sharing between the central and local governments, increase the transparency of the tax system, and enhance the authority of the central government.⁶⁾
- Pre-reform situation: According to 'fiscal contracting', local governments handed over a certain quota stated in the contract to the central government.
- Despite rapid economic growth in the 1990s, the central government experienced difficulty raising adequate tax revenue because the central government lacked systematic control over local governments. Local governments set aside extra-budgetary funds, lowered tax rates, and increased income tax deductions in their favor (Zhang and Martinez-Vazquez, 2003). As

<Table III -5> Current Revenue and Expenditure Items of the Central and Local Governments

Revenue	Central revenue	Tariff, consumption tax; central corporate tax; income tax of local bank, foreign bank, and non-bank financial institutions; payment from railroad, banks and insurers; profits from state-owned companies
	Local revenue	Business tax, local corporate tax, personal income tax, urban land use tax, fixed assets investment orientation regulation tax, city maintenance and construction tax, house property tax, tax on vehicles and boat operation, stamp tax, slaughter tax, farm land occupation tax, deed tax, land appreciation tax, charge for using state-owned land, etc.
	Shared revenue	VAT (central 75%, local 25%), corporate tax and personal income tax included in shared revenue (central 60%, local 40%), resource tax (ocean oil resource tax to central, other resource tax to local), stock transaction tax (central 97%, Shanghai and Shenzhen 3%)
Expenditures	Central expenditures	Defense, armed police security, foreign affairs central administration, basic construction investment, central corporation technology improvement, geological prospecting, interest on debt, agriculture, culture, education, and sanitation
	Local expenditures	Local administration, inspection, armed police security, militia, local company technology improvement, agriculture, urban maintenance and construction, local culture, education, and sanitation

Source: Seok-kyu Jeong, "Key Issues in China' Public Finance Reform and Reform Prospects," Presentation at the PEMNA Center Seminar, Jun. 19, 2013.

6) Wong, Christine P.W, *Central-local Relations Revisited: The 1994 Tax-Sharing Reform and Public Expenditure Management in China*, China Perspectives 31, 2000, pp.52-63.

a result, the central government budget as a share of GDP fell drastically from 31 percent in 1978 to only 12 percent by 1993 (Knight and Shi, 1999).

- Also, income disparity across regions began to emerge as a social issue. The regional income disparity became more extreme due to the outsized political influence of relatively wealthy provincial governments (Eui-seop Kim, 2006).
- Tax-sharing reform did a great deal to make the tax system more efficient and improve tax administration, fiscal soundness, and accountability.
- It also has its adverse side-effects such as pressure on local government finance and exacerbation of the regional disparity in distribution of government finance.⁷⁾
- Additional details of the tax-sharing system are as follows.
- Corporate tax revenue collected from railroads, the national postal service, state-owned banks, and major state-owned companies (oil, natural gas, and chemicals) goes to the central government. Other corporate tax revenue is shared between the central government and local governments at a ratio of 60:40.
 - Total revenue from stamp tax, which is also called securities transaction tax, is collected 40:60 between the central government and local governments. Within the stamp tax, 97 percent of stock transaction tax revenue⁸⁾ belongs to the central government and the remaining three percent goes to local governments.⁹⁾
- Details of tax revenue of the central government
- About 85 percent of the tax revenue of the central government comes from value-added taxes, consumption taxes, corporate income taxes, and individual income taxes.

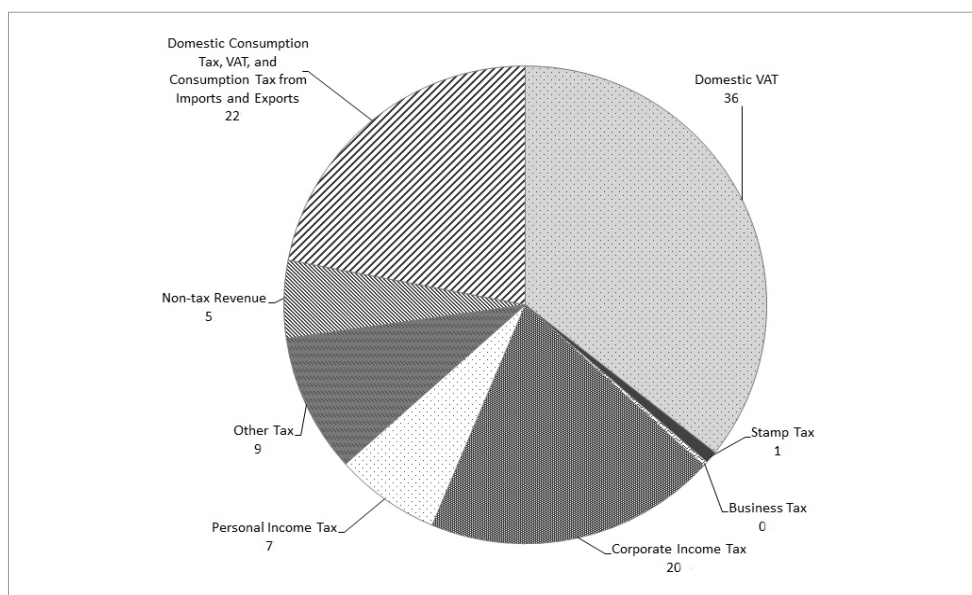
7) Im, Seong-il, "China's Public Finance and Taxation (I)," Korea Research Institute for Local Administration, 2007.

8) Total stamp taxes from stock transactions totaled CNY 438.45 million. Of this amount, CNY 425.28 million was allocated to the central government.

9) Im, Seong-il, "China's Public Finance and Taxation (I)," Korea Research Institute for Local Administration, 2007.

[Figure III-8] Central Government's Revenue by Source (2011)

(Unit: %)

Source: *China Statistical Yearbook*, 2012.

<Table III-6> Tax Revenue Sharing Ratio Between Central Government and Local Governments (2011)

(Unit: %)

Revenue items	Ratio	
	Central	Local
Domestic VAT	75.32	24.68
Domestic consumption tax, VAT, and consumption tax from imports and exports	100.00	-
Business tax	1.28	98.72
Corporate income tax	59.77	40.23
Personal income tax	60.01	39.99
Resource tax	-	100.00
Stamp tax	40.81	59.19
House property tax	-	100.00
Other tax	32.18	67.82

Source: *China Statistical Yearbook*, 2012.

- According to *China Statistical Yearbook 2012*, total tax revenue in 2011 was divided 55:45 between the central government and local governments.

<Table III-7> Central and Local Government Revenue Breakdown

(Unit: CNY 100 million, %)

Revenue items	Central + Local	Amount		Percentage	
		Central	Local	Central	Local
Domestic VAT	24,266.63	18,277.38	5,989.25	35.61	11.40%
Domestic consumption tax, VAT, and consumption tax from import and export	11,291.88	11,291.88	0.00	22.00	-
Business tax	13,679.00	174.56	13,504.44	0.34	25.70
Corporate income tax	16,769.64	10,023.35	6,746.29	19.5	12.84
Personal income tax	6,054.11	3,633.07	2,421.04	7.08	4.61
Resource tax	595.87	-	595.87	-	1.13
Stamp tax	1,042.22	425.28	616.94	0.83	1.17
House property tax	1,102.39	-	1,102.39	-	2.10
Other tax	14,936.65	4,806.13	10,130.52	9.36	19.28
Total tax	89,738.39	4,8631.65	41,106.74		
Non-tax revenue	14,136.04	26,95.67	11,440.37	5.25	21.77
Total	103,874.43	51,327.32	52,547.11	100.00	100.00

Source: *China Statistical Yearbook*, 2012.

- In the case of local governments, apart from tax revenue, the ratio of 'extra-budget' and 'off-budget' is high. The share of non-tax revenue in local government revenue is 21.77 percent, which is much higher than that of the central government (5.25 percent).



E. Key Issues in China's Local Taxation

☐ Background of adopting the house property tax¹⁰⁾

- China's local governments do not have legal authority to levy taxes against their citizens or to issue debt.
- Since most land in China is legally owned by the state, levying taxes on property and land had very limited effect.
- Therefore, many local governments began to seek non-tax revenue. They leased land to companies or individuals to receive leasing fees or borrowed money directly from banks to build infrastructure such as roads, railroads, and bridges.
- A rise in the leasing fee of land unleashed a surge in house prices. Corruption concerning sales or leasing of land became rampant.

☐ (Securing adequate finance for local governments) The share of land leasing fees in local governments declines; local governments seek other ways to raise revenue

- Local governments leased land and covered their financing needs with the leasing fee. As of 2010, land leasing fees accounted for one-third of the total revenue of local governments.
- According to a survey by the China Index Institute in 2012, the share of land leasing fees plummeted to 16 percent in Shanghai and 35.7 percent in Beijing.¹¹⁾
- Since the land leasing fee is so volatile, local governments began to seek regular income sources to cover their fiscal needs.

☐ (Need to set tax base for China's real estate tax and understand the source of tax)

- The tax base in real estate is not fair value but historical price (=acquisition

10) Man, Joyce Yanyun, "China's Property Tax Reform: Progress and Challenges," Lincoln Institute of Land Policy, 2012.

11) China Index Institute. 2012. <http://www.chinanews.com/estate/2012/01-04/3580986.shtml>



price). When real estate prices are rising sharply, levying tax based on acquisition price means losing opportunities for higher tax revenue.

- As house tax is not included in property tax, people increasingly traded houses for speculation and investment purposes. Even when house prices skyrocketed, governments could not control the house prices by raising the tax.
- As a result, multiple houses became owned by a single person and many houses were left unoccupied in urban areas. Nevertheless, low-income people who really needed a place to live experienced difficulty in buying houses.

Simulation of Property Tax Currently Under Revision

- In 2006, six cities were selected for the "market value" simulation. The number of cities was increased to 10 in 2007.
- In 2011, Shanghai was selected as a pilot city for levying personal property tax. If a Shanghai resident who already owns a house purchases an additional house of 1070 ft^2 or more, a tax base on 430 ft^2 (excluding 640 ft^2) is used to levy personal property tax.

Issues that need to be resolved for Chinese local governments to set property taxes

- Local governments are concerned about a possible decline in house prices due to personal property tax and a decline in revenue from leasing local government-owned land.
- Local government officials were able to easily adjust and raise rents for land without any market valuation. On the other hand, levying personal property tax requires a complex process of market valuation via CAMA (Computer Assisted Mass Appraisal). Local government officials are, therefore, reluctant to accept the property tax revision.
- Real estate investors and speculators are also against the property tax revision.
- As the tax base, deduction criteria, the role of administrators, and tax rate appraisal are suboptimal, further research is required.

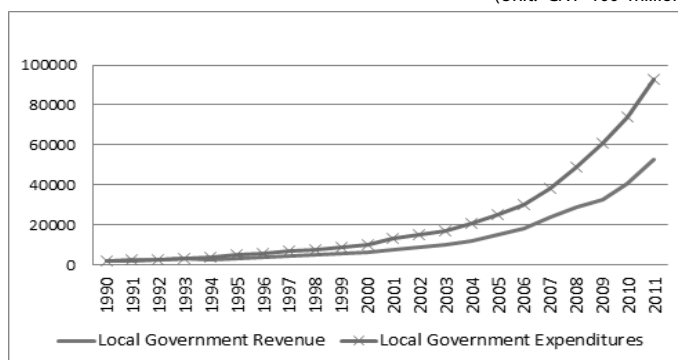
2. Overview of China's Local Finance and Its System

A. China's Local Public Finance

- China's local government revenue is steadily rising.
 - China's local government revenue rose about 29 percent year-on-year in 2011.
 - Local tax revenue for the year totaled CNY 4.1107 trillion and accounted for about 78 percent of total revenue.
- Local government expenditures are rising more rapidly than local government revenue.
 - Local government expenditures rose about 26 percent year-on-year in 2011.
 - The widening gap between revenue and expenditures since 1994 must be addressed as it would strain China's public finance in coming years.

[Figure III-9] Changes in Local Government Finance

(Unit: CNY 100 million)

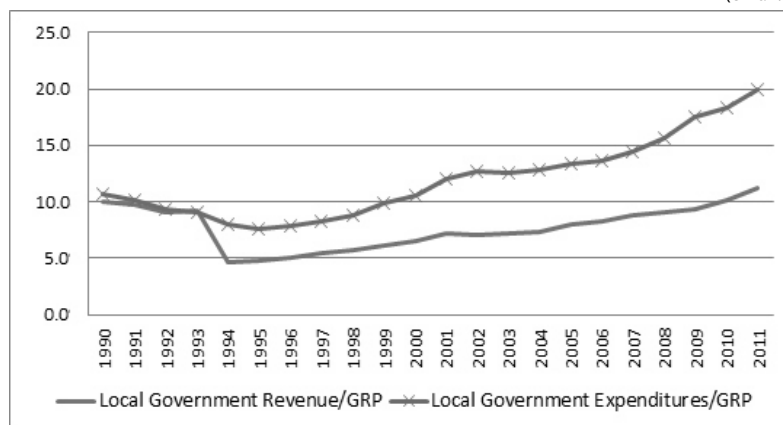


Source: *China Statistical Yearbook*, 2012.

- Since the tax-sharing reform in 1994, local government revenue has been growing 9~29 percent each year, but the gap between local government revenue and expenditures has been widening since 1994.
 - Local revenue as a share of GRP has been also increasing since 1994. (=Local revenue/GRP)

- Local expenditures as a share of GRP also began moving upward around 1994 and have been rising steadily. (=Local expenditure/GRP)

[Figure III -10] Local Total Revenue and Total Expenditure as a Share of GRP
(Unit: %)



Source: *China Statistical Yearbook*, 2012.

■ Fiscal expenditure by area (Local)

- Miscellaneous expenditures account for the largest share of total expenditures: about 33.2 percent. This is followed by education at 16.7% and the social safety net at 11.4%.

<Table III -8> Local Fiscal Expenditures (2011)

(Unit: CNY 100 million, %)

Total	General public service	Defense	Public security	Education	Science and technology	Social safety net	Medical and health-care	Environmental protection	Agriculture, forestry and water conservancy	Other
92,734	10,085	198	5,267	15,498	1,886	10,607	6,358	2,567	9,521	30,746
100.0	10.9	0.2	5.7	16.7	2.0	11.4	6.9	2.8	10.3	33.2

Source: *China Statistical Yearbook*, 2012.



B. China's Intergovernmental Transfer Policy and Its Status

- The Chinese government offers grants, an intergovernmental transfer scheme to narrow the financial gap across local governments, after fiscal revenue for the central government is secured.
 - Underdeveloped western regions fund their expenditures by intergovernmental transfers from the central government. These account for about 54.1 percent of their total local government expenditures.¹²⁾
- (Background of introducing the intergovernmental transfer payments)
 - After adopting the tax-sharing system in 1994, that is after "tax revenue" is shared, local governments in charge of fiscal expenditures experienced deterioration in their fiscal deficits.
 - Local governments are not authorized to levy taxes or issue local bonds, which renders intergovernmental transfers from the central government the only means by which they can correct the imbalance in local finance and cover their fiscal deficits.

C. Types of Central Government Grants and Their Trends

- The intergovernmental transfer scheme entails general purpose grants, special purpose grants, and other grants.
 - General purpose grants include equalization transfers, which ease the fiscal imbalance across regions. They are similar to the Local Shared Tax (LST) in Korea.
 - Special purpose grants are government grants for purposes designated by the central government in certain projects led by the central government.
- Other grants include tax rebates and revenue settlement grants (accounting settlement grants).

12) Jang, No-sun and Hwa Kim, "Transition and Development of China's Public Finance Reform - Focusing on the Tax-sharing System," *Social Science Studies*, Vol. 48, 2009.

- Tax rebates: In 1994, when the tax-sharing reform was adopted, tax rebates were introduced as grants order to guarantee vested rights of local finance and reduce opposition to the tax-sharing system. As of 1993, 30 percent of value-added taxes and consumption taxes collected were returned to the appropriate local governments as grants.¹³⁾
- Revenue Settlement Grant (Accounting Settlement Grant): After a fiscal year ends, the central government and local governments settle accounts on some extra budgetary items. In some cases, fiscal transfers are made from the central to local governments and vice versa. This fiscal transfer system is unique to China.¹⁴⁾

<Table III-9> Changes in Amounts of Grants by Type (1980~1993)

(Unit: CNY billion)

	Total	Tax rebates	General purpose grants	Special purpose grants
1980	14.1	7.2	5.9	1
1981	15.2	6.3	6.4	2.5
1982	19.1	7.1	6.9	5.1
1983	21.2	8.9	7.2	5.1
1984	25.4	10.2	7.8	7.4
1985	34.5	18.3	9.5	6.7
1986	46.4	25.7	8.6	12.1
1987	48.1	27.8	9.9	10.4
1988	53.8	27.3	8.2	18.3
1989	56.2	28.8	8.4	19
1990	58.5	29.6	8.6	20.3
1991	55.5	35.5	8.6	11.4
1992	59.6	37.8	10.1	11.7
1993	54.5	36	9.5	9

Source: Wong, Christine P. W., op. cit., 1996, p.52.

13) Jang, No-sun and Hwa Kim, "Transition and Development of China's Public Finance Reform - Focusing on the Tax-sharing System," *Social Science Studies*, Vol. 48, 2009.

14) Im, Seong-il, "China's Local Finance System," Korea Research Institute for Local Administration, 1999.

<Table III-10> Amounts of Grants by Type

(Unit: %)

	As a share of GDP					As a share of total subsidy				
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
Tax rebate	2.7	2.7	2.6	2.6	2.3	70.5	62.7	53.0	48.9	38.9
General purpose grants	0.3	0.3	0.5	0.9	1.4	7.5	7.5	10.2	17.9	24.5
Special purpose grants	0.7	1.1	1.8	1.6	2.0	18.1	26.4	33.9	30.6	34.6
Fixed grants	0.1	0.1	0.1	0.1	0.1	3.9	3.4	2.9	2.6	2.0
Total grants	3.8	4.2	5.0	5.2	5.8	100.0	100.0	100.0	100.0	100.0

Source: Ahmad, Singh, Fortuna, 2004, p. 9.

Eui-seop Kim, "China's Fiscal Decentralization and Changes in Central-Local Fiscal Relations," The Korean Journal of Local Finance, Vol. 11, No. 1, 2006. 6. pp. 129-160.

Types of central government transfers and their allocation mechanism¹⁵⁾

① Revenue-sharing transfers:

- Provincial governments receive 25 percent of the value-added tax (VAT) and 40 percent of the enterprise income tax from the central government.

② Tax rebates:

- Provincial governments were assured that, even after 1994, they would receive at least the same amount of the VAT and excise tax revenue they had collected in 1993.

$$TR_t = TR_t \left[1 + 0.3 \left(\frac{VAT_t - VAT_{t-1} + ET_t - ET_{t-1}}{VAT_{t-1} + ET_{t-1}} \right) \right]^{16)}$$

③ Equalization transfers:

- The equalization transfers were established in 1995 to reduce regional fiscal disparities. They fill a part of the gap between fiscal needs and fiscal revenue of a provincial government.

15) Shah, Anwar and Chunli Shen, "The Reform of Intergovernmental Transfer System to Achieve a Harmonious Society and a Level Playing Field for Regional Development in China," World Bank, December 2006..

16) TR_t : Tax rebate to a province at year t



$$ET_i = TET * \frac{SE_i - SR_i}{SE - SR} \quad 17)$$

④ Grants for increasing wages of civil servants:

- The central government raised the wage rate for civil servants in 1999 and 2001, and a special grant was set up in 1999 to cover the increased wage of civil servants in western and central regions.

$$Wage Grant_i = Exp_i \times BasicExpenditureRatio_i \quad 18)$$

⑤ Grants for rural tax reform:

- The rural tax reform in 2002 and the abolishment of agricultural taxes in 2006 greatly reduced provincial government revenue. The grants for rural tax reform were established to fill the fiscal gap caused by these reforms.

⑥ Grants for Minority Regions:

- The grants for minority regions were first provided in 2000. They support economic development in minority regions.

CNY 1 billion*(1+growth rate of central VAT revenue)+0.8*Central increased VAT collection in minority areas¹⁹⁾

⑦ Pre-1994 Grandfathered subsidies:

- Although the Fiscal Contracting System expired with the tax reform in 1994, provincial governments continued to receive subsidies according to their fiscal contracts in effect in 1993. The sixteen provinces of Inner Mongolia, Jilin, Fujian, Jiangxi, Shandong, Guangxi, Hainan, Sichuan, Guizhou, Yunnan, Tibet, Shanxi, Gansu, Qinghai, Ningxia, and Xinjiang receive this grant.

17) ET_i : Equalization transfer for province i

TET: Total equalization grant available in the budget year

SE_i : Standard expenditure in province i

SR_i : Standard revenue in province i

SE: Total standard expenditure of the country

SR: Total standard revenue of the country

18) $Wage Grant_i$: the grant for increasing wages received by province i

Exp: the increase of provincial budgetary expenditure due to central policy of increasing wages

BasicExpenditureRatio: the ratio of the personal and office expense to the total disposable revenue of the province i

19) "The total grants equals a base amount of CNY 1 billion in 2000 with a yearly growth rate equal to that of central VAT revenue, and that rebate of the 80% of the central increased VAT collection in minority areas."

⑧ Ad hoc transfers (Earmarked transfer):

- The ad hoc transfers are government subsidies allocated for various purposes such as agricultural development, infrastructure construction, and emergency funding for natural disaster recovery.

■ As of 2012, grants totaled CNY 4.538 trillion or around nine percent of GDP, which is nominally high.

- A significant part of fiscal transfers from the Chinese central government to local governments includes fiscal transfers made from local governments to the central government. For comparison, it would be reasonable to offset transfers originally made from local governments and not accept the nominal figure of nine percent as it is.

<Table III-11> Central-Local Transfers (2002~2012)

(Unit: CNY billion, %)

Year	Total transfers including tax rebates and government subsidies	Annual Growth rate
2002	736.2	
2003	824	11.9
2004	1,037	25.8
2005	1,147	10.6
2006	1,349	17.6
2007	1,811	34.24
2008	2,294	26.7
2009	2,862	24.7
2010	3,234	12.9
2011	3,989	23.3
2012	4,538	13.7

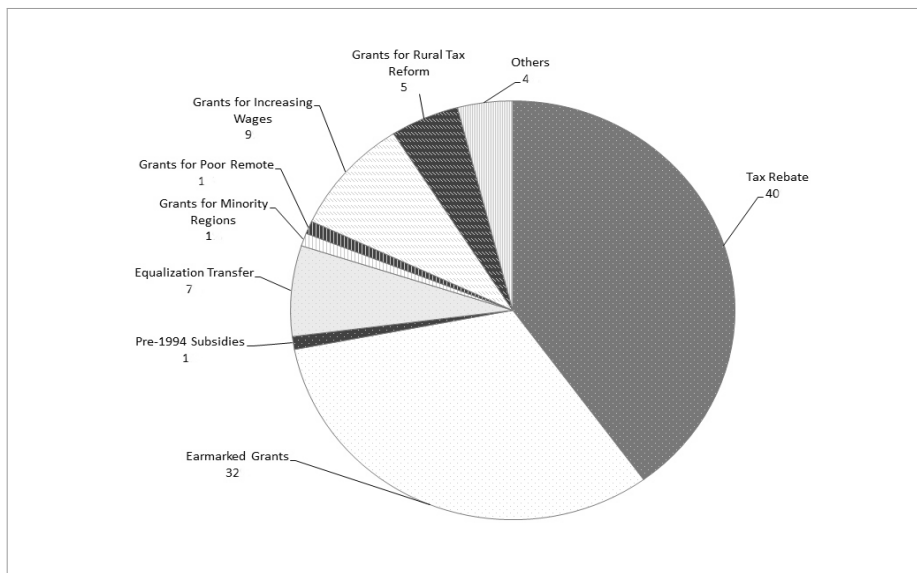
Source: Ministry of Finance, "Report on the Implementation of the Central and Local Budgets," 2002~2012, Figures only.



- Intergovernmental transfers as a share of the central government tax revenue and changes in shares within transfer items since 1994
 - As of 2011, national tax revenue totaled CNY 8.977 trillion, and the central-local transfers totaled CNY 3.989 trillion or roughly 44.5 percent.
 - What is noteworthy is that the share of tax rebates is steadily declining. The "revenue vested rights of provincial governments" accounted for 35 percent of total tax revenue at the time of the tax reform in 1994 and have persistently declined since then, falling to around five percent by 2011.
 - The share of general purpose grants or equalization transfers increased from around two percent in 1994 to 20 percent in 2011. Simultaneously, the share of government grants for agriculture, forestry and fishery, transportation, and housing increased.
 - This indicates that China's central government, as the fiscal authority, continues to maintain its commitment to balanced development and is consistently increasing its share in relevant sectors.

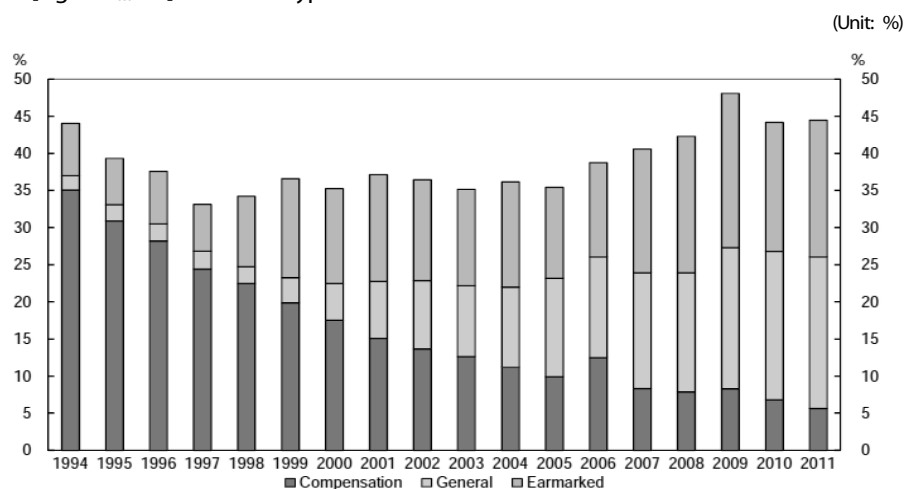
[Figure III-11] Central-Local Transfer (2004)

(Unit: %)



Source: Shen, Chunli, Jing Jin and Heng-Fu Zou, "Fiscal Decentralization in China: History, Impact, Challenges and Next Steps," *Analysis of Economics and Finance*, 13-1, 2012, pp.1-51.

[Figure III-12] Different Types of Transfers as a Share of National Tax Revenue



Source: Ministry of Finance, *Finance Yearbook* 2012.

Wang, Xiao and Richard Herd, "The System of Revenue Sharing and Fiscal Transfers in China," OECD Economics Department Working Papers, No. 1030, OECD Publishing, 2012.

<Table III-12> Major Components of Central-Provincial Transfers (2011)

(Unit: %)

Types of Transfers	Ratio
Compensation Transfers	12
General Transfers	46
Equalization Transfer	19
Pension and Social Security	7
Wage Adjustment for Civil Service	7
Compulsory Education	3
Others	10
Earmarked Transfers	42
Agriculture, Forestry & Water	12
Transportation	9
Affordable Housing	4
Energy Saving and Pollution Abatement	4
Social Security and Employment	4
Others	9

Source: Ministry of Finance, *Finance Yearbook* 2012.

<Table III-13> Grants as a Share of Total Fiscal Expenditures by Region (2003)

(Unit: CNY billion, %, CNY)

	Total expenditure	Grants	Grants as a share of fiscal expenditure	Per capita total expenditure	Per capita grants
Beijing	73	18	25	5,047	1,236
Tianjin	31	13	42	3,087	1,286
Hebei	65	34	53	955	502
Shanxi	42	22	53	1,254	664
Inner Mongolia	45	27	61	1,875	1,132
Liaoning	78	41	53	1,863	974
Jilin	41	29	71	1,513	1,072
Heilongjiang	56	32	57	1,481	839
Shanghai	109	33	31	6,164	1,869
Jiangsu	105	33	32	1,405	442
Zhejiang	90	28	32	1,846	577
Anhui	51	29	58	823	471
Fujian	45	15	34	1,292	428
Jiangxi	38	22	58	898	517
Shandong	101	33	33	1,108	362
Henan	72	39	55	741	403
Hubei	54	31	58	951	545
Hunan	57	33	58	861	495
Guangdong	170	44	26	1,892	491
Guangxi	44	24	55	913	494
Hainan	11	6	57	1,300	740
Chongqing	34	20	59	1,219	713
Sichuan	73	41	56	896	501
Guizhou	33	22	67	859	568
Yunnan	59	35	60	1,342	800
Tibet	15	13	90	5,404	4,815
Shaanxi	42	25	60	1,139	681
Gansu	30	21	70	1,182	828
Qinghai	12	10	82	2,285	1,873
Ningxia	11	7	67	1,824	1,207
Xinjiang	37	24	66	1,905	1,241
Max			90	6,164	1,869
Min			25	823	362
Average			54		

Source: Martinez-Vazquez, Jorge, Baoyun Qian, Shuilin Wang and Heng-Fu Zou, "A Treaties on Public Finance in China," No. 555 CEMA Working Papers, China Economics and Management Academy, Central University of Finance and Economics, 2012.

Per capita total expenditure and per capita subsidy are calculated based on *China Statistical Yearbook 2012*.

- According to data since 2003 on grants as a share of fiscal expenditures across regions, the share in wealthy Beijing is about 25 percent and the share in Tibet is 92 percent. This implies that grants function well within the total amount in adjusting finance. By 2011, the government's determination to increase the equalization transfers for regional balanced development became consistently manifest.

D. Sub-provincial Government Grants and Their Trends

- Grants transferred from provincial governments to low-level governments have a similar mechanism as the transfers from the central government to provincial governments. The same allocation formulas are used for the equalization transfers and the tax rebate.
- ① Prefecture Management Model
 - As of 2005, 20 provinces adopted this model. Provincial governments support prefectural governments, and prefectures support counties.

<Table III-14> Province-Prefecture Transfers (2003)

(Unit: %, CNY billion)

Transfer Types	Percentage	Amount
Revenue Sharing Transfers	29	336.63
Tax Rebates	21	243.77
Grants for Increasing Wages	10	116.08
Equalization Transfer	5	58.04
Grants for Rural Tax Reform	4	46.43
Grants for Minority Regions	0	0.00
Pre-1994 Subsidies	2	23.22
Ad Hoc Transfers	19	220.55
Others	10	116.08
Total	100	802.70

Source: Shah, Anwar and Chunli Shen, "The Reform of the Intergovernmental Transfer System to Achieve a Harmonious Society and a Level Playing Field for Regional Development in China," World Bank Policy Research Working Paper, December 2006, Figure 4.

② Province Managing County model

- Provincial governments support county governments directly without going through prefectural governments.
- Eleven provincial governments adopted this model (Anhui, Fujian, Heilongjiang, Hainan, Hubei, Ningxia, Zhexiang, Beijing, Tianjin, Shanghai, and Chongqing). This system is also used by some prefectures such as Dalian, Ningbo, Qiongdiao, Shenzhen, and Xiamen.
- County governments subsidize townships and villages.

<Table III-15> Provincial/Prefecture - County Transfers (2003)

(Unit: %, CNY billion)

Transfer Types	Percentage	Amount
Revenue Sharing Transfers	21	243.77
Tax Rebates	23	266.98
Grants for Increasing Wages	13	150.90
Equalization Transfer	6	69.65
Grants for Rural Tax Reform	6	69.65
Grants for Minority Regions	0	0.00
Pre-1994 Subsidies	3	34.82
Ad Hoc Transfers	18	208.94
Others	10	116.08
Total	100	541.20

Source: Shah, Anwar and Chunli Shen, "The Reform of the Intergovernmental Transfer System to Achieve a Harmonious Society and a Level Playing Field for Regional Development in China," World Bank Policy Research Working Paper, December 2006, Figure 4.

E. Intergovernmental Transfer Effect Analysis

- ① A previous study (Shuanglin Lin, 2011) analyzed the effect of intergovernmental transfers in China from 1995 through 2005 based on provincial panel data.²⁰⁾



□ Study method

- Data for the empirical study were taken from the China Statistical Yearbook and Government Finance Yearbook of China. The study covered the panel data of 31 provincial governments in China from 1995 through 2004.
- The Ministry of Finance data in the Government Finance Yearbook of China (1996~2005) were used for transfers to the central government; the National Bureau of Statistics of China database in the China Statistical Yearbook (1998, 1999, 2001, 2005, etc.) were used for GDP data; the National Bureau of Statistics of China database in the China Statistical Yearbook (1995~2006) were used for population data, and the China Regional Economy database was used for RPI.

□ Findings and implications

- An empirical analysis on the determinants of intergovernmental transfers based on the panel data of 31 provincial governments from 1995 through 2004 showed that
 - Provincial governments with high income levels were receiving greater amounts of transfers than low-income provincial governments. Per capita transfers were higher in high-growth regions than in low-growth regions.
 - Also, transfers from the central government to low-growth regions, minority regions that are classified as poor areas, and western regions were higher than to other regions.
- In conclusion, the role of the equalization transfers in supporting under-developed regions seems to be significant. However, the current intergovernmental transfer system in which the share of tax rebates is high in absolute terms is not effective in resolving regional fiscal disparities.
- The study concludes that the only option for addressing the intractable regional income and fiscal disparities is to abolish the tax rebates and to increase provincial governments' share of the VAT revenue.

20) Lin, Shuanglin, "Central Government Transfers: For Equity or For Growth?," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.

② A previous study (Zhang and Zheng, 2011)²¹⁾ attempted analysis of effects through econometric analysis.

- Zhang and Zheng(2011) state that studies prior to 2011 strongly viewed transfers as financial resources for political purposes and that a dominating number of politicians considered transfers as a social safety net for the majority of the people.
 - Now, the economic effects of transfers should be analyzed. For instance, the central government needs to conduct analysis of effects to determine whether support for Nationally Designated Poverty Counties (NDPC), that is underdeveloped areas, should continue.
- Before 2011, studies were conducted at the provincial level due to data accessibility. However, this paper covered the county level from 1997 through 2003.
 - The study states that despite policies for balanced development such as the equalization transfers, the transfers are not in fact used in ways that promote balanced regional development.
 - The current system is not conducive to balanced regional development because the tax rebates are designed to return more to wealthier regions.
- Empirical results: Analysis of effects of tax rebates vs. equalization grants
 - The tax rebate program was established in 1994 with the tax reform. It aims to offer greater tax benefits to provinces that undertake the central government's reforms more proactively.
 - Unlike the tax rebates, the equalization grants are designed to provide greater benefits to rural areas or underdeveloped regions.
 - Further development method: Analyses need to consider the innate differences of each region through the fixed effect model.

21) Zhang, Li and Xinye Zheng, "The Determinants of Intergovernmental Transfer," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.



Findings

- China's subsidy program generally provides greater support to regions that are already financially strong due to the tax rebate program.
- However, the effects of the equalization grants are manifest in poor areas and rural areas, though they are limited to some areas.

3. China's Debt Level

A. Debt of China's Central Government

- As of December 2010, China's debt was officially CNY 6.7 trillion, which is very low at 17 percent of GDP. However, this includes only the central government's debt. If debts by local governments are included, China's debt level is estimated to be many times higher than the official figure.

<Table III-16> Central Government Debt

(Unit: CNY 100 million)

Year	Total	Domestic Debt	External Debt
2005	32,614.21	31,848.59	765.52
2006	350,15.28	34,380.24	635.02
2007	52,074.65	51,467.39	607.26
2008	53,271.54	52,799.32	472.22
2009	60,237.68	59,736.95	500.73
2010	67,548.11	66,987.97	560.14
2011	72,044.51	71,410.80	633.71

Source: *China Statistical Yearbook 2012*.

B. Debt of China's Local Governments

- According to the National Audit Office of China, as of the end of 2010, local government debt totaled CNY 10.7199 trillion.²²⁾
 - About 46.38 percent of this debt was by loan platforms, and about 80 percent of the debt was sourced from bank loans.
- The use of local government loan platforms implies that local governments set up financial institutions in order to raise investment funds for the construction of infrastructure and other purposes. They raise and invest funds by issuing bank loans or bonds using land, stock, and cash provided by local governments as underlying assets.
- Given that interest on debt is paid by local governments' extra budgetary revenue from the proceeds from the sale of land, the debt risk should be closely monitored.
 - Need to increase transparent and legal funding channels by changing local governments' funding structure, which mainly depends on loan platform companies, and legalizing the issuance of bonds by local governments.

<Table III-17> Governments Debts by Government Level

(Unit: CNY 100 million)

Year	2008	2009
National debt	48,753	55,411
Local debt	-	2,000
Loan platform by local governments	41,000	74,800
GDP	314,045	335,353
Total debt as a share of GDP (%)	28	39

Source: Liu, Jinhe, "Chinese Local Governments' Debt Crisis," *SERI China Review*, SERI, 2011.

22) KIEP Beijing Office, Beijing Office Briefing, "Overview of Chinese Local Government's Debts and their Prospect," KIEP, 2011.

4. Key Issues in China's Fiscal Reform

■ In 2012, the Ministry of Finance demonstrated its commitment to "fiscal reform" through a press release (China News, December 20, 2012). The fiscal reform basically has three points.

① Restructuring of fiscal system

- Raise the ratio of general purpose transfers and lower the ratio of special purpose transfers.
- Improve the fiscal system of sub-provincial governments for more balanced fiscal allocation and enhance the basic social security financial service function of county-level governments.

② Restructuring of budget system

- Seek to improve the norms and transparency of government fund budget, increase the scope of state-owned capital budget, and enhance the management of the social insurance fund budget.
- Plan to improve local government's debt management by improving the budgeting and execution management system and initiating the government accounting reform.

③ Tax revenue reform

- Begin a pilot project for converting business taxes of some service industries to value-added taxes to address the imbalance between goods and services.
- Improve the consumption tax system to rationalize the collection scope of consumption taxes and tax rate regulations and promote energy-saving and reduction in waste generation.
- Initiate a stable pilot project based on insights gleaned from the real estate tax reform.
- Review and legislate the environmental protection tax reform plan.
- Consolidate administrative charges and government funds based on the guiding principles and classification principles that tax is the main source and fees and charges are supplementary sources.

IV. China's Regional Development Policy

1. China's Regional Policy

A. Guangdong Province Case Analysis

■ A previous study on funding for infrastructure development in the Guangdong region compiled seven funding options.²³⁾

- 1) Funding through general budget
 - General taxes, proceeds from operating state-owned assets, administrative fees, other revenue such as fines, transfers from higher-level governments, and funds carried forward from the previous year
- 2) Funding through extra-budgetary funds
 - Fees and charges: expressway tolls, utility service charges (water and sewage), and etc.
- 3) Loans from the central government
 - Once the amount of a loan is determined, several government ministries receive a certain amount from the central government depending on the policy priority and decisions by central government officials. Then, central government ministries allocate these funds to projects initiated by provincial and local governments.
- 4) Funding from the government and profit-oriented funds
 - Funding through proceeds from service institutions or corporations, earned surpluses or transfers from service institutions or corporations, and proceeds from leasing land

23) Mikesell, John L., Jun Ma, Alfred Tat-Kei Ho, and Meili Niu, "Financial Local Public Infrastructure: Guangdong Province," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.

5) Funding from retail bank loans

- ① Through service institutions or corporations operated by the government: Service institutions or corporations operated by the government can borrow money from retail banks by putting up their revenue as collateral. They can also lease out operation rights on some of their businesses (e.g., water supply and sewage) to private operators for a certain period and pay back loans with such proceeds.
- ② Through partnership with private investors or enterprises: Loans can be paid back with future proceeds from infrastructure projects such as real estate development.

6) Funding through foreign investment

- Some infrastructure projects are managed and funded by foreign companies.

7) Private donation and international organization funds

B. Shandong Province Case Analysis²⁴⁾

- Example of Zouping County in Shandong Province: As a self-rescue measure to fund the county government, which is in financial distress, a land lease plan was introduced.
 - Tax revenue decreased in many rural farming areas when the agricultural tax was abolished in 2006. However, in the case of Zouping county, the agricultural tax then accounted for only 3.3 percent of its revenue, so the financial impact from the abolishment of agricultural tax was not significant.
 - Local governments developed and leased out land to secure additional budget funds. They established a land bank to borrow money using land as collateral.
 - In order to attract investors after land development, they also offered deductions on leasing fees for land and began to attract large companies.

24) Whiting, Susan, "Fiscal Reform and Land Public Finance: Zouping County in National Context," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.



2. Recent Trends in Economic Development Policy

A. Direction of Central Government's Economic Development Policy

- The '12.5 Plan (the 12th Five-year Economic Development Plan)' is currently underway.
 - In 2011, new strategies were suggested based on the 'harmony of growth and distribution' during President Xi Jinping's term for new urbanization, income redistribution, industrial restructuring, and real estate policy²⁵⁾

B. Regional Development Policies of Local 'Two Meetings'²⁶⁾

- Inland areas are in the "quantitative growth" stage of development, so the center of growth is shifting from the coastal regions to inland areas. They are expected to grow fast as a result of industrial relocation, abundant resources and market potential, and the government's support policies.
 - The coastal regions seeks 'qualitative growth' rather than 'quantitative growth.' They announced to initiate innovation and industrial advancement proactively.

25) Shin, Jong-ho, "China in the Era of Xi Jinping: A New Take-off or the Beginning of a Crisis," *Issues & Diagnosis*, Gyeonggi Research Institute, 2013.

26) Kim, Buyong and et al., "Trend Briefing by Province in China, 2013 Details of China's Local Two Meetings and Their Implications," KIEP, 2013.

V. Conclusion and Policy Implications

1. Review of Key Findings

- Prior to proposing specific improvement plans for China's public finance and intergovernmental finance systems, there is a need to present clear objectives for improving the central-local intergovernmental fiscal relations.
 - In theory, the central government intervenes in local governments' finance for the purposes of redistribution and fiscal sustainability.
 - The Chinese fiscal authorities are now identifying revenue sources for the centralization of public finance (commitment to legalize real estate tax base) and discussing considerations of debt levels.
- The main roles of the Chinese central government finance and local government finance since the reform and liberalization in 1978 may be summarized as follows:
 - For the purpose of securing its funds, the central government shared the revenue sources through the tax-sharing reform in 1994. Based on the available funds, the central government supported efforts to attract investment most actively by granting various tax benefits and deregulation.
 - At the same time, it supported underdeveloped regions by using the funds for 'balanced development' to reduce regional economic disparities.
 - Local governments are in charge of executing major expenditures for such matters as education, welfare, environmental protection and industry.



2. Features of China's Decentralized Model

- Roy Bahl (2011) explained that "the efficiency gains from the fiscal decentralization" may be possible in developed countries, but this is a challenge in countries in transition or developing countries.²⁷⁾
- (Streamlining of decision-making - Political advancement) In order to apply the decentralization concept discussed in academia, some preconditions are required.
 - First, legally or systematically, regional or local governments should duly hear requests from local residents. That is, rather than appointed chief officers, elected chief officers are more likely to respond seriously to residents' requests.
 - Second, the chief officers of local governments should have the legal duty to address local residents' requests.
 - Third, basic level governments should be guaranteed some minimum degree of taxation authority.
 - Fourth, basic level governments should have adequate discretion to set the levels and shares of their expenditures.
 - The above-listed preconditions imply that the efficiency gains from the fiscal decentralization are not achieved simply by improving programs, but also by having governments and residents pay a significant price.
- How would China's decentralization model evolve?
 - In China, where the election of the heads of organizations is not possible, the current expenditure model based on so-called best practices is not applicable.

27) Bahl, Roy, "Intergovernmental Fiscal Relations and Local Public Finance: What Is Next on the Reform Agenda?," in Man, Joyce Yanyun and Yu-Hung Hong (eds), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy, 2011.



- Direction of improvement in China's expenditures and fiscal management
 - Need mid/long-term approach on social welfare spending: The share of public assistance spending by local governments, in particular sub-county governments, that are in charge of pensions, healthcare, compulsory education, security, and economic development is very significant. Need to develop an outlook and mid-term plan in this respect.
 - Fiscal expenditure and debt management system: Local governments have especially great responsibility over spending in China, which means that an institutional mechanism for the central government to manage local governments' spending (including debts) is required to control the size and pace of debts issued by local governments.
- Direction of China's revenue improvement and discussion issues
 - Need to increase the central government's role in revenue: Need to secure funds for balanced development and reorganize the grant policy by reducing tax rebates and increasing the equalization transfers.
 - The key agenda of the current tax reform is enhancing the tax administration function to set in place the house property tax.

3. Future Study and Limitation

- This study aimed to provide basic data for understanding China's central and local government finance by summarizing available data on China's local finance and examining key findings.
- Going forward, there is a need to elaborate on the political structure and public finance and economic systems in greater detail
 - (Political structure) Understand the governance of China's political structure.



- (Central and local fiscal system) Examine the roles of the Ministry of Finance through China's fiscal and budget systems, analyze major policies and their effects, and understand major programs and policies.
- (Effect analysis of major economic policies and fiscal policies) China's reform and liberalization was achieved through the urbanization policy. China's industrial restructuring through the migration of population and subsequent urban growth and the rise in local fiscal spending are systematic. Understanding this structure is critical towards understanding China's public finance system overall. There also seems to be a need to quantify policy effects by analyzing China's national statistics.
- (Understanding the scope and details of fiscal activities at the local government level) China's national finance is structurally inseparable from local finance. Therefore, it is necessary to understand the fiscal operation of local governments for both revenue and expenditures.

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