Preparing the Ground

China's quest for sustainable growth calls for bold fiscal reforms

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THREE and a half decades into arguably the most successful development story of the modern era, China finds itself at a critical juncture. It must shift from a nearly exhausted investment-driven and export-reliant growth model—with rising macroeconomic and financial risks and unsustainable environmental costs—to a new path of more domestic consumption–based, more inclusive, and greener growth.

The dominant role of China's government in the economy means that the management of its finances—fiscal policy—is both a foundation of its past success and the root of future challenges. Fiscal policy reforms are needed to safeguard past achievements and prepare the ground for sustained improvements in the future.

Strategic reform goals

The goals of these strategic reforms are fourfold:

Balance the budget—Slow the accumulation of debt that would eventually burden government budgets and taxpayers, while being mindful of fiscal policy's role in preventing a sharp slowdown in growth;

Get prices right—Deal with the negative impact of resource use, especially energy, and eliminate subsidies that favor state-owned enterprises over the private sector;

Ensure the efficient use of state assets and their proceeds by hardening the budget constraints of local governments and state-owned enterprises; and

Help the economy rebalance from excessive saving and inefficient investment to higher household income and consumption and lower but more productive private investment, especially in the still-underdeveloped service sector.

Implementing this agenda would help safeguard macroeconomic stability, strengthen the government's role as a prudent and efficient steward of public resources, and foster much-needed structural change in the economy—in other words, help secure more balanced, more equal, and more environment-friendly growth—for the benefit of China, the region, and the global economy.

China's development record over the past 35 years has been nothing short of astonishing, with the economy growing at about 10 percent a year. Real per capita income has more than quadrupled since 1980, to about $7,600 in 2014, placing China in the ranks of lower-middle-income countries and lifting more than 600 million people out of poverty, according to the World Bank's World Development Indicators. And China is now the largest economy in the world on a purchasing-power-parity basis. China's economic status contributed to the recent decision to include its currency—the renminbi—in the IMF's special drawing right (SDR) basket.

China's fiscal policy and reforms have played a key role in its development strategy. As per capita income has grown, demand for public goods and services has also increased. Over the years, fiscal reforms—including to tax policy, revenue administration and expenditure policy, intergovernmental fiscal relations, budgeting processes and treasury management, and provision of public goods—have helped China's public sector cope with these rising demands while investing heavily in the country's economic development. Major reforms in intergovernmental relations have improved revenue and smoothed expenditure across provinces. And public financial management reforms have supported increased efficiency and control of public spending. Notably, the government has significantly reduced or brought on budget previously extrabudgetary funds and modernized its budgetary systems, including through better classification of expenditures.

Despite these reforms, vulnerabilities have recently emerged that could threaten the sustainability of long-term growth. Growing macroeconomic imbalances, fiscal and financial risks, rising inequality, and environmental degradation require increasing attention.

China's stimulus program, implemented in the aftermath of the global financial crisis, designated about 11 percent of GDP mainly for infrastructure investment and social housing projects. The stimulus supported China's rapid growth and provided a welcome lift to global demand. But it has proved difficult to unwind and has contributed to widening fiscal imbalances and a buildup of government debt. And most of the stimulus was implemented by local governments, mainly through off-budget financing, raising concern about the sustainability of local public finances.

China has also experienced rising inequality, partly because the tax system is not very progressive and large gaps remain in social protection spending. It has made notable efforts to expand the social security system and protect the most vulnerable, but large disparities remain. For example, the pension system offers nearly universal old-age coverage, but salaried retirees receive much higher benefits than nonsalaried retirees. Reducing this gap remains an important challenge.

China's rapid growth has had environmental consequences. It is the largest emitter of carbon dioxide (CO_2) in the world, accounting for 25 percent of the global total in 2012. Outdoor air pollution, partly from fuel combustion, caused 1.4 million premature deaths in 2010 according to the World Health Organization. Traffic congestion is growing relentlessly: traffic delays in Beijing, one of the world's most congested cities, are estimated to cost over 4 percent of the city's GDP. Fossil fuel subsidies in China, including implicit subsidies from undercharging for environmental costs, amounted to 17.3 percent of GDP in 2013.

A rocky path

In light of these challenges, a new generation of fiscal policies will play a central role in China's transition to more balanced, more inclusive, and greener growth.

Balancing the budget: To reduce fiscal deficits and contain public debt, China has begun implementing key reforms of taxes, expenditures, pricing, and social security. It is essential to move from the current five-year-plan system to medium-term budgeting—as China's new budget law, effective January 2015, proposes—that allows better fiscal policy management across the cycle, takes local government finances into consideration, and offers greater fiscal transparency. Future tax reforms should attempt to reduce income inequality while providing a broader tax base for local governments and enhancing efficiency in revenue collection. Reform of the personal income tax schedule could help redistribute income, while ongoing reform to replace the business tax with a value-added tax could improve overall tax progressivity. Expanding annual property taxes nationwide could help fund local government services and reduce inequality. On the spending side, there is room to strengthen the equity and sustainability of the social security system to address growing social inequality. In particular, it is critical to consolidate the pension system for salaried and nonsalaried workers and facilitate mobility across pension plans.

Getting prices right: Efficient energy taxation is essential to environment-friendly growth. The price of fossil fuels needs to reflect their contribution to pollution for growth to be environmentally sustainable. Energy taxes are a straightforward extension of gasoline taxes. Carbon charges can be applied in proportion to a fuel's CO_2 emission rate, local air pollution charges can be set on coal use, with credit for emission-control technologies linked directly to smokestack emissions. Gasoline taxes should reflect all adverse side effects from vehicle use—CO_2 emissions, local air pollution, traffic congestion, accidents, and road damage. A full energy tax reform could reduce CO_2 emissions by 26 percent and fossil fuel air pollution deaths by 60 percent, while raising revenue by about 9 percent of GDP.

Ensuring efficient use of state assets: Reform of state-owned enterprises is key to giving the market a more decisive role in the economy and unlocking new sources of growth. Leveling the playing field between state-owned enterprises and other firms can be accomplished by increasing the share of their profits that goes to the government budget, eliminating government subsidies, strengthening governance, and improving these enterprises' commercial orientation. Ultimately, such reform must also include greater tolerance of state-owned enterprise bankruptcy or exit and their full exposure to competition with private firms. These reforms can significantly boost productivity and create millions of jobs.

Rebalancing is a critical component of China's transition.

Rebalancing the economy: Rebalancing is a critical component of China's transition to a new growth model. The recent large increase in investment, driven largely by public sector spending, has led to less-efficient capital spending, thwarted growth, and increased debt. Encouraging a shift in demand toward consumption and away from saving, combined with more productive private investment, would make growth more sustainable.

Reforming the social safety net and increasing health and education spending are important priorities. At 10 percent of GDP, social spending in China is about half what it is in high-income members of the Organisation for Economic Co-operation and Development, so there is plenty of scope to spend more on health, education, and the social safety net. Social security contributions in China are regressive and high: mandatory contributions to pension, medical, unemployment, occupational injury, and maternity benefits add up to more than 40 percent of wages. Strengthening China's social security system will help reduce household precautionary saving, while lowering social contributions will help reduce inequality.

Over the past three and half decades, China has had remarkable success in achieving rapid economic growth and reducing poverty. Fiscal policy has played a major role in that accomplishment. Now a new generation of fiscal policy reforms is needed to safeguard past achievements and lay the groundwork for sustained improvement in the future. ■

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