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**Working Paper**

## Fiscal Reform in the People's Republic of China: Current Issues and Future Agenda

ADB Research Paper Series, No. 55

**Provided in Cooperation with:**

Asian Development Bank Institute (ADBI), Tokyo

*Suggested Citation:* Kanamori, Toshiki (2004) : Fiscal Reform in the People's Republic of China: Current Issues and Future Agenda, ADB Research Paper Series, No. 55, Asian Development Bank Institute (ADBI), Tokyo,  
<https://hdl.handle.net/11540/4160>

This Version is available at:

<https://hdl.handle.net/10419/111143>

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# **Fiscal Reform in the People's Republic of China –Current Issues and Future Agenda–**

Toshiki Kanamori

March 2004

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PRC's future agenda for fiscal reform involves first building public finance structures that will conform to the market-oriented macroeconomic system emerging from its ongoing reforms and opening-up policy. Second, fiscal instruments will need to be strengthened as part of PRC's policy of achieving stable and sustainable economic growth combined with social welfare and justice.

ADB Institute  
Research Paper Series  
No. 55

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**Fiscal Reform in the People's  
Republic of China  
–Current Issues and Future Agenda–**

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## ABSTRACT

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In recent years, economists and policymakers have given much greater attention to fiscal reform in the PRC. This reflects the fact that after the Asian financial crisis the fiscal balance of the PRC government rapidly worsened. Second, the PRC economy as a whole has been moving in a more market-oriented direction since its accession to the World Trade Organization (WTO). The current agenda for fiscal reform includes the low level of fiscal revenue relative to GDP, the tax-sharing scheme between central and local governments, preferential tax treatment for foreign-invested companies, and the tax structure and tax collection for individuals, particularly the wealthy.

The agenda for future fiscal reform in the PRC involves first building a public finance structure that conforms to the market-oriented macroeconomic system that will emerge from ongoing reforms, and the PRC's opening-up policy. The second agenda is the strengthening of fiscal instruments as a national macroeconomic policy for achieving stable and sustainable economic growth, and a policy for achieving social welfare and justice.

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# **Fiscal Reform in the People's Republic of China**

## **–Current Issues and Future Agenda–**

Toshiki Kanamori<sup>†</sup>

### **1. Introduction**

Fiscal reform is seen as one of the four major reforms in the People's Republic of China (PRC). However, it appears that in comparison to other reforms, such as state-owned enterprise, financial and administrative reform, fiscal reform has not been given much attention. This is primarily due to the fact that budget conditions in the PRC are still healthy in comparison to other developed countries, and also to the fact that fiscal reform is regarded, in any case, as a matter of the reform of state-owned enterprises and the financial sector.<sup>1</sup>

However, since the Asian financial crisis, the PRC government has adopted a series of expansionary fiscal policies, resulting in worsening budget conditions. Furthermore, upon its accession to the WTO, the PRC is to undertake more open and reform-oriented policies. Against these backgrounds, there are currently arguments among experts, both inside and outside the PRC, regarding how to improve or build up the public finance structure to be in line with a more market-oriented economy.

This brief paper summarises these arguments and attempts to put forward an agenda for possible fiscal reform in the PRC. In the annex, it also briefly touches on the recent fiscal conditions of Hong Kong, China, whose public finance is operated and administered independently from Beijing.

### **2. The Public Finance Structure: Three Historical Stages**

Historically, the public finance structure in the PRC can be divided into three stages. The first is prior to 1978; the second from 1979 to 1994; and the third stage from 1994 up to the present (Table 1).

During the first stage, the entire economic system was strictly planned by the central government. Consequently, in public finance, all revenues and expenditures were also centrally controlled. The revenues of local governments were all transferred to the central government, which then allocated expenditures to local governments. The

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<sup>†</sup> The author thanks Dr. Zhao Zhijun, ADBI Visiting Researcher and Professor of Economic Research Institute, China Academy of Social Sciences (CASS), for his valuable comments in finalizing this paper.

<sup>1</sup> The official fiscal imbalance to GDP in the PRC is still below the international safety/acceptable level of 3%, and the ratio of public debt outstanding to GDP is also still below 30%, again lower than that of Japan and many other developed countries. Also, unless there are unexpected political problems, the external debt should not become a serious matter for the moment. Foreign reserves in 2003 exceeded US\$400 billion, almost double the 2001 level. However, the non-performing loans (NPL) of state-owned banks can be regarded as "hidden fiscal debts." In addition, various measures to promote social safety nets are expected to put pressure on future government spending. Therefore, we should not be too optimistic. Many experts believe that if we include these NPLs, the PRC's national debt outstanding is well above 100% of GDP.

profits of state-owned enterprises were also transferred to the central government with the exception of some marginal portions such as employees' remuneration.

**Table 1. Three Historical Stages**

<i>First Stage (before 1978)</i>	— Centrally controlled public finance under a centrally planned economy
<i>Second Stage (1979-1994)</i>	— Decentralisation and introduction of new taxes under the transition of the economy
<i>Third Stage (1994-present)</i>	— Overall tax reform in 1994, laying the foundation for the present finance structure

The second stage coincides with the economy in transition, i.e. the period when the PRC was moving from a centrally planned economy to a more market-oriented one. During this stage, indirect taxes such as the turnover tax (taxation on the gross production of manufacturing enterprises) and business tax (taxation on the margin of service industries) as well as direct taxes including the enterprise income tax, were introduced. Furthermore, the turnover tax, which did not allow deductions, was gradually replaced by value added tax (VAT).

The third stage began in 1994, when comprehensive tax reform was implemented. During this stage, turnover tax rates, which ranged from 1.5 percent to 66 percent, were streamlined, and indirect tax came to be comprised of the VAT, business tax and consumption tax. In addition, a new enterprise income tax law was enacted, and more than 30 tax items relating to the enterprise income tax were also streamlined. It should be noted that the PRC economy was undergoing high inflation at that time, and that one of the primary purposes of the tax reform was to curb inflation. From this standpoint, the government decided to rely more on production type value-added tax and discourage investment by state-owned enterprises by not granting tax deductions for investment. Based on this new law, a system for sharing the income tax between central and local governments was introduced. Under this system, the enterprise income tax was shared between the central and local governments according to administrative jurisdictions. The 1994 tax reform laid the foundation for the PRC's current public finance structure. Although there are constraints in terms of the availability of data, it appears that indirect taxes as a whole account for almost 80-90% of total national revenue. The VAT is the largest tax item, making up approximately 40% of total revenue (Table 2).<sup>2</sup>

<sup>2</sup> The revenue statistics of the PRC are somewhat enigmatic. According to *China Statistical Year Book 2001*, total tax revenues including both central and local governments in 2000 were 1.258 trillion renminbi, of which industrial and commercial related tax accounted for more than 80% or 1.037 trillion, and customs and tariffs, enterprise income taxes and agriculture-relating taxes 75, 99.9, and 47 billion respectively. There is no mention of the individual income tax. On the other hand, another table in the same yearbook shows the breakdown of industrial and commercial taxes. According to this table, the VAT accounts for more than 40% of total industrial and commercial taxes, at 455 billion renminbi, other business taxes 187 billion, and the consumption tax 86 billion. Furthermore 641 billion out of a total of 1.258 trillion renminbi are local government revenues. The breakdown of the 641 billion renminbi shows that the individual income tax is 51 billion, and enterprise income tax 105.4 billion, a figure higher than the above 99.9.

**Table 2. Revenue by Major Tax Items (billion RMB)**

	1995	2000	2002
Total tax revenue	604	1,259	1,700
VAT	249 (41%)	535 (42%)	630 (37%)
Business tax	87	189	248
Consumption tax	60	87	105

Source: China Statistical Bureau, State Administration of Taxation

### 3. Issues

Quite a number of arguments have been made regarding how to address the deteriorating budget situation in the short term after the Asian financial crisis, and to build up a more appropriate public finance structure after PRC's accession to the WTO. Among them, the following issues seem to be particularly important.

#### 3.1. Raising Revenue Relative to GDP

Revenues as a share of GDP were in decline over a long period of time. In particular, as mentioned earlier, since the overall tax reform in 1994 aimed to discourage investment of state-owned enterprises by relying more on flat VAT, revenue relative to GDP had been declining sharply. Although the ratio started to pick up for the last two to three years, its level is still low (Table 3). According to researchers from the People's University of China (People's University of China, *Finance & Taxation*), the average tax/GDP elasticity during 1990-1996 was only 0.61, which by definition resulted in a long-standing decline in tax revenue relative to GDP. Since tax revenue was primarily from flat indirect taxes, the elasticity was inevitably less than 1.00. However, even taking this into account, 0.6 appears to be too low. In fact, elasticity jumped to 2.76 for 1997-2000, despite the fact that there was no significant change in the tax structure during this period. The improvement in elasticity can probably be attributed mainly to the strengthening of tax collection efforts.

**Table 3. Revenue Relative to GDP**

	1985	1990	1995	2000	2001	2002	2003
GDP (billion RMB)	899	1,860	5,749	8,823	9,435	10,696	11,667
Revenues (billion RMB)	204	282	604	1,258	1,530	1,700	2,046
Revenues/GDP ratio (%)	22.7	15.2	10.5	14.3	16.2	15.9	17.5

Note: Figures do not include debt revenue.

Source: State Administration of Taxation, China Statistical Bureau

Service sector and related individual income in the PRC is now growing faster than GDP growth. Assuming further improvements in tax collection as well as the success of ongoing reforms of state-owned enterprises, the ratio of revenues to GDP is expected to improve further. It is reported that PRC authorities themselves have set a target to raise the ratio to 20 percent over the next three to five years. Some experts indicate that it may be possible to raise the ratio by 3-4% during the next five to ten years.

According to the China Year Book 2001, there are a number of special factors that have contributed to the recent increase in the revenue/GDP ratio: the transformation of automobile purchase fees to taxes and the selling of state-owned shares in the capital market. There are other factors as well. First, tightening control over illegal smuggling increased custom revenues, from 29 billion RMB in 1995, to 56 billion RMB in 1999, and 75 billion RMB in 2000. Second, tighter control over abuses of the VAT refund arrangement for overseas exports has contributed to the increase in the revenue/GDP ratio. This refund arrangement was introduced in 1985, and the ratio was raised on three occasions in order to promote exports after the Asian crisis. Since that time, there have been repeated abuses of the system. For instance, exporters and authorities colluded to produce false export documents. The PRC central government at a national conference in November 2000 launched a campaign to crack down on such abuses. However, the crackdown has its limits. Medium- and long-term improvements in the revenue/GDP ratio and the building of a sound public finance structure certainly depend on the overall efficiency of the tax collection system as well as on the success of state-owned enterprise reform.

### ***3.2. Preferential Treatments for Foreign Enterprises and the National Treatment (NT) Principle***

After the PRC joined the WTO in 2001, people began to pay greater attention to how the PRC government would or would not revise its existing preferential tax treatments for foreign-invested companies. Currently, while domestic companies pay a 33%, 27% and 18% progressive enterprise income tax, foreign-invested companies pay a flat tax. The tax rates are 15% in the five special economic zones of Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan, and in the economic and technological development zones including Pudong in Shanghai. In open cities such as Guangdong and Dongguan, the rate is 24%. Although municipal governments have the authority to add on an extra 3%, they in fact provide foreign companies with further preferential treatments in order to attract foreign investment. In particular after 1994, many municipalities introduced a variety of preferential treatments for foreign companies, which are beyond the central government's control. Consequently domestic companies currently pay roughly more than double the tax paid by foreign companies.

Many experts claim that this kind of differential treatment between domestic and foreign companies is inappropriate. For instance, Yang Zhigang, Research Fellow of the Institute of Finance and Trade Economics of the China Academy of Social Sciences (CASS), wrote in a 2001 article that these treatments are not based on any coherent industrial policy, and only lead to regional imbalances. He goes on to state that it is unfair from the viewpoint of market competition to treat domestic and foreign

companies differently, and refers to cases in which domestic companies form “facade” joint ventures with foreign companies to receive preferential tax treatments. Wang Guohua, professor of the University of Finance and Economics in Beijing, claims that the current preferential treatments for foreign companies are applied regardless of what project or what sector has relatively high cost and revenue losses, thus impeding the competitiveness of domestic companies.

On the other hand, some experts argue that certain preferential treatment should be retained in order to attract foreign investment. For example, Wang Yongjun, associate professor of the University of Finance and Economics in Beijing, argues that “national treatment (NT)” under WTO means that foreign companies should not be treated in an inferior way to domestic companies, and that preferential treatment for foreign companies do not necessarily violate WTO rules.

What is the view of PRC authorities on this issue? It seems that in principle, they plan to abolish the current preferential treatments for foreign companies at some point during the implementation of the country’s WTO commitments, as already shown in the “Five Major Principles for Tax Reform” announced by the Finance Minister in July 2000. It is also reported that the head of the State Tax Administration (SAT) stated at an open forum in April 2002 that preferential treatments have played a role in attracting foreign investment, but that NT under the WTO rules is a more important principle. However, officials in the trade area have sent different signals. For instance, officials of the Ministry of Commerce (former Ministry of Trade and Economic Cooperation) confirmed that foreign investors continue to enjoy privileges despite the PRC’s accession to the WTO. Even SAT says that if the favourable treatments are abolished, they will be phased out gradually, over a period of five years or so. In any case, it appears that no definite decision has yet been made, and a wide range of discussions are taking place among the authorities on whether to terminate or retain the preferential treatments, and if they are terminated, what timetable to use.

What are the views of foreign companies on this issue? The author contacted Japanese manufacturing companies and commercial banks in Hong Kong, China and the mainland from 2001-2002, to exchange views on business in the PRC as a whole. Many companies expressed some concern on this issue and pointed out that if the preferential tax treatments were abolished, there would be a negative impact on their business in the PRC. At the same time, they had greater complaints on issues such as among other things, the fact that PRC laws and regulations are unstable and that various procedures are too complicated. While pointing out these very negative factors, they said that the cheap labor force and huge potential market attracted them to the mainland. Overall, it seems that they do not necessarily recognise preferential treatments as a major factor attracting them to go to the mainland. In any case, under the situation as described above, they are waiting for the PRC’s final decision.<sup>3</sup>

If tax rates are eventually unified, experts assume that the figure will be 24-28%. This seems to be based on the current tax rates for domestic and foreign companies, as well as the desire of authorities to avoid any revenue losses. Clearly, the issue should be dealt with strategically, considering the question as to which industry or

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<sup>3</sup> In particular, foreign invested companies located in Guandong Province normally sign a “trusted assembly contract” with local municipalities and do not pay taxes. Therefore it seems that they are more interested in the future of trusted contracts than in the future of the preferential tax treatment.

region the PRC wants its foreign investors to come. From this viewpoint, it can be said that it is a matter of industrial policy rather than public finance. In this connection, it is worth mentioning that a high-ranking official in charge of the development of the western region was quoted as saying that the tax rate of 33 percent there would be cut to 15%, the same rate as the special economic zones, and that the tax rate in the minority autonomous regions would be cut even more, to 0%-5%.<sup>4</sup>

### 3.3. Tax Sharing between Central and Local Governments

At present, expenditures and revenues are not well balanced between the central and local governments (Tables 4, 5). According to Yang Zhigang, while local government expenditures such as education, research and development, salary payments and social security are all increasing, revenues have failed to cover these expenditures. In other words, expenditures are more decentralised than revenues. Because of this, tax sharing or transfer mechanisms between the central and local governments have become an important issue.

**Table 4. Revenue Share between Central and Local Governments (%)**

	1985	1990	1995	1999	2000	2001	2002
Central	38.4	33.8	52.2	51.1	52.2	52.4	55
Local	61.6	66.2	47.8	48.9	47.8	47.6	45

**Table 5. Expenditure Share between Central and Local Governments (%)**

	1985	1990	1995	1999	2000	2001	2002
Central	39.7	32.6	29.2	31.5	34.7	30.5	30.7
Local	60.3	67.4	70.8	68.5	65.3	69.5	69.3

Source: China Statistical Bureau

Since the implementation of tax reform in 1994, the enterprise income tax has been distributed according to the administrative jurisdiction of enterprises. Income tax from enterprises under the control of the central government belongs to the central government, and income tax from enterprises under the control of local governments belongs to the local governments. The amount of transfers from local governments to the central government is determined through annual negotiations between the central

<sup>4</sup> The February 2004 *China Economic News* reported that enterprise income tax laws for domestic and foreign firms will be unified this year, coming into force next year. The unified tax rate is expected to be 25%. At the same time, it reported that preferential tax treatments will be limited to some special regions. The sources were not identified and these decisions are not yet confirmed.

and local governments. This tax sharing system was expected to clarify the relation between central and local governments in terms of enterprise income tax, and was also expected to enhance local government tax collection efforts, thereby making the public finance structure of local governments more solid and stable.

However, the following shortcomings have been pointed out in the 1994 tax sharing system. First, there was a tacit understanding that the tax distribution among local governments in place before 1994 should be kept intact as far as possible. In other words, the 1994 reform has excessive protection to the vested interests of the local governments before 1994, and as a result, regional imbalances were aggravated.

Second, while the classification of tax distribution based on the administrative jurisdiction of enterprises encouraged local governments to strengthen their tax collection efforts and develop regional enterprises, on the other hand, in order to ensure revenues, they tended to develop unnecessary projects and protect their own enterprises, even if they were, for instance, polluting firms. Furthermore, the 1994 tax sharing system assumed single property ownership of enterprises—that the investor in enterprises would be either local governments or the central government—and failed to take account of new types of ownership such as private enterprises and joint ventures with foreign companies.

Third, the lack of clear criteria for transfers between central and local governments allowed various political or non-economic considerations to creep into the system, bringing inefficiency to public finance as whole.

Against this background, the new tax sharing system was introduced in January 2002. It is reported that under the new system, while the distribution of income tax based on administrative jurisdiction was terminated, the central government shares income taxes with local governments at a fixed ratio. The fixed ratio was set to be 50-50 in 2002, 60-40 in 2003, and after 2004 the ratio will be reviewed according to the actual amount by that time. The new system is considered to be the biggest change since the 1994 reform, and it is expected to limit local governments' discretionary power to grant incentives to investors and protect local enterprises, thereby contributing to the building of a solid public finance structure in line with a market-oriented economy.

However, it seems that the new system still has problems. First, the current revenues of local governments are assumed as a base, and if drastic changes takes place, adjustments will have be made. Like the 1994 reform, this might end up simply protecting vested interests. Second, although the fixed sharing ratio is expected to limit the power of local authorities, it may go against the overall direction of decentralisation and bring about a “return to centrally controlled public finance”. In either case, the new system has just started. We should pay careful attention to how it works, and how it contributes to building a public finance structure that is in line with a more market-oriented economy.

### ***3.4. Structural Changes in the Composition of Individual Income Tax***

The individual income tax is levied on PRC citizens, foreign residents and individual enterprises. When it was introduced in 1980, the tax rates and tax deductions were different for the various groups, and the tax structure was very complicated. Since 1994,

it has been gradually simplified, applying the same tax rates albeit with different tax deductions and minimum taxable incomes.

Since the share of individual tax revenue has been marginal, it has not received much attention. However, it is reported that in recent years, the collection of the individual income tax has risen rapidly, with an annual increase in the tens of millions of RMB (Table 6). Given the widening gap between the rich and poor, as shown in the Gini coefficient of 0.39, the individual income tax will attract more attention, both as an important revenue source and from a social policy dimension. In fact, the PRC government is trying to strengthen the monitoring of collection from high-income individuals. We should wait to see what concrete measures are being undertaken by the authorities in the immediate future.<sup>5</sup>

**Table 6. Proportion of Individual Income Tax to Total Tax Revenue**

	1995	2000	2002	2003
Total tax revenue (billion RMB)	604	1,259	1,700	2,046
Individual income tax (billion RMB)	13	66	121	
Share (%)	2.2	5.2	7.1	

Source: China Statistical Bureau

Although there are data constraints, when looking at the breakdown of individual income tax components, the following features are worth highlighting (Table 7). First, as a result of successive salary raises for public officials, wage income continues to be the major component, accounting for more than 40 percent of total individual income tax revenue. Second, with the resumption of taxation on interest and dividends in 1999, this has become the second largest tax component. Finally, as a result, the three largest components (wage income, interest and dividends, and private business income) account for about 90% of total revenue, with other individual items being negligible.

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<sup>5</sup> According to various sources, the individual income tax was withdrawn by state-owned enterprises in the past, but the State Tax Administration is now considering allowing individuals whose annual income exceeds 100,000 renminbi to go directly to the tax administration office. In addition it is reported that progressive tax rates are being reviewed with a view to making them flatter, while tightening tax collection efforts.

**Table 7. Breakdown of Individual Income Tax (%)**

	<b>1994</b>	<b>2000</b>
Wage Income	39.01	42.86
Private Business Income	45.93	20.12
Interest, Dividends, Bonuses	4.4	28.70
Others	10.66	8.32
Total	100.00	100.00

Source: China Economic News

### **3.5. Other Issues**

The following other issues will need to be addressed in the process of fiscal reform.

- Budget drafting is not sufficiently scientific and objective. Since many budget items do not conform to international standards, it is very difficult to make international comparisons. Budgeting on a departmental basis in areas such as education, agriculture, and science technology, which was introduced in 2000 on an experimental basis, appears to be a good sign in this respect.
- In other countries, fiscal revenues and expenditures are normally administered and monitored through a single treasury account. Since there are a number of treasury accounts in the PRC, it is difficult for the government to know and monitor the fiscal situation adequately. Proposals have been made recently to introduce a single treasury account. This is again an encouraging sign and we should watch closely progress in the future.<sup>6</sup>
- Currently no deductions are allowed for investments into research and development when calculating enterprise income tax. Furthermore, some experts have pointed out that the depreciation rates are too low, impeding the incentives for enterprises to make regular investments. The deduction for the VAT also appears to be insufficient. For instance, the cost of capital goods is not an allowable deduction, a fact which again impedes incentives for enterprises to invest, especially enterprises in capital-intensive industries (see above Section 1).
- Although since the Asian financial crisis, government bond issues have been made at a rapid pace to stimulate internal demand, the bond market is still immature and faces a lack of liquidity. Currently, almost 100% of government bonds are held by individuals or state-owned commercial banks (Table 8). The bonds held by individuals are government saving bonds, and commercial banks are not allowed to buy and sell bonds on the capital market due to the separation

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<sup>6</sup> *People's Daily* (April 2003) reported that the Ministry of Finance (MOF) closed 27 accounts, accounting for 85% of total accounts. MOF is also amending the relevant laws and regulations to give the remaining accounts clear legal status.

of the banking and securities businesses. They can only buy and sell on the inter bank market. Consequently, fiscal policy and national debt management policy have still not developed into an effective macroeconomic instrument. In the future, there will be the need to review the business demarcations and also to allow foreigners and domestic institutional investors to invest in government bonds.

**Table 8. Who Holds Government Bonds?(%)**

	1992	1995	1998	1999
Individuals	71.3	60.0	27.9	55.2
Financial Institutions	18.8	40.4	71.6	44.5

Source: People's University of China "Finance and Taxation"

#### 4. Concluding Remarks: Future Agenda

In summary, based on the above arguments and taking account the possible acceleration of the reforms and opening up of the economy as a whole, the future agenda for fiscal reform in the PRC looks like this.

First on the agenda is the building of a public finance structure that will be in conformity with the market-oriented macroeconomic system resulting from the ongoing reform and opening-up policies. To achieve this, it is vital to pursue the decentralisation of public finance, thereby strengthening the financial structure of local governments. However, at the same time we should bear in mind that in the past, local governments tended to collect various illegal fees and pursue unnecessary investments. When promoting decentralisation, it is critical to look at whether local governments have really become reliable. In this sense, the reverse movement (namely centralisation) might be unavoidable at least for the time being.<sup>7</sup> In any case, the PRC authorities should continue to seek a desirable fiscal relationship between central and local governments, including appropriate tax transfer mechanisms. In connection with this first dimension, other important issues include reviewing the preferential treatments for foreign investors under the NT principle of WTO rules, and raising the efficiency of budget planning and implementation.

The second item on the agenda will be strengthening of the role of fiscal instruments for macroeconomic policy. This can be divided into two sub-agendas, namely macroeconomic policy for achieving stable economic growth, and social welfare policy. From the first dimension, it is essential to develop quickly government

<sup>7</sup> A rural tax reform to streamline illegal fees on farmers was launched in Anhui Province in 1994 on an experimental basis. Since then, it has expanded to other provinces. According to *People's Daily* (January 7, 2004), in 2002 about 620 million farmers, or three quarters of all farmers, benefited from this reform. The financial burden on farmers was reduced by at least 30%. On the other hand, the central government has allocated at least 10 billion renminbi each year since 2002 to local governments to pay the wages of rural teachers, which used to be covered by farmers. It also reported that the State Council decided to send inspection teams to the provinces this year to check the progress of the reform.

bond markets with liquidity, and thereby to develop the capital market as a whole. Historically in Japan, large-scale government bond issues incidentally triggered the establishment of a mature capital market. Perhaps there may be lessons to learn from Japan's experience here.

In view of the widening gap between rich and poor in the PRC, public finance as a social policy instrument is becoming increasingly important. More specifically, enhancing the income redistribution function of the taxation system through a progressive individual income tax and monitoring of tax collection from the wealthy is becoming an urgent issue.

## **Annex: The Fiscal Situation of Hong Kong, China: Structural Background**

According to a recent report in the *People's Daily*, the HK, China Chief Executive, in his policy address for 2004, highlighted two problems: deflation and the fiscal deficit. The fiscal balance has been worsening since the end of the 1990s. The ratio of fiscal balance to GDP in 2000, 2001, 2002 and 2003 was 0.6, 4.9, 4.8, and 6.0 respectively (Table 9). In 2003, the unexpected increase in spending was explained by a temporary factor, i.e. the outbreak of SARS. This, of course, does not explain the whole picture. There are two major underlying factors behind the fiscal deficit deterioration.

First, revenue from real estate, which once accounted for approximately 40% of total revenue, began to decline sharply at the end of the 1990s, due to the bursting of the real estate bubble. Surprisingly, there has been no significant tax reform in HK, China since the introduction of certain regulations in the 1940s to cover war-related expenses. Over the past six decades, there were only three minor amendments, and no substantive change in the fundamental tax structure. In the 1970s and 1980s, the administration considered introducing a consumption tax to widen the tax base, taking account of its internationally narrow tax base. However, this move was postponed due to the hyperinflation in the late 1980s, out of concern that the consumption tax might aggravate inflation. In the first half of the 1990s, the government enjoyed an increase in property tax revenues thanks to the real estate bubble, concealing the underlying structural problem of the tax system, which relied too heavily on real estate and lacked a wide and stable tax base. Beginning in 2000, this structural problem became apparent due to the bursting of the bubble after the Asian financial crisis. This is somewhat similar to Japan's experience in the mid-1990s.

Second, despite the decrease in revenues, spending has been growing at a rapid pace. To some extent, this reflects increasing needs for social security and education. However the underlying problem is that despite the general impression, the size of the HK, China administration is not necessarily small in terms of administrative expenditures. The ratio of public expenditures to GDP jumped up from 15% in 1990 to 24% in 2002. For comparison, the ratio of Singapore, which is deemed to be a "big government," is currently 23% (excluding defence expenditures, the ratio is just 14%). The high ratio in HK, China is primarily due to the levels of remuneration of public servants; that accounts for almost 70% of total public expenditures.

Accordingly the recent deterioration of fiscal balance in HK, China seems at first glance to be attributable to the cyclical macroeconomic conditions. However, looking more deeply, we see that the fundamental problem is a mismatch between "small government" on the revenue side and "big government" on the expenditure side. To solve the problem, it would seem necessary to widen the stable tax base by introducing a consumption tax, for example, on one hand (in fact, the introduction of a consumption tax would have an enormous impact on revenue increase, as shown by Table 10). Second it would be necessary to cut the excessive salary levels of public servants as well as promote the privatisation of public facilities such as airports and railways.

So far, HK, China has only announced a general target for restoring the fiscal balance, by cutting the ratio of public expenditures to GDP to less than 20% by the

2008/09 fiscal year. The initial target was 2006/07, but this date was postponed due to the SARS crisis. Since 2002, HK, China has been trying to reduce the salary levels of public servants, though this has invited strong resistance and political turmoil. HK, China continues to stress that it has plentiful fiscal reserves and that its fiscal deficit is still manageable. By doing so, it tries to avoid a situation where its fiscal imbalance brings uncertainty to the market. It seems that it expects revenue to pick up again thanks to a macroeconomic recovery. However, fiscal reserves have fallen from HK\$460 billion in 1998 to HK\$320 billion in 2002. We should also note that HK, China's current deflation can be seen as structural rather than cyclical, and we cannot simply expect that the macro-economy will automatically hit bottom and pick up again. In this sense, the fiscal imbalance is a tough and challenging issue for HK, China.

**Table 9. Economic Indicators of HK, China (%)**

	1999	2000	2001	2002	2003
Real GDP growth	3.0	10.4	0.6	2.3	3.0
Inflation	-4.0	-3.8	-1.4	-3.0	-2.0
Unemployment	6.2	4.9	4.9	7.3	7.9
Fiscal deficit to GDP	0.8	-0.6	-4.9	-4.8	-6.0

Source: Standard Chartered Bank

**Table 10. Possible Measures to Increase Fiscal Revenues  
(%, hundred million HK\$)**

	Current scheme	Adjustment ratio	Revenue increase
Corporate tax	16 %	1.0 %	26
Individual income tax	15 %	1.0 %	22
Tax deductions	108,000 HK\$	-10.0 %	20
Others		New measures	20
Total			(88)
3 % consumption tax			180

Source: CPA Australia, KPMG etc.

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