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**Working Paper**

## Key issues of central and local government finance in the People's Republic of China

ADB Working Paper, No. 620

**Provided in Cooperation with:**

Asian Development Bank Institute (ADBI), Tokyo

*Suggested Citation:* Qichun, Zhang; Shufang, Li (2016) : Key issues of central and local government finance in the People's Republic of China, ADB Working Paper, No. 620, Asian Development Bank Institute (ADBI), Tokyo

This Version is available at:

<https://hdl.handle.net/10419/163119>

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**ADB Working Paper Series**

**KEY ISSUES OF CENTRAL  
AND LOCAL GOVERNMENT  
FINANCE IN THE PEOPLE'S  
REPUBLIC OF CHINA**

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No. 620  
December 2016

**Asian Development Bank Institute**

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Suggested citation:

Zhang, Q. and S. Li. 2016. Key Issues of Central and Local Government Finance in the People's Republic of China. ADBI Working Paper 620. Tokyo: Asian Development Bank Institute. Available: <https://www.adb.org/publications/key-issues-central-and-local-government-finance-prc>

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**Abstract**

Fiscal decentralization has been established in the People's Republic of China (PRC), but crises emerge at the local government level due to remaining problems of the fiscal administration system of tax allocation and the impact of replacing the business tax with a value added tax. The PRC taxation system requires readjustment and local governments have begun to focus on innovative financing models. The main path to stable and sustainable government finances is to maintain the general public budget and the government fund budget. The present study shows that use of innovative fundraising and financing channels will lead to the upgrading of local government infrastructure and public service. Suggestions for enhancing local government fiscal stability and sustainability include: reducing the fiscal burden at the local level by standardizing and legalizing outlay responsibilities at all government levels; forming a long-term fiscal growth mechanism by establishing a modern taxation system; establishing a standardized and predictable transfer payment system by introducing block transfer payments and prioritized transfer payments as a basis for a stable growth mechanism for general transfer payments; promoting public-private partnership legislation to encourage participation of social capital and maximize the multiplier effect of public expenditure; and improving the mid-term budget and debt-annexed budget and establishing a government planning mechanism for investment and debt financing of major infrastructure construction projects.

**JEL Classification:** E62

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# 1. GENERAL INTRODUCTION TO THE FISCAL RELATIONS BETWEEN THE PEOPLE'S REPUBLIC OF CHINA CENTRAL GOVERNMENT AND LOCAL GOVERNMENT

## 1.1 Background of Fiscal Relations between the People's Republic of China Central Government and Local Government

**Tax-sharing reform in 1994 established a standardized framework of fiscal decentralization.** Since its founding, the People's Republic of China (PRC) has undergone continuous financial reform, moving from a fiscal system of highly centralized control over revenue and expenditure to a system of unified leadership and level-by-level administration, then to a system that divides revenue and expenditure between the central and local governments according to rules decided every five years, and finally to the current tax-sharing system. Tax-sharing reform has resulted in increases of the ratio of tax revenue to gross domestic product (GDP) and the ratio of central financial income to overall fiscal income. It has also strengthened central government's ability to exercise macro-control. Therefore, the tax-sharing reform set up a preliminary system of standardized fiscal decentralization.

**However, some fundamental problems in the tax-sharing system emerged with the change of the PRC's economy.** After the reform, the unbalanced division of government power and unstandardized expenditure liabilities led to financial centralization and the decentralization of administrative power. In 2014, central government revenue accounted for 45.95% of total general financial revenue while central government spending was 14.87% of national overall public spending. Many local governments, however, were financially trapped. By 2004, only 58.76% of local governments had managed to become financially independent. Local government spending relied heavily on transfer payments, government debt, and land finance. In 2014, transfer payments from central government constituted 40.47% of local public budget revenue and government debt accounted for 7.68% of local expenditure.

## 1.2 Major Recent Reforms

**As the unbalanced division of government power and unstandardized expenditure liability caused the co-existence of both an excess and lack of governmental responsibility, the PRC government is committed to making certain adjustments.** The imbalance in the division of government power and the unclear division of expenditure liabilities are mainly reflected in the following three aspects. First, local government assumes responsibilities that should be held by central government, such as for national security, frontier defense roads, the maintenance of international boundary rivers, inter-basin river management, the prevention and treatment of interregional pollution, and water and ocean usage management. The expenditure of "basic public education service" is divided among prefectures, provincial governments, and central governments in terms of staff pay and public spending, which goes against the general finance-sharing principle that administrative power accords with expenditure liability. The pure public goods "public health service" and mixed public goods "public medical care" can hardly be distinguished, with both being mainly undertaken by local government; municipal governments bear responsibility for "social

insurance,” which should be under central government’s control, resulting in an overall low level of social insurance; local government has partial judicial powers, which easily causes distortions of justice. Second, instead of delegating administrative power—for example, for managing preschools, water and toilet renovation programs in villages, and village image projects—to lower levels, the central government interferes unconditionally. Third, central government and local governments always deviate from their established policies when governing. To solve these issues, the PRC government has issued a series of policies. The 2012 12th Five-Year Plan of the national basic public service system clearly divides expenditure responsibilities between central and provincial governments regarding basic public services, but it hardly explains the expenditure liability of local government below the province level. However, it is expected that administrative power and expenditure liability will be further subdivided for all government levels below the province level. The “Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform,” made at the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CCCPC), states a system that balances administrative power and expenditure liability must be established and that appropriate centralization of power and expenditure liability is needed. The decision also implies adjustment of the right of jurisdiction for local government and a proper separation of the fund management system and administration division. The “Decision of the CPC Central Committee on Major Issues Pertaining to Comprehensively Promoting the Rule of Law,” adopted by the fourth plenary session of the 18th CCCPC, states that the standardization and legalization of governance must be achieved, and the legal system of administrative power at all levels of government, especially between central and local offices, must be improved. These suggestions by the CCCPC demonstrate that the separation of power and expenditure liability between central and local governments is in the process of being standardized and legalized.

**Regarding tax reform, importance has been attached to individual income tax, environment protection tax, resource tax, building tax, and business tax.** In 2002, the PRC started income tax distribution reform, which involved moving from a tax system where central and local government distribute income tax by administrative subordination to one where central and local government distribute income tax using fixed percentages (central government at 60%, local government at 40%). The Individual Income Tax Law of the People’s Republic of China, revised in 2011, merely made some adjustments to the tax rate and tax threshold. Therefore, individual income tax reform remains the key issue of the current tax reform. As early as 2007, “a comprehensive scheme on energy conservation and emissions reduction” issued by the state council explicitly stated that environment tax must be levied. The Third Plenary Session of the 18th CCCPC further strengthened tax-for-fees for environmental reform. A draft environment protection tax law was published in 2015. Environment tax, as an important policy instrument of environmental management, can have a positive effect on curbing pollution and can also be a main source of income for local government. In a new round of resource tax reform, Xinjiang was the first local authority to introduce resource tax on petrol and gas, which was subsequently implemented across the PRC in 2011. The 2013 “Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform” again urged resource tax reform. In 2015, Provisional Regulations on resource tax became one of the legislative programs requiring urgent implementation for deepening overall reform in the PRC and firmly establishing the rule of law. The resource tax reform will increase the income of local governments. In 2011, Shanghai and Chongqing began pilot reforms of levying building tax on residential housing. Although enlarging the scope of the pilot program on individual housing tax was proposed many times, it made little

substantial progress, with building tax being merely listed in the legislation working plan drawn up by the standing committee of the National People's Congress. Since implementing business tax, more and more areas and industries have adopted it. But business tax will disappear altogether and is to be replaced by VAT, which will result in a structural tax reduction and the disappearance of the main local tax category—business tax.

**As transfer payment systems become increasingly standardized, transfer payments from central government will provide much stronger financial support for local governments' income.** Owing to the problems left over from the reform of the tax-sharing system, local offices have become over-dependent on central transfer payments. Many other problems have emerged in recent years, such as too many rules for special transfer payments, too much pressure from supporting funds, and payment delays. To further regulate and perfect transfer payments, the new budget law clearly states that general transfer payment has a dominant role in transfer payments, that a sound assessment and quitting mechanism must be established for special transfer payment, and that matching requirements must be abolished. All these measures contribute to restructuring the transfer payment system and reducing the phenomenon of “running to the ministries for money,” which can help local governments in making a budget plan and provide them with a more stable and predictable financial income.

**The Ministry of Finance has reformed and regulated the financial management system for local governments below the province level multiple times.** The reform of “the country directly under the provincial government” and “the villages directly under the country-level government” financial management structure gives country-level government more financial power. Under the financial management structure of “the country directly under the province,” some of the financial powers of the municipal governments are delegated to the country-level government, and provincial financial bureaus can directly contact financial departments in countries and towns.

**Such a financial management structure can help provincial financial bureaus play a more effective role in controlling the financial gap in their jurisdictions, so as to help ease fiscal difficulties of country-level government.** The “town directly under country government” system, with towns as independent accounting subjects and with country-level financial departments directly managing and supervising towns' financial revenue and expenditure, plays a significant role in reducing the size of township debts.

**The 2014 budget law added that local government is allowed to borrow and go into debt.** The new law addressed such problems as how to borrow, how to manage, and how to pay back local governments' debt, and it standardized the management of local government debts.

**Moreover, the new budget law laid the legal foundation for nationwide implementation of comprehensive budget management.** It regulates the functional orientation, compilation principles, and interrelationship between the following budgets: general public budget, government fund budget, state-owned capital management budget, and social insurance fund budget. It also incorporates land leasing revenue and state-owned capital operating revenue in the total revenue of local governments. All these measures provide effective and thorough checks on government fiscal revenue and expenditure, increase local governments' total income, diminish the negative effects of tax-reducing policies (such as VAT revenue in place of business tax) on local governments, and effectively combat corruption.



### **1.3 Current Situation and Problems that Need to be Addressed Urgently**

Although the framework of fiscal decentralization in the PRC has been basically established, the system of tax distribution is still to be improved. The “new normal” of the PRC economy gives rise to unprecedented financial stress on the tax distribution system. In terms of outlay responsibility, the combination of “centralization of financial power and decentralization of administrative power,” together with a lack of explanation of outlay responsibilities for governments below the province level in the tax distribution system, put huge financial stresses on local governments, especially the country-level governments. In spite of the fact that the reform of layout responsibility system has been put on the agenda, no detailed scheme came into being, restricted by the advancement of government administrative system reform. The “General plan on deepening fiscal and taxation system” proposed the reform of layout responsibility rather than the reform of administrative power and financial power. Therefore, it will be a significant future task to further specify administrative power and expenditure liability of governments at all levels, especially local governments, so that administrative power and financial power are matched for all levels of government. In terms of tax reform, 1994 saw the most significant reform and restructuring of the industrial and commercial tax system. But as reforms in real estate tax, resources tax, environmental tax, and the replacement of VAT for business tax are beginning to take effect, the local taxation system faces major challenges and taxation categories may need to be rethought. Local financial problems have, to a large extent, been resolved, but local governments continue to struggle because of a lack of financial resources. In addition, turnover tax still has a very important role, with the ratio between direct tax and turnover tax at 70:30, and with the ratio of tax revenue from all types of enterprises and natural persons roughly at 90:10. Therefore, there are large differences between the current situation in the PRC and the structural features required in a modern taxation system. Hence, adjusting the proportion of direct and indirect taxation and legalization of the tax system is needed to establish a modern tax system.

Transfer payments play an essential role in maintaining stability in local finance. Although numerous improvements still need to be made, it is becoming more standardized. As the formula for balanced transfer payments has been established, the future reform focus ought to be on the further adjustment and perfection of factors, the selection of weight coefficients, better equalization of general transfer payments, the clearance and merging of special transfer payments, as well as higher efficiency of fund use. Local government debts are a cause of great concern. The general mapping and assessment of local debts was basically completed in 2015. The new budget act standardizes the management of local government debt in accordance with the reform thinking of “opening the front door, blocking back doors and building walls,” but it remains necessary to find a better mechanism for local government to borrow money and manage debt. To achieve a system of comprehensive budget management, the government fund budget, the state-owned capital operating budget, and the social insurance fund budget have been included in the budget management. However, local government budgets, in practice, are far from comprehensive and transparent, with a lack of standardization in financial revenue and expenditure. Therefore, to put in place a comprehensive budget system, greater efforts should be made to clearly define the management scope of various non-tax revenues and strictly differentiate diverse programs and funds by their nature by categorizing them into the following four kinds of budget: public budget, government fund budget, state-owned capital operating budget, and social insurance fund budget.

The PRC's imperfect tax-distribution system, in conjunction with the "new normal" of the PRC economy, results in instability and low sustainability of both financial income growth and local government financing mechanisms, which have been made worse by the replacement of business tax by VAT. It has become extremely urgent, therefore, to explore new ways of capital growth and new capital-raising models, and come up with a mechanism for maintaining the stability and sustainability of local government finance.

## **2. EVALUATION OF THE PEOPLE'S REPUBLIC OF CHINA'S INNOVATIVE INITIATIVES TO INCREASE LOCAL GOVERNMENT REVENUE**

### **2.1 Local Governments' Financial Distress under the Tax-sharing Fiscal System**

The tax-sharing fiscal management system reform of 1994 primarily established a framework for financial distribution between central and local governments. However, the leftover problems of the tax-sharing fiscal management system, as well as the impact of replacing business tax with VAT, gave rise to financial difficulties for local governments on a large scale. Therefore, the PRC's tax system needs restructuring.

**On the one hand, the incomplete tax-sharing system reform of 1994 led to financial difficulties for local governments.** First, the laws and regulations meant to clearly divide administrative power and financial power between central and local governments are inadequate. The existing rules are rather vague and too general. Second, central and local governments share too many categories of taxes, which goes against the original intention of the tax-sharing system. Moreover, reform of transfer payments has involved some irrational measures. Lastly, the financial system below the province level remains in a chaotic state. These factors have resulted in the centralization of financial power and the decentralization of administrative power, as well as severe financial difficulties for local governments and particularly grassroots local government bodies.

**On the other hand, local governments are strongly affected by the replacement of business tax by VAT.** This brought about the disappearance of a main local tax, as business tax was the biggest tax revenue income of local governments. To diminish the impact on local governments, they are entitled to share VAT revenues with the central government by collecting 25% of VAT income. Although this method temporarily solved the problems caused by the revenue losses suffered by local governments, it also has drawbacks. The replacement of business tax by VAT may result in competition for tax resources and greater investment by local governments.

### **2.2 Innovative Initiatives taken by the People's Republic of China Government to Increase the Fiscal Revenue of Local Governments**

**All local governments attach great importance to economic growth, as it increases fiscal revenue.** The growth of local government revenue goes hand in hand with local economic development. On the one hand, economic growth enlarges the tax base, thus increasing tax revenue. On the other hand, economic prosperity can expand demand for land, which increases land prices and thus land transfer income.

Therefore, local governments at all levels regard local economic growth and GDP growth as indicators to evaluate their governing capacity.

**Apart from developing the regional economy, the PRC government and academia consider tax reform to be an important measure to increase local government revenue.** The PRC government is committed to establishing a local taxation system through reforming and perfecting the systems of environmental tax, VAT, and consumption tax. Five taxation laws have been included in urgent legislative projects: “2015 Legislative Work Plan of the State Council,” “Regulations on Environmental Protection Tax,” “Regulations on Tax Collection and Management (Amendment),” “Provisional Regulations on Value-added Tax (Amendment),” “Provisional Regulations on Consumption Tax (Amendment),” and “Regulations on Resources Tax (Amendment).” Although regulations on real estate tax are not in the 2015 Legislative Work Plan of the State Council, they have been included in the 2015 legislative work plan of the committee of the National People’s Congress and preparatory legislative projects.

**To increase the proportion of VAT that local governments are allowed to collect is not a credible plan for solving their financial difficulties.** Before the implementation of VAT, central and local government shared VAT revenue at the ratio of 75:25. After the implementation, some scholars suggested that the most direct way to make up for local financial losses would be to raise the proportion of VAT for local governments. Although there was no consensus among scholars on the ideal VAT-sharing proportion, those who advocate sharing VAT revenue hold that a ratio of about 50:50 comes close to compensating the financial losses of local government. But such an increase would also result in fiercer competition for tax revenue. Moreover, that too many taxes are shared by central and local governments goes against the principle of a tax-sharing fiscal system, so it should be avoided as much as possible.

**The most popular suggestion for solving the financial difficulties of local governments is to define consumption tax as a tax shared by central and local government to compensate for local financial losses caused by the replacement of business tax with VAT.** According to the principles of tax distribution, it is preferable to classify a tax attached to the place of residence as a local tax, such as sales tax and consumption tax. At present, consumption tax is collected by central government, which contradicts this principle. Transforming consumption tax into a sharing tax is not only reasonable, but would also increase local government revenue. Consumption tax is imposed in different links of transaction. Consumption tax collected in the production and wholesale link is a capital levy. Therefore, distributing consumption tax over different links increases local financial revenue without stimulating competition for tax revenue. If we move the links forward to the retail stage and make consumption tax (a central tax) a local tax, we can largely offset the shortfall in local tax revenue brought about by replacing business tax with VAT.

**Another feasible option would be to make individual income tax a major tax of the local tax system.** At present, central government and local government share the revenue at a ratio of 60:40. Corporate income tax is a kind of capital tax. Local governments can easily attract corporations to come to the area by changing the investment environment and conditions for corporations. Therefore, if only local governments were to collect corporate income tax, it would result in tax competition among them. However, as individual income tax is a low-liquidity labor levy, it would not give rise to fierce tax competition if collected by local governments only. In 2014, personal income revenue collected by central government was 1.5 times higher than that collected by local governments. If personal income tax is collected exclusively by

local government, with the improvement of the tax system it will become one of the most important sources of revenue for local governments.

**At present, it is impossible for real estate tax to become a main local tax. But in the long run, it is suitable for cultivation as a main local tax.** Although real estate belongs to the local tax system, individual housing, in 2011, did not constitute a real estate tax base. In January 2011, Shanghai and Chongqing started pilot programs of imposing tax on individual housing. Chongqing aimed at high-end apartments and villas, whereas Shanghai put emphasis on new housing with floor area per capita as the threshold. But the proportion of real estate tax revenue in total revenue did not change much—in 2013, for Shanghai it had risen from 2.3% to 2.45%, and for Chongqing from 2.25% to 2.82%. Moreover, real estate tax reform may also affect the people who benefit from the existing tax system. Therefore, real estate tax cannot be a main local tax in the short term, but in the long term it could be cultivated as such.

**For resource tax, the change from a volume-based tax mechanism to a price-based mechanism will increase local fiscal revenue, but it is only suitable as a main taxation for resource-rich provinces.** Although, at present, resource tax is a sharing tax, all kinds of resource tax, except offshore petrol tax, are local taxes. “The 2011 Revised Provisional Regulations of the People’s Republic of China on Resource Tax” specifies that oil and gas resources should be taxed according to price, which tends to improve the efficiency of resource use and reduce the waste of resources, as well as increase local government revenue. The proportion of resource tax revenue in total revenue increased from 1.28% in 2010 to 1.76% in 2014. As resource tax revenue in total local revenue remains low, it is difficult for it to become the main local tax. Unlike crude oil, natural gas and other resources are taxed according to quantity. With the improvement brought about by resource tax reform, resource taxes will gradually become a significant local financial revenue. For resource-rich provinces in the central and western regions, resource tax revenue is a significant revenue source. For example, resource tax revenue in Xinjiang accounted for 8.7% of total revenue in 2013, up from 7.8% in 2010, and in Heilongjiang it was 8.3% in 2013, down from 8.7% in 2010. Such resource-rich provinces can cultivate resource tax as a main local tax.

**Environmental protection tax placed under local government’s administration can increase local financial resources.** But because of its small scale, it cannot become a main local tax in the short term. “Regulations of People’s Republic of China on Environmental Protection Tax” (Exposure Draft) establish the legal basis for imposing environmental protection taxes, but say nothing about the attribution. Environmental protection tax is, in fact, transforming administrative fees into taxes. The pollution tax is levied by local governments that mainly bear the responsibility for environmental protection. According to the principle that power and authority must match, it is reasonable for local governments to take charge of environmental protection tax. Although “fee-to-tax” will not enlarge local governments’ tax income, with the standardization of environmental tax and the expansion of the tax base, it may become a significant source of revenue for local government. However, it is unlikely to become a main local tax due to its small scale. Resource tax levied on the basis of price rather than volume can increase local fiscal revenue, but it is only suitable as a main local tax for resource-rich provinces.

### 3. INNOVATIVE FINANCING MODELS OF LOCAL GOVERNMENT

With the gradual emergence of the disadvantages and risks of traditional financing modes, local governments have been paying more attention to innovative financing models. Financial difficulties have forced local governments to rely on such financing modes as land-leasing and government-invested companies. But the features of these financing channels are low stability, high risk, and low sustainability. As a result, in addition to resorting to innovative revenue channels, the PRC's local governments are taking creative measures to be able to provide public services, for instance, through issuing local government bonds, establishing public-private partnerships (PPP), and transfer payments from the central government.

#### 3.1 Bonds Issued by Local Government

**Local government bond issuing has made steady progress and the prospects for its further development are promising.** To stimulate the economy, the central government allowed local governments to issue bonds with a yearly quota of CNY200 billion in 2009, 2010, and 2011. In 2011, Shanghai, Zhejiang province, Shenzhen province, and Guangdong province, were the first pilot areas to issue local government bonds. In 2014, 10 pilot provinces and cities managed to pay back the local government bonds themselves. From 2009 until 2013, local government bonds accounted for 6.1%, 4.9%, 3.8%, 4.1%, and 5.1% of local government revenue, respectively, showing a V-shaped development trend. The reason is that the central government had encouraged local governments to establish “borrowing platforms” to expand their investment financing, resulting in local governments borrowing as much as they could, which from 2009 to 2011 caused a local government credit crisis, and hence poor performances of local government bonds in the trading market. But in 2011, the central government started pilot implementation of local government-issued bonds, thus gradually expanding the financial autonomy of local governments and enlarging the size of the local government bond market. The Budget Law of 2014 specifies the rules under which local governments can issue bonds. In 2015, the central government launched a program of debt-to-bond and initiated a special bond. All these measures have played an essential role in easing the payback pressure on local governments, regulating local government borrowing, as well as controlling and resolving the debt risk of local governments. At the same time, the central government provides solid support for local governments to develop the innovative financing channel of issuing local government bonds.

**Table 1: Local Government Bonds (2009–2013)**  
unit: financial revenue (CNY billion, ratio [%])

	2009	2010	2011	2012	2013
Local government bond revenue	2,000	2,000	2,000	2,500	3,500
Local government total revenue	32,602.59	40,613.04	52,547.11	61,078.29	69,011.16
Ratio	6.1	4.9	3.8	4.1	5.1

Source: China Statistical Yearbook (2010–2014).

### 3.2 Pilot Program of Public-Private Partnership Project

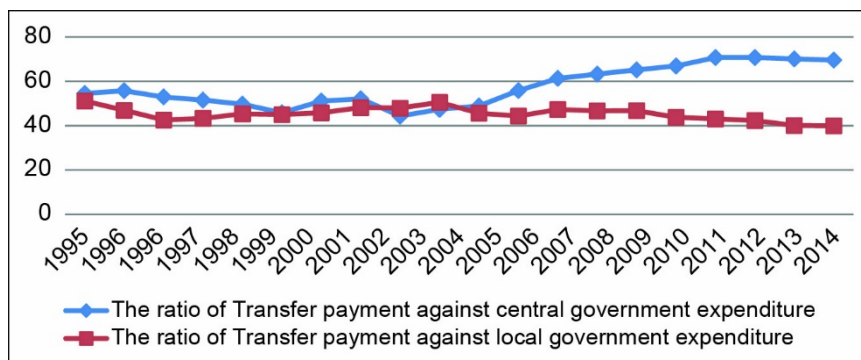
**PPP financing models have become a popular financing option for local governments.** In 2015, the central government issued 19 PPP-related policies, which will regulate PPP development and facilitate various investment and financing activities. The National Development and Reform Commission has a special PPP project column on its official website, publishing a total of 1,041 projects to be promoted, with the total amount invested reaching CNY1.97 trillion. Encouraged by a series of policies of the central government, local government has been active in introducing social capital and a number of PPP programs have emerged.

**PPP financing models can make up for the shortcomings of traditional financing methods and ease fiscal and financial stress. But the uncertainty in cooperative relations with government remains a factor restricting the development of PPP patterns.** The PPP financing mode in the PRC has experienced three stages of development. In the first stage, PPP was mainly in build–operate–transfer (BOT) mode. At this stage, the PPP mode was in its introduction phase, mainly led by the State Planning Commission and with the foreign investment fund as its main financial source for project development. Some BOT pilot programs are the Guangxi Laibin Power Plant built in 1995, the sixth Waterworks of Chengdu, and Changsha Power Plant. Although the above pilot programs did not work well, they had far-reaching effects, and provided a good foundation for the future development of the PPP mode in the PRC. In the second stage, PPP mainly took the transfer–operate–transfer (TOT) mode and BOT mode. At this stage, project participants and the factors affecting project development were diversified. The PPP project gradually brought in social capital as the authorities in various industries and local governments became increasingly involved. Examples of projects in this stage were Beijing Metro Line 4 and the National Stadium. The PPP mode in the third stage is the standardization stage. Due to the uncertainty of cooperative relations with government, social capital has concerns over the development of the PPP mode. In 2014, the treasury department began to design and improve PPP pilot programs, perfect the legislation mechanism, and set up a risk-sharing system and an appropriate withdrawal mechanism, aimed at balancing the interests of public departments and private companies so they can engage in fair competition for new projects.

### 3.3 Transfer Payments from Central Government

**The PRC's massive transfer payment system provides the financial basis for the equalization of basic public services, which is also indicative of local governments' over-reliance on transfer payments.** The amount of transfer payments increased from CNY253.4 billion in 1995 to CNY5.17 trillion in 2014 and has continued to increase along with the growth of per capita GDP since 2014. In 2014, about 70% of total central government expenditure was spent as transfer payments. This shows that the PRC government is already equipped with an extensive transfer payment system, which provides local governments with a solid financial foundation for equalizing basic public services. However, 40% of local government expenditure is from the central government transfer payment. Such a large amount of transfer payments also shows that local governments, over-dependent on transfer payments, face severe financial difficulties.

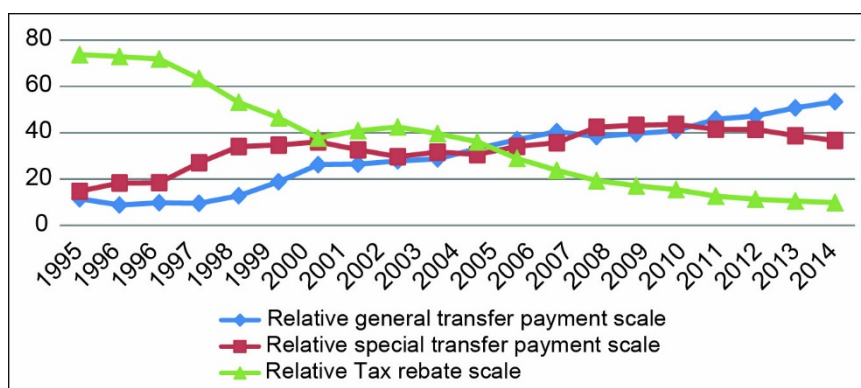
**Figure 1: Relative Central Government Transfer Payment, 1995–2014 (%)**



Source: Ministry of Finance of the People’s Republic of China (<http://yss.mof.gov.cn/>).

**Further optimization of the structure of transfer payments has reduced the uncertainty about local government funding sources, but the general transfer payments and the internal structure of special transfer payments needs to be further optimized.** The early stage of tax-sharing reform saw the highest ratio of tax rebates to transfers. In 1995, it reached 74%. After this, the share began to decline while general transfer payments and special transfer payments rose. By 2006, the relative size of general transfer payments had reached 37%, exceeding the tax rebate for the first time, thus general transfer payment became the largest transitional payment program. However, with the expansion of special transfer payments, in 2010 they exceeded general transfer payments. Yet in 2014, general transfer payments took the largest share. The 2014 Budget Act specifies that the aim of transfer payment reform is making the general transfer payment the major transfer payment and establishing and improving the withdrawal mechanism and regular assessment mechanism for special transfer payments. It is expected that the proportion of general transfer payments will continue to increase year by year, whereas the proportion of special transfer payments will decline. This will provide local governments with more stable financial resources, promoting equalization of basic public services and coordination of regional development. At present, general transfer payments in the PRC are made up of 28 projects. However, only balance transfer payments are subject to a transfer payment formula. To further improve the internal structure of general transfer payments and special transfer payments therefore remains an important task.

**Figure 2: Relative Transfer Payment Scale, 1995–2014 (%)**



Source: China Finance Yearbook (1996–2014); Ministry of Finance of the People’s Republic of China (<http://yss.mof.gov.cn/>).

## 4. MECHANISMS TO MONITOR AND ENSURE FISCAL STABILITY AND SUSTAINABILITY AT THE LOCAL GOVERNMENT LEVEL OF THE PEOPLE'S REPUBLIC OF CHINA

### 4.1 Major Factors Influencing Fiscal Stability and Sustainability at the Local Government Level of the People's Republic of China

With the “new normal” of the PRC's economic development, growth of local governments' fiscal revenues has slowed. In 2014, the growth of revenue from main taxes slowed, the real estate market made a series of policy shifts, and more sectors began to implement the pilot program of replacing the business tax with a VAT. Affected by these factors, national general fiscal revenue in 2014 increased by 8.6%, which was 4.3% lower than in 2012 and 1.6% lower than in 2013. In 2014, local governments' fiscal revenues rose by 9.9%—the first time growth of local governments' fiscal revenues had dropped to a single-digit level since 2003. It will be a “new normal” for fiscal revenue growth to stay at the single-digit level, rather than grow rapidly as in the past.

**Extensive growth will not ensure sustainable rapid growth of local governments' fiscal revenues.** Since the 1994 tax allocation reform, many local governments have maintained rapid economic development at a cost to the environment. But extensive growth, which sacrifices the environment to develop the economy and increase fiscal revenue, is no longer sustainable; the growth mode has been changing from extensive growth to intensive growth.

**That total disposable local revenue and outlay responsibility do not match led to unsustainable fiscal revenues of local governments.** Statistics show that from 2005 to 2014, total fiscal expenditure of local governments grew by 5.1 times, and local tax revenues only by 4.6 times. In times of financial difficulties, fiscal revenue cannot be sustained at high levels, resulting in low levels of fiscal expenditure and a negative impact on the economy. Mechanisms to manage and monitor local governments' fiscal revenues are backward and decisions are mainly made by superiors through administrative orders. It is harmful for other supervision subjects to monitor financial management and it often leads to a waste of financial resources.

**Unsteady fiscal revenues of local government have resulted from an irrational revenue structure.** First, the tax structure is irrational. Except business tax, local taxes involve high cost, provide unsteady income, have dispersed tax sources, and collection and management is difficult. Replacing the business tax with a VAT caused many problems for the PRC's local governments, including a lack of main taxes and instable tax sources. Second, the transfer payment structure is irrational. As for general transfer payments, it has too many categories and multiple targets, and its equalization function is weakened. As for special transfer payments, it involves too many fields and it is not distributed based on objective formula-based calculations.

**Unsustainable government debt aggravated the instability of local government finance.** By the end of June 2013, local government debt which needs to be paid back by local governments amounted to CNY10.9 trillion, debts for which local governments have guaranty responsibility amounted to CNY2.7 trillion, and debts for which local governments bear some responsibility amounted to CNY4.4 trillion. Therefore, the total



local governmental debts amounted to CNY17.9 trillion. According to the latest assessment report of the PRC economy issued by the International Monetary Fund (IMF), local government debt in the PRC will account for 45% of GDP at the end of 2015. Debt is a double-edged sword—managed and used well, it produces favorable results; if not, local governments will be heavily indebted. Or worse, a financial crisis and a fiscal crisis would result and the sustainable development of local finance would be hindered.

## 4.2 Mechanisms to Monitor and Ensure Fiscal Stability and Sustainability at the Local Government Level

**Since the “new normal” of the economy and the intensive development mode are irreversible, the best way to ensure stable and sustainable government finances is to maintain the stability of the general public budget and the government fund budget.** Generally speaking, PRC local government finance has been fairly sustainable and stable. But the steadiness of local government finance was affected by the remaining problems of the fiscal administration system of tax allocation and the impact of replacing business tax with VAT. Moreover, the imperfections of the government fund budget revealed the unsteadiness of local government finance.

**Establishing a mechanism to standardize outlay responsibilities at all government levels is the basis for maintaining the stability and sustainability of government finance.** Poorly defined outlay responsibilities between central and local governments resulted in uncertainty surrounding the fiscal expenditure of local governments. Therefore, the basis for maintaining the stability and sustainability of government finance is to standardize and legalize the outlay responsibilities at all government levels.

**To maintain the stability of local government finance, there are three important paths—establishing a long-term development mechanism of the general public budget, drawing up an annexed budget plan for governmental debts, and improving the performance assessment mechanism of budget and expenditure.** The major sources of local governments’ fiscal revenues are taxes, transfer payment revenues, and debt revenues. **Regarding tax capability**, tax revenues are total disposable local revenues for general budgetary expenditures and the financial safeguard for local governments to provide necessary basic public services for people. Therefore, the core function of tax revenues is to provide stability to local government finance. To maintain the stability of local government finance despite the remaining problems of the fiscal administration system of tax allocation and the impact of replacing the business tax with a VAT, improving the taxation system and setting up a stable growth mechanism of tax revenues should be a priority. **Regarding transfer payment capability**, an objective formula-based calculation and a better management of general transfer payment is required to fully allow equalization of general transfer payments and to set norms for special transfer payment management. **Regarding debt revenues**, there are three methods for moving government debts onto the budget—according to the public budget pattern, the annexed budget pattern, and the double-entry budget pattern. In the PRC, local government debts, including revenues of local government bonds issued by the Ministry of Finance as an agent, bond-lending revenues, and surplus funds of bond-lending revenues of the last year are usually counted as parts of the general public budget. More specifically, they are counted as parts of total annual revenue on the income and expenditure sheet of the public financial budget. However, the debt budgeting method is too simple to reveal the scale, structure, and usages of local government debts. According to the new Budget Law, it

is not realistic to move government debts onto the double-entry budget in the short term. Therefore, establishing a debt-annexed budget would be a plausible way to maintain the stability and sustainability of the debt revenues of local governments. **Regarding budgetary expenditure**, four approaches can be adopted to effectively enhance the steadiness of local government finances. First, the expenditure structure should be optimized. Second, the performance assessment mechanism of the budgetary fund should be improved. Third, the usage efficiency of budgetary funds should be increased, especially of budgetary funds for major infrastructure programs. And fourth, the multiplier effect of public expenditure should be maximized.

**Establishing a mechanism to balance and monitor the governmental fund budget can also effectively maintain the steadiness and sustainability of local government finance.** According to the new Budget Law, the governmental fund budget is to be specially used for specific public affairs and will be counted in the fund category according to the income and expenditure needs of fund programs. Moreover, local governments are to adopt the principle that expenditure is determined by revenues. The most important task to improve the governmental fund budget system is to monitor the budget and maintain budget balance. Therefore, establishing a mechanism to balance and monitor the governmental fund budget will be an important approach to maintaining the steadiness and sustainability of local government finances.

## **5. INFLUENCE OF INNOVATIVE INCOME-INCREASING AND FINANCING APPROACHES OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNMENT ON INFRASTRUCTURE INVESTMENT SPENDING CAPABILITY AND OTHER SPENDING CAPABILITY OF LOCAL GOVERNMENTS**

**The PRC government has adopted a series of innovative approaches to increase fiscal revenue and expand financing channels.** By improving the local taxation system step by step, a normal growth mechanism for tax revenue is to be set up to guarantee general public budgetary spending capability. The financing and investment channels of local governments are to be kept expanding through innovative financing measures, including the issuing of local government bonds, operating a PPP model, and improving the transfer payment mechanism. These measures, by enhancing the stability and sustainability of local governments, could safeguard local governments financially to allow them to improve infrastructure development, basic public services, and ecological construction.

### **5.1 Influences of Tax Allocation Reform**

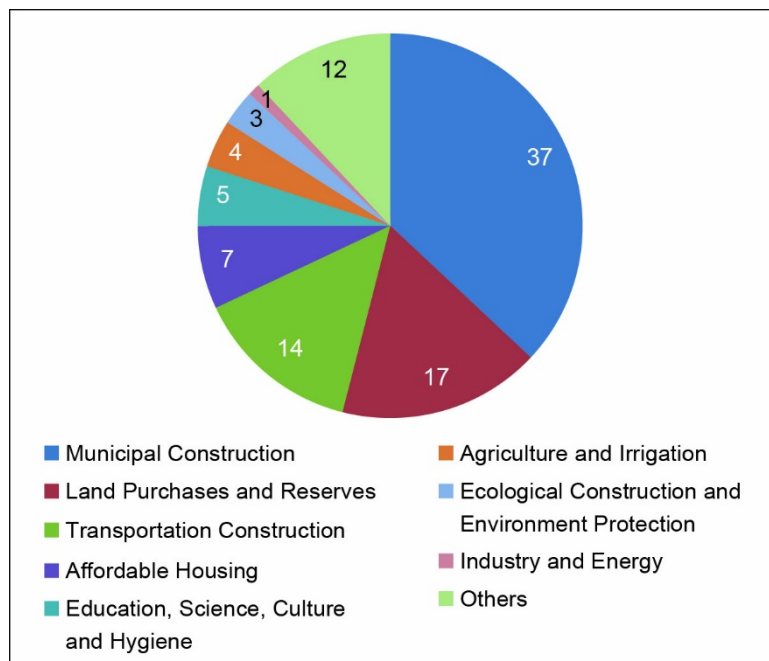
**Growth of tax revenue laid the financial foundation for local governments to offer basic public services.** The equalization of basic public services by 2020 is an arduous task. Under the imperfect tax allocation system, the PRC's economic development entered a "new normal" and economic growth slowed. To guarantee the consistent and sound development of the economy, it is necessary to operate structural tax-reducing policies, including replacing business tax with VAT. The economic downturn and replacing business tax with VAT will definitely reduce the fiscal revenues of PRC local governments and disclose more traits of unsteady and unsustainable fiscal revenues of local governments. Thus, basic public services provided by local governments will be

adversely affected. The PRC government is currently promoting structural tax reduction reform, the major goals of which are to reduce turnover tax, increase property tax, and maintain income tax. Although the reform of replacing business taxes with value added taxes decreases the fiscal revenues of local governments, reform of income tax, consumption tax, resource tax, and real estate tax could establish a taxation growth mechanism and ensure the growth and improvement of local government fiscal revenues so that a greater part of fiscal revenues could be used for ecological construction and expenses like education, hygiene, and social insurance. However, it is worth noting that the essence of environment protection tax is fee-to-tax. Therefore, the environment protection tax will not increase the tax base of local governments in the short term. Once managed by the taxation system, it will be managed according to the overall plan rather than being specially used for protection of the environment. Governments should take this into account when devising expenditure policies because it may reduce fiscal revenues that can be used for environmental protection.

### 5.2 Influences of Innovative Financing Channels

**Innovative financing channels will lead to the upgrading of local government infrastructure construction and public service capability.**

**Figure 3: Investment Directions of Local Government Debts Due in June 2013 (%)**



Source: National Audit Office of the People's Republic of China (<http://www.audit.gov.cn/n1992130/n1992150/n1992379/3432165.html>).

**First, issuing local bonds profoundly upgraded local government's investment capability for infrastructure construction.** Statistics published by the National Audit Office of the People's Republic of China showed how local governments' debt funds were used in June 2013. The debt funds were mainly used for expenditure on municipal construction, land purchases and reserves, and transportation construction, which together accounted for 68% of debt funds. Spending on affordable housing, education, science, culture and hygiene, ecological construction, and environmental protection accounted for a further 15% (See Figure 3). Although local governments

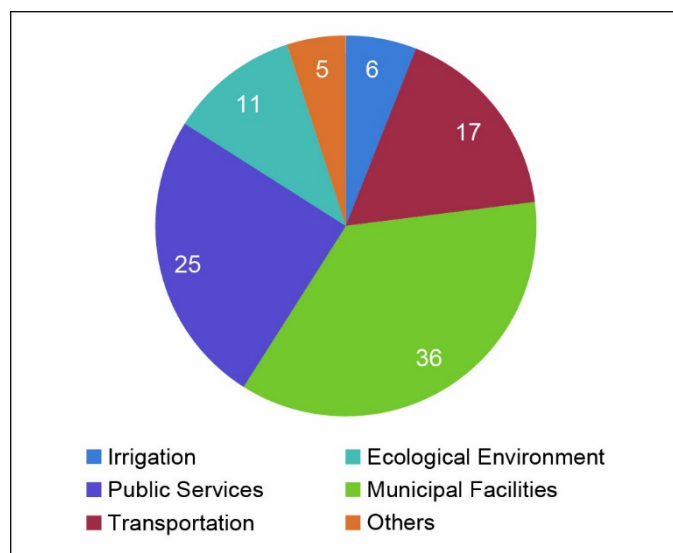
could raise funds for infrastructure construction and basic public serving programs through Local Government Financing Platforms, the risks related to raising money through Local Government Financing Platform are extremely high. The New Budget Law has granted local governments the right to issue bonds under specific circumstances, which will make a big difference in local governments' financing approaches to infrastructure construction. The New Budget Law sets clear requirements for the budgets of provinces, autonomous regions, and municipalities approved by the state council. According to these requirements, funds necessary for construction investment can be raised by issuing local government bonds and the amounts will have to be within the limits set by the state council. As for public welfare projects with or without profits, local governments can raise funds through special bond financing approaches and general bond financing approaches. Therefore, local government bonds are mainly to be used for infrastructure construction. If financing risks are well controlled, local government bonds could offer financial safeguards for local governments' infrastructure construction.

**Second, PPP models could provide a stable and sustainable source of income for local governments to undertake municipal construction and provide public services, transportation, and ecological environmental protection.** The Third Plenary Session of the 18th CPC Central Committee proposed that private capital be allowed to participate in urban infrastructure investment and operation by franchise and other means. Seven key areas would be opened up in the future: ecological environmental protection, agriculture and irrigation, municipal construction, transportation, energy sources, information and facilities for civil space, and social undertakings. The PPP model binds infrastructure construction to its operation to provide more infrastructures at lower cost and higher quality. Multiform public-private partnerships would be explored in the areas of local governments' infrastructure construction to arouse the enthusiasm of people from all walks of life. This would enhance local government's capacity to invest in infrastructure construction. Among the 1,043 PPP promotion programs released by the National Development and Reform Committee, municipal facilities, public services, and transportation projects take the largest shares, accounting for 36.15%, 25.41%, and 16.87%, respectively (see Figure 4). Moreover, 10.74% of projects are used for ecological environmental construction (see Figure 3). It shows that the PPP model is a cooperative model that shares benefits as well as risks and requires full cooperation between local government and business. The model will offer local governments more financing channels for infrastructure construction, improve their public services capabilities, and to some extent enhance their spending capabilities on ecological environmental protection.

**Third, central government transfer payments to local governments can improve basic public services capabilities and promote equitable access to them.** Since the beginning of the reform and the opening-up policies in 1978, the government has been offering people more and more basic public services, including general public services, basic education, public health and basic medical care, basic scientific research, ecological environment protection, and public welfare infrastructure. Since the 1994 tax allocation reform, with the expansion of central government transfer payments to local governments, the gap in basic public services capabilities between districts has been expanding, in part because special transfer payments and tax rebates with adverse equalization effect were relatively large before 2006. Since 2006, with the expansion of general transfer payments, equitable access to basic public services across districts has improved further. The new Budget Law requires that general transfer payments are the main part of all transfer payments and that a regular assessment of and withdrawal mechanism for special transfer payments will be established and further developed. The requirements would not only improve the basic

public services capabilities of local governments, but also promote equitable access to basic public services. As the transfer payment system becomes more and more transparent and well regulated, central government transfer payments to local governments become a steadier financial source for local governments to develop basic public services.

**Figure 4: Cartogram of Categories of National PPP Programs released by the National Development and Reform Committee in May 2015 (%)**



Source: National Development and Reform Commission ([http://www.ndrc.gov.cn/gzdt/201608/t20160823\\_815427.html](http://www.ndrc.gov.cn/gzdt/201608/t20160823_815427.html)).

## 6. POLICY IMPLICATIONS AND SUGGESTIONS

To solve the remaining problems of the fiscal administration system of tax allocation, recover from the shock of the “new normal” and the reform of replacing the business tax with a VAT, and maintain fiscal stability and sustainability at the local government level, it is advisable to establish a standardized, decentralized fiscal administration system and a modern financial system in conformity with the overall spirit and requirements of the new Budget Law and the spirit of the overall plan for deepening structural tax reforms.

**The first suggestion is the standardization and legalization of the outlay responsibility of governments at all levels to reduce the fiscal burden of local governments and safeguard their financial stability from the very beginning.** It is suggested that the classification of the outlay responsibility of governments at all levels should be standardized in every basic public service field according to the principle of the Budget Law. It should be made possible to adjust the classification according to economic and social developments and it should also be standardized and defined in the form of laws or regulations. Such arrangements could transfer outlay responsibilities from local governments to central and provincial governments. As the outlay responsibilities of county and township governments are reduced and provincial governments play a more important role in offering public services, the financial stability of local governments could be ensured.

**The second suggestion is to form a long-term fiscal growth mechanism by establishing a modern taxation system.** There are three ways to form a long-term fiscal growth mechanism. The first method is to develop new main taxes. Against the backdrop of replacing the business tax with a VAT, local governments at all levels should establish one to three main taxes based on objective formula-based calculations. These main taxes should have broad tax bases, high tax stability, and growth potential. Moreover, they should be easy to collect by local governments, they should be related to local industrial development, and they should have a visible impact on government revenue and the industrial structure of the region. In the short term, it would be beneficial to promote the reform of consumption tax and individual income tax and make them main taxes of the local taxation system. In the long run, reform of real estate tax, resource tax, and environmental protection tax should be promoted so that these taxes could function as supplementary taxes. The second method is to integrate and optimize current taxes. The current tax for maintaining and building cities, contract tax, tax on the occupancy of cultivated land, and real estate tax could be integrated into the real estate tax to improve the property tax system. The resource tax rate should be increased and the levying scope of resource tax should be expanded so as to improve the resource tax system and increase the utilization rate of resources. The third method is to introduce new taxes. By speeding up the pace of tax-for-fees reform, new categories of tax, such as real estate tax, inheritance tax, gift tax, and social security taxes could be levied to cultivate supplementary local taxes.

**The third suggestion is to establish a standardized and predictable transfer payment system by introducing block transfer payments and prioritized transfer payments as a basis for a stable growth mechanism for general transfer payments.** To maximize the equalization effect of general transfer payments, our suggestions include: improving the internal structure of general transfer payments; highlighting key objective factors like population density and natural endowments, as well as factors related to social stability and national unity in ethnic minority areas, border areas, and old revolutionary base areas to make the general transfer payment equalization formula more reasonable; incorporating factors related to agriculture, rural areas, and farmers, agricultural population urbanization, and aid for major regions into the transfer payment equalization formula; establishing a growth mechanism for general transfer payments based on objective formula-based calculations and estimation. Regarding general transfer payments, apart from equilibrium transfer payments, original system subsidies, and transfer payments in ethnic minority areas, most transfer payments have specific purposes, which is the main feature of special transfer payments. Thus, suggestions for reform of the special transfer payment system include: eliminating some special funds; merging some special funds; and introducing block transfer payments so that transfer payments can be flexible and in conformity with policies. Local government transfer payment revenues can be made more transparent and stable by establishing a more standardized and predictable transfer payment system.

**The fourth suggestion is to promote PPP legislation, encourage participation of social capital, and maximize the multiplier effect of public expenditure.** Though developing rapidly, the PPP model is still not widely recognized due to the uncertainty of cooperation with governments. Therefore, relevant laws or policies need to be established in the PRC. By protecting the interests of social capital with legislative guarantees and encouraging social capital to participate in infrastructure construction, the multiplier effect of public expenditure could be magnified.

**The final suggestion is to improve the mid-term budget and debt-annexed budget and establish a government planning mechanism for investment and debt financing of major infrastructure construction.** The local government planning mechanism for investment and financing of major infrastructure construction is an important factor of local fiscal sustainability. Therefore, regarding project initiation, the project library for major infrastructure construction should be improved. A mid-term budget system for major projects should be established and the mid-term budget and feasibility report should be examined by the Standing Committee of the National People's Congress before implementation. Regarding project financing, it is recommended that the local government debt management system be standardized, a debt-annexed budget and a dynamic risk detection mechanism set up, and a debt risk mechanism to control and dissolve risks of local governments established. Regarding project implementation, it is suggested that the diversified supervision system for major investment projects should be strengthened. All the above measures contribute to guaranteeing the financial stability and sustainability of major infrastructure construction of local governments.

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