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**Article**

## The fiscal system of China under the New Normal: Trends and changes

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# The fiscal system of China under the New Normal: trends and changes

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## Abstract

**Purpose** – More and more statistics have repeatedly shown that as the economic development has entered the New Normal, the Chinese fiscal system has experienced tremendous changes. Although chance cannot be ruled out, much of those changes indicate trends, and they can even be said to be the result of the law of economic development. These trends and changes have repeatedly demonstrated that, as a reflection and an inevitable result of the economic developing speed shift, structural adjustment and energy conversion, the Chinese fiscal system, far from the conventional operating state, has progressed on a new path. The paper aims to discuss this issue.

**Design/methodology/approach** – This paper systematically analyzes several new trends and changes in the Chinese fiscal system under the New Normal. First, revenue growth has experienced a sharp downward trend, while the tax elasticity coefficient has declined rapidly. Second, fiscal expenditure has risen against the tendency, while the rigidity of expenditure has kept on increasing.

**Findings** – Considering the present fiscal and taxation system reform with the analysis above, it can be seen that if the reform's progress for the past two years is slower than expected – thus, preventing the effects of all aspects from a timely achievement – then, in the recent period, the agreement on the fiscal and taxation system reform will be reached and challenges entirely different from the past, including sharp slowdown in revenue growth rate, fiscal expenditure rising against trend and increases in fiscal deficit and government debts will be faced. The factors encouraging the reform are gathering gradually. The growth of the strength to push the reform forward is speeding up. And the pace of the reform in relevant areas is quickening.

**Originality/value** – In the face of those trends and changes, on the one hand, the authors should deeply understand and accurately grasp them through a comprehensive summary and systematic analysis. On the other hand, a series of conventional ideas, thoughts and strategies should be adjusted comprehensively and duly. Taking a train of new ideas, thoughts and strategies, the authors ought to actively adapt to and initiate a new Chinese fiscal structure under the New Normal of China's economy.

**Keywords** Economic New Normal, New trends and changes, Revenue and expenditure, Fiscal policy, Reform of fiscal and taxation systems

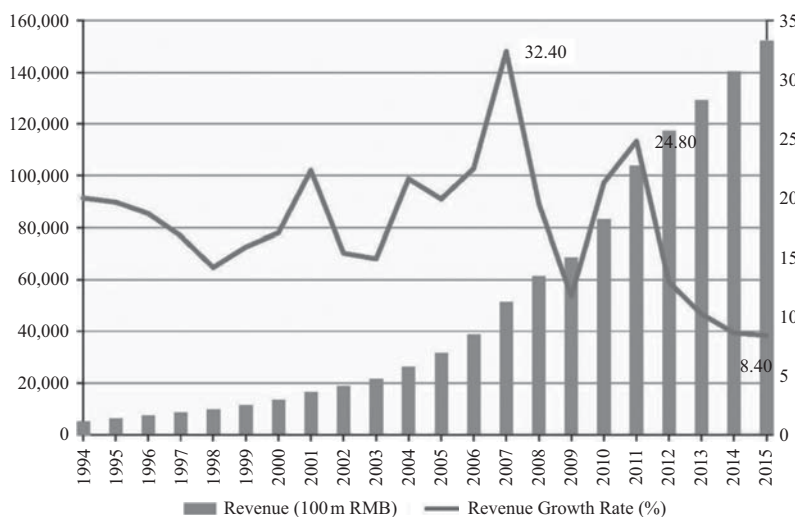
**Paper type** Research paper

## Change (trend) 1: revenue growth experiences a sharp downward trend, while tax elasticity declines rapidly

The basic theory of economics tells us that there is a substantial correspondence between economic growth and revenue (Romer and Romer, 2007). In addition, judging from the development of other related countries, it can be seen that economic growth will lead to a greater revenue increase and that an economic downturn will bring about a sharper revenue decline (IMF, 2015). Over the past few years, it is this kind of trajectory that China's revenue has followed.

Figure 1 shows that with the continuing economic slowdown, the growth rate of China's general public budget revenue went with a sharp download trend after the 24.8 percent in 2011, aside from the peak of 32.4 percent in 2007. It was 12.9 percent in 2012,





**Sources:** National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press. Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

**Figure 1.**  
Revenue growth rate  
trend (1994–2015)

10.2 percent in 2013, 8.6 percent in 2014 and 8.4 percent in 2015. In other words, the growth rate has dropped sharply from 24.8 to 8.4 percent in just four years. Not only did China move directly from a double-digit era to a single-digit one, but also the growth rate in 2015 was only a third of the rate four years ago. The downward trend is so shockingly sharp.

Looking further, 8.4 percent growth in 2015 was only nominal. From the nominal growth rate to the actual rate, at least two subtractions must be made: first, the 11 government-managed fund incomes transferred from the government-managed fund budget should be deducted, with the actual rate at 5.8 percent, calculated with a comparable caliber. This figure is less than one-quarter of what it was four years ago and is also 1.5 percent lower than the budget increase. That is the second consecutive year that the budget revenue has not been achieved. Second, after deducting the revenue brought by specific special revenue-increasing measures based on the consideration of balancing the budget, such as increasing the profit margin turned over by certain state-owned enterprises and institutions, the growth rate of 5.8 percent will also have to be reduced appropriately. Therefore, it can be said that the decline in the revenue growth rate so far is sharp and sudden.

A more serious problem is that the slowdown is just the beginning, without any sign of bottoming out. Looking to 2016 and the coming years, the following factors' changes are worthy of particular attention.

First, the economy determines the fiscal system. With the continuing downturn of the global economy, China has gradually promoted the supply-side structural reform by cutting overcapacity, reducing excess inventory, deleveraging, lowering costs and strengthening areas of weakness, but the pressure of the economic slowdown keeps on increasing. If there are no unconventionally special revenue-increasing measures, the further decline in revenue growth is a foregone conclusion.

Second, as the primary source of China's revenue, the taxation revenue under the existing taxation system mainly comes from indirect taxes, such as value-added tax (VAT),

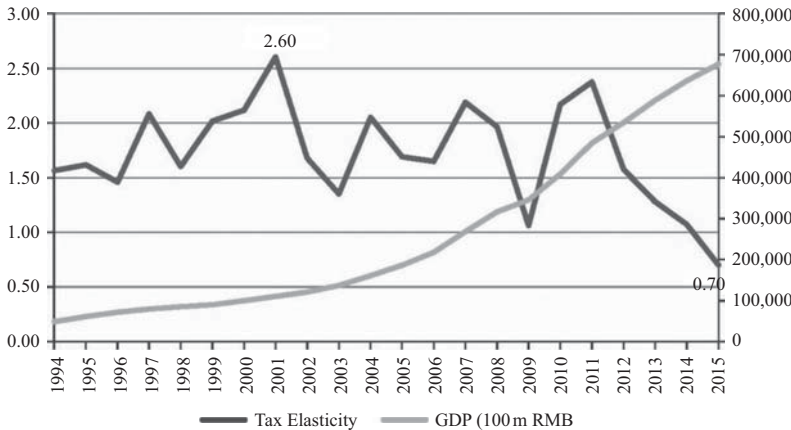
consumption tax and business tax. Such a taxation revenue pattern of “indirect taxes being predominate” means that, with the economic slowdown and the PPI’s continuing decline even becoming negative, revenue growth slows down at a pace faster than the deceleration rate of GDP, which can be expected.

The reason for such analysis is that a large number of studies have confirmed that among the factors affecting China’s taxation revenue, economic fluctuation and price fluctuation are two main ones (Gao, 2006; Lv and Li, 2007; Li’an *et al.*, 2012). In 2015, the growth rate of taxation revenue was 4.8 percent, and it was the first time since 1994 that it had fallen below the GDP growth rate (6.9 percent). Moreover, throughout 2015, the monthly growth rate of the taxation revenue did not exceed 5 percent, and it was even less than 3 percent in the first half of the year. Each of them was lower than the GDP growth rate of the same period. Hereto, a more reliable explanation is that the taxation system structure with indirect taxes as its main body and industrial-added value as tax basis is highly correlated with price. Affected by the long-term downward trend in price indexes such as PPI, the revenue growth momentum has been significantly reduced.

Third, in recent years, accompanied by a pressure increase in downward economic trend, China’s tax elasticity coefficient has a rapid decline. The ratio of tax revenue growth rate to GDP growth rate is named as the tax elasticity coefficient. That is an essential standard for measuring taxation revenue-increasing ability (Craig and Heins, 1979). In the past years, as shown in Figure 2, China’s taxation revenue is elastic (with a tax elasticity coefficient of more than 1).

From 1994 to 2015, the average tax elasticity coefficient was 1.72, even higher than 2 in eight years of the period. For example, in 2011, it was 2.38. However, after that it began to decline. It was 1.57 in 2012, reduced by 0.81 in one year. It was 1.28 in 2013 and 1.07 in 2014. In 2015, it fell below 1, the critical point, and further decreased to 0.7. From being very elastic to lacking elasticity, this change took only five years.

Fourth, while the growth rate of tax revenue declines, mainly affected by the above factors, the contribution of non-taxation revenue growth to the overall revenue growth rate is increasing (Table I). From March 2014 to now, the monthly average growth rate of



**Figure 2.**  
The trends of tax  
elasticity coefficient  
and GDP (1994–2015)

**Sources:** National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press. Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and the Central and Local Draft Budgets for 2016, *People’s Daily*, March 18, 2016. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

Table I.

The trends in changes  
of taxation revenue  
and non-taxation  
revenue (2007–2015)

	Proportion of non-taxation revenue to general public budget revenue (%)	Proportion of taxation revenue to general public budget revenue (%)
2007	11	89
2008	12	88
2009	13	87
2010	12	88
2011	14	86
2012	14	86
2013	14	86
2014	15	85
2015	18	82

**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

non-taxation revenue was as high as 23.61 percent, and all monthly growth rates are not less than 10 percent. The average monthly growth rate of tax revenue during the same period was only 5.58 percent. In 2015, non-taxation revenue was 2,732.5bn RMB, representing an increase of 28.9 percent and an increase of 10.6 percent with the same caliber. However, since the non-taxation revenue, whose increase in contribution can fill the vacancy caused by the reduction of tax revenue, is much smaller than taxation revenue, in any case, the decline of the overall revenue cannot be reversed.

Fifth, in the overall decline of the revenue growth rate, the declines in different regions are different, so are the declines in central and local governments. Some resource- and energy-dependent provinces, such as the Jilin, Heilongjiang, Liaoning and Shanxi, are faced with a revenue growth decline and a negative growth. As the central government's dependence on indirect taxation revenue is higher than that of local governments, the growth rate decline in revenue of the central government is much sharper. The imbalance between different regions and between the central and local governments can be said to aggravate the revenue whose growth rate has been declining.

Sixth, based on the need for maintaining stable growth and promoting supply-side structural reform, tax cuts have taken the place of traditional expenditure increase to become the first choice in the list of tools that can be selected for proactive fiscal policy. Whether this is the full implementation of large-scale tax cuts, represented by the comprehensive replacement of business tax with VAT, or the tax cuts for small and micro businesses, the revenue growth rate will have a further and sharper decline. This will continue as long as the direct tax reform featuring mainly individual income tax and real estate tax with a tendency of tax increase is not implemented synchronously, or the intensity of tax increase is less than that of tax cuts, making the increase unable to offset the cut, further deteriorating the decline in the growth rate of government revenue.

Under the interaction of the factors above, compared with 2015, the revenue growth rate may be further reduced after being calculated with a comparable caliber, if there are no other special revenue-increasing measures or necessary reform actions to hedge against it.

## Change (trend) 2: fiscal expenditure rises, while the rigidity of expenditure strengthens

Meanwhile, the fiscal expenditure rises against the tendency. In general, expenditures in all areas have not gone beyond the general trajectory of declining correspondingly with the decrease of disposable financial resources (Romer and Romer, 2008). As the economy slows down, there is a significant demand for expenditure growth in maintaining steady growth,

adjusting the structure, promoting the reform, improving people's lives and guarding against risks. In addition, with the effect of inertia, there is a marked tendency toward the increase in the cost of social security including pension and medical care, and the stress of medium-term and long-term expenditures is also high.

In 2015, even though the GDP growth rate fell to 6.9 percent, the growth rate of the national general public budget expenditure still reached 15.8 percent. The difference is as much as 8.9 percent. If the revenue growth rate is compared with the expenditure growth rate within a longer term, it can be found that during the 50 months, from February 2012 to April 2016, only three scattered months showed expenditure growth rates lower than their own revenue growth rates. For each month of the rest, its expenditure growth was larger than its revenue growth.

A more serious problem is that, looking forward to 2016 and the coming years, the pressure of the various expenditures as mentioned above will undoubtedly increase and tend to build up further.

First, when the economy slows down, China's fiscal expenditure boasts a tradition of counter-cyclical regulation that the government will provide financial aid in the end. In 1998 and 2008, the two rounds of proactive fiscal policy all achieved economic stabilization through expenditure expansion (Gao, 2010). In the context of the general plan of building a moderately prosperous society in all respects, namely, doubling the size of the 2010 GDP and per capita income of urban and rural residents by 2020, proposed at the Fifth Plenary Session of the 18th Central Committee of the Communist Party of China, fiscal policies, as a regulatory tool of the government's first level, will continue to play a vital role in reaching the economic growth rate's annual average target of no less than 6.5 percent. It can be expected that at least during the 13th Five-Year Plan period, China's fiscal policy will remain expansive.

Against that background, the increase in the fiscal deficit is inevitable, and it is unavoidable that the proportion of fiscal deficit to GDP increases gradually year by year. In 2015, the growth rate of fiscal expenditure was 6.27 percent higher than that of revenue, and the expenditure was 2,355.1bn RMB higher than the revenue. The actual deficit-to-GDP ratio reached 3.48 percent. In 2016, China's budget deficit-to-GDP ratio was projected at 3 percent, and the budget deficit was planned at 2.18 trillion RMB, representing a year-on-year increase of 560bn RMB. However, if other aspects, which were not included in the deficit nominally and have almost the same influence as the actual deficit, are taken into consideration to make a calculation based on international caliber, China's deficit-to-GDP ratio will be more than 3 percent.

Second, even if no strong stimulus measures are taken, the promotion of supply-side structural reform still needs the corresponding increase in fiscal expenditure as a precondition. Under the goal of stabilizing the macroeconomic policy and environment, whether it is cutting overcapacity, reducing excess inventory, deleveraging, lowering costs or strengthening areas of weakness, an increase in fiscal expenditure is almost integral.

Third, if smoothing economic fluctuations and alleviating economic downturns are reasons for short-term expenditure growth under the counter-cyclical fiscal adjustment, then the structural change in economic and social development is the direct reason for the long-term rigid growth in fiscal expenditure. Many countries' rigid growth of fiscal expenditure was encouraged greatly by their own population structure change, long-term economic transformation and international status change (Xiahui, 2013). At present, China is experiencing a similar economic and social development. In 2010, the working-age population in China began to decline from its peak, and the demographic dividend officially disappeared (Cai, 2010). In 2014, China became the second largest economy in the world, its international responsibility increasing correspondingly (Xi, 2015). In 2015, China's structural reform was comprehensively put into practice, with innovative

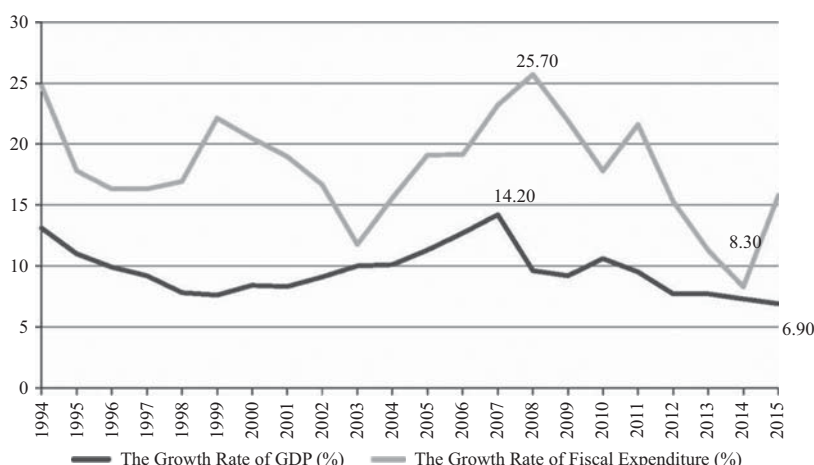
development as its top priority (Li, 2016). Judging from the long-term trend, the growth rate of China's fiscal expenditure has never been lower than that of GDP since 1994 (Figure 3). Even though the growth rate of revenue in 2015 is lower than that of GDP, the growth rate of fiscal expenditure is still twice the GDP growth rate.

Fourth, the analysis of macroeconomics shows that fiscal expenditure has historically been following a growing trend. Whether it is a period of a high economic growth rate, a low economic growth rate or a medium economic growth rate, the trend has always been followed. That has been written as an economic law in textbooks. In other words, regardless of the economic trend in 2016 and the coming years, no matter the revenue, the rigid growth momentum of fiscal expenditure will not only show no change, but may be strengthened.

### Change (trend) 3: the government budget changes from “surplus” to “short of revenue” and the non-general public budget plays a more important role in the full budget

In the past years, one of the daily tasks confronting China's budget management was how to allocate and use “surplus” revenue from budget implementation. Due to the large scale and regularity of “surplus,” not only does the decision to allocate and use “surplus” gain much attention, but also problems associated with this process, including the decision-making mechanism and its economic and social impact, have always been controversies.

However, in the gradual slowdown of revenue growth, the fiscal “surplus,” which existed for many consecutive years, has changed to “short on revenue” since 2015. Calculated according to the same caliber, the general public budget revenue's growth rate target of that year was 7.3 percent and the actual growth rate was 5.8 percent, which means a difference of 1.5 percent. The result of deducting the actual revenue growth from the budget revenue growth is the revenue shortage of 208.3bn RMB, accounting for 1.37 percent of the general public budget revenue of that year.



**Sources:** National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press. Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

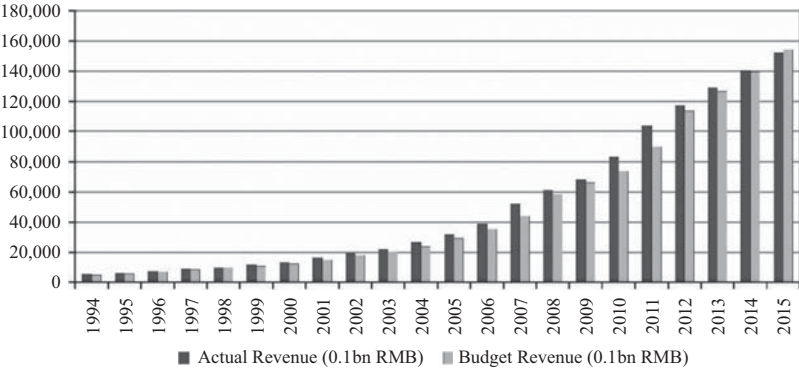
**Figure 3.**  
The comparison of the  
growth rate trends  
of GDP and  
fiscal expenditure  
(1994–2015)

In fact, if the impact of some particular revenue-stimulating factors had been removed, the turning point from “surplus” to “shortage” could be as early as 2014. As mentioned above, the revenue growth rate of 8.6 percent in that year was realized in the context of adopting a series of special measures including some financial institutions’ increase in profits that are turned over to China’s government. If the government exerts no special measure to proactively deal with the revenue growth slowdown, it is very likely that it cannot reach the national revenue growth rate’s budget target of 8 percent in 2014. In that case, “shortage” will be on the horizon one year earlier.

It can be seen from Figure 4 that although the turning point from “surplus” to “shortage” occurred in 2015, this change was not made in one step. Before that, along with the economic slowdown trend’s gradual formation and increasing prominence, the fiscal “surplus” has stepped out of the reduction trajectory for several years. In 2013, the national “surplus” was 257.9bn RMB and in 2014, 84bn RMB. Compared with the past, the proportion and scale of “surplus” have been continuously reduced.

A more serious problem is that the “surplus” is reduced and eventually turned to “shortage.” Whether for the central or local government, “shortage” of revenue is not temporary. It is very likely to be regular, or even worse. Figure 5 shows that judging from the central and local general public budgets, the proportions of “surplus” to central and local revenues have changed dramatically. Before 2013, the two curves showing the proportions of “surplus” in the central revenue and to the local revenue were all basically above the zero line. However, it has been below the line in the past two years. In 2015, after removing the comparison of the same caliber and certain special revenue-increasing factors, the central revenue fell by 0.5 percent, and the local revenue growth was 2.5 percent lower than the budget growth, some resource- and energy-dependent provinces’ revenue were growing negatively.

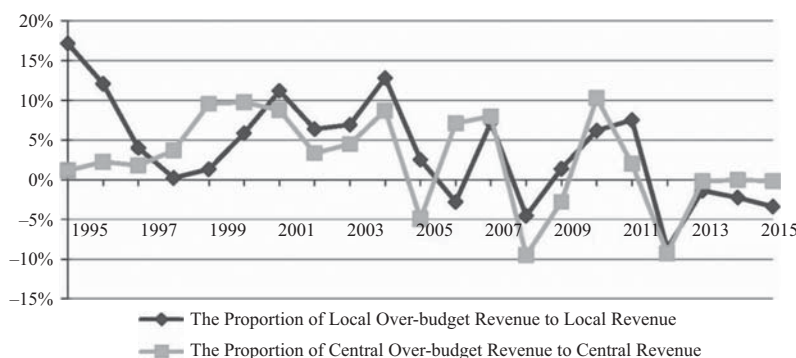
From how to allocate and mobilize “surplus” to how to deal with and make up for “shortage” deficit, it is a very significant change for China’s budget management. That means that, in the context of economic development entering the New Normal, the actual revenue is likely to go beyond the range of budget revenue. That may even be of a strong possibility in most years. Therefore, how to make up for the “shortage” deficit will increasingly become the top challenge in China’s budget management.



**Figure 4.**  
The comparison of  
national actual  
revenue and  
budget revenue  
from 1994 to 2015

**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for the Last Year and on the Draft Budgets for the Next Year, submitted by Ministry of Finance to the National People’s Congress of the People’s Republic of China (NPC) from 1994 to 2015 for approval. See [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/)





**Sources:** Ministry of Finance: National Financial Statement (2010–2014); see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/). Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and on the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016

**Figure 5.**  
The proportions of  
central and local over-  
budget revenue to  
their respective  
general Public  
budget revenue

As a result, dramatic changes have emerged. The non-general public budget revenue becomes a new force suddenly rising, a result of profound significance. It has increasingly become an important power controlling the budget management and fiscal balance.

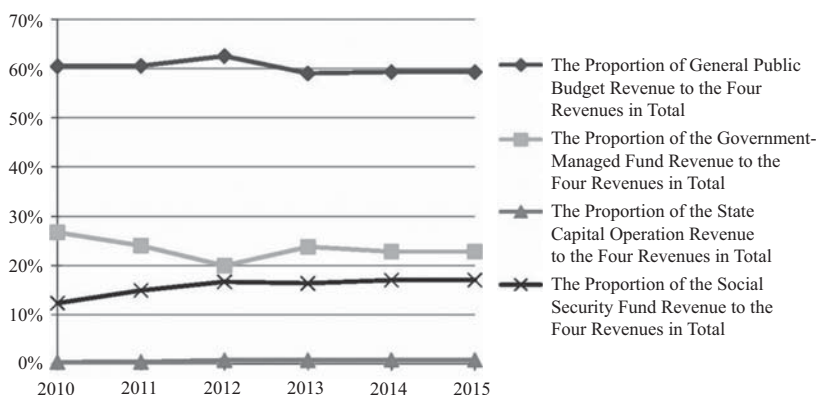
In the past, the budget management that people talk of largely referred to the general public budget, unless there was a particular context and meaning indicated. However, in addition to the general public budget, other budgets can and should be included in China's Government revenue and expenditure, including budgets for government-managed funds, social security funds, and state capital operations. As early as the Third Plenary Session of the 16th Central Committee of the CPC in 2003, "the implementation of full-caliber budget management" was put forward based on such a budget concept and government revenue and expenditure pattern. However, in the following years, it has remained at the planning stage and has not been actually implemented.

However, as the "shortage" of revenue comes into being and the need to compensate for the fiscal gap arises from the "shortage," the new Budget Law was implemented on January 1, 2015, under the banner of comprehensively continuing the reform, which officially expanded the concept of budget into government's full-caliber budget system including four budgets, the general public budget and government-managed funds budget, social security funds budget and state capital operations budget. It is in such context that the significance of non-general public budget revenue for the government's fiscal balance started to become prominent. In 2013, the proportion of general public budget revenue to full-caliber government revenue was 58.95 percent, but before 2013, that proportion was above 60 percent (Figure 6). Correspondingly, non-general public budgets revenues, including budgets for government-managed funds, social security funds and state capital operations, account for a larger and larger proportion of the fuller budget's revenues. As a result, the fiscal balance is increasingly dependent on non-general public budgets revenues. Thus, it is self-evident to pay more attention to the non-general public budget management and to strengthen the balance between general public budgets and non-general public budgets.

#### **Change (trend) 4: the fiscal policy expands cyclically, highlighting the significance of the full-caliber effect assessment**

Our fiscal management has always been done cautiously. The cautiousness is shown in the decisions regarding fiscal policy direction. In the past, an expansionary fiscal policy,

**Figure 6.**  
The proportions of  
four budget revenues  
in the government's  
full-caliber total  
revenue between 2010  
and 2015



**Sources:** Ministry of Finance: National Financial Statement (2010–2014); see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/). Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and on the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016

tight fiscal policy or the extent of expansion or tightness was generally discussed once a year. Even if the new fiscal policy structure was the same as the original one, it must be expressed in the Central Economic Work Meeting held at the end of each year that it is to continue to implement proactive fiscal policy or to continue to implement prudent fiscal policy next year.

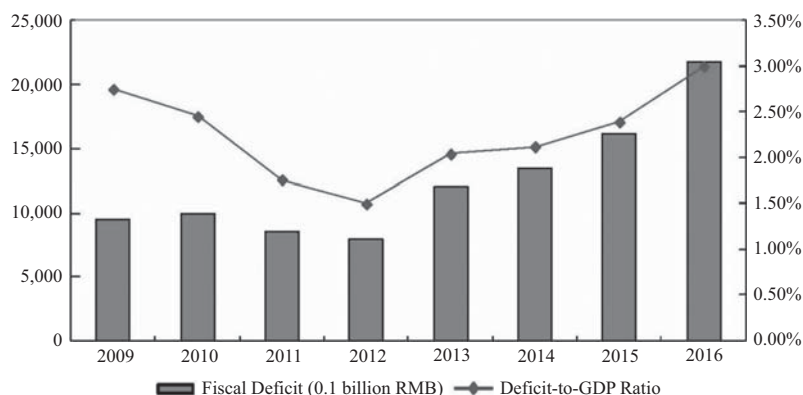
However, as the economic situation undergoes turning point changes, on the one hand, the economy continues to go downwards, and the pressure goes on with a gradual increase. On the other hand, the strategic goal of building a moderately prosperous society in all respects has a fundamental requirement for the GDP growth rate to be kept above 6.5 percent. The promotion of supply-side structural reform has an urgent need for a stable macroeconomic environment. The gathering of these challenges means that in the long cycle of macroeconomic performance, at least during the 13th Five-Year Plan period, China's macroeconomic policies, especially fiscal policy, must maintain expansion. In other words, China's fiscal policies have already entered a trajectory of cyclical expansion, being contrary to the past fiscal policies that were discussed once a year before making a decision.

Furthermore, while the fiscal policies are showing a cyclical expansion, the intensity of fiscal expansion is also gradually increasing. From “continuing to implement proactive fiscal policies” in 2015 to “proactive fiscal policies shall have its strength” in 2015, and then to “proactive fiscal policies must be strengthened” in 2016, the Central Economy Work Meeting's change of the fiscal policies-oriented expressing is an observable mark.

Against that background, there will be a relatively significant increase in both fiscal deficit and government debt. As a result, the deficit-to-GDP ratio (the ratio of fiscal deficit to GDP) and the debt-to-GDP ratio (the ratio of government debt to GDP), as two indicators managing and controlling fiscal economic risks, will also have a marked increase. For example, in 2016, the fiscal deficit of 2.18 trillion RMB was listed in the general public budgets, representing a year-on-year increase of 560bn RMB. The deficit-to-GDP ratio was also increased from 2.3 to 3 percent in the same year. Wherein, the central government had a deficit of 1.4 trillion RMB, and the local government's deficit was 780bn RMB, with a total year-on-year increase of 280bn RMB. The balance of the central government bonds had a limit of 12,590.835bn RMB, and the balance limit of local government general debts was 10,707.24bn RMB. The former is 1.4 trillion RMB more than the limit of 2015, and the latter shows a net increase on the basis of zero.

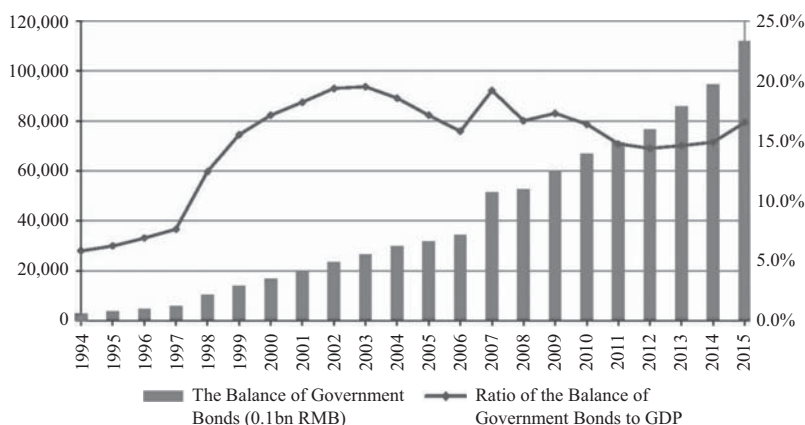
In fact, looking back to 2012, it can also be seen from Figures 7 and 8 that these gradual increases of fiscal deficit and government debts have so far lasted for four years, sharing the same time period with the economic slowdown. Looking forward to the basic prospect of the macroeconomic situation during the 13th Five-Year Plan period, it can certainly be said that this trend will not weaken but possibly further increase.

Similar to the analysis above, the change in the general public budgets, under the implementation of the new Budget Law, naturally affects the non-general public budgets, and then is reflected in the full-caliber government budget including the general public



**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for the Last Year and on the Draft Budgets for the Next Year, submitted by Ministry of Finance to the National People's Congress of the People's Republic of China (NPC) from 2009 to 2016 for approval; see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/). National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press

**Figure 7.**  
Fiscal deficit and its  
ratio to GDP



**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for the Last Year and on the Draft Budgets for the Next Year, submitted by Ministry of Finance to the National People's Congress of the People's Republic of China (NPC) from 1994 to 2016 for approval; see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/). National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press

**Figure 8.**  
The balance of  
government bonds  
and its ratio to GDP

budget and budgets for government-managed funds, social security funds and state capital operations. Therefore, from the perspective of a full-caliber government budget, measuring, managing and controlling economic risks with the full-caliber fiscal deficit and government debts will be a new trend and a new normal, following the cyclical expansion of fiscal policy.

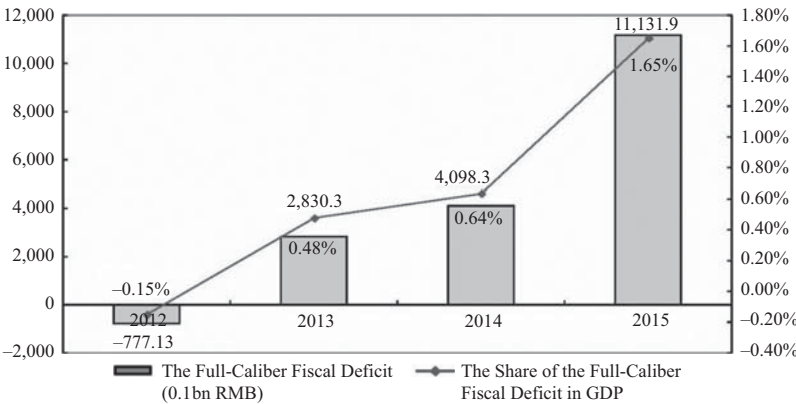
It can be seen from Figure 9 that in 2015, if the general public budget deficit is 1,620bn RMB, its share in GDP is 2.39 percent. If the other three government budgets are added on the basis of that to calculate the full-caliber government budget, then the fiscal deficit will be reduced to 1,113.19bn RMB, accounting for 1.65 percent of GDP.

That is a fundamental change (trend). It reveals that in the context of the fiscal policy cyclical expansion, it is necessary to accurately measure the fiscal deficit and the government debt from the perspective of the full-caliber government budgets instead of general public budgets. It helps us not only to evaluate the expansion extent and the macroeconomic effect of fiscal policy comprehensively and systematically but also to manage and control the fiscal and economic risks related to that.

**Change (trend) 5: the centralized system exhibits a trend of loosening, showing the sign back to the tax distribution system**

Historical experience tells us that the relationship between the central fiscal system and the local fiscal system resembles the financial exchange between two generations within a family. If parents are financially healthy or have sufficient financial resources, with an ability to fulfill the needs of their children by giving them money, then it is natural and regular to directly meddle in or strictly control their children’s financial arrangements. However, once the parents’ financial situation gets worse or their financial resources are inadequate, they no longer have the ability to satisfy the needs of their children as before. As a result, as financial support for their children declines, the intervention and control will be reduced, even if they do not want that.

The relationship between the central fiscal system and the local fiscal system is like that. Since 1994, despite the fact that China has always held the banner of the tax distribution system in the fiscal system, as the central revenue accounts for a larger and larger proportion of national revenue and the central fiscal system gradually increases the transfer payments to local fiscal system, in fact, the primary trend of the relationship between central



**Figure 9.**  
The basic situation  
of the full-caliber  
fiscal deficit between  
2012 and 2015

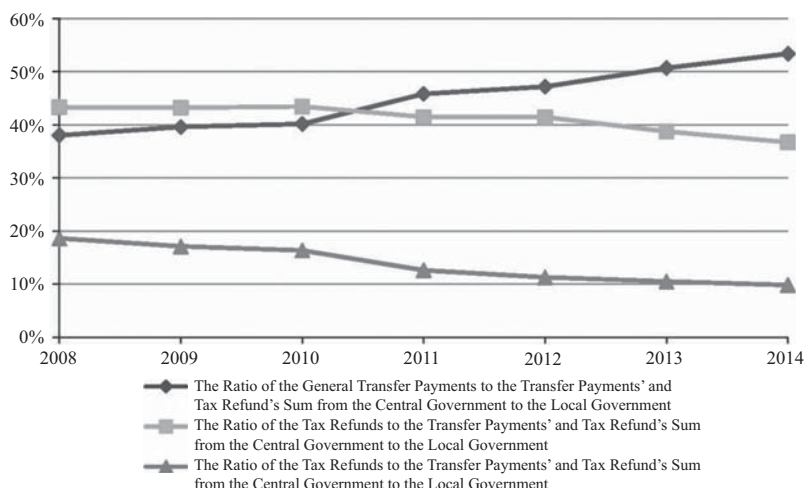
**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and on the Central and Local Draft Budgets for 2016, *People’s Daily*, March 18, 2016. Ministry of Finance: National Financial Statement (2012–2014) [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/)

fiscal system and local fiscal system in over 20 years' tends to centralization rather than devolution. This can be confirmed from many angles. For example, the match of financial power and authority takes the place of the combination of financial power and authority to be the fundamental principle of dealing with fiscal relationship between the central fiscal system and the local fiscal system; On the issue of the tax categories division, some local taxes, even some major local taxes were transferred to shared taxes between the central and local governments. The proportion of the latter is over 80 percent. As for the adjustment of the transfer payment system, the standardization process coexists with the phenomenon of begging ministries for money. In the implementation of hierarchical fiscal management, the management power and balance power of local revenue and expenditure are not covered in the long term. In fact, that local fiscal system is meaningless to some extent. Moreover, there are other similar facts.

However, we have seen that under the revenue slowdown and increasing contradiction between revenue and expenditure, especially the central fiscal system becoming increasingly difficult, the centralization pattern, which has been with China's fiscal system for a long time, has had some sign of loosening, at least since 2015.

For example, transfer payments. Figures 10 and 11 show that the general transfer payments account for a steadily increasing percentage of the transfer payments' and tax refund's sum from the central government to the local government. This percentage reached 53.44 percent in 2014, which is nearly 3 percent higher than that in 2013. They also show that since 2011, the ratio of transfer payments' and tax refund's sum in the central general public budget expenditures has declined gradually and continuously, going away from the former increasing trend. This percentage was 70.74 percent in 2011, 70.11 percent in 2012 and 69.57 percent in 2014. In the three years, it decreased by 1.17 percent.

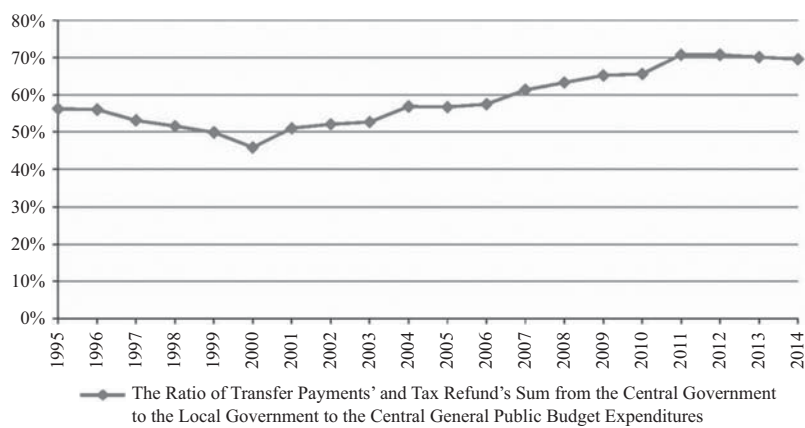
Local debt is another example. After the implementation of the new Budget Law and the issue of The Opinions of the State Council on Strengthening Local Government Debts Management (issued by the State Council (2014) No. 43), Ministry of Finance successively published The Notice on the Print and Distribution of the Interim Measures of Local Governments General Bonds Issuing and Management (C. K. (2015) No. 64) and The Notice on the Print and Distribution of the Interim Measures of Local Governments Special Bonds



**Figure 10.**  
The structural trend  
of transfer payments  
from the central  
government to the  
local government

**Sources:** Ministry of Finance: National Financial Statement (2008-2015);  
see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/)

**Figure 11.**  
The ratio of transfer payments' and tax refund's sum from the central government to the local government to the central general public budget expenditures



**Sources:** Ministry of Finance: *Finance Yearbook of China* (1995–2007), *China State Finance Magazine*. Ministry of Finance: National Financial Statement (2007–2015); see [www.mof.gov.cn/zhengwuxinxi/caizhengshuju/](http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/)

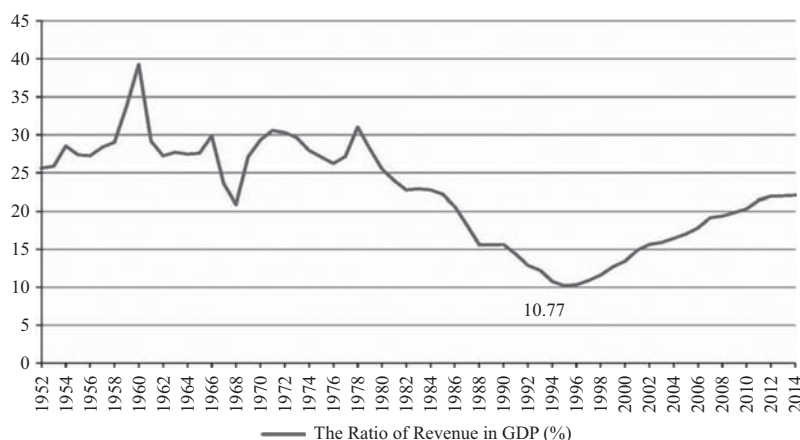
Issuing and Management (C.K. (2015) No. 83). The central fiscal system, taking this as an opportunity, began to loosen local debt control and allowed local governments to manage the issue and repayment of local debts by themselves. The standardization and institutionalization of local government financing through debts officially emerged.

It can be assumed that following this trend, the centralization structure of the fiscal system that has plagued us in the long term will likely be loosened further, and it may even return to the tax distribution system. In that process, many concepts, such as the gradual improvement of the local fiscal system, the mobilization of local government and the real implementation of fiscal system reform under the background of comprehensively deepening the reform, are going to be realized.

**Change (trend) 6: fiscal difficulties force continued reform of fiscal and taxation system, resulting in a new dynamic**

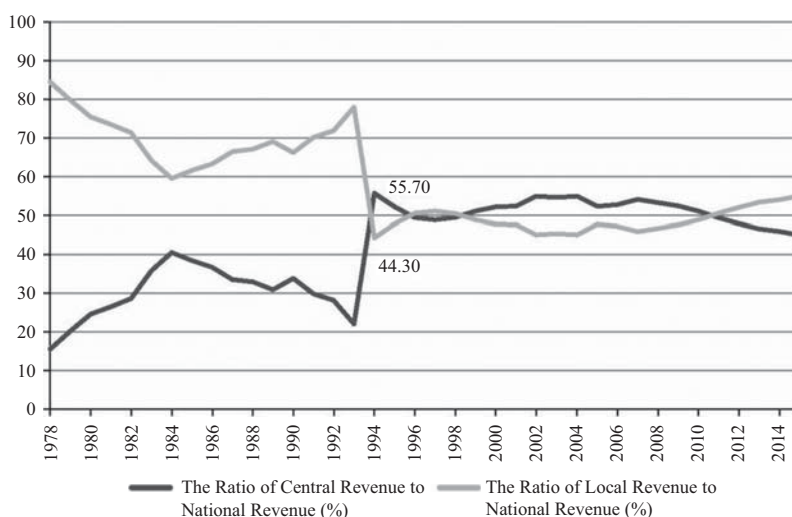
The history of the fiscal and taxation systems' reforms in ancient and modern China, and abroad shows that every significant financial and taxation system reform takes place during difficult financial periods, instead of periods of ample finance. The greater the gap between revenue and expenditure is, the more challenges the fiscal balance will face. The more limits public finances suffer, the more dynamic and vital the reforms will be, and the less obstacles the reforms will face. And it will be easier to launch the proposed fiscal and taxation reforms.

China's fiscal and taxation system reform in 1994 was an excellent example of this. The reason why the reform was able to begin smoothly and comprehensively with an unprecedented scale, in the final analysis, is the extreme difficulty of the finance at that time, making the original system unrealistic. It can be clearly seen that if the annual value of the revenue's ratio in GDP is made to be a curve, it is a deep-V trajectory from 1978 to 2015. The lowest point appeared around 1994. As is shown in Figure 12, the ratio of revenue to GDP was 31.02 percent in 1978 and only 10.77 percent in 1994. During that period, revenue and expenditures at all levels were difficult to move on. In particular, the central government, under the decline of its revenue's ratio to national revenue (Figure 13), even could not implement the most basic budget. It can be said that it is the growing fiscal difficulties that have made fiscal and taxation system reform imminent and eventually led to reform.



**Sources:** National Bureau of Statistics: China Statistical Yearbook 2015, China Statistics Press. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

**Figure 12.**  
The change of  
revenue's proportion  
in GDP before and  
after the fiscal and  
taxation system  
reform in 1994



**Sources:** Ministry of Finance: Report on the Implementation of the Central and Local Budgets for 2015 and on the Central and Local Draft Budgets for 2016, *People's Daily*, March 18, 2016. Ministry of Finance: Finance Yearbook of China (1994–2015), *China State Finance Magazine*

**Figure 13.**  
The changes of local  
and central revenues'  
ratios to the national  
revenue before and  
after the fiscal and  
taxation system  
reform in 1994

Considering the present fiscal and taxation system reform with the analysis above, it can be seen that if the reform's progress for the past two years is slower than expected. Thus, preventing the effects of all aspects from a timely achievement, then in the recent period, the agreement on the fiscal and taxation system reform will be reached and challenges entirely different from the past, including sharp slowdown in revenue growth rate, fiscal expenditure rising against trend and increases in fiscal deficit and government debts will be faced.



The factors encouraging the reform are gathering gradually. The growth of the strength to push the reform forward is speeding up. And the pace of the reform in relevant areas is quickening.

Comprehensively replacing business tax with VAT is an example. As a measure for macroeconomic control policy as well as fiscal and taxation system reform started in 2012, it was officially launched in the whole China in May 2016 after a long-distance running for more than four years and a halt of four months. It serves as an opportunity. With the formation of the transitional plan on revenue distribution between the central and local governments, the overall plan on that and the guidelines on the reform of powers' and spending responsibilities' division between the central and local government seem ready to come out. Furthermore, there is a gradual achievement of the 500bn tax reduction because of replacing business tax with VAT comprehensively. Under the goal of stabilizing tax burdens, it is likely to propel the reform of direct taxes represented by individual income tax and real estate tax.

Another example is the full-caliber government budget management. That is a reform that had been decided as early as 2003. Making any progress was challenging since it has influenced the interests of relevant departments. However, under an enormous pressure on the general public budget performance and the budget revenue that were not reached for two consecutive years, the reform became an unavoidable measure to reduce the fiscal pressure and balance the revenue and expenditure of the general public budgets. A total of 16 budgets for government-managed funds, including local education supplementary tax, the culture construction fee, employment security fund for the disabled, water conservancy construction and education fund counted and drew from the income of local land, the toll revenue of government that is transfer to other parties to repay loans, forestry maintenance funds, forest vegetation restoration fee, water conservancy construction funds, harbor dues on vessels, Yangtze estuary waterway maintenance revenue, compensation fee for water and land conservation, government housing fund, occupation fee for radio frequency, realization revenue of rail asset and the revenue of reserved asset realization of electric power reform, have been shifted into the general public budget successively since 2015. Thus, the process of balancing government-managed fund revenue began.

The new Budget Law is also an example. After more than ten years of amendment, a halt because of severe problems and starting again, it was passed in August 2014 and formally implemented on January 1, 2015.

It is against this background that, in recent times, the financial authorities have continuously released information on fiscal and taxation system reform, "The budget reform has made decisive progress. Taxation reform has been propelled in an orderly manner. The fiscal system reform has been actively promoted. In such periods, it is necessary to take measures to push forward fiscal and taxation system reform" (Ministry of Finance, 2016).

It can be expected that in 2016 and the next few years, China may experience strong momentum toward a new round of fiscal and taxation system reforms that have been long-awaited.

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### Further reading

- Gao, P. (2014a), "From the adaptation of socialist market economy to matching national governance system: discussion on the basic orientation of the new round of fiscal and taxation system reform", *Finance & Trade Economics*, Vol. 35 No. 3, pp. 5-20.
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