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China Economic Update

Special Topic: An Update of China's Fiscal and Tax Reforms

October 2014

The World Bank economic update provides an update on recent economic and social developments and policies in China, and presents findings from ongoing World Bank work on China. The update was led by Karlis Smits (Senior Economist), the main author, with contributions from Chorching Goh (Lead Economist), Bingjie Hu (economist), Ekaterine Vashakmadze (Senior Economist), and Luan Zhao (Financial Analyst). A special topic on Fiscal and Tax Reforms was prepared by Chorching Goh (Lead Economist), Roy Bahl, and Baoyun Qiao. The team gratefully acknowledged the support from the China country team, and guidance of Bert Hofman (Country Director), Sudhir Shetty (Regional Chief Economist), and Mathew Verghis (Practice Manager, Macroeconomics and Fiscal Management Global Practice). A box on social infrastructure gap was prepared by Jingyi Jiang. The team would like to thank Nannan Liu and Wenrui Li for excellent research assistance. Helpful comments are gratefully acknowledged from Nikola Spatafora. The team would also like to thank Tianshu Chen, Li Li, Ying Yu, Xiaoting Li and Lin Yang for support in the production and dissemination of this report. The finding, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the Executive Directors of the World Bank or governments they represent. This report takes into account information available up to October 21, 2014. Questions and feedback can be addressed to Li Li (lli2@worldbank.org).

Macroeconomics and Fiscal Management Global Practice

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Overview

Growth in China continued to slow in 2014, reflecting policy steps to put economic growth on a more sustainable footing. Policy efforts to tighten credit growth, reduce excess capacity, internalize the cost of industrial pollution, and harden budget constraints of local governments accelerated in 2014. While reducing short-term growth, these measures will generate a much needed realignment of growth in the medium term.

Targeted support measures and the recovery of external demand have limited the growth slowdown, but pressures from the weak housing market remain a significant drag on domestic economic activity. The real estate sector, an important engine of growth of recent years, continues to adjust to policies to tighten credit and reduce supply mismatches. At the same time the government has sufficient policy buffers to contain a disorderly adjustment in the housing market. Additional steps to loosen credit constraints for homebuyers could be introduced if needed.

Largely due to weaker-than-expected domestic economic activity this year, the growth forecast for 2014 has been revised downward to 7.4 percent, still meeting the government's indicative growth target of *about* 7.5 percent. For 2015–16 average growth is expected to ease to slightly above 7 percent as policy efforts to place the economy on a more sustainable growth path are likely to intensify. But engineering this gradual slowdown is a key challenge. Especially important will be policies that facilitate the movement of resources from sectors with excess capacity, notably measures to gradually remove state guarantees and allow inefficient firms, including state-owned enterprises, to fail. This will require a careful balancing between enhancing market discipline and avoiding disruptions to the labor market. Over time, the role of administrative credit allocation needs to be gradually replaced with a market-based mechanism.

The government's indicative growth number for 2015 will signal the priority that the authorities put on growth and reforms. The current emphasis on meeting short-term growth targets will make it more challenging to implement the policies necessary to shift growth to a more sustainable medium-term path. Specifically, a focus on meeting an ambitious growth target would require more expansionary macroeconomic policies. In an uncertain global economic environment, China's sizable policy buffers could be reserved to maintain overall macroeconomic stability in case of unexpected domestic or external economic shocks.

China's key medium-term policy challenge remains implementing reforms that support China's next transformation toward more efficient, equitable, and sustainable growth. Progress has been made in 2014. A comprehensive reform plan was introduced to put China's public finances on a more stable footing. Revisions in the budget law provide far greater transparency and accountability for local government debt management. Reform plans were announced to make gradual adjustments to the *hukou* system to integrate migrants into urban life. Land reforms are likely to have the largest growth impact, but they are also the most complex.

Implementing reforms can accelerate China's economic growth potential, but it will not reverse a moderation of growth over the next decade. Without policy action, the slowdown in China's potential growth in the medium term could be more severe.

Section 1
Recent Economic Developments

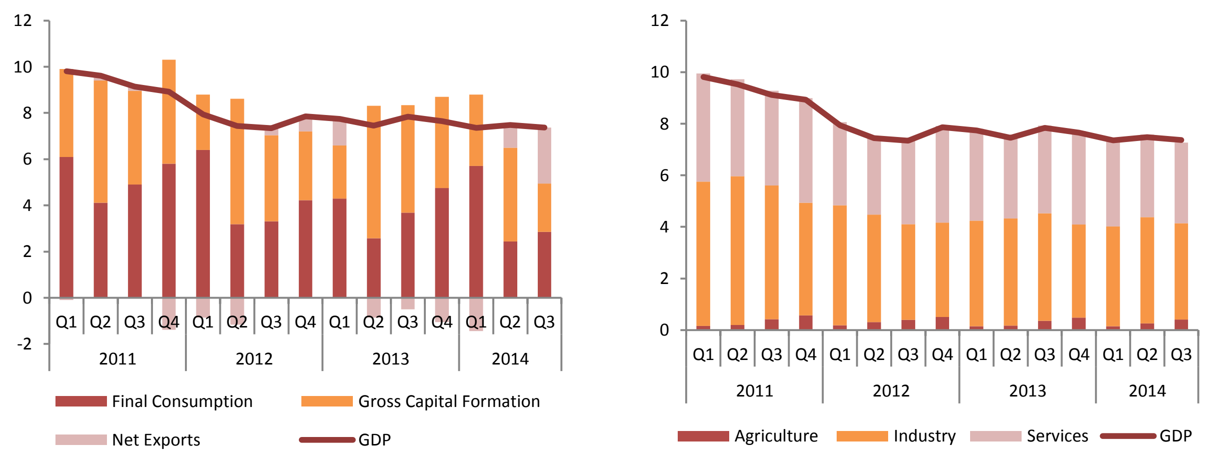
Growth continued to slow reflecting renewed policy efforts to rebalance the economy

Growth in China continued to slow in 2014 reflecting policy steps to make economic growth more sustainable. Policy efforts to tighten credit growth, reduce excess capacity, internalize the cost of industrial pollution, and harden budget constraints of local governments intensified in 2014. While reducing short-term growth, these steps will generate a much needed realignment of growth in the medium term. Targeted support measures and the recovery of external demand have helped stabilize growth along this transition, but pressures from the weak housing market remain a significant drag on growth.

Targeted stimulus measures have limited the growth slowdown and allowed structural adjustments to continue. In the first three quarters economic activity expanded 7.4 percent, within the government's indicative growth target of *about* 7.5 percent for the year. Policy measures and favorable external conditions enabled growth to stabilize in the second quarter, but momentum has again started slipping: growth in the third quarter decelerated to 7.3 percent (year on year) or 1.9 percent (quarter on quarter) from 7.5 percent and 2.0 percent, respectively, in the second quarter. Weaknesses in the real estate market kept gross capital formation softening, which contributed only 2.1 percentage points in the third quarter against 4.1 percentage points in the second (figure 1.1). Net exports rose in line with external demand, but private consumption growth remained weak across a broad range of consumer goods, including durables. Industrial activity slowed, particularly in heavy industry, mining, and power generation, reflecting both measures to reduce overinvestment and energy intensity and the impact of the real estate slowdown.

Figure 1.1 Growth continued to slow

Decomposition of economic growth drivers on the expenditure side, percent (year on year) | Decomposition of economic growth drivers on the production side, percent (year on year)



Note: Industry refers to secondary industry, which covers manufacturing and construction; services refers to tertiary industry.
Source: World Bank staff calculations based on CEIC data.

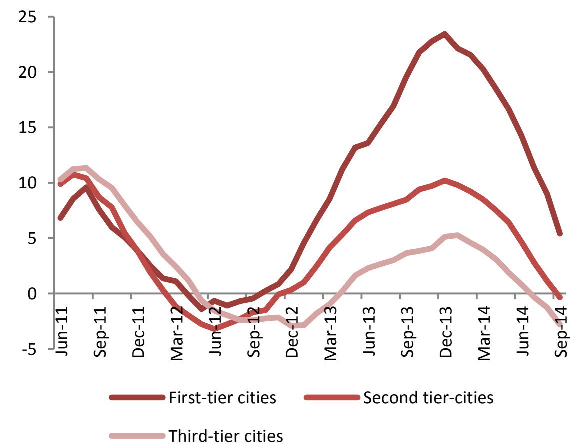
The real estate sector, an important engine of growth of recent years, is undergoing adjustments as policies to tighten credit and reduce supply mismatches continue. Weakness in the property market is broad based—residential, commercial, and office sectors have experienced sharp declines in sales volumes. Residential real estate, the largest and most important part, is particularly weak—79 out of all

100 surveyed cities reported month-on-month price declines in September, with the largest declines in third-tier cities, which generally have the weakest residential housing conditions (figure 1.2). While the adjustment in prices in the first-tier cities[1] appears the largest, on average prices there remain high at about RMB 28,000 per square meter versus only about RMB 10,000 in second-tier[2] and RMB 7,000 in third-tier cities. There are early signs that the inventory-to-sales ratio is stabilizing in recent month, but excess inventory remains high.

Figure 1.2 Real estate market remains weak with high excess inventory and decelerating property prices

Residential (new construction) properties in 10 major cities: inventory-to-sales ratio (area)

Residential housing price index of 100 cities by tier, percent (year on year)

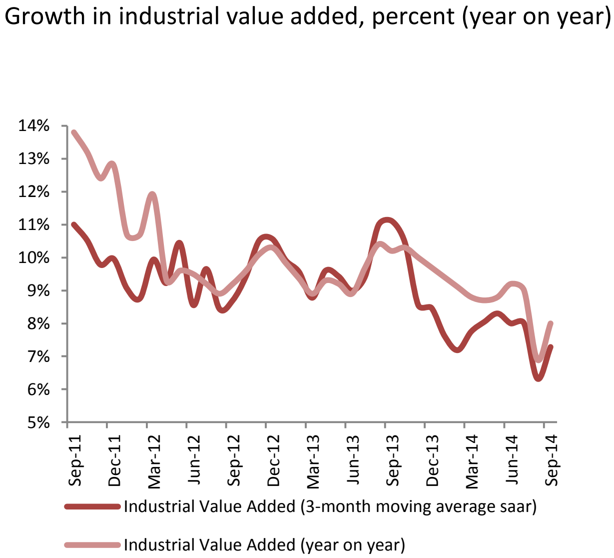


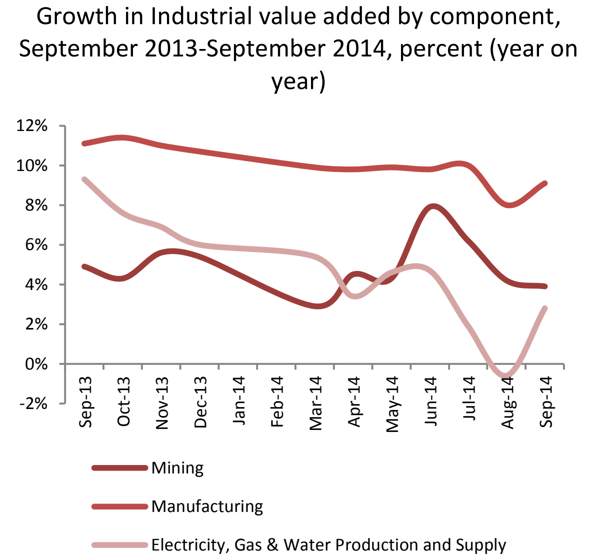
Source: World Bank staff calculations based on Wind Info data and Soufun.

On the supply side, weak domestic demand and policy tightening in sectors with high energy intensity continue to weigh on industrial activity. Industrial production growth maintained its moderation to 8.0 percent (year on year) in the third quarter from 8.9 percent the previous quarter. Export-oriented manufacturing, particularly light manufacturing, remained robust, but growth in value added in mining and in production of energy, electricity, and heat kept decelerating in the third quarter, to 4.8 percent and 1.4 percent (year on year) (figure 1.3). In manufacturing, where value added rose by 9.0 percent in the third quarter, production of rail transport equipment registered the highest gain—14.1 percent (year on year).

[1] Average includes Beijing, Shanghai, Guangzhou and Shenzhen.
[2] Average includes Tianjin, Chongqing, Hangzhou, Nanjing, Wuhan, Shenyang, Chengdu, Xi'an, Dalian, Qingdao, Ningbo, Suzhou, Changsha, Jinan, Xiamen, Changchun, Harbin, Taiyuan, Zhengzhou, Hefei, Nanchang and Fuzhou.

Figure 1.3 Industrial activity remains weak, but recovers from a sharp decline in August





Source: World Bank staff calculations based on CEIC data.

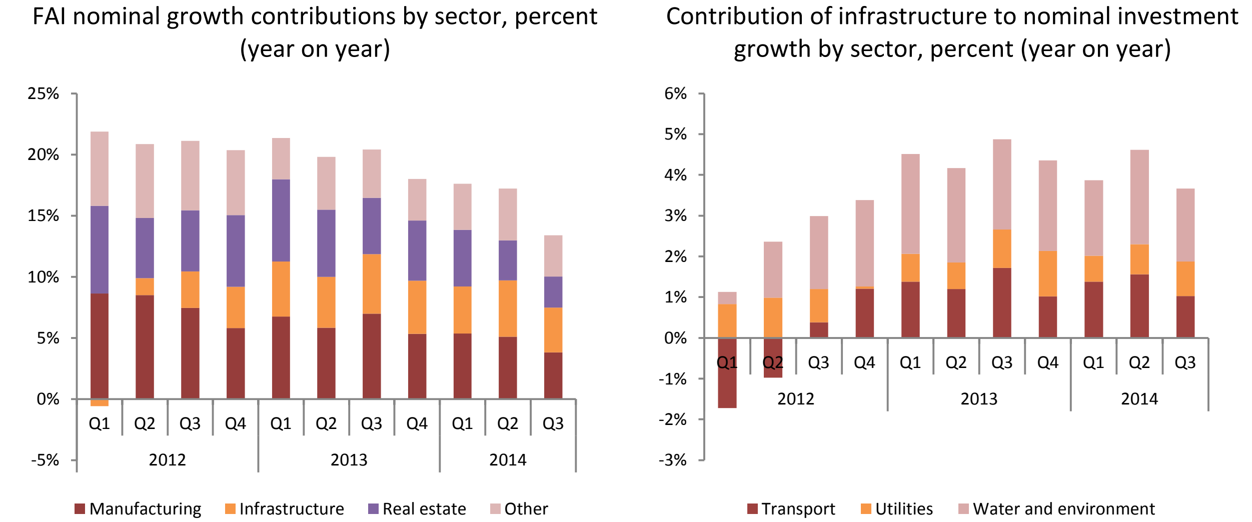
Services remained upbeat as the structure of economic growth continued to evolve from an industrial to a service base. In the first three quarters of 2014 almost half of GDP growth has come from the services sector. Its contribution to growth was 3.6 percentage points of GDP, that of industry 3.3 (of which manufacturing 2.7). Value added growth in transport sector has continued to increase in the first three quarters increasing by 7.0 percent (year on year).

Activity in construction remains robust as new investments in social housing and infrastructure have offset the impact of ongoing adjustments in real estate. Policy steps introduced earlier this year to accelerate shanty town redevelopment and social housing program (including targeted funding from the policy banks) has boosted construction activity. In the first three quarters of this year, value-added growth in construction sector decelerated only modestly to 9.0 percent from 9.2 in the first half of the year; that of real estate decelerated from 2.5 to 2.3. In addition, fairly robust infrastructure construction has provided an additional buffer for the construction industry.

On the demand side, domestic rebalancing from reliance on investment continues. The contribution of gross capital formation to GDP growth decelerated to about 2.1 percentage points in the third quarter, approximately half of that in the previous quarter. China's headline measure of investment, fixed asset investment (FAI)—a broad measure that also includes land sales and purchases of used capital—grew 13.4 percent in the third quarter, down from 17.2 percent in the previous quarter. Investment in manufacturing facilities, which accounted for a third of FAI in the last three years, continues to decelerate gradually in recent quarters (figure 1.4), slowed by overcapacity in the steel, cement, ferrous metals, and plate glass industries. Real estate investment, which accounted for a quarter of FAI in the previous three years[3], grew at its slowest pace since 2009, dragged down by declines in housing prices. Infrastructure investment growth also decelerated to 17.7 percent (year on year) from 24.0 percent the previous quarter (see figure 1.4).

[3] An input-output table for 2010 suggests that the construction industry accounts for about half of all gross capital formation, equivalent to 24 percent of GDP.

Figure 1.4 A decline in real estate investment growth is partly offset by an increase in infrastructure investment growth



Source: World Bank staff calculations based on CEIC data.

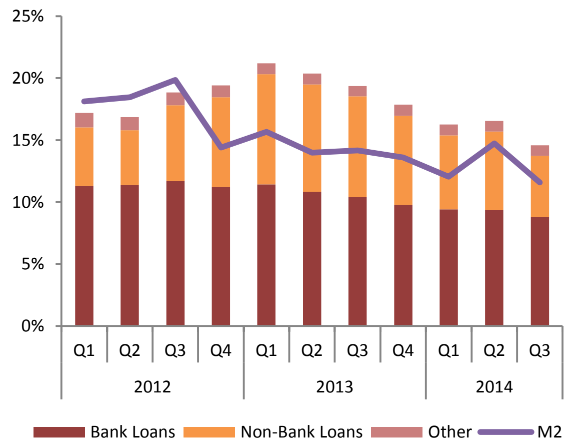
Consumption growth remained weak as adjustments in real estate have undermined consumer confidence. The Westpac-MNI China Consumer Sentiment Index has fallen by 7 percent this year as households become increasingly concerned about future expectations for the economic growth. The contribution of consumption to GDP growth in the second quarter was the lowest in five years (at 2.4 percentage points, or about a third of total growth), and in the third quarter it remained weak at 2.9 percentage points of GDP. Year-on-year real retail sales growth continued to decelerate from 10.8 percent in the first quarter to 10.6 percent in the third quarter. The weakness affected a broad range of consumer goods, including food, garments, footwear, household electric appliances, and durable goods.

The credit impulse continues to fade as administrative regulations rein in credit growth

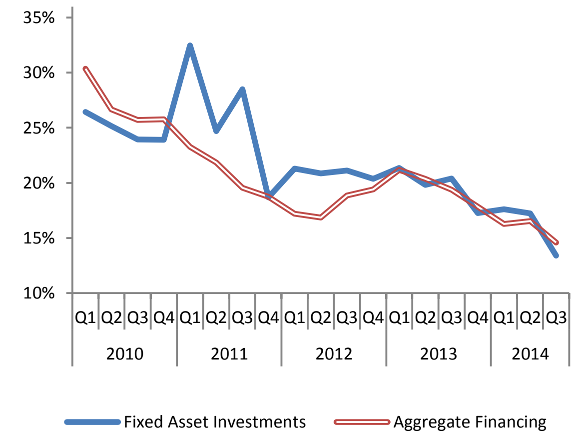
Monetary policy stays accommodative, but the credit impulse is fading. Broad money (M2) growth is decelerating as credit growth moderates, despite targeted measures to ease liquidity conditions for small and medium-size enterprises (SMEs), affordable housing and agriculture (figure 1.5). M2 growth decelerated to 11.6 percent (year on year) in the third quarter, after a temporary hike to 14.7 percent in the second quarter. The growth of aggregate financing (stock)—a broad measure of credit—decelerated from 19.4 percent (year on year) in the third quarter of 2013 to 14.6 percent in the same period this year, driven by moderating growth of credit products linked to China's shadow banking sector, notably trust loans. The authorities have continued to limit off-balance credit. In the third quarter, nonbank credit growth decelerated to 19.9 percent (year on year) from a staggering 37.8 percent in the same quarter of 2013. Nevertheless, the credit stock as a share of GDP continues to increase, but a weakening of the credit impulse remains a drag on investment growth, which continues to decelerate (see figure 1.5).

Figure 1.5 A weakening credit impulse has reduced an excessive reliance on investment growth

Growth of aggregate financing stock and its components, and of M2, percent (year on year)



Growth of FAI and Aggregate Financing stock, percent, (year on year)

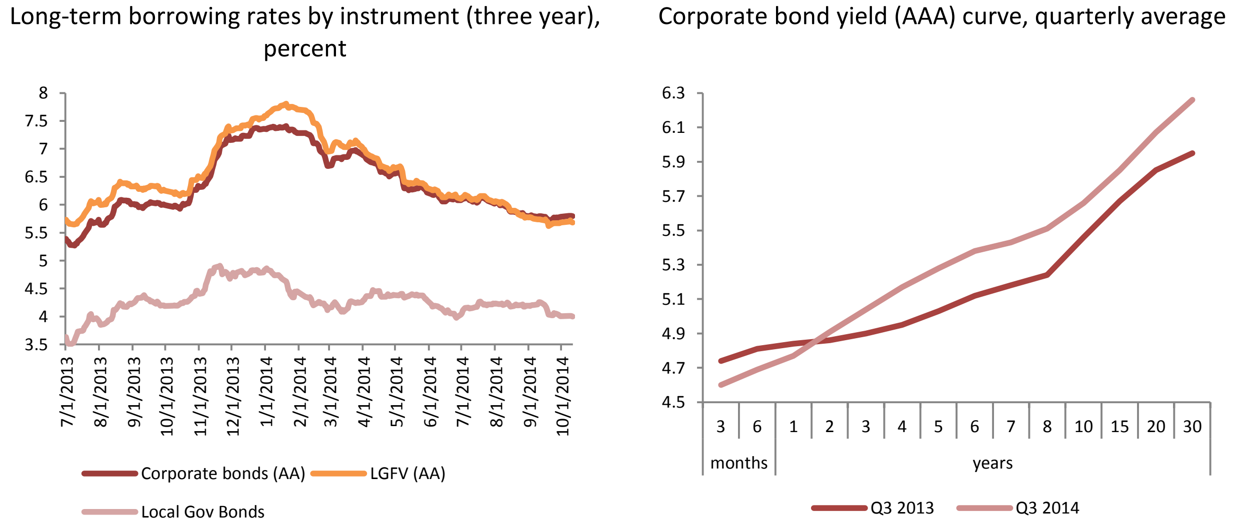


Source: World Bank staff calculations based on CEIC data.

Despite policy efforts to redirect credit, some sectors are still credit constrained. Although the central bank is urging banks to adjust their lending practices and to give more support to SMEs, labor-intensive industries, and first-time mortgage applicants, and to strictly control credit to sectors that suffer from overindebtedness and excess capacity, progress is slow. According to the most recent China Household Finance Survey by Southwest University of Finance and Economics, among the micro and small enterprises that demonstrated effective demands for credit, only 46.2 percent had access to bank loans in 2013. In June the People's Bank of China lowered required reserve requirements by 0.5 percentage points for select commercial banks that have allocated a certain percentage of credit to rural and micro and small enterprises. Moreover, in July the calculation method of the loan-to-deposit ratio for commercial banks was adjusted to promote more support for the economy, specifically credit to rural and small and micro enterprises. Lately, policy steps have also been taken to ease credit constraints for residential mortgage applicants and select real estate developers.

Interbank rates are stable with the central bank providing sufficient liquidity, but medium- and long term market rates are high. The central bank addressed anxieties in the interbank market by injecting liquidity and communicating its policy intentions. In the first three quarters of 2014, the interbank rates (seven-day Shanghai Interbank Offered Rate) averaged about 3.6 percent. However, long-term interest rates have continued to remain high, with yields on three-year corporate bonds (AA) averaging about 5.9 percent in the third quarter (figure 1.6). Moreover, a yield curve of corporate bonds has become steeper, indicating declining short-term interest rates but higher longer term rates in the third quarter of 2014 relative to the previous year (see figure 1.6).

Figure 1.6 Medium and long term market rates remain high



Source: World Bank staff calculations based on Wind Info data.

Despite continuing increases in the monetary base, inflationary pressures remained quiescent, reflecting weak domestic demand conditions. In the first nine months of the year, inflation as measured by the consumer price index decelerated to 2.1 percent from 2.5 percent in the same period of 2013. In September inflation slowed to 1.6 percent, the lowest since January 2010. Similarly, food price inflation in the first nine months declined to 3.3 percent from 4.4 percent in the same period last year. However, nonfood inflation averaged at 1.6 percent (year on year) in the same period in both 2013 and 2014. Producer price index deflation was 1.8 percent (year on year) in September, slightly weaker than the average of 1.6 percent for the first nine months of 2014. This index has been negative for 31 consecutive months, suggesting that the industrial sector continues to face deflationary pressures due to weak demand and excess supply. Most of these pressures stem from heavy industry, which continues to experience the strongest deflationary pressures.

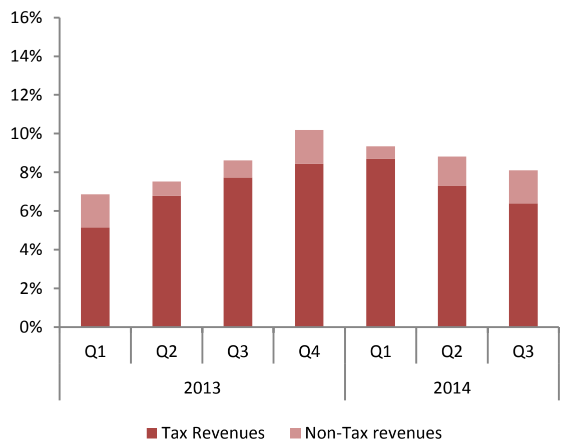
Fiscal policy remains accommodative but the stance tightens as revenue growth moderates

China's overall fiscal position is strong, but a slowdown in real estate translated into slower revenue growth, particularly in the third quarter. In the first three quarters of 2014, total public finance budget revenues increased 8.1 percent (year on year) while in the third quarter the revenue growth weakened to 6.5 percent, against an annual increase of 7.9 percent planned in the budget law. As equivalent expenditures increased 13.2 percent (versus 8.2 percent in the budget law), the annual fiscal deficit stood at 2.4 percent of GDP at the third quarter of 2014, up from 2.1 percent in 2013.

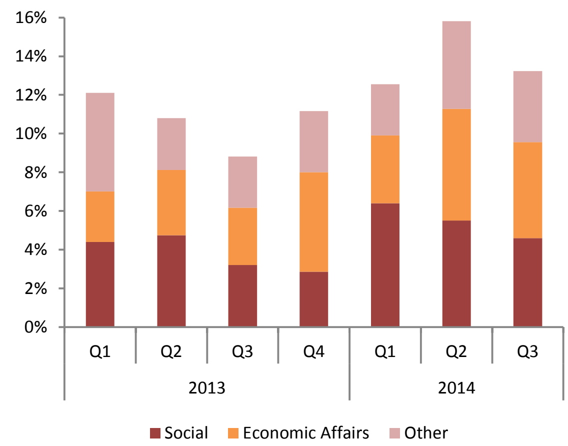
The widening of the public finance budget deficit reflected moderating revenues and robust expenditure growth. Collection of indirect consumption taxes—value-added tax (VAT) and consumption tax—weakened and direct income tax revenues—corporate and personal income taxes—decelerated in the third quarter after a modest pickup in the second. Recently introduced policy initiatives to reduce the tax burden on SMEs have also lowered fiscal revenues. After three straight quarters of expenditure increases (especially on economic affairs), growth moderated in the third quarter (figure 1.7).

Figure 1.7 The public finance budget deficit widens as revenue growth slows and expenditure growth remains steady

Growth of nominal fiscal revenues (central and local governments) by type, percent(year to date, year on year)



Growth of nominal fiscal expenditures by type, percent (year to date, year on year)



Source: World Bank staff calculations based on CEIC data.

A large share of government spending supports capital expenditures in transport, housing, and other economic activities, as gaps in providing core public services remain wide. While the size of government expenditures (public finance budget, government fund budget, and social security budget) remains similar to the Organisation for Economic Co-operation and Development (OECD) average, the composition of expenditures differs substantially (table 1.1). First, spending on general public services is under half the OECD average. It is declining due to continuing efforts to reduce wasteful public outlays: in the first half of 2014 it accounted for only 2.4 percent of GDP, down from 3.0 percent in 2013. Second, despite gradual increases, expenditures on social services (health, education, and social protection) are far lower than in the OECD countries. Third, outlays on economic affairs, housing, and community amenities are about three times as high as the OECD average.

Table 1.1 Government expenditures (budget outlays) by function, percentage of GDP

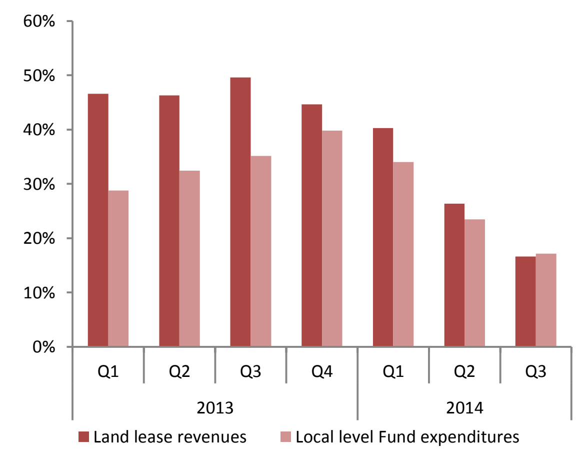
	Total	Total without social protection	General public services	Economic affairs, housing, and community amenities	Health	Education	Social protection
2010	33.9	27.9	2.9	17.0	1.2	3.1	6.0
2011	34.7	28.6	2.9	17.3	1.4	3.5	6.2
2012	35.2	28.3	3.0	16.2	1.4	4.1	6.9
2013	37.8	30.4	3.0	18.3	1.5	3.9	7.5
2014 H1	39.4	30.7	2.4	18.5	1.8	3.7	8.7
OECD average, 2011	45.8	29.6	6.3	5.5	6.7	5.7	16.3

Memorandum: Economic affairs, housing, and community amenities includes government funds budget expenditures; Social Protection includes expenditures of Social Security Funds.
Source: World Bank staff estimates based on CEIC data. OECD data (OECD 2013).

The weaknesses in the property sector have sharply constrained local governments' fiscal space as revenues from land lease transactions slow. Land lease revenues are the main source of local governments' budget revenues—and the main vehicle for financing capital spending. Of the 40 largest cities, third-tier cities have seen the largest declines in such revenues, with a fall of about 27 percent (year on year) in the first three quarters of 2014. Kunming saw a staggering 72 percent drop over that period. In first-tier cities the decline averaged a modest 5.7 percent, though Shanghai saw a drop of 36 percent. A review of the 40 largest cities suggests that a decline in land lease revenues tends to be larger in municipalities that are financially weaker with smaller public budget revenues as a share of GDP (figure 1.8).

Figure 1.8 Fiscal revenues from land lease transactions slow sharply

Growth of land lease revenues and Local Governments Fund Budget expenditures, percent (year to date, year on year)



A relationship between growth of land lease revenues and local revenues as a share of GDP

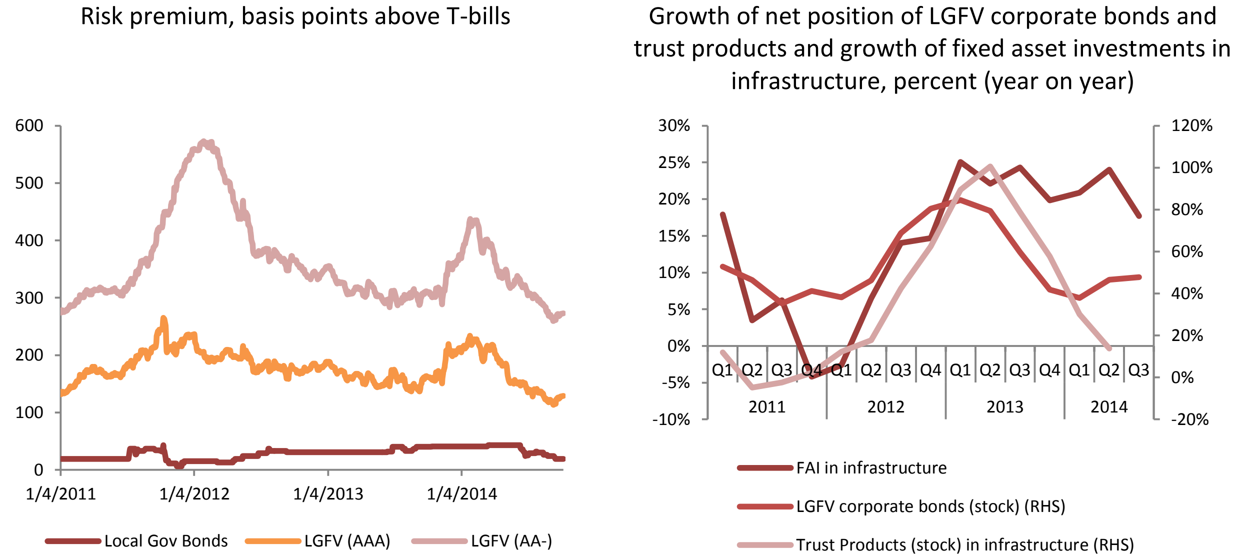
Source: World Bank staff calculations based on CEIC and Wind Info data.

Managing local government debt remains a challenge. Still, the growth of debt among nine provincial and nine city-level governments across China is slowing: according to the National Audit Office, their debt grew 3.8 percent from end-June 2013 to end-March 2014, or 7 percentage points lower than in the first half of 2013. At the same time a significant amount of debt continues to be rolled over. In recent months the risk premium of local government financing vehicle (LGFV) issued corporate bonds has declined (figure 1.9), partly reflecting expectations that public finance reforms will make local government debt on a more stable (see section 2 for discussion on recently approved policy steps).

In May 2014 the Ministry of Finance started a pilot program relaxing rules for 10 local governments to issue their own municipal bonds. The program aims to lower the financing cost of debt, limit the operations of off-budget financing vehicles, and reduce reliance on shadow banking for funding. Beijing, for example, issued RMB 10.5 billion fixed rate municipal bonds at 4.00 percent (5 years), 4.18 percent (7 years) and 4.24 percent (10 years) in August, much less than local government loans secured in the past through financing vehicles. Even so, issuing municipal bonds (directly or by the Ministry of Finance on behalf of municipalities) raised RMB 400 billion in 2014, significantly less than the estimated funding gap of local governments.

Issuance of corporate bonds by LGFVs to fund municipal investments remains high. In the first nine months of 2014, LGFVs issued corporate bonds totaling more than a trillion RMB. But recent growth-supporting measures to increase infrastructure expenditures, especially in the transport sector, have relied on more formal debt instruments, including credit support of China’s policy banks. Subsequently, growth of FAI in infrastructure is no longer strongly correlated with an increase in net debt position of LGFVs (figure 1.9).

Figure 1.9: The risk premium of LGFV issued corporate bonds has declined



Source: World Bank staff calculations based on Wind Info and China Trustee Association data.

Despite decelerating growth, the labor market is strong

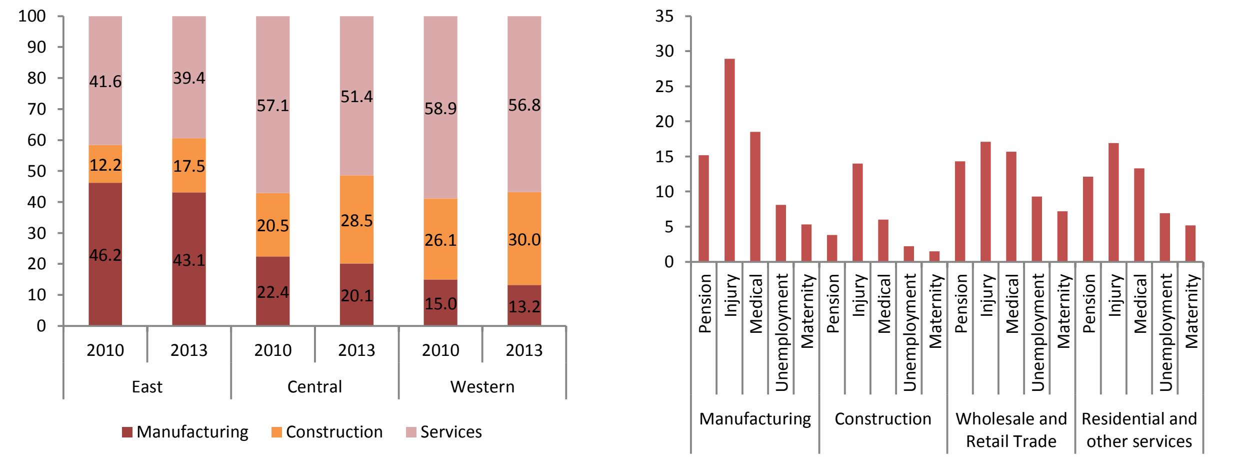
A dynamic labor market is supporting overall growth in jobs and incomes. In the first eight months of 2014, urban employment increased by 9.7 million, on track to exceed this year's government's indicative target of 10 million new urban jobs. Services are absorbing workers as the structural transformation of the economy continues. Also, recently introduced measures to ease company registration procedures by streamlining the administrative procedures have contributed to a more dynamic labor market. Data from the State Administration for Industry and Commerce show that about 2.65 million new companies were registered in the first nine months of 2014, up 52.4 percent from the same period last year. The reported unemployment rate is stable.

Some categories of worker, and some regions, are feeling pressures from decelerating growth. A large share of migrant workers is employed in construction, particularly in central and western provinces where the slowdown is the largest (figure 1.10). At the same time the share of migrant workers employed in services, a sector which is growing robustly, is declining. And lacking formal social safety nets, migrants are of the most vulnerable to change. A recent migrant survey by the National Bureau of Statistics showed that only about 2 percent of migrant workers in construction have formal unemployment insurance.

Figure 1.10 Migrant workers are one of the most vulnerable segment of the labor market

Share of migrants by sectors and regions, percent of total migrant population

Share of migrants covered by formal social safety nets, percent of total migrant population



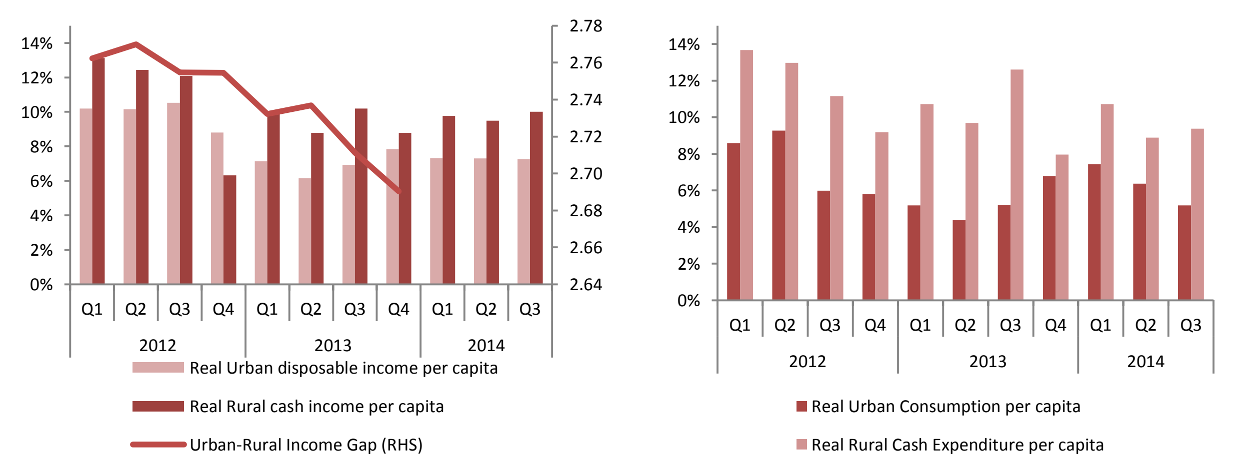
Source: World Bank staff calculations based on Wind Info data.

Moderating economic growth has slowed the growth of urban consumption. Growth of incomes and consumption in rural areas continues to grow faster than in urban areas in recent years, reducing the urban-rural income gap. Urban and rural real disposable income growth continued to remain robust in the second and third quarters (figure 1.11). But urban real consumption growth continued to decelerate in the first three quarters.

Figure 1.11 Urban and rural income growth remains robust, but urban consumption growth moderates

Growth in urban and rural real dispoable incomes, year on year and urban-rural income gap

Growth in urban and rural real consumption per capita, percent (year on year)



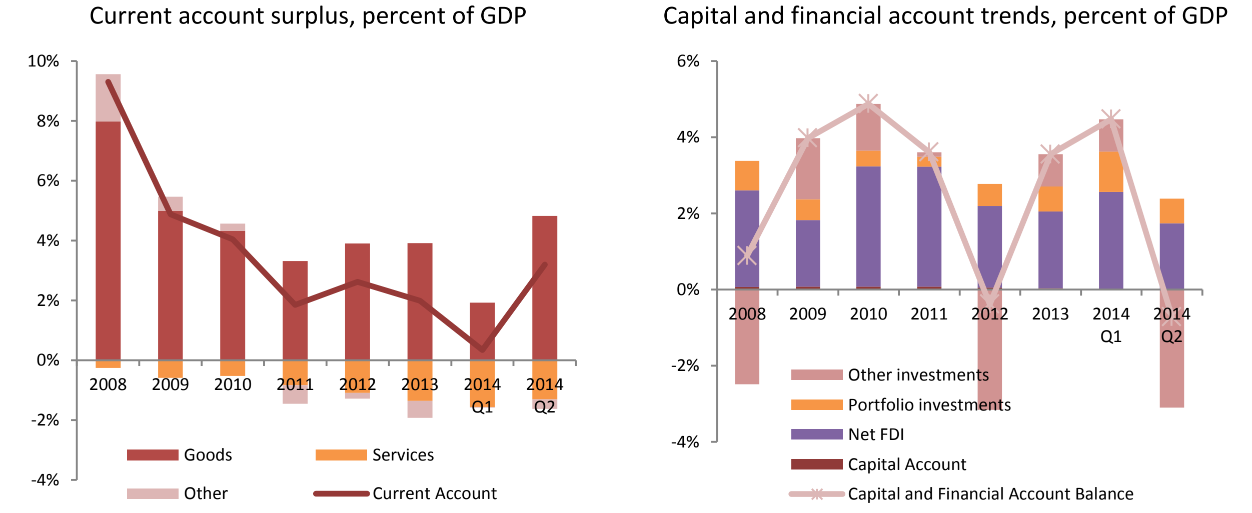
Source: World Bank staff calculations based on CEIC data.

A favorable external environment has provided a buffer

In the second and third quarters the economy benefited from a favorable external environment, as global demand showed signs of recovery. Output growth and import demand in the United States firmed in the second and third quarters. China's merchandise trade surplus rose to USD 128 billion in the third quarter. Exports of goods grew 13.0 percent (year on year) in the quarter, and imports of goods 2.8 percent. But due to weak exports in the first quarter, year-to-date growth in merchandise exports is only 4.9 percent. And while the goods trade balance stayed positive in the second quarter, the services balance deteriorated further to a deficit of 1.3 percent of GDP.

China's external position improved, reflecting buoyant exports and weak imports. The current account surplus jumped 10 times from USD 7.0 billion to USD 72.2 billion between the first and second quarters. For the first half of 2014, the current account surplus amounted to was 0.9 percent of GDP (figure 1.12). Net foreign direct investment came in at USD 40.3 billion in the second quarter, though down on the first quarter's USD 53.7 billion.

Figure 1.12 The current account surplus improved in the first half of 2014

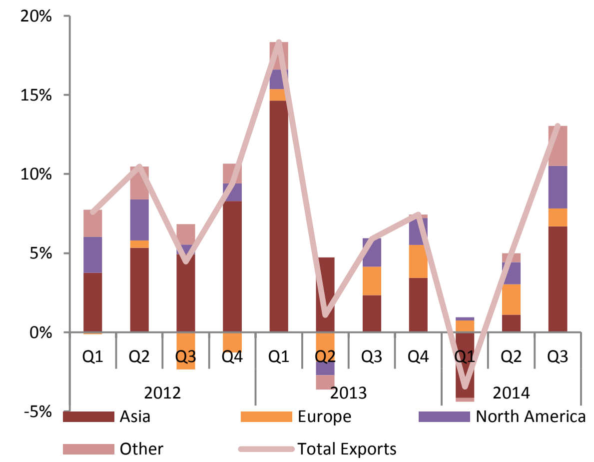


Source: World Bank staff calculations based on CEIC data.

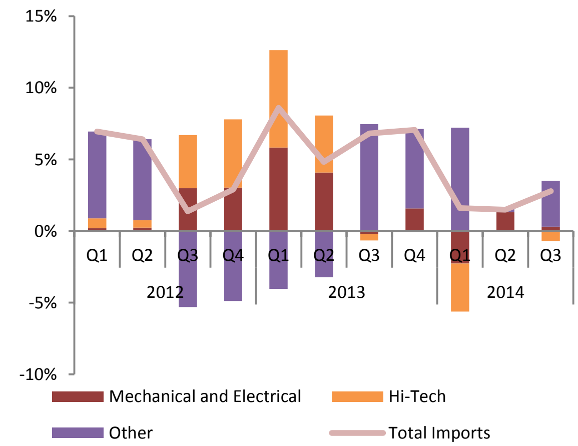
Imports continued to remain weak. In the first nine months, growth of merchandise imports decelerated to 2.6 percent (year on year) from 6.8 percent in the same period of 2013 (figure 1.13). The weak performance of imports reflected the slowdown in industrial activity, weak domestic demand and declining commodity prices. Metal imports declined over the past few months in both value and volume terms. Growing concern over a slowdown in the Euro Area and emerging economies, a strong US dollar, a well-supplied oil market and good agricultural crop prospects have contributed to a weakening of many commodity prices since the summer. The World Bank's energy price index declined by about six percent during the third quarter after being broadly stable in the first half of the year.

Figure 1.13 The trade balance has improved in recent quarters

Exports growth by geographic area, percent (year on year)



Imports growth by product group, percent (year on year)

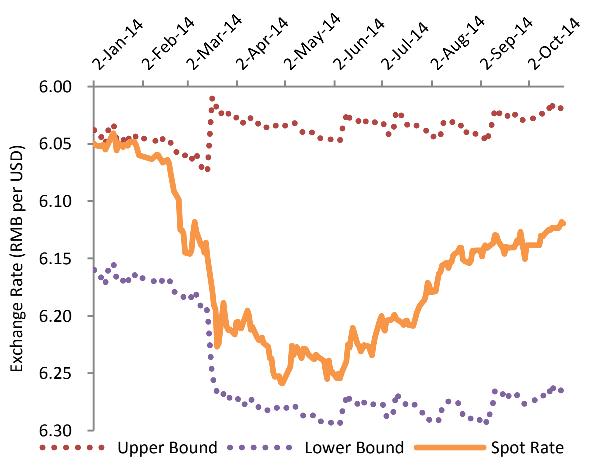


Note: Calculated in nominal USD terms.
Source: World Bank staff calculations based on CEIC data.

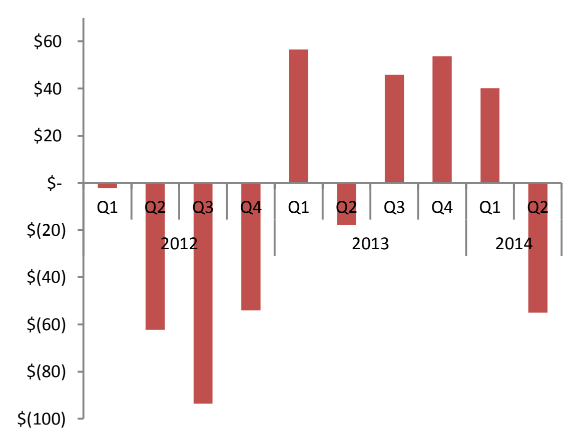
The exchange rate reversed its slide and continued to appreciate in the third quarter. The RMB is the only major emerging market currency that has appreciated in the last few quarters; others declined in expectation of normalizing monetary policy in the United States. A widening of the currency's trading band earlier this year has reversed some of the net capital flows in second quarter (figure 1.14).

Figure 1.14 The exchange rate reversed its slide suggesting a likely return to net capital inflows

Exchange rate, RMB/USD



Net capital inflows (other than foreign direct investment), billions of USD



Source: World Bank staff calculations based on CEIC data.

Section 2
Economic Prospects

China's transition to more sustainable levels of growth will continue

In China growth will gradually moderate to 7.4 percent in 2014 and 7.1 percent in 2016, reflecting intensified policy efforts to address financial vulnerabilities and structural constraints and to make growth more sustainable (table 2.1). In the short term, recent infrastructure and social housing initiatives by the central government, targeted monetary support measures, and positive contribution from net exports will partly offset some of the real estate slowdown, enabling the authorities to attain the indicative growth target. Over time, reforms and a gradual withdrawal of stimulus will reduce overinvestment and related imbalances. In particular, efforts to contain local government debt, within a framework where local government spending mandates are better aligned with their revenues, will rationalize local infrastructure investment. Similarly, measures to curb the growth in shadow-banking credit will curb excessive risk taking, including in the industrial and property sectors, and gradually contain credit expansion bringing it to a more sustainable level.

The global economic recovery, which is underway, remains weak and fragile, with many downside risks present. Global growth has been revised downwards and is now expected at 2.6 percent in 2014, only marginally up from 2.4 percent in 2013. In the United States, the recovery is proceeding broadly as foreseen, however, in other high-income economies, particularly in the Euro Area, growth has stagnated. Despite the setbacks observed this year, activity is expected to strengthen in 2015–16 led by the United States, which will lift trading partner exports. Stabilizing and slowly expanding activity in other high-income countries, should add some modest momentum. However, the projected pick-up in global trade growth remains below historical averages. In addition, there are significant downside risks to the global outlook. In particular, stagnation in the Euro Area could prove to be secular, accompanied by very low inflation or deflation and trigger weaker than expected global recovery. Increased geopolitical tensions can also negatively affect global recovery.

External financial conditions are expected to tighten; an abrupt rise in global interest rates cannot be ruled out. The baseline scenario is associated with an orderly normalization of monetary policy in the United States, and gradual tightening of global financial conditions. However, the tightening of global financial conditions could be sharp, causing financial market volatility. Overall, the normalization process will be complex, because monetary policy in high-income economies has remained extraordinarily expansionary over an unusually extended period. The unwinding of large central bank interventions, in an environment of uncertainty about future policy, could be accompanied by abrupt market reactions, increased volatility, and an overshooting of interest rates. Abrupt changes in market expectations could also lead to a sharper than expected reduction in capital inflows, increasing volatility in China's capital account. While China's reliance on external financing is low, rising interest rates could increase debt service costs for some corporates. China's external debt represents less than 6 percent of total debt; however, in dollar terms, it is significant–about USD 1 trillion in mid-2014.

Table 2.1 Main economic indicators for China

	2013	*2014e*	*2015f*	*2016f*
Output, employment, and prices				
Real GDP (% change yoy)	7.7	7.4	7.2	7.1
Domestic demand (% change yoy)	8.3	7.4	7.5	7.3
Industrial production index[a] (% change yoy)	9.7	8.0	8.0	7.5
Unemployment (%)[b]	4.1	4.1	4.1	4.1
Consumer price index (% change yoy)	2.6	3.0	3.0	3.0
Public sector				
Public finance budget revenues (% of GDP)	22.9	21.8	21.7	22.1
Public finance budget expenditures (% of GDP)	25.0	24.0	23.8	24.1
Public finance budget balance (% of GDP)	–2.1	–2.2	–2.0	–2.0
Domestic public sector debt (% of GDP)[c]	15.3	15.8	16.4	16.8
Foreign trade, balance of payments, and external debt				
Trade balance (USD billions)	259.2	290.7	298.0	308.2
Exports of goods (USD billions)	2,219.0	2,339.0	2,485.5	2,649.5
Imports of goods (USD billions)	1,859.0	2,048.2	2,187.5	2,341.3
Current account balance (USD billions)	188.6	184	206	225
(% of GDP)	2.1	1.8	1.9	1.9
Foreign exchange reserves, gross (USD billions)	3,866.3	3,981.0	4,185.5	4,423.2

e is estimate; *f* is forecast
a. Annual data are not comparable with quarterly and monthly data. Annual data cover all industrial enterprises while quarterly and monthly data refer only to enterprises with sales above RMB 5.0 million.
b. Official urban unemployment only, excluding laid-off workers.
c. Includes treasury bonds, policy financial bonds, and other financial bonds (end-period outstanding).
Source: World Bank staff estimates and projections.

Progress in rebalancing the sources of growth in domestic demand in 2015 will remain gradual. Aggregate consumption is expected to contribute 4.2 percentage points of GDP. Investment growth will continue to decelerate due to credit tightening and ongoing adjustments in the property sector. Excess inventory is likely to further slow investment in the real estate sector in the next few quarters. Accelerated rail and social housing development will partly offset a decline in manufacturing and real estate investment. Gross capital formation is expected to contribute 2.8 percentage points of GDP. Net exports are set to increase gradually and contribute 0.2 percentage points of GDP. Inflation will stay contained, expected to be 3.0 percent in 2015. The labor market is set to remain robust; the key challenge is to maintain healthy wage growth, especially in the nontradable sector.

On the supply side, sectors with excess capacity will continue to experience headwinds as credit conditions tighten further and environmental costs of pollution become internalized. Economic growth will continue to evolve from an industrial to a services base. Manufacturing will be increasingly affected by measures targeting sectors with excess capacity, high energy demand, and high pollution. The implementation of China's revised Environmental Protection Law will formally being in 2015. The revisions include provisions increasing penalties for violating Environmental regulations, expanding the scope of projects subjected to environmental impact assessment requirements and streamlining the process of bring public interest lawsuits related to environmental degradation.

There are downside and upside risks to the 2015 projection. First, a failure to strengthen the vulnerabilities in the financial sector could leave the economy increasingly saddled with inefficient firms, bad loans and weaker financial institutions. This could reduce economic activity by undermining productivity growth and increasing capital misallocation. Second, the housing sector might not bottom out, instead continuing to decelerate, further undermining consumer confidence and economic activity. On the upside, there is a possibility that external recovery might be more rapid than previously expected, boosting China's export growth.

Key short-term policy challenge: strengthening market discipline in the financial sector while avoiding disruptions to the labor market

The key policy challenge is strengthening market discipline in the financial sector. This will require implementing policies that facilitate reallocating resources from the sectors that have excess capacity to those with high growth potential. Examples of such policy steps include gradually removing state guarantees and allowing inefficient firms, including in particular state-owned enterprises to fail. In some cases this will require a careful balancing between enhancing market discipline and avoiding disruptions to the labor market. In the long run, the role of ad hoc administrative measures will be gradually replaced by a market-based mechanism where interest rates clear the credit market and allocate capital.

The government's indicative growth number for 2015 will signal the priority that the authorities put on growth and reforms. The current emphasis on meeting growth targets could narrow policy options to implement reforms. In particular, a prevalent concern is that a policy focused on meeting an ambitious growth target, similar to one for set for 2014, would require macroeconomic policies to remain oriented to support domestic demand rather than on reforms required for more sustainable development. While the government still has enough room for accommodative policies, such a move would perpetuate China's traditional growth model that relies on government-led investment fueled by credit expansion. In an increasingly uncertain economic environment China's sizable policy buffers could be reserved to maintain overall macroeconomic stability in case of unexpected domestic or external economic shock.

While strengthening market discipline in the financial sector, the authorities appear to have the necessary buffers to prevent a disorderly debt unwinding. At 55.5 percent of GDP, total public debt is moderate. This provides enough fiscal space to employ additional stimulus if growth slows sharply. Institutional buffers, too, are strong. Public debt is mainly held domestically by a small group of institutions and the financial system is still largely state owned. Financial repression restricts savings instruments outside the banking system (especially once real estate investment loses attractiveness), and capital controls on portfolio investment and bank lending prevent sharp capital outflows. Finally, China has sizable reserve buffers.

But a failure to strengthen the vulnerabilities in the financial sector could increase the risk of reduced economic activity arising from increased capital misallocation and weakened financial system. A practice of extending credit lines to roll-over maturing credit to inefficient firms or sectors not only weakens financial institutions but also undermines productivity. Even with sufficient policy buffers in such a scenario it would be difficult to avoid a long period of slow growth.

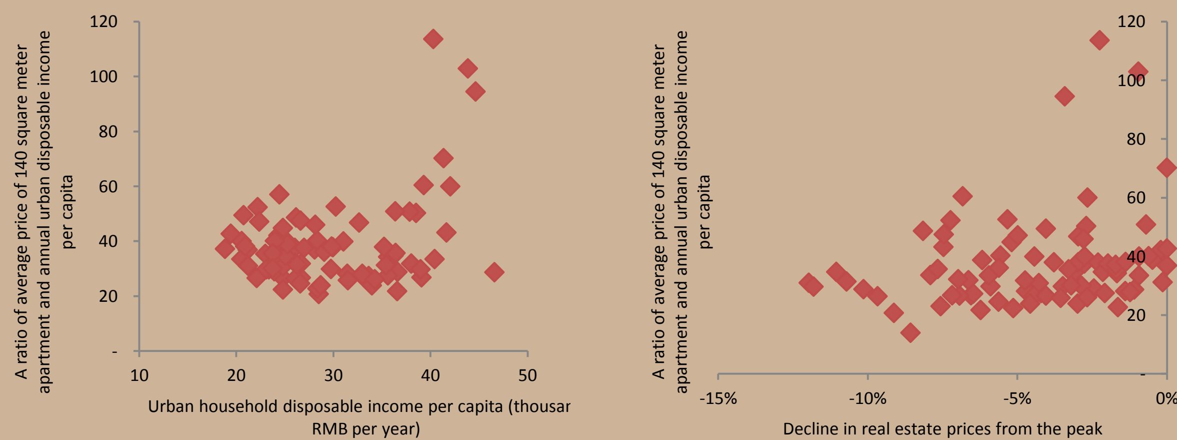
Housing will continue its structural adjustment. In recent months housing starts have picked up, but housing construction activity remains weak. Excess inventory will depress housing prices over the next few quarters. The policy response is constrained because some of the adjustment is structural rather than temporary. Over recent years market distortions have contributed to supply mismatches and a rapid increase in housing prices (box 2.1). A more stable housing market will require that these market distortions be resolved.

Box 2.1 How market distortions contributed in three ways to China's housing problems

First, distortions in land policies contributed to excessive increases in land prices. Because all local governments are the owners of urban land in their jurisdiction, they have strong incentives to supply cheap land for industrial use to generate economic growth. But because many local governments follow the same approach, cheap industrial land is not a comparative advantage. Instead, not only has excess industrial land fueled inefficient growth of urban boundaries and industrial developments zones, but it also has contributed to record prices for residential and commercial land, which remains tightly controlled.

Second, an interest rate cap on saving deposits has made housing an alternate means to store wealth. This has misallocated capital and excessively increased residential housing prices, particularly in first-tier cities, such that real estate prices have risen much faster than incomes, undermining housing affordability and feeding into many local housing bubbles (box figure 1).

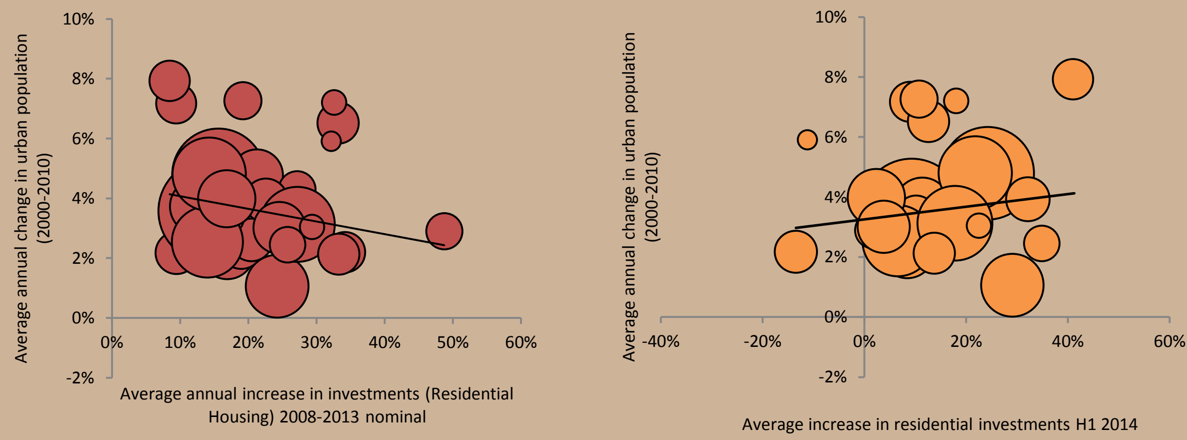
Box figure 1 Affordability of housing declined in cities where household incomes were higher, and recent adjustments in real estate prices did not affect cities where housing is least affordable



Source: World Bank staff calculations based on Wind Info data.

Third, local government incentives to boost economic development, in addition to more traditional responsibilities of managing municipal services, have contributed to misallocated housing supply. Housing demand is highly correlated with increased employment. But in places with weak employment growth, local government incentives to boost growth have led to excessive reliance on land conversion to finance investment-led growth and to provide incentives to real estate developers, with much more housing built where population growth was not very strong. Indeed, the last five years have seen a negative relationship between growth in fixed asset real estate investments and population growth (box figure 2).

Box figure 2: Between 2008 and 2013, investments in residential housing increased more in cities with slower population growth, while in the first half of 2014 this relationship reversed



Memorandum: sized according to population size of respective cities.
Source: World Bank staff calculations based on CEIC and Population Census data.

The government has taken steps to help contain a disorderly adjustment in the housing market. A social housing initiative will offer a supply response for much needed social housing units. Credit constraints for homebuyers have also been loosened. In late September the authorities cut mortgage rates and down-payment levels for some home buyers for the first time since the 2008 global financial crisis. Accompanying the relaxation of lending rules were additional steps to increase financing for real estate developers.

Key medium-term policy challenge: implementing reforms to cement China's next transformation toward more efficient, equitable, and sustainable growth

China's growth slowdown is not temporary, but structural; therefore, structural reforms are needed to maintain reasonably high rates of growth. First, the productivity gains from the structural transformation of the labor market, the demographic dividend, and capital accumulation are set to decline gradually, consistent with the moderation in growth in other rapidly developing economies. Second, the global environment has changed, and exports can no longer drive economic growth: domestic demand has to become the driver of growth. Third, China's rapid economic growth , unprecedented in its scale, has done severe damage to environmental, with both domestic and global implications.

So, China's next economic transformation toward more efficient, equitable, and sustainable growth will depend on how successful structural reforms in land, labor, and capital markets are. The plenum in November 2013 set ambitious goals to change the role of the government by giving market forces a decisive role in allocating factors of production, particularly land and capital, and getting out of providing goods that the private market is better at providing. Subsequently, the Ministry of Land and Resources has published the Regulation on Economical and Intensive Utilization of Land, addressing the issue of excessive land conversion. A pilot program to attract private investment for and improve the corporate governance six large state-owned enterprises was announced in August, paving the way for other state enterprises to establish "mixed ownership" entities in future. In 2014 reform plans were outlined to make adjustments to the *hukou* system to integrate migrants into urban life and to overhaul the public finance system by addressing distorted incentives of local governments.

Steps have been taken to put China' public finances on a more stable footing. On June 30, 2014, China's leaders endorsed broad reforms to the nation's fiscal and tax system (see section 3). The reform focuses on three areas: strengthening budget management processes, advancing tax reforms, and improving intergovernmental relations. The objective of tax reform is to optimize the tax structure by changing the excise tax system to promote energy savings and emission reductions, continue to replace the business tax with the VAT, and broaden the tax base of local governments by advancing legislation on the real estate tax. The authorities have also set out a near-term 2016 deadline for completing substantial reforms to help complete the longer term reform agenda by 2020.

Revisions to China's budget law, effective January 2015, are ambitious step in a comprehensive fiscal policy reform. The revisions provide a framework for far greater transparency and accountability for local government debt management. The amendments to the budget law will help the local government reduce the transaction costs and financing costs of debt by issuing bonds rather than establishing off-budget financing vehicles to finance infrastructure projects.

In early October the State Council announced a set of new rules regulating local government debt to comply with the amended budget law. Specifically, the central government made it clear that it will not bail out the local governments in financial distress, effectively banning local government borrowing through LGFVs. The *no-bailout rule* will be strengthened by the establishment of assessment accountability mechanisms where the government debt will be taken as one of the hard measures in evaluating the government performance and local government officials will be held responsible and penalized for over-borrowing, illegal borrowing, illegal usage of debt financing, malicious evasion of debts. As a transitional arrangement, local governments need to identify whether the existing LGFV debt belongs to government debt or the corporate debt of state enterprises, and include the former part in their budget.

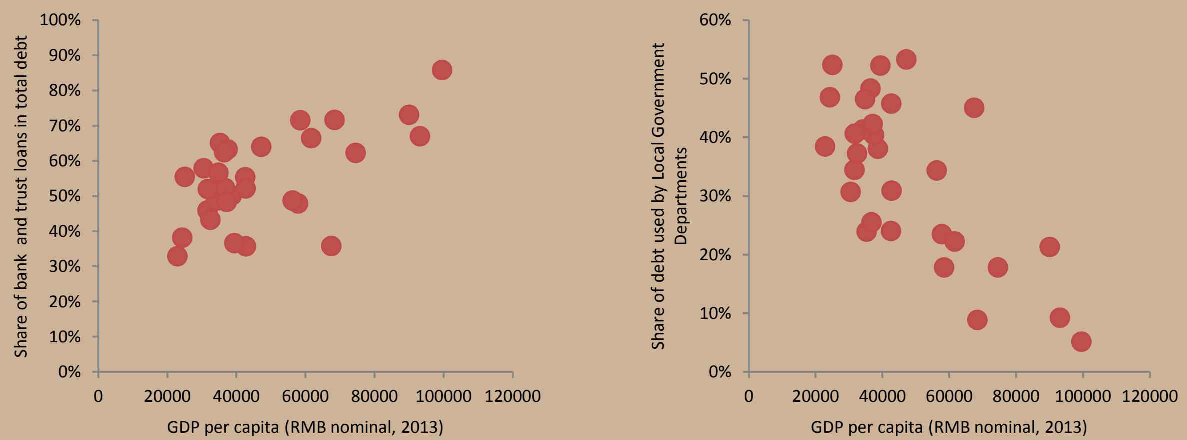
Fully implementing the amendments will take time, however. At the start of this transition, market-based instruments, such as municipal bonds, alone will be able to absorb a fraction of existing outstanding local government debt. More comprehensive steps, including transitional arrangements, will be needed to address the outstanding stock of local government debt (including guarantees and contingent liabilities), estimated at about RMB 17.9 trillion or (31.5 percent of GDP in 2014). While a recent audit by the National Audit Office sheds some light on the composition of local government debt (box 2.2), the lack of timely and comprehensive data on such debt clouds the transparency of local debt management. A large part of debt cannot, it seems, be immediately converted toward market-based instruments (such as municipal bonds) due to weak underlying quality of assets backing these instruments.

Box 2.2 Structure of local government debt

There are 154,000 borrowers in government organizations and state-owned enterprises using more than 30 financing tools, according to a recently released provincial-level local government audit conducted by the National Audit Office. It reveals two main patterns.

First, traditional bank or trust loans are associated with financially stable localities (box figure 1). This is expected, as financially stronger municipalities are viewed as more creditworthy by market participants. At the same time financially weaker municipalities are more likely to register debt directly with local government, as market participants are likely to discount the implicit guarantee issued to a special financing vehicle created by these weaker municipalities.

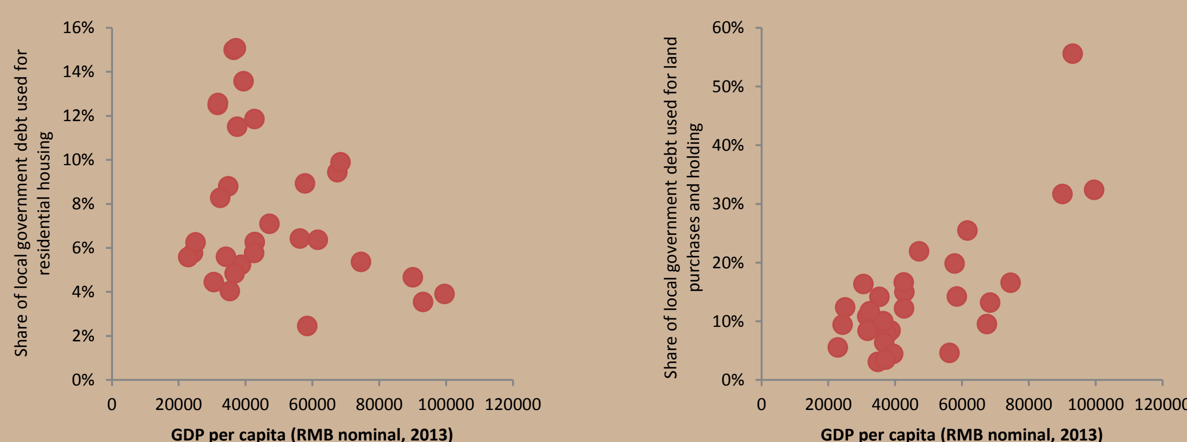
Box figure 1 Richer municipalities rely more on market-based instruments to finance debt



Source: World Bank staff estimates based on Wind Info data and National Audit Office results.

Second, the use of debt differs widely among municipalities. Poorer municipalities use debt to finance economic activity directly, such as capital investments, while richer municipalities use debt as leverage to finance investments for land conversion (such as compensation to farmers and infrastructure for rezoning). Both of these practices affect residential housing markets: the former leads to excess supply in areas with weak economic activity, the latter makes local governments vulnerable to downward adjustments in land prices (box figure 2).

Box figure 2 Local government debt has contributed to housing market supply mismatches



Source: World Bank staff estimates based on Wind Info data and National Audit Office results.

Closely related financial sector reforms are progressing more gradually. Authorities have announced policy commitments to fully liberalize interest rates by 2016. Some steps have already been taken. In March 2014 the ceiling on deposit rates for small deposits in foreign currencies was removed in the pilot Shanghai Free Trade Area. Qualified private investors are allowed to set up financial institutions such as small or medium-size banks, conditioned on greater supervision. The pilot work has been launched, and the first group of five pilot banks was publicly announced in March 2014. A deposit insurance system is being developed. Delays in implementing financial sector reforms could perpetuate capital misallocation and undermine the health of the banking system.

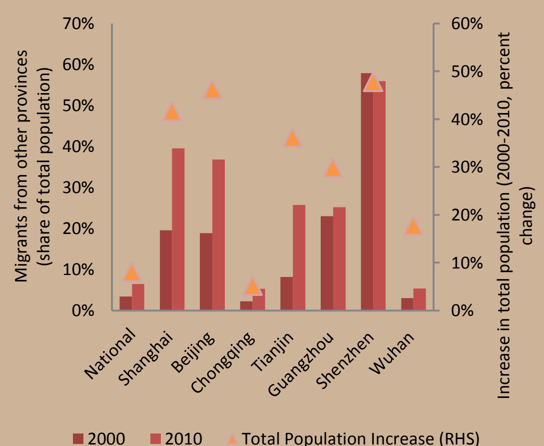
The urban-rural *hukou* system will be unified gradually. In July 2014 China's State Council released details on proposed reforms of China's *hukou* system of household registration. The government aims for a total of 100 million new urban *hukous* to be issued by 2020, a modest number, given about 250 million migrants currently dwelling in cities. In addition, initially the government will fully relax residency restrictions for smaller cities and towns (with populations under 500,000), but not initially the larger cities. Requirement for *hukou* registration will be regulated in large cities with populations of 1 million–5 million. In these cities the relaxation of *hukou* registration will be set taking into account the capacity of the cities to provide adequate public services for new residents. Migrants to large megacities—with populations of more than 5 million—will have to qualify under a points system that considers individual factors, including job profile. *Hukou* reform has encountered significant resistance from local government leaders who are mostly unwilling to take on the additional public service burdens. And for smaller cities to benefit from removing the residency restrictions will require narrowing the gap of public service provision with the larger cities (box 2.3).

Box 2.3. Attracting new residents to China's small cities will require narrowing the social infrastructure gap

Despite tight control over population flows through the hukou system, China's megacities in the coastal region have attracted the most migrants and experienced disproportionately rapid population growth since 2000 (box figure 1). Using the methodology of Desmet and Rossi-Hansberg (2013), it is estimated that differences in productivity accounts for more than half of the city-size distribution and internal migration. City-specific amenities that directly improve welfare also play an important role, accounting for around a third of the actual size distribution.

Box figure 1 Megacities in the coastal region attract the most migrants as cities with higher labor productivity tend to attract more migrants

Population growth and a share of migrants from other provinces in largest cities

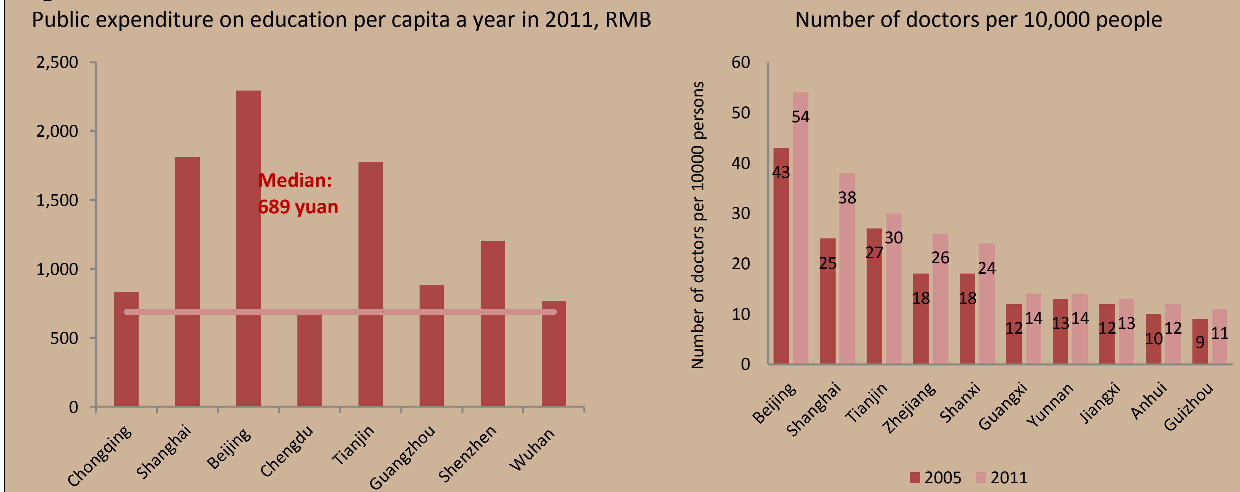


A relationship between labor productivity and migration flows across cities in China

Source: Estimates based on 2000 and 2010 Population Census.

Differences in social infrastructures such as education and health care are also driving internal migration. Schools and hospitals contribute to human capital development, which leads to better income prospects. Cities that provide great access to these public amenities tend to attract more migrants. Staggering differences in education investment and health care coverage contribute to the agglomeration pattern of migration (box figure 2). Specifically, Shanghai and Beijing spend 150–200 percent more on education per capita than most cities in China. For health care the discrepancy of doctors per capita between leading and lagging regions widened between 2005 and 2011. Increasing the public budget for education and health care and, more importantly, improving the cost effectiveness of these social infrastructure investments should be on the forefront of local governments' policy agenda.

Box figure 2 Public resources for education and health care exhibit staggering differences across cities and regions



Source: Estimates from China Data Online and 2010 Population Census.

Given the persistent gap in productivity and social infrastructure across regions, removing *hukou* restrictions under the status quo is likely to reinforce the current agglomeration patterns of urbanization and increase regional economic inequality. Lower-tier cities need to provide attractive income opportunities (adjusted for living cost) and growth potential to induce a net migrant inflow. Policies to facilitate technology diffusion and to address social infrastructure discrepancy will boost the economic dynamism in small and medium-size cities. These policies should be adopted to complement *hukou* reform to generate balanced regional economic growth.

Land reforms are likely to have the largest growth impact. Land is of central importance to China's economic growth and social stability, but local implementation of land policies has led to unintended consequences widely viewed as unsustainable (Urban China (World Bank and DRC, 2014)). Rigid land policies have effectively tied half the population to rural areas that produce only 10 percent of GDP. Rural land is held in small parcels, making it difficult to assemble economically sized farms, increase agricultural productivity, and raise rural incomes.[4] The 2008 global economic crisis and the subsequent accommodative fiscal policy stance have had a dramatic effect China's land-based economic growth model through accelerated land taking and conversion, bringing the inefficiencies of current land tenure arrangements and the need for reform into even clearer focus.

Reforms to land, public finance, and the *hukou* system require a carefully coordinated approach. Reforms need to recalibrate the use of land, improve land governance, and reduce the government's dependence on revenue from land conversions and land leases. They could facilitate the transition from land asset sales to a modern tax system aligned better with China's new economic structure. They could also deepen land markets, clarify rural citizens in their property rights and land assets at home, and boost their opportunities and entitlements for integrating into cities. Thus to increase the efficiency of land use, it is necessary to ensure the security of agricultural land tenure, including introducing the transferability of land rights and reforming land acquisition and compensation practices. This action includes rolling out the recent policy decision to grant indefinite land use rights to farmers, to expand land registration, and to strengthen rural land markets.

[4] Despite massive off-farm migration, rural population growth has meant that cultivated land per agricultural laborer has remained fairly constant, increasing only from 0.35 hectares in 1978 to 0.41 in 2008. Average Chinese farm holdings are well under 1 hectare, far lower than the global average; the average farm in the United States is 300 times bigger than in China.

Implementing such a coordinated reform plan can accelerate China's economic growth potential, but it will not reverse a moderation of growth over the next decade. Recent calculations made for the Urban China study (World Bank and DRC, 2014) indicate that these "second generation" reforms are likely to have a smaller impact on growth than the "first generation" reforms implemented over the last few decades. Such a reform scenario could increase China's potential growth about 0.8 percentage point in the first year and a cumulative 3.5 percentage points over five years. Without policy action, the slowdown in China's potential growth in the medium term could be more severe. In such a scenario economic activity could start to stagnate as resource misallocation, particularly in the financial sector, would continue to reduce productivity of firms, strength of financial institutions and confidence of consumers.

Section 3
Special Topic: An Update of China's Fiscal and Tax Reforms[5]

Background

The revenue and expenditure growth in China over the past 20 years has been admirable and has contributed to important accomplishments. Over 500 million people have been lifted out of poverty, the urban infrastructure has developed quickly, and social services have improved significantly. But the rapidly growing economy that has made all of this possible has also hidden some important deficiencies in the system of public financing. China has outgrown its public finance system. The regime of taxes, public expenditures and central-local fiscal relations is no longer compatible with the government's expanded responsibilities to its citizens and—more important—cannot efficiently support the new economic order that the government seeks to create.

China is now facing two major transitions—continuing urbanization and slower GDP growth—as well as the need to address a backlog of important public servicing needs. Each of these will require changes to the public finance system. Managing the government sector during these transitions, especially the finances of subnational governments, presents major public policy challenges. The government will need to decide how much it will let fiscal policy be driven by incremental fixes, or whether it heads off the problems with major structural reforms. The recently announced new directions for fiscal reform suggest that the latter path has been chosen.

New Reforms

On June 30th of 2014 China's top leaders endorsed a program of reform to the nation's tax system, budgeting practices and center-local fiscal relations. While the detail of the fiscal reform plan is not yet proposed, the broad proposals are impressive and ambitious. The objectives for fiscal and tax reforms in the Third Plenum decisions are:

"Public finance is the foundation and a critical pillar for state governance. A scientifically designed fiscal and tax regime is the institution that guarantees resource allocation optimization, market unification, social equality, and long-lasting security and peace for a nation."

China has set a timetable to build such a modern fiscal system. The Minister of Finance has said that the major reform tasks concerning the fiscal and tax system will be completed by 2016, and a modern fiscal system will be fully developed by 2020. This will not be minor amendments to current policies; but rather will involve systemic restructuring and institutional innovation. He said the years 2014 and 2015 will be vital in pushing forward the reforms.

The Minister of Finance Lou Jiwei explained the blueprint in drawing a comparison between the 1994 reforms and the new plan. He pointed out that the former straightened out the revenue relationship between the state and enterprises, and between central and local governments, while the current

[5] This material is drawn from Party's 3rd plenum of 18th central committee, the revised Budget Law, the State Council 2014/43 on strengthening the subnational debt management, and the State Council 2014/45 the decision on deepening the reform of budget management system.

reforms will redefine the roles and functions of central and local governments, enhance overall state governance, and improve bureaucratic efficiency. In other words, the current fiscal and tax reforms are as much about political economy as they are about economics. Minister Lou explained that reforms will be achieved by fulfilling three objectives: Improving the budget management system; improving the tax system; and building a system that matches an appropriate allocation of governmental functions and spending responsibilities.

Improving the budget management system

China's top legislature on August 31th of 2014 adopted a revision to the Budget Law which clears ambiguity and closes loopholes in managing the trillions of yuan involved in fiscal revenue and spending. This is the first time the Budget Law has been revised since it took effect in 1995. As the law is closely interrelated with China's ongoing fiscal reform, it took an unusually long time to revise it—seven years to draft a bill for the first reading in 2011 and four readings to get it passed. Members of the Standing Committee of the National People's Congress (NPC) adopted the bill through a vote at the bi-monthly legislative session, saying that the revision has responded to needed improvements in the budgeting system.

The old Budget Law was adopted when China was more strongly influenced by planned economy concepts and was at an early stage of applying budget management techniques. It had only a very general definition of what the government budget covered, leaving a great deal of room for interpretation by governments. The revised law, on the other hand, defines the government budget as being made up of four parts: public finance budget, government fund budget, SOE operation budget and Social Security budget.

The State Council’s decision on deepening the reform of budget management system on September 26 of 2014 (State Council, 2014/45) listed the main tasks of the reform.

(1) **Improve the government budget system by requiring that all government revenues and expenditures are included, and by making the budget more transparent.** The transparency of the government budget will be improved by making public all revenues and expenditures (by both the central and local governments). In fact, the revised law asks government financial departments to publish their budgets and final account reports within 20 days after they are adopted by the legislature. The disclosure and transparency of the budget will allow the public to be more aware of government policies and spending.

(2) **Build a system based on a medium term fiscal plans.** The government will shift from the current “balanced budget” to an expenditure and policy-oriented budget. Another change will be the building of a budget balancing system which will extend beyond one year so that budget deficits can be made up over the following years (or surpluses carried forward). In particular, the fiscal department at all levels of government will work together with line agencies to establish the mid-term fiscal plan which covers 3 years.

(3) **Eliminate preferential tax policies.** In the past, such policies have had a negative impact on state tax collections as well as on fair competition in the market. Regional tax incentives that are proven to have positive effects will be applied nationwide. In the future, all preferential tax policies will be enacted through a unified system based on specialized tax laws and regulations. China will also improve the management of tax collections. This means that the amount of tax revenue collected by local governments will be based on tax laws and best administrative practice, rather than on the current system of fiscal target setting.

(4) **Strengthen the management of carry-over funds and arrears.** The new budget control system will improve the fiscal expenditure structure and sever the connection between regional GDP and the expenditures of local governments. The previous connection (mainly based on derivation revenue sharing and expenditure mandates) has contributed to rigid and inefficient government behavior. The government plans to regulate and reduce the number of mandates. Such mechanically budgeted items now account for nearly half of total fiscal expenditures and have reduced the fiscal resources that could otherwise be spent in more needed areas. Further, China will improve the intergovernmental transfer system by enhancing the clarity of the process and by cleaning up the messy "special transfer payment" program. Particularly, the share of general (unconditional) transfers will be targeted to rise to over 60 percent of total transfers. Meanwhile, China will build and implement a clean-up mechanism for carry-over funds and arrears. Another goal is to improve the management of government purchasing.

(5) **Strengthen budget execution.** Measures to improve the performance of fiscal expenditures include hardening the budget constraint, normalizing the treasury system, improving the budget performance management mechanism, and building an accrual-based and comprehensive government fiscal reporting system.

(6) **Formalize the subnational government debt management.** China will build a formal subnational borrowing system. The central government will control the ceiling for borrowing and limit the borrowing channel to bonds of provincial governments. Meanwhile, the central government will establish the risk warning and solvency system for subnational debt. More importantly, China will establish and enforce the accountability mechanisms. The level of government debt will be taken as one of the hard measures in evaluating the performance and local government officials. More detail on strengthening the subnational debt management is provided in The State Council 2014 Directive 43. One of the most controversial issues is local government bonds. The old version of the law banned local governments from issuing bonds, but in practice some local governments used "back door" approaches to raise funds, mostly to finance infrastructure. The use of this approach was mostly unsupervised. To tackle this situation, the revision limits the power to sell bonds to provincial-level governments, and imposes some strict conditions. It not only limits the amount of bonds but also regulates their issuance and their use. Under the new version, provincial governments are allowed to issue bonds within a quota set by the State Council, China's cabinet, and approved by the NPC or its standing committee. Money raised by the bonds can only be used for public infrastructure services, and not for government operations. The debts must be included in the provincial budget and supervised by provincial people's congresses. The central government will assess the risk implied for each issue. If the risk is too great, it has promised warnings, a fast response and punishment for those responsible. The revised law has helped clarify several important principles on how to manage local debt, and how to set rules and divide liabilities. Local government financing vehicles (local governments' financing platforms, LGFVs in short) will no longer play their previous role of financing infrastructure for subnational governments. Previous projects financed through LGFVs should be restructured with three different reform channels. The LGFVs operating in competitive markets should become market entities and the local government should not have any responsibility for their debts. The LGFVs with stable revenues, involved in public service projects, are candidates for a Public Private Partnerships approach and the responsibilities of government should be clarified. Those LGFVs engaged in public service projects, but not having a stable revenue stream, should be financed directly by subnational governments. Some of these proposals by Ministry of Finance are under discussion.

(7) **Improve fiscal discipline.** Proposed measures include strengthening the audit function, promoting transparency, and decreasing the discretionary power of government. The key will be that all fiscal activities should be governed by laws and monitored by the people. In particular, officials and activities that violate the fiscal disciplines should be punished.

Improving the tax system

Reforms in the tax system will put an emphasis on strengthening the role of the market in resource allocation. The country is planning to lock in six tax categories as major reform targets: Value-added tax (VAT), excise tax, resources tax, environmental protection tax, property tax and individual income tax.

(1) Government will continue with a scheme to replace turnover tax with VAT in more sectors including services, construction, real estate and finance. According to Minister Lou, it is expected that the turnover tax will be eliminated by 2015. China has been pushing for VAT reform by replacing the turnover tax since the beginning of 2012 in a bid to push forward structural tax reform and boost the growth potential of the service industries. The reform started with transportation and some modern service sectors, and expanded to railway transportation, postal services and the telecom industry.

(2) The next step in the reforms of the excise tax system will be initiated by adjusting its scope, tax rate, tax-collection, and the revenue sharing scheme. The reforms will make the excise tax more functional with respect to adjusting the tax treatment of high energy-consumption, high pollution products and certain luxury goods.

(3) China is speeding up its resource tax reforms in the coal sector and plans to levy a resources tax on coal based on sales value instead of production volume. It also proposes to scrap arbitrary levies on coal miners starting from December 1 of 2014. The tax rates will be decided by provincial governments within a range of 2 and 10 percent with central authorities' approval. The central government also ordered local governments to cancel a series of administrative charges on coal miners. Currently, coal firms need to pay both taxes and various charges. The reform aims to cut charges and reduce the overall burden for coal enterprises. Resource tax will expand to the ecological system, including rivers, forests, grasslands, sea coasts and lake shores.

(4) The current administrative charge on pollution will be upgraded to an environmental protection tax, in order to boost environmental and ecological protection through taxation.

(5) China will accelerate legislation of a property tax. Currently, the property tax is being piloted in the cities of Shanghai and Chongqing.

(6) China will reform the individual income tax, with an emphasis on addressing income distribution issues.

Building a system that matches an appropriate allocation of governmental functions and spending responsibilities

The rationale behind this principle is to explicitly carve out the allocation of functions between the central and subnational governments. This will improve clarity in the system and move the responsibility of functions to governments with the best comparative advantages in delivering the function. Expenditure responsibility for defense, foreign affairs, national security, and market rules and management should be the function of the central government. Part of social security, and the construction and maintenance of projects with cross-regional benefits should be the shared functions of the central and subnational governments. The provision of regional public services should be a local government responsibility. Any financing shortfalls for delivering assigned responsibilities can be covered by intergovernmental transfers. Meanwhile, in general, the current revenue assignment structure should remain stable and should improve the revenue assignment between the central and local government.

Conclusions

China is to be applauded for moving in the direction of fiscal reform, and by elevating the reform discussion to such a high level. Clearly, one goal is to formalize and legalize fiscal practices. The approach is pro-active and ambitious, and the objective seems to be moving toward a comprehensive reform to respond to changes in the economy. The general direction of the reform includes the major elements of the fiscal system. Though the detail of the package is not yet completed, the stated intentions seem to hold great promise for addressing the major problems that lie ahead.

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