Remarks at launch of World-Bank book on Fiscal Policy in China
By Teresa Ter-Minassian

Good, afternoon, ladies and gentlemen. It is a pleasure for me to attend the launching on this important book on the public finances in China and to participate in this panel with such high-level experts, including a key policy maker, Minister Lou Jiwei who played such an important role in the modernization of the public finances in China.

As mentioned by previous speakers, this book, which presents the proceedings of a 2006 high-level conference co-sponsored by the Ministry of Finance of China and the World Bank on the theme of Fiscal Policy for a Harmonious Society, contains a number of though provoking reflections by internationally known experts on themes of great policy relevance for China. I warmly congratulate the organizers of that conference and especially Minister Lou Jiwei and Mr. Wang Shuilin, the editors of the book, for such a successful effort.

In my brief intervention, building on the paper in the book, which I co-authored with my colleague, Ms. Annalisa Fedelino, I would like to touch upon the following **main themes**:

- t**he role that fiscal policy can play in China today towards the achievement of national and global objectives, building on the progress achieved to date; and**
- **how further reforms in the tax and public expenditure areas can help achieve such objectives.**

Reflecting sustained efforts at fiscal consolidation over the last several years, **China today enjoys a very sound fiscal position,** with a budget deficit under 1% of GDP and a low (under 17% of GDP) gross government debt, among the strongest for emerging markets. Although **significant fiscal challenges loom over the longer term** (relating to the aging of the population, and to potential recapitalization needs of financial and non-financial SOEs), the fiscal position seems to offer **some scope for supporting domestic consumption** in the likely event of a deceleration of export growth, reflecting the ongoing downturn of external demand. At the same time, to avoid an intensification of already significant inflation pressures, it would be important to maintain a tight monetary policy stance and to continue the recent trend of appreciation of the exchange rate. **Sustaining domestic demand is important both from a national perspective (as China needs to continue growing at a rapid rate, to absorb new entrants into the labor force and reduce poverty), and from a global perspective, as China is now a major engine of worldwide growth .**

But, **sustaining growth while maintaining an overall macroeconomically and fiscally sound stance, is not enough**. As the papers in the book highlight, Chinese fiscal policy-makers continue to face a number of **important structural challenges:**

- **reducing** large and still growing **regional disparities** in income and in the level and quality of essential public services (including old-age protection; education and health)
- continuing to **improve the structure of the tax system,** to reduce distortions and facilitate its enforcement
- **reforming the system of intergovernmental transfers,** to enable it to perform a more adequate equalization role
- further **modernizing the tax administration;** and
- **strengthening budget and public expenditure management**, not only at the central, but also at the subnational levels of government, which carry out the bulk of expenditure functions in China.

In most of these areas, the government is already pursuing a substantial reform agenda, but further efforts are needed. Let me take the few remaining minutes allotted to me to elaborate briefly on some issues.

- As highlighted in the book, the tax reform of 1994 contributed importantly to the **impressive revenue growth over the last decade**. Moreover, some steps have been taken in the more recent years to reduce distortions in the tax system, and make it more transparent. Specifically:

  > In the **VAT**—which represents more than 40 percent of total tax revenue—the government has been piloting a reform to allow credits for the tax paid on capital inputs, with a view to progressively moving from a production-type to a consumption-type VAT, in line with best international practice. No progress has been made however in bringing under the VAT the taxation of services, which are currently subject to subnational level taxation (the business tax) allowing no input credit.

  > The **enterprise income tax** has also grown significantly, but its revenue remains well below what would be justified by its relatively high statutory standard rate. This reflects both weaknesses in the revenue administration and extensive tax incentives—although improvements on both fronts have been recorded in recent years. Effective January 1, 2008, the government has unified the income tax treatment for domestic

and foreign enterprises—a very welcome move that will create a more level-playing field for all investors; and one that was also advocated in our chapter.

> The **personal income tax** is also in need of reform, in particular: (i) the top rate should be aligned to the EIT rate; and (ii) the number of tax schedules and the number of rates within each schedule should be reduced.

These measures obviously should not be taken in isolation. The chapter highlights that:

- **There are important tax administration aspects** that should be considered. The Central Revenue Administration (SAT) is pursuing a major modernization effort, with assistance from various multilateral and bilateral institutions, including the Fund and the World Bank, and the impressive revenue performance undoubtedly also reflects the results of this effort, which needs to be sustained over the medium term.

- **There are significant implications for the system of intergovernmental fiscal relations**. Just one example: the VAT is shared between the central government and provinces, while the business tax, under which services are taxed, accrues to provinces. Bringing services under the VAT net would erode an important source of revenue for provinces, in the absence of other (countervailing) reforms.

- **There are also important sequencing issues**: revenue losses due to allowing creditability of capital goods under the VAT should be offset by other measures, for example increases in excises. And reforms should be properly phased in, to avoid straining the tax administration capacity.

On **expenditure policy,** attention has focused on reforming the pension system, and strengthening the provision of social services, especially healthcare and education. These issues are covered extensively elsewhere in the book; and Bank colleagues work more directly on some of these sectoral issues. Just a couple of general considerations, mostly from a macroeconomic standpoint:

- First, recall that **inadequate provision of social services is one of the main factors driving households' precautionary savings in China**. As pensions are insufficient, and healthcare and education are very costly, households build up savings to as an insurance against such expenses.

- Second, **China stands out as one of the most decentralized countries in the world in terms of spending mandates**. It relies almost exclusively on local governments for the provision of health and education, as well as social security—this puts China as an outlier among OECD countries. Best international practice and efficiency considerations call for a more centralized pooling of social security, for example. Hence, reforming expenditure policies will require coordination with reforms of the system of intergovernmental fiscal relations.

In our chapter in the book, we also emphasize the **importance of sound public financial management** systems. Among other measures, China has recently adopted a new budget classification and strengthened treasury management, while revisions to the Budget Law are under way.

To summarize, fiscal policy can play an important role in rebalancing growth; it can also help address some of the existing social imbalances; and can contribute to the maintenance of a favorable business environment. As we say in the book, fiscal policy cannot do this alone—in fact, attention has mostly focused on other macroeconomic issues, including the exchange rate regime and the spectacular accumulation of foreign assets. But **fiscal policy is certainly an important element of the reform agenda; and one that should be pursued decisively, taking advantage of the propitious times China is enjoying**. Paraphrasing (and extending) what Mr. Lou Jiwei notes in his chapter, some of these reforms "are not only a matter of urgency but also a practical and feasible policy choice."

Many thanks

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