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978-1-009-09818-2 — China's Public Finance
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An Overview of China's Public Finance

China is the most populous country in the world with a population of 1.4 billion right now. It has a history with written records for more than three thousand years. More than two thousand years ago, the Chin Dynasty (221–207 BC), was established, from which many believe China got its name. China's territory was shaped through conquering and being conquered. Currently, China's territorial area ranks third after that of Russia and Canada. China is an upper-middle-income country with a per capita gross domestic product (GDP) of about $10,000 up to now, and China is expected to become the world's largest economy in a decade. China is the biggest trade partner for more than one hundred countries and its influence on the world economy has been growing quickly.

Public finance plays an important role in China. The main functions of public finance include obtaining resources needed by the government to provide public goods and services, correcting externalities to improve economic efficiency, promoting sustainable economic growth, redistributing income to allow all people to share the fruit of economic development, and maintaining economic stability. In China, public finance is also utilized to maintain political continuity and stability. For two thousand years after the Chin dynasty, China's government was small, but it is big now.

Since economic reforms started forty years ago, China's fiscal system has been dramatically reformed. China has established a tax system dominated by consumption taxes, which is very effective in generating tax revenue. It continues to allocate a large proportion of government expenditure to economic construction, and it has adopted expansionary fiscal policies since the 1997 Asian financial crisis. Local governments have been granted great fiscal freedom to collect extra-budgetary revenues, sell land, and borrow from banks to finance infrastructure investment. China's current fiscal system is favorable to investment and economic growth.

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As China is a country where the government is still heavily involved in investment and production through state-owned enterprises (SOEs) and state-controlled enterprises, collects a large amount of tax revenue, sets development strategies and industrial policies, and actively intervenes in economic development and people's daily lives, understanding China's public finance is essential to understanding the Chinese economy. How does the government intervene in the economy? How large is the government? Where do government revenues come from? Where does the government spend its revenue? How are infrastructures financed in China? How are Chinese social security and health insurance systems managed? What is the relationship between the central and local governments? How serious is local government debt? How does China affect the world economy through its fiscal policies? What are the challenges to China's fiscal system? How should the fiscal system be reformed? All of these questions are intriguing for scholars, investors, and policy makers around the world. This book intends to address these issues.

This overview first discusses traditional Chinese philosophies on public finance, then it describes public finance under the centrally planned economic system, followed by an examination of market-oriented public finance reforms before exploring the challenges to China's public finance. Finally, it explains the contributions of this book.

1.1 Traditional Chinese Philosophies on Public Finance

Numerous ideas exist about how tax should be collected and where tax revenue should be spent. In *The Wealth of Nations*, Adam Smith proposed four maxims of taxation. First was equality – that is, people must contribute to the support of the government in proportion to their respective abilities. Second was certainty – that is, the tax (time, manner, quantity) imposed on each individual must be certain, transparent, and not arbitrary. Third was convenience for taxpayers. Fourth was economy in tax collection. In modern times, the tax system has assumed more roles such as stabilizing the economy and stimulating economic growth. China's public finance is heavily influenced by traditional Chinese philosophies, Chinese history, modern public finance theory, the experience of advanced countries, and China's economic development. It is interesting to discuss traditional Chinese philosophies on public finance that have had a profound influence on the behavior of the Chinese government historically and currently.

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Low Taxation

The concept of low taxation was developed thousands of years ago during the Spring and Autumn Period and the Warring States Period (770–221 BC). Confucius (551–479 BC), the great ancient philosopher, expressed the idea of low taxation clearly in his conversations and writings. Confucian philosophy has been the most important part of Chinese culture, which has affected the government's behavior and the daily lives of Chinese people. *Lun Yu* (*The Discourses and Sayings of Confucius*), the most famous book that recorded Confucius's thoughts, documents a well-known conversation between King Ai of the kingdom of Lu and one of Confucius's disciples, You Ruo.[1]

King Ai asked You Ruo, "What should I do with inadequate government revenue due to the poor harvest?"

You Ruo replied, "Why don't you enforce a tax law which could authorize you to collect 10 percent of the harvested grains?"

King Ai answered, "20 percent of the grains have already been collected, but the revenue is still not adequate."

You Ruo responded, "If the people are rich, you will be rich. If the people are poor, how could you be rich?"

In this conversation, Confucius's disciple suggested that King Ai should make his people rich so as to enlarge the tax base and thus increase government revenue while keeping the tax rate low.

Here is another story from more than two thousand years ago.[2] One day, Confucius traveled to a remote mountain area and saw a lady crying. He went over and asked the lady the reason for her weeping. The lady replied that her son had recently been killed by a tiger and her husband and her father-in-law were also killed by tigers. Confucius was puzzled and asked why they chose to stay in this dangerous area. The lady replied that they could not afford heavy taxes and levies in a safe area, but in this remote mountain area, taxes were lower because government officials could not reach it. Hearing this, Confucius was very sad and sighed, "Tyranny and exorbitant taxes are fiercer than tigers (*ke zheng meng yu hu ye*)!"

Mencius (372–289 BC), another disciple of Confucius, also advocated for low taxation. He suggested that the government should eliminate all other taxes except an agricultural tax. He specifically criticized the collection of market, head, and housing taxes. Mencius opposed excessive taxation and accused rulers of the warring states of imposing taxes like

[1] Wang (2016). [2] Zhang (1995).

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brigands. He believed that the tax rate should be kept at 10 percent.[3] The belief in low taxes and less forced labor (*qing yao bo fu*) was the Confucian view on taxation, which has dominated Chinese public finance for more than two thousand years. Confucius and his followers also took issue with the extravagant and wasteful lifestyle of rulers and they advocated for thriftiness.

The Chin Dynasty disregarded Confucian philosophy. After defeating the other six kingdoms on what is now the Chinese mainland and establishing a unified dynasty, the ruler of Chin did not give up the wartime policy of high taxation and continued to extort excessive taxes and levies to build the Great Wall, the Terracotta Army, ancient expressways, etc. Taxes and levies added up to two-thirds of farmers' total crops; men began to do corvée at the age of seventeen and could not be exempted until the age of sixty.[4] The rebellion soon started, the Chin Dynasty was quickly overthrown, and the Han Dynasty was established. Confucian philosophy became popular in China, and low taxation was the main principle of government finance for more than two thousand years. For example, Emperor Wen of the Han Dynasty set the agricultural tax rate at one-thirtieth. Throughout Chinese history, almost all influential scholars criticized high taxes and levies in China. Many believed 10 percent is the fairest tax rate.[5] However, some scholars argued that 10 percent is still too high. For example, Ye Shi in the Song Dynasty contended that in the old times, the government could collect 10 percent tax and be able to provide adequate services to all people, but in his time, the government did not provide adequate services to people, therefore the tax rate should be one-twentieth or one-thirtieth.[6] Later historians attributed the collapse of almost every dynasty to heavy taxes and levies.

Implicit Taxation

In modern times, an important feature of a good tax system is transparency. However, implicitness or concealment was a characteristic of the traditional Chinese tax system. Instead of collecting taxes directly and transparently from people, the government often controlled some necessities, such as iron and salt, and sold the products at high prices. Iron was a necessity for production and salt was a necessity for consumption, and demands for these two goods were rather inelastic. By charging monopoly prices, the government could obtain a large amount of revenue. The idea

[3] Zhao (2002). [4] Wang (2013). [5] Ming Huang and Yi Zeng (2016). [6] Ye (1977).

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was put forward by Guan Zhong (723–645 BC), the prime minister of the Qi kingdom (*qi guo*). He wrote that instead of taxation that would reduce people's wealth and make them dislike the government, the government should monopolize the sale of salt, iron, forest products, and ores to obtain revenue.[7] Guan Zhong even detailed his plan as follows. For salt, he suggested letting the public boil seawater to make salt using dead wood as fuel; the government would then collect salt from the public and monopolize the transportation and sale of salt. For iron, he suggested letting the public make iron and submit iron to the government; the government would then sell the iron. The government received 30 percent of the revenue while the private producers received the remaining 70 percent. Guan Zhong also suggested that the government should intervene in the trade of grain through judicious buying and selling to keep the price at a constant level and earn profits. The purpose of collecting taxes implicitly was to deceive people and maintain the ruler's position.

This implicit revenue collection had a profound influence on the Chinese tax system. In every dynasty, the government monopolized the production or sale of some essential products to pursue revenues. Even the sale of tea and cooking oil was monopolized by the government occasionally. After 1949, the government nationalized almost all industrial enterprises, which provided revenues for the new government. After the economic reforms in 1978, the government started to allow private enterprises to develop, but still controlled many SOEs in manufacturing, energy, telecommunication, real estate, and finance. Many SOEs have charged high prices and thus contributed to the government's large amounts of revenue. Today, most of the tax revenue is collected from producers and then the tax burden is transferred to consumers by increasing product prices. Also, in recent decades, local governments in China have monopolized land sales, charging real estate developers extremely high prices for land; the developers then transfer the cost of land to buyers through high housing prices. All of these are implicit ways of taxation.

Balanced Government Budget

For a long time in Chinese history, all political philosophers advocated balancing the government budget – that is, setting government expenditure according to government revenue. Dai Sheng, a statesman during the Han Dynasty (202 BC–AD 220), theorized that annual government

[7] Fang (2017).

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expenditure should equal the average of annual government revenue over the previous thirty years. If so, even with poor harvests due to drought or flood, people would not starve and the emperor could have meat with every meal and enjoy music every day. If the government's accumulated funds are less than the sum of government expenditures over nine years, then the accumulated funds are insufficient; if the accumulated funds are less than the sum of expenditures over six years, then the country is in crisis; and if the accumulated funds are less than the sum of expenditures over three years, then the country should hardly be called a country.[8] Dai Sheng strongly urged the government to run a budget surplus.

During the Han Dynasty, statesman Huan Kuan in his famous book *On Salt and Iron* suggested that government spending should be based on revenue and government should have a surplus.[9] During the Tang Dynasty (618–907), statesman Su Ting argued that the government should estimate its revenue and then decide how much to spend.[10] During the Ming Dynasty (1368–1644), Zhang Juzheng, a famous political reformer, argued that the emperor should determine government expenditures based on revenue and should make efforts to save.[11]

The philosophy of balancing the budget or having a surplus has deeply affected government behavior in Chinese history. The Chinese government followed the doctrine of running budget surpluses before 1894. After the Sino-Japanese War in 1895, the Chinese government began to run budget deficits and accumulated a large amount of debt. In the first half of the 1900s, China experienced many years of war, particularly, the war with Japan (1937–45) and the civil war (1946–9). As a result, the government ran large deficits year after year and government debt skyrocketed.

After the civil war, the communist government adopted the ancient philosophy of balancing the budget or having a surplus. This philosophy was carried on until recent decades. In 1994, the government passed the budget law, clearly indicating that the central government should try to balance the budget and that all local governments must balance their budgets and should not issue bonds.

1.2 Public Finance under the Centrally Planned Economic System

In 1949, the People's Republic of China was established. The government seized all enterprises owned by the nationalist government and enterprises

[8] Long (1995). [9] Chen (2015).
[10] Ouyang and Song, 1060, edited by Chao Zhao (2016). [11] Pan (2014).

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related to nationalist government officials, then turned these enterprises into SOEs. The government allowed other private enterprises to continue to exist. The government also implemented land reforms in rural areas, seizing all land from landlords and allocating land equally to all farmers. The Chinese economy recovered rapidly during the first eight years after 1949. Meanwhile, the government established new tax laws and government revenue increased quickly.

The rapid industrialization of the Soviet Union under a centrally planned economic system inspired the Chinese leaders to follow the Soviet model. By the end of 1956, China completed "socialist economic reforms," turning all large- and medium-sized private enterprises into SOEs and small private enterprises into collectively owned enterprises. In 1958, the government took back the land previously allocated to farmers and established collective farms called the people's communes. A people's commune consisted of around ten large production brigades, and each production brigade consisted of about five small production teams (small villages). Each team was a production unit, owning the land collectively, working together and sharing the after-tax crops. In 1958, China's paramount leader, Chairman Mao, launched the Great Leap Forward (1958–60) aimed at catching up with the United Kingdom and the United States in a short period. It turned out to be a great failure. Poor harvests and the waste of food led to famine and many people died of hunger and disease.

Starting from 1961, the Chinese economy entered five years of adjustments and reforms. Farmers were allocated a small plot of land on which they could grow any crops they liked. Factory workers were awarded bonuses for good performance. The economy quickly recovered, and China entered a period of prosperity. However, Mao believed that these reforms were the same mistakes made by the Soviet Union leaders after the death of Stalin and these reforms could lead China down the wrong road of capitalism. In 1966, he launched the Great Proletariat Cultural Revolution to prevent China from going onto the capitalist road. Farmers' private plots were taken back and bonuses and awards were no longer given to workers. The revolution lasted for ten years and the economy stagnated. People suffered from poverty and endless political struggles.

China has five levels of government: the central government, provincial governments (autonomous regions and province-level municipalities), prefecture governments (including prefecture-level cities), county governments (including county-level cities), and township governments (people's communes).

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From 1958 to 1978, China's public finance was based on a centrally planned economic system. The government adhered to all traditional philosophies of public finance such as a balanced budget and implicit but low taxation. The government adopted a uniform budgeting approach. Under this approach, local governments and SOEs submitted all their revenues to the central government and the central government then allocated these revenues to local governments, central government agencies, and SOEs for their expenditures.

Government revenue consisted mainly of the contributions from SOEs. In 1978, the contributions from SOEs accounted for more than 50 percent of total government revenue. The government collected agricultural taxes by explicitly requiring farmers to submit a part of their crops to the government and then implicitly forcing farmers to sell a part of their crops to the government at a much lower-than-market price. Since wages were low, the individual income tax was not collected until 1980. In 1978, total government revenue accounted for more than 30 percent of GDP. In addition to budgetary revenue, the Chinese government had extra-budgetary revenues, which were collected by local governments, government agencies, government institutions, and SOEs. In 1978, the extra-budgetary revenue accounted for 10 percent of GDP.

Government expenditures include budgetary and extra-budgetary expenditures. Budgetary expenditures were proposed by fiscal authorities at every level of government and approved by the People's Congresses at every level. The government allocated a large amount of its expenditure to public investment in building roads, bridges, ports, dams, etc. For example, in 1959, government spending on economic construction accounted for 71.7 percent of total spending (Figure 6.4).

A social security system was established in China in the early 1950s for workers of SOEs, collectively owned enterprises, government administrative units (e.g., Ministry of Education), and operative units (e.g., public universities and state-owned hospitals). The social security system was run by the government and financed by general fiscal revenue. During the Cultural Revolution, the economy was in chaos and the social security system encountered a severe payment crisis. Each SOE had to pay social security benefits to its retirees using its own revenue. Rural residents did not have any social security and had to rely completely on family for old-age support. Each village provided collective support to the old without descendants and to the disabled without family members.

The government also established health insurance systems for government employees and employees of SOEs. In the early 1950s, China

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established Labor Health Insurance (LHI) for employees of SOEs and collectively owned enterprises, and Government Health Insurance (GHI) for employees of government administrative and operative units. The funds for GHI came from the general fiscal revenue. Labor Health Insurance was managed by various labor departments, which collected funds from each enterprise to cover their employees' medical expenses. To control the healthcare expenditures of SOEs, each enterprise's total medical spending was limited to a fixed proportion of the enterprise's total revenue. All large SOEs had their own healthcare clinics or hospitals, schools, nursery schools, and so on, just like a small society.

A medical cooperative system (MCS) was established in rural China in the late 1960s. Each village union established a medical cooperative station, which was financed by the rural residents themselves and the village administration. Selected farmers with rudimentary medical training served as so-called barefoot doctors and provided healthcare services to rural residents. For treatment of serious illnesses, rural residents had to go to hospitals owned by the government of the township, county, prefecture, or province and pay all expenses themselves. The government provided free immunizations to rural residents. The public healthcare system was effective in controlling infectious diseases through immunization, improving sanitation, and controlling disease vectors, including mosquitoes for malaria and snails for schistosomiasis.

Starting from 1958, migration from rural to urban areas was restricted. A rural–urban resident system was established in China and it became very difficult to change from a rural residency to an urban one. A newborn is a rural resident if his/her mother is a rural resident, and a newborn is an urban resident if his/her mother is an urban resident. Rural residents could only become urban residents by attending colleges after passing competitive examinations or joining the military and being promoted to a certain rank. This household registration system was an insurmountable obstacle against rural residents moving to urban areas. For several decades, urban residents had government-provided jobs, guaranteed food, and social insurance while rural residents did not. Rural residents were second-class citizens and their lives were much harder than urban residents' lives.

For several decades, the Chinese government followed a balanced budget philosophy. The basic budgetary principle was "balanced budget or with a small surplus." From 1949 to 1957, the government financed deficits by issuing both domestic and foreign debt. China and the Soviet Union signed the China–Soviet Friendship Allies Mutual Assistance Treaty, and the Chinese government borrowed money from the Soviet

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Union to complete some essential projects. In the late 1950s, the relationship between China and the Soviet Union deteriorated due to ideological differences. The Chinese government's borrowing from the Soviet Union came to an end. From 1959 to 1980, China did not issue any domestic bonds and it printed money to finance budget deficits when necessary.

Under the centrally planned system, local governments served as branches of the central government. They collected revenues but strictly followed the central government's command on how to spend these revenues. In 1978, the central government's share of total revenue was 15.5 percent and the local governments' revenue share was 84.5 percent (see Table 11.1). That does not mean China had fiscal decentralization. Generally, in public finance, the local governments' share of fiscal revenue or expenditure is used to measure the degree of fiscal decentralization. However, this measure is not suitable for China since only the central government can determine how to use the revenue. Thus, China's fiscal system was highly centralized before 1978 though the revenue share of local governments was high.

1.3 Market-Oriented Public Finance Reforms

The socialist system has two unsolvable problems. First, managers and workers lack incentives to work. Second, it is very difficult to make good plans and implement them accordingly. The main problem with the socialist public finance system was that local governments and SOEs lacked fiscal freedom. To address the problem, in the late 1970s, the central government allowed SOEs to issue bonuses to workers, and in the 1980s, the government launched a reform called "substituting taxes with profits" (*li gai shui*), to provide SOEs with incentives to pursue profits, to reduce the fiscal dependence of SOEs on the government, and to promote market competition. Other reforms included granting local governments freedom to pursue revenues and to spend the revenues at their will.

However, the earlier reforms had caused a decline in the share of total government revenue in output, and giving local governments more fiscal freedom had caused a decline in the central government's share of total government revenue. In 1993, the share of general fiscal revenue in GDP was only 12 percent and the revenue share of the central government in total government revenue was only 22 percent.[12] The central government was determined to reverse this trend.

[12] Ministry of Finance of China (1994).

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