

# China's Fiscal Predicament

Chen-yuan Tung

*American Asian Review*

vol. XXI, no. 1, (Spring 2003), pp. 25-53.

## **Abstract**

Chinese current fiscal situation exists a huge gap between the available resources and the inevitable fiscal need for the Chinese government. Beijing was unable to significantly improve its fiscal position through adopting new fiscal systems because of the strong opposition of local governments. As a result, the Chinese government heavily relies on debts to sustain the fiscal function and the fiscal sustainability of the Chinese government is fatally threatened in the future.

Specifically, on the one hand, it is imperative for Beijing to continue its proactive fiscal policy to maintain necessary and vital rapid economic growth; on the other hand, the Chinese fiscal expansion needs to be reduced as soon as possible because of the concerns of mounting deficit and debts. This poses a serious dilemma for China. In addition, Chinese current tax system does not moderate, but exacerbate regional inequalities. China needs to install an adequately funded system of equalization grants in order to balance regional inequalities. Moreover, China must change the basis of rural taxation in order to prevent deteriorating social instability in the rural area.

## I. Fiscal Reforms in China

In the reform era, the Chinese central government delegated greater economic power to local officials in order to win their support for economic reforms and to increase the central government's revenues. Initially, Beijing adopted the "eating in separate kitchens" reform in 1980 because the central government was faced with a debilitating fiscal deficit in the late 1970s. This reform required localities to bear greater financial responsibilities, including in basic education, public works, public health, and welfare subsidies. The Center hoped that decentralization would give local governments sufficient incentives to maximize budgetary revenues, thus making the fiscal "pie" bigger, which, in turn, would enlarge the size of the Center's own slice. Thus, decentralization was not a grace from the central government, but a trade-off between obligation and revenues for both the Center and the localities.<sup>1</sup>

As a result, Beijing must now secure local consent to any new revenue-sharing arrangements. Given the localities' considerable financial responsibilities, Beijing must either compensate them for any resulting losses, or must redistribute such responsibilities. Otherwise, such an arrangement could be very counter-productive. For example, in 1983, the central government introduced the taxes-for-profit system designed to reduce the negotiability of enterprises' financial obligations to the state treasury and to restore central strength and authority. In an effort to win approval for the new system, the Center made two fateful compromises: (1) enterprises would retain about the same amount of money under the new system as they retained under the old system; (2) there would be no change in the distribution of central-local finances. In other words, to overcome the (potential) resistance of key local interests (factory managers and local officials), the Center agreed that the redistributive dimensions of the new system would be minimal.<sup>2</sup>

However, even with the above compromises of the Center, the new system threatened the financial position of local governments and diminished their patronage over local enterprises. On the one hand, local enterprises were supposed to pay taxes to local governments; on the other hand, many local enterprises were joint ventures with local government ownership. With retained

---

<sup>1</sup> Shaoguang Wang, "Central-Local Fiscal Politics in China," in Hao Jia and Zhimin Lin (eds.), *Changing Central-Local Relations in China: Reform and State Capacity* (Boulder: Westview Press, 1994), 92-94. Shaoguang Wang and Angang Hu, *The Chinese Economy in Crisis: State Capacity and Tax Reform* (Armonk, New York: M.E. Sharpe, 2001), 50-51. Xiangyang Xin, *Bainian Boyi: Zhongguo Zhongyang yu Difang Guanxi Yibai Nian* [A Hundred-Year Game: 100-Year Relationship between the Center and the Localities in China] (Jinan, Shandong: Shandong Renmin Chubanshe, 2000), 247-48.

<sup>2</sup> David Bachman, "Implementing Chinese Tax Policy," in David M. Lampton (ed.), *Policy Implementation in Post-Mao China* (Berkeley: University of California Press, 1987), 140-45.

profits accruing to the benefit of “local shareholders,” there was a continued incentive to shift deficits to the Center and hide profits from taxation. Therefore, local enterprises and local governments had reasons to collude to hide revenues from the center by diverting offbudget into myriad extrabudgetary funds, which were financed by fees, charges, and other levies. Partially due to resistance from local governments, both profit margins and tax margins began to slope downwards beginning in early 1985 and for some twenty-two successive months. Faced with this situation, the Center had no choice but to give up the taxes-for-profit experiment in 1987.<sup>3</sup>

Since at least 1987, the central leadership has been concerned about the growing budget deficit, which increased from 0.3 percent of GDP in 1980 to 1.3 percent in 1988. In addition, the central government’s share of national revenues fell from 38.5 percent in 1985 to 28 percent in 1993 and to 22 percent in 1993. As a result, during the early 1990s, the Center considered the central government’s share of total collected revenues (averaged 3.6 percent of GDP during 1991-93) to be seriously inadequate. Furthermore, Beijing wanted to change the particularistic fiscal contracting system to an arrangement with separate tax systems for the Center and localities, in order both to rationalize the fiscal structure and to raise the Center’s share of revenues. However, at the end of 1990 and the beginning of 1991, as part of the discussions that resulted in the Eighth Five-Year Plan, Beijing failed to introduce its new financial arrangement, because of resistance from a number of the wealthier provinces.<sup>4</sup>

In the second half of 1993, the central government, represented by then Vice-Premier Zhu Rongji, began to negotiate with the local governments over new fiscal arrangements. The new tax assignment system (*fen shui zhi*), which was adopted in 1994, clearly delineated central, local, and shared taxes and established central administration for the major taxes. It was an attempt to establish a uniform tax system and was designed to strengthen the central government’s extractive capacity, by raising its share of national fiscal revenue, and the share of state fiscal revenue in GDP.<sup>5</sup>

The central government made at least two significant concessions to the local governments

---

<sup>3</sup> Bachman, “Implementing Chinese Tax Policy,” 157-89. Shaoguang Wang, “Central-Local Fiscal Politics in China,” 95-96.

<sup>4</sup> David S. G. Goodman, “The Politics of Regionalism: Economic Development, Conflict and Negotiation,” in David S. G. Goodman and Gerald Segal (eds.), *China Deconstructs: Politics, Trade and Regionalism* (New York: Routledge, 1994), 6. Dali L. Yang, “Reform and the Restructuring of Central-Local Relations,” in David S. G. Goodman and Gerald Segal (eds.), *China Deconstructs: Politics, Trade and Regionalism* (New York: Routledge, 1994), 74-75.

<sup>5</sup> Szu-chien Hsu, “Central-Local Relations in the PRC under the Tax Assignment System: An Empirical Evaluation, 1994-1997,” *Issues & Studies*, vol. 36, no. 2 (March/April 2000): 38.

in order to secure their willingness to participate in the new system. The first concession was the “tax return” (*shui shou fan huan*), a form of compensation for possible losses by the provinces. This concession was made in order to ensure that the amount of local revenue in each province would not decrease in comparison with the old system. The second concession was that the tax return for the following year was to be calculated in an incremental way, based on the growth in each province, instead of according to a national average. This concession, of course, weakened the re-distributive effect of the tax assignment system. Nonetheless, these concessions were necessary to obtain local cooperation.<sup>6</sup>

Yet after the tax assignment system was implemented, the central government had not significantly increased its revenue-extractive capacity because local governments continued to undermine the state’s ability to extract fiscal resources from the growing economy. For example, while the extra-budgetary fiscal revenues<sup>7</sup> of the central government were brought under control after 1993, declining from RMB 170.8 billion in 1992 (44.3 percent of total state extra-budgetary revenues) to RMB 23 billion (6.8 percent) in 1999, those of the local governments skyrocketed from RMB 214.7 billion (55.7 percent of total state extra-budgetary revenues) to RMB 315.5 billion (93.2 percent).<sup>8</sup> Hsu Szu-chien, a scholar at the National Chengchi University in Taiwan, contends that this may be seen as a counter-strategy adopted by the local governments in the face of the central government’s new rules on the distribution of fiscal resources, notwithstanding the central government’s major concessions to gain local support for those rules.<sup>9</sup>

## II. Chinese Current Fiscal Position

Table 1 shows that the central government’s share of total state revenue collection increased rapidly from 20.2 percent in 1979 to 38.4 percent in 1985, but declined gradually until 1994. Nevertheless, on the eve of the 1994 fiscal overhaul, this share stood higher than its 1979 level. With the introduction of the tax assignment system in 1994, the Center’s share jumped to 55.7 percent in 1994, but had declined slightly to around 52 percent in 2000. As a matter of fact, this

---

<sup>6</sup> Hsu, “Central-Local Relations in the PRC,” 39-41.

<sup>7</sup> Extra-budgetary revenues are revenues in the public sector that are not subject to central budgetary control, such as various charges and fees collected by local governments.

<sup>8</sup> Because adjustment on the coverage of extra-budgetary revenues and expenditures from 1993 to 1995 and in 1998 has made, the figures are not comparable with the previous years. Since 1997, the extra-budgetary revenue and expenditures do not include the intra-budgetary government funds (fee), the figures are not comparable with the previous years. The rapid decline of the central extra-budgetary fiscal revenues was in part due to the exclusion from the extrabudgetary accounts of state-owned enterprise profits after 1993.

<sup>9</sup> Hsu, “Central-Local Relations in the PRC,” 51-52. See also Wang and Hu, *The Chinese Economy in Crisis*, 212-78.

share declined steadily in 1995-1997, and has risen slowly in 1998-2000 as a result of improved tax administration, especially the anti-smuggling effort (since all customs related taxes accrue to the Center), combined with more effective treasury controls. But the Center's objective of raising the central share to 60 percent has in general not been achieved.<sup>10</sup>

Table 1. Share of Central Government in State Revenue Collection, Disposable Revenue, and Expenditures, 1979-2000

Year	Revenue collection (%)	Disposable revenue (%)	Expenditures (%)
1979	20.2	46.8	51.1
1982	28.6	51.2	53.0
1985	38.4	51.2	39.7
1988	32.9	44.3	33.9
1991	29.8	39.0	32.2
1992	28.1	37.9	31.3
1993	22.0	31.6	28.3
1994	55.7	29.3	30.2
1995	52.2	27.4	29.2
1996	49.4	27.4	27.1
1997	48.9	28.8	27.4
1998	49.5	n.a.	28.9
1999	51.1	n.a.	31.5
2000	52.2	n.a.	34.7

Note:

Disposable revenue is the sum of centrally-collected revenue and remittances from the provinces, through revenue sharing, minus regime subsidies and tax return from the central government to local governments.

Source:

National Bureau of Statistics (PRC), *China Statistical Yearbook*, no. 20 (2001) (Beijing: China Statistics Press, 2001), 257.

Zhongli Liu, *Zhongguo Caizheng Fazhan Wenti Yanjiu* (The Study on Chinese Fiscal Development Issues) (Beijing: Zhongguo Caizheng Jingji Chubanshe, 1999), 95.

With its *shui shou fan huan* concession, however, although the central government collects the majority of state revenues, it lacks real control, since the provinces are essentially allowed to

<sup>10</sup> Ehtisham Ahmad, Li Keping, Thomas Richardson, and Raju Singh, "Recentralization in China?," *IMF Working Paper*, WP/02/168, 7-10.

automatically claim most of those funds. Therefore, the budgetary strength of the Center should be measured by its share of disposable revenue. According to Finance Minister Liu Zhongli, the share of disposable revenue for the central government (A) is the ratio of the sum of centrally-collected revenue (B) and remittances (C) from the provinces (through revenue sharing) minus regime subsidies (D) and tax return (E) from the central government to local governments, to total national budgetary revenue (F), as shown in the following formula.<sup>11</sup>

$$A = [(B+C) - (D+E)] / F$$

The Center's disposable revenue increased from 46.8 percent of total state revenues in 1979 to 51.2 percent in 1985, but has declined since then. By 1993, the Center's share of disposable revenue was only 31.6 percent. After adoption of the new tax assignment system in 1994, it had further declined to 28.8 percent by 1997.

After the 1994 new tax assignment system, though the Center's total revenues to GDP reversed the trend of declining over the past ten years, the central government's disposable revenues did not increase in terms of GDP. There were three clear effects of the new system: First, revenues collected by the Center increased from averaged 3.6 percent of GDP during 1991-93 to 6.2 percent of GDP during 1994-2000. Second, transfers from local governments to the Center declined from averaged 2 percent of GDP during 1991-93 to 0.9 percent of GDP during 1994-2000. Third, transfers from the Center to local governments increased enormously from 2.1 percent of GDP during 1991-93 to 4.5 percent of GDP during 1994-2000. As a result, the Center's disposable revenues (equal to total central revenues minus transfers to local governments) did not increase, but declined from 3.5 percent of GDP during 1991-93 to 2.6 percent of GDP during 1994-2000. (See Table 2.)

Table 2. The Central Government's Disposable Revenues in Terms of GDP, 1990-2000

	Unit: % of GDP										
Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total Central revenues	8.0	6.6	5.8	4.5	7.4	6.6	6.2	6.5	6.9	7.8	7.8
Collected revenues	5.4	4.3	3.7	2.8	6.2	5.5	5.3	5.7	6.2	7.1	7.1

<sup>11</sup> Zhongli Liu, *Zhongguo Caizheng Fazhan Wenti Yanjiu* (The Study on Chinese Fiscal Development Issues) (Beijing: Zhongguo Caizheng Jingji Chubanshe, 1999), 94-99.

Transfers from local levels	2.6	2.3	2.1	1.7	1.2	1.0	0.9	0.8	0.8	0.7	0.7
Transfers to local levels	3.2	2.6	2.2	1.6	5.1	4.2	4.0	3.8	4.2	5.0	5.0
Disposable revenues	4.8	4.0	3.6	2.9	2.3	2.4	2.2	2.7	2.7	2.8	2.8

Note: Disposable revenues = total revenues (collected revenues and transfers from local levels) – transfers to local levels.

Source: Ehtisham Ahmad, Li Keping, Thomas Richardson, and Raju Singh, “Recentralization in China?,” *IMF Working Paper*, WP/02/168, 8.

In addition, the Center’s share of national expenditures dropped from more than 50 percent in 1979-1984 to less than 30 percent in 1993-1998, then increased to 34.7 percent in 2000. In comparison, among twenty major developed and developing countries examined by the IMF, central governments accounted for 80.6 percent of disposable revenue and 70.1 percent of expenditures (on average) in 1994.<sup>12</sup>

Furthermore, over the past two decades, the resources available to the Chinese state to tackle the staggering challenges of economic development and social security reforms ahead have been declining in terms of both the share of state budget and the share of expenditure for the central government to its GDP. State fiscal revenues declined from 28.4 percent of GDP in 1979 to 10.7 percent in 1995, and then rose to 15 percent in 2000. State expenditures declined from 31.8 percent of GDP in 1979 to 11.7 percent of GDP in 1995 and then up to 17.8 percent in 2000, well below the developing country average of 32 percent.<sup>13</sup> In particular, the share of resources controlled by the Chinese central government in terms of GDP has been declining more rapidly. Despite the shares of *collected* revenue of the Chinese central government maintained at around 5-7 percent of GDP in the 1980s and 1990s, the share of its expenditure to GDP declined sharply from 16.2 percent in 1979 to 3.2 percent in 1996, then up to 6.2 percent in 2000 (see Table 3).<sup>14</sup> In fact, the rapid increase of the share of the Center’s expenditure to GDP in 1998-2000 reflected the rapid growing fiscal debts of the central government.

<sup>12</sup> Le-Yin Zhang, “Chinese Central-Provincial Fiscal Relationships, Budgetary Decline and the Impact of the 1994 Fiscal Reform: An Evaluation,” *China Quarterly*, no. 157 (March 1999): 121-40.

<sup>13</sup> World Bank, *China 2020: Development Challenges in the New Century* (Washington, D.C.: World Bank, 1997), 24-25.

<sup>14</sup> Before state-owned enterprise (SOE) reforms, SOE investment was accounted as the expenditure of the central government. Now, the central government is no longer responsible for that investment. Therefore, in addition to other reasons, this change also contributes to the reduction of overall expenditure of the central government.

Table 3. Chinese Fiscal Position, 1979-2000

Period	1979	1988	1994	1995	1996	1997	1998	1999	2000
State Revenue (RMB billion)	114.6	235.7	521.8	624.2	740.8	865.1	987.6	1144.4	1339.5
Share of GDP (%)	28.4	15.8	11.2	10.7	10.9	11.6	12.4	14.0	15.0
State Expenditure (RMB billion)	128.2	249.1	579.3	682.4	793.8	923.4	1079.8	1318.8	1588.7
Share of GDP (%)	31.8	16.7	12.4	11.7	11.7	12.4	13.6	16.1	17.8
Collected revenue by the central government (RMB billion)	23.1	77.5	290.7	325.7	366.1	422.7	489.2	584.9	698.9
Share of GDP (%)	5.7	5.2	6.2	5.6	5.4	5.7	6.2	7.1	7.8
Expenditure of the central government (RMB billion)	65.5	84.5	175.4	199.5	215.1	253.3	312.6	415.2	552.0
Share of GDP (%)	16.2	5.7	3.8	3.4	3.2	3.4	3.9	5.1	6.2

Note:

1. The state revenue refers to revenue actually collected by the central and local governments.
2. Revenue in this table does not include revenue from domestic and foreign borrowings, and expenditure does not include the payment of the principal and interest of domestic and foreign debts and the expenditure for capital construction using foreign loans.

Source:

National Bureau of Statistics (PRC), *China Statistical Yearbook*, no. 20 (2001) (Beijing: China Statistics Press, 2001), 245-46, 257-58.

### III. Chinese Central Government Finance

#### Economic Reforms

Chinese current fiscal position has enormously limited Beijing's ability to respond to the inevitable need to spend more on economic development, social security reforms (i.e., reforms of pensions and unemployment insurance), and environmental protection. According to the 1997 World Bank report, the overall annual expenditure shortfall in the high-priority areas, such as spending on health, education, poverty alleviation, pensions, infrastructure, and environment protection, has been estimated at 4.6 percent of GDP or 135 percent of the 1997 total expenditure of the central government.<sup>15</sup> The World Bank estimates that between 1995 and 2004 China would need to invest \$744 billion, about RMB 6 trillion, or 103 percent of its 1995 GDP, in

<sup>15</sup> World Bank, *China 2020*, 102-03.



electric power, telecommunications, transportation, and water and sanitation infrastructure.<sup>16</sup>

The above estimate is very conservative because it does not include extra spending to support future economic reforms – such as payments for laid-off workers of state-owned enterprises (SOEs), monetizing housing benefits, or the costs of reforming the banking system. For example, in 1998 the central government provided RMB 18 billion for reform of SOEs and for supporting post-flood rehabilitation. In early 1999, Chen Qingtai, vice minister of the State Economic and Trade Commission, pointed out that the direct cost for reforming SOEs in the next three years would range from RMB 600 billion to 800 billion (more than twice the 1998 total central government expenditures).<sup>17</sup>

Regarding the costs of reforming the banking system, in 1998 the State Council issued RMB 270 billion of special treasury bonds to recapitalize four major state-owned commercial banks. In 2001, Dai Xianglong, governor of the People's Bank of China (the central bank), admitted that China's non-performing loans (NPLs) were still as high as RMB 3,549 billion or about 40 percent of its GDP in 2000, including NPLs transferred to four asset management companies (AMCs).<sup>18</sup> According to Pieter Bottelier, a professor at the Johns Hopkins University School of Advanced International Studies, the aggregate stock of remaining NPLs plus those transferred to the AMCs may range from RMB 4,000 to 4,500 billion at the end of 2000. Including losses accumulated elsewhere in the public financial system, Bottelier estimates that total irrecoverable losses in the state financial sector are RMB 3,700-4,250 billion (US\$ 450-510 billion or 45-50 percent of GDP). This ultimately needs to be paid by the central government.<sup>19</sup>

## **Social Security Reforms**

The urgency of social security reforms comes not only from the need to delink social welfare responsibilities from state enterprise management so as to accelerate SOE reform, but a sound social security net is also needed for current unemployed persons, laid-off workers, illegal rural migrants in Chinese cities, known as the “floating population,” and rural residents in order

---

<sup>16</sup> World Bank, *Infrastructure Development in East Asia and Pacific: Towards a New Public-Private Partnership* (Washington, D.C.: World Bank, 1995), 4.

<sup>17</sup> “Reform of State-Owned Enterprises Needs 800 Billion Yuan in Next 3 Years” (in Chinese), Hong Kong *Ming Pao*, November 11, 1998, p. b15, in FBIS-CHI-98-317.

<sup>18</sup> Zhang-rong Kang, “Dai Xianglong: Commercial Banks' NPLs Account for 25%,” *Gongshang Shibao* [Commerce Times], March 27, 2001.

<sup>19</sup> Pieter Bottelier, “China's Domestic Debts: Will They Interfere with Financial Sector Liberalization and WTO Commitments? Issues and Strategies,” Discussion paper for Wilton Park Conference #654 on Economic and Enterprise Reform in China: the Challenges for Government and Business, November 5-8, 2001, 5-6.

to avoid large-scale social instability. For example, in late 1995, in Nanchong, a Sichuan city, 20,000 workers besieged the town hall for 30 hours in protest at not being paid for six months.<sup>20</sup>

Available sources indicate that many types of social conflicts are on the rise at a rapid pace in China in recent years. In late February 2000, more than 20,000 workers and their families in Yangjiazhangzi, a mining town 250 miles northeast of Beijing, battled with police and soldiers for three days. The miners were incensed over the loss of their jobs and the alleged corruption of officials. They burned car, barricaded streets, smashed windows and set oil drums afire in protests that were finally quelled by a detachment of soldiers from the PLA.<sup>21</sup> In late December 2001, around 2,000 workers occupied the Shuangfeng Textile Factory to protest corrupt officials, missing pension funds, and mass layoffs. They battled repeatedly with police for two weeks.<sup>22</sup> In March 2002, as many as 80,000 laid-off workers in heavy-industrial cities Fushan, Daqing, and Liaoyang of northeast China took to the streets. These protests, demanding job-offers, living allowances, and pensions, last for couple weeks.<sup>23</sup>

Furthermore, demographic change in China rapidly worsens the situation. According to the United Nations, the proportion of those 60 years old and above will grow from 7.6 percent of the Chinese population in 1982 to 9.8 percent in 2000, and further to 15.2 percent in 2020. This trend is driving up the cost of health care and pensions. In addition, the Chinese labor force growth is slowing. In 1978 there were thirty workers contributing to the pension system for each retiree, but in 1997 there were ten people of working age for every pensioner. By 2020 there will be six, and by 2050 only three. Moreover, an additional 16 years of life for the average worker retiring today and indexing pensions to wages has dramatically increased the pension burden.<sup>24</sup>

More immediately, China is already facing a pension crisis in its state enterprises. Some enterprises have more pensioners than workers. As the financial performance of enterprises weakened in the 1990s, a growing number of firms discontinued or delayed making contributions to local pension pools. The World Bank estimates that the reserves of the pension system in the mid-1990s were only RMB 30 billion, or only 0.6 percent of GDP and less than a third of the pension payments made to retirees in 1994. By the end of March 1999 total social premium

---

<sup>20</sup> Geoffrey Murray, *China: The Next Superpower* (New York: St. Martin's Press, 1998), 25.

<sup>21</sup> John Pomfret, "Miners' Riot A Symbol of China's New Discontent," *Washington Post*, April 5, 2000, A1.

<sup>22</sup> Philip P. Pan, "'High Tide' of Labor Unrest in China," *Washington Post*, January 21, 2001, A1.

<sup>23</sup> Robert Marquand, "China Faces Growing Labor Unrest," *Christian Science Monitor*, March 25, 2002, p. 6. John Pomfret, "With Carrots and Sticks, China Quiets Protesters," *Washington Post*, March 22, 2002, A24.

<sup>24</sup> United Nations Development Programme (China), *The China Human Development Report* (New York: Oxford University Press, 1999), 65. Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), 44-47.

arrears of enterprises, including contributions both for pensions and unemployment insurance funds, were RMB 33 billion. The World Bank characterizes China's situation as a "pension crisis in the state-owned enterprise sector" and an "urgent and immediate problem."<sup>25</sup>

In addition, in the late 1990s, around 90 million persons in the rural labor force, who were wage-employed in town and village enterprises, and 88 million<sup>26</sup> the floating population, were not provided by a retirement pension and unemployment insurance. Furthermore, there were about 120-140 million<sup>27</sup> labor surplus in the rural area, where there was virtually not a social security system in the late 1990s. Moreover, China's rate of unemployment plus laid-off workers at least doubled between 1993 and 1998 and would continue to double in the early 2000s.<sup>28</sup> If Chinese economic growth slows down, enormous unemployed and laid-off workers, floating population, and surplus labor would trigger severe social instability, and even turmoil in China.

Despite the urgency of social security reforms, Beijing has insufficient funds to support adequate reforms. The World Bank estimates that implicit pension debt in the mid-1990s was equal to about 50 percent of China's GDP. A World Bank expert estimates that in 2000 the implicit social security debt was about 71 percent of GDP. Bank of China International estimates unfunded obligations were about 79 percent of GDP in 2000.<sup>29</sup> According to an estimate by Nicholas Lardy (a senior fellow at the Brookings Institution), *annual* social expenditure financed by enterprises that should be shifted to fiscal financing might amount to 3.3 percent of GDP.<sup>30</sup> In 1998 and 1999 the central government resorted to ad hoc fiscal transfers in order to settle outstanding pension obligations, and undertook a significant centralization in the form of mandatory provincial pooling for all industrial enterprises, regardless of ownership or industry.<sup>31</sup> In 2000 Beijing injected only RMB 87.6 billion, or less than one percent of China's GDP, into the program of pension and unemployment insurance. Note the 2000 injection was already one-third more than that in 1999, but far from sufficient in order to establish a sound social security system

---

<sup>25</sup> Nicholas R. Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, 19-20. Athar Hussain, "Social Welfare in China in the Context of Three Transitions," unpublished manuscript, 21. World Bank, *China: Pension System Reform* (Washington, D.C.: World Bank, 1996), ix, 2, 15, 26.

<sup>26</sup> "National Migrants Across Provinces Were More Than 40 Million" (in Chinese), National Bureau of Statistics of China, September 9, 2002, <http://www.stats.gov.cn/tjfx/jdfx/200209090124.htm>.

<sup>27</sup> United Nations Development Programme, *The China Human Development Report*, 63.

<sup>28</sup> World Bank, "China," *China Quarterly*, March 20, 2000: 12. World Bank, "China," *China Quarterly*, September 18, 2000: 12.

<sup>29</sup> Gordan G. Chang, "Appendix: Pension and Other Social Security Obligations," Research Paper, US-China Commission, <http://www.uscc.gov/chang.htm>, accessed October 17, 2002, 2.

<sup>30</sup> Lardy, *China's Unfinished Economic Revolution*, 161.

<sup>31</sup> Ahmad, et. al., "Recentralization in China?," 19.

in China.<sup>32</sup>

## Environmental Protection

Many Chinese localities suffered from the negative effects of desertification. Chinese statistics show that desertification has been causing an annual direct economic loss of RMB 207 billion (\$25 billion) for China by the late-1990s.<sup>33</sup> According to the U.S. National Intelligence Council, economic losses due to drought in the arid northern plain of China are estimated at more than RMB 133 billion (\$16 billion) in 2000.<sup>34</sup> In addition, the World Bank estimates that the annual costs of air and water pollution in China were between RMB 262 billion (3.5 percent of GDP) and RMB 577 billion (7.7 percent of GDP) by 1997, a number that is expected to almost double by the year 2020.<sup>35</sup> According to Xinhua News Agency, by 2001, water shortages were the cause of economic losses amounting to more than RMB 120 billion annually.<sup>36</sup>

Finally, natural disasters, exacerbated by Chinese environmental destruction and over-development, has also brought serious damage and sizeable costs to the Chinese. According to Hu Angang, a scholar of the Chinese Academy of Sciences, annual direct economic loss due to natural disasters between 1990 and 1994 was on average RMB 119 billion, between 3 to 5 percent of GDP.<sup>37</sup> During the 1990s, on average 380 million people, or one third of China's population, were affected by natural disasters every year.<sup>38</sup>

Despite this serious environmental damage, investment in environmental protection remains very limited because of the fiscal constraint of the Chinese government. China contributed a mere 0.9 percent of its GDP to environmental protection spending for the 1996-2000 period and will raise the expenditure to 1.2 percent for the 2001-05 period. It was estimated by the Chinese government that between 1996 and 2001 China needed to spend an annual RMB 1.5 billion to

---

<sup>32</sup> "PRC Xiang Huaicheng Says Government to Provide More Funds for Social Security," Beijing Xinhua, March 10, 2001, in FBIS-CHI-2001-0310.

<sup>33</sup> "Xinhua: China 10<sup>th</sup> Five-Year Plan Gives Priority to Environmental Protection," Beijing Xinhua, March 12, 2001, in FBIS-CHI-2001-0312. Zhengling Kou, "Desertification, a Grave Threat to China," *Beijing Review*, September 21-27, 1998: 22.

<sup>34</sup> Melinda Liu, "Waiting for Rain," *Newsweek* (Atlantic edition), August 21, 2000, 44.

<sup>35</sup> World Bank, *Clear Water, Blue Skies: China's Environment in the New Century* (Washington, D.C.: World Bank, 1997), 23, 37.

<sup>36</sup> "Xinhua: China Moves to End Water Crisis," Beijing Xinhua, March 7, 2001, in FBIS-CHI-2001-0307.

<sup>37</sup> Angang Hu, "Great Challenges Faced in China's Reforms," In Angang Hu (ed.), *Zhongguo Zoxiang* [Prospects of China] (Hangzhou, Zhejiang: Zhejiang Renmin Chubanshe, 2000), 46-47.

<sup>38</sup> "Disasters Kill 4,610, Cost \$36.4 Billion in 1998," Beijing Xinhua, October 16, 1998, in FBIS-CHI-98-289.

prevent desertification, while, in reality Beijing only invested an annual RMB 30 million.<sup>39</sup>

#### IV. Stabilizing Economy/Maintaining Economic Growth

To maintain necessary economic growth rate after 1997, the government resorted to fiscal expansion to boost domestic demand. The State Council issued RMB 100 billion treasury bonds in 1998, RMB 110 billion in 1999, and RMB 150 billion in 2000 and 2001, to finance investment to improve the country's infrastructure. According to Xiang Huaicheng (finance minister) and Zeng Peiyan (chairman of the State Development Planning Commission), implementation of a pro-active fiscal policy has stimulated economic growth by 1.5 percentage points in 1998, 2.0 percentage points in 1999, 1.7 percentage points in 2000, and 1.8 percentage points in 2001. That is, the fiscal expansion contributed around 25 percent of Chinese economic growth rates during 1998-2001. These bonds totaled RMB 510 billion and almost equaled to the total expenditures of the central government in 2000. If this practice continues for a sustained period, this will generate enormous fiscal burdens in the future, as these bonds will have to be serviced.<sup>40</sup>

There is an emergent need for Beijing to maintain the continuous proactive fiscal policy. In March 2002, Premier Zhu Rongji said in a press conference that if the Chinese government had not adopted its proactive fiscal and prudent monetary policy between 1998 and 2002, "China's economy would probably have collapsed."<sup>41</sup> In the same month, Premier Zhu told economist Stephen Roach of Morgan Stanley, "Without pro-active fiscal stimulus, the (Chinese) economy would have collapsed in early 1998."<sup>42</sup>

However, in April 2002, Chinese Finance Minister Xiang Huaicheng stressed, "The Fiscal situation is grim. Revenue is growing too slow and expenditure is growing too fast. Not enough money is being collected and too much is being spent."<sup>43</sup> He said, "The proactive fiscal policy

---

<sup>39</sup> "Xinhua: China 10<sup>th</sup> Five-Year Plan Gives Priority to Environmental Protection," Beijing Xinhua, March 12, 2001, in FBIS-CHI-2001-0312.

<sup>40</sup> Chu-yuan Cheng, "China's Economy: Recent Development and Long-Term Prospects," *Issues & Studies*, vol. 36, no. 5 (September/October 2000): 130-32. "Major Decision, Successful Practice – State Planning Commission Official Answers Reporter's Questions on Three-year Treasury Bond Investments" (in Chinese), Beijing Xinhua Domestic Service, December 29, 2000, in FBIS-CHI-2000-1229. "Xiang Huaicheng on PRC's 'Pro-Active Fiscal Policy' in Report to NPC," Beijing Xinhua, March 6, 2001, in FBIS-CHI-2001-0306. Peiyan Zeng (ed.), *Report on China's National Economic and Social Development for 2002* (in Chinese) (Beijing: Zhongguo Jihua Chubanshe, 2002), 34.

<sup>41</sup> "Comparison – Xinhua Reports on Premier Zhu Rongji News Conference" (in Chinese), Beijing Xinhua Domestic Service, March 15, 2002, in FBIS-CHI-2002-0315.

<sup>42</sup> Stephen Roach, "China: Straight Talk from Zhu," Global Economic Forum, Morgan Stanley, March 27, 2002.

<sup>43</sup> Mark O'Neill, "Beijing Heavy Spending Alert," *South China Morning Post*, April 17, 2002, 1.

will definitely be phased out eventually. But this will be a gradual process and could take several years.”<sup>44</sup> A month later, he underscored that China is paying particular attention to the deficit issue, taking a series of preventive steps to deal with the deficit problem properly.<sup>45</sup> This indeed poses a serious dilemma for Chinese fiscal policy between stabilizing economy (stimulating economic growth) and fiscal sustainability.

## V. Redistribution of the Income and Rural Taxation

While China has experienced rapid economic growth in the last two decades, at the same time there has been a serious increase in regional inequalities. In 1991, per capita GDP in Shanghai was RMB 6,114, 4.5 times that of Guizhou’s RMB 1,360. The already large disparities have also tended to worsen, as the coastal provinces have grown at a rate higher than the inland areas. In 1999, per capita GDP in Shanghai reached RMB 27,449, 11.2 times that of Guizhou’s RMB 2,458. In terms of regions, in 1998 GDP per capita in the eastern region of China was RMB 11,533 while that in the western region was only RMB 4,159. GDP per capita in the eastern region was 2.8 times that in the western region.<sup>46</sup>

Fiscal policy is supposed to play some role in moderating regional inequalities. Nevertheless, the *shui shou fan huan* has been explicitly regressive and thus transferred more money to wealthier provinces. By 1998, the *shui shou fan huan* was almost 2/3 of total transfers, while the transfers under the pre-1994 old system were only about 3 and 1/2 percent of the total. Indeed, fiscal revenue per capita of wealthy coastal provinces like Zhejiang and Fujian, after taking account of all transfers and extrabudgetary revenues, is as much as twice that of poorer inland regions like Gansu and, to a lesser extent, Yunnan.<sup>47</sup>

As a result, the new tax assignment system did not moderate, but exacerbate regional inequalities. The overall transfer system continues to be sharply regressive, rewarding wealthy regions with increased transfers. The main element in the regressivity is the *shui shou fan huan*, which is not offset by other transfers, including the relatively small equalization transfers.<sup>48</sup> During 2000, the Center has sought to address some of regional inequalities through an explicit

---

<sup>44</sup> Chang, “The Capital Needs of the People’s Republic of China,” 13.

<sup>45</sup> “China: Finance Minister Announces Deficit Redress, Civil Service Pay Rise” (in Chinese), Zhongguo Xinwen She News Agency, May 12, 2002, in BBC Monitoring International Reports, May 12, 2002.

<sup>46</sup> Guo Zhang and Shanlang Lin, (eds.), *Zhongguo Fazhan Wenti Baogao*[The Report on China’s Development Issues] (Beijing: Zhongguo Shehui Kexue Chubanshe, 2001), 101, 116-17.

<sup>47</sup> Ahmad, et. al., “Recentralization in China?,” 12, 22.

<sup>48</sup> Ahmad, et. al., “Recentralization in China?,” 13.

policy of developing the western and central provinces. In the future, China needs to install an adequately funded system of equalization grants in order to balance regional inequalities.

Furthermore, in the 1990s, the Chinese government at all levels captured only 10-16 percent of GDP in taxes in its regular budget. The result was that governments at all levels, particularly in the rural area, were beset by chronic shortages of funds. In fact, by 1999 more than 60 percent of total government revenues were derived from fees. Poorer, agriculture-dependent regions had to rely on their own funds to develop or provide essential services. Because agriculture was the major resource, rural governments had to rely on extraction of taxes and fees from the peasants in order to meet their expenses and to carry out development programs. An investigation by the central government in the late 1990s reported that almost 90 percent of the fees collected by local governments were either unauthorized or illegal.<sup>49</sup>

Despite Beijing's efforts to lighten farmers' burdens, by the late-1990s, the situation did not improve but, instead, worsened. The Central Committee of the Chinese Communist Party and the State Council set requirements for reducing the peasants' burdens almost every year in the 1990s, and issued orders in 1992 and again in 1996 to check fee rates and set the ceiling for the rate at no more than 5 percent of the farmers' annual net income. However, due to heavy financial burdens and slumping agricultural product sale, income of some 900 million people living in the countryside decreased for four consecutive years – between 1996 to 2000. According to Chinese official figures, farmers in some places saw illegal fees still rise in 2000, with fee charges, fund collections, and illegal fines rising by as much as 21 percent. According to a 2001 official survey, pertinent fees for peasants in Huanyuan, Anhui, was more than three times the agricultural tax.<sup>50</sup>

In some areas peasants pay about a half of their income in taxes when they should pay a small percentage of that. This has triggered a series of riots in Chinese rural areas. Peasant unrest is substantial, but mostly localized and sporadic, and occurs more often in the interior provinces than along the coast. For example, according to the Sichuan Information Office, in June 1993, in Renshou County, Sichuan, local government demands for excessive highway repair contributions resulted in riots involving more than 10,000 people. The armed police force fired tear gas in order

---

<sup>49</sup> Minxin Pei, "Will China Become Another Indonesia?," *Foreign Policy*, Fall 1999: 100-01.

<sup>50</sup> Shuguang Zhang, "China to Begin Comprehensive Reform of Taxes and Fees in Rural Areas" (in Chinese), Beijing Xinhua Hong Kong Service, February 15, 2001, in FBIS-CHI-2001-0215. "China's Three Major Rural Reforms Introduced" (in Chinese), Beijing Xinhua Hong Kong Service, February 21, 2001, in FBIS-CHI-2001-0221. "PRC: Tax-for-fees Reform to Boost Economy Viewed," Beijing Xinhua, February 22, 2001, in FBIS-CHI-2001-0222.

to disperse the crowd and rescue 180 policemen from the siege.<sup>51</sup> It was reported that, from July 30 to August 2 in 1997, over 200,000 peasants in twelve counties in Hubei province demonstrated against local officials who had used state grain procurement funds to travel abroad and purchase cars, homes, office buildings, leaving the peasants with IOUs. The situation was quite similar in Jiangxi, Hunan, and Anhui provinces, involving an estimated half a million participants, leaving at least 184 injured and 14 dead.<sup>52</sup> In the largest such outburst in recent years, about 20,000 peasants tore down the homes of corrupt officials in southern Jiangxi Province in August 2000 in a tax revolt, which quickly spread from village to village and county to county.<sup>53</sup>

The central government, concerned about the implications for social stability, is attempting to change the basis of rural taxation. The essence of Beijing's plan is to replace the dozens, even hundreds, of fees and charges with one centrally-administered tax. It had tried the "tax for fee" experiment on a wide basis but scaled back its initial efforts. That temporary retreat led to an attempt to implement the concept in eastern Anhui Province in 2000, an experiment that was extended to Jiangsu Province and about 100 counties in other provinces in 2001. Beijing is now talking about expanding the experiment to still other areas. However, Beijing essentially put the Anhui plan on hold in July 2001 after complaints from officials that local governments were losing revenue and therefore faced bankruptcy.<sup>54</sup>

## VI. Fiscal Deficit and Debt

More specifically, while faced with ballooning demand for expenditures, the central government faces a serious difficulty in raising additional revenues or adopting a new fiscal system for the Center and the localities as explained in the section of fiscal reforms. For instance, the Ministry of Finance proposed amending the Highway Law by replacing ad hoc automobile and road fees collected by provincial and local governments with a uniform national fuel tax, which would generate about RMB 100 billion of tax revenue, an increase of 20 percent in central government collected revenues. A vote on the amendment was postponed twice and in spring 1999 this proposal was voted down by the Standing Committee of the National People's

---

<sup>51</sup> "Sichuan Spokesman on Riots" (in Chinese), Beijing Zhongguo Xinwen She, June 12, 1993, in FBIS-CHI-93-112.

<sup>52</sup> Cheng Mu, "Peasants Riots Erupt in Hubei and Jiangxi," *China Focus*, October 1, 1997. Thomas P. Bernstein and Xiaobo Lu, "Taxation without Representation: Peasants, the Central and the Local States in Reform China," *China Quarterly*, no. 163 (September 2000): 754-755. Allen T. Cheng, "A Rural Dilemma," *Asiaweek*, February 23, 2001, <http://taiwansecurity.org/News/2001/Asiaweek-022301.htm>, accessed February 26, 2001.

<sup>53</sup> Vivien Pik-kwan Chan, "20,000 Farmers Riot Over Taxes," *South China Morning Post*, August 30, 2000, 1.

<sup>54</sup> Chang, "The Capital Needs of the People's Republic of China," 8-9.



Congress (NPC) because of strong local opposition.<sup>55</sup> In late 1999, the NPC finally removed the last legal roadblock to introduction of a central fuel tax, but the Center has been unable to implement the change as a result of local government opposition.<sup>56</sup>

In addition, some local authorities often maximize their revenues at the expense of tax contributions to the central government. Local authorities often grant local SOEs generous exemptions from the taxes that are shared with the central government, but preserve their own portion of tax revenues mostly untouched.<sup>57</sup> Parenthetically, in a June 2002 speech at the Peking University, Finance Minister Xiang Huaicheng angrily criticized local officials of blockage of tax system reforms.<sup>58</sup>

Finally, there is a problem of fiscal rigidity in expanding tax revenue bases for Chinese economy. As the role of market forces in the economy grew, rapidly changing prices and quantities made it harder for tax collectors to monitor enterprises behavior. The local governments have still strong incentives to conceal information about local revenue from the center. Further, the number of taxpayers increased dramatically. At the same time, the growth of the non-state sector was causing problems for tax administration.<sup>59</sup> As a result, despite the dramatic reduction of their share of total industrial output, SOEs are still the primary sources of tax revenue for all government levels in China, from the center to the urban localities. In 1978, profits and taxes handed over to the state by SOEs accounted for about 87 percent of the state revenue. In recent years, the Chinese government's continued dependence upon SOEs for fiscal revenue is striking. For instance, in 1995, SOEs produced only 35 percent of China's industrial output value but still contributed 71 percent of state revenue, and in 1998 the level was still as high as 55 percent.<sup>60</sup>

Since the requirements for central government expenditures have exceeded available funds considerably and continue to be increasing, the Chinese government has incurred an increasingly large fiscal deficit and debt. The budget deficit increased from RMB 1.4 billion (0.3 percent of GDP) in 1980, to RMB 65.5 billion (1.0 percent) in 1996, and then jumped to RMB 259.8 billion

---

<sup>55</sup> Lardy, "When Will China's Financial System Meet China's Needs?," 12-3.

<sup>56</sup> Ahmad, et. al., "Recentralization in China?," 20.

<sup>57</sup> Chi Lo, "China's Fiscal Time Bomb," *China Business Review*, September/October 1999, 17.

<sup>58</sup> Mei Cheng, "Xiang Huaicheng Addresses in Beida, Criticizing Local Officials of Blockage of Tax System Reforms," *Gongshang Shibao* [Commerce Times], June 19, 2002.

<sup>59</sup> Ahmad, et. al., "Recentralization in China?," 4-5, 7-11.

<sup>60</sup> Edward S. Steinfeld, *Forging Reform in China: The Fate of State-Owned Industry* (New York: Cambridge University Press, 1998), 17. Jiao Ran and Zhenjun, "State-Owned Enterprises as Viewed From National Conditions" (in Chinese), Beijing Xinhua Domestic Service, September 17, 1999, in FBIS-CHI-1999-0918.

(2.9 percent) in 2000 (see Table 4).

Table 4. Fiscal Deficit of the Central Government, 1980-2000

	1980	1984	1988	1992	1994	1996	1998	1999	2000
Deficit (RMB billion)	1.4	4.8	19.4	23.1	67.6	65.5	95.8	179.7	259.8
Deficit/GDP (%)	0.3	0.7	1.3	0.9	1.5	1.0	1.2	2.2	2.9

Sources:

National Bureau of Statistics (PRC), *China Statistical Yearbook*, no. 18 (1999) (Beijing: China Statistics Press, 1999), 266, 284.

Xinhua, quoting financial minister reports to the National People's Congress, 2000-2001.

The 2000 figure of fiscal deficit almost reaches the internationally accepted alarm level of three percent.<sup>61</sup> As a matter of fact, Chinese official figures gravely underestimate the seriousness of the fiscal problem in China for four reasons. First, the World Bank argues that more accurate representation of government activities is provided by the concept of the consolidated government deficit. This consists of the fiscal deficit plus the part of the People's Bank of China (central bank) lending to the financial system that finances the government-directed expenditure of the SOEs. Consequently, between 1986 and 1994 the consolidated deficit may have averaged from 4.9 to 5.7 percent of GDP – more than triple the 1.5 percent deficit in the 1994 official budget.<sup>62</sup> In addition, Lardy estimates that the broader public sector non-financial deficit by the mid-1990s had been running at an unsustainable level of over 10 percent of GDP for almost a decade.<sup>63</sup>

Second, the Chinese government expenditures significantly depend on debt financing. The Chinese government incurred only RMB 3.5 billion (0.9 percent of GDP) of debt in 1979 and RMB 27.1 billion (1.8 percent of GDP) in 1988. Beginning in 1994, however, the government was precluded from borrowing from the central bank to finance its budget deficit. As a result, debt incurred by the government jumped from RMB 73.9 billion (2.1 percent of GDP) in 1994, to RMB 418.0 billion (4.7 percent of GDP) in 1999. Thus, the stock of outstanding treasury bonds leaped from RMB 157.2 billion (4.5 percent of GDP) in 1994 to RMB 996.5 billion (12.2 percent of GDP) in 1999 (see Table 5). According to Pei Minxin, a senior associate at the Carnegie Endowment for International Peace, Chinese central government borrowed 55.2 cents for every

<sup>61</sup> Junrong Tian, "Continue to Arose Nongovernmental Investment" (in Chinese), Beijing *Renmin Ribao*, April 20, 1999, p. 1, in FBIS-CHI-1999-0426.

<sup>62</sup> World Bank, *China 2020*, 28.

<sup>63</sup> Lardy, *China's Unfinished Economic Revolution*, 5.

dollar it spent in 1997.<sup>64</sup> According to Lardy, by 1999 about 70 percent of central government expenditure was financed by debt.<sup>65</sup>

Table 5. Fiscal Situation of Chinese Central Government, 1979-2000

Period	1979	1988	1993	1994	1995	1996	1997	1998	1999	2000
Debt incurred (RMB billion)	3.5	27.1	73.9	117.5	155.0	196.7	247.7	331.1	371.5	418.0
Debt incurred/GDP (%)	0.9	1.8	2.1	2.5	2.7	2.9	3.3	4.2	4.5	4.7
Balance of cumulative government bonds (RMB billion)	n.a.	n.a.	157.2	257.8	355.9	462.0	550.9	786.2	996.5	n.a.
Government bonds/GDP (%)	n.a.	n.a.	4.5	5.5	6.2	6.8	7.5	10.1	12.2	n.a.

Note:

Government bonds include sovereign bonds, state investment bonds, and state investment company bonds.

Sources:

National Bureau of Statistics (PRC), *China Statistical Yearbook*, no. 20 (2001) (Beijing: China Statistics Press, 2001), 249.

Haocheng Gong and Guoqing Dai (eds.), *2000 Zhongguo Jinrong Fazhan Baogao* [2000 China's Financial Development Report] (Shanghai: Shanghai Caijin Daxue Chubanshe, 2000), 25.

Third, real debt for the Chinese government is much larger than the nominal figure. Lardy estimated that the balance of outstanding non-treasury government bonds, mostly issued by the State Development Bank, at year-end 1998 was RMB 532.2 billion (7 percent of GDP). Inclusive of these bonds, according to Lardy, by year-end 1998 explicit government debt was RMB 1606.1 billion (20.5 percent of GDP), almost five times the level of 1993.<sup>66</sup> The World Bank has a very similar estimate. According to its estimate, Chinese domestic public sector debt, including treasury bonds, policy financial bonds, and other financial bonds, increased from 12.3 percent of GDP in 1997, to 16.4 in 1998, and 20.7 percent in 1999.<sup>67</sup>

This estimate excludes corporate bonds issued by state-owned manufacturing firms, as well as other contingent or implicit government liabilities such as non-performing loans extended by state-owned banks, pension arrears of the government and government-owned firms, and unfunded pension liabilities of current employees of the government and government-owned

<sup>64</sup> Pei, "Will China Become Another Indonesia?," 100.

<sup>65</sup> Cited from David M. Lampton, "Rapporteur's Summary," in Dick Clark (ed.), *U.S.-China Relations* (Washington, D.C.: Aspen Institute, 1999), 7.

<sup>66</sup> Lardy, "When Will China's Financial System Meet China's Needs?," 14-19.

<sup>67</sup> World Bank, "China," *China Quarterly*, September 18, 2000, 15.

firms. It also excludes implicit liabilities of local governments. For example, Lardy argues that any serious attempt to recapitalize the financial system will immediately push government debt to a level over 50 percent of output.<sup>68</sup> According to an estimate of the World Bank, the implicit state pension debt was about 50 percent of GDP in 1994.<sup>69</sup>

According to Bottelier's estimate, the aggregate of registered, implicit, and contingency state debt – sovereign and non-sovereign; foreign and domestic – is about 133-192 percent of GDP in 2000. "Contingency debt" includes government guaranteed debt, the unfunded "old" pension debt, the non-performing loan portfolio of state banks (now partially transferred to state-owned AMC's), and under-capitalization of state banks and enterprises. Sovereign state debt -- external and internal -- accounts for 21 percent of GDP; domestic bonds issued by AMC's and State Policy banks 25 percent; contingent NPL debt 37-44 percent of GDP; the present value of unfunded future state pension liabilities 45-95 percent; the present value of the funds to recapitalize SOEs 5-7 percent.<sup>70</sup> According to another estimate by the World Bank, China's explicit and implicit debt was over 173 percent of GDP in 2000. Furthermore, new hidden debt in the form of the under-capitalization of the financial system is being accumulated in state-owned banks and enterprises at a conservatively estimated rate of 2 percent of GDP annually.<sup>71</sup>

Fourth, the government's increasing reliance on debt financing for its spending needs make the payment and servicing of the public debt a mounting concern. The share of fiscal revenue spent on debt service and repayment rose to 24 percent of total government fiscal revenue in 1998, from less than 3 percent in 1989. According to Lardy's estimate, interest payments on treasury debt in 1999 were estimated to be RMB 83 billion, compared to RMB 5.2 billion in 1992, a 16-fold increase in 7 years. Interest burden, a percent of central government outlays exclusive of transfers to local governments, has quadrupled from less than 4 percent in 1993 to an estimated 19 percent in 1998 and 17 percent in 1999. Therefore, China cannot continue to service its debt for long by simply issuing more. Worse still, if bond investors are worried about the government's credit or political instability, they will demand sharply higher interest rates, causing government debt to spiral.<sup>72</sup>

---

<sup>68</sup> Lardy, "When Will China's Financial System Meet China's Needs?," 20-37.

<sup>69</sup> World Bank, *China: Pension System Reform* (Washington, D.C.: World Bank, 1996), ix, 2, 15, 26.

<sup>70</sup> Bottelier, "China's Domestic Debts," 8-9.

<sup>71</sup> World Bank, "China," issued on September 27, 2001.

<sup>72</sup> Lo, "China's Fiscal Time Bomb," 18. Lardy, "When Will China's Financial System Meet China's Needs?," 14-17. William Gamble, "The Middle Kingdom Runs Dry," *Foreign Affairs*, vol. 79, no. 6 (November/December 2000): 20.

## VII. Conclusion

Chinese current fiscal situation exists a huge gap between the available resources and the inevitable fiscal need for the Chinese government. On the one hand, the resources available to the Chinese state to tackle the staggering challenges of economic development and social security reforms have been gravely declining. In 2000, the share of state fiscal revenues declined to 15 percent of GDP, and, more alarmingly, the share of expenditure for the central government dropped to around 6 percent of GDP. On the other hand, the inevitable fiscal need for the Chinese government to spend on economic development, social security reforms, and environmental protection is tremendous, including the contingent liabilities of the banking sector, the fiscal obligations arising from reform of SOEs and the social security system. Furthermore, the Chinese government must adopt fiscal stimulus to maintain necessary and vital rapid economic growth.

To meet the need of fiscal function, the Chinese government has attempted several times to improve its fiscal position through adopting new fiscal arrangements between the Center and localities. Beijing has made significant concessions to localities in order to obtain their cooperation for the new fiscal system. However, with the strong opposition of local governments, particularly the wealthier provinces, Beijing accomplished yet very limited goals in raising its share of revenues. In the late 1990s, Beijing's share of state disposable revenues and expenditures was only about 30 percent.

At this moment, the Chinese government obviously does not have sufficient resources to address necessary economic and social security reforms and environmental protection, and thus heavily relies on debts to sustain the fiscal function. Its nominal fiscal deficit has reached 3 percent of GDP and Beijing borrowed 55-70 percent for every dollar it spent in the late 1990s. Debt servicing and repayment accounted for 24 percent of total government fiscal revenue in 1998. More seriously, the aggregate of registered, implicit, and contingency state debt was estimated of 133-192 percent of GDP in 2000, while the Center's expenditure was only 6.2 percent of GDP at that year.

Because of the huge gap between the available resources and inevitable fiscal need, inability to improve fiscal position through adopting new fiscal systems, and huge debts, the fiscal sustainability of the Chinese government is fatally threatened in the future. In particular, on the one hand, it is imperative for Beijing to continue its proactive fiscal policy; on the other hand, the Chinese fiscal expansion needs to be reduced as soon as possible because of the concerns of mounting deficit and debts. This poses a serious dilemma for China. Moreover, Chinese current

tax system does not moderate, but exacerbate regional inequalities. China needs to install an adequately funded system of equalization grants in order to balance regional inequalities. Finally, China must change the basis of rural taxation in order to prevent deteriorating social instability in the rural area. The new leadership after the 16<sup>th</sup> National Party Congress in November 2002 must pay more attention to these issues to avoid a fiscal and resulting economic crisis.