

REFORMING CHINA'S PUBLIC FINANCES TO SUSTAIN GROWTH

LIN Shuanglin & Sarah Y. TONG

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Executive Summary

1. China's rapid growth in recent decades has been supported by its public finance, characterized by a pro-growth taxation system, growth enhancing government expenditure, and an expansionary fiscal policy.
2. After the 1994 tax reforms, consumption taxes have become predominant. These taxes are non-progressive and in favor of savings and investment. The large allocation to economic construction implies that government expenditure also favors growth. China has also adopted an expansionary fiscal policy since the 1997 Asian financial crisis.
3. However, China's public finance is in urgent need of overhaul to sustain future growth as the economy faces serious challenges. Rising income inequality threatens growth and demands that China move toward collecting more progressive taxes such as income taxes and property taxes.
4. Meanwhile, the worsening of various social and environmental problems requires that the government spend considerably more on social areas such as education, healthcare, social security, welfare, and environmental protection. Perhaps more significantly, the problem of rising local government debt has to be resolved.
5. The government has made it clear that reforming public finance will top its next round of economic reforms during the recently concluded Third Plenum of the Chinese Communist Party's 18th Party Congress. To reduce the regressiveness of the taxation, for example, China will make income tax more progressive and levy taxes on personal properties.
6. Moreover, the government will spend more to help the poor by increasing its expenditures on education, healthcare, environmental protection, poverty relief, and social welfare.

7. To sustain economic growth, the government is reducing the overall tax burden of enterprises to encourage business investment and facilitate industrial upgrading and technological innovation. The on-going experiment of the “value-added tax for business tax reform” is a good example.
8. To reduce local government debt, the central government will take over some spending responsibilities for public goods. It may also need to allow local governments to establish local taxes and issue bonds for financing local projects.
9. In the coming decades, China’s economy will have to rely less on pro-growth tax and government spending policies. As such, public finance reforms aim to redistribute income, protect environment, stimulate private sector investment, increase human capital accumulation, and promote technological progress.