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China's Post-COVID Goldilocks Budget – How Big Should It Be?[1]

By Christine WONG

China was the only major economy to grow in 2020. After a steep drop in GDP (gross domestic product) during the first quarter when the country went into a strict lockdown, the economy bounced back in the second quarter, and posted growth rates of 3.2%, 4.9% and 6.5% in the second, third and fourth quarters, respectively. By year-end, the economy appeared to be back on its pre-COVID growth trend.

The budget fared less well and ended the year with revenues down 3.9%, though it performed better than expected at the last National People's Congress meeting in May 2020. Against the backdrop of a 6.8% drop in GDP in the first quarter and fiscal revenues that were down 14.5% year-on-year in the first four months, the budget contained a large consolidated deficit of RMB11.6 trillion. This was to provide an additional RMB7 trillion in spending, equal to almost 7% of GDP, compared to that in 2019 (Table 1).[2] With the economy growing again, is the stimulus programme still needed in 2021?

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[1] Unless otherwise noted, information in this commentary is drawn from the Ministry of Finance, *Report on the Execution of the Central and Local Budgets for 2020 and on the Draft Central and Local Budgets for 2021*, Fourth Session of the 13th National People's Congress of the People's Republic of China, 5 March 2021. Hereafter referred to as the budget report.

[2] Calculated from the consolidated budget deficit of RMB11.6 trillion, compared with RMB4.5 trillion in 2019. For details, see Wong, Christine, EAI Commentary No. 16, 6 July 2020.

TABLE 1 GOVENMENT FINANCES

(RMB billion unless otherwise noted)	2019	2020 Budget (May 2020)	2020 Year-end outturn	2020 Outturn compared to budget	2021 Budget	2021 Compared to 2020 outturn	2021 Compared to 2019
General Budget							
Revenues	**19,038**	**18,027**	**18,290**	***1.5%***	**19,765**	***8.1%***	***3.8%***
Central	8,931	8,277	8,277	*0.0%*	8,945	*8.1%*	*0.2%*
Local (excludes transfers from central budget)	10,108	9,750	10,012	*2.7%*	10,820	*8.1%*	*7.0%*
Expenditures	**23,887**	**24,785**	**24,559**	***-0.9%***	**24,962**	***1.6%***	***4.5%***
Central (excludes transfers to local governments)	3,512	3,504	3,510	*0.2%*	3,502	*-0.2%*	*-0.3%*
Local	20,376	21,232	21,049	*-0.9%*	21,461	*2.0%*	*5.3%*
General budget balance	**-4,849**	**-6,758**	**-6,269**	***-7.2%***	**-5,197**	***-17.1%***	***7.2%***
General budget balance as share of GDP	*-4.9%*	*-6.7%*	*-6.2%*		***-4.8%***		
Government Fund Budget balance	-685	-4468	-2451	*-45.1%*	-3674		
State Capital Operating Budget balance	167	102	223	*118.3%*	123		
Social Security Fund Budget balance	841	-500	-672	*34.5%*	277		
Consolidated fiscal revenues	36,201	34,264	35,328	*3.1%*	**38,523**	*3.1%*	*9.0%*
Consolidated fiscal expenditures	40,727	45,887	44,497	*-3.0%*	**46,995**	*-3.0%*	*5.6%*
Consolidated fiscal balance	**-4,526**	**-11,623**	**-9,169**	***-21.1%***	**-8,471**	***-21.1%***	***-7.6%***
Consolidated fiscal balance (% of GDP)	***-4.6***	***-11.4***	***-9.0***		***-7.8***		
*Memo: Nominal GDP**	*98,652*	*101,599*	*101,599*		*108,711*		

* CEIC, 2021 estimated with 7% growth.

The government's answer seems to be no. Although the published ('headline') budget deficit of RMB3.57 trillion is only RMB190 billion smaller than the RMB3.76 trillion last year, the 2021 projected *consolidated budget deficit* is much smaller than last year's (see Box A for the calculation of the published budget deficit).

Unlike the emphasis on mobilising resources to support the economy in 2020, the emphasis of this year's budget report is on stability, sustainability and efficiency. As shown in Table 1, even though general budget revenues are expected to grow by 8.1%, expenditures will increase by only 1.6%. The general budget deficit of RMB5.2 trillion is 17% smaller than the 2020 outturn and 23% smaller than the RMB6.76 trillion in the 2020 budget. More importantly, the consolidated budget deficit of RMB8.47 trillion is more than RMB3 trillion smaller than the budgeted RMB11.6 trillion in 2020.

BOX A HOW THE 2021 PUBLISHED BUDGET DEFICIT IS CALCULATED*

The published deficit of RMB3.57 trillion (3.2% of GDP) is derived by bringing in RMB1.63 trillion from other fiscal resources, the government fund and the state capital operating budgets, the budget stabilisation fund and other reserves, to offset the general budget deficit of RMB5.2 trillion. Details of the balancing are as follows:

Central government general budget	RMB (billion)	Local government general budget	RMB (billion)
Own revenues	8945	Own revenues	10820
Transfer from budget stabilisation fund (BSF)	95	Central transfers	8337
Transfers from GF budget and SC operating budget	98.5	Transfers from GFB, SCOB, BSF and carryovers	1483.5
Total funds available	**9138.5**	**Total funds available**	**20640.5**
Own expenditures	3502		
Transfers to local governments	8337		
Transfer to reserve funds	50		
Total expenditures	**11888.5**	**Total expenditures**	**21460.5**
Central government budget balance	-2750	Local government budget balance	-820
Total general budget balance	**-3570**		

* For a more detailed explanation of budget reporting, see Wong (2020). EAI Commentary No. 16, 6 July 2020.

Despite the finance minister's vow not to "apply sharp brakes" to the stimulus programme, most of the fiscal measures introduced in 2020 to support the economy will be withdrawn. The biggest change will come from phasing out the waiver and deferral of corporate social insurance contributions, which accounted for RMB1.7 trillion of the estimated RMB2.6 trillion in tax and fee cuts last year. Of the remainder, the waiver of VAT and reduction of income tax for micro, small and household businesses will continue, a programme that cost an estimated RMB500 billion last year.[3] It will be expanded, with the eligibility threshold for enterprises raised from RMB100,000 to RMB150,000 per month in turnover, but the expansion is likely to have a negligible effect given that an estimated 92% of these enterprises were already exempted from VAT under the old threshold, and their income tax rate was only 5%, to be cut to 2.5%.[4] In line with the policy emphasis on supporting technology and innovation, tax write-offs for R&D expenditures will be raised from 75% to 100%. There will also be no more special COVID bond, which had added RMB1 trillion last year, although RMB3.65 trillion in local government special project bonds will be issued, only RMB100 billion less than in 2020.

The reduction in support was already foreshadowed in budget implementation through the second half of 2020 when monthly data on fiscal outturns showed that even when revenues were starting to recover, authorities consistently held expenditures below budgeted levels.[5] With revenues 1.5% higher and expenditure 0.9% lower than the budget presented last May, the general budget deficit outturn was reduced by half a per cent of GDP. This was replicated in the other three budgets, where all expenditures were held below budgeted levels. Together, they allowed the government to reduce the consolidated budget deficit to 9% of GDP, shaving 2.4% off the stimulus programme that was approved in May.

This budget conservatism may reflect the government's confidence that the economy will be back on track for growth, freeing fiscal authorities to refocus on the core tasks of deleveraging and promoting fiscal sustainability. It may also be driven by other reasons, among them the weakening of the government's fiscal position over the past few years. Slowing economic growth and tax changes such as the conversion of the VAT and raising the personal income tax threshold have eroded government revenues, which had fallen from 22% of GDP in 2015 to 18% in 2020. Even though expenditures have also been reduced, primary deficits have grown (Figure A).

Another constraint on the government's options, ironically, may be the success of budget management reform since 2015 that allowed the Ministry of Finance to extend budgetary control by moving resources from the government fund budget (GFB) and state capital operating budget (SCOB) into the general budget.[6] Table 2 shows that transfers in 2020 from the GFB and SCOB may have taken as much as 35% of total revenues in those budgets. Now in the seventh year of this process, resources that can be brought into the general budget may be largely depleted, reducing this year's transfers. Even though regulations do not permit social security funds to be transferred to the budget, the Ministry of Finance was able to shift some of the costs of the stimulus programme to the fund by offering waivers and deferrals to social insurance contributions to support enterprises. These added up to RMB1.7 trillion last year in

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3 http://www.china.com.cn/zhibo/content_76291788.htm#fullText, accessed 11 August 2020.

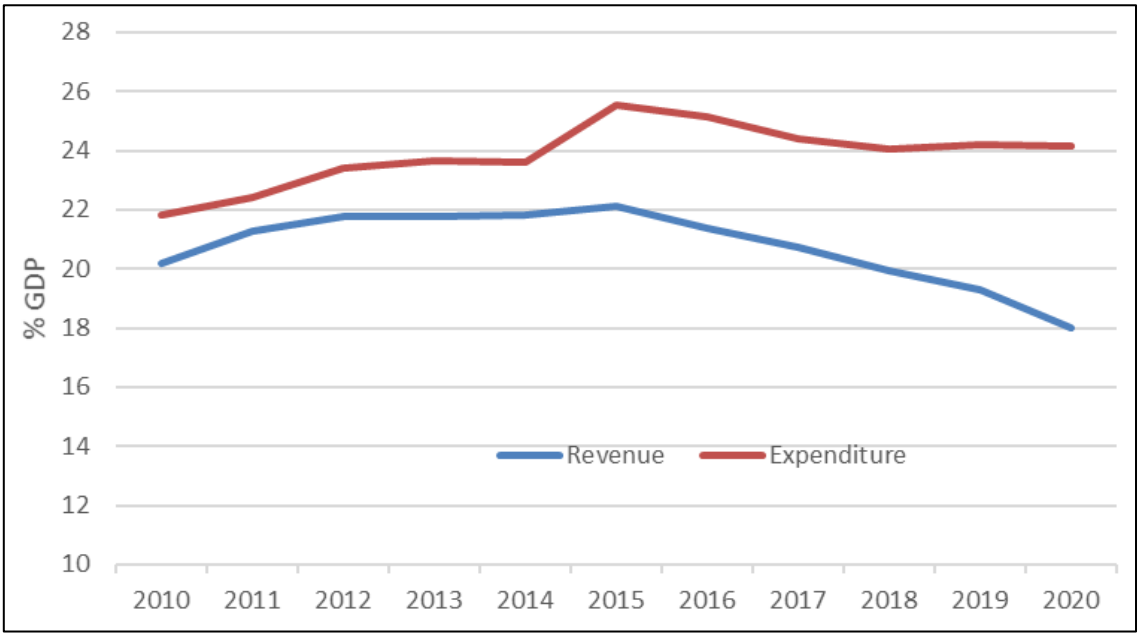
4 http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/202103/t20210306_3666690.htm, accessed 6 March 2021.

5 Ministry of Finance monthly fiscal outturns.

6 Budget Law 2015. http://www.kuaiji.com/news/1751900, accessed 5 June 2015.

lost revenues for the social security fund, a 13.3% drop. Growing concern over China's population ageing and the financial viability of its social security programmes will likely limit the further raiding of the social security fund coffers.

FIGURE A TRENDS IN REVENUES AND EXPENDITURE SINCE 2010



Source: NBS, various years.

TABLE 2 PROGRESS IN EXTENDING BUDGETING CONTROL OVER FISCAL RESOURCES

	Transfers from reserves and GF and SCO budgets (RMB 100 million)	Transfers as share of revenues in the GF and SCO budgets*
2015	8055.1	17.9%
2016	7271.1	14.8%
2017	10,138.9	15.8%
2018	14,772.8	18.9%
2019	22,161.0	25.0%
2020	29,980.0	35.2%
2021	16,770.0	17.0%

* These shares may be somewhat overestimated by the inclusion of reserves in the numerator.
Source: calculations based on data from MOF final accounts and budget reports to the NPC, various years.

Finally, local government fiscal difficulties may be another constraint on the government's options. Concerns over local governments' ability to meet payroll and provide basic services led to the creation last year of a special transfer mechanism (the "direct express 直达 mechanism"). This mechanism sent RMB2 trillion directly to the prefectures and counties in support of the "three guarantees" (basic services, payroll and government functions). The new transfer mechanism bypassed the normal, time-consuming process of sending down central transfers level-by-level through the administrative hierarchy, from the central treasury to the provincial treasuries, to the prefectural (municipal) treasuries, and finally to the counties and districts. The mechanism was intended also to prevent the leakages and diversions that often

plague other transfers when the intermediary levels of local governments are also facing fiscal gaps – a situation that has marked China's intergovernmental fiscal system since the 1994 tax-sharing system reform.[7]

While the mechanism is considered a success and expected to become a permanent feature of the intergovernmental fiscal system, it met only a small portion of expenditure needs at the county level of more than RMB10 trillion.[8] Indeed, last year's underspending relative to budget may have been, rather than as a policy choice, due to revenue shortfalls at the local government level. Indirect evidence of this is presented in Table 3, which shows that, through the past decade, transfers have grown at a slower pace than local government expenditures. With local governments in aggregate dependent on transfers to finance half of their expenditures, slowing growth in transfers reduces the availability of revenues for funding local expenditures, especially as the 'efficiency savings' from budget and public financial management reforms over the past few years may have run their course, and idle balances are increasingly hard to find.

TABLE 3 AVERAGE ANNUAL GROWTH RATES FOR LOCAL GOVERNMENT EXPENDITURES AND TRANSFER

	Total revenue	Local expenditures	Net transfers*
2000-2010	20.0%	21.7%	26.8%
2010-2015	12.9%	15.4%	12.9%
2015-2019	5.7%	7.9%	5.9%
2018-2019	3.8%	8.3%	2.4%
2019-2020	-3.9%	3.3%	

* excluding tax rebates.
Source: author's calculations from NBS and MOF.

Just as the "6% or more" economic growth target for the year set at the NPC seemed deliberately modest, the 2021 budget appears to be drafted in the same spirit. This is even more vividly demonstrated by comparing it to the 2019 budget – a pre-COVID 'normal' year. The respective 3.8% and 4.5% increase in revenues and expenditures over 2019 are very modest and the 2021 general budget deficit of 4.8% of GDP is held at the same level as 2019. The larger consolidated fiscal deficit (by nearly RMB4 trillion, or 3.2% of GDP) is due almost entirely to the RMB3.65 trillion in special project bonds in support of local government infrastructural investments. What is perhaps most surprising is that transfers to local governments will increase by only RMB55 billion in 2021, less than 1%, even as the budget report acknowledges difficulties at the local level. Transfers including tax rebates totalling

[7] See, for example, World Bank (2007). China: Public Services for Building the New Socialist Countryside. Report No. 40221-CN, 2007. http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/16/000020953_20080116091210/Rendered/PDF/402210CN.pdf. Accessed 13 March 2021.

[8] Since 2013, the grass-roots level of county governments (including urban districts) have accounted for more than 45% of national budget expenditures. See Wong, Christine. "An Update on Fiscal Reform", in R Garnaut, L Song, and Cai Fang (eds). *China's Forty Years of Reform and Development: 1978-2018*. Canberra, ANU Press, 2018. http://press-files.anu.edu.au/downloads/press/n4267/pdf/ch15.pdf, accessed 13 March 2021.

RMB8.3 trillion are already 93% of the central government's projected revenues for the year. Thus, there is not much more to give unless the central government is willing to accept a larger deficit.

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