China's Fiscal Sustainable Development during the 14th FYP Period

Yan Kun (闫坤)* and Bao Shuguang (鲍曙光)
National Academy of Economic Strategy (NAES), Chinese Academy of Social Sciences (CASS), Beijing, China
Rural Development Institute (RDI), CASS

Abstract: *In the context of national governance, public finance is embedded into China's economic, political, and social systems as a medium between various national subsystems. As such, fiscal sustainable development should be viewed from a systematic and integrated perspective. This paper created an analytical framework consisting of three aspects: fiscal resource adequacy, institutional soundness and effectiveness, and external shocks. Chinese government has a relatively healthy balance sheet with adequate fiscal resources; however, it is faced with implicit debt risks and inefficiencies. China has initially established a basic fiscal framework with Chinese characteristics that are compatible with national governance, but problems remain in terms of fiscal responsibility, lawfulness, efficiency, fairness, and compatibility. When dealing with external shocks, policymakers should establish a clear fiscal policy rationale and approach based on the implications of fiscal sustainability. Fiscal sustainable development requires the strengthening of government capabilities to assess management and operation; thus, expanding available fiscal resources. Fiscal reforms should be expedited in order to create a modern fiscal system. Furthermore, a fiscal policy system should be developed and optimized according to the principles of fiscal sustainability in order to withstand external shocks.*

Keywords: *Fiscal sustainable development, national governance, high-quality development, national balance sheet, debt risk*
JEL Classification Codes: H11, H60
DOI: 10.19602/j.chinaeconomist.2022.01.04

1. Introduction

Current slowing fiscal revenue growth, rigid increase of fiscal spending, fundamentally changed fiscal landscape, revenue and spending contradictions, and more pressing and complex fiscal risks call for China to urgently secure a sustainable fiscal development. Released in 2016, the *13th Five-Year Plan (FYP) for Economic and Social Development of the People's Republic of China (2016–2020)* for the first time called for "improving fiscal sustainability mechanisms". In 2018, the Ministry of Finance further identified "ensuring local fiscal sustainability" as a future priority. Increasingly, fiscal sustainability has become an issue of great concern for academia and policymakers.

2. Theoretical Discussions on Fiscal Sustainable Development

2.1 Basic Concept of Fiscal Sustainable Development

Buiter (1985) offered the first strict definition of fiscal sustainability. Since then, numerous

* CONTACT: Yan Kun, email: yankun@cass.org.cn.
Acknowledgement: This study is supported by the General Program of the National Social Science Fund of China (NSSFC) "Study on the Policy Design and Evaluation for the Prevention of Intergenerational Poverty Transmission through Education" (Grant No. 18BJL123). We appreciate the comments from external reviewers and Editorial Division but take sole responsibility for this paper.

research institutions and academics have defined the concept and implications of fiscal sustainability from different dimensions. Chinese and international academics have expressed their understanding of fiscal sustainability from two perspectives: debt (Wilcox, 1989; Buiter, 2002; Rubio *et al*., 2010) and fiscal income and spending (Yu, 2000; Deng and Chen, 2017). However, those studies have some shortcomings. First, existing studies on fiscal sustainability are confined to the framework of economics analysis. As the foundation and important pillar of national governance, fiscal sustainable development must be examined under a broader, more comprehensive multi-disciplinary evaluation framework. Second, the framework of fiscal sustainability analysis for Western countries may not apply to China as a country with unique national conditions. According to fiscal sociology, a society in the broad sense comprises three subsystems, including economic, political, and social subsystems. Public finance is a node of the three subsystems and a medium for connecting the subsystems. In a broad sense, China's fiscal sustainable development refers to the sufficient public resources and good governance of public finance in order to fulfill spending responsibilities and obligations as part of national governance, promoting long-term national security, stability, and overall sustainable development.

2.2 Implications of Fiscal Sustainable Development

China's fiscal sustainable development can be construed in the following four aspects: First, fiscal sustainable development can be explained from a system theory perspective. Public finance is a critical aspect of national governance. Since public finance is embedded into economic, social, and political systems, fiscal sustainable development should be viewed from a holistic and integrated perspective, paying attention to both fiscal sustainability and the role of public finance that underpins socio-economic sustainability.

Second, fiscal sustainable development should contribute to the self-repair and self-regulation of the fiscal system and enhance fiscal risk tolerance. Through institutional design, public finance should enhance its self-recovery and self-adjustment capabilities thus making fiscal institutional arrangements for defusing risks and bolstering fiscal risk tolerance by preventing the accumulation of risks and problems from triggering a crisis. With their automatic stabilizer functions, taxation, and social security have a countercyclical effect on economic fluctuations, and the progressive taxation system helps regulate income distribution.

Third, fiscal sustainable development should create fiscal space. Considering public finance's role as a node of intermediation, fiscal sustainability requires sufficient resiliency and space to cope with internal and external shocks in economic, social, and ecological spheres during the transition period, thus achieving national governance goals.

2.3 Analytical Approach and Basic Framework of China's Fiscal Sustainable Development

Studies in economics, political science, and sociology have yielded numerous results on sustainable development, providing an approach for creating a research framework on sustainable development. Referencing Zheng (2008), Liu (2015), and Ostrom *et al*. (2000), this paper creates an evaluation framework consisting of three aspects: Fiscal resource adequacy, institutional legitimacy and effectiveness, and external shocks, for the analysis of China's fiscal sustainability.

First, fiscal resource adequacy refers to whether sufficient fiscal resources are in place for the performance of public spending responsibilities needed to cope with various risks and shocks. Fiscal resources refer to the fiscal revenues and various assets and resources that can generate revenues. Fiscal resources are the premise and material foundation for sustainability, consisting of stock assets and current resources. Current resources refers to fiscal revenue and spending, and stock assets refers to government assets and liabilities. This paper analyzes China's fiscal sustainable development from a fiscal stock assets perspective beyond traditional analysis of fiscal revenue and spending, and has a more comprehensive study of the government's financial sustainable development.

Second, institutional legitimacy and effectiveness are key aspects of the sustainability of China's fiscal system. In investigating the political system, Lipset (1993) put forth an analysis approach of "legitimacy" and "effectiveness": The lawfulness and effectiveness of governance are two basic questions facing all countries in their national governance (Lin, 2009). As the foundation and important pillar of national governance, public finance must also face the two basic issues of lawfulness and effectiveness. In China's context, the lawfulness and effectiveness of China's fiscal system are measured by the criteria of high-quality development, including accountability, legality, efficiency, fairness, and adaptability. Among them, accountability means a clear demarcation of the boundary of fiscal powers, especially government spending responsibilities, and the constraint of political power through the fiscal system. Legality refers to compliance with the statutory authorizations by the National People's Congress as China's legislature and the rule of law for public finance. Essentially, legality is all about procedural justice. Efficiency means that the fiscal system should strive to address structural issues facing China's economy, boost endogenous growth, and raise fiscal efficiency. Fairness means that the public finance system should protect social fairness and justice, improve public welfare and income distribution, and enhance public services. Adaptability means that the fiscal system should be adjusted and improved based on national development strategies and institutional problems.

Lastly, fiscal policymaking should consider external shocks, including major domestic and international risks and repercussions, effectively mitigating the impact of those shocks. Human society is fraught with risks. Internationally, rising populist and protectionist sentiments give rise to the China-US clashes. Public health risks are on the rise, as reflected in the frequent eruptions of public health incidents such as SARS and COVID-19. In the face of these risks and crises, science-based and reasonable fiscal policies should be adopted to mitigate and prevent external risks and crises, strike a balance between short-term stability and mid- and long-term growth, and enhance sustainable development while effectively coping with the shocks.

In a nutshell, the fiscal sustainable development framework consists of three elements: Adequate fiscal resources, reasonable and effective fiscal systems, and external shocks that create fiscal, economic and social uncertainties. These three elements are correlated and interact with each other. The fiscal system determines a country's capacity in collecting fiscal resources to keep its public finance running and counteract external shocks. The adequacy of fiscal resources determines the space and capacity of government macroeconomic regulation; external shocks will affect the entire socio-economic system. In coping with external shocks, a country must rely on its fiscal system's self-repair and self-regulatory capabilities and adopt fiscal policies based on its fiscal resources for sustainable fiscal and national development.

3. Evaluation of China's Fiscal Sustainable Development during the 14th Five-Year Plan Period (2021-2025)

Based on the above considerations, this section will provide an evaluation from three aspects for a more comprehensive analysis of China's fiscal sustainable development.

3.1 Adequacy of Fiscal Resources

This section analyzes the adequacy of China's fiscal resources from a government balance sheet perspective. Our analysis is primarily based on Li (2018) and Tang and Liang (2019) due to their studies being the most continuous and influential with more recent data. Through a comparative analysis, we have performed an analysis in data availability, comparability, and continuity, based on Li's inventory of China's government assets and explicit liabilities, after referencing Tang's calculation of contingent and implicit liabilities.

China's aggregate government assets are hefty, exceeding 140 trillion yuan in 2016 (Li *et al.*, 2018;

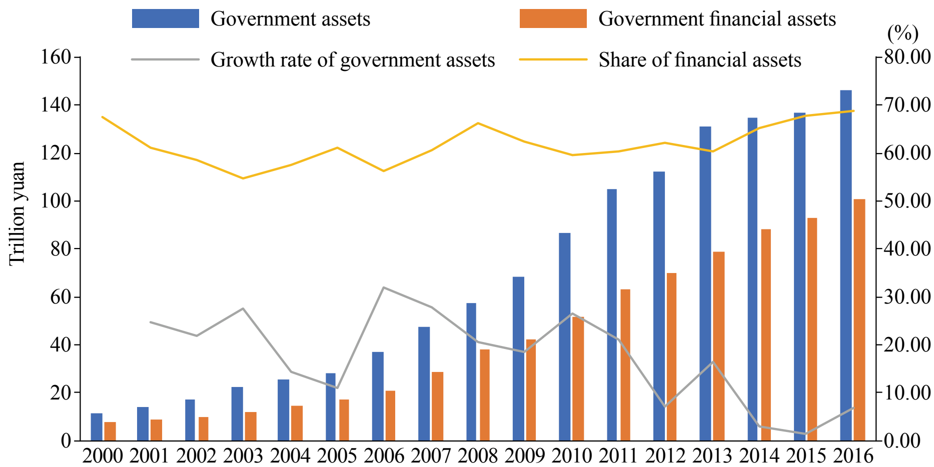

Figure 1: Size and Structure of China's Government Assets

Source: Li *et al.* (2018).

Tang and Liang, 2019). As illustrated in Figure 1, the annual growth of China's government assets has averaged close to 18% since 2000, significantly outpacing GDP growth; however, it started to slow sharply since 2011. In terms of asset structure, China's government assets are dominated by financial assets, accounting for more than 60% in most years. Financial assets are highly cashable and liquid. With liabilities taken into account, China's government balance sheet remains healthy. The net assets of the Chinese government increased from 55.5 trillion yuan in 2010 to 81.6 trillion yuan in 2016, which far exceed those of developed countries. China's debt to asset ratio started to increase since 2010 but only reached 44.18% by 2016. China's government balance sheet is relatively sound with limited debt risks. Fiscal resources at the government's disposal are sufficient with a relatively broad space for maneuverability. Government debt solvency and risk resiliency are both strong.

Meanwhile, some problems and challenges still exist regarding the adequacy of China's fiscal resources. First, the problem of implicit debt cannot be overlooked and presents a significant risk to China's fiscal sustainability. On the liability side, China's government debt has doubled in a mere six years from 30.94 trillion yuan in 2010 with an average growth rate of 13.4% during 2011-2016. The slowing growth of China's government liabilities in 2015 and 2016 suggest that China's debt risk mitigation measures had worked. In terms of the amount of debt, China's contingent and implicit debts accounted for 56.5% of China's total debt in 2016 and was up slightly from 54.6% in 2010. In terms of volatility, contingent and implicit debt growth have been higher than the explicit debt growth prior and in 2014, however, slower than the explicit debt growth in 2015 and 2016. Considering such volatility, contingent and implicit debts were more uncontrollable.

Another problem regarding China's fiscal resource adequacy is inefficiency. Change in government assets and liabilities primarily stems from the contribution of flow at the flow level and the change in asset value at the stock level. While the former refers to change in assets or liabilities stemming from annual government public spending, the latter originates from the change in the value of assets in stock (Li, 2018). Problems exist within both aspects.

In terms of the stock, existing government assets are underutilized and cannot establish a stable wealth growth mechanism. Since 2001, contribution of fiscal spending and public investment to China's government assets has gradually increased, up from 34.3% in 2001 to 73.8% in 2016. Contribution of fiscal spending and public investment to government net financial assets increased, averaging 57.8% in 2014-2016. Moreover, this suggests poor value maintenance and appreciation of China's assets in stock, which have been underutilized. Numerous assets have been idle, causing a significant waste of resources.

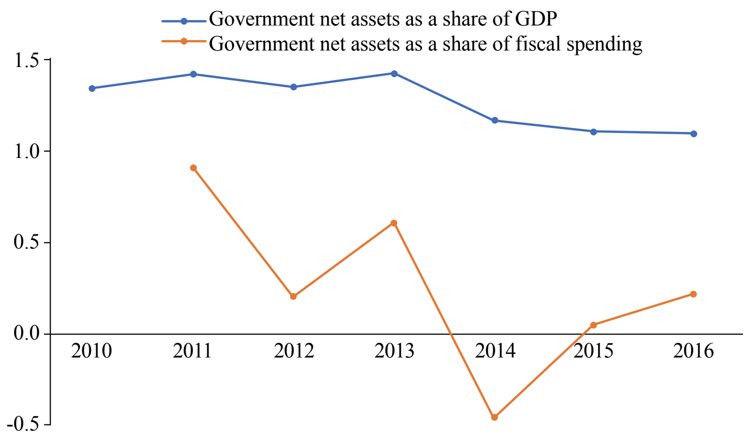

Figure 2: Input and Output of China's Government Net Assets

Source: *Report on the Implementation of the Central and Local Budgets and on the Draft Budgets*; calculated based on the research results of Li and Tang's research team.

In terms of the increment, government assets have largely derived from public investment and fiscal spending, but the efficiency of public investment has been poor. Public spending is a key contributor to China's growing government assets over recent years, but the problem of inefficiency is also becoming more evident. According to Figure 2, China's government net assets have been on the decline both as a share of GDP and as a share of fiscal spending, i.e. GDP and fiscal spending each year have resulted in slowing growth in government assets. That is to say, the wealth creation effects of China's GDP and fiscal spending have diminished with inefficient output. Government control of excessive resources will crowd out market-led investment; more government investment and less market-led investment will put a damper on economic efficiency, making China's growth target harder to attain and requiring more public investment to stimulate the economy in a vicious cycle (Bai, 2018).[1]

On the whole, China's sufficient fiscal resources and sound government balance sheets create solid material conditions for fiscal sustainable development. However, the adequacy of China's fiscal resources is also faced with the problem of contingent and implicit debts and inefficiencies. Implicit local government debt, aging population and environmental fragilities present key risks for fiscal sustainability at present and in the foreseeable future.

3.2 Institutional Lawfulness and Effectiveness

Based on the above analysis, this section will evaluate the lawfulness and effectiveness of China's fiscal system in terms of accountability, lawfulness, efficiency, fairness, and adaptability as key elements of China's fiscal sustainability.

3.2.1 Accountability

Accountability refers to the fulfillment of fiscal responsibilities in supporting national governance. It is both the boundary of fiscal power and a reflection of fiscal functions. The tax sharing reform of 1994 has initially created a public finance system with Chinese characteristics compatible with China's socialist market economy. Since then, China has taken steps to straighten out and transform the government-market relationship. With a brand-new orientation of public finance adopted at the Third Plenum of the 18th CPC Central Committee, public finance has become the foundation and medium for

[1] Bai, Chongen: *Transforming Local Government Incentives from Rapid Growth to High-Quality Development*, Sohu.net, February 28, 2018.

China's political, economic, and social subsystems, therefore putting forth new requirements on fiscal functions. According to those requirements, some problems still exist in China's fiscal system.

Externally, the nebulous boundary between government and market society and unbalanced responsibilities have blurred the boundary of fiscal spending. Unlimited spending responsibilities breed risks for institutional unsustainability. On one hand, fiscal spending is not subject to any boundary constraint due to the nebulous boundary between government and market society. All contradictions and pressures in the transition period are transferred to the government sector, forcing public finance to assume more responsibilities, and passive spending exerts huge pressures and challenges to fiscal stability (Fu and Li, 2013). On the other hand, public finance intervened excessively in microscopic affairs, and excessive fiscal interventions in market and social affairs go beyond a reasonable scope of fiscal functions, hampering the development of market and social functions and forcing the government to assume unreasonable spending responsibilities.

Internally, fiscal functions are disintegrated due to a lack of clear demarcation of rights and responsibilities between government agencies. China's fiscal budget allocation is decentralized among various functional authorities with "secondary fiscal allocation powers". To various degrees, functional agencies have been given a great deal of power to allocate budgetary funds. The fragmentation of fiscal powers has made national governance less effective and fiscal authorities less capable of allocating funds. The involvement of multiple competent authorities means that fiscal resources are not used under centralized and science-based management, and that fiscal functions are heavily influenced by the competing interests of functional authorities, presenting challenges to fiscal transformation and further heightening risks to fiscal sustainability.

China has initially established a fiscal system compatible with the socialist market economy, and the boundary of fiscal powers is generally stable. With the deepening of China's reforms, however, the boundary among government, market and society remains nebulous, public finance still assumes actual "unlimited spending responsibilities," and the government sometimes distorts the role of the market and the private sector. In terms of accountability, the boundary of China's fiscal powers is generally stable but subject to incessant minor institutional adjustments and regional changes. As reforms entered uncharted waters, fiscal boundary in some areas has become even more blurred due to obsolete concepts and practices and has yet to be further clarified.

3.2.2 Lawfulness

In terms of lawfulness, China has made constant progress in fiscal legislation. The establishment of the tax sharing system has been followed by continuous progress in China's fiscal legislation. China has adopted the *Budget Law* and the *Implementing Regulations on the Budget Law* and enacted the newly revised *Budget Law* in 2014 in order to regulate government fiscal behaviors for the first time from various aspects and transform the *Budget Law* from an administrative law to one that curbs government power; thus, highlighting the authority of the National People's Congress (NPC) for auditing and supervising final accounts.

Regarding tax legislation, China has instituted and enacted ten substantive tax laws, including the *Individual Income Tax Law*, the *Enterprise Income Tax Law*, the *Law on Environmental Protection Tax,* and the *Law on Resource Tax*, reflecting the statutory principles of taxation. In terms of supporting legislation, the *Audit Law*, the *Accounting Law*, the *Government Procurement Law,* and the *Law on Tenders and Bids* have further improved the development of China's legal systems for fiscal supervision.

In 2016, the Ministry of Finance released the *Implementing Program for Law-based Public Finance* in an attempt to develop a modern legal system for public finance underpinned by the central-local fiscal relations law and the budget law and enhance legislations on fiscal revenue, fiscal spending and fiscal administration. Yet China's fiscal legislation process still falls short of the requirements of national governance and a modern fiscal system.

First, China's fiscal legislation remains insufficient and dominated by government and departmental regulations, and fiscal laws are relatively few. China's fiscal system operates in the absence of a basic law, transfer payment law and central-local fiscal relations law. In terms of revenues, land transfer revenues and non-tax revenues are not regulated by law; in terms of spending, current legislation has yet to cover all government spending behaviors. Second, the status of the National People's Congress as China's legislature remains relatively low, budgetary powers are not evenly allocated between the executive and legislative authorities, and the binding force of the law is not strong. Executive authorities still wield great discretionary power in budgetary adjustment, greatly reducing the regulatory effectiveness and foreseeability of the budget law. The budgetary management and supervisory functions of the National People's Congress have yet to be enhanced. The National People's Congress's lack of powers in budgetary decision-making and implementation points to the lack of regulations on budgetary authorization and budgetary power restraint, which are key elements of the fiscal rule of law.

3.2.3 Efficiency

Efficiency in the allocation of fiscal resources: China has constantly improved fiscal revenue and spending structure and reformed the budgetary system in order to raise fiscal efficiency. Regarding revenue, China has established a tax system compatible with the socialist market economy and is conducive to incentivizing market entities and promoting sustainable socio-economic development. Regarding spending, China has further improved its fiscal spending structure, giving prominence to public welfare programs. Fiscal support mechanisms for key areas such as public welfare, poverty reduction, and research in science and technology have been steadily improving with increasing fiscal investment. Regarding the reform of the budgetary system, steps have been taken to clarify and improve the institutional framework of departmental budget and budget management. China has established and improved the "four budgetary systems," including the general public budgets, government-managed fund budgets, state-owned capital management budget, and social insurance fund budgets; therefore, steadily advancing the mid-term fiscal planning and management, increasing budgetary transparency, and establishing a comprehensive budgetary performance management system. However, China has yet to improve the efficiency of its own economic and social development and address the structural challenges concerning the transition of economic growth engines, industrial restructuring, and income distribution. China must address its structural and institutional problems and fiscal inefficiencies in order to develop a modern fiscal system and pursue high-quality development.

First, fiscal revenue management needs to be further standardized to clarify the boundary between taxes and fees rents. The "four budgetary systems" are nebulous in terms of their form and management. As the most standardized budgetary revenue, tax revenue as a share of the "four budgetary revenues" has been decreased from 53% in 2011 to 44% in 2019. Second, China's tax structure has a distortive effect on the economic structure. Turnover tax represents a lion's share of China's tax revenue, which reached 51.02% in 2019. Third, economic growth drivers increasingly shift from factor input to innovation as China enters a new stage of high-quality development, in which the role of technology and education cannot be emphasized more. The problem is that inadequacies still exist in the fiscal input mechanisms for R&D and education.

3.2.4 Fairness

One of the fiscal functions and goals is to preserve social fairness and justice. In recent years, China has continuously enhanced the income distribution effect of its tax system, established fiscal spending mechanisms for public welfare, and equalized access to public services. Steps have been taken to form a multitiered social protection system featuring full coverage, urban and rural coordination, clear rights and responsibilities, a moderate level of protection, and fiscal sustainability. However, there is still room to improve the fairness of China's fiscal system.

First, structural distortions exist in fiscal spending. Government investment and capital formation expenditures account for an outsize share. Excessive productive spending has proportionally reduced spending on public welfare and public services. China's education, healthcare, social security and employment services are far from satisfying people's growing needs for a better life. Problems in healthcare accessibility and affordability remain. Vocational training services are insufficient. Significant gaps in pension fund exist. The level of public services varies considerably between urban and rural regions, and public welfare programs are still inadequate.

Second, public finance has a limited regulatory effect on income distribution. The lack of fairness is giving rise to social contradictions and conflicts. China's tax system has a significant regressive effect due to various reasons. For instance, income tax and property tax account for a minuscule share of total tax revenue, a unified social protection tax is absent, and the individual income tax has an insufficient regulatory effect on income distribution. Such regressive effect is unfavorable to regulating income distribution and enhancing social fairness through taxation.

3.2.5 Adaptability

The Third Plenum of the 18th CPC Central Committee has defined the role of public finance as the "groundwork and pillar of national governance" within the new era. Fiscal reform has always played a fundamental role and has made great progress in improving budgetary management systems, deepening tax reforms, and adjusting the fiscal relationship between central and local governments.

First, China has reformed its budgetary management system, improved government budgetary system, made steady progress in mid-term fiscal planning management, budget transparency and cross-year budget balance mechanism, and implemented budgetary performance management on all fronts (Yan and Yu, 2017).

Second, China has implemented tax reforms, including the business tax to VAT reform, the individual income tax reform and the consumption tax and property tax reforms, established the comprehensive and classified individual income tax system, and started to collect the environmental protection tax.

Third, China has reformed the division between central and local fiscal powers and spending responsibilities to improve central-local fiscal relations. Specifically, it has enacted the *Guiding Opinions on Reforming the Division between Central and Local Fiscal Powers and Spending Responsibilities* and the *Reform Program for Dividing Common Fiscal Powers and Spending Responsibilities in Basic Public Services* to accelerate the reforms of central and local fiscal powers and spending responsibilities in 15 areas. However, the progress of China's fiscal reforms has been slower than expected. Then Finance Minister Lou Jiwei also said in 2016 that the current progress of China's fiscal reforms was "a bit slower than required by the Third Plenum".[2] Hence, China should continue expediting fiscal reforms, improve the modern fiscal system, and lay a solid foundation for fiscal sustainability.

3.3 External Shocks

Human society is fraught with risks but has yet to create a knowledge system for coping with uncertainties and derived risks (Liu *et al.*, 2018). Currently, China's public finance is confronted with significantly more risks and external shocks than before. Frequent public crises such as the SARS crisis of 2003 and the global financial crisis of 2008 highlight the importance of coping with external shocks. This section will offer an analysis of how to cope with major external shocks from a sustainability perspective with the COVID-19 pandemic as an example. In response to the economic shocks of the COVID-19 pandemic, the Chinese government has ramped up macroeconomic regulation and demonstrated China's institutional strengths in both pandemic control and the recovery of economic

[2] Zhu Rongji: Finance Minister Lou Jiwei answers questions on fiscal work and fiscal reforms (transcript), Caixin.net, March 7, 2016.

and social life. Economic recovery has been boosted by implementing a proactive fiscal policy, including infrastructure construction such as the 5G network and data centers. In addition, China has raised the fiscal deficit ratio, issued special treasury bonds, scaled up local government special bonds, and introduced a succession of measures to lower taxes and fees in supporting pandemic control. These measures have been timely and necessary; however, the logic and approach of fiscal policy for addressing external shocks should be clarified from a fiscal sustainability perspective.

First, a proactive fiscal policy must balance the relationship between short-term, mid- and long-term economic growth and prevent the deterioration of mid- and long-term structural problems due to the preoccupation with short-term growth. China's current economic problems are primarily structural ones. A proactive fiscal policy must strike a balance between social and economic growth and mid- and long-term economic growth potentials, thus refraining from reverting to a deluge of stimulus policies that could further deteriorate the structural problems facing China's economy; therefore, making future structural adjustments and economic transitions more challenging.

Second, a proactive fiscal policy must be efficiency-oriented, reasonable, and effective. Fiscal policy effectiveness is subject to the multiplier and crowding-out effects. With increasing government spending and fiscal deficit or debt, the fiscal policy's crowding-out effect becomes more evident. Hence, China's current proactive fiscal policy should increase efficiency and fiscal spending, in particular, limit government investment in areas where market failure discourages private investment; therefore, avoiding the crowding-out effect on private capital.

Lastly, the fiscal policy should strengthen economic fundamentals at the micro level and benefit economic entities through institutional reforms. Without conducive market fundamentals, no fiscal policy or macro-regulation policy would achieve real effects in the long term. Hence, we must strengthen economic fundamentals, adopt more targeted fiscal policies, remove obsolete barriers and institutional bottlenecks through institutional reforms, and enhance policy benefits to economic entities.

4. Policy Implications for Enhancing Fiscal Sustainable Development in the 14th FYP Period

Faced with various risks, China must step up top-down design, deepen reforms on all fronts, and create a modern public finance system to undergird fiscal sustainability.

4.1 Ramping up Government Asset Management and Operations and Expanding Fiscal Resources

Facing slowing fiscal income growth and increasing fiscal spending, policymakers must explore fiscal innovations to expand fiscal resources and meet fiscal sustainability needs.

4.1.1 Enhancing government balance sheet management and innovating fiscal investment and financing systems

We should further straighten out the government balance sheet and classify and take stock of various government assets and liabilities based on government functions and financial objectives. Priority should be given to improving the database, reporting and managing government assets and liabilities, formulating government balance sheets, enhancing supervision over government assets and liabilities, evaluating balance-sheet risks continuously, and creating a balance-sheet information disclosure system. We should put into place a standard government debt financing system to improve government credit rating, debt monitoring, and debt information disclosure.

We should deregulate private investment, treat all investors equally, implement the negative list management, and expedite the transition towards a service-based government. Financing channels should be broadened by developing industrial (equity) investment funds, asset securitization, debt financing instruments for non-financial corporations, and project revenue bonds. Fiscal guidance and inducement effects should be brought into play by introducing government guidance fund, private capital, funds from financial institutions, social security funds, insurance funds, and overseas capital, and public-private partnership (PPP) model should be improved. The stock of assets and liabilities should be activated by investing the pension fund and the housing provident fund in capital markets, and developing mechanisms for the maintenance and appreciation of government assets. Private capital should be introduced through financial leasing and asset securitization to activate the stock of projects, increase government asset liquidity, and use project revenues to support public services and infrastructure.

4.1.2 Enhancing public investment effectiveness

We should review and clarify the areas and directions of government spending, prioritize public services and areas of market failure, and introduce private financial capital in other areas to give play to the decisive role of market mechanisms and raise investment efficiency. We should enhance the planning of government investment projects, create a standard project investment decision-making mechanism, adopt a rigorous project review and approval system, and formulate cross-year government investment plans. Investment project proposal and confirmation, decision-making, and use of funds and debt repayment should be brought under integrated management in order to raise efficiency and curb local debt risk.

4.1.3 Advancing reforms in critical areas to address mid- and long-term potential risks

One priority is to reform the pension insurance system. We should set clear objectives of the pension insurance system, reasonably share responsibilities among the government, enterprises and individuals, integrate the social security fund management functions of various departments, expedite the national pooling of employee basic pension, and share responsibilities between central and local governments. Insurance coverage should be broadened to give more protection to high-risk and vulnerable groups. We should create a multitiered pension protection system with market-based funds and diverse and professional investors, foster a multitiered pension protection system, develop quasi-compulsory professional annuity as the second pillar of the pension fund, and encourage commercial pension insurance and personal savings pension insurance by offering tax credits and subsidies. More state capital should be allocated to supplement the social protection fund and bolster the national social protection reserve fund system.

Another priority is to enhance environmental management. We should further straighten out and specify the administrative powers of government at all levels for environmental protection, and enhance the fiscal spending powers and responsibilities of central and provincial governments. Environmental legislation should be improved by offering tax credits and penalties and broadening the scope of environmental tax based on the emergency of pollutants, including CO_2 emissions. Legislation should be introduced to create a horizontal transfer payment system for ecological compensation to reduce the cost of negotiation among local governments, which should be held accountable for environmental protection in their jurisdictions. Avenues should be created for public and media agencies to participate in environmental supervision.

4.2 Advancing Fiscal Reforms and Creating a Modern Fiscal System

4.2.1 Fostering market and social development, and clarifying the scope of fiscal responsibilities and expenditures

The scope of fiscal responsibilities and expenditures should be clarified to facilitate the transition towards a “limited and effective government”. Specifically, we should deepen institutional reforms, transform government functions, foster and strengthen the market society, allow market entities and the “third sector” to play a larger role and assume more responsibilities, thereby freeing the government from "unlimited responsibilities"; therefore transforming government functions. In fostering the market society and promoting its interactions with the government, we should establish a clear boundary between the government and the market society, focus the government on market failures, public administration and services, identify the boundary and scope of fiscal spending responsibilities, and give play to a decisive role of the market in allocating resources.

4.2.2 Aligning administrative powers with spending responsibilities

We should divide administrative powers and spending responsibilities between central and local governments and clearly define the functions of the government at all levels. We should reasonably divide administrative powers and spending responsibilities between central and local governments with a general consideration to fairness, efficiency, and fiscal sustainability. The central government should assume more administrative powers and spending responsibilities as appropriate and delegate fewer matters to local governments. Priority areas should be demarcated in more detail and with more clarity to clear barriers to implementation. Fiscal powers should be matched with administrative powers by improving the transfer payment system as well as developing the local tax system.

4.2.3 Reforming and improve the fiscal revenue system

The structure of fiscal revenues should be reshaped to increase fiscal revenue standardization. Specifically, we should straighten out administrative fees and government funds, disclose non-tax revenues, propel the tax-for-fee reform of the basic pension fund, reduce non-tax revenues and government fund revenues as a share of total government revenues, and increase the share of tax revenues. SOE profit submission mechanism should be improved by raising the proportion of state-owned capital gains that are turned over to the public finance. We should raise tax revenues as a share of total public revenues, improve the property tax system, expedite the individual income tax (IIT) reform featuring comprehensive declaration and itemized deduction, carry out the "fee-to-tax" social security reform, and levy the inheritance and gift tax. We should reduce indirect tax rates and continue improving the VAT structure. Resource tax and environmental tax should be reformed to greenize existing taxes. We should also reallocate existing taxes at central, provincial, city and county levels, improve the resource tax, expedite the reforms of the property tax and the consumption tax, and create a system of local staple taxes. Law-based taxation should be steadily advanced through tax legislation.

4.2.4 Creating a performance-based modern budget management system

Steps should be taken to reform the budget management system referencing international experience and based on China's national conditions. In carrying out the principles laid out in the *Opinions of the CPC Central Committee and the State Council on Comprehensively Implementing Budget Performance Management*, we should take steps to build a comprehensive, full-process and full-coverage budget performance management system, clarify spending responsibilities, and introduce performance evaluation in budgetary management. With a performance-oriented approach, innovation should be breathed into the budgetary model and management, transform the method of budgetary control, the scope of budgetary system and the means of fiscal administration, and take steps to create an institutional framework for budget performance management.

4.3 Instituting and Optimizing the Fiscal Policy System Based on Fiscal Sustainability

We should stabilize growth and restructure the economy by ramping up fiscal spending on new infrastructure development such as new-type urbanization, transportation, and water conservancy among other major projects. Given China's weak areas and structural issues, fiscal spending should be focused on such new infrastructure sectors as 5G communication, new-energy vehicle charging facilities, artificial intelligence (AI), big data and smart cities, and public infrastructure and services for densely populated metropolitan areas. After systematically taking stock of new-type infrastructure facilities and various processes, we should focus fiscal spending on areas of market failure and public services; thus, introducing private financial capital in areas where market mechanisms can be introduced as well as giving play to the decisive role of the market in allocating resources. In the mid and long term, we should lower institutional costs and strengthen economic fundamentals at the micro level. Market-oriented labor, capital and land reforms should be carried out to eliminate administrative monopoly, ineffective regulations, alter disadvantaged status of private sector, and undergird fair market competition. The government should also ramp up fiscal spending on scientific research, technological innovation, and strengthen the technological competitiveness of enterprises. Social housing, education, healthcare, and social security reforms should be carried out in order to enhance social welfare, reduce household burden, and expand domestic consumption.

References:

[1] Buiter, Willem H. 2002. "The Fiscal Theory of The Price Level: A Critique." *Economic Journal*, 112:459-480.

[2] Buiter, Willem H., Persson Torsten, and Minford Patrick.1985. "A Guide to Public Sector Debt and Deficits." *Economic Policy,* 1(1):13-79.

[3] Deng, Xiaolan, and Baodong Chen. 2017. "Research on Fiscal Sustainability's Problems and Solutions under the New Normal: Also Focus on Fiscal Supply-Side Reform Policy." *Journal of Central University of Finance & Economics*, 1:3-10.

[4] Fu, Zhihua, and Chengwei Li. 2013. "Vigilance on Unlimited Fiscal Expenditure Responsibility." *Chinese Cadres Reference*, 9:13-14.

[5] Li ,Yang, ed. 2018. *China National Balance Sheet 2018*. Beijing: China Social Sciences Press.

[6] Lipset, Martin. 1993. *Political Man: the Social Bases of Politics*, translated by Liu Gangmin and Nie Rong. Beijing: Commercial Press.

[7] Liu, Shangxi, Chengwei Li, and Dewei Yang. 2018. "Finance and State Governance: Based on the Logic of Uncertainty and Risk Society." *Public Finance Research*, 1:10-19.

[8] Liu, Shangxi. 2015. "An Analytical Assessment Framework for Local Fiscal Capacity." *National Governance*, 12:31-37.

[9] Ostrom, Elinor, Larry Schroeder, and Susan Wynne. 1993. *Institutional Incentives and Sustainable Development: Infrastructure.* Boulder: Westview Press.

[10] Rubio, Oscar B., Carmen, Díaz-Roldán, and Vicente Esteve. 2010. "On the Sustainability of Government Deficits: Some Long-term Evidence for Spain, 1850-2000." *Journal of Applied Economics*, 13(2): 263-281.

[11] Tang, linmin, and Zihua Liang. 2019. "The Chinese Government Balance Sheet 2019." *Financial Minds*, 5:19-53.

[12] Wilcox, David W.1989. "The Sustainability of Government Deficits: Implications of the Present-Value Borrowing Constraint." *Journal of Money, Credit and Banking*, 21(3):291-306.

[13] Yan, Kun, and Shuyi Yu. 2017. "Review and Prospect of China's Fiscal and Taxation System Reform since the 18th CPC National Congress." *China Finance,* 20:19-22.

[14] Yu, Yongding. 2000. "A Theoretical Framework of Financial Stability Study." *World Economy*, 23(6):3-12.

[15] Zheng, Gongcheng. 2008. *30 Years of China Social Security*. Beijing: People's Publishing House.