

## Achieving Strategic Change in a Decentralised Economy: Intergovernmental and Fiscal Challenges

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## Introduction

China's structural rebalancing is a multidimensional challenge, spanning from energy intensity and investment domination to low provision of basic public services. Implications for the fiscal system are profound, involving:

- the level and distribution of public expenditures;
- the level, composition and decentralisation of fiscal revenues; and the level, composition and orientation of fiscal transfers.
- Also needed is a more effective system of incentives for greater effectiveness and accountability

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## Key Issues for Rebalancing China's Fiscal System

- Public expenditure on merit goods (i.e., health and basic education) must be increased, particularly in central and western regions and in rural areas
- Fiscal revenue system should be broadened
- The system of revenue sharing and fiscal transfers should be reformed
- Fiscal transfers need to be targeted on national priorities and their effectiveness improved.

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## Basic Public Services, Public Goods and Merit Goods

- Public goods are non-rival and non-exclusive. The consumption of public goods by one person does not reduce the consumption by other people. Secondly, once a public good is provided for a society, its members cannot be excluded from consuming it, even if they do not pay for its production.
- Examples are National defence, environment, Public health (e.g., immunisation, sanitation)

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## Merit Goods

- Merit goods are those private goods whose benefits accrue to both the individual and the society, because these goods have powerful externalities
- Education and health care are best examples
- That is why governments in most countries are involved in the provision of these goods
- That is also why the world community is concerned about MDGs

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## Public Spending on Basic Services in China

- China's public expenditure on education and health is too low, although it has been rising in the past few years.
- Correspondingly, the share of private expenditure on education and health is too high
- Thus, access to these public services is based on income. This situation also leads to high precautionary savings, low consumption, and vulnerability to income shocks - pushing many households into poverty

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### Public Spending on Education & Health 2000-2008 (% of GDP)

	2000	2004	2008
<b>Education</b>	1.7	2.0	3.4
<b>Health</b>	0.5	0.6	1.2

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### Rising Dependence on Private Funding - Education (% of Total Spending)

Year	Government Expenditure	Personal Spending	All Other sources
1991	84.5	4.4	11.1
2000	66.6	15.5	18.0
2002	63.7	16.8	19.4
2004	61.7	18.6	19.7

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## Rising Dependence on Private Funding - Health (% of Total Spending)

Year	Government Expenditure	Personal Expenditure	Social Spending
1980	28.0	16.0	56.0
1995	17.0	50.3	32.8
2000	15.5	59.0	25.5
2006	18.1	49.3	32.6

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## Benefits of Higher Public Spending on Health

- High private health spending is most likely causing households to save more. Higher government spending on health would reduce the need for precautionary saving and enable households to spend more on other goods and services. IMF estimates show that a 1% of GDP increase in govt health spending would boost private consumption by 2% of GDP (i.e., multiplier effect of 3 of GDP). The case of education is not the same, however.

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## Basic Public Services and Fiscal Decentralisation in China

- Responsibility for basic education and health services rests with local governments, whereas the fiscal revenue is principally under the control of the central government.
- Local governments have little authority to either impose taxes or vary tax rates even if they wanted to raise additional funds
- This makes the levels of these services across provinces dependent on 'own revenue' and therefore highly unequal

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Fig.1: Government Expenditure on Disease Control by Province by GRPPC

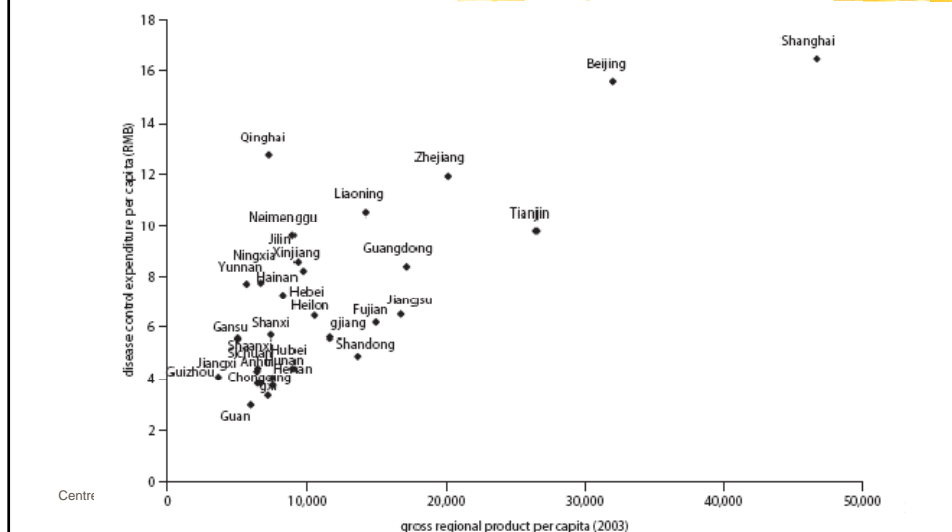
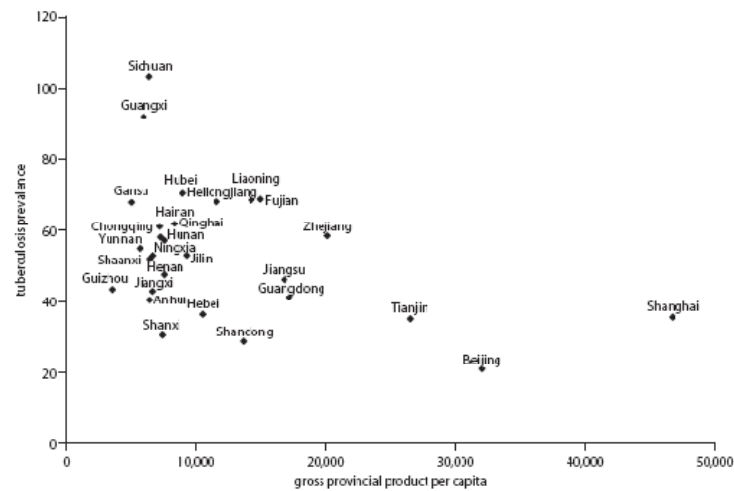


Fig. 2: The Incidence of TB by Province by GDPPC



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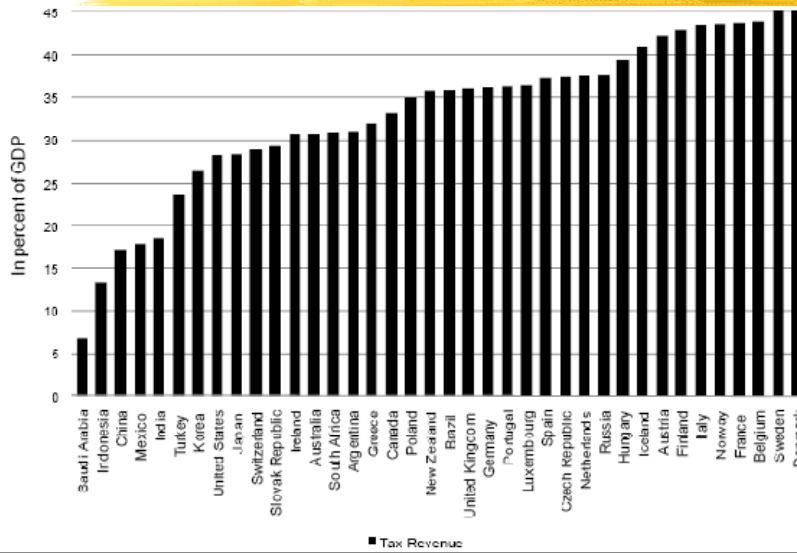
## Issues in China's Fiscal Revenue System

- Tax revenue in relation to GDP is low
- Fiscal revenue system is too heavily reliant on VAT
- Not enough revenue is raised from income taxation
- Provincial revenues are concentrated in wealthy east coast provinces
- Local governments have little power over tax rates and tax bases

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### Tax Revenue in OECD and Other G-20 Countries



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### PIT in Tax Revenue in Selected Countries

	Tax Revenue % of GDP	PIT/Total Tax Revenue	PIT Top Marginal Rate
Russia	35.9	11.1	13
Brazil	35.8	8.9	27.5
Korea	26.5	16.7	35
India	<b>18.6</b>	<b>11.7</b>	<b>30</b>
China	<b>18.0</b>	<b>6.9</b>	<b>45</b>

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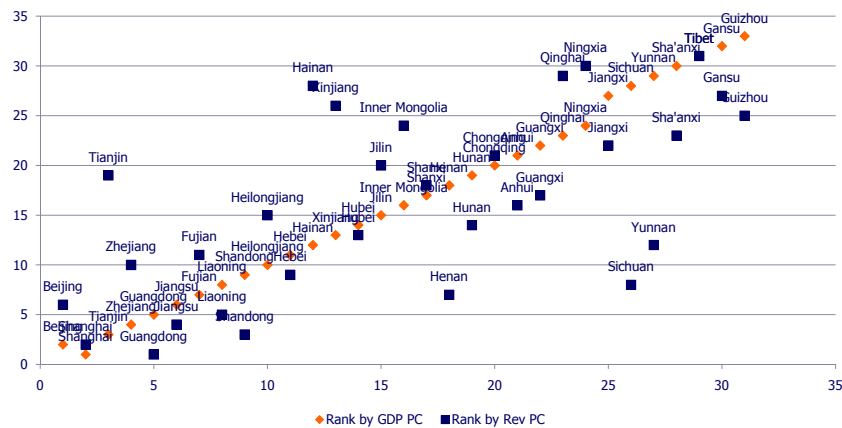
## Taxes on Goods & Services in Selected Countries

	Goods Taxes % of Tax Revenue	VAT % Total Tax Revenue	Excises % Total Tax Revenue
China	65.6	47.3	4.7
Brazil	29.4	25.3	0.6
Korea	28.3	15.8	11.5
Russia	20.7	18.2	2.5
India	14.1	---	14.1

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### Figure 2: Regional Concentration of China's Fiscal Revenues



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## Intergovernmental Fiscal Transfers

- Fiscal transfers are not well-aligned to national priorities
- While nearly 50% of transfers are in the form of special purpose grants, their effectiveness is poor and accountability of local governments is low (NAO).
- Distribution of tax rebates and system subsidies continues to be based on pre-1994 shares
- Although distribution of 'general fiscal transfer' is based on fiscal capacity equalisation, its weight in total transfers remains small. Besides capacity equalisation is not suitable for China's priorities

## Categorical Equalisation

- If horizontal inequality is perceived in terms of the provision of merit goods, as it is in China right now, categorical equalisation is more effective than capacity equalisation.
- This approach to equalisation is used in the USA, where Congress views horizontal equity in terms of service levels, not local tax rates.

## Why Categorical Equalisation for China?

- National priorities need to be implemented at sub-national government levels
- Sub-national governments in China do not exercise choices for tax rates and tax bases
- Fiscal costs of categorical equalisation will be lower

## Higher Weighting be given for Population with Higher Need

- Higher weights should be given to:
  - Rural population
  - Population in the age group 0-14 years
  - Population in the age group 64 years and above
- As these measures of need are independent of policy and are objective measures of relative demand for education and health, they cannot be manipulated. So, moral hazard will be avoided.

## Equalisation is Never Free of Cost

- Costs of equalisation depend on size of the recipient population & the equalisation gap
- In China, this could mean that urban population (44% of total) would subsidise basic public services for the rural population (56% of total)
- Urban-Rural income gap is now around 3.3:1
- The choice of equalisation standard – national or provincial average – will also affect the cost, and hence the need for higher taxes or lower spending on other services or both

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## Improving Incentives, Effectiveness & Accountability of Fiscal Transfers

- Targets for fiscal transfers must be in terms of Output/Outcomes of health and education
- Memorandums of Understanding (MOU) should be signed with every provincial government
- Reliable statistics be developed on outputs and outcomes for monitoring performance – may be with involvement of leading universities
- Performance based incentives should be used to encourage compliance with MOUs.

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## Current Incentives are Mainly Administrative

- Co-ordination is currently via Leader's Groups and promotion of local government personnel is used as an incentive for implementation of national government policies.
- But, results often indicate either perfunctory compliance or disregard of Beijing's instructions
- A new system of incentives based on meeting mutually agreed policy targets is needed for implementing policies for structural rebalancing in energy efficiency and social development

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## Ineffectiveness of Current Incentives

After citing cases of huge expenditure on urban beautification projects instead of productive infrastructure in in Gansu, Shaanxi, Guizhou, Shi Yulong and Du Ping 2004, wrote: "These cases provide us with a typical scenario of urban infrastructure projects in the western region. It is difficult to understand what is going on. If these can be the best ways to promote urbanization and the western region development process, we will definitely have to face a disappointing outcome in the near future."

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## Competing Forces Against Inland Regions

- The former Mayor of Shenzhen, SDPC Vice-chair Li Zibin lead a high profile tour of 50 overseas Chinese investors to the western region, but only one Hong Kong investor agreed to invest in a cement factory in Sichuan (p.152).
- The Shanghai developers, the Shanghai municipality, and even the Ministry of Construction strongly resisted the efforts of central officials to encourage the Shanghai commercial and real estate developers to 'go west' and invest in the western region. Their main argument was that the Chinese government has been encouraging them to follow the market and become competitive, but that there was no money to be made in the west." (Gregory T. Chin 2004, p.153).

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## Conclusion

- Urgent need for increasing public expenditure on health and education
- Valuable opportunity for redesigning tax system more consistent with new national priorities
- Urgent need for addressing fiscal inequalities across provinces and between urban & rural areas by categorical equalisation of health and education outcomes
- Need for greater compliance with targeted fiscal transfers

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# Thank You

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## Regional Shares of Selected Economic Indicators

	Western	Central	Eastern
	Regional GDP as % of National GDP		
Before WRDS	17.97	32.0	50.04
After	17.05	29.47	53.48
	GDP PC % of National Average		
Before WRDS	62.45	80.45	159.08
After	60.29	76.16	162.01
	Own Fiscal Revenue		
Before WRDS	18.94	28.17	52.89
After	16.86	22.85	60.29
	Urban Employment		
Before WRDS	22.67	38.80	38.52
After	22.13	32.07	45.80

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Table 1: Income Inequalities in China  
(GINI)

Year	National	Urban	Rural
1985	0.237	0.169	0.233
1990	0.300	0.183	0.304
1995	0.345	0.215	0.351
2000	0.354	0.253	0.352
2005	0.410	0.341	0.348
2007	0.408	0.334	0.338
Note: Peaks shown in Red		OECD Eco. Survey of China, 2010	

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## Basic Public Services as a Public Goods and Merit Goods

- Public goods are non-rival and non-exclusive (Samuelson 1954, Musgrave 1959)
- Examples of public goods
  - National defence, Global environment, Public health (e.g., immunisation, sanitation, clean drinking water)
- Merit Goods are those private goods that also benefit society
- Examples of merit goods
  - Education and health (e.g., MDGs)

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## Rebalancing Issues at the end of 10<sup>th</sup> FYP

- an unbalanced economic structure and slow change in the pattern of economic growth;
- excessive consumption of energy and resources;
- worsening environmental pollution;
- serious unemployment;
- imbalance between investment and consumption;
- widening disparities in development between urban and rural areas and between regions; and
- **inadequate development of social programs.**

- Premier Wen Jiabao, March 2006 Report on the Work of the Government

## Rebalancing Aims of the 11<sup>th</sup> Five Year Plan

The aims were to:

- Change the structure of economic growth towards the services sector
- Accelerate growth of those service sectors that directly contribute to individual welfare (e.g. Education & health)
- Reduce income disparities between urban and rural populations and among China's regions
- Improve the position of people in rural areas

## Potential Improvements in Intergovernmental Co-ordination

- A bottom-up approach to policy formulation
- Better co-ordination mechanisms and forums
- Effective co-ordination would improve the likelihood of compliance, because the local governments should feel involved and have a sense of ownership of policies
- Local capacity building – for both policy analysis and implementation.