

Key Points

- The most important structural challenge facing the PRC in the post-global crisis period is rebalancing toward domestic sources of growth.
- Rebalancing requires a comprehensive reform package of mutually supportive and consistent policies rather than a single policy pursued in isolation.
- These include reforms in the finance sector, labor market, and pricing, including a more flexible exchange rate system.
- Within a favorable overall policy environment, fiscal policy can play a key role in the rebalancing process.
- Specific fiscal measures include shifting the composition of public spending, developing automatic stabilizers, expanding the supply of low-income housing, establishing property taxes, and reforming the value-added tax system.

The Role of Fiscal Policy in Rebalancing the People's Republic of China

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The People's Republic of China (PRC) has weathered the global financial crisis remarkably well. Effective and timely government stimulus measures resulted in a stronger recovery than expected. The massive fiscal stimulus launched in November 2008 has played a key role in the PRC's V-shaped economic recovery.

While the government's decisive fiscal response facilitated a rapid recovery, a wide range of medium-term structural challenges loom on the horizon. Successfully addressing these challenges—which include preparing for an aging population and achieving more inclusive growth—is essential for sustaining growth in the medium and long term. The most important structural challenge facing the PRC in the post-crisis period is rebalancing the sources of growth.

The global crisis has highlighted the risks of excessive dependence on exports as the engine of growth. Furthermore, growth driven primarily by investment eventually leads to deterioration in the quality of investments and excess capacity. Therefore, the PRC needs to shift away from an export- and investment-led growth model to a more balanced model that accords a greater role to domestic demand and consumption. This brief highlights the pivotal role to be played by fiscal policy in PRC's rebalancing process if other supportive and complementary policies are in place.

Creating a Favorable Environment for Rebalancing

Excessive reliance on investment, exports, and industrial development has created structural imbalances in the PRC that jeopardize future growth. These include (i) declining total factor productivity levels resulting from overinvestment and excess capacity in key industries; (ii) labor surpluses owing to the capital-intensive nature of the growth model; (iii) widening income inequality and regional disparities due to the geographical bias of export-oriented industry; (iv) high savings that constrain

consumption and downplay the role of domestic demand as a source of growth; and (v) an allocation of resources that undermined the development of services, particularly the provision of social services.

Rebalancing is a complex process that covers a wide range of structural adjustments to both the supply and demand sides of the economy. Therefore, rebalancing requires a comprehensive reform package of mutually supportive and consistent policies rather than a single policy pursued in isolation, as suggested below.

Financial reform

Liberalizing the finance sector, including capital markets, would improve the allocation of capital in support of the transition to a services-oriented economy. In particular, the small and medium enterprises that are the backbone of the services sector would benefit from improved access to bank lending. On the demand side, greater availability of consumer credit would boost private consumption, especially of durable goods. Financial development would also foster consumption by diluting the precautionary savings motive, for example, by increasing the availability of private health and retirement insurance. In light of the weakness of rural consumption, one area that deserves particular attention is facilitating access to financial services and products in rural areas. This requires the design of specific lending products targeting rural consumption needs.

Labor market reform

The unbalanced, capital-intensive nature of PRC's growth strategy has led to large labor surpluses, mainly in rural areas. This has been compounded by rigidities in the labor market, particularly the non-portability of benefits and restricted labor mobility owing to cumbersome household registration (*hukou*) requirements. To address these issues, a far-reaching reform in the labor market is necessary. Main reform targets should include the relaxation of the *hukou* system, and improvement of public services for migrant workers and of the portability of benefits. These measures will boost consumption by adding to household income and by reducing precautionary savings. Enhanced worker mobility would also help narrow income inequality and regional disparities. In this context, developing services would underpin efforts to increase labor mobility by generating new employment opportunities across the country.

Pricing reform

A more flexible exchange rate system would be a key component of the policy package for rebalancing. An undervalued currency is, in effect, a subsidy for exports because it enhances their international competitiveness. A stronger currency would reverse the trend and favor non-tradables over tradables. Additionally, it would lower the cost of imports and increase household purchasing capacity, resulting in a positive income effect that encourages consumption. However, the exchange rate is only one of several subsidies for manufacturing and exports in the PRC. A wide range of production inputs—including land, labor, energy, water, natural resources and the environment—is underpriced due to policy distortions. Removing those distortions so that input prices reflect true marginal costs would facilitate the reallocation of resources from export-oriented manufacturing to domestic services.

Policy Directions for the PRC

This brief identifies six positive policy prescriptions to strengthen the role of fiscal policy in PRC's rebalancing process.

First, shifting the composition of public spending from investment to public services would raise the disposable income of households and thus reduce precautionary savings and encourage consumption. State redistributive mechanisms have been weakened in the transition toward a market-oriented economy. Taxation was introduced, but government transfers, particularly for education, health, housing, and pensions, declined sharply. While social spending is being increased at present, public expenditure on education, health, and social security combined still amounts to 6% of gross domestic product (GDP) compared to 28% in Organisation for Economic Co-operation and Development (OECD) countries.

Second, further developing automatic stabilizers in the PRC would mitigate the risk and uncertainty households

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face, and thus strengthen private consumption, as they are triggered by built-in tax codes or spending rules that increase net public expenditures in a recession, and reduce them in an upturn. Further, although their primary objective is to reduce short-run output volatility, automatic stabilizers also have a strong element of social protection.

Third, expanding the supply of low-income housing would increase the disposable income of poorer households. In this context, fiscal policy can contribute to increasing both the supply of and demand for housing. The PRC could establish a formal mechanism for construction of low-income public housing in the form of municipal housing authorities. Additionally, the introduction of fiscal incentives for developers would attract the private sector into the less profitable, low-income housing segment. On the demand side, consumers would benefit from tax exemptions, cash subsidies or housing allowances, and capital grants. Further, the provision of state guarantees and/or public mortgages would mitigate credit rationing and make housing financing available to a larger share of the population.

Fourth, a property tax would mitigate local governments' heavy reliance on land sales for their revenues. Being imposed on all property owners based on the value of their properties, a property tax is a significant source of stable tax revenue for local governments. Although the PRC has not yet introduced a property tax, four cities—Beijing, Chongqing, Shenzhen, and Shanghai—are planning to start experimental schemes to tax home ownership, motivated by the goal of curbing property speculation targeting only high-end luxury residences. While these taxes are a step in the right direction, the ultimate goal must be a genuine property tax based on home values and universally imposed on all urban homes.

Fifth, reforming the value-added tax (VAT) system to include services would also result in higher government revenue and a better provision of public services. The VAT is the single largest source of tax revenues in the

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PRC, amounting to 5.5% of GDP in 2009. VAT revenues are shared between the central (75%) and the local (25%) governments. In the PRC, the VAT is levied only on the manufacturing sector. Services are subject to the business tax instead. Given the heavy dependence of local governments on VAT revenues, local governments face a strong incentive to promote manufacturing over services. It would thus be advisable to include services in the VAT base, which in turn will raise local government revenues, thus enhancing their capacity to provide public services.

A major background factor which further favors the active use of fiscal policy for rebalancing the PRC is the country's relatively healthy state of public finances. Due to a history of fiscal prudence and more or less balanced government budgets, the ratio of PRC's government debt to GDP currently stands at slightly over 20%. While there are some qualifications, such as potentially large local government debt and contingent liabilities, the PRC is clearly in a strong fiscal position with enough fiscal space to undertake a moderate fiscal expansion in the medium term. In fact, it was precisely such ample fiscal space that allowed the government to pursue the massive fiscal stimulus which enabled the country to mount a speedy and robust recovery from the crisis. In principle, a change in the composition of fiscal policy—e.g., away from physical infrastructure investments toward health, education, pensions, and social protection—can promote rebalancing without fiscal expansion. In practice, in light of the fact that the PRC is a low-tax, small-government region in the international context, the scope for shifting the composition of government spending remains limited. The country also has pressing infrastructure needs in the medium term, especially in the interior provinces, so it would be sub-optimal to cut back spending on infrastructure to make more room for social protection outlays. Therefore, implementing specific pro-rebalancing fiscal measures, such as strengthening social protection and social safety nets or building low-income housing, is likely to require a moderate easing of the fiscal stance in the medium term.

The PRC today stands at a crossroads between a growth paradigm, which was largely driven by exports and investment, and a new paradigm, which will give higher priority to domestic demand and consumption. Exports and investment has powered the country's stunning transformation and will continue to do so in the future. However, more sustainable growth in the post-global crisis period is likely to require a more balanced economic structure in which domestic demand and consumption play a bigger role. As discussed in this brief, one potentially powerful tool for rebalancing the PRC economy within a favorable overall policy and institutional environment is fiscal policy. More specifically, the primary contribution of fiscal policy to the country's rebalancing process will lie not in the macroeconomic sphere—i.e., temporarily boosting aggregate demand—but in the microeconomic sphere—i.e., promoting structural reform which alters household and firm behavior in a way that raises domestic demand and adjusts the output mix toward the domestic market on a sustained basis.

Finally, strengthening fiscal transfers across the country would also underpin the rebalancing agenda. Existing transfers of fiscal resources from the central government to local governments in the PRC are currently ad hoc and not predictable in magnitude or timing. This constrains the capacity of local governments to provide public services. One approach would be to transfer a larger share of tax revenues from the center to local areas. In particular, the share of VAT revenue accruing to local governments could rise from the current 25%. Alternatively, the central government, while maintaining the existing decentralized scheme for the provision of

Strengthening fiscal transfers across the country would also underpin the rebalancing agenda

social services, could increase its share in their financing. This could be achieved through the introduction of redistributive and equalizing mechanisms in the central government transfers to support poorer provinces. Otherwise, large inter-provincial disparities in social public spending per person would remain, constraining consumption in central and western provinces.

To conclude, rebalancing the PRC requires a mutually supportive package of policies. Greater exchange rate flexibility, a core component of this package, will promote rebalancing in the long run. In the short run, however, a stronger yuan will adversely affect industries and firms that lack international competitiveness. Fiscal policy can minimize such adjustment costs by, for example, providing social protection to the affected workers. In addition, fiscal policy can also directly promote rebalancing through a wide variety of ways, as was above seen. The government has already begun to implement some pro-rebalancing fiscal policies under the Harmonious Society Program. Another cause for optimism is the healthy state of the public finances, which should allow for a temporary increase in rebalancing-related fiscal expenditures. Finally, the primary role of fiscal policy in rebalancing is to foster structural change rather than temporarily stimulate aggregate demand.

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