

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT¹

Sector Road Map

A. Sector Performance, Problems, and Opportunities

1. **Public expenditure and fiscal management.** The People's Republic of China (PRC) tax system underwent major reform in 1994 and adopted the Tax Sharing System, which was followed by refinements of income taxes and the turnover tax system. The initiatives stopped the decline of the share of fiscal revenue in gross domestic product (GDP), and allowed a much needed increase in government expenditure. The result was an expansion in infrastructure and other public services required to support the PRC's rapid economic growth and urbanization, and help alleviate poverty.

2. But the reforms led to sizeable, fiscal imbalances. The 1994 reforms shifted revenue-raising powers from local governments to the central government. Local governments now receive around half of total tax revenue, yet deliver 85% of public spending. Local governments face sizable funding difficulties even with the benefit of large central government transfers. By mid-2013, local government direct debt had reached 18.6% of GDP and guarantees and contingent liabilities another 12.0% of GDP.² With central government debt at 21.2%, the PRC's overall government debt situation is still manageable. However, the rapid rise of local government debt since 2008, extensive off-budget financing and an associated lack of transparency, and short maturity periods now need to be addressed.

3. The 1994 Budget Law had prevented local governments from direct borrowing without State Council approval. Local governments consequently turned to alternative sources of financing, many of which lacked adequate governance and transparency arrangements, and the central government has recently acted to curb their use. A sustainable solution requires the provision of more fiscal autonomy and flexibility to borrow. Such reforms need to be tied to the adoption of open and transparent debt financing within a strengthened fiscal governance and debt management framework. Hard budget constraints and the credibility of fiscal commitments need to be entrenched, which requires local governments to be exposed to market disciplines.

4. There are many opportunities to improve the quality of public expenditure and fiscal management and enhance transparency at the local government level. Priority initiatives include: the strengthening of debt and budget reporting and cash management; the adoption of early warning systems, fiscal rules and targets, credit ratings, and medium-term fiscal frameworks; the acceleration of property tax reform; the improvement of local tax system; and the provision of new revenue sources. Such initiatives are needed to ensure that the PRC's continued growth and urbanization will be fiscally feasible.

5. There are also opportunities to improve the public finances at the central government level. Notably, adoption of the 'polluter pays' principle in taxation can boost efforts to reduce air pollution and other forms of environmental degradation in the PRC. A strengthened, centralized system of tax administration could generate large efficiency gains. The tax reform system can

¹ This summary draws on sector reviews, ADB's technical assistance projects, and ADB. 2014. Money Matters: Local Government Finance in the People's Republic of China (<http://www.adb.org/sites/default/files/publication/151515/money-matters-local-government-finance-peoples-republic-china.pdf>).

² National Audit Office, People's Republic of China (PRC). 2013. *National Government Debt Audit Results*. Beijing. (<http://www.audit.gov.cn/n1992130/n1992150/n1992500/n3432077.files/n3432112.pdf>)

also help target reducing inequality in line with the PRC's current tax system is contributing very little to reducing inequality, in contrast to the practice in most high income countries.

6. The PRC's national legal and regulatory framework for public financial management is detailed and comprehensive. The centralized payments processing system, the standardized budgetary system, the alignment of accounting and auditing standards with international standards, and preliminary action to adopt accrual accounting are examples of this. Public procurement generally follows international standards, as do audit systems. The main constraint is in staff capacity, in terms of numbers, qualifications, knowledge, and the experience of staff. While capacity is improving, meeting the increasingly sophisticated demands arising from the modernizing economy is an ongoing challenge. There are also some shortcomings in adherence to the formal rules because of gaps in financial checks and balances.

7. **Decentralization.** The system of fiscal decentralization can be improved through targeted formula-based transfer systems or block grants focused on sources of disadvantage. Such reforms are needed to correct for large variations in revenue-raising capacity across the country and within provinces. Without such improvements, substantial differences in expenditure will continue and result in disparities in access to basic public services. Reforms are also required to the assignment of expenditure responsibilities across levels of government.

8. **State owned enterprises (SOEs)** are declining in importance but remain an important feature of the PRC economy. Certain sectors are mainly operated by SOEs, such as finance and infrastructure, where productivity of these SOEs needs to be enhanced. Full and fair competition and improved SOE governance could bring greater opportunities.

9. **Social protection.** There are large disparities in social protection benefits provided to urban registered residents versus rural residents, and migrant workers who have limited access to social protection. Another challenge is the financing scheme for the social protection. Although local governments are mostly responsible for the provision of social protection, their revenue capacity does not meet the expenditure responsibilities. The gap in financial capacity and responsibility is resulting in insufficient benefits and large gaps in access to services. Improved designs and resourcing could do much to assist the most disadvantaged in the PRC and provide an effective safety net for those most vulnerable to economic restructuring and the lower, 'new normal' rate of economic growth.

10. **Law and judiciary.** The legal and regulatory framework required for a socialist market economy is largely in place, but broad understanding and enforcement of commercial, and other, law is lacking. The judiciary is hampered by inexperience in complex business matters, by an uncertain mandate and by vagueness in many laws and rules that makes them difficult to implement consistently. Current reforms designed to insulate the judiciary from local political interference are welcome. Further areas for attention are drafting laws and regulations to clarify rights and obligations, continuing the professionalization of the judiciary, and clarifying the role of the judiciary as a constitutional matter.

B. Government's Sector Strategy

11. The "Decisions on Important Issues Concerning Comprehensive and Far Reaching Reform" issued at the Third Plenum of the 18th Central Committee of the Communist Party of

China held in November 2013 set out the next phase of public finance reform.³ They noted the persistent incompatibilities with a modern system, and called for reform of the budget and tax systems, and of intergovernmental fiscal relations. A timetable was subsequently set for the completion of the priority reforms by 2016, and the introduction of the basics of a modern fiscal system that is compatible with modern approaches to good governance by 2020. The importance of governance reforms were emphasized by the Fourth Plenary Session of the 18th Central Committee of the Communist Party of China held in October 2014, which focused on the strengthening of rule of law.

12. The Third Plenum clarified that coverage of the value added tax, the PRC's main source of tax revenue, is to be expanded, development of the property tax is to be accelerated, and that environmental protection taxes will be implemented. The share of revenue generated by direct taxation is to rise gradually. Special transfer payments to local governments are to be reformed and standardized. Implementation has already begun through revisions in the Budget Law to allow local government borrowing and consolidate government budgets and improve their transparency, and through the approval of local government bonds. Local government financing is now to be secured via bonds, either backed by the budget or the revenue flows of projects, or through public-private partnerships (PPPs).

13. The Decisions committed to expand the participation of social capital in urban infrastructure investment and operation through concessions and other ways so as to broaden urbanization financing channels, to accelerate the transformation of government functions, and to improve fiscal investment and management.⁴ While the focus is on economic infrastructure, the private sector is also encouraged to deliver social and environmental services. Wide ranging policy announcements and regulatory releases from the central government issued in late 2014 and early 2015, and subsequently mirrored by local governments, have provided a comprehensive update of the PRC's operational framework for PPPs.

14. The reform of SOEs is to continue. The SOEs reform not only emphasizes on introducing non-state-owned capital to SOEs, but also encourages state-owned capital to non-state-owned enterprises. Projects that are aligned with industrial policies and promote economic transformation and upgrading will be supported to attract non-state-owned capital into areas, such as petroleum, natural gas, electricity, railway, telecommunication, and public services.

15. The Third Plenum stressed the importance of building a fairer and more sustainable social welfare system. A number of measures were adopted in 2014 to reduce the fragmentation of the social assistance programs between the urban and rural population, and between occupations in urban areas. Although additional financial mechanisms, regulations and operational guidelines still need to be developed, these initiatives set out the actions required to achieve a sustainable and equitable social welfare system.

C. ADB Sector Experience and Assistance Program

16. The Asian Development Bank (ADB) has a long-standing engagement in the strengthening of the PRC's public sector management. By supporting the creation of knowledge and the sharing of good practices, and building capacity, ADB has helped promote improved public expenditure and fiscal management systems and practices and enhance social welfare

³ Communist Party of China (CPC) Central Committee. 2013. *Decisions on Important Issues Concerning Comprehensive and Far-reaching Reform*. Third Plenum of the 18th Central Committee of the Communist Party of China Available at http://www.chinadaily.com.cn/china/2013cpctps/2013-11/16/content_17109648.htm.

⁴ Social capital encompasses the private for-profit sector, SOEs, and the not-for-profit sector.

systems. The reform agenda established by the government since 2013 is broadly consistent with past advice from ADB.

17. ADB has supported the strengthening of: (i) fiscal reforms in the areas of expenditure assignment, budget preparation, taxation, treasury operations, local government bond and debt management, and fiscal decentralization; (ii) SOE reforms; (iii) PPPs, by supporting advocacy and capacity development, the strengthening the enabling environment, and project development; (iv) social protection systems, by supporting the improvement in implementation schemes of minimum-living standard guarantee systems, establishment of new rural pension schemes, and strengthening of urban pension systems; and (v) law and judiciary. Support has primarily been provided through technical assistance, with 46 projects and sub-projects costing \$22.7 million approved since 2006. ADB has also contributed through knowledge products with more than 30 publications released on public sector management and related areas since 2006.

18. ADB will continue to support the government's public sector management reforms to improve the effectiveness and efficiency of government, enhance inclusiveness of the growth process, and help secure fiscal sustainability. The emphasis will remain on public expenditure and fiscal management and decentralization, PPP reforms, social protection and local government bond issuance system reform. These activities will aim to strengthen the efficiency, equity, and transparency of the delivery of public services and social protection.

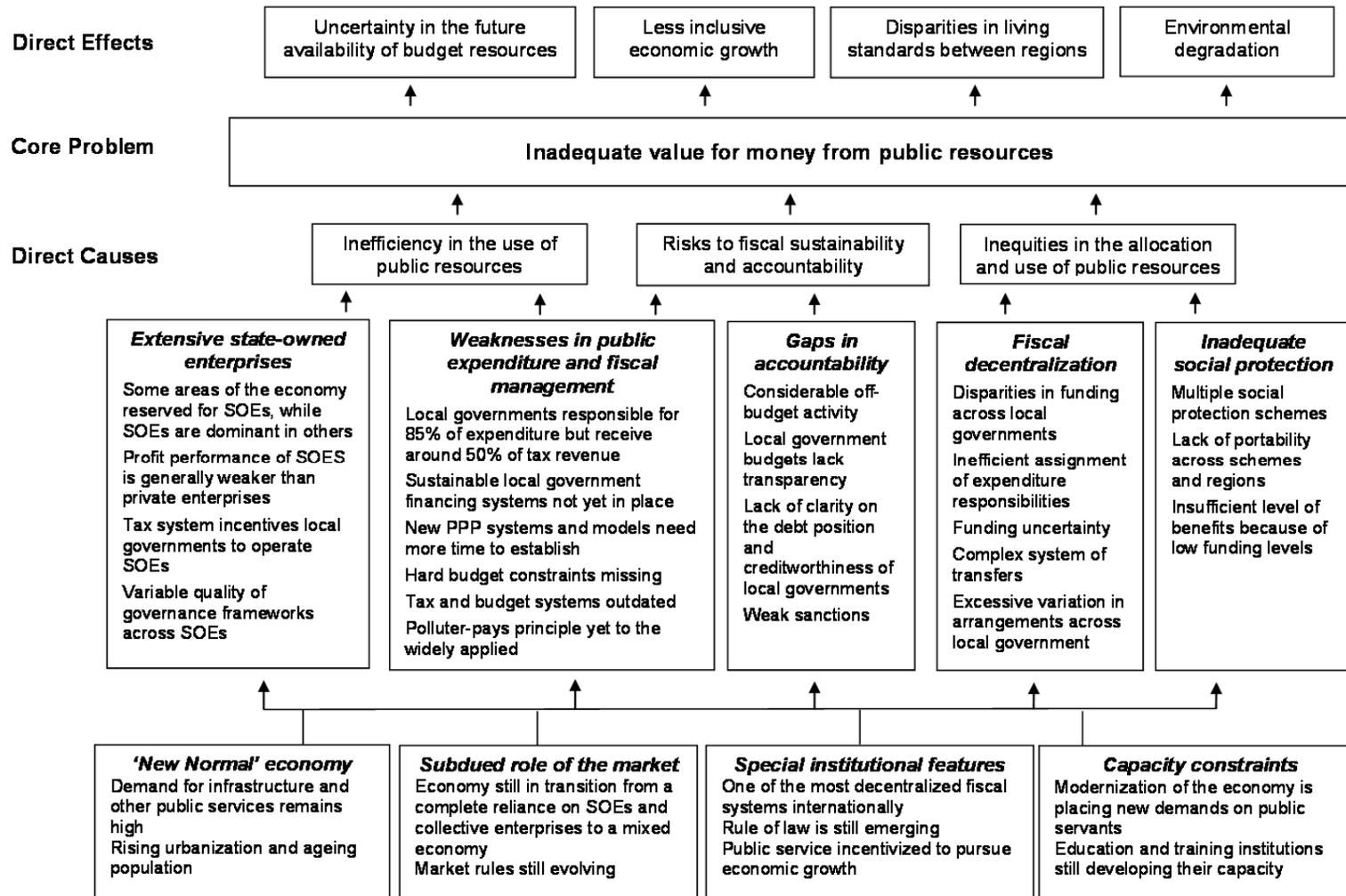
19. Support for public expenditure and fiscal management and decentralization will focus on improvements to the budget and tax system, and the system of fiscal decentralization. Sovereign support for PPPs will continue a transition towards a project emphasis. Opportunities will be pursued to help establish project development facilities and PPP funds providing government financial support to PPPs, building on support from ADB for such initiatives in other regions. The focus of PPP support will remain on local governments. Much of the project-level responsibility for PPPs rests with local governments and they must rapidly build their ability to use PPPs well if the ramp-up in PPP activity in the PRC is to succeed.

20. In the area of social protection, ADB will support improvements in the equity and sustainability of the social protection system, which is necessary to achieve inclusive growth. This will focus on the strengthening of linkages between social assistance and social security systems, the portability of pension benefits, raising the level of benefits, the pooling of funds with an aim of establishing a national pool, and improved coordination between urban and rural social protection programs so as to move towards a unified social welfare system.

21. ADB support for the law and judiciary will be largely combined with other activities. Support will center on the elaboration of laws to provide clear guidance to individuals and businesses, capacity development in the use of complex contractual and financial mechanisms to create a sound enabling environment for PPP and capacity development for the judiciary to create a predictable and stable commercial system.

22. Priority will be given to supporting issues that align with the frontier reform issues which link with ADB's earlier advisory support and allow for a continued, knowledge engagement. Larger, cohesive technical assistance projects will be favored, and new modes of supporting public sector management, such as results-based lending, will be employed. Opportunities will be pursued to assist the implementation of reforms through sovereign loan projects, such as by supporting the adoption of good practices for PPPs or assisting fiscal adjustment. When working at the local government level, priority will be given to fiscally disadvantaged provinces where feasible.

Problem Tree for Public Sector Management



PPP = public-private partnerships SOEs = state-owned enterprises

Source: ADB staff based on ADB. 2014. Money Matters: Local Government Finance in the People's Republic of China (<http://www.adb.org/sites/default/files/publication/151515/money-matters-local-government-finance-peoples-republic-china.pdf>)