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Subnational Debt Management and Restructuring

LESSONS FROM INTERNATIONAL EXPERIENCE

EDITORS

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SUMMARIES AND PRESENTATIONS

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, to its affiliated organizations or to members of its Board of Executive Directors or the countries they represent.

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Priorities in the Short and Medium-term for China's Subnational Government Debt: Good Practices and Options

Roy Bahl¹⁷

INTRODUCTION

Subnational government debt policy in China has been ad hoc and reactive to infrastructure needs and economic development incentives. Until 2014, provincial and local governments had little or no formal borrowing powers, but used a variety of “backdoor” approaches to finance infrastructure. However with the issuance of the new budget law in 2014, the government has taken the first steps toward rationalizing the use of debt finance by subnational governments. So far, however, the effort has been more focused on making provision for addressing the management of obligations incurred in the last decade than on putting in place the right set of institutions, incentives and controls for a sustainable framework.

In this paper, I address the issue of how China gets from where it is now to a sustainable framework for subnational government borrowing. The next subjects to take up, I think, are the reasons why the present efforts should be focused on a transition program. A debt framework that can be sustainable in the long run will need to wait on structural and management reforms in four areas: (a) developing a strategy for controlling provincial and local government borrowing, (b) modernizing the approach to local government finance and to defining and enforcing hard budget constraints at the subnational government level, (c) establishing a more balanced approach to central and subnational government finances, and (d) identifying repayment options for subnational government debt.

WHY A TRANSITION PROGRAM IS NEEDED

The program of debt financing that China builds now will be a transition to a more permanent framework, and it will likely be in place for a number of years while important structural and management reforms are put in place to support effective subnational government borrowing. But infrastructure financing will not wait, hence the need for an interim regime. The transition program, which necessarily will emphasize direct controls, may be very different from the eventual permanent framework, which might rely more heavily on a combination of local discretion, market signals, incentives, and fiscal rules. Several factors make the transition approach necessary and advisable.

Changing Economic Conditions

The growth rate in the Chinese economy is projected to decline to about 6 percent by 2020 (World Bank and Development Research Center, 2014, pp81-126). Even though this is a healthy economic growth by world standards, it will not generate the fiscal surpluses that were seen in the past two decades.

Expenditure management in this setting will present challenges. One particularly important issue is that an aging population will put pressure on pension and health outlays. The share of population aged

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60 years and over will rise quickly in coming decades, from around 12 percent in 2010 to almost 25 percent by 2030 and to more than 33 percent by 2050. This will not only place greater strain on family support networks but also will challenge social programs, pensions, and, in particular, health care (World Bank and Development Research Center, 2014, pp263-358).

Expenditure claims such as this together with the expected lower level of revenues means that the nominal growth in some expenditure programs of central and subnational governments will need to be slowed, or new discretionary increases in revenues will need to be implemented. The implications are that increased pressure will be placed on local government revenues, and the residual available to finance new borrowing will be limited.

Governments tend to be especially wary of economic policies that might discourage new investments and reduce economic growth in times when there are concerns about the performance of the economy and about job growth. If a new initiative is proposed, such as further separation of the roles of government and the private sector or reductions in tax incentives, there may be significant pushback or postponement of the new initiatives. This has already happened in the case of the State Council recommendations for halting local tax and subsidy programs for private enterprises. Improvements in the transparency of the budget, and measures to tighten the hard budget constraint, will be much more difficult in a time of concern about slow economic and job growth.

Infrastructure Demands

Slow economic growth or not, the demand for new infrastructure and for the renewal of existing infrastructure will be significant. Infrastructure demand will come from a number of fronts. Continued in-migration from rural areas will bring some pressure on capital finances. If the growth rate in real wages increases and the hoped-for growth in middle class consumption comes to pass, the composition of public services demanded could be pushed in the direction of better social services, a better natural environment, and better amenities. Changes in expenditure demand also could come from the business sector because of a shift away from manufacturing and toward a growth in the service sector. Pressures on the government expenditure budgets also will come from a need to address backlogs of unmet expenditure needs, debt and pension fund payments, and congestion and pollution problems. Other costs to be addressed include the maintenance costs of the increased public capital stock that has been built over the past decade and the higher cost associated with the urban sprawl that has come to characterize many Chinese metropolitan areas (World Bank and Development Research Center, 2014, pp 127-186).

Some infrastructure investment might be delayed, but it will not be halted. A framework for borrowing by subnational governments will be required during the transition period.

Cleaning up the Debt Backlog

The estimated debt of subnational governments at the end of 2014 was about RMB 24 trillion (US\$3.7 trillion), equivalent to about 38 percent of GDP. Presently, the government is focused on refinancing maturing debt to relieve the burden on current expenditure budgets. The program allows provincial and local governments to swap RMB 1 trillion in high interest and short maturity debt for lower interest and

longer maturity bonds. This could free up resources to support additional government borrowing or to address current expenditure needs.

Oversight

The transition plan will almost certainly emphasize direct controls on borrowing by subnational governments, as the State Council laid down in 2014. One should expect the central government to play a more direct role in determining which subnational governments can borrow, how much they can borrow, and for what purposes they can borrow.

Until the role of the financing platforms is fully spelled out this will likely be regulated by the central government. The new budget law and the State Council Regulations of 2014 would seem to have called for the elimination of some elements of this practice, but the phase-out will take some time.

The implementation of the full transition version of a debt framework will come well before the decisions about any new intergovernmental financing reforms, because the latter will involve major changes that will require time for design and implementation. Therefore, the transition framework will need to stay within the constraints of the present system and the new regulations given by the State Council. The central government will decide who can borrow and who cannot, and repayment of the debt will be from a “surplus” of unconditional grants and shared taxes over current expenditures and repayment of existing debt and pension/health fund obligations.

Building a Debt Management Capability

There is much to be done in putting together an administrative architecture that will manage the debt framework. The administration of a permanent framework that monitors the performance of subnational governments and the adherence to fiscal rules will be more complicated than a model that depends on direct controls. Development of the management capability to support a permanent framework is not presently in place and will take time to develop.

At the subnational government level, debt management will also require a management infrastructure. The new budget reform will help because it mandates more transparency in all four local budgets. But matters will be complicated by the absence of a capital budget and less than complete transparency in the government fund budget. Efficient fiscal planning will be enhanced by the use of medium term fiscal planning networks.

At the central (and/or provincial) level, a capability will need to be established to measure and compare the creditworthiness of subnational governments. Usually, “creditworthiness” has to do with assessing the ability of the local government to repay its debts fully and in a timely fashion. Governments are then ranked according to the ease with which they can meet this test, and are rated. The central government, or an independent rating agency, will need to do this assessment. If it is the central government, it will be necessary for it to set standards for creditworthiness, and to develop and update a data base for all subnational governments.

MARKETS, FISCAL RULES AND DIRECT CONTROLS

Ultimately, China will need to decide on a balance between direct control of debt issuance (approvals on a case by case basis), fiscal rules that govern access to debt markets, and market discipline. However, even before it gets to the point of making that decision, the government must address several issues concerning the intergovernmental fiscal structure: (a) how to deal with the incompatibility of the present vertical imbalance in the system with the evaluation of debt repayment potential, (b) how to establish fiscal rules under the present intergovernmental fiscal system, (c) how to design and enforce incentives for fiscal discipline, and (d) how to reconcile the inherent conflict between eligibility to borrow and equalization.

Most of these issues are not yet addressed, and likely will not be in the very near future. The enactment of a new borrowing regime will likely go forward under the present intergovernmental public financing system.

Vertical Fiscal Balance

The Chinese intergovernmental fiscal system is unbalanced. Most of the spending responsibility lies with the subnational governments, and therefore much of the demand for capital financing will lie with subnational governments. But almost all power to raise revenues lies with the central government. The exception is land lease revenues. In effect, the subnational governments have no capacity to repay debt other than that capacity given to them by the central government in the form of grants and shared taxes.

Administrative Controls, Fiscal Rules and Incentives

Any debt framework established for the transition period will almost certainly be characterized by direct administrative controls, and some fiscal rules, but how will these controls and rules be established? A first question to be raised is how debt will be rationed across and within provinces. If the criteria is revenue strength and the probability of meeting all debt service payments, then some lower income provincial and local governments will likely be excluded. But even this will be a difficult assessment to make because the only recurrent revenue source for subnational governments is intergovernmental transfers. At least for the interim period, the recourse will be to measure a fiscal surplus between “non-controllable” expenditure requirements and entitlement revenues from shared taxes. This will not be an easy calculation to make or to monitor.

Fiscal rules could be used and fiscal indicators could be compared to assess ability to repay debt. For example, a “green light” community for new borrowing would be one whose debt burden is not high, who has fiscal resources that are high relative to expenditure needs, and whose economy is not vulnerable to cyclical swings and is not experiencing slow growth. Some measures of the quality of management of the local government might be added, based on their present practices.

There are many questions to be answered about how to make the fiscal rules. For example, which sources of subnational government revenue should be used to make such a calculation? At present, the revenues available to subnational governments are shared tax entitlements and unconditional grants, earmarked grants, dedicated national taxes, and land leases. Of these, land leases are questionable as collateral for lending, and dedicated national taxes (e.g., the business tax) are vulnerable to central

government policy decisions. Earmarked grants are not available for repayment of general debt. This leaves only shared taxes and unconditional grants available as sources to cover debt repayment. A fiscal rule for the transition program might define a threshold for borrowing as the controllable portion of these resources as a percent of GDP.

Rewards, Incentives and Penalties

Debt policy could also include rewards, incentives and disincentives to induce more responsible fiscal behavior by subnational governments. The following might be considered, some for the transition period but others for the permanent program.

- The fiscal rules could provide for increased borrowing in the event of increased revenue mobilization. If viewed in the traditional way, this would involve local governments increasing their tax rates or broadening their tax base to increase revenue mobilization. Subnational governments in China have no power to set the tax rates. However, Chinese local governments can expand the tax base, in two ways. First, they can use discretionary powers such as giving fiscal incentives to attract industry and thereby expand the tax base. Second, the tax bureaus in the provinces can follow the 2014 mandate of the State Council and collect full rather than partial liabilities and thereby increase total revenues.
- Beyond the transition period, subnational governments could be given rate setting powers and could increase tax revenues as a local option. This would become part of the debt framework for the long run, and revenue effort relative to expenditure needs could become the basis of an important fiscal rule.

There also could be disincentives built into the debt framework.

- Borrowing by subnational governments could be restricted to government services, and could exclude any private sector activities. This might limit the demand for new borrowing.
- Punitive measures could be put in place for subnational governments that defaulted on debt repayments. These might include an intercept of intergovernmental transfers, or replacement of lead provincial and local government officials. Fiscal discipline could be built into the regular evaluation of local government lenders.
- Borrowing windows would be closed to subnational governments that did not meet the tests laid down in the fiscal rules.
- Governments that did not meet certain tests of good fiscal management – timely approval of the budget, transparency of good budget reporting, separation of government from private sector activities – would not be given access to credit markets.

Creditworthiness and Equalization

Both the transition and the permanent framework will need to make provision for the problem of subnational governments with limited fiscal capacity. The creditworthiness approach will give borrowing power to subnational governments that can show stronger repayment potential and less risk of default.

But this approach often will rule out places with a weaker needs-resources balance, and will be inconsistent with equalization policy.

How might this problem be addressed under the longer run framework? There are several ways.

- Substitution of grant for loan financing,
- Subsidize part of the repayment burden of the loan,
- Build more equalization into the intergovernmental transfer system,
- Reassign the responsibilities for some pro-poor expenditure programs to higher levels of government.

HARD BUDGET CONSTRAINTS AND FISCAL MODERNIZATION

China has recognized that its intergovernmental fiscal system has important weaknesses and that some reforms in the structure are necessary (Lou, 2013; Bahl, Goh and Qiao, 2014; Bahl, Goh and Qiao, forthcoming). Many of these needed reforms have to do with cleaning up the concept of a hard budget constraint, as applied in China. Three issues of particular importance are: (a) the right place for land leases in the financing structure, (b) the limited revenue discretion of local governments, and (c) the need for modernization of the subnational government fiscal structure and management.

Land Leasing as a Revenue Source

In theory, the sale of locally owned assets can be a source of financing for capital projects. Turning an asset that generates little current return into a part of the public infrastructure that generates a long term flow of benefits for the population can be good policy. China managed to use land leases to finance a significant amount of public infrastructure to accommodate a huge in migration of rural population.

The problem with the sale of land leases to finance new infrastructure was not with the selling of a government-owned asset, but with the regime that went with this. It included (a) confiscation of land from farmers, (b) investment in some infrastructure that benefitted private sector enterprises, (c) the lack of transparency and uncertain liabilities, (d) ignoring the risk of sustainability if land values fell, (e) poor project selection, and (f) the accumulation of unnecessary amounts of land reserves.

What to do in a new borrowing framework, either during a transition or in a sustainable borrowing framework? Land leases could be collateral for revenue bonds in financing a public project, or they could be part of the repayment guarantee for a general obligation bond (i.e., they could be part of the dedicated revenue stream). But, as has been learned in the past two years, the demand for land leases can be volatile and revenues can fluctuate widely.

Local Government Revenue Discretion

In a sustainable borrowing framework, as might be found in some industrial countries, subnational governments have the discretion to raise taxes. If expenditure needs rose to a level to challenge the possibility to repay loans, the tax rate could be increased. In this way the subnational government would be able to balance the budget and cover the fixed obligations. But under the present regime in China, local

governments do not have a formal discretion to increase taxes. They may, and have, used backdoor approaches to generate a flow of revenues to finance capital projects, e.g., extra budgetary revenues, UDIC financing platforms, tax collections that do not match tax liabilities, are examples. But all of these have proved to be non-sustainable.

Even the intergovernmental transfers that support subnational government budgets have not proven to be sustainable. The income tax revenue shares have been reduced, and more recently the business tax and the agricultural tax have been abolished.

Liberalizing the Intergovernmental Fiscal System

In the fall of 2014, China's top leaders presented a program for fiscal reform of the nation's tax system, budgeting practices and center-local fiscal relations. The broad proposals are impressive, and a timetable has been set to modernize the fiscal system. The Minister of Finance has said that the major reform tasks concerning the fiscal and tax system will be completed by 2016, and a modern system will be fully developed by 2020.

On August 31st of 2014, China's legislature adopted a revision to the Budget Law. This is the first time the Budget Law has been revised since it took effect in 1995. The old Budget Law was adopted when China was more strongly influenced by planned economy concepts, leaving a great deal of room for interpretation by governments. The amendments to the Budget Law are closely interrelated with China's fiscal reform. It took an unusually long time to revise it—seven years to draft a bill for the first reading in 2011 and four readings to get it passed. Subsequently in September of 2014, the State Council followed suit with directives on deepening the reform of budget and debt management.

Among the key areas for reform are to improve legislation, clarify powers and responsibilities, restructure the tax system, stabilize tax burdens, produce transparent budgets, increase efficiency, and establish a modern fiscal system for both the central and local governments. In order to achieve these goals, the CCCPC proposes three major fiscal reform measures: improvement of the budget management system, improvement of the tax system, and establishment of a system of matching between administrative authority and expenditure responsibility. All are important to developing a sustainable framework for subnational government borrowing.

Improve the budget management system. A completely standardized, open and transparent budget system will be adopted. The focus of budget review will be extended from fiscal balance and deficit size to expenditure budget analysis and fiscal policies. Most major expenditures that are presently indexed to increases in financial revenues or GDP will be delinked. This will allow a significant increase in budget flexibility. China also will establish a multi-year budget balance mechanism, a comprehensive government financial reporting system on an accrual basis, and a standardized and reasonable debt management and early warning risk mechanism for both central and local governments. The plan also includes integrating and regulating special transfer payments, and gradually cancelling funds that flow from local governments to the competitive sector.

Improve the taxation system. Reforms in the tax structure will be implemented, and there will be a gradual increase in the proportion of direct taxes. The ongoing reform of the VAT will continue with the

folding-in of the business tax, and the tax rate structure will be simplified. The structure of consumption taxes will be upgraded and will be imposed on products that consume too much energy and cause serious pollution as well as some high-end consumer goods. Other elements of the tax reform plan include establishing an individual income tax system in which taxable income is defined in both comprehensive and categorized ways, passing new real estate tax legislation and implementing this in a timely manner, accelerating the resource tax reform, and changing the current environmental protection fee into an environmental tax.

In line with the principles of unifying the tax system, promoting equality in tax burdens and fair competition in the private market sector, the management of preferential tax policies, especially regional preferential tax policies, will be rationalized. Legislation regarding the use of preferential tax treatments will be made clear and regulations will be issued. This will enable determination of which preferential policies can be continued and which cannot. In addition, the collection and management system for provincial and local government taxes will be upgraded.

*Comments on CCCPC decision by Minister Lou.*¹⁸ Finance Minister Lou Jiwei commented on these CCCPC decisions by pointing out that the budget management system reform, is the foundation and should be the first step taken in the reform. The reform of revenue distribution should be implemented after the substantial completion of tax system reform. Meanwhile, building a better system of matching between administrative authority and expenditure responsibility may require more time to form a consensus plan. While reform of the budget management system may make decisive progress in the short run, and reform of the taxation system may make significant progress in legislation and promotion in the short run, the reform of assignments of administrative authorities and expenditure responsibilities may only get as far as reaching a basic consensus. The major works and tasks of fiscal and taxation reforms will be basically achieved by 2016 and various reforms will be put in place, but a modern fiscal system may not be established before 2020.

A NEW VERTICAL BALANCE?

A transition framework for subnational government borrowing will be formed under the present financing arrangements, i.e., heavily decentralized expenditure assignments and heavily centralized revenue assignments. At present, most spending (over 80 percent) is made directly by subnational governments, but all revenue raising power (except land leasing) is at the central level.

A sustainable debt framework for the longer run might benefit if China moved to a more balanced vertical fiscal structure, i.e., if there was a better match between the expenditure responsibilities for each level and their revenue raising powers. This discussion about revenue and expenditure assignments has begun, but the conclusions remain in the offing. Three components of a rebalancing might be considered: (a) assignment of more expenditure responsibility to the central government, (b) restructuring the revenue sharing system, and (c) giving more fiscal autonomy to subnational governments. Any of these three changes would have a significant effect on the borrowing framework.

¹⁸ As reported in Bahl, Goh and Qiao (2015), forthcoming.

Expenditure Assignment

Expenditure assignments in China have not been changed since before the TSS reform in 1994. The present day Chinese economy is quite different from the one for which the present division of government expenditure responsibilities was cast. A thorough review of the division of expenditure responsibilities is long overdue. The end result of such a review could be a new budget law that will lay out the responsibilities for each sub function of government.

Reform of expenditure assignments in China could usefully center on three areas. First, a more clear division between the role of government and the role of the private sector is needed. Second, the question of which level of government is best suited to finance and manage social insurance programs should be revisited. Third, there is need to review all of the functions of government in order to formalize and clarify the division of responsibility. On the first area, a reform direction that called for less direct involvement of government in the competitive sector would seem the right path. On the second area, both income distribution and labor mobility goals would seem to argue for more fiscal centralization. On the third, the maturing of the Chinese economy and the presence of spatial externalities suggests that there is need for more involvement of higher level governments in direct service delivery and/or coordination.

Changes in expenditure assignments would change the borrowing needs of subnational governments, and could lead to changes in the fiscal rules or direct controls of debt issuance. And if finance did follow function, it also will require changes in the ability to repay debt.

Revenue Sharing

Changes in revenue assignment will be driven by the increased expenditure needs related to urbanization and by reassignments of expenditure responsibility. China faces the need to rebalance its system by shifting some functions to the central government level, and to provide for some sources of subnational government revenues to address the needs of provincial, city and county governments. The central government financing gap will be best handled by an increased retention rate of shared taxes. The subnational government revenue needs could be addressed by new local taxes. Both of these fiscal reforms would bring the Chinese intergovernmental fiscal system into better vertical balance.

The case for subnational government taxation in China is a strong one. This initiative has always been off limits for Chinese intergovernmental fiscal reform, but perhaps the time has come. There are a number of benefits. Revenue mobilization would be enhanced because local governments have information advantages that give them a comparative advantage in the collection of certain types of taxes. Property and land taxes are a good example of this advantage. There also is a regional efficiency argument to be made. Substituting local taxes for some intergovernmental transfers would lead to a higher tax price in some local areas and force labor and capital owners to take this into account in making location decisions. China is struggling with urban sprawl. A system of property and land taxes could help rationalize land use patterns and provide incentives for more compact investments. Finally, there is an equalization argument, i.e., as local governments in higher income regions substitute own taxes for intergovernmental transfers, central funds will be freed up for distribution to lower income regions.

Empowering urban local governments to levy higher or lower tax rates would allow the fiscal system to preserve some of the innovation and the competitive strategy of local governments that has served China so well. The use of land lease sales in recent years and the use of extra budgetary charges in the 1990s and 2000s are examples of this resourcefulness. With taxing powers, local governments would have the wherewithal to expand the delivery of services that are in high demand or that would allow them to better capture their comparative advantage. It would also improve the creditworthiness for local governments by showing a stronger ability to service debt or to maintain public facilities. In general, local taxing powers would give local governments an instrument to use in shifting their competitive strategies from the back door to the front.

Is Local Autonomy Necessary?

If provincial and local governments issue debt under the current intergovernmental fiscal structure, repayment will be from central transfers to local governments. Nearly all sources of revenue are determined in amount by central government sharing rates and centrally-determined distribution schemes. Moreover, lenders should see some risk in this because central policies on intergovernmental transfers can change. See, for example, the recent decision to eliminate the major local government tax source by folding it into the value added tax.

A major question in developing a debt framework for subnational government finance is whether ability to repay debt can be fully guaranteed by intergovernmental transfers, or requires some local discretion.

SUBNATIONAL GOVERNMENT TAXING OPTIONS

China has been slow to move away from its centralized system of public financing. But the problems with the centralized approach have become increasingly apparent. Subnational governments have sought (and found) backdoor approaches to do what they want, and sometimes this has led to undesirable outcomes, e.g., extrabudgetary funds and land lease collateral for unsustainable debt. When these backdoor approaches are withdrawn, subnational governments do not have autonomous local revenues to pledge to the servicing of debt. The question we raise here is whether there are feasible options for local government tax revenues. Our answer is that there are potentially revenue productive options that pass the tests of good international practice. Whether they pass the test for good governance in China is another issue.

Property Taxation

For three decades, *property taxation* has been discussed as a possibility for a major local government tax in China, but to date a broad-based annual property tax has not been introduced on a nationwide basis. This is not to say that real property is not taxed in China, but most of the existing taxes on real estate take place at the time of transfer and are better described as an ad hoc group of levies rather than a property tax system with clearly defined objectives. Together, these taxes on real property account for about 8 percent of national tax revenues, and 1.6 percent of GDP.

The property tax has great potential as a revenue source in China. It is an opportune time to realize this potential. Most important, it could fill a revenue gap at the subnational government level, and could

be especially productive in larger urban areas. To get some idea of the revenue potential, note that industrial countries raise an average of more than 2 percent of GDP in property tax while low income countries raise about 0.6 percent of GDP on average.

Advantages and Disadvantages. Because the ownership of real property wealth is usually concentrated in the highest income classes, the tax burden tends not to fall heavily on low income households. To the extent that higher taxes are paid on properties that tend to have better public services, the property tax might be seen as a benefit levy. Finally, since residential property taxes are capitalized into reduced property values, market decisions will be more rational because owners will pay a charge for the benefits of local services delivered, and speculators will face a real cost of holding their land off the market.

The major problems with the property tax have to do with its difficult administration and its unpopularity with property owners. With respect to the former, good administration requires identification of all parcels and their ownership, valuation and revaluation, collection from individual owners, and it requires extensive recordkeeping and updating. All facets of the administration must be done well to realize the full revenue benefits from the tax. The political unpopularity, which seems disproportionate to the tax burden, has to do with the judgmental nature of the assessment, and the high visibility of the tax burden.

Potential in China. China is one of the few countries in the world that does not levy an annual tax on residential property. In theory, China could generate considerable revenues with such an urban tax. An annual property tax that would yield the equivalent of one percent of GDP may be a feasible reform target in China.

Revenue mobilization is of course an important objective, but the property tax also can be structured to encourage land use patterns that might lead to reductions in external costs. If the base of the tax is the assessed market value of the user right, for example, it could approximate an annual charge on location rents. The tax could be structured to provide an incentive for all users to develop and use land more intensively and could be made more consistent with an infill strategy for urban development. So would a tax on vacant property in the built up area that is imposed at a differentially higher rate. Again, this would not be a tax directly on the land, but on the market value of the user right. If the market value increased, so too would the tax. Liability would rest with the holder of the user right. With respect to property taxation, unused properties would be taxed at the same as occupied properties, at their value in highest use.

Other property-related financing instruments might be useful in achieving the objectives of recapturing some of the value created by public investment, and increasing the density of cities. These might include CEPACs as used in Brazil, special assessments, betterment levies, valorization, and tax increment financing.

Motor Vehicle Taxation

Local government taxes on the ownership and use of motor vehicles could fit a Chinese strategy for coping with urbanization. The number of motor vehicles is growing faster than the population in urban

areas, their use imposes infrastructure costs on urban local governments, and they generate external costs that are for the most part uncompensated. Nearly 80 percent of the vehicle fleet is privately owned.

The rapid growth in motor vehicles compared to that of the road network has been instrumental to the growing congestion levels and longer commutes. The result is a heavy external cost in terms of congestion and pollution. One study of Beijing has put the level of external costs at between 7.5 percent and 15 percent for all types of externalities (reported in World Bank and Development Research Center, 2014, pp187-262).

Given this situation, it is understandable that Chinese policy has focused on controlling automobile use in large urban areas, and a good start has been made in this direction in a few cities. However, there is arguably even more to be gained by giving subnational governments additional control over motor vehicle taxation. The result could be to discourage the use of private cars, at the margin, while generating new revenues to defray some of the costs involved.

Chinese cities could continue to use tax and charge policies either to increase the price of owning and using a motor vehicle, relative to using a public transport system, or to make a different housing location choice. This could be done by charging drivers for the full cost of using private vehicles, including environmental and social costs, through mechanisms such as higher registration fees, higher gasoline taxes, higher tolls and parking fees or various forms of congestion pricing. Depending on the price elasticity of demand, local governments could generate significant revenues from these charges and taxes.

At present, Chinese subnational governments are not funded to any significant extent by taxes on motor vehicles. The registration tax on motor vehicles produces only a small revenue flow, and the tax on motor fuels is a central government levy. The experience with parking fees, toll and congestion charges as resource allocation measures is growing but has not yet become a major subnational government revenue source.

The annual tax on motor vehicle registrations is based on engine capacity, as it is in most countries. At present, revenues from this tax are equivalent to only about 6 percent of that the present level of revenue received in VAT revenue sharing. The taxation of motor fuels is a more lucrative tax base, and it would more directly tax the use of motor vehicles. The question is whether such a tax could be locally administered in China's larger cities. Ideally, the tax would be collected at the pump. Alternatively, it could be assessed at the factory gate as it is now, but the destination of shipments could be tracked. This would put in place a system whereby the rate of motor fuel tax could vary from one local government to another. Even at the current central government excise tax rates, a motor fuels levy would enable local governments to collect an amount about equivalent to one-third of VAT revenue sharing.

Would it be fair to levy a higher tax on motor fuels in large cities? China's gasoline prices are already above those in most developing countries, and above those in the US, but below the average in the European countries (World Bank and Development Research Center, 2014, pp439-535). On the other hand, Chinese gas prices are not high enough to cover the external costs of congestion and pollution.

Would it be efficient to levy a higher rate of gasoline tax in China's large metropolitan areas? At the margin, this would lead to a higher cost of living and would be a factor affecting migration decisions.

Higher gasoline prices would be consistent with other urban planning goals, such as reducing the congestion and pollution that come with automobile use, and raising the price of urban sprawl. In all of this, however, it is not so clear that the elasticities of substitution are high enough to make much of a difference unless there were very large rate increases.

Local Retail Sales Taxes

Local government sales taxes can be efficient instruments of urban government finance if collections can be shifted from an origin basis (place of manufacture or distribution) to a destination basis (place of consumption). In the United States, for example, a local government retail sales tax is collected at the point of consumption. Under an origin-based arrangement, such as China's VAT, by contrast, collection is at the point of production and some of the tax burden may be borne by consumers who live in another jurisdiction.

If administration on a destination basis could be made feasible, sales taxes on selected items of consumption could be revenue productive and would pass some of the tests of a good local tax. This might be done adequately for some items of consumption, for example, high end jewelry, durables and imported luxury goods. But for most consumer goods, a retail sales tax would encourage tax avoidance by providing an incentive to shift the point of consumption to informal traders that are not easily policed by the tax authorities.

The problems with collection from informal sector retailers is also the reason why the revenue productive excises cannot be converted to retail sales taxes with higher rates imposed on consumption in cities. Otherwise, particularly beer, liquor and cigarettes would be attractive revenue bases. There is another option. All of the excise revenue could continue to be collected as at present, but the revenues could be assigned to cities on some formula basis. This would be a transfer of revenue, but would not give the local governments any power to increase or reduce rates, or to differentiate their rate from that in other urban areas. In effect, it would be another tax sharing transfer.

Piggyback Taxes

Some of the administrative problems with local taxation can be avoided by adopting a "piggybacking" approach, i.e., to allow the local government to select a tax rate to be imposed on a central government tax base. Piggybacking is already done in China with the urban construction and maintenance tax and the education surtax. In these two cases, the base is the aggregate tax collections from VAT, excise taxes and the business tax, and the revenues from this surtax are allocated fully to the local government. The sur-rate, however is set by the central government.

The piggyback tax proposed here might be viewed as a benefit charge, i.e., a payment for using city services. Under such a reform, the existing UMCT and education surcharge would be replaced with an "urban service tax". The local government then could be given the option of increasing the piggyback tax rate above its present level.

To demonstrate, let us suppose that the tax rate on UMCT was increased from 9 percent to 12 percent. The additional revenue generation would be large enough to recoup an amount equivalent to about 44 percent of the shared VAT revenues. Similarly, a piggyback personal income tax could generate enough

new revenue to recover an amount equivalent to 9 percent of VAT revenue sharing. There are good arguments to use individual income tax revenue sharing, including the lower likelihood that the burden will be exported. But the already high tax rate on labor is a major drawback. Unless the social security contribution rate can be lowered, this is probably not a viable option.

CONCLUDING THOUGHTS

China could benefit significantly from an overhaul of its intergovernmental financing system. One benefit is that such a reform could help rationalize a sustainable framework for subnational government debt. The deliberations behind changes in provincial and local government expenditure and financing structure will take time. But the development of the national infrastructure will not wait until all of the needed structural changes to the intergovernmental fiscal system are put in place. For this reason, China needs (Beijing: China Financial and Economic Publishing House) a transition plan for capital financing. The transition framework for borrowing needs to be recognized as just that – a bridge from the present system to a sustainable long term framework. Even though the transition debt policies could be in place for a number of years, the Chinese Government would benefit if it had its long term objectives for subnational government borrowing in place when it develops the transition plan.

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