THE FISCAL POLICY FRAMEWORK IN CHINA

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In the last decades important economic and social changes occurred in China. In particular, in introducing a socialist market economic regime, the fiscal policy framework has been significantly reformed. In order to understand China's fiscal policy framework, it is necessary to review its experience, the present economic and social situation and its perspectives. Section 1 describes the Chinese fiscal system, Section 2 assesses the role played by fiscal policy in macroeconomic control and regulation, Section 3 reviews fiscal regulation in practice and Section 4 discusses the experience drawn from it. The last section sketches a rough outlook of the fiscal policy.

1 The tax system

1.1 The sharing of revenue and expenditure between government tiers

China has adopted a tax sharing system, whereby revenues are divided between the central government and local governments. The central government is responsible for expenditure on national defence, foreign affairs, and central government agencies, economic reforms, coordination of regional development and macroeconomic adjustment. The jurisdiction of the local governments covers the running costs of local departments, and expenditure on economic and social regional development.

Following the principle of matching tax jurisdiction with expenditure responsibility, taxes are divided into three categories: national taxes, local taxes and joint taxes (*i.e.* taxes shared between the central and local governments). National taxes are used, *inter alia*, to ensure macroeconomic stability; local taxes fund regional spending whereas joint taxes are mainly devoted to economic development. The system is illustrated in detail in Table 1.

1.2 The budgetary situation: An overview[1]

1.2.1 The budget balance and its main components

Figures 1 and 2 show total revenue as a share of GDP and the growth rate of total revenue and expenditure from 1952 to 2005. Since the late 1990s, revenue has

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[1] All data in this section are taken from *Finance Yearbook of China 2006*.

Table 1

Tax Sharing between the Central and Local Governments

Central Taxes	**Local Taxes**
Customs duties; VAT on imports and consumption; tax collected by customs and excise; consumption tax; enterprise income tax paid by the Ministry of Railway Transportation, China’s Post Office, four wholly state-owned commercial banks, three policy banks, the Offshore Petroleum and Natural Gas Corporation, PetroChina Company Limited and the China Petroleum & Chemical Corporation; business tax; income and urban maintenance and development tax paid by the head offices of the Ministry of Railway Transportation, various banks and insurance institutions; income tax on national enterprises; vessel tonnage tax; vehicle purchase tax; special purpose tax.	Business tax (excluding the part paid by the Ministry of Railway Transportation, various banks and insurance institutions); income tax on local enterprises; urban land use tax; regulatory tax for fixed investment; urban maintenance and development tax (excluding the part paid by the Ministry of Railway Transportation, various banks and insurance institutions); real estate tax; farmland occupation tax; land appreciation tax; urban real estate tax; vehicle and vessel usage tax; licence plate tax; deed tax; stamp duty; agricultural tax and animal husbandry tax (including tax on special farming products) and State-owned land use tax.
Joint Taxes	
Domestic VAT (75 per cent to central government and 25 per cent to local governments); income tax (60 per cent to central government and 40 to local governments); resource tax (the share paid by offshore oil enterprises to the central government and the remaining part to the local governments); stamp tax revenue collected on stock transactions (97 per cent to the central government, the remaining share to local governments).	

Source: The Ministry of Finance of China.

Figure 1

Total Revenue
(percent of GDP)

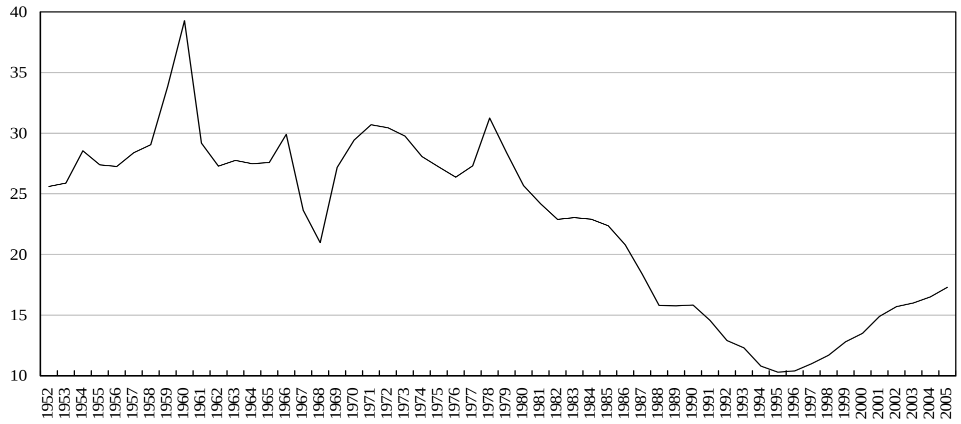
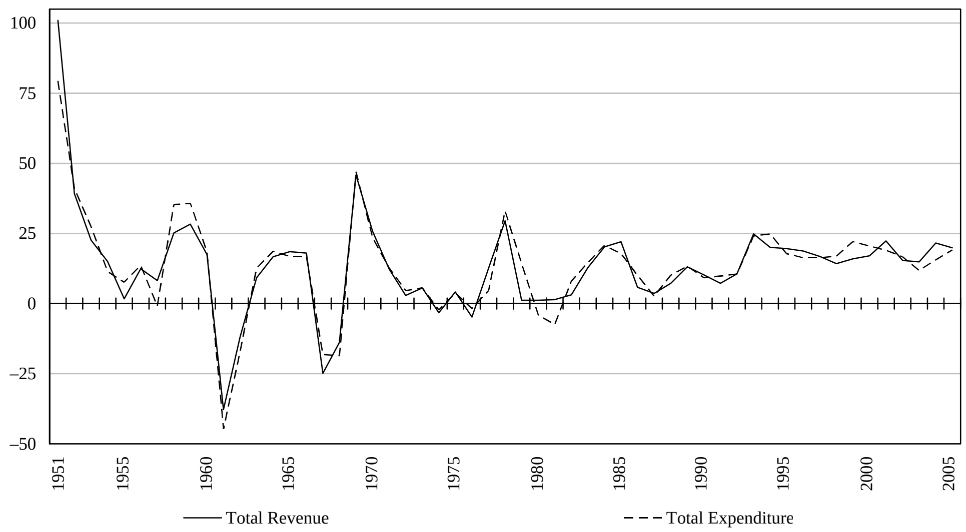


Figure 2

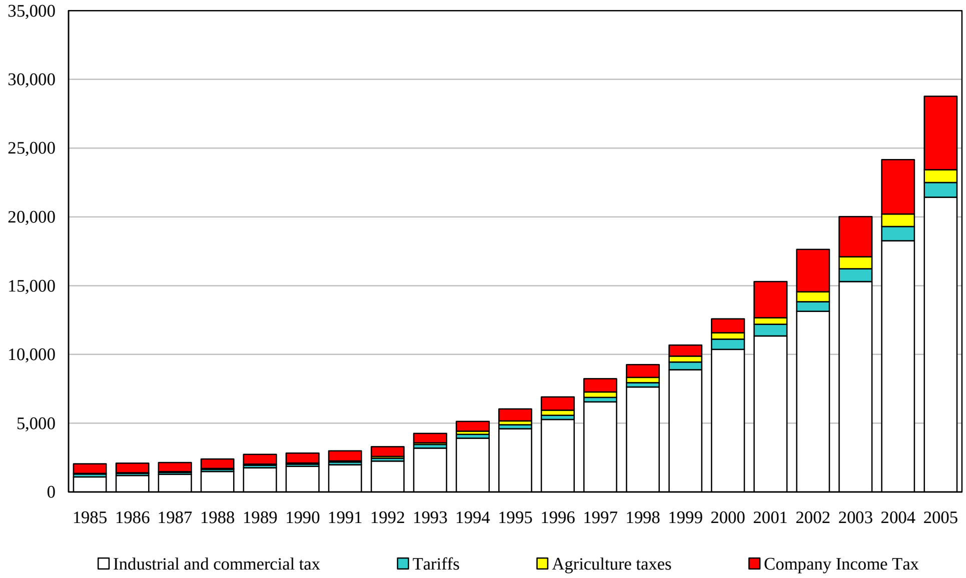
Growth Rate of Revenue and Expenditure
(percent)



Note:
For the sake of comparability, price subsidies are reported as expenditure also before 1986.
Since the year 2000, expenditure includes the interest payments on public debt.

Figure 3

Tax Revenue
(hundred million yuan)



Notes:
The agricultural taxes include agricultural tax, animal husbandry tax, tax on the use of cultivated land, the taxes on special farming products and forest products and contract taxes.
Before 2001 company income tax only applied to state-owned and collective enterprises.
Since 1994 the income taxes levied on state-owned enterprises include the income tax levied on local financial enterprises.

grown rapidly and more smoothly than in previous years.

Since 1994 revenue mainly stems from taxes;[2] revenue from extra charges for education also plays an important role. Figure 3 shows that industrial and commercial taxes are the source of revenue.

Figure 4 illustrates the composition of expenditure by function over the period 1996-2005: expenditure on economic development, culture and education, and government administration are the main items. Expenditure on culture and education increased at the fastest rate, while expenditure on national defence was a small item.

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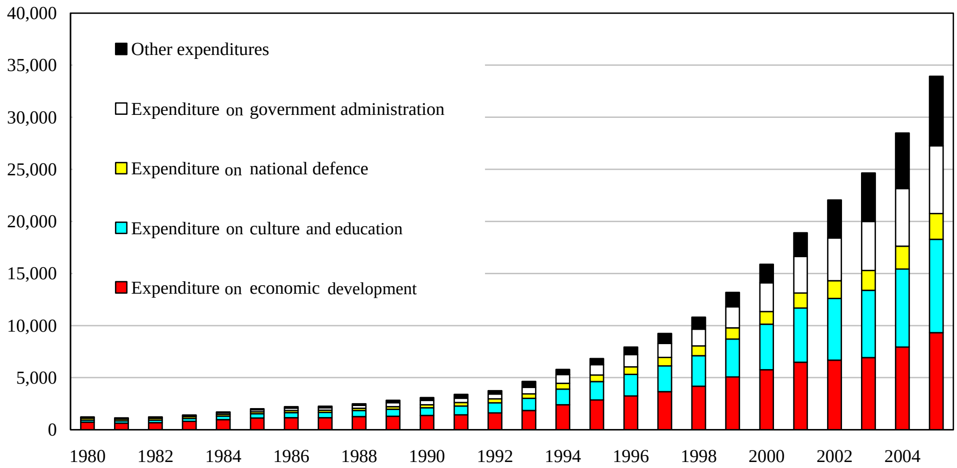
[2] Prior to 1978, business tax was the largest item in total taxes. It was eliminated in the tax reform of 1994.

Figure 4

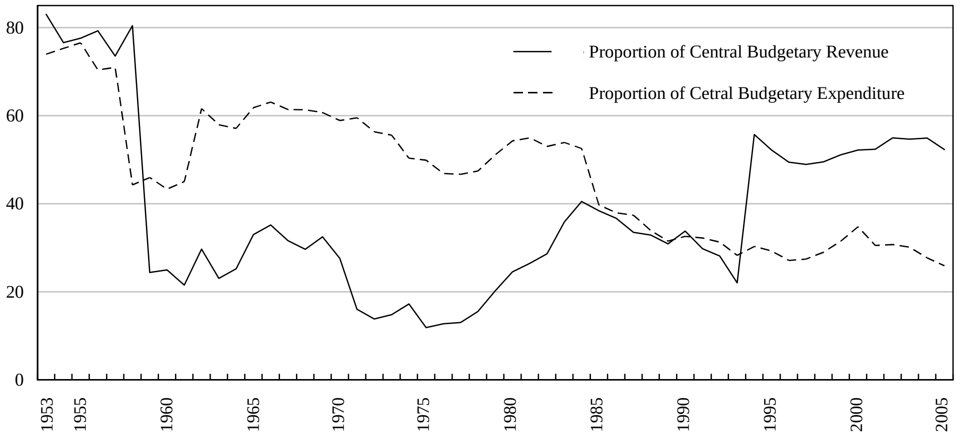
Expenditure by Function
(hundred millions yuan)



Note: Expenditure for payment of principal and interest on public debt and expenditure for capital formation financed by foreign loans are not included.

Figure 5

Share of Central to General Government Revenue and Expenditure
(percent)



1.2.2 Central versus local governments

Almost all central government revenue stems from taxes (Figure 5). On the expenditure side, a higher degree of heterogeneity can be detected (Figure 6). Among the expenditure of central government, national defence spending is the most important item, followed by capital development, interest payments and general administration expenses.

The composition of local governments' revenue and expenditure is represented in Figure 7 and Figure 8 respectively. Taxes are the main revenue source, whereas expenses on culture, education, science and health care, on government administration and on capital development are the main expenditure items.

1.2.3 Extra-budgetary revenue and expenditure

Figure 9 and Figure 10 display the composition of extra-budgetary revenue and expenditure. The largest revenue item is the revenue of administrative units and institutions. Administrative expenditure is the largest and fastest growing item.

1.3 The main functions of the Ministry of Finance

At present the Ministry of Finance has the following four main functions. First, it designs and implements strategies, policies and guidelines, medium- and long-term development plans and public finance and taxation reforms, also with reference to resource distribution between the central and local governments and between state and enterprises. The Ministry also plays a role in macroeconomic policy making and provides policy advice on macroeconomic regulation and on the allocation of public funds.

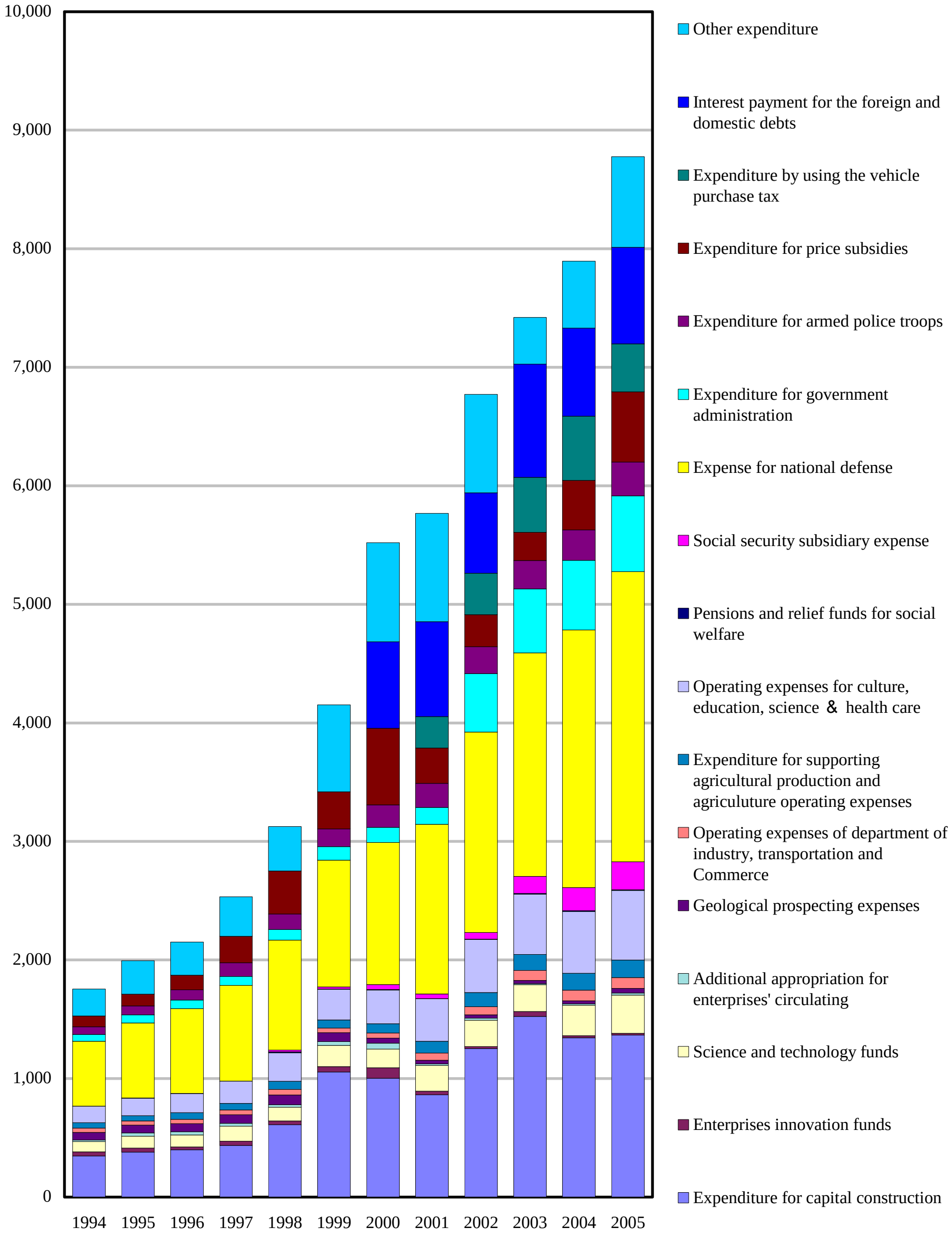
Second, the Ministry of Finance prepares the draft annual budget of the central government and its accounts, implements the budget and reports – to the National People's Congress and to the Standing Committee of the National People's Congress – on the central and local budgets and accounts. It manages public revenue, central government accounts and other governmental funds.

Third, the Ministry has to propose tax legislation plans and collection regulation, which have to be reviewed with the State Tax Administration Units and then reported to the State Council. It has to collect taxes according to the budget and can propose adjustments with respect to tax rates and tax incentives, including temporary and special regimes with a major effect on public finances.

Moreover, the Ministry of Finance administers central government expenditures, formulates and implements government procurement policies. It also manages social security and promotes the use uniform standards and policies in public good provision.

Figure 6

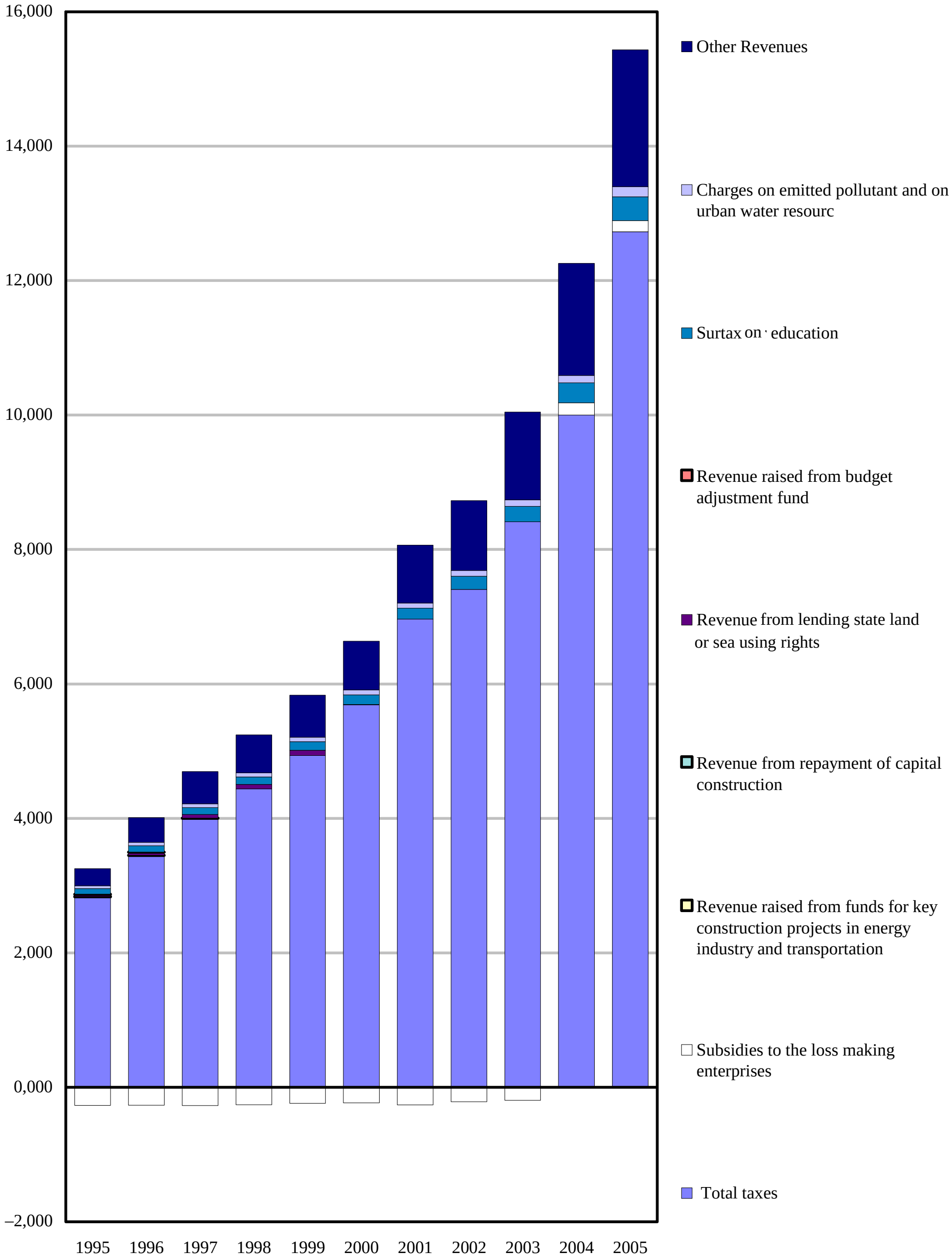
Composition of Central Government Expenditure
(hundred millions yuan)



Note:
Expenditure for government administration includes the expenditures for public security, procuratorial work and spending of the court of justice and for foreign affairs.
Since the year 2000, expenditure includes interest payments on public debt.

Figure 7

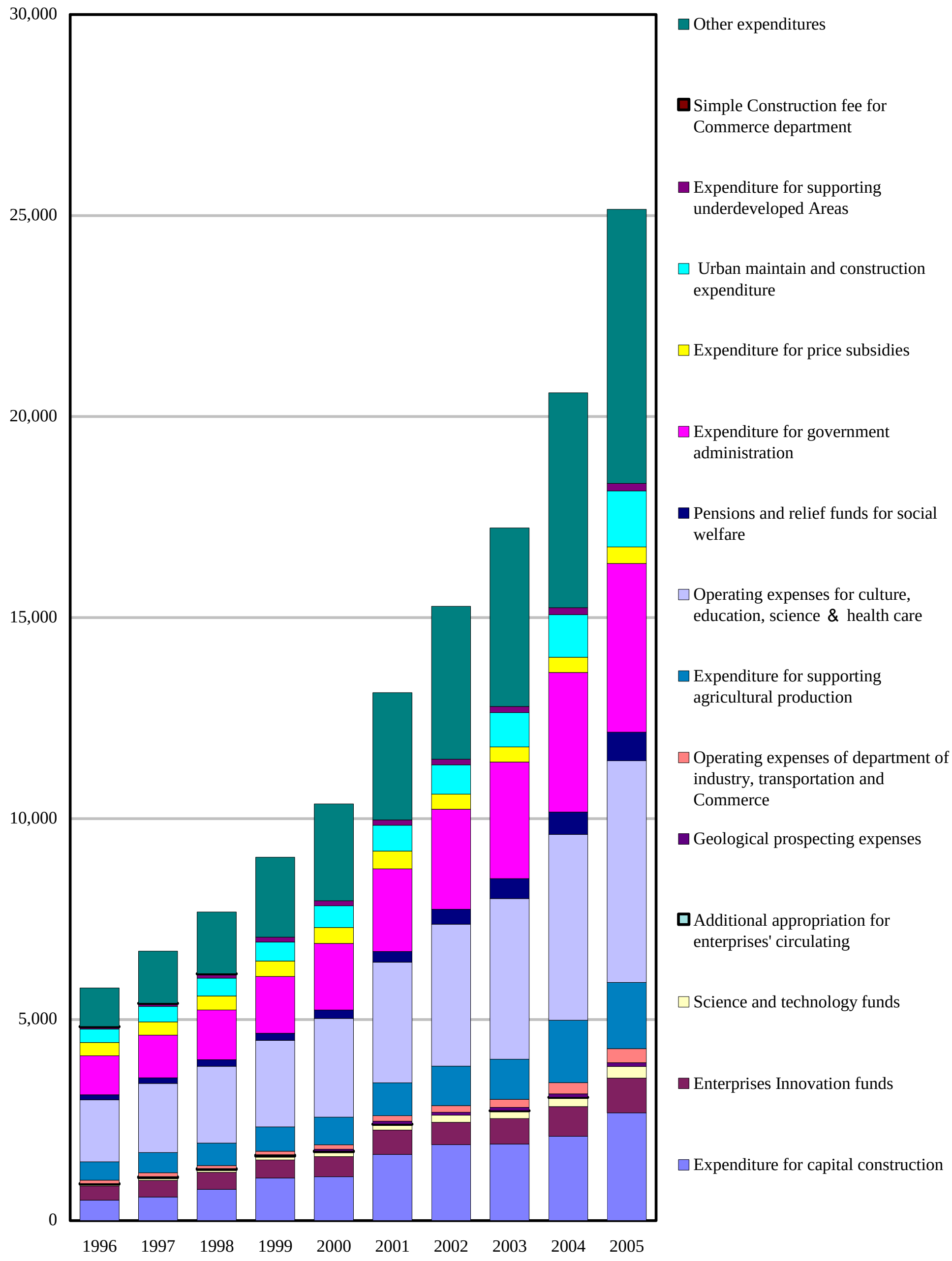
Composition of Local Governments Revenue
(hundred millions yuan)



Note: After the tax share system was adopted in 1994 (75 per cent of VAT and consumption tax belongs to central government), the local government revenue decreased.

Figure 8

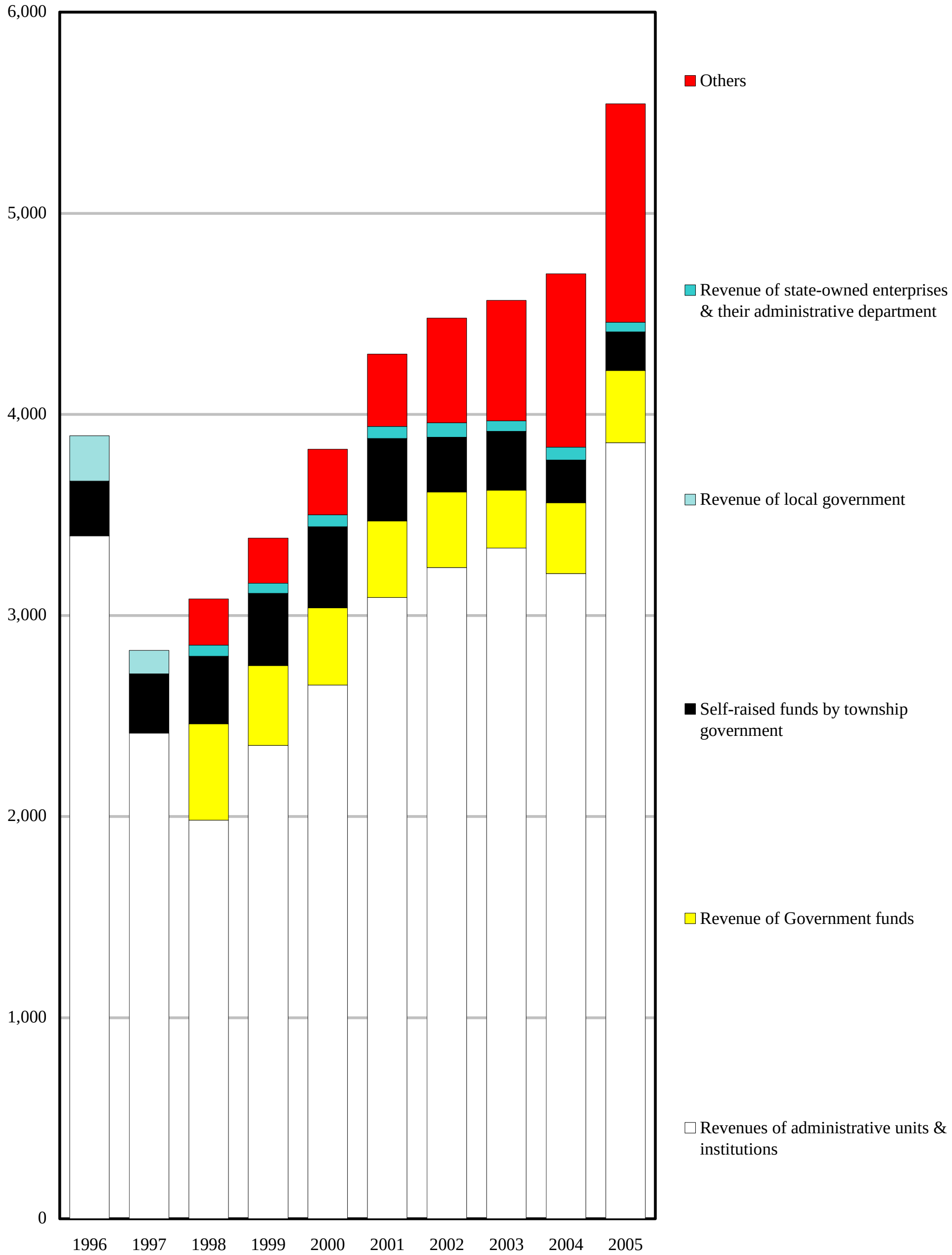
Composition of Local Governments Expenditure
(hundred millions yuan)



Note: Expenditure for government administration includes the expenditures for public security, procuratorial work and the court of justice and for foreign affairs.

Figure 9

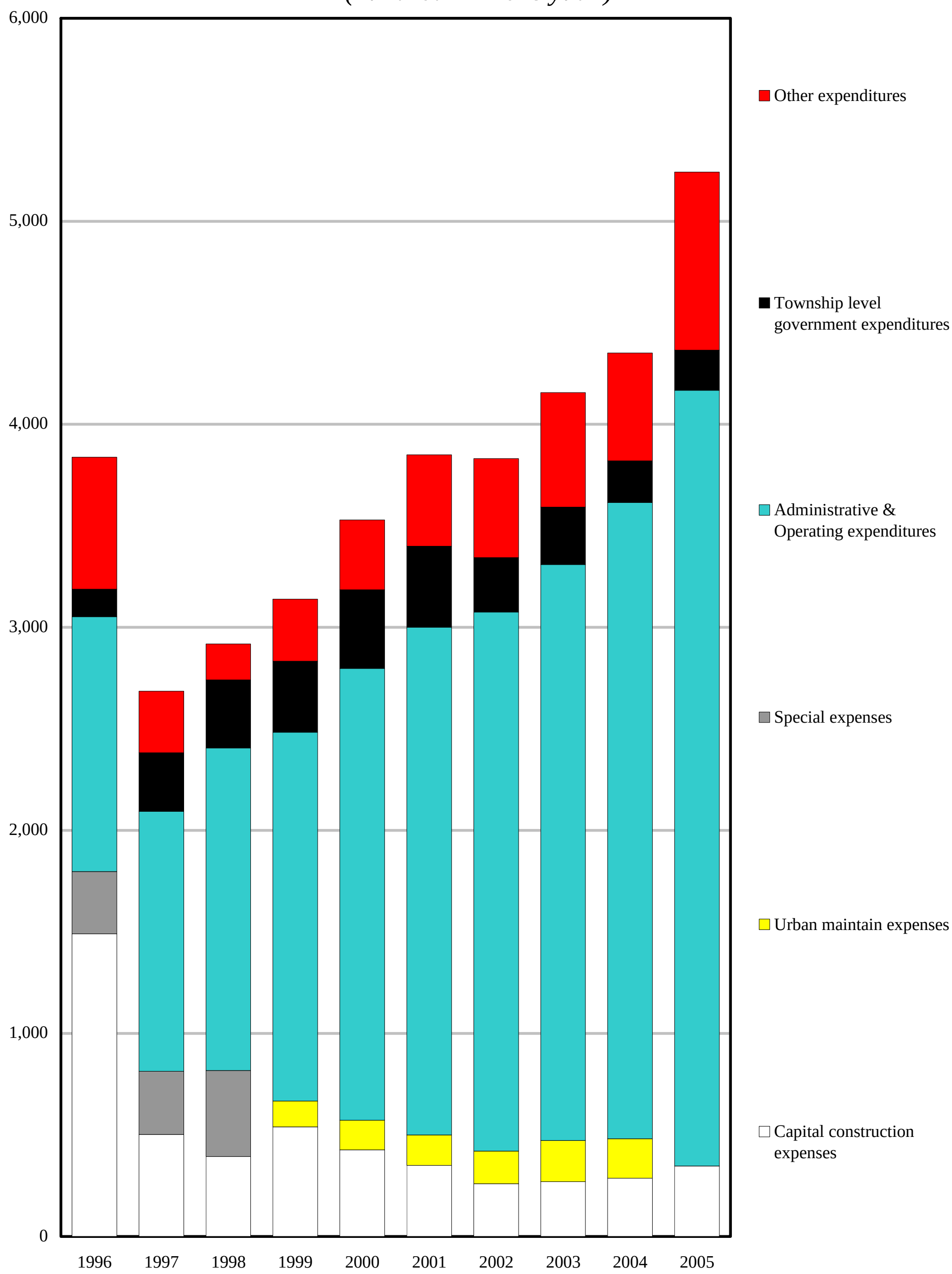
Composition of Extra-budgetary Revenue
(hundred millions yuan)



Note: For the sake of comparability, after 1997 the extra-budgetary revenue and expenditure continue not to include those funds (fees) which were excluded up to 1996.

Figure 10

Composition of Extra-budgetary Expenditure
(hundred millions yuan)



Note: For the sake of comparability, after 1997 the extra-budgetary revenue and expenditure continue not to include those funds (fees) which were excluded up to 1996.

In addition, the Ministry allocates financial resources between the state and the enterprises and defines the general principles of enterprise accounting. It also supervises the management of the publicly controlled enterprises and manages the return of state-owned funds. Finally, it consolidates and analyzes the annual financial accounts of national enterprises.

Furthermore, the Ministry of finance formulates and implements policies, rules and regulations on managing public domestic debt and prepares plans for treasury bond issuance.

Finally, it monitors the implementation of fiscal and tax policies, laws and regulations and administers resident offices of Fiscal Supervision Commissioners.

2 The role of fiscal policy in macroeconomic stabilization

Even if, in the economic literature, there is no consensus on the extent and effectiveness of public macroeconomic control, there is no doubt that the government has to be an important player in any market economy. Indeed, in the face of market failures, the government can and should play a role.

Since its reform and opening up, China has moved from being a traditional planned economy to being a socialist market economy. The market mechanism is becoming more important in the allocation of resources. Meanwhile, the Chinese government has constantly been adjusting the tools of macro control methods.

2.1 The areas in which macroeconomic control is necessary

Four main areas in which macroeconomic control is necessary can be pointed out.

First, the government has to participate and regulate resource allocation wherever there are market failures in the provision of public goods. The government will properly direct and mix existing manpower, material and capital resources in the society through revenue-generating and spending activities as well as by formulating, adjusting and implementing related policies. It will use policy signals to reasonably allocate resources between the public and the private sector and ensure effective supply of public goods. For example, the government may directly increase the supply of public goods through fiscal spending on national defence and major infrastructure projects.

Second, the government may use economic, legal and administrative measures to address externalities, especially negative ones. In this regard, the government can introduce subsides and taxes. For example, to address overproduction of a good, the government may levy higher taxes or charges so that the private marginal costs are made equal to the social marginal costs. To address underproduction, the government may introduce such incentives as fiscal subsides and tax preference.

Moreover, a reasonable income gap is a stimulant and driving force for economic growth. If some people are richer than others, their status can spur the others to work harder in order to gain the same status. It is the case that the market mechanism widens such a gap to the point where it is too big from the society perspective.

The market itself cannot lead to a fair income distribution, which is exactly what a harmonious society needs to achieve. Therefore, the government has to rely upon external forces and find a non-market approach, which is implemented by the government's redistributive policy that includes setting a mandatory minimum wage level and income redistribution. That being said, when moderating the income gap, the government also needs to strike a proper balance between fairness and efficiency and avoid the tendency towards equalitarianism. This means that the government has to refrain from blindly redistributing, regardless of individual ability and contribution. Otherwise, economic efficiency may be lost and this will ultimately impede the improvement of social well-being.

Finally, the market can properly work only under the assumption of complete information and full competition. However, in practice, due to a variety of reasons, information is incomplete and/or asymmetric. On a more serious note, a certain degree of blindness of the market leads to economic instability, *i.e.* the economy moves from growth to recession and depression (crisis) and then back to recovery and growth. In this process, productivity is often hugely eroded and can even lead to economic stagnation and social instability.

To smooth out economic fluctuations, it is imperative that the government takes adequate measures to increase employment, contain inflation and maintain economic stability. Government fiscal policy has the purpose of stabilizing the economy.

2.2 Fiscal policy: automatic stabilizers and discretionary measures

The main tools of government macroeconomic control are fiscal policy and monetary policy. Fiscal policy can affect the economy via both automatic stabilizers and discretionary measures.

In particular, under certain circumstances, fiscal policy based on the internal mechanism of the revenue and expenditure system can smooth economic fluctuations and thus stabilize the economy. Since it automatically stabilizes the economy, this mechanism is usually referred to as "automatic stabilizer". It works mainly through the progressiveness of the personal income tax, expenditure on social welfare and the control of the price of agricultural products.

Nevertheless, it may be the case that automatic stabilizers are not sufficient to stabilize the economy. The government has to adjust its expenditure and revenue programs on the basis of the current economic conditions so as to smooth economic fluctuations. This is usually referred to as discretionary fiscal measures. The main task of the discretionary fiscal policy is to keep the balance between total supply and demand.

Fiscal policy tools include changes to taxes, subsidies, investment programs, transfer payment and government bond policies.

3 Fiscal policy in China

3.1 Moderately tight fiscal policy (1993-97)

From 1993 to 1997, in face of the economic overheating and inflation, the Chinese government implemented a moderately tight fiscal policy. The policy has achieved its goal in stabilizing the economy and maintaining a stable growth. This can be considered the first successful experience of the Chinese government in stabilizing the economy, since China became a socialist market economy. It was characterized by the use of economic tools as opposed to administrative control measures.

3.1.1 Background

In 1991 and 1992, the GDP growth in China reached to 9.3 and 14.2 per cent respectively. In 1993, the GDP in the first quarter grew by 15.1 per cent. By the end of June, the total money in circulation increased by 54.1 per cent over the same period of the previous year.

Investment and consumption demand were increasing at a very high pace. In the first half of 1993, the overall fixed asset investment increased by 61 per cent, the highest rate after the reform. Consumption demand also expanded rapidly. From January to May, the cash expenditure of banks in wage payment and other individual withdraw increased by 36.4 per cent.

Starting in October 1992, prices accelerated. In January 1993 the increase in the consumption price index (CPI) reached 8.4 per cent, further climbed to a two-digit rate in March and to 12.5 per cent in May. From January to May, the raw material, fuel and energy price index increased by 31 per cent, and raw material prices increased by 43 per cent on a yearly basis.

Imbalances emerged in the industrial structure. The over-expanding construction industry faced constraints stemming from bottlenecks in infrastructure and primary industries. Transportation, especially railway transportation, was stretched to its limit. The gap between demand and supply in input markets was further widening. Energy products – such as electricity and oil – were in severe shortages.

Fiscal difficulties were increasing. Fiscal expenditure grew faster than fiscal revenue. Fiscal deficit continued expanding.

There were deficits in the balance of payments. Imports increased rapidly, whilst exports were sluggish, resulting in decreasing foreign reserves.

The economy was getting seriously overheated. Without timely and effective macroeconomic adjustment, the imbalance between aggregate demand and aggregate supply would have further grown and the economy would have been affected by an even more sizeable volatility.

3.1.2 Measures of moderately tight fiscal policies

The Chinese government paid great attention to problems in the economy and adopted adequate measures to address these issues.

On June 24, 1993, the government approved the document "Viewpoints on the Current Economic Situation and Strengthening Macro Economic Management", calling for sixteen measures to strengthen and improve macroeconomic policy. On that basis, the Minister of Finance introduced a series of tightening fiscal measures on the control of aggregate demand and on structural adjustment.

First, in order to ensure relatively rapid growth of fiscal revenue, tax collection and the cleaning up of tax preferential regimes have been strengthened.

Second, the strict deficit control is an important ingredient of a moderately tight fiscal policy. The government required that local governments to balance their budgets. In March 1994, the second meeting of the 8th National People's Congress approved the *Budget Law of the People's Republic of China*, which stipulates that deficit is not allowed for the current budget of the central government and for the overall budget of local governments. Indeed, local budgets should be based on the "spending according to collecting" principle, so as to achieve the budget balance. From 1994, central government's fiscal deficit was financed mainly through bond issuance, as opposed to overdraft from the central bank.

Third, regulations on performance-based salaries in enterprises were implemented in order to ensure a strict control on the purchasing power of social consortiums and on the rate of growth of consumption.

Fourth, in January 1994 the government issued the *Notice for Continuing to Strengthen Macro Management on Fixed Asset Investment* in order to clean up infrastructure construction projects and to control the fast growth of fixed asset investments.

Fifth, to accommodate socialist market economic development, the government decided to adopt a tax-sharing fiscal system that can speed up fiscal regulation reforms and foster institutional innovation.

Sixth, a new tax system was introduced and tax polices were improved. In 1994, the government implemented a comprehensive tax reform and established a new system suitable for a market economy, based on the guidelines of “unification of tax laws, fair share of tax burden, simplification of tax system and rational share of fiscal responsibility”.

Borrowing from international practices, the government changed its approach from a turnover tax characterised by differentiated rates across types of products to a turnover tax system centred on VAT, complemented by a consumption tax and a business tax. Also the rule of setting income taxes according to the ownership of enterprises was changed; the income taxes of the state-owned, collective owned and private enterprises are now subject to the same tax, *i.e.* the enterprise income tax. The previous regime, according to which state-owned enterprises were required to pay a fixed income tax, is no longer in place. The income tax levied on domestic residents, the individual income tax on foreign citizens and the income tax on urban and rural private businesses were all unified into a single individual income tax.

Thanks to the reform, a tax system suitable for a socialist market economy has been established. Meanwhile, attention has been paid to the regulatory function of tax policy. For example, VAT on some agriculture products and on agriculture production materials was decreased or abolished.

Finally, moderately tight policy can lead to a structural adjustment by combing both tightening and expanding measures and by adjusting aggregate demand. Attention was also paid to adjust expenditure structure and strengthen support for the weak parts of the national economy, especially to sustain the agriculture development. From 1994, the Ministry of Finance established a national special reserve fund for grain, grain risk fund and by-products risk fund so as to protect the national grain reserves, to achieve price stability for agriculture products and to maintain farmer’s production committment. Special funds have been arranged to replenish “vegetable baskets” and production bases of grain, cotton and oil.

3.1.3 Results of the moderately tight fiscal policy

The moderately tight fiscal policy implemented was counter-cyclical. Inflation was brought under effective control and the economy was back on a track of moderate growth. A “high growth, low inflation” economic situation was achieved which was a solid foundation for a sustainable, rapid and healthy development of the Chinese economy.

The Chinese economy had a successful “soft landing”. The overheating was gradually eliminated and the fiscal and financial situation was improved.

Now, with hindsight, had the government failed to adopt a moderately tight fiscal and monetary policies, failed to achieve “soft-landing” of the economy and failed to establish a fiscal system to ensure stable fiscal revenue growth, the Chinese economy would have been unable to avoid a significant slowdown under the large-scale external shock that was the Asian financial crisis.

3.2 Pro-active fiscal policy (1998)

In 1998, the Chinese government decided to implement a pro-active fiscal policy, which was the second major shift in fiscal policy after China launched a socialist market economy. The pro-active fiscal policy is basically an expansionary fiscal policy. The choice to switch to a pro-active fiscal policy was important and made in a timely and resolute manner in a context characterized by an insufficient effective demand and deflation, after the outbreak of the Asian financial crisis.

3.2.1 Background

The pro-active fiscal policy was adopted in 1998 in an effort to address the impact of the Asian financial crisis on domestic economy. China had to face a very severe external and internal economic environment: foreign trade was severely attacked; consumption demand growth decreased; growth in investment demand was weak; prices were decreasing; structural imbalances became more pronounced.

3.2.2 Measures of pro-active fiscal policy

From 1998 to 2004, 910 billion yuan long-term treasury bonds for construction were issued. The development of infrastructure concerned six areas: irrigation, transportation and communication, urban infrastructure, environmental protection, construction and improvement of urban and rural power grids, and depots for national grain reserves. In the second part of the period, the government gradually increased the public investment in other areas, including western region development, technology reinforcement in main industries, high and new technology industry, returning farmland to forests (grass), education. More resources were devoted to striking the balance between urban and rural areas among different regions.

Technologically advanced enterprises which were affected by national industrial policies were allowed to deduct from the corporate income tax base 40 per cent of the domestically-made equipment they bought. In order to stimulate individual consumption, in November 1999 interest tax was resumed on resident deposits. Sales tax, contract tax and land appreciation tax for real estate have been reduced to encourage the housing market.

Other measures include: redistributing income to stimulate consumption, improving public finance and increasing transfer payments to central and western regions, optimizing non-tax revenues and expanding domestic demand.

3.2.3 Result of pro-active fiscal policy

First, investment continued to grow rapidly. Consumption demand, foreign trade and export kept growing at a fast pace. Overall, economic growth accelerated.

Second, the CPI and the Retail Price Index increased again after the deflationary period. Price indices of upstream products such as industrial products continued climbing up.

Third, transportation developed on an unprecedented scale. Construction of water utilities was bolstered remarkably. Infrastructure in rural areas was significantly improved. The pace of industrial upgrading and restructuring picked up speed.

In addition, ecological and environmental protection was increased in order to improve people's living conditions and promote the development of social undertakings. Urban infrastructure construction achieved notable results. Development of social undertakings such as education and sanitation remarkably gained ground.

Finally, revenue maintained the rapid growth momentum, and financial strength was significantly enhanced. The mechanism that guarantees a stable growth of revenue was further consolidated. The effectiveness of macro regulation was remarkably enhanced.

3.3 Prudent fiscal policy (2005)

In early 2005, the Chinese Government decided to implement a prudent fiscal policy, *i.e.* a neutral fiscal policy. This was the third major transition of fiscal policy in China's macroeconomic regulation since the country began to establish a socialist market economic system. It was not only an important decision made by the Chinese Government in response to new challenges, but also a way of effectively implementing the prescriptions of economic theory.

3.3.1 Background

Favourable economic conditions prevailed

After the implementation of the long-term market-oriented reform, the functioning of the market mechanism has been markedly enhanced. The prices of about 90 per cent of goods and services were determined by the market. Private sector became the main driving force of economic development. Non-governmental investments tended to be active. The income distribution mechanism started to reflect the relative role of production factors.

The economy moved from deflation and insufficient demand to a rough balance between aggregate demand and supply.

Finally, China's per capita GDP exceeded US$1,000 in 2003, and reached around US$1,200 in 2004. The focus of China's consumption shifted from foodstuff, clothing and household goods to housing, transportation and travel.

The economy stepped into the rising phase of a cycle of rapid growth

GDP increased by 9.5 per cent in 2003 and 2004. In the context of a rapid economic growth, bottlenecks and resource shortages emerged. Prices tended to increase. Increases of leading price indicators speeded up. The unemployment rate slowed down. The balance of payment recorded a surplus.

Structural problems in the economy emerged

Structural problems became conspicuous. Investments were overheated in some industries (real estate, iron and steel among them), whereas other industries were underdeveloped (agriculture, ecological and environmental conservation, education and social security). Disequilibria between urban and rural areas, between eastern and central-western regions, between man and nature became apparent. Structural contradictions became increasingly outstanding.

Economic growth pattern was in sharp contradiction with the shortages of resources and environment preservation. The transformation of the economic growth pattern was a priority on the agenda of macroeconomic regulation.

3.3.2 The implementation of the prudent fiscal policy

What the government used to define as a "prudent" fiscal policy is usually labelled in economics as a "neutral" fiscal policy. Similarly, what the government used to define as a "pro-active" fiscal policy is usually labelled in economics as an "expansionary" fiscal policy.

A neutral fiscal policy neither expands nor tightens aggregate demand. Generally speaking, under the conditions of equilibrium between aggregate demand and supply, relatively stable price and steady economic performance, it is reasonable to implement a neutral fiscal policy, reduce government's direct intervention and let the market mechanism fully play its functions. Neutrality does not imply a balance between revenue and expenditure.

The shift from pro-active (expansionary) to prudent (neutral) enables fiscal policy to better play its role in balancing social and economic development. The content of the prudent (neutral) fiscal policy can be summarized as controlling deficits, advancing reforms, increasing revenue and curbing expenditure.

Reducing the central government deficit is a way to signal the importance of macroeconomic stability and thus to prevent the renewal of inflationary pressure and the re-emergence of deflation. Keeping the deficit under control and having a good regulatory ability is necessary for the government to cope with unexpected events. A prudent fiscal policy does not imply a sudden elimination of fiscal deficits, but implies their gradual scale-down. This is consistent with the Chinese economic situation and helps to maintain economic and social stability.

The strategy of balanced development raises new requests concerning the allocation of fiscal resources. It requires a further adjustment of the orientation and structure of fiscal policy, a gradual reduction of direct public investment in commercial and competitive sectors, and an input increase in public services.

In order to create a sound and fair policy environment for the market and for economic development, the government promoted a series of reforms, such as: transforming production-based VAT to consumption-based VAT, accelerating the preparatory legislative work of unifying domestic and foreign corporate income tax systems, deepening the rural tax-for-fee reform, improving the mechanism of export tax rebate and improving income distribution, social security, education and public health.

4 Fiscal regulation in practice

Since 1993, the economy experienced three dramatic changes. Accordingly, fiscal policy underwent three adjustments. Chinese government adopted tight, pro-active and prudent fiscal policies successively, which greatly promoted sustained, rapid and healthy development of the national economy. Reviewing China’s fiscal regulation in practice can help to better understand the fiscal policy framework.

4.1 Fiscal policy in a market economy

In a socialist market economy, governmental macroeconomic control has to be based on the principles and the rules of a market economy and so the market has to be the main player in determining the resources allocation. The purpose of macroeconomic control is to cope with market failures. As a major tool for governmental macroeconomic control, fiscal policy has to be performed in accordance with law of the market economy. Since 1992, when China set the goal of establishing socialist market economy, the Chinese government fully respected the working of the market in an efficient and effective way: it modified existing macroeconomic tools and introduced new ones. China’s macroeconomic control system has been improving over time.

4.2 Macroeconomic control during the transition to a socialist market economy

In the course of establishing and improving a socialist market economy, fiscal management was adjusted in response to changes in the economic system. Macroeconomic control shifted from being direct to being indirect while the number of the macroeconomic tools increased.

4.2.1 Shifting from direct to indirect regulation

In the first ten years after China began to reform and open up its economic system, the macroeconomic regulation was implemented only via administrative measures, which directly affected the production activities of individuals at the microeconomic level. In the 1980s, the Chinese government began to consciously use fiscal and monetary policies as an indirect way to regulate the economic system. However, because of the constraints stemming from the administrative and planning system, at that time macroeconomic regulation failed to achieve satisfying results. It was only after 1992, when the government set the goal of establishing a socialist market economy and promoting market-based mechanisms, that macroeconomic management became effective. The three adjustments of fiscal policy since 1992 were instrumental in the successful transition from direct to indirect regulation.

To cool down the heated economy, in 1992 and 1993 China adopted a tight fiscal policy. Fiscal policy kept being tight up to 1997. Initially, direct administrative means kept playing the main role. For example, consumption of public institutions was strictly examined before being approved. But during the transition, more market-based mechanisms got more important over time.

From 1998 to 2003 the pro-active fiscal policy focused more on indirect management tools working via the issuance of Treasury bond, taxation, interest subsidy and income redistribution. Administrative tool were still used.

Since 2004 China began to adjust its fiscal policy. Though some administrative measures are still in place, indirect control measures replaced direct control as the major form of economic management.

4.2.2 Diversifying fiscal regulatory tools

Before 1993 China's fiscal management was dominated by administrative control. The available policy tools were also severely limited.

From 1993 to 1997 the Chinese government adopted tight fiscal policy while beginning to reform the fiscal and tax system. Budgetary policy generally and, in particular, the Treasury bond issuance, taxation, transfer payments and other similar measures aimed at enhancing economic growth.

From 1998 to 2003, even more tools for fiscal management became available. In fact, tax policy and income distribution policy were also used. In addition, there were both revenue and expenditure policies. Adjustment paid attention to both demand and supply. There were both development-oriented policies, that aimed at stimulating investment and consumption, and stability-oriented policies.

In 2004 attempts were made to curb the increase in fiscal deficits and to reduce the issuance of long-term Treasury bonds. Economic development targets and social development targets had the same priority. Short-, medium- and long-term strategies were combined. Tax reform and income redistribution system reform were bushed forward. Evidence shows that fiscal policy tools are becoming more effective over time.

4.3 The key role of discretionary fiscal policy

The key to successful fiscal adjustment lies in correct forecasting, accurate analysis and good design of discretionary measures. That means fiscal policy has to take into account the circumstances and the agents that it is meant to affect.

4.3.1 Discretionary fiscal policy

In theory, fiscal policy can affect the economy either via discretionary measures or via automatic stabilizers. In practice, the turnover tax and the income tax are the main taxes in China. Direct taxation accounts for a small share of overall revenue. The opposite holds for the turnover tax. In these circumstances, the automatic stabilizers are not big enough. Therefore, the government has to closely monitor economic development and pro-actively and appropriately use fiscal policy to affect the economy. It is important to strike the right balance between the working of automatic stabilizers and discretionary measures.

4.3.2 Discretionary policy in practice

Discretionary fiscal policy has to be based on an accurate assessment of the current and perspective economic situation. Therefore, economic forecast and analysis should be improved in order to provide an adequate basis for decision-making purposes. The design of fiscal policy is decided depending on how revenue and expenditure are evolving over time and on revenue and expenditure targets. The expenditure policy has a more direct and faster impact on the economy than the revenue policy. Still, revenue policy plays an important role in sustaining economic growth. In practice, the fiscal policy tools change as the relevant economic circumstances change.

There should be coordination between fiscal policy and the other macro-management policies, such as monetary policy, land policy and industrial policy. Macroeconomic policies are those that concern both demand adjustment and supply management. Only trough coordination the various macroeconomic policies can be combined so as to be effective in achieving their goals.

5 The fiscal policy outlook

China’s fiscal policy framework can be understood only by understanding the country’s history, the present economic and social situation and perspectives. Moving further along the lines defined with the economic reforms will be very important in shaping and improving the fiscal policy framework. Some of the reforms have already been enacted, and others will be implemented and completed in the coming years.

5.1 The role of non-fiscal revenue

The government will fully implement the tax reform and thus will create more room for using the tax leverage. The tax reform will be further developed in order to aim at "simplifying tax system, broadening tax base, lowing tax rates and enforcing tax collection". In the light of the lessons drawn from the pilot program on VAT reform in the North-Eastern area of China, the government will implement the VAT reform nationwide as soon as possible, applying the same tax regime to both domestic and foreign enterprises and improving the rural tax regime.

The government will replace some administrative fees with taxes, will levy a fuel tax and a real estate tax and will consider the possibility of converting the social insurance fee into social security tax. Depending on economic and social conditions and on the need to narrow the income gap, the government will start to levy heritage and gift taxes at an appropriate time.

The government has to assess the financial resources that could potentially stem from non-tax revenue, which played a minor role for a long time. In addition, in order to make administrative fee charges and governmental funds management more efficient, the government will increase the role played by non-tax revenue at the state level. Through these reforms, the ratio of fiscal revenue to GDP will be kept at a reasonable level.

5.2 The reform of fiscal management system

As a first step, the system of budget formulation has to be improved. This goal can be reached by: (1) improving the decision-making mechanism for budget resources allocation which is closely linked with the government macro-economic policies and the government's administrative objectives; (2) improving the system for recruitment of qualified staff which manages the budget and other projects; (3) speeding up the work to establish a standardized budget process and therefore ensuring standardized budget procedures for the National People's Congress, its Standing Committee, the government, the audit agency and other departments, in order to maintain effective budget compilation and execution.

The government will accelerate the reform which should lead to a centralized treasury account system and a centralised procurement system. The government will further strengthen the coordinated management of revenue and expenditure and will set up an appropriate monitoring system.

The government will build up and improve a system for assessing the impact and effectiveness of expenditure.

5.3 Improving the fiscal management system at the local level

At present the main public finance problem is that some provincial governments have failed to play an effective role in providing adequate financial resources to the local governments belonging to their area. Moreover, the financial difficulties at the county and township levels are worsening. Therefore, the provision of public services is getting inadequate and the development of social welfare in the rural areas is lagging behind.

In the near future the government, while continuing to improve the fiscal management of the existing tax-sharing system, will further improve the fiscal management system below the provincial level, will clarify the expenditure responsibilities of local governments below the provincial level, will appropriately classify the fiscal revenue of the local governments and will help to provide local governments with stable and adequate source of revenue.

The government will also expand the pilot program of fiscal management reform on “putting the counties under the direct administration of the provincial government” to reduce the layers of government, expand the administrative approval power at the county level and increase the effectiveness of fiscal administration and the use of funds.

In addition, the government will improve the pilot program to reform the fiscal management system at the town level. For the underdeveloped townships which have a small endowment of revenue, the approach called “township finance being administrated by the county” will be applied.

The government will also introduce a mechanism to induce provincial governments to increase transfers to their local governments and encourage the local governments to strictly limit the number of the government-paid employees and reduce administrative costs.

A budget review mechanism will be adopted. Based on the standard procedures, the provincial governments will provide guidance and review the budget of the counties under their direct administration and, in particular, the budget of those in financial distress.

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