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An Overview of China's Public Finance

China is the most populous country in the world with a population of 1.4 billion right now. It has a history with written records for more than three thousand years. More than two thousand years ago, the Chin Dynasty (221–207 BC), was established, from which many believe China got its name. China's territory was shaped through conquering and being conquered. Currently, China's territorial area ranks third after that of Russia and Canada. China is an upper-middle-income country with a per capita gross domestic product (GDP) of about $10,000 up to now, and China is expected to become the world's largest economy in a decade. China is the biggest trade partner for more than one hundred countries and its influence on the world economy has been growing quickly.

Public finance plays an important role in China. The main functions of public finance include obtaining resources needed by the government to provide public goods and services, correcting externalities to improve economic efficiency, promoting sustainable economic growth, redistributing income to allow all people to share the fruit of economic development, and maintaining economic stability. In China, public finance is also utilized to maintain political continuity and stability. For two thousand years after the Chin dynasty, China's government was small, but it is big now.

Since economic reforms started forty years ago, China's fiscal system has been dramatically reformed. China has established a tax system dominated by consumption taxes, which is very effective in generating tax revenue. It continues to allocate a large proportion of government expenditure to economic construction, and it has adopted expansionary fiscal policies since the 1997 Asian financial crisis. Local governments have been granted great fiscal freedom to collect extra-budgetary revenues, sell land, and borrow from banks to finance infrastructure investment. China's current fiscal system is favorable to investment and economic growth.

As China is a country where the government is still heavily involved in investment and production through state-owned enterprises (SOEs) and state-controlled enterprises, collects a large amount of tax revenue, sets development strategies and industrial policies, and actively intervenes in economic development and people's daily lives, understanding China's public finance is essential to understanding the Chinese economy. How does the government intervene in the economy? How large is the government? Where do government revenues come from? Where does the government spend its revenue? How are infrastructures financed in China? How are Chinese social security and health insurance systems managed? What is the relationship between the central and local governments? How serious is local government debt? How does China affect the world economy through its fiscal policies? What are the challenges to China's fiscal system? How should the fiscal system be reformed? All of these questions are intriguing for scholars, investors, and policy makers around the world. This book intends to address these issues.

This overview first discusses traditional Chinese philosophies on public finance, then it describes public finance under the centrally planned economic system, followed by an examination of market-oriented public finance reforms before exploring the challenges to China's public finance. Finally, it explains the contributions of this book.

1.1 Traditional Chinese Philosophies on Public Finance

Numerous ideas exist about how tax should be collected and where tax revenue should be spent. In *The Wealth of Nations*, Adam Smith proposed four maxims of taxation. First was equality – that is, people must contribute to the support of the government in proportion to their respective abilities. Second was certainty – that is, the tax (time, manner, quantity) imposed on each individual must be certain, transparent, and not arbitrary. Third was convenience for taxpayers. Fourth was economy in tax collection. In modern times, the tax system has assumed more roles such as stabilizing the economy and stimulating economic growth. China's public finance is heavily influenced by traditional Chinese philosophies, Chinese history, modern public finance theory, the experience of advanced countries, and China's economic development. It is interesting to discuss traditional Chinese philosophies on public finance that have had a profound influence on the behavior of the Chinese government historically and currently.

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Low Taxation

The concept of low taxation was developed thousands of years ago during the Spring and Autumn Period and the Warring States Period (770–221 BC). Confucius (551–479 BC), the great ancient philosopher, expressed the idea of low taxation clearly in his conversations and writings. Confucian philosophy has been the most important part of Chinese culture, which has affected the government's behavior and the daily lives of Chinese people. *Lun Yu* (*The Discourses and Sayings of Confucius*), the most famous book that recorded Confucius's thoughts, documents a well-known conversation between King Ai of the kingdom of Lu and one of Confucius's disciples, You Ruo.[1]

> King Ai asked You Ruo, "What should I do with inadequate government revenue due to the poor harvest?"
>
> You Ruo replied, "Why don't you enforce a tax law which could authorize you to collect 10 percent of the harvested grains?"
>
> King Ai answered, "20 percent of the grains have already been collected, but the revenue is still not adequate."
>
> You Ruo responded, "If the people are rich, you will be rich. If the people are poor, how could you be rich?"

In this conversation, Confucius's disciple suggested that King Ai should make his people rich so as to enlarge the tax base and thus increase government revenue while keeping the tax rate low.

Here is another story from more than two thousand years ago.[2] One day, Confucius traveled to a remote mountain area and saw a lady crying. He went over and asked the lady the reason for her weeping. The lady replied that her son had recently been killed by a tiger and her husband and her father-in-law were also killed by tigers. Confucius was puzzled and asked why they chose to stay in this dangerous area. The lady replied that they could not afford heavy taxes and levies in a safe area, but in this remote mountain area, taxes were lower because government officials could not reach it. Hearing this, Confucius was very sad and sighed, "Tyranny and exorbitant taxes are fiercer than tigers (*ke zheng meng yu hu ye*)!"

Mencius (372–289 BC), another disciple of Confucius, also advocated for low taxation. He suggested that the government should eliminate all other taxes except an agricultural tax. He specifically criticized the collection of market, head, and housing taxes. Mencius opposed excessive taxation and accused rulers of the warring states of imposing taxes like

[1] Wang (2016). [2] Zhang (1995).

brigands. He believed that the tax rate should be kept at 10 percent.[3] The belief in low taxes and less forced labor (*qing yao bo fu*) was the Confucian view on taxation, which has dominated Chinese public finance for more than two thousand years. Confucius and his followers also took issue with the extravagant and wasteful lifestyle of rulers and they advocated for thriftiness.

The Chin Dynasty disregarded Confucian philosophy. After defeating the other six kingdoms on what is now the Chinese mainland and establishing a unified dynasty, the ruler of Chin did not give up the wartime policy of high taxation and continued to extort excessive taxes and levies to build the Great Wall, the Terracotta Army, ancient expressways, etc. Taxes and levies added up to two-thirds of farmers' total crops; men began to do corvée at the age of seventeen and could not be exempted until the age of sixty.[4] The rebellion soon started, the Chin Dynasty was quickly overthrown, and the Han Dynasty was established. Confucian philosophy became popular in China, and low taxation was the main principle of government finance for more than two thousand years. For example, Emperor Wen of the Han Dynasty set the agricultural tax rate at one-thirtieth. Throughout Chinese history, almost all influential scholars criticized high taxes and levies in China. Many believed 10 percent is the fairest tax rate.[5] However, some scholars argued that 10 percent is still too high. For example, Ye Shi in the Song Dynasty contended that in the old times, the government could collect 10 percent tax and be able to provide adequate services to all people, but in his time, the government did not provide adequate services to people, therefore the tax rate should be one-twentieth or one-thirtieth.[6] Later historians attributed the collapse of almost every dynasty to heavy taxes and levies.

Implicit Taxation

In modern times, an important feature of a good tax system is transparency. However, implicitness or concealment was a characteristic of the traditional Chinese tax system. Instead of collecting taxes directly and transparently from people, the government often controlled some necessities, such as iron and salt, and sold the products at high prices. Iron was a necessity for production and salt was a necessity for consumption, and demands for these two goods were rather inelastic. By charging monopoly prices, the government could obtain a large amount of revenue. The idea

[3] Zhao (2002). [4] Wang (2013). [5] Ming Huang and Yi Zeng (2016). [6] Ye (1977).

was put forward by Guan Zhong (723–645 BC), the prime minister of the Qi kingdom (*qi guo*). He wrote that instead of taxation that would reduce people's wealth and make them dislike the government, the government should monopolize the sale of salt, iron, forest products, and ores to obtain revenue.[7] Guan Zhong even detailed his plan as follows. For salt, he suggested letting the public boil seawater to make salt using dead wood as fuel; the government would then collect salt from the public and monopolize the transportation and sale of salt. For iron, he suggested letting the public make iron and submit iron to the government; the government would then sell the iron. The government received 30 percent of the revenue while the private producers received the remaining 70 percent. Guan Zhong also suggested that the government should intervene in the trade of grain through judicious buying and selling to keep the price at a constant level and earn profits. The purpose of collecting taxes implicitly was to deceive people and maintain the ruler's position.

This implicit revenue collection had a profound influence on the Chinese tax system. In every dynasty, the government monopolized the production or sale of some essential products to pursue revenues. Even the sale of tea and cooking oil was monopolized by the government occasionally. After 1949, the government nationalized almost all industrial enterprises, which provided revenues for the new government. After the economic reforms in 1978, the government started to allow private enterprises to develop, but still controlled many SOEs in manufacturing, energy, telecommunication, real estate, and finance. Many SOEs have charged high prices and thus contributed to the government's large amounts of revenue. Today, most of the tax revenue is collected from producers and then the tax burden is transferred to consumers by increasing product prices. Also, in recent decades, local governments in China have monopolized land sales, charging real estate developers extremely high prices for land; the developers then transfer the cost of land to buyers through high housing prices. All of these are implicit ways of taxation.

Balanced Government Budget

For a long time in Chinese history, all political philosophers advocated balancing the government budget – that is, setting government expenditure according to government revenue. Dai Sheng, a statesman during the Han Dynasty (202 BC–AD 220), theorized that annual government

[7] Fang (2017).

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expenditure should equal the average of annual government revenue over the previous thirty years. If so, even with poor harvests due to drought or flood, people would not starve and the emperor could have meat with every meal and enjoy music every day. If the government's accumulated funds are less than the sum of government expenditures over nine years, then the accumulated funds are insufficient; if the accumulated funds are less than the sum of expenditures over six years, then the country is in crisis; and if the accumulated funds are less than the sum of expenditures over three years, then the country should hardly be called a country.[8] Dai Sheng strongly urged the government to run a budget surplus.

During the Han Dynasty, statesman Huan Kuan in his famous book *On Salt and Iron* suggested that government spending should be based on revenue and government should have a surplus.[9] During the Tang Dynasty (618–907), statesman Su Ting argued that the government should estimate its revenue and then decide how much to spend.[10] During the Ming Dynasty (1368–1644), Zhang Juzheng, a famous political reformer, argued that the emperor should determine government expenditures based on revenue and should make efforts to save.[11]

The philosophy of balancing the budget or having a surplus has deeply affected government behavior in Chinese history. The Chinese government followed the doctrine of running budget surpluses before 1894. After the Sino-Japanese War in 1895, the Chinese government began to run budget deficits and accumulated a large amount of debt. In the first half of the 1900s, China experienced many years of war, particularly, the war with Japan (1937–45) and the civil war (1946–9). As a result, the government ran large deficits year after year and government debt skyrocketed.

After the civil war, the communist government adopted the ancient philosophy of balancing the budget or having a surplus. This philosophy was carried on until recent decades. In 1994, the government passed the budget law, clearly indicating that the central government should try to balance the budget and that all local governments must balance their budgets and should not issue bonds.

1.2 Public Finance under the Centrally Planned Economic System

In 1949, the People's Republic of China was established. The government seized all enterprises owned by the nationalist government and enterprises

[8] Long (1995). [9] Chen (2015).
[10] Ouyang and Song, 1060, edited by Chao Zhao (2016). [11] Pan (2014).

related to nationalist government officials, then turned these enterprises into SOEs. The government allowed other private enterprises to continue to exist. The government also implemented land reforms in rural areas, seizing all land from landlords and allocating land equally to all farmers. The Chinese economy recovered rapidly during the first eight years after 1949. Meanwhile, the government established new tax laws and government revenue increased quickly.

The rapid industrialization of the Soviet Union under a centrally planned economic system inspired the Chinese leaders to follow the Soviet model. By the end of 1956, China completed "socialist economic reforms," turning all large- and medium-sized private enterprises into SOEs and small private enterprises into collectively owned enterprises. In 1958, the government took back the land previously allocated to farmers and established collective farms called the people's communes. A people's commune consisted of around ten large production brigades, and each production brigade consisted of about five small production teams (small villages). Each team was a production unit, owning the land collectively, working together and sharing the after-tax crops. In 1958, China's paramount leader, Chairman Mao, launched the Great Leap Forward (1958–60) aimed at catching up with the United Kingdom and the United States in a short period. It turned out to be a great failure. Poor harvests and the waste of food led to famine and many people died of hunger and disease.

Starting from 1961, the Chinese economy entered five years of adjustments and reforms. Farmers were allocated a small plot of land on which they could grow any crops they liked. Factory workers were awarded bonuses for good performance. The economy quickly recovered, and China entered a period of prosperity. However, Mao believed that these reforms were the same mistakes made by the Soviet Union leaders after the death of Stalin and these reforms could lead China down the wrong road of capitalism. In 1966, he launched the Great Proletariat Cultural Revolution to prevent China from going onto the capitalist road. Farmers' private plots were taken back and bonuses and awards were no longer given to workers. The revolution lasted for ten years and the economy stagnated. People suffered from poverty and endless political struggles.

China has five levels of government: the central government, provincial governments (autonomous regions and province-level municipalities), prefecture governments (including prefecture-level cities), county governments (including county-level cities), and township governments (people's communes).

From 1958 to 1978, China's public finance was based on a centrally planned economic system. The government adhered to all traditional philosophies of public finance such as a balanced budget and implicit but low taxation. The government adopted a uniform budgeting approach. Under this approach, local governments and SOEs submitted all their revenues to the central government and the central government then allocated these revenues to local governments, central government agencies, and SOEs for their expenditures.

Government revenue consisted mainly of the contributions from SOEs. In 1978, the contributions from SOEs accounted for more than 50 percent of total government revenue. The government collected agricultural taxes by explicitly requiring farmers to submit a part of their crops to the government and then implicitly forcing farmers to sell a part of their crops to the government at a much lower-than-market price. Since wages were low, the individual income tax was not collected until 1980. In 1978, total government revenue accounted for more than 30 percent of GDP. In addition to budgetary revenue, the Chinese government had extra-budgetary revenues, which were collected by local governments, government agencies, government institutions, and SOEs. In 1978, the extra-budgetary revenue accounted for 10 percent of GDP.

Government expenditures include budgetary and extra-budgetary expenditures. Budgetary expenditures were proposed by fiscal authorities at every level of government and approved by the People's Congresses at every level. The government allocated a large amount of its expenditure to public investment in building roads, bridges, ports, dams, etc. For example, in 1959, government spending on economic construction accounted for 71.7 percent of total spending (Figure 6.4).

A social security system was established in China in the early 1950s for workers of SOEs, collectively owned enterprises, government administrative units (e.g., Ministry of Education), and operative units (e.g., public universities and state-owned hospitals). The social security system was run by the government and financed by general fiscal revenue. During the Cultural Revolution, the economy was in chaos and the social security system encountered a severe payment crisis. Each SOE had to pay social security benefits to its retirees using its own revenue. Rural residents did not have any social security and had to rely completely on family for old-age support. Each village provided collective support to the old without descendants and to the disabled without family members.

The government also established health insurance systems for government employees and employees of SOEs. In the early 1950s, China established Labor Health Insurance (LHI) for employees of SOEs and collectively owned enterprises, and Government Health Insurance (GHI) for employees of government administrative and operative units. The funds for GHI came from the general fiscal revenue. Labor Health Insurance was managed by various labor departments, which collected funds from each enterprise to cover their employees' medical expenses. To control the healthcare expenditures of SOEs, each enterprise's total medical spending was limited to a fixed proportion of the enterprise's total revenue. All large SOEs had their own healthcare clinics or hospitals, schools, nursery schools, and so on, just like a small society.

A medical cooperative system (MCS) was established in rural China in the late 1960s. Each village union established a medical cooperative station, which was financed by the rural residents themselves and the village administration. Selected farmers with rudimentary medical training served as so-called barefoot doctors and provided healthcare services to rural residents. For treatment of serious illnesses, rural residents had to go to hospitals owned by the government of the township, county, prefecture, or province and pay all expenses themselves. The government provided free immunizations to rural residents. The public healthcare system was effective in controlling infectious diseases through immunization, improving sanitation, and controlling disease vectors, including mosquitoes for malaria and snails for schistosomiasis.

Starting from 1958, migration from rural to urban areas was restricted. A rural–urban resident system was established in China and it became very difficult to change from a rural residency to an urban one. A newborn is a rural resident if his/her mother is a rural resident, and a newborn is an urban resident if his/her mother is an urban resident. Rural residents could only become urban residents by attending colleges after passing competitive examinations or joining the military and being promoted to a certain rank. This household registration system was an insurmountable obstacle against rural residents moving to urban areas. For several decades, urban residents had government-provided jobs, guaranteed food, and social insurance while rural residents did not. Rural residents were second-class citizens and their lives were much harder than urban residents' lives.

For several decades, the Chinese government followed a balanced budget philosophy. The basic budgetary principle was "balanced budget or with a small surplus." From 1949 to 1957, the government financed deficits by issuing both domestic and foreign debt. China and the Soviet Union signed the China–Soviet Friendship Allies Mutual Assistance Treaty, and the Chinese government borrowed money from the Soviet

Union to complete some essential projects. In the late 1950s, the relationship between China and the Soviet Union deteriorated due to ideological differences. The Chinese government's borrowing from the Soviet Union came to an end. From 1959 to 1980, China did not issue any domestic bonds and it printed money to finance budget deficits when necessary.

Under the centrally planned system, local governments served as branches of the central government. They collected revenues but strictly followed the central government's command on how to spend these revenues. In 1978, the central government's share of total revenue was 15.5 percent and the local governments' revenue share was 84.5 percent (see Table 11.1). That does not mean China had fiscal decentralization. Generally, in public finance, the local governments' share of fiscal revenue or expenditure is used to measure the degree of fiscal decentralization. However, this measure is not suitable for China since only the central government can determine how to use the revenue. Thus, China's fiscal system was highly centralized before 1978 though the revenue share of local governments was high.

1.3 Market-Oriented Public Finance Reforms

The socialist system has two unsolvable problems. First, managers and workers lack incentives to work. Second, it is very difficult to make good plans and implement them accordingly. The main problem with the socialist public finance system was that local governments and SOEs lacked fiscal freedom. To address the problem, in the late 1970s, the central government allowed SOEs to issue bonuses to workers, and in the 1980s, the government launched a reform called "substituting taxes with profits" (*li gai shui*), to provide SOEs with incentives to pursue profits, to reduce the fiscal dependence of SOEs on the government, and to promote market competition. Other reforms included granting local governments freedom to pursue revenues and to spend the revenues at their will.

However, the earlier reforms had caused a decline in the share of total government revenue in output, and giving local governments more fiscal freedom had caused a decline in the central government's share of total government revenue. In 1993, the share of general fiscal revenue in GDP was only 12 percent and the revenue share of the central government in total government revenue was only 22 percent.[12] The central government was determined to reverse this trend.

[12] Ministry of Finance of China (1994).

In 1994, a new tax system called the tax-sharing system was established. Taxes were divided into three categories: national taxes, local taxes, and shared taxes. The number of taxes was reduced from thirty-seven to twenty-three. A value-added tax (VAT) was imposed universally on production, wholesale, retail, and importing of goods; a business tax was collected from the service industries; a corporate income tax was imposed on all enterprises; a consumption tax was introduced on special products; and a progressive individual income tax was imposed on total monthly income with some deductions. Central and local tax bureaus were established at the provincial, prefecture, and county levels.

Tax laws and regulations are made by the National People's Congress (NPC) and its Standing Committee, the State Council, the Ministry of Finance, the State Taxation Administration, the State Council Committee on Tariff Regulations, and the Customs Office. Currently, only a few kinds of taxes in China are based on laws passed by the NPC Instead, most taxes are based on regulations set by the State Council. Detailed tax rules are made by the Ministry of Finance, the State Taxation Administration, the State Council Committee on Tariff Regulations, and the Customs Office. China's fiscal year is the same as the calendar year – that is, it starts on January 1 and ends on December 31.

The Chinese government also had extra-budgetary revenue. Lacking budgetary revenues, the central government encouraged local governments and government administrative and operative units to pursue extra-budgetary revenues through running businesses and collecting fees and charges to finance their expenditures. As a result, extra-budgetary revenue was higher than budgetary revenue in the early 1990s. As fees and charges skyrocketed, the public became outraged. The central government began to implement fiscal reforms by eliminating some fees and charges and turning others into taxes. Extra-budgetary revenue was eliminated in 2011. In addition to budgetary and extra-budgetary revenue, in the past twenty years, local government revenue from land sales and bank borrowing has increased considerably.

On the expenditure side, reforms have been focused on the allocation of government expenditures. Government budgetary expenditures were roughly classified into the following five categories before 2007: economic construction; social, cultural, and educational development; national defense; government administration; and other expenditures. For years, government expenditure on economic construction has declined. Government expenditure on economic construction was 64.1 percent of total government expenditure in 1978 and decreased to 26.6 percent in

2006; government expenditure on social, cultural, and educational development was 13.1 percent in 1978 and increased to 26.8 percent in 2006; and government administrative expenditures increased from 4.7 percent in 1978 to 18.7 percent in 2006 (see Figure 6.4). The classification has changed since 2007. According to the International Monetary Fund, the share of government expenditure on economic affairs was 37.7 percent in 2006, 25.1 percent in 2016, and 23.1 percent in 2017 (see Table 6.4).

China's social security system has been reformed dramatically. When SOEs were forced to compete with other enterprises in the market, some SOEs that had losses immediately became unable to pay social security benefits to their retirees. The government began to reform the social security system by pooling the social security accounts of all enterprises. In 1986, the government called for moving social security from enterprises to society. Both short-term and long-term workers, as well as enterprises, were required to make contributions to the social security funds run by local governments. In 1995, the State Council decided to establish individual pension accounts and social pooling accounts covering all urban workers. Beginning from 2006, an individual contributed 8 percent of his/her taxable wage to his/her individual account, while the employer contributed 20 percent of the employee's wage to the social pooling account. Both the social pooling account and individual accounts are managed by local governments at the provincial, city, or even county level. In 2009, the government established the rural social security system, subsidizing rural farmers older than sixty years old with small monthly payments, and required young farmers to contribute a small amount of funds to their individual accounts with some government subsidies. The rural social security system is managed by the local government and the social security payment is financed by the central and local governments using general fiscal revenues.

New urban healthcare system reforms have also been established in China. In 1995, a regional healthcare insurance system, Health Insurance for Urban Workers (HIUW), was introduced to replace the collapsing LHI. Under this new system, each city should provide healthcare insurance to all participants. In 2009, the government called for deepening healthcare system reform. Employers began to contribute 4.2 percent of employees' wages to the social pooling account and 1.8 percent to the individual accounts, and an employee contributed 2 percent of his/her wages to his/her individual account.

As the people's communes in rural China collapsed, the MCS also collapsed in the early 1980s. Thus, for many years, there was no rural healthcare system. In 2000, the New Medical Cooperative System (NMCS) was introduced to rural China in which one-third of the cost would be borne each by the farmer, the local government, and the central government. Farmers participate in the NMCS in family units and participation is voluntary. Those unable to pay would have their fees paid by the local Civil Affairs Bureau on a means-tested basis. Almost all farmers have joined the system since then. In 2010, Health Insurance for Urban Residents (HIUR) was established, covering health insurance for the urban nonworking population. In 2016, the government merged the NRCMS and the HIUR into a new system called Health Insurance for Urban and Rural Residents (HIURR).

Local governments obtained more fiscal freedom after economic reforms. The economic reforms started with the decentralization of decision-making in which the central government designated a lot of spending responsibilities to local governments. Local governments' extra-budgetary revenue greatly expanded in the early 1990s. As the extra-budgetary revenue declined in early 2000, local governments started to increase land sales and to borrow a large amount from banks through their investment companies. Thus, local governments have had considerable fiscal freedom to raise revenues and dispose of those revenues for many years.

In the early 1990s, the central government set a goal to increase the share of total government revenue in GDP to 20 percent and the share of the central government revenue in total revenue to 60 percent. After the 1994 tax reforms, although the share of total government revenue in GDP has exceeded 20 percent, the share of central government revenue in total revenue is still around 45 percent. The central government has never set a limit on its share of total government expenditure, which is only about 15 percent now! Budget reforms have also made progress. In 2014, the government passed a new budget law specifying clearly that China's government budget includes four parts: general government budget, social insurance, government funds, and state capital budget.

1.4 Challenges to China's Public Finance

China now confronts various challenges, including slowing economic growth, an aging population, growing income inequality, the worsening environment, and resources depletion. Public finance is important in dealing with these challenges. However, although reformed in many ways and for many years, China's public finance has many serious problems, such as inadequate progressivity in the tax system, insufficient government expenditures for the poor, underdeveloped health insurance systems, growing social security debt in some regions, fiscal imbalance between the central and local governments, and high local government debt. Besides, government investment is inefficient and government intervention in production is excessive. The public finance system must be properly reformed for fiscal sustainability and for efficiency and equity, as well as for sustainable economic growth.

The tax system needs to be reformed since the current tax system is not progressive. The major taxes are of the consumption type, including VAT, the consumption tax, and urban maintenance and construction taxes. In 2019, these consumption-type taxes accounted for 50.5 percent of total tax revenue, while the progressive individual income tax accounted for only 6.6 percent. The share of corporate income tax in total tax revenue reached 23.6 percent in 2019 (see Table 2.1). High tax rates have put China on the top of the Forbes Tax Misery Index. China's tax revenue has been increasing at an extraordinary rate since the 1994 tax reforms due to high tax rates and an enlarged tax base. Meanwhile, tax evasion and corruption in tax collection are widespread in China.

On the expenditure side, the government has spent a large amount on economic affairs while not spending enough on public consumption goods. According to the International Monetary Fund, the share of government expenditure on economic affairs in total government expenditure was 32.1 percent in 2010 and 23.1 percent in 2017 in China (see Table 6.3), higher than most countries with data available. On the contrary, the share of government expenditure on healthcare was 4.5 percent in 2010 and 9.7 percent in 2017 in China, while it was 24.6 percent in the United States, 14.5 percent in France, 16.3 percent in Germany, and 19.9 percent in Japan. In addition, the share of government expenditure on social protection was 19.7 percent in 2010 and 23.5 percent in 2017 in China, while it was 42.6 percent in France, 43.7 percent in Germany, 41.9 percent in Japan, and 39 percent in Poland in 2018 (see Table 6.7).

Another serious problem is high social security debt in some regions. China's social security system is run by local governments. The social security system for urban workers includes an individual or personal account and a social pooling account. The contribution rate is very high; however, the social pooling account still has a deficit and the funds from individual accounts are used for social pooling account payments, leaving the individual accounts with a large vacancy. Thus, the system is not sustainable. In recent years, the government has provided some social security benefits to the rural old that are financed by general fiscal revenue, but the payments are far from enough. Also, China faces a more severe population aging problem than other countries due to the one-child policy. Without reforms, there will not be enough young people to provide social security benefits for older generations.

In the healthcare area, it is still difficult for many people to access healthcare services and to pay high medical costs. Healthcare insurance is underdeveloped. The system is largely based on an individual's ability to pay for the service, creating inequities in access to healthcare services, and it is difficult for many poor people to obtain basic care. Government interventions in healthcare services are excessive. Medical service fees are set by the government and the fees are very low. Doctors are underpaid and they rely on bonuses and tips from patients for income. The relationship between doctors and patients is very tense and occasionally turns into violence.

The imbalance between revenues and expenditures at the local level in China is severe. The 1994 tax reforms in China greatly shifted fiscal revenue from local governments to the central government and shifted spending responsibilities from the central government to local governments. Since the tax reforms, every province has had fiscal deficits every year and the central government has run a surplus every year. As a result, local governments have become heavily dependent on the central government for transfers. Every local government begs the higher-level government for transfers. There are two types of transfers from the central government: grants and VAT rebates. Grants, including general grants and matching grants, are given to local governments mainly based on need. Fairness and corruption became a solemn issue in intergovernmental transfers.

Local government debt has been increasing, which causes great concerns over China's fiscal sustainability. For a long time, local governments did not have explicit debt and their debt mainly came from the borrowing of their investment companies or financing vehicles. Local government debt is very high, and in some regions, government debt is higher than 100 percent of GDP. In addition to local government debt, government debt has accumulated in the central government branches and institutions. In recent years, the government started to advocate public–private partnership (PPP) projects and to provide a guarantee for bank loans of private enterprises, resulting in considerable hidden government debt. Local government debt is mostly outside of the government budget.

Another problem is the lack of transparency of government budgets. Details of government budgets at each level of government are not available to the public. The People's Congress at each level of government is supposed to discuss and approve the budgets; however, currently, the Congress appears to be only a rubber stamp without much power. There exist off-budget government revenues and expenditures in local governments and government institutions, which are not revealed to the public or reported to higher levels of government.

1.5 This Book's Contributions

This book provides a comprehensive and insightful analysis of China's public finance. It covers important topics, such as government budgetary revenue, extra-budgetary revenue, off-budget revenue, government expenditures, budget deficits, central and local government debt, VAT, individual and corporate income taxes, infrastructure investments, social security and health insurance, the fiscal relationship between the central and local governments, fiscal policies, and equitable and sustainable growth. It examines China's public finance reforms in recent decades and then analyzes the reasons for and the consequences of these reforms. It explores the challenges to China's public finance, examines problems within the public finance system, and delivers deliberate policy suggestions. This book is featured by its unprecedentedly extensive coverage of relevant contents, novel yet cautiously put views, the latest available statistics from reliable resources, and in-depth exploration of issues and policies with significance and general public interest. In brief, the book bridges the gaps in the literature on China's public finance and is prepared to meet the ever-increasing demand for the latest information on China's public finance.

Chapter 2 analyzes the rises and falls of China's government revenue in the past four decades. It estimates the size of China's government revenue, which includes general fiscal revenue, government funds, social insurance funds, and operating income from state-owned capital, as well as extra-budgetary revenue. It discusses China's tax reforms, analyzes the reasons for the ups and downs of the general fiscal revenue and other government revenues, and compares the size of China's government revenue with that of other countries, examines the problems in the current revenue system, and discusses prospects for further tax reforms.

Chapter 3 analyzes consumption-based taxes in China. The Chinese government now heavily depends on the consumption-type VAT and the consumption tax, a special tax on specific goods, such as alcoholic products, cigarettes, and automobiles. Two additional taxes, the urban maintenance and construction tax and an additional fee for education, share the same tax base as the VAT. These consumption-based taxes account for more than half of China's total tax revenue. Other taxes on goods and services, such as tariffs, vehicle purchase taxes, resource taxes, and environmental taxes are also examined in this chapter. The advantages and disadvantages of consumption taxes are evaluated as well.

Chapter 4 deals with the individual income tax, a tax introduced in China two thousand years ago. It examines the evolution of the individual income tax system and compares the changes in the marginal and average tax rates in recent decades. It unravels the mystery of the small proportion of the individual income tax in total tax revenue despite the high marginal tax rate for the individual income tax. It discusses the optimal income tax rates for China. The chapter ends with an analysis of the problems of the individual income tax system and offers suggestions for further individual income tax reforms.

Chapter 5 studies the corporate income tax. Revenue from the corporate income tax has been increasing in China, which is at odds with the worldwide trend. Unlike the individual income tax, the corporate income tax accounts for a large proportion of total tax revenue in China. The reasons for this unusual phenomenon are thoroughly analyzed in this chapter. It also examines corporate income taxes from various industries and from diverse enterprises such as SOEs, domestic private enterprises, and foreign enterprises, and it compares the corporate income taxes in different provinces. Policy suggestions are provided at the end of this chapter, such as reducing the corporate income tax to stimulate investment and economic growth.

Chapter 6 analyzes the size and structure of China's government expenditure. It estimates the size of China's government expenditure, which includes general fiscal expenditure, expenditure financed by government funds, social insurance expenditure, expenditure financed by the operating income from state-owned capital, off-budget expenditure financed by local government debt, and extra-budgetary expenditure. It reveals phenomena like the Chinese government spending a large proportion of its revenue on economic construction while spending an insufficient amount on education, healthcare and social welfare, and local governments undertaking most of the total government expenditure. The problems with the current expenditure system and prospective reforms are also discussed in this chapter.

Chapter 7 discusses China's infrastructure development. It analyzes the ways in which infrastructure investment has been financed, including revenues from land sales, bank loans, infrastructure development funds, domestic and foreign debt, taxes, fees, and user charges. It shows the composition of funds for financing key infrastructures, including transportation, telecommunication, energy, and sanitation. It demonstrates that China's infrastructures have grown rapidly in the past twenty-five years. It examines the reasons for the fast infrastructure development in China and the problems with infrastructure development, including a solid tax system, a pro-infrastructure spending system, expansionary fiscal policies, and large local government revenues from land sales and bank borrowing. It also evaluates China's Belt and Road Initiative and discusses the benefits and potential risks to the countries involved.

Chapter 8 is concerned with social security. It discusses the evolution of social security systems for different groups of citizens such as urban workers, government employees, rural residents, and urban nonworking residents. It explores existing problems in the social security system, such as unequal social security benefits between urban and rural senior citizens, the decentralized social security management system, low returns in individual accounts, and the growing debt in social pooling accounts. Challenges such as population aging are also explored in this chapter and reform options are discussed, such as reducing social security debt, postponing the retirement age for urban workers, increasing benefits to retired farmers, increasing the size of the individual accounts of young farmers, and establishing a nationwide social security system.

Chapter 9 is on healthcare reforms. First, it examines different government health insurance programs: the new rural cooperative medical system, health insurance for urban workers, health insurance for urban residents, health insurance for government employees, and health insurance for urban and rural residents. Next, it analyzes the healthcare supply system, particularly the state-owned hospitals (SOHs). Then, it scrutinizes the problems with the healthcare system, including underdeveloped healthcare insurance, heavy government subsidies to SOHs, excessive government intervention in healthcare service provisions, the shortage of qualified doctors, urban–rural healthcare disparity, and unsustainability of the healthcare insurance system. Finally, it offers policy suggestions on healthcare reforms.

Chapter 10 tackles the controversial issue of high local government debt. It first examines sources of local government debt and clarifies that most of China's local government debt is set apart from the government budget.

It then estimates the size of China's local government debt over time, scrutinizes the reasons for the fast debt accumulation, and evaluates the immediate impacts and potential problems of high local government debt. In this latter part, the size of government debt in each region is also estimated and the large disparities in government debt among regions are exposed. It shows that local government debt is rather high in some regions. It also shows that the size of local government assets is substantial. Thus, although high, China's local government debt is still manageable. It finally discusses the measures China has taken to curb local government debt and offers suggestions for additional fiscal reforms needed for curtailing local government debt.

Chapter 11 analyzes the fiscal relationship between the central and local governments. It first examines China's budget system and the central-local tax-sharing system, the fiscal imbalance between local fiscal revenues and expenditures, and the massive fiscal transfers from the central to local governments. It then discusses fiscal decentralization through extra-budgetary revenue collection, land sales, and bank borrowing by local governments. Next, it discusses the fiscal imbalance of the central and local governments and regional fiscal disparities. Policy suggestions on how to improve the central and local fiscal relationship are provided in the end, including an increase in local government revenue and the shift of some expenditure responsibilities from local governments to the central government, as well as granting local governments more fiscal freedom.

Chapter 12 analyzes how China's pro-growth tax system and expenditure system, the expansionary fiscal policies, and local government fiscal expansion outside formal budgets have stimulated China's economic growth in recent decades. It discusses China's growth perspective and shows that China may become the largest economy in the world in less than a decade. It also exposes the challenges China faces, such as income inequality, environmental degradation, resource depletion, slowing economic growth, and an aging population. It finally discusses fiscal reforms needed for equitable and sustainable economic growth, including reinforcing environmental and resource tax laws, curtailing government debt, stimulating private investment, raising transfers to low-income families, and increasing government expenditures on education, healthcare, and welfare.

The book is the fruit of the author's long-term endeavors in many aspects: years of research on public economics and China's public finance, years of teaching China's public finance at both the graduate and undergraduate levels at Peking University, as well as many field trips to Chinese provinces, combined with many collaborated research projects with the Ministry of Finance of China, and policy advising to the Chinese government, the World Bank, the International Monetary Fund, and the United Nations. The book is firmly grounded in modern public finance theory stemming from the experiences of public finance reforms in China and the extensive statistical data of China's public finance. It demystifies many enigmas of China's public finance and presents an easily understandable context to readers. This book will be helpful for researchers, graduate and undergraduate students, and policy makers interested in understanding China's public finance and economic development. Scholars and students in related disciplines, such as political science, sociology, legal studies, public administration, and business administration, may also find the book thought-provoking and valuable.