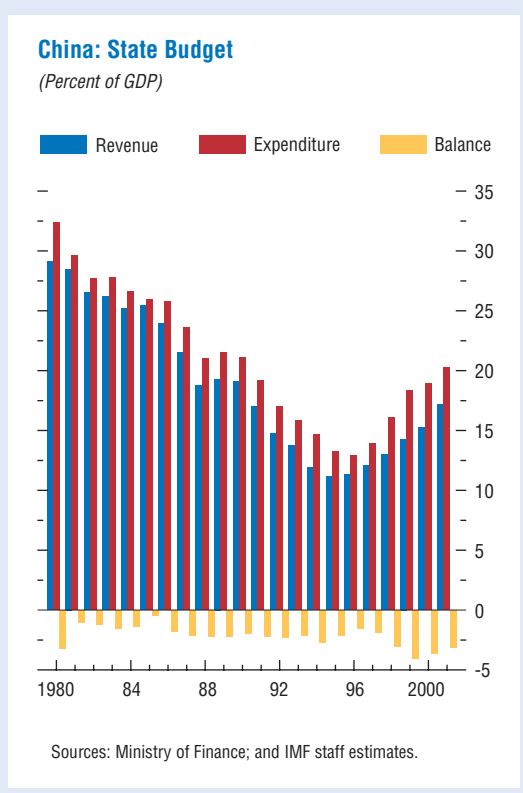


Box 1.4. China's Medium-Term Fiscal Challenges

Over the past two decades, China's progress in reforming its economy has resulted in sustained large increases in incomes and deep reduction in poverty. Despite these impressive achievements, a long reform agenda remains to be accomplished. While reforming the financial sector, restructuring the state-owned enterprises, and improving the social safety net are at the top of this agenda, intrinsically linked to these objectives is the need to assure the medium-term sustainability of China's fiscal situation.

At first glance, fiscal sustainability may not appear to be a pressing issue for China. The official debt stock is low and the state budget deficit modest. Official data show that the state budget deficit¹ has hovered at relatively low levels over the last 20 years (see the figure). While the budget deficit widened somewhat in the wake of the Asian crisis, it gradually narrowed over the past two years (to about 3½ percent of GDP in 2001, from its recent peak of 4 percent of GDP in 1999).² Reflecting the low state budget deficits, the stock of explicit government debt stood at 23 percent of GDP at end-2000,³ of which 18 percent of GDP was domestic.

Fiscal activity in China, however, extends well beyond the official state budget. For example, following the formal separation of state-owned



enterprise finances from the budget, the government extensively used the banking system to support state-owned enterprises, and a significant share of these loans have become nonperforming. The loan losses of the state-owned banks, although not legally a liability of the government, are likely to require additional state resources in the future.

If the government's quasi-fiscal liabilities from the banking system were included, the broader fiscal deficit and public debt-to-GDP ratio would be significantly larger. Although a precise estimation of these liabilities is constrained by data limitations, it is likely that the fiscal deficit including new nonrecoverable bank loans is currently on the order of 5–6 percent of GDP. The stock of nonrecoverable bank loans at end-2000 was estimated at between 50 to 75 percent of GDP (of which an amount equivalent to 15½ percent of GDP has been transferred to asset management compa-

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¹Including funds borrowed by the central government and on-lent to local governments and official external lending to government agencies, but excluding quasi-fiscal activities.

²From the early 1980s till the mid-1990s, both revenue and expenditure declined steadily. This was largely due to the separation of the financial accounts of state-owned enterprises from the budgetary accounts, which was undertaken to improve the state-owned enterprises' managerial and financial autonomy. The turnaround in revenue and spending since the mid-1990s reflects, in part, tax reforms that are still ongoing, and the fiscal stimulus packages introduced in response to the Asian crisis.

³Including bonds issued to recapitalize the four state-owned commercial banks in 1998, and bonds used for on-lending to local governments.

nies).⁴ Hence, taking into account the stock of these loans would raise public debt to 75–100 percent of GDP (as of end-2000).

Furthermore, substantial pressures exist for additional public spending in the coming years.

- Over the next decade, China will need to increase its expenditure on health, education, poverty alleviation, infrastructure, and the environment to meet its stated development goals.
- Progress in state-owned enterprise reform will also entail costs, as the remaining social responsibilities (such as health, education, and pensions) carried out by these entities will have to be taken up at least partly by the government.
- The pension system will need to be reformed with potentially large fiscal costs. The current pay-as-you-go system (which covers mainly state sector employees) will require increasing government support in the long run as the ratio of contributors to beneficiaries declines. In addition, the government intends to move in time toward a new three-pillar nationwide pension system, with one pillar being a publicly funded minimum pension for all workers.⁵

⁴In 1999 and 2000, ¥1.4 trillion of nonperforming loans from the state banks and one policy bank were transferred to four newly created asset management companies (AMCs). The AMCs have started disposing of these assets, including to foreigners, with the assistance of international investment banks. The losses of the AMCs will eventually have to be borne by the government.

⁵As currently envisaged, a nationwide three-pillar pension system would consist of a public pension, mandatory individual pension accounts, and voluntary supplementary individual accounts. A pilot provincial pension reform project was started in late 2001. The government also intends to use part of the proceeds from privatization (sales of state enterprise shares) to finance reforms.

- The current system of fiscal federalism, where each province is more or less fiscally independent, will have to be reexamined with a view toward ensuring that all provincial governments have sufficient resources to provide certain minimum standards of basic government services.

The fairly high level of total (explicit and contingent) debt, combined with the additional pressures described above, suggests that strong economic growth alone will not provide sufficient fiscal resources to meet the country's needs without an unsustainable buildup in public debt.

Stabilizing the fiscal outlook will require

- dealing forcefully with the flow of new bad loans in the banking system, which is a key objective of the ongoing state-owned enterprise and banking reforms;
- reducing the state budget deficit further; given the expenditure needs foreseen, this will have to involve a continued strengthening of the revenue effort through improvements in tax administration and policy (sustaining the buoyancy of revenues), as well as further reorientation of spending to priority areas; and
- reforming the pension system through both parameter changes in existing pension arrangements (including raising the retirement age and increasing contributions) and careful design of new institutional arrangements.

Overall, China's fiscal position, while not calling for sharp and immediate corrective measures, will require a gradual but sustained adjustment effort over the medium term. With such an effort, including measures to reduce the budget deficit and to effect continued state-owned enterprise, financial sector, and pension reforms, the public sector debt burden could be contained and gradually reduced over the medium term.

Source: IMF, April 2002 World Economic Outlook, Chapter 1.