

Challenges for China's Public Spending

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Introduction

China's evolution from a centrally-planned to a market-based economy is leading to major transformations of its public expenditure policies. Much progress has been made in raising infrastructure spending to a level more in line with China's development needs and in modernising mechanisms for budget planning and implementation. Nevertheless, significant challenges remain.

The institutions and arrangements governing China's public spending policies have evolved considerably since the central planning era but still bear important vestiges of that period. While the distinction between spending carried out by the government versus that by businesses, other organisations, and individuals outside the government has become progressively sharper over time, it remains somewhat blurred. Furthermore, responsibility for carrying out government spending remains highly decentralised while the basic decisions about how spending is to be allocated and financed are highly centralised.

This incomplete adaptation of these arrangements is the source of many of China's current problems with public spending. The transparency, accountability, controllability and overall effectiveness of public spending are greatly hampered by the substantial amount of expenditure which the government controls or is liable for that occurs outside the formal budget. The uneven decentralisation of expenditure responsibilities and the resources to pay for them have led to marked divergences in spending per-capita among regions and between urban and rural areas, and have generated adverse incentives in carrying out spending by local governments. They have also limited the amount the government has been able to spend on key social needs such as education and health. The government is making a strong effort to deal with these problems and has made significant progress but more remains to be done.

These challenges and the efforts being made to address them are discussed in detail in the OECD publication, *Challenges for China's Public Spending: Toward Greater Effectiveness and Equity*, and summarised in this Policy Brief. ■

How large is government spending?

Total official government spending amounted to 27% of gross domestic product (GDP) in 2004 but this may be an underestimate and a more realistic estimate may be over 30% of GDP. Official spending consists of two components: *On-budget spending* – the expenditure included in the formal budgets of all government levels – which amounted to 20.3% of GDP; and *extra-budgetary accounts*, mainly at the sub-national level, used to pay for social security and a variety of other purposes. Outlays in these areas were 3.3% and 3.4% of GDP, respectively, in 2004.

There is, however, also a large amount of *off-budget* spending by sub-national governments that is not officially recorded or sanctioned but which could be as high as 4% of GDP according to academic estimates. While such outlays cannot be precisely estimated, they would very likely bring China's actual public spending to above 30% of GDP, a level still below that of most OECD countries. Since these estimates were made, GDP has been increased as a result of the economic census. All figures in this report show spending relative to pre-revision GDP but if the comparison were made relative to current estimates of GDP, total official spending would amount to 23% of GDP and total spending including off-budget expenditure would likely be above 26% of revised GDP.

In line with practice in most other countries, the government accounts do not include the accrual of contingent liabilities nor tax expenditures. In China's case, contingent liabilities have mainly stemmed from the government effectively acting as the guarantor of lending by banks. If all bad loans not covered by the banks themselves or by asset sales are eventually assumed by the government, there will be a significant increase in government interest payments. *Tax expenditures*, such as the foregone revenues from exemptions and other tax preferences given to foreign enterprises operating in China, are also significant. ■

How to improve the allocation of spending?

A large part of public spending funds investment, with total outlays amounting to 9% of GDP in 2002. This ratio is higher than that of nearly all OECD countries and most other large developing countries. In addition, a relatively large proportion of spending, almost one-fifth of on-budget outlays, goes to public administration, most of which is spent by sub-national governments. Investment and public spending have both increased as a share of total government spending over the past decade.

In contrast, a relatively low portion of outlays are made on basic human welfare and development needs, such as education, health, science, and social security. Furthermore, the share of total spending going to education, health, and science has fallen over the last decade. In relation to GDP, public spending on education and health is well below that of nearly all OECD as well as most comparable developing countries, while private spending in these areas is among the highest in the world (Figure 1).

Educational attainment and health quality compare reasonably well with other countries at a comparable stage of development. However, the low level of government spending on education and health has led to widespread

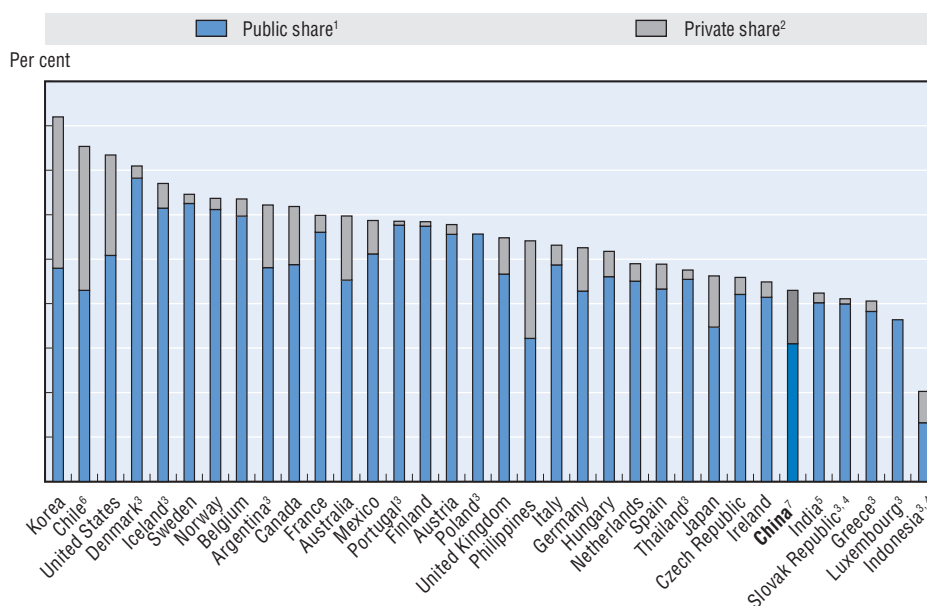
inequalities in education and health spending, with urban areas and coastal provinces spending much more than rural areas and many provinces in the centre and west of the country. This leads to marked differences in outcomes: literacy rates, years of schooling, and life expectancy are all much lower in rural areas compared to urban areas. The healthcare system has come under increasing strain and according to some reports is in near-crisis. ■

What is being done to improve the effectiveness of spending?

The multiple layers of government pose a number of significant problems for the control of total expenditure. The large amount of spending carried out outside the formal budget seriously reduces the transparency of public spending and greatly complicates effective management of and accountability for that spending, as well as making it difficult to adequately control public spending. Indeed, contingent liabilities and off-budget spending by sub-national governments may represent the greatest uncertainties in the spending outlook.

Government authorities recognise that budget planning and implementation, oversight, and service delivery must be modernised and improved if the money is to be used effectively. Notably, authorities have been working since the late 1990s to bring onto the regular budget the legitimate expenditure activities that have been carried out through extra-budgetary accounts or off-budget. Vigorous efforts are also being made to suppress unauthorised

FIGURE 1.
PUBLIC AND PRIVATE
EDUCATION SPENDING
AS PERCENTAGE OF GDP
IN SELECTED COUNTRIES
IN 2001



1. Including public subsidies to households attributable for educational institutions. Including direct expenditure on educational institutions from international sources.
2. Net of public subsidies attributable for educational institutions.
3. Public subsidies to households not included in public expenditure, but in private expenditure.
4. Year of reference 1999.
5. Direct expenditure on educational institutions from international sources exceeds 1.5 per cent of all public expenditure.
6. Year of reference 2002.
7. Includes on-budget and extra-budgetary education-related spending.

off-budget funds and surcharges, especially for local authorities in rural areas.

Additional reforms are being taken to improve the traditionally fragmented budget systems and procedures. These include establishing a single treasury account to replace the older system whereby individual government departments have often been responsible for both collecting and spending certain revenues. Reforms are also underway to establish a multi-year budget framework and to produce separate and more integrated budgets for current and capital expenditures. These efforts will help to ensure greater consistency in spending over time and allow the implications of debt financing to be better taken into account.

Authorities have also been seeking to reform the nearly 1.3 million Public Service Units (PSUs), which encompass public hospitals, educational facilities, weather stations, cultural facilities and a wide range of other institutions. The PSUs carry out much of public spending but operate under often vague guidelines and limited accountability.

Reforms are being undertaken to revise the traditional system for evaluating the performance of public officials at lower government levels so that it better reflects their achievement of government priorities. Efforts are also being made to institute improved systems for evaluating the outcomes of spending (not just whether funds are spent as budgeted). Impressive progress has also been made in subjecting government procurement to open and competitive bidding: by 2003, nearly two-thirds of government purchases were subject to some form of open bidding.

Important as these efforts are, most are still at a fairly early stage and are insufficient, particularly at lower government levels. There also are a number of important gaps in the efforts that need to be addressed. For example, the decision-making authority over capital, personnel and current expenditure lies with three different organisations and the capital budget is not anchored into a medium-term framework.

Spending might become more effective in meeting development goals, such as the eventual narrowing of the wide gaps in living standards among provinces and between urban and rural areas, if outlays on education and health were increased. Indeed, the government has long set a goal of raising education spending to 4% of GDP, from the current level of slightly above 3%.

Public outlays in health, particularly in rural areas, also need to increase to deal with potential threats from epidemic diseases. Much of the needed increase in spending on these needs could probably be achieved by reallocating some spending over time away from public administration and investment, where evidence suggests that there is significant waste and inefficiency. For example, a survey by the National Audit Office in 2004 found that only half of infrastructure projects receiving central government bond financing met government standards. And as noted below, there appear to be substantial inefficiencies in administration by sub-national governments. ■

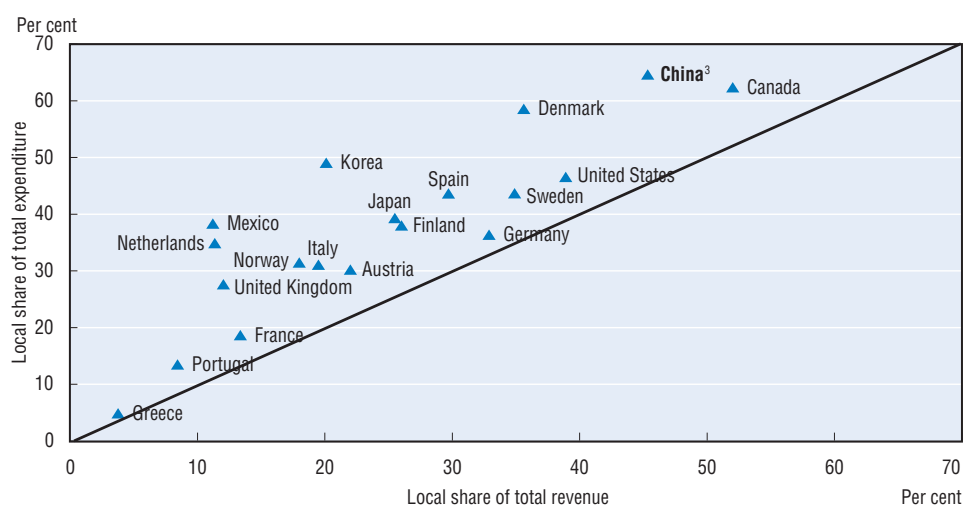
What problems do lower levels of government face?

With respect to carrying out spending and collecting revenues, the fiscal system has one of the highest degrees of decentralisation in the world (Figure 2). However the decentralisation of spending is very uneven across regions and this has led to serious problems in overall government spending. Moreover, while the administration of spending and taxation is decentralised to provinces and lower levels of government, local authorities are subject to extensive central direction of their spending and have few discretionary taxation powers.

Sub-national governments at the provincial, prefecture, county, township, and village levels carry out the bulk of public expenditures. They bear the main responsibility for education, health, social welfare, and infrastructure. Revenues are also highly decentralised but less so than expenditures. Moreover, while responsible for carrying out most spending, sub-national governments have almost no control over local tax rates or over what can be taxed. They are also subject to extensive central government direction of their spending and have increasingly been burdened by unfunded mandates, such as paying for restructuring of local state-owned enterprises and supporting their laid-off workers.

This gap between expenditure responsibilities and revenues has necessitated a large-scale system of transfers, from the central government to provinces and within provinces from higher to lower government levels. Transfers have increased considerably in size over time, and central government transfers now account for 53% of its total on-budget expenditure. Nearly half of provinces depend on central government transfers for one-third or more of their total fiscal resources. The transfer system has become highly complex, with more than a dozen components for central government transfers alone.

FIGURE 2.
GOVERNMENT EXPENDITURE AND REVENUE: THE LOCAL SHARE¹
2003²



1. Social security outlays are not included in local spending but are included in total expenditure figures.
 2. Or latest year available: 2000 for Japan, 2002 for Denmark, Korea and Mexico.
 3. Chinese data include on-budget and extra-budgetary accounts and central government bond issues on behalf of local governments.

They are determined by a range of criteria, including the amount of taxes raised by provinces, and are at best partially related to actual needs.

The overall result is that large numbers of sub-national governments face severe gaps between spending requirements and their fiscal resources. Many county and township governments barely have enough funds to pay their workers, let alone adequately fund education, health or other key needs. The gaps appear to be greatest in the poorer interior provinces and for (mainly rural) counties and townships within provinces. In fact, because the central government's Western Development Programme has somewhat reduced the gaps in western provinces, it is now the central provinces that appear to have the greatest problems.

The gap between spending needs and resources is a key factor behind the large disparities in spending on education, health, and other social needs between poorer provinces in the interior and the wealthier coastal provinces and between urban and rural areas. It has also been an important factor behind the relatively low level of overall government spending on education and health. The strains engendered by the financing gaps have also encouraged the accumulation of substantial illegal government debt at sub-national levels and the resort to off-budget spending.

However, lack of money from the central government is not the only factor behind these problems. There are serious distortions in the distribution of revenues and transfers within provinces, which have nearly complete discretion in this area. Some provinces are fairly efficient in distributing those funds in accordance with needs but in others funds are held back for their own purposes and not enough is given to the lower levels.

There are also large inefficiencies in sub-national government administration, such as overstaffing and, in some cases, excessive layers. Also, because of the way they are evaluated by their superiors, local government officials allocate money to high-visibility projects rather than to "softer" areas such as education and health where the returns are less visible but may be significantly greater in the long run. ■

What can be done to address these problems?

A thorough reform of fiscal relations among government levels is essential to resolving the problems in China's public spending. The key priority is to bring the fiscal resources of sub-national governments into line with their actual expenditure needs.

Neither increasing the share of taxes accruing to sub-national governments nor shifting spending responsibilities up to central government is likely to resolve the problem. Given the large differences in income per-capita among and within provinces, greater tax sharing with sub-national governments would actually increase divergences in revenues. Greater central government responsibility for spending could lead to less effective spending if it were to take less account of local conditions.

Reform of the inter-governmental transfer system is therefore essential. Formulas for allocating transfers need to be revised to take better account

of actual fiscal needs. Central government mandates that entail additional spending by sub-national governments should be explicitly accounted for in budget statements and accompanied by transfers or other additional revenue.

Other steps to ensure that sub-national governments use their resources more effectively are also needed. For example, at least in some provinces, a case can be made for bypassing the prefecture level in allocating revenue and indeed several provinces have already taken such a step. Sub-national governments need to be subject to clear guidelines as to how they share their fiscal resources with lower levels in accordance with need. Sub-national governments also need to become more accountable. To this end, the establishment of clear benchmarks and indicators of the effectiveness of spending policies that could be used to compare performances within and across provinces would be very helpful.

In sum, China's government well recognises the need for improving efficiency of public spending and for reforming inter-governmental fiscal relations and has taken important steps in these areas. However, much more remains to be done to provide adequate public services for this rapidly growing economy. ■

For further information

More information on the publication *Challenges for China's Public Spending: Toward Greater Effectiveness and Equity* can be obtained from Margit Molnar. E-mail: margit.molnar@oecd.org, Tel.: +33 1 45 24 89 49.

For further reading

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