

Summary: Conference on Local Financing for Sustainable Development in China

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Sustainable and inclusive development has become a matter of extreme urgency for China, as it is for developed and developing countries alike. An international conference to examine the general issues and associated implications for China was held in Guangzhou, China, during January 9-10, and was jointly organized by the Asia Research Center, London School of Economics, and Sun Yat-Sen University. It facilitated an exchange of views between leading international and Chinese academics, Chinese officials, and representatives of international agencies (including the IMF, Asian Development Bank, the World Bank, and United Nations Environment Programme).

Co-organizer Dr. Ehtisham Ahmad of the London School of Economics set the stage by describing work on the fiscal underpinnings of investment for sustainable development for the G24 group of countries and the UN Commission on Sustainable Development, and the applicability of the general framework to the Chinese context. He stressed the need for fiscal policy to be seen in conjunction with a sustainable rebalancing strategy, and for the specifics of the Chinese governance structure to be kept in mind. Modern instruments for taxation and financial management are essential, even in a "Confucian" governance structure. The generation of information and appropriate incentive structures require the joint consideration of taxes and social policies at different levels of government together with more appropriate institutional arrangements. Dr. Ying Qian (ADB) explained some of the inter linkages and ADB's support to the Government of China in area related to expenditure and revenue assignments, transfer design and management of subnational liabilities as part of the new strategy.

The rebalancing towards new green urban centers is part of China's Strategy to achieve a more ecologically sustainable growth path, together with redistribution towards lagging regions. Dr. Xubei Luo (World Bank) applied some recent work on regional "hubs" in China to the context of within Guangdong disparities and rebalancing towards lagging

regions in the province. Dr. Joy Kim explained some work being done by UNEP to examine the general equilibrium consequences of "green growth" in a number of countries, suggesting that this might be a useful path to follow in developing options for the Chinese context.

Dr. Ahmad (LSE) argued that tax reforms had played an import role in consolidating the reforms initiated by Deng Xiao Ping, and more tax reform is needed in order to stimulate and support further structural change. He reviewed the political economy underpinnings of the 1994 fiscal reforms in China, which had become a model for a range of countries. However, the instruments used in 1994 were incomplete and the tax administration (SAT) was at a nascent stage. A gradual improvement had taken place since then. However, further reforms needed a comprehensive approach. Mr. Jing Xiang (Guangdong SAT) reviewed some of the problems faced in the problem with the current assignments, especially with the conversion of the business tax into a VAT. He pointed to the narrow base of the property tax, which could be disequalizing. He also examined options for local excises. However, Dr. Ahmad (LSE) and Professor Brosio (Torino) argued (based on a paper in the *Handbook of Multilevel Finance*, 2015 that they edited) that a close linkage between taxes and benefits is needed--e.g., using the Marshallian principle of linking property taxes to local services—could help in improving accountability and also disperse opposition to the tax. This could offset the difficulties seen in the pilots in Chongqing and Shanghai. The same principle applies at the provincial level, e.g., in relation to a piggy-back on the personal income tax. Reliance on resources generated by a local piggy-back would also facilitate the generation of third-party information needed for the effective operation of the personal income tax, and to provide an anchor for sustainable access to credit. They also argued for congestion taxes, and also a provincial tax on aviation. However, at the municipal level, they echoed Mr. Xiang's point about uneven tax bases within the province and argued that own-source revenues would need to be supplemented by a provincial equalization framework, along the lines of the central equalization across provinces.

Turning to governance structures, Dr. Ahmad (LSE) argued that many Western models were based on the implicit assumption of inter-jurisdictional competition based on electoral discipline. This also typically underlies the advice from international agencies. However, the framework begins to break down without accurate and standardized information, or asymmetric information that permits "hiding liabilities", to pass the buck to the central government or future administrations, if not generations. This has been seen recently during the crisis in Europe. The need for such information is even greater when there are appointed officials with no electoral discipline. This is the Chinese case, which he termed the "Confucian" model. In addition, there is a significant role for an appropriately designed income tax to keep local officials honest, as part of a feedback

mechanism for accountability. There is increasing participation by citizens on the choice and design of investment options as seen in the case of the Guangzhou BRT. And Professor Suihong Chen of the MOF's Research Institute for Fiscal Science, in a joint paper with Professor James Chan (Illinois and Beijing Universities) focused on the extensive work being done to move towards accrual accounting, in line with the IMF's Government Financial Statistics (GFS) standards. She also referred to work on the relevance of the US GASB and IPSAS standards in the Chinese context. She stressed the importance of uniformity of standards and treatment of assets and liabilities. A basic problem is that financing vehicles for State Owned Enterprises are not on the balance sheets. Local governments often establish enterprises to shift assets or liabilities. She mentioned that accounting and reporting standards were due to be finalized during 2015, including also the information system requirements for greater transparency.

Given the build-up of local debt and liabilities highlighted by the China National Audit Office, and the likelihood of an increase in repayment pressures in the next couple of years, the framework for the measurement and management of liabilities takes on an increasing importance. Professor Guang Zhang (Xiamen University) focused on the role of pension liabilities that are accruing rapidly given the ageing of the population, particularly in the coastal regions, and which need to be assessed in local budgets, especially since these are local and not national liabilities at the present time. This assignment of responsibilities is atypical in an international context. However, the increasing pressures on local governments may force a resolution of the assignment of pension responsibilities in the short-term. Professor Xiaorong Zhang (Fudan University) presented some interesting work to develop local balance sheets for selected cities. The issue of developing local bond markets for deepening the financial system was also raised as an important element in China's capital market development and the efficient availability of finance for investment. Mr. Kezhou Xiao (LSE) linked the buildup of liabilities to the dispersion of transfers at the subnational level in Provinces, focusing on the Guangdong case. This was linked in turn to the increasing disparities within the province, and reinforces the need for rebalancing as stressed in the paper by Dr. Xubei Luo. Professor Meili Niu (SYSU) presented case studies of successful PPPs in different cities in Guangzhou. The discussion suggested that local governments are interested in PPPs largely to circumvent constraints on their revenue sources and the tightening of access to credit through special financial vehicles. Participants suggested that the liabilities generated by PPPs should be recorded in local balance sheets (developing Professor Xiaorong Zhang's approach and in line with IPSAS standards) with appropriate provisioning in local budgets.

Dr. Lili Liu (World Bank) presented some international examples of measurement of subnational debt. Professor Gisela Faerber (Speyer University) provided a contrast

between the debt generation patterns in Chinese local governments—a U-shaped tendency with the highest debts in the rich and poorest regions, with the lack of a pattern in Germany. Professor Wen Wang (Indiana University) presented an analysis of the political economy factors underlying US local government debt. Professor Qi Zhang (with Professor Fang Wang, Zhongnan University of Economics and Law) described the current practice of debt information disclosure by Chinese local governments. The reporting is fragmented and unreliable, reflecting a lack of unified reporting standards and transparency. There is a need to assess contingent liabilities properly. This poses major challenges in providing reliable information on Chinese local government liabilities. They argue for standardized reporting, with both stock and flow indicators, based on accrual accounting, echoing the recommendations of the Chan and Chen paper.

In the final full session, Mrs. Ter-Minassian (former IMF Director), presented alternative approaches used around the world to manage sub-national liabilities. Drawing on the literature, she drew some lessons for China: (1) administrative controls do not work well, and it is also unrealistic to prohibit borrowing or rely only on market discipline; (2) borrowing should be allowed subject to tight fiscal rules with limits related to debt service capacity; existence of own-source revenues; and comprehensive accounting standards including PPPs and SOEs. Professor Bordinon (Milan), drawing on a forthcoming volume on the Crisis in Europe, edited by Ahmad, Bordinon and Brosio), focused on the problems with fiscal rules in Europe that led to a sense of false security among national and EC policy makers. Indeed, he argued that Europe represents examples of how not to establish fiscal rules. For China, he argued for tight monitoring, based on standardized flows of information not only on current expenditures but also investments, including PPPs, and SOEs. He urged caution concerning new financial and hedging instruments. Moreover, hard budget constraints are needed and this requires own-source revenues at rational levels of government (e.g., two subnational levels are difficult enough to manage). Dr. Gupta (IMF) closed the program with an argument for placing the budget process in a medium-term perspective.

A round table argued for subnational investments and sustainable growth to involve a comprehensive approach, where the interactions between policy measures requires more work at different levels of government. A very substantial research and policy agenda is involved, and coordination among academics and policy makers is highly desirable.