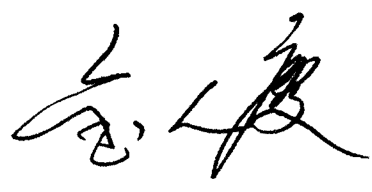
FISCAL POLICY IN CHINA

THEORY AND PRACTICE



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Preface

In a modern market economy, economic modulation is realized through the "invisible hand" of the market and the "visible hand" of the government. The market serves as a fundamental mechanism in the allocation of resources whereas government macro control comes to rescue in case of a market failure and helps enable a favorable environment in which the market mechanism can work effectively. The two major instruments the government uses in executing macro control are fiscal and monetary policies. And the fiscal policies are more effective in stabilizing economy, optimizing resource allocation and regulating income distribution through taxation, subsidies, investment, government bonds, transfer payment and budgetary measures.

In the past decade or so, under the solid leadership of the Communist Party of China and the Chinese government, profound changes have taken place in China's economic regime. A socialist market economy has taken an initial form. Remarkable economic achievements in China have captured the world's attention. Meanwhile, the Chinese government, in view of its changing economic situation and development levels, has properly utilized international good practices, made active explorations, and successfully implemented the courageous and resolute decisions to introduce the moderately tightening (contractionary) fiscal policy in 1993, the proactive (expansionary) fiscal policy in 1998 and the prudent (neutral) fiscal policy in 2005. As a result, the regulation of Chinese government through fiscal policies has changed from direct control dominated by administrative measures into an indirect one featuring mainly economic measures. Moreover, the evolution has also forcefully promoted rapid, sound and sustained development of China's national economy. On top of that, the Chinese government is gaining increasing command over its market economy. By practicing fiscal modulation, China not only won acclaim and commendation from the international community, but also learned four basic valuable lessons. First, fiscal policy must accommodate economic changes in a discretionary way. This is the essence and key to the effectiveness of fiscal measures. Second, fiscal policy should follow the laws of market economy and give a full play to the market function. It should focus on promoting structural reform and institutional innovation. Third, fiscal policy must be more closely coordinated with monetary policy to maximize the combined effects of these two policy instruments. Fourth, fiscal modulation should always put "promoting growth" first and strive to realize balanced social and economic development.

In the first two decades of this century, the Chinese government shall focus its resources on building a comprehensive well-off society at a higher level which will benefit more than one billion population, constructing a harmonious socialist society, and making its economy more developed, its society more advanced, its cultures more flourishing, and people's life more enjoyable. To that end, it is imperative that the fiscal modulation and operation mechanism be further improved and supported with sound and effective ways and measures to bring about a greater regulatory role for fiscal policy.

This book is an effort to present a clear roadmap for the evolution of fiscal policy and, on that basis, objectively look into the key factors which have promoted and enriched fiscal policy as well as their profound implications for social and economic development. It aims to shed light on the orientation of fiscal policy in the coming years from the perspective of an integrated and globalized market and the requirements for implementing the scientific approach of development and the "five balances". These ideas and thoughts will hopefully ignite more in-depth, systematic and creative thinking and study among fiscal theory researchers and fiscal policy makers. In that sense, the book is a humble tribute to the ongoing theoretical exploration and practical reform of fiscal policies in a hope to having fiscal policies contribute better and more to China's great undertaking of building a well-off and harmonious society in an all-round way.

The Author

September 2005

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Chapter One

Market Economy and Fiscal Policy

Market economy is an effective mechanism for resource allocation and economic operation, created out of the long social practice of the mankind. As the market mechanism only has the one-folded function of increasing economic performance, the government has the objective need for exercising macro control to address market deficiencies. In this sense, both the government and the market are indispensable to the big picture. The two basic tools the government employs to realize macro control are fiscal and monetary policies. The former helps moderate economic performance through taxation and budgetary measures, subsidies, government bonds, income distribution and transfer payment. Since its reform and opening up, China has reformed its traditional planned economy and basically put in place a socialist market economy. The market mechanism is playing an increasingly central and fundamental role of allocating resources. Meanwhile, the Chinese government has been constantly exploring macro control methods which befit its market economy regime. With a socialist market economy already in place and growing, fiscal policy is showing increasing importance in relation to macro control.

I. Market Failure and Government Modulation

The development of a market economy has always been accompanied by state intervention or government macro control to varying degrees. Despite of dissimilar views as various schools of economics study may hold on the government's macro control and non-uniform models different countries follow, it is irrefutable that macro control is needed for any market economy. The market mechanism is susceptible to failures in certain areas, where government macro control can and should play a role. Looking at the social-economic history of the mankind, the market mechanism plays a fundamental role in allocating resources. The role of government macro control should start from addressing market failures and then to realizing the objective of comprehensive social-economic progress by way of correcting and overcoming market failures. The necessity of macro control is manifested in the following main areas.

1. Government Modulation versus Market Failure in the Supply of Public Goods

The products for human consumption are divided into public and private goods. Provided the total social resources are fixed, there needs to be a reasonable proportion as to how many resources go for public goods and how many go for private goods. However, in a pure market economy, the most ideal proportion is more often than not unattainable, due to the unique nature of private and public goods.

Private goods are exclusive and competitive. By exclusive, it means if someone consumes a private good, no others will have access to it anymore. In other words, the product can only be consumed when received. By competitive, it means persons who are reluctant to pay for the good or offer lower prices for it will consume none or less of the product. For example, bread sold in the market is a private good.

Contrasting to private goods, public goods are non-exclusive and non-competitive. By non-exclusive, it means the product is not exclusively consumed by a given person. It is impossible or too costly to limit the consumption of the product to others. In other words, an individual, whether having paid for the product or not, will and must consume the product in any event. For example, national defense is a typical public good. It is on one hand extremely difficult to exclude a resident in a country from enjoying the benefits of national defense. On the other hand, it is unlikely that the person opts to not enjoy the product. By non-competitive, it means given a fixed level of productivity, one person's consumption will not decrease the amount to be consumed by others. In other words, many people can consume the product simultaneously. For example, as a public good, national defense protects your life and property safety no less than for others.

These attributes of public goods make it difficult for the market to fully play out its role. The non-exclusivity of public goods disables their providers from charging the consumers, who are also reluctant to pay. As a result, public goods are free for consumption under any circumstances. That gives rise to the problem of "free-riding". If the market is manipulated to exclude people from enjoying public goods, then the efficiency of resource allocation will turn awfully low. The non-competitiveness of public goods decides that the supplying costs will not rise because of one more person's consumption. In others words, the marginal costs for allowing more people to consume public goods are zero. These characteristics of public goods preclude them from being supplied into the market by the private sector. If the private sector attempts to supply public goods in a market, the result will only be a serious undersupply of public goods. Therefore, the market mechanism has quite pronounced risks of failure when it comes to supplying public goods or services. This is exactly where and why government intervention comes into play.

The solution to the market failure in the provision of public goods is to let the government participate in and regulate resource allocation. 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 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 defense and major infrastructure projects.

2. Government Modulation versus Market Failure in Externality

Externality means that an individual or company affects other individuals or companies in his/its activities but fails to pay the costs or receive the benefits. If an individual or company brings benefits to other individuals or companies in his/its activities but does not receive compensations for that, this situation is called a positive external effect. Contrarily, if an individual or company brings losses to other individuals or companies in his/its activities but does not share the costs, the situation is called a negative external effect. For products or services with external effects, their private marginal costs and social marginal costs are not the same, nor are their private marginal gains and social marginal gains. In the case of a negative external effect, the private marginal costs are lower than the social marginal costs, meaning the society has taken over part of the costs from the individual. This scenario is referred to as the spill-out of costs. For example, a company produces pollutants which harm the social living environment, but it does not pay extra costs for that. In the case of a positive external effect, the private marginal gains are less than the social marginal gains. The society enjoys part of the gains, which we call the spill-out of gains. For example, if a beacon or street lamp is built by a private investor, it will bring convenience to passing-by ships or people. If we solely rely on the market mechanism, then products or services with a positive external effect will be in undersupply because the gains from them are not generous enough. And products or services with a negative external effect will be hard to contain because there is no need to pay the necessary costs. Therefore, the market alone is not effective enough to correct or address problems in the supply of products or services with external effects or to optimize resource allocation in the society.

The government may use economic, legal and administrative measures to address the externality issue in the market, especially negative externality. In this regard, the economic measures at the government's disposal are fiscal subsidies and tax policies. For example, to address overproduction caused by a negative external effect, the government may levy higher tax or charges so that the private marginal costs are made equal to the social marginal costs. In so doing, the external costs are internalized and overproduction curbed. To address underproduction as a result of a positive external effect, the government may introduce such incentives as fiscal subsidies and tax preference.

3. Government Modulation versus Market Failure in Unfair Income Distribution

In a pure market economic situation, the basic principle for income distribution is that wages are paid for labor, rents are collected from a land, and profits or interests are gained from capital. In other words, the market mechanism distributes income in proportion to the level of individual capability, contribution and properties in possession. As people differ by the properties they possess or inherit or their labor skills, a stark discrepancy may arise if income distribution is solely determined by the market mechanism. A reasonable income gap is a stimulant and driving force for economic growth. A handful of people being rich first will encourage many more like-minded people to follow suit and work harder for the same status. However, the market mechanism has the inherent effect of widening such a gap. So it only brings the gap bigger until one day it is too big to be properly accommodated by the society and a series of negative social consequences will emerge, such as poverty, squandering of wealth among the better-off people, social conflicts and low-income class having no chance of development or improving their situation. This outcome will destabilize economic and social development. Therefore, the market mechanism alone will inevitably lead to unfair income distribution.

The market itself can not bring fairness to income distribution, which is exactly what a harmonious society needs to achieve. Therefore, we have to rely upon external forces and find a non-market approach. This non-market approach is the government's distribution policy, including setting a mandatory minimum wage level and income redistribution. The government's budgetary power enables it to redistribute income. By using its compulsory taxing power, the government directly interferes in the process of national income distribution. And by devising proper tax policies, for example, progressive income tax policy, it collects money from those who have excessively high incomes and transfer the money to low-income earners in the society in the form of fiscal spending such as social security, medical insurance and food stamp allowances. Through income redistribution, the government may tune the relationship between all interested parties in the income distribution and keep their income gaps within a reasonable range. In this way, the goal of fair income distribution is achieved. 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 toward equalitarianism. That means the government has to refrain from blindly pursuing even-out income distribution regardless of individual ability and contribution. Otherwise, economic efficiency may be lost, which will ultimately impede the improvement of social well-being.

4. Government Modulation versus Market Failure in Keeping Economic Stability

In a pure market economy, various players in the economy make decisions and produce separately. They decide independently as to when and what to produce and in what quantities. These dispersed economic behaviors are normally regulated by the "invisible hand" of the market. Market regulation can only ensure smooth social reproduction when there is complete information and full competition in the market. However, in a real economic setting, due to a variety of reasons, information is incomplete or asymmetrical, which renders dispersed economic behaviors largely aimless or even leads to higher costs of market "test error". On a more serious note, it will lead to imbalance of social supply and demand and cause economic instability, unemployment and inflation. When the total social supply is less than the total social demand, the prices will rise, leading various economic players to expand their production and more jobs to be created. When the supply is greater than the demand, the prices will drop and various economic players will cut production and jobs will be lost. Therefore, certain blindness in the market creates an economic cycle, namely, growth to recession to depression (crisis) to recovery and back to growth. In this process, social productivity is often hugely eroded, even bringing about more serious consequences like economic stagnation and social instability.

To iron out economic fluctuation, it is imperative that the government take corresponding measures to increase employment, contain inflation, and maintain economic stability. Government fiscal policy has the purpose of stabilizing the economy. When the total social demand is notably higher than the total supply (economic overheating), the government may curb total social demand by cutting back its budgetary spending, compressing government demand, increasing tax and reducing non-government demand. When the total social supply is notably higher than the total demand (economic depression), the government may stimulate total social demand by increasing budgetary spending, boosting government demand or reducing tax and expanding non-government demand. If the total social demand and supply is kept in equilibrium, the government may balance its budget to sustain stable development of the national economy. The above-mentioned policy adjustments aim to promote the effective utilization of resources and achieve full employment.

In summary, only when the "invisible hand" of the market and the "visible hand" of government macro control are organically combined can a market economy run in a healthy and orderly state. The market plays a fundamental role in allocating resources whereas government macro control only addresses areas of "market failure". "Market failure" is the basis for the government to implement the macro control policy. The market mechanism should play its role to the largest extent. Only in areas where the market mechanism is unable to play a moderating role or do so effectively is government intervention needed. Moreover, one important objective of government macro control is to create a favorable environment to maximize the role of the market. Government macro control should, in every possible case, use economic measures, supported with necessary legal and administrative measures. In others words, the market should have the primary role while government macro control should remain secondary.