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“China: Fiscal Policies for Economic Development”

Xiang Huaicheng, Finance Minister of the People’s Republic of China

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Minister Xiang Huaicheng:

Thank you very much Dr. Lampton, in particular for giving a very rich diversity to the dull personal biography that I have. Actually, my personal experience is not as colorful as Dr. Lampton has painted to you. I have prepared a written text here that outlines some of the aspects concerning the Chinese economy and fiscal system that can be distributed to you. What I will do here is basically run through some of the major points in hopefully what will be a short time.

I very much value today’s opportunity to speak to SAIS at an event that is co-sponsored by The Nixon Center. I will basically put forward the following points: One is the question, “What is the main theme of the Chinese economy?” My answer to this question is first reform and second development. And what in turn is the main them of China’s state finance? My answer is development first and reform second.

Just now Professor Lampton said that I am responsible for the fiscal policy in China. So in the mindset of the Chinese people I am a person who deals with money. I try to maneuver myself and my policies basically surrounding the permeating theme of money. What I will do is talk to you about the reform and development of the Chinese economy made in the past few years from the standpoint of state finance. My first observation is that the economic restructuring in China has never stopped -- It has always been broadening and deepening into new territories and areas. Never give any credence to people who say that the Chinese economic reform has stopped. As a matter of fact, we have come to a point where it is simply impossible for us to stop anymore.

I would like also to attempt to characterize the main thrust of China’s development in the next few years, and I hope you will remember these generalizations. Development will always be a theme in China’s economy. Economic restructuring will be the main line running through the whole process. Reform and opening up and scientific and technological progress will provide the driving force for Chine’s economic growth. While the objective and fundamental point of departure is the improvement of people’s living standards.

I believe that in the case of foreigners and the Chinese people alike, if you can understand the above mentioned summary, I believe you are in a very good position in trying to understand and analyze economic development in China because you have got the right direction. Talking about direction here, what is the direction of China's economic reform? The direction is the development of a socialist market economy.

What are the major elements of China's economic reforms? These elements are really a very diverse set of elements and very rich and all dimensional, all quite colorful. Four years ago, Prime Minister Zhu Rongji of China characterized China's reforms by saying that it involved three deliveries and five reforms. The main areas covered by the Prime Minister in his remarks include: first the reform of state owned enterprises; second the reform of the system of investment and financing; third the financial and fiscal reform in China; fourth social security system reform, and fifth the fees to tax conversion in China. The last reform, the fees to tax conversion, is really uniquely Chinese.

The United States also has undertaken these kind economic adjustments in the U.S. before, but that happened quite awhile ago. That was in the 1880s, when the United States was in the middle of an era of advancement. At that time in the United States, in terms of taxation, the federal government simply could not collect all the fiscal revenues that it was entitled to and that it should collect. On the other hand, there was simply a multitude of different fees, levies, and charges as a supplementary source of federal revenue. As we say in Chinese, "If you only have one set of taxation, then the taxation burden might be quite alright. But if you have secondary level of taxation, then probably the burden might be quite heavy. But then if you have a third or even fourth tier of taxation, then the burden would be unbearable for the people."

Among the reforms that I have outlined above, I believe these areas are most important for China both today and tomorrow: the first is the reform of the social security system, the second is the fees to tax conversion in rural areas in China, and the third is the fiscal and financial reform. All three reforms can support the reform of state owned enterprises (SOEs) from different angles. Actually, I wouldn't say that the problem with state owned enterprises in China are so formidable that they simply defy solution. The most serious problem is that we have too many people at the SOEs. We even have a jingle in Chinese, "For a job of one person we actually have three people for one position. One person is actually doing the job. The second is just looking on. The third person might try to create some trouble for the first person." We have to break this egalitarian mode of work and redistribution, by creating another "big pot", so to speak. That is the "big pot" of the social security system.

The second point I would like to touch upon is that China has constantly attained more and more development in the process of reforms. At the lunch preceding this talk, there was a person at The Nixon Center who mentioned that China was now the bright star among Asian countries. And just now Dr. Lampton also just emphasized the quite important role that China can now play on the international economic stage. For our part, we really would like to decline the honor of becoming a big star. China is not that important for global economy in any way. The Chinese economy is only one-tenth the size of the American economy - last year the total economic value in China was only \$1.16 trillion. We are just like a tiny speck in the global economy, not too significant.

But it is an economy that is developing all the time. In the past few years, even the lowest growth figure in China amounted to 7.1 percent. We can't afford to grow too slowly because slow growth

in China would mean that we would lag behind even further. Even when we grow at 10 percent, that would still mean that we would grow, in terms of the amount of increase of economic output, equal to 1 percent growth in America. I would still further not want to talk about Chinese GDP in per capita terms because we simply have so many people that our per capita GDP is very low. What I want to tell you here is that for the next few years we are quite confident of attaining a growth rate of approximately 7 percent. We have set for ourselves a modest goal of a having a GDP in 2010 amounting to \$2 trillion.

The third point is that China will continue to open wider to the outside world. Since China's entry into the World Trade Organization in December of last year, the opening up of China, of course, has reached the point of no return. Indeed, our agenda of opening up to the outside world will be so crowded even if we just proceed step-by-step along the commitment that we have made upon our accession. I want to particularly emphasize this point to our foreign friends -- China is a responsible country. We take our commitments very seriously and we honor our words. It is just like being a person. If you want to enjoy people's confidence then you have to honor you words. It is the same case with countries. Countries have to honor their commitment in order to enjoy a level of integrity among the rest of the international community. So of course, in China, we will carry out each and every commitment we have made.

To sum up the points I have mentioned so far: First, China's economic reform has not stopped. Second, China is developing country. Third, China is an open country. So with these remarks I would like to open up the floor for your questions.

Question (David M. Lampton): In speaking recently of China's economy and budget in the first quarter of this year 2002, Mr. Minister, you are quoted as saying that the fiscal situation in China is rather grim. You noted a government spending in the first quarter of this year was up 23 percent and revenue was only up 3.4 percent compared with a year earlier. My question really is as follows: what are the causes of spending outstripping revenue, what will it mean for China if this problem persists, and how rapidly do you believe you can get it under control?

Minister Xiang: I think Mr. Lampton is very well informed. I left Beijing for the United States on the 18th and I gave a press conference on the 16th where I made the remark that Mr. Lampton quoted. It seems he has already gotten hold of what I said on the 16th. It is so perfectly normal; we are living in an information age. Indeed, in the first quarter of this year, China's fiscal situation is less than satisfactory. With the revenue growing by only 3.4 percent while expenditure growing by 23.9 percent. But why should I feel worried about this? Because in the previous four years, since I became the finance minister, the government revenue has increased by an annual average rate of 17.5 percent. I would like to step down from my office in a decent way, rather than in any less than decent way. That is why I send a signal that the revenue increase of 3.4 percent is simply not possible. We have step up our efforts with the revenue side and we have to collect all the revenue that should be collected. My assistants told me that a combination of factors has been behind the outpacing of revenue by revenue that has been alluded to, but I wouldn't listen to them. If you are not collecting as much revenue as you would like, then you should be more cautious in spending. But what has happened is that while the revenue is not coming in as fast as we hoped the expenditure has become quite reckless and has increased by 23.9 percent. As we say in Chinese, "Spend money like a flowing current in the river."

This would bring me to the National People's Congress session in March that Professor Lampton referred to. For four years I have always been a top grade student because the government revenue

has been high and the fiscal situation in China has been strong. But this time, because of that, I only got 80 percent approval for my budget report in the parliament, and I lost 20 percent of the votes. Why should I lose support with 20 percent of the parliamentary deputies? Because this year the budget is running a deficit of 50 billion yuan. The total budgetary deficit would amount to 309.8 billion yuan. Indeed, I can understand why the parliamentarians in China have their own views and have their complaints about the fiscal position at this point. I believe they are quite right, because I what kept telling them throughout last year, was how good China's economic performance was last year. But this year what has happened is that our budgetary deficit will increase. They find that these two facts can not be reconciled with each other. So instead of a decrease in the budgetary deficit why should there have to be an increase?

I have to say that I face more difficulties than I can tell those parliamentarians. This is because the budget was compiled in the third to fourth quarter of the previous year. In that time the US economy was not in terribly good shape. How can I anticipate that the US economy would turn the corner and start on a good track again? I cannot sell out my American friends either. I cannot tell the people in China that we have a larger deficit because the US economic situation is not too satisfactory, etc. That is not too good to say.

What I want to tell Professor Lampton is that the increase in China's fiscal revenue will not be maintained at the rate of 3.4 percent. After April, the situation will look up and it will be better and better on a month-by-month basis. This is not a bluff. This idea of mine is well grounded. The first contributing factor is a strong economic recovery in the United States. The second factor the first quarter of GDP growth in China was 7.6 percent, 0.3 percent higher than last year. Thirdly, the various reforms that will enhance China's taxation system and will actually increase the sources of revenue have basically been carried out. The computerized management of the taxation has also made very big headway. Fourthly, I have really galvanized all these people to work in my press conference on the 16th of April. I will come again to the United States in September. If the situation has not improved, I will not talk to anybody about it. Thank you.

Question: I want to know, you said one of your main goals is to increase the living standard of your people (also my family members too), and the GDP increase is 7.1 percent and the government increase 17.5 percent, the government takes a big chunk of the increase in GDP. How do you increase the consumer spending, to increase the people's life? Looking at the case of Japan, if you keep a very high GDP increase, you will have overvalued real estate and banks will have a lot of junk loans. How will China face this problem?

Minister Xiang: I think you are quite right. In the past 4 years, China's fiscal revenue growth has registered at a rate of about 17.5 percent. Actually the ratio of government revenue to GDP for the year 2001 was 17.1 percent. You can make an international comparison for this particular figure. The government does not take too high a percentage of economic growth from the economy.

Your first question relates to how the Chinese government can try to improve the people's living standard on the back of that figure. In the past four years, we have raised the salaries of the people on the government payroll four times. How many people have benefited from this pay raise? Basically, twice as many people as the Canadian population, 2.5 times the Australian population. 46.5 million people have been included in this pay raise package. What has been the margin of this pay raise? After the four pay rises, their average basic salaries have been doubled. This has contributed to relative rise in living standards among people in administrative and government agencies and departments and so on. Historically speaking, these pay raises were the most

dramatic and fastest pay raises ever undertaken by China. They do not have any precedent. Take myself for an example. In 18 years, since I started working after university, I have only received one pay raise. But of course, that was already a thing of the past, already beyond recall.

So let me address your second question, whether a sustained high rate of GDP growth will lead to bubbles. I cannot say that there are no bubbles whatsoever in China's economy, but probably not too many of them. It is like drinking beer -- If the beer doesn't have any foam then probably the beer is not too tasty. But, of course, if you have too many bubbles than that will create problems. I would really say that the manner in which you manage the quantity of these bubbles really borders on art. I myself am not a master of this art. I would say there is one person in China who could do that, Prime Minister Zhu Rongji. Thank you.

Question: At the 9th NPC you spoke about nine different objectives. One of these objectives was accounting and the changes in the accounting laws, etc. I was wondering if you would talk to us a little about what you were thinking about?

Minister Xiang: But for myself, although the accounting is part of my personal portfolio, I am afraid I will not go into terrible details here. I will try as much as possible to address your question. As far as my understanding goes, China's accounting system faces three major problems. The first major problem is the absence of a unified standard of accounting in China. In different agencies you might run into different standards of accounting and accounting differs in China from that in foreign countries. The first task I have to do is to unify these accounting standards. Additionally, China's parliament has already adopted the accounting law. This is the very first and very significant step towards unification of accounting standards.

And secondly, following the promulgation of the accounting law; law enforcement of this particular law has not been very satisfactory. That is to say, there are still widespread fraudulent accounting practices. As I mentioned a moment ago about WTO, a person should of course place importance on his personal integrity while a country should honor its commitments. Mainly the people that I have in mind are those accountants who lack public morality. In order to carry out an education campaign targeting those accounting people, try to dissuade them against engaging in fraudulent practices, and try to increase the level of honesty in their trade, China has set up two nation-wide accounting schools and the third one is in the process of being set up. The two existing schools are in Beijing and Shanghai, respectively. Quite frankly speaking, the model for my two accounting schools was actually based on the Anderson case, which of course was involved in the Enron collapse. Actually Anderson runs a school in Chicago for its accountants. That school educates its accountants in the principles of their work and in their morality standards they have to live up to. I visited that school and found it a very good idea but never had I expected that what should happen to Anderson. In the course of setting up the third accounting school, Prime Minister Zhu Rongji visited and inspected our schools and he said four remarks that have become the major guidelines for our school. These four statements are: integrity is most important, moral standards should be stressed, and accountants should always follow the principles and lines of their trade, and should never rig the books.

The third task I have is to regulate intermediaries in the accounting system. We should integrate the accounting firms, tax services, consulting firms, and asset management companies to the general management. This work has made quite some progress. That is why I have mentioned this progress in a report delivered to the National People's Congress. I really believe the problem will be enormous if the books made by those accountants can not be trusted. Because, that would

mean an investor would have no knowledge as to where his money had gone. So, I will try my best to do this.

Question: In the wake of the East Asian financial crisis in 1997, the finance ministry began issuing special stimulus bonds and those special stimulus bonds have been issued every year since then, about 150 billion yuan per year. I wonder what is your opinion on how much those bonds and the infrastructure spending they have gone for has contributed to China's GDP growth. Does the finance ministry have any plans to phase out the special stimulus bonds?

Minister Xiang: Let me take up your first question concerning the contribution of the proactive fiscal policy or expansionary fiscal policy to GDP growth in China. Indeed, in the past few years the average annual issuance of special treasury bonds amounted to about 100 to 150 billion yuan. Now the cumulative amount of special treasury bonds stood at 511 billion yuan. As to the rate of contribution to economic growth, the state statistics bureau actually came up with specific figures. According to them, in 1998 the contribution rate of the proactive fiscal policy to economic growth was 1.8 percent, the figure for 1999 was 2 percent, for 2000 1.5 percent, and for last year 1.7 percent. These are not my figures, but the people at the State Statistics Bureau somehow make their own calculations. This time I have actually brought with me a little brochure that I personally supervised in compilation. It is about it is about proactive fiscal policy in China. If you are interested I can share with you a copy. You don't have to worry there is an English translation. All these books are for Professor Lampton.

Let me now take up the second part of your question. Actually you have been very polite with me. You didn't point out bluntly that such expansionary fiscal policy cannot be sustained and has to be phased out gradually year by year. Quite frankly where my inclination is concerned I would like to gradually withdraw from these expansionary fiscal policies on a year by year basis. As an official in China who has for many years engaged in economic work in China, I know perfectly well that expansionary fiscal policies can only last in the short term, they cannot be carried over to the long term. In 1998, I personally made a recommendation to the Chinese government to switch from a moderately austere fiscal policy to a more expansionary fiscal policy. I explained to the government leaders that such a policy can only be carried out for one or two years and cannot be sustained into the long term. I have also written articles on this subject.

I have drawn upon what was written in a memo by Mr. Schultz, the economic assistant to the US President back in the 1960s. His article talked about his recommendations for the counter cyclical economic adjustment in the United States. What he was basically advocating was a relatively expansionary fiscal policy. He also added that such a policy can only last for the short term and not in the long term. In the case of expansionary fiscal policies, one person would suffer a great deal while many more people would feel very comfortable. Because they don't need to actually spend any money while benefiting from such a scheme. As you mentioned, most of these treasury bonds have gone into infrastructure projects. It is like tree planting. Some people dig the holes. Some people put a tree in the hole. My job is to fill out the holes dug there. As in the case of building infrastructure you have to spend money. But if you want to discontinue infrastructure projects you have to spend money as well. The withdrawal process has to be gradual. It has to be process whereby the outstanding debt is reduced on a gradual basis. It cannot be done in one year. It certainly cannot be done immediately. I pay very close attention to the indicators of China's macro economy. I am worried almost every day about inflationary figures. Fortunately, right now in China inflation is still negative and there is some slight deflationary pressure. But still we have to be very careful about that.

Question: My question is with expenditure outpacing revenue the government is finding itself hard-pressed to provide public goods in many parts of China. For example, access to health care is very limited to Chinese citizens, especially in rural areas. This has created a social and political space for NGOs and social organizations can begin to take an increasing role. What is your opinion on these organizations? Do you feel that they can help remove some of the burden from a fiscally overextended government and can they generally positively contribute to China's development? Secondly, where do you see the relationship between these organizations and the state going?

Minister Xiang: If I understand you correctly, you are asking about the degree of contributions NGOs can make to the society and the government. The Chinese government has never had any prejudice against the NGOs. Looking at the current situation, the NGOs which attempt to provide for some social services that the government cannot extend itself to have not been in a particularly strong position to do that. If we may change the word "NGO" into "social elements and forces," I believe we very much welcome any effort by any NGO or any non-governmental institution that wants to devote itself to providing for the public good.

Question: Mr. Minister, my name is Bill Jones. I am with *Executive Intelligence Review* magazine. I think that the entry of China into the world economy, the time is really overripe. I think the potential that we can only imagine today that China can give to the world will be of tremendous benefit for your country and for the world as a whole. Nevertheless, you are entering into a financial system that is wracked with crises, crises which seems to be of a systemic nature. We have seen the Asia crisis for instance, which China was protected against simply because China had not been fully integrated into that international financial system. But we have seen since then a succession of crises in many countries of the world, which seem to come more and more often. Therefore, what you are faced with as you enter into the world economy is a question that many finance ministers have grappled with over the years of creating an international financial architecture, which provides stability. I am sure that you have contemplated these issues yourself and now you are going to have to deal with them as we go into this 21st Century with China as a major player. I was wondering if you have any thoughts as to how you view the crises that have appeared on the international horizon and if you have any recommendation on what China would recommend to try and change the system to create more stability?

Minister Xiang: Thank you. You have given me a very big question to deal with. I believe anybody who can answer this question can win the Nobel Prize. I am almost sure that I cannot answer this question satisfactorily. This is really too big a question. I believe you are perfectly right when saying that each and every finance minister, each every central bank chief, and every government leader has to grapple with this question. As far as I know, international financial institutions such as the IMF are all studying the various ways that any given countries might be able to ward off unexpected financial crises. So each and every country, just like international financial organizations, is studying ways to strengthen financial regulation and supervision.

Just now you seem to have suggested that if you don't integrate yourself into the global financial system, you can be protected from the crisis. Actually, that is not possible. In today's world of globalization it is simply not possible for a country to be completely on its own. Following the financial crisis in Southeast Asia of 1997, the impact of these financial crises on China's economy in 1998 has not been marginal but rather serious. Just to share with you one figure, export in 1998 from China almost registered zero growth. The growth rate nominally was 0.5 percent, actually

was comparative to the previous year. While the growth figure for exports in 1997 with the previous year was 20 percent. So you can see the plummeting exports. I believe the most effective way to prevent financial crisis is first to put your own house in order. Second is to strengthen the financial regulation and supervision over situations that might have an impact on your particular country. Good macro policies are also quite necessary. Of course it is very easy for me to say here but it would be very difficult to actually do this. Thank you!

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George L. Argyros, Chairman
John H. Taylor, Executive Director

THE NIXON CENTER

Maurice R. Greenberg, Chairman
Dimitri K. Simes, President
1615 L Street, NW, Suite 1250
Washington, DC 20036
202-887-1000 Fax 202-887-5222
