COALITION FOR URBAN TRANSITIONS

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Grantham Research Institute on Climate Change and the Environment

FINANCING A SUSTAINABLE AND INCLUSIVE URBAN TRANSITION IN CHINA

Executive summary

Ehtisham Ahmad
and Sarah Colenbrander

Executive summary

China's development strategy has been remarkably successful, driving one of the most significant demographic and economic transformations the world has ever seen. In 1980, fewer than one in five people in China lived in an urban area. Over the past 40 years, China's gross domestic product (GDP) achieved double-digit growth almost consistently, lifting around 750 million people out of poverty.[1] Today, China is the second-largest economy in the world and three out of every five residents live in urban areas.[2] Most of this urban population and economic growth has been concentrated in the megacities on China's east coast, from which firms can ship their products easily to global markets.

This paper explains how China's rapid industrialisation and urbanisation was underpinned by fiscal policy choices, particularly the establishment of a modern national tax system. In 1993/94, China introduced a central tax administration that put in place a value-added tax (VAT) and corporate tax, along with a revenue-sharing system and an equalisation system. For political economy purposes, China also established a time-bound revenue transfer back to the provinces and cities producing revenues. Taken together, these fiscal reforms were remarkably successful, strengthening national fiscal institutions, increasing the tax-to-GDP ratio sufficiently to meet basic services and infrastructure needs, and creating millions of manufacturing jobs in China's coastal cities. The 1993/94 reforms therefore placed China in a strong position to address major economic challenges and shocks.

However, China's emphasis on coastal cities, combined with the deployment of specific fiscal tools, has also had significant negative consequences. Inequality has increased – both within cities and between the coastal metropolitan areas and the rest of the country. Local governments have vast spending responsibilities but have progressively lost control over revenues. To finance spending and investments, they turned to land sales and debt-financing using off-budget local financing vehicles to borrow (as they were prohibited until 2015 from borrowing directly). Few local governments now have clear records of their full liabilities. The concentration of production and workers in coastal megacities has exacerbated severe pollution and environmental degradation, and China is now the world's largest greenhouse gas emitter. Between 2000 and 2014, China's urban areas expanded by an area of land bigger than Belgium – often into fragile ecosystems such as deltas and wetlands.[3] Consequently, urban sprawl and vulnerability to environmental hazards are a growing concern. These challenges are exemplified in three case study cities in this paper: Guangzhou, Nanchang and Jieshou.

As China prepares its 14th Five-Year Plan, it needs to deploy fiscal instruments strategically.

As China prepares its 14th Five-Year Plan (covering 2021–2025), it needs to deploy fiscal instruments strategically to address all these issues simultaneously. The Five-Year Plan needs to foster continued economic growth in a time of increasing uncertainty about future trade patterns and related job creation. At the same time, it needs to ensure that economic opportunity and wealth are shared more equitably, improving living standards while sharply reducing carbon emissions and pollution. Finally, it needs to nurture effective, accountable local governments that can fulfil their assigned responsibilities in a fiscally sustainable way.

Given their central role in the economy, cities are at the heart of the challenge ahead. China needs to transform its established urban areas into more compact, connected and clean cities while simultaneously steering future urbanisation towards sustainable hubs in its interior to secure long-term improvements in well-being for its people. Fiscal policy has a crucial role to play in delivering sustainable urban development, accompanied by strategic policies and investments in the energy, environment, housing, industry, land use and transport sectors.

RECOMMENDATIONS

This paper identifies four key fiscal reforms that could help create the right incentives for a sustainable, inclusive urban transition, supporting China to achieve its broader development objectives:

1. **Convert some revenue-sharing arrangements, such as on the personal income tax, into a surcharge, or piggy-back, on the national tax** (administered by the State Taxation Administration for all levels of government). This should directly enhance equity within cities but also create incentives for local governments to provide the information needed to improve taxation of assets and non-wage income. This builds on the current arrangement for some taxes on property transactions, whereby central legislation permits rate-setting by local governments within specified bands.

2. **Introduce a national carbon tax and authorise a surcharge or piggy-back.** China is currently refining and scaling a national emissions trading scheme. This could be complemented by a national carbon tax, which would establish a base rate for greenhouse gas emissions that prevents a race to the bottom. A surcharge within a legislated band (to build on existing precedents) could further help achieve local environmental goals by enabling higher carbon pricing in more polluted, congested cities, while attracting businesses to cleaner cities that have lower carbon tax rates.

3. **Introduce a recurrent beneficial property tax at the city level.** A property tax could help achieve distributional goals by strengthening the taxation of assets, as well as redressing local governments' dependence on land sales that distort planning and investment decisions. A pioneering new analysis commissioned for this working paper demonstrates that linking such a property tax to local services, such as education or social housing, improves the distributional impact of the tax, enhances accountability to citizens, provides an assured stream of funding for basic services and enables access to private finance for investment.

4. **Make a concerted effort to generate full information on liabilities within local balance sheets.** Accurate and timely information on subnational liabilities is tremendously important to manage national fiscal risks, but it is difficult to generate data accurately. An examination of the books of a small Chinese city found that its explicit debt was double the amount shown on its balance sheet, and implicit liabilities were four times higher again. This finding shows why local governments and their financing vehicles need to use international accounting and reporting standards if they are to access credit in the future, whether bank loans, bonds or public-private partnerships (PPPs). Improved recording and monitoring of liabilities should be complemented by more stringent criteria for new infrastructure projects to ensure investments are helping create compact, connected and clean cities.

Taken together, these fiscal reforms could establish the incentives necessary to advance the central government's other urgent priorities: accountable local governments, balanced macroeconomic growth, high-quality public services, cleaner air and falling greenhouse gas emissions. In this way, China's fiscal policy can help secure national economic prosperity and improve quality of life while tackling the climate crisis.

REFERENCES

1. World Bank, 2020. Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population) – China. Washington, DC, USA. Available at: https://data.worldbank.org/indicator/SI.POV.DDAY?locations=CN.

2. UN DESA, 2018. *World Urbanization Prospects 2018*. United Nations Department of Economic and Social Affairs, New York. Available at: https://population.un.org/wup/.

3. Coalition for Urban Transitions, 2019. *Climate Emergency, Urban Opportunity: How National Governments Can Secure Economic Prosperity and Avert Climate Catastrophe by Transforming Cities*. World Resources Institute Ross Center for Sustainable Cities and C40 Cities Climate Leadership Group, London and Washington, DC. Available at: https://urbantransitions.global/urban-opportunity/.

Funded by UK Government

This material has been funded by the UK government; however, the views expressed do not necessarily reflect the UK government's official policies.

Coalition for Urban Transitions
c/o World Resources Institute
10 G St NE
Suite 800
Washington, DC 20002, USA

C40 Cities Climate Leadership Group
3 Queen Victoria Street
London EC4N 4TQ
United Kingdom

WRI Ross Center for Sustainable Cities
10 G St NE
Suite 800
Washington, DC 20002, USA

ABOUT THIS PAPER

This paper summarises a research programme led by the London School of Economics and Political Science (LSE) and carried out in conjunction with colleagues from the Capital University of Economics and Business, Fudan, Sun Yat-Sen and Zhejiang Universities, and the Chinese Academy of Social Science. China's Ministry of Finance and the Chinese Academy of Fiscal Science have been kept informed and have commented on the research at regular intervals. The research programme is supported by the Coalition for Urban Transitions, the leading global initiative helping national governments unlock the power of inclusive, zero-carbon cities. The opinions expressed and arguments employed are those of the authors.

CITATION

Ahmad, E. and Colenbrander, S. 2020. *Financing a sustainable and inclusive urban transition in China*. Coalition for Urban Transitions, London and Washington, DC. Available at: https://urbantransitions.global/publications

Find us
urbantransitions.global
@NCECities

Photo credit: Zhu Difeng / Shutterstock