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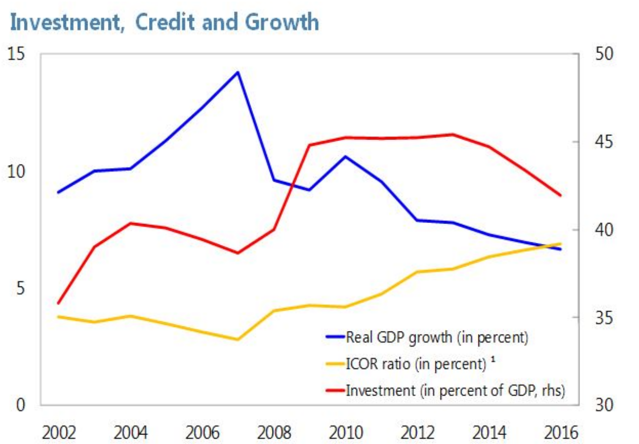
# Why China Needs "Soft" Infrastructure Investment Now

**The Chinese government must move away from directing and owning resources.**

China's impressive economic growth over the past decades has depended in no small measure on investment or capital deepening, with its investments into physical capital continuously among the world's highest. As a result, the country has been completely transformed by the rapid construction of airports, roads, bridges and entire cities. The world's largest high-speed rail system is Chinese.

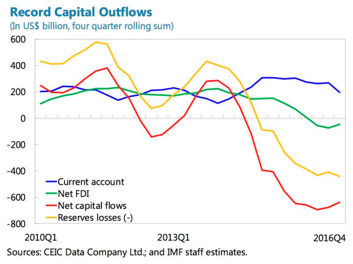
However, the old growth model that relied on investment and inexpensive labour is reaching its limits. Despite continuously high investment rates, China's GDP growth rate has declined over the past decade, as has the productivity of additional physical capital investment (Figure 1). Recognising this, China's leadership has embarked on reforms to rebalance the economy: from investment to consumption, from industry to services, and from external to domestic demand.




1/ The ICOR ratio is a proxy of the inverse marginal product of capital. The higher the index, the less productive capital is.

China faces some issues that are related to imbalances such as rising credit to the private sector (now projected by the IMF to reach over 290 percent of GDP by 2022). And in 2015 and 2016, the country experienced large net capital outflows and a fall in reserves, prompting the government to enforce existing capital controls more vigorously and to introduce reserve requirements on foreign exchange forwards. A sharp increase in nonstandard credit assets and the proliferation of wealth management products has also raised concern that this could lead to greater vulnerabilities.

Because China now accounts for a greater share of global output (in purchasing power terms) than the United States, much depends on China's ability to implement reforms and constantly recalibrate its



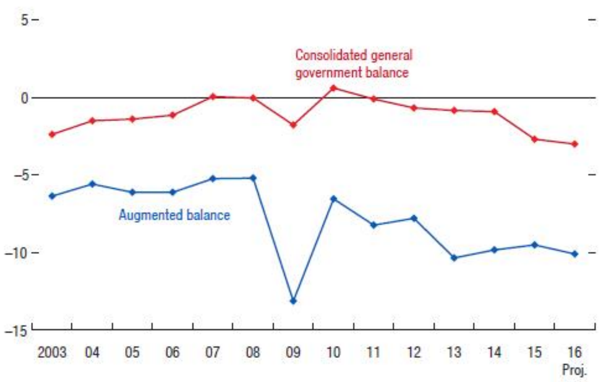

risks. Therefore, a key ingredient to the economy's successful transformation is to continue improving *soft infrastructure*, that is, the institutional foundations that underpin and guide functioning markets. policies to minimise

This is the theme of the new book **Modernizing China: Investing in Soft Infrastructure**. It was also the topic of a breakfast briefing held at INSEAD in April, jointly organised by INSEAD Emerging Markets Institute and the International Monetary Fund.

**Fiscal policy challenges**

For soft infrastructure development, the first crucial area we point to is public finance frameworks. Even though China's fiscal deficit is below 4 percent of GDP, when local government financing vehicles are included it exceeds 10 percent. Stronger fiscal policy frameworks and social safety nets, in turn, will address structural intergovernmental imbalances and support more inclusive and environmentally friendly growth.

Figure 1.8. Fiscal Deficit Remains Large, but More On-Budget
*(Percent of GDP)*




Sources: CEIC; Chinese authorities; and IMF staff estimates.

**Tax policy reform**

Facing rising inequality and growing demand for better services, reforms to tax policy are another issue. These reforms can help ensure equitable collection and distribution of income, foster incentives to improve public services and put local governments on a better fiscal footing. While the overall tax burden is similar to Asian peers in the OECD (20 percent of GDP), the redistributive effects of taxes and transfers is still limited. The tax revenue structure is heavily tilted toward indirect taxes and does not correct for environmental externalities.

Ongoing revenue reforms could partly address these issues. China's VAT reform is commendable. Additionally, a dual income tax – based on the two main categories of labour and capital – is more suitable for individual income tax than a global income tax system. There is also room to effectively improve the progressiveness of taxes and widen the tax base. A gradual shift from indirect to direct taxes can strengthen redistributive power. Reducing the social security contribution rate can support rebalancing and ensure sustainability.

In addition, shifting to an *ad-valorem* environmental tax to replace various fees and surcharges would be welcome. Because these tax reforms cut across ministries, inter-ministerial collaboration and top-level leadership is required.

**Local government finances**

Besides providing basic public services, local governments have undertaken sizeable investments that have contributed to rapid growth. They have also been involved in land development and contributed to the real-estate boom. Indeed, the success of local officials was often assessed based on the growth performance in the region.

Yet local government finances have faced a structural misalignment. Revenue bases are small relative to spending obligations. This implies that local governments have to rely on fiscal transfers or resort to financing through things such as land sales and setting up financing vehicles to borrow from banks and capital markets. Refinancing and transfers have contributed to a sharp increase in government debt over the last few years.

The revised budget law of early 2015 was important in putting fiscal and budgetary management on a sounder footing and imposing harder budget constraints on local governments. By formally allowing local governments to issue bonds, while prohibiting other forms of borrowing – also known as "opening the front door while closing the back door" in China – the budget law aimed to strengthen the transparency and accountability of local government finances and addressed intergovernmental fiscal relationships.

However, as China maintains ambitious growth targets, incentives remain strong for local governments to borrow in ways that are prohibited in the budget law. At the same time, local government bond markets, although growing, remain underdeveloped, with limited liquidity and differentiation of risks. Thus, the list of reforms needed to strengthen local government finances is long. It includes reining in the circumvention of rules and developing the bond market with greater liquidity and credit discipline. It also includes formulating a resolution framework for potential financial distress of local government, monitoring emerging risks and misuse of public-private partnerships, and better aligning local government revenue and spending with a larger local revenue base. In addition, reform should include a larger share of social spending at the central level.

Moreover, investing in soft infrastructure is not limited to the fiscal area. China needs to provide a credible framework for the reform of its state-owned enterprises, reducing overcapacity and eliminating zombie firms; liberalise internal and external capital markets; reduce pollution; move to greener growth with sustainable energy use; and move to timelier, market-friendly communication. Addressing these challenges simultaneously is crucial not just for China, but for the region and the world given the country's economic size, trade links and increasing financial integration. China is performing a delicate balancing act. The world should hold its breath.

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