【*Gao Peiyong*】China's Active Fiscal Policy in Changes

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Along with the watershed changes to Chinese economy since the 18th National Congress of the Communist Party of China (CPC), many economic terms which have been in use for years have taken on hugely different connotations, even though their name is still the same. If applied indiscriminately to current economic situation, they might lead us to paradoxical conclusions. The active fiscal policy is a case in point.

I. **New context facing the active fiscal policy**

China introduced the term "active fiscal policy" in 1998 in response to the financial crisis in Southeast Asia. For a long time, the word "active" was used as a synonym for "expansion." In the public understanding, the active fiscal policy is an expansionary fiscal policy, equivalent to fiscal expansion by reducing taxes and fees, expanding expenditure and adding deficits.

Following this line of thought, in recent years, whenever it was proposed that the active fiscal policy should be "vigorous," or "intensified," or "more active and effective," it would be interpreted as the intent on further expansion from the previous year, or as that the government was unsatisfied with the effect of fiscal expansion the previous year, and eager to fill the gap in the expansion effect.

Even when the Central Economic Work Conference proposed that the 2019 active fiscal policy should be "more vigorous and effective," it was also understood by many from the perspective of "expansion."

We should, however, note that the "active fiscal policy" and follow-up practices were introduced during the rapid economic growth period in China, and that 2019 is the second year since China officially declared to shift from high-speed growth to high-quality development. Obviously, all the decisions about the 2019 active fiscal policy are targeting the high-quality development stage rather than the high-speed growth stage, and aim to understand and lead financial policy practices in the high-quality development stage rather than the high-speed growth stage. It means, at the very least, that the active fiscal policy needs to be "more vigorous and effective" in a very different context.

This immediately leads us to a question: How is the active fiscal policy in the high-quality development stage different from that in the high-speed growth stage in terms of connotation and course of action?

A further question to ponder is: what can we do to make the 2019 active fiscal policy "more vigorous and effective" in one of the most complex and challenging situations in years, especially in face of the new economic downward pressure brought by profound changes in the external environment?

II. A macro environment unlike before

If we look closely at China's macro-economic and policy environment as she moves into a stage of high-quality development and compare it with what it used to be during the stage of high-speed growth, we will find a number of profound changes taking place:

(1) At the stage of high-quality development, the main contradiction faced by the Chinese economy is the problem of structure rather than of the aggregate, on the supply side rather than the demand side. Although the new economic downward pressure is mainly reflected in the total demand and on the demand side, the problem of the total demand and on the demand side is secondary with respect to the problem of structure and on the supply side. It's based on this understanding that the Central Economic Work Conference found "the principal contradiction in China's economic operation still lies with the supply side and the structure."

(2) The main line of China's macro policy in the stage of high-quality development is supply-side structural reform, not demand management. Although the new downward economic pressure has highlighted the necessity of demand management, compared with the improvement of supply structure and quality, the expansion of demand is a secondary goal and should be

handled in “moderation” to avoid "massive flooding." The macro policy still targets demand, but aims primarily at supply. It was out of this consideration that the Central Economic Work Conference called on to "adhere unswervingly to supply-side structural reform as the main line," and the 2019 "Two Sessions" stressed "to continue to follow supply-side structural reform as the main line."

(3) China's macro-control in the stage of high-quality development relies fundamentally on deepening reform, not policy arrangements. Although the new downward economic pressure pushes and shapes discretionary policy choices, the short-term counter-cyclical "hedging" practices produce by no means the same effects as institutional changes and fundamental reforms in various areas. Based on this understanding, the Central Economic Work Conference and the 2019 "Two Sessions" stressed again and again to "turn more to reform and market-oriented and law-based methods."

To be sure, the current active fiscal policy has completely different connotations and course of action from before.

III. Tax and fee cuts unlike before

Based on the macro-economic and policy environment of China at the stage of high-quality development, if we take a close look at all the decisions and moves China has taken to cut taxes and fees in 2019, it can be clearly found that the most important changes are not in scale and intensity, but in the operating mechanism and course of action.

Most notably, unlike the tax and fee cuts made in the high growth stage for fiscal expansion, the current tax and fee cuts are part of the supply-side structural reform, mainly to reduce costs, hence:

(1) The current tax and fee cuts are aimed at structural adjustment, especially on the supply side. The logic is that by cutting taxes and fees which are translated into the product and service prices, we can reduce the production and operation cost of companies, which is conducive to the improvement of either the supply structure or the supply quality. Either way, it will eventually improve the quality, efficiency and momentum of economic development.

(2) The current tax and fee cuts are clearly directional. The taxes and fees to be cut are mainly those born by corporate, not individual taxpayers. When we talk about tax and fee cuts, we often talk about "business taxes and fees" and "cost reduction for the real economy," meaning the tax and fee cuts are mainly for enterprises, especially in the real economy. In short, the current tax and fee cuts are aimed at a leaner structure, not a smaller aggregate.

(3) The current tax and fee cuts should be carried out on the supply side, to reduce the business cost, especially the production and operating costs. Therefore, particular discretion is required when deciding which taxes and fees to cut, and the decision should be purpose-specific. It is indirect taxes and fees accruing in business production and operation, not direct ones, that should be cut. A typical example is the value-added tax.

(4) The income deficit caused by tax and fee cuts must not be addressed by adding deficits and issuing government bonds. The only way out is cutting government expenditure. For one thing, if the government cuts taxes and fees while adding deficits and issuing bonds of equivalent amount at the same time, the pattern of resource allocation will not change. For another, there are the government debts to be repaid. Even if the government can delay the repayment of principal indefinitely by keeping issuing replacement debt, the interest due will add on to existing government expenditure and drive up the future tax burden or business cost. Therefore, the only desirable ending of tax and fee cuts is “a strapped government yet well-to-do people”.

(5) The current tax and fee cuts are usually associated with the defusing of structural contradictions in economic operation, and implemented as a long-term strategy for sustainable, sound and stable economic development. So tax and fee cuts are not some periodic action, but indicate a trend of the future; they are not some makeshift arrangement, but a sustained and effective action. They often go in the same direction as the tax and fee system reform and are themselves reformative.

IV. Expenditure expansion unlike before

The expansion of government expenditure under the banner of active fiscal policy is mainly manifested in growing government investment. In contrast to the rapid growth stage, China's current expansion of government investment is associated with, or in other words, centered on, adjusting the structure and improving weak links.

(1) By associating with structural adjustment, we mean government investment should be increased not only to boost aggregate demand, but also to adjust the economic structure. Since the principal contradiction is with the structure, not with the aggregate, government investment expansion should be more than a short-term hedging means. Instead it should aim for two birds: increasing demand and adjusting the structure, leaning more towards the latter than the former, so as to play the key role of government investment in optimizing the supply structure.

(2) By associating with improving weak links, we mean government investment expansion should focus on not only the demand side, but also the supply side. Since the main aspect of the contradiction lies on the supply side, not the demand side, the government should increase investment in a differentiated way on the supply and demand sides in light of their differences, and must focus on making pertinent efforts to strengthen the weak links in order to release the effective potential demand and optimize medium- and long-term supply.

(3) By associating with adjusting the structure and improving weak links, we mean government investment expansion should serve the supply-side structural reform. On the one hand, we cannot repeat ourselves in relaxing the policy to increase aggregate demand and neglect economic structure adjustment. On the other hand, we should not neglect the advance of reform because of discretionary policy making, which will postpone or even reverse our agreed reform plans.

This shows that in the face of the new economic downward pressure, it is necessary to increase and accelerate government investment, but we must not deviate from the course of action in the high-quality development stage, of which adjusting the structure and improving weak links are the key. Improving weak links is our top priority. While increasing government investment, we should do so to strengthen weak links, and try to boost demand and adjust the structure at the same time. In addition, when there is a conflict between demand boost and structural adjustment, we should step up efforts to strengthen weak links, give priority to structural adjustment, and focus on catching up in core technology and infrastructure.

V. Addition of deficits unlike before

The addition of fiscal deficits was long considered a sign of active fiscal policy. It seemed the inevitable result of tax and fee cuts and increased government spending in the period of high-speed growth, but the situation has changed greatly as we move into the stage of high-quality development. The addition of fiscal deficits is more and more restricted by the prevention and defuse of financial and fiscal risks, therefore:

(1) The addition of deficits cannot be done simply to serve the macroeconomic policy, but should take into account the need to prevent and mitigate financial and fiscal risks. Considering that the financial and fiscal risks faced by China today are unprecedented, and that fending off and defusing major risks is one of the "three battles" that must be won to build a moderately prosperous society in all respects, we should set a ceiling or warning line for additional deficits and do everything we can to not cross it.

(2) We must hold deficit in awe. We should not decide the size and margin of additional deficits based on our old thinking. Since the EU-originated and universally-applied red line of 3% (i.e. a state's fiscal deficit should not exceed 3% of its GDP) has already been accepted by ordinary Chinese people, and that the Chinese government often uses the number to show how well it has done in fending off risks, we should set 3% as the ceiling not to break and use it to stabilize people's expectations.

(3) The effect of additional deficits on increasing aggregate demand should be "moderate", not "all-out." Even if the deficit is added to deepen the supply-side structural reform or strengthen counter-cyclical adjustment, its role in macro-control is only "supporting", not "leading."

(4) We should focus on improving the allocation and use efficiency fiscal funds, adjusting and optimizing the expenditure structure, maintaining some while cutting others. It is also necessary to continue to put fiscal stock into use, strengthen overall coordination, and make every penny count.

This shows that in the face of the new economic downward pressure, it is necessary to increase fiscal deficits and their proportion in GDP, but we should always do so with the mind in goal: to fend off and defuse financial risks. We should balance the relationship between stable growth and risk prevention, and appropriately increase expenditure while strengthening government debt management. Unless it is absolutely necessary, we must never relax our vigilance against financial risks while working on economic growth. We must not expand regardless of the cost, or spend regardless of the repayment.

VI. The active fiscal policy of 2019: a case study

By aligning the active fiscal policy with the high-quality development stage, and analyzing the reduction of taxes and fees, expenditure expansion and addition of deficits, we find our previous understanding obsolete when applied to the current active fiscal policy in China.

From the second half of last year to the Central Economic Work Conference, and then to this year's "Two Sessions," China launched a series of measures to implement the active fiscal policy. To gain a better understanding of these measures, we should first carefully identify the profound changes involved.

(1) The current active fiscal policy holds the same name as it was in the stage of high-speed growth and it is proposed to become “more vigorous and effective” in 2019, but in the current stage of high-quality development, the word "active" is no longer equal to "expansion," but implies "structural adjustment" on top of the original implication of "domestic demand expansion”, which will enable the policy to "play a greater role in expanding domestic demand and adjusting the structure."

(2) The talk about tax and fee cuts continues and the year 2019 has cut nearly two trillion yuan in taxes and fees, but those affected are mainly business taxes and social security payment, with the main goal of "cost reduction." The deficit caused by the cuts was not addressed by adding government deficits and issuing government bonds, but by reducing government spending to benefit the taxpayers. The cuts are not carried out in the form of policy arrangement, but are bundled with the reform of tax and fee system and realized via institutional reform.

(3) The necessity of investment increase remains, and the investment within the central budget reaches 577.6 billion yuan in 2019, an increase of 40 billion yuan over the previous year, but the increase in investment is no longer aimed at the scale, but the effect - "reasonable increase in effective investment." The increase in government investment is associated with the structural

reform on the supply side and guarding against and defusing financial risks, closely follows national development strategies, and focuses on "speeding up to strengthen key weak links in economic and social development,” and on "structural adjustment" projects.

(4) Deficits are still added. The general public budget deficit in 2019 is 2.76 trillion yuan, an increase of 380 billion yuan over the previous year, the deficit rate is 2.8%, an increase of 0.2 percentage points from last year, but the additional deficits are included based on full assessment of current financial and fiscal risks, and on creating a stable macro policy environment to stabilize expectations. In this way, we can always hold fiscal deficits and financial risks in awe, and do our best to keep the deficit rate below the warning line of 3%.