Sustaining Growth through the Recovery and Beyond

Special Topic - Fiscal Policy for Inclusive Growth

WORLD BANK GROUP

China Economic Update - June 2023

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List of Abbreviations

ASEAN	Association of Southeast Asian Nations
CAR	Capital adequacy ratio
CBIRC	China Banking and Insurance Regulatory Commission
CHN	China
CFPS	China Family Panel Survey
CIT	Corporate Income Tax
COVID-19, COVID	Coronavirus Disease 2019
CO_2	Carbon Dioxide
CSS	Contributions to Social Security
CPI	Consumer Price Index
DRC	Development Research Center of the State Council
EU	European Union
ETS	Emission Trading Scheme
EMDE	Emerging Market and Developing Economies
FDI	Foreign Direct Investment
FYP	China’s Five Year Plan
GDP	Gross Domestic Product
GPB	General Public Budget
H1	First Half Year
H2	Second Half Year
HIC	High Income Country
ICT	Information And Communication Technology
IP Royalties	Intellectual Property Royalties
LGFV	Local Government Financing Vehicle
LGSB	Local Government Special Bonds
LIC	Low-income Country
LMIC	Lower Middle-income Country
LPR	Loan Prime Rate
MLF	Medium-term Lending Facility
MOF	Ministry of Finance
NBS	China National Bureau of Statistics
NEA	China National Energy Administration
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
PBC	People’s Bank of China
POE	Private-Owned Enterprise
PPI	Producer Price Index
PPP	Purchasing Power Parity
PIT	Personal Income Tax
q/q	Quarter-on-Quarter
Q1	First Quarter
Q2	Second Quarter

Q3	Third Quarter
Q4	Fourth Quarter
REITs	Real Estate Investment Trusts
RMB	Renminbi
RHS	Right hand side
sa	Seasonally Adjusted
SAFE	State Administration of Foreign Exchange
SHIBOR	Shanghai Interbank Offered Rate
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprise
UMIC	Upper-middle Income Country
USD	US Dollar
VAT	Value-added Tax
WBG	World Bank Group
WDI	World Development Indicators
y/y	Year-on-Year
ytd	Year-to-Date
3mma	Three-month Moving Average
12mma	Twelve-month Moving Average

Executive Summary

Economic activity bounced back in Q1 2023 with the removal of mobility restrictions and a surge in spending on services, but growth momentum has slowed since April. GDP expanded by 4.5 percent y/y in the first quarter of 2023, up from 3 percent y/y in 2022. The recovery in the first quarter was spurred by the release of pent-up consumer demand, some improvement in housing sector activity, and policy support. However, growth momentum has slowed since April, indicating that China's recovery remains fragile and dependent on policy support.

The drivers that could sustain the growth momentum—further improvements in the labor market and household incomes, a recovery in business confidence and private investment, and a turnaround in the housing market—are yet to gain traction. At 3.8 percent (y/y), real per capita disposable income growth remained below the growth rate of overall economic activity during the first quarter. China's rebound has also failed to alleviate youth unemployment, with the youth unemployment rate reaching a new high of 20.4 percent in April. Private investment has remained subdued since early 2022. The incipient improvement in the property market is concentrated in large cities and driven by existing project completion boosted by policy support, while housing starts and investment remain subdued. Addressing some of these vulnerabilities will require measures that go beyond short-term macroeconomic support, as discussed below.

China's GDP growth is projected to rise to a 5.6 percent in 2023, led by a rebound in consumer spending. Growth will be led by a recovery in consumer demand, particularly for services. Capital spending in infrastructure and manufacturing is expected to remain resilient. Net exports are expected to weigh on growth, due to softer external demand coupled with a modest acceleration in import growth reflecting improved domestic demand.

China Economic Outlook	***2021***	***2022***	***2023f***	***2024f***	***2025f***
Real GDP growth (%)	8.4	3.0	5.6	4.6	4.4
Consumer Price Index (CPI) (% change, average)	0.9	2.0	1.5	2.4	2.0
Current account balance (% of GDP)	1.8	2.3	1.3	1.0	0.7
Consolidated fiscal balance (% of GDP) *	-4.0	-6.4	-6.5	-4.8	-3.9

Sources: World Bank.
Note: See note for Table 1.

Risks to the outlook are tilted to the downside. Sluggish income growth, lingering uncertainty about the recovery in the labor market, and high household precautionary saving could hold back consumer spending. Although the property sector is showing signs of stabilization, structural issues, including excessive leverage among developers remain largely unaddressed, and if they persist for much longer could weigh on the economic recovery. Externally, risks emanate from an uncertain global growth path, larger than expected tightening in financial conditions, and heightened geopolitical tensions. On the upside, a faster jobs recovery could boost sentiment and contribute to higher consumption growth.

Following this year's recovery, growth is expected to return to a path of structural deceleration. Economic growth is projected to slow to 4.6 percent and 4.4 percent in 2024 and 2025, respectively, partly due to structural and external factors. Trend growth tends to decline as the economy matures, as higher levels of physical capital face diminishing returns. In addition, China's mounting debt levels – total non-financial sector debt increased to an all-time high of 287 percent of GDP in 2022 – will constrain investment-driven growth in the future, while its demographic dividend is fading with rapid population aging. Persistent income inequality and the high carbon intensity of China's economy pose additional challenges to medium-term growth and development. In addition, global per capita growth is expected to remain slower than in the decade before 2020 (World Bank, 2023), weighing on future demand for China's exports. And rising geopolitical tensions are contributing to a decoupling of critical supply chains and curtailing China's access to critical technology.

The economic recovery offers an important opportunity for policymakers to refocus their efforts on achieving China's longer-term development objectives. Structural reforms remain crucial to solidify the recovery and achieve the longer-term goals to (i) become a high-income country by 2035 through productivity-led and environmentally sustainable growth; (ii) peak carbon emissions before 2030 and become carbon-neutral by 2060; and (iii) share the gains from economic growth more equally among the population.

To revive productivity growth, China will need to rely on innovation, technology adoption, and a more efficient allocation of resources, and to achieve this, deeper reforms to increase the role of markets, the private sector, and competition are instrumental. Rebalancing China's demand toward household consumption will be important to sustain a solid pace of economic growth. This can be done by expanding the coverage and benefit adequacy of China's social safety nets and ensuring portability of benefits across provinces. To sustain robust growth beyond the short term, China will also need to address the high level of indebtedness in the economy which may be constraining investment. This will require stronger institutions to manage insolvency, firm restructuring, and bankruptcy. Shifting from the use of administrative targets and quotas to more market-based instruments, including a strengthened emission trading scheme (ETS), could help achieve a more efficient decarbonization path while ensuring reliable energy supply. Lastly, to address the challenge of inequality in China, policymakers could further liberalize the hukou system and deploy fiscal tools (see also the special topic of this edition).

Fiscal Policy for Inclusive Growth

As discussed above, China's policymakers have emphasized more equitable income distribution alongside economic growth as a key policy objective. Robust economic growth that creates jobs and boosts household incomes remains an important mechanism for reducing inequality. In addition, fiscal policy—both revenue and expenditure measures—can play a role in ensuring that the gains from economic growth are shared more equally among China's citizens.

Empirical evidence suggests that the net-benefits (public services and transfers received minus taxes paid) which families receive from China's fiscal system are progressive—delivering greater value to households with lower incomes. Publicly provided education and health services account for a high share of the support provided by the government to low-income households. However, the overall impact of fiscal policy on inequality is partly reduced by the burden of regressive indirect taxes such as value added tax (VAT) and other consumption taxes which fall disproportionately on poorer households. Compared to peers and high-income countries, China relies more heavily on VAT and collects less personal income tax (PIT), which tends to be progressive.

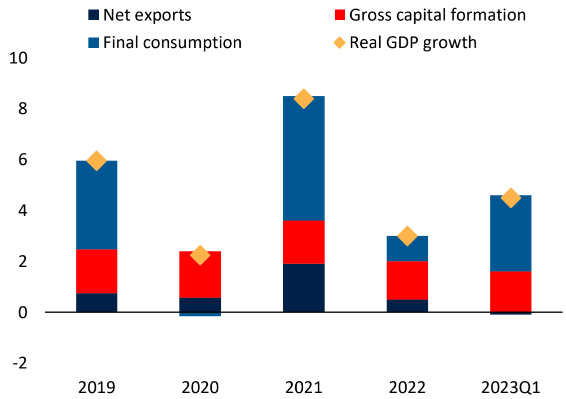
Hence, there is scope for fiscal policy to make a greater dent on inequality. This could be done by increasing the share of fiscal revenues collected through progressive taxes such as the PIT and property taxes. On the expenditure side, China's fiscal system is already contributing significantly to reducing inequality. Further improvements could focus on closing the remaining gaps in access to high-quality public services, increasing the coverage and level of social benefits, and ensuring that these benefits are portable across provinces.

Figure 1. The *China Economic Update* at a glance

Reopening has led to an upturn, boosted by a strong rebound in consumption and services

A. GDP demand components

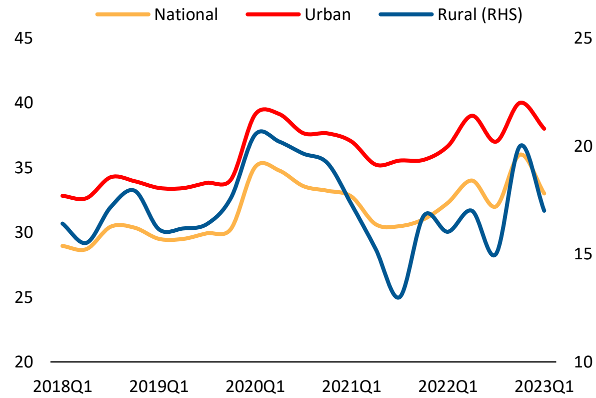
(Contribution to growth, percentage points)



But the recovery remains fragile, with household savings above pre-pandemic levels

B. Household savings rate

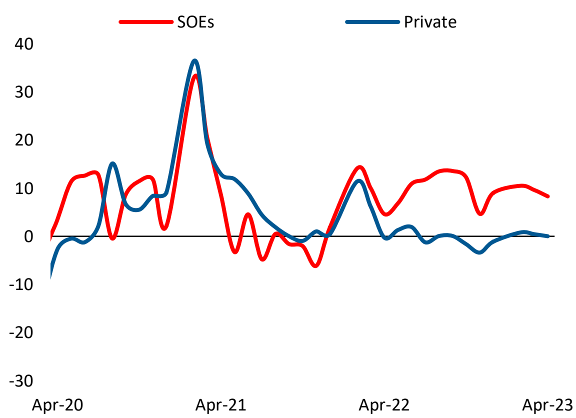
(Percent, seasonally adjusted)



The investment recovery has been uneven

C. Fixed investment growth

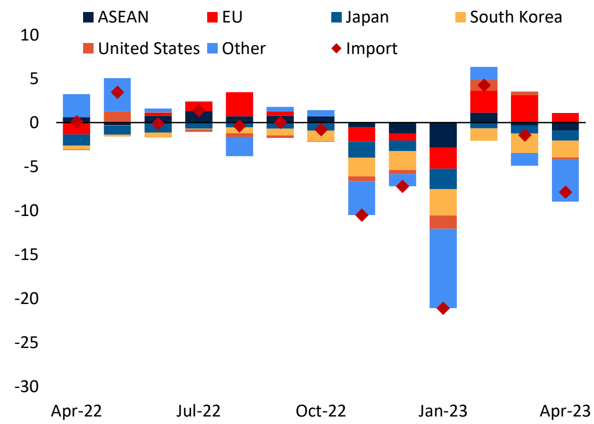
(Percent y/y)



Mirroring the uneven domestic recovery, goods imports remain weak

D. Goods import growth

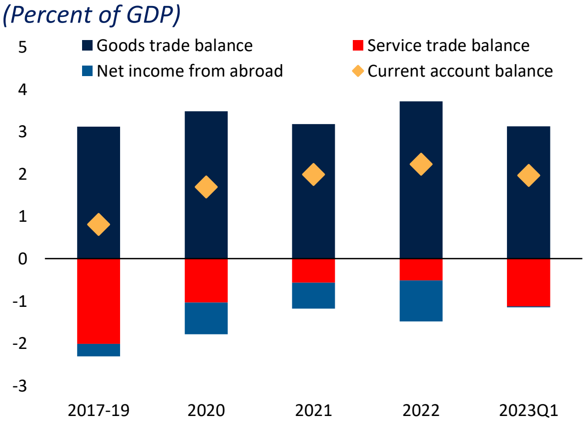
(Percent y/y; percentage points)



China maintained a current account surplus due to a robust goods trade surplus

E. Current account balance

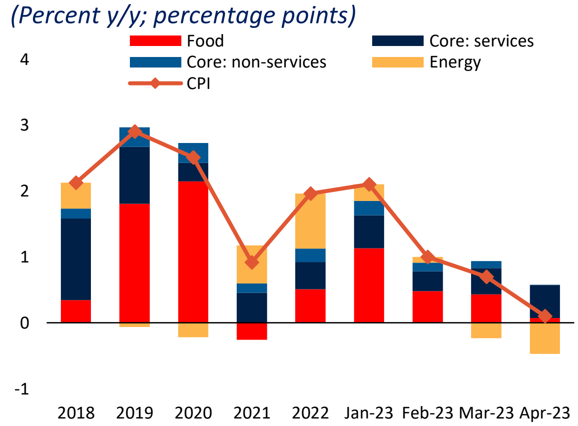
(Percent of GDP)



Consumer price inflation remains subdued, reflecting nascent consumption recovery

F. Consumer price inflation

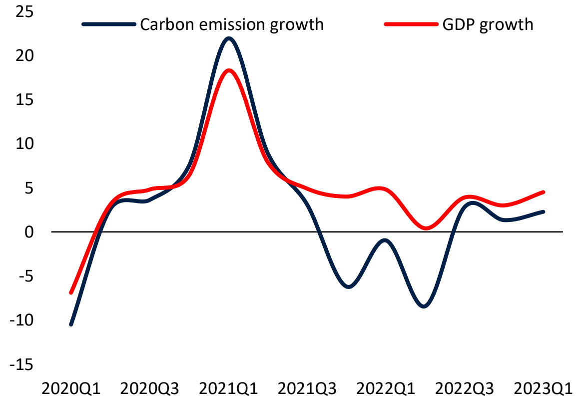
(Percent y/y; percentage points)



Carbon emissions have increased moderately amid services-led recovery

G. Carbon emission growth

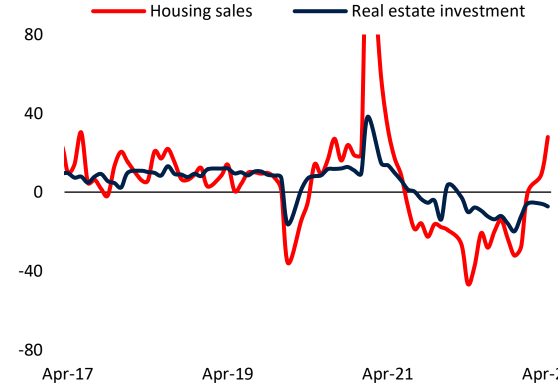
(Percent y/y)



Housing market is showing an incipient and uneven stabilization

H. Housing sales and real estate investment

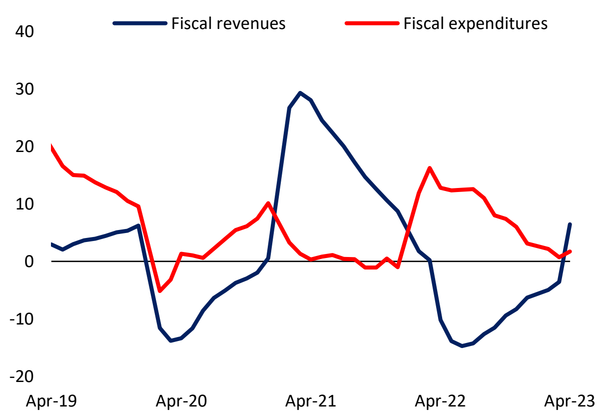
(Percent y/y)



Both fiscal revenues and expenditures remain weak, raising the risk of under-execution of the Budget

I. Growth in fiscal revenues and expenditures

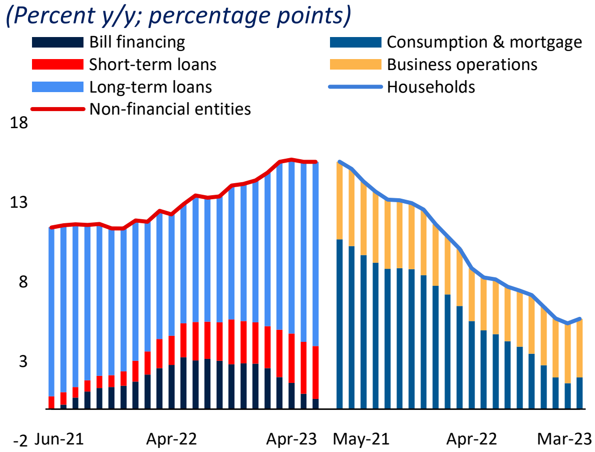
(Percent y/y, ytd)



Credit demand has started to pick up following the reopening

J. Corporate and household loan growth

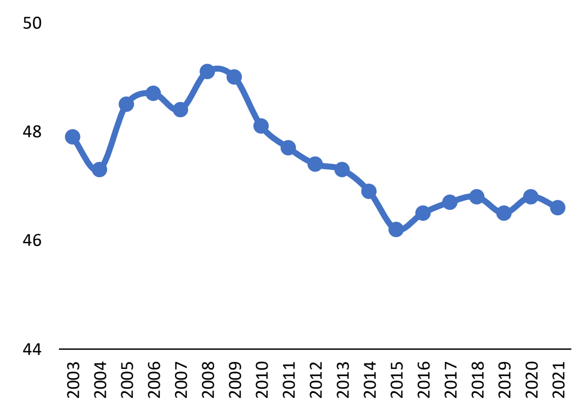
(Percent y/y; percentage points)



Income inequality after declining for several years, has recently stabilized at a relatively high level

K. Gini Index

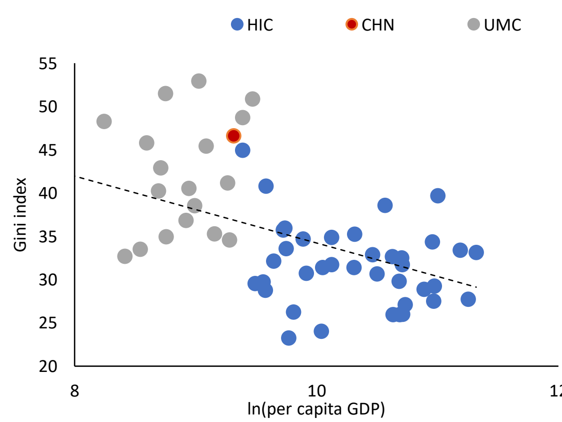
(Index)



Inequality in China remains relatively high compared to peers

L. Income inequality and per capita GDP

(USD, Index)



Source: NBS; China Custom; SAFE; PBC; Carbon Monitor; NBS Household Survey Yearbook; World Bank Poverty and Inequality Platform; WDI; World Bank.

I. Recent Economic Developments

Reopening has led to an upturn, but the recovery remains fragile

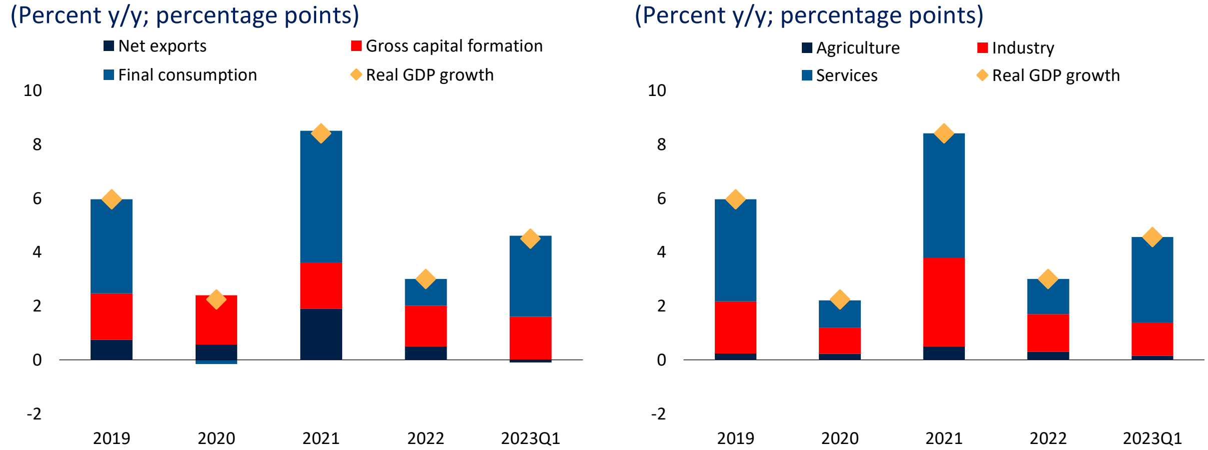
Economic activity bounced back in Q1 2023 with the removal of mobility restrictions and a surge in spending on services, but growth momentum slowed since April. GDP expanded by 4.5 percent y/y in the first quarter of 2023, up from 3 percent in 2022. The recovery in Q1 was spurred by the release of pent-up consumer demand, some improvement in housing sector activity, and policy support**.** However, growth momentum has slowed since April, indicating that China's recovery remains dependent on policy support and that the drivers that could sustain the growth momentum—further improvements in the labor market and household incomes, a recovery in business confidence and private investment, and a turnaround in the housing market—are yet to gain traction.

On the demand side, consumption saw the strongest recovery in the first quarter of 2023. Consumption contributed 3 percentage points y/y to growth, up from 1 percentage point in 2022, thanks to the release of pent-up demand. Travel and other contact-dependent services led the recovery, while durable goods consumption lagged. The growth contribution of gross capital formation increased modestly to 1.6 percentage points, from 1.5 percentage points in 2022, supported by infrastructure and manufacturing investment, while the drag from real estate investment narrowed. Amid a challenging global environment, the growth contribution from net exports moderated to -0.1 percentage points from 0.5 percentage points in 2022 (Figure 2A).

Figure 2. The recovery has been led by consumption and services

A. GDP demand components (Percent y/y; percentage points)

B. GDP sectoral decomposition (Percent y/y; percentage points)



Source: NBS; World Bank.

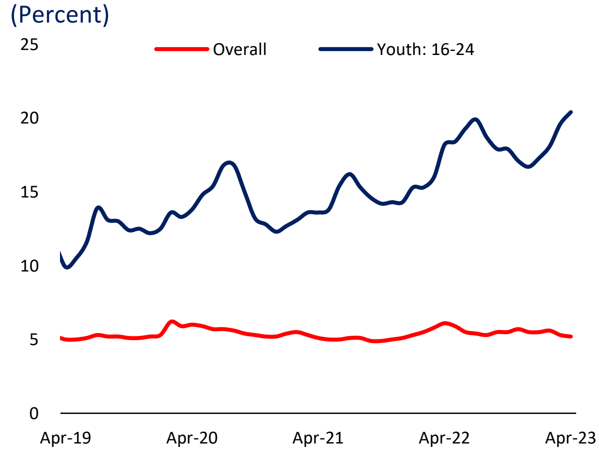
On the production side, a strong rebound in the services sector drove Q1 growth. Services contributed 3.1 percentage points y/y to Q1 growth, up from 1.2 percentage points in 2022 (Figure 2B). Specifically, contact-sensitive services such as hotel and catering and transportation services led the upswing. Property-related services moderately recovered, registering their first positive year-on-year growth since Q2 2021. The growth contribution of industry lagged services and decreased to 1.2 percentage points in Q1, from 1.5 percentage points in 2022. Within the manufacturing sector new energy vehicle and solar cell manufacturing outperformed. Meanwhile, the growth contribution of agriculture moderated to 0.2 percentage points from 0.3 percentage points in 2022, likely due to adverse weather.

The strong rebound in services demand notwithstanding, the consumption recovery remains incomplete. Following the initial strong rebound in Q1, the growth momentum of retail sales decelerated in April owing to persistent weakness in the sales of durable goods such as furniture and home appliances. This is partly explained by sluggish household income growth. Real disposable income per capita rose by 3.8 percent y/y in Q1 2023, below the growth rate of overall economic activity. Meanwhile, China's rebound has failed to alleviate youth unemployment. Unemployment among those aged 16-24 rose sharply in April to 20.4 percent, exceeding the 19.9 percent rate recorded in July 2022, although overall unemployment rates remained steady at 5.2 percent in April (Figure 3A).[1]

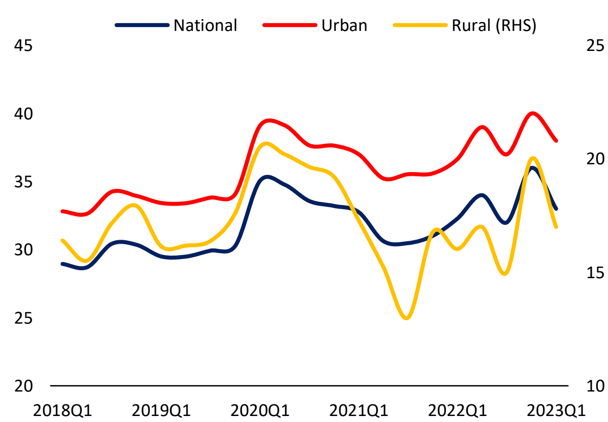
With the recovery in employment and household income still incomplete, households have remained cautious with their spending and, instead, preferred to save. The seasonally adjusted household savings rate has decreased slightly since its peak in Q4 2022 but remained 3 percentage points higher in Q1 2023 than the pre-pandemic level (Figure 3B).

Figure 3. Despite a strong rebound in spending on services, the consumption recovery is still incomplete

A. Overall and youth unemployment rates
(Percent)



B. Household savings rates
(Percent, seasonally adjusted)



Source: NBS; World Bank.

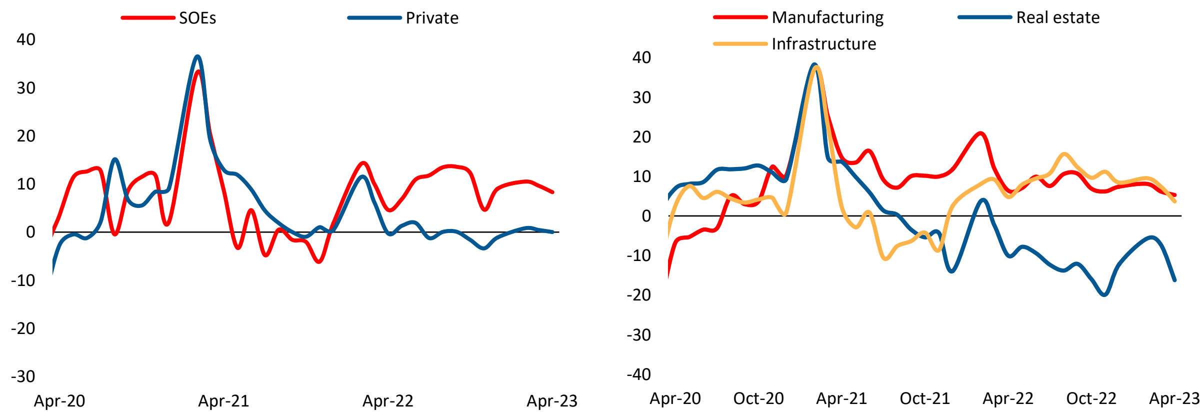
[1] See also *China Economic Update December 2022* for a more in-depth discussion of youth unemployment.

On the investment side, the recovery was led by the public sector, while private sector investment remains subdued. Private investment remained weak in January-April 2023, rising by only 0.4 percent y/y compared to a 9.4 percent increase in public investment (Figure 4A). The sharp increase in public investment was driven by recent credit policy easing and the government's push to support infrastructure investment, both of which disproportionately benefitted SOEs (Figure 4B). In April, growth in public investment, which has been a significant catalyst for economic recovery in Q1, experienced a slight loss of momentum.

Figure 4. Investment recovery has been uneven

A. Fixed asset investment by ownership
(Percent y/y)

B. Fixed asset investment by sector
(Percent y/y)



Source: NBS; World Bank.

Tourism spending surged while goods imports remained weak

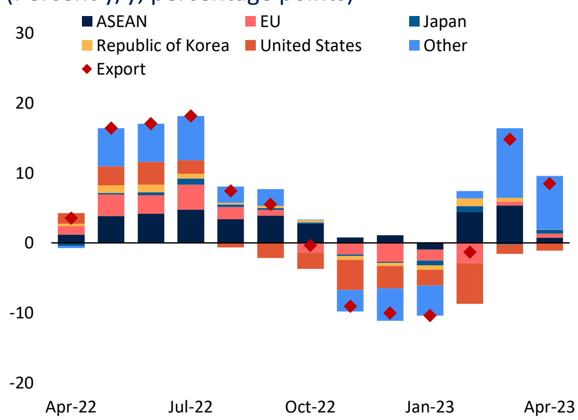
China's merchandise exports were somewhat stronger in Q1 2023 compared to the second half of last year, backed by robust demand from emerging economies. In volume terms, exports increased on average by 2.4 percent y/y in the first four months, compared to a decline of 4.1 percent in H2 2022. The improvement in real exports was supported by increased shipments to emerging economies, particularly intermediate goods and electrical vehicles to ASEAN (Figure 5A). In contrast, sluggish demand hampered exports to advanced economies. Meanwhile, China's exports in US dollar value terms expanded by 2.5 percent y/y in the first four months of 2023 compared to 1.4 percent in H2 2022, as growth of export prices accelerated.

China's real merchandise imports improved somewhat as domestic demand began to recover. Imports in volume terms expanded by 0.8 percent y/y in the first four months of 2022, compared to a contraction of 5.1 percent in H2 2022, as domestic demand for some import goods improved. Relatively weak demand from advanced economies weighed on China's imports of intermediate inputs such as semiconductors from Japan, the Republic of Korea, and Taiwan, China (Figure 5B). Meanwhile, lower import prices, particularly global commodity prices, resulted in a more pronounced decrease in China's imports in US dollar terms, which declined by 7.3 percent y/y in in the first four months of this year.

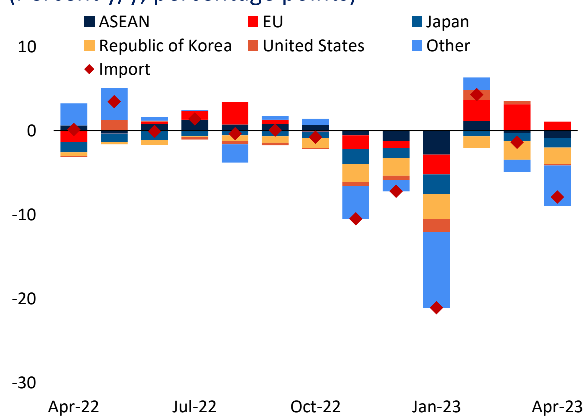
In contrast to still subdued goods import demand, China's outbound tourism surged, following the easing of travel restrictions. The growth rate of tourism spending soared to 46.5 percent y/y in the first quarter of 2023 to US$ 46.3 billion, as overseas travel gradually normalized. This upswing was the key driver behind the uptick in services imports which expanded by 12.8 percent y/y (Figure 5C). At the same time, intellectual property royalty payments, as well as financial and commercial services imports, continued to decline albeit at a slower rate than in Q4 2022, which could be linked to heightened geopolitical uncertainty. Meanwhile, services exports shrank by 13.3 percent y/y in 2023Q1, largely due to a substantial reduction in international freight costs compared to the same period last year (Figure 5D).

Figure 5. Exports have shown short-term resilience, while imports are recovering slowly

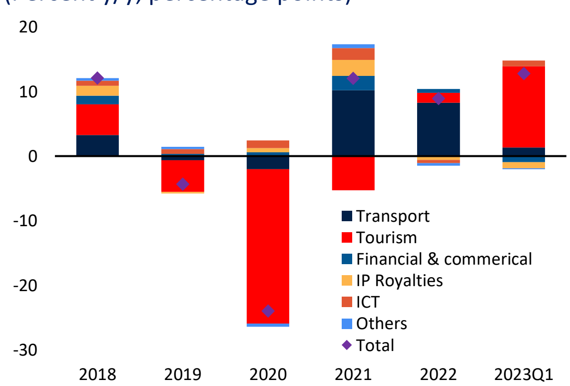
A. Goods exports by country
(Percent y/y, percentage points)



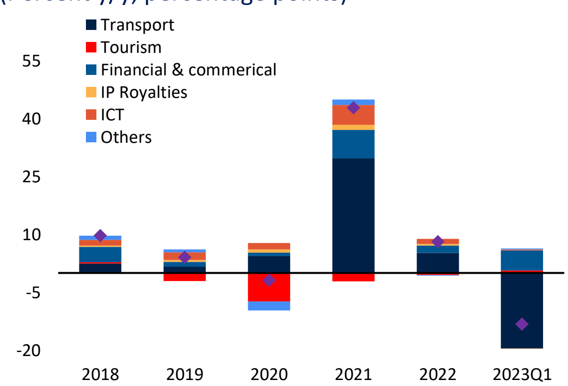
B. Goods import by country
(Percent y/y, percentage points)



C. Services import by category
(Percent y/y, percentage points)



D. Services exports by category
(Percent y/y, percentage points)



Source: China Customs; SAFE; World Bank.

The current account surplus persists

China maintained a current account surplus in the first quarter of 2023 thanks to a robust merchandise trade surplus. China's current account surplus expanded during the pandemic, due to the country's ability to swiftly restore production after each COVID-19 wave. The surplus of 2.0 percent of GDP in Q1 2023 also reflects suppressed import demand coupled with resilient exports (Figure 6A). A substantial goods trade surplus of US$ 129.9 billion (3.1 percent of GDP) in Q1 more than offset the services trade deficit of US$ 47.0 billion (1.1 percent of GDP).

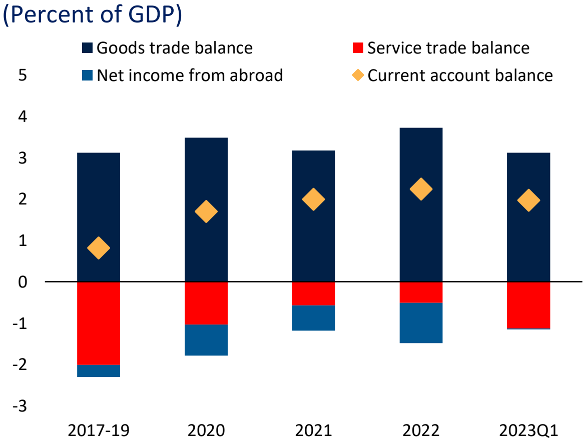
The financial account deficit widened slightly in Q1, as foreign investors remain cautious on long-term investments in China. The deficit inched up to 1.4 percent of GDP, up from 0.9 percent of GDP in Q4 2022, primarily driven by larger net Foreign Direct Investment (FDI) outflows amounting to 0.7 percent of GDP (Figure 6B). In particular, FDI outflows increased as China's enterprises advanced investment in wholesale and retail trade and logistics abroad. FDI inflows into China decreased, which likely reflects subdued global demand growth prospects and lingering risks to China's domestic recovery but could also be in part due to geopolitical uncertainty weighing on foreign investor sentiment. High-frequency market data suggest that net portfolio investment outflows slowed to the tune of US$ 8.5 billion in Q1 2023, compared to US$ 13.9 billion in Q4 2022. Net equity inflows increased on the back of China's reopening, which partially offset outflows from the bond market, caused by narrowing interest rate differentials between China and other major economies.

Capital outflows combined with broader US dollar strength caused a weakening of the RMB. The RMB depreciated against both the US Dollar and on a trade-weighted basis, despite a large current account surplus (Figure 6C). Year to date, the RMB has fallen by 3.7 percent against the US dollar. China's external buffers remain robust. Foreign exchange reserves increased by US$ 77.1 billion in the first four months of this year to US$ 3.2 trillion at the end of April (Figure 6D).

Figure 6. Current account surplus remained large, while financial account deficit widened

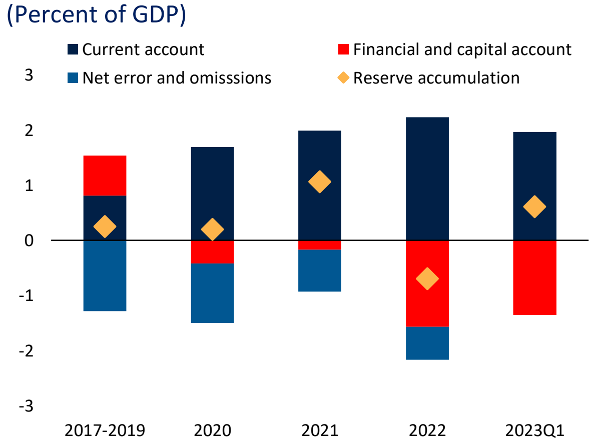
A. Current account balance

(Percent of GDP)



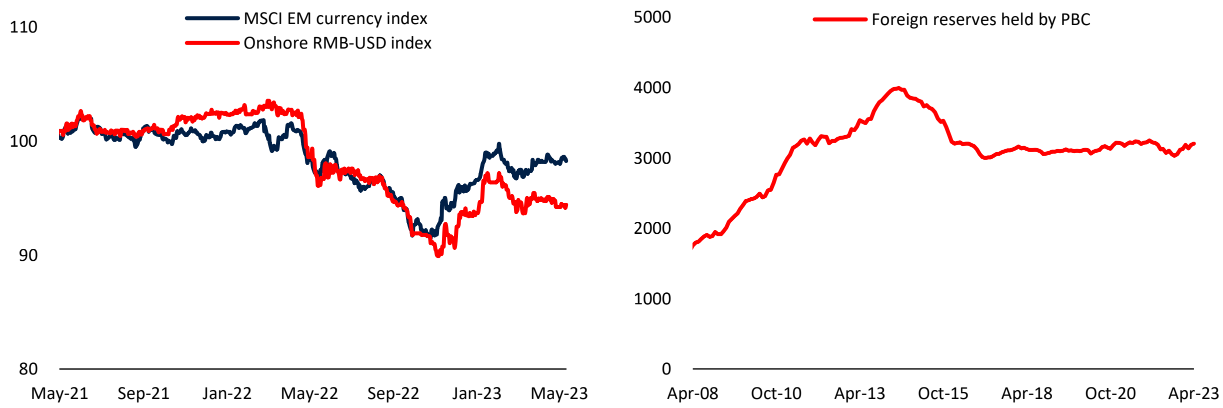
B. Net capital outflows

(Percent of GDP)



C. Exchange rate
(Index, December 31, 2020 = 100)

D. Foreign reserve accumulation
(Billion USD)



Source: SAFE; Wind; World Bank.

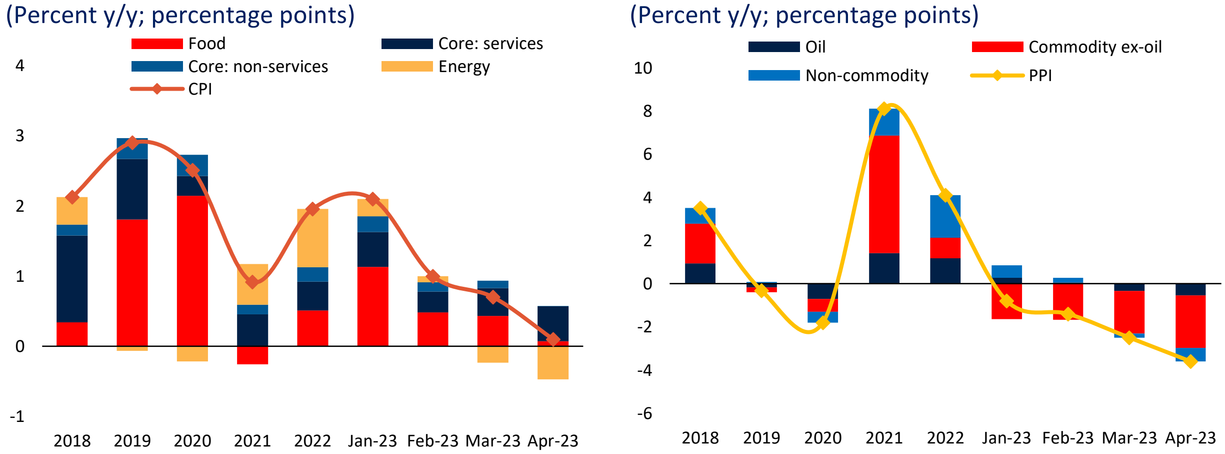
Despite improved demand, consumer inflation remains soft

China's consumer price inflation remained subdued in the first four months of 2023, reflecting the uneven consumer demand recovery. Headline inflation registered a moderate reading of 1.0 percent y/y in the first four months, primarily attributed to a decline in energy prices from a high base last year (Figure 7A). Meanwhile, core inflation excluding volatile food and energy prices, averaged 0.8 percent y/y between January and April 2023, significantly below the pre-pandemic average of 1.8 percent y/y. While services inflation picked up, goods inflation slowed, driven by lackluster demand especially for consumer durables amid still-cautious consumer sentiment.

Figure 7. Inflation has been subdued amid weak domestic and external demand

A. Consumer price inflation
(Percent y/y; percentage points)

B. Producer price inflation
(Percent y/y; percentage points)



Source: NBS; World Bank.

Producer price inflation has trended down for most of this year on falling global oil and metal prices. PPI inflation averaged -2.1 percent y/y in the first four months of 2023 and has fallen for seven consecutive months. This has largely been driven by the decline in oil prices from last year's high base, lower ferrous metal prices stemming from a sluggish housing construction sector, and subdued domestic and external goods demand (Figure 7B).

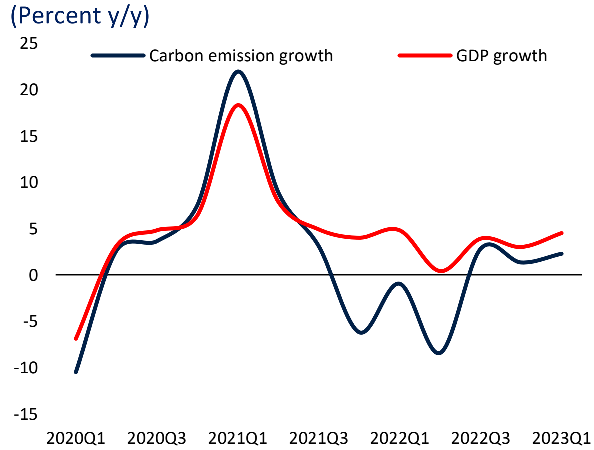
Carbon emissions increase moderately amid services-led recovery

China's carbon emissions saw moderate growth in the first quarter of 2023 amid a services-led recovery. After low growth in 2022, China's carbon dioxide (CO_2) emissions are estimated to have increased by 2.3 percent y/y in the first quarter of 2023 (Figure 8A). The consumption and services-led recovery has resulted in a more gradual increase in carbon emissions compared to the investment-driven rebound seen in late 2020 and early 2021. Growth in the first quarter of 2023 was primarily driven by the rebound in industry, which contributed 1.7 percentage points to total emissions growth. The power sector contributed a limited 0.5 percentage points to this growth and ground transport emissions 0.4 percentage points. Residential emissions contributed a negative 0.5 percentage points, likely due to the reopening resulting in less time being spent in homes (Figure 8B).

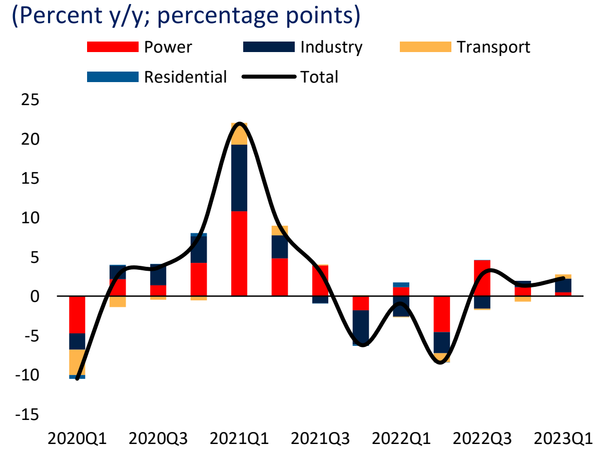
Recent developments in the energy sector emphasize the challenges of decarbonization: substantial investments in renewable energy alongside surging coal production and imports. The prioritization of energy security in response to the 2021 energy crisis has meant that coal imports have continued to surge, increasing 97 percent y/y in the first quarter of 2023. This partially reflects the low base effect from the first quarter of 2022, but imports were still significantly higher than pre-pandemic levels, with this first quarter value still being 76 percent higher than in the first quarter of 2019. Meanwhile, after rapid growth in new coal power plant approvals during the second half of 2022, which saw over 10GW of approvals on average each month, new approvals slowed somewhat to a total of 10GW of capacity in the first quarter of 2023. However, solar capacity installations also grew rapidly in the first quarter of 2023 by 34 percent y/y, while renewable energy generation rose 11.4 percent y/y.

Figure 8. Carbon emissions grew moderately in the first quarter of 2023

A. Carbon emissions and GDP growth
(Percent y/y)



B. Contribution to y/y growth by sector
(Percent y/y; percentage points)



Source: Carbon Monitor for emissions data; World Bank.

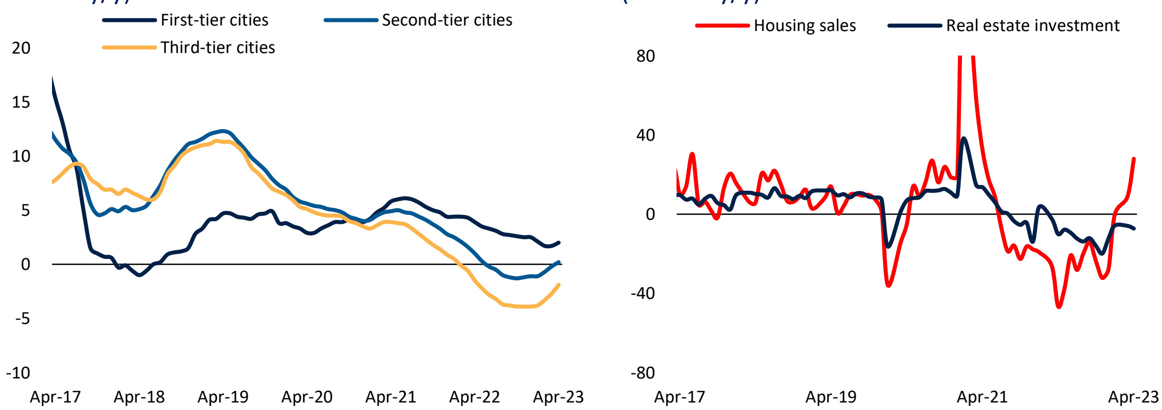
The housing market recovery remains uneven

The housing market recovery is concentrated in large cities and driven by existing project completion boosted by policy support, while housing starts and investment remain subdued. Following an extended downturn, sales of new homes in value terms rose by 8.8 percent y/y in January-April 2023. This is partially explained by a low base in the first four months of 2022 but also reflects tentative signs of recovery. Home prices in first- and second-tier cities, also increased. These improvements can be largely attributed to economic reopening, which unleashed pent-up demand, and measures to allow lower mortgage rates for first-time buyers (Figure 9A). However, while property completions increased on the back of policy support to complete pre-sold but stalled projects, real estate investment dropped by 6.2 percent and housing starts by 21.2 percent in the first four months of 2023, indicating that a sustained recovery will take time to materialize (Figure 9B).

Figure 9. Housing market is showing signs of an incipient stabilization

A. New home prices across tier cities
(Percent y/y)

B. New home sales and real estate investment
(Percent y/y)



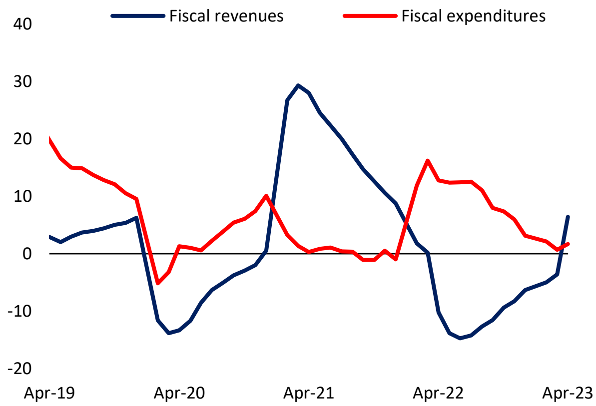
Source: NBS; Wind; World Bank.

Fiscal pressures especially at the subnational level persist

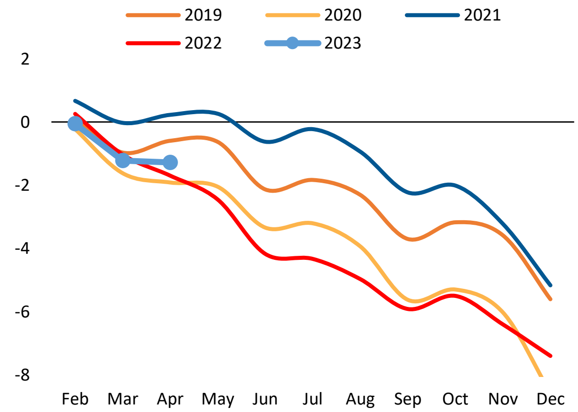
Both revenues and expenditures remained weak in the first four months of 2023, raising the risk of under-execution of the Budget. Income from the sale of land use rights declined by 21.7 percent y/y (-23.3 percent in 2022), reflecting the persistent weakness in real estate investment. In addition, tax revenues decreased, as consumption and personal income taxes declined and more than offset increases in VAT and corporate income tax collection. On the spending side, consolidated fiscal expenditure rose only by 1.7 percent y/y in the first four months of 2023, led by increased spending on education, social security and employment (Figure 10A). Spending on social security and public health remained elevated in January-February but declined notably afterward as the COVID-19 wave faded. Overall, with higher revenues the consolidated fiscal deficit narrowed to 1.3 percent of GDP in January-April 2023, compared to a deficit of 1.7 percent of GDP in the same period last year (Figure 10B).

Figure 10. Both fiscal revenues and expenditures remained weak

A. Growth in fiscal revenues and expenditures
(Percent y/y, ytd)



B. Consolidated fiscal deficit
(Percent of GDP)



Source: Ministry of Finance (MOF); World Bank.
Note: China's budget system consists of (i) the General Public Budget which includes tax and non-tax revenues, current expenditures, and a portion of capital expenditures; (ii) the Government Fund Budget which reflects mainly land-lease revenues of local governments and expenditures for specific infrastructure and social projects; (iii) the Social Security Fund Budget which records social insurance contributions and disbursements; and (iv) the SOE Fund Budget which is the state-owned assets operation budget. The consolidated budget balance refers to the sum of (i), (ii), (iii), and (iv) minus net withdrawals from the government's stabilization fund. Data on (iii) and (iv) are only reported at annual frequency. In the General Public Budget, local government revenues exclude transfers from central budget, and central government expenditures exclude transfers to local governments.

Local governments continue to face pressure from weak land sales, which will be partly compensated for by higher transfers from the central government. Amid a gradual stabilization of the property market, the government expects revenues from land sales to remain at levels similar to last year's. The remaining financing gap in 2023 will be filled by higher central government transfers to local governments, issuance of government bonds, and a drawdown of fiscal reserves. The total annual bond financing quota used to fund infrastructure investment is set at RMB 7.7 trillion (5.9 percent of GDP) for 2023, compared to RMB 7.5 trillion in 2022.

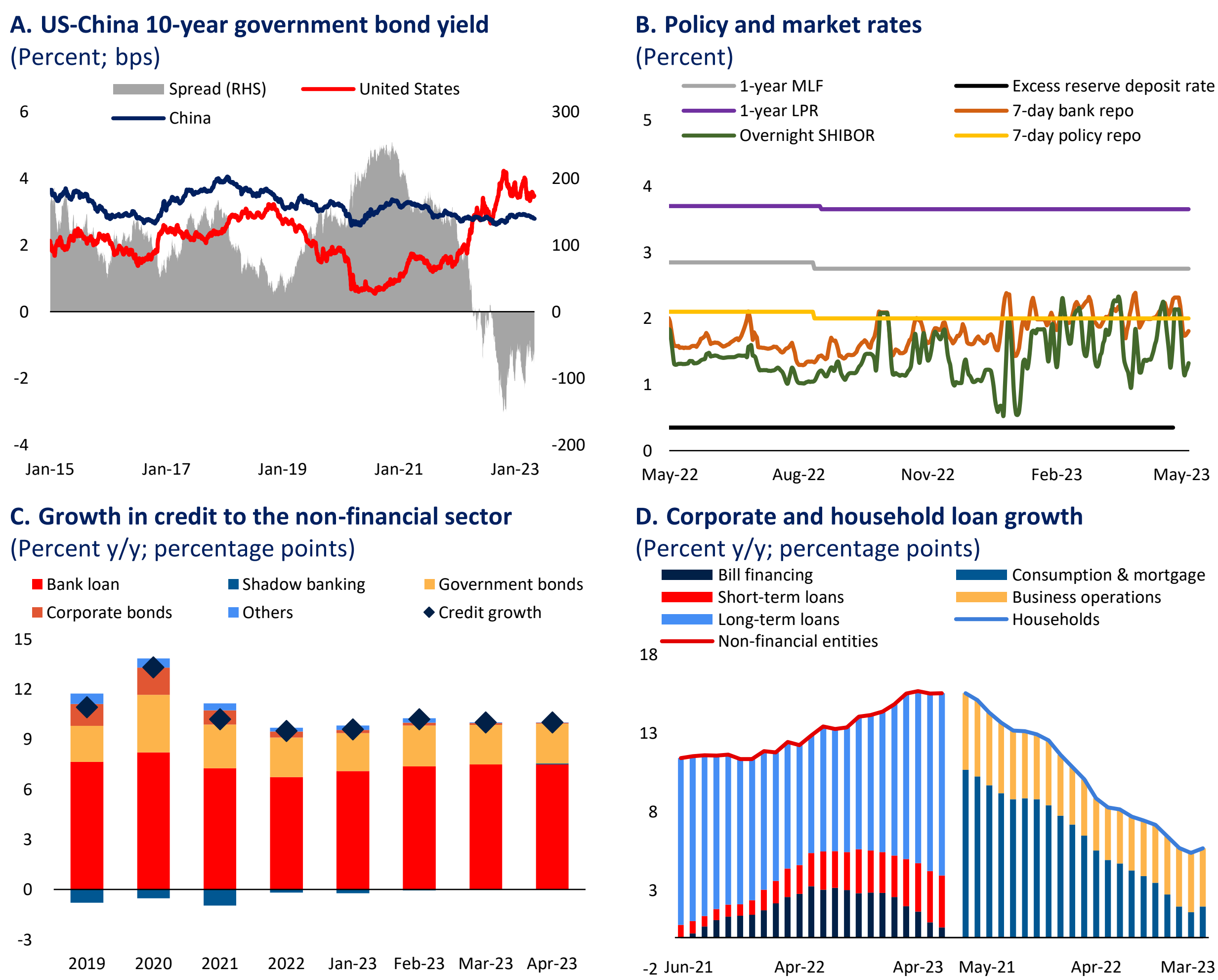
Credit demand picked up following the reopening

The People's Bank of China (PBC) has maintained a moderately accommodative but cautious policy stance, reflecting concerns over capital outflows and financial stability risks. The PBC has relied less on interest rate cuts (35 basis points in 2022 for 5-year LPR but no cut so far in 2023) and more on lowering the required reserve ratio for banks (60 bps in 2022 and an additional 25 bps in 2023). Given high non-financial sector debt (see next section), the authorities have tried to balance short-term support to the economy with longer-term efforts to limit the rise in leverage. The policy divergence with other major central banks that raised sharply interest rates has also constrained the PBC's room to maneuver due to concerns over capital outflows. The spread between China's 10-year central government bond yield and the corresponding US Treasury yield has been negative since April 2022 (Figure 11A). Despite liquidity provision by the

PBC, short-term market interest rates have been volatile since December 2022, likely reflecting higher uncertainty following the easing of COVID-19 policies (Figure 11B).

Following subdued credit demand in 2022, growth in credit to the non-financial sector picked up with the economic reopening. Growth in credit to the non-financial sector increased to 9.8 percent y/y in the first four months of 2023, from an average of 9.5 percent y/y in 2022 (Figure 11C). The pick-up in credit growth was due to a rise in corporate credit, improvements in consumer credit and mortgages, and higher issuance of government bonds. Continued support for infrastructure projects drove the expansion in corporate loans, likely through policy banks, and acceleration in government bond issuance. Both short-term and long-term household loan growth increased, reflecting some improvement in confidence, as well as policy support in the form of lower mortgage rates (Figure 11D).

Figure 11. The PBC has maintained a moderately accommodative but cautious policy stance



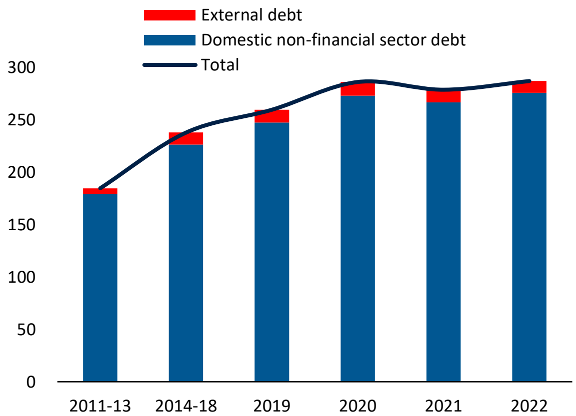
Source: PBC; Wind; CEIC; World Bank.
Note: Credit growth in Figure C refers to y/y growth rate of total social financing (excluding equity).

Amid the pick-up in credit growth, debt continues to rise

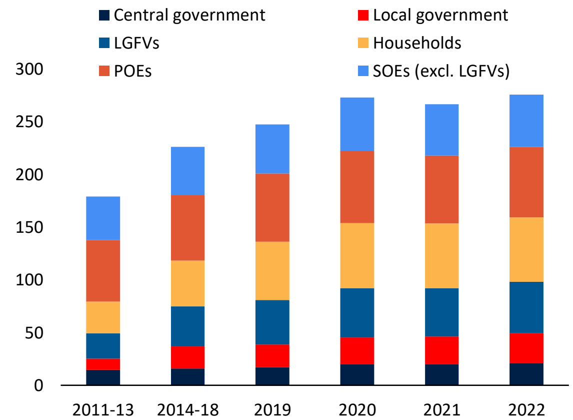
China's debt-to-GDP ratio increased to a new high in 2022. Non-financial sector debt, including external borrowing, increased to an all-time high of 287 percent of GDP (Figure 12A). A sharp slowdown in economic growth, combined with higher borrowing to finance a large state-sector stimulus, led to a sharp increase in the domestic non-financial debt ratio by almost 10 percentage points. Total external debt on the other hand has remained low and even declined slightly by 1 percentage point to an estimated 11.2 percent of GDP at end-2022. Overall, the total debt-to-GDP ratio is 27 percentage points higher than its pre-pandemic level.

Figure 12. Debt level surged to a new high

A. Composition of total non-financial sector debt
(Percent of GDP)



B. Domestic non-financial sector debt
(Percent of GDP)



Source: PBC; Wind; CEIC; World Bank.
Note: Figure B. LGFVs = Local government financial vehicles; POE = Private-owned enterprise; SOE = State-owned enterprise.

The increase in overall debt was driven by the corporate and government sectors. Household debt remained broadly stable in 2022 at 61 percent of GDP, as high uncertainty, sluggish growth in household income, and a weak housing sector constrained household leverage. On the other hand, credit easing measures implemented by the government contributed to the rise in corporate debt (Figure 12B). During the pandemic, the government relied heavily on infrastructure stimulus, while facing reduced revenues due to the downturn in the housing market, weaker overall economic activities, and tax cuts. The financing gap of local governments, although partially offset by an increase in the inter-governmental fiscal transfers, contributed to the rise in local government debt. This has raised concerns about the risks of local government debt in some highly leveraged provinces (see Box 1).

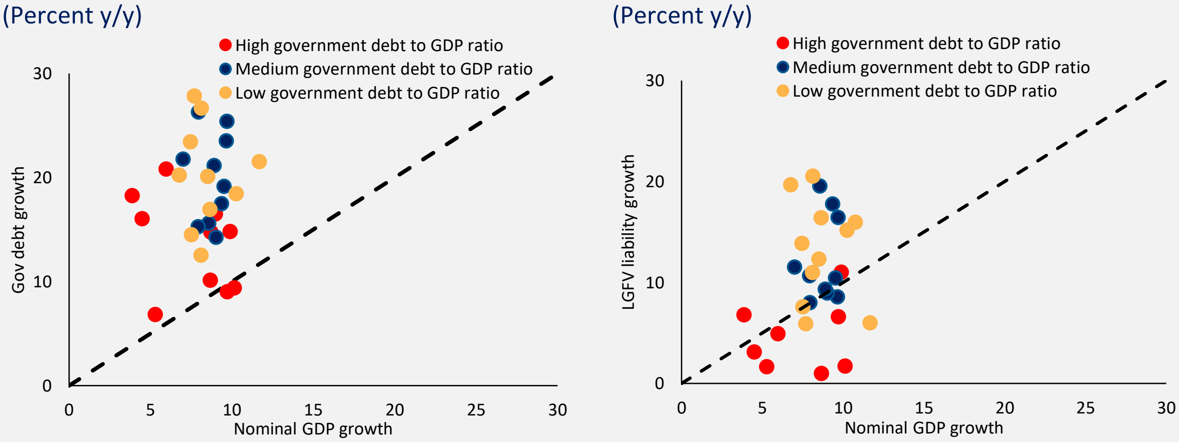
Box 1. Local government debt in China – a cross-provincial analysis

During the COVID-19 pandemic, local government debt expanded rapidly. Nationwide, the local on-budget government debt ratio, measured as government bonds outstanding as a percent of nominal GDP, increased by 7.3 percentage points to 29 percent of GDP from 2019 to 2022. LGFV debt also increased but at a slower pace, which is in part due to efforts to shift towards more transparent on-budget financing since the 2014 budget reform (World Bank, 2017).[2] In almost all provinces, on-budget government debt grew at a faster rate than nominal GDP growth (Figure 13A). However, balance sheet constraints have emerged for some highly leveraged provinces—growth in both local government debt and LGFV liabilities was relatively low in those localities (Figure 13B).

Figure 13. Local governments resorted to on- and off-budget financing during the pandemic

A. GDP and government debt growth
(Percent y/y)

B. GDP and LGFV liability growth
(Percent y/y)



Source: Wind; NBS; World Bank.
Note: High, medium and low government debt-to-GDP ratio in Figure A are defined as top, middle and bottom terciles, respectively.

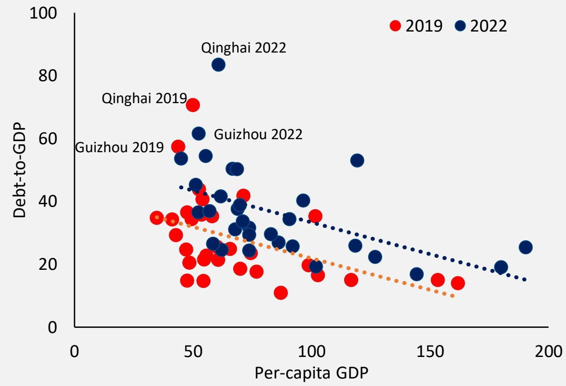
The market increasingly prices a higher risk premium for more leveraged provinces which are also often poorer. Average bond rates are higher for LGFVs in more leveraged provinces with lower per capita GDP (Figure 14AB). Market risk pricing that better reflects creditworthiness can be an effective mechanism for promoting responsible borrowing behavior.

[2] Under the 2014 Budget Law, local governments bear no legal responsibility for the financial obligations of LGFVs. However, many LGFVs produce public goods and services (e.g., public infrastructure) and rely substantially on government financial support such as land transfers, subsidies, grants, and credit guarantees. Hence, some LGFV debt can be considered contingent government liability. Ideally, the "market test" to determine if an LGFV is a public or market unit should be done on a case-by-case basis, as some LGFV activities could be commercial operations. However, the detailed financial statement data required for case-by-case analysis are not publicly available (Mano and Stokoe, 2017). Hence, the LGFV estimates in this analysis are subject to limitations.

Figure 14. Bond financing costs for LGFVs were higher in highly leveraged poorer provinces

A. Debt-to-GDP ratio and LGFV bond rates
(Percent; percent)

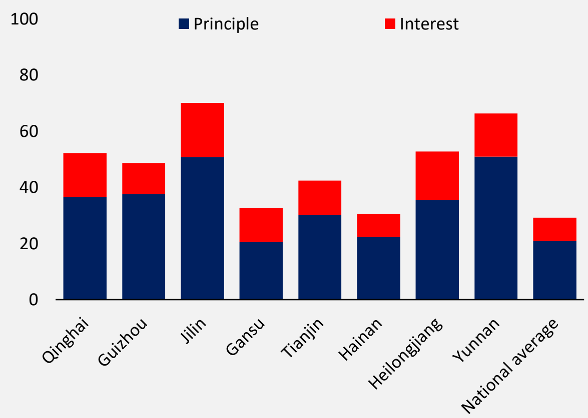
B. Debt-to-GDP ratio and per-capita GDP
(Percent; RMB thousand)



Source: Wind; NBS; World Bank.
Note: Interest rate in Figure A refer to average coupon rates for three-year LGFV bonds.

Concerns over local government debt stress have risen amid the housing market downturn. Regulatory tightening, intended to curtail excessive leverage, led to a severe downturn in the property sector. As a result, local governments experienced a significant decline in land sales which represent a major source of subnational government revenue. At the same time, debt service costs increased substantially, particularly in some highly leveraged provinces (Figure 15). Meanwhile, LGFVs—which are heavily involved in the property market—could face idiosyncratic risks, particularly in low-income regions with higher local government debt and, possibly, large stocks of unfinished housing (IMF 2023). In addition, the refinancing risks for LGFVs have risen, as the average maturity for LGFV bonds decreased to 4.8 years in 2022, from 5.7 years in 2018.

Figure 15. Government debt service
(Percent of consolidated fiscal revenue)



Source: Wind; NBS; World Bank.

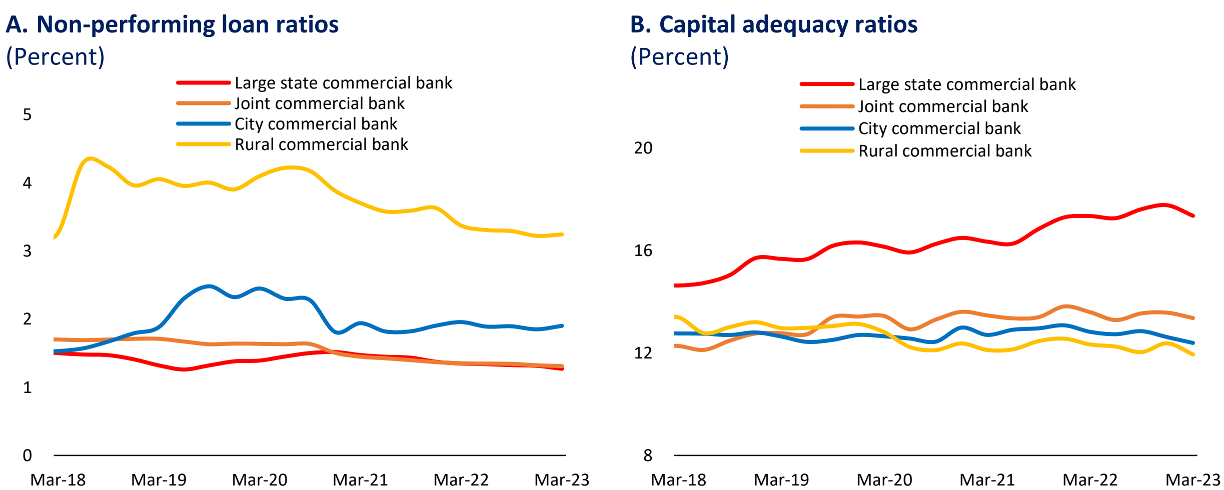
As economic activity is gradually normalizing, the government could shift the focus on containing debt risks. The central government could bear a larger fiscal deficit and more debt to mitigate sub-national debt risks. It could also allow greater flexibility to rebalance public spending from infrastructure investment toward more social spending, which would likely generate long-term returns to human capital formation. This could be combined with reforms to increase spending efficiency and enhance revenue autonomy. For example, recurrent property tax assigned to subnational levels would help raise revenue and make richer provinces less dependent on central transfers, thereby freeing up fiscal space for higher transfers to less developed provinces. SOE reforms, including improving corporate governance, increasing financial transparency, and restructuring unprofitable entities, would further help to contain sub-national off-budget debt risks.

The banking sector is vulnerable to property sector risks

Non-performing loans (NPLs) have continued to decline, but NPL ratios for rural banks remain higher than for other financial institutions. The reported aggregate NPL ratio continued to decrease, standing at 1.62 at the end of March 2023, lower than pre-pandemic levels (Figure 16A). While NPLs decreased for all banks, they dropped more significantly among city and rural commercial banks. However, credit risk for rural banks remained significantly higher than for other financial institutions: the NPL ratio for rural commercial banks was 3.24 percent. Moreover, regulatory forbearance may have masked the underlying deterioration of credit quality in the banking sector. Several forbearance measures that were introduced during the COVID-19 pandemic remain in place. These include the delay in the recognition of NPLs and flexible repayment arrangements for borrowers.

The banking sector has substantial exposure to the property sector. As of 2023Q1, mortgage loans totaled RMB 40.6 trillion, representing 18 percent of total bank loans, while direct loans to property developers amounted to 5.9 percent of total loans.[3] The exposure of banks to mortgages is mitigated by relatively high down payments. Property-related NPLs are relatively low but are higher than overall NPL ratios for state-owned banks, city commercial banks, and joint stock banks (World Bank, 2022a). While aggregate risks are relatively contained, some individual banks with large exposures to key property developers may face balance sheet pressures.

Figure 16. The banking sector appears sound, with rural banks remaining more at risk



Source: National Financial Regulatory Administration (former CBIRC); Wind; World Bank.

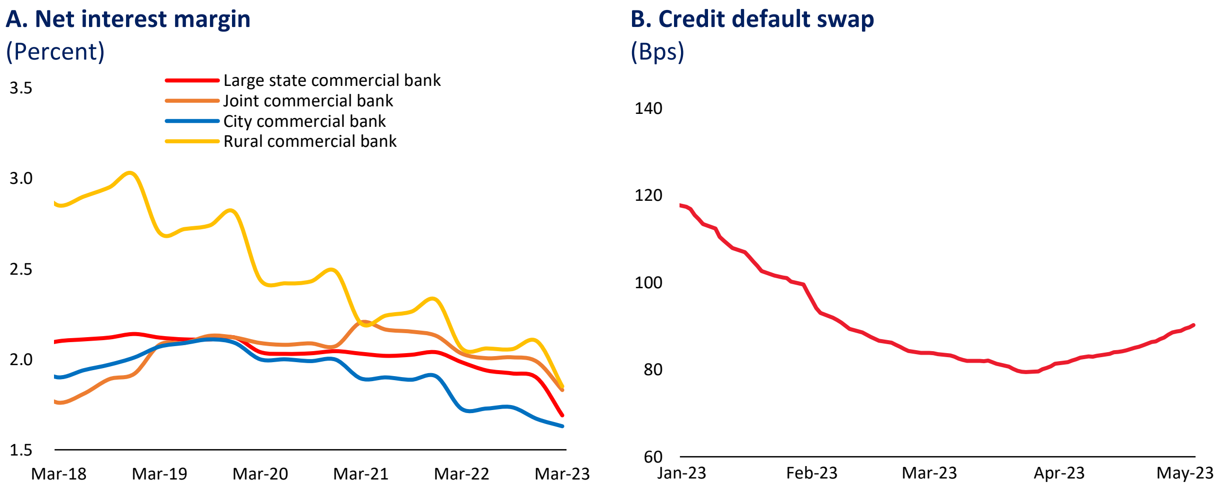
Banking sector buffers appear adequate overall, though they decreased slightly in 2023Q1. The aggregate capital adequacy ratio (CAR) of commercial banks declined marginally from the peak

[3] Property developers also depend on shadow credit (e.g., trust loans).

of 15.2 percent reached in December 2022 to 14.9 percent in March 2023. Yet, China's capital adequacy ratio remains significantly above the prudential minimum requirement of 10.5 percent. Large state banks, which account for roughly half of total commercial bank assets, reported a decrease in CAR from 17.8 in 2022Q4 to 17.3 in 2023Q1. The capital adequacy of rural commercial banks remains the lowest in China's banking sector with a CAR of 11.9 percent (Figure 16B).

Bank profitability has been declining since the start of the pandemic, as banks were encouraged to support the economy even as their funding costs were reduced only moderately. Net interest margins decreased further for all banks in March 2023, particularly among large state commercial banks and rural banks (Figure 17A). Regulators' calls on banks to support the economy and lend to sectors hit by the COVID-19 pandemic could have contributed to declining profitability. The market has responded to slightly weaker bank financials by requiring a higher credit risk premium (Figure 17B).

Figure 17. Bank profitability has declined



Source: National Financial Regulatory Administration (former CBIRC); Bloomberg; Wind; World Bank.
Note: Figure B shows the average of the largest ten banks in terms of gross assets.

II. Outlook, Risks, and Policy Implications

Global outlook

Following a sharp slowdown in global growth last year, China will continue to face a challenging external environment. According to World Bank projections, global growth is expected to slow further this year, to 2.1 percent, before picking up only modestly to 2.4 percent in 2024 (Figure 18A; World Bank 2023). The drag on activity from continued substantial monetary policy tightening to restore price stability is increasingly evident in interest-rate sensitive sectors. Moreover, recent turmoil in European and US banking sectors has contributed to tighter financial conditions and added to uncertainty. While global headline inflation has declined owing to a combination of base effects, easing supply chain pressures and moderating global commodity prices, it remains above target in most inflation-targeting economies and underlying inflation pressures persist.

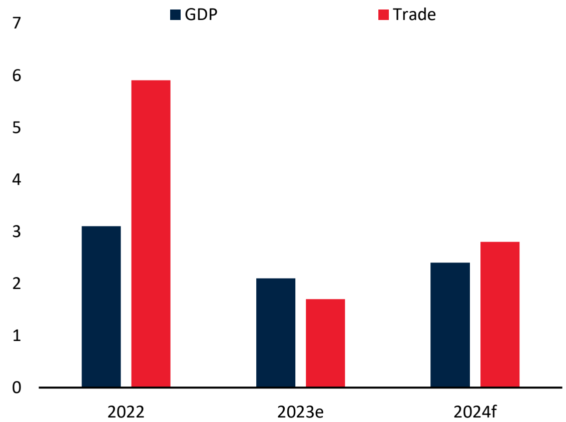
Global trade is expected to slow this year, alongside weakening global activity and a rotation in global demand away from tradeable goods, back towards its pre-pandemic composition. In early 2023 global goods trade contracted, as weak demand in advanced economies weighed on exports in emerging market and developing economies (EMDEs). Slowing demand for goods and falling freight costs have contributed to the return of global supply chain pressures to pre-pandemic levels early in the year. Global services trade has fared better, supported by the ongoing recovery in global tourism amid an easing of pandemic-induced mobility restrictions. Global trade growth is expected to recover only modestly in 2024, in tandem with global activity but dampened by a rising number of restrictive trade measures.

Risks to the global outlook are tilted to the downside. Persistent underlying inflation pressures may result in tighter than expected monetary policy, which would further weigh on growth. Additional banking sector stress could also lead to tighter than expected financial conditions, with the risk of disorderly bank failures sparking systematic financial crises and protracted economic losses. Geopolitical tensions have worsened—as reflected in the rising number of protectionist measures—and could intensify, sapping productivity growth, increasing prices, and dampening investment, all of which would weigh on growth. Conversely, growth could be stronger than expected if the recent signs of resilience in major economies in the face of substantial headwinds endures.

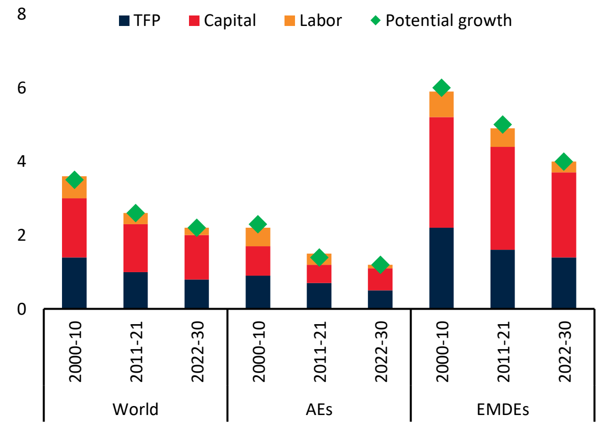
The materialization of downside risks could weaken global potential growth which, absent reforms, is already set to slow (Kose and Ohnsorge 2023). Over the remainder of the decade, average annual world potential growth is expected to slow to 2.2 percent, down from 2.6 percent in the preceding decade (Figure 18B). This expected slowdown reflects both demographic factors, including slowing working-age population growth and declining labor force participation as populations age, as well as weaker productivity growth. The decline in potential growth is expected to be widespread, affecting both advanced economies and EMDEs, and among EMDE regions the most pronounced slowdown is anticipated in East Asia and the Pacific.

Figure 18. External environment remains challenging

A. World GDP and trade growth
(Percent y/y)



B. Contribution to potential growth
(Percent y/y, percentage points)



Source: Penn World Tables, World Bank.
Note: AEs = advanced economies; EMDEs = emerging market and developing economies. 2022-30 are projections. Based on production function approach, GDP-weighted arithmetic averages for a sample of 29 advanced economies and 53 EMDEs.

China outlook

After slowing to 3.0 percent in 2022, China's GDP growth is projected to rise to 5.6 percent in 2023, led by a rebound in consumer spending. This marks an upward revision of 1.3 percentage points from the December *China Economic Update* which accounts for a faster-than-expected reopening in Q1 2023. Growth will be led by a recovery in consumer demand, particularly for services. Capital spending in infrastructure and manufacturing is expected to remain resilient. Net exports are expected to weigh on growth, due to softer external demand coupled with a modest acceleration in import growth reflecting improved domestic demand (Table 1).

Following this year's recovery, growth is expected to return to a path of structural deceleration. Economic growth is projected to slow to 4.6 percent and 4.4 percent in 2024 and 2025, respectively, partly due to structural and external factors. Trend growth usually declines as the economy matures, as higher levels of physical capital run into diminishing returns to the further accumulation of capital. In addition, China's mounting debt levels will constrain investment-driven growth in the future, while its demographic dividend has also started to fade with rapid population aging. Persistent income inequality and the high carbon intensity of China's economy pose additional challenges to medium-term growth and development. In addition, global per capita growth is expected to remain slower than in the decade before 2020 (World Bank, 2023), weighing on future demand for China's exports. And rising geopolitical tensions are contributing to a decoupling of supply chains and curtailing China's access to critical technology.

To support the ongoing recovery the macroeconomic policy stance is expected to remain relatively accommodative. Fiscal policy will likely be broadly neutral this year, with policy support consisting in large part of infrastructure spending. The consolidated budget deficit is set to widen to 6.5 percent of GDP in 2023, broadly unchanged from last year's realized deficit of 6.4 percent. Analysis conducted by the World Bank (2022b) shows that the spending multiplier is expected to be notably higher following the reopening of China's economy. Unless inflation moves well above target and capital outflows intensify, monetary policy could maintain a moderately accommodative stance to solidify the economic recovery. With average inflation projected at 1.8 percent in 2023, further monetary policy easing may be warranted until the recovery in domestic private demand is firmly established.

Policy easing in the property sector will be maintained in 2023, though still-weak housing demand and high developer debt continue to constrain the recovery. The authorities have steadily stepped-up support measures for the property sector, including lower mortgage rates, tax breaks for home buyers, looser home-purchase restrictions, a moratorium on developer loans, and a grace period for banks to comply with property sector exposure caps. However, much-needed developer debt restructuring continues to be slow. Persistent developer balance sheet constraints would mean a gradual recovery in this sector.

The current account balance is projected to narrow to 1.3 percent of GDP in 2023, reflecting a sharp decline in the trade surplus. Although exports have shown some resilience in March and April, China's export sector has been grappling with a marked decline in external demand due to weaker global growth. At the same time, import growth is expected to strengthen with the domestic demand recovery. Meanwhile, the resumption of outbound tourism activities is likely to widen the services trade deficit.

Headline inflation is expected to remain modest reflecting ongoing economic slack in labor markets and weaker global energy prices. Headline inflation is projected to remain below the official target of 3 percent. Core inflation will remain subdued since lingering economic slack, particularly in labor markets, is likely to offset potential upticks in services inflation.

Table 1. China selected economic indicators, 2020-2025

Annual percentage change, unless otherwise indicated	***2020***	***2021***	***2022***	***2023f***	***2024f***	***2025f***
Real GDP growth, at constant market prices	2.2	8.4	3.0	5.6	4.6	4.4
Private consumption	-1.8	11.7	0.9	10.9	5.6	5.4
Government consumption	3.2	3.3	4.2	2.7	3.5	2.9
Gross fixed capital formation	3.2	3.1	3.5	3.6	4.7	4.6
Exports, goods and services	1.7	18.3	0.5	-0.1	2.2	2.0

Imports, goods and services	-1.4	10.2	-3.2	2.0	2.8	2.6
Real GDP growth, at constant factor prices	2.2	8.4	3.0	5.6	4.6	4.4
Agriculture	3.1	7.1	4.1	3.1	3.0	3.0
Industry	2.5	8.7	3.8	3.4	3.8	3.5
Services	1.9	8.5	2.3	7.7	5.5	5.3
Inflation (Consumer price index)	2.5	0.9	2.0	1.5	2.4	2.0
Current account balance (% of GDP)	1.7	1.8	2.3	1.3	1.0	0.7
Net foreign direct investment (% of GDP)	0.7	1.2	0.2	0.5	0.3	0.3
Consolidated fiscal balance (% of GDP) *	-8.5	-4.0	-6.4	-6.5	-4.8	-3.9
Government debt (% of GDP)	45.4	46.9	51.0	53.8	55.4	56.0
Primary balance (% of GDP) *	-7.5	-2.9	-5.2	-5.2	-3.5	-2.7

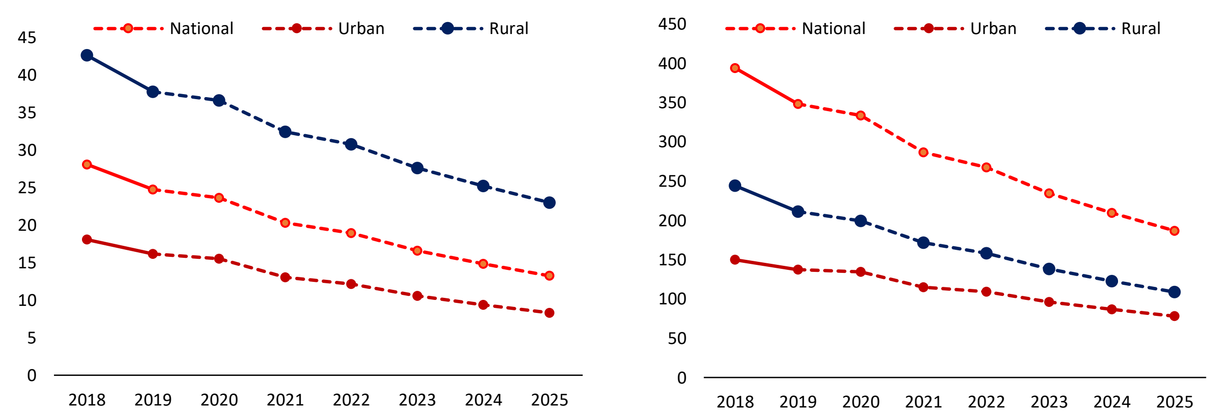
Source: World Bank.
Note: f = forecast (baseline). * World Bank staff calculations.

Poverty reduction has continued, with the pace expected to accelerate in 2023. While rural extreme poverty following the national definition (US$ 2.3/day per person in 2017 purchasing power parity (PPP)) has effectively been eliminated, about 19 percent of the population (267 million people) is estimated to have consumption levels below the World Bank's upper-middle-income poverty line of US$ 6.85/day per person (2017 PPP) in 2022 (Figure 19A). This would imply that 19 million people were lifted out of poverty in 2022, compared with 47 million estimated for 2021 (Figure 19B). The overall outlook for the economy suggests that the pace is likely to accelerate in 2023, with 33 million people estimated to be lifted out of poverty, reaching a similar pace to the pre-COVID years. The urban poverty rate is expected to decline faster than the rural rate, but continued urbanization means that the share of the poor residing in urban areas is projected to continue to grow.

Figure 19. Poverty reduction will continue, likely at a faster pace than in 2022

A. Poverty rate
($6.85 per person per day, percent)

B. Number of poor
($6.85 per person per day, millions of people)



Source: World Bank estimates using tabulated data from China's National Bureau of Statistics (NBS) and World Bank's GDP growth projections.
Note: Last grouped data available to calculate poverty is for 2019. Projections based on per capita GDP growth estimates, using a neutral distribution assumption with pass-through 0.85 to per capita household consumption.

Risks

Risks to the outlook are tilted to the downside. Sluggish income growth, lingering uncertainty about the recovery in the labor market, and high household precautionary saving could hold back consumer spending. Conversely, a faster job recovery could boost sentiment and contribute to higher consumption growth.

Although the property sector is showing signs of stabilization, structural issues have yet to be tackled and could weigh on the economic recovery. This is due to unaddressed vulnerabilities, including real estate developer balance sheet weaknesses and excess capacity in some property markets in lower-tier cities. In addition, prolonged weakness in home-buyer sentiment and in the labor market could weigh on housing demand.

Externally, risks are mainly to the downside and emanate from an uncertain global growth path, larger than expected tightening in financial conditions, and heightened geopolitical tensions. A materialization of such risks could increase policy uncertainty, disrupt trade, and hold back investment.

Policy implications: Pivot toward longer-term objectives

The economic recovery offers an important opportunity for policymakers to refocus their efforts on achieving China's longer-term development objectives. Structural reforms remain crucial to solidify the recovery and achieve the longer-term goals to (i) become a high-income country by 2035 through productivity-led and environmentally sustainable growth; (ii) peak carbon emissions before 2030 and become carbon-neutral by 2060; and (iii) share the gains from economic growth more equally among citizens.

To revive productivity growth, China will need to reply on innovation, technology adoption, and a more efficient allocation of resources. China has made investing in domestic innovation capacity a priority. To ensure that resources flow to the most productive sectors and firms deeper reforms to increase the role of markets, the private sector, and competition are needed. Weaker economic fundamentals during the pandemic and the tightening in anti-monopoly provisions in 2021 surprised markets and contributed to a deterioration in investor confidence. Ensuring greater regulatory predictability and transparency could help address market distortions without inhibiting investment. Likewise, critical SOE reforms, such as ensuring fair competition with private firms and facilitating the orderly exit of unprofitable SOEs would enhance the efficiency of capital allocation.

Rebalancing China's demand toward household consumption will be important to sustain a solid pace of economic growth. Historical drivers of growth —a high investment rate and strong exports—now contribute less to growth than in the past. For example, large infrastructure stimulus supported growth during the pandemic, but the returns on investment are lower today compared to earlier downturns. Because traditional infrastructure is no longer a constraint to growth in China, it now takes more infrastructure investment to produce a unit of output compared to a decade ago (World Bank and DRC, 2019). To prepare for future downturns, policymakers could expand the coverage and benefit adequacy of China's social safety nets and ensure portability of benefits across provinces. This in turn would not only build automatic fiscal stabilizers that could be deployed during downturns but also lower precautionary saving (which rose substantially during the pandemic) and help rebalance the economy towards private consumption-driven growth.

To sustain robust growth beyond the short term, China will also need to address the high level of indebtedness in the economy which may be constraining investment. With the economy already on a recovering trajectory, this offers a good opportunity for policymakers to re-focus on reducing financial risks. Stronger institutions to manage insolvency, firm restructuring, and bankruptcy could facilitate the exit of unviable firms and the allocation of resources toward more dynamic and productive firms. In the property sector, deep-seated vulnerabilities including high leverage and excess capacity in some property markets remain unaddressed. Complementing short-term regulatory easing and liquidity support with more decisive efforts to develop a framework for dealing at scale with the debt overhang could help return the sector to more robust and sustainable growth while containing financial risks.

Achieving China's carbon neutrality goal by 2060 will require restructuring of the relatively carbon-intensive energy, industry, and transport sectors, cities, and land use patterns. This will require significant public and private investment—an additional US$ 14-17 trillion (1.1 percent of GDP) from now until 2060 for green investments in the transport and electricity sectors (World Bank, 2022c). Decarbonization will also require the right incentives. Economy-wide use of carbon pricing, including through the Emissions Trading Scheme, will provide the correct incentives and price signals to businesses for green investments and innovation and to households to green their consumption patterns. The low-carbon transition of the power sector, the largest source of emissions, will need to come first to achieve the rapid decline in emissions necessary to meet the country's carbon goals. The rise in global energy prices in 2022 raised concerns over energy security in many countries. In China, this led to a sharp increase in approvals for new coal-fired power plants in 2022. China's National Energy Administration (NEA) guidance states that new coal power plants should only be permitted to support grid stability. Heightened scrutiny of the approval of new coal power plants and the implementation of the NEA's guidance will be critical to both meet climate targets and avoid inefficiency and future economic losses.

Finally, there are two key areas of reform to address the challenge of inequality in China: the hukou system and fiscal policy. The hukou system can be further liberalized to extend access to public services to migrant workers. On the fiscal revenue side, the authorities could increase the tax base and progressivity of the personal income tax and introduce a property tax. On the expenditure side, spending could shift from infrastructure to social services to improve the quality of education and health in lagging regions and rural areas. The government could also strengthen the social safety net by increasing coverage and benefit levels. The next chapter of the report explores the scope for fiscal policy to help reduce inequality in more detail.

Table 2. Policy measures to support longer-term objectives

Area	Policy recommendations
Macroeconomic rebalancing	• Extending hukou liberalization in all urban areas • Strengthen social safety net by increasing coverage and benefits, while ensuring its sustainability through parametric changes such as increasing the retirement age • Establish a unified national social security system with portable pension and unemployment benefits for rural and urban residents • Further reforms to increase local government revenues, including implementing a property tax at an appropriate time • Increase the progressivity of the personal income tax • Reorient fiscal efforts toward social spending and safety nets to facilitate the rebalancing from investment to consumption • Abolish growth targets to reduce local government incentives for debt-financed infrastructure spending
Real Estate/ Deleveraging	• Strengthen insolvency and debt resolution framework and institutions to facilitate the exit of unviable firms and reduce leverage • Broaden financing options for developers, including greater reliance on Real Estate Investment Trusts (REITs) • Strengthen rules to safeguard pre-sale funds to protect home buyers • Expand the range of financial assets available to households
Private sector	• Promote stable and predictable regulatory environment • Ensure level playing field between SOEs and non-SOEs through ensuring competitive neutrality, removing implicit guarantees, and fostering the orderly exit of unprofitable SOEs • Further liberalize trade in services and digital trade • Reduce the list of sectors restricted to foreign investment to those related to national security.
Green transition	• Market-focused reforms to energy markets and the ETS to provide the correct incentives and price signals • Structural reforms to mobilize markets to guide the allocation of capital, land, labor, and R&D investment to enable the economy to respond efficiently to changing price signals and regulations • Deepen integration of electricity markets to ensure efficient utilization of renewable generation assets • Decarbonize transport by pricing, regulatory measures, infrastructure investments, and technological innovation • Reduce subsidies for coal-intensive industries • Invest in the development of new technologies, including carbon capture and storage • Targeted fiscal support to people and communities would be needed to offset the expected negative and regressive welfare impact of the transition

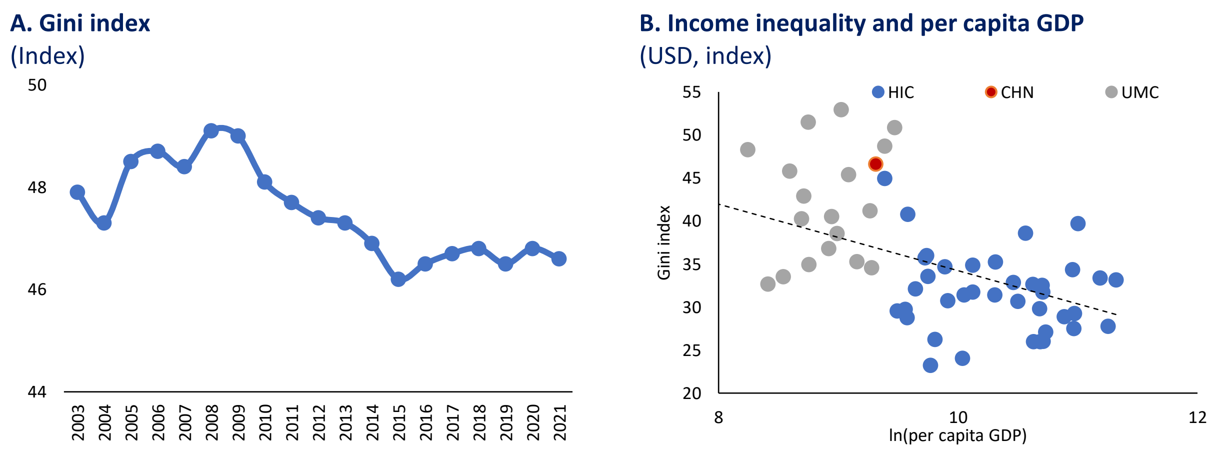
III. Fiscal Policy for Inclusive Growth

The challenge of inequality

China's impressive economic performance over the last four decades has resulted in unparalleled improvements in living standards and poverty reduction. The rapid transformation of the economy—from agriculture to labor-intensive manufacturing and services, as people moved from rural to urban areas and found better jobs—sustained strong growth over 40 years, raised average incomes, and lifted close to 800 million Chinese out of poverty (World Bank and DRC 2022). This transformation was supported by a multi-pronged strategy that included investments not only in physical capital but also in human capital by improving and expanding education and health services.

Since the 2000s, policymakers turned to place-based fiscal support, public investment targeting rural areas and lagging provinces, and social assistance transfers to address growing concerns over inequality even as poverty kept declining.[4] Disparities between urban and rural areas and between Eastern and Western regions rose in the first two decades of China's economic transformation. In response, starting in the mid-2000s, public investments in lagging regions combined with a rise in the minimum wage, the end of agricultural taxes, and an increased role for social protection policies helped narrow the urban-rural and regional gaps (World Bank, 2020). Income inequality, as measured by the Gini coefficient reported by NBS, peaked in 2008, declined for several years, and has recently stabilized at a relatively high level (Figure 20A). Still, with a Gini coefficient at 46.6 in 2021 (latest available estimate) inequality remains high for China's level of development (Figure 20B).

Figure 20. Inequality in China remains relatively high compared to peers



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[4] See World Bank and DRC (2022) for a detailed analysis of policies that drove China's success in eliminating poverty and expanding economic opportunities.

Source: Panel A: NBS Household Survey Yearbook; Panel B: NBS, World Bank Poverty and Inequality Platform, and WDI; World Bank.
Note: Year corresponds to the latest year with information on Gini index (varies by country). Only countries that report income inequality (not expenditure) are included. HIC: High income country; CHN: China; UMIC – Upper-middle income country.

Reducing inequality remains an important priority as China pursues its longer-term development objectives. The economy will need to rebalance from an investment- and export-led model based on high-carbon industry and low-cost, labor-intensive manufacturing toward one led by domestic consumption, services, and increases in productivity (World Bank and DRC, 2019). A larger share of income for the bottom of the distribution could support that transition, as poorer households tend to spend a larger share of their marginal income. China's green transition can also be facilitated through policies to ease labor mobility from high-carbon to low-carbon sectors, as well as measures to strengthen the social safety net to ensure that those adversely affected by the transition are not left behind (World Bank, 2022c). In addition, China's population aging requires further investment in human capital potential to compensate for a shrinking labor force (World Bank and DRC, 2022). Closing gaps in access to quality public services will be key to ensuring equal economic opportunities and increased social mobility for future generations.

Recognizing the challenge of inequality, China's government has made achieving "common prosperity" a priority. Policymakers continue to target sufficient economic growth that creates jobs and boosts household incomes. In addition, they also emphasize "the roles of taxation, social security, and transfer payments in regulating income distribution".[5]

Against this backdrop, this focus chapter explores to what extent China's fiscal system contributes to reducing inequality and whether there is space to do more. The research underpinning the chapter combines information from a nationally representative survey of Chinese households in 2018, the China Family Panel Survey (fifth wave), together with fiscal and administrative data for 2018 from the 2019 China Statistical Yearbook to conduct this analysis.[6] The analysis covers a subset of the fiscal system, assessing taxes and social sector spending that accrue directly to households. Spending on infrastructure, for example, or corporate income taxes, which are more difficult to assign to households are not covered in the analysis. The following sections highlight some key findings and draw a few policy conclusions.

[5] See, for example, Report to the 20th National Congress of the Communist Party of China (October 16, 2022) and Report on the Implementation of the 2022 Plan for National Economic and Social Development and on the 2023 Draft Plan for National Economic and Social Development (March 5, 2023).

[6] China Family Panel Survey (CFPS) is a nationally representative biennial longitudinal survey conducted by the Institute of Social Science Survey (ISSS) of Peking University. The CFPS has a smaller sample size compared to the official survey conducted by NBS. The CFPS has been used in other empirical studies when micro data are not available (see, for example, Kanbur et al 2021).

Who benefits, and who pays?

How governments spend and collect revenues can have implications for inequality. When essential services such as education are provided free of cost to segments of the population who may otherwise be unable to send their children to schools, public resources are redistributed to close income gaps between the rich and the poor. The same effect is achieved when targeted cash assistance is provided to the poorest and the most vulnerable members of society. Conversely, there may be instances in which certain subsidies provided by the government accrue more to those who are already relatively rich, in which case the policy may end up widening gaps. Similarly, certain types of taxes that require the rich to pay more (relative to their income) can reduce inequality while, conversely, taxes that fall heavier on the poorer parts of the distribution, can contribute to widening gaps. Thus, how governments spend and raise their revenue directly influences the amount of redistribution the fiscal system achieves, which in turn influences inequality.

In China, households across the income distribution are beneficiaries of government social spending in absolute terms. Figure 21 shows the value of total benefits in renminbi accruing to households at different parts of the income distribution, starting from the poorest 10 percent (the bottom or 1st decile) to the richest 10 percent (the top or 10th decile). The analysis shows that the gross value of the total benefits is distributed roughly uniformly: households in all parts of the income distribution receive direct benefits from the government in some form and the value of these benefits is roughly similar for the richest and the poorest. The composition of the benefits is different, however. For instance, cash transfers and education benefits are more prominent for the poorest, whereas health and resident pension benefits are more prominent for households at the top end of the distribution.[7, 8, 9]

As expected, richer households contribute more to the fiscal system than poorer ones in absolute terms. Households pay into the fiscal system in the form of PIT, VAT, and consumption taxes on their purchases and through their contributions into the employee or resident social security schemes. There are several reasons for this. First, the rich consume more than the poor

[7] Note that the cash assistance includes transfers through the Dibao, Tekun, Temporary Relief, and Natural Disaster Relief programs. It potentially also includes other types of cash-like subsidies that are provided to households for agricultural purposes. The household survey identifies the total amount of cash transfers received without collecting information about the specific type of assistance received or how much was received through each of the different types of assistance.

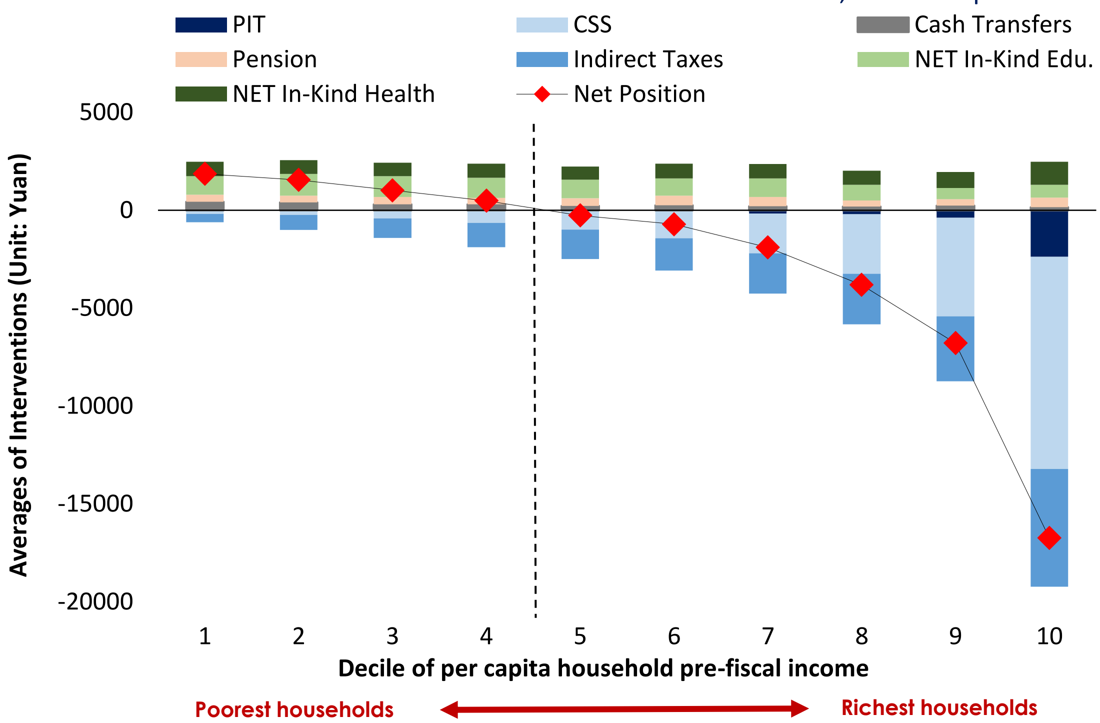
[8] The value of households' in-kind education benefit is imputed based on administrative data of per-student government spending on different levels of education, differentiated by province, as published in the China Statistical Yearbook of 2019. The net benefits are obtained by subtracting user-fees and out-of-pocket spending incurred by households as reported in the CFPS. Net benefits for health are estimated based on survey-reported expenses and reimbursements for healthcare services.

[9] The analysis excludes pensions received through the employee system because these contributory pensions are treated as deferred income as opposed to transfers from the government. Pensions received through the resident system, on the other hand, are non-contributory and treated as transfers in the analysis.

in monetary terms and, as such, the average per capita value of VAT and consumption taxes paid are also higher (Figure 21). Second, higher earners contribute more to the social security system, as these contributions (particularly the employee scheme) are indexed to earned income. Finally, the PIT accounts for a small share of payments into the fiscal system relative to that collected via indirect taxes and social security contributions and is concentrated mostly among households in the top decile.

Taken together, the fiscal system is progressive in absolute terms. The results imply that the net benefit position of households – that is the benefit received from the fiscal system net of any payments made into the fiscal system – is progressive. Poorer households receive a positive net benefit while the net benefit position becomes more and more negative higher up the income distribution. In fact, more than half of the population is a net payer into the fiscal system, while a little over 40 percent of the population is a net beneficiary of China's fiscal system.

Figure 21. Two-fifths of the Chinese population is net beneficiary of the fiscal system
(Absolute incidence of taxes and benefits across the income distribution, deciles of pre-fiscal income)

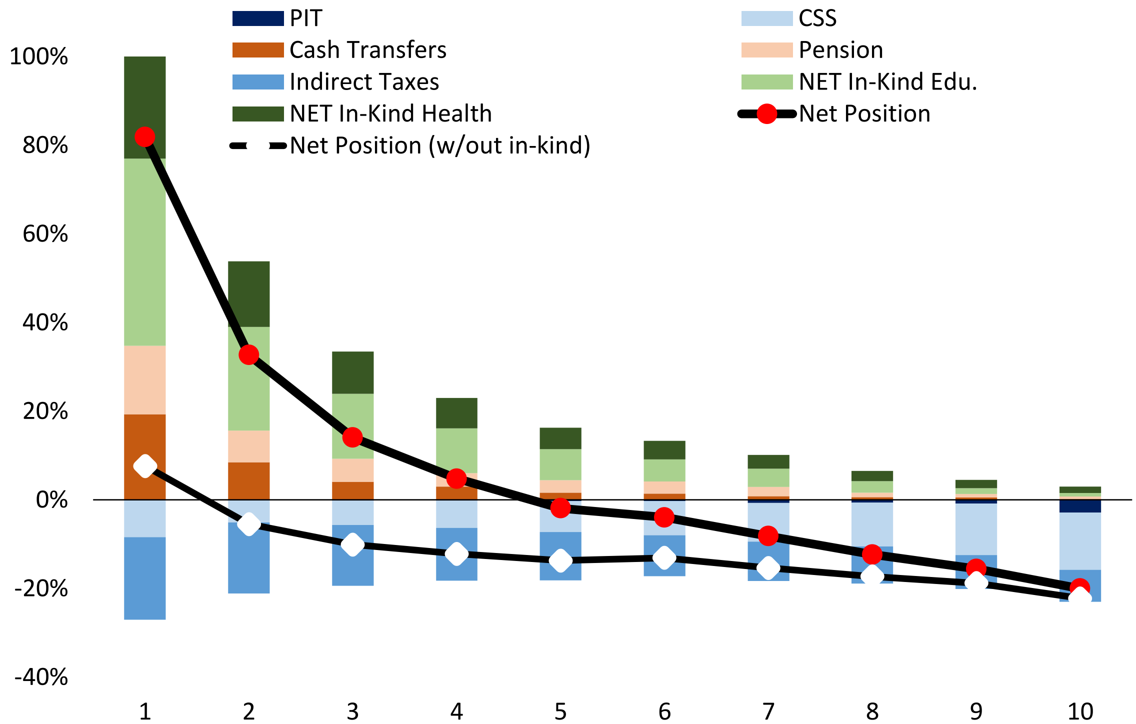


Source: Lugo et al. (forthcoming).
Note: (i) Analysis based on China Family Panel Survey (2018) and administrative and fiscal data from the China Statistical Yearbook 2019; (ii) PIT–personal income tax; CSS–contributions to social security; Indirect taxes include VAT and consumption tax; Pension includes pension received through the resident system, employee pensions are treated as deferred income; net in-kind education and health benefits are monetized values of benefits received through education and health systems less of any user fees and out-of-pocket expenses incurred to access these services.

The fiscal system is also progressive in relative terms, especially with respect to in-kind education and health benefits that favor the relatively poor.[10] Instead of looking at currency values, Figure 22 shows taxes and benefits as a share of households' income before the fiscal system intervenes (the pre-fiscal income). Three observations are noteworthy. First, in gross terms, the overall value of the benefits received are worth quite a lot to households that receive them. For households in the poorest decile, for example, the total value of benefits received through the fiscal system is almost as large as their pre-fiscal income. Second, the value of the benefits declines as one moves up the income distribution, that is, the benefits account for a smaller share of pre-fiscal income as households become richer. Third, the progressivity of the fiscal system is driven for the most part by publicly provided education and health services.

Figure 22. The fiscal system is progressive but most of the progressivity comes from in-kind health and education benefits; on a purely cash basis, everyone outside of the bottom decile of the income distribution is a net payer

(Incidence of taxes and benefits relative to income, deciles of pre-fiscal income)



Source: Lugo et al. (forthcoming).

Note: (i) Analysis based on China Family Panel Survey (2018) and administrative and fiscal data from the China Statistical Yearbook 2019; (ii) PIT- personal income tax; CSS – contributions to social security; Indirect taxes include VAT and consumption tax; Pension includes pension received through the resident system, employee pensions are treated as deferred income; net in-kind education and health benefits are monetized values of benefits received through education and health systems less of any user fees and out-of-pocket expenses incurred to access these services.

[10] In-kind benefits are received in non-cash forms. For example, a household that has a secondary school-aged child who goes to a public school without paying school fees benefits from the free provision of public education, but the monetary value of that benefit is not convertible into cash.

While benefits of the fiscal system disproportionately favor the relatively poor, the burden of taxes and contributions is heavier on the less well-off too. The share of pre-fiscal income that is paid in the form of indirect taxes is just as large – for some deciles larger – for poorer households than it is for richer ones. Furthermore, considering just the monetary components of the benefits ("Net position w/out in-kind" in Figure 22), only households in the bottom 10 percent of the income distribution are net beneficiaries. All other households pay more into the fiscal system than they receive as monetary benefits, and the net contributions as a proportion of pre-fiscal income are similar across deciles. In other words, not enough is being collected from those who can probably afford to pay and, in turn, quite a bit is being taken from those for whom these taxes and contributions may be burdensome. The net result is that for those at the bottom parts of the distribution, the generous benefits they receive through the fiscal system are, by and large, being negated through more than commensurate amounts that are collected from them through indirect taxes and contributions to the social security system.

A more progressive fiscal system for the future

Social spending and human capital investment already contribute significantly to reducing inequality, but the hard task of shifting China's growth model, decarbonizing the economy, and dealing with population aging will require further investment in human capital. China has more than doubled its spending on education over the last 15 years, but at 3.6 percent of GDP in 2018 it was still lower than the average for the upper middle-income countries (UMICs) of 4.5 percent. Spending on health (1.7 percent of GDP) was similarly about half of the UMIC average of 3.4 percent.[11] Spending better would be just as important to close access and quality gaps across economic sectors and geographic regions. Expanding coverage of social assistance programs, controlling rising health care costs, addressing gaps that exist within the two-tiered social insurance system (for instance, by increasing the benefits of the resident pension system, particularly in rural areas), ensuring portability of social benefits, are all improvements that could lower the burden of out-of-pocket spending for the relatively less well-off (World Bank and DRC 2022).

Turning to the revenue side of the budget, China's domestic revenue mobilization level is higher than the upper-middle income country average, though still below the OECD average. As countries develop, their ability to collect revenue from domestic sources improves. The tax base broadens, greater numbers of workers and firms engage in formal economic activities and administrative capabilities of the state improve, making it easier to collect different types of taxes effectively and efficiently. Average revenue collection for low-income countries (LIC) is 18.3 percent of GDP. This increases to 21.5 for lower middle-income countries (LMICs), 25.6 percent

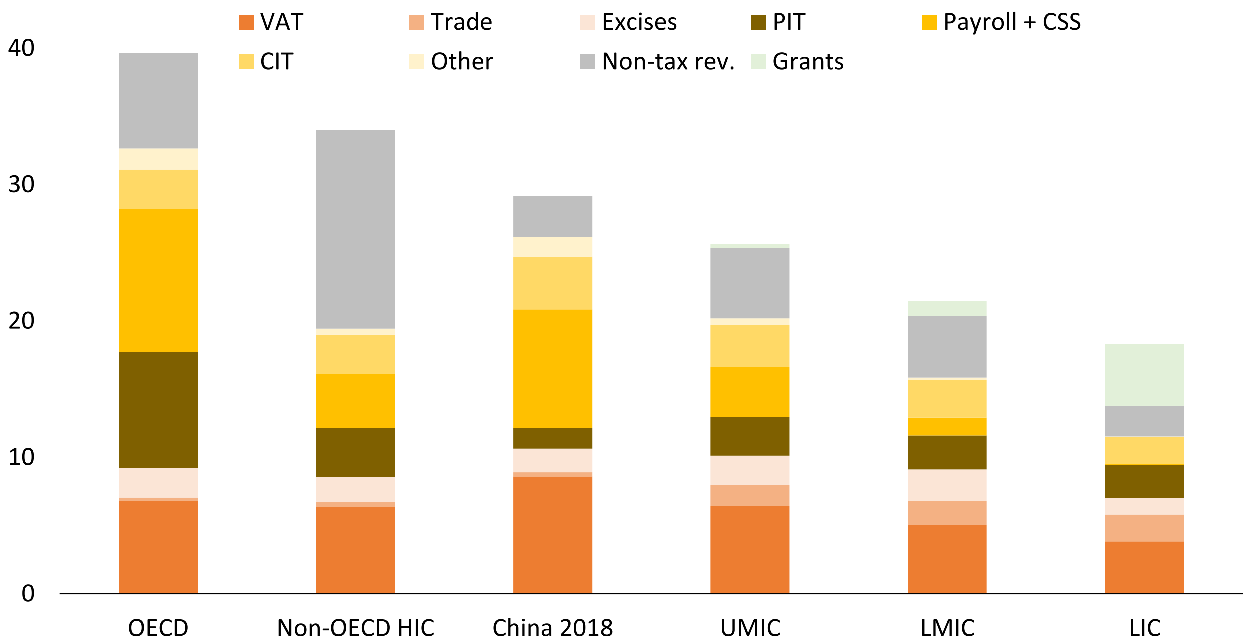
[11] China numbers are from the Finance Yearbook of China 2019 and averages of other country types are based on data from the International Center for Tax and Development.

for the UMICs, and 39.6 percent of GDP for OECD (Figure 23). At 29.1 percent of GDP, China's overall domestic revenue mobilization in 2018 was above the UMIC average.

However, China collects a greater share of revenues in indirect taxes compared to richer countries. China's heavy reliance on indirect taxes such as the VAT and its relative under-utilization of direct tax instruments such as the PIT, makes its revenue mix somewhat inconsistent with its level of development. As countries develop, their reliance on broad consumption-based indirect taxes declines. For example, VAT and excise taxes account for 34 percent of total revenue for LMICs, 33 percent for UMICs, and 23 percent in OECD countries. In China, indirect taxes accounted for 35 percent of total revenue in 2018. Richer countries also collect more in PIT. PIT accounts for 2.5 percent of GDP in LMICs, 2.8 percent in UMICs, and 8.5 percent of GDP in the OECD. As share of total revenue, PIT is 21 percent in the OECD. By comparison, only 5 percent of total revenues come from PIT in China.

Figure 23. Richer countries rely more on direct taxes such as PIT; reliance on indirect taxes such as VAT is higher among poorer countries

(Revenue sources, as % of GDP)



Source: International Centre for Tax and Development. Numbers for China are based on Finance Yearbook of China 2019.

Note: The figure shows the composition of government revenue as a percentage of GDP, aggregated by income group. OECD countries form a separate group. Data by revenue type are from 2020 when available or the most recent available year back to 2015. The sample includes 155 economies. CIT = corporate income tax; GDP = gross domestic product; HICs = high-income countries; LICs = low-income countries; LMICs = lower-middle-income countries; OECD = Organization for Economic Co-operation and Development; PIT = personal income tax; CSS = contribution to social security; UMICs = upper-middle-income countries; VAT = value added tax.

Indirect taxes are generally regressive, as the burden of these taxes falls disproportionately on the lower deciles of the income distribution. Indirect taxes are applied on the level of consumption and, because poorer households spend a larger share of their income on consumption (compared to richer ones), indirect taxes paid account for a greater share of their incomes too.

In contrast, personal income taxes are progressive and have the potential to significantly enhance the progressivity of the entire fiscal system. China's PIT, despite a relatively progressive structure (comparable to OECD countries), has relatively wide income brackets and a large personal allowance. The personal allowance is twice the size of the average per capita income from wages and salaries and several times the average wage in many cities.[12] Hence, the tax base is small, given that most workers do not pay income tax at all, while those with slightly higher wages pay only little, given the low introductory tax rates and the wide salary bands. The top marginal tax rate of 30 percent applies only to those with about 5 times the average wage, affecting only a small minority of workers with very high incomes. This is reflected in the relative incidence of PIT. In China, the top 10 percent of the income distribution pays just 2.8 percent of pre-fiscal income in PIT in comparison to 8.1 percent in UMICs and 27.5 percent in the OECD.

In sum, there are opportunities on both the revenue and expenditure side of China's budget to make fiscal policies more progressive and help address inequality. The analysis presented here shows that the fiscal system delivers greater value to those who need the most support, but the progressivity of the overall package is eroded to some extent by the burden of indirect taxes which fall disproportionately on poorer households. Hence, the fiscal system could make a greater dent on inequality by collecting more from those who could afford to pay more and leave more money in the pockets of those who need it the most. This can be done by increasing the share of fiscal revenues collected through progressive taxes such as the PIT and property taxes. Property taxes also put resources directly in the hands of local governments who are responsible for 80 percent of public spending in China. On the expenditure side, China's fiscal system is already contributing significantly to reducing inequality, especially via in-kind health and education benefits. Further improvements could focus on closing the remaining gaps in access to high-quality public services (e.g., for migrant workers and rural residents). In addition, increasing the level of social benefits and ensuring that they are portable could help make China's green transition fair by assisting those most vulnerable to adverse weather and job losses related to climate change.

[12] IMF (2018). "The People's Republic of China. Technical Assistance Report: Tax Policy and Employment Creation" Washington, DC: International Monetary Fund

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