China| Decoding China's Multi-Layered Fiscal Budget

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At the annual "Two Sessions" held in March 2025, Chinese authorities announced that the 2025 general public budget would carry an official projected deficit of RMB 5.66 trillion (approximately $780 billion), equivalent to 4% of GDP. This represents an unprecedented level of fiscal expansion for China. Historically, the government has emphasized fiscal prudence, maintaining official deficits below 3%. Even during the height of the COVID-19 pandemic in 2020—when extraordinary stimulus was necessary—the proposed fiscal deficit was a mere 3.6% of GDP.

This year's 4% deficit signals the government's growing urgency to stimulate a sluggish economy. However, caution is warranted when interpreting this figure as a direct measure of policy stimulus. China's complex fiscal structure makes it difficult to assess the true extent of its fiscal stance using headline figures alone. (Figure 1)

The Multi-Layered Structure of China's Fiscal Budget

As stipulated in China's 2014 Budget Law, China's fiscal budget indeed includes four parts: the General Public Budget, the Government Funds Budget, the State Capital Operations budget, and the Social Insurance Fund Budget. Each plays a unique role within the broader fiscal ecosystem (Figure 2):

- **General Public Budget:** This is the core component of China's fiscal system. It includes both tax and non-tax revenues, and can be supplemented by the Central Budget Stabilization and Adjustment Fund and surpluses from the State Capital Operations Budget. To bridge gaps between income and expenditure, both central and local governments are permitted to issue general bonds.

  On the expenditure side, local governments are dominant, accounting for over 80% of national spending in the general public budget. Accordingly, the transfer payments from the central government to local governments make up more than one-third of total national expenditure.

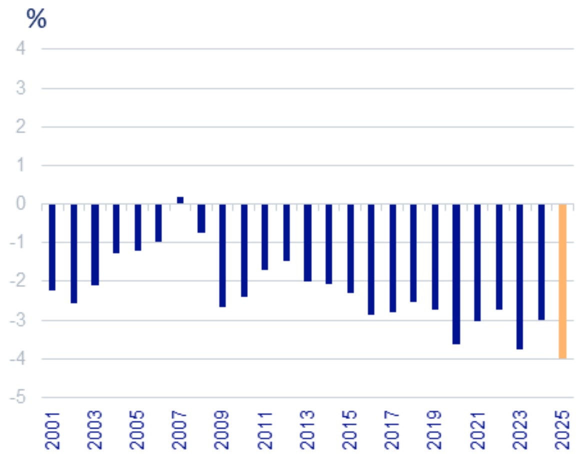
- **Government Funds Budget**: Largely under the control of local governments, this budget is primarily financed through land sales. Additional funding comes from the issuance of special bonds by both central and local governments. In 2025, the central government is to issue ultra long-term special government bonds of RMB 1.3 trillion ($179 billion) and local government special bonds of RMB 4.4 trillion. In addition, the central government plans to issue special bonds of RMB 500 billion, replenishing the capital of large state-owned banks.

On the expenditure side, funds are earmarked mainly for local government's projects such as infrastructure and social wellbeing. The proceeds from the ultra-long-term special government bonds will specifically target large-scale national infrastructure initiatives as well as the programs aimed at boosting consumption.

- **State Capital Operations Budget:** Managed by the State-owned Assets Supervision and Administration Commission (SASAC), this budget oversees revenues and expenditures related to the operations of state-owned enterprises (SOEs). Any surplus from this budget is transferred to the general public budget, enhancing its fiscal capacity.

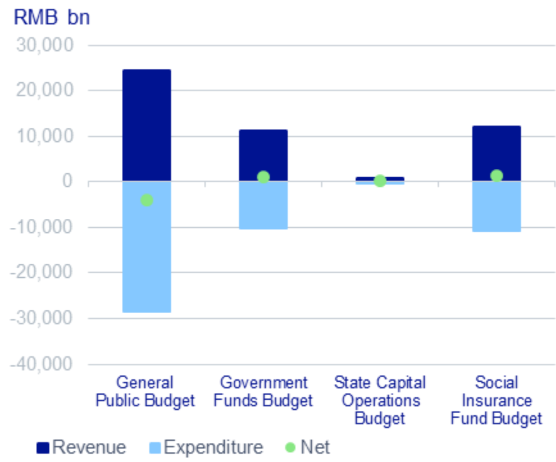
- **Social Insurance Fund Budget:** Administered by the National Council for Social Security Fund, this budget supports China's social welfare programs. Income is sourced from designated social contributions, and spending is primarily directed toward pensions and medical insurance. Any surplus is retained within the fund to strengthen its long-term sustainability.

FIGURE 1: GENERAL PUBLIC DEFICIT DOES NOT VARY MUCH FROM YEAR TO YEAR…



Source: CEIC & BBVA Research

FIGURE 2: … WHILE THE GENUINE FISCAL STANCE ALSO DEPENDS ON OTHER ITEM (2024)



Source: CEIC & BBVA Research

… With Complicated Impacts On the Economy

A government's fiscal budget plays a crucial role in shaping the overall economy by influencing aggregate demand, investment levels, and public sentiment. In China, the impact of fiscal policy on the real economy is further complicated by its multi-layered budgetary structure, which includes several distinct components with different transmission mechanisms.

First, the **General Public Budget** operates in line with conventional fiscal policy frameworks. When the government increases spending and thereby runs a higher deficit—typically through infrastructure investments, subsidies, or social welfare programs—it injects liquidity into the economy, stimulating consumption and business activity. Conversely, reducing expenditure or raising taxes narrows the deficit, which can help contain inflation, albeit at the cost of slower economic growth.

Second, the **State Capital Operations Budget** has a limited but pro-cyclical influence on the economy. Its revenues primarily come from profits of state-owned enterprises (SOEs), while expenditures are largely composed of subsidies to these same entities. Any surplus is transferred to the General Public Budget, meaning there is no net injection of new funds into the economy through this channel.

Third, the **Social Insurance Fund Budget** exerts minimal direct influence on real economic activity, as its expenditures are relatively inflexible and focused on long-term obligations such as pensions and medical insurance. Surpluses are retained within the fund to ensure its long-term sustainability, rather than being used for short-term economic stimulus.

Lastly, the **Government Funds Budget** can exert a substantial influence on the economy, although its transmission mechanism differs from that of the **General Public Budget**. The shortfall between income and expenditure in this budget is financed through the issuance of special-purpose bonds (including ultra-long-term special government bonds, local government special bonds etc.). This structure allows the Chinese government to stimulate economic activity—particularly through infrastructure and development spending—without increasing the official fiscal deficit recorded in the General Public Budget.

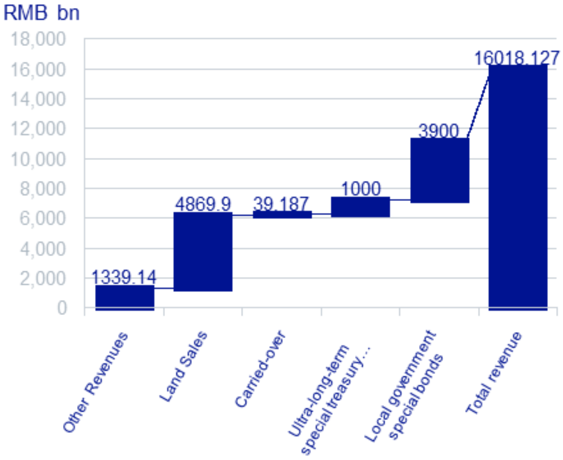
Transmission of Government Funds Budget to Real Economy

It is important to distinguish the transmission mechanism of the Government Funds Budget from that of the General Public Budget. The Government Funds Budget drives activity through the overall scale of its expenditures while the General Public Budget influences economic growth primarily through its deficits. This is because its main source of revenue, excluding debt issuances, comes from local government land sales rather than tax collections. (Figure 3) When land sales decline, the revenue of the Government Funds Budget falls accordingly, leading to a proportional reduction in spending. This reduction tends to have a contractionary effect on the aggregate demand, as there is no natural offset. In contrast, when public spending under the General Public Budget declines due to lower tax collections, the decrease in tax burden allows taxpayers to retain more disposable income, which can partially offset the negative effects of reduced government spending on aggregate demand.

The transmission mechanism of the Government Funds Budget tends to amplify fluctuations in the property market and exerts a more procyclical impact on the broader economy. When local governments generate substantial revenue from land sales, they typically increase spending on infrastructure projects and expand social welfare programs, thereby boosting aggregate demand and supporting economic growth. Conversely, when the property market cools and demand for government-controlled land declines, local governments face revenue shortfalls. As a result, they are often forced to scale back infrastructure investment and cut social spending, further dampening economic activity and exacerbating the downturn.

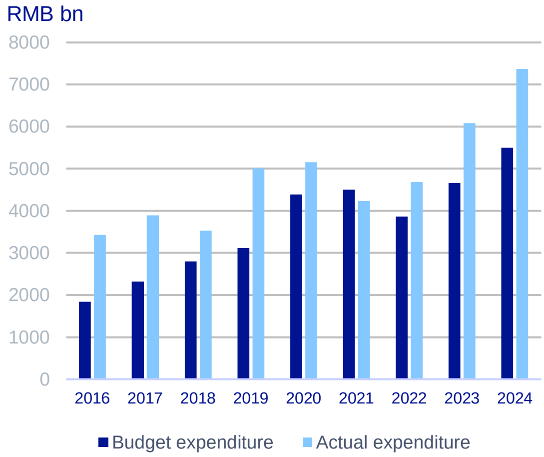
In theory, the authorities can issue additional special-purpose bonds to offset the shortfall between revenue and expenditure in the Government Funds Budget. Since 2022, the volume of such bond issuances has indeed been on the rise. However, this effort has proven insufficient, as evidenced by the persistent gap between actual and budgeted spending within the Government Funds over the period of 2023-2024. (Figure 4)

FIGURE 3: LAND SALES DOMINATE REVENUE OF GOVERNMENT FUNDS (2024)



Source: CEIC & BBVA Research

FIGURE 4: NEGATIVE FISCAL GAP ASSOCIATED WITH ECONOMIC DOWNTURN



Source: CEIC & BBVA Research

Government Funds Spending imply persistent deflation this year

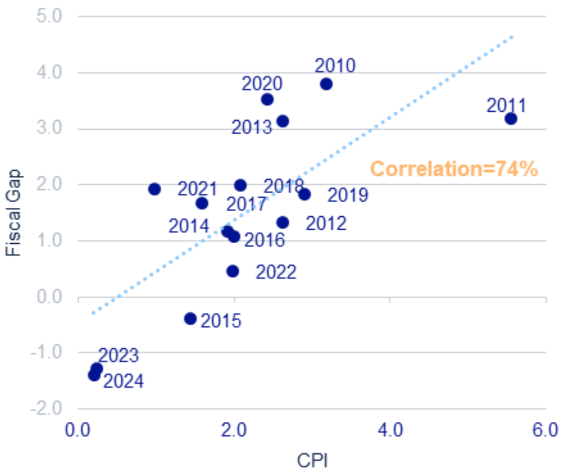
The fiscal gap between actual and budgeted Government Funds spending can be viewed as a proxy for shocks to aggregate demand. Historical data reveal a strong correlation between this fiscal gap and key price indicators at the yearly frequency, including the Consumer Price Index (CPI) and the GDP deflator. (Figure 5) At the same time, its correlation with the Producer Price Index (PPI) is not statistically significant. This might be due to the fact that the PPI is more sensitive to supply-side factors, whereas the fiscal gap primarily reflects demand-side dynamics.

If history is any guide, the evolution of this fiscal gap over the course of the year can serve as a useful indicator of China's broader economic trajectory. In the first half of 2025, China's economy grew by 5.3%, surpassing the official growth target of around 5%. However, inflationary pressures remain subdued. The Consumer Price Index (CPI) edged down by an average -0.1% in the first eight months of the year, while the GDP deflator stayed in negative territory in both Q1 and Q2—indicating ongoing deflationary trends.

In the first eight months of the year, the aggregate spending of the government funds only completed 50% of its budgeted figure. Given the continued weakness in the property market, land sales by local governments are likely to fall short of expectations in the second half of the year. (Figure 6 & 7) Compared to its performance over the past few years, we infer that the fiscal gap in 2025 might remain in a negative territory unless the authorities are willing to issue additional debts to offset the shortfall of land sales.

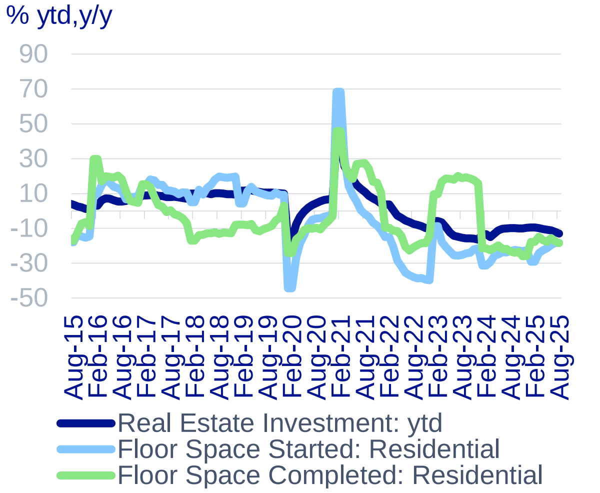
Overall, the current trajectory of the fiscal gap does not bode well for inflation dynamics in the second half of the year, reinforcing concerns about persistent demand-side weakness in China's economy.

FIGURE 5: THE FISCAL GAP IS HIGHLY CORRELATED WITH CPI



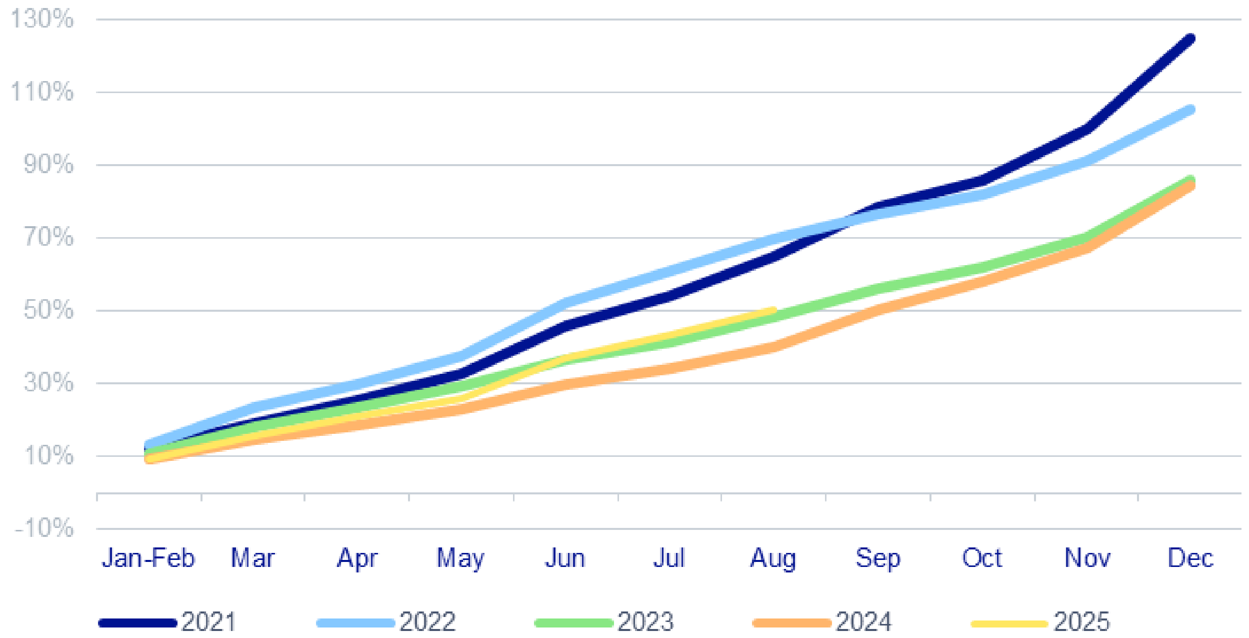
Source: CEIC & BBVA Research

FIGURE 6: THE PROPERTY MARKET CONTINUES ITS DOWNTREND



Source: CEIC & BBVA Research

FIGURE 7: THE PACE OF GOVERNMENT FUNDS SPENDING AS % OF BUDGET



Source: CEIC and BBVA Research

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