

The Rise of the Regions:

Fiscal Reform and the Decline of Central State Capacity in China

Shaoguang Wang

Andrew G. Walder, ed. The Waning of the Communist State: Economic Origins of Political Decline in China and Hungary (Berkeley: University of California Press, 1995), pp. 87-113

Analytically, central planning has three distinct characteristics relationships. The first is the state monopoly that emerged when the private sector was eliminated and the collective sector brought under tight state control. The second is omnipresent regulation which, by leaving little space outside of plans, straitjackets economic agents' decision-making. The third is the concentration of authority in the hands of the central government. Local governments are granted little discretion over resources and decision making and allowed to act only as "transmission belts" of the central government.

While central planning provides communist regimes with a high degree of control, it has two fatal defects. One is information dependence: the center has to rely upon agents spread widely across the nation for information. In a hierarchical system, those at the bottom have little choice but to pursue their objectives by manipulating the supply of information to the center. Therefore there is always the danger that information transmitted to the center is distorted. As economic development multiplies the volume of information that central planners have to process, the information supremacy

of agents over the principal tends to be enhanced. The other defect of the centrally planned economy is its neglect of agents' incentives. Agents are assumed to have no goals other than those that are set at the top of the hierarchy; but they do have their own objectives, which are not always in line with the principal's. This is an important cause of "slack" in the system.

Departures from central planning are an effort to overcome these two defects. Departures may take any of the three forms Walder discusses in the introduction to this volume, which we may term decentralization (fiscal reform), deregulation (enterprise reform), and demonopolization (alternative economic sectors). Whereas demonopolization reinvigorates the non-state sector, decentralization and deregulation involve mainly changes in various relationships within the public sector. Indeed, the success or failure of a country's departure from central planning to a large extent hinges on its reform of the public sector. It therefore is important to understand the political consequences of decentralization and deregulation.

This chapter examines the growth of extrabudgetary funds in China, which I believe clearly gauges the extent of decentralization and deregulation. Extrabudgetary funds are funds in the public sector that are not subject to central budgetary control. In an ideal-type centrally planned economy, nothing should escape central control. Nevertheless, extrabudgetary funds have existed in China since the establishment of the People's Republic. They are "funds in the public sector" in that they include only funds at the disposal of government agencies and state enterprises, but not funds belonging to collective enterprises, private firms, and households. Those funds are "not subject to central budgetary control," because they are retained by government agencies and state enterprises and they are not recorded in formal budgets. Since they are not subject to central budgetary scrutiny, they are

also outside of central plans. The expansion and contraction of extrabudgetary funds has mirrored changes in the role of central planning over the past forty years. Whenever Beijing adopted measures to decentralize, local governments' extrabudgetary funds have grown; and whenever Beijing adopted measures to deregulate, state enterprises' extrabudgetary funds have expanded. As a result of drastic decentralization and deregulation in the 1980s, almost as much "public money" is circulating outside the state budget as within it today. In many provinces, extrabudgetary revenues and/or expenditures have even surpassed their budgetary counterparts. Given their magnitude, some Chinese economists and policy makers now refer to extrabudgetary funds as China's "second budget."

The central argument of this chapter is that the rise of the "second budget" after the late 1970s has contributed to the decline of central state capacity in China. What do I mean by "state capacity"? Why is state capacity important? How do we measure it? What causes state capacity to vary? I will address these issues in the first part of the chapter. In the second part, I will apply the concepts developed in the first in an analysis of the rise of extrabudgetary funds. I attempt to show the causal connections between the rise of extrabudgetary funds and the weakening of state capacity. In the last part, I examine the socioeconomic and political consequences of declining state capacity. I argue that the crises we witnessed in China in the late 1980s were attributable, at least in part, to the political weakness of the center vis-a-vis its own agents.

State Capacity

Definition

State capacity is one of the defining characteristics of any political system (Almond and Powell 1966, Katzenstein 1978, Zysman 1983, Migdal 1988, Ikenberry 1988, Organski and Kugler 1980). By "state capacity" I refer to the ability of a government to administer its territory effectively (Skocpol 1985). In the modern world, the survival and functioning of a political system depends on four basic state capacities: the capacity to mobilize financial resources from the society to pursue what the central policy-makers perceive as the "national interest" (extractive capacity); the capacity to guide national socioeconomic development (steering capacity); the capacity to dominate by using symbols and creating consensus (legitimation capacity); and the capacity to dominate by the use or threat of force (coercive capacity).

These four capacities are conceptually distinct but interrelated in practice. For instance, the legitimation of a regime is dependent on its performance. If the state is able to produce and deliver economic and social goods at the level its subjects expect or at least as its rulers promise, it should have no legitimacy problem. On the other hand, if the state apparatus cannot adequately steer the economic system, this is likely to result in a decline in its legitimacy. With legitimation capacity, the state can effectively steer activities without the necessity of constantly deploying coercion. Without legitimacy, however, the state would find it much more difficult to extract resources from the society, and would have to bear much higher costs for maintaining law and order (Habermas 1973). An overloading of control problems would weaken the state's coercive capacity, which in turn would lower the expected cost of joining the opposition. Of course, the decline of the four capacities rarely occurs simultaneously or in the same sequences in different cases. But their changes do tend to reinforce each

other. Once overall state capacity falls below a certain threshold, the regime would be in serious trouble, if not in danger of collapse.

Measurement

State capacity is more easily asserted than measured. Indeed the concept of overall state capacity as discussed above is too complicated for ready measurement. In this chapter, therefore, extractive capacity is selected as a key indicator of overall state capacity. The substitution is based on the assumption that an effective political system should be able to extract resources, aggregate them, and use them for national purposes; a government that is unable to generate sufficient resources for realizing its policy goals is less effective. Extractive capacity is arguably the most fundamental of state capacities. The availability of resources permits the state to carry out its other tasks. Many empirical studies have shown that the government's political-capacity-as-fiscal-extractive-capacity provides a useful analytic tool for explaining such divergent phenomena as the outcomes of wars among major powers (Organski and Kugler 1980), demographic transitions (Organski, Kugler, Johnson, and Cohen 1984), the probability of developing countries' suspending their external debt service payments (Snider 1990a), and domestic political violence (Snider 1990b).

To construct an indicator of the state's extractive capacity, we need two points of reference. The first is the absolute value of the actual revenue captured by the public sector. The other is gross domestic product (GDP) or national income, which measures the total volume of financial resources of the nation. The two reference points enable us to define state extractive capacity as the ratio of the former to the latter:

$$\text{State Extractive Capacity} = \frac{\text{Size of Public Sector}}{\text{Total Financial Resources}}$$

$$= \frac{\text{Budgetary Funds}}{\text{National Income}} \quad [I]$$

Since extrabudgetary funds are an additional source of public expenditure and investment in China, they should be included when we measure the size of the public sector. Thus, definition [II] may provide us a better tool for measuring the extent to which the national income is captured by the public sector in China.

$$\text{State Extractive Capacity} = \frac{\text{Budgetary Funds} + \text{Extrabudgetary Funds}}{\text{National Income}} \quad [II]$$

The Determinants of State Capacity

As a dependent variable, what are the determinants affecting longitudinal variation in the extractive capacity of the state? What factors influence the executive's ability to allocate resources in pursuit of its policy objectives? In discussing the conditions underlying effectiveness of the state, emphasis has been laid on "state autonomy." Many believe that the state as a corporate entity is unlikely to be capable of formulating goals or implementing them unless it is somewhat insulated from the surrounding social

structure. Here societal resistance is considered the primary obstacle to the effectiveness of state actions (Krasner 1978a).

While there is no doubt that state autonomy is necessary for effective state intervention, however, it is mistaken to think that autonomy is in itself sufficient for effective state action. It is mistaken because the state is not monolithic. Instead, it has a complex structure both horizontally in terms of numerous ministries and vertically in terms of different levels of government. Central ministries and local governments, supposedly rulers' agencies, don't always share their principal's aims. It is probably more realistic to assume that they have goals other than those imposed by rulers. If they do, they could be competing extractors. In analyzing political constraints on the extractive capacity of the state, we thus need to distinguish between resistance by private citizens who are directly affected by the extractive policies of the state, and competition among state agents who desire control over the resources already extracted in the name of the state. While resistance occurs mainly at the extraction stage, competition is more likely to appear at the allocation stage (Lamborn 1983).

Having intentionally destroyed all competing societal centers of power, the communist state is no doubt much more insulated from societal pressures than its counterparts in the West or in the Third World. Authoritarian statism, however, does not correspond to a univocal strengthening of the state. To enforce authoritarian rule, the state has to construct an elaborate set of agencies throughout the nation. These agencies may over time develop their own preferences. The unique preferences these agencies assume create in them centrifugal tendencies. These state agencies could become "power centers" competing with central rulers and threatening the coherence and the

stability of the state as a corporate whole. The principal weak point in the state socialist system thus is more likely to lie "within the regime itself, within the apparatus of the state," than "outside it in its relations with civil society (Schmitter 1975)."

Due to spatial distance, it is usually much more difficult for national leaders to monitor local governments' activity than central ministries'. This study therefore will focus on subnational governments.¹ The extent to which local governments are able to compete with the rulers over resources, and thereby weaken overall state capacity, depends on two variables: their preferences and the resources already at their disposal. The desire to compete depends on how far local governments' preferences deviate from the center's. When local governments have no preferences of their own, or their preferences largely converge with the rulers', we should expect that subnational governments act as central decision makers' deputies, implementing whatever orders they receive from the center. Local governments would not seek to capture resources for themselves unless they have interests that diverge from their superiors'. However, it is one thing to have a desire to compete, while it is another to have an ability to compete. The ability to compete is a function of local governments' control over relevant power resources and their ability to influence central decision-making. Local governments could improve their situations by employing the resources already under their control to gain control over other (and more) resources.

The distinctive sense of identity and the independent source of resources tend to reinforce each other. The growing consciousness of self-interest is likely to enhance local governments' desire to grasp more resources into their own hands; with more resources under their control, subnational governments are inclined to develop new independent preferences.

The process of mutual reinforcement could result in a centrifugal tendency among local governments.

Since the state is not a monolithic entity, we need to modify definitions [I] and [II]. These definitions assess the extractive capacity of the state by breaking the state into its components, assessing the capacity of each part, and then summing the capacity of all components for the total capacity of the state. But, as often happens, the value of a whole sometimes is smaller than the sum of the values of its parts. When local governments pursue goals running contrary to the center's interest, for instance, financial resources at their disposal would undermine rather than enhance the overall capacity of the state.

I am not suggesting that local governments always use their share of budgetary income and extrabudgetary funds under their control to pursue interests that are at odds with the center's. Nor should we assume that every yuan extracted in the name of the state serves to strengthen state capacity. It should be clear by now that when I speak of state capacity, I am referring to the aggregate capacity of the state as a corporate whole, which is definitely weaker than what definition [I] or [II] suggests. How much weaker? There is no way to give a precise answer. In fact, we do not need a precise answer so long as we are able to gauge a longitudinal trend. For these reasons, I give the following three definitions to approximate the real extractive capacity of the central state. The definitions [III], [IV], and [V] are based on a truism: at least, central planners are able to employ the center's share of budgetary revenues at will to pursue what they believe to be the national interests.

Central Budgetary Funds

$$\text{State Extractive Capacity} = \frac{\text{Central Budgetary Funds}}{\text{Total Budgetary Funds}} \quad [\text{ III }]$$

$$\text{State Extractive Capacity} = \frac{\text{Central Budgetary Funds}}{\text{Budgetary Funds} + \text{Extrabudgetary Funds}} \quad [\text{ IV }]$$

$$\text{State Extractive Capacity} = \frac{\text{Central Budgetary Funds}}{\text{National Income}} \quad [\text{ V }]$$

Definitions [III], [IV], and [V] are indispensable supplements to definitions [I] and [II]. When the preferences of the central and local governments are convergent, definitions [I] and [II] should be able to serve as a good indicator of state extractive capacity. However, definitions [III], [IV], and [V] better measure state extractive capacity when the preferences of the central and local governments diverge.

The Rise of the Second Budget

The Evolution of Extrabudgetary Funds before the Reform

China came closest to the ideal model of central planning during the First Five Year Plan (1953-1957). Under the unified fiscal system adopted in the early 1950s, the scope of the Chinese budget was even broader than that of the Soviet Union. While the Soviet Union allowed enterprises to retain a substantial portion of their profits and depreciation funds, the Chinese budget centralized virtually all enterprise profits and depreciation funds

through the state budget. Enterprises had to rely on the state budget not only for investment but also working capital (Lardy 1978).

During this period, only a few insignificant sources of funds were left outside the state budget. Among them the most important were major repair funds and bonus funds controlled by enterprises; and the agricultural surtax, surcharges on industrial and commercial taxes, and miscellaneous fees controlled by local governments (Lardy 1978). Those funds were called "extrabudgetary funds." Throughout the First Five Year plan, the size of the extrabudgetary funds was very small, ranging from 4.2 percent to 8.5 percent of budgetary revenue, and the use of those funds was generally subject to strict central regulations (Du 1984, Deng 1990) (see Table 2-1).

A number of observations about the pre-reform period are worth notice. First, during Mao's era, departures from central planning took the form of administrative decentralization. Every time the center decided to decentralize control over resources and decision-making to governments at lower levels, extrabudgetary funds expanded quickly. There were two such upsurges of extrabudgetary funds in the pre-reform period, both of which were the results of Mao's decentralization drives. The first hike occurred during the Great Leap Forward(1958-1960). In a matter of three years, the extrabudgetary funds registered a 447 percent increase, climbing from 2.6 billion yuan in 1957 to 11.8 billion in 1960. The other hike took place when Mao launched his second decentralization drive in the early 1970s. Between 1970 and 1977, while the budget revenue grew only 31.9%, extrabudgetary funds tripled, reaching 31 billion yuan in 1977.

Second, subsequent recentralization never succeeded in returning fiscal flows to their prior state, because local forces that warmly embraced decentralization resisted recentralization. Despite the center's intense

efforts, for instance, its recentralization program of the early 1960s could not bring extrabudgetary funds down to the level of the mid-1950s. Although the ratio of extrabudgetary to budgetary funds often fluctuated in the pre-reform period, the direction of change was unmistakable. It grew from an insignificant 6.5 percent during the mid-1950s to a 35.6 percent in 1977 (General Planning Department 1992). Correspondingly, central control over regional economic activity declined. With more resources under their control, localities found that they did not have to take central plans as seriously as in the past; some even acted contrary to central plans and discontinued cooperation with other localities mandated by central planners (Lyons 1987). The late Mao era, from the mid sixties to the mid seventies, thus was characterized by two seemingly contrasting trends: At the same time that the state was becoming increasingly repressive, the state organizational structure was being gradually fragmented, with lower levels of government gaining at the expense of the center (World Bank 1990a).

Third, in the Mao era the institution of extrabudgetary funds was mainly used to address just one of the two main defects of the centrally planned economy--information dependency. This was reflected in the fact that the most important components of extrabudgetary funds had been major repair funds and depreciation funds. Such funds were used primarily to give enterprises and local administrative authorities some flexibility in maintaining and improving their production capability. The incentive function of extrabudgetary funds was very weak. Bonus funds were nonexistent in many years. When they existed, they were awarded only to enterprises that over-fulfilled output and profit plans; and their volume was small, in general no more than 1 to 3.5 percent of the total profits (Lardy 1978). Under such an institutional arrangement, although enterprises or local governments might have an

organizational interest in expanding the size of extrabudgetary funds, factory managers and local government officials as individuals did not have a personal stake in doing so. Since they could not gain much personally from the expansion of extrabudgetary funds, they tended to give in when facing great pressure from Beijing. That was an important reason why the centrifugal tendencies, though growing, were still limited in the late Mao era.

The Expansion of Extrabudgetary Funds after the Reform

Deng's decentralization differs from Mao's in that it attempted to address both information and incentive problems, emphasizing the latter. The essence of Deng Xiaoping's far-reaching economic reform can be summarized in one Chinese phrase, fangquan rangli, that is, devolve control over resources and decision-making power to subnational governments on the one hand and to enterprises on the other (Li 1990). It was hoped that fangquan rangli would motivate enterprises and local governments to pursue greater efficiency; greater efficiency would generate more profits; more profits would enlarge the tax base; and eventually the enlarged tax base would bring about a higher level of revenues for the central government.

Fangquan rangli involves changes mainly in two respects. On the one hand, "eating in separate kitchens" (fenzhao chifan) was introduced in 1980 to expand local governments' fiscal autonomy. On the other hand, state enterprises were allowed to retain a larger proportion of profit for their own uses. Since many authors have discussed in detail changing central-local fiscal relations (Oksenberg and Tong 1991, Oi 1992, Shirk 1993), I need not repeat them here. In what follows, I shall focus on the second development, which is the explosion of extrabudgetary funds in the 1980s.

The Explosion of Extrabudgetary Funds There are three primary ways for enterprises to retain profits. First is depreciation funds, which existed

before the reforms. However, there were important policy changes concerning the rate of depreciation and the management of depreciation funds after 1978. In 1978, the rate of depreciation was only 3.7 percent, but it increased gradually to 5.3 percent by 1985. As the size of China's fixed assets grew at a fast pace in the 1980s, the higher rates of depreciation allowed enterprises to retain billions more yuan a year (Deng 1990, Feng 1990). "Retain" is a term that needs some qualification. Before 1978, enterprises usually had to surrender a large percentage or in some cases even all of the depreciation funds they had retained to government agencies (in most cases, local ones). In this case, enterprises had no discretion over the use of funds retained in their names. On the eve of the reform, as a measure of recentralization, the central government decided to collect 50 percent of depreciation funds for the central treasury. After 1979, however, central policies began to grant enterprises larger and larger shares of the funds. Finally, in 1985, the central government gave up its share altogether, leaving all depreciation funds to enterprises (Li, Fan, and Cong 1987).

Major repair funds are the second main source of enterprise income. Set at a certain percentage of the depreciation funds, the major repair funds grew along with depreciation funds (Deng 1990).

The most important source of extrabudgetary funds is the enterprises' retained profits. Before 1978, enterprises remitted almost all their surplus funds to the state and, in return, the government provided financing for the enterprises' production requirements and investment. As a result, state firms were not motivated to maximize profit. Profit retention was designed to foster state-owned firms' profit maximization incentive. Since 1978, there have been four regimes of profit retention: "enterprise fund," "profit retention," "tax-for-profits," and "tax contracting" (Lee 1991).

We need not to go into details of those schemes. Suffice it to say that they all shared a common feature: the profit-retention rate of an enterprise was set on the basis of periodic negotiations between the enterprise and its administrative overseer rather than strictly according to its performance. In the early years of the reform, the negotiability of enterprise's financial obligation to the state budget was partially attributable to China's distorted price structure. Since the prices of almost all products and production factors then were set by planners, it was almost impossible to establish a clear linkage between the level of an enterprise's profits and its real performance. Negotiation was supposed to work as a mechanism for determining how large proportion of the profits an enterprise deserved to retain. The negotiability, however, gave the enterprise an incentive to divert its resources more to rent-seeking activity (e.g., striving for a higher rate of profit-retention in its bargaining with the superior government agency) than to the improvement of its efficiency. As a result, the initial reform was not successful. "State revenue decreased significantly, while performance of state enterprises did not improve significantly (Lee 1993, p. 181)."

One may expect that as China's price reform proceeded, the negotiability would recede into the background. But that did not happen. If the negotiability was a bad design, then why did the government allow it to persist? In fact, the central government made numerous attempts to reduce the negotiability. The tax-for-profits system implemented from 1983 to 1986 was such an attempt (Bachman 1987). Under this system, a state enterprise was supposed to pay its income tax according to a stipulated and non-negotiable tax rate. Only the enterprise's share of the remaining profits was still subject to bargaining, and the central government hoped to wipe out all vestiges of arbitrary bargaining eventually. But, local governments did not

like the tax-for-profits system, because it threatened their discretionary control over local enterprises. Due to their strong resistance, the central government was forced to abandon the tax-for-profits system, replacing it with the tax contracting system in 1987.

The new system was entirely based upon bargaining. The enterprise was required to deliver a tax or taxable profit quota in lieu of income tax, but there was no stipulated formula for determining the amount of profit remission. The negotiability of tax contract created opportunities for the enterprise and the local government to collude to increase their own revenues at the expense of the state budget (Lee 1993).

Through these schemes of profit retention, enterprises were able to retain larger and larger shares of their profits in the 1980s. In 1978, the ratio of retained profits to total profits was lower than 5 percent. But, now estimates ranged from 33.7 percent to 62.2 percent (Deng 1990, He 1987, Cai 1988, Ning 1991). Even if we take the conservative estimation, enterprises' retained profits still increased 14 fold while total profits grew only 170 percent between 1978 and 1987 (Deng 1990). Obviously, retained profits eroded government revenues from state enterprises: what the state budget received was a declining share of enterprise income.

Due to these changes, the volume of extrabudgetary funds controlled by state enterprises underwent a phenomenal increase. In 1978, extrabudgetary funds controlled by enterprises accounted for only about 8.4 percent of national income. By 1991, the ratio had risen to more than 15.4 percent. That addition 7 percent of national income represented 112.8 billion yuan in lost revenues for the state budget, five times the size of China's fiscal deficit in that year (State Statistics Bureau 1992).

Like the extrabudgetary funds controlled by state enterprises, those controlled by administrative agencies have also grown at a high rate. Between 1978 and 1991, such funds grew eleven fold (see Table 2-2).

On paper, the extrabudgetary funds of the third category--those directly under the control of local governments--do not appear to have grown much (also see Table 2-2). But, as I shall detail below, local governments had no difficulty capturing some of the resources retained by the enterprises under their jurisdiction. What local governments actually controlled thus was much larger than what was nominally under their names.

Together, the three categories of extrabudgetary funds reached 324.3 billion yuan in 1991, exceeding budget revenues (314.9 billion) for the same year. For this reason, many Chinese scholars and policy makers call extrabudgetary funds China's "second budget." Before 1978, the growth rates of extrabudgetary funds often oscillated greatly over short intervals, which meant that extrabudgetary funds were sensitive to central policy changes and that central policy makers had some control over the size of extrabudgetary funds. After 1978, however, the fluctuation began to flatten out and there are no longer any instance of negative growth. Moreover, the growth rate of extrabudgetary funds has been consistently higher than that of national income, gross domestic product, or budgetary incomes (Wang 1989). Given the central government's countless efforts to arrest the growth of extrabudgetary funds, the secular trend of sustained increase reveals how ineffective the central control over extrabudgetary funds has become.

Control and Resistance In the early 1980s when extrabudgetary funds grew to roughly half the size of budgetary revenue, some Chinese economists and policy makers already realized that the growth of extrabudgetary funds could get out of hand (Contemporary Chinese Public Finance Editorial Group

1990). Beijing then faced a delicate task: to limit the negative impact of growing extrabudgetary funds on macroeconomic stability without hindering the incentive effects of the funds. In the past, whenever the center wanted to confine negative effects of extrabudgetary funds, it simply resorted to administrative measures, such as moving some funds from the extrabudgetary category to the budgetary category. In the 1980s, Beijing sought to deal with problems caused by oversized extrabudgetary funds by imposing taxes on them. At the end of 1982, the State Council introduced a 10 percent energy and transport surcharge on all extrabudgetary funds. The next year, the surcharge was increased to 15 percent (Contemporary Chinese Public Finance Editorial Group 1990). At first, the energy and transport charge was said to be levied for only three years. By 1985, however, the growth of extrabudgetary funds had not been contained. Thus, Beijing declared that the charge would become a permanent tax in 1986. Meanwhile, the State Council put out more stern regulations about the extracting and use of extrabudgetary funds (State Council 1986). In 1986, the central effort seemed to have some effect. The ratio of extrabudgetary funds to budget revenues fell for the first time since 1978, though the magnitude of change was very small. But the success proved to be short-lived. The ratio went up by 10 percent in 1987, which was the biggest annual leap in six years. In the following years, more control mechanisms were tried. In 1989, another tax, "a budget adjustment charge," was imposed on extrabudgetary funds (State Council 1989). Despite all those efforts, extrabudgetary funds have continued to expand.

In the early 1960s, the central government cut the volume of extrabudgetary funds in half. Why wasn't the central government able to repeat what it had done two decades ago in the 1980s?

First, monitoring problems are far more intractable than before. In the pre-reform period when enterprises were forced to hand 95 percent of their profits upwards and receive allocations to cover their operational costs, there were few funds to hide and it was difficult to hide them. Profit sharing has exceedingly complicated the monitoring process. No matter what form profit sharing took, it had to be implemented according to some elaborate formulas, which necessarily required a larger volume and better quality of information for central controllers to detect noncompliance. Since such information was hard to come by, local units had much less difficulty than before in generating extrabudgetary funds through various legal, quasi-legal, and illegal ways.

Second, the incentives of managers and local officials to increase extrabudgetary funds have increased greatly. Before the reform, as pointed out above, extrabudgetary funds were mainly designed to overcome central planners' information dependence problem. After the reform, instead, extrabudgetary funds were allowed to grow in order to provide incentives to state agents and primary producers. Extrabudgetary funds now could be used to sponsor housing projects, to increase bonuses, to provide various forms of local collective welfare, and the like. Obviously, the larger the volume of extrabudgetary funds under local discretion, the more local people, especially officials and managers, benefit. Since personal interests now are at stake, enterprise managers and local government officials have become more energetic and innovative in expanding extrabudgetary funds and more determined to resist Beijing's attempts to recentralize.

Third, and most important, local governments who are supposed to police noncompliant behaviors by enterprises in acquiring and using extrabudgetary funds have become noncompliant themselves. Under the "eating from separate

kitchens" system, local governments' objective is to enhance their own revenue base. Therefore, they tend not to enforce central guidelines strictly when this means reducing the amount of extrabudgetary funds left in the local economy (Oi 1992).

Local government generally would rather see enterprise earnings retained than transferred to the center by way of taxes, because as long as money is kept within the localities, they benefit from it in one way or another. Three mechanisms have often been used by local governments to let local enterprises expand their extrabudgetary funds by diverting budgetary funds. First, local authorities often wink at the enterprises' practice of tax evasion. A check conducted in 1987-88 under the auspices of the State Council, for instance, uncovered fiscal fraud amounting to 10 billion yuan (4.2 percent of the budgetary income of 1988). That was probably just the tip of the iceberg . It was estimated that at least a half of state enterprises were engaged in some forms of avoidance and that an amount of revenue equivalent to about 2-3 percent of national income was lost in fiscal fraud.²

Second, local governments often grant tax holiday and ad-hoc tax relief for local enterprises (Walder 1992). In many cases, such authorizations exceed their statutory rights and contravene tax laws. In 1978, exempted or relieved taxes amounted to only 600 million yuan nationwide. In 1988, however, 10 billion yuan of taxes were absolved. Between 1978 and 1988, a total of 48.6 billion yuan of taxes were not collected, which was equivalent to 83 percent of the deficits occurring in the same period (Wang 1990).

Third, the shift to tax contracting in 1986 made it easier for local governments to leave a much larger share of profits to local enterprises. Unlike the "taxes for profit" reform, the contracting system relies on ad-hoc negotiation of profit or tax delivery responsibilities between enterprises and

their supervisory bodies, which allows local governments to continue acting as "patriarchs" in their regions. Indeed, more often than not local governments are very lavish in negotiating contracts with their subordinate enterprises. Small wonder a World Bank study finds that whatever forms of contracting were adopted, the effective rates of income tax were always much lower than the nominal rate (World Bank 1990b).

Local governments benefit both directly and indirectly from what local enterprises have retained. Direct benefits usually take the form of what is known in Chinese as tanpai--the imposition of various fees on enterprises in addition to formal tax obligations (Huang 1990). Without any statutory basis, such ad-hoc charges are a main vehicle for local governments to appropriate local enterprises' retained profits. A nationwide survey conducted in 1990 found that there were altogether more than 50,000 varieties of such charges (Editorial Committee 1991), from which local authorities extracted at least 20 billion yuan a year (Wang 1988). A large percentage of enterprises' extrabudgetary funds was sucked away by tanpai. Empirical studies suggest that somewhere between 20 and 60 percent of extrabudgetary funds originally retained in the name of enterprises eventually ended up in the coffers of local governments (Liang 1989, Zhu 1990, Li 1991, Y. Wang 1992). Some enterprises complain that the burden of tanpai is twice as heavy as that of formal income taxes (Wang and Xiao 1992).

Even if extrabudgetary enterprise funds don't change hands, local governments can still dictate how such funds are used. A strategy for local governments to do so is pingpan (assortment plate), which refers to schemes in which various local enterprises are "invited" to invest in projects local governments consider vital for regional development. It is hard for enterprises to reject such "invitations." On the one hand, the local

government generally has fairly good information about the financial strength of every enterprise within its jurisdiction. Therefore, lack of funds cannot serve as a sufficient excuse for not accepting such "invitations." On the other hand, as centralized material allocation is withering, a substantial portion of the materials falling outside central purview are managed by local governments (World Bank 1990a). Moreover, banking institutions have also increasingly come under the control of local governments. Depending on local governments for allocating cheap inputs and credit, enterprises cannot afford to offend local bosses by not following their guidance.

Even if enterprises spend their extrabudgetary funds in housing projects or distribute them as bonuses, local governments would still benefit in the sense that their burden of financial expenditures in those areas would be lightened.

Under a situation in which local forces have strong incentives to maximize extrabudgetary funds, the center needs an effective apparatus for policing local forces if it hopes to control the size of those funds. Measures that were once effective in containing local forces prior to the reform have become increasingly irrelevant in the post-reform era. New control mechanisms, however, have yet to be developed. The result is what we have observed--the explosion of extrabudgetary funds in the 1980s.

The Decline of State Capacity

The explosion of extrabudgetary funds represents a significant erosion of the state's extractive capacity. In Table 2-3, I use the five definitions developed in part I to estimate the changes of the Chinese government's political-capacity-as-fiscal-extractive-capability in the last four decades.

From the column II of the table, we find that, contrary to conventional wisdom, the size of the public sector has expanded rather than contracted

during the reform era, if extrabudgetary funds are included. Of the enlarged public sector, however, the portion under the center's control has been significantly reduced (columns III and IV). In market economies, the ratio of central state revenues to total state revenues is normally higher than 50 percent. Even in the United States, a very decentralized system by world standards, the federal government's tax income accounts for about 60 percent of the total tax revenues (World Bank 1990b). But in China, the central government's share (28 percent) is now only half that of the federal government of the United States. In theory, due to its major role in the national economy, the central government in a socialist country should command a substantially larger share of GDP or national income than in a capitalist setting (Musgrave 1969). However, the share of national income controlled by the central government of China (column V) has declined from 24 percent in the 1950s and 1960s to 13 percent in the 1980s, much lower than what central governments in developed countries (24.2 percent of GNP) and middle income countries (24 percent of GNP) were able to capture, and even lower than what central governments in Third World countries were able to get (15.4 percent of GNP) (World Bank 1990b).

Is the rise of the "second budget" an important factor causing the decline in central extractive capacity? The five columns suggest that the decline of the central state's extractive capacity is due as much to a declining share of budgetary revenue in national income as to the accelerating growth of extrabudgetary funds. If there were no extrabudgetary funds, both the share of national income occurring through taxes to the state (25 percent, column I) and the center's share of total budget revenues (50 percent, column III) would have been considered comparable to other countries'. Only when

taking into account extrabudgetary funds held by lower levels of government and state enterprises do we find that the center's share is too small.

A correlation analysis of the relations between the growth of extrabudgetary funds and budgetary funds produces the results shown in Table 2-4.³ Here we find that the growth of extrabudgetary funds and the growth of budgetary funds were positively correlated in the early years of the People's Republic, not correlated in the chaotic Cultural Revolution period, and negatively correlated in the reform era. When the preferences of the central and local governments were largely convergent, local governments did not try to increase extrabudgetary funds at the expense of budgetary funds. That is why the correlation was positive in the first period. No correlation in the second period was probably due to the fact that in this period the preferences of the central and local governments began to diverge but the center was still able to maintain a degree of extractive capacity. The negative correlation in the reform era indicates that local forces have gotten the upper hand in their competition for resources with the center. Indeed, since the reform started, extrabudgetary funds have grown at much higher rates than that of budget income. While the former grew around 9.3-fold between 1978 and 1991, the latter increased less than 2.8-fold. An enormous amount of financial resources that would have been seized by the state budget thus have been either "given" willingly by the center to enterprises and local governments, or "taken" by the local forces against the center's will.

Political Consequences of the Decline of Central Extractive Capacity

The decline of central extractive capacity has had three important political consequences: a decline in central state steering capacity, a

decline in legitimation capacity, and a growth in the power of local government.

The Decline of Steering Capacity

In any economic system, a careful management of effective demand is crucial for macroeconomic stability. Such a function must primarily be performed at the central level (Oates 1988). To perform the role of stabilization, however, the central government has to have sufficient financial resources at its disposal. Without the support of sufficient resources, its policy instruments are not likely to be effective. The declining extractive capacity has weakened Beijing's steering capacity.

First, both individual and public consumption have expanded more rapidly than central leaders would like. Between 1978 and 1987, the income of urban residents increased at an average annual rate of 17.2 percent, and public consumption 16.3 percent, both of which were much higher than the growth of national income (13.4 percent). The central government has adopted since the early 1980s numerous measures to curb the expansion of consumption, but so far they have had little effect, because most of the money has come from extrabudgetary funds (Deng 1990).

Enterprises are the driving force in the explosive growth of consumption. They have good reason to divert as much extrabudgetary funds as possible to current consumption. First of all, enterprises are granted only the right to dispose of extrabudgetary funds; they do not have ownership. If they invest such funds in productive projects, at best they would be allowed to retain a part of the profits produced by the projects. In other words, they would have only a partial ownership of what the funds would bring about. If they consume those funds now, however, they in effect enjoy a full ownership. Moreover, if enterprises accumulate extrabudgetary funds, their

savings may be tapped to satisfy the revenue needs of the local government in forms of tanpai. Furthermore, what a single enterprise retains after taxes is generally too small to be used for meaningful investments (Li, Fan, and Cong 1987, Deng 1990). For these reasons, enterprises' best strategy in handling extrabudgetary funds is to consume them. Numerous studies have shown that 70-80 percent of enterprises' retained profits were spent on consumption (Song 1989, Bi, Ren, Tie 1991).

Second, Beijing has largely lost control over the level and structure of investment. Between 1978 and 1987, China's capital investment grew at an average annual rate of 21.9 percent, much higher than the targeted rate and the growth rate of national income (Qiu 1991). Local governments have been the driving force behind the capital expansion. Most of the local projects are orchestrated by local governments (Deng 1990). Local governments' favorites are high-profit processing projects, which they expect to become lucrative sources of future local income. Despite discouragement from Beijing, the decade of the 1980s saw small cigarette factories, small breweries, small textile mills, small home electronic appliance plants, and the like springing up throughout China. In sectors that produce positive externalities, however, local governments have little incentive to invest and thereby the level of investment has been too low. Investment in energy, raw material, transport, and communication, for instance, has lagged far behind that in processing industries, thus creating many "bottlenecks" in the economy (Xiao and Wan 1992, Chen 1993).

In theory, the central government could solve the problem of structural imbalance by investing to fill the structural gaps, but to do so it has to have sufficient investable funds at its disposal. But that is exactly what the central government has found difficult to obtain. Since the early 1980s,

extrabudgetary funds and bank loans, both of which are controlled by local governments, have underwritten most capital constructions. The proportion of capital investments financed through the state budget has been falling since the start of the reform. By the end of the 1980s, it may have dropped to below 10 percent (Yao 1991). Therefore, it is not surprising that the central government has been able to control neither the level nor the structure of capital investments.

Due to the runaway increase of both consumption and investment, the aggregate demand for consumer goods and capital goods persistently exceeded the supply capacity of the economy throughout much of the 1980s, which posed an enduring threat to macroeconomic stability.

A sign of macroeconomic instability is inflation. From 1951 to 1978, the average annual inflation rate was just 0.7 percent. In the first five years of the reform, inflation remained mild, rising annually 2.6 percent on average from 1979 to 1984. After 1984, prices started to rise at an accelerated rate. In 1988, the inflation rate climbed to 18.5 percent, and in the first six months of 1989, it reached 25.5 percent. The urban costs of living increased even faster. As the inflation rate rose to levels that had been unknown in decades, the whole nation was thrown into panic. Dissatisfaction with the high inflation rate was an important factor that brought millions of people to the streets in 1989 (S. Wang 1992). In 1992 and 1993, when a new round of "investment fever" (touzi re) and "consumption fever" (xiaofei re) engulfed China, inflation rate again quickly climbed to the level of double digit, thus giving rise to concerns of political stability (Yuan 1993).

In addition, the continuing lags in infrastructure development pose a threat to China's future development. As pointed out above, the expansion of

the processing sector has constantly outpaced the development of the country's infrastructure in the past decade. Given the existing distribution of resources, it is unlikely that the center's investment in energy, transportation, and raw materials industries would be able to offset the pressure exerted by growing local investment in processing industries. If the existing "bottlenecks" are going to persist or take a turn for the worse, it is doubtful how long China's impressive growth record of the last fifteen years or so will last (Wang and Hu 1993).

The Decline of Legitimation Capacity

Two factors have contributed to the decline of legitimation capacity: inequality and corruption. The explosive growth of funds outside central control has resulted in growing inter-regional, inter-sectoral, and inter-unit inequality. In theory, the central government should have the prime responsibility for distribution policies (Oates 1988). But in today's China there are an immense amount of financial resources that are not subject to central redistribution; and what are available to the center are not sufficient for it to perform the function of distribution. Extrabudgetary funds simply stay where they are created. Enormous gaps thus exist between units, sectors, and regions in terms of how much extrabudgetary funds they obtain (General Planning Department of Ministry of Finance 1992). Since extrabudgetary funds tend to be self-multiplying, the gaps are likely to be perpetuated and widened. The 11 coastal provinces, for instance, procured 55 percent of all local extrabudgetary funds in 1985. Two years later their share went up to over 70 percent (Deng 1990). As mentioned above, enterprises are inclined to divert most of their retained funds toward increasing bonuses and other forms of welfare; and local governments tend to spend extrabudgetary funds on projects providing local public goods. As a result, the quality of

life for people working in different units or living in different regions differs a great deal (He and Tang 1992, Zheng and Zhang 1992, Li and Shang 1993, Zhang 1994), and the gaps are going to persist and widen unless the center's ability to perform the function of distribution is enhanced.

The augmentation of extrabudgetary funds has also facilitated corruption. Since it has become a common practice for enterprises and local governments to file false reports about their extrabudgetary incomes and to misrepresent their extrabudgetary expenditures, doors are open for corrupt local officials to spend public money for their personal enjoyment.

Extrabudgetary funds enable enterprises and government agencies to establish what Chinese call "little pots of gold" (xiaojinku). From such "little pots of gold," corrupt officials can draw money to buy fleets of foreign cars, to pay their expenses on traveling in China or abroad, to purchase nice apartments for their families, and to entertain themselves in luxurious restaurants.

Not only are existing extrabudgetary funds likely to be misused, power is often misused to create extrabudgetary funds. Ad-hoc charges are a case in point. Because funds allocated through money-tight budgetary processes are not adequate for government agencies to support their routine operations, not to mention providing competitive earnings for their staff, those agencies have become desperate to explore new sources of income. The ad-hoc charges are a means through which they can make extra incomes. Facing mounting fiscal deficits, the central government has also been compelled to legitimate such practices (An 1992). Such "profit-making" activities have further distorted the roles of those state agencies. Instead of seeing the corporate goals of the state as the best means of maximizing their individual self-interests, Chinese bureaucrats are becoming increasingly dependent on "rents" and

therefore increasingly committed to the expansion of "rental havens." As a result, not just individual bureaucrats but also whole bureaucratic institutions are becoming corrupted (Lan 1993, Yu and Yang 1993). Corruption has enabled some officials and their relatives to become super-rich overnight, thus further widening the gap between the "haves" and "have nots" (Zhu and Zhu 1993).

The widening inequality and rampant corruption have considerably undermined the legitimacy of the communist regime. Were one to single out one factor underlying Chinese's support for the communist regime, it would be their expectation of a society in which people are equal and the government is honest. But, now, despite the improvement of living standard for almost everyone, people feel that their society is becoming increasingly "unjust." A 1988 public opinion survey found that 88.7 percent of urban residents believed that social inequalities were "great" or "very great" in China. That was one of the main reasons why millions of Chinese took part in the protest movement of 1989 (S. Wang 1992).

The Fragmentation of the State

Mounting social and economic problems are symptoms of the inability of the central government to guide societal development. Central control capacity apparently is not sufficient to resolve those problems. However, the weakening of central control should be attributed not so much to challenges from what many now call the rise of "civil society" as to the fragmentation of the state. Thanks to Deng's fiscal decentralization, the state apparatus in China has been gradually fragmented. The central government at first intentionally "withdrew" from some of the areas where it had intensively intervened in the past, hoping that the autonomy granted to lower levels of government and enterprises would improve the efficiency of the system. Local

forces exploited the opportunity to appropriate every bit of resources and power left off by the center and thereby gradually strengthened their ability to compete for control over more resources with the center. As the center's extractive capacity declined, its policy options became increasingly limited, and the effectiveness of its policy tools was greatly impaired. Thus, in effect, the center was "pushed out" of some of the areas in which it wanted to retain a firm control. In a space of fifteen years or so, the Chinese political structure has been transformed from one that was once reputed for its high degree of centralization and effectiveness, into one in which the center has difficulty in coordinating its own agents' behavior. Because power and resources are dispersed, the exercise of central control now depends to a large extent upon the consent of the subnational units whose actions are slipping from central control. Beijing no longer has undisputed authority over local forces; the center is just one level of decision making and not necessarily the one with guaranteed access to channels of effective control down to the grass-roots. Subnational units are of course still under the nominal control of the center, but they have their own agendas and, more important, they have resources to pursue those agendas even in defiance of central guidance. The corporate coherence of state organizations, which is imperative for the state to play its roles, has been greatly weakened.

Acknowledgments

Deborah Davis, James Scott, Ian Shapiro, Andrew Walder, and participants at seminars at Columbia University, Duke University, and University of Washington have commented on this paper. I wish to thank them for their helpful criticisms. I also wish to acknowledge the financial support for this project by Yale Center for International and Area Studies Research Fund, Yale Social Science Faculty Research Fund, and Center for Modern China Research Fund.

Table 2-1

Growth of Budgetary Funds, Extrabudgetary Funds,
and National Income (in 100 Million yuan)

<u>Year</u>	<u>B-Income</u>	<u>E-Income</u>	<u>N-Income</u>
1952	173.94	13.62	589
1953	213.24	8.91	709
1954	253.53	14.23	748
1955	255.46	17.02	788
1956	286.26	21.42	882
1957	310.04	26.33	908
1958	387.60	55.99	1118
1959	487.12	96.55	1222
1960	572.29	117.78	1220
1961	356.06	57.40	996
1962	313.55	63.63	924
1963	342.25	51.85	1000
1964	399.54	65.86	1166
1965	473.32	75.56	1387
1966	558.71	81.13	1586
1967	419.36	83.61	1487
1968	361.25	77.44	1415
1969	526.76	87.42	1617
1970	662.90	100.94	1926
1971	744.73	118.56	2077
1972	766.56	134.24	2136

<u>Year</u>	<u>B-Income</u>	<u>E-Income</u>	<u>N-Income</u>
1973	809.67	191.29	2318
1974	783.14	219.72	2348
1975	815.61	251.48	2503
1976	776.58	275.32	2427
1977	874.46	311.31	2644
1978	1121.12	347.11	3010
1979	1067.96	452.85	3350
1980	1042.22	557.40	3688
1981	1016.38	601.07	3941
1982	1040.11	802.74	4258
1983	1169.58	967.68	4736
1984	1424.52	1188.48	5652
1985	1776.55	1530.03	7020
1986	2122.01	1737.31	7859
1987	2199.35	2028.80	9313
1988	2357.24	2360.77	11738
1989	2664.90	2658.83	13176
1990	2937.10	2708.64	14384
1991	3149.48	3243.30	16117

B-Income: Budgetary income.

E-Income: Extrabudgetary income.

N-Income: National income.

Source: General Planning Department of Ministry of Finance. 1992

Zhongguo Caizheng Tongji [China Finance Statistics]. Beijing:

Science Press, pp. 13-14, 19, 339.

Table 2-2

Extrabudgetary Funds by Ownership (in 100 million yuan)

<u>Year</u>	<u>Local Government</u>	<u>Administrative Agency</u>	<u>Enterprise</u>
1952	12.53		1.09
1953	1.40	2.07	5.44
1954	2.07	3.34	8.82
1955	3.27	3.68	10.07
1956	5.00	3.85	12.57
1957	5.66	3.80	16.87
1958	17.59	9.29	29.11
1959	35.39	11.78	49.38
1960	23.39	23.13	71.26
1961	13.29	15.61	28.50
1962	20.50	15.21	27.92
1963	7.19	11.99	32.67
1964	8.87	16.07	40.92
1965	9.47	18.74	47.35
1966	10.36	20.00	50.77
1967	9.72	22.00	51.89
1968	9.96	24.00	43.48
1969	12.19	26.00	49.23
1970	13.45	28.00	59.49
1971	14.72	30.00	73.84
1972	23.28	31.66	79.30
1973	24.14	32.57	134.58
1974	22.65	34.60	162.47
1975	27.86	42.30	181.32

<u>Year</u>	<u>Local Government</u>	<u>Administrative Agency</u>	<u>Enterprise</u>
1976	28.35	48.81	198.16
1977	30.76	56.84	223.71
1978	31.09	63.41	252.61
1979	39.94	68.66	344.35
1980	40.85	74.44	442.11
1981	41.30	84.90	474.87
1982	45.27	101.15	656.32
1983	49.79	113.88	804.01
1984	55.23	142.52	990.73
1985	44.08	233.22	1252.73
1986	43.20	294.22	1399.89
1987	44.61	358.41	1625.78
1988	48.94	438.94	1872.89
1989	54.36	500.66	2103.81
1990	60.59	576.95	2071.10
1991	68.77	697.00	2477.53

Source: General Planning Department of Ministry of Finance. 1992.
Zhongguo Caizheng Tongji [China Finance Statistics].
Beijing: Science Press, pp. 188-89.

Table 2-3:

Changes in State Extractive Capacity: 1952-1989

	I	II	III	IV	V
Year	BI/NI	BI+EI/NI ⁴	CBI/BI	CBI/BI+EI	CBI/NI
1952-1966	0.35	0.40	0.67	0.59	0.24
1967-1977	0.33	0.41	0.62	0.50	0.20
1978-1989	0.25	0.45	0.50	0.28	0.13

BI: Budgetary income

CBI: Central budgetary income

EI: Extrabudgetary income

NI: National income

Source: General Planning Department of Ministry of Finance. 1992.

Zhongguo Caizheng Tongji [China Finance Statistics].

Beijing: Science Press.

Table 2-4

	Cor. Coeff.	Std. error	t-stat
1952-1966	0.841	0.14	5.614***
1967-1977	0.143	0.27	0.433
1978-1991	-0.714	0.24	3.531**

*** Significant at the 0.001 level

** Significant at the 0.01 level

Source: General Planning Department of Ministry of Finance. 1992.

Zhongguo Caizheng Tongji [China Finance Statistics].

Beijing: Science Press, pp. 319-20.

Footnotes to Chapter 2

¹ For the sake of convenience, in this study we treat the central government as a homogeneous entity represented by what Levi calls "the rulers (1988)," what Zysman calls "the national political executive (1983)," what Krasner calls "central decision makers (1978b)," or what Chinese call "the center" (zhongyang). It needs to be emphasized that, composed by hundreds of agencies and thousands of bureaucrats, the central government as such is also internally fragmented; and that conflicts between different central agencies, like ones between the central government and local governments, could compromise the ability of the central government to pursue coherent policies.

² Caizheng 12 (December 1989), p. 8.

³ The idea of conducting this type of analysis comes from Deng Yingtao (1990), pp. 278-279.

⁴ According to some authoritative Chinese sources, the center's share in budget revenues has been declining in the last four decades. In the first three year of the PRC, the center's share was as high as 80%. It stabilized at about 70% in the FFYP, and then fell down to about 50% during the GLF period before it rebounded to around 65% in the rest of the 1960s. In the 1970s, Mao's second decentralization caused the center's share in revenues dropping again, down to just slightly over 60%. Deng Xiaoping's reform has driven the ratio further downward to about 50% on average for the whole decade of the 1980s. See Yun Zhiping and Wang Hong, (1990) and Wu Mingyi, (1990). In 1989, the center's share was only 45.2%. See Yuan Dong, (1992). For the sake of convenience, I set the center's share of

budget revenues at 67% for the entire period of 1952-66, 62% for the period of 1967-77, and 50% for the period of 1978-89 in this column.