"Central-local Relations Revisited: the 1994 Tax Sharing Reform and Public Expenditure Management in China"[1]

Christine P.W. Wong

World Bank Office in China

July 2000

As China moves forward in its transition toward a market economy, the budget becomes increasingly important as a policy instrument. Along with monetary policy, it is the Government's main tool for maintaining macroeconomic stability and allocating resources to achieve policy objectives, taking over the role that used to be preformed by the Plan. As the Plan is stripped of its resource support and transformed into an indicative guide, the budget becomes more clearly a reflection of Government's policy intentions. Through the transition, the budget finances some new tasks, such as the social responsibilities formerly financed by state-owned enterprises (SOEs), and phases out some old ones, such as investments in commercial operations. The budget will also have a role in resolving the legacy of the planning system, which left banks severely undercapitalized, pension systems underfunded, and many SOEs in the red. In the economic slowdown of the late 1990s, government spending became China's key tool for stimulating domestic demand and employment growth.

The elevated role of the Budget brought new scrutiny to the health of the fiscal system and how well it serves public needs. In a recent report, the World Bank found the Chinese budget to be weak and largely ineffectual in performing its key functions of maintaining aggregate fiscal discipline, matching resources to government priorities, and delivering services efficiently.[2] China's budget system and processes give spending units too much authority and require virtually no accountability, and thus provide a weak foundation for government prudence, accountability, and responsiveness. The government does not adequately track where, how, or how much public money is spent, what services the public sector delivers, or how many people the state employs.

---

[1] Paper for the International Conference on "Central-Periphery Relations in China: Integration, Disintegration or Reshaping of an Empire?" Chinese University of Hong Kong, March 24-25, 2000. The views in this paper are those of the author and do not necessarily represent those of the World Bank.

[2] World Bank, *China: Managing Public Expenditures for Better Results*, 2000.

Many of these findings were echoed in the National Auditor-General's stinging criticisms issued in June 1999, at the annual meeting of the National People's Congress Standing Committee, which focused especially on the lax management of public funds in the implementation of the 1998 budget. In the wake of these criticisms, the NPC ordered the Ministry of Finance to implement some immediate changes.[3]

Delivering these changes will require overhauling the core processes of budget preparation and execution, as well as funds management. Through the 1990s the government has made a number of promising reforms in budgetary management: passing the Budget Law and experimenting with new budgeting techniques. Reform of extrabugetary funds began in 1996 and intensified in 1998 and 1999. In 1999 the MOF began to formulate organizational budgets that show all budgetary, extrabudgetary and other resources and spending for each ministry[4]. Minister of Finance Xiang Huaicheng also announced plans for treasury reform to improve financial management of public funds, and introduction of new standards for government procurement.

These measures comprise a large, complex and ambitious package of reforms that will be crucial in moving China toward a modern budget management system and a well-functioning public sector. However, their successful implementation hinges on support from central ministries and local governments. *There is a real danger that if the key reforms of extending budgetary control over extrabudgetary funds, and treasury reform and reform of the budgeting system are perceived as centralizing reforms that enhance the power of the Ministry of Finance, they will meet with fierce resistance.* MOF's failed attempt to introduce a fuel tax in 1999 serves as a clear warning of this danger. Proposed as a replacement for the plethora of local levies on the purchase and use of vehicles, the national fuel tax was intended to rationalize the financing mechanisms for road building and maintenance. In spite of MOF's promise to return all the revenues to local governments, rollout of the tax has been deferred indefinitely.[5]

---

[3] These changes include speeding up the budget preparation cycle, consulting with the NPC in greater detail on budget formulation, shifting to an organizational (departmental) presentation of the budget, and introducing standardized procurement guidelines.

[4] In 1999 MOF presented organizational budgets for four ministries to the NPC: Ministry of Education, the Ministry of Science and Technology, the Ministry of Labor and Social Security and the Ministry of Agriculture.

[5] Passage of the fuel tax had a prerequisite of a revision to the National Highway Law, which contained a clause stating that there would be a fuel *fee* as a financing mechanism for highways. The NPC took the unprecedented step of rejecting the amendment proposal twice, the second time by only one vote. When the revision was passed on a third try on October 31, 1999, the MoF was confident that the fuel tax would be quickly rolled out – requiring only a State Council directive. In December, however, the Communications

This paper revisits intergovernmental relations in China to highlight their important role in determining the outcome of this critical set of reforms on the government's agenda. I will argue that the evolution of central-local relations in China has to be understood within the context of China's transition experience, whereby fiscal decentralization occurred in an ad hoc and uncoordinated process that was mainly driven by the breakdown of the old fiscal system, where the central government devolved responsibilities to lower levels largely as a strategy of burden-shedding. The 1994 Tax Sharing Reform was an important event that marked the first attempt to put intergovernmental fiscal relations on an objective basis, but the process is far from complete. Many steps remain in clarifying and separating central and local responsibilities, and the central government's slowness in putting resources into an equalization transfer scheme has reinforced local suspicions about the firmness of central government commitment toward building healthy local finances.

The next section of the paper will briefly review the evolution of intergovernmental relations through 1993. Section II looks at the main objectives and components of the 1994 reform package. Section III examines the outcomes of this reform. The last section concludes with a look at the next steps in central-local relations.

I. The Problematic Evolution of Central-Local Relations: 1979-1993

In the "Maoist" economy (1949-1979), many resource allocation levers were decentralized but the budget remained highly centralized (Wong 1985, 1986, 1991, passim).

Stylized facts of the fiscal system include the following:

1) All revenues accrued to the central government, and all expenditures were budgeted by central government through the extensive use of "norms". Local discretionary spending was confined to minor amounts financed from extrabudgetary funds.[6]

2) The revenue system was industry-centered – government revenues depended on three features of the planned economy: fixed prices that favored industry, state ownership of, and compulsory

---

Bureaus in some provinces sent out notices that the fuel levies and vehicle purchase fees would be collected through year-end 2000.

[6] Extrabudgetary funds was a category of budgetary funds that local governments were allowed to set aside from budgetary allocations. In the 1950s they were held to less than 5 percent of budgetary funds.

procurement and mandated trade among producers at plan prices. These features ensured that value-added from all sectors would be transferred to industry. In the Soviet-type system agriculture was irrelevant for the generation of budgetary revenues. Its contribution was hidden through the "price scissors".

3) The tax system was simple and crude: there were few tax types – no personal or corporate income taxes, or resource taxes. Revenues for the state coffers were captured through taxes and profit remittances – prices and taxes were used interchangeably for revenue generation purposes. At the end of the 1970s profits from SOEs accounted for nearly half of total government revenues.

4) Tax administration was simple and straightforward: there were relatively few taxpayers – SOEs. The accounts of SOEs were easy to monitor: given fixed prices, planned output and sales, tax capacity and tax effort were easy to determine. The government had several accounts for each enterprise (output plan, input plans, budget and profit plans, etc.) from which consistency checks could be made.

Pre-reform intergovernmental relations

In this centralized system, the central government set spending priorities and approved local budgets. Local governments were agents of the central government (in close parallel to SOEs – the distinction between local governments and SOEs was unimportant since both were budgetary units of central government). Policy was set by the central government: on civil service salary scales, pension and unemployment benefit levels, educational standards, health care standards, etc., and tax collection was delegated to local governments.

Expenditure assignments. The central government was responsible for national defense, economic development (capital spending, R&D, universities and research institutes), industrial policy, and administration of national institutions such as the judicial system. It delegated to local governments responsibilities for delivering day-to-day public administration and social services such as education (except universities), public safety, health care, social security, housing, and other local/urban services.

Financing for local expenditures came from the central budget, with revenue sharing calculated to permit local governments to finance their expenditure responsibilities. (Again, the parallel with SOEs carrying out quasi-fiscal spending is strong – this is the origin of the unclear division of responsibility between government and enterprises.) Thus, *intergovernmental transfers were set to finance the gap between locally collected revenues and permitted local expenditures*.

This *revenue sharing system* was highly redistributive, with sharing rates that varied greatly across regions. For example, while Shanghai gave up 80-90 percent of its collected revenues, Guizhou was able to finance more than two-thirds of its expenditures from central subsidies.[7] Aside from equalization concerns, these revenue sharing rates were important for compensating for the effect of unequal prices and incomes, such that industrial regions remitted high proportions of their revenues, and agricultural and natural resource-producing regions received large transfers.

Effects of the transition

Fiscal Decline

Revenues fell from 35 percent of GDP in 1978 to below 12 percent in the mid-1990s. This was caused by the unsustainability of the old revenue mechanism as central planning was dismantled: profitability fell in industry as prices adjusted to market forces, sharply cutting the government's revenue intake through SOEs. The emergence of nonstate/private enterprises competing for profits in industry also contributed to revenue decline. Finally, enterprise reforms required profit-sharing schemes to provide incentives, which reduced revenue flows to the budget.

Lagging tax administration also contributed to the fiscal decline

- The rapidly changing economic conditions and changes in prices and sales made it hard to monitor financial performance and tax obligations of enterprises
- The shift to many taxpayers required a new approach -- in the rural sector, for example, the agricultural tax used to be collected from 50,000 communes. Now it has to be collected from more than 200 million households and millions of township and village enterprises.

Tax policy didn't change fast enough. The rapidly changing economic structure brought changes to the tax base. The traditional tax base of SOEs was eroded but new taxes were not introduced quickly enough to tap the "new" economy. The result was that many of the growing sectors went undertaxed – services, foreign invested firms, export sector, and the property sector.

---

[7] National Bureau of Statistics, *Comprehensive Statistical Data and Materials on the Fifty Years of New China*, China Statistics Press, 1999.

The locus of expenditures shifted downward. Local expenditures grew much faster than central expenditures, especially safety net expenditures – unemployment insurance, early retirements increased pension spending, increased subsidies for housing, fuel, etc. Wage increases generally pushed up the cost of providing labor-intensive local services. The central budget absorbed most of the cuts, mainly in capital spending. As a result, the share of local expenditures has risen from 45% of the total in 1980 to more than 70% in the late 1990s.

The old revenue sharing system broke down.
Fiscal stress led to growing budget deficits that led in turn to dwindling intergovernmental transfers and a *de facto* devolution of responsibilities to local governments. As local governments were left increasingly with the burden of financing, *they shifted from providing services to financing them:* an unplanned decentralization of responsibilities.

The central government could no longer monitor tax effort at the local level, and was forced to negotiate with increasingly recalcitrant local governments on revenue shares. From 1980, four different revenue sharing systems were introduced and abandoned as the central government tried to finetune the system of incentives for local governments, culminating in introduction of the "fiscal contracts" in 1988, under which the central government negotiated contracts with each province on revenue transfers.[8]

By the early 1990s, a climate of distrust surrounded intergovernmental fiscal relations. The central government attributed the continuing fiscal decline in part to local government unwillingness to collect taxes while diverting funds from budgetary to extrabudgetary channels, while local governments saw the repeated changes in revenue sharing rules as a lack of firm commitment by the central government to revenue assignments. Moreover, through the 1980s in several rounds the central government revised the ownership of key sectors and introduced new levies to increase its share of revenues (e.g. the Energy and Transport Key Construction Fund and the Budget Adjustment Fund). Several rounds of "borrowings" also helped to convince local

[8] For analyses of this evolution, see Michel Oksenberg and James Tong (1991), "The evolution of central-provincial fiscal relations in China, 1953-1983: the formal system," *China Quarterly*, March; Christine P.W. Wong (1991), "Central-local relations in an era of fiscal decline: the paradox of fiscal decentralization in post-Mao China," *China Quarterly* (December); Wong (1992), "Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China," *Modern China* (April).

governments that surplus revenues were not safe from the central government predation (Wong, Heady and Woo 1995).

II. The 1994 Tax Sharing Reform

The fiscal reform of 1994 was a fairly comprehensive package of measures designed to address three areas of concern: to stem the fiscal decline and provide adequate revenues for government, especially central government; eliminate the distortionary elements of the tax structure and increase its transparency; and revamp central-local revenue sharing arrangements. Among its key provisions was a major reform in indirect taxes that extended the value-added tax (VAT) to all turnover, eliminating the product tax and replacing the business tax in many services. It simplified the tax structure and unified treatment of taxpayers for some taxes.

The centerpiece of the package was introduction of the Tax Sharing System (*fenshuizhi*), which fundamentally changed the way revenues are shared between the central and provincial governments. Under the Tax Sharing System (TSS), taxes were reassigned between the central and local governments. Central taxes (or "central fixed incomes") include customs duties, the consumption tax, VAT revenues collected by customs, income taxes from central enterprises, banks and nonbank financial intermediaries; the remitted profits, income taxes, business taxes, and urban construction and maintenance taxes of the railroad, bank headquarters and insurance companies; and resource taxes on offshore oil extraction. Local taxes (or "local fixed incomes") consist of business taxes (excluding those named above as central fixed incomes), income taxes and profit remittances of local enterprises, urban land use taxes, personal income taxes, the fixed asset investment orientation tax, urban construction and maintenance tax, real estate taxes, vehicle utilization tax, the stamp tax, animal slaughter tax, agricultural taxes, title tax, capital gains tax on land, state land sales revenues, resource taxes derived from land-based resources, and the securities trading tax. Only the VAT is shared, at the fixed rate of 75 percent for the central government, and 25 percent for local governments.

To phase in the new revenue divisions, the central government introduced an important modification to the TSS. First, adhering to the “hold harmless” principle, the central government committed to rebating to each province an amount equal to the reduction in the local tax base due to TSS:

Base year tax rebate = PBR – (LT + 0.25 x VAT)

where: PBR is the province's base retained revenue in the base year (1993); and the new tax base consists of the newly designated local taxes (LT) plus 25% of the VAT.

In addition, to permit each province to share in the growth of its "lost" tax base over time, the central government committed to giving back 30 percent of its increased revenue from VAT and consumption tax (CT) each year:

Tax rebate in 1994 to province i =

$(PBR_i – LT_i – 0.25 \text{ x } VAT_i)_{1993}$ x {1+ 0.3 x $[0.75 \text{ x } VAT_i \text{ increase} + CT_i \text{ increase}]_{1994}$}

Thereafter, the amount of tax rebate for province i in the year t =

Tax rebate $_{i, t-1}$ x {1+ 0.3 x $[0.75 \text{ x } VAT_i \text{ increase} + CT_i \text{ increase}]_t$}

The second important change under the 1994 reform was that to avoid the problem of poor local effort in collecting central government taxes, tax administration was also reformed, with the establishment of a national tax system (NTS) to collect central government revenues, and a local tax system to collect local taxes. This was achieved by splitting the existing tax bureaus into national and local tax offices. The main responsibility of the NTS is the collection of VAT and consumption tax -- they collect all of both taxes and then transfer 25 percent of the VAT revenue to the local government. In most localities the split was achieved by reassigning staff according to their current functions: those in charge of turnover taxes were assigned to the NTS, and those assigned to local taxes went to the local tax bureaus.

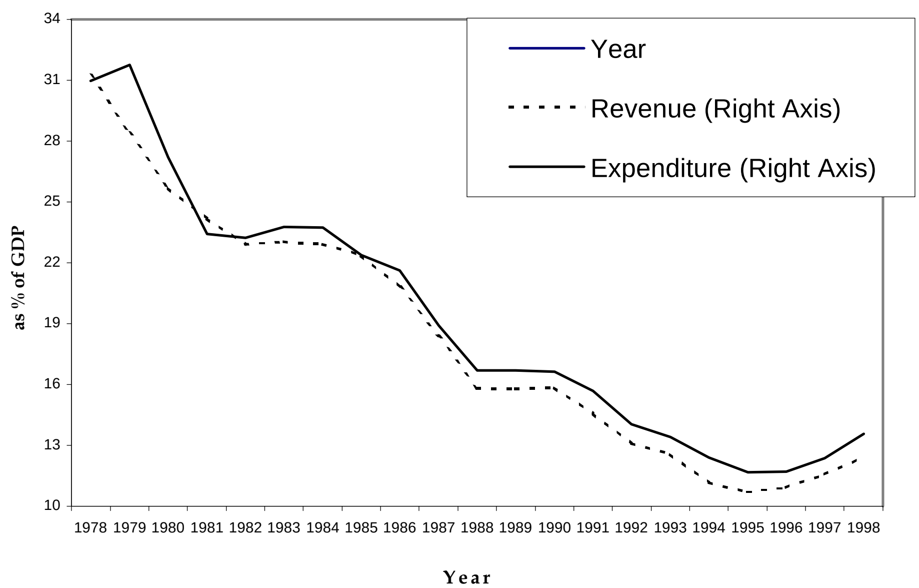
III. Outcomes of the 1994 Reform

Assessing the reform's outcome is not straightforward, for three reasons. First it depends on whose perspective is adopted, given the differences in central and local interests. Second, the reform gave rise to some obfuscation over statistical reporting, which has made it difficult to decipher the reform's impact on the vertical distribution of revenues. Third, one of the byproducts of the reform was to give incentive to falsification of fiscal reporting, which also contributes to difficulties in assessing the outcomes.

Tax reform. Judging by the objectives spelled out by the central government at the outset, the 1994 reform achieved some notable successes. The tax structure is greatly simplified. The VAT has replaced the product tax, and has been implemented basically at a uniform rate of 17 percent. The enterprise income tax structure has been merged to put all domestic enterprises on the same tax schedule, and the top rate has been reduced from 55 percent to 33 percent. The former system of profit and tax contracts, under which SOEs negotiated annual remittance obligations, has been eliminated, and many exemptions were eliminated.

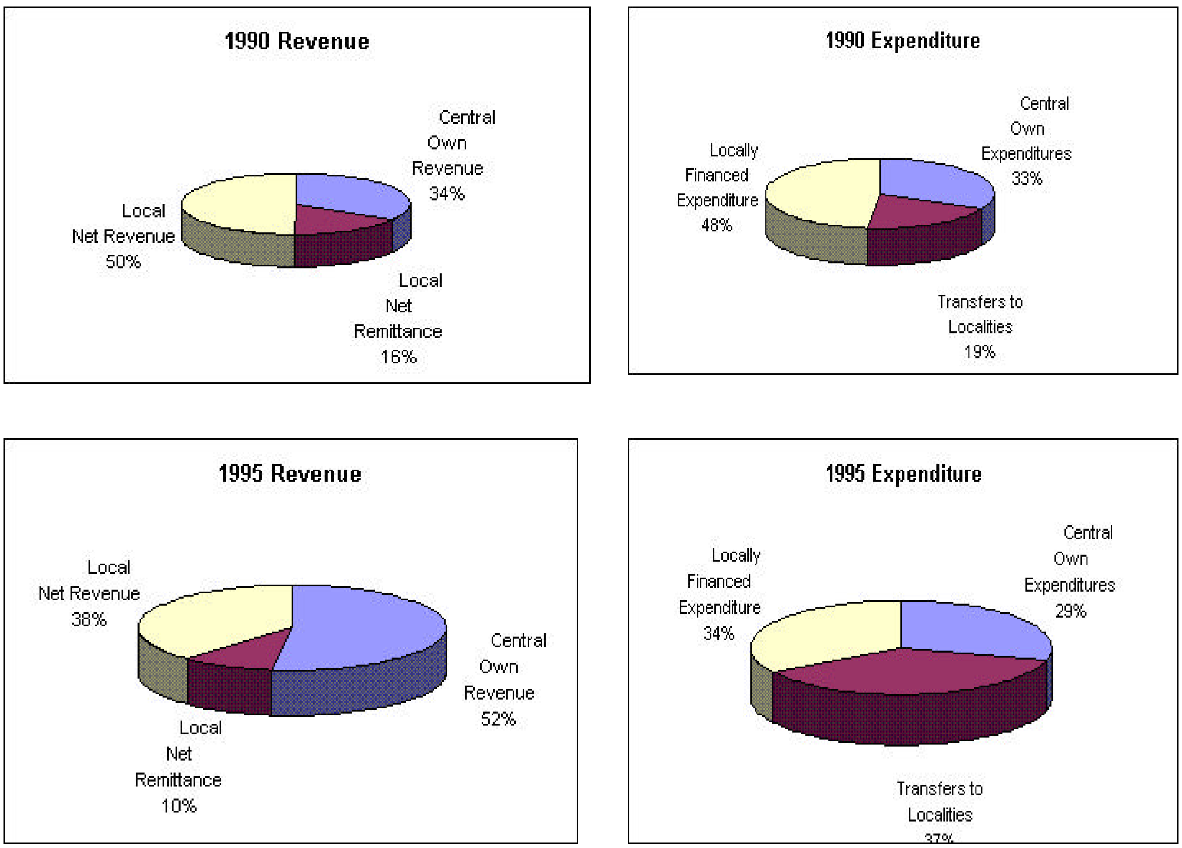
Re-Centralization. The central government's objective for the reform was, from the outset, to achieve *recentralization* of the fiscal system under the slogan of "raising the two ratios" – the revenue-to-GDP ratio, and the ratio of central government's share to total revenue. By this criterion the reform can also be judged to have achieved some success. Even though the revenue-GDP ratio continued to fall through 1994 and 1995, the seventeen-year decline was finally reversed in 1996. In 1999 revenues were 14.2 percent of GDP (see Figure A).

Figure A: The End of Decline?

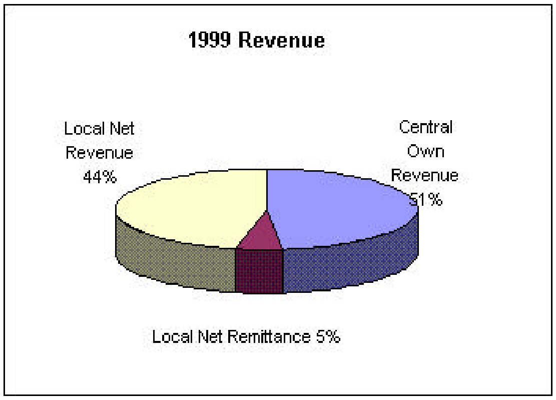


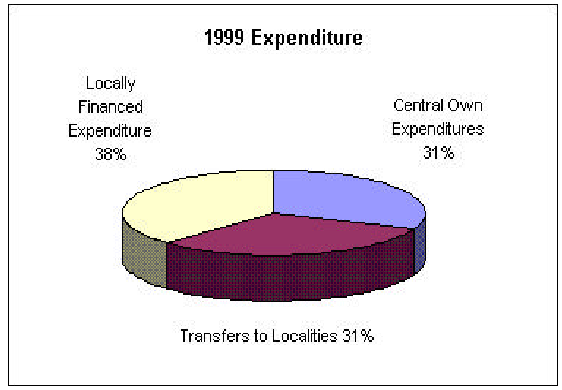
The objective of raising the central share of revenues has also been achieved, though short of the original target level of 60 percent. In 1994, the one-time transfer of the bulk of VAT and CT revenues to central coffers boosted the central share from 22 percent of total revenues to 55.7 percent. The expectation was that the longrun trend under the TSS would be toward *centralization* of revenues, given that the VAT was the most productive tax in the system, and one that would be fully administered by the NTS. Surprisingly, however, even though the revenue buoyancy of the VAT has been high (1.365 over the 1994-1998 period), its share in total tax revenues has slipped from 43 to 37.4 percent of tax revenues, while the consumption tax has slipped from 9.1 to 8.4 percent. [9] In contrast, the business tax, mostly a local tax, has risen from 12.6 to 16.2 percent of tax revenues, while the personal income tax, an insignificant tax in 1994, collected 34 billion yuan and accounted for more than 6 percent of local taxes in 1998. Due to the higher income elasticity of local taxes, the central share of revenues has slipped, but remains around 50 percent (see Figure B). This finally ended the situation where the central government depended on local remittances to finance its outlays.

Figure B: Central Revenue and Expenditure after Local Transfers
(by percentage)



[9] Ministry of Finance, *China Fiscal Statistical Yearbooks (zhongguo caizheng nianjian*), 1995 and 1999.





Source: Ministry of Finance, China Finance Yearbook 1996, p. 535; and Liu Zhongli (1998) and Xiang Huaicheng (1999).

The creation of the NTS has insulated the collection of central taxes from local interventions and is undoubtedly a factor contributing to raising the "two ratios". More importantly, the process whereby the NTS collects all central VAT revenues and returns a part of it to local governments has created a new lever of central control – the Ministry of Finance can threaten to withhold tax refunds to provinces that do not comply with its directives.

Misleading statistics. Data on the effect of TSS on central-local revenue shares have been difficult to interpret for a number of reasons. First, the 1993 local tax figures were inflated. The Government had announced in August 1993, that 1993 would be used as the base year for the TSS reform. This led to a surge in tax collection during the last four months of the year, with the incredible result that turnover tax revenues for the year were 49.6 percent higher than in 1992. This biases any comparison of local revenues using 1993 figures.

The second problem is the way fiscal statistics are often used: in the statistical yearbooks central and local fiscal revenues are reported before transfers, with each including all "fixed incomes" accruing to its side. In this format, local revenues include the 25 percent of VAT accruing to the locality, but exclude the tax rebate that is returned under the TSS agreement. These data show *every* provincial unit including Shanghai, Beijing and Tianjin, in a net deficit position and dependent on central transfers. Local officials often use this set of data to show how difficult their fiscal position is. Since the tax refunds are large and nondiscretionary, however, excluding them from local revenues significantly overstates the extent of centralization effected under TSS. For example, in 1998 Shanghai had local revenues of 38.07 billion yuan and spent 47 billion yuan. Its "deficit" was covered by a transfer of 21.68 billion yuan from the central government, most of it in tax refunds (MOF 1999, p.405). Similarly, Beijing had revenues of 22.95 billion yuan but spent 28.07 billion yuan, receiving 10.67 billion in central transfers (*Ibid*. p.396). Including the tax refunds as local revenue would present a significantly different picture of central-local revenue shares, one that is closer to reality.

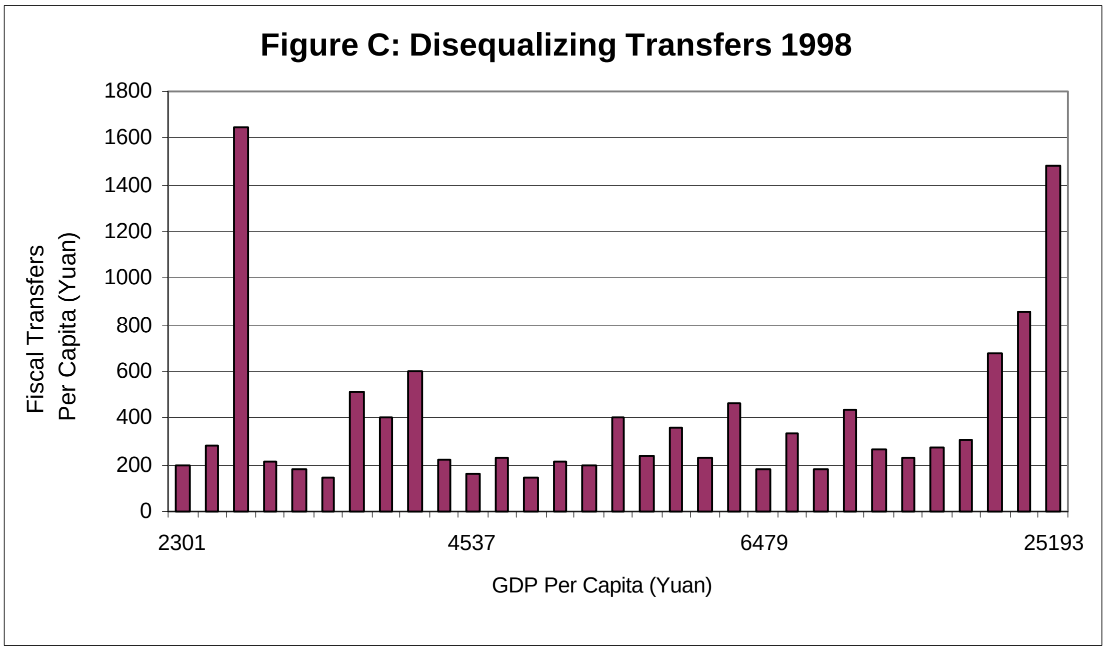
A more worrisome problem is the falsification of local statistics. Reports of this practice date to 1994, when the Ministry of Finance introduced revenue growth targets (or reference targets) as a retaliatory measure aimed at provinces that were suspected of having artificially inflated revenues in 1993, mandating that their revenue growth in 1994 match or surpass levels achieved in 1993.[10] Provinces in turn imposed revenue growth targets on subprovincial governments. The result was a widespread introduction of a variety of systems of rewards and punishment at the local levels. Even though the MOF stopped this practice of issuing revenue growth targets after 1994, it apparently has continued at the local levels. For example, Puding County, a nationally designated poor county in Guizhou, received a revenue growth target of 20 percent for 1997 from the provincial fiscal department. To meet this target, the county finance bureau set contracts mandating revenue growth (after tax sharing with the central government) of 15 percent, 20 percent and 25 percent per year with its eleven subordinate townships and towns. Townships meeting their targets would be given rewards of Y10,000; 20,000 and 30,000; while the township leaders would receive Y3-5000. On the downside, those not meeting their targets would be penalized by amounts equal to the rewards (i.e. Y30-50,000 for the townships, and Y3-5000 for township leaders). Large additional rewards were reported to be in store for those meeting their targets three years in a row.[11] That these incentives gave rise to falsification of data was confirmed by MOF officials, who explained that when revenues fall short of targets, officials might try to avoid penalties by reporting inflated revenues on one side of the ledger and inflated expenditure figures on the other side. Recent reports in publications of the National Tax Service confirm these problems.

Equalization. The 1994 reform should also be assessed in terms of conventional standards of whether it was efficiency enhancing or equalizing. *A priori*, one would expect the reform to have had a counter-equalizing effect on the regional distribution of revenues and expenditures

10 When turnover tax revenues for 1993 increased by 49.6 percent on the announcement that 1993 would be used as the base year for future tax refunds, the MoF suspected that many provinces had inflated their collections by calling in not only tax arrears but may have persuaded enterprises to pre-pay their 1994 tax obligations. To prevent these provinces from gaining and to ensure revenue growth in 1994 and after, the Ministry of Finance set targets for revenue growth for each province, with the threat of reductions in base revenues for those provinces that failed to meet their target.

11 Notes from a visit to Guizhou, June 1997.

since TSS shifted the revenue sharing principle from the previous, weakly redistributive one to the derivation principle -- where transfers are pegged to collections, returning more to the revenue-rich regions than to poor ones (Figure C). To offset this counter-equalizing effect, the Government had promised to roll out a new, formula-based transfer payments scheme to aid poor regions. While a “transitional pilot intergovernmental transfer scheme” has been in use since 1995 (and modified each year), it remains grossly underfunded (see Table 1). With a funding of 6 billion yuan in 1998, this scheme comprised just 1.8 percent of all central transfers to the provinces.



This expectation is supported by anecdotal evidence For example, I found in fieldwork in Guizhou in 1997 that per capita real fiscal expenditures had fallen in the province beginning from the late 1980s, despite the provincial tax effort that brought higher than average revenue growth during the 1990s. Similar results were found in an ADB study (1998), which reported real per capita expenditures falling by 14% in Gansu province during 1991-96, in contrast to the increases in Hebei and Guangdong provinces.[12] These changes are important to document and address, since structural reforms and a slowdown in economic growth in 1998-1999 have exacerbated fiscal pressures everywhere. Given the large existing regional disparities in socioeconomic indicators, such that Beijing has the same infant mortality rate as France, but Qinghai and Yunnan are barely equal to Ghana or Bolivia, the declining fiscal capacity of the poorest localities may be further jeopardizing the provision of basic services in those areas.

Table 1 Transitional Transfer Scheme

(100 million Yuan)

	1995	1996	1997	1998
Total	20.70	34.64	50.21	60.57
Beijing				
Tianjin				
Hebei	0.69	1.03	1.58	1.91
Shanxi	0.35	0.96	1.59	1.96
Inner Mongolia	2.47	3.71	4.97	5.76
Liaoning				
Jilin		0.47	0.96	1.34
Heilongjiang	0.50	0.79	1.79	1.92
Shanghai				
Jiangsu				
Zhejiang				
Anhui	0.81	1.10	1.60	2.05
Fujian				
Jiangxi	0.77	1.44	1.98	2.43
Shandong				
Henan	1.41	1.95	3.65	4.32
Hubei	1.34	1.75	2.66	3.03
Hunan	0.95	1.51	2.04	2.34
Guangdong				
Guangxi	1.09	1.84	2.52	2.98
Hainan			0.63	0.88
Chongqing				0.76
Sichuan	1.81	2.95	3.63	3.81
Guizhou	2.59	3.69	4.26	5.58
Yunnan	0.12	0.20	0.20	0.24
Tibet		1.00	1.77	2.10
Sha'anxi	0.55	1.62	2.45	2.72
Gansu	0.71	1.32	2.06	2.29
Qinghai	1.04	1.91	2.94	3.97
Ningxia	1.04	1.59	1.93	2.21
Xinjiang	2.46	3.81	5.00	5.97

[12] William Capron, Richard S. Eckaus, Loraine West, and Susan Whiting, “A Study of Extrabudgetary Revenues and Expenditures in the People’s Republic of China,” Asian Development Bank TA 2743, 1999.

Source: Local Finance, 1999.8.

Efficiency. The reforms were unlikely to have been efficiency-enhancing for two reasons. First, the government once again juggled revenue assignments, but left the expenditure assignments untouched. In the process, the reform increased the vertical imbalance and imposed further fiscal stress on local governments. These pressures appear to be most intense in the rural sector and in the poor regions. In the words of one Hunan official, "Township finances (in the province) are basically bankrupt, and county finances are near-bankruptcy, such that wage arrears (to civil servants) are not an isolated phenomenon… In Hunan we have a saying, 'it is normal for payroll to be a month behind. For payroll to be two months behind is habitual. If it is three months late it's a little awkward, but it is not considered strange to be four months behind.'"[13] He reported that all five counties and two cities subordinate to Hengyang Municipality were behind in meeting payroll in 1999.

Second, the reforms did not address issues of extrabudgetary and off budget financing of local government. Since 1994 these problems appeared to have worsened. As explained in Section II, through the transition expenditures have devolved to local levels. Two growing expenditure items are the financing of social safety nets -- pensions, unemployment insurance, disability, and minimum income support; and capital investment expenditures. The latter are large because of the need to build new infrastructure or replace or refurbish obsolete and poorly maintained ones. In the "rust belt" areas local governments have also borne the uncompensated transfers of social expenditures from SOEs -- housing, childcare, medical care, education, and pension debts. Until the 1994 reform gave local governments some significant tax types (business tax, enterprise profit and personal income taxes), they had few tax revenues that were not subject to negotiated sharing with the central government. Even after the 1994 reform, local governments cannot set the rates or change the bases of collection; nor can they introduce new taxes.

The only avenue open to local governments for revenue expansion is to develop extrabudgetary and off-budget resources, and one they have pursued energetically. Virtually all levels of government – down to municipal districts and villages – have the capacity to exact payment from local taxpayers. They are also owners of substantial assets such as land, enterprises, and sometimes natural resources. Constrained by rules and regulations on the sale of these assets, local governments could nevertheless use the assets as collateral for bank loans, or as investment

[13] Paper from Hengyang Municipality, 1999.

in joint ventures.[14] In the liberalizing climate of the 1990s, many local governments entered business ventures to expand their revenue bases. However, the rapidly growing extra-budgetary and off budget funds undermine fiscal discipline, hamper funding of the government's priorities, and give rise to wasteful spending and corruption (World Bank, forthcoming).

Intergovernmental relations. The reforms have failed to improve intergovernmental relations. In the eyes of some local officials, it was yet another round of "reform" in which the central government achieved its objectives at the expense of local governments. They point to the lack of reform on central transfers, where hundreds of types of earmarked grants are still allocated in an ad hoc, nontransparent fashion that hinder local budgeting efforts. They argue that the central government has reneged on a key plank of the TSS, the equalization scheme. Instead, the central government is seen to signal its preference for retaining control, by pumping more funds into earmarked transfers and final accounts transfers while pleading a lack of funds for equalization. Of the five types of central transfers in 1999, more than 100 billion yuan were spent in earmarked transfers, and 10-15 billion were spent as final account subsidies.

IV. Next Steps in Intergovernmental Reform

Even though China is a unitary country, it has many features of fiscal federalism, with increasingly autonomous local governments. Fiscal decentralization was inevitable once the country embarked on its program of market reform, since the fiscal system inherited from the period of central planning was fundamentally incompatible with decentralized decision-making through market mechanisms, and therefore unsustainable. Moreover, China's huge size and regional diversity require decentralized management.

China's approach to intergovernmental reform has to date been partial and incremental. This has led to a growing mismatch between revenues and expenditure responsibilities for subnational governments. Knowing the stress this has imposed on local budgets, the central government has tolerated and often encouraged local governments to seek "self-reliant" solutions that have resulted, over time, to a situation where resources allocated by government (at all levels) *outside* the budget are far larger than those on-budget.[15]

---

[14] For examples of these, see David Zweig (papers on zone fever).

[15] This is the argument in Christine Wong (1998), "Fiscal Dualism in China: Gradualist Reform and the Growth of Off-Budget Finance," in Donald Brean, Editor, *Taxation in Modern China* (New York:

In the current reform to improve budgetary management, China's first priority is to move toward a more comprehensive budget. Without it, better budgetary procedures will show only limited results in terms of better matching expenditures with the Government's priorities, and more cost-effective service delivery. The government made a good start with State Council Document 29, which aimed to clarify and limit the authority for setting fees and levies, sharply curb the practice of setting up "funds" to finance capital expenditures, increase MOF supervision of funds, and extend budgetary management over the 13 largest "funds" that account for more than 100 billion yuan in revenues. Over time, the Government's announced aim is to convert some fees to taxes and integrate them fully into the budget. Given that extrabudgetary funds finance a large share of government functions, in particular at local levels, enlisting the support of local governments is critical. This gives real urgency to repairing central-local relations.

Build a partnership with local governments. To complete its transition toward a market economy, China will have to undertake the necessary reforms to transform its public sector and build the institutions that will support the development of a vigorous market economy. The strategic challenge over the next few years is how to push forward the critical reforms in budgetary management, treasury management, along with extrabudgetary reform. The package of reforms will be complex, difficult and protracted. The good news is that there exists a surprising consensus across levels of government on the need for reform. The central government must tap this sentiment to work out a comprehensive set of changes designed to enlist local governments as *partners* in the transition process that put local finance on a stable and healthy path of development. This will require revamping expenditure assignments, revising revenue assignments that includes conferring some real fiscal autonomy on local governments in exchange for extending budgetary scrutiny over extrabudgetary and off budget resources, and revising the Budget Law to guarantee these assignments.

Complete the 1994 reforms. The first step is to complete the extension of TSS to lower levels. The TSS reform divided taxes between the central and provincial governments, but left it to the provinces to divide "local" taxes among the four levels of province, prefecture/municipality,

---

Routledge Press); and (1999) "Converting fees to taxes: reform of extrabudgetaryfunds and intergovernmental fiscal relations in China, 1999 and beyond," paper presented at the Association for Asian Studies Meetings, Boston, Massachusetts (March). In the 1999 paper, I estimate that extrabudgetary funds and extrabudgetary activities of government and their agencies add up to 16-22.5% of GDP. This estimate includes 8-10% of GDP in extrabudgetary fees and funds, 2-3% in unreported expenditures of government, county, and township. How the provinces have done this and what implications these divisions have on equalization and efficiency should be reviewed, and if necessary, rectified. New problems have also emerged on the administration of "local" taxes. The recent placement of the local tax system under provincial control has led to complaints that lower level governments are forced to offer ever-larger incentives to tax collectors who are not answerable to them. Intra-provincial equalization is also an important concern given the large size and diversity of many of China's provinces.

Clarify and revamp expenditure assignments. Unclear expenditure assignments remain a major weakness in China's intergovernmental fiscal relations. On paper, China's intergovernmental division of responsibilities is roughly in line with that dictated by public finance theory and reflected in international best practices. In practice, several levels of government are involved in the same or similar activity. Reducing overlap among levels of government will be a key area for efficiency gains. Local governments have some unreasonable expenditure assignments that should be removed, e.g. local financing of safety nets and pensions, usually at the municipal level. This creates big problems for "rust belt" cities. Environmental protection, given the externalities, should not be a purely local responsibility. Public health and basic education are also issues to be reviewed. Considerations for revising expenditure assignments should be an integral part of the process of redesigning government – to focus more sharply government expenditures on public goods and to shed unnecessary items that should be provided by the private sector.

Stop unfunded mandates. Central government regularly decides on policies that affect spending at the lower levels, but do not provide the financial means for the policy. This practice continues unabated – the civil service pay increase implemented in 1999 will be only partly paid by increased central transfers. To honor the new expenditure assignments requires the central government to stop "throwing dinner parties" where they "expect local governments to pay the bills".

Revamp earmarked grants. In addition to general equalization grants, China could rethink its system of earmarked grants. The current transfers are mainly used for SOE subsidies, but they could become a tool for furthering national goals without imposing unfunded mandates on lower

---

3-5% in quasi-fiscal spending via the banking system, 1-2% in commercial incomes of governments, and the 2-2.5% in social security system.

level governments. Since most of the service delivery takes place at subprovincial level, central government could consider targeting these grants to municipal or even county level. Although the effective design and monitoring of earmarked grants is no easy matter, the task will become less cumbersome with improved budgeting, treasury management and accounting systems.

Revise the Tax Sharing Commitments. China will not overcome the regional disparities in service delivery without further revision of TSS. The 1994 reforms did too little to redistribute resources across provinces, and this situation will likely persist for a long time unless the rules are changed. To reduce horizontal disparities more quickly, the central government must be able to use an increasing share of the tax refunds for equalization in order to finance improvements in service delivery in poorer provinces.

References

Asian Development Bank, "A Study of Extrabudgetary Revenues and Expenditures in the People's Republic of China" (by William Capron, Richard S. Eckaus, Loraine West, and Susan Whiting), Asian Development Bank Technical Assistance Project No. 2743, 1999.

Michel Oksenberg and James Tong (1991), "The evolution of central-provincial fiscal relations in China, 1953-1983: the formal system," *China Quarterly*, March.

Ministry of Finance, *China Fiscal Statistical Yearbooks (zhongguo caizheng nianjian*), 1995 and 1999.

National Bureau of Statistics, *Comprehensive Statistical Data and Materials on the Fifty Years of New China*, China Statistics Press, 1999.

Christine P.W. Wong (1985), "Material Allocation and Decentralization: Impact of the Local Sector on Industrial Reform," *The Political Economy of Reform in Post-Mao China*, Elizabeth J. Perry and Christine Wong, Editors, Harvard University Press.

_______(1991), "Central-local relations in an era of fiscal decline: the paradox of fiscal decentralization in post-Mao China," *China Quarterly* (December).

_______(1992), "Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China," *Modern China* (April).

______ (1998), "Fiscal Dualism in China: Gradualist Reform and the Growth of Off-Budget Finance," in Donald Brean, Editor, *Taxation in Modern China* (New York: Routledge Press).

______(1999), "Converting fees to taxes: reform of extrabudgetary funds and intergovernmental fiscal relations in China, 1999 and beyond," paper presented at the Association for Asian Studies Meetings, Boston, Massachusetts (March).

Wong, Christine, Christopher Heady and Wing T. Woo (1995), *Fiscal Management and Economic Reform in the People's Republic of China*, Oxford University Press.

World Bank (2000), *China: Managing Public Expenditures for Better Results* (grey cover).

David Zweig (1998) paper on zone fever.