

## Fiscal Decentralization in China: History, Impact, Challenges and Next Steps

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Fiscal decentralization has been a fundamental aspect of China's transition to a market economy, and the country has made substantial effort to break down its highly centralized fiscal management system with various forms of fiscal contracting systems (1978-1993) and later a tax sharing system (1994-present). This paper is aimed to provide a comprehensive review of China's experience in fiscal decentralization, explore the impact of fiscal decentralization on economic growth and public expenditures, and to identify political as well as economic issues arising after the 1994 tax sharing reform. As the government is shifting the development policy towards building a harmonious society, the current fiscal system requires immediate policy attention for its opaque and inappropriate expenditure assignment, particularly at the sub-provincial levels, the vertical fiscal gap and widening fiscal disparities, the complex and malfunctioning intergovernmental transfer system, the neglected sub-provincial fiscal arrangements, and the weakness in the vertical accountability of local governments to the Center as well as the horizontal accountability of local administrations to local needs and preferences.

*Key Words:* Fiscal decentralization; Fiscal federalism; Public finance; Fiscal policy; Public expenditure; China.

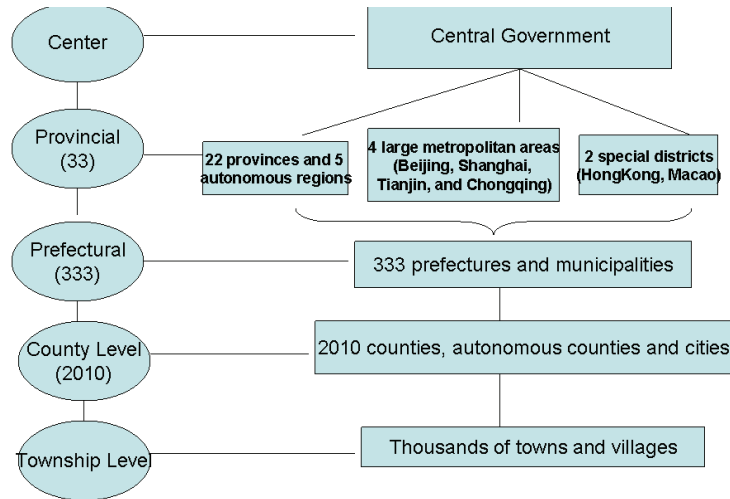
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## 1. INTRODUCTION

The last decade has witnessed a world trend of fiscal decentralization in the developing countries as an escape from inadequate growth and inefficient governance. Fiscal decentralization is widely recognized as an essential component in China's transition to a market economy, and advocated by many for its contribution to the country's remarkable economic performance over the last 30 years. The country has made substantial effort to break down its highly centralized fiscal management system with various forms of fiscal contracting systems and later a tax sharing system.

Although China remains a unitary political system, the current structure of governance bears prominent features of fiscal decentralization. Sub-national governments in China are organized in a four-level hierarchy, with each level of government reporting to the next highest level (see Figure 1).

**FIG. 1.** China: Structure of Government (End of 2005)



Source: China Statistical Yearbook 2006.

In a comparative perspective, China is much more decentralized than most developing and transition countries, especially on the spending side (table 1). In 2005, more than 70 percent of the entire public expenditure was made at the sub-national levels, in contrast to the average 19.6 percent in developing countries and 22.3 percent in transition economies.

This paper is aimed to provide a comprehensive review of China's experience in fiscal decentralization, explore the impact of fiscal decentralization

**TABLE 1.**

Fiscal Decentralization Indicators: China vs. Other Countries

Indicator	China	Developing Countries	Transition Economies	OECD countries
Subnational share of government revenue	48	16.6	18.4	19
Subnational share of government expenditure	74	19.6	22.3	32

Note: Data for China are for 2005. Data for other countries are for various years and adapted from Shah (2004).

on economic growth and public expenditures, and to identify political as well as economic issues arising after the 1994 tax sharing reform.

The paper is divided into six main parts: the second section provides a historical overview of China's fiscal decentralization before 1994; the third section briefly summarizes the economic and political background of the 1994 reform; the 1994 tax sharing reform and its impact are examined in the fourth section; the next section focuses on the existing expenditure and revenue assignments of the fiscal system; the in-depth analysis of the intergovernmental transfer system is presented in the sixth section; the following section addresses various issues related to local government financing, including local taxes and local borrowing; the eighth section assesses the shifting of fiscal power between the central government and local governments through decentralization; the debate over the impact of fiscal decentralization on economic growth is highlighted in the ninth section; the tenth section discusses political and economic issues induced by the fiscal decentralization reforms; and the paper concludes that the time is ripe for significant amendment and reforms of the existing fiscal arrangements, and lists potential policy options for consideration.

## 2. A HISTORICAL REVIEW OF FISCAL DECENTRALIZATION BEFORE 1994

A good knowledge of the history and process of China's fiscal decentralization is indispensable to understand the challenges facing the country's intergovernmental fiscal system today. This paper therefore opens with a thorough review of the major changes in China's fiscal system since the inception of the People's Republic in 1949. This survey is divided into three periods: the pre-reform fiscal system of 1949-1978; the ad-hoc decentralization of 1979-1993; and the tax assignment system, in operation from 1994 to the present. For each period, the fiscal system is reviewed under

three themes—tax assignment, expenditure assignment, and the intergovernmental transfer system.

**(1) 1949 — 1978 Pre-Reform Fiscal System: Central Control System**

The centralization of planning, finance, and administration dominated the first 30 years of the People’s Republic (1949-78). It was a system in which all decisions about what people needed were decided from the top. Revenues were collected by local governments and accrued to the center. The consolidated budget system forbade discretionary spending power for local governments. And in the context of the pre-industrial, agrarian, and under-developed conditions then prevailing in China, the central planning system worked (Lardy 1978; Oksenberg and Tong 1991; Riskin 2000; Wong 2000; Wong, et al. 1995).

**Tax System**

The tax system was crude, with no personal or corporate income taxes. Revenues were largely raised from the profit remittances of state-owned enterprises (SOEs), whose profitability was ensured by state-fixed prices. At the end of the 1970s, profits from SOEs accounted for nearly half of total government revenues. Although the provinces participated in raising revenues, their expenditures were budgeted by the center.

Tax administration was simple since there were relatively few taxpayers, and those few were mainly SOEs. Tax collection was delegated to local governments. Given fixed prices and planned output and sales, the accounts of SOEs were easy to monitor and their revenues were easy to determine (Wong 2000).

**Expenditure and Budget**

Expenditures were essentially determined at the center. Under the consolidated budget system, the central government set spending priorities, approved local budgets according to local spending needs, and determined civil service salary scales, pension and unemployment benefits, educational and health care standards, etc. In the absence of independent budgets, sub-national governments lacked discretionary spending power. They were budgetary units identical to SOEs — merely agents of the central government.

With respect to expenditure assignment, 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. Sub-national governments were in charge of delivering day-to-day public administration and social services such as primary and secondary education, public safety, health care, social security, housing, and other local/urban services.

**The Intergovernmental Transfer System: Fiscal Gap Transfers**

Since local finance came from the central budget, intergovernmental transfers were set to finance the gap between locally collected revenues and permitted local expenditures. In other words, local income in excess of expenses was submitted to the central government, and shortfalls were automatically covered. This revenue-sharing system was highly redistributive: 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 (Wong 2000).

The pre-reform fiscal system was simple and effective in the particular context, but it was completely lacking in fiscal incentives for local governments or enterprises. As China's leaders set their sights on a market economy from 1979 onward, the mechanisms of the planned economy — including monopoly state ownership of industry, administrative prices, and central economic planning — were dismantled, and accordingly the fiscal system quickly broke down. For example, the foundation of the pre-reform fiscal system — profits from state-owned enterprises — collapsed in the face of the burgeoning non-state sector, growing competition imposed on SOEs, and rising wages and resource prices. Furthermore, tax administration was enormously challenged by the proliferation of enterprises with various forms of ownership. The fiscal system was on the verge of a crash, and during the 1980s a number of different revenue-sharing systems were tried out to overcome the rigidities of the central planning system. The next section will elaborate on these major fiscal reforms from 1979 to 1993.

**(2) 1979 — 1993 Ad Hoc Decentralization: Fiscal Contracting System**

The series of fiscal reforms over the period 1979-1993 were mostly driven by the significant reduction in fiscal revenue collection as a percentage of GDP and the precipitous decline in the central government's share of revenues. The central government grappled with the considerable fiscal pressure it was facing by devolving expenditure responsibilities to sub-national governments — a move that led to complex bargaining over sharing schemes between different levels of government. Fiscal reforms in this period were aimed at promoting local economic development through increasing the responsibilities of local governments and increasing their autonomy in carrying out fiscal functions, while also preserving an adequate degree of fiscal control for the central government. Three different revenue-sharing systems were introduced in 1980, 1985, and 1988. These reforms have been described as an example of 'market-preserving' federalism, which refers to a special type of federalism that limits the degree to which a country's po-

litical system can encroach upon its markets (Montinola, et al. 1995; Qian and Weingast 1997).<sup>1</sup>

### **1980 Contract Responsibility System**

In 1980, the highly centralized system was replaced by a fiscal revenue-sharing system. From then on, the central and provincial governments each began to ‘eat in separate kitchens’, which provided sub-national governments with an incentive to collect revenues. Under this system, central-provincial sharing rules were established by the central government; provincial-prefectural relations were governed by the province; and this principle extended to prefectural-county relations. There were three basic types of revenues under the reformed system: central-fixed revenues, local-fixed revenues, and shared revenues. During the period 1980-84, about 80 percent of shared revenues were remitted to the central government and 20 percent were retained by local governments. The bases and rates of all taxes, whether shared or fixed, were determined by the central government. Enterprises were supposed to pay taxes to the level of government to which they were subordinate. Most revenues were collected by local finance bureaus.

### **1985 Modified Contract Responsibility System**

The uniform-sharing formula reform during the period 1980-1984 boosted revenue collection in many areas — creating large surpluses in affluent provinces but also deficits in poor provinces. In 1985, the State Council redesigned revenue-sharing arrangements by varying schedules based on localities’ budget balances in previous years. The financially weak provinces were allowed to retain more revenues, but the wealthier regions, like Shanghai, Beijing, Tianjin, Liaoning, Jiangsu, and Zhejiang, were penalized by a requirement to remit more revenues to the center. As a consequence, the revenues from these regions generally grew more slowly than the national average, since the high level of remittance curbed local enthusiasm for expanding their tax bases.

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<sup>1</sup>Montinola, Qian, and Weingast identify a set of five conditions that represent an ideal type of institutional arrangement for market-preserving federalism (italics in original). (1) There exists a hierarchy of governments with a delineated scope of authority (for example, between the national and sub-national governments) so that each government is autonomous in its own sphere of authority. (2) The sub-national governments have primary authority over the economy within their jurisdictions. (3) The national government has the authority to police the common market and to ensure the mobility of goods and factors across sub-government jurisdictions. (4) Revenue sharing among governments is limited and borrowing by governments is constrained so that all governments face hard budget constraints. (5) The allocation of authority and responsibility has an institutionalized degree of durability so that it cannot be altered by the national government either unilaterally or under pressure from sub-national governments. While condition (1) is the defining feature of federalism, conditions two through five are required to ensure federalism’s market-preserving qualities.

### **1988 Fiscal Contracting System**

In the period 1988-1993, the 'fiscal contracting system' was implemented. This system required each level of government to contract with its subordinate level to meet certain revenue and expenditure targets. Six types of central-provincial revenue-sharing methods were adopted and applied to a range of provinces (see Table 2). Sub-national governments were required to finance their own expenditures through self-generated and shared revenues (Agarwala 1992; Lou 2008).

### **The Intergovernmental Transfer System: Mixed Gap-Filling Transfer System**

During this period, the transfer system was still predominantly a matter of transfers to fill gaps. When the base amount for expenditures was larger than the fixed local revenues, the province was allowed to keep all of the fixed revenue, and in addition was entitled to shared revenues, which filled the fiscal gap. When the base amount of expenditure in a province was less than its base amount of local fixed revenue, the province had to remit the surplus to the central government. And when the base amount for expenditure in the province was greater than both the base amounts for its fixed revenue and the shared revenues, then the province was permitted to keep both, filling the fiscal gap with 'fixed subsidy' grants from the central government (Zhang and Martinez-Vazquez 2003).

The system of intergovernmental transfers in China consisted of four kinds of central-local grants. First, 'Fixed Subsidies' were a transfer program aimed at redistributing revenues and expenditures to maintain local fiscal balance. Subsidies were given to provinces with base-year expenditures larger than base-year revenues. Second, 'Special-Purpose Grants' were initially used for disaster relief, poverty reduction, and other specific purposes, and were later expanded in both the range of programs and the size of the financial resources. Third, 'Annual Accounting Closing Transfers', determined at the end of each fiscal year, acted as an adjustment to net revenues and expenditures, taking into account transfers between central and local governments. And fourth, 'Capital Grants' were conditional grants disbursed by the central government mainly for local capital construction and other investment activities. Under the fiscal contract system, some provinces had to remit to the central government a part of their revenues, set according to a predetermined lump-sum amount or to a progressively increasing ratio of revenues. The central government depended a great deal on receiving transfers from the better-off provinces during this period.

**TABLE 2.**

1988 Fiscal Contracting Methods

<p><b>1. contracted sharing rate with fixed yearly growth rate of revenue</b></p> <p>The central-local revenue sharing rate and the yearly growth rate of local revenues were based on the revenue performance of the province over recent years and negotiated by the central and provincial governments. If the real growth rate was greater than the contracted rate, the province could keep all the surpluses. If the real growth rate was lower than the contracted rate, then the province had to make up the gap.</p> <p>Central gov't shared revenue in the province = revenue in the province in previous year * (1 + contracted yearly growth rate of the province) * contracted central shared ratio</p>
<p><b>2. fixed local shared rate in total revenue</b></p> <p>The sharing rate was determined on the basis of a base amount for total expenditure and a base amount for total revenue. In other words, the province shares the revenue growth according to the same ratio.</p> <p>Local gov't shared ratio of total revenue in the province = base amount for expenditure in province / base amount for total revenue in province</p>
<p><b>3. fixed local shared rate in total revenue + incremental fixed shared rate</b></p> <p>Besides sharing total revenue on the basis of a fixed shared ratio, the province could share the revenue growth at a different sharing ratio.</p>
<p><b>4. contracted remittance with fixed annual growth rate</b></p> <p>The province remits to the central gov't a fixed amount per year plus a variable amount determined by a fixed yearly growth rate contracted by the center and the province.</p>
<p><b>5. fixed contracted remittance</b></p> <p>The province remitted to the central gov't a fixed amount every year which equal to the revenue surplus in the base year:</p> <p>Fixed contracted remittance in province = base amount for revenue – base amount for expenditure</p>
<p><b>6. fixed contracted grants</b></p> <p>For all provinces whose base amount for expenditure was larger than the base amount for revenue, they keep all the base revenue and in addition get a fixed contracted grant from the central gov't every year which was theoretically equal to the fiscal gap in the base year.</p>

### 3. ECONOMIC AND POLITICAL BACKGROUND OF THE 1994 TAX SHARING REFORM

Despite the persistent efforts to revamp the malfunctioning fiscal system, the late 80s and early 90s were marked by a series of challenges, includ-



ing the continuing decline of the ‘two ratios’ (budgetary revenue to GDP, and central to total budgetary revenue); interference of local governments in the private sector<sup>2</sup>; increasing regional fiscal disparities; devolution of expenditure responsibilities (accompanied by diversion of resources away from formal budgets into extra-budgetary channels); and ongoing distrust between the center and localities (Lou 2008). The following section will address these issues in detail, one by one.

#### **Fiscal Decline**

The 1988 fiscal contracting system further dampened fiscal power at the center. Since the assignment of revenue was not clear, sub-national governments continued to appropriate central revenues. The center relied on local tax collection, which was highly subject to local authorities who frequently granted tax exemptions without proper central authorization. The local abuse of tax power instigated a vicious cycle of jurisdictional competition. The central government’s share of revenue fell from 33 percent in 1988 to only 22 percent in 1993 (see Figure 2). On the other side, local governments increased their revenue share, particularly those that were major contributors to the central government’s revenue. The fiscal contracts were not strictly adhered to and were revised repeatedly for some regions. The resulting phenomenon of a ‘weak trunk with strong branches’ compelled the central government to borrow continuously from local governments. The role of the central government in bridging regional fiscal disparities was dramatically weakened, and central support for basic public services was also constrained.

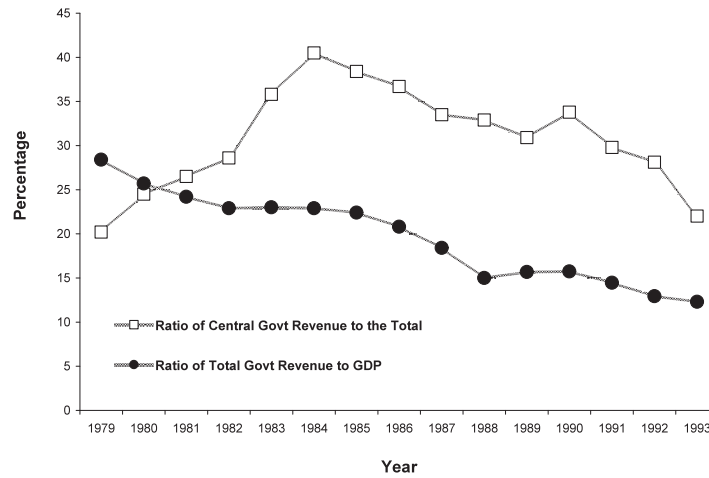
#### **Distortion in the Private Sector**

The fiscal contracting system of the 1980s, aligning tax revenues in accordance with the ownership of SOEs, induced a number of problems. First, the system aligned the interests of the government with those of enterprises, which not only encouraged sub-national governments to interfere in the operation of the enterprises and hence hindered the process of separating governments from enterprises (Zhengqi Fenli), but was also detrimental to the market economy by rendering special treatment to SOEs and destroying fair competition. Second, the system provided local governments with incentives to pursue their own fiscal interests in enlarging tax bases by the expansion of local enterprises such as distilleries and cigarette factories, which generated overlapping construction and development, and meanwhile stirred local protectionism.

#### **Increasing Fiscal Disparities**

The fiscal contracting system also contributed to greater regional disparities. With a variety of fiscal contracts in use (see Table 2), the system

<sup>2</sup>For example, duplication of industries to capture revenues that formerly flowed to the national treasury; granting of generous tax concessions to local SOEs; and expanded lending to these SOEs by local banks.

**FIG. 2.** The Two Ratios, 1979-1993

Source: China Statistical Yearbook 2004

was primarily the result of political negotiation between the central government and individual provinces, and it worked in a way detrimental to the poor regions. Rich provinces in the coastal region, like Canton, Shanghai, and Shandong, were able to have more advantageous contracts due to their development strategies and their political leverage. These provinces accumulated a substantial and growing revenue base by retaining most of the incremental revenues within the province. In the meantime, the central government was financially incapable of narrowing regional imbalances.

#### **Devolution of Fiscal Responsibilities and Growing Distrust between Center and Local**

Fiscal stress at the center forced the central government to cut intergovernmental transfers and shed more spending responsibilities to the lower levels of government. Meanwhile, local expenditures grew much faster than central expenditures, especially in unemployment insurance, pension funds, and housing subsidies. The share of local expenditure rose from 45 percent of the total in 1981 to about 72 percent in 1993. The role of local governments shifted from simply providing services to acting as both financier and provider.

A climate of distrust featured in intergovernmental fiscal relations in the early 1990s. The central government recognized that the continuing fiscal decline was partly due to local government unwillingness to collect taxes, while local government was also diverting funds from budgetary to extra-budgetary channels. From the local perspective, the repeated changes in

revenue-sharing rules were viewed as a sign of a lack of firm commitment at the center to building solid local finances. Moreover, on several occasions during the 1980s, the central government revised the ownership of key sectors and introduced new levies — for example, the Energy and Transport Key Construction Fund and the Budget Adjustment Fund — in order to increase its share of revenues. The central government also ‘borrowed’ revenue from local governments as a way of absorbing excessive local revenues. The manipulative actions by the center convinced local governments that surplus revenues were not safe from the center’s predatory behavior, and thus significant revenues were subtly switched into myriad extra-budgetary funds (Ahmad, et al. 2002; Wong, et al. 1995).

While the fiscal reforms of the 1980s all failed to reverse the trend of falling fiscal revenues, on the positive side, fiscal reforms during this period provided a device to mobilize local revenue collection in an effort to promote local economic development. When the 1988-90 system was supposed to expire in 1991, the central government failed to pursue alternative approaches, and the contracting system was extended until the end of 1993. A radical reform of the fiscal system was finally cooked up in 1994, at the climax of the fiscal struggle in China. The Tax Sharing Reform of 1994 was initiated with fixing the intergovernmental fiscal system as its main objective.

#### 4. THE 1994 TAX SHARING REFORM

The 1994 reform, which created a framework of fiscal relations between the central and local governments, is considered the most intensive and far-reaching institutional restructuring for intergovernmental fiscal relations since 1949. The reform was essentially an attempt to deal with basic revenue problems by curbing the fiscal decline and providing sufficient resources, especially to the central government; simplifying the tax structure by reducing tax types and rates; and unifying the tax burden on taxpayers. It also put central-local revenue-sharing on a more transparent, objective basis by replacing negotiated contracts with a rule-based system of tax assignment.

The centerpiece of the reform was the introduction of the tax assignment system (*fenshuizhi*), which specifies the way revenues are shared between the central and provincial governments. A detailed analysis of the tax assignment system is provided in the next section. The tax structure was greatly simplified. Value Added Tax (VAT) replaced the turnover-based product tax and was implemented at a uniform rate of 17 percent. Corporate income tax was unified to include all domestic enterprises, and the top rate was reduced from 55 percent to 33 percent. Excise taxes on tobacco, liquor, and other luxuries were introduced. The previous system of

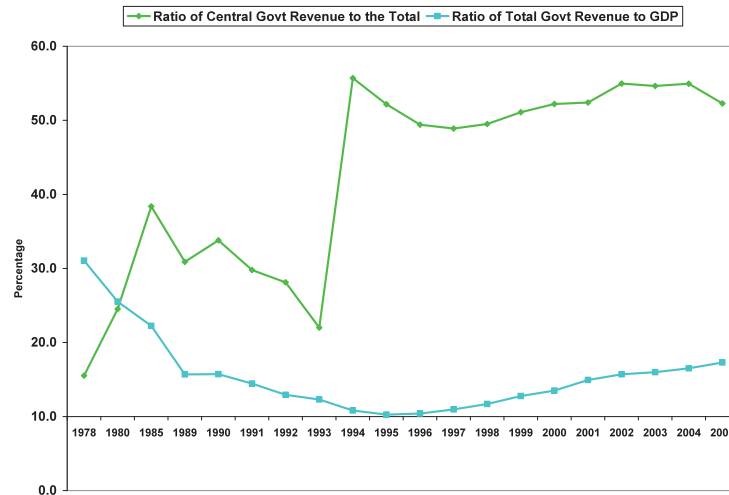
profit and tax contracts, under which SOEs negotiated annual transfers to the government budget, was largely eliminated (Ahmad, et al. 2002; Wong 2000).

Along with the changes in the division of revenue sources, a major effort was made by the central government to establish its own revenue-collection bodies which in effect centralized the revenue system for the first time since the economic reform started in 1978. In 1994 and 1995, National Tax Services (NTS) were established in all provinces to collect central-fixed revenues and shared revenues. These NTSs were organized on the basis of the divisions in charge of central-fixed and shared taxes within previous tax bureaus. The former divisions in charge of local taxes became Local Tax Services. The State Bureau of General Taxation, the central headquarters of the NTSs, was empowered to supervise local NTSs, appoint their directors and provide funding for their operations.

**The 1994 reform achieved remarkable successes:**

**Improving the “two ratios”:** The immediate impact of the tax assignment system on the division of revenue sources between the central and sub-national governments was significant, and finally ended the situation of the central government relying on local remittances to finance its outlays. As shown in Figure 3, the ratio of the central government’s revenue to the total jumped from 22 percent in 1993 to about 56 percent in 1994. Although the ratio came down slightly after 1994, the average was above 50 percent and 52.3 percent in 2005, compared to no more than 40 percent for the 15 years after 1978. One of the prominent changes in the tax system that can be credited with increasing the central governments share of revenue was the central collection of VAT. In 1994, VAT alone accounted for about 42 percent of total government revenue. The creation of the NTSs has also certainly made a difference. Owing to the unified taxation system, in which local governments are forbidden to introduce tax reductions or exemptions without central approval, the fall in the ratio of revenue to GDP was halted in 1996, after a 17-year decline. The national fiscal revenue increased from 521.8 billion yuan in 1994 to 3,161.8 billion yuan in 2005, an average annual increase of 17.8 percent. Total government revenues as a percentage of GDP increased from 12.3 percent in 1993 to 17.3 percent in 2005. It is important to mention that GDP was increasing remarkably during the same period.

**Simplifying the Intergovernmental Fiscal System:** The 1994 tax assignment system replaced the previous system of six types of fiscal contracts. The clearer and more appropriate assignment of taxes not only put a stop to the enduring misappropriation of revenues between the central and local governments, but also provided the right incentives for sub-national governments. For instance, since excise taxes were assigned to the central government and business taxes to local governments, the incentives for

**FIG. 3.** The Two Ratios, 1978-2005

Source: Authors, based on data from China Statistical Yearbook 2006.

localities to over-develop enterprises with higher tax returns, such as distilleries and tobacco companies, were corrected (Zhang and Martinez-Vazquez 2003).

**Tightening Fiscal Control:** The establishment of National Tax Services offered tighter control over general tax collection and local tax exemption policies. The interference of local authorities in tax administration and collection of central and shared revenues was substantially restrained. The 1994 reform abolished all the tax reductions and exemptions that provincial governments had granted for turnover tax in the past. Any new tax exemptions must be approved by the center and must be reported in a separate schedule of the tax return.

## 5. THE CURRENT INTERGOVERNMENTAL FISCAL SYSTEM

### Revenue Assignment

The tax-sharing reform of 1994 explicitly defined taxes as central taxes, shared taxes and local taxes. Table 3 summarizes the current tax assignment system in theory and Table 4 illustrates central and local revenues as distributed in 2005. Taxes that can be used in the pursuit of maintaining national objectives are assigned as central taxes, such as tariffs; taxes that can be interpreted as more relevant to economic development are assigned as shared taxes, including value added tax, business tax, s-

**TABLE 3.**  
Tax Assignment

Taxes	Central(%)	Local(%)
Central Tax		
Tariffs	100	0
Consumption Tax	100	0
Shared Tax		
VAT	75	25
Business Tax	3	97
Stamp Tax on Security Exchange	97	3
Personal Income Tax	60	40
Company Income Tax	60	40
Local Tax		
Resource Tax	0	100
Urban Maintenance and Development Tax	0	100
Urban Land Using Tax	0	100
Agriculture and Related Tax	0	100
Tax on Contracts	0	100
Tax on the Use of Arable Land	0	100
Vehicle Purchasing Tax	0	100
Other Local Taxes	0	100

Source: Shen (2008).

tamp tax on sales of securities, personal income tax, and company income tax; and taxes more suitable to be collected and administered by local governments, such as the Urban Maintenance and Development Tax and the taxes on Use of Arable Land and Urban Land Use, are assigned as local taxes. The central government slightly amended the revenue-sharing arrangement between the central and sub-national governments after the 1994 reform. First, from May 1997, the sharing ratio of stamp taxes on sales of securities between the central and local governments was adjusted from 50-50 to 88-12; from 1 October 2000, it was changed to 97-3. Second, the business tax rate on the financial and insurance industry increased from five percent to eight percent, with all the extra revenues going to the central government. Third, from 1 January 2002, the central and sub-national governments shared company income tax and personal income tax in a ratio of 50-50. From 2003, the ratio was altered to 60-40, central-provincial (Su 2003; Zhang and Martinez-Vazquez 2003).

As shown in Table 4, the revenue-sharing practiced by the central and provincial governments in 2005 was consistent with the 1994 tax assignment policy, except for some minor deviations — for instance, provincial governments accounted for 27 percent of VAT collection, instead of the 25

**TABLE 4.**

Central and Local Revenues, 2005

Unit: billion yuan

Items	Total			
	Government Revenue (billion yuan)	Central Government (billion yuan)	Sub-national Government (billion yuan)	Sub-national Sharing Ratio (%)
<b>Central Tax</b>				
Tariffs	106.62	106.62	0	0
Consumption Tax	163.38	163.38	0	0
Consumption Tax and Value Added Tax on Imports	421.18	421.18	0	0
Vehicle Purchase Tax	58.33	58.33	0	0
Cargo Tax	1.38	1.38	0	0
<b>Shared Tax</b>				
Value Added Tax	1,079.21	793.14	286.08	27
Business Tax	423.25	12.96	410.28	97
Stamp Tax on Security Exchange	6.73	6.53	0.2	3
Personal Income Tax	209.49	125.69	83.8	40
Company Income Tax	534.39	320.4	213.99	40
<b>Local Tax</b>				
Urban Maintenance and Development Tax	79.57	0.47	79.1	99
Tax on Contracts	73.51	0	73.51	100
Resource Tax	14.22	0	14.22	100
Tax on the Use of Arable Land	14.19	0	14.19	100
Urban Land Using Tax	13.73	0	13.73	100
Agriculture and Related Taxes	5.94	0	5.94	100

Source: China Statistical Yearbook (2006).

percent assigned to them in principle. The present tax-assignment arrangement has two outstanding features. First, the central government gets a grip on major profitable taxes, collecting 73 percent of VAT (793.41 billion yuan), 60 percent of company income tax (320.40 billion yuan) and 60 percent of personal income tax (125.69 billion yuan). In 2005, the fiscal revenue of the central government accounted for 56 percent of the total tax revenues. Second, sub-national governments are highly dependent on shared taxes.

#### **Expenditure Assignment**

The 1994 reform did not change the assignments of responsibility practiced before 1994. The current system, as set out in the constitution, is broadly consistent with international practices: the central government is

responsible for nationwide services, including national defense, foreign affairs, the operation of the central government body, macro-economic control and coordination of economic development, and providing funds for universities, hospitals, research institutions, newspapers, publishing houses, etc. that come directly under the control of the central government. The sub-national governments are responsible for delivering most public goods and services, the development of the local economy, and the operation of various institutions.

In the absence of specific central government guidelines, the actual division of expenditure responsibilities among sub-provincial governments is left to the discretion of each level of government. The higher-level government has discretion to determine the expenditure assignment of the level immediately below it. In other words, provinces determine the assignments of cities/prefectures, prefectures determine the assignments of counties, and the latter determine the revenues and expenditures of townships. Table 5 illustrates the in-principle assignment of responsibilities in China today. The exclusive central responsibilities include national defense, foreign affairs, geological prospecting expenses, and public debt. The exclusive sub-national responsibilities are urban maintenance and construction, environmental protection, water supply, and community services. All other government spending is shared by the center and sub-national governments. Sub-national governments at each level are responsible for delivering public services, including education, health care, social welfare, public safety, and other local and urban services; government administration; and local economic development.

How is public expenditure distributed in practice? Table 6 compares budgetary expenditure for the top ten items between the central and sub-national governments in 2005. The total central expenditure was 1,125.55 billion yuan, only 24 percent of overall government spending. The central government allocated most of its financial resources to national defense (21.74 percent of the total central expenditure), servicing the interest on public debt (14.17 percent), and capital construction (12.13 percent). Sub-national government spending was 3,527.30 billion yuan, accounting for 76 percent of total government budgetary expenditure. The most important spending items at the sub-national level included operating expenses for culture, education, science, and health care (15.64 percent of total sub-national spending), operating expenses for education (10.57%), and capital construction (7.59%). For specific sectors, sub-national governments accounted for 94 percent of the operating expenses for education, 98 percent of the operating expenses for health, and 87 percent of social security subsidiary expenses. The hierarchical assignment of responsibility has two prominent features. First, sub-national governments, particularly at the county and township levels, are excessively burdened (see Table 5). In prac-



**TABLE 5.**  
Expenditure Assignment by Administrative Levels

Functions	Central	Provincial	Prefecture	County	Township
National Defense	*				
Foreign Affairs	*				
Geological Prospecting Expenses	*				
Public Debt	*				
Education	*	*	*	*	*
Health Care	*	*	*	*	*
Social Welfare	*	*	*	*	*
Agriculture	*	*	*	*	*
Government Administration	*	*	*	*	*
Capital Construction	*	*	*	*	*
Research and Development	*	*	*	*	*
Culture Development	*	*	*	*	*
Policy Subsidies	*	*	*	*	*
Armed Police Troops	*	*	*	*	*
Urban Maintenance and Construction		*	*	*	*
Environmental Protection		*	*	*	*
Water Supply			*	*	*
Community Services				*	*

Source: Shen (2008).

tice, education and health care are concentrated mostly at the county and lower levels, although these public services would be more appropriately assigned to the central and provincial levels in respect to the spillover effects for the society as a whole. The redistributive government function for social security is mainly administered at the provincial and prefecture levels, whereas it commonly relies more on the central government in order to reap the benefits of risk pooling and equalization. Second, the assignment of responsibility is ambiguous, given the fact of wide concurrent expenditure assignments. The vague definition has created a loophole for each level of government to push its own responsibilities downward while retaining as much revenue as possible. Ultimately, the bottom level of government is taking a disproportionately large share of the responsibilities with only a limited revenue base.

## 6. THE INTERGOVERNMENTAL TRANSFER SYSTEM

Central-provincial and provincial-local fiscal transfers are the dominant source of revenues of provincial and local governments in China, accounting for 67 percent of provincial, accounting for more than half of local fiscal

**TABLE 6.**  
Budgetary Expenditure by Function, 2005

**Top 10 Central Spending Items**

item	Billion yuan	%
Total	1,125.55	
Expenditure for National Defense	244.7	21.74%
Interest Payment for Domestic and Foreign Debts	159.47	14.17%
Expenditure for Capital Construction	136.56	12.13%
Expenditure for Price Subsidies	59.14	5.25%
Operating Expenses for Culture, Education, Science and Health Care	58.77	5.22%
Other Expenditures	47.46	4.22%
Expenditure for Government Administration	46.43	4.13%
Expenditure by Using the Vehicle Purchase Tax	40.39	3.59%
Other Price Subsidies	35.46	3.15%
Innovation Funds and Science & Technology Promotion Funds	33.79	3.00%

**Top 10 Sub-national Spending Items**

Item	Billion Yuan	%
Total	3,527.30	
Operating Expenses for Culture, Education, Science and Health Care	551.65	15.64%
Operating Expenses for Education	373	10.57%
Expenditure for Capital Construction	267.58	7.59%
Other Expenditures	246.8	7.00%
Expenditure for Government Administration	241.92	6.86%
Expenditure for Public Security Agency, Procuratorial Agency and Court of Justice	176.41	5.00%
Expenditure for Supporting Rural Production	164.49	4.66%
Social Security Subsidiary Expenses	158.09	4.48%
Expenses of Agriculture, Forest, Irrigation and Meteorology	148.57	4.21%
Urban Maintenance and Construction Expenditure	139.36	3.95%

Source: China Statistical Yearbook 2006.

resources. Central transfers<sup>3</sup> in China can be classified into two broad categories: general purpose and specific purpose transfers. The general purpose transfers consists of (a) the tax rebate designed to return a fraction of revenues by origin (province of collection), and (b) the equalization transfer established in 1995 as effort to ease the widening regional disparities. The equalization transfer was called “transitory period grant” until 2001 and then renamed “the general-purpose grant” since 2002. The equalization grant has grown rapidly in size from only 2.07 billion yuan in its initial year to 74.5 billion yuan in 2004. Specific purpose transfers include (a)

<sup>3</sup>The sub-provincial transfer design is quite similar to that of central transfers to provincial governments, though the grant composition varies significantly across provinces due to the diversity of regional fiscal resources.

grants for increasing wages (b) grants for rural tax reform (c) grants for minority regions (d) prio-1994 subsidies (e) other ad hoc transfers. About 200 plus ad hoc grants, termed as “earmarked grants” (Zhuaxiang Zhuanyi Zhifu) by the Ministry of Finance, China, are used to subsidize a wide variety of spending projects such as capital constructions and social relief for calamities.

Figure 4 illustrates the structure of the central-local transfers in 2004. The largest central-provincial fiscal transfer was the tax rebate (404.97 billion yuan), followed by earmarked grants (322.33 billion). These two transfers accounted for more than 70 percent of the total central-provincial transfers. The 2004 equalization transfer was 74.50 billion yuan, amounting to 7 percent of the total central-provincial transfers.

The major transfer programs will be introduced briefly in the following.

#### (a) Tax Rebate

With the 1994 tax reform, VAT and excise taxes were brought under central tax administration and a program of tax rebates were instituted for VAT and excise taxes in 1994 which returned a fraction of these revenues to the province of origin. The provinces were assured that under centralized collection, each province would receive at the minimum the VAT and excise tax revenues it retained in 1993. For VAT and excise taxes, they have also been assured that their current rebates would total last year’s rebate plus 30% of the growth in VAT and excise tax revenues (Budget Committee 2002). Algebraically,

$$TR_t = TR_{t-1} \left[ 1 + 0.3 \left( \frac{VAT_t - VAT_{t-1} + ET_t - ET_{t-1}}{VAT_{t-1} + ET_{t-1}} \right) \right]$$

Where:

$TR_t$  - tax rebate to a province at year  $t$

$VAT$  - value-added tax

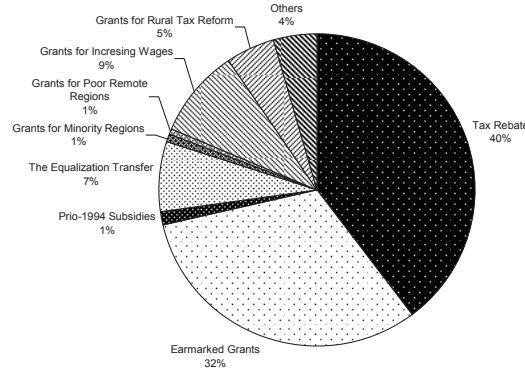
$ET$  - Excise taxes (Xiaofei Shui)

In 2002, Personal Income Tax and Company Income Tax were also brought under the central tax administration and a program of tax rebate similar to VAT tax rebate was instituted. Effective on January 1, 2002, all income taxes from enterprises<sup>4</sup> and personal income were shared by the central government and provincial governments at the ratio of 50 to 50. Since 2003, the central share has been raised to 60 percent. To assure stability in provincial revenues, income tax rebate program to institute to

<sup>4</sup>The income tax from the following enterprises is excluded from the sharing policy: rail transportation, state post office, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, Construction Bank of China, State Development Bank, China Bank of Agricultural Development, Import and Export Bank of China, enterprises of offshore oil and national gas, China Petroleum and Natural Gas Co. Limited, and China Petroleum Chemical Co. Limited.

ensure that all provinces received income tax revenues no less than what they received in 2001.

**FIG. 4.** Center-Local Transfers, 2004



Source: Author, based on data from Ministry of Finance, China

#### (b) The Equalization Grant

In 1995, the equalization grant, the first formula based transfer (the so-called transitory period grant until 2001) was established with a view to reducing regional fiscal disparities. The amount of the equalization transfer for a province  $i$  is determined by three factors: standard revenue of the province, standard expenditure of the province, and the share of the provincial standard fiscal gap of the total fiscal gap. Algebraically,

$$ET_i = TET \times \frac{SE_i - SR_i}{SE - SR}$$

Where

- $ET_i$  - the equalization transfer for province  $i$
- $TET$  - total equalization grant available in the budget year
- $SE_i$  - standard expenditure of province  $i$
- $SR_i$  - standard revenue of province  $i$
- $SE$  - total standard expenditure of the country
- $SR$  - total standard revenue of the country

The size of the pool for the equalization transfer ( $TET$ ) is determined by the central government on an ad-hoc basis, subject to annual funding availability.

The standard revenues are equal to standard local own and shared taxes plus tax rebate plus various grants subtracted by remittances to the central

government. In the formula, tax rebate, various grants, and remittances to the central government are actual amounts paid by the central government. For each type of tax, standard tax revenue is determined by multiplying the standard tax base with the standard tax rate. For personal income tax, the standard tax base includes salaries and income of private industrial and commercial enterprises. The actual income tax collection from other bases is regarded as the standard revenue. The income tax base of salaries is estimated using per capita taxable salaries net of exemptions and number of employees. The tax rate of salaries is local average effective tax rate, adjusted with a regional coefficient. The standard expenditures are measured as the total spending of seven sectors and for each sector the standard spending cover personal expenditure (salaries and bonus) and office expenditures (vehicles, heating, and others).

Although the equalization grant has been growing rapidly (2.07 billion yuan in 1995 to 74.5 billion yuan in 2004), but growth in specific purpose transfers has outpaced the growth of equalization transfers (Shah and Shen 2006).

#### **(c) Earmarked Grants**

The ad hoc transfers are categorized as “earmarked grants” by the Ministry of Finance. Various ad hoc transfers to finance various programs have grown over time in number and size. Currently there are about 200 programs accounting for more than 20 percent of total central transfers. These transfers are program-based and allocated for specific purposes such as subsidizing agricultural development, supporting infrastructure construction, assisting backward regions, and providing emergency funding for natural catastrophes. This transfer has risen to 322.3 billion yuan in 2004 (Shah and Shen 2006).

#### **(d) Grants for Increasing Wages of Civil Servants**

When the center raised the wage rate for public sector employees in 1999 and 2001, a special grant was established in 1999 to support the implementation of this policy in western and central regions. Thus the purpose of this transfer is to fill the fiscal gap caused by the central policy mandate. The wage rate was first increased by an amount of monthly 120 yuan per capita on July 1, 1999, then further raised at a rate of monthly 100 yuan per capita on January 1, 2001, and on October 1, 2001, additional 80 yuan per capita per month was added. The wage increase was also accompanied by the construction of a bonus system for civil servants from 2001 (equivalent to an approximate increase of one month of wages) and by the establishment of a subsidy system for remote areas. More than 700 counties were eligible to receive this grant. Besides, provinces faced with difficulties of paying teachers' wages in rural elementary and middle schools are also compensated by this transfer (Zhang 2003).

The grant allocation can be characterized as:

$$\text{WageGrant}_i = \text{ExpIncrease}_i \times \text{BasicExpenditureRatio}_i$$

Where

WageGrant C the grant for increasing wages received by province  $i$

ExpIncrease C the increase of provincial budgetary expenditure due to central policy of increasing wages

BasicExpenditureRatio C the ratio of the personal and office expenses to the total disposable revenue of the province  $i$

According to the formula, the volume of the grant received by province  $i$  is dependent upon the provincial expenditure increase due to the wage policy and the share of basic expenditure (including personnel and office expenses) in the total disposable revenue of the province. The increased expenditure is determined by the number of civil servants in province  $i$  and the standard of wage increase by the central government. The total transfer in 2004 amounted to 91.94 billion yuan (Shah and Shen 2006).

**(e) Grants for Rural Tax Reform**

The transfer was created in 2000 to foster the implementation of the central policy to rescind “three village deductions and five township charges” (xiangtongchou he cun tiliu ) and gradually abolish agricultural taxes. The “three deductions” collected by villages are: collective investment, public welfare funds, and cadre compensation. The “five charges” include charges for rural education, family planning, militia training, rural road construction and maintenance, and subsidies to entitled groups levied by townships. This transfer is aimed at filling the fiscal gap caused by the rural tax reform. In 2004, the total of 52.33 billion yuan was transferred to provincial governments.

**(f) Grants for Minority Regions**

The grant for minority regions was established in 2000 in order to support economic development in minority regions which are usually backward in their economic performance. The total grant equals a base amount of 1 billion yuan in 2000 with a yearly growth rate equal to that of central VAT revenue, and the rebate of the 80 percent of the central increased VAT collection in minority areas. This transfer has risen to 7.69 billion yuan in 2004 (Shah and Shen 2006).

**(g) Prio-1994 Subsidies**

Prio-1994 subsidies are the contracted fixed grants under the “Fiscal Contracting System” during the period 1988-1993. The total of the grant was both 12.6 billion yuan in 2003 and 2004. Since 1994, local governments have continued to remit revenues to or receive transfers from the centre according to their fiscal contracts in effect in 1993. The amount of transfers is approximately equal to the estimated deficit (gap between revenue and

expenditure) measured in the base year. Sixteen provinces, including Inner Mongolia, Jilin, Fujian, Jiangxi, Shandong, Guangxi, Hainan, Sichuan, Guizhou, Yunnan, Tibet, Shanxi, Gansu, Qinghai, Ningxia, and Xinjiang, still receive this type of grant.

## **7. LOCAL GOVERNMENT FINANCING: LOCAL TAXES AND LOCAL BORROWING**

### **Local Taxes**

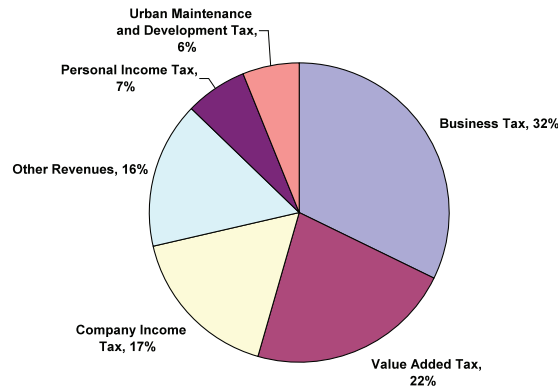
In contrast to the expenditure side, the taxation power in China very much resides in the Center. The two major means of controlling tax revenues are determining the tax rate and defining the base. Centralization of both these dimensions is remarkable in China. Sub-national governments have the latitude in determining the rates of minor taxes, but even for these they are only allowed to set tax rates within a limited range (Ahmad 2008).

Local revenues in China mainly comprise of five shared taxes — Value-Added Tax, Business Tax, Company Income Tax, Personal Income Tax, and Stamp Tax — and exclusively local taxes — Tax on City Maintenance and Construction, Tax on Real Estates, Agricultural Tax, Contract Tax, Resource Tax, Tax on the Adjustments of the investment in the fixed assets, Tax on the Use of Urban Land, Land Value-Added Tax, Tax on the Use of Vehicles and Ships, Slaughter Tax, Banquet Tax, Tax on Special Agricultural Products, Tax on Animal Husbandry, Tax on the Occupancy of Cultivated Land, State-owned Assets Profit, Penalty and Confiscatory Income, Income from use of sea area, field, and diggings, Expert Project Income, and administrative fees, as well as other income. Figure 5 illustrates the major sources of revenue for sub-national governments in 2005. Apparently, the shared taxes with the center are the key financial means, Business Tax accounting for 32 percent, VAT 22 percent, Company Income Tax 17 percent, and Personal Income Tax 7 percent. The most important local tax is Urban Maintenance and Development Tax which made up six percent of the total sub-national revenues.

Do the above observations, based on the aggregate sub-national data, hold true in individual provinces? Table 7 breaks down sub-national tax revenue by 31 provinces in 2005. The provinces are ranked by their revenue capacity, from the highest (Guangdong) to the lowest (Tibet). The picture is very clear: provincial finance is highly dependent on shared taxes — business tax, VAT, company income tax, and personal income tax. For instance, in 2005 Beijing obtained almost 80 percent of revenue from the four shared taxes, or 73 billion yuan out of the total 92 billion. Business tax is the foremost important local revenue source. The only exceptions are Shanxi, Heilongjiang, and Tibet, where revenue from VAT surpasses

business tax. Thanks to their remarkable economic performance, wealthy regions, including Guangdong, Shanghai, Jiangsu, Zhejiang, and Beijing, are also able to reap the benefits of company and personal income tax. Revenue from purely local taxes is relatively large in affluent provinces. In Guangdong, for example, local tax accounts for about 31 percent, compared to 22 percent at the sub-national level as a whole.

FIG. 5. Sub-National Revenue Composition, 2005



Source: Authors, based on data from China Statistical Yearbook 2006.

### Local Borrowing

Under China's 1994 budget law, local governments are forbidden to incur either domestic or foreign indebtedness unless otherwise permitted by law. However, the reality is many local governments are on the verge of bankruptcy due to debt services. It is estimated that the total local borrowing was over US\$120 billion by the end of 2004 (Wei 2004). The total debt of the grassroots governments was around US\$ 40 billion by the end of 2001, over half of which was borrowed by townships. According to the Audit report to the national congress in June 2002, the total debt for 49 counties (cities) audited was about US\$ 8 billion, about 2.1 times of the yearly disposable fiscal resources. The total debts should be much higher if the implicit debts such as the unpaid civil servants salaries and farmers' services were included. Local borrowing can be roughly categorized as follows:

#### Direct Borrowing and Loan Guarantee

It is illegal but in practice the law and regulations of local borrowing were widely violated by local governments. Almost all local governments of



different levels in China incurred direct borrowing and the actual borrowing could be from any department of a local government.

Another form of borrowing is debt to the government employees, mainly teachers of elementary and secondary school, and vendors providing products or services to governments. Local governments (particularly the county and township governments) in dire fiscal straits are unable to pay the full salaries of elementary and secondary school teachers and the unpaid part becomes the local debt. On some occasions, grassroots governments issue informal debt papers (*baitiao*) to farmers when they are financially incapable to pay farmers for their agriculture products.

Meanwhile, almost all local governments provide loan guarantees for SOEs directly or indirectly, although it is neither allowed by the budget law. Local governments also provide loan guarantees to the central bank for local financial institutions to avoid financial risk.

#### **Borrowing from Commercial Banks**

As banks have been transformed into financial institutions, local governments posed prevailing impact on the administration of bank lending through the appointment of regional bank heads, and also through intangible influences such as the supply of water and electricity, housing, recruitment of bank employees, and schooling of children (Huang 1996). Therefore, local government gained substantial control over the credit supply and emboldened overlending and underpricing of loans, which led to the excessive expansion of banks' credit and a mounting number of bad and non-performing loans. Ultimately the borrowers of nonperforming loans may default, requiring the lender to absorb the loss. In 1998, the central government had to bail out local government by issuing 270 billion yuan of government bonds to recapitalize the state-owned banks (Jin and Zou 2003, 308)

#### **Indirect Borrowing**

Sub-national governments take on indirect borrowing through various channels such as local-owned enterprises or Trust and Investment Companies (TICs).

Local enterprises, in charge of providing public services, can and do borrow from banks and on the capital market. Given the local finance stress and insufficient financial support from the upper levels, such local borrowing essentially finances much sub-national spending. This in turn created contingent liabilities for local governments. Local governments may also borrow through "collective financing" in which various groups of people, such as government employees and employees of local SOEs, are selected to be borrow from by local governments. The borrowing could be voluntary, but most of time it was forced by local governments. Most of these borrowings were used to start local enterprises. However, a significant part of these projects were not successful and the bankruptcy of these enterprises

**TABLE 7.**  
Government Revenue by Province, 2005

Province	Unit: million yuan					
	Total	VAT	BT	CIT	PIT	TUMC
Total	1,488,422.0	264,422.1	410,281.6	174,590.2	83,796.9	79,101.9
Guangdong	180,720.40	32,358.50	55,576.70	23,644.80	13,242.50	6,433.70
Shanghai	141,739.80	22,612.40	51,292.70	24,914.90	11,192.40	4,979.10
Jiangsu	132,267.50	26,557.10	34,281.80	17,769.60	6,619.50	7,065.70
Shandong	107,312.50	19,300.40	21,779.30	11,082.80	3,889.40	6,595.10
Zhejiang	106,659.60	20,423.40	32,433.50	16,791.90	6,611.90	6,163.60
Beijing	91,921.00	9,759.80	38,376.20	16,476.20	8,452.30	3,883.40
Liaoning	67,527.70	11,305.70	16,468.50	7,219.90	3,280.50	3,992.00
Henan	53,765.10	8,796.90	11,159.60	5,156.40	2,204.50	2,917.70
Hebei	51,570.20	12,103.50	10,527.90	5,336.80	2,824.00	2,925.10
Sichuan	47,966.40	7,107.40	13,476.40	3,994.10	2,208.40	2,808.60
Fujian	43,260.00	7,312.70	12,460.80	5,426.50	2,741.40	1,855.40
Hunan	39,526.50	5,893.30	9,424.50	2,183.40	1,675.70	2,502.20
Hubei	37,552.20	6,591.00	9,133.50	3,906.40	1,746.20	2,402.80
Shanxi	36,834.40	10,269.50	6,070.00	3,699.50	1,368.10	2,131.00
Anhui	33,401.70	5,772.40	7,810.40	3,008.10	1,249.60	2,048.60
Tianjin	33,185.10	6,423.80	9,645.50	4,141.60	1,882.20	1,587.60
Heilongjiang	31,820.60	8,501.60	5,956.00	1,857.60	1,556.20	2,760.40
Yunnan	31,264.90	5,601.90	6,764.30	3,334.80	1,194.40	2,957.30
Guangxi	28,303.60	3,932.70	6,838.10	1,854.10	1,457.60	1,291.60
Inner Mongolia	27,745.50	4,844.70	7,827.10	1,935.50	1,006.80	1,424.50
Shaanxi	27,531.80	5,534.40	6,927.20	2,059.40	1,022.40	2,076.60
Chongqing	25,680.70	3,365.50	7,020.20	1,398.20	1,066.60	1,315.90
Jiangxi	25,292.40	3,387.40	6,284.00	1,741.20	1,126.50	1,127.20
Jilin	20,715.20	3,953.30	4,759.00	1,391.60	1,112.20	1,315.70
Guizhou	18,249.60	3,137.00	4,630.60	1,608.10	889.70	1,291.30
Xinjiang	18,031.80	4,293.60	4,766.50	757.60	931.20	1,367.00
Gansu	12,350.30	2,533.40	3,158.90	843.20	517.90	935.80
Hainan	6,868.00	974.00	2,367.90	452.70	356.90	370.10
Ningxia	4,772.20	873.20	1,575.80	260.80	222.00	303.90
Qinghai	3,382.20	783.80	1,001.80	254.00	102.90	232.00
Tibet	1,203.10	118.20	487.20	88.80	44.80	41.10

Notes: 1. VAT C Value-Added Tax; BT C Business Tax; CIT C Company Income Tax; PIT - Personal Income Tax; TUMC C Tax on Urban Maintenance and Construction.

Source: Statistical Yearbook of China (2006).

due to lack of management skills and experiences imposed serious debts to local governments. Local authorities also maintain considerable latitude in securing and deploying financial resources for investment projects. For instance, sub-national governments are allowed to approve investment projects below 50 million yuan and technology promotion projects below 30 million. These projects can be funded by commercial and indirect borrowing, which resulted in redundant of sub-national medium- and small-sized investment projects (Jin and Zou 2003).

Another channel for local indirect borrowing is establishing dummy financial companies, which has fueled the proliferation of Trust and Investment Companies (TICs) and securities houses at subnational levels. TICs receive government and enterprise trust deposits or trusted deposits. Most TICs were created by the four state-owned specialized banks, and some by other banks, the MOF, or municipalities. In the late 1980s, as many as 365 TICs were in business across the country (Mehran, et al. 1996).

#### **Foreign Borrowing**

External borrowing by the central and local government-owned financial institutions has been managed by a credit management system, under which the issuance of debt requires a quota from the SDPC and an approval from the State Administration of Foreign Exchange (SAFE). Most of these local financial institutions are TICs controlled by local governments and those TICs engaged in international business are referred to as International Trust and Investment Companies (ITICs). Since the borrowing by these entities are not guaranteed by any direct or indirect credit support from the central government and hence the central government refused to bail out ITICs, Guangdong ITIC went bankrupt in 1999 as well as Fujian ITIC, Tianjin ITIC, Shanghai ITIC, Daian ITIC, Shandong ITIC, and Shenzhen ITIC. By the end of 1998, the external debt of domestic financial institutions (including central agencies) was \$41.99 billion, 28.8 percent of China's total external debt. It is a question whether the central government has to step in once financial failure emerge on a large scale among these ITICs (Jin and Zou 2003, 313).

Although practiced informally or illegally, local borrowing played an important role in local economic development and in alleviating local fiscal pressure, particularly for those localities struggling to make ends meet. The significant improvement of local infrastructure in almost all jurisdictions in the last decade is partially attributed to local borrowing. However, illegal local borrowing usually operated behind the screen, is difficult to control and susceptible to corruption, which seriously damages local governments' accountability.

## 8. FISCAL POWER SHIFTING THROUGH DECENTRALIZATION

China's decentralization is featured by the devolution of fiscal power during the period of contracting system (1979-1993) and the recentralization of fiscal power under the current tax sharing system (1994-present).

### (1) 1979 - 1993: Fiscal Power Devolution

In 1980, China implemented the policy of *fenzhaochifan* ("eating in different kitchens"), aiming to separate the central and local budgets. Budgetary contracts between the central and local governments were established which often varied by regions and were subject to renegotiations when circumstances changed. During the process of fiscal decentralization, local governments developed power and their relationships with local enterprises strengthened.

Under the 1980-93 fiscal contract system, local governments, as agents of the central government, had strong incentives to reduce the revenue transfer to the center and heighten the need for transfers from the center as net local net income was to be transferred to the central government and shortfalls were to be covered automatically. The "Fiscal Contracting System", established in 1988, also created a strong incentive for local governments to conceal information about local revenues from the center as this information would be valuable when the fiscal contracts were negotiated. During this time, many of the new townships and village enterprises were joint ventures with local government ownership; local enterprises and local governments colluded to hide profits from taxation and shift deficits to the center with retained profits accruing to the benefit of "local shareholders". Thus the system heightened an asymmetry, in that local governments absorbed excess revenues, while deficits were covered by the center (Ahmad, et al. 2002). Further, although local governments did not have the authority to alter the statutory tax rates and bases, they literally controlled the effective rates and bases by offering varying degrees of tax concessions to enterprises and shifting budgetary funds to extra-budgetary funds.

The waning central fiscal control and distorted local incentives prompted a conspicuous falling trend of central revenues and a significant reduction in fiscal revenue collection as a percentage of GDP. The ratio of total government revenue to GDP declined from 28.4 percent to about 12.6 percent over the period 1979-1993; the central government's share of the total revenue reduced from 40.5 percent to 22 percent over the period 1984-1993.

In the face of the plummeting fiscal revenue, the center had to resort to various ad hoc instruments, including arbitrarily shifting expenditure responsibilities to local governments, cutting intergovernmental transfers, forcing local governments to purchase bonds at lower-than-market rates,

and recentralizing locally-owned enterprises, to influence revenue remittances from local governments (Ma and Norregaard 1998).

However, these instruments only created a vicious cycle of perverse reactions from the local governments as the center was apt to revise the rules of the game to penalize local governments with fast growing revenues. Local governments, with distrust on the center and also increasing pressure to meet new spending responsibilities, began collecting a wide variety of extra-budgetary revenues, and even levying illegal fees and charges for providing basic public services when the fiscal needs were beyond the revenue capacity. Meanwhile, the weakening fiscal power at the center increased government deficits and reduced the central government's flexibility in using fiscal policy in stabilization and redistribution.

### **(2) 1994-present: Predatory Fiscal Federalism**

The 1994 Tax Sharing Reform was a turning point — the central government strengthened its fiscal power through capturing core taxes and establishing central tax administration. Indeed, since 1994, the central government has rapidly centralized the most lucrative sources of revenue, including value-added tax, resource tax, and personal and corporate income tax. In the case of the VAT, the four layers of local government—provincial, prefectural/city, county, and township—together share only 25% of VAT intake. In 2002, the central government further ordered local governments to give 50% of personal and enterprise income tax over to the central government. As chart 6 reveals, local revenue as a share of total government revenue dropped rapidly after the 1994 tax centralization while the local expenditure as a share of total government expenditure lingered around 70 percent.

The process of recentralizing revenues upward and devolving expenditures downward extends from the central to the provincial to the prefectural to the county and ultimately to the township and village level. Each level pushes fiscal responsibilities down to lower levels while asserting the largest possible claim on revenue residuals. At the grassroots levels—the county and township levels — local governments are left no choice but either predate on local residents, enterprises, and financial institutions or simply not provide the primary public services.

Politically, the increasing fiscal dependence of county governments on higher levels may lead to greater political dependence. The fiscal system today is even more capable of reinforcing the central mandates and hence more vulnerable to punitive measures from the center (Wedeman 1999; Yang 2004). The central government is also attempting to inject more earmarked funds directly to the county level (Wong 2005), which further enhances the organizational integration of grass-roots government with the center. Central edicts may carry more weight than it would have under the old fiscal

system, which is confirmed by the observation of the rapid local response to the center's action on the SARS scare (Liu and Shih 2004).

In the wake of stronger central power in the midst of fiscal decentralization, some researchers have offered their explanation: in China, fiscal decentralization in the context of political authoritarianism creates a unique version of distorted federalism, which is named predatory fiscal federalism by some researchers (Shih, et al. 2004; Yao and Yang 2003; Zhang 2003; Zhu and Ye 2001). Due to a hierarchical party structure and the absence of national elections, the central and provincial governments bear enormous leverage over grassroots governments. The higher tiers of government devolve fiscal responsibilities down to the lowest levels of government and meanwhile the most productive sources of revenue are captured by the top tiers of government<sup>5</sup>. Plus fiscal responsibilities at various levels are not defined in the constitution and therefore left to the manipulation of higher tiers of governments. Bureaucrats at all level manage to maximize revenue in order to build up administrative performance (zhengji). For instance, infrastructure construction is a main way to present government performance, which indeed led to rampant redundant investment in many places. In this fiscal structure, Shih et al. (2004) argued that the central government's only incentive to transfer money downward is the fear of widespread social stability or the complete collapse of grassroots governments.

## 9. EFFECTS OF FISCAL DECENTRALIZATION ON MACROECONOMIC PERFORMANCE

The conventional wisdom favors decentralization as a way to improve the efficiency of the public sector and thus promote economic growth (Bahl and Linn 1992; Bird and Wallich 1992; Oates 1972; Shah 1994; 1998) because local governments are better positioned than the national government to deliver public services that match local preferences and needs. Many proposals favor assigning more revenue and expenditure responsibilities to local governments. The question of whether fiscal decentralization has contributed to China's economic success over the past 25 years is still open to debate. Quantitative studies of the impact of fiscal decentralization on economic growth yield conflicting conclusions. Table 8 provides an overview of various studies conducted on this subject.

Some scholars argue that fiscal decentralization has been conducive to China's economic development. Qi (1992) and Qian (1999) suggested that the fiscal contract system (1980-1993) provided material incentives that

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<sup>5</sup>This form of fiscal arrangement is still considered federal because local governments do not merely serve as agents to implement standardized central policies; they have considerable discretion to enact specific policies and they have to pay for the provision of most public goods.

**TABLE 8.**

China: Fiscal Decentralization and Economic Growth

Literature	Time Period	Conclusion: the impact of fiscal decentralization on economic growth
Qi (1992)		positive
Qian and Weingast (1997)	1980-1993	positive
Yang (1997)		negative
Ma (1997)		positive
Davoodi and Zou (1998)	1970-1989 (46 countries)	negative in developing countries
Zhang and Zou (1998)	1980-1992	negative
Qian (1999)	1980-1993	positive
Young (2000)		negative
Lin and Liu (2000)	70-93	positive
Jin and Zou (2005)	1979 - 1999	Divergence in revenue and expenditure at the sub-national level is associated with higher rates of growth
Jin, Qian and Weingast (2005)	1970-1999	positive

stimulated sub-national governments to promote local economies. Qian and Weingast (1997) argued that the fiscal contract system enabled sub-national governments to avoid revenue predation from the center and therefore retain financial resources for investments that promoted economic growth. Lin and Liu (2000) have found that fiscal decentralization is one of the key driving forces<sup>6</sup> of China's remarkable economic performance via improvement in efficiency rather than increases in investment. Jin, Qian and Weingast (2005) suggested that fiscal decentralization reforms considerably strengthened the fiscal incentives of provincial governments which are generally conducive to provincial economic development and reform.

Some studies have, however, offered evidence suggesting that fiscal decentralization is detrimental to China's economic growth. Yang (1997) and Young (2000) offered evidence suggesting that fiscal decentralization fragmented the national market, encouraged local protectionism, induced duplicate investments, and hence negatively affected economic development. Davoodi and Zou (1998) using a panel data of 46 countries over the 1970-1989 period find a negative relationship between fiscal decentralization and growth in developing countries. Zhang and Zou (1998) provided supportive evidence demonstrating that the share of central government development spending has a positive impact on economic growth while the share of provincial government development spending is negatively related

<sup>6</sup>Other driving forces include rural reform, the nonstate sector, and capital accumulation.

to growth. Using data across 28 Chinese provinces over the period of 1980-1992, they have found a significant and negative relationship between the degree of fiscal decentralization and provincial economic growth. Another concern is that the aggressive decentralization has crowded out public spending on national priorities by local public projects. Some public infrastructures crucial to economic growth are better provided by the central government, such as high ways, railways, telecommunication, and power. The inefficient resource allocation induced by the fast fiscal decentralization is detrimental to the overall economic performance. Jin and Zou (2005) empirically approved that divergence, rather than convergence, in revenue and expenditures at the sub-national level of government is associated with higher rates of growth.

The negative relationship between fiscal decentralization and economic growth may indicate that in real life local governments may not be responsive to local preferences and needs. This can occur when local officials are not elected by local constituents or “voting by feet” is not realizable in the certain policy and economic environment. Furthermore, the merit of fiscal decentralization have to be measured relative to existing revenue and expenditure assignments as well as the stage of economic development (Shah, et al. 2004).

## **10. POLITICAL AS WELL AS ECONOMIC ISSUES ARISING AFTER 1994**

### **(1) Decentralization and Inequality**

It is argued by many scholars that fiscal decentralization has exacerbated regional inequality in China. One is that, fiscal decentralization, combined with distorted price systems and duplicated industry structures across regions, led to inter-regional trade protection and fragmented domestic markets as a consequence of local governments’ rent-seeking behaviors (World Bank. 2003; Young 2000). Qiu, et al. (2003) developed a theoretical model to reveal that fiscal decentralization and international trade protection together give rise to inter-regional trade protection which can widen the regional gap in China. On the other hand, fiscal expenditure decentralization reform that hardens the budget constraints for grass-root levels of government undermines the revenue-starved jurisdictions’ ability to provide public goods and services, aggravate the lower level governments’ fiscal burden, and prevent them from pursuing further economic investment and development, which ultimately leads to the regional income and fiscal gaps (Jin and Zou 2003; Park, et al. 1996). Shen and Zou (2008) investigates China’s regional disparities in poverty distribution and find an increasing concentration of the rural poor in southwestern provinces and the urban poor in northern China. They argue that political choices and public poli-



cies have a critical impact on how the effects of endowment and geography play out in the country's poverty distribution. Kanbur and Zhang (2001) examined the time series of regional inequality measured by the GE coefficient over the period of 1952-1999. They have found that decentralization had a significant and positive effect on the degree of regional inequality; and it has especially enlarged the rural-urban inequality though it reduced the coastal-inland inequality. To shed more light on this issue, further empirical analyses are needed using more refined measures of decentralization and more disaggregated data.

China's decentralized fiscal system has not coped well with the problem of mushrooming inequality (Shen 2007). By 2005 China's richest province (Shanghai) had more than eight times the per capita spending of the poorest province (Anhui). In contrast, in the United States, the poorest state has about 65 percent of the average state revenues; in Germany any state below 95 percent of the average level is subsidized through the equalization transfer mechanisms; and in Brazil the richest state has less than three times the per capita revenues of the poorest state (World Bank 2002). Inequality in public spending is much more severe at the sub-provincial level. The richest county has about 48 times the level of per capita spending than the poorest county (World Bank 2006).

The consensus among observers of China is that both the willingness and capability of the government to cope with inequality have weakened. In the pre-reform period, the fiscal system was highly redistributive. For instance, over the period 1978-1980, Shanghai turned over half of its provincial GDP while the poor provinces received large subsidies as large as 20-25 percent of their GDP. The fiscal decentralization between 1979 and 1994 had greatly reduced the scale of inter-regional redistribution as a result of the localization of public finance and remarkable decline in inter-governmental transfers. For example, in 1993, Shanghai only submitted only about 8.5 percent of its GDP, and other rich provinces turned over even less. The net remittance of Guangdong, was only 0.4 percent of GDP. Meanwhile, subsidies to poor regions cut down sharply (Wang and Hu 1999). However, the mild redistributive feature through the 1993 fiscal system was essentially eliminated by the 1994 Tax Sharing Reform. The taxes were reassigned, with the center capturing the most lucrative taxes, and the transfer of "tax rebate" was introduced, favoring the rich regions as the leverage to buy in those affluent provinces.

Moreover, even other discretionary transfers, including earmarked grants and equalization grants, are not targeted to poorer provinces. Instead, the fiscal transfer system is used to maintain the loyalty of local officials and key constituents (Liu and Shih 2004, 20-21). Wang (2001) attempted to explore the underlying logic of intergovernmental transfers in China and has found that that maintaining national unity is an overriding concern

for Chinese political elites -provinces with predominantly non-Han population have been given the highest levels of subsidies, even though their income levels exceed those of the poorer provinces. Wong (2000) suggested that the overall impact of inter-governmental transfers is disequalizing net of all effects, inter-governmental transfers tend to favor more developed provinces. Liu and Shih (2004) also confirmed that the post-1994 fiscal system has exacerbated the divergence in county-level fiscal balance after fiscal transfers are taken into account. Tsui (2005) conducted an analysis on the impact of the intergovernmental transfers on fiscal disparities at the county-level. Not surprisingly, the tax rebate is the conspicuous source of dis-equalizing, contributing more than 21 percent of fiscal disparities in 2000. The TPG, designed supposedly for fiscal equalization, actually increases fiscal inequality.

## **(2) Dramatic Vertical Fiscal Gap due to Mismatch between Expenditure and Revenue Assignments**

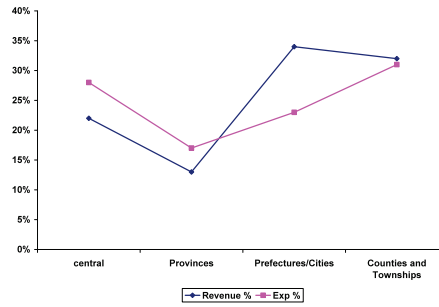
During a seminar held by the Ministry of Finance and World Bank in Dali 2004, a local officer visualized the picture of local government financing with his words, “Center finances are booming; provincial finances are improving; prefectural finances are not bad; county finances are near-bankrupt; and township finances are basically bankrupt.” Wong (2000) recorded a report from a Hunan official regarding wage arrears to civil servants, “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.”

The 1994 tax assignment reform only dealt with revenue assignments, leaving the expenditure assignments intact. Current revenue assignments are poorly linked to expenditure responsibilities (Ahmad, et al. 2002). Since the 1994 tax sharing reform, the combination of pushing down expenditure responsibilities to lower levels of government without providing adequate financial support has generated an increasingly widening fiscal gap and intensified local fiscal stress (see Figure 3), leaving local governments highly dependent on fiscal transfers from upper-level in fulfilling their spending needs. Consequently, core public services are generally underfunded in the rural sector and in the poor regions. The time series data in Figure 3 clearly demonstrates the vertical fiscal gap is deteriorating over the past decade. An alternative perspective of investigating fiscal gap at each level of the government organ at different time, as shown in Figure 6, strengthens the evidence that the vertical fiscal gap at county and township governments is severe and worsening radically over the years.

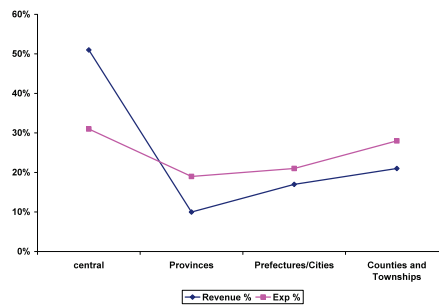
In recent years, the critical financial problems at the local level have been recognized by the central government, and the policy-makers have come up with some corrective interventions (mainly by setting up a new fiscal transfer scheme). For instance, in 2001-2002, the central government

FIG. 6. Revenue and Expenditure Share by Administrative Levels

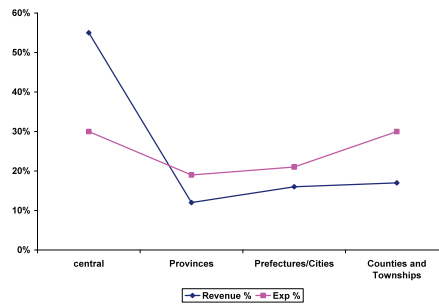
Revenue and Expenditure Share by Administrative Levels, 1993



Revenue and Expenditure Share by Administrative Levels, 1999



Revenue and Expenditure Share by Administrative Levels, 2003



Source: Shen forthcoming.

established a new intergovernmental fiscal grant, “Grants for Increasing Wages for Public Servants”, to assist local governments in covering the cost of wage increases. Similar approach was applied for the rural fee reform in 2002 by creating a new central grant entitled “Grants for Rural Tax Reform”.

Although such corrective interventions deliver a positive signal of the central government's willingness to gradually take back some responsibilities, the strategy itself is only a quick fix, not likely to sustain for meeting long-term needs. And these corrective interventions occur on an ad hoc basis, with the amounts often determined later in the fiscal year dependent on available budgetary resources. It raises unpredictability in local government budgeting (World Bank 2003).

### **(3) Deficient and Unequal Public Services Delivery**

To achieve efficient services delivery, countries and national states must institute an effective division of labor among multi-levels of government and assign appropriate financing instruments (fiscal revenues) to match fiscal responsibilities. China's highly decentralized system could be a boon to managing service delivery, but under the current arrangements, grassroots governments have inadequate revenues for meeting their heavy expenditure responsibilities and receive little help from the system of intergovernmental transfers. As a result, some local authorities truly lack the capability to deliver basic public services, no matter how much they tax the local population (Shen forthcoming; Shih, et al. 2004; Zhou 2003; Zhu and Ye 2001). Core public services like education and public health, which are usually seen as responsibilities shared by central and sub-national governments due to their important spillover effects for the society as a whole, are assigned to local governments in China. As of 2004, 63 percent of overall government expenditure responsibilities were about equally distributed among the provincial, prefecture and county levels of government, and townships accounted for 7 percent. It is critical to mention that rural governments at the county and township levels, treated the same as urban governments in the Chinese fiscal system, are responsible for daily government administration, providing core social services, and investments in infrastructure. As a result of revenue recentralization and responsibility devolution in the past two decades, rural governments are relatively bankrupt leaving many basic public services unfunded. Many local governments, especially those in poor western regions, are providing fewer and lower quality public services and passing along a higher proportion of the costs to their constituents.

There is also substantial evidence of great regional and local inequalities in the financing and delivery of basic services. No mechanisms exist to ensure minimum service standards across regions. As regional disparity in income grew, this has led to growing regional disparities in services through the 1990s and a default in the delivery of vital services in many poor localities (West 1999; World Bank 2005). However, the central government does send billions in transfer payments to provincial and grassroots governments each year in the fear of the collapse of rural public good provision and wide-spread instability. The question for then becomes the efficiency rather than the amount of grants. At the top of the government hierar-

chy, except the Premier and the Secretary General of the CCP, one or two voting members in the ruling Standing Committee of Politburo<sup>7</sup> would be removed from office if wide-spread instability broke out in a region or if public services totally collapsed. Thus the General Secretary and the Premier require provincial officials to cap taxes and to provide essential public goods in case of the disturbance. Likewise, provincial leaders command prefecture and county officials to make the commitment. However, officials at all levels realize that the requirement is only meant to prevent the worst scenarios from occurring. Therefore, despite the huge amount of resources transferred from the center, the revenue predation at higher tiers of government remains and grassroots governments simply struggle to get their ends meet (Shih, et al. 2004, 6-9).

#### **(4) Proliferation of Extra-Budgetary Resources**

Besieged by pressing fiscal needs but constrained financial resources, local governments have vigorously pursued extra-budgetary funds. A significant portion of government spending does not go through formal budget channel. Local governments are also faced with growing spending needs, particularly the financing of social safety nets and infrastructure investment. Some localities have to take over the uncompensated transfers of social expenditures from SOEs, including housing, childcare, medical care, education, and pension debts. In spite of overwhelming fiscal needs, local governments in China literally have no tax autonomy: the center set tax rates and the bases of collection. Plus the central government, knowing the stress on local budgets, tolerated and often encouraged local governments to seek “self-reliant” solutions. The channel open to local governments for revenue expansion is to develop extra-budgetary<sup>8</sup> and off-budget<sup>9</sup> resources, in the form of fees and charges, over which the local officials have complete control and face virtually no oversight (World Bank. 2002). Table 9 lists extra-budgetary revenue by item from 1978 to 2004. In 2004, the total extra-budget revenue was 469.92 billion yuan, about 17.8 percent of the total budgetary revenues and roughly 3 percent of GDP. If taking a look at the expenditure side (table 10), we can find that majority of the extra-budget expenditure has been categorized as administrative expenses (313.38 billion yuan out of the total 435.17 billion yuan, more than 72 percent, in 2004).

<sup>7</sup>The total number of members of the Standing Committee of Politburo is roughly 12.

<sup>8</sup>Extra-budgetary revenues are obtained by government units using coercive power but are not included in the formal budget system. They include various surcharges and service fees charged by government agencies. In theory, extra-budgetary revenues are collected based on regulations promulgated by the central or provincial level governments.

<sup>9</sup>Off-budget revenues are collected by government units, particularly, township and village level governments, without the authorization from the central or provincial level governments.

TABLE 9.

Extra-Budgetary Revenue by Item, 1978-2004

Unit: billion yuan

Year	Total	Revenue of Administrative and Institutional Units	Revenue of Funds	Revenue from Fundraising Programs of Township Governments	Revenue of Local Governments	Revenue of SOE and its Governing Department	Other Revenues
1978	34.71	6.34			3.11	25.26	
1980	55.74	7.44			4.09	44.21	
1985	153.00	23.32			4.41	125.27	
1989	265.88	50.07			5.44	210.38	
1990	270.86	57.70			6.06	207.11	
1991	324.33	69.70			6.88	247.75	
1992	385.49	88.55			9.09	287.86	
1993	143.25	131.78			11.47		
1994	186.25	172.25			14.00		
1995	240.65	223.49			17.17		
1996	389.33	339.58		27.29	22.47		
1997	282.60	241.43		29.58	11.59		
1998	308.23	198.19	47.84	33.73			23.00
1999	338.52	235.43	39.65	35.89			22.54
2000	382.64	265.45	38.35	40.33			32.58
2001	430.00	309.00	38.00	41.00			36.00
2002	447.90	323.80	37.60	27.20			52.10
2003	456.68	333.57	28.71	29.31			59.85
2004	469.92	320.84	35.13	21.31			86.23

Notes: 1) Due to adjustment on the coverage of extra-budgetary revenues from 1993 to 1995 and in 1998, the figures are not comparable with the previous years.

2) Since 1997, the extra-budgetary revenues do not include the intra-budgetary government fund (fee), the figures are not comparable.

Source: China Statistical Yearbook 2006.

Since the central government took actions to transform extrabudgetary funds to budgetary expenditures, the level of extrabudgetary expenses compared to the budgetary expenditure has been reduced dramatically, from 33 percent in 1999 to 19 percent in 2004 (Figure 7).

Prior to 1994, budget deficits were financed by a combination of credits from the People's Bank of China (PBC) and domestic and international borrowing. The new budget law (effective January 1, 1995) stipulates budgets at all levels of government shall be balanced and that any violation of the balanced budget would result in administrative prosecution against parties directly responsible (Jin and Zou 2003, 301). Faced with

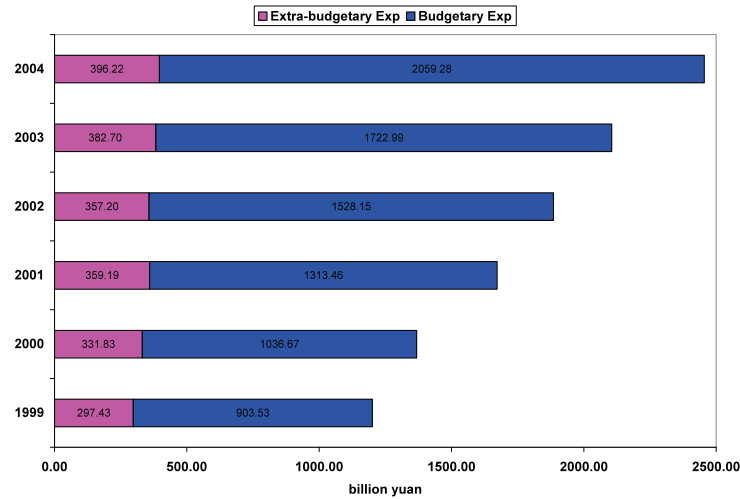
**TABLE 10.**

Extra-budgetary Expenditure by Item, 1999-2004

Unit: billion yuan

Year	Total	Capital Construction	Administrative Expenses	Urban Maintenance	Township Govts	Others
1999	313.91	53.98	181.61	12.75	35.03	30.54
2000	352.90	42.62	222.51	14.64	38.74	34.40
2001	385.00	35.00	250.00	15.00	40.00	45.00
2002	383.10	26.00	265.50	16.00	26.80	48.80
2003	415.64	26.99	283.66	20.26	28.31	56.42
2004	435.17	28.73	313.38	19.38	20.51	53.17

Source: (National Bureau of Statistics 2006).

**FIG. 7.** Subnational Government Expenditure: Extra-budgetary vs. Budgetary, 1999-2004

Source: Authors, based on data from China Statistical Yearbook 2006.

tight budgetary constraints as a result of low level of formal taxations and skyrocketing pending needs generated by local development and public services delivery, the lower authorities usually cannot meet their budgets by formal taxation alone and thus have to pursue “informal” channels aggressively — diverting resources from the budget to extra-budgetary channels, protecting local enterprises, and imposing an array of arbitrary fees making schooling and medical care too costly for poor households. Local governments at the present time lack discretion to change the rates or define the base of local taxes or to decide whether or not to adopt taxes from the

list of taxes assigned to them. The illegal fees, the main source of extra-budgetary funds at the local level, range from surcharges on household utility bills/road maintenance/vehicle purchases to hospitals and school charges (World Bank 2002). The Ministry of Finance found in 1996 that in a Hebei county 71.5 per cent came from all kinds of fees while only 28.5 per cent from formal taxes (Bernstein and Lu 2003). The proliferation of “illegal” fees at the local level has become a matter of concern regarding the distortionary effects on the overall fairness of the system: The farmers in the poor western provinces have to pay for compulsory education from their own pocket and their family members seriously ill basically wait for death.

The 1994 tax-assignment reform did little to discipline the opaque and regressive extra-budgetary funds. Local governments and line departments continue to use extra-budgetary and off-budgetary funds as a way to avoid central government (or other higher level government) restriction on the use of these funds. The non-budgetary financing at the macro-level undermines fiscal discipline, hampers efficient resource allocation, and gives rise to wasteful spending and corruption.

#### **(5) Farmers’ Financial Burden and Rural Tax Reform**

The farmer burden has landed at the center of the political debate as complaints, petitions, and even violent unrest are spreading as a consequence of county and township governments passing their financial stress to local residents through indirect borrowing, heavier taxation and informal fees (Jin, et al. 2008; Li 2001; Ren 2002; Tao, et al. 2005). Since the banking reform of 1998 when the power to appoint bank managers was removed from local authorities, taxation and informal charges became the few means of fulfilling their fiscal obligations (Bernstein and Lu 2003).

Throughout the reform-era, the center has launched several campaigns to limit the administrative fees collected by grassroots governments. These reforms culminated to the recent tax-for-fees (feigaishui) reform in March 2000, which attempted to remove all local informal charges and lift the rates of formal agricultural taxes. Then a provincial pilot program of rural taxation reform in Anhui was initiated, but very soon the local budgets in Anhui were under great financial strain due to significant reduction of revenues. Complaints from local officials were accumulating; in some districts of Anhui, taxation rate surged up again and after a short-term reduction, local fees re-emerged (Ren 2002). In 2002, the rural taxation reform in 20 provinces across China was carried out, accompanied by a central transfer of RMB 25 billion and provincial transfers of about the same amount. Premier Wen Jiabao’s government began to remove all informal fees and the formal agricultural tax in 2004; all were abolished in 2006. The central government provided increased transfers, largely to inland agriculture



based regions, to compensate for the local revenue lost as a result of the reforms (Ahmad 2008) .

While it is too early to analyze the full implications of the rural tax reform, a prominent issue has emerged — the central transfers to compensate for the loss in township revenues from the abolition of self-generated funds in agriculture has not been sufficient. It is estimated by some source that the loss in rural taxes and fees in 2005 was Y150 billion, more than twice the additional transfer from the center of Y66.4 billion. The shortage of funding is reportedly resulting in rising township deficits and debt in most provinces except Sichuan and a worsening public services (Ahmad 2008). Tao, et al. (2005) argued that the burden problem lies in the intrinsic nature of the Chinese predatory fiscal federalism. The authoritarian regime is able to embolden insufficiently funded state mandates in the countryside; in the meantime, the decentralized system impeded the government to monitor the behavior of local cadres who can impose charges on farmers in the name of implementing these central government mandates. Their empirical analysis, based upon field interviews in 2003-2004 and a panel data set across eight provinces from 1986-2002, revealed that the increase of rural income disparity and the uneven tax and fee distribution among different income groups explained the increasingly severe rural taxation after 1990s.

#### **(6) Weak Vertical and Horizontal Accountability Mechanisms**

For the efficiency gains from fiscal decentralization to be realized, local governments need to be responsive to their residents. The presence of accountability mechanisms is considered as an indispensable condition for effective fiscal decentralization (Seabright 1996). China's intergovernmental fiscal system is extraordinarily weak in both vertical and horizontal accountability. Without accountability, more equalization of spending to poorer provinces may lead to greater waste of resources rather than better service delivery for the unfortunate portion of the population.

Considering the high degree of expenditure decentralization in China, a prominent issue is vertical accountability of local governments to the central government. The evaluation criteria for local officials have been focusing on achieving growth and attracting investment. These measures are quantifiable and the accountability system has performed reasonably well. However, the shift of China's development strategy from an aggressive pursuit of economic performance to paying more attention to fairness and equity, underlined by Premier Wen Jiabao in his report to the Tenth National People's Congress on March 2006, reflects the need to put more weight on non-growth measures, such as educational attainment, health status of the people, and quality of the environment. The central government faces incredible challenges to gauge how local governments are doing

towards these multiple objectives, and to use that information to make staffing and policy decisions (Dollar and Hofman 2008).

The horizontal accountability is almost absent in the current intergovernmental fiscal system in China. Local governments are not stimulated to prioritize local spending according to the needs and preferences of their residents. The remarkable local fiscal stress has not retained local governments to focus primarily on social affairs and public service provision, but instead, local administrations lavishly spend on projects that easily demonstrate performance of local officials. A series of institutional weaknesses have contributed to the problem. First, local officials are not restrained by any form of institutionalized scrutiny by local residents. Second, local officials are evaluated and promoted largely based on their performance on local economic development rather than public services. Further, the current fiscal system requires local governments to take responsibility for local economic development and adjustment to macroeconomic changes, which provides various channels for local authorities to intervene the private sector at the expense of fewer and lower quality of basic public services (Martinez-Vazquez, et al. 2008).

## 11. CONCLUSION AND POLICY OPTIONS

Building a harmonious society (hexie shehui), the most frequently used phrase in China's official media these days, reflects an essential shift of China's development strategy from dominantly striving for economic performance to paying more attention to the concerns of the marginalized. It was underlined by Premier Wen Jiabao in his report to the Tenth National People's Congress on March 2006 in which deepening reform of the fiscal system was highlighted as one of the key policy areas in achieving the objective. Given the objective of improving local public services and promoting balanced economic development, the present system of fiscal decentralization fails to promote fairness and equity, enabling all of Chinese to share the fruits of reform and development. Aspects of the current system that require policy attention include the opaque and inappropriate expenditure assignment, particularly at the sub-provincial levels; the vertical fiscal gap and widening fiscal disparities; the complex and malfunctioning intergovernmental transfer system; the neglected sub-provincial fiscal arrangements; and the weakness in the vertical accountability of local governments to the Center as well as the horizontal accountability of local administrations to the local needs and preferences.

### **(1) Revamp the Expenditure Assignment to Clarify the Responsibilities of Government**

The murky and inappropriate expenditure assignment, particularly at the county and township levels, requires immediate policy attention. Ac-

According to widely accepted and practiced rules of responsibility division, local governments should focus on public services and social affairs while the central government emphasize on such national issues as national defense, foreign affairs, macro-economic stability, and functions of regional equalization. Apparently, China's local governments need to gradually withdraw from the responsibility of local economic development and take a major role in public services provision.

Some existing expenditure assignments require being centralized. The responsibilities assigned to county-level governments for pensions and income support schemes are generally central government functions in most countries, as the social security programs generally entail a certain level of risk pooling and redistribution (Martinez-Vazquez, et al. 2008). The financing of basic public services like education and health cannot heavily depend on sub-provincial governments. The central and provincial governments should take more responsibility in ensuring the national minimum standards of the core public services.

**(2) Deal with vertical fiscal gap and horizontal fiscal inequality**

To ease the local fiscal stress and curb the growing fiscal disparity, several options could be considered. First, continue to enlarge the amount of resources for the equalization transfer on the condition of a much more transparent, detailed assignment of obligatory functions across all levels of government and a better definition of affordable national minimum standards of basic public services. Although the equalization grant has been growing rapidly (2.07 billion yuan in 1995 to 74.5 billion yuan in 2004), but growth in specific purpose transfers has outpaced the growth of equalization transfers (Shah and Shen 2006).

Second, more revenue sources could be generated at poor regions in tandem of further modernization of the tax system. For instance, the current Company Income Tax is residence based rather than the common rule of source based. The residence base has the potential to deprive poor provinces of significant revenues as company headquarters are usually located in richer provinces. To make CIT a source bases tax requires establishing income attribution rules to attribute income to various locations based upon value added, employment and sales etc. This will allow western provinces to claw back additional CIT revenues (Shah and Shen 2006). Another option is to increase taxes on natural resources, as most of valuable resources are located in poor regions whereas consumers are mostly from rich regions. For urban areas, property tax is a desirable form of stable local tax to replace the existing real estate and land taxes.

Third, China could consider cutting transfers to rich regions in exchange for more tax autonomy. There is no consensus on the degree of autonomy that should be devolved to local governments but greater revenue autonomy must be considered an important reform in putting decentralization to

work at the local level in any decentralized country. One possible option is to discontinue tax by tax sharing for PIT and CIT, allowing supplementary variable flat rate charges by provincial-local governments. In addition, provincial-local governments may be given flexibility to set own tax rates within a defined band (Shah and Shen 2006).

Fourth, the central government could be more aggressive in terms of getting involved in the sub-provincial distribution of resources. It has been confirmed by many studies that intra-provincial disparities are more severe than inter-provincial inequalities. The center could ensure the bottom line of disparity across sub-provincial jurisdictions by targeting the transfers directly towards the county level, thereby making equalization a truly central task (Dollar and Hofman 2008). The proposed measures have the potential to ease fiscal disparities while enhancing accountability to local residents.

### **(3) Reform the intergovernmental transfer system to promote equalization and ensure national minimum standards of basic public services**

China's intergovernmental transfer system is overly complex and a large number of transfer programs have been designed in an ad hoc manner as short term palliatives to deal with emerging issues/crisis but allowed to continue in perpetuity without any serious review. To deal with the opaque and compound system, a series of reform options could be considered.

First, establish a legal framework and designate a coordinating ministry. All transfer programs in China are instituted by executive order and do not require formal legislative approval by the National People's Congress. Further all programs lack a sunset clause and review requirements for renewal. This informality breeds incentives for transfer programs to be introduced in a "putting the fire out" fashion" i.e. to institute grant programs with emerging problems without ensuig how various pieces of the puzzle fit together. China may consider instituting a legislative framework for major grant programs and designating the State Council or the Ministry of Finance to play a coordinating role. In addition, a fiscal arrangements committee comprising the Centre, provinces and local government chaired by the central Finance Minister, may be appointed to act as the primary initiating and deliberative body on central transfers (Shah and Shen 2006).

Second, introduce output-based fiscal transfers to achieve national minimum standards in merit goods such as education, health, and infrastructure. These transfers could be based on relevant service population. A larger role of the central government must be recognized in financing rural services in view of the inadequate potential for raising adequate own source revenues by rural areas (Shah and Shen 2006). The minimum guarantee system for basic public services is not only a matter of urgency but also a feasible policy choice. It was based on such concept that, in 2006, a propos-

al was adopted to guarantee public funding for rural compulsory education (Lou 2008).

Third, rationalize and simplify the fiscal equalization transfer. This can be done by introducing an explicit standard of equalization e.g. national average standard for fiscal capacity or a fraction of this standard. This standard should determine both the pool and the allocation. Simplify the representative tax system and have fiscal capacity calculations done for eight bases only : VAT, PIT and CIT, Business Tax, Urban maintenance and construction tax, housing property tax, vehicles taxes and all other sundry taxes combined. User charges should be excluded from these calculations. Discontinue the representative expenditure system (RES) for fiscal need calculations and instead use per capita (per service population) output based transfers for national merit goods as discussed above (Shah and Shen 2006).

Fourth, the existing earmarked grants must be simplified and formalized. The centrally sponsored schemes account for a critical source of revenue for local governments in China, and they are justified on the same bases as conditional grants are in other countries: addressing externalities, pursuing national objectives, and so on. However, the issue is the number of the schemes is just too many and last decade has seen a continued growth. The oversized earmarked grants blur the lines of responsibility, burden the administrative capacity of the local governments, and undermine local budget autonomy.

#### **(4) A shift focus on developing a sound fiscal system at the sub-provincial level**

China's intergovernmental fiscal reforms have been primarily focusing on the relations between the central government and provincial governments, leaving the sub-provincial fiscal arrangements at the leeway of each provincial government. The resulting fiscal stress as well as widening fiscal disparities across county and township levels requires prompt policy actions. The good news is the Center has recognized this issue and a few policies have been implemented since 2000. For instance, "province managing county" model has been developed in seven provinces (Anhui, Fujian, Heilongjiang, Hainan, Hubei, Ningxia, and Zhejiang) by the year 2005, which simplifies the hierarchy of fiscal management and improves the managerial efficiency. In addition, the central government has been encouraging supervision of township finance by county governments.

#### **(5) Strengthen Vertical and Horizontal Accountability Mechanisms**

The accountability of local governments to the Center is distorted and their accountability to local residents is extremely weak. In order to improve vertical accountability, more fiscal transparency is indispensable at all levels of government. The expansion of local revenue autonomy will not

happen overnight; Central Government in China in the foreseeable future would remain a dominant source of financing sub-national services especially in the Western regions and rural services. Under such an environment, it is important to establish a national framework for fiscal transparency, responsibility and accountability that is binding on all orders of government. This framework should specify principles and rules for fiscal prudence and fiscal discipline, framework for responsible credit market access, framework for fiscal insolvency for local governments, transparency and access to information by all. More budgetary information would allow the People's Congress at all levels to better assume their oversight function. The imminent revision of the budget law provides an opportunity to institute more transparency in the intergovernmental system in law. Recent experiences of Brazil and South Africa with such legislation may be instructive for China (Shah and Shen 2008). In addition, as the transfer programs for national minimum standards of basic public service are gradually established (education, health, water, etc.), the output-based performance criteria, such as student attainment, could be used as a tool of accountability.

China still has a long way to go towards strengthening horizontal accountability of local governments to their residents. One possible option to pursue is the approach to benchmark the quality of local governance. A good example is the Governance Performance Project (GPP) in the United States, an independent program that evaluates how well state governments perform their basic management functions and that provide states the information and data to serve citizens better. The GPP focused on four aspects: money (how well does the state manage its fiscal resources), people (how well does the state manage its employees), infrastructure (how well does the state manage its physical infrastructure and other resources supported by capital expenditures?), and information (how well do elected leaders and managers use information and technology to measure the effectiveness of services, make decisions, and communicate with citizens?). There is no standard way to create such a benchmarking scorecard, but the information generated on the quality of governance could stimulate a healthy debate and competitive pressure on localities to improve public services. Another relevant mechanism practiced in other countries is the concept of participatory budgeting which essentially means involving citizens in the budgetary decision-making. It has been enthusiastically pursued in Latin American countries like Brazil. The China Development Foundation is experimenting with participatory budget processes in several local governments. A fuller evaluation of the program will help to understand whether the approach is applicable in China's specific fiscal environment.

In conclusion, the time is ripe for significant amendment and reforms of the existing fiscal arrangements, particularly below the provincial level, so as to collaborate the recent shift in China's development policy towards

more emphasis on fairness and equity. The reallocation of fiscal resources must be complemented by a clear and proper definition of government's roles and functions at all levels and better mechanisms to strengthen vertical and horizontal accountability.

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