# Fiscal Decentralization in China:

## History, Impact, Challenges and Next Steps

**Chunli Shen**

University of Maryland, USA

**Jing Jin**

Central University of Finance and Economics, China

**Heng-fu Zou**

Peking University, Wuhan University, China, and the World Bank

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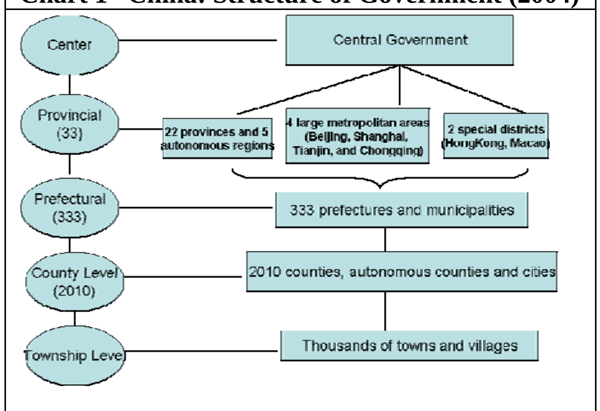
Mailing address: Heng-fu Zou, The World Bank, Development Research Group, 1818 H St. NW, Washington, DC 20433, USA. Email: Hzou@worldbank.org; Tel. 202-473-7939; Fax: 202-522-1154.

## 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. With respect to China, fiscal decentralization has been a fundamental aspect of its transition to a market economy; and the country has made substantial efforts 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).

**Chart 1 China: Structure of Government (2004)**




*Source: China Atlas (2005)*

Although China remains a unitary political system, the current structure of governance gives strong feel of a fiscal federalism: local governments in China are organized in a four-level hierarchical way with each level of government reporting to the next highest level (see Chart 1), and they have been given considerable latitude in shaping local policies and managing fiscal resources. About 70 percent of the entire public expenditure was made at the sub-national levels and over 55 percent at sub-provincial levels in 2004 (Qiu 2005).

However, China is much less decentralized than what appears on the surface. The center exerts substantial control over localities through the intergovernmental fiscal system, several binding expenditure laws, and numerous expenditure mandates as well as its authoritarian political arrangement. Sub-national governments are largely dependent on shares of central taxes and grants after the 1994 reform. In 2003, they financed 67 percent of provincial, 57 percent of prefecture and 66 percent of county and lower level expenditures (Qiao and Shah 2006). The local fiscal dependence, combined with a hierarchical party structure and the absence of national elections, emboldens predatory behavior of the upper-level governments and hence confines the full benefits of fiscal decentralization.

It is widely believed that decentralization in China has contributed to the country's remarkable economic performance over the last 25 years (Jin, et al. 2005;Jin and Zou 2003;Lin and Liu 2000;Qian 1999) whereas the issue is still open to debate. Fiscal decentralization has also brought many unintended problems, including increasing regional disparities, proliferation of off-budgetary funds, deficient and unequal public services delivery, farmers' financial burden and rural unrest.

The objectives of this paper are to review the experience of China's fiscal decentralization, explore the impact of fiscal decentralization on growth and public expenditures, and identify political as well as economic issues arising after 1994 tax sharing reform in the last decade.

After some background discussions, this paper is divided into six main parts: section 2 briefly summaries the process of China's fiscal decentralization; section 3 examines the expenditure and revenue assignments as well as the intergovernmental transfer system; section 4 addresses various issues related to local government financing, including local taxes, intergovernmental transfers, and local borrowing; section 5 assesses the shifting of fiscal power between the central government and local governments through decentralization; section 6 analyzes the effects of fiscal decentralization on economic growth; section 7 highlights political and economic issues induced by the fiscal decentralization reforms; and the paper concludes with potential policy options.

## 1. Economic and Political Background of the 1994 Tax Sharing Reform

The rigid centralization of planning, finance, and administration, adopted from the Soviet Union, dominated the first 30 years of the People's Republic (1949-79). However, the central planning system did not thrive in the pre-industrial, agrarian, and under-developed conditions of China. At the dawn of the reform period in the late 1970s, the centralized system was already decimated: provincial and local governments ran most enterprises and took responsible for planning and economic administration within their jurisdictions. Nevertheless, the fiscal system was still highly centralized: the consolidated budget system forbid the discretionary spending power of the local governments; revenues, largely from the profit remittances of state-owned enterprises (SOEs), were collected by local governments and accrued to the center (Riskin 2000;Wong 2000;Wong, et al. 1995).

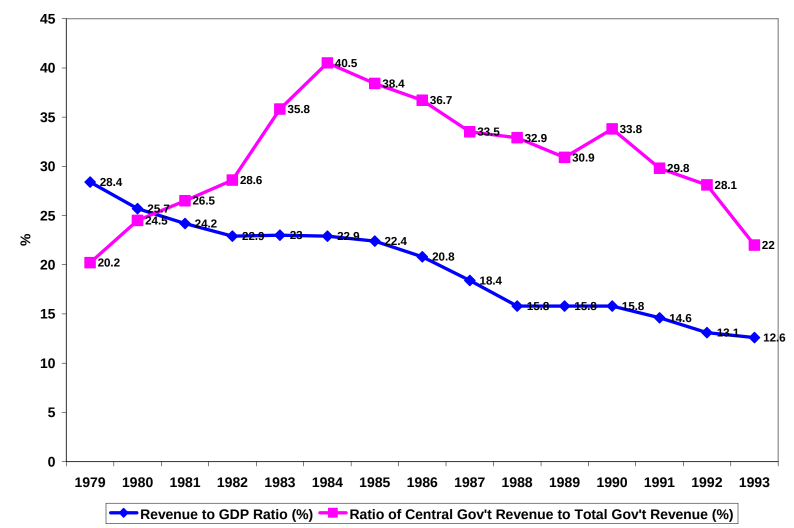
As China's leaders set their sights on a market economy beginning in 1979, the mechanisms of the planned economy, including the monopoly state ownership of industry, administrative prices, and the central economic planning, were dismantled and accordingly the fiscal system broke down quickly. While some scholars (Lin and Liu 2000) reckon these changes as a more or less carefully thought out response to China's changing needs, many scholars believe that the evolution of China's fiscal decentralization has been an ad hoc and uncoordinated process; it was mainly driven by the collapse of the old fiscal system as the central government trying to tackle dysfunctional behavior under the pressure induced by reforms (Wong 2000). This breakdown was inevitable with the erosion of the SOE profits - the foundation of the previous fiscal system – in the face of burgeoning non-state sector, growing competition imposed on SOEs, and rising wages and resource prices. Furthermore, tax administration was enormously challenged by the rapidly changing conditions and the proliferation of enterprises of various ownership forms. The government revenue collection plummeted from 35 percent of GDP in the late 1970s to just 12.6 percent in 1993. The devolution of fiscal responsibilities to lower levels appeared prevalent in coping with mounting fiscal stress. The center, increasingly revenue-dependent on local governments, was left no choice but negotiate with localities for its own share. The fiscal system was on the verge of crash, and a number of different revenue sharing systems were tried out during the 1980s.

Despite the persistent efforts to revamp the malfunctioning fiscal system, the late 80s and early 90s were marked by a continuing decline of the "two ratios" (budgetary revenue to GDP and central to total budgetary revenue), interference of local governments in the private sector, increasing regional fiscal disparities, devolution of expenditure responsibilities accompanied by diversion of resources away from formal budget into extra-budgetary channels, and ongoing distrust between center and localities.

### *Fiscal Decline*

This 1988 fiscal contracting system further dampened fiscal power at the center. Since the revenue assignment was not clear, local 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 intrigued a vicious cycle of jurisdictional competition. The central government's shared of revenue fell from 33 percent in 1988 to only 22 percent in percent in 1993 (Chart 2). On the other side, local governments increased their revenue share, particularly those that were major contributors to the central government's revenue. In practice, the contracts were not strictly adhered to and were revised repeatedly for some regions.

**Chart 2 The Two Ratios, 1979 - 1993**




*Source: China Statistical Yearbook 2004*

### *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 paralleled the interests of the government in line with those of enterprises, which not only encouraged various levels of governments to interfere in the operation of the enterprises and hence hindered the process of separating governments from enterprises (*Zhengqi Fenli*), but also did harm to the market economy by rendering the special treatment to SOEs and destructing fair competition. Second, the system provided local governments with incentives to pursue their own fine fiscal interests in enlarging tax bases by the expansion of local enterprises such as distilleries and cigarette factories, which also generated overlapping construction and development and inspired local protectionism.

### *Increasing Fiscal Disparities*

The system also contributed to greater regional fiscal disparities. With a great variety of fiscal contracts in use, the system was a chief result of political negotiation between the central and individual province; it worked in a way detrimental to the poor regions. Rich provinces in the East like Canton, Shanghai, and Shandong, were able to have more advantageous contracts because of the development strategies and their political leverage.

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

On one hand, fiscal stress at the center forced Beijing to cut intergovernmental transfers and meanwhile shed more spending responsibilities to the lower levels of government. On the other hand, local expenditure grew much faster than central expenditures, especially 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 surrounded intergovernmental fiscal relations in the early 1990s. The central government recognized the continuing fiscal decline partly due to local government unwillingness to collect taxes while 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 lacking firm commitment at the center to build solid local finance. Moreover, during the 1980s, on several occasions the central government revised the ownership of key sectors and introduced new levies to increase its share of revenues, e.g. the Energy and Transport Key Construction Fund and the Budget Adjustment Fund. The central government also “borrowed” revenue from local governments as a way to absorb some 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 amount of revenues was switched subtly into myriad extra-budgetary funds (Ahmad 2002;Wong, et al. 1995).

When the 1988–90 system was supposed to expire in 1991, Beijing failed to pursue alternative approaches; the contracting system was extended until the end of 1993. A radical reform of the fiscal system was finally cooked out in 1994 at the climax of the fiscal struggle.

## 2. History of Fiscal Decentralization in China

China has made substantial efforts to decentralize its fiscal management system. The 1980s' and early 1990s' reforms were aimed at promoting local economic development through increasing local governments' responsibilities and their autonomy in carrying out fiscal functions, while preserving an adequate degree of fiscal control for the central government. The strategy did boost local growth in many regions, but it also brought many unintended problems including declining general government revenues, waning fiscal position of the overall government, weakening macroeconomic management, and rising regional disparities. At the culmination of the struggle, the 1994 Tax Sharing Reform was initiated as the first attempt to fix the intergovernmental fiscal system as the main purpose. However, the grand undertaking was undermined by preserving many features of the pre-reform arrangements: a lump-sum transfer, or tax rebate, was established to guarantee the coastal provinces' pre-1994 income level, and it remains a dominant plank of the total central transfers until today; the vague responsibilities assignment between levels of governments was left unaddressed, which is indeed a principal cause of starved local finance and the enduring quandary of extra- and off – budget revenues; and furthermore, the equalization transfer has remained small after a decade of implementation which further deteriorates the relations between central and local governments.

### 1) 1949-1978 Pre-Reform Fiscal System – Central Control System

The fiscal system installed by the new regime in the 1950s largely ensembles the Soviet practice. Over the period 1949-79, China government made several attempts to overcome the rigid centralization of planning, finance, and administration. At the inception of the reform period in the late 1970s, China was already characterized by many features of fiscal federalism: provincial and local governments ran most enterprises and were responsible for planning and economic administration within their jurisdictions. Nevertheless, Beijing determines every aspect of the fiscal system. It is a simple and effective system under pre-reform conditions, but one completely lacking in fiscal incentives for local governments or enterprises (Lardy 1978;Oksenberg and Tong 1991;Riskin 2000;Wong 2000;Wong, et al. 1995).

***Tax System***

The tax system was crude with only few tax types even absent of income and corporate taxes. Revenues were largely raised from the profit remittances from, and taxes on, state-owned enterprises (SOEs), whose profitability was ensured by the structure of 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 – mainly SOEs. Tax collection was delegated to local governments. The accounts of SOEs were easy to monitor: given fixed prices, planned output and sales, tax capacity and tax effort were easy to determine. Taxes and profits, collected locally, were transferred back to the local governments according to the local spending needs approved by the center (Wong 2000).

***Expenditure and Budget***

Expenditures were essentially all determined at the center. Under the consolidated budget system, the central government set spending priorities, approved local budgets, and determined civil service salary scale, pension and unemployment benefits, educational and health care standards, etc.; sub-national governments, in the absence of independent budgets, lacked discretionary spending power. Local governments, as budgetary units identical to SOEs, were 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 such as the judicial system. Local 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 to be transferred to the central government and shortfalls were to be covered automatically. 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). Such a system was highly devoted to the equalization concerns.

**2) 1979 – 1993 Ad Hoc Decentralization -- Fiscal Contract System**

The prominent features of the period 1979-1993 comprised a significant reduction in fiscal revenue collection as a percentage of GDP and a conspicuous falling trend of central revenues. As the tax effort at the local level could no longer be monitored, the central government was forced to negotiate with increasingly disobedient local governments on revenue shares. From 1980, three different revenue sharing systems were introduced and abandoned as they all failed to reverse the trend of falling fiscal revenues, but induced undesired malpractices one after another. On the positive side, fiscal reforms during this period provided the device to mobilize local revenue collection in an effort to promote local economic development.

***1980 Contract Responsibility System***

A fiscal revenue sharing system replaced the highly centralized system in 1980. 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 revenue. Under that system, central-provincial sharing rules were established by the central government; provincial-municipal relations were governed by the province; and this principal extended to lower levels. 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% of the shared revenues were remitted to the central government and 20% were retained by local governments. The bases and rates of all the taxes, whether shared or fixed, were determined by the central government. Enterprises were supposed to pay taxes to the level of government they subordinate to. Almost all revenues, except a few minor central-fixed revenues, were collected by the local finance bureaus.

### *1985 Modified Contract Responsibility System*

The uniform-sharing formula during the period 1980-1984 created undesired surpluses in affluent provinces and deficits in poor provinces although the reform boosted more revenue collection in many localities. In 1985, the State Council redesigned revenue-sharing arrangements by varying schedules based on localities' budget balances in the 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 remitting 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.

### *1988 Fiscal Contracting System*

In the period 1988 – 1993, the government implemented a "fiscal contracting system" that introduced six types of central-provincial revenue-sharing methods, each applied to some provinces (Agarwala 1992).

| **Table 1 1988 Fiscal Contracting Methods** |
|---|
| ***1. contracted sharing rate with fixed yearly growth rate of revenue***<br>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.<br><br>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 |
| ***2. fixed local shared rate in total revenue***<br>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.<br><br>Local gov't shared ratio of total revenue in the province = base amount for expenditure in province / base amount for total revenue in province |
| ***3. fixed local shared rate in total revenue + incremental fixed shared rate***<br>Besides sharing total revenue on the basis of a fixed shared ratio, the province could share the revenue growth at a different sharing ratio. |
| ***4. contracted remittance with fixed annual growth rate***<br>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. |
| ***5. fixed contracted remittance***<br>The province remitted to the central gov't a fixed amount every year which equal to the revenue surplus in the base year:<br><br>Fixed contracted remittance in province = base amount for revenue – base amount for expenditure |
| ***6. fixed contracted grants***<br>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. |

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

During this period, the transfer system was still dominantly gap-filling transfer: when the base amount for expenditures was larger than the fixed local revenues, the province was allowed to keep all the fixed revenue and in addition, 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 shared revenues, then the province can keep both and in addition, the fiscal gap was filled with the "fixed amount" grants from the central government every year (Zhang and Martinez-Vazquez 2003). The system of intergovernmental transfers in China consisted of four kinds of central-local grants. Under the fiscal contract system, some provinces had to remit to the central government part of their revenues, according to a predetermined lump-sum amount or a progressively increasing ratio of revenues. The central government depended a great deal on this local transfer from the better-off provinces during that period.

**a. Fixed Subsidy**: This transfer was aimed at redistributing revenues and expenditures to maintain local fiscal balance. Subsidies were given to provinces with base-year expenditures large than base-year revenues.

**b. Special-Purpose Grant**: The transfer was initially used for disaster relief, poverty reduction, and other specific purposes, it was expanding in terms of both the range of the programs and the size of the financial resources.

**c. Annual Accounting Closing Transfers**: The amount of this transfer was determined at the end of each fiscal year. It acted as an adjustment to the net revenues and expenditures, taking into account transfers between central and local governments.

**d. Capital Grants**: The central government also disbursed conditional grants mainly for local capital construction and other investment activities.

**3) 1994 – present: Tax Sharing Reform**

The fiscal reform of 1994 was a real attempt to deal with the basic revenue problems by curbing the fiscal decline and providing sufficient resources especially to the central government, simplifying the tax structure and enhancing its transparency, and improving central-local revenue sharing arrangements.

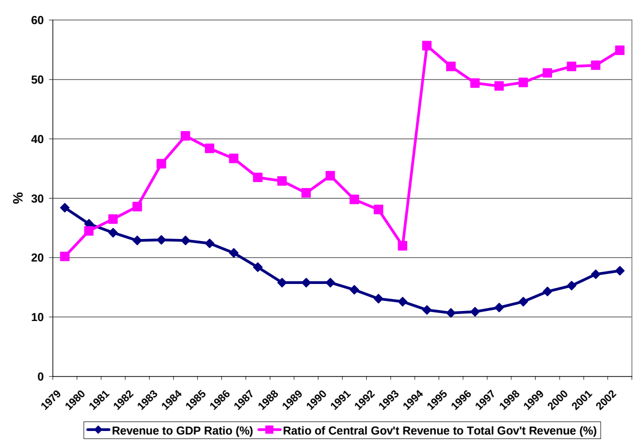
The centerpiece of the reform was the introduction of the Tax Assignment System (*fenshuizhi*), which specifies the way revenues are shared between the central and provincial governments. The detailed analysis of the tax assignment system is provided in the next section. The tax structure was greatly simplified. The Value-Added Tax (VAT) replaced the turnover-based product tax, and has been implemented basically at a uniform rate of 17 percent. The corporate income tax was unified to include all domestic enterprises, and the top rate has been reduced from 55 percent to 33 percent. The consumption 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 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 (NTSs) were established in all provinces to collect central-fixed revenues and shared revenues. These NTSs are organized on the basis of the divisions in charge of central-fixed and shared taxes under the old tax bureaus. The former divisions in charge of local taxes became Local Tax Services (LTSs). 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 some notable successes:

**Improving the "two ratios":** The immediate impact of the tax-assignment system on the division of revenue sources between the central and local governments was very significant, which finally ended the situation that the central government relied on local remittances to finance its outlays. As shown in the Chart 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, compared to no more than 40 percent for 15 years since 1978. On of the prominent changes in the tax system accredited for the increase in the share of central government revenue is the center now controls VAT collection. In 1994, VAT alone accounted for about 42% of total government revenue (Ma 1997a). The creation of the NTS has also certainly made a difference. The decline in the revenue-to-GDP ratio was also finally halted in 1996 after seventeen-year decline. The fiscal revenue accounted for 17.8 percent of GDP in 2002. It is important to mention that GDP was increasing remarkably during the period.

**Chart 3 The Two Ratios, 1979-2002**




*Source: Ministry of Finance*

**Simplifying the Intergovernmental Finance System:** The 1994 Tax Assignment System replaced the previous six types of fiscal contract system, which makes the system much easier to manage. The clearer and proper assignment of taxes not only put a stop to the enduring misappropriation of revenues between central and local governments, but also provided right incentives to sub-national governments. For instance, since excise taxes are assigned to the central government and business taxes to local governments, the incentives for localities to over-develop enterprises with higher tax returns, such as distilleries and tobacco companies, are corrected (Zhang and Martinez-Vazquez 2003).

**Tightening Fiscal Control:** The establishment of NTSs offered a better 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 are substantially restrained. The 1994 reform abolished all tax reduction and exemptions granted by provincial governments for the turnover tax in the past. The new tax exemptions have to be approved by the center and reported in a separate schedule of the tax return.

## 3. Expenditure and Revenue Assignment as well as Intergovernmental Transfer System

### 1) Revenue Assignment

The tax sharing reform in 1994 explicitly defined fiscal revenue as the central revenue, shared revenue and the local revenue. Taxes that can be used in the pursuit of maintaining national objectives were assigned as central taxes; the taxes that could be interpreted as more relevant to economic development were assigned as shared taxes; and the taxes more suitable to be collected and administered by the local governments were assigned as local taxes. Table 2 reflects the current tax assignment system. The central government changed the revenue sharing arrangement between the central and sub-national governments little by little after the 1994 reform. First, from May 1997, the sharing ratio of Stamp Taxes on Security Exchange between the central and local governments was adjusted from 50%-50% to 88%-12%; from 1st Oct 2000, it was changed to 97%- 3% in subsequent three years. Second, the business tax rate on the financial and insurance industry increased from 5% to 8%, and the central government gets all the extra revenues. Third, since January 1, 2002, the central and local governments share all the company income tax revenues, except a list of enterprises, and personal income tax revenues together at the ratio of 50%-50% in 2002. In 2003 and 2004, the central government's sharing rate went up to 60% (Su 2003;Zhang and Martinez-Vazquez 2003). In 2004, the fiscal revenue of the central government is RMB150.10 billions, counting for 57% of total fiscal revenue which is RMB 263.96 billions, while the fiscal revenue of the local governments is RMB110 billions in total, or 43% of the total fiscal revenue.

Financial pressures on local governments have intensified since the introduction of the Tax Sharing System in 1994, which re-centralized revenues without cutting expenditure assignments to localities. At the sub-national level, the centralizing trend occurs at each level at the expense of the subordinate governments. The taxes assigned at the present time exclusively to the local level in general do not provide an adequate revenue base for local governments.

**Table 2 Revenue Shares of Various Orders of Government, 2004**

| Taxes | Central | Provincial |
|---|---|---|
| Tariffs | 100% | - |
| Excise Tax | 100% | - |
| Vehicle Purchasing Tax | 100% | - |
| VAT and Excise Tax on Imported Goods | 100% | - |
| VAT | 73% | 27% |
| Business Tax | 3% | 97% |
| Stamp Tax on Security Transactions | 97% | 3% |
| Individual Income Tax | 60% | 40% |
| Enterprise Income Tax | 60% | 40% |
| Urban Maintenance and Construction Tax | 1% | 99% |
| Urban and Township Land Use Tax | - | 100% |
| Housing Property Tax | - | 100% |
| Vehicle and Vessel Use Tax | - | 100% |
| Land Appreciation Tax | - | 100% |
| Stamp Tax | - | 100% |
| Agriculture and Animal Husbandry Tax | - | 100% |
| Tax on Special Products | - | 100% |
| Contract Tax | - | 100% |
| Farmland Occupation Tax | - | 100% |
| Gift and Bequest Tax | - | 100% |
| Slaughter and Banquet Tax | - | 100% |
| Fixed Asset Investment Tax | - | 100% |
| Resource Tax | - | 100% |

*Source: China Statistical Yearbook 2005.*

Table 3 provides an overview of central and local taxes during the period 1996-2003. Local governments rely most on Business Tax, VAT, and Enterprise Income Tax (276.76, 181.01, 117.89 billion yuan respectively in 2003), amounting to about 70 percent of the local total. As for the central government, VAT, Taxes on Imports, Enterprise Income Tax, and Consumption Tax are the key resources with the total of 1113.72 billion yuan in 2003, accounting almost 96 percent of the total central revenues.

**Table 3 Central and Local Taxes, 1996-2003**
**Unit: billion yuan**

| Taxes | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **Excise Tax** | 62.02 | 67.87 | 81.49 | 82.07 | 85.83 | 93.00 | 104.63 | 118.23 |
| **Excise Tax and VAT on** | 44.77 | 50.75 | 55.55 | 101.56 | 149.17 | 165.16 | 188.57 | 278.86 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Imports** | | | | | | | | | |
| **Tariffs** | | 30.18 | 31.95 | 31.30 | 56.22 | 75.05 | 84.05 | 70.43 | 92.31 |
| **Cargo Tax** | | | | | | | 0.62 | 0.85 | 0.94 |
| **Vehicle Purchase Tax** | | | | | | | 26.58 | 34.88 | 46.82 |
| **Tax Rebate for Foreign Trade Company** | | -82.77 | -55.50 | -43.62 | -62.67 | -105.00 | -108.00 | -115.00 | -198.86 |
| **Other Central Taxes** | | 2.29 | 2.82 | 4.24 | 4.30 | 0.00 | 0.00 | 0.00 | 0.00 |
| | | | | | | | | | |
| **VAT** | Central | 222.00 | 245.96 | 272.00 | 290.76 | 341.32 | 401.55 | 463.10 | 542.56 |
| | Local | 74.28 | 82.43 | 90.84 | 97.43 | 114.00 | 134.17 | 154.74 | 181.10 |
| **Business Tax** | Central | 4.63 | 16.33 | 23.46 | 21.49 | 24.31 | 21.50 | 15.53 | 7.69 |
| | Local | 100.63 | 116.10 | 134.05 | 145.37 | 162.57 | 184.91 | 229.50 | 276.76 |
| **Enterprise Income Tax** | Central | 56.56 | 42.47 | 39.69 | 59.17 | 61.02 | 94.53 | 188.22 | 174.07 |
| | Local | 40.28 | 53.84 | 52.86 | 62.44 | 105.18 | 168.56 | 120.06 | 117.88 |
| **Personal Income Tax** | Central | | | | 0.08 | 14.95 | 27.92 | 60.60 | 85.08 |
| | Local | | | | 41.28 | 51.02 | 71.60 | 60.58 | 56.73 |
| **Stamp Tax on Security Exchange** | Central | 6.08 | 20.22 | 18.03 | 21.53 | 42.29 | 26.59 | 10.86 | 12.39 |
| | Local | 6.08 | 3.51 | 2.46 | 6.71 | 5.47 | 1.70 | 0.34 | 0.38 |
| **Urban Maintenance and Construction Tax** | Central | 0.31 | 0.33 | 0.29 | 0.26 | 0.33 | 0.36 | 0.37 | 0.33 |
| | Local | 24.19 | 26.87 | 29.20 | 31.26 | 34.90 | 38.06 | 46.71 | 54.67 |
| | | | | | | | | | |
| **Tax on Resources** | | 5.73 | 5.65 | 6.19 | 6.29 | 6.36 | 6.71 | 7.51 | 8.33 |
| **Urban Land Using Tax** | | 3.93 | 4.41 | 5.41 | 5.91 | 6.48 | 6.62 | 7.68 | 9.16 |
| **Agricultural Tax** | | 33.83 | 36.50 | 36.54 | 39.05 | 29.89 | 28.63 | 42.14 | 42.38 |
| **Fixed Assets Investment Adjustment Tax** | | 6.22 | 7.84 | 10.76 | 13.01 | 4.63 | 1.56 | 0.80 | |
| **Tax on the Use of Cultivated Land** | | 3.12 | 3.25 | 3.34 | 3.30 | 3.53 | 3.83 | 5.73 | 9.00 |
| **Other Local Taxes** | | 46.60 | 59.81 | 72.20 | 41.45 | 44.87 | 49.94 | 64.82 | 84.95 |
| | | | | | | | | | |
| **Central Total** | | 346.08 | 423.20 | 482.44 | 574.77 | 689.27 | 833.86 | 1023.03 | 1160.40 |
| **Local Total** | | 344.90 | 400.20 | 443.85 | 493.49 | 568.89 | 696.28 | 740.62 | 841.33 |

***Source: Finance Yearbook of China (2004).***

## 2) Expenditure Assignment

The 1994 reform did not change the responsibility assignments that existed by law and practice before 1994. The extent system, as set out in the constitution, is broadly consistent with international practices: the central government is responsible for nation-wide services including national defense, foreign affairs, the operation of the central government body, the macro-economic control and coordination of economic development, and providing funds for universities, hospitals, research institutions, newspapers, publishing houses, etc that 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 operation of various institutions. Table 4 illustrates the current responsibility assignments in China. Ma and Norregaard (1998) suggest that the expenditure assignment is largely a result of the division of budgetary agencies' affiliations. The central budget is responsible for state-owned enterprises, universities, hospitals, and research institutions; expenditures of budgetary agencies "owned" by local governments, including primary and secondary schools, most hospitals, local infrastructure facilities, pension funds, and various extra-budgetary funds, are the responsibilities of local budgets (Ma and Norregaard 1998, 2).

**Table 4 Fiscal Decentralization: Responsibility Assignment by Administrative Levels**

| Public Services | Central | Provincial | Local |
|---|---|---|---|
| National Defense | * | | |
| Foreign Affairs | * | | |
| Administration of the Central Gov't | * | | |
| Administration of the Sub-national Governments | | * | * |
| Geological Prospecting Expenses | * | | |
| Macro-economic control and regional coordination of economic development | * | | |
| Public Debt | * | | |
| R&D | * | * | * |
| Capital Investment | * | * | * |
| Running Costs of the Military Police | * | * | * |
| Agricultural Support | * | * | * |
| Law and Order | * | * | * |
| Culture | * | * | * |
| Education | * | * | * |
| Health | * | * | * |
| Social Security | * | * | * |
| Price Subsidies | * | * | * |
| Urban Maintenance and Construction | | * | * |
| Militia | | * | * |

*Sources: Su 2003 and Zhang 2003.*

There is substantial overlapping between the center's and the local governments' responsibilities in heavy industrial sectors (e.g. electricity and raw materials), large infrastructure projects, higher education, R&D, and social safety nets, which complicates both the revenue assignments and the needed design of the transfer system. Further, unfunded central mandates have overloaded localities. For instance, since 1980 the central government has increased the standards of rural basic education on paper, but no new resources have been assigned to townships and counties to provide these services.

**Table 5 Public Expenditure by Function and Levels of Government, 2004**

| Function | Central | Provincial | Sub-Provincial |
|---|---|---|---|

China's local governments (provincial, prefecture, county, and township) have a much larger portion of expenditure responsibilities that are out of line with international practice. Local governments play the key role in providing social services such as education, health care, social security, housing and urban/local services. According to Table 5, sub-provincial governments covered 75 percent of education expenditure, 70 percent of health, and 70 percent of various social services. Some assignments seem to be wrong – for example, assigning local governments major redistributive activities as social security, unemployment insurance, and basic social welfare which should be reassigned to the national or provincial levels in order to reap the benefits of risk pooling and equalization; and assigning local governments the core services of primary education and public health which are usually the sharing responsibilities between national and provincial governments.

| | | | |
|---|---|---|---|
| Defense | 99% | | |
| Law and Order | 5% | 30% | 65% |
| Debt Servicing | 99% | 1% | |
| Economic Services | 40% | 20% | 40% |
| General Administration | 20% | 40% | 40% |
| Subsidies | 15% | 25% | 60% |
| Social Services | 10% | 20% | 70% |
| Education | 10% | 15% | 75% |
| Health | 5% | 25% | 70% |
| Total | 30% | 15% | 55% |

*Source: Qiu 2005*

With no 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, and the cities determine the assignments of counties and the latter determine the revenues and expenditures of townships. The outcome is quite regressive, leaving the lowest level of government financially starved. County and township levels of government spend 70 percent of budgetary expenditures for education, and 55-60 percent of those for health. Cities at the prefecture and county levels account for all expenditures on unemployment insurance, social security, and welfare (World Bank. 2002).

Table 6 compares budgetary expenditure between central and local governments in 2003. The central government poured most of its financial resources to national defense, capital construction, and debt services, which are respectively 188.53, 152.28, and 95.52 billion yuan. Sub-national governments spent about a quarter of the budget on operating expenses for culture, education, science and health, that is, 399.76 billion yuan, followed by the investment of 190.65 billion yuan in capital construction.

**Table 6 Budgetary Expenditure of Central and Local Government by Item, 2003**
**Unit: billion yuan**

| Items | Central | Local |
|---|---|---|
| National Defense | 188.53 | |
| Armed Police Troops | 24.00 | |
| Social Security Subsidiary Expense | 14.44 | |
| Expenditure by Using the Vehicle Purchase Tax | 46.52 | |
| Interest Payment for the Foreign and Domestic Debts | 95.52 | |
| Capital Construction | 152.28 | 190.65 |
| Enterprises Innovation Funds | 4.21 | 63.43 |
| Science and Technology Funds | 22.63 | 19.04 |
| Additional Appropriation for Enterprises' Circulating | 1.06 | 0.14 |
| Geological Prospecting Expenses | 2.56 | 8.14 |
| Operating Expenses of Dept of Industry, Transportation, and Commerce | 8.45 | 20.07 |
| Supporting Agricultural Production and Agricultural Operating Expenses | 13.56 | 99.93 |
| Operating Expenses for Culture, Education, Science and Health | 50.79 | 399.76 |
| Pensions and Relief Funds for Social Welfare | 0.51 | 49.37 |
| Government Administration | 53.95 | 289.82 |
| Price Subsidies | 23.75 | 37.98 |
| Urban Maintenances and Construction Expenditure | | 85.08 |
| Supporting Underdeveloped Areas | | 15.60 |
| Other Expenses | 39.26 | 443.99 |
| Total | 742.02 | 1723.00 |

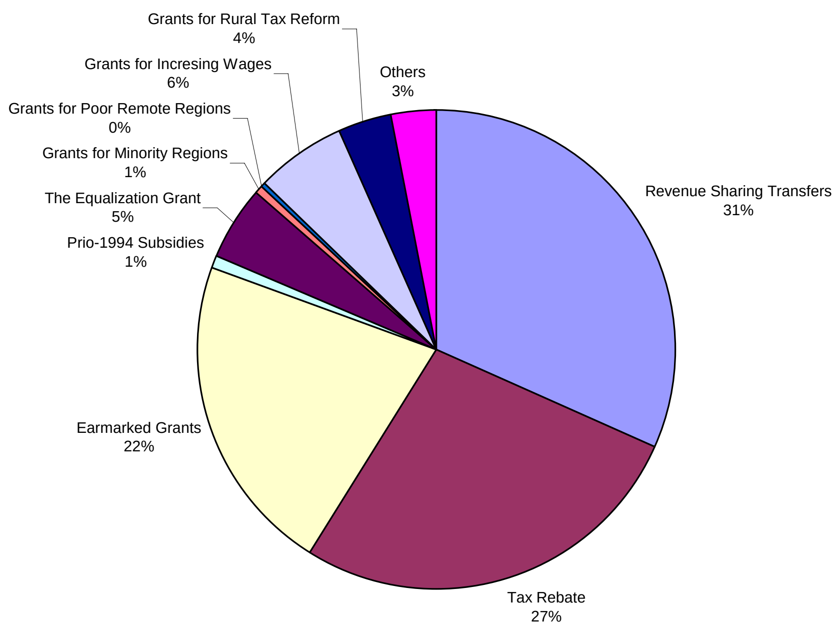
*Source: Finance Yearbook of China 2004*

### 3) Intergovernmental Transfer System

Improving the intergovernmental fiscal transfer system was another stated objective of the 1994 fiscal reform, but progress in this area has been limited. In 1995, first formula-based equalization transfer was launched in China. However, after a decade of implementation, the equalization transfer has remained small (about 7.3 percent of the total central transfers in 2004) and majority of central transfers, in the format of tax rebate, have been negotiated with provinces, thus virtually preserving the pre-1994 pattern of interregional fiscal distribution. As a result, The current system of intergovernmental transfers in China is poorly designed to address the regional fiscal disparities and to support the financing of vital social services such as education and public health although the volume of central transfers is large, accounting for 46 and 48 percent of local expenditures in 2001 and 2002 (World Bank. 2003, 70).

Chart 4 illustrates the structure of the central-local transfers in 2004. The largest central-provincial fiscal transfer was the revenue sharing transfers (469.5 billion yuan), followed by the tax rebate (404.97 billion yuan) and earmarked grants (322.33 billion). These three transfers combined accounted for more than 80 percent of the total central-provincial transfers. The 2004 equalization transfer was 74.50 billion yuan, amounting to 5 percent of the total central-provincial transfers.

**Chart 4 Center-Local Transfers, 2004**




*Source: Ministry of Finance, China*

### *The Revenue Sharing Transfers*

Sub-national governments in China receive 25 percent of the proceeds of the value-added tax (VAT) and 40 percent of the enterprise income taxes and the personal income tax from the central government. Since the central government determines the tax base, tax rate, and collects VAT and most of income taxes, they are more suitably classified as general purpose transfers following the general convention in the public finance literature.

### *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 consumption tax revenues (Budget Committee 2002). Algebraically,

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

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 Enterprise 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[1] 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 ensure that all provinces received income tax revenues no less than what they received in 2001.

***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

[1] 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.

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).

### *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:

$$WageGrant_i = ExpIncrease_i * BasicExpenditureRatio_i$$

Where

WageGrant – the grant for increasing wages received by province i

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

BasicExpenditureRatio – 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).

### *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.

### *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).

### *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, Shannxi, Gansu, Qinghai, Ningxia, and Xinjiang, still receive this type of grant.

***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,

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

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 by themselves cannot address public service delivery needs. At the lower end of the distribution, county and township governments in poor regions are unable to fulfill their expenditure responsibilities, and consequently provide insufficient levels of vital public services (Shah and Shen 2006).

## 4. Local Government Financing: local taxes, intergovernmental transfers, and local borrowing

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. The process of recentralizing revenues upward and devolving expenditures downward has deteriorated fiscal vertical imbalance and imposed further fiscal stress on local governments, particularly those in the rural sector and in the poor regions.

### 1) Local Taxes

Local taxes in China mainly comprise of Value-Added Tax, Business Tax, Enterprises’ Income Tax, Personal Income Tax, Tax on City Maintenance and Construction, Stamp Tax,

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.

Table 7 provides main tax revenues of 31 provinces in 2003. Local finance is highly dependent on the shared taxes - Business Tax, VAT, Enterprise Income Tax, Personal Income Tax, and Urban Maintenance and Construction Tax, all of which are shared taxes with the central government. For instance, in 2003, Beijing obtained almost 90 percent of revenue from the five shared taxes, or 51.88 million yuan out of the total 59.25 billion; Chongqing's 60 percent of government revenue was from the shared taxes. The Business Tax is the foremost important revenue source. The only exceptions are Shanxi, Heilongjiang, and Tibet, where revenue from VAT surpasses Business Tax. Thanks to the remarkable economic performance, wealthy regions, including Guangdong, Shanghai, Beijing, Zhejiang, and Jiangxu, are also able to reap the benefits of economic development from enterprise and individual income tax. Revenue from local taxes is slim, totally 673.6 billion yuan in 2003 accounting for only about 30 percent of the entire local revenues.

The regional divergence of government revenue is evident. Table 8 compares local revenues in Guangdong, Shanghai, Hebei, Shaani, and Tibet. Guangdong collected the largest income for each individual tax and for the total in 2003. In contrast to Guangdong's total 131.55 billion yuan, Shanghai obtained 88.62 billion, the second in the nation; Hebei 33.58 billion, the tenth out of the 31 provinces; Shaanxi 17.73 billion, the twentieth; and Tibet resided at the bottom with revenue of just 0.81 billion yuan.

**Table 7   Government Revenue by Province, 2003**
**Unit: billion yuan**

| | Total | VAT | BT | EIT | PIT | TCMC | RET | AT | CT | AF |
|---|---|---|---|---|---|---|---|---|---|---|
| Region Total | 985.00 | 181.10 | 276.76 | 104.35 | 56.72 | 54.67 | 32.39 | 33.66 | 35.80 | 71.41 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Beijing | 59.25 | 7.53 | 26.37 | 9.37 | 5.72 | 2.89 | 3.08 | 0.06 | 2.04 | 1.81 |
| Tianjin | 20.45 | 4.52 | 6.43 | 2.38 | 1.25 | 1.08 | 0.72 | 0.04 | 0.83 | 1.47 |
| Hebei | 33.58 | 6.87 | 6.54 | 2.87 | 1.81 | 1.88 | 0.90 | 2.50 | 0.60 | 2.94 |
| Shanxi | 18.61 | 5.14 | 3.66 | 1.42 | 0.86 | 1.30 | 0.53 | 0.39 | 0.16 | 1.35 |
| Inner Mongolia | 13.87 | 2.26 | 3.63 | 0.72 | 0.54 | 0.70 | 0.59 | 0.70 | 0.28 | 1.23 |
| Liaoning | 44.70 | 8.55 | 11.91 | 3.59 | 2.36 | 2.58 | 2.07 | 0.72 | 1.57 | 3.79 |
| Jilin | 15.40 | 3.07 | 3.50 | 1.18 | 0.78 | 0.93 | 0.64 | 1.02 | 0.49 | 1.50 |
| Heilongjiang | 24.89 | 5.86 | 4.61 | 1.08 | 1.10 | 2.10 | 0.90 | 1.63 | 0.55 | 1.52 |
| Shanghai | 88.62 | 17.02 | 33.23 | 14.62 | 7.18 | 3.56 | 2.24 | 0.01 | 6.35 | 2.28 |
| Jiangsu | 79.81 | 18.14 | 20.72 | 9.27 | 4.02 | 4.63 | 2.32 | 2.66 | 4.03 | 5.08 |
| Zhejiang | 70.66 | 15.50 | 22.01 | 10.65 | 4.58 | 4.22 | 1.73 | 0.54 | 4.78 | 2.03 |
| Anhui | 22.07 | 3.70 | 4.60 | 1.90 | 0.82 | 1.33 | 0.60 | 2.67 | 0.71 | 2.30 |
| Fujian | 30.47 | 5.44 | 8.47 | 3.68 | 2.13 | 1.39 | 1.31 | 0.12 | 1.15 | 2.14 |
| Jiangxi | 16.82 | 2.31 | 4.32 | 0.97 | 0.73 | 0.82 | 0.35 | 1.57 | 0.69 | 1.82 |
| Shandong | 71.38 | 12.61 | 14.47 | 6.64 | 2.60 | 4.44 | 2.45 | 4.24 | 1.53 | 7.57 |
| Henan | 33.81 | 5.79 | 7.53 | 2.91 | 1.56 | 2.05 | 0.92 | 3.77 | 0.59 | 3.00 |
| Hubei | 25.98 | 4.56 | 5.74 | 2.13 | 1.15 | 1.74 | 0.82 | 2.32 | 0.58 | 2.43 |
| Hunan | 26.86 | 3.61 | 6.02 | 1.35 | 1.22 | 1.63 | 0.65 | 1.82 | 0.56 | 3.49 |
| Guangdong | 131.55 | 23.37 | 41.58 | 17.00 | 9.48 | 4.77 | 4.56 | 0.80 | 4.85 | 8.77 |
| Guangxi | 20.37 | 2.87 | 4.79 | 1.31 | 1.03 | 0.95 | 0.60 | 0.68 | 0.45 | 2.20 |
| Hainan | 5.13 | 0.64 | 1.61 | 0.26 | 0.28 | 0.27 | 0.26 | 0.05 | 0.14 | 0.47 |
| Chongqing | 16.16 | 2.47 | 4.66 | 0.88 | 0.79 | 0.87 | 0.42 | 0.62 | 0.42 | 2.59 |
| Sichuan | 33.66 | 4.81 | 8.96 | 2.48 | 1.44 | 2.06 | 0.94 | 2.11 | 1.17 | 4.23 |
| Guizhou | 12.46 | 1.94 | 3.15 | 0.84 | 0.54 | 0.87 | 0.37 | 0.52 | 0.18 | 1.17 |
| Yunnan | 22.90 | 3.91 | 4.52 | 2.15 | 0.84 | 2.36 | 0.70 | 0.48 | 0.41 | 1.24 |
| Tibet | 0.81 | 0.09 | 0.40 | 0.07 | 0.03 | 0.03 | 0.00 | 0.00 | 0.00 | 0.06 |
| Shaanxi | 17.73 | 3.16 | 5.10 | 1.28 | 0.69 | 1.23 | 0.66 | 0.66 | 0.25 | 1.03 |
| Gansu | 8.77 | 1.81 | 2.41 | 0.53 | 0.37 | 0.70 | 0.34 | 0.53 | 0.10 | 0.58 |
| Qinghai | 2.40 | 0.53 | 0.73 | 0.12 | 0.08 | 0.15 | 0.08 | 0.05 | 0.03 | 0.12 |
| Ningxia | 3.00 | 0.50 | 1.09 | 0.17 | 0.13 | 0.18 | 0.12 | 0.07 | 0.08 | 0.20 |
| Xinjiang | 12.82 | 2.52 | 3.99 | 0.52 | 0.63 | 0.95 | 0.52 | 0.31 | 0.25 | 0.98 |

1. VAT – Value-Added Tax; BT – Business Tax; EIT – Enterprises' Income Tax; PIT - Personal Income Tax; TCMC – Tax on City Maintenance and Construction; RET – Tax on Real Estates; AT – Agricultural Tax; CT – Contract Tax; AF – Administrative Fees
2. Other items of revenues not listed in the table: Resource Tax; Tax on the Adjustments of the investment in the fixed assets; Stamp Tax; 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; Other Income.
3. *Source: Statistical Yearbook of China (2004)*

**Table 8 Provincial Revenue, 2003**
**Unit: billion yuan**

| **Local Taxes** | **Guangdong (1/31)*** | **Shanghai (2/31)** | **Hebei (10/31)** | **Shaanxi (20/31)** | **Tibet (31/31)** |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| VAT | 23.37 | 17.02 | 6.87 | 3.16 | 0.09 |
| Business Tax | 41.58 | 33.23 | 6.54 | 5.10 | 0.40 |
| Enterprise Income Tax | 17.00 | 14.62 | 2.87 | 1.28 | 0.07 |
| Return for Enterprises' Income Tax | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Personal Income Tax | 9.48 | 7.18 | 1.81 | 0.69 | 0.03 |
| Tax on Resources | 0.15 | 0.00 | 0.58 | 0.26 | 0.02 |
| Fixed Assets Investment Adjustment Tax | 0.02 | 0.00 | 0.00 | 0.02 | 0.00 |
| Urban Maintenance and Construction Tax | 4.77 | 3.56 | 1.88 | 1.23 | 0.03 |
| Tax on Real Estates | 4.56 | 2.24 | 0.90 | 0.66 | 0.00 |
| Stamp Tax | 1.41 | 1.32 | 0.23 | 0.13 | 0.00 |
| Urban Land Using Tax | 0.59 | 0.23 | 0.39 | 0.26 | 0.00 |
| Land Value-added Tax | 0.84 | 0.17 | 0.02 | 0.01 | 0.00 |
| Tax on the Use of Vehicles and Ships | 0.66 | 0.12 | 0.08 | 0.05 | 0.00 |
| Slaughter Tax | 0.07 | 0.00 | 0.00 | 0.00 | 0.00 |
| Banquet Tax | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Agricultural Tax | 0.80 | 0.01 | 2.50 | 0.66 | 0.00 |
| Tax on the Special Agricultural Products | 0.14 | 0.00 | 0.08 | 0.42 | 0.00 |
| Tax on the Animal Husbandry | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Tax on the Use of Cultivated Land | 0.66 | 0.32 | 0.19 | 0.14 | 0.00 |
| Contract Tax | 4.85 | 6.35 | 0.60 | 0.25 | 0.00 |
| State-owned Asset Profit | 2.08 | 0.00 | 0.38 | 0.90 | 0.01 |
| Planning Subsidies to the Loss-suffered SOEs | -0.29 | -3.62 | -0.16 | -0.13 | -0.09 |
| Administrative Fees | 8.77 | 2.28 | 2.94 | 1.03 | 0.06 |
| Penalty and Confiscatory Income | 4.48 | 1.41 | 2.60 | 0.75 | 0.03 |
| Income from the Use of Sea Area, Field and Diggings | 0.13 | 0.00 | 0.03 | 0.00 | 0.00 |
| Expert Project Income | 3.35 | 1.98 | 1.67 | 0.68 | 0.03 |
| Other Income | 2.08 | 0.20 | 0.58 | 0.19 | 0.13 |
| Total | 131.55 | 88.62 | 33.58 | 17.73 | 0.81 |

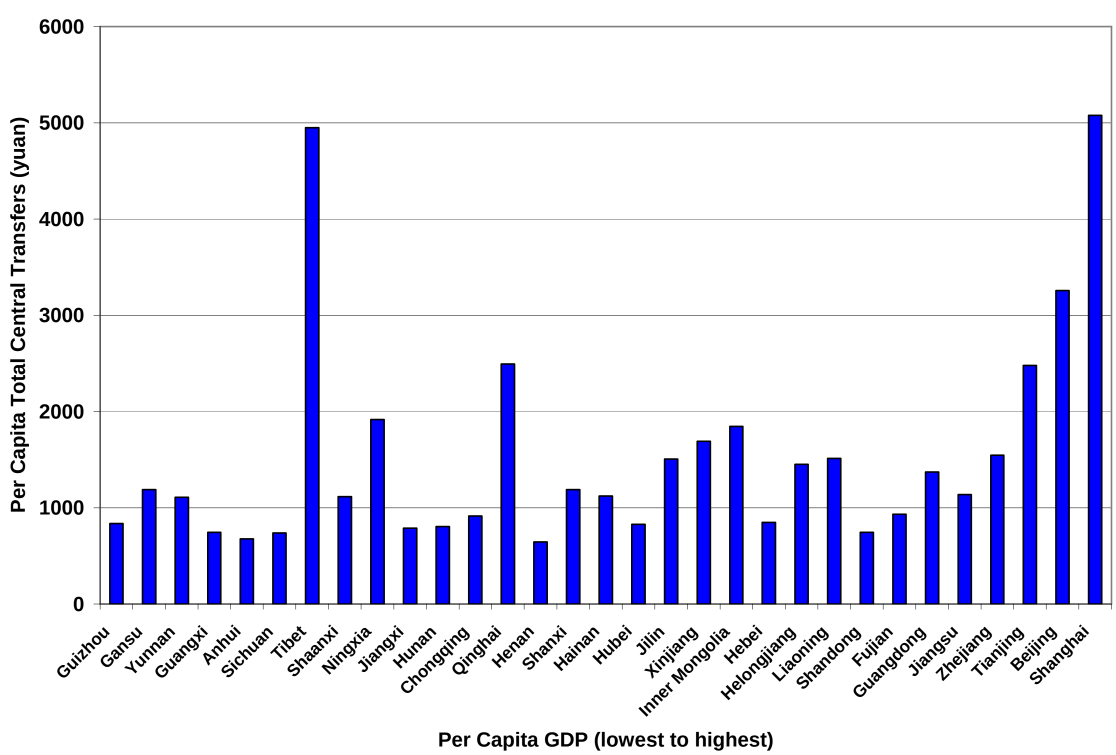
*****This is the ranking of provincial tax revenues
*Source: Statistical Yearbook of China (2004)*

**2) Intergovernmental Transfers**

Intergovernmental fiscal transfers between different tiers of the government system have assumed an important role in China's fiscal reform: China's central government increasingly relies on intergovernmental grants to promote nationwide fiscal equalization and poverty reduction; and local governments are highly dependent upon the grants to fulfill their basic spending needs. For instance, in 2002, the overall grant funding received by county level governments exceeded 39 percent of these local governments' total budgetary revenue and 43 percent of their budgetary expenditure (Yao 2005a, 3).

Chart 5 depicts the distribution of per capita central transfers by province in 2004. For the total central transfers, Shanghai, the richest province, was the highest per capita recipient province (5,079 yuan) and Henan the lowest (646 yuan) with the national average of 1117 yuan per capita. Table 9 breaks down provincial per capita central transfers into major categories. When it comes to revenue sharing transfers, Shanghai obtained the national highest per capita transfers of 2,830 yuan; Hainan received the lowest within the eastern region (179 yuan); Shanxi and Xinjiang were the highest recipients in the central and western regions respectively; and Tibet received the lowest in the western China and also in the nation. As for the tax rebate, Shanghai, Jilin, and Yunnan received the largest amount in the eastern, central, and western China respectively. For obvious reasons, the six coastal provinces – Beijing, Guangdong, Jiangsu, Shanghai, Tianjin, and Zhejiang did not receive any equalization transfers. Tibet received the highest per capita equalization transfer of 705 yuan (Shah and Shen 2006).

**Chart 5 Distribution of Total Central Transfers - Per Capita by Province - 2004**




The total central transfers also include revenue sharing transfers that are 25% of VAT and 40% of Personal and Enterprise Income Taxes in each province.
*Source: Shah and Shen 2006.*

**Table 9 A Regional Perspective on China's Central Transfers (2004)**

**Unit: per capita yuan**

| | **Nation-wide** | | | **Eastern PRC** | | | **Central PRC** | | | **Western PRC** | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Min | Max | Mean | Min | Max | Mean | Min | Max | Mean | Min | Max | Mean |
| GDP per capita | 4,078 (Guizhou) | 42,768 (Shanghai) | 12,614 | 9,405 (Hainan) | 42,768 (Shanghai) | 19,351 | 7,449 (Anhui) | 13,893 (Heilongjiang) | 9,376 | 4,078 (Guizhou) | 11,376 (Inner Mongolia) | 7,430 |
| General Purpose Transfers: | | | | | | | | | | | | |
| Revenue Sharing Transfers | 81 (Tibet) | 2,830 (Shanghai) | 330 | 179 (Hainan) | 2,830 (Shanghai) | 610 | 119 (Jiangxi) | 324 (Shanxi) | 164 | 81 (Tibet) | 237 (Xinjiang) | 152 |
| Tax Rebate | 126 (Jiangxi) | 2,123 (Shanghai) | 313 | 172 (Hainan) | 2,123 (Shanghai) | 523 | 126 (Jiangxi) | 276 (Jilin) | 175 | 139 (Guizhou) | 359 (Yunnan) | 194 |
| The Equalization Transfer | 0 (Beijing, Guangdong Jiangsu, Shanghai, Tianjin, Zhejiang) | 705 (Tibet) | 3 | 0 | 108 (Hainan) | 14 | 54 (Henan) | 125 (Jilin) | 71 | 41 (Yunnan) | 705 (Tibet) | 100 |
| Specific Purpose Transfers: | | | | | | | | | | | | |
| Ad Hoc Transfers | 31 (Guangdong | 1,657 (Tibet) | 249 | 31 (Guangdong) | 413 (Liaoning) | 127 | 166 (Henan) | 612 (Jilin) | 288 | 180 (Guangxi) | 1,657 (Tibet) | 366 |
| Total Central Transfers | 646 (Henan) | 5,079 (Shanghai) | 1117 | 745 (Shandong) | 5,079 (Shanghai) | 1,352 | 646 (Henan) | 1,506 (Jilin) | 883 | 739 (Sichuan) | 4,950 (Tibet) | 1075 |

*Source: Shah and Shen 2006.*

### 3) 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$120 billions by the end of 2004 (Wei 2004). The total debt of the grassroots governments was around US$ 40 billions 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 billions, 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 venders 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 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 hourses 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.

## 5. 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 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.

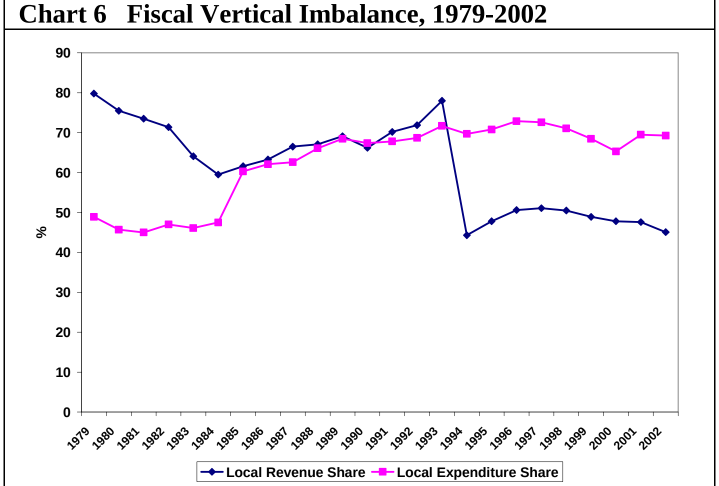
The waning central fiscal control and distorted local incentives prompted a conspicuous falling trend of central revenues and a significant reduction in fiscal revenue collection as a percentage of GDP. The ratio of total government revenue to GDP declined from 28.4 percent to about 12.6 percent over 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 opt 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**

**Chart 6 Fiscal Vertical Imbalance, 1979-2002**




*Source: China Statistical Yearbooks*

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[2]. 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.

## 6. 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 (Bird, 1993; Bird and Wallich 1993; Bahl and Linn 1992; Gramlich 1993; Oates 1993, 1972; and World Bank1990, 1992) 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. Table 10 provides an overview of various studies conducted on this subject.

**Table 10 China: Fiscal Decentralization and Economic Growth**

| Literature | Time Period | Conclusion |
|---|---|---|
| **Qi (1992)** | | positive |
| **Qian and Weingast (1997)** | 1980-1993 | Promoted economic development |
| **Yang (1997)** | | Negatively affected economic growth |
| **Ma (1997)** | | positive |
| **Zhang and Zou (1998)** | 1980-1992 | negative |
| **Qian (1999)** | 1980-1993 | Promoted local economies |
| **Young (2000)** | | Negatively affected economic growth |
| **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 |

Some scholars argue that fiscal decentralization has been conducive to China's economic development. Qi (1992) and Qian (1999) suggested that the fiscal contract

2 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.

system (1980-1993) provided material incentives that 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[3] 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. 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 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.

## 7. Political as well as Economic Issues arising after Decentralization

### 1) Decentralization and Inequality

[3] Other driving forces include rural reform, the nonstate sector, and capital accumulation.

It is widely believed 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 pursing further economic investment and development, which ultimately leads to the regional income and fiscal gaps (Jin and Zou 2003;Park, et al. 1996;Yao 2005b). 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. 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. Yao (2005a) uses a comprehensive dataset for 2755 counties and applied a single-threshold linear-spline model to evaluate the most recent grant policies. The study reveals a significant equalizing effect of grants to the rural low-revenue-capacity counties yet a significant counter-equalization effect to urban high-revenue-capacity counties. For the majority of counties, the effects of equalizing and disequalizing grant policies sum up to zero (Yao 2005a, 28).

**2) Proliferation of Off-Budgetary Resources**

Besieged by pressing fiscal needs but constrained financial resources, local governments have vigorously pursued extra-budgetary funds. 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[4] and off-budget[5] resources, in the form of fees and charges, over which the local officials have complete control and face virtually no oversight (World Bank. 2002). While no official figures are available, some estimates suggest that the number of extra-budgetary funds and off-budgetary funds may be as large as 1,000. Some scholar estimated that the size of extra-budgetary and off-budgetary revenues is similar to the level of budgetary resources, accounting for 11-12 percent of GDP (Ma and Norregaard 1998, 2).

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. With almost half of the public sector revenue wandering outside the budgetary system, the non-budgetary financing at the macro-level undermines fiscal discipline, hampers efficient resource allocation, and gives rise to wasteful spending and corruption. The unruly system of extra- and off-budget finance further impoverishes life of poor farmers by levying myriad fees and charges for basic public services. Such “unauthorized” use of revenues poses substantial challenges to the national fiscal discipline, economic reforms, and political stability; it has made poor farmers in the less-developed regions more miserable.

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

[4] 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.

[5] Off-budget revenues are collected by government units, particularly, township and village level governments, without the authorization from the central or provincial level governments.

balanced and that any violation of the balanced budget would result in administrative prosecution against parties directly responsible (Jin and Zou 2003, 301).

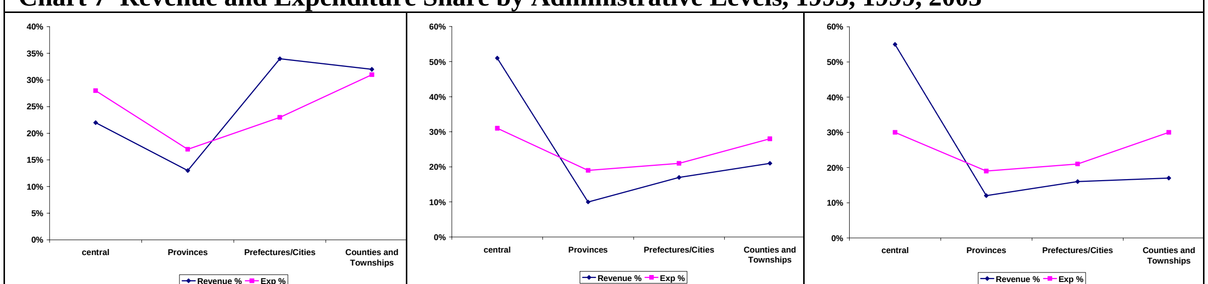
Faced with tight budgetary constraints as a result of low level of formal taxations and skyrocketing pending needs generated by local development and public services delivery, the lower authorities usually cannot meet their budgets by formal taxation alone and thus have to pursue “informal” channels 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 growth of illegal fees, the main source of extra-budgetary funds at the local level, now may be as much as 20 percent of GDP, two thirds of which accrue to sub-national Governments. The list of fees ranges from surcharges on household utility bills/road maintenance/vehicle purchases to hospitals and school charges (World Bank. 2002, 62). 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.

**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 (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 was 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. Chart 7 illustrates the widening vertical fiscal gap during the process of fiscal decentralization. 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.

**Chart 7 Revenue and Expenditure Share by Administrative Levels, 1993, 1999, 2003**




*Source: China Statistical Yearbooks*

There is also substantial evidence of great regional and local inequalities in the 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, 22). Table 11 summaries provincial per capita budgetary expenditure on education, health, and social security in 2003. Despite the fact that Guangdong spent per capita 3064.29 yuan on education, Liaoning only allocated 97.49 yuan and Tibet 15.06 yuan per person. When it comes to health spending, Chongqing and Shanghai resided as the top two (771.43 yuan and 652.33 yuan per individual), compared to on 23.09 yuan in Anhui, 12.2 in Ningxia, 6.09 yuan in Tiebt, and 5.89 yuan in Hainan. As for expenditure on social safety net, the regional variation is strikingly large: the highest spending resided in Chongqing, Hunan, and Qinghai (respectively 5064.29 yuan, 1436.29 yuan, and 1011.11 yuan) whereas the lowest was only 79.09 yuan in Guangxi, 45.8 yuan in Ningxia, 21.63 yuan in Hainan, and 8.51 yuan in Tibet.

**Table 11 Regional Per Capita Budgetary Expenditure on Education, Health, and Social Security (2003)**

nit: yuan

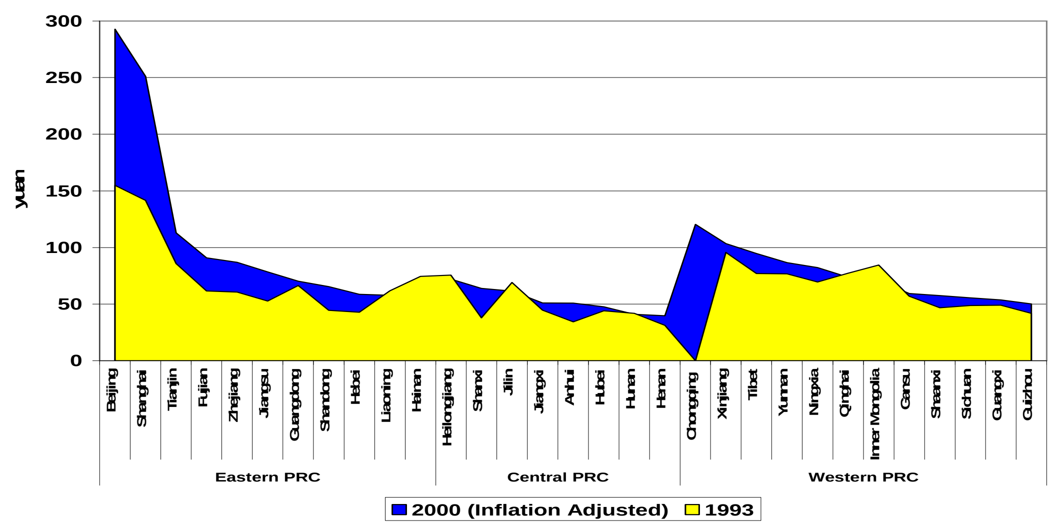
| | Operation Exp of Education | Public Health | Social Security* |
|---|---|---|---|
| Beijing | 678.57 | 340.66 | 477.34 |
| Tianjin | 470.82 | 151.34 | 341.25 |
| Hebei | 175.95 | 51.41 | 163.39 |
| Shanxi | 462.91 | 139.42 | 593.41 |
| Inner Mongolia | 538.08 | 169.14 | 649.85 |
| Liaoning | 97.49 | 24.99 | 195.18 |
| Jilin | 225.63 | 67.65 | 396.64 |
| Heilongjiang | 222.07 | 63.25 | 267.52 |
| Shanghai | 2354.84 | 652.33 | 980.29 |
| Jiangsu | 662.35 | 205.62 | 358.36 |
| Zhejiang | 297.14 | 82.16 | 85.78 |
| Anhui | 114.23 | 23.09 | 138.00 |
| Fujian | 198.72 | 44.23 | 97.22 |
| Jiangxi | 100.62 | 23.56 | 107.64 |
| Shandong | 513.47 | 113.53 | 306.77 |
| Henan | 308.42 | 70.99 | 301.83 |
| Hubei | 106.03 | 28.80 | 116.15 |
| Hunan | 1247.92 | 232.69 | 1436.29 |
| Guangdong | 169.25 | 46.91 | 96.50 |
| Guangxi | 118.72 | 31.52 | 79.09 |
| Hainan | 18.94 | 5.89 | 21.63 |
| Chongqing | 3064.29 | 771.43 | 5064.29 |
| Sichuan | 224.21 | 64.65 | 258.80 |
| Guizhou | 741.06 | 213.32 | 387.18 |
| Yunnan | 297.76 | 104.47 | 334.82 |
| Tibet | 15.06 | 6.09 | 8.51 |
| Shaanxi | 171.32 | 43.15 | 199.48 |
| Gansu | 108.78 | 26.97 | 143.74 |
| Qinghai | 466.67 | 196.30 | 1011.11 |
| Ningxia | 37.40 | 12.20 | 45.80 |
| Xinjiang | 203.61 | 69.92 | 243.18 |

*Expenditure for Social Security comprises three parts: expenditure for pension and relief funds for social welfare, expenditure for retired persons in administrative department, and expenditure on subsidies to social security programs.

*Source: Statistical Yearbook of China 2004*

Chart 8 compares per capita education and health expenditure by counties in 1993 and 2000. It is shocking to find out that counties in seven provinces literally spent less on education and health in 2000 than 1993. Particularly, Hainan spent 18.2 yuan less, Inner Mongolia 13.7 yuan less, and Jilin 7.6 yuan less. In the meantime, county expenses on education and health in Beijing and Shanghai was increased by 137.9 yuan and 109.5 yuan respectively.

**Chart 8 Provincial Average of Per Capita County Education and Health Expenditure, 1993, 2000**




*Source: adapted from Liu and Shih 2004.*
The comprehensive county-level fiscal data is from the *Statistical Material for Prefectures, Cities, and Counties Nationwide (Quanguo Dishixian Caizheng Tongji Ziliao)*.

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 hierarchy, except the Premier and the Secretary General of the CCP, one or two voting members in the ruling Standing Committee of Politburo[6] 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

[6] The total number of members of the Standing Committee of Politburo is roughly 12.

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) Farmers' Burden and Rural Unrest**

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 grassroots governments passing their financial stress to local residents through indirect borrowing, heavier taxation and informal fees (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.

However, the issue of peasant burden and the risk of rural unrest are still haunting the regime. 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 8 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.

## 8. Conclusion and Policy Options

Given the objective of improving local public services and promoting economic growth, the present system of fiscal decentralization may not be sustainable in the long run. The way forward will almost certainly embrace a significant modification and reforms of the existing intergovernmental fiscal system. We explore a few general policy options for China in this concluding section.

**(1) Set up formal and stable expenditure assignment to clarify the responsibilities of governments**

China has made dramatic progress in separating government from SOEs and re-defining the function and responsibility of government in the economy in last two decades with the economic reform and fiscal decentralization, but there are still many problems from the expenditure assignment perspective. In particular, a stable and transparent expenditure assignment with less concurrent responsibilities is in need. It has significant meaning in China's political framework because (a) it will significantly improve the accountabilities of both the central and local governments; (b) it can effectively prohibit government from encroaching private sectors; and (c) sound expenditure assignment is also a key component to solve the horizontal fiscal disparities as the expenditure follows with proper fiscal revenue.

It is necessary to stress that local government should focus on the public services and social affairs while the central government has the expenditure responsibilities on such national issues as national defense, foreign affairs, economic development, and improving regional equality besides the public services and social affairs. This is the prerequisite for building the sound system of expenditure assignment. The central government should implement macroeconomic policies such as monetary policy, fiscal policy, exchange rate etc, and create a harmony macroeconomic atmosphere and environment for the stable and healthy development of society and economy. The local governments are mainly in charge of managing social affairs, organizing and delivering public services. Apparently, local governments need to switch the focus from economic construction to public services gradually.

It is important to build broad and formal coordinating institutions to deal with concurrent assignment. The responsibilities should be defined for a multi-dimensional array of attributes, including: (i) actually producing a good or delivering a service, (ii) providing or administering the service, (iii) financing a service, and (iv) setting standards, regulations, and policies guiding the provision of government services. While there is no problem, with assigning competencies over these attributes in the case of exclusive assignments, there is a need to be explicit about their assignment in the case of concurrent expenditure assignments.

**(2) Align the decentralized fiscal system properly to guarantee all citizens have access to basic public service**

First, it is necessary to start to build national minimal standard of basic public services. The wide and increasing regional disparity in China could be harmful for the cohesive of the country. A national minimal standard of public services can play significant role in improve national cohesive. Basic public services should cover nine years compulsory education, basic hygiene medical treatment, basic unemployment compensation and endowment insurance and essential communal facilities services in rural public services.

Second, it should be the central government's responsibility to guarantee all citizens have access to basic public service. Although equalization transfer can be regarded as an important approach to address the issue of regional disparity, it should be more important in China to through setting national minimal standard and centralizing basic public services. Most of governments at and under county level cannot provide adequately basic public services, such as education, health care and social security net. Meanwhile, the provision of basic public services by the governments at and under county level also causes the equity problem. With wide economic disparity across provinces, it is also not a good choice to assign the responsibility to provincial governments.

**(3) Provide sound local autonomy to improve local fiscal capacity**

International experience suggests that local governments are more efficient and effective in implementing their responsibilities when they are also responsible for raising the revenues that they spend. In most federal and unitary but decentralized countries, decentralization reaches local governments quite fully, with these entities having different degrees of revenue autonomy and exclusive responsibility for an array of functions and services. This status for local governments is the result of explicit legislation in unitary decentralized countries. The most important issue in China is how to balance the legislative revenue autonomy and the administrative revenue autonomy. Apparently there is no such a political mechanism to prevent the local government from practicing wide administrative revenue autonomy or abuse legislations. Improve current system to provide local government reasonable tax autonomy and formalize the administrative autonomy is one of the most important tasks.

First, the revenue autonomy should be built based on the right balance between devolution of responsibilities according to economies of scale, the internalization of costs, and available administrative capacity. There is no consensus on the degree of autonomy that should be devolved to local governments. However, most federal systems provide local governments with their own sources of revenue, with autonomy to change at the margin, tax rates or other elements of the structure of the tax. A tentative list of the most widely used local taxes across countries would include property taxes, user charges, business license fees, permits and excise taxes, motor vehicle taxation, income taxes, and sales taxes.

Second, an asymmetric approach can be explored as a means to allow major cities and other local governments with more developed capacity to introduce piggyback income taxes and other forms of local tax autonomy. Greater revenue autonomy must be considered an important reform in putting decentralization to work at the local level in any decentralized country. Most sub-national governments need to augment their revenues due to the large share of committed expenditures and increasing needs. This can be accomplished in a number of ways, including increasing own source revenues, improved tax administration, and increasing intergovernmental transfers. Enhancing the revenue autonomy of sub-national governments would have the added advantage of tightening the

Wicksellian link between costs and benefits which would help foster greater fiscal discipline.

Third, it is necessary to increase the share rates of local part in major taxes such as VAT and income taxes to improve the fiscal capacity of local government. The framework of current tax sharing system is consistent with international good practice in revenue assignment since multiple uses of the same base, if properly coordinated, is found to simplify administration and reduce compliance costs. However, China's tax sharing system has showed significant differences. The major difference is that the tax rates are determined by the central government, and local governments do not have autonomy to alter rate. The advantage is that it may eliminate the horizontal tax competitions, but the disadvantage is that uniform arrangement of tax sharing cannot fit all jurisdictions.

Fourth, it is necessary to continue to reform tax system. The main objective is that governments at each level should have a stable tax base and main taxes, either exclusively or shared with other governments. Good property tax for governments at and under county level should be a reasonable approach. It not only provides a main fiscal resource for richer jurisdictions, but also simplified currently over-complicated local tax system. Technically, current VAT and enterprise income tax have serious problem. Production type VAT generates distortion to market, and the enterprise income tax based on ownership further enlarge the distortion. In addition, the problem of tax mobility across province has not been seriously recognized in China. Current revenue assignment is not able to deal with the increasing tax competition.

**(4) Formalize local borrowing system to support sustainable development**

First, decentralize the authority of local borrowing to jurisdictions with reasonable fiscal capacity. International experience suggests that local borrowing has the potential to generate significant benefits for local governments by allowing them to finance public capital projects. Current budget law prohibited local governments from borrowing. However, it did not effectively prevent local government from informal borrowing, and caused various issues. In future reforms, first, it is necessary to consider to permit local borrowing. Second, set strict central control on local borrowing. Currently, China's bond market is not well developed, and therefore, the municipal bond market should not be regarded as the main approach of local borrowing although it is necessary to start to build the system.

**(5) Standardize intergovernmental transfer to meet the goals of governments**

Generally speaking, intergovernmental fiscal transfers are used to correct for vertical and horizontal imbalances, inter-jurisdictional spillovers, and promote national objectives. All countries use special purpose grants of one type or another to promote national priorities and address inter-jurisdictional spillovers. Equalization grants and special purpose transfers also help reduce vertical imbalances or the mismatch between expenditure responsibilities and own sources of revenues for sub-national governments. Often different forms of revenue sharing, in themselves a type of transfer, are used to address vertical imbalances. However, the only fail proof way to address vertical imbalances is to provide sub-national governments with an adequate level of revenue autonomy. In summary, a system of transfers is needed for many good reasons, but it can easily be misused, and transfers are not a substitute for a healthy degree of tax autonomy.

First, central transfer should focus on national minimal standard of public services and provincial transfer should focus on equity of local service provision. Current revenue assignment cannot guarantee all citizens have access to basic public services. On other hand, requiring sub-national governments to rely too heavily on own revenues to close vertical imbalances may give rise to economically and/or politically unacceptable differences in the quality and quantity of critical social and economic services among jurisdictions. Although in practice countries differ in how, and if, they use measures of expenditure needs and/or fiscal capacity in their equalization formulae, a well-designed equalization grant is often used in many countries to reduce horizontal fiscal disparities among sub-national governments arising from differences in expenditure needs and fiscal capacity. The intergovernmental transfer should be designed to focus on national minimal standard of public services.

The design of transfers is of critical importance for efficiency and equity of local service provision, revenues autonomy, and fiscal health of local governments. In China, one of the priorities in public finance is to allow all citizens to have access to basic public services. Consequently, intergovernmental transfer for both decreasing the regional disparity and solving the vertical fiscal imbalance should be based on national minimal standard of public services.

Second, it is necessary to improve the transparency of transfers. To achieve the goal of transparency, a couple of measures should be in the agenda.

(a). it is very important to build an intergovernmental transfer system to make sure the predictability of local budget. The formula-driven intergovernmental transfer is the key in the design of future reform in intergovernmental transfer to match current budget law. It also helps to align the behavior of governments and improve governments' accountabilities.

(b). capital transfers should address externalities across local governments, assist with financing constraints for lumpy capital, ameliorate significantly different infrastructure endowments when these are not the result of voluntary decisions, and pursue sectoral objectives. Two major policy biases need to be openly addressed. First, the belief by some central authorities that capital expenditures are always more efficient than recurrent expenditures and second, the lack of maintenance of existing infrastructure. Conditional matching grant arrangements can help sub-national governments to take ownership and more properly maintain infrastructure. Capital grants vary by the degree of flexibility in the use of the funds. They can either be specific project-based grants, which tend to be closely administered and monitored by line ministries, and categorical or block grants. Capital grants also vary by the way funds are allocated. The approaches include *ad hoc* decisions and negotiations, use of a pre-established formula, and competition processes with defined application procedures. There is no single best approach to the design of capital transfers, but non-transparent, highly detailed, and discretionary procedures should be avoided. Formulas based on needs and clients are often quite feasible. In Australia, for example, funding for school buildings based on the number of students is available. Although a few countries use a loan and grant combination for the implementation of capital grants, the vast majority of countries just use a grant formula often accompanied by matching arrangements. Matching arrangements can raise some liquidity problems for low income sub-national governments, but the matching rate can also be adjusted for fiscal capacity.

(c). it is necessary to formalize conditional grants. The centrally sponsored schemes are an important 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. It is generally recognized, however, that there are too many schemes in China. There, the trend has been in the opposite direction of the international trend, with a continued growth in the number of schemes. In fact, the schemes provide a backdoor for the federal government to micro-manage decisions that are ostensibly the responsibility of the states, and burden the administrative capacity of the states, reduce their budgetary autonomy, and distort state decision-making and priorities. Furthermore, these schemes blur the lines of responsibility.

Conditional grants can be block grants for health, social services, and other areas, while categorical grants require states to apply them to particular narrower areas of expenditure. These categorical grants act as central mandates on the provincial receiving the central assistance. The criteria of distribution include measures of need of the community, capacity of providing services, cost of providing services, and tax effort. The formulas can be very simple or very complicated, but they are generally related to population and per capita income.

In summary, transfers to local governments should be clear, transparent, and formula based. The methodologies should be simple and use available measures, such as population and property taxation. With time, as data on reliable developmental indicators are compiled, transfers could also be related to other proxies of revenue capacity and expenditure need. Given the types of services that are provided at the local level (i.e., water supply, sanitation, and streetlights) a simple formula with population could be initially used.

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