Soft-Budget Constraints
and Local Government in China

Jing Jin and Heng-fu Zou

A significant feature of China's economic reform since 1978 is the devolution of the central government's control over the economy to subnational governments. The fiscal system is decentralized among five levels of government—national, provincial, municipal, county, and township governments—which are broadly categorized into center, provincial, and local governments (all subprovincial governments). This chapter mainly focuses on soft budget constraints in the relationship between the central government and the provinces. The term local refers to the levels below provinces and subnational to the levels below the center unless otherwise specified.

China's subsidy, taxation, credit, and administrative pricing systems are all subject to soft budget constraints. Prior to 1994 under the Chinese fiscal regime, the collection of all taxes and profits followed the prereform pattern: local government collections were remitted to the center and then transferred back to the provinces according to expenditure needs approved by the center. Policymakers in the central government decided what type of revenues should be collected and how these revenues were to be reallocated for national and local public good provisions. Most expenditures at subnational levels were financed by central transfers and complemented by a few self-retained local tax receipts. The prereform fiscal system resulted in a fundamental lack of incentives and efficiency, which became the major concern of the central authorities. In the 1980s, a series of reforms were implemented to revamp the fiscal relations between the central and subnational governments. Although incentives to spur tax collection efforts by local governments were successful to a certain extent, they also reduced the share of revenues passed on to the central government. Before the 1994 tax system reform, the central government's share of total revenue declined from 44 percent in 1978 to 23 percent in 1993,
while the total subnational revenue share increased from roughly 56 percent to 77 percent during same period. At the same time, the consolidated government revenue share in GDP also shrunk, from 47 percent in 1978 to 13 percent in 1993. Although fiscal decentralization in the 1980s shifted more resources to local governments in terms of increased share in total revenues, the shrinking pie also considerably reduced the budgetary resources allocated at the provincial level (table 9.1).

Throughout the 1980s, the central government’s inability to cut spending to stay within declining revenue created persistent budget deficits that contributed to mounting inflationary pressures. At the same time, subnational governments faced greatly expanded expenditure responsibilities stemming from obligations imposed by national policy (Wong 1991). As the central government responded to fiscal pressure by attempting to devolve expenditure responsibilities to lower levels of government, it left provincial governments starved for revenues. Apart from the intensified bargaining between central and local governments over the sharing schemes, fiscal pressures created by the contract system of the 1980s led to undesirable responses by subnational governments. Examples include the diversion of resources from budgetary to extrabudgetary channels, the duplication of industries to capture revenues that formerly flowed to the national treasury, generous tax concessions to local state-owned enterprises (SOEs) under their own jurisdictions, and expanded local bank lending to these SOEs. All of these measures circumvented the central government’s efforts to impose hard budget constraints and weakened overall financial discipline.

As the country moved toward economic federalism with the fiscal decentralization coincident with a continuous decline of government revenue as a percentage of national income in the fiscal sphere, the unitary political system was also transformed and decentralized. Although the central bureaucratic hierarchy continued to select, assign, and promote top provincial cadres (Huang 1996), since 1983, bureau-level officials (e.g., the heads of provincial fiscal bureaus and the managers of provincial branches of national banks) have been selected by provincial governments and appointed by the corresponding level of the People’s Congress. No central approval is required. Driven by common economic interests and the pressure to seek growth, the most important measure of their political performance, the directors of fiscal and banking agencies tend to “stand where they sit” rather than
### Table 9.1
Central and provincial government revenue shares in total revenue and GDP

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<th>Total revenue (billion yuan)</th>
<th>Central tax revenue (billion yuan)</th>
<th>Total central revenue (billion yuan)</th>
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<th>Share of total central revenue in total revenue (%)</th>
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Sources: China Statistical Yearbook (1999); China Government Finance Yearbook (various issues).

*Before 1994, a considerable amount of central revenue came from SOEs' profit remittance, which exclusively went to the central treasury. Since 1984, the profit remittance had been increasingly replaced by enterprises' income tax. Profit remittance from SOEs remained as a residual category until 1993 before it terminated.

*Tax assignment system reform introduced. Data after 1994 are not compatible with those before 1994.
delegate to their central line administrators. As a result, the former hierarchical management has been considerably weakened and increasingly transformed into horizontal administration featured by a highly fragmented economy. The central authority's attempt to strengthen the hierarchical management by strengthening personnel management at the level of provincial party secretaries and governors thus may not necessarily be able to penetrate the horizontal alignment coalitions increasingly shaped by common interests and contiguity at the subnational level. According to Yang (1997), the heads of faster-growing provinces now tend to be promoted more quickly than otherwise would be the case. Bo (1996) also finds that provincial leaders of more populous and richer provinces are more likely to be promoted than those in less populous and less developed ones.

This chapter outlines some major economic and administrative mechanisms that undermine the central government's endeavor to harden the budget constraint on provincial governments. Section 9.1 describes briefly the evolution of China's intergovernmental fiscal relations in the postreform period, section 9.2 presents the major channels of soft budget constraints on provincial governments, and section 9.3 sets out the conclusions.

9.1 Evolution of Intergovernmental Fiscal Relations, 1980s–1990s


In 1980, the centralized fiscal regime was replaced with the fiscal contract system whereby each level of government contracted with the next level up to meet certain revenue and expenditure targets. Central and subnational governments shared the revenue proportionately or in the form of a fixed quota plus a percentage share. At the same time, subnational governments were required to finance their own expenditures through self-generated and shared revenues, a step in the direction of hardening the budget constraint on local governments.

Unlike other countries where taxes are collected by the central government and then allocated to subnational governments, local authorities in China collected all tax revenues and remitted a portion to higher levels of government. The amount submitted to the central coffers depended on provincial receipts and the sharing formula between the center and provinces. Given such a highly decentralized revenue collection system, the center had to resort to various instruments to ensure
revenue remittance from local authorities. These instruments in turn led to perverse reactions from the provinces, which always found ways to retain more revenues through their relaxed revenue collection for and the negotiations with the center regarding shared revenue.

From 1980 through the early 1990s, four revenue-sharing systems were employed, with many variations. Until the tax system reform in 1994, six different contract types were in use between the central government and provinces, with many more at the subprovincial level (table 9.2) (also see World Bank 1993 and Bahl and Wallich 1992).

Type A: Incremental contract Based on 1987 revenues, the provincial retention rate of all tax revenues ranged from 28 percent to 80 percent, while local remittance the center needed was to increase from 3.5 percent to 6.5 percent (contracted growth rate) on an annual basis. Tax revenues in excess of the stipulated growth rates were retained entirely by provinces.

Type B: Basic proportional sharing A fixed proportion of all revenues was remitted to the center.

Type C: Proportional sharing and incremental sharing A certain proportion of the actual revenue collection of the previous year was retained, and then a different (usually higher) proportion of revenues was retained for the incremental amount in excess of the total revenues for the previous year.

Type D: Remittance incremental contract A specific nominal amount was transferred to the center in the initial year; in subsequent years, the remitted amount increased at a contracted rate (9 percent for Guangdong province and 7 percent for Hunan province).

Type E: Fixed remittance A specific nominal amount was transferred to the center with no annual adjustments.

Type F: Fixed subsidy Deficit provinces received fixed subsidies.2

Two crucial features survived every change in revenue-sharing systems. First, central fixed revenues were not subject to revenue sharing, so whatever was designated as central revenues left the pool of revenues to which revenue-sharing formulas were applied.3 Second, enterprise income, both remitted profits and direct tax revenues (after 1984), was still divided among governments according to their administrative subordination—state-owned enterprises subordinated to the central, provincial, and local governments, respectively.
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*Source: Ministry of Finance, P.R. China. Also see Bahl and Wallich (1992). World Bank (1993).*

*After the cities of Wuhan and Chongqing were treated differently from Hubei and Sichuan provinces, the provinces changed from net providers to the state to net recipients of subsidies from the state.*
9.1.2 Problems of the Fiscal Contract System

Declining Central Revenue as a Percentage of Total Revenue
The decentralized nature of tax collection by local governments meant that the central government lacked effective supervision of tax collections and remittances by provincial governments. Consequently, local governments avoided sharing revenues with the center through various means. For example, if the total revenue collected by Jiangsu provincial government was within the total amount of the previous year (took taking 1987 as the base year) plus a 5 percent increase, Jiangsu provincial government could retain 41 percent of the total revenue collected. Any amount exceeding the total increased revenue can be retained by the provincial government. Frequently, tax revenues stagnated for years, limiting the amount for sharing with the center. This phenomenon was prevalent among the provinces under contracts A, B, and C. Assuming some growth in taxes accruing to the provinces by transferring budgetary revenue to extrabudgetary items or allowing generous tax recessions to local enterprises so that benefits could be accrued within the enterprises under the jurisdiction of subnational governments, the center’s share would decrease.

In other cases, tax remitted to the center was fixed in nominal terms for many years, and growth was retained by the province. Guangdong, one of the fastest-growing economies in China, is a case at point. Its remittance was fixed at 1.4 billion yuan for many years. Not until 1988 was the remittance incremental contract implemented (table 9.2), under which its remittance was set at an annual increase of 9 percent, with 1987 as the base year. By 1993, its remittance increased to 2.4 billion yuan, barely 7 percent of its total 34.7 billion revenue.

With the power of tax collection, provincial governments acted strategically to escape sharing their revenues with the center, which resulted in a decline of central revenue share in relation to that of the local government in total revenue (table 9.1). Tax generation in such a fiscal system tends to be inelastic with respect to GDP and procyclical. In a rapidly growing economy with fiscal contracts containing a large fixed component, the rate of increase in tax revenues would be less than that of income growth. Tax policy thus becomes a procyclical mechanism that exacerbates economic fluctuations instead of moderating them (Agarwala 1992). When government expenditure increases in line with GDP, the deficit is likely to expand as a consequence.
Extrabudgetary Fund
The rapid growth of extrabudgetary revenues was a striking feature of tax reform during the 1980s. By 1992, the size of such revenue was almost equal to state revenue and accrued mostly to state-owned enterprises and their supervisory agencies (see section 9.2). Richer provinces could raise extrabudgetary funds more easily than poorer ones.

Regional Disparity
The fiscal contract system led to an increasing regional disparity. Provinces with enormous economic potential such as Guangdong accumulated a substantial and growing revenue base by retaining most of the incremental revenues within the province through a contract system that, in fact, favored better-off provinces with more bargaining power, and for some other provinces, moving revenues to extrabudgetary funds without sharing with the center. This shift in financial flows from the early 1980s, where central government received more from the provinces with surpluses than it paid out in transfers and grants (Ahmad 1997), handcuffs the central government in stabilizing the economy and bridging horizontal imbalances.

Administrative Decentralization
The transition from a vertical hierarchy to horizontal administration began with Mao’s decentralization of state enterprise ownership among the central, provincial, and county governments and local communes during the 1970s (Sachs, Woo, and Yang 2000). During the 1980s, the central authorities gave subnational governments the power to nominate and assign most provincial officials. Before 1983, the Cadre that dominated the Chinese Communist party appointed and promoted officials two levels down, as evidenced by the fact that the Department of Organization (DOO) under the Central Committee of the CCP managed this process. Since 1983, the central government has been less involved in supervising provincial-level appointments, making the appointment system only “one level down.” Directors of fiscal agencies and tax bureaus are now determined by provincial governments and their party committees (Huang 1996). This new decentralized organization includes managers of local branches of state banks (a point that will be elaborated later).

In combination with fiscal decentralization, provincial governments e the wherewithal and authority to circumvent central plans
and policies in favor of regional priorities. Although provincial fiscal agencies and tax bureaus were subject to the hierarchical (professional) instructions of the Ministry of Finance at the center, they are, in fact, under the leadership of their respective provincial governments. The new mechanism has problems of its own: "The shortcoming of the two-level downward system was excessive centralization and unwieldiness; the problem with the one-level system was that it encouraged nepotism and localism because it concentrated too many appointment decisions locally" (Manion 1985).

9.1.3 1994–Present: Dual Track System of Tax Assignments Together with the Contract System

The central government introduced the tax assignment system in 1994 to strengthen the central government's ability to achieve macroeconomic stabilization, regional equalization, and efficient public goods provisions. At the same time, the reform introduced more rigorous budget constraints on local governments.

The objectives of the reform package were fourfold: (1) to simplify and rationalize the tax structure by reducing tax types, tax rates, unifying the tax burden on taxpayers, and reducing exemptions; (2) raise the revenue-to-GDP ratio; (3) raise the central-to-total revenues ratio; and (4) put central-local revenue sharing on a more transparent, objective basis by shifting the negotiated sharing of general revenues to a tax assignment system.

Under the new system, taxes were reassigned between the central and local governments as follows:

- Taxes exclusive to the central government: Tariff duties, income taxes of state-owned enterprises (SOEs) under the jurisdiction of the central government, consumption taxes, import-related consumption taxes, and taxes imposed on banks, nonbank financial institutions and insurance companies, and taxes on railroads
- Taxes exclusive to provincial governments: Sales taxes (provided that sales taxes applicable to banks and railroads would be payable to the central government), income taxes from SOEs under the jurisdiction of provincial governments and collectively owned enterprises, and personal income taxes
- Shared taxes: The value-added tax (VAT) (at the fixed rate of 75 percent for the central government, and 25 percent for local govern-
ments), stamp duties on securities transactions, taxes on natural resources, and other taxes.

In order to implement this tax assignment system and ensure the effective collection of the central government's portion of revenues, the central and provincial tax collection bureaus were to be separated. Once separation was fully implemented, the central and provincial governments were to collect their own exclusive taxes. The shared taxes were to be levied and collected by the central tax bureau and then shared between the central and provincial governments.

This new tax assignment system met with unprecedented resistance from provincial authorities, and significant concessions by the central government were obtained (for details, see Wang 1997). As a compromise, the revised scheme would ensure provincial interests of fait accompli with the new assignments applied only to the incremental receipts (with 1993 as the base year).

The revenue-sharing contracts negotiated under the old system were allowed to remain effective at the same time. The provinces were still supposed to remit a specified amount of locally collected revenues to, or receive a certain amount of subsidies from, the central government. In practice, after the provinces share taxes with the center under the new rule effective since 1994, they have had to "hand over remittances to or receive subsidies from the center according to the old revenue-sharing contracts. In the end, no one knew what constituted real central revenue or local revenue" (Wang 1997).

The de facto dual track system that combined tax assignment with the contract regime thus limited the ability of the central government to harden budget constraints on local governments. Moreover, a policy to ensure the provincial revenue level in 1993 triggered sudden inflated receipts in their 1993 reported budgetary revenues. Provinces that tried to underreport their revenues in order to avoid sharing with the center in the previous fiscal contract system now faced the opposite problem. More 1993 budgetary revenues also meant more return transfers the provinces could receive from the center. In 1993, the actual total subnational revenues increased by 88.8 billion within a single year, from 250.3 billion yuan in 1992 to 339.1 billion yuan, which was 28.3 percent higher than the budgeted amount and 39.9 percent higher than the previous year. The Ministry of Finance agreed to top up the reported 1993 revenues of provinces with one proviso: if the province's revenue growth rate of 1994 was not parallel to that of 1993, the 1993
base amount would be subjected to readjustment according to the lower growth rate of 1994, and the extra transfers for 1993 would be deducted from the transfers for 1994.

The implementation of the new tax system increased central revenues from 95.8 billion yuan in 1993 to 290.7 billion yuan in 1994 and correspondingly raised the central share in total revenues from 22 percent in 1993 to 55.7 percent in 1994, and decreased aggregated provincial revenues from 339.1 billion yuan in 1993 to 231.1 billion yuan in 1994 (table 9.1). According to the deal between the central and provincial authorities, the reduced amount was to be topped up by central return transfers. Therefore, in 1994, the central expenditure was 4,14.4 billion yuan (including transfers), although the budgetary spending at the discretion of central government was only 175.4 billion yuan. Transfers from the center to provinces soared from 54.5 billion yuan in 1993 to 238.9 billion yuan in 1994, among which roughly 180 billion was the return transfers from the center to top up their 1993 revenue level.4

After all these adjustments, the redistribution of revenues did not improve. The central government’s revenues continued to experience a decline (52.2 percent in 1995, 49.4 percent in 1996, and 48.9 percent in 1997)5 because local government tax revenues from the agricultural tax, individual income tax, and business tax increased at a faster pace than central government tax revenues from the VAT, certain customs tariffs, and consumption taxes. In addition, the central government increased export VAT rebates and reduced customs tariffs in order to encourage exports and technology imports and attract foreign direct investment.

9.2 Forms of the Soft Budget Constraint

The fiscal year in China follows the calendar year. State budgets are prepared every September, and the National Budget Department of the MOF collects the spending plans and revenue estimates from ministries and agencies of the central and provincial governments. The aggregated budget prepared by the MOF (for central and aggregated sub-national governments combined) is then submitted to the State Council. After the State Council approves the budget, the draft budget is sent to the National People’s Congress (NPC), usually by March of the next year, for final approval, when the processing budget has already been executed for three months. Pursuant to the budget law
effective January 1, 1995, the NPC reviews and approves the budget for the central government. The budget law also lays out rules and procedures for the review and approval by the corresponding people’s congresses of the corresponding local governments’ budgets. In practice, the review and approval of subnational budgets follow the approval of the budget by NPC at the superior level. Only after the aggregated national budget is approved can the NPC at the provincial level start to review the aggregated provincial budget. The auditing of the national budget by the National Auditing Office is carried out in June of the next year.

Prior to 1994, budget deficits were financed through a combination of credits from the People’s Bank of China (PBC) and domestic and international borrowing as debt revenues. The new budget law (effective January 1, 1995) states in its first chapter that budgets at all levels of government shall be balanced. Chapter 10 of the same law stipulates that any violation of the balanced budget approved by the legal process would result in administrative prosecution against parties directly responsible. The government now finances its budget deficits only through domestic and international borrowings, and such borrowing is no longer counted as debt revenues in the state budget.

9.2.1  Legacies of 1994 Fiscal Reform and Central-Provincial Bargaining

One way for subnational governments to balance their budgets each year is by increasing transfers from the center through grant allocations and revenue bargaining. Fiscal redistribution by earmarked grants occurs through an ad hoc case-by-case process, which is often poorly targeted and provides grants too small to meet basic needs in poorer regions. Also, the arbitrary nature of central grant allocations has led to extensive negotiations and rent seeking by local authorities, tying up valuable administrative resources.

Under the contract system of the 1980s and early 1990s, transfers were obtained by local authorities through negotiating or renegotiating the contracted rates and periods under each sharing method. Remittance revenues were subject to adjustment and resulted in a default by subnational governments. For example, in 1991, in response to the regional flood in some eastern areas (Hua Dong region), the central government waived or reduced the required remittances from the affected provinces (Gao 1993). The budget constraint suffered a
considerable discount during the bargaining process between the center and provinces.

The fragmented data released by the Chinese government after 1994 provide little information on the outcomes in the post-fiscal reform period. Hence, a quantitative assessment not possible at present. However, several facts have indicated the difficulties of hardening budget constraints on subnational governments.

**Transfers**

Tax assignment reform implemented in 1994 fixed transfers to ensure the falt accompli of provincial revenue in 1993. This left the central authorities with little revenue to narrow regional disparity. From 1995 to 1997, the annual transfers averaged only 3 billion yuan, which was unlikely to contribute to horizontal balance. Bargaining for central transfers increased among poorer provinces when the allocations of grants remained arbitrary in nature and the introduction of a formula-based transfer scheme lagged behind.

**Revenue Assignments**

The 1994 reform redefined the fiscal relations only between the center and provinces. It authorized provinces to define the intergovernmental fiscal relations between provinces and their localities. When provinces reshaped their fiscal relations with the localities, they followed the central government's suit by assigning themselves the most stable and biggest chunk of revenues. As a result, local fiscal difficulties were exacerbated, and deficits further devolved down along the hierarchy. This reform therefore lacks any way to ensure the fiscal capacity of local governments to deliver their public good provisions.

**Expenditure Assignments**

The 1994 reform focused on only the revenue side as manifested by the emphasis on raising the two ratios (total government revenue as a percentage in GDP and central government revenue as a percentage in total government revenue) without clarifying and adjusting expenditure responsibilities among levels of government. Although the central government specified that framework provincial budgets should follow, such guidance consists solely of some general principles "Budget Law," 1994). In addition, expenditure pressure has increased at the provincial level, partly due to the centralization efforts in revenue and partly due to the increasing spending mandated by the central
authority. Like the central government in the 1980s, provinces now attempt to devolve expenditure responsibilities to lower levels. Without local government elections to restrain subnational governments' excessive taxing power, some of the expenditures are ultimately devolved to the individuals in the forms of proliferated charges, fees, and fines.

**Tax Administration**

In the prereform era before 1994, tax policies could not be implemented as intended because tax collection was manipulated by the subnational governments to act strategically with the center in prioritizing their needs. As a consequence, the central government may not have full control over its tax bases and marginal tax rates because tax administration in China became ruled by negotiation rather than law (Vehorn and Ahmad 1997).

The structure of tax administration was overhauled during 1994, when the system was split into a central administration responsible for the collection of central and shared taxes and a parallel provincial (or local) tax administration for local taxes. In September 1993, when the State Council officially approved the reform plan, to be effective on January 1, 1994, only three months were left for the preparation. The tax bureaus could not be split before the new rules came into effect (Wang 1997).

Although the central government reserves sole authority over tax bases and rates, this administrative arrangement tends to encourage better collection effort for taxes retained at the subnational level but relatively less effort for taxes that are transferred upward. The central authorities believed that the continued decline of central revenue share in total revenue after 1994 was partially attributed to such implementation bias of subnational tax administration. As shown in table 9.3, the increase in provincial taxes was by far outpaced that of central taxes, in particular for personal income tax and other charges. Consequently, the share of central tax in total revenue declined, as did the aggregate central revenue share in total government revenue.

Although the 1994 tax system reform is a substantial move toward tax assignments, lagged reforms in other areas forbid the central government from hardening the budget constraints on provinces. For example, the ownership and the income tax of SOEs are still defined by the enterprises' jurisdictional subordination. As a result, SOEs continue to be the arenas where the budget constraints on lower
Table 9.3  
Selected central and provincial tax shares in total government tax revenue, 1994–1997

<table>
<thead>
<tr>
<th>Central revenue in each year</th>
<th>Revenue at central level (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>VAT (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Central SOE income tax (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Consumption tax (billion yuan)</th>
<th>Share in total revenue (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>290.7</td>
<td>55.7</td>
<td>172.8</td>
<td>33.1</td>
<td>38.9</td>
<td>7.5</td>
<td>48.7</td>
<td>9.3</td>
</tr>
<tr>
<td>1995</td>
<td>325.7</td>
<td>52.2</td>
<td>194.8</td>
<td>31.2</td>
<td>48.3</td>
<td>7.7</td>
<td>54.1</td>
<td>8.7</td>
</tr>
<tr>
<td>1996</td>
<td>366.1</td>
<td>49.4</td>
<td>222</td>
<td>30</td>
<td>51.2</td>
<td>6.9</td>
<td>62</td>
<td>8.4</td>
</tr>
<tr>
<td>1997</td>
<td>422.7</td>
<td>48.9</td>
<td>246</td>
<td>29.5</td>
<td>35.6</td>
<td>4.1</td>
<td>67.9</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Average annual growth rate: 13.3% 12.5% 11.7% -3.3%

<table>
<thead>
<tr>
<th>Provisonal revenue each year</th>
<th>Revenue at local level (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Business tax (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Local SOE income tax (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Personal income tax (billion yuan)</th>
<th>Share in total revenue (%)</th>
<th>Other charges (billion yuan)</th>
<th>Share in total revenue (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>231.2</td>
<td>44.3</td>
<td>64.7</td>
<td>12.4</td>
<td>19.3</td>
<td>3.7</td>
<td>7.3</td>
<td>1.4</td>
<td>27.1</td>
<td>5.2</td>
</tr>
<tr>
<td>1995</td>
<td>298.6</td>
<td>47.8</td>
<td>82.8</td>
<td>13.3</td>
<td>23.2</td>
<td>3.7</td>
<td>13.1</td>
<td>2.1</td>
<td>45.1</td>
<td>7.2</td>
</tr>
<tr>
<td>1996</td>
<td>374.7</td>
<td>50.6</td>
<td>100.6</td>
<td>13.6</td>
<td>25.7</td>
<td>3.5</td>
<td>19.3</td>
<td>2.6</td>
<td>63.3</td>
<td>8.6</td>
</tr>
<tr>
<td>1997</td>
<td>442.4</td>
<td>51.2</td>
<td>116.1</td>
<td>13.4</td>
<td>37</td>
<td>4.3</td>
<td>26</td>
<td>3</td>
<td>80.2</td>
<td>9.3</td>
</tr>
</tbody>
</table>

Average annual growth rate: 24.2% 21.5% 24.2% 52.8% 43.5%

levels of government are softened (center to provinces, provinces to localities).

9.2.2 Subsidies

Subnational governments in China pay huge subsidies to SOEs for their losses resulting from market or price distortions. With direct ownership of SOEs, subnational governments can subsidize their respective loss-making enterprises and list such financial transactions as negative revenues in their budgets. Less explicit forms of subsidies are debt forgiveness and reduced or refunded government taxes and charges.

Between 1985 and 1995, total subsidies declined from 50.7 billion yuan to 32.8 billion. Their share in total expenditure (including SOE subsidies) dropped from 20 percent in 1985 to 4.6 percent in 1995 (figure 9.1). Such a significantly diminished role of subsidies may be largely attributed to a comparatively rapid increase in total expenditure when subsidies remained around their 1985 level. In practice, a portion of the government assistance to SOEs covers the operational inefficiencies of these enterprises (Lall and Hofman 1995).

At the same time, SOEs are obligated to employ redundant workers and bear the cost of related services, such as housing, health care, child care, schooling, and pensions. Many SOEs share the spending responsibilities of local governments and have become conduits for central-local financial transfers. As Steinfeld (1999) explains, SOEs are continually exposed to intervention by local state agencies, empowered

![Figure 9.1](image.png)

Subsidies to loss-making enterprises as percent of total expenditures. Source: Finance Yearbook of China (1997).
by the very policies of governmental decentralization that were intended to undermine command planning. Meanwhile, profit contracts—arrangements intended to rationalize the relationship between firm and state—fail to protect the firm from the state yet encourage the firm to overproduce and overexpand. Overproduction is then fostered by soft credit, capital made available through a banking system that was supposed to be the linchpin of market reform. On top of all that, new accounting standards, intended to permit managers the kind of autonomy that would encourage market behavior, make the misapplication of funds or outright decapitalization of the firm even easier.

9.2.3 Credit Plan and Borrowing from Commercial Banks

Prior to the economic reforms in China, the credit plan, together with the cash plan, the central government budget, and the foreign exchange plan, represented the financial side of the physical plan. Although plans are still drafted, their significance has steadily diminished since 1978. The reestablishment of the banking system in the early reform period (1978–1994) led to the independent operation of the People’s Construction Bank of China (renamed China Construction Bank, CCB) and the Bank of China (BOC), which were subordinates under MOF and PBC, respectively, before the reform. At the same time, the Agricultural Bank of China (ABC) was established to take over the PBC’s rural banking business. By 1994, there were three policy banks, three state commercial banks, four universal banks, and a number of other local commercial banks and nonbank financial institutions.

The Credit Plan

The annual credit plan, which was formulated by the PBC, in consultation with the MOF and State Planning Commission (renamed the State Development and Planning Commission, SDPC), took into account the need for investment in fixed capital and working capital, as well as PBC’s direct financing of the government’s deficit. Ultimately, the credit plan was approved by the State Council and implemented by the PBC’s provincial and local branches and, later, through a set of credit quotas for each specialized and universal bank. As banks have been transformed into financing institutions, local governments have gained a powerful influence over the administration of bank lending through the appointment of regional bank leaders. Apart from these formal controls, local governments retain intangible influences
that banks ignore at their own peril. For example, the supply of water and electricity, housing, recruitment of bank employees, and schooling of children all are potentially under the influence of local governments (Huang 1996). These relationships further undermine central control over subnational governments and possibly lead to corruption. "Contiguity brings personalism to relationships, and personalism is the enemy of arm's length relationships" (Tanzi 1995). Local governments thus gained substantial control over the credit supply, which has become a source of soft budget constraints of local governments and SOEs, as well as inflation (Qian and Rolland 1998).

The commercialization of banks has enhanced the profit motives of lending operations, merging the economic interests of banks with those of the local governments, both of which want to develop industries with high accounting profits (Huang 1996). Thus, the developmental urges of banks are now similar to those of the local industrial bureaus. This convergence of incentives means that it is harder for the central government to achieve its industrial policy goal through the credit plans. Moreover, although the formal power over credit creation rests with the headquarters of the PBC (and ultimately with the State Council), the operational autonomy granted to the local bank branches attenuates this central power. Bank branches are motivated to create credits on their own by converting deposits into loans (Bowles and White 1993).

The credit plan also allocates preferential interest rates to some regions and sectors. In addition to making direct contributions to the capital of the bank, the MOF provides indirect support to the bank through interest subsidies allocated each year in the annual budget of the government to the projects receiving loans from the bank. These subsidies are intended to further the government's economic development policies by enabling borrowers to obtain loans at interest rates below commercial rates (World Bank 1993).

Local officials' easy influence on the pattern of overlending combined with underpricing of loans contributed to the excessive expansion of banks' credit and a mounting number of bad and nonperforming loans. Even frequent interest rate changes could not curb the situation, partly because the soft budget constraints on SOEs make them unresponsive to the cost of borrowing. In fact, the impact of interest rate changes was felt much more on household savings than on bank lending (Mehran, Quintyn, Nordman, and Laurens 1996). According to a statement by the governor of the PBC, Dai Xianglong, the share
of nonperforming loans in the portfolios of the four largest state-owned banks increased to 25 percent by the end of 1997. "Ultimately the borrowers of nonperforming loans may default, requiring the lender to absorb the loss, drawing on either reserves or its own capital" (Lardy 1998). In 1998, the MOF issued 270 billion yuan in government bonds to recapitalize these state-owned banks. Such capital injection are an indirect measure of the center's bailout to local governments.

Following the commercialization of the banking system, China's State Development Bank was established on March 17, 1994, replacing the PCBC as the policy-oriented bank fostering economic development through long-term financing for policy-oriented and related projects in accordance with the government's development plan and industrial policies. More specifically, its mission is to extend loans to policy-oriented medium- and large-scale construction, technological transformation, and related projects for key state infrastructure facilities, basic industries, and pillar industries.

According to China's 1994 budget law, local governments are forbidden to borrow on the capital market. However, local enterprises (which provide public services) can and do borrow from banks and on the capital market despite their dependence on government subsidies of various kinds, which often makes them de facto government agencies. Given the still limited direct and indirect transfers from the center to provinces, such borrowing from local commercial banks by enterprises (under the jurisdiction of local governments) actually finances much subnational spending. This in turn creates contingent liabilities for local governments and, given the lack of transparency, is less easily controlled than explicit government borrowing.

Although the central government reserved credit resources such as bank loans and capital market access for use only by state-approved projects and it strengthened the traditional investment plan and approval mechanism, local authorities still maintained considerable latitude in securing and deploying financial resources. For example, subnational government maintained the power to approve investment projects below 50 million yuan (projects above 50 million yuan require approval by SDPC) and technical transformation or technology promotion projects below 30 million yuan (projects above 30 million yuan require approval by the State Economic and Trade). These projects can be funded by commercial and indirect borrowing. These rules have resulted in redundant investment of medium- and small-sized invest-
ment projects directly under the jurisdiction of subnational governments. Moreover, in the fiscal system before 1994, the product tax and business tax were both exclusively assigned to the subnational government, leading to the expansion of capital construction, particularly those industries (e.g., tobacco and alcohol) that generate high revenue from the product tax and business tax.

Chinese funding statistics are separated into five categories: budget, domestic credit, foreign capital, own funds ("self-raised," retained, or extrabudgetary funds), and, more recently, other sources, like stocks and bonds (World Bank 1995). Investment in aggregate and individual projects relies on a combination of funding sources, and the portfolio of sources has been changing over time. The nature of budget finance of enterprise investments has changed from direct capital grants to an annual lump-sum allocation to the capital construction fund, managed by SDPC. Budgetary financing for investment has declined in local budgets, and consequently recourse to alternative finance sources has become more common (World Bank 1993). As the share of budgetary funds fell, investments increasingly were financed by nonbudgetary sources (foreign capital, domestic credit, and other) in the second half of the 1980s, with an increasing reliance on own funds in the early 1990s. The share of self-raised funds increased substantially from 32 percent in 1985 to 43 percent in 1995, and the share of foreign capital increased from 7 percent in 1985 to 15 percent in 1995 (figures 9.2 and 9.3). By 1991, the amount of nonbudgetary financial resources used for local projects equaled central projects and largely exceeded the investment on central projects by 1995 (figure 9.4). The domestic credit level reached 22 percent in 1990 and increased modestly to 23 percent in 1995.

9.2.4 Indirect Borrowing and Foreign Borrowing

Indirect Borrowing
Provincial and local governments undertake indirect borrowing mainly by creating dummy financial companies that are able to borrow and provide resources for local government expenditures. Another method of indirect borrowing has been through a buildup of arrears, as well as IOUs on the procurement of agricultural products (Ahmad 1997).

Thus, soft budget constraints are reflected in the proliferation of trust and investment companies (TICs) and securities houses under the jurisdictions of provincial and local governments. According to
Figure 9.2
Figure 9.3
Meltzer, Quintyn, Nordman, and Laurens (1996), TICs receive government and enterprise trust deposits or entrusted deposits. The larger companies also underwrite and broker securities. Most TICs were established by the four state-owned specialized banks, while other banks, the MOE, and some municipalities also own TICs. Banks initially established these TICs to circumvent the credit quotas, but most TICs have been increasingly engaged in the banking business, taking household deposits, and granting working capital loans. In the late 1980s, as many as 365 TICs were operating throughout China. A portion of these TICs are engaged in international business and referred to as international trust and investment companies (ITICs). Some of them are involved in external borrowing.

**External Borrowing**

SDPC authorizes and establishes quotas for external debt. The State Administration of Foreign Exchange (SAFE) monitors and regulates compliance with these quotas for external borrowing through a registration process. Under the budget law, local governments are not allowed to incur foreign indebtedness unless otherwise permitted by law. However, external borrowing by the central and local government-owned financial institutions has been managed by a "window" management system, under which the issuance of debt requires a quota from the SDPC and an approval from SAFE. This system of
quotas and approvals favors a limited number of predesignated window companies. The window management system is being replaced by a credit management system, whereby the quotas and approvals will be granted to central and local government-owned enterprises and financial institutions (including leasing companies) on the basis of their demonstrated capacity to repay the borrowings, their free-standing creditworthiness, and China's balance-of-payments situation. Unless otherwise stated by the central government in the relevant debt issuance documents or other official PRC documents, borrowings by these entities are not guaranteed by any direct or indirect credit support from the central government. Most of these local window financial institutions are TTICs controlled by local governments. Before Guangdong International Trust and Investment Company (GITIC) went bankrupt in the first half of 1999, other local financial institutions enjoying the same treatment included Fujian ITIC, Tianjin ITIC, Shanghai ITIC, Dalian 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, accounting for 28.8 percent of China's total external debt. With the bankruptcy of GITIC, the first since the economic reform, the central government took a step forward in hardening budget constraint on subnational governments by refusing to bail out GITIC. Should financial difficulties emerge on a large scale among these ITICs, it is not clear whether the central government will join forces with provincial authorities to bail them out.

9.2.5 Tax Incentive Policies

Tax incentive policies are widely adopted by developing countries to attract foreign direct investment or serve their industrial policy (e.g., increase infrastructure investment and high- and new-technology investment). One of the most salient features of China's tax incentive policies is its strong discrimination against domestic investors in favor of foreign investors and its regional and industry preferences (World Bank 1999). In addition to general fiscal incentives, the application of these tax incentives, especially the exemptions and reductions of corporate income tax, can be more generous within the special economic zones (SEZs), coastal open economic zones, economic and technology development zones (EDTZs), and high- and new-technology development zones. These policies sparked keen competition among subnational governments for the right to establish such special economic
zones, which adversely affected the central government. First, subnational governments’ offer of ever-greater tax relief reduced government revenues. Second, the establishment of unauthorized SEZs weakened the ability of the central government to set and control macroeconomic policy.

Only four cities—Shenzhen, Xiamen, Zhuhai, and Shantou—were opened as SEZs in 1980. In 1984, fourteen more coastal cities were opened to foreign investment as ETDZs, allowing them to grant SEZ-like incentives. Through the 1990s, special zones extended to all coastal provinces, which were authorized to give tax incentives or attractive commercial terms to foreign investors. Special incentives for developing projects in the interior were also created, especially for provincial capital cities (Rosen 1999). Yang (1997) reported 111 development zones in 1991 (only 27 of which were centrally approved), 1,951 by September 1992, and as many as 8,700 by mid-1993.

9.2.6 Extrabudgetary Funds

Although public finance has been centrally controlled since 1949, certain revenues and expenditures of SOEs, local governments, agencies of the central government, and certain public institutions have historically been excluded from the state budget. These extrabudgetary revenues and expenditures are subject to varying degrees of control and regulation by the central government.

Since 1980, a devolution of expenditures from central to local governments, down to the township level, has led to a rapid increase in local expenditures, particularly administrative costs, health, education, and scientific research expenditures. The decentralization of expenditures over the reform period can be attributed to the following shifts: (1) a new emphasis on functions traditionally administered at local levels, such as social expenditures; (2) increases in administrative expenses and wages (largely due to the rapid increase in the number of civil servants at local level), which fell more heavily on local governments; and (3) sharp rises in locally administered but centrally set price subsidies. The local own-tax sources of revenues have not kept pace with rising expenditures, and local governments have become increasingly dependent on their extrabudgetary funds to perform their functions. In 1992, for example, the total extrabudgetary funds at both the central and subnational levels represented 46 percent of total expenditures, whereas extrabudgetary funds financed 41
percent of local expenditure and 54 percent of central expenditure (figure 9.5).

Extrabudgetary funds fall under three broad institutional categories: (1) extrabudgetary funds of local fiscal bureaus, including surcharges on taxes set by local governments (e.g., agricultural surcharges); (2) extrabudgetary funds of administrative agencies and institutions (non-profit agencies, shi ye dan wei), including highway maintenance and other cost-recovery fees, market, and other fees, collected by government units; and (3) extrabudgetary funds of SOEs, including earmarked funds for the technical transformation and major maintenance funds (e.g., depreciation funds), retained profits, and short-term loans for circulation purposes (i.e., working capital). Foreign investment and international loans are sometimes included in this category. Before 1992, about 80 percent of these funds were owned by the enterprise sector (figure 9.6).18

Initially, the explicit objective of extrabudgetary transactions was to allow increased flexibility. They were also supposed to change the structure of incentives to help revitalize SOEs, speed up growth, and in general improve incentives for government units.

The increasing use of price subsidies and SOE subsidies during the second half of the 1980s pushed more pressing expenditures off the budget. This allowed a rapid growth of extrabudgetary funds, which became a particularly striking feature of the tax reform period of the 1980s (figure 9.7). A combination of reform initiatives (e.g., the profit-retention schemes, enterprise retention of depreciation funds, and the

Figure 9.5
Figure 9.6

Figure 9.7
Extrabudgetary revenue as a percentage of total government revenue. Source: Finance Yearbook of China (1997).

deduction of pretax amortization before tax payments, which transferred resources from the government to the enterprise sector) gave the SOEs more autonomy but at the same time reduced fiscal control over resources. Starting in 1993, extrabudgetary funds of SOEs were abolished, which then led to a substantial increase of extrabudgetary funds in the other two categories (see figure 9.6). In 1996, for example, the aggregated extrabudgetary revenue of central administrations increased by nearly 200 percent and that of the provincial governments increased by 41 percent.19
Extrabudgetary funds together with local government self-raised funds (all off the budget) are used in ways that supplement the budget: to finance fixed-asset investment, major maintenance, bonuses and welfare payments, administrative expenditures, expenditures in the social sectors, transfers and taxes paid to the central government, increases in working capital, and other earmarked programs (figure 9.8).20

From the second half of 1980s to the first half of the 1990s, the extrabudgetary funds became the central government’s major concern. Since provinces are required to report extrabudgetary revenues only in very broad aggregated categories and there are no requirements for them to report their extrabudgetary expenditures to the MOF, the central authority lacked any effective instruments to monitor the funds. Although MOF resorted to restricting the number of banking accounts, that is, requiring all extrabudgetary funds be deposited into the specific fiscal accounts with each extrabudgetary fund having one bank account, this measure actually made the fiscal departments rely on the banking sector for the surveillance. Nonetheless, the banking sector was experiencing a substantial decentralization under which each bank was urged to depend on its own funding resources. As branches of different banks at localities started to solicit more clients, they were more than happy to offer shelter for extrabudgetary funds, among which a

![Graph showing extrabudgetary expenditures](image)

**Figure 9.8**
portion came from local fiscal departments. As a result, one agency could end up with several accounts for one kind of extrabudgetary fund.

The growth of extrabudgetary funds has undermined control over the scale of total government expenditures by enabling growth-oriented local governments to spend more freely outside the purview of central budgetary control. Local governments have tended to spend virtually all the revenues generated from ad hoc off-budget fiscal levies (Lall and Hofman 1995). In 1996, the twenty-ninth decree of the State Council brought thirteen extrabudgetary funds, totaling 150 billion yuan, under the supervision of the MOF (Ding 1997). According to the decree, all revenues generated from these funds are to be remitted to the treasury, and their expenditure is subjected to financial management by the MOF based on the proposed plans drafted by line administrations. The income from these extrabudgetary funds is to be earmarked for specific projects and not used for any other purposes or to balance the budgets. The decree further stated that similar measures would be introduced as the government sees fit.

Although the policy measures introduced in 1993 and 1996 shrank the extrabudgetary funds statistically, with high investment demand and limited financing, extrabudgetary funds have remained, proliferating at all levels of government. For local governments, which control most of these funds, they have become an important financing source. The proliferation of extrabudgetary funds has blurred the distinction among budgetary priorities and weakened the budgetary control mechanisms essential to a well-functioning fiscal system.

9.3 Conclusion

During the fiscal reform of the 1980s and 1990s, local governments in China responded to tightening budget constraints in ways that undermined desired fiscal discipline by (1) expanding the local tax base at the cost of the central government; (2) turning budgetary into extrabudgetary funds and tapping enterprises’ extrabudgetary funds for government purposes; (3) pushing expenditures into extrabudgetary items, sometimes financed by indirect local borrowing, which placed additional demands on local banks and strains macroeconomic stability; (4) raising funds through internal and external borrowings; and (5) extending tax preferential policies by lavishly establishing SEZs. In addition, local governments have reduced effective tax rates on enter-
prise profits below the statutory rate by enterprise profit contracts. They have offered tax concessions to enterprises that affect the size of taxable income, to the detriment of tax buoyancy—for instance, by manipulating the rules for pretax repayment of investment loans. And because the resource-strapped local governments depend on local enterprises for their revenues, they are tempted into inefficient regional competition and local protectionism made possible by gaps in competition regulations.

The reform introduced in 1994 continues to meet significant resistance at the local level. The premise that taxes belong to the central government unless specifically assigned to the localities is not accepted at the local level. The goals of uniformity and transparency were compromised at the outset when the central government set the transfer rule based on the assurance of the status quo distribution in 1993.

In addition, the reform’s effectiveness on hardening the budget constraints on provinces is undermined when (1) expenditure assignments are not clarified between levels of governments and provinces can always pass on expenditure responsibilities to the lower levels, (2) provinces are allowed to define the fiscal relations with localities and have the opportunity to squeeze most of the revenues (left by the center) for themselves, and (3) local officials are not restrained by any form of institutionalized local political participation so that they can pass their deficits on to local residents.

A shift to the tax assignment system by itself cannot harden budget constraints. The highly fragmented authoritarian arrangement still features the ownership of enterprises by local governments that have strong links to financial intermediaries. Thus, local governments enjoy both a soft budget constraint and autonomy in lending decisions, which enables them to resort to SOEs for both delivery of public services and debt financing. Soft budgets are thus incurred for both the SOEs and local governments. At the same time, SOEs treat tax liabilities lightly in an environment where the local finance bureaus play the double role of tax collector and owner and in a situation where taxes are frequently contracted rather than assessed. Budgetary financing of SOE investment is still virtually free; repayment ratios of the banks are extremely low or repayments are canceled out against tax obligation. This works to the detriment of banking sector stability.

The separation of policy and commercial lending is not enough by itself to foster commercialization of the banking sector. Specialized banks are still subject to lending quotas, are obliged to provide working
capital loans to SOEs, can lend only for government-approved projects, and finance SDB through the compulsory purchase of its bonds. Banks cannot operate on a commercial basis until project-specific credit allocation has been eliminated. A hard budget constraint on local governments and SOEs cannot be established until local governments and the banking sector are separated and distributed ownership is phased out.

In the past twenty years, tax preferential policies played a significant role in attracting foreign direct investment to facilitate the economic reform agenda in China. However, the lavish adoption of such a policy by subnational governments without the approval of the center largely undermined fiscal discipline and negatively affected the industrial restructuring and regional development agenda set by the central government. The tax system reform should also address this issue by cleaning up the SEZs and tax preferential policies.

Notes

1. Unlike the previous system, reform in the 1980s allowed provincial authorities to retain all or a proportion of the tax collected after sharing with the center.


3. Examples are income taxes from railways, coal mining, and the petroleum and airline industries, as well as income taxes of banks, insurance companies, and other organizations.

4. Most of which clustered in the last three months of the year after the central government promulgated the tax reform plan in September 1993 (Wang 1997).


8. For example, the Agricultural Law, Education Law, and Science and Technology Law all put forward that subnational governments' spending in these areas shall increase at a higher rate than that of the government's current revenue.


11. Bank of Communications, China International Trust and Investment Corporation (CITIC)'s Industrial Bank, China Everbright Bank, and Hua Xia Bank.


15. Ministry of Finance.

16. For detailed information about tax exemptions and reductions, see World Bank (1999, 21–25).

17. Besides the widely applied income tax holidays, the reduction in corporate income tax rate is also substantial; whereas the corporate income tax rate is 33 percent, many activities and regions enjoy reduced tax rates of between 15 and 24 percent. In addition, many investment projects in those regions and activities are exempted from the 17 percent import tariffs on imports of equipment and raw materials. Export-oriented enterprises in the special economic zones and the economic technological development zones where the enterprise income tax has already been reduced to 15 percent would be taxed at 10 percent (World Bank 1999).

18. Since 1993, the extrabudgetary funds of SOEs are categorized not as extrabudgetary funds but as enterprises’ own fund.


20. Data on extrabudgetary revenues have been collected since 1982, but data on extrabudgetary expenditures were not recorded until 1982.

21. Some of the local fiscal agencies moved their budgetary fund to extrabudgetary accounts.

References


