Local Public Finance in China: Challenges and Policy Options

Jorge Martinez
Baoyun Qian
Shuilin Wang
Heng-fu Zou

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Background

China is a unitary country with strong federalist features. The administrative division of China is as follows: (1) The country is divided into provinces, autonomous regions, and municipalities directly under the central government; (2) Provinces and autonomous regions are divided into autonomous prefectures, counties, autonomous counties and cities; (3) Counties and autonomous counties are divided into townships, nationality townships and towns. Municipalities directly under the central government and other large cities are divided into districts and counties. Autonomous prefectures are divided into counties, autonomous counties, and cities.[1] In practical terms, besides the central government, there are four tiers of sub-national governments: provincial, prefecture (city), county, and township. According to the constitution, people's congress and people's government at the levels of province, prefecture (or city), county and township are the local legislative organs of state power and executive organs of power, respectively.

Geographically, China is divided into the eastern coastal region, the central region, and the western region.[2] The eastern coastal region of China is relativly richer than the central and western regions, as shown in Table 1.1 in terms of per capita GDP.

Table 1.1 Per Capita GDP by Provinces in China: 2003

Region	Provincice	Per Capita GDP (in US Dollar)	Rank by Per Capita GDP
East coast	Shanghai	4428	1
	Beijing	3049	2
	Tianjin	2934	3
	Zhejiang	2434	4
	Guangdong	2076	5
	Jiangsu	2039	6
	Fujian	1818	7
	Liaoning	1728	8
	Shandong	1652	9
	Hebei	1271	11
	Hainan	1003	16
Middle	Heilongjiang	1408	10
	Jilin	1131	13
	Hubei	1091	15
	Shanxi	898	17
	Henan	884	19
	Hunan	844	21

[1] See article 30 in Constitution of the People's Republic of China
[2] The east region includes Beijing, Tianjin, Hebei, Liaoning, Shanghai, Shandong, Zhejiang, Fujian, Guangdong, and Hainan, while the central region includes Heilongjiang, Jilin, Shanxi, Henan, Hubei, Hunan, Jiangxi, and Anhui, and the western region includes Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia, Xingjiang, Inner Mongolia, and Guangxi.

	Jiangxi	806	23
	Anhui	751	27
Western	Xinjiang	1177	12
	Inner Mongolia	1095	14
	Qinghai	886	18
	Chongqing	872	20
	Tibet	828	22
	Ningxia	805	24
	Shaanxi	788	25
	Sichuan	760	26
	Yunnan	683	28
	Guangxi	683	29
	Gansu	607	30
	Guizhou	425	31

Source: China Statistic Year Book 2004

In general, population density decreases as we move from east to west, as shown in Table 1.2.

Table 1.2 Population Distribution and Density in China: 2003

Region	Population (thousand)	As % of total	Area (thousand km^2)	Population density (persons per km^2)
Total	1260498	100	9600	131
Beijing	14070	1.12	17	828
Tianjin	9956	0.79	12	830
Hebei	66569	5.28	190	350
Shanxi	32558	2.58	157	207
Inner Mongolia	23510	1.87	1142	21
Liaoning	41549	3.30	150	277
Jilin	26684	2.12	189	141
Heilongjiang	37693	2.99	460	82
Shanghai	16061	1.27	8	2008
Jiangsu	72967	5.79	105	695
Zhejiang	45934	3.64	105	437
Anhui	62652	4.97	140	448
Fujian	34261	2.72	122	281
Jiangxi	41741	3.31	167	250
Shandong	89775	7.12	158	568
Henan	95029	7.54	166	572
Hubei	59184	4.70	186	318
Hunan	65521	5.20	212	309
Guangdong	77676	6.16	179	434
Guangxi	47661	3.78	236	202

Hainan	7939	0.63	34	234
Chongqing	30713	2.44	82.4	373
Sichuan	85739	6.80	483.6	177
Guizhou	37933	3.01	176	216
Yunnan	42836	3.40	384	112
Tibet	2638	0.21	1202	2
Shaanxi	36314	2.88	205	177
Gansu	25628	2.03	406	63
Qinghai	5225	0.41	720	7
Ningxia	5650	0.45	66	86
Xinjiang	18834	1.49	1663	11
Max	95029	7.54	1663	2008
Min	2638	0.21	8	2

Source: China Statistic Year Book 2004 and China Population Statistic Year Book 1997

A brief overview of fiscal reforms in China

The current system of intergovernmental fiscal relations in China is the result of successive fiscal reforms starting at the beginning of the 1980s. Before that time, China had been under the central planning system since 1949, when the People's Republic of China started. Under central planning all expenditures were budgeted by the central government, and the major function of the fiscal system was to keep records of all revenues accrued and expenditures disbursed by the central government. This was mostly an accounting function, since the belief was that taxation should be eliminated eventually, as all of the economy would be owned by the state. The tax system was very simple, and included only the unified tax for industry and commence and the agriculture tax. The collection of all revenues was delegated to local governments.

The major revenue source for government was profits from SOEs, which accounted at the end of the 1970s for nearly half of total government revenues. The accounts of SOEs were regarded as part of the fiscal system. In fact, these accounts were relatively easy to monitor through fixed prices and the planned output and sales under planned economy.

In this centralized system, local governments were mere agents of the central government. Local governments had the responsibility to collect taxes, and received the "necessary" fiscal resources from central government, with these needs exclusively determined by the central government. Obviously, local budgets did not enjoy any autonomy, and local governments' accounts were regarded as part of the central government's accounts. The central government set spending priorities, approved local budgets and set policies on civil service salary scales, pension and unemployment benefit levels, educational standards, health care standards, as well as any other relevant aspects of local budgets.

In summary, the central planning system did not provide appropriate incentives to encourage local governments to pursue local economic development and local social welfare. Instead, local governments simply had the function of collecting taxes and delivering centrally designed services

The Fiscal Responsibility System Reform

The economic reforms starting at the beginning of the 1980s redefined the relation between the government and non-government sectors and intergovernmental relations. After some initial fiscal decentralization experiments during the period 1978 to 1983, China started formal nationwide fiscal reforms in 1984 with the adoption of “Fiscal Responsibility System" (FRS) reform. The 1984 reform replaced the appropriation of profits with the introduction of a corporate income tax for SOEs and started to build other elements of a new tax system to fit the market economy that was being developed. A key aspect of the FRS was the greater separation of the government function from private sector activities, and the fact that now local governments could get more fiscal revenues by collecting more taxes. Under the FRS, the central government allowed provincial governments to retain some part of the proceeds remaining after remitting a fixed sum of revenues to the central government for a certain period of time. The revenues transferred to the central government were preset by contracts established in one-to-one bargaining between the central and provincial government.

The FRS gave sub-national governments the incentives to collect taxes because it provided them, at least to some extent, with the “ownership” of some fiscal resources by local governments. In addition, the lack of strict tax laws in combination with a decentralized tax administration and control gave sub-national governments the power to control their effective tax rates and actual tax bases, even if sub-national governments did not have the legal authority to alter the statutory rates and bases. In this environment, sub-national governments rationally opted to use "favoritism," for local enterprises, providing them with more direct resources and incentives, such as tax exemptions; the natural consequence was the the decrease or slowing down of the growth of budget revenues. Meanwhile, the lack of stability and transparency led to difficult bargaining bouts between the central government and each one of the provincial governments. The aggregate outcome of the system was a fast and pronounced decrease of the central government’s share in total fiscal revenues accompanied by the decrease of the share of fiscal revenues in GDP.

The trend toward lower tax collections was of less importance to sub-national governments because extra-budgetary account provided an alternative way to finance their expenditures with the added benefit of not running the risk of an eventual claw back by the central government.[3] Extra-budgetary funds[4] to a large extent could be regarded as part of total government budgetary revenues because these funds have been used all along for projects ranging from infrastructure to public services. The difference from formal budgetary funds is that extra-budgetary funds were compatible with the incentives of sub-national governments, and sub-national governments could use them to shield tax

[3] That is, any increase of formal tax collections by sub-national governments meant the greater likelihood of tougher contractual terms in the next round of contracting with the central governments and theefore the claw back of the some part of the additional tax resources formally collected.
[4] Extra-budgetary funds receive a specific definition by the central authorities. Some off-budget funds such as the “illegal fees” imposed on farmers are not regarded as part of the extra-budgetary funds.

collections from the revenue sharing agreements with the central governments. Lacking formal taxing powers and finding transfers from higher levels increasingly unreliable, sub-national governments energetically pursued off-budget revenue expansion (Wong 1998, and Fan 1998). The FRS reform made extra-budgetary funds more important for sub-national governments; both their volume and their relative importance vis-à-vis budgetary revenues increased rapidly over time up to the time of the next round of fiscal reform.[5]

The Fiscal Contracting System

In 1988, the central government introduced several fiscal contracting modules to address the problems that had arisen with the FRS and improve the performance of the fiscal system, under the name of the "Fiscal Contracting System" (FCS) reform. The major modules in this new system included:

a. Fixed grants: For provinces whose expenditures were larger than their base amount of revenues, the central government would provide them with fixed grants. Sixteen provinces adopted this module.
b. Fixed remittance: Provincial governments would remit a fixed amount to the central government. Three provincial governments adopted this module.
c. Increasing remittance: Provincial governments would remit to the central government a fixed amount plus yearly increasing amounts at a fixed growth rate (as contracted between the central and local governments. Two provincial governments adopted this module.
d. Fixed sharing rate. Total revenue is shared by the central government and sub-national governments at a fixed sharing rate. Three provincial governments adopted this module.
e. Increasing sharing rate. Total revenue is shared by the central government and sub-national governments at annual increasing sharing rates, as negotiated between the two levels.
f. Fixed sharing rate plus. In this case the base revenue is shared by the central government and sub-national government at a fixed sharing rate. The incremental revenue is shared by the central and sub-national governments at another fixed sharing rate. Three provincial governments adopted this module.

The Fiscal Contracting System further led to the decentralization of fiscal resources, very high by international standards (Bahl and Wallich, 1992), and to a further drop in the share of total fiscal revenues in GDP. In addition, the FRS was very difficult to manage because the implementations of the system involved too many negotiations and variable factors.

The Tax Sharing System Reform

In 1994 China's government introduced the Tax Sharing System (TSS) reform with the two major goals of increasing the share of government expenditure in total GDP and the

[5] The importance and evolution of extra-budget and off-budget funds in China are examined in the appendix to this paper by Li Zhang.

share of central budgetary revenues in total budgetary revenue. This reform introduced clear and stable assignments of tax revenues between the central and provincial governments, and created separate tax administration services at both levels of government. The TSS reformed the value added tax (VAT) as the major government revenue source, and set up a uniform tax-sharing system. The share arrangements for VAT were 75 percent for the central government and 25 percent for the sub-national governments. The central government own taxes and all shared taxes were collected by the newly created National Tax Services (NTSs), which operated in all provinces. The new system provided for separate local (sub-national) tax services (LTSs) for the collection of the taxes assigned to local governments. The headquarters of the NTSs, the State Administration of Taxation, was empowered to supervise local tax services and prohibit the use of tax exemptions by local governments.

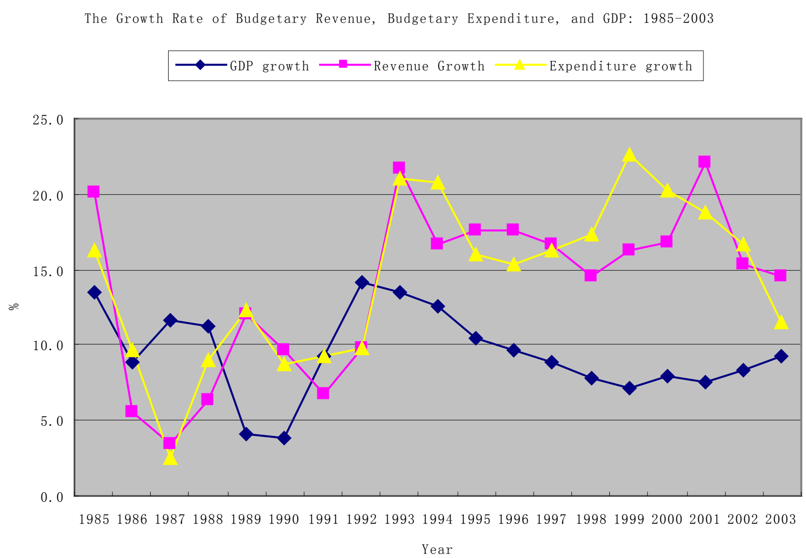
Several subsequent policy changes supplemented the TSS reform. The most important of these were the *Rural Tax-for-Fee Reform and the abolishment of the agriculture taxes Reform*, which had the objective of reducing the tax burden on farmers. The *Tax-for-Fee Reform* was first experimented with in eastern Anhui province in 1994 and, two years later, in 50 selected countries in seven other major agricultural provinces. The central government extended the experiment to the whole of Anhui province in 2000 in a bid to standardize the tax burdens on farmers and eliminate the growing arbitrary administrative fees being charged to them. In 2002, the central government further rolled out the Tax-for- Fee reform to a total of 20 provinces, comprising 620 million farmers, or three quarters of the country's total. The outcome was that the financial burden on farmers was cut by at least 30 percent. The Chinese government further decided in late 2003 to abolish, exempt or lower 15 charges on the country's 900 million farmers in a bid again to reduce what was considered excessive financial burdens.[6]More recently, China’s government made the decision to abolish the agriculture taxes, which had been assigned to local governments, particularly county and lower level governments, starting in 2006.

Another important policy change is related to the corporate and individual income taxes. A reform in 2001 made the corporate income and individual income taxes shared between the central and sub-national governments at 50/50 sharing ratios. The share of the central government was increased to 60 percent in 2002. This further recentralization of tax revenues was justified by the need to increase the pool of available funds for redistribution and equalization of poorer central and western provinces.

Allocation Patterns of Fiscal Resources in China

The different stages of intergovernmental fiscal reforms have had significant impacts on the level and the distribution of fiscal resources. But first, as shown in Graph 1, it is important to point out that during the entire reform period, the GDP and also government total revenues and expenditures grew at high nominal rates.

[6] The list of the 15 charges published by the Ministry of Finance and the State Development and Reform Commission involved quarantine certificates, licensing fees for using water resources, education, land-use rights certificates, and charges for fishing boat inspections.



Graph 1

However, as shown in Table 1.3, government revenues as percent of GDP and also government expenditures as percent of GDP continued to decrease from 1980 (when they stood at 25.7 percent and 27.2 percent of GDP, respectively) to 1995, just before the effects of the 1994 TSS reform had started to take place; at that time, government revenues were at 10.9 percent of GDP and government expenditures at 11.9 percent.

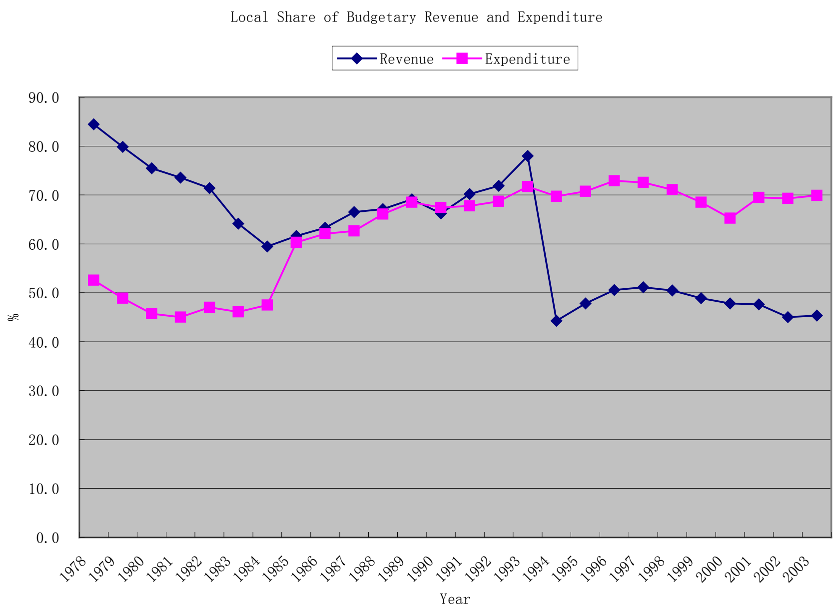
Table 1.3. GDP and Revenues and Expenditures as Percent of GDP (1980-2003)

year	GDP	Revenue		Expenditure	
		Amount	As % of GDP	Amount	As % of GDP
1980	4517.8	1159.9	25.7	1228.8	27.2
1981	4860.3	1175.8	24.2	1138.4	23.4
1982	5301.8	1212.3	22.9	1230.0	23.2
1983	5957.4	1367.0	22.9	1409.5	23.7
1984	7206.7	1642.9	22.8	1701.0	23.6
1985	8989.1	2004.8	22.3	2004.3	22.3
1986	10201.4	2122.0	20.8	2204.9	21.6
1987	11954.5	2199.4	18.4	2262.2	18.9
1988	14922.3	2357.2	15.8	2491.2	16.7
1989	16917.8	2664.9	15.8	2823.8	16.7
1990	18598.4	2937.1	15.8	3083.6	16.6
1991	21662.5	3149.5	14.5	3386.6	15.6
1992	26651.9	3483.4	13.1	3742.2	14.0

1993	34560.5	4349.0	12.6	4642.3	13.4
1994	46532.9	5218.1	11.2	5792.6	12.4
1995	57277.3	6242.2	10.9	6823.7	11.9
1996	66850.5	7408.0	11.1	7937.6	11.9
1997	73142.7	8651.1	11.8	9233.6	12.6
1998	76967.2	9876.0	12.8	10798.2	14.0
1999	80579.4	11444.1	14.2	13187.7	16.4
2000	88254.0	13395.2	15.2	15886.5	18.0
2001	95727.9	16386.0	17.1	18902.6	19.7
2002	103935.3	18903.6	18.2	22053.2	21.2
2003	116603.2	21715.3	18.6	24650.0	21.1

Source: China statistical year book 2004

While the sub-national government share in total government expenditures increased monotonically from the 1984 FRS reform until the 1994 TSS reform and has shown a relatively stable pattern since then (Graph 2). The 1994 reform significantly decreased the share of sub-national government revenues (before transfers) in total revenue; this share has slowly continued to drift downward.



Graph 2

The 1994 reform not only increased the share of total government revenues in GDP and the share of the central government in total revenues but, by clarifying revenue assignments between the central government and local governments, it also improved sub-national government incentives to increase their budgetary revenues. In addition, as more fiscal resources have been concentrated in the central government, the 1994 reform has increased the capacity of the central government to pursue the national objectives such as carrying out large-scale infrastructure projects, more equalization of fiscal resources across jurisdictions, and the ability to conduct macroeconomic stabilization policies. These are all quite significant achievements from the conditions that were present in the late 1980s and early 1990s. However, a significant portion of this paper addresses what else needs to be done, primarily as a consequence of the fact that the 1994 reform failed to provide clear expenditure assignments among different government levels and reform some of those assignments.

Main issues

Although the fiscal decentralization reforms in China clarified the revenue assignment between the central government and provincial governments, the revenue assignment for sub-national governments did not improve much, and lower level governments have only very limited tax bases in general. At the same time, the decentralization reforms did not provide a clear expenditure assignment for sub-national governments, especially local governments at the county level and below. Some of the main challenges facing the current system include the following:

First, considerable horizontal fiscal disparities between east coast areas and middle and western areas and between urban and rural areas in general pose serious threats to the cohesion of the nation.

A main fact in the distribution of fiscal resources that has remained present throughout all the reforms is the significant regional disparities in fiscal resources across China's sub-national governments. This is one of the main challenges still facing the fiscal system. In fact, the 1994 reform led to higher regional disparities in sub-national own revenues, as shown in Table 1.4. This was a result of growth in overall fiscal capacity and rather small equalization transfers. The coefficient of variation for per capita own revenues has continued to increase since 1994 as has the range between the maximum and minimum values, which stood at over 16 fold in 2003. Regional disparities could be, to some extent, interpreted as the necessary cost to achieve other goals of economic reforms such as economic development and growth and more sub-national autonomy; however, the costs of these disparities also have increased and could now exceed the potential benefits.

Table 1.4 Disparities in provincial per capita own revenues: 1985-2003

	Max	Min	Max/Min	Average	C.V.
1985	1492	49	30.4	172	1.69
1986	1445	56	25.8	188	1.53
1987	1321	70	18.9	195	1.35
1988	1163	81	14.4	201	1.13
1989	1196	96	12.5	226	1.03
1990	1180	96	12.3	229	0.99
1991	1432	94	15.2	278	0.99
1992	1309	95	13.8	269	0.94
1993	1725	124	13.9	358	0.89
1994	665	57	11.7	228	0.68
1995	1552	111	14.0	310	0.97
1996	1977	139	14.2	388	1.00

1997	2282	155	14.7	439	1.04
1998	2600	179	14.5	511	1.04
1999	2849	200	14.2	563	1.08
2000	2900	239	12.1	611	1.04
2001	3776	263	14.4	757	1.12
2002	4363	282	15.5	831	1.17
2003	5180	322	16.1	952	1.18

Source: China statistical year book, various years

Increasing transfers from the center through grant allocations can be regarded as one way for sub-national governments to balance their budgets each year, but currently the intergovernmental transfer system has very limited abilities to reduce existing fiscal disparities. The major component of intergovernmental transfers is represented by the “tax rebate”, which was a product of the fiscal system before TSS reform and designed to hold harmless the richer sub-national governments during the implementation of the TSS reform; currently, the “tax rebate” still represents a major impediment to the equity and efficiency objectives of the intergovernmental transfer system.

In addition, intergovernmental transfer is one of areas that have least transparency in China’s intergovernmental fiscal relations system. According to the current budget process, the lower level government submits its budget to the upper level government and so on to the central government, and the central budget is the last to be approved. Consequently, the intergovernmental transfer for local government is unknown until the budget of the central government is approved. It appears that sub-national budgets are not able to incorporate intergovernmental transfers until the budget implementation process is well under way, and in fact, intergovernmental transfers are difficult to track in fiscal accounts partially because of these peculiarities of the budget process. For example, a recent report from the State Audit Bureau[7] shows that only 22.5 percent of total intergovernmental “subsidy” (transfers) from the central government got reported in the provincial accounts for a total 414.9 billion Yuan transfer in17 provinces that were audited.

The fact that the Ministry of Finance is not the only department that determines intergovernmental transfers at the central level also complicates the intergovernmental transfer system. Several departments under the State Council also control their own fiscal resources and allocate them to provincial and sub-provincial governments. However, in many cases there are no clear procedures in the decision-making process for the determination of these fiscal transfers. This discretionary nature of central grant allocations has led to extensive negotiations and rent-seeking by sub-national authorities, tying up valuable administrative resources.

More recently, starting with 2002, the central government embarked upon an effort to increase intergovernmental transfers and reduce horizontal disparities. As a result, actually sub-national governments’ expenditure disparities decreased temporally.

[7] 2003 Audit Report on Central Budget and Other Fiscal Revenue and Expenditure, National Auditing office.

However, this effort appears to have been unsuccessful, as fiscal disparity has continued to increase again.

Second, the under-provision of basic public services at the local level (in education, health care, and social security) endangers the sustainable economic development of many areas, and besides it causes significant welfare losses for the country. Currently, almost all basic public services are provided by government units at the county level and below, but revenue assignments and intergovernmental transfers to sub-provincial governments are less well-defined. Although extra-budgetary funds together with local government self-raised funds (off-budget) are still used as an alternative to supplement local budgets, these are not sufficient to palliate the existing fiscal gaps. Currently, a majority of the local governments are not even able to finance their operational expenditures, and "*feeding finance" (or financing only the running expenditures of government)* is still a very common phenomenon for local governments at the county level and below in the central and western areas of the country.

Third, weak fiscal performance of county and township governments in poor jurisdictions damages the credibility of all government levels, at the same time it has led to increasing levels of arrears and indebtness. In fact, local government debt has become a serious problem in China, especially for government units at the county level and below in the central and western areas of the country. According to China's 1994 Budget Law, local governments are forbidden from borrowing in the capital market. However, given the still limited direct financing and indirect financing through intergovernmental transfers, much of the actual financing of these sub-national governments' spending is through borrowing. This borrowing comes from local commercial banks by using enterprises under the jurisdiction of local governments, from residents-- particularly the employees of local government-- and SOEs directly under the local governments, and from privately owned enterprises. Meanwhile, deficits have been accumulating at a rapid pace into significant debt levels, becoming a heavy burden for these local governments. The current framework of intergovernmental fiscal relations has difficulties in presenting strategic solutions for this issue.

Fourth, low horizontal accountability of local government officials to their residents has likely exascerbated the local fiscal difficulties listed above. Limited fiscal resources do not prevent local government from expanding into areas with heavy overhead expenditures as there are no clear delineations for government responsibilities between the public and private sectors and among governments at different levels. The current system presents local governments with a wide array of responsibilities including economic development and adjustment to macro-economic changes (unemployment compensation, etc.), besides being responsible for social affairs and the delivery of public services. And it is this system in turn that provides local governments with various channels to encroach into private sector activities at the same time the level and quality of basic public services is further reduced, as local officials are not restrained by any form of institutionalized local political participation. Far from discouraging this behavior, the current system of incentives in intergovernmental relations encourages it because local officials get rated and promoted for their performance mostly in the area of economic development as opposed to the delivery of public services.

In summary, China's current fiscal system faces serious challenges, and a significant number of local governments in China are in a serious fiscal crisis. This has negatively affected the quantity and quality of basic public services for many millions of people. Improving public service delivery in health, education and other basic areas and assuring that services are delivered in an equitable manner will go along way to alleviate poverty in the worst off areas of the country and will help provide the foundations for sustainable economic economic development in the decades ahead.[8]

In this paper, we take stock of the current state of the system of local public finance in China, with the objectives of identifying the critical weak points and providing some policy options for further reform of the system. The rest of the paper is organized as follows. Chapter 2 reviews the issues with the assignment of expenditure responsibilities to local governments. Chapter 3, in turn, analyzes the issues pertaining to the assignment of revenue sources to local governments. Chapter 4 addresses the problems of vertical and horizontal imbalances and the implementation of intergovernmental transfers. Chapter 5 evaluates the overall performance of China's decentralization system. Chapter 6 concludes and explores several options for policy reform.

[8] See the discussions in Ravallion and Chen (2004) for China and Boex et al. (2006) for developing countries in general.

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