Local Public Finance in China: Policy Options

Jorge Martinez
Baoyun Qian
Shuilin Wang
Li Zhang
Heng-fu Zou

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Addressing the problems identified with the current system of intergovernmental relations in China will require an integrated comprehensive strategy because of the clear interdependencies among many of these issues. Actual reform may be phased in in stages as long as there is an explicit strategy guiding the reforms.

In this section we highlight the main areas and some options available for a reform strategy largely based on our analysis in previous sections and on what has and has not worked in the international experience. For this reason we stop to describe, when relevant, some of the experiences and approaches other large countries in the international community have used for addressing similar problems and dilemmas in decentralization policy.

Setup formal and stable expenditure assignments to clarify the responsibilities of all government levels

In the last two decades, China has made dramatic progress in separating government from SOEs and re-defining the functions and responsibilities of government in the economy. But, there are still significant problems from an expenditure assignment perspective. In particular, a stable and transparent expenditure assignment at all levels of government with less concurrent responsibilities is needed. This step has significant meaning in China's current policy framework because: (a) it will enable the more efficient organization and provision of basic public goods and services to residents and will significantly improve the accountability of both the central and local governments; (b) it can effectively help the elimination of government encroachment in the private sector; and (c) it can provide sound expenditure assignment which also constitute a key component to solving the issues of vertical and horizontal fiscal disparities, as "finance must follow function."

First, this is not the place for suggesting a specific and detailed assignment of responsibilities, but we should stress that sub-national governments should focus on organizing and delivering basic public goods and services and the management of social affairs while the central government should focus on country-wide issues pertaining to national defense, foreign affairs, macro-regulation and macro-environment, and equalizing sub-national government to fulfill their responsibilities The system also needs to introduce enough accountability mechanisms to provide incentives to sub-national governments to properly weigh spending on economic development and construction and other public services, especially those in the social areas.

Second, it is necessary to seek ways to assign exclusive responsibilities wherever possible. Practically in all decentralized countries, and this is certainly true of Australia, Brazil, Canada, the Russian Federation, and the U.S., there are a number of responsibilities that are exclusively assigned to local governments. This is even true in countries like Canada and the U.S. where the local governments are "creatures" of the states. Most decentralized countries have at some point or another struggled with instability, lack of clarity, and controversy in the practice of the assignment of competencies and expenditure obligations at different levels of government. In Brazil, India, and the Russian Federation, there is still a lack of exclusive responsibilities assigned to sub-national governments and a lack of clarity regarding who is responsible for what in the case of many overlapping functions. As in the case of China, the lack of clarity in assignments is more acute in the division of responsibilities between the intermediate level and local governments. In the Russian Federation, for example, the lack of clarity in the assignment of responsibility for primary and secondary education between the regional and local levels of government has meant that in some regions teacher salaries simply went unpaid as different government levels argued about who was responsible for paying teacher salaries. In India, the murkiness in assignments has meant a lack of monitoring and accountability for services, where in some states it has been reported that half of the teachers may not regularly be at the schools.

Of course, highly decentralized and successful federations such as Canada and the United States (U.S.) have taken years of friction and disputes to reach their current distribution of responsibility across levels of government. Thus practice can substitute for explicit assignments in the law, but relatively younger decentralized countries may avoid these costly transactions through more explicit and clear assignments. This is precisely what the Russian Federation attempted to do in the comprehensive Budget Code of 2002, although it fell short of achieving this aim.

Third, it is important to build broad and formal coordinating institutions to deal with assignments that stay concurrent. In order to clarify concurrent responsibilities it is important to explicitly assign the multi-dimensional array of attributes that go with assigned function, including: (i) actually producing a good or delivering a service, (ii) providing or administering the service, (iii) financing a service, and (iv) setting standards, regulations, and policies guiding the provision of government services. In addition, when multiple levels of government are involved in the same sector, broad and formal coordinating institutions are needed.

In Germany's "cooperative federalism" model all decisions are coordinated through an extensive net of multilevel committees. In the U.S., the pattern of assigning responsibilities varies widely from sector to sector and state to state, so sectoral coordination is done by technocrats in some areas where there is a clear need, such as highways and law enforcement. Somewhere in between the German and U.S. models are the practices of Australia, Canada, and New Zealand, countries that use periodic formal meetings of elected officials and bureaucrats to discuss mutually important fiscal issues. For example, Canada has two organizations for coordination, dialog, and conflict resolution: (i) functional federalism, in which ministers and officials from federal and provincial departments meet to discuss issues of policy coordination and program delivery mechanisms; (ii) summit federalism, where first ministers meet for negotiations of difficult "horizontal" problems, that is problems of one specific government department. Similarly, in Australia, the Council of Australian Governments (COAG) initiates, develops, and monitors the implementation of policy reforms that are of national significance and which require cooperative action by Australian governments.

It is worth stressing the role of the central government in these coordinating institutions. But on the other hand, central governments must resist the urge to intervene and go around formal expenditure assignments. This is often not followed in the international practice; often central government agencies play a larger direct role in service provision than theory and international best practice would suggest. In Brazil, for example, in a three-tier federation the municipalities share the same many assignments with the states as a result of the 1988 Constitution. However, the central government has found it difficult to withdraw from some purely local functions such as public markets, local schools, and local bridges after more than a decade since adoption of the 1988 Constitution. Another thorny issue to be avoided in the practice of expenditure assignments is the issuing of unfunded expenditure mandates. These were very common in the Russian Federation, until the approval of the Budget Code in 2002 that made them an illegal practice and forced the federal government to provide targeted transfers for each mandate.

Align the decentralized fiscal system properly to guarantee all citizens have access to basic public services regardless of where they happen to live

It is necessary to start considering the definition of national minimal standard for basic public services and ways to ensure that sub-national governments have the means to finance them. In this respect, some countries differentiate in the assignment of expenditure responsibilities to sub-national governments between “delegated” and “own” responsibilities. In the case of delegated responsibilities, the central authorities have the right to regulate and monitor the delivery of services at the sub-national level but also the obligation of ensuring financing and administrative capacity of sub-national governments.

The wide and increasing regional disparities in China for some very basic public services are not only inequitable but could be harmful to the country’s cohesiveness. Examples of areas where ensuring minimum standards are needed include: nine years compulsory education, basic hygiene and medical treatment, basic unemployment compensation and survivor and dependent insurance, and essential communal facilities.

Improving sub-national government efficiency through sound local autonomy

The degree of local autonomy is central to the effective functioning of a decentralized fiscal system. In most federal and unitary but decentralized countries, decentralization reaches local governments quite fully, with these jurisdictions having different degrees of revenue autonomy and exclusive responsibility for an array of functions and services. This status for local governments is the result of explicit legislation in unitary decentralized countries. In the case of mature federal systems, such as Australia, Canada, and the U.S., local governments are creations of the states or provinces, and local governments are not even mentioned in their constitutions. However, through traditions of self-governance and practice, local governments in these countries have achieved significant levels of autonomy and self-governance. It also is important to note that in these countries, although the states define and govern the local level, federal governments still have direct programs for local governments. In the case of other federal countries, such as Brazil, Mexico, and Russia, state governments have been reluctant to decentralize to the local level, which in turn has led federal governments to intervene. The most important issue to China decentralization reform is how to strengthen sound local autonomy. This issue has several facets:

First, autonomy should be built based on the right balance between devolution of responsibilities according to economies of scale, the internalization of costs, and available administrative capacity. There is no universal rule for the degree of autonomy that should be devolved to local governments.

In the revenue area, most federal systems provide local governments with their own sources of revenue, with autonomy to change at the margin, tax rates or other elements of the structure of the tax. A tentative list of the most widely used local taxes across countries would include property taxes, user charges, business license fees, permits and excise taxes, motor vehicle taxation, income taxes, and sales taxes. In countries such as the U.S., revenues collected from the property tax using modern appraisal and billing techniques represent a major source of revenue for local governments. In Brazil, the property tax represents a substantial source of revenue, although its application is through simplified forms of mass appraisal, using a few readily observable and measurable characteristics of each property. A piggyback, flat-rate income tax is a tax instrument with considerable potential to provide sub-national revenue autonomy, as the experience of Canada and the U.S. demonstrates as well as the experience of Japan and many European countries.

User charges and fees play an important role at the local level in mature federations. For example, local user charges in Australia, Canada, and the U.S. include highway tolls, public transportation charges, parks and recreation charges, water provision charges and so on. Besides creating a market-like connection between the costs and benefits of service delivery, user fees improve cost recovery and provide strong incentives for conservation, not wasting supply of the service, such as in the case of water provision.

Second, an asymmetric approach can be explored as a means to allow major cities and other local governments with more developed capacity to introduce piggyback income taxes and other forms of local tax autonomy or perform a different and wider set of functions. Greater revenue autonomy must be considered an important reform in putting decentralization to work at the local level in any decentralized country. Most sub-national governments need to augment their revenues due to the large share of committed expenditures and increasing needs. This can be accomplished in any number of ways, including increasing own source revenues, improving tax administration, and increasing intergovernmental transfers. Enhancing the revenue autonomy of sub-national governments would have the added advantage of increasing accountability and helping foster greater fiscal discipline. However, this is never an easy task, but the international experience shows that it can be done. Brazil’s approach to property taxation (i.e., field surveys, use of a highly simplified form of mass appraisal, and use of construction cost data) can be implemented by rural and urban governments to address the current weaknesses of the administration of the property tax system.

The comprehensive review of Russia's fiscal federalism undertaken by the Kozak Commission in 2002-03 resulted in a set of legal changes which, among other things, introduced a rather comprehensive set of asymmetrical designs for sub-national governments. In particular, separate packages of functions were assigned to each tier and type of local government (i.e., rural, urban). In Spain, historically there were large asymmetries on the expenditure side. This country had a "large responsibility" group of five regions that were assigned many more responsibilities that the general "small responsibility" group of regions. Over the past two decades Spain has gradually increased the number of responsibilities to the rest of the regions and nowadays all communities have similar capacities and take on the same responsibilities.

Third, a desirable way to provide revenue autonomy at the sub-national level is for the central government to create fiscal space for sub-national governments in the use of some major taxes, preferably the personal income tax and excises. The current framework of the current tax sharing system, although it does not provide sub-national governments with any autonomy, clearly indicates that it is possible to have multiple uses of the same tax base by different levels of government. This is consistent with international good practice in revenue assignment since multiple uses of the same base, if properly coordinated, is found to simplify administration and reduce compliance costs. Canada, the U.S., and many European countries have concurrent powers to levy income taxes at the federal, provincial/state, and local levels. In Canada, tax collection agreements between the federal and provincial governments provide for joint use of the same income tax base. The provinces, with the exception of Quebec and Ontario, set their own personal and corporate income tax rates, in a 'piggyback' fashion, as a percent of the rate charged by the Center. The taxes are collected by the central government and then remitted directly to the provinces. In most Canadian provinces, a local surcharge is levied at a flat, locally-established rate as a percentage of the national tax liability rather than the national tax base, and collected by the central government. This arrangement is known as "tax supplementation."

Similarly, in Switzerland, most cantons allow local governments to levy surcharges at locally-established rates on the cantonal income taxes. In the U.S., many states piggyback on the federal income tax, but the piggybacking does not extend to central collection, only to reliance by states, if they wish, on federal tax definitions, structures, and reported amounts. Most states levy income taxes separate from, but coordinated with, the federal income tax. There are two major coordination mechanisms in the U.S. These mechanisms are complementary, not mutually exclusive. First, states may choose to cooperate on tax administration with the higher level government through a regular exchange of information. Work by one level of government can generate revenue for another level at little or no additional cost. For example, at the federal level, the Internal Revenue Service may inform a state of an audit finding regarding an individual residing in that state. Second, states may choose to coordinate their tax base with the higher level government. For example, several U.S. states levy their state individual income tax on a taxpayer's amount of federal adjusted gross income, so that the state income tax form simply begins with a number extracted from the federal income tax form. Coordinating tax bases reduces administration and compliance costs and fosters greater coordination on tax enforcement between levels of government.

Other examples of countries with piggyback income taxes include Belgium, Denmark, Norway, Spain, and Sweden. Piggybacking arrangements provide sub-national governments with considerable revenue autonomy because they can set the tax rate, administer the tax separately if they so desire, and even limit the ability to define the base. Piggybacking arrangements allow the states and the Center to exchange information which can increase the effectiveness of enforcement activities. A drawback of piggybacking arrangements is that there are fiscal externalities across different levels of government; a simple form of fiscal externality is that state revenues may change whenever the federal government changes the definition of the income tax base.

In China, the current arrangement for tax sharing , with tax rates determined by the central government, can be complemented with piggy back separate taxes on personal income and excises, by providing sub-national governments with autonomy to alter their rates within the maximum and minimum rates legislated at the Centre.

Fourth, the reform in revenue assignments should be complemented with further reform of the tax system. The main objective should be that governments at each level should have a stable tax base and main tax (es), either exclusively or sharing the base with other governments so that it provides them with a good measure of revenue autonomy. This will be a big challenge for China's lower-level governments (counties and townships) since many of these jurisdictions are still isolated from a modern market economy, and rely mainly on traditional agriculture. However, land and property taxes should be considered as the best fit in the future for those levels of government. The further reform of the personal income tax making a broader more universal tax should provide adequate fiscal space for the introduction of piggyback taxes at the provincial and prefecture (city) levels. The reform of the tax system and revenue assignments must explicitly recognize the issue of tax mobility and tax competition across sub-national jurisdictions. Even with autonomy there has been increasing tax competition, taking place not always in a transparent and rational way. Although some degree of inter-jurisdictional competition can have desirable efficiency effects, excesses such as "a run to the bottom" should be avoided with suitable tax measures (for example, minimum rates for autonomous taxes).

Technically, the current structures of the VAT and corporate income tax still have serious problems. The production type VAT generates distortion in the market, especially regarding capital investment. The sharing of the corporate income tax, based on ownership, also creates distortions in sub-national government behavior, creating incentives for encroachment into the private sector.

Overhaul the entire intergovernmental transfer system

Intergovernmental fiscal transfers are used to correct for vertical and horizontal imbalances, inter-jurisdictional spillovers, and to promote national objectives. Most countries, the U.S. appears to be the lone exception, use equalization grants to address horizontal fiscal disparities among jurisdictions. All countries, the U.S. included, use special purpose grants of one type or another to promote national priorities and address inter-jurisdictional spillovers. Equalization grants and special purpose transfers also help reduce vertical imbalances or the mismatch between expenditure responsibilities and own sources of revenues for sub-national governments. Often different forms of revenue sharing, in themselves a type of transfer, are used to address vertical imbalances. However, the only fail-proof way to address vertical imbalances is to provide sub-national governments with an adequate level of revenue autonomy, as discussed in the previous recommendation. In short, a system of transfers is needed for many good reasons, but it can easily be misused, and transfers are not a substitute for a significant degree of tax autonomy.

In China, we have seen that current revenue assignment cannot guarantee all citizens have access to basic public services. On other hand, even after the reform of revenue assignments and the provision of greater autonomy at the sub-national level, requiring sub-national governments to rely exclusively on own revenues to close vertical imbalances may give rise to economically and/or politically unacceptable differences in the quality and quantity of critical social and economic services across jurisdictions. Although in practice countries differ in how, and if, they use equalization grants with measures of expenditure needs and/or fiscal capacity in their formulae, a well-designed equalization grant is a necessary instrument to reduce horizontal fiscal disparities among sub-national governments arising from differences in expenditure needs and fiscal capacity. Thus, while more revenue autonomy is desirable, the resulting fiscal disparities must be addressed through an equalization system; a useful rule of thumb is to design the system so that the richest sub-national jurisdictions are able to finance themselves from their own taxes while the rest of the jurisdictions are assisted by unconditional equalization transfers that close the gap in terms of existing fiscal capacity and expenditure needs. The definition and computation of expenditure needs in the system of equalization transfers should focus on minimum national standards in the provision of basic public services. But this last issue actually requires a wider focus.

The design of transfers is of critical importance for efficiency and equity of local service provision, autonomy, and fiscal health of local governments. In China, one of the current priorities in public finance is to allow all citizens to have access to basic public services. Consequently, the reform of the intergovernmental transfer system for both decreasing the regional disparities and addressing vertical fiscal imbalances should be based on national minimum standards for public services.

Canada provides some useful experiences from this perspective. The primary goal of intergovernmental fiscal transfers in the Canadian system is to maintain minimum national standards in provincial-local public services, thus compensating for vertical and horizontal imbalances between provinces. Accordingly, several block transfers are made to low-income provinces for this purpose. The major two are the Canada Health and Social Transfer (CHST) and Equalization Transfer. While the equalization program focuses on horizontal imbalances, the CHST is the primary means for closing the vertical fiscal gap. The equalization transfer is based exclusively on tax capacity.[1] As such, the equalization formula is based on the province's tax base capacity relative to the national average, in a way that does not provide a negative incentive to provinces to use their autonomous sources of revenues. The CHST is provided to fund health, post-secondary education, and social services according to provincial priorities.

Another important focus area is that the reform of the transfer system should provide not only a framework for central-provincial transfers but also frameworks for transfer systems at the sub-provincial level. These sub-provincial transfer systems should be designed to address horizontal fiscal disparities and allow upper level governments to address externalities and pursue policy objectives in their own interest through local government activities and budgets. Stability and transparency should be the emphasized characteristics in these reforms, in order to increase the predictability of local budgets. The use of formulas for the distribution of funds and also for the funding mechanism of the transfers is the key to transparency and stability.

The fact is that even in mature federations such as Australia, Canada, and the U.S., local governments rely heavily on transfers from federal and state governments. An ideal transfer system to local governments entails a combination of general-purpose and specific-purpose transfers, and the composition of this combination depends on the service mix provided by local governments. Local governments in other federations rely heavily on general purpose grants with relatively few conditions. Often, formula-driven systems are used to equalize horizontal fiscal disparities at the local level. In Australia, for example, general purpose, recurrent grants to local governments are determined using a discretionary growth factor each year. Canadian Provinces use different formulas: (i) some provinces recognize needs and fiscal capacity; (ii) others just recognize tax base deficiencies, in some cases just on the basis of property taxes; (iii) others do it by classes of municipalities, (e.g., urban and rural); (iv) others equalize on the basis of a few expenditure categories (i.e., mandatory expenditures such as police, fire, water and sewer, leaving out expenditures such as parks, culture, and recreation; and (v) others include all expenditure categories. The U.S. emphasizes conditional or categorical grants more than other federations, where funds are distributed according to factors to measure the needs of the community, capacity to provide public services, cost of providing public services, and tax effort made by the community to provide public services.

Another aspect of the reform of the transfer system is the necessary rationalization of conditional grants. The centrally sponsored schemes are an important source of revenue for sub-national governments in China, and they are justified on the same bases as conditional grants are in other countries: addressing externalities, pursuing national objectives, and so on. It is generally recognized, however, that there are too many schemes in China. Actually, the trend in China, with a continued growth in the number of schemes, has been in the opposite direction of the international trend toward rationalization into a smaller set of block grants. In China, the schemes provide a backdoor for central government agencies to micro-manage decisions that are ostensibly

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[1] Canada does not take into account differences in expenditure needs in the equalization grant, but other countries, such as Australia, take into account both expenditure needs and fiscal capacity in their formulas..

the responsibility of the sub-national governments, blur the lines of responsibility, burden the administrative capacity of sub-national governments, and reduce their budgetary autonomy. The implementation of the schemes in a non-transparent fashion and late in the budget cycle also significantly distorts the decision-making and budget priorities at the sub-national level.

A particular type of conditional grants requires special attention. These are capital transfers, which should be used to address externalities across local governments, assist with financing constraints for lumpy capital, ameliorate significantly different infrastructure endowments when these are not the result of voluntary decisions, and pursue sectoral objectives. Two major policy biases need to be openly addressed in the implementation of capital transfers. The first is the belief by some central authorities that capital expenditures are always more efficient than recurrent expenditures, and second, the lack of maintenance of existing infrastructure. Concerning the first issue, it must be acknowledged that the use of funds for properly operating infrastructure facilities can be as efficient as investing in the facility itself. Making sure that sub-national governments take ownership of the capital infrastructure is a key aspect for proper maintenance. Conditional matching grant arrangements can help sub-national governments to take ownership and more properly maintain infrastructure.

In the international practice, capital grants vary by the degree of flexibility in the use of the funds. They can either be specific project-based grants, which tend to be closely administered and monitored by line ministries, and categorical or block grants. Capital grants also vary by the way funds are allocated. The approaches include *ad hoc* decisions and negotiations, use of a pre-established formula, and competition processes with defined application procedures. There is no single best approach to the design of capital transfers, but non-transparent, highly detailed, and discretionary procedures should be avoided. Formulas based on needs and clients are often quite feasible. In Australia, for example, funding for school buildings based on the number of students is available. Although a few countries use a loan and grant combination for the implementation of capital grants, the vast majority of countries just use a grant formula often accompanied by matching arrangements. Matching arrangements can raise some liquidity problems for low income sub-national governments, but the matching rate can also be adjusted for fiscal capacity.

One particular issue that needs to be addressed in China is that the present process tends to generate low rates of return on investments because there is a bias in favor of taking up new projects while projects that are underway are not fully funded and are then allowed to languish and remain unfinished for long periods of time. The longer periods for completion lower the rate of return on projects. Besides, the states are underfunding maintenance and the current process does not provide any incentives to prevent this, which results in the faster deterioration in public infrastructure, further lowering the rate of return.

The institutional set up for the implementation of capital transfers varies across countries, but there has been a significant trend to remove the implementation of capital grants and capital budgeting from ministries of planning or economy and to integrate them with the rest of the budget process in ministries of finance. This has been an imperative result from the need to coordinate all aspects of budgeting. Despite that trend, countries often retain the vehicle of a PIP (Public Investment Program) but integrated into a Medium Term Expenditure Framework (MTEF) or multi-year budget that covers the entire budget.

Formalize sub-national borrowing

As we have seen, despite the fact that the Budget Code prohibits borrowing at the sub-national level, practically all sub-national governments in China borrow funds but do so in a non-transparent, inefficient and risky way. This situation calls for drastic reform to allow sub-national governments to borrow with a transparent and prudent set of rules.

The international experience suggests that local borrowing has the potential to generate significant benefits for local governments by allowing them to finance public capital projects, especially when the flows of taxes are not necessarily coincident with capital spending needs. For example, in the United States, most sub-national governments are prohibited from incurring current budget deficits; however, most state and local governments are allowed to issue long term debt for the purpose of investments in capital infrastructures such as roads, water and sewer systems, or drainage projects. In fact, various types of debt instruments are used by sub-national governments. State and local governments participate directly in the capital market by issuing bonds.[2] The advantage of relying on capital markets is that it serves to regulate and constrain state and local governments' issuance of debt. If the market perceives that a sub-national government entity is issuing an unreasonably large amount of debt which makes repayment less likely, the interest that the borrowing government has to pay will rise, making it a less desirable undertaking. Also lower ratings due to poor economic or fiscal conditions (including an already high level of debt) will result in higher interest rates for the borrowing government to pay. Bond guarantees is another advantage of relying on capital markets. A purchaser of an insured bond is guaranteed that, even if the local government is not capable of paying the interest and principal, the insurance company will.

In Canada, provinces may borrow funds for any purpose, and there is no internal or external federal control at all over provincial borrowing. However, municipalities are not permitted to budget an operating deficit with the exception that the municipality can secure short-term financing to meet current needs but must budget to repay that debt usually within the next fiscal year. However, it is common in Canada that local governments use long-term borrowing to finance municipal infrastructure investment. Although at least large municipalities have the option to go directly to the capital market, it is typical that there is a provincial authority through which or from which municipalities can borrow, and all the provincial government municipal financing corporations guarantee repayment of the debt that they issue. One major reason for this

[2] A competitive advantage for sub-national governments over other borrowers in a capital market is that the federal income tax does not tax interest earned by holders of such bonds. Therefore the interest rates paid by state and local governments are below those paid by other bond issuers.

approach is that municipalities are hierarchically ordered under the provincial government. The major advantage of the pooling of the municipal debt is that provincial guarantee provides lower interest rates than individual local governments would be able to obtain because it reduces risk to the lender; this arrangement is especially beneficial to smaller municipalities. Meanwhile, it helps to minimize the administrative cost because of economies of scale. It is also common in Canada for the provincial government to use subsidies to reduce the need for borrowing or to assist in meeting debt obligations. For example, the provincial government uses intergovernmental transfers to assist capital programs, introduce general interest subsidies on municipal (or local) government debt or provide debt relief. The federal and provincial governments sometimes lend funds for certain programs (e.g., environmental, housing) at reduced interest rates.

When financial capital markets are not sufficiently developed, the international approach has been to regulate sub-national government borrowing through a combination of rules, limits, and some timescentral government discretion. Where these rules are not properly set and enforced, sub-national borrowing can lead to substantial problems. In Brazil, for example, although there was extensive and complex legislation for controlling sub-national government debt, state and local government debt presented a troublesome growth pattern up to 1998, mainly due to extremely permissive rules in terms of debt rollover and the fact that the federal government got into a pattern of bailing out insolvent state and local governments. In most countries, the state exerts considerable control on total borrowing. For instance, in Germany, Länder and local authorities can only borrow for investment purposes, in proportion to their financial capacity, and subject to agreement by the interior ministry. Spain imposes similar limits to total debt service spending and only allows short-term borrowing to cover cash-flow requirements and long-term borrowing to finance public investment projects. In France, borrowing is not allowed to cover current expenditure or to refinance existing loans, but regional and local authorities have considerable latitude in deciding how much to borrow for capital expenditure. Some countries bring in greater controls over borrowing by sub-central governments. For instance, Austria introduced an 'internal' Stability Pact in January 1999 to help ensure that the overall deficit position for all levels of government does not exceed 3%. This is done by allowing very little margin for borrowing by sub-central tiers of government, who are only permitted to run an aggregate deficit of 0.3% of GDP. In Italy, borrowing is typically only undertaken for capital projects and it has imposed a similar 'internal pact.' Nevertheless, sub-national government access to credit markets is riddled with potential moral hazard problems. In some cases, federal intervention in the form of a bailout has been required even in mature federations, such as Canada, Germany, Sweden, and the U.S. To curb the moral hazard problem, the U.S. has introduced explicit bankruptcy procedures through financial control boards; other countries, such as Hungary have also introduced explicit bankruptcy procedures for sub-national governments.

A typology of approaches in the international practice used to control sub-national borrowing includes the following: (i) *Market discipline*: In this type of control, higher level governments typically stay out of any direct involvement with local borrowing, and instead the system relies on market forces to ensure that local debt is managed, controlled, and disciplined. For this system to operate well, certain conditions are required, including: free and open financial markets, easy availability of information on local debt and repayment capacity, and no bailout expectations. Countries that rely on this approach include Finland, France, Portugal, Spain, and the U.S. Nevertheless, some of these conditions are often not met in developing countries (ii) *Direct administrative controls*: Higher level governments directly control the borrowing of local governments with limitations on debt, restrictions on external borrowing, and approval of specific investment projects. This approach is found in developed countries, such as Austria, Canada, Ireland, Japan, Spain, U.K., and many developing countries, such as Argentina, Bolivia, Brazil, Chile, Colombia, India, and Mexico. The advantage is that higher level governments have a better handle on coordinating the overall country debt, including external borrowings. The disadvantage is that this strategy diminishes local government autonomy to make investment decisions according to local circumstances. (iii) *Cooperative controls*: Limitations on local borrowing are negotiated between higher level governments and local governments. An agreement is reached regarding overall deficit targets, revenue and expenditure growth, and controls on local government debt. Examples include developed countries, like Canada where municipalities are bound by provincially set rules and processes of approval administered directly by a provincial ministry or agency. However, this requires effective cooperation and fiscal discipline. In the absence of cooperation and fiscal discipline, this approach is unable to prevent excessive debt, as the experiences of Brazil and Colombia demonstrate. (iv) *Rule-based control*: Actions of local governments are prescribed in various rules written in the constitution, law, or regulations. These may establish limits on the level of allowable debt, limits on debt-service capacity, stipulate limitations on the type of borrowing (e.g. capital projects), and the like. This approach is transparent, and it treats all local governments equally. However, it gives local governments an incentive to devise schemes that attempt to avoid or evade the rules, such as reclassifying current expenditures as capital expenditures, creating off-budget agencies and even government-owned enterprises, and relying on payment via arrears. Its success depends on the ability to monitor compliance with the rules.

International experience also suggests that sole reliance on only one of these approaches may not be sufficient. For example, in the U.S., all local governments are required to have balanced budgets, but the effective borrowing constraint imposed by such requirements, even when written into the state's constitution, is often limited. Often the requirement only applies to the budget, excluding social security and capital spending; in some cases, the requirement only refers ex ante to the formulated rather than the realized budget; and there may be other escape clauses, including extra budgetary sources of funds. Effectively, therefore, market discipline plays an important role in achieving borrowing discipline (Ter-Minassian and Craig, 1997). In Germany, the budget laws specify the conditions under which sub-national borrowing can be undertaken. Local authority borrowing is limited to cash flow needs and is subject to approval by the Länder (state) authorities. In practice, there are weaknesses in both the formulation and application of the Länder laws. The investment requirements are specified ex ante rather than ex post and the interpretation of what constitutes investment is flexible. Spain is another example where multiple approaches are used to control local borrowing, including a market approach, legal rules, and cooperative controls. In addition, ministry of finance approval is generally required for domestic borrowing, but there are some exceptions, including for those local authorities covered by Autonomous Communities.

On the supply side for sub-national credit, the international experience offers two main models of fund supply: the bank lending model of Western Europe, and the municipal bond model of North America:

(a) Municipal bank lending: This approach is founded on three principles: (i) municipal banks establish lasting and stable relationships with the local government, which is helpful to small municipalities that need assistance with project preparation, financing, and implementation; (ii) municipal banks perform the function of delegated monitoring; however, this may be inefficient, except in the case of a large loan; and (iii) municipal bank operations are characterized by bundled services and bundled pricing. In some cases where municipal banks have had little or no history of relationship banking, financial deregulation has forced them to lend like commercial banks, and municipalities are constrained to accessing short-term loans.

(b) Municipal bond market: This model offers contrasted features to the municipal banking approach, as follows: (i) instead of a banking relationship, this model is based on competition. Each bond is subject to competitive bidding which results in large savings for large and established municipal issuers. However, this is not so useful in serving the lending needs of smaller and inexperienced local governments. Although credit pooling has proven to be partially successful in meeting the financing needs of less creditworthy local governments, such as the state bond banks found in the U.S., where a special state intermediary with a superior credit rating raises funds through bond issuances and on-lends to local governments by purchasing their bonds. (ii) The municipal bond model is based on public monitoring as opposed to delegated monitoring. The creditworthiness depends on the public disclosure of municipal financial information. (iii) The bundled services received from a municipal bond are typically unbundled in a municipal bond market. Municipalities can decide to receive advisory services from various institutions other than the municipal bank. These can be purchased on the basis of a competitive bid thereby lowering project costs.

The review of the international practice in the above paragraphs provides potentially useful starting points for the structuring a reformed approach to sub-national borrowing in China.

Improving local expenditure management

Although fiscal decentralization can improve the efficiency of public expenditures, due to the information advantage of local governments as well as the use of incentive compatible mechanisms for local governments, China's experience shows some important shortcomings in realizing these potential efficiency gains. One significant feature of China's decentralization system bearing on the issue of efficiency is that the accountability of sub-national government officials to local residents is rather weak; the direct appointment of officials tends to make them mostly accountable to the upper/central government authorities. In this scenario, improving the quality of expenditure management takes special meaning.

The current budgeting system in China lacks adequate procedures for planning, control and audit of budgets, and there is a wide perception that a significant share of government budgets are wasted or misdirected.[3] Improving expenditure management at the sub-national level should be on the agenda for future fiscal reform. The clearer definition of expenditure assignment and the transparency of public expenditure should play an important role in improving local expenditure management. But further measures should be considered.

A particularly important item in the reform agenda should be to find the means for increasing the accountability of local governments to their residents by empowering the community and even institutions to demand certain standards in the delivery of services. Different approaches have been used in the international experience. Local governance in some countries is reinforced by institutions that facilitate the involvement of civil society in the delivery of public services. For example, in Canada, Local Boards are not-for-profit, community-based organizations comprised of volunteers from business, labor, education, and community groups which support local governments in a variety of ways. Similar institutions exist in the U.S. In the education sector, for example, there is evidence that community managed schools can lower teacher absenteeism and improve schooling outcomes, as has been the case in now well-known initiatives, such as the EDUCO program in El Salvador, and similar programs in Nicaragua and in India's state of Madhya Pradesh.

There is also a need for greater fiscal discipline at the sub-national level. The international experience shows different countries have been using different approaches to increase fiscal discipline among sub-national governments:

(a) <u>spending limits</u>. It has become more common for countries to introduce expenditure rules to impose ceilings on specific areas of expenditure or for particular programs. The advantage of capping expenditure is that the process is well understood by players in budget negotiations and the wider public, and it tackles deficit bias by addressing the principal source of rising deficits. In addition, governments are made accountable for what they can control most directly, as opposed, for example, to deficit limits. In the U.S., many studies have concluded that the specific expenditure ceilings embodied in the

[3] To some extent, public expenditures have also been gripped by corrupt activities. For example, it was estimated by the *Law and Regulation Daily* that the total public expenditure on banquet (Gong Kuan Chi He) was over 100 billion yuan a year in 2002. The daily press also has released cases of government officials gambling with public funds (Guan Du) and so on.

Budget Enforcement Act have played a significant role in reducing expenditure.[4] In Canada, the Fiscal Spending Control Act of 1992 established a nominal expenditure limit for the period 1992 to 1996. In addition, since 1994 the government introduced several policy rules that were not formally legislated. The main objective was to control public expenditure growth, reduce fiscal imbalances, and stop the increase in public debt. The deficit of 5 per cent of GDP in 1995 became a surplus of more than 1 per cent of GDP by 1999, and the ratio of net public debt to GDP was reduced from around 70 per cent in 1995 to 52 per cent in 2000. (Daban et al, 2003). Other countries like Finland, the Netherlands, and Sweden have also emphasized expenditure limits, supported by procedural requirements, whereby proposals resulting in overruns in certain expenditure areas must be accompanied by offsetting expenditure cuts elsewhere or by revenue increases.

(b) <u>increased budgetary transparency</u>. New Zealand pioneered an approach to fiscal management and budget control that places primary and explicit emphasis on transparency with the Fiscal Responsibility Act of 1994. Australia and the U.K. have since adopted similar approaches, as has Brazil and other countries in Latin America.

(c) <u>designing explicit deficit and debt rules</u>. This is the most common approach to fiscal discipline in the international practice; in particular, the commitment to these rules makes it easier for fiscal authorities to withstand pressures for higher spending. On the other hand, this type of rules can be broken through a variety of informal approaches.

All these budgetary innovations around the world can have useful applications in the reform of China's budgeting system. Expenditure limits may be an effective tool for controlling deficits at the sub-national level, although the effectiveness of this approach depends heavily on quite independent executive and legislative powers. Lack of budgetary transparency is a serious problem in expenditure management in China given the still significant importance of extra-budgetary and off-budget expenditure channels. Increasing budget transparency and efficiency by incorporating all extra and off budget activities into the respective government budget is the obvious step. One difficulty lies in the fact that these reforms need to be coordinated with other aspects of the reform, such as providing more significant equalization grants to poorer jurisdictions and more revenue autonomy in general to all sub-national governments.[5] Setting explicit rules for debt level and debt service can also contribute to fiscal discipline. However, there are already rules, such as the prohibition to run deficits or to borrow, which are neither respected nor enforced.

Budgetary management and public expenditure efficiency can also be related to the vertical administrative structure of government. These are always difficult issues to address because the vertical structure of government sometimes has to do more with

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[4] This approach may have been better suited to the U.S. budget process than the earlier deficit reduction targets contained in the Gramm-Rudman-Hollings Act, which provided for automatic spending cuts to take effect if the president and Congress failed to reach established targets

[5] Note that there appears to be some evidence that the poorer jurisdictions tend to rely more heavily on extra-budgetary expenditure and other charges.

history and tradition than with any notion of efficiency per se. Nevertheless, the current vertical structure of government in China also needs to be reassessed, in particular whether five levels of government is an efficient structure and whether less discretion and more explicit rules for dealings with different levels is desirable.

We have seen in this paper that the current government structure clearly allows upper-level governments to abuse their position by decentralizing too many responsibilities and not enough resources. This leads to highly inefficient situations and reduced citizen welfare. In particular, a lot of expenditure responsibilities are taken by the township governments, which in many cases lack the necessary capacity for the provision of public services. At the other end of the structure, there is a growing perception that the government at the prefecture level may be quite redundant and that it may be contributing sometimes to distorting central government messages.

APPENDIX: The Evolving Role of Extra-Budgetary and Off-Budget Funds in the Financing of Social Services at the County and Village Level in China

I. Introduction

It has long been a tradition that the fiscal reforms in China only tackle the revenue side of the budget, while leaving things untouched on the expenditure side.[6] The latest comprehensive tax reform in 1994 and the subsequent changes in revenue assignments are no exception in this regard. Different from most other countries, in China it is the lower level of sub-national governments who take the responsibilities of financing and delivering not only public education, public health, but also social security and the safety net. The five-layer hierarchical government structure and lack of well delineated expenditure assignments among level of governments make it often possible for higher-level governments to shift expenditure responsibilities to lower-level governments, without allocating corresponding revenue sources to finance them. Even worse, the central government has often issued some mandatory expenditure items that the local governments are required to fulfill, while no corresponding funds have been allocated to implement those new expenditure responsibilities, converting those orders into “unfunded mandates.”

However, in the meantime, the lack of formal revenue autonomy makes it hard for sub-national governments to access additional fiscal resources; this situation is especially critical for lower-level governments, including country and township governments that are typically left with very restricted budgetary flexibility. It is well known that, with the exception of only very few minor local taxes, the rates and structure of taxes are generally determined by the central government. A further budgetary restriction is the fact that local governments are not allowed to borrow, which shuts off a major financing source typically available to local governments in decentralized countries. For many years now, along a trend toward re-centralization practically since the 1994 reforms, the center has been keeping more and better revenue sources to itself, while leaving sub-national governments with less productive and more narrowly defined revenue sources.

The most conspicuous consequence of this lack of sufficient revenue sources and tax autonomy has been to make it increasingly difficult for local governments to perform the basic functions assigned to them. In this light, it is not surprising that quite often the quality and quantity of public services at the local government level have been deteriorating. On the other hand, the pressure to deliver on their expenditure responsibilities, especially from the mandates issued by the center, has prompted lower-level governments to exercise “informal” revenue autonomy in a variety of ways.

The first has been the introduction of fees and surcharges well beyond what has been prescribed in the law. These “informal” (or “illegal”) fees and surcharges now comprise one of the major sources of revenues at the local level. It is important to note that that these “informal” fees have contributed significantly over the years to funding the basic expenditure needs and public service provisions of local governments. But at the same time, for many good reasons the proliferation of “informal” fees at the local level has become a big concern for the central authorities because of the distortions created in the allocation of resources, compliance costs for taxpayers, and more importantly, their potential unfairness and regressivity vis-à-vis poor households.

In this note, we review the nature and evolution of extra-budgetary funds at the local level in China. Our interest is to research the role extra-budgetary funds have been playing in the financing of social services at the country and village level in China. Establishing this role is critical for assessing the impact of central government policies targeting the reduction or elimination of these funds. To the extent that many of the “informal” fees are regressive, their elimination should contribute to making the impact of local budgets fairer. However, the significant reduction of this source of revenue for local governments without adequate replacement in terms of new tax assignments or transfers from upper levels inexorably would lead to the reduction of the quality and quantity of local public services, of which social services for education, health and welfare represent the lion’s share. This reduction in social services should be regressive because the benefit incidence of these services is well known to be progressive or pro-poor. Therefore, an assessment of the on-going central government polices would need to be made in the context of the net fiscal incidence, taking into account not only the incidence of revenue sources but also the incidence of expenditures.

Establishing the nature and evolution of extra-budgetary funds at the local level is an important piece of the required analytical process for assessing current policies. This is what this note attempts to achieve. The rest of the paper is organized as follows. In Section 2 we review the nature of extra-budgetary funds. Section 3 analyzes the evolution of these funds. In Section 4 we highlight the main features of extra-budgetary and off-budgetary funds, while in Section 5 we attempt to quantify the off-budget revenue flows. Section 6 assesses the current situation.

II. The Definition of Extra-Budgetary Funds

The term ‘extra-budgetary funds’ originated from the fiscal systems of the former Soviet Union, where they were used to provide additional revenue from sources outside of the budget. In China, this term has been used traditionally for the “official part” of extra-budgetary funds that are formally recorded in the statistical yearbooks of China.[7]

In the latest yearbook available to us (2003), the official definition of extra-budgetary fund is:

[7] Statistics used in this appendix, unless otherwise noted, are from Statistics Yearbook of China and Financial Statistics of China, various issues.

"…financial fund of various types not covered by the regular government budgetary management, which is collected, allocated or arranged by government agencies, institutions and social organizations while performing duties delegated to them or on behalf of the government in accordance with laws, rules and regulations."(page 306)

Based on this definition, extra-budgetary funds mainly cover the following items: administrative and institutional fees, governmental funds and extra charges that are stipulated by laws and regulations; administrative and institutional fees approved by the State Council and provincial governments and their financial and planning (price management) departments; governmental funds and extra charges established by the State Council and the Ministry of Finance; funds turned over to competent departments by their subordinate institutions; self-raised and collected funds by township governments for their own expenditure; social security funds and other financial funds that are not covered in budgetary management.

This definition of extra-budgetary funds is a relatively narrow one. In effect, revenue based on this definition only consists of part of the outside-budget revenue sources that different levels of governments collect and use at their discretion to finance public goods provision, fulfilling other expenditure responsibilities and even satisfying the local officials' personal interests. This portion of revenue under this official definition, even though not in the budget and therefore not subject to the governments' formal budget control, is monitored and constrained by various levels of governments, though to a lesser extent than budgetary sources. The Ministry of Finance in the "Implementation of extra-budgetary funds administration (1996) stipulates that special accounts should be opened by the financial departments in banks for the management of revenue and expenditure of these extra-budgetary funds. In addition, the management of the revenue and expenditure are required to be conducted separately, or, as it is put in the 2003 yearbook,

"revenue of institutions and departments must enter into the special accounts of the financial departments at the same administrative level, and their extra-budgetary expenditure is arranged in line with the extra-budget plans and appropriated from these accounts" (Page 306)

As a result, compared with budgetary funds, even though local governments usually have more discretion over these extra-budgetary funds, they are not completely at the discretion of local governments. Nonetheless, local governments do gain greater autonomy over these funds (vis-à-vis regular budget funds) because there is no need to remit the revenue to the center. This is exactly the idea behind the creation of the funds in the first place. For these reasons, local governments often attempt to divert regular budgetary revenue to extra-budgetary revenue. Of course, this practice contributes to a lower share of central government revenue in total revenue.

Besides these officially authorized extra-budgetary funds, which are somewhat imprecisely recorded in the government statistics, there are some other kinds of revenue sources, sometimes informal other times illegal, that fall within local governments' control. Scholars have used different terms for these additional funds, including "off-budgetary funds," "out-of-the-system funds," and even "illegal monies,"etc. These other funds, of course, are also outside of the regular budget and usually provide local governments with fuller discretion over their usage.[8] However, these revenue sources also contribute to the revenue pool available to the local governments, which are possibly used to finance public service delivery and other government functions.

In a broader sense, extra-budgetary funds can be imprecisely defined as "all funds collected by every level of government and their agencies, but that are not budgetary funds" (Wong 1997). However, there are no data for this broadly defined extra-budgetary fund. This is partly because the extra-budgetary funds are not only usually vague by definition, making it difficult to measure their size, but also because local governments have discretionary power over them to a higher extent than the regular budgetary funds or the official extra-budgetary funds. This makes local governments not only reluctant to report the revenue, but also often try to conceal them entirely in order to obtain higher revenue autonomy.[9] The illegitimate nature of collecting some of the fees and surcharges also contributes to the underreporting or non-reporting of the funds.

Consequently, it is nearly impossible to determine the magnitude of this broadly based extra-budgetary fund. The data in the statistical yearbooks provide only an estimate of the officially defined extra-budgetary fund, which will be our subject in the analysis below. For other parts of the extra-budgetary funds, there is at best some anecdotal evidence available, mainly estimations done by scholars in various studies. When we take into account the fact that local governments have more discretionary power over the extra-budgetary funds, especially those not under the supervision of the central government, we can reasonably expect that local governments' behavior in pursuing off-budgetary funds and the like is at least as vigorous as that of pursuing the official extra-budgetary funds.

At any rate, even though we intend to discuss here the role of the broad extra-budgetary funds, we are necessarily limited to using only data on the official extra-budgetary funds to illustrate their size and trends. Actually, even for the officially defined extra-budgetary funds, we only have data for provincial level governments; data for sub-provincial level governments (prefectures [cities], counties and townships) are not available. Our working hypothesis is that the provincial data for the official extra-budgetary funds provide us with a roughly accurate representation, if not of the overall level of these funds, of their trend and evolution over time.

III. The Evolution of Official Extra-Budgetary Funds

It is important to recognize from the start that even the definition and the main components of the official extra-budgetary funds have been changing over time, along with the changes in macroeconomic conditions and successive fiscal reforms.

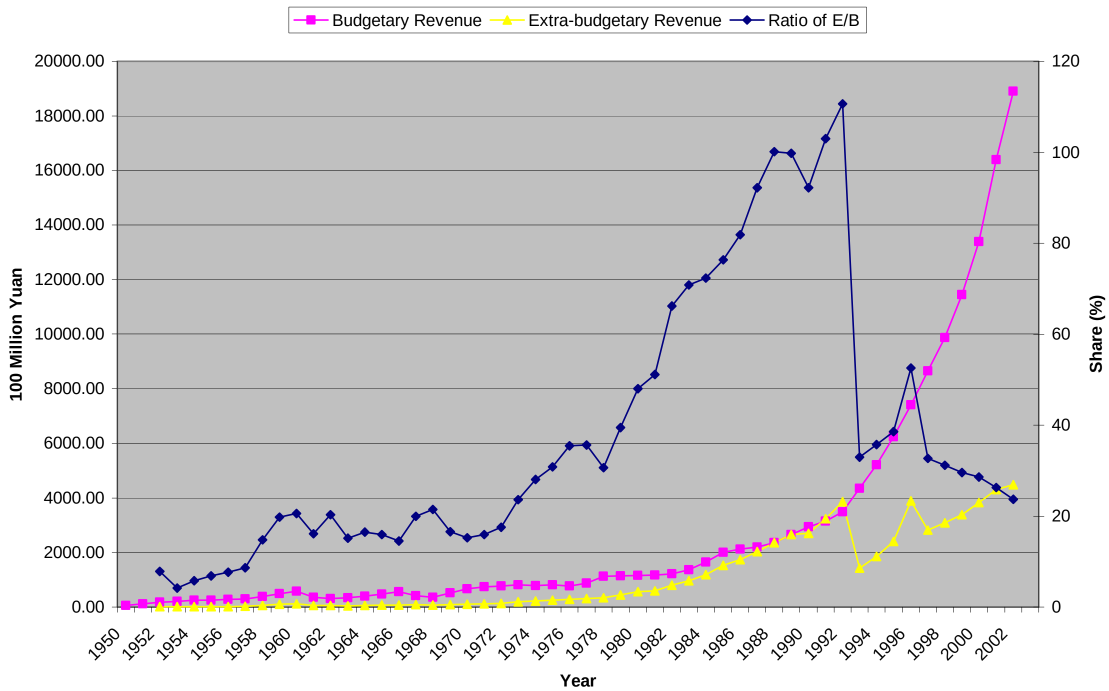
[8] For example, Wang (1997) points out that off-budgetary revenue, which comes from "ad hoc charges, unauthorized fees, forced 'contributions', and the like," is completely outside central government's reach and under local governments' full command.
[9] The blurriness in definition is true even for the official definition of extra-budgetary funds

Extra-budgetary funds date back to the early 1950s, when local governments were allowed to collect some small amounts in tax surcharges outside the official budget in order to supplement their funding for local financial needs. This supplementing revenue source left to the local governments' discretion was clearly meant to give local governments some degree of revenue autonomy.

The size and magnitude of the official extra-budgetary funds have experienced several big changes since they were first introduced, which can be observed from official statistics in the yearbooks. In 1952, besides local governments, the only other major category of agents that could carry extra-budgetary fund collections was state-owned enterprises and their administrative departments. Starting with 1953, administrative units and institutions were also allowed to carry extra-budgetary funds. In 1955, enterprises' bonus funds and major repair funds also became part of the extra-budgetary funds. Other sources of income, such as rental income from publicly owned housing, user fees, surcharges for public utilities, and others were later on added to the allowed sources of extra-budgetary funds (Wong, Heady et al. 1995). During those early years, revenue from state-owned enterprises and their administrative departments represented the lion's share of the extra-budgetary funds: about 50-60% of total EBF for most of the years and never fell below 40%. After 1973, this share rose to over 70% and 80% and was as high as 83% in 1984.

As we can see from the comparison between the extra-budgetary revenue and budgetary revenue in Chart 1 below, the ratio of extra-budgetary revenue over budgetary revenue has exhibited an increasing trend since the very beginning. It was lingering between 10-20% before 1975, and then showed a fast growing trend starting from the level of 30% in 1978 to outgrow budgetary revenue in some years after 1988, with the ratio reaching as high as 110% in 1992. This trend is explained in part as the result of the devolution of administrative power from the government sector to state-owned enterprises (SOEs) in 1978. These measures not only allowed SOEs to keep the depreciation funds and after-tax profits without remitting them to the different levels of government,, but the SOEs also were given greater incentives to conduct profit-making production activities, and with greater autonomy. In this manner, a huge amount of revenue was accumulated and kept away from the official budgetary sources of revenue.

Chart 1 Comparisons of Total Budgetary and Extra-budgetary Revenue

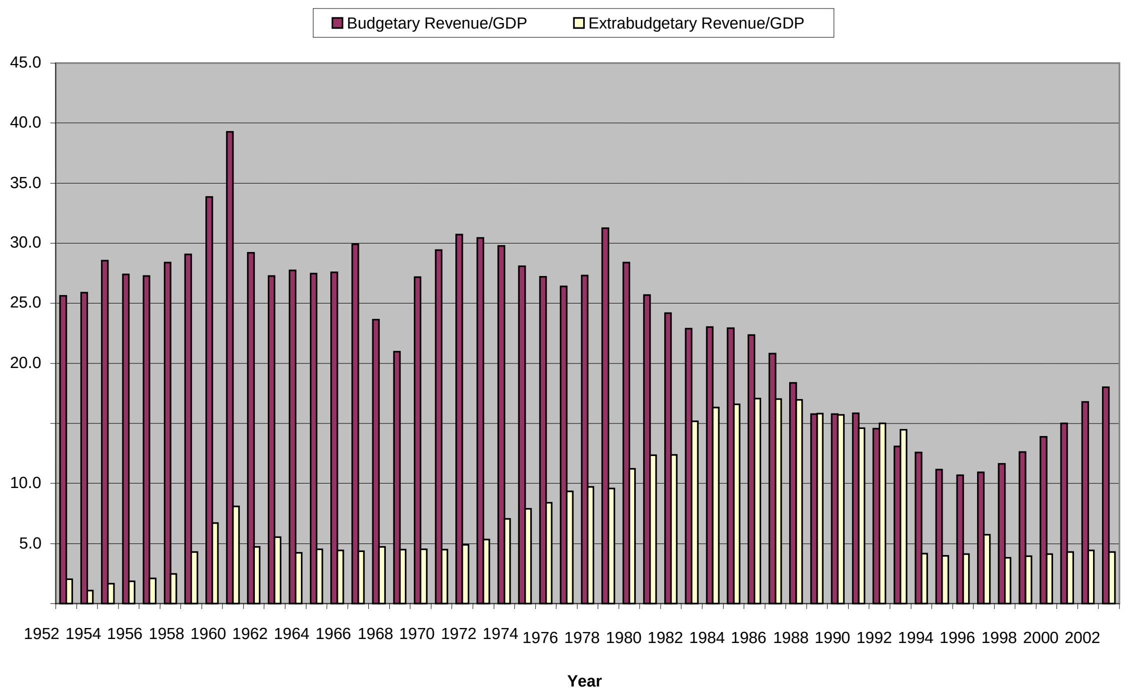


In the interim, the share of budgetary revenue over GDP had been exhibiting a decreasing trend. As illustrated in Chart 2, the share had been in the range of 25-30% throughout most of the years since the early 1950s.[10] However, starting from the early 1970s, when the size of extra-budgetary revenue started to climb up the scale, the share of the budgetary revenue over GDP started to exhibit a downward trend. By the end of the 1980s and the early 1990s, the shares of budgetary revenue in GDP were equivalent to that of extra-budgetary revenue, and in 1991-92, the latter even outgrew the former, as can be observed in the previous charts.[11]

[10] With the exception of 1959-60 when the share exceeded 30% and almost reached 40%, and 1968-69 when the shares fell below 25%.

[11] Wong (1997) presents a detailed description of the items included in each of the categories for years before 1992. For example, EBFs under local governments include industrial-commercial tax surcharges, urban public utility surcharges, and agricultural and animal husbandry tax surcharges. EBFs under SOEs and their administrative departments include renovation and reconstruction funds, retained profits major repairs fund, technical development fund, oilfield maintenance fees, and natural gas exploration fund.

Chart 2 Ratios of Budgetary and Extrabudgetary Revenue to GDP



By 1993, the central government had come to realize that the major sources of revenue had fallen outside of the government's budget control; actually, the share of budgetary revenues over GDP had decreased from the previous level of 25%-30% to about 10%, thus jeopardizing the central government's ability to maintain macroeconomic stability, performing income redistribution, and other conventional roles. One measure taken to address this situation was to exclude the revenues from SOEs and their administrative departments from the EBF. As a result, the share of total extra-budgetary revenue to total budgetary revenue dropped dramatically, from over 110% 1992 to only 33% in 1993. This can also be seen clearly from Chart 2, in which the share of extra-budgetary revenue over GDP dropped from about 15% in 1992 to less than 5% in 1993. This dramatic change was in large part the result of the fact that EBFs formerly belonging to the SOEs were formally alloted into the regular budgets.

In addition, starting in 1996, self-raised funds by township governments, a major source of extra-budgetary funds at the township government level, were included in the accounting of total extra-budgetary funds. However, at the same time, the central government began to "discipline" the collection of extra-budgetary funds by bringing some of the revenue sources outside the budget into the budgetary control, including the revenue from "governmental funds" and fees local governments were allowed to collect by law.[12] From 1997 on, those funds and fees have been brought into government

12 There is no exact definition for "governmental funds." However, one interpretation based on a number of sources is that "governmental funds" cover funds stipulated by laws and regulations or established by the State Council and the Ministry of Finance, which are not included in the regular budget. These funds are used for fulfilling different government functions, including industry and transportation sectors, culture and education, social insurance, government housing and so on.

budgetary management and have been excluded from the extra budgetary revenue. Partly as a result of that, as we can see from both Chart 1 and 2, budgetary revenues have been increasing sharply as a share of GDP. Extra-budgetary revenues have also experienced some moderate increase in absolute terms, remaining stable as a share of GDP. However, the ratio of extra-budgetary revenue over budgetary revenue has continued to decrease, with the downward trend becoming more apparent after 1997.[13] On the expenditure side, extra-budgetary funds also represent an important share. As reported in OECD (2006), extra-budgetary expenditure reached 3.4% of GDP or about one-sixth of all budgetary expenditures in 2003.

IV. Some facts on extra-budgetary and off-budgetary funds

Extra-budgetary revenues have long been important local government revenue sources in implementing their expenditure responsibilities. “The practice [of tapping extra-budgetary funds to finance government expenditures] is so pervasive that extra budgetary funds are commonly considered a ‘second budget,’ whose availability substantially alleviates the revenue squeeze at the local level” (Wong 1991). As we saw from the statistics earlier, in some years the amount of extra-budgetary revenue sources was even comparable to or greater than the budgetary revenue. In some years when the budgetary revenue was low and could not even satisfy the needs for those mandatory expenditures, budgetary revenue could at most be enough for “subsistence” (*chifan caizheng*) (World Bank 2002). Extra-budgetary funds have also been instrumental in allowing sub-national governments to adapt and absorb a variety of central government mandates.[14] One of the most important mandates has been “the setting of wages for local civil servants by the central authorities,” without allocating sufficient revenue sources to pay for them (Bahl and Martinez-Vazquez 2003); another example of an unfunded mandate is provided by the National Education Law, which required that the budgetary expenditure on education should achieve 4% of GDP by 2000(Wong and Bird 2004).

Meanwhile, the 1994 Tax Sharing System (TSS) reform was oriented to recentralize revenue sources. The TSS reform established a separate system of tax collections for central government revenues; the national tax administration agency became responsible for the collection of not only all central taxes, but also all shared taxes. The local tax administration was left responsible for the collection of only local taxes. Even though there are still various links between national tax administration officials and the relevant local authorities where they operate, local governments cannot

[13] Due to the changes in the scope of extra-budgetary revenue and expenditure over years, the official statistics explicitly state that the data in 1993-1995 and 1996 are not comparable with previous years. The data after 1997 have changed again and are not consistent with previous years. Therefore, to be consistent, our analysis below will focus on the data after 1997.

[14] Clearly, the issuance of unfunded mandates by the central government has not been independent from the perception at the central level of the ability of sub-national governments to absorb these additional responsibilities because of sizable extra-budgetary funds at the sub-national level. The lack of information of the size of the extra-budgetary funds makes it impossible to judge how much of a burden these measures actually represented for sub-national governments.

access any longer the revenue sources that are within the national tax administration's jurisdiction; the latter represent the major portion of formal tax revenues. In addition, local governments are not allowed to borrow, even though there have been some informal borrowings between local governments and SOEs and other entities.[15] The recentralization of revenue sources and the unavailability of borrowing represented a severe fiscal shock for many sub-national governments.

Another important feature of intergovernmental fiscal relations in China that frames the importance of extra-budgetary funds is the fact that there is no well-established transfer system. The budgetary consequences of the recentralization of revenues for many sub-national governments and their ability to provide basic services were not sufficiently buffered by equalization and other types of transfers. Actually, transfers between the center and the provinces have often been based on the individual province's bargaining power rather than expenditure needs, and provinces with better economic conditions are the ones with greater bargaining power, while poorer provinces with greater financial needs lack bargaining power. The consequences of this system for poor localities often have been aggravated by the fact that the funds reaching the provinces could be largely retained at these higher levels of sub-national government and never be passed on to local governments.[16]

The lack of adequate budgetary revenue sources on the one hand, and pressures from their expenditure responsibilities on the other, have legitimized the role of EBF as a source of sub-national government financing (World Bank 2002). As the expenditure items shown in the official statistics, EBF have been used on capital construction, administration and operation, as well as on other outlets, and also as township level government expenditure sources throughout the years and on urban maintenance since 1999. Therefore, extra-budgetary funds have been an indispensable part of general revenue source in fulfilling functions of local governments.

V. Off-budgetary revenues

As we briefly mentioned earlier, the EBF in the official statistics only capture a part of the outside-of-budget revenues that local governments and administrative agencies collect and spend. Off-budgetary revenue are neither under the governments' budgetary revenues nor under the extra-budgetary administration; these revenues appear to be substantial revenue sources that are under local governments' full discretion. These revenues mainly consist of fees and surcharges authorized or unauthorized but implicitly approved by the governments, or simply the so-called illegal fees. Although regulations and guidelines from central or higher-level governments have prohibited using these

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[15] Local governments used to be able to borrow funds in the banking system, and this option was not available anymore after the financial reform and changes in the banking system.

[16] In more recent years, the central authorities have reacted by providing more transfer funds to the poorest provinces; thus it has often happened that the richer and poor areas can often get the help they need, while the areas with middle-level income do not get much help from the center, leading to a reversal: lower income areas being better off than middle income areas.

illegal fees and charges, it appears that local governments have continued to use them.[17] Not only were budgetary revenues diverted into extra-budgetary revenue, but also extra-budgetary revenues have been sneaked into the off-budgetary revenues, the reason being that the latter give local governments more discretionary power. The off-budget revenues have enabled local governments to gain additional autonomy in expenditure decisions, including delivering local public services, paying off wage bills of public servants, maintaining and improving local administration conditions, and so. But in addition, it is quite likely that there have considerable amounts of these funds being used to satisfy the personal interests of local government officials, including personal "perks" or direct cash bonuses; all this, of course, has provided local governments with strong incentives to continue to collect them.

As the central government increased efforts for bringing more extra-budgetary revenue items into the regular budgets, local governments' collection activities of extra-budgetary revenue and off-budgetary revenue became more aggressive with greater reliance on the socalled "illegal" fees. Because of information asymmetries, the central autorities continued to have problems in effectively monitoring the behavior of local governments. These usually illegal monies have been called different things including the "'three arbitraries' (*san luan*), 'arbitrary taxation' (*luan shoufei*), 'arbitrary fines' (*luan fakuan*), or 'arbitrary apportionments' or expropriation (*luan tanpai*)" (Wedeman 2000). These arbitrary levies, it is widely believed, have produced significant distortions in resource allocations, driven up the compliance costs for taxpayers, and even become a deterrent for investments in some areas. In rural areas of China, these fees and levies have long been a heavy burden on farmers and, given their coercive nature and often improper usage, they have contributed to social instability in rural China.

The size of the off-budgetary revenue is not really known. Unlike the case of the officially recorded EBF, off-budgetary funds are usually not accounted for in any formal way. Adding to this lack of information is the fact that some of them are one-time affairs, collected for financing some special projects and spent accordingly.[18] Several researchers have attempted to estimate the size of these funds. For example, Ping (2005) estimates that in 2004, the off-budgetary revenue was comparable to the official extra-budgetary revenue, which was at 800 billion Yuan.[19] In that case, total broadly-defined extra-budgetary revenues would amount to 1,600 billion Yuan, compared to 2,500 billion Yuan in formal tax revenues. Ping (2005) estimates that for local governments, total extra-budgetary revenues represent half of the budgetary revenues for 2004. Similar estimates on the expenditure side have been made by Wong (2001) and Ma (2000) , which suggest that off-budget expenditures have risen from around 2% of GDP in the mid-1990s to around 4% of GDP in the early 2000s (OECD 2006).

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[17] It is not infrequent that different levels of governments collude in the collections of these fees and surcharges.

[18] Often, funds collected in the name of constructing some projects are not used for that purpose (even if they are used in the announced project, the whole amount is rarely used in the project.) Instead, the projects become an excuse for the governments and administrative agencies to levy those fees.

[19] Unfortunately, we could not obtain detailed information on how Ping (2005) estimates the size of the off-budgetary funds.

According to Wong and Bird (2004), a full account of EBF and extra-budgetary activities of governments in the late 1990s, besides the officially recorded EBF, should cover items such as "expenditures of branches of government that were not reported in budgetary or extra-budgetary accounts," including tax expenditures, "arrears – unpaid/deferred wages to teachers and civil servants, unpaid subsidies to grain marketing system, farmers who are not paid for crops sold to grain stations, unpaid utility bills," and partially compensated "goods and services provided by enterprises or PSUs," "quasi-fiscal expenditures of government, the most important of which are directed credit to SOEs," "quasi-fiscal expenditures of enterprises and PSUs – for goods and services provided on government's behalf (such as enterprise-run schools, clinics, and hospitals; pension expenditures financed from PSU funds, and carrying excess, unwanted staff and workers)," and so on. Based on this accounting, the official extra-budgetary funds and off-budgetary activities of government add up to 18-27 percent of GDP in total public spending, with off-budgetary funds comprising more than half. Together with budgetary revenue, total public sector revenues have been 30-35 percent of GDP throughout the reform and open policy era (Wong and Bird (2004)). These estimates are inevitably rough, since the size of numerous off-budgetary activities is unknown. However, these apparently conservative estimates provide a sharp view of the potential importance of off-budgetary funds in China.

VI Issues and Problems

The central government has been trying to enforce the administration of extra-budgetary revenues and making efforts to reduce or eliminate illegal fees and surcharges. Major campaigns against these arbitrary charges have been launched on several occasions in recent times. In 1998, the Ministry of Finance claimed that both the central and local governments had cancelled fees totaling 62.3 billion Yuan, equivalent to 6% of the budgetary revenue (Wedeman 2000). In 2000, with the objective of alleviating the burdens on farmers and improving their living conditions, the "Tax-for-Fee" and agriculture tax reforms were launched in Anhui province. More recently, these reforms have been extended to many other provinces, aiming at the abolishment of the agriculture tax in the entire country.

However, some new issues have arisen in the process of eliminating all illegal fees and surcharges and reinforcing the administration of extra-budgetary revenues. First and foremost, extra-budgetary revenue and off-budgetary revenue have been major sources of revenues for local governments. Because the expenditure responsibilities of local governments have not been reduced, the imbalance between expenditure responsibilities and the revenue sources to fund them has been aggravated by the recent "Tax-for-Fee" and agriculture tax reforms and thus further compromised the ability of local governments to deliver basic public services, such as in health and education. It must be remembered that local governments had been financing half or more of their expenditures from EBF (Wong 1998).

The real impact of cutting the fees and EBFs on public expenditures is likely to vary according to the priorities of local officials. In the case of corrupt government officials, it is more likely that expenditures on public services would be the ones being cut, in order to maintain their consumptive expenditures. But even in the case of honest government officials, the lower level of available revenues is likely to have an impact on service provision; some of these results would seem to be already apparent in the agriculture sector. After the agriculture taxes have been eliminated, basic investment in infrastructures that used to be financed from agriculture tax revenues are not currently being completed. The lack of public funding has prompted farmers to engage in small-scale investment in irrigation facilities, while the public water systems that are more efficient and more effective appear to have been left unattended. Wu (2004), Tan (2001) and Xiao (2004), among others exemplified these points in several case studies.

Second, EBF and off-budgetary revenues are more important revenue sources for local governments, especially for lower level governments. The current tax system centralizes major tax revenues to the central government, leaving local governments little autonomy in fiscal resources. Transfers have to go through many government layers, which make the lower level governments more vulnerable in obtaining revenue sources. Meanwhile, the heavy expenditure responsibilities for basic social services remain highly decentralized. This situation led higher level governments to allow lower level governments to raise revenues outside the formal budgets sources. As we saw above, these sources became important supplements to budgetary revenue, sometimes even more important than the budgetary revenue itself. The pursuit of funds made local governments go beyond the legal bounds and collect arbitrary fees and charges, impose heavy and unfair burdens on many taxpayers, especially farmers. At the same time, this necessity opened the door for corrupt officials to abuse their positions. All this in turn led the central government to clamp down on the use of fees and to the reform of agriculture taxes. But the effective reduction in local revenues without full compensation by adjusting other parts of the system can easily lead to undesirable consequences: local governments may still levy fees in other more subtle and concealed ways and more importantly local governments will be forced to cut expenditures on basic services. All this is likely to contribute to the regressivity of China’s fiscal system.

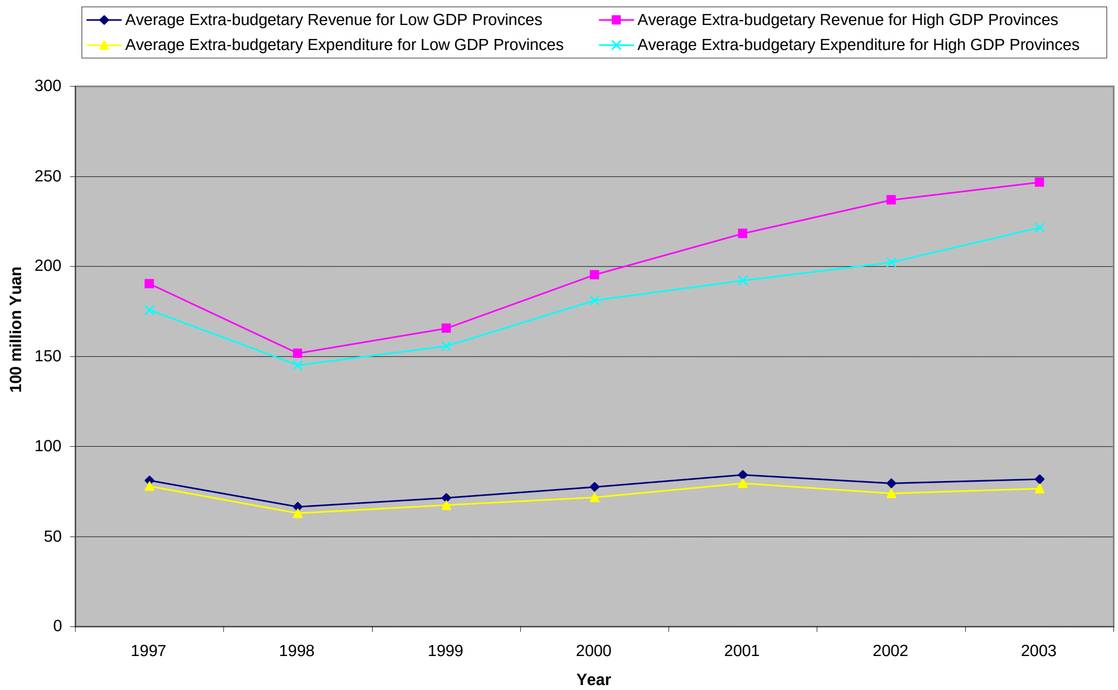
China’s fiscal system involves several markedly regressive features. Richer provinces can usually collect more in tax revenues, and they can also keep more within their control under the current tax-sharing arrangements. On the other hand, most poor provinces have much less revenue available even after transfers from the central government are taken into account. Many central government expenditure policies also tend also to favor richer provinces. The provincial level extra-budgetary revenue shows that, from 1999 to 2003, the provinces with the highest extra-budgetary revenues have stayed the same: Guangdong, Zhejiang, Jiangsu and Shandong. Meanwhile, the provinces with the lowest extra-budgetary revenues have stayed the same, too: Tibet, Ningxia and Qinghai. Meanwhile, those provinces with the highest extra-budgetary revenues are exactly those with the highest GDP, or the richest provinces; similarly for those provinces with lowest extra-budgetary revenues.

In addition, formalizing the administration of EBF and off-budgetary revenues is likely to significantly affect the overall availability of funds to local governments in poorer areas. The capability to raise budgetary revenue as well as EBF and off-budgetary revenues is significantly correlated with the economic conditions in the location.[20] As we can see from the Chart 3 below, the average extra-budgetary revenues for poor provinces with lower GDP are much less than for rich provinces with higher GDP. In addition, the difference in extra-budgetary revenues between rich and poor provinces has been increasing over time. For poor provinces, the absolute values of the extra-budgetary revenues have been relatively stagnant. On the expenditure side, extra-budgetary expenditures are always within the scope of extra-budgetary revenues, but moreso for richer provinces, which gives richer provinces more discretion in spending their extra-budgetary funds than is the case for poor provinces.

Due to limited data availability, we are using the official provincial level of extra-budgetary revenues and expenditures to illustrate the argument. Nonetheless, incentives and constraints taken together, EBF and off-budgetary funds for governments at lower levels should exhibit similar trends. For example, richer counties can obtain high revenues by selling or renting out commercially used land to investors. In the case of poorer counties, even when investors do have a demand for the same type of lands, the poor counties have to accept lower sales or rental prices due to the rent differentials in different locations. Thus, richer counties are more capable of raising revenues than poorer counties, and therefore restrictions on formal and quasi-formal revenue sources are likely to make things relatively worse for poorer local governments and make the system relatively more regressive. Li (2005) documented in Qufu, Shangdong province, a relatively rich prefecture, local government obtained 90 million Yuan by tendering new household registrations (or “Hukou”) for people immigrated from other places, while in the poorer Anshun Prefecture, Guizhou province, only 1.5 million Yuan was raised in the same period by the same activities. Of course, the apparent reason is that people prefer to migrate to bigger and richer cities rather than smaller and poorer cities. Note that these types of revenues do not show up either in the budget formal revenue nor in the extra-budgetary revenue of local governments; instead the become part of the “xiaojinku”, or off-budgetary funds.

[20] Based on provincial level data, the simple correlation between extra-budgetary revenue and budgetary revenue is 0.8525; correlation between extra-budgetary revenue and GDP is 0.9316. The correlation coefficient between GDP and budgetary revenue is even higher.

Chart 3 Evolvement of Extra-budgetary Funds in Rich and Poor Provinces



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