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**Intergovernmental Fiscal Relations: The Chinese System in Perspective**

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**Abstract**

This paper provides an overview of recent Chinese reforms to introduce a modern system of fiscal federalism that balances the need for central macroeconomic control with the economic advantages of decentralized government. Following a discussion of the rationale for decentralization, the paper describes the main structural and economic developments in China in this area, including their impact on economic stabilization. The key measures in the 1994 fiscal reforms as well as reform initiatives needed in the future are also discussed.

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## SUMMARY

This paper discusses developments and reforms in the system of intergovernmental fiscal relations in China during the past two decades, including their implications for macroeconomic management, as well as some outstanding issues.

By way of background, the paper describes some key conclusions of the literature on fiscal decentralization. Decentralization has many advantages, including greater economic efficiency and budgetary discipline at the local level, but a decentralized system will function well only under strict conditions regarding both the assignment of revenue and expenditure responsibilities among different levels of government and the mechanism of intergovernmental transfers. The paper reviews which responsibilities are best assigned to central and which to local governments as well as the main considerations entailed in designing an appropriate transfers mechanism.

The paper describes developments in intergovernmental fiscal relations in China, including the measures taken as part of the comprehensive fiscal reform of 1994 and how they have affected macroeconomic management. In the period since 1978, changes in intergovernmental relations have included greater fiscal decentralization, especially through greater local autonomy over taxation and a strong element of central-local bargaining in the fiscal process. Decentralization, together with a growth in off-budget activities, has contributed to a weakening in the center's control over fiscal policy, which, in combination with a trend decline in the overall revenue-GDP ratio, has limited the role of fiscal policy in macroeconomic stabilization, redistribution, and fulfilling expenditure needs. The 1994 reforms included measures to address some of the problems inherent in the earlier system, including those related to macroeconomic policy management, in part by strengthening the central government's revenue position. Several important issues remain to be resolved, however, including formulation of an appropriate legal framework, the integration of off-budget activities into the budget framework, rationalization of the transfers mechanism, and the relatively low buoyancy of central government revenues.

## I. INTRODUCTION

China's recent experience underscores the economic importance of the system of intergovernmental fiscal relations. As in many transition economies, the structure of subnational governments and their relations with the central government have emerged as important policy issues. The experiences of other countries and the variety of systems that have been adopted by different countries suggest that there is no "ideal" system of intergovernmental relations, and that the choice of a particular system involves both advantages and disadvantages.<sup>2</sup> Issues related to fiscal relations among different levels of government in a single country are in a sense the domestic counterpart to broader issues concerned with the constraints on national tax policies imposed by closer economic integration among different countries or "globalization."<sup>3</sup>

Relations among different levels of government have several dimensions, with the territorial structure of government itself usually being determined by historical, social, and political considerations in addition to purely economic factors. This paper nonetheless focusses on the *economic* aspects of the system of intergovernmental relations in China. In order to provide a perspective for the Chinese policy experiences in this field, Section II briefly puts forward some key conclusions of the economic literature on intergovernmental fiscal relations, especially with regard to the normative guidelines for an efficient structure of government. Sections III and IV discuss developments in China prior to the comprehensive fiscal reforms in 1994, and describe the main intergovernmental elements of that reform. Finally, Section V discusses how some of the economic implications of the system of intergovernmental fiscal relations in China, including the erosion of central control over fiscal policy and limitations in the scope for fiscal policy itself, may be addressed.

## II. ISSUES IN INTERGOVERNMENTAL FISCAL RELATIONS: A CONCEPTUAL BACKGROUND

An important rationale for establishing a decentralized government—one in which the subcentral levels have an appropriate degree of autonomy in fiscal decisions—is to improve

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<sup>2</sup>Ter-Minassian (1997) represents a comprehensive recent discussion of various countries' experience with fiscal federalism.

<sup>3</sup>See, for example, Tanzi (1996), who argues that tax competition between nations to attract mobile tax bases (particularly enterprise profits and returns from financial saving instruments) may lead to so-called tax degradation or suboptimal levels of taxation.

**economic efficiency** with regard to the provision of public goods.<sup>4</sup> The efficiency argument for greater decentralization starts with two main observations. First, the benefits from some kinds of public goods, such as street lighting and fire protection, typically accrue to only the local community, whereas the benefits from others, such as defense and the judicial system, accrue to the nation as a whole. Second, preferences for public goods usually differ across regions or groups of the population. On these considerations, economic efficiency and welfare would be greater if the supply of public goods of a local nature were provided through a decentralized system which adapted the provision of public goods to accord with the preferences of the local populations.<sup>5</sup> A decentralized system may also increase efficiency by promoting competition among local governments to provide the best service at least cost. In addition, the existence of a multitude of local bodies fosters experimentation and cost-effective innovations.

A decentralized system has several **other benefits**. It provides the basis for a competitive “market” for local public goods, where the benefits of the public goods and services accrue mainly to the local population which also bears most of the burden, through local taxation, for the provision of these goods and services.<sup>6</sup> Further, fiscal decentralization ensures that local preferences for public services are revealed and are financed through benefit taxation imposed by local governments who are held accountable for the provision of the services and their financing. In this sense, it also contributes to resolving or alleviating the free-rider problem in public-good provisioning. Finally, in a decentralized system, local governments’ better knowledge of the local population may help to enhance local revenue mobilization through the use of benefit taxation.

While there is general agreement regarding the virtues of decentralization, it is also generally acknowledged that a decentralized system will function well only under strict conditions concerning expenditure and revenue assignment and the design of transfers to local governments. While in practice the design of the fiscal tiers between levels of government must be tailored to the specific circumstances of each country, including its stage of

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<sup>4</sup>See Oates (1992) and Musgrave and Musgrave (1989). In addition, please note that in discussing decentralization it is customary to distinguish between **administrative decentralization**, where local governments act solely as “agents” of the central government, and **fiscal decentralization**, where local governments are assigned a degree of fiscal autonomy. This section is concerned with fiscal decentralization.

<sup>5</sup>This conclusion assumes that local public goods have limited externalities, which could be felt beyond the local population, and that the costs of providing the goods can be internalized to the local population.

<sup>6</sup>Tiebout (1956) describes this market as representing the outcome of choices made by mobile voters (who can “vote with their feet”) that best satisfies individuals’ demands for local public services.

development, the general (normative) conditions relating to tax and expenditure assignment and to the system of transfers may briefly be summarized as follows.

### A. Expenditure Assignment

A fundamental decision entailed in decentralization is the allocation of expenditure responsibilities across levels of government. A guiding principle concerning expenditure assignment is the so-called “benefit principle,” according to which the responsibility for a particular function should be accorded to the level of government to whose jurisdiction the benefits of the function accrue. A clear, consistent, and stable system of expenditure assignment to each level of government based on the spatial characteristics of the public goods in question is required in order to minimize externalities between local governments, and to ensure accountability and political responsiveness. Lower levels of government should be given clear and well-defined expenditure autonomy with respect to allowed variations in service levels and composition of expenditures, consistent with any minimum standards determined by the central government. In addition, the legal framework should ensure that local governments refrain from purely commercial activities (such as industrial production or banking).

Subnational governments are thus best given responsibility for the provision of public goods and services that are of a clear regional or local nature, for reasons of **allocative efficiency**. Urban services such as street lighting, sanitation, water provision, and urban mass transit are good examples, since most of their benefits accrue locally. Other examples are kindergartens, primary education and basic health care. Secondary education, specialized health care, and environmental protection are better provided by regional governments, since their benefits extend to larger areas.

An important implication of the benefit principle is that macroeconomic **stabilization policies** (for example, those relating to inflation and unemployment) are most efficiently carried out by the central government. The rationale is that because of the “openness” of local and regional economies, locally implemented stabilization policies would lead to large spillover effects on neighboring regions. Also, local governments do not have authority over the full range of macroeconomic policies (monetary policy, for example) to carry out stabilization effectively. The fact that the stabilization objective is often the overriding one for economic policy in transition economies has sometimes been used to argue in favor of a

centralized government structure and centralized policies in these economies.<sup>7 8</sup> The argument is often extended by pointing to the need in some cases for allocating the responsibility for investment in basic infrastructure to the center.

In a similar vein, central governments are generally better suited than local governments to carry out general **redistribution policies**, since the active pursuit of such policies by local governments may lead to migration from and to other localities of the groups affected by such policies. An additional consideration is that fiscal decentralization may contribute to regional (including rural-urban) disparities in income and wealth, because local governments in wealthier localities will benefit most from greater local taxing powers.

### **B. Tax Assignment**

Tax assignment in a fiscally decentralized system should involve the central government maintaining appropriate taxing powers consistent with its macroeconomic responsibilities, but should include a system of local taxes with one, or at most a few, major tax sources allocated to lower levels of government. Lower levels of government should be allowed well-defined autonomy in setting the rates—although not generally in defining the bases—of the taxes that they have been assigned. It should be noted that the question of tax assignment may be dealt with quite separately from the question of who administers and collects the taxes. Tax assignment should be determined on the basis of which taxes constitute good central taxes and which are better suited as local taxes, while tax administration and collection may best be implemented by the center where there are significant administrative economies of scale.<sup>9</sup> A number of criteria have been generally recognized as qualifying a tax to be a “good” local tax (see Box 1).

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<sup>7</sup>See Bahl and Wallace (1996).

<sup>8</sup>Recently, however, some authors have argued in favor of assigning at least some responsibilities for stabilization policies to subnational levels of government on the basis that economic cycles may not always be highly correlated across regions (see, for example, Gramlich (1987)).

<sup>9</sup>A given tax may thus be administered (i.e., levied, audited, collected) by the central tax administration while the yield ultimately accrues to the relevant local governments who may also have determined the rate.

### Box 1. Criteria for “good” Local Taxes

- The base of taxes assigned to the local level should not be mobile, or taxpayers will relocate from high to low tax areas and the freedom of local authorities to vary rates will be constrained.
- Tax bases of local taxes should not be unevenly distributed across jurisdictions, so as to allow a uniform level of provision of public goods and services across the country.
- Local taxes should be visible: it should be clear to local taxpayers what the tax liability is, thereby encouraging local government accountability. In the same vein, it should not be possible to “export” the tax to nonresidents thereby weakening the link between payment of the tax and services received.
- Local taxes should be able to raise sufficient and stable revenue to meet the needs of subcentral levels of government and to minimize vertical fiscal imbalances.
- Taxes and user charges based on the benefit principle can be adequately used at all levels of governments, but are particularly suitable to the local level since the benefits are “internalized” to the local taxpayers.

These broad criteria translate into more specific (normative) recommendations concerning the taxes that can appropriately be assigned to lower levels of government. For example, **property taxes**, including in particular land taxes, are usually good local taxes because it is always clear which authority is entitled to the revenue from them; their administration requires only local information and administration costs are generally moderate provided there is a cadastre; and their yield can be predicted with fair accuracy.

In many countries, **personal income taxes (PITs)**, considered attractive for their generally high buoyancy, are shared between the central and the local governments. In many countries, the same statutory tax base is used for both the local and the central income tax (a case of “overlapping” or “piggybacking” of taxes), mainly because this has been found to be a cost-effective way of taxing a global income tax base in local jurisdictions. Because it requires an efficient administrative system with up-to-date recording of taxpayers’ residence, overlapping personal income taxes are used more often in industrial countries. **Payroll taxes** are used in many countries as a benefit tax to finance social safety nets. Generally, these taxes are considered more appropriate as central than as local taxes.

**Retail sales taxes and excises**, which are levied on the final sale to the consumer, can in some cases be assigned to local governments but should not be levied at very different tax rates across localities or they would drive consumers away from high tax areas. In contrast, **value-added taxes** are most appropriately assigned to the central government mainly because of the complexities involved in allocating revenues among different localities.



**Corporate profit taxes** are usually best left to the central government (except sometimes in countries where provinces or states are very large). The economic activities of corporations are typically diversified and complex, with factor inputs originating from a number of regions and from abroad, and with sales similarly going to a multitude of regions. Local taxation of corporate profits would to a large extent result in the tax being exported or shifted to other jurisdictions in a nontransparent way, thus rendering the associated tax burden almost imperceptible to local citizens. In addition, given that the profit-tax base is usually very mobile, local authority over its taxation could lead to tax avoidance, with enterprises that have activities in many regions seeking to place their costs in high-tax regions and their revenues in low-tax regions (for example through transfer-pricing mechanisms). Finally, **taxes on natural resources** are generally considered better as central than as local taxes, since their bases normally are very unevenly distributed across regions.<sup>10</sup>

### C. Transfers

A system of general and specific transfers should ensure that externalities are corrected and an acceptable degree of equity achieved by equalizing fiscal capacities and “objective” expenditure needs beyond the control of individual local governments. Done properly, this would ensure that differences in tax rates across subnational governments at the same level reflect differences in expenditure policies and service levels decided by the local councils in accordance with local preferences, and not factors beyond their immediate control (such as income disparities, demographics, and social factors). Only in this case will elected local councils have equal opportunities to provide their constituencies with public services at a comparable tax price.

There are two broad categories of transfers: **general purpose transfers** and **specific purpose transfers**. Concerning general purpose transfers, local governments are usually free to choose how to spend them, but the share that each subnational government receives is fixed by rules determined by the central government.<sup>11</sup> These transfers are intended to reduce fiscal imbalances across levels of government or to reduce revenue disparities between jurisdictions at the same level. With regard to specific transfers, the central government ultimately decides how the funds should be spent. The size of the transfer may be determined by the central government, or may depend upon the spending decisions of lower levels of government, under so-called matching or co-financing schemes. Specific purpose transfers are intended to correct

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<sup>10</sup>Although a local tax share may be considered appropriate to cover the infrastructure and other costs of local governments associated with hosting natural resource industries.

<sup>11</sup>The amounts received by individual authorities may also depend on their own tax efforts, that is, the extent to which they actually exploit their tax sources.

interjurisdictional spillovers or to achieve specific national priorities and policies concerning services provided by lower levels of government.<sup>12</sup>

The distribution of transfers among subnational governments should aim to be fair, thereby providing more equal opportunities for different local governments to provide basic goods and services to local populations. A fair distribution is best achieved by general purpose, equalization grants. These should allow individual subnational governments to provide public services at standards similar to those provided by other subnational units, without imposing taxes and charges at levels appreciably different from those prevailing under other subnational governments.<sup>13</sup> Also, general transfers should be allocated among subnational governments according to well-defined, nonnegotiable formulas based on objective factors over which individual governments have no discretionary control. Subnational governments should have predictable shares in total transfers, in order to allow them to formulate budgetary decisions on a medium-term basis. Transfers should when possible provide incentives for sound management practices and discourage inefficiency, and should not encourage local governments to run budget deficits.

To summarize, a decentralized system of government with well-designed expenditure and revenue assignments supported by an appropriate transfer and equalization mechanism will enhance economic efficiency and ensure budgetary discipline at the local level. Most countries operating a multi-level government broadly satisfying these requirements have in addition found it necessary to establish mechanisms to ensure that the local governments as a whole comply with broad macroeconomic targets. The mechanisms range from negotiations and voluntary agreements between the national and individual local governments to stipulations that local governments comply strictly with quantitative targets, including, for example, ceilings on local government employment and tax rates as well as on local government expenditures, floors on local expenditure cuts, and controls on borrowing by local governments.

### **III. INTERGOVERNMENTAL FISCAL RELATIONS IN CHINA, 1978–94**

In the period since 1978, China's economy has grown rapidly, against the background of reforms that have allowed market forces a greater role in resource allocation. Changes in the system of intergovernmental relations have included greater decentralization of fiscal authority, especially in terms of increasing the autonomy of local governments over taxation. Decentralization has been accompanied by a growth in off budget (or "extrabudgetary")

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<sup>12</sup>For example, to promote preventative medicine or environmental protection, or to ensure equal national standards in the provision of certain basic public services like health or education (so-called "merit" goods).

<sup>13</sup>See, for further background, Oates (1979).

activities of local governments. Greater decentralization together with the growth in off-budget activities have contributed to a weakening in the center's control over fiscal policy. A parallel development has been a trend decline in the ratio of budgetary tax revenue to GDP to very low levels (Table 1), reflecting weaknesses in both central and local tax revenues. The declines in the central government's control over fiscal policy and in the tax ratio have restricted the role of fiscal policy in macroeconomic stabilization, in redistribution to mitigate regional economic disparities, and in fulfilling expenditure needs.

### **A. The Institutional Framework**

In China, the fiscal administration consists of a central government and four subnational levels of government referred to as "local governments." The local governments are: (i) 31 provincial-level localities, consisting of 22 provinces, 4 municipalities with significant independent powers directly under the central government,<sup>14</sup> and 5 autonomous regions;<sup>15</sup> (ii) over 300 prefectures and municipalities at the prefectural level; (iii) over 2,100 counties, autonomous counties, and cities at the county level; and (iv) several tens of thousands of townships, towns, and city districts. The sub-provincial levels of government operate under the authority of the provincial level.

Intergovernmental fiscal responsibilities, in terms of revenue assignment and expenditure responsibilities, are not explicitly delineated in China's constitution. During most of the reform period, intergovernmental fiscal relations were based on a complex set of negotiated contracts between the central and local governments. Since 1994, wide-ranging reforms as well as legislative changes have clarified to some extent the fiscal responsibilities of different levels of government, but important areas—notably the system of intergovernmental transfers—remain to be addressed.

### **B. Developments in Central and Local Revenues and Expenditures**

During the period 1978–94, local governments gained increasing influence over fiscal revenues. Unlike in most countries, the central government in China did not include a nationwide tax administration, and tax collection was mainly the responsibility of local

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<sup>14</sup>Chongqing became the fourth such municipality on January 1, 1997 joining Beijing, Tianjin, and Shanghai.

<sup>15</sup>On July 1, 1997 Hong Kong became China's first Special Administrative Region (SAR). The present paper is, however, concerned only with fiscal arrangements in the People's Republic of China and not in Hong Kong SAR. For a discussion of the Hong Kong SAR economy, including its institutional arrangements, see Dodsworth and Mihaljek (1997).

governments.<sup>16</sup> While the central government controlled tax legislation, tax assignment evolved from a centrally controlled system to one based on revenue sharing.<sup>17</sup> Before 1980, all taxes and profits were remitted to the central government, which then made transfers to local governments based on centrally approved expenditure priorities. Revenue sharing was introduced in 1980, in part with the intention of raising the incentive for local governments to increase revenue collections. Under revenue sharing, all revenue no longer automatically accrued to the central government. The central government designated revenues from each tax as being so-called “central fixed revenue” (accruing to the central government), “local fixed revenue” (accruing to local governments), or “shared revenue.” Shared revenue was divided between the central and local governments according to negotiated but flexible contracts.<sup>18</sup>

The revenue-sharing system was subsequently modified: first (in 1985) with the intention of raising the share of revenue retained by poorer regions and then (in 1988), when the tax efforts of richer regions flagged, of raising the revenue share of these regions as well. In 1985, the system was revised so that if a locality raised local fixed revenue in excess of its expenditure, a part of that revenue had to be submitted to the center. If local fixed revenue fell short of local expenditure, a higher proportion of shared revenue could be retained by the locality. If even all of shared revenue did not suffice to balance the local budget, the locality usually received a grant from the center.<sup>19</sup> While it limited increases in regional fiscal disparities, the revision reduced the incentive of faster-growing regions to increase tax collection. In 1988, the system was further changed to one consisting of several kinds of revenue-sharing contracts (i.e., with different terms), each adopted by a limited number of localities, that on the whole increased the portion of revenue that localities were allowed to retain (see Box 2). As a result of the changes in 1985 and 1988, the terms under which revenue was divided between the central and local governments came to differ across localities, and began to include an increased element of bargaining.

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<sup>16</sup>There were a few exceptions. For example, customs duties and taxes paid by large centrally-owned state enterprises were collected by the customs administration and the central government, respectively.

<sup>17</sup>For a comprehensive discussion of the pre-1994 system, and subsequent developments, see Ma (1997).

<sup>18</sup>The contracts were sometimes altered at the discretion of the central government. In addition, a small part of shared revenue was divided in a fixed proportion. For example, the central and local governments received 50 percent each of the revenue from the urban land use tax.

<sup>19</sup>Moreover, the minority areas received from the center an additional 10 percent above their entitlement under these arrangements, and shortfalls of revenue in the case of natural calamities were covered entirely by the center, outside the regular arrangements.

**Box 2. Types of Contracting Arrangements, 1978–94**

- A specific amount of revenue was to be handed over by the local government to the central government. The local government kept any amount in excess of this quota. If it could not meet its quota, the local government had to use funds previously accumulated. The quota was increased by 4–5 percent annually. Ten provinces out of 29 adopted this type of contract.
- A variant of the first arrangement set progressive growth rates for the amount handed over to the central government. Any amount exceeding the specified growth was retained by the local government. This approach was adopted in two provinces.
- Different shares for sharing revenue above a base amount were established. Any revenue increase in excess of the base was divided according to specified shares, with typical local shares in the 25–30 percent range. Three regions adopted this method.
- The local government was obliged to transfer a fixed amount to the central government for 4–5 years. This type of contract applied to the city of Shanghai.

The assignment of expenditure responsibilities among different levels of government remained largely unchanged. In particular, there was no decentralization similar to that in revenue assignment.<sup>20</sup> Expenditure policy and legislation remained under the purview of the central government, while administrative functions overlapped between the central and local governments.<sup>21</sup> The central government budget was responsible for expenditure on most capital outlays and on national defense as well as for servicing government debt. Local government budgets were responsible for spending on social welfare (including health and

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<sup>20</sup>However, after 1981 the central government stopped stipulating specific expenditures in local budgets, leaving these to be determined by local governments within the overall limits of the state budget.

<sup>21</sup>Most administrative functions were the responsibility of local governments. The main exclusively central functions were defense, foreign affairs and monetary affairs.

education), and for most expenditures on administration and agricultural development. In addition, local budgets bore most of the costs of budgetary subsidies.<sup>22</sup>

Overall budgetary revenue and expenditure declined in relation to GDP, as did the share of the central government in expenditure (Tables 1 and 2). Overall budgetary revenue declined from 30 percent of GDP in the early 1980s to 12 percent in 1994, reflecting declines in both the central and local revenue ratios (to 6.7 percent and 5.3 percent, respectively, when measured before transfers).<sup>23</sup> Budgetary expenditures declined by similar amounts (to 13.6 percent overall, and to 4.1 percent and 9.5 percent, respectively, for the central and local governments), reflecting cutbacks in often necessary expenditures and the shifting of others to off budget accounts. The central government's share of "own revenue" (i.e., revenue before transfers) actually increased during the 1980s, before declining subsequently (see Table 2), but the increase was more than offset by the negotiated revenue-sharing transfers and other transfers. At the same time, the share of local governments in total expenditure increased. As a consequence, the vertical fiscal imbalances between the central and local governments declined sharply during the 1980s so that by the early 1990s, the central government's share of total revenue was not much out of line with its share of total expenditure.

A prominent feature of the fiscal landscape during 1978–94—as well as subsequently—was the growth of "extrabudgetary funds" (Table 3). These were funds outside the scope of the formal budget (including in terms of monitoring and approval) but subject to control by different levels of government. Most extrabudgetary funds were controlled by local governments. Revenues for these funds initially included the retained earnings of local state-owned enterprises (SOEs),<sup>24</sup> public utilities surcharges, transportation fees, rental income on public housing, and various social funds, as well as ad hoc fees and charges. Extrabudgetary expenditures were mainly directed toward priority capital projects of local governments. The balance of extrabudgetary revenue and expenditure remained in

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<sup>22</sup>See Wong (1991) for further discussion. While the distribution of the costs of price subsidies changed often, in the early 1990s local governments bore over two thirds of the costs. Essentially, the central government transfers a fixed amount to localities to cover the difference between the cost of grain procurement at controlled prices—the "grain quota"—and the market value of procurement. Localities must bear the cost of any consumption of subsidized grain above the quota.

<sup>23</sup>A further discussion of the revenue decline is provided by Arora and Norregaard (1997).

<sup>24</sup>In 1993, SOEs' retained earnings ceased in principle to be under the control of the government. However, there continued to be reports of local governments imposing arbitrary charges on SOEs to tap into these funds. (See Ma (1997).)

surplus. The size of extrabudgetary funds rose steadily in relation to budgetary funds, to nearly 100 percent (for revenues) and 80 percent (for expenditures) in 1992.<sup>25</sup>

Local governments in principle were not allowed to borrow, but the guideline was often not followed. In practice, local budget deficits were often financed through extrabudgetary funds, grants from the central government, and arrears as well as through various financial instruments.

Implementation of the complex, contract-based revenue system described above entailed a web of intergovernmental transfers through which the central government carried out an interregional income redistribution policy. Local governments made revenue-sharing transfers to the center based on their contractual arrangements. The central government in turn made transfers to localities in the form of subsidies or grants.<sup>26</sup> From 1989 onward, central government transfers to local governments were larger than local transfers to the center which in part reflected the central government's increased efforts to redistribute fiscal resources from surplus to deficit localities.

### C. Key Economic Implications

The changes in the system of intergovernmental fiscal relations were consistent with other structural reforms to move the economy from a centrally planned system to one based on decentralized decision making. Reforms in intergovernmental fiscal relations were incomplete, however, as the revenue sharing system was complex and retained a strong element of ad hoc bargaining, the expenditure assignment system was not decentralized, and the transfer system was broadly unchanged. These aspects of the system—as well as the occasionally perverse incentives that it posed to local governments—may at times have

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<sup>25</sup>Complete data are not available for the late 1970s, but Ma (1997) suggests that in 1978 the ratio of local extrabudgetary to budgetary funds was 66 percent. For the period after 1992, due to a change in the definition of extrabudgetary funds in the official data, comparable data are not available. A new time series suggests, however, that the size of extrabudgetary funds has remained relatively high in the last few years.

<sup>26</sup>In addition, one of the contracts formulated in 1988 required the center to pay localities a revenue-sharing transfer. Central government transfers that comprised subsidies or grants were of three kinds. "Quota grants" compensated local governments for the local budget deficit in the base year (i.e., the year in which the contract was made). "Special purpose grants" were given to finance specific tasks of national priority that were undertaken by local governments. "Account-settlement grants" were in relation to revenue-sharing contracts, changes in the ownership of fixed assets, or general compensation to local governments (for example, in response to any adverse effects on their budgets resulting from central government measures).

compromised macroeconomic stability, weakened the central government's control over fiscal policy, contributed to regional fiscal disparities, and reduced efficiency in resource allocation.

The intergovernmental system—both its revenue and expenditure aspects—at times contributed to expansionary pressures, especially at the local level. While the revenue contracts tended to fix for extended periods the level of revenue accruing to the central government, they contributed to local revenue being quite closely related to changes in economic activity.<sup>27</sup> In turn, increases in local revenue during periods of economic expansion tended to be followed by corresponding increases in local expenditures, rather than by budgetary surpluses. The expansionary bias may have existed partly because, unlike the central government, local governments did not have macroeconomic management responsibilities that constrained their spending plans. In addition, under the revenue contracts, local governments were often required to make larger remittances to the center if they started to run budget surpluses. Moreover, expansionary pressures at the local level did not tend to subside during periods of slow growth, since local deficits were partly financed by grants from the center.

At the same time, local budgets were exposed to greater uncertainty, as pressures from the center often spilled over, including in the form of arbitrary assignments of additional expenditure responsibilities (referred to in other countries as “expenditure dumping”) and ad hoc revisions to contracts. In part, due to such uncertainty, local governments intensified efforts to promote industrial expansion as a source of both budgetary and extrabudgetary funds. Rapid local expansion had obvious benefits, but also often contributed to macroeconomic overheating.<sup>28</sup>

Elements of the intergovernmental system contributed toward limiting the scope for fiscal policy. The nature of the fiscal contracts—especially the additional burdens placed on localities whose budgets performed well—gave local governments incentives both to reduce their overall tax efforts and to shift revenue collection efforts away from revenues that had to be shared with the center toward those over which they had greater control. They provided generous ad hoc tax concessions, exemptions, and refunds to SOEs under their jurisdiction,

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<sup>27</sup>For example, the changes to the revenue-sharing system in 1988 allowed several local governments to retain a higher share of revenue if revenue growth was sufficiently strong. The changes included requiring ten provinces to share with the center a fixed proportion of revenue if revenue grew within a range of 3.5–6.5 percent in a year, but allowing them to retain all of the revenue in excess of 6.5 percent growth; and requiring three other provinces to transfer to the center a fixed proportion of revenue until a pre-specified level (in millions of yuan) was attained, beyond which a smaller proportion needed to be transferred.

<sup>28</sup>Expansion was also often achieved through policies that were uncoordinated among regions, contributing to inefficiencies (discussed below).



increasing these SOEs' retained earnings.<sup>29</sup> Retained earnings were part of the extrabudgetary funds, on which local governments drew to finance local projects.<sup>30</sup> Both the prevalence of tax breaks and the shifting of revenues from budgetary to extrabudgetary accounts contributed to the decline in the budgetary revenue ratio, which in turn reduced the ability of fiscal policy to perform its full range of functions. In addition, the increasing retention of budgetary revenue by the local governments (under the contracts) contributed to the decline in the share of the central government in revenue. The decline in this share, along with the lack of corresponding expenditure decentralization, led to large vertical fiscal imbalances and an erosion specifically in the central government's control over fiscal policy.

The central government was restricted by its fiscal weaknesses from undertaking appropriate redistribution in order to reduce regional economic disparities. In addition, grants from the center often went to relatively well-off provinces in the form of budgetary subsidies.<sup>31</sup> As a result of these factors, the deterioration in the fiscal positions of the deficit provinces was larger than the improvement of the fiscal position of the surplus provinces.<sup>32</sup> A related development was the emergence of regional protectionism. Fiscal uncertainties, as mentioned, induced local governments to develop their own sources of revenue, which led them to press for an expansion of local SOEs. Local governments also had the authority to restrict inflows of goods from other localities, and to approve the use of inputs produced in their own localities. The protection from competition of local SOEs was sometimes used as a justification to set up barriers to interprovincial trade. Regional protectionism contributed to inefficiencies in economy-wide resource allocation, including "duplicate investment," whereby identical, large projects were established in several localities at once, and "irrational investment," whereby investments were made in projects that quickly turned out to be unprofitable.<sup>33</sup>

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<sup>29</sup>Tax rates and bases, while legally determined by the central government, were thus increasingly influenced by local governments, who were responsible for tax collection.

<sup>30</sup>Funds were shifted to extrabudgetary accounts for other reasons as well, such as to avoid central government scrutiny.

<sup>31</sup>These consisted of price subsidies for "daily living necessities" and subsidies to cover the operating losses of SOEs.

<sup>32</sup> See World Bank (1993), Table A-19 on page 258.

<sup>33</sup>Of course there were other reasons for duplicate and irrational investment. One reason was declining central authority and oversight with regard to investment planning. A second reason was that since capital markets were not well developed, and financial intermediation was thus limited, investible funds tended to be reinvested locally regardless of the rates of return in other regions. See Bell and others (1993).

#### IV. ADDRESSING THE PROBLEMS: THE 1994 REFORM

As part of the wide-ranging fiscal reforms implemented in January 1994, the complex, contract-based intergovernmental revenue system was replaced by the transparent delineation of revenue sources for the central and local governments. In addition, the central government's authority over tax collection was enhanced through the creation of a National Tax Service, and reforms were initiated with respect to the tax administrative system to make it more compatible with the conditions of a market economy. These reforms were intended to raise the share of the center in fiscal revenue (to around 60 percent over the medium term), and to strengthen fiscal policy as an instrument for macroeconomic management and other national priorities such as the reduction of regional disparities. The clear delineation of revenue assignments was also expected to impose greater discipline on all levels of government in their expenditure decisions.<sup>34</sup>

Under the new system, as before, taxes were classified as central-fixed taxes, local-fixed taxes, and shared taxes (see Box 3). An important difference was that these assignments were explicit in the tax regulations and not subject to bargaining. In order to minimize the disruption to local government finances, the central government guaranteed the localities that local revenues would not be allowed to fall below a "basic amount" (based upon actual local revenues, in nominal terms, collected in 1993). The main means by which the guarantee was intended to be fulfilled was through transfers of part of VAT and excise revenue from the central government to local governments. This system of guaranteed basic amounts is—with some modifications—still in force. The changed revenue assignment was supported by a new system of tax administration under the auspices of the State Administration of Taxation, with the newly established National Tax Service being made responsible for collecting all central and shared taxes and the local tax services being limited to collecting local taxes.

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<sup>34</sup>For a detailed description of the 1994 fiscal reforms, see Tseng and others (1994).

### **Box 3. The New System of Tax Sharing**

The central government was assigned revenue from the income tax on centrally owned SOEs; the business tax on railways and the financial sector (including banks, nonbank institutions, and insurance companies); the excise tax; customs duties; and the value-added tax (VAT) on imports.

Local governments were assigned revenue from the income tax on all enterprises that were not centrally owned (i.e., locally owned SOEs, collectives, joint ventures, and private enterprises); personal and agricultural income taxes; the remainder of the business tax; the VAT on real estate transactions; urban land use taxes; stamp taxes; and minor transactions taxes. Except as above, the VAT was intended to be shared between the central and local governments in the ratio of 75 percent to 25 percent.

Under the new system of tax administration, local tax services were assigned responsibility for collecting only local taxes, with all central and shared taxes being the responsibility of the National Tax Service.

The system of expenditure responsibilities was essentially unchanged. It was envisaged that the central government's share in total expenditure would remain at around 40 percent, and that a fiscal surplus would thus be recorded at the central level. The surplus was intended to be used to finance a system of equalizing grants, based on "objective criteria" (such as poverty levels and costs arising from natural disasters), which were not, however, established at the time. The need was recognized for the grants mechanism to be made transparent, and to avoid past problems such as using grants simply to fill gaps in local budgets (reducing the incentives for fiscal prudence at the local level) or basing grants on subjective criteria (opening the system to undue political influence, particularly from the local level, and possibly widening regional disparities).

Later in 1994, the authorities drafted the Budget Law, which further strengthened the basis for fiscal operations. Under the law, which came into effect from 1995, central approval of local budgets was abolished, and budgetary procedures were clarified, requiring the local and central budgets to be formulated in a consistent macroeconomic framework. Local governments were disallowed from financing any deficits through bond issues, bank borrowing, or grants from the central government. They were required to run balanced budgets or to use accumulated budgetary surpluses and extrabudgetary funds to finance deficits.

## V. DEVELOPMENTS IN CHINA SINCE 1994 AND OUTSTANDING ISSUES

### A. Developments

Since the reform of 1994, the overall revenue ratio has continued to decline, although it seems to have stabilized at about 11½ percent of GDP in 1996. The share of the central government in total revenue (before transfers) underwent a step increase in 1994 following the changes in tax assignment and administration. Subsequently, however, the revenues of the local governments have continued to perform much better than the revenues of the central government, resulting in a renewed tendency toward decentralization of taxation (with regard to actual yields rather than the authority to tax). This is the outcome of a much more buoyant system of local than central taxes, particularly as reflected in the yields of the personal income tax and the business taxes (mainly turnover taxes on selected services), which accrue to local governments. In addition, the VAT, hitherto the strongest performer among taxes, has lost some of its momentum, in turn constraining central government tax yields. In sum, the share of the central government in total revenue (before transfers), while significantly higher than prior to the 1994 reform, has been falling steadily.

Although the available data are particularly scarce in this area, the activities of off-budget funds and operations, which are predominantly undertaken at the local government level, seem to have further escalated in recent years. Off budget revenue and expenditure may each, according to some estimates, have reached almost 6 percent of GDP. Some (but far from all) of these off-budget activities relate to public utilities, and should, consistent with GFS principles, remain classified outside the general government. Others, however, are standard budgetary operations that are nonetheless conducted outside the official budgetary framework. Recognizing that the large role of local governments in off-budget activities has eroded central-government control over fiscal policy, and that off-budget activities have introduced a degree of nontransparency in the fiscal process, the center recently issued strict regulations to central and local entities to repeal all nonauthorized funds and fees. In addition, it included 13 large central funds in the budgetary process in 1997, and announced an intention to continue with the appropriate integration of extrabudgetary funds into the budgetary process. It is not clear at this point to what extent the off budget activities will simply be transferred to the local budgets, and to what extent they will be curtailed, and hence reduce the size of the general government.

With regard to the five social funds, the approach adopted by the authorities of conducting pilot experiments in selected cities and regions has continued, although the scope of these schemes has not been broadened. The authorities intend to establish a modern social safety net, including nationwide pension schemes and unemployment schemes, by the end of the century, which should relieve the SOEs from the costs of extensive social responsibilities. The social funds, as well as local governments, may need to assume substantial responsibilities in this regard.

The system of transfers which has emerged following the 1994 reform comprises the following four types of grants: (i) **Revenue returned**, which is the grant introduced in connection with the 1994 reform to ensure that each local government received a “guaranteed” basic amount following the changes in tax-sharing arrangements under the reform; (ii) **Special purpose grants**, which are specific grants, administered by individual sector ministries; (iii) **Subsidies under the original fiscal system**, which were part of the pre-1994 system of transfers to and from local governments that has continued basically unchanged (but with a total amount which has been fixed in nominal terms); and (iv) **Transitional period transfer**, which was introduced in 1996 and is based on “objective” criteria for each region.<sup>35</sup> It is the intention that the transitional period transfer will form the basis for an increasingly important equalization grant in the coming years.

## **B. Outstanding Issues**

The 1994 reform contributed toward alleviating some of the problems created by the previous system of intergovernmental fiscal relations, including for macroeconomic policy management, in part by strengthening the central government’s revenue position compared with earlier years. A continuation of the transformation to a market-based economy, and maintaining the present high growth performance with low inflation, will require ongoing improvements in the fiscal system, including a further strengthening in the buoyancy of central government taxes. In addition, the increasing (and partly tax-induced) economic disparities between coastal and inland regions remain to be addressed. Comprehensive reforms have been initiated in the SOE sector which will include reducing SOEs’ present social obligations, perhaps by transferring the obligations to local governments and to the social funds. These reforms, together with the plans to substantially expand the scope of the social safety net, will require mobilization of significant new fiscal resources, including at the local level. While reforms of the system of intergovernmental fiscal relations per se obviously cannot resolve all of the problems involved, they can contribute to making the process smooth.

Notwithstanding the 1994 reforms, several important issues remain to be resolved in the area of intergovernmental fiscal relations. A transparent and stable **legal framework** for the activities of subnational governments, that clearly delineates the degree of autonomy of local governments particularly with regard to expenditure responsibilities, has yet to be

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<sup>35</sup>These criteria include items such as population, a benchmark level of expenditure, and tax capacity.

formulated;<sup>36</sup> several **extrabudgetary funds** and operations remain outside the official budget framework, making fiscal management more difficult and limiting the transparency of the fiscal accounts; the **transfer system**, which was not changed as part of the 1994 reforms, retains elements of bargaining and unpredictability as well as an element of gap-filling. The authorities intend to establish a transfer system based on “objective” criteria that would overcome these problems and also help in equalizing regional disparities in public goods provision; notwithstanding a strengthening relative to the pre-1994 period, the **buoyancy of central government revenues** remains relatively low. The authorities are taking measures to strengthen these revenues, including by scaling back overly generous tax concessions to certain kinds of enterprises.

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<sup>36</sup>In order for the benefits from decentralization to be maximized, it is necessary for local officials to be fully accountable for their policies. Ensuring accountability in turn has implications for both expenditure and tax assignment. On the expenditure side, for example, expenditure responsibilities assigned to local governments should cover only goods and services of a clearly local nature. On the tax side, local governments might be assigned a tax source (or a few tax sources) over which they have a measure of autonomy in determining tax rates. (Appropriate tax sources, which have the required immobile tax bases, include land and property taxes and personal income taxes.)

Table 1. China: Budgetary Developments, 1980-96

(Percent of GDP, GFS basis)

	1980	1982	1984	1986	1988	1990	1992	1994	1996
Revenue	30.6	29.1	25.2	24.0	18.8	19.2	14.7	12.0	11.4
Tax	13.3	14.4	14.6	22.0	17.3	16.9	13.0	11.2	10.2
Direct	1.7	1.7	2.1	7.4	5.1	4.6	3.0	2.0	1.9
Indirect	11.6	12.7	12.5	14.6	12.2	12.3	10.0	9.2	8.2
Nontax	17.3	14.7	10.5	1.9	1.5	2.2	1.8	0.7	1.2
Expenditure	34.1	30.6	26.6	25.8	21.0	21.1	17.0	13.6	12.9
Current	22.5	22.8	18.9	18.4	15.9	16.6	13.7	11.5	10.8
Subsidies	6.4	7.3	5.5	5.7	5.1	5.2	3.4	1.5	1.2
Capital	11.6	7.8	7.7	7.4	5.1	4.6	3.4	2.0	2.1
Balance	-3.5	-1.5	-1.4	-1.8	-2.2	-2.0	-2.3	-1.6	-1.5

Source: China Statistical Yearbook, various issues.

Table 2. China: Central and Local Government Shares of Own Revenue, 1957-96

	1957	1965	1977	1980	1984	1990	1993	1994	1995	1996
(In percent)										
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Central government 1/	72.6	33.0	12.9	19.4	33.6	41.3	33.4	55.7	52.4	49.5
Local government 1/	27.4	67.0	87.1	80.6	66.4	58.7	66.6	44.3	47.6	50.5
Total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Central government 2/	71.0	61.7	46.7	53.7	46.7	43.3	37.0	30.3	29.9	27.1
Local governments 2/	29.0	38.3	53.3	46.3	53.3	56.7	63.0	69.7	70.1	72.9
Total local own revenue in percent of total local revenue	...	...	...	...	...	76.9	86.2	50.1	54.4	57.8

Source: China Statistical Yearbook, various issues. Data were available only for selected years. Data are classified according to national definitions.

1/ Revenue before transfers (or "own" revenue).

2/ Expenditure before transfers (or "own expenditure").



Table 3. China: Extrabudgetary Funds of Central and Local Governments, 1982-94 1/

	1982	1984	1986	1988	1990	1991	1992	1993	1994
(In billions of yuan)									
Extrabudgetary Revenue	80	119	174	236	271	324	385	143	186
Central government	27	47	72	91	107	138	171	25	28
Local governments	53	72	102	145	164	186	215	119	158
Extrabudgetary Expenditure	73	111	158	215	271	309	365	131	171
Central government	23	42	64	84	104	126	159	20	23
Local governments	51	69	94	130	167	183	206	112	149
Balance of extrabudgetary funds	7	7	16	22	0	15	20	12	15
Central government	4	5	8	6	4	12	11	5	6
Local governments	2	2	8	15	-3	3	9	7	9
(In percent of GDP)									
Extrabudgetary Revenue	15.3	16.6	17.0	15.8	14.6	15.0	14.5	4.1	4.0
Central government	5.2	6.6	7.0	6.1	5.8	6.4	6.4	0.7	0.6
Local governments	10.1	10.0	10.0	9.7	8.8	8.6	8.1	3.4	3.4
Extrabudgetary Expenditure	14.0	15.5	15.5	14.4	14.6	14.3	13.7	3.8	3.7
Central government	4.3	5.9	6.3	5.6	5.6	5.8	6.0	0.6	0.5
Local governments	9.7	9.7	9.2	8.7	9.0	8.5	7.7	3.2	3.2
Balance of extrabudgetary funds	1.3	1.0	1.6	1.4	0.0	0.7	0.8	0.3	0.3
Central government	0.8	0.7	0.7	0.4	0.2	0.5	0.4	0.1	0.1
Local governments	0.5	0.3	0.8	1.0	-0.2	0.2	0.3	0.2	0.2

Source: China Statistical Yearbook, various issues.

1/ Does not include the social funds. There is a break in the series in 1993, when several items hitherto included in the authorities definition of extrabudgetary funds (including mainly the retained earnings of state enterprises) began to be excluded.

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