CHINA'S FISCAL DECENTRALIZATION

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1. China has a population of 1.2 billion people and covers an area of 9.6 million square kilometers. Administratively, the country is divided into 31 provincial-level localities, including 22 provinces, 4 municipalities directly under the central government, and 5 autonomous regions (unless otherwise stated, we hereafter refer to the 31 provincial level localities as provinces).[1] The average population size of a province is 40 million, larger than most states and provinces in other large countries. Below the provincial level, there are three administrative levels. They include: 335 prefectures and municipalities at the prefectural level; 2,142 counties, autonomous counties, and cities at the county level; and several tens of thousands of townships, towns and city districts.[2] China's vast population and territory, as well as its geographical and economic diversity, suggest the great importance of policy coordination between the central and subnational governments.

2. Over the past 20 years, China has made substantial efforts to decentralize its formerly high centralized fiscal management system. The objective of the decentralization was to increase the local governments' responsibility for local economic development and their autonomy in carrying out fiscal functions to achieve this goal, while preserving an adequate degree of fiscal control for the central government. However, while fiscal decentralization promoted growth in many regions, it also brought many unintended problems, including rising government deficits, weakening macroeconomic management, and increasing regional disparities.

3. The rest of the paper is organized as follows. The first three sections review three main aspects of China's intergovernmental fiscal relations: (i) division of expenditure responsibilities between levels of government, (ii) allocation of revenue sources between levels of government, and (iii) intergovernmental fiscal transfers. The fourth section points out a number of outstanding problems in China's decentralization process and discusses possible reform options. The last section turns to the lessons that other developing countries might draw from China's experiences with fiscal decentralization.

I. ASSIGNMENT OF EXPENDITURES

4. China's state budget consists of the central budget and the local budgets. The central budget is approved by the National People's Congress, and the local budgets are approved by the people's

[1] Taiwan Province of China is not included.

[2] Figures at the end of 1996. See State Statistical Bureau (1997).

congresses at the local levels. The local budgets include the provincial, county, and municipal budgets. In principle, the division of expenditure responsibilities between the center and the local governments is broadly consistent with international practices. The central government's expenditure responsibilities include national defense; foreign aid and external relations; capital construction and technical upgrading of centrally owned enterprises and outlays on their new product development; agriculture, forestry, and water conservation at the central level; industrial, transportation, and commercial operations of national importance; some education, culture, health and social services; outlays on centrally obligated price subsidies; geological surveys; and repayment of public debt. Local expenditure responsibilities include basic construction and technical improvement of locally owned enterprises and their new product development; rural production assistance, agricultural development and water conservation at the local level; urban maintenance and construction; education, health, culture, and social services; social welfare and pensions; administrative expenditures; and a range of price subsidies.[3]

5. In practice, the division of expenditure responsibilities is largely a result of the division of budgetary agencies' affiliations. For example, some state-owned enterprises, universities, hospitals, and research institutions are "owned" be the central government, and therefore the central budget is responsible for funding their operations and new investments. Accordingly, expenditures of budgetary agencies "owned" by local governments are the responsibilities of the local budgets. For examples, primary and secondary schools, most hospitals, local infrastructure facilities, pension funds, and various extrabudgetary funds[4] are owned by local governments, and the central government only provides subsidies to poor regions for bringing up the standards of basic public services. There is substantial overlapping between the center's and the local governments' responsibilities in heavy industrial sectors (e.g., electricity and raw materials), large infrastructure projects, as well as in higher education and research and developments. For example, the central government finances power plants, railways, and telecommunication networks of "national importance", and provinces are often required to co-finance these projects. There are both central and local universities, and some universities are co-financed by the central and local budgets. Since a substantial part of investment outlays come from the central budget, the location of projects becomes a matter of importance. Provinces compete with each other to garner a greater share of these outlays during the annual budgeting process.

6. Since 1980, as part of the decentralization in fiscal management, the central government no longer stipulates individual items of expenditures in provincial budgets but continues to formulate the

[3] See Agarwala (1992).

[4] Extrabudgetary revenues are obtained by government units using coercive power but are not included in the formal budget system. They include various surcharges and service fees charged by government agencies. In theory, extrabudgetary revenues are collected based on regulations promulgated by the central or provincial level governments. Off-budget revenues are collected by government units, particularly, township and village level governments, without the authorization from the central or provincial level governments. While no official figures are available, some estimates suggest that the number of extrabudgetary funds and off-budgetary funds in china may be as large as 1,000. It is estimated that while the government budgetary revenues accounts for only 11-12 percent of GDP, the size of extrabudgetary and off-budgetary revenues is similar to that level, making the consolidated government revenue-to-GDP ratio close to 25 percent of GDP (estimates of Mr. Gang Fan, China Academy of Social Science).

guidelines indicating the acceptable level of expenditure for each province.[5] The allowed expenditure of each province is formulated based on the "base figure"—the expenditure of the province in a certain base year—adjusted by factors such as changes in policy priority (e.g., the State Council's approval of a new development zone may increase this region's expenditure allowance) and inflation (e.g., inflation increases the payments of wages and other procurement), price reform (e.g., certain price reforms require the provinces to spend more on subsidizing food and housing), etc. The provinces are required to make their expenditure plans consistent with the central government guidelines, but may augment expenditures if more resources are likely to be available to the province. On individual items of local government expenditure, the center has a set of detailed regulations restricting government employees' wages and the items that government agencies at all levels can purchase.

II. REVENUE-SHARING AND TAX ASSIGNMENT

7. Before 1980, China's fiscal system was characterized by centralized revenue collection and centralized fiscal transfers, that is, most taxes and profits were collected by local governments and were remitted to the central government, and then in part transferred back to the local governments according to expenditure needs approved by the center. Since the early 1980s, the central-provincial fiscal relation has gone through three major phases.[6] In 1980, the highly centralized system was changed into a revenue-sharing system in which the central and provincial governments each began to "eat in separate kitchens." This system, called the contract responsibility system, emulated a similar system adopted in rural areas in the late 1970s.[7] There were three basic types of revenue under the reformed system: central revenues (those revenues and taxes that accrue to the center), local revenues (that accrue to the local governments), and shared revenues (shared between the center and local governments). During the 1980-84 period, about 80 percent of the shared revenues were remitted to the central government and 20 percent were retained by local governments. Almost all revenues, except customs duties and a few minor central revenues, were collected by the local tax bureaus. The bases and rates of all the taxes, whether shared or fixed, were determined by national tax laws.

8. Although some local governments became more enthusiastic about collecting revenues during the 1980-84 period, the uniform sharing formula created large surpluses in wealthy provinces and deficits in poor provinces. In 1985, the State Council redesigned revenue-sharing arrangements by differentiating schedules based on local governments' budget balances in the previous years. The central government allowed financially weak regions to retain more revenues, while it continued to maintain a tight grip over those regions, including Shanghai, Beijing, Tianjin, Liaoning, Jiangsu, and Zhejiang, that were the most important sources of central revenue. The revenues from these regions generally grew more slowly than the national average since the high share of remittances dampened

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[5] "Provincial regulations concerning the introduction of a fiscal management system by which the scope of revenues and expenditures is defined for the central and local governments, respectively, and each is responsible for the balancing of its own budget," issued by the State Council, February 1, 1980. See, Economic Research Center of the State Council (1981).

[6] For a detailed discussion of China's central-provincial fiscal relations, see (Ma (1997a)).

[7] The central-local fiscal system adopted in 1988 was named The Big (comprehensive) Fiscal Contract System. The rest of this paper broadly refers to all variants of the decentralized fiscal system adopted since 1980 as the "fiscal contract system."

local enthusiasm for expanding the tax bases. To mitigate this effect, in 1988, the State Council decided to adopt a new system that introduced six types of central-provincial revenue-sharing methods, each applied to a number of provinces (Agarwala (1992)).

9. This new fiscal contract system further increased the revenue share retained by the local governments, particularly those that were major contributors to the central government's revenue. However, the contracts were not strictly adhered to and were revised repeatedly for some regions. In 1991, when the 1988-90 system was supposed to expire, the central government was unable to negotiate a satisfactory replacement; as a result, the 1988-90 system was extended until the end of 1993, with limited modifications on revenue-sharing ratios and quotas.

10. Under the 1980-93 fiscal contract system, the local governments controlled the effective tax rates and bases despite the fact that they did not have the authority to alter the statutory rates and bases. They offered varying degrees of tax concessions to enterprises and shifted budgetary funds to extrabudgetary funds, thus minimizing tax sharing with the central government. As a result, the center had to resort to various ad hoc instruments (e.g, ad hoc revisions to fiscal contracts, arbitrarily shifting expenditure responsibilities to local governments, forcing local governments to purchase bonds at lower-than-market rates, and recentralizing locally-owned enterprises) to influence revenue remittances from local governments, and these instruments led in some cases to perverse reactions from the local governments. Hence, for most local governments, there was a strong incentive to conceal their revenue capacities, as the center tended to revise the rules of the game to penalize local governments with fast growing revenues.

11. As a result of the declining local tax efforts and developments in the state-enterprise sector,[8] China's budgetary revenue-to-GDP ratio declined sharply.[9] From 1979 to 1993, the ratio of total budgetary revenue to GDP declined from 28 percent to about 13 percent; the central government's share (after revenue-sharing) declined from 51 percent to 28 percent (see Table 1). These changes led to increased government deficits and reduced the central government's flexibility in using fiscal policy instruments in stabilization and redistribution. Since the late 1980s, the central government has been increasingly concerned with the potential political and economic consequences of its weakening fiscal power, and has repeatedly expressed its intention to increase both the revenue-to-GDP ratio and the ratio of central government revenue to total government revenue. Although this proposal was written into the eighth Five Year Plan (1991-95), the decline of these two ratios continued between 1990 and 1993.

12. In an attempt to raise these two ratios as well as to strengthen the central government's ability to use tax and expenditure policy instruments, the central government decided in late 1993, as part of a comprehensive tax reform package, to replace the fiscal contract system with a tax assignment system, which redefined the sources of revenue for the central and local governments, as well as those remain to be shared. Under the new system, the tax revenues assigned to the central

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[8] In the early 1980s, as an effort to increase enterprise autonomy, the government permitted the state-owned enterprises (SOEs) to retain some revenues. Since mid-1980s, the further decline in SOEs' profitability reflected mainly the increased level of competition and serious governance problems.

[9] For extrabudgetary revenues and off-budget revenues, see discussions in footnote 4 and Section IV.

government include mainly those from: customs duties; a consumption tax collected by customs; a value added tax (VAT) and the income tax on centrally-owned state enterprises; turnover taxes on

Table 1. China: Central-Local Fiscal Status, 1979-96

	Revenue		Expenditure	
	Central	Local	Central	Local
	(In percent)			
1979	20.2	79.8	51.1	48.9
1980	24.5	75.5	54.3	45.7
1981	26.5	73.5	55.0	45.0
1982	28.6	71.4	53.0	47.0
1983	35.8	64.1	53.9	46.1
1984	40.5	59.5	52.5	47.5
1985	38.4	61.6	39.7	60.3
1986	36.7	63.3	37.9	62.1
1987	33.5	66.5	37.4	62.6
1988	32.9	67.1	33.9	66.1
1989	30.9	69.1	31.5	68.5
1990	33.8	66.2	32.6	67.4
1991	29.8	70.2	32.2	67.8
1992	28.1	71.9	31.3	68.7
1993	22.0	78.0	28.3	71.7
1994	55.7	44.3	30.3	69.7
1995	52.2	47.8	29.2	70.8
1996	52.2	47.8	27.1	72.9
1997	48.8	51.2	27.4	72.6

Source: Calculated using data from the province from State Statistical Bureau (1998).

Note: Revenue does not include (exclude) fiscal transfers from (to) the center.
Expenditure equals revenue plus fiscal transfers from the center to the province, and minus fiscal transfers from the province to the center.

railway, banks, and insurance companies; and income taxes from financial institutions set up by the headquarters of People's Bank of China (PBC). The local tax revenues include mainly the business tax (except for turnover taxes of banks, railways, and insurance companies), income tax of locally owned state enterprises, and the personal income tax. The shared taxes include the VAT, the securities trading tax, and the natural resources tax. The VAT revenue is divided with 75 percent going to the central government and 25 percent to local governments. The securities trading tax, currently collected only in Shanghai and Shenzhen in the form of a stamp duty, is divided equally between the central and local coffers. Proceeds of the natural resources tax are largely kept by local governments.

13. Along with the changes in tax assignments, a major effort was made by the central government to establish its own revenue collection agencies. In 1994 and 1995, the center set up national tax services (NTSs) in all provinces to collect central taxes and shared taxes. The State Bureau of General Taxation, the central headquarters of the NTSs, is empowered to supervise local NTSs, appoint their directors, and provide funding for their operations.

14. The immediate impact of the tax assignment system on the division of revenue sources between the central and local governments was very significant. The percentage of total budgetary revenue collected by the central government jumped from 22 percent in 1993 to 56 increase in the share of central government revenue, the most important one was that the center was now in charge of collecting the VAT, formerly a local responsibility under the fiscal contract system. In 1994, this tax alone accounted for about 42 percent of total government revenue.

15. While the tax assignment system has introduced more transparency and stability to the revenue-sharing system, many elements of the old system remain. As a compromise with many provinces that opposed the reform in 1993, the center agreed that this reform would be carried out gradually over the span of a few years. The center promised to return part of the shared revenues to ensure that each province would not retain less revenue than it did in 1993. The retained revenue of a province in 1993 would be used as the basis for calculating the amount of shared revenues to be returned from the central government to local governments after 1994. The center would increase its share of total government revenue only from the increase in the shared revenues, mainly the VAT. To win the support of local governments, the center also promised to allow the tax exemptions approved by provincial level governments to continue and not to shift new expenditure responsibilities to local governments in 1994 and 1995.

16. The experience of implementing the tax assignment system over the past four years has not been fully satisfactory. The biggest challenge faced by the central government is the unexpected decline in the share of central government revenue after the one-time increase in 1994.[10] From 1994 to 1997, the share of central government revenue in total government revenue fell steadily from about 56 percent to less than 49 percent (see Table 1). A number of factors have contributed to this decline. First, the bases for many local taxes (e.g., the business tax and the personal income tax) increased at much higher rates than those of central taxes. For example, in 1995 the receipts of the personal income tax increased by 80 percent[11] and of business tax by 28 percent, compared with the 11 percent growth of central revenues. The increase in business tax receipts partly reflects the incentive of many local governments to promote the service sector, as the proceeds of this tax have accrued 100 percent to local governments since 1994. A related explanation is that while local revenues coming from

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[10] In designing the 1994 reform, the center expected that its share in total government revenue would continue to increase over the next five years, as the center would retain 70 percent of any percentage increase in VAT proceeds.

[11] This to a large extent reflects the interaction of a high and fixed threshold for exemption and rapidly increasing personal incomes.

nonstate-owned units have become increasingly important, central revenues continue to rely primarily on the taxation of state-owned enterprises, the least dynamic sector in the economy. Second, the separation of administration of central and local taxes greatly stimulated the enthusiasm of local governments to collect revenues. In many provinces, local tax services are better equipped and their employees are better paid compared with the NTSs. Third, while officially the NTSs are independent from local authorities, their operations rely on local agencies for many services (such as water, electricity, gas, child care, education of employees' children). In case of conflict of interests, the NTSs often find it difficult to insist on the priority of the collection of central taxes.

III. INTERGOVERNMENTAL FISCAL TRANSFERS

17. Improving the intergovernmental fiscal transfer system was another stated objective of the 1994 fiscal reform, but progress in this area has so far been limited. Currently, the Chinese transfer system consists of four types of transfers (grants). The first type of transfer is based on the old contract system prevailing during 1988-93. Since 1994, local governments have continued to remit revenues to or receive transfers from the center according to their fiscal contracts in effect in 1993. The second type of transfer is the "returned revenue" from the center according to a calculation that ensures each locality retains no less than what it had in 1993. Accounting for more than two-thirds of total central government transfers, these two types of transfer suffer from at least two major flaws. First, they were not designed to address the increasingly important regional disparity issue; rather, they were largely designed to recognize the vested interests of the local governments. Second, the criteria on which these transfers are determined are rather ad hoc; that is, these transfer mechanisms lack scientific measurements of fiscal capacities and fiscal needs. This can easily lead to an unjustified distribution pattern and encourage bargaining on the part of local governments.

18. The third type of transfer includes various specific purpose grants, such as those for price subsidies, education projects, environmental projects, disaster relief, and poor regions' development. The fourth type of transfer, introduced in 1996, is the "transitional fiscal transfer program." It aims to reduce regional disparities in the level of public services and bases the assessment of local fiscal capacities and needs on objective variables. The key variables used in assessing local expenditure needs include GDP, population, the number of civil servants, regional wage differentials, the number of students, and the population density. Nevertheless, in 1996, the size of the new program was only 0.5 percent of total central government revenue and the program was applied to just 18 provinces and autonomous regions (Zhang (1996)). In 1997, this program was slightly modified in its calculation of local fiscal capacities and needs, and its size was expanded to about one percent of the central government revenue.

IV. DISCUSSION OF OUTSTANDING ISSUES

19. Despite the partial success of the 1994 reform, which improved the transparency and stability of the central-local fiscal relations, several issues remain outstanding and need to be addressed in the short and medium term:

- So far, the division of taxing powers and expenditure responsibilities between levels of the government is still determined by the central government, rather than through legislation of the National Congress. This allows the central government to change the rules frequently in its own interest. Without a commitment to a more stable division of powers, the local governments tend to react strategically to expected policy changes, thereby leading to unexpected outcomes.

- The share of central government revenue in total government revenue has continued to decline since the 1994 tax reform. The 1994 reform did, to some extent, strengthen the central government's ability to use tax and expenditure policies by recentralizing some taxing powers from the local governments. The share of central government revenue in total government revenue increased from 33 percent in 1993 to 57 percent in 1994. However, since 1994, the growth rate of central revenues has been significantly lower than that of local revenues. As a result, the center’s share in total government revenue declined to 49 percent in 1997. The center’s original objective of increasing its share of total revenue to 60 percent is unlikely to be achieved anytime soon.

- As a result of the tight budgetary situation, the central government has not been able to set up a sizable equalization transfer program for redistribution purposes. As pointed out by some scholars (Hu and Wang (1994)), China’s regional disparity in income level and fiscal capacity is one of the largest in the world. However, its fiscal transfer system has played almost no role in equalization, with most transfers determined on the basis of vested interests and political influences (Ma (1997b)).

20. Under the fiscal contract system before 1994, many local governments and line departments found various ways to shift budgetary revenues to these funds in order to avoid revenue sharing with the central government. After the tax reform of 1994, local governments and line departments continue to use extra-budgetary and off-budgetary funds as a way to avoid central government (or other higher level government) restriction on the use of these funds. The consequence of almost half of the public sector revenue (in the form of extrabudgetary and off-budgetary funds) wandering outside the budgetary system is that the fiscal authority has limited control over the allocation of resources, particularly when budgetary expenditures are largely “entitlements” with little flexibility. The redistributive role of fiscal allocation is thus seriously constrained by the government's inability to control extrabudgetary and off-budgetary funds.

21. To address these issues, the government would have to consider the following actions: (1) Strengthening national tax services at the provincial and local levels. Lines of authority of central and local tax services, including the priority of central over local tax collections, should be clearly established; (2) Further broadening tax bases, particularly the value-added tax, and eliminating unnecessary tax exemptions; (3) Setting up a consolidated public sector accounting system that includes budgetary, extrabudgetary and certain off-budgetary revenues and expenditures in order to effectively conduct macroeconomic control; and (4) Continuing the reform of the state enterprise sector and further reducing the government’s involvement in the productive sector. This will ease the pressure for nonproductive subsidies to SOEs and allow more flexibility for budgetary allocations to social services.

V. LESSONS TO BE LEARNED

22. Owing to its frequent and generally very comprehensive reforms, as well as the variety of different systems practiced in its different provinces, China has gained particularly interesting experiences which can be used to derive useful lessons for other countries embarking on fiscal decentralization. These lessons include in particular the following:

Expenditure assignment

- A stable and transparent legal framework for the allocation of expenditure tasks is an indispensable element of a sound decentralized system. This would include applying the principle of benefit areas to the extent possible, and establishing legal measures to prevent the emergence of off-budget activities in the form of extrabudgetary funds. It would also involve a clear division of labor between local governments and local enterprises, with local governments taking on the responsibility for public services.

Tax assignment

- A "bottom-up" system of transfers or collection and allocation of taxes rarely works satisfactorily, since lower levels of governments invariably will find ways to minimize the share to be transferred "upward".

- A crucial element in a sound system is a stable and transparent system of tax assignment and tax sharing which clearly prescribes which tax sources can be legally applied at the local level.

- The tax system must provide local governments with sufficient and reasonably buoyant tax sources, so they can carry on their tasks without reverting to the use of "innovative" and frequently illegal revenue raising activities.

- Tax bases assigned to local governments should be defined by national legislation to prevent the central government from frequently changing the rules of the games, thereby protecting local tax efforts. This will also help to prevent local governments from engaging in unhealthy tax competition through base-setting, and to avoid the possibility of tax exporting and free-rider situations.

- Local governments should be assigned one or a few substantive tax sources over which they have a minimum of autonomy to set the tax rates, to ensure the necessary local accountability which is a *sine qua non* of a sound local fiscal system, and to avoid that local pressures for improving financing resources lead to the emergence of extrabudgetary funds.

- Substantive and buoyant tax sources should be left to the center for it to be able to carry out its responsibilities, including macroeconomic management. This would presumably involve "sharing" the personal income tax under a piggy-backing system.

Intergovernmental fiscal transfers

- The use of significant, and particularly gap-filling, transfers to local governments should be avoided where possible, and replaced with local own resources and equalization grants.

- Remaining transfers, which should correct for well-specified externalities and provide substantial equalization, should be provided under a stable and transparent legal framework, with fixed and nonnegotiable parameters.

- The transfer system should provide a significant amount of equalization of expenditure needs and tax capacities across jurisdictions, to provide local governments with more equal opportunities to produce an average level of local services at an average "tax" price.

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