China’s Long March to Decentralization

Jorge Martinez-Vazquez
Georgia State University, jorgemartinez@gsu.edu

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Decentralization in Asia and Latin America

Towards a Comparative Interdisciplinary Perspective

Edited by

Paul Smoke
New York University, USA

Eduardo J. Gómez
Brown University, USA

and

George E. Peterson
The Urban Institute, USA

STUDIES IN FISCAL FEDERALISM AND STATE–LOCAL FINANCE

Edward Elgar
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INTRODUCTION

China is a unitary country with a population of around 1.3 billion, an area of 9.6 million square kilometers, and a public sector organized into five tiers of government. Below the central government there are 31 provincial level units, and below the provinces there are 331 prefectural level units (of which 236 are cities), 2109 county-level units (of which 427 are cities), and 44,741 township-level units. Intergovernmental relations in China are organized in a strongly hierarchical fashion, giving the system significant federalist features; for example, prefectures and cities report exclusively to the provincial governments, and so down the hierarchy with each level of government reporting to the next highest level. These hierarchical relations are accentuated by the fact that government officials at all levels are appointed, not elected, and by the tight political control exercised by the Communist Party up and down all government channels.

In local terms, China is a highly decentralized country, with 70 per cent of total public expenditures going through subnational government budgets in 2003. The current legal framework confers substantial decision making autonomy on each level of government, with budgets approved by the council (or People's Congress) at the respective level. In reality, as discussed further below in this chapter, budgetary autonomy at the subnational level is limited in several important ways. But nevertheless from a fiscal viewpoint, if not politically or administratively, government in China today operates in a largely decentralized fashion.

The main objective of this chapter is to assess China's current system of decentralized finance, highlighting both strengths and weaknesses and the challenges ahead for getting decentralization to work more efficiently and fairly. Getting to where China is today in terms of decentralization has been a 'long march' of trials and errors, dead ends and progressive paths. Before we begin the in-depth review of current institutions and their operation, we think it is helpful to briefly look back at how China got here today.
The system of intergovernmental fiscal relations has experienced several major changes since the pro market reforms started in 1979. Throughout these changes the system has retained a nested hierarchical structure, with the central government setting fiscal arrangements exclusively with the provinces, the provinces doing the same with the prefectures, and so on down to the counties and settlements. Before 1979, under the central planning period, many aspects of public resource allocations were de-centralized but the budget process remained highly centralized, with all revenues and expenditures going through the central government budget. Under planning, price setting was the main allocation rule, and taxes were few and their enforcement simple through the state-owned enterprises (SOEs).

In 1978, China’s authorities made the historical decision to abandon central planning and adopt a market-oriented policy, and to start opening the country’s economy to the rest of the world. After some experimentation from 1978 to 1983, the Chinese government introduced the first comprehensive reform of the fiscal system in 1984, with the name of the Fiscal Responsibility System (FRS). Under the FRS, the central government tried different revenue sharing arrangements until in 1988 it introduced ‘fiscal contracting’ reform. This arrangement consisted of bilateral contracts between the center and each of the provinces for fixed periods of time, whereby provincial governments in essence were allowed to retain part of the tax revenues remaining after the remittance of a fixed sum to the central government. This arrangement lasted through 1993.

A key feature of the contracting system was its (short-term) incentive compatibility vis-à-vis subnational governments; unlike in the past, provincial governments could now generate more fiscal revenue by collecting more tax in any year. However, because of the expectations of re-contracting at some point in the future, partly on the basis of what had been collected during the former contract period, in the longer term subnational governments had negative incentives to exercise lower tax effort or to shift resources to extra-budgetary accounts, which would be less visible to the central authorities. The system was difficult to administer, as there were a large number of fiscal contracts in use, and it involved extensive negotiations. The central authorities were eyeballing relatively higher revenues and lower expenditure needs for provincial budgets and attempting to flush out subnational resources hidden in extra-budgetary funds. Meanwhile, the provinces were trying to do exactly the reverse. Tax sharing rates were customized for different provinces depending on their perceived wealth and needs. The central government used those customized shares together with customized transfers with the objective of redistributing fiscal resources across subnational governments.
The 'contracting system' rapidly worked against the interests of the central government. Because of their *de facto* control of the tax administration, subnational governments engineered ways to contribute fewer fiscal resources to the central government by, for example, providing subnational SOEs with tax advantages at the expense of the central coffers and by hiding resources from the central government in extra-budgetary funds.\(^6\) Strong competition among subnational governments to attract more economic development compounded this behavior. These forces led to a fast decrease in the share of the central government in total budget revenues, as well as to the decline of total budgetary revenues in GDP.\(^7\)

The ratio of revenues to GNP fell from 22.4 per cent in 1985 to 10.7 per cent in 1995 while the ratio of central government revenues to total revenues fell from 38.4 per cent in 1985 to 22 per cent in 1993 (Figure 5.1).

![Figure 5.1 Performance of the 'Two Ratios'](image)

*Source: MOF data, China Statistics Yearbook, various years.*

**Figure 5.1 Performance of the 'Two Ratios'**

An important institutional detail of this period that contributed to a variety of problems was the fact that tax revenues were shared among the center and subnational governments according to the principle of ownership (by level of government) of enterprises. This commingled the fiscal interests of governments with those of the SOEs, retarding the adaptation to market principles, leading to unfair competition and providing incentives
for protectionist policies and narrow fiscal interests, for example with each province trying to have its own distilleries and cigarette factories.

These changes in revenue sharing arrangements gradually led to the de-linking of revenue assignments from expenditure needs (World Bank, 2002). The positive side was that the contracting system tended to harden the budget constraint of subnational governments, an important step towards increased fiscal discipline at the subnational level. One negative side was the greater reliance on extra-budgetary funds by subnational governments, reducing the transparency and efficiency of budget allocations. The lower availability of fiscal resources at the central level in this period and the de-linking between revenues and expenditure needs also meant that many poor local governments, especially at the lowest levels of counties and townships, found themselves incapable of delivering important services that had been entrusted to them.

Facing all these problems, the central government decided to adopt fundamental reform of its tax policy, tax administration and intergovernmental fiscal relations systems in 1994, which became known as the 'Tax-sharing System' (TSS) reform. The goal in tax policy was to modernize the tax structure by simplifying income taxation, disallowing most forms of tax preferences, adopting a credit invoice system for the VAT, and introducing excise taxes on a number of goods. In tax administration, the TSS reform created separate tax administrations at the central and subnational levels. The subnational tax administration bureaus were entrusted with the enforcement of income taxes, among others, while the central tax administration was responsible for the VAT and for all taxes on centrally owned SOEs. These measures in tax policy and administration had the distinctive goal of increasing the overall tax take in GDP.

For intergovernmental fiscal relations, the main goal of the central government was to increase the central government share in overall revenues and to improve the transparency and stability of revenue assignments. The new revenue assignments are discussed below, but in essence the reform provided exclusive taxes for the central government (e.g., excises) and local governments (e.g., most income taxes), and established uniform rules for the sharing of other taxes, including VAT. Subnational governments also lost their ability to provide tax advantages to SOEs and to increase their extra-budgetary funds from those sources.

The two fundamental goals of the TSS reform, the improvement of the 'two ratios' – the central government share in total revenues, and the share of revenues in GDP – were achieved. By 2003 the share of the central government was back to 54.6 per cent and the share of revenues in GDP was at 18.5 per cent. The TSS reform accomplished several other things. It simplified the system and righted a series of incentive problems with the
previous system mainly by eliminating opportunities. For example, the granting of tax advantages was disallowed at the same time as income taxes became administered by the subnational tax administrations (except for centrally owned SOEs) or the excises were centralized so the incentive to build distilleries and tobacco companies all over the place was gone.

The TSS reform presented two main problems. First, it left the problematic and obsolete expenditure assignments inherited from the planning era unchanged. Second, it led to the worsening of horizontal fiscal disparities. Despite a high volume of transfers, the new system failed to equalize enough to guarantee poor subnational governments enough resources to supply basic services. Thus a main problem with the current intergovernmental finance is a faulty system of transfers. In addition, the TSS reform did not go far enough in reforming revenue assignments; subnational governments still have little revenue autonomy and the sharing of tax revenues is plagued by unfair apportionment issues. Other problems with the current system include the lack of subnational borrowing autonomy, and issues related to fiscal management and budgetary autonomy. The rest of this chapter is dedicated to examining in more detail the issues and remaining challenges with all these fundamental aspects of the current system of intergovernmental relations in China.

THE EXPENDITURE ASSIGNMENT

China does not have a formal explicit assignment of expenditure responsibilities among the different levels of government, as other countries do either in the Constitution or a major law. The current Budget Law discusses the division of expenditure assignments between the central and local governments only in very broad terms. Other legal instruments also make reference in passing to expenditure assignments. In practice, the actual division of expenditure responsibilities has been determined by sectoral and other specialized laws over the years. The main division of responsibilities between the central and subnational governments as a whole is summarized in Table 5.1. These assignments follow, with an important exception, the general principles and international practice of assigning competencies according to the size of the benefit area; thus public services reaching the entire country are assigned to the central level and those with geographically smaller areas are assigned to subnational governments. As discussed in more detail below, the exception with principles and international practice is the assignment of certain aspects of social security, such as unemployment compensation, to the subnational level. Besides these elements of social security services and the
ordinary responsibilities for public administration and safety and security, it is notable that subnational governments’ main responsibilities lie in the areas of economic development (physical infrastructure and agricultural and industrial development) and the provision of social services (education, health care, housing and communal services).

Table 5.1 The Assignment of Expenditure Responsibilities Between the Central and Subnational Governments

<table>
<thead>
<tr>
<th>Main expenditure responsibilities of the central government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
</tr>
<tr>
<td>Foreign affairs</td>
</tr>
<tr>
<td>Operation of the central government</td>
</tr>
<tr>
<td>Operational expenses for cultural, educational, scientific and public health undertakings at the central level</td>
</tr>
<tr>
<td>Key capital construction</td>
</tr>
<tr>
<td>Technical renovation and new product development in centrally owned enterprises</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Subsidies</td>
</tr>
<tr>
<td>Macroeconomic control and regional coordination of economic development</td>
</tr>
<tr>
<td>Social security</td>
</tr>
<tr>
<td>Debt</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Main expenditure responsibilities of Subnational governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operation of subnational governments</td>
</tr>
<tr>
<td>Operational expenses on cultural, educational, scientific and public health undertakings at the subnational level</td>
</tr>
<tr>
<td>Subnational capital construction</td>
</tr>
<tr>
<td>Fund for technical renovation and new product development in locally owned enterprises</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Urban maintenance and construction</td>
</tr>
<tr>
<td>Social security</td>
</tr>
<tr>
<td>Subsidies</td>
</tr>
</tbody>
</table>


The lack of a formal assignment of expenditure responsibility has meant that over the years the actual division of expenditure responsibilities among the different levels of subnational governments has been left to the discretion of the next higher level government. That is, in practice, especially at the subnational level, the higher-level government has had discretion to determine the assignment of expenditures of the level immediately below it. Thus, the provinces determine the service assignments of cities/prefectures, and the cities determine the assignments of counties and the latter determine the revenues and expenditures of towns and townships.
Because there are no specific central guidelines on the distribution of responsibilities between provinces and lower levels, each province can potentially have a different assignment of expenditure responsibilities among their four levels of government. The evidence available is that the distribution of expenditure responsibilities indeed differs significantly among provinces (World Bank, 2002).

This hierarchical ad hoc approach to expenditure assignments has meant necessarily that the central government cannot easily determine the revenue needs of subnational governments at the aggregate provincial level. Similarly, given the diversity of expenditure assignments within the provinces, the central government is very unlikely to be able to design policies to deal directly with sub-provincial governments by, for example, setting a targeted transfer program or standards for public services independently of the provincial authorities. China’s system of decentralization is thus very hierarchical and the central authorities are very unlikely to be able to bypass that hierarchical structure even if they wanted to do it.

The Vertical Composition of Expenditures

Whatever the degree of formality in expenditure assignment, much of the story is told by the actual shares by level and function. Table 5.2 (Part I) presents the central and local government shares per main expenditure category for selected years between 1978 and 2003. While in 1978, the share in consolidated expenditures of the central government (46 per cent) was quite similar to that of subnational governments (54 per cent), by 2003 the share for subnational government expenditures had increased to over two-thirds and the share of the central government had fallen to under one-third of the total.

These relative shares have been stable for almost ten years, but with a slight upward drift for the relative importance of subnational governments. From the viewpoint of the actual division of expenditure responsibilities Table 5.2 is particularly revealing. There has been a remarkable stability in the division of responsibilities for key services. In social services (education, health, culture and science) the subnational governments accounted for 89 per cent of expenditures in 2003, and this share has remained rather stable throughout a long period of time, going all the way back to 1978.
Table 5.2  Central and Subnational Budgetary Expenditures, 1978–2003

<table>
<thead>
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<tbody>
<tr>
<td></td>
<td>Central</td>
<td>Subnational</td>
<td>Central</td>
<td>Subnational</td>
</tr>
<tr>
<td></td>
<td>Shares per Expenditure Category, 1978–2003a</td>
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<td></td>
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</tr>
<tr>
<td>Total</td>
<td>46.13</td>
<td>53.87</td>
<td>33.65</td>
<td>66.35</td>
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<tr>
<td>Capital Construction</td>
<td>55.75</td>
<td>44.25</td>
<td>47.93</td>
<td>52.07</td>
</tr>
<tr>
<td>Working Capital</td>
<td>29.31</td>
<td>70.69</td>
<td>80.66</td>
<td>19.34</td>
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<tr>
<td>Tech’l Upgrading and R&amp;D</td>
<td>33.33</td>
<td>66.67</td>
<td>27.25</td>
<td>72.75</td>
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<td>30.00</td>
<td>70.00</td>
<td>98.73</td>
<td>1.27</td>
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<tr>
<td>Industry, Transport &amp; Commerce</td>
<td>55.56</td>
<td>44.44</td>
<td>33.37</td>
<td>66.63</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2.6</td>
<td>97.4</td>
<td>16.46</td>
<td>83.54</td>
</tr>
<tr>
<td>Culture, Education, Science &amp; Health</td>
<td>11.5</td>
<td>88.5</td>
<td>10.02</td>
<td>89.98</td>
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<tr>
<td>Social Relief &amp; Welfare</td>
<td>0.00</td>
<td>100.00</td>
<td>0.69</td>
<td>99.31</td>
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<tr>
<td>Defense</td>
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<td>4.17</td>
<td>99.37</td>
<td>0.63</td>
</tr>
<tr>
<td>Gov’t Administration</td>
<td>8.16</td>
<td>91.84</td>
<td>2.43</td>
<td>97.57</td>
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<tr>
<td>Gov’t Debt Servicec</td>
<td>100</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>SOE Lossesd</td>
<td>38.79</td>
<td>61.21</td>
<td>27.75</td>
<td>72.25</td>
</tr>
<tr>
<td>Price Subsidies</td>
<td>47.3</td>
<td>52.7</td>
<td></td>
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<tr>
<td>Othere</td>
<td>47.3</td>
<td>52.7</td>
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</tbody>
</table>

Notes:

a  The total may add to less or more than 100, because of reporting discrepancies and data availability.
b  Central and subnational share in Part I = 100 per cent for each expenditure category.
c  Government debt service included the payment of principal and interest of domestic and foreign debts until about 1998. Beginning in the 1999 budget interest payments are reported as a separate item. Since in the yearbook, there is no separate accounting of local government and central government in this expenditure category and the fact that the majority is paid by the central government, we denote the total amount as the central share.
d  The breakdown of central and local figures for SOE Loss in 1978 are estimated from the average of the same data from 1988–1991.
e  The local expenditure categories not listed here, group into the category ‘Others’ in the panels. This category includes, for example in 2003, expenditure of operating expenses of other departments, retired persons in administrative departments, subsidies to social security programs, expenditure for armed police troops, city maintenance, supporting underdeveloped areas, developing land and sea areas, interest of debts, special items, and other expenditure. We do not list this category for central government due to the problem with debt services we mentioned above.
f  Distribution of Expenditure by category in Part II: vertical sum = 100 per cent.
Table 5.2  Central and Subnational Budgetary Expenditures, 1978–2003 (continued)

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<td>Subnational</td>
<td>Central</td>
<td>Subnational</td>
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<td>Subnational</td>
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<td>Subnational</td>
<td>Central</td>
<td>Subnational</td>
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<td>Subnational</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<td>100</td>
<td>100</td>
<td>100</td>
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<td>100</td>
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<tr>
<td>Capital Construction</td>
<td>44.55</td>
<td>30.26</td>
<td>15.4</td>
<td>8.5</td>
<td>17.06</td>
<td>11.17</td>
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<td>11.07</td>
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<tr>
<td>Working Capital</td>
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<td>6.2</td>
<td>1.1</td>
<td>0.1</td>
<td>0.91</td>
<td>0.21</td>
<td>0.14</td>
<td>0.01</td>
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<tr>
<td>Tech'l Upgrading and R&amp;D</td>
<td>3.71</td>
<td>6.35</td>
<td>5.5</td>
<td>7.5</td>
<td>4.54</td>
<td>5.92</td>
<td>3.62</td>
<td>4.79</td>
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<tr>
<td>Geological Prospecting Industry, Transport &amp; Commerce</td>
<td>1.06</td>
<td>2.12</td>
<td>2.7</td>
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<td>0.81</td>
<td>0.42</td>
<td>0.34</td>
<td>0.47</td>
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<td>1.4</td>
<td>0.78</td>
<td>1.03</td>
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<td>Culture, Education, Science &amp; Health</td>
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<td>11.35</td>
<td>1.4</td>
<td>3.6</td>
<td>1.42</td>
<td>6.60</td>
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<td>5.80</td>
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<tr>
<td>Social Relief &amp; Welfare</td>
<td>2.3</td>
<td>15.13</td>
<td>6</td>
<td>27.3</td>
<td>5.28</td>
<td>23.44</td>
<td>6.85</td>
<td>23.20</td>
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<tr>
<td>Defense</td>
<td>28.45</td>
<td>1.06</td>
<td>25.8</td>
<td>0.1</td>
<td>22.06</td>
<td>0.09</td>
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<td>Gov't Administration</td>
<td>0.71</td>
<td>6.81</td>
<td>0.5</td>
<td>10.9</td>
<td>2.36</td>
<td>15.87</td>
<td>7.27</td>
<td>16.87</td>
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<td>Gov't Debt Serviced</td>
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<td>35.9</td>
<td>–</td>
<td>29.08</td>
<td>–</td>
<td>39.78</td>
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<tr>
<td>SOE Losses</td>
<td>7.9</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td></td>
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</tr>
<tr>
<td>Price Subsidies</td>
<td>0</td>
<td>0</td>
<td>4.1</td>
<td>5.5</td>
<td>11.90</td>
<td>3.79</td>
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<tr>
<td>Other</td>
<td>6.2</td>
<td>5.9</td>
<td>32.7</td>
<td>–</td>
<td>29.45</td>
<td>–</td>
<td>31.48</td>
<td>–</td>
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*Source:* MOF Data. The local expenditures include the earmarked transfers from the central government.
Much more unusual in a fiscally decentralized system, the role of subnational governments in the area of social assistance and welfare has remained dominant through the decades. In 2003 subnational governments’ expenditures in welfare and social security represented a little less than 99 per cent of total expenditures in this sector, practically unmoved from a figure of 100 per cent in 1978. Subnational governments also play a dominant role in economic areas such as industry, commerce, and agriculture. Areas of change in the central subnational shares include the financing of price subsidies, which started mostly as a subnational government responsibility, then became more evenly divided, and more recently subnational governments have again taken a lead; in 2003, almost two-thirds of the price subsidies were paid by subnational governments. The central government is practically responsible for the entirety of defense expenditures, and also for debt service. Capital infrastructure responsibilities are also quite decentralized: in 2003, subnational governments represented 55 per cent of this type of expenditure.

The changes over time in the composition of subnational government budget expenditures (as a percentage of total budget subnational government expenditures) and of central government expenditures are also quite telling (Table 5.2, Part II). In 1978, 30.3 per cent of all subnational government expenditures were in capital construction, but this had decreased to 11 per cent in 2003. Other important expenditure categories at the subnational level back in 1978 were expenditures on social services (15 per cent), and agriculture (11 per cent). In 2003 expenditures in public services had increased to 23.2 per cent, while agriculture had decreased to 5.8 per cent. Another important change in relative importance was the increase in government administration expenditures from 6.8 per cent in 1978 to 16.8 per cent in 2003. Remarkably, the relative importance of expenditures in social relief and welfare were at 2.9 per cent of the total in 1978 and remained at the same level in 2003. At the same time, new expenditures have emerged that are not captured by the categories in the table – this is reflected in the growth of the residual item ‘others’, which grew from 6 per cent of total local expenditures in 1978 to more than 30 per cent in 2003. Included in this residual are expenditures on urban maintenance and construction, tax administration, and civil service pensions. The major expenditure items for the central government in 1978 were capital construction (44.5 per cent), defense expenditures (30 per cent), and SOE losses (8 per cent). In 2003 the most important expenditures at the central level were defense (25.4 per cent), capital construction (20.5 per cent), and debt service (12.9 per cent).

As a percentage of GNP, both central and subnational government expenditure have experienced a wild ride since the late 1970s. While in 1978
Subnational expenditures represented 18.2 per cent of GNP and central government expenditures 15.6 per cent, by 1995 (the year the 1994 TSS reforms were put into effect) these levels had fallen, respectively, to 8.4 per cent and 4.3 per cent. By 2003, subnational government expenditures relative to GNP had recovered fully at 19.75 per cent. The recovery of central government expenditures was more modest and represented 7.3 per cent of GNP in 2003.

In order to get a clearer picture of budgetary subnational government expenditures, I recalculated local expenditures to include enterprise subsidies, which are treated as negative revenue in official accounts. I also regrouped expenditures by function to be able to see with more clarity the shifts in the composition of aggregate subnational expenditures through the transition period (Table 5.3). The largest reduction in expenditures (by share) is in subsidies – with the abolition of nearly all administratively fixed prices, the need for price subsidies has been virtually eliminated. The government has also gradually reduced subsidies to state-owned enterprises – even as the number of loss-making SOEs continued to grow through the 1990s. As a result, spending on subsidies has fallen from 25.1 per cent in 1986 to only 3.3 per cent of total budgetary expenditures in 2003. Expenditures for ‘development’, comprising capital construction, technical renovation in enterprises, geological surveys, science and technology, agricultural support, and urban maintenance, have stayed at approximately the same level between 26 and 27 per cent. Social spending, comprising education, health, culture and science, has increased only moderately, from 23.8 per cent in 1986 to 26.8 per cent in 2003. Administration expenditures rose moderately from 23.8 per cent to 25.8 per cent. The biggest increase took place in the residual category of ‘other’ (defined above), which rose from 5.3 per cent in 1986 to 23.3 per cent of the total in 2003.

The recalculations in Table 5.3 illustrate the difficulty of analyzing expenditure composition and changes in policy priorities under the budget classification system used in China.

This system is largely a legacy of the Soviet centrally planned system, which uses a mix of functional, economic and organizational categories. For example, the classification does not make a clear distinction between investment and recurrent expenditures. The separately identified capital expenditure item, ‘capital construction’, does not include all capital expenditures, since many agencies such as industry, transport, agriculture, and urban construction undertake capital construction activity not included in ‘capital construction’. Elsewhere, capital expenditures financed under earmarked schemes are lumped together with current expenditures. For example, the Compulsory Education Program, the largest earmarked grant for education, mainly funds capital spending, yet resources are commingled...
**Table 5.3 Recalculated Subnational Expenditures**

**Part I: Shares of Total (%)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Adjusted Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>2. Capital Construction</td>
<td>13.1</td>
<td>8.1</td>
<td>10.9</td>
<td>10.9</td>
</tr>
<tr>
<td>3. Technical Transformation</td>
<td>5.0</td>
<td>6.4</td>
<td>4.7</td>
<td>4.7</td>
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<tr>
<td>4. Makeshift Building</td>
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<td>0.0</td>
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<td>5. Geological Prospecting</td>
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<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>6. Science &amp; Technology</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>7. Working Capital</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>8. Agricultural Support^a</td>
<td>3.4</td>
<td>7.5</td>
<td>6.5</td>
<td>5.7</td>
</tr>
<tr>
<td>9. Agriculture &amp; Fisheries</td>
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<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>10. Industry, Transport, Commerce</td>
<td>1.5</td>
<td>1.3</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>11. Urban Maintenance</td>
<td>4.6</td>
<td>5.6</td>
<td>4.4</td>
<td>4.9</td>
</tr>
<tr>
<td>12. Urban Employment Placement</td>
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<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>13. Culture, Education, Health^b</td>
<td>21.3</td>
<td>25.9</td>
<td>22.9</td>
<td>22.9</td>
</tr>
<tr>
<td>14. Science</td>
<td>0.4</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>15. Other Administration</td>
<td>3.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>16. Welfare Assistance</td>
<td>2.3</td>
<td>2.2</td>
<td>2.0</td>
<td>2.8</td>
</tr>
<tr>
<td>17. Militia</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>18. Air Defense</td>
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<tr>
<td>19. Administration</td>
<td>9.1</td>
<td>15.8</td>
<td>15.5</td>
<td>19.7</td>
</tr>
<tr>
<td>20. Policy Subsidies^c</td>
<td>15.9</td>
<td>5.2</td>
<td>3.7</td>
<td>2.2</td>
</tr>
<tr>
<td>21. Other</td>
<td>4.0</td>
<td>15.3</td>
<td>23.7</td>
<td>21.5</td>
</tr>
<tr>
<td>22. Earmarked Expenditures^d</td>
<td>1.0</td>
<td>0.4</td>
<td>1.9</td>
<td>1.8</td>
</tr>
<tr>
<td>23. Enterprise Loss Subsidies</td>
<td>9.2</td>
<td>5.3</td>
<td>2.2</td>
<td>1.1</td>
</tr>
</tbody>
</table>

**Part II: Shares of Total (%)**

<table>
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<tr>
<th></th>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1. Total Subsidies</td>
<td>25.1</td>
<td>10.4</td>
<td>5.9</td>
<td>3.3</td>
</tr>
<tr>
<td>2. Development^e</td>
<td>27.5</td>
<td>27.7</td>
<td>26.8</td>
<td>26.8</td>
</tr>
<tr>
<td>3. Administration^f</td>
<td>18.4</td>
<td>17.1</td>
<td>16.5</td>
<td>20.9</td>
</tr>
<tr>
<td>4. Social^g</td>
<td>23.8</td>
<td>28.1</td>
<td>24.9</td>
<td>25.8</td>
</tr>
<tr>
<td>5. All others</td>
<td>5.3</td>
<td>16.6</td>
<td>25.8</td>
<td>23.3</td>
</tr>
<tr>
<td>6. Memo item:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Reported Total^h</td>
<td>138 000</td>
<td>482 833</td>
<td>1045 428</td>
<td>1722 985</td>
</tr>
</tbody>
</table>

**Notes:**

a In 1995 and 1999 this item is combined with running costs of Agric. Departments.
b Includes science in later years.
c Prior to 1998 this was called ‘price subsidies’.
d In 1995 this item comprises new product development funds and aid to poor regions.
e Development = Part I item numbers: (1+2+3+4+5+6+10).
f Administration = Part I item numbers: (8+9+14+15+16+18).
g Social = Part I item numbers: (11+12+15).
h Total Subsidies = Part I item numbers: (19+22).

**Source:** MOF data, *China Statistics Yearbook*, various years.
with allocations for recurrent expenditures at the local level. In addition, the expenditures incurred by different departments as shown in the budget do not represent functional categories. There are multiple heads to show expenditures on a single major function. For example, administrative expenditures are scattered through several headings including 'administration' and 'other administration'. Nor is it possible to identify the expenditures incurred on maintenance of infrastructure capital stock to assess its adequacy.

Main Issues with Expenditure Assignments

Lack of clear assignments
The lack of a formal clear assignment has some advantages. For example, it requires provincial governments and all other tiers down the hierarchy to adapt to the specific characteristics of the local entities below them. Either because the characteristics of provinces differ or for other reasons, there appear in fact to be significant differences in the intra-provincial organization of expenditure responsibilities (World Bank, 2002). The lack of a clear formal assignment, however, also has disadvantages. One of these is that the lack of guidelines from the law or the central government has let many provincial governments push down expenditure responsibilities to the lowest levels of governments without adequate funding and capacity. In addition, these lower levels appear to have no comparative advantage in delivering, for example, a variety of health and education services. The lack of clarity and the *ad hoc* decisions about responsibilities can also easily lead to friction, inefficiencies and sometimes the failure to deliver the service.

This lack of clarity in the *de facto* assignment of responsibilities is compounded by a high degree of concurrent and overlapping expenditures among the subnational levels in China. Although in theory there is nothing necessarily wrong with concurrent assignments in particular areas, and sometimes they may be desirable, in practice, concurrent responsibilities make it harder to identify what level of government should be accountable for the delivery of particular services. Inefficient under-provision of services is more likely in the presence of extensive concurrent responsibilities. In the case of concurrent responsibilities for education, expenditure responsibilities are divided in practice by 'ownership'; this means that a school set up by the county is financed from county funds, while one set up by the township is financed from the township budget, and so on. The involvement of poor townships in the delivery of education services appears to continue despite the fact that the central government has repeatedly called for counties to finance rural basic education.
The inability of many subnational governments to deliver critical services assigned to them has increasingly made the central government play the role of the rescuer of last resort, especially in the areas of social security and safety net. The growing bailouts to local governments would seem to indicate not only that current expenditure assignments may not be sustainable, but also that the roles of different tiers are increasingly blurred. They also signal the willingness of the central government to accept incrementally more responsibility for financing certain functions traditionally assigned to the subnational level.

**Inefficient expenditure assignments**
There are many problem areas in the current practice with the assignments. Among the most conspicuous are the following: cities at the prefecture and county levels are fully responsible for unemployment insurance and social security and welfare; counties and townships, the lowest tiers of government, are responsible for the majority of education and health expenditures; and local governments in general are responsible for social protection and welfare programs. The assignment of these responsibilities is out of line with international practice and first principles. In fact, the assignment of responsibilities for social security at the lower levels of government puts China in a league of its own since no other country in the world has a similar practice. Given the large population of many of China’s provinces a case could be made for reassigning social security to this level, as opposed to the central level, as is usually done in other countries. However, it appears that even for pension schemes, the effort to move toward provincial pooling has made only limited progress. The inability of many local governments to finance the social safety net has led in recent years to widespread pension arrears and defaults that have forced the central government to intervene with subsidies. The assignment of education, health, and social assistance to county and township governments, which often have limited administrative capacity and meager fiscal resources, has also led to serious deficiencies in the services provided.

**The fulfillment of capital expenditure responsibilities**
Local governments are, correctly, responsible for financing the infrastructure needed to deliver the services assigned to them. However, in reality many local governments, especially counties and townships, lack the liquid resources to undertake the required investments. But since local governments are not permitted to borrow, the system currently provides no clear answer for local officials on how to develop capital infrastructure other than to beg from a higher-level government or make use of extra-budgetary channels. Given the vast unmet needs for new and replacement
capital infrastructure, it would seem that it is time for the central
government to consider how best to allow responsible and well-regulated
subnational borrowing. Substantial borrowing has already occurred through
local enterprises, project entities, and other more or less legitimate channels.
Thus again, as in the case of the illegal fees, it would seem preferable if the
central government were to accept the reality of subnational government
borrowing and take the initiative to regulate and control this process better.

REVENUE ASSIGNMENTS AND TAX AUTONOMY

The 1994 the TSS reform represented a significant change for the central–
subnational revenue assignments. Major accomplishments of the 1994
reform were the discontinuance of the contractual or negotiated system
between the central and provincial government, replacing it with an explicit
and stable revenue assignment, and the creation of separate tax
administrations for the enforcement of central and local taxes.

Current Revenue Assignments

As mentioned above, the 1994 TSS reform introduced explicit revenue
assignments between the central and provincial governments by distinguishing
three categories of taxes: central government ‘own’ taxes, local government
‘own’ taxes, and shared taxes between the two levels of government (Table 5.4).

Several features are notable in this formal revenue assignment. First,
with the very minor exceptions discussed below, the TSS reform did not
provide provincial governments with any significant degree of tax
autonomy, in particular the discretion to set rates for their ‘own’ taxes.
Second, following the hierarchical vertical structure tradition, the TSS
reform only provided explicit revenue assignments between the central and
provincial governments, leaving it to the discretion of provincial
governments to arrange revenue assignments at the sub-provincial level.
Third, elements of the previous ‘contracting system’ of revenue
assignments were kept in place. To win the support for the TSS reform from
the provinces that stood to lose the most, the central government agreed to
phase in the reforms over a number of years, which in effect kept all
provinces at the revenues they had in 1993. This was achieved through the
introduction of a formula-based ‘tax rebate’ to each province. This tax
rebate has represented since 1995 the most important form of transfer from
the central government to the provinces. Fourth, for major taxes the TSS
reform failed to centralize the VAT and assigned 100 per cent of personal
income tax (PIT) and enterprise income tax (EIT) to local governments.15
### Table 5.4 Revenue Assignments between the Central and Subnational Governments

<table>
<thead>
<tr>
<th>I. Taxes exclusively assigned to the Central Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Excise taxes</td>
</tr>
<tr>
<td>2. Income tax of all central government enterprises</td>
</tr>
<tr>
<td>3. Taxes collected from the Ministry of Railroads and from the headquarters of banks and insurance companies</td>
</tr>
<tr>
<td>4. Income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures</td>
</tr>
<tr>
<td>5. Energy and transportation fund contribution</td>
</tr>
<tr>
<td>6. Seventy per cent of the three sales taxes collected from enterprises owned by the Ministry of Industry, the Ministry of Power, SINOPEC (petrochemicals), and the China nonferrous metals companies</td>
</tr>
<tr>
<td>7. All customs duty, VAT and excise taxes on imports</td>
</tr>
<tr>
<td>8. Enterprise income tax collected from banks and other financial institutions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>II. Taxes shared between the central and subnational governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Value-added tax (75 per cent central, 25 per cent provincial)</td>
</tr>
<tr>
<td>2. National resource taxes (coal, gas, oil &amp; other minerals if the enterprises are fully Chinese owned)</td>
</tr>
<tr>
<td>3. Construction tax on the cost of construction of buildings that are outside the plan and financed from retained earnings</td>
</tr>
<tr>
<td>4. Salt tax</td>
</tr>
<tr>
<td>5. Security and exchange tax (50 per cent central, 50 per cent provincial)</td>
</tr>
<tr>
<td>6. Individual and commercial tax, and income tax levied on foreign &amp; joint venture enterprises</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>III. Taxes exclusively assigned to subnational governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Income tax and adjustment tax of locally owned state enterprises, collectives, and private enterprises</td>
</tr>
<tr>
<td>2. Business (gross receipts) tax falling on sectors not covered by VAT (transportation and communications, construction, financial and insurance, post and telecommunications, culture and sports, enter., hotels and restaurants, and other)</td>
</tr>
<tr>
<td>3. Rural market (stall rental) trading tax</td>
</tr>
<tr>
<td>4. The urban maintenance and construction tax (a surcharge on the tax liability of enterprises for business tax, consumption tax, and VAT)</td>
</tr>
<tr>
<td>5. The urban land use tax</td>
</tr>
<tr>
<td>6. Vehicle and vessel utilization tax</td>
</tr>
<tr>
<td>7. Thirty per cent of the product and VAT revenues collected from enterprises owned by the Ministry of Industry, Ministry of Power, SINOPEC, and the China nonferrous metals companies</td>
</tr>
<tr>
<td>8. Individual income tax</td>
</tr>
<tr>
<td>9. Value-added tax on land</td>
</tr>
<tr>
<td>10. Education surtax</td>
</tr>
<tr>
<td>11. Entertainment and slaughter taxes</td>
</tr>
<tr>
<td>12. Property tax</td>
</tr>
<tr>
<td>13. Surtax on collective enterprises</td>
</tr>
<tr>
<td>14. Resources tax</td>
</tr>
<tr>
<td>15. Fixed asset investment tax (discontinued in 1999)</td>
</tr>
<tr>
<td>16. Fines for delinquent taxes</td>
</tr>
</tbody>
</table>

**Notes:**

- Starting in 1997, the central government share increased several years ending at 97 per cent in 2002.
- Starting in 2002, the central government has a share in the collection receipts from these taxes.

**Source:** Updated from Bahl (1999b).
## Table 5.5 The Relative Shares of Different Sources of Revenues (2003)*
(Computed without Subsidies to Loss-making Enterprises)

<table>
<thead>
<tr>
<th>Region</th>
<th>Total Revenue (RMB 10 000 Yuan)</th>
<th>Value-Added Tax</th>
<th>Business Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing</td>
<td>6 435 934</td>
<td>11.69</td>
<td>40.97</td>
</tr>
<tr>
<td>Tianjin</td>
<td>2 075 295</td>
<td>21.78</td>
<td>30.99</td>
</tr>
<tr>
<td>Hebei</td>
<td>3 373 823</td>
<td>20.37</td>
<td>19.37</td>
</tr>
<tr>
<td>Shanxi</td>
<td>1 878 534</td>
<td>27.34</td>
<td>19.50</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td>1 393 306</td>
<td>16.22</td>
<td>26.08</td>
</tr>
<tr>
<td>Liaoning</td>
<td>4 503 797</td>
<td>18.98</td>
<td>26.44</td>
</tr>
<tr>
<td>Jilin</td>
<td>1 602 981</td>
<td>19.14</td>
<td>21.85</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>2 510 438</td>
<td>23.36</td>
<td>18.38</td>
</tr>
<tr>
<td>Shanghai</td>
<td>9 224 143</td>
<td>18.45</td>
<td>36.03</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>8 054 123</td>
<td>22.53</td>
<td>25.73</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>7 537 731</td>
<td>20.56</td>
<td>29.20</td>
</tr>
<tr>
<td>Anhui</td>
<td>2 230 407</td>
<td>16.57</td>
<td>20.61</td>
</tr>
<tr>
<td>Fujian</td>
<td>3 050 039</td>
<td>17.83</td>
<td>27.78</td>
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<tr>
<td>Jiangxi</td>
<td>1 683 862</td>
<td>13.70</td>
<td>25.63</td>
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<tr>
<td>Shandong</td>
<td>7 186 771</td>
<td>17.54</td>
<td>20.14</td>
</tr>
<tr>
<td>Henan</td>
<td>3 397 595</td>
<td>17.06</td>
<td>22.17</td>
</tr>
<tr>
<td>Hubei</td>
<td>2 640 044</td>
<td>17.29</td>
<td>21.75</td>
</tr>
<tr>
<td>Hunan</td>
<td>2 726 273</td>
<td>13.25</td>
<td>22.09</td>
</tr>
<tr>
<td>Guangdong</td>
<td>13 183 733</td>
<td>17.73</td>
<td>31.54</td>
</tr>
<tr>
<td>Guangxi</td>
<td>2 051 950</td>
<td>13.98</td>
<td>23.35</td>
</tr>
<tr>
<td>Hainan</td>
<td>5 13 205</td>
<td>12.40</td>
<td>31.30</td>
</tr>
<tr>
<td>Chongqing</td>
<td>1 638 937</td>
<td>15.05</td>
<td>28.46</td>
</tr>
<tr>
<td>Sichuan</td>
<td>3 393 318</td>
<td>14.17</td>
<td>26.41</td>
</tr>
<tr>
<td>Guizhou</td>
<td>1 250 921</td>
<td>15.53</td>
<td>25.15</td>
</tr>
<tr>
<td>Yunnan</td>
<td>2 313 589</td>
<td>16.90</td>
<td>19.52</td>
</tr>
<tr>
<td>Tibet</td>
<td>90 685</td>
<td>10.33</td>
<td>44.29</td>
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<tr>
<td>Shaanxi</td>
<td>1 786 306</td>
<td>17.71</td>
<td>28.58</td>
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<tr>
<td>Gansu</td>
<td>889 465</td>
<td>20.38</td>
<td>27.06</td>
</tr>
<tr>
<td>Qinghai</td>
<td>240 451</td>
<td>21.84</td>
<td>30.39</td>
</tr>
<tr>
<td>Ningxia</td>
<td>300 321</td>
<td>16.79</td>
<td>36.28</td>
</tr>
<tr>
<td>Xinjiang</td>
<td>1 282 302</td>
<td>19.64</td>
<td>31.08</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100 440 279</strong></td>
<td><strong>18.03</strong></td>
<td><strong>27.55</strong></td>
</tr>
</tbody>
</table>

| Mean            | 3 240 009                       | 17.62           | 27.04        |
| Standard Deviation | 3 016 481                     | 3.70            | 6.35         |
| Coefficient of Variation | 0.93                   | 0.21            | 0.23         |
| Maximum         | 13 183 733                      | 27.34           | 44.29        |
| Minimum         | 90 685                          | 10.33           | 18.38        |

**Notes:**

a All other categories in the Yearbook not listed in this table include Resource Tax, Tax on the Adjustment of the Investment in the Fixed Assets, Tax on Real Estates, Stamp Tax, Tax on the Use of Urban Land, Land Value Added Tax, Tax on the Use of Vehicles and Ships, Slaughter Tax, Banquet Tax, Tax on Animal Husbandry, Tax on the Occupancy of Cultivated Land, Contract Tax, State-owned Assets Profit, Income From Use of Sea Area, Field and Diggings and Other Income.

b The computations are based on the magnitude of shares in total revenue. Categories in this table are slightly different than those in the Yearbook.
<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>14.56</td>
<td>8.89</td>
<td>4.48</td>
<td>0.10</td>
<td>2.82</td>
</tr>
<tr>
<td>11.47</td>
<td>6.04</td>
<td>5.20</td>
<td>0.18</td>
<td>7.10</td>
</tr>
<tr>
<td>8.50</td>
<td>5.38</td>
<td>5.56</td>
<td>7.66</td>
<td>8.73</td>
</tr>
<tr>
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<td>3.14</td>
<td>3.49</td>
<td>0.01</td>
<td>2.47</td>
</tr>
</tbody>
</table>

Notes:

- Enterprises’ Income Tax is the result of combining the figures of Enterprises’ Income Tax with Return for Enterprises’ Income Tax in the Yearbook.
- The Agricultural Tax is the result of combining Agricultural Tax and Tax on Special Agricultural Products in the Yearbook.

Starting in the late 1990s the government has added some new taxes and assigned them to central revenues, as well as revised some of the assignments of taxes, especially related to the PIT and the EIT. Although the 1994 Tax Sharing System (TSS) reform had assigned the EIT and the PIT as local taxes, in 2002 receipts from these two taxes were split 50–50 between central and local governments. In 2003, the central government sharing rate was increased to 60 per cent. There were no further changes in 2004.

**Actual Revenue Shares**

Only a few of the taxes assigned to the local level are of any revenue significance. The relative importance in total revenues at the province level (and below) of different taxes is summarized in Table 5.5. In China, the item ‘Subsidies to Loss-making State-owned Enterprises’ is still considered a ‘negative source of revenue’. However, the relative shares of different sources of revenues are computed in Table 5.5 without this item, in order to provide a less distorted picture of collections.

On average, the most important sources of local revenues (consolidated by province) are the business tax with 27 per cent, the VAT, with 18 per cent and the EIT with 10 per cent. Smaller but still significant sources of revenues are the PIT with 5 per cent, the tax on urban construction and the maintenance tax also with 5 per cent, and the agricultural tax with less than 4 per cent. The relative importance of administrative fees has risen in recent years and in 2003 they represented 7 per cent of total subnational revenues. On average, subsidies to loss-making SOEs represent less than 3 per cent of total revenues and have continued to decrease in recent years.

There is significant variation across the provinces for every single source of revenue, as captured by the coefficient of variation and the range between the maximum and minimum values across provinces, indicated at the bottom of Table 5.5. For example, administrative fees represent 15.8 per cent of the revenues in Chongqing but only 2.5 per cent in Shanghai. There is not necessarily a rich and poor explanation for the composition of revenues. For example, the business tax represented 41 per cent in Beijing and 36 per cent in Shanghai but also 44 per cent in Tibet. It is also interesting that ‘Subsidies to Loss-making State-owned Enterprises’ has a larger variation across provinces than any source of revenue. Subsidies represent 12 per cent of revenues and about 10 per cent in Beijing and Zhejiang.
Table 5.6 The Aggregate Performance of Subnational Revenue Collections, 1978–2003

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Budgetary Revenue Collections as a per cent of GNP</th>
<th>Subnational Collections as a per cent of Total Expenditure</th>
<th>Subnational Expenditure as a per cent of Subnational Collections</th>
</tr>
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<tbody>
<tr>
<td>1978</td>
<td>31.6</td>
<td>26.7</td>
<td>4.9</td>
</tr>
<tr>
<td>1979</td>
<td>28.7</td>
<td>22.9</td>
<td>5.8</td>
</tr>
<tr>
<td>1980</td>
<td>25.9</td>
<td>19.6</td>
<td>6.4</td>
</tr>
<tr>
<td>1981</td>
<td>24.6</td>
<td>18.1</td>
<td>6.5</td>
</tr>
<tr>
<td>1982</td>
<td>23.3</td>
<td>16.7</td>
<td>6.7</td>
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<td>1983</td>
<td>23.5</td>
<td>15.1</td>
<td>8.4</td>
</tr>
<tr>
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<td>23.6</td>
<td>14.0</td>
<td>9.6</td>
</tr>
<tr>
<td>1985</td>
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<td>13.7</td>
<td>8.6</td>
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<tr>
<td>1986</td>
<td>20.8</td>
<td>13.2</td>
<td>7.6</td>
</tr>
<tr>
<td>1987</td>
<td>18.4</td>
<td>12.2</td>
<td>6.2</td>
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<td>1988</td>
<td>15.8</td>
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<tr>
<td>1994</td>
<td>11.2</td>
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<td>1995</td>
<td>10.9</td>
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<tr>
<td>1996</td>
<td>11.1</td>
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<td>1997</td>
<td>11.8</td>
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<td>2003</td>
<td>18.6</td>
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<td>10.2</td>
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</tbody>
</table>

Source: China Statistics Yearbook, various years.

The aggregate performance of local revenue collections as a percentage of GNP has experienced significant fluctuations since the late 1970s. Local revenues deteriorated rapidly from the 1980s to the mid-1990s, under the contracting system, and they began to improve steadily after the 1994 TSS reform. Local budgetary revenue collections went from 26.7 per cent of GNP in 1978 to 5 per cent of GNP in 1994 to 8.4 per cent in 2003 (Table 5.6). The turnaround in performance is also captured by the significant jump in the buoyancy coefficient of local budgetary revenues with respect to GNP, which during the 1978–93 period stood at 0.587 and increased to 1.597 in the 1994–99 period (Table 5.6). Nevertheless, the share of local revenues in total government budgetary revenue collections has declined almost steadily from a high of 84.5 per cent in 1978 to 45 per
cent in 2003. The increasing dependency of subnational governments on central transfers is revealed by a steady increase in the ratio of subnational government budgetary expenditures to subnational budgetary revenues, which stood at 175 per cent in 2003 (Table 5.6). However, including tax rebates as local revenues (rather than as transfers) would significantly reduce this degree of dependence. To the extent that tax rebates are non-discretionary transfers, the real dependence of local governments on central transfers is much less than indicated by budgetary statistics.

Sub-provincial Revenue Assignments

The 1994 TSS reform, as pointed out above, did not provide a specific revenue assignment structure at the sub-provincial level. Instead, continuing a long tradition, provincial governments were given the discretion to arrange revenue assignments with their local governments in any way they wanted to. It appears that the provincial governments follow the traditional hierarchical approach by setting only revenue assignments between the province and the first layer of local governments, the cities and prefectures. In turn, the cities and prefectures are left to their own discretion to arrange revenue assignments with the next layer of local governments, the counties. The same applies for the counties vis-à-vis the lowest layer of local governments, the towns and townships. The discretion to design revenue assignments at the sub-provincial level basically implies the existence of a large variety of revenue assignments at the sub-provincial level. This tendency is reinforced by the discretion available to them to introduce extra-budgetary and off-budget revenue instruments.

Soon after the 1994 TSS reform, the central authorities demanded that the provinces formalize their tax assignments with lower levels. Different arrangements have emerged characterized by how 'local' taxes and tax rebates have been shared among the different tiers. These can be roughly grouped into three types (Shi, 1998). In the first group, the provincial governments have chosen to pass through all local taxes and rebates to sub-provincial levels. In a second group are those provinces that have kept a portion of local taxes and rebates. In the third group, which may be called the centralizing provinces, the provincial level has captured a relatively large portion of all local taxes and rebates. Table 5.7 shows the sharing arrangement in Hebei, Jiangsu, Gansu and Hunan Provinces. The overwhelming criterion in the arrangements for tax assignments and revenue sharing at the sub-provincial level appears to be the 'ownership' principle: the level of government which owns the enterprise paying taxes is entitled to receive those taxes. This criterion applies for the sharing of taxes and also for the allocation of 'rebate transfers' from the central government.
Main Issues with Revenue Assignments

Although the 1994 TSS reform introduced explicit and stable sharing arrangements at the central-provincial level, representing a marked improvement over the contracting system that was in place before, the TSS failed to address a list of several other important issues.

Insufficient formal revenue autonomy
The most effective way to provide budgetary accountability and responsiveness is by granting local governments a meaningful degree of tax autonomy. Through local tax autonomy taxpayers become more aware of the costs of services and local officials’ actions are subject to closer scrutiny by taxpayers. An adequate degree of tax autonomy is also important as a form of addressing vertical imbalances and for providing local governments with creditworthiness in capital markets. However, with the very limited exceptions discussed below, local governments at the present time lack discretion to change the rates or any other element of the taxes assigned to them. The only local tax autonomy provided in the 1994 TSS reform was

<table>
<thead>
<tr>
<th></th>
<th>Cent'l Govt.</th>
<th>Hebei</th>
<th>Jiangsu</th>
<th>Gansu</th>
<th>Hunan</th>
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</thead>
<tbody>
<tr>
<td>'Old System' Remittance/Subsidy</td>
<td>Retained</td>
<td>Retained</td>
<td>Retained</td>
<td>Retained</td>
<td>Retained</td>
</tr>
<tr>
<td>Subnational Share of VAT</td>
<td>25%</td>
<td>25%</td>
<td>12.5% retained by province, except in counties facing fin’l difficulties</td>
<td>25%</td>
<td>5% retained by prov. – 20% passed through</td>
</tr>
<tr>
<td>Rebate of the Incremental VAT and Excise</td>
<td>30%</td>
<td>30%</td>
<td>25% passed through</td>
<td>20% passed through</td>
<td>20% passed through</td>
</tr>
<tr>
<td>Additional Transfers</td>
<td>Rich counties make add’l ‘contributions’ to finance provincial expends. &amp; transfers</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

restricted to the selection of the rate of the land use tax within maximum and minimum legislated rates, and the choice of introducing (or not) the entertainment tax and the slaughter tax.

**Backdoor revenue autonomy**

The budget pressures on subnational budgets, in part the result of the lack of formal revenue autonomy, over the years has led local governments to exercise 'informal' revenue autonomy in various ways. The most important of these has been the introduction of fees well beyond what has been prescribed in the law. For this reason, many of these fees are often referred to as 'illegal' fees. Fees represent the main source of local extra-budgetary funds, which, although declining in importance, still represent a significant part of local budgets. The list of fees includes surcharges on household utility bills, hospitals and school charges, road maintenance, advertisement, vehicle purchases and so on.

The proliferation of 'illegal' fees at the local level became a matter of concern for the central authorities because of the distortions created in the allocation of resources, compliance costs for taxpayers, and their potential regressivity. On the other hand, these fees have contributed significantly to the funding required to cover basic expenditure needs of local governments. And although they have been termed 'illegal', it appears that in most cases the fees are approved by the provincial authorities. However, the policy being pursued by the central authorities of converting fees into taxes or budgetary fees is justified because of the need to reduce and eventually eliminate the practice of extra-budgetary funds. This is needed to increase the transparency of subnational budgets and to increase efficiency in the allocation of public resources. Somewhat paradoxically, despite the significant budgetary importance of fees, local governments in China do not make wide use of fees for cost recovery purposes in those services where benefits are localized to individuals and where exclusion from the service is possible for those individuals that do not pay. For example, there is little reliance on user charges to finance public utility services, such as water and sewerage services.

**Lack of formal revenue assignments below the province level**

The lack of formal assignments for local governments provides provincial governments with budget flexibility but it also carries important costs, including lower revenue autonomy and reduced intergovernmental accountability. In addition, this approach reduces the revenue predictability of local governments, diminishing their ability to plan and budget for expenditures. But more importantly, the lack of formal assignments creates negative incentives for revenue mobilization and encourages local
governments to hide resources in extra-budgetary funds. Of course, the costs for local governments depend on the actual policies followed by the provinces. In some provinces, sub-provincial revenue assignments appear to have remained stable for many years.

Despite the problems, there has been no hurry to explore the adoption of open formal revenue assignments at the sub-provincial level. Perhaps there is not as much instability and uncertainty as some believe. There is little doubt, however, that formal assignments to all levels of government, which provide some exclusive autonomous tax basis to each, need to be in the reform agenda of the central government. The central authorities may opt for issuing voluntary recommendations defining mandatory principles, or even legislating the entire structure of revenue assignments at the sub-provincial level. The option of mandating full revenue assignments is more common in unitary countries, generally smaller and less complex than China. Given the diversity, size, and complexity of China’s provinces, a completely uniform system of revenue assignments mandated by the central government may not be the most desirable option.

Revenue sharing and apportionment of tax revenues
Several problems exist with the current revenue assignments between the central and provincial governments. The first problem is created by the sharing of the VAT with local governments on the basis of the ‘derivation principle’ (i.e., according to where the tax is collected). This type of arrangement generally leads to an unfair distribution of resources since the VAT can be credited and debited in different local jurisdictions, or it may be paid exclusively where the headquarters of the enterprise is located. The current revenue-sharing arrangement for the VAT also has significantly contributed to the increasing disparities in revenue distribution across provinces in favor of the richest provinces, and it has also led to protectionist policies by local jurisdictions attempting to maximize their share of the VAT. These difficulties have led other countries to centralize VAT revenues, as most recently has been the case in Russia, where VAT and other central government revenues are distributed according to a formula-based system of equalization transfers and other grants. Other countries use other approaches to share the VAT with the subnational governments, for example, population in Germany, or estimates of aggregate consumption in Spain and Maritime Provinces in Canada.

Another problem related to sharing the VAT is the existence of the ‘business’ or gross receipts tax assigned to local governments, which falls on a number of service sectors excluded from the VAT. From a tax policy perspective, it is clear that the highly distortionary business tax should be abolished, and the coverage of the VAT extended to most of those sectors
now under the business tax. However, the business tax currently represents the most significant source of revenue for local governments; thus this reform would need to be closely integrated with the reform of the sharing of the VAT between central and subnational governments, and the reform of revenue assignments in general.

The choice of the enterprise income tax (EIT) to be shared with local governments, especially below the provincial level, is also a problem. The EIT is not an ideal tax for local governments because it is an unstable source and burdens can be exported to other communities, detracting from accountability. Also because the tax base of the EIT is less evenly distributed, it can enhance horizontal fiscal disparities. The sharing of the EIT with local governments is further complicated by two factors. The first is the survival of the ‘ownership’ criterion, meaningful under the planned socialist economy paradigm, but irrelevant in the transition to a market economy. The second factor is that tax sharing of the EIT is by place of registration or the headquarters of the enterprise, which is a source of inequities. China may have to live with revenue sharing of the EIT between the central and local governments, but how these revenues are actually shared can be significantly improved through apportionment formulas and the like.

Despite the problem, the importance of VAT and EIT to subnational governments today means that reform and reassignment of these key taxes may be politically impossible except in the context of a comprehensive reform of intergovernmental fiscal relations and the tax system. Good alternatives exist. For example, a superior source of subnational revenues could be the use of piggyback personal income tax, especially considering how underutilized this tax has been in China. The property tax is another tax with great potential at the local level, but one that is too complicated and not well administered today. Meanwhile, the central government, through the recent centralization of personal income tax revenues starting in 2002, appears to be centralizing the wrong tax: the personal income tax instead of the VAT.

**The role of tax administration in intergovernmental fiscal relations**

The 1994 TSS reforms split China’s tax administration system into two separate bodies, a central tax administration in charge of collecting central and shared tax revenues, and a local tax administration in charge of exclusively collecting local taxes. This reform pursued a more ‘incentive compatible’ arrangement in comparison to the arrangement under the previous (contracting) system where a single tax administration body, largely controlled by the subnational authorities, collected all taxes. That
previous administrative arrangement had been seen as the main culprit for the precipitous fall in collections, especially for central government revenues. Despite the two reforms, several problems still remain.

The old official and personal allegiances of central tax administrators to local government officials, at the province, city and county levels, appear to continue. It is common among local governments to provide both bonuses and penalties for the performance of central tax administrators at their level. In some cases, the local governments also cover some of the costs of central tax administrators, such as health insurance. This is evidence that there may still be conflict of interests among administrators. Local officials are likely more interested in increasing the after-tax profits of enterprises they own than in increasing tax collections for the central government. Thus there is still work to be done to eliminate the de facto dual subordination of central tax administration officials.

While there are four subnational levels of government, there is only one tax administration agency. The conflict of interest and the moral hazard problems that existed prior to the 1994 TSS reforms between the central and local governments have reappeared in similar forms in the enforcement of all local taxes by the single agency controlled by the provincial authorities. Counties and prefectures often feel that their interests are not adequately addressed. In the future, as China moves toward explicit assignments of tax revenues at the sub-provincial level, it will be desirable to introduce separate tax administrations at the prefecture/city level, and even at the county level.

INTERGOVERNMENTAL TRANSFERS

As discussed above, there has been a growing mismatch between expenditure and revenue assignments at the subnational level in China. While expenditure assignments have been kept steady and needs have expanded over times, revenues have been increasingly centralized. This type of vertical imbalance between central and subnational governments is not uncommon. As growth and overall economic development have been markedly unbalanced among China's provinces and across local governments within provinces over the last decades, horizontal fiscal disparities or imbalances have increased quite significantly. The central government has designed a system of transfers to address these vertical and horizontal imbalances. Conditional transfers have also been introduced to help the central authorities pursue national objectives and priorities through the budgets and activities of subnational governments.
Vertical and Horizontal Imbalances

There is no clearly best way to measure vertical fiscal imbalances – the mismatch between expenditure responsibilities and available funding – at different levels of government. One difficulty lies with ambiguity on ‘needs’, unless predetermined quantities and qualities of public services are agreed upon. However, vertical imbalances may be manifest when local governments lack resources to provide the most basic level of services at the same time they are experiencing budget deficits. The most effective and perhaps simplest way to close vertical imbalances is to provide local governments with meaningful revenue autonomy, which they can use to expand or contract their budgets to match the demand and ability to pay for services. Clearly, by these standards, there is a pronounced vertical imbalance among China’s local governments. The measurement of these imbalances is complicated by the pervasive presence of extra-budgetary funds and the suspicion at the upper levels of government that lower levels have the funds hidden to finance necessities they say they cannot afford. As can be seen in Figure 5.2, the gap between subnational expenditures and revenues as a percentage of total figures increased significantly after the 1994 reform and it has not improved since then. This illustrates the significant transfer dependence of subnational governments in China.

The evidence on horizontal fiscal disparities is easier to gather. As shown in Table 5.8, per capita tax revenues in 2003 were as high as RMB 5391 yuan in Shanghai and as low as RMB 323 yuan in Guizhou province. A disparity of over 16-fold in revenues per capita between the richest and poorest province is extraordinarily high by international standards and demonstrates the existence of wide horizontal fiscal disparities, and the available evidence is that these disparities have continued to increase over time (see Figure 5.3). There is also evidence that fiscal disparities are quite pronounced within provinces (World Bank, 2002). As these disparities related to the level of economic development, they show up across all major tax sources, most importantly in the business tax (Table 5.8).

Property taxes tend to be less concentrated geographically than taxes on enterprise income. Horizontal fiscal disparities are caused not only by differences in the geographical distribution of the tax base but also by the structure of taxes. For example, the relatively high coefficient of variation for the distribution of per capita revenues from the individual income tax, at 1.67 in 2003, is likely related to the high minimum exemption threshold for this tax. The adoption of uniform tax and sharing rules in the 1994 TSS reform, otherwise desirable, also caused an increase in disparities because under the previous contracting system central authorities were able to ‘regulate’ or discriminate between richer and poorer provinces.
China’s long march to decentralization

Local Expenditures as per cent of total

Source: MOF data, China Statistics Yearbook, various years.

Figure 5.3 The Coefficient of Variation of Per Capita Subnational Budgetary Expenditure Across Provinces, 1985–2002

Source: MOF data, China Statistics Yearbook, various years.

Figure 5.2 Trends in Subnational Fiscal Status

Source: MOF data, China Statistics Yearbook, various years.
### Table 5.8 Horizontal Revenue Disparities across Subnational Governments in 2003 (RMB Yuan per capita)

<table>
<thead>
<tr>
<th>Region</th>
<th>Total Revenue</th>
<th>Value-added Tax</th>
<th>Business Tax</th>
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<tr>
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<td>636.04</td>
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<tr>
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<td>498.39</td>
<td>101.51</td>
<td>96.54</td>
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<td>566.80</td>
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<td>110.52</td>
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<td>152.68</td>
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<td>203.07</td>
<td>282.88</td>
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<td>120.94</td>
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<td>Shanghai</td>
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<td>994.74</td>
<td>1,942.22</td>
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Table 5.8  Horizontal Revenue Disparities across Subnational Governments in 2003 (RMB Yuan per capita) (cont’d)

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<th>Agricultural Tax</th>
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<td>22.09</td>
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Source: China Statistics Yearbook, 2003. Refer to notes for Table 5.5.
## Table 5.9 Horizontal Expenditure Disparities across Subnational Governments in 2003 (RMB Yuan per capita)

<table>
<thead>
<tr>
<th>Region</th>
<th>Total</th>
<th>Capital Construction</th>
<th>Technological Upgrading and R&amp;D</th>
<th>Industry, Transport &amp; Commerce</th>
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<tr>
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<td>1 430.37</td>
<td>912.07</td>
<td>24.19</td>
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**Notes:**

a This is the sum of Expenditure for Innovation Enterprises and Expenditure for Science and Technology Promotion.
b This is the sum of Expenditure for Operating Expenses of Department of Industry and Transportation and Expenditure for Operating Expenses of Department of Commerce.
c This is the sum of Expenditure for Agriculture, Expenditure for Forestry, Expenditure for Operational Expenses of Agriculture, Forestry, Water Conservancy and Meteorology.
Table 5.9 Horizontal Expenditure Disparities across Subnational Governments in 2003 (RMB Yuan per capita) (cont’d)

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\(^d\) This is the sum of Expenditure for Operating Expenses of Departments of Culture, Sport & Broadcasting, Education, Department of Science and Expenditure for Public Health.

\(^e\) This is the sum of Expenditure for Government Administration, Expenditure for Foreign Affairs, Expenditure for Public Security Agency, Procuratorial Agency and Court of Justice.

The disparities in expenditures per capita (Table 5.9) are less pronounced than is the case for revenues per capita. For example the coefficient of variation for expenditures per capita across provinces for 2003 is 0.77 (Table 5.9), which is considerably lower than that for revenues at 1.20 (Table 5.8). However, the disparities in expenditures per capita are still considerable. Budgetary expenditures per capita in 2003 were as high as RMB 6361 yuan in Shanghai and RMB 5045 yuan in Beijing and as low as RMB 741 yuan in Henan and RMB 791 yuan in Anhui provinces, representing more than an eight-fold difference between the best and worst-off provinces. Two other features in the distribution of expenditures per capita in Table 5.9 are noticeable. First, there is a higher disparity in per capita expenditures in more discretionary items, such as capital construction and technology, than on more basic items, such as health, education and welfare. Thus, in a sense, disparities on the expenditure side may not be as pronounced as they appear in the aggregate figures.

Second, Table 5.9 shows that per capita budgetary expenditures in relatively poor provinces such as Tibet and Gansu are higher than in provinces relatively richer in per capita GDP such as Hebei or Hunan. This is most pronounced for Tibet, which in 2003 had expenditures per capita in capital construction, for example, five times the average value for all provinces, and higher than in Shanghai and Beijing.

All this reflects the fact that equalization transfers and poverty alleviation seem to be concentrated in the poorest provinces, leading to ranking reversals in terms of per capita income and expenditures, especially among the poorest and middle level provinces. These policies are likely to be demoralizing to those subnational governments that end up last despite their efforts (for example, note Hebei’s steep drop in per capita expenditures relative to the national average).

Whatever the reasons behind China’s current horizontal disparities, it is quite clear that they need to be addressed through a well designed and effective system of transfers.

An Overview of the Current Transfer System

Under the current TSS framework, there are three types of general grants from the central government to subnational governments: (i) the tax rebate; (ii) general purpose unconditional grants; and (iii) special purpose or conditional grants. With data for 2000, from a total amount of RMB 405.8 billion yuan of central government grants to subnational governments, the tax rebate transfer was by far the largest, representing 54 per cent of the total. General purpose grants and specific purpose grants represented 21 and 22 per cent of the total, respectively.
The tax rebate was the result of a compromise in the design of the TSS reform, which grandfathered the vested interests of local governments prior to the 1994 reform. In essence, the tax rebate sends back to the provinces the amount of VAT and excise taxes that otherwise would have gone to the subnational governments had the tax assignments prevailing under the contracting system (prior to the 1994 TSS reform) remained in place and remitted in accordance with the derivation principle. The goal of the tax rebate was to smooth out opposition or other difficulties and ensure the smooth implementation of the 1994 reform. The significance of the tax rebate transfer is the highly un-equalizing impact it has on horizontal fiscal disparities, since a disproportionate share of these funds goes to the richer subnational governments.

The general purpose grants include different forms of unconditional use funds and revenue sharing, and only a small share of all unconditional grants, about 10 per cent (or just about 2 per cent of all transfers) in 2000, were explicitly designed to serve as an equalization grant. However, as we see immediately below, many of the other general purpose grants also pursue equalization objectives. The special purpose grants consist of many different types of conditional transfers, often designed as matching transfers, and administered by line ministries and other central government agencies in the pursuit of all kinds of sectoral policy objectives.

Equalization Grants

Unlike many other countries, China does not have an explicit equalization grant system. Rather, the equalization grant system in China involves a number of different grants which have been designed with equalization features. These grants include: (a) the transitory period grants; (b) the pre-tax sharing system grants; (c) the equalization grants for minority regions; (d) the grants for covering the increased wages of civil servants and (e) a number of other smaller grants.

Transitory period grants. These grants were introduced in 1995 as a complementary measure to the 1994 TSS reform. Their total amount is determined by the central government, on an ad hoc basis considering budgetary demands every year and distributed according to a formula that takes into account ‘standard revenues and expenditure’. In 2001, these grants amounted to RMB 13.8 billion yuan. There is a question of whether these grants will be the vehicle for the implementation of a more ambitious equalization program by China’s government in the future. They currently represent just a tiny amount of what the provinces receive, for example, with the tax rebate transfers.
Pre-tax sharing system grants. These grants are the fixed grants that existed under the ‘contracted fiscal system’ before the 1994 TSS reform. Under the ‘contracted fiscal system’, whether a province had to transfer resources to the central government or received grants depended on the gap between its revenues and expenditures measured in the base year. Despite the methodological problems involved, it is quite likely that the pre-TSS grants were strongly equalizing. At present there are about 16 provinces receiving these grants, mostly the central and west regions of the country, which are poorer in terms of income per capita. In size, these transfers are less than 1 per cent of all transfers.

Grants to minority regions. The central government established an equalization grant system specifically geared to the ‘minority regions’ in 2000. In the initial year the funding was RMB 1 billion yuan and this amount grows with a percentage (80 per cent) of the growth in VAT collections in the regions. The total amount distributed in 2001 was RMB 3.3 billion yuan.

Grants for increasing the standard wages of civil servants. These grants were designed to support the poorer provinces in the central and western parts of the country with the implementation of policies for increasing the standard wages of civil servants mandated by the central government. Without this assistance many of these provinces would have faced serious fiscal difficulties complying with the wage mandate.

As in the case of central province relations, the provincial governments also implement several forms of grants that pursue an equalization objective. These include pre-tax sharing system grants, transitory period grants, compensation for wage increases, and others. These grants at the provincial level follow the structure of central government grants, but frequently the upper-level governments attach some type of conditionality.

Main Challenges with the Current System of Equalization Transfers

China’s current equalization transfer system scores well in some areas but it fails in other fundamental areas. The system should be the first priority for reform, but in conjunction with other intergovernmental finance reforms.

What is being done right? Most transfers that have an equalization motive take into account lower tax capacity and greater expenditure needs of local governments in some sort of formula. Practically all of these transfers at the central level are unconditional or lump-sum grants.

In terms of problems, clearly the equalization grant system is too complex. Up until now, the central government has established nine...
equalization grants. By comparison, most countries with decentralized systems of public finance have only one equalization grant. The complexity of the system also has to do with how those grants are structured. In addition, the determination of the pool of funds is in some cases uncertain, and the grants are severely underfunded relative to the growing problems of horizontal fiscal disparities.

There has been, in addition, a tendency at the central level toward the buttressing of specific purpose grants to the detriment of unconditional equalization grants. Often in recent years, whenever the central government has introduced an important policy toward subnational governments, it has also invariably established an earmarked grant to match that policy, leaving fewer funds available for the equalization grants.

One last point is that the effectiveness of China's equalization system is likely compromised because of the strong federalist features in the current vertical structure of government. As we have seen, provinces can largely decide how to arrange their fiscal affairs with cities and prefectures, and these latter with counties, and so on. Often, it would appear that provincial and prefecture-level governments do not allocate enough funds within their budgets for equalization purposes, perhaps following the path indicated by the central authorities. In some cases the provincial governments appear to have retained funds from central grants that were intended for counties and townships. In this sense subnational equalization grants have not played the necessary supporting role in reducing fiscal disparities. Discretion among subnational governments regarding how they want to organize their intergovernmental fiscal relations reduces the ability of the central government to implement its own policies and achieve its own objectives.

Some recent reform initiatives for the transfer system appear to go in the right direction but still fall short. For example the central authorities have been re-examining specific purpose grants and some have been converted into equalization grants. A second initiative has been to design specific regulations to enhance the effectiveness of central government policies at the subnational level, which so far has not materialized. There is also a move to increase the pool of funds available for equalization, as in the case of the new sharing arrangements between the center and subnational governments in the PIT and EIT. In 2002 another RMB 10 billion yuan were added to the equalization grants pool from those sources. The overall thrust for reform in this area should be to make the system of equalization grants simpler and more transparent.

Besides strengthening the equalization grant system, there are other policies that may be even more successful in addressing horizontal fiscal disparities. Liberalizing the internal migration regulations, in particular the residence registration system or Hukou, should relieve fiscal pressures on
the poorer local governments in the central and western provinces (from unemployment, poverty, and demand for basic services). Liberalizing the financing system should also help income convergence among China's provinces. China's financial system, through the role of the monopoly state banking system, has historically subsidized the richer provinces where there has been a higher concentration of SOEs. The more recent liberalization of foreign direct investment to all provinces in China, and not just to a few richer provinces in the eastern part of the country, should also help the convergence process.

FISCAL MANAGEMENT AND BUDGETARY AUTONOMY

The entire budget process at the central and subnational government levels in China is still based on the 1994 Budget Law and its implementing regulations. With the passage of time and the rapid developments in so many areas of public governance, the Budget Law has become obsolete and inadequate for the needs of local governments. As a precursor to budget reform at the national level, since the early 1990s the budget process at the local level has undergone several important reform initiatives. These include the adoption of a 'zero-based' budgeting approach with the objective of better prioritizing the use of available resources; and an effort to decrease the importance of extra-budgetary funds by converting fees and charges into taxes and bringing the funds into fiscal accounts.

Nevertheless, despite these recent reforms, the budget process at the local level in China still presents serious problems. The efficiency of subnational expenditures is low, with severe overstaffing and too many agencies and organizations. There is a predominance of input budgeting, and a central planning mentality still reigns in budget bureaus – for example, there is an emphasis on new buildings rather than on facilitating access and using existing resources better.

Budgetary autonomy to prioritize expenditures and choose the optimal combination of inputs for service delivery is limited in several important ways. Progress has been slow in bringing extra-budgetary funds into the regular budget, and the structure of local budgets remains fragmented, with extra-budget and off-budget funds representing in many cases half of all local budgets. Budget classification is still not presented in a way that conveys information on the use of resources and objectives of spending programs to facilitate the decision-making process. The approval of budgets, despite recent government efforts, continues to take place too late in the year. For these reasons budgets sometimes are just ex-post financial
statements. In addition, controls over budget execution remain weak as the treasury reforms make slow progress, ex-post external audit is still in the development stage, and budget evaluation practices are practically non-existent.

The ongoing reforms of the budget process at the subnational level exhibit two major weaknesses. First, the reforms lack adequate scope: the current problems the local budget process presents, as discussed below, go well beyond those being addressed by the current reforms. Second, the reforms lack comprehensiveness: the current piecemeal approach fails to capture the interrelationships and dependencies that exist among the different stages of the budget process. This piecemeal approach to budgetary reform in China compares unfavorably with the reforms taken or those under way in other transitional countries (Russia and other transitional countries in the Former Soviet Union and Central and Eastern Europe).39

Reforming the budget process at the local level in China is important because budget procedures and institutions are key determinants of the overall level of efficiency in the delivery of public services to citizens. Increasing efficiency in the delivery of public services requires both an explicit statement of budget priorities and budget institutions that are effective in implementing those policy priorities. A clear statement of priorities requires in turn a budget approach that ensures the simultaneous prioritization of all government activities, on and off budget. The effective implementation of budget priorities requires budget institutions that provide clear positive incentives as well as penalties so that spending agencies adhere to the stated priorities during budget execution.

**How Much Budgetary Autonomy Exists at the Local Level?**

As a unitary country, China delegates all budget authority from the central government level. However, even within a unitary state, realizing the benefits of decentralization is only possible if there is an adequate degree of budgetary autonomy at the local level. The exercise of budgetary autonomy at the local level has several dimensions.

First, budgetary autonomy at the local level requires that local governments be able to prepare their own budgets separately from the budget of the central government and any other upper-level government. This requires that local governments be able to approve their own budgets even if the upper-level government fails to approve its budget on time. If part of the funds comes from the upper-level government, as in the case of tax sharing and transfers, these funds must be determined by fixed and stable rules in the case of revenue sharing and by formula in the case of transfers. In this regard, earmarked funds that are allocated on an *ad hoc*
basis by higher levels hinder local budgeting (especially when they require matching funds) unless they are made well in advance of the budget year. In China, the budget processes at the five levels of government remain hierarchically interlinked. Provincial budgets cannot be formulated and approved until the central government budget is approved. Similarly, the budgets of prefectures and cities cannot be approved until the provincial budget is approved, and so on. The late approval of the central government budget traditionally started a chain reaction, which led to many local government budgets being approved very late in the year.

Second, local governments need to be able to increase and decrease the size of their budgets through the exercise of an adequate degree of tax autonomy. As discussed in the presentation of revenue assignments above, at the present time, there is in China practically no autonomy at the local level to raise revenues at the margin.

Third, local governments require sufficient stability and predictability of revenues and expenditures. The 1994 TSS reform introduced stability and certainty in revenue assignments for provincial governments, but, as noted above, there is no formal revenue assignment at the sub-provincial level, and the system is still evolving. The current system of transfers, rebates, and withdrawals is still changed with high frequency by upper-level governments, and there is still an element of the negotiated (and uncertain) system that prevailed prior to 1994. The requirement of hefty matching contributions for many earmarked but undefined transfers by upper-level governments often forces lower-level governments to maintain substantial reserves of funds until the earmarked funds and the matching conditions are made known.

Fourth, local governments need discretion to use their resources, or most of them, according to their own priorities and the freedom to deliver public services using the production techniques and combinations of inputs they consider to be most cost efficient. The current budget practice performs much better in this dimension, but currently there is a long list of laws and regulations local governments must take into account in the formulation of their budgets. However, few local governments actually appear to comply with all these laws and regulations.

A source of more serious concern is the fact that budgetary discretion is undermined by the flow of unfunded mandates from the central government. The most important of these mandates is the setting of wages for local civil servants by the central authorities. This lack of flexibility detracts from the ability of local governments to keep more able employees or to take advantage of local labor market conditions. In practice, in at least some provinces, county governments are burdened with the requirements to hire recent college and high school graduates, in effect working as
employers of last resort. Discretion on how to spend resources to minimize the costs of delivering public services is further diminished by the fact that the Committee for Public Service and the Personnel Bureau also determine staffing levels for all agencies. To add to the damage, at the spending unit level, managers have little incentive to save in personnel because this budget item is budgeted separately. Saving in personnel simply means foregoing the budget allocation. Indeed, in times of uncertain and unstable transfers, the only certainty local governments can count on is the commitment to pay salaries. It should not come as a surprise, therefore, that budget expenditures are still loaded up with wages and salaries, as local governments have moved other (more discretionary) spending off budget. For poor regions, it appears that adding staff is often the only mechanism for getting more transfers from higher levels. Increasing budgetary autonomy and discretion in decision-making will require controlling the practice of unfunded mandates. But, to extrapolate from international experience, it may not be sufficient to prohibit them by law. What will be required in addition is the exercise of legislative restraint at the central government level as well as several other measures. Granting local governments increased powers for hiring and firing is also required, for the determination of optimal staffing levels, and for wage setting.

Extra-Budgetary Funds and Other Budget Issues

Budgets represent the most significant fiscal policy instrument in the hands of government and therefore need to provide complete information to policy-makers and convey clear information on policy objectives. The current budget structure at the local level in China does neither.

An important problem is the presence of extra-budgetary and off-budget funds. However, their relative importance has been in decline for a number of years. Prior to the 1994 TSS reform, at the height of the ‘contracting system’, extra-budgetary funds represented as much as 80 per cent of subnational total resources. The current policy has been to convert fees and charges for extra-budgetary funds into taxes feeding directly into the regular budget, and extra-budgetary funds are now estimated to represent less than 20 per cent of the resources available to subnational governments. Still, this practice violates the principles of completeness and comprehensiveness of public budgets. The fragmentation in decision-making represented by extra-budgetary funds does not allow proper prioritization in the use of available resources. With the exception of some cost recovery fees for self-sustaining activities, there is no reason for the existence of extra-budgetary funds at the local level in China. But, as we have seen, there are plenty of explanations for the presence of these funds that must be
addressed if reform is to occur.

Traditionally, budget formulation in China has been input-oriented, building incrementally on the resource allocations of past years without focusing on goals, outcomes or performance. This approach made it difficult to properly prioritize public expenditures. The ongoing reforms have adopted a 'zero-based budgeting' approach as the vehicle to force budget officials to break with the budgetary inertia of the past and prioritize public expenditures. However, none of the levels of government is truly practicing or plans to introduce a rigorous version of zero-based budgeting. Most notable is the fact that wages and salaries, which in some local governments reach over 70 per cent of the budget, are not included in the 'zero-budgeting' exercise. In addition, upper-level governments are still virtually in charge of approving the budgets of lower-level governments.

There are several budget activities that currently go unreported and which also escape regular budget scrutiny. The first is the granting of tax incentives and other favorable tax treatment to particular activities or enterprises. Although the central authorities have tried to prohibit the practice, local governments have provided and continue to provide tax incentives, primarily to encourage economic development. Local governments also provide hidden and soft loans to enterprises, and in some cases government loan guarantees. These represent direct use of budget resources or hidden liabilities. Requiring governments to explicitly report these activities will increase the transparency of local budgets.

Traditionally the budget departments or finance bureaus at the local level have not distinguished between budget execution and budget formulation, on the one hand, and internal audit or budget control, on the other hand. The lack of personnel specialization in many provinces continues to create inefficiencies and conflicts of interest, in particular in audit and control. This problem, and others related to the slow disbursement of funds, will become less of an issue as the introduction of a modern treasury function at the local level progresses. A second set of problems in budget execution has to do with the lack of formal discretion in budget execution and the lack of institutions and tradition to hold budget managers accountable for results. Theoretically, budget managers have no discretion at all since the Budget Law requires the previous approval of the local Finance Bureau for the reallocation of any amount of funds. However, it appears that in practice the virement of non-personal resources is a common practice in the process of budget execution. This is a bad combination. Formally providing some degree of budget flexibility and holding managers accountable for the results would be a superior arrangement. The lack of formal flexibility is most damaging to the efficient use of resources in the personnel area. Local governments have to hire staff according to the rules
China’s long march to decentralization

and mandates of the Employment Bureau. It is not certain how compulsory these orders are, although it does appear that some local governments follow them to the letter. This lack of flexibility has led to paradoxical situations in which, for example, health facilities are overstaffed but also have a shortage of specialized personnel.

The weakest link in China’s budget process is external ex-post audit and general oversight over budget performance. The purpose of external ex-post audit is to examine after the close of the fiscal year the correct use of funds by the executive branch and other organs of government. This function needs to be carried out externally or independently of the spending units in the executive branch. The external audit unit may respond to the legislative branch of government or be an independent institution. External ex-post institutions at the local level in China meet only some of the requisite features. In China, the local ‘audit bureaus’ carry out the ex-post audit of the final account of last year’s local budget. However, even though local audit bureaus also report to the People’s Congress, they are under the direct authority of the executive branch of government. Budget evaluation with a focus on performance and budget outcomes does not yet exist in China.

CONCLUSION

China’s approach to intergovernmental fiscal relations reforms has been gradual and measured. This type of approach has had the advantages of avoiding major disruptions and increasing acceptance by subnational governments. But China’s incremental piecemeal reform efforts have also had some serious drawbacks. For example, we have seen that the most recent major reform, the Tax Sharing System of 1994, addressed problems of revenue assignments and tax administration, but left other key pieces of the intergovernmental system untouched, most notably expenditure assignments. The result is that the current system is full of conflicts and contradictions, and performs poorly on efficiency and equity grounds.

Examples of these contradictions abound. For example, the lack of adequate revenue sources at the subnational level has led the central government to the use of ad hoc earmarked subsidies to subnational governments, with the amounts determined ex-post, based on the availability of funds. While these subsidies provide short-term relief, they also have some harmful effects in the longer term. The lack of predictability and stability creates uncertainty among local governments and is inimical to the goal of transparent and predictable local budgets. On the tax side, piecemeal measures such as the partial re-centralization of the enterprise income tax and the personal income tax do nothing to address the current
distortions in revenue assignments, associated with the rather arbitrary sharing of the VAT and the heavy reliance by subnational governments on the 'business (turnover) tax'. The system of intergovernmental fiscal relations is extraordinarily complex and non-transparent, with overlays of remnants of past systems. It is also widely regarded as unfair and unreliable, subject to change at the discretion of higher levels.

The main problem with intergovernmental reform in China has been the lack of a comprehensive blueprint or strategy suggesting explicit goals for decentralization and how the different elements of the system will link with each other in arriving at those goals. Developing such a strategy is complicated and perhaps it has not been politically feasible. For example, China’s fiscal decentralization reform continues to be conditioned by success in tax policy and tax administration reform and it involves problematic self-government political issues. Or perhaps there has been a perception that a comprehensive strategy would necessarily require an all-at-once or 'big bang' implementation of the strategy. This could not be further from the truth. Implementation of the reform strategy can be gradual and lessons learned along the way can be incorporated into the overall strategy. But even though the reform process has been gradual, it has been extremely slow in internalizing lessons.

Given the remarkable growth of China over the last decade, more aggressive equalization policies may have been expected from the central government, but it has only been recently that fiscal reforms have paid attention to this issue. Of course, redistributational policies always require a high level of national consensus, even in countries like China with a single party regime, and this consensus may not have been there, given the pressure exercised by the richer coastal provinces in Beijing defending their own interests. The challenge of how to turn around growing fiscal disparities will be helped by addressing other policies outside the fiscal domain. These include the reform of internal migration, the reform of the financial system and the distribution of financial resources, and generally the extension of the benefits of globalization beyond the eastern region to the rest of the country.

Other important challenges include the reform of expenditure assignments, providing subnational governments with adequate revenue autonomy, simplifying and strengthening the transfer system, allowing responsible borrowing, and civil service reform. In the area of expenditure assignments in particular, there is a need to re-centralize most of the responsibilities for social welfare and the safety net, including pension systems, unemployment compensation, and health insurance. Providing subnational governments with more revenue autonomy will require parallel reform efforts in tax policy and tax administration. The personal income tax
and property taxes are the best vehicles to provide autonomy for the provincial and local governments. Centralizing VAT revenues would not only help address the now-unfair apportionment of this tax but would also enable the central governments to fund a more aggressive equalization policy. The prohibition of subnational government borrowing should be carefully lifted. Local governments are already borrowing for capital expenditures. It would be better for the borrowing to be more transparent to facilitate monitoring and regulation.

Improving public sector performance at the subnational level will require progressive reform of the civil service system. The starting point should be to allow subnational governments to provide better pay incentives and to eliminate the uniform national wage scale, which has been distorting, impractical and financially troublesome to many subnational governments. The last step would be to allow free hiring and firing and the elimination of the personnel establishment system for subnational governments. The hardest challenge of all will be to seek ways of increasing subnational government responsiveness to citizens' needs and preferences by ultimately allowing freely contested elections.

NOTES

1. Some sections of this chapter update and draw upon recent work by the author in World Bank (2002) and joint work in Wong and Martinez-Vazquez (2002) and Zhang and Martinez-Vazquez (2003). I am thankful to Li Zhang for her very able assistance and to Christine Wong for comments and feedback on earlier drafts of some of the material in this chapter.
2. At this level there are actually 22 provinces, five autonomous regions and four cities with provincial status (Beijing, Shanghai, Tianjin and Chongqing).
3. One major implication of the lack of democratic representation is the diminished accountability of local officials to local residents and the incentives for them to concentrate on fulfilling the wishes of the central authorities. See Bahl and Martinez-Vazquez (2005).
4. China's fiscal system during this period was very similar to those in the centrally planned economies of Central and Eastern Europe and the Former Soviet Union. See Martinez-Vazquez and McNab (2000).
5. However, fairness and equal treatment were difficult to achieve. The perception was often that richer more developed provinces on the eastern coast were sometimes able to get preferable terms vis-à-vis poorer inland provinces.
7. The lower profitability of SOEs due to the transition to market prices and competition from non-state/private enterprises also had a role in the decline in tax revenues. In addition the new economic environment of the market transition with many more taxpayers and economic activities likely contributed to tax enforcement problems.
8. See Bahl (1998 and 1999b) for an in-depth discussion of the different aspects of TSS reform.
9. For example, the State Council Supplementary Regulations on the Implementation of the TSS of 1994 have a brief description of local governments’ main expenditure responsibilities.

10. It is important to keep in mind throughout the discussion of the data that we will be discussing official budget data and that we will not cover expenditure data from off-budget and extra-budgetary funds.

11. The data are for the central and consolidated subnational levels. At present, information on the breakdown of expenditures among the levels of subnational governments is available only on a province-by-province basis. See World Bank (2002) for a survey of four provinces.

12. This reflects the fact that subnational governments are not allowed to borrow.

13. The high frequency of concurrent assignments in China may be interpreted as a legacy of the Maoist economy, when divisions of responsibility were unimportant as every unit strove to be self-reliant.

14. Aside from those financed at the four provincial-level cities of Beijing, Shanghai, Tianjin and Chongqing.

15. For centrally owned enterprises, the EIT still accrues to the central government. Also, some of the personal income tax in recent years has gone to the central government to fund transfers to poorer inland provinces.

16. New central taxes include the income tax on savings deposits and the vehicle purchase tax. Other reapportionments include the sharing rates on the business tax levied on banks, and the stock market trading tax.

17. Some enterprises including banks, China Gas Company and China Oil and Chemistry Company were excluded from these sharing arrangements.

18. This is a gross receipts tax falling mainly on service sectors not covered by the VAT. See Table 5.1.

19. This partly reflects the effort of the central authorities to force subnational governments to get rid of (or transform) the numerous illegal fees that have been used in the past.

20. There are 12 provinces in this group: Shanghai, Tianjin, Beijing, Chongqing, Hebei, Shanxi, Inner Mongolia, Shandong, Sichuan, Xinjiang, Zhejiang and Hainan.

21. The eleven provinces in this group are Hunan, Hubei, Jiangxi, Guangdong, Guangxi, Qingha, Henan, Liaoning, Anhui, Yunnan and Tibet.

22. The eight provinces in this group are Gansu, Jiangsu, Fujian, Guizhou, Ningxia, Jilin, Heilongjiang and Shaanxi.

23. This term is coined in Bahl (1999a).

24. Although they are said to be big, there are no published data on the extra-budgetary funds. Ahmad et al. (2000) reported that extra-budgetary funds represented close to 40 per cent of all revenues at the local level in 1999. See Wong (1999) for a discussion of the important role of extra-budgetary funds in China.

25. The sharing of the VAT on a derivation basis is in fact equivalent to a provincial VAT system on an origin basis – the VAT is levied where production takes place, but with completely harmonized bases and rates as defined in the national law. An implication of this type of tax is to provide incentives for protectionist policies.

26. A third alternative may be the creation of a dual system with central and regional VATs (see Ebril et al., 2002). But given the poor enforcement of the central VAT (Bin, 2000), it is doubtful that this is a viable option for China at present.

27. See the discussion on the personal income tax potential for China in World Bank (2002).


29. This term is coined in Bahl (1999a).
29. This issue has been raised previously in Wong (1997), Bernstein and Lu (2001) and Riskin et al. (2001).

30. See Zhang and Martinez-Vazquez (2003) for a full discussion. The description here is based on that work.

31. Data on the composition of grants are not available in the Statistical Yearbook and can only be obtained from the Ministry of Finance, which explains why we only have data for several years ago.

32. The denomination of 'transitory period' is based on the fact that Ministry of Finance officials responsible for their design appear to have felt tentative about the formula and impact. A political motive may have been involved also to reduce subnational expectations about the size and impact of these grants.

33. The largest amounts go to Tibet and Inner Mongolia.

34. Minority regions consist of eight provinces and eight minority prefectures located in non-minority provinces in 2000.

35. The central government decided to increase wages starting 1 July 1999 by an amount of RMB 120 per capita each month. During 2001, there were four wage increases. Complementing these four policy decisions, the central government established four types of grants. However, in addition, the central government also established a system of grants specifically designed to help provinces facing fiscal difficulties to pay the wages of teachers in elementary and middle schools in rural areas.

36. As we discussed above, some provinces share the tax rebate quite fully with local government and others hardly at all. In addition, all provinces implement special purpose grants with their local governments. The system is hierarchically replicated down the vertical structure of local governments in different forms.

37. For example, about RMB 4 billion of subsidies for food in urban areas were transferred into the transitory equalization grants in 2001. The same was done with earmarked grants for the development of border regions.

38. See Bahl and Martinez-Vazquez (2005) for a discussion of how other central government policies may have affected interregional income and fiscal disparities.

39. See Martinez-Vazquez and Boex (2001) for a review of fiscal management and budgeting reform in transitional countries.

40. For other laws and regulations, it is unclear which are compulsory and which can be simply taken as general working principles and guidelines for budget formulation.

41. There have been numerous rounds of pay increases for civil servants over the past few years, including the associated increases in pension benefits. This has brought many poor local governments to the brink. In response, the central government has been implementing a set of specialized transfers to help the poorer local governments meet their payroll obligations. Unfunded mandates also arise from entitlements in central government laws, such as access to free basic education in the Law on Education.

42. These measures could include the creation of a watchdog committee at the National Peoples' Congress to review ex-ante draft legislation for the existence of unfunded mandates, the creation of an intergovernmental permanent commission with broad representation to evaluate ex-post the appearance of mandates, increasing the clarity and transparency of the assignment of expenditure responsibilities, especially in those areas where there are concurrent responsibilities.

43. See Wong and Martinez-Vazquez (2002).

44. On the potential policy tradeoff between economic growth and regional fiscal equalization, the central government appears to have chosen the side of economic growth. See Qiao et al. (2002).
45. The process got started recently with the creation of the National Social Security Fund by the central government.

REFERENCES


