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# Intergovernmental Fiscal Relations and Local Public Finance: What Is Next on the Reform Agenda?

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ROY W. BAHL

Is China one of the world's most decentralized countries, or one of the most centralized? In fact, it is both. On one hand, 70 percent of all government expenditures pass through the subnational government budgets. On the other hand, subnational governments have no independent (formal) taxing powers. The question that might be raised is whether the longer-term intention is to develop a system of local public finance that would give subprovincial governments more fiscal discretion, or whether some other structure is envisaged. Either way, the issue to consider is what specific reform packages would move China toward its goal.

On average, subnational governments account for about one-third of all government spending in OECD (Organisation for Economic Co-operation and Development) countries. The economic model that explains the efficiency gains from this fiscal decentralization, however, does not travel so well to transitional and developing countries, where subnational government expenditure autonomy is less prominent in the budgetary makeup. Nor does it fit as well where elected and autonomous local governments are not the norm. The purpose of this chapter is to review structural practices in fiscal decentralization and to ask whether the international practice holds any lessons for China.

The analysis of local public finance in China must be put in a different context than in other countries. This is because taxation powers in China are almost completely centralized and because decisions about tax policy, tax administration, and intergovernmental fiscal relations are inextricably linked (Bahl 1999).<sup>1</sup> Note also that China's formal intergovernmental fiscal system is limited to central-provincial fiscal relations. The "local public finance" system is mostly about provincial-local fiscal relations, and this structure varies from province to province. Since local governments

<sup>1</sup> Tax policy decisions and tax administration efficiency affect the total pool of funds available for revenue sharing. The revenue-sharing arrangements can provide incentives for subnational governments to divert funds to extrabudgetary accounts, thereby reducing central government revenues.

have no formal taxing power, and since provincial governments are totally dependent on the center for their revenues, central-provincial fiscal arrangements define the budget constraint for local governments. Central-provincial relations, therefore, cannot be separated from the discussion of local government spending and financing. Finally, when we talk in this chapter about “local government” in China, we will mean the three tiers of government that operate at the subprovincial level.<sup>2</sup>

This said, we begin this discussion by noting the very great importance of subprovincial governments in the fiscal system. This importance might be measured both in terms of the amounts spent by subprovincial governments and in terms of the important functions for which they have responsibility. On average, the 2004 *China Statistical Yearbook* reports that in 2004 subprovincial governments spent 571 yuan per person, an amount that can be compared to the 679 yuan spent by the central government (excluding transfers). Provincial and subprovincial governments have heavy responsibility for the provision of social security, health care, basic education, public safety, and economic development services. The budget emphasis on social services is even greater for subprovincial governments than for provincial governments.

## The Decentralization Model: Theory and Practice

China has never formally adopted a fiscal decentralization program in the sense of issuing a white paper that outlines a strategy for empowering its local governments. Nor has it called for significant autonomy and more self-governance at the bottom tier of government, as was done, for example, in the constitutional amendments in India in the 1990s. In fact, China has sent mixed policy signals about whether it will or will not move toward a more decentralized structure of government. On one hand, subnational governments now account for about 70 percent of all government expenditures, and there have been recent policy measures designed to strengthen subprovincial finances (Lou 2008). On the other hand, the major 1994 reform recentralized intergovernmental finances on the revenue side, and policy actions since have continued in this direction. All of this may be due to growing pains, and a country as large as China may eventually find fiscal decentralization irresistible. Or possibly the Chinese style of decentralization, and the way it goes about developing its local public finance system, will be different from that seen in other parts of the world. So the question we might start with is whether the western decentralization model is a good or bad fit for China.

### Theory

The fiscal decentralization model is by now well known. At its core, it is about capturing the welfare gains that come from moving government decision making closer to the people. This economic efficiency argument drives the thinking of most economists who work on this subject (Oates 1972). The argument is straightforward. Let us assume that people’s preferences for government services vary—for example, because of religion, language, ethnic mix, climate, or economic base. Let us assume further that people have sorted themselves so that those with like preferences live in

<sup>2</sup>These include prefectures (prefecture-level cities), counties (county-level cities), and townships.

the same province (city, township).<sup>3</sup> If subnational governments respond to these preferences in structuring their budgets, decentralization will result in variations in the package of services delivered in different places. People will get what they want, and the welfare of the population will be enhanced. Under the same circumstances, but with a centralized system, service provision would be more uniform, and people in different regions would be less likely to get the service mix they want.

Advocates will point out that successful fiscal decentralization can at once attack several of the problems that face developing economies: revenue mobilization, innovation in economic decision making, accountability of elected officials, capacity development at the local level, and grassroot participation in governance.

This story on the benefits of decentralization is a good one, and it is easy to believe that these welfare gains exist, even if they cannot be precisely measured. An important question is whether these gains are large enough to warrant the (possible) disruption of the national public financing system that would be brought about by the required structural changes. There also is the question of whether these gains are attainable in China—that is, whether the necessary conditions are in place to capture the benefits of moving to a decentralized system.

For fiscal decentralization to be fully successful, a number of conditions must be met. First, regional and local government legislatures must be accountable to the regional and local population. If local political leadership is elected, the question becomes whether the electorate has the information and inclination to exercise the vote to assure accountability. If these political leaders are appointed rather than elected, the question becomes whether they see their self-interest as being joined with the satisfaction of the local population.

Second, the chief officers of the regional or local government must be accountable to their legislature. If they are appointed by the center or state, their allegiance will be to a higher level of government, and local programs may not be delivered according to local preferences. One can imagine the problems that could arise. The mayor's directive about enforcement of property tax penalties for failure to pay might have a hollow ring if the chief local tax collector is appointed by a higher-level government. The same might be said for the implementation of local health and education policies.

Third, subnational governments should have some independent taxing powers—that is, provincial and local governments should have the ability to determine at least the tax rate for some important sources of local government finance. This is important if the local population is to hold the political leadership accountable for the quality of public services delivered. The test to which politicians will be put by local voters will be a much harder one if voters pay directly for services than if services are financed by a transfer from the center.

Fourth, subnational governments should be responsible for some important government services. The issue here is that the local voters should care about the quality of services delivered. In most cases, states and provinces are assigned services that affect the quality of people's lives and so this criterion is satisfied. However, in the

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<sup>3</sup>Note that the economic base and location characteristics of the local government also will shape people's preferences.

case of local (third-tier) governments, this is not always the case. Where these local governments are given responsibility for little more than housekeeping functions, the local population is not likely to revolt over the quality of services delivered.

Fifth, subnational governments should have adequate discretion over the level and composition of expenditures. If a higher-level government mandates the expenditures, the subnational government has little ability to respond to citizen preferences. Excessive mandates can be an important impediment to fiscal decentralization.

What we conclude from this discussion is that the efficiency gains that might be captured with fiscal decentralization are far from automatic. There must be a structure in place to allow the subnational government to capture these gains. In some ways, China would seem a likely candidate to capture the efficiency gains from fiscal decentralization. Certainly, the fourth and fifth (expenditure) tests discussed above are passed because provincial and lower-level governments have control over a significant share of the expenditure budget and can set expenditure priorities. Subprovincial governments in particular are called on to deliver important social services (education, health) that matter to the local populations. Direct central control over chief local officers has been relaxed since the 1980s. Directors of fiscal agencies and tax bureaus are now appointed by provincial governments, though the provincial government leadership itself is appointed by the center.

In other ways, local governments in China are constrained in their fiscal choices. They are saddled with mandates and expenditure controls, and they have little or no independent taxing powers.

Finally, there is the issue of the vote. While half of all government spending does pass through local government budgets, there is little popular political representation (Bahl and Martinez-Vazquez 2006). Without political representation, the local population has no direct way of revealing its preferences for more or fewer public services. The provincial governors are still appointed; thus their accountability is upward, to the level of government and the political body that appointed them and will reward them. This absence of political representation at the local level is the major difference between decentralization in China and that in OECD countries.

Evidence supports the argument that an absence of political representation and the appointment of political leadership have not been impediments to local economic growth. In this respect, the Chinese version of federalism that empowered centrally appointed local officials, rewarded their successes with economic development, and encouraged them to compete with one another appears to have been a successful alternative to political decentralization (Qian and Weingast 1997).

## Practice

One might test the hypothesis that the benefits of decentralization outweigh the costs by looking for evidence of the growing fiscal importance of subnational governments. In fact, countries around the world have moved only slowly toward the adoption of more decentralized intergovernmental fiscal systems. Bahl and Wallace (2005) use International Monetary Fund (IMF) *Government Finance Statistics Yearbook* data to estimate that the subnational government share of public expenditures has remained at about 13 to 14 percent in developing countries over the last

**TABLE 13.1**

Distribution of Government Expenditure and Taxes by Level of Government, 2003 (percent)

	China		United States		Canada		Brazil	
	Exp.	Taxes	Exp.	Taxes	Exp.	Taxes	Exp.	Taxes
Central	30	100	48	56	41	54	60	70
Provincial	18	0	21	24	45	37	28	26
Subprovincial	52	0	31	20	14	9	12	4

SOURCE: International Monetary Fund, various issues.

NOTE: Exp. = expenditures.

three decades.<sup>4</sup> The subnational government expenditure share is more than two times higher in the OECD countries and also has been stable over this period.

China is an outlier in this comparative empirical picture. First, its subnational government expenditure share is about 70 percent, arguably the highest in the world. Second, it is an outlier in terms of vertical balance—that is, in the extent to which subnational government taxes are adequate in amount to cover subnational government expenditures. To illustrate, we show comparable statistics in table 13.1 for China, the United States, Canada, and Brazil. In the United States and Canada, the local government (subprovincial) share is a smaller, 31 and 14 percent of total government spending, respectively, but local taxes cover two-thirds or more of total local spending. In Brazil, the local government share of spending is 12 percent, and about one-third of this is financed by local taxes.<sup>5</sup>

These average levels of fiscal decentralization hide a great deal of intercountry variation, which several analysts have tried to explain using cross-section regression analysis. Bahl and Wallace (2005) found that the subnational government expenditure share is significantly higher in countries with a higher per capita GDP, a larger population size, and a lower degree of corruption. This more or less matches the findings in other studies.<sup>6</sup> China is not easily “fitted” to the conclusions from this regression analysis. Its low per capita GDP would suggest an expected lower level of expenditure decentralization, but its larger size would suggest an offsetting effect.<sup>7</sup>

## The Financial Instruments of Fiscal Decentralization

Subnational government budgets in most countries are driven by expenditure assignments, and financing is provided through subnational government taxation,

<sup>4</sup>Decentralization is measured here as the subnational government share of total government expenditure—that is, subnational government expenditures as the numerator and total central plus subnational government expenditures as the denominator. This is a flawed (though commonly used) measure of fiscal decentralization because it does not indicate whether the subnational government has any significant influence over how the money will be spent.

<sup>5</sup>In India, by contrast, state governments finance about half of current expenditures from their own revenue sources (Rao 2009).

<sup>6</sup>For a good literature review, see Letelier (2005).

<sup>7</sup>In the Bahl and Wallace study, the elasticity of expenditure decentralization with respect to per capita GDP, and the elasticities with respect to either population size or land area, are not significantly different.

by intergovernmental transfers, and in some cases by borrowing. The practice of using these instruments, however, is different in China from the international practice, particularly with respect to expenditure and revenue assignment. On this subject, we can say more about provincial government finance than we can about local government finance, since data at the subprovincial level are difficult to come by—in most developing countries and in China.

### Expenditure Assignment: International Practice

The division of government expenditure responsibility among central, provincial, and local governments can fall back to four sets of “rules” or “guidelines.” The first is that the central government should have primary responsibility for stabilization policy and income distribution policies (Musgrave 1959). Provincial-level stabilization policies—for example, borrowing to stimulate job creation—would fail because factor mobility would result in the benefits from provincially financed programs spilling over to other jurisdictions. In the case of income distribution responsibility, provincial and local governments are not likely to have the resources to address the needs for income security, and, in any case, the mobility of labor and capital could weaken the revenue base and increase the size of the client population in the province. According to the conventional thinking, this leaves subnational governments to concentrate on the allocation function—that is, to decide how resources will be divided among various expenditure heads and how the funds will be raised.

The second set of guidelines address the issue of how to decide which expenditure responsibilities will be allocated to which level of government. In the context of local government finance, one might begin with the decentralization theorem “Services should be delivered at the lowest possible level of government consistent with allocative efficiency.” The two qualifications are the following:

1. The presence of economies of scale will push the assignment of responsibility for a function to a higher level of government or to an autonomous body. Examples include public utilities and regional hospitals.
2. The presence of external benefits or costs in the delivery of a function will force its assignment toward a higher level of government. Examples include inter-province trunk roads, research universities, and medical schools.

For the most part, these basic rules are reflected in expenditure assignments. Central governments are usually responsible for at least the financing of transfer payments to individuals, interprovince roads, defense, and the justice system, while provincial or state governments may have responsibility for interlocal roads, regional hospitals, large-scale irrigation projects, and the like. Depending on their size, local governments and autonomous local agencies may have responsibility for general urban maintenance, including local streets, water, sewerage and solid waste disposal, public transportation, basic health services, and primary and secondary education. There are departures from this assignment pattern, of course, but in



most countries the expenditure assignments more or less “follow the rules.”<sup>8</sup> Problems with expenditure assignment more often arise when there are concurrent assignments, that is, when two levels of government share in the provision of a function. In that case, the responsibility for service delivery can become murky as a result of duplication of effort or failure to deliver the service.

The third guideline for expenditure assignment is the time-tested advice of public finance students: “Finance follows function.” The rule here is that the right order for sequencing is to first assign expenditure responsibilities among levels of government and then assign revenue-raising powers. This suggests that the right progression is to determine the revenue needs for a subnational government by first costing out the minimum level of services to be provided. If the process begins instead with allocating a share of the national budget to subnational government, this funding formula becomes the first step in the process of defining the level of services that will be delivered. The whole question of minimum service levels becomes obscured by the issue of affordability.

Despite these good arguments, many (most) countries focus on defining a revenue entitlement for subnational governments and then find a way to make expenditure needs fit this constraint. For example, Indonesia decided on the allocation of 25 percent of central taxes to its local governments, and the Philippines decided on 40 percent, without calculating these percentages according to a detailed assessment of expenditure needs. Another part of this sequencing argument is that efficiency in subnational government financing (particularly for local governments) depends on the specific services that are delivered. For example, efficiency considerations might dictate that education be financed by a combination of local taxes and transfers, parks by general local taxes, and refuse collection by user charges. Absent a knowledge of the expenditure responsibilities of subnational governments, how could the most efficient assignment of revenues be decided?

A fourth guideline is that there should be a (vertical) balance between expenditure assignment and revenue assignment. The counterfactual here is a one-to-one ratio of own revenues to expenditures. Deviations from this norm should occur because transfers are needed to bring public service levels in poorer jurisdictions up to some acceptable level and to correct for underprovision of services where there are large spillover effects. Where a low revenue assignment is made to subnational governments, the intergovernmental transfer system must be set at a high enough level to fill in the gap between local revenues and the minimum level of services. A mistake often made is to over-assign expenditure responsibility to subnational governments, relative to the central government’s ability to finance the necessary vertical share with transfers. The result of this is sometimes a soft budget constraint for subnational governments that might be filled by bailout-type grants from the center or by imprudent borrowing by the subnational governments.

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<sup>8</sup> For a good discussion of the criteria for expenditure assignment and the complexities of making assignments, see Ebel and Vaillancourt (2008).



## Expenditure Assignment: China

The assignment of expenditure responsibility is spread across tiers of government in China. Approximately 70 percent of expenditures are made below the central government level and 52 percent below the provincial government level. By comparison with other large countries, China makes heavy use of subnational governments in delivering public services (table 13.1). There are, however, some features of the practice of expenditure assignment in China that are at odds with best international practice. The fact that nearly all subnational government expenditures are financed by central transfers is a significant difference in approach.

One might question whether it makes sense to apply international norms to China. In some ways the international experience of expenditure assignment is not relevant to China. The absence of political representation means that accountability, in the western sense of the concept, is not so relevant an issue. Moreover, many of China's provinces are larger than most countries, so some of the problematic spillover issues encountered in other countries might be less relevant.

On the other hand, some of the international norms are relevant. China's assignment of expenditure responsibilities is still emerging. There remain some anomalies that go back to pre-market times and that are not sustainable under the present economic system. Some rethinking of expenditure assignments might rank high on China's intergovernmental reform agenda (Lou 2008). In this regard, reform thinking might center on the important issues of responsibility for income maintenance functions, clarity in expenditure assignment, and sequencing (whether function should follow finance). Changes in all of these areas are necessary if there is to be a sustainable vertical balance in the Chinese intergovernmental fiscal system.

*Income Maintenance.* A striking difference between China and most other countries is the degree to which subprovincial governments are responsible for income-maintenance functions. Social welfare and unemployment expenditures are a responsibility of the subprovincial governments in China. This responsibility includes the compensation payments and pensions of former workers in state-owned enterprises. Subnational governments account for a large share of expenditures for "pensions and social relief" and for subsidies to social security. Within the subnational sector, responsibility for the bulk of these expenditures falls to prefectures and counties.

As a result of these expenditure assignments and the reforms of state-owned enterprises (SOEs), the fiscal systems of prefectural and county-level cities have come under pressure. There were defaults on the payment of pensions and unemployment benefits and a wave of popular protests that were most pervasive in the "rust belt" cities of the Northeast (World Bank, forthcoming). In response, the central government intervened with subsidies to bail out subprovincial governments. In many cases, the grants and subsidies from the central government have not been adequate to offset mandated increases in expenditures. The central government has also introduced such measures as social security reforms, the merging of unemployment benefits with the SOE living stipend schemes, *dibao* (minimum

living stipend) schemes, and the urban medical insurance scheme, aimed at restoring budgetary stability to local governments.

*Unclear Assignments.* The assignment of functions is not clear. Expenditure may be assigned to levels of government as exclusive responsibilities or as concurrent responsibilities. While most analysts favor the exclusive route in order to maximize clarity in who is responsible for what, most countries have a significant list of concurrent functions. China is no exception here. Arguably, China's budget laws are less precise in defining expenditure responsibility than is the case in many other countries. In the case of provincial-local governments, the issue is particularly murky (Dollar and Hofman 2008).

The result of this murkiness is underprovision of services for some functions and duplication of services in other cases. This situation could lead to higher-level governments imposing mandates to force spending in "uncovered" areas, and it compromises accountability because it is not clear exactly what functions local governments are responsible for. Moreover, without a clear assignment of expenditure responsibility, it is not possible to define "minimum expenditures" that ought to be the foundation of the intergovernmental transfer system.<sup>9</sup>

1. *Sequencing.* Another departure of China practice from the basic principles of public finance (a departure shared by most developing countries) is that the public finance system is structured with function following finance. That is, the resource distribution appears to be decided independent from the division of expenditure responsibilities. An important international lesson, often hard-learned, is that if these two sides of the public finance equation are separated, significant fiscal disparities can result. Large fiscal disparities now characterize the Chinese intergovernmental fiscal system (Dollar and Hofman 2008; Lou 2008). Interprovince disparities in spending in China are larger than among subnational governments in OECD countries.

2. *Macroeconomic management.* Contrary to the budgeting principles that recommend reserving macroeconomic policy and management for central governments, China assigns significant responsibility in this area to subnational governments. Provincial and local governments have formal responsibility for economic development and industrial policy. They carry this out through various tax incentives, tax preferences, subsidies, and regulatory activities. A mixing of public service responsibility and economic development responsibility has led some local governments to accumulate significant debt. As the market economy continues to develop, some responsibility for macroeconomic management almost certainly will be removed from subnational governments.

3. *Local discretion.* While subnational governments do account for a large share of expenditures, and they do have considerable freedom in rearranging expenditure priorities, their autonomy is limited by mandates placed on them by higher-level governments.

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<sup>9</sup>For a discussion of the problems that come with concurrent responsibilities for service provision, see Martinez-Vazquez et al. (2008).

4. *Reform direction.* To date, intergovernmental reforms in China have left the question of expenditure assignment mostly untouched. In fact, the comprehensive 1994 reform dramatically recentralized revenues but was mostly silent on expenditure responsibility (Bahl 1999). More recently, the rural fee reform and elimination of the agricultural income tax, without revenue-neutral compensating grants, had the same effect. These policy changes significantly exacerbated the vertical imbalance and put great pressure on the intergovernmental finance system to both fill the financing gap and equalize the fiscal disparities.

### Revenue Assignment: International Practice

The revenue assignments made in a country answer the question about what levels of government will be allowed to levy what taxes. There is no complete agreement among scholars and practitioners about which taxes are best assigned to subnational governments. There are, however, a number of general guidelines in the public finance literature:

1. In a system of fiscal decentralization, subnational government officials should be accountable to their voting constituency if the welfare gains are to be fully captured. Local voters will put their elected officials to a harder test on efficient service delivery if services are substantially financed by locally imposed taxes.
2. Local taxation promotes efficiency in local government spending. Without provincial or local government taxation, the tax price for public services will be set too low, and the subnational government will tend to overspend. Or the demand for local government services will outrun the allocation of intergovernmental transfers, and without taxing powers local governments will underspend. By “subnational government taxing powers” we mean the autonomy to determine the level of tax revenue, at least by setting the tax rate.
3. The choice of tax instruments to be used by subnational governments should be influenced by administrative costs, and by “correspondence”—that is, the burden of the tax should be borne within the jurisdiction where the benefits of the resulting expenditures are enjoyed.
4. Provincial-level governments can levy broad-based income and sales taxes where administration permits. In the case of income taxes, this might take the form of a piggyback on the central tax.
5. Lower-level governments should tax immobile factors. This is usually taken to include taxes on property, licenses on local businesses, and certain taxes on motor vehicles.
6. The smallest of local governments should focus on user charges or benefit taxes. Because of administrative problems, their tax structures should stress simplification.

The practice of subnational government taxation in most industrial countries is in step with these principles, but the practice in developing countries is not. The practice in OECD countries includes using income and sales taxes at the state (provincial) level and allowing the subnational governments to set the tax rate. At the

local level, cities and municipalities rely heavily on the property tax and on taxes on motor vehicles, but they also may use piggyback sales or income taxes (as in the United States and Denmark) or profits tax (as in Switzerland).

The story is very different in developing countries, where local government taxes, on average, account for only about 10 percent of total taxes. There often is intense resistance on the part of central governments to delegating taxing powers to the third tier. In fact, there are relatively few instances in developing countries where local governments, or even provinces, have been given significant taxing powers.<sup>10</sup> The assignment of taxes to subnational governments in many countries appears to have been more ad hoc than based on first principles. Subnational governments in low-income countries often have inherited taxes that are too politically hot for the center to handle (taxes on agriculture) or very difficult to administer (property taxes or sales taxes on services). Often, the “local taxes” are not local taxes at all because the rate and base are defined by higher-level governments.

### Revenue Assignment: China

The most important characteristic of the Chinese practice is that subnational governments have no control over setting the rate or base of the major taxes in the system. In effect, all taxes are central. Subnational governments can influence revenue outcomes by their use of industrial policy to grow the tax base, and in some cases by their collection efforts, but the international practice of setting the tax rate at the provincial or local government level is not followed.

Chinese terminology treats the subnational government share of central taxes as “own-source revenues.”<sup>11</sup> In part, this is because the tax-sharing arrangement is viewed as an entitlement of the recipient government. Another justification is that subnational governments feel that they have some discretion in influencing the revenues from these taxes. First, they may influence the growth in the tax base by providing a better climate for investment and for growth in productivity. Second, they may be more efficient collectors of taxes, have some formal responsibility for tax administration, and have better knowledge about local taxable activities. This reasoning leads some Chinese analysts to think of increases in own-source revenues as increased revenue mobilization by subnational governments.

By this categorization, subprovincial governments in China received nearly 40 percent of their revenues from “own sources” in 2003 (World Bank 2006), but this percentage fell over the 1995–2003 period. In part, this is because the central government has reduced its revenue sharing with the provinces—for example, the subnational shares of the personal income tax and the enterprise income tax have been reduced. The World Bank (2002) argues that provinces have passed on some of this decline in revenue sharing to lower-level governments. There is another important implication, however. Since the financing of subprovincial governments has been shifting from shared taxes (an entitlement approach) to transfers (a more

<sup>10</sup> There are, of course, exceptions—for example, Argentina, Brazil, and India.

<sup>11</sup> In most countries, own-source revenues of a local government are those over which the local government has some discretion to set the tax rate. A shared tax whose rate and base is determined by a higher-level government is more properly thought of as an intergovernmental transfer (Bahl and Linn 1992).

discretionary approach), decisions about the sectors and regions where public resources will be invested are increasingly determined by provincial governments.

Little detail can be given about revenue assignments at the subprovincial level, because these assignments vary from province to province. In general, the pattern seems to follow the central-provincial pattern: No independent taxing powers, and now a shift from revenue-sharing entitlements to grants-in-aid.

Local governments can make use of extrabudgetary funds—that is, nontax revenues that can be used for financing public services. Martinez-Vazquez et al. (2008) estimate that extrabudgetary expenditures were equivalent to 23 percent of budgetary expenditures in 2002. While down from levels in the early 1990s (Bahl 1999), this share is still significant.

### Revenue Assignment: Reform Directions for China

China's development of a harmonious society could benefit from a reform of its revenue assignment model. Depending on national development strategy, and on the issues that the government would like to address, a number of reform directions might be considered. First, the present system will not establish an accountability of political leaders to local taxpayers to the same degree as would provincial and local government taxation. If the longer-term goal is to bring some political accountability to the system, the option of giving rate-setting powers to subnational governments might be considered. This could also address the problem of soft budget constraints.

A second issue that might be addressed with revenue assignment is equalization. Under the present system, subnational governments have no possibility for substituting locally raised revenues for intergovernmental transfers in order to meet expenditure demands. Such a substitution could free up intergovernmental transfers for the equalization fund at either the central or the provincial level.

A third issue has to do with the present approach of rewarding local officials for promoting economic development and growing the tax base. This practice may not be sustainable in the long run because of the perverse incentives that it embodies—for example, zoning out migrant workers because of their high public-sector costs, undervaluing congestion and other environmental costs, and failing to take full account of the additional infrastructure and social costs of continued industrial expansion. Another reform direction might be to reward provincial and local officials on the basis of quality of services delivered.

### Intergovernmental Transfers: International Practice

There are no hard and fast rules about the best way to structure a system of intergovernmental transfers. Moreover, the practice varies widely, from country to country. There are, however, some generally accepted rights and wrongs that can guide the practice. The following are some principles that are often discussed:

1. The desired impacts of the transfer system should guide its design. For example, if a conditional grant is meant to stimulate the production of a particular public

service, the design of the grant should provide an adequate incentive for the subnational government to stimulate that production. Or if the idea is to allow local governments to tailor their spending programs to local preferences, unconditional grants should be used. This guideline may seem evident, but it is not always followed.

2. The structure of intergovernmental transfers should be transparent—that is, every recipient government should understand how the size of its transfer will be determined. Formula-based distributions or derivation-based shared taxes are examples of transparent distributions of transfers. The impact of changes in these formulae also can be understood by recipients.
3. Intergovernmental transfers should not be distributed according to the level of the deficit incurred by a subnational government. Deficit grants are the enemy of fiscal discipline at either the provincial or the subprovincial level.
4. Higher-level governments should regularly evaluate their transfer programs to determine whether the objectives are being achieved. For example, if a particular transfer program is meant to be equalizing, it should be subjected to a regular evaluation to determine whether it is achieving this objective.

Even if these general rules are followed, there is ample room to design grant instruments in different ways. A taxonomy of intergovernmental transfers, developed by Bahl and Linn (1992), defines two distinct components: a vertical sharing mechanism and a horizontal sharing mechanism. There are three more or less common approaches to determining the size of the total grant pool (i.e., the vertical dimension). *Shared taxes* are most consistent with decentralization in that they guarantee subnational governments a vertical share, usually a share of a broad-based tax. Moreover, these transfers often are distributed on an unconditional basis, and so give subnational governments discretion over how the money will be spent. *Ad hoc transfers* determine the vertical share on a political basis, usually on a year-by-year basis, and reduce the amount of budgetary certainty given to subnational governments. The *cost reimbursement determination* of the vertical share is used mostly for the conditional grants that are in the portfolio of most governments. This is a centralizing approach in that it makes transfers from this pool conditional upon spending the money for a designed purpose. The “right” approach to vertical sharing depends on what the central government is trying to accomplish with its transfer system.

The horizontal sharing mechanism, the allocation of revenues among eligible recipients, might take the form of *derivation*—that is, subnational governments may retain a share of what is collected within their boundaries. Alternatively, they may receive grants distributed by *formula*, by *cost reimbursement*, or according to *ad hoc* methods. Until one decides on both the horizontal and the vertical dimensions, the transfer system is not defined and its impacts cannot be evaluated.

### Intergovernmental Transfers: Chinese Practice

We can follow this same taxonomy to describe the Chinese central-provincial transfer system (table 13.2). This schematic allows us to focus on a number of potential strengths



TABLE 13.2

## China's System of Intergovernmental Transfers

Method of Allocating the Divisible Pool Among Eligible Units	Method of Determining the Total Divisible Pool		
	Specified Share of National or State Government tax	Ad Hoc Decision	Reimbursement of Approved Expenditures
Derivation	tax sharing and rebates (62.5 percent)	—	—
Formula	grants to minority regions (0.1 percent)	equalization grants (4.9 percent)	wage grants (6.1 percent)
Total or partial reimbursement of costs		grants for rural fee reform (3.5 percent)	—
Ad hoc		original system (quota) subsidies	earmarked grants (21.2 percent)

SOURCE: Adapted from Bahl and Linn, 1992.

and weaknesses of the transfer system. The system of transfers to provinces is summarized in table 13.3.

First, we might observe that the system is mostly transparent. Over 60 percent of transfers are distributed by revenue sharing on a derivation basis. The earmarked grants (about 20 percent of the total) are the exception to this transparency.

Second, the Chinese system has little equalization built into it, despite the existence of very great fiscal and economic disparities across provinces. Several researchers have pointed out the absence of equalization in the Chinese system of transfers (Bahl 1999; Dabla-Norris, 2005; Dollar and Hoffman 2008; Lin, 2011; Shah and Shen 2008). This result might be expected. About two-thirds of transfers are allocated according to the derivation of collections of VAT and income tax (see table 13.3). The equalization grant per se accounts for less than 5 percent of total transfers and is weakly equalizing at best. The remaining transfers in the system are equalizing but account for a small share of the total.<sup>12</sup>

Lou (2008, 159) takes another view. He acknowledges large interregional disparities but argues that these have been reduced by the transfer system: "In 2005 the ratio of fiscal revenues in the eastern, central and western parts of China stood at 60:23:17, while the ratio of their expenditures stood at 46:29:25."

While we can describe the arrangements for vertical and horizontal sharing as between the central and provincial governments, we cannot provide a parallel description for provincial-local government allocations. The latter vary by province, and provinces are not required to report on their arrangements. Nor does the central government regularly monitor their policies.

The central government now raises about 70 percent of all revenues but directly accounts for only about 30 percent of expenditures. It is left to the transfer system to fill

<sup>12</sup>For a review, see Shah and Shen (2008).



TABLE 13.3

## Central-Provincial Intergovernmental Transfers: Vertical and Horizontal Shares

Transfer Type	Date Introduced	Vertical Share	Horizontal Share
VAT and excise tax rebate	1994	The base for the rebate to each province was fixed in 1994, to allow maintenance of its previous level of expenditure. Thereafter, the rebate grows by 30 percent of the growth of revenues from these taxes collected in the province.	Derivation basis.
Income tax rebate	2002	The amount was fixed in 2002 for each province, to allow it to maintain its previous level of expenditures.	Derivation basis.
General transfer (formerly transitional transfer)	1995	No fixed share until 2002. Since 2002 the vertical share has included the incremental revenues accruing to the central government from EIT and PIT over the 2001 level.	According to a needs-based formula that includes a component for the ethnic minority population.
Original system (quota) subsidy	1980s	No fixed share.	Distributed only to poor and ethnic minority provinces. Amounts were fixed in nominal terms in 1987, with only minor changes for compensatory adjustments.
Wage increase subsidy	1999	No fixed share.	Initially, this subsidy was given only to the poorer inland provinces in the central and western regions, to offset the costs of civil service wage increases mandated by the central government. Since 2001 Liaoning, Shandong, and Fujian have also been eligible, albeit only for partial compensation.
Minority region subsidy	2000	No fixed share.	For the 14 provinces and regions with large concentrations of ethnic minority populations. Funding comes from (1) central budget appropriation, and (2) 80 percent of the incremental VAT collected in the 14 provinces. Half of the second component is returned to the collecting provinces and regions by derivation. The other half is pooled with central appropriations (1) and distributed according to a needs-based formula.
Rural fee reform subsidy, subsidies for agricultural tax reduction and adjusting responsibilities	2001, 2003	No fixed share.	All provinces are divided into four groups, to receive compensation for revenue losses under the rural tax-for-fee reform and the abolition of agricultural taxes, at rates of 100% (central and western grain-producing provinces), 80% (non-grain-producing provinces in central and western provinces), 50% (major grain-producing provinces in the coastal region), and 0% (other coastal provinces).
Subsidy from the issuance of additional state debts	1999	A share of additional state bonds issued under the fiscal stimulus program.	Tilted toward the western and central provinces.

this vertical gap. Much the same might be said of provincial-local transfers. Sub-provincial governments account for an estimated 52 percent of subnational government expenditures, with virtually no taxing power. Few if any other intergovernmental transfer systems in the world are asked to carry this much of the financing load.

## The Property Tax

The property tax is almost everyone's choice for a principal local government tax revenue source in both developing and industrialized countries.<sup>13</sup> Despite all of the good work that has been done in designing more efficient property tax structures and administrations, however, the revenue yield of the property tax in developing countries is very low. The best comparable data available (International Monetary Fund, various years) suggest an average yield equivalent to only about 0.6 percent of GDP (table 13.4). De Cesare (2004) finds a similar result in her more detailed analysis for Latin American countries. Note also from this table that the property tax share of GDP is more than three times higher in the OECD countries than in developing countries. Lotz (2006), however, observes a limit on property taxes in OECD countries, perhaps at no more than 3 percent of GDP.

A number of hypotheses have been offered about why property tax revenues are so low in developing countries. Arguably, the most important reason is that the property tax works best as a local government tax, and fiscal decentralization has not been as embraced in developing as in industrialized countries. Bahl and Martinez-Vazquez (2008) use data from a panel of 70 countries for 1990, 1995, and 2000 to show a significant positive effect of both expenditure decentralization and the level of per capita GDP on the level of the effective property tax rate.<sup>14</sup> Higher-income countries and countries that are more decentralized use the property tax more intensively. Again, China can be seen as a mixed bag, with its relatively low per capita GDP a dampening factor and its high level of expenditure decentralization a stimulative factor.

Man (2011, chapters 1 and 6) argues that the burden of the property tax falls on capital and as such may lead to slower economic growth. Her econometric analysis of data for over 2,000 counties in China is consistent with this hypothesis. This suggests that land and property taxes would not be favored by local officials who are graded on a basis of the economic performance of their jurisdiction.

Another argument for the low level of revenues raised by the property tax is that efficient administration is very costly, both in terms of the setup (fixed cost) and the operating costs. In particular, proper valuation and revaluation are thought to be beyond the reach of most subnational government tax administrations, unless very significant expenditures are made to put the capacity in place. The barriers to efficient administration include the absence of a full and up-to-date survey of all land (urban and rural) and records of title that would allow tax liability to be determined. Putting the human resource infrastructure and the information base in place to effi-

<sup>13</sup> Three books of essays that review property tax practice in developing and transitional countries are Bahl (1979); Bird and Slack (2004); and Bahl, Martinez-Vazquez, and Youngman (2008).

<sup>14</sup> The effective rate of property tax is measured as the ratio of property tax collections to GDP.

TABLE 13.4

## Property Tax as Share of GDP (percent)

	1970s	1980s	1990s	2000s
OECD countries (number of countries)	1.24 (16)	1.31 (18)	1.44 (16)	2.12 (18)
Developing countries (number of countries)	0.42 (20)	0.36 (27)	0.42 (23)	0.60 (29)
Transition countries (number of countries)	0.34 (1)	0.59 (4)	0.54 (20)	0.68 (18)
All countries (number of countries)	0.77 (37)	0.73 (49)	0.75 (59)	1.04 (65)

SOURCE: Bahl and Martinez-Vazquez, 2008.

NOTE: The average for the 2000s is for the years 2000 and 2001.

ciently administer the property tax would also be an expensive proposition. At current yields of the property tax, it would be difficult to justify such outlays, by either the central or the subnational levels of government. The result is that most developing countries improve their administrations with marginal changes rather than with comprehensive reforms.

Neither is the property tax a major source of revenue in China. Its yield is well less than the average level of revenues (relative to GDP) raised in developing countries.<sup>15</sup> Though the present yield is low relative to other taxes in the system, the growth in revenues has been significant in recent years (Man, 2011, chapters 1 and 6). Will the property tax become a major source of revenue for China in the future? If this is to happen, are there lessons in the international experience?

Chinese authorities are reported to be considering developing a local property tax. This policy initiative has been discussed for several years (Bahl, 1999; Ter-Minassian and Fedelino 2008). Various rationales have been offered for imposing a property tax in China.<sup>16</sup> In fact, taxes on land and buildings in China already exist.<sup>17</sup> The one that is most like the standard property tax is a notional charge per unit of area used, which varies by location within the urban area (Bahl and Zhang 1989).

Clearly, China could build on this structure to develop a property tax that would finance a significant share of subprovincial government revenue. An ambitious target for property tax revenues—after a suitable transition period—is 1 percent of GDP. This is about the same share of GDP as that raised from property taxes in Sweden and Poland. In 2003, it would have yielded 121 billion yuan in revenue.

### Defining the Tax Base

The base of the Chinese property tax would likely be real property and land. It could initially be an urban tax, perhaps levied only by municipalities. Agricultural

<sup>15</sup> This includes revenues from all recurrent and transfer taxes.

<sup>16</sup> These rationales include the need for subprovincial governments to switch their emphasis away from economic growth and toward the provision of social services and the belief that a better tax system would lead to more rational subprovincial government behavior, especially regarding land conversion and off-budget financing.

<sup>17</sup> For a description of the existing eight taxes on land and buildings, see Hong (2009).

land would be excluded because of the recently rolled-out rural fee reform and the elimination of the agricultural tax (a land-based tax).

It does not seem feasible for China to adopt a U.S.-style capital value property tax on land and improvements. Apart from the administrative constraints, the absence of a property market where land is bought and sold means that there is no good basis for establishing the values of individual parcels. Some land is leased through a bidding process, but this remains a small percentage of total land. In most cases, user rights are assigned. An area-based tax with notional rates, as presently exists, might be workable if two issues could be resolved. First, rates of tax would have to be increased dramatically before the property tax could become a meaningful source of revenue. Second, some method would need to be developed to periodically upgrade the notional location values.

### Determining Tax Rates

In many countries, subprovincial governments have discretion in setting property tax rates. This discretion is justified on the basis of equating the benefits received from local public services with their (tax) price. Since the quality and cost of public services differ from city to city, one would expect the property tax payment also to differ. Allowing discretion in determining tax rates could strengthen the accountability of Chinese local officials in financing and delivering local services. For example, they could raise the property tax rate in line with expanding the local budget to improve service delivery.<sup>18</sup> In the past, local officials have been willing to raise extrabudgetary fees and charges, so it seems reasonable to suggest that they might be willing to impose higher levels of property tax if they could retain the revenues.

### Administering a Property Tax

Administrative considerations will strongly influence the structure of the Chinese property tax. Given the lack of private ownership of land and the absence of an open market in property transfers, the task is daunting. While there clearly is a market for real estate, it is not clear what process could be used to assign a value to every parcel. Moreover, there is no existing cadre of skilled valuers to develop the tax base. Finally, there is the issue of educating taxpayers and local officials to accept this new levy. All of this suggests that implementing a significant property tax will be a gradual process in China.

### Leasing

A major issue to be resolved in China is reconciling the concept of a property tax with the Chinese land tenure arrangements. Hong (2009) poses the question simply: "How is the government going to get lessees to pay property tax when they do not own the property?" At present, enterprises and individuals have user rights that are gained from a competitive bid, negotiation, or a transfer from government. Should a

<sup>18</sup> There is some limited rate-setting power for urban subprovincial governments under the present land use tax.

property tax, or charge, be placed on these users? More to the point, should those who have purchased leases be charged again with the property tax?

One view is that when a new property tax is enacted, the existing users of leased land should be taxed, just like anyone else. In other words, leaseholds should *not* be given a property tax exemption, nor “grandfathered” (i.e., held harmless in their treatment). Leasing and property taxes coexist in many other countries (e.g., the U.K.), and there are many systems (e.g., in The Netherlands) that tax ownership and use separately.

A tax on land that has been leased may be thought of as a charge for public service benefits, whereas the lease amount is a payment for the use of the property. However, the original lease amount may well have been higher because expected subprovincial government public service benefits were capitalized into the value of the lease. But if these public expenditures were not financed by a property tax, there would not have been a corresponding land value reduction due to tax capitalization. If the property tax is new, and the services it finances are new, the case for levying property tax on top of the lease is stronger.

There is another view. Advocates of grandfathering argue that current leaseholders have already paid many fees on their leasehold that can be considered as taxes. Research has found that up to 40 percent of the total costs of a lease can consist of fees, many of which are quasi-taxes. If the property tax were to replace some of the levies and fees already charged, there could be an argument for grandfathering: Existing leaseholders would have paid “extra” taxes in the past. This case is strongest if the new tax does not finance the provision of new or enhanced services. Still, a property tax does not differ from any new tax imposed to provide better services. This case for grandfathering is not a strong one.

If the government feels bound to consider compensation for existing leaseholders, a better way would be to relax the restriction on transferability of a lease (which is currently not possible) or on the use of the land that is leased. Transferability would increase the value of the land for the leaseholder, it would promote better utilization of land, and it would soften the blow on current leaseholders who feel they have been double taxed.

### Property Taxation: The Way Forward

Successful implementation of a local property tax requires much planning. The higher the revenue targets, the greater the amount of planning required. The following areas require detailed planning before introducing a property tax:

- *Develop a policy framework for property taxation in China.* This framework would include establishing the tax base and exemption policy and addressing the question of discretion for subprovincial governments to set tax rates. This framework must be completed and debated before further reforms are undertaken. When approved, this framework would become the basis for drafting the property tax law.
- *Make provision for the tax administration and for the division of tasks among the levels of government.* This includes establishing acceptable valuation procedures

and collection procedures. Some processes for training and certifying valuers must be considered. This step also includes establishing a venue for appeals—a property tax court. After the administrative planning is complete, implementing regulations can be drafted.

- *Establish an appropriate data base to support the levying of the property tax.* Every taxing jurisdiction will need an up-to-date cadastre with particulars for each property, including information on assigned user rights.

## Other Local Tax Options

There are at least two other options for subnational government taxes that are worth consideration in China. Access to the individual income tax has been mentioned in previous studies (Ahmad 2008; Bahl 1999). The international experience also would suggest taxes on motor vehicles as an option.

### Individual Income Tax

If subnational governments in China are to be given an independent source of revenue, in which rate setting can be at least partially delegated to provincial or subprovincial governments, the individual income tax could be a good candidate. This option has some desirable features as a local revenue source:

- It could give subnational governments some discretion in determining the size of their budgets, and hence could create accountability for their decisions and the quality of services they provide.
- The burden of such a tax, if levied on payrolls, would likely remain within the local area. There would be little exporting to other provinces or other subprovincial governments. Even in cases where nonresident workers are taxed, part of the levy could be seen as a charge for using locally provided services.
- This could be a productive revenue source, at least for the more urbanized local areas. Note from the discussion above that at present it constitutes only a small percentage of provincial and subprovincial government revenue.
- Provincial governments could use this reform to improve equalization. By reducing transfers to higher-income subprovincial governments (e.g., prefectures), which could make up the loss by increasing individual income tax rates, funds could be freed up for transfers to lower-income subprovincial governments. Or if provincial governments levied the income tax surcharge, they could allocate the increased vertical share to an equalization fund.
- Higher-income tax rates in wealthier provinces would reflect the access to a better quality of services in those provinces.
- Administration for this tax is already in place.

There also are many reasons a subnational individual income tax might not be a good fit with China's fiscal strategy. The most obvious is that the central government has chosen to control tax policy at the central level and has not given discretionary

taxing powers to subnational governments. The Chinese government may not soon be ready to shift away from this long-standing component of its economic strategy. Another weakness of local income taxation in China is that its revenue benefits might be captured by relatively few subprovincial governments. Zhang and Martinez-Vazquez (2003) point out that the nine coastal provinces collect 70 percent of income taxes. This concentration of revenues in higher-income places strengthens the argument that a locally levied income tax could be a good replacement for transfers to higher-income subprovincial governments.

Competition between the central and subprovincial government sectors for the revenue base also argues against decentralizing the individual income tax. Recently, the central government has increased its share of income taxes. Even if it did decentralize this base, again, there would be some concern that it would be reclaimed. Stability would be an issue.

Another argument against reassigning the individual income tax to subnational governments is that there are income-redistribution objectives for individual income taxation that are more properly the responsibility of the central government. In its present form, the Chinese individual income tax structure is built around a progressive marginal rate schedule. How could China reconcile the income-distribution objective, which suggests centralization, with the proposal for provincial and local income taxes as a quasi-user charge for local services provided?

The answer is that these goals for the individual income tax will not conflict if the tax structure is designed properly. There would seem to be two choices for the design. One route is retaining the present system, whereby the central government determines the rate and base of the income tax and can introduce whatever degree of progressivity is desired. But this approach fails in two ways. It is counter-equalizing across regions, and it offers no provincial-local choice as to the level of the tax rate. A resident would pay the same income tax rate in Shanghai as in Yantai, even though the marginal cost of delivering local public services in the two urban areas might be quite different.

The second route is for subprovincial governments to be given some discretion to determine the income tax rate. Such an arrangement could work as follows: The tax base would be nationally uniform and defined by the central government. The central government would also prescribe a minimum and maximum rate of tax, and local (provincial) governments would be given discretion to set their rate within this range. This is essentially the system used in the Nordic countries (Lotz 2006). One version of the local discretion approach, and arguably a good transition, would be to allow urban subprovincial governments (prefectures) to impose a tax as a surcharge on central income tax liability, with permission from the higher-level government. The prefecture would retain both its normal share and 100 percent of the surcharge amount. The center could prescribe a minimum and maximum value for the surcharge.<sup>19</sup> If the local tax rate were simply added to the present progressive rate structure, the government's income distribution intent would be preserved.

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<sup>19</sup> This approach is also favored by Bird (2006) in his review of the world practice of subprovincial government revenue mobilization.



## Motor Vehicle Taxes

A good revenue source for subprovincial government, particularly for the more urbanized local areas, is the taxation of motor vehicle use. This could take the form of tolls, parking taxes, licenses, and even the taxation of motor fuel consumption (Bahl and Linn 1992). Taxes on motor vehicle purchases are better left to higher-level governments, but there are good arguments for considering motor vehicle use as an object of subprovincial government taxation:

- It could be a very productive revenue source. Certainly the number of motor vehicles is growing rapidly.
- It might serve a social purpose in that it taxes those who impose pollution and congestion costs on the public.
- Charging higher taxes for operating motor vehicles in larger cities (assuming that larger cities choose to impose higher motor vehicle taxes) would reflect the higher cost of providing services in those cities. This would move the Chinese fiscal strategy a step closer to asking residents and workers in different cities to pay the different marginal costs of the local public services they demand.
- It should be administratively feasible. Tolls, licenses, and parking fees are all relatively easy to assess and collect. Taxes on motor fuels are more problematic; moreover, if there are differential tax rates across local jurisdictions, some fuel carrying could result. Nevertheless, fuel taxes levied in urban areas may be feasible.

Arguments against allowing motor vehicle use to become a subject of local tax are, first, that it could be seen as an encroachment on central government revenues. This is particularly true for taxes on motor fuels. Second, some would see this as discouraging economic growth in larger cities, if larger cities were forced to adopt higher rates of tax. Third, there would be a political cost of imposing a higher tax on motor vehicle operation. Finally, the door would be open for tax avoidance measures that could lead to unfairness—for example, special tax treatment for the use of motor vehicles assigned to government officials.

## Conclusions and Reform Options

China's intergovernmental reforms must be part of a larger reform package that will define how provincial and local governments fit into the national economic development strategy. In this connection, a number of questions might be raised:

- Will the equalization of public service levels, across and within provinces, become a higher priority goal?
- Will the practice of rewarding the local leadership based on economic growth be discontinued in favor of rewards based on more traditional measures of governmental performance, such as the quality of services delivered?
- Will internal migration policies be relaxed to allow rural “floating” workers full access to local services?

With these and a number of other questions answered, the government might consider intergovernmental reforms that would lay the groundwork for a system of local public finance.

China's system of local government finance is an important component of its development strategy. About 70 percent of all government expenditures in China pass through subprovincial government budgets, including expenditures for crucial education and health services and some income maintenance functions. While China has used subprovincial governments in important ways, it has not embraced a local government finance system like those that exist in many industrialized countries. Whether such a system should be an objective in China is a matter of government economic policy and governance strategy. That larger question is not addressed here. Rather, this chapter is focused on the lessons that could be learned from the international experience if China were to adopt an approach of developing a local government finance system.

If China were to be guided by international practice, the following primary issues might be addressed with intergovernmental fiscal policy:

- There is a significant vertical imbalance in China. Subnational governments account for about 70 percent of government expenditures but have virtually no taxing powers. Subprovincial governments account for about 50 percent of government expenditures and also have virtually no taxing powers. By comparison with OECD countries, this is a very large vertical fiscal imbalance. The traditional approach to resolving such a large vertical imbalance is to assign taxing powers to subnational governments.
- The intergovernmental system suffers from a horizontal fiscal imbalance, as well. This shows up in the form of significant fiscal disparities among provincial and subprovincial governments and in the degree of mismatch between expenditure needs and revenues available. Other countries address this type of imbalance with an equalization program. China's revenue-sharing system tends to be counter-equalizing, and some past research suggests that it exacerbates these disparities. This issue could be addressed by increasing the size of the equalization fund. The increase might be financed by reducing transfers to higher-income provinces in return for new taxing powers.
- Neither provincial nor subprovincial governments have independent taxing powers. In many industrialized countries, subnational governments have been given such taxing powers (at least rate-setting powers), and this has allowed them to meet demands for public services. Among the opportunities for subnational and subprovincial taxation in China are property taxes, individual income taxes, and motor vehicle taxes.
- As a prerequisite to developing an OECD-style local finance system, China would need to rethink its present expenditure assignment model. First, there is a need for more precise delineation of the responsibilities at various levels of government. Second, the present practice of assigning significant responsibility for social welfare and pensions to subprovincial governments might be rethought.

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