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INTERGOVERNMENTAL FISCAL RELATIONS IN CHINA

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INTRODUCTION

The development of the “best” fiscal arrangement among levels of government has rarely been as widely discussed and debated as it has been in the past five years (e.g., the devolution of the Soviet Union, the “new federalism” in the U.S., decentralization in the Baltics, the breakup in the Balkans). Among other factors, the enhanced technical abilities of local governments to provide services, and a worldwide trend toward elected government have contributed to a belief in the increased potential of fiscal decentralization.

In many countries, the emphasis has been to increase the budgetary share of the local governments. This has been the case in the countries of the former Soviet Union. (Bahl and Wallich, 1994; Bahl and Wallace, 1995; and Martinez-Vazquez and Wallace, 1995) In China, however, the direction of reform has been different. Intergovernmental policies in China appear to be aimed at granting the *central* government a larger share of overall revenue. In the midst of a significant change in its tax policy and tax administration (in 1994), China has significantly restructured the relationships among levels of government. This change and its potential impacts are the focus of this paper.

THE THEORY OF FISCAL DECENTRALIZATION

One way to examine the determinants of fiscal decentralization is to consider the a priori reasons why a country might choose decentralization of its fiscal structure, that is, the theory of fiscal federalism (Oates, 1972). These a priori arguments might be recast in a developing and transition country framework, and might be thought of, as below, as the advantages and disadvantages of fiscal decentralization (Bahl and Linn, 1992).

Advantages of Decentralization

Economists invoke an efficiency criterion in arguing for fiscal decentralization. If preferences for public services differ across subgroups of the population, and if externalities are not present, then welfare is maximized if local communities vote their preferences and provide the level and mix of public services that they want. The results of decentralization will be that the mix of services provided will match the demands of the local population, government officials will become more accountable to voters for the quality of services they provide, and local populations will be more willing to pay for public services.

A second argument, not often made, is that fiscal decentralization can enhance revenue mobilization. Some taxes are suited to local government because their assessment and collection requires familiarity with the local economy and population, and/or because they are perceived as quasi-benefit charges that finance local services. In this regard, the property tax and other land-based taxes are usually thought of as suitable local government taxes. The individual income tax is a suitable candidate for local resource mobilization, as are taxes on smaller firms that might not be reached by the national VAT.

In fact, the efficiency case for fiscal decentralization is much stronger in industrial than in developing or transition countries. This is because in developing countries local councils are not always elected, chief officials are not always locally appointed, and adjustments in the allocation of local resources are often severely constrained by central government controls (including central government budget approval, appointment of certain local officials and central tax administration). In this setting—where the devolution of revenue authority and expenditure responsibility is not accompanied by a relaxation of central government control over local fiscal decisionmaking—there is less to be gained from fiscal decentralization than would be the case in industrial countries.

Advantages of Centralization

The arguments for fiscal centralization, on the other hand, are stronger in transition and developing than in industrial countries. History has shown that *stabilization policy* is an especially important concern in developing economies and in those economies that are in transition to a capitalist system.¹ This argues for central government control of the main fiscal instruments (taxation, spending, and borrowing). Under a highly decentralized system where the local governments have a built-in claim on a share of total revenues raised, the central government will find itself in a difficult position insofar as increasing revenues to reduce the total deficit, or passing structural tax reforms that might be aimed at stimulating savings or reducing imports.

In transition countries that are undergoing privatization and building a public and industrial infrastructure, the need for a coherent *investment policy* is also an argument for fiscal centralization. As a corollary, centralization allows the national government to allocate fiscal resources to goods and services with national benefits, whereas local autonomy would inevitably lead to greater expenditures on those services that have more local benefits.

Several arguments for *income distribution* also support fiscal centralization. The most important is that regional (and rural-urban) disparities in income and wealth may be accentuated by fiscal decentralization because wealthier urban governments will benefit most from greater local taxing powers. Centralization allows the national government more discretion in shaping regional differences in levels of public service and taxation.

CHINA'S SYSTEM OF INTERGOVERNMENTAL RELATIONS: PRE-1994

Until 1994, China's revenue sharing system was primarily a division of sales and profit taxes among the central, provincial, and local governments. Taxes were collected by the local governments and "shared-up" to the higher levels. The amount of shared tax revenue that finally shows up in the local government budget depends on the centrally determined tax base and tax rates, the tax administration, and the sharing formulas. In addition, there are earmarked grants given to provincial governments by the Center.

The Growth and Division of Revenues

Between 1983 and 1992, real expenditures of provincial and local governments increased by 35 percent, but this was slower than the growth in GNP and slower than the growth in local government expenditures. In fact, at the time of the income tax reform in 1983, the local government *sector* was spending an amount equivalent to 73 percent of what they collected and turning 27 percent over to the central government for national purposes. By 1992, the local government sector was spending an amount equivalent to their total collections and was receiving an additional subsidy from the Center equivalent to about 6 percent of expenditures. This change in the division of revenues, and the consequent growth in extrabudgetary revenues, prompted a reform of the revenue sharing system.

Fiscal Disparities

Revenue collections in China are roughly proportional to income level. The five highest income provinces account for 18 percent of local government revenue collections and 19 percent of national income. However, these provinces account for only 10 percent of the national population. This suggests that there are significant disparities in per capita revenue collections among the provinces. In fact, the disparity in per capita revenue collections among the provinces is from ¥ 1180 in Shanghai to ¥ 96 in Anhui and ¥ 8 in Tibet. This is quite a substantial range.

Bahl and Wallich (1992) estimated an OLS regression of per capita budgetary collections against per capita income, the rate of urbanization, and population size. The results show a strong significant relationship between per capita revenue collections and per capita income. The income elasticities are high: In 1990, a 10 percent difference in per capita income tended to be associated with a 16 percent difference in per capita revenue collections.² Population size did show the expected negative relationship with revenues, but was not significant in either the 1987 or the 1990 equations.

Disparities are much less pronounced on the expenditure side, with a per capita variation of 6:1 between the highest and lowest provinces. The pattern of variation across provinces might be explained in the following way: Higher income provinces spend more because of the greater demand for public services by their citizens and their enterprises, their ability to raise more "local fixed" revenues, their ability to attract more grants, and very importantly, their ability to slow the flow of revenues to the Center. More urbanized provinces spend more, arguably because urbanization reflects a greater capacity to raise and retain taxes.

CHINA'S SYSTEM: AFTER 1994

China's 1994 Tax Reform introduced significant changes to the overall revenue structure and tax administration, as well as a new system of revenue sharing. The following presents a summary of the major tax policy changes.³

Tax Policy

The enterprise income tax rate schedule was changed to a traditional, marginal rate schedule, with rates from 18 to 33 percent. The tax base was broadened by elimination of local government exemptions, the loan principal repayment deduction, and the system of local government "contracting" (negotiating tax liability on a case-by-case basis). These base-broadening measures were somewhat offset by new accounting regulations that increased certain deductions (for labor, bad debt and depreciation), and the adjustment of firms to the new regulations. The net effect of the enterprise income tax changes was expected to be revenue neutral.

The value-added tax was also revised substantially in the 1994 Tax Reform. The new VAT rates are 17 percent for most goods, and 13 percent for newspapers, books, foodstuffs, and utilities. Exports are zero-rated, but the central government pays the credit.⁴ The VAT base was broadened under the reform, reducing the number of exempt items and bringing in other items that were taxed under the product tax (which is currently being phased out). Administratively, the VAT system changed from a presumptive credit method to an invoice-credit method.

Tax Administration Change

Before 1994, tax administration was a central government function. However, the local offices of the STA had divided loyalties, and there was some question about the efficiency with which local taxes were collected. Moreover, the central office in Beijing has relatively tight control over the largely manual operations of the Provincial offices.

The administrative system was changed dramatically in 1994 in two major ways. First, a separate local tax bureau was established and given responsibility for income taxes and several smaller levies. This provides an incentive for income tax revenue mobilization. Second, a credit-invoice method was adopted for VAT administration, a change that should increase revenues in the long run.

Accounting and Administrative Changes

A series of accounting and administrative reforms have also been undertaken since 1992. Among the most important changes are the following: bad debts can no longer be written off directly against profits, inventory valuation is carried out using LIFO, FIFO, or moving average methods, accelerated depreciation replaced straight line depreciation, a cost accounting system that is more in line with international standards was adopted, and loan repayment has been distinguished from interest payment.

These changes have had significant impacts. In general, they have put the system more in line with international practice and have altered some of the incentives that firms face. In the short run, the disruption caused by the changes may dampen revenue yield. In the long-run, the result should be higher revenue yields, more efficiency in both tax administration and production, and a more stable source of revenue for both the central and local governments.

Revenue Sharing Reform

There were two major changes in the Chinese system of revenue sharing in 1994. Perhaps most important in the long run is that all revenues from the enterprise and individual income taxes are assigned to provincial governments. All decisions about the tax rate and tax base, however, have been kept by the central government. Arguably, this is the first step toward a true assignment system with some local rate setting autonomy.

The 1994 reform also changed the method by which the value added tax is shared. Under the new system, there are four steps in determining the provincial government share.

1. The central government gets 75 percent of "base" value added tax collections, and the local government gets 25 percent on a derivation basis.
2. The Center then makes a transfer to the local government of an additional amount adequate to keep them whole with respect to their 1993 expenditures.

3. The amount transferred to the central government (or from the central government in the case of deficit provinces) must be held constant.

4. The yearly increment in the VAT is divided 25 percent to the provincial government and 75 percent to the Center. Of the 75 percent central share of the increment, 30 percent is given to the locals.

To better illustrate the working of the new system, and to suggest the kinds of special arrangements that exist, an example for Yunnan Province might be useful. Under a special arrangement in Yunnan province, the subnational governments share the VAT with the Center according to a 75 percent central, 25 percent local split. Revenues from the consumption tax (base year equivalent) are given fully to the local government (incremental increases are treated differently, as described below). The calculation of the "base amounts" for sharing is a complicated matter. The "base" amounts for Yunnan, for example, are the totals that *would have been collected in 1993 had the 1994 tax laws been in place*. It is a hypothetical amount.

There are three types of grants in the system. *Earmarked Grants* are primarily for construction projects and for subsidies for heating coal and food (grain subsidies). The distribution of this amount among provinces is by formula in the case of subsidies, and by project selection (ad hoc) in the case of construction projects. There was no change in this component in 1994. *Deficit or system grants to the poor provinces* existed under the previous system and continue to exist. Under the old system, these provinces kept all they collected and received a lump sum grant to cover their remaining expenditures. Now they share the VAT, etc., just as any other province, but they are kept whole at their 1993 level with a continuation of the deficit grant and a "revenue return" grant. *Revenue return grants* are received by all provinces. They are equal to the amount of VAT and consumption tax required to be returned to the local governments to hold them harmless at 1993 levels of expenditure net of transfers to the central government.

Intra-Province Sharing

The Chinese system takes on a characteristic of federalism by allowing the provincial governments to make all decisions about intra-province sharing. There are few restrictions, and provincial governments do make quite different decisions about how they share taxes and about the distribution of grants among their subordinate local governments.

The 1994 reform did not change the division of powers in this regard; higher level governments still retain control over lower level units. However, the 1994 reform does have profound effects on this sharing. The new rules that assign the enterprise income tax and its administration entirely to subnational governments mean that provincial governments must rethink distribution policy. The revenues from the enterprise income tax and the skill of administration will be heavily concentrated in the wealthier parts of the province. A second area for rethinking stems from the fact that the primary reason for special income tax preferences for enterprises has now disappeared. This means that more revenue will flow formally through the budgetary system and provincial governments must rethink how they will redistribute these monies among the rich and poor districts/counties.

CONCLUSIONS AND ISSUES FOR THE FUTURE

Clearly, China is an emerging federalism. The 1994 changes were far-reaching and important, but they were one step in a movement toward a more stable intergovernmental system. It is quite likely that other major changes will occur before the decade ends. But the 1994 changes were important in changing the basic direction of the Center. We might conclude that it had the following effects:

1. It was a first step toward phasing out of derivation-based sharing for the VAT, and toward the reservation of this tax for the central government. The VAT is not an appropriate local tax.

2. The enterprise income tax is not a suitable local tax. Provincial governments will soon find ways to use the tax to compete against one another, and this competition will not always be done in ways that stimulate the overall economy. Moreover, as the Chinese economy continues to mature, the problem of formula allocation of profits among the provinces will become an issue.

3. The 1994 reform will likely widen the disparities between the rich and poor provinces, as the enterprise income tax revenue yield recovers. This can be offset with a change in policy about subventions/grants, or by altering the sharing rules about the incremental portion of VAT collections.

4. The 1994 reform has not addressed the issue of intra-province disparities.

5. Local governments still have not been given any autonomy in tax rate setting, or in setting the level of user charges. Therefore, there is no way for local governments to mobilize additional resources, except through their income tax administration system. For the time being, this may be a major incentive.

6. The individual income tax is assigned to the local level, and this has the potential for being a productive local tax. However, it is levied on a narrow base and the threshold is quite high.

7. The separation of the central and local tax bureaus is a major step toward an assignment system, but there is still need for the central government to gain some measure of control over the local systems for monitoring purposes. Until the tax information system is computerized, effective control will not be possible.

ENDNOTES

1. For an overview see Wallich (1994) and Bird, Ebel and Wallich (1995).
2. Hofman (1993) has pointed out that virtually all of the variation in per capita collections can be explained by a *squared* per capita income term.
3. For more detailed discussion of these changes, see Bahl and Wallace (1995).
4. For those goods where the 17 percent VAT rate led to what was considered too great a tax reduction (e.g., cigarettes), a special consumption tax was imposed.

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