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Central-Local Fiscal Relations in China

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III. CENTRAL-LOCAL FISCAL RELATIONS AND REVENUE SHARING

Introduction

3.1 The tax structure and the system of intergovernmental fiscal relations are inextricably linked in the Chinese fiscal system. The laws of taxation and the powers and responsibilities of the various levels of government are laid down by the central government, and subnational governments are responsible for tax administration, share in revenue collections, and have a substantial amount of latitude in awarding tax preferences to enterprises. The development of the system--perhaps better characterized as a series of arrangements--of tax administration and central/local relations has given provincial and local governments increasing freedom to alter the fiscal system to meet their own objectives. Among the more important implications of this arrangement is that the "tax levers" the central government designs may be different from the fiscal measures actually implemented at the local level. Yet the success of any central government tax reform will depend on the implementation by subnational governments.1/ A successful tax reform program in China will almost certainly have to be accompanied by changes in the system of intergovernmental relations. Section A below reviews the experience, principles and criteria for decentralized and centralized fiscal systems. In Section B, China's system of intergovernmental relations is described. An initial assessment is outlined in Section C, while Section D develops options for reform. One option is in keeping with the present centralized model, but strengthens it in numerous ways; another is a decentralized model. The choice between these two depends on the Chinese authorities' desire for macro-control and equalization capability, compared with the benefits of decentralization.

A. Fiscal Decentralization and the Role of Local Government: Principles, Criteria and the International Practice

3.2 In China and in virtually every other country there is debate about the "proper" way to organize the public sector to deliver and finance services. Most of the debate centers around which level of government should provide which public services, how much fiscal autonomy should the local government have, and the relationship between the revenue base given to local governments and their expenditure responsibilities. This section is meant to develop a framework for thinking about such questions in China.

Fiscal Centralization vs Fiscal Decentralization

3.3 The arguments for fiscal centralization and decentralization relate to the major tax objectives of government--stabilization policy, equity between units of government and resource allocation and growth. Where the flexibility to pursue stabilization policy is especially important (such as in

1/ In China, and in this report, all Provinces and Cities with provincial status are referred to as provincial governments (including the cities which have Province status; Shanghai, Beijing and Tianjin), while cities and counties are referred to as "local" governments. Where both levels of government are referred to, the report indicates "subnational."

low income economies "exposed" to international fluctuations, variations in commodity prices, etc.) central government control of the major tax and borrowing instruments would be called for. It is sometimes thought that the implementation of economic growth policy also argues for fiscal centralization. Where investment capital is short, its mobilization and direction by the central government can help maximize returns.2/ If local governments are given access to major tax bases, they may "compete" with the central government and therefore limit the amount that is available for the central government. On the expenditure side, more centralization allows the government to steer the allocation of public resources in the direction of goods and services with national benefits, whereas more local autonomy would inevitably produce more localized benefits.

3.4 Income distribution arguments also support the case for fiscal centralization. In most developing countries, regional, and/or rural-urban disparities in income and wealth are pronounced, and may be accentuated by fiscal decentralization because the already wealthier urban local governments will benefit most from increased local government taxing powers. A centralized fiscal system will enable the central government to provide transfers to poorer provinces. Finally, central governments are thought to have a superior capacity in the areas of tax administration. A corollary to this argument is that skilled fiscal managers--analysts, accountants, valuers, collectors--are in too short supply in LDCs to be shared between the central and local governments.

3.5 There are also good theoretical arguments for a decentralized structure of local governance in LDCs. Perhaps the most compelling is that local governments because of their proximity, are able to reach the growing taxable capacity in urban areas more easily than could the central government. An increased rate of national resource mobilization could occur. It is very difficult for central governments to capture much of this fiscal surplus. Neither central government income nor consumption taxes typically reach small firms, workers in smaller firms or outside the larger cities, or the self-employed. Local government business and occupation licenses, sales taxes, permits and property taxes have a much better chance.

What Revenue Raising Powers For Subnational Governments?

3.6 Theory does not provide a guide to the "right" share of national revenues and expenditures for local governments. Beyond the obvious conclusion that revenue responsibility and expenditure assignment should be in balance, little guidance can be offered as to the optimal division of revenues among central and subnational governments. Neither may China look to some international norm for guidance in deciding on which revenue sources should be allocated to Provincial and local governments. One valid generalization which can be made is that the proper mix of subnational government revenues depends in part on the expenditure responsibilities which are assigned to subnational governments. In fact, for a given set of expenditure responsibilities, an appropriate revenue mix may be chosen largely on efficiency grounds.

2/ Note that this does not argue for a larger role of government per se, but only for a larger share of the center, vis-a-vis local governments.

3.7 For publicly provided goods and services, where the benefits accrue to individuals within a jurisdiction and where the exclusion principle can be applied in pricing, user charges are most efficient.3/ This is the case particularly for public utilities such as water supply, sewerage, power, and telephone, but also for public transit and housing. Other local services, such as general local administration, traffic control, street lighting and security, are local public goods whose primary benefits accrue to the local population but where the exclusion principle in pricing cannot be applied. These are most appropriately financed by taxes whose burden is local.

3.8 Provincial or national intergovernmental transfers should contribute to financing services such as health and education where substantial spillovers into neighboring jurisdictions occur. Purely local financing tends to underprovide these services from a regional or national perspective. Finally, borrowing is an appropriate source of financing capital outlays for infrastructure with long-lasting benefits. This is the case particularly for public utility and road infrastructure expenditure. Expenditures of an infrastructural nature, or others with broader provincial or national benefit are appropriately financed at the provincial or national level.

3.9 The assignment of taxes to national and subnational governments varies widely. Taxes usually levied at the national level include resource taxes, and personal and corporate income taxes because of their important role in stabilization and distribution policy. Customs duties are also almost always national-level taxes because of their strategic importance. Sales taxes are often levied at the provincial level. Excises and surcharges are also often provincial taxes, as their revenue growth is stable.

3.10 There are many exceptions to these patterns: Switzerland and the United States permit local jurisdictions to levy corporate income taxes as well as personal income taxes and natural resource taxes. By contrast, in Australia and Canada the provinces are prevented from using sales or other indirect taxes. In Nigeria, until recently, export duties accrued to local governments, and, in Malaysia, natural resource taxes are local. The actual practice of revenue assignment may be explained by a variety of factors, both historical and political, and by the relative tax capacities of specific levels of government (and the differing availability of tax bases at the local level). The relative administrative strength of the national and subnational governments is also important in determining the outcome, as is the division of expenditure responsibilities between them, itself usually related to the capacities of national and local-level governments.

Intergovernmental Transfers

3.11 Whatever the outcome of the tax assignment, it often leaves one level of government with insufficient revenues. Many countries have resolved the revenue/expenditure imbalance between central and lower level governments and the division of taxing authority with a system of central government transfers--shared taxes, various types of grants and even loans--to subnational

3/ See Roy Bahl and Johannes Linn; Urban Finance in Developing Countries; forthcoming.

governments. This permits central governments to retain the authority to levy taxes on the more productive bases, but it gives provincial or local governments a flow of revenues. This is a step toward fiscal decentralization in that it provides financing for subnational government services, but the degree to which it gives subnational governments more autonomy in their budget decisions depends on how the system is structured.

3.12 The design of a program of intergovernmental transfers should be led by the objectives the government wants to achieve. But which level of government should define the objectives? Because objectives such as equity, revenue elasticity and neutrality often conflict, establishing priorities is difficult. These questions raise an important but frequently misunderstood feature of intergovernmental transfer systems: even with the best of design, any system has advantages and disadvantages. On the one hand, a formal (formula) program of intergovernmental transfers can broaden the resource base of local governments and provide for a growing source of revenue if transfers are related to the growth in a more elastic central government tax base (e.g., if transfers are a share of sales or income taxes). A transfer program has the added advantage of avoiding the high administrative costs which can be associated with local government tax assessment and collection. On the other hand, transfers and shared taxes can make subnational governments less accountable for their fiscal decisions (they may now increase spending without increasing taxes); hence, there will be less incentive to improve the efficiency of subnational government operations. Likewise, when transfers are large, subnational governments will have less incentive to search for new revenue sources or to improve the efficiency of collection from existing bases, and their tax effort may be dampened.

3.13 Other "advantages" and "disadvantages" are much less clear-cut. For example, an important issue in the design of transfer systems is the choice of whether and how the transfers will be controlled by the center. A disadvantage of central control, from the point of view of the subnational governments, is that transfer allocations may be political decisions and the flow of funds will be uncertain in amount from year to year. This makes fiscal planning very difficult for local governments. On the other hand, central control can enhance the budget flexibility of the central government, and in that sense is a great advantage for the center's macroeconomic management. Another example is that in some countries transfers carry "matching requirements", meaning that local governments must match a portion of the central transfer. This can distort subnational government expenditure choices if they are encouraged to spend because of the low "tax price" of certain types of outlay. Viewed from the central government's point of view, however, such conditions attached to the receipt of such transfers may help accomplish national goals.

3.14 In fact, transfer policies are always controversial from some point of view. Indeed, conclusions about the advantages and disadvantages of any particular program of central transfers to subnational governments depends on whether a national or a subnational government point of view is taken. Uncertainty for one level of government about the regularity and adequacy of transfer flows is the other level of government's budgetary flexibility.

3.15 Depending on their priorities, governments make use of many different types of transfer grants. Shared taxes, distributed on a basis of origin of collections, are an effective way to support the public finances in urban areas and to stimulate their tax compliance. "Formula grants" are typically used to distribute funds according to a formula based on expenditure needs and fiscal capacity. There are usually two objectives of transfer policy: (a) correcting "vertical imbalances," that is the misalignment of expenditure responsibility and tax capacity among levels of government; and (b) reducing geographical or "horizontal" differences between rich and poor provinces to permit a more equal level of expenditures among regions.

3.16 In order to pursue horizontal equity, shared taxes are not always allocated to local governments in the same proportion as they are collected. Instead, revenue sharing may allocate shared taxes on the basis of population, urbanization, per capita incomes, etc. Grants allocated on a basis of per capita income or another index of need may also be used to offset local governments' low tax capacities. Grants are also often given for specific purposes and special programs ("earmarked grants") to address deficiencies in public expenditures in specific expenditure categories. In general, the two objectives of revenue adequacy and horizontal equity cannot be met with only one approach.

3.17 Some transfer or revenue-sharing systems are also designed to encourage local tax effort or, at least, not to impair the local governments' incentives to raise taxes. For example, in India, 10% of the allocation to provinces through formula grants, is given on the basis of tax effort. Box 3.1 shows the range of approaches to formula grants.

3.18 Each of the basic transfer approaches has disadvantages, and none will satisfy all the objectives of an intergovernmental transfer system. One solution is to mix the approaches in a single system. For example, many countries such as India and Brazil use both equalizing and revenue stimulative transfers in the same system.

<u>China in an International Context</u>

3.19 There is no "normal" share of expenditures made by subnational governments. Political considerations, regional realities, constitutional requirements and administrative elements are all crucial to understanding the development of different systems. The most basic issue on the tax side is the command over resources by the various levels of government and the resultant independence (or lack thereof) of each governmental unit in meeting its expenditure goals. The financial resources of each level of government depend on the division of tax powers. Because revenues and expenditures do not usually match, fiscal transfers are required to match resources with each level of government's expenditure responsibilities. Some countries find it to their advantage to give more fiscal powers and responsibilities to local governments, while others chose to rely on the different forms of intergovernmental transfer outlined above. This section explores how China fits the international patterns and what it can learn from the experience of other countries.

Box 3.1: FORMULA GRANTS

Four basic approaches to allocating central revenue resources among local governments are: (i) tax sharing, (ii) ad hoc distributions, (iii) reimbursement of the costs of specified undertakings, and (iv) by formula.

Formula grants are popular because they are objective and easily understood, and because they give the central government the opportunity to target the distribution of funds among local governments in a way consistent with national policy. An added advantage is that as local governments outgrow their needs for revenue sharing, or as their needs change relative to other local governments, the grant distribution is automatically adjusted by the formula and no discretionary government action is called for.

Formula grants are usually pointed towards either a recognition of variations in expenditure needs or of differences in fiscal capacity, i.e., in the ability to raise revenue while making an average effort. Expenditure needs are proxied in many ways including per capita income, population, infrastructure adequacy, and the like. Examples include the following:

The distribution of education grants in Colombia is based primarily on the population size of each Province. Philippine general purpose grants are distributed according to population and land area. Transportation grants to Brazilian state and local governments are allocated according to population, land area, and the consumption of imported fuels. The distribution of India's excise tax grant has made use of a poverty index. Grants to compensate some provinces for low income and low fiscal capacity are often distributed partially by the reciprocal of per capita income. This is done in Brazil and India. Yet other formula grant systems have explicitly included a tax effort measure to induce Provinces to increase their rate of revenue mobilization. (Examples are the US, Nigeria, India.)

The disadvantages to the formula grant are that the choice of the grant elements can be influenced by politics. Moreover the choice of a formula may be limited to what data are available, and as such may reflect neither true expenditure need or fiscal capacity. Moreover, detailed and timely data are almost never available at the local government level.

Source: Roy Bahl and Johannes Linn; Urban Public Finance in Developing Countries; forthcoming.

3.20 On average, subnational governments in industrial countries account for about 30% of all government expenditures, compared to 15% in the LDCs. This pattern has not changed significantly during the past two decades. It is difficult to say how China fits into this international pattern. The subnational share of government expenditures (about 55%) and revenues collected (about 65%) are well above these averages. However, taking the revenues which actually represent local revenues (a far smaller fraction than revenues collected, because almost all taxes in China are collected at the local level) the proportion of "own revenues" is closer to 15% of total revenue.4/ Table 3.1 shows the range of experiences.

3.21 The Chinese system probably gives less formal fiscal autonomy to local governments than is the case in other countries. In most other countries the fiscal powers of local governments are limited, although local fiscal independence is greater in industrial than developing countries. In

4/ Own sources are defined as those revenues collected by local government for its own use, plus those taxes unconditionally assigned or which accrue automatically to local government. Own revenues include the agriculture tax; income tax from collectives and state enterprises owned by the subnational government; and a sales tax surcharge, plus a variety of smaller taxes.

Table 3.1 : IMPORTANCE OF LOCAL GOVERNMENT REVENUE SHARE, SELECTED COUNTRIES
(% of total revenues)

Country	Local government "own" revenues as % of total government revenues	Country	Local government "own" revenues as % of total government revenues
Nigeria	26.5	Israel	11.4
Tanzania	21.7	Syria	5.7
Uganda	20.0	Turkey	2.2
Kenya	16.2		
Zambia	6.8	Colombia	47.7
Malawi	3.7	Brazil	36.1
		Venezuela	5.5
		Dominican Republic	5.4
Korea	16.4	Panama	5.2
Philippines	11.2	Costa Rica	4.2
Sri Lanka	4.2	Peru	4.0
Indonesia	1.6		
Australia	25.0	US	36.0
Germany	55.0	China /a	11.0
Canada	51.0	China /b	63.0

/a Measured on a accrual basis and includes only "own" revenues; i.e., those that accrue to local government before any sharing takes place. If data were presented on a "collection" basis, local government collections would amount to about 65% of total government revenues.
/b Collection basis.

Notes: Data for countries other than China: 1970s. China: 1985.

Source: R. Bird, "Intergovernmental Fiscal Relations in Developing Countries"; IBRD, 1976/1977. Data for industrial countries: Hunter, 1977, p. 104.

developing countries, the tax bases available to local governments and maximum rates are usually fixed. Similar arrangements usually hold for adjusting user charges for most major services, e.g., water rates, bus fares, rents. Most LDC central or state governments have approval powers over local government budgets, and the extent to which this process reduces local fiscal autonomy depends on the tightness of the review process. Local government budget autonomy is also commonly hampered by central government expenditure mandates. The borrowing powers of local governments are quite limited in most LDCs. Though credit is made available to subnational governments under a variety of schemes, most local governments are given little discretion over the amount or purpose of the loan, the source of the funds, or the terms of repayment.

3.22 Another important limitation in defining local autonomy has to do with the nature of selecting local officials. For example, it may matter little that local governments have a broad range of fiscal powers if all subnational financing and governance decisions rest in the hands of centrally-appointed officials. Again, a broad range of practices is followed, but central governments frequently make these appointments.

3.23 China provides significant formal limits to local government autonomy. There is virtually no local discretion as regards revenue raising; indeed purely local taxes cover less than one fifth of their expenditures, as Table 3.2 shows. Yet because the system gives local governments responsibility for administering and thus implementing the fiscal system, there is room for local governments to gain fiscal discretion by using informal methods, such as the granting of preferential tax treatment for enterprises.

Table 3.2: TAX COLLECTION AND EXPENDITURE OF CENTRAL AND LOCAL GOVERNMENTS, 1980-86 /a
(Billions of Yuan)

	1980	1981	1982	1983	1984	1985	1986	1987
Centrally collected revenue	21.0	22.5	25.8	37.2	52.4	69.0	91.7	-
Central government expenditures	65.0	60.2	57.5	64.2	72.8	81.9	96.2	-
"Collections Deficit"	-44.0	-41.7	-31.7	-27.0	-21.4	-12.9	-4.9	-
Local government collections /b	87.5	86.4	86.6	87.7	97.7	117.6	134.3	-
Local government expenditures	56.2	51.3	57.8	65.8	80.8	104.6	136.8	-
"Collections Surplus"	31.3	31.5	28.8	22.7	16.9	13.0	-2.5	-
Local government "fixed" revenue (est.) /c	11.8	11.6	12.5	15.3	15.9	19.0	-	-

/a The difference between the local governments' surplus and the central government's deficit is the central government's foreign borrowing and domestic budget deficit.
/b Central and local government collections are before transfer from local governments to the central government.
/c Defined according to the specifications of the system fixed for 1985-87. Includes the collectives' income tax, the agriculture tax, and estimated profits taxes on locally owned enterprises. These three taxes are the major "fixed local revenues" fixed in the 1985-87 reform of the revenue sharing system. In practice, many of these revenues are shared with the central government (see para. 3.44).

Source: MOF. According to national definitions of revenue and expenditure, and before any transfers or subsidies.

3.24 Most large countries in the world are organized as federalisms: India, Nigeria and Brazil are examples among the developing countries, and the United States, Canada and West Germany are examples from among the industrialized countries, but China is not. This system, typically but not always, transfers controls over local finances from the central government to an intermediate level of government such as the State, Province, or Department.

3.25 There are strong arguments for and against the federal form. In populous and large countries where local preferences and needs vary widely, e.g., India and Brazil, it enables the central government to avoid direct dealings with a large number of urban governments. For example, the central government can use grant formulas to recognize broad differences in needs and preferences without having to take into account the specific needs of individual cities, or it may simply assign responsibility for local finances to the provincial government.

B. The Present System of Subnational Finance in China

3.26 Despite its size and diversity, China has chosen a unitary system of government in which the Constitution does not expressly delineate the powers and responsibilities of the various levels of government. Yet the central, provincial and local levels of government have distinct powers and responsibilities, and in many respects the Chinese system functions as a federalism. Fiscal behavior varies enough across provinces to contravene national uniformity in China.

3.27 China's system of intergovernmental transfers is an important component of total public financing, perhaps more so than in any other country.

China's shared tax system based on sales and profits taxes makes revenue in principle responsive to growth in income and prices. The distribution of tax shares among Provinces is changing from a broad formula-based approach with an equalizing intent to an ad hoc approach characterized in recent years by substantial negotiation and a variety of special purpose discretionary grants. The Chinese system does not make use of categorical or cost reimbursement grants to stimulate spending for particular purposes, and while there are special purpose grants, there are no formula-based grants which take account of the population characteristics of Provinces. China does use matching grants.

Provincial Government Finances

3.28 In the Chinese system, the central government has direct relations with Provincial governments. This system is roughly described in Figure 3.1. All governments within a Province report directly (or indirectly) to the Provincial government, and carry out their duties subject to Provincial regulations. This system of vertical relationships creates a setting within the Province allowing a degree of fiscal decentralization to the local government level. For example, in Zhejiang Province at the end of 1985, there were 8 provincial cities (municipalities), 66 counties, 3 county-level cities, 3 prefectures and 508 towns.

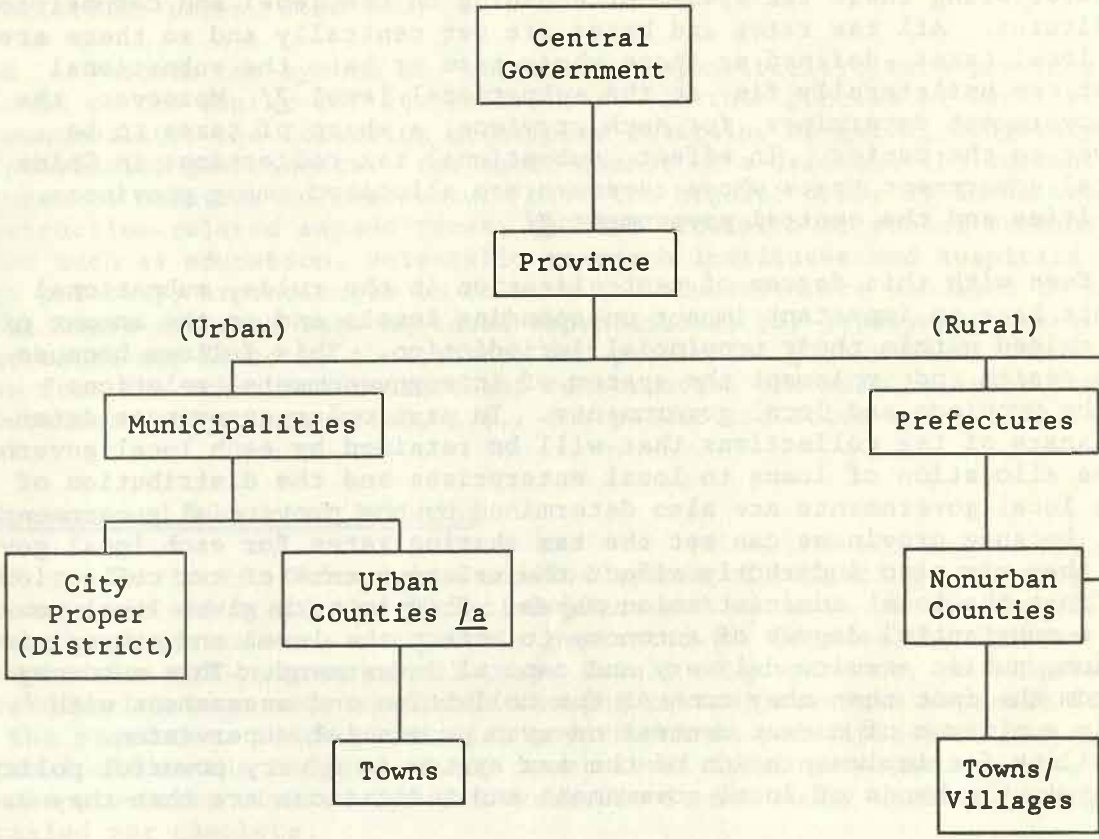
3.29 In some ways, the Chinese fiscal system is as decentralized as its governmental structure. Municipal and county governments' tax bureaus directly assess and collect about 70% of all taxes.5/ Expenditure responsibility is less decentralized in that provincial and local governments account, on average, for over 50% of total direct expenditures. Only a few countries in the world can claim as great a degree of expenditure or revenue decentralization and none can claim this degree of decentralization in tax administration.6/ Table 3.2 shows recent trends in the revenues and expenditures of central and subnational governments.

3.30 The central government spends more than it collects. Central government expenditures, until recently, amounted to half or more of publicly budgeted outlays. The central government's major areas of expenditure responsibility are defense, foreign affairs and foreign aid, national universities and research, central ministries, general administration, and large investment projects. In addition, the central government provides revenue transfers to poor provinces.

5/ Note that no information is available on revenues which actually accrue to subnational governments, after sharing with the Center.

6/ The comparable ratios for the United States--which is a decentralized fiscal system by world standards--are 43% of taxes collected and 42% of expenditures made by state and local governments. The ratio of subnational to central government expenditure exceeds 75% in Denmark, Australia, Switzerland, Italy and Canada, but subnational government revenue autonomy is more limited. Roy Bahl, "The Design of Intergovernmental Transfers in Industrialized Countries," Public Budgeting and Finance, Winter 1986, Volume 6, Number 4, pp. 3-22.

Figure 3.1: GOVERNMENT STRUCTURE IN CHINA



/a In some provinces, and in some special cases, urban counties may be directly subordinate to the Provincial government.

3.31 The responsibilities of the provincial and lower-level authorities include their own investment projects, and most, but not all, public expenditures on education and health, local administration (and tax collection), culture, science and agricultural support, including irrigation, agricultural research, extension activities, and other rural expenditures. Since the inception of the economic reforms, there has been a gradual trend towards decentralizing expenditures, with the central government's share in total outlays declining and a corresponding increase in the expenditure share of local governments. Consequently the center's share of total expenditures has been declining from about 50% of total expenditures to 41% (Tables 3.2 and 3.4). Little is known, however, about the types of expenditure shifts which have taken place.

3.32 Degrees of Autonomy: Revenues. Revenue collection and expenditure disbursement are not the only dimensions of fiscal decentralization and one can find many areas where fiscal decisions are subject to substantial central control and direction. By comparison with most countries in the world, subnational governments in China have little formal, or legal independence in matters of structuring their tax system or deciding on the level and composition of expenditures. All tax rates and bases are set centrally and so there are no truly local taxes--defined as those whose rate or base the subnational government can unilaterally fix--at the subnational level.7/ Moreover, the central government determines, for each province, a share of taxes to be turned over to the center. In effect, subnational tax collections in China are central government taxes whose revenues are allocated among provinces, municipalities and the central government.8/

3.33 Even with this degree of centralization in the rules, subnational governments have an important impact on spending levels and on the amount of revenues raised within their provincial jurisdiction. This follows because Provinces design and implement the system of intergovernmental relations between the province and local governments. In particular, provinces determine the share of tax collections that will be retained by each local government. The allocation of loans to local enterprises and the distribution of grants to local governments are also determined by the provincial government. Moreover, because provinces can set the tax sharing rates for each local government, they may also indirectly affect the relative rate of tax collection or tax effort the local administration makes. This in turn gives local governments a substantial degree of autonomy to affect the level and composition of taxation, public service delivery and capital investment. This autonomy arises from the fact that they control tax collection and assessment with apparently a minimum of direct central or even provincial supervision. Responsibility for implementation of the tax system is a very powerful policy instrument in the hands of local government and indications are that they use it.

3.34 Expenditure Autonomy. Autonomy on the expenditure side of the budget is limited for provinces. Subnational government budgets are determined as part of a consolidated central, provincial and local budget and as such must satisfy the (negotiated) fiscal targets laid down by higher level government. The budgetary choices of provincial governments are further limited by expenditure rules, mandates and monitoring by higher level government.

3.35 Within the province, there is more room for discretion. At the local level, provincial governments are responsible for approving the budgets and financial plans of municipal and county governments. This means they can control the spatial distribution of expenditures within the province. There appears to be great variation in the system of province-local relations across

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7/ Local governments are entitled to set surtax rates on a variety of taxes, as described in Annex 1. Local governments can also design and collect a set of extrabudgetary fees, and charges.

8/ It also should be noted that a number of other important financial measures and regulations are strictly prescribed by the central government and are followed with little variation, such as the allocation of foreign exchange earnings between the general government and enterprise sectors.

provinces, suggesting that provincial governments have significant room to adjust fiscal decisions to accommodate local needs and preferences within the parameters set by the central government. (Provincial/local relations are described in paras. 3.58-64.)

3.36 Within the system of "vertical" responsibility, each province must account to the center for its activities. In this process of vertical accountability, the following principles restrain, or guide, budgetary choices of provincial governments: (a) there cannot be a deficit; (b) current expenditures to maintain infrastructure have the highest priority among urban construction-related expenditures; (c) the provision of social overhead facilities such as education, scientific research institutes and hospitals take a high priority; expenditures on culture and education are mandated to increase by at least the same rate as total expenditures; (d) employment levels and wage rates are fixed by the central and provincial governments; (e) all revenues from the urban maintenance and construction tax must be spent for urban maintenance and construction, i.e., for public utilities and public facilities.

Budgeting and Financial Planning

3.37 In theory, China has a unified system of budgeting--covering all accounts--in which all the financial plans and accounts of the central and subnational governments are jointly presented.9/ Because the Chinese budget consolidates the budgets of all three levels of government, no budgetary breakdown has been made available showing central revenues separate from those of the provinces. Each provincial government in principle also has a budget which includes the budgets of all lower level local governments, but, at least in the provinces visited for this work, it is not fully unified, being neither detailed nor complete.

3.38 Because government budgets are not fully unified in the sense of including all revenues and expenditures, it is difficult to construct an estimate of the total amount of revenues raised or expenditures made by the subnational governments or in particular local areas.10/ For example, extrabudgetary revenues and expenditures (nonplan) are reported in the budget, along with budgetary receipts and outlays. However, departmental revenues and grants received are generally not reported in the accounts. The transfers between, and overlaps among, the budgets of the government, the SOEs and public utilities are not apparent, especially for local government: Some examples include those transfers to the SOEs which are included under "technical transformation" in the provincial budget (without distinguishing

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9/ "Unified" budgeting is used here to mean a budget which incorporates all accounts of the government unit. "Consolidated" uses the Chinese terminology and reflects the joint presentation of the budget of all levels of government.

10/ This absence of a unified budget at the local level has its parallel in the Consolidated Budget of the MOF in which a variety of extrabudgetary expenditures, revenues and accounts are not reflected (see Chapter I and Box 1.2 on "Recasting the Chinese Budget").

grants and loans). Other transfers to cover SOE losses are shown as an expenditure in the general provincial budget and not as a transfer, unless the loss is 'unplanned," in which case it is shown as negative profits tax revenue (i.e., it is subtracted from revenues, paralleling the approach in the consolidated MOF Budget described in Box 1.2). Grants to provincial and local governments do not appear to be shown separately in the budget.

3.39 With regard to the distinction made in some countries between capital and current budgets, each local (urban) government has a regular budget and a construction budget, but these do not correspond to a division of current and capital expenditures, and there is no separate reporting of capital financing.

Tax Administration

3.40 Provincial governments cannot vary the nominal rates of tax, nor may they redefine the legal tax base. However, they have almost complete autonomy in assessing and collecting taxes, and along with the lower level county government can and do give tax relief without having to seek approval from the Center. One could fairly say that subnational governments can substantially alter the level and pattern of effective tax rates paid by enterprises.

3.41 The organization of tax administration in China centers around the activities of two organizations: the Tax Bureau and the Finance Department. In theory, these bureaus are at the same time organs of the central and local governments. There are separate Tax Bureaus and Finance Departments at the city, county and province levels. The functions of the Tax Bureau and the Finance Department seem clearly distinguishable in principle. The Finance Department conducts tax policy allowed by law at the provincial and local levels, and manages the expenditure side of the budget. The Tax Bureau is responsible for implementing central tax law and collecting taxes. In practice, the division of responsibility is not so clear, and the directives given to the Tax Bureau by the central government and its subnational government are not always consistent. Many of the Tax Bureaus' actions in the provinces visited for this work suggest substantial tension as a result of this system of 'dual leadership". Also it appears the Tax Bureau is more likely to act as an agent of the provincial or local governments than of the central government. The Finance Bureau clearly plays a leadership role within the provincial and local governments.

3.42 Provincial and local governments have a surprising amount of discretion in granting tax relief. Their activities in this regard are referred to as the policy of "stimulating enterprise through tax expenditures" where three methods of granting preferences are used. First, if the provincial government wants to promote a new product or a pioneer industry, it may authorize a reduced tax rate or a tax holiday for a number of years (usually not to exceed five years). Second, the Finance Bureau may enter into a contract arrangement with an enterprise for payment of a negotiated amount of taxes. These were described in Box 1.1 on the Contracting System. Third, the Tax Bureau may grant *ad hoc* tax relief to enterprises on a case-by-case basis depending on the needs of the enterprise. There is every indication that they use this discretion to promote the economic development of the local area, even though the preferences granted sometimes do not conform with the objectives of the central government and seriously impair its revenue.

Provincial and Local Revenues

3.43 Provincial governments have four revenue sources: shared taxes, extrabudgetary funds, user fees and capital finance. China's revenue sharing system is primarily a division of sales and profit taxes among the central, provincial, and local governments. Whereas in most countries the taxes are collected by the central government and then allocated to the lower level subnational governments, in China they are collected by the local governments and "shared-up" to the higher levels. The amount of shared tax revenue finally going to the provincial government budget depends on the tax base and rate, tax administration, and the sharing formulae. The amount finding its way into the central budget depends on provincial receipts, and the sharing formula between center and province. The sharing formulae, therefore, has two elements: the proportion of revenues from any given tax shared between center and the province, and the sharing method for the tax and its distribution amongst local governments within the province actually doing the collecting. To understand the revenue-sharing system in China, one must understand all of these dimensions.

3.44 Tax Revenues. By law, there are three categories of revenues--"fixed central government revenues," "fixed local government revenues" and "shared revenues." Box 3.2 shows the principal taxes in each of these categories prior to the 1988 proposed changes. Revenues collected from local taxes are, in principle, assigned fully to the local government and are referred to as "local fixed revenues." Rate determination and base definition, however, are not under local control. In practice, however, most "local fixed" and "shared" taxes have been subject to sharing apparently because adherence to these categories caused a revenue shortfall to the central government. Since the mission visited China in May/June 1988, certain minor changes have taken place in the allocation of these taxes to different levels of government. Because these are minor taxes, it is unlikely that these shifts would affect the report's analysis or recommendations.11/

3.45 Extrabudgetary Funds. Other sources of revenue for provincial governments, earmarked for capital purposes, are extrabudgetary funds.12/ Extrabudgetary revenues of the government itself are relatively small compared

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11/ Exceptions are the UMCT and a few other local taxes, which are retained locally. The detail on the proportion of each tax that is shared, central, or local is provided for 1987 and 1988 in Annex 2, Tables 3 and 4.

12/ This figure excludes the extrabudgetary funds (retained profits) of the SOEs. These include a set of taxes and charges that are controlled by the local or provincial Finance Department, the most important of which is the public utility surcharge--a 10% tax on the utility bills of consumers. There also are some minor taxes and charges in this category, including the surcharge on the agricultural tax, revenues received from public housing and public property, and some institutional income that accrues to the various city enterprises.

Box 3.2: REVENUE ALLOCATION AND TAX SHARING

I. "Fixed Central Government Revenues":

1. Income and adjustment tax of all central government enterprises.
2. Business tax from railroads, bank and insurance company headquarters.
3. Profit remittances by all enterprises producing arms.
4. Price subsidies paid to producers of grain, cotton and oil (treated as a negative revenue of the central government).
5. Fuel oil special tax.
6. Income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures.
7. Treasury bond income.
8. 70% of the three sales taxes collected from enterprises owned by the Ministry of Industry, the Ministry of Power, SINOPEC, and the China Nonferrous Metals Company.
9. All customs duty and all VAT and product taxes collected at customs.
10. Tobacco Tax and Business Tax on Tobacco.
11. Product tax on liquor and tobacco.

II. In 1985-87, the "local fixed revenues" were as follows:

1. Income tax and adjustment tax of locally-owned enterprises.
2. Income tax from collectively owned enterprises (ICIT).
3. Agriculture tax.
4. Rural market trading tax levied on private sector traders.
5. Local government grain trading loss (a negative tax).
6. Fines for delinquent taxes.
7. The Urban Maintenance and Construction Tax (UMCT).1/
8. Housing tax.2/
9. Vehicle utilization tax.
10. 30% of the sales tax revenues collected from enterprises owned by the Ministry of Power, SINOPEC, and the China Nonferrous Metals Company.
11. Individual income tax.
12. Wage bonus tax.
13. Self-employed Entrepreneurs Tax.
14. Slaughter Tax.
15. Cattle Trading Tax.
16. Contract Tax.

III. Taxes shared between the central and local governments:

1. All sales taxes (value-added, business, and product) revenues from all enterprises, except those expressly excluded as described above under I.6, I.9, I.10.
2. Natural resource taxes.
3. Construction tax.
4. Salt tax.
5. Industrial and commercial tax, and income tax, levied on foreign and joint venture enterprises.
6. Energy and transportation fund tax.

1/ The UMCT is set at 7% of total sales tax liability for municipalities (5% for towns and 1% everywhere else).

2/ Private, owner-occupied housing and government buildings are exempt and the Housing Bureau pays at a preferential rate of 12%. Payments by enterprises are deductible from adjustment tax liability. On foreigners, it is called the "real estate tax" and is equal to 18% of rental value or 1.2% of capital value. Land is not taxed, only the buildings.

to other provincial and local revenue sources, and account for only 3% of total extrabudgetary funds (enterprise retained earnings are about 80% and extrabudgetary revenues of government agencies are about 17%) and less than 1.6% of government budgetary revenue.

3.46 User Charges. Though the public utility enterprises attempt to recoup a portion of costs through user charges, there has been no strong sentiment to raise rates to efficient (marginal cost) levels. Cost recovery is a much bigger matter than simply raising the level of the user charge. Water, sewerage and gas (LPG) charges, bus fares and housing cannot be adjusted independent of national wage and price policy and enterprise and tax reform policy. Perhaps as important, but less widely recognized, is the relationship between increasing the rate of user charge and the sharing of revenues among the three levels of government. An increased user charge--paid by enterprises or by individuals and compensated by an increase in wages--will lower the profits and therefore the tax liability of enterprises. The result will be a shift in revenue power (a) from the central to the local level because the whole of the user charge "stays at home," and (b) from the general government to the public utility enterprises. Unfortunately, no data are available for making a good estimate of the percentage of total costs recouped by user charges, but it is probably quite low. Residential user charges have changed little since Liberation, though there has been some movement in rates charged the enterprises. Within limits set by the central government, local governments can increase rates, and have done so for commercial and industrial users.

3.47 Capital Grants and Borrowing. China has no regular, formula grant program to support capital projects; all grants are on an *ad hoc* basis. There is no mechanism or formal program for lending to local governments, and there is no formal mechanism that guides local governments in developing beneficiary financing schemes. Capital financing is done from some combination of current revenues, planned loans or grants, special exceptions to the restrictions on borrowing, and creative, *ad hoc* approaches to benefit financing.

3.48 Provincial and local governments in China cannot borrow. However, there appear to be ways to avoid these restrictions. Short-term borrowing (less than one year) and even some longer term credit financing does occur. In some cases, municipally owned enterprises borrow for infrastructure projects and in some cases the municipal government has pledged its general revenues to secure loans to its enterprises.

3.49 The "price" of capital construction is high because it must be financed from current revenues rather than loans, i.e., by current rather than future beneficiaries; and by the general public rather than direct beneficiaries.

Intergovernmental Fiscal Relations

3.50 There are three important dimensions to the system of intergovernmental fiscal relations in China. The first is the system of tax sharing, outlined above, which determines the amount of resources that will be allocated to the subnational government sector. The second is the distribution of these funds *among* provinces, and includes both the tax sharing formulae and the flow of grants and subsidies. The third is the system of horizontal fiscal relations *within* the province, the method by which the provincial government allocates fiscal resources among its counties and municipalities.

3.51 Central-Provincial Transfers. The central government fixes and adjusts the tax sharing arrangements with the provinces. The system in China is essentially a sharing of revenues from a specified set of taxes, almost all of which are collected by the local governments. The total amount of the distributable pool is determined primarily by the amount collected from these taxes, but the distribution among provinces is determined by a combination of (a) origin of collections, (b) formula, and (c) negotiation and ad hoc decisions. The latter has given rise to the so-called "provincial contracting system" in which most provinces contract with the central government to permit an agreed revenue amount or proportion.

3.52 The basic retention formula was most recently amended in 1988. The retention rate may be either positive or negative and determines, in principle, whether the province remits a share to the center or receives a subsidy.13/ Some provinces do not operate under a retention ratio, but contract with the Center for a fixed delivery quota. This was part of the reform of the system begun in 1988, under the name of "provincial contracting". The results of applying the retention rate are described in Table 3.3. For example, Beijing in 1987 would be able to retain 49.5% of its 1987 collections from shared taxes. This system was intended to give provinces an incentive to collect taxes on behalf of the Center, by giving them a larger fraction of total collections. Of course, all fixed central government revenues would be turned over to the Center. As may be seen from the Table (Col. 3), 13 provinces had a "collections surplus" in 1987, i.e, shared plus local fixed revenues exceeded allowable expenditures and the tax sharing ratio was unity or less.

3.53 The remainder of the provinces were, in 1987, deficit provinces (see Column 6). The eight autonomous regions, the provinces with heavy minority populations and those least developed are singled out for special treatment. They receive a subsidy equal to their calculated deficit and this amount was to be increased by 10% per year, a figure taken roughly to approximate needed revenue growth. This system is known as the "minority budget system". In four other cases, the provinces under a "deficit province system" were allowed to retain all fixed and shared revenue collections and the central government paid a subsidy equivalent to the size of their 1986 deficit.

13/ The formula planned for 1988 is:

$$\text{Retention Ratio 88} = \frac{(L86 + S86)\,(\text{RATIO } 83) - T88}{(L86 + S86) - T88}$$

where S86 = shared revenue in 1986
L86 = "local fixed revenue" in 1986
T88 = the 13 taxes assigned to local governments in 1988
Ratio 83 = Allowable expenditures in 1983 ÷ Actual revenues collected in 1983.

This simplifies to

$$\text{Retention Ratio 88} = \frac{(E83)(1+r) - T88}{S(86) + (L86 - T88)}$$

This formula has been adapted a number of times since 1984. Full details of these changes are provided in Annex 2. Among the reasons for the change are the transfer of enterprises from provincial to central ownership.

Table 3.3: CHINA: REVENUE-SHARING SYSTEM BETWEEN THE CENTRAL AND PROVINCIAL GOVERNMENTS, 1985-1987

Provinces and regions	Fixed percentage of total revenue collected is retained by Province			Province retained all revenue collected and received agreed amount from the Center /a			Province retains all own revenue and pays agreed amount to the Center			/b Fixed or contract delivery
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1988
	(%)			(In millions of yuan)						
North China										
Beijing	48.2	49.55	49.55							**
Tianjin	39.5	39.45	39.45							**
Hebei	69.0	72.00	72.00							**
Shanxi	97.5	97.50	97.50							N.A.
Inner Mongolia				1,783*	1,961.74	2,059.83				N.A.
Northeast China										
Liaoning	51.1	52.66	52.66							N.A.
Jilin				397	396.62	396.62				
Heilongjiang	96.0							142.70	142.0	N.A.
East China										
Shanghai	26.0	23.54	23.54							**
Jiangsu	39.0	41.00	41.00							**
Zhejiang	55.0	55.00	60.81							**
An Hui	80.1	80.10	80.10							
Fujian				235		234.86	234.86			N.A.
Jiangxi				239		239.46	239.46			N.A.
Shandong	59.0	77.47						75.0		N.A.
Central/South China										
Henan	81.0	81.00	87.10							N.A.
Hubei	86.5	100.00	100.00							N.A.
Hunan	88.0	88.00	88.00							N.A.
Gangdong							772.00	778.08	778.00	**
Guangxi				716*		788.03	827.43			
Southwest China										
Sichuan	89.0	100.00	100.00							N.A.
Guizhou				743*	817.57	858.45				N.A.
Yunnan				637*	925.88	972.17				N.A.
Tibet				750*	825.32	866.59				N.A.
Northwest China										
Shaanxi				270	270.26	270.26				N.A.
Gansu				246	245.60	245.60				N.A.
Qinghai				611*	671.88	705.47				N.A.
Ningxia				494*	543.14	570.30				N.A.
Xinjiang				1,450*	1,594.85	1,674.59				N.A.

/a Asterisk indicates subsidies were to increase by 10% per year after 1985.
/b Two asterisks indicate quota contract delivery, also known as "provisional" contracting.
N.A. Information not available for the province's arrangements with the Center for 1988.

Source: Data Supplied by MOF.

3.54 A "provincial fixed contracting quota", or "incremental sharing rate" on revenues above a target level applies in some provinces. Since 1988, it has been applied in provinces including Jiangsu, Zhejiang, Hebei, Beijing, Tianjin, Guangdong and Shanghai (see Column 10). Under this system, a base quota of shared revenues must be transferred to the central government while all (or part of the) revenues collected over and above this quota may be kept by the province. The purpose of this special program, which can provide for up to 100% retention of above-quota collections, is to give these provinces--seen as keystones of China's development because of their outward orientation --greater incentive to collect tax and scope for growth. Within this group, Guangdong and Shanghai are among those to receive this special treatment. Guangdong is allowed to retain all taxes collected, after it remits to the Center a fixed quota. Shanghai remits Y 10.5 billion to the Center and retains any excess. Five other provinces (shown with ** for 1988 in Table 3.3) are also under this "provincial contracting system", but the contract targets are not known for these provinces.

3.55 While the provincial contracting arrangements can--if the above-contract share is low--provide increased incentives to collect revenue, they do not eliminate the potential conflict of interest between local and central governments, nor does it alleviate a crucial problem associated with decentralization, that is, the loss of control and flexibility by the Center over the use of tax policy for macroeconomic purposes referred to in Chapter I.

3.56 Moreover, the provincial contracting system, if more widely applied, can lead to severe revenue consequences. The fact that most contracts are fixed in nominal terms has left an increased share of fiscal resources in the hands of local governments. This reduces the growth, and, potentially the real volume, of resources in the hands of central government. Finally, as noted in Chapter I, like enterprise contracting, the provincial contract arrangement introduces a pro-cyclical bias to the fiscal system. This occurs because the revenue received by the central government under the "fixed remittance" contract system remains relatively constant regardless of the underlying growth of economic activity.

3.57 Implementation of the System. While the formulas themselves are not very complicated, the revenue sharing system is not simple to administer. Three problems are worth considering. First, implementation of the system requires reporting a substantial amount of detailed fiscal data by the province and verification of accuracy by the central government. Provinces do not appear to gather detailed fiscal data from their local governments, and the central government does not have a good mechanism for monitoring available data. Second, and contrary to government intentions, the sharing rates are not fixed for a specified number of years and negotiation and barter by the provincial governments are possible. Third, the actual transfer of the funds poses an administrative problem. Under the present system the People's Bank appears to be the fiscal collection agent and deposits the monthly or quarterly amounts to the appropriate central, provincial or municipal/county accounts, based on the sharing formulas.

Tax Sharing Between Provinces and Their Local Governments

3.58 Provincial governments set the general rules defining revenue sharing among local governments within their jurisdiction. They receive no guidelines from the Central Government for setting the sharing rates and are constrained only by their own economic plans, the total amount available for sharing, and provincial politics. Not surprisingly, provincial governments have developed many different systems.

3.59 Revenue Sharing. The approaches taken in Jiangsu and Anhui Province illustrate some of the differences. Jiangsu Province shares with each local government a flat percentage of its tax collections that varies across localities.14/ The sharing rate is determined on an *ad hoc* basis for each of the 11 cities and is reported by provincial officials to be equalizing, with cities in the poorer southern parts of the Province and those in more remote locations having higher retention rates.

3.60 The city governments in Jiangsu in turn determine the tax sharing rates for their urban counties, though the Province may stipulate the average sharing rate for an entire urban region. For example, the average retention rate for Nanjing and the counties under its administration may not exceed 22%. Changzhou, where the provincial government assigns the county retention rates directly, is the one exception to this general rule that cities determine the urban county tax retention rates.

3.61 Jiangsu has a special fiscal arrangement with the Provincial capital, Nanjing. Because it is the highest income city in the province, its basic retention rate of 17.5% is the lowest in the Province, but Nanjing is allowed to retain 30% of collections above the previous year's amount. It is noteworthy that although Jiangsu has benefitted from the increased provincial/central "incremental retention" rate in the last two years the Nanjing incremental retention rate has *not* been increased.

3.62 Anhui Province offers another example of the complexity of provincial relations. The local government's base year 1983 revenues and expenditures are used to fix the revenue retention ratio (E/R). However, an "incremental formula" applies to local revenue collections above the base level, where the local government retained share is lower and the provincial share *higher* than the basic ratio. Clearly, this system does *not* give local governments an incentive to increase their rate of revenue mobilization. A subsidy is paid to the local government if base expenditure exceed revenues. Apparently, the province attempts to allocate resources amongst local governments on an equalizing basis. The counties surrounding Hefei have an incremental retention rate of 80%, nearly 90% of the counties retain all revenues collected and receive a subsidy, and smaller cities have a higher incremental retention rate than larger, and presumably higher income, cities.

3.63 Like Jiangsu, there is a special arrangement for the provincial capital of Hefei based apparently on a special contract basis. The city's basic retention rate is 14.93%, and its incremental retention rate is 27%, for an average retention of about 22% of total shared tax collections in 1987.

3.64 *Provincial Grants.* The other dimension of Provincial finance is grants to the local governments. The concept of a grant-in-aid (as distinct from a price subsidy for agricultural products) to a local government is not one with which provincial officials in China are accustomed to working. There is no regular, formula-based program of grants to local governments. Three classes of grant appear to be used: (a) earmarked grants for purposes such as capital construction projects, natural disasters, and special assistance for underdeveloped regions; (b) grants for "year-end reconciliations," e.g., to compensate local government for a change in ownership of an enterprise during

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14/ Some provinces, such as Zhejiang, have a different sharing rate for each tax.

the year; and (c) subsidies to particular local governments for special purposes, including deficit grants. Apparently, the total amount allocated and the distribution among local governments is determined on an ad hoc basis rather than by formula.

C. Initial Assessment and Issues

3.65 The Chinese system of intergovernmental relations is complex, and very responsive to provincial interests. The ostensible objectives of the system are to improve resource mobilization, to improve provincial tax effort, and to achieve fiscal equalization. How well the system achieves these goals --in the context of balancing local and central command over resources--is discussed below.

3.66 Shifting Fiscal Balance. The fiscal balance between the central government sector and the provincial-local government sector appears to have shifted. Table 3.4 shows recent trends in the collections and expenditures of central and local governments. Inasmuch as data were not made available on the actual division of revenues between local and central governments, the discussion below focuses on collections. The central government's share of collections has been increasing, from about 23% of total collections in 1982 to 40% in 1986 (line 1 of Table 3.4). This shift resulted in part from the transfer to the Center of state enterprises in certain sectors whose profit taxes now accrue directly to the Center. Also contributing to this shift were the centralization of certain indirect tax revenues (petroleum, petrochemicals, nonferrous metals, and electric power) and the rapid growth of import duties.

Table 3.4: CHANGING FISCAL IMPORTANCE OF THE CENTRAL AND SUBNATIONAL GOVERNMENT SECTORS (%)

	1982	1983	1984	1985	1986
1. Central Gov. share of collections (% of total)	23.0	29.8	34.9	37.0	40.5
2. Central Gov. share of expenditures (% of total)	49.9	49.6	47.8	43.3	41.3
3. Center expenditures as % Center collections	222.8	172.5	141.0	115.7	104.9
4. Subnational expenditures as % subnat. collections	66.7	74.1	82.7	88.9	101.8
5. Subnational transfer as % Subnat. collections	33.3	25.9	17.3	11.1	-1.8
Ratio of Collections to GDP:					
6. Provincial Government	17.1	15.6	14.4	14.1	13.3
7. Central Government	5.1	6.6	7.8	8.3	9.7

Note: The figures refer to centrally (and locally) collections and not to actual revenues, by each level of government, before grants and revenue transfers. "Revenues" and expenditure are by national, not GFS definitions and therefore differ from the figures shown in Chapter I.

Source: Ministry of Finance.

3.67 The shift in the Center's share of total expenditures and revenues is a very important change. The result is that the provincial-local sector is becoming increasingly independent, and "revenue entitled", in that the revenues previously passed on to the Center are now retained at the local level. Whereas in 1982, provincial-local governments passed an amount equivalent to about one-third of what they collected (line 5), by 1986 the transfer was 2% less than total collections. Or to put it another way, they spent 66% of their collections in 1982, while in 1986, they spend more than they collect.

3.68 The central government, on the other hand, was spending 2.28 times the amount it collected in 1982, that is, it was then highly dependent on revenue transfers passed up from the provinces, but it spent only 1.04% of collections in 1986. This decline comes partly from the central government increasing its share in revenue collections (through the shifts described earlier), in the context of a marked overall decline in total collections but also because of the reduced local transfers to the Center (line 5). The implications for central expenditures are shown in line 2, which shows there has been a shift away from the central sector in favor of provincial-local government expenditures. Overall, the Center's expenditure capacity has thus been curtailed. Indeed local expenditures have grown at an annual rate of 13%, compared to a rate of 4% for central government. (No data is available on the type of expenditures accounting for these changes.) If provincial and local governments had been held to their 1982 transfer ratio of one-third, the central government would have had an additional Y 46 billion available in 1986.

3.69 These statistics suggest a number of conclusions and raise a number of policy questions. First, the Chinese system has become increasingly centralized on the collection side (line 1). A second observation is that the system is becoming increasingly decentralized on the expenditure side (line 2). Is the revenue decline by design or is it because local revenue efforts are flagging? Provincial and local government collections have fallen as a percent of GDP from 17% in 1982 to 13.3% in 1986 (Table 3.4). This could be a result of increased preferential treatment by local tax administration officials, but it also could be due to central government pricing or quota policies that reduce enterprise profits and gross receipts. The central government's share in collections, meanwhile, has increased from 5% to 9.7% of GDP. Is the decentralized expenditure shift due to reform priorities or due to a constrained central revenue system, due to declining transfers?

3.70 A third observation is that whether by design or not, each sector is now spending about what it collects. One is tempted to conclude that locally collected (as distinct from actual accrued revenues) taxes--the shared and local fixed taxes plus the local government tax collections from central enterprises--are the "right" revenue volume for subnational governments. This needs only be supplemented (as it is now) with some system of horizontal transfers among the provinces.

3.71 An important implication of these shifts in favor of the subnational government sector is that the central government's ability to use discretionary policy to redistribute among provinces, or to centralize national finances, is much more limited.

3.72 Fiscal Disparities between Provinces. There are wide disparities in per capita revenue collections among the provinces, ranging from Y 1,492 in Shanghai to Y 52 in Guangxi and Y 40 in Tibet, with an average of Y 169 in 1985 (see Appendix Table 4). What causes such great disparities in per capita collections among the provinces? The answer almost certainly is that higher levels of revenue mobilization are related to higher levels of economic activity, and perhaps to a higher rate of urbanization. The four provinces with highest per capita income collected the greatest per capita revenue amounts, while low income provinces collected the least. The relationship between per capita revenue and per capita gross output is so strong that the four provinces with the highest level of per capita output (Shanghai, Beijing, Tianjin, and Liaoning) collected 31% of revenues even though they account for 6.4% of the national population. This relationship is confirmed in a more systematic way by estimating the relationship between per capita collections and per capita gross value of output, holding constant population and urbanization (see equation (1) of Table 3.5).15/

3.73 Disparities are also pronounced on the expenditure side, with a per capita variation around average expenditures of Y 152 ranging from Y 346 in Shanghai and Y 344 in Beijing to Y 63 in Sichuan and Y 66 in Anhui. The same four high income provinces account for 15.2% of expenditures. Higher income provinces are able to spend more because of some combination of a greater demand for public services (proxied by urbanization), and the ability to raise more "local fixed" and extrabudgetary revenues (proxied by per capita output; see equation 2 of Table 3.5). Revenues appear to stay where they are generated. Populous provinces spend significantly less on a per capita basis, even after controlling for the amount of gross value generated and the demand for public services (as proxied by the rate of urbanization). One interpretation of this result is that more services are provided in the less populous as well as in the more urban provinces, and that the second, urbanization, variable does not adequately control for the large rural population.

3.74 Examining the equalization features of the tax-cum-transfer system shows some interesting results. The relationship between the expenditure-collections ratio 16/ and output and urbanization variables shows this ratio is lower in high income or urban provinces (see equation 3 of Table 3.5). Thus, the transfer system helps to equalize in some sense the expenditure capacity (as proxied by this ratio) between rich and poor provinces although it does not, of course, equalize expenditure levels, as shown by the results of equation 2 above. As equation 3 shows, moreover, the retention rate also appears to be lower in provinces with large populations, cet. par., and this may not be equalizing. As measured by the gini coefficient, the disparity

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15/ Ordinary Least Squares estimates. See Annex 2 for a detailed discussion.

16/ This ratio might be viewed as an approximation of the global retention rate on revenues collected. It should not be confused with the formal tax retention rate. The retention rate we calculate here includes fixed local revenues and collections from central government enterprises in the denominator, and it includes all budgetary expenditures in the numerator.

across provinces in per capita expenditures (.34) is less than the disparity in per capita collections (.54).

Table 3.5: OLS REGRESSION RESULTS FOR CHINESE REVENUES AND EXPENDITURES AGAINST SELECTED INDEPENDENT VARIABLES: BY PROVINCE FOR 1985 REGRESSION COEFFICIENTS /a

Equation	Dependent variable	Logarithms (L) or Linear (N)	Constant	Per Capita Output (100 RMB)	% of Population Living in Urban Areas	Population	R2	N
1.	Per Capita Collections	L	-5.308 (7.06)	1.391 (11.790)	0.314 (2.241)	0.053 (1.052)	...0.91	29
2.	Per Capita Expenditures	L	5.433 (11.38)	0.436 (6.154)	0.106 (1.362)	-0.443 (-14.783)	...0.93	29
3.	Ratio of Expenditures To Collections	L	6.739 (11.322)	-0.558 (6.315)	-0.168 (1.728)	-0.308 (8.242)	...0.82	29
4.	Ratio of Collections To Total Output Value	N	0.059 (6.454)	1.514 (E-05) (5.168)	0.0002 (0.600)	...	...0.63	29

/a T-statistic shown in parentheses below the regression coefficient.

3.75 In summary, there are very great fiscal disparities among the Chinese provinces. Revenue collections are highly concentrated (41% of collections in five provinces) and per capita collections in the highest province are 37 times that in the lowest. The transfer system helps to equalize expenditure capacity in that the expenditure-collection ratio varies from over 400% in Qinghai and over 100% in 14 other provinces, to 12% in Shanghai. However, it does not fully equalize expenditures and there remains a significant disparity in per capita expenditures, with higher income provinces spending significantly more. The fiscal expenditure differentials can be expected to increase as a result of the provincial contracting system. Under this system, better off provinces retain more revenues, generated by their growing tax base, while poorer provinces will not benefit from growth in transfers from an increasingly constrained and revenue-poor central government.

3.76 Tax Effort. An analysis of the level and growth of collections across provinces shows that, on average, tax collections are higher in Provinces where income is higher (Appendix Table 5). This finding stops short, however, of indicating whether higher income provinces also make a greater tax effort, i.e., whether they raise more or less revenue than might be expected given their economic base, level of urbanization, etc. For example, of the ten provinces with the highest levels of per capita output, six had below average revenue growth during this period. Conversely, of the ten provinces with the lowest level of per capita output, nine had above average growth in revenue collections. For policy purposes, the Chinese government wants to know not only which provinces have a greater capacity to finance, but how extensively they use this capacity. Otherwise, there is the risk of subnational governments using increased "central" resources to substitute for what otherwise would have been increased local government revenue mobilization.

3.77 The ratio of collection to gross output is one measure of collection effort. This ranges from 18% in Shanghai to 5.4% in Shandong. In a province as poor as Gansu, it is to 9.8% (see Table 3.6). Much of this variation is to the expected, because of differences in these provinces' taxable capacity. Hence this result cannot be used to infer that higher income Shanghai exerts more than twice the revenue effort as does lower income Gansu. In fact, as is shown below, Gansu actually makes a greater collection effort than Shanghai. The problem with straightforward comparisons of collection-output ratios to infer tax effort is that proper account is not taken of differences in taxable capacity.

3.78 If the taxable capacity of the province is a function of its income level and its degree of urbanization, the higher level of per capita income--proxied here by the per capita gross value of output--should imply a greater capacity to collect taxes. Urbanization may also contribute to taxable capacity because urban economic activities are more easily reached by the administrative system (they provide better "tax handles") than do rural activities.

3.79 Using per capita income and urbanization as indicators, each province's taxable capacity has been estimated and is shown in Column 2 of Table 3.6.17/ For example, based on the average practice and its own level of per capita output and urbanization, we would "expect" Beijing's collection ratio, or taxable capacity, to be 12.78% of output.

3.80 Tax effort is the extent to which a province uses this capacity, and may be measured as the ratio of the actual collection rate to estimated taxable capacity. Thus Beijing's predicted tax capacity is 12.7% of output (column 2), but the province actually raised 15.2% (column 1). This shows above average tax effort--specifically an effort which is 19% above average as is shown by the "tax effort index" (column 3). Shanghai, by contrast, in spite of its large absolute volume of actual collections makes only an average tax effort.

3.81 The ranking of provinces making stronger and weaker revenue collection efforts reflects interesting factors. In general, many of the higher income provinces make a lower level of revenue effort, e.g., Jiangsu, Zhejiang, Shandong and Liaoning all make below average efforts and Shanghai is just about average. Therefore, the system the Central Government has designed to "encourage" revenue collection does not appear to be effective in encouraging those provinces where taxable capacity is highest to make the greatest effort. In fact, richer provinces are not always associated even with more rapid budgetary revenue growth. Box 3.3 discusses tax effort in an international context.

17/ The method used here follows the approach developed in Roy Bahl "A Regression Approach to Taxable Capacity"; see 1970 IMF Staff Papers. Equation 5 of Table 3.5 shows the relevant coefficients. Tax capacity is positively related to per capita income (B1=1.54) and to urbanization B2=.0002.

Table 3.6: COMPARISONS OF TAXABLE CAPACITY AND TAX EFFORT: BY PROVINCE

Province	Ratio of Collection to Gross Output, 1986	Estimated Taxable Capacity 1986	Tax Effort Index /a	Tax Effort Ranking
Beijing	15.24	12.78	1.19	5
Tianjin	14.42	13.30	1.08	8
Hebei	7.52	8.00	0.94	15
Shanxi	8.93	8.48	1.05	9
Inner Mongolia	7.87	7.92	0.99	13
Liaoning	9.75	10.57	0.92	15
Jilin	7.75	9.09	0.85	18
Heilongjiang	7.82	9.09	0.86	17
Shanghai	18.06	17.95	1.01	11
Jiangsu	6.30	9.49	0.66	19
Zhejijng	7.93	9.18	0.86	17
Anhui	6.49	7.55	0.86	17
Fujian	9.35	8.05	1.16	6
Jiangxi	7.10	7.59	0.94	15
Shandong	5.44	8.70	0.63	20
Henan	7.45	7.42	1.00	12
Hubei	7.63	8.49	0.90	16
Hunan	8.06	7.73	1.04	10
Guangdong	8.51	8.33	1.02	11
Guangxi	8.90	7.43	1.20	4
Sichuan	7.18	7.52	0.96	14
Guizhou	8.79	7.18	1.23	3
Yunnan	12.35	7.28	1.70	1
Tibet	6.02	6.97	0.86	17
Shaanxi	7.86	7.84	1.00	12
Gansu	9.86	7.76	1.27	2
Quinhai	7.85	7.69	1.02	11
Ningxia	8.61	7.74	1.11	7
Xinjiang	6.25	8.14	7.68	--

/a Ratio of Tax capacity to actual collections.

Other Problems and Issues

3.82 The economic reform program will bring important changes to the role of the subnational government sector in China. First, with more enterprise autonomy in management decisions and responsibility for financing their own operations, the provinces and local governments will shift emphasis from directly productive investments to general infrastructure development. Second, as enterprises become more independent in their management and record keeping, and as smaller enterprises and collectives grow in number, there will be a need to increase the efficiency of the tax administration system. Third, as markets become integrated, provincial and local governments eventually may find themselves competing for enterprise activity, possibly on a basis of public service levels and effective tax rates. Finally, local governments may look to the retained earnings of enterprises as a new source of infrastructure capital financing; over time this could lead to use of more formal benefit charges and borrowing relative to general taxation.

Box 3.3: REVENUE SHARING AND TAX EFFORT

The effect which revenue sharing has on the tax effort of recipient provinces is an important concern. For example, if transfers from the central government cause the provinces' own tax collection efforts to decline, little has been gained in terms of increased support for expenditure programs. It is important, therefore, that revenue sharing consider tax effort, at least implicitly, in determining allocations among provinces. China's system does so via its emphasis on "responsibility" and the incentives provided through the incremental retention schemes.

The effectiveness of this approach is difficult to judge. Generally speaking, the first step in assessing "tax effort" is to measure "taxable capacity." Tax capacity, intuitively, is determined by such factors as the level of income, the presence of easily taxed activities, the degree of urbanization, and so on. An estimate of taxable capacity can be made in China, by estimating the potential tax base of each province, and then applying an average tax rate to this potential base.1/ Tax effort is measured by comparing the actual taxes collected in a province to the estimate of its taxable capacity.

Why are these questions important in China? In the first place, one of the explicit objectives of the Chinese revenue-sharing system is to encourage the provinces' own tax efforts; and, indeed, the central government has made substantial revenue concessions to the provinces to stimulate tax effort. In the absence of some estimation along the lines just described, it is difficult to know whether these measures are having the desired effect, or whether some poorer provinces may need additional transfers, because even a major tax effort (in relation to a small base) generates insufficient revenues.

In India, tax effort is used as one element of the formula for revenue equalization. In West Germany and Canada, tax capacity and tax effort have long been used as integral parts of the revenue equalization formulas. In Germany, for example, the average tax capacity of all states taken together is used as a yardstick of the minimum expenditures which the central government would like to be carried out in each state. The difference between this average per capita tax capacity and a province's actual tax capacity is calculated, and the difference (which may be either positive or negative) is paid into an "equalization fund" by the surplus provinces, or withdrawn from this fund by the deficit provinces.

The German system, like the Chinese system, therefore, transfers resources from surplus provinces to deficit provinces. Whereas, in most countries, transfers are made from the central government, in Germany there is a settlement between the provinces, and in Germany, the amount transferred by more prosperous provinces is exactly equal to the amount transferred to deficit provinces.

The German approach makes less-than-average tax effort costly, because tax sharing is based on estimates of the province's tax capacity. Thus, any province where tax effort is not commensurate with tax capacity will not be compensated for this below-average effort.

In China, the revenue-sharing system, in all three of its variants, is designed to give incentives to the provinces to increase their tax collection. The sharing system in place in the majority of provinces, and the fixed quota delivery systems accomplish this by giving certain provinces a proportional share in all additional revenues that they collect. In the "responsibility" system, the province retains 100% of incremental revenues collected over a certain quota. Likewise, in both variants of the "minority budget" system, provinces retain 100% of any revenue collected, transferring nothing to the central government.

Strictly speaking, however, the incentive is being given for increased tax collection, not tax effort. There is no way of knowing, in the absence of estimates of taxable capacity, how a province's collection relates to its taxable capacity. Thus, increases in tax collections may result from rapid increases in the tax base, while tax effort in relation to this base in fact declines.

Under the current system of collection, the central government relies heavily on the tax effort of local governments. If the central government moves to collect its own taxes in the future, its reliance on the tax efforts of lower-level governments would of course be reduced. However, in the interest of balanced revenue growth, and to insure that the provinces' own collection efforts are not negatively affected, China may want to incorporate tax effort criteria into the revenue-sharing formula. One alternative would be a bonus paid to those provinces whose tax effort increased relative to changes in the average tax effort of all provinces.

1/ The average or "effective" tax rate is defined as the revenue raised from a given tax in all provinces, as a percentage of the tax base across all provinces.

3.83 How well equipped are provinces and local governments to handle this new role and to take advantage of these new opportunities? What problems must they overcome in order to fully support the system reform? The answer, partly, is that there are some difficult problems to be resolved: a revenue base that may not be growing adequately, a system of implicit prices that compromises some of the objectives of a "good" system, weaknesses in tax administration, encouragement of informal approaches to local government fiscal autonomy, and inadequate fiscal accounting and planning.

3.84 The present fiscal structure may not give provincial or other levels of government an adequate revenue flow to meet their expenditure requirements. Because there is no forecast or projection of expenditure needs, nor a clear statement of expenditure responsibilities of respective levels of government, the target income elasticity for expenditures is taken to be unity. The present system may not meet this target, though data limitations prohibit us from drawing a firm conclusion here. A number of pieces of evidence of revenue inadequacy might be cited. A substantial backlog of infrastructure needs is believed to exist. Eliminating this backlog is a future problem, along with the budgetary pressures of large increases in urban population. The profits tax, an important overall revenue source and major source of financing for provincial and local governments, does not have an income elastic base (partly because of contracting--see Chapter I), is cyclically variable in yield, and is sensitive to central government decisions about pricing and wage policy. Moreover, the continuing shift of the economic structure towards collectives and household firms expands the profits tax base to include activities taxable at a lower rate and harder-to-tax activities. The turnover tax may be more income elastic and more stable than the profits tax in the long run but, again, only a portion of its revenues accrue to subnational governments.

3.85 To answer this set of problems concerning revenue adequacy, the elasticity of the tax base will have to be increased. The best route for such improvement may be tax simplification so that compliance and monitoring are easier (as outlined further in Chapter IV) and strengthening administrative procedures and staff skills. An increase in the elasticity of the tax system, achieved by taxing the growing surpluses in the household and other sectors (as suggested in Chapters I and II), does not conflict with government objectives of increasing the financial strength or efficient performance of enterprises.

3.86 A second set of problems has to do with the structure of the provincial and local financing system and the incentives such tax sharing may provide for undesirable behavior by local governments. First, a potentially important problem area, where local governments may not be stimulated to maximum efficiency, is tax administration. The incentives for avoiding full tax payment may be substantial: tax rates are high and the overall tax share retained through sharing or incremental quota arrangements by the municipality can be low. This alone suggests that local governments benefit little from higher collections and may not make a full effort. In addition, a principal component of the tax base is the sales and profits of municipally owned enterprises. The local government would prefer to see such enterprises flourish, (and if necessary levy <u>ad hoc</u> charges which may be fully retained) rather than subject them to a shared tax.

3.87 Possibly more important are the efficiency costs associated with not giving local governments some degree of autonomy. The governance system is decentralized in terms of the administration of public services, but formal local fiscal autonomy is limited. Legal tax rates do not vary significantly among communities or even within urban areas (although specific enterprises may be able to reach agreement on a preferential treatment). If diversity in tax rates is not allowed, the goal of making local officials more accountable for their actions and thereby improving the efficiency of the delivery of local public services becomes very difficult to achieve. Moreover, interregional tax rates reflecting location rents and/or the costs of urbanization will not be developed and the tax system will not contribute to improving the spatial distribution of economic activity. The uniformity of the tax/subsidy system and the absence of a land tax probably promote a concentration of economic activity in the urban core (versus the outlying areas) as well as an inefficient use of land.

3.88 Finally, provincial and local officials will react to the absence of formal autonomy by taking "back-door" approaches (negotiating, bargaining, "experimenting") which may have effects that run counter to the goals of government policy (as discussed in Chapter I). The development of the system of tax administration and central-local relations since 1983 has given provincial and local governments just such freedom to shape the fiscal system to meet their own objectives. If a tax rate on an enterprise seems onerous, it may be lowered by a contract negotiated with local authorities; if an enterprise is to be encouraged, it may receive special tax treatment; if a local government is mobilizing increased resources, its retention rate might be lowered; and "favored" provinces may be more able to negotiate a special rate with the central government.

3.89 These back-door approaches destroy the concept of a fiscal system because they break the link between structure and implementation. The tax "levers" that the central government designs may be vastly different from the fiscal measures that are actually implemented at the local level. And even were it not for these "back door measures," the administrative system may not be sophisticated enough to enable this "fine tuning" to achieve the desired objectives. These "levers" are wasted by an assessment and collection system that has not yet caught up, and by offsetting actions of provincial and local governments.

3.90 Another general concern--reflected throughout the report--is tax administration. There are incentives and opportunities for provincial and local governments to assist enterprises in tax avoidance. Moreover, the system is complicated and difficult to administer, it requires a highly qualified staff for efficient administration, and books of account for smaller firms may be inadequate to the task of determining sales and profits tax activity. This problem will grow as smaller collectives and private businesses become more important.

3.91 In addition, there are problems with the way in which provincial and local governments marshal financial information to plan and control their fiscal activities. It is not possible to construct a unified budget of local government finances or of total capital expenditures in the urban areas, or to net out transfers between the municipal government and the enterprises or even between the provincial and municipal government. There is no multiyear budgetary forecasting and no capital budget. In general, the budget does not appear to be used for planning purposes.

3.92 A more general problem seems to be growing up with the reform. With the switch from direct controls to "levers," there may be a tendency to try and do too much with the tax and transfer system. Example of some of its incentives include: (a) the phasing out of the adjustment tax depends in part on the amount of capital investment a firm makes; (b) property tax is deductible from adjustment tax; (c) the construction tax rate varies by type of construction, e.g., plant expansion versus new plant; (d) there are more than 60 sales tax rates; (e) there are many ad hoc tax exemptions and "experimental" treatments, e.g., wage tax bonus is sometimes treated as a business cost; and (f) in some provinces there is a different local-provincial sharing formula for each tax, e.g., the distribution of taxes among the central government and the provincial, municipal and subdistrict governments in Zhejiang requires the application of 12 different formulae. It is not clear that the tax system can achieve all these goals.

D. Options for Reform

3.93 The first step in a reform program is for the government to decide on the role it wants to assign the provincial and local government sector. In particular, the questions are whether provincial, municipal and county governments will be given some degree of revenue-raising autonomy, whether tax administration can remain a local government responsibility, and whether the intergovernmental transfer system will include a formula-based grant program.

3.94 The choice of a particular central-local fiscal relationship will depend on how the government weighs the benefits of decentralized economic development policies against the costs of having less effective central fiscal management. There are strong forces justifying more fiscal centralization in China at the present time. Inflation and a budget deficit suggest a need for more central control over the budget for stabilization policy purposes. Moreover, the economic system reform relies heavily on the use of tax policy as an instrument to influence economic decisions, and local control over the implementation of the tax system can (and probably has) compromised some of the objectives of central government tax policy. In order to gain more central control over the revenue system, it will be necessary to reduce if not eliminate the provincial and local government power to allow contracting of types involving tax remission or special tax concessions.

3.95 To centralize the fiscal system, however, sacrifices possibilities of vesting more budgetary decision-making powers in local governments and to reduce the revenue-raising incentives of provincial and local governments, which are goals of system reform. Fiscal centralization vs. fiscal decentralization is a hard choice and each has benefits that the government does not want to sacrifice. Yet, one cannot have it both ways.

3.96 If the decision is in favor of increased fiscal decentralization in China, then three possible models can be developed; each with differing implications for administration, and the extent and nature of the autonomy given to provinces.

Limited Tax Sharing

3.97 This approach would call for separate central and provincial taxing powers, and the abolition of the shared tax system. The two questions to resolve would be which taxes to give to each level of government and what to do about tax administration. At one extreme is a very centralized approach under which the enterprise income tax and the product, business, and value added taxes would become fixed central revenues. Provincial governments would be given the minor taxes (e.g., the 13 "fixed local taxes" assigned to them in 1988). There would have to be separate central and subnational tax administrations because it would not be reasonable to expect that local governments would aggressively collect central taxes when they would not receive a share (see Box 4.5 in Chapter IV).

3.98 If this solution were adopted, provincial and local governments would be unable to finance all services for which they are now responsible, and one of two courses of action would be called for. One possibility would be for the central government to assume direct responsibility for provision of certain services. This is not an attractive option because one tenet of the system reform is increased decentralization, and because China is simply too large and diverse a country for a centralized public expenditure system to be managed efficiently. A more likely solution is to create a regular program of central grants to provincial governments to make up for the revenue shortfall. The grant could be distributed on a formula basis, with the elements of the formula chosen to reflect need. For example, the grant distribution among provinces might be based on some combination of per capita income level, population size, some indicator of infrastructure needs, urbanization, etc. Provinces would then develop their own formulas for allocations among the local governments (see Box 3.1 on Formula Grants).

3.99 The very great advantage of the centralized version of the local autonomy approach is that it enables a maximum of central control over interregional equalization and the sectoral composition of investment. It also puts the government in a better position to use the tax system for macrostabilization goals, and, because it merges responsibility for tax structure and tax administration, it makes possible the use of the tax system to achieve allocative goals. The latter point is especially important: the tax "levers" that the central government designed would be implemented. The biggest disadvantages to this approach are the loss of provincial and local control over the tax system, the reduced incentive for revenue mobilization by local governments, and the increased expense associated with two separate tax administration machineries and with the maintenance and operation of a grant system. This centralized approach has been adopted by most low income countries that have unitary forms of government.

Balanced Tax Sharing

3.100 There is also a more decentralized, or balanced version of the separation of powers approach. The subnational governments could be given access to one of the productive tax bases--namely control over the sales tax 18/ or the profits tax. Revenues could be large enough, at least for the highest income provinces, that a supplementary national grant scheme would not be necessary. Under this solution, provincial governments would have a considerable amount of discretion in determining the level of revenues and expenditures, and "the size of government" in the local area. When policy analysts and economists speak about fiscal decentralization, this is the version they usually have in mind.

3.101 The assignment of broad provincial and local taxing powers works in the United States and in the developing world, in Brazil, Colombia and Nigeria, in which between 25% and 50% of all taxes are local. There are reasons why it also could work in China. Chinese local governments have broad expenditure responsibilities and this would make the revenue raising authority commensurate. Certainly local governments now have as much skill as the Center in administering a broad-based consumption or income tax.

3.102 There are also problems with this solution. Consider the problem of which of the two major taxes to choose. The profits tax would be a good choice because it is revenue productive, but it is also cyclically unstable and can be effected dramatically by central government policies, e.g., price changes for raw materials, a new wage policy, quota reductions, alteration in foreign trade policy. The sales tax would be more stable, but it is unlikely that the central government would agree to give up so productive a revenue source. The recently introduced urban land tax is a natural choice for a local government revenue source, but its revenue yield is unlikely to be significant. Another problem is that if the profit or sales tax were to be assigned to local government, then the two taxes would almost certainly have to be administered by separate central and local government tax administrations. This would be inefficient because book audits would be duplicated, enterprises would have to double their reporting requirements, and economies of scale in tax administration training and computerization would be lost. Finally, such a program would be counterequalizing in that the highest income provinces would generate the greatest amounts of revenue and a program of compensating grants would have to be developed.

Base-Sharing Model

3.103 A third model might be sharing of the tax base, not the tax revenues. This arrangement would have subnational and central governments share in the base of the enterprise income and product, business, and value-added taxes. This would differ from the present system in two important ways. First, the central government tax would be fixed and totally independent of the local tax, and second, provincial governments would be permitted to elect (within a

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18/ Note that if the VAT were made into a provincial tax, allowing differential rather than uniform rates in all provinces, raises special administrative problems.

range) a surtax rate on each base. For example, a basic rate (say 20%) on the enterprise income tax would belong to the central government as fixed revenue, and the provincial government could elect an additional rate of 10% (minimum) or 20% (maximum).19/ For indirect taxes, the subnational rate might be an additional charge levied as a percentage of the central government product tax liability, in much the same way as the present urban construction and maintenance tax is levied. In fact, the UCMT offers some precedent for this approach, except that the present 7%, 5% and 1% surtax rates are fixed by the Center rather than chosen by lower level governments.

3.104 In the case of turnover taxes the addition of a local surcharge poses few conceptual or practical difficulties provided the bases for the two taxes are indeed the same (i.e. if the surcharge is truly a surcharge). An invoice-based VAT could raise some difficulties under this approach. One problem is that provinces specializing in intermediate goods would almost certainly prefer to "export" taxes to other provinces rather than zero-rate their own "exports". A true destination VAT would require some kind of adjustment for taxes on "imported" goods, as will now be the case in EEC countries. However it is doubtful local (provincial) governments would wish to give credit for "foreign" taxes on inputs suffered on purchases from suppliers in other provinces. In Brazil, for example, the VAT is a provincial tax, but the federal government sets maximum rates.20/ While the experience of VAT harmonization in European Community offers some parallels here,21/ it appears unlikely a regionally rate-differentiated VAT could operate satisfactorily in China without central control.

3.105 Would revenues be adequate to meet provincial and local government expenditure needs under such a program? If the surtax limits were set to reflect expenditure needs, the higher income provinces could generate adequate revenues but the lower income provinces could not. Two kinds of compensating formula grant programs would be required. One is an equalizing program to reflect the low fiscal capacity of some provinces. This is really no different in principle from the present system which supplements tax sharing with transfers to deficit provinces. The other needed grant program would be to stimulate expenditures on projects with national significance, and all provinces would participate.

3.106 Local revenue administration might be retained under a base-sharing program, but provincial and local governments would not be permitted to engage in any tax relief policies that would affect the base or rate of the central government tax. If provincial governments chose to contract with enterprises

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19/ In practice, the exact rates would be worked out based on the division of expenditure responsibility between the central and local governments. In the case of the VAT, this could mean that VAT surrates, if surcharges were permitted, would have to be identical across provinces.

20/ See Ved Gandhi; "Tax Assignment and Revenue Sharing in Brazil, India, Malaysia and Nigeria", in C. McLure, ed. Tax Assignment in Federal Countries; ANU Press, 1983.

21/ See Tait, Alan, VAT: International Experiences and Problems; 1986.

or provide tax preferences at the cost of reducing their own tax base, they could do so; hence the decentralization advantages would not be lost and some degree of responsibility would be built into the system. They could not, however, give preferential treatment on the central government tax. The system is described with an example in Box 3.4. Compared to the limited tax sharing and balanced tax sharing models discussed above, this approach implies less central governance and management of the tax revenue base and considerably more fiscal self-determination.

Box 3.4: PROFIT AND SALES TAX SHARING UNDER A BASE-SHARING MODEL

The simple numerical example here describes one version of how an enterprise would be treated under such a system. We have assumed fixed central sales and profits tax rates of 10% and 20%, respectively, and to make matters simple have assumed that the tax bases are gross sales and gross profits, respectively. In case A, the provincial government chooses rates of 5% and 15%, with no preferential treatments, with the result that it collects Y 950 from this enterprise by comparison with Y 1,600 for the Central Government.

	Case A	Case B
Gross Sales	10,000	10,000
Central Sales Tax at 10%	1,000	1,000
A. Provincial Sales Tax at 5%	500	
B. Provincial Sales Tax at 3%		300
Less Production Expenses equals	5,500	5,500
Gross Profits	3,000	3,000/a
Central Profits Tax at 20%	600	600
A. Provincial Profit Tax at 15%	450	-
B. Provincial Profit Tax at 10%	-	320
Total Central Revenue	1,600	1,600
Total Local Revenue	950	620

Now let us assume that the provincial government offers a preferential treatment to this enterprise and limits the sales and profits tax rates to 3% and 10%, respectively. Central revenues could not be affected, Y 1,600 is still raised in Case B, but local revenues would be reduced to Y 620 because of the tax abatement.

/a Note that sales tax relief would affect the definition of local government taxable profits, (since sales taxes are normally a deductible expense) but not central government taxable profits.

3.107 There are disadvantages to this shared base approach. Provinces with a stronger economic base would have an advantage and the supplementary grant program would have to be created and maintained. The local tax administration system would have to be carefully monitored by a better Management Information System (MIS) than presently exists, to ensure proper collection of the Center's tax share. Another disadvantage is that the central government would give up some control over the tax system and therefore would have less leeway in using tax policy to pursue stabilization and macroeconomic goals.

3.108 Despite the disadvantages, one might be able to make a good case that this is an appropriate approach for China. It provides fiscal decentralization and the option to continue to allow provincial governments to follow local industrial policy, if this were considered desirable, while allowing the central government to retain some control over the level of taxation and complete control over the definition of the tax base. This system would give the local governments a significant incentive to improve the efficiency of their tax administration and of their public service delivery system. It might also be argued that, by comparison with the present system, central government macroeconomic control would not be compromised markedly.

Patching Up the Present System

3.109 The above are radical reforms calling for eliminating the existing tax sharing system, giving local governments some rate-setting autonomy, creating a grant system, and changing the nature of responsibility for tax administration. Another possibility is that the decentralization of the economic reform will have to go more slowly, and the first step should be to patch up the present system. The objective is to eliminate some of the most objectionable features of the present system while retaining its strengths. The areas where reform is most needed are: (i) changes in the system of central-provincial revenue sharing; (ii) rationalizing the system of provincial-local relations; (iii) bringing the implementation of central tax policy under control; (iv) improving the system of capital financing, and (v) modernizing the system of tax administration and financial management.

3.110 Central Provincial Relations. The following changes should be made in the system of central-provincial relations:

(a) If the tax sharing system is to be retained at all, the sharing ratios should be determined on some objective basis rather than in an ad hoc way. The 1983 base year approach should be replaced. If Zhejiang's retention rate, for example, is to be lower than Anhui's, the difference should be based on some objective indicators. The government may want to substitute a formula for the present negotiated and judgemental approach, to compensate for lower fiscal capacity or greater fiscal need, or to reward greater revenue mobilization.

(b) The tax sharing ratios should be fixed for a number of years to provide provincial governments with some certainty, and to discourage the central government from allowing the sharing ratio to become a subject of annual negotiation. One possibility would be to set up a "grants commission" along the lines of those in India and Australia, to study and recommend a fixed, 5-year program of revenue sharing.

(c) The provincial and local governments should know the sharing ratio well before the beginning of the fiscal year, to ensure better fiscal planning and so that any incentive effects might be realized. At present, such information is given to the provinces well into the fiscal year. Increased tax effort cannot be expected to result.

(d) The present approach to grants to provincial governments should be rationalized, perhaps converted to a regular grant program with a known pattern of distribution--and coordinated with the shared tax system.

3.111 The objective of making subnational governments more responsible for their actions would be served by giving subnational governments some taxing powers, though likely candidates for generating significant revenues are not apparent. Among the possible revenue sources for local governments, in addition to the list of 13 approved in 1988, are agricultural taxes, the land tax or charge, and the dividends paid to local governments by state owned enterprises for the use of assets. The latter were proposed in Chapter II as a way of separating the roles of government as owner and tax collector. While this would give local governments some independent revenue raising power, it would be far from adequate for covering the expenditure responsibilities undertaken by local government.

3.112 The central government must rationalize its delegation of powers to provincial governments, and the latters' control over local governments, with China's overall national development objectives. What is to be done when provincial policy runs counter to national objectives? The hard choice to be made here is between accepting this outcome as an unavoidable cost of decentralization and compromising the autonomy of provincial governments in controlling their fiscal structure. The view here, and perhaps the prevailing view in China, is that the enterprise contracting system is one area where the cost of decentralization has become too great and central regulation or limits are necessary. Another such area is the method of provincial-local tax sharing and whether this reinforces or offsets central fiscal objectives.

3.113 Provincial-Local Relations. Regardless of the local autonomy issue, the government should urge a reform in the system of provincial-local relations. In particular, the present system of interprovincial revenue sharing is unduly complicated, perhaps inconsistent with national goals, and will present some major problems as system reform progresses. It can also be argued that the national revenue mobilization objectives are not well served by the provincial-local arrangements. Three changes might be considered. First, all taxes should be shared at a uniform rate. Second, provincial governments might consider increasing the municipal tax-sharing percentage for larger cities. If the retention rate were increased above its present level (usually less than one-third), an important incentive to improve administration would be provided in exactly those cities where revenue-raising potential is greatest. However, this action would drain provincial government resources and could come at a cost of less fiscal equalization within the province.

3.114 More generally, provincial governments should rationalize the intraprovincial tax-sharing system. The sharing percentages should not vary across local governments in an ad hoc manner and the merits of a system of horizontal transfers--perhaps a capital grant system--should be considered. In any case, the distribution of grants and tax-sharing subsidies within provinces should be carefully, empirically studied to determine whether it measures up to the equalization and development goals of the Regional Economic Plan. This begs a bigger issue, namely whether the central government should play a direct role in the formulation of policy by provincial governments with respect to their local governments. Central governments in other large countries have done this when provincial policies became out of step with national goals (e.g., the United States, Brazil, and Nigeria) and China may be approaching a similar situation. However, this would be yet another step back from fiscal decentralization.

3.115 Local Discretion in Tax Administration. Perhaps the most important reform area is whether provincial and local governments should have the authority to give special tax treatment to enterprises. Clearly, the objective of giving the central government more control over the tax system to better pursue stabilization policy and allocative goals would be served by eliminating or reducing local government discretion for giving tax concessions or tax remission contracts to enterprises. One option, argued in Section II above, is for the central government to limit such provincial and local government discretionary power to contracting out of after tax profits. Another is the "balanced tax sharing" version of revenue sharing discussed above, which places responsibility for paying for tax preferences directly on the unit of government granting the preference. Either way, an evaluation of the options will come down to the question of how important it is for provincial/local governments to play a role in forming industrial policy. The central government must also put in place a central data system to monitor the effectiveness of local collection and assessment activities.

3.116 Capital Financing. There are good possibilities for mobilizing more resources for infrastructure finance. A formal mechanism for borrowing and benefit financing could permit local governments to finance capital projects by tapping the willingness-to-pay of project beneficiaries. Likewise, a more formal and appropriately designed program of provincial government capital grants should replace the present ad hoc system.

3.117 Tax Administration and Financial Management. Subnational budgets can be recast as more effective planning tools. The objective should be to regularly produce a unified local area budget, fully identify capital construction and maintenance spending and financing, and trace out all interaccount transfers. Multiyear budgetary forecasting and capital budgeting should be a regular part of the planning process. The government needs to accept and act on the proposition that local government fiscal planning must be integrated with the long-term economic plan for an area.

3.118 Potential improvements in tax administration are an important consideration. Without a full survey of administrative problems, it is difficult even to suggest the elements of a reform program. Among the possible needs, developed further in the next Chapter, are the introduction of taxpayer identification numbers and a master file, more staff training, simplification of the tax structure itself, improved collections and assessment, and computerization. An even more important underlying question is whether the tax administration system should be more centralized and whether the administrative problems are as much related to the structure of the tax system as to its operation. Short of a thorough study of all these issues, it would seem ill-advised to consider the creation of a separate central and local government tax administration.