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Central-Local Fiscal Relations and Revenue Sharing

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Central-Local Fiscal Relations and Revenue Sharing

Introduction

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 in Beijing, but subnational governments have the responsibility for tax administration, share in revenue collections, and are given a substantial amount of latitude in awarding tax preferences to enterprises. The success of central government tax reform will depend to a great extent on the reaction of the local governments.

2. This annex is about the possibilities and needs for reforming the intergovernmental fiscal system to support the general economic reform in China.1/ In the first section, the norms for deciding on the right amount of fiscal decentralization and the right structure of local finances are discussed, and the international experience is reviewed. A brief description of the present system of local financing in China, some evidence about its performance, and a review of the problems encountered follows. The final section of the annex presents the broad outlines of the reform options.

A. FISCAL DECENTRALIZATION AND THE ROLE OF SUBNATIONAL GOVERNMENT: PRINCIPLES, CRITERIA AND THE INTERNATIONAL PRACTICE

3. In virtually every country there is disagreement about the "proper" way to organize the public sector to deliver and finance services. Most of the debate centers on questions about which level of government should provide which public services, how much management and fiscal autonomy should the local government sector have, whether the revenue base given to local governments is commensurate with their expenditure responsibilities, and how fragmented should be the structure of local government within urban areas. This section is meant to develop a framework for answering such questions in the China context.2/

1/ A much longer version of this analysis is in Roy Bahl "Local Government Finance and Intergovernmental Relations in China" (World Bank, unpublished manuscript).

2/ For a more detailed discussion see Roy Bahl and Johannes Linn "Urban Public Finance and Management in Developing Countries" World Bank, forthcoming.

Fiscal Centralization vs. Decentralization

4. The decentralization of population and economic activity is a goal that is common to many governments and is frequently the advice of international agencies. Many countries also have come to realize that the strengthening of local governments, by granting them some meaningful fiscal autonomy, is an important component of successful economic decentralization. Others take the view that more fiscal decentralization leads to better governance because there is more participation in the public decision-making process.

5. The Case for Centralization. The arguments for fiscal centralization are stronger in developing than in industrialized countries. Stabilization is especially important since low income economies are less diversified and therefore are more "exposed" to international fluctuations in commodity prices, natural disasters, wars, worldwide recession, etc. This argues for central government control of the major tax and borrowing instruments. The implementation of economic growth policy may also be taken to argue for fiscal centralization, i.e., investment capital is short, and must be mobilized and directed by the central government to maximize returns. 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 tax. As a corollary to this, 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.

6. There are also income distribution arguments that support the case for fiscal centralization. The most important is that regional (and rural-urban) disparities in income and wealth are usually pronounced, an important national concern. These disparities may be accentuated by fiscal decentralization because the already wealthier urban local governments will benefit most from increased local government taxing powers. Centralization allows the national government more discretion in shaping regional differences in public service levels and taxation, an especially important consideration to governments who intend to use tax and subsidy policy to shape the spatial distribution of economic development.

7. Central governments are thought to have a superior capacity in the areas of tax administration and the management and delivery of public services. Local governments in almost every country are charged with having very weak administrative practices, and less local autonomy means less chance for local government financial mismanagement. 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.

8. The Case for Decentralization. There are also good arguments for a decentralized structure of local governance. One might counter the above justifications of centralization with the following: (a) cities would have the authority and responsibility to levy higher taxes and could thereby charge residents the full marginal cost of urbanization. A more efficient size distribution of cities could result; (b) bringing expenditure and tax level

determination closer to the people will generate improvements in local public services and will lead to greater satisfaction with government services on the part of local area residents. this is because local governments could adjust budgets in accordance with local preferences. A more efficient distribution of local public services could result; (c) stronger local governments will contribute to nation-building since people can identify more closely with local than central government; and (d) local governments might be able to get at parts of a growing taxable capacity in urban areas more easily than could the central government. An increased rate of national resource mobilization could occur.

9. The efficiency of fiscal decentralization is much stronger in the industrialized than in the developing countries. This is partly because voter preferences are not as readily translated into budget outcomes in low income countries. Adjustments in the allocation of local resources are often severely constrained by central government controls. These controls include approval of the budget, central appointment of local government officers, central government regulation of tax administration, mandates as to local government employee salary levels, and the general absence of a mechanism by which local voters may reveal their preferences for a larger or smaller sized government. In this setting--where the devolution of revenue authority and expenditure responsibility is not accompanied by reduced central government control over local fiscal decision making--there is less to be gained from tax/expenditure decentralization than would be the case in industrialized countries.

10. Revenue mobilization ultimately may make the case for fiscal decentralization. Along with urbanization and economic development, a taxable capacity and a willingness to purchase public services will develop. It will be very difficult for central governments to capture much of this fiscal surplus: central government income and consumption taxes do not 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.

11. Political Considerations. The political advocates of fiscal centralization are often less vocal but are possibly more persuasive. The political calculus of centralists counts decentralization as creating a natural power base for political rivals and as promoting factionalism. Officials also have political motives to limit further decentralization in that a stronger local government sector would drain away some of their budgetary control. As Bird has noted, though perhaps too strongly, "the main political objective in most countries--national unity--is centralizing in nature and that the theoretical merits of decentralization receive little weight in practice."3/

3/ Richard Bird; Intergovernmental Fiscal Relations in Developing Countries, World Bank Staff Paper No. 305, October 1983, p. 46.

Fiscal Decentralization: The International Practice

12. Pattern of Fiscal Decentralization. Fiscal decentralization has gone further in some countries than in others. The move toward decentralization will more likely come with the movement to a higher stage of economic development, which is usually associated with urbanization, an increased degree of local administrative capacity, improved implementation skills of local governments, and perhaps the desire to reduce regional disparities in the quality of public services. On average, subnational governments in more industrialized countries accounted for about one-third of all government expenditures, compared to half that percentage in the LDCs. This pattern did not change significantly during the 1960s and 1970s.

13. Research suggests there are three principal determinants of expenditure decentralization. Cross-section studies have shown that "stage of development," measured as per capita GNP or urbanization, is associated with a significantly greater expenditure share at the subnational government level. A second influence on fiscal decentralization is country size, i.e., the larger the country, the more the fiscal decentralization. The point is that fiscal management in very large countries becomes unwieldy and, cet. par., leads to a much stronger role for the subnational government sector.

14. Finally, there is the "crisis effect," i.e., a propensity to give less discretionary powers to local governments in countries where there is a continuing threat of social upheaval. Threat of war, political unrest and economic boom or bust can give rise to increased centralization. There are many country examples of this effect. In the aftermath of civil war, Zaire considered complete abolition of local government, and Bolivia and Honduras abolished their municipal councils in the late 1970s, as did Jamaica during the serious economic crisis of the early 1980s. "Revenue bonanzas" may also stimulate fiscal centralization. One example is the increasing size of the Nigerian public sector during the oil price increase. The revenues did not pass through to state governments whose share of total Federal revenues fell from 40% in 1970 to 15% by 1973.

15. Local Government Autonomy. Typically, the structure of government in LDCs makes provision for three different degrees of autonomy for its local governments. The smaller, more rural local governments are thought to have less means to plan and manage their fiscal affairs, and have the least fiscal autonomy. The rural local government system is often managed directly by the central government (e.g., Kenya) or through provincial governments (e.g., the Philippines). Municipalities, urban governments of larger size, are given more autonomy and a broader range of revenue-raising powers and fiscal discretion. These governments often have both municipal and provincial government status.

16. There is still a great deal of variation in the fiscal powers given to local government and in the methods by which the central government controls local taxing and spending programs. There are trade-offs to be made in choosing more or less autonomy for local governments and political considerations will weigh heavily in the choices eventually made. The answer, to the extent there is one, must be in an understanding of the reasons for the actual decentralization choices made by various countries.

17. (a) Federal Systems. Many countries have chosen a federal system to structure the relationship between central and subnational governments. India, Pakistan, Malaysia, Nigeria and Brazil are examples among the developing countries, and the United States, Canada and West Germany are examples from among the industrialized countries. This system, typically but not always, transfers controls over local finances from the central government to an intermediate level of government (e.g., State, Province, Department). Local governments in a traditional federal system are generally dependent upon the state (provincial) government for direct provision of some services, a pass-through of central grants, approval of borrowing plans, approval of tax rate increases, the assignment of expenditure responsibility and taxing power, and sometimes the appointment of chief government officers. Under this system, the central government has essentially passed the responsibility for regulating and controlling local government finance to the provincial government level. The degree of local government autonomy that results depends on how stringently provincial governments enforce these powers. There are strong arguments, for and against an intermediate level government with substantial budgetary responsibility and control. 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.

18. There are disadvantages to this approach. The federal structure creates an intermediate level of decision making that complicates the implementation of any national urban plan, i.e., it is necessary to rely on state governments to pass central funds through to targeted urban and rural governments. If state governments are relatively autonomous in their fiscal and economic planning, the resulting allocation may not match the central government's goals. A case is the 1960s and 1970s when the U.S. government watched states follow policies that accentuated fiscal disparities between lower income central city governments and higher income suburban governments.

19. To counter such disadvantages, some federal countries seem to have taken the position that the creation of a viable local government system--including an economic development role--requires a program of direct central-local relations. The resources passed directly through in this manner are at the expense of the intermediate or State level. Direct federal-local relations have become more important in recent years in Brazil and Mexico,4/ and in Nigeria the new constitution in 1979 recognized "...the existence of local governments as a distinct third level of government within the national federal governmental system."5/

4/ Diogo Lordello de Mello, "Local Administration and National Development Strategies: A Latin American Perspective," paper presented at the Latin American Studies Association and African Studies Association, Houston, Texas, November 2-7, 1977, pp. 28-37.

5/ Ladipo Adamolekun, Osa Osemwata, and Dele Olowu; "Report on the Performance of Local Governments in Bendel, Kwara, Lagos, Ogun, Ondo, and Oyo States: 1976-1980," Department of Public Administration, University of Ife, December 1980, p. 97.

20. (b) Central Regulation. More countries are organized as unitary than as federal systems. Under a unitary system, there is not a legal statement of the powers and responsibilities of subnational governments, and provincial government fiscal powers are given through direct central regulation. The important issue here is "fiscal autonomy," the control over sufficient resources to plan and manage the provision of local public services without continuous interference and control by higher level authorities. The degree of autonomy may be defined by: (a) whether there is latitude in revising tax rates and bases; (b) whether borrowing powers are circumscribed; (c) whether the local budget is subject to higher level approval and monitoring; and (d) whether the local officials are appointed by a higher level government.

21. Local government authority to adjust tax rates and to enact new taxes is limited in most countries, but is more limited in developing countries. In general, the national or state law prescribes the tax bases available (or unavailable) to local governments and sets maximum rates within which local governments must operate. These restrictions usually hold even for the largest cities. When the rate ceilings are binding, local governments have little revenue discretion and are dependent on the higher level government for approval of every revenue proposal. A similar arrangement holds for the adjusting of user charges for most major services, e.g., water rates, bus fares, rents. The issue then becomes whether or not the approving central or state government will permit the requested increases in rates and charges. Experience varies but some countries have consistently refused requests for local rate increases, e.g., cities in Bangladesh have been held at 1960 property tax rates despite repeated requests for increments. All countries are not subject to such stringent controls. Brazil and Venezuela are among the exceptions in that municipal laws are not subject to approval by higher level governments, though some tax changes do require approval by a central agency.

22. Most LDC central or state governments have approval powers over local government budgets. The extent to which this process reduces local fiscal autonomy depends on the tightness of the review process. The experience in this regard varies widely. Nairobi has faced a line-by-line review of budget expenditures by the Kenyan Ministry of Local Government, but the Ministry of the Interior in Indonesia generally accepts the proposal of the Jakarta metropolitan council. Local government budget autonomy may also be hampered by central government mandates. For example, nearly 50% of Philippine municipal government budgets are earmarked for specific purposes, hence the latitude to adjust the budget to respond to local demands is quite limited. Less permanent but unexpected central government mandates may also have dramatic and direct effects on the level of local government spending. A quite common form of mandate which local governments in LDCs face is a hiring freeze, a reaction by Central government to what it sees as irresponsible management.

23. The borrowing powers of local governments are quite limited in most LDCs. Though credit is made available to local 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. The issuance of debt is tightly controlled by central governments on grounds that total domestic credit expansion is an important stabilization issue and that

the allocation of scarce credit among regions and purposes must conform closely to the National Development Plan. Still, some local governments have been given more autonomy than others in the planning and issuance of debt. For example, the Calcutta Metropolitan Development Authority may borrow in the open market (from Banks and Provident Funds) subject to a limit tied to its tax revenues; the Nairobi City Council may also sell bonds in the market, but Ministry of Finance approval is required; and local governments in many countries are allowed to engage in short term borrowing from commercial banks.

24. Perhaps the most important issues of all in defining local autonomy have to do with the nature of selecting local officials. It may matter little that local governments have a broad range of fiscal powers if all local financing and governance decisions rest in the hands of centrally-appointed officials. Again, a broad range of practices is followed, even with respect to the largest cities. At one extreme are the very centralized systems such as in Seoul, Tunis and Bangkok, where the government head is an appointee of the nation's President. At the other extreme the local council and mayor are elected in Colombo, Sri Lanka, and in Brazilian cities. In between are many shades of centralization and decentralization.

25. In some countries, local government officials are part of the civil service. The chief administrative officer in India is a government appointee; in Mexico City, which has state and city status, he is a federal appointee. Chief officers may be seconded from the federal or state service in Nigeria, and the local assessor and treasurer are, in fact, central government employees in the Philippines. In many Latin American countries, the municipal chief executive also represents the central government in the municipality.

<u>What Revenue Powers for Local Governments?</u>

26. The above discussion suggests there is no hard and fast rule that argues for the "right" share of national revenues and expenditures for local governments. China is unlikely to find an international norm for guidance in deciding on which revenue sources should be allocated to Provincial and local governments. The proper mix of local government revenues depends in part on the expenditure responsibilities which are assigned to local governments.

27. An appropriate revenue mix may be chosen largely on efficiency grounds. 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. This is the case particularly for public utilities such as water supply, sewerage, power, and telephone, but also for public transit and housing. These services may involve externalities, but most of them are likely to be local in nature and can therefore appropriately be handled either by cross-subsidies among service users or by subsidies from other locally raised revenue sources.

28. 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 so that "the electorate is confronted with the true

opportunity cost involved."6/ For services for which substantial spillovers into neighboring jurisdictions occur, such as health and education, state or national intergovernmental transfers should contribute to their financing. Purely local financing would lead to underprovision of these services from a regional or national perspective.

29. Finally, borrowing is an appropriate source of financing capital outlays for those services which involve investment in long-lasting infrastructure, which is the case particularly for public utilities and road infrastructure.

30. The system in China does not even approximate these efficiency norms. Local taxes cover only a small share of the budget. Benefit charges account for a small fraction of the cost of providing services that might be priced, and there is no borrowing to finance long-lived assets. Most financing is from shared taxes, which is really a form of intergovernmental transfer since the local government has no say in rate or base determination. The only intergovernmental transfer targeted to a specific function, the urban maintenance and construction tax, is not focused on a public service characterized by substantial spillovers. A reasonable argument might be made that the Chinese system overcharges the general public vs specific beneficiaries, and current taxpayers vs future beneficiaries. Both biases should act to discourage efforts at increased resource mobilization by local governments.

31. Intergovernmental Transfers. One way to resolve the conflict between central and lower level governments over the division of taxing authority and expenditure responsibility is a system of central government transfers--shared taxes, various types of grants and even loans--to subnational governments. The compromise in the grants solution is that it permits central governments to retain the authority to levy taxes on the more productive bases but it guarantees state or local governments a flow of revenues. A grant system is a step toward fiscal decentralization in that it provides financing for local government services, but the degree to which it gives local governments more autonomy in their budget decisions depends on how the system is structured.

32. Even with the best of design, there will be advantages and disadvantages to any grant system. On the one hand, a formal program of intergovernmental transfers can broaden the resource base of local governments and provide for a growing source of revenue if grant distributions are tied to the growth in a more elastic central government tax base. A grant program has the added advantage of avoiding the high administrative costs usually associated with local government tax assessment and collection. On the other hand, grants can make local 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 local government operations, or to be innovative in service delivery methods. Conclusions about the advantages and disadvantages of any particular program of central grants-in-aid to local governments depends on whether a national or a local government point of view is taken: uncertainty about the regularity and adequacy of grant flows for one level of government may be the other level's budgetary flexibility.

6/ Richard Musgrave and Peggy Musgrave, Public Finance in Theory and Practice. McGraw-Hill, New York, 1984, pp. 64-65.

33. (a) Allocative Effects. A first criterion in evaluating the intergovernmental transfer system is whether it causes local governments to behave any differently than they would have in the absence of the grant. If local governments had raised all of their funds from own sources, would they have raised more? Is more being spent for capital purposes or for education because of the grant? Do intergovernmental transfers make local government officials less accountable for the efficiency with which they spend the funds than would be the case if all expenditures were financed from locally raised taxes?

34. (b) Accountability. The local government fiscal system can be structured to be an effective instrument for making local decisionmakers and managers accountable for their operations. This accountability, one hopes, can lead to a better managed and more efficient local government. Three routes have been taken to achieve this effect. The first is for local services to be financed by local taxes; hence the accountability is to the local population who pays the taxes.

35. A second approach is good local management by mandate of the central government. If the central government strictly regulates local operations, then the accountability of local officials is to the central government and not to the local population. This approach is often taken in setting standards such as for highway construction, teacher salaries, and user charges. However, central governments in many countries do not have the wherewithal to carefully monitor the activities of all local governments or perhaps the vision to write regulations to cover every set of local conditions.

36. The third approach is to finance the local service with a grant rather than a local tax, but to rely on provisions in the grant to induce an accountability on the part of local officials. The intuitive argument against grant financing is that local taxpayers do not see grants as "costing" them anything; hence they will not become agitated if the money is spent with less than maximum efficiency. Neither will there be accountability to the central government if the money is given with no strings attached. This suggests that a part of the responsibility for ensuring good local level management be shifted to the central government level. This can be done with appropriate grant design, the principle being that local government officials should see a reward or penalty associated with the efficiency of their operations. This can be done by mandates as to how the money may be spent and by requiring a match as a condition of receiving the grant.

37. Shared taxes on a derivation basis (such as are used in China) provide accountability to the local population if these are seen as local taxes and if local officials are locally elected. A general principle is the greater the percentage share of the tax returned to the local government and the more easily is the shared tax identified, the more the local population will identify with the tax. For example, the return of 100% of the property tax collected is more likely to be seen as a local tax than is the return of 10% of total central government internal revenue collections.

38. (c) Budget Distortions. A grant may cause a local community to change its budget priorities, e.g., to spend more on education than it would have in the absence of an education grant. Suppose the local community is thought to be spending too little on primary education to satisfy national goals. The result of a conditional education grant could be to stimulate spending on that function, thereby increasing national welfare, but at the cost of a higher tax rate or of reduced community spending for some noneducation purposes. The local community is clearly worse off--it has been deterred from reaching its preferred budget outcome. The nation, however, may be better off if the aided function (education, in this case) is characterized by significant external benefits.

39. Not all types of grants are equally effective in stimulating expenditures for a particular purpose. Partial cost reimbursement grants which lower the relative price of one government service versus all others offer the best possibility for such an effect and are often used to financially support services which the government wants to encourage. Such grants provide both a price effect (they lower the relative tax of each unit of the aided function) and an income effect (an increased flow of funds to the local government) to stimulate spending on the function. Teacher salary grants and public works grants are examples of such programs.

40. A second possibility is that central assistance may carry conditions or mandates. The most obvious case is conditional grants, i.e., grants that are earmarked to be spent for a particular service. Conditionality is an element of most grant programs, but its effectiveness depends on the income elasticity of demand for the aided function, whether the local government would have spent something for the aided function in any case, and whether local revenues are "fungible."

41. (d) Tax Effort Effects. It is the tax effort issue--the fear that grants may reduce rather than increase local government revenue mobilization --that has probably raised the most questions about the allocative aspects of grant design. Many central government policymakers would argue that grants to local governments should be stimulative rather than substitutive, i.e., a one dollar grant should have the net effect of increasing total local government expenditures by more than one dollar. This implies that to receive an additional one dollar in grants, the local government would have to provide a matching amount.

42. International experience suggests several approaches to stimulate local governments to find ways to increase tax effort: (a) include a tax effort term in the distribution formula; (b) distribute grants on a partial cost reimbursement basis, i.e., require a matching local share of costs; and (c) use general purpose, lumpsum grants and rely on a strong income elasticity of demand for public services to induce a stimulative effect.

43. The first possibility is to build tax effort directly into the allocation formula and thereby to reward governments that are willing to tax themselves more heavily. In this case, governments which exert a relatively greater tax effort would receive a larger grant. The logic here is that increased taxes would be rewarded by even greater increases in expenditure benefits and therefore citizens would be less resistant to the tax rate increases. The price of an increase in taxes, in effect, would fall.

44. Another possibility for inducing a stimulative effect on local taxes is a partial cost reimbursement grant. Because the government pays a share of the cost, aided local government goods become "cheaper" relative to all other goods and the local population will demand more of the now cheaper public goods. How much more they will demand again depends on the strength of the income and price elasticities of demand. However, partial cost reimbursement grants may not be stimulative of revenue effort. This is because administrative and legal constraints may simply make it impossible for the local government to mobilize additional resources, i.e., the incentive may exist and the population may be willing, but the administrative and legal capacity to increase taxes is not there. In this case, the grant is likely to be fully spent on the aided function, but no new taxes will be raised. The matching share for a public works grant may simply come from what would otherwise have been spent for primary education, or even from what the government would have spent on public works in the absence of the grant.

45. The most common form of grants are general purpose subsidies: they are not matching and do not contain a tax effort term in the allocation formula. These grants exert only an income effect and their stimulative impact on taxes depends on the strength of the income elasticity of demand for government goods. Economic theory and empirical studies in developed countries suggest that such grants are relatively ineffective for stimulating revenue effort. If a community receives an additional yuan in grant funds, at least some of it will probably show up as a lower rate of taxation (increased rate of spending on private goods) than otherwise would have existed.

46. (e) Equalizing Effects. An important feature of grants is the extent to which they equalize fiscal capacities and public service levels among local governments. With so much discussion focused on the need to achieve a more balanced population and income growth within LDCs, there is much concern about how central grant funds are distributed across regions and among eligible local government units. Moreover, the competition among states, regions and local areas makes the distribution of grant funds an explosive and potentially divisive political issue.

47. A first step in designing an equalizing grant system is defining "equalization." There are at least two views on exactly what a grant system is supposed to equalize. The first would hold that the intent is to equalize the capacity of local governments to finance a given level of services. The second is that expenditure "needs" should guide the distribution of grant monies.

48. The "capacity" approach would lead to the inclusion of per capita income in the revenue sharing formula. However, such a program would provide no incentive for the recipient government to increase its tax effort. To adjust for this we might define the fiscal capacity of a local government in terms of some "normative" tax effort. Of course, full capacity equalization is not realistic. Interjurisdictional disparities in fiscal capacity are simply too large to be fully offset. Moreover, accurate disaggregated personal income data are not available to measure financial capacity differences or to gauge equalization efforts. Perhaps this explains the virtual absence of this approach in the developing countries.

49. The second view of the equalization objective would focus on expenditure "needs" rather than fiscal capacity. That is, the grant formula needs to be structured so as to channel more funds to areas where needs are greatest. "Need," however, is a subjective concept, and most governments have simply chosen what seem to be sensible and objective proxy measures rather than developed more sophisticated needs indicators. The crude indicator of needs most often used is population, i.e., equal per capita allocations of central government assistance could be argued to deal with some variations in local government needs. There are, of course, substantial weaknesses with using population size as an allocator of central government grants. It leaves out considerations such as the concentration of poverty, economies and diseconomies of scale, and the possibility that the levels of income and population go hand in hand in many developing countries. If the most populous jurisdictions also tend to have the highest income, a straight per capita allocation will not be equalizing. An aid distribution which gives the larger cities more on a per capita basis probably tends to widen the disparity in financial capacity.

50. Ideally, formula equalization grants would include per capita personal income in the allocation. Estimates of local area personal income, however, are rarely available in LDCs (none that we know of). In practice, formula grants are most often distributed on a land area and per capita basis (Philippines, Tunisia, Colombia and Turkey) and hence are not likely to equalize fiscal capacity. Deficit grants may also be equalizing. If minimum approved expenditure levels and standard revenue yield are used in computing the deficit, communities with higher fiscal capacities will qualify for little if any of the grant. This turns out to be the case in the distribution of Korea's deficit grant. <u>Ad hoc</u> grant distributions are potentially equalizing because the grant funds can be arbitrarily directed toward those communities that are thought to have lowest incomes.

51. Shared taxes are much less likely to be equalizing. Shared taxes distributed on a basis of origin of collection are counterequalizing in returning a greater grant share to higher income communities. Cost reimbursement grant programs often have a similar effect in that they reward the highest spending communities by defraying a percentage of the cost incurred. Capital subsidies may be even more counterequalizing in awarding grants to those governments most able to design and implement capital projects.

52. (f) <u>Revenue Adequacy</u>. The most important purpose of the grant system is to provide an adequate source of revenue for local governments. "Adequacy" is difficult to define, but one might begin with two propositions: that grants should be large enough to redress the imbalance between the revenue bases and expenditure responsibility assigned to local governments, and that grant revenues should grow at least in proportion to the growth in local population and prices. The first of these goals might be satisfied by the central government allocating sufficient funds to the total grant program. What is "sufficient" depends almost exclusively on the priority which is assigned to improving the quality of public services assigned to the local governments.

53. The second proposition is more a matter of grant design. An adequate growth of grant revenues might be defined as one that would allow local governments a better opportunity to hold real per capita expenditures constant. Whether grants are population and inflation responsive, however, depends on three features of the grant system: (a) how the growth in the distributable grant pool is determined; (b) how the allocations among local governments are made; and (c) whether the central government actually makes the full monetary distributions called for by the grant system.

54. A shared tax system of determining the total grant pool, where the "referenced" tax is income elastic, is the best method of insuring revenue adequacy. The Philippine and Colombian systems are, in theory, based on income-elastic shared national revenue sources. If these shared taxes are distributed on a derivation basis, or even on a formula basis that is weighted heavily toward population, the goal of maintaining real per capita expenditures can likely be realized. If the distribution of the shared tax is by origin of collection, then the grant flow will be adequate only for those areas experiencing real income growth, usually the larger and higher income cities.

55. Grant distributions which are tied to ad hoc government decisions are the least likely to produce adequate revenue flows to local governments. The temptation to reduce the local government share to accommodate other national needs is just too great. There are many examples, but the experience in Jamaica, Korea, Kenya and Bangladesh as recited above are illustrative. In each case the move to an ad hoc determination of the size of the distributive pool foretold a slower rate of local revenue growth.

Fiscal Planning

56. The grant system should be structured so as to encourage efficient management and fiscal planning by local governments. Grant revenues should be a part of the local budgeting process, just as any other regular revenue source. Unfortunately, the budgeting for grant receipts is much less certain in most LDCs. In some cases this is due to the nature of the grant system itself. Grants determined on an ad hoc basis can hardly be predicted in amount, and forecasts of cost reimbursement grants depend on speculation about which costs will be eligible and which projects will be approved. At the other end of the spectrum, pure shared taxes and shared taxes with a formula distribution offer the best possibilities for designing a grant system which enhances local fiscal planning.

Local Autonomy and Decentralization

57. A final question is whether and by how much the grant system weakens local autonomy, i.e., the participation of the local population in the fiscal decision-making process. In raising a given amount of revenue, a locally raised tax would provide more autonomy than would a grant of equal yield. This is because the burden would be placed on the community to both set the tax rate and decide on the level and composition of expenditure. A grant, however, does not necessarily weaken local autonomy. It depends again on the structure of the grant system. At one extreme is the pure shared tax where the local government does not set the tax rate but receives a return on taxes

paid in the local area. In this case, there is not a complete separation of the pain of taxation and the benefits received from the expenditure of those tax monies. Depending on the conditions placed on the disposition of the grant funds, local autonomy may be weakened least with this kind of intergovernmental transfer.

58. Beyond this point, one might say only that general purpose grants provide more local discretion than do conditional grants (grants designated for a specific purpose, or requiring a matching contribution). Cost reimbursement grants are conditional, and would seem to limit local autonomy more than any other form. Where there is full cost reimbursement for a particular function, the local government may have little to say about the level or composition of services provided. For example, the central government is not likely to pay all teachers' salaries without playing the major role in determining the number of teachers and the salary schedules. Nor is it likely to fund capital projects without a say in project design. Partial cost reimbursement projects also impinge on local autonomy (compared to general purpose grants) because the required match (price effect) induces a distortion in the local government budget.

B. GOVERNMENTAL DECENTRALIZATION AND LOCAL FINANCE IN CHINA

59. Most think of China as having a highly centralized political, economic and administrative system. After all, there is a one-party political system and the economy is centrally planned. There would seem little room for a strong system of local self-governance. A moment of reflection might cause one to rethink this conclusion--China's vast land area and its large and heterogeneous population make governance from Beijing an unlikely prospect. Most other large countries with diverse populations (Brazil, Nigeria, India, United States, Canada) are organized as federalisms and are among the more decentralized countries in the world. China, it turns out, has steered a middle course. Taxing powers are a zealously guarded Central prerogative and there is a hierarchical process for approving just about any fiscal decision. Yet, by passing implementation responsibilities to Provincial and local governments, the system does give them considerable discretion in fiscal matters.

The Structure of Subnational Governments

60. The system of government in China is unitary, i.e., 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 fiscal system functions as under federalism. The discussion below describes the vertical and horizontal dimensions of government structure and draws on some experience in various provinces to suggest that it is not a nationally uniform system.

61. Vertical Relations. Usually one thinks of how to "place" local government in the national system in terms of the vertical system of relationships with the Central and Provincial levels of government. In the Chinese system, the central government has direct relations with Provincial governments (including three cities which have Province status: Shanghai, Beijing

and Tianjin). This system is roughly described in Figure A. All local governments in a Province report directly (or indirectly) to the Provincial government, and carry out their duties subject to Provincial regulations. There is no separate system of direct central-local relations.

62. There are separate "urban" and "rural" hierarchies of government within Provinces. On the urban side, municipal governments are the first level beneath the Province. The municipal area (other countries may refer to this as the metropolitan area) is divided into a "city proper" and a number of counties that are assigned to the municipality. These rural counties are further subdivided into towns. In some provinces the urban counties may be subordinate to the municipal administration while in other provinces they may report directly to the Province. In either case, the counties are further subdivided into towns.

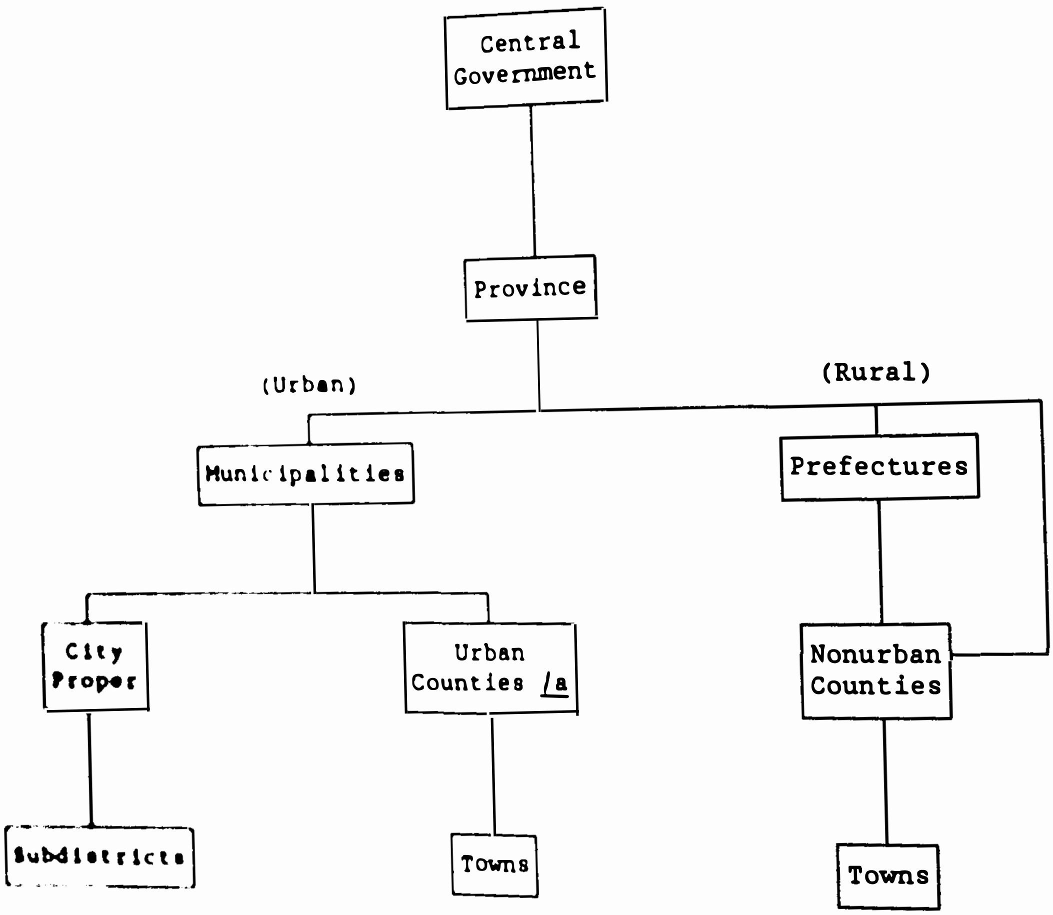
63. The city proper is divided into the "built-up area" for planning purposes and into districts for administrative purposes. There is a further level of vertical decentralization within the city proper. Municipalities may contain one or more subdistrict governments; subcity governments which have independent budgets, defined expenditure responsibility and specified revenue sources. While they do not carry out large capital construction projects, they do have a wide range of maintenance and general service activities, may own and operate enterprises and share in the taxes collected from these enterprises, and in some cities are given authority to collect all taxes from private businesses. The subdistricts are subordinate to the municipality and can have a noticeable fiscal importance.

64. The system of rural local government also is described in Figure A. Positioned between the county governments and the Provincial government is the Prefecture. These are groupings of counties and a form of administrative decentralization for the provincial governments. No counties, cities or towns are budgetarily subordinate to prefectures, but prefectures may have their own enterprises and share in taxes, planning, coordination and certain personnel decisions. Rural counties have no direct relationship with the municipalities. All counties are divided and subdivided into administrative districts, but also may contain towns which are central places of urban areas of 20,000 or more and which may have an independent budget. Most towns are financially subordinate to counties which are financially subordinate to the provincial government.

65. This system of vertical relationships creates a setting within the Province in which there could be a very great degree of fiscal decentralization to the local government level. For example, in Zhejiang at the end of 1985, there were 8 provincial cities (municipalities), 66 counties, 3 county-level cities, 3 prefectures and 508 towns.7/

7/ A more complete description of the structure of local government in Zhejiang may be found in Zhejiang: Challenges of Rapid Urbanization, World Bank Sector Report, 1987, Appendix B.

Figure A: GOVERNMENT STRUCTURE IN CHINA



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

66. Horizontal Relations. An equally important dimension of local government structure in China is the system of horizontal relations, i.e., the division of powers and responsibilities among local governments within an urban area. As noted above, urban governance consists of a core municipal government and a surrounding set of counties that--in some provinces--"belong"

to that municipality.8/ For example, in Jiangsu, urban counties are subordinate to the core municipality.

67. Within the city or municipal area, there is considerable decentralization in the responsibility for delivering government services. Municipalities, counties, public utilities and public service enterprises all have separate accounts and some measure of fiscal autonomy. One way to think about the division of responsibility and financing is to picture the municipal government as having three sectors. The first, the general municipal government services sector, includes the delivery and financing of goods and services that have general benefits and cannot be easily "priced." These more public goods--such as education, health, cultural activities and general administration--are more amenable to financing by taxation than by user charges or prices. These services and their financing are included in the general budget of the municipal government. The situation as regards delivery of these services is complicated because most municipalities have set up public service companies, often to provide construction services (e.g., construction, engineering services, the sale of building materials). These companies support the capital expenditure activities of the general municipal government, but they may also sell their services to other municipalities or counties on a contract basis. A substantial amount of their financing is through transfers from the general municipal budget. Other public companies provide more traditional public services, such as parks and gardens, and derive the great majority of their revenues from the general municipal budget.

68. The second sector is the public utility companies. These municipally owned enterprises produce services which can be priced, but which are public in that substantial external benefits are produced for the community at large. The most important of these are water supply, gas (LPG) and public transportation. Though municipally owned and regulated, and usually subsidized, utility companies have independent budgets and separate management. They are financed by a combination of user charges, transfers from the general municipal budget and implicit subsidies, and they pay taxes to the municipal government.

8/ Where counties are not directly subordinate to cities (e.g., Zhejiang Province), there is still a relationship in terms of regulatory and planning functions. The municipality sets the regional economic planning targets and allocates activity between the city and county. There are also some fiscal controls, e.g., urban county personnel appointments are approved by the city government. In some other cities in China, the city and county budgets are completely unified. In fact, the city of Hangzhou consolidated the urban county accounts and brought them under the city budget for two years in the early 1980s, but eventually returned to a separate budgetary system.

69. The third sector is municipally owned business enterprises.9/ These companies produce products that can be priced and sold to the public or to other business enterprises, and they can make a profit or incur a loss. They have independent budgets and management but are linked to the general municipal budget in two ways: (a) they pay taxes to the city; and (b) the city may transfer funds from its budget (in grant or loan form) to cover deficits or to stimulate technical improvements in the productive process of enterprises. The financial ties between enterprises and local governments have changed since 1983. Coincident with granting enterprises increased management autonomy, the central government mandated that subsidies would be provided to cover only planned losses, and that enterprises should finance their capital improvements from retained earnings and from borrowing rather than with subsidies.

70. The fiscal structure that is companion to this system of horizontal relations may be roughly summarized as follows: General municipal expenditures consist of expenditures for general municipal services 10/ and transfers to public utility companies and business enterprises. Total local government revenues consist of shares of the sales and profits taxes on all municipally owned enterprises, and on collectives and private businesses; the urban maintenance and construction tax whose base also includes provincial and central enterprises; a number of other taxes and fees of lesser revenue importance; some grants and loans; and user charges levied by the utilities. Some significant tax/expenditure activities within the urban area are outside the local government accounts. The Central and Provincial governments directly operate certain public service facilities within the urban area, including the electricity and telephone utilities, institutions of higher education, hospitals, the post office and airports. Some revenues are outside the local accounts. All customs duties and advance sales taxes on imports as well as all taxes on banks, railways, and aviation are assessed and collected by the Central Government. There are also "departmental" revenues and expenditures of the local governments, i.e., amounts that do not show up in the municipal or public utility budgets.

Subnational Autonomy

71. In some ways, the Chinese fiscal system is as decentralized as its governmental structure. Municipal and county governments directly assess and collect about two-thirds of all taxes. Expenditure responsibility is less decentralized in that provincial and local governments account, on average, for about 53% of total direct expenditures. Only a few countries in the world

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9/ We use the term "municipally owned" to refer to state enterprises that are controlled and regulated by the municipal government, and to draw a distinction with (a) those that are under the control of the central government, provincial government, subdistricts or counties; and (b) collectives and private businesses.

10/ Including some price subsidies and some expenditures made directly on behalf of the public utilities.

can claim as great a degree of expenditure or revenue decentralization and none can claim this degree of decentralization in tax administration.11/

72. On the other hand, revenue collection and expenditure disbursement are not the only dimensions of fiscal decentralization. In many areas fiscal decisions are subject to substantial central control and direction. By comparison with most countries in the world, local governments in China have little formal 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 at either the municipal or provincial level. Moreover, Beijing determines, for each Province, a share of taxes to be turned over to the center. In effect, local taxes in China are central government taxes whose revenues are allocated among provinces, municipalities and the central government.12/ It also should be noted that a number of other important fiscal measures and regulations are strictly prescribed in Beijing and are followed with little variation. These include the allocation of foreign exchange earnings between the general government and enterprise sectors, local enterprise borrowing and procedures to compensate for the purchase of agricultural land.

73. Revenue-Raising Discretion. Even with this degree of centralization in the rules for local governance, subnational governments can have an important impact on spending levels and on the amount of revenues raised in urban areas. Provincial governments design and implement the system of intergovernmental relations between province and local government. In particular, they determine the share of tax collections that will be retained by each local government, and they may impose certain special taxes or permit local governments to do so. The allocation of credit to local enterprises and the distribution of grants amongst local governments are also determined by the Provincial government. Provincial governments are responsible for approving the budgets and financial plans of municipal and county governments. This means that they can to a substantial degree control the spatial distribution of expenditures within the province. Moreover, because they can set the tax sharing rates for each municipal government, they may also effect the relative rate of tax collection by municipalities.

11/ The comparable ratios for the United States--which is a decentralized fiscal system by world standards--are 43% of taxes collected by state and local governments and 42% of expenditure 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.

12/ Technically, taxes are classified as "central," "local" or "shared," but in fact all rates and bases are centrally determined.

74. It would appear that there is great variation across Provinces in the system of Province-local relations, suggesting that Provincial governments do indeed have significant room to adjust fiscal decisions to local needs and preference.

75. Local governments can also have a substantial degree of effective autonomy to affect the level and composition of taxing, public service delivery and capital investment. Most important is that local governments control tax collection and assessment with what appears to be a minimum of direct central or provincial supervision. Responsibility for implementation of the tax system is a very powerful policy instrument in the hands of local government. There is some indication that they use it. Also on the revenue-raising side, local governments can give tax incentives, and can design and collect a set of extrabudgetary fees, charges and even minor taxes.

76. Local governments can have other important allocative effects. In theory, the municipal government Price Commission can make rate adjustments for the public utilities, without provincial or central approval. Municipal governments may control the tax shares of their subdistricts and in some Provinces have responsibility for approving the budgets of their counties. Despite these powers, it is important to remember that municipal governments have little autonomy on the revenue side when it comes to fixing tax rates or taxing new bases; nor can they borrow and there does not appear to be a formal provision for them to set up self-financing schemes. Even the existence of a municipal price commission in and of itself tells us little about local autonomy. In fact, user charges are rarely changed and there has been little adjustment in housing rents, bus fares, or water rates since the time of the revolution.

77. <u>Control Over the Enterprise Sector.</u> A very important dimension of local fiscal autonomy in China is that subnational governments can have a direct as well as an indirect impact on the growth of their taxable base. For example, the production quota of municipally owned enterprises can be increased, new state firms can be formed and collectives and private businesses can be encouraged. This dimension of local fiscal autonomy highlights a fundamental difference between the role of local governments in China and in market economies. In most western countries the local governments can have a substantial control over the level of the tax rate but virtually no control over the growth in the tax base. They can give tax abatements and can provide subsidies to attract industries but they cannot exert direct managerial control and do not in practice stimulate the local economy by starting new firms. Local governments in China can also give tax abatements but otherwise are in almost the reverse position. They have little say in nominal tax rate determination or legal tax base definition but can have a substantial direct effect on the determination of output and investment of local enterprises, and on the prices charged for local output.13/

13/ It is important to note that the economic system reform begins to break this linkage by granting management autonomy to the enterprise sector, eliminating profit remittances, and decontrolling prices.

78. Perhaps more important in the context of the present economic reforms is that subnational governments can take fiscal actions to improve the profitability of their SOEs and therefore can indirectly increase general government revenues. Certainly provincial and local governments can stimulate investment from retained earnings by reducing enterprise tax burdens. They may do this directly with tax rate relief measures or they can institute measures to increase the cost basis of an enterprise's income position, e.g., by allowing full deductibility of loan repayments, or counting all wage bonus and employee benefit expenditures as costs of doing business. The local government also may institute cost reduction measures, stimulate (subsidize) investment in capital improvements and subsidize input prices. These controls do give the local governments substantial discretion and may even increase the local tax base in the long run. In the short run, however, such measures almost certainly compromise the revenue position of local governments. A recent analysis of Changzhou City illustrates this by showing that the general municipal government share of total urban area income declined from 48% in 1980 to 32% in 1986.

79. Expenditure Autonomy. Autonomy on the expenditure side of the budget is in several respects limited. The level of spending in the province is constrained by the growth in revenues and by the centrally specified tax sharing ratio. Total local government revenues are determined by the level of output and profits of the enterprises, the local tax sharing ratio with the Province, and the amount that can be raised from local taxes and charges and from extrabudgetary sources. However, there is a further discretionary element to this expenditure determination. The local government budget is determined as part of a consolidated central, provincial and local budget and must satisfy the targets laid down by higher level governments. The process is as follows: First, each local government gives its estimates and proposals to the Provincial government which prepares a proposed budget for submission to the Center. The central government prepares a final budget, which is approved by the State Council, and each Province budget is determined as a part of this central budget. The Provincial government gives each municipal and county government a "target" level of revenues to be raised.

80. As the year goes on the progress of local governments in meeting these targets is monitored. For local governments that exceed the target revenue level--as is the case for most larger municipalities--the process ends and the actual level of spending is determined primarily by the sharing ratio and amount of revenue raised. If a municipal or county government cannot meet the revenue target, then either a provincial subsidy is provided or the local government is "ordered" to increase its revenue mobilization or reduce its expenditures. Apparently, increased revenue mobilization can be done in one of several ways, including (a) the efficiency of tax collections can be improved; (b) tax relief to enterprises can be curtailed; (c) new municipal enterprises can be formed; (d) the production efficiency of state-owned enterprises (SOEs) can be encouraged; and (e) production quotas can be increased.

81. Even if a municipal government satisfies the revenue target, its budgetary choices are still limited by expenditure rules, mandates and monitoring by higher level governments. Each local government department has a "vertical" responsibility, i.e., it must account to its provincial level

bureaus. Moreover, there is a general accountability to the provincial government. In this process of vertical accountability, some combination of negotiation and the following principles and restraints limit or guide the budgetary choices of local 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 schools, scientific research institutes and hospitals take a high priority; (d) expenditures on culture and education are mandated to increase by at least the same rate as total expenditures; (e) employment levels and compensation rates are fixed by the Central and Provincial governments; and (f) all revenues from the urban maintenance and construction tax must be spent for urban maintenance and construction, i.e., for public facilities.

82. A final step in the local budget preparation process is required approved by the People's Congress. The municipal government makes a presentation to the budget committee of the Congress, which then studies the pattern of the budget (in general terms as opposed to a line-by-line analysis). This study focuses on the expenditure side of the budget. There usually is "no problem with approval," though the Finance Director for Hangzhou reported that in one recent year the Congress rejected the proposed level of capital expenditure as being too high. The deliberations by the Congress also guide municipal officials in working out the detail of the budgets, e.g., which roads to repair. At the end of the year, the municipality must give an accounting of its budgetary performance to this same committee.

Budgeting and Financial Planning

83. In theory, China has a system of budgeting in which the financial plan and accounts of the central and all subnational governments are consolidated. The provincial government also has a consolidated budget which includes the budgets of all local governments. In fact, the Provincial government does have a consolidated budget but, at least in the provinces visited for this work, it is neither detailed nor complete. Because local government budgets do not include all revenues and expenditures, it is difficult to construct an estimate of the total amount of revenues raised or expenditures made by all local governments in the urban area. The omissions and budget consolidation problems are discussed below.

84. Budget Cycle. Every local government must have a budget, with approval by the provincial government required. The consolidated Provincial budget, in turn, must be approved at the Center. Budget estimates are presented by the third quarter of the preceding year but the budget is usually not finally approved until March (or later) of the budget year. In the interim, the budget is managed according to the draft budget or according to the previous year's budget with some allowable rate of increase.

85. Budget Structure. There is not a separate capital budget. Each urban local 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 finances. Extrabudgetary revenues

and expenditures (non-plan) are reported in the budget, along with budgetary receipts and outlays. Departmental revenues, and grants received by local governments, are generally not reported in the accounts.

86. Local governments' annual budgets and year-end financial statements apparently are designed less for fiscal planning purposes than to provide an accounting of revenues and expenditures. If it were to be a useful planning document, the budget would be presented so as to permit analysis of the full range of local government fiscal activity within the urban area. This would require consolidation of the general municipal budget, the public utility budgets, and the extrabudgetary accounts. However, no municipality visited for this study had constructed such a consolidated budget.

87. The transfers between and overlaps among the budgets of the municipal government, the SOEs and public utilities are not easily followed, and budgets are not complete. Transfers to the SOEs are shown under the head "technical reform" in the municipal budget. Often, however, this amount is paid to a fund in the Construction Bank and then loaned to the enterprises (SOEs and collectives). It is not possible (from an examination of the accounts) to separate the loan and grant amounts. Another form of transfer has the purpose of covering an SOE deficit. If an SOE plans for a deficit,14/ then the subsidy is shown as an expenditure in the general municipal budget and not as a transfer. If the deficit is not planned, profits tax revenues in the budget are recorded as lower than collections by the amount of the transfer.15/

88. A related problem is with the public utilities. There do not appear to be formal transfers from the general municipal account to the public utility accounts. However, some expenditures made on behalf of the public utilities--particularly equipment and construction expenditures--are shown as direct expenditure items in the urban maintenance and construction account of the general municipal budget.16/ There are also some implicit transfers, e.g., subsidized gas prices for buses. As a result of this practice, the expenditures of the public utilities are understated, and the true total outlays are unknown.

89. The extrabudgetary account requires some further explanation, because of its potentially important role in the financing of urban construction. Extrabudgetary funds may be raised either by local governments (in the form of special earmarked charges or surcharges), by public institutions (in the form of charges for services), or by enterprises (in the form of retained earnings). The funds are spent according to State financial regulations but they are not in the State general budget, hence these funds provide some fiscal discretion for local governments. These amounts are reported in the local government accounts.

14/ That is, if the deficit is approved as a part of the budget.

15/ Or in some municipalities, the transfer is shown separately as a negative revenue.

16/ For example, the World Bank estimates that the general municipal budget in Hangzhou in 1986 includes Y 1.5 million in expenditures for new buses.

90. A further, necessary level of disaggregation of a local government budget is to separate the amount spent for current consumption from that spent for capital. In fact, capital expenditures are defined in the Chinese system, but are not easily separated out in the local government financial accounts.17/

91. There are four capital items in the general budgetary expenditures of the municipality: "capital construction," "technical transformation and modernization," "investments in SOEs," and "urban maintenance and construction." Most of the latter are maintenance expenditures. In addition, there are some capital expenditures made from the extrabudgetary revenues, i.e., revenues raised outside the municipal budget or profits retained by the public utility enterprises, and from grants. No municipality we met with had constructed a consolidated statement of total capital expenditures.18/

92. The revenue accounts likewise are not easily manipulated for analytic purposes. In particular, the provincial governments in Anhui and Jiangsu could not estimate the amount of grants to local governments, nor could they estimate the amount of grant and subsidy received from the central government.

Tax Administration

93. Local governments cannot vary the nominal rates of tax, nor may they redefine the legal bases. However, they have almost complete autonomy in the assessment and collection of taxes, and along with the provincial government can 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.

94. Organization. The organization of tax administration in China centers around the activities of two organizations: the tax bureau and the finance department. In theory, both bureaus are at the same time organs of the central and local governments, and there are separate tax bureaus and finance departments at the city, county and province levels. The municipal tax bureau director must report directly to the city administration and to the provincial tax bureau director. Similarly, the province tax bureau director must supervise the activities of the local bureaus in line with the wishes of both the provincial and the central government. County tax bureaus may report to the city to which they "belong" or directly to the province.

17/ Capital expenditures in the Chinese governmental accounting system include four components: project expenditures for construction or substantial expansion/upgrading of buildings, e.g., schools, factories, residential housing, shops, etc.; installation of new equipment (fixed assets) such as power generators; expenditures for other equipment, such as mechanical tools and vehicles; and surveys of land to expand productive capacity. There are alternative definitions of capital vs. consumption expenditures in cases where the proper classification is not clear cut, e.g., a life of greater than two years, an expenditure in excess of Y 50,000 for a new asset, and an expenditure above a certain amount to upgrade a fixed asset.

18/ However, each year the municipality must report its total capital expenditures to the Province who in turn reports the Province-wide amounts to MURCEP. It is not clear how this is done.

95. The functions of the tax bureau and the finance department seem clearly distinguishable, at least in theory. The finance department makes whatever tax policy the law allows at the local and provincial levels, and manages the expenditure side of the budget. The tax bureau is responsible for implementing the law. In practice, the division of responsibility is not so clear, and the directives given to the tax bureau by the central and subnational governments are not always consistent. Many of the actions of the tax bureau in the provinces visited for this work suggest that it is more likely to act as an agent of the local or provincial governments than of the central government (Annex 3).

96. The tax bureau and the finance department are described as "parallel" in the hierarchy at the provincial government level. At the local government level, however, the tax bureau was described as "half a step lower." And though the tax bureau has responsibility for collecting all taxes, there is a definite feeling that some taxes are under the jurisdiction of the finance department. For example, all sales taxes and the income tax on collective enterprises are viewed as "belonging to the tax bureau," but the income tax on SOEs is seen as a finance department source of revenues.19/ In fact, the "finance department revenues" are paid into a separate account.

97. Tax Expenditures. Provincial and local governments have a surprising amount of discretion in the granting of tax relief. 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.

98. Three methods of granting tax expenditures may be used. First, if the provincial government wants to promote a new product or a pioneer industry, it may authorize a reduced tax rate or even a tax holiday for a number of years. Second, the finance department may enter into a contract arrangement with an enterprise for payment of a given amount of taxes. The enterprise may be asked to pay a contracted amount of tax and no more, or if taxable profits exceed the contract amount, the additional amount of tax theoretically due could be shared between the government and the enterprise. Another alternative could be incremental sharing where the enterprise retention rate on additional profits would fall as output increased. Third, the tax bureau may grant relief to enterprises on a case-by-case basis depending on the needs of the enterprise. These needs are initially assessed and evaluated by a tax bureau officer responsible for the enterprise--in the case of larger enterprises, the official may even be resident at the site.

99. There are no reliable statistics on the revenue costs of tax incentives, but some data from Jiangsu give an idea of the magnitude of the loss. Officials report that over 90% of the registered enterprises actually make some form of tax payment. This result suggests that to the extent tax expenditures impose a revenue cost, it is due to preferential tax reductions rather than to outright exemption.

19/ In interviews with tax bureau officials in both Jiangsu and Anhui, revenues were reported net of the "finance bureau sources." We were referred to the finance bureau for an accounting of these revenues.

C. TAXATION AND REVENUE SHARING

100. 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 subnational governments, in China they are collected by the local governments and "shared-up" to the higher levels. The amount of shared tax revenue that finally comes to the local government budget depends on the tax base and the tax rate, the tax administration, and the sharing formulae. The sharing formulae, in turn, has two elements: the proportion of revenues from any given tax that is to be shared with the province, and the method by which this amount will be distributed amongst local governments within the province. To understand the revenue-sharing system in China, one must understand all of these dimensions.

Revenue Performance

101. Local and Provincial governments in China derive their revenues from a combination of designated local revenues, shared taxes and extrabudgetary revenues. The revenue growth for all Provincial and Local governments, described in Table 1, shows substantial real growth in the revenues collected by and allocated to Provincial and local governments in the 1980s. However, these data show that the allocations have not been growing as fast as total output, or as fast as provincial and local budgetary expenditures. Moreover, there is a wide variation among provinces in this performance, as described in Table 2.

Table 1: BUDGETARY COLLECTIONS BY PROVINCIAL AND LOCAL GOVERNMENTS

Year	Total (in 100 million yuan)	Average annual percent increase		Percent of gross output value	Expenditure as a percent of collections
		Nominal	Real /a		
1981	853.86			11.3	60
1982	863.54	1.13	1.63	10.4	67
1983	876.95	3.74	4.15	9.7	73
1984	973.91	8.71	7.34	9.0	84
1985	1,177.00	20.90	14.19	8.8	89
1986	1,325.49	12.60	7.50	8.7	104

/a Deflated by the general index of retail prices, 1956 = 100.

Source: Computed from data provided by Ministry of Finance.

Revenue Assignment

102. By law, there are three categories of revenues--fixed central government revenues, fixed local government revenues and shared revenues. The intent in the past was to make use of these three categories and to finally apply the sharing ratio to the shared tax category. In practice, however, this has not been done in that no distinction was drawn between local fixed and shared taxes. The government's intention is to change this with the new 1988 formula. The discussion immediately below relates to the definition of the three categories prior to the proposed 1988 changes.

Table 2: BUDGETARY EXPENDITURE BY PROVINCE
(in 100 million yuan)

	1983	1986	Percent increase
Beijing	19.61	44.27	125
Tianjin	20.49	34.85	70
Hebei	28.27	53.82	90
Shanxi	24.01	41.17	71
Inner Mongolia	22.83	43.89	92
Liaoning	34.17	75.51	120
Heilongjiang	30.71	61.47	100
Jiangsu	32.29	66.16	104
Shanghai	19.03	56.95	199
Zhejiang	21.94	50.95	132
Anhui	20.38	46.18	126
Shandong	32.41	67.94	109
Henan	30.06	69.20	130
Hubei	28.32	58.02	104
Hunan	25.31	54.29	114
Sichuan	36.64	87.74	139
Jilin	19.41	50.12	158
Jiangxi	17.27	36.63	112
Shaanxi	18.81	35.59	89
Gansu	15.53	30.01	93
Fujian	17.55	37.62	114
Guangxi	18.84	42.22	124
Yunnan	24.03	47.31	97
Tibet	5.88	8.97	61
Qinghai	7.39	12.22	65
Ningxia	6.95	12.02	73
Xinjiang	18.61	35.12	89
Guangdong	37.65	89.55	138
Guizhou	15.55	30.39	95
Total	649.94	1,380.18	112

Source: Computed from data provided by Ministry of Finance.

103. Fixed Central Revenues. The following are revenues that "belong" to the central government and are either collected directly by the Center or are collected at the local level and turned over to the central government.

1. Income and adjustment tax of all central government enterprises.

2. Business tax from railroads, bank headquarters and insurance company headquarters.

3. Profit remittances by all enterprises owned by the military.

4. Price subsidies paid to producers of grain, cotton and oil are treated as a negative revenue of the central government.

5. Fuel oil special tax. To conserve oil for export and for foreign exchange reasons and to encourage the conversion to coal, there is a special tax on oil use. The proceeds are earmarked for coal conversion projects.

6. Income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures.

7. Treasury bond income.

8. Energy and transportation fund contribution. This is really a tax of 15% on enterprise profits net of profit and adjustment tax but inclusive of the depreciation fund. It is earmarked for central government energy and transportation projects. The sharing arrangement has changed over the years, but it is not really a fixed central government revenue source. In 1984 the central government set a target for collections in each province. The target amount was turned over to the central government and any surplus was kept by the local government. In 1985 and 1986, the central government again claimed the target amount but any surplus was shared 30% to the central government and 70% to the local government. In 1987 and 1988, if a local government reached its target, the revenues were shared 70% to the central government and 30% to the local government; if the target was exceeded sharing was 50-50 on the excess.

9. Seventy percent of the three sales taxes collected from enterprises owned by the Ministry of Industry, the Ministry of Power, SINOPEC (petrochemicals), and the China non-ferrous metals company.

10. All customs duty and all sales taxes collected at customs.

104. Local Fixed Revenues. Revenues collected from a few taxes are assigned fully to the local government doing the collecting. Rates and base definition, however, are not under local control. The local taxes account for a minor share of total local revenues. The following revenues were classified as fixed revenues of local governments in 1985-87. The original intention of the classification was that these would be retained fully by the local governments, but this never materialized. The problem was almost certainly too much revenue loss to the central government. Note below that this classification was amended by dropping the first two categories in 1988.

1. Income tax and adjustment tax of locally-owned enterprises.

2. Income tax from collectively owned enterprises.

3. Agriculture tax.

4. Rural market trading tax. This is a stall rental charge, based on notional assessment, levied mostly on private sector traders.

5. Local grain trading loss. The local government's losses from selling grain at a subsidized price and from storage cost is treated as a negative tax.

6. Fines for delinquent taxes.

7. The Urban Maintenance and Construction Tax (UMCT). The UMCT is set at 7% of total sales tax liability for municipalities (5% for towns and 1% everywhere else). The tax accrues entirely to the collecting

local government, is earmarked for urban maintenance and construction, and is collected from all enterprises (including provincial and central SOEs).

8. Housing tax. 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 building.

9. Vehicle utilization tax.

10. Thirty percent of the sales tax revenues collected from enterprises owned by the Ministry of Power, SINOPEC, and the China non-ferrous metals company.

105. Shared Revenues. The following are the taxes (revenues) that are designated for sharing between the central and local governments. This list is for 1985-87.

1. All sales tax (value-added, business, and product) revenues from all enterprises, except those expressly excluded as described above.

2. Natural resource taxes. This includes taxes on coal, gas, oil, and other minerals if the enterprises are fully Chinese-owned. This can be an important revenue source, e.g., in Heilongjiang province it has recently yielded about 1.2 billion yuan per year, and in Shanxi the tax on coal mining activities is important.

3. Construction Tax. This is a tax on the cost of construction of buildings which are outside the plan and are financed from retained earnings. The tax rate is 10% of the amount spent. However, there appears to be substantial negotiation in determining liability for this tax. (It was reported that buildings with construction costs less than 500,000 yuan were exempt.)

4. Salt tax.

5. Individual income tax.

6. Wage bonus tax. Certain bonuses e.g., for innovation, are legitimately deductible from profits tax liability. Most bonuses are not deductible.

7. Industrial and commercial tax, and income tax, levied on foreign and joint venture enterprises. The sales tax on joint ventures and foreign firms is still referred to as the "industrial and commercial tax."

The detail on the proportion of each tax that is shared, central, or local is provided for 1987 and 1988 in Tables 3 and 4.

Table 3: SHARING ARRANGEMENTS IN 1987 BY TYPE OF TAX
(in %)

Tax category	"Shared"	"Fixed Central"	"Fixed Local"
Industrial-Commercial Taxes			
1. Product and VAT:			
a. Enterprises owned by four Ministries	30	70	0
b. Tobacco products produced by centrally owned enterprises	0	100	0
c. Other general taxes	100	0	0
d. Product tax and VAT on imported goods	0	100	0
e. Refund of product tax and VAT to central government foreign trade company	0	100	0
f. Refund of product tax and VAT on export goods, to industrial enterprises and local foreign trade enterprises	100	0	0
2. Business Tax			
a. Enterprises owned by four Ministries	30	70	0
b. Railway, central tobacco enterprises, bank headquarters	0	100	0
c. General business tax	100	0	0
d. Self-employed urban and rural households in industry and commerce	100	0	0
3. Consolidated Industry and Commerce Tax			
a. Offshore oil enterprises	0	100	0
b. Other enterprises	100	0	0
c. Imported products	0	100	0
Other Taxes			
4. Special Adjustment Tax	0	100	0
5. Collective Enterprises Income Tax	100	0	0
6. Self-Employed Households in Industry and Commerce	100	0	0
7. Individual Income Tax	100	0	0
8. Individual Income Adjusted Tax	100	0	0
9. Joint Venture Income Tax			
a. Offshore oil	0	100	0
b. All other	100	0	0
10. Foreign Enterprise Income Tax			
a. Offshore oil	0	100	0
b. All other	100	0	0
11. Urban Construction and Maintenance Tax	0	0	100
12. Vehicle Utilization Tax	100	0	0
13. Local Vehicle Utilization Tax	0	0	100
14. House Tax	100	0	0
15. Slaughter Tax	100	0	0
16. Animal Trading Tax (livestock transactions)	100	0	0
17. Free Market Transaction Tax	100	0	0
18. Natural Resource Tax	100	0	0
19. Central Resource Tax	0	100	0
20. SOE Bonus Tax	100	0	0
21. SOE Wage Adjustment Tax	100	0	0
22. Institutions Bonus Tax	100	0	0
23. Collectives Bonus Tax	0	0	100
24. Construction Tax	100	0	0
25. Special Fuel Using Tax (crude oil burning tax)	0	100	0
26. Deduction and Refund of Fuel Tax	100	0	0
27. Salt Tax	100	0	0
28. Revenue from Penalties and Fines			
a. Customs duty categories	0	100	0
29. Agriculture Taxes			
a. Animal husbandry	100	0	0
b. Forestry and special products	100	0	0
c. Central land occupation tax	0	100	0
d. Local land occupation tax	0	0	100
30. Income Tax			
a. SOEs income tax	100	0	0
b. SOEs adjustment tax	100	0	0
c. SOEs profit remittance	100	0	0
d. Subsidies for planned losses	100	0	0
31. Contribution for Energy Transportation Projects			
a. Paid by central SOEs	0	100	0
b. Paid by local SOEs	0	100	0
32. Interest Income	n.a.	n.a.	n.a.
33. Earmarked Revenue	n.a.	n.a.	n.a.
34. Revenue from Loan Repayment for Capital Construction	n.a.	n.a.	n.a.
35. Revenue from Other Sources			
a. Other revenue from joint ventures	100	0	0

Table 4: SHARING ARRANGEMENTS IN 1988 BY TYPE OF TAX
(in %)

Tax category	"Shared"	"Fixed Central"	"Fixed Local"
Industrial-Commercial Taxes			
1. Product and VAT:			
a. Enterprises owned by four Ministries	30	70	0
b. Tobacco products produced by centrally owned enterprises	0	100	0
c. Other general taxes	100	0	0
d. Product tax and VAT on imported goods	0	100	0
e. Refund of product tax and VAT to central government foreign trade company	0	100	0
f. Refund of product tax and VAT on export goods, to industrial enterprises and local foreign trade enterprises	100	0	0
2. Business Tax			
a. Enterprises owned by four Ministries	30	70	0
b. Railway, central tobacco enterprises, bank headquarters	0	100	0
c. General business tax	100	0	0
d. Self-employed urban and rural households in industry and commerce	100	0	0
3. Consolidated Industry and Commerce Tax			
a. Offshore oil enterprises	0	100	0
b. Other enterprises	100	0	0
c. Imported products	0	100	0
Other Taxes			
4. Special Adjustment Tax	0	100	0
5. Collective Enterprises Income Tax	100	0	0
6. Self-Employed Households in Industry and Commerce	100	0	0
7. Individual Income Tax	100	0	0
8. Individual Income Adjusted Tax	100	0	0
9. Joint Venture Income Tax			
a. Offshore oil	0	100	0
b. All other	100	0	0
10. Foreign Enterprise Income Tax			
a. Offshore oil	0	100	0
b. All other	100	0	0
11. Urban Construction and Maintenance Tax	0	0	100
12. Vehicle Utilization Tax	100	0	0
13. Local Vehicle Utilization Tax	0	0	100
14. House Tax	100	0	0
15. Slaughter Tax	100	0	0
16. Animal Trading Tax (livestock transactions)	100	0	0
17. Free Market Transaction Tax	100	0	0
18. Natural Resource Tax	100	0	0
19. Central Resource Tax	0	100	0
20. SOE Bonus Tax	100	0	0
21. SOE Wage Adjustment Tax	100	0	0
22. Institutions Bonus Tax	100	0	0
23. Collectives Bonus Tax	0	0	100
24. Construction Tax	100	0	0
25. Special Fuel Using Tax (crude oil burning tax)	0	100	0
26. Deduction and Refund of Fuel Tax	100	0	0
27. Salt Tax	100	0	0
28. Revenue from Penalties and Fines			
a. Customs duty categories	0	100	0
29. Agriculture Taxes			
a. Animal husbandry	100	0	0
b. Forestry and special products	100	0	0
c. Central land occupation tax	0	100	0
d. Local land occupation tax	0	0	100
30. Income Tax			
a. SOEs income tax	100	0	0
b. SOEs adjustment tax	100	0	0
c. SOEs profit remittance	100	0	0
d. Subsidies for planned losses	100	0	0
31. Contribution for Energy Transportation Projects			
a. Paid by central SOEs	0	100	0
b. Paid by local SOEs	0	100	0
32. Interest Income	n.a.	n.a.	n.a.
33. Earmarked Revenue	n.a.	n.a.	n.a.
34. Revenue from Loan Repayment for Capital Construction	n.a.	n.a.	n.a.
35. Revenue from Other Sources			
a. Other revenue from joint ventures	100	0	0

Tax Structure

106. Most taxes are shared among the local, provincial and central governments. The most important of these are sales taxes and taxes on profits. The other locally collected and shared taxes include the construction tax, the wage bonus tax, and the energy and transportation fund contribution. Each of these is discussed below in terms of the structure of the tax and the sharing arrangement which determined the amounts of revenue that will become available to the municipality.

107. Taxes on Profits and Retained Earnings. The profits tax is levied on the gross profits of SOEs, collectives, and private businesses according to three different rate schedules. A flat rate of 55% is applied to large and medium sized SOEs. Smaller firms are subject to a graduated rate schedule which rises from 7% for firms with profits less than Y 300 to 55% for firms whose profit is greater than Y 80,000. Private businesses are also taxed according to a graduated rate schedule.

108. In addition to the general profits tax, there is an excess profits tax, known as the "adjustment tax." At the first stage of the switch from a remittance to a tax system in 1984, the adoption of a 55% rate would have created some inequities. Enterprises selling products with relatively high fixed prices and those which have benefited heavily from past government investment (e.g., those with well developed and modern plant and facilities) could be argued to earn "excess" profits. The government attempts to tax most of these excess profits away, according to a complicated (and often negotiated) rate determination which must be carried out for every liable enterprise.

109. Two other features of the adjustment tax are notable. One is that property tax payments by enterprises may be credited against adjustment tax liability. The other is that the government is in the process of phasing out the adjustment tax. There is, however, no set formula for phasing out this tax. Though the reduction in adjustment tax is negotiated on a case-by-case basis, it was noted that enterprises undertaking technical reform could be more successful in obtaining reductions. A third reduction in gross profits is an earmarked contribution for the central government energy and transportation fund.

110. Wage Bonus Tax and Construction Tax. These are two separate taxes on specified uses of retained earnings by enterprises. Neither are particularly strong revenue producers, and both seem designed to achieve allocative goals. The wage bonus tax is meant to discourage the use of after-tax profits to pay excessive wage bonuses and the construction tax to penalize certain types of (extrabudgetary) construction investment by enterprises.

111. The potential bases against which these taxes might be levied are defined by central government regulations as to the disposition of after-tax profits. The State suggests that these retained earnings be allocated as follows: at least 60% for capital investment purposes and no more than 20% to

either of improved employee welfare or wage bonuses.20/ Most enterprises follow these guidelines.

112. Wage bonuses are not taxed unless the bonus exceeds four months pay.21/ The tax rate is 20% of the bonus for a bonus equivalent to 4 to 5 months pay, 50% for 5 to 6 months equivalent, 100% for 6 to 7 months and 200% for more than 7 months equivalent.22/ There are, however, many exemptions and a special set of rules applied to nonproductive enterprises.23/ The wage bonus tax is assessed and collected by the municipality. The subdistrict makes collections from its enterprises but passes the full amount on to the municipality.24/

113. The construction tax is part of the Central Government's program to control the use of retained earnings for capital construction expenditures. On the surface, the purpose of this tax seems unclear. Enterprises are already under "suggestion" to spend at least 60% of retained earnings for capital purposes. Planned construction financed by grants, or "nonproductive" capital construction are exempt from tax as are expenditures for technical upgrading or for the purchase of machinery and equipment. Otherwise, a tax rate of 10% is applied to all capital construction expenditures made from retained earnings--including expenditures made for housing construction. The tax applies equally to SOEs, collectives and private firms.

114. Sales Tax. China has a uniform national sales tax, administered by municipal and county governments. This is the most productive tax in the system and its revenues are shared in varying ways among the local, provincial and Central Governments. The sales tax is primarily assessed and collected by the municipal government. Legally, the tax is applied in the *ad valorem* form, but for small businesses with inadequate books of account, flat charges are used.

115. Property Tax. Since October 1, 1986, local governments in China have been empowered to assess and collect a property (housing) tax at a rate of 18% of rental value. Proceeds from this tax are shared as follows: 25% retained

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20/ Actually, these proportions are "suggested" and apply only to retained earnings up to an amount equivalent to the 1983 level. Above the amount, the "suggested" proportions are 50%, 30% and 20%, respectively.

21/ There are designated industries that are not required to pay the wage bonus tax, e.g., those who employ heavy labor such as dock workers.

22/ This formula was effective nationwide, beginning in 1976.

23/ The national accounts defines "productive" activities in terms of activities in agriculture, commerce, transportation, construction and industry. All other activities--e.g., education, health, etc.--are classified as "nonproductive."

24/ In Hangzhou, subdistrict governments now share in the proceeds of wage bonus taxes collected from subdistrict enterprises.

by the local government, 30% to the province and 45% to the Central Government. There is not yet enough collection experience to comment on revenue yield, except to note that this tax has not produced significant revenue to date.

Extrabudgetary Revenues

116. Another source of revenue for local governments, earmarked for capital purposes, are extrabudgetary funds.25/ These include a set of taxes and charges that are controlled by the local government finance department, the most important of which is the public utility surcharge--a 10% tax on the utility bills of consumers. Until 1985, the other important source of extrabudgetary funds had been the industrial and commercial tax, a 5% surcharge on industrial and commercial profits, that was replaced by the UMCT. 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. The latter include such items as fees and charges from hospitals, road maintenance charges, advertisement fees, etc.

117. Extrabudgetary revenues are relatively small compared to other revenue sources. These extra budgetary revenues of local governments account for less than 3% of state budgetary revenue, although they can make a significant financing contribution in some cases, e.g., 7.2% of total municipal (budgetary plus extrabudgetary) expenditures in Hangzhou in 1985.

User Charges

118. Though the public utility enterprises do attempt to recoup a portion of costs through user charges, there has been no strong sentiment to raise rates to efficient levels. The issue is that 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 rents are all linked inextricably to wage 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 that increases wages will lower profits tax liability and hence the shared central, provincial and local tax. The result will be a shift in revenue power from the central to the local level since the whole of the user charge "stays at home," and from the general government to the public utility enterprises.

Borrowing, Capital, Grants, and Self-Financing

119. Capital projects in urban areas around the world are commonly financed with some combination of capital grants, loans and beneficiary charges (self-financing). Many types of current expenditures, especially those with substantial external benefits are also commonly supported with grant financing from the central or provincial government. China is quite

25/ This discussion excludes the extrabudgetary funds of the SOEs.

different in that it has no regular grant program to support capital projects or current expenditures (all grants are on an ad hoc basis);26/ 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.

120. The absence of central or provincial government direction in this area, however, does not mean that variants of these financing methods are never used. In fact, there are grant programs at the central and provincial government levels but they have not been formalized, i.e., they are related to particular projects or objectives and cannot be counted on as a regular flow by the local governments. The central government gives three types of grants to provincial governments. The first is earmarked grants for a variety of purposes, including capital construction projects, natural disasters, and for underdeveloped regions. Apparently, neither the total amount allocated nor the distribution among provinces is done by any formula. An ad hoc approach is used.

121. The second type is grants for year-end reconciliations. The example given was to compensate the local government for a change in ownership of an enterprise during the year. The third type is subsidies to particular local governments for special purposes. For example, if an enterprise had undertaken a major technical upgrading and as a result, profits were very low, then a special grant might be in order. To compensate for a bad harvest would be another justification for such a grant. Finally, this category would include grants to local governments to cover deficits that the central government had approved. It was noted that all provinces receive the first and second types of grant.

122. Local governments in China cannot run a deficit and cannot borrow. However, there appear to be ways to avoid these restrictions. On the matter of deficit financing, short-term borrowing (less than one year) apparently does occur. Even for longer-term capital financing, some ways can be found to access credit. For example, municipally owned enterprises can borrow and in some cases the municipal government has pledged its general revenues to secure the loans.

D. INTERGOVERNMENTAL FISCAL RELATIONS

123. There are three important dimensions to the system of intergovernmental fiscal relations in China. The first is provincial-central government relations, and includes both tax sharing and the flow of grants and subsidies. The second is the system of provincial-municipal tax sharing which was outlined above. 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. These three dimensions are closely interrelated.

26/ In effect, the system of shared taxes in China is a kind of formula based transfer system.

124. Another issue considered here is borrowing by subnational governments. We treat this as a topic under intergovernmental fiscal relations because the allocation of credit or even the capitalization of a local government credit institution are central government decisions. Moreover, the allocation of scarce loan resources among provincial and local governments would be guided by central government development and equalization objectives.

Central-Provincial Transfers

125. The central government fixes and adjusts the tax-sharing arrangements with the Provinces. In theory, this allows the Center to control the distribution of resources available to different levels of government. The sharing ratio serves another important function in giving a target for total expenditures by the provincial government and by all its local governments. For example, from its allocation of 80% of all collections of shared revenues, Anhui Province must decide on its own budget, as well as the level of expenditures for each local government in the province. One of the decisions the provincial government must take is the amount of funds it wants to hold back for itself for *ad hoc* distribution among all local governments in the Province.

126. The system in China is essentially a sharing of revenues from a specified set of taxes, 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) *ad hoc* decisions.

127. The basic sharing formula, first applied in 1985, is

$$\text{RATIO} = \frac{E(83)}{R(83)}$$

where Ratio = The share of collections to be retained by the province
E(83) = Actual amount of "Allowable" local government expenditures in 1983
R(83) = Actual amount of local fixed plus shared revenues collected in 1983

128. To understand the sharing system, it is necessary to understand precisely which expenditures are allowable and which revenues collections are to be included in the sharing base.

129. Expenditures that Qualify for Shared Financing. All Provincial and local government expenditures cannot be included in the numerator of the sharing ratio. The following are the "allowable" local government expenditures.

(a) Category 1: Construction Expenditures. All planned capital investments whose financing is from local funds (net of central government grants) and net of any capital expenditures financed from extrabudgetary funds.

(b) Category 2: Technology Transformation. Local governments subsidize enterprises for technical upgrading, e.g., new machinery or equipment. These subsidies previously took the form of grants but now are mostly loans, and in any case the entire subsidy program is being phased out with increasing enterprise management and financial autonomy.

(c) Category 3: Research and Development. These are subsidies to enterprises to carry out research or to experiment with new product lines. They are mostly loans and are being gradually phased out.

(d) Category 4: Temporary Warehouse Buildings. The local government gives subsidies to certain enterprises to construct temporary warehouses for seasonal agricultural products.

(e) Category 5: Support for Agricultural Development. These are subsidies paid to villages or to individuals to increase food production, e.g., the creation of fish ponds. They may be grants and loans, but are increasingly the latter.

(f) Category 6: Urban Maintenance and Construction Expenditure. This category of expenditure is mostly maintenance and is financed almost exclusively from the urban maintenance and construction tax (7% of total sales tax liability in municipalities). These expenditures--to the extent they are financed by the urban maintenance and construction tax--are not counted in the numerator of the sharing ratio.27/ This category also includes some environmental protection outlays and refuse collection expenditures.

(g) Category 7: Expenditures on Agriculture, Forestry and Irrigation Projects.

(h) Category 8: Expenditures on Industry, Transportation, and Commerce. Expenditures associated with these activities, such as building maintenance and schools that are operated by these bureaus (vocational education) are included here.

(i) Category 9: Education, Culture and Public Health. These expenditures are for all government schools, primary through university level, and include all teachers' salaries, maintenance of school facilities, administration, scholarships. Hospitals and clinic expenditures, including all salaries, are also in this category. Cultural activities such as cinemas and broadcasting are a part of this expenditure category.

(j) Category 10: Social Relief. There are welfare expenditures such as for the elderly who are childless, orphanages, the disabled, etc.

27/ The UMCT is not shared and therefore is not counted in the denominator.

(k) Category 11: Administration Expenditure. This includes the salaries of local government workers, and the maintenance of local government buildings.

(l) Category 12: Other Expenditures. This residual category includes tax administration expenditures.28/

130. These categories do not exhaust all expenditures made by the local governments. As noted above, all expenditures financed either from extrabudgetary revenue, central government grants or fixed local revenues are not included. This means that any expenditures associated with public utilities other than transfers from the general municipal account are not included. Enterprise losses are not included as an allowable expenditure because they are counted as a negative revenue.

131. Determining the Revenue Shares. The basic revenue sharing formula is described in paragraph 127, and the allowable components of the numerator and denominator are described above. The 1985 calculations followed this formula with one deviation: the urban construction and maintenance tax was subtracted from both the numerator and denominator. The base year chosen for the computation was 1983, since the fiscal outcomes were known and Provincial and local governments would not be able to influence the outcome.

132. The results of applying this procedure are described in Table 5. For example, allowable expenditures in Beijing were equivalent to 48.2% of total shared and local fixed revenues in 1985, hence Beijing in 1985 would be able to retain 48.2% of all it collected from those two categories of tax. Of course, all fixed Central government revenues would have to be turned over to the center. As may be seen from the table, 15 provinces were in such a surplus position in 1985, i.e., shared plus local fixed revenues exceeded allowable expenditures and the tax sharing ratio was less than unity.

133. The remainder of the provinces (with the exception of Guangdong) were in a deficit position. In these cases, the province is allowed to retain all of its fixed and shared revenue collections and the central government pays a subsidy equivalent to the size of the 1983 deficit. Eight of these deficit provinces--the autonomous regions, the provinces with heavy minority populations and those which are least developed--were singled out for special treatment. They were to receive the deficit subsidy, but this amount was to be increased by 10% per year. Apparently, 10% was taken as a number that would roughly approximate needed revenue growth. In fact, the 10% increment was given in 1986 but was reduced to 5% in 1987 and 1988 with the intention to eliminate it in 1989.

134. Guangdong is treated differently from the other surplus provinces. By special arrangement in 1985, it retained all fixed local and shared collections, but was to turn over a fixed annual amount of Y 772 million to the Central government. This was the estimated amount of the 1985 surplus.

28/ Two additional notes are helpful: categories 1, 5, 6, and 9 are the most important in terms of amount spent; and housing maintenance expenditures may be included under 7, 8, 9 or 11.

Table 5: REVENUE-SHARING SYSTEM BETWEEN THE CENTRAL AND LOCAL GOVERNMENTS, 1985-87 /a

Provinces & regions	Fixed percentage of total revenue retained by province			Province retains all own revenue and receives fixed amount from the center			Province retains own revenue and pays fixed amount to the center		
	1985	1986	1987	1985	1986	1987	1985	1986	1987
	(%)			(Yuan million)					
North China									
Beijing	48.20	49.55	49.55						
Tianjin	39.50	39.45	39.45						
Hebei	69.00	72.00	72.00						
Shanxi	97.50	97.50	97.50						
Inner Mongolia				1,783.00	1,961.74	2,059.83			
Northeast China									
Liaoning	51.10	52.66	52.66						
Jilin				397.00	396.62	396.62			
Heilongjiang	96.00							142.70	142.70
East China									
Shanghai	26.00	23.54	23.54						
Jiangsu	39.00	41.00	41.00						
Zhejiang	55.00	55.00	60.81						
Anhui	80.10	80.10	80.10						
Fujian				235.00	234.86	234.86			
Jiangxi				239.00	239.46	239.46			
Shandong	59.00	77.47							75.00
Central/South China									
Henan	81.00	81.00	87.71						
Hubei	66.50	100.00	100.00						
Hunan	88.00	88.00	88.00						
Guangdong							772.00	778.08	778.08
Guangxi				716.00	788.03	827.43			
Southwest China									
Sichuan	89.00	100.00	100.00						
Guizhou				743.00	817.57	858.45			
Yunnan				637.00	925.88	972.17			
Tibet				750.00	825.32	866.59			
Northwest China									
Shaanxi				270.00	270.26	270.26			
Gansu				246.00	245.60	245.60			
Qinghai				611.00	671.88	705.47			
Ningxia				494.00	543.14	570.30			
Xinjiang				1,450.00	1,594.85	1,674.59			

/a Subsidies were to increase by 10% per year after 1985.

Source: Data supplied by Ministry of Finance.

135. There were no changes in the basic approach in 1986, but there were some changes in the sharing ratios. In 1986, some enterprises were transferred from Central government to Provincial or local government ownership. This increases the denominator in the sharing ratio (in most cases by more than it increases the numerator) and therefore lowers the retained share (in the case of surplus provinces), reduces the size of the deficit transfer (in the case of deficit provinces), or increases the size of the fixed transfer to the central government (in the case of Guangdong). Ownership of other enterprises was transferred from local to central government. This would have exactly the opposite effect. The changes were significant enough that adjustments were made for a few provinces (see Table 5).

136. The adjustments in the 1986 sharing ratio due to changes in ownership were made in one of three ways. To illustrate, let us suppose that total provincial revenues are Y 1 billion and that provincial enterprises transferred to the center had 1985 revenues of Y 100 million. Under method (1), the denominator of the sharing ratio--still using 1983 as a base year--would be reduced to Y 900 million and the sharing ratio would rise accordingly. Under method (2), the same approach would be taken but the adjustment would be based on 1983 revenue data for the enterprise in question. This method was not frequently used because many enterprises had not converted to the tax system in 1983 and therefore appropriate data for using method (2) were not available. Under method (3), the sharing ratio in the base year would be increased by the ratio of the transferred revenue to the total revenue, i.e., in this case the retained share would be increased by 10%.

137. There were also changes in the system in 1987. First, there were more adjustments in the sharing rates because of the changes in ownership of some enterprises, using essentially the same methods as described above. Most notably, the tobacco enterprises were switched from provincial to central government ownership. Second, and more important, the sharing arrangement was changed for several provinces, on an ad hoc basis. An incremental sharing rate on revenues above a target level was introduced in Jiangsu, Zhejiang, Hebei, Beijing, and Tianjin.

138. Substantial changes for 1988 are being discussed, though at mid-1988 all provinces except Guangdong and Shanghai continue to operate under the 1987 arrangements. A major decision has already been taken to permit local governments to retain all fixed local revenue, i.e., the sharing formula will apply only to the shared revenue. However, the fixed local revenue category has been amended to exclude income taxes on locally owned and collectively owned enterprises. Though the wage bonus tax has been added to the fixed local revenue list, the net effect of this change is to dramatically weaken even the theoretical claim of local governments on the revenue base. The new list of local fixed revenues is as follows:

1. Income and business taxes levied on all private enterprises.
2. Adjustment tax for individual income tax.
3. Boat and vehicle use tax.
4. Slaughter tax.
5. Market trading tax.
6. Wage bonus tax of enterprises.
7. Wage adjustment tax of enterprises.
8. Special product tax in agriculture and forestry.
9. Housing construction tax.

10. Urban Maintenance and Construction Tax. This is still a local fixed revenue, though it is not often referred to as such because it is an earmarked tax for construction and maintenance.

139. The sharing formula also may be changed. The new formula reported in discussion with Chinese officials is

$$\text{Ratio 86} = \frac{(L86 + S86)\ (\text{RATIO 83}) - T86}{(L86 + S86) - T86}$$

where S86 = shared revenue in 1986
L86 = local fixed revenue in 1986
T86 = the 13 taxes assigned to local governments in 1988

This simplifies to

$$\text{Ratio 86} = \frac{(E83)\ (1+r) - T86}{S(86) + (L86 - T86)}$$

where r is the percentage increase in local fixed plus shared revenue between 1983 and 1986. In other words, the assumption is made that the growth in expenditure requirements can be approximated with the actual growth in revenue yield from local and shared taxes. Local fixed taxes (new definition) are netted out of the numerator since they may now be applied to reduce the amount of expenditure that needs to be covered from shared revenues, and they are subtracted from the denominator because the proceeds are no longer to be shared.

140. Guangdong and Shanghai are to receive special treatment. As before, Guangdong will be allowed to retain all fixed and shared taxes collected, but the amount remitted to the center will be increased by 9% per year beginning in 1989. Shanghai will remit Y 10.5 billion to the center and retain any excess.

Implementation of the System

141. While the formula itself is not very complicated, this is not a simple revenue-sharing system to administer. Three problems are worth considering. First, implementation of the system requires the reporting of a substantial amount of detailed fiscal data by the province, and requires some verification of accuracy by the central government. Second, there is the question of how often the sharing rates will be changed and whether the door has now been opened for annual negotiation of the rate. Third, the actual transfer of the funds poses an administrative problem.

142. Provincial Fiscal Data. Calculation of the sharing ratio requires detailed revenue and expenditure data for each province. It would not be surprising to find that the Central Government does not get accurate fiscal reports from the provinces. Each Provincial government must gather the data

from each local government--an enormous task when one considers that the fiscal information systems are not computerized within the provinces and that some of these provinces are larger than many countries. Moreover, both the Provincial Government and the lower-level local governments have an incentive to understate their revenue collections and overstate their allowable expenditures.

143. The Central government does not appear to have an effective way to monitor these reported data. In March, the Provincial government is required to report the actual outcomes for the previous fiscal year to the Budget Bureau of MOF and the Bureau may call on local officials to verify the reported data. It is not clear what "verification" means in this case. Ministry officials did note that provincial officials are required to report to Beijing quarterly, concerning progress toward their fiscal targets, and could be called on at that time to explain the data. It was also reported that MOF officials do make field inspections. However, it is not clear exactly how the verifications are done.

144. One possibility for verification of reported data would be statistical testing. Since the government knows a good deal about the performance of the local economy, it might be able to construct a revenue model to determine if revenue performance is reasonable and whether revenue expectations are being met. The Budget Bureau claimed to use a judgemental approach to link revenue performance to the local and provincial economic base, but reported that there was no formal statistical model.

145. Frequency of Change. The data problems associated with implementing the system can be lessened if the sharing rates are adopted for a fixed number of years, as is done in some other countries. The more frequent the changes in the system, the more the door is opened for negotiation and barter by the local governments. This apparently is the situation in China. The government's intention in 1985 was to put a system in place for only two years. The proposed revisions for 1988 are the first major change since that time.

146. Transferring Funds. Since taxes are mostly collected at the local (municipal and county) level of government and then shared up, there arises the question of how the funds are actually transferred. The present system would appear to be that the People's Bank acts as the collection agent and deposits the monthly or quarterly amounts to the appropriate Central, Provincial or Municipal/County accounts, based on the sharing formulae.

Box 1: JIANGSU PROVINCE

Since 1977, Jiangsu has retained a share of its total collections. As Provincial officials put it, "expenditure depends on revenue collection." But the story is far more complicated. The basic rate in 1984 was 35.7%, i.e., the Province retained 35.7% of all revenues collected (except for the "special case" items described in the revenue sharing notes above). In 1985, the rate was raised to 39% based on negotiation and a change in the ownership status of some enterprises. In 1986, the basic rate was raised to 41%, and an "incremental" sharing rate of 10% was instituted. The incremental sharing rate was triggered when revenues exceeded the amount collected in the previous year. In other words, the province retained 41% of 1986 collections up to the amount collected in 1985, and for any amount above this it retained 51%.

In 1987, the basic rate was held at 41% but the incremental rate was raised to 56%. In 1988, an even more favorable sharing rate was granted. The basic rate remained 41%, but the incremental rate was increased to 100% for all collections above 5.5% over the previous year. In other words, the Central Government requires a fixed contribution of 105.5% of the previous year's revenue and is content to allow the province to keep any excess.

Box 2: ANHUI PROVINCE

The system of revenue sharing established in 1985 did not change between 1985 and 1987, but there is a proposed change for 1988. The basic formula was determined in 1985 based on 1983 data. Expenditures to be covered were Y 1.72 billion in 1983 and revenues were Y 2.14 billion. The sharing (retention) ratio was thus established at 80.1%.

The Anhui experience gives some new insights into the workings of the revenue-sharing system. It is far more complicated than a constant sharing rate of 80.1%. Consider the following:

(a) Anhui collects Y 3.88 billion in revenue. Before sharing, this amount is reduced by the Y 120 million collected from electric power, oil, petrochemicals, and nonferrous metal enterprises which goes directly to the central government.

(b) The sharing base is further reduced to Y 3.618 billion because of the Y 262 million in local (not shared) taxes collected. The local taxes include bonus tax on collectives, waste fee, UMCT, insurance company revenue, and vehicle use tax.

(c) The sharing percentage of 80.1% applied to Y 3.618 billion gives an approximation of the amount the Province may retain. Interestingly, however, this is only an approximation and the 80.1% is an average rate. There are some "special" treatments. For example, since cigarette enterprises are centrally owned, income tax collections revert to the center. Sales taxes on cigarettes, wine and other tobacco products are not shared in the normal way. The increment over each succeeding year is divided 60% to the central government and 40% to the province, but the "base" amount goes to the Center. This began in 1983 and is a national policy meant to limit the production of cigarettes.

There recently has been some discussion of an adjustment in the sharing ratio, but this has not yet been approved. The Central government has proposed a reduction in the sharing (retention) ratio from 80.1% to 76% on ground that there has been a shift in ownership of some enterprises and that local fixed taxes are now more productive and able to carry a larger share of the expenditure financing burden. The provincial government disagrees and the matter is under negotiation.

Fiscal Disparities

147. There are wide disparities in per capita revenue collections among the provinces, from Y 1,492 in Shanghai to Y 52 in Guangxi and Y 40 in Tibet (see Table 6). The mean level of per capita provincial and local budgetary revenue collections was Y 169 in 1985. The higher levels of revenue mobilization are due to higher levels of economic activity, and perhaps to a higher rate of urbanization. Even a quick glance at the statistics reported in Table 6 confirms this: the four highest income provinces (in per capita terms) also collect the greatest per capita amounts of revenue, and the opposite is true of the low income provinces.29/

29/ We have used the gross value of agricultural and industrial output as a rough proxy for income level. There are a number of reasons for this. First, because wages are controlled and workers are subsidized by enterprises and government, output may be a reasonable indicator of variations in the individual welfare among profits. Second, gross output roughly measures variations in the enterprise tax base level. Third, the simple correlation between per capita national income and the per capita gross value of agricultural and industrial output in 1985 is very high. Finally, output data are more readily available on a province level than are income data.

Table 6: REVENUE AND EXPENDITURE DISPARITIES AMONG PROVINCES
(1985)

	Budgetary revenue collections: Per capita amount (Rmb/person)	Budgetary revenue collections: Percent of total	Budgetary expenditures: Per capita amount (Rmb/person)	Budgetary expenditures: Percent of total	Percent of total population	Ranking: Per capita national income
Beijing	609	4.97	344	3.15	0.92	2
Tianjin	597	4.10	334	2.58	0.78	3
Hebei	81	3.84	75	3.98	5.33	14
Shanxi	95	2.12	135	3.40	2.52	12
Inner Mongolia	72	1.22	170	3.27	1.93	16
Liaoning	231	7.24	154	5.44	3.54	4
Heilongjiang	98	2.76	135	4.27	3.18	5
Shanghai	1,492	15.43	346	4.02	1.17	1
Jiangsu	135	7.14	81	4.83	5.97	6
Zhejiang	145	4.95	93	3.57	3.87	7
Anhui	58	2.56	66	3.24	4.95	21
Fujian	92	2.13	113	2.93	2.61	17
Jiangxi	56	1.66	81	2.68	3.32	22
Shandong	88	5.74	67	4.90	7.39	10
Henan	63	4.16	64	4.73	7.41	25
Hubei	102	4.27	88	4.17	4.74	11
Hunan	70	3.33	71	3.83	5.40	19
Guangdong	112	5.92	107	6.41	6.01	9
Guangxi	52	1.71	77	2.84	3.72	28
Sichuan	57	4.99	63	6.13	9.79	26
Guizhou	49	1.23	80	2.28	2.85	29
Yunnan	80	2.33	108	3.51	3.27	27
Tibet	40	0.07	517	0.98	0.19	18
Shaanxi	68	1.72	92	2.63	2.88	24
Gansu	81	1.40	118	2.29	1.96	23
Qinghai	60	0.20	248	0.96	0.39	15
Ningxia	70	0.25	237	0.94	0.40	20
Xinjiang	62	0.72	210	2.73	1.31	13

Source: Data supplied by MOF.

148. This relationship can be tested in a more systematic way by estimating the relationship between per capita budgetary revenues and per capita gross value of output, holding constant the population and the percent of Province population living in urban areas (U). The result of the OLS estimate shows a strong significant relationship between per capita revenue and per capita gross output (see Table 7, equations 1 and 2). The relationship is so strong that the four Provinces with the highest level of per capita output (Shanghai, Beijing, Tianjin, and Liaoning) raised 31.7% of revenues even though they account for only 6.4% of the national population.

149. Disparities are much less pronounced on the expenditure side, with a per capita variation from Y 346 in Shanghai and Y 344 in Beijing to Y 63 in Sichuan and Y 66 in Anhui. The four highest income provinces, with 6.4% of the population, account for 15.2% of the expenditures. The pattern of variation is described in equation (3) of Table 7. Higher income provinces do spend more because of some combination of a greater demand for public services, and the ability to raise more "local fixed" and extrabudgetary revenues. Money sticks where it hits. Provinces with greater populations spend significantly less on a per capita basis, even after controlling for the amount of gross value generated and the rate of urbanization. One interpretation of this result is that more services are provided in the less populous and more urban provinces, and that the urbanization variable does not adequately control for the large rural population.

Table 7: OLS REGRESSION RESULTS FOR CHINESE REVENUES AND EXPENDITURES AGAINST SELECTED INDEPENDENT VARIABLES: BY PROVINCE FOR 1985
REGRESSION COEFFICIENTS /a

Equa-tion	Dependent variable	Logarithms (L) or Linear (N)	Constant	Per capita output (100 RMB)	Percent of population living in urban areas	Population	$\bar{R}^2$	N
1.	Per Capita Revenue	L	-5.049 (8.53)	1.357 (0.114)	0.333 (0.129)	...	0.91	29
2.	Per Capita Revenue	L	-5.608 (7.06)	1.391 (11.790)	0.314 (2.241)	0.053 (1.052)	0.91	29
3.	Per Capita Expenditures	L	5.433 (11.38)	0.436 (6.154)	0.106 (1.362)	-0.443 (-14.783)	0.93	29
4.	Ratio of Expenditures to Revenues Raised	L	6.739 (11.322)	-0.558 (6.315)	-0.168 (1.728)	-0.308 (8.242)	0.82	29
5.	Ratio of Revenues 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.

150. To describe the equalization features of the system, we examine the relationship between the expenditure-revenue ratio and this same set of explanatory variables (equation 4 in Table 7). This ratio might be viewed as an approximation of the retention rate on revenues collected.30/ The transfer system is equalizing in that the retention ratio is lower in Provinces that have higher incomes and greater rates of urbanization. However, the retention rate also appears to be lower in provinces with a larger population, cet. par., and this may not be equalizing.

151. 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 is equalizing in that the expenditure-revenue collection ratio varies from over 400% in Qinghai and over 100% in 14 other provinces, to 12% in Shanghai. Even so, there remains a significant disparity in per capita expenditures with higher income provinces spending significantly more.

Provincial-Local Tax Sharing

152. Provincial governments set the general rules which define the sharing of revenues among local governments within the Province. They receive no guidelines from the central government in setting the sharing rates, and are constrained in this matter only by provincial politics, their own economic plans and the total amount available for sharing. Not surprisingly, provincial governments have developed many different systems.

153. Zhejiang. Zhejiang appears to have a relatively complicated system. The municipalities, subdistricts, province and central government all share in the revenues collected from the profits tax. Local-provincial sharing is determined by the provincial government in the form of a set of allocation

30/ This should not be confused with the formal tax sharing 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.

formulae, and provincial-central sharing is determined by the Central Government. A summary of the profit tax sharing arrangement is presented in Table 8, but some elaboration about a few important points is necessary:

(a) A government may not share in the profits tax revenues of a business owned by a higher level government. For example, the municipality has responsibility for collecting tax from provincial and central enterprises, but it may not share in these revenues.31/ The province, however, shares in the revenues collected from municipal enterprises, etc.

(b) The sharing formula first attempts to protect the level of local government expenditures in 1983 and the level of remittances made to the province as of 1983. That is, municipal governments have first claim on profits tax revenues up to an amount equivalent to their 1983 'approved' expenditures. The second claim is by the provincial government for an amount equivalent to the 1983 remittance to the province by the municipal government.32/ Any increment is shared on a 70/30 basis between municipality and province. Since subdistricts have only recently been given taxing authority, they do not participate in the 1983 rule but share with the municipality on a basis prescribed by the latter, e.g., a 50/50 basis in Hangzhou.

(c) The base of the profits tax is reduced by preferential tax treatment for certain enterprises, and these tax preferences may be granted by the provincial government. For example, the tax rate on public utilities and on services is held to a maximum of 15%.

(d) For 28 counties, the general terms of sharing arrangement between provinces and counties is the same as that between provinces and cities. The remainder receive a preferential sharing treatment.

(e) Local governments in Zhejiang Province receive little revenue from either the salt tax or the natural resource tax. If they did, however, the sharing arrangement would be the same as in the case of the profits tax.

(f) Subdistricts have been given authority to collect all taxes from private business in the municipalities studied. This is shared with the municipality on a 50/50 basis.

134. It should be noted that these general sharing rules do not hold for every local government in the province, e.g., at the option of the province, a municipality or a county could be allowed to keep all profits tax collected. This points up an important feature of Chinese intergovernmental fiscal relations: that the provincial government can freely alter the sharing formula. Indeed, it was pointed out by provincial officials that the sharing percentages do vary among local governments depending on their level of economic

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31/ The UMCT is the exception to this rule.

32/ This is equivalent to the difference between profit tax revenues collected in 1983 and "approved expenditures."

development and on the extent to which their economic base is dominated by large, centrally owned enterprises.

Table 8: TAX AND TAX-SHARING ARRANGEMENT FOR PROFIT AND ADJUSTMENT TAX IN ZHEJIANG /a /b

Recipient: Subdistrict government	Municipal government	Provincial government	Central government
Type of Tax/Base Profits of:			
Subdistrict-owned enterprises, and all private businesses	Municipal and subdistrict enterprises, collectives and private business	Provincial-owned enterprises and taxes collected by the municipal government	Central-owned enterprises and all profit taxes collected in the province
Sharing Formulae:			
Shares 50% of collections with the municipality	Receives 50% of subdistrict collections		Receives 45% of all profits taxes collected in province
	The difference between 1983 revenues collected and "adjusted" 1983 expenditures is remitted to the province. The base amount is retained by the municipality	Receives the difference between 1983 revenues and adjusted expenditures from every local government, except for those given special treatment	
	Keeps 70% of the increment in revenues over the 1983 amount	Received 30% of the increment in revenues over the 1983 amounts, from all local governments except those given special treatment	

/a These are the general features of the sharing arrangement. There are negotiated variations from this general pattern.
/b Public utilities and certain services are taxed at a maximum rate of 15%.

Source: Data provided by Zhejiang provincial and municipal government officials.

155. The wage bonus tax is shared. The sharing of the wage bonus tax is 52% of total collections retained by the municipality, 3% to the province, and 45% to the Central Government. The construction tax is administered by the municipal government but all revenues are turned over to the province which then turns over 45% to the Central Government.

156. The sharing of sales tax revenues does not favor municipalities and counties. From total revenues collected in any year, an amount equivalent to the previous year's collection will be turned over to the provincial government. Of any increment over the previous year's collections, 5% may be retained by the municipality in the case of Hangzhou and Ningbo, and 10% in the case of Shaoxing and Quzhou. The remainder of the increment is turned over to the province.

157. The sales tax is revenue productive but municipalities (other than Wenzhou) would appear to share very little in this revenue productivity.33/ Sales tax sharing between province and counties is a different matter. There are two arrangements for county sharing: 36 counties retain 15% of collections and 28 counties retain 15% of the increment over the previous year. It is not the case that all urban counties are necessarily in the latter group, e.g., three of Hangzhou's seven counties are in the first group.

158. Another important dimension of intergovernmental relations is the degree to which the provincial government redistributes taxable capacity, e.g., from rich to poor counties or from urban to rural areas. This feature of the intergovernmental system might be referred to as "horizontal" sharing. The Province has two fiscal tools which it can use to redistribute fiscal resources. The most powerful is that it may vary the tax-sharing ratios for each local government, apparently without central government approval. For example, the municipality of Wenzhou is permitted, by provincial order, to retain a greater share of its profits tax collections than are other municipalities. As a result, Wenzhou retains nearly 60% of all revenues raised--nearly twice the rate retained by some of the other municipalities. The explanation given by provincial officials for this arrangement is that Wenzhou is relatively poor, has very few state-owned enterprises and therefore must rely heavily on smaller collectives and private firms to generate revenues. Provincial officials also acknowledged that tax-sharing rates differ among the counties. The sales tax-sharing rate varied only slightly among the cities studied, but provincial officials noted that the rate actually varies "from higher-income areas turning it nearly all over to lower-income areas keeping it all." The decisions about tax sharing rates are made on an ad hoc rather than a formula basis.

159. The second tool available to redistribute fiscal resources within the province is grants and subsidies. There are two dimensions to any grant program: the method used to determine the size of the total grant fund, i.e., how much is available for distribution; and the method used to distribute the grant among eligible local governments. Zhejiang Province does not use a formal method to make either decision. The grant program for local governments is purely an ad hoc affair and is changeable from year to year. Provincial officials could not estimate the grant share of these discretionary funds, but indicated that it would not be a major component of the province budget. If as much as 25% of the provincial government budget was allocated to grants, this would be equivalent to about 15% of locally retained revenues.

33/ A new sales tax-sharing formula was adopted in 1987, retroactive to 1986. The new formula is: $RS_t = S_t - (S_b\ (1+X)^{t-b})$

Where RS_t = retained sales tax revenue in year t
S_t = sales taxes collected in year t
S_b = sales taxes collected in the base year (b=1984)

In other words, the province will prescribe a growth rate, X, to which the local government will be entitled.

One might infer from this that there is a limited potential for the province to use its grant system to augment local revenues.

160. Whatever amount is available for grants, the principle for distributing it within the province is said to be equalization, i.e., "to stimulate economic development in the poorer areas." The province claims to have per capita income estimates for each municipality and county, but they do not use these in making the grant allocations. They rely instead on "expert judgment" to guide their equalization efforts. Provincial officials were unable to provide data on the distribution of grants among local governments. This suggests that the province does not evaluate the extent to which its programs achieve their equalization objectives.

161. Jiangsu. Jiangsu Province shares a flat percentage of total tax collections with each local government. 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 south and those in more remote locations having higher retention rates. The assignment of tax-sharing rates for urban counties is a responsibility of the city governments in Jiangsu, 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%. The city of Changzhou is one exception to this general rule, and in this case the provincial government assigns the county sharing rates directly.

162. There is a special arrangement with the provincial capital, Nanjing City. Because it is the highest income city in the province, its basic retention rate of 17.5% is the lowest in the province. This was determined on a basis of the ratio of 1983 expenditures to 1983 revenues. In 1984, the basic sharing rate was lowered to 15.53%, because of changes in the ownership status of some enterprises. It is important to remember that certain fixed local taxes and extrabudgetary revenues are excluded from this sharing and are fully retained by the local government. In Nanjing in 1987, total tax collections were Y 1.66 billion and shared tax collections were Y 1.48 billion. The difference is mostly the urban construction and maintenance tax.

163. In addition to the basic sharing rate, Nanjing is allowed to retain 30% of collections above the previous year's amount. (In 1984, the incremental sharing rate was only 7%.) The collections of shared taxes in Nanjing in recent years have increased at a rate of about 10%: Y 1.48 billion in 1987; Y 1.33 billion in 1986; Y 1.2 billion in 1985. It is noteworthy that with the increased province-wide incremental sharing rate in the last two years, the Nanjing incremental sharing rate has not been increased.

164. The other dimension of Provincial-Local Transfers in Jiangsu is grants to the local governments. The concept of a grant in aid (as opposed to a price subsidy for agricultural products) to a local government is not one that provincial officials are used to working with. These are grants, but for special designated purposes and are distributed among local governments on an ad hoc basis. There is, at present, no plan to establish a regular grant program. As to the size of the distributable pool from which grants are made,

the provincial government noted that it retained about 25% of the total province-wide tax share for its own direct expenditures and for grants.

165. Anhui. Anhui Province, like Jiangsu, shares revenues with local governments on a basis of total collections, i.e., it does not vary the sharing rate by tax as is done in Zhejiang. The sharing formula is based on 1983 revenue and expenditure data. If base-year revenues are greater than base-year expenditures, then the sharing ratio (E/R) is less than unity. If base-year expenditures are greater than base-year revenues, then the province pays a subsidy to the local government of amount E-R. In both cases, and in the case of county subsidies, the R is defined net of the central government share of taxes.

166. Consider the example of a city whose base year revenues were Y 1 million and have not increased since that time. Case I: If base year expenditures were Y 600,000, the city would pay approximately 20% of revenues of Y 1 million (Y 200,000) to the center, and deliver Y 200,000 to the province. The sharing ratio would be 60% of revenues, i.e., Y 600,000 divided by Y 1 million. Case II: Suppose base-year expenditures are Y 900,000. The province will have to pay the city a subsidy of Y 100,000. The central government will still receive its Y 200,000.

167. Now return to case I: base year revenue of Y 1 million and expenditures of Y 600,000. Suppose that revenues in a later year increase to Y 2 million. The central government will receive about Y 400,000 (19.9% of Y 2 million). The amount the local government will receive depends on a province-determined formula, illustrated in Table 9. On the first Y 1 million (the revenue amount in the base year), the local government will receive the basic 60% share and the province will receive the remaining 20%. Anything over the base amount of revenue is shared by an incremental formula, with the local government share lower and the provincial government share higher than the base year percentage. For example, for the four largest cities, the local government may retain only 30% of the second million collected while the province share rises to 50%. For the four smaller cities, group B, the local share is 32% of the increment. Clearly, local governments in Anhui are not given an incentive to increase their rate of revenue mobilization.

Table 9: REVENUE SHARING BETWEEN PROVINCE AND CITIES: AN ILLUSTRATION

Level of government	First Y 1 million	Second Y 1 million	
		Group A	Group B
Central	200	200	200
Provincial	200	500	480
Local	600	300	320

Source: Based on data provided by Anhui Provincial officials.

168. Another system is in place for the 74 counties, though the provincial government, and not the cities, determines the sharing rate. Administratively, counties are on the same footing as cities in that they report directly to the provincial government. The basic formula is the same as for

cities, using base year 1983 revenue and expenditure data. In most cases, the counties had deficits in 1983, so a subsidy is required to cover the base year shortfall. For 63 of the 74 counties requiring a subsidy in 1987, the total subsidy was Y 246.8 million. Counties are subject to an incremental sharing rate on the excess over the basic amount. It is the same for all counties: 20% to the central government; 10% to the provincial government; and 70% to the county.

169. Hefei city shares revenue with the province according to what appears to be a contract basis. The data presented in Table 10 were supplied for 1987.

Table 10: REVENUE SHARING IN HEFEI

(1)	Actual revenue collected	629 million
(2)	Less: Local fixed revenue	38 million
(3)	Equals: Shared pool	591 million
(4)	Less: Base year (1983) revenue	318 million
	(4a) Local government share (14.9%)	47 million
(5)	Equals: Incremental shared revenue	273 million
	(5a) Central government share (24%)	55 million
	(5b) Provincial government share (49%)	136 million
	(5c) City government share (27%)	82 million

Source: Hefei Municipal Officials.

The city's basic (1983) sharing rate is 14.93% (Y 7,484 in allowable 1983 expenditures divided by Y 318,114 in revenue collections). Therefore, 14.93% of Y 318 million, or Y 47 million of the base amount is retained, plus the incremental amount of Y 82 million, line (5c), for a total of Y 129 million. It was reported that there also were Y 78 million in grant revenues that were not reported in the above computations. In total, then, Hefei city retained an average of about 22% of total shared tax collections in 1987.

170. Apparently, the province attempts to allocate resources among local governments on an equalizing basis. The counties surrounding Hefei have an incremental sharing rate of 80%, nearly 90% of the counties retain all revenues collected and receive a subsidy, and smaller cities have a higher incremental sharing rate than larger (and presumable higher-income) cities.

Intraprovincial Sharing

171. Yet another dimension of revenue sharing in China is the division of resources among the three levels of subnational government within urban areas: municipality, county, and subdistrict. All participate in the sharing of revenues, but the methods used to determine the division vary by Province.

172. In Jiangsu, the sharing arrangements are generally determined by the municipal government. The results of this approach might be illustrated by taking the case of Nanjing City. The counties that surround Nanjing are permitted to retain much higher shares of collections. The present retention rates for the five counties are 37.7%, 75.35%, 66.58%, 73.89% and 77.32%. The

sharing rates are said to vary according to the city's judgement about the degree of underdevelopment of the counties. There is also sharing between the city and the ten subdistrict governments. For the shared revenues collected by these subdistricts, they may retain a "basic share" and an incremental share of 30% over the previous year's collections. The basic retention rate varies between 41% and 22% around an average of 23.16%. The variation is determined by the city, largely on a basis of the degree of development of the subdistrict.

E. PROBLEMS AND ISSUES IN SUBNATIONAL FINANCE

173. There is little doubt that China's system of local public finance and intergovernmental relations will change in order to better support the system reform. This analysis, earlier studies, and interviews with local and national officials in China point up four areas of concern: (a) the adequacy of revenues and of revenue growth; (b) undesirable effects on resource allocation created by biases in the tax structure and tax-sharing system; (c) the efficiency of tax administration; and (d) inadequate planning and monitoring of local government finances.

Revenue Adequacy

174. Revenue adequacy is not easily defined. It is always true that there is too little tax money to fully satisfy public service desires, therefore, we cannot say whether any particular rate of current expenditures is generating a "proper" level of general government services. We treat the revenue adequacy question by addressing three issues: (a) Is the level of general government infrastructure expenditures seen by authorities to be too low? (b) Has the growth in general revenues kept pace with the growth in population, prices and incomes? (c) Has there been a general shift in available resources away from the general government sector and to the enterprise sector?

175. The answer to the first question is clear enough. Public service levels are deficient in all parts of China and virtually every Ministry estimates a substantial backlog in unmet needs. Inadequacies in the general infrastructure were cited as a major impediment to economic development in both provinces visited. Population growth in the urban areas and increasing industrialization promise to press the available infrastructure even harder in the future. The answer to the second question is that the yield of the Chinese tax system has kept pace with prices and population (there has been real growth in the 1980s) but not with the growth in total output (see Table 2). The claim of provincial and local government on total output fell noticeably in the first half of the 1980s. With respect to the third issue, there appears to have been a shift in fiscal balance among the levels of government. The central government's share of revenue collections has been increasing, but its share of direct expenditures has been declining (Table 11). This is a very important change. The result is that the provincial-local sector is becoming increasingly self-sufficient. Whereas in 1982, provincial-local governments spent an amount equivalent to only about two-thirds of what they collected, by 1986 their direct expenditures were 4% greater than total collections.

Table 11: CHANGING FISCAL IMPORTANCE OF THE CENTRAL AND SUBNATIONAL GOVERNMENT SECTORS
%

	1982	1983	1984	1985	1986
	111.1	111.1	111.1	111.1	111.1
Central Government Share of:					
Collections	23.0	29.8	34.9	37.0	40.5
Expenditures	49.9	49.6	47.8	43.3	41.3
Expenditure-Collection Ratio					
Center	222.8	172.5	141.0	115.7	104.9
Subnational	66.7	74.1	82.7	88.9	101.8
Ratio of Collections to GNP					
Subnational	17.1	15.6	14.4	14.1	14.1
Central	5.1	6.6	7.8	8.3	9.7

176. The central government, on the other hand, was spending 2.28 times the amount it collected in 1982, but this multiple had fallen to only 1.04 in 1986. This decline is partly because there has been a shift in emphasis from central to provincial-local government expenditures. If provincial and local governments had been held to their 1982 retention ratio of two-thirds, the central government would have had an additional Y 46 billion available in 1986.

177. These statistics suggest a number of conclusions and raise a number of policy questions. First, the Chinese system has become increasingly centralized on the revenue side. Is this by design or is it because local revenue efforts are flagging? Provincial and local government collections have fallen as a percent of GNP during the 1980s (Table 11) and this could be a result of increases in preferential treatments or lax administration, but it also could be due to central government pricing or quota policies which reduce enterprise profits.

178. A second implication is that by design or no, each sector is now spending about what they raise. One is tempted to conclude that the shared and local fixed taxes plus the local government collections from central enterprises are the "right" revenue base for subnational governments. This needs only be supplemented (as it is now) with some system of horizontal transfers among the provinces. There is another way to view the "self-sufficiency" of the subnational government sector. This shift means that the central government's ability to use discretionary policy to redistribute among provinces, or to centralize national finances, is much more limited in 1986 than it was in 1982.

Allocative Effects

179. The Chinese system of taxation and tax sharing includes a number of penalties and incentives that might draw out undesirable actions from enterprises and local governments. We refer to these incentives and penalties as "prices" because they change the cost of one activity or decision relative to all others. We cannot document the extent to which responses to these price effects actually take place, other than with impressionistic, hearsay or very

indirect evidence. However, guided by theory we can point out the direction of the possible impact of these "tax-price" distortions in the fiscal system.

180. Incentives to Collect Taxes. The tax-sharing system in China presents provincial and municipal governments with a set of implicit prices that may affect their tax administration efforts. Simply put, if you cannot keep all you collect, you may not try as hard in your collection efforts, or you may even try to find a way around the system to keep a greater share. The questions raised here are whether the sharing (retention) rates are low enough to stimulate provincial and local governments to engage in some avoidance technique, and whether there are avenues open for such avoidance.34/ The incentives are clearly present. Municipalities normally keep about one-third of what they collect, but a greater share is possible depending on what has been negotiated between the local government and the province.

181. The avenues are open for less than full payment of taxes due. Local and provincial governments may reduce the amount of taxes due from enterprises by providing special arrangements to help enterprises over hardship periods or by giving tax holidays to encourage new activities. The phase-out of the adjustment tax may be negotiated by local governments, and contracts may be written to prescribe lower tax liabilities for some enterprises. All of these arrangements are well within the spirit and the letter of the law. They represent a form of tax avoidance. Local governments also can become more lax in their assessment and collection efforts and can permit enterprises to underdeclare tax liability. This is a form of evasion on the part of both the enterprise and the local government. Because there is a minimum of supervision of tax administration by higher level governments, the avenues for evasion are clearly open.

182. Revenue Mobilization. An important policy question is whether the tax sharing system significantly dampens overall revenue mobilization. Would it not seem reasonable to presume that local governments will try harder at collection when they retain a greater share of the amount collected? Is a one-third share a great enough incentive for municipal governments to make an aggressive effort at assessment and collection? Can a shared tax system exist alongside substantial local discretion in tax administration?

183. In principle, a shared-tax system is better than a grant system in stimulating local government revenue, because the amount of grants received is seen as independent of the tax administration effort exerted. A fully retained local government tax would offer the greatest incentive for efficient administration. In between, in terms of revenue stimulation, are sharing rates of varying levels. The point is that there is some price elasticity of demand for local taxes and the higher the local government retention rate, and the fewer the options for avoidance, the better should be the collection efforts. The questions raised here are whether the retention rates are presently high enough to encourage the efficiency of local tax administration that

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34/ It is important to distinguish avoidance from evasion in this discussion. The former is legal and in this discussion is due to the actions of provincial and local governments. Evasion is illegal and is due to the actions of taxpayers (enterprises, collectives and private business).

is desired and to dampen the enthusiasm for avoidance and even evasion. Put another way, how high would the retention rate have to be in order to convince local governments that local welfare would be better served by taxing the marginal dollar into the public budget than by leaving it to be reinvested as part of the retained earnings of enterprises?

184. If local or provincial governments see the share of taxes they must turn over to a higher level of government as "too great," one would expect that they might use some sort of avoidance technique to remit a smaller share. Like all public finance issues in China, this one is very complicated. Consider the case of a municipality that may keep only about one-third of all they collect. On the one hand, the more they collect the more they retain; hence there is an incentive for better enforcement and an incentive not to look for or to generate loopholes. On the other hand, municipalities collect most revenues from their own enterprises and less profits tax means more retained earnings and less call on general municipal revenues for technical upgrading, infrastructure investment, etc. One might expect the municipal government to cooperate with the enterprises in holding down "costs." One of the main conclusions of a World Bank study on the behavior of enterprises was that "Enterprises can change the rules of the game to their financial benefit, and almost every enterprise on one pretext or another is made into an exceptional case, entitled to special treatment."35/ The study goes on to note the granting of special tax incentives, transforming loans to grants, subsidizing worker bonuses and artificially maintaining levels of retained profits.

185. In fact, central officials have stated a suspicion that many of the provinces were "holding back" on the proper level of remittance. It was believed that many had authorized the tax exemption and preferential tax treatment of certain firms, thereby lowering the total taxable base. In this way the after-tax profits of municipally owned firms may be increased and more resources may be "kept at home" in the province.36/ The World Bank has also noted this as a national issue, "...there is some suggestion that local cadres provide tax exemptions and preference for "their" enterprises and local undertakings, which are not in accordance with strict interpretation of central policy."37/ One independent study of tax compliance in China reports a stream

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35/ William Byrd, Gene Tidrick, Chen Jiyuan, Xu Lu, Tang Zongkun, and Chen Lantong, Recent Chinese Economic Reforms: Studies of Two Industrial Enterprises, World Bank Staff Working Paper 642, 1984, p. 61.

36/ Finance Minister Wang Bingqian, in his 1987 budget message, stated that some people "...evaded taxes, retained a larger share of profits than they were entitled to for their own enterprises, falsified accounts about losses to secure subsidies, and diverted state funds to uses other than those prescribed." Washington Post, March 27, 1987, p. A30.

37/ World Bank, China's Fiscal System, p. 42.

of evidence that local officials have evaded or avoided payment of taxes in order to use funds for local purposes.38/

186. The pattern of growth in revenues and expenditures over the 1983-86 period is described in Table 12. 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. In terms of revenue collections, then, there has been some narrowing of the disparity reported above. The pattern of growth is much less clear on the expenditure side, e.g., Shanghai recorded the highest percent increase over this period and Tianjin one of the lowest. Perhaps the most important issue is what happened to the retention rate (the ratio of revenues to expenditures) during this period. As shown in Table 13, the retention rate increased in 24 of 29 provinces and it increased nationally, from 74 to 101% (Table 11). It is not clear that the ratio increased more in low income than high income provinces.

Table 12: PERCENT INCREASE IN REVENUES AND EXPENDITURES, BY PROVINCE FOR 1983-86

Province	Budgetary collections			Budgetary expenditures		
	Percent increase	Relative (average=100)	Rank	Percent increase	Relative (average=100)	Rank
Beijing	125.75	111.92	8	61.05	127.30	18
Tianjin	70.08	62.38	27	40.68	84.83	22
Hebei	90.38	80.44	22	40.62	84.69	23
Shanxi	71.47	63.61	26	18.59	38.77	26
Inner Mongolia	92.25	82.10	21	129.18	269.38	2
Liaoning	120.98	107.68	10	12.49	26.05	28
Heilongjiang	100.16	89.15	17	109.07	227.43	5
Jiangsu	104.89	93.36	15	119.67	249.53	4
Shanghai	199.26	177.35	1	15.86	33.06	27
Zhejiang	132.22	117.68	5	32.40	67.55	24
Anhui	126.59	112.67	7	64.18	133.83	15
Shandong	109.63	97.57	14	58.33	121.63	19
Henan	130.21	115.89	16	135.57	202.70	1
Hubei	104.87	93.34	16	77.75	162.14	12
Hunan	114.50	101.91	11	21.15	44.10	25
Sichuan	139.47	124.13	3	50.71	105.75	20
Jilin	158.22	140.82	2	42.38	88.38	21
Jiangxi	112.10	99.77	13	62.79	130.94	16
Shaanxi	89.21	79.40	23	125.74	262.19	3
Gansu	93.24	82.99	20	81.64	170.24	9
Fujian	114.36	101.78	12	62.74	130.82	17
Guangxi	124.10	110.45	9	88.88	105.33	8
Yunnan	96.88	86.23	18	74.96	156.30	13
Tibet	52.55	46.77	29	-85.42	-178.12	29
Qinghai	65.36	58.17	28	65.68	136.96	14
Ningxia	72.95	64.93	25	81.28	169.50	10
Xinjiang	88.72	78.96	24	108.44	226.13	6
Guangdong	137.85	122.69	4	105.62	220.24	7
Guizhou	95.43	84.94	19	81.17	169.27	11

38/ David Bachman, "Implementing Chinese Tax Policy," unpublished paper, Department of Political Science, Stanford University, June 1983, p. 42.

Table 13: CHANGES IN THE RATIO OF EXPENDITURES TO COLLECTIONS: FOR 1983-86 BY PROVINCE

Province	Ratio 1983	Ratio 1986	Change 1983-86
Beijing	0.52	0.73	0.21
Tianjin	0.53	0.64	0.11
Hebei	0.78	1.05	0.27
Shanxi	0.99	1.44	0.45
Inner Mongolia	3.27	2.74	-0.53
Liaoning	0.39	0.76	0.37
Jilin	1.37	1.70	0.33
Heilongjiang	1.42	1.29	-0.13
Shanghai	0.12	0.32	0.20
Jiangsu	0.43	0.67	0.24
Zhejiang	0.53	0.74	0.21
Anhui	0.91	1.30	0.39
Fujian	1.42	1.29	-0.13
Jiangxi	1.28	1.52	0.24
Shandong	0.63	1.09	0.46
Henan	0.82	1.26	0.44
Hubei	0.70	1.01	0.31
Hunan	0.86	1.14	0.28
Guangdong	1.04	1.09	0.05
Guangxi	1.36	1.67	0.31
Sichuan	0.89	1.30	0.41
Guizhou	1.78	1.85	0.07
Yunnan	1.40	1.58	0.18
Tibet	12.25	128.14	115.89
Shaanxi	1.29	1.48	0.19
Gansu	1.42	1.52	0.10
Qinghai	4.80	3.81	-0.99
Ningxia	3.90	3.28	-0.62
Xinjiang	3.31	3.44	0.13

Tax Effort

187. The statistics above describe the level and growth of revenue collections, and show that, on average, collections are higher in Provinces where income is higher. This stops short, however, of telling us whether higher income provinces 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 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.

188. A first approximation of revenue effort is the ratio of budgetary revenues to gross output. This is shown in column (1) of Table 14. For example, revenues raised in Shanghai in 1986 were equivalent to 18% of output by comparison to 9.8% in Gansu (and 8.7% for the nation as a whole). But much of this variation is expected because of differences in 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 shown below, the estimate is that Gansu actually makes a greater revenue effort than Shanghai. The problem with straightforward comparisons of revenue-output ratios to infer tax effort is that differences in taxable capacity are not properly accounted for.

Table 14: COMPARISONS OF TAXABLE CAPACITY AND TAX EFFORT BY PROVINCE

Province	Ratio of budgetary collection to gross output, 1986	Taxable capacity 1986	Index of tax effort	Tax effort ranking
Beijing	15.24	12.78	1.19	5
Tianjin	14.42	13.30	1.08	8
Hebei	7.52	8.90	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
Zhejiang	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
Qinghai	7.85	7.69	1.02	11
Ningxia	8.61	7.74	1.11	7
Xinjiang	6.25	8.14	7.68	-

189. If the taxable capacity of a province is a function of its income level and its degree of urbanization, the higher the level of per capita income--proxied here by the per capita gross value of output--the greater the capacity to raise profit and sales taxes. Urbanization may also contribute to taxable capacity because urban economic activities are more easily reached by the administrative system (provide better tax handles) than do rural activities. The average relationship between the share of output raised and these two indicators of taxable capacity is determined from a linear OLS estimate as

described in equation (5) of Table 7.39/ The results show that taxable capacity is significantly higher if per capita output is higher, and is positively (though not significantly) related to the level of urbanization. We may take the predicted value of the revenue ratio from this equation (column 2 of Table 14) as a measure of taxable capacity. For example, we would say that based on the average practice and its own level of per capita output and urbanization, we would "expect" Beijing's revenue ratio, or taxable capacity, to be 12.78%.

190. Tax effort is the extent to which a province uses this capacity, and may be measured as the ratio of the actual rate at which output is taxed (column 1) to estimated taxable capacity. To follow the example above, we expect Beijing to raise revenues equivalent to 12.78% of output (column 2), the province actually raised 15.24% in 1986 (column 1), hence there is an above average effort--specifically an effort which is 19% above average as is shown by the effort index of 1.19 in column (3) of Table 14. Shanghai, by contrast, raises questions about what would be expected and makes an average tax effort with an index of 1.01.

191. Some provinces make stronger and some make weaker revenue collection efforts. In general, it would appear that 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.

192. Incentives for Capital Construction. Deficient urban infrastructure is a major problem facing all Chinese cities. Does the fiscal system in China work to reduce or to accentuate the capital financing gap? More specifically, the questions are: (a) whether the system requires or even permits beneficiaries to pay the cost of capital projects, and (b) whether the system encourages municipal governments to spend a greater share of their budgets for capital purposes. The answers to these questions should be a resounding yes in China where urban capital financing is thought to be a major bottleneck to growth. In fact, the system does not encourage local governments to finance infrastructure development.

193. The urban maintenance and construction tax and the public utility surcharge are earmarked for capital construction and maintenance. While these presumably encourage spending to improve the capital stock, they do not account for a large share of capital construction and maintenance expenditures in these municipalities. The greater share of infrastructure financing must be supported by the general revenues of the municipal government, grants from higher level governments, and by enterprise revenues.

194. It might be useful to think about the constraints to increasing the rate of capital investment by local governments in terms of those methods of financing that are not available to municipalities. The most important is that local governments may not borrow. Only enterprises may incur debt.

39/ The method used here follows the approach developed in Roy Bahl "A Regression Approach to Tax Effort and Tax Ratio Analysis," International Monetary Fund Staff Papers, Vol. 18, No. 3, November 1971.

There is no formal mechanism whereby a local government can apply for and secure a capital construction loan, even if repayment potential is not in question. Long-lived and expensive projects, then, must be financed from a combination of current revenues, ad hoc grants and accumulated savings from current revenues. This is another important "price" effect in that it shifts the burden of financing projects with future benefits onto current taxpayers and onto the general public rather than specific beneficiaries. This raises the price of infrastructure investments and enhances the relative attractiveness of consumption-type expenditures.

195. There is no formal program of benefit charge financing. Even if those who might derive primary benefits from a project exhibit a strong willingness to pay, there is no mechanism to tap this willingness. The central or provincial governments do not offer technical assistance to set up such programs, though there are isolated examples of the application of benefit or user charges to finance capital projects. The result is that some desired projects may go unfinanced, and others may be underpriced to beneficiaries and overpriced to the general public.

196. Incentives for Governmental Decentralization. The economic reform calls for a decentralization of fiscal decision-making. Local government taxing powers, local government tax administration and separate local borrowing powers are all being discussed. Decentralization as a strategy is meant to move government decisions closer to the people who will be most affected by those decisions, to allow tax rates and expenditure composition to vary with local preferences and to make local officials (and local enterprise managers) more accountable for their actions. The fruits of decentralization ought to be a more efficient system of local government, and one whose makeup varies from place to place depending in part on what residents want and what they are willing to pay for. But in order to get the benefits of decentralization, one has to permit local government officials (acting on behalf of local residents) to make the important fiscal choices. In other words, decentralization requires that it be possible for the price of public services--tax rates--to vary from one local area to another depending on the preferences of local residents.

197. The government structure in China is certainly conducive to a marked degree of decentralization. The public utility companies (water, gas, buses) are more or less autonomous in their management and day-to-day operations. The outlying counties of the metropolitan area are governed with some autonomy and in some Provinces are financially independent from the city. The city

area itself is divided into districts that have independent budgets and identified expenditure responsibilities and sources of finance.40/ But the decentralized Chinese governmental structure does not extend to a freedom to set tax rates, choose tax bases, or to fully shape expenditure budgets. Uniformity in tax rates and structures is imposed on all local governments. Municipal government budgets must operate within limits prescribed by the provincial government, employee compensation is strictly controlled by the central government, and there are many mandated expenditure requirements. The subdistricts are faced with the same kinds of restrictions. A decentralized administrative structure is in place, but there is little if any formal fiscal decentralization.

198. The word "formal" is important because local governments can and do exert fiscal control. Clearly, the more tax revenue that is collected locally, the more the local government can do on the expenditure side. There are a number of other discretionary actions that they may take, though some require provincial government approval. Local governments may stimulate the profitability of their enterprises by redefining the cost basis for determining profits,41/ they may adjust the composition of public expenditures (within limits), with provincial authorization they may tax some enterprises at lower rates, they may share taxes with their subdivisions in any way they choose, and as discussed above they may vary their tax administration efforts. While this does give local governments some fiscal discretion, it is more ad hoc than planned. A reasonable conclusion might be that the fiscal system in China is quite decentralized but, paradoxically, this decentralization is neither guided nor planned.

199. Profit-Making Incentives. It is beyond the scope of the paper to consider the full range of economic effects of the Chinese tax structure. Yet for urban local governments in China, the growth in profits defines much of the growth in their tax base. If the current structure of the profit tax biases business decisions in a way that slows the growth in profits, it compromises the municipal government's ability to deliver and finance services.

40/ It is not easily seen why the administrative structure for service delivery is so decentralized in China. In many countries decentralization takes place purely for management reasons--some urban areas grow too large to be easily controlled from the City Manager's office or the menu of services they must provide gets too large and too diverse and some necessary specialization is lost. This state of affairs leads to various forms of decentralization. For example, public service companies are created to allow technical specialization, to avoid constraining civil service salary schedules and work rules, and perhaps to protect any financial surplus that might be generated. Aside form technical specialization, these advantages are not important in the system in China where work rules and salary schedules are centrally determined, and where transfers between the enterprise and municipal budgets are strictly mandated.

41/ For example, loan principal repayments and wage bonus may be counted as deductible costs, and separate depreciation schedules may be set for collectives.

It is important, therefore, to determine whether there are price effects inherent in the structure of the profits tax that slow the rate of increase in profits.

200. The profits tax, rules for the distribution of retained earnings and the ancillary taxes on profits and retained earnings are complicated (which makes administration difficult and perhaps uneven across enterprises) and are restrictive and burdensome in a way that may cause a dampening of enthusiasm for profit-making and/or a search for ways around the tax. A telltale sign of such a deficiency in the tax structure is when the government itself begins making special provisions to offset the undesirable features of the system, e.g., the giving of special tax incentives. This is now happening in China.

201. There are three potentially important problems with the current profits tax system. First, it severely restricts the choices which managers may make to improve the efficiency of operations. The uses of retained earnings, for example, are "suggested" (at least 60% for capital purposes, and maxima of 20% for employee welfare and 20% for wage bonus). Second, and more important, a high rate of tax is imposed on the firm, leaving a relatively small amount for investment. This is not conducive to stimulating profit-making through reinvestment, it does not provide an incentive for managerial risk-taking, and it may leave the firm with insufficient resources for expansion.

202. A third problem is that the high tax rate gives an incentive for evasion and avoidance to the enterprise. From the point of view of the enterprises, high tax rates increase the rewards for evasion. Though we have no official government estimates of evasion, and have made none of our own, we can report the results of earlier work on the issue. Based on newspaper reports and some data, Bachman is able to reach the following conclusions.

> "By mid-1982, a total of Y 2.5 billion of financial violations had been recovered by the state and this did not include the Y 1.3 billion in tax evasions uncovered. By the end of 1982, Y 3.8 billion of taxes were in arrears, an increase of 11.3% over 1981. In Inner Mongolia, "the total amount of money involved in financial violations amounted to about one-fourth of the region's annual financial revenue." It was estimated that about 40% of Shanghai's state-owned and collective enterprises evaded taxes. In Qinghai, 57% of all enterprises were guilty of tax evasion or fraud. In Liaoning a survey of 2,617 enterprises revealed that 1,311 had evaded tax payments. In ten provinces, 47% of all enterprises and 63% of all supply and marketing co-ops inspected violated financial discipline. Most of this was attributed to a lack of understanding of the law and negligence, but fraud and deliberate evasion were present also. It appeared that the harder Chinese officials looked for violations, the more they found. And from late 1980, the State Council and the CCP have authorized multiple finan-

cial investigations as the best way of cracking down on these abuses.42/

Tax Administration

203. There are a number of reasons why one might think there are weaknesses in the Chinese tax administration system (Annex 3). First, the system is very complicated and therefore not easily administered. There are three different sales taxes levied on different types of sales--including a value-added tax on selected sectors--at more than 60 different rates. The profits tax has three different rate schedules, includes six different taxes on profits and the use of profits, and it provides special treatment for industrial firms. The adjustment tax must be computed separately for every firm, and it is being phased out on a negotiated basis. The Chinese tax system is not substantially more complex than those which exist in many countries--and there is no personal income tax to administer--but it is no simple matter to efficiently administer this system.43/ It requires a well-developed assessment, collection and recordkeeping system and a highly qualified staff to do the work.

204. For the most part, the system is not self-assessed. Each firm works with its tax inspector to estimate and declare its liability in a monthly form submitted to the Local Tax Bureau; payment is then remitted to the local government.

205. Recordkeeping is a source of difficulty in tax administration in most low-income countries. One side of the problem is inadequacies in the books of account kept by the firms liable for tax. One would expect this to be a problem in China. It is virtually certain that small firms do not keep books of account that would allow assessment of modern sales and income taxes. Some would argue that there are staffing inadequacies within the enterprises which contribute to inadequate books of account. It is reported that from a national survey (based on 1978 data) of the financial and accounting personnel of 1,200 enterprises, only 22% had graduated from middle school or above and 48% had not even received short-term training in finance and accounting.44/ Provincial officials reported that the comparable percentages in Zhejiang in 1984 were 30% not having received short-term training in finance and accounting and that 13% had received professional higher education.

42/ Bachman, op. cit., p. 43.

43/ These general features are only the tip of the iceberg. The system is laced with complications, e.g., property tax is deductible from adjustment tax liability, wage bonus tax liability comes from a very complicated formula or may be forgiven by negotiations, the construction tax rate on plant expansions is lower than that on new plant, etc.

44/ Reported by Bachman, op. cit., p. 15, based on Lu Peijian "Vigorously Raise the Professional Level of Financial and Accounting Personnel," Caiwu Yu Juaiji, 1979, No. 2, September 1979.

206. The other side of the recordkeeping problem is the master file kept by the Government. The purpose of this file is to identify all potential taxpayers, record their payment history, and provide information necessary to assess their tax liability. Common practice is to identify firms by a unique taxpayer identification number. The system in most of China is a manual one which consists of a ledger book (none of the five municipalities was computerized) and there is no unique taxpayer identification number.

207. This system of taxation requires an adequate sized, qualified staff. In this case, "qualified" means an understanding of the tax laws and the capability of doing an examination of books of account. Both the profits tax and the sales tax (particularly the VAT component) require analysis of the income statements of firms and therefore some level of training in accountancy. Most low-income countries have great difficulties in recruiting a tax administration staff with such training. It appears that China faces this problem.

208. Tax administration could be a major problem in China's future. The growing private sector and especially the increasing number of small firms almost certainly suggest more difficulty in assessment and collection. The smaller firms are likely to have the least complete books of account and to be the hardest to monitor in terms of gross receipts or profits. Moreover, increased reliance on the profit motive, together with a high tax rate, heightens the rewards of tax evasion and tax avoidance and increases the workload required for effective tax administration. This problem may be exacerbated where responsibility for assessing and collecting from private firms lies with the subdistrict governments, which are less well equipped than the municipal government to pursue the hardest-to-tax sectors.

Financial Planning and Monitoring

209. Meetings with local officials and a working of the data indicate two types of problems with the system of local government financial management. The first is that the budget is not used as an instrument of fiscal planning, indeed, there seems to be little fiscal planning by local governments. The second problem is that there appears to be no system for tracking and monitoring revenue and expenditure activities.

210. Budget Consolidation. Effective local financial management begins with adequate information. Budget consolidation will generate information to answer three types of questions: How much is spent by all local governments operating in the urban area, for what purposes are these funds spent, and what revenue sources support this expenditure? To obtain such information, the following is necessary: (a) A method to net out transfers and prepare a consolidated budget or financial statement for all local governments in the urban area. (b) A uniform set of budget classifications with clear identification of capital and current expenditures by type, etc. (c) A clear demarcation among various types of taxes, charges, fees and financing from external sources. None of these conditions are met by the present system of local financial administration. There is no consolidated budget prepared by local or provincial officials, nor is there a capital budget or even a clear demarcation of capital expenditure.

211. A second important requirement for good financial planning is to track the level and rate of growth in capital expenditures, as well as the source of financing these outlays. Under the present budgetary system this is not easily done. "Capital" expenditures are reported in the municipal budget under "capital construction," but the latter includes a great deal of maintenance expenditures. There is a category "capital expenditures" included in the public utility accounts for some cities, but it is not clear that this includes only (or all) capital spending. The mission was unable to obtain an accounting of capital expenditures made by municipal public service enterprises, such as for road construction, but it appears that the financing of these companies is largely supported by general fund transfers. Proper estimates of the share of local resources allocated to capital investment are not easily made and perhaps are not made at all.

212. The same classification problem arises on the expenditure side where financial planning requires good estimates of at least the amount being spent on maintenance of the capital stock and the degree of subsidy provided to enterprises. As in most countries, capital maintenance expenditures are not accurately estimated in China. The problem with data on subsidies is less conceptual than it is reporting. The subsidy is provided to enterprises as a direct expenditure for "technical upgrading and reform," or as a more general subsidy to cover any short-term or planned long-term financial deficit of the enterprise. With respect to the latter, the subsidy is sometimes shown in the local accounts as a negative tax, sometimes as an expenditure, sometimes as both and is sometimes subsumed in "net" tax collections. If it is reported only as part of net revenues, it becomes impossible to identify the amount of transfer necessary to cover enterprise losses.

213. A special data problem has to do with provincial grants to local governments. This is important information because it allows the Provincial government to determine whether it is spending an adequate amount to support the financial position of local governments and to evaluate the degree to which these transfers equalize the disparities in fiscal capacity among local governments. Provincial officials were unable to identify the amount of grants made to local governments.

214. <u>Forecasting.</u> Financial planning means multiyear planning. This year's capital expenditures imply future commitments to maintenance, there may be prospects for a decline in the tax base, loans must be repaid, etc. It is essential that local governments make their financial decisions in light of what the future may hold. This implies the need for a multiyear forecast of revenues and expenditures. No local government we visited had done any such multiyear fiscal planning.

215. <u>Capital Budgeting.</u> A capital budget has two components. One is a multiyear capital expenditure plan with priorities clearly established and timing clearly set out. The other is a multiyear financing plan which lays out the sources of revenue support for each year. The capital budget should also acknowledge the maintenance requirements implied by any given level of capital spending activity. Without such a budget, capital facility planning becomes a year-to-year exercise. No local government the mission visited had such a capital budget. Most had some form of physical planning for capital

projects, but none had a firm financing plan. The financial side of planning is important in that it brings more realism to the physical plan and it stimulates local governments to search for ways to cover capital costs. It appears that local governments in China do not use their budgets as part of the planning process.

F. OPTIONS FOR REFORM

216. The role of local government in China is broader than that in other countries. Local government directs and regulates the activities of a major portion of the commercial and industrial sector including SOEs, and therefore manages much of the growth in its own tax base. Local government also is the implementing agency for the government's principal income redistribution programs, and assesses and collects most of the nation's taxes. Whereas in other countries such efforts by local governments might fail because of the openness of the economy, firms and individuals are not so freely mobile in China and local governments are therefore in a better position to carry off income redistribution programs. Oddly enough, it is the allocation function where Chinese local governments are less important than their counterparts in western countries: taxing powers are limited and there are considerable restrictions on expenditure choice.

217. The economic system reform is bringing some changes to the role of local governments in China and will have a considerable impact on local finances. These impacts are important considerations in evaluating proposed reforms in local and provincial expenditure and financing policy. Some possible impacts are:

(a) Giving more autonomy to enterprises will break or weaken the direct control of local governments over their tax base. It could also lessen the incentive to avoid taxes.

(b) The combination of enterprise autonomy and the switch from a remittance to a tax system increases the premium on effective tax administration.

(c) Decontrolling some input and product prices should increase the revenue buoyancy of sales taxation.

(d) Increased wages and rents will increase the tax-paying potential of households.

(e) If enterprises become more self-reliant in choosing and financing their investments, local and provincial governments may redirect their capital expenditures away from directly productive investments and towards infrastructure.

218. In this context, what should be the direction of municipal and provincial fiscal reform in China, i.e., what should be the goals and priorities that lead the changes in the local financing system? In line with the system reform, one might think in terms of four objectives. The first is to increase the overall level of resource mobilization for urban infrastructure maintenance and construction. Second, tax administration practices and tax policy

changes at the local level should support the Government's program of strengthening the efficiency of enterprises. Third, the administrative efficiency of the tax system should be improved and modernized. Fourth, the local government tax and expenditure systems should be made more efficient by creating a more decentralized local financing system, i.e., one that gives a formal method to permit some variations in tax and expenditure patterns across and within urban areas.

219. The foundations for a fiscal reform at the subnational government level are now being laid in China and the central government is considering a number of reform measures. Among these fiscal reform options are more taxing powers for local government, a revision of the tax-sharing system, the institution of new methods of infrastructure financing, improved fiscal planning and a strengthening of the local tax administration.

Increased Local Revenue Raising

220. Giving local governments the power to set tax rates is one reform possibility that would fit the objectives outlined above: it could raise more revenue and if imposed at local option rather than at mandated central rates, it could make local officials more accountable to their constituency and stimulate the tax enforcement efforts of local governments. In short, it could lead to a more decentralized fiscal system. Such a program could also promote efficiency in the size distribution of cities, and in the distribution of economic activity within urban areas. This is because local tax rates can reflect interregional variations in the cost of providing infrastructure and public services, as well as intraurban variations in the quality of public services offered or in the cost of locations occupied.

221. Most prominently mentioned by government officials in this connection is a land-use tax or a land-use fee. While this seems the most likely possibility for a new tax to be levied at the option of a local government, it is by no means the only alternative. A local surcharge on the profits or sales tax and increased user charges should also be considered. A more radical option is a separation of central-provincial-local taxing powers with designated taxes assigned to each level.

The Land-Use Tax or Charge

222. There are now proposals at the central government level to enact a land-use tax or charge in urban areas. On June 25, 1986, a Land Law was passed, authorizing the imposition of a charge for the use of urban land. However, there is not yet a clear definition of rate, base, implementation, etc. The matter is now under study in the Ministry of Finance and MURCEP, under the direct supervision of the State Council, and experiments and basic research are underway in several cities.45/

45/ Fushun is the only city authorized to levy a land-use fee, but MURCEP officials report that over 90 cities and 100 counties are now experimenting with some form of land-use charge.

223. The rationale for levying a land-use tax or fee is straightforward. Land is owned by the State and has a location value; therefore, it seems appropriate to charge for its use and to have the charge vary by location. Theory tells us that if an enterprise does not pay such a tax or fee, it will overuse land relative to other factors of production. The impression among many Chinese officials is that this is exactly what has happened. They argue that one can observe industrial firms occupying prime commercial locations and that enterprises often do not use land as intensively as they should. Some form of tax or charge on land use, if levied at a high enough rate, could force enterprises to consider the cost of the land.

224. Another part of the justification is that the location benefits of land are partly (largely) due to government investments in infrastructure and public services. Why should a commercial shop earn and retain extraordinary profits because it had been assigned a location on a main road with street lights, a major bus route, etc. The part of profits that can be attributed to better public services should be taxed away. This would remove the unfair competitive advantage that some enterprises now have. The third justification for the land-use fee, and not the least important, is as a revenue-raising measure.

225. Those not in favor of the land-use charge use two arguments. First, profits are already taxed at a high rate <u>and</u> there is an excess profits (adjustment) tax. Surely this already taxes location rents. Second, enterprises cannot afford the land-use tax and many will be forced into a loss position. Indeed, some already are loss-makers. There are good counters to both of these arguments. The adjustment tax is being phased out and will not be replaced by another tax on excess profits. On the question of affordability, the very idea of the tax (charge) is to make the firm reconsider its use of urban land. If the tax is kept low enough to be affordable by all, very little reconsideration will go on.

226. The problem with a land-use tax is probably less with its justification in a socialist economy and with how it fits in the system reform, than with its implementation. How does one assign property and location value when there is no formal market in which land is bought and sold? And how does one employ taxation to induce a better use of urban land when enterprise location mobility is very limited? Finally, there is the question of the adequacy of the existing cadastre and the sheer problems of recordkeeping.

227. The Chinese are confident that the implementation problems can be overcome and the debate seems to be centering on policy issues--how the tax will be structured. These issues are being addressed in a series of studies underway in China. A MURCEP working group is considering general issues as is a MOF study team. The Shanghai and Beijing municipal governments have carried out case studies and the World Bank and CASS are involved in a joint research project on land-use taxation.46/

46/ The World Bank and the Chinese Academy of Social Sciences "Paying for Land Use in China," draft, September 1988.

228. (a) Rate and Base Structure. Decisions about rate and base have not yet been made but there seems to be general agreement that the base of the tax will be land area. The tax will be specific rather than *ad valorem*, i.e., it will be levied at some rate per square meter. Even though a land (or property) value will not be developed for each property, the location value of land will be roughly reflected in the tax. This will be done by developing a kind of index number that would establish the relative value of properties in different areas of the city. The authorities could then assign a value per square meter to each area of the city and subject every property in the area to that charge.

229. Shanghai and Beijing research studies have already considered the possibility of applying different rates of tax or charge to various types of commercial, industrial and residential property. Under such schemes the residential sector receives a substantial tax preference, or is exempt, and enterprises pay the bulk of the tax. In order words, it could be a "classified" property tax such as that imposed in much of the United States.47/ While classified property taxes may fit some notions of ability to pay--large commercial shops have a greater taxable capacity than warehouses--they also send some other signals to those choosing a business location. Lower-taxed activities in prime locations will receive a subsidy relative to more heavily taxed (and presumably more profitable) activities. Such a subsidy will dampen the potential allocative effects of the tax by removing some of the tax penalty for a suboptimal use of urban land. Moreover, a classified property tax can be very complicated since there would be one rate for each type of property in each zone. In the Shanghai study, where this approach was taken, the analysis was based on more than 30 different rates.

230. How will the tax rate be determined? There apparently has been a good deal of discussion about using this tax to provide some local government fiscal autonomy. To allow local governments to set the tax rate would be a major departure from present practice where local governments have no significant rate-setting autonomy. MURCEP officials felt that local governments should be permitted to make the decision on the tax rate but that the upper and lower limits should be prescribed by the central government. The Ministry of Finance has a similar view. Whether local governments get rate-setting autonomy or not, however, they will have a measure of control over the workings of this tax. Administration, and particularly the determination of the tax base--keeping the cadastre, identifying the value zones, updating land value or rent estimates--will be left to the local governments. Therefore, the local governments will play a major role in determining the allocative effects of the tax and its revenue success.

231. (b) Earmarking. As to how the new revenues will be spent, the logical candidates would seem to be general purposes or earmarked for infrastructure. Many of those interviewed felt that the Urban Construction Bureau of the municipal government should collect the land-use fee and that it should be

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47/ Under a classified property tax, the effective rate of taxation varies according to the use of the property. In the United States, this usually means a lower rate for residential and agricultural uses and a higher rate for commercial and industrial uses.

earmarked for capital purposes. Hence, it would supplement the UMCT as a source of capital finance. In some ways this is appropriate since the location value of land is significantly influenced by the availability of public infrastructure services. On the other hand, earmarking reduces the flexibility of the local government to allocate its resources where they are most needed and amounts to a forced discipline on local governments. One might question whether this is necessary in the Chinese setting.

232. (c) Revenue Yield. What is the revenue potential of the land-use tax? This is a difficult question to answer. One tact is to assume that it will be borne out of profits and to ask what reduction in net profits is "affordable." The answer in Shanghai was that an effective tax rate on the order of 2 to 3% of profits was affordable. This led the researchers to propose a rate structure that would have yielded only Y 300 million in 1985, i.e., an amount equivalent to about 1% of total taxes collected by the Shanghai municipal government. A similar target was proposed in the Beijing study. These would seem to be very low-end estimates of the potential yield of the tax. Moreover, because of deductibility there would be offsetting revenue losses at the provincial and central government levels.

233. An important consideration in assessing revenue yield is whether the land-use charge will be treated as a tax or a fee. As a fee, it could be levied by the local government as an enterprise user charge and the revenues would not be divided between provincial and central governments. As a shared tax, revenues would have to be divided between the central and provincial governments. In either case, the burden could be partly shifted away from the local area.

234. (d) Allocative Effects. The hope is that a tax on land use, if it could not be passed forward to consumers, would force users to choose more profitable locations and a "better" distribution of land use would result. Whether such land-use effects would actually result depends on three considerations. The first is whether there is some mechanism for enterprises to sell or trade property rights and choose alternative locations. Land-use effects require that firms be mobile and that they be able to choose among alternative locations. At present, the allocation of land to enterprises is made by the municipal governments and enterprises may not buy or sell land freely. However, transfers of land between enterprises are possible with municipal government approval. The problem is that the process of changing location is cumbersome, and it is required that compensation be paid to dispossessed enterprises and workers. Our interviews suggested that enterprises did not commonly have the funds to pay the compensation and build the new plant.

235. The second consideration is whether enterprises would be able to avoid the tax by passing it forward in the form of an increase in product price. If so, there would be no real incentive for a firm to move from a high-tax cost to a low-tax cost location. Moreover, as is shown in the numerical example above, some of the increased tax on the enterprise can be cushioned through deductibility and a lower profits tax. For example, under plausible assumptions we might conclude that each Y 100 land-use charge leads to a tax burden increase of about Y 30 for the enterprises. In order to have an effect on land-use decisions, then, the land-use charge may require a high

nominal rate. The third consideration is the level of the tax rate itself. At a low enough rate, the land-use tax could not have important allocative consequences, i.e., even if enterprises were free to move, and even if the tax could not be passed on, the penalties for a "bad" land-use choice would be small.

236. If the land-use tax were successful in its mission to make the use of higher-valued land more intensive, one would expect to find larger buildings, less residential land use, and less unplanned open space in central areas. A high-rate, land-use tax would probably also promote employment decentralization within the urban area as it forced every enterprise to pay the higher cost of more centrally located and better serviced sites. It is important to note that there could also be undesirable allocative consequences. If the land-use fee affected plant and housing location choices, it could affect the demand for public transit and possibly increase the length of the journey to work and congestion. Moreover, there is the larger question about whether society gains from charging the right price for land when services such as transport and housing are improperly priced.

237. (e) Equity. The land-use tax should also be evaluated according to its equity or fairness. Of course, the tax cannot finally be paid by a business--it must be either shifted forward to consumers or backward to labor. If the tax is passed forward in higher prices, it will fall on those who consume goods produced in the taxed sector. More likely, however, it will not be passed forward completely because prices will not be allowed to fully respond. As regards backward shifting, the final incidence pattern is very difficult to sort out. Part of the burden will be borne in the form of lower retained earnings than otherwise would have been the case and consequently there would be reduced wages, worker benefits, and enterprise investments. Complicating matters is the fact that the land-use tax payment will be partially offset (via deductibility) by a reduction in the profits tax. Much more work is needed to sort out this set of incidence effects.

238. (f) Administration. Evaluation of the land-use tax should also consider administrative feasibility and cost. *A priori*, one might expect that the land-use tax could raise major administrative problems. Certainly it implies preparation of tax maps and registries which identify and measure every property, and identify every user. If buildings also must be measured, and their general condition determined, the administrative costs multiply. Moreover, how will a set of "value zones" be determined, so that each parcel may be assigned a tax rate? This seems an especially formidable problem in a country where there is no formal land market, no staff trained in modern property tax administration, and possibly no up-to-date cadastral maps that are matched with the names of current occupiers. The property tax assessment process is subjective in its best forms and without a strong administrative structure can become very arbitrary and unfair.

239. These administrative problems are real enough, but are not insurmountable. Chinese officials feel that land records are in reasonable shape and that the central government could provide important technical assistance in establishing the assessment system. MURCEP expected that a special state land management bureau might be created to assist in the recordkeeping and to

lay the groundwork for an effective administration. They also felt that a cadastre may already exist in many if not most cities.

240. Still, experience in other countries has shown that even in the best of circumstances, good property tax administration can be an expensive proposition. If a high administrative cost is the case in China, one might argue that the land-use tax can be justified only if it is levied at a high enough rate to be a substantial revenue producer. MURCEP takes issue with this point and argues that the tax cannot be large in amount. The reason they give is that land prices are low and that enterprises could not absorb a high rate of tax without price adjustments. Consequently, they urge that it be a "small" tax, probably yielding less than the urban maintenance and construction tax. This raises a key question. Why set up a potentially cumbersome new administrative mechanism to collect a relatively small amount of revenue?

241. In sum the land-use tax presents an important quandary to local officials. The central issue is what is to be accomplished with this tax. If the idea is to raise money, improve the allocation of land among various uses, and give local governments some revenue autonomy, then one can justify the increased administrative cost by levying the tax at a high enough rate to make it a substantial revenue producer. To allow enterprises to pass the tax on in the form of higher prices or to give preferential tax treatment to certain uses (housing) would defeat the revenue raising and allocative objectives of the tax. It also seems clear that the allocative objectives of a land-use tax can only be served properly if the government moves to get other prices "right," e.g., public utilities, housing, transportation, etc. Finally, underlying any thought of using a land-use fee to raise revenue is the need to establish some form of land market or at least develop the mechanism for the trading of property location rights among enterprises. A tax on immobile firms could raise significant revenue but it would not cause any improvement in the distribution of land uses, and it would be partially paid out of reduced profits taxes.

242. If the tax is levied at a low rate to avoid undesirable price effects, as some have argued it should, then it may be a much less interesting proposition. It would raise less revenue, have little effect on allocative decisions, and would require the government to put in place an administrative machinery. As a pure revenue measure, a surcharge on the profits tax or a higher UMCT rate would be a better way to go.

A Local Surcharge Option

243. As an alternative to designing a new local tax, municipalities could be given the option of taxing the present bases at a prescribed higher (local) rate. For example, an additional percent on the sales tax or profits tax base could be imposed at the discretion of the local government. This approach has obvious advantages of administrative ease (especially when compared with the creation of a new land-use tax) and it would grant some local government autonomy.

244. Whether sales or income based, the mechanics of a local option surcharge are straightforward. The tax rate is *ad valorem* and may be taken

either against taxable profits/taxable sales or against tax payment liability. The difference between the two is that special tax incentives might be disallowed in the former case, and of course the nominal rate of tax (for equal revenue yield) would be much higher in the latter case. A "local option" feature would enable the local government to choose the level of a surtax rate. To maintain some central control, the surtax rate might have a required minimum and a maximum. Moreover, local governments could alter their own base through preferential treatment of enterprises, but could not alter the central government tax base. An example of how the system would work was described in Chapter III, Main Report.

245. There are disadvantages to a local option tax. One is that governments with stronger economic bases are given an extra advantage over poorer local governments in that they can collect more revenue at the same rate. The advantage of more prosperous cities under both taxes would be further compounded if it were able to "export" a greater share to foreigners or to consumers who reside elsewhere in the province or the country. Another disadvantage is that the local and higher level governments would be placed in a position of competing with one another for the same tax base. Central governments with deficit budgets may see this as giving up some potential for revenue mobilization.

246. On the other hand, the surcharge has great advantages over the alternative of designing and implementing a new tax. The administrative structure to assess and collect the tax is in place and it can be a substantial revenue producer. Moreover, it is a way to give local governments some revenue autonomy, if the surrate were to be levied--within prescribed limits--at the option of the local government. Compared to a low yield land-use tax, a profits or sales tax surcharge are clearly superior as revenue-raising measures.

247. Which is the better choice, a sales or a profits tax surcharge on enterprises? In capitalist economies much of the debate would center around which tax would most compromise the ability of the local area to attract new business. An added issue for the business income tax is how to prorate profits among locations in the case of multiplant firms. The most important issue, though, is that the sales tax is levied on the value of total output and ignores both ability to pay taxes and enterprise efficiency whereas the profits tax is a narrower ability to pay levy. In China, one could make strong arguments for the sales tax: (a) more firms would be covered, and this would better fit the use of the revenues to provide local benefit services; (b) more efficient enterprises would not be penalized with a higher tax and this would better fit the objectives of the system reform; and (c) local accounting practices are such that total output value can probably be estimated more accurately than total profits.

248. Under either form an important problem to overcome would be the temptation for a higher level government to offset the revenue gains of local governments that were particularly successful with the tax. A local option surcharge would have to be coordinated with a revision in provincial-local fiscal relations. It would make little sense to give a municipal government the option to levy a higher local tax and then have the provincial government allocate resources away from the municipality by adjusting the sharing rate on

other taxes. The municipal government revenue-raising objective would be defeated. A better strategy would be to redefine the shared tax system to maintain neutrality if not to reward those local governments who choose to levy the local option tax.

Increased User Charges

249. A third option for giving local governments more autonomy and for generating more local resources is increased user charges to cover the cost of urban services and to charge users for the benefits they receive. The areas most prominently mentioned in this regard are bus services, water supply, gas and housing, where present charges are nominal. On the surface, increased user charges might be seen as a way of covering the cost of certain services and freeing general revenues for other purposes. However, the situation in China is more complicated. User charge financing of public services will lead to more efficient levels of service provision, but it is not clear how much of a revenue boost local governments will receive. Consider the case of housing. Housing reform would raise rents to economic levels but would also require increases in wages and would shift some of the burden for housing investment and maintenance to the household. From the point of view of the local government and the enterprises, wage costs would be higher but the increased rent payments would cover a larger share of housing maintenance expenditures. As wage costs rise, profits tax liability would be reduced and the net effect could well be a transfer of resources from the general public budget to housing.

250. More generally, there are three parties to be considered: the municipal government, the public utility company, and the enterprise (suppose, for the moment, that it is not planned to increase the user charge on households). An increased user charge on enterprises, because it is a deductible cost, would lower their profitability and therefore reduce the profits tax. This would be partially, but not completely, offset by an increase in sales tax revenues from the public utility enterprise. The public utility company, on the other hand, would realize an increase in profitability (partially offset by the increased sales tax) and therefore would generate an increased profits tax payment to the municipality. However, public utilities are taxed at a preferential rate in most provinces. The municipal government may well receive a net reduction in revenues if public utility user charges were increased. However, it also could be that the improved financial position of public utilities would result in their having more resources to devote to capital improvements and therefore to a lesser drain on general municipal revenues. That is, where local government subsidies to the utilities have been necessary, increased user charges will relieve some pressure on the general municipal budget. It is also important to note that the increased rate or charge could result in better services from the utility and it could impose a kind of self-rationing on consumers.

Tax Assignment

251. Another possibility for achieving fiscal decentralization and increasing subnational revenues is to assign taxes to either the provincial, municipal or central government level, e.g., the entire amount of profits tax

revenue would accrue to the municipality, all sales taxes would accrue to the central government, etc. There are advantages to this approach, which is followed in many countries. Local governments could be given control over the tax rate and base. Within some limits, they would finally have formal taxing autonomy. Local residents and enterprises could clearly identify with "their" tax and could more easily hold local officials accountable for the level of the tax rate and for the efficiency with which the revenues are spent.

252. There are also disadvantages. One is that local autonomy will bring some diversity and nonuniformity. Tax rates and the quality of public services will vary across municipalities, and these variations will be related to the taxable wealth of the community. Natural resource endowments and existing infrastructure are distributed unevenly and some communities will inevitably be disadvantaged. This almost certainly will lead, as it has in other countries, to a program of compensating grants. The trick is to design a compensating program that will equalize while neither killing the incentive to mobilize more local tax revenues nor eliminating the diversity in tax prices that are necessary to help shape an efficient spatial distribution of economic activity. As the experience in many countries will attest, designing and implementing such a system is a very difficult proposition.

253. Another major disadvantage of the assignment solution is tax administration. Such a program would call for a separate administration of central and local taxes. This involves an inefficient duplication of activities and further strains the use of scarce technical manpower.

254. A third major issue is what tax will the subnational governments be given? In practice it is not likely that the Central Government would relinquish control over either of the two major taxes, and it is not at all clear that it should. The sales tax is the major revenue producer in China and will almost certainly not be decentralized. Few central governments do not levy a general sales tax,48/ though many share the proceeds with subnational governments. The profits tax raises another set of problems. It is needed by the Central Government for stabilization purposes and for use in stimulating investment and output in "target" sectors. As a purely local government revenue, it would raise other problems. Local government budgets would be at the mercy of the potentially erratic behavior of profits and the sensitivity of the tax base to changes in central government macroeconomic and pricing policy, and those local governments with relatively few profitable enterprises would be sorely disadvantaged.

Increased Subnational Tax Shares

255. Another way to increase subnational revenues is simply to change the sharing formulae, i.e., to allow the provincial and local governments to retain a greater percentage of what they collect. Increased local tax shares is an interesting possibility as part of a reform program for local government finances. Its possible effects, however, are uncertain and require further analysis. The central government is already moving in this direction by increasing the marginal retention rates for provinces with a greater taxable

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48/ The United States is the most notable exception.

capacity, and by entering into special contracting arrangements with certain provinces (e.g., Shanghai). With respect to municipal and county governments, this reform presumably could be accomplished without central government approval, because the formulae are fixed at the provincial government level. Certainly, there is a precedent for using the sharing rate as a policy instrument within provinces. In virtually every province, there are wide variations in the retention rate. Low income counties and municipalities usually are given a higher share, and "special incentive programs" give higher shares to targeted local governments.

256. There are some advantages to this approach to generating more revenues for local government purposes. Most important, it would keep a substantial amount of revenue at the municipal level and therefore increase the amount available for allocation to capital projects. This approach could also stimulate municipal governments to increase their rate of collection. At present, Hangzhou, the capital city of Zhejiang, retains for its own purposes only about Y 28 of every Y 100 in budgetary revenue it collects. Nanjing, the largest and wealthiest city in Jiangsu Province, retains about 27% of its shared tax collections, as compared to over 50% for the entire province. Hefei retains about 22%, by comparison to 80% for the whole of Anhui province. A greater local tax share might create more of a sense of local autonomy as local residents identified the profits and sales taxes more as local revenue and less as intergovernmental transfers. More important, local officials would be given a greater incentive to improve their tax administration efforts. A combination of the system reform which passes more autonomy and responsibility to the enterprises, and an increased sharing rate, would reduce the gains from collusion between the local governments and the enterprises and would likely increase overall resource mobilization.

257. The proposal for an increased local tax share also has serious drawbacks. From the point of view of the central government, an increased share to the provinces might be seen as a further drain on total revenues, and an exacerbation of the central government's budget deficit problem. Moreover, in reducing the pool of funds available to the central government, it constrains the government's ability to equalize resources through a grant system. A similar problem arises with respect to provincial governments. An increased municipal tax share would reduce the Provincial government's "distributable pool," its ability to reallocate revenues among local governments in the province, and ultimately the importance of its fiscal role in the Chinese system of public financing. This proposal would involve a trade-off between encouraging more revenue mobilization by local governments on the one hand, and the redistribution of more funds from richer to poorer areas by provincial grants. It could well be counterequalizing.

Reforming the Present System

258. All of the schemes reviewed above are based on incentives of one kind or another: increased tax retention rates to stimulate more local effort, increased user charges to tap the willingness of beneficiaries to pay for public services, etc. All would be substitutes for the present incentive scheme which in effect lets local governments reduce the overall tax burden by *ad hoc*

tax incentives to enterprises. An alternative approach is to continue the present system.

259. Among its advantages are that it fits the goal of decentralization and recognizes that provincial and local governments are in the best position to know how to provide tax relief to stimulate the local economy. It also leaves it to the provincial and local governments to decide what type of tax relief is best, i.e., a contract to stimulate production, a holiday to protect a pioneer industry, a one-year abatement to help an enterprise through a cash flow problem, etc. There is an efficiency case for the ad hoc approach since each local government is able to trade between preferential tax treatments and revenues for general government services.

260. On the other hand, there are arguments against the ad hoc, decentralized approach. First, this approach reduces rather than increases general revenues of local governments, at least in the short run. Moreover, the local government decision to reduce the shared profit or sales tax burden of an enterprise also reduces provincial and central government revenues. Second, because it is an ad hoc approach, it produces a very uneven pattern of effective tax rates across enterprises. Whether this pattern of horizontal inequity is acceptable depends on the objectives of the local economic plan and on whether the local government tax officials have enough information to fine tune the distribution of tax burdens to fit some objective. A third problem with the ad hoc approach is that it is not conducive to developing an efficient tax administration. Proliferation of special treatments for enterprises makes the tax system more complicated and more difficult for local officials to administer. Moreover, there is almost certainly some tendency to be lax in assessments when there are so many possibilities for special treatment.

261. But perhaps the most damning criticism of the ad hoc approach is that it destroys the notion of a system of taxation. The central government increasingly discusses the possibilities of using the tax system as a "lever" to influence economic activity. However, if local governments can change the distribution of the pattern of effective tax rates without clearing such changes with higher level governments, then the intent of using the tax system to influence economic activity can be defeated. In this case there is a direct trade-off between the central government's objectives to indirectly control the allocation of resources in the economy, and decentralization in the form of power to grant tax incentives.

262. The central policy question becomes whether it is possible to grant local governments some increased powers as incentives to increase revenue mobilization, and at the same time to allow them to retain the power to grant abatements, holidays, contracts, etc. To the extent the government's objective is to create more uniformity in its system, the proper strategy is probably to move toward eliminating the ad hoc power of local government to influence the distribution of effective tax rates. To the extent decentralization is more important than the use of taxes as an economic level, there might be some argument for a continuation of the present practice. The granting of increased taxing powers and a continuation of the present ad hoc practices, however, are not compatible.

Borrowing and Self-Financing

263. Local governments in China make relatively little use of borrowing to finance capital projects. There is no formal, regular program for lending to local governments, e.g., a revolving fund or a specialized local government loans authority.

264. In most countries, some use is made of debt to finance infrastructure development in urban areas. Capital projects are long-lived and it is appropriate to pay for their use over a period of time, providing of course that the borrower (the local government in this case) has a sufficient capacity to repay the loan. Typically, local governments must borrow in a prescribed way from a central government loan fund. These funds are usually capitalized by the central government, distributions are controlled by central government regulations, and in some cases technical assistance is provided for project preparation. There are many such schemes but their common feature is that the central government sets the terms of the loan, defines the acceptable uses of debt finance and controls the flow of loan funds. There is quite a different situation in the United States where state and local governments are given a great deal of autonomy in deciding how much to borrow, under what terms and from whom.

265. There is clearly a potential for debt finance by local governments in China. Some local governments have an adequate repayment potential for long-lived municipal projects, and the debt could be serviced directly from general revenues or from some combination of general revenues and benefit charges. There is some use of self-financing of this type, but it tends to be ad hoc and is not looked to by municipalities as a general method for financing capital projects.

266. To move forward with borrowing and self-financing (benefit charges) as methods to stimulate local resource mobilization and local capital investment, the Central Government will have to take the lead. Some form of national or regional (Provincial) loans authority could be established, with commercial-type rules for the distribution of funds. Such an agency would require a staff qualified to assist municipalities in preparing project applications and financing schemes, and to evaluate repayment potential. There are a number of possibilities for capitalizing such a program: an earmarked tax, deposits from provincial enterprises, the cash balances of local governments and the Provincial government, and a central grant.

267. A key question in considering the viability of a local government development bank is whether local governments have a capacity to repay the debt they incur. In general, there are two sources from which loans may be repaid: general revenues and beneficiary charges. For the municipalities which have been studied in the course of this research, we may say that revenues have increased in real per capita terms, though perhaps not in proportion to the increase in real personal income. This would seem to indicate a capacity to repay debt, though it may imply that local governments would have to shift priorities from current to capital purposes. One might also conclude that the capacity to repay debt could be substantially enhanced by a reformed system of municipal financing--taxes that were more responsive to income

growth and user charges that better reflected the marginal cost of services provided.

268. The other capital financing possibility is self-financing, i.e., municipal loans can be repaid in part by beneficiary charges. These charges can take many forms. In some countries, the government captures a share of any increase in land values that results from a public investment. For example, when a new road causes adjacent land values to increase, a special tax may be levied on the increase (or betterment). In China, at present there is no mechanism for land value increment taxation, but a properly designed land-use charge might be used to capture some of these benefits. There are many other forms of benefit charge, e.g., road and bridge tolls, pollution charges, full cost recovery from public utility users. Indeed, while there is no formal benefit charge program in China, there is plenty of evidence of innovative self-financing schemes. Many local governments have taken advantage of particular opportunities to finance capital projects with charges to beneficiaries, but these seem to have been developed on a case-by-case basis and there is no common practice.

269. The time is right for China to make increasing use of benefit charges. Infrastructure is short and enterprises are willing to pay for capital improvements. Moreover, the system reform will result in increased savings by enterprises, hence an increasing capacity to pay a benefit charge for appropriate capital investments. What is needed now is central government guidance in establishing such programs and encouraging their use.

Budgeting and Planning

270. It can be properly concluded that fiscal planning at the provincial and local government level is less well developed than it should be in China. A first step to modernizing the fiscal planning process would be to alter the structure of the local budget to make it a tool that could be more effectively used for planning and control. Some immediate steps in this direction would be to:

(a) clearly delineate current and capital expenditures, and separate capital construction from capital maintenance expenditures;

(b) show price subsidies to enterprises explicitly, and show transfers to enterprises as separate expenditure items rather than as reductions in total taxes collected;

(c) prepare separate financial statements for each enterprise and clearly show actual total costs and subsidies received from the government (including the tax subsidy);

(d) prepare a consolidated local government budget that includes public utilities, extrabudgetary funds and the general municipal budget, where all transfers have been netted out;

(e) the Provincial government should prepare a statement of intergovernmental flows: taxes received and grants/subsidies paid to each local government. In this way, the net flow of resources can be traced and the impact evaluated; and

(f) provinces should keep central records on the fiscal activities of all local governments, and should make these accounts uniform. These data could be used as basic information in revising and monitoring the revenue sharing system and in comparing and evaluating the debt repayment ability of local governments.

271. Municipalities should prepare five-year revenue and expenditure forecasts to study the potential impact of future changes in the local economy or in government policy, and five-year capital budgets that include both capital expenditure priorities and a financing plan. The Central Government should take the lead in assisting local governments to work out the detail of these fiscal planning models. They should be formally linked to the local and regional economic plans.

Tax Administration

272. The present system of tax administration will not support the objectives of China's economic reform. China's tax structure has very recently been modernized (a profits tax and a value-added tax have been installed since 1984) but its tax administration has not kept pace, i.e., there does not appear to have been a recent program to update the administrative procedures and the training. The new system seems to be operating with much the same type of staff and under much the same procedures as when the major revenue instruments were profits remittances and an extended excise system.

273. If there is now a tax administration problem in China, it may get worse. The growing number of small private firms and collectives--which are the hard-to-tax sectors in China--suggests an increased opportunity for evasion and a much more difficult administrative task. Moreover, the system reform calls for more autonomy for enterprises. On the one hand, increased enterprise autonomy reduces the likelihood of collusion since local governments will now gain less from a reduction in the enterprise tax burden. Moreover, there will be a more formal separation of the local government from enterprise managers and their accountants and this will shift the nature of the tax from self-assessment to central assessment or at least central monitoring. This should improve tax administration. On the other hand, enterprises may now retain profits for investment and worker benefits, hence there are new incentives to reduce the tax burden through avoidance and evasion.

274. These are more statements of impression than the results of analysis. Without a survey of administrative problems, it is difficult to even suggest the elements of a reform program. One might, however, think of four areas where investigation might be made. The first is whether the government's personnel policies and training programs have led to an adequate number of qualified tax administrators. The second has to do with whether the administrative system has been adapted to accommodate the changing economic system. For example, a growing private and collective sector implies a greater need to identify enterprises and track their activities, hence the need for a taxpaying numbering system, more information on transactions, more government

attention to assessment and audit, and computerization. Third, there is the question of whether the structure of the tax system is so complicated that it blocks effective administration. This problem would suggest that the first step toward a better administration is a simplification of the tax structure.

275. The fourth area is the most difficult to address. If there are not to be separate central and local taxes, should the government create a central tax administration similar to that which exists in most countries? The arguments in favor of this are strong. Under the present system where the local governments must surrender a majority of the tax they collect, there are disincentives to aggressive assessment and collection efforts. A centralized system would eliminate these disincentives by taking local governments out of the business of collecting central government taxes. Another advantage of a central tax administration is that procedures could be standardized across the country and the processes of manual preparation, monitoring, and gathering and reporting statistics would all realize economies of scale. The central government is more able to bring specialized technical assistance to the whole system of tax assessment and collection, and is in the best position to modernize the tax administration to keep it in step with the modernization of the tax structure. It is important that China's new tax structure be implemented so that it achieves the intended economic impacts, and that it be implemented in a uniform way across the country. Finally, there are a number of advantages to centralization that relate to the staffing of an efficient tax administration service. Among these are the advantages of central organization of the training programs, the ease of transferability of personnel within a centralized system, and the greater possibility of promotion and advancement within a central revenue service.

276. There are also disadvantages with a central tax administration service in China. If coupled with increased local fiscal autonomy, there would have to be a local tax administration. Separate central and local systems would involve duplication of effort and inevitably a weaker, "second-class" local administration. Another problem is that a central revenue system in China would be an enormous bureaucracy, and inevitably would have to decentralize to accommodate the great diversity in tax administration needs within the country. The biggest disadvantage to centralization is that intimate familiarity with the local economy and its tax-paying base can be lost. For example, most central sales and income tax systems in low income countries do not have a very broad coverage of firms, whereas locally administered systems seem more able to identify and assess smaller firms.

277. Perhaps a better course would be to reform the tax administration to capture the best features of centralization and decentralization. A few principles that might be considered in thinking about such a reform are as follows:

(a) general procedures for taxpayer identification, recordkeeping, and assessment should be centralized, and all related manuals should be centrally prepared and updated;

(b) a major staff training program should be centrally designed and implemented;

(c) a "statistics of taxation" series should be organized centrally and regularly produced to help in monitoring the performance of the tax system and the administrative efforts of each decentralized local unit;

(d) assessment, collection and audit responsibilities should remain at the local level, but procedures should be established by the Central Government and regulated through the provincial level; and

(e) tax sharing is a good scheme to stimulate local tax effort but the local shares should be the same for all taxes so as not to encourage different levels of administrative effort for different taxes.

Annex 3 pursues this matter in more detail.