China: Evaluating the Impact of Intergovernmental Fiscal Reform

Fiscal Decentralization in Developing Countries

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2

China: evaluating the impact of intergovernmental fiscal reform

ROY W. BAHL

In China's fiscal system, the distinction blurs as among tax policy reform, tax administration reform, and intergovernmental fiscal reform. So linked are they that changes in any one of the three legs of the public financing structure will automatically affect the other two:

- all tax rates and bases are centrally determined, so structural changes have direct impacts on local as well as central government revenues;
- revenues from these centrally determined taxes are shared between the central and local governments, partly on a derivation basis with the retention rates varying by tax, and partly in the form of an *ad hoc* grant;
- the tax administration system is decentralized enough that local governments have derived some fiscal autonomy from a creative implementation of the tax assessment and collection system.

The comprehensive fiscal reform in China in 1994 altered the structure of the major taxes, changed the responsibilities for tax administration, and modified the revenue-sharing arrangements. It also curtailed the ability of local governments to use "back-door" approaches to revenue mobilization. As a result, the entire intergovernmental system was redefined. This chapter is an attempt to evaluate the impact of these changes.[1]

In the next sections, the Chinese intergovernmental fiscal system before and after the 1994 reform is described and the underlying revenue concerns that drove the reform are considered. Most of the remainder of the chapter is an evaluation of the impacts of the 1994 reform on the intergovernmental fiscal system.[2] A concluding section presents a summary comparison of Chinese fiscal decentralization with the world practice.

Revenue structure

The Chinese tax structure is highly centralized, with the rates and bases of all taxes in the system set by the central government. However, the enterprise income tax and sales taxes together account for about 90 percent of

Table 2.1. *China: distribution of budgetary revenues, 1992 and 1995 (percentages)*

	1992	1995
Industrial and commercial taxes[a]	68.1	76.0
Tariffs	6.5	4.8
SOE income tax	19.0	12.6
Collective income tax	2.9	2.0
Other	3.6	4.6

Note: [a] Primarily sales taxes.
Source: Statistical Yearbook of China, 1996.

total budgetary revenue (table 2.1). The other thirteen taxes in the system give considerably less than 10 percent of total revenues, with the balance coming from miscellaneous non-tax revenues.[3] With the enterprise income tax in decline, and the individual income tax very narrowly based, China has moved to heavier reliance on sales taxes. By 1992, indirect taxes accounted for more than 70 percent of total collections.

Enterprise income tax

Before the 1994 reform, income tax on enterprises comprised a family of taxes. There were separate tax treatments for large state-owned enter-prises, small state-owned companies, collectives, individual household enterprises, joint ventures, and foreign enterprises. There were five differ-ent rate structures, and differences in the definition of the tax bases for the several surtaxes applied. Taxable profit was defined as the difference between gross sales and allowable costs, but there were some notable departures from the conventional practice; for example, repayment of loan principal was an allowable deduction, the depreciation deduction was an actual cash expense, and bonuses and some fringe benefit payments were not allowable labor cost deductions.

A combination of this complex tax structure, the uneven quality of record-keeping by enterprises, and the manually operated collection, assessment, and audit system made this an especially difficult tax to administer. To complicate matters further, most state-owned enterprises did not pay according to the legal rate schedule, but according to a con-tractual arrangement with the local government.[4] This "contract," agreed to by the local government administration and the enterprise (but not by the central government), usually required the enterprise to pay a quota amount of tax or to guarantee a quota level of taxable profit. In effect, contracting was a step backward to the time when enterprises were not taxed but paid their profits to the government sector.

Not only did these practices affect the efficiency with which the economy operated, but also they had built-in biases against some provinces and in favor of others, depending on the structure of their economy. Those provinces with profitable enterprises of course did better, and those with a greater concentration of state-owned enterprises were favored because the tax system did not fully reach the collective and private enterprise sectors. Moreover, provinces with more profitable, state-owned enterprises were in a position to use preferential tax treatment in effect to transfer enterprise profits from (shared) general taxes to local extrabudgetary accounts.

The 1994 reform dramatically changed the enterprise income tax and the intergovernmental fiscal system. The surtaxes were eliminated, all domestic enterprises were brought under the same regime regardless of ownership, and there was a reduction in the top rate from 55 percent to 33 percent. Tax-contracting between enterprises and government was prohibited, and the system of deductions was restructured to move closer to international practice. Central–local sharing of enterprise income tax revenues was dropped in favor of assignment of all enterprise income tax revenues to provincial governments.[5] The new system was meant to be revenue-neutral in total, but it is not revenue-neutral for every province individually.

Indirect taxes

Before the 1994 reform, there were three sales taxes in China: product tax, business tax and value-added tax (VAT).[6] The product tax was levied on the total sales value of specified manufactured and imported goods. The base of the tax was the price paid by the buyer, with rates ranging from 3 percent to 60 percent. Over the last few years, the VAT has gradually replaced the product tax as the standard levy on manufactured and imported goods. The pre-reform VAT had twelve different rates. The base of the Chinese VAT is similar to international practice in that exports are zero-rated, and exemptions include agriculture and most services. But it is different in that exemptions include the construction, transport, communications, wholesale, and retail sectors. Credit is not allowed for tax paid on capital inputs. The method of calculating the base is a major departure from international practice. Taxes paid on intermediate goods were credited, but, until recently, according to presumptive methods rather than invoices. The service sector was taxed through a turnover tax referred to as the business tax. It was levied on gross receipts, with rates ranging from 3 to 10 percent.

The sales tax was overdue for reform. It was terribly complicated and costly to administer. Earlier the sales tax had been used as a device to regulate profits and prices, and by the late 1980s, there were over 250 different sales tax rates. But, with most prices decontrolled, this was no longer necessary and created significant distortions in the economy (World Bank, 1990). Evasion seemed to be a problem, and the revenue income elasticity was less than unity. Finally, the structure and administration of the VAT departed too much from good practice and did not give China the revenue productivity and self-policing advantages that it has given other countries.

The structure of the pre-reform indirect tax system also raises issues of intergovernmental fiscal relations, because some provinces fared better than others under the taxing and revenue-sharing rules that governed the indirect taxes. First, the indirect taxes were part of the sharing pool, so a larger sales tax base meant greater revenues under China's derivation-based sharing system. The VAT was a counter-equalizing form of revenue-sharing. Second, some of the structural features of the indirect taxes had implications for the relative fiscal capacity of provinces: the failure to credit capital expenses both raised more revenues from capital-intensive enterprises and discouraged capital investment; export credits were paid by the central government thereby advantaging exporting provinces; state-owned enterprises were taxed more heavily than collectives or private enterprises; and the complicated rate structure made the revenue yield a function of provincial economic structure rather than total output.

The 1994 reform program substantially restructured the sales tax system. The VAT was expanded to absorb most sectors covered under the product tax, and the latter will eventually be phased out. The wholesale and retail sectors are taxed under VAT rather than under the business tax. A two-rate VAT system was adopted (17 percent and 13 percent), and presumptive crediting was eliminated in favor of an invoice method. Because of the potential revenue cost, there was no proposal to permit a credit for taxes paid on capital goods.

From the point of view of intergovernmental relations, the 1994 reform was a major change. The VAT was made a central government levy, not subject to sharing, though a transitional sharing arrangement was put in place. Administrative arrangements were also changed, and beginning in 1994, the VAT was fully administered by the central government without local involvement.

Tax administration

The 1994 reform established separate national and local tax administration services. This was a major national policy change with far-reaching implications. Economists have long written about the folly of separating tax structure reform from tax administration considerations (Bird, 1989), but in China it is also true that intergovernmental reform cannot be divorced from tax administration reform. Reform of the revenue-sharing and taxation systems in 1994 could not have achieved its objectives unless the administrative system was also changed.

The responsibility of the National Tax Service (NTS) is to collect central and shared taxes. The NTS has about 500,000 employees and operates down to the county level. Prior to the 1994 reform, two-thirds of these employees operated at the lowest level of government, with relatively little central supervision. Consequently, they developed close ties with the local finance offices, and with the locally owned enterprises (IMF, 1994). This led to a kind of collusion that was thought to weaken the position of the central government in revenue-sharing (World Bank, 1990).

Under the reformed system, a separate local tax service operates in each province with responsibility for collection of "local taxes," including the enterprise income tax on locally owned enterprises, collectives, and private businesses.[7] The local tax service is now part of the local finance departments, and its operations are funded from local resources. The central tax service is responsible for collecting the VAT and all other central or shared taxes. The NTS still operates on a regional basis, but is independent from the local tax service.

This reform is an attempt to solve a longstanding problem of divided loyalties among the local officers in the former State Tax Bureau. There no longer will be a question about the objectives of the tax administration office as regards the choice between full taxation under the law and maximization of retained local revenue. The NTS now has every incentive to collect fully the indirect taxes due, since these are the mainstay of the central government revenue structure. The local tax service must decide how it will treat local enterprises under the income tax, but if it chooses to grant preferential treatment it must absorb whatever revenue costs occur.

Revenue-sharing

China's revenue-sharing system is primarily a division of national sales and profit taxes among the central, provincial, and local governments. Whereas in most countries taxes are collected by the central government and then allocated to the subnational governments, in China they have been collected by the local governments and "shared-up" to the higher levels. The amount of shared tax revenue that finally shows up in the local government budget depends on the centrally determined tax base and tax rates, the tax administration, the assignment of revenues to the local government, and the sharing formulas. These formulas, in turn, have 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 is distributed amongst local governments within the province. In addition, there are earmarked grants which are given to provincial governments by the center. To understand the revenue-sharing system in China, and to understand the implications of the 1994 reform, one must understand all of these dimensions. It is a very complicated matter.

In the following subsections, the three major issues surrounding revenue sharing are taken up: the actual distribution formulas for shared taxes, the distribution of earmarked grants, and the pattern of extrabudgetary revenues of local governments. The last of these is properly part of the discussion of intergovernmental fiscal relations in China, because extrabudgetary funds reflect the success of Chinese local governments in mobilizing resources outside the sharing pool.

Shared taxes

The revenue-sharing formulas have been regularly adjusted since the fiscal reform began in 1983. The 1994 reform can be best understood as another step in this transition. The formula has changed over time and was not always strictly applied, but the government has held to a basic philosophy: that local governments should retain enough revenue to cover a "basic" level of services and should turn the remainder over to the center. The debate and negotiation usually centered around what should be the "approved level" of expenditure and by how much the approved level should grow each year.[8]

The revenue-sharing formula in operation from 1985–88 provided for three categories of provinces: those which retain a fixed percentage of what they collect (fifteen provinces), those which keep all they collect and receive a subsidy, and those which retain all they collect and pay a fixed subsidy to the center (Guangdong Province).

There was dissatisfaction with this system of tax-sharing. The subnational governments felt that their shares were too low, and both sides felt that the system was too arbitrary. The ability of the central government to use fiscal policy as an instrument of macroeconomic policy and regional equalization was limited, local government incentives for increased revenue mobilization were weak, and local government incentives to move revenues to the extrabudgetary sector were strong. Some *ad hoc* adjustments were made in 1987 to address the incentives issue (an incremental sharing rate on revenues above a target level was introduced in Jiangsu, Zhejiang, Hebei, Beijing, and Tianjin) but this did not quiet the calls for a complete reform.

Beginning in 1988, the system was changed to an even more negotiated approach. The idea was still to allow the local governments to retain an amount of revenue that would enable them to cover a basic level of expenditure needs. The base year chosen to define the expenditure amount was 1987. Local governments retained the base amount plus a share of any increase in revenues, as negotiated in advance. This agreement, originally planned to be in force for three years, led to six different arrangements for tax-sharing.[9]

The fundamental problem, however, remained. The system was negotiated and not transparent. This led to criticisms that it was unfair. The local governments continued to have an incentive to channel tax money to their own treasuries, outside the formal revenue-sharing system. And, though neither the central nor the local governments felt that the division of the revenues was correct, the flow of resources to the central government and the overall level of revenue mobilization declined.

The 1994 reform also directly addressed the revenue-sharing system. The most important element of the revenue-sharing reform was the designation of the value-added tax as a central tax which would be shared 75/25 between the center and the provinces.[10] The enterprise income tax (other than that collected from centrally owned enterprises) and the individual income tax would be assigned fully to the local governments. Local governments would also have responsibility for income tax collection. This would seem to be a first step toward an assignment system – though as noted above, the local governments have no authority to set the rate and base of the tax.

Earmarked grants

In addition to shared taxes, local governments receive earmarked grants from the central government. The purposes of this subsidy include appropriations for capital construction projects, price subsidies for urban grain consumption, social relief funds, and special subsidies for health and education of the poor, of ethnic minorities, and in border provinces.[11] There is no set formula to determine the amount of earmarked grants for distribution in any given year, and the distribution among the provinces appears to be *ad hoc* rather than formula-based. Earmarked grants have grown significantly, and were greater in magnitude than tax-sharing transfers to the central government in 1992.[12] In 1990, earmarked grants were equivalent in amount to 14.4 percent of local government budgetary expenditures, slightly less than in 1985.

Some would argue that a primary purpose of earmarked grants is equalization. In fact, China has no equalization grant program. Simple correlations show that per capita earmarked grants are distributed in significantly larger amounts to higher income provinces.[13] These are project rather than entitlement grants, and it is not unusual for more developed regions to absorb more of such grants because of their greater capability at project preparation and their greater ability to "buy in" on a matching basis.

Extrabudgetary revenue

The 1980s and early 1990s saw a rapid growth in revenue outside the budgetary accounts. Local governments in particular had found a way to siphon revenues away from the normal budgetary accounts – and the sharing pool – to special purpose spending. The declining ratio of taxes to GNP over the past decade reflects this transfer of funds.

There are two types of extrabudgetary revenue in China. The first is the "fiscal extrabudgetary funds" of the government. These are earmarked for capital purposes and include a set of taxes and charges that are controlled by the local government finance department. The most important is the public utility surcharge – a 10 percent tax on the utility bills of consumers – and the urban construction and maintenance tax. There are also 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. The World Bank (1994: 31) estimates that fiscal extrabudgetary revenues grew from 2.6 percent of GDP in 1978 to 4.2 percent in 1993, and now are equivalent to about one-fourth of total budgetary revenues.

The other type of extrabudgetary revenue is the retained earnings and depreciation funds of locally owned enterprises. Extrabudgetary funds of this type expanded very rapidly in the 1980s, and in 1993 were equivalent in amount to about 12 percent of GDP. In principle, these funds should not be classified as part of the government budget because they are not resources over which the local governments have direct control. Nor is their rapid growth necessarily a cause for alarm. It could reflect increased profitability, increased enterprise savings, and government policy to allow enterprises more flexibility in managing their resources (World Bank, 1993: 17–19). However, the flagging level of enterprise income tax collections suggests that the increase in extrabudgetary funds was at least partly a result of the contracting system between local governments and enterprises that led to a channeling of resources from the budgetary to the extrabudgetary side. Some of these revenues were used for social purposes and to support the economic development goals of the local government administration, and their growth was heavily influenced by local taxing and contracting practices.[14]

Extrabudgetary funds are by their very nature sensitive to the business cycle. In 1992, total extrabudgetary revenues of local governments were equivalent to about 89 percent of local government budgetary collections. This share increased after 1986 when enterprise contracting began to grow significantly. The responsiveness of extrabudgetary revenues to GNP would appear to be greater than the responsiveness of budgetary revenues – there is a positive and significant relationship between the ratio of local government extrabudgetary revenues to budgetary collections, and to GNP, over the 1983–92 period.[15]

Objective of the reform

The 1994 reform of the fiscal system was prompted by the slow growth in central government revenues. The primary contributing factors were a long-term decline in tax revenue collections as a share of GNP and a reduced share of total revenue going to the central government. The 1994 reform was an attempt both to increase the revenue income elasticity of the system and to recentralize. It also reflected an attempt by the center to regain control over fiscal policy.

The declining tax ratio

The revenue trend over the period 1985–95 is described in table 2.2. The national tax ratio (collections as a share of GNP) had fallen to less than half of its level of about 23 percent at the time the enterprise income tax was introduced.[16] By 1995, government revenue mobilization was about 11 percent of GNP, a low share by international standards.[17] A declining government share of GNP in China is not a problem *per se* because it reflects the narrowing of the scope of government responsibility.[18] However, this decline was greater than was planned and fiscal deficits arose.[19] Between 1985 and 1993, the revenue income elasticity of the

Table 2.2. *Tax revenue performance, 1985–95*

	Total tax revenue (billions of yuan)	Total tax revenue as a percentage of GNP	Enterprise income tax revenues as a percentage of GNP[a]
1985	208.5	23.18	8.23
1986	213.3	20.90	7.20
1987	218.3	18.26	5.91
1988	244.2	16.36	4.87
1989	279.1	16.49	4.51
1990	290.0	15.59	4.27
1991	306.5	14.14	3.72
1992	335.7	12.59	2.93
1993	430.5	12.45	2.11
1994	512.7	11.01	1.52
1995	603.8	10.54	1.53

Note: [a] Includes direct remittances by enterprises.
Source: *Statistical Yearbook of China, 1996.*

Chinese tax system was only 0.60, that is, the rate of revenue growth was a little more than half the rate of growth in GNP.[20] Such a slow growth in revenue will almost certainly create budgetary balance problems and restrain expenditure growth. Government policy is to increase the income elasticity of the revenue system, and reduce the size of the deficit (Zhongli, 1996).

The decline in the revenue share of GNP is largely due to the declining budgetary contributions of the enterprise income tax. On the one hand, this is neither unexpected nor undesirable. The enterprise reform in China was meant to reduce payments to the government and to give enterprises more control over their resources (World Bank, 1994). On the other hand, this industrial policy alone would not seem to have dictated so great a reduction in enterprise tax payments. There are several explanations for the large reduction: the offloading of some enterprises from the government sector, the granting of tax incentives by local governments, and enterprise losses. Another reason for the weak revenue performance of the enterprise income tax is the failure to expand the tax base adequately to include the private and collective enterprise sector. In the early 1990s, about 60 percent of GNP was accounted for by the non-state sector, but almost 80 percent of tax revenues were derived from the state-owned enterprises (IMF, 1994: 28). Whatever the reason, at a 1.5 percent share of GNP, the enterprise income tax has become much less a force in economic policy than it was at over 8 percent of GNP in its early years (see table 2.2).

Division of revenues

The revenue–expenditure balance between central and local governments changed markedly in the 1980s and early 1990s. At the time of the income tax reform in 1983, the local government sector was spending an amount equivalent to 74 percent of what it collected and turning a net 26 percent over to the central government for national purposes. By 1992, the local government sector was spending all of its collections and receiving an additional subsidy from the center equivalent in amount to about 2 percent of expenditures (table 2.3). Historically (through the mid-1980s) central fixed revenues were considerably less than central government expenditures, and the difference was made up with net transfers from the local government sector. For example, in 1984, the local governments ran a "collections surplus" of about 17 billion yuan while the central government ran a "collections deficit" of about 23 billion yuan (table 2.3). The net transfer was from local to center. However, by 1988, the local government sector was regularly running a collection deficit. In fact, in 1992, there was a net transfer from the center to the subnational sector (excluding any earmarked grants) equivalent to about 19 percent of central collections. It is this change in the division of revenues that prompted the 1994 reform of the revenue-sharing system.

Central government macroeconomic policy

Prior to the 1994 reform, central officials complained that the intergovernmental system compromised the effectiveness of macroeconomic policy. Because subnational governments retained too large a share of the pie, the central government did not have the resources to invest adequately in national projects, to compensate poor regions for inadequate taxable capacity, or to control the aggregate level of expenditure and investment in the country. Moreover, during periods of expansion, enterprises were prone to increase their rate of investment because of the availability of funds and because the automatic stabilizer built into the enterprise income tax was nullified by the practice of contracting. The result was that aggregate demand grew, the government revenue share of GNP fell, and a fiscal deficit resulted. There is an analogous procyclical effect in times of recession. Under the contract system, the central government could do very little to control this situation.

It was also the case in the pre-reform period that the ability of the central government to pursue discretionary fiscal policy was limited because of the possibility of offsetting policy reactions by the local governments. For

Table 2.3. *Tax collection and expenditure of central and local governments, 1980–95 (billions of yuan)*[a]

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Central government																
Collection[b]	28.4	31.1	34.7	49.0	66.5	77.0	77.8	73.6	77.5	82.3	99.2	98.8	98.0	95.8	290.7	325.7
Expenditure	66.7	62.6	65.2	76.0	89.3	79.5	83.6	84.6	84.5	88.9	100.4	109.1	117.0	131.2	175.4	199.5
Collection surplus/ deficit	−38.2	−31.5	−30.5	−27.0	−22.8	−2.6	−5.8	−10.9	−7.0	−6.6	−1.2	−10.3	−19.1	−35.5	115.2	126.1
Local government																
Collection[b]	87.5	86.5	86.5	87.7	97.7	123.5	134.4	146.3	158.2	184.2	194.5	221.1	250.4	339.1	231.2	298.6
Expenditure	56.2	51.3	57.8	65.0	80.8	120.9	136.9	141.7	164.6	193.5	207.9	229.6	257.2	333.0	403.8	482.8
Collection surplus/ deficit	31.3	35.2	28.7	22.7	17.0	2.6	−2.5	4.7	−6.4	−9.3	−13.4	−8.5	−6.8	6.1	−172.7	−184.3

Notes:
[a] The difference between the local government's surplus and the central government's deficit is the central government's foreign borrowing and domestic budget deficit.
[b] Central and local government collections are before transfer from local governments to the central government, and before earmarked grant distribution to the local governments.
Source: Statistical Yearbook of China, 1996.

example, the central government might levy an extra tax to cool down an overheated economy, but local governments could react to this by renegotiating their contracts with enterprises to stimulate investment, or they could give preferential tax treatments to avoid the consequences of the central tax.

Another problem with the revenue-sharing system was that it compromised the implementation of the government's industrial policy. Qiang (1995) makes the point that the sharing of income taxes from local enterprises and the sharing of indirect taxes collected in local areas encourages local governments to favor development of projects that show high profits and sales. It is a problem in all countries that local officials, facing a relatively short political life, favor investment projects that have a high visibility and offer a substantial short-term return. It is an especially acute problem for China because of the substantial amount of resources in the hands of local governments and locally owned enterprises (Chinese People's Bank of Construction, 1993).

This leads to a number of problems. First, it diverts resources away from the more productive social investments that the central government would prefer. In effect, it dramatically limits the ability of the central government to control the direction of investment in the economy. Second, it has encouraged some governments to erect barriers to trade in order to protect local investments (and implicitly to protect the local tax base). Third, it is not clear that decentralization in the budgetary and extrabudgetary accounts has led to a more rapid economic growth rate (Zhang and Zou, 1996).

The validity of the argument that the center was losing its ability to control effectively the fiscal sector rests on the argument that an increasing share of total revenues was accruing to the local government sector.[21] This concern is borne out by the evidence presented in table 2.3. Moreover, the situation worsened through the early 1990s. The elasticity of central government revenue collections with respect to GNP during the 1985–93 period was 0.24, which is less than the 0.72 GNP elasticity of subnational government collections.[22] The collections' disparity in favor of local governments accelerated with the growth of the contracting system from 1988. During the 1985–87 period, the ratio of local government to total government budgetary collections averaged 54.2 percent. During the 1988–92 period, the average was 59.5 percent. The nexus of collections had clearly shifted toward the local governments.

The bigger issue is that the subnational governments' proportion of revenues, *after sharing*, was increasing. There was a net transfer of resources from the center to local governments after 1986 ("net transfer" is measured here as the sum of local government budgetary collections and earmarked transfers from the center to the local governments, less shared tax transfers from the local governments to the center). By 1990, the net transfer was about 2 billion yuan from the center to the local governments. As recently as 1985, there had been a significant net transfer to the center.

There are a number of reasons why this happened. First, the sharing formulas implemented in 1988 were negotiated to favor the local governments. Second, poor economic performance and natural disasters prevented local governments from reaching their negotiated amounts and forced the central government to forgive part of the planned transfer, and to increase earmarked grants. Third, local governments used their authority to grant tax concessions and favorable contracts, and this reduced the flow of revenue to the central government (Cullen and Fu, 1996: 7).

For whatever reasons, the central government's ability to use the fiscal system for macroeconomic policy purposes was quite limited by 1992. The center collected only 28 percent of total revenues in the country, and paid out more in transfers to the local government sector than it received back (table 2.3). The enterprise income tax had become a much less important fiscal instrument, largely because the local governments had more or less replaced it with negotiated contracts.

Evaluation of the 1994 reform

An evaluation of the success of the 1994 reform in improving intergovernmental fiscal relations is problematic, for two reasons. The first is that the objectives of the Chinese government were different from those pursued in most reforms of the system of central–local finances. The central government of China was attempting to wrestle control of fiscal and macroeconomic policy back from the local government sector. The evaluation of the reform must begin with an assessment of how well they did this. While it is also appropriate to consider the more usual issues that arise when one evaluates an intergovernmental reform – equalization and local autonomy, for example – it is necessary to recognize that these were not the driving forces behind the Chinese reform.

The second problem is that data are not yet available to carry out a quantitative analysis of the new system of revenue-sharing. In part, this is because the Chinese government has not yet made available the detailed data on the outcomes in the post-reform period. The data now available for 1994 and 1995 may show only muted effects of the reform on the intergovernmental fiscal system because of the provisions to maintain previous levels during a "transition" period.

Central control

Will the 1994 reform recentralize the fiscal system? The shift of the VAT to a central revenue source and the elimination of contracting would seem to guarantee this result. Note from table 2.3 that in 1994 and 1995, the central government collected 52 and 56 percent of total revenues, and was in a surplus position.[23] The local governments, on the other hand, were in a deficit position and forced to rely on grant distributions from the center. China has moved to the top-down revenue-sharing approach which is used by most countries in the world.

In fact the central government's gain of control over the aggregate budget is understated here because of a transitional revenue-sharing arrangement. In the longer term, fiscal recentralization will be occurring in three important ways:

- The VAT is the most productive tax in the system, is fully administered by the central government, and is no longer a shared tax.
- Revenue-sharing in China is now top-down rather than bottom-up, and the central government can more easily control the allocation of funds.
- There is no longer a contracting mechanism that will allow local governments and enterprises to negotiate tax liabilities. This means that the tax measures undertaken for stabilization purposes now have a better chance to achieve their desired objectives.

The move to an assignment system for local government revenues raises two issues. First, the assignment of the enterprise income taxes to local governments may present difficulties in the future. As and when Chinese enterprises begin to operate in multiple provinces, the problem of allocating profits will arise and will bring complication and possibly undesirable competition. The US experience is a case in point (McLure, 1981). It is unlikely that the provinces can build their long-run fiscal health on an enterprise income tax. The assignment of the VAT to the central government is appropriate, because the VAT is best administered centrally. But sharing the VAT on a derivation basis, as is still done, encourages protectionist-type activities by provinces to preserve their tax base. A formula-based system for sharing VAT revenues with the provinces would avoid this problem.

Resources available to local governments

The resources available to local government under the reformed system will depend on whether the overall rate of revenue mobilization is increased, and on the willingness of the central government to make transfers to local government from its new-found wealth.

With respect to total revenues available, the government expects the net effect of the reform to be revenue-neutral in the short run. On the one hand, there are expected negative revenue effects, *ceteris paribus* from lowering the top enterprise income tax rate from 55 percent to 33 percent; from eliminating the surtaxes; and from correcting part of the understatement of labor and capital costs in calculating enterprise profits. A potential short-run revenue loss could be anticipated from the switch to the credit invoice method under the VAT. This is a completely different approach to VAT administration, and some transition costs could be incurred in the first years of operation.[24]

Other elements of the reform are expected to produce revenue increases. The elimination of contracting could increase revenues significantly. Revenues from the enterprise income tax will also increase as a result of the elimination of the loan repayment deduction that will broaden the base. The World Bank (1990) estimated the revenue cost of the loan repayment deduction to be equivalent to about 3 percent of total revenue in 1986. If enterprise income tax revenues were to be restored to 1985 levels, relative to GNP, total government tax revenues would be higher by about 6 percent of GNP.

Short-run revenue-neutrality has not yet been achieved. Total revenue collections continued to fall in 1994 and 1995 relative to GNP (table 2.2).[25] The long-run revenue consequences of the reform, however, are likely to be more significant. The value-added tax is a more efficient revenue-raising instrument than the product tax, in that it reaches a much greater number of transactions and it has a self-policing component. If the administration of the Chinese sales tax was deficient, the shift to a credit-invoice VAT could bring significantly greater long-run revenue growth than the present system. Wong, Heady, and Woo (1995: 52), point out that the buoyancy of the Chinese VAT in the pre-reform period was low relative to that in other countries. The elasticity of the income tax could also increase because the incentives for locals to offer preferential income tax relief have been reduced. Moreover, the local governments have an intimate familiarity with local enterprises and can enhance the efficiency of local collections.

There are aspects of this reform that suggest diminished local government revenues. The more income-elastic VAT was assigned fully to the central government. Revenues from the VAT are now shared with local governments, but this seems to be a transition measure, and in the long run, derivation-based VAT-sharing may be phased out. The reform assigns all income taxes to the local governments. If the long-run elasticity of the income taxes is less than that of the VAT, and surely it will be, then the relative growth potential of local government taxes will be less. Moreover, the enterprise income tax is less stable over the business cycle, hence local government revenue streams will become less certain.

The longer-run revenue position of local governments would appear to depend on the central government assigning another significant source of taxation to the local governments or establishing a buoyant intergovernmental grant program. The individual income tax, with an expanded base and piggybacked on to the central tax, would seem the ideal revenue source for Chinese provincial governments. As to increased transfers, a more productive VAT would increase the central pool available for tax-sharing and for earmarked grants. Whether local governments would actually benefit from an increased revenue pool depends on the willingness of the central government to allocate more resources to the subnational level.

Local government autonomy

The 1994 reform did not increase the autonomy of local governments in taxation. The power to set rates and define bases, for all taxes, remained with the central government. In the past, local governments had taken some autonomy using "back-door" approaches such as providing preferential tax treatments in return for infrastructure investment, or to pursue industrial policy. The 1994 reform eliminated the practice of enterprise tax contracts with local governments. This was unquestionably good tax policy. The elimination of contracting substituted a transparent tax system for a negotiated one, and placed all enterprises on a more equal footing.

However much this measure improved the functioning of the economy, it did reduce the fiscal discretion of local governments. Local governments in China had made the granting of tax incentives an integral part of their industrial policy. Moreover, they had used a combination of tax incentives and discretion in matters of tax administration to leverage more social overhead investment by enterprises. The elimination of these preferential, discretionary tax treatments was necessary for macroeconomic purposes, but it clearly weakened fiscal decentralization.

The changes in the tax administration system may also be having a centralizing effect. Local governments now collect only income taxes and the smaller "local taxes" and no longer exert control over the assessment, collection, and audit of the VAT. An important component of local government discretion in tax administration was thus eliminated.

Fiscal disparities

Evaluation of the equalization features of the revenue-sharing system is not straightforward, since the government's objectives are not clear on this matter. We can, however, address the question of whether the reform will increase or reduce fiscal disparities. Four questions could be answered on an *a priori* basis, and supporting empirical evidence might be provided:

- Has the spread in the revenue collection rate between rich and poor provinces changed?
- Have expenditure differences between provinces changed?
- Is there evidence of greater equalization than in the pre-reform period?
- Do provinces still exert the same pattern of tax effort as in the pre-reform period?

Revenue capacity

Revenue collections are determined by income level and tax effort. One would expect wealthier provinces to have a significant advantage, and the data seem to bear this out in the pre-reform period. In 1992, the five wealthiest provinces accounted for 23 percent of GDP and 13 percent of the national population but about one-fourth of all revenue collections. In 1995, with local revenue collections now primarily income taxes, the revenue share rose to 30 percent (table 2.4). The five poorest provinces accounted for about 13 percent of national income but 19 percent of the population. The provinces collected about 12 percent of total revenue and the share fell between 1992 and 1995. The disparity in per capita revenue collections among the provinces in 1995 ranged from 1,551 yuan in Shanghai to 139 yuan in Anhui.

The relationship between income level and collection rate can be tested in a more systematic way to determine if it generally explains the pattern of variation in per capita collections across the twenty-eight provinces.[26] We have estimated a linear regression of per capita collections by local governments in 1990 and 1995 on per capita GDP and population size. Per capita GDP is included to measure the taxing power of the province, and population gives the impact of a size effect on local collections.

The results presented in table 2.5 show a strong significant relationship between per capita revenue collections and per capita income in both years. The cross-sectional income elasticities are about unity: in 1995, a 10 percent difference in per capita income tended to be associated with about a 10 percent difference in per capita revenue collections. Population size did show the expected negative relationship with revenues.[27]

Table 2.4. *Fiscal and economic concentration in rich and poor provinces*

	1990	1995
Five richest provinces[a]		
Percentage of GDP	22.8	23.9
Percentage of population	12.7	12.4
Percentage of revenue collections	26.0	30.3
Percentage of local government expenditures	19.8	25.5
Five poorest provinces[b]		
Percentage of GDP	12.7	10.6
Percentage of population	18.9	19.0
Percentage of revenue collections	12.3	10.5
Percentage of local government expenditures	14.0	12.4

Notes:
[a] Shanghai, Beijing, Tianjin, Guangdong, and Zhejiang.
[b] Guizhou, Gansu, Sha'anxi, Jiangxi, and Henan. Tibet and Hainan are excluded because of special circumstances and data availability.
Sources: Computed from data provided in the *Statistical Yearbook of China* and data provided by the Chinese Ministry of Finance.

Table 2.5. *Regressions of per capita local government revenues and expenditures on selected variables*[a]

	Per capita revenues		Per capita expenditures	
	1990	1995	1990	1995
Constant	−2.7636	−2.9755	2.4332	1.1178
	(3.64)	(4.32)	(4.10)	(1.63)
Population	1.1207	1.0736	0.5600	0.7235
	(12.25)	(14.01)	(7.84)	(9.46)
Per capita GDP	−0.0828	−0.1037	−0.3442	−0.2865
	(1.58)	(2.06)	(8.40)	(5.71)
R^2	0.88	0.95	0.89	0.86
N[b]	28	28	28	28

Notes:
[a] All variables expressed in logarithms with t-statistics shown in parentheses below the regression coefficients.
[b] Tibet and Hainan are not included.

There has been some weakening in the relationship between collections and income. Virtually all of the higher income provinces had growth rates in budgetary collections that were below the 1987–92 national average (Bahl, 1994). The regression estimates presented in table 2.5 show that the cross-sectional income elasticity of collections fell from 1.12 in 1990 to 1.07 in 1995.

Expenditure variations

Disparities are much less pronounced on the expenditure side of local budgets, because of the equalizing effects of the transfer system. In 1995, per capita expenditures varied from highs of 1,837 yuan in Shanghai and 1,234 yuan in Beijing to 228 yuan in Henan and 225 yuan in Anhui.[28] The five highest-income provinces, with 13 percent of the population, account for 25 percent of the expenditures, whereas the five lowest-income ones, with 19 percent of the population account for 12 percent of expenditures. We can conclude that per capita expenditure variations in China are very great indeed, even though less than those for collections.

What are the determinants of the variations? Higher-income provinces spend significantly more on a per capita basis because of the greater demand for public services by their citizens and their enterprises, their ability to raise more "local fixed" revenues, their ability to attract more grants, and very importantly, their ability to slow the flow of revenues to the center. More heavily populated provinces spend less on a per capita basis, because the fixed component of their cost is spread over a larger population base. The expenditure regression results presented in table 2.5 confirm these expectations. About three-quarters of the interprovince variations in per capita expenditures can be explained by variations in per capita income and population size. Both variables are significant and have the expected sign. The expenditure income elasticity is smaller than the revenue elasticity in both years, suggesting some degree of equalization in the system. In 1995, a 10 percent higher level of per capita income was, on average, associated with about a 1 percent higher level of per capita expenditures and a 1 percent higher level of per capita collection. The equalization of the system appeared to lessen between 1990 and 1995.

Redistribution and the 1994 reform

One could make the case that the 1994 fiscal reform will not reduce disparities in per capita expenditures, nor will it compensate for uneven taxable capacity among the provinces. An unintended effect of the fiscal reform of 1994 is a possible widening of the fiscal disparities among provinces. By giving the local governments all revenues raised from income taxes, on a derivation basis, the central government has given an advantage to the higher-income provinces with more profitable enterprises. And by giving local governments responsibility for collecting these taxes, advantage has been given to the provinces that have the means to mount better administrative efforts. Again these are likely to be the better-off provinces.

The empirical analysis presented above shows that per capita expenditure disparities are less pronounced than per capita revenue collection disparities, suggesting some degree of equalization in the system. However, this pattern is less true in 1995 than it was in 1990, suggesting that the reformed system may be less equalizing.[29]

Tax effort

A criticism of the present intergovernmental fiscal system is that there is insufficient incentive for revenue mobilization, and therefore tax effort on the part of the local governments is lower than it should be. This should have been expected in the pre-reform system. The tax-sharing formula was based on a retention rate where a percentage of collections was paid to the central government. This provided a significant incentive to move funds from the budgetary accounts to the extrabudgetary ones. Moreover, the local administration still saw itself partly as tax collector from the state-owned enterprises, and partly as owner. Jun Ma (1996) shows that the central government's failure to commit to pre-announced revenue-sharing formulas tempted local governments to reduce their tax collection efforts.

Can local governments influence tax effort? In the pre-reform system, the answer was that they could, in many ways. The local administration could negotiate "revenue-losing" contracts with local enterprises, could give tax incentives to them, and could urge the local tax collection service to be less vigorous in their efforts. As Casanegra (1987: 25) has pointed out, ". . . tax administration *is* tax policy." Even in the reformed system, there may be inducements to lower levels of tax effort. Though they may no longer write tax contracts, local governments now control the administration of all income taxes. Though the giving of tax incentives now imposes a dollar-for-dollar loss to local budgets, relief from the enterprise income tax still may be provided for industrial policy purposes. The revenue cost may be made up with a central grant, which, without conditions, might be seen locally as a substitute for higher income tax collections.

We have carried out a tax effort analysis, following the approach described in Bahl and Wallich (1992) and updated in World Bank (1993). The first step is to estimate an OLS regression of per capita local government revenue collections on per capita income and population size. The

Table 2.6. *Tax effort indices and rankings: 1990 and 1995*

	1990			1995		
Province	Tax effort indices	Tax effort rankings	Per capita GDP ranking	Tax effort indices	Tax effort rankings	Per capita GDP ranking
Beijing	1.00	15	2	1.16	5	2
Tianjin	1.03	13	3	1.03	12	3
Hebei	0.92	20	13	0.92	21	14
Shanxi	1.14	5	15	1.30	3	18
Inner Mongolia	0.99	16	16	0.96	18	16
Liaoning	1.12	6	4	1.12	7	6
Jilin	1.07	7	19	0.99	16	13
Heilongjing	1.02	14	8	0.95	19	11
Shanghai	1.40	2	1	1.30	4	1
Jiangsu	0.93	19	7	0.68	27	7
Zhejiang	1.07	8	6	0.67	28	5
Anhui	0.84	23	24	0.93	20	22
Fujian	1.03	12	11	1.01	14	8
Jiangxi	0.88	21	22	1.08	9	26
Shandong	0.77	26	9	0.77	26	10
Henan	0.94	18	26	0.97	17	25
Hubei	0.87	22	12	0.85	23	15
Hunan	0.97	17	18	1.06	10	20
Guangdong	0.75	27	5	1.39	2	4
Guangxi	1.06	9	28	1.03	13	19
Sichuan	1.05	10	25	1.05	11	23
Guizhou	1.32	3	29	1.11	8	30
Yunan	1.78	1	21	1.60	1	24
Sha'anxi	1.05	11	20	1.00	15	27
Gansu	1.27	4	23	1.13	6	29
Qinghai	0.81	25	14	0.79	25	17
Ningxia	0.82	24	17	0.88	22	21
Xingjiang	0.68	28	10	0.83	24	12

results of this analysis are presented in table 2.5. This equation is then used to obtain an "estimated" value of per capita collections for each province. This might be interpreted as a measure of taxable capacity, that is, it is the amount that a province would raise if it used its tax base to the same extent as other provinces. For example, in 1995 Hebei is estimated to have a capacity to raise taxes of 203 yuan per capita (predicted by the equation), but actually raises only 186 yuan per capita. Hebei, then, has a tax effort index of 0.92, which is 8 percent below the average and ranks Hebei twenty-first among the provinces in tax effort in 1995.

The estimated indices of tax effort are presented for each province for 1990 and 1995 in table 2.6. There seems to be no clear pattern to the distribution of tax effort indices. There is no significant correlation with either per capita income, the ratio of expenditures to collections, or the rate of urbanization. The results do not support the hypothesis that the present revenue-sharing system reduces the rate of revenue mobilization.

Summary appraisal of the reform

China's 1994 reform was not promoted primarily as one to encourage fiscal decentralization – in fact, the announced objective was precisely the opposite. But the reform program has had profound effects on the balance of powers between central and local governments in one of the most important countries in the world. Though data are not yet available to do a full quantitative evaluation of the outcome, the following are some stylized conclusions that might be drawn.

First, China is not a federal country, but its public finance system has features of fiscal federalism. Using the Western model for evaluating reforms of fiscal federalism, we might conclude that the Chinese reforms were neither efficiency-enhancing nor equalizing. However, they were aimed primarily at redressing what was perceived as too great a revenue distribution to the local governments, and at regaining control over industrial policy.

Second, one cannot separate tax policy, tax administration, and intergovernmental fiscal structure in evaluating fiscal decentralization in China. The 1994 tax structure reform was good tax policy. But in assigning enterprise income taxes to local governments, and continuing a derivation-based VAT, the reform was not good intergovernmental policy. The division of tax administration powers between local and central governments was good policy in that it overcame the problem of divided loyalties on the part of local tax administrators, but local governments are left with full responsibility for a tax whose rate and base they cannot influence.

Third, there is little in the 1994 reform that will increase the fiscal autonomy of subnational governments in China. The new budget law does give some discretion over spending composition, but the revenue constraint is still imposed by the center. Moreover, anticipated future tax structure changes in the enterprise income tax may further tighten this constraint. Yet by moving the structure away from a negotiated model toward a more objective system, the center has put in place the basis for a future fiscal decentralization. The former negotiated system with divided tax administration responsibilities would never support a Western-type fiscal decentralization.

Fourth, the long-term impact of the new revenue-sharing system and the new tax structure is a recentralization of revenues. The local share will diminish in future years if the present arrangement is maintained. Either a new source of local government tax revenue must emerge, expenditure reassignment to the central government must take place, or the grant system must be expanded.

Fifth, the new revenue-sharing formula is more transparent than the previous negotiated system, and this is a major improvement. However, it is not equalizing, it does not provide incentives for increased revenue mobilization, and, in the transition period, it retains some bad features: the VAT continues to be shared on a derivation basis and the earmarked grants are still distributed on an *ad hoc* basis. As Bird (1984: 217) so correctly noted in the context of the Colombian reform, "more good ideas have probably come to naught because of transitional difficulties than for any other reason except the political opposition of those who would lose as a result of the change." The final test of the success of the revenue-sharing reform in China – at least from a Western perspective about what is good decentralization – is whether the transitional arrangements can be abandoned in favor of a fully objective system.

Grading China's decentralization

Large countries tend to decentralize their government because the diseconomies of central management are great, because large countries tend to be ethnically diverse, and because large countries have wide variations among their provinces in the demand for government services. China is something of a paradox in that it is the largest country in the world but continues with a highly centralized fiscal structure. Predictably, however, local governments, sometimes acting independently and sometimes acting with the consent of the central government, have taken "back-door" approaches to fiscal autonomy. The 1994 reform eliminated some of these surreptitious routes to local autonomy, and took the first steps toward establishing a modern, assignment-based intergovernmental fiscal system.

Because the 1994 reform represented such an important policy crossroads, it would seem a good time to take stock of the Chinese version of decentralization. The criteria for effective decentralization shown in the left column of table 2.7 provide a checklist. The conclusion from this evaluation is that China is in the very early stages of decentralization, and many of the features required for successful local governance are not yet in place.

The biggest difference between China and the decentralized systems in the West is the absence of popular representation. Local councils must be popularly elected and local chief officials must be locally appointed for the efficiency gains from decentralization to occur (Bahl and Linn, 1992: ch. 3). The other major difference from international practice in decentralized

Table 2.7. *Requirements for effective decentralization*

Benchmark	Situation in China
Elected local council	Elections, but not popular elections.
Locally appointed chief officials	Chief provincial and local government officials are appointed by the next highest level of government.
Locally approved budget	Local authority budgets do not require approval, but total revenues are fixed by the center.
Absence of mandates as regards local government employment and salaries	Guidelines provided by the central government.
Local governments may exert control on the level of some revenue sources	Local governments may choose whether or not to levy certain taxes or charges. The rates and bases of nearly all taxes, however, are beyond their reach.
Local governments have some powers to borrow	Local governments may not borrow directly.
The grant system is transparent and local governments understand their entitlements	The grant system is *ad hoc*. The central government decides on the retention rates under the sharing system, and on the distribution of earmarked grants.
Expenditure assignment is clear	Expenditure assignment is relatively clear to local government officials.
Local governments have the capacity to collect taxes and deliver services efficiently	Local governments vary widely in their capacity to deliver services effectively. Problems arise mostly because of limited revenues and shortage of capital and skilled employees.
Local governments keep adequate books of account	The professional and technical ability of staff in many local authorities is below the level needed to produce accurate and meaningful accounts. In some provinces the capacity is quite strong.
The central government has the ability to monitor the progress of effective fiscal decentralization	There is a fiscal planning unit that deals with intergovernmental fiscal relations in the Ministry of Finance, but there is no strong underlying data system to support the work of the staff.

countries is on the financing side: local governments in China may not set tax rates or borrow for capital projects. Again, determination of the size of local government is largely a matter of central decision. These are the major structural impediments to an effective system of local government financing.

There are also capacity problems to be overcome. There is a wide variation in the ability of local governments to absorb more fiscal responsibility.

Some provincial and municipal governments in China have well-developed systems of fiscal administration, while others (especially in the rural areas) have very weak ones. It is also a problem that the central government presently has only a limited ability to monitor local government fiscal behavior.

On the other hand, some significant recent changes in the fiscal system could set the stage for fiscal decentralization. The 1994 reform systematized the situation by eliminating the practice of "every province for itself" autonomy. The first steps toward decentralization have been taken on the expenditure side, which is the right place to begin. Local governments have some budget autonomy and are subject to relaxed guidelines as regards public expenditure mandates, and expenditure assignment seems relatively clear.

Looking forward, one could take two differing views about the future of decentralization in China. One is that the 1994 reform clearly was a recentralization of the fiscal system and weakened the hand of the local governments. The other view is that the reform replaced a negotiated system with a structure on which a decentralized system could be built. If decentralization were a goal of the Chinese government, and it is not clear that this is the case, then the following reforms are now more within reach than in the period before 1994: a transparent grant system, based on formula rather than *ad hoc* distributions and derivation; taxation by an assignment system and possibly with some local discretion to add surtaxes to national bases; an individual income tax as an important source of local government revenue; and local borrowing powers, at least for the largest and most prosperous provinces. If such measures are to be part of the next steps in Chinese fiscal reform, the central government would do well to begin by strengthening its capacity to provide technical leadership and to monitor local government fiscal behavior.

Notes

1 Throughout this chapter we use the term "local government" to refer to all sub-national governments.

2 An evaluation of the tax structure implications of the reform is in Bahl (forthcoming). In the tax and revenue sections of this chapter, I draw liberally on that earlier analysis. Baoyun Qioa provided excellent research assistance for both this chapter and the earlier paper.

3 The *Statistical Yearbook of China*, which is the data source used for most of this analysis, does not disaggregate indirect tax revenues by type, nor does it present detail on the smaller local levies. It does, however, provide official statistics on Chinese public finance. Other studies, however, have provided more

detail relying on unpublished data provided by the Ministry of Finance and the State Tax Bureau. These reports have shown the VAT, product tax, and business tax to account for about equal shares of indirect tax revenue in 1992 (Bahl, 1994).

4 The tax contracts varied widely, from lump-sum payments to marginal rates that varied with the level of profits. For a description, see World Bank (1990: annex 2).

5 All income tax revenues collected from centrally owned enterprises belong to the central government. All other enterprise income tax revenues, regardless of ownership, revert to the provincial government.

6 For a good description of sales taxes in China, see World Bank (1990: 28–34).

7 In total, the local tax service collects fifteen different taxes.

8 The evolution of the tax-sharing formulas is discussed in Bahl and Wallich (1992).

9 This description is elaborated in Qiang (1995).

10 In fact, in the initial years the revenue-sharing may be different from the 75/25 target because local governments were promised their revenues would be kept at least at 1993 levels in the first years of the reform.

11 World Bank (1993: 80–81) and Bahl (1994).

12 Data are not available for more recent years.

13 The simple correlation between per capita earmarked grants and per capita income is 0.425, and between per capita earmarked grants and population is −0.662 (Bahl, 1994).

14 For a discussion of the long-term growth of extrabudgetary revenues, and the composition of this growth, see Wong, Heady, and Woo (1995: appendix I).

15 The ratio of extrabudgetary to budgetary revenue increased with GNP over the 1983–92 period, as indicated by the following regression results:

$$\mathrm{EXB/B} = 69.8 + \underset{(2.45)}{0.00093\,\mathrm{GNP}} \qquad R^2 = 0.43$$

where EXB = extrabudgetary revenue, B = budgetary revenue, and the figure in parentheses is the *t*-statistic.

16 The decline in the revenue share is exaggerated by the Chinese definition of revenues and expenditures, notably the treatment of debt issued as a revenue, debt repaid as an expenditure, subsidies to cover enterprise losses as a negative revenue, and the exclusion of government "departmental" revenues from the budgetary accounts. When adjustments are made to conform these data to standard international classifications, the results show that the Chinese revenue share of GNP still declined substantially, but less than is reported in table 2.2 (World Bank, 1994).

17 Various analysts estimate the tax ratio to be higher by 1 to 2 percent of GNP, depending on the data source used and the definition of revenues (Xu, 1995; World Bank, 1994; IMF, 1994). Data from the *Statistical Yearbook of China*, used in this chapter, give consistently lower estimates. All analyses, however, show much the same declining trend.

18 Neither is a comparatively low tax ratio an indicator of "bad" fiscal performance. Many of China's social services, for example, are provided as tax expenditures rather than through tax financing.

19 The consolidated fiscal deficit in China is not large by international standards (about 6 percent of GDP) but it has grown significantly since the late 1980s (World Bank, 1994).

20 Estimated from a linear regression of tax revenues on GNP with both variables expressed in logarithms. Technically, this is a buoyancy rather than an elasticity coefficient because no adjustments have been made for discretionary changes.

21 This argument was also made by Xu (1995: 1–25).

22 The elasticities were estimated from linear regression of tax collections on GNP with both variables expressed in logarithms, but no adjustments were made for discretionary changes.

23 The data in table 2.3 also indicate a local surplus in 1993, but this is an "announcement effect." In anticipation of the 1994 reform, local governments increased revenues in 1993 to establish a larger base for the new revenue-sharing system (Xu, 1995: 18).

24 Xu (1995, tables 2 and 3) estimates a reduction in both direct and indirect taxes as a result of the reform.

25 In fact, a decline in the tax share of GDP may not be inconsistent with revenue-neutrality, because the pre-reform system was already showing a declining trend relative to GDP.

26 Tibet and Hainan have been dropped from this analysis as special cases.

27 These relationships also held for the period 1985–90 in work reported by Bahl and Wallich (1992), Bahl (1994), and a study by Hofman reported in World Bank (1993). Hofman shows that virtually all of the variation in per capita collections can be explained by a *squared* per capita income term.

28 The range in 1991 per capita state and local government expenditures in the United States (excluding Alaska) was from $6,525 in New York to $2,715 in Arkansas. The range in China was more than three times that in the United States.

29 It is not entirely correct to draw conclusions about the new system based on 1995 results, because it was still in a transition period where part of the VAT was shared with local governments. Moreover, the sharing arrangements were irregular because of a provision whereby provinces were guaranteed support for their basic level of expenditures in 1993.

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