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China's Fiscal System: A Work in Progress

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*China's Fiscal System: A Work in Progress**

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Abstract:

We argue in this paper that unless China begins to tackle more systematically the serious problems that have emerged in the finances of its various levels of sub-national government the problems to which the present unsatisfactory system give rise will over time increasingly distort resource allocation, increase distributional tensions, and slow down the impressive recent growth of the Chinese economy. Despite the lack of solid and reliable information on the size and nature of China's real fiscal system, we show that the evidence available is generally consistent with this pessimistic reading. China's fiscal and – in time – economic future thus rests to some extent on reforms to key aspects of its fiscal system, especially its intergovernmental finances. Moreover, a more consistent and purposive framework to this complex of problems seems needed. Given the scale and scope of China's underlying public finance problems, the 'reactive gradualism' evidenced in recent ad hoc reforms to this or that piece of the fiscal system has, we suggest, run its course.

Key Words: China; intergovernmental finance; taxation; budget

JEL Codes: H11, H70, O53 P21

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Introduction

Public finance matters. It matters for sustained economic growth. It matters for economic stability. It matters for the distribution of income and wealth. It matters for the delivery of such basic services as education and health. It matters for political stability. These statements are in true in China as in any country. What differentiates China from other countries is not that its development is magically unrelated to what its public sector does and how it is financed but rather that the key to its public finance system lies in intergovernmental financial relations.

Unless China begins to tackle more systematically the serious problems that have emerged in the finances of its various levels of sub-national government the problems to which the present unsatisfactory system give rise will over time increasingly distort resource allocation, increase distributional tensions, and slow down the impressive recent growth of the Chinese economy. These statements may seem strong but as we show in this paper the evidence on hand –although far from fully satisfactory given the lack of solid and reliable information on the size and nature of China’s real fiscal system -- is overwhelmingly consistent with this pessimistic reading. China’s fiscal and – in time – economic future rests to a greater extent than seems generally to be understood on the success achieved in strengthening and extending recent ad hoc reforms to key aspects of its fiscal system within a more consistent and purposive framework. No doubt, once fully seized of the problem, China will be able to deal with it. But what seems clear is that the fiscal dimension of China’s development needs more attention than it has received to date.

In Section 1 we discuss the strongly ‘path-dependent’ nature of China’s fiscal development in the reform era. In Section 2, we consider the revenue side of public finance with special attention to the unusual extent to which public sector activities in China are financed ‘off-budget’. In Section 3 we consider more briefly some aspects of budgeting and public expenditure management. In Section 4 we argue that the revenue and expenditure problems cannot be understood or resolved without dealing with the underlying problem of developing a more sustainable fiscal structure of public agencies and sub-national governments. In Section 5, we briefly consider China’s fiscal system in international perspective. Section 6 concludes.

The Development of the Fiscal System

China’s fiscal development in recent years illustrates clearly the importance of ‘path dependency.’ How a country’s institutions develop depends critically upon where they start. To understand either the present or the future of China’s fiscal system, one must first understand where it came from: would-be reformers everywhere have learned that it can be perilous to underestimate the inertia of fiscal institutions. Although China has been collecting taxes for millennia, fortunately to understand the present system we

need only to consider the fiscal system that was installed in the 1950s, largely reflecting then-current Soviet practice.

The Starting Point

Under that system, essentially all expenditures were determined at the center. Importantly for future developments, however, responsibilities for day-to-day public administration and social services such as education (except universities), public safety, health care, social security, housing, and other local/urban services were all delegated to local governments. Financing for these services was provided by the central government through the revenue-sharing system, under which all revenues belonged to the central government.

At the time revenues came largely from industrial profits and were collected in a highly uneven pattern from different regions and localities. In principle, sharing rates were set annually at levels leaving each local government sufficient resources to finance its (centrally) approved expenditures. In practice, the revenue-sharing system was largely negotiated in nature. More generally, the way in which taxes and prices were intertwined made both the incidence and the effects of the fiscal system non-transparent. Although the implicitly perverse incentive structure of the pre-reform fiscal system was in part held in check by direct controls and in some instances offset by aspects of the financial structure, on the whole it seems clear that it was conducive to neither growth nor equity.²

The Decline of the Budget, 1978-1993

Once the mechanisms of the planned economy – administrative prices, compulsory procurement and planned delivery, monopoly state ownership of industry – began to be dismantled, the formal revenue system quickly began to erode. The immediate impact of market reform was rapid and dramatic erosion in the traditional tax base of the planned economy as SOE profits and revenue collection declined steeply.³ Central revenues were especially hard-hit because local governments in rich regions often shielded local enterprises from taxation to avoid sharing revenues with central government.⁴

To some extent, of course, these results were presumably desired: the central government did not want to hinder the initial expansion in agriculture and the growth of new small rural industries by imposing heavy tax burdens. In any case, China had no real tax administration in place that could have taxed rural-based growth. No one

² For an early assessment, see World Bank (1988); for more general discussion of the structure and effects of Soviet-type fiscal systems, see e.g. Wanless (1985).

³ Of course, this phenomenon occurred to varying extents in all 'transitional' economies: see World Bank (1996).

⁴ For example, under the planned economy Shanghai remitted more than 80 percent of its revenues to the central government. This high 'tax' on Shanghai revenues created incentives for collusion between the municipal government and its subordinate enterprises and the potential for informally sharing the "saved revenues" within Shanghai. For analyses of this evolution, see Oksenberg and Tong (1991) and Wong (1991, 1992).

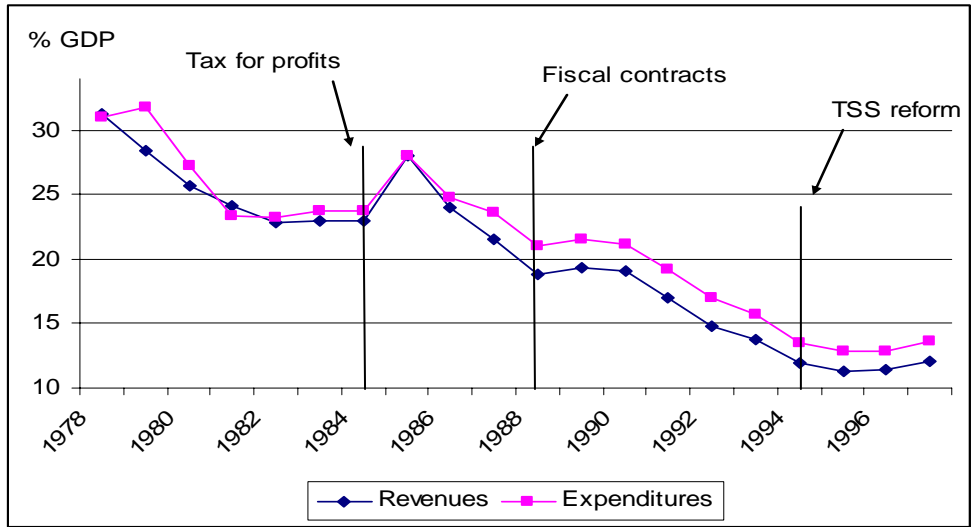
recognizable as a modern tax official had been needed under the old system, so it is not a surprise that no such officials existed when fiscal reform began at the end of the 1970s. The Chinese tax system rested on the local collection of revenues that were then remitted to the center, and this administrative structure proved vulnerable to erosion as central economic control lessened. Unfortunately, these fundamental administrative problems were not initially understood, and the immediate fiscal reform as part of the ‘new Chinese system’ took the form of a series of changes in tax structure.

With respect to enterprise profits, for example, in 1984, an income tax on state-owned enterprises was introduced to replace profit remittances. This reform met with fierce resistance and in 1986 was replaced by a ‘contract’ system, under which enterprises signed multi-year contracts specifying their profit remittances. Faced with a steep fiscal decline and lacking the capacity to monitor tax effort at the provinces, in 1988 the central government introduced a further system of fiscal contracts (the ‘fiscal responsibility system’) with local governments. These contracts stipulated a lump-sum remittance (or subsidy) to the center from each province, to increase annually by an agreed rate, with any additional revenues accruing to the province. In return, provinces accepted responsibility for meeting their expenditure requirements from retained revenues. The result was a fundamental change in the fiscal system: by de-linking revenue-sharing from expenditure needs, fiscal contracts put local governments on a self-financing basis for the first time – a de facto devolution of responsibilities that was later codified in the 1994 Budget Law.

Fiscal contracts did not, however, solve the central government’s financial problems as revenues continued to decline (Figure 1) due to continuing problems of SOE profitability and persistent credibility problems of the central government (Wong, Heady and Woo 1995). Moreover, as the generous terms of the contracts gave local governments a disproportionate share of new revenues, the central share of revenues fell rapidly, to just over 20 percent in 1993.⁵ At the nadir, the central budget allocated only 3 percent of GDP, with seemingly no end to the decline in sight.

⁵ This was largely because the contracts had failed to anticipate the high inflation rates through the late 1980s and early 1990s, when revenues grew at an annual rate of 12 percent from 1987 to 1993 while remittances grew at low single digit rates.

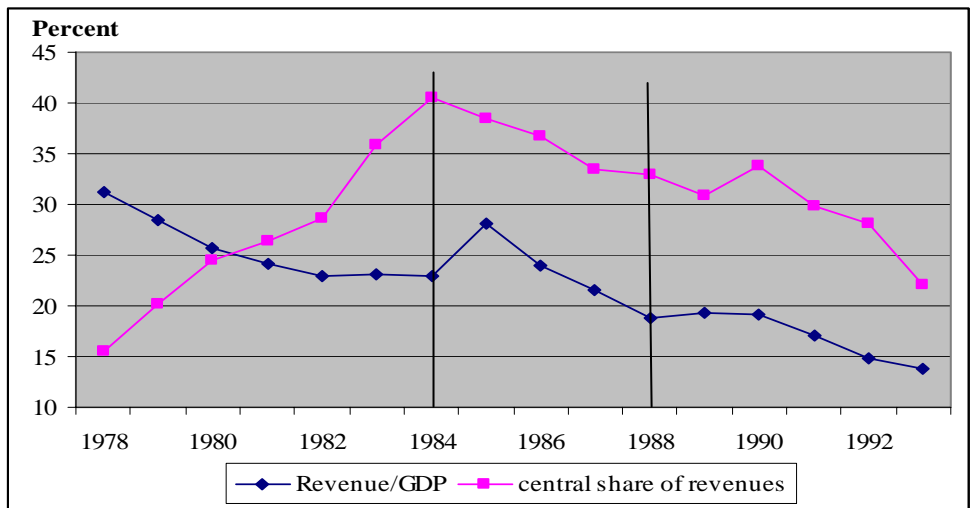
Figure 1. The Long Fiscal Decline



Source: data from the Ministry of Finance, adjusted to conventional definitions.

Accompanying this decline of the budget, however, ‘extrabudgetary revenues’ grew during the 1980s and 1990s offsetting the budgetary trend to some extent. It is important to note, however, that the nontax fees and levies and quasi fiscal expenditures included under the general rubric of extrabudgetary revenues were even more decentralized than budgetary revenues and were largely outside of the purview of the Ministry of Finance. Their existence thus did little to offset the erosion of allocative control by the central government. By the early 1990s, the situation for the central government was said to be “desperate,” spurring a drastic reform with two paramount objectives – stemming the decline of revenues and clawing back a majority share for the central government or “raising the two ratios” (revenue/GDP and central/total revenue) (Figure 2).

Figure 2. The “two ratios”



The 1994 Reform

The major fiscal reform of 1994 aimed to ‘recentralize’ the fiscal system. The fiscal reform package introduced in 1994 actually had three main components: tax sharing, tax modernization, and tax administration (Bahl 1999). While the Tax Sharing System (*fenshuizhi*) was the most visible and controversial element, the other two were also important changes that have received far less notice.

Tax Modernization

An important component of the 1994 reform was tax modernization -- simplifying the tax structure, eliminating distortionary elements and increasing transparency. The complex multi-tiered system of turnover taxes borrowed from the Soviet Union was replaced with a VAT which now applies to all manufacturing, repair and assembly activities, primarily at a single rate of 17 percent. On eleven products an additional excise tax (the Consumption Tax) is applied at differing rates in addition to the VAT: tobacco products, alcohol, and a few luxury consumer goods such as cosmetics, jewelry, gas and kerosene, and motor vehicles. A business tax is applied to services including banking and insurance, wholesale and retail trade, transfer of real estate and invisible assets and entertainment, generally at a rate of 5 percent of turnover.

During the 1980s the multiple-rated turnover taxes created important distortions, attracting too much investment into some sectors and encouraging vertical integration within enterprises, thus contributing to duplication and convergence in industrial structures across regions. Even after market competition had eroded profit margins, sectors with high product tax rates (up to 60 percent of the price) continued to attract entry. Local governments seeking to maximize revenues would choose to enter sectors where the sum of profits and tax rates was above average even if profit rates were expected to be low or even negative. This appears to have been the case in industries such as liquor and tobacco. For example, Zhou (2000) reported that even in the late 1990s thirty of the 31 provincial-level units had cigarette manufacturing plants even though few provinces grew tobacco. At the firm level, 55 percent of the 178 manufacturers were loss-making on an after-tax basis in 1996. In 1998 although at least four provinces showed negative unit profit rates among cigarette manufacturers in their province, all had positive returns when taxes were included. Differential tax rates thus prolonged local protectionism of less efficient producers.

The single rate VAT introduced in 1994 eliminated the undesirable allocative effect of turnover taxes.⁶ By taxing only the portion of value-added in any enterprise, the VAT also eliminated tax cascading and much of the incentive for vertical integration that

⁶ There had previously been 21 rates for the product tax, ranging from 3 percent to 60 percent and 4 business tax rates (3-15 percent). The reform also unified the turnover tax treatment for domestic and foreign enterprises by eliminating the consolidated industrial and commercial tax (with 40 rates ranging from 1.5 - 69 percent) previously applied to foreign enterprises, placing them also under the VAT.

had existed under the product taxes (and their predecessors, the industrial-commercial taxes).⁷ Since those taxes were paid on gross output value, they had created significant incentives against specialization in the production of intermediate inputs.

The Tax Sharing System

The Tax Sharing System (TSS) fundamentally changed the way revenues are shared between the central and provincial governments by shifting from a negotiated system of general revenue sharing to a mix of tax assignments and tax sharing. Under the TSS, taxes are assigned to central government, local government, or shared (Table 1). By assigning the biggest tax, the VAT, as a shared tax and claiming 75 percent of its receipts, the central government reclaimed a majority portion of total revenues.⁸ At the same time, however, the TSS essentially swept aside all earlier concerns about the disqualifying effect of the tax assignment, apparently in part at least to win quick agreement from the (rich) provinces.⁹

On the other hand, the TSS cut incentives for local duplication and protectionism by reducing local 'ownership' of turnover taxes. Under the previous regime, product tax revenues from local enterprises were pooled with other revenues and shared with the central government. As fiscal decentralization turned over the bulk of marginal revenues to local governments, these product taxes stayed mostly in local coffers. Even though a complicated tax rebate scheme commits the central government to rebating some 30 percent of its new revenues from the VAT and the accompanying excise taxes – the Consumption Tax (CT) -- the TSS significantly diluted the linkage between enterprises and local revenues. For the cigarette industry, for example, where the product tax had been 40-66 percent (MOF 1982),¹⁰ it was usually revenue-enhancing for local governments to carry loss-making manufacturers. Under the TSS, even though there is a 40 percent excise tax in addition to the VAT, only 25 percent of the VAT accrues to local government, plus 30 percent of any incremental revenues collected by the central government. In a saturated market, if the local cigarette manufacturer is not able to increase sales (on which tax rebates are based), the local government would receive none of the CT revenues and no further rebates on the VAT.

⁷ Some incentive remained owing to the lack of crediting for capital inputs.

⁸ The VAT accounts for nearly half of all tax revenues in China. It is also a reliable tax whose revenues go up with GDP regardless of profitability and is thus less cyclical than income or profit taxes.

⁹ See, for example, Zhao (2003) who describes the desperate funding crisis in which the central leadership found that they had also lost control over tax collection at the local levels. In the course of introducing the VAT, for example, Beijing Municipality was found to have under-reported 9.8 billion yuan in revenues.

¹⁰ These are embedded (tax-inclusive) rates. Ad valorem rates would be much higher.

Table 1: Revenue Assignments between the Central and Provincial Governments**Taxes exclusively assigned to the Central Government**

1. Excise taxes
2. Taxes collected from the Ministry of Railroads and from the headquarters of banks and insurance companies
3. Income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures
4. Energy and transportation fund contribution
5. 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 nonferrous metals companies.
6. All customs duty, VAT and excise taxes on imports
7. Enterprise income tax collected from banks and other financial institutions.

Taxes shared between the central and local governments

1. Value-added tax (75 percent central, 25 percent provincial)
2. Natural resource taxes (coal, gas, oil, and other minerals if the enterprises are fully Chinese owned.)
3. Construction tax on the cost of construction of buildings that are outside the plan and financed from retained earnings
4. Salt tax
5. Industrial and commercial tax, and income tax levied on foreign and joint venture enterprises.
6. Security and exchange tax (50 percent central, 50 percent provincial) – added in late 1990s
7. Income tax of all enterprises – added in 2002
8. Personal income taxes – added in 2002.

Taxes exclusively assigned to local governments

1. Business (gross receipts) tax falling on sectors not covered by VAT (transportation and communications, construction, finance and insurance, post and telecommunications, culture and sports, entertainment, hotels and restaurants, and other)
2. Rural market (stall rental) trading tax
3. The urban maintenance and construction tax (a surcharge on the tax liability of enterprises for business tax, consumption tax, and VAT)
4. The urban land use tax
5. Vehicle and vessel utilization tax
6. Thirty percent of the product and VAT revenues collected from enterprises owned by the Ministry of Industry, Ministry of Power, SINOPEC, and the China nonferrous metals companies
7. Value-added tax on land
8. Education surtax
9. Entertainment and slaughter taxes
10. Property tax
11. Surtax on collective enterprises
12. Resources tax
13. Fixed asset investment tax (discontinued in 1999)
14. Fines for delinquent taxes.

Source: adapted from World Bank (2002) Table 4.1.

To maintain some incentives for promoting local industry, however, the TSS provided that the enterprise income tax (EIT) would continue to be divided by ownership (or subordination) with central enterprises paying EIT to the central government, provincial enterprises to the provincial government, and so on. Although this meant that local governments still had an incentive to enter industries where profit margins are high, such opportunities were increasingly limited to protected sectors such as cigarettes, telecommunications, and the automobile industry, where high tariff walls or government controls continued to maintain rents.¹¹ With only a minor portion of VAT accruing to local coffers, protection of inefficient loss-making enterprises is likely to be more short-lived under the TSS. In the cigarette industry, for example, the result over time should be consolidation similar to that occurring earlier in other industries such as breweries and manufacturers of household appliances.

Tax Administration

The 1994 reform established a national tax administration in China for the first time. The previous local tax bureaus were split into two distinct offices: a national tax administration responsible for collecting central and shared taxes (the VAT, the CT and customs duties, as well as the EIT from central enterprises), and a local tax administration responsible for collecting local taxes. By removing central taxes and the VAT from local administration, the reform largely eliminated opportunities for local governments to divert central revenues into local coffers through manipulations of tax assessments. The recovery of revenue collections from the trough of 11 percent of GDP in 1996 to the current level of nearly 20 percent can be mostly attributed to stemming this hemorrhage.

Overview of the Reform

The 1994 reforms, hereafter referred to simply as the TSS, fundamentally changed incentives for local governments. While reducing fiscal incentives for promoting local industry, the TSS also shifted incentives more toward commerce and trade by expanding the business tax on services and assigning it to local governments where it has become an important revenue source that rivals the VAT.

Some distortions remain. For example, sharing revenues of the VAT and the EIT with local governments on a derivation basis (where taxes are collected, such as the headquarters of enterprises) may in the long run hinder the growth of national enterprises and slow down the consolidation process. If an enterprise has production facilities (not independent units) in more than one jurisdiction, the issue of where it pays its VAT and EIT arises. Since these taxes are likely to be paid exclusively in the jurisdiction where the headquarters of the enterprise is located, the result may again be protectionist policies by local jurisdictions attempting to maximize their share of the VAT and EIT, to the detriment of a more efficient allocation of resources.

¹¹ Naughton (1992) shows the rapid convergence of profit rates across industries through the 1980s as entry was opened. The exceptions were sectors where government monopolies were retained.

In addition, by sharing VAT revenues with local governments at a flat rate by origin, the TSS introduced a highly disequalizing feature to revenue sharing, ensuring that revenue-rich regions keep more. Under the TSS, coastal provinces gained revenue shares relative to inland provinces. From 1992 to 1998 the ratio of provincial per capita fiscal expenditures in Shanghai grew from 2.5 to 3.9 times the national average, in Beijing from 2.2 to 2.7, and in Guangdong from 1.1 to 1.4. In contrast, in Henan the ratio fell from 0.44 to 0.42, in Gansu from 0.8 to 0.6, and in Hunan from 0.53 to 0.49 (MOF 2002).

More generally, because the TSS recentralized revenues but left expenditure assignments unchanged, it created a huge fiscal gap for local governments (see Figure 3). Unlike the previous regime under which only poor provinces received transfers, under TSS all provincial units including Shanghai and Beijing are now dependent on central transfers to finance expenditures. In aggregate, provinces are now dependent on transfers to finance nearly 50 percent of their expenditures (Figure 4). How these transfers are designed thus has a direct impact on distributional outcomes. Despite an initial promise to roll out a formula-based equalization transfer system to counter the regressive effects of the TSS, this was not done. A ‘transitional intergovernmental transfer’ was introduced in 1995 but never accounted for more than 1-2 percent of total transfers through the 1990s. Instead, under the TSS, transfers were dominated by tax rebates that also favor the rich, reinforcing the disequalizing character of the tax sharing system itself (see Figures 5 and 6).

Figure 3. The evolving local fiscal status

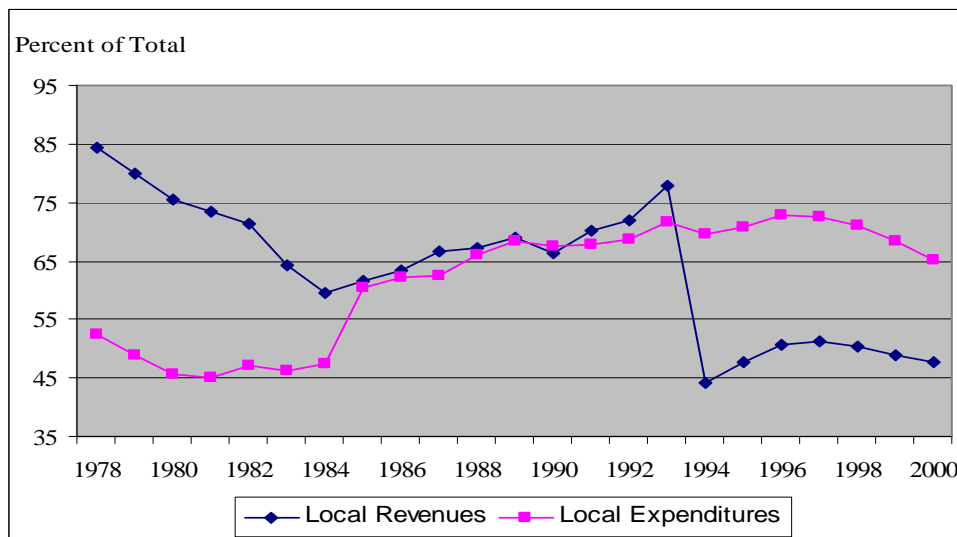


Figure 4. Transfers as a share of local expenditures

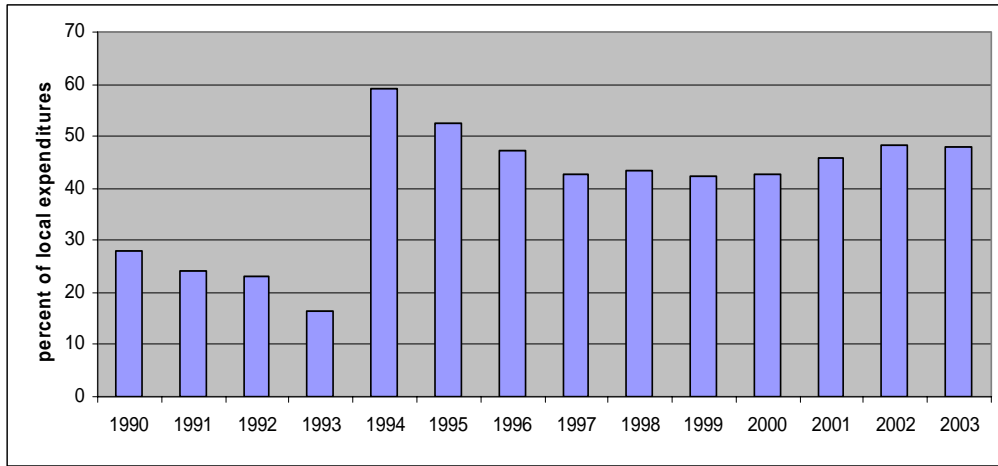


Figure 5. Per capita transfers by province (1998)

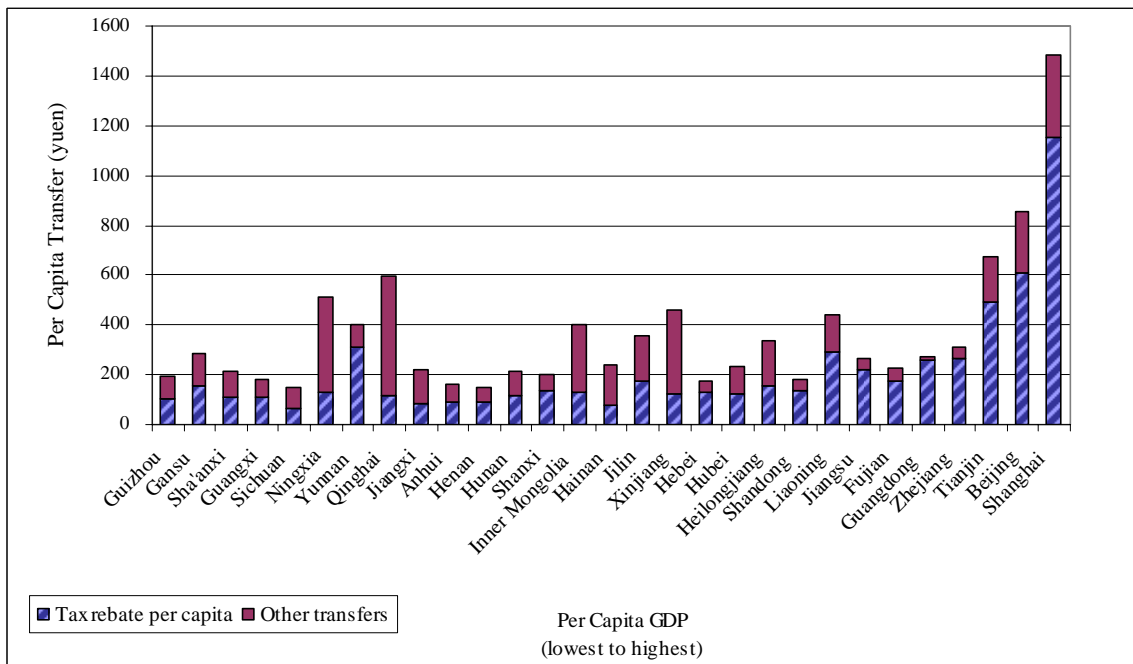
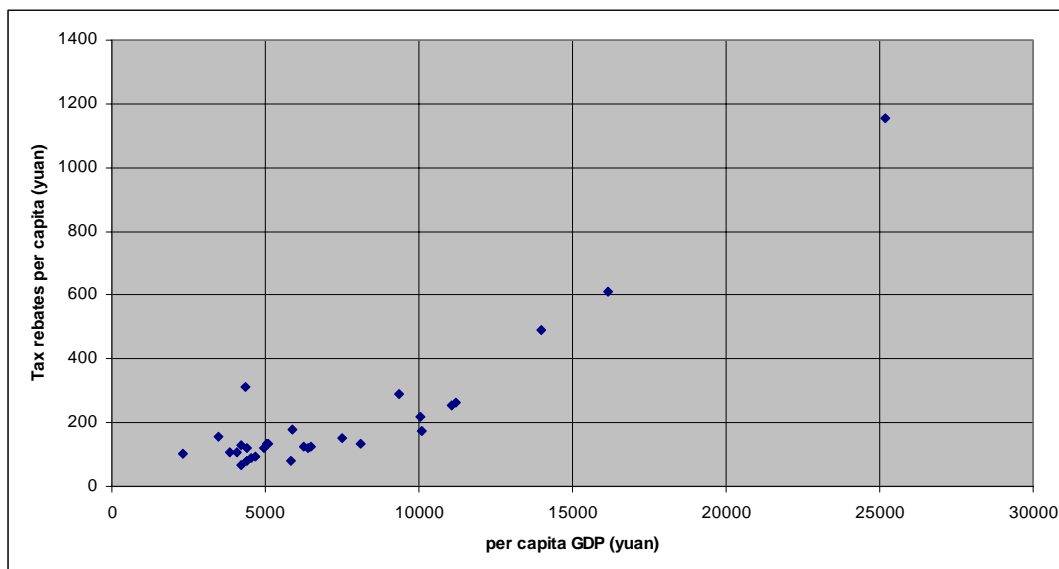


Figure 6. The distribution of tax rebates by province

A System in Transition

As this brief account suggests, the most critical fiscal issues in China today essentially arise from the mismatch of expenditures and revenues between levels of government resulting from the 1994 reform and the resulting distortions as China's various layers of government struggled to find their fiscal feet in this fundamentally distorted structure. Important as it was, the 1994 reform by no means marked the end of the reform process though it may perhaps (as Churchill once said) mark the end of the beginning of that process. In recent years, for example, local governments have attempted to cope with their increasing fiscal problems by increasing revenues in a variety of legal, quasi-legal, and even illegal ways, as we discuss in the next section.

China's current fiscal system is the product of a quarter century of changes, some of them drastic, but it is clearly a system still in transition and remains very much a work in progress. Nonetheless, despite the problems remaining in the fiscal area, it is important to remember two things. First, China has already come far in fiscal terms. The reform era started with a fiscal system that was completely unsuitable for a mixed economy. Over the last two decades, many sensible changes have been introduced in tax policy, in tax administration, in expenditure management, and even, to a lesser extent, in intergovernmental finance. Secondly, as we noted at the beginning, despite getting so many fiscal matters 'wrong' China has clearly managed to do incredibly well to date in economic terms. Although in some ways surprising, on closer examination this outcome is by no means inexplicable. To a considerable extent China has managed to overcome the macroeconomic problems that would otherwise have arisen from its fiscal imbalance through a combination of monetary and financial policy and continued political control from the centre. Similarly, despite the relatively chaotic operation of its overwhelmingly important sub-national government sector, to date Chinese officials and entrepreneurs

have been able to cope amazingly well -- albeit at the expense of piling up a series of problems that if not resolved in some more satisfactory fashion than heretofore will, we argue, increasingly distort and perhaps even eventually halt development.

Mobilizing Public Sector Resources

The common view of China's revenue policy over the last two decades is that the government has been fighting a largely losing struggle to maintain its resource base in the face of drastic changes in economic structure. The need for such a 'fight' seems obvious, since government revenue as a share of GDP fell drastically from 35 percent in 1980 to 19 percent in 1990 and then still further to a low of 11 percent in 1995-96 before rising again towards the end of the century. The central government in particular lost out in the earlier years, with its revenues falling to as little as 3 percent of GDP in 1993 and even after the 1994 reform amounting to only 9 percent by 2000.

The Tax System

In many respects the current tax structure appears as 'modern' as that in most countries. Unsurprisingly, however, there is still much room for reform. The VAT, for example, although a major revenue producer, is not really a VAT because it does not credit capital expenditures and thus penalizes new investment. China's VAT is thus not the destination-based consumption-type tax found in most countries (Ebrill et al., 2001) but rather an origin-based production-type tax that also excludes from the tax base many services which are subject to a separate business tax collected by local governments. This VAT design hampers export competitiveness, penalizes investment, generates distortions through cascading and creates incentives for local protectionism. With WTO accession it has become urgent to reform the VAT to bring it in line with international practice. Shifting to a more normal consumption-type VAT, however, would be expensive. Since investment constitutes 35-40 percent of GDP, exempting investment could cost the Government more than one-third of its VAT receipts unless the change is offset either by a rate increase (from the already relatively high 17 percent) or by broadening the base to include services and offsetting the likely effects on local revenues in some way.¹⁴ Currently reforms are underway to move toward a consumption-type VAT, beginning in the three Northeast provinces of Liaoning, Heilongjiang and Jilin in 2004. Although the reform is to be rolled out nationwide late in 2005, no details are yet known. In the Northeast pilot provinces, in order to keep costs under control, tax credits were applied only to selected investments and were also limited to firms that were in business prior to the introduction of the reform.

Similarly, the enterprise income tax (EIT) regime leaves much to be desired. It is marked by tax preferences, with large differences in the treatment of domestic- and foreign-funded businesses that both add to the complexity of the tax system and lead to

¹²The business tax accounted for an average of 24 percent of local "own revenues" before tax rebates in 2000, but was as high as 37 percent in Beijing. For detailed discussion of China's VAT, see Ahmad, Singh and Lockwood (2004).

losses in revenue and unfair competition among enterprises. The present sharing of revenues from both the VAT and the EIT with local governments on a derivation basis is at best a transitional arrangement.¹⁵ For instance, sharing VAT revenues on a derivation basis (where taxes are collected at points such as the headquarters of enterprises) has been a major cause of the increasing disparities in revenue distribution in favor of the richest provinces. Moreover, unfairness has been accentuated because the VAT can be credited and debited in different local jurisdictions. EIT sharing also is suspect: for example, even if an enterprise has production facilities (not independent units) in other jurisdictions, EIT is usually paid exclusively in the jurisdiction where the headquarters of the enterprise are located.¹⁶

Other aspects of the tax system are also cause for concern. For example, the relatively high taxes imposed on banking deter the development of the financial sector and impose added fiscal costs to saving and investment. More generally, revenues from the formal tax system are relatively low and not very buoyant. In part perhaps reflecting the apparently low level of official concern with emerging interpersonal inequality, little has been done to develop personal income taxes or for that matter the property and land taxes that seem needed to finance China's growing urban development in a sustainable fashion (Hong 2003).¹⁷ There is thus still much that could usefully be done to improve the tax structure.

Equally or more important, tax administration remains weak and there appears to be substantial leakage and much scope for corruption (Li 1997). These problems seem especially important at the local level, where collection costs are high – estimated at 3-4 percent in the aggregate, and as high as 10 percent or more in some localities.¹⁸ Despite the creation of local tax offices in 1994, no steps have yet been taken to establish an effective local tax administration. Local governments have no tax autonomy: all “local” taxes are assigned, with both rates and bases set by the central government.

Outside the Budget

In China, however, the formal budget is only a part of the fiscal story, and not necessarily the most important part. In addition to the extra-budgetary funds that grew so rapidly in the first half of the 1990s, many other implicit and hidden revenues, transfers, and expenditures pervade the system, driven in part by the lack of any good formal local

¹³ Revenue sharing of the VAT and the EIT by the central government with local governments on a derivation basis was a logical move, given the old Soviet system, and many transition economies moving from a Soviet-type tax system took this step. However, it is also a source of unfairness and significant distortions, leading many transition countries to abandon significant parts of this system. Most recently, Russia, Ukraine, and Kazakhstan have discontinued revenue sharing for the VAT and reassigned this tax fully to the central level.

¹⁴ The EIT accounted for an average 13 percent of revenues, but was 20 percent or more for a number of provinces including Beijing, Shanghai, Tianjin, Zhejiang, Jiangsu, and Tibet.

¹⁵ On the greater political than economic importance of such redistributive taxes in emerging democracies, see for example Bird (2003) on Latin America. So far, at least, there is little evidence that this has been an important factor in Chinese policy.

¹⁶ These figures are based on fieldwork carried out in 2003-2004.

tax bases and facilitated by the continuing obscurity of the line between 'government' and 'business' at the local level. After prolonged wavering during the 1980s about whether government agencies should be engaged in profit-making activities, tacit permission was given in the early 1990s for these activities to continue (Duckett 1998). With the TSS recentralization of revenues (raising the central share from 20 percent to 60 percent) creating a huge fiscal gap for local governments, allowing local governments to tap off-budget revenues was a stop-gap measure to avoid some of the potential adverse effects the TSS reform would otherwise have on economic growth by enabling local governments to secure sufficient finance to carry out their assigned functions.

When Zhu Rongji became premier in March 1998, he announced that fiscal reform would be one of the five areas of reform priority for his administration, and the program to "convert fees into taxes" (*feigaishui*) was the first major effort in fiscal reform. This seemed an appropriate focus because *luanshoufei* (the reckless collection of fees) had become the bane of businesses and citizens alike. This practice also created a serious problem for the central government as it eroded tax capacity and subverted the whole budgeting process, thereby impeding the government's ability to carry out its core fiscal functions of macro management, equalization, and resource allocation.

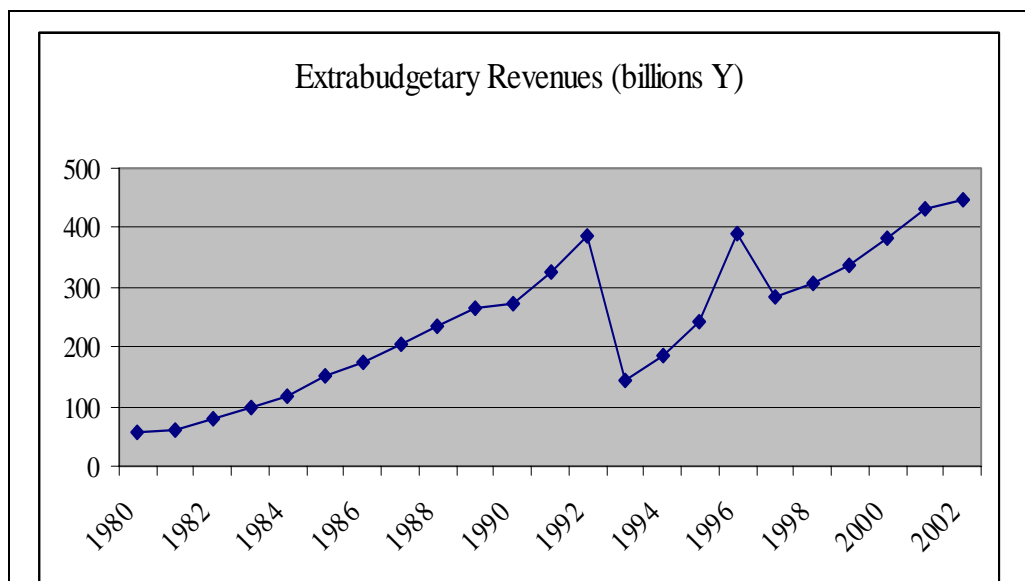
A nationwide audit by a blue-ribbon group consisting of the Ministry of Finance, the then-State Planning Commission, the State Council Audit Office, the People's Bank of China, and the Ministry of Supervision in mid-1996 found more than 384 billion yuan in 'extra-budgetary funds' (EBF), about 50 percent more than the reported figures and equal to 6 percent of GDP. Given that budgetary revenues were only 11.3 percent of GDP that year, this amounted to more than half of budget revenues and more than one-third of resources available to government. In 1997 the Ministry of Finance estimated that EBF totalled more than 400 billion yuan. In 1998, estimates of the size of EBF climbed higher still – the Ministry of Finance used a range of 8-10 percent of GDP,¹⁹ but officials of the State Administration of Taxation often cited estimates of 15 percent or more.²⁰

As this range of estimates suggests, it is surprisingly difficult to measure the real size of public sector activities in China. Reporting requirements are much looser for EBF than for budgetary resources. Some EBF consists of incomes and expenditures of extrabudgetary enterprises of government and their agencies, whose interaction with budgetary resources is murky, ill-defined, and in flux. These problems are compounded by differing definitions of what is 'extrabudgetary', and by the fact that recipients of EBF have no incentive to disclose fully the extent of their receipts and payees are often afraid to report fully the extent of payment. From 1996 onward, still more confusion was sown by the many changes introduced to the reporting of extrabudgetary funds in the budget as well as the reclassification of administrative units under government: see Figure 7.

¹⁷ In a speech at a meeting of finance ministers in Paris in December, 1998, Vice Minister Lou Jiwei spoke of government fees and charges that equalled about 10 percent of GDP and were "not entirely under the control of the budget."

¹⁸ This number has been widely cited in the SAT newspaper, *zhongguo shuiwubao*, and attributed to the highest officials of SAT, including its deputy chief as well as chief economist.

Figure 7.



NOTES:

- The large decrease in extrabudgetary revenues in 1993 was a result of changes in how extra-budgetary revenues were covered and measured. Specifically, data from after 1993 does not include revenues from 'State Operated Enterprises' and is not comparable with earlier figures. See Table 2.

- The large decrease in EBF revenues in 1996 was accounted for by drops in the revenues of Administrative Units and Local Governments. The causes were: removal of business incomes from public service units from EBF, abolition of many fees under the campaign to stop the "reckless levying of fees", and incorporation of some administrative charges into the budget. The decline would have been even larger except for the inclusion of 'Revenue from Fundraising Programs of Township Governments' in the totals for extrabudgetary revenue. See Table 3.

- In 1998 the scope of extrabudgetary revenues was changed again to no longer include 'Revenue from Local Governments' However, 'Revenue of Funds' and 'Other Revenue' were added, and 'Revenues of State-Owned Enterprises and its Governing Departments' was also reintroduced into the total extrabudgetary revenues. This involved reclassification of some revenues such as revenues from sales of land leases, which became "fund revenue". See Table 3.

Source: China Statistical Yearbooks (*Zhongguo Tongji Nianjian*) and interviews at MOF.

Year	Total EB Revenue	Local Government EB Funds	Administrative Unit EB Funds	SOE & Department EB Funds
1990	2708.64	60.58	576.95	2071.1
1991	3243.31	68.77	697	2477.54
1992	3854.92	90.88	885.45	2878.59
1993	1432.54	114.71	1317.83	--
1994	1862.53	140.03	1722.5	--
1995	2406.5	171.65	2234.85	--

Year	Total EB Revenue	Admin EB Funds	Local EB Funds	Township Fundraising	Revenue Of Funds	SOE Revenue	Other Revenue
1994	1862.53	1722.50	140.03	--	--	--	--
1995	2406.50	2234.85	171.65	--	--	--	--
1996	3893.34	3395.75	224.69	272.90	--	--	--
1997	2826.00	2414.32	115.90	295.78	--	--	--
1998	3082.29	1981.92	--	337.31	478.41	54.67	229.98
1999	3385.17	2354.28	--	358.86	396.51	50.11	225.41
2000	3826.43	2654.54	--	403.34	383.51	59.22	325.81
2001	4300.00	3090.00	--	410.00	380.00	60.00	360.00

What Are EBF?

A broad definition of EBF is that they constitute all resources managed directly or indirectly by administrative branches of the government outside the normal budgetary process. Since the essence of budgeting is to weigh expenditures against one another, or against increased revenue, from the perspective of public expenditure management the critical distinction between budgetary and extrabudgetary funds is the extent to which the resources are put through the normal budgetary deliberations.²¹

Two common types of EBF are found around the world: (1) Special accounts segregated from the budget and intended for carrying out a specific activity, or to benefit a specific agency. These accounts are often organized as funds or as self-balancing accounting entities. (2) Revenues raised outside the budget framework by administrative

¹⁹For a discussion of how the management of extrabudgetary funds differs in China from that in OECD countries, see World Bank (2000), Chapter 3.

units as well as off-budget payments by the Treasury, the central bank, or any other organization which has authority over public money. Type 1 EBF are earmarked funds that are protected from annual budgetary deliberations. Type 2 EBF are nonbudgetary revenues of branches of government. Type 1 are thus extrabudgetary by use and Type 2 by source. In most countries EBF tend to be predominantly Type 1 (Bird and Jun 2005). The principal exceptions are former Soviet-type economies such as China.²² In the particular case of China the Budget Law explicitly prohibits the transfer to budgetary revenues to extrabudgetary accounts²³ so that EBF in China are thus extra-budgetary both by source and by use. As discussed below, the primary motivation for the development of EBF in China, especially at the subnational level, has clearly been revenue enhancement rather than earmarking,

The term ‘extrabudgetary funds’ is generally used in China in a narrower sense than the above discussion implies. Following Soviet practice, explicit extrabudgetary funds were first created in the early 1950s as small amounts of funds set aside from centralized management and control.²⁴ As the concept evolved, however, EBF came to refer to fees and funds that are not taxes or budgetary items but that nonetheless are specifically authorized by some government body.²⁵ This definition leaves out significant public resources that are neither budgetary nor extrabudgetary in this sense. Such funds are variously called self-raised funds, extra-extrabudgetary funds, off-budgetary funds, or extra-system revenues. One important example is revenue from the sale of land leases: because of the irregular, nonrecurrent nature of such revenue, the Ministry of Finance agreed that it should not be included in local budgetary revenues to avoid affecting the revenue sharing base. However, no treatment was clearly specified for such funds. In some localities such revenues were called extrabudgetary revenue; elsewhere they were listed as ‘self-raised funds’. It was only in the late 1990s that they began to be treated as “fund revenues” and reported in the budget as a “below the line” item. For all these reasons, it is far from simple to tell just what is being counted in references to extrabudgetary resources in China.

The Effects of EBF

In general, both earmarking and EBF tend to increase under conditions of fiscal stress and progressive breakdown of budgetary procedures. Since the passage of Proposition 13 in 1978 severely restricted property tax increases in California, for example, local governments have resorted to a plethora of user charges to enhance revenues and finance local services. Moreover, tax increases have tended to earmark

²⁰ For a discussion of the situation with respect to EBF in Russia, see World Bank (1996a).

²¹ Reported in *Renmin Ribao (People's Daily)*, August 6, 1996.

²² The earliest examples were the surcharge on the agricultural tax that local governments were permitted to spend without higher level approval and the surcharge on the wage bill that could be set aside for workers's bonuses, etc.

²³ While most EBF thus have legal authorization from some level of government or branch, these decrees usually lack specificity and rarely contain detailed criteria for the use of funds. Many are internal documents known only to the relevant authorities.

revenues for specific uses, thus making them extrabudgetary.²⁶ Similarly, the breakdown of macroeconomic discipline in Argentina during the 1980s led to a proliferation of earmarking: at the peak more than 30 percent of the budget was locked up in special budgetary accounts.²⁷ In some ways, China seems to have followed the same path. In the 1990s a series of laws and decrees carved out pieces of the budget for specific uses: for example, the National Education Law mandated that by 2000 the budget would spend 4 percent of GDP on education, and the Agriculture Law required that budgetary spending on agriculture must grow at a faster rate than budgetary revenues.

However, several features distinguish EBF in China from those in most developing (though not most transitional)²⁸ economies. One such feature is that the budget is not comprehensive, and government engages in many activities off budget. Under central planning, allocative decisions by government were only partially reflected in the budget. Administrative prices and the credit plan also played important roles in directing resources to achieve government objectives. As budgetary revenues fell from 35 percent of the GDP to less than 12 percent during the transition, the government understandably depended increasingly on extra-budgetary levers to achieve its policy goals. Throughout much of the 1990s, for example, the government implemented its industrial policy largely through directed lending and financed social expenditures through state-owned enterprises. During the 1985-1995 period, quasi-fiscal spending in the form of directed lending was estimated to have been 6-8 percent of GDP (or half as much as in-budget expenditures). In addition, tax expenditures were another 1-2 percent of GDP (World Bank 1999).

The sheer size of the EBF sector as well as its composition also distinguishes China. With EBF (excluding extrabudgetary activities and social security) estimated variously at 70-125 percent of the budget, China represents an extreme case of dependency on extrabudgetary finance. Importantly, most of these extrabudgetary activities are at the subnational level since subnational governments are responsible for providing significant expenditures, including social safety nets (pensions, unemployment insurance, disability, minimum income support, etc.) and capital investment (especially the need to replace or refurbish obsolete and poorly maintained infrastructure). In addition, to a considerable extent they have also borne the uncompensated transfers of social expenditures from SOEs -- housing, child care, medical care and sometimes education. How can local governments pay for all this? Even after the 1994 reform, these governments cannot set their tax rates or change the bases of collection; nor can they introduce new taxes. On the other hand, they have ownership over substantial assets such as land, enterprises, and sometimes natural resources.

²⁴ An example is Proposition 99, which imposed a 25-cent per pack tax on cigarettes with revenues earmarked for spending on anti-smoking propaganda and cancer research.

²⁵ In Brazil, even without crisis, earmarking at the federal level had, by some measures, grown to close to 80 percent of revenues by 2002. For a recent discussion of earmarking in this and other countries, see Bird and Jun (2005).

²⁶ See, for examples, Wallich (1994), Bird, Ebel and Wallich (1995), and Bubnova and Way (1998).

In the circumstances, it is not surprising that local governments have responded to fiscal pressures in a variety of ways:

- They have accumulated arrears -- wage arrears to teachers, medical workers, and civil servants; payments arrears (pensions, unemployment insurance, and debt to suppliers such as utilities).
- They have borrowed (usually illegally) from SOEs, pension funds, unemployment insurance funds, and banks. Unfortunately, while there is considerable anecdotal evidence about borrowing by local governments in some parts of China, there are no firm numbers on the true extent or precise nature of this phenomenon.²⁹
- They have defaulted on obligations to provide social services at adequate levels.
- They have forced enterprises to finance public expenditures – passing on fiscal burdens to the enterprise sector, and often, via enterprises to the banking sector.
- Most importantly, however, they have focused their efforts on developing EBF. Virtually all levels of government – down to municipal districts and villages – have the capacity to exact payments under various names from local businesses and residents. It is not surprising that most EBFs in China are at the subnational level.

Many EBFs have been introduced to provide financing for a specific purpose.³⁰ For example, the Three Gorges construction fee is levied to raise funds for the Three Gorges project. Such fees are usually collected by the spending units rather than by tax authorities. Too many collectors and poor record-keeping led to reforms announced in several provinces in 1999 requiring collectors to show a fee collection permit and to issue official receipts for money collected. Surveys by the State Tax Administration show that collection costs can absorb as much as 30 percent of revenues collected. It may be, as the saying was in the late 1990s, that ‘fees feed’ but it seems that often those who fed most were those who collected them. ‘Fees’ in China are almost invariably supply-driven and bear no resemblance to the benefit-oriented ‘demand-driven’ user fees often proposed by writers on local finance (e.g. Bird, 2001).

Until budget reforms began at the end of the 1990s, EBF funds were not subject to treasury management or budgetary oversight. Instead, EBF were kept in numerous bank accounts separate from budgetary funds, reporting was infrequent, and final accounts were not available until more than a year after the fiscal year. Frequent complaints that local governments treated EBF as “cash boxes” to draw on at will again suggest poor accountability.

²⁷Walden (this volume) suggests that the mere existence of such borrowing does not imply that sub-national governments face a ‘soft’ local budget constraint. On the contrary, he suggests that competition for borrowed funds, driven in part by the ability of local decision-makers to reap benefits from such borrowing but checked by continuing party control, is one of the main ways in which ‘competitive federalism’ is at work in China today.

²⁸ The main exceptions are administrative fees levied by government departments for services rendered – e.g. fees for passports, drivers’ licenses, etc., which go into the general funds of the department.

How Large are EBF?

A full accounting of extrabudgetary resources collected and used by government in the late 1990s would include the following:

1. “Extrabudgetary” (nontax) revenues collected by branches of government in the performance of services – 8-10 percent of GDP.
2. Expenditures of branches of government that were not reported in budgetary or extrabudgetary accounts – total 2-3 percent of GDP or more
 - a) Tax expenditures – tax incentives or tax credits – estimated at 100-150 billion yuan annually, or 1-1.5 percent of GDP
 - b) Arrears – unpaid/deferred wages to teachers and civil servants, unpaid subsidies to grain marketing system, farmers who are not paid for crops sold to grain stations, unpaid utility bills, etc. – amount unknown
 - c) Goods and services provided by enterprises or ‘public sector units (PSUs, such as schools and hospitals) for less than full compensation – amount unknown
3. Quasi-fiscal expenditures of government, the most important of which are directed credit to SOEs – estimated to average 6-8 percent of GDP during 1985-1995, less in the late 1990s – 3-5 percent of GDP?
4. Quasi-fiscal expenditures of enterprises and PSUs – for goods and services provided on government’s behalf (such as enterprise-run schools, clinics, and hospitals; pension expenditures financed from PSU funds, and carrying excess, unwanted staff and workers) – 2-3 percent of GDP?
5. Commercial incomes or losses of government branches (“self raised funds”), and revenues from asset sales – amount sizeable during early – mid 1990s, but smaller in late 1990s – 1-2 percent GDP?³¹
6. Social security – since 1996 treated as an extrabudgetary account – annual flows 2-2.5 percent of GDP.

By this accounting, the extrabudgetary funds and extrabudgetary activities of government added another 19-27 percent of GDP in total to public spending, far higher than official estimates. Official statistics of EBF – even from the audits and estimates of the MOF and SAT– count only the first and partially the fifth of these items. Rough as the above estimates inevitably are, if they are at all close to being correct, the notion of fiscal decline that has formed the backdrop to most analyses of the public sector in China must, it seems, be abandoned. Total public sector revenues (budget + extra-budget) may have remained at the level of 30-35% of GDP throughout the transition period. What has declined is the piece of this large pie that is administered by the Ministry of Finance through the budget.

The existence of such huge EBF has serious implications for the ability of government to perform its core functions of stabilization, equalization, and resource allocation. Moreover, the long term dynamics underlying this dual track fiscal system seems to favor a continuing shift from the budget to the extrabudgetary track: line ministries, local governments, and enterprises all prefer fees and levies to taxes, *ceteris*

²⁹ In the 21st Century this component has once again ballooned as local governments moved into real estate development through a variety of public-private partnerships.

paribus, because they confer more discretionary power to lower level agents. Absent drastic reform, the result was a continual erosion of the budget and a breakdown of the budget process.

Without an effective system of monitoring and control (either by higher level governments or by an electorate), the extensive decentralized taxing power that exists in reality through the EBF mechanism is obviously prone to abuse. EBF have softened the budget constraint for all levels of government, allowing governments to maintain both bloated workforces and a wide range of activities. The Chinese press cites many instances of excessive spending by local governments -- construction of a huge international airport across the border from Hong Kong in Zhuhai, the tens of thousands of “development zones”, “tourism spots” and luxury hotels, and, increasingly in the 21st Century, elaborate plazas and city center shopping malls. Even in poor localities there is a good deal of lavish public spending on banquets and karaoke bars, etc.

One outcome has been political problems with worsening popular perceptions of government. Converting the present multitude of hidden taxes and transfers to a system of explicit taxes and fees is a necessary but unpopular part of the transition to a market economy. The process has been made even more difficult by the common perception that governments at all levels are abusing their power in imposing fees and levies to enrich themselves.

Local governments and the units (schools, etc.) providing public services at the local level now finance half or more of their expenditures from EBF (Fan 1998, Wong 1998, World Bank 2002). Most of these fees were until recently completely outside the budget. Once a fee was authorized, in most cases local finance departments had no idea how much was collected or what was done with the funds. The 2002 reforms have strengthened attempts to bring extra-budgetary revenues under control but resistance reportedly remains widespread.

EBF are not all bad, of course. They have provided considerable and arguably desirable autonomy to local governments. On the other hand, they have also added considerably to the obscurity and probably also the regressivity of the general public finance scene in China. No one really knows what is going on within the bowels of China’s complex and opaque fiscal system.³² No news is not necessarily good news. In fact, it is decidedly bad news from the perspective of building a more transparent public sector to support China’s continuing drive to modernization.

³⁰ For instance, there is considerable confusion about the real size and nature of the ‘public sector units’ (PSUs) -- schools, hospitals, transport systems, etc. etc. -- that actually provide services. There is no central data source on the operation and finances of the ‘public sector’ broadly defined: different data are collected by different ministries for different purposes and most of these data are not publicly available in any case.

Spending and Services

Getting public money is never easy. Unfortunately, spending it sensibly seems to be equally difficult, or so Chinese experience suggests. Public financial management is weak at all levels of government. It was not until 1999 that any reforms were made in budget preparation, execution, monitoring and audit, and there is still much to be done in all these areas at the central level of government, let alone at lower levels. Many fundamental problems in financial management remain. For example, since personnel decisions are essentially outside the financial system, significant rigidities and waste are created. The recent reform in rural fees illustrates the problem. The township employees formerly collecting these fees may now be jobless in the sense that they have nothing to do, but they are still there and still have to be paid. Indeed, in many instances they now may be paid more than before in view of the decision to bring township salaries in line with county salaries. Unless changes are made in personnel and financial management systems, increased revenues channeled to townships are thus likely to be eaten up by unproductive salaries.

Budget Reform

Budget reform has lagged in China. Until the end of the century the budgeting process had changed little from the planned economy. As the economy became increasingly decentralized and market-oriented, the budget gained importance as the key instrument for resource allocation and macroeconomic management. Its effectiveness as a policy instrument for managing public expenditures, however, was hampered by the increasingly inappropriate budgeting process.³³ The budgeting process was passive and incremental, provided inadequate time for preparation, had little focus on strategic priorities, and was unable to shift expenditures to emerging needs or to adequately track how public funds were spent or even how many people the government employed.

The outcomes of poor budgeting practice are all too evident:

- Spending is poorly matched to policy with the result that inadequate support is provided to priority sectors while public resources are wasted on sectors that should not be supported by public funds.
- Spending units have too much autonomy due to ineffective oversight and accountability: Tasks are not well-defined, and no one is really accountable for results.
- The late formulation of the central budget cascades through the intergovernmental system since transfers are determined level by level, and each level has to wait for information from the higher level before it can formulate its own spending and transfer plans. Moreover, since capital subsidies usually have matching provisions, local governments often have to hold large reserves in anticipation.

³¹ See World Bank (2000) for an in-depth analysis of China's public expenditure management system in the late 1990s. The report's analysis remains relevant since many of the problems persist.

In addition, the general quality of reporting at subnational levels is poor, financial reports are difficult to compare, and consolidating government financial information is an extremely complex exercise. Audit is particularly poor. Each local government has its own audit bureau which reports to the People's Congress, but as a rule these bureaus are under-staffed and under-trained. Moreover, since they are directly responsible to the government they are auditing the value of the auditing process is impaired..

Budget reform became a prominent issue in 1999 when as mentioned earlier the National Auditor-General issued stinging criticisms of the implementation of the 1998 budget and the management of public funds in general. Among the criticisms were:

- Authorizations releasing funds for spending ministries were not made until well into the fiscal year; indeed, some ministries did not receive their budgets until the fourth quarter. Such delays seriously undermined the significance of the budget.
- Management of government funds was found to be extremely lax. In some instances, funds were diverted to overseas accounts and to illegal uses such as investing in companies and buildings.
- Reporting requirements for extrabudgetary funds (EBF) were routinely ignored. Indeed, even the Ministry of Finance (MOF) itself failed to present final accounts for those EBF that are (paradoxically) included in the budget.
- Uncollected and diverted extrabudgetary fees were rampant. Illegal uses included pension reserves invested in companies or used for speculation in the securities markets.

These concerns led to a comprehensive program of budget reform. The National People's Congress (NPC) directed that immediate changes be made for the next budget cycle, including the introduction of standardized procurement procedures to cut waste and corruption, public disclosure of all intergovernmental transfers by province, and greater consultation with the NPC to participate more actively in the budgeting process.³⁴ Since 1999, the MOF has introduced new procedures for budget preparation and approval, and strengthened budget reporting to the National People's Congress. To adjust to the new budget procedures, the MOF underwent a radical restructuring in 1999 to reorganize its departments. A new budget classification scheme is under preparation and some elements have been introduced already. To improve the accountability of spending units, the MOF began to formulate organizational budgets, shifting from allocation by sectors and functions to allocation to organizations.³⁵ It also took advantage of this change to require each Ministry to show all budgetary, extra-budgetary and other resources and spending—an important step toward improved accounting and budgeting for extra-budgetary funds. In 2000, the Minister of Finance announced plans for treasury reform to improve financial management of public funds, and introduction of new standards for government procurement.

³² This last point was a logical extension of the creation of the Budget Committee in early 1999 to replace the more general-purpose Economic and Finance Committee.

³³ In 1999 MOF presented organizational budgets for four ministries to the NPC: Ministry of Education, the Ministry of Science and Technology, the Ministry of Labor and Social Security and the Ministry of Agriculture. In 2000 this was extended to 26, for approval of the 2001 budget.

Despite these useful reforms, however, and progress in a number of related areas—promulgation of a new law on procurement, introduction of organizational budgets to all central government departments, the separation of revenues and expenditures in budgeting for extra-budgetary funds, and rural fee reform -- the overall pace of change has been slow. This is not surprising: a budget system is a complex set of processes and procedures and of reports and supporting information systems. Changing the budget system requires a redefinition of all these elements as well as the design and installation of a new and more reliable and comprehensive government financial management information system. Such tasks are detailed and time-intensive, requiring large amounts of human and financial resources as well as continuing support from the highest levels of government.

Public Service Delivery

Along with decentralization to local governments, the Chinese fiscal system has also decentralized authority to service delivery units, conferring on these public service units (PSUs) unprecedented and often unwarranted autonomy to expand revenue generation through offering new services. Driven by fiscal pressure, over the last decade or so the government gradually expanded the autonomy given to such PSUs as schools and hospitals. In effect, the government both invited non-government participation in the financing of services that were formerly solely financed by the public sector and also offered market-like incentives to PSU managers. While rigorous analysis of the outcomes of this policy is not yet possible, what information is available suggests that the outcomes have at best been mixed.

Many PSUs seem to have gone far outside of their core competences and neglected their core tasks in the pursuit of more revenue. Converting 'nonproductive' land into commercial ventures has been a particularly favored activity over the past few years.³⁶ Many examples can be cited -- from city parks studded with commercial ventures to produce revenue for the park services department to universities entering real estate development ventures and selling or leasing 'unneeded' office space or residential apartments. The recent history of the health sector provides one, perhaps extreme, example of commercialization gone astray. Health services have expanded rapidly. At the same time, however, costs have escalated, and access for both the rural population and the urban poor appears to have been reduced. To earn profits to support the operation of health services (and their own salaries), doctors seem to be prescribing both too many drugs and costly diagnostic tests, resulting in expensive and often inappropriate patterns of care. In the absence of effective oversight, and in an environment in which consumers' voices are weak, some PSUs have misused state assets or abused customers, especially in markets characterized by monopolies, imperfect competition, asymmetric information or external economies.

³⁴ In addition, a good deal of productive agricultural land near cities is also being converted, often illegally, to such uses (Wu 2004).

Although public perception in China appears to be that budgetary support for PSUs such as schools and hospitals that provide services has declined, in fact it has been growing in recent years more rapidly than total budgetary expenditures, rising from 23 percent of budgetary appropriations in 2000 to 30 percent by 2002, and providing on average a bit less than half the total funding of PSUs, although with wide variations from sector to sector.

Nonetheless, many PSUs mobilize revenues from a wide variety of other sources including service revenues, business incomes, remittances from subsidiaries, and, of course, extrabudgetary revenues. Since the definitions of some of these categories are unclear even to those who use them, and many definitions are still evolving – for example, the distinction between service revenues (*shiyè shouru*) and business incomes (*jingyingxing shouru*) is frequently blurred -- we will simply distinguish between budgetary and nonbudgetary revenues. In reality, even some avowedly nonbudgetary revenues involve implicit transfers from the public sector and hence indirect costs to the budget. For example, monopoly rents may be created by the state and assigned to PSUs in lieu of or as supplements to budgetary appropriations. Thus a publishing company may be given a monopoly on publishing textbooks, which are very profitable. These monopoly rents show up in the accounts as ‘business incomes’ but are unearned. Another monopoly rent openly used to support the over 500 state-owned presses arises from restrictions on the issuance of ISBN numbers since such a number is in effect a license to publish.³⁷

The imputed rental cost attributable to the free use of state assets such as land and buildings also constitutes an important public contribution to many PSUs. Strikingly, in recent years it appears that more and more PSUs have been receiving income by conversion of these assets to commercial uses. For example, an art museum recently swapped its site in central Beijing for an annual rental income of RMB 15 million, plus an agreement from the renter to build a new campus on the outskirts of the city for the museum’s training center. The recent wave of university expansions has been largely financed by land grants, a process that has inadvertently turned some universities into real estate development companies as they try to monetize these grants through the selling of “excess” residential flats and office space.

Equally obscure is the other side of the ledger, namely, the extent to which what should be budgetary costs are borne by PSUs. An important example is pension expenditures. Since most employees of PSUs are included in the traditional pension scheme for civil servants, the contributions to their pensions funded from the budget are counted as budgetary appropriations to the PSU, which of course inflates the true budgetary support of current operations. In some instances, however, such as hospitals, it appears that the appropriations received are insufficient to cover pension costs so that the PSUs end up in effect being net ‘taxpayers’ with respect to pensions. Sometimes PSUs have also been used to absorb other budgetary ‘downloads’ for example when they are required to absorb employees laid off from government and even in some cases

³⁵ Under WTO rules the practice of limiting the issuance of ISBN numbers each year is being phased out, beginning in 2004.

graduates who cannot find jobs elsewhere. Finally, in some instances PSUs have been used to generate profits that are then used to supplement budgetary resources and pay civil servants.

Given the scale of the PSU sector and its important role as both consumer of public resources and provider of public services, public management and budget reform cannot proceed much further without considerable reform in the PSU sector. Given the highly decentralized character of the Chinese fiscal system, this means that a fundamental overhaul of the intergovernmental system is also needed to support such reform.

The Key to the Fiscal Future: Intergovernmental Finance

China's considerable decentralization has sometimes been viewed as largely an incidental fall-out of the reform process: certainly, its intergovernmental fiscal system deserves this label. The unsatisfactory state of the intergovernmental finance system is becoming an increasingly important obstacle to development. To date, reforms have invariably been gradualist and incremental, responding to immediate problems with short-term fixes. In some instances, as with the recent rural fee reform, rather than making the serious fiscal adjustments required, government agencies and lower tiers of government have not only been allowed but even encouraged to resort to off-budget means of financing public sector activities, thus building up more problems for the future.

All this matters because China is, in many ways, one of the most fiscally decentralized countries in the world. Chinese officials of course understand this very well. Unfortunately, despite the central importance of getting intergovernmental finance right in China, the coherence of the intergovernmental fiscal system in China has been steadily chipped away by piecemeal incremental changes over the years. As in the past, future fiscal reforms in China are likely to follow a gradualist path, reacting to crises as they occur. It is not clear, however, either that further reactive incremental reform will suffice. Experience in other transitional countries, for example, suggests that gradualism in fiscal matters is sometimes not enough and indeed may sometimes make things worse. Transitional fixes to transitional problems have a way of becoming quasi-permanent obstacles to needed long-term institutional change.³⁸ As Chinese experience shows, partial fixes of complex problems may create new problems requiring new fixes that create new problems and so on and so on.

Many problems at the top of the national agenda originate in intergovernmental fiscal relations – pension arrears, arrears or defaults on living stipend support for laid-off workers, problems of financing rural basic education, and civil service wage arrears. All are manifestations of the difficulties local governments face in performing their assigned responsibilities. In his report to the National People's Congress in March 2002 noting that many governments at the county and township levels were unable to meet payroll in full for civil servants, Minister of Finance Xiang Huaicheng called for Government to

³⁶With respect to taxation, for example, see World Bank (2003) for a recent detailed examination of this process in Ukraine.

“gradually establish a mechanism to ensure normal payment of wages, accelerate changes in the functions of counties and townships...and create conditions for fundamentally overcoming financial difficulties in counties and townships.”³⁹ This important task remains to be done.

Under the earlier highly centralized fiscal system, local governments performed delegated functions as agents of the central government in delivering services chosen by the central government, often with norms set by the central government. Revenue assignments were ex post, adjusted to finance the delegated functions performed, and highly negotiable. In this system, transfers were necessary only for those provinces that, even after being assigned 100 percent of collected revenues, could not meet expenditure needs. On the other hand, some local governments were assigned only a small fraction of collected revenues, such as Shanghai.⁴⁰

Growing Fiscal Disparities

During the 1980s, as attention was focused on how to resuscitate revenue collections, reforms to the intergovernmental system were likewise designed to stimulate tax effort by local governments. Virtually no attention was paid to expenditure assignments. Equally little attention was paid to transfers, which were increasingly driven by dwindling central resources (Wong 1997). By the mid-1990s, the intergovernmental fiscal system had evolved to one in which local governments were saddled with heavy and unsustainable expenditure assignments. Social security and pensions are the responsibility of cities and counties, and education and health care were primarily the responsibilities of city districts and townships until 2001.

These expenditure responsibilities were supported neither by revenue assignments nor an effective system of transfers, leaving many local governments unable to perform their assigned functions. No supporting system was in place to ensure minimum standards of service provision across regions. As economic growth also became more concentrated in coastal regions during the 1990s, income disparities accelerated, and the outcome was a sharp rise in interregional disparities in fiscal spending, accompanied by a gradual deterioration in public services provided in the inland provinces. By the mid-1990s fiscal problems were very serious in poor regions. According to Heberer (2001), in Yunnan Province on China’s southwestern border, 106 of the 127 counties were unable to meet budgeted expenditures in 1995. In neighboring Guizhou (the poorest province in China) many counties could not meet payroll in full. In the Liangshan Yi minority Prefecture in Sichuan Province, this led to the elimination of free medical care and epidemic prevention programs, free films and cultural activities. Many clinics and health stations closed. Epidemic diseases thought to have been wiped out reappeared. In 1996, only 40 percent of Yi children attended school, a figure that dropped to 10 percent in the poorer villages.

³⁷ Reports indicate cumulative arrears of 6.5 billion yuan at year end 2001 (Xiang 2002).

³⁸ This system was called “highly redistributive” by earlier writers (e.g. Lardy 1998) and indeed it was in many ways.

These outcomes are highly regressive, with governments in poor regions providing fewer and lower quality services and passing along a higher proportion of the costs to their constituents. With local funding problems limiting services the national government has been unable to deliver on some priority programs such as universal basic education. For example, China is still years away from providing the nine years of free education to all children targeted for Year 2000. In spite of repeated pledges by the State Council to increase investment in human development, budgetary spending on education remained stagnant at about 2 -2.5 percent of GDP during 1978-1999, half the level called for in the 1985 Education Law, and well below the levels of spending in neighboring East Asian economies. Similarly, in health care, public spending is low, also less than 2 percent of GDP.⁴¹

Some attempt to reverse this trend of growing inequality began around 1998, when the government began to redirect fiscal resources toward equalization, including the “Go West” development strategy launched in 1999. A major driver of transfer policy in China appears to be concern for the growing regional disparities that many consider have marred the country’s impressive growth performance. As Benjamin et al. (this volume) argue, it may well be that although interregional inequality has indeed grown, so has intraregional inequality so that the relative importance of the interregional component has not changed. Whether or not one accepts this argument, one may still find the level of interregional inequality ‘unlovely’ and hence worthy of policy correction. While evidence around the world suggests that Heston (this volume) is probably correct in arguing that even the best policy can do little to change interregional disparities, countries are of course free to try to do so, as indeed China has been doing for some years through a complex set of intergovernmental transfers.⁴²

Five broad types of central transfers are shown in Table 4. Tax rebates are based on the central government’s commitment at the introduction of the TSS reform to return to local governments a share of the growing VAT and excise tax bases. The formula is complex and contested, but returns to each province an additional 30 percent of the incremental central government receipts from VAT and excises derived in the province each year. Quota subsidies are a leftover from the previous revenue-sharing regime, under which provinces that did not collect sufficient revenues to finance their approved expenditures received a subsidy each year. These subsidies were frozen in nominal terms around 1987 and set as “quotas”.⁴³

³⁹ Such spending is highly concentrated in the civil service medical insurance system and in urban hospitals, and little trickles down to the rural sector. WHO (2000) ranked China 144th for the overall performance of the health system out of 191 countries, but 188th in terms of fairness in financial contribution.

⁴⁰ Recent useful reviews of transfers may be found in Bahl and Martinez-Vazquez (2003), Zhang and Martinez-Vazquez (2002), and Ahmad, Singh, and Fortuna (2004).

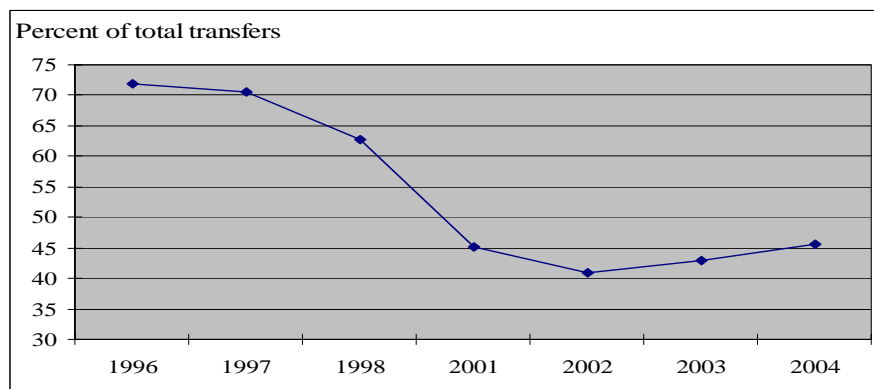
⁴¹ In addition to fiscal transfers, other policies such as tax incentives and financial subsidies have frequently been employed in the name of regional development in China (Bird and Chen, 1998). The regional development issue, however, is not further discussed here: in any case, as Bird and Smart (2002) note, in principle intergovernmental fiscal transfers have quite distinct objectives from regional development.

Table 4. Transfers by type

(billions Yuan)	1994	1995	1996	1997	1998	1999	2000
1. Tax rebates	179.9	186.7	194.9	201.2	208.3	212.1	220.7
	75.3%	73.7%	72.9%	71.8%	63.4%	53.1%	46.5%
2. Quota subsidies	11.4	11.5	11.1	11.2	11.3	11.4	12.0
	4.8%	4.5%	4.2%	4.0%	3.4%	2.9%	2.5%
3. Transitional equalization grants		2.1	3.5	5.0	6.1	7.5	8.5
		0.8%	1.3%	1.8%	1.8%	1.9%	1.8%
4. Earmarked grants	36.1	34.4	48.9	51.6	59.1	113.9	119.9
	15.1%	13.6%	18.3%	18.4%	18.0%	28.5%	25.3%
5. Wage increase transfer						34.3	45.1
						8.4%	9.7%

Source: Zhang and Martinez (2002).

A few years ago the Ministry of Finance began to revise the system of transfers to reduce the dominance of tax rebates and hence increase the amount of regional equalization (see Figure 8). An especially important boost was given by a change in 2002 that shifted the enterprise income tax and the personal income tax from local taxes to shared taxes. To make this shift more acceptable to local governments, the central government committed itself to retaining only 20 percent of the total receipts from these taxes, its share prior to 2002, and to put all additional receipts into equalization under the ‘transitional transfer’. In 2003 this added about 14 billion yuan to equalization.⁴⁴

Figure 8. The diminished role of tax rebates

The Tenuous Link between Transfers and Services

To some extent offsetting the government’s intention to equalize, however, the continued and accentuated failure of the intergovernmental system has required

⁴² Interview with officials at Ministry of Finance, February 2004. See also Ahmad, Singh, and Fortuna (2004).

increasing central government bail-outs in response to emerging problems in pension arrears, financing rural basic education, etc. The costs of such bailouts have risen rapidly since 1998:

- Subsidies to local social security schemes rose from zero to RMB 10 billion in 2000, RMB 34.9 billion in 2001, and RMB 51.2 billion in the 2002 budget.
- Subsidies for living stipends to laid-off workers from state-owned enterprises continue to be substantial though they are scattered in different categories and difficult to count. (In the 2004 budget pension and living stipends for laid off workers and their re-employment training appeared to total RMB 86 billion.)
- Subsidies to local minimum living stipend schemes rose from zero to RMB 2.3 billion in 2001, and RMB 4.6 billion in the 2002 budget. It doubled again in 2003 to RMB 9.2 billion.

A particular problem is that the civil service wage increases introduced since 1999 have absorbed a growing portion of central transfers and squeezed out other subsidies. Social security bailouts plus the wage increase subsidies in 2001 accounted for nearly one-third of all central transfers and more than 60 percent of transfers net of tax rebates. In 2002 central expenditures on these items jumped to more than RMB400 billion, absorbing all of the central government transfers to local governments outside of tax rebates and “system subsidies”, leaving little room for new programs such as subsidies for rural fee reform.⁴⁵

An important consequence of this pattern of transfers is that increased transfers from the center often do not result in better services at the periphery. Recent experience has taught local governments that the Ministry of Finance will intervene whenever necessary to preserve social stability and will go to great lengths to prevent wage arrears from getting out of hand. Civil servants are thus in effect ‘free goods’ to local governments. In addition, the nationally unified civil service wage scale translates into salaries that are very high relative to local incomes in poor regions, and this gap has grown even greater as civil service wages have more than doubled since 1999. This has proved to be an irresistible lure -- many local governments added staff during the period when Zhu Rongji was implementing a draconian program at the central government to downsize the civil service. In one extremely poor rural county visited in early 2003, for example, in spite of increased transfers from higher levels there was no money for non-personnel recurrent expenses in any department from schools to agricultural stations essentially because the county had been adding staff at an accelerating rate. The result was that more transfers ended up producing fewer rather than more services to residents.

As these examples indicate, the expenditure side of the intergovernmental fiscal structure is seriously deficient. No effective system of intergovernmental fiscal transfers

⁴³ These calculations are based on figures of RMB175.5 billion in transfers to offset civil service wage increases in the central and Western provinces, and RMB177.7 billion in transfers to subsidize local payouts of SOE laid off worker living stipends, unemployment stipends, and minimum living stipend support. No figures were reported for subsidies to local social security schemes, but if we assume that they were RMB51.2 billion as budgeted, these transfers totaled RMB404 billion, compared to the reported total of RMB402 billion (Zhu Rongji 2003).

either supports local governments in carrying out their assigned responsibilities or redresses growing regional disparities. The murkiness of expenditure assignments confuses accountability considerably. When everyone is responsible, no one is responsible. The problems inherent in this murky environment have cascaded down on the lowest level of government in the difficult fiscal circumstances of recent years as each level has increasingly tried to capture revenues by redefining the ‘sharing’ of revenues in its own favor as much as possible.

Not enough attention appears to have been paid to how fiscal reforms affect local finances and autonomy. The recent experience in the implementation of the Rural Fee Reform (RFR) illustrates how this failure undermined a program that might have provided the first dramatic success and helped build momentum for public finance reform. Rolled out since 2002 for nationwide implementation in three phases, the RFR was intended to reduce the overall burden of taxes and fees in the rural sector and to end unreasonable levies by township and village officials. It also aimed to bring into the formal budget many of the extra-budgetary resources that had financed rural government—a laudable measure. It eliminated, in one stroke, all fees levied by the township governments and village associations. The most important of the fees eliminated were the “three levies and five unifications”, which included the rural education surcharges and public reserve funds of village associations which had been key sources of funding for rural education, the militia, subsidies for rural officials, and social relief. In exchange, the agricultural tax rate was raised from an average of 2 percent to 7 percent, with the increased revenues earmarked for the township governments, and a surcharge of 20 percent earmarked for village associations.⁴⁶ In addition, the central government committed to making additional transfers to each province based on estimates of lost revenues due to the reform.

Even though this program has many laudable features and should have been welcomed by the rural population, its rollout has been controversial since the pilot experiment in Anhui Province in 2000. Although the overall tax burden does seem to have fallen, it has done so at the expense of service provision, especially rural education. To correct this, the State Council called in July 2001 for moving the responsibility of paying rural teachers’ salaries to the county level to preserve a vital service—rural education. Such mandated changes in inter-governmental expenditure assignments, however, are unlikely to succeed unless accompanied by more basic reforms in intergovernmental finance because fees and EBF already finance many vital services provided by local governments.

China in International Perspective

In this section we stand back from the intricate details of the Chinese fiscal puzzle and take a broader look at China’s fiscal development in international perspective.

⁴⁴This increase in agricultural tax rates also reflects the incorporation of the agricultural special products tax and the slaughter tax – two unpopular taxes widely considered to be regressive.

China is a large, developing, transitional country. Like other large countries, it has had some problems owing to its size and its diversity. Like other developing countries, it has at times had difficulty in coping with the pace of change and in establishing a sustainable balance between equity and efficiency in the face of severe constraints on administrative capacity. Like other transitional countries, it has found 'institution-building' in the public sector to be a complex and time-consuming task. As noted earlier, to understand the development of Chinese fiscal policy in the reform period it is important both to have a clear understanding of the objectives of policy and also to know how fiscal policies worked with (or against) other policies – monetary, exchange rate, regulatory, etc. Consider, for example, the not always clear role played by the fiscal system in relation to changing policies towards (central) SOEs, a matter on which there is considerable controversy (Huang, this volume). Consider also the more transparent fiscal policy toward FDI and its less transparent relation to, on one hand, changes in the formal tax system and on the other financial subsidy policy (Bird and Chen 1998). Some changes in fiscal policy appear to have been driven by macroeconomic concerns, some by 'control' concerns, and some by the desire to offset or reinforce other policy instruments in achieving particular objectives.

China is particularly unusual in international perspective in the extent to which it assigns heavy responsibilities for the provision of vital social support and nearly all public services to governments at the prefecture, county and township levels while not adequately supporting these expenditure assignments either through revenue assignments or an intergovernmental transfer system. The assignment of such important and potentially costly services as pensions and unemployment benefits to low levels of the government structure is unusual, and accounts for the exceptionally high proportion (55 percent) of total budgetary expenditures by these three levels of government. In comparison, for a sample of about 100 countries for which data is available, sub-national governments (including states or provinces) account, on average, for only 13 percent of total budgetary expenditures in developing countries, and 35 percent in developed countries.⁴⁷ In other countries social security is almost always provided by the central government while 'safety net' welfare systems are almost always jointly financed by the national government, in part because their cyclical nature makes them generally inappropriate for local governments. Similarly, the responsibility for basic education and public health is usually shared with provincial and central governments to ensure some minimum provision levels across localities.

Also unusual is the fact that in China most public goods and services that touch people's lives are delivered by local governments. One result is that many of the problems at the top of the national agenda such as pension arrears have at base originated in the financial difficulties local governments face in performing their assigned responsibilities. Local funding problems have also limited the success of priority national programs such as universal basic education and health.

⁴⁵ The sample is about 100 countries for which sub-national budgetary data is available from IMF, World Bank, OECD and other sources. We are grateful to Roy Bahl and his associates at Georgia State University for these data.

Even after its substantial recovery since the mid-1990s, the formal revenue system in China remains relatively weak, generating about 18 percent of GDP, only half of which is under Central Government control.⁴⁸ At the same time, however, the public sector as a whole raises large amounts of revenues off budget—perhaps more than 20 percent of GDP (if one includes disguised spending through the banks) -- although in ways that are often inefficient, inequitable, nontransparent and distorting.

In all these ways, China does indeed seem different. On the other hand, in many ways, China's experience can also be readily linked to what has emerged in other countries. With respect to expenditure management, for example, most OECD countries have reformed their systems over the past 20 years as experience emphasized the critical importance of (1) being clear about who has the authority to make what decisions, (2) matching authority (flexibility) and accountability, and (3) strengthening both the capacity and willingness to re-order priorities and reallocate resources. These concerns arose owing largely to the rising fiscal imbalances and lagging public sector performance at the end of the 1970s and early 1980s, which in turn came in part at least from budget processes that were focused on a single year and on inputs rather than results. Detailed line item budgets and strict central control over expenditures discouraged managers from taking initiatives to achieve better results. These reforms increased budget coverage and moved to a multi-year perspective, enforced spending limits, improved the links between policy priorities and spending and matched greater managerial autonomy with more accountability for results. China, it seems, may be beginning to follow a similar path.

The experience of other transitional countries also seems relevant to China in many ways, for example in showing the importance of increasing the realism of the budget by such means as improving the comprehensiveness and transparency of the budget, improving the accuracy of revenue estimates, tightening the links between policy priorities and budget allocations during budget formulation, and ensuring the timely flow of budgeted funds to organizations to underpin high quality service delivery (combined with accountability for their efficiency and effectiveness). Since China has all these problems, it may have something to learn from the extensive (though not always successful) experience elsewhere with budgetary and expenditure management reform.

No doubt, as so often before, there will in the end be a distinct Chinese twist to the ways in which China handles its fiscal problems. Still, no matter what it ends up doing, two general conclusions seem warranted with respect to China's fiscal system. First, while obfuscated by many characteristics of China's institutional structure as well as the rapid and changing pattern of its growth, the basic fiscal problems facing the country do not seem to be all that novel in kind or even in degree. Secondly, something will definitely have to be done on many fiscal fronts, in particular to disentangle and rationalize the intergovernmental situation, if China is to continue to modernize at a rapid pace. At the 'micro' as at the 'macro' level, the key to future progress in China's fiscal system is to face up to the need to develop a more sustainable system of

⁴⁶ This compares to central (or federal) revenues of 20 percent of GDP in the U.S., 41 percent in France, 19 percent in Thailand and Indonesia, 27 percent in Malaysia, 35 percent in Singapore, and 13 percent in Indonesia in the mid-1990s (Lou Jiwei 2000).

intergovernmental fiscal relations, an important part of which is to bring into view the enormous range of public sector activities currently hidden deep in the 'off-budget' swamp. As the title of this chapter indicates, China's fiscal system thus continues very much to be 'a work in progress.'

Public Finance Matters

As we have argued, structural reform of China's public finances and especially of its intergovernmental fiscal system is critical to resolving continuing problems in such core segments of the economy as banking, education, health, and rural development. The centrality of the fiscal system to progress in these areas is not always obvious. On the surface, for example, China's macroeconomic performance looks unproblematic. The record of public investment in growth-supporting infrastructure such as highways, ports, power plants and a variety of urban services has been nothing short of astonishing, and social stability and public safety are high. On the whole, albeit with lags, fiscal policy seems over time to have adapted to reflect both changing links between markets and sectors and changing policy objectives. In all these important respects the public finance system, though it obviously has some problems, appears to be doing its main job and providing adequate support for government functions.⁴⁹

Far more attention has been paid to the fragility of the financial (banking) sector, for example, than to fiscal problems. In reality, however, many of China's non-performing loans result from the combination of off-loading social expenditures (such as housing, education, healthcare and pensions) from the government to state-owned enterprises (SOE) and the accompanying hidden subsidization of SOE through bank lending. Government-directed bank support of both regional development objectives and commercial investments has recently created yet more non-performing assets. Such non-performing loans are in large part simply a way of disguising (larger) government deficits since in the end they essentially represent a transfer of expenditures from the government budget to the banks. Such 'financial sector problems' cannot be fixed until the public sector is reined in and funded on a more disciplined and sustainable basis.

Matters are equally bleak on the revenue side of the budget. The use of state assets by the government and its agencies to raise off-budget revenues is a major source of inefficiencies, distorted incentives, and ultimately loss of state assets. Public finance issues—how the public sector is financed and how public funds are spent—are thus closely interconnected to the very visible problems of both the financial sector and state asset management. Moreover, as the Chinese economy has become more decentralized and market-based the budget has increasingly become the most important instrument available to government to carry out such core functions as maintaining economic growth and stability, allocating resources to achieve national goals, delivering critical public goods and protecting vulnerable groups in society. The continuing procedural and

⁴⁹ In contrast, severe economic difficulties have led governments in many other transitional countries (Russia, Hungary, Kazakhstan, etc.) to institute deep reforms that have fundamentally reformed their public finance systems, though often not sufficiently in the view of many observers.

substantive weaknesses in fiscal policy thus have ramifications for almost every aspect of public policy in China.

As the Chinese economy comes increasingly to resemble other mixed economies, in which more recognizably ‘private’ agents respond to more distinguishably ‘public’ policies, the key role now played in fiscal policy by discretionary and arbitrary policy adjustments will almost certainly have to decline if growth and well-being is to be sustained. Similarly, as China becomes more integrated into the world economy its tax system too will inevitably tend to converge more towards the norm in certain respects, as indeed WTO accession has already brought to the fore to some extent (Li 2005). As China’s regional and income disparities increase – and they almost certainly will – political necessity will likely lead to more calls for redress, exacerbating the already considerable strain on fiscal resources.

The gradualism that has characterized Chinese fiscal policy to date may still be able to cope with such problems, but it can do so much more effectively if it becomes “gradualism with a purpose” so that incremental reforms move the fiscal system more clearly in the direction of some desired end-state. China has in many respects made an excellent start towards solving many of the fiscal problems we discuss in this paper. Even where it has not done so well, some might argue that ‘non-optimal’ fiscal policy may to some extent, whether consciously or unintentionally, usefully offset even less optimal policies in other areas (e.g. the financial sector). Up to now, however, China has conspicuously failed to deal systematically with such critical problems of intergovernmental finance as expenditure and revenue assignment, transfer design, sub-national borrowing, and, by no means least, the development of an adequate institutional framework within which to develop and adapt such policies. Although partly occluded by continuing party dominance, fiscal errors have, as we show below, accumulated over time to the point where it can be argued that unless China tackles these matters soon, the attempt to build a new economy on the wreck of the old soviet-type fiscal system may yet come to a grinding halt, pulled down by the morass of ad hoc, piecemeal, and often illicit arrangements that continue to be hastily put into place in attempts to avert imminent fiscal calamity in one or another part of the public sector. While we have no crystal ball that enables us to tell when, or how, the system will change or if the will to change is yet there, some such changes must, we suggest, come soon if China’s growth is not to be thrown seriously off track.

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