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# *Expenditure Assignments in China*<sup>1</sup>

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## **Introduction**

China has been carrying out a significant fiscal decentralization policy for over three decades. However, reforms have largely concentrated on the revenue side of budgets, and generally they have not been coordinated with an explicit strategy for the decentralization of expenditure assignments. Although significant strides have been made in the areas of tax assignments and tax administration, other areas—in particular, the assignment of government functions—have advanced much less. Yet a stable, efficient, and fair decentralized system of public finance in China will require an unambiguous and well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government. The assignment of responsibilities is by no means the only condition, but it is the most important, and it should also be the first in a well-sequenced decentralization reform effort.<sup>2</sup>

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<sup>1</sup> We are thankful to Andrey Timofeev, Bert Hofman, and Dana Weist for helpful comments to previous drafts and to J. Vernon Henderson for comments provided during the conference.

<sup>2</sup> See Bahl and Martinez-Vazquez (2006b) for a discussion of the sequencing of decentralization reforms.

This chapter reviews the most important current issues surrounding the assignment of expenditure responsibilities in China.<sup>3</sup> In order to put those issues in the proper perspective, an overview is provided of the general principles of expenditure assignments and the common problems encountered in the international experience. The chapter also provides a road map and practical recommendations for the reform of expenditure assignments in China.

### **Principles of Expenditure Assignments in Theory and Practice**

#### The Role of the Public Sector in the Economy

Before the question of expenditure assignment is addressed, it is necessary to define clearly the roles of the private and public sectors in the economy. Many countries, especially transitional countries, have undergone massive privatization of state and local enterprises involved in what can basically be considered private-sector economic activities. While there has been privatization in China in some cases, it has yet to begin in earnest in other areas of the economy. Thus, a first step to expenditure assignment reform in China is to define the responsibilities of the public sector and ascertain what activities can be privatized. In theory, the role of the public sector should be limited to those services and activities that private markets will not supply efficiently—either because of the difficulty of charging a price or because of joint-consumption benefits—and those with desirable redistributive value.

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<sup>3</sup> See Bahl and Martinez-Vazquez (2006a) for a wider perspective of decentralization reform in China.

## The Primacy of Expenditure Assignment in Intergovernmental Fiscal Relations

### Design

Most experts in decentralization policy agree that the first fundamental step in the design of a system of intergovernmental fiscal relations should be a clear assignment of functional responsibilities among different levels of government. The international experience shows that instability, controversy, and, ultimately, inefficiency in public service delivery can follow when the decentralization laws are silent or unclear about the competencies and expenditure obligations of different levels of government.

Designing the other important pieces of a system of decentralized finances, including revenue assignments and transfers, in the absence of a clear expenditure assignment is to put the cart before the horse. Decentralization initiatives in Latin American countries (e.g., Colombia, Ecuador, Bolivia, and Nicaragua) over the past several decades have made this type of mistake. Revenues were assigned to subnational governments and transfers put in place before it was decided what functional competencies would be transferred from the central government to subnational governments. This led to weak decentralized systems and fiscally overburdened central governments in those countries for years to come.

### General Principles of Expenditure Assignments

The theory of public finance suggests some fundamental rules for the assignment of expenditure responsibilities in a decentralized system. However, these rules do not provide an absolute best way for deciding which level of government should be responsible for particular public services. Together with the rules or best principles,

the adequacy of any functional assignment has to be judged in terms of how well it achieves the goals or objectives set up by the government in its decentralization strategy.

*The critical role of the efficiency criterion.* The efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as well as possible. In plainer words, government expenditure that does not address the needs and preferences of citizens is partially or absolutely wasted. The approximation of needs and preferences is best achieved via the “subsidiarity” principle.<sup>4</sup> What this principle says is that the responsibility for the provision of services should be at the lowest level of government compatible with the size of the “benefit area” associated with those services. The benefit area for sanitation services is clearly the local community, but for air traffic control the benefit area may be the entire national territory. The provision of services with smaller benefit areas by smaller governments makes it more likely that there will be a good match between the services provided and the local residents’ preferences. However, leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient underprovision of services in the case of economies of scale in the production of services or in the presence of jurisdictional externalities (e.g., a tertiary hospital solely financed by a single municipality but providing regional services). Further efficiency in the provision of public services can be achieved when service

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<sup>4</sup> The principle is widely accepted by fiscal decentralization experts and has also been adopted as a practical guide. For example, the European Charter of Local Self-Government formally adopts the subsidiarity principle as the most prominent guide for expenditure assignments.

provision is linked to the costs of service provision via fees, service charges, or local taxes; the fundamental reason for this is that these “pricing” mechanisms help reveal taxpayers’ residences to local officials.

*The objectives of redistribution and stability in public service provision.* It is generally agreed that expenditures undertaken by government for equity or income equalization reasons, such as social welfare programs, should be the domain of the central government, or at least should be financed by the central government. It is thought that local or regional governments would have difficulties sustaining independent programs of this nature because they risk attracting the needy from other areas and would thus have to tax their (potentially mobile) residents more heavily. But, while funding for such programs should be a central government responsibility, implementation can, in many cases, be left to local governments, which may have informational and other comparative advantages in delivering the service. Expenditures undertaken for the stabilization of the economy, such as massive investment or unemployment compensation, are generally ascribed to the central government because of their scale; subnational governments may be too small to be effective, and their efforts may be quickly diluted within the rest of the national economy (Martinez-Vazquez and McNab 2003).

But no matter how the general principles above are implemented, the conclusion needs to be that there is no single best assignment. What is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as in citizens’ preferences. However, decentralized systems of

finance work much more smoothly when at any given moment there is a concrete, clear, and stable assignment of expenditure responsibilities.

#### Expenditure Assignments in the International Experience

Not surprisingly, the assignment of expenditure responsibilities among different levels of government varies widely in the international experience. This variety reflects different approaches to decentralization, as in federal and more decentralized countries, and unitary and more centralized countries, and differences in policy objectives. It may also reflect problematic choices of assignments in some cases.

Often, expenditure assignments broadly agree with generally accepted principles. For example, there is a general correspondence between the geographical dimension of benefits from a particular service and the level of government responsible for provision of that service. By and large, the functions allocated to the central government have a national dimension. These include defense and internal security, the justice system, foreign relations, and research. Some expenditures with macroeconomic and redistributive implications, such as pensions and unemployment compensation, are often the responsibility of the central government, as well, and those expenditures are financed by extrabudgetary funds (Wong 1997; Bahl 2000; Bahl and Martinez-Vazquez 2006a). Correspondingly, most of the expenditure responsibilities of subnational governments involve services with regional or local benefit areas, such as tertiary hospitals, primary education, fire protection, and sanitation. Appearances can be misleading, however, and a number of countries have several important problems in their expenditure assignments.

### Common Problems with Expenditure Assignments

The international experience with expenditure assignments also provides some valuable lessons in what to avoid, including the following:

- *Lack of formal assignment.* A common problem found in the international experience, especially in the case of transitional countries during the 1990s, is the lack of a formal assignment of responsibilities. Although it is true that highly decentralized countries, such as the United States, lack a formal assignment of expenditure responsibilities in the law, such countries have a de facto assignment that has been achieved through many trials and tribulations over a long period of time—in some cases, centuries. Countries that are newly decentralizing are better served by adopting explicit assignments of responsibilities. The preferred vehicle for the assignment of expenditure responsibilities is the decentralization law or budget code. Some countries list expenditure responsibilities in their constitutions. Although it may be wise to put into the constitution some general principles for expenditure assignments (for example, a general respect for the subsidiarity principle), detailed expenditure assignments enshrined in a constitution prove difficult to change.
- *Inefficient assignments.* A second common problem in the assignment of expenditure responsibilities is wrong or inefficient assignments. This is the case, for example, in the assignment of expenditure responsibilities for social protection and welfare exclusively to local governments. Other examples include the assignment of responsibilities for national defense locally or of

local fire protection services or water and sewerage services nationally. A more common mistake is the assignment of all capital expenditure responsibilities to the central level, regardless of the level of government responsible for provision of the services associated with the capital infrastructure. Such a decision is typically guided either by assumptions about the central government's capacity to finance large projects or by the belief that only central government officials are qualified to make capital investment decisions. Dichotomizing the responsibilities for building (by the central government) and maintenance and operations (at the subnational level) can introduce "moral hazard" problems leading to a lack of proper maintenance of capital infrastructure.

- *Wide cosharing of responsibilities.* The cosharing of responsibilities within a particular public service is likely to cause confusion leading to inefficiencies. In an ideal world, all inputs for the delivery of a particular service would be simultaneously decided by a single authority. Fragmentation of duties within a service is more likely to cause, for example, a relative disproportion of funds to be spent on salaries and much less on operations; similarly, maintenance may be reduced to a minimum. On the other hand, the cosharing of responsibilities for a single service may be necessary given national political objectives. For example, subnational governments may be responsible for primary and secondary education, but curricula and textbook production may be carried out by the national government. The cosharing of responsibilities

becomes less of a problem when particular attributes and tasks (e.g., for financing, regulation, and implementation) in a common service are clearly assigned to different levels of government. Problems arise when the assignment of these attributes is unclear—for example, when two different levels of government are responsible for financing and regulation for the same basic service.

### **Challenges with Expenditure Assignments in China**

China is a large and diverse country with no single decentralization law and seemingly without an explicit decentralization strategy.<sup>5</sup> The current model of expenditure assignments is roughly based on the role of designing catchment areas for services. China's current decentralization system provides subnational governments with considerable expenditure autonomy (World Bank 2002), but the system may not necessarily be providing the most desirable mix of public goods and services at the local level.

The elements of the current system of expenditure assignment in China that present problems include (1) the mismatch between expenditure responsibilities and revenue sources at the lowest levels of government (counties and townships), where many important social services are concentrated; (2) a general lack of clarity of expenditure assignments aggravated by the lack of formal assignments; (3) several wrongly assigned responsibilities, such as pensions and unemployment insurance, at the lowest level; and (4) the lack of horizontal accountability mechanisms, with

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<sup>5</sup> This section draws on Martinez-Vazquez (2006).

possibly important undesirable consequences, including the underprovision of basic public services.

### How the System Got Here

The current system of intergovernmental fiscal relations in China is the result of successive fiscal reforms starting at the beginning of the 1980s. Before that time, China had been under a central planning system since 1949, when the People's Republic of China was created. The recent reforms—of the fiscal responsibility system, starting at the beginning of the 1980s; the fiscal contracting system, starting in 1988 (Bahl and Christine Wallich 1992); and the tax sharing system, starting in 1994—have the striking feature of putting almost exclusive emphasis on improving revenue assignments and transfers and practically ignoring the question of expenditure assignments.<sup>6</sup>

This means that the assignment of expenditure responsibilities remained virtually unchanged until some of the more recent reforms described below. To a large extent, expenditure assignments in many areas are still a legacy of the Maoist economy, in which the division of responsibilities was unimportant, as every unit strove to be self-reliant. For example, to a large extent the current responsibility for providing social services at the lowest government levels is a legacy of the system of collective agriculture, under which the communes and brigades of the People's Republic financed education, health, and social welfare.

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<sup>6</sup> See Martinez-Vazquez (2006) for a discussion of the reform stages.

### Current Expenditure Assignments

As we have mentioned, expenditure responsibilities in China are highly decentralized. The budget law confers substantial autonomy and quite broad expenditure responsibilities on each level of subnational government. However, expenditure assignments are far from being transparent and clear, mostly because of the lack of formal assignments and the extensive concurrent expenditure responsibilities among different levels of government. This conspicuous presence of concurrent responsibilities can be traced back to the planned economy era. At that time, it was not considered necessary to separate the responsibilities of different spheres of government as providers of public services (local governments acted as agents of the central government, carrying out assigned tasks only), nor was it considered necessary to separate the expenditure responsibilities of governments from those of state-owned enterprises (SOEs). The latter fact was due to the cohesive functions of the government in both the public and private sectors; in fact, government before the mid-1980s jointly determined fiscal expenditures and the expenses of the SOEs.

As defined by the current legislation, the division of the main expenditure responsibilities among the central and provincial governments is summarized in figure 2.1.

**Figure 2.1****The Assignment of Expenditure Responsibilities between the Central and Sub-national Governments****Main expenditure responsibilities of the central government**

Defense  
 Foreign affairs  
 Operation of the central government  
 Operational expenses for cultural, educational, scientific and public health undertakings at the central level  
 Key capital construction  
 Technical renovation and new product development in centrally owned enterprises  
 Agriculture  
 Subsidies  
 Macro-economic control and regional coordination of economic development  
 Social security  
 Debt

**Main expenditure responsibilities of Sub-national governments**

Operation of sub-national governments  
 Operational expenses on cultural, educational, scientific and public health undertakings at the sub-national level  
 Sub-national capital construction  
 Fund for technical renovation and new product development in locally owned Enterprises  
 Agriculture  
 Urban maintenance and construction  
 Social security  
 Subsidies

Source: Zhang and Martinez-Vazquez (2003).

In practice the main characteristics of the current assignment of expenditure responsibilities can be summarized as follows:

- *A blurred distinction between the public and private sectors.* During the process of transition from the planned economy to the market economy, government gradually relied more heavily on market mechanisms and gave up direct intervention in the private sector. However, government's expenditure responsibilities are still very wide. Currently, a significant number of enterprises are still owned by (or belong to) governments at

different levels, and there is still a variety of channels through which governments can directly or indirectly encroach into private-sector activities through their SOEs (Qiao and Shah 2006). The low level of development of the legal framework that regulates the behavior of governments and government officials has led to high levels of administrative discretion. Thus, China is still in the process of clearly differentiating between private- and public-sector activities and aligning the responsibilities of the government sector to fit the development of the market economy.

- *Extensive use of concurrent responsibilities and highly decentralized responsibilities for basic public services.* There has been no apparent change in policy or practice in expenditure assignment between the central government and local governments and among subprovincial governments since the initiation of the market-oriented reforms. Most recently, the 1994 tax-sharing system reform restated the pre-reform expenditure assignments. It is particularly important that the expenditure assignment for subprovincial governments is still entirely left to the discretion of the provincial government. To improve the expenditure assignments at the subprovincial government level, the central government's Ministry of Finance (MOF) issued "Suggestions on Improving Subprovincial Fiscal Relations" in December 2002, with the objective of providing further guidelines on subprovincial expenditure assignment, but these fall short of an explicit expenditure assignment.

Concurrent responsibilities between the central and subnational levels of government are still the norm, and usually these are ad hoc. Exclusive responsibilities at the central and subnational levels are few. The central government tends to be exclusively responsible for national defense issues, and local governments exclusively provide services on urban maintenance and construction. Other public services show concurrent or coshared responsibilities. The relative shares of expenditures for different levels of government in 2003 are listed in table 2.1.

Although there has been a slight trend toward centralization in recent years, the provision of basic public services is still mainly the responsibility of subprovincial governments, particularly county-level governments. The three most important categories of social services are basic education, health, and social welfare.

**Table 2.1**  
**Relative Shares of Expenditure at Different Government Levels, 2003**  
**(in percents)**

Expenditures	Central	Provincial	Prefecture	County and under
Total	30	18	22	30
Capital investment	44	23	22	11
Agriculture expenditure	12	46	11	30
Education	8	15	18	60
Scientific research	63	23	9	5
Health care	3	22	32	43
Social security	11	39	32	18
Government administration	19	11	22	48
Public security & procuratorial agencies, court of justice	5	25	34	35
National defense	99	1	0	0
Foreign affairs	87	13	0	0
Foreign aid	100	0	0	0
Other	29	16	25	31

*Source:* National Bureau of Statistics of China; Ministry of Finance.

*Education services* are divided into basic education, higher education, and vocational training.<sup>7</sup> Most vocational education is now left to private market institutions. County-level governments, which include cities and urban districts, are mostly responsible for basic education services. The role of the central government is that of policy maker and overall planner. In addition, the central government has responsibility for teachers' training and for setting up special education funds for subsidizing basic education in poor and minority areas. Provincial governments have the overall responsibility for formulating the development plan for basic education in their territories and providing assistance to counties to help them meet recurrent expenditures in education. The responsibility for actually implementing compulsory education programs, including the financing of basic education, lies with the cities, or districts of large cities, in urban areas and with counties in rural areas.

The provision of basic education services in rural areas is one of the major current concerns for the central government because of the generally worse service conditions there. Some new initiatives, especially "The Decision on Further Strengthening Rural Education," issued by the State Council in September 2003, have expanded the expenditure responsibilities of the central government for basic education. With that initiative, the implementation of compulsory education became a central government shared responsibility. The central government's goal was to support students from poor families by waiving their textbook, tuition, and miscellaneous fees and by subsidizing housing expenditures for elementary and

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<sup>7</sup> See "Implementation Suggestions of the State Council on the Guidelines for the Reform and Development of Education in China," issued in July 1994.

secondary education students. The central government, as well as provincial governments, started setting up special funds for the support of this program in 2003. All students who meet the requirements of the poverty standard are supposed to have been enjoying the listed benefits since 2006.

The assignment of expenditure responsibilities for higher education differs from that for basic education. In general, private institutions of higher education in China are few, and they account for a very small portion of these services; private institutions tend to concentrate on vocational training. Public higher education institutions are divided into two groups: one belongs to the central government, and the other belongs to subnational governments. Thus, expenditure responsibilities for higher education are shared between the central government and the provincial governments. The central government has responsibility for the national development of higher education and provides direct support to the higher education organizations that belong to the central government. The provincial governments have responsibility for the provincial development of higher education and support the higher education institutions that belong to the provincial governments.

*Health care* services are mostly the responsibility of the county level of government and below. The central government has continued to announce its commitment to public health care,<sup>8</sup> but in practice its responsibility for health care has been minimal for years. The huge rural-urban divide that exists in many aspects of

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<sup>8</sup> For example, "The Decision on Public Health Reform and Development by the Central Government," issued in January 1997, requires that public spending on health care at both the central government and subnational government levels increase at a higher rate of growth than general budgetary expenditures.

daily life in China—in particular, in access to public services—takes on special meaning in the area of health services. For this reason, coverage of rural health care has recently become one of the stated major concerns of the central government. “The Decision of the Central Committee of the Communist Party of China and the State Council to Further Strengthen Rural Health Care,” issued by the central government in October 2002, provided detailed responsibilities for the provision of rural health care services among different levels of government. The central government now has the responsibility for designing the overall plan for rural public health care, the provincial governments have responsibility for its implementation, and the county governments have overall responsibility for rural public health care delivery. In addition, the central government is responsible for subsidizing programs for the prevention and control of highly infectious diseases, endemic diseases, occupational diseases, and so on in poorer areas; provincial governments are responsible for subsidizing health programs of county (city) governments and for paying the costs of planned vaccinations; and county governments are responsible for the delivery of all rural public health services.

One of the newest initiatives in health services is the rebuilding of the rural collaborative health care system, which began in January 2003. This program expanded the responsibilities of both the central government and provincial governments regarding health care. It established, among other measures, that from 2003 on, in addition to the contribution of RMB 10 per resident every year, the central government should pay RMB 20 and provincial governments no less than RMB 20 a

year for each rural resident who joins the rural collaborative health care system. The provincial governments were given discretion to arrange the sharing of their contribution among the different subnational government levels in their jurisdictions.

*Social security* remains mainly the responsibility of subnational governments. The main component of current social security expenditure is the minimum living standard paid to urban dwellers. Thus, the expenditure responsibilities in this area are more concentrated at the provincial and prefecture levels, and less responsibility is placed at the county level of government and below, the vast majority of whose population are rural residents, who have much less coverage under the social security system.

*Operation-oriented local expenditure structure.* Subprovincial governments have always given priority to current administrative needs over other spending needs. Currently, the expenditure pattern in some areas, particularly in poorer areas, is still regarded as “feeding finance” (*chi fan cai zhen*) or just meeting government administration costs. The structure of the components in total government expenditures at different levels are shown in table 2.2. Typically, subnational governments give priority to administration spending, local public security agencies, procuratorial agencies, and courts of justice in their expenditure decisions. By design, most government personnel are concentrated at lower levels of government; in many cases these local governments have been acting as employers of last resort. This has led to the growth of local expenditures on employees.

**Table 2.2**  
**Composition of Budget Expenditure at Different Government Levels, 2003**  
**(in percents)**

Expenditures	Central	Provincial	Prefecture	County and Under
Total	100.0	100.0	100.0	100.0
Capital investment	20.5	17.4	14.1	5.0
Agriculture expenditure	1.8	11.6	2.4	4.7
Education	3.2	9.4	9.7	23.8
Scientific research	2.6	1.5	0.5	0.2
Health care	0.3	3.8	4.7	4.5
Social security	1.9	10.9	7.5	3.0
Government administration	5.4	4.7	8.5	13.4
Public security & procuratorial agencies, court of justice	1.0	7.3	8.4	6.1
National defense	25.4	0.5	0.0	0.0
Foreign affairs	0.9	0.2	0.0	0.0
Foreign aid	0.7	0.0	0.0	0.0
Other	36.2	32.6	44.1	39.3

*Source:* National Bureau of Statistics of China; Ministry of Finance.

Basic public services do not represent a significant share of local expenditures. In particular, in the total expenditures of county-level governments, which are the main providers of basic public services, the sum of education, health care, and social security counts for approximately 30 percent, as shown in table 2.2. In subnational government aggregate expenditures, the same services count for around 25 percent on average, while in some provinces it counts for less than 17 percent (table 2.3).

On the other hand, it appears that in provinces where the services are more decentralized, service delivery outcomes are improved. For example, in provinces where the provincial government remains the main spending authority, infant mortality rates are higher than in provinces where counties have the main spending authority (Uchimura and Jütting 2007).

**Table 2.3**  
**Aggregate Expenditure Composition at the Subnational Level, 2005**

Expenditures	Max.	Min.	Avg.	C.V.
Capital construction	30.41	4.81	11.60	0.49
Agriculture	4.76	1.49	3.57	0.22
Education	18.80	10.99	14.72	0.15
Public health	6.20	2.80	4.08	0.21
Subsidies for social security programs	16.62	1.72	6.86	0.55
Government administration	15.07	4.19	9.75	0.22
Public security & procuratorial agencies, court of justice	10.11	4.42	6.58	0.20
City maintenance	11.77	0.23	4.50	0.52
Underdeveloped areas	2.57	0.00	1.05	0.75

*Source:* National Bureau of Statistics of China; Ministry of Finance.

*Hierarchical expenditure managing model.* Nowadays each subnational government has its own budget, but practically speaking, the budget of each government includes both its own budget and the consolidated budget of all the governments under it; of course, for the lowest government, the township government, its own budget is equivalent to a consolidated budget. The government budget at each level is approved by the People's Congress at that level, which also checks the consolidated budget. The approved budget of each subnational government is submitted to the next level of government, and so on up to the MOF, for the record and for the compilation of the upper-level government's consolidated budget and eventually the national consolidated budget. The national budgets are the last to be approved. The main issue with this approach is that local residents' input into the shape and content of local expenditure budgets is limited. Instead, local expenditure management is conducted mostly through the bureaucratic hierarchy.

*Significant administrative autonomy for local expenditure decisions.* Currently, subnational government officials still practice “administrative autonomy” to increase their effective autonomy and go beyond the confines and constraints imposed by the local budget and related regulations. In general, the management of funds is through a “distributive model,” whereby various government agencies and divisions of the finance department make their own expenditure decisions, and some expenditures may not be included in the budget. One manifestation of the administrative autonomy at the subnational level is the prevalence of extrabudgetary funds. It is important to note that a significant portion of subnational government expenditures do not go through the regular budget channels. Fundamentally, extrabudgetary expenditures do not differ that much from ordinary budgetary expenditures. As shown in table 2.4, the largest share of the officially recorded extrabudgetary funds is spent on government administration (72 percent for 2004). Other uses of extrabudgetary funds overlap considerably with those of ordinary budget items.

**Table 2.4**  
**Most Important Extrabudgetary Expenditures, 2004**

Item	Percent of Total
Capital construction	6.6
Public administration	72.0
City maintenance	4.5
Township expense	4.7
Other	12.2

*Source:* National Bureau of Statistics of China 2006.

As the central government has taken various measures to transform its extrabudgetary expenditures into budgetary expenditures (Wong 1998; 2000),

extrabudgetary funds at the central government level have decreased dramatically (Qiao and Shah 2006). In contrast, extrabudgetary expenditures still play a very important role at the subnational level, despite the central government's long effort to reduce their use and importance and transform extrabudgetary funds into ordinary budgetary funds. As a matter of fact, the ratio of extrabudgetary to budgetary expenditures for subnational governments was still around 20 percent in 2004.

The use of revenues from the sale of land in off-budget funds is another manifestation of administrative autonomy. In addition, soft-budget constraints are still a problem in China's system. One manifestation of a soft-budget constraint is in the dealings between SOEs and government. Some SOEs are generally not very competitive and rely heavily on government to survive; however, they also help the interests of local governments.<sup>9</sup>

In recent years the central government has taken steps to improve expenditure management processes, including the creation of budgeting departments, according to which each government agency and public service unit has a single budget that combines all budgetary and extrabudgetary funds; the introduction of a treasury system and the centralization of payment administration, by which all expenditure funds for each government are controlled in a single account of the central bank; and the standardization of governmental procurement practices.

#### Main Issues with Expenditure Assignments

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<sup>9</sup> According to China's 1994 budget law, subnational governments are forbidden from borrowing on the capital market except with special approval from the central government; however, they can effectively borrow through SOEs.

Little has been done to reform policy and clarify expenditure assignments over the past several decades. This is especially true at the subprovincial level. The main challenges facing the current system in expenditure assignments include the following:

- *A mismatch of expenditure responsibilities and revenue sources at the lowest levels of administration.* Local governments (especially county and township levels) have very heavy expenditure responsibilities in education, health, and social insurance that are out of line with international practice. While the tax-sharing system reform has recentralized revenue assignments, there has been considerable devolution of expenditure responsibilities to local governments. More important, the vertical imbalances caused by revenue centralization and expenditure decentralization have not been adequately offset by intergovernmental transfers (Jia 2004).
- *Significant regional disparities in fiscal performance.* The current system of decentralized finance in China yields significant horizontal fiscal disparities (Qiao, Martinez-Vazquez, and Xu 2008). These disparities occur across provinces but also within provinces, especially between urban and rural areas, and there is evidence that they are expanding. The expanding disparities in expenditure per capita and in service delivery are likely to be harmful for cohesion of the country. The increasing trend in expenditure disparities, which was temporarily stopped for several years starting in 1998 as several intergovernmental transfer programs were newly introduced by the central

government, has continued since 2000. Since 2003, reforms in intergovernmental transfers to improve rural basic public services have slightly decreased the disparity. (See table 2.5.) In 2005, public expenditures per capita in the best-off province were 7.9 times larger than those for the worst-off province, and the coefficient of variation across provinces was 0.73.

These disparities are very large by international standards.

**Table 2. 5**  
**Per Capita Expenditure Disparities Across Provinces, 1990–2005 (in RMB)**

<i>Year</i>	<i>Max.</i>	<i>Min.</i>	<i>Avg.</i>	<i>C.V.</i>
1990	613	99	251	0.57
1991	664	102	280	0.56
1992	729	112	296	0.56
1993	958	122	372	0.57
1994	1,452	157	444	0.69
1995	1,837	226	538	0.71
1996	2,348	278	632	0.72
1997	2,806	308	698	0.77
1998	3,211	347	811	0.76
1999	3,620	409	943	0.76
2000	3,635	225	1,075	0.70
2001	4,387	532	1,383	0.73
2002	5,307	655	1,620	0.75
2003	6,361	741	1,792	0.77
2004	7,936	905	2,082	0.75
2005	9,259	1,165	2,538	0.73

*Source:* National Bureau of Statistics of China for the years cited.

C.V.: coefficient of variation

- *Serious underprovision of basic public services in poor jurisdictions.* For county governments that have only limited revenues, the ability to spend on local public goods depends heavily on intergovernmental transfers (Uchimura and Jütting 2007). But without adequate resources at the lower levels of

government, the current levels of intergovernmental transfers and the budget priority decisions taken by the local governments have led in many cases to the underprovision of basic public services (Martinez-Vazquez, Qiao, and Zhang 2008). China's system of intergovernmental finance is far from achieving the goal of providing all citizens with similar access to basic public services. While the average per capita educational expenditure is RMB 352, the poorest jurisdiction spends only RMB 171, less than half of the national average and less than one-sixth of what the richest jurisdiction spends. The underprovision in some areas of public health services and social security are even more significant. The poorest jurisdiction spends RMB 39 per capita on health care, which represents 37 percent of the average and only 9 percent of what is spent by the richest jurisdiction. In the case of social security programs, the lowest jurisdiction spends RMB 29 per capita on subsidies for social security programs, which represents 19 percent of the average and 7 percent of what is spent by the richest jurisdiction (table 2.6).

- *Lack of horizontal accountability mechanisms.* An important question is whether local governments are prioritizing local budget expenditures according to the needs and preferences of their residents (Oates 1972; 2005). The generally low horizontal accountability of local government officials to their residents has likely exacerbated problems with the delivery of services. Accountability of government officials to residents has been further reduced because an increasing number of people have migrated internally without the

official documents and are “illegally” residing in urban areas, especially in the eastern provinces, without a right to access basic services. But even in the poorer areas, the limited fiscal resources have not prevented local governments from expanding into areas with heavy overhead expenditures that in many other countries are left to the private sector. In China there continues to be no clear delineation for government responsibilities between the public and private sectors.

**Table 2.6**  
**Subnational Expenditures per Capita, 2005 (in RMB)**

Expenditures	Max.	Min.	Avg.	C.V.
Total	9,259	1,165	2,538	0.73
Capital construction	2,077	76	358	1.35
Agriculture	216	38	82	0.49
Education	1,029	171	352	0.59
Public health	427	39	105	0.80
Social security programs	405	29	156	0.69
Government administration	1,009	118	231	0.71
Public security & procuratorial agencies, court of justice	549	70	162	0.70
City maintenance	499	16	117	1.03
Underdeveloped areas	152	0	24	1.26

*Source:* National Bureau of Statistics of China; Ministry of Finance.

C.V.: Coefficient of variation.

- *The undesired consequences of lacking a clear assignment of responsibilities.*

The lack of explicit expenditure assignments at the subprovincial level has led to considerable overlapping of responsibilities and eventually lower accountability because of the difficulty of identifying what level of government should be accountable for the delivery of particular services.

Inefficient underprovision of services is more likely in the presence of

extensive concurrent responsibilities. The lack of explicit assignments has also meant considerable murkiness as to which level is responsible for financing expenditures and how the financing responsibilities are divided. This has facilitated the convenient offloading of responsibilities down the hierarchical structure of government. In education, for example, despite the fact that in many cases resources are inadequate, counties have been called on in recent years to finance basic education reform. Some of these upper-level government measures can be considered as unfunded government mandates. The lack of explicit assignments has also led to significant differences in the distribution of responsibilities among local governments across provinces. Although in theory there is nothing wrong with variety in approaches to expenditure assignments, the absence of a holistic approach to expenditure (and revenue) assignments means that matching revenue sources with expenditure functions at each local level is made more difficult, as is targeting pass-through transfers from the central government to lower-level local governments. The absence of a unified approach to expenditure assignments also makes the tasks of setting standards for the provision of public services and monitoring performance harder, and it can be expected to contribute to wide variation in the standards of services.

- *Several inefficient expenditure assignments.* Several of the current expenditure assignments are problematic. The most conspicuous example is the responsibility assigned to city- or county-level governments for pensions,

unemployment, and income support schemes. Such assignments are hardly replicated anywhere else in the world; general pension schemes, unemployment insurance, and other social security measures tend to be central government responsibilities. Either provincial or national pooling would seem to be the correct approach to the assignment of these services. These types of social security schemes require a level of risk pooling and redistribution that cannot be matched at the level of county governments.<sup>10</sup> Whereas welfare benefits are almost nonexistent in rural areas, in urban areas there is often a lack of redistribution because poorer communities with the highest needs are least financially able to fund these expenditures. The inability of many local governments to finance the social safety net has led in recent years to widespread pension arrears and defaults that have forced the central government to intervene with subsidies.

### **A Roadmap for Reform**

Setting up formal and stable expenditure assignments to clarify the responsibilities of all government levels must become a priority for reform. A clear and explicit assignment of expenditure responsibilities at all levels could (1) facilitate a more efficient organization and provision of basic public services; (2) significantly improve the accountability of public officials to residents; (3) help eliminate government encroachment in the private sector; and (4) help address the issues of vertical and horizontal fiscal disparities.

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<sup>10</sup> <FNTX>See, for example, Ahmad (1995) and the references therein.

In the past two decades, China has made considerable progress in separating government from SOEs and redefining the functions and responsibilities of government in the economy. But there are still significant problems from an expenditure assignment perspective (Martinez-Vazquez 1998). In particular, a stable and transparent expenditure assignment at all levels of government, emphasizing exclusive over concurrent responsibilities, is desirable.<sup>11</sup>

The other option is to continue with the current system and muddle through until an acceptable system presents itself through piecemeal reforms. Practice can substitute for explicit assignments in the law, but relatively younger decentralized countries like China may avoid costly transactions through more explicit and clear assignments. When concurrent responsibilities are desirable, assignments should be clarified by explicitly assigning the multidimensional array of attributes that go with each function, including (1) actually producing a good or delivering a service; (2) providing or administering the service; (3) financing the service; and (4) setting standards, regulations, and policies for the provision of services. In addition to clarifying assignments, it will be important to improve coordinating institutions across levels of government to address different interpretations and conflicts arising from concurrent assignments.<sup>12</sup>

But the question is how to proceed with comprehensive reform in expenditure

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<sup>11</sup> For example, in many decentralized large countries, including Australia, Brazil, Canada, the Russian Federation, and the United States, a number of responsibilities are exclusively assigned to local governments.

<sup>12</sup> For example, Australia, Canada, and New Zealand use periodic formal meetings of elected officials and bureaucrats at different levels to discuss mutually important expenditure assignments and other fiscal issues.

assignments. The rest of this chapter provides practical guidelines that can be followed in this reform process. Among the most important steps to accomplish reform is the appointment of a high-level intergovernmental reform commission charged first with mapping out the current de facto expenditure assignments and providing a blueprint for reform options. Further below, we list the steps for comprehensive reform. However, first, because comprehensive reform can be politically difficult, some worthwhile reforms that can be made piecemeal follow:

- *Reassign selected expenditure responsibilities.* The financing and provision of social security services (pensions, disability and survivor benefits, and unemployment) should be recentralized, at the provincial or central government level. The recent policy measures assigning more responsibility for social security at the central level are steps in the right direction.
- *Address the existing large fiscal disparities and align the decentralized fiscal system more properly to ensure that all citizens have access to basic public services regardless of where they happen to live.* Addressing the existing fiscal disparities will require, at a minimum, significantly enhancing the role of equalization grants in the current intergovernmental system. This will require at the center an increase in the pool of funds dedicated to equalization, the consolidation of many existing small transfers with equalization objectives, and a distribution formula that takes into account fiscal capacities and expenditure needs. At the subcentral level, clear guidelines for the provinces, prefectures, and counties (if applicable) would need to be legislated to

introduce (1) sufficient funding for equalization grants for the governments immediately below; and (2) distribution formulas that capture, to the extent the data allow, the differences in fiscal opportunity and expenditure needs of subordinate local governments. A small set of conditional sectoral grants could also be considered in order to guarantee some minimum standards of service throughout the national territory. In this regard it may be worth considering the use of national minimum standards for basic public services and the use of conditional grants to ensure that all subnational governments have the means to finance them.

- *Improve the accountability and quality of local expenditure management.* A significant feature of China's decentralization system bearing on the issue of efficiency is that the accountability of subnational government officials to local residents is weak; the direct appointment of officials tends to make them mostly accountable to the upper and central government authorities. The system needs to introduce adequate accountability mechanisms to provide incentives to subnational governments to properly weigh spending on economic development and construction and other public services, especially those in the social areas. Besides local elections, different approaches are used internationally to better empower communities. For example, local governance in some countries is reinforced by institutions that facilitate the involvement of civil society in the delivery of public services.<sup>13</sup> For example, in the education

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<sup>13</sup> For example, in Canada, Local Boards are not-for-profit, community-based organizations composed

sector, there is now evidence that community-managed schools can lower teacher absenteeism and improve schooling outcomes.

### Important Preliminary Questions

- *What should be the scope of the reform in expenditure assignments and privatization?* A benefit of extending the scope of the reform to all activities within the fiscal system is that we can identify activities at the central and subnational levels that do not serve a public function and that by their nature can be better provided in the private sector. The reform of expenditure assignments provides an excellent opportunity for the privatization of activities that do not belong in the public sector.
- *Should assignments be distinguished as “delegated” or “own” responsibilities?* In determining expenditure assignments we may want to make a distinction between voluntary (or “own”) responsibilities and mandatory (or “delegated”) functions of subnational governments. A decision needs to be made as to whether it is desirable to differentiate between what subnational governments *can* do and what they *must* do. However, doing this is not a requirement for a clear assignment of expenditure responsibilities. Delegated responsibilities are typically paid via conditional or tied grants.
- *How far should “exclusive” (as opposed to “concurrent”) assignments be taken?* Exclusive responsibility is more conducive to accountability and generally a more efficient provision of services; however, in practice,

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of volunteers from business, labor, education, and community groups that support local governments in a variety of ways. Similar institutions exist in the United States.

exclusive responsibilities are not always possible, and they may not be desirable in some cases.

- *Which general approach—“general competence” or “closed list”—should be used for expenditure responsibilities?* Here the choice is between a “general competence” approach followed by some exclusions or exceptions and a “closed list” of competences. A closed-list approach is more cumbersome, but it can offer more protection to subnational governments from encroachment by central or upper-level governments. Typically, the question boils down to what level of government may have “residual powers,” in case a particular (new) function does not appear in the law in the closed list of any one level of government.
- *What legal instrument should be employed to specify expenditure assignments?* Because an assignment should be stable over time, especially given the time needed for strategic planning and capacity building, it should be in the law—for example, in the decentralization law or the budget code. It is less preferable to introduce expenditure assignments in the constitution.
- *How much needs to be specified in the law, and how much can be left to coordination or even interpretation by the courts?* No expenditure assignment can ever be detailed enough to preempt the need for dialogue and coordination among different levels of government, but there is the matter of the level of specificity in the law. That is, how much should we rely on the legal text and implementation rules vis-à-vis a more general text that will be subject to

interpretation as we go, by practice and coordinating institutions, and ultimately be left for interpretation and rulings by the courts of law?

- *Should expenditure assignments be determined at all levels or just between the central and the “aggregated” subnational level?* When there is a single tier of government below the central government, the assignment of functions must cover all government levels. However, when there are two or more tiers of government at the subnational level, there are several choices of approach. An explicit assignment at all levels is more transparent and efficient but, of course, less flexible in adapting to specific characteristics of subnational units.
- *Deciding between uniform versus asymmetric responsibilities?* Some local jurisdictions may be too small to realize economies of scale in the delivery of public services; they may lack adequate fiscal capacity and tax base and also lack administrative and managerial capacity. Although there are some ways to get around the small scale, such as privatization of services, the creation of special districts, or associations of local governments, the most preferable solution to the problem is the amalgamation of smaller local governments into larger units with adequate size and capacity. If amalgamation is not politically feasible, the solution could be an asymmetric assignment of expenditure responsibilities, in which more or less responsibilities are assigned according to the capacity of local governments.

#### Identifying Who Should Be Involved

It may be assumed that in the case of China, the determination of expenditure

assignments is the prerogative of the national or central authorities. As mentioned earlier, leadership of the reform should be assigned to an intergovernmental reform commission with wide representation of the most important stakeholders at the central and subnational levels. The commission, with support of a technical secretariat or working group, would need to establish the general strategy and scope of the reform, as well as an implementation plan with an explicit time schedule. If there is no commission, perhaps the Ministry of Finance could take the lead in the reform effort. However, that is likely to be less than ideal.

#### Determining What Information Is Needed

Setting up to conduct comprehensive reform of expenditure assignments will require significant amounts of data on actual and potential expenditures and expenditure needs associated with the reassignment. Getting all of this information on a timely basis may be one of the most significant hurdles to expenditure assignment reform. But it will be important that adequate resources are dedicated to this task.

#### Enforcement

One of the big difficulties with expenditure assignments, and in other policy areas, as well, is that there may be significant differences between what the assignments are in practice and what is specified in the law and regulations. These problems will tend to be minimized if the process of reform is highly participatory, involving all stakeholders, and the reforms are well publicized. The added clarity to the assignment of expenditure responsibilities by the reform should also contribute to reducing differences between practice and law. Intergovernmental institutions for cooperation

and dialogue among the different levels of government can also work well in this context.

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