CENTRAL-LOCAL FISCAL RELATIONS IN CHINA

By Susan H. Whiting

NATIONAL COMMITTEE ON UNITED STATES – CHINA RELATIONS
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A Report Based on the Proceedings of the International Conference on Intergovernmental Fiscal Relations in China

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PREFACE

At the March 2007 National People's Congress, China's premier Wen Jiabao delivered his annual report on the work of the government. Among the major themes were the acceleration of the building of a "new socialist countryside" and the assistance to people left behind in the country's economic boom. For a blueprint of just how Beijing might go about achieving these goals, one needs to turn to the government's Central and Local Budgets for 2007. It is in that document that various measures are discussed in greater detail, including the government's plan to increase spending on rural development and social services, and to increase "transfer payments to improve the ability of local governments to provide basic public services."

The Chinese government has officially enshrined the policy goal of striving for a "harmonious society." Reform of public finance helps meet the challenge of reducing regional and urban-rural disparities and improving public health, education and social security; it stands as a cornerstone of that policy goal. China's fiscal system has undergone major transformations as its economy evolves from a centrally planned to a market-based one. In 1994, for example, the central government changed the way it shares tax revenues with the provinces, a key reference point for the changing dynamics of intergovernmental fiscal relations in China. The 1994 tax reform accomplished many important policy goals and left the center with greater control of tax revenues. However, sub-provincial governments continue to shoulder the main burden of providing health care, schooling and other services. All too often cash-strapped local governments resort to illegal land grabs and illegal levies. This has directly contributed to increasing social tension. To students of fiscal policy, the government's pledge to increase transfer payments therefore is not surprising.

While terms such as "special transfer payment" or "extra-legal off-budget expenditures" may sound technical to the layman's ear, the hot debates on rebalancing China's public spending and better managing the central-local fiscal relations are anything but academic. To explore the changing central-local dynamics through the lens of fiscal reform, the National Committee on U.S.-China Relations and Renmin University of China co-organized a conference on China's intergovernmental fiscal relations in Beijing last summer. Generous funding was provided by the Ford Foundation. Over 40 scholars and practitioners shared comparative perspectives on the fiscal relations between central and sub-national governments, including responsibility for policy mandates, resource allocations, budgeting process and reform of government structures and practices. The participants included six experts from the United States, the United Kingdom and France; the Ministry of Finance and provincial budget officials; and prominent scholars from academic and research institutions in the field of public finance and taxation. The high quality of presentations and the lively exchange of ideas made for an excellent conference.

The report that follows was written by Professor Susan Whiting of the University of Washington. Professor Whiting is a participant in the National Committee's Public Intellectuals Program, a multi-year program designed to nurture the next generation of China scholars in the United States. She attended the conference as the rapporteur, and the views reflected, except where otherwise noted, are her own and not those of any other participants.

The National Committee and Renmin University of China are most grateful to the many organizations and individuals who gave their time, knowledge, hospitality and financial resources to make the conference such a success: the Ford Foundation; the Chinese and international specialists who attended the conference and the other specialists who helped us conceptualize it; the School of Finance and the China Financial Policy Research Center of Renmin University of China, which served as hosts; Professors Guo Qingwang and Zhu Qing at Renda and Ling Li and Anne Phelan at the National Committee, all of whom were instrumental in the planning and implementation of the project; Zhang Changdong, who translated the report into Chinese, and Jonathan Lowet, also at the National Committee, who helped edit and typeset the report.

We hope that those who read the report will find it useful in better understanding the important issues involved.

Stephen A. Orlins	Chen Yulu
President National Committee on United States–China Relations	Vice President Dean, School of Finance Renmin University of China

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INTRODUCTION

Central-local fiscal relations have undergone a series of fundamental changes during the course of China's transition from a planned to a market economy. Current challenges grow out of a number of features of the Chinese political economy, the most important of which is the mismatch between the allocation of revenues and the assignment of expenditure responsibilities across levels of government. Local governments—county governments in particular—lack adequate revenues to finance the wide range of public goods and services they are mandated by higher levels to provide. This fiscal gap drives additional problems, including the growth of off-budget funds and hidden government debts at the local level. The mismatch between revenues and expenditure responsibilities also leads to unusually heavy reliance on intergovernmental fiscal transfers that, nonetheless, have not yet effectively redressed the high levels of inequality that have emerged in the context of economic reform. The National Committee on U.S.-China Relations and Renmin University of China jointly convened a conference to address these issues through presentations and discussion of the current Chinese system and alternative models of central-local fiscal relations.

This report provides a summary and analysis of the issues examined at the conference. The first section focuses on the evolution of the fiscal system since the initiation of economic reform. The second section lays out the rationale for the conference and an overview of the proceedings organized around the five major themes: 1) the misalignment of revenues and expenditures, 2) the problem of revenue inadequacy at the local level, 3) the quest for additional local revenue through off-budget finance and debt, 4) the state of intergovernmental fiscal transfers and inequality, and 5) the political aspects of fiscal problems. Throughout, the report highlights alternative models and the discussion of potential challenges in implementing reform in China. The final section summarizes the policy recommendations that resulted from the exchange of ideas at the conference.

BACKGROUND

Since the initiation of economic reform in the late 1970s, the fiscal system has evolved to better suit the needs of a market economy. At the end of the Maoist era, the fiscal system was characterized by unified incomes and expenditures ( ): sub-national governments turned virtually all tax receipts and profits from state-owned enterprises over to the central government and then looked to the center to meet their expenditure needs.[1] In the 1980s, a fiscal contracting system ( ) emerged in which local governments handed a fixed quota of tax revenues over to higher levels, while retaining a larger share of above-quota revenues. Local governments gained control of much of their own tax revenues and, at the same time, the central government devolved responsibility for financing many public goods to local governments.[2]

Several features of this system, in place until 1994, are noteworthy: high marginal revenue retention rates encouraged local governments to promote economic activity within their jurisdictions, periodic renegotiation of the tax quota prompted local governments to hide revenues by shifting them off-budget, and the central government sacrificed control over a large share of fiscal revenue. These points are evident in the decline in the central share of budgetary revenue to a low of 22 percent in 1993, and in the rapid growth of extra-budgetary funds as a share of total government expenditure. Revenue mobilization also suffered in the shift from a planned to a market economy, with budgetary revenue as a share of GDP falling to a low of about 11 percent by the mid-1990s.[3]

As a continent-sized country with provinces as large as, or larger than, some European states, China is, of necessity, relatively decentralized. There are five tiers of government, reaching from the center, through 32 provincial, 333 municipal and 2,860 county-level units, to the townships. The township-level units, numbering 43,255, had an average population of roughly 30,000 people as of 2004. Moreover, staffing levels suggest that the real work of governance takes place well below the center. Nearly 60 percent of civil service employees work at the county or township levels.

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[1] Oksenberg and Tong 1991.

[2] Wong 1991.

[3] Corporate income taxes replaced profit remittances by state-owned enterprises as a source of budgetary revenue. The profits of state-owned enterprises, however, were badly eroded due to increasing competition from new, non-state market entrants. At the same time, the state had only a fledgling capacity to collect corporate income taxes from new private firms.

However, China remains a unitary state, in which only the center has the right to legislate taxes. There is a hierarchy of authoritative rules and laws issued by the center: most authoritative, in principle, are the laws—including tax and budget laws—passed by the National People's Congress, followed by regulations promulgated by the State Council and rules put out by ministries and then central agencies, such as the Ministry of Finance (MOF) and State Administration of Taxation. Tax bases and rates are set by the central government; local governments have only limited authority to adjust certain tax rates within a certain range in a few instances.

Tax and fiscal reforms were designed to address the weaknesses of the transitional fiscal system within the context of a highly decentralized, unitary state. The center used its authority to implement the new tax sharing system ( ) beginning in 1994. This system was designed to recentralize control over revenue following the dissolution of central control during the preceding fiscal contracting regime. As a result, revenue control is now significantly more centralized than expenditure responsibility, since the reforms left expenditure responsibilities largely unchanged. Under the tax sharing system, taxes are divided into central, local, and shared categories, with major revenue earners controlled primarily by the central government. For example, in 1994, a revamped and expanded VAT-tax replaced the turnover taxes of the planned economy as a key revenue source; the center assigned the VAT-tax to the shared category, retaining 75 percent and returning 25 percent to the localities. The reallocation of revenue drove the center's share of budgetary funds from 22 percent in 1993 to more than 50 percent in 1994 and thereafter. Even so, the center allocates less than 10 percent of GDP—"a relatively low figure for a large and diversified country that faces many major expenditure needs in continuing SOE reform, recapitalizing the banking sector, implementing pension reform, etc."[4]

Finally, to improve revenue mobilization and counter incentives for local governments to hide tax revenues from the center, a National Tax Service (NTS) was established as part of the 1994 reforms. The NTS has offices at all levels of government and collects both central and shared taxes. The Local Tax Service (LTS), which has offices at the provincial level and below, collects local taxes. These institutional changes were a contributing factor in the reversal of the trend of falling revenues as a percentage of GDP. Budgetary revenue as a share of GDP increased from 10.8 percent in 1994 to 17.3 percent in 2005.

[4] Wong 2005a:13.

These changes in fiscal policy are clearly affecting the dynamics between China's central government and the localities. Few resources are being transferred from the center downward, making it more difficult for some lower level governments to provide basic education, health care, unemployment insurance and other centrally mandated services. At the same time, some of the relatively prosperous provinces are able to manifest greater independence from Beijing than in the past, making it difficult for the central government to ensure that its policy objectives are put into action. These dynamics must be addressed if China's leaders are to meet ambitious goals for reducing disparities in standards of living, implementing the rule of law, and ensuring social stability.

CONFERENCE OVERVIEW

In light of these challenges in central-local fiscal relations and the relevance of both international and Chinese experience and scholarship on these issues, the National Committee on U.S.-China Relations, with the School of Finance of Renmin University of China, convened the "International Conference on Intergovernmental Fiscal Relations in China" July 10 and 11, 2006, on the Renmin University campus in Beijing. The conference received financial support from the Ford Foundation. It brought together policymakers, practitioners, and analysts from China and abroad. Five foreign and five Chinese experts presented papers at the conference, and nearly two dozen Chinese scholars served as commentators or discussants, or provided background papers. The two-day event was organized into seven panels addressing 1) a framework for the fiscal responsibilities of governments, 2) local perspectives on intergovernmental fiscal relations, 3) coordination mechanisms for central and provincial fiscal relations, 4) budget constraints and the behavior of governments, 5) the transfer system and the balance between finance and power, 6) governance structure and national government power, and 7) Chinese choices regarding fiscal relations among governments.

Five major themes emerged from the panel presentations and discussions. The most important of these, touched upon by nearly all the conference participants, is the mismatch between the allocation of revenues and the assignment of expenditure responsibilities across levels of government. The second theme follows from the first: many participants highlighted the severe revenue inadequacy facing local governments—county governments in particular. These local governments lack adequate resources to finance the wide range of public goods and services that higher levels mandated them to provide. Several conference participants provided a focus on the special challenges of funding education, and a presentation on the experience of the state of Arkansas provided an alternative model for funding education. The third theme similarly follows from the second: the fiscal gap facing local governments drives additional problems, including the growth of off-budget funds and hidden government debts at the local level. While many participants identified these problems in the Chinese case, one presentation drew on the experience of OECD countries to provide alternative models for local tax autonomy and local government debt issuance. The fourth theme raised by participants focused on the heavy reliance on intergovernmental fiscal transfers and the challenges that remain in redressing the high levels of inequality that have emerged in the context of economic reform in China. Also presented was the experience of the United Kingdom, another unitary and highly centralized case, in designing fiscal institutions to address equalization issues. A focus on the role of individual income taxes and individual entitlements in the United States provided a contrast to the Chinese and British models. Finally, the fifth theme identified some of the political aspects of the fiscal challenges facing the Chinese state.

The Mismatch between Revenue Assignments and Expenditure Responsibilities

The trend in China has been toward concentrating fiscal revenues at the highest levels of the system, while expenditure shares have remained roughly the same. Professors Tang Gongliang and An Tifu highlighted this trend, while Professor Christine Wong provided an illustration: between 1993 and 2003, central and provincial shares of total revenue increased from 35 percent to 66 percent, while their shares of total expenditure increased from 45 percent to only 49 percent. Dr. Zhang Zhihua illustrated some changes that have further centralized control over revenue and reduced local revenues, which are only partially compensated for by increasing intergovernmental fiscal transfers, as other participants noted. In 2002, for example, the central government reassigned corporate and individual income taxes from the local to the shared category, with the center taking 50 percent in the first year and 60 percent thereafter. Professor Li Bo provided data showing the effects of this reassignment of central-local control on Hubei Province. There, the local share of income taxes fell from 5.32 billion yuan in 2001 (23 percent of local revenues ( )) to 3.75 billion yuan in 2002, 3.28 billion yuan in 2003, 4.19 billion yuan in 2004, and 4.65 billion yuan in 2005 (15 percent of local revenues).

In 2006, the center completely abolished the agriculture tax nationwide, following a series of changes in taxes and fees on rural residents in recent years, including the abolition of collective revenues for villages and townships (“ ”[5]). Data provided by Professor Li Bo illustrated that in Hubei, the 3.3 billion yuan in four agriculture taxes[6] ( ) and animal slaughter tax ( ) constituted 11 percent of local revenues in 2004. The abolition of the two primary agriculture taxes—again, only partially compensated for by new intergovernmental fiscal

[5] Among the rural taxes and fees that have been abolished were three types of village levies (for public reserve funds, public welfare funds, and management fees) and five types of township pooling funds (for rural education, family planning, militia training, rural road construction, and subsidies to entitled groups such as disabled veterans). Wen Jiabao, “Government Work Report 2006,” (http://english.gov.cn/2006-03/14/content_227247_2.htm).

[6] The four agricultural taxes include agricultural tax, agricultural specialty duty, farmland occupation tax and deed tax ( ).

transfers—put a further revenue squeeze on local administrations at the lowest levels of the government hierarchy.

Several conference participants, including Professors Sun Kai and Ma Guoxian, also pointed out that the 1994 Budget Law and subsequent regulations leave sub-provincial revenue sharing arrangements largely to the discretion of governments at the provincial level and below, allowing for significant variation across provinces. In many provinces, revenue control has shifted upwards, leaving little revenue to divide at the sub-provincial level—a situation Professor Li Bo referred to as "having a head but no feet ( )." To address this problem, some provinces have implemented a reform involving direct provincial oversight of county public finance ( ). In sum, conference participants demonstrated the extent to which control over revenue has become increasingly centralized.

From the perspective of expenditure responsibilities, by contrast, China is among the most decentralized countries in the world; nearly three-quarters of all government expenditure takes place at sub-national levels. Elsewhere, as Professor Christine Wong noted, the average level of sub-national expenditure throughout the 1990s was 14 percent for developing countries, 26 percent for countries in transition, and 32 percent for OECD countries. Comparable figures were 61 percent for Japan and 46 percent for India. Many participants emphasized that education and health in particular are shouldered to an unusual degree by local governments in China. Professor Wang Yongjun estimated that the average share of these expenditures borne by the lowest-level governments (counties and townships) is 70 percent for education and from 55 to 60 percent for public health.

In recent years, the State Council has promoted a policy of increasing the importance of the county vis-à-vis the township ( ), although expenditures remain highly decentralized, even at the county level. With the 2001 State Council "Decision on the Reform and Development of Basic Education ( )," for example, payment of rural teachers' salaries is now handled at the county level. Subsequent reforms in the treasury system have similarly shifted the disbursement of salaries of other public employees to the county level.[7] As a result, the township level of public finance is becoming "hollowed out."[8]

Professor Ruan Yisheng and others raised the question of how many levels of government are most desirable. There was debate among participants regarding the merit of moving from five to three levels of government. Dr. Ray Scheppach, for

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[7] Wong 2005b:25.
[8] Zhou Feizhou 2006.

example, noted that the smallest governments are often inefficient. Professor Chen Suihong, by contrast, highlighted the value of smaller units to facilitate citizen access to information and participation.

Revenue Inadequacy

The disjuncture between revenue assignments and expenditure responsibility has left sub-national governments facing a substantial fiscal gap. Local taxes and the local portion of shared taxes cover only about 40-45 percent of local fiscal needs. Professor Sun Kai indicated that this fiscal gap has generated a relatively high degree of dependence by lower-level governments on fiscal transfers, which have grown from 239 billion yuan in 1994 to 1,041 billion yuan in 2004. Since the consolidation of the new tax sharing system, the central government has dedicated roughly 70 percent of its revenues to fiscal transfers, providing between 40 and 50 percent of local governments' budgetary expenditures. As Professor Wang Yongjun noted, with 50 percent of fiscal needs covered by intergovernmental fiscal transfers, and another 40 percent covered by local and shared taxes, roughly 10 percent of fiscal needs remain unmet. He emphasized that fiscal deficits are effectively pushed onto lower levels as a result of the existing division of expenditure responsibilities.

Insufficient provision of public goods and services: the case of education

The fiscal gaps in the existing system have resulted in failures in national public policy; education policy is a notable example. As several participants emphasized, one high-profile goal was the achievement of universal basic education—nine years of publicly funded, compulsory education—by the year 2000. Despite State Council pronouncements about increasing investment in human development, during the first quarter-century of reform, "budgetary spending on education remained stagnant at about 2-2.5 percent of GDP…, half the level called for in the 1985 Education Law and well below the levels of spending in neighboring East Asian economies."[9] Professor Christine Wong pointed out that 17 percent of rural counties nationwide were unable to provide nine years of basic education as of 2004. Moreover, resources available for education are highly unequal. For example, at the primary level in 2002, spending per student was 5,500 yuan in Shanghai but only 600 yuan in Guizhou.

Mr. Richard Weiss presented the history of the increasingly centralized approach to providing education in the state of Arkansas. To enforce the constitutional mandate of providing free and equal education to children, the Arkansas courts have forced

[9] Wong 2005a:11.

the state to help poor school districts. In order to provide equal access to an "adequate education" for students in both rural and urban school districts throughout the state, Arkansas now provides 66 percent of total education funding, while local governments provide 34 percent. He noted that public education is the single largest expenditure in the state, accounting for 55 percent of expenditures out of general revenues. At the local level, there is a property tax levied on the assessed valuation of property. The state equalizes on top of that up to $5,400 per child, financed in part by increases in the state sales tax. Even the poorest district exceeds the base amount per child, since there are extra millions of dollars levied for buildings. However, disparities still exist: for example, the Bentonville District spends $15,392 per student while the Gosnell District spends only $6,675. The state also matches district dollars to develop school facilities—a concern of the court, which ruled that sub-standard facilities undermined the provision of an "adequate education." Moreover, the law allows the state to take over a district if it fails to maintain adequate teacher salaries. In sum, Arkansas centralized financing and control of public education to improve equalization.

There is no parallel in China to the experience of the state of Arkansas. Professor Cai Hongying pointed out that in China, by contrast, responsibility for education rests at the county level. She suggested that responsibilities of the center, the province and the county in China should be defined by law and that some particular tax revenue should be assigned to education in order to achieve adequate funding. She further noted that the provincial level in China has few tax types on which to draw to support education, in contrast to property and other taxes on which state governments in the United States can draw.

Aside from revenue adequacy, in China the challenge includes monitoring and evaluating the use of transfers. Taking education funding as an example, Professor Christine Wong noted that intergovernmental transfers were inadequately predictable, transparent, or incentivized. Once funding for education reaches the county, for instance, it is unclear what revenues are provided directly by the county and what revenues come from transfers. Furthermore, outlays tend to be employed inefficiently—in particular, increasing the number of administrative staff. Professor Wong noted that the World Bank study on decentralization in East Asia showed that while in China almost 70 percent of local government resources went for salaries, comparable figures were only 41 percent in Thailand, 45 percent in the Philippines, and 55 percent in Cambodia. Dr. Scheppach commented that more than 800 auditors from the legislative and executive branches in the United States are permanently assigned to states to ensure the proper use of federal transfers, while even more are needed to evaluate performance outcomes.

Mr. Alan Carter noted that for capital spending in education, local governments in the United Kingdom put in requests to higher levels, which are responsible for evaluating those requests and issuing permission for certain projects. The advantage of this approach is that there is some control over public sector borrowing; the disadvantage is that government-supported borrowing risks becoming a free good to which local governments do not have to contribute. The key, he concluded, are the incentives built into the system.

Going Off-Budget and Taking on Debt

Reliance on extra-budgetary and off-budget funds

Many conference participants emphasized that one of the most prominent ways in which local governments cope with revenue inadequacy is by generating revenue outside the formal budget system in the form of extra-budgetary and off-budget funds. Extra-budgetary funds are defined as levies and user charges collected and spent by government agencies in performing duties delegated to them by higher levels.[10] In recent years, the Ministry of Finance has begun to exert greater oversight over these funds; in principle, all extra-budgetary funds are public fiscal revenues approved at the central or provincial level, and deposited in special fiscal accounts. In addition, pooled pension funds and unemployment insurance funds are registered and managed as extra-budgetary funds in social security accounts. It is estimated that extra-budgetary, social security and government bond expenditures add approximately seven percent of GDP to official expenditure.[11]

Off-budget funds, by contrast, exist outside effective MOF oversight. Although no comprehensive data exist, these funds are estimated to rival or even exceed the size of the formal budget for many local governments, as Professors Chen Gong and Sun Wenji both pointed out. The sources of off-budget funds reflect both available "revenue handles"—in other words, places where revenue opportunities exist to exploit—and gaps in effective MOF oversight. According to Professors Chen Gong and Wang Yongjun, these sources have shifted over time from enterprise fees, to highway fees, to land transfer fees ( ), and to sales of government assets. One problem with off-budget funds is that these funds, which constitute an important supplement to budgetary revenues, are most abundant in wealthier areas with the greatest access to budgetary revenues. According to one study of land fees conducted in 2004, Guangdong, Shandong, Hunan, and Jiangsu provinces generated

[10] According to Dr. Molnar, in practice, even some surtaxes, such as the rural education surcharge, are still collected by local governments and treated as extra-budgetary funds, despite their formal abolition by the central government.
[11] OECD 2006:19.

the most off-budget funds from land transfers.[12] Nationwide, these funds were estimated at 615 billion yuan in 2004, equivalent to roughly three to four percent of GDP. Moreover, because these funds lack MOF oversight, they easily shade into corruption; real estate developers, for example, may provide kickbacks to local government officials who make available land at low prices, shortchanging the farmers who lose access to the land in the process. These funds also support legitimate government expenditures, however. According to Professor Li Bo, the funds derived from land transfer fees in Hubei Province, for example, are "almost without exception" dedicated to basic infrastructure development. Other scholars confirm that compared with budgetary funds, off-budget funds tend to have positive effects on spending for infrastructure and administration but negative or neutral effects on education, agriculture, and other public goods.[13]

Local government debt

Another major concern of conference participants, both from the perspective of existing problems and from the perspective of policy recommendations, is local government indebtedness. As several participants, such as Professors Chen Gong and An Tifu, commented, the Budget Law forbids local government to take on debt without the express permission of the State Council, yet another way that local governments cope with revenue inadequacy is to engage in illicit borrowing. Such debt is effectively hidden, but, as Professor Chen Gong suggests, estimates of government debt at the county, township, and village levels range from 363 billion yuan to 1 trillion yuan, equivalent to 3.5 to 9.3 percent of GDP. Local governments take on debt to cover both current and capital expenditures. Debts take a range of forms, including wage arrears and illicit borrowing from financial institutions. In 2002, Minister of Finance Xiang Huaicheng openly acknowledged the problem of wage arrears for teachers and civil servants.[14]

Local governments employ various mechanisms to engage in illicit borrowing from financial institutions, according to Professor Li Qiyun. One such mechanism entails using local enterprises as "windows" to the banking system, providing loan guarantees so that enterprises can get bank loans, the funds from which are then transferred to the local governments. Professor Christine Wong noted that local governments effectively soften their budget constraints through uncontrolled off-budget revenue and illicit borrowing.

[12] Ping 2006a.
[13] Ping 2006b.
[14] Xiang as cited in Wong 2005b:21 and OECD 2006:34.

Participants discussed alternative models that provide greater tax autonomy to sub-national governments. Dr. Margit Molnar drew on the experience of OECD countries to illustrate mechanisms for local governments in China to have some tax autonomy and employ debt in a manageable way. She discussed the pros and cons of various local taxes, such as property taxes (which are stable and immobile, although there can be valuation problems); business taxes (which are not too volatile, are difficult to evade, and are of the benefit type but which may place a burden on start-ups); and personal income taxes (which can be inefficient as local taxes). Mr. Liu Shangxi offered the view that the problem is not about the power to levy taxes at the sub-national level but rather the basic problem of inadequate resources. Dr. Scheppach noted that in contrast to China, states are sovereign in the United States. Local governments are subject to state authority and the state may grant local governments the right to tax or to seek a loan.

Dr. Molnar also examined the issue of local government debt. She suggested that only well-off local governments be allowed to issue debt. Although this policy might exacerbate inequality, it could also free up central resources. The purpose for such debt should be limited to funding new capital investments. Such sub-central debt would have to be highly regulated, including sound financial reporting with the elimination of incentives for inaccurate reporting, limits on debt service ratio, as well as limits on kinds of collateral. Mr. Weiss noted that bond underwriters look at a local government's ability to raise taxes to pay for debt, and Dr. Molnar noted that in some places rating agencies play a role in determining local governments' ability to issue debt.

Intergovernmental Fiscal Transfers and Implications for Regional Inequality

The fiscal system to date largely has failed to address significant and growing regional inequality. Dr. Zhang Zhihua noted that the central and western regions, respectively, enjoyed only 55 and 75 percent of the fiscal capacity of the eastern region in 1994, but those figures declined to 43 and 48 percent by the year 2000. Such disparities reflect not only the impact of disproportionate growth in the coastal region but also the effect of the tax sharing system. Since the end of the last decade, however, equalization policies have become a higher priority for government policy makers. Resources dedicated to equalization have increased, as many conference participants emphasized. Nevertheless, Professor Wang Yongjun provided data for 2005 indicating per capita budgetary expenditures of 8,008 yuan in Shanghai and 908 in Henan, giving a highly unequal ratio of 8.8:1 for the richest and poorest provinces.

Transfer dependence and inequality

Changes in the system of intergovernmental fiscal transfers have slowed the trend toward greater disequalization but have not reversed it. Intergovernmental fiscal transfers are multi-stranded, and only some of these strands are effectively equalizing, as many other participants noted. Dr. Zhang Zhihua provided an overview of the trends in intergovernmental fiscal transfers, including tax rebates, earmarked transfers, special transfer funds, and general purpose transfers. The largest element in central government transfers are tax rebates. The main tax rebate ( ), pegged to the growth of VAT and consumption taxes, was negotiated between the center and the provinces in 1993. It was intended to safeguard the immediate interests of powerful localities by preventing any severe decline in revenue after the tax sharing system was implemented. Therefore, Professor Sun Kai suggested, it accrues to the benefit of the wealthier provinces. However, the rebate reflects a shrinking portion of total transfers; it accounted for about three-quarters of central transfers during the mid-1990s, less than half in 2002, and roughly one third—or about 375 billion yuan—in 2005. This trend leaves room in the central government budget for more equalizing transfers.

Dr. Zhang pointed out that another large element of intergovernmental fiscal transfers is in the category of earmarked transfers, which totaled about 350 billion yuan in 2005. This category is increasingly broad, reflecting many different government policy initiatives and encompassing development funds for major infrastructure projects, agriculture, and underdeveloped areas. Beginning in 1999, with the implementation of the Western Regional Development Initiative, these funds have been targeted increasingly toward projects in the poorer western and inland regions of the country. A potentially disequalizing element in these transfers is the requirement for matching funds from local governments in order to access many of these grants. Moreover, as Mr. Li Jieyun and Professor Sun Kai both highlighted, these funds are subject to lax central government oversight. For example, grants allocated for defined periods continue well beyond the intended time frame. Professor Christine Wong suggested that part of the reason for poor management is inadequate staffing at the ministry level, where a small number of personnel bear responsibility for the evaluation of submitted requests as well as the oversight of the entire program.

A wide array of other special transfer funds is also intended to meet specific purposes. For example, the Ministry of Finance separately reports an earmarked transfer for minority areas, which has risen from 2.5 billion yuan in 2000 to 16 billion yuan in 2005, channeling more funds into potentially equalizing uses.

Some conference participants pointed out that many special transfer funds reflect central government attempts to compensate local governments for the adverse effects of reforms. A wage adjustment subsidy was introduced in 1998 to offset the cost of centrally mandated wage increases for public employees, which has resulted in the doubling of civil servant salaries. According to Dr. Zhang, wage adjustment subsidies reached nearly 100 billion yuan in 2004 and remained at that level in 2005. Social security subsidies include bailouts for local social security schemes as well as subsidies to support payments to laid-off or unemployed workers, which reached and exceeded 50 billion yuan in 2001 and 2002, respectively. "Both the wage increase subsidies and subsidies to social security and welfare programs are transfers aimed at bailing out local governments: meeting payroll, and keeping social security and unemployment schemes from defaulting."[15] This kind of ad hoc public financing has certain attendant weaknesses; many participants noted the problem of over-staffing in particular. "Rudimentary budgeting practices that allocate subsidies on a per-staff basis continue to encourage adding staff despite national campaigns calling for downsizing the civil service."[16]

With rural tax and fee reform, another special transfer was established to increase the resources of local governments adversely affected by the reforms. This special transfer, which provides funds for the payment of primary and middle school teachers' salaries, has increased rapidly from 8 billion yuan in 2001 to 66 billion yuan in 2005. In 2005, it was supplemented by a special program to aid counties and townships in difficulty. This program operates on the basis of "awards" or "bonuses," allocating 15 billion yuan in 2005 to counties and townships meeting certain criteria—namely increasing tax revenues, reducing government staff, increasing grain production, and running a clean government. As Dr. Zhang noted, these special transfers went primarily to the central and western regions, with only about ten percent going to the eastern region.

Dr. Zhang also pointed out that general purpose transfers, intended to be equalizing, totaled more than 110 billion yuan in 2005. Close to half of these transfers went to the western region, half went to the central region, and only a small percentage went to the eastern region. An important element in the rule-based calculation of this transfer is the number of civil servants on the official government payroll, which introduces a bias away from population-based measures of need for public services, and reinforces incentives to add to already-high government staffing levels, as both

[15] Wong 2005a:15
[16] Ibid.

Mr. Li Jieyun and Professor Christine Wong emphasized. The impact of the general purpose transfer is limited by their small size compared to rebates and earmarked transfers.

Professor Wong acknowledged the efforts to equalize through intergovernmental fiscal transfers such as the rural fee transfer and the wage adjustment transfer, but she noted that new programs like the cooperative medical scheme and minimum living standards had also been put in place and concluded that, looking at per capita own revenue plus per capita transfers, there was no clear pattern of fiscal equalization. Participants differed in their interpretations of the impact of the tax rebate. Dr. Molnar found that the tax rebate is redistributive because only 30 percent goes back to the province of origin; so, she argued, rich provinces send a significant amount of revenue to the center for potential redistribution. By contrast, Professor An Tifu, similar to Professors Sun Kai and Christine Wong, argued that the size of the tax rebate is an obstacle to achieving equalization. Professor Wang Chuanlun stressed the importance of stability in the fiscal system and suggested that only marginal adjustments be made in fiscal transfers.

Dr. Scheppach introduced some aspects of intergovernmental budgetary arrangements in the United States. He emphasized that there is no explicit federal policy to redistribute income across states; nor is there a federal policy to stimulate growth in low-income states. Rather, there are a number of federally funded programs, administered by states but targeted at low-income individuals, that have some redistributive effect; these include 8-10 spending "entitlement" programs, the largest of which are for health (Medicaid), welfare (food stamps) and education. Since individual recipients tend to be concentrated in low-income states, there is some *de facto* redistribution. In addition, there is some progressivity in the federal income tax paid by individuals, which contributes to the *de facto* redistribution from wealthy to poor states. Dr. Scheppach highlighted certain strengths of the system, including its significance for the mobility of workers, its ability to accommodate local experimentation and innovation, and its relatively clear division of responsibilities. He also noted certain weaknesses, including duplication of programs such as Medicaid and Medicare, the excessively large number of categorical grant programs—many of which lack explicit performance measures, and the existence of unfunded federal mandates such as the requirement of a new single format for state driver's licenses.

Discussion of the U.S. system focused on the role of the individual income tax. Professor Liu Yi noted some of what she characterized as the cultural and institutional differences between the U.S. and Chinese systems. In particular, she noted that individual incomes are not very effectively monitored in China and that the VAT-tax is the key revenue-earning tax, in contrast to American reliance on the individual income tax. Professor Wang Chuanlun discussed the relations between federal and local governments, noting that in the United States, increased taxes empowered the federal government to take on more responsibilities; he also noted recent debates over whether the federal government has amassed too much taxation power.

Mr. Carter introduced local government funding in the United Kingdom as an example of a centralized, unitary state in which the majority of local government spending is financed through grants from the central government. He highlighted the high degree of equalization in the fiscal system, particularly in education. Mr. Carter noted that local authorities rely on one source of local tax revenue—a property tax (the council tax). The advantages of such a tax lie in the immobility of the asset (contributing to a 99 percent collection rate) and the stability. The disadvantage is the burden of a tax unrelated to income on taxpayers with fixed incomes.

Participants reflected differing views on centralization vs. decentralization. Trade-offs exist between the cost of local revenue collection and the cost of managing large-scale transfers. Professor Christine Wong suggested that such a high degree of reliance on transfers entails significant administrative inefficiencies. Also debated were the effects of centralization on incentives for revenue mobilization and whether tax competition might result in the underprovision of public goods. While Mr. Carter and Professor Chen Suihong expressed concern about the risks of excessive tax competition, Dr. Scheppach noted that while states may compete with each other on taxes, they also compete on providing support for better research and development, better universities, better health care, and better basic education. Local governments with the lowest taxes may not be the fastest growing.

Political Factors Exacerbating Problems in Central-Local Fiscal Relations

Professor Wang Yongjun posed the question of why China's fiscal decentralization in the context of a unitary state has not improved the performance and efficiency of public service provision, as predicted by the theory of fiscal federalism. He found the answer, in part, in political factors that exacerbate problems in central-local fiscal relations. He suggested that the preconditions for effective decentralization—accountability, responsiveness, and capacity—are missing. Several features of the current political system contribute to the tensions and challenges in central-local fiscal relations discussed above.

As several participants pointed out, top party and government officials at each level of the state hierarchy (e.g., CCP party secretaries, mayors, county executives) are not accountable to the citizens whom they govern but rather to the party-state apparatus at the next higher level, which bears the responsibility for both appointing them and evaluating their job performance. The performance of leading cadres is monitored and evaluated on the basis of performance criteria reflecting the priorities and concerns of political elites and not necessarily those of the community members. According to Professor Wu Hao, performance targets often include GDP growth, employment levels, fiscal revenue, exports, and utilization of foreign direct investment. As both Professors Wu Hao and Wang Yongjun noted, these features of the political system lead to counterproductive behaviors such as privileging investment over service provision and channeling government investment into wasteful, high-profile projects selected for their short-term impact. Moreover, this system exacerbates pressure to go off-budget or incur debt to meet performance targets when budgetary revenues are inadequate. Participants also highlighted the lack of accountability to the local people's congress, which they characterized as having form without substance.

RECOMMENDATIONS

Scholars and policy analysts at the conference suggested a range of policy recommendations intended to address the challenges and tensions highlighted in the preceding discussion.

Improving revenue and expenditure assignments

The centralization of control over revenue coupled with highly decentralized expenditure responsibilities have left many local governments, particularly at the county and township levels, in dire financial straits. One means of addressing this tension, as Professor Christine Wong indicated, is shifting the locus of expenditure responsibility for pensions, welfare, and unemployment to the center or to the central and provincial levels combined. Some participants suggested that basic education should be funded at the provincial level. Many participants emphasized that new legislation should make explicit what level of government bears responsibility for what functions. As Professor Wang Yongjun noted, unclear and overlapping expenditure responsibilities allow higher level governments to shift the burden of revenue inadequacy through unfunded or underfunded mandates onto lower levels, creating incentives for off-budget financing and local debt.

Many participants recommended strengthening guidelines that govern sub-provincial revenue and expenditure assignments. Dr. Molnar spoke to the subsidiarity principle of assigning revenue and expenditure responsibilities to the lowest level involved where externalities can be identified and accountability can be maintained. She suggested that funds would be used more efficiently if the level of revenue raising and expenditure responsibility are matched, allowing recognition of the marginal social cost of raising revenue. In addition, Dr. Scheppach highlighted the importance of projecting forward and accounting for changing technologies of tax collection—as with personal income tax.

Local autonomy and accountability

Local governments would benefit from greater revenue autonomy through the constitutional authority to legislate local taxes, as noted by Professors Tang Gongliang and An Tifu. Implementing such tax authority can take different forms: Dr. Molnar commented that sub-national governments in many countries have discretionary authority over tax rates, even if tax bases are determined at the center. Participants suggested new taxes, such as property or retail sales taxes, could appropriately be assigned to local levels. Greater *de jure* local tax-setting autonomy may further contribute to stemming the tide of off-budget funds, since local governments may substitute *de facto* autonomy over off-budget funds for the missing *de jure* autonomy over taxes.

Professor Christine Wong suggested that local governments could also gain more decision making autonomy through a move away from extreme reliance on earmarked transfers, which are difficult for the center to manage, to greater use of general transfers.

Many scholars, including Professors Wang Yongjun, Wang Zecai, Wu Hao and Li Bo, cautioned that such authority must be accompanied by greater accountability for local officials to the communities they serve. They indicated that improving the accountability of local governments in conjunction with increasing their tax autonomy would require extending experiments in electing township leaders to the county level, removing effective restrictions on the nomination process for local people's congress deputies, and providing local congresses with real constitutional authority to approve local budgets.

Unifying the budget

Continuing to bring off-budget funds into budgetary oversight will not only improve the allocation and management of revenues and expenditures, but also contribute to controlling corruption. Professors Chen Gong and An Tifu highlighted the need to bring land transfer fees in particular into the budgetary system, with local government control and central government oversight. Professor Chen called on the central government to pass new legislation to regulate and supervise their use. Professors Christine Wong and Cai Hongying highlighted the need for a more specific and enforceable budget law.

Formalizing and regulating local government debt

Professors Chen Gong and An Tifu advocated revising the budget law to allow for debt financing on the part of local governments. Dr. Molnar called for appropriate debt financing for wealthier local governments—not for existing debt or current expenditures, but exclusively for capital investments. She cautioned that such debt financing must be accompanied by sounder financial reporting, including of contingent liabilities of local governments such as loan guarantees and non-performing loans of local financial institutions. She also highlighted the need to eliminate incentives for inaccurate reporting.

Dr. Scheppach suggested that moving toward a privatized banking system would reduce the problem of inappropriate, hidden local government debt because it would ultimately eliminate the incentive for banks to make such loans.

Streamlining government

While controversial, some conference participants advocated moving from five levels to three levels of government (the center, the province and the county), which would involve reforming the current system of cities supervising counties and eliminating the township level.

Improving intergovernmental fiscal transfers

Further reforms are needed to move away from the disequalizing elements of intergovernmental fiscal transfers. Moreover, abandoning formulas for calculating fiscal transfers on a per-staff basis rather than on a per capita basis would contribute to correcting the problem of government overstaffing at the local level. Finally, increasing the skeletal staff at the ministry level responsible for administering earmarked transfers would facilitate planning and oversight.

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[1] Oksenberg and Tong 1991

[2] Wong 1991

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[4] Wong 2005a: 13

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[7] Wong 2005b:25

[8] 2006

[9] Wong 2005a: 11

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[11] OECD 2006: 19

[12] 2006a

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[13] 2006b

[14] Wong 2005b:21 OECD 2006:34

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[15] Wong 2005a

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