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## Issues in Intergovernmental Fiscal Relations in China

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**Abstract**

**This Working Paper should not be reported as representing the views of the IMF.**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

The paper reviews the changing nature of intergovernmental fiscal relations between the provinces and the central government in China over the past two decades and provides an assessment of the success of previous reforms in meeting their objectives. Key existing weaknesses in the current system that undermine these objectives are identified. Alternative instruments, procedures, rules, and incentives that could result in better outcomes are outlined by drawing upon relevant cross-country experiences.

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## **I. INTRODUCTION**

Since the 1980s, the system of intergovernmental fiscal relations (IFR) in China has evolved against the backdrop of significant economic restructuring. In recent years, important progress has been made with respect to tax policy, tax administration, and public expenditure management. The establishment of a separate state tax administration and the introduction of the Budget Law in 1994 were important steps towards modernizing China's tax administration and expenditure management systems.

Reforms in IFR, however, have been gradualist and incremental in scope, and the design and implementation of the system of IFR have not kept pace with the challenges posed by the process of transition to a market economy. Moreover, reforms to date have generally responded to only the most immediate problems, with ad hoc short-term fixes. The fixes themselves may give rise to further distortions in the system and require fiscal adjustments that are often not made. More importantly, the current piecemeal approach fails to capture the interrelationships and dependencies that exist among various elements of IFR – expenditure and revenue assignments, intergovernmental transfers, and subnational borrowing and debt – and to establish a transparent, rules-based system that instills sound incentives. There is a growing concern that the current system is unable to effectively perform the key functions of allocating resources in line with national goals, redressing regional disparities, and strengthening macroeconomic management.

This paper analyzes current challenges in the system of IFR in China. It begins with a review of developments in IFR over the past two decades and an assessment of the success of previous reforms in meeting their objectives. The paper then identifies key existing weaknesses in the system that undermine the above-mentioned objectives and analyzes why reforms in these areas have proven to be so difficult. Finally, it discusses how alternative instruments, procedures, rules, and incentives could result in better outcomes by drawing upon relevant cross-country experiences.

## **II. BACKGROUND**

### **A. Pre-1994 Intergovernmental Finance System**

Fiscal relations between the center and subnational governments since the 1980s have evolved in two distinct stages, decentralization in the early years followed by recentralization since the mid-1990s. In the pre-reform period, revenue collection was highly centralized with local governments remitting most of tax revenues to the center and receiving transfers for expenditures from the national budget.<sup>2</sup> The 1980s reforms decentralized the revenue sharing system and granted local governments greater autonomy in investment approval, entry regulation, and resource allocation (Oi, 1995). This was reflected in the remarkable growth of township and village enterprises (TVEs), which not

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<sup>2</sup> The term local government refers to the four administrative layers below the central government (province, prefecture/municipality, county/city, and township/district).

only contributed to local economic development, but played a crucial role in providing local public goods (Qian, 2002).<sup>3</sup>

The introduction of the fiscal contracting system, known as “eating from separate kitchens”, was further intended to provide incentives for local governments to collect revenue, pursue economic prosperity, and help foster rapid growth. Several commentators have argued that the devolution of regulatory authority from central to local governments along with high marginal revenue retention rates at the provincial levels aligned interests of local governments and businesses and were instrumental in promoting local economic development (Qian and Weingast, 1996 and Qian and Roland, 1999). Others have noted that such incentives only really worked in a handful of coastal provinces because these also benefited from foreign direct investment (FDI) flows, tradition of entrepreneurship, and soft financial budget constraints on enterprises (Young, 2000; Tsai, 2004). However, empirical evidence on the relationship between decentralization and economic growth over this period is mixed (see Zhang and Zou, 1998; Lin and Liu, 2000; and Jin, Qian and Weingast, 2003).

Although incentives to spur tax collections were successful to a certain extent, the share of total revenue transferred to the central government fell from 39 percent to 22 percent in 1993, a percentage that is much lower than the average for developing and industrial countries more generally (see Table 1). Moreover, overall revenue collections declined sharply despite high growth rates, falling from a high of 31 percent of GDP in 1978 to 11.2 percent in 1994 (Ahmad and others, 2002). Declining central share of revenues and persistent budget deficits constrained the central government’s ability to conduct macroeconomic management and exacerbated regional fiscal disparities. The expenditure share of the subnational governments increased from about 49 percent in 1979 to over 67 percent in 1990, a share that is much higher than in most federations (see Table 1), with the center devolving expenditure responsibilities for most social services to local governments.

Sizable horizontal imbalances emerged across provinces, with affluent provinces benefiting disproportionately from the negotiated fiscal contract system. For instance, Raiser (1998) finds that per capita income convergence across Chinese provinces declined since 1985 as the system of tax sharing and intergovernmental transfers disproportionately benefited the wealthier coastal provinces. Net remittances from wealthier provinces declined sharply – with Shanghai in 1993 turning over only about 8.5 percent of its GDP, and Guangdong only 0.4 percent of its GDP – over this period with a resultant decline in subsidies to poor regions (Wang and Hu, 1999). West and Wong (1995) note that inequities in the spread of resources across regions translated into growing disparities in service delivery, particularly in rural areas.

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<sup>3</sup> By 1993, the share of TVEs in national industrial output had jumped to 36 percent from 9 percent in 1978 (Chen and Qian, 1998). The central government stipulated that TVE after-tax profits be essentially used for reinvestment and provision of local public goods, such as maintaining order, building roads, providing water and irrigation systems, and implementing family planning. In 1985, half of the after-tax profits of TVEs were reinvested and the half were used for local public expenditure (Qian, 2000).

Table 1: China's Decentralization in an International Context

Countries	Share of Subnational Governments (in percent of total)			
	Revenues		Expenditures	
	1990	1997	1990	1997
Argentina	38.2	41.1	46.3	43.9
Australia	20.0	22.7	50.9	47.9
China 1/	33.8	48.8	67.4	72.6
Germany	28.9	28.8	40.2	37.8
India	33.0	36.1	51.1	53.3
Indonesia	2.9	2.9	13.1	14.8
Mexico	19.0	20.6	17.8	26.1
Russian Federation	...	40.6	...	37.6
South Africa	5.5	5.3	20.7	49.8
United States	33.8.	32.9	42.0	46.4

Source: *World Development*, 2000.

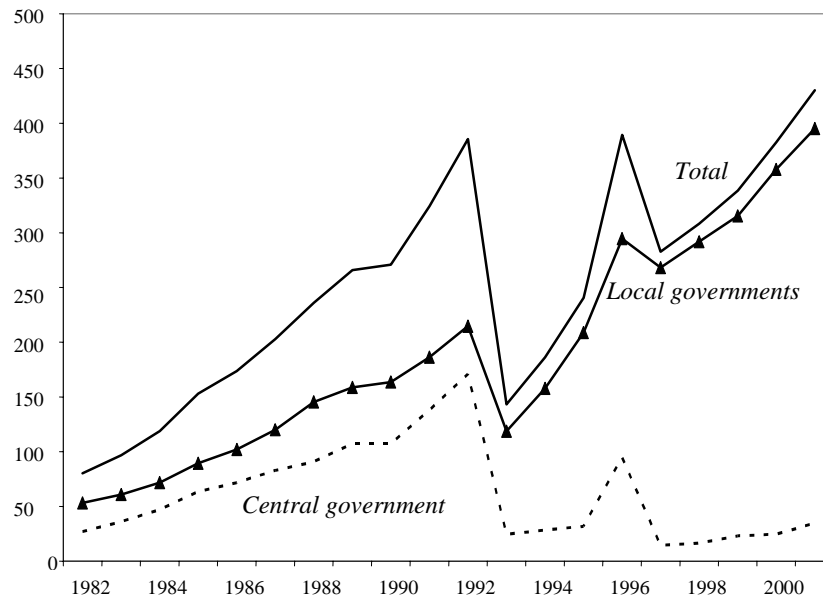
1/ For China from Ahmad and others, 2002.

While the decline in revenues was closely related to declining state-owned enterprise (SOE) profits, and the decision to let SOEs retain a portion of their profits to finance their investment, there were serious disincentives implicit in the fiscal contracting system.<sup>4</sup> Effective local control of tax administration and a non-transparent, largely negotiated, tax and transfer contract system, which encouraged bilateral bargaining with the center for the share of revenues that could be retained, undermined revenue collections. The dramatic increase in expenditure requirements of local governments – their share rose from 45 percent in 1981 to 72 percent in 1993 – increased fiscal pressures at local levels and encouraged the proliferation of extra-budgetary funds (EBFs) (see Figure 1) and self-raised funds that were not shared with the center at the expense of budget revenues (Ma and Norregaard, 1998).<sup>5</sup>

<sup>4</sup> Prior to the reforms, the SOE sector generated much of the revenues of the state budget. Since the early 1980, there was structural shift in revenue bases resulting from a decline in the SOE sector as a source of budgetary revenues.

<sup>5</sup> At the provincial and county levels, EBFs, which were technically legal, consisted of retained earnings and depreciation of local SOEs, as well as user fees and public utility charges levied by agencies involved in the administration of SOEs. In 1993, the central government redefined EBFs by excluding revenue from SOEs. Self-raised funds refers to (continued...)

**Figure 1: Extrabudgetary Funds  
(In billions of Yuan)**



Source: *China Finance Yearbook* (2002).

Jin and Zou (2003) provide further evidence to suggest that growing quasi-fiscal deficits, expenditure overruns and indirect borrowing undermined fiscal management and provided a soft budget constraint for subnational governments.

## **B. 1994 Tax Reforms and After**

Against this backdrop, the 1994 tax reform introduced a major overhaul of the tax and transfer system and tax administration. The over-arching objective of the reform was to strengthen macroeconomic performance, achieve regional equalization and efficient public goods provision. Specifically, it attempted to arrest the fiscal decline (raise the two revenue ratios), simplify the tax system, eliminate distortions, modify revenue assignments to different levels of government, and shift from ad hoc, negotiated transfers to transparent rule-based revenue assignments. Important measures introduced in 1994 included (i) reforms in the tax system including the introduction of production-based value-added tax (VAT); (ii) reassignment of taxes between central and local governments to have separate “central fixed incomes,” “local fixed incomes,” and shared revenue from the VAT; (iii) the

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fees collected by township and village governments without the approval of higher level governments. They include fees for specific public goods, profits from TVEs, contributions from local entrepreneurs, and assorted surcharges and fees (Bahl, 1999).

establishment of a separate state tax administration to collect central and shared taxes; and (iv) the establishment of general purpose equalization transfers.<sup>6</sup>

The re-assignment of taxes and establishment of national tax service to administer the new central and shared tax system succeeded in achieving the objective of raising the two revenue ratios. Total revenue collections increased to over 18 percent of GDP in 2002, and the central government share of total budget revenue rose from a low of 22 percent in 1993 to around 50 percent in 2002. The re-assignment of revenues from enterprise profit tax (EIT) and personal income tax (PIT) to the center in 2002 is further expected to increase the central share of revenues.

The re-centralization of revenues was accompanied with increases in central transfers as a share of GDP, which rose from 1.5 percent in 1993 to about 6 percent in 2001 (Ahmad and others, 2004b). The transfer system was based on four main pillars. *Revenue returned* transfers, which provided each province with 30 percent of the increase in VAT receipts over the 1993 base (prior to the reform) and *fixed subsidies*, which ensured that every province has total revenues no lower than subsidies in 1993, were introduced to guarantee provinces the pre-reform level of transfers. *General purpose* transfers, including for equalization purposes, were also put in place to improve the equity of the old system. Finally, *specific purpose* (earmarked) grants, which are allocated on an ad hoc negotiated basis, represented a growing share of transfers (see Figure 2).

In recent years several reforms in the fiscal arena have had important implications for IFR in China. The rural fee reform, which was first implemented on a pilot basis and instituted nationwide in 2002, aimed at reducing the overall burden of taxes and fees in rural areas and improving the transparency of local budgets.<sup>7</sup> Prior to the reform, Lin and others. (2002) note that the high excess burden of arbitrary rural taxation and heavy burden of central mandates, including grain procurement, birth control, and nine-year compulsory education, imposed significant fiscal distress on local counties and townships.

Since the 1990s, a series of reforms were introduced to improve expenditure management (introduction of organizational budgets to all central government departments, promulgation

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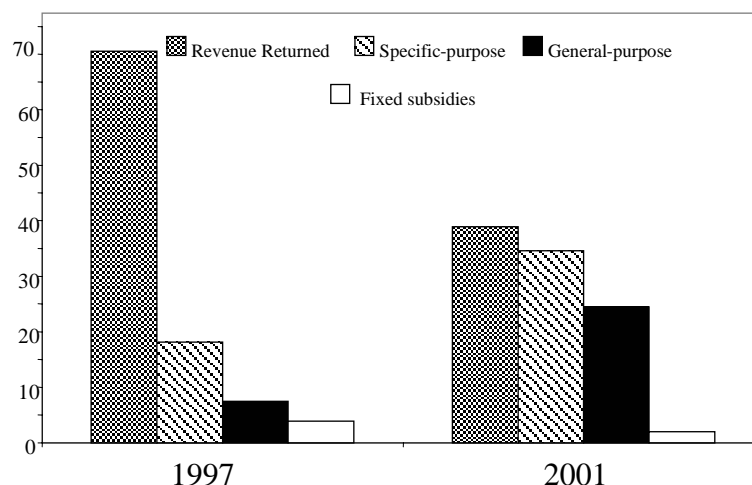
<sup>6</sup> Revenue assigned to local governments included 25 percent of the new VAT, a turnover-type business tax, the personal income tax (PIT), and the enterprise income tax levied on local SOEs and foreign-financed enterprises. The central government received 75 percent of the VAT, excise and trade taxes, and the EIT from centrally owned SOEs. See Bahl (1999), Ahmad and others (2002, 2004a) for a detailed discussion of the 1994 Tax Reform.

<sup>7</sup> In exchange for eliminating rural fees and charges, the agricultural tax rate was raised from an average of 2 percent to 7 percent, with increased revenues earmarked for township governments, and a surcharge of 20 percent earmarked for village associations. There is some evidence to suggest that the tax burden has declined in areas where reform was piloted. Lin and others (2002) note that it fell by 31 percent per capita on average in Anhui province, 30 percent in Jiangsu and 25 percent in others.



**Figure 2: Transfers from Central to Local Governments**

(Percent of Total Transfers)



Source: Ahmad and others 2004a

of new Law on Government Procurement, etc.). Since 1999, a major program of budget reforms has also been underway and attempts made to control off-budget and extrabudgetary funds and consolidate them into budget process, particularly at the central level. These reforms will be crucial in moving China toward a modern budget management system and a well-functioning public sector.

### III. KEY WEAKNESSES IN CURRENT SYSTEM

Recent reforms in the fiscal arena have streamlined the tax system, improved its buoyancy, strengthened tax administration, and public expenditure management. However, many challenges remain. This section identifies key weaknesses in four dimensions of IFR in China – expenditure assignments, revenue assignments, intergovernmental transfers, and fiscal management – many of which have persisted over the last two decades despite various reforms. These weaknesses, in turn, pose challenges for the equity and effectiveness of service delivery and for the transparency and accountability of the fiscal system as a whole.

#### A. Expenditure Assignments

The recentralization of tax revenues in 1994 was not accompanied by revisions to expenditure responsibilities, which remained as under the centrally planned system, with local governments acting as agents of central government. As a result, the pattern of expenditure assignments in China continues to suffer from several problems. First, there is no formal, legal assignment of expenditure responsibilities at the subprovincial level. This has resulted in a high incidence of concurrent expenditure assignments and created the potential for higher-level governments to shift or dump financing responsibilities downwards (Bahl and Martinez-Vazquez, 2003).

Local governments, particularly at the subprovincial level, are assigned heavy responsibilities for the provision of education and health services, unemployment insurance,

and social security. In 2002, the share of local governments in total budget revenue was about 45 percent, but they accounted for 70 percent of total budget expenditures, a share that has remained relatively stable during the last decade. By contrast, in most large federations, subnational expenditures average 50 percent or less of total expenditures in the 1990s (see Table 1). By this comparison, China ranks as one of most decentralized countries in the world.

Local governments account for over 90 percent of total spending in culture, education and health, and for virtually all the social relief and welfare expenditure, including pension payments which are decentralized all the way up to the county level. Many of these are designed with co-financing requirements or have minimum service standards set by the center and are unsustainable for many poor regions in light of current revenue assignments and inadequate system of equalization transfers (see below). For example, the ratio of provincial governments' expenditures to their own revenue has surged from about 103 percent in 1991 to around 180 percent in 2002 (IMF, 2004). The decentralization of expenditures over the reform period can be attributed to a number of factors. The divestiture of social responsibilities of SOEs – particularly in the areas of health and education – to local governments, increases in administrative expenses and wages (largely due to the rapid increase in the number of civil servant at the local level – see World Bank, 2002, as well as rapid urbanization which created a need for local governments to provide basic infrastructure services, are some of the reasons for the proliferation of subnational expenditure mandates.

In other countries, social security is almost exclusively provided by the central government and responsibilities for basic education, public health and social safety nets are shared to ensure some minimum provision levels across localities. While subnational governments can have a comparative advantage in implementing many social assistance programs because of their proximity to and knowledge of the groups in need, the rationale for leaving regulatory and financing responsibilities at the central level is stronger when the programs are intended to offer standardized benefits or services throughout the national territory. In China, there is growing evidence of significant disparities in the provision of social assistance between richer and poorer regions, with poorer regions failing to pay benefits for social assistance or entering into substantial payments arrears (see below).<sup>8</sup>

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<sup>8</sup> Arrears have buildup in key social sectors such as pensions, and rural health and education services. Arrears have also been reported by local governments for servicing of on-lending loans, including for sovereign issues that must be assumed by the center. For instance, subsidies for civil service wage increases rose from RMB 89.2 billion on 2001 to RMB 175.5 billion in 2002, while subsidies to local social security schemes increased from RMB 34.9 billion in 2000 to RMB 51.2 billion in 2002 (World Bank, 2003).

## B. Revenue Assignments

Despite improvements in revenue sharing arrangements instituted in the 1994 reforms, there are marked differences in revenue generating capacity across provinces and within provinces at the local level. These differences largely stem from the structure of taxation and the failure of the 1994 reforms to put in place a well-defined assignment for subprovincial governments.

Provincial governments diverge significantly with respect to their revenue raising capabilities. Revenue-sharing for the VAT and the EIT (which along with the business tax account for about 70 percent of total provincial government revenue) on a derivation basis has further increased the disparities in revenue distribution in favor of the richest provinces (see Table 2). The bases for these taxes typically cover the manufacturing and services sectors; hence, coastal regions – where the share of GDP of these sectors is the highest – benefit more from the current fiscal system more than central and western provinces, whose economic structure relies more heavily on agriculture (IMF, 2004). A similar pattern applies to the personal income tax. In 2002, the ratio between the highest and lowest per capita budgetary revenue collections was 15.9 – with coastal regions and large cities far outstripping others.

Table 2: Differences in Revenue Performance Across Regions

	Ratio of Budgetary Revenue to Regional GDP		Income Per Capita (In RMB)
	1995	2002	2002
Selected top provinces			
Shanghai	15.1	23.4	33,285
Beijing	16.9	22.4	22,577
Selected bottom provinces			
Tibet	5.3	6.1	7,760
Guanxi	8.91	11.4	5,092
National average 1/	10.2	11.8	9,255

Source: *China Finance Yearbook*, 2003.

1/ For revenues, denotes simple average across provinces.

The 1994 tax reform did not provide a specific revenue assignment structure at the subprovincial level. Instead, different arrangements have emerged for sharing of local taxes and tax rebates among subprovincial governments. The “ownership” principle, that is, the level of government which owns the enterprise paying the tax is entitled to those taxes, is a dominant criterion used for tax assignments and revenue sharing within each province. Taxes shared between prefecture/cities and counties include a variety of taxes on property such as farmland occupation tax, land appreciation tax, and housing property tax, vehicle taxes, and other taxes that can be considered “nuisance” taxes, since they raise little revenues but often have high administrative and compliance costs associated with them (World Bank, 2002).

The rural fee reform has sought to rationalize the system of subprovincial taxation. However, by not explicitly examining the implied changes in expenditure assignments and transfers of the “fee-tax swap”, it failed to systematically address the implications for the quality of service provision or sustainability of local budgets. The loss of revenues from informal charges has been compensated by ad hoc special purpose grants, without granting any sufficiently large and flexible revenue source to local legislatures. The recent decision to rescind the agricultural tax has additional implications for local fiscal sustainability, making the case for reform of tax assignment at the subprovincial level all the more urgent.

### **C. Intergovernmental Transfers**

One area of growing concern is the increase in regional disparities and the ability of local governments to deliver a minimum standard of public services. The current systems of intergovernmental transfers, in spite of the large volume of flows – central government transfers financed 48 percent of local expenditures and over 43 of subnational revenues in 2002 – does not sufficiently redistribute resources.<sup>9</sup>

As discussed in the previous section, specific purpose grants, which are allocated on an ad hoc and discretionary basis, represent a growing share of transfers (see Figure 2). The importance of these types of transfers not only reflects the proactive stance of regional policy carried out by the center, but is also a reflection of unsustainable expenditure assignments, and was mandated by the emergence in recent years of pension and other arrears, bail outs for local government social protection programs, and fiscal stimulus packages. The ad hoc and discretionary nature of specific purpose grants make the transfer system less transparent and more difficult to monitor, as the center lacks the ability to track how the related funds are spend; they also undermine the rules-based character of the transfer system that the 1994 reform aimed to introduce. Moreover, since they are often disbursed in the form of matching grants, which favors rich regions, it is unclear whether they have been equalizing in the aggregate.

In recent years, there have been attempts to convert some earmarked grants into equalization grants. For example, in 2001 around RMB 4 billion of subsidies for food in urban areas were transferred into the transitory equalization grants. The same was done with earmarked transfers for the development of border regions (Zhang and Martinez-Vazquez, 2003). However, the small size of the equalization fund, averaging around 1 percent of GDP in 1997–2001, and the continued importance of revenue-retained transfers which favor the richest coastal provinces and large cities, also impairs the system’s ability to reduce horizontal fiscal disparities across regions.

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<sup>9</sup> This compares with an average of 24 percent of subnational revenues for transition economies in Eastern Europe and the Former Soviet Union, 81 percent in South Africa, and 75-95 percent of subnational revenues in Indonesia, Nigeria, and Mexico (Shah, 2003).

The failure of the current system to bring about significant equalization and achieve greater economic balance lies in the political economy of intergovernmental relations and the emergence of an asymmetric system since the 1980s. The pre-1994 fiscal reforms were associated with ad hoc bilateral arrangements between the center and provinces, with wealthier regions (coastal provinces and large cities) obtaining preferential revenue sharing arrangements.<sup>10</sup> An important objective of 1994 reform was to move towards a more uniform and transparent rules-based system. However, Wang (1997) notes that this objective was not met as the political bargain struck to secure approval of tax reforms, particularly from the richest provinces, resulted in a regressive arrangement of transfers. The “hold-harmless” provision – reflected in lump-sum transfers to guarantee provinces pre-1994 income levels – benefited wealthier coastal provinces that generated much of the revenues. While the share of such transfers has declined considerably in recent years, transfers based on the “revenue-returned” principle remain dominant, accounting for over 40 percent of overall transfers. This has imparted a regressive character to the current system, introduced asymmetry in fiscal relations and divorced transfers from expenditure needs and revenue capacity (Wong, 2000). The above transfers and the small share of the equalization fund have preserved the pre-1994 system of interregional local revenues and, as a result, marked regional income imbalances remain between coastal and western provinces.

#### **D. Fiscal Management**

Despite recent reforms, official coverage of subnational fiscal activities remains incomplete and a systematic and comprehensive management system of direct and contingent liabilities at the local level with concomitant information for the central government is lacking. Budget reforms at the subnational levels lack adequate scope and are not comprehensive. For instance, while reported extrabudgetary funds managed by the central government declined significantly after the 1994 reform (see Figure 1), those controlled by local government averaged around 58 percent of local budget revenues in 2002 (World Bank, 2002).

A credible system of sanctions and penalties essential to discourage the circumvention of the fiscal discipline rules imposed by the central government is absent. For instance, the credibility of the penalties for default on debt payments to the central government – deduction from central government transfers – is seriously undermined by bailouts and the existence of gap-filling transfers.

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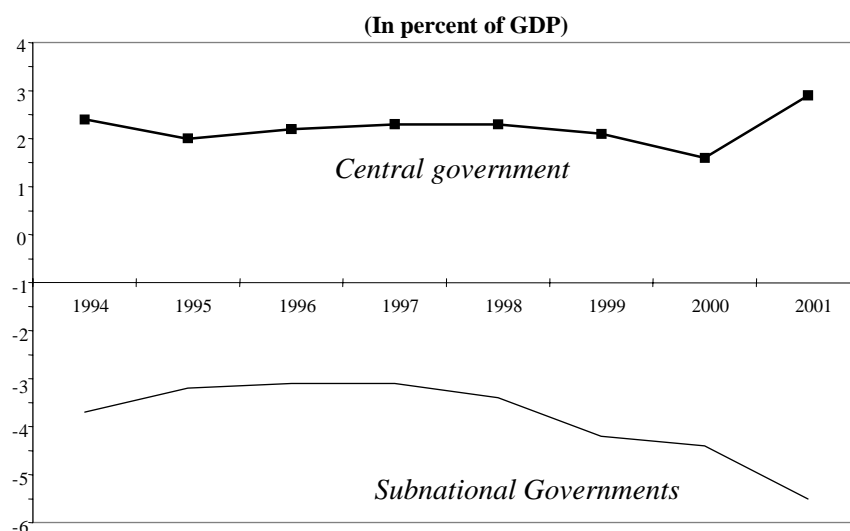
<sup>10</sup> Agarwala (1992) enumerates different scenarios which lead to bargaining over intergovernmental transfers between central and provincial governments. Overlapping and opaque responsibilities of governments and the absence of rules-based governance encouraged such bargaining.

#### IV. IMPLICATIONS OF CURRENT SYSTEM OF IFR

Incremental reforms in the fiscal arena and in public expenditure management have failed to adequately address the fundamental contradictions between the formal and informal systems of IFR which are the source of many of the distortions and incentive problems that plague IFR. While the formal system is relatively centralized, local governments have compensated for restricted formal autonomy with a greater share of informal budgetary activities. Unclear delineation of roles and responsibilities of various levels of government, recentralization of revenues, limited formal local tax autonomy and own-source revenues in the face of an excessive expenditure burdens has created incentives for local governments to engage in “creative accounting” and to extract resources from the central government while off-loading liabilities (Bahl, 1999; Bahl and Martinez-Vazquez, 2003).

Many provinces face severe budgetary pressures, arising from the imbalances between revenue assignment and transfers and heavy expenditure responsibilities and unfunded mandates which are assigned by the center, such as minimum service standards in education and health. This has resulted in a deterioration of the fiscal position of subnational governments. Vertical imbalances between the center and subnational governments have widened over the last decade (see Figure 3).<sup>11</sup>

**Figure 3: Vertical Imbalance Between Center and Subnational Governments<sup>1/</sup>**



Source: Ahmad and others, 2004

1/ Based on official definition of difference between budgetary revenues and expenditures; for subnational governments, revenue is before transfers.

<sup>11</sup> While balances adjusted for revenue-returned transfers are lower, given the regressive nature of these transfers, these imbalances are larger for the poorer regions.

Such vertical imbalances are no uncommon in large federations (for example, Australia and India), as they allow the center to play a larger role in macroeconomic stabilization and equalization. In China, however, the regressive and inadequate nature of the transfer system works against the principle of equalization.

The resultant mismatch between expenditure and revenue assignments, in the face of inadequate transfers from higher level governments has resulted in local governments experiencing difficulties in financing basic services, and more so in poorer provinces where revenue is lower. This, in turn, has served to reinforce the large and growing regional disparities in fiscal spending and service provision in critical areas such as basic education and public health which emerged in the 1980s and early 1990s.<sup>12</sup> Among provinces, the ratio between the highest and the lowest in terms of per capita budgetary expenditures increased from 5.9 in 1990 to over 8 in 2002 (see Table 3). Local governments in the regions are frequently unable to fulfill their expenditure responsibilities, and as a result provide inadequate levels of vital public services.<sup>13</sup>

Table 3: Budget Disparities Among Selected Regions (2002)

Regions	Per Capita Budget Revenues (RMB)	Per Capita Expenditures (RMB)
<i>East</i>		
Shanghai	4,362.8	5,307.0
Guandong	1,529.0	1,935.5
Tianjin	1,706.4	2,633.7
<i>Central</i>		
Sichuan	336.5	809.0
Hunan	348.7	804.1
Anhui	315.9	720.8
<i>West</i>		
Shaanxi	457.9	1,102.1
Gansu	294.0	1,056.7
Guizhou	282.2	825.3
<i>Other</i>		
Beijing	3,752.6	4,415.7

Source: China Finance Yearbook, 2003

Local governments continue to have very limited tax setting ability after the 1994 reform, with the authority to modify the rates of a few minor taxes. The inability to raise own-revenues at the margin undermines fiscal accountability at local levels. As a result, there has been a continued reliance on off-budget sources of funding, accumulation of arrears, and

<sup>12</sup> One example of this trend is the rising out-of-pocket expenditures on education and health, particularly in rural areas. Kanbur and Zhang (2003) note that out-of-pocket expenditures for healthcare increased from 16 percent in 1980 to 61 percent in 2001; for education, they increased from 2.3 percent to 12 percent between 1990 and 1998.

<sup>13</sup> Hofman and Guerra (2004) provide some empirical evidence to suggest that fiscal disparities in China have translated into disparities in service delivery and outcomes among subnational governments. They relate differences in life expectancy, Human Development indicators, and number of hospital beds per capita to expenditures per capita across provinces and find that the two are significantly correlated.

indirect borrowing at the subnational levels. The precise extent of local government indebtedness is unknown, but there is increasing concern that sizeable contingent liabilities at the subnational level, limited central and provincial oversight over off-budget funds, and poor monitoring and regulation of indirect borrowing has created substantial fiscal risks. For instance, the government's 2002 Audit Report notes that at the end of 2001, 49 cities and counties had a total of RMB 1.6 billion in debt, equivalent to 2.1 times their disposable financial resources for that year.<sup>14</sup>

Local governments have a number of ways of gaining influence and leverage over SOEs and banks operating on their territories. Thus, they enjoy both a soft budget constraint and autonomy in lending decisions. Jin and Zou (2003) note that while direct subsidization of loss-making enterprises by subnational governments has declined over the years, they continue to provide indirect subsidies in the form of debt forgiveness and reduced or refunded government taxes. At the same time, local governments can resort to SOEs for both delivery of services and debt financing. The ensuing lack of transparency creates opportunities for rent seeking and encourages regional policies that are inimical to fair-competition and detrimental to well-functioning markets.

While the budget law prohibits direct borrowing or issuance of guarantees by subnational governments, in practice, they have the freedom to establish fully or partially owned companies which can borrow from banks. This in turn creates contingent liabilities for local governments, which given the absence of a systematic and comprehensive management system for monitoring, is less easily controlled than explicit government borrowing.<sup>15</sup>

The use of extrabudgetary funds and off-budget sources, which allow local governments to maintain considerable resources outside the official budget and not subject to central control, represents another informal tool of fiscal policy. The continued use of these funds has blurred priority setting and weakened budgetary control mechanisms essential to a well-functioning fiscal system. Local governments also have incentives to generate payment arrears to be covered by specific purpose grants (as in the case of wages and salaries), or to be reduced or forgiven (in the case of repayment of loans on-lent by the center). These informal activities detract from the accountability and transparency of fiscal system, complicate macroeconomic management, and create significant future risks.<sup>16</sup>

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<sup>14</sup> In some cases, accumulated arrears have kept on growing. As of September 2002, 42 counties and townships have RMB 1.8 billion in arrears – more than three times their arrears in 1998.

<sup>15</sup> The macro-economic crises in Argentina and in Brazil in the late-1990s were to a large extent exacerbated by the absence of effective monitoring of subnational borrowing and true deficits.

<sup>16</sup> A recent study by the State Council's Development and Research Center warned that the unspecified amount of hidden debt linked to local government could pose a more serious threat to China's economic growth than the country's ailing banking system, *The Asian Wall Street Journal*, April 2004.

(continued...)



## **V. RECOMMENDATIONS AND POLICY OPTIONS**

While China has made important progress in needed directions, incremental reforms in the fiscal system have fallen short of achieving a sound and effective system of IFR. Many of recent initiatives to address weaknesses in the system are more in the nature of temporary palliatives, rather than a systematic attempt to rationalize the design and implementation of the system. This partly explains why many of the problems plaguing the system discussed in previous sections have persisted over the last two decades despite various reforms. There is an urgent need to address these challenges, not only to reduce regional disparities, but more importantly to prevent erosion of social cohesion and weakening support for future reforms. The remainder of this section outlines the key elements of such a reform by drawing upon relevant cross-country experiences.<sup>17</sup>

In the ensuing discussion, it is important to note that there is no unique optimum system of IFR or prescribed set of rules governing the decentralization process. In most countries, the outcome of IFR is the result of often internally-inconsistent accumulated reforms, adopted over time, and in response to economic and political realities that change over time, as is the case in China. However, international experience does suggest that the efficiency and equity of the system and incentives for responsible fiscal behavior and hard-budget constraints can be undermined when the system of IFR is characterized by (i) lack of clarity in the respective roles and responsibilities of each tier of government; (ii) lack of subnational autonomy over expenditure and revenue decisions, and a high degree of dependence on discretionary transfers; (iii) lack of constraints on subnational direct and indirect borrowing; and (iv) weak budgetary institutions for monitoring and control of subnational operations (Dabla-Norris, 2004; Rodden and others, 2003; Litvack and others, 1998). What is key, therefore, is that the design of the system foster sound incentives and the devolution of fiscal powers and resources be commensurate with the assigned roles and responsibilities as well as the institutional strengths and capacities of the various levels of government. The latter provides a metric to guide the sequencing of reforms in the various elements of IFR.

The first task of any reform strategy for China is to establish consensus on what should be objectives of the government's decentralization policy and the core functions of the different levels of governments to guide the ensuing reform process. Responsibilities need to be made clearer so that different levels of governments can be held accountable. Given the inherent tradeoffs, conflicting interests and incentives involved, a cooperative approach would be the best way to manage the reform process. International experiences show that while countries have chosen very different ways of securing the required cooperation, common experiences seem to indicate that an efficient system is characterized by transparent, regular, and comprehensive exchanges of information and discussions, and that cooperation must take place at the political as well as the technical level. A high level commission could be appointed in China involving budget, tax, and planning authorities, along with

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<sup>17</sup> Many of the elements of the reform strategy has been discussed in various studies. See World Bank (2000, 2002) and Ahmad and others (2003, 2004a, 2004b).

representatives of local governments, that would provide an overall framework and set the pace and sequencing of reform implementation.

### **A. Expenditure Assignments**

A clear and explicit assignment of expenditure responsibilities between different levels of government is the first required step for IFR reform. The decision on how to allocate tasks between the different tiers not only shapes the nature of the inter-governmental fiscal relations, including the financing needs of each level of government, but it also guides the structure of revenue assignments and transfers. As discussed in the previous section, expenditure pressures on subnational governments have intensified in the last decade, with local governments facing large and unclear expenditure mandates. While a complete overhaul of expenditure assignments may warrant a medium-term perspective, a review of social spending responsibilities at subnational levels of government is imperative to increase the efficiency and accountability of expenditures.

As mentioned in the Section II, China is virtually alone among developing countries in assigning responsibilities for social security, unemployment insurance and basic social services to prefecture (city) and county governments.<sup>18</sup> It is widely agreed that subnational service delivery is useful in reducing poverty and in the provision of social safety nets, particularly when there are significant differences in poverty indicators within the country. However, in most countries, the role of subnational governments in the implementation of social assistance programs is limited to the extraction of information on local needs and preferences and to administrative tasks in income certification and personnel management. When subnational governments play an active role in the implementation of welfare programs, financing is provided by the central government through block grants.

Any reform of expenditures in China will require reassignment of pension and unemployment insurance responsibilities to the national or provincial level. At a minimum, pooling of pensions at the provincial level would eliminate the need for soft transfers by the center to sub-provincial administrations running pension arrears. However, this does not eliminate the higher burdens borne by the wealthier coastal provinces, which face more adverse demographic characteristics. Central pooling of pensions would reduce the burden on these provinces, and make it politically more feasible for the government to undertake important revenue assignment and transfer reforms. Given the factors that give rise to unemployment, central pooling of unemployment insurance is highly desirable. Moreover, unemployment benefits act as an automatic stabilizer and thus have a macroeconomic function that would be enhanced by centralization. (World Bank, 2002). In Canada, studies show that a certain amount of interprovincial redistribution occurs in federal programs such as unemployment insurance. This is due to the fact that while unemployment premiums are

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<sup>18</sup> Any subnational funding of social assistance and welfare programs is confined almost exclusively to developed countries. For instance, in Spain and Switzerland, subnational jurisdictions are free to set benefit levels and eligibility conditions for most central government-financed welfare programs.

the same across provinces and industries, unemployment rates vary significantly across provinces, resulting in implicit transfers between provinces (Bird and Vaillancourt, 2001).

For other services, the new assignment should explicitly identify the level of government that has exclusive responsibility for its financing and delivery. Several transition economies, such as Russia, have legislated detailed expenditure assignments in their budget codes or laws on local government.<sup>19</sup> A related issue is the role of the central government or other higher level governments in determining policy objectives, such as minimum standards for education, health care and other services. The challenge here lies in matching these prescriptions with available finances for local governments. As discussed in the previous section, the mismatch between the two has resulted in either under-provision of local public services or resort to extrabudgetary resources by local governments to finance services to build arrears or use other means to soften the local budget constraint. Subprovincial governments in China should be relieved of the burden of unfunded mandates in these areas, and mandates financed directly by higher level governments or in the form of compensating transfers to offset their costs.

International experience suggests that incentives for effective service delivery can be strengthened through adequate enforcement and performance monitoring, as well as the choice of financing instruments, such as reliance on matching grants and conditionality on block grants based on the fulfillment of explicit, quantifiable performance objectives, among others. Open-ended, gap-filling block grants and lump-sum transfers seldom create strong incentives for cost-effectiveness and efficiency in service delivery (see discussion on transfers below). For instance, Canada and the United States rely on transparent specific purpose or matching grants to meet central government objectives in order to reduce horizontal imbalances in some functional areas.

Given the large existing disparities in service delivery in China, central and provincial governments need to be assigned partial responsibilities for financing education and health services. In many countries, local education and health budgets are financed in large part through earmarked grants and transfers from higher levels of government. In some countries, transfers are formula-based and take expenditure needs into account, particularly when the equalization of subnational expenditure capacity is pursued.<sup>20</sup> Functions can then be costed subject to the minimum standards set by the center. For instance, in Chile, in an attempt to

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<sup>19</sup> For instance, one clause in Russia's 2000 Budget Code requires that any legislation that specifies joint responsibilities must include a specific breakdown in tasks according to obligations of the different levels of government (Dabla-Norris, 2004).

<sup>20</sup> In Brazil, for example, a national minimum spending level per primary school student is set annually with a federal top-up grant to subnational governments that cannot afford the minimum spending level set by the center (de Mello, 2001). In Colombia, while there are no equalizing grants based on per capita expenditure needs and standardized costs in health care, a share of central government transfers to the municipalities is earmarked to finance health care spending (Bossert, 2000).

equalize spending capacity in health care, a horizontal equity fund (Municipal Common Fund) was set up, reassigning up to 60 percent of the revenues of wealthier municipalities to their poorer counterparts using a formula based on population and municipal income (Bossert, 2000).

## **B. Revenue Assignments**

Tax reforms are imperative in the short run to secure revenue adequacy and a measure of revenue autonomy for local governments, to generate sufficient resources for the central government, and to reduce distortions in the allocation of resources and increase fairness. Another urgent reason for IFR reform is China's recent accession to the World Trade Organization (WTO), which warrants adjustments in the current tax system – specifically, in the VAT and the EIT – that will require major revisions in revenue-sharing rules.

The current production-type VAT design hampers export competitiveness, penalizes investment, generates distortions through cascading and creates incentives for local protectionism (World Bank, 2003). With WTO accession, converting this to a consumption-type VAT where firms can deduct their capital expenditures has become imperative. However, such a move would reduce VAT revenues considerably for both central and provincial governments. Under certain simplifying assumptions, Ahmad and others (2004b) estimate the average revenue loss across provinces from such a move to be in the 10 to 30 percent range, depending on the efficiency of revenue collections. One option to compensate provinces for their revenue shortfall would be to increase the share of VAT assigned to local governments. Depending on assumptions about collection efficiency, a revenue-neutral increase in the provincial VAT share rate would need to be in the range of 30 to 36 percent (Ahmad and others, 2004b). The budgetary implications for the central government of this option would be severe, with the center losing over a third of its current collections. An additional concern is that a higher VAT sharing rule for provinces could prove to be disequalizing, further exacerbating regional disparities in revenue collections.

The second option would be to extend the VAT to all services and would involve eliminating the currently cascading business tax currently collected by local governments.<sup>21</sup> Such a move could largely offset losses associated with the move to a C-VAT but would have additional distributional consequences. Under an unchanged VAT-sharing rate, the reform would reduce subnational revenues but raise central government revenues overall. Ahmad and others (2004b) estimate these additional revenues accruing to the center to be in the range of 1.3 to 2.7 percent of GDP. The additional revenues could then be redistributed to provinces for equalization purposes or for raising the revenue share in favor of local governments. Both options necessitate a reform of tax assignments at the subnational level, the elements of which are discussed below.

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<sup>21</sup> The business tax accounted for an average of 24 percent of local “own revenues” before tax rebates in 2000, but was as high as 37 percent in Beijing.

Alternatively, the government could consider eliminating VAT-sharing and re-centralization of the VAT, as was done recently in Russia. Recentralization of VAT revenues in China would provide the center with additional resources to the tune of 1.5 percent of GDP. This would reduce economic distortions and improve inter-jurisdictional fairness, while significantly increasing central government share of revenues and enhancing its scope for redistribution and stabilization. In Russia, for instance, in partial compensation for the lost revenue, a new transfer fund was set up to finance federal expenditure mandates in the regions and the share of subnational budgets in the personal income tax was increased. In China, however, given the relative importance of VAT to local government revenues (accounting for over 20 percent of total tax revenues in 2002), such a reform is likely to receive considerable political resistance, if undertaken in isolation.

The EIT, which is currently shared between the center and provinces, is marked by tax preferences, and large differences in the treatment of domestic and foreign enterprises which encourages unfair competition among enterprises and adds to the complexity of the tax system.<sup>22</sup> The EIT is also widely considered to be inappropriate for tax sharing. As in the case of the VAT, given its importance to local revenues, particularly for the wealthier regions, any reform of the EIT is not likely to win much support.

One element of this strategy would be to grant provinces and counties greater control over the rates of assigned taxes at the margin. China is not alone in granting limited tax autonomy to its subnational governments. In most developing and transition economies, there are often limited choices for the delegation of taxing autonomy to local governments. The alternative is to leave the bulk of the revenue raising powers at the central level, as is the case in Russia and Mexico, and to provide transfers to accommodate the resultant vertical imbalances. However, international experiences suggests that providing greater autonomy at the margin is important for linking expenditure and revenue decisions and strengthening subnational fiscal accountability. For instance, the Mexican experience with centralization of VAT revenues in the 1980s suggests that such a strategy could undermine subnational fiscal responsibility and the efficiency of service delivery if the division of expenditure responsibilities across different levels of government remains unclear and there is weak accountability in service provision (Diaz-Cayeros and others, 2002).

Conventional wisdom assigns taxes to regions and localities on factors that are relatively immobile or largely resident based, so as to avoid externalities and other problems in collection (Oates, 1972). In this respect, PIT and property taxes can be two important sources of revenue autonomy at the local level. While there are strong arguments for standardizing the base of the PIT, piggybacking on the existing PIT, as is done in Brazil and Canada, would provide provinces with greater flexibility over their revenue sources.<sup>23</sup> This would involve

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<sup>22</sup> The EIT accounted for an average of 13 percent of local revenues, but was 20 percent or more for a number of provinces including Beijing, Shanghai, Tianjin, and Zhejiang (World Bank, 2003).

<sup>23</sup> The current share of PIT revenues in total tax revenues of around 3 to 4 percent compares unfavorably with the 11 percent share in the countries of the former Soviet Union. In OECD (continued...)

reforming the current PIT by splitting it into two different taxes and granting provinces bounded control over a number of percentage points above the uniform national tax rate. At the county level, strengthening the property tax, including enhanced valuation and recording mechanisms for leasehold policies, and basing annual taxes on the annual lease value equivalent should be considered.<sup>24</sup> Both of these reforms will provide significant revenues to the wealthier coastal provinces and larger cities – potentially deflecting political pressures in other areas of tax reform.

### **C. Transfers**

Reforms in the design of the intergovernmental transfer system are necessitated by widening horizontal fiscal disparities across regions and the need to undertake tax reforms. Countries have typically relied on a variety of measures to address horizontal imbalances. Australia and Canada have transfer programs that use an explicit standard of equalization of fiscal capacities. In developing countries, these are not easy to determine, but equalization objectives are implicitly attempted in the general revenue sharing mechanisms used in Argentina, Brazil, India, Nigeria, and Mexico. The system of intergovernmental transfers in China does have some equalizing elements, but it is not explicitly designed to reduce disparities in unmet expenditure needs or fiscal capacity. As discussed in the previous section, this is largely due to the small size of the equalization fund, and the high proportion of revenue-retained and ad hoc specific purpose grants in the transfer system.

The funding for the current system of equalization grants in China is inadequate to address widening regional disparities. While the overall size of the equalization block grant should be determined in a macroeconomic context to be consistent with affordability and macroeconomic stability, there can be some amalgamation of existing grants to increase the equalization fund. One option would be to eliminate revenue-retained transfers, which are inherently regressive in nature, and to replace them by equalization transfers, essentially fulfilling the objectives of the 1994 reform. This would give the central government the largest scope for redistribution but may not prove to be politically expedient. Another option could be to freeze revenue returned transfers at their current levels without any compensation through equalization transfers, with the eventual aim of phasing them out. This option partially offsets the political economy drawbacks of the former, but provides less scope for redistribution. Again, political opposition to both options could be diffused by the center assuming some currently inappropriate expenditure assignments (e.g. pensions) and by granting more own-source revenues.

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countries, PIT represented 27 percent of total revenues in 1998, but this comparison is less meaningful for China than that with countries of the former Soviet Union (World Bank, 2002).

<sup>24</sup> For a detailed discussion of evolving property tax systems in developing countries, see Malme and Youngman (2001).

There is also a need to ensure that equalization objectives are implemented at the subnational levels. Designing central transfer mechanisms for county level administrations may be difficult to determine as well as to administer. This approach was adopted in Ukraine, with the central government directly determining equalization transfers for subprovincial governments. In Brazil, the FPM – a special fund for municipalities – uses demographic and economic variables to allocate federal revenues directly to municipalities and cities.<sup>25</sup> Alternatively, the central government could provide mandatory rules and frameworks to provincial governments. Appropriate adjustments in expenditure and revenue assignments at the provincial and prefecture levels could help ensure that they have sufficient fiscal resources to provide the necessary equalization grants to county level governments.

The transparency of the transfer system in China could be enhanced by either accommodating all special purpose programs within the equalization framework or instituting more effective monitoring of the effective use of existing special purpose program. International experience suggests that one important characteristic of a sound intergovernmental transfer program is that transfers be determined as objectively and openly as possible, ideally by some well-established formula, and not be subject to hidden political negotiation and discretion by the center (Bahl, 1999). While specific purpose transfers provide flexibility to the central government, they can discourage subnational governments from increasing efficiency and becoming self-reliant. It also makes it easier for subnational governments to blame shortfalls in service provision on inadequate funding from the center.

Mexico and Brazil have moved in this direction by eliminating most discretionary transfers. In both countries, conditional grants are increasingly used as incentives by which subnational governments can effectively assume result-oriented responsibilities tied to additional resources. In Canada, in addition to equalization transfers, program-specific transfers and a block grant (the Canada Health and Social Transfer) which provides for an equal per capita grant are provided to provinces. The latter is only nominally related to expenditures on education, health and social services but is determined in a transparent manner by the central government (Bird and Vaillancourt, 2001).

#### **D. Subnational Borrowing and Arrangements for Fiscal Management**

The decision to allow subnational borrowing in China will depend critically on proper incentives for local governments to comply with the rules, the availability comprehensive information on subnational activities and borrowing sanctions and credible sanctions when the criteria are breached. The vast needs for infrastructure investment at subnational levels in China could be accommodated by allowing fiscally-responsible borrowing for long-term investment with appropriate safeguards. As in other developing and transition economies, the challenge is to ensure that such borrowing does not undermine macroeconomic stability. A

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<sup>25</sup> Specifically, 10 percent of the fund is distributed to the capital of each states, and the rest to municipalities. Within these shares, the coefficient of each municipality is determined by two criteria: the state to which the municipality belongs and the size of its population (Rezende and Afonso, 2002).

rules-based approach, such as the one adopted in the United States, and Japan, with strict rules and regulations for borrowing only for capital purposes, including overall debt and debt service limits could be considered. Alternatively, in countries where ceilings on the stock of debt or debt service burden are absent (South Africa and the Czech Republic), hard budget constraints are enforced by legally prohibiting central government guarantees of subnational debt and state guarantees of public enterprise debt.

Ensuring fiscal discipline at the subnational level and creating an enabling environment that allows responsible subnational borrowing will require strengthening monitoring and oversight of local governments operations and any direct and contingent liabilities. Many countries have begun to redesign their systems of IFR to improve incentives for prudent fiscal behavior. Brazil's federal government bailout of states in 1997 required states to sign formal debt restructuring contracts with the central government and to bear part of the bailout costs. Interest penalties were imposed for noncompliance and states used constitutionally mandated transfers as collateral for new bonds. Following a series of bailout, the central government of Mexico introduced a new subnational debt regulatory framework in 2000 that included a legal ban on discretionary central government transfers and guarantees for states, mandatory risk-based credit ratings for all subnational loans, and compulsory collateralization of subnational loans.

Ongoing reforms in budgetary and treasury management in China should be extended in a comprehensive manner to subnational governments. This would involve a wider monitoring of fiscal activities at the local level and instituting a more open and transparent budget process. The current piecemeal approach to budgetary reform in China compares somewhat unfavorably with those underway in other transition countries in Central and Eastern Europe and in the former Soviet Union. In these countries, reforms have typically examined all aspects of the budget process and articulated a coordinated reform design either in a budget code for the entire public sector or separate budget codes for central and subnational governments (World Bank, 2002).

The current system of budgetary and financial management in China makes it difficult for the central authority to monitor outlays, and track the use of intergovernmental fiscal transfers. Given the size and importance of subnational extrabudgetary funds, eliminating them, as was done in other transition economies like Hungary and Kazakhstan, may prove to be difficult. Instead, the focus in the short run should be on improving reporting and management of these funds, with the eventual aim of integrating them into the budget.

Improved monitoring of fiscal operations should be combined with a credible system of sanctions and penalties to encourage fiscal discipline and enforce hard budget constraints. Countries have adopted different approaches to penalize fiscal subnational irresponsibility. The Fiscal Responsibility Law (2000) in Brazil allows for the application of financial penalties for local governments, bankruptcy laws in Hungary and South Africa introduce judicial sanctions. Germany and the US allow for a more interventionist approach, such as the take over of the administrative functions of the local government by a higher level government or by an independent board.



## **VI. CONCLUSIONS**

Despite important progress in needed directions, incremental reforms in the fiscal system in China have fallen short of achieving a sound and effective system of IFR. A comprehensive reform of the system is needed to tackle persistent problems in IFR on a permanent base. Such a reform would seek to recalibrate IFR so as to better align and formalize revenue and expenditure assignments at subnational levels, achieve greater equity in fiscal resource distribution, strengthen central fiscal management, and increase accountability. It will require a concerted effort to ensure that local revenue bases, intergovernmental transfers and local borrowing authority are commensurate with expenditure responsibilities assigned to different levels of government and a comprehensive and centralized monitoring of subnational operations put in place. The failure of the 1994 reforms to bring about adequate equalization and put in place a transparent and efficient system of transfers also suggests that adopting a comprehensive approach will make it easier to undertake reforms that may be politically unfeasible or unwieldy if taken in isolation.

Clearly it may be unfeasible to move on all these fronts simultaneously and a gradual approach may be warranted. What is imperative, however, is that the overall reform package be consistent and take into account the interrelationships between the various elements of IFR, the tax system, and the institutional and technical capacities of different levels of government.

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