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CURRENCY EQUIVALENTS

Currency Unit: Yuan (Y)

\$1.00 = Y 5.46

Y 1.00 = \$0.18

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

Metric system

ACRONYMS AND ABBREVIATIONS

AAPRC	- Audit Administration of the People's Republic of China	MIS	- Management Information System
ABC	- Agricultural Bank of China	MOF	- Ministry of Finance
ADB	- Asian Development Bank	MOFERT	- Ministry of Foreign Economic Relations and Trade
BOC	- Bank of China	MR	- Ministry of Railways
BOF	- Bureau of Finance	MYE	- Multiyear Expenditures
CASS	- Chinese Academies of Natural and Social Sciences	NCGA	- National Council on Government Accounting
CC	- Capital Construction	NFEBR	- Nonfiscal Extrabudgetary Revenue
CCP	- China's Communist Party	OECD	- Organization of Economic Cooperation and Development
CDs	- Certificates of Deposit	NPC	- National People's Congress
CEM	- Country Economic Memorandum	PBC	- People's Bank of China
CESH	- Culture, Education, Science and Health	PCBC	- People's Construction Bank of China
CIECC	- China International Engineering Consulting Company	PEMS	- Public Expenditure Management System
CPA	- Certified Public Accountant	PIC	- Provincial Investment Company
CPE	- Centrally Planned Economy	PPC	- Provincial Planning Commission
CSY	- China Statistical Yearbook	PRC	- People's Republic of China
EBR	- Extrabudgetary Revenue	PSBR	- Public Sector Borrowing Requirements
FEBR	- Fiscal Extrabudgetary Revenue	R&D	- Research and Development
FYP	- Five-Year Plan	RCCs	- Rural Credit Cooperatives
GAAP	- Generally Accepted Accounting Practices	RIFS	- Research Institute of Fiscal Science
GAO	- General Accounting Office	RMC	- Resident Mission, China
GFS	- Government Finance Statistics	SAMB	- State Asset Management Bureau
GNP	- Gross National Product	SB	- Specialized Bank
GDP	- Gross Domestic Product	SEC	- State Economic Commission
GVIAO	- Gross Value of Industrial and Agricultural Output	SIC	- State Investment Corporation
IBRD	- International Bank for Reconstruction and Development	SNA	- System of National Accounts
ICBC	- Industrial and Commercial Bank of China	SOE	- State-Owned Enterprise
ICOR	- Incremental Capital-Output Ratio	SPC	- State Planning Commission
IDA	- International Development Association	SSB	- State Statistical Bureau
IOT	- Investment-Oriented Tax	STIN	- State Fixed Investment
IM	- Inner Mongolia	SWF	- Social Welfare Function
IMF	- International Monetary Fund	TB	- Treasury Bond
(L/D)	- Loans/Deposits	TVE	- Town and Village Enterprise
		UB	- Universal Bank
		UCCs	- Urban Credit Cooperatives
		ZBB	- Zero-Base Budgeting

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PREFACE

This report is based on a mission that visited China in April 1992. Mission members were Fernando Montes-Negret (Senior Economist, Mission Leader), Anand Rajaram (Economist, Investment Planning and Budgeting), Bert Hofman (Economist, Intergovernmental Relations), Christine P.W. Wong (Consultant, Intergovernmental Relations), Y.V. Reddy (Consultant, Budget System) and Wang Yuan (Beijing Finances, RMC). Bert Hofman assumed task management for the latter stages of this report. E.C. Hwa (RMC) joined the mission's discussions in Beijing. Effective assistance was provided at headquarters by Xiaofeng Hua. Valerie Charles provided competent secretarial and editorial support.

The mission was hosted and received invaluable support from a team headed by Messrs. Zhu Fulin, Director of the Comprehensive Planning Department and Gao Qiang, Director of the Budget Management Department of the Ministry of Finance (MOF) and Professor Ye Zhen Peng, Deputy Director of the Research Institute of Fiscal Science (RIFS). The authorities made excellent collaborative arrangements, produced valuable background papers, provided an adequate forum for the substantive discussions in Beijing, and arranged for the mission's visit to two provinces. The mission duly acknowledges and extends its gratitude to the officials from the various government agencies who participated in the mission's discussions in Beijing.

The mission extends its special thanks to the provincial authorities of Inner Mongolia and Hubei and the city authorities of Wuhan for their hospitality and the very productive discussions held during our visit. Messrs. Ye Qi-Xiang (RIFS) and Zhang Wen Bin (MOF) accompanied the mission to Hohhot and Wuhan, respectively.

The report benefitted greatly from comments by Messrs. B. Naughton, A. Shah, A. Premchand, F. M. Chandri and in particular from Mr. A. Keidel's comments.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Introduction

- i. Economic reform since 1978 significantly changed the role and profile of the government budget. The budget has evolved from an all-encompassing accounting mechanism for the Plan toward an account of general government. Decentralization of decision power greatly reduced and altered the scope of the budget. The entrepreneurial decentralization that proved crucial in the success of China's economic reform decreased the budgetary presence of State-Owned Enterprises (SOEs). Decentralization of government functions enlarged the budgetary presence of local government, and the devolution of decision power increased the importance of local government in the budgetary process. These significant changes in the government were accompanied by only marginal changes in the budget system and in intergovernmental fiscal institutions.**
- ii. China's budget system served the country well under central planning but it increasingly falls short of the demands which China's emerging socialist market economy puts on it, and budgetary practices lag behind the economic decentralization in the reform period. The current budget system does not adequately reflect the present and future fiscal responsibilities of China's government. The budget is not well equipped for its growing function as a macroeconomic policy tool, and is still overly geared toward the traditional role as a resource mobilizer. Intergovernmental fiscal relations have not fully adapted to the new independence gained by local government, leading to a proliferation of extra- and offbudgetary practices that undermined budget control and macroeconomic stability. The dwindling fiscal resources in the sharing system led to an erosion of the fiscal equalization between provinces.**
- iii. The main challenge for the Chinese authorities is to make the budget a more effective policy tool, both in its role as an indirect lever in managing macroeconomic developments, and a better-designed instrument for meeting new social objectives. This report analyzes the current problems with the budget system and recommends how it can be transformed to meet the challenge. The report recognizes that many of the recommendations can only be implemented as the overall reform program unfolds and the future role of government is clarified, but some changes can immediately improve the effectiveness of the budget.**
- iv. The report focuses on two crucial features of the fiscal infrastructure: (a) the structural and institutional aspects of the budget system; and (b) China's intergovernmental finances with particular reference to expenditure assignments by levels of government. China's fiscal system needs reforms in other areas as well, and earlier World Bank studies have**

addressed these in detail.^{1/} Fiscal policy in a market based economy aims to (a) promote macroeconomic stability, (b) enable efficient allocation of scarce resources, and (c) guarantee equitable outcomes of the economic process. The increased openness of China's economy will make fiscal policy *the* dominant macroeconomic policy tool, but fiscal policy will also play the dominant role in allocation and income redistribution, as the importance of the Plan further diminishes. Reforms to equip government with the appropriate tools for fiscal policy in the market based economy are therefore a matter of urgency.

v. Necessary reforms outside the scope of this report include (a) transforming China's revenue system into a true tax system, (b) broadening China's tax base, and (c) modernizing tax collection. China's government has recognized the need for reforms, but the initiatives taken have not been without problems. The experiments of separating taxes and profits goes in the direction of a true tax system, but implementation is held up by reluctance to phase out the tax deductibility of debts, an issue that could be solved by grandfathering these debts. The ongoing extension of VAT and Business Tax to a wider category of goods and services is diversifying the tax system, but the complicated rate structure remains a barrier to an equitable and efficient system. The reformed tax system will only be effectively enforced with a solid collection mechanism, and with the increased income flows across provinces, and the loosening of ties between SOEs and government, a national tax system becomes necessary.

Budgetary Trends Over the Reform Period

vi. China's budget reflects the profound changes in society that have taken place since 1978. Following the overall retrenchment of the government from the economy, budgetary expenditures declined by over 10 percentage points of GNP over 1978-91. To a considerable degree, this is a result of conscious and desirable policy reform, as SOEs were allowed to keep more resources, and at the same time saw their excess profits decline as competition increased. However, including the *fiscal* part of extrabudgetary funds (that is, funds that are essentially of the same nature as budget resources), government still commands more than a quarter of GNP, a share comparable with that of other Asian developing economies. Priorities shifted away from resource mobilization for production enterprises toward more traditional government tasks. The greatest cuts have been in capital expenditures, as State-Owned Enterprises (SOEs) were excluded from the state budget in the course of reform, as they now retained profits for reinvestment. Further sharp cuts took place in reported national defense spending, whereas social expenditures, administration, and price subsidies all grew moderately, and debt service grew rapidly as a share of GNP. The trend toward social expenditures is likely to continue as enterprise reforms will move social expenditures of enterprises to the budget, thus enlarging government's share in GNP. Overall, the decline in government's revenue share of GNP outpaced expenditure decline, leading to persistent budget deficits over the reform period, reaching 2.5 percent in 1992 (IMF definition).

vii. Extrabudgetary revenue gained strongly in importance, rising from a third of budgetary funds in 1978 to over 90 percent in 1990. However, in 1990 only one sixth of total extrabudgetary funds, or 2.6 percent of GNP, are *fiscal* extrabudgetary funds, related to government functions. The bulk of extrabudgetary funds consist of retained earnings and

^{1/} World Bank, "China: Revenue Mobilization and Tax Policy," Washington, D.C., 1990; and "China: Reforming Intergovernmental Fiscal Relations," Washington D.C., November 27, 1991.

depreciation funds of SOEs, which have been growing fast in the course of increased independence of SOEs.

viii. Responsibility for administering public expenditure shifted towards lower levels of government over the reform period, concurrent with the general decentralization. Central government's share of total government expenditure is now below 40 percent. Although this may appear low in international comparison, it is by no means exceptionally low for a country of China's size and development stage. Also, China's central government share is suppressed by the largely offbudget finance of Social Security and Defence, usually central government functions. The downward shift of expenditures over the reform period can be attributed largely to: (a) the new emphasis on functions traditionally administered at local levels, such as social expenditures; (b) wage increases and increases in administrative expenses, which fell more heavily on local governments; and (c) sharp rises in locally administered, but centrally set price subsidies. Local governments' own sources of revenue did not keep pace with rising expenditures, and they became increasingly dependent on earmarked grants from central government, and strongly expanded their reliance on extrabudgetary funds to perform government functions. Tax sharing through the tax contracts decreased rapidly in importance, as central government gradually augmented its fixed revenue base through the reassignment of individual taxes or a change in enterprise ownership. Such sharing now accounts for about 20 percent of local revenues and expenditure, and about a quarter of the center's.

ix. Budgetary finance of China's high investment share in GNP decreased substantially over the 1980s, a trend even more pronounced for investments in the state sector. Budget finance was replaced by: (a) own funds, that rose with the growing independence of enterprises; (b) foreign funds—increasingly in the form of direct foreign investment—as China opened up; (c) domestic loans; and, more recently, (d) new mechanisms of finance such as stocks and bonds. The nature of budget finance of enterprise investments changed from direct capital grants to an annual lump sum allocation for the capital construction fund, managed by SPC. The decline in budgetary finance of investment was particularly pronounced in local budgets, and consequently the recourse to alternative finance sources was stronger at that level.

x. In summary, the expenditure composition of the budget has substantially changed over the reform period. In recent years, more of the budget has gone to the provision of public goods (social services, infrastructure), while the share of enterprise finance has gone down, and the locus of expenditures has shifted to local government. The functional specialization between government and enterprises, as reflected in these numbers, has been the major driving force behind China's economic success. Moreover, the decentralization of ownership to local government has strongly enhanced competition among SOEs, and substantially reduced x-inefficiencies. However, the fundamental changes in China's society have not been without problems for the budgetary system.

Main Issues and Problems

xi. **The Budget System.** While many changes have occurred in the scope, coverage and size of government expenditure in recent years, and many fiscal reforms have been instituted, budgetary *processes* and practices in China have not kept up with the accelerated pace of reform in the 1980s. The scope of the budget in China is lagging behind the changing role of government: government activities are not unified in the budget, whereas nongovernment activities still remain on the budget. Enterprises still have a strong presence in the fiscal

accounts, although financial independence is the stated policy. The proliferation of offbudget and extrabudget funds blurred priority setting and has weakened the budgetary control mechanisms essential to a well-functioning fiscal system.

xii. Actual expenditures consistently supersede budget estimates, by as much as 18 percent in the mid-1980s, but in 1992 still by over 8 percent of budgeted expenditures. Multiyear expenditure planning is hardly developed, and the current method for budget planning invites incrementalism. Individual economic units have resisted periodic program and project assessments and incrementalism in the budget process has contributed to weaker control and increased pressure on the budget.

xiii. The Chinese government has moved away from detailed planning activities of other sectors in the economy to guiding these decisions. This should entail accompanying budget reforms, especially to enhance the budget as a provider of signals to economic agents, and as an instrument of macroeconomic policy, but this has yet to be seen. In particular, government's capacity to define a system of incentives through the budget is inhibited by the restricted publicity of the detailed budget and the late approval of the budget which impedes economic agents to take account of government plans in a timely way. Macroeconomic control is weakened by the wide divergence between estimated and actual expenditures and revenues as noted above.

xiv. Recourse to bargaining and noncompliance with fiscal regulations have contributed to fiscal indiscipline across institutions. Rules and codes regarding enterprise tax liability are evolving, but enterprises treat tax liability lightly in an environment where the finance bureaus play the double role of tax collector and owner, and in a situation where taxes are frequently contracted rather than assessed. Budgetary finance of SOE investment is still virtually free, as repayment ratios of the PCBC are extremely low, or as repayments are canceled out against tax obligation. This has negative microeconomic and macroeconomic consequences, and works to the detriment of banking sector stability. The Chinese authorities have initiated a number of changes in the budget system to deal with this situation, but these measures fall short of preparing the budget for its new role. Many of these problems are not unusual for an economy in transition. However, future budgetary reform needs to address them if macroeconomic difficulties are to be avoided in the future, and a number of actions set out below can be taken immediately to improve the functioning of the budget.

xv. The recommendations of this report are therefore designed to address these issues by suggesting ways in which the scope and coverage of the budget can be redesigned in order to make it more closely match the new role of government as it is emerging in the course of reform. Similarly, such reforms of the budget are necessary if the government is to be equipped with a budget that will assist it to manage macroeconomic policy, and permit it to use the budget to guide the decisions of other economic agents.

xvi. **Intergovernmental Finance.** China has not yet fundamentally changed the system of intergovernmental finance despite the increased role and responsibility of local government, and this has given rise to a number of problems. Furthermore, the devolution of power to an already deconcentrated government has given local government de facto command over functions that determine macroeconomic stability. The lack of reform has driven central and local government to take actions that further undermined the fiscal system. An increasing mismatch between local revenue and expenditure assignment has occurred over the reform period, as local

governments took on increased responsibilities for, for example, price subsidies, but without new sources of revenue. Uncertainty increased in intergovernmental relations, due to changing level of ownership of enterprises, expansion of central fixed taxes, and central "borrowing" from localities. Repeated "recontracting" undermined the tax contract which, in principle, were well-designed to generate revenues; it reduced revenue collections well below potential; and made fiscal planning at the local level more difficult. As the resources in the revenue-sharing system stagnated, the central government allowed the redistributive element of the fiscal system to weaken, at times when diverging economic conditions—a possible threat to reforms—would require more equalization among regions. Fiscal redistribution now takes place mainly through ad hoc, earmarked grants allocated on a one-by-one basis, often poorly targeted and too small to meet basic needs in the poorer regions. Moreover, the arbitrary nature of central grant allocations led to extensive negotiations and rent-seeking by localities, tying up valuable administrative resources.

xvii. Besides increased rent-seeking, local governments responded to the fiscal squeeze in other ways that undermine the desired fiscal system and jeopardized macroeconomic stability. The local reactions include: (a) expanding the local tax base at the cost of central government; (b) turning budgetary into extrabudgetary funds and tapping enterprises' extrabudgetary funds for government purposes; (c) pushing expenditures offbudget, sometimes financed by indirect local borrowing that puts additional demands on local banks, and strains macroeconomic stability; and (d) run arrears in payments or issue IOUs, a practice that fuels inflation. Local governments have reduced effective tax rates on enterprise profits below the statutory rate via enterprise profit contracts. Local governments offer tax concessions to enterprises that affect the size of the taxable income to the detriment of tax buoyancy, for instance by manipulating the rules for pretax repayment of investment loans. Moreover, the resource-strapped local governments depend on local enterprises for their revenues, and are thus tempted into inefficient regional competition and local protectionism, made possible by voids in competition regulation. The Chinese authorities have repeatedly changed central-local fiscal contract, but without fundamentally altering the incentives in the intergovernmental fiscal relations that give way to the observed dysfunctional outcomes.

xviii. Future reforms in this area will therefore need to focus on clarification of expenditure assignment, on formulation of criteria for fiscal redistribution, on the measurement of fiscal need and on an appropriate system for assigning revenues to each level of government. The report contends that the present system is creating distortions and inefficiencies by its lack of clarity, and that, in particular, the first two issues need to be resolved before a detailed design of tax-sharing can take place on a rational basis.

A Long-Run Budgetary Framework

xix. Within the context of overall fiscal reforms, China's budgetary process and intergovernmental relations need fundamental change to support fiscal policy that promotes efficiency, equity and macroeconomic stability. The increasing importance of fiscal policy in macroeconomic management urges for speeding up fiscal reforms. Fiscal reforms can only be brought to success if all parties gain, which is more likely the more comprehensive the reforms are. Budgetary reforms and changing intergovernmental relations should therefore go hand in hand with a broadening of the tax base, the creation of a local tax base, a rationalized tax collection system, and a reestablishment of central government's macroeconomic control. The evidence from the past with fiscal reforms suggests that the experimental, regionally limited

piecemeal reform method, successful in many areas, may not work with fiscal reforms. A gradual nationwide implementation of an established reform plan encompassing the various aspects of fiscal reform promises to be the better method.

xx. The Budget and the Scope of Government. Budget reforms must change the scope, content and objectives of the budget and budgetary policy. In the long run, the budget should reflect the role China's authorities see for government in society in a unified and clear way. Nongovernment activities should be removed from the government budget and fiscal accounts, including enterprise extrabudgetary funds. Budgetary investment expenditures should concentrate on government functions. Fiscal extrabudgetary funds should become an integral part of the budget. Government activities now performed by enterprises, such as social security, should be brought on the budget. Quasi-fiscal activities of the banking system, such as subsidies to loss-making SOEs and for agricultural inputs should be made transparent on the budget. The establishment of separate policy banks to manage policy loans seems superfluous, if not damaging, and designation of an existing institution as the main policy bank seems preferable. Unifying government activities on the budget is a precondition for the budgetary process to become a meaningful mechanism for allocating scarce resources over government objectives. A unified budget will reflect the macroeconomic significance of government action, a precondition for rational macroeconomic policy.

xxi. Government's share of the economy should be an outcome of the change in budgetary scope instead of being a goal in itself: there is no objectively optimal share of government in an economy. More important is the ability to finance the desired share of government in a non-inflationary way: tax reforms and tax administration reforms should in the long run achieve that goal, and eliminate recourse to the banking system.

xxii. China's authorities desire to keep a substantial state ownership of enterprises. A Nonfinancial Public Sector (NFPS) Account consolidating government and State Owned Enterprises would be a useful supplement to the government budget. The NFPS is based on the criterium of government control, instead of the criterium of government functions. As long as China's government exerts considerable control over SOEs, and SOEs remain instruments for implementing government policies, public sector accounts would yield a better picture of the overall government establishment. The public sector borrowing requirement (PSBR) would be more relevant than the government deficit in determining the overall macroeconomic stance of government. Financial institutions owned and controlled by government should not be consolidated in the public sector accounts, because this would eliminate information on which part of the PSBR is financed by banks. Government ownership does not preclude a beneficial separation of functions within government. Separating the ownership function from the tax collector function is indispensable for the implementation of rule based policies, for the imposition of hard budget constraints, and therefore for improving SOE performance.

xxiii. The Budget as a Policy Tool. The budget's increased role as a macroeconomic policy tool could be emphasized by integrating the budget with macroeconomic developments. This requires an explicit recognition of the macroeconomic assumptions behind the budget in the form of a background document on the economic outlook to be published with the budget.

xxiv. China's budget classification and presentation needs adjustment such that the budget will be useful for multiple users and uses, and adoption of the international standard of budget categorization and presentation is strongly recommended. The presentation of the budget should

allow economic analysis of government plans by means of an economic presentation, in addition to a functional and administrative classification that assigns spending authority to specific ministries, units and levels of government.

xxv. MOF could improve the quality of expenditure decision making. The incremental base number method should be abandoned, and more output and program-oriented budgeting techniques should be adopted. Introducing multiyear budgets and commitment budgets, together with crossreference between Plan and budget would improve expenditure planning, and recognize the multiyear nature of many government programs and policies. Capital budgeting capabilities of MOF need further strengthening. The fiscal reporting system must be geared more toward policy analysis, and the AAPRC mandate should be expanded to include output and effectiveness audits. Institutional mechanisms, such as the expenditure review committees many countries have, should be established to raise efficiency of government expenditures. Such expenditure reviews would be instrumental in effectively increasing the tight fiscal envelope, and therefore contribute to overall fiscal reform.

xxvi. The legal basis for budgeting and expenditure control needs strengthening. The draft Budget Law should explicitly assign responsibilities to units and institutions concerning rights and obligations on expenditure budgeting, approval, authorization, disbursement and audits. Procedures for redressing expenditure overruns should be made explicit, and sanctions in case of abuse should be codified. The budget law should be supplemented by a detailed budget manual, explaining in detail the rights and responsibilities of those involved in the budget process.

xxvii. **Intergovernmental Finance.** China's authorities should assign functions clearly over levels of government, with efficiency of service delivery and fiscal equity as guiding principles. For example, education and health care should be primarily a local responsibility with central government only setting general guidelines, whereas other functions, especially those of internal market regulation and competition policy should be assigned to central government.

xxviii. Control over government functions crucial for macroeconomic stability should be recentralized, including control over aggregate government borrowing, and overall tax burden. The increasing intergovernmental flows of goods, production factors and income gives central government a comparative advantage in tax collection, and a National Revenue Service (NRS) is highly desirable. Such a recentralization of control over *administration* of revenue sources (borrowing, taxes) may well coincide with a decentralization of the revenue *accrual* from these sources. The expenditure assignment should be the basis of a new revenue assignment, and the expenditures necessary to perform the assigned functions efficiently should be covered by the revenue assignment—provided the overall fiscal envelope is sufficiently large due to China's tax reforms. The efficiency of government service delivery depends to a considerable extent on the autonomy a level of government has, on the financial incentives it has for cost savings, and therefore on the means with which the expenditures are financed.

xxix. China's authorities should assign each level of government a substantial own tax base, with which it finances functions for which it has full responsibilities. China's authorities should assign local governments a true local tax base—including significant control over tax rates—and exploit the opportunity for more accountability and the incentive for better and cheaper public services such a tax base gives. Own tax bases can furthermore serve to absorb variations in expenditure needs without a tiresome renegotiation of intergovernmental fiscal relations. Finally,

extension of the local tax base contributes to break the present deadlock in the system of intergovernmental fiscal relations. To some extent, fiscal extrabudgetary funds are a de facto local tax base, but a legal basis for this should be provided, and as argued before, these funds should be brought on the budget. For local government, property taxes would be an excellent own tax source, which is thus far hardly exploited in China. However, the subordination principle in income taxation distorts incentives for local government, and should be abandoned in further reforms of the tax system.

xxx. **Tax Sharing and Equalization.** A full separation of tax bases in China is probably not feasible, nor desirable in the light of efficiency of collection, assuming that the NRS will be established. The fiscal gap between expenditure needs and revenues from the own tax base can be filled by tax sharing, general grants, specific grants, or a combination thereof. If tax sharing is chosen, a necessary condition for tax buoyancy is that the collecting agent has a large *stake* in the taxes it collects, i.e., its share of the tax should form a substantial part of total revenues for that agent. To accommodate for the increasing divergence in economic performance among regions, and the consequential growing divergence in fiscal capacity, a fiscal system with equalizing properties is necessary. Horizontal equalization of fiscal capacity between localities can be achieved through tax sharing arrangements or through equalization grants. Whatever the mechanism chosen, China's authorities should design horizontal equalization mechanisms that are resilient to inflation, and can accommodate substantial shifts in relative welfare positions of localities, which are likely to occur as reforms deepen.

xxxi. Administratively, it is more complicated to incorporate equalization considerations in tax sharing arrangements, and usually a separate equalization fund is set up, or central government allocates funds directly to poorer provinces. The latter solution would, however, require a larger share of tax revenues going to central government, which seems difficult in the present Chinese situation. For China, an interprovincial equalization fund could be the appropriate way to strengthen horizontal equalization. This closed-end fund could be filled by a certain percentage of taxes shared between central and local government: this earmarking will have no effect on tax effort in the case of a NRS. The fund could for instance be *administered* by a body at arm's length of central government, with both local and central representatives. Disbursements from the equalization fund could be based on broad indicators of expenditure need, such as population, area and urbanization, and on fiscal capacity of the locality stemming from its own tax base. A variety of formula-based grants schemes or tax sharing arrangements can be found around the world, but China's authorities should make the primarily *political* decisions on what factors should be given weight in the formula, and to what extent fiscal capacity should be equalized across localities.

xxxii. The elements of intergovernmental fiscal relations as set out here need to be captured in a Local Government Finance law. The law would work out the constitutional division of labor between levels of government, and specify the financing mechanisms, including the above mentioned tax sharing and equalization arrangements. The law would in part serve as a guarantee for local government that the NRS will not be abused to reverse the devolution of the reform period, and would establish the increased local autonomy by means of codifying local taxation rights.

Immediate Actions

xxxiii. China's authorities can take a number of immediate actions that clarify the scope of the budget, improve its function as a policy tool, and improve intergovernmental fiscal relations.

xxxiv. To restore budgetary unity, the various levels of government *fiscal* extrabudgetary funds should be reported as part of the budget, without necessarily changing the control over these funds. *Enterprise* extrabudgetary funds should be removed from fiscal accounts, as they no longer fall within the scope of government.

xxxv. The budget should clearly differentiate between government and non government where already possible. Among others, this requires that the budget clearly distinguishes size and nature of government budgetary support to enterprises. To prepare a further delineation of government and nongovernment, MOF should prepare an inventory of those units and agencies that operate in the budgetary and *fiscal* extrabudgetary sphere. Such a listing and the change therein as reforms proceed should be reported along with the budget.

xxxvi. The Chinese authorities should consider a wider publication of a more detailed budget, together with a detailed description of the categories. This would enhance their capacity to guide decisions of other economic agents. MOF should initiate a recoding of budgetary classifications, which would allow multiple users access to budgetary data for multiple uses. This would require training of all levels of government involved in budgeting.

xxxvii. MOF should facilitate a wider flow of information between levels of government, between ministries and even between its own departments. MOF should strengthen the capacity to analyze budgetary implications of economic data, both macroeconomic and microeconomic. Data and analytic capacity combined would enhance the accuracy of the budget forecasts, strengthen the programmatic effect of budgets, and would make the macroeconomic effects of budgetary decisions more transparent. MOF, SSB and SPC should establish a working group on data reporting, which should work on consistency in reporting on budgetary data.

xxxviii. MOF should adopt stricter measures to contain the impact of expenditure overruns. Inclusion of contingencies in the budget is a first step, but MOF should issue more detailed and stricter regulations concerning budget readjustment, including detailed rules on which institution is responsible for absorbing the expenditure overrun and sanctions for the case of noncompliance. Enforcement of this new regulation requires more regular monitoring of budget implementation by MOF, especially at local level. Announced and unannounced inspections may be instrumental in enforcement. MOF's and AAPRC's audit capacity therefore urgently need strengthening.

xxxix. The budget should clarify the size and nature of budgetary support for enterprises. A clearer differentiation between loans, grants and subsidies should be made. Policy loans through the banking system should be registered as a contingent budgetary obligation. MOF should issue clear performance and eligibility criteria for the various means of budgetary support.

xl. The present tax sharing experiments do not match the fundamental revision of intergovernmental fiscal relations as sketched above. Notably, the experiments largely maintain the fiscal contracting system, which lies at the heart of the present problems. Moreover, the

experiments have not been implemented as designed by MOF, and therefore seem more and more irrelevant for the evolving situation in China. China's authorities should therefore consider substantially modifying, or even giving up these experiments altogether.

xli. An intergovernmental committee to tackle the various issues in intergovernmental fiscal relations should be established. The committee, manned by both local and central representatives should solve the technical issues in implementing intergovernmental fiscal reform. The committee should make proposals for the criteria governing the equalization fund. They should be in charge of drafting the suggested Local Government Finance Law. The committee may evolve into the administrative body that manages the interprovincial equalization fund.

xlii. The erosion of equalization through the fiscal system should be stopped now. Government should consider to increase the lump sum transfers to poor provinces right away, without waiting for the fundamental revision of the system. Also, cofinancing requirements for earmarked grants could be differentiated among provinces, to account for the different fiscal capacity. Both measures could be financed with cutbacks in price and SOE subsidies. The equalization payments could be gradually enlarged as the new interprovincial equalization fund will be established. This fund should be built up gradually, starting with a low percentage of all shared taxes. This percentage would then gradually be increased until the structural level is reached. In this way, local governments could easily adjust to the small changes, and probably can pay their "contribution" to the fund out of overall revenue increase.

Links with Other Reforms

xliii. The above recommendations could be implemented independent of other reforms, their impact would be enhanced by reforms in other sectors. The main linkages are spelled out below.

xliv. **Financial Reforms.** The speed at which delineation of government from the rest of the sectors can proceed and thus the budget unification can be completed depends on the speed of reform in other sectors. In particular, financial sector reform and enterprise are essential for progress in the budgetary sphere. The further development of the emerging stock markets will yield better alternatives to the financing of enterprise investment than the banking system. Developing a long-term bonds market would equally improve enterprise funding, would reduce the need for bank finance of budget deficits, and would enable government to better spread debt repayments. A well functioning financial market could relieve the budget from the present task to mobilize resources for national investment programs. Finally, a reformed banking system will help imposing hard budget constraints on state owned enterprises, a necessary condition for enterprise reform.

xlv. **Enterprise Reform.** Enterprise reform will substantially affect the budget, as it will reduce subsidies, and may increase revenues. Until SOEs operate on a for-profit basis, and are no longer used for implementing government policies, such as minimizing open unemployment in the course of price reforms, the financial links between SOEs and government will go beyond those in other mixed economies. These links, as long as they last, should appear on the budget, however, and not be hidden in the financial system.

xlvi. **Regulatory Framework.** Central government should fill the regulatory void that gives leeway to regional protectionism. Government should prepare and issue national laws

regarding competition, company law and contract law to fill the institutional void, which gives localities protectionist leeway. Central government should strengthen its capacity to monitor local government's implementation of national tax laws and regulation. MOF should start the preparations of a national tax system. The system would curtail illegal and inefficient tax exemptions by local government, and would facilitate the introduction of a new tax and tax sharing system.

I. BUDGETARY POLICY AND INTERGOVERNMENTAL FISCAL RELATIONS: AN INTRODUCTION

A. CHINA'S BUDGET AND THE CHANGING ROLE OF GOVERNMENT

1.1 Government budgets reflect the outcome of the political process in which choices are made among competing demands for limited resources, and the size of government activities in the economy is decided upon. Budgets can be a powerful tool for allocating national resources, setting national priorities, determining the relative size of the private and public sectors, and expressing the nature of intergovernmental relations. To the extent that budgets weight, articulate, and legitimize the demands from all interested parties, translating them into a "collective interest," the budget could be seen as an expression of the country's "revealed preferences."^{1/}

1.2 **Toward a Mixed Economy.** In broad terms, the goal of economic reform in China ^{2/} has been to institute an economic system in which:

- (a) the government would continue to play a central role in economic management in terms of: formulating and implementing laws and regulations; formulating and applying economic policies, and establishing and readjusting the management system. Instruments should focus more on macroeconomic management and rule-based approaches with emphasis on market-determined prices in products and production factors;
- (b) the government would participate in providing of social services and welfare but through mechanisms and institutions that would facilitate efficient risk pooling and service delivery, with more equitable burden sharing between individuals and the government sector;
- (c) the government would continue to decentralize its participative role and enable the enterprise sector to make its own decisions on investments, products, and quantities to be produced and sold, responding to market forces. Market forces

^{1/} As discussed in some of the public finance literature dealing with the theory of the public interest, "It is less elegant, but not less scientific, to take as a starting point for evaluation of social actions the revealed objectives of society instead of the derived ones." P.O. Steiner, "Public Expenditure Budgeting," in A.S. Blinder (ed.), *The Economics of Public Finance*, Washington, Brookings, 1974.

^{2/} For a comprehensive review of the "reform decade," see *China: Country Economic Memorandum—Planning and Reform in the 1990s*, World Bank, Washington D.C., 1992.

would increasingly determine the allocation of resources, and the government would rely more on indirect policy instruments;^{3/}

- (d) the government would decentralize operations within the government sector and enable local governments at different levels to perform specified government functions, encouraging competition and performance comparisons in the provision of public goods;
- (e) planning, focusing on channeling of public investments to key sectors, and market principles would coexist in a complementary fashion.

1.3 Progress along these lines are transforming China into a "mixed-economy,"^{4/} where public policies would be mainly conducted according to rules and indirect fiscal and monetary instruments common to industrial and developing countries.

1.4 **Fiscal Policy and Fiscal Reform in China.** Fiscal policy in a market based economy aims to: (a) promote macroeconomic stability; (b) enable efficient allocation of scarce resources; and (c) guaranty equitable outcomes of the economic process. The increased openness of China's economy will make fiscal policy *the* dominant macroeconomic policy tool, but fiscal policy will also play the dominant role in allocation and income redistribution, as central economic planning further recedes. Reforms to equip government with the appropriate tools for fiscal policy in the market based economy are therefore a matter of urgency.

1.5 This report discusses two crucial elements in the fiscal infrastructure: budgetary policy and intergovernmental relations, but China's fiscal system needs reforms in other areas as well, and earlier World Bank Studies have addressed these in detail.^{5/} Necessary reforms include: (a) transforming China's revenue system into a true tax system; (b) broadening China's tax base; and (c) modernizing tax collection needs to be modernized. The experiments of separating taxes and profits goes in the direction of a true tax system, but implementation is held up by reluctance to phase out the tax deductibility of debts, and issue that could be solved by grandfathering these debts. The extension of VAT and Business Tax to a wider category of goods and services is diversifying the tax system, but the complicated rate structure remains a barrier to an equitable and efficient system. The reformed tax system will only be effectively enforced with a solid collection mechanism, and with the increased income flows across provinces, and the loosening of ties between SOEs and government, a national tax system becomes necessary. Proper arrangements of intergovernmental finance as discussed in this report will make it feasible as well.

1.6 China's budget system mirrors the profound changes that have taken place in society and the organization of the state since the late 1970s. Gradually the state budget has evolved from an all-encompassing account of the public sector into a reflection of the accounts

^{3/} In the Chinese literature, this is usually referred to as "the state regulating the market and the market guiding the enterprises."

^{4/} Since the 14th party congress, one could use the term "socialist market economy."

^{5/} World Bank, "China: Revenue Mobilization and Tax Policy," Washington, D.C., 1990; and "China: Reforming Intergovernmental Fiscal Relations," Washington D.C., November 27, 1991.

of the general government (central plus local governments). This redefinition of the scope of the functions and economic activities of the government has been carried out through a process of devolution of functions to financial and nonfinancial public enterprises and local governments. The budget also reflects the changing government's economic role in carrying out development objectives, while reducing its direct role in the production of goods and services.

1.7 In addition to the change in the coverage of governmental activities, the evolution of the budget also reveals the extent to which expenditure priorities have been altered during the years of reform, as a response to changing policies, for example, away from military expenditures and toward social sectors like education and health. The budget also summarizes the financial implications of the compromises made during the reform to achieve sometimes contradictory objectives: reforming relative prices in favor of the agricultural sector, while protecting urban standards of living; and giving a larger role to markets and competition, while at the same time shielding state-owned enterprises (SOEs) from those same forces.

1.8 **Outline of the Chapter.** This chapter presents a brief overview of the main trends in budgetary revenues and expenditures and in the fiscal deficit and its financing since the beginning of the reforms. Then, it discusses the change in governmental expenditure priorities in a few main categories whose importance has increased or declined during the last years. Three annexes to this chapter include a detailed definition of the main expenditure items in the Chinese classification of the budgetary accounts (Annex 1.1), and a detailed discussion of the fastest growing budgetary expenditures (debt service, Annex 1.2 and the Government's wage bill, Annex 1.3).

B. TRENDS IN EXPENDITURES AND REVENUES

1.9 Trends in aggregate budgetary revenues and expenditures and in the fiscal deficit and its financing in 1978-91 are reviewed below.

1.10 **Budgetary Expenditures.** Following the overall retrenchment of the government from the economy, budgetary expenditures declined from 31 percent of GNP in 1978 to 20.4 percent in 1991 ^{6/} (Table A-1.2). The greatest cuts have been in capital expenditures, from 12.6 percent of GNP in 1978 to 3.9 percent in 1991, as SOEs were excluded from the state budget in the course of reform. Further sharp cuts took place over those same years in national defense spending, from 4.7 percent of GNP to 1.8 percent. Against the general trend, nondefense current expenditures rose slightly, from 13.7 percent of GNP to 14.7 percent; social expenditures, administration, and price subsidies all grew moderately in terms of GNP, while debt service grew very rapidly (see Annex 1.2).

1.11 **Budgetary Revenues.** Over the reform period, China's budgetary revenues have declined significantly, from 31.3 percent of GNP in 1978 to 16.8 percent in 1991.^{7/} While the decline in revenue in terms of GNP was intended, nonetheless, it became a major concern of the Chinese government, a main driving force in the decline in expenditures, and the cause of recurrent changes in the fiscal system and in central-local fiscal relations. However, with the

^{6/} Chinese definition. Due to lack of detailed statistics, it was not always possible to use data compatible with the international practice.

^{7/} Chinese definition, excluding debt issued.

benefit of hindsight, the decline in revenues is not surprising and can largely be explained as a direct consequence of the government's economic reforms. The main factor behind the decline in revenues has been the reduced budgetary contributions from SOEs—direct tax payments and profit remittances—which fell from 20.6 percent of GNP to less than 5 percent during the period, while enterprise losses—registered as negative revenue—grew strongly. Enterprise income reached 55 percent of total revenues through the mid-1970s before tax reform reduced this component to virtually zero in the mid-1980s.^{8/}

1.12 The reduction in SOE contributions was caused by a combination of reform initiatives that transferred resources from the government to the enterprise sector and policies relaxing entry, resulting in increased competition.^{9/} The profit-retention schemes, enterprise retention of depreciation funds, and the deduction of pretax amortization before tax payments gave the SOEs more autonomy, but at the same time, reduced fiscal control over resources. More pronounced was the erosion of the government's fiscal capacity by market forces: (i) relative price adjustments shifted profits from the heavily taxed industrial sector to less taxed sectors, notably agriculture and rural enterprises;^{10/} (ii) increasing competition in the industrial sector, especially from town and village enterprises (TVEs) and collective enterprises but also from abroad, depleted SOE monopoly rents and reduced government revenues. During this period, taxes on international trade and personal incomes did not increase nearly enough to offset the decline in enterprise income taxation.

1.13 Expenditure Shares.^{11/} In recent years more of the budget has gone to provide "purer" public goods and services (infrastructure and social services) and less industrial investment and production financing, as the general government's scope and coverage was reduced. With the notable exception of debt service, some of the most rapidly rising expenditure categories have increasingly fallen on resource-starved local budgets, forcing them to look to other extrabudgetary sources of income to finance their current and capital expenditures (Chapter 3). The main changes in the relative shares of the goods and services financed by the budget between 1978 and 1991 were (Figure 1.1):

- (a) Capital Construction. A large portion of fixed capital formation could be decentralized from the budget to nonfinancial public enterprises. As a result of

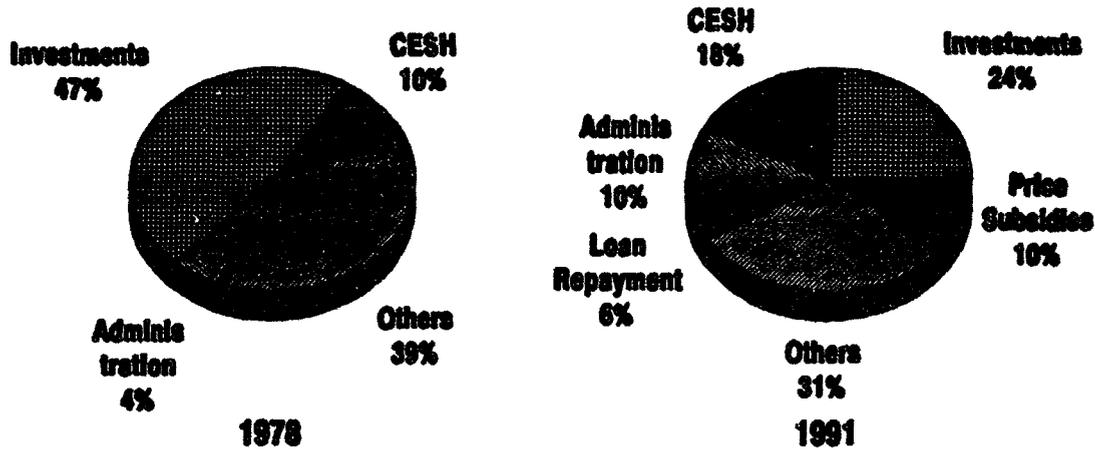
^{8/} C. Wong, "Fiscal Reforms and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China," *Modern China*, Vol. 8, No. 2, April 1992, pp. 197-226.

^{9/} Barry Naughton, "Implications of the State Monopoly over Industry and its Relaxation," *Modern China*, Vol. 18, No. 1 (January 1992), pp. 14-41.

^{10/} See World Bank, "China: Revenue Mobilization and Tax Policy," Washington D.C. 1990; Christine P.W. Wong, "Central-Local Relations in an Era of Fiscal Decline: the Paradox of Fiscal Decentralization," *China Quarterly* (December 1991).

^{11/} The Chinese classification of budgetary expenditures has not kept pace with the changing nature, coverage, and increasing complexity of public activities. The traditional classification includes 13 main heads of account (Table 1.1), combining functional and economic criteria, and without distinguishing between current and capital expenditures. At a more disaggregated level (Annex 1.1), China's budgetary expenditures are classified into 29 main items, with the same shortcomings mentioned above, which limits the informational content and utility of the budgetary information for analytical purposes.

Figure 1.1: SHIFTS IN BUDGETARY EXPENDITURES
(percent of total expenditures)



Note: Investment—Capital Construction and Technical Transformation.

Source: Table 1.2.

increasing differentiation between the economic functions of the public sector.^{12/} A portion of which was financed by extrabudgetary funds (Chapters 2 and Annexes 2.4-2.6). The share of capital construction ^{13/} in total budgetary outlays fell by half, from over 40 percent of total expenditures in the late 1970s (almost 13 percent of GNP) to about 20 percent (less than 4 percent of China's GNP) in 1991. A further decline is budgeted for 1992. The change in the share of capital construction expenditures in the state's budget hides the drastic decline in local government's share of these expenditures: in 1978 the central:local split was about 56:44, in 1991 it was 74:26, and it is expected to decline to 79:21 in the 1992 budget. While the share of capital construction was cut in half during the reform years, it also became an expenditure responsibility more concentrated at the center.

^{12/} Including the general government (central and local governments), nonfinancial and financial institutions.

^{13/} See definition, in Annex 1.1.

Table 1.1: STATE BUDGETARY EXPENDITURES
(Y billion and percent)

Item	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Total Expenditures	111.1	127.4	131.3	111.5	129.2	154.6	184.5	233.1	244.2	270.7	304.0	345.2	379.2	412.0	
Of which:															
Capital construction	45.2	51.5	41.9	33.1	30.9	38.3	48.9	58.4	67.2	62.8	63.3	62.6	72.6	72.4	
Working capital	6.7	5.2	3.7	2.3	2.4	1.3	1.4	1.4	1.2	1.2	1.0	1.2	1.1	1.1	
Technical updating and transformation	6.3	7.2	8.0	6.5	6.9	7.9	10.3	12.5	12.5	15.1	14.6	15.4	18.4	18.0	
Geological prospecting	2.0	2.2	2.3	2.2	2.3	2.6	3.0	3.1	3.0	3.3	3.3	3.5	3.8	4.3	
Industry, transportation and commerce	1.0	2.1	2.3	2.4	2.4	2.8	3.1	3.5	3.5	4.2	4.5	4.5	5.2	5.6	
Agriculture	7.7	9.0	8.2	7.4	8.0	9.6	10.1	12.4	13.4	15.9	19.7	22.2	24.3	26.0	
Culture, education science and health	11.3	13.2	15.6	17.1	19.7	22.4	26.3	31.7	38.0	40.3	46.6	55.3	61.7	69.9	
Education	6.6	7.7	9.4	10.2	11.6	12.8	16.8	18.4	22.7	23.7	27.9	31.6	35.3	40.6	
Science and social relief	1.9	2.2	2.0	2.2	2.4	2.5	3.6	3.7	4.2	4.8	5.0	5.5	6.8	6.7	
National defense	16.8	22.3	19.4	16.8	17.6	18.1	19.2	20.1	21.0	21.8	21.8	25.1	29.0	33.0	
Government administration	4.9	5.7	6.7	7.1	8.2	10.2	13.7	16.4	19.5	19.2	23.9	28.5	38.0	40.2	
Payment of loans	-	-	-	-	-	-	-	-	8.0	8.0	7.7	7.2	19.0	24.6	
Price subsidies	-	-	-	-	-	-	-	-	29.5	29.5	31.7	37.4	38.1	37.1	
Other	-0.1	-0.9	-1.1	-2.1	-2.4	-1.8	-0.1	7.0	0.7	4.0	2.4	39.6	44.6	45.5	
Share in total expenditures															
Capital construction	40.66	40.42	34.54	29.69	26.60	29.62	31.63	31.65	28.83	25.64	23.38	20.59	21.03	19.14	
Working capital	6.03	4.08	3.05	2.08	1.01	0.65	0.76	0.43	0.49	0.39	0.26	0.32	0.27	0.27	
Technical updating and transformation	5.67	5.65	6.60	5.83	5.98	7.24	6.68	6.10	6.10	6.88	6.68	6.39	4.66	4.57	
Geological prospecting	1.80	1.73	1.90	1.97	1.99	1.68	1.63	1.33	1.22	1.22	1.44	1.09	1.04	1.04	
Industry, transportation, and commerce	1.62	1.65	1.90	2.15	2.17	2.01	1.90	1.59	1.35	1.44	1.48	1.36	1.37	1.36	
Agriculture	6.93	7.06	6.76	6.64	6.94	6.73	5.47	5.32	5.47	5.87	6.48	6.43	6.41	6.31	
Culture, education, science and health	10.17	12.86	15.34	17.09	17.32	17.01	17.18	16.30	16.46	17.96	18.19	18.43	17.87	18.69	
Education	5.94	6.94	7.75	9.15	10.06	9.90	9.27	9.18	9.27	10.21	10.39	10.23	10.70	-	
Science and social relief	1.21	1.23	1.65	1.67	1.62	1.66	1.54	1.60	1.51	1.55	1.64	1.59	1.79	1.63	
National defense	17.12	17.39	15.99	15.07	15.26	13.69	13.71	13.41	12.07	11.51	11.21	12.30	11.04	10.44	
Government administration	4.41	4.47	5.32	6.37	7.11	7.09	8.06	7.81	7.96	8.03	8.98	9.36	10.02	9.76	
Payment of loans	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.16	
Price subsidies	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Other	-0.09	-0.71	-0.91	-1.68	-2.06	-1.39	-0.06	3.79	0.30	1.63	0.89	13.03	1.07	11.04	
Total expenditures/GNP	30.96	31.87	27.16	23.36	22.20	22.26	22.21	21.53	24.04	21.67	19.36	19.25	19.04	20.37	
Capital construction/GNP	12.60	12.88	9.37	6.93	6.56	7.02	6.82	6.93	6.96	6.93	4.53	3.96	4.16	3.70	
Social expenditures/GNP	3.15	3.30	3.49	3.79	3.66	3.70	3.82	3.82	3.77	3.57	3.48	3.650	3.75	3.83	
Administrative expenditures/GNP	1.37	1.43	1.63	1.69	1.68	1.76	1.68	1.68	1.66	1.73	1.71	1.81	1.91	2.04	
Price subsidies/GNP	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
National defense/GNP	4.68	5.38	4.34	3.52	3.29	3.24	2.84	2.07	2.60	2.61	1.56	1.69	1.67	1.77	
Noncurrent item	358.8	399.8	447.0	477.3	519.3	560.9	606.2	656.8	693.6	740.1	798.4	857.9	914.0	961.8	
GNP	358.8	399.8	447.0	477.3	519.3	560.9	606.2	656.8	693.6	740.1	798.4	857.9	914.0	961.8	

Source: China: Statistical Yearbook, 1990 (Tables T6.1 and T6.8) and MOF. It assumes real GNP growth of 7.5 percent in 1992.

- (b) **Technical Upgrading and Transformation.**^{14/} The share of these investments have made up a stable portion (5.5-7 percent) of total budgetary expenditures over the first ten years of reform. Since the 1988 austerity program, these expenditures have slightly declined in relative importance, a trend that is expected to continue as SOEs finance an increasingly large proportion of their investments with depreciation funds, retained earnings, and commercial borrowing (Annex 2.4). The share of capital construction and technical renovations taken together provides a better picture of budgetary investments. This share fell from 47 percent of total budgetary outlays in 1978 to 24 percent in 1991.
- (c) **Culture, Education, Science and Health (CESH).** Social expenditures are by now the largest category of budgetary outlays, almost doubling their share in budgetary expenditures between 1978 and 1991, from 10 percent in 1978 to about one fifth in 1991. This rapid growth can be largely explained by the rise in educational expenditures, up from about 6 percent of total expenditures in the late 1970s to almost 11 percent in 1991. The new, higher plateau was achieved early in the reform period, where the most drastic changes in the composition of expenditures took place. Since then, the share of education has remained constant, at about 58 percent of social expenditures. Health expenditures have also increased their share in total expenditures (Box 3.3). For both categories of expenditures, administrative costs (especially labor), absorb as much as 80-90 percent of total outlays. The rapid rise in real wages over the last years might have eroded the supply of these services in real terms.
- Contrary to the change in the center-local split for capital construction, the split for CESH expenditures has remained practically unchanged at a ratio of 11:89, with most social expenditures in the local budgets (Table A-3.8).
- (d) **Government Administration.** The share of administrative expenditures has grown constantly since 1978, from 4.4 percent of total budgetary outlays in 1978 to about 10 percent in 1991, reflecting a rising number of government employees and rapidly rising nominal wages (Annex 1.3).
- (e) **Repayment of Loans.** MOF started to place government bonds in China's domestic market only in 1981. At first these placements were carried out through mandatory allocations, but more recently via voluntary placements increasingly among households. The late start and the modest size of the early issues ^{15/} led initially to a slow increase of the government's domestic debt. The outstanding volume of government paper in December 1985 amounted to less than Y 24 billion, 2.8 percent of China's GDP. Since 1987, however, the

^{14/} Technological upgrading and transformation is artificially distinguished from capital construction by the size of the investments and share of civil works in investment projects as well as by their organizational affiliation, see Annex 1.1.

^{15/} The bonds issued from 1981 to 1984 averaged about Y 4.4 billion a year and were issued with a maturity of ten years, redeemable in equal portions starting in 1986. The larger 1985 bond issue (about Y 6 billion) carried a shorter, five-year maturity.

volume of treasury securities issued swelled; diversification (and cost) of the instruments used have increased; and maturities have shortened. Although the overall "visible" ^{16/} government deficit to be financed (by domestic and foreign sources) ^{17/} has averaged 2.3 percent of GNP annually since 1987, the size of the government's domestic debt in December 1991 was more than five times its 1985 level, Y 122 billion ^{18/} or 6.5 percent of GNP. The *overall size* of the government's domestic debt remains small by international standards, not only vis-à-vis China's GNP, but also considering its high savings rate,^{19/} and rapid economic growth. Yet the debt structure has created persistent financing and servicing difficulties for the authorities.

The rapid rise in the public debt after 1987 (Annex 1.2) in a still embryonic domestic capital market ^{20/} and, more important, the continuous shortening of new treasury bond maturities ^{21/} has resulted in a "bunching" of amortization and interest payments (payable upon maturity) which ended in a severe "liquidity crunch" in 1990. As a result of these changes, the share of debt repayment in total budgetary outlays has risen from 2 percent in the mid-1980s to 6.5 percent in 1991 and an estimated 10.5 percent in 1992—all of it has fallen in the lap of the central government. Management and financing of other budgetary categories has increased, forcing the central government to renegotiate tax contracts and other predatory practices, with the negative incentives mentioned above (Chapter 3).

- (f) **Price Subsidies.** After 1986, when price subsidies were reflected as an expenditure item, their share in total budgetary outlays grew to a peak of about 12.3 percent in 1989. As price reforms were adopted, subsidies' share started to decline, to an expected share of 8.2 percent in 1992. In terms of the budgetary "outlet," about 85 percent of all price subsidies are reflected in local budgets, though largely financed out of earmarked central grants.

^{16/} To contain the size of the measured deficit, many budgetary obligations have been shifted to the banking system.

^{17/} Between two-thirds and three-quarters of the government's overall deficit in the last five years (1987-91) has been financed domestically.

^{18/} Includes the outstanding volume of government bonds and issues classified under "Financial Institutions," with the exception of the "Banks' Financial Bonds" (Annex Table 1.2).

^{19/} In 1987-91, China's Gross National Savings averaged 39 percent of GNP.

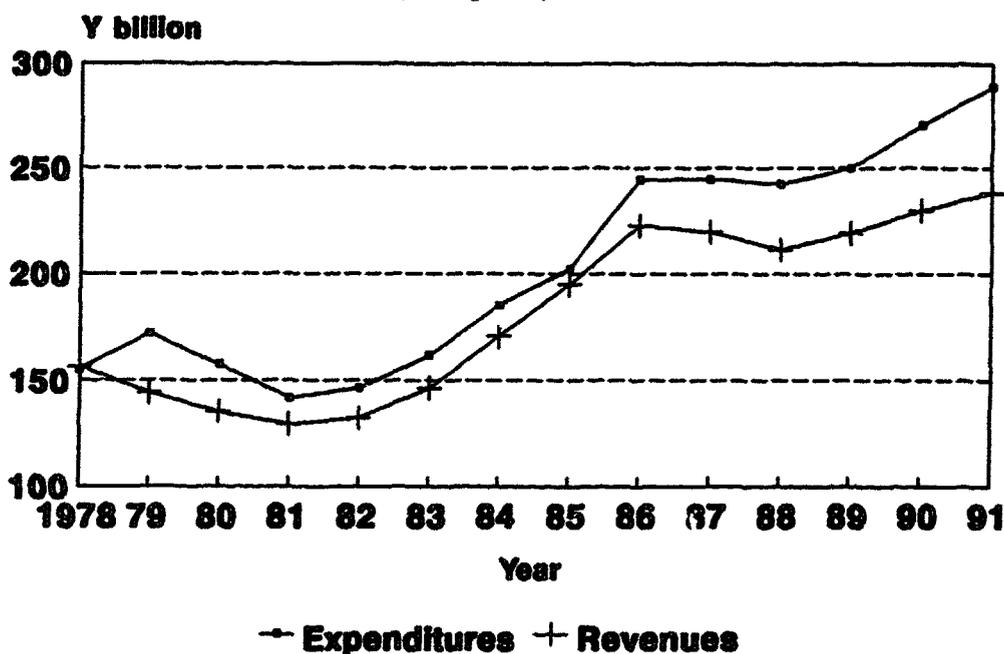
^{20/} Initially, with no secondary markets, MOF issues accounted for practically all outstanding market instruments (not including CDs). Since December 1991, government paper has accounted for about 70 percent of all outstanding debt (again excluding CDs). See Annex Table 1.2.

^{21/} From ten years in the early 1980s, to five years in 1985, and recently to three years.

C. ISSUES

1.14 **Measuring the Relative Decline in the Size of the Government.** The decline of government share in GNP has been a major concern of Chinese authorities. However, despite the undeniable decline in the share of government in GNP, both government expenditures and revenues ^{22/} have experienced significant growth *in real terms*. Real expenditures grew by an annual 4.8 percent over the whole reform period (1978-91), and by 7.3 percent between 1981 and 1991 (Table A-1.3 and Figure 1.2). Real revenues grew less, but still increased by an average of 3.2 percent per year between 1978 and 1991, and by 6.3 percent in 1981-91. Thus, government's shrinking share of GNP does not imply a loss of control over real resources, but merely a lagging behind the total economy's exceptional real growth.

Figure 1.2: ON THE RISE
Real Budgetary Revenues and Expenditures
(1987 prices)



Source: MOF Data; China CEM.

1.15 **Recasting the Budget.** To make a meaningful assessment of the recent change in the government's share, certain adjustments need to be made, as Chinese fiscal statistics do not follow international practice.^{23/} The main ones are:

- (a) Subsidies to loss-making enterprises and, before 1986, price subsidies for daily living necessities, are treated as negative revenues rather than expenditures;

^{22/} Chinese definition, corrected for debt issue.

^{23/} For an elaborate discussion of the differences, see: World Bank, "China: Revenue Mobilization and Tax Policy," Washington D.C. 1990, p. 9-10.

- (b) Debt issued is treated as revenue rather than as a financing item "below the line";
- (c) Debt (principal) repayments are treated as expenditures, rather than as a negative financing item. Adjusted for these accounting differences over the reform period, both expenditures and revenues still follow the declining trend in terms of GNP, but at a higher level. Expenditures decline from 34.1 percent of GNP in 1978 to 22.5 percent in 1991; and revenues fall from 34.4 percent to 19.8 percent over the same period (Table A-1.4).
- (d) Chinese fiscal statistics differ from the International Monetary Fund (IMF) standard classification ^{24/} in the treatment of extrabudgetary revenues. About 80 percent of total extrabudgetary funds consist of enterprise depreciation funds and retained earnings, which should not be included at all as part of the government's fiscal accounts.^{25/} The other categories of extrabudgetary revenues of local finance bureaus and administrative and nonprofit units should be considered fiscal revenue. We label these funds *fiscal extrabudgetary funds*, and consider them as part of general government revenue.^{26/} They should therefore be brought into the budget (Chapter 2). On the expenditure side, no statistics on extrabudgetary expenditure per institution are available. However, as a general rule, entities that collect the revenues are also entitled to spend them.^{27/} Fiscal extrabudgetary expenditures are therefore assumed to be equal to the fiscal extrabudgetary revenues.^{28/}

1.16 **Adjusted Figures.** The budgetary expenditures adjusted for the GFS format, including fiscal extrabudgetary expenditures, show the same declining trend in terms of GNP as the Chinese figures discussed above. However, the government's much higher share over the whole reform period fell from 36.8 percent in 1978 to 26 percent in 1990 (Figure 1.3 and Table A-1.4). The revenue decline is similar as before, but the levels differ from the Chinese figures.

^{24/} IMF, *"A Manual of Government Finance Statistics,"* Washington D.C., 1986.

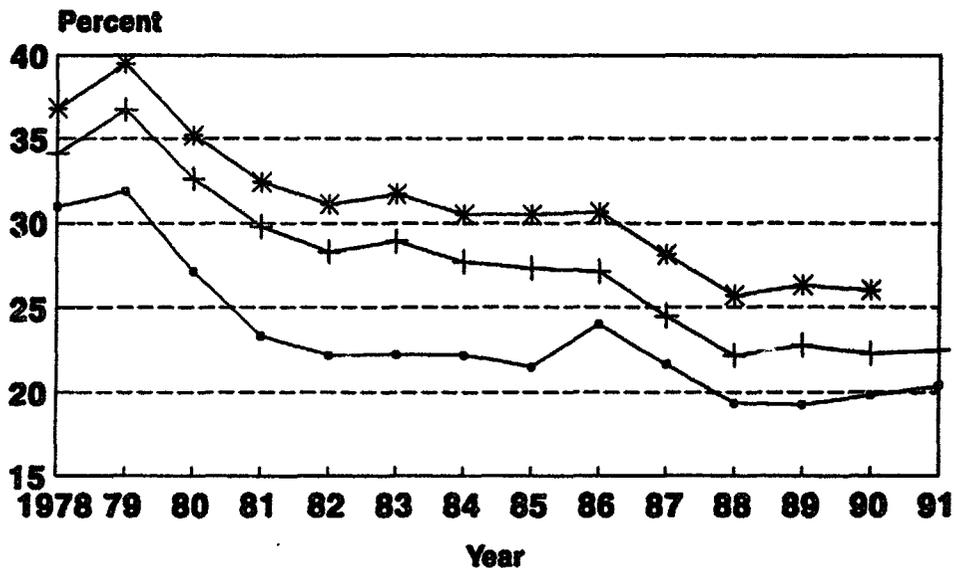
^{25/} One modification applies here: the Chinese government exercises considerable control over the SOE extrabudgetary funds, indirectly through regulation but also directly, because MOF and the finance bureaus still exercise substantial influence over day-to-day management (the State Council's *"Circular on Strengthening the Management of Extrabudgetary Funds"* (April 13, 1986) speaks of "planned management with policy guidance"). To the extent that this influence is used to pursue government goals instead of enterprise goals, extrabudgetary revenues could be considered quasi-taxation.

^{26/} See IMF, *A Manual of Government Finance Statistics*, p.8, where "Nonprofit Institutions mainly financed and effectively controlled by government" fall under the general government. During the mission it was suggested that some of the nonprofit units were financially self-sufficient, but for lack of detailed data, all of them are treated as general government.

^{27/} See the State Council's *"Circular on Strengthening the Management of Extrabudgetary Funds,"* (April 13, 1986).

^{28/} This assumption neglects (i) a difference in timing of revenues and expenditure and (ii) the use of fiscal extrabudgetary funds for reducing budgetary deficits (Box 3.2).

Figure 1.3: SHIFTING PERCEPTIONS
Budgetary Expenditures Adjusted
(percent of GNP)



— Chinese Definition + Excl. Extrabudgetary * Incl. Extrabudgetary

Source: MOF data; for adjustments, see text.

1.17 The adjusted figures shed a different light on government's declining share: (a) a 26 percent share of GNP is comparable with the share of other Asian developing countries which averaged 27.0 percent in 1988;^{29/} (b) the decline was to a considerable extent the consequence of the policy of increased autonomy for SOEs, which accounts for almost half the fiscal decline.^{30/} If the decline in defense expenditures is included, about 80 percent of the fall can be accounted for.

1.18 Apart from the extrabudgetary expenditures, a number of offbudget activities can be considered as government, the most important being: quasi-fiscal activities of the banking system; social expenditures of SOEs; and offbudget defence expenditures. Quasi-fiscal activities of the banking system could add up to as much as 6.8 percent of GNP in 1991.^{31/} Social spending by SOEs could amount to as much as 3-4 percent of GNP, and an equal amount could be spend on defence outside the budget. Since detailed data are lacking, a comprehensive view of expenditures on government functions cannot be established, which is a concern in itself.

^{29/} See Ke-young Chu and Richard Hemming, eds., "Public Expenditure Handbook," (Washington D.C. 1991), IMF p.23.

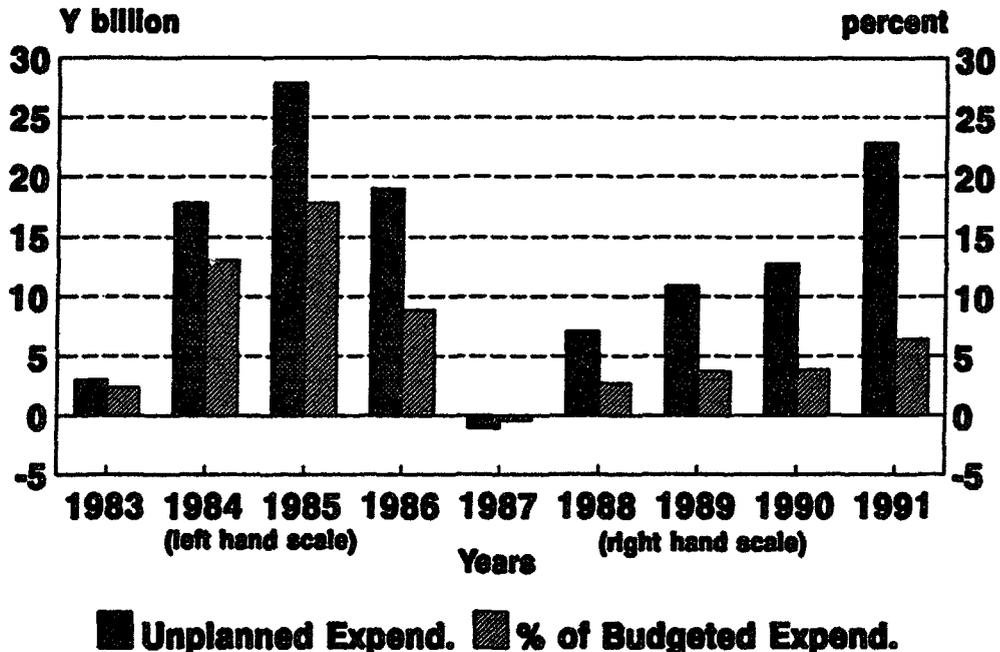
^{30/} The extrabudgetary funds of SOEs rose from 7 percent of GNP in 1978 to almost 12 percent in 1990.

^{31/} Wong, Christine et al, *Economic Reform and Fiscal Management in China*, Asian development Bank, February 1993 (draft).

1.19 To evaluate the government's share in GNP, China's authorities should first make the fundamental political decisions about its role in society, then judge what resources are required to perform that role in a cost-effective way. The budgetary process could be an effective tool for both steps, but at present in China, it is not.

1.20 **The Real Issues.** The concern over the "first ratio" is actually a concern over the inability to find a sustainable, noninflationary finance source for government expenditures, and as such not at the heart of this report. However, the apparent inability of the central government to contain spending within the limits of substantial *real* revenue growth and the resulting deficit is equally worrisome. A good illustration of this lack of control is the excess of actual expenditures over the budgeted expenditures (Figure 1.4), which, after a brief decline from the 1985 peak, have again been rising for the last four years. Apparently, budgetary procedures and practices cannot achieve the stated objectives of expenditure control and deficit reduction. Furthermore, the budget seems to be failing as an instrument for rational priority setting. For example, expenditures on price subsidies and SOE subsidies grew during the second half of the 1980s, pushing other more pressing expenditures off the budget. The lack of control and the lack of priority setting within the budget point to the need for budgetary reform (Chapter 2).

Figure 1.4: OUT OF CONTROL
Unplanned Expenditures (1983-91)



Note: Unplanned = Actual minus budgeted expenditures.

Source: Various Budget Speeches and MOF.

1.21 **Fiscal Deficit.** The State budget was in continuous deficit during the 1980s. Since 1987, the annual deficit has amounted to an average 2.3 percent of China's GNP. The deficit in 1986-88 was largely attributable to lagging state revenues after the adoption of provincial and SOE tax contracts. From 1989 through 1991, the financial position of the

government underwent a marked deterioration, with an overshooting of the *planned* deficit from 1.5 percent and 1.6 percent of GNP in 1990 and 1991 to *actual* deficits of 2.1 percent and 2.6 percent, respectively.^{32/} Since 1988, fiscal deficits have mainly reflected the state's difficulty in controlling expenditures. After the rectification program was adopted in 1988, the erosion of the state's budgetary revenues was temporarily reversed,^{33/} but other expenditures became more difficult to control.^{34/}

Table 1.2: EXPLICIT FINANCING OF STATE BUDGET DEFICIT
(Y billion and percent)

	1987	1988	1989	1990	1991
Deficit (Y)	24.7	33.4	37.4	36.8	50.1
Total	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
Domestic	<u>72.5</u>	<u>66.0</u>	<u>69.8</u>	<u>64.4</u>	<u>76.2</u>
PBC <u>/a</u>	47.0	52.3	-28.7	73.4	55.2
Other <u>/b</u>	53.0	47.7	128.7	26.6	44.8
Foreign	<u>27.5</u>	<u>34.0</u>	<u>30.2</u>	<u>36.6</u>	<u>23.8</u>
Gross	156.0	120.9	127.4	135.9	146.2
Amortization	-56.0	-20.9	-27.4	-35.9	-46.2

/a Gross credit to MOF less MOF's deposits at PBC.

/b Largely domestic bond issues (including Special Construction Funds).

Source: MOF and IMF.

1.22 **Financing the Deficit.** Since 1987, about a third of the state's average annual deficit (IMF definition) has been financed by foreign credit (Table 1.2). Amortization payments more than doubled between 1988 and 1991, and gross borrowing requirements have also increased rapidly (though from a small base). The complement of the state's financing requirements (70 percent) has come from domestic sources. Among the domestic sources, the relative shares of the People's Bank of China (PBC) and the domestic bond market have shown

^{32/} The same occurred in 1991, where preliminary data point to a deficit of 3.1 percent of GNP, 0.9 percent high than budgeted.

^{33/} Total revenues as a percentage of GNP increased by 0.5 points between 1988 and 1989 but again fell, to about 20 percent of GNP in 1990 and an estimated 19 percent in 1991.

^{34/} During the first year of the rectification program, subsidies (daily living necessities and operating losses of SOEs) rose by 0.7 points of GNP, reaching 6 percent of GNP in 1990 and absorbing over a quarter of total budgetary expenditures (26.7 percent). The need to stimulate the economy and finance increasing inventories, the postponement of tax increases (the business tax rate in 1991), the relaxation of administrative controls over capital construction, and unexpected expenditures (floods) made the fiscal performance worse than expected.

substantial instability over the last five years, although on average PBC has provided about 40 percent ^{35/} of the domestic funds, while 60 percent were raised in the domestic capital market.

D. OUTLINE OF THE REPORT

1.23 This report emphasizes the structural and institutional aspects of the budgetary system; it suggests options for reform and for allocating expenditure responsibilities by levels of government; it documents and analyzes the consequences of local government underfunding; and it examines the major changes in the investment finance system and its relationship with the plan and the budget.

1.24 Chapter 2 deals with the changing nature of the government budget system in China. It reviews the extent of modernization needed in budget institutions and processes to support economic reform and ways of improving their effectiveness as management tools. This review is meant to provide a framework for changing the budget system. The institutional framework and the associated budget processes are the focus of the chapter. A brief discussion of the evolution and current status of the budgetary system and review of recent initiatives to modernize it is followed by suggestions for future directions of improvements.

1.25 Chapter 3 deals with the assignment of expenditure responsibilities over levels of government in China, and its financing. China's expenditure and revenue assignment is put into international perspective. The chapter reviews the major trends in central-local shares of government expenditures and revenues over the reform period, and the pattern of expenditures and taxes across provinces. Special attention is given to the redistributive properties of China's system of intergovernmental transfers. The recommendations address the correction of the dysfunctional outcomes that emerged over the last decade.

1.26 The annexes to this report provide details on a number of institutional features and issues of China's fiscal system that fall outside the scope of the main report, but that may serve the reader who is unfamiliar with China.

^{35/} Excluding 1989, PBC's share is closer to 55 percent.

II. A FRAMEWORK FOR BUDGETARY REFORM

A. INTRODUCTION

2.1 This chapter examines the changing nature of the government budget system in China. It reviews how far budget institutions and processes need to be modernized to support economic reform and how to make them more effective policy tools. This review provides a framework for changing the budget system and focusses on the institutions and the associated budget process. The chapter discusses the current status of the budgetary system, recent initiatives to modernize it discussed and offers suggestions for further improvements.^{1/}

2.2 An assessment of China's budgetary system, and recommendations for improvements require a well-stated vision of the emerging needs of China's economy. Chapter 1 argues that China is heading toward a mixed economy; this chapter evaluates current budgetary practices against those practices required for this type of economy. However, the chapter recognizes the features incompatible with the role of government in mixed economy may remain on China's budget for some time to come. The chapter provides—where appropriate—recommendations on immediate steps toward the future role of the budget, while accommodating for these special features.

2.3 Government budgets have three main functions in a mixed economy: (a) a tool of accountability at government agency level; (b) a tool of management, emphasizing efficiency in achieving certain goals; and (c) an instrument of economic policy, contributing to growth, macroeconomic stability, and equity.^{2/} To perform these functions, budgets should ideally have a number of features:

1/ Some limitations of this report should be noted at the onset. First, because many budgetary details are kept confidential in China, not all the information that is usually public in other countries is available for analysis. Second, many issues that arise in the actual working of a system might be missed when work is constrained to a more general and static examination of the budgetary process. This chapter therefore deals mainly with the structural, institutional, legal and systemic aspects of the budget process, rather than operational procedures and related issues. Third, abundant definitional discrepancies in the concepts used in China make reconciling budgetary operations into internationally comparable formats most difficult. Fourth, for lack of disaggregated information, three areas relevant to the budget process could not be covered in detail: accounting, cash management and fiscal reporting. The annexes to this chapter summarize the mission's understanding of key budgetary regulations (Annex 2.1); describe the functions and organization of core agencies and departments (Annex 2.2); outline the characteristics of the management information system (MIS) and fiscal reporting system (Annex 2.3) under the aegis of the Ministry of Finance (MOF); and describe the main channels and mechanisms of investment finance (Annexes 2.4-2.6).

2/ A. Premchand, *Government Budgeting and Expenditure Control*, IMF, Washington D.C., 1990.

- (a) **The scope of the budget should be clear. This requires:**
 - **Unity.** The government budget should clearly define the government as a juridical entity, show all financial transaction for purposes of legislative approval but leave out nongovernment transaction. For purposes of economic analysis, supplementary documentation submitted with the budget would provide more comprehensive economic information.
 - **Clarity.** The classification of budgetary items into categories should be clear and consistent and should serve the purpose of control, accountability, and efficiency. Classification should also serve as a tool for planning and managing each agency's internal activities.
- (b) **The effectiveness of the budget as a policy tool depends on:**
 - **Operational Adequacy.** The budget should meet the operational needs of enhancing efficiency in fiscal management. In addition, it should be an effective management tool for public policy and should be able to meet the changing needs of an economy in transition.
 - **Compliance.** The budget provisions should be complied with and the design of rules and regulations, the control capacity, as well as built-in incentives, should be such that compliance is encouraged.
 - **Regularity.** The budget process should have a well-established periodicity, allowing the budget to become operative when the fiscal year begins. The budget calendar should be designed to suit and serve the objective of regularity.
- (c) **The budget should have an informational role, requiring:**
 - **Publicity.** The details of the budget should be easily accessible to economic agents and the general public, serving the center as a communication vehicle to decentralized government agencies and economic agents.
 - **Accuracy.** Budgetary estimates should reflect the most likely outcome as accurately as possible. Given the uncertainties involved, mechanisms should be provided for managing contingencies.

Against these ideal features, the following sections will contrast present budgetary practices in China, identifying issues that need attention and suggesting reform options.

B. THE SCOPE OF THE BUDGET

Issues

(a) Unity

2.4 A budget's scope depends on the scope of government and the purposes of the budget. As government's scope changed in the 1980s, a retrenchment of the budget's coverage and a corresponding expansion of extrabudgetary transactions were normal. Not surprisingly, extrabudgetary funds increased enormously during the reform decade. At end-1990, extrabudgetary funds reached Y 270 billion compared with total budgetary revenues of Y 330 billion, over 80 percent of all central and local revenues. However, as analyzed below, almost 80 percent of this extrabudgetary revenues (Y 207 billion) were enterprise-owned funds, while the balance (Y 63 billion) were fiscal extrabudgetary funds controlled by public institutions and financial departments. Financial departments contributed to undermining budget unity by originating many overlapping budget and nonbudget transactions and by allowing government agencies to shift operations on and off-budget. Use of extrabudgetary funds for capital construction also contributed to the overheating of the economy and often created budgetary liabilities for future maintenance and operational expenditures.

2.5 **Borderline Between the General Government and Other Sectors.** Government units are broadly divided into three groups: (a) full budgetary units whose revenues and expenditures are included in the budget (e.g., line ministries); (b) differentiated budgetary units that receive budgetary support and whose revenue and expenditure gaps are filled with budget transfers (e.g., government print shop selling subsidized publications); and (c) self-reliant units that do not need any budgetary support and are permitted to retain their surpluses of receipts over expenditures (e.g., self-sufficient utility companies). Some of these units are empowered to levy fees and surcharges.^{3/} In addition, entities similar to enterprises (in that they are subject to taxes, receive subsidies, and must remit their profits to the budget) should be treated off-budget, with only the net flows shown in the budget.^{4/} However, this differentiation of the agencies' role vis-à-vis the budget has not been completed in China and confusion and overlapping persist.

2.6 **Extrabudgetary Funds.** The present definition of extrabudgetary funds is all-inclusive, encompassing transactions that should not be channeled through the State budget.^{5/} The principle of unity demands that all operations that are *in the nature of government transactions* should be fully accounted for in the budget. We define those extrabudgetary funds that are generated in such operations as fiscal extrabudgetary funds. Correspondingly, operations that are not in the nature of the government transactions should not be included in the budget,

^{3/} While their power to raise fees in theory is constrained by the Price Bureau, in practice they exercise discretion in raising revenues.

^{4/} Cash-operating surpluses of SOEs should be shown under nontax government revenue ("Entrepreneurial and Property Income"), while SOE losses should be classified under current expenditure as subsidies to nonfinancial public enterprises (distinguishing them from capital transfers to nonfinancial enterprises). See IMF (1986).

^{5/} Although they should be captured by a nonfinancial public sector budget.

except for their net effect, such as profit remittances from and subsidies to SOEs. Along these lines and consistent with the authorities' intention of fostering further economic reform and differentiation inside the public sector, SOE funds should not be included in, or denominated, as extrabudgetary funds. This would be in line with the "Regulations for Transforming the Operating Mechanisms of the SOEs." Fiscal extrabudgetary funds should be brought back into the budget and reclassified (ideally) according to internationally accepted practices.

2.7 Extrabudgetary funds expanded very rapidly as a result of the reforms initiated in the 1980s (Table A-2.1). Since not all the financial needs could be covered while continuing to manage the accounts of many units and SOEs within the scope of the State budget, a more flexible and decentralized management of "social funds" was found necessary. The explicit objective of extrabudgetary transactions was to allow increased flexibility. They were also supposed to change the structure of incentives to help revitalize SOEs, speed up growth, and renew the development of horizontal ties atrophied by prolonged overcentralization, and, in general, improve incentives for government units.

2.8 The decentralizing reforms are often seen by the Center as having gone too far and many advocate for a stricter control (that is, recentralization) of "social funds."^{6/} The argument needs to be examined by disaggregating extrabudgetary funds into their various components. Extrabudgetary funds fall under three broad institutional categories: (a) extrabudgetary funds of local finance bureaus, including, on the revenue side, surcharges on taxes set by local governments (for example, agricultural surcharges); (b) extrabudgetary funds of administrative agencies and institutions, including highway maintenance and other cost-recovery fees, market and other fees, collected by government units; and (c) extrabudgetary funds of SOEs, including earmarked funds for the Technical Transformation and Major Maintenance Funds (depreciation fund), retained profits, and short-term loans for circulation purposes (that is, working capital). Foreign investment and international loans are sometimes included in this category. In terms of composition, about 80 percent of these funds are owned by the enterprise sector. On the expenditure side, extrabudgetary funds are used to finance fixed-asset investment, major maintenance, bonuses and welfare payments, administrative expenditures, expenditures in the social sectors, transfers and taxes paid to the central government, increases in working capital and other earmarked expenditures (Box 2.1).

2.9 At present, extrabudgetary funds are not part of the budget, but they are subject to regulation in terms of those who are permitted to use them, the scope, the nature, and the purpose for which these funds can be used.^{7/} The original intention was to increase SOEs' and government units' flexibility in budgetary operations and provide incentives consistent with the policies of unified leadership and decentralized management. However, since 1986, extrabudgetary funds have been increasingly regulated, subject to annual budgets and presentation of final accounts. There is an awareness in China that "if we continue to limit our thinking to funds within the budget, the reform of the fiscal system would be limited in scope"

^{6/} The main reasons behind the call for tighter control over extrabudgetary funds were: to stop illegal forms of taxation, conversion of budgetary funds into extrabudgetary funds, excessive capital construction outside of the SPC approval process and plan, and diversion of earmarked extrabudgetary funds. See State Council "Circular on Strengthening the Management of Extrabudgetary Funds," April 13, 1986.

^{7/} See State Council, "Circular on Strengthening the Management of Extrabudgetary Funds," Beijing, April 13, 1986.

Box 2.1: 1990 EXTRABUDGETARY FUNDS
(Y billion)

Revenues: Classified according to agent		Expenditures: Classified according to use	
(i) Local finance dept.	: 6	Fixed asset investment	: 93
(ii) Administrative Agencies	: 57	of which:	
(iii) SOEs, of which:	: 207	Capital construction	: 27
Technical transformation	: 66	Technical transformation	: 66
Maintenance	: 37	Major Repairs	: 30
Retained profits	: 70	Welfare	: 24
Special purpose fund	: 30	Bonuses	: 11
Other	: 4	City maintenance and new product trial	: 5
		Road use fees	: 14
		Administrative agencies	: 18
		Culture, education & health	: 17
		Changes in working capital	: 5
		Transfers to budget	: 29
		Other	: 24
(iv) <u>Total</u>	: <u>270</u>	<u>Total</u>	: <u>270</u>

and, that therefore," [we must] direct our eyes and thoughts to the entire sum of social funds and deliberate the reform of the fiscal system comprehensively.^{8/} The argument for restoring budgetary unity should not be confused with a call for *recentralization*. It is a call for reclassifying fiscal operations and agencies to bring into the budget "conventional" sources of government funds and expenditures, which level of government should control these funds is discussed in Chapter 3. Commercial operations and remaining financial and nonfinancial enterprises and institutions should be taken out of the budget so as to demarcate the boundary between the general government sector and other sectors.^{9/}

2.10 **The Credit Plan.** PBC formulates the annual credit plan in consultation with MOF and SPC, taking into account the needs for investment in fixed capital and working capital, as well as PBC's direct financing of the government's deficit.^{10/} In recent years, the credit plan has been more involved in microeconomic, sectoral, and regional financing (Annex 3.2), by means of five channels of "policy lending": (a) allotting credit to supplement budgetary resources for investment in key sectors and enterprises not covered by the capital construction budget; (b) making up for shortfalls in budgetary allocations to individual projects when actual expenditures exceed budget appropriations (Annex 2.4); (c) providing support to loss-making

^{8/} Xiang Huaicheng, op. cit., p. 38.

^{9/} For definitions and conventions, see IMF, *A Manual on Government Finance Statistics*, Washington D.C., 1986.

^{10/} World Bank, *Financial Sector Policies and Institutional Development*, Washington, D.C., 1990.

SOEs; (d) finance agricultural inputs; and (e) clearing interenterprise arrears. The credit plan also involves allocation of credit at preferential interest rates to some regions and sectors while it is not clear how interest subsidies are met by the budget. PBC allocates credit to specialized banks which make project funds available, particularly to PCBC for capital construction lending. Banks must also finance out of their own funds "key construction projects"; after appraisal, technical transformation projects; and exercise choice in funding smaller projects. Thus, the credit plan operates as an extended arm of the State budget making it difficult to assess the sectoral and regional allocation of funds ^{11/} or the efficiency of their use, while concealing the true size of the public-sector fiscal deficit.

2.11 **Debt.** Mobilization of credit by government units is directly linked with the scope of the budget. The financial requirements of the general government should receive special attention for policy-making; different forms of classification are essential for different analytical purposes (for example, by type of debt holder and by type of debt instrument). In China, the lack of clarity regarding the budget's coverage leads to ambiguities about the nature of the obligations and guarantees that emerge (for example, sovereign versus nonsovereign foreign debts). The government's financial requirements need to be coordinated with those of nonfinancial enterprises for conducting short-term monetary policy. However, a comprehensive picture of the government's overall demand on aggregate savings very difficult to obtain due to: the dispersion of the approval process for local currency borrowing; the unconventional forms of borrowing sometimes used at the local level; the forced nature of some debts (interenterprise "triangular debts")^{12/}; the institutional weaknesses and lack of coordination of central agencies (MOF and PBC); and the speed with which securities markets develop and the embryonic state of the regulatory framework. In addition, while government routes budgetary loans through specialized institutions (PCBC), the debt servicing from these institutions to the government is not clearly reflected in the budget. The limited information of the budgetary authorities about fiscal extrabudgetary funds hinders assessing, the financial needs of government units and their repayment capacity. Ways of improving the efficiency of SOE use of credit is yet another aspect requiring the attention of the Chinese authorities. The existing system does not provide a separate recording and analysis of SOE use of borrowed funds.^{13/} As part of the preparation of a consolidated budget for the nonfinancial public sector, this issue should receive attention.

^{11/} The government explicitly recognizes that the "State budget and bank credits and loans are two channels through which the State mobilizes and distributes funds," in "Budget Planning, Implementation and Control at Various Levels of Government," MOF, Background Material One, April 1992, p. 2. See discussion of the provincial allocation of the credit plan in Annex 3.2.

^{12/} Debts that are often disentangled with government directed credit (often from PBC and in excess of the credit target). These credits might become contingent liabilities of government with the financial sector when such rescue operations are used to address solvency and not merely temporary liquidity problems.

^{13/} The low return on government assets was mentioned as a major source of concern for the budgetary authorities. The first step in addressing this issue is to establish a regular flow of information and financial indicators on nonfinancial public enterprises either to the State Asset Administration Bureau or to MOF directly, in parallel from the reporting mechanisms to line ministries responsible for SOEs.

(b) **Clarity**

2.12 Clarity poses the most serious problems in the areas of: (a) coverage,^{14/} (b) classification and definitions, and (c) presentation of the budget.

2.13 **Classification and Definitions.** Prior to the 1992 budget, revenues were classified by source: (a) taxes (the main source); (b) receipts from enterprises; (c) receipts from major projects; (d) miscellaneous receipts; (e) subsidies to cover SOE losses (treated as a negative revenue); and (f) domestic and international borrowing (treated as a budgetary revenue above the line, not as financing). Expenditures were not classified by the nature of the transaction (economic classification), but rather by the purpose of the financing provided (functional classification). In neither case, was a systematic distinction made between current and capital expenditures, and pooling major expenditure items into homogeneous and consistent groupings was problematic (Chapter 1 and Annex 1.1). No cross-classification of expenditures was prepared.

2.14 **Presentation of the Budget.** Deficiencies in the traditional budget presentation led the authorities to begin significant reforms in 1992:

- **The 1992 Budget.** The regulations for the management of the State budget stipulate that, starting with the 1992 Budget, its presentation would change "from a single budget system to a dual budget system," classifying expenditures according to their "nature" (that is, "productive" or "nonproductive") into the regular budget and the construction budget. The new presentation applies to the State budget only; below the central government, adopting the new system is initially optional. The authorities see three main advantages in the new, experimental system: (a) it establishes a clearer distinction between sources and uses of budgetary funds in each of the two budgets and shows any savings in the regular budget; (b) it allows stricter controls to be adopted over the regular budget and use of any surplus to fund capital construction; and (c) it will facilitate "performance analysis and supervision of budgetary revenues and expenditures to strengthen financial control."^{15/} Newspaper accounts of the new system mentioned four expected improvements: (i) the promotion of capital construction, while protecting people's consumption; (ii) more transparency in government accounts; (iii) increased restrictions on expenditures; and (iv) incentive to reform SOEs and the investment system.
- **Assessing China's Budgetary Reform.** The 1992 budget is not a structural reform but a new presentation of existing accounts, and it may not bring about the hoped-for advantages. Moreover the 1992 budget still differs significantly from international practice: (a) (planned) losses from nonproductive and productive SOEs from current and construction revenues, respectively, are netted out; (b) "nonproductive construction" is classified as a current expenditure; (c) amortization and interest payments are classified together as an

^{14/} The main issues dealing with coverage were already discussed above, under the heading Unity.

^{15/} Wang Bingqian, *Report on the Implementation of the State Budget for 1991 and the Draft State Budget for 1992*, 5th Session of the 7th NPC, Beijing, March 21, 1992, p. 9.

expenditure in the construction account, while international convention considers interest payments a current expenditure and amortization as (negative) financing;^{16/} and (d) revenue under the construction account includes the current account surplus and tax-like revenues that are earmarked for capital construction. The deficit on the construction account has been identified, and recourse to domestic debt borrowing, external borrowing and domestic bank borrowing has been indicated. The transition to the new presentation might prove difficult, because the new format is not mandatory at provincial level and below. The mission was informed that some provinces (Jiangsu) have adopted the new presentation at every government level, while others (Inner Mongolia) will continue with the old system. Additional effort will be required from MOF to consolidate the State budget.

2.15 Taxes and enterprise income are intermingled in the current account. Enterprise income is based on a negotiation with each enterprise. Expenditure classification still combines administrative, economic, and functional orientations. Before the dual-budget system, current expenditures were broadly distinguished from capital expenditures. Most capital expenditures for fixed investment were shown as one item (capital construction); other expenditures with a substantial capital component were shown under technical transformation. In practice, some maintenance expenditures appear to be included under the capital construction budget, and some minor capital expenditures show up under other heads of account. An attempt was made to identify the predominant nature of expenditure (current or capital, developmental or nondevelopmental, central or local, or both) under each of the detailed 29 heads of expenditures. Thus, under many expenditure heads, only current expenditures were shown, but capital expenditures were lumped together mostly under two heads. Under the new system of State budget presentation, expenditures under the current account include expenditures on nonproductive capital construction (Box 2.2).

2.16 In the 1992 Budget, under the construction account expenditures, all the productive capital construction is lumped as a single item, but it is subdivided into expenditures financed by domestic funds and those financed by foreign borrowing. This is essentially presentational. Other expenditures for fixed capital formation, technical transformation, and city maintenance are also shown as a lump-sum figures. Paradoxically, provision for working capital is included as part of the construction account. Geological prospecting is brought under the construction account, but it is not clear whether as an investment in developmental activity involving current expenditures or as acquisition of capital assets. Repayment of debt and payment of interest are again lumped under the construction account. Thus, expenditures under the new State Budget presentation, viz., between current and construction account appear to be based on a distinction between development and nondevelopmental expenditures. By implication, expenditures on education and health are treated as nondevelopmental. The adoption of the IMF standard economic and functional classifications used by most countries would still allow China

^{16/} Interest is defined as payment for the use of borrowed money (current expenditure). It should be distinguished from repayment of borrowed money which is classified as (negative) financing. See IMF, *A Manual on Government Finance Statistics*, 1986, p. 179 and p. 175, Table C.

Box 2.3: NEW PRESENTATION OF THE 1993 STATE BUDGET (A)
(billions of Yuan)

Current Account		
1.	Total revenue / <i>b</i>	302.2
	Tax	304.2
	Product tax	67.2
	Value-added tax	47.6
	Business tax	61.6
	State enterprise income tax	55.1
	State enterprise adjustment tax	5.5
	Collective enterprise income tax	10.6
	Tariff	20.0
	Agriculture tax	7.3
	Enterprise income	5.7
	State Budget Adjustment Fund	12.3
	Others	10.9
2.	Total expenditure	257.6
	Nonproductive construction	15.5
	Institution development and social welfare	102.0
	Agriculture, forest and water conservancy	12.3
	Education, science and health	77.0
	Compensation and social relief	67.3
	State general expenditure	77.2
	Defense	37.0
	Administrative expenditure	36.7
	Price subsidies	33.6
	Others	26.7
	Central and local stand-by fund	2.7
	Surplus	44.6
Construction Account		
1.	Total revenue / <i>c</i>	
	Surplus from current account	44.6
	Special construction revenue	47.4
	Key construction fund for energy and transportation	16.2
	City maintenance and construction tax	10.9
	Adjustment tax on direction of capital investment	3.1
	Occupation tax of cultivated land	1.7
	Others	2.8
2.	Total expenditure	154.4
	Basic productive construction	58.5
	Construction financed by domestic fund	37.8
	Construction financed by foreign borrowing	20.6
	Technology transformation and new product innovation	18.0
	Increment of working capital	1.0
	Geology prospecting	4.3
	Agriculture production aid	13.7
	Special agriculture development fund	4.4
	Agriculture production aid	9.3
	City maintenance	13.2
	Development fund for less developed areas	1.8
	Simple construction for commercial department	1.0
	Repayment of debt principle and interest	43.0
	Domestic principle and interest repayment	34.7
	External debt principle and interest repayment	8.4
	Construction Account Deficit	79.4
	Financing	
	Domestic debt issuing	38.0
	External borrowing	20.6
	domestic bank borrowing	20.8

/A The new current and construction budget system was introduced in 1992 at the national level and for selected provinces. Experimentation with this system will last until 1994.

/B Subsidies for nonproduction enterprises (Y 30.87 billion) netted out.

/C Subsidies for loss-making enterprises (Y 19.821 billion) netted out.

Source: Ministry of Finance (MOF).

to distinguish, for example, between "developmental" and "nondevelopmental" expenditures.^{17/}

Recommendations

2.17 The immediate actions would consist of: (a) establishing clear criteria for determining the boundary between the general government and other sectors, including differentiating the government units into the three categories mentioned above; (b) removing the transactions in the nature of governmental activities from extrabudgetary funds and bringing them into the budget while ceasing direct government intervention in managing extrabudgetary funds owned by SOEs;^{18/} (c) reviewing the extent to which earmarking of fiscal extrabudgetary funds is to continue; (d) introducing clear accounting and classification systems to separate policy loans from budgetary operations, and budgetary loans from capital grants, and developing a measure of the deficit of the nonfinancial public sector and its financing.

2.18 **Budget Coverage.** The management of the budget-coverage problem requires action in several stages:

- (a) First, government functions must be classified by major programs/activities, starting with the broad objectives and moving progressively toward the narrower ones. This should correct the current mixing of economic classifications (for example, capital construction) with functional classifications (for example, education). This vital first step entails more than simply reclassifying *existing* functions. It requires decisions on which functions government should carry out and where to place those functions—on or off budget. The consequences of these decisions must be considered on relations between agencies performing a particular function and the budget).^{19/} The future system should clearly define budget coverage, showing the transactions between governmental units and the budget, indicating the support to be given to semigovernmental units and government transactions with enterprises as owner in a format distinct from those as a sovereign.^{20/}
- (b) Second, present efforts to refine an economic classification of government expenditures should continue (see below), in particular, the distinction between

^{17/} The exclusion of the first three items (that is, general public services, defense and, public order and safety) from total government expenditures in the IMF functional classification (op. cit., Table B/C, p. 193), would provide an approximation to "productive expenses."

^{18/} An "arms-length" relationship of the various levels of government with their enterprises seems essential in fostering this process, for example, by adopting forms of indirect control through holding companies and a more active role of the State Asset Management Bureau.

^{19/} Three types of questions need to be answered: (a) who should be the producer? (b) who should pay? and (c) when does the government have a comparative advantage as an economic organization? The answers to these questions should indicate the nature and best form of government intervention (for example, government financing or government provision). See J. Stiglitz, op. cit.

^{20/} A list of institutions attached to the budget should clarify its coverage.

current and capital expenditures. The payoff of having the functional and economic classifications of government expenditures (cross-classification) for economic analysis is very high and should be one of the objectives of budgetary reform.

- (c) Third, a Nonfinancial Public Sector (NFPS) Account consolidating government and State-Owned Enterprises would be a useful supplement to the government budget. The NFPS is based on the criterium of government control, instead of the criterium of government functions. As long as China's government exerts considerable control over SOEs, and SOEs remain instruments for implementing government policies, public sector accounts would yield a better picture of the overall government establishment. The public sector borrowing requirement (PSRB) would be more relevant than the government deficit in determining the overall macroeconomic stance of government. Financial institutions owned and controlled by government should not be consolidated in the public sector accounts, because this would eliminate information on which part of the PSBR is financed by banks.

2.19 Fiscal Extrabudgetary Operations. There will be resistance to restoring the unity of the budget, from spending departments and units, which have substantial (de facto) freedom under the existing system. As a first step, it may be necessary to either: (a) consider stringent measures such as a state regulation coupled with administrative mechanisms and time limits to bring fiscal extrabudgetary funds into the State budget; or, preferably but not exclusively, (b) create incentives, like maintaining earmarking of previous fiscal extrabudgetary funds to reassure agencies, units and local administrations that they will not lose resources or control over them as it may happen if these funds are grouped with other general budgetary funds. The Chinese authorities have accepted the general principle of bringing surcharges into the budget and have already implemented it for education. This will have to be extended, and all surcharges brought into respective local government's budgets.

2.20 Regarding user fees (e.g., road use), the government might appropriately consider more effective statutory mechanisms—which need not be under the control of the Price Bureau—whereby the amount of fees chargeable, the purpose and the use are defined and modified from time to time in consultation between MOF and the respective government units. The budgetary support to some of these units would become autonomous and would be determined by objective criteria based on recommendations by possibly new regulatory bodies.^{21/} Identification of cost and profit centers in each unit would be an essential step in bringing about their clear differentiation (into full budgetary units, intermediate, and self-reliant units). MOF would have to play a crucial role in identifying such centers. Management of retained profits would also be automatically linked to unit differentiation, determination of the accounting practices, and relationships with the budget. Earmarked revenues should be constantly reviewed to keep them within reasonable levels—consistent with the flexibility the government needs in allocating resources. This will be especially important as government's total revenues shrink in relation to its increasing responsibilities as a result of the reforms.

2.21 Debt and Credit. The management of debt incurred by SOEs is highly decentralized and should not become a direct liability of government at some future date. PBC,

^{21/} Most countries have "Tariff Boards" or Regulatory Commissions for this purpose.

as China's bank supervisor, should have enough autonomy to assess the quality of the banks' loan portfolios, ordering provisions to cover credit risks fully and writing off nonrecoverable credits. Borrowing by government units should be separately identified and formally approved by MOF and local finance bureaus; the budget should explicitly recognize these liabilities. Further, since the credit plan allocates debt for various activities and debt financing is often used simply because budgetary appropriations leave cost escalations unfunded, a process of formal government guarantees should be adopted. Hence, an overall and continuous review of public-sector debt, would be an essential immediate step, pending differentiation of governmental units. Banks and bank supervisors should increasingly see SOEs as fully accountable for their profits and losses, and the commercial risks involved in lending to them should be assessed with no recourse to the budget in case of default. In other cases (lending to nonprofit units fully dependent on the budget and mandatory policy loans), should be registered with and cleared in advance by MOF. In the latter case, the explicit guarantee of the government (as approved by the relevant contract authority) would back these lending operations and this administrative decision should be clearly reflected as an effective or contingent liability in the budget. For bond issues, a similar process of differentiation and disclosure needs to be developed.

2.22 Policy Lending and Policy Bank. China's authorities have recognized the necessity of relieving the specialized banks of quasi-fiscal "policy lending." China is considering setting up "policy banks" for taking over the policy lending tasks.^{22/} However, creating special institutions for policy loans may only slow down the commercialization of the specialized banks, and designation of an existing institution as a policy bank would seem preferable. Furthermore, part of the policy lending—notably the subsidies to loss-making SOEs, and the subsidies for agricultural procurement—are a *fiscal* task, and should be on the government budget if China's authorities choose to continue them. Only the development lending for long-gestating projects, such as infrastructure investment, could possibly be handled by a policy bank, but such a task seems to fit in well with the tasks of the existing PCBC.

2.23 Classification. To align budget classifications with the increasing market orientation of the economy, to make it useful for economic analysis and policy-making, this report recommends the following:

- (a) Each agency (units, departments, local governments) should modify its accounting system to show every revenue and expenditure under separate and redefined current and capital categories. A simple reordering of the old classification is not sufficient; new definitions need to be introduced.
- (b) On the current receipt side, taxes can be differentiated into three categories: taxes on income and profits; taxes on international trade; and taxes on goods and services. All taxed income (to the extent it is recurrent) should be brought under the current account, whether earmarked for capital construction or not.
- (c) Subsidies to cover enterprise losses should not be netted out and should be shown as part of the government's current expenditures. Any capital transfers to SOEs should be classified as a capital expenditure. This presentation is

^{22/} Indeed, with the decision to set up an export-import bank, China has created such a policy bank.

essential to maintain the gross nature of taxes and the true nature of the government support to SOEs (acquisition of a capital asset).

- (d) The State budget should show the repayment of loans to the government as a separate item.
- (e) On the expenditure side, the capital budget should differentiate between acquisition of capital assets, capital transfers, loans, and the acquisition of shares. Acquisition of capital assets can be divided into land, equipment, etc. Every agency must break down current and capital expenditures in this format. In other words, the capital construction and technical transformation budgets should be disaggregated by function and agency. The proposed presentation would enable the introduction of cross-classifications (combining functional and economic classifications) which are so important for analysis.
- (f) For analytical purposes, the economic classification should separate current and capital expenditures. Current expenditures should be shown under three main categories: (i) wages and salaries and purchases of other goods and services; (ii) interest payments; and (iii) subsidies and current transfers (to SOEs, to other levels of government, and "other"). Each agency will have to identify its main programs and separate expenditures into current and capital by purpose. Each agency should have objectives, programs, and cost centers. Simultaneously, a code should be assigned to each account (with clear definitions and instructions) to guarantee consistency, facilitate automation, and serve multiple uses, including distinguishing between SPC-approved expenditures, developmental and nondevelopmental expenditures.
- (g) As regards debt, the budget should classify interest payments under current expenditures; amortization under financing.
- (h) The Chinese authorities should enlarge the role and responsibilities of MOF and the finance bureaus to include responsibility for implementing the proposed improvements in the budget system, and these entities should revise their organization. MOF should resolve possible conflicts of interest resulting from MOF's triple role as owner/financial manager, tax collector, and supervisor (Annex 2.1).^{23/}
- (i) MOF should establish separate unit to work on classification of budgetary transactions. This unit will have to organize its work into working groups at grassroots (units in central departments and at local level).
- (j) As budgetary accounts are being reclassified government units should be identified as governmental, semigovernmental, and commercial. After agreement on the broad direction of the reforms, an organizational study would be desirable of the core agencies participating in the budgetary process.

^{23/} In particular the departments of: Industry and Communications; Commerce, Trade and Banking; and Agriculture.

- (k) Finally, government statistics cannot ignore the needs of other users and other data systems. The Mission observed little coordination between MOF with SSB and SPC, which has serious implications in terms of inconsistent information, noncomparable classifications, and great difficulties in producing the new System of National Accounts. An interinstitutional task force should examine these issues and offer solutions.

C. THE BUDGET AS A POLICY TOOL

Issues

(a) Compliance

2.24 Expenditure overruns are the main cause of missed fiscal targets (Chapter 1). The persistent fiscal deficits which are higher than budgeted increase macroeconomic instability, as they are financed by increased recourse to PBC or Bank financed, or by running arrears in the case of local governments. Furthermore, expenditure overruns undermine the efficiency of expenditures, as spending agents have no incentives to save, since the overruns will be financed anyway. Although cost overruns occur regularly, capital investment budgets do not seem to contain contingencies, and the overall reserves of "one to four percent" (state budget regulations) are not nearly enough to cover overruns such as the 8 percent of 1992. Although the budget has effectively isolated itself from the consequences of overspending of SPC directed projects, by means of a lump sum allocation to SPC, the macroeconomic consequences of overspending on such projects still remain.

2.25 Expenditure overruns are caused by a combination of projection errors, wilful underestimation, and lack of incentive to stay within the spending limits. The lack of linkage between economic planning and the budget, and the absence of crossreference documents of multiyear planning and the budget seems to add to projection errors and overspending. Wilful underestimation seems to be promoted by the "base number method" budgeting principle, through which expenditures within the base number are approved more easily than those superseding the base number, regardless of their merits. Furthermore, MOF does not seem to have the institutional capacity to address the costs overruns. The regulations on state budget management specify legal sanctions against overspending, but the terms overspending and misspending seem to be reserved for the budgetary contribution while overall cost overruns may go un sanctioned, as long as they are financed by other means. Finally, although there are mid-year budget reviews within the administration, overspending does not have to take the political hurdle of a supplementary budget, and the overspending will become generally known only at the time of next year's budget.

2.26 On the revenue side, the existing fiscal system is characterized by contracting with local governments and enterprises, trying to provide incentives for collecting and paying taxes.^{24/} Tax contracting with enterprises makes compliance nontransparent and increases tax administration and control costs. Field inspections and posting of tax personnel are practiced to increase the cost of noncompliance. However, this nonrule-based approach to tax

^{24/} See IBRD, *China: Reforming Intergovernmental Fiscal Relations*, November 27, 1991.

administration cannot solve the principal agent problem,^{25/} which leaves ample scope for noncompliance. In addition, a negotiated tax system exacerbates the intrinsic conflict of interests among the triple roles played by government agencies as owners, tax collectors, and supervisors. This exercise of power creates plenty of incentives and opportunities for tax avoidance (and corruption). Finally, the tax contracts inhibit tax buoyancy in times of accelerated growth, when predetermined contracted taxes form an even smaller share of GNP. This contrasts sharply with the tax system in other countries, where progressiveness in the tax system forms an automatic stabilizer of economic cycles.

(b) **Regularity**

2.27 The Budget Cycle. The budget cycle in China currently consists of: (a) analysis of the current year's budget implementation and projection of the next year's revenues and expenditures. This exercise is carried out in the third quarter of the current year; (b) determining next year's "control quotas" by MOF and SPC, using current year preliminary figures ("base method"), adjusted according to the (annual and FYP) plan's targets and taking into account the proposals of local governments ("factor method"). After their approval by the State Council, quotas are communicated to the ministries and provincial governments, forming the basis for compiling unit and local budgets ^{26/} (reported to MOF in the unified budget forms described in Annex 2.1); (c) compiling the draft State budget by MOF, followed by the State Council's approval; (d) discussion and approval of the draft State budget by NPC's Financial and Economic Committee and submission of a resolution to the NPC; (e) implementation of the annual State budget; and (f) examination and approval of the final accounts by the State Council and the People's Congresses (Annex 2.1).

2.28 The Fiscal Year. The fiscal year coincides with the calendar year (January 1 to December 31). The budget becomes effective as late as April, which reduces the actual span of the fiscal year to nine months. Thus, the budget is executed in the first quarter on a "tentative basis." The delay is attributed primarily to legislative lags, but there are also difficulties in linking next year's projected budget to the short-term outlook for the economy so that MOF can establish control quotas early enough to finish consultations with the central departments and local governments and draft the budget before year-end (see following section). Since "control quotas" for the next year are largely an extrapolation of the outcome of the current year, MOF has indicated that it would be very difficult to anticipate the timetable for compiling the draft budget. The abbreviated chronology of the budgetary cycle is shown in Box 2.3.

^{25/} Arising when the principal agent (that is, center) is unable to perform a certain task directly (that is, collecting taxes or exercise ownership rights) and must find mechanisms/incentives to motivate a third party (that is, provinces or enterprise managers) to perform the task in the principal's interest (that is, maximize tax collections and enterprise profits).

^{26/} Control quotas are determined by the center for provinces with contracts "linking local revenues and expenditures and practicing total revenue-sharing" (that is, fixed percentage and added revenue sharing contracts), as a form of setting minimum tax collections and maximum expenditures, setting a tax collection targets, and playing a macro-stabilization function. For localities with contracts not linking revenues and expenditures and contracting at different levels (that is, sharing revenue at negotiated rates and receiving transfers from the center), MOF sets only the control quota for revenues, letting localities determine their expenditures according to "their financial capabilities."

**Box 2.3: INDICATIVE BUDGET CALENDAR: TIMETABLE FOR COMPILING
THE STATE BUDGET /1**

June - July	SPC issues control figures over major indices of the next year's economic and social development.
July	MOF issues the next year's budgetary revenue and expenditure control quotas.
August - September	Provinces, autonomous regions, and municipalities provide suggested figures to SPC and MOF, based on the control quotas.
Around October	SPC and MOF hold joint or separate national planning and financial conferences to determine next year's budget targets through consultation and deliberation.
After October	First Iteration: budgets are compiled from the bottom up. Second Iteration: budgets are compiled from the center down to the lower levels.
Before the end of the year	After collecting general budget plans, MOF compiles the draft State budget plan to be submitted to the State Council for review and approval.
Around March	MOF, on behalf of the State Council, submits a report on last year's budget execution and next year's draft state budget to the annual NPC session for approval. After approval, the budget plan acquires legal force and becomes applicable to provinces, departments, and units.

/1 The calendar shown is indicative. From year to year, the actual procedures may vary.

(c) Operational Adequacy

2.29 Under the present budget system previous year's expenditures play a large a role in the determination of next year's expenditures, and less consideration is given to program and macroeconomic effects of these expenditures. MOF seems to lack the information and the capacity necessary for assessing the usefulness of expenditures budgeted by line ministries and units. The AAPRC focuses its audits on compliance, and the economic efficiency of public expenditures is of low priority.

2.30 Expenditure planning is little linked to economic developments and in price developments. Actual tax revenues seem to be closely linked to the Plan growth figures, which determine the tax contracts, irrespective of the actual economic developments.

Recommendations

(a) Compliance

2.31 Three areas of compliance were flagged for attention in the 1992 budget speech: the role of finance departments; the need to control and increase the efficiency of public expenditures and resource use; and ensuring compliance with laws and regulations. To deal effectively with these concerns, the following actions are recommended:

- **Compliance and Information.** Compliance is a key area of the budget system. Compliance is possible only when clear-cut, equitable, and realistic rules *formally* provide for flexibility and exemptions. Compliance, therefore, is not related simply to administrative discipline but to the pull of incentives faced by government employees and agencies which may or may not reinforce the norms embodied in rules and regulations. At the same time control procedures and the content and timeliness of MOF's information flows and analytical capabilities need strengthening. Field inspections and siting government functionaries should be complemented by better statistical methods of reporting and supervision, off-site surveillance and targeted sample inspections.
- **Autonomy and Control.** Incentives must be provided for compliance by spending agencies. A number of countries (for example, Australia) have found successful approaches, where MOF acts as an investment banker in negotiating with spending agencies and making financing decisions. This approach has the advantage of putting the "burden of proof" on the shoulders of the spending ministries and agencies, forcing them to present objective and well-documented cost/benefit analyses for review and approval by MOF. At the same time, built-in incentives should encourage agencies in raising the efficiency of expenditures. MOF provides incentives for agencies to do their own evaluations and allows them enough flexibility to reallocate funds among programs within their budget ceilings. In this process, forward expenditure estimates become a valid benchmark for cost effectiveness of reallocating funds to existing or new programs.
- **Transparency.** The future system should introduce a rule-based, transparent system backed by detailed instructions, audits, and appeal procedures, as well as penal clauses and policy-driven incentives. The immediate actions consist of identifying major areas of noncompliance in terms of specific departments and development of a rule-based system. Systematic review of fiscal laws and regulations to identify the reasons for noncompliance should be adopted so that more rule-based systems can be introduced, especially in budgetary relationships with enterprises and local governments. In the medium term, revenue-sharing arrangements have to replace the contract system with local governments; and a rule-based interface has to replace contracting with enterprises. For this to be possible, changes in rules, procedures and budget process are necessary, a daunting task in an economy so large and complex as China's.

- **Budget Manual.** The role of finance departments can be more clearly defined and strengthened by publishing an instruction book or manual to explain how the State budget regulations work.
- **Expenditure Review Committee.** Institutional mechanisms (like some countries' expenditure review committees) should be established to develop methods of raising the efficiency of expenditures and, more broadly, the public administration. Such bodies should also recommend budgetary reforms and expenditure-control mechanisms. The budget, in the last analysis, is itself an incentive mechanism for triggering response by public agents. Particular attention should be given to the relative incentives being given for or against compliance.

The NPC role should be enhanced for studying, approving, and amending the State budget.^{27/} The Finance and Economic Committee, with its 28 knowledgeable members in financial matters, may be in the best position to examine the budget in detail. Strengthening this committee's powers for meaningful examination and discussion of the draft budget is highly recommended.

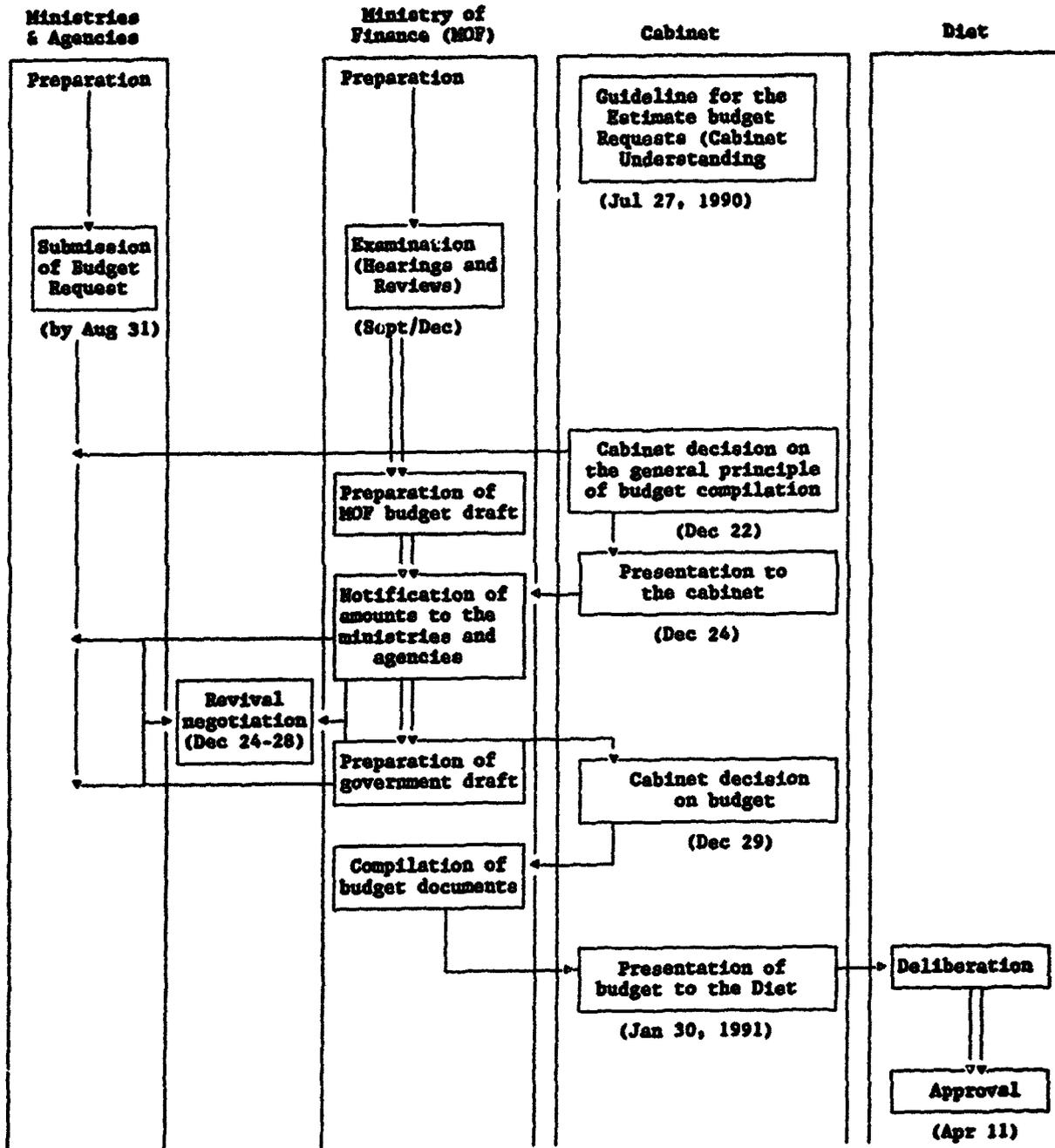
(b) Regularity

2.32 The Peoples' Congresses usually do not change draft budgets, but it cannot be presumed (nor is it desirable) that approvals will continue to be proforma.^{28/} The alternatives are either to amend the dates of the budget cycle, including the NPC schedule, or to change the fiscal year. While there is no internationally recommended budget year, and practices vary, it is recommended that China's future system ensure completion of the budget-approval process by the time the fiscal year begins. A chronology of the budget-approval process and an illustration of the steps in Japan's budget process are shown in Box 2.4 and Figure 2.1, where the budget cycle starts a year before the parliamentary approval of the budget, while in the Netherlands (Box 2.5), the cycle also starts early in the year, with draft budgets submitted to MOF before April 15 of year (t-1). The Chinese authorities should immediately begin studies considering the two options—changing the fiscal year or amending the timing of the present approval process—so that the process is completed by the time budget begins to operate. To meet that deadline, MOF needs to initiate the budget compilation much earlier than June-July of the previous year as at present.

^{27/} The final approval by NPC involves consideration of the budget by a body having a membership of 3,000 delegates. The Standing Committee has about 150 members.

^{28/} In 1991, the NPC requested an extraordinary Y 1 billion reduction in the fiscal deficit of the government's draft budget.

Figure 2.1: STEPS IN JAPAN'S BUDGET PROCESS



Note: Although the Conference Committee of Both Houses was held after the House of Councillors' rejection on April 11, the Houses could not reach a consensus. Therefore, the FY1991 budget became effective as approved by the House of Representatives on March 14 because of its superior powers of decision on budgets.

Source: *The Japanese Budget in Brief*, Japan's MOF, Tokyo, 1991.

Box 2.4: JAPANESE BUDGET PROCESS ^{1/}

1. Calendar of Main Points of Decision-Making and Activities

The fiscal year (FY) begins on April (year t) and ends on the following March 31 (year t+1).

Months before start of FY(t)	Main events and activities
(Year t-1):	
12-11 (April/May)	Ministries (and agencies) start preparation of reports on next year's budget.
10-09 (June/July)	Cabinet discusses and agrees policy guidelines on budget requests, prepared by MOF.
08 (August)	Ministries submit revenues, expenditure estimates and budget requests to MOF. Ministries submit request of Fiscal Investment and Loan Program (FILP) funds.
07-04 (September/December)	MOF holds budget hearings with Ministries and agencies about budget requests (including FILP funds). MOF negotiations with Ministries take place hierarchically, from lower official levels to Ministerial level (if necessary).
04 (December)	Cabinet decides on budget estimates (including FILP program), taking also into account the macroeconomic results for the new fiscal year.
(Year t):	
03 (Late January)	Cabinet submits budget documents to the Diet. MOF delivers two budget speeches to the two Houses.
01-0 (March/April)	Diet debates and approves the budget.
0 (1 April)	Start of fiscal year (t)

2. The Annual Budget Cycle

Each ministry and agency begins estimating its revenue and expenditure for the following fiscal year budget around April or May of each year. They must prepare reports on expected revenue, required expenditures and other necessary matters under their jurisdiction and send them to MOF no later than August 31.

^{1/} See OECD, *The Control and Management of Government Expenditure* (Paris: OECD, 1987) and Budget Bureau, MOF, *The Japanese Budget in Brief: 1991*, Tokyo, 1991.

...Continued

Box 2.4: (cont'd)

In June or July, the cabinet discusses and decides on guidelines for the MOF budget request. The guidelines contain instructions to be followed by each ministry and agency in making its calculations.

According to the cabinet agreement on the guideline for the estimate budget request for the next fiscal year, these guidelines include a percent adjustment for current and capital expenditures, measured against the nominal expenditure level under the previous budget. Excluding national debt service costs and local allocation tax grants, the guidelines apply only to about 33 percent of total general account expenditures, also taking into account the obligatory character of several programs.

In preparing its budget, each ministry decides on requests after hearing the opinion of the Policy Affairs Research Council, consisting of members of Diet of the ruling party in late August.

The MOF draft budget for departmental budgets includes unallotted financial resources for the "revival negotiations"—meaning that new negotiations take place higher in the hierarchy. (The guidelines for budget estimate requests do not contain unallotted financial resources for the revival negotiations).

After the examination process which includes hearings and reviews by MOF from September to early December, MOF prepares the draft budget and submits it to ministries and agencies in late December. After the notification of the MOF draft budget to ministries and agencies, the "revival negotiations" between MOF and each ministry and agency take place. For nearly a week, financial decision-making takes place through negotiations at three official levels up to ministerial level.

The MOF draft budget includes unallotted financial resources that are distributed to specific programs in the course of the revival negotiations. The total amount of expenditures in the draft does not change after the revival negotiations.

When negotiations do not reach a settlement, they are then run by the three major executives of the ruling LDP; secretary-general, chairman of the Policy Affairs Research Council, and the chairman of the Executive Council. The final decision is made by the prime minister, if the second level of negotiations fails.

At the end of December, the Economic Planning Agency prepares the "Outlook and Basic Policy on the National Economy" for the following fiscal year through consultation with relevant ministries including MOF. The cabinet must approve the outlook. At nearly the same time, "General Principles of Budget Compilation" are decided by the cabinet as well. Finally, the government approves the budget for submission to the Diet.

Usually the deliberation process of both houses ends in early April.

(c) Operational Adequacy

2.33 Various measures can then be taken to improve the budget formulation and implementation systems and improve the operational adequacy. Among these later measures, the following should be considered to improve operational adequacy:

2.34 **Reduce Incrementalism.** The "base method" should be deemphasized and the "factor method" given a heavier weight and new meaning in forecasting next year's revenues and

Box 2.5: FORMULATION OF THE BUDGET: THE NETHERLANDS 1/

Technical Aspects of Multiyear Estimates

Multiyear estimates (MYE) for control purposes are registered for both expenditure and nontax revenues of central government. There is no link to a medium-term fiscal plan; MYE serve as a means of control for MOF, rather than as proclaimed resources for the spending ministries. They reflect (expenditure) projections according to policies that have been agreed by the cabinet (which might include a future change in policy).

MYE, linked to the current year (t-1), cover the budget year (t) and four future years. MYE expenditure estimates comprise, among other central government expenditures, interest payments, unemployment benefits, and grants. Provision is made for the costs of repricing estimates according to the forecasted price and pay level of the budget year. MYE, therefore, remain on constant price and wage bases. These estimates, sensitive to macroeconomic developments, are based on technical assumptions about future years. They are not based on macroeconomic forecasts.

MYE are built up from the level of votes (articles), or are sometimes more disaggregated. In fact, MYE are rolled forward in an almost continuous process: each change in (multiyear) budgetary developments, once checked and agreed by MOF, results in a change of the budget/multiyear estimates. Usually, changes refer to estimate failures and are, therefore, said to be "exogenous," that is, not the result of new policy initiatives (which occur as well from time to time). Ministries construct the new fin-1 year bottom-up.

MYE are published once a year, in an annex to the budget memorandum. The estimates relate, however, to a much more aggregate level; usually, only some five "homogenous groups" of detailed sections are presented per budget chapter. The spring memorandum includes only changes in the previous budget memorandum's MYE. Their presentation is not on the (legal) detailed section but in a more policy-oriented grouping of sections.

The Annual Budget Cycle

The preparation of the budget starts in January-February year (t-1). MOF submits a letter to the Council of Ministers, putting forward proposals for the allocation of resources to the various parts of the public sector. These proposals are usually based upon the expected medium-term development of the economy and upon the baseline (that is, unchanged policy), multiyear expenditure estimates, and some projection of revenues. For several years, this allocation has involved expenditure reductions: the total extent of cutbacks and their allocation within the public sector are now essential parts of the MOF letter to the Council. Not only the allocation, but also specific measures to achieve the budget cutbacks, are part of the letter. The cabinet discusses and makes decisions in February-March. In the next three or four months, detailed budgets take shape; departments are free to curtail other programs or outlays than those proposed by the minister of finance if the cutbacks add up to the same amount.

In May-June, first drafts of the budgets are discussed by senior officials of the spending departments and the director-general of the budget; if necessary, bilateral talks take place at ministerial level.

The Council of Ministers makes a final decision in July about the expenditure side of the budget. In July (and if necessary, in August), decision-making takes place about a range of other measures and issues, like social premium rates, additional tax measures, etc., also given the other nonbudgetary goals of government policy (for example, income-policy considerations). The third Tuesday of September, the cabinet submits to Parliament the draft budgets of the spending departments and the budget memorandum, setting out the financial-economic and budgetary policy for the budget year. In October, Parliament discusses the general political and financial policy lines set out by the Cabinet. During the next three or four months, all budgets are discussed and decided upon, turning them into annual appropriation acts. Parliament has the right to amend the budget.

1/ Adapted from OECD, *The Control and Management of Government Expenditures* (Paris: OECD, 1987).

expenditures. As long as the "base figure" budget method is practiced the units are likely to perpetuate the status quo. The adoption of zero-base budgeting (ZBB) on a trial basis for certain recurrent programs might be advisable. An economic outlook ^{29/} should be released when the draft State budget goes to NPC, spelling out the main macroeconomic assumptions on which the budget is based. In most developed countries, certain expenditure categories and inflation estimates are derived from forecasts of economic activity. Other items are simply annual cash limits, operating costs systems (with feedback from expenditure formulas for programs like unemployment benefits), and in some cases (Australia, Japan) built-in efficiency dividends (for example, Australia, Japan) to force cost reductions.^{30/}

2.35 Cost-Effectiveness. MOF should develop the information and technical capacity to examine program content, relevance, and cost-effectiveness, in order to judge the merits of continuous and usually additional financing. Moving away from crude "incrementalism" in expenditure planning toward an analytical and efficiency *output-oriented budgeting approach should be the ultimate objective of budgetary reform.* There is no evidence of performance specification and monitoring within government units. Spending agencies' performance should be related to objective criteria and financial indicators, resource constraints, and expenditure efficiency. (Specifying performance in physical terms for major programs and expenditure categories has improved compliance with expenditure ceilings). AAPRC should continue its efforts to strengthen comprehensive audits going beyond compliance, examining the economy and efficiency of public expenditures.^{31/} MOF should insist on receiving transparent and timely information on performance so that it can identify needed improvements and, through annual audits, gain experience in developing MYE plans. The Netherlands has interesting and innovative experiences in this area and a successful system of efficiency and effectiveness reviews (Box 2.6). MOF can best assert its control over expenditures by strengthening accountability rather than by imposing prior controls that might delay or paralyze administrative decisions.

2.36 Rolling Budgets. The impact of present commitments on future budgetary transactions must be captured. Rolling budgets (or some adaptation of procedures like the Australian "Running Cost System" and forward estimates), would give government agencies incentives for evaluating programs and reallocating funds to more productive uses. Formulating rolling budgets is an important means of fostering awareness of the implications of changes in intra-institutional and intragovernmental relationships and assessing the budgetary implications of policy changes. To begin with an indicative, multiyear budget, coinciding with the current five-year plan, should be outlined. A two-year rolling budget could be attempted for the 1994 budget. At that time, a choice could be made between (a) a three-year rolling budget and (b) a combination of five-year outline and two-year rolling budget. Significant institutional strengthening of MOF's relevant departments will be indispensable.

^{29/} Most countries make this medium-term outlook, with emphasis on fiscal projections, part of the budget's documentation sent to parliament.

^{30/} The Australian running-cost system projects base administrative expenditures, *plus* the cost impact of expected inflation, *less* a preset "efficiency dividend" to force productivity increases.

^{31/} Specific recommendations to strengthen MOF's information system and AAPRC auditing function are included in Annex 2.3.

Box 2.6: EFFICIENCY AND EFFECTIVENESS REVIEWS: THE NETHERLANDS

1. Reconsideration Procedure

The main instrument of policy review is the "Reconsideration Procedure," introduced in its present form in 1981. This procedure aims at reviewing existing policy areas within the public sector so as to develop policy alternatives that can help to curtail public expenditure. Only alternatives costing the same or less can be considered, with a mandatory 20 percent funding level reduction included as one option. Subjects for reconsideration are decided by the Council of Ministers. In earlier years, all government departments had to participate; however, this requirement was relaxed as more flexibility was sought in the reconsideration procedure. As of 1983, the Reconsideration have been incorporated into the budget cycle (although the procedure can be started separately). Since budget preparation in the Netherlands starts usually in February of year (t-1), each round of reconsideration is now to be completed by November 1. In the next three months, the results can be brought together for a first (political) assessment prior to the actual budget preparation. The minister of finance thus possesses a first assessment of the political implications when preparing his budget proposals for the new fiscal year (to be included in the "framework letter").

Since mid-1985, some additional procedural modifications were approved by the cabinet. Reconsideration reviews can now be started at any time of the year. This possibility increases the flexibility of the procedure without impairing its efficacy. Another modification makes political decision-making about completed studies somewhat more flexible as well; both the responsible minister(s) and the minister of finance can take the initiative and decisions need not be submitted to full cabinet if no general cabinet policy is involved, provided that the ministers concerned are in agreement.

All reports are made public by submission to Parliament. In addition, a summary report is published for each round of reconsideration, which also serves as a basis for the political assessment of results. Decisions made in the process of budget preparation on the basis of reconsideration reports are described in the budget proposals of the different departments, and are summarized in the budget memorandum. The whole procedure is guided by a small, ministerial commission, consisting of the prime minister, the vice prime minister(s), and MOF. Advice and administrative support is provided by MOF.

2. Budget implementation: major instruments of in-year control

The general treatment of changes in the budget is dealt with in the "Rules of Stringent Budget Policy." These rules constitute procedures regarding what to do in case of setbacks and windfalls both of expenditures and nontax revenues. The rules governing compensation for items are formulated in such a way that, normally speaking, any excess in expenditure is compensated for by corresponding reductions in expenditures in the same budget "chapter." Attention is also given to the question of whether overruns of specific departmental items should be compensated for by that department, or by all departments. As another instrument of control, cash limits can be imposed on departmental spending totals. The decision to use this instrument is usually made in the spring memorandum. Cash limits have been imposed for some years. The instrument of cash limits tightens up the rules of Stringent Budget Policy. Both cash limits and rules can be implemented only with respect to the current budget. Finally, prior approval by the minister of finance can be required for some items and commitments, even though the necessary finance has been voted by Parliament.

During the implementation phase of the budget, Parliament is informed by the cabinet several times. After submission of the draft budget to Parliament in September, the spring memorandum is usually released in May or June. If economic developments turn out worse than projected and/or other budgetary setbacks occur, an "early spring memorandum" might have to be released (usually in March), in which cabinet may put forward additional budget cutbacks in the current budget and, if necessary, in multiyear expenditures.

3. Managerial Discretion

Efficient use of resources is the responsibility of the minister in charge of the spending Ministry, although the minister of finance bears a general responsibility. A spending manager usually cannot transfer unspent funds from one section (article) to another without parliamentary approval. However, under very limited and explicit conditions, a small amount may be transferred. Under certain conditions, transfers of appropriated money to the next fiscal year are permitted. However, this is restricted by the minister of finance to maintain budgetary discipline and control: not all balances can be carried forward. Budget sections eligible for carry-forward and the maximum so permitted are indicated in the Appropriation Act. The cabinet plans to seek an appropriate way to abolish this carry-forward possibility.

2.37 MOF's Role in Capital Budgeting. MOF should play a larger role in capital construction than simply allocating funds to SPC and line ministries. To serve the intended purpose of the reform, a distinction must be made between the economic appraisal of projects and their significance as part of the government's activities. Regarding commercial enterprises, the budgetary authorities have to take a view about the nature and extent of the support to be offered (loans, grants, equity). For all governmental activities, MOF should make sure that goals are achieved cost effectively and that adequate operation and maintenance (O&M) expenditures are budgeted. Hence, MOF input should be increased in determining whether budgetary allocations for each capital construction project seems warranted, developing the institutional capacity to conduct efficiency and effectiveness reviews to promote continual search for better value for money for main expenditure categories and programs. Target reductions for administrative expenditures would complement these measures.

2.38 Contingencies. Cost escalation in construction projects is not adequately recognized by the budget process. SPC either decides that project cost increases will be picked up by extrabudgetary resources, including bank credit, or reorders priorities among the projects. This procedure undermines the crucial role of the budget in economic management. Investment plan therefore must be realistically funded, with resources for contingencies included from the start. (Recent experience with cost escalation justifies immediate introduction of amended budgeting procedures in this respect).

2.39 Core Investment Program. As part of the formulation of the investment budget, core and noncore project identification should be introduced so that unforeseen circumstances can be met without seriously disrupting the core element. Right now, SPC's "key project" concept seems to provide for such differentiation. A review could be made whether the "key project" concept can be expanded or amended, or whether separate noncore projects should be identified.

2.40 Fiscal Reporting. The fiscal reporting system must be transformed from an accounting system into an integrated MIS suitable for analyzing policies and other fiscal issues (Annex 2.3). The importance of fiscal reporting would be gradually enhanced as reform progresses. However, immediate attention to a formal fiscal reporting system is recommended.

2.41 Expenditure Review Committee. The problem of budget overruns (Chapter 1) has been highlighted by the Chinese authorities. A committee to examine differences between original and revised estimates at regular intervals would enhance the Government's understanding of the reasons for such variations. In this way, budget estimating procedures, and compliance could be improved. One successful practice introduced by Australia and being adopted by other countries (Canada), consisted of establishing a permanent Expenditure Review Committee (chaired by the prime minister and with members from the largest spending ministries). A separate unit could be formed in MOF to conduct these periodic evaluations. Evaluation, which is different from continual monitoring, refers to specific components of the budget and the related agencies, and involves analysis of activities in relation to the budget. Such unit would also be able to evaluate systematically some of the budget-reform experiments.

2.42 Mid-Year Review. A mid-year, detailed review of the budget would force the system to revise the present fiscal reporting and make systematic adjustment in the budget. This review would include a formal procedure for obtaining supplementary estimates by an appropriate committee such as the NPC Finance and Economic Committee.

2.43 Training. Finally, the implementation of the suggested reforms will require significant procedural changes and training of the relevant staff. The complexity of the proposed changes should not be underestimated and significant technical assistance should be tapped in carefully preparing the modernization of China's budgetary functions and strengthening the institutional capacity to design, manage and implement the required reforms.

2.44 Fiscal policy information is scattered and the reporting system emphasizes accounting and cash flows, with only a nod to the macroeconomic outlook and policy objectives. Audit coverage is also limited.^{32/} The budget should become an instrument of fiscal policy and a tool of macro economic management. The immediate actions should be taken to elaborate budget regulations, introducing efficiency parameters for expenditures, to develop the audit system, to initiate fiscal reporting and revised information flows. Standard concepts and definitions must be developed. Medium-term actions involve developing fiscal instruments for both macroeconomic management and efficiency within government operations. The existing Chinese system is unique and not easily reconcilable with statistical system and for international comparisons. The future system should be flexible enough to serve multiple purposes and users, integrating the budgetary statistics with the new system of national accounts (SNA), enabling international comparisons on par with industrial countries. Immediate actions require closer coordination among SSB, SPC, and MOF to work toward compatible definitions. Implementation would be over the medium term.

D. THE INFORMATIONAL ROLE OF THE BUDGET

Issues

(a) Publicity

2.45 The Budget Speech and the parameters of the FYP are available for budget approval and wider dissemination. From time to time, the various ministries and departments make available broad elements of both plan and budget. However, the information provided is inadequate for informational demands in China's "mixed economy." Future budgets should state the intentions of public policy in different key areas clearly and in some detail, with an eye on the incentives and disincentives proposed for different economic agents. The budget should also show budget programs by function, including the allocation of investments by project, sector, and program. In many countries, governments must publish forward expenditure estimates for three to five years beyond the current fiscal year.

2.46 Budget documents are background reports on the state of the economy, spelling out the key assumptions underlying the draft budget. As MOF gains experience, short- and medium-term scenarios could be added in conjunction with multiyear expenditure plans, more detailed financial plans, and PSBR estimates. MOF should provide the overall public-sector budget for informational purposes. The immediate action consists of increasing the detail and completeness of the budget documents and making them widely available to the NPC and the public so that economic agents can make informed decisions. Medium-term action would involve introducing an economic survey system (coinciding with the budget presentation) and a

^{32/} Only 50 percent of provincial governments and 30 percent of prefectures and counties are audited annually. See Annex 2.3.

report on the overall position of the nonfinancial public sector (government sector plus public enterprise sector).

2.47 The budget is a key instrument for realizing economic reform objectives. Consistent with the strategy of "unified leadership and decentralized management," the budget should serve the center as a communication vehicle to decentralized government agencies and the enterprise sector (SOEs and others). As the economy becomes increasingly market oriented, it needs more information about government intentions, especially about incentives and disincentives flowing from the budget. Only through publicity, visible information, can the government induce economic agents to follow public policies. This is why budget clarity, and detail, and diffusion should be improved.

(b) Accuracy

2.48 In the existing system, revenue and expenditure estimates are usually based mainly on base figures. However, uncertainty surrounds both revenue and expenditure sides due to multiple factors. They include: mid-year changes in affiliations (subordination) of SOEs between different levels of government; changes during the fiscal year in tax rates and their bases, as well as their applicability; introduction of unauthorized levies;^{33/} granting of tax exemptions by local governments and the open-ended nature of enterprise losses and the deductibility of amortization of bank loans from taxable income (tax expenditures); the increasing complexity of the tax and revenue-sharing systems; the lack of a national tax administration and, more broadly, the negotiated character of taxation at all levels, as well as the perverse contractual incentives for paying taxes. Nonetheless, in past budget speeches, somehow tax plans are always met or exceeded. Plans may be intentionally reachable (that is, *ex-ante* underestimation of revenues) and/or possibly "borrowing" from extrabudgetary revenues may fill any gap.

2.49 On the expenditure side (Chapter 1), slippages have been significant and they have worsened over the last few years. Explanations for slippage include: the effect of cost escalation is not explicitly recognized; and, if inflation increases, the unfunded gap naturally rises. Until recently—slippage factors also included rising price subsidies, creeping administrative expenditures ("incrementalism" and rising wage pressures), and "bunching" of amortization of the domestic public debt. Some of these factors are complex and difficult to predict. Apart from truly unpredictable occurrences (that is, natural disasters), the real issue is the center's limited ability to know more precisely and control the true level of expenditures. Prior to the 1992 budget, revenues and financing were combined. However, a major outstanding issue is MOF's limited information and control over potential budgetary liabilities resulting from the funding provided by the specialized banks (SBs) to SOEs and other government units for

^{33/} As mentioned in the 1992 Budget Speech, efforts are being made to stop indiscriminate fines, charges, and levies. At the same time, there also appear to be cases of unauthorized reduction of taxes and granting of exemptions. Finance and tax bureaus have been instructed to tighten control over all tax expenditures.

capital construction.^{34/} For the SBs, financing of SPC-defined "key projects" is mandatory. In 1991, 28 percent of bank credit (flow) went to finance fixed-asset loans, while 17 percent of the SBs loan portfolio (stock) is locked in long-term financing of public investment (Annex 3.2).

2.50 Local budgets are subject to the same uncertainties. In addition, at the time local budgets are formulated and approved, the central allocation of earmarked funds to the provinces is kept as an open issue, and the actual allocation takes place after local budgets approval and well into the implementation phase (Box 3.5). As central earmarked grants gain in importance (compared to quota subsidies)^{35/} and past "firm" commitments fall in relative importance (for example, central earmarked funds to cover local price subsidies and enterprise losses), local budget uncertainty is likely to increase.

Recommendations

2.51 **Accuracy.** The institutional and technical capacity of the core agencies must be analyzed to: (a) link the short-term macroeconomic outlook with expected budgetary developments; (b) understand the seasonality of revenues and expenditures and improve the opportunity and reliability of next year's estimates; and (c) to move to a system of forward estimates or rolling expenditure planning. Recommendations on these issues are as follows:

- (a) **Link Budget to the Economy.** Strengthening the analytical capabilities of the core agencies should be a key objective of China's budgetary reform. Significant segmentation within and across core agencies impedes information flows, and the relative weakness of the more macro-oriented departments (for example, MOF Comprehensive Planning Department) leads MOF to lose sight of the budget's links with the economy and the policy process. As a result the budget process becomes almost exclusively operationally driven. Explicit links among forecasts of economic activity, revenue and expenditures, and expected inflation should be more fully integrated into the budgetary process.
- (b) **Project Next Year's Budget.** The contractual nature of tax revenues reduces uncertainty about collections during the contract period. The existing negotiated tax system, however, introduces enormous uncertainty in any change of regime (new contracting). To the extent possible, changes in taxes, contracts, enterprise affiliations, etc., should also be synchronized with the fiscal year to enhance the accuracy of MOF estimates. On the expenditure side, the real issue is the capacity of MOF to control expenditures and the consistent underestimation of mainly local administrative expenditures, but seasonality and the short span of the actual fiscal year may also induce year-end "spending binges." To address the considerable slippage between planned and actual expenditures, a permanent expenditure review committee should be set up to identify the causes and recommend corrective measures, including more explicit recognition of the effects of inflation. The focus should be on reducing uncertainties by moving

34/ Although that might not be the case for "big ticket" items, in which the center is more involved, it is common for SOEs to substitute bank credit for scarcer budgetary funds, making it impossible to enforce hard budget constraints.

35/ As discussed in Chapter 3.

to a more rules-based system and putting in place expenditure control systems.^{36/} The budgetary authorities should also make contingency plans for unforeseen circumstances (for example, core investment programs for an orderly cut of expenditures, rolling budgets).

- (c) **Plan Multiyear Expenditure.** Many governmental functions are continuous, and projects take years to complete. To mitigate the effects of the budget's annuality, some countries have introduced devices such as multiyear budgetary commitments for longer-term assurances of funding. Such strategies could help to reduce the uncertainty about financing at the local level. The United Kingdom, for example, makes an annual public expenditure survey. Each nationalized industry is entitled to make firm plans and commitments for investment projects amounting to 100 percent of its agreed investment program in the first year ahead, 85 percent in the second year, and 70 percent in the third year.^{37/} MYE plans require strengthening the links between the budget and the plan and might result in substantial improvements in executing the investment budget and controlling expenditures.

E. CONCLUDING REMARKS

2.52 Fiscal policy in general, and budgetary processes and practices in particular, could not keep up with the accelerating pace of reform in the 1980s. Here as in other areas, China's economic reforms have proceeded in increments, creating along the way new contradictions that have, in turn, impelled more extensive reform policies.^{38/} The lack of a clearly articulated and coherent blueprint for market reforms ^{39/} raises the never-ending challenge of dealing with a semireformed economy in which the old administrative controls of the centrally planned economy (CPE) have become less effective, while the indirect necessary fiscal, and monetary policy tools—and institutions—to steer an increasingly market-oriented and decentralized economy are just being developed. The difficulties in controlling expenditures by the central government (Chapter 1), resulted in persistent fiscal deficits and a systematic underestimation of their size and true economic impact, and to large and growing public-sector borrowing requirements (PSBR). The lag in reforming the fiscal system has allowed problems to grow instead of aiding the reform process.

^{36/} Budgetary appropriations to projects without detailed feasibility studies appears to be on the rise. The 1992 Budget Speech indicates that, starting this year, no major expenditures would be undertaken without prior feasibility studies.

^{37/} See OECD, *The Control and Management of Government Expenditure*, p. 49.

^{38/} Nicholas R. Lardy, "Is China Different? The Fate of its Economic Reform," in D. Chirot (ed.), *The Crisis of Leninism* (Seattle: 1989), University of Washington Press.

^{39/} Attributed to China's "weaknesses in the economics research infrastructure, a legacy of two decades of anti-intellectualism, as well as the anti-economism of the Cultural Revolution." See C.Z. Lir, "Open-Ended Economic Reform in China," in V. Nee and D. Stark, *Remaking the Economic Institutions of Socialism: China and Eastern Europe* (San Francisco, 1989), Stanford University Press, p. 101.

2.53 The control mentality continued to overestimate the effectiveness of direct controls, despite the lack of the enormous amounts of information required to make direct controls effective. The inadequacies of the budget's coverage, focus, management, and disclosure of information, as well as the increasing lack of compliance, made controlling expenditures and monitoring the effectiveness of public programs very difficult. The control mentality also underestimated the powers of essential indirect controls in China's decentralizing economy. As a legacy of China's past as a CPE, approaches are still deep-rooted to: (a) intermingling the state budget and credit and foreign-exchange plans, with all the plans operating as accounting instruments to facilitate implementation of physical transactions; (b) incomplete differentiation of interenterprise and government-enterprise transactions, blurring the integrity of enterprises vis-à-vis the budget and the banks; (c) distorted incentives to economic agents, resulting in soft-budget constraints and underpricing of capital; and (d) lack of attention to the structure of incentives. The old CPE hierarchical structures within the government sector persisted, at least in theory, while in practice, lower levels of government and enterprises began to assert their autonomy more forcefully through bargaining and noncompliance. While the budgetary system gradually settled for a form of "unified leadership and decentralized management," in the 1980s, it became apparent that new, more rule-based forms of fiscal organization were needed.

2.54 The role of the budget as an instrument of macroeconomic control is increasingly recognized: it needs to play a different role than in the past, as a new indirect instrument of control suitable for the economy's increasing market-orientation. Nonetheless, the emerging economic and political realities have made such reforms difficult. For example, tax contracting and the absence of individual income taxes and a national tax administration have limited the center's participation in the gains from economic growth. Powerful local interest now oppose further fiscal reform. "Fiscal disorder," has followed economic agents' attempt to escape budgetary control mechanisms by looking to extra- and off-budgetary funds and operations to meet what should have been budgetary tasks. "Fiscal undiscipline" has been prevalent among the various institutions partly because of the continued and, perhaps, increasing recourse to bargaining and noncompliance with fiscal regulations. Individual units and departments have increased their pressure on the budget, resisting an assessment of program and project worthiness, leading to "incrementalism" in expenditures and weakening control.

2.55 Budgetary reforms are complex, involve fundamental changes in the present system, and should be attempted only after careful planning. In most countries, the government appoints interministerial task forces with a well-defined mandate and timetable to offer specific recommendations and strategies for reforming budgetary practices and processes. The first task is to develop a medium- to long-term strategic focus about the role of the public sector, bearing in mind that China is in a process of rapid economic reform toward a mixed economy. However, it is increasingly evident that the institutions and systems of the past are unable to cope with the new realities, and a fundamental rethinking is called for regarding the role of the budget and the rules and structure of core institutions. Given the fluidity of the present situation the new system will need to be sufficiently flexible to accommodate the government's rapidly changing role.

2.56 The second task involves careful preparation and sequencing of the budgetary reforms along the seven "organizing principles" discussed in Section C. The starting point should be a systematic revision and updating of the classification and definition of the budgetary items as sketched in the Chapter's recommendations on clarity, ideally following international

practices, but also taking into account China-specific adaptation. Transitional arrangements should be put in place working in parallel until new formats, systems and procedures are tried and proven, giving MOF sufficient confidence before replacing the existing budgetary system. An in-depth knowledge of budgetary practices in other countries (particularly Japan, Australia, the Netherlands and Canada) through visits, secondments and requests for technical assistance could provide very valuable firsthand experience, useful in designing the required reforms and adaptations most useful for China.

2.57 Task forces to study budgetary reform are also charged, as part of the review of the budget formulation and execution process, to propose methodologies for assessing existing expenditure programs with a view to determining their continuity and adopting reforms to enhance their effectiveness. Management of change warrants attention to institutional strengthening in numerous areas and core agencies, in particular the Ministry of Finance which will continue to play the central role with an enhanced macroeconomic focus. Institutional and sequencing aspects in which budgetary decision-making occurs has been shown to have important effects on budget outcomes. Consequently, as part of China's budgetary reforms, MOF's institutional structure should receive considerable attention, as well as the strengthening of its technical, analytical and informational capabilities to provide leadership in the adoption of modern budgetary practices concomitant with China's new economic realities. The study of international experiences and recourse to technical assistance could play a fundamental catalytic role in fostering China's budgetary reform and minimizing the costs of transition to the new system.

III. EXPENDITURE ASSIGNMENT IN A DECENTRALIZED ECONOMY

A. INTRODUCTION

3.1 This chapter deals with the assignment and financing of expenditure responsibilities over levels of government in China. The chapter puts China's expenditure and revenue assignment in an international perspective. Major trends in central and local shares in government expenditures are reviewed in Section C and causes of the decentralization of expenditures over the reform period are analyzed. Section D analyzes the trends in revenues of central and local government, and argues that revenue assignment has not kept pace with shifting expenditure responsibilities. The subsequent analysis of expenditure patterns across provinces in Section E concludes that fiscal capacity among provinces has converged over the reform period, due to higher tax rates in the poorer provinces. The equalizing properties of the fiscal system itself have lapsed over the reform period. Section F identifies the consequences of the inadequacies in China's intergovernmental fiscal relations, and Section G concludes with recommendations.

3.2 For lack of data, subprovincial assignments of expenditures and revenues will be omitted, except for some individual case studies. The expenditure assignment over levels of government could not be completely analyzed, as no breakdown of capital construction by function and level of government was provided. Government tasks performed by enterprises falls outside the scope of this investigation. The chapter is supplemented by annexes on the theoretical aspects of decentralization (Annex 3.1), a preliminary analysis of regional redistribution through the banking system (Annex 3.2), the financing of price subsidies by levels of government (Annex 3.3), on methods for analyzing decentralization and the factors explaining China's apparent high degree of decentralization (Annex 3.4), and on public finances in three Chinese provinces (Annex 3.5).

B. AN INTERNATIONAL PERSPECTIVE ON EXPENDITURE ASSIGNMENT OVER LEVELS OF GOVERNMENT

Theoretical Considerations 1/

3.3 The division of labor among levels of government is a decisive element in the efficiency and effectiveness of public policy. The literature on fiscal decentralization has focused on efficiency, but the assignment of functions over levels of government has implications as well, intended or unintended, for equity and stability.

1/ See Annex 3.1 for a more elaborate treatment of the arguments in favor and against decentralization.

3.4 The traditional theory of fiscal federalism deals with the optimal supply of public goods and services from an efficiency perspective. Many public goods produce only local benefits (for example, roads and police) and there are strong arguments for decentralizing their supply to lower levels of government. These arguments include: (i) information on the demand for such goods and on the costs of supplying them is more readily available at the local level; (ii) accountability of government at lower levels is better assured because: (a) the constituents are closer to the local government than to the central government, and (b) people can move to another locality, if they feel the tax price they pay for their public goods is too high; and (iii) decentralized supply of local goods, provided that local governments face the right incentives, leads to competition among local governments, enhancing efficiency and innovation in the supply of public goods. Moreover, different localities' experiences provide information for comparing local governments' performances, which enhances political accountability to the public and financial and managerial accountability to higher levels of government.

3.5 Several arguments have been raised against decentralizing government functions, the major ones are: (a) spatial externalities: some public goods and services have positive or negative spillovers to other constituencies, leading to over- or undersupply of certain goods and services. For this reason, government's stabilization and redistribution functions are usually assigned to the central government. However, local government spending for reasons of efficiency can affect macroeconomic stability and equity as well; (b) imperfect mobility of people invalidates the corrective mechanism of "voting with one's feet"; (c) economies of scale in services like electricity supply might prevent local governments from supplying those services optimally; (d) lack of administrative capacity at lower levels of government may impair the efficiency of local public goods supply.

3.6 Based on theoretical arguments, a tentative division of labor over levels of government can be proposed (Table 3.1), distinguishing between service *responsibility* and service *provision*. The first is concerned with the objectives of a program or service, the second with the actual delivery of the service, and the two need not coincide.^{2/}

3.7 Table 3.1 is not a blueprint for assigning functions over levels of government, because arguments for and against decentralization offer only a rough guideline. Decentralization, or centralization in itself, does not confer welfare improvements. The design of the fiscal system, the division of expenditure responsibilities and the means to finance expenditures, set the incentives for behavior by subnational governments, and therefore determine the outcome in terms of efficiency, equity, and stability.

Some International Evidence

3.8 Because theory provides only limited guidance on expenditure assignment over levels of government, the wide variety of assignments from country to country and from period to period is not surprising. In most OECD countries right after World War II the tendency toward centralization was strong, not least due to the expansion of social security programs, primarily a central task. Since the 1970s, however, a reappraisal of the role of subnational

^{2/} Moreover, service provision need not coincide with service production. For instance, local governments may be assigned the provision of local infrastructure, but the actual production of infrastructure may very well be left to enterprises outside the public sector.

Table 3.1: CONCEPTUAL BASIS OF EXPENDITURE ASSIGNMENT

Expenditure category	Service responsibility	Service provision	Comments
Defense	F	F	National benefits
Foreign affairs	F	F	"
International trade	F	F	"
Environment	F	S,L	"
Currency, banking	F	F	"
Interstate commerce	F	F	"
Immigration	F	F	"
Unemployment insurance	F	F	"
Airlines/railways	F	F	"
Industry/agriculture	F,S,L	S,L	Interstate spillovers
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	"
Social welfare	F,S,L	S,L	"
Police	S,L	S,L	Primarily local benefits
Highways	F,S,L	S,L	Some roads with spillovers; others primarily local
Natural resources	F,S,L	S,L	Promotes a common market

F = central government; S = intermediate government (province, state); L = local government.

Source: Anwar Shah, "Perspectives on the Design of Intergovernmental Fiscal Relations," *PRE Working Paper Series*, No. 726, Washington, D.C., July 1991, p. 6 and p. 7.

governments has taken place.^{3/} Most developing countries remain highly centralized, but some tendency toward decentralization is appearing, due in part to the budgetary difficulties of central governments, notably in Latin America.^{4/} Other countries had to decentralize because

^{3/} William Oates, "The Theory of Fiscal Federalism: Revenue and Expenditure Issues: A survey of Recent Theoretical and Empirical Research," paper prepared for the OECD Conference *Fiscal Federalism in Economies in Transition*, Paris, April 2-3 1991.

^{4/} For a summary of the experience in various Latin American Countries, see Tim Campbell et al., "Decentralization to Local Government in LAC: National Strategies and Local Response in Planning, Spending and Management," Report No.5 (Internal IBRD report), July 1991.

the central government itself disintegrated, as in various East European countries and the former Soviet Union.

3.9 The extent of decentralization is readily, though incompletely measured, by the shares of expenditures by each level of government. Expenditures net of grants identify the administration of the various functions; expenditures including grants to other levels of government identify the financing of functions.^{5/}

3.10 Table A-16 shows the assignment of expenditure administration by levels of government for a sample of 39 developing and developed countries over a three-year period. The central government administers most expenditures: In all but four countries listed it accounted for over 50 percent, and an average share in total expenditures of 72.3 percent. The spectrum is wide, ranging from Yugoslavia (23 percent) to Paraguay (95 percent). Central governments have a larger portion of expenditures in developing countries (77.8 percent) than in developed countries (65.9 percent).

3.11 China, with 40 percent of expenditures at the central level, may seem at first to be "overdecentralized." However, before deciding that China falls outside the normal pattern, several factors that determine the degree of centralization have to be taken into account. Annex 3.4B presents an empirical analysis on the determinants of decentralization. It is found that the degree of decentralization is positively associated with: (a) income per capita; (b) the degree of urbanization; (c) the size of a country, either measured by population or by area; and (d) the presence of a federal structure. Taking these determinants into account, China's degree of decentralization falls within the normal pattern, if population is taken as an indicator of size.

3.12 The extent of centralization varies widely between the functions of government shown in Table A-16. With 45 percent of total government expenditures, the central government plays the lesser role in education, a trend that is more pronounced in developed countries. Regarding health expenditures almost 60 percent are centrally administered. Social security and welfare is usually a central function, except in Denmark, India, and Indonesia. The extent of decentralization per function is uncorrelated with the share of GDP devoted to a certain function,^{6/} but the more centralized total expenditures are, the more centralized are also the individual functions shown. The latter finding could be interpreted as indicating the dominance of the characteristics of the country as a whole (centralized or decentralized) over that of the function (a central function versus a local function).

3.13 In China, social security is virtually absent from the government's budget, in part because enterprises perform this function. Budgetary defense expenditures strongly underestimate total expenditures on this function, as most of the PLA is financed by profits of

^{5/} A large body of empirical research on decentralization exists. For an overview see: Michael Wasylenko, "Fiscal Decentralization and Economic Development," *Public Budgeting and Finance*, vol. 7, (1987), pp. 57-61. The most recent and complete database on fiscal decentralization is Jonathan Levin, "Measuring the Role of Subnational Governments," *IMF Working Paper* 91/8, January 1991, and his data will be used for subsequent analysis.

^{6/} In linear regressions, with the central share of education health, and social security as the dependent variables, regressed on a constant and the share of GDP devoted to the three categories, the coefficient of the share of GDP was not significant at the 5 percent level.

extrabudgetary enterprises. Since social security and defense are normally *central* functions, this explains in part the low expenditure share of China's central government.

3.14 Expenditures by level of government is only one aspect of decentralization, which in itself says little about the degree of autonomy that various levels of government have in performing those functions. Some additional evidence on the degree of autonomy can be found by reviewing the legal assignment of functions. The *de jure* service responsibilities and service provision for a selection of countries and government functions are given in Table 3.2. The *de jure* responsibilities fall broadly in line with the expenditure assignments arising from the fiscal federalism literature shown in Table 3.1.^{7/} The functions that define an internal market—the functions of international trade, currency and banking and the arrangements on interstate commerce—are all central responsibilities. Central government involvement in education, health, and welfare is justified for reasons of equity: the services are not considered purely private goods but constitute transfers in kind.

3.15 Important measures of responsibility and control over expenditures fall outside the realm of expenditure data and basic legal assignment. Among those measures are: detailed regulations and directives; central selection, training and promotion of the government's staff; central authorization for disbursements; central inspection, reporting, accounting and auditing; and frequent referrals to the central government on policy decisions. Such influences of central government on subnational government can only be identified by a detailed review of rules and regulations, which goes beyond the scope of this chapter.

C. EXPENDITURE ASSIGNMENT IN CHINA

The Institutional Framework

3.16 China is divided into four subnational administrative levels:^{8/} (a) 30 provinces,^{9/} autonomous regions and municipalities under central government; (b) 336 prefectures and municipalities at prefectural level; (c) 2,182 counties, autonomous counties, and cities at county level; and (d) townships, towns, and city districts. Government levels below central government are referred to as "local government." The hierarchy among the levels of government is illustrated in Figure 3.1.

3.17 China's provincial level has an average population of 30 million in 1990, with provinces like Sichuan populated by over a hundred million. This is large in international comparison: states and federal districts in Brazil have an average 5.3 million inhabitants; the states of the United States and the German Laender have on average 5 million inhabitants; the French regions and the Australian states, 2 million. Only the Indian states, with an average of 26.5 million inhabitants approximate the size of the Chinese provinces. The prefectural level

^{7/} Shah, 1991, p. 6.

^{8/} See Article 30 of the 1982 Constitution.

^{9/} Including Taiwan province, there are 31; another 14 cities have so-called independent budgetary and planning status, which implies that they are independent of the province in budget and planning matters.

Table 3.2: EXPENDITURE ASSIGNMENT IN SELECTED COUNTRIES

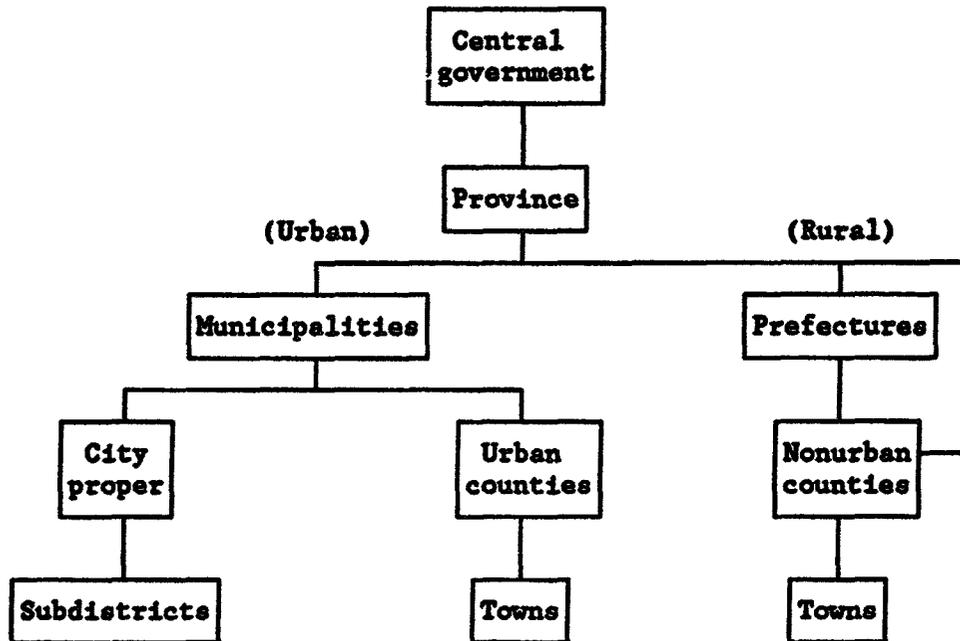
	Defe.	Fore. Aff.	Int'l Trade	Envir.	Cur. Bank	IntSt Trade	Immig	Unempl Insur.	Air Rail	Ind. Agric.	Educ.	Health	Soc. Welf	Police	Rgvy	Natu. Resour	Resid
Argentina:																	
(1)	F	F	F		F	F			F,S		F,S,L	F,S,L		F,S	F,S	F,S	S
(2)	F	F	F		F	F			F,S		F,S,L	F,S,L		F,S	F,S	F,S	S
Bangladesh:																	
(1)	F	F	F		F					L	L	L	L	L	L	L	
(2)	F	F	F		F					L	L	L	L	L	L	L	
Brazil:																	
(1)	F	F	F	F,S	F	F	F	F	F	F,S	F,S	F,S	F,S	F,S	F	F,S	S
(2)	F	F	F	F,S	F	F	F	F	F	F,S	F,S,L	F,S,L	F,S	F,S	F,S	F,S,L	S
Czechoslovakia:																	
(1)	F	F	F		F	F	F			S	L	L	S	F			
(2)	F	F	F		F	F	F			S	L	L	S,L	F			
India:																	
(1)	F	F	F	F,S	F	F	F	F,S	F	F,S	F,S	S	F,S	S	F	F,S	F
(2)	F	F	F	F,S	F	F	F	F,S	F	F,S	F,S,L	S,L	F,S	S	F	F,S	F
Indonesia:																	
(1)	F	F	F		F					F,S,L	F,S,L	F,S,L					
(2)	F	F	F		F					F,S,L	F,S,L	F,S,L					
Japan:																	
(1)	F	F	F							L	F,L	F,L	F,L	F,L	L	L	
(2)	F	F	F							L	F,L	F,L	F,L	F,L	L	L	
Malaysia:																	
(1)	F	F	F	L	F	F	F		F	F,S	F	F,S	F,S	F	F	S	F
(2)	F	F	F	L	F	F	F		F	F,S	F	F,S	F,S	F	F	S	F
Mexico:																	
(1)	F	F	F	F	F	F	F		F	F	F,S	F,S		S,L			S
(2)	F	F	F	F	F	F	F		F	F	F,S	F,S		S,L			S
Nigeria:																	
(1)	F	F	F	F,S	F	F	F		F	F,S	F,S	S,L		F	F,S,L	F,S,L	F
(2)	F	F	F	F,S	F	F	F		F	F,S	F,S	S,L		F	F,S,L	F,S,L	F
Pakistan:																	
(1)	F	F			F		F	F,S	F	F,S	F,S,L	F,S,L	F,S	S	F,S	F	S
(2)	F	F			F		F	F,S	F	F,S	F,S,L	F,S,L	F,S	S	F,S	F	S
Philippines:																	
(1)	F	F	F		F	F					F		F	S,L			
(2)	F	F	F		F	F					S,L		S,L	S,L			
Soviet Union/a																	
(1)	F	F	F		F				F				F				
(2)	F	F	F		F				F	F,S,L	F,S,L	F,S,L	F,S,L	F			
Thailand:																	
(1)	F	F	F		F						L	L		L	L		
(2)	F	F	F		F						L	L		L	L		
Yugoslavia:																	
(1)	F	F	F		F	F	F		F		S	S	S		F	F	
(2)	F	F	F		F	F	F		F		S,L	S,L	S,L		F	F	

/a Allocation of Expenditure responsibility between republics and local governments is still an open question. For row (2), the table reflects actual distribution of main expenditures between different budgets in 1989.

Notes: F = Federal/Central Government
 S = State/Provincial/Republic/Departmental Government
 L = Local Government
 (1) = Service Responsibility
 (2) = Provision of service

Sources: Anwar Shah, "Perspectives on the Design of Intergovernmental Fiscal Relations," Policy Research Working Paper Series, No. 726, July 1991 [Adjusted].

Figure 3.1: GOVERNMENT STRUCTURE IN CHINA



Source: World Bank "Revenue Mobilization and Tax Policy," Washington, D.C., July 1991.

in China, averaging 3.4 million inhabitants, is also much larger than the comparable level in the United States, where counties average 82,000 inhabitants.

3.18 Although China is a unitary country, powers for subnational governments are acknowledged in the constitution. The principle of the division of powers is given in Article 3: "...giving full play to the initiative and enthusiasm of the local authorities under the unified leadership of the central authorities," and Article 100 gives provinces the right to adopt their own regulations as long as they do not conflict with central regulations. Local People's Congresses examine and approve plans for economic development and budgets for the locality, submitted by local governments (Art. 99). The plans and budgets are submitted to higher level Standing Committees of People's Congresses for the record.

3.19 Article 89(4) delegates the formulation of a detailed division of power between central and provincial level to the State Council,^{10/} but Article 107 defines the role of local people's governments at and above county level: "... [they] conduct the administrative work concerning the economy, education, science, culture, public health, physical culture, urban and rural development, finance, civil affairs, public security, nationalities' affairs, juridical administration, supervision and family planning in their respective administrative areas...." The functions overlap extensively with those of the State Council, which, according to Art. 89, "directs and administers" the work on urban and rural development, education, science, culture, public health, physical culture, family planning, civil affairs, public security, juridical administration, and supervision. The strong overlap in functions can be explained by the

^{10/} Such detailed division of power has not yet been published to our knowledge.

Chinese tradition of assigning functions hierarchically. For instance, there are not simply universities, but central and local universities, making education both a local and a central responsibility, and a hospital or a bridge in a city can be financed by the central government, by the provincial government, or by the city government.

3.20 The distinction of expenditure assignments is complicated by the fact that many of the tasks that are internationally considered government tasks are performed by enterprises in China, and the expenditures on public services done in such a way do not appear on the budget of any level of government. To give an extreme example: Shanghai municipality has "contracted out" industrial development to financial enterprises like Shanghai Investment Trust Company and Jui Shi. The enterprises have the responsibility for developing infrastructure but, at the same time, raise taxes from the firms operating on their premises. Neither the expenditures, nor the revenues of these enterprises will appear on Shanghai's budget.^{11/}

3.21 Local governments have the authority to appoint and train their own administrative personnel, and the governor makes the important personnel decisions. The governor is appointed by central government. In general, there is little exchange of personnel between localities and the center or between different local administrations. Vertical relations predominate in the government. Horizontal relations between provinces or between municipalities in the same or in different provinces is limited to informal contacts.

3.22 Autonomous regions, prefectures, and counties are assigned some further powers in Section 6 of the constitution, and Art. 117 gives them the right to keep all revenues accruing to these areas. Article 122 orders the state to give financial, material and technical support to autonomous regions.

3.23 In 1980 the central government announced that it would no longer stipulate individual items of expenditures in provincial budgets and turned its attention to revamping the revenue side of the budget but retained the right to set general expenditure guidelines. The expenditure assignments specified in the Provisional Regulations ^{12/} overlap with the constitutional assignment and determine the share of local revenue that remains in a locality to finance those expenditures.^{13/}

^{11/} See Remy Prud'homme, "Urban Finance in China," paper prepared for a World Bank-UNDP seminar, Shanghai, February 1991.

^{12/} "Provisional Regulations Concerning the Introduction of a Fiscal Management System by Which the Scope of Revenue and Expenditures is Defined for the Central and Local Governments, Respectively, and Each is Responsible for the Balancing of Its Own Budget," issued by the State Council, February 1, 1980, attached to "The State Council's Circular on the Introduction of a Fiscal Management System by Which the Scope of Revenue and Expenditure Is Defined for the Central and Local Governments, Respectively, and Each Is Responsible for the Balancing of Its Own Budget," *China Economic Yearbook*, 1981, pp. 130-131.

^{13/} See Section D and World Bank, "Revenue Mobilization and Tax Policy," Washington D.C., 1991.

Local Autonomy in China ^{14/}

3.24 The institutional framework leaves ample scope for local autonomy over local expenditures, but local government discretion is restricted in many respects. In principle, no formal approval of the local budget is required (only submission), but because the local budgets are part of the State budget, they are approved *de facto* by the NPC as well. Moreover, the local government, which prepares and submits the local budgets, is responsible not only to the People's Congress at the same level, but also to the government one level above.^{15/}

3.25 In the budget formulation phase, the central government exercises binding influence on the composition of the expenditures through the control quotas issued by MOF, determining allowed expenditures. The allowed expenditures in turn determine the revenue share retained in the provinces (see below). Allowed expenditures are determined by the "base number," the expenditures in a certain base year, adjusted through "factor adjustment," which prescribes changes in expenditures according to national priorities, price adjustments, and changes in national laws. By the factor adjustment method, expenditure quotas are imposed on the provinces, which extend those targets to subprovincial governments. The general constraint on local budgets is that no deficits are allowed. However, deficits do arise, *ex-post*, and are financed either by arrears or by using extrabudgetary funds. Local expenditures are further determined by central decisions on wages and prices, and by a set of detailed regulations on government consumption.^{16/} In the extrabudgetary sphere, a number of State Council regulations prescribe the scope and use of both fiscal and enterprise extrabudgetary funds.

3.26 On the revenue side, local autonomy is *de jure* even more restricted than on the expenditure side. The central government determines both the base and the rate of all taxes, and, formally, there are no local taxes. The central government has the final say on fiscal contracts between center and provinces and the allocation of earmarked grants, thereby determining the local revenue base. However, because local governments are the principal tax collectors, they control most *effective* tax rates and bases, and they have increasingly used this discretion over the reform period (Section F, this chapter). Fiscal extrabudgetary revenues—fees and levies for government services—are prescribed and controlled by the Price Bureau, but *de facto* they constitute a form of true local tax base.

3.27 Several features of Chinese society weaken the case for local autonomy and may explain the stress on central control over local public finances. Perhaps most notable is the institutionalized immobility of people, which limits "voting with one's feet," a powerful mechanism for controlling local government behavior and performance. However, the increasing size of China's "floating population" ^{17/} is a sign that the absolute immobility of the past is

^{14/} In China, all government levels below central government are called "local government."

^{15/} Articles 109 and 110 of the Constitution, and the Budget Regulations in Annex 2.2.

^{16/} See, for example, "Emergency Circular on Strengthening Control over Nonproduction Consumption by Social Groups," National Leading Group on Controlling Social Consumption, Document No. 13 (1991).

^{17/} Some sources estimate the number at 50 million. See World Bank, "China: Strategies For Reducing Poverty in the 1990s," Report No. 10409-CHA, p. 58.

eroding and that the administrative controls can no longer check the differences in income and work opportunities between localities.

3.28 A second distinctive feature of the Chinese system is partial reliance on state planning and administered pricing.^{18/} Decentralizing decision-making under the conditions of nonmarket clearing prices may lead to decisions that are beneficial to the decision-making locality, but detrimental to the general welfare. Moreover, the impact of government spending is at least partially transmitted through quantity movements instead of price movements, and decentralizing such spending may aggravate cyclical movements in the economy.

3.29 A third feature is the strong interest of local governments in locally owned SOEs: because the tax system leaves *de jure* no local autonomy in determining the tax base and rates, the only way to increase revenue is by increasing the size of the tax base. This could induce suboptimal tax and spending policies to the benefit of local enterprises and thus to the benefit of local governments' command over resources, but disregarding the preferences of the local population. Moreover, creating a favorable environment for local firms may have negative externalities across the border of the constituency, if they take the form of entry restrictions or result in overinvestment nationwide. A final feature of the Chinese fiscal system is the absence of personal income taxation. The implication of it is that the expenditure side of public finance gains importance in attaining equity goals.

3.30 These features of Chinese society undo some of the corrective mechanisms for local governments, and increase the impact of local governments' behavior across its boundaries. A substantial amount of central government control over local government behavior therefore seems an appropriate second-best policy for achieving efficiency and stability. At the same time, the increased decentralization over the 1980s has ignited strong entrepreneurial activity that resulted in the well-known record growth rates. This *entrepreneurial* decentralization, however, should be distinguished from the *governmental* decentralization which is the topic of this chapter.

3.31 The perception in China is that central control over localities is crumbling, and the desire to recentralize part of government finance is strong, as expressed in the goal of "increasing the two ratios": the ratio of government revenues to GNP and the share of central government in general government expenditures and revenues. The rest of this chapter is devoted to: (a) determining whether the perception of reduced central government control is validated by general trends of expenditures and revenues; (b) explaining these trends in terms of incentives built into the system of central local relations and exogenous development; (c) identifying dysfunctional outcomes like the undersupply of public services, reduced equalization of the fiscal system, and increased use of tax expenditures; (d) suggesting improvements in intergovernmental fiscal relations, so as to keep the benefits of decentralization and minimize the dysfunctional outcomes.

Trends in Central and Local Expenditures and Revenues

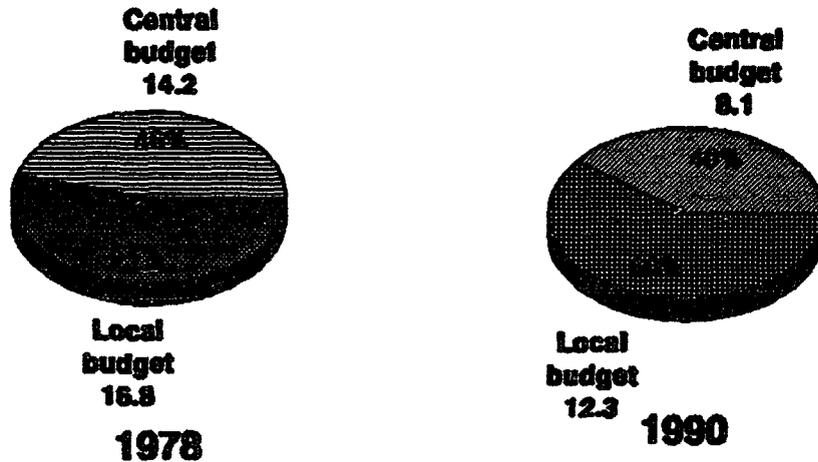
3.32 **Sharing a Shrinking Pie.** The locus of budgetary expenditures ^{19/} shifted toward lower levels of government throughout the 1980s. The local share in total government

^{18/} About 47 percent of all prices are still administered and "guided" by the State.

^{19/} "Expenditures" refers to the administration of expenditures, unless otherwise stated.

budgetary expenditures rose from 54 percent in 1978 to over 60 percent in 1990 (Chinese definition). However, in line with the sharp decline of government's share in GNP, local governments' share was reduced from 16.8 percent to 12.3 percent of GNP over the same period (Figure 3.2 and Table A-1.2).

Figure 3.2: CENTRAL-LOCAL EXPENDITURES
Sharing a Shrinking Pie
(Percent of GNP and percent of total)



Source: Table A-1.2.

3.33 Within the local budgets, expenditures also appear to be shifting downward from the provincial level to cities and counties (Annex 3.5). However, published data on subprovincial fiscal entities are scattered,^{20/} and often fail to present data for meaningful analysis. Table 3.3 presents data on the share of the province proper in local expenditures. Over the sample, the provincial level spends an average of a little over one third of total expenditures and collects 28 percent of the revenues. In general, the prefectural level (including the major cities) seems to be the large surplus generator; both provincial and county levels spend more than they collect in (local) revenues.

3.34 Although the share of local revenue after tax sharing increased over the 1980s, own revenues ^{21/} became increasingly insufficient for covering expenditures, and local

^{20/} Apparently, an internal publication (China Finance and Banking Annual Statements) exists which records information on the subprovincial level. However, the mission did not have access to it.

^{21/} Own revenue of a fiscal entity is the revenue accruing after tax sharing, but before earmarked grants. Own revenue gives in general more control over expenditures than earmarked grants.

**Table 3.3: PROVINCIAL SHARE IN LOCAL EXPENDITURES AND REVENUES
FOR SELECTED PROVINCES
(percent)**

	Year	Expenditures	Revenues
Hainan	1989	42.7	..
Hubei	1990	26.5	..
Hunan	1988	29.0	17.5
Inner Mongolia	1992	24.1	11.0
Liaoning	1987	60.8	54.3
Shaanxi	1989	24.7	15.8
Shandong	1990	21.0	..
Shanxi	1988	26.1	20.5
Tianjin ^{/a}	1990	69.4	52.1
Xinjiang	1989	23.4	..
Average		34.8	28.5

^{/a} Tianjin is a city with provincial status, which explains the high provincial-level share of expenditures.

Sources: Various provincial yearbooks.

dependence on central earmarked grants rose from 14.5 percent of budgetary expenditures in 1982 to 22.4 percent in 1990 ^{22/} (Figure 3.3 and Annex 3.5A).

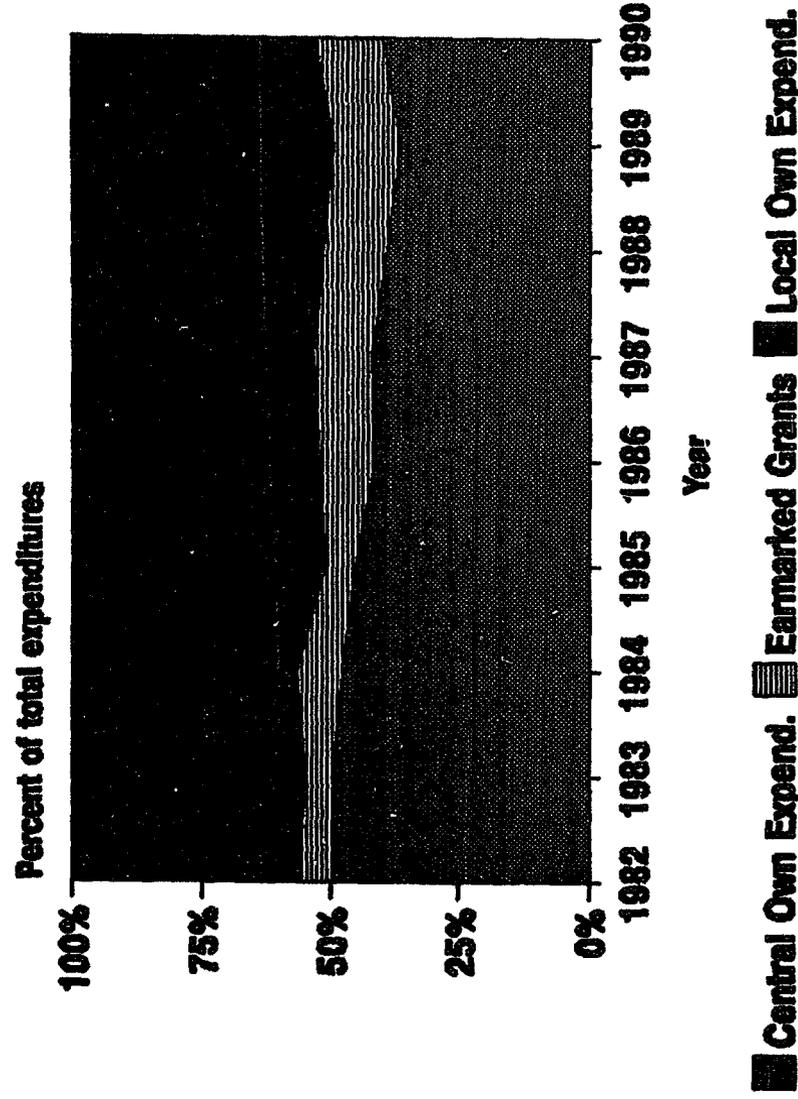
3.35 The financing of expenditures by the center, and thereby the control over expenditures, has consequently declined less than the expenditure administration data suggest. The reduced loss of control holds *a fortiori* if one accounts for the substantial cofinancing requirements in China: one yuan of earmarked grants may "move" over two yuan of local expenditures in a direction desired by the central government.^{23/}

3.36 **Second Courses.** A major concern of the Chinese government has been the rising importance of extrabudgetary funds, especially at the local level. Although the growth in total extrabudgetary funds (including SOE funds) was larger at the central level in 1981-90 (18.8 percent nominal annual growth versus 15.1 percent for local extrabudgetary funds), *fiscal* extrabudgetary funds are mainly local, and local government benefitted from the substantial

^{22/} Earmarked grants are intergovernmental fiscal transfers conditional on the performance of a certain task. The earmarked grants figure is arrived at by using the assumption that local governments have no deficits, nor have substantial reserve building or depletion in the aggregate.

^{23/} For a detailed analysis of the revenue system and intergovernmental transfers, see Section D (Intergovernmental Financial Flows).

Figure 3.3: KEEPING CONTROL
Central and Local Expenditures and Earmarked Grants



Source: Table A-1.2.

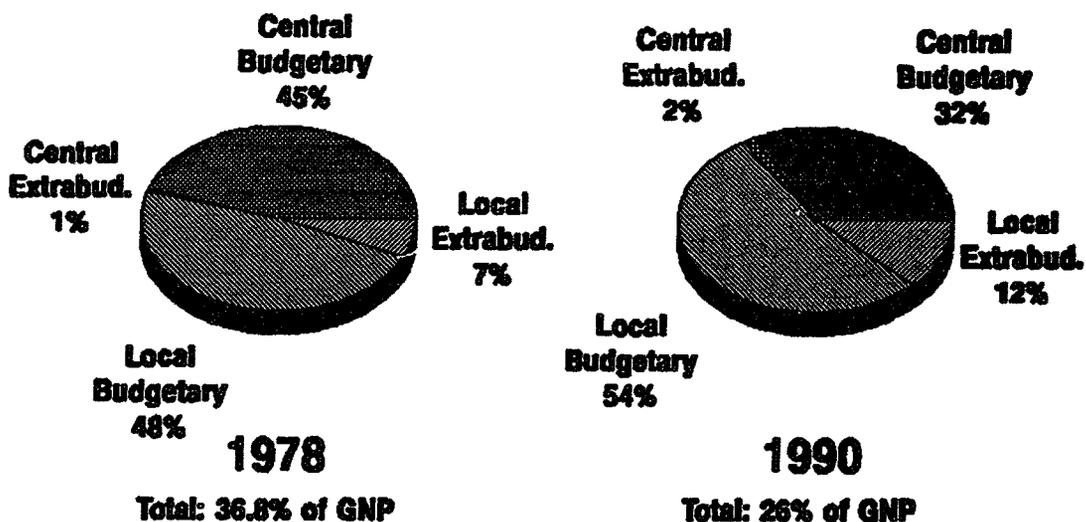
growth in this category.^{24/} Extrapolating the 1987 central local division of fiscal extrabudgetary funds,^{25/} and again assuming that extrabudgetary expenditures equal revenues, a comprehensive, central-local split of fiscal expenditures can be estimated. The overwhelming share of local governments in *fiscal* extrabudgetary funds shifts the conclusion on central-local expenditure trends (and, by construction, on revenue trends). Local governments strongly increased their share in total government expenditures, from 55 percent in 1978 to 66 percent in 1990 (Figure 3.4). To a large extent, the rise in fiscal extrabudgetary funds is desirable, given that it reflects the more rational pricing of government services. That such a rise took place at the local level is normal, given that local government is the predominant supplier of these services.

3.37 A Closer Look: Analysis of Major Expenditure Categories. To shed light on the increase of local government's share, a closer look to the development of individual items on central and local budgets is required. Data in Table A-14 largely reflect the constitutional

^{24/} See Chapters 1 and 2 for a more elaborate discussion of extrabudgetary funds.

^{25/} The central-local split-up of fiscal extrabudgetary funds can be derived only for 1987. See *China Finance Statistics 1950-1988*, Beijing, 1989, p. 110.

**Figure 3.4: CENTRAL LOCAL EXPENDITURES
Second Courses**



Source: Table A-1.4.

intergovernmental division of labor.^{26/} In 1978 central expenditures were concentrated in capital construction (48.4 percent) and national defense (30.9 percent). In the 1992 draft budget, they will be similarly concentrated (capital construction, 32 percent; national defense, 20.2 percent), but a new expenditure component has been added, debt servicing, which will absorb 23.6 percent. In contrast, local expenditures on these components comprises only 6.8 percent of the total, while culture, education, and health will absorb 29.7 percent, administration 14.5 percent, and price subsidies 12.4 percent.

3.38 The deepest cuts were made in "development expenditures," including capital construction, technical renovation, geological surveys, and working capital, down from 16.5 percent of GNP in 1978 to 5.3 percent in 1990 and 4.9 percent in 1992. National defense spending, too, was cut, from 4.7 percent of GNP in 1978 to 1.7 percent in 1992, a substantial reduction in the central government's share in total expenditures. Together, these reduced central expenditures by 7.6 percent of GNP and local expenditures by 4.6 percent. In contrast, two components grew from zero to significant portions of total expenditures: debt service and price subsidies, which absorbed 1.09 percent and 2.19 percent of GNP in 1990, respectively (and 2.15 and 1.68 percent in 1992).

3.39 The shift in expenditures to local government is largely attributable to intended and unintended consequences of the reform program affecting especially those categories

^{26/} One caveat about the expenditure assignment over levels of government: because the large budgetary category of capital construction cannot be disaggregated by functions and levels of government, the analysis may be biased. For a further analysis of budgetary capital construction, see Annex 2.4.

dominating local budgets. The increased share of local expenditures resulted from: (a) increased emphasis on policies traditionally administered at local levels, notably in the category culture, education, science, and health (CESH); (b) wage increases, which affected local governments more than the central government through administrative expenditures; and (c) sharply rising price subsidies, administered mainly by local government.

(a) Culture, Education, Science, and Health

3.40 The second largest component of local expenditures is CESH, budgeted at Y 68.2 billion in the 1992 draft budget and absorbing 29.7 percent of local expenditures. (In the 1990 final account, CESH was 22.6 percent of local expenditures.) Total expenditures on this component have grown rapidly in the reform period, from Y 11.3 billion in 1978 to Y 77 billion planned in the 1992 draft budget, an average annual nominal growth of 14.7 percent. Education is the largest part of CESH, close to 60 percent of total expenditures. Health care is a distant second, at 20-24 percent of the total (Table 3.4).

Table 3.4: BREAKDOWN OF EXPENDITURES ON CULTURE, EDUCATION, SCIENCE, AND HEALTH (Y 100 million)

	1978	1985	1986	1987	1988
Total	112.66	316.70	379.93	402.75	486.10
Culture	4.10	11.29	13.50	13.52	15.40
Education	65.60	184.16	214.32	226.66	278.73
Health	27.26	70.26	83.14	86.20	100.98
Physical education	2.54	7.53	9.89	10.01	11.67
Science	5.41	13.74	21.43	29.50	35.65
Communications and broadcasting	3.78	11.19	14.20	14.16	16.08
Family planning	1.98	7.45	8.03	8.52	10.04
Other	1.99	11.08	15.42	14.18	17.55
Memorandum Items					
Share of education (%)	58.2	58.2	56.4	56.3	57.3
Health (%)	24.2	22.2	21.9	21.4	20.8

Source: *China Finance Statistics 1950-88*, p. 82.

3.41 **Education.** Budgetary expenditures on education grew from Y 6.56 billion in 1978 to Y 16.42 billion in 1985 and Y 27.87 billion in 1988, and a projected Y 45.2 billion in the 1992 draft budget. This represents an average annual growth of 14.8 percent in nominal terms in 1978-92. Since 1985 growth has averaged 15.6 percent a year. The rapid growth has resulted directly from educational reforms (implemented in 1985) and the "Law on Compulsory Education" (1986) (Box 3.1). However, already through the early 1980s, many provinces raised

Box 3.1: DECENTRALIZING EDUCATION IN CHINA

The responsibility for educational administration and finance in China was decentralized over the 1980s. Central government remained responsible for a minor part of university education, but decentralized the responsibility for secondary education to provincial, municipal, county, and township level. Primary education was already a provincial responsibility before 1980. Decisions regarding public spending on education are now made at corresponding level, prepared and enacted by the financial bureaucracy (Ministry of Finance, Department of Finance, finance bureau, etc.), with only minor grants from higher-level education authorities. The grants are usually matching grants, but some equalizing component is present. Budgetary educational expenditures are partly financed from general revenues of the various layers of government, and partly by earmarked levies, which can amount to the equivalent of a 3 percent sales tax in rural areas. About a third of educational expenditures is financed by tuition fees and off-budget "community contributions" from individuals and firms.

The decentralization of responsibility for educational objectives and instruments was limited. The "Law of Compulsory Education" prescribed targets to be reached in education. The most significant among them are: (a) faster growth in educational expenditures than in total expenditures; (b) continuous growth in educational expenditure per student; and (c) an increase in the duration of compulsory education from 5 years to 9.

The first two targets seem in conflict with the goals of decentralization. Because central government is less informed than local government on the local costs of education, decisions about expenditures and financing should be decentralized. The expenditure targets run contrary to the goal of cost efficiency and may result in waste. Local managers who must increase expenditures may become less sensitive to potential cost reductions. Decentralization bears the risk of lowering quality standards, but inspection or central examination could overcome that problem more effectively than setting spending minimums.

The third target may prove to be too much for poorer areas, already strained by decentralization. Their expenditure responsibilities have grown but not their financial means, and their ability to raise taxes or community contributions is limited. The quality of education is lower in northern areas and, within provinces, partly because of the unequal distribution of resources.^{1/} Teachers, the main input, receive better treatment in cities (gongban teachers) than in villages (minban teachers). Gongban teachers are paid directly by government, and much better than minban teachers, who must often take a second job, to the detriment of educational quality. Supplies of educational materials are inferior in rural areas, as the community contributions that pay for supplies are much lower there than in cities.

In partial recognition of the financial problems of poorer communities, the Law of Compulsory Education allows for an implementation in stages, the richest provinces being the first to fulfill the requirements. This arrangement seems unsatisfactory, because it puts students in poorer areas at a disadvantage for schooling, a public good. The optimal policy would probably be to implement the apparently desirable nine-year curriculum nationwide, while providing the poorer provinces, municipalities and villages with grants to cover the additional costs.

^{1/} World Bank, "China: Provincial Education Planning and Finance," Report No. 8657-CHA, June 1991.

their CESH shares of expenditures.^{27/} Rising labor costs have been a major contributor to the growth of budgetary expenditures on education. State-sector wages rose at an average annual rate of 10.5 percent in 1978-90, and the cost of providing education has risen correspondingly, since personnel costs comprise some 80-90 percent of the total in primary and secondary education.^{28/} Costs of education have also been pushed up by the rising costs of supplies, especially books, whose prices have risen much faster than urban retail prices. This implies that, although education expenditures have risen strongly at the local level, the actual output and quality may have increased by much less.^{29/}

3.42 Health. Budgetary expenditures on health are the second largest part of CESH. They grew at an average annual rate of 14 percent in nominal terms from Y 2.73 billion in 1978 to Y 10.1 billion in 1988. In 1990 budgetary allocations were Y 8.6 billion (Y 7.94 billion for medical care plus Y 660 million for Chinese medicine). The rise in budgetary allocations did not prevent a marked increase in private contributions to health care, as costs rose even faster. Some of the cost increases in health care are a direct result of the decentralization strategy pursued. Budgetary funding was geared toward expensive institutional care, and the incentives for medical personnel were biased toward a strong increase in user charges and medicine prescriptions, because the profits could be and were used for bonus payments (Box 3.2).

(b) Administrative Costs

3.43 Government administration spans three expenditure categories: the largest is "government administration" itself, which includes civil servants in government agencies (and excludes school teachers). The others are employees in sectoral departments (including agriculture, forestry, fisheries, industry, transport, and commerce). Administrative expenditures rose from Y 10.55 billion in 1978 to a planned Y 58.8 billion in the 1992 budget (Table 3.5). This 13 percent (nominal terms) average annual growth in administrative spending was much faster than the annual growth in total expenditures (9.8 percent), and its share in total expenditures grew from 9.5 percent to 14.3 percent during the period. Administrative expenditures are overwhelmingly borne at the local level in the 1992 budget, 80 percent of total administrative expenditures and over 21 percent of total local expenditures.

^{27/} In Guangxi Province, for example, CESH expenditures grew by 102.5 percent in 1981-85, and its CESH share in the provincial budget grew from an average of 19 percent during 1976-80 to 32 percent (*Guangxi Yearbook*, 1986, pp. 458-459). Similarly, Sichuan Province raised its education and health expenditures from 25 percent of the budget during the fifth five-year plan (5FYP) to 34 percent in the 6FYP (*Sichuan Economic Yearbook*, 1986, p. 132).

^{28/} World Bank, "China: Provincial Education Planning and Finance—Sector Study" Washington, D.C. June 1991, Table 4.6; and *Xinjiang Financial Yearbook*, 1986.

^{29/} In 1978-90, local CESH expenditures grew at an average annual rate of 13.3 percent. In 1978-88, unit costs in the provision of primary and secondary schooling rose at estimated annual rates of 13.8 percent and 13.5 percent, respectively (World Bank, "China: Provincial Education Planning and Finance—Sector Study" Washington, D.C. June 1991, p. 56, Table 3.22). Here, it is assumed that educational expenditures were directly correlated with CESH expenditures.

Box 3.2: DECENTRALIZING HEALTH CARE IN CHINA

The combination of accessible primary health care, improved nutrition, and better education, housing, and sanitation has improved the health of China's population well beyond that of most countries with comparable income per capita. Moreover, this has been achieved in a comparably cost-effective way. However, a number of factors have caused a rapid increase in the ratio of health spending to GDP, from 2.6 percent in 1980 to an estimated 3.6 percent in 1990, a real increase of 11.2 percent a year over the decade. Apart from demographic and epidemiological factors, a driving force behind the increase was the change from the commune health care system to the principle of "cost recovery" for health institutions at the end of the 1970s. Cost recovery can mightily enhance efficiency and is a good tool in decentralizing responsibilities. Many countries have found that people are quite willing to pay for good health services. In China, cost recovery has led to a wealth of local initiative and variety in the provision of health care. However, several developments in China point out that the success of cost recovery in terms of equity and efficiency depends on the way it is introduced.

The incentive for health institutions to supply services for fees has led to a shift in resources from prevention (for which no services can be charged) to treatment, which can be profitable. An example of this are the Anti-Epidemic Stations, whose prevention tasks are fully funded by the provincial budgets, for example, drinking water testing. Cost recovery shifted their attention to commercial product testing, where profits can be made for employee bonuses. A second example is the increasing recourse to institutional treatment. This trend was enhanced by the way budgetary funds are allocated, covering basic salaries of institutional workers, but not those of rural general practitioners. For the user of health services, subsidized institutional care became cheaper than nearly full-cost primary health care. The budgetary support for institutions gave equally strong incentive to build (mostly urban) hospitals, resulting in overcapacity, because subsidies for recurrent costs are tied to the size of the institution. The fee structure itself is tilted toward the introduction of new treatments, as the Price Bureau, which regulates fees, allows more discretion for those treatments than for older, established ones. As part of the cost-recovery program, institutions were allowed a surcharge on medicine, which predictably led to a strong increase in the prescription of drugs. The insured are especially prone to overprescription and overtreatment, because health insurance usually requires no copayments. Because health insurance premiums are deductible from profit before taxes, the inappropriate finance structure also becomes a budgetary problem as substantial revenue is foregone.

Perhaps more pervasive than the inefficiencies tied to the cost-recovery system in China were the effects on equity. Insurance coverage is limited to about 200 million people, and the health needs beyond infant care for the rest of the population "are left primarily to market forces, personal wealth and good fortune."^{1/} In 1990, patient fees constituted 37 percent of health expenditures compared to 14 percent at the beginning of the 1980s (Figure 1). The budgetary share saw a rapid decline over the same period, while the decline in the share covered by insurance was less steep only because of the strong increase in the cost per insured patient. Central appropriations primarily cover research costs and central administration expenses and are only marginally devoted to programs targeted at poorer areas. Thus, public funding for the health care system depends largely on budgetary means, and therefore on the economic performance, of the province. Provincial budgetary allocations per capita, which for China as a whole average Y 7 per year, may be as high as Y 22 in coastal provinces, and as low as Y 4 in some poorer areas. Provincial inequities add up to the traditional urban-rural divide.

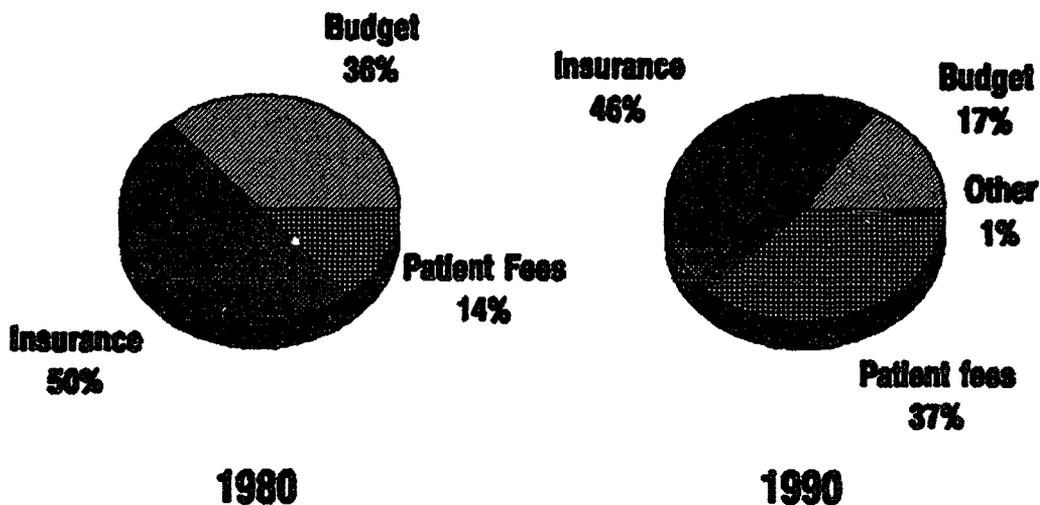
Increasing the coverage of health insurance would not only bring more equity to the system of health care but would also lead to efficiency gains, by widening the risk pool. Until such a wider coverage is in place, there is no alternative to increased budgetary allocations if China wants to achieve equal access to health care nationwide. An increased central share in of the center in budgetary health expenditures should be combined with a needs test for distribution of the funds between the provinces. The Ministry of Health has recognized most of these problems, and the equal distribution of health care among provinces is at the center of their attention. However, central budgetary allocations to equalize health care so far remain extremely limited.

^{1/} World Bank, "Long-Term Issues and Options in Health Transition," Report No. 7965-CHA, June 25, 1990.

...Continued

Box 3.2: (cont'd)

HEALTH FINANCING IN CHINA
Shifting the Burden
(percent of total costs)



Note: 1990 figures are estimates.

Source: World Bank 1990 and update.

3.44

Administrative costs have escalated for three reasons:

- (a) The rapid rise of urban wages has pushed up labor costs in government agencies. During 1978 to 1990, average wages in the state sector rose from Y 644 to Y 2,140, an average annual growth of 10.5 percent, as compared to the average rise in the urban retail index of 6.9 percent. While the average wage for civil servants is slightly lower than that for workers in SOEs, government salaries follow the trend set by SOEs.^{30/} In the reform period, decentralized management of SOEs encouraged rapid wage increases, under conditions of rapid growth and soft budget constraints.

^{30/}

In 1990 the average annual wage in SOEs was Y 2,347 compared to Y 2,113 for government employees and Y 2,180 for workers in social institutions.

Table 3.5: ADMINISTRATIVE EXPENDITURES

	1978	1985	1990	1992/ ^a
Y Billion				
Total	10.55	22.95	49.1	58.8
Local	9.05	18.30	41.0	49.0
Percent of Total Expenditures				
Total	9.5	12.4	14.2	14.3
Local	15.3	17.5	19.7	21.3
Percent of GNP				
Total	2.94	2.68	2.82	2.94
Local	2.52	2.14	2.36	2.45

^a Planned.

- (b) The number of administrative personnel has grown. Rising wages could have been offset by a reduction in the size of the workforce, as the government reduces its role in economic management. Instead, the number of administrative personnel rose by 45 percent in 1978-90, from 20 million to 29 million, an annual growth of 3.1 percent.^{31/} More recently, this growth rate has reportedly picked up to 5 percent a year, outpacing the overall rate of growth in state-sector employment (an average of 2.8 percent a year in 1978-90).^{32/}
- (c) New demands have arisen for administrative services. In 1986, for example, a new layer of financial management and tax collection was created at the township level to handle the expanded workload from decollectivization and rural diversification. With decollectivization in agriculture, instead of collecting taxes from 6 million production teams that were tightly controlled by the 50,000 communes, the government now collects from nearly 200 million farm households. In addition, with the rapid growth of rural enterprises and trade, taxes have grown more varied, more complicated, and more lucrative, justifying the creation of new finance offices in the more than 44,000 townships. The increase in government employment has also been caused in part by a shift from the armed forces to civil service—as defense expenditures are cut. The

^{31/} Hong Yong Lee, 1990.

^{32/} *China Statistical Yearbook 1991*, p. 95. The Yearbook gives the number of employees in government, party, and social organizations as 10.79 million at the end of 1990 (p. 101), compared with the figure of 9 million given by MOF. The difference may be accounted for by the inclusion of pensioners in the larger number.

government sector has borne a significant burden in absorbing demobilized soldiers (Annex 3.5B).^{33/}

3.45 The government has been slow to cut or transfer personnel from departments since the reform. A prime example is the hierarchy of price bureaus that runs through every level of government from central to county. With the reduction of state price controls and the progressive freeing of prices to be determined by market forces, the bureaus' "raison d'être" has been largely eliminated. Yet they continue to operate apace: in one medium-size city in Jiangsu, the city-level bureau had, in mid-1991, a staff of 49 to supervise 38 controlled prices. They also supervised the work of 10 price bureaus at the subordinate counties and cities, each with an average staff of 10. Not only was this staffing level excessive for the workload, but it had also grown several-fold during the reform period. In the Jiangsu bureau, the staff was only 12 persons in 1983, and at the county level, 3 to 4 persons each. The government's inability or unwillingness to lay off superfluous workers is attributable to resistance to dismantling the "iron rice pot" that permeates the whole state sector. But the government is also seen as the employer of last resort—for demobilized soldiers, but also in some areas for technical school graduates who cannot find jobs.^{34/}

(c) Price Subsidies

3.46 Price subsidies did not appear as a budgetary category until 1985. Before that, the costs of price subsidies were netted out from the revenue side. In the course of the producer price reforms, the share of expenditures devoted to price subsidies has risen sharply. Only recently did consumer price reforms slow the rise in expenditures, but inflation is still putting upward pressure on nominal expenditures. Since 1986, most price subsidies have been administered by local governments: 84.8 percent of all price subsidies in the 1992 budget and 12.4 percent of local expenditures, down from a peak of 18.3 percent in 1988. The shift of expenditures on price subsidies to lower levels of government has been an important factor in increasing local governments' share of total expenditures. The financing of price subsidies is markedly different from the administration:^{35/} a considerable part of central government grants to local governments is earmarked for price subsidies. Moreover, the budgetary outlays show only part of the true costs of price subsidies (for an extensive discussion, see Annex 3.3). First, grain bureau losses can be considered price subsidies; second, the turnover taxes foregone due to lower-than-market prices are a budget loss; third, the SOEs' in-kind subsidies to their personnel reduce profits, and thereby taxes and profit remittances. Though hard to measure, these three factors constitute considerable losses to the budget, and thus increase the potential gains from speeding up price reform.

3.47 Consumer price reforms will ease the pressure on the budget, but they may also increase some expenditures categories, notably administration, if the government were to grant wage increases to compensate for lost price subsidies.

^{33/} This was cited in both Hubei and Inner Mongolia as a key reason for the increase in administrative personnel. See also *Wuhan Yearbook*, 1990, p. 211.

^{34/} Xinjiang Caizheng Nianjian, 1986.

^{35/} Administration includes, and financing excludes, grants from other levels of government.

(d) SOE Subsidies

3.48 Like price subsidies, the administration of subsidies to SOEs were shifted to lower levels of government during the 1980s, further increasing local governments' share of total expenditures. In 1978, when SOE subsidies amounted to about 1 percent of GNP, local governments carried 20 percent of these expenditures on their budgets. By 1990, when the SOE subsidies had risen to 3.3 percent of GNP, local governments' share had risen to 60 percent. The size and distribution of SOE subsidies is primarily a consequence of central government policy. Total SOE subsidies are determined by price controls and the decision to compensate SOEs for "policy losses" resulting from the price controls as well as for nonpolicy-related losses including poor management. The distribution of losses over central and local government is determined by the impact of price reforms on central and local firms and by the changes in subordination of SOEs from the local to the central level, and vice versa. Local governments are compensated for a downward transfer of a loss-making enterprise.^{36/} After the transfer the administration of subsidies is registered on the local budgets, which increases the local share of total expenditures. To illustrate the impact of the downward shift of both price and SOE subsidies: if the central-local division of subsidies had remained at its 1985 level, central expenditures in 1991 would have been 44 percent of total, instead of the actual share of 33 percent.

(e) Capital Construction

3.49 The budgetary share of capital construction declined strongly over the reform period. The decline was much stronger at the local level than at the central level. Before reform, capital construction was the largest component of expenditure at both the central and local levels. In 1978, local governments spent 33.9 percent of total local expenditures on capital construction compared to 48.4 percent of the central budget. In the 1992 budget, the share of capital construction in local expenditures fell to 6.8 percent, but it is still 32 percent at the central level. Also in the broader category of investment expenditures,^{37/} local expenditures declined strongly in relative terms, from 56.7 percent of total local spending (Y 33.5 billion) in 1978 to 16.9 percent (Y 38.3 billion) in the 1992 budget. The reduction in the share of budgetary funds devoted to investment is caused partly by the transfer of investment responsibilities to enterprises in the reform process, but this does not explain the much stronger decline of investment in local budgets. Local governments might have been expected to spend more on the assigned regional development tasks because of their strong interest in increasing their tax base. Apparently, budgetary resources leave too little room for local governments to perform their regional development functions. Bottlenecks result, especially in local provision of infrastructure.^{38/} However, regional development has not disappeared as a government

^{36/} If a transfer takes place during a fiscal contract period, "final account settlement" compensates for decreased profits or increased losses. Once a new contract is made, final account settlements are included in the base figures of the contract (Section C.3).

^{37/} Capital Construction, Technological Upgrading, Geological Prospecting and half of Agricultural Support expenditures.

^{38/} World Bank, "China: CEM—Reform and the Role of the Plan in the 1990s," Washington, D.C., June 19, 1992.

function but was pushed off-budget, by recourse to extrabudgetary funds and borrowing (Section F).

3.50 *To summarize*, changes in the size and structure of the local budget have been driven by: (a) sharp rises in traditional local budgetary expenditures like CESH and administration, due to exogenous cost increases, especially rising staff and wages; (b) the greater impact on the local than on the central budget of central government support decisions for priority sectors (currently education, science and agriculture); and (c) the downward shift of administrative responsibility for price and SOE subsidies, and their escalating cost, in the second half of the 1980s.^{39/}

3.51 Given these underlying factors, the decline of the "second ratio," the share of central government in general government, seems less worrisome. Control, again, is the real issue. Apparently, the changes in overall expenditures were unexpected and largely outside the control of the budgetary authorities. A second issue is whether revenue assignment has kept pace with the change in expenditure assignment. The sharp decline in regional development expenditures on local budgets, the extensive recourse to extrabudgetary funds and tax expenditures by localities, and the increased recourse to user charges in the social services (Section F) indicate a shortage of fiscal resources at the local level. However, a closer look at financing of expenditures is needed to settle that issue.

D. FINANCING EXPENDITURES

International Experience

3.52 Expenditures can be financed in two ways: by "own revenue" and by grants from other levels of government. Own revenue—either sources assigned to a level of government, or revenue stemming from tax-sharing arrangements^{40/}—give an indication of a subnational government's financial independence from the central government; intergovernmental grants yield insight in the nature and methods of intergovernmental relationships.^{41/} For China, the transfers arising from the fiscal contracts—the revenue remittances and the quota subsidies—are part of the tax-sharing arrangements. Own revenue is therefore the revenue left after redistribution through the fiscal contract.

3.53 A system of financing expenditure assignments serves four main functions: (a) the fiscal goal of financing the expenditure responsibilities assigned to a level of government;

^{39/} For instance, had the central-local division of expenditures on subsidies stayed at its 1985 level, central expenditures would have been 44 percent of total expenditures in 1991, marginally less than the 45 percent in 1978 instead of 33 percent, the actual share (Table A-14).

^{40/} The IMF *Manual on Government Finance Statistics* defines "Own Revenue" of a government level as those taxes collected and retained by that level, and that portion of taxes collected by other parts of government, but (i) on which the government exercises some influence on the rate or distribution, or (ii) of which the government level by law automatically receives a part of the taxes arising in their territory, or (iii) when they receive tax revenue under a tax law, leaving no discretion to the collecting government.

^{41/} Sometimes it is hard to distinguish between tax-sharing and intergovernmental grants, as not all the tax-sharing arrangements are codified in each country.

(b) the efficiency goal of providing a level of government with the incentive to perform its tasks as efficiently as possible; (c) the equity goal of redistributing income and giving each citizen a certain amount of public services (redistributing fiscal capacity); and (d) a macroeconomic stability goal, to the extent that government finance instruments can be used to stabilize the economy. Considering a finance system's diverse goals, it is not surprising that existing arrangements are often complex and contentious between levels of government.

3.54 There is no ideal system of intergovernmental finance, but some general lessons can nonetheless be drawn from the international experience:^{42/} (a) revenue assignments should follow expenditure assignments; otherwise, essential government functions may be left unfinanced and unperformed; (b) the more interest a local government has in its own tax base, the less central supervision is required; the costs and benefits of discretion over a local tax base should be internalized by the locality;^{43/} (c) national objectives should be matched by fiscal incentives for localities to perform them; (d) intergovernmental transfers should pursue only a few simple objectives; (e) stability of intergovernmental finance is a necessary condition for the incentives within the system to work; and (f) tax sharing only functions smoothly if the collecting level of government is an important stakeholder in the shared taxes; if not, collection of shared taxes will be problematic. A full description of intergovernmental finance in a variety of countries goes beyond the scope of the report, but an illustration is given in Box 3.3.^{44/}

3.55 In the sample of 39 countries analyzed in Section 3B, the decentralization of tax revenues is less pronounced than that of expenditures (Table A-14). On the basis of taxes assigned to levels of government, only the Yugoslavian central government commanded less than 50 percent of all tax revenue; central government's average share in total tax revenues was 83 percent. Centralization of tax revenue is strongly correlated with the centralization of expenditures.^{45/} The central government's dominance in tax revenues stems in particular from taxes on income, while property taxes are the major tax source for subnational government, a source hardly exploited in China.^{46/} User charges are also a considerable part of subnational revenues (especially local government) in industrial countries (Table 3.6).

3.56 The gap between expenditure assignment and own revenue is covered by intergovernmental grants (Tables A-17 and A-18). For the sample of 39 countries, an average of 11.5 percent of total government expenditures is financed by intergovernmental grants. The grant share is much higher for educational expenditures (19.4 percent); higher for populous

^{42/} For a more elaborate discussion, see Annex 3.1.

^{43/} The requirement should prevent destructive tax competition.

^{44/} A good description of the Brazilian system can be found in Anwar Shah, "The New Fiscal Federalism in Brazil," World Bank Discussion Paper No. 124, World Bank, 1991.

^{45/} The correlation coefficient between the central share of government expenditures and the central share of government tax revenues for the 39 countries is 0.86. In a simple linear regression including a constant, the partial correlation coefficient is 0.98, with a t-statistic of 10.13.

^{46/} World Bank, "China: Urban Housing Reform—Issues and Implementation Options," Washington, D.C., June 26, 1991.

Box 3.3: TAX SHARING AND FISCAL EQUALIZATION IN GERMANY

The intergovernmental financial system in Germany ^{1/} consists of two main parts: (a) a vertical sharing of taxes between Bund (federal government), Laender (states), and Gemeinde (municipalities); and (b) a horizontal equalization between the states.

The vertical sharing system, based on Article 106 of the constitution, regulates the sharing between the individual state and the central government of the Verbundsteuern (shared taxes) accrued in that state.^{2/} The shared taxes constitute about 80 percent of all taxes collected (1987 figures). The shares are given in Table 1.

Table 1: VERTICAL TAX SHARING IN GERMANY
(Percent)

Tax	Central government	States	Municipalities
Personal income tax	42.5	42.5	15.0
Corporate income tax	50.0	50.0	0.0
Turnover tax	65.0	35.0	0.0
Business taxes	8.0	8.0	84.0

Source: Bundesministerium der Finanzen.

Besides the shared taxes, each level of government has its own taxes. The federal government receive very strongly unequally divided taxes on oil, tobacco, and liquor, trade taxes, and some minor taxes, about 13 percent of total tax collections. The states receive chiefly property taxes, estate duties, and automobile taxes, 4.4 percent of total tax collections. The municipal tax base, mainly real estate taxes, amounts to 2.3 percent of total tax collections.

Fiscal equalization between the Laender takes place *after* vertical sharing with the central government. Article 107 of the constitution addresses the state to "appropriately" equalize the fiscal capacity between the Laender, and the "Finanzausgleichgesetz" (fiscal equalization law) sets the norms and means for equalization. Each state's equalized fiscal revenue is supposed to achieve at least 95 percent of the average equalization yardstick (Ausgleichsmesszahl), a measure of fiscal need. To determine the equalization payments, first the fiscal capacity of the states has to be determined.

A state's fiscal capacity is determined by: (a) the state share of the shared taxed; (b) the state's own taxes; (c) 50 percent of a federal earmarked grant for mining; (d) 50 percent of the municipal share of the personal income tax, and 50 percent of the "standardized" real estate tax.^{3/} The high cost of determining a state's potential tax revenues precludes that measure of fiscal capacity. Also, the additional equalizing effect would be negligible, as most of the disregarded taxes are evenly spread among the states. However, since the item under (c) is substantial and unequally distributed among states, it is taken into account. A correction of the fiscal capacity is made according to special needs of certain states, in particular for sea harbors.^{4/}

- ^{1/} The description of the German system refers to the period before unification.
- ^{2/} Determining the source of the tax has been problematic in the German system, but a special law (Zerlegungsgesetz) removed some difficulties.
- ^{3/} The amount of real estate tax taken into account is the one that would have been levied given the average rate.
- ^{4/} It would have been more logical to make the correction on the fiscal needs side.

...Continued

Box 3.3: (cont'd)

A state's fiscal need is defined as the average per capita fiscal capacity over all states, multiplied by "enhanced population weights." The population weights for state revenues are 135 percent for city states, and 100 percent for the rest. For municipal revenues, the weights vary from 100 percent to 130 percent, depending on the size of the city. The rationale for the population weight is that densely populated areas need more public goods (roads, police) and provide services to surrounding states. "Fiscal needs," thus calculated, does not take into account variation in the costs of supplying public goods, nor does it consider variations in demand for public goods between states.

Equalization payments come about by comparing fiscal capacity and fiscal need. States with a higher fiscal capacity than need pay equalization payments to states where the opposite holds. Payments are made until each state reaches at least 95 percent of average fiscal need.

Though not problem-free, the German system of horizontal equalization is a practical, efficient, equalizing system that leaves enough incentives for initiative at the state level.^{5/} The strong legal basis of the system prevents extensive rent seeking for favorable treatment by the federal government. The relatively simple setup of the system gives clear incentives to the states, and is easily administered by central government. The equalization system can deal smoothly with changes in fiscal revenue, as the amount devoted to equalization is endogenously determined. It also accommodates changes in relative position automatically.^{6/}

To some extent, the system is biased against own tax effort, due to its highly equalizing properties, but the incentive for the states to give the best public service for the lowest tax still works from the expenditure side. Efficiency in providing services is not punished by a reduction of fiscal need, and thus frees resources for other uses. Moreover, at the local level, the incentive for user charges is not diminished, because they are not taken into account for fiscal capacity.

^{5/} There exists extensive jurisdiction by the Constitutional Court on the issues of sharing and equalization.

^{6/} The exogenous shock of unification did, however, cause some stress on the system, and special treatment was found necessary for the new states.

countries; and lower for federal countries and countries with highly centralized expenditures.^{47/}

^{47/} A regression was estimated with the percentage of expenditures financed by grants as the dependent variable. The result was (t-statistics of the coefficients in parentheses):

$$\text{Percent Grant Finance} = 39.27 + 0.013 * (\text{Population}) - 0.37 * (\text{Central share of total expenditure}) - 4.24 * (\text{Federal dummy})$$

(8.74) (2.22) (6.62) (1.96)

Table 3.6: NONTAX REVENUE FOR SELECTED OECD COUNTRIES, 1988
(Percent of total revenues)

Country	Intermediate government (state, province, etc.)	Local government
Australia	15.7	37.6
Austria	13.0	31.6
Canada	14.4	15.1
Germany	12.9	36.3
Switzerland	18.4	31.2
United States	26.8	23.2
France	..	20.7
United Kingdom	..	20.4

Source: Organization for Economic Cooperation and Development (OECD), *Revenue Statistics of OECD Member Countries 1965-1989*, Paris, 1990.

Central-Local Revenue Sharing in China

3.57 Previous discussions ^{48/} of central-local revenue division have focused on the design of revenue-sharing systems. This focus stems from the assumption that revenue sharing is the centerpiece of fiscal reform. As long as local agents collect revenues (in the absence of a national tax system), and the central budget depends on remittances from local government, local retention rates of shared revenues and their determinants will be the crucial incentive mechanisms motivating local collection efforts. Indeed, the Chinese government has tinkered continuously, and apparently unsuccessfully, with the revenue-sharing formulas to try to improve incentives for local revenue collection (Box 3.4). Since 1980, no fewer than four revenue-sharing systems have been employed, with many variations, culminating in the fiscal contracting system introduced after 1987. Even today, six different contract types are in use between the central government and the provinces, and many more at the subprovincial level.

3.58 Less attention has been given to the fact that revenues are divided between the central and local governments in a two-stage process. In the first stage, the central government sets the rules on the portion of collected revenues that are set aside for central government (central fixed revenues), the minor portion set aside for local government (local fixed revenue), with the remainder going into a pool of shared revenue. The shared revenue is split between central and provincial governments according to the revenue-sharing formulas on the fiscal contract: that is, these contracts apply only to the second stage of revenue division. Throughout

^{48/} See, for example, the collection of articles in *Chinese Economic Studies* (Fall 1990 and Winter 1990/1991); and Christine P. Wong, "Central Local Relations in an Era of Fiscal Decline," *China Quarterly* (December 1991). World Bank, *Revenue Mobilization and Tax Policy* (June 1991) and World Bank, "Reforming Intergovernmental Fiscal Relations," Report No. 10050-CHA, November 1991, give an in-depth treatment of the subject and offer extensive recommendations. However, some aspects of the system, and notably quantitative information on it, were up to now less known. Both are stressed in this section.

Box 3.4: PROVINCIAL TAX EFFORT IN CHINA

Tax effort, defined as taxes raised divided by tax capacity,^{1/} is an important figure in fiscal decentralization. It indicates the extent to which a government makes use of its taxable capacity, and therefore may indicate inefficient collection, tax avoidance or (excessive) tax exemption. If subnational governments are the tax collectors, as is the case in China, tax effort can play a role in monitoring and influencing subnational government's behavior. Equally, it may serve as a factor in sharing central funds with subnational governments, the idea being that those subnational governments that do not make enough use of their tax base would receive less central funds. A common way to estimate tax effort is by using regression analysis.^{2/} For analyzing tax effort of subnational governments in a cross-section analysis, a number of factors affecting tax capacity (such as Income, Urbanization) are taken as explanatory variables for the taxes actually collected. The estimated relation reflects "average behavior" in tax collection. The tax effort of a specific subnational government is found by dividing actual tax collection by the tax capacity predicted by the fitted equation.

For China, tax effort analysis has several problems, notably the nature of the published data on provincial tax collection, the proliferation of taxes and the complexity of the tax structure.^{3/} Published data on provincial tax collection show only local revenue raised, leaving out the central fixed taxes. Whereas the local tax collection is shared according to the province-specific tax contract, central fixed taxes are remitted to Beijing. Given this arrangement, one would expect a priori the collection effort for central fixed taxes to be lower than for local taxes. Equally, one would expect the marginal remittance rate to be of influence on tax effort. The varying taxes and tax rates on different goods is another complication for the analysis, as the tax collection per Yuan of provincial GDP may differ substantially between provinces if the composition of GDP differs markedly.

To illustrate the sensitivity of tax effort analysis for the factors mentioned above, we have estimated three equations explaining per capita provincial tax collection in the Chinese Provinces for 1990 (Table 1). On the basis of the regression result and actual tax collection per province, tax effort was calculated (Table 2). The first regression fits tax collection as a function of (squared) income per capita. The regression has adequate explanatory power, and the tax effort so calculated ascribes province the highest tax effort, whereas, for example, Sichuan is on place 21, and Tibet is last in the tax effort ranking. If one adds a proxy variable for urbanization (equation 2), assuming that highly urbanized areas are more easily taxed, the ranking changes slightly, for example, with Sichuan now ranking 15, and Hebei moving from twenty-second to eighteenth place in the ranking, but Yunnan still ranking first. The third equation takes into account two variables reflecting the composition of a province's production base: (a) the share of Agriculture in Gross Value of Industrial and Agricultural Output (GVIAO) ^{4/} and (b) the production of cigarettes, a product especially high tax yielding. Again, the estimation explains the per capita tax collection in the Chinese provinces well (in terms of R² and F statistics), and the coefficients of the additional variables are significant. However, the provincial ranking for tax effort is strikingly different from the second equation: Yunnan falls from the first to the eight place, Shanxi from ninth to twenty-first, Inner Mongolia rises from seventeenth to tenth place, etc.

- 1/ Tax capacity is, in theory, equal to the maximum amount of taxes to be raised, given existing tax laws. In practice, as explained below, a somewhat different interpretation is used.
- 2/ See, for example, Roy Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis," *IMF Staff Papers*, Vol. 18, 1971, No., 3, pp. 570-612.
- 3/ For an extensive description of China's tax system, see World Bank, *China: Revenue Mobilization and Tax Effort*, Washington, D.C., 1990.
- 4/ A problem in using GVIAO is that it includes the production of central enterprises, which is not part of a province's local tax base.

...Continued

Box 3.4: (cont'd)

In order to test for the influence of the features of the tax contract on tax effort, contract-specific dummies ^{5/} were added to regression equation 3. On the basis of economic theory, one would expect that those provinces with the lowest marginal remittance rate would have the highest tax effort, *ceteris paribus*. However, none of the dummies were found significant; thus, no negative or positive influence of the contracts could be established in this way.

The analysis shows that care must be taken in drawing conclusions on tax effort from aggregate data. A low tax effort may be easily explained as the consequence of a low-yielding tax base, due to the tax rates on the province's main production. Since the provinces have virtually no legal right to set their own tax rates, they can hardly be held responsible for low tax effort due to such reasons. A careful and detailed analysis of tax base and rates compared with actual tax collection would be a better basis for detecting anomalies in tax effort.

Table 1: ESTIMATES OF TAX CAPACITY FOR CHINESE PROVINCES

Independent variables	Dependent variable: local budgetary revenue per capita for 1990 /a		
	Equation (1)	Equation (2)	Equation (3)
Constant	80.95 (9.73)	188.30 (3.20)	253.09 (5.86)
Squared national income per capita /b (Divided by \bar{Y} 1,000)	0.05 (31.37)	0.05 (19.33)	0.04 (21.37)
Urbanisation (% of population reg- istered as urban)		1.35 (1.84)	1.51 (2.71)
Agricultural share in GVIAO (%)			-2.90 (3.92)
Production of cigarettes per capita (1,000 cases)			0.88 (4.01)
R ²	0.97	0.98	0.99
F-statistic	984	537	549
Number of observations	29	29	29

/a Alternatively, one could take Revenue/GNI as a dependent variable. The regression results are similar, although tax effort calculations could be different.

/b Revenue per capita shows a slight progression with respect to income per capita, potentially due to higher taxation of luxury goods. Therefore, the latter variable was squared for the estimation, as this yielded a better fit.

^{5/} There are five basic types of tax contract between center and provinces; see Table 3.6.

...Continued

Box 3.4: (cont'd)

Table 2: VARIOUS MEASURES OF TAX EFFORT

	Equation (1)		Equation (2)		Equation (3)	
	Tax effort	Rank	Tax effort	Rank	Tax effort	Rank
Beijing	1.03	13	1.01	12	1.02	15
Tianjin	1.06	11	1.01	11	0.96	18
Hebei	0.89	22	0.95	18	0.92	20
Shanxi	1.29	3	1.30	4	1.21	3
Inner Mongolia	1.07	10	0.96	17	1.09	10
Liaoning	1.14	5	1.08	7	1.03	13
Jilin	1.59	2	1.35	3	1.17	4
Heilongjiang	0.94	17	0.86	24	0.80	27
Shanghai	0.98	15	1.00	14	1.01	16
Jiangsu	0.88	23	0.91	20	0.90	23
Zhejiang	1.01	14	1.07	8	1.05	12
Anhui	0.77	27	0.83	26	0.88	24
Fujian	1.12	7	1.17	6	1.22	2
Jiangxi	0.84	24	0.87	23	1.05	11
Shandong	0.73	28	0.79	28	0.74	28
Henan	0.82	26	0.90	22	0.90	22
Hubei	0.91	19	0.94	19	0.86	26
Hunan	0.91	20	0.98	15	0.94	19
Guangdong	0.83	25	0.86	25	0.86	25
Guangxi	0.98	16	0.82	27	0.97	17
Hainan						
Sichuan	0.90	21	0.96	16	1.10	9
Guizhou	1.10	8	1.22	5	1.11	7
Yunnan	1.63	1	1.78	1	1.10	8
Tibet	0.07	29	0.07	29	0.27	29
Shaanxi	1.05	12	1.07	9	0.91	21
Gansu	1.21	4	1.35	2	1.36	1
Qinghai	1.12	6	1.05	10	1.12	6
Ningxia	1.07	9	1.01	13	1.09	14
Xinjiang	0.94	18	0.91	21	1.15	5

Note: Equations refer to the regressions of Table 1.

the reform period, changes introduced in the first-stage division have reduced the importance of revenue-sharing contracts, undermining their intended incentive effects.

3.59 Virtually all revenues but customs duties in China are collected by local agencies (tax or finance bureaus). Revenues are deposited at the PBC, which divides them into three portions: central fixed revenues, local fixed revenues, and shared revenues (Annex 2.3). Beginning with fiscal reform in the 1980s, the division among central, local, and shared revenues has been based on two criteria, source and ownership of enterprises. Under the system of "sharing revenues by specific sources" introduced in 1980, "fixed revenues" at each level comprised primarily remitted profits from "owned" enterprises—central fixed revenues came from central enterprise profits, and provincial fixed revenues came from provincial enterprise profits. Tax revenues were also divided by type and origin. Central fixed revenue also included customs duties, borrowing, and indirect taxes collected by the Ministry of Railroads, which also entered into central fixed revenues. Local fixed revenue at that time included the agricultural

tax, salt tax, and income taxes on collective enterprises. Localities are not allowed to borrow (see, however, Annex 3.5C).

3.60 The revenue retention rate for the provinces is determined by the allowed expenditures. Allowed expenditures are determined by the expenditures in a base year (the "base number"), corrected for inflation and changes in government policy. No effort has been made to cost out the expenditure needs of the province, and the system is incremental in nature; nor is there an explicit equalization component in the revenue retention rate (see Box 3.5 for approaches to expenditure need determination). The revenue retention rate is set such that the local share of shared revenues plus the local fixed revenues are enough to cover these allowed expenditures. For a few revenue-rich provinces, such as Liaoning, where local fixed revenues exceeded the approved local expenditures, the central government also "shared" the local fixed revenues.^{49/}

3.61 Since 1980, two crucial features have survived every change in revenue-sharing systems. First, central fixed revenues are not subject to revenue sharing, so that whatever is designated as central revenues leaves the pool of revenues to which revenue-sharing formulas are applied.^{50/} Second, enterprise income, both remitted profits and direct tax revenues (after 1984), are still divided among governments according to ownership. This principle of division implies that, if the central government expands the scope of its ownership over enterprises, it reduces the pool of shared revenues. Through the recentralization of key enterprises and selected sectors such as the automotive industry, power industry, nonferrous metals, coal, oil, and petrochemicals the portion of total revenues designated as central fixed revenues has risen from 14.3 percent in 1979 to 41.2 percent in 1990,^{51/} and the portion subject to revenue sharing has fallen to less than 60 percent of total revenues.^{52/}

3.62 In addition to changes in subordination, changes in the revenues designated as central fixed revenue, local revenue and shared revenue have occurred regularly over the 1980s. Table A-19 gives the present first-stage division of revenue sources, which differs from the

^{49/} This is a simplified description of the system applied to most provinces. The exceptions were the three municipalities of Shanghai, Tianjin and Beijing, where revenue-sharing was applied to all revenues, not just shared revenues. At the other extreme, the two coastal provinces, Guangdong and Fujian, paid a lump sum to the central government each year, and their revenues were otherwise not subject to sharing. For more details, see Christine P.W. Wong, "Fiscal Reform and Local Industrialization: the Problematic Sequencing of Reform in Post-Mao China," *Modern China*, Vol. 18, No. 2 (April 1992), pp. 197-226.

^{50/} Central fixed revenue can, however, come from a tax shared outside the contract, like the contributions to the energy and transportation fund.

^{51/} Excluding debt revenue, central government fixed revenue rose from 11.5 percent of total government revenue in 1979 to 33.8 percent in 1990.

^{52/} The exact portion of revenue subject to sharing cannot be determined for lack of any detailed data on local fixed revenue.

Box 3.5: REVENUE SHARING FORMULAS: SOME STRATEGIES

Two strategies are available for estimating expenditure needs, a crucial element in any formula-based system. One begins with concrete expenditure norms, and then seeks to "cost them out," using, for example, per-pupil costs of education, given the standard cost of a teacher, classroom operation to derive a cost figure. Performing this calculation for each expenditure function can build up each jurisdiction's expenditure need. While the precision of this strategy has much appeal (it is being applied successfully, for instance, in Denmark), its drawbacks is its complexity and the cost of keeping the indicators current.

A different and far simpler way to define expenditure needs is based on umbrella variables such as population, per capita income, city size, poverty rates, density, the centrality of a city, and so forth. This strategy is used in Germany and for some grant programs in the United States.

The formulas in many countries also incorporate an estimate of the revenue capacity of localities. The revenue-raising capacity of localities is important, because, if actual revenues and not tax capacities are used, an oblast could reduce its tax effort and collections and receive correspondingly higher transfers. An appropriate measure for estimating local revenue capacity might include any local tax bases.

In *India*, each major tax is assigned a formula that dictates how revenues will be distributed between the center and states, and among states. Although the weights placed on formula components differ by tax, the factors included in the formula are generally the same. For example, 85 percent of income tax goes into a state pool from which allocations are made according to each state's "contribution" to taxes, the "distance" of income per capita relative to states with higher per capita income multiplied by the population, population and "backwardness" (as measured by the population of tribal groups associated with underdevelopment and the number of agricultural laborers). The Finance Commission meets at least once every five years to make recommendations about the design of tax sharing and grant formula.

In *Nigeria*, most taxes are collected by the federal government, except for the personal income tax, which is collected and retained in full by the states. A share of federally collected funds (31.5 percent) is allocated into a States Joint Account (SJA). A formula is used to distribute 95 percent of the SJA, with the following components: population (40 percent); "minimum responsibilities of government" (40 percent—the proportion of recurrent expenditure to total federal revenue of the state with the smallest budget in a given period); a social development factor (15 percent) that currently includes indicators of school enrollment and may be expanded to include health indicators; and internal revenue effort (5 percent). The other 5 percent of the SJA is not placed in the equalizing pool, but is distributed to mineral-producing states on the basis of derivation.

...Continued

Box 3.5 (cont'd)

In Nigeria, 10 percent of all federally collected revenues are allocated to the local governments. Of this amount, 25 percent is distributed in equal shares to local governments; the rest is distributed by population. A problem with the local scheme is that it does not consider the capacities of local governments. A third special fund allocates 3.5 percent of federally collected funds for Federal Capital Territory and to states on the basis of their ecological problems. Formula-based distribution is important in Nigeria because, without it, distributions could be sensitive to political pressures.

In the *Philippines*, 20 percent of federally collected taxes are allocated to the subnational pool. This pool is distributed according to a formula which includes population (70 percent), land area (20 percent), and equal shares (10 percent). The tax on petroleum products is allocated on the basis of derivation.

In *Canada*, the goal of the equalization formula is to ensure that all provinces receive the equivalent of at least the national average tax rate applied to the national average revenue base. The following calculation is made for each provincial tax for each province. First, the national average tax rate is determined by *dividing* the total tax revenue for all provinces by the total tax base for all provinces. Second, this rate is applied to a province's revenue base, and a provincial per capita yield is determined, which is applied to the total revenue base to determine a national per capita yield. The provincial entitlement is the *difference* in the above national and provincial per capita yields, *times* the province's population.

Source: Christine I. Wallich: "Fiscal Decentralization: Intergovernmental Fiscal relations in Russia," World Bank, 1993 (slightly altered).

division in 1988 and 1985.^{53/} In the fiscal experiments announced by the Chinese governments, the division has again changed (Section G).

Intergovernmental Financial Flows

3.63 Other components of central-local financial flows underscore the reduced significance of revenue-sharing contracts in the 1990s. Figure 3.5 shows three main downward flows and three upward flows. At the center are revenue transfers under fiscal contracts between the central and provincial governments. These contracts are detailed in Table 3.7. Under these fiscal contracts, 21 provinces and cities remit revenues to the central government (L1), while 14 provinces receive "quota subsidies"—unconditional grants—from the central government (C1).^{54/}

^{53/} See Roy Bahl and Christine Wallich, "Intergovernmental Fiscal Relations in China," *PPR Working Paper Series*, No. 863, February 1992, Tables 2a and 2b. For an evolution of the sharing arrangements over the reform period, see also World Bank, "China: Reforming Intergovernmental Fiscal Relations," Report No. 10050-CHA, World Bank, November 1991.

^{54/} This list includes five cities that have independent plan and budget status.

Table 3.7: CHINA: CENTRAL-LOCAL REVENUE-SHARING CONTRACTS, 1988-90

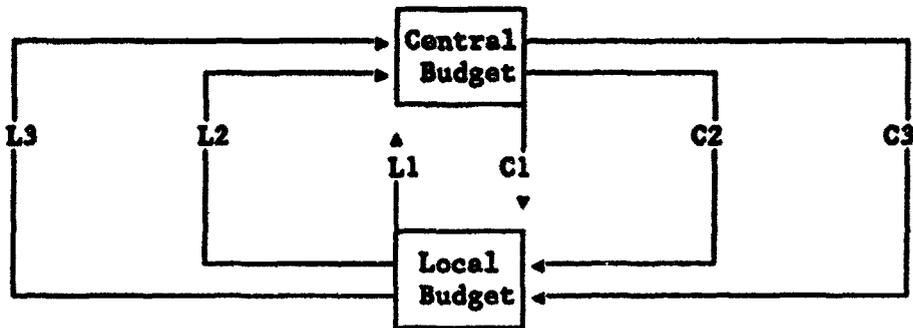
	(1)	(2)		(3)		(4)	(5)		(6)
	Basic sharing rate (%)	Basic retention rate (%)	Contracted rate of increase (%)	Basic retention rate (%)	Marginal retention rate (%)	Fixed quota to State (Y 100 mln)	Initial amount to State (Y 100 mln)	Contracted annual rate of increase (%)	Payment to deficit provinces (Y 100 mln)
Beijing	-	50.0	4.0	-	-	-	-	-	-
Hebei	-	70.0	4.5	-	-	-	-	-	-
Liaoning	-	58.3	4.5	-	-	-	-	-	-
Shenyang	-	30.3	4.0	-	-	-	-	-	-
Harbin	-	45.0	5.0	-	-	-	-	-	-
Jiangsu	-	41.0	5.0	-	-	-	-	-	-
Zhejiang	-	61.5	6.5	-	-	-	-	-	-
Ningbo	-	27.9	5.3	-	-	-	-	-	-
Henan	-	80.0	5.0	-	-	-	-	-	-
Chongqing ^{/a}	-	33.5	4.0	-	-	-	-	-	-
Tianjin	46.5	-	-	-	-	-	-	-	-
Shanghai	87.6	-	-	-	-	-	-	-	-
Anhui	77.5	-	-	-	-	-	-	-	-
Dalian	-	-	-	27.7	27.3	-	-	-	-
Qingdao	-	-	-	16.0	34.0	-	-	-	-
Hubei ^{/a}	-	-	-	17.0	25.0	-	-	-	-
Guangdong (inc. Guangzhou)	-	-	-	-	-	-	14.1	9.0	-
Hunan	-	-	-	-	-	-	6.0	7.0	-
Shanghai	-	-	-	-	-	105.0	-	-	-
Shandong	-	-	-	-	-	2.0	-	-	-
Heilongjiang	-	-	-	-	-	5.0	-	-	-
Jilin	-	-	-	-	-	-	-	-	1.1
Jiangxi	-	-	-	-	-	-	-	-	0.5
Shaanxi (inc. Xian)	-	-	-	-	-	-	-	-	1.2
Gansu	-	-	-	-	-	-	-	-	1.1
Fujian (beginning 1989)	-	-	-	-	-	-	-	-	0.5
Inner Mongolia	-	-	-	-	-	-	-	-	18.4
Guangxi	-	-	-	-	-	-	-	-	6.1
Tibet	-	-	-	-	-	-	-	-	9.0
Ningxia	-	-	-	-	-	-	-	-	5.3
Xinjiang	-	-	-	-	-	-	-	-	15.3
Guizhou	-	-	-	-	-	-	-	-	7.4
Yunnan	-	-	-	-	-	-	-	-	6.7
Qinghai	-	-	-	-	-	-	-	-	6.6
Hainan	-	-	-	-	-	-	-	-	1.4
Hubei	-	-	-	-	-	-	-	-	^{/b}

^{/a} After the cities of Wuhan and Chongqing were separated from Hubei and Sichuan provinces, the provinces changed from net providers to the state to net recipients of subsidies from the state. Data are not available on the other "independent cities," such as Nanjing, Ningpo, etc.

^{/b} The payment is 4.8 percent of Wuhan's remittance.

Source: Bahl and Wallich, 1992.

Figure 3.5: INTERGOVERNMENTAL FINANCIAL FLOWS



KEY

- | |
|---|
| <p>Central-local transfers</p> <ul style="list-style-type: none">C1 = quotas subsidies under fiscal contractsC2 = earmarked grantsC3 = compensatory payments <p>Local-central transfers</p> <ul style="list-style-type: none">L1 = remittances under fiscal contractsL2 = special taxesL3 = compensatory payments |
|---|

3.64 In addition to contracted revenue transfers, the central government sends earmarked grants to provinces for specific uses (C2, Figure 3.5). These include appropriations for capital construction projects, price subsidies for urban grain consumption, social relief funds, and special subsidies for health and education of the poor, minority, and border provinces. The third component of central transfers to provinces comprises "final account subsidies," which are compensatory payments for the loss of revenues from profitable local enterprises that have been transferred to central ownership (C3). Centralization and decentralization of enterprises is proposed by the responsible line ministry, and approved by the industry department of MOF. Although the final accounts subsidies should guarantee budget neutrality of ownership rearrangements; local governments complain that central government takes "the yeasted bread," those enterprises that have high growth potential. Final account subsidies are temporary: whenever revenue-sharing contracts are renegotiated, they are factored into the base numbers, so that the financial flows are either added to C1, or subtracted from L1.^{55/}

3.65 On the side of provincial transfers to the central government, special taxes accrue to the central government. Introduced since 1988, these taxes include two on cigarettes and one on liquor (L2).^{56/} The third component comprises compensatory payments to the central government for enterprises that have been transferred downward to local control (L3). Like the

^{55/} The flows may also be negative, if the transferred enterprise was loss-making.

^{56/} Revenues from these taxes do not enter the normal contractual sharing but are shared separately.

downward payments for recentralized enterprises, these upward payments are to be replaced by adjustments in the revenue-sharing contracts upon their revision.

3.66 A final transfer from local to central government is central government's "borrowing" from the provinces. In 1982, central government "borrowed" more than Y 8 billion from provinces, but the incurred debt was written off upon recontracting in 1983. Although central government has reportedly promised that it would no longer borrow from provinces, Shanghai, for example, registered for both 1989 and 1990 a "loan" of Y 0.4 billion to central government.^{57/}

3.67 The existence of these multiple flows upward and downward significantly alters our understanding of the budgetary process, since resources available for expenditure at each level of government are "net" of all these positive and negative flows. At the central level, these resources are: the sum of central fixed revenues, provincial remittances, special tax remittances, and local compensatory payments for enterprise transfers; *minus* the sum of quota subsidies to deficit provinces, earmarked grants to provinces, and compensatory payments for enterprise transfers. Only two of these components (C1 and L1) are governed by the revenue-sharing contracts.

3.68 Table 3.8 presents the breakdown of central-local transfers for 1990. Through the fiscal reforms of the 1980s, revenue-sharing transfers have greatly diminished in importance. Figure 3.6 illustrates the sharp decline in *net* transfers through the revenue-sharing system, which fell from 9.3 percent of GNP in 1981 to 1.9 percent in 1990.

Table 3.8: ESTIMATED CENTRAL-LOCAL TRANSFERS,
1990
(Y billion)

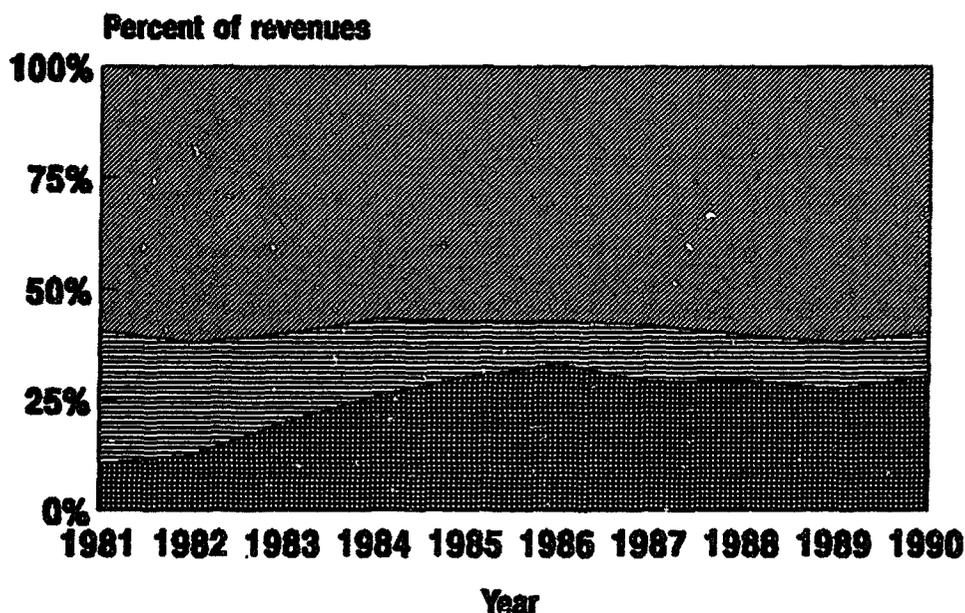
Source of transfer	Amount
Quota subsidies under fiscal contracts (C1)	8.1
Earmarked grants (C2)	circa 30.0
Compensatory payments (C3)	8.5
<u>Total</u>	<u>46.6</u>

Source: Derived from MOF data; see also Figure 3.5, this report.

3.69 By 1990, quota subsidies to poor provinces accounted for only 0.43 percent of GNP, a mere 17.3 percent of the total transfers from the central government to local

^{57/} Zhimin Lin, "Provincial Responses to Fiscal Decentralization: The Case of Anhui, Guangdong and Shanghai," paper presented at the conference "Transforming Concepts into Working Realities," The Chinese University of Hong Kong, September 9-11, 1991.

Figure 3.6: DWINDLING SHARING
Central and Local Revenues and Net Tax Sharing



■ Central fixed rev. ■ Net shared revenues ■ Local revenue after sharing

Note: for an explanation of the categories, see text.

Source: Table A-1.2.

governments. In contrast, earmarked grants have grown steadily, and in 1990 they comprised nearly two thirds of total central-local transfers (Section 3.C). Similarly, while little detailed information has been provided on the size of compensatory payments, they also appear to be significant—almost 20 percent of total central-local transfers in 1990.^{58/} For its own expenditures, the central government eliminated its dependence on remittances through the revenue-sharing system. A net receiver of 5.3 percent of GNP in revenue from local governments in 1983, the central government has become a net provider of 0.8 percent of GNP to local governments in 1990. In contrast, local governments' own revenue is falling increasingly short of expenditures, covering only 77.5 percent of its budgetary expenditures, down from 87.6 percent in 1983 (Table A-1.2).

3.70 By increasing the central fixed revenue base, the central government *reduced* its dependence on shared revenue over the 1980s. In contrast, local governments' own revenues fell progressively short of expenditures, thereby *increasing* their dependence on earmarked grants

^{58/} This estimate is reached by subtracting the amount of earmarked grants given to the mission from total earmarked grants and final account subsidies derived in Table A-1.1.

from the central government, and increasing their incentives to develop extrabudgetary operations.

E. EXPENDITURES AND INTERPROVINCIAL EQUITY

Cross-Provincial Expenditure Patterns

3.71 General Trends. Actual expenditures equal the resources available for local use after all transfers. Table A-4.2 shows provincial per capita budgetary expenditures from 1978 to 1990. Two trends stand out: (a) expenditures grew rapidly in all provinces throughout the period, and (b) there was a *relative convergence* of per capita expenditures across provinces, although the differences in the level of per capita expenditures still remain large. The range in per capita expenditures had narrowed between 1978 and 1990, and the top-to-bottom expenditure ratio was reduced from 6.90 to 5.95. The coefficient of variation in per capita provincial expenditures also decreased secularly, from 0.70 in 1978 to 0.55 in 1990. Table A-4.2 shows that rankings of most provinces changed between 1978 and 1988, especially in the middle rank. However, the same five provinces appeared at the top in both 1978 and 1988 (Beijing, Shanghai, Tianjin, Qinghai, and Ningxia). At the bottom, there is a good deal of inertia: the lowest five provinces in 1990 came from among the lowest 1978-tier (Anhui, Henan, Sichuan, Hunan, and Guizhou).

3.72 Some Recasted Figures. Correcting the budgetary expenditure data for SOE subsidies (that is, counting them as expenditures), a somewhat different view emerges: (a) dispersion, as measured by the coefficient of variation, is larger in 1987 and 1990; and (b) the degree of dispersion increases between 1987 and 1990, and the coefficient of variation rises from 0.62 to 0.68 (Table A-4.2). Including fiscal extrabudgetary expenditures for 1987 ^{59/} reduces the dispersion in expenditures per capita, suggesting that provinces with smaller budgetary resources had relatively more extrabudgetary expenditures.

3.73 Determinants of Expenditures. Variation in expenditure level across Chinese provinces can, to some extent, be explained by demand and cost factors (Annex 3.4A). Regression analysis reveals that provincial budgetary expenditures per capita are strongly positively correlated with provincial income per capita. This could be due to the high income elasticity of demand for public goods, but also due to the budget constraint of the provincial government, as tax revenues are equally strongly correlated with income per capita. Highly urbanized provinces have higher per capita budgetary expenditures, as urban areas need more infrastructure. The higher the provincial population, the lower the expenditures per capita, a finding that may indicate economies of scale in the provision of provincial public services. A higher share of dependents (students and pensioners) also increases budgetary expenditures per capita. The higher the share of SOEs in the gross value of industrial and agricultural output (GVIAO), the higher the expenditures per capita tend to be. Given the average practice across the Chinese provinces, and controlling for income, population and urbanization, Tibet, Beijing, Qinghai and Tianjin have unusually higher per capita expenditures. To explore the differences in expenditures across provinces further, the major expenditure categories will be analyzed below.

^{59/} 1987 is the only year for which provincial fiscal extrabudgetary expenditures are available.

Culture, Education, Science and Technology, Health

3.74 Table 3.9 presents per capita expenditures on CESH by province for 1978 and 1990. The 1978 average expenditure for the country was Y 10.4 per capita. Excluding Tibet, the range goes from Y 7.8 in Sichuan, to Y 28.7 in Beijing. As expected, the three municipalities of Beijing, Shanghai, and Tianjin were ranked among the top five. More surprising is that this group also included Qinghai and Ningxia, two provinces with per capita incomes in the mid-range, but this may be explained by the higher unit costs of providing education and health care in sparsely populated regions.^{60/} and by their status as minority areas. At the bottom, Sichuan, Henan, Anhui, Hunan, Guizhou, Jiangsu, and Shandong are clustered together, with per capita expenditures ranging from Y 7.8 to Y 8.6.^{61/} By 1990, the ranking of the provinces by per capita CESH expenditure had changed only slightly (Table A-5.2), but the range had substantially widened: the ratio of top to bottom expenditures grew from 3.94 to 5.38. At the top, Beijing spent Y 148 per capita,^{62/} compared to Y 27.5 in Henan. Even among the top five spenders, the range had widened; between first-placed Beijing and fourth- and fifth-placed Qinghai and Xinjiang there was a difference of nearly Y 70 per capita.

3.75 The large gap between top and bottom spenders on CESH looks worrisome when placed in China's institutional context. Urban and state-sector wages, set nationwide by the central government, allow for only small regional differentials. Differences in spending across regions are therefore not offset by lower personnel costs in poor regions and translate directly into differences in output. The uniform salaries across regions aggravate the pervasive, large urban-rural differentials in poor regions; urban wage costs absorb a larger portion of the paltry local resource pool. Data from the education sector confirm this observation: nationwide, in 1985 minban teachers earned only two thirds of the salaries earned by gongban teachers. In the poor provinces, however, minbans earned only one fourth as much as gongbans.^{63/}

3.76 Poor provinces spend a larger share of their budgets on CESH than do rich provinces, but their per capita expenditures on CESH are below the national average. Table 3.8 shows that in 1978, the top five provinces spent 11.9 to 13.7 percent of their total expenditures on CESH, less than the national average of 17.0 percent. Their per capita expenditures were more than twice the national average. In contrast, the bottom seven all spent more than 17 percent of their budgets, but had per capita expenditure levels 17-25 percent below the national average. The same pattern holds for 1990, but the poor provinces had fallen farther behind, with per capita CESH expenditures 23-41 percent below the national average. Thus,

60/ MOF interview. This is also the common explanation for Tibet as an outlier in per capita social expenditures.

61/ In richer provinces like Jiangsu and Shandong, a considerable percentage of social expenditures is not shown on the budget at all, but performed by TVEs and profitable industrial corporations.

62/ Beijing's high educational expenditures may, in part, be explained by the presence of several central universities, although the logic of the fiscal system would imply that expenditures on those universities does not show up in local expenditures.

63/ World Bank, "China: Provincial Education Planning and Finance—Sector Study," Washington, D.C., June 1991, p. 59.

poor provinces try harder on social expenditures (devoting a larger share of their budgets) but are falling increasingly behind the richer.

Table 3.9: PROVINCIAL CESH AND CC EXPENDITURES

	1978				1990			
	CESH		CC	CESH+CC	CESH		CC	CESH+CC
	Per capita (Y)	% E	% E	% E	Per capita (Y)	% E	% E	% E
Top Five								
Beijing	28.7	11.9	53.4	65.3	147.9	23.4	17.3	40.7
Shanghai	27.8	11.7	40.6	52.7	128.4	22.7	10.7	33.4
Qinghai	24.9	13.4	34.4	47.8	106.9	23.5	18.5	42.0
Tianjin	24.3	12.1	41.4	53.5	80.4	21.0	8.5	39.5
Ningxia	22.2	13.7	39.6	53.3	79.3	25.4	9.8	35.2
Bottom								
Sichuan	7.8	21.3	31.2	52.5	27.5	25.9	5.9	31.8
Henan	8.2	20.9	29.0	49.9	29.4	27.1	5.6	32.7
Anhui	8.3	21.5	23.1	44.6	33.7	25.5	7.0	32.5
Hunan	8.4	17.7	31.2	48.9	34.3	23.1	9.3	32.4
Guizhou	8.5	18.5	27.7	46.2	35.5	26.6	6.6	33.2
Jiangsu	8.5	17.5	-	-	-	-	-	-
Shandong	8.6	19.3	-	-	-	-	-	-
National average	10.4	17.0	33.9	50.9	46.3	26.3	8.9	35.2

Note: CESH = Culture, Education, Science and Health; CC = Capital Construction; E = Budgetary Expenditures.

3.77 The budgetary shares of CESH and capital spending are inversely related. Table 3.8 shows that, compared to national average levels, the top provinces in CESH expenditure devoted less of their budgets to CESH and more to capital construction, while the bottom provinces spent proportionately more on CESH and thus had less for other categories, including capital construction. This fact has three important implications: (a) lower levels of spending on capital construction may doom the poor provinces to a lower growth path; (b) since economic growth is necessary to generate revenue growth, poorer provinces will continue to lag behind in fiscal capacity, starving their social and economic programs; (c) because CESH spending represents investment in human capital, the poor provinces could be locked into a vicious circle of poverty.

Price Subsidies

3.78 Table A-20 shows the share of total subsidies in total expenditures by province for 1987. That year, the national average for the share of provincial expenditures on the subsidies was 26.1 percent. Across provinces, the share ranged from a low of 15.5 percent in

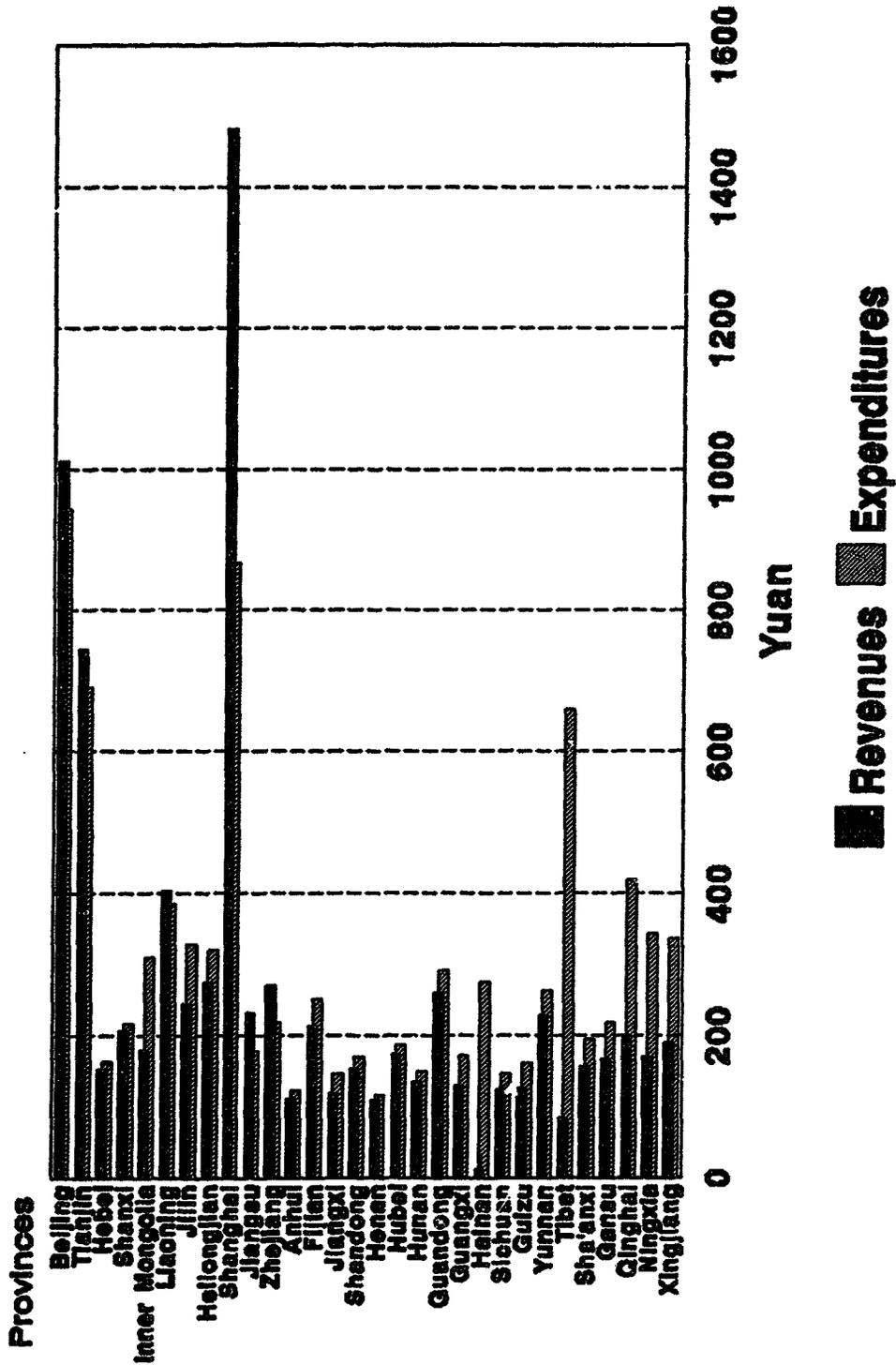
Ningxia to 36.8 percent in Beijing. Because most subsidies go to urban grain consumption, which are relatively fixed per capita, provinces with a high percentage of urban population would be expected to spend more on subsidies than less urban provinces. The presence of two of the three municipalities at the top of the ranking, Beijing and Tianjin, confirms this expectation. In addition, the three highly urbanized northeastern provinces of Liaoning, Jilin, and Heilongjiang, also devoted more than 30 percent of their expenditures to subsidies.⁶⁴ The rapid growth of subsidy costs through the 1980s imposed a growing burden on local budgets, but appeared to have had no clear regional income consequences.

3.79 The growth of interregional disparities within specific expenditure components during the same period highlights the central problem in expenditure assignments, where too much is devoted to nondiscretionary expenditures at the local level. Because poor provinces have too little left to finance both development and social services, they are forced into a choice that perpetuates their low-income status. Paradoxically, the bulk of mandated, nondiscretionary expenditures is absorbed by price subsidies that are devoted to protecting the basic needs of the urban populace. By targeting the better-off urban populace, subsidies exacerbate urban-rural inequities and are regressive in nature.

Does the Fiscal System Equalize?

3.80 The lack of personal income taxation and a nationwide social security system, and the restriction on people's moving to places where they can improve their income or receive more and better public services, puts strong demands on China's fiscal system for both income

Figure 3.7: PER CAPITA EXPENDITURES AND REVENUES IN CHINA'S PROVINCES, 1990 (Yuan)



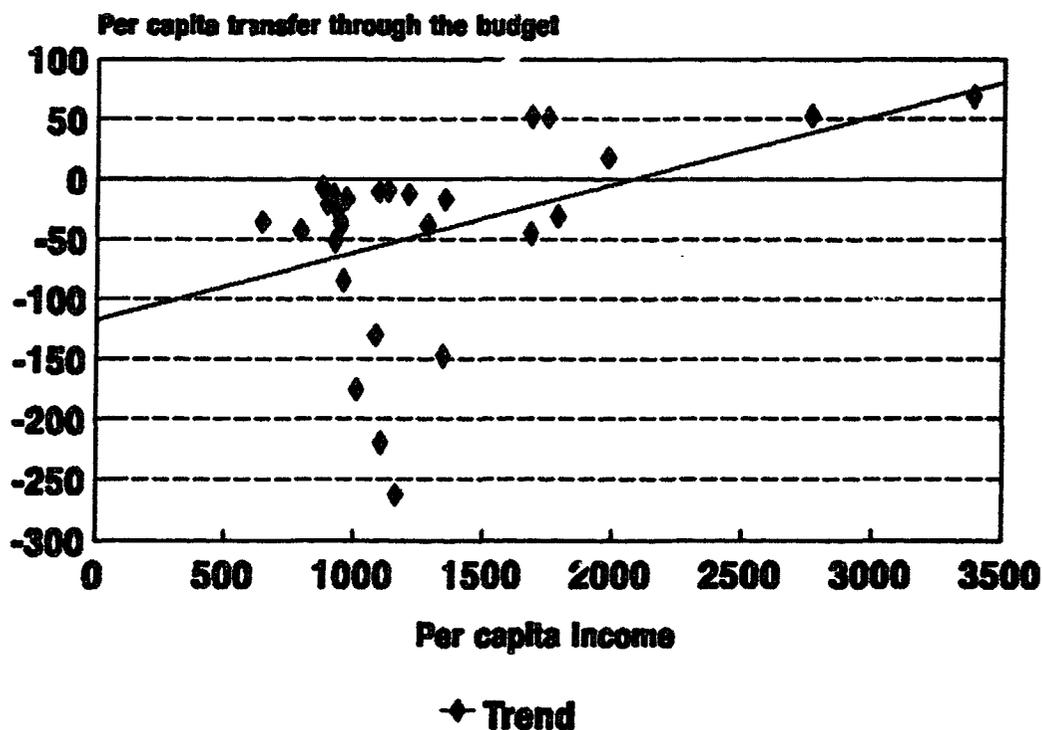
Note: Budgetary revenues and expenditures corrected for SOE subsidies.

Source: Table A-4.2 and A-6.2.

Qinghai (which has a large Tibetan population) and the minority and border areas of Inner Mongolia, Ningxia, and Xinjiang.

3.83 Excluding Shanghai and Tibet, the relation between net transfers per capita and income per capita is weak. Figure 3.8 shows the relation between per capita income and per capita transfer to (+) or received from (-) the center in 1990. The relation between income and transfers is positive, but the slope of the curve is small and dispersion around the trend is large. The wide dispersion gives the redistribution arbitrary features. To illustrate: the provinces bunched around a per capita national income of Y 1,000 receive widely different amounts of transfers. Henan (income Y 872) receives only Y 6.9, whereas Gansu (income Y 919) receives Y 52.0.

Figure 3.8: REDISTRIBUTION THROUGH THE BUDGET, 1990
(yuan)



Note: Excluding Tibet and Shanghai.

Source: Table A-8.1 and A-11.

3.84 Over the 1980s, the surplus provinces sharply reduced their transfers to the center: Shanghai, from Y 1,128 per capita in 1983 to Y 613.5 in 1990, Tianjin, from Y 231.1 in 1983 to Y 52.9 in 1990, and Beijing, from Y 216.6 to Y 68.97 over the same period. In real terms, the decline was steeper: for example, Shanghai transferred in 1990 only about a third of the amount transferred in 1983.^{66/} Over the 1980s, however, the amount of central fixed revenue increased strongly (Section 3.3), to become the main source of the transfers. The

^{66/} In 1987 prices, Shanghai transferred Y 1,413 per capita in 1983 and Y 480 in 1990.

provinces overall are "in deficit" toward the center, with Y 14.31 per capita in 1990, against a surplus of Y 22.15 per capita in 1983.^{67/}

3.85 Increased Transfers, More Earmarking. Transfers from the central government to local governments increased sharply (15 percent real growth in 1985-90), but the composition shifted from quota subsidies to earmarked grants (Section 3.D). In 1987 prices, quota subsidies declined from Y 9.4 billion in 1985 to Y 6.1 billion in 1991 (Table A-1.3); in 1985, the quota subsidies still constituted 44.5 percent of all central-local transfers, but in 1990 only 14.6 percent (Table A-1.1). For provinces for which earmarked grants could be derived, the same pattern held: quota subsidies declined and earmarked grants increased (Table A-15).^{68/} However, the most striking feature in the data on earmarked grants was its distribution across provinces. Relatively rich provinces like Shanghai and Guangdong received substantial amounts of earmarked grants, Y 171 and Y 57.5, respectively, per capita in 1990, while poor provinces like Guizhou and Guangxi received Y 23.9 and Y 28.3 per capita, respectively.

3.86 The distribution of earmarked grants can be partly explained by the impact of central policies across provinces: the inefficient and regressive system of price subsidies and the subsidization of enterprise losses is cofinanced by the center through earmarked grants. Old industrial centers, where SOEs dominate, are the main beneficiaries. A second cause may lie in the high cofinancing requirement attached to central grants for CESH projects. Due to the poor provinces' weak own-revenue base, they cannot always comply with the cofinancing requirement, and might therefore forgo central earmarked grants. Differentiation of cofinancing requirements by province seems to be the exception rather than the rule, and only a limited amount of central budgetary funds is earmarked for projects in poor rural and minority areas.^{69/} Thus, although total central-local transfers increased, the growth came from the earmarked grants, benefiting primarily the richer provinces, and increasing the urban-rural divide.

3.87 Subprovincial Equity. While China's mass poverty has been dramatically reduced by the strong economic growth of the reform period, and urban poverty has virtually disappeared, 100 million poor remain, concentrated in remote and mountainous counties, in the Northeast, the North, and the Southeast provinces.^{70/} For those "pockets of poverty" with a weak fiscal capacity, subprovincial fiscal transfers are crucial. Although few data on subprovincial finance are published, evidence from the education and the health sectors (Boxes 3.1 and 3.2) suggest many of the social services are not provided or are of substandard quality

^{67/} Overall transfers per capita were found by *dividing* the central-local transfer through total population.

^{68/} Earmarked grants were derived from total flows from or to the center, corrected for the flows from the fiscal contract. Because the contractual flows are not known for each province, a complete distribution of earmarked grants cannot be derived.

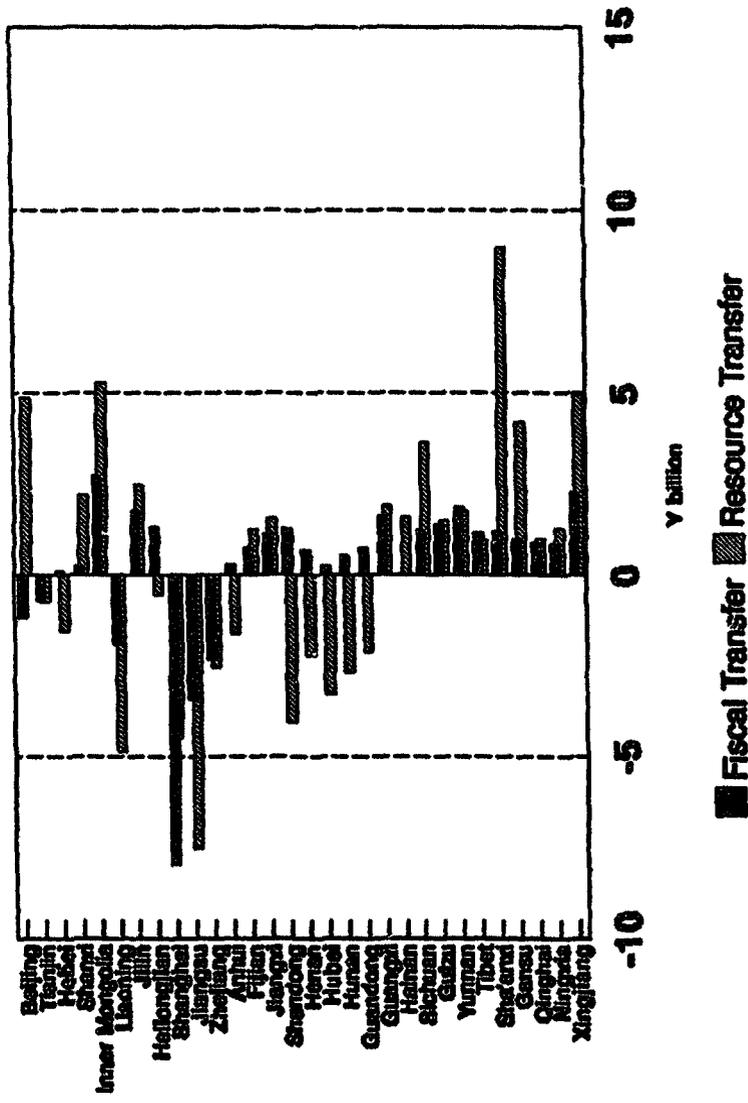
^{69/} The figures for 1991 for the special funds are: Fund for Education of Poor and Minority Areas, Y 22 million; central contribution to the Development Fund, Y 800 million (the fund gives credit to poor areas); the "Three West Fund," Y 200 million; Basic Needs Fund, Y 24.8 million.

^{70/} See World Bank, "China: Strategies for Reducing Poverty in the 1990s," Report No. 10409-CHA, May 1992.

in poor counties and townships. The odds against school attendance, which are already higher in poorer areas due to their higher opportunity costs in terms of foregone income, is enhanced by user fees which are often higher than those in the richer areas. These observations suggest that the fiscal transfers get "stuck" at provincial and prefectural level, and that the subprovincial fiscal system cannot target transfers to counties that need most central support.

3.88 Not by Budgets Alone. The budgetary flows between the central government and the provinces constitute only part of the total redistribution through administrative channels. To illustrate the relative importance of fiscal flows, Figure 3.9 plots the fiscal flows and the real resource flows to and from the provinces. Real resource flows are measured by Net Provincial Income *minus* Net Provincial Income Produced. This difference might be financed by fiscal flows, flows in central enterprises, out-of-province workers' remittances, but also by credit flows and foreign investment.

Figure 3.9: MORE THAN FISCAL ALONE
Fiscal and Resource Transfer, 1989



Note: Resource transfer = provincial income used-provincial income produced.

Source: Table A-10.2.

3.89 The figure shows that Beijing, for example, makes a fiscal transfer to the center, but receives a much larger opposite transfer by other means, and is a net receiver of resources. The large fiscal transfer out of Shanghai is partially offset by other flows, making the net

resource outflow smaller. Shaanxi, a poor province receiving a relatively low fiscal transfer receives a much larger nonfiscal transfer.^{71/}

3.90 A significant part of the nonbudgetary redistribution takes place through the banking system, which has become more and more a substitute for the budget over the reform period (Chapter 2). Although more complete data are lacking, Annex 3.2 provides some preliminary evidence by looking at the loan/deposit ratio in the banking system per province. The ratios reveal that both the poorer provinces and provinces with a strong SOE industrial base receive credit allocations well above their deposits, yielding above-average loan/deposit ratios. Thus, their resource envelope is extended over by PBC's credit allocation system.

3.91 The price system is a second important factor. Most state-set prices are biased against provinces with natural resources and, in general, beneficial to industrial provinces. As a result of price reforms, however, this channel is gradually losing its importance as a tool for redistribution. In contrast, a third administrative channel has gained importance over the reform period, "policy subsidies," for example, permission from the center to form special economic zones or receive some other preferential treatment. Plans to extend such policies to the inner provinces have been proposed. In the meantime, the concentration of these zones in the coastal regions has been instrumental in their strong growth performance.

3.92 In summary, the equalizing properties of the fiscal system declined over the 1980s, and transfers from the central government to the provinces are only weakly related to per capita income. Redistributive quota grants have given way to earmarked subsidies, not targeted toward poor provinces. Off-budget flows play an important role in the redistribution of resources among provinces and between them and the center.

3.93 The Chinese authorities point out that, during the 1980s, fiscal capacity in each province has increased strongly and that a convergence has taken place. While this is true, the increase in the poorer provinces' fiscal capacity has been achieved not by fiscal redistribution but by a strong increase in their overall tax rate, while the tax rate of richer provinces has declined (Table A-6.3). Whether convergence in fiscal capacity and expenditures has taken place is, to a certain extent, irrelevant. The present system of quotas and earmarked grants fails to account properly for relative changes among income of provinces, cannot accommodate for inflation, and seems to result in an arbitrary distribution of fiscal capacity among provinces. This system will thus sustain or accentuate cross-provincial income differences.

F. FISCAL INCENTIVES AND DYSFUNCTIONAL OUTCOMES

3.94 Strain on the fiscal system comes as no surprise, given the depth and speed of reforms in China and is to some extent tolerable, given the phenomenal growth that the *entrepreneurial* decentralization has caused. However, the reluctance to fundamentally change the intergovernmental fiscal system in the light of de facto devolution of power has led to a number of avoidable problems, and to actions by central and local government that further

^{71/} This analysis serves only as an illustration. As China retrenches from the central planning system, resource flows can no longer be seen as intended consequences of central policy. The inflow of resources to Shanghai from outside the fiscal system may be explained by the province's success in attracting foreign investments.

undermined the system and threatens macroeconomic stability. The most important ones are listed below.

3.95 Mismatch of Expenditure and Revenue Assignments. Revenues and expenditures are increasingly mismatched at subnational levels of government. China's intergovernmental fiscal relations have been largely revenue-driven. Little attention has been given so far to the expenditure side, especially to matching expenditures with revenues. At the county and township level in particular, revenue seems inadequate for the expenditures assigned to those levels, leaving essential government functions neglected. The mismatch has been accentuated by the center's policy-induced change in expenditure responsibilities and has sometimes undermined central government policies, for example, in education and infrastructure. CESH in poor regions has been inadequate and is falling farther behind richer regions. The long-term implications for interregional income distribution are negative.

3.96 Uncertainty. The central government's actions throughout the process often helped to undermine efficiency and equity of the fiscal system and created a set of adverse incentives leading to dysfunctional outcomes. As revenues fell in GNP terms, and as the budget deficit grew, the central government reacted by expanding its claims on revenues by increasing the central fixed taxes, protecting its own finances at the expense of local government finances—"borrowing" from localities.

3.97 Local governments considered predatory repeated attempts to renegotiate revenue-sharing contracts, to "borrow" local surpluses, to reclaim ownership of enterprises in high-growth industries, and to readjust the subordination of cities with big revenue surpluses. Repeated unilateral "recontracting" by the central government has blurred and undermined contract incentives, reduced revenue collection well below its potential, and made fiscal planning at local level much more difficult under the ad-hoc character of the earmarked grants (see below).

3.98 Reduced Redistributions. As fiscal resources in the revenue-sharing system stagnated, the central government allowed the redistributive element to weaken. By fixing the quota subsidies to poor regions in nominal terms since 1988—changing the policy to increase them by 10 percent a year—it allowed their real value to erode with inflation.^{72/} Instead, fiscal redistribution now takes place mainly through ad hoc, earmarked grants, introduced piecemeal as needed and often poorly targeted and too small to meet basic needs in the poorer regions. Moreover, the arbitrary nature of central grant allocations has given way to extensive negotiations and rent-seeking behavior by the localities, tying up valuable administrative resources.

3.99 Extra- and Off-Budgetary Activities. Besides increased rent-seeking, local governments have responded to the fiscal squeeze in other ways that run counter to reform objectives and that undermine the fiscal system itself. These local "reactions" include inefficient, nontransparent, and sometimes illegal attempts to: (a) expand the local tax base; (b) tap enterprises' extrabudgetary funds; (c) push expenditures off budget, sometimes financed by

^{72/} Under the 1985-87 contracts, quota subsidies were scheduled to increase by 10 percent a year, to provide for real growth after cost increases. Due to the center's own worsening fiscal difficulties, the policy was abandoned in 1988.

indirect local borrowing, or paid for by the enterprise and private sectors; and (d) impose public service fees and levies—excessive in some cases, inequitable in others.

3.100 A variant of the above strategy is that of pushing governmental expenditures "off budget." In Xuzhou City in Jiangsu, most staff salaries in township-level finance departments are paid by township economic commissions from off-budget industrial funds.^{73/} Earlier mission discussion of educational financing showed that provinces are increasingly seeking nonbudgetary funds to supplement budgetary appropriations, including running factories to earn incomes for schools, collecting "social contributions," etc. In poor provinces, especially in the rural sector, many costs are passed along to parents, by charging tuition and fees and obliging the parents to help subsidize the minban teachers' wages. Although cost recovery can enhance efficiency, the level of parent's contribution can form a serious access barrier. "Contributions" from firms constitute a form of taxation not based in any law. From a policy formulation perspective, the extra- and off-budgetary activities blur the view on what government actually does, and how it is financed.

3.101 **Inefficient Regional Competition.** Evoking the localities' interest in expanding the local tax base was a goal of decentralization of fiscal responsibility. However, as the budgetary resources were no longer sufficient to achieve the goal (as seen in the virtual disappearance of capital construction from the local budgets), the instruments used for this purpose became inappropriate. Distorted price and tax structures channeled resources to the "wrong" sectors and policy-guided bank loans more and more replaced budgetary finance (Annex 4). This diversion of resources led to excess capacity in processing industries, where revenue potential is high especially when local monopolies can be established. Because the price and tax structures are uniform nationwide, the regional composition of industry has been duplicative, since resources are channeled to the same high-tax/high-revenue industries everywhere. To maximize revenue growth, provinces have even subsidized high-cost producers in high-tax industries like beverages and tobacco.^{74/} The convergence of industrial structure across regions exacerbates the tendency toward protectionism and hinders the development of a national market. Throughout the reform decade, local revenue dependence on the financial health of local enterprises has induced local officials to protect their resources and markets. A result has been intermittent outbreaks of "wool wars," "silk cocoon wars," and other barriers to resource flows between regions, including limits on "capital outflow" through the interbank market.

3.102 **Fiscal Predation.** Under severe fiscal pressure, many local governments have succumbed to tapping enterprise funds by imposing a variety of legal and illegal levies (including educational surcharges, utility surcharges, "environmental fees," and the like). They have also shifted costs to enterprises for responsibilities ranging from education,^{75/} road-building, and

^{73/} To hold down administrative costs on the budget, only 160 of the 660 personnel in the city's fiscal hierarchy (with offices in 180 townships, 6 counties and 1 district) have been put on the payroll for administrative personnel (xingzheng bianzhi).

^{74/} In 1986, Guangxi paid out subsidies totaling Y 29.85 million to support production of "key-point, high-tax products" in the tobacco-drying and cigarette industries (*Guangxi Nianjian*, 1987, p. 554).

^{75/} For example, TVEs spend about Y 20 billion on education and welfare outside the budget, which is more than 40 percent of budgetary expenditures on those categories. See Speech by Vice Premier Tian Jiyun (June 1992).

environmental protection to hosting banquets for governmental functions. Lacking a strong legal framework to protect enterprises from fiscal predation, such practices have proliferated despite myriad regulations promulgated to prohibit them.^{76/} Government predation over enterprise funds violates the spirit of enterprise reform, which aims to increase enterprise autonomy and to insulate them from government interference. Predation blurs the incentives for enterprises to respond to market forces and therefore impairs allocative efficiency.

3.103 Tax Expenditures. Another set of problems are tax expenditures. Although the provinces have no formal powers for setting tax rates, local governments can set the effective tax rates on enterprise profits via enterprise profit contracts.^{77/} They can also offer tax expenditures to enterprises and affect the size of the taxable income, by stipulating portions to be exempt from taxation, by setting the rules for pretax repayment of investment loans, etc. In extreme cases, they can exempt enterprises from indirect taxes, by waiving part of sales taxes for enterprises in financial difficulty. As long as the revenue-retention rate is less than 1, local governments have an incentive to pursue evasive or avoidance tactics to keep resources at home instead of sharing them with higher levels of government, thereby turning budgetary funds into extrabudgetary funds. Funds "stored" in this way in the enterprises can then be tapped for community projects.^{78/}

3.104 Allowing lower level governments to make tax expenditures under revenue-sharing arrangements creates a set of highly regressive incentives. Making revenue-rich provinces more generous in offering tax expenditures than poor ones has adverse implications for regional income growth. Rich provinces can "share" the costs of tax expenditures upward to the central government; poor provinces have to bear the full cost themselves. Moreover, because of the intense pressures on their budgets and the restriction on borrowing, poor provinces cannot forgo present revenues for future revenues. The increasing use of tax expenditures ultimately results in lower effective tax rates in rich areas than in poor ones, and in lower overall taxation than desired.

3.105 New Directions? In partial recognition of the problems in the present fiscal system, the Chinese government has initiated experimental reforms, to be implemented in the cities of Dalian, Wuhan, Shenyang, Qingdao, Chongqing, Tianjin, and the provinces of Liaoning, Xingjiang, and Zhejiang. Labeled "tax-sharing system," the experimental system retains much of the present system: revenues are divided into central fixed, local fixed and shared revenues, and the local retention rate will still be driven by base number expenditures. The main difference is the assignment of different taxes to different levels, with the most important change the local SOE income tax, which now becomes "local fixed," thereby increasing the incentive for local protectionism, although reducing the incentive for—illegal—tax exemption.

^{76/} Donald C. Clarke, "The Legal Background to the Behavior of State-Owned Enterprises," December 1989, processed.

^{77/} By specifying a lump-sum payment that includes income tax, adjustment tax, and profit remittances, tax contracts essentially undid all the efforts of separating taxes and income in the tax reform of 1983-84.

^{78/} Xu Riqing, "Some Thoughts on Local Government Fiscal Contracting," *Caimao Jingji* (Finance and Trade Economics), 1988(11), pp. 53-54.

3.106 The stated aim of the reforms is to increase central government's tax buoyancy. At the same time, however, the expenditure assignments remain basically the same, and the shortage of funds at the local level is potentially aggravated. The experiment does not anticipate a true local tax base, with tax base and rate determined at local level. Tax revenue will therefore only by accident follow expenditure levels, and regular adjustment of either the local fixed taxes, or the sharing rate and accompanying local lobby activities is to be expected. The base number expenditures are determined by past expenditures, retaining the incrementalism of the old system, and forgoing the opportunity to put expenditures on a more rational basis. Moreover, no fundamental reconsideration of expenditure assignment over levels of government has taken place. The experiment therefore seems insufficient to deal with the more fundamental problems in China's fiscal system.

G. RECOMMENDATIONS

3.107 The dysfunctional outcomes of the fiscal system that have occurred over the reform period blur the fundamental gains of decentralization. Instead of recentralizing—an option that may no longer be open, given the rising power of the provinces—the Chinese government should realign the institutional structure to give localities the right incentives for providing public services in an efficient and equitable way without jeopardizing macroeconomic stability.

3.108 China should embark on a more fundamental reform of intergovernmental fiscal relations than the incrementalism and experiments thus far pursued. Fiscal reforms can only be brought to success if all parties gain, which is more likely the more comprehensive the reforms are. Budgetary reforms and changing intergovernmental relations should therefore go hand in hand with a broadening of the tax base, the creation of a local tax base, a rationalized tax collection system, and a reestablishment of central government's macroeconomic control. The evidence from the past with fiscal reforms suggests that the experimental, regionally limited piecemeal reform method, successful in many areas, may not work with fiscal reforms. A gradual nationwide implementation of an established reform plan encompassing the various aspects of fiscal reform promises to be the better method.

3.109 China's authorities should make clear assignment of functions among levels of government, with efficiency of service delivery and equity among localities as guiding principles and avoiding the existing duplication of functions at various levels. In assigning functions, Chinese authorities should account for the de facto devolution of functions that has already taken place over the reform period.

3.110 Some government functions, especially those determining China's internal market, should be recentralized. Regional development should not lead to inefficient duplication of industrial investments. The central government could, for example, pursue an industrial policy through the investment orientation tax, interest rate subsidies, or other measures. Local governments should be allowed to pursue regional development goals, but impediments to goods and factor movement should be strongly opposed by the central authorities. In this context, it should be noted that the policy to restrict the movement of labor enhances local protectionism. To counter local protectionism, central government should fill the institutional void with realm of competition, regulation, company law, and contract law in order to restore the unified market.

3.111 Recentralization of Macroeconomic Functions. Control over government functions crucial for macroeconomic stability should be recentralized, including control over aggregate government borrowing, and overall tax burden. The increasing intergovernmental flows of goods, production factors and income gives central government a comparative advantage in tax collection, and a National Revenue Service (NRS) is highly desirable. Such a recentralization of control over *administration* of revenue sources (borrowing, taxes) may well coincide with a decentralization of the revenue *accrual* from these sources. The expenditure assignment should be the basis of a new revenue assignment, and the expenditures necessary to perform the assigned functions efficiently should be covered by the revenue assignment—provided the overall fiscal envelope is sufficiently large due to China's tax reforms. The efficiency of government service delivery depends to a considerable extent on the autonomy a level of government has, on the financial incentives it has for cost savings, and therefore on the means the expenditures are financed.

3.112 Own Tax Base. China's authorities should assign each level of government a substantial own tax base, with which it finances functions for which it has full responsibilities. China's authorities should assign local governments a true local tax base, and exploit the opportunity for more accountability and the incentive for better and cheaper public services such a tax base gives. Own tax bases can furthermore serve to absorb variations in expenditure needs without a tiresome renegotiation of intergovernmental fiscal relations. Finally, extension of the local tax base contributes to break the present deadlock in the system of intergovernmental fiscal relations. For local government, property taxes would be an excellent own tax source, which is thus far hardly exploited in China. However, the subordination principle in income taxation distorts incentives for local government, and should be abandoned in further reforms of the tax system.

3.113 Tax Sharing and Equalization. A full separation of tax bases in China is probably not feasible, nor desirable with respect to efficiency of collection, assuming that the NRS will be established. The fiscal gap between expenditure needs and revenues from the own tax base can be filled by tax sharing, general grants, specific grants, or a combination thereof. To accommodate for the increasing divergence in economic performance among regions, and the consequential growing divergence in fiscal capacity necessitates a fiscal system with equalizing properties. Horizontal equalization of fiscal capacity between localities can be achieved through tax sharing arrangements or through equalization grants. Whatever the mechanism chosen, China's authorities should design horizontal equalization mechanisms that are resilient to inflation, and can accommodate substantial shifts in relative welfare positions of localities, which are likely to occur as reforms deepen.

3.114 Administratively, it is more complicated to incorporate equalization considerations in tax sharing arrangements, and usually a separate equalization fund is set up, or central government allocates funds directly to poorer provinces. The latter solution would, however, require a larger share of tax revenues going to central government, which seems difficult in the present Chinese situation. For China, an interprovincial equalization fund could be the appropriate way to strengthen horizontal equalization. This closed-end fund could be filled by a certain percentage of taxes shared between central and local government: this earmarking will have no effect on tax effort in the case of a NRS. The fund could for instance be *administered* by a body at arm's length of central government, with both local and central representatives. Disbursements from the equalization fund could be based on broad indicators of expenditure need, such as population, area and urbanization, and on fiscal capacity of the

locality stemming from its own tax base. A variety of formula-based grants schemes or tax sharing arrangements can be found around the world, but China's authorities should make the primarily *political* decisions on what factors should be given weight in the formula, and to what extent fiscal capacity should be equalized across localities.

3.115 Local Government Finance Law. The elements of intergovernmental fiscal relations as set out here need to be captured in a Local Government Finance law. The law would work out the constitutional division of labor between levels of government, and specify the financing mechanisms, including the above mentioned tax sharing and equalization arrangements. The law would in part serve as a guarantee for local government that the NRS will not be abused to reverse the devolution of the reform period, and would establish the increased local autonomy by means of codifying local taxation rights.

3.116 Intergovernmental Committee. An intergovernmental committee to tackle the various issues in intergovernmental fiscal relations should be established. The committee, manned by both local and central representatives should solve the technical issues in implementing intergovernmental fiscal reform. The committee should make proposals for the criteria governing the equalization fund. They should be in charge of drafting the suggested Local Government Finance Law. The committee may evolve into the administrative body that manages the interprovincial equalization fund.

3.117 Experiments. The present tax sharing experiments do not match the fundamental revision of intergovernmental fiscal relations as sketched above. Moreover, the experiments have not been implemented as designed by MOF, and therefore seem more and more irrelevant for the evolving situation in China. China's authorities should therefore consider giving up these experiments altogether.

3.118 Short-Term Quota Transfer Increase. In the short run, further erosion of equalization funds should be prevented. As a start, certain tax revenues could be partially assigned for equalization, equal to the quota transfers now given. The taxes feeding the equalization fund should be income elastic, so that revenue keeps up with overall economic development. Resources saved from phasing out SOE and price subsidies could be used to supplement the quota transfers. Interprovincial equity could be further strengthened by differentiating the cofinancing requirements for earmarked grants from the central government.

3.119 Monitoring Capacity. Concurrent with the improvements in the regulations, central government should strengthen its capacity to monitor local implementation of national law. Regular announced and unannounced inspections of local government policy would increase compliance with these laws. Further study on tax effort and representative tax systems could help the central government identify provinces that are giving excessive tax concessions. The costs of industrial policies should be made transparent by declaring in the budget revenues foregone and subsidies made in exercising regional development functions.

3.120 Earmarked Grants. The fiscal system should give localities more incentives to pursue national objectives, especially in the social sector. This requires a larger financial commitment from central government in the form of earmarked grants. The funds for such programs can be released by phasing out the inefficient earmarked grants for SOE losses and price subsidies. The earmarked grants should be tied to objective criteria (possibly formulas) and should come from closed-end funds so as to retain control over central government

expenditures. Appropriations for earmarked grants should be program-based, not entitlement based ^{79/} and, once decided, should remain stable for some time to improve the local environment for budgetary planning. Central earmarked grants should be reflected in local budgets.

3.121 Fiscal Extrabudgetary Funds. Fiscal extrabudgetary funds should become part of local budgets (Chapter 2). To preserve local autonomy over the funds and enhance the cost-recovery incentives for local public services, fiscal extrabudgetary expenditures and revenues should remain separate from the fiscal contract, and be integrated in the local tax base in the future. In the longer run, self-sufficient nonprofit units producing marketable goods could become independent, and consequently be removed from the governments' accounts. Fees and levies of administrative units should in principle be treated as general fiscal revenue, which should not necessarily remain within the unit that generates them. Some earmarking might, however, still be instrumental in increasing revenue-raising incentives. Enterprise extrabudgetary funds should no longer fall under government control or appear on local fiscal statements.

3.122 Cost Recovery. Without a nationwide system of income redistribution and considering the wide divergence in fiscal capacity from region to region, the cost-recovery principle should be applied with utmost care to social services, like health and education, as fees could become barriers to access. Central government should set guidelines for local user fees. Increasing health insurance coverage and introducing education vouchers could be effective in enhancing efficiency of supply, while assuring access to social services. Until such instruments are operative, however, increased budgetary financing of social services seems mandatory.

3.123 Central involvement in local functions in a country as large as China can only be limited and should be well specified in terms of goals and instruments. The general principle of "unified leadership and decentralized management" is a strong one, and should not be eroded by a complex system of central-local or central-subprovincial earmarked grants. Such a system would undermine local responsibility for local public finances.

3.124 Subprovincial Information. The central government appears to have little knowledge on subprovincial finance which hinders the formulation of nationwide policies. If the central government wants to play a substantial role in policies on the subprovincial level and better target its national policies, it should build up the necessary information bases to address the relevant policy issues. As a first step, a unified system of fiscal reporting among provinces is imperative. Widely published and detailed provincial fiscal accounts would also allow provinces to learn from each others' experiences, thereby enhancing imitation of best practice. Combined with other data, provincial statistics could become the basis of output and efficiency indicators.^{80/} Subprovincial equity should be further studied to determine whether equalization funds reach the levels of government that most need the funds.

^{79/} That is, be tied to specific programs for specifically set out goals, not as general support for local government budgets, which should be covered by either own revenues or general grants.

^{80/} A more active exchange of government personnel between provinces may enhance the dissemination of best practice, increasing the efficiency of government overall.

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