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EXTRABUDGETARY FUNDS

by
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EXTRABUDGETARY FUNDS

I. Definition

Fiscal extrabudgetary funds (EBF) can be broadly characterized as resources managed directly or indirectly by administrative branches of the government outside the normal budgetary process.

1. They can be special accounts, segregated from the budget, and intended for carrying out a specific activity, or to benefit a specific agency. These are often organized as a fund, or as a self-balancing accounting entity; or

2. they can be revenues raised outside the budget framework by administrative units, and off-budget payments by the Treasury, the central bank, or any other organization which has authority over public money.

From the public expenditure management perspective, the most important distinction between budgetary and extrabudgetary funds is the extent to which the resources are put through the normal budgetary deliberations. The essence of budgeting practice is to weigh expenditures against one another, or against increased revenue -- it is the process of allocating scarce revenue among competing uses. The possibility of deciding on the financial allocation for an activity within the overall budget framework, is critical for characterizing a budgetary activity. Type 1 EBF are earmarked funds that are protected from annual budgetary deliberations. By this definition, all earmarked funds are extrabudgetary whether they come from budgetary or extrabudgetary sources.

Type 2 extrabudgetary funds are the nontax revenues of branches of government. They comprise the ambiguous region where the distinction is blurred between administrative and non-administrative functions of the government. It is normal practice to exclude from the government administration those public entities which comply with all of the following requirements: they do not provide pure public goods, they are granted full administrative autonomy, and they raise most of their own revenue. But many activities are on the borderline between administrative and commercial activities, and are classified differently according to the prevailing institutional and economic arrangements, e.g. the national lottery, or universities. For example, many OECD countries exclude from the budget allocation process, and even from budgetary funds management, some self raised funds of agencies that are largely dependent on the budget. Examples are the Statutory Bodies in Australia, Crown Agencies in New Zealand, the rechtsfahige Anstalten in Germany, and the Etablissement Publics such as museums in France. These public agencies are established under separate laws, and have budgeting and financial management rules separate from the budget law. Often, they have government representatives on their board. The budget only shows the subsidies to those organizations. Such organizations are not unlike state-owned enterprises, which are usually also treated on a net basis.

Type 2 funds are extrabudgetary by source. They are also normally, but not necessarily, extrabudgetary by use. To the extent that budget accounting and deliberations take in these nontax revenues, they can be integrated into the budget in allocative decisions.

II. Taxonomy: Some Common Types of Extrabudgetary Funds
• insurance funds, e.g. social security schemes. They are characterized by the contingent nature of expenditures, in face of a (compulsory) premium payment. Social security schemes do not always correspond to the theoretical precept of a strong link between payment and service, since there is often a strong redistribution component, whereby the more affluent tax payers cross-subsidize less affluent citizens.

• Trust funds, e.g. pension funds. These are privately-owned resources that are deposited with the Government for future disbursement. The link between payment and service is valid only for those systems based on the capitalization principle. Many public pension schemes, for instance, are instead based on the pay-as-you-go system, in which pensions do not necessarily correspond to contributions.

• Earmarked funds, e.g. road funds, research & technology funds. These resources are linked to an identifiable revenue source, and assigned to a specific kind of expenditure or public institution. Earmarked funds often tend to absorb revenue from a host of different sources, only marginally linked to the output supplied, thereby blurring the link between price and service.

• Financial reserve for risky activities, e.g. currency stabilization funds. These reserves imply a link between revenue and expenditure only to the extent that they are self-financed through a zero-sum mechanism, i.e. the resources spent in one period are those accumulated in a previous period.

• Government or central bank direct lending or on-lending. Under the GFS classification, budget should include a net lending item. However, in some systems, lending by the central administration or central bank is not included in the budget.

• Unappropriated expenditures, that is expenditures carried out without budget authority, usually in response to unforecasted and compelling events. Many budgets include contingency funds for this kind of expenditure, but the legislation often allows also for limited unappropriated expenditures. Large unappropriated expenditures are often the result of lack of budgeting for contingent liabilities.

• Fees and earnings of administrative departments, or cost recovery of public services, which are not devolved to the Treasury, e.g. payment of medicines in public health facilities. The link between price and service is sometimes weakened by non-exclusivity in consumption, which is typical of public goods.

Other forms of extrabudgetary activity include:

• Mandatory non-commercial expenditures by enterprises (or quasi fiscal activities), e.g. enterprise nurseries and schools, or mandatory payments by individuals, e.g. trade unions contributions. This constitutes an indirect fiscal activity of the state.

• Tax rebates or credit rebates which are equivalent to a hidden subsidy expenditure of government.
# Box 1. A Sample of Extrabudgetary Funds

<table>
<thead>
<tr>
<th>Types of Extrabudgetary resources</th>
<th>USA</th>
<th>Russia</th>
<th>Germany</th>
<th>New Zealand</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two federal fiscal trusts funds:</td>
<td>Two federal fiscal trusts funds:</td>
<td>5 social funds.</td>
<td>Social security fund.</td>
<td>Unappropriated expenditures.</td>
<td>Social security fund.</td>
</tr>
<tr>
<td>1) Old age and Survivors fund</td>
<td>1) Old age and Survivors fund</td>
<td>Technological development fund.</td>
<td>Unappropriated expenditures.</td>
<td>Permanent appropriations for public and constitutional organizations.</td>
<td>Contingent liabilities</td>
</tr>
<tr>
<td>2) Disability fund</td>
<td>2) Disability fund</td>
<td>50 industrial funds (R&amp;D, Investment, and Economic Distress funds)</td>
<td>Directed state eminent tax and credit subsidies.</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Directed state eminent tax and credit subsidies.</td>
<td>Cost recovery.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Employers and employees contributions (payroll taxes)</th>
<th>Social fund: employers and employees contributions.</th>
<th>Social security financed through employers and employees contributions and through budget transfers.</th>
<th>General revenue.</th>
<th>Social security financed through employers and employees contributions and through budget transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Social security financed through employers and employees contributions and through budget transfers.</td>
<td>Social security fund: employers and employees contributions.</td>
<td>Social security provided by law or decree.</td>
<td>Social security provided by law or decree.</td>
<td>Social security provided by law or decree.</td>
</tr>
<tr>
<td></td>
<td>Social security financed through employers and employees contributions and through budget transfers.</td>
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<td>Social security provided by law or decree.</td>
<td>Social security provided by law or decree.</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Rules of EBF Constitution</th>
<th>By law</th>
<th>Extra-budgetary funds: by law or decree.</th>
<th>Unappropriated expenditures authorized by law or decree.</th>
<th>Permanent appropriations: by law.</th>
<th>Social security provided by law or decree.</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Cost recovery: decision of the levying office.</td>
<td>Unappropriated expenditures authorized by the MoF only under unforeseen and compelling circumstances, and either below DM10m or if is a legal obligation.</td>
<td>Unappropriated expenditures: maximum 1% of ministerial appropriation with authorization of MoF</td>
<td>Social security provided by law or decree.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Direct loans: MoF decision</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Budgeting (organ, integration with main budget)</th>
<th>The off-budget funds are included in the budget presentation. Unified totals are shown for expenditure, revenue, and deficit.</th>
<th>EBFs not included in budget document.</th>
<th>Social funds prepare their own budgets. The budget includes only the flows to and from the social funds and the budget.</th>
<th>Completely integrated with budget.</th>
<th>Social security prepares its own budget which is discussed during the budget session. The parliament can impose an annual spending limit. Unified totals are presented as annexes to the budget document.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Social security funds manage their own accounts, but within the Treasury system.</td>
<td>EBFs not included in budget document.</td>
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<tr>
<td>Treasury management</td>
<td>Industrial funds: revenue should be paid to line ministries who distribute it. In practice, large portions are kept by enterprises and spent or kept in bank accounts.</td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transactions with budget funds</th>
<th>Only limited financing from general revenue, for unfunded entitlemets.</th>
<th>Budget transfers finance social security.</th>
<th>Not applicable</th>
<th>Budget finances different social security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting &amp; consolidation with budget accounts</td>
<td>No full consolidation with budget accounts.</td>
<td>No full consolidation with budget accounts.</td>
<td>No full consolidation with budget accounts.</td>
<td>No full consolidation with budget accounts.</td>
</tr>
<tr>
<td>Reporting and Monitoring</td>
<td>No reporting to Treasury.</td>
<td>No reporting to Treasury.</td>
<td>Same as budgetary items.</td>
<td>No regular reporting to treasury.</td>
</tr>
</tbody>
</table>

## III. The Rationale for Extrabudgetary Funds

EBFs are mainly used for activities which are to a large extent self-financing but which are not suitable for commercial provision, or whose provision the Government wishes to guarantee. The purpose of extrabudgetary accounts is to protect some activities from regular budgetary reviews of financial allocations, to ensure the resilience of funding over time. The question is why certain expenditures should escape the screening and weighing process of the budget.
Extrabudgetary funds can be useful for:

- financing certain activities for which the public pays a price and expects a service in return. The budgetary decision process would delink price and service, by determining the price and the funding for the service independently. In these cases, extrabudgetary finance is a specific form of earmarking. However, individual (or nonpublic) goods, such as electricity or water, are usually not financed through EBFs because they can best be supplied by profit-motivated enterprises.

- showing government commitments to a long-term moral or legal obligation, such as war veterans’ pensions, or the repayment of public debt. This gives rise to permanent appropriations which cannot be modified during the budget process, but require a different legislative process and sometimes constitutional amendments to change.

- responding quickly to expenditure needs arising from unforeseen events. Unforeseen events should be distinguished from risky activities such as government guarantees. For the latter, the budget should account for the risks it assumes as a contingent liability, and budget for contingent expenditures.

In practice, many extrabudgetary activities have emerged as spontaneous responses to weaknesses of the budgetary process, and have weak theoretical justification. For example, some EBFs have grown out of a form of self-financing, by administrations wanting to circumvent the general budgetary regulations and financial constraints. Others have been developed by the Government as a palliative for its own administrative incapacity to intervene effectively with normal budgetary procedures. They represent effectively a form of unbridled deconcentration. Other extrabudgetary activities have been the result of poor budgeting and cash management, resulting in unplanned fiscal activities.

IV. Earmarked funds and User Charges

Earmarking refers to the specific designation of funds to some particular use. The earmarking of tax revenues is usually justified using the benefit principle. Since the provision of public goods cannot be efficiently or equitably financed with user charges (in the pure sense), the government may try to mimic the functioning of the market by taxing some activities related to the provision of the public good. An example is the construction of roads. For example, since it is not feasible to collect tolls for most roads (esp. in urban areas), the government may use a tax on fuels to finance these projects as a substitute for the “optimal toll” that could not be introduced because of high costs of administration. Figure A shows the financing of U.S. Federal Highway Trust Funds. Other examples are the earmarking of the revenue obtained from payroll taxes to the Social Security System.

1 According to this principle, an equitable tax system is one under which each taxpayer contributes in line with the benefits which he or she receives from public services. For the benefit principle to be operational, expenditure benefits for particular taxpayer must be known. Moreover, this principle cannot cover taxes needed to finance transfer payments or meet redistributional objectives.
In the 1990s there has been a general increase in the use of earmarked taxes in place of general taxes in the U.S., where taxpayers have shown growing resistance to paying more taxes to finance public services, while demonstrating apparent willingness to pay earmarked taxes for "worthy" causes. This has been noted as part of the shift toward a contractual form of government (Wagner), where the replacement of general taxes by benefit taxes and user charges is seen as an attempt to place Government more directly on a contractual footing with the taxpayers. As such, earmarked taxes "create a kind of quasi-pricing of governmental services" (Wagner, p.9). In this climate, politicians have promoted the use of earmarked taxes to increase revenues without having to resort to tax increases — e.g. this was encouraged by both the Reagan and Bush administrations in the U.S. To "sell" them to voters, sponsors have even resorted to calling these earmarked taxes "user fees".

Strictly speaking, they are not the same. A "pure user fee" is a charge by a government agency in exchange for the goods and services that agency provides to consumers. An efficient pure user fee would be equal to the marginal cost of providing that service. Earmarked taxes are *like* user charges in that both resort to justification in the benefit principle. However, although most earmarked taxes are collected from the general group benefiting from the specific services provided by government, payments are usually not closely linked to the marginal cost of service provision, nor to the marginal benefits of the services. In extreme cases, the taxpayers are not even beneficiaries — one example is Proposition 99 in California, in which the public voted to increase cigarette taxes and earmarked the revenues for health care projects. This tax increase was widely labelled as a "user fee" imposed on smokers, despite the fact that they were not the main beneficiaries.²

² It was noted that in opinion polls conducted prior to its passage, the Proposition was supported by two-thirds of the voters polled. This is roughly the proportion of nonsmokers in the adult population.
**Box 2. Proposition 99 in California—Seven Years Later**

**Judge Halts Tobacco Tax Diversion $128 Million Marked for Cancer Research Being Used for Low-Income Health Care**

A Sacramento judge has ordered the state to immediately stop diverting tobacco tax revenues from anti-smoking research and educational programs to health care for the poor.

At issue is $128 million in funds that Gov. Pete Wilson and the Legislature shifted last summer from the purposes named in Proposition 99 to other health programs to help balance the state's 1995 and 1996 fiscal-year budgets.

Superior Court Judge Roger Warren said in a written order that the shift is "invalid and void" because it violated terms of the 1988 ballot initiative in which voters approved a 25-cents-per-pack tax increase on cigarettes.

Warren issued a preliminary ruling to that effect last month and made his ruling final Thursday.

**Praise from Cancer Society**

Reacting Friday, representatives of the American Cancer Society and American Lung Association praised the ruling as "a complete victory for the people of California."

A Wilson administration spokeswoman said the decision puts at risk programs for low-income children and the handicapped.

The cancer and lung groups were among 10 petitioners who filed the suit last September.

"We're delighted," said plaintiffs' attorney George Waters. "It's not that we want to move the money to some nebulous goal. The University of California has a world-class research program that was stopped in its tracks because of this."

Ad campaign crippled

In addition to that research into detection of lung cancer and gene therapy to retard hardening of the arteries, the shift also reduced funds for an advertising campaign that supporters credit with reducing smoking in California by 28 percent over the past five years, more than double the nationwide reduction in smoking.

"This court decision assures that the state must abide by the wishes of the voters and prevents the state from diverting monies in violation of a voter-approved initiative," said Spencer Koerner, chairman of the board of the American Lung Association of California.

**Critical Health Funds**

But Shannon Bowman, spokeswoman for Wilson's Health and Welfare Agency, said earlier that the order will take away funds now used for health screenings and immunizations for low-income children and other preventive health services.

"These are important services to critical, low-income populations," she said after the order was initially released. Bowman said Friday she could not make any additional comment until the attorneys had completed their review of the final ruling.

Warren's ruling takes effect immediately. Warren also directed state attorneys to return to his court in 30 days with a report of the steps they have taken to comply with his order.

To complicate matters still further, in practice, many user fees charged by government (e.g., fees for library use, or tuition for public universities) are not aimed at full cost-recovery, so the distinction from earmarked taxes is blurred. Instead, these fees are sometimes used as a rationing device, or to provide signals to government on the level of demand.

Another motivation for earmarking arises from principal-agent problems. If voters believe that budget bureaucrats act according to their own goals, and do not sufficiently respect the goals of their principals (voters), they may demand earmarking to protect some favored programs.

In general, earmarking tends to increase under conditions of fiscal stress and progressive breakdown of budgetary procedures. Since the passage of Proposition 13 in 1978 severely restricted general tax increases, for example, local governments in California have resorted to a plethora of user charges to enhance revenues and finance local services. Box 3 presents a brief discussion of excessive earmarking in Argentina during a period of progressive macro break-down.

Box 3. Earmarked Funds in Argentina

At the end of the 1980’s the Argentine Federal government used 47 taxes to collect revenues (excluding social security contributions). There were 8 agencies responsible for the administration and collection of these taxes. The most important was the DGI (the Argentine Internal Revenue Service) which had responsibility over 32 of those taxes. These accounted for 78% of the tax revenues. The second in importance was the Customs Office, responsible for seven taxes that accounted for 18% of total tax collections. The third was the Department of Energy; it administered 3 taxes that produced 3% of total revenues. There were five other agencies responsible for five earmarked taxes that financed a fraction of their outlays (Department of Health, the Public Horse Track, the Radio and TV agency, the Public Institute of Cinema and the regulatory agency of production and trading of meat).

Some of these 47 taxes were earmarked to special budget accounts (SBAs) or to decentralized agencies (DAs). As of 1988 there were 94 SBAs that were usually supervised by a Department of the Executive, and also received some revenues out of the general taxes.

As of 1988 there were 68 DAs which had financial and administrative autonomy. They also received revenues out of specific taxes earmarked to them or from the general budget. Table 2 summarizes the evolution of SBAs and DAs. The reforms of the 1990s reduced the number of SBAs from 94 in 1988 to 22 in 1997, and the number of DAs from 68 in 1988 to 55 in 1997. The reform had an important impact on the administration of the Federal Budget: in 1997 only 17% of total tax revenues was earmarked to a SBA or a DA, compared to 31% in 1988.

In some cases the end of earmarking was accompanied by the elimination of the specific tax that financed the special fund. The Argentine Federal government was very active in eliminating “tax handles” (e.g., taxes on electricity and natural gas consumption, excise taxes on tires, tax on pharmaceutical products, tax on exports of agricultural products, tax on maritime freight, some import

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3 In fact, in 1993 all SBAs were eliminated, but 22 budget programs continued to receive revenues out of earmarked taxes.
taxes and a tax on domestic sales of beef and grains), that were earmarked to some budget accounts or decentralized agencies. It also eliminated other inefficient taxes which financed the general budget (e.g. the tax on bank debits).

The 1989 Economic Emergency Law was the first instrument used to reduce the number of SBAs and DAs. In 1991 a presidential Decree that deregulated some economic activities eliminated other earmarked accounts, and finally the Budget Law of 1993 eliminated Special Accounts although some government programs continued receiving some earmarked funds. Some public hospitals that were counted as DAs were transferred to the provinces in 1992, and in the case of the Public Universities they maintained the autonomy in their administration, but are no longer named as DA in the budget.

In 1989 public finances in Argentina were in a complete disorder. The country had just suffered a hyperinflation and it was necessary to improve the fiscal position of the government. The Congress approved the Emergency Law together with a Privatization Law that initiated the reform of the public sector. Further measures were adopted during 1990, as it proved difficult to improve the Federal government deficit, especially because of the importance of short-term debt. One of the objectives of the Emergency Law was to help reducing the fiscal deficit and some funds could be obtained from SBAs and DAs. As the Law was passed in a very difficult economic moment and at the beginning of a new administration, it was relatively easy to reduce the degree of earmarking.

Table 1. Earmarked revenues in Argentina

<table>
<thead>
<tr>
<th></th>
<th>1988</th>
<th>1990</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. # of Special Budget Accounts (SBAs)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. # of SBAs with revenues from specific taxes</td>
<td>27</td>
<td>23</td>
<td>22</td>
</tr>
<tr>
<td>b. Revenues from specific taxes/Total revenues of the SBAs</td>
<td>78%</td>
<td>78%</td>
<td>87%</td>
</tr>
<tr>
<td>c. Earmarked revenues of the SBAs/Total Revenues of the Federal Government</td>
<td>20%</td>
<td>15%</td>
<td>12%</td>
</tr>
<tr>
<td>II. # of Decentralized Agencies (DAs)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. # of DAs with revenues from specific taxes</td>
<td>15</td>
<td>15</td>
<td>7</td>
</tr>
<tr>
<td>b. Revenues from specific taxes/Total revenues of the DAs</td>
<td>67%</td>
<td>48%</td>
<td>64%</td>
</tr>
<tr>
<td>c. Earmarked revenues of the DAs/Total Revenues of the Federal Government</td>
<td>11%</td>
<td>7%</td>
<td>5%</td>
</tr>
<tr>
<td>III. Earmarked revenues of the SBAs and the DAs/Total revenues of the Federal Government (Ic + IIc)</td>
<td>31%</td>
<td>22%</td>
<td>17%</td>
</tr>
</tbody>
</table>

But in the case of those agencies that were administering some special programs the reform had to wait until the markets were deregulated in 1991 and the following years. Some examples are the SBAs that were administered by the Department of Energy (electricity and natural gas markets were privatized in 1992), or the Boards responsible for the regulation of primary products (sugarcane, yerba mate, grains and beef). It is interesting to note that one of the most important earmarked funds that subsidizes tobacco growers was able to undue the 50% reduction in its revenue that was approved by the 1989 Emergency Law, and is still active. This is a consequence of the very efficient lobby of tobacco growers that has an important representation in the Senate because tobacco is grown in several northern provinces of Argentina.

4 In fact a large fraction of the Federal government debt were the high reserve requirements imposed on the banking system. As most of bank deposits were at 7-day notice, it can be said that “public debt” had to be renewed every 7 days.
Finally, it has to be mentioned that the number of DAs active as of 1997 includes 7 regulatory agencies of the private utilities that came out of the privatization program of the Argentine government. There is a well-grounded literature that concludes about the importance of regulating utilities with bodies that are independent of the Executive, so as to increase the likelihood of a professional resolution of conflicts in sectors that are characterized by huge specific investments which are easier to “expropriate” by the government.

There may be other agencies that need more flexibility than the average public agency. For example, the tax collection agency needs a flexible labor policy for its employees (so as to be able to fire those agents that the managers believe are corrupt but with few proofs to sue them in Court) but this flexibility can be achieved even if it is treated in the budget as any other government program.

V. The Special Case of Transition Economies

Transition economies have generally undergone severe fiscal decline, as the dismantling of the mechanisms of economic control quickly eroded the government's tax base, most notably state-owned enterprise profits. The causes differed somewhat across countries: in the former Soviet Union industrial production collapsed with the Union, as existing supply networks were disrupted and much of the demand for military-industrial products evaporated. In other countries the emergence of market forces realigned prices, usually against industry in favor of raw materials; the entry of nonstate firms realigned prices in favor of raw materials; the entry of nonstate firms eroded monopoly profits in state-owned industry, and conferring autonomy on state-owned enterprises, all reduced financial flows to state coffers. Across-the-board, transformation of the economy severely reduced government's ability to monitor tax effort, leading to dramatic losses in tax collection. Whatever the causes, the outcome was the same—fiscal revenues declined (see Table 1), and fiscal pressures grew enormous as governments were forced to make do with a much reduced share of GNP while meeting new demands of the market economy.

Table 1: Fiscal Decline in countries in transition (in per cent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Pre-reform/Post-reform</th>
<th>Total Revenue</th>
<th>Total Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pre-reform</td>
<td>Post-reform</td>
<td>Pre-reform</td>
</tr>
<tr>
<td>Albania</td>
<td>1989/1993</td>
<td>51.3</td>
<td>28.0</td>
</tr>
<tr>
<td>Armenia</td>
<td>1991/1993</td>
<td>26.0</td>
<td>20.4</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>1991/1993</td>
<td>35.6</td>
<td>38.4</td>
</tr>
<tr>
<td>Belarus</td>
<td>1991/1993</td>
<td>49.1</td>
<td>47.5</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1989/1993</td>
<td>60.0</td>
<td>30.6</td>
</tr>
<tr>
<td>Croatia</td>
<td>1991/1993</td>
<td>34.2</td>
<td>33.8</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1989/1993</td>
<td>62.1</td>
<td>49.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>1991/1993</td>
<td>36.4</td>
<td>32.5</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>1991/1993</td>
<td>36.8</td>
<td>34.3</td>
</tr>
<tr>
<td>Georgia</td>
<td>1991/1993</td>
<td>29.9</td>
<td>12.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>1989/1993</td>
<td>48.5</td>
<td>47.5</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>1989/1993</td>
<td>35.4</td>
<td>22.4</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>1989/1992</td>
<td>38.0</td>
<td>12.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>1991/1993</td>
<td>37.4</td>
<td>33.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1989/1993</td>
<td>50.0</td>
<td>25.1</td>
</tr>
<tr>
<td>Moldova</td>
<td>1993</td>
<td>17.7</td>
<td></td>
</tr>
</tbody>
</table>
Under central planning, allocative decisions by government had been only partially reflected in the budget, while administrative prices and credit plans also played important roles in directing resources to achieve government objectives. Faced with enormous fiscal pressures during the transition, many countries have to varying extents retained some allocative role for these extrabudgetary levers. In China, for example, the government has continued to finance policy expenditures such as investment outlays and social expenditures of state-owned enterprises (SOEs) through the banking sector. During 1985-1995 these quasi-fiscal activities of government were estimated to have averaged more than 8% of GDP (or half as much as in-budget expenditures) (World Bank 1998). For Russia, the EBRD (1994) estimated that in 1992 extrabudgetary operations of the government amounted to 23% of GDP, through “directed” bank credits to state-owned enterprises, off-budget operations of government in investment, military spending, and trade subsidies, etc.

Extrabudgetary Activities at the Subnational level

In this section we will focus especially on the extrabudgetary activities of subnational governments, which have also been subjected to extreme fiscal stress.

One legacy of the Soviet-type fiscal system was that local governments have substantial expenditure responsibilities, most notably the provision of social services – health, education, social services, and public safety (see Table 2). One unusual feature of expenditure assignments in transition economies is local responsibility for safety nets and pension schemes – these create huge financing problems in the economic restructuring during the transition. Another legacy of the Soviet system is that local government had extremely limited taxing authority – even through the transition of a decade or more, central/federal governments have generally clung to their monopoly over taxing powers.

<table>
<thead>
<tr>
<th>Poland</th>
<th>1989/1992</th>
<th>41.4</th>
<th>44.0</th>
<th>48.8</th>
<th>50.7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>1989/1993</td>
<td>51.1</td>
<td>30.9</td>
<td>42.7</td>
<td>31.0</td>
</tr>
<tr>
<td>Russia</td>
<td>1989/1993</td>
<td>41.0</td>
<td>33.8</td>
<td>49.5</td>
<td>41.8</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1989/1993</td>
<td>62.1</td>
<td>48.0</td>
<td>64.5</td>
<td>55.5</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1993</td>
<td></td>
<td>49.8</td>
<td></td>
<td>49.4</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>1989</td>
<td>41.1</td>
<td></td>
<td>38.6</td>
<td></td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>1989/1992</td>
<td>30.1</td>
<td>45.0</td>
<td>32.0</td>
<td>31.0</td>
</tr>
<tr>
<td>Ukraine</td>
<td>1991/1993</td>
<td>38.3</td>
<td>42.3</td>
<td>51.9</td>
<td>55.6</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>1989/1992</td>
<td>35.0</td>
<td>33.5</td>
<td>35.9</td>
<td>46.5</td>
</tr>
<tr>
<td>Mean</td>
<td></td>
<td>41.2</td>
<td>33.9</td>
<td>43.0</td>
<td>42.9</td>
</tr>
</tbody>
</table>

Source: EBRD 1994

Table 2. Subnational Shares of Revenues and Expenditures in Selected Countries (% of Total)

<table>
<thead>
<tr>
<th>Federal countries</th>
<th>Year</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>1995</td>
<td>41</td>
</tr>
<tr>
<td>Canada</td>
<td>1993</td>
<td>58.3</td>
</tr>
</tbody>
</table>
The shared features of local public finance in transition economies, from China to Russia, Hungary, Poland, Albania, Bulgaria, Romania, and Ukraine, include the following:

- Fiscal pressures led to increasing decentralization of expenditures
- Subnational governments are responsible for providing significant expenditures, including social safety nets (pensions, unemployment insurance, disability, minimum income support, etc.) and capital investment -- even in strategic sectors such as highways and airports, especially the need to replace or refurbish obsolete and poorly maintained infrastructure.
- They have also borne the uncompensated transfers of social expenditures from SOEs -- housing, child care, medical care and sometimes education.
- They have few taxing powers
- They have ownership over substantial assets such as land, enterprises, and sometimes natural resources

Subnational governments have generally responded to fiscal pressures by

- accumulating arrears -- tax arrears, wage arrears, debt to suppliers (esp. to utilities)
- borrowing (usually illegally, from SOEs, pension funds, unemployment insurance funds, banks)
- failing to provide social services
- requiring local enterprises to finance public expenditures -- passing on fiscal burdens to the enterprise sector, and often, via enterprises to the banking sector; and
- developing extrabudgetary revenues
The primary motivation for the development of extrabudgetary revenues in transition economies, therefore, is revenue enhancement, rather than earmarking. In some countries extrabudgetary resources have become an important source of supplementary finance at the subnational levels.

EBF come from three sources:
1. Increasing user charges for government provided goods and services – housing, medical care, education, water, etc.
2. Administrative fees for government services such as passports, driver’s licenses, hawker’s licenses, etc.
3. Incomes from state assets

Charging for services provided by government was largely symbolic under the planned economy, which emphasized free provision of basic goods and services – housing, admission to parks, medical care, education, etc. Cost-recovery was rarely applied. Even for housing, for example, rents were nominal and usually did not even cover maintenance costs. In the transition period, user charges have increased significantly, but they still comprise low proportions of subnational budgets compared to other countries. Indeed, even though subnational governments are straining to find revenue enhancements, they are often constrained by national laws and price regulation on how much they can charge for publicly provided services such as water and garbage removal.

Administrative fees have proliferated, as governments look for revenues to augment low civil service salaries or inadequate recurrent budgets for government offices. In most Chinese cities “penalties and fines” comprise 10% or more of total budgetary revenues.

The growing need to earn income from state assets has increased the potential for abuse of locally owned state assets, giving rise to the pervasive phenomena of “entrepreneurial” local governments:
- Creation of privately owned, unregulated local monopolies
- Dissipation of scarce managerial skills on trying to squeeze money out of state assets
- Creation of money-making venture that fail (with high probability -- considering that in market economies only 1 in 5 small businesses survive the first 3 years of existence): tourist hotels, restaurants, golf courses, real estate development, etc.

Box 4. Entrepreneurial Activities Of Government In Shanghai
Since the 1980s China's largest city has enjoyed substantial autonomy in developing its own sources of funding off budget, through a variety of fees and levies. One major source is the infrastructure and hook-up fee levied on residential housing construction, tapping into the construction boom. Altogether the city collects some 25 fees from housing construction that paid for half of all appropriations for urban services and investment during 1995-1997. In addition, the city has set up a number of directly owned corporations that bundle together earmarked tax revenues, borrowed funds, user charges, etc., to finance services and further investment in infrastructure. To enhance the municipal government's capacity to service these infrastructural loans, it was given special permission to bundle together profit-making projects with public works.

The Shanghai Jiushi Company (SJC) was created in 1986 and has since then built two large-scale bridges on the Huangpu River, a new subway system, expansion of the airport, a pollution treatment plant for the Huangpu River, and the expansion of the telephone system. Owned by the Shanghai Municipal Planning Commission, the SJC is an independent economic entity with legal person status. It is a limited liability company. Its sources of funds include concessionary loans from foreign governments, the World Bank, the Asian Development Bank; overseas bond issues, and commercial loans from domestic and foreign banks. Aside from infrastructural projects, the SJC has also invested in hotels (with a total of 5700 rooms), and industrial projects such as a plant for refrigerator compressors, cathode-ray tubes, the Shanghai Phillips Semi-Conductor Company, and the Yichang Steelrolling Plant. Through 1990, it had invested a total of $904 million, with 213 projects completed and in operation.

Another key corporation in managing city funds is the General Corporation of Shanghai Municipal Property Development (SMPD), which was set up in 1992 under the Municipal Construction Commission. It pools financing from budgetary allocations for urban construction, revenues from the urban construction and maintenance tax, fees and charges on public facilities, some rental incomes on city-owned property, and other earmarked incomes such as 30% of the tax-exempt incomes of development companies. The SMPD also has the power to borrow and invest in profit-making ventures including real estate development. In recent years the SMPD has issued 500 million yuan of urban construction bonds. In 1997, the municipality transferred ownership of its infrastructural properties to bring the SMPD's equity capital to 80 billion yuan.

The adverse effects of EBFs include:

• weaker macroeconomic management, by barring a comprehensive assessment of all expenditures and revenue, and hindering expenditure control. This in turn impairs the ability of the fiscal and monetary authorities to act consistently and incisively to ensure macroeconomic stability.
• increased rigidity of resource allocation, which affects policymakers' ability to fund strategic priorities
• lower efficiency of service delivery, as they encourage overspending in those areas where (earmarked) revenue is plenty. Also, the lack of a comprehensive budgetary framework for EBFs can lead to the duplication of expenditure or taxes.
• looser financial control, as the lack of standardized accounting and reporting rules, and the complexity of transactions between the extrabudgetary funds and the budgetary funds makes financial management non-transparent.

5 This is a 7 % surcharge on turnover taxes -- the VAT, business and consumption taxes
• Inefficient cash management, because idle balances are held in many separate accounts, thereby increasing the borrowing requirement of the government, and its interest payments. EBFs share with earmarked funds the property of increasing the rigidity of public resources allocation, and making it difficult to use the budget to implement strategic policy choices.

• Diverts scarce managerial skills from government to business activities
REFERENCES


TOWARDS A MORE COMPREHENSIVE BUDGET

The rapidly growing extra-budgetary and off budget funds—now almost 40 percent of government resources—undermine fiscal discipline, hamper funding of the government's priorities, and give rise to wasteful spending. However, these funds have also served well to finance local initiatives outside the rigid planning system. China needs to better integrate extra-budgetary funds into budgetary management, but should carefully balance the incentives for revenue mobilization, service delivery, and expenditure control.

Extra-budgetary funds

China's extra-budgetary funds (EBF) comprise surtaxes, levies and user charges accruing to government and administrative units. They were originally created in the 1950s to set aside small amounts of funds for the discretionary use of local governments, administrative agencies and enterprises. Examples of these early EBFs are the surcharges on the agricultural tax and the Industrial and Commercial Tax that was used to finance urban maintenance and construction. Rental incomes from public housing, users' fees, surcharges for public utilities were also counted as EBF. All EBFs were earmarked for specific uses, and were set aside from the budgetary process under decentralized management and allocation by different agencies and organizations.

During the 1980s EBF grew rapidly with decentralizing reforms of the economy. Official statistics show that they grew from 2.6 percent of GDP in 1978 to over 4 percent of GDP in 1995. A 1996 audit found that EBF totaled more than Y380 billion, or more than 6 percent of GDP, and far exceeding the officially reported amount. There are some 905 types of EBFs, collected through thousands of funds and fees at all levels of government. The 1996 audit discovered some 2500 fees that were levied without authorization (Box A-1.1).

Local governments rely to a much larger extent on EBFs than central government. Local governments, which lack tax autonomy, have used EBFs as de facto taxing mechanisms, a practice tolerated and even condoned by the central authorities.

Although Government considers extra-budgetary

Box A-1.1: "Would you like that with fees?"

McDonald's Restaurants in Beijing pay 31 fees on average, of which only 14 are legal, all this beyond the normal taxes due. With those fees, McDonald's supports not only the normal Beijing Municipal services, but also air shelter repairs, river cleaning, public festival decoration and communist party propaganda. The restaurant also pays for not having security guards—which is still cheaper than having one.

The illegal fees and fines and various apportioned charges that the many central, municipal, county, and township authorities impose on enterprises and individuals increasingly affect normal business operation, so much so that it is now seen as a deterrent for foreign investors. This has prodded the State Council to issue a circular on July 7, 1997: "On Abolishing Illegal Fees and Fines and Various Apportioned Charges for Enterprises." The circular orders that any illegal charges, fines, fund collections, foundation projects and other apportioned charges to the enterprises must be abolished.

Abolishing the fees is easier said than done, however, as repeatedly failed attempts to limit the taxing of farmers have shown. The key reason for failure to resolve the illegal fees is that, notwithstanding some excesses, many of the illegal fees pay for useful services, or pay the wages for civil servants that cannot be fired.

funds to be fiscal resources, they are managed separate from budgetary funds:

- The funds are allocated outside the budget process. Extra-budgetary allocation takes place when they become available.
- The funds are reported outside the budgetary reporting system. Reports on extra-budgetary funds are infrequent; and final accounts are only available more than a year after the budget year closes.
- The funds are managed through bank accounts separate from budgetary funds,
- The funds have a separate accounting system and accounting classification.

**Other off-budget funds.** Besides EBFs, China has numerous other off-budget funds. Most of these are not considered fiscal funds, and not included in the fiscal accounts, and some are not reported at all. Off-budget funds include:

- **Self-raised Funds.** Local governments and Nonprofit organizations (NPOs) manage "self raised funds," comprising TVE profits and remittances, management fees collected by NPOs, rental income from collective assets, and the "unified levy" (tongchou) collected from farm households for financing rural education, militia training, road building, family planning and social welfare. In 1993-1994 SRF amounted to about 20 percent of total revenues accruing to township level governments. Other self-raised funds include (illegal) local government bonds, “contributions” and outright borrowing from banks. Revenues from some state asset sales such as land leases have also been kept off budget.⁴

- **Social Security Funds.** China's social security funds are administered off-budget at local level. Provincial pooling of pension and unemployment funds has started, but most funds are administered at municipal level. At present, these funds runs slight surplus, but at current levels of benefit, the pension funds are seriously underfunded. Unemployment funds are also likely to run deficits, once SOE reforms will accelerate, and hidden unemployment becomes visible. Social security funds are reported in official statistics, but are not considered fiscal in China.

- **Tax Expenditures.** Even less visible are China’s numerous tax expenditures. A variety of industries receive tax exemption or tax reduction, in particular high tech industries, foreign invested enterprises, and enterprises in special economic zones. These deviations from normal tax policy have effects similar to expenditures: granting tax exemptions for, say, technology, means that less money can be spent for education. In the same vain, too much tax expenditures undermine the revenue base, and may cause budget deficits. Some estimate the total amount of tax expenditures to be Y100-150 billion in 1995.⁵ Others have estimated that in 1994 tax reductions and exemptions to foreigners added to over 1 percent of GDP.⁶

- **Arrears:** Finally, regular reports on arrears appear in Chinese newspapers: teachers go without pay, and grain bureaus do not pay farmers for their grain. China’s cash-based system does not capture these arrears, which make the budget deficit on an accrual basis larger than that on a cash basis.

**An international perspective on extra-budgetary funds**

Practically all OECD countries, developing countries, and in particular countries in transition have EBFs (Table A-1.1). Some of these funds bear similarities to China’s extra-budgetary funds, but there are fundamental differences. OECD “extra-budgetary transactions” comprise all government transactions that operate outside the normal budgetary procedure. This exclusion can be at the funding stage (if budgetary revenues are set aside for a designated expenditure), at the budgeting stage (if financing is not fully determined by budget deliberations), or at the funds management stage (if extra-budgetary funds are organized as accounting entities with own accounts).

Unlike in China, OECD extra-budgetary funds need not be funded by earmarked or extra-budgetary revenues, but can be funded from budgetary appropriations. Earmarking within the budgetary framework is commonly done through special accounts, which pool the revenue from one or more sources and are accessible only for
<table>
<thead>
<tr>
<th>Types of Extra-budgetary resources.</th>
<th>USA</th>
<th>Russia</th>
<th>Germany</th>
<th>New Zealand</th>
<th>France</th>
<th>South Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two federal fiscal trusts funds:</td>
<td>Two federal fiscal trusts funds:</td>
<td>5 social funds.</td>
<td>Social security fund.</td>
<td>Unappropriated expenditures.</td>
<td>Social security fund.</td>
<td>Around 30 extra-budgetary funds</td>
</tr>
<tr>
<td>1) Old age and Survivors fund</td>
<td>1) Old age and Survivors fund</td>
<td>Technological development fund.</td>
<td>Permanent appropriations for public debt and constitutional organizations.</td>
<td>Permanent appropriations for public debt and constitutional organizations.</td>
<td>&quot;Special Budgetary Funds&quot; (e.g. Grain Management fund, abolished 1994)</td>
<td></td>
</tr>
<tr>
<td>2) Disability fund</td>
<td>2) Disability fund</td>
<td>50 industrial funds (R&amp;D, Investment, and Economic Distress funds)</td>
<td>Directed state Implicit tax and credit subsidies.</td>
<td></td>
<td>Credit subsidies.</td>
<td></td>
</tr>
<tr>
<td>Revenue source</td>
<td>Employers and employees contributions (payroll taxes)</td>
<td>Social fund: employers and employees contributions. Industrial funds: percentage of production costs or of sales.</td>
<td>Social security financed through employers and employees contributions and through budget transfers.</td>
<td>General revenue.</td>
<td>Social security financed through employers and employees contributions and through budget transfers</td>
<td>Special funds financed by earmarked taxes, and transfer from budget special accounts.</td>
</tr>
<tr>
<td>Rules of EBF</td>
<td>By law</td>
<td>Extra-budgetary funds: by law or decree.</td>
<td>Unappropriated expenditures authorized by the MOF only under unforeseen and compelling circumstances, and either below DM10m or if is a legal obligation.</td>
<td>Permanent appropriations: by law.</td>
<td>Unappropriated expenditures: maximum 1% of ministerial appropriation with authorization of MOF</td>
<td>Established by law, with time limit, under the authority of a line ministry.</td>
</tr>
<tr>
<td>Constitution</td>
<td></td>
<td>Cost recovery: decision of the levying office.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budgeting (organ, integration with main budget)</td>
<td>The off-budget funds are included in the budget presentation. unified totals are shown for expenditure, revenue, and deficit.</td>
<td>EBFs not included in budget document. Line ministries make budget of EBFs. Heads of agency decide on level of cost recovery public service.</td>
<td>Social funds prepare their own budgets. The budget includes only the flows to and from the social funds and the budget.</td>
<td>Completely integrated with budget.</td>
<td>Social security prepare its own budget which is discussed during the budget session. The parliament can impose an annual spending limit. Unified total are presented as an annex to the budget document.</td>
<td>Budgeting done by line ministry, and approved by the president.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Unified budget totals are presented with the budget document.</td>
</tr>
<tr>
<td>Treasury</td>
<td>Social security</td>
<td>Industrial funds:</td>
<td>Social security has its permanent</td>
<td>Funds kept in a</td>
<td>Fund kept in separate</td>
<td></td>
</tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Table A-1.1: International comparison of extrabudgetary funds**
<table>
<thead>
<tr>
<th></th>
<th>USA</th>
<th>Russia</th>
<th>Germany</th>
<th>New Zealand</th>
<th>France</th>
<th>South Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>management</td>
<td>funds manage their own accounts, but within the Treasury system. Treasury borrows at market rate from them.</td>
<td>revenue should be paid to line ministries who distribute it. In practice, large portions are kept by enterprises and spent or kept in bank accounts.</td>
<td>own accounts.</td>
<td>appropriation: same as for normal budget items.</td>
<td>separate treasury account, managed by an autonomous agency (URSAF)</td>
<td>bank account under authority of line ministries. Treasury can borrow from surplus funds, after negotiating with the line ministry.</td>
</tr>
<tr>
<td>Transactions with budget funds</td>
<td>Only limited financing from general revenue, for unfunded entitlements.</td>
<td>EB funds keeps their surplus, although, for industrial funds, part of surplus is kept by enterprises belonging to the fund.</td>
<td>Budget transfers finance social security.</td>
<td>Not applicable</td>
<td>Budget finances deficit of social security</td>
<td>EB funds keep surplus or lend it to treasury; get budget funding or budget loan for deficit.</td>
</tr>
<tr>
<td>Accounting &amp; consolidation with budget accounts</td>
<td>No full consolidation with budget accounts.</td>
<td>No full consolidation possible with budget accounts.</td>
<td>No full consolidation with budget accounts.</td>
<td>Accounting: same as for budget. Full consolidation</td>
<td>Separate accounting. No full consolidation of social security accounts with budget accounts</td>
<td>EB Funds use commercial accounting system. No consolidation.</td>
</tr>
<tr>
<td>Reporting and Monitoring</td>
<td>No reporting to Treasury.</td>
<td>No reporting to Treasury.</td>
<td>Same as budgetary items.</td>
<td>No regular reporting to treasury.</td>
<td>No regular reporting to treasury. Subject to the same external auditing practices.</td>
<td>20</td>
</tr>
</tbody>
</table>
specified expenditures. These revenues and expenditures are subject to the normal budgeting procedure at the execution stage. The difference is their privileged access to the special accounts. Such earmarked funds protect funding within the budgetary allocation, but they do not protect the activity against revisions of the budgetary allocation from year to year. Annex 13 provides an illustrative example of earmarked funding of highway construction in the U.S.A.

Many OECD countries exclude some self raised funds of agencies largely dependent on the budget from the budget allocation process, and even from budgetary funds management. Examples are the Statutory Bodies in Australia, Crown Agencies in New Zealand, the rechtsfaehige Anstalten in Germany, and the Etablissement Publics such as museums in France. These public agencies are established under separate laws, and have budgeting and financial management rules separate from the budget law. Often, they have government representatives on their board. The budget only shows the subsidies to those organizations. Such organizations are not unlike SOEs, which are usually also treated on a net basis.

The Russian practice with many industry-specific EBFs comes closest to the Chinese situation, showing the common roots of the budget system. The Korean extra-budgetary funds are also similar to the Chinese ones. In both Russia and Korea, however, the number of extra-budgetary funds is far smaller than the 900 types of funds in China.

Minimizing disadvantages of EBFs

Extra-budgetary funds can have advantages for certain type of expenditures (Box A-1.2). However, often disadvantages dominate. Practices which tend to minimize the negative effects of EBAs include:

- EBAs should be constituted by law, and respond to well-identified criteria, so as to avoid the unnecessary multiplication of EBAs. In France and in the United States, among others, extra-budgetary funds must be instituted by law, whereas in Russia they can be established by

<table>
<thead>
<tr>
<th>Box A-1.2: Pros and cons of Extra-budgetary funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBAs are mainly used for activities which are to a large extent self-financing but which are not suitable for commercial provision, or whose provision the Government wishes to guarantee. The purpose of extra-budgetary accounts is to protect some activities from regular budgetary reviews of financial allocations, to ensure the resilience of funding over time. The question is why certain expenditures should escape the screening and weighing process of the budget. Extra-budgetary funds can be useful for:</td>
</tr>
<tr>
<td>• financing certain activities for which the public pays a price and expects a service in return. The budgetary decision process would delink price and service, by determining the price and the funding for the service independently. In this case, extra-budgetary finance is a specific form of earmarking. Social security or road maintenance are examples of such services. However, individual goods, such as electricity or water, are usually not financed through EBAs because they can best be supplied by profit-motivated enterprises.</td>
</tr>
<tr>
<td>• showing government commitments to a long-term moral or legal obligation, such as war veteran pensions, or the reimbursement of public debt. This gives rise to permanent appropriations which cannot be modified during the budget process, but require a different legislative process and sometimes constitutional amendments.</td>
</tr>
<tr>
<td>• responding quickly to expenditure needs arising from unforeseen events. Unforeseen events should be distinguished from risky activities such as government guarantees. The budget should account for the risks it assumes as a contingent liability, and budget for contingent expenditures.</td>
</tr>
<tr>
<td>The adverse effects of EBAs include:</td>
</tr>
<tr>
<td>• weaker macroeconomic management, by barring a comprehensive assessment of all expenditures and revenue, and hindering expenditure control. This in turn impairs the ability of the fiscal and monetary authorities to act consistently and incisively to ensure macroeconomic stability.</td>
</tr>
<tr>
<td>• increased rigidity of resource allocation, which affects policymakers' ability to fund strategic priorities</td>
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<tr>
<td>• lower efficiency of service delivery, as they encourage overspending in those areas where (earmarked) revenue is plenty. Also, the lack of a comprehensive budgetary framework for EBAs can lead to the duplication of expenditure or taxes.</td>
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<tr>
<td>• looser financial control, as the lack of standardized accounting and reporting rules, and the complexity of transactions between the extra-budgetary funds and the budgetary funds makes financial management intransparent.</td>
</tr>
<tr>
<td>• inefficient cash management, because idle balances are held in many separate accounts, thereby increasing the borrowing requirement of the government, and its interest payments. EBAs share with earmarked funds the property of increasing the rigidity of public resources allocation, and making it difficult to use the budget to implement strategic policy choices.</td>
</tr>
</tbody>
</table>
decree. In Germany and New Zealand, non-appropriated expenditures may be incurred only under exceptional events, and for limited amounts.

- The extra-budgetary resources should be kept under the authority of the Treasury, possibly with some special procedures to guarantee the priority of funding. This facilitates cash management, while assuring the regularity of funding for the extra-budgetary activities.

- Accounting should allow easy consolidation of EBAs with the budget accounts, and the central budgeting agency should have unrestricted and automatic access to the extra-budgetary accounts. If this is not feasible, at the minimum EBAs totals should be added to the budget totals to provide an unified measure of public fiscal activity.

- Reporting and auditing requirement should be identical to those of the budget accounts. For example, non-appropriated expenditures are fully reported in the New Zealand Government financial statements.

Reforming China’s Extra-budgetary funds

China’s public expenditure management is severely weakened by the large and growing amount of EBF and other off-budget financing. The large amount of extra-budgetary funds fragments government resources; threatens aggregate fiscal discipline, and reduces incentives for agencies to operate cost-effectively.

State Council Document No. 29 (Annex) is an important first step towards a more comprehensive budget. The main changes under Document no. 29 are:

- It extends budgetary management to thirteen funds that had been treated as “below the line” items in the budget. These amount to a total of ¥115 billion, out of a total of ¥380 billion.

- It increases MOF supervision of the allocation and disbursement of funds.

- It shifts ownership of revenues collected under EBF from the collecting unit to MOF and local finance departments. The comprehensive department is put in charge of managing these funds.

- It announces the intent to convert some “fees” to “taxes.”

- It clarifies and sharply limits the authority for setting fees and levies, stipulating that only the central government can set up “funds”, and only central government and provincial governments can levy fees.

- It eliminates the category of “self-raised funds” at the township level and below and folds the funds into EBF, while extending coverage of EBF to include other nonbudgetary revenues collected by township governments including various voluntary contributions, revenues from fiscal loan repayments, and interest from fiscal bank accounts.

With these changes, China has taken a decisive step towards consolidating budgetary management, gaining control over the aggregate spending level, and curbing the proliferation of funds and fees. In further integrating extra-budgetary funds, however, the authorities face a delicate trade-off between incentives for service delivery and revenue mobilization by the spending units, and improved treasury management and expenditure control. Ignoring these trade-offs may result in a rapid recurrence of off-budget funds, as happened in the past. Notably, extra-budgetary funds play an important role in funding local government. Abolishing them, or reducing incentives to collect them by exercising too much central control may leave important services unfunded, or may force local governments to invent new levies and fees. Finally, many EBFs finance investments controlled by SPC, or finance the recurrent costs for maintaining and operating past investments. If extra-budgetary funds are integrated in the budget, the coordination between planning and budget would have to be significantly strengthened.
For these reasons, reintegrating EBFs with the budget must be a gradual process with several difficult policy choices to make. In line with State Council Document No 29, and building on the 1996 audit of extra-budgetary funds, the authorities would need to review all of the 600-700 types of legal fees, levies, charges, and surcharges and decide whether to continue them as extra-budgetary funds. Some of these funds, starting with the illegal ones, will be abolished. EBFs that are truly taxes, should be fully integrated in budgetary management, and treated as general revenues. Others, such as surcharges for specific goals, could remain outside the budgetary allocation process as earmarked funds, but would be fully integrated in collection, treasury management, reporting and audit. And finally, some user charges may be excluded from budgetary management altogether, and be used for funding commercialized NPOs.

In the short run, Government could focus on improved reporting and funds management of EBFs. Over time, emphasis should shift to consolidating the number of extra-budgetary funds, and to simplify collection. Finally, the hard question whether Government has a role in the activities financed by EBFs should be tackled.

**Improve funds management and reporting**

- **Improving reporting** A first step to improve reporting could be to allow the collecting spending unit to retain the funds, but to require them to present sources and uses of extra-budgetary funds together with the budget proposals and budget reports, even if the NPC only allocates budgetary funds. During budget implementation, budget units should be required to report on extra-budgetary funds as frequently as budgetary funds. Over time, the reporting system, and the accounting and classification of budgetary and extra-budgetary funds could be unified.

- **Consolidate bank accounts and treasury management.** The supervision of remaining extra-budgetary funds could be further improved by integrating the budgetary and extra-budgetary bank accounts of budget units. This would have to fit into a more general overhaul of treasury management and accounting practices in China, but already there seems to be few reasons for keeping separate budgetary and extra-budgetary bank accounts for expenditures, and for keeping separate disbursement processes. Even if Government decides to maintain extra-budgetary funds,

**Consolidate funds**

- **Review taxes, levies, fees.** Many fees raised in China are truly taxes, and should be treated as such. Examples of this type include surcharges for rural education levied on urban building construction, and the education surcharge on the VAT and other turnover taxes. Revenues from user charges should remain with the collecting unit for financing the services for which they are levied. Revenues from taxes should go into general government revenues and used to finance the broad range of government services:

- **Consolidate remaining funds.** Consolidating the fees and funds into fewer items and categories should help simplify the payment structure and reduce the costs of collection and administration. Some of the surcharges on taxes could be integrated in the tax rate, others that have outlived their use could be abolished and replaced by the increasing general revenues. Reducing the number of collection units would reduce the taxpayers’ burden of dealing with a multitude of collectors, and would reduce collection. For example, the collection costs for the township unified levy, collected from farm households, absorb as much as 25 percent of revenues collected. Local tax bureaus can act as agents in the collection of most fees and charges at much reduced costs.
**Reconsider the role of Government**

- **Reconsider role of Government:** In reviewing the EBFs, government would need to decide which tasks financed by EBFs are worth continuing, and worth continuing as government tasks. Divest the activities that are no longer considered government activities, either to the private sector, or to commercialized SOEs (see also Chapter 5).

- **Reconsider government organizations.** The review of extra-budgetary funds need to go hand in hand with a review of organizations within government. NPOs that are fully or largely funded by user charges might be better off as more independent units, or even enterprises. In some cases, this may require increases in user charges to cover long term costs. Even some organizations that still depend on significant budgetary contributions could be better managed outside the budgetary framework. The “Regulation on Financial Management for Non-Profit Making Entities” of 1989 would need extension and revision to define a framework for such independent NPOs, including budgeting and financial reporting rules. Until such a revision has taken place, Government could consider treating NPOs as autonomous budgetary agencies governed by a contract that specifies revenue retention arrangement and expected performance.

- **Reconsider intergovernmental fiscal relations.** Because EBFs have become a major source of local finance, integrating them in the budget is likely to require adjustments in intergovernmental fiscal relations. If extra-budgetary levies are consolidated with the tax

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**Box A-1.3: Japan's Budget: General and Special Accounts**

The Japanese budget system might be a useful halfway house for some of the extra-budgetary funds Government decides to integrate further into the budget allocation process. The Japanese budget separates the general accounts from 38 special accounts, grouped into 8 groups (Table)

<table>
<thead>
<tr>
<th>Type</th>
<th>Number</th>
<th>Explanation</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>The enterprise special account</td>
<td>5</td>
<td>To manage specific government administered enterprises</td>
<td>Mint Bureau, Printing Bureau, Postal Service</td>
</tr>
<tr>
<td>The insurance special account</td>
<td>11</td>
<td>(a) Special insurance, reinsurance, and social insurance that the private sector does not provide (b) insurance comparable to private insurance</td>
<td>(a) welfare insurance, National insurance, labor insurance; (b) Postal life insurance, forest insurance</td>
</tr>
<tr>
<td>Special account for public investment</td>
<td>5</td>
<td>for certain public works</td>
<td>Port improvements, road improvements, flood control</td>
</tr>
<tr>
<td>Special account for administrative business</td>
<td>9</td>
<td>to manage administrative business, except insurance and public works</td>
<td>national schools, hospitals</td>
</tr>
<tr>
<td>Special accounts for loans</td>
<td>2</td>
<td>to manage the loan program to public corporations for specific purposes</td>
<td>industrial investment, Urban development loan</td>
</tr>
<tr>
<td>Special account for fund management</td>
<td>2</td>
<td>to manage public funds established for specific purposes</td>
<td>Trust fund bureau fund; foreign exchange fund</td>
</tr>
<tr>
<td>The consolidated fund special account</td>
<td>4</td>
<td>to consolidate and account for revenues and expenditures for specific purposes</td>
<td>National debt consolidation fund; local allocation and transfer tax</td>
</tr>
</tbody>
</table>

The special accounts are established by legislation under specified conditions. These may be instituted when Government carries out specific projects, manages specific funds, or when it deems it necessary to administer some revenues and expenditures from the general budget. The special accounts are financed by transfers from the general account, user charges, insurance premiums, and loans from the fiscal investment and loan program, which captures the postal savings and some social insurance funds. Both the general account and the special account are reviewed and approved by Parliament as part of the normal budget process.

*Source: MOF Japan*
structure, a reassignment of tax revenues may become necessary. Alternatively, higher levels of government could consider earmarked grants for the activities previously financed with extra-budgetary funds.

- **Unify budgeting procedures.** Over time, for those extra-budgetary funds that are truly government funds, budget procedures for budgetary and extra-budgetary funds should be merged. Ministries and budgetary agencies would have to include the sources and uses of extra-budgetary funds in a single budget proposal. MOF’s organization would have to adapt to the unified budgeting procedures. The Budget Law already allows for such an integrated budget. A first step in that direction would be to unify the accounting system for budgetary and extra-budgetary funds.

**A Halfway House?**

For some of the extra-budgetary funds Government decides to integrate further into the budget allocation process, the Japanese budget system might be a useful halfway house (Box A-1.3). The Japanese budget separates the general accounts from 38 special accounts. The special accounts are financed by general revenues, earmarked taxes, and user charges, and are earmarked for certain uses. They are approved by parliament as part of the normal budget process, and managed throughout the treasury accounts at the Bank of Japan. However, the Japanese system maintains some of the disadvantages of the current situation in that significant parts of the budget are earmarked, and the system can therefore only be transitional.

**How to treat other off-budget funds**

*Social Security Funds.* Social security funds lend themselves less for full integration in the budgetary framework. However, reporting on these funds could be greatly improved. In most countries, public social security funds are reported together with the budget, and China should aim for the same. Together with improved reports on extrabudgetary funds, this would establish a comprehensive reporting on General Government (Figure A-1.1).
Contingent liabilities. Because contingent liabilities could greatly affect China’s budget at some future date, regular review of the size of these liabilities is a priority. In OECD countries, reporting on these liabilities is far from comprehensive. New Zealand has the fullest treatment of “fiscal risks,” including contingent liabilities—claims against the government which will arise if a specific event occurs—and any event which if it occurred, would affect the revenues or expenditures of the State. Most OECD countries report on loan guarantees given, either by simply listing them, or, as in Germany, by budgeting for the likely default on the loans guaranteed.

To start reporting on contingent liabilities of the budget, the authorities could first make an inventory of possible liabilities may accrue to the budget. Undoubtedly, those in the banking sector and in social security will constitute the bulk of it, but there may be more. China’s policymakers would then have to decide for which liabilities they would have to or want to take on responsibilities. For those, the authorities would need to design reporting formats and reporting requirements.

Because of the prominence of State Enterprises, and the importance of the public sector deficit for the fiscal stance of Government, MOF could consider focusing fiscal discipline on the public sector deficit in addition to the budget deficit—as countries like the UK, France, and New Zealand. MOF has data on the public sector deficit readily available, because SOEs already

\[
\text{Central Government} + \text{Local Governments} = \text{Government} \\
\text{Social Security and Extrabudgetary funds} = \text{General Government} \\
\text{Nonfinancial State Enterprises} = \text{Nonfinancial Public Sector} \\
\text{State Banks} = \text{Public Sector}
\]
regularly report their financial accounts to MOF. However, Fiscal reports on the public sector are usually restricted to the public sector deficit. Reports on the complete accounts of the public sector are usually compiled by statistical bureaus, together with the national accounts.

Tax Expenditures. The sheer size of China's tax expenditures and their similarity to expenditures necessitates a fuller reporting over these funds. Many OECD countries include reports on tax expenditures with the budget (e.g. the USA and New Zealand), or regularly present reports to Parliament (e.g. Germany's bi-annual Subventionsbericht). For China, if not the NPC, at least the policy makers should be made aware of the resources foregone in giving tax reductions. They can then regularly decide whether the tax expenditures still match their strategic priorities. Over time, the Authorities should not only consider whether the tax expenditures still support their priorities, but also whether the instrument of tax expenditure is still appropriate for achieving the objectives, or whether others such as subsidies may be more appropriate.

Endnotes
1. Until 1993, EBF included enterprise funds — retained profits, depreciation, technical renovation and welfare funds, which were at their peak as much as 80 percent of the total EBFs. The current definition of EBF includes only “fiscal” EBF — those accruing to governments and NPOs
2. The audit was conducted by MOF, SPC, the State General Audit Agency, PBC and the Ministry of Supervision. See China Securities January 29, 1997.
3. For example at the township level off-budgetary resources are explicitly recognized for financing government — since their founding in 1986, township finance bureaus have been required to report receipts and expenditures of “three types of funds”: budgetary, extra-budgetary, and self-raised funds. A State Council decree in 1991 explicitly permitted township governments to impose a fee on TVEs to finance agricultural subsidies, called the “using industry to aid agriculture” fee.
4. The State Land Bureau estimates that over the past few years revenues from sales of land leases have totaled more than 25 billion Yuan nationwide, only a fraction of which were reported as fiscal revenues.
5. Source: mission interviews It is not clear whether the 1996 audit captured these revenues.
6. IMF, Article IV consultations, annex to the report on Recent Economic Developments. The most important one is the exemption from import duties on import of capital goods by foreign funded enterprises. This exemption was abolished in 1996, with firms grandfathered until end-1997. However, China has announced to reinstate the exemption in 1998.
7. In the United States, the budget includes several earmarked funds, which are denominated “trust funds”.
8. Underpinning the New Zealand approach has been a shift to a full accruals approach to budgeting.
Decentralization is a sine qua non of market reform and liberalization, to provide a stronger link between effort and reward, and to allow economic agents more flexibility in responding to market changes. However, decentralization is fraught with difficulty in the fiscal sector because the revenue producing mechanism was such an integral part of the system of centralized planning and resource allocation that decentralization of the economy leads to jarring disruptions in revenue flows. As a result, market reforms are typically associated with significant fiscal declines, and the falling GDP share of the budget makes governments even more reluctant to decentralize, for fear of a further slippage in government revenues. Paradoxically, decentralization of the fiscal system is inevitable because market reforms quickly erode the government’s ability to monitor tax effort, making the highly redistributive system of revenue sharing unsustainable.

In China, the government pursued a cautious and incremental approach to fiscal reform during 1979-1993, a period during which the budget fell from about 35% of GDP to less than 15%. Amidst fiscal pressures, a number of ad hoc changes occurred that have had an adverse effect on equity and efficiency of the fiscal system. The allocative distortions that resulted from the multi-tiered turnover taxes inherited from the Soviet type fiscal system were discussed in Wong (1985, 1987, 1991, and 1992). In a recently completed study conducted for the Asian Development Bank, Wong (1996) found substantial evidence pointing to a deterioration in the distribution of fiscal resources and service provision across regions.

This paper focuses on the rapid growth of off budget funds (OBF) in China as the emergence of a dual-track system of government finance, where an informal system of quasi-taxes and levies has been permitted to grow in response to local fiscal needs. Off budget funds consist of “extrabudgetary” funds, “self raised” funds and other nonbudgetary revenues of local governments and administrative agencies. These comprise users’ fees, tax surcharges, bond issues, incomes from sales of state assets, and a variety of local levies. By the mid-1990s, this off budget system, in aggregate national statistics, has grown to account for more than one-third of total resources available to government. In many localities it dwarfs the budget in size. While the increasing reliance on users’ fees and other nontax sources of finance is common to all transition economies as they go through the process of decentralization and devolution, in China these OBF have evolved further and account for a larger share of government spending. Moreover, many of the local levies are negotiated between the enterprises and local officials; as such, they help to perpetuate some softness in tax obligations in the Chinese fiscal system.

While the topic of off budget finance is not new, this paper is the first systematic attempt at tracing the growth of off budget funds in China in the reform period, explaining their role and significance in the economy, and assessing their impact on equity and efficiency in the overall system of public finance. Section I starts with some stylized facts about the strategy of gradualist reform in China and its impact on the fiscal system. Section II discusses the nature and significance of OBF. Section III examines some implications of OBF, and Section IV concludes by highlighting the problems of this dualistic fiscal system.

6 cite Wong and Zahid...

7 This paper draws from Wong 1996 unless otherwise noted.
I. The Gradualist Reform Strategy and Fiscal Status

Since the early 1990s the Chinese experience of successfully transforming its planned economy into one that is increasingly directed by market forces has finally gained recognition in the heated debate between "big bang" and gradualism. Among all transition economies, China has had the longest running and most successful experience with economic liberalization to date. Through a process of step-by-step, incremental reduction of state control, China has turned most of the economy over to market allocation. By the mid-1990s, the share of GDP produced by the state sector had fallen to less than 20%, with state owned enterprises accounting for less than 45% of gross industrial output. In the process, the Chinese economy has also enjoyed unprecedented growth and structural change, with annual growth of 9.5% in real GDP during 1978-1994, a decline in the proportion of the labor force in agriculture from 71% to 56% in 1993, and exports rising to more than 20% of GDP. During the transition the average Chinese citizen has enjoyed relative price stability and impressive improvements in their standard of living, buttressed by steady increases in life expectancy and improvements in other socioeconomic indicators.

Aside from the incremental, cautious approach to liberalization, the most notable feature of gradualist reform is the creation of a dualistic economy in the short to medium term, where a market segment is permitted to emerge and grow while the planned segment is gradually allowed to wither away.\(^8\)

Gradualist reform in China was a process of piecemeal, incremental changes whereby the state progressively reduced its control over the economy and introduced better incentives to guide economic agents toward more efficient behavior. The classic example of this was in industry, where the government gradually reduced plan control over production and marketing, and allowed entry of nonstate enterprises into industries previously monopolized by the state sector. This created a dualistic structure whereby state enterprises traded at plan prices while nonstate enterprises traded at market prices. At the same time, state enterprises were also permitted to sell a portion of their "extra plan" output at market prices, which were usually much higher. These incentives created a dynamic whereby all economic agents -- state and nonstate alike, helped to push the economy toward deregulation (Byrd 1987).

Gradualist reform in the fiscal sector

In the pre-reform system, government revenues had been heavily drawn from profit remittances from state-owned enterprises (SOEs). On the eve of reform, profit remittances from SOEs accounted for half of all government revenues. Revenue capacity of the system was dependent on three features of the planned economy: 1) fixed prices that were rigged to favor industry, designed to transfer surpluses from other sectors. 2) State ownership of industry and restricted entry, and 3) compulsory procurement of agricultural products and mandated trade among producers at plan prices. Once reform began in 1979, these features were gradually eliminated, weakening revenue capacity, and the budget fell from fell from 35% of GDP in 1978 to 27% in 1985, 20% in 1990, and 12.7% in 1994 (see Figure A).

It is clear from the steep fiscal decline that the Soviet-type fiscal system inherited from the planned economy was wholly unsuited to a decentralized, market economy, and that all the key parts of the fiscal system must be altered simultaneously -- tax structure, tax administration, and intergovernmental revenue sharing.

\(^8\) Barry Naughton has characterized this as a process of "growing out of the plan" (1995).
The tax structure must be reformed to introduce a more broadbased system that taxes all sectors more equally, rather than depending on industry alone. Rate structures must be unified to treat all taxpayers equally, rather than distinguishing between taxpayers by ownership type -- this is the distortion that has produced the famous roundtripping of Chinese capital -- where Chinese firms send their money out to HK or some other place and then bring it back in as “foreign investment” to qualify enterprises for tax preferences. In the early-1990s this roundtripping was estimated to account for as much as 25% of foreign direct investment in China (World Bank 1994). Even more problematic was the system of indirect taxes, which had hundreds of rates that differed by product, and varied from 0 to several hundred percent, which must be unified to eliminate the distortions to resource allocation.

Revenue sharing arrangements had to be revamped. Under the Soviet-type fiscal system, all revenues were collected by local governments and shared upward with the central government. The system was highly redistributive, requiring rich provinces to hand over large portions of revenues to the central government to finance transfers to poor provinces (Lardy 1978). The system had very poor incentives, but monitoring was also fairly straightforward, where revenue capacity was relatively easy to determine given fixed prices and tight control over entry into industry. In any case, centralized control over budgets prevented local governments from hiding unauthorized expenditures. In contrast, monitoring of tax effort has become virtually impossible in the transition period, as large shifts in prices and unrestricted entry into industry have caused large shifts in tax capacity in every region. At the same time, decentralization of budgetary control means that local governments now have both the motive and opportunity to shield local revenues from sharing with higher levels. It is widely believed that the recent fiscal decline is partly caused by the unwillingness of local governments to collect revenues (Wong, Heady, and Woo 1995).

Finally, tax administration also needs to be reformed. Under the Soviet-type system, the number of taxpayers -- namely the SOEs and state or collective farms -- was relatively small, and they were under tight state supervision. Tax administration was simple, and depended on voluntary compliance by taxpayers. In a decentralized, market economy, taxes have to be collected from many more taxpayers, whose accounts are not so easily monitored. For example, in the rural sector the government used to collect taxes from about 50,000 people’s communes. Now it must collect from more than 200 million households and more than a million TVEs.

Rather than moving quickly on these three fronts, through 1993 the Chinese government followed basically the same incremental approach in the fiscal sector, with reform efforts focused on tinkering with incentives and making some marginal changes in the tax structure and tax administration.

-- tax reform was introduced in 1983-84 under the “replacing profits with taxes” (līgāishù) program. An income tax was introduced to SOEs, to replace profit remittances with tax payments in an attempt to reduce the negotiability of SOE financial obligations to the state. A reform of indirect taxes split the turnover tax (the industrial-commercial tax) into product taxes, business taxes and a value added tax. The total number of rates was reduced.
-- tax administration was to be strengthened by making the Tax Bureau independent of the Ministry of Finance, and making it a line agency subordinated to Headquarters in Beijing rather than control from local governments.
Even after all these changes, however, in 1993 the Chinese fiscal system still bore its essential Soviet character -- with an industry-centered tax structure, multi-tiered turnover taxes that varied across products, tax administration that was largely locally managed, and revenue sharing by negotiation. In the meantime, fiscal pressures grew worse, especially at the local level, where the costs of providing day-to-day administration and social services grew much faster than revenue. During 1978-1993, when nominal budgetary revenues grew 2.8 times and the local government share a little more than 3 times, the wage index grew to 864 (1978=100) (SSB 1995, p. 112). The solution was to permit local governments to introduce users' fees and other levies to supplement budgetary revenues as needed.

II. The Nature and Significance of Off Budget Funds

In this light, the development of off budget finance in China can be seen as a byproduct of the gradualist reform strategy and a "back door" decentralization of fiscal control. Even though the fees and levies that comprise the off-budget resources have been widely criticized as chaotic and excessive, many are actually levied with the blessing of and occasional supervision by higher level governments. They are tolerated because there is recognition that revenues within the budgetary system are insufficient to finance expenditure responsibilities at the lower levels of government.

"Extrabudgetary" funds (EBF) were a feature of Soviet-type fiscal systems. They were originally created to provide a supplementary source of funds outside of budgetary appropriations for the discretionary use of local governments, administrative agencies and enterprises. Later, users' fees and local surcharges that were meant to be retained for local use were also placed under EBF, to separate them from budgetary revenues that were shared with the central government.

In China, the first extrabudgetary funds were created in the early 1950s, when local governments were allowed to levy some tax surcharges to provide small amounts of resources for local use, such as the surcharge on the agricultural tax, and later the surcharge on Industrial-Commercial Tax that was used to finance urban maintenance and construction. As enterprise bonus funds and major repairs funds were set up in 1955, they too came under the category of EBF. Rental incomes from public housing, users' fees, surcharges for public utilities, etc. were also counted as EBF. What all these different funds had in common was that they were often earmarked for specific uses, and they came under decentralized management and allocation by different agencies and organizations.

The size of EBF rose and fell with cycles of decentralization and recentralization. After growing rapidly during the Great Leap Forward (1958-61), they were drastically cut back during the 1960s. With the onset of the Cultural Revolution (1966), however, EBF experienced another round of sustained growth. Through the 1970s EBF under management of enterprises grew especially rapidly, at an average annual rate of 13.7% per year from 1965 to 1978. This growth was due primarily to the decentralization of depreciation funds to enterprise control in 1967, a 0.5% increase in depreciation rates, and the rapid growth of enterprise fixed assets in the 1970s. It also benefitted from the addition of enterprise welfare funds (of 11% of total wage bill). By 1978, EBF under enterprise control had grown to over 25 billion yuan. On the eve of reform in 1978, total EBF were 34.7 billion yuan, equal to more than 30% of the size of budgetary revenues.

At yearend 1993 there were still 21 product tax rates (ranging from 3 to 60%), 13 VAT rates (8-45%), and 4 business tax rates (3-15%). In addition, for foreign enterprises there was the the consolidated industrial and commercial tax (with 40 rates ranging from 1.5 - 69 percent).
revenues, or about 10% of GDP. Throughout the 1980s and 1990s, off budget resources enjoyed double-digit growth while the growth of budgetary revenues fell behind GDP growth. By the early 1990s (and until SOE funds were excluded from extrabudgetary accounts in 1993), off budget funds grew to rival the size of the budget -- in 1991 EBF alone was equal to 95% of budgetary revenues, or over 16% of GDP.

The main sources of extrabudgetary funds are presented in Table 1 for 1981-90. Through 1992 enterprise funds belonging to SOEs and their supervisory agencies continued to dominate EBF, accounting for about 80% of the total. These comprised of retained profits, depreciation and major repairs funds that were turned over to enterprise control, through reforms that sought to give enterprises more decision-making autonomy and to offer them better incentives for profit-maximizing behavior. Enterprise funds grew at an annual rate of 19.2% during 1978-1990.

The portion under local government control comprised only 2.9% of total EBF in 1990. They came from 11 sources including surcharges of taxes and public utilities, and incomes of extrabudgetary enterprises owned by local governments. Through 1990 this was the slowest growing category of EBF, with an average annual rate of 5.7% during 1978-1990, compared with 18.7% in the growth of total EBF.

The portion of EBF under administrative agencies comprised 17.2% of the total in 1990. The sources for this portion include over 70 types of incomes including road maintenance fees, the educational surcharge on turnover taxes, rental incomes of public housing, market management fees and management fees collected from individual and private enterprises. In addition, this category includes incomes from enterprises run by administrative agencies, such as workshops and factories owned by schools, hotels and restaurants run by industrial exhibition halls, etc. This component grew at an average annual rate of 20.2% during 1978-1990, due to the proliferation of fees and income-generating enterprises run by administrative agencies.

In addition to EBF, there are also "self raised funds" managed by local governments and administrative agencies at the county and township levels. Self raised funds come from fees, rental income from collective assets, profits and other remittances from TVEs, and, in some provinces, the "unified levy" (tongchou) on villages. The list of typical sources of SRF is presented in Table 2. While most of the fees are levied on enterprises, many also fall on rural households. For example, townships in Shandong impose a "unified levy" to finance five services -- rural education, militia training, cadre subsidies and old age and welfare support. These are collected from households by village officials and turned over to the township for unified allocation.

Other forms of off budget finance include various instruments of debt finance by local governments -- bonds, "contributions" and outright borrowing from banks (Park et al 1996, Zuo

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10 Extrabudgetary enterprises are those built with extrabudgetary resources of local governments. These enterprises were initially distinguished from state-owned enterprises in that they did not remit profits to the government, and were thus "extra, or outside of the budget". In that sense, they were treated much like collective enterprises. This category was first introduced in 1958. In the early 1980s, with decentralization and the growth of locally managed funds, many extrabudgetary enterprises were built. However, with the introduction of income taxes for SOEs in 1983 and profit-contracting in 1986, the distinction between extrabudgetary and in-budget SOEs was largely eliminated, and the category of "extrabudgetary" enterprises may have vanished.
Sales of state assets such as land leases and public housing are also reported variously as budgetary or off budget resources. In many cities these off budget resources are the main source of finance for infrastructural investments and are usually not incorporated into budgetary accounts.

While all levels of government depend to varying extents on users' fees, asset sales and other nonbudgetary resources, at the township level there is explicit official recognition of nonbudgetary sources for financing government -- since 1986 townships have been required to report receipts and expenditures of "three types of funds" to the county level: budgetary, extrabudgetary, and self raised funds. In the 1990s nonbudgetary resources account for more than one fourth of revenues and about one third of expenditures at the township level. For some localities the role of nonbudgetary revenues is much larger (Sun et al. 1994, Zuo 1996).

The uses of EBF and SRF are virtually identical to those of budgetary revenues, and they are commonly referred to as "the second budget". They are spent on education, health, farmland investment, road maintenance and construction, family planning services, administration (paying salaries and subsidies for cadres), etc., in ways that clearly supplement the budget. Sometimes explicit transfers are made from EBF to augment budgetary revenues.

The salient characteristics of OBF

Tax-like characteristics. Public finance theory distinguishes between the choice of users' fees and taxes as the best way to finance different types of public services. Users' fees are generally recommended when users are easily identifiable and separable, and where the service produces few or no external benefits. For example, users' fees are usually applied to finance public utilities, some parks, etc. Taxes are considered the appropriate tool for financing public services that involve significant external benefits or costs (such as basic education and preventive health care), where benefits are nonexclusionary (such as police and fire protection), or that are recognized and accepted as a general social obligation (such as providing welfare and housing for the indigent).

Users' fees form a significant portion of the sources of EBF/SRF. Examples include the charges on public utilities, rental incomes from public housing, the animal slaughter tax, etc., which are paid by the beneficiaries of the services financed by the fees. However, a significant portion comes from what amount to quasi taxes, that are either levies on the general public or are intended to finance general social obligations. Examples of this latter type include one of the newly introduced surcharges for rural education, which is levied on urban building construction, as a flat fee per square meter of constructed space. Similarly, fees are levied in many provinces (including Jiangsu, Guangdong and Shanghai) on profits of township and village enterprises to finance subsidies for agriculture. In these cases, since the levies fall on nonusers, and the funds are used to finance general social obligations (education and rural development, respectively), they are quasi taxes, and not user's fees.

Ambiguous legal status. Off budget finance occupies a grey area in public life, with an ambiguous status that reflects the ambivalent official and popular views of their legitimacy. In any society, the issues of the optimal level and forms of taxation are controversial, closely tied to differing views of what government should and should not do. These issues are even more contentious in transition economies, where the role of government itself is undergoing rapid change and intense debate. Since they are imposed by local governments and agencies, often
without explicit permission from the top, the legitimacy of many fees and levies is likely to be questioned.

At the clearly legitimate end are the extrabudgetary fees that were created by law or regulation, whose sources and uses are specified and come under the same oversight and rigorous reporting requirements as budgetary revenues. The surcharges on agricultural tax, the urban educational surcharge, the road maintenance and construction fee are some examples of OBF in this category. They were simply set aside from the budget for earmarking purposes, to distinguish them from general revenues.

In the middle are some of the fees levied by rural governments, such as the “unified levy” on villages and “support agriculture” fees levied on TVEs. These are accepted as supplements to budgetary resources, to finance expenditures often stipulated by national policy. For example, the “unified levy” provides funding for support to the elderly and indigent, an obligation on the community under the “five guarantees” (wubaohu) program, created in the 1950s to guarantee five kinds of provision: shelter, clothing, food, medical care and burial. This was an obligation stipulated by national policy and financed from collective funds in the past. Since township and village governments are not empowered to levy taxes, these fees are tolerated by higher level government as substitutes for providing the financing.

At the far end and more questionable are the many “voluntary contributions” that enterprises and households are asked to make toward a variety of public expenditures, from tree plantings, school and road construction to preparations for the Asian Games and National Day celebrations. In any case, the system of fees and levies is open to abuse given the weakness of oversight from higher level governments and, in absence of meaningful elections, limited accountability of local officials to the public.

Decentralized Taxing Authority. Within the formal fiscal system, all taxing powers reside with the central government, which levies taxes, sets the rates and defines the tax base. In contrast, the off budget system is decentralized, and all levels of government have the power to impose levies, and set their rates and bases. Even though each level of government attempts to set guidelines and limits on quasi taxes, there is substantial autonomy at the lower levels.

III. IMPLICATIONS OF OFF BUDGET FUNDS

The Dynamics of a Dual Track System.

The dual-track analogy can be applied to OBF because they share two features in common with the “market” or decentralized segments of other sectors. First, they are extra-plan -- outside the purview of government planning and allocative control. Second, they provide better incentives -- since they are wholly retained by the localities, incentives for “tax” effort are much better than within the formal budgetary system. Local governments have two motivations for promoting the growth of off budget funds. One is to supplement budgetary resources for financing government, and the second is to shift resources from a taxed sector to an untaxed sector. By exempting enterprises from taxes -- which local governments were able to do because the system of decentralized tax administration gave them substantial power over tax collection -- local officials “create” more after-tax profits, over which they can impose various fees and levies. Nor are enterprises averse to an arrangement that confers greater negotiability over their tax obligation, especially in a financially repressed environment where they continue to require help from local
officials. With incentives that encourage all agents to push for shifting more resources from the budget to the off-budget segment, the dynamic created is similar to that characterizing the dualistic structure in other sectors. It is not surprising that the growth of OBF has had the effect of hastening the decline of the formal budget.

Size of Government

The existence of significant OBF raises a number of questions. The first concerns the true size of government. Given that much of the off-budget funds go to supplementing budgetary expenditures, the true size of government exceeds that portrayed by the budget alone. Indeed, some studies have argued that since some of the budgetary revenues were simply shifted over to off-budget categories in the reform process, total government must be considered the sum of budget revenues and extrabudgetary revenues (Sicular, Oi). In this view, the alarm about fiscal decline in China is unjustified since adding together budgetary and extrabudgetary funds yields a total government share of GDP that has fallen from 45% to around 30% (Figure B). The latter figure is still high for a country at China’s level of development.

Counting all of EBF as part of government overstates its size by a significant margin since more than three quarters of EBF consisted of enterprise funds which were, at least in theory, not subject to government allocation. Instead, it was argued in Wong, Heady and Woo 1995 that a broad definition of government should include the “fiscal” portion of extrabudgetary funds -- those accruing to local governments and administrative units -- but exclude the enterprise portion of EBF. The reality is that since cash-starved local governments have often found it hard to resist the temptation to tap the rich trove of enterprise funds, enterprise funds are partially used by government. And in the absence of clear property rights, enterprises have been in a weak position to fend off such predation. In Figure B we present three curves showing the GDP-share of government: Curve A represents budgetary revenues, curve B represents budgetary plus fiscal EBF, and curve C represents budgetary plus all EBF. The size of government is shown as a shaded band bounded by curves B and C.

In addition, there are also SRF and other off-budget funds that are not included in EBF statistics, the size and distribution of which are difficult to ascertain because local governments have little incentive to make full disclosure of all the resources available to them. Data from the Ministry of Finance show the extrabudgetary revenues controlled by local governments and administrative agencies at about $210$ billion, or 4.7% of GDP in 1994. In addition, Wong (1996) estimates that rural governments at the county and township levels controlled another 2-3% of GDP in "self-raised funds". Together, even by this narrow definition (excluding enterprise funds), OBF were equal in size to almost 60% of budgetary revenues, accounting for a substantial portion of resources available to government.

Degree Of Decentralization

The Ministry of Finance reports that, of the portion of EBF under administrative agencies, only about 10% are controlled by those at the central level. Since OBF are managed almost entirely by local governments and their administrative agencies, then, their existence makes the Chinese fiscal system even more decentralized than the picture painted by budgetary accounts. Table 3 shows the central-local division of revenues, both including and excluding fiscal EBF. For example, in 1992, fiscal EBF were about 4% of GDP, when budgetary revenues were 14.7% of GDP. Adding this to local government’s share means that 70% of the revenues in the broadbased
budget came under local allocation, compared to 60% of the budget share. In 1993 the adjusted local share was 75%.

This means that as long as OBF remain a large share of total government finance, raising the central share of budgetary revenues will have a muted impact on central control. In 1994, for example, even though introduction of the Tax Sharing System succeeded in raising the central share of revenues to 56% of the total, the real central share of total government was only a little more than 40%. If we assume that local governments also use some enterprise EBF, and when we add the SRF of rural governments, the likelihood of the central government gaining a majority share of total government finance fades further still.

**Macro stabilization**

One key function of the budget is to maintain macroeconomic stability. This is an especially important function in developing countries with weak or repressed financial sectors. On the one hand, the rapid growth of OBF must be seen as a flexible response by local governments to budgetary problems. The resulting revenue mobilization has helped to alleviate fiscal pressures and reduce deficits, which have aided efforts to balance the budget. On the other hand, the existence of significant off budget spending by local governments erodes the central government's ability to control overall expenditure and use fiscal policy as a tool of macroeconomic stabilization, with repercussions on allocative efficiency elsewhere in the economy.

**Efficiency**

On the positive side, the increased application of users' fees for publicly provided private goods (such as urban water and power supply, and housing) has helped to bring prices closer to cost recovery levels, reduced subsidies and price distortions, improving allocative efficiency. These fees have also helped to finance infrastructural investments that relieved bottlenecks. By giving local governments some de facto taxing authority, OBF have provided more flexibility for responding to local needs and improved the supply of education and health care in many localities.

On the downside, it was noted earlier that the system of OBF helps to perpetuate the softness in tax obligations, which is harmful to efforts to sever the paternalistic ties binding enterprises to local officials. The pursuit of OBF (in the form of enterprise profit remittances) has led local governments to invest in profit-making activities such as "tourism spots", hotels and restaurants. It also perpetuates government participation in economic activities.

Moreover, the system of off budget finance is inefficient from a tax administration perspective. First there is an uncontrollable proliferation of fees and levies that the government has found impossible to curb despite repeated calls and edicts. For example, one survey in Hunan Province found that TVEs were subjected to more than 100 types of fees, paid to 60-odd administrative units and agencies (cited in Furasawa 1990).

This proliferation of fees and levies has resulted in a system of quasi taxes that is extremely complex, where uncoordinated, multiple fees are imposed on the same taxpayer, using different bases for calculation. For example, Susan Whiting(1993) reports that in suburban Shanghai, the bulk of nonbudgetary revenues came from four fees: a per worker annual levy of Y220 for "using
industry to support agriculture" (yigong zhinong), a per worker fee of Y84 to support agricultural sidelines, a rural education fee of 2 percent of gross profits, and a social expenditure fee of 7 percent of taxable profits. All were levied on TVEs, but on different tax bases (on gross profits, taxable profits, and the number of workers). These fees fail the test for transparency and simplicity, and their multiplicity increases the costs of collection.

They also create problems for budget management, where allocative efficiency is reduced by fragmentation of these fees under different government departments and agencies. For example, a typical municipal budget in China includes only revenues that accrue to the budget, such as collections of taxes and profit remittances of city-owned enterprises. Even though fees collected by public utilities and public housing constitute major portions of financing for these municipal services, they are kept separated from the budget, in the extrabudgetary accounts of the management agencies (World Bank 1990). This fragmentation makes it difficult to coordinate the planning for the provision of municipal services, reducing fungeability and allocative efficiency.

Equity Concerns

Per capita extrabudgetary revenue and budgetary revenue are highly correlated since extrabudgetary fees are frequently levied on the same tax base. This is true of all the surcharges tacked onto existing taxes, which generate the bulk of the EBF accruing to local governments and administrative agencies. The industry-dependent characteristic of the formal tax system appears to be replicated by many local levies as well (Zuo 1996, Sun et al.). The coincidence of taxes and quasi-taxes on the same tax base (industry) means that the size of budgetary and off-budgetary revenues is closely correlated: prosperous localities are rich in both, while poor localities facing tight fiscal constraints find little relief from EBF/SRF. At the provincial level, the correlation between budgetary revenues and EBF is extremely high -- 0.89-0.96 during 1983-1990. Since extrabudgetary revenue is not shared with higher levels of government, extrabudgetary revenue is approximately equal to extrabudgetary expenditure -- for the provincial sample the correlation coefficient was 0.9942 for 1990, and extrabudgetary expenditures are highly correlated with budgetary expenditures (correlation coefficient of 0.9842 in 1990). Thus, the growing reliance on off-budget finance of local governments means, ceteris paribus, increasing regional disparities and the erosion of the equalization achieved through the redistribution of budgetary revenues. The coincidence of budgetary and off budgetary resources is also confirmed in studies of rural finance, where the reliance on off budget funds clearly amplifies the tendency toward growing regional disparities in China.

At the household level, the crude methods of assessment and collection used for fees at the lowest tiers of government sometimes result in a highly regressive tax structure. At the township and village levels, for example, per head levies are commonly used to finance public services formerly provided by the collectives. These often result in higher tax rates on poor households/villages. In one township in Shandong Province, township officials reported that the "unified levy" was Y27 per head in 1993, which was calibrated to be less than 2 percent of rural incomes. In fact, the per capita levy actually ranged from Y13.2 to Y33.4 across the 43 villages, which translated into a tax rate of only 1 percent of income in one of the most prosperous villages, but 5.3 percent in the poorest one.

IV Conclusion
OBF is in many ways conceptually attractive -- it fits the new market mentality of linking rewards to (tax) effort, providing flexibility in meeting local needs, and, by establishing a pattern of local financing for various services, can be seen as a precursor of a new mode of governance (see Fan Gang chapter in this volume). However, this paper has examined the nature and implications of OBF with regard to its effect on the government’s ability to use fiscal policy to manage macroeconomic stabilization, effect efficient resource allocation, and meet social objectives. Their impact appears to be somewhat mixed on the first two functions of macro stabilization and allocative efficiency. With respect to the social objective of equalization, however, the effects of OBF are definitely negative, where the growing reliance on offbudget funds has amplified the already large regional disparities in income and government services (Wong 1996 and West and Wong 1995). The adverse impact of OBF on regional disparities cannot be taken lightly given that China is a vast country with a special concern for keeping regional income differences within tolerable limits. Alarm over growing disparities was sounded in the Ninth Five Year Plan that was announced in March 1996, which called for a renewed commitment to helping poor regions.

In addition, the system of OBF is prone to abuse because it is difficult to restrain local spending, especially in localities with abundant TVEs, where it is fairly painless to extract OBF from enterprise funds. In China today it is easy to cite instances of excessive spending by local governments on infrastructural investment -- construction of a huge international airport across the border from Hong Kong in Zhuhai, the tens of thousands of “development zones” built during the early 1990s, “tourism spots” and luxury hotels. In even poor localities there is a good deal of lavish public spending on banquets and karaoke bars, etc. Partly the opportunity for levying local fees springs from the lack of legal protection of property rights over the assets of enterprises and individuals, and from the lack of clarity over the scope of work of local governments, which opened the door to fiscal predation and the excessive expansion of these funds. These point to a need to install safeguards to protect citizens and enterprises from unreasonable actions by local governments.

It is time to consolidate the two tracks of the fiscal system. The present structure of fees and levies should be examined, and legitimate ones incorporated into the formal system of budgetary accounting. The distinction between budgetary and extrabudgetary funds is a remnant of the Soviet-type fiscal system that has outlived its usefulness. Since the 1994 Tax Sharing System has shifted intergovernmental revenue sharing from a negotiated basis to a partial tax assignment system, the old distinctions that separated extrabudgetary revenue from budgetary ones are no longer meaningful. The users’ fees and levies that are meant to be locally retained can be assigned as local taxes, to finance the services for which they are charged. Those fees and levies that are really taxes -- that are not payment for a specific service, should be included in the tax sharing system and counted as a financial resource in the proposed system of intergovernmental transfers.

An increasingly decentralized economy requires a more decentralized fiscal system with clear tax and expenditure assignments for each level of government. In exchange for the consolidation of OBF with the budget, the central government should be willing to devolve some taxing authority to lower levels. With the 1994 fiscal reform, China has moved a long way toward a modern tax system. The logical next step is the merger of the two tracks, which requires a comprehensive overview of the system of revenue and expenditure assignments, not just piecemeal changes. Fiscal reforms that deal only with the formal budget and its division of resources will not only leave intact a large and problematic sector that needs urgent attention, but any changes in formal system may create more pressures for further growth in off budget finance.
The birth of multilateral debt settlements -- further tax offsets -- appears to have taken place in late 1994 and 1995, just as the newly elected government of Leonid Kuchma instituted a policy of monetary reform. As the supply of printed money stabilized and arrears increased, local governments became increasingly pressed to cover expenditures. The problem of tax arrears became more acute as the government could no longer rely on increased emissions to cover costs. According to interviews in Donetsk and Khmelnytsk, local officials took the initiative of canceling tax debts in exchange for services provided to budgetary organizations. Only later—in the spring and fall of 1996—was a regulatory framework developed by the Ministry of Finance to register and control this activity.

The simplest form of tax-offset occurs when an enterprise owes the government for taxes, while the government owes the enterprise subsidies. The mutual debts are canceled. An extension of simple tax offset is when an enterprise owes the governments taxes whereas the government owes the enterprise-exporter or miner compensation for VAT.

Another typical "three-pronged" tax offset is diagrammed below:

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Here, the bakery owes the regional government for taxes, while the hospital owes the bakery for bread provided. At the same time, the government owes the hospital funding. Typically, the bakery will come to the regional financial office to lobby to have the tax debt canceled in exchange for forgiving the debt from the hospital. If the tax debt is canceled, the local financial office lists the same amount as having been provided to the regional hospital.

A wide range of other types of tax offsets also exist. For example, as noted above, central transfers often come in the form of tax offsets through gas companies. For example, in one case "Kievtransgas" owed the state budget in taxes, while Ternopil oblast owed the gas company for services provided. The state budget canceled the gas company's debt in exchange for canceling Ternopil's debt to the gas company. This transaction was subsequently listed as a subsidy to the oblast.

The tax offset used to cover the transfer to Khmelnytsk worked in the following way:

```
Central Budget  -->  Russia
     ↓             ↓
     |             |
     ↑             ↑
UKRGASPRoM
     ▼             ▼
KHMELNYTSK OBLAST
```

The government of Ukraine here paid Russia on behalf of Ukrgasprom for debts—a transaction that was subsequently registered in part as a transfer to Khmelnytsk. (In this way, the first tranche of the World Bank coal sector adjustment loan, some of which was used to pay gas debts to Russia, may have ultimately been registered as transfers to Khmelnytsk.)

The government made significant use of tax offsets to cover debts to gas companies. For example, in the first quarter of 1997, 93% of debts to two of the largest gas companies—Ukrgasprom and Uknafta—for compensation for lower prices provided to the population were paid in the form of tax offsets (a total of Hr. 145 million in subsidies). It is likely that a large number of these assets were registered as transfers to the regions.\(^\text{12}\)

\(^{12}\), Based on data provided by the Ministry of Finance of Ukraine.
Another "state-of-the-art" way of municipal coping with lack of funds was found in Khmelnytsk. The city has sometimes used difference in energy prices to inexpensively cover the budgetary organizations' debt to Oblenergo.  

Here, the local budget did not pay subsidies owed to the budgetary organization (such as a school) for energy consumption. As a result, the school owed oblenergo Hr. 200,000. Simultaneously there is an enterprise that owes the local budget taxes in the amount of Hr. 80,000 but has a Russian energy promissory note obtained in another transaction with a 55% discount as a non-cash payment. On the Ukrainian market this veksel costs about 200,000 Hr. The enterprise then covers its debt to the local government by paying with 80,000 thousand veksel for budgetary school's 200,000 energy bill. Thus through this tax offset the local budget covers it's 200,000 debt by "paying" only Hr. 80,000.

Finally, in some cases tax offsets are made in lieu of salaries to individuals—although this is done rarely and reportedly only on a voluntary basis. In such cases, an individual's debt to communal services or income tax is canceled in exchange for part of the salary debt. An official at the Donetsk oblast Labor office claimed that approximately 10% of salaries were paid in this manner. In the data collected from Khmelnytsk, we find that approximately 1% of income tax was collected in the form of tax offsets.

**Overall Levels of Tax Offsets**

Ministry of Finance officials estimate that a third of revenues at the regional level were collected in the form of tax offsets in 1996. In the first five months of 1997, the level of tax offset use was 16%. The lower 1997 figure appears largely due to the fact that tax offsets were forbidden in the first months of that year. In 1997, the percentage of tax offsets varied considerably among oblasts—from 4% and 6% in Odessa and Mykolaiv to 30% in Chemivets and Luhansk.

The decision of whether or not to use tax offsets appears to be a function of several different factors including the level of tax debt in a particular oblast, demand by

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13 Energy generation and distribution oblast enterprise.
budgetary organizations for expenditures whose debt can be canceled via tax offsets (i.e. food, energy, etc.), as well as the preferences of the local financial administrators involved. One common hypothesis offered by several different financial officials is that industrialized oblasts use tax offsets more than less industrialized ones. The assumption is that in more industrialized oblasts, industries will be in a better position to lobby for tax offsets, which tend to benefit industry the most. Data obtained for 1996 generally supports this conclusion. Despite the fact that tax offsets are used in cases of tax arrears, it is the richer areas - as well as the less agricultural ones - that use tax offsets more often. The correlation below suggest that tax offsets may be used more where powerful industries are able to lobby for them.

Use of Tax Offset by Expenditures

From the limited available data, it is difficult to determine how much tax offsets are used for different categories of expenditure. Available evidence suggests that tax offsets are not necessarily used significantly more in one type of municipal expenditure (i.e. education or health) than another. Thus, data from Khmelnytsk city for 1996 shows that most of the main area of expenditures (i.e. social protection, health, and education) were financed by tax offsets between 20% and 30%.\textsuperscript{14} Education was financed slightly more by tax offsets (29%). However, with the limited data available, it is difficult to determine whether or not this represents a general pattern. The data from Donetsk city shows a different pattern – with communal subsidies overwhelmingly paid for with tax offsets. This may be because communal enterprises, which service budgetary organizations, have an easier time arranging tax offsets.

Table 1
Tax offsets as part of Khmelnytsk city budget, 1996

<table>
<thead>
<tr>
<th>Area of expenditure</th>
<th>Percentage of budget</th>
<th>Percentage of the bill paid by tax offset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social protection</td>
<td>21</td>
<td>20</td>
</tr>
<tr>
<td>Education</td>
<td>36</td>
<td>29</td>
</tr>
<tr>
<td>Health</td>
<td>28</td>
<td>22</td>
</tr>
<tr>
<td>Culture and media</td>
<td>2</td>
<td>19</td>
</tr>
<tr>
<td>Housing and communal services</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Self-governance</td>
<td>2</td>
<td>0.6</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>23</td>
</tr>
</tbody>
</table>

\textit{Source: Khmelnytsk city administration financial department}

\textsuperscript{14} In Donetsk city, we were only able to obtain data on the use of tax offsets in education in 1996 – 21%. Clearly, more evidence needs to be collected to confidently determine that tax offsets do not favor one expenditure over another.
Table 2
Tax offsets as part of Donetsk city budget, 1996

<table>
<thead>
<tr>
<th>Area of expenditure</th>
<th>Total funding</th>
<th>Percentage paid by tax offset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>57896</td>
<td>22</td>
</tr>
<tr>
<td><strong>Culture</strong></td>
<td>1058</td>
<td>5</td>
</tr>
<tr>
<td>Health</td>
<td>56092</td>
<td>13</td>
</tr>
<tr>
<td>Sport</td>
<td>983</td>
<td>17</td>
</tr>
<tr>
<td>Self-governance</td>
<td>5227</td>
<td>4</td>
</tr>
<tr>
<td>Aide to poor, including communal subsidies</td>
<td>4984</td>
<td>64</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>75240</td>
<td>23</td>
</tr>
</tbody>
</table>

Source: Donetsk city administration financial department

Tax offsets, rather, appear to be a direct function of the article of expenditure — i.e. salary, materials, etc. As one official in Enakievo put it: "Barter is for services. Cash is for salaries." The breakdown of expenditures along these lines is revealed in data provided by the Donetsk city education department (table 10). Here, we find that 100% of salaries are paid in cash, while 80% of communal services are paid for in barter form.

*Use of Tax Offsets by Type of Tax*

The impact of tax offsets on tax collection appears to be more complicated. One important issue is which taxes are covered by tax offsets. When a local official is approached by an enterprise which wants to undertake an offset, the official is often in a position to decide which tax to apply the offset to — VAT, corporate income tax, etc. The decision of which tax to apply for a particular tax offset would appear to be driven by the desire of the local official to ensure that the locality in question covers as many of its costs with shares from other levels of government and receives as much as possible in cash. Thus, the official should try to apply tax offsets as much as possible to taxes that (1) do not provide a large amount of cash to the locality and (2) whose greater share goes to the center (or oblast). Thus, a particular locality (in Khmelnytsk for example) may keep 100% of VAT and 70% of corporate income tax. If the absolute size of the two tax debts is about equal, we would expect the official to try and apply tax offsets to corporate income tax as much as possible — given that part of the tax offset will then be applied as a loss to the center.

Interviews with officials in Enakievo and Khmelnytsk suggest that these officials consciously manipulate tax offsets in this manner to ensure that as many tax offsets as possible are applied to the center's tax share (see below). However, the data was not available for us to make a broader based statistical confirmation of how officials use the choice of tax to pay for their own expenditures with shares of taxes from other levels of government.15

*The Impact of Tax Offsets on Regional Finances*

15 We may find that such attempts may cancel each other out.
Tax offsets have been immensely controversial. Overall, central officials interviewed tended to see tax offsets as a mechanism depriving the central government of needed cash while local officials saw tax offsets as the only viable way to ensure that bills are paid. Most of those interviewed in the Ministry of Finances and the State Treasury were intensely opposed to offsets, arguing that they permit enterprises to avoid tax payment. By contrast, most of the local officials we spoke with in Donetsk, Khmelnytsk and Yenakievo felt that such offsets were the only means of covering costs. They argued that firms owing taxes should not have to wait 45 days before turning that debt into a tax offset, as stipulated in the November 20 Ministry of Finances Order. Representatives in Donetsk said that in many cases it was clear right away that a specific debt from an enterprise could only be paid by a tax offset and saw no reason to wait for 45 days, by which time the firm would be punished a fine. The opposition to the 45-day rule confirms that many local leaders view tax offsets as a normal way of doing business. One tax official in Donetsk even suggested that computer programs should be written to link indebtedness and conduct large, multi-party offsets involving a wide range of mutually-indebted enterprises.

Local authorities make several arguments in favor of tax offsets. First, they contend that without such measures, arrears would grow out of control. For such officials it makes no sense to simply allow arrears to grow when they could be canceled to cover local expenditures. They argue that tax offsets help budgetary organizations survive by paying for communal services which schools, hospitals and other organizations could not otherwise afford. Tax offsets are seen as sometimes the only viable way of paying for communal services and to save cash for salaries, which are considered priority.

Not surprisingly, directors of enterprises are strong supporters of tax offsets. Tax offsets relieve enterprises of large tax debts. Enterprise pressure on local officials may also explain why so many local leaders back such measures. At a city council meeting in Mariupol in April 1997, for example, representatives of metal plants strongly opposed efforts by the local mayor, Mikhail Pozhivanov to curb the use of offsets, which he felt were depriving the budget of needed cash.

The controversy over tax offsets is reflected in the fact that the right to conduct tax offsets has been revoked and re-given several times. In December of 1996, the Cabinet of Ministers issued a regulation forbidding the use of tax offsets by local governments. However, by February, the government had revoked its decision and began allowing tax offsets again. On May 21 of 1997, the central government tried again to keep the level of tax offsets under control by passing a resolution dictating that energy bills should be paid in cash. Officials in Khmelnytsk and Donetsk feared that this Regulation would create significant problems for localities. The head of finances for Yenakievo city in Donetsk claimed that electricity suppliers had already threatened to shut off electricity at some schools. However, it does not appear that the Resolution was enforced:

16 At the same time, this resolution exempts many budgetary organizations are exempt from being cut off (including hospitals, child and disabled rehabilitation centers, military establishments and
Given the large number of tax arrears, it is not hard to understand why local governments began to conduct tax offsets. But while offsets may sometimes appear to be the only way of decreasing arrears, we contend that they are likely to ultimately create more problems than they solve. Below, we argue that tax offsets likely create distortions in intergovernmental finance and enterprise and budgetary organization behavior and efficiency. The hypotheses below reflects initial thinking and will ultimately require more data and greater investigation to prove.

(a) Tax offsets give the regions an opportunity to highjack central tax shares

Oblasts and rayons are permitted to take the center's share of taxes in the form of tax offsets almost entirely at their own discretion. Thus, a city may cancel bakery's 100% VAT charges in exchange for food products to a budgetary organization -- even though the city is due only 20% of VAT and the tax offset is used to cover services provided to municipal schools. These types of offsets are subsequently recorded by the State Treasury as debts of the region or rayon to the center or Oblast respectively. According to data provided by the Treasury, the central government "lost" just over Hr. 100 million in tax offsets in February and the first three weeks of March of this year.

The localities appear to be conscious of who (the center, Oblast, or rayon/city) loses from any particular tax offset. Thus, the financial official in the city of Enakievo (Donetsk Oblast) keeps a record of how much each level of government "loses" in each tax offset arrangement. In Yenakievo for the first five months of 1997, the amount of the center's tax share that was used to cover local expenditures in tax offsets was Hr. 1,504,000, whereas the amount of local government's share that was used by the center to cover its expenditures on VAT compensation to exporters and miners was 134,000 Hryvna.

Officials in the city of Khmelnystsk also appear to have made significant use of this mechanism to cover local expenses in 1996. Thus, Khmelnystsk city obtained 6.6% of its own share of taxes in the form of tax offsets in 1996. However, 21.9% of their total expenditures were covered in offsets. The fifteen point difference between the percentage of revenues and expenditures can be explained by the fact that Khmelnystsk city obtained oblast and central shares by the process of tax offsets in order to cover costs.

(b) Tax offsets may reduce tax payments in cash

It is difficult to prove how much the presence of tax offsets reduces tax collection in cash. However, the existence of a mechanism for enterprises to avoid paying taxes in cash would seem on the face of it to encourage enterprises...
to hide cash reserves. This is the view of many officials, who feel that tax offsets reduce the pressure on enterprises to pay taxes.

(c) **Tax offsets hinder effective functioning of enterprises**

As tax offsets are widely used to pay for service provision. Thus service providers—such as energy, water, and heat providers—receive fewer cash payments from the government. The absence of cash undermines the profitability and effectiveness of such enterprises and induces non-payments to the suppliers. Thus, the tax offsets are effectively a short-term solution to the arrears problem and in the longer term promote growth of arrears and induce barter relationships. The Resolution of 21 May limiting barter payments for energy was instituted precisely because tax offsets—among other forms of barter—had limited the amount of liquid assets available to energy utilities.

(d) **Tax offsets may favor governmental enterprises at the expense of private ones**

Officials in Donetsk oblast and Enakievo city stated that their policy was not to accept applications for tax offsets coming from private firms. Such firms, they said, were rich enough to pay cash. It is unclear whether, given contemporary market conditions in Ukraine, such differential treatment is or is not beneficial. On one hand, it protects private firms from "unhealthy" arrears accumulation and allows efficient resource allocation decisions. On the other hand it clearly creates unfair competitive advantage to inefficient governmental enterprises which would otherwise have to pay taxes in cash or risk bankruptcy.

(e) **Tax offsets may promote soft budget constraints and operating inefficiency for budgetary organizations**

With strong pressure to pay wages, in many cases schools and hospitals assume that virtually all cash will go towards salaries while tax offsets will cover communal expenses. Thus, if a director of a school saves on energy, s/he will not be able to use resources saved on other types of expenditures (since she cannot use tax offsets for other expenditures). At the same time, tax offsets make it profitable for enterprises to build up debts from budgetary organizations since such debts can later be used to bargain for a reduction or even cancellation of the enterprise's tax burden. Thus, tax offsets appear to encourage both enterprises and budgetary organizations to increase arrears.

(f) **Finally, tax offsets also appear to encourage enterprises to hold onto non-core social assets**

Assets such as cafeterias, communal services, small food and processing facilities allow virtually all large former-state enterprises to provide services to budgetary organizations in exchange to tax offsets. Thus, according to Debt Cancellation journal of Yenakievo financial department, in the first quarter of
1997, 6 of 24 former state enterprises in Yenakievo could access tax offsets by providing non-core services to the budgetary organizations.

Recommendations

At first glance, the tax offsets might appear as a pure accounting mechanism to reduce increasing arrears. It would seem to make little sense to permit arrears to increase when they can simply be canceled on the basis of mutual debts. Indeed, if tax offsets were conducted on a one-time basis, they might be a useful way to reduce the burden of debts for all parties. However when tax offsets become part of the normal practice of local finance (as they appear to have become in many oblasts), they potentially have a reverse effect by creating distortions that may ultimately thwart the goal of reducing arrears - by promoting soft budget constraints to budgetary organizations, reducing tax payments in cash and depriving the center of cash. Given the potentially distortionary effects of tax offsets, they should be either outlawed directly or phased out gradually. Under the current system, local managers lack a real picture of the true nature of debts and thus do not have the information necessary to undertake effective cost cutting.