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China Improving Rural Public Finance for the Harmonious Society

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The study on public finance in rural areas was led by Achim Fock (Task Team Leader) and Christine P. Wong. They are also the main authors of this report.

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Abbreviations and Acronyms

ABC	Agricultural Bank of China	KWV	Key Working Village
ADBC	Agricultural Development Bank of China	LGOPR	Leading Group Office of Poverty Reduction
AQSIQ	State Administration of Quality Supervision and Inspection and Quarantine	MDG	Millennium Development Goal
ACWF	All-China Women's Federation	MOLSS	Ministry of Labor and Social Security
ATA	Agricultural Tax Abolition	M&E	Monitoring & Evaluation
BOF	Bureau of Finance	MLR	Ministry of Land and Resources
BT	Business Tax	MOA	Ministry of Agriculture
CBRC	China Banking Regulatory Commission	MOC	Ministry of Communications
CYL	Communist Youth League	MOCA	Ministry of Civil Affairs
CAD	Comprehensive Agric. Development	MOE	Ministry of Education
CASS	Chinese Academy of Social Sciences	MOF	Ministry of Finance
CEP	Compulsory Education Program	MOH	Ministry of Health
CFY	China Financial Yearbook (MOF)	MOLSS	Ministry of Labor and Social Security
CMA	Central Meteorological Administration	MOST	Ministry of Science and Technology
CSO	Civil Society Organizations	MWR	Ministry of Water Resources
CSY	China Statistical Yearbook (NBS)	NBS	National Bureau of Statistics
CT	Consumption Tax	NCMS	New Cooperative Medical Scheme
DFID	Department for International Development	NDRC	National Development and Reform Commission
DRC	Development Research Center of the State Council	NPL	Non-Performing Loans
EIT	Enterprise Income Tax	NSC	New Socialist Countryside
FDF	Fiscal Development (Poverty Alleviation) Funds	PBC	People's Bank of China
FFW	Food-for-Work	PIT	Personal Income Tax
FPC	"Fiscally poor" county	PSE	Producer Support Estimate
GIS	Geographic Information System	PSU	Public Services Unit
GPT	general-purpose transfers	RCC	Rural Credit Cooperative
GTZ	Gesellschaft für Technische Zusammenarbeit	RCF	Rural Cooperative Foundation
Ha	Hectare	RFR	Rural Fee Reform
HHS	(US) Department of Health and Human Services	RMB	Renminbi
IFS	Intergovernmental Fiscal System	RTFR	Rural Tax and Fee Reform
IIT	Individual Income Tax	SAT	State Administration of Taxation
ICT	Information and Communication Technology	SCPSR	State Commission on Public Sector Reform
KWC	Key Working County	SFA	State Forestry Administration
		SGA	State Grain Administration
		SOCAD	State Office of CAD
		SPT	Specific-purpose transfers
		TCC	Technical Cooperation Credit
		TEOS	"two exemptions and one subsidy"
		TSS	Tax Sharing System
		TVE	Township and Village Enterprise
		UMCT	Urban Maintenance and Construction Tax
		VAT	Value-added Tax

Glossary of Chinese Terms

村	<i>cun</i>	village
村民委员会	<i>cunmin weiyuanhui</i>	village committee
村民小组	<i>cunmin xiaozu</i>	village groups
村长	<i>cun zhang</i>	village head
村支书	<i>cun zhi shu</i>	village party secretary
党政办公室	<i>dangzheng bangongshi</i>	“the office of the Party and the government”
低保	<i>dibao</i>	minimum living standard
费改税	<i>feigaishui</i>	Rural Fee Reform or Tax-for-Fee Reform
户口	<i>hukou</i>	household registration system
核定	<i>heding</i>	“fixing”
机构编制委员会	<i>jigou bianzhi weiyuanhui</i>	post establishment committee
机构编制办公室	<i>jigou bianzhi bangongshi</i>	post establishment general office
集资	<i>jizi</i>	special assessments on farmers
可支配收入	<i>kezhi peicaili</i>	disposable funds
七站八所	<i>qizhan basuo</i>	“seven stations and eight offices”
三定	<i>sanding</i>	“three fixes” (functions of official posts)
三定方案	<i>sanding fang'an</i>	“three fixes plan”
三农问题	<i>sannong wenti</i>	issues related to farmers, agriculture, and rural development
事业单位	<i>shiye danwei</i>	public services unit
特困	<i>tekun</i>	very poor household
提留	<i>tiliu</i>	(three) regular fee assessments (to villages)
统筹	<i>tongchou</i>	(five) regular fee assessments (to township)
五保户	<i>wubaohu</i>	“Five Guaranteed” households
县	<i>xian</i>	county
乡	<i>xiang</i>	township
县级	<i>xianji</i>	county-level
县乡财政体制	<i>xianxiang caizheng tizhi</i>	“county-township fiscal system”
小康社会	<i>xiaokang shehui</i>	“moderately well-off society”
小组	<i>xiaozu</i>	natural village or village group
行政村	<i>(xingzheng) cun</i>	administrative village
系统	<i>xitong</i>	‘systems’
一办三中心	<i>yiban sanzongxin</i>	“one office and three or four centers”.
一事一议	<i>yishi yiyi</i>	“one (village) assembly for one affair”
以县为主	<i>yixian weizhu</i>	reform reassigning teacher salary to county level
杂费	<i>zafei</i>	miscellaneous (education) fees
镇	<i>zhen</i>	town
中央机构编制委员会	<i>zhongyang jigou bianzhi weiyuanhui</i>	State Commission on Public Sector Reform
专项补贴	<i>zhuangxiang butie</i>	earmarked transfers
转移支付	<i>zhuanyizhifu</i>	transfer
自然村	<i>zirancun</i>	natural village

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Annexes

Annex 1: Case Study, Shuangliu County, Sichuan

This case study looks at public finance in one of the richest counties in western China, both in terms of GDP and fiscal capacity. It has a population of almost 900,000 and a total area of more than 1,000 square km. The county has 24 towns and 2 townships, with more than 450 administrative villages.

Annex 2: Case Study, Ninglang County, Yunnan

This case study looks at public finance in one of China's poorest counties in terms of GDP or rural net income per capita. Ninglang is a mountainous county with a total area of more than 6,000 square km. It has a small population of less than 250,000 people, many of whom are from ethnic minorities. The county has 16 townships and close to 100 administrative villages.

Annex 3: Case Study, Huaxian County, Henan

This case study looks at public finance in a typical agriculture-dominated county. Huaxian is located in the dry, Yellow River watershed of Henan province. It is classified as one of the key national counties for poverty reduction. Its total population is more than 1 million; the total area is close to 2,000 square km. The county has 9 towns and 13 townships, and more than 1,000 administrative villages.

Annex 4: Institutional and Personnel Issues: The Case of Huaxian

This includes a report produced from our field visit to Huaxian that focuses specifically on the institutional and personnel aspects of the county. It includes additional information and analysis on the situation in the respective municipality (Anyang City) in Henan.

Annex 5: Village Finance

A comprehensive survey focusing on governance and public finance in villages and townships was conducted in a total of about 100 villages and 50 townships of 25 counties in the five provinces of Jilin, Hebei, Shanxi, Sichuan, and Jiangsu. The survey also included a survey of 1,200 households and other elements. This annex looks at the village finance part of the survey.

Annex 6: Fiscal Reform and the Role of the Township

This annex is based on the same survey as that in Annex 5 and focuses on the public finance situation in the 50 townships, including their relationships with the counties.

Executive Summary

This report aims to assist the government in improving implementation of the NSC program, especially in raising the effectiveness of public expenditures, and the harmonization of public finance. While this report pays particular attention to rural aspects of public finance, it addresses this topic within the overall framework of intergovernmental finance that impacts both rural and urban areas. Similarly, the discussions and recommendations in this report are intended to move the system towards one that is harmonized and does not differentiate between ‘rural’ and ‘urban’ areas. This objective of the central government is fully supported by this report. It is undertaken as part of a wider effort by the World Bank to assist the government in reforming public expenditure management and fiscal policy, which over the past few years has included “China – Managing Public Expenditures for Better Results” (World Bank 2000), “China – National Development and Sub-National Finance” (World Bank 2002), “China – Deepening Public Service Unit Reform to Improve Service Delivery” (World Bank 2005c), “Reforming Subnational Finance: Lessons from Northeast China” (World Bank 2006a), and “Meeting China’s Rural Health Challenges” (World Bank 2006b).

Key Findings¹

Central Government spending on rural development has increased sharply. However, as the many reforms and new programs introduced over the past few years have cascaded down to the grassroots, i.e. county, township and village levels, in rapid succession, it is often difficult to sort out their effects. Some of the effects are contradictory. For example, the Rural Tax and Fee Reform² has greatly reduced farmers’ burdens, but it has also reduced fiscal resources at the grassroots levels that may be affecting the delivery of services, such as the routine maintenance of infrastructure, such as roads, schools, and water systems.

New programs have increased expenditure needs. The costs of many of these new programs are shared between central and local governments. For example, the program to improve rural roads has brought increased central spending, but has imposed counterpart funding requirements that have increased the burdens on the lowest levels – townships and even villages. The NCMS, the new rural social welfare programs, and the latest program to provide free rural basic education all impose new expenditure responsibilities, including on local governments. This has enlarged the gap between local own revenues and expenditures and puts more pressure on transfers.

The growth in overall transfers has also increased earmarked grants, each with its own purpose, targeting, and implementation mechanisms. These earmarked funds provide much-needed funding for local Governments. At the same time, they also increase the administrative burden on grassroots governments.

Regional disparities in per capita fiscal expenditures (and by implication, the provision of services) are very large across rural governments. Among the 2,800 county-level jurisdictions, in 2003 the richest spent 48 times as much as the poorest – a gap that is unusually large compared to that in other countries.

¹ The empirical work for this study comprises fieldwork in four provinces (Sichuan, Yunnan, Henan, and Jiangxi), and two surveys at the township and village levels.

² The term “Rural Tax and Fee Reforms” is used in this report to refer to the combination of the reform that abolished rural fees and later abolished agricultural taxes.

1. This indicates that more resources will be needed, as the government's recent efforts have fallen short. Since the late 1990s the government has introduced many new transfer programs targeted at the poor regions, and the overall amount of "fiscal capacity" transfers has grown rapidly. Even so, these transfers have done little to ameliorate the large disparities in fiscal resources across localities. The efforts to equalize fiscal resources through transfers are insufficient to offset the continuing growth in income disparities under the market reforms.
2. Whether and how counties and townships are benefiting from the new policies and reforms appears to vary widely across regions. Since the counties and townships sit at the bottom of the administrative structure and the intermediate levels interpret policies and control the allocation of resources to the lower levels, they face differing arrangements from the various provinces and municipalities. For example, under the reform to extend tax sharing arrangements to the sub-provincial levels, some provinces (e.g., Jiangsu and Henan) are devolving revenues to lower levels, while others (e.g., Liaoning and Heilongjiang) are centralizing revenues to the provincial level (World Bank 2006a). Even within a single province, the treatment can vary across municipalities, as found in Anshan, Panjin, and Yingkou in Liaoning province, for example (Chapter 3). Indeed, whenever there is a "local" counterpart funding requirement – for the NCMS or free rural education, for example – counties and townships sit at the end of the decision chain in terms of negotiating how to share financing of the local portion, and can only hope for the goodwill of the higher levels.

Although increased transfers have allowed for more public spending, they have also increased the complexity of financial management at the local level. By conventional measures (though not by the Chinese official definition), specific-purpose transfers account for three-quarters of total transfers net of tax rebates.³ As transfers are funding more than half of the budgetary spending of county and township governments, this trend is exacerbating the lack of local budget autonomy, with negative consequences for budget allocation. Also, budget discipline has not improved. Evidence such as the emergence of new fees via the creation of "project entities," land sales, evidence of significant local debt, and persistent overstaffing raises serious questions about the sustainability of the reforms and the Central Government's approach that relies heavily on an increase of (mostly earmarked) transfers to address issues in rural development.

Increasingly, it is seen that more funding solves only one part of the problem. Another, and equally formidable, obstacle to improving rural public finance is the inefficiency of many local governments. In fact, the low quality of services observed in Henan and Yunnan can in part be attributed to local governments' allocative decisions that were unfavorable to their rural users/citizens. For example, the field visits found that some rural schools that had no money for heating or electric lighting had so many teachers that on average each teacher taught only twelve hours per week. In the same vein, agricultural extension services, police stations, and even emergency medical services were often spending nearly all of their budgetary appropriations on staff expenditures, leaving little or no funding for the vehicles or fuel needed to take them to the field. These allocative decisions can be traced to the distorted incentives

³ A conventional measure of "specific-purpose transfers" would include earmarked transfers, earmarked transfers from state bonds, wage increase transfers, and final account subsidies. See Chapter 4.

created by the current system of budgeting, which uses staff numbers as the basis for calculating expenditure needs for local governments (and hence for the determination of transfers). This budgeting practice runs counter to government efforts to downsize public employment. In poorer regions the incentive to expand staff size is further reinforced by the system of nationally unified civil service wage-setting, which makes remuneration in public employment extremely attractive compared to local incomes. The weakness of mechanisms for holding local officials accountable for performance on service delivery means that there are few incentives for local governments to resist expansion of staff.

Recommendations

Building the NSC presents formidable challenges. Given the enormous gap that exists between urban and rural areas, and given the huge size of the rural population, the amount of resources required to bridge the gap will be immense. The first challenge therefore is to balance the social objectives for equalization against financial considerations of affordability in defining acceptable standards, e.g., defined as minimum public service standards for all – including the poorer rural population. The second challenge is to improve the transmission of resources and enact new policies through China’s highly decentralized, five-tiered administrative system, where resources have to travel through four intermediate layers of government and agencies before reaching the intended recipients. Improving the efficiency and responsiveness of the service providers presents another set of challenges to create incentives and accountability mechanisms.

Rural governments at the county (and township) levels are the key agents in implementing rural policies. Under China’s highly decentralized fiscal and administrative system, all of the vital social support and nearly all public services are provided by governments at the grassroots levels, including education, health, social welfare, agricultural extension, and most infrastructural services. In the past, counties and townships were the weak link that hindered the achievement of some priority programs on the national agenda, such as the nine years of basic education for all (World Bank 2002). Implementation of the NSC program will require strengthening the capacity of rural governments and improving their incentives to deliver. This requires stronger participation by citizens; more transparency and monitoring from both, citizens and higher-level governments; and a better alignment of fiscal and personnel decisions with the priorities of the NSC.

Adhering to the spirit of building the NSC requires a much greater redistribution of resources to the countryside, and more efforts to reduce inter-jurisdictional disparities. A successful program of equalization should begin by defining clear objectives and specific goals to be accomplished, be they the equalization of fiscal revenues, expenditures, or services. In the past year the government has moved toward specifying some minimum service standards – for example, in announcing the goal of providing free basic education for all rural children. Formulating a list of such goals for the NSC would create a precondition for developing specific programs and making arrangements for financing. This list would presumably include minimum standards for clean water, sanitation, rural roads, schooling, health care, and social relief – most of which are already covered by existing government programs.

Before this background, the report stresses the need for a comprehensive reform strategy of the rural public finance system. Such strategy should be implemented “gradually with purpose”, and the Central Government needs to play a strong role in coordinating and leading the

implementation of the reforms and programs. Decentralization of reform initiatives has produced some outstanding results in the past, whereby provinces piloted reform initiatives (such as Anhui in leading the Rural Fee Reform) that were later adopted for nationwide rollout. It is clear that given the size of the country and the diversity of the rural areas, including the capacity of local rural governments, China should not pursue a uniform strategy for all. Central and provincial governments should continue and possibly strengthen the diversity of arrangements with which they manage the relationships with lower levels. However, the Central Government needs to ensure the completeness of the reform at all levels. How national policies are transmitted through the intermediate levels has a direct impact on outcomes. The current system of decentralized management of reforms – whereby provinces choose the design of the reform measures for the prefectures, prefectures choose the design for the counties, etc. – poses significant risks to effective implementation. For example, as the Rural Tax and Fee Reform and agricultural tax reforms are drastically changing revenue shares across tiers of rural government, a policy that permits the county to define the terms of the new revenue sharing with the townships under the “completing the Tax Sharing System reform” program may be opening the door to replicating the past problems of higher levels grabbing revenues and pushing down fiscal deficits. There is growing evidence from the implementation of the NCMS that leaving the design of the schemes to the counties in some cases has allowed financial considerations to dominate over the objectives of providing risk coverage to the schemes’ participants. In such cases, central intervention should be designed to safeguard the interests of the intended beneficiaries of the reforms. One option for doing this is to create an oversight body tasked with vetting the reform designs of local governments to ensure compliance with the original reform objectives. This body could also be assigned responsibility for monitoring and evaluating reforms and assisting in enforcement of reform implementation.

This report makes the following key recommendations for the comprehensive reform strategy:

Rebalance expenditure assignments

A rebalancing of the fiscal system is essential to achieve the fundamental changes envisioned under the NSC. This will require some combination of expenditure reassignments, assigning new own sources of revenue for rural governments, a restructuring of intergovernmental transfers, and establishing a framework for responsible borrowing.

Clarifying expenditure assignments. Implementation of new and existing programs would benefit from a clearer assignment of responsibilities. At present many programs are not implemented, or implemented only partially or inefficiently, because too much murkiness exists regarding which level of “local” government is responsible. The absence of a clear assignment of responsibility is problematic in a number of ways:

- It can lead to overlapping responsibilities, to unfunded mandates that are pushed down to the lower levels of local government, or to the underprovision of essential public services. Implementation of the “two exemptions and one subsidy” program for rural education during 2003-2005 provides a good example of the resulting problems (see Box 1).
- It leaves the expenditure needs of the various levels of governments undefined. Without clearly defined expenditure needs, it is difficult to define an effective system of

intergovernmental transfers, as it is unclear how much a local government needs in order to implement national policies.

- It undermines the accountability of local governments, as neither their constituents, nor their supervising governments know what to expect in terms of service delivery from that level of government.

Box 1. Implementation of “Two Exemptions and One Subsidy” in Southwest China

The “two exemptions and one subsidy” (TEOS) is a program of student assistance that was first introduced in 2003. The program was aimed at reducing the out-of-pocket costs of basic education for students from poor families, by relieving them of the costs of textbooks and miscellaneous fees and by providing subsidies for boarding. It marked a new approach by the government to keep children from staying out of school because of family financial difficulties. In 2005 the Central Government provided some RMB 7 billion to cover an estimated 34 million students in the middle and western provinces.

As is typical for earmarked grants programs, the TEOS requires joint financing from subnational governments. Under the program, the Central Government provides a standard subsidy to cover textbooks (RMB 70 per annum for primary school students and RMB 140 per annum for middle school students). In order to obtain the textbook subsidy (the first exemption), the Central Government requires that the provinces commit to providing subsidies to defray the “miscellaneous fees” (*zafei*) to the same students (the second exemption), along with a subsidy for boarding students (the one subsidy). The program leaves it to the provinces to organize sharing the costs of the *zafei* and the boarding subsidy among the provincial, prefectural, and county levels.

Visits to rural schools in three counties in the Southwest in 2005 found both the coverage (share of students) and the level of subsidies to be far below program guidelines, and the financial assistance short of committed levels. In nearly all cases, students were receiving only partial exemptions from textbooks, and none of the primary schools were providing any exemptions from the *zafei*. In implementation, the program appeared to have shrunk from “two exemptions, one subsidy” to “half-an-exemption, no subsidy.”

Starting in 2006, the Central Government initiated a Rural Compulsory Education Fee Guarantee System Reform to ensure that the 9-year Rural Compulsory Education program be fully implemented. The 4 basic components of this reform are, first, to exempt all the miscellaneous fees and relieve the costs of textbooks and provide boarding subsidies for poor students; second, to enhance the level of guarantee for public expenditure of primary and middle school; third, to establish a long term mechanism for the school facility maintenance and improvement; and, forth, is to strengthen the guarantee for rural teacher’s salaries.

The principle of this initiative is to clearly define the responsibilities of various levels, share cost between central and local governments, increase fiscal investment, heighten the level of guarantee, and implement in a programmatic approach. It aims to incorporate the rural compulsory education into the coverage of public finance and gradually establish the cost-sharing fee guarantee system. To materialize this reform, the Government will increase funds accumulated to about 218.2 billion during the period of 2006 to 2010, among which RMB 125.8 billion yuan from the Central Government and RMB 92.4 billion yuan from local governments.

Source: DFID Southwest Basic Education Project and MOF.

Some recentralization of responsibilities may need to be considered. As the urbanization process and out-migration continues, rural governments at the county and township levels are facing increasing burdens for the provision of income maintenance responsibilities (e.g., pensions, disability, and welfare support for farmers who have lost their land). In most countries these are the responsibilities of the Central Government, and in China they are, in most cases, beyond the financing capacity of the rural governments. Financial responsibilities for providing basic education are also often beyond the fiscal capacities of the rural governments under the current system of revenue assignments in China. In most countries these costs are factored into considerations of expenditure needs in grant schemes. With the introduction of the program to provide free rural education, China essentially is moving toward this model. A more systematic review of all major rural government responsibilities should be undertaken to reconsider assignments in light of revenue and administrative capacities.

Defining the boundaries of authorities/functions for every level of subnational government is long overdue, especially in rural areas where the government's role is evolving rapidly. In many unitary countries, the Central Government determines by law what types of activities local governments can engage in through a positive list of functions. The Central Government may also specify a list of obligatory functions that a local government *must* perform to ensure that fiscal resources are directed toward tasks that are considered national priorities. In some countries, local governments are granted a wide range of autonomy (“general competence”). In China, where local governments enjoy a high degree of *de facto* autonomy, specifying a list of obligatory functions could be a first step toward helping to direct resources toward national priorities, such as those defined under building the NSC. This should be done for each of the four levels of local government. It could also help reduce the continued engagement of many rural governments in providing basically private, tradable goods.

Rebalance revenue assignments

China should consider devolving more revenue sources to local government. Currently China is an outlier compared to other countries in terms of its heavy reliance on transfers. In a sample of developing countries, Bahl and Wallace (2004) found that on average transfers fund nearly half of all subnational expenditures, similar to the level in China. However, these transfers absorb only 24 percent of central revenues, and 3 percent of GDP – compared to around 70 percent and more than 7 percent, respectively, in China. Shifting the balance toward assigning more “own” revenues to local governments is likely to bring improvements in the use of funds in China. Other countries have found that “spending other people’s money” generally does not encourage frugal financial management.

One opportunity for increasing local own revenues is by raising the rates of natural resources taxation. Many of China’s scarce resources (including water, energy, and land) are located in the poor regions, whereas most of the consumers of these resources are located in the rich regions. Taxing these scarce resources by means of higher resource taxes – which accrue mostly to local governments – might be good for a more efficient use of these resources and could also help to reduce some of the current fiscal disparities. However, implementation has to take into account the specificities of the resource and localities as these might tend to overuse natural resources, to the detriment of their citizens and the nation.

Other means of rebuilding revenue-raising capacities at the grassroots levels should be

explored. In most countries, local governments rely on a mix of local taxes, user charges, and transfers to finance services. In China, rural citizens are still paying substantial fees for public services, such as contributions for infrastructure investments, education, or public health, but many of these contributions are questionable in terms of their impact on fairness and efficiency. A careful transition from the existing fees toward reasonable taxes and user charges could ensure increased revenues. In the current climate, however, this might be perceived to run counter to the objective of reducing the “farmers’ burden.” It is therefore of the utmost importance to clearly differentiate between an illegal or “unjust” fee and user charges and taxes that are closely linked to a fairer and more efficient system with better service delivery.

A further element for improving local revenue is the creation of a responsible system for local borrowing, so that local governments can pay for lumpy capital investments. Allowing local borrowing, at least by some government levels, will – if implemented together with strong accountability mechanisms – also improve transparency and reduce the risk of excessive “illegal” borrowing that some local governments seem to practice today.

Revenues from land transactions should be included in local fiscal revenues, and the creation of an administrative infrastructure for a land market should be a priority in the next stage of reforms. Land is one of the main assets in the rural areas, and land-related revenues already account for a large part of local government financing in many localities. However, most of these revenues are off-budget and non-transparent, and there are substantial inefficiencies in the land administration system. The lack of a well-functioning land market also poses an obstacle to developing a property tax for rural land. Strengthening the land administration system should be very high on the political agenda for many reasons stemming from social, economic, and environmental concerns. However, even when looking at the issue only from a public finance perspective, an improvement in land administration seems to be an investment with one of the highest returns.⁴

Improve fiscal transfers

Much more effective use could be made of central transfers. Currently the Central Government spends 70 percent of its revenues on transfers, and could reap huge potential benefits by making them more effective in achieving national objectives. Aside from strengthening the focus on equalization, improving the system of transfers will likely require reducing the share devoted to earmarked grants, as well as rationalizing and streamlining the existing programs of earmarked grants. Earmarked grants can play an important role in disseminating innovations and in ensuring the appropriate provision of public services by persuading or enabling local governments to provide particular services. However, they have some well-known limitations.

First, the use of earmarked grants goes against the principle that local governments are better at judging what is needed at the local level. For example, recent surveys of rural households have found that investments financed by Central Government earmarked grants for rural infrastructure yield less satisfaction than those from local investments (Zhang et al., forthcoming).

⁴ The government has been working, with support from the World Bank, on reform options and is supporting a pilot program in Anhui province. Further testing and the roll-out of successful models should be a strong priority for the government at all levels, including the Ministry of Finance and the Finance Bureaus.

Second, earmarked transfers have long been criticized in China for their fragmentation of funding, duplication, and poor coordination. These problems have grown worse with the recent proliferation of grant types, all managed by separate line ministries and agencies. Since coordination among line agencies is typically weak, overlapping coverage and duplication are almost inevitable, especially in rural development. In auditing the 2004 budget implementation, for example, the Auditor General's Office found 124 county and road projects had won funding inappropriately from multiple central transfer programs.⁵

A system of broad conditional block grants for the main functions defined by the goals of building the NSC (e.g., basic education, rural infrastructure, and public health), with equalizing dimensions and conditional on performance, could be a good alternative and an intermediate step toward reducing the role of earmarked transfers. This would maintain the 'earmarking' for priority sectors and areas, but move the conditionality from one focusing on specific input to outputs. Testing this approach might be better than a too great multitude of *ad hoc* earmarked grants, but would be short of a single unconditional equalizing grant that is inadvisable before a better specified system of expenditure responsibilities and accountability is in place. In order to ensure compliance, it would require the building of a reliable and transparent monitoring and evaluation system.

Strengthen administrative capacity

The reforms must go beyond the fiscal system and include wider administrative and other institutional reforms. The design of the RFR fully realizes the complementarity of fiscal and administrative reforms. However, while the fiscal elements of the reform were implemented rapidly, the institutional elements will require more time and effort. It is crucial that these associated reforms be carried out in order to sustain the "burden reduction" gains of the RFR.

There is a need for better horizontal coordination mechanisms across central and other levels of government. Currently, ministries and other agencies responsible for various aspects of rural development are highly fragmented and overall coordination among them is weak. Moreover, the shift from policies focusing on agriculture or other sectors to a more comprehensive policy of a NSC strongly increases the need for improved coordination. This paradigm shift from sectoral to more comprehensive rural development policies has taken place in many developed countries and China might look for ideas in the coordinating institutions of these countries.

Substantial improvements can be made through improved capacity at the local level. The central level needs to lead the reform strategy and its implementation and should support the strengthening of the capacity of local governments through training and fostering an exchange of knowledge across counties. Local governments will also have to increase their coordination mechanisms -- within local government, especially at the province and county levels; between local governments in order to enhance capacity-building across jurisdictions and to overcome spill-over effects; and between local governments and other stakeholders, in particular citizens as well as the private sector and Civil Society Organizations.

Improved accountability in line with the broadened national policy objectives requires significant improvement of information flow, including monitoring of public service outcomes. Inevitably, it will be more difficult for the Central Government to know if local

⁵ Report of the Office of the Auditor General, March 29, 2006.

government is doing a good job of meeting these multiple objectives and to use that information in staffing and financing decisions. Consequently, there is a strong need to adjust monitoring toward new objectives, improve evaluation, and increase transparency and information flow. The reliability of data requires more independence in monitoring of implementing government levels or implementing agencies. The stronger involvement of citizens including through citizens' scorecards or more publicizing of data can significantly contribute to this aim.

Create an information system for managing decentralization and reform. The transition from a centrally planned economy to a decentralized, market-oriented economy requires a shift in the collection and reporting of information that policymakers need for policy decisions. In China the system of statistical reporting has not made sufficient changes to meet the new requirements, and at present it is inadequate to support policymaking, especially for the rural sector. For example, it is currently not possible to fully identify what government spends on the rural sector. The new category of *sannong* spending represents an effort by the Central Government to track what it devotes to the rural sector, but it is very much a work in progress. The statistical system also provides very limited information on service delivery at subnational levels. When such information is available, it is not disaggregated between the rural and urban sectors. Estimates are increasingly difficult to make from regional totals because of the commingling of urban units in what used to be more purely rural categories of counties and townships. As a result, the extent of the inadequacy of rural services in the poor regions can only be glimpsed through anecdotal reports and field visits, which are necessarily limited in scope and coverage. In the medium to long run, building a good system to provide up-to-date information on rural development will be critical to underpinning all the recommended changes in the implementation of the NSC – to report on progress, enforce accountability, monitor programs, and evaluate performance, etc. The stronger involvement of the citizens that are the ultimate beneficiaries of the public services would increase the reliability of the data.

Enforce accountability of local Governments. Without accountability, more equalization of spending to poorer localities could well lead to a higher waste of resources rather than to better service delivery. As noted earlier, clearly defining goals and assigning clear responsibilities are preconditions for enforcing accountability at the local level. In China's highly decentralized system, a key issue is the accountability of local governments to the Central Government. There are two main instruments to hold local governments and government officials accountable. One is through the fiscal system, and making fiscal transfers dependent on local government performance is a strong incentive. Another important instrument of this accountability is the personnel system including the evaluation criteria for local officials.

Improving the effectiveness of public expenditures will require changes to the personnel system. Personnel and public finance are closely interlinked, in particular at the local government level where personnel costs make up nearly 70 percent of government spending (World Bank 2006a). Moreover, a personnel system that gives local governments more control over recruitment and remuneration is a precondition to making them accountable for performance.

- Efforts should be strengthened to realign the performance evaluations of government officials, in particular those at the top of local rural government, with the multi-dimensional objectives of a *xiaokang* society, including the building of a NSC.

- The post establishment system as currently in operation should be reformed to give the MOF and Finance Bureaus greater authority in determining the size and cost of the civil service.
- Greater use should be made of flexible, non-civil service terms of service, especially for employees of public service units.
- The national unified civil service compensation system should be gradually replaced by a decentralized system that is sensitive to local conditions. The Central Government should lay down pay principles and guidelines, but allow local jurisdictions to set their own pay levels.
- Steps should be taken to ensure that only those who go through the open, competitive system should be hired as civil servants.

Strengthen Grassroots Level, including Communities

Careful consideration is needed for the assignment of responsibilities for the NSC among the county, township, and village. The RTFR has hollowed out finances at the township and village levels, as part of an ongoing process of reassigning functions from the township (and village) levels to the county. This is a massive task, and one fraught with considerable risk to service delivery as well as to budget discipline, if not done together with a careful mapping of responsibilities and expenditure needs. Empirical studies should be carried out to assess whether the county is the best level for managing and delivering many vital services previously undertaken at lower levels. The answers will likely vary across the country, depending on population density and accessibility to transport.

Particular attention should be paid to villages, i.e., communities, which should be recognized as key for the delivery of many local public goods and services, although this varies widely across regions. The village development plans under the poverty projects are a positive example of how community-level involvement can be increased. Such processes can be further strengthened through national and international experience in community participation. They are fully consistent with the NSC program, which calls for promoting democratic management, and therefore could be rolled out throughout the countries. But there are also other ways of strengthening the involvement of citizens in public service delivery, e.g., through other “communities” such as water user associations or through stronger private engagement in service delivery. A very crucial role communities and citizens can play in the provision of public services is by their active involvement in their monitoring and evaluation and the feedback mechanisms this entails for the government.

Rural public finance has undergone fundamental changes, and many more reforms are under way. Substantial progress has been made, including the reduction of farmer burden and more fiscal resources for rural development. Still, great challenges lie ahead. Given China’s rapid development and the still widening rural-urban disparities, the rural public finance system needs to undergo further fundamental changes to adequately support the building of the NSC.

Chapter 1. Introduction

1.1. Rationale

China's rural policies are in flux. Over the past few years, the government has increased its focus on rural development. Premier Wen Jiabao's repeated calls for attention to the "*sannong*" issues, i.e., problems related to agriculture, farmers, and rural society, have been high on the government's agenda.⁶ In line with this new focus, the government has significantly increased resources allocated to the rural sector, and introduced many new programs. Beginning with the Rural Tax and Fee Reform in 2000, the government has also implemented a number of reforms aimed at improving the fiscal health of rural governments and alleviating farmers' burdens.

The government has announced that its long-term goal is to build a *xiaokang* (well-off) society⁷ in "an all-round way." The 16th Party Congress defined the objective of a *xiaokang* society – to be reached by 2020 – to include social, environmental, equality, and other objectives -- in addition to income and economic growth.⁸ This comprehensive view of the country's long-term goal has strong implications for its path of development. As stated by Premier Wen Jiabao (2004), it involves "putting people first," and promoting reform and innovation in accordance with the "five balances" — balancing urban and rural development, balancing development among regions, balancing economic and social development, balancing man and nature, and balancing domestic development and opening wider to the outside world. The focus on addressing the rising income gap received a further boost when the Party's Central Committee devoted its October 2006 plenary session to social issues and approved the "Resolutions of the CPC Central Committee on Major Issues Regarding the Building of a Harmonious Socialist Society."⁹

As part of the strategy to reach a *xiaokang* society, the "building of a NSC is a top priority of the government of China for its Eleventh Five Year Plan period. In his speech to the National People's Congress in March 2006, Premier Wen Jiabao (2006) referred to the building a NSC as a "major historic task" and emphasized that it "will have an overall impact on building a moderately prosperous society in all respects and modernizing the country."¹⁰ The target and

⁶ The key policy objectives related to the *sannong wenti* include increasing agricultural productivity and maintaining food security, raising farmers' incomes, reducing poverty, and improving environmental sustainability.

⁷ The term *xiaokang* society refers to a well-off society in which all people can lead a fairly comfortable life. The term was first used by Deng Xiaoping when reform and opening up were launched in the late 1970s. Deng defined *xiaokang* with reference to a target per capita GDP of US\$800 by 2000. Because of China's rapid economic growth, a *xiaokang* society as defined by Deng was roughly achieved by the end of the last century.

⁸ Areas of a *xiaokang* society set by the Party include, in addition to the GDP per capita growth target (US\$3,000 by 2020), improving democracy; advancing science and education; enriching culture; fostering social harmony; and upgrading the texture of the life of the people. See Jiang Zemin, *Report at 16th National Congress of the Communist Party of China*, November 17, 2002. Many attempts have been made to further specify a *xiaokang* society, and develop indicators and targets for its monitoring. See, for example, China Statistics Press (1999, Appendix 1); UN Country Team in China (2004); Li and Zhu (2003).

⁹ *China Daily*, October 12, 2006.

¹⁰ Earlier, Premier Wen had already stated that "Solving the *sannong* issues remain the top priority work (*zhongzhong zhizhong*) for the whole Party" and he stressed the guiding principle of "industry feeding (*fanpu*) agriculture," and cities supporting rural villages. Wen Jiabao's Explanations on the CCP Suggestions on the Eleventh Five Year Plan on National Economic and Social Development (October 8, 2005). See Xinhua News Agency, October 19, 2005.

requirements of building a NSC can be summarized as to develop production, raise living standards, (create) a cultured rural environment, (ensure) tidy and clean villages, and (institute) democratic management.¹¹ These goals encompass requirements for economic, political, cultural, and social changes that can be described as the promotion of modern agriculture; the deepening of comprehensive reforms initiated by the RFR, including in areas of township organizations, rural basic education, rural public finance, financial systems, land procurement, etc.; further development of rural public services; and finding ways to raise rural incomes.

The call for “building a NSC” further underscores the government’s strategy to reverse the trend of increasing rural-urban inequalities and to reduce poverty. Income inequality in China between rural and urban areas has increased (see Box 2) and China is now at a point in its transition period whereby the trend of rising inequality should be reversed with further growth and development. This is a strong rationale for the Government’s emphasis on addressing inequity, i.e. inequalities in opportunities, through improved public services in rural areas. Experiences from many Asian countries underline this trend and give confidence that inequalities will decrease as the transition process matures.

Box 2. Rural-Urban Inequality and Inequity

While China has achieved great economic success since its reform starting in the late 1970s, development between rural and urban areas as well as between different regions has been uneven. Absolute inequalities have increased significantly between and within both urban and rural areas (Ravallion and Chen 2004). Rural and urban areas show multi-dimensional inequalities in income, wealth, human development, and public service delivery.

Income inequality. Rural-urban income inequality decreased in some earlier phases of the transition process, but has increased lately. In 2005, the ratio of disposable income of urban households to net income of rural households was 3.22 (see Appendix 9 Table 1).

Inequality in wealth. According to surveys conducted by the Chinese Academy of Social Sciences (CASS), the national growth rate of wealth between 1995 and 2003 exceeded that of GDP and income per capita. However, the accumulation of wealth in urban areas was almost ten times that in rural areas, and a key component of the overall inequality (see Appendix 9 Table 2).

Inequality in the Human Development Index. Human development in rural and urban areas shows distinct differences. The Human Development Index estimated by the UNDP (2005) for 2003 was 0.81 for urban areas and only 0.67 for rural areas. This reflects inequality in many respects. For example, life expectancy in urban areas was 75.2 versus 69.6 in rural areas (2000 Census Data). Levels of education are also very different. The share of the population without a formal education among 15 to 64 year olds was 2.5 percent in urban areas and 8.7 percent in rural areas (2000 Census Data).

Inequality in public service delivery. Much of the inequality in the Human Development Index reflects inequality in public services. These show large disparities in terms of funding, access, quality, and, hence, output between rural and urban areas. For example, education

¹¹ In Chinese this is summed up in twenty characters: 生产发展 生活宽裕 乡风文明 村容整洁 管理民主. A good summary of the history and policy trends and priorities for building a “new socialist countryside” are provided by Minister of Finance Jin Renqing (2006).

operating expenses in urban districts are 3 times greater than that in rural communities; also, in 2003 health expenses in urban areas were almost 3 times that in rural areas (UNDP 2005). In terms of access to services, the 431 counties which did not reach the 9 year compulsory education target in 2003 were all remote rural counties. In terms of health services, the official numbers reported by MOH (2004) for the year 2002 were 5.2 doctors per 1000 persons in urban areas, but only 2.7 in rural areas. Looking at public services output, the large differences in education level in rural and urban areas might serve as one example (see Appendix 9, Table 3).

This renewed emphasis on rural development is long overdue. Clearly, a strong urbanization strategy and migration from rural to urban areas will play a key role in achieving the objective of a more equitable society. Nevertheless, China cannot achieve this objective without strong emphasis on rural development. A more equitable society in which rural citizens have access to good education, to information, to affordable health services, etc. will greatly facilitate and smooth the migration process. Even under the most rapid urbanization scenarios China will continue to have a very large rural population for many decades to come.¹² The United Nations Population Division projects China's rural population in 2020 to still be about 661 million people and in 2030 571 million people – corresponding to an urbanization rate of 61 percent. Consequently, although demographic projections are crucial in the planning process – especially in local planning – for a country as dynamic as China, long-term investments and reform decisions for rural areas are crucial for improving the living standards of this large share of the population.

Achieving the objective of a *xiaokang* society and a NSC will require substantially increased resources as well as fundamental reforms to revamp a wide range of institutions so as to eliminate their urban biases. Under the commune system, agriculture was to pay to support the industrialization process and the rural grassroots level was supposed to be self-sufficient, including in the provision of basic services such as health and education. This overall picture continued through much of the 1990s. Even as government revenues improved rapidly after the Tax Sharing System (TSS) reform, rural areas were largely excluded. In many localities, the inability of rural governments to finance their responsibilities to provide services in basic education, public health, water, sanitation, etc. meant that many rural citizens received inadequate public services, as reflected in their lower scores on the Human Development Index (World Bank 2002). Increasingly, it became clear that inadequate local public finance was impeding the implementation of key parts of the government's development agenda, such as providing universal basic education and public health (World Bank 2002). In order to implement the NSC program, the intergovernmental fiscal system will have to be reformed to provide rural governments with sufficient resources to finance the added expenditures.

Currently, the rural-urban divide in China is still strong in almost all facets of social and economic life. In particular, factor markets are still deeply divided by institutional barriers, including through *hukou*, i.e., the household registration system, in the case of labor; communal versus state ownership and associated differences in regulations and their enforcement in the case of land; and failing rural financial markets (e.g., for longer-term credit) versus possibly excessive urban investments in the case of capital. The economic reforms that began almost three decades ago have further cemented the differences in how rural and urban areas are governed.

¹² See United Nations Population Division, online data at <http://esa.un.org/unpp>

Given this background, there is a clear need for additional reforms of the public finance system and, specifically, for improved rural development. Fundamental changes are a normal part of a country's transition process. For example, now that China has entered the stage of a middle-income country, the government has announced that the course of the rural sector having financial responsibility for rapid urbanization and industrialization should be reversed. The call for, in Premier Wen Jiabao's words, "extending public finance to provide full coverage to rural villages" as part of the goal of achieving a *xiaokang* society provides a clear direction. The question is how the system can cope most efficiently with these fundamental changes. Numerous past reforms have been bold and in the right direction, but have not added up to an efficient and sustainable public finance system. More analysis and reforms are required.

1.2. Objective and Scope

The objective of this study is to assist the government of China to better implement its NSC program by reforming the rural public finance system. We aim to develop a reform strategy and plan based on a systematic analysis of the current situation. Such a system will provide more effective and efficient government and improved financing and delivery of public services to China's rural citizens, including the poor.

Rural public finance can be defined as that part of the public finance system that is concerned with the taxation and financing of "agriculture, farmers, and rural areas."¹³ In a more narrow sense we look at the financing of local, predominantly rural, governments, including their income through local revenues and expenditures for (local) public goods and services, in particular for rural citizens.¹⁴ A discussion of the definition of "rural" is provided in Box 3.

Box 3. Defining "Rural" in Rural Public Finance

"Rural" is generally referred to as a space with relatively low population density – as opposed to "urban." There are many ways to delineate such a "rural" area, including by land use, by *hukou*, by government administrative unit, or by the socio-economic situation. For the purpose of this study it is most practical to define "rural" in accordance with administrative boundaries.

According to official statistics (end 2005) of the 2,862 county-level regions in China, 1,636 (57 percent) are counties and 374 (13 percent) county-level cities, the others being (urban) districts under the administration of cities. One level below, the number of township-level regions was reported (end 2005) to be about 41,600, of which 16,600 (41 percent) are townships and 19,500 (46 percent) towns, with the remaining units (14 percent) being so-called (urban) street communities. While the township level is regarded as the lowest government level in China, villages have, at least until very recently, important administrative and service functions,

¹³ In its broadest sense this would include many elements that serve both rural and urban citizens, such as basic research or national defense.

¹⁴ For practical reasons of how the statistics – and the administration – are organized, this focuses on the population living in townships and villages. Obviously, it includes some urban population and excludes rural migrants to urban areas.

¹⁵ The 2005 China Statistical Yearbook, using a sample survey, reports for 2004 that about 108 million people, or close to 9 percent of China's population, resided outside the town, township, or sub-district in which they were registered; most of this was due to rural urban migration. Another figure on "rural population" also published by the 2006 Statistical Yearbook (Table 13-3) is 949 million "persons residing and registered in rural areas". In

including welfare relief and old-age support, some support to primary schools, and operation and maintenance of the village-level infrastructure. A total of about 640 thousand village committees exist (end 2005). The number of rural population in China depends on the definition and statistical method, including for migrants with rural *hukou*. Data for 2005 based on the census data shows the total number of “rural Citizens in China was 745 million, or 57 percent (China Statistical Yearbook 2006).¹⁵

Rural public finance is an integral part of the overall intergovernmental fiscal system. A key focus of this report’s recommendation is on how the Central Government can reform the overall system and the incentives it provides to improve rural public finance and therefore service delivery at the grassroots level.

A difficulty in defining the scope of rural public finance – which is reflected in the difficulties faced by this report – is the unclear delineation of public finance. Delineation problems exist, in particular, in the following areas:

First, there are substantial linkages between the fiscal and the financial sectors, including in rural areas. Such linkages exist throughout the world, especially in the area of rural development where many goods and services are neither purely “public” nor purely “private,”¹⁶ and where attempts are made to mitigate weaknesses in rural finance through direct government intervention in the financial market. However, in rural China these problems are particularly pronounced and many of the formal and informal institutional linkages between the fiscal and financial sectors are to the detriment of both the public and the financial sectors. The main problems arise because of government (at least *de facto*) ownership of rural financial institutions and their poor management. This creates contingent liabilities for local governments, as well as for the public institutions’ borrowing from rural financial institutions in an environment that formally forbids local government borrowing. In addition, the government uses financial institutions for policy interventions, many of which are not, or not adequately, compensated. While these issues are described in some detail in Appendix 3, they lie largely out of the scope of this report.

Second, the question of what is or should be part of “public” finance is also evolving. In fact, the delineation between what is public and should be dealt with by the government – with public finance as only one of several instruments – and what is private and should be left to the market is at the center of China’s transition process. Given its importance, the discussion of what is “public” is reflected in many parts of this report. During the period of the planned economy, there basically were no private goods and services. The introduction of the household responsibility system and subsequent reforms resulted in an agricultural sector that was supposed to help industrialization and be “self-sufficient” in terms of its own goods and service requirements. “Public” goods such as health, education, public research, social safety, and village infrastructural services were the responsibility of the communities/village. Currently, they continue to be regarded as the responsibility of the vaguely defined “local” level and, as a result, they are not well covered by public finance. This has led to the “unreasonable” burdens on rural residents through the collection of fees, levies, contributions of corvée labor, and very substantial

contrast to the census-based figure this one is based on *hukou* and the town classification standards of 1964.

¹⁶ For example, agricultural services are a prime example of a wide range from purely public services over toll goods and common pool goods to purely private services.

private contributions to services such as health or education. It has also led to a rising inequality in service provision between rural and urban areas.

The problem of the unclear delineation of rural public finance is compounded by the fact that the definition is blurred and, partly as a consequence, corresponding data are not always consistent, reliable, or available.¹⁷ Therefore, the picture remains incomplete. Nevertheless, by looking at the information available on “*sannong*” public expenditure by the Central Government and other intergovernmental fiscal transfers, a key element in the “vertical” element of rural public finance, and at public finance of counties, townships, and villages, we can draw substantive conclusions on the strengths and weaknesses of the system.

1.3. Methodology and Outline

This report is largely based on substantial work undertaken in cooperation with the Ministry of Finance since 2004. It includes case studies of several counties; surveys at the village and county levels; as well as analyses of statistical information.¹⁸ The World Bank and the Ministry of Finance worked jointly on some of these activities and in parallel on others. Studies commissioned in parallel by the Ministry of Finance include those conducted by Su et al. (2005) and Zhao et al. (2005a, 2005b, 2006).

At the same time, there has been a great deal of other scholarly and official interest in studying the problems of rural finance over the past several years. A number of excellent studies have been completed or are in progress in China, and this report has drawn on these works as well as on international experience. Most importantly, this work was done in parallel, but in close cooperation, with the study “Reforming Subnational Finance: Lessons from Northeast China” (World Bank 2006a). Some of the findings from the latter work have been incorporated into this report and *vice versa*.

The structure of this report is as follows:

Chapter 2 analyzes the considerable number of reform efforts that have been introduced to the rural public finance system. It looks at the RFR in depth, as well as other associated and related reforms and evaluates the overall outcome of these reforms.

Chapter 3 provides an overview of China’s intergovernmental system as the framework for rural public finance. It includes an analysis of the expenditure and revenue assignments and their development, and the impact on rural public finance.

The transfer system, an integral part of the intergovernmental fiscal system, is treated separately in Chapter 4 because of its overwhelming importance for rural public finance. The chapter analyzes how far the transfer system goes in addressing the fiscal imbalances and providing the necessary public funds for rural areas. It also assesses the role of earmarked transfers.

Chapter 5 then looks at the public finance situation at the grassroots level, i.e., the financing of

¹⁷ For statistical sources, see Reference 2: Main Sources of Statistical Information.

¹⁸ See Annexes in Volume II of this report as well as two other unpublished reports: one by Zhou et al. (2005) “Township Finance: Institutions, Indebtedness, and Development.” which is based on a survey of public financing in 16 township in 8 counties of Chongqing, Hunan, Jiangsu, and Jilin; and Wong (2004b) on “Intergovernmental Transfers”, which is based on a field trip to Jiangxi province that looked at the intergovernmental system as a whole, as well as at 4 special purpose transfers related to education, poverty reduction, comprehensive agricultural development, and water-related rural infrastructure.

villages, townships, and counties, including how recent developments have impacted their situation and what remaining issues exist at these levels.

Finally, Chapter 6 summarizes the findings of this study, proposes a strategy for policy reforms, and suggests ideas for its implementation.

Chapter 2. Reforms and their Outcome

The rural sector has been the arena for some of the boldest fiscal reforms in the past few years. Starting with the RFR in 2001, a number of measures have been introduced – the abolition of agricultural taxes, adjustments to the TSS, the *yixian weizhu* reform to move the payment of rural teachers’ salaries to the county level, the fiscal management reform to put provinces directly supervising counties, the “three rewards and one subsidy” program, etc. All of these have aimed at strengthening rural public finance. They reflect a clear recognition by government that rural governments are currently operating under severe financial constraints, and that problems of rural public finance constitute a bottleneck to implementation of the national agenda for building a harmonious, well-off society. This chapter reviews the recent reforms and their impact.

2.1. First Phase RTFR – The Rural Fee Reform

The Rural Tax and Fee Reform (RTFR) is by far the most important reforms affecting rural public finance in recent years. The RTFR includes two phases. The first stage, which started from 2000 and was referred to as the Rural Fee Reform (RFR) or Tax-for-Fee Reform, had at its core a substantial reform of the rural tax and fee system. This was followed, starting from 2004, by the abolishment of agricultural taxes – and promotion of associated institutional reforms. In the following, we will first discuss these two reform phases.

In a speech in April 2000, Vice Premier Wen Jiabao called the RFR one of the most important reforms in the rural sector over the past 50 years, whose impact is comparable to that of the Land Reform in the early 1950s and the return to household farming in the early 1980s.¹⁹ The RFR was first piloted in Anhui province starting from the late 1990s. It was adopted for step-by-step nationwide rollout in 2001, with implementation in most provinces in 2002 and 2003.

In introducing the RFR in 2000, Premier Zhu Rongji explained the reform in this way:

“Promoting the RFR is the fundamental strategy for protecting the legal rights of farmers and reducing their burdens. The basic approach in the RFR is to raise – by an appropriate amount – the existing rates of the agricultural tax and the agricultural special products tax, while abolishing all administrative fees that are levied on farmers, including the unified township levy and the village accumulation levy.”²⁰

The reform began with twin objectives: to reduce the overall fiscal burden on farmers and to impose a more structured framework for financing government at the grassroots levels by bringing previously extra-budgetary revenues and expenditures on budget. These objectives were intertwined: the fact that grassroots governments were financed mostly off-budget prior to the RFR meant that they generally operated free of oversight from higher levels and unrestrained by tax laws. Thus, the RFR was an important component of the nationwide reform of extra-budgetary fees beginning in the late 1990s that sought to curb the growth of extra-budgetary revenues and bring them onto the budget as much as possible (World Bank 2002). It was also partly a response to the growing complaints of farmers toiling under the ever-growing burdens of

¹⁹ “Vice Premier Wen Jiabao speech at the conference on disseminating Anhui’s experience and mobilization for RFR pilots, April 13, 2000.” Reprinted in State Council RFR Work Group (2001).

²⁰ “Speech at the CCP Economic Work Conference, November 28, 2000.” Reprinted in State Council RFR Work Group (2001).

fees and levies.²¹ Box 4 details the specific measures of the RFR regarding taxes and fees.

Box 4. Specific Measures on Taxes and Fees

The specific measures of the RFR are summed up in abbreviated form in the slogan “the three eliminations, two adjustments, and one reform.” These include:

1. Eliminating the township unified levy, rural education levies, and other administrative fees and fund-raising aimed at farmers, including the education surcharge and the animal slaughter tax (often levied on a per capita basis) (Li 2003). The use of a mandatory labor contribution was to be gradually eliminated -- cut from the original maximum 20 days per year to 15 days per year per person in 2002, to 10 days in 2003, and to zero in 2004.
2. Adjusting the agricultural tax base by:
 - Verifying and fixing (*heding*) the taxable area for agricultural tax determination. In principle, this should be the farmland contracted by farmers for agricultural production in the second round of contracting. The county government is charged with making “appropriate adjustments” for significant variations in output among townships, fixing the “normal taxable output” and “normal yields.”
 - Fixing the basis for tax payments:
 - a) The post-RFR agricultural tax rate was set at 7 percent (up from around 2-3 percent) of normal output, except for state farms which are taxed at 4 percent.
 - b) Farmers have the right to pay in cash, but cannot be forced to do so. Cash payments are calculated at the price of RMB 1.04 per kilogram in Henan province, but the counties have some discretion.
 - The county can use up to 2 percent of the total agricultural tax in exemptions for poverty alleviation and disaster relief.
 - Double taxation is eliminated by stipulating that farmland that is included in the taxable area for the agricultural tax will not be subject to the agricultural special products tax. (The special products tax will be retained for tobacco, but will be levied only on land that is not under the agricultural tax.)
3. The reform will replace the village levy by a surcharge of up to 20 percent of the agricultural tax to provide revenues for village activities.

Source: Chinese Communist Party Central Committee, Document No. 30, 2000.

In essence, the RFR began as a tax rationalization and budget reform measure that sought to bring township and village finance more fully into the budget. By banning extra-budgetary levies, the government aimed to harden the budget constraints and curb the excesses in “taxing and spending” at the grassroots level. Prior to the RFR, there was a common saying in the countryside: “the first tax is light, the second tax is heavy, and the third tax is a bottomless pit” (*toushui qing, ershui zhong, sanshui shi ge wudidong*). The “first tax” referred to the agricultural tax. The “second tax” was the township and village levies that were explicitly permitted, and the “third tax” was the additional fees, levies, compulsory investments, and donations that local officials often used to fund capital investments and other extra-budgetary expenditures. The RFR merged the “first” and “second” taxes and eliminated the “third” tax, thereby significantly reducing the overall burden on farmers. More importantly, by fixing the tax

²¹ These are well documented in two popular books on the plight of farmers. Cao (2000) and Chen and Chuntao (2004). See also Bernstein and Lu (2003).

rates and tax base, the reform set an upper limit for the farmers' tax obligations. Henceforth, fund-raising for infrastructural investments would require approval by village assemblies.

The positive outcomes of the RFR are unambiguous. In the first years of the reform, it was reported that overall the RFR resulted in a dramatically reduced burden on farmers.²² In particular, it eliminated numerous ad hoc and sometimes abusive and excessive fees and levies. It also brought a large component of extra-budgetary revenues into the budget for unified allocation, in the form of an expanded agricultural tax. In the words of one official in Henan province: "The RFR raised the quality of resources by concentrating them in the fiscal system" rather than through fees collected by disparate agencies and local governments (see Annex 3).

To help offset the loss of revenue from the RFR in 2001 the Central Government introduced the RFR subsidy. The RFR subsidy is allocated across provinces by the formula of "1-8-5-0." Under this formula, provinces are divided into four categories to replace revenues by the RFR subsidy:

1. Central and western provinces that are grain "exporters," 100 percent
2. Central and western provinces that are not grain "exporters," 80 percent
3. Coastal provinces that are grain "exporters," 50 percent
4. Coastal, non-grain-exporting provinces, 0 percent

To illustrate the impact of the RFR, some financial calculations on the implementation of the RFR in Henan (a category 1 province) are presented in Table 1. These official calculations show that in 2000, prior to the RFR, fees and levies accounted for some 82 percent of the revenues available at the township level in the province, while agricultural taxes accounted for only 18 percent of the total. After the RFR, in 2002 the expanded agricultural taxes generated roughly half of the revenues in the rural sector. Transfers from the central and provincial governments together provided another 36 percent of the total. In the reform plan, it was assumed that a modest level of voluntary contributions from farmers (RMB 15 per capita per annum) according to a case-by-case approval method (*yishi yiyi*) would provide 13 percent. These calculations left a funding gap of only 4 percent compared to the 2000 level – a small amount to be offset by cost savings. The total "burden reduction" in 2002 was to have been 39 percent compared to 2000 (with tax payments and voluntary contributions totaling RMB 6.23 billion).²³ As it turned out, since farmers did not approve any contribution under the *yishi yiyi* system in 2002, the actual burden reduction was 48 percent. Depending on how much village-level infrastructure was built and financed by the government, this left a larger funding gap – up to 17 percent – compared to the 2000 level.

Table 1. Rural Revenues Pre- and Post-RFR in Henan

Revenue source (RMB billion)	2000	2002 (actual)	change
Agricultural tax	0.9	3.73	+2.83
Agricultural tax surcharge (20%)	-	0.75	+0.75
Agricultural special products tax	0.66	0.19	-0.47
Slaughter tax	0.05	0.06	+0.01

²² Nationwide, this reduction has been reported to be as high as 40 to 50 percent.

²³ It should be noted that the calculations and reported figures for the impact of the RFR on the "burden reduction" should be used with care. While all calculations show substantial impacts, reported numbers are often not exact and not fully consistent.

Revenue source (RMB billion)	2000	2002 (actual)	change
Special products tax on tobacco	0.2	0.2	0
Total agricultural taxes	1.81 (18%)	4.93 (51%)	+3.12
Township unified levy	2.6	0	-2.6
Village levy	2.35	0	-2.35
Other fees and levies	3.4	0	-3.4
Total non-tax revenues	8.35 (82%)	0	-8.35
<i>Central government subsidy</i>	-	2.82 (29%)	+2.82
<i>Provincial subsidy</i>	-	0.7 (7%)	+0.7
<i>Farmers voluntary contribution*</i>	-	1.3 (13%)	1.3
Total available revenue	10.16	9.75	-0.41 (4%)
Total paid by farmers	10.16	6.23	-3.93 (-39%)

Note: Figures in parentheses refer to shares of total available revenues; * Projected, with a ceiling set at RMB 15 per year from farmers.

Source: Annex 3 (Mission notes and Henan Statistical Yearbook 2004).

2.2. Second Phase RTRF - Agricultural Tax Abolition (ATA)

In 2003 the government announced that beginning in 2004 provinces should try to reduce the agricultural tax rates (just raised to 7 percent under the RFR) by 1-3 percent per year, to reach a zero rate by 2007. This reform was further accelerated, with the government announcing in December 2005 that the tax had already been abolished in all but three provinces.²⁴ By early 2006, it had been completely abolished nationwide.²⁵ Building on this momentum, in February 2006 the agricultural special products tax and the slaughter tax were also formally abolished.²⁶

The ATA was a response to the growing complaints that the agricultural taxes were unfair. While until 2005 urban citizens were exempt from personal income taxes (PIT) for the first RMB 9,600 per year,²⁷ no such exemption existed for the much poorer rural citizens, who were subject to agricultural taxes regardless of income level. For fair treatment of all citizens under the tax laws, proponents argued for the abolition of the agricultural tax.²⁸ From overall revenue considerations, this was not costly. Even the expanded agricultural and animal husbandry taxes together produced only RMB 33.4 billion in 2003, equal to 1.7 percent of current revenues (Finance Yearbook 2004). In terms of net revenue the “yield” was even lower for these two taxes since they were notoriously costly to collect from the two hundred million rural households.

While the ATA was welcomed for bringing further reductions in the farmers’ burdens, it also injected some confusion into the ongoing reforms and up-ended all the careful plans for revenue-replacement under the RFR reform. Moreover, it also undermined two principal

²⁴ These were Hebei, Shandong, and Yunnan. Even in these provinces, the tax had been abolished in more than 210 counties. Jin Renqing interview in *People’s Daily*, December 31, 2005.

²⁵ The Decision of the Standing Committee of the National People’s Congress on Abolishing the Regulation of the People’s Republic of China on the Agriculture Tax, issued December 29, 2005, formally abolished the agricultural tax effective January 1, 2006.

²⁶ Decision of State Council Order No. 459, issued on February 17, 2006, for immediate implementation.

²⁷ The threshold for the PIT was doubled in 2005 from RMB 800 per month to RMB 1,600 per month, or RMB 19,200 per year.

²⁸ See, for example, Yang et al. (2003).

objectives of the RFR – that of imposing a more structured framework on rural public finance and hardening the budget constraints on grassroots governments. Abolishing the agricultural taxes also further diminished the already slim local tax base, especially in inland, rural localities where, aside from agriculture, there is little economic activity to tax.

The immediate effect of the ATA is twofold. First, it imposes a much greater burden on central transfers, both in quantity and term. While transfers were always required under the RFR to fill the revenue gap, they were meant to be transitional, and would be obviated as cost savings are realized from improved efficiencies and associated reforms. With the elimination of the agricultural taxes, however, the gap is now larger, and transfers will be needed for a long period until a stronger revenue base will be rebuilt.

Second, it has created new urgency for implementing the associated reforms to generate some cost savings. On the positive side, the abolition of the agricultural tax has eliminated the need in local finance departments for the large corps of tax collectors who had been deployed to perform the mammoth task of going door-to-door to collect the tax.²⁹

The immediate revenue impact

The revenue gap at the local level is substantial. As shown in Table 1 above, provincial officials in Henan had counted on the expanded agricultural tax to replace a significant part of the revenues lost from eliminating the fees and levies – roughly RMB 3 billion (compared with the RMB 2.9 billion in central subsidies in 2002). With the abolition of the agricultural tax, however, these calculations became obsolete, and a huge gap remained in rural finance. Although the Central Government has increased the subsidy to support the reforms, available information indicates that in the aggregate, transfers are replacing only a fraction of the revenue losses stemming from the RTFR. Two sets of estimates are presented in Table 2. The first comes from a speech delivered by Vice Premier Wen Jiabao in April 2000 at a national conference on Anhui's RFR experience, and the second comes from a group of experts at the State Administration of Taxation (SAT). These estimates vary significantly, especially in terms of the size of illegal fees and levies and the valuation of compulsory labor – two components of the farmers' burdens for which aggregate statistics do not exist. Under the higher estimate by Yang Yuanwei and his colleagues (Yang et al. 2003), prior to the RFR total resources available to township governments may have been as high as RMB 216 billion. With the elimination of fees and the abolition of agricultural taxes, township governments only have available to them transfers from higher levels. Since central subsidies for the RFR and agricultural tax replacement totaled only RMB 64.8 billion in 2005, this left a post-RTFR shortfall of as much as RMB 154 billion. Put another way, according to the estimate of Yang and his colleagues, post-RFR grassroots governments have at their disposal as little as one-third of their pre-RTFR resources. Even under the more benign scenario described by (Vice) Premier Wen, they have one-third less than they had before the RTFR.

²⁹ In the counties visited by the mission, up to three-quarters of the staff in township-level finance departments were assigned to collect the agricultural tax.

Table 2. The Effect of the RTFR on Rural Revenues

(billion RMB)	Wen Jiabao	Yang et al.
Figures from:	1997	circa 2000
Total collected revenues:	114.3	160
of which: agricultural taxes		34
township and village unified levies		59
other fees and levies		27
irregular fees and levies	20.0	40
plus: compulsory labor contribution	8.1	59
Total mobilized resources	142.4	219
Replacement revenues		
Central transfers (2005)	64.8	64.8
Revenue loss under the RTFR (1)	-49.5 (-35%)	-55.2 (-46%)
Revenue loss under the RTFR (2)	-77.6 (-55%)	-154.2 (-70%)

(1) Includes only legally permitted fees and levies, and excludes compulsory labor valuation.

(2) Includes total mobilized resources.

Source: Wen Jiabao speech at National Conference on Anhui's RFR Experience, April 13, 2000 (reprinted in State Council 2001); Yang et al. (2003); and Xu (2006).

Of course, the revenue impact of the RTFR varies by region and by administrative level, in accordance with the respective weight of the agricultural taxes in their total revenue – hitting hardest those localities most dependent on these taxes. Data in Table 3 below show that across provinces, the weight of agricultural taxes varied from 17 percent of total revenues in Anhui to nearly zero in Tibet. In this table we provide an illustrative ranking of provinces according to the revenue impact of the RTFR. One of the difficulties in estimating the revenue impact of this reform is the significant ambiguity that exists in what is reported as “agricultural taxes” – a problem compounded by the lack of a distinction between the singular and the plural in the Chinese language. This is discussed in Box 5.

Box 5. “Agricultural Tax” versus “Agricultural Taxes”

In common usage, the terms “agricultural tax” and “agricultural taxes” are often used interchangeably. The first refers to a land-based tax on crop production. The second refers to a broad category that typically includes five taxes: the agricultural tax itself, the agricultural special products tax that was intended to tax high value economic crops, the animal husbandry tax, the title tax on land transfers, and the slaughter tax. The slaughter tax had been largely eliminated by the end of the 1990s, and sometimes the farmland occupation tax was included as the fifth tax under the category of agricultural taxes. The table below presents the revenues from these taxes in Henan province. It illustrates the revenue differences depending on the scope of what is counted as “agricultural tax” or “agricultural taxes.”

Reported Statistics on Agricultural Taxes in Henan Province

Revenue calculations (RMB million)	2001	2002	2003	Urban share
<i>Agricultural Tax</i>	673.04	3731.22	3770.52	0.4%
Agricultural Tax Surcharge (20%)		746.24	754.1	0.0%
Agricultural Special Products Tax	936.72	391.81	271.21	0.0%
Slaughter Tax	194.52	58.31	0.56	0.0%
Total Agricultural Taxes	1804.28	4927.58	4796.39	0.3%
Title Tax	300.7	388.19	590.71	81.5%
Farmland Occupation Tax	116.87	90.46	183.29	10.4%
Broadest Definition Agricultural Taxes	2221.85	5406.23	5570.39	9.3%

Source: Henan Statistical Yearbook, 2004, pp.460-461; Chinese Fiscal Yearbook, 2001, p.51.

The distinguishing feature of these “agricultural taxes” appears to be the collection agency. Unlike other taxes, the agricultural taxes are, with the exception in 8 provinces, collected by the Finance Bureaus rather than by the local Tax Bureaus. In fact, the title tax and the farmland occupation tax are quite different from the other taxes because they are levied on non-agricultural uses, and they fall mostly on residents of urban and urbanizing areas rather than on farmers. The revenues of the title and farmland occupation taxes also accrue mostly to urban governments, rather than to counties and townships. This distinction is important because the RTFR aims to eliminate taxes on farmers, and the farmland occupation tax and the title tax are unaffected by the reform. It is often unclear in discussions or reports to which of the three levels of the “agricultural tax” the figures refer.

Source: Fieldwork visit to Henan province, December 2004; Meeting at SAT, February 13, 2004.

The rankings presented in Table 3 are approximate. First, as illustrated in the table of Box 5 above, the tax share data from 2003 already reflect some reductions in agricultural tax revenues from the RTFR, and therefore understate the effect of the reform on provincial revenues. For the agricultural special products tax, for example, the RFR reduced the scope of what could be taxed and reduced the rates by as much as one-half on many products. In Henan, revenues from the agricultural special products tax fell from RMB 937 million in 2001 to only RMB 271 million in 2003. Second, because we cannot disaggregate the share of tobacco in the agricultural special products tax revenues, the rankings show the effect of eliminating all of the revenues from this tax. This clearly overstates the impact on Yunnan, for example, a province that is heavily

dependent on tobacco. Since a new tax on tobacco was introduced to replace the agricultural special products tax, the impact on Yunnan's revenues will be smaller. Excluding Yunnan, Table 3 shows the most affected provinces to be Anhui, Henan, and Hubei, where the reforms will reduce revenues by some 10 percent or more. At the bottom, there are nine provinces and cities where the impact will be less than 1 percent of total revenue, and another eight where the impact will be less than 4 percent of revenue.³⁰

Table 3. Ranking of Estimated Revenue Impact by Selected Provinces, 2003

Province and national ranking	Taxes to be eliminated*	Five agric. Taxes	Province and national ranking	Taxes to be eliminated*	Five agric. taxes
1. Anhui	12.09	17.12	18. Chongqing	4.72	8.34
2. Henan	11.96	14.25	20. Jiangsu	3.33	10.17
3. Yunnan	10.86	13.57	23. Liaoning	2.31	6.18
4. Hubei	9.96	12.79	28. Guangdong	0.71	4.90
6. Jiangxi	9.52	10.92	34. Shanghai	0.01	7.54
15. Sichuan	6.83	8.32	35. Tibet	0.00	0.03
<i>average</i>				4.75	8.52
<i>standard deviation</i>				3.76	3.46
<i>coefficient of variation</i>				0.79	0.41

Notes: Taxes to be eliminated include the agricultural tax, animal husbandry tax, and agricultural special products tax. Shares are a percentage of total provincial revenues. "Provinces" include some major cities such as Dalian and Xiamen.

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

Across counties, the dependence on agricultural taxes varies even more widely for consolidated budgets (including townships). In Table 4 we present summary data from all rural counties in Yunnan and Henan provinces. The average share of the five agricultural taxes was 32 percent among counties in Yunnan and 37 percent in Henan, but the maximum share was around three-quarters in both provinces.

Table 4. The Share of Agricultural Taxes in County Revenues, 2003

	Yunnan	Henan
Maximum	76.5%	74.5%
Minimum	1.1%	5.3%
Average	31.6%	37.0%
Standard deviation	14.4%	16.4%
Coefficient of variation	0.46	0.44

Note: This is the sum of five taxes: the agricultural tax, animal husbandry tax, agricultural special products tax, farmland occupation tax, and title tax. The slaughter tax is also often included, but this tax generates insufficient revenues to make a difference.

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

³⁰ The complete table with all provinces is provided in Appendix 9 Table 5.

The impact of the RTFR falls overwhelmingly at the township level. This is shown in Table 5 that further breaks down agricultural tax revenues across administrative levels. In 2003, while agricultural taxes constituted 8.7 percent of total revenues for subnational governments, they were less than 2 percent of provincial revenues but 31 percent of township revenues. Columns 2 and 3 show that abolishing the agricultural, animal husbandry, and special product taxes will reduce subnational revenues by 4.3 percent, but for townships the reduction will be 27 percent of revenues. The provincial and prefectural levels will feel no impact. Surprisingly, the effect will also be very small at the county level.

Table 5. Share of Agricultural Taxes in Total Revenues by Administrative Level, 2003

	All agricultural taxes	Agricultural taxes to be abolished*
Subnational Total	8.7	4.3
Province	1.6	0.0
Prefecture	6.3	0.2
County	8.1	2.6
Township	31.1	27.3

* The agricultural tax, animal husbandry tax, slaughter tax, and agricultural special products tax. The farmland occupation tax and the title tax remain.

Source: Based on Compendium of Local Fiscal Statistics, 2003.

Replacement of revenue losses caused by the ATA clearly imposes a further, significant burden on central transfers. Currently there appear to be two problems. First, as shown above, there is a sizable gap between what rural (especially township and village) grassroots levels are receiving from transfers and their previous revenues. This raises the question of what the appropriate revenue replacement level should be. Second, the fact that the revenue losses have occurred at the lowest administrative level means that central monies have to travel a long way to reach the intended recipients. Under the current Intergovernmental Fiscal System (IFS), this path is not straightforward.

2.3. Associated Reforms of the RTFR Program

From the outset, the architects of the RFR program planned for restructuring rural governments and reducing staff to be core components of the RFR that would provide cost savings to offset revenue losses from the fee reductions.³¹ In a speech to the National RFR Work Conference in November 2000, Vice Premier Wen Jiabao stated:

“Here I want to emphasize several points: First, in the process of piloting the RFR, the localities should stay focused on reducing farmers’ burdens and ensuring discipline in grassroots government behavior. The reform should start by reorganizing government and reducing staff to cut expenditures, rather than relying wholly on central transfers to fill fiscal gaps. Central transfers are to be used only as a transitional aid to ensure the normal functioning of grassroots governments.”³²

In many localities there were proposals to consolidate villages, townships, and school districts to create more efficient scales for service provision, along with calls for reducing

³¹ These are included in the Implementation Document on the RFR issued in 2000: Chinese Communist Party Central Committee Document No. 7, jointly issued by the CCPCC and State Council. Reprinted in State Council RFR Work Group (2001).

³² Speech on November 4, 2000. Reprinted in State Council RFR Work Group (2001).

staff in schools and government agencies (State Council RFR Work Group 2001). Following issuance of CCCPC Document No. 30 in December 2000, the Central Committee Office and State Council Office jointly issued a document calling for an average 20 percent reduction in the number of staff posts at the municipal (prefectural), county, and township levels, to be set by the provincial authorities and implemented on a level-by-level basis.³³ This call is reflected, for example, in Huaxian (Henan province), in an implementing document on the RFR calling for a reduction of “no less than 27 percent” in staff size in government and Party organizations, and controlling the overall number of public service unit (PSU) staff. The document calls for limiting the number of posts to 30 in small townships, and 35 in large townships. In villages, the number of officials is to be limited to 5-7 in large villages with a population exceeding 5,000, and 3-5 in most villages. To further control costs, subsidies for village officials are to be kept at no more than RMB 200 per staff per month. Non-production-related expenditures should also be controlled, including setting limits on subscription fees for newspapers and magazines and abolishing entertainment expenditures at the village level. According to the Ministry of Civil Affairs, 876 townships in 20 provinces were dissolved or merged in the first 9 months of 2004, bringing cuts of some 86,400 jobs and RMB 864 million in budgetary savings.³⁴

These associated reforms are crucial to sustain the “burden reduction” objective of the RFR reform. As illustrated by the numbers in Table 1 above, subsidies from higher-level governments replaced about 35 percent of the pre-RFR revenues in 2002, accounting for two-thirds of the reduction in farmers’ burdens. But to prevent the burden from “rebounding” or having a negative implication for public expenditures, additional sources would have to be found. One such source is expected savings from improved allocation efficiency due to farmers’ participation in project selection. For the first time, the RFR presents the public with the possibility of choice – farmers can vote (with a two-thirds majority) to “tax” themselves to undertake infrastructural investments (*yishi yiyi*). This new arrangement will presumably cut out unwanted investments and ensure a more responsive pattern of investment. Another potential source of savings is from cutting rural administration and raising efficiency in service provision. The reform design of the RTFR explicitly relies on these efficiency gains to alleviate burdens also by encouraging farmers’ involvement in the delivery of goods and services.

However, as can be expected, these institutional changes have been implemented slowly. It will take even longer for their effects to show. In fact, the comprehensive rural reforms, which are an important component of the “developing of the NSC”, can be seen as a continuation and deepening of the RTFR in this regard. “At present, the priorities of comprehensive rural reform are: promoting the reform of township institutions while focusing on transferring government roles and functions; promoting the rural compulsory education reform while focusing on implementing the mechanism for ensuring educational expenses; promoting the reform of county and township fiscal management system while focusing on strengthening the financial capacity of grassroots-level governments, [...]” (MOF, 2007). In the meantime, the burden is on central transfers to help meet the fiscal gaps created by the RTFR.

³³ Chinese Communist Party Central Committee Office and State Council Office, “Some Opinions on Personnel Downsizing at the Municipal, County, and Township Levels,” December 26, 2000. Reprinted in State Council RFR Work Group (2001).

³⁴ *China Daily*, November 17, 2004.

2.4. Other Adjustments to Revenues

Aside from the RTFR, two other reforms implemented in recent years have had a significant impact on rural finances. These include the measure to “complete” the TSS reform introduced in 2002, and the “three rewards and one subsidy” introduced in spring 2005. Both are policy responses to the increasingly evident fiscal problems of rural governments that were manifested by the wave of wage arrears for teachers and civil servants and public protests by farmers starting in the late 1990s. In his report to the National People’s Congress in March 2002, noting that many governments at the county and township levels were unable to meet their payrolls in full for civil servants, Minister of Finance Xiang Huaicheng called for government to “gradually establish a mechanism to ensure normal payment of wages, accelerate changes in the functions of counties and townships, and create conditions for fundamentally overcoming financial difficulties in counties and townships.”³⁵

Completing the TSS reform at the sub-provincial levels

“Completing the TSS reform at the sub-provincial levels” is a major reform to correct many of the problems of the Tax Sharing System. At the first cut, it calls for “completing” the TSS reform by eliminating the fiscal contracts³⁶ that have remained in use at the sub-provincial levels. Even though in 1994 the TSS introduced a new system of revenue sharing by tax assignment and tax sharing, this change was only implemented between the central and provincial governments, and not completely at the lower levels (World Bank 2002). More importantly, the reform aims to inject transparency and order into sub-provincial fiscal relations, by simplifying the intergovernmental system, injecting greater uniformity in revenue-sharing, and strengthening the fiscal capacity of counties and townships (especially the poor ones).

This reform was introduced with little fanfare, when the State Council issued a “notification” to central agencies and provinces in December 2002. The document calls on provinces to: (1) rationalize and clarify expenditure responsibilities among sub-provincial levels, and to eliminate the practice of unfunded mandates; (2) rationalize the division of revenues; (3) improve the system of sub-provincial transfers; (4) adjust the fiscal role of townships to fit their economic conditions, specifically by reassigning responsibilities of smaller townships in less developed areas to counties. It also calls for strengthening supervision over townships to ensure compliance with national regulations against borrowing or providing guarantees for projects; and (5) strengthen budget management to improve the efficiency of public expenditures.

The most important changes stipulated in the document, aside from revamping the revenue-sharing arrangements among subnational levels, are:

- A greater role for provinces in supporting rural public finance and improving equalization. Provinces are explicitly assigned responsibilities for: (i) determining the basis for transfers to lower levels through “rationally estimating the basic expenditure needs of subordinate municipalities and counties” and, along with municipalities, increasing general purpose transfers to help counties meet their expenditure needs; (ii) supervising municipalities in meeting their responsibilities for equalization (municipalities must report their equalization

³⁵ Reports indicate cumulative arrears of RMB 6.5 billion at year-end 2001 (Xiang 2002).

³⁶ In the mid-1980s intergovernmental revenue sharing was fixed by “fiscal contracts” that stipulated a lump sum or proportional transfer. These contracts should have been replaced by the tax sharing under the TSS, but often were not.

measures to the province for the record); (iii) merging and consolidating the original system subsidies and remittances into transfer payments, and taking steps to guarantee that central transfers reach counties and townships; and (iv) ensuring that the fiscal system for townships fits their economic conditions. The document calls for adjusting the fiscal role of townships by reassigning responsibilities of smaller townships in less developed areas to counties. It also calls for strengthening supervision over townships to ensure compliance with national regulations against borrowing or providing guarantees for projects; and (v) strengthening budget management to improve the efficiency of public expenditures.

- A readjustment of the role of townships to recentralize some functions at the county level.
- To end unfunded mandates, the document stipulates that provinces and municipalities must not push down expenditures to the counties and townships; when they delegate tasks to lower levels, they must arrange sufficient financing. If cost sharing is required, it should be based on the distribution of benefits while taking into account the limited financing capacity of the counties and townships.

Significantly, the State Council document also calls for a decentralized approach to implementing this reform. While the thrust of the reform is to increase resources at the county and township levels, the State Council document calls for different treatments depending on local conditions. In localities where per capita fiscal disparities are “relatively small,” it calls for reducing the provincial and prefectural revenue shares to improve incentives for revenue mobilization at the grassroots levels. In localities where fiscal disparities are “relatively great,” it calls for raising revenue shares at the higher levels, and using these resources for equalization transfers to the counties and townships. In implementation to date, different approaches can be seen across localities. In some, provincial authorities have reduced the number of shared taxes at the provincial level to leave more resources to the lower levels. In Henan, for example, provincial authorities have turned over some 60 percent of the provincial tax base to the municipalities. In Jiangsu, early implementation of these changes reduced the provincial share of revenues to roughly 20 percent of the total. In contrast, Liaoning province is increasing the provincial share. Even within a single province, the direction of change differs across municipalities. For example, in Liaoning, Anshan municipality is choosing to end its sharing of the VAT, enterprise income tax (EIT), PIT, and business tax collected by the counties. This decentralizing thrust in Anshan contrasts with that in Panjin and Yingkou municipalities, which are taking 40 percent of the local portion (after sharing with the province) of the VAT, EIT, PIT, business tax, and real estate tax collected by the counties (World Bank 2006a).

The “three rewards and one subsidy” program

The “three rewards and one subsidy” program was rolled out in May 2005. It is the product of a high-level task force appointed by the National People’s Congress in 2004 to investigate the fiscal problems of counties and townships.³⁷ The program’s stated aim is to “solve” the problems of “fiscally poor” counties (FPC) within three years. The government allocated RMB 15 billion from the central budget for 2005, with a target of RMB 30 to 40 billion for total spending, including local counterpart funds. The program is designed to support and enhance

³⁷ This information is based on MOF Document No. 77, May 8, 2005, “Notification on the 2005 Central Budgetary Rewards and Subsidies to Local Governments in Providing Assistance to Counties and Townships to Resolve Fiscal Difficulties,” and interviews at MOF, February 2005.

completion of the TSS reform by boosting the incentives for revenue mobilization and provincial equalization efforts, as well as by the more painful downsizing reforms. It has five components, as shown in Box 6.

Box 6. Components of the Three Rewards and One Subsidy Program

An **incentive program** for local governments to restore fiscal balance, this component has two parts. The first part is a grant to county governments that improve their fiscal balance through above-average revenue mobilization. All FPCs are eligible for this program. The second part is a grant to provinces that increase their equalization transfers to counties. This component is funded as a recurrent allocation to be included under General Transfers.

FPCs are defined as those whose “available revenues” were insufficient to meet “basic fiscal needs” in 2003. Available revenues are the sum of ordinary own revenues, fiscal capacity transfers from higher levels, and extra-budgetary revenues included in the budget. Basic fiscal needs are calculated from the total number of budget-supported local government employees, a coefficient for average running costs per staff, and a regional cost coefficient.

Provincial transfers will include the following: tax rebates for the VAT, excise tax, EIT, and PIT; a General Transfer, minority region transfer, RFR subsidy, wage increase transfer, original system subsidy, and other fiscal capacity transfers. The amount of the reward will be according to a fixed coefficient of the increases, based on the following schedule: (i) 0.3 of the increased revenue collections for FPCs; and (ii) 0.23 for provinces that increased transfers to FPCs. All provinces and municipalities are eligible to participate in the program except Beijing, Tianjin, Shanghai, Zhejiang, Jiangsu, Guangdong, and the line-item cities of Dalian, Qingdao, Ningbo, Xiamen, and Shenzhen.

The rewards will be distributed through the provinces. Provinces must first use the funds to meet fiscal needs in the FPCs. Only after the fiscal gaps are filled in the FPCs can the funds be used to meet the needs of other counties. Provinces are not allowed to use the funds at the provincial level.

An **incentive program** for counties to reduce the number of organizations and staff size. This program will give a one-time reward of RMB 500,000 for eliminating one township, and RMB 4,000 for cutting one staff position, from the 2004 level.

A **reward program** for major grain producing counties. The goal is to encourage grain production and to keep land under agricultural use by helping to alleviate fiscal pressures on these counties. The rewards are designated directly for the 700 or so eligible counties but they are disbursed through the provinces. The rewards will be distributed by a formula that includes planting area, grain output, and grain sales. Counties are eligible for the reward if they maintain the base levels for the selected indicators, fixed from five-year averages.

A **subsidy program** for counties based on past “good behavior,” which would flow through the provinces. This applies to provinces that have had above average equalization efforts in the past, defined as transfers to FPCs that exceeded the national average. Local governments that undertook downsizing during 2000-2003 will receive one-time rewards of RMB 400,000 for each township eliminated, and RMB 3,000 for each staff person cut. The rewards will be paid out over a three-year period.

An **incentive program** to encourage provinces to build a monitoring and accountability

framework to “regulate and monitor” the fiscal performance of local governments. At present the data base for staffing has been completed but currently the data base for finances is still under development. Provinces must report on the use of rewards and subsidies and their procedures and achievements in attempting to resolve the fiscal problems of the FPCs. These should be included in the budget reports to the people’s congresses and sent upward to the Ministry of Finance for the record. The Central Government will undertake special inspections of the data and reports on the usage of funds under the rewards and subsidy program.

2.5. Changes in Expenditure Assignments

While the reforms are attempting to channel more resources to rural governments, the government is continuously adding new programs that increase expenditure responsibilities at the county and township levels, including the program to build a NSC, which is part of the Eleventh Five Year Plan. Other programs announced in recent years include the commitment to provide free rural compulsory education, the New Cooperative Medical Scheme (NCMS), the minimum living stipend, support to the “five guaranteed” households (*wubaohu*), etc. All of these are worthy attempts to extend public services and the social safety net to the countryside, but they also add significant new costs to the financing burden of rural areas, especially county governments.

The most important change affecting township finance in recent years was the reassignment of rural teachers’ salaries. In an effort to stem the wave of wage arrears to rural teachers, in 2001 the State Council ordered that rural teachers’ salaries be paid from county budgets, rather than from township budgets. In most provinces, implementation began in 2002. Prior to the change, education had been the single largest expenditure at the township level, absorbing one-half to two-thirds of expenditures in most townships. Teachers’ salaries were often 80-90 percent or more of budgetary expenditures in primary and middle schools. This change caused a seismic shift in fiscal burdens away from the townships and to the counties. The shift of this large expenditure assignment had to be accommodated by a corresponding shift in revenue assignment. In 2004 in Henan province, for example, townships were required to remit to the counties an amount equal to the new cost burdens for the salary payments accruing to the county level. In practice, this meant that the RTFR transfers from higher levels were captured at the county level, and only monies left over after paying teachers’ salaries were passed through to the townships.

Other initiatives are also shifting responsibilities from townships to counties. Aside from the change in financing rural teachers’ salaries, for several years a broad program has been underway to shift service provision to the counties in the spirit of the *yixian weizhu* -- elevating the role of the county. Moreover, the ongoing reform of the treasury system is moving salary payments of other rural public employees to the county level for direct disbursement. Even where direct disbursement is impractical because of a lack of bank branches in townships and villages, the general thrust of the reform is to centralize cash management at the county level by closing down township accounts and routing all disbursements to the county. All of these changes are hollowing out township coffers and stripping township governments of allocative authority.

Chapter 3. The Intergovernmental Fiscal System

Under the current division of labor among administrative levels in China, virtually all responsibilities for providing the public goods and services required to support the construction of the NSC fall to rural governments at the county and township levels. These include responsibilities not only for infrastructure such as roads and water systems, but also vital social services such as basic education, public health, and social safety nets. Whether the governments will be able to carry out these responsibilities depends on whether they have sufficient resources and appropriate incentives. This chapter reviews the current status of rural public finance within the overall intergovernmental fiscal system. Transfers, an integral part of the system, are treated separately in the following chapter because of their unique importance for rural public finance.

3.1. Concepts and Framework

This examination of rural public finance begins with an examination of the current intergovernmental fiscal system, referring to the assignment of expenditures, revenues, transfers, and subnational borrowing. The intergovernmental fiscal system determines local government responsibilities and the resources they can mobilize. How the system is designed and how well its components work together have a great impact on shaping the outcomes.

All countries in the world assign some functions to local governments based on the belief that some services are better delivered by local governments, which are more familiar with local needs and conditions. A subsidiary principle calls for the provision of services to be devolved to the lowest-level jurisdiction that corresponds to the benefit area (Oates 1972; Tiebout 1956). In general, it is believed that assigning more responsibilities to local governments can be useful to achieve a more efficient allocation of resources and to stimulate economic growth, and the worldwide trend is the direction of decentralization (see, for example, World Bank 2005b). However, decentralization may weaken the government's capacity to ensure an equitable provision of services to citizens in different jurisdictions, or to maintain macroeconomic stability (Bahl and Martinez-Vasquez 2006). In countries where administrative capacities are limited and concentrated at the center, devolution of responsibilities may lead to greater inefficiencies and deterioration of services (Prud'homme 1995).

Therefore, economic theory offers no one-size-fits-all template for deciding which level of government should be responsible for the provision of particular services. Because of the existing trade-offs, countries choose different degrees of fiscal decentralization in accordance with their objectives and priorities, as well as their historical circumstances, and any given assignment can only be judged against the objectives set by the Central Government in its decentralization strategy. Moreover, at any given degree of decentralization, countries have also chosen somewhat different configurations for their IFS, with some countries assigning more own source revenues to local governments while others relying more on the use of intergovernmental transfers.

Moreover, the provision of public services in rural areas is a challenge in all countries around the world. There are three common features to rural local governments in most countries: weak tax bases, high costs of providing services, and weak administrative capacities for managing resources and services. These are especially marked in remote communities where service provision is costly due to factors such as geographic conditions or low population density, and where local governments do not have a sufficient tax base to be economically

viable. For instance, class sizes may be smaller in schools, public facilities may be used at lower capacities, and a premium may have to be paid to attract qualified teachers, doctors, and administrative staff to work in remote rural areas.³⁸ Most remote communities do not offer a great many services. In industrialized countries in the OECD, rural local governments draw on a mix of local taxes, user charges, and transfers to meet national standards for minimum service provision – for basic education, health care, sanitation, and infrastructural services. Given their lower revenue capacities and higher expenditure needs, these governments are relatively more dependent on transfers than their urban counterparts.

However, in China the problems of financing rural governments are not confined to those in remote locations, but apply more generally. While high costs and weak administrative capacities are common to localities in remote regions, virtually all rural counties and township governments (and villages) face large fiscal gaps that are firmly rooted in the highly decentralized system of finance and how it has evolved over the past 25 years.

3.2. The Organization of Rural Public Finance in China

Overall intergovernmental organization

China is among the most decentralized countries in the world. Subnational governments at the provincial, municipal, county, and township levels account for 70 percent of national budgetary expenditures. This decentralized system is discussed in detail in the World Bank (2006a) report. Consequently, this chapter will focus mainly on some features of the Chinese system that are the most important in shaping rural public finance.

Table 6. Division of Expenditures by Administrative Level

	Budgetary Expenditures 2004		Budgetary Expenditures 2003	
	Total	of which for Education	Total	of which for Education
Central	27.7%	7%	30.1%	8%
Provinces	18.7%	15%	18.7%	15%
Prefectures/Cities	22.2%	18%	21.5%	18%
Counties	25.2%	46%	23.3%	42%
Townships	6.1%	14%	6.3%	17%

Source: Calculated from Compendium of Local Fiscal Statistics, 2003, 2004; and Finance Yearbook of China, 2004, 2005.

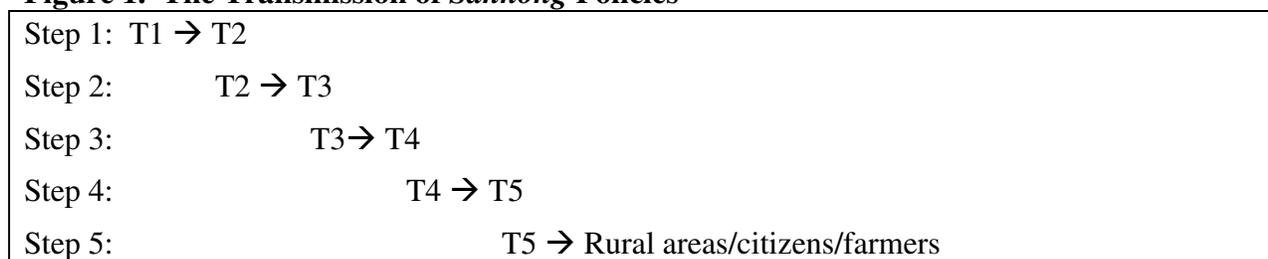
First, while in most countries decentralization is to the second, intermediate tier of government, in China it reaches all the way down to the lowest levels of government. This is shown in Table 6, where significant expenditure shares (and thus de facto responsibilities for service delivery) are distributed among each of the five levels of government (Appendix 4 presents the five-tiered administrative structure). Sitting at the bottom of this structure, rural local governments at the county and township levels in China together account for some 30 percent of total national budgetary expenditures. This is because they have almost sole responsibility for the provision of vital public services to the rural populace. For example, as

³⁸ In Canada, municipal spending on all services is considerably higher in remote areas than in the rest of the country – 41 percent higher than in the country on average in the Yukon; 173 percent higher in the Northwest Territories; and 171 percent higher in Nunavut (Kitchen and Slack).

shown in Table 6, the high costs of providing basic education explain why the county and township levels account for nearly 60 percent of total budgetary outlays for education.

Second, the organizational structure of the Chinese government is unique with respect to a number of features. A powerful influence on shaping the way policies and resources reach rural governments is the “nested” hierarchy of the various government levels. This administrative system depends on level-by-level delegation: The Central Government issues orders and sends resources to the provinces (T1 → T2), and depends on the provinces to transmit the resources downward to the lower levels. The provinces in turn delegate to prefectures/municipalities (T2 → T3), and so on down the hierarchy. In this system, interactions are bilateral, involving only two tiers at a time.³⁹ Given the way this structure is organized, central policies and resources aimed at the rural sector – e.g., *sannong* policies – go through a 5-step process before reaching their intended recipients. This is illustrated in Figure 1.⁴⁰

Figure 1. The Transmission of Sannong Policies



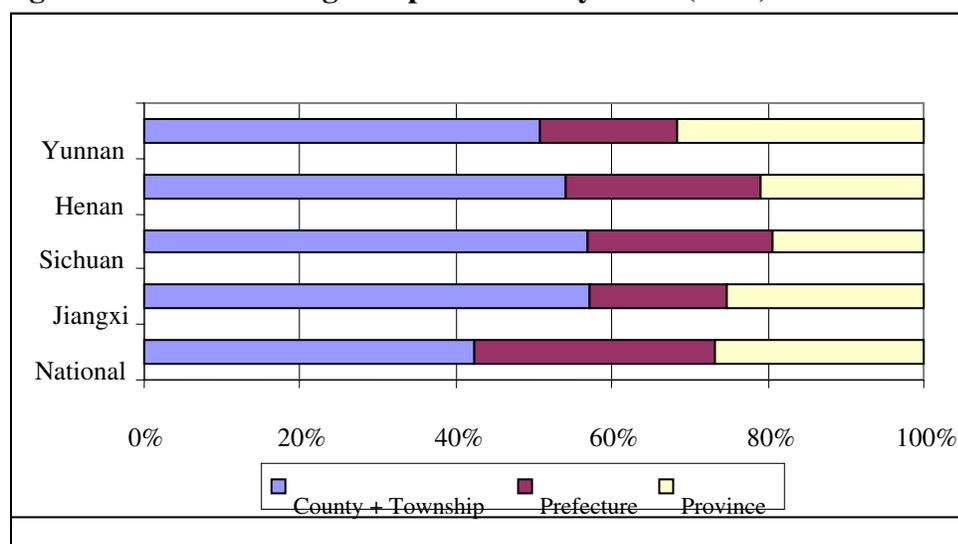
Such significant powers of intermediate levels are especially pronounced for the provinces. Although neither the Constitution nor the Budget Law (1994) assigns specific authorities to the intermediate levels, they are given these authorities *by delegation*, often implicitly. These powers stem from the absence of specific formal assignments to subnational governments. Not surprisingly, this decentralized approach has resulted in differing shares of revenues and expenditures managed by rural local governments across provinces. This unusual aspect of China’s public finance system has been noted in earlier studies (see, for example, World Bank 2002). It is also illustrated in Figure 2, where we show the shares for the four provinces where we conducted fieldwork for this study. In each of the four provinces, the county plus township shares of expenditures are more than 50 percent of the (subnational) total, significantly higher than the national average of 43 percent.⁴¹

³⁹ This explains why the Central Government is unusually small in China, with only 50,000 staff sitting at the apex of a public sector that comprises 33 million employees if public service units are included (see World Bank 2006).

⁴⁰ A number of pilot programs test improvements in administrative efficiency by putting counties directly under the administration of the province, or by putting towns directly under the administration of the prefecture. However, while this reduces the number of layers, the principal structure as a nested administration is not changed.

⁴¹ By themselves, these different shares of the rural sector may be merely reflections of the different degrees of urbanization across provinces. For example, as measured by the share of agriculture in provincial GDP, the four fieldwork provinces are all significantly more “agricultural” (and rural) than the national average. The shares of the primary sector in provincial GDP in 2003 were 1.44, 1.42, 1.37, and 1.22 and in 2004 1.40, 1.34, 1.34, and 1.23 times the national average in Sichuan, Yunnan, Jiangxi, and Henan, respectively (Statistical Yearbook 2004, 2005).

Figure 2. Shares of Budget Expenditures by Level (2003)



Source: Compendium of Local Fiscal Statistics, 2003.

The share of expenditures accounted for by the provincial government also varies significantly across provinces. The provincial share is more indicative of choice since, unlike other subnational governments, provincial governments have no clear role in the direct provision of services. While averaging 28 percent nationwide (when the four provincial-level municipalities are excluded), this share ranges from lows of 13 and 14 percent in Zhejiang and Guangdong, to highs of 49 and 43 percent in Qinghai and Ningxia respectively.⁴² To show the diversity of choices made by different provinces, Table 7 shows the summary descriptive statistics for 27 provinces and autonomous regions. The shares of revenues and expenditures by level for all provinces are presented in Appendix 9 Table 9.

Table 7. Descriptive Statistics of Subnational Expenditure and Revenue Shares, 2003

Expenditure shares	Mean	Std. Dev.	Maximum	Minimum	C.V.
Province	28.0%	9.1%	49.4%	12.8%	0.33
Prefecture	24.4%	8.0%	48.9%	15.0%	0.33
County + township	47.7%	8.2%	63.2%	30.3%	0.17
Revenue shares					
Province	22.1%	8.2%	42.4%	11.4%	0.37
Prefecture	31.2%	6.8%	50.9%	19.0%	0.22
County + township	46.7%	10.8%	65.2%	22.1%	0.23

Note: Data exclude Beijing, Tianjin, Shanghai and Tibet.

Source: China Prefectures, Cities and Counties Fiscal Statistics 2003.

These features of the current fiscal arrangements in China combine to produce two salient outcomes in rural public finance: First, rural local governments in the different regions face different fiscal environments, both in terms of how much autonomy they have in spending decisions and also in terms of the resources available for meeting expenditure responsibilities. Second, it is not a straightforward process for the Central Government to implement changes in

⁴² MOF (2003); Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

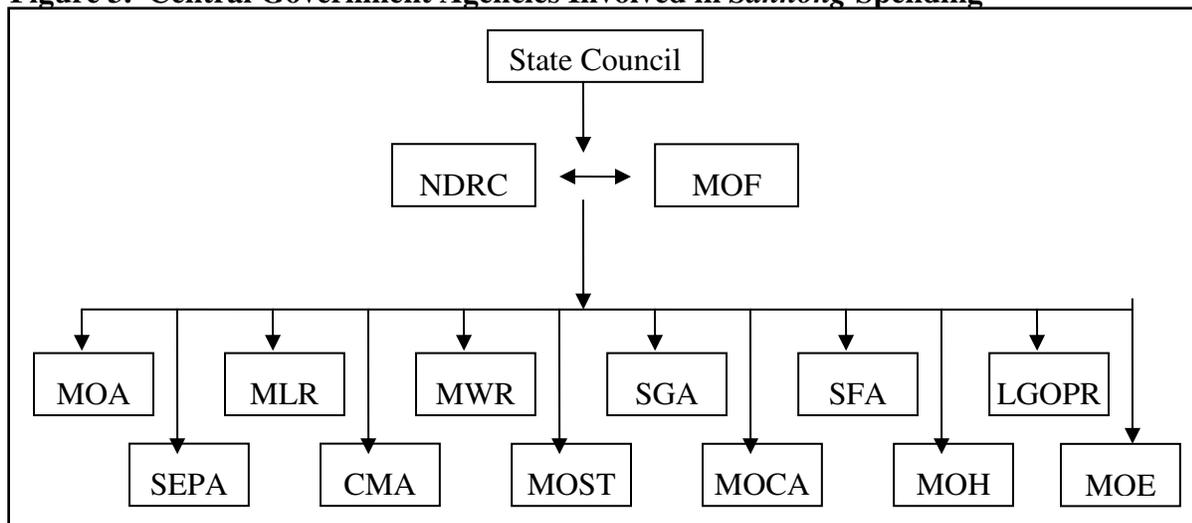
rural policies since these changes are mediated by several intermediate levels of government.

Organizational structure for rural development

Many government agencies are involved in the financing – and implementation – of public goods and services for rural development, including at the central level. Under the leadership of the State Council, the two “super-ministries,” i.e., the National Development and Reform Committee (NDRC) and the Ministry of Finance (MOF), have the greatest decision-making power. They are not only planning and coordinating bodies for the other line agencies, but they also channel funds through their own systems. For instance, the Food-for-Work (FFW) poverty program and other infrastructure-related programs are administered through the NDRC; the Comprehensive Agriculture Development (CAD) program is implemented by the State Office for CAD under the MOF (SOCAD) and its corresponding agencies at the subnational level.

The following line agencies have the most direct involvement in agriculture and rural development: Ministry of Agriculture (MOA), Ministry of Water Resources (MWR), Ministry of Land and Natural Resources (MLR), State Forestry Administration (SFA), Leading Group Office of Poverty Reduction (LGOPR), and State Grain Administration (SGA). Others, including the Ministry of Education (MOE), Ministry of Health (MOH), Ministry of Civil Affairs (MOCA), Ministry of Communications (MOC), Ministry of Labor and Social Security (MOLSS), Ministry of Science and Technology (MOST), the Central Meteorological Administration (CMA), the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ), and even the Commission for Science and Technology and Industry for National Defense should be mentioned because of the importance of their services, including to rural areas. A summary presentation is shown in Figure 3 below.

Figure 3. Central Government Agencies Involved in Sannong Spending



Source: Adapted from the website of the Central People’s Government of the PRC: http://www.gov.cn/gjjg/2005-08/01/content_18608.htm; Xinhua information.

Many other central-level agencies are also involved in rural development, though not necessarily in the implementation of interventions that use central fiscal resources. In this context mass organizations like the All-China Women’s Federation (ACWF) or the Communist Youth League (CYL), or the Supply and Marketing Cooperatives need to be mentioned. Of course, last

but not least, the most powerful organs defining rural development and its financing are those of the Party and “hybrid” (Party and government) agencies, such as such as the Leading Group for Financial and Economic Affairs or the State Commission on Public Sector Reform (SCPSR).⁴³

Responsibilities at the central level are not clearly delineated and gaps and overlaps of responsibilities and lack of coordination lead to inefficiencies. For example, there are overlapping responsibilities between the NDRC, broadly responsible for planning, and the MOF, responsible for budget planning (and execution). A lack of coordination can lead to a situation where the NDRC’s planning and approval of capital investments are not in line with the MOF’s planning and allocation of recurrent costs for the operation and maintenance of an investment. Similarly, some types of investment funded through and implemented by SOCAD, e.g., for land preparation or irrigation and drainage, might also get support from the MWR or the MOA or, in poverty areas, the LGOPR or the NDRC-administered FFW program. However, there is no centralized monitoring and evaluation system that allows the Central Government to comprehensively assess the overall programs; in which counties, townships, and villages they are implemented; and their efficiency and impact. Appendix 9 Table 4 provides an attempt to list the responsibilities of a few key departments.

The situation becomes even more complicated when looking at specific government functions. For example, Liang (2003) points out that “the present administrative management system ... still carr[ies] the characteristics of the planned economy. Problems of division among departments and detachment of management continue to exist, especially in managing agricultural and rural economic affairs. According to statistics, fourteen ministries and commissions (or administration bureaus) are involved in governing the process before, during, and after production. Among them, eight agencies are involved in the management of the quality and safety of farm produce, eight for agricultural investment, six for processing and distribution of farm produce, and five for management of agricultural production materials.”⁴⁴

The organizational structure of the Central Government is mirrored at all four other levels of government, leading to a highly complex organizational structure. The structure of government agencies described for the central level is largely the same at the province, prefecture, and county levels. At the township level, so-called “stations” or “centers” and their staff correspond to the government structures at the higher levels. Variations exist across localities, generally due to historical reasons. For examples, some provinces, prefectures, or

⁴³ The official English-language name of this committee, often referred to as the “post establishing committee,” is the State Commission on Public Sector Reform.

⁴⁴ Liang (2003) continues with an example, using grain crops “[...] the Ministry of Agriculture administers independently the production, domestic inspection, and quarantine and technical extension for grain crops, while the [National] Development Planning Commission administers grain market balance, import and export plan and purchasing and marketing price, the State Economic and Trade Commission and the China Supply and Marketing Cooperatives jointly administer production materials distribution, the Ministry of Science and Technology manages key science and technology research programs and demonstration projects in agricultural science and technology, the State Administration of Quality Supervision and Inspection and Quarantine administers the quality standard and inspection and quarantine of grain and its products as well the sanitary supervision of grain for import and export, the Ministry of Foreign Trade and Economic Cooperation administers the negotiation, dispute settlement, and quota allocation, the provincial governments administer the balance of grain supply and demand among regions, the State Bureau of Grain Reserve administers grain distribution and collection and storage policy, the Agricultural Development Bank administers managing the grain purchase capital, the State Economic and Trade Commission and the Ministry of Agriculture administer building the farm produce market system, and the State Economic and Trade Commission administers food processing policy.”

counties might have both a Bureau of Agriculture and a Bureau of Animal Husbandry, with both reporting vertically to the MOA; or there might be a “Rural Affairs Office” and an Agricultural Commission with larger, coordinating functions across sub-sectors.

Basically all the functions covered by the various agencies at the central level are covered by those at each of the subnational levels as well. Responsibilities are not restricted to policy-making and implementation, but often involve the channeling of funds and, not infrequently, the need to allocate fiscal resources at many government levels. For example, as will be shown below, the Central Government is increasingly engaging beyond its “core,” i.e., national-level functions such as basic agricultural research or agricultural price support. Over the last few years the Central Government has increasingly provided earmarked transfers for the financing of public goods and services in rural areas that can be described as “local,” including village-level infrastructure (roads, water supply, etc.), and it is now starting (from a very low level) to assume a greater role in the financing of compulsory education in rural areas.

Personnel system

Another important aspect of the administrative system that fundamentally impacts rural public finance is the personnel system due to its unique features. This system and how it is implemented, in particular at the grassroots level, is described in detail in Appendix 5 and Annex 4. In summary, the Party and government at the central level determine the personnel system – together with the government organization system at each level. This includes the number and level of staff each government agency can have. The central authorities also determine salary levels for all levels. Finally, performance evaluations and promotions are highly hierarchical in the sense that the top positions of each government level are determined by the higher level. Overall, this system reflects the strong degree of accountability of local governments to the central level. It has worked well in terms of bringing results for the previously rather one-dimensional goal of economic growth.

However, the system also has substantial problems. For example, setting standard salary levels for a country as large and diverse as China naturally leads to “overpayments” in the economically poorest areas and “underpayments” in richer areas – compared to the economic strength and salary levels of those localities. As a result, there are high non-salary payments in rich areas, and these are generally much less controlled. In poorer areas, as will be shown below, this contributes to the tremendous staffing costs. Financial constraints often play a smaller role than other considerations when hiring and paying staff. Moreover, the system is not well enforced. The resulting problems of “overstaffing” with negative consequences for the service delivery of public resources will be shown in Chapter 5 below. Finally, it remains to be seen how far performance evaluations for local government leaders can work under the new framework of a set of multi-dimensional goals including social and environmental objectives.

3.3. Expenditure Assignments

Expenditure responsibilities are only defined in broad terms for central and “local” authorities in the Budget Law (1994). The law leaves it to the subnational governments to work out how to divide “local” responsibilities and revenues among the four levels. Table 8 shows the broad assignments under the Budget Law.

Table 8. Division of Responsibilities between the Central and Local Governments

Central Government	Subnational Governments
1. National defense	1. Local government administration
2. Diplomacy and foreign affairs	2. Local public services
3. Military police	3. Locally financed basic infrastructure & technical renovations
4. Key construction projects	4. Support to agriculture
5. Central Government administration	5. Urban maintenance and construction
6. Public services at the central level	6. Price subsidies
7. Debt service payments	7. Other expenditures

Source: Adapted from the Budget Law (1994).

Given the absence of specific assignments, in a broad sense the four levels of subnational governments share joint responsibility for all functions not assigned to the Central Government. In practice, another salient feature of China's intergovernmental fiscal system is the prevalence of concurrent assignments of expenditures (World Bank 2006a), with all four levels of subnational governments engaged in virtually all budgeted activities. This is illustrated in Table 9, showing a range of major services provided concurrently by several levels of government, including rural governments at the county and township levels.

Table 9. Expenditure Assignments by Government Level

	Central (T1)	Provinces (T2)	Municipalities (T3)	Counties (T4)	Townships (T5)
Higher education	x	x	x		
Intermediate education		x	x	x	x
Basic education				x	x
Culture	x	x	x	x	x
Basic R&D	x	x	x		
Health	x	x	x	x	x
Family planning			x	x	x
Administration	x	x	x	x	x
Law and justice system	x	x	x	x	x
Social security		x	x	x	x

Source: Adapted from Zhao et al. (2005b).

As shown in Table 10 below, rural local government expenditures are overwhelmingly concentrated in the provision of social services, administration, and economic services. In aggregate terms these three categories together account for 76 and 85 percent of expenditures at the county and township levels, respectively.⁴⁵ In recent years, under the RFR, some expenditure assignments have moved from the township to the county level – most notably the payment of teachers' salaries, as discussed in Chapter 2. While these changes affected the relative shares between the township and county levels, they did not represent a reduction in the responsibilities

⁴⁵ Social services include basic education, public health, and social welfare. Economic services include the operating expenses of the agriculture, forestry, animal husbandry, and industrial departments, and the agencies in charge of water conservancy. The definitions of expenditure categories in Table 9 are presented in Appendix 8 on Budget Definitions.

for rural governments (counties plus townships) as a whole. Instead, many new programs have been rolled out in rapid succession, thus adding to expenditure burdens.⁴⁶

Table 10. Composition of Budgetary Expenditures of Rural Local Governments, 2004

(Shares of total)	All Subnational Governments	Counties	Townships
1. Capital Investments and Development	20.5%	14.8%	7.2%
2. Economic Services	14.4%	14.4%	13.9%
Agriculture	7.5%	8.6%	10.2%
3. Social Services	31.0%	36.8%	39.2%
Education	15.3%	21.6%	28.1%
Health	4.0%	4.6%	2.3%
4. Administration	21.7%	24.7%	28.9%
5. Subsidies	10.8%	7.6%	10.0%
6. Others	2.0%	2.1%	0.9%
Provision of Services (2 + 3 + 4)	67.1%	75.9%	82.0%

Note: See Appendix 8 for definitions of expenditure items.

Source: Compendium of Local Fiscal Statistics, 2004.

Local rural governments have great difficulties in adequately assuming their expenditure responsibilities. Little information is collected systematically in China on the state of services delivered on the ground. However, it can be surmised from the high average proportions of total expenditures devoted to service provision (and their great variability) that many rural counties and townships at the lower end of the income distribution are unable to fund their expenditure responsibilities at adequate levels.⁴⁷ Even for the key national priority task of providing nine years of basic education, for example, the Ministry of Education found that at year-end 2002, 431 counties, nearly all of which are in remote mountainous areas, had not reached this target. Together these counties have a population of 107 million – more than one-eighth of the rural population (Wang Zhan 2003).⁴⁸ This picture of inadequate provision of rural services is supported by the large rural-urban difference of indicators such as infant mortality (see Box 2 above) as well as anecdotal evidence collected during field visits undertaken in this study. An example is the case of Hua county (Huaxian), a nationally designated poor county in the central province of Henan. Huaxian’s consolidated budget (for both the county and its townships) is presented in Table 11.

Table 11. Budgetary Expenditures in Huaxian, 2003

Expenditure Category:	Per capita (RMB)	Share of total budget
Administration	68	22%
Education	120	39%
Agriculture (incl. forestry, water conservancy, meteorology)	23	7%

⁴⁶ Examples include the New Cooperative Medical Scheme (NCMS), the recently announced “free rural education” program, the rural minimum living stipends, and others, as mentioned in Chapter 2.

⁴⁷ This is consistent with the findings of empirical studies, such as World Bank (2002), Heberer (2001) and Chen and Han (2005).

⁴⁸ By the end of 2004, the number of counties not achieving this target had been reduced to 284, still a significant share of all counties.

Expenditure Category:	Per capita (RMB)	Share of total budget
Health	10	3%
Social assistance/relief	15	5%
Capital construction	17	6%
Other	56	18%
Total	308	100%

Source: Annex 3.

Even though Huaxian devoted 39 percent of its budgetary expenditures to education, nearly twice the national average for counties, it managed to spend only RMB 678 per student enrolled in basic education, or 62 percent of the national average.⁴⁹ With education taking up a large part of available revenues, and administration taking another 22 percent, Huaxian was hard-pressed to find resources to meet all of its responsibilities. Compared to other counties, it spent proportionally less on capital investments, health, and economic services. Even though the county is one of the largest grain producers in China, Huaxian also spent comparatively little on agricultural services. In 2003 the budget allocated only RMB 23 per capita for the operating costs of all departments related to agriculture, an amount that was less than 10 percent of that spent in Ninglang county in Yunnan, a remote and mountainous locality (Annex 2). The Huaxian county government provided no funding for any other economic services.

3.4. Revenue Assignments

In order for rural local governments to deliver the many assigned vital (and often costly) services, the IFS must assign sufficient revenues to them, either through own taxes and user charges, or through transfers. In either case, given the very large regional disparities in income and revenue capacity across regions, transfers play an important role in alleviating horizontal inequities. If these conditions are not met (either because of inadequate own revenues and/or inadequate transfers), the outcome is an inadequate provision of services and large disparities in services across localities. Moreover, where resources are inadequate, shared responsibility often leads to higher levels of government delegating responsibilities to lower levels of government.

Under the TSS, all taxes are assigned to the Central Government, “local” government, or shared. At the outset, the TSS aimed to simplify the revenue sharing system by introducing a simple, transparent, and uniform structure for revenue assignments across provinces. The system was introduced with only a few shared taxes – the VAT (75 percent central and 25 percent local) and the resource tax (assigned to either central or local government by type of resource). The sharing rates would be uniform across all regions. Appendix 7 shows the current tax assignments.

In practice, however, the system of revenue assignments remained very complicated, especially at the subnational levels.⁵⁰ In many localities, especially at the township level, pre-TSS “fiscal contracts” were retained, under which the local government either received or remitted a lump-sum amount or a proportion of revenues (Zhou et al. 2005). The TSS simply

⁴⁹ See World Bank (2005a); national figure calculated from Chinese Finance Yearbook, 2004.

⁵⁰ This is discussed in detail in World Bank (2002, Chapter 2).

added a new layer to the division of revenues – in Chinese this is commonly referred to as the “simultaneous implementation of two (revenue-sharing) systems.” In addition, the extension of the TSS to the subnational level only began in 2002, and has been implemented differently in different provinces. The current situation is that “local” taxes are extensively shared among subnational levels. At the county and township levels, rural local governments collect a relatively large number of taxes, but draw their revenues mainly from a few taxes.

Nationwide, at both the county and township levels, the VAT, business tax (BT), and the income taxes (enterprise and personal) are the main sources of revenue. In 2003 these four taxes combined accounted for 54 percent and 53 percent of total revenues at the county and township levels, respectively. The importance of these taxes suggests that they are the focus of local revenue mobilization efforts. At the same time, through the 1990s in nearly all provinces the intermediate levels – the provinces and the prefectures – laid claim to a share of the taxes collected in the counties and townships, making it an increasingly uphill battle for the lower levels to increase revenues. This is illustrated in Table 12, which assembles information from three municipalities, two from Liaoning and one from Shaanxi, whose situations are not atypical. The multiple claims by different levels of government to the few revenue-rich taxes point to the potential for tension that is inherent in the present system of tax assignment and tax sharing. Under conditions of fiscal stress, the temptation for higher levels to “grab” revenues is undoubtedly great, and the Constitution provides no protection for the lowest levels of government.

Table 12. Multiple Claims to the Main Taxes, 2003

Government level			Tax Type (Share in Percent)			
			VAT	BT	EIT	PIT
Central level			75	0	60	60
Liaoning Province	Provincial level		10	30	20	15
	Anshan Municipality	municipal level	5	30	5	10
		county level	10	40	15	15
	Panjin & Yingkou Municipalities	municipal level	6	28	8	10
		county level	9	42	12	15
	Shaanxi Province	Provincial level		7.5	30	..
Hanyang Municipality		municipal level	2.5	10
		Liquan county	15	60

Sources: World Bank (2006a); Zhao et al. (2005b).

Aside from these four main taxes, counties also collect significant revenues from penalties and fines, and administrative fees (primarily from the education surcharge and pollution fees). In 2003, when agricultural taxes had been raised in many places through the implementation of the RFR and before they were abolished in 2005-2006, township governments drew nearly one-quarter of their revenues from the agricultural tax. These are shown in Table 13.

Table 13. Sources of Revenues of Counties and Townships, 2003

	County	Township		County	Township
VAT	17.7%	19.4%	Slaughter Tax*	0.0%	0.1%
BT	25.3%	22.9%	Agricultural Tax*	1.5%	22.6%
EIT	6.8%	6.0%	Agr. Spec. Products Tax*	1.1%	4.6%
PIT	4.1%	4.6%	Farmland occupation tax	1.7%	1.5%
Resource Tax	0.8%	1.5%	Title tax	3.7%	2.3%
UMCT	5.7%	4.7%	Profits from state-owned assets	2.5%	0.2%
Real Estate Tax	3.9%	3.0%	Administrative fees	7.2%	1.3%
Stamp Tax	1.1%	0.8%	Penalties and confiscatory incomes	7.8%	0.6%
Urban Land Use Tax	1.3%	1.2%	Earmarked revenues	4.3%	0.8%
VAT on Land	0.5%	0.4%	Other incomes	2.2%	0.6%
Vehicle Utilization Tax	0.4%	0.7%	Sum of VAT, BT, EIT, and PIT	54.0%	52.9%

* Abolished or curtailed under the RFTR step-by-step beginning in 2001. The shares in 2003 were already diminished from their peaks.

Data source: Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties.

This high dependence on turnover and enterprise taxes implies that fiscal resources are very unequally distributed across the rural sector, as they are concentrated in areas where enterprises are concentrated – in coastal regions and peri-urban locations. This is shown in Table 14, which compares the revenue compositions of selected counties, including two visited by the study team. The poor, agricultural county of Huaxian in Henan drew more than half of its revenues from the five agricultural taxes, three times the national average for counties. In contrast, the much more prosperous Shuangliu county on the periphery of Chengdu relied on agricultural taxes for only 11 percent of its revenue in 2003, and business taxes alone supplied 35 percent of its revenue.

Table 14. The Composition of Tax Revenues at the County Level, 2003

	National Average for counties + townships	Henan Provincial Average	Huaxian	Sichuan Provincial Average	Shuangliu
Per capita Revenues (RMB)		529	269	637	698
VAT	18.3%	16.4%	8.2%	13.0%	12.2%
Business Tax	24.5%	21.4%	10.8%	21.2%	35.1%
EIT	6.5%	6.8%	2.6%	9.8%	5.9%
PIT	4.2%	3.2%	2.4%	4.1%	4.7%
Urban Maintenance and Construction Tax (UMCT)	5.3%	4.8%	1.6%	7.5%	5.1%
Agricultural Taxes	15.9%	24.3%	50.4%	18.6%	11.4%
Other Revenues	25.2%	23.1%	23.8%	25.8%	25.4%

Note: County level includes townships. National average includes counties and county-level cities, but excludes districts.

Source: Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

Until the RFR was implemented, townships also depended on extra-budgetary fees and levies to finance as much as half of their public expenditures. A group of experts at the State Administration of Taxation estimated that legally prescribed fees and levies at the township and village levels totaled RMB 86 billion in 2000 (Yang et al. 2003). If these estimates are correct, fees and levies would have financed roughly one-third of public expenditures at the township level.⁵¹ In addition, illegal fees might have added another RMB 40 billion, and unpaid, compulsory labor would have contributed an amount valued at RMB 59 billion to total township expenditures. Put another way, township finance drew from in-budget resources (own revenues and transfers) RMB 187 billion to finance public expenditures, and another RMB 185 billion -- nearly exactly an equal amount -- from extra-budgetary resources of fees, levies, and labor contributions. While higher-level governments determine the amount of in-budget resources available to local governments, they have much less control over extra-budgetary resources. There are widespread reports that extra-budgetary funds, in particular currently from land transactions, still contribute to large resources outside the budget -- depending on widely varying access to such revenues.

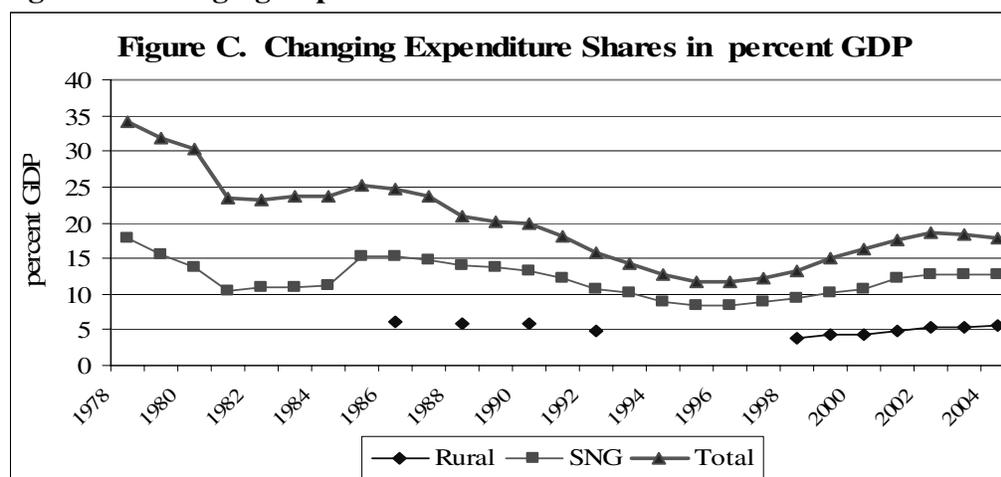
3.5. Trends in Rural Public Finance

Throughout the transition period, governments at all levels have faced enormous upward pressure on public spending, while laboring under a steep fiscal decline that was reversed only in the mid-1990s. Until the TSS introduced a new set of tax instruments and tax administration, the relaxation of state control over the economy had led to a rapid erosion of the government's capacity to tax (World Bank 2002; Wong 2005a). As the budget shrank from more than 30 percent of GDP to less than 12 percent during 1980-1995, all levels of government felt the squeeze (see Figure 4). At the same time, rapid economic growth and urbanization raised demands for new investments in basic infrastructure and improved services. In education, enrollment rates have risen at all levels, and especially in higher education. Health care spending has risen rapidly. Social safety net expenditures have also increased enormously as a result of reforms in state-owned enterprises and the aging population. Many of these demands fall on local budgets. In addition, wages have risen steeply during the transition, driving up the cost of labor-intensive public services -- again hitting subnational budgets harder.⁵² Figure 4 shows that, as a share of GDP, subnational expenditures fell (from 18 percent in 1978 to 8.3 percent at the lowest point) through the mid-1990s, before recovering somewhat in 2003-2004 (to 12.8 percent).

⁵¹ This was equal to 50 percent of the budget expenditures of RMB 187 billion at the township level (CFY 2001).

⁵² This was true starting in the 1980s (Wong 1991).

Figure 4. Changing Expenditure Shares in Percent of GDP



Note: SNG means “subnational government.”

Source: Calculated from Compendium of Local Fiscal Statistics.

While the TSS saved the Chinese fiscal system by reversing the fiscal decline, its impact on rural public finance was more adverse. Some salient trends are presented in Table 15 to show the changing status of rural public finance. From the mid-1980s, under decentralization both revenue and expenditure shares were increasing for the rural sector and the two were closely balanced. After the TSS in 1994, the trends diverged. While expenditures hovered around 30 percent of the national total, the county and township governments’ share of revenues fell sharply, from 30 percent in 1992 to only 17 percent in 2004. The result of these divergent trends was the growth of a vertical fiscal gap for these local levels, to 9 percentage points in 1998 and 14 percentage points in 2004 (or, in GDP terms, from near zero to 2.5 percent).

Table 15. Trends in Rural Public Finance

(percent)	1986	1988	1990	1992	1998	2000	2002	2004
‘Rural’ share of total expenditures	24.7	28.3	29.7	30.9	28.2	26.2	28.6	31.3
County	19.2	21.0	21.3	21.6	19.9	18.9	21.9	25.2
Township	5.5	7.3	8.4	9.3	8.3	7.3	6.8	6.1
Township share of rural	22.3	25.8	28.3	30.1	29.3	27.8	23.7	19.6
‘Rural’ share of total revenues	21.7	28.6	28.4	30.1	20.3	19.7	17.1	17.2
County	12.5	17.1	16.1	16.6	11.5	12.0	11.0	12.0
Township	9.2	11.5	12.3	13.5	8.8	7.7	6.1	5.2
Township share of rural	42.4	40.2	43.3	44.9	43.5	38.9	35.6	30.0
Fiscal gap for rural	-3.0	0.3	-1.3	-0.8	-7.9	-6.6	-11.6	-14.2
County	-6.7	-3.9	-5.2	-5.0	-8.5	-6.9	-10.9	-13.2
Township	3.7	4.2	3.9	4.2	0.6	0.4	-0.7	-1.0
As % GDP	-0.7	0.1	-0.3	-0.1	-1.0	-1.1	-2.1	-2.5

Note: * The fiscal gap is measured as revenue share minus expenditure share.

Source: Compendium of Township Financial Statistics, 1986-1992; World Bank (2002); and MOF provincial dataset 2003.

The TSS also produced sharply divergent trends for townships and counties. Up through 1992, the township shares were growing both on the revenue side – with the rapid growth of township and village enterprises (TVEs) -- and on the expenditure side. These trends were reversed after the TSS. Between 1992 and 1998, the township share of revenues fell steeply, as the product taxes from TVEs were converted to VAT, whose revenues were mostly captured by higher-level governments – as seen earlier in Table 14. Township revenues continued to fall from 1998 to 2004, with the RFR and the reassignment of the EIT cutting into the rural tax base. The decline continued with the abolition of the agricultural taxes.

The township’s share of expenditures also fell from 1992 onward, albeit more slowly than revenue. This decline may have been partly caused by the reassignment of some functions to the county level. It may also reflect a squeeze on services provided by townships and villages. More detailed information is needed to disentangle the different causes, but the shift of resources away from the whole rural sector (counties and townships), and especially away from the townships, is likely indicative of an adverse trend in rural public services.⁵³

In contrast, the county’s share of expenditures in total government expenditure actually increased, and its revenue share remained relatively constant. Consequently, the relative power between the county and township level has shifted significantly. In 2004, the share of the township in the consolidated (county plus township) budget was only 30 percent on the revenue side and a mere 20 percent on the expenditure side.

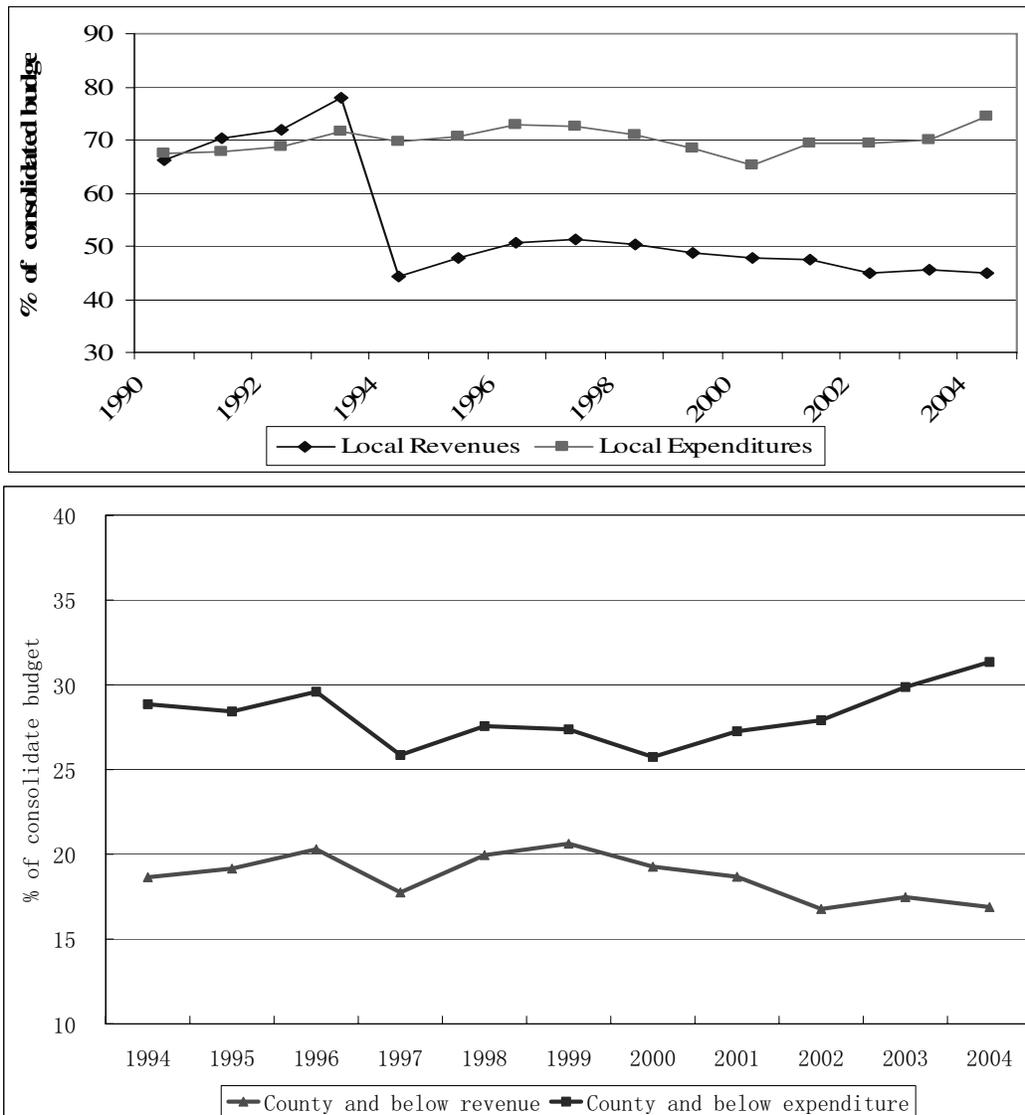
The autonomy of county governments overall might have increased, but by far the greater impact has been on townships that are left with very little autonomy. To analyze more rigorously the evolving fiscal status of rural governments, we need detailed information on expenditure assignments and how they may have shifted, which is unavailable. Nevertheless, the overall trends in the rural sector clearly indicate that revenues and expenditures are moving in opposite directions. This provides evidence of an increasing reliance on central transfers and, unless the transfers are mostly unrestricted, a decline in overall local government autonomy.

⁵³ County governments are increasingly split between their urban core in the county town and their rural constituents.

Chapter 4. Intergovernmental Fiscal Transfers

The prevailing revenue and expenditure assignments impose a great burden on the system of transfers to achieve coherence in the intergovernmental fiscal system. By recentralizing revenues but leaving expenditure assignments unchanged, the TSS introduced a huge vertical fiscal gap for subnational governments (Figure 5), a gap that must be filled to permit subnational governments to perform their assigned functions as before. The large and growing horizontal disparities across localities in the course of China's rapid growth and engagement in the global economy require that transfers also play a role in dampening fiscal inequalities among subnational governments.

Figure 5. The Vertical Fiscal Gap for (a) Subnational and (b) Consolidated County Levels



Source: Based on Compendium of Local Fiscal Statistics; Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties; unadjusted.

4.1. The Role of Intergovernmental Transfers

Intergovernmental transfers are a critical part of fiscal systems around the world. They are directly linked to revenue and expenditure assignments across levels of government. In any system, the assignment of expenditure responsibilities should be based on considerations of efficiency and responsiveness in service provision. Once expenditure assignments are set, subnational governments must have adequate resources for meeting these responsibilities from a mixture of own revenues – provided through revenue assignments -- and transfers. The choice of the appropriate balance between own revenues and transfers should similarly be based on considerations of the national objectives for achieving efficiency and equity in the provision of local public goods. In general, transfers are used:

- a) To meet vertical fiscal gaps. In most countries, the national or Central Government retains the major tax bases, yet many services are provided by local governments, and there is a mismatch between local revenue capacity and expenditure needs. Transfers are needed to give local governments sufficient resources to finance their expenditures.
- b) To alleviate horizontal fiscal disparities. Differences in resource endowments and levels of development mean that local governments have different revenue capacities. Local governments may also have different expenditure needs. For example, China's old industrial bases have greater social security outlays that impose heavier burdens on local budgets; the extremely cold climate in the Northeast and northern provinces leads to higher costs of schooling and running government offices, etc. Transfers are often designed to offset these differences to effect some equalization across localities.
- c) To address inter-jurisdictional spillovers. Economic theory suggests that local governments tend to under-invest in services whose benefits are not fully captured in the locality – examples include pollution control, interregional highways, and higher education. Transfers are needed to offset these externalities to induce local governments to provide socially efficient amounts of services.
- d) In addition to these economic reasons, transfers are sometimes provided for political reasons – to reward “old revolutionary bases,” to build solidarity with ethnic minorities, or simply to carry out national policies.⁵⁴ Box 7 provides a taxonomy and some best practices on intergovernmental transfers.

⁵⁴ For references on intergovernmental transfers, see Bahl and Linn (1992), Shah (1994), Bird and Smart (2002) and Schroeder and Smoke (2003).

Box 7. Principles and Better Practices in Grant Design

There are two broad types of transfers, general purpose and specific purpose. **General-purpose transfers** (GPT) give subnational governments full discretion over the use of transferred funds. **Specific-purpose transfers** (SPT) are made on the condition that the funds are used only for specific purposes (sometimes called conditional grants). A middle-variant is sectorally limited block grants that permit the recipient government to choose how funds are used within a specified sector, such as health or capital investment. For example, a capital development grant may allow the subnational government the choice to use the funds to construct new roads, health centers, or school buildings, but not to construct a new city hall.

Transfers can be **matching or non-matching**. Matching grants require that subnational governments provide counterpart funds, otherwise they are non-matching grants. In budgeting for transfers, governments also choose whether to make them open-ended (where the amount given is unlimited as long as conditions for eligibility are met), or close-ended (where a ceiling is fixed for the total amount to be spent under the grant program).

In general, the type of transfer used depends on the objective of the grant program as well as macroeconomic considerations. The following table provides a taxonomy of grant types and some examples of their uses in other countries.

Grant Objective	Grant Design	Better Practices	Practices to Avoid
To reduce regional fiscal disparities	- General non-matching - Fiscal capacity equalization transfers	- Fiscal equalization programs of Australia, Canada, and Germany	- General revenue sharing with multiple factors
To compensate for benefit spillover	- Open-ended matching transfers with matching rate consistent with spill-out of benefits	- Transfers for teaching hospitals in South Africa	
To set national minimum standards	- Conditional non-matching block transfers with conditions on standards of service and access	- Grants for roads and primary education in Indonesia - Education transfers in Colombia, Chile, and South Africa	- Conditional transfers with conditions on spending alone - Ad-hoc grants
To influence local priorities in areas of high national but low local priority	- Open-ended matching transfers (preferably with matching rate to vary inversely with fiscal capacity)	- Matching transfers for social assistance, as in Canada	- Ad hoc grants
To stabilize the economy	- Capital grants, but financing for maintenance should be part of the grant or conditions	- Limit use of capital grants and encourage private sector participation by providing political and policy risk guarantees	- Stabilization grants with no future upkeep requirements

Source: Based on World Bank (1997, Box 7.4.)

4.2. Current Status of Transfers

Intergovernmental transfers⁵⁵ are large in nominal terms, and they have grown rapidly in recent years.⁵⁶ Figures in Table 16 show a large one-time jump in 1994 to adjust for the change in revenue assignments under the TSS, after which central transfers stabilized at about 4 percent of GDP in the mid-1990s but began to grow again after 1998. By 2004, transfers were equal to 6.5 percent of GDP. More remarkably, transfers have taken up 70 percent or more of Central Government revenues in recent years (2000-2004) – for every RMB 100 the Central Government collects in taxes, it turns over RMB 70 to subnational governments through intergovernmental transfers.

Table 16. The Growing Importance of Transfers

	Total Transfers from the Central Government (RMB billion)	As percentage of	
		GDP *	Central Government Revenues
1986	46.4	4.5%	59.6%
1992	59.7	2.2%	60.8%
1994	238.9	5.0%	82.2%
2000	474.8	4.8%	67.9%
2001	601.5	5.5%	70.1%
2002	736.2	6.1%	70.9%
2003	826.1	6.1%	69.6%
2004	1037.9	6.5%	71.7%
2005		6.3%	66.5%

* GDP from 1993 onward uses the revised series from December 2005.⁵⁷

Source: Budget speeches to the NPC; CSY, various years; Lou (2000), Wong (1997).

From the subnational perspective, transfers are equally important – in 2004 they financed half of the total budgetary expenditures of subnational governments. This is shown in Figure 6, where subnational transfer dependency can be seen trending upward since the late 1990s. This trend is especially notable since it occurred during a period when subnational expenditures were growing rapidly, at annual rates of more than 17 percent.⁵⁸

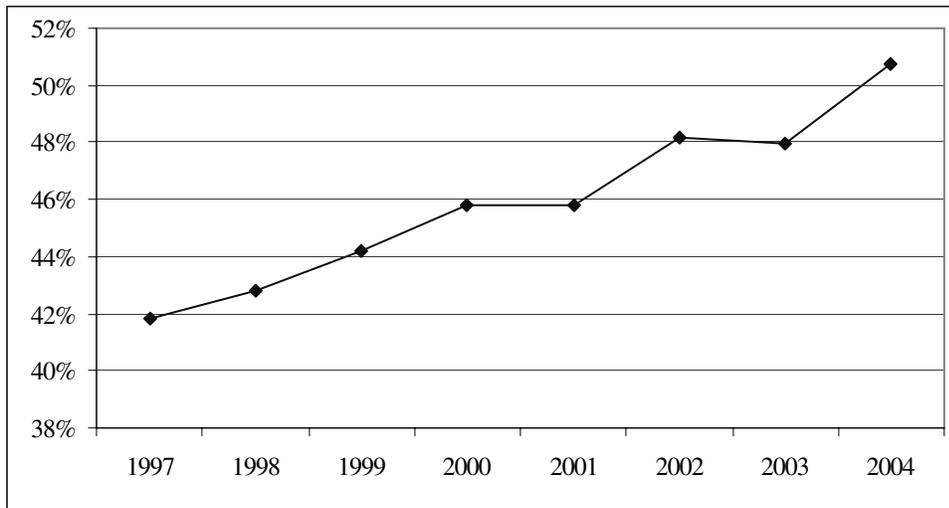
⁵⁵ Unless otherwise noted, this chapter adopts a broad definition of “transfers” to include tax rebates.

⁵⁶ The growth rate is in nominal terms. During 1997-2004 the CPI rose only 3.1 percent, while the retail price index fell by 7.4 percent. Average wages, though, rose by 148 percent (calculated from NBS 2005 data).

⁵⁷ NBS announced an upward adjustment of the 2004 GDP by 17 percent, and adjusted the GDP series back to 1993 using the revised basis. The adjusted GDP series is reported in the World Bank Office in Beijing Quarterly Update, February 2006.

⁵⁸ The growth rate is in nominal terms. During 1997-2004 the CPI rose only 3.1 percent, while the retail price index fell by 7.4 percent. Average wages, however, rose by 148 percent (calculated from NBS 2005 data).

Figure 6. Transfer Dependency at the Subnational Level



Note: Calculated as transfers divided by subnational expenditures.

Source: Based on Compendium of Local Fiscal Statistics, unadjusted.

This is a high degree of dependency on transfers. Economic theory suggests that incentives favor own revenues over transfers for the efficient management of funds (Bahl 1999). Because “spending other people’s money” tends to elicit less frugal behavior by the recipients of transfers, the use of transfers thus imposes a management burden on the Central Government for monitoring and evaluating the use of funds. For efficiency reasons, countries might choose to limit the use of transfers, mainly by reducing as much as possible the size of the vertical fiscal gap and relying on transfers principally to serve the needs of national objectives for economic development and social equity. However, considerations of revenue mobilization and efficient tax administration might exert a push in the opposite direction.

In developing countries tax revenues are generally more centralized than expenditures, and transfers play an important role in filling the vertical fiscal gap as well as in meeting equalization objectives (Bird 2003). In an important recent study, Bahl and Wallace (2004) found a surprisingly high reliance on transfers around the world. This trend increased from the 1990s to the early 2000s and was especially marked for the developing countries (Table 17). In this light, it can be seen that in 1990 the share of subnational dependency on transfers was actually lower in China than the averages for both industrialized and developing countries; China caught up with the average for developing countries only in the early 2000s. However, China really stands out in transfers as a percentage of Central Government revenues, and, relatedly, of GDP (second and third columns), where the Chinese figures are much higher than the world averages. This mainly reflects the much higher than average degree of expenditure decentralization in China that is grossly misaligned with revenue assignments. Taken as a whole, Table 17 shows China’s dependency on transfers to be exceptionally high, as was the rate of increase in dependence over the past decade.

Table 17. Comparing China's Transfer Dependency to Other Countries

	Intergovernmental transfers as a percentage of		
	Subnational government expenditures	Total tax collections of the higher-level government	GDP
China*			
1990-1993	23.0	59.0	2.4
2000-2003	46.9	69.6	6.4
<i>Change</i>	+23.9	+10.6	+4.0
Average for 19 industrialized countries			
early 1990s	43.7	21.9	5.0
early 2000s	41.7	23.2	5.4
<i>Change</i>	-2.0	+1.3	+0.4
Average for 37 developing countries			
early 1990s	36.9	13.6	2
early 2000s	48.8	24.3	3
<i>Change</i>	+11.9	+10.7	+1.0

* Averages are for 1990-1993, and 2000-2003. Column two is transfers as a percentage of central revenues (excluding remittances).

Source: Table 15; Bahl and Wallace (2004, Table 1).

Two other features of the current system of transfers in China stand out, and both point to the vulnerabilities in the Chinese intergovernmental fiscal system.

First, as expected, transfer dependency is even higher at lower levels of government. In Table 18 we compare the shares of budgetary expenditure financed by transfers for provinces (consolidated – including sub-provincial) with those of counties and townships. The average dependency of counties, including townships, was 57.5 percent in 2003 for all provinces, with a range of 41 percent in Shandong to 89 percent in Tibet and a standard deviation of 10 percent. The average figure for 2004 was 61.3 percent. On the one hand, this is a very high rate of transfer dependency, with more than RMB 60 coming from higher levels for every RMB 100 spent by local governments at these levels. For the township level alone, the rate of dependency would be higher still – since the RTFR eliminated almost all own revenues in agriculture-dominated regions. On the other hand, an average dependency ratio that is only about 9 percentage points higher for rural local governments compared to that for consolidated subnational expenditures is relatively small, given the heavy expenditure assignments to these levels and the relative concentration of revenues at higher (especially municipal) levels.

Table 18. Transfer Dependency by Province, 2003

Share of budgetary expenditures financed by transfers	Consolidated provincial expenditures	Expenditures at county and township levels
Average for all provinces (31) (weighted)	50.4%	57.7%
Maximum	90.9%	88.5%
Minimum	20.4%	40.8%
<i>Standard deviation</i>	<i>16.8%</i>	<i>10.4%</i>
<i>Coeff. of variation</i>	<i>0.33</i>	<i>0.18</i>
Yunnan	58.0%	68.6%

Share of budgetary expenditures financed by transfers	Consolidated provincial expenditures	Expenditures at county and township levels
Sichuan	54.7%	66.3%
Jiangxi	56.2%	60.7%
Henan	53.2%	59.6%

Source: Calculated from Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003 and Finance Yearbook, 2004.

Second, the current system of transfers appears to be funded entirely by the Central Government, with little input from intermediate levels. The fiscal statistical system does not report on the role of provinces, municipalities, and counties in the financing of transfers. In 2003 counties and townships reported receiving net transfers totaling RMB 424.8 billion, and the prefecture level (not including counties) reported receiving RMB 235.2 billion (Compendium of Local Fiscal Statistics 2003). These add up to RMB 660 billion, or RMB 174.4 billion less than the total central transfers for the year, 21 percent of the total (CFY 2004).

Even taking into account some underreporting,⁵⁹ the picture appears to be that a typical province makes little, if any, contribution to intergovernmental transfers to lower levels that are designed to equalize fiscal capacities. This is supported by anecdotal evidence collected from fieldwork studies, which suggests strongly that there is little participation by provinces and municipalities in the provision of transfers to rural governments (Su et al. 2005; Zhao et al. 2005b). It is also consistent with overall fiscal trends, which have generated increasing pressures on intermediate levels of government that make the latter's participation increasingly unlikely. This constitutes a major vulnerability in the Chinese system of decentralized fiscal management as intermediate levels have little "ownership" in the use of transfers and may not always agree with the Central Government's objectives. In many other countries intergovernmental transfers are financed by the Central Government, but in China it is a challenge to ensure that the monies reach the targeted recipients that are several layers down in the multi-tiered nested hierarchy.

4.3. Past Developments in the Transfers Regime

Until recently, the importance of transfers in performing different functions in the intergovernmental fiscal system was underappreciated in China, and reform of the system of transfers lagged far behind reform of other components in the overall program to revamp the system of public finance to meet the needs of a decentralized, market-oriented economy.

Under the planned economy, general-purpose transfers were not clearly delineated, and earmarked grants were embedded in economic plans. In the highly centralized Chinese fiscal system from the 1950s to the 1970s, the line between transfers and revenue assignments was fluid and indistinct. All revenues belonged to the Central Government, and revenue assignments were made ex post to permit local governments to finance expenditures approved by the Central

⁵⁹ Some provincial expenditure may be on projects that benefit local (including rural) areas and residents, but are not accounted for in local budgets. There also is a time-lag between receiving central transfers and passing them through to the lower levels; during periods when transfers are increasing rapidly, this could result in significant amounts of funds being left at the provincial level during the year. However, over time, this should be accounted for.

Government. In such a system, strictly speaking, all local expenditures were financed with central transfers, but they were hidden in revenue “retention rates” that varied across administrative units. What was then called “subsidies” was only the injection of funds into the poorest provinces that could not meet expenditure needs even after being given 100 percent of their own collected revenues (see Box 8 for a brief description of transfers in planned economies). The same principles applied to lower levels of the fiscal system, where each administrative unit either received a “subsidy” or made a “remittance” depending on whether or not locally collected revenues exceeded approved expenditures.

Box 8. The Treatment of Transfers in Planned Economies

Intergovernmental fiscal arrangements were unique in planned, Soviet-type economies. Under their highly centralized fiscal systems, the three components of the intergovernmental system – expenditure assignments, revenue assignments, and transfers – were fluid and ad hoc. In centrally planned economies, responsibilities for day-to-day public administration and social services, such as education (except universities), public safety, health care, social security, housing, and other local and urban services, were assigned to local governments. When measured in terms of the share of budgetary expenditures accounted for by the subnational governments, these economies appeared to be highly decentralized. However, these were *delegated* functions whose norms (or service standards) were often set by the Central Government, and the services were delivered by local governments acting as *agents* of the Central Government. All revenues belonged to the Central Government but were collected by local governments and remitted upward. Revenue assignments were ex post, negotiated annually, and adjusted to finance the delegated functions.

In this system, the line between transfers and revenue assignments was fluid, and most of what would be considered “transfers” in Western systems was hidden. Strictly speaking, all local expenditures were financed with central transfers. In other words, even though large cities such as Shanghai and Beijing were allowed to retain only a small fraction of the revenues they collected, they were actually receiving per capita transfers that were much higher than the national average, as reflected in their higher per capita fiscal spending. Instead, what were called “transfers” were only the additional injections that were necessary for those provinces that could not meet expenditure needs even after being assigned 100 percent of their own collected revenues. This was essentially the system operating in China at the outset of the market reforms in the late 1970s.

Although earmarked grants were also used in Soviet-type economies to finance specific programs or projects, there was no need to create special mechanisms within the fiscal system for their monitoring (beyond the audit) since such mechanisms were already embedded in the economic plan, the primary instrument for implementing policies and programs.

Source: Wong (2007).

Through the 1980s and early 1990s, as the MOF was preoccupied with the need to stem the fiscal decline and hemorrhaging of central revenues, fiscal reform efforts were focused on revenue mobilization and tax modernization. Less attention was paid to the needs of equalization and improving the effectiveness in the use of funds (World Bank 2000, 2002). Government was slow to reform the system of transfers even as revenue assignments were revised repeatedly, and, more egregiously, even when revenue assignments and expenditure

needs were delinked in the late 1980s (Wong 2007). As late as 1993 there were only three types of central transfers to the provinces: quota subsidies, earmarked subsidies, and final account subsidies (Wong, Heady, Woo 1995). The first, quota subsidies, were general-purpose transfers given to poor provinces to help them meet expenditure needs.⁶⁰ The second and third were specific-purpose transfers earmarked for projects and programs, or were compensatory payments for revisions to the tax bases, transfers of enterprise ownership, etc. Embedded in the final account subsidies were compensations for the transfer of SOEs or adjustments in responsibilities (Wang et al. 1999).

A new system of transfers was needed with the introduction of the TSS. Since the TSS fundamentally changed the way revenues were assigned in the Chinese system, it should have triggered an accommodative change in the system of transfers. The TSS not only recentralized revenues, but also made revenue assignments much more favorable to rich localities by shifting from a redistributive system of general revenue sharing to a system of tax assignment and tax sharing by origin. The TSS is inherently disequalizing because it has allowed the rich regions to keep more of their revenues. Prior to its introduction, preliminary plans had called for reforming the system of transfers and creating a formula-based equalization grant to offset the disequalizing character of the TSS (Wong, Heady, and Woo 1995). A formula-based, equalization grant was introduced in 1995 as a “transitional transfer,” but provided little funding – it accounted for less than 2 percent of total transfers through 1998 -- and had little impact. Instead, to gain support for the TSS from the coastal provinces, the government committed to a system of tax rebates that returned to the provinces a portion of the “growth” in the VAT and excise taxes. These rebates were added on to the existing transfers (quota subsidies, earmarked subsidies, and final account subsidies) that were otherwise left to continue as before, and largely at the same levels (Table 19). Because they were also based on tax collections by origin, these tax rebates served only to amplify the disequalizing feature of the TSS (Figure 7).

Table 19. Intergovernmental Transfers by Type, 1994-1998

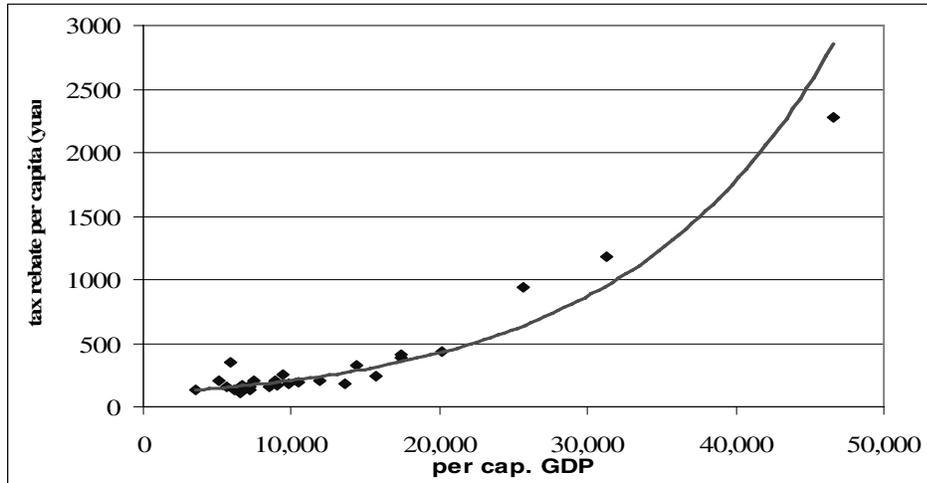
(RMB billion)	1994	1995	1996	1997	1998
Total transfers	238.9	253.3	267.2	280.1	328.5
Tax rebates	179.9	186.7	194.9	201.2	208.3
Transitional transfers		2.1	3.5	5.0	6.1
Quota subsidies/"Original system" grants	11.4	11.5	11.1	11.2	11.3
Earmarked grants	36.1	34.4	48.9	51.6	59.1
Earmarked grants from bonds					28.7
Final account subsidies	11.5*	7.1	7.2	9.3	9.4

* Residual.

Source: Wang et al. (1999); Zhang and Martinez-Vasquez (2003).

⁶⁰ During the period when central revenues were falling steeply (as a share of GDP), these transfers were frozen in nominal terms at the 1987 level. These remain unchanged today.

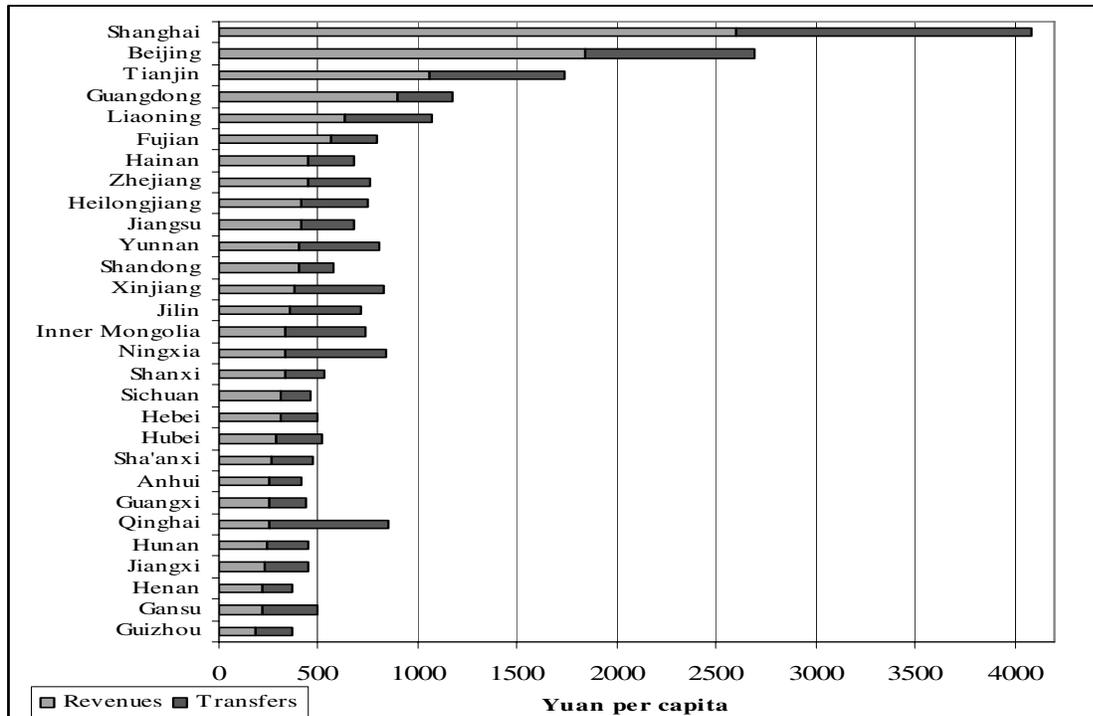
Figure 7. The Distribution of Tax Rebates by Province (2003)



Source: Compendium of Local Fiscal Statistics, 2003.

The biased implementation of the TSS ushered in a period of growing fiscal disparities across regions. During most of the 1990s tax rebates dominated the system of intergovernmental transfers and contributed to the trend of growing regional disparities and the deterioration in public services in poor regions that have been documented in many studies (World Bank 2002; Wong 1997, 2005; Heberer 2001; Chen 2003). The distribution of revenues and transfers per capita by province in 1998 is shown in Figure 8, where it can be seen that transfers were largely reinforcing, rather than dampening fiscal disparities across regions.

Figure 8. The Distribution of Own Revenues and Transfers by Province (1998)



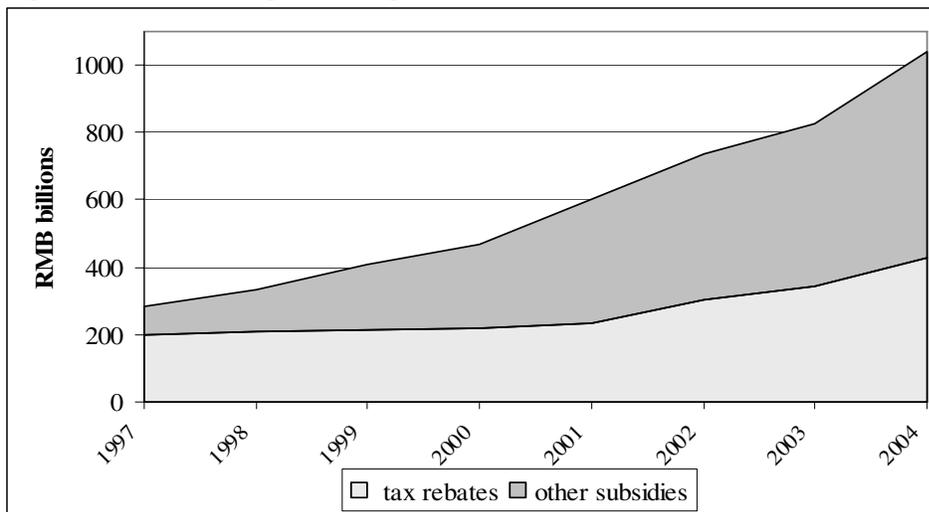
Source: Chinese Fiscal Yearbook, 1999.

4.4. Current Reforms of the Transfer System

As transfers grew in importance, in the late 1990s they also started to respond to the growing inequalities. Efforts began with increased funding and introduction of new transfer types, but over time evolved to include a broad array of instruments and approaches that herald the beginnings of a new transfer regime and policies toward redistribution.

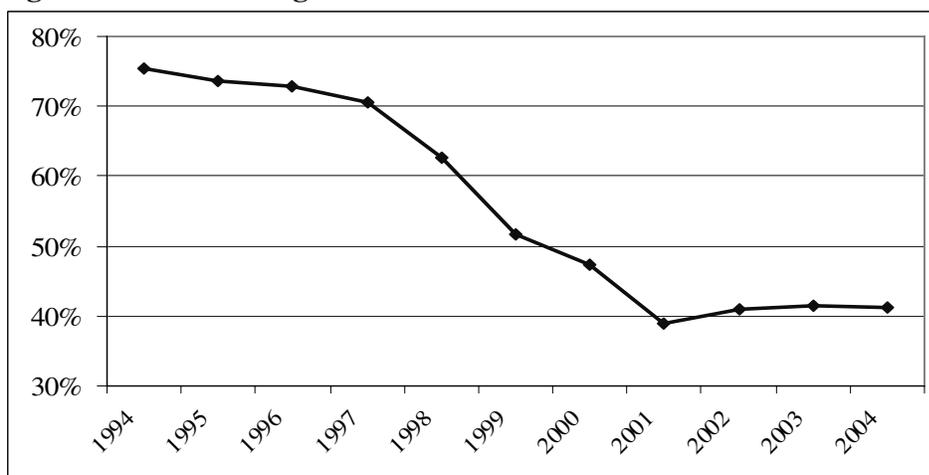
Efforts to reverse the growing inequality began in the late 1990s when the Central Government greatly increased transfers to local governments – as seen earlier in Table 15 and Figure 6. The quantitative significance of this change is demonstrated in Figures 9 and 10, as the rapid increase in transfers outside of tax rebates quickly diluted the share of tax rebates from 1998. *Ceteris paribus*, this should have improved the distribution of fiscal resources across provinces unless the new transfers turned out to be sharply disequalizing.

Figure 9. Increasing Funding for Transfers



Source: Budget speeches; Zhu (2003); Zhang and Martinez (2003).

Figure 10. The Falling Share of Tax Rebates in Total Transfers



Source: Same as Figure 9.

The increased funding came mostly from a proliferation of new transfer types. The “additional transfers from state bonds” were introduced in 1998 under the Fiscal Stimulus

program; the wage increase subsidy was added in 1999 to help subnational governments pay for the civil service wage increases mandated by the Central Government; the minority region subsidy was introduced in 2000; the RFR subsidy in 2001; the income tax rebate in 2002; and the subsidies for the agricultural tax reduction in 2003. These are outlined in Table 20.

Table 20. Adding New Transfers

Transfer type	Year introduced	Equalization content
1. Quota subsidies "Original system" grants	pre-1990s	yes
2. Earmarked grants	pre-1990s	?
3. Final account subsidies	pre-1990s	?
4. Tax rebates on VAT and excise tax	1994	no
5. Transitional subsidies - General transfer	1995	yes
6. Earmarked grants from state bonds	1998	yes
7. Wage increase transfer	1999	yes
8. Grant for minority regions	2000	yes
9. Rural Fee Reform transfer	2001	yes
10. Tax rebates on income taxes	2002	no
11. Agricultural tax reduction subsidy	2003	yes

Source: Various official documents.

The equalization content of the transfers has been increasing. The government has implemented measures to ensure that the equalization objective is built into the design of the new transfers. All six major new transfers introduced since 1998 have some equalization impact, even including the rebate on income taxes. Although the income tax rebates are themselves disequalizing, their introduction was the byproduct of an important "Robin Hood-type" equalization measure that took away 60 percent of income tax revenues accruing to all local governments and returning some 40 percent of them to the poor local governments. Prior to 2002, revenues from the EIT were divided according to "ownership" – "central" enterprises paid to the Central Government, "local" enterprises paid to the respective local governments, and the PITs were local except for those of foreign residents, which accrued to the Central Government. The reassignment of the two income taxes revised the revenue shares, but the Central Government committed to retaining only the same (approximately 20 percent) share it had received prior to the change, and turning over all additional revenue to the equalization pool for General Transfers. These revenues now form the majority source of funds for the equalization pool, contributing more than RMB 35 billion in 2003, compared to other appropriations of RMB 15.3 billion from the central budget (MOF 2004).

The government has begun to commit specific revenue sources for transfer programs. This is aimed at ensuring financing for transfer programs and protecting them against funding squeezes. These represent steps toward establishing objective, transparent, and predictable funding for transfers programs. The commitment of specific revenues for equalization, such as the additional revenues from the EIT and PIT, was also a strategy to win provincial government support for the reassignments of revenues – as was the case for the recentralization of the tax on securities trading, whose revenues are earmarked for social security subsidies. This trend will likely be further strengthened under the new Transfers Law being drafted.

A number of other equalization measures have been put in place. Aside from increasing

equalization transfers, the government has also implemented new policies designed to redistribute resources and income, including the RFR and the abolition of the agricultural taxes which benefit farmers, the lowest income group in Chinese society. Other measures are designed to dampen regional inequalities, primarily through the asymmetric application of subsidies to omit the rich regions. This is true for the wage increase transfer and the RFR transfer and subsidies for the agricultural tax reduction, among others (see World Bank 2006a). Other examples include the change in policy regarding the VAT export tax rebate by derivation: from 2005 local governments were asked to share 7.5 percent of the costs of the incremental portion of these export tax rebates (over the 2004 base), a change from what used to be a wholly Central Government responsibility. This policy was expected to have some equalizing effect since the costs borne by local governments will be greater in the major exporting (i.e., coastal) regions.

Table 21. The Changing Composition of Intergovernmental Transfers

	1995	1998	2000	2002	2004
Tax rebates	73.7%	62.7%	47.3%	40.9%	39.0%
"Fiscal capacity" transfers	9.9%	8.0%	13.7%	23.2%	25.4%
of which: general transfers	0.8%	1.8%	1.8%	3.8%	7.2%
"Original system" quota subsidies	4.5%	3.4%	2.6%	1.7%	1.2%
Earmarked grants	13.6%	26.4%	35.3%	33.1%	33.0%
Final account subsidies	2.8%	2.8%	3.6%	2.8%	2.6%
<i>Shares of transfers net of tax rebates</i>					
"Fiscal capacity" transfers	37.8%	21.6%	26.1%	39.2%	41.7%
Earmarked grants	51.5%	70.8%	67.1%	56.0%	54.1%
<i>Recalculating shares net of tax rebates</i>					
General purpose transfers	20.4%	14.0%	9.4%	10.2%	15.0%
Specific purpose transfers	62.2%	78.4%	83.6%	85.2%	82.3%

Source: Based on Compendium of Local Fiscal Statistics; Budget Speeches; Zhang and Martinez-Vasquez (2003).

The new transfer regime is also characterized by a high degree of reliance on earmarked transfers. This is a reversal of the practice, in place through most of the 1990s, to reduce the role of earmarked transfers by channeling more resources into general-purpose transfers including tax rebates (see Table 21). Earmarked transfers began to increase rapidly in 1998, in both absolute and relative terms, aided by the increased resources created by the fiscal stimulus program. The greatly increased spending on capital construction was channeled primarily through earmarked grants, including the new component of "earmarked transfers from state bonds."⁶¹ Many new programs also have added earmarked subsidies. Even counting by the narrow Chinese definition, in 2004 the Central Government allocated some RMB 350 billion in earmarked transfers, one-third of the total. This is the sum of "earmarked subsidies," "earmarked subsidies from state bonds," and final account subsidies. Since many other transfer types shown in Table 20 are also earmarked, the true extent of earmarking is far greater. Reclassifying the transfer types according to the conventional types of general-purpose transfers and specific-purpose transfers at the bottom of Table 21, we show that specific-purpose transfers comprised more than

⁶¹ The RMB 100 billion in additional state bond issuance allowed the Central Government to fund new programs, mostly in capital investments.

80 percent of transfers in 2004, net of tax rebates. Box 9 presents the classification of transfers under the Chinese system.

Box 9. Chinese Definitions of “Earmarked” and “Equalization” Transfers

The term “fiscal capacity transfers” (*cailixing zhuanyi zhifu*) was introduced in 2002. In an official document (see MOF 2004) explaining the new terminology used to describe intergovernmental transfers, it is stated that “At present, central transfer payments to local governments can be divided into two types: fiscal capacity transfers and earmarked transfers. Fiscal capacity transfers refer to those transfers whose funds can be allocated by the recipient governments on a discretionary basis as part of own revenues, *and fall within the scope of equalization transfers*” (emphasis added). By implication, earmarked grants are everything else. Elsewhere, reporting in the Ministry of Finance includes the following under fiscal capacity transfers:

1. General Transfers
2. Minority Area Transfers
3. RFR Transfers
4. Agricultural Tax Reduction Subsidies
5. Wage Adjustment Subsidies

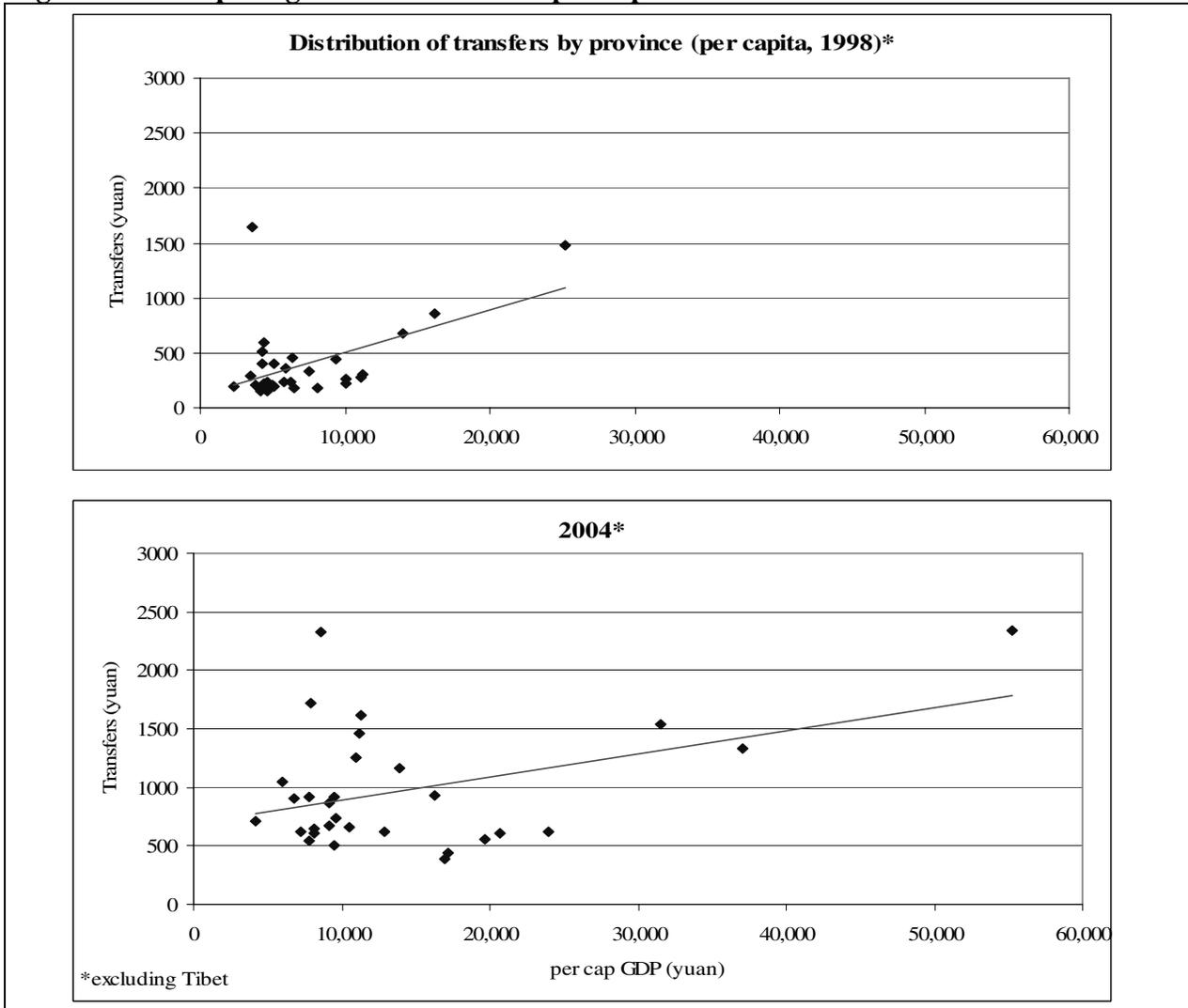
Interestingly, this category excludes the “Original System Subsidies” (quota subsidies), which were the equalization grants under the pre-TSS fiscal system. Aside from the General Transfer and minority area transfer, the other three categories of fiscal capacity transfers are all designed to either replace revenue losses due to reform (the RFR and the agricultural tax reduction), or to help defray cost increases due to policy change (the wage adjustment subsidy). While they have the effect of enhancing local fiscal capacities, they also have some “earmarked” character.

4.5. Assessing the Current System of Transfers

The new changes represent only incremental additions to the existing system of transfers – they are adding layers, but not fundamentally altering the nature of the transfer system. The current system of intergovernmental transfers is the sum of all the layers – including even the “original system” quota subsidies preserved from the 1988 fiscal contracting system. The resultant system is complex, with many contradictory elements.

In spite of varied and impressive efforts, the overall effect to improve equalization appears small. This surprising outcome is shown in Figure 11, where a comparison of the distribution of per capita transfers across provinces shows little improvement from 1998 to 2004. The figure shows that both per capita GDP and transfers have increased for every province. However, the underlying regressive character of the overall transfer system remains – on average, rich provinces still get more than poor provinces. At the sub-provincial levels the situation is similar – on average, rich counties receive more transfers per capita than poor counties (World Bank 2006a).

Figure 11. Comparing the Distribution of per capita Transfers in 1998 and 2004



More importantly, given that recent reforms have brought significant shifts in revenue shares, including the recentralization of the income taxes, we should examine the overall distribution of income and fiscal resources, rather than transfers alone. Income disparities are very large across provinces in China, and they have grown with the introduction of the market economy, especially in the 1990s. These disparities are shown in Table 22, where the richest province (Shanghai) had a per capita GDP that was 7.3 times that of the poorest (Guizhou) in 1990. This relative gap had grown to 13 times by 2004. The absolute gap between these two provinces grew tenfold, from RMB 5,100 to more than RMB 51,000. Such large income gaps make a strong case for the Central Government to play a role in redistribution so as to help spread the benefits of growth to all provinces. The secular increase of the coefficient of variation since 1990 also indicates a widening of provincial income gaps.

Table 22. Income Disparities across Provinces

In GDP per capita (RMB)	1990	1996	2000	2004
Richest (1) – Shanghai	5910	22,275	34,547	55,307
Poorest (2) – Guizhou	810	2021	2662	4215
Ratio of (1) to (2)	7.3	11.0	13.0	13.1
Average	1859	6131	8592	14289
Absolute gap [(1) - (2)]	5100	20,254	31,885	51,092
Coeff. Of variation (31 provinces)	0.61	0.68	0.76	0.75

Source: New China 50 Years of Statistics; China Statistical Yearbook, 2001, 2005.

Overall fiscal disparities remain very large across provinces, and the transfer system is unable to reverse the growing fiscal disparities. In Table 23 we show fiscal disparities across provinces, measured by per capita budgetary expenditures. As expected, fiscal disparities increased significantly from 1992 to 1998 under the TSS, as measured both by the ratio of the highest to lowest per capita expenditures and the coefficient of the variation, which indicates increasing dispersion among provincial expenditures.⁶² From 1998 to 2002 the disparities appear to have moderated, indicating the effects of the increased efforts at equalization. The trend since then is difficult to interpret.

Despite a narrowing, the gap between the richest and poorest provinces remains very large, and much larger than before the TSS reform. The coefficient of the variation was also significantly larger in 2002 or 2004 than in 1992, indicating an increased dispersion in per capita budgetary spending across provinces. The richest province (Shanghai) spent nearly RMB 8,000 per capita in 2004, compared to the poorest (Guizhou), which spent only RMB 906 per capita. These disparities are somewhat smaller than the disparities in per capita GDP, but are still very large, indicating that fiscal policies have played a positive but limited role in redistribution. The coefficient of the variation has increased by some 40 percent since 1990, again indicating a widening of provincial disparities that the transfers are unable to reverse.

Table 23. Provincial Disparities in per capita Budgetary Expenditures

In RMB	1990	1992	1994	1996	1998	2000	2002	2003	2004
Highest (1)	609	737	1452	2415	3211	3708	5307	8112	7936
Lowest (2)	104	127	157	278	347	470	655	734	906
Ratio of (1) to (2)	5.9	5.8	9.3	8.7	9.2	7.9	8.1	11.1	8.8
Average	242	285	416	603	795	1027	1502	1807	1989
Absolute gap	505	609	1296	2136	2863	3239	4652	7378	7031
Coeff. of variation	0.54	0.53	0.64	0.74	0.76	0.72	0.69	0.89	0.76

Note: Excluding Tibet.

Source: Finance Yearbook of China, various years.

The large persistent inequalities show that the transfer system is still inadequate. Together, the trends indicate that the recent equalization efforts are far from adequate. Moreover, with the most recent figures once again showing a deteriorating distribution, especially in 2003 and 2004, questions arise about whether the recent efforts will be able to produce sustainable effects to reverse the inequalities.

⁶² Data for 1994 are omitted because they contain a great deal of “noise” associated with falsified data on the eve of the TSS reform. Tibet is also omitted as an outlier, whose high transfers bias the distribution disproportionately.

Too much is spent on transfers that are not equalizing. While the effect of transfers (excluding tax rebates) was somewhat equalizing across provinces, it was far from enough to offset the disequalizing effect of the tax rebates.

4.6. Earmarked Transfers

As discussed above, earmarked transfers play an extremely large role in the financing of public services in rural areas, and problems of earmarked transfers are especially salient. The recent changes to strengthen equalization objectives, improve targeting, etc. have all been made only at the margin, through adding new programs and tweaking old ones. They have mostly left existing programs in place, ensuring that outcomes will change only gradually. As a consequence of this proliferation and layering of transfers, problems are especially notable in earmarked transfers.

Earmarked transfers specifically targeted toward rural development have increased rapidly. Appendix 10 provides a description of such transfers. “*Sannong*” expenditures have to be interpreted with great care as their definition and composition are frequently changing and as they also include budgetary expenditures at the central level. Nevertheless, their increase, according to one definition, from RMB 136 billion in 2000 to RMB 298 billion in 2005, shows the government’s emphasis on addressing issues of rural development through earmarked transfers.

Program funding from the center is typically inadequate and requires matching funds. This is also partly caused by the proliferation of transfer programs. Fiscal theory and international best practices all emphasize that allocating sufficient revenues is a precondition for effective grant programs. This condition remains elusive in China today. Despite increased resources in recent years, funding levels are small relative to needs, partly because most new monies have gone into new programs. In 2004, total funding under the Fiscal Development Funds (FDF) for supporting less developed areas was around RMB 16 billion, which, if completely disbursed and perfectly distributed, would have provided only around RMB 130 per head for the estimated 120 million targeted population. Typically, central transfers finance only a tiny portion of the designated projects. In the Compulsory Education Program, for example, during 1996-1998 it was estimated that for the 383 projects receiving funding from central subsidies, total expenditures were nearly RMB 133 billion. Central subsidies to the projects were only RMB 1.5 billion, or just over 1 percent of total costs (Li 2002). Even with increased funding for both the CEP and the Dilapidated Schools Renovation Project in recent years, school construction is financed largely with local funds, and this is widely reported as a major reason for local government indebtedness. The same is true of poverty programs. In Jiangxi, the FDF provides a subsidy of RMB 10,000 per kilometer of rural road built in the targeted villages, while the average investment requirement is estimated to be RMB 30,000, and as much as RMB 50,000 in the hilly regions (Wong 2005b).

Underfunding is exacerbated by the decentralized fiscal system and the inadequacy of revenues at the lower levels. In Jiangxi province, for example, the program to promote the use of biogas calls for providing subsidies of RMB 900 per family to defray installation costs of around RMB 1,600. In one county the actual payout was only RMB 300 per family because of funding constraints. This reduction significantly eroded the incentive effect of the program and further confined its benefits to the richer households that could afford to pay the difference. Similarly, the reach of the Two Exemptions and One Subsidy program is constrained by the

financing capacity of local governments that have to finance the exemption of miscellaneous fees and subsidies to boarding students. In two counties visited by the mission in 2004, the numbers of recipients were in each case dictated by local funding availability, and were far less than what officials estimated to be the numbers eligible under the program.⁶³

The requirements for counterpart funding are often beyond the affordability of local governments in poor regions. Besides the funding gaps described above, in most earmarked transfer programs there is an explicit requirement for counterpart funding. Although this is a good strategy to encourage mobilization of local resources and to ensure local ownership of programs, the requirement runs up against local financing constraints, which can limit the effectiveness of the program and sometimes distort outcomes. To apply for funding under the CEP program, for example, local governments are required to commit counterpart funds at a ratio of 1.5-2:1 counterpart to central funds.⁶⁴ Procedures require each provincial government to sign an agreement with the Ministry of Education and the Ministry of Finance to commit to provide counterpart funds at the start of the project. However, the agreements do not spell out the division of responsibility among the province, prefectures, counties, and townships governments in coming up with the funds, and this has often resulted in too much responsibility being pushed down to the lowest levels, exceeding their financing capacity.

Even when the Central Government reduces or waives counterpart requirements for some programs, these changes are not always implemented at lower levels. In Jiangxi, for example, one Key Working County (KWC) had to provide 10 percent of the fiscal contributions to the CAD program in 2004, even though the policy explicitly called for poor counties to be exempted from counterpart funding requirements. Persistent underfunding will lead to an implementation bias that disadvantages the poorest regions or persons and undermine the equalization intent. With the rural tax bases further depleted after the RTFR, the problem of counterpart funding will be exacerbated, yet even the latest program for promoting Free Rural Education still requires that most funding be provided by subnational governments.

Targeting remains imprecise, limiting the effects on equalization. For example, while focusing resources on Key Working Villages (KWVs) has helped to improve targeting of the FDF funds, non-key villages receive little assistance, even for critical needs in priority areas such as safe drinking water. More importantly, the selection of projects for poverty reduction spending is still confined to lists offered by executing agencies, which are often biased toward overly large projects that are not well linked to the needs of the poor.

The decentralized treasury management system constrains the effectiveness of earmarking. At present, the treasury system is managed level by level: the central treasury only manages fiscal resources at the central level and their transfer to the next level – the provinces. Once the earmarked funds are transferred to the provinces, they come under provincial allocation, and it is the provinces that decide whether to respect Central Government earmarking. The same applies to transfers from provinces to prefectures, and from prefectures to counties, etc. In the rural sector, it is the county governments that ultimately decide how to allocate earmarked funds entering the county treasuries. Given this set-up, it is difficult to preclude the diversion of funds to other uses, especially when local governments are hard-pressed to finance their heavy

⁶³ In both cases, quotas were issued to primary schools, rather than to the schools applying for funding based on the number of eligible students.

⁶⁴ The lower ratio applies to “phase 3” provinces, which are mostly in the western region.

responsibilities.

Fragmentation, duplication, and poor coordination are key problems, and result from many of these transfers being managed by line ministries. Coordination among line agencies is weak and a proliferation of so-called Project Leading Groups, created on a policy/program/project-specific ad hoc basis, often does not overcome problems at the working level. Consequently, there is overlapping coverage of selected services, such as water resource management and the promotion of industry. For example, substantial transfers for irrigation and drainage works exist under both MWR and the SOCAD, often with different standards, requirements, and procedures. In addition, programs like the Poverty Relief Funds or FFW program also finance irrigation and drainage investments. The lack of transparency and coordination exists as a problem even at the intra-agency level. For example, typical transfers for small watershed rehabilitation, which are implemented under the water and soil conservation departments of the water resources line agency, typically exclude investments in drinking water supply, for which the other departments execute specific earmarked transfers. Table 24 presents some examples of duplication and overlapping coverage under the different programs.

Table 24. Examples of Duplicative and Overlapping Coverage of Earmarked Transfers

By Use	Transfer programs	Executing Agencies
Compulsory Education	National Compulsory Education Project for Poor Regions (CEP)	MOE
	Two Exemptions and One Subsidy (TEOS) to reduce out-of-pocket costs of education for poor children	MOE
	"Two Basics" Project to eliminate adult illiteracy and build dormitories	MOE
	Dilapidated Schools Renovation Project for Middle and Primary Schools	MOE
	Compulsory education for ethnic minorities	State Ethnic Affairs Commission
	Special education for disabled children	MOE
	Scholarship funds for compulsory education in poor areas	MOE
Drinking Water		MWR
	Poverty Relief Funds	LGOPR
	Food-for-Work	NDRC
	SOCAD	SOCAD
Rural Roads	Rural Roads	MOC
	Poverty Relief Funds	LGOPR
	Food for Work	NDRC
	SOCAD	SOCAD
Rural Enterprise Development	Poverty Relief Funds	LGOPR
	Food-for-Work	NDRC
	SOCAD	SOCAD

Source: Authors.

One fundamental problem is that the Central Government does not have the capacity to effectively supervise, monitor, and evaluate its many transfers. This holds for individual transfers, but also for the overall impact of public goods and service delivery, such as the illiteracy rate, health status, environmental degradation, etc. The monitoring agencies, especially the Statistical Bureau, but also the Environmental Protection Bureau and others, lack independence from local governments.⁶⁵ Consequently, the leverage of the Central Government to hold local officials accountable for providing the goods and services for which the funds are intended is too weak to be effective.

Tougher financial management procedures introduced under the budget reform interact with the multi-layered administrative system to raise transaction costs and add to timing problems downstream. To strengthen management over earmarked funds and reduce opportunities for their diversion, the Regulations on Supervising the Fiscal Funds for Poverty Reduction require that a reimbursement system be established and adopted for all projects using the FDF. The general procedure is the following: First, the projects must be approved by the county Bureau of Finance (BOF) and Planning Committee or the LGOPR. The supervisory organizations then sign contracts or agreements with the implementing agency specifying quality standards and disbursement procedures. These contracts are reported to the county BOF for endorsement. At this point, the county BOF provides 30 percent to 50 percent of the contract amount as an advance payment, and the remainder is paid on a reimbursement basis after the supervisory organization and county BOF have inspected and accepted the work. This process is time-consuming and cumbersome, especially in the rural sector where funds must typically pass through several layers of the bureaucracy in China's multi-tiered system. The timing of earmarked transfers is problematic in at least two dimensions; first, funds often do not arrive when they are most needed because of delays in application, approval, and disbursement procedures; second, many funds are applied for and allocated on an annual basis, even funds for capital construction, thus making planning very awkward.

There are complaints that these procedures have increased transaction costs and added further delays to the delivery of funds. One informal survey conducted in more than 20 counties found that in 2002 the costs of lobbying for poverty development grants and their disbursement absorbed on average RMB 30-80,000 for every county Poverty Alleviation Office. If typical, these costs were equal to 0.5-1.3 percent of the total poverty alleviation funds allocated to the KWCs. Moreover, the delay in delivery of funds was such that in August 2004 some counties had not yet received poverty funds for the year 2003 (Li et al. 2005, p.53).

Local government budget autonomy is greatly constrained by the proliferation of earmarked transfers. The ad-hoc funding levels and uncertain timing of their arrival further undermine any meaningful budget process at the local levels. The proliferation of transfers also results in reduced transparency, including at the local levels, leading to a lack of accountability and often preventing local governments from effectively coordinating various programs.

Moreover, the proliferation of earmarked grants in recent years has made the system of transfers in China more complex and opaque than ever. Before the Tax Sharing System reform, the Ministry of Finance had compiled information on total earmarked transfers, their

⁶⁵ Monitoring by citizens is still weak and cannot compensate for the strong and independent monitoring and evaluation of independent agencies.

uses, and their distribution by province (Wong 1997, Tables 1.4-1.6). With their recent proliferation and the confused classifications, these data have ceased to be meaningful.

The current administrative structure is incompatible with reliance on a large and growing program of earmarked transfers to achieve policy objectives.

- Earmarked transfers require monitoring and supervision to ensure effectiveness. These capacities are very weak under China's current administrative set-up. At the central level, the Budget Departments in the MOF are grossly understaffed for managing the more than one hundred programs of earmarked grants they administer. As a result, virtually all proposals are routinely approved and mainly checked only for compliance with the law. The Agriculture Department is charged with managing some 25 programs of earmarked grants for the rural sector – some of which are further sub-divided by line agencies.
- Similarly, the administrative capacity of other central-level agencies that have executing functions is too weak. Ministries are too small to effectively design, supervise, monitor, and evaluate the various different programs. The example in Box 10 provides an example indicative of the enormous capacity required in the United States to administer large and complex transfer programs in health and human services. Moreover, the effectiveness of the agencies that monitor the outcome of local public service provision, e.g., literacy or environmental pollution, is undermined by their limited independence at the local level.
- The current system of intergovernmental revenue and expenditure assignments does not support the introduction of new programs and transfers that require matching funds at the local level. The already strained fiscal capacities at the county and township levels cannot support additional expenditure assignments, and any additional assignments will dilute or undermine program outcomes. Moreover, under current conditions the proliferation of earmarked transfers undermines any effective budgeting and planning process of grassroots governments, and it further erodes incentives for revenue mobilization or efficient resource use.
- There is no effective system to ensure the transmission of transfers from level to level without leakage of funds. Although Jiangxi provincial officials reported providing RMB 20 per student in non-salary running costs to primary and middle schools throughout the province, in Suichuan county officials reported receiving only RMB 10 per student.

Box 10. An Example of Managing Conditional Grants in the U.S.

The U.S. is unusual among OECD countries in terms of its reliance on conditional grants -- by the late 1990s all general-purpose grants from the Federal Government to local governments had been eliminated.

The Department of Health and Human Services (HHS) is the largest single agency handling federal conditional grants. The department had a budget of US\$ 581 billion in FY 2005, representing almost a quarter of all federal outlays, with 67,444 employees. It administered more grant dollars than all other federal agencies combined. The HHS Medicare program is the nation's largest health insurer, handling more than 1 billion claims per year. Medicare and Medicaid together provide health care insurance for one in four Americans.

HHS works closely with state and local governments, and many HHS-funded services are provided at the local levels by state or county agencies, or through private sector grantees. The department's programs are administered by 11 operating divisions, including eight agencies in the U.S. Public Health Service and three human services agencies.

Chapter 5. The Grassroots Level: Village, Township, and County Finance

Rural public finance is ultimately a matter of financing local government and public service provision in rural areas. As shown in the previous chapters, the situation on the ground is determined by the overall IFS. The Central Government is key to determining this system and reforming it. This chapter looks in more detail at these outcomes at the grassroots level.

5.1. Village Finance

Overview

Villages figure prominently in the NSC as the basic unit of the *xiaokang* society in the countryside. Although they are not an official level of government, they have a well-defined governance structure. With their firmly established administrative structure, villages are the basic level of governance of public affairs for most rural citizens. In 2004, China had a total of 652,700 administrative villages (China Statistical Yearbook 2005).⁶⁶ A typical “administrative village”⁶⁷ (*cun*) generally has a population of one thousand to several thousand people, but can be as small as only a few hundred or as large as ten thousand people. The average village in the 100 sample survey that provides the basis for much of this Section and that is analyzed in detail in Annex 5⁶⁸ had a population of about 1,400 people, a labor force of about 700, an average net rural income of RMB 2,600 (2004), and a total cultivated area of about 2,270 mu (150 ha). Most administrative villages consist of a number village groups (*cunmin xiaozu*), also known in some areas as “*xiaocun*” – literally “small village” – they are generally established at the level of a natural village. Usually only a few village groups make up an administrative village, but there can be up to ten or even more in some of the more mountainous areas. These natural villages are the most basic unit of the community; the administrative village is formed to have sufficient scale for local administration and the provision of basic public services. A typical village is described in Box 11.

Box 11. A Typical Village in Sichuan

T. Village has a total population of 1,143 people (338 households) in 7 natural villages. The village has two plain areas with about 388 mu of paddy land. The remaining 1,582 mu of farmland is dryland located in a hilly area. Besides paddy, farmers grow peanuts, vegetables, and some fruits; they raise sheep, ducks, fish, and chicken. The village has 7 so-called specialized households (2 with more than 100 chicken; 2 with more than 500 ducks; 2 with a total of over 10 mu of fish ponds; and 1 with more than 100 pigs) and a privately-owned brick factory with about 70 workers. However, the greatest part of the average net income per capita (RMB 3,284) comes from work outside the village, where about half of the 482-strong labor force is working. Although the village children go to school in the town seat (about 2 km away), the village has a kindergarten with one teacher and 40 children. It also has a health

⁶⁶ The number of village committees has declined by about 11.5 percent in the five-year period from 1999 to 2004.

⁶⁷ The traditional term “administrative village” is used here, since the formal term “village committee” has a second meaning referring to the self-governing organization of the village.

⁶⁸ The survey can be considered quite representative for the country as a whole. Due to the limited sample size, however, findings on sub-sets of villages, such as those in certain provinces or in the poorest villages, must be interpreted with care.

station staffed by one health worker.

The village leadership, consisting of 6 people, is supported by the town Finance Bureau with a total of more than RMB 10,000 per year. Village leadership includes the Party secretary, village head, village secretary, the deputy village chief in charge of science and technology, the chairwomen of the Women's Federation, and the Youth League secretary. In addition, the town and county Finance Bureau provide financial support to the leaders of the 7 natural villages and to 12 retired officials (retired village directors, Party secretaries, natural village leaders, etc.).

The village elects a village committee every three years. Although its three members do not receive financial support, they are responsible for economic development, public safety, and social affairs under the guidance of the village leadership. Important decisions, such as village-level investments which require fund raising, are discussed at the village assembly which is called by the director of the village committee.

The village does not have own resources or a budget. Village leaders are supported by the town or county Finance Bureau, as are the 6 very poor households that receive social assistance through the minimum living standard insurance (RMB 40 per month per person). Although the village provides the building for the health station and the kindergarten, subsidies (very limited) for these institutions come from the Finance Bureau (RMB 300 per month for the kindergarten). If the villagers decide in the village assembly to make an investment, they have to collect the funds from the inhabitants. For example, in 2003 the village decided to broaden a bridge, for which RMB 14 was collected per person and paid into the accounting center of the town. Villagers who worked on the project received payment of RMB 12 per day.

Source: Authors' Interview with Party Secretary and Village Secretary, 2004.

Village administrations are “self-governing” – and led by the Party. By law, the village assembly (*cunmin huiyi* or *cunmin dahui*) is the highest authority in village self-governance. Day-to-day activities of self-governance are carried out by the village committees. The village head (village committee director) and village committee members are democratically elected by the villagers. However, the village committee is subordinate to the village Communist Party secretary (*cun zhi shu*), who is a nominated official.⁶⁹

The village administration has important functions in implementing government policies and in the provision of public goods and service. This includes the enforcement of government policies in such important areas as land administration or family planning, and, in the area of public finance, the collection of fees and other revenues and the financing and provision of public goods and services. The communes and the later villages were and still are – at least de

⁶⁹ Usually, the village-level Party institution is a branch of the Party committee at the township level rather than a Party committee itself, so the village-level head is a head of the Party branch committee. The relationship between elected village committees and village Party committees can be contentious. Measures to mitigate this problem include encouraging the village Party secretaries to run for village head, so that he/she combines both positions (one shoulder pole – *yi jian tiao*), or experiments such as those in Shandong or Handan of Hubei that aim at standardizing the power of the respective bodies and include the establishment of a “joint conference of the village Party branch and the village committee” (Fewsmith 2006). In addition to the village committee and the Party committee, most villages have so-called small groups (*xiaozu*) for financial affairs, cultural affairs, etc.

facto – an instrumental level for some key public services. In particular, villages continue to play an important role in the provision of rural infrastructural services and are involved in poverty reduction activities, social welfare, basic education, and public health. Even though most of the public investments and services in which villages are involved are largely financed from above, some crucial resources are still provided by the village level and their provision is supported by the villages. With the call to extend public finance and service delivery into the rural areas, the importance of the village level as a (quasi) government for rural citizens is likely to increase.

The specific authority of the village administration, and hence the scope of village financing, is largely undefined and varies widely in practice. An understanding of village financing requires knowledge about the relationship and dynamics between the village administration and the villagers, and the village administration and the higher-level governments. This is not an easy task, for several reasons. The willingness and ability of the various village administrations – under the leadership of the Party secretary – to engage villagers in the provision of public services differ enormously. In addition, the authority of the village administration vis-à-vis that of the township is not clearly defined and varies quite widely in practice. The township usually has a strong influence over village finances, including in the direct payment of village cadres, etc. In fact, most village accounts today are administered by the township, and village accounting books are kept with the township. This is intended to reduce corruption at the village level by taking the financial accounts away from the village leadership. At the same time, however, it also limits village authority to manage its own business. Moreover, a village road or an irrigation canal passing through a village might be formally “owned” by the township, but in practice the government still does not take responsibility for the operation and maintenance of most small-scale infrastructure. Responsibility to provide a social safety net might formally be a government responsibility, but the village might still feel the need to engage in this area if the government fails to provide adequate funding.

Village Financial Revenues

Village revenues are very limited, and constraints have become more accentuated over time. As mentioned above, villages have only limited authority over financial resources. The sources of village revenue are usually few and small. As Table 25 below shows, village revenues in 2004 were only about RMB 80 per capita – or about RMB 110,000 per average village– and almost constant in nominal terms compared to 2000. Over the same period, rural net incomes increased significantly and China’s fiscal revenue as a whole almost doubled. Compared to total government budget spending of more than RMB 2,000 per citizen, the total amount of village finance is obviously very limited (only about 4 percent).

Constant nominal village revenues during a period of rapid economic and fiscal growth stand in contrast to the government’s policy to extend public finance to rural areas. As shown above, demand for the provision of public goods and services has increased over the same period. More investments were made, with more resources in absolute terms required from the villages to match investment funds from other sources and to operate and maintain the investments. Stable revenues in nominal terms also stand in contrast to the various regulatory efforts by the government to strengthen village affairs, self-governance by villagers (also, but not only, through the *yishi yiyi* reform), and the capacity of villages. The relative financial authority of villages vis-à-vis the government has fallen during a period of rapidly increasing fiscal growth and fiscal spending for the “*sannong wenti*.” This points to the strong top-down implementation

of – largely capital investment – interventions.

Table 25. Village Revenue by Categories in 2000 and 2004

in RMB per capita		2000		2004	
		Mean	% of total	Mean	% of total
1	Transfers from above	4.6	5.9	17.8	21.7
2	Regular fee assessments (<i>tiliu</i>)	30.0	38.1	0.2	0.2
3	Surcharges on agricultural tax	0.2	0.2	4.7	5.7
4	Contract payments for land	8.1	10.3	12.0	14.6
5	Contract payments for enterprises	5.8	7.4	7.9	9.6
6	Land and asset sales	15.8	20	23.5	28.6
7	Other revenues	14.3	18.2	16.0	19.5
8	Total revenues	78.7	100	82.1	100.0

Note: “Other revenues” include income from: administration fees charged to village enterprises; shared profits with village enterprises; fines for violating the birth control policy; fines for other penalties; interest, rents, and repayment of credits; collective operations; etc.

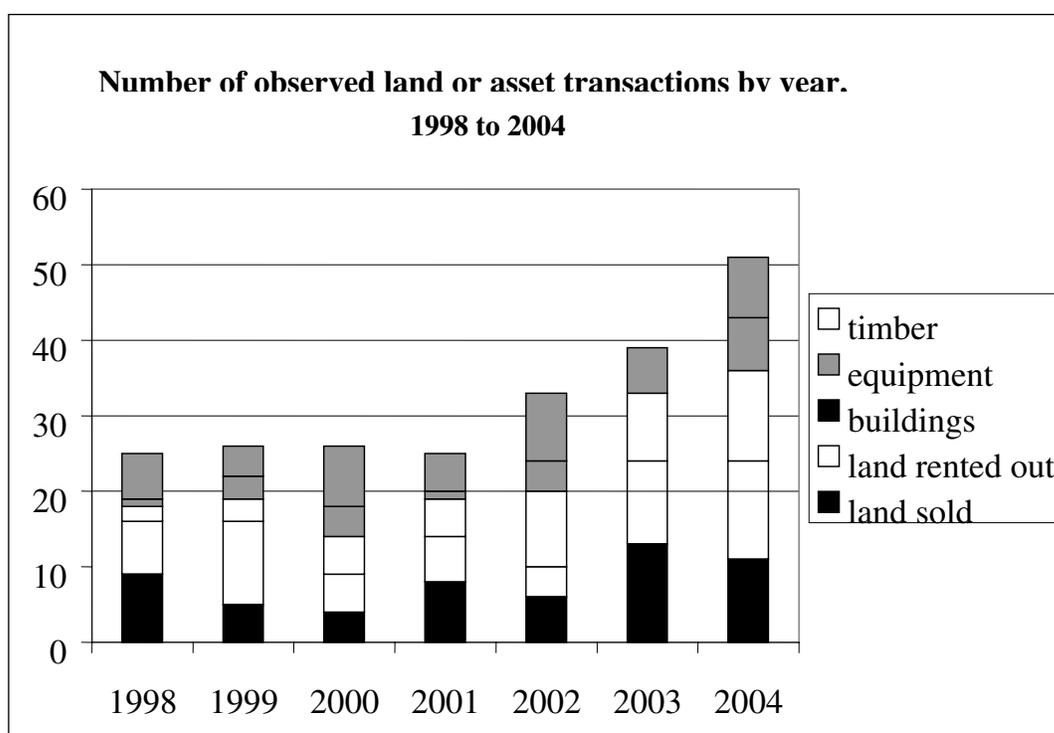
Source: Annex 5.

Changes in the composition of revenues during the reform period are substantial. The regular fee assessment (*tiliu*), which accounted for about RMB 30 per capita, or almost 40 percent of village revenue in 2000, was eliminated through the RFR. Only less than two-thirds of the shortfall from regular fee assessments was compensated for through the newly assessed surcharge on the agricultural tax and transfers from above. The remaining gap has been made up from other largely land-related fees. A similar effect might have occurred with the subsequent ATA, which again increased the villages’ dependence on subsidies as well as on finding other sources of revenues.

Most importantly, income from land and asset sales and contract payments for land increased by almost 50 percent during the period from 2000 to 2004. These revenues seem to be the only flexibility for villages to increase revenues – apart from making debt. While villages used to rely to a considerable extent on own (legal) sources of revenues, especially the *tiliu*, villages now rely almost exclusively on transfers from above, other (non-*tiliu*) fees, penalties, and other extraordinary income. Transfers have grown considerably in importance, but are still not the major part of village revenue. Even after the replacement of the surcharge on the agricultural tax in 2005 and 2006, transfers are unlikely to make up for more than a quarter of total village revenues. Most worrying is the rise in land-related income. While villages have used these sources to make up for the shortfall from the recent reforms, this phenomenon creates other problems. Furthermore, income from the sale of land and assets is unsustainable. See Box 12 on village revenues from land.

Box 12. The Importance of Land and Asset Sales for Village Finance

As part of the village survey, the number of times villages sold land or other assets was examined. The chart below shows a significant increase in the frequency of these transactions over time. The number of villages selling land rights has increased from 3 to 4 per year in the early 1990s (not shown in the chart) to 24 in both 2003 and 2004, or nearly one-quarter of our sample. For other assets, including buildings, equipment, and timber, we observe almost a tripling in the frequency of sales, from 10 times in 1998 to 29 times in 2004. Revenue from these sales in 2003 and 2004 that went to the village (which nets out the compensation to households) averaged RMB 35,000 per village for land-related transactions, plus another about RMB 35,000 per village for the sale of other assets.



Overall, the rural fee reform had a negative impact on most village revenues. Out of all 100 villages surveyed, 40 percent experienced a drop in revenue of 25 percent or more. For example, the 20 villages surveyed in Sichuan experienced an average reduction in per capita revenue of nearly one-third. Transfers to villages are distributed very unevenly across provinces, with villages in Jilin receiving RMB 42 per capita in 2004 (up from RMB 4 in 2000) and those in Hebei receiving only RMB 4 in 2004 (up from close to zero in 2000). Similarly, access to land-based income also differs widely. Thus, the large differences in village revenue across the country further increased from 2000 to 2004.⁷⁰ While the reduction of revenues partly reflects

⁷⁰ The Gini coefficient for per capita fiscal revenue increased from 0.54 to 0.59 between 2000 and 2004. However, transfers and total revenue of the economically poorest (in rural net income per head) 20 percent of villages in the

the objective of the rural fee reform to limit the ability of villages (and local governments) to raise income from farmers, the overall loss in village revenue, especially if measured relative to government revenue, may have been an unintentional result.

Village Expenditures

Current expenditures of villages remained constant in nominal terms. Village expenditures in the current years 2000 and 2004 amounted to about RMB 70 per capita and therefore roughly matched village revenues in the same year.⁷¹ The structure of expenditures – excluding debt financing – also remained relatively stable, but there was a small, but noticeable shift from recurrent to capital expenditures. Expenditures for administration and maintenance experienced a decline (see Table 26).

Table 26. Village Expenditures by Categories in 2000 and 2004

	<i>RMB per capita</i>	2000		2004	
		Mean	% of total	Mean	% of total
1	Expenditures for recurrent costs	44.8	57	40.1	64
2	<i>Salaries</i>	15.0	20	14.4	21
3	<i>Administrative expenditures</i>	9.0	10	6.7	13
4	<i>Maintenance expenditures</i>	10.6	11	8.0	15
5	<i>Social welfare expenditures</i>	3.8	9	6.1	5
6	<i>Other expenditures</i>	6.4	7	5.0	9
7	Repayment of principal	11.0	18	12.9	16
8	Expenditures for capital investments	23.0	60	42.5	33
	<i>Financed by current</i>				
9	<i>revenues/ savings</i>	14.6	25	17.3	21
10	<i>Financed by debt</i>	8.4	36	25.2	12
11	Total expenditures, current (excl. Row 10)	70.4	100	70.3	100
12	Total expenditures, including debt (Row 10)	78.8	136	95.5	112

Note: Row 1 is the sum of Rows 2 to 6; Row 7 is the sum of Rows 8 and 9; Row 11 is the sum of Rows 1, 7, and 10.

Source: Annex 5.

The reduction in recurrent expenditures raises concerns about sustainability. Recurrent expenditures made up almost two-thirds of total expenditures in 2000, and declined by about 10 percent in nominal terms by 2004. The declining expenditures of recurrent costs require further analysis. However, one would clearly expect a negative impact on the villages' ability to function. Salaries of cadres remained relatively stable at about one-fifth of total village expenditures. But stable salaries, as well as stable overall village funding at a time of rapid economic and fiscal growth, decrease the incentive for villagers to engage in village administration. Also, the net decline in administrative and maintenance expenses at a time of

sample increased even more rapidly than that for the richest villages, with those in the middle falling farther behind.

⁷¹ Differences across villages contributed to an overall increase in the inequality of per capita fiscal expenditure between 2000 and 2004, as reflected by the increase in the Gini coefficient for total village fiscal expenditures of 0.50 to 0.57.

rapidly increasing infrastructure raises concerns about the sustainability of these investments. After all, responsibility for the operation and maintenance of the rapidly increasing infrastructure, while often unclear, in practice generally falls to the villages.

The total amount of village capital expenditures almost doubled, and was financed by debt.

Capital expenditures increased from RMB 23 per capita in 2000 to almost RMB 43 per capita in 2004. Most of the investment in 2004 was debt financed, and total new debt almost tripled from a little over RMB 8 per capita in 2000 to RMB 25 per capita in 2004. The growth in capital expenditures stands in contrast to our field observations in early 2004 in Henan province, where the rural fee reform and the introduction of the *yishi yiyi* reportedly led to at least a temporary disinterest of villagers in new investments. However, this case might have been an outlier and limited to the years immediately following the introduction of the RFR. The survey finding is fully consistent with the large increase in centrally-funded village infrastructure projects and their requirement for local matching funds. The development is clearly positive, if one looks at the increased accompanying infrastructural services. Nevertheless, concerns about the observed growth of village expenditures financed by debt are serious.

The increasing levels of indebtedness raise questions of financial sustainability. A net increase in debt, or a current “budget deficit” of more than RMB 12 per villager, is substantial, making up about 15 percent of village revenue. Moreover, an analysis of the stock of village liabilities shows that a further increase in village debt is unsustainable over the medium term. Total village liabilities amounted to more than RMB 250 per villager in 2004.⁷² This points to a total debt of all villages in China equal to about RMB 240 billion, which is more than three times annual village revenue and is considered high when taking into account village receivables of about RMB 140 per capita.⁷³ Almost half the debt is owed to financial institutions, mostly rural credit cooperatives (RCCs), and substantial amounts are owed to enterprises and farmers. In per capita terms, village liabilities remained fairly constant between 2000 and 2004, as did the breakdown in their sources. Interviews with the village accountants revealed that they expected only a little more than half of all village debt would be repaid, showing that a significant burden is being placed on the financial and private sectors (see Table 27).

Table 27. Village Liabilities in 2004

<i>RMB per capita</i>		Mean	Percentage >0	Percent of total
1	Village debts, total	253	86	100.0
2	Financial institutions	120	58	47.5
3	Higher levels of government	21	25	8.2
4	Enterprises	36	46	14.1
5	Unpaid wages	14	41	5.7
6	Farmers	42	53	16.4
7	Other	21	25	8.2
8	<i>Estimated % to be repaid</i>	55		

Source: Annex 5.

⁷² There are large differences across provinces in the magnitude of these debts (Table 27). The highest debt was in Shaanxi, at RMB 462.1, followed by Jilin (RMB 397.2), and then Hebei (RMB 338.6), Jiangsu (RMB 145.2), and Sichuan (RMB 45.4).

⁷³ Figure for 2004; the figure for 2000 is similar (RMB 136 per capita). More than half of the receivables are from farmers, about a fifth from higher levels of government. The estimated recovery rate, however, is fairly low, with 30 percent in 2004 and 24 percent in 2000.

Village-level capital investments

Infrastructure investments are the driving factor behind village finance. As shown above, villages spend almost half their financial resources on village-level infrastructure investments. Hence, while most funding of village infrastructure comes from outside village finance and village control, an understanding of the financing of village-level infrastructure is central to understanding village-level dynamics.

Annual infrastructure investments in villages almost quadrupled from 2000 to 2004. Table 28 below shows the enormous increase in public investments in village infrastructure. Per capita investments from all financing sources increased from RMB 48 in 2000 to RMB 191 in 2004. These are clearly substantial investments that reflect the tilt toward the rural sector and, specifically, the increase of transfers by the Central Government since the beginning of the decade. Infrastructure investments were implemented in most (72 percent) villages in the sample in 2004, and some villages had two or more projects, so that the average number of projects amounted to almost one investment project per village. The average investment project in 2004 cost about RMB 160,000.

Table 28. Village Public Investments in 2000 and 2004

<i>RMB per capita</i>	2000			2004		
	Mean	%>0	% of total	Mean	%>0	% of total
Roads & Bridges	15	30	31	124	66	65
Irrigation & Drainage	10	28	21	20	40	11
Drinking Water Supply	4	16	9	18	32	9
Schools	9	12	18	7	18	4
Clinics	0	2	0	1	4	1
Others	10	17	20	22	34	11
Total	48	59	100	191	94	100

Note: Others include electricity, office buildings, green for grain, telephones, cable television, broadcasts, etc.

Source: Annex 5.

Most investments are for roads, followed by irrigation and drainage and drinking water. The dominant type of investment is for public roads. Roads already accounted for almost a third of the total investment amount in 2000, but their share increased to almost two-thirds in 2004, with a total investment of RMB 124 per villager. Irrigation and drainage and drinking water were the two other important areas of public investments in 2000 and 2004. Investments for schools declined in importance, likely a reflection of the policy to consolidate primary schools, often in towns and townships. Similarly, almost no investments for clinics were observed, which largely reflects the fact that the management and operation of clinics have been subcontracted to individuals.

The higher-level government has assumed major responsibility for financing village infrastructure, but the contributions from villages and farmers have doubled. In 2000, villages were still largely in charge of their own infrastructure financing. Village commitments accounted for about 47 percent of total investment financing, through the use of current revenue/savings or financing by debt. In addition, households contributed about 18 percent through special assessments on farmers, or *jizi*. Capital expenditures financed from above

represented only one-fifth (21.3 percent). The primary role of village (including household) self-financing in 2000 implies that much of the heterogeneity we observe in levels of total public goods investment reflects structures at the village level influencing the ability and willingness of the villages to undertake investment projects. The picture changed dramatically by 2004 when capital expenditures financed from above rose to 59 percent, or more than RMB 100 per capita, while capital expenditures financed by the village committee declined to 22 percent and that financed by households declined to 11 percent. Nevertheless, in absolute terms, contributions from villages increased from RMB 23 per capita in 2000 to RMB 44 per capita in 2004, and that from households from RMB 9 per capita to RMB 21 per capita (see Table 29).

Table 29. Funding of Village Capital Investments in 2000 and 2004

	Mean	Percentage financed from:			
		Government	Village Committee	Farmers	Others ^b
2000					
Roads & Bridges	15	23	47	29	2
Irrigation & Drainage	10	42	31	21	5
Drinking Water Supply	4	5	2	4	90
Others ^a	19	12	66	11	11
Total	48	21	47	18	14
2004					
Roads & Bridges	124	65	23	11	1
Irrigation & Drainage	20	51	28	10	11
Drinking Water Supply	18	43	24	19	14
Others ^a	30	52	13	7	28
Total	191	59	22	11	8

a. Others include schools, clinics, electricity, office buildings, green for grain, telephones, cable television, broadcasts, etc.

b. Others includes donations from abroad, donations from enterprises, donations from universities, small group investments, private investments, investments from power supply corporations, investments from broadcast bureaus, etc.

Source: Annex 5.

Additional resources are provided through the unpaid labor of farmers. The analysis above looks only at financial investments and, therefore, excludes the unpaid labor input by the villagers themselves. Villagers still contribute unpaid labor to village projects, even in 2004 and beyond. According to the survey, 58 percent of all investment projects in 2004 used unpaid labor. The total labor contribution amounted to about 56,000 days for the entire sample of 100 villages. Converting this into value terms yields a contribution of amount RMB 10 per villager,⁷⁴ or about 5 percent of the capital investment.

The policy of *yishi yiyi* is not strictly applied. Although we have not systematically surveyed the enforcement of *yishi yiyi* in the decision-making process, participation by villagers in the planning, design, implementation, and monitoring of capital investments varies widely. It appears that *yishi yiyi*, as required by the RFR, is not applied extensively. All key decisions on

⁷⁴ The conversion used RMB 23 as the cost per labor day, using a net rural income of RMB 2,600 per capita, a labor force about half the size of the total population, and the assumption of 220 labor days per laborer.

capital investments seem to be made at the local government (county) level.

Differences across China

Villages vary tremendously in terms of their financial strength, investments, and provision of public goods and services. This is shown in Table 30. For example, 2004 per capita village revenues are highest in Jilin and Jiangsu, with RMB 156 and RMB 110, respectively. Villages in these two provinces also receive the highest transfers per capita. Transfers to other provinces are much smaller, with total village revenue in Sichuan amounting to only RMB 23 per capita. Similarly, per capita capital investments in villages range widely from RMB 353 in Jiangsu to only RMB 63 in Hebei, and per capita village debt is as large as RMB 542 in villages in Shanxi and only RMB 91 in villages in Sichuan.

Table 30. Village Financing by Province and Poor Villages in 2004

<i>RMB per capita</i>	Total	Jiangsu	Si-chuan	Shan-xi	Jilin	Hebei	Poor
Revenues	82	110	23	48	156	41	134
<i>Transfers from above</i>	18	20	9	7	42	3	46
Total Expenditure, incl. debt-financing	95	168	56	52	104	50	85
<i>Recurrent Expenditures</i>	40	62	20	27	54	22	38
<i>Repayment of Principal</i>	13	9	8	8	34	4	29
<i>Total Capital Expenditures</i>	42	97	28	18	17	24	20
Deficit/Surplus	-13	-58	-33	-4	52	-9	50
Total Public Goods Investment	191	353	215	156	78	63	171
Total Village-level Liabilities	253	177	91	542	275	355	664

Note: "Poor" is defined as the 20 percent poorest villages.

Source: Annex 5.

The impacts of the recent reforms are most pronounced in poor and agriculture-dominated villages with little ability to raise revenues from land or asset sales or enterprises. On the positive side, the poorest villages were more than compensated for their loss of village assessments on farmers through transfers from above. Total per capita revenue of the poorest villages was well below average in 2000, but well above average in 2004. However, poor villages were already highly indebted, with debts of more than RMB 676 per capita in 2000. In 2000, the poorest fifth of villages were financing nearly 85 percent of their capital expenditures by debt. They had to allocate above-average amounts to service their debt.

Total capital investments increased in all villages. However, the poorest villages gained less than the richest villages. In particular, the increase in per capita transfers for capital investments was much greater to the richest villages than it was to the poorest villages. Particularly problematic was the financial situation of those villages that did not have access to income from land, assets, enterprises, etc.

5.2. Township Public Finance

Overview

Townships and towns are the lowest level of the five-tier government structure. A total of more than 37,000 township-level governments existed in China in 2004. Due to a continued push to merge or eliminate townships, the number of townships is decreasing rapidly (see Box 13 below). This trend will likely continue due to the attractive incentives offered in the “three rewards and one subsidy” program, whereby counties receive bonuses of RMB 300,000-400,000 for eliminating one township. The average population of a township is about 25,000 people. With the exception of a small minority of the population residing in the township seat, township residents have a rural *hukou*. A typical township might have about 15 administrative villages, but this number differs widely from region to region. Average grain output was more than 11,000 tons.

Table 31. Declining Number of Townships

	1985	1990	1995	2000	2004
Number of township-level jurisdictions	72,153	55,838	47,136	43,735	37,354
of which townships	-	-	-	-	19,883

Source: China Statistical Yearbook, various years.

The core township institutions are broadly similar to those of the county and higher levels of government. They include a Party committee, specific government sectoral offices, the people’s congress, the procuratorate and judiciary, mass organizations,⁷⁵ etc. However, the traditional structure might have changed after several structural reforms. For example, it is not uncommon for the Party committee, the Government Administrative Office, and the people’s congress to be combined into one department, namely, “the office of the Party and government” (*dangzheng bangongshi*). In addition, the townships have a number of PSUs. In the past, these were often referred to as “seven stations and eight offices” (*qizhan basuo*), but due to organizational reforms they have generally been combined into fewer (three or four) so-called service centers. Concretely, the agricultural, husbandry, irrigation, agricultural machinery and technology, and forestry units might be combined into an “agricultural service center”; the arts, sports, and communication sectors into a “cultural service center”; and those sectors related to social security into a “social issues center.”⁷⁶ The organizational structure of a typical township is presented in Appendix 4 Chart 6.

Box 13. Reforming Townships through Mergers

Townships were created as units of government after adoption of the new Chinese Constitution on December 4, 1982. Most townships replaced the former people’s communes and assumed many of their functions; others were formed from the former production brigades or by other methods. After their establishment was completed in 1985, there were more than 70,000 townships in China. Additional subsequent restructuring resulted in a fall in the number of

⁷⁵ For example, the Communist Youth League, the All-China Women’s Federation, etc.

⁷⁶ This township government structure might be called “one office and three or four centers” (*yiban sanzongxin*). Despite formal changes in structure, the centers still assign their employees responsibility for different jobs, such as agricultural techniques, agricultural machinery, culture, and communications, etc. Therefore, in practice there has not been a major change. In our interviews, most of the leaders in the township government still used the old names to describe their internal organization.

townships and towns in 1988 to 56,000. Thereafter, most years saw only a modest decline in the number of townships. However, the pace of merging or eliminating townships picked up at the beginning of this decade, with the number of townships falling from more than 44,000 in 2000 to about 37,000 in 2004.

The Central Government is supporting this development. The period of the Tenth Five Year Plan saw an acceleration in the growth of towns as a main instrument for urbanization. More importantly, the main rationale for the accelerated merger of townships is in line with the RFR. The objective is to improve the efficiency of local governments and thereby pay for part of the reduced “farmers’ burden,” but also to provide quality services more cost-efficiently.

However, actual decisions and implementation of township reforms are carried out at the local level and vary considerably across the country. While evaluation of these reforms nationwide is weak and not well documented, anecdotal evidence suggests that achieving the objectives, in particular a reduction of costs, is very difficult. According to Wang Fenqing (2004), the “fiscally-dependent population” was estimated to be 235 persons per township, while according to the 1993 institutional reform scheme of the State Council, the target was to be an average of 20 persons per township and a maximum of 45 persons. According to Pan Wei (2004) and Wen Tiejun et al. (2003), there are major problems associated with the process of township mergers, including:

1. Wasteful public expenditures due to excessive construction projects;
2. Limited or no efficiency gains through the reduction in the number of staff or agencies;
3. The reassignment and reduction of staff numbers in some locations leading to adjustment problems, including problems in effectively addressing social conflicts.

Systematic, comprehensive research on this topic would certainly provide guidance for furthering the process of township reform and would contribute to increasing the efficiency and effectiveness of local rural governments.

Source: CSY 2005; Wang Fenqing (2004); Pan Wei (2004); Wen Tiejun et al. (2003).

The role of townships varies substantially over time and space, but in general over the last few years townships have become increasingly dependent on the county government. Most townships, emerging from the former communes, used to be largely self-contained units that provided for basically all public (and other) goods and services. However, especially since the start of the RFR, more and more township expenditure responsibilities have been assumed by the county or higher levels of government. Most importantly, as shown in Chapter 2 above, the *yixian weizhu* reform shifted responsibility for paying teachers’ salaries for rural basic education to the county. Townships also assume very limited responsibility for rural health care, much of which has been privatized, and for social safety. Finally, the Central Government has assumed major responsibility for rural infrastructure through earmarked transfers that are largely implemented under the authority of the county. The core responsibilities of townships are limited to a few areas, such as those related to agriculture or family planning. Of course, townships have responsibility for implementing the policies of higher-level governments and for assisting in the administration of higher-level programs. However, in this sense they are sub-ordinate agents of the counties rather than independent levels of government. This point will be analyzed in further detail below.

Our analysis of township public finance is based on a survey of 50 townships over five provinces (Annex 6) as well as Zhou et al. (2005) and several case studies (Annex 1 to 3). The 50 townships in the sample have an average population of 27,900 people, with a total labor force of 12,200, of whom 4,100 work and live outside the town. Annual rural net income was about RMB 3,100 in 2004, and the primary sector still accounted for about 42 percent of total GDP (estimated at RMB 193 million per township). This empirical information can be considered quite representative for the country as a whole. However, when interpreting the information one needs to be fully aware of the great heterogeneity among townships across the country. In particular, due to the limited sample size, findings on sub-sets of townships, such as those in certain provinces, must be analyzed with great caution.

County-Township Relationships and Township Revenue

Township finances are largely determined by the “county-township fiscal system” (*xianxiang caizheng tizhi*). This system of expenditure assignment and revenue sharing is highly decentralized. With the notable exception of the *yixian weizhu* reform that mandates counties pay teachers’ salaries, higher-level governments provide only general guidance. Specific rules are established essentially independently in each county. A “contract” is negotiated between the county and its townships and might differ even among the various townships within the same county.⁷⁷ Typical elements of a county-township fiscal system include the “bases” for expenditures, usually made on the basis of the salaries and operational expenses for which the township is responsible; the “bases” for the sharing of local revenues; rules for the sharing of the surplus or deficits between actual revenue collection and the revenue “basis”; “system remittances” or “system subsidies” to close the gap between the revenue base and the expenditure base; and rules on how often the system and bases should be revisited (annually or every few years). Rules – as the system arrangements as a whole – are highly discretionary and often set incentives that are undesirable from a macro point of view.⁷⁸ Table 32 shows the resulting variations across counties and townships for the sharing of selected taxes; expenditure bases and other elements of the “system” also vary widely.

Table 32. Revenue Sharing of Selected Taxes for Selected Counties and Townships

	Province	Hunan		Chongqing			Jilin		Jiangsu		
	County	X.	N.	F.	T.	H.	J.	Y.	W.		
	Township				T.	Y.	K.	M.			
VAT	Central	75	75	75	75	75	75	75	75	75	
	Province						12.5	12.5	12.5		
	City										
	County							3.75	12.5	25	18.75
	Township	25	25	25	25	25	12.5	8.75			6.25

⁷⁷ Important adjustments that determine the sharing of funds (and, hence, power) for several years, such as those on the level of “bases,” are usually the outcome of extensive negotiations between county and township governments. Anecdotal information from our field work suggests that final documents are issued after five or more rounds of discussions.

⁷⁸ For example, the incentives for townships to fulfill their revenue base might be so strong that they borrow funds – reportedly even from neighboring townships – in order to be perceived as fulfilling their revenue base.

	Province	Hunan		Chongqing			Jilin			Jiangsu	
	County	X.	N.	F.	T.	H.	J.	Y.	W.		
	Township				T.	Y.		K.	M.		
BT	Central										
	Province				40	40	50	50	50		
	City										
	County				35	30			50	100	40
	Township	100	100	100	25	30	50	50			60
EIT	Central	60	60	60	60	60	60	60	60	60	60
	Province	12	12				16	16	16		
	City										
	County									40*	16
	Township	28	28	40	40	40	24	24	24		24
PIT	Central	60	60	50	60	60	60	60	60	60	60
	Province	12	12		16	16	16	16	16		
	City										
	County				4					40*	16
	Township	28	28	50	20	24	24	24	24		24

Source: Zhou et al. (2005).

A budget or comprehensive planning process does not exist at the township level. While rich townships, especially those with income from land and other off-budget sources, may have substantial fiscal capacity, the average township basically has no fiscal capacity. Township finance beyond the negotiations with the county is largely one of accounting. Fiscal allocations are fundamentally the remunerations of budget-supported employees, plus some limited operational expenses. Additional resources often lead to the hiring of extra staff. Hence, budget planning is largely meaningless. This is reflected in the fact that budgets sent to the township people's congress for approval are often just a few sentences, and submission and approval can be delayed for as much as a year, i.e. to after the implementation period.

Total township fiscal revenues have declined. The fiscal authority of townships is largely determined by their "disposable fiscal revenues" after the sharing system, as well as their extra-budgetary and other off-budget funds. "Disposable fiscal resources" are the funds available to the townships after remittances to and transfers (so-called "subsidies") from the county are added/subtracted from the local fiscal revenues. The survey of fifty townships shows constant disposable fiscal revenues from 2000 to 2004. Total fiscal revenues amounted to RMB 211 per capita in 2000, but the figure declined to RMB 182 per capita in 2004. During periods of rapid economic growth and even faster fiscal growth, these measures indicate a strong relative decline in the fiscal authority of townships. The reason for this relative decline is the reassignment of some expenditures to the county level, in particular the payment of rural teachers' salaries. Such reassignments of expenditures are likely to be accompanied by reassignments of revenues (see Table 33).

Table 33. Structure of Township Revenue in 2000 and 2004

	2000		2004	
	RMB / capita	percent	RMB / capita	Percent
Local Taxation Income	95	100	129	100
Value-added Tax	18	19	20	16
Business Tax	13	13	42	33
Income Tax for Enterprises	6	6	5	4
Individual Income Tax	7	7	7	5
Agricultural Tax	19	21	26	20
Agricultural Specialty Products Tax	13	14	0	0
Occupied Land Tax	1	1	3	2
Other Income	18	20	26	20
Township-to-County Transfers	34		93	
County-to-Township Transfers	58		84	
Disposable Fiscal Resources	119		119	
Total Extra-budgetary Income	55		53	
Total Self-raised Income (incl. <i>tiliu</i>)	37		10	
<i>Tongchou</i>	20		0	
<i>Tiliu</i>	14		0	
Other	4		10	
Total Fiscal Revenues	211		182	

Source: Annex 6.

Increased remittances to counties offset increased transfers and a modest increase in local tax revenue. Local tax revenues increased from about RMB 95 per capita in 2000 to RMB 129 in 2004, mainly due to increased business tax collection. However, most of the increase was submitted to higher levels. Tax income for townships only increased from RMB 66 to RMB 70 per capita. Transfers from above increased at a much higher rate. In particular, RFR subsidies and earmarked transfers now complement the old systems and other transfers. The share of transfers over own revenue further increased after 2004 as the agricultural taxes were largely eliminated and replaced by transfers. However, remittances from townships to counties increased even more rapidly, largely as a result of the *yixian weizhu* reform.

Extra-budgetary and self-raised resources have declined. This should be seen as a major achievement of the RFR, as accountability and management for budgetary resources are stronger than for extra-budgetary resources. At the same time, decreasing off-budget funds that are not offset by larger disposable fiscal budget resources means that townships today have considerably fewer available resources than they did at the beginning of the reforms. The ability of township leaders to respond to unfunded mandates and other emergency expenditures has been substantially reduced. For example, at the end of 2000 when townships were trying to balance their fiscal accounts, they used RMB 22 per capita from extra-budgetary funds to supplement their in-budget fiscal resources; in 2004, this figure was down to only RMB 6 per capita.⁷⁹

⁷⁹ However, we note that the survey might not have covered all off-budget resources, including those accrued by

Township Expenditures

The decline in revenue is reflected in reduced expenditures, in particular for education. Township budget expenditures fell from RMB 142 per capita in 2000 to RMB 126 per capita in 2004, a drop of 11 percent. This is largely due to a shift of expenditures in education, including payments for retired teachers. The increases were the largest for other miscellaneous expenditures, which are made up of allocations for township infrastructure maintenance, agricultural extension, water control, etc., and for administrative management. Clearly, the involvement of townships in the financing of social services including education, health, and also social safety, is marginal. Nevertheless, townships have maintained their importance in other expenditure areas. Expenditures for administration and other expenditures have risen rapidly (see Table 34).

Table 34. Structure of Township Expenditures in 2000 and 2004

	2000		2004	
	RMB / capita	percent	RMB / capita	percent
Budget Expenditures	142	100	126	100
Education	74	44	12	12
Health	7	5	5	4
Wages for retired workers	12	10	6	5
Social welfare	7	5	9	6
Expenditures for administration	24	22	38	33
Other expenditures	17	15	56	40
<i>Expenditures for Salaries and Wages</i>	<i>112</i>	<i>77</i>	<i>66</i>	<i>53</i>
<i>Office Expense Expenditures</i>	<i>19</i>	<i>13</i>	<i>24</i>	<i>21</i>
<i>Special Expenditures</i>	<i>6</i>	<i>4</i>	<i>12</i>	<i>10</i>
Total Extra-budgetary Expenditures	62		59	
Total Current Expenditure	204		186	
Total public investment expenditures	77		217	
Financed by township	50		80	

Source: Annex 6.

Rapidly increasing capital investments in the areas of townships are generally not accounted for in the township budget. Expenditures for infrastructure have been rapidly increasing. According to the survey of fifty townships, in 2000 only RMB 77 per capita of investments were made by the townships for building roads, schools, irrigation, and other public goods infrastructure projects. By 2004, this amount had risen to RMB 217, nearly a tripling during the fiscal reform period.⁸⁰ A large part of the increase was for rural roads, which

certain PSUs or resources from land or asset transactions.

⁸⁰ The townships are not always aware of infrastructure investments in their villages that are financed purely by the villages themselves. Hence, the figures presented underestimate the total capital investments in a township. This also explains, at least in part, the differences between what is stated here and what is stated by the villagers (see section below) regarding the share financed by the village.

accounted for more than half of the investments in 2004 (see Table 35).

Table 35. Township Investment in Public Goods Construction, 2000 and 2004

	2004				2000 ^a			
	Mean in RMB per capita	Percentage from...			Mean in RMB per capita	Percentage from...		
		Higher government	township	village level		higher government	township	village level
1 Total	217	53	37	10	77	26	64	10
2 Roads & bridges	115	60	30	10	22	23	57	20
3 Irrigation	31	32	58	10	11	48	31	21
4 Drinking water	17	67	18	15	8	45	49	6
5 Schools	19	43	53	4	26	16	83	1
6 Clinics	4	58	42	0	1	11	89	0
7 Other ^b	31	45	43	12	9	24	75	1

a: Total sample is 50; only 48 townships have complete information; 1 missing in Shaanxi and 1 missing in Hebei.

b: Others include electricity, office buildings, green for grain, telephones, cable television, broadcasts, etc..

Source: Annex 6.

Increasing capital investments have increased pressures on township finance. The township itself finances only a part of the capital investments. In fact, contributions by the townships have decreased substantially as a share of total capital investments, from almost two-thirds (64 percent) in 2000 to little more than one-third (37 percent) in 2004. Nevertheless, this is still an increase in absolute terms from about RMB 49 per capita in 2000 to RMB 80 per capita in 2004.

Township debts are increasing. Given the tight fiscal conditions, when increases in investment by upper levels have been accompanied by demands for matching funds (as they often are), many townships have dealt with the higher demands through borrowing. Between 2000 and 2004, the debt of townships continued to rise. On a per capita basis, this means that, on average, debt rose by 23 percent (from RMB 236 per capita to RMB 290 per capita).⁸¹ When asked what are the main reasons for the rising debt, more than half of the townships reported that unlike in the past (when borrowing to cover township enterprise-related expenses and debts was most common), the main reason now for borrowing was to invest in infrastructure projects.⁸² Clearly, both current and capital fiscal management in China's townships have come under increased stress as the fiscal reforms have proceeded (see Table 36).

⁸¹ The survey of 16 townships revealed even a higher indebtedness of townships, with an average of RMB 18.8 million (RMB 10.5 million on average for the 12 surveyed counties in central and western China). See Annex 6.

⁸² The survey of 16 townships also showed substantial debt due to township enterprises and old debt from the dissolved Rural Cooperative Foundations (RCFs). See Annex 6.

Table 36. Township-level Liabilities in 2000 and 2004

	2000		2004	
	RMB / capita	RMB / capita	percent of total	percent of total
Total township debts	236	290	100	100
Loans from RCCs	36	32	13	17
Loans from other banks	20	25	12	12
Loans from legal entities	31	80	20	10
Loans from individuals	29	35	13	13
Loans from informal financial institutions	4	8	2	2
Loans from upper level organizations	51	44	16	19
Defaults on wages (delayed payments)	20	30	10	10
Other	45	37	14	17
Estimated percentage to be repaid	60	47		

Source: Annex 6.

Personnel costs have not been curbed. The structure of expenditures apparently improved from 2000, when almost all funds went to salaries, to 2004, when operational expenses accounted for almost one-quarter of expenditures. The absolute value of spending on wages, according to the official breakdowns, fell by RMB 56 from RMB 112 per capita to RMB 66 per capita. The share of total expenditures devoted to wages also fell sharply, from 77 percent to 53 percent. However, a closer examination reveals that, in fact, all of the absolute fall in wage expenditures can be more than accounted for by the shift of expenditures for teachers' salaries from the township to the county budget. Salaries and wages of township employees have grown in line with national policies. Even though township officials do not receive the same amount of additional benefits as higher-levels officials, the growth rate of their remuneration is higher than the economic growth rate of a poor or even average township.

The number of employees supported by the budget has increased. According to our analysis, the government's personnel reforms, a key part of the effort by the Central Government to restore the fiscal health of townships, have failed to limit expenditures. Although the Central Government has spent a lot of time and effort in trying to cut the number of civil servants and other personnel who are supported by local fiscal resources, in fact, a careful analysis shows that in most provinces there has been no progress in any of the categories, except for the locally controlled public-service-providing enterprises such as the rural credit cooperatives. Teachers are excluded from this analysis since they have generally been moved to county employment statistics. While the number of civil servants in established posts per township declined from 28 in 2000 to 26 in 2004, the total number of other employees, mainly in PSU, excluding enterprises, overall remained constant at around 53. Two provinces, Jilin and Shanxi, saw increases in staff numbers and only Jiangsu saw significant reductions in township employees. Data from Henan, presented in Table 37, where we present provincial-wide information on township staffing in 2003, show serious overstaffing problems.

Table 37. Establishment and Number Employed at the Township Level in Henan, 2003

	Establishment	Number Employed	Overstaffing (%)
Party/government organizations	63,786	78,634	23%
PSUs	114,870	220,327	92%
Total	178,656	298,961	67%

Source: Annex 3.

The reform impact has been unequal across townships. A breakdown of our survey results is problematic because of the limited sample size. However, most of the effects of the reforms described above can be found in all provinces.⁸³ Fiscal revenues including extra-budgetary and off-budget resources declined from 2000 to 2004. Expenditures remained constant or declined. However, capital investments increased in the townships of all provinces, particularly in Jilin and Shanxi. Interestingly, the analysis reveals that poor townships fared far better than average townships. In the poorest townships in our sample, between 2000 and 2004 revenues and expenditures rose, public investment outpaced all other groups of villages, and village debt did not rise. Hence, in terms of their effect on the poorest townships, the fiscal reforms appear to have been beneficial.

In summary, the fiscal stress on townships has increased and the role of townships has been marginalized. As shown above, the overall revenue of townships has declined and township discretionary funds have been replaced by earmarked transfers. Expenditures are tight for wages and other operational expenses; pressures from villages to provide financial support, for example for the operation and maintenance of infrastructure, have increased as the fiscal stress on villages has increased; the public services role of townships has been marginalized and is only significant in areas such as agriculture, forestry, etc. The average township has far less freedom than ever before to make financial or other decisions.

5.3. County Public Finance

Overview

The county is arguably the most important level of grassroots government, and for achieving the objectives of building the NSC. In 2003, this level accounted for about one-quarter (23.3 percent) of all of China's public expenditures. There were 2,862 county-level jurisdictions in China, including about 1,606 counties and national minority autonomous counties, 852 districts, and 374 county-level cities (see Appendix 4 Chart 2). Our analysis focuses on counties (*xian*). A typical county might have about twenty towns and townships, perhaps three hundred villages, and a population of close to half a million. The vast majority (on average 85 percent) of the population is rural. Agriculture is the largest sector in terms of employment and often still the largest sector in terms of GDP. However, the diversity among counties in terms of size, administrative structure, socio-economic situation, etc. is enormous. For example, population can range from 10,000 in some remote areas to well over 1 million people; GDP might be as small as RMB 10 million or larger than RMB 10 billion.

The administrative structure of county government largely corresponds to that of higher administrative levels, but with some variation across the country, and substantial differences in

⁸³ Shanxi is an exception. For some reason that we cannot explain, fiscal revenues and expenditures of townships in Shanxi actually increased substantially from 2000 to 2004.

the capacity of county governments and individual agencies at the county level. Under the “dual rule” system, many county government departments receive instructions from both the county (the Party committee and county head) and administrative guidance from counterpart agencies at higher levels. Almost universally, the institutional structure consists of the Party committee; the government; the people’s congress and the people’s consultative conference; and the judicial organs such as the courts and procuratorate. A typical county government might be composed of 25 or more departments or agencies, each of which has a counterpart in the respective province (municipality) and at the center. Usually attached to the county government are many hundreds of PSUs, including hospitals, primary and middle schools, and other units providing services. It is not uncommon that this category includes units with core government authority such as the local tax offices stationed in the townships, but it might also include units that are managed largely as commercial entities. The bulk of county government staff is employed in these PSUs. Appendix 4 Chart 5 and Annex 3 provide a more detailed description of the county organizational structure.

Much of this sub-chapter is based on the case studies undertaken in 2004, as well as analysis of fiscal data for all counties in China.⁸⁴ We focus the analysis only counties and county-level cities, i.e., not on districts.

Fiscal Growth and Changing Budget Structures

The fiscal capacity of counties has steadily increased over the last decade. Using 1995, the year after the TSS reform, as a base year, fiscal expenditures of counties (excluding county-level cities) increased by close to 15 percent annually, but with slower growth in the 1990s and very substantial growth of around 20 percent since 2000. While county budget expenditures were RMB 323 per capita in 2000, they almost doubled to around RMB 636 per capita in 2004. About a quarter (25.2 percent) of China’s total budget expenditures (34.9 of subnational expenditures), or about RMB717 billion, is spent at the county level (non-consolidated; 2004 data).

As shown above, the authority of counties over township governments has increased. The transfer of the expenditure assignment for teachers’ salaries, and, not infrequently, civil servants, from the township to the county level increased the formal authority of counties. Moreover, many of the rapidly increasing capital investments that come with the increasing transfers, especially from the Central Government, are largely implemented by the county. Townships are involved in the administrative and day-to-day work of implementation, but have limited say over the allocation of the investments. Therefore, although the overall share of county plus township expenditures in total government expenditures has remained relatively constant, the importance of the counties has grown significantly and, correspondingly, the role of the townships has declined. This is already shown in Table 15 of Chapter 3 above and is confirmed by the figures in Table 38.

⁸⁴ In interpreting the findings it is important to note that in general county-level fiscal data are consolidated data, i.e., they include townships.

Table 38. Revenue and Expenditure of Counties

	Expenditure (%)				Revenue(%)			
	1993	2000	2003	2004	1993	2000	2003	2004
Above County	74	72	70.3	68.8	69.0	80.0	82.6	83.0
County	16	20	23.3	25.2	19	12	11.5	11.9
Township	11	8	6.3	6.1	13	8	5.8	5.1

Source: Based on Compendium of Local Fiscal Statistics, various years.

As we have seen in the above analysis, county own revenues have decreased in relative terms. In particular, local own revenues decreased due to the 1994 TSS reform. The share of consolidated county own revenues, i.e., including those of the townships, further decreased thereafter. However, almost exclusively this had an effect on the townships, in particular due to the RFTF. County-level own revenues remained more or less constant in relative terms and the average county budget expenditures increased to RMB 636 per capita in 2004 (see Table 38). Nevertheless, given that many decisions at the township level are largely determined at the county level, the decline in the township level has reduced the authority of the rural local governments as a whole.

Table 39. Revenue and Expenditure of Counties, 1995-2004

Year	Budget Revenue (RMB per capita)	Own Revenue (% of budget rev.)	Budget Expenditure (RMB per capita)	Budget Expenditure (change over previous year)	C.V. of OR per capita	C.V. of OE per capita
1995	183	0.47	192	19%	0.70	0.67
1996	227	0.50	233	21%	0.72	0.73
1997	250	0.50	254	9%	0.71	0.72
1998	267	0.53	267	5%	0.80	0.74
1999	308	0.49	300	12%	0.88	0.71
2000	325	0.46	323	8%	0.84	0.72
2001	418	0.40	405	26%	0.87	0.77
2002	495	0.34	489	21%	0.87	0.74
2003	569	0.34	557	14%	0.90	0.77
2004	647	0.31	636	16%	0.91	0.78

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, various years.

The dependency of counties on higher-level governments has increased. Again, as shown above, the widening fiscal gap is made up for through transfers. This becomes obvious in the changing composition of budget revenues from own revenues to transfers.

Despite the budget expansions, the long existing poor fiscal situation of many counties remains. In fact, in a number of counties the fiscal situation has worsened over the last few years. The level of indebtedness of counties (and townships) points in this direction. For more details, see Box 14. The main reasons for this continuing fiscal situation are the following:

Box 14. County-level Indebtedness

County-level government indebtedness is arguably the most worrisome among all levels of local governments. Due to a confluence of factors, such as dealing with revenue shortages and seeking rewards by making investments, county governments have been borrowing, often excessively, through both legal and illegal channels. Their repayment behavior is irregular and their outstanding debt is significant.

Level of indebtedness. Analysis based on data from 57 counties in three provinces and one municipality in China suggests that county-level debt can be as high as 14 percent of GDP. Similarly, the debt burden measured as debt stock over own revenue is quite large. The average ratios of debt to own, disposable, and total revenue is estimated to be, respectively, 335 percent, 255 percent, and 138 percent under a best case scenario; and 558 percent, 425 percent, and 231 percent under a worst case scenario. Even the lowest debt to own revenue ratio (138 percent) is much higher than the international standard for developing countries, which ranges from 60 percent (as measured by Standard & Poor's), or the level of some individual countries such as Colombia (80 percent).

Debt composition. As for the debt composition, central-bank earmarked borrowing to address local financial risks is the largest debt item—accounting for 27 percent of the total explicit debt of these governments. Borrowing from domestic banks ranks second (17 percent), followed by intergovernmental borrowing (15 percent), onlent state bonds (10 percent), foreign loans including loans from international financial institutions (9 percent), salary arrears (4 percent), and borrowings from individuals (4 percent).

Causes. There is a confluence of incentives in China which motivates local governments to borrow irresponsibly. Due to *intergovernmental fiscal relations* with large vertical and horizontal imbalances and the non-transparent transfer payment system, counties in China are constantly short of revenue and have to turn to borrowing to carry out their responsibilities. The *role of government* is not clearly defined and county government often takes up market functions, exposing itself to market risks. The inadequate *information disclosure* system and lack of credit assessment for local governments are additional reasons for the indebtedness of local governments. *Banks* in China do not operate entirely on commercial principles. Many of them have close ties to local governments. The poor *financial management* system is a major cause of the current lack of understanding of local government indebtedness in terms of its level, structure, and debt repayment behavior. An incomplete *definition* of debt, poor information reporting and monitoring systems, and weak implementation practices all contribute to the currently unsound debt management situation. Finally, *current performance criteria* of local officials are mainly focused on growth and investment.

Debt reduction approaches. International experience suggests that immediate policy options could include debt rescheduling, expenditure reductions, and revenue mobilization. *Debt rescheduling.* When the debt maturities are extended, say, from 5 years to 10 and 15 years respectively, the burden of servicing the debt can be greatly reduced. *Expenditure reductions.* Counties tend to have high shares of personnel spending, which not only limit the provision of services, but also weaken their debt servicing capacity. *Revenue mobilization.* Increasing the revenue sources for local governments is a key measure for debt reduction. Options could include introducing a property tax and a transportation vehicle tax, or revising the current personal income tax design.

Source: Input by Mei Wang based on Wang (2006).

First, the costs of running the government have increased considerably. Most importantly, salary increases that are uniformly set at the central level, which make up a very substantial portion of local government expenditures, have increased greatly. If one deflates budget increases with the salary growth rate for “Government Agencies, Party Agencies, and Social

Organizations,” the “real” growth rate in budget expenditures amounts to only 1 to 2 percent per year.

Second, obviously the increased budgets have to be set against the counties’ expenditure assignments. These considerable budget assignments have increased substantially with the greater focus on delivering public services to rural areas. The *yixian weizhu* reform put the county in charge of paying teachers’ salaries in rural schools, a large addition to the county budget. Moreover, the focus on rural development has been accompanied by greater demands. Examples include the pilot or roll-out of new programs such as the NCMS; rural social security; rural *dibao*; and increased capital investments funded by higher-level governments, but requiring matching contributions or, at a minimum, leading to administrative costs for the counties.

Third, the ability of county governments to raise extra-budgetary funds to pay for public services has been constrained by the RFR. In fact, the **increase in budget resources in the consolidated county budget is partly due to the shift from extra-budgetary funds.** As shown in Chapter 2 above, the net impact of the RFR on county and township governments has been negative. The RFR has increased accountability, but needs to be evaluated against the backdrop of the increases in public financial resources.

At the same time, the richer counties have seen increases in other off-budget resources, mainly from land-related transactions. Although we lack comprehensive data on the magnitude of this development, there is evidence that these increases can be very substantial, at least for the richer counties. For more details see Box 15.

Box 15. Local Government Revenues from Land Transfers and Land-related Financing

Revenues from government-dominated land transactions are an important part of the income of local governments at the municipal, county, and township levels. This is also the case at the village level even though the village committees are not legally counted as a level of government. With the abolition or reduction of many other extra-budgetary revenue sources and with the continuing strong, but distorted to certain extent, incentive for pursuing urbanization, land transaction-related revenues now constitute a larger part of the non-budgetary funding of local governments. A study carried out by the World Bank and the Development Research Center for the State Council (DRC) (World Bank 2005a) found that extra-budgetary income related to land is substantial and, in many cases, equal to or in excess of the fiscal revenue of local governments.

The revenues from land-related transactions can be divided into two sub-categories, i.e., land-use right transfer fees and loans secured through government-run land banking sectors. The land-use right transfer fee is a one-time payment made by land users for obtaining urban land-use rights for a certain number of years (e.g., 70 years for residential purposes, about 40 years for industrial purposes). Official data show that from 2001 to 2003, the total revenue from the land-use right transfer fees was as high as RMB 910 billion (US\$ 110 billion). In some municipalities and counties, the land-use transfer fee revenues alone were higher than the governments’ fiscal revenues.

At the same time, there has been an increasing reliance on mortgage loans by local governments using requisitioned land as collateral through the use of “land banks.” The same joint study (World Bank 2005a) found that the amount of mortgage loans in many areas was far larger than the amount of land-use right transfer fees and accounted for more than half of the governments’

extra-budgetary incomes. The study also confirmed that land transaction-related revenues account for 80 to 90 percent of total investment in infrastructure construction of local governments in many areas.

This over-reliance of local governments on revenue from land transaction-related revenues is a result of a fundamental feature of the land policy: the persistent duality of rural and urban land tenure systems and the state's monopoly of the primary market for land used for urban construction. Under the current policy framework, rural land and urban land are subject to different rights regimes and administered by separate institutions. Generally, urban land enjoys a more complete set of rights than rural land. Associated with this separation of rights, the sole mediator of the urban-rural interface is the government, which has exclusive power to acquire rural land and transfer it to urban users. That is, it is impossible to reach a direct deal on land transfers between those holding rights over rural land and those ultimately acquiring it for new urban uses. Rural land must be acquired by the government before it can be used for urban construction. This is true whether the construction is for public, quasi-public, or even clearly private uses. This duality and the government's associated monopoly over the primary market for urban land create unfavorable social consequences for holders of rural land rights and makes urban land markets less efficient than they could be.

In addition to the over-reliance of local governments on revenue from land transaction-related revenues, the duality of the rural and urban land tenure systems and the state's monopoly over the primary market for urban construction result in two other serious problems. The first is the weak land rights of farmers. This problem expresses itself in many different ways. For example, the process of land requisition and the levels of compensation are perceived to be unfair to farmers. Farmers are also in a disadvantageous position to challenge violations of their rights by collectives, such as illegal land readjustments.

The second serious problem is the inefficient forms of urban growth and the difficulties in reducing the rate of farmland conversion. The artificially low price of rural land encourages a land-intensive urban growth that leads to a huge waste of precious land resources. The government has taken strong steps to impose tighter regulatory controls over farmland conversion. However, it will be difficult to suppress efforts to evade these controls if no steps are taken to fundamentally alter the economic incentives that drive the current rapid urban expansion.

While land-related revenues increase the ability of local governments to provide public goods and services, an overall assessment of this development is clearly negative with respect to local public finances. The weak auditing and monitoring of non-budgetary funds contrast sharply with the very limited local autonomy in the formal budget. This results in problems in fiscal discipline over a lack of alignment of local government incentives with national priorities to an increase in corruption.

Source: Input by Guo Li based on World Bank (2005a).

The overall picture hides tremendous variability across counties and the fact that while some counties are relatively well off, others face enormous fiscal difficulties. Per capita expenditures of the fiscally richest quintile of counties (only) exceed those of the fiscally poorest counties by more than 4 (4.2 in 2003). This is excluding non-budgetary resources which can be assumed to be correlated with budgetary resources. This is a tremendous range, even if the costs of service delivery and expenditure assignments vary across counties. While the ratio has declined

somewhat since the beginning of the decade, it is still higher than after the TSS (3.9 in 1995). The coefficient of variation in Table 40 shows a similar picture of continuously high variability of per capita expenditures across counties.

In addition, the fiscal inequalities of counties within provinces are not decreasing. Even though some provinces such as Henan show improving trends, others such as Sichuan or Jiangsu show increasing intra-province inequalities. This is shown in Table 39. Quite surprising are the huge differences in intra-provincial variation in county expenditures. The lowest variations seem to be in the central provinces, whereas they are very large in Sichuan. These differences can only partly be explained by the heterogeneity within provinces; they also reflect the emphasis individual provinces might place on fiscal equalization.

Table 40. Variation of County Budget Expenditures by Selected Provinces

	Sichuan	Henan	Zhejiang	Jiangsu	Shanxi	Jilin	Hebei
1995	0.65	0.37	0.41	0.26	0.31	0.46	0.33
2000	0.73	0.34	0.40	0.33	0.43	0.44	0.32
2003	0.84	0.29	0.41	0.38	0.30	0.40	0.30

Note: Measured as Coefficient of Variation in Per Capita County Budget Expenditure.

Source: China Prefectures, Cities, and Counties Fiscal Statistics, various years. Authors' calculations.

Own revenues have increased relatively little, at an average rate of 10 percent nominally since 1995 and at an even lower rate since 2000. This is small compared with the growth rates of the economy and the budget as a whole. Due to the lack of tax setting authority and formal legal borrowing, and inefficient tax administration and few incentives for revenue collection, the variability of raising own revenues has increased substantially.

The variation of own revenues across counties has increased considerably. This trend can be easily explained by pointing to the rapidly growing economy and substantial differences in economic growth across the country, as well as the fiscal policies such as the elimination of rural fees and agricultural taxes.

The vast majority of the increase in county budgets comes from transfers, which have increased at a tremendous rate, close to 20 percent since 1995 and about 30 percent between 2000 and 2004. Today, transfers make up close to two-thirds of county revenues.

The tremendous variation in the fiscal situation of counties is illustrated in Table 40 using the three case study counties. While the table shows 2002 data, it indicates the tremendous differences, and these have not been addressed through subsequent reforms. Huaxian, a poor county in Henan, had a much weaker fiscal situation than the economically extremely poor Ninglang or the very rich Shuangliu.

Table 41. Comparing the Three Fieldwork Counties, 2002

	Huaxian	Ninglang	Shuangliu
per capita GDP (RMB)	3,231	1,686	14,809
per capita fiscal revenues*	269	690	698
per capita expenditures**	273	811	709
Education	116	195	166
Administration	43	105	98
Aiding agriculture	6	17	19

	Huaxian	Ninglang	Shuangliu
Running agric. depts.	8	158	32
% population supported by budget incl. PSUs	2.0%	4.1%	2.4%

Notes: * including transfers and includes state debt onlending and earmarked subsidies, most of which are for capital expenditures and should be netted out; ** current year expenditures net of remittances

Source: Annex 3.

Nevertheless, the differences do not translate into the same differences in public goods and service delivery. For example, based on our field observations key services such as education were certainly unsatisfactory in Huaxian, but not worse than in Ninglang – even though Ninglang spent more fiscal resources per student. One other factor is the costs of delivery, which are higher in mountainous Ninglang with its poor infrastructure. However, it is likely that the efficiency of the administration is even more important. This is partly expressed in the share of people supported by the government, which was much higher in Ninglang than in Huaxian. The underlying reasons for this efficiency are discussed in the following section.

Planning and Budget Processes, Financial Management

The planning and budget processes of county governments are constrained and seem weak in the face of the new challenges of building a NSC. There are several reasons for this. One is the large number of higher-level mandates that when aggregated exceed many local governments’ fiscal and administrative capacities.

Another severe constraint on county governments’ ability to implement a better budget process is the personnel system. Decisions on agencies and positions are approved by a joint Party-government agency set up at each administrative level and by higher-level committees, ultimately reporting to the State Commission on Public Sector Reform (see Appendix 5). Consequently, local governments have only limited power to change their formal institutional and personnel structures. Moreover, the personnel decision-making process that is largely determined by the higher levels includes salaries and other benefits of government employees. The growth in government-related salary levels over the last years (15 percent on average between 1998 and 2003) might be justified in high-growth urban areas, but does not balance the local economy in many of the poorer and agriculture-dominated localities. Consequently, personnel-related costs take up an overwhelming share of the total budget in many counties.

In practice, local governments often add more employees than approved, thereby leading to “overstaffing.” Overstaffing, i.e., local governments employing more staff than approved by the post establishment system (Commission on Public Sector Reform) is widely publicized in China and was found by the study team in all three counties visited (Annexes 1, 2, and 3). Additional staff are usually hired by the PSUs rather than by core government agencies and they often have a different employment status than regularly-hired personnel. On the one hand, the hiring of such additional staff may reflect the mismatch between officially approved employees and the many tasks that these employees must execute. But, on the other hand, this is also a way for local government leaders to support specific individuals and their families, in particular since the hiring process for such staff is usually much less transparent than that required, for example, for civil servants at higher-level governments. Moreover, a number of county governments still regard it as their responsibility to offer jobs to any college graduates of their county, if they

cannot otherwise find a job (see Annex 3). This tendency to increase staffing levels leads to the soft budget constraints of county governments. Payment for all government employees is the top priority of the government and a reason for the (de facto) bail-outs of counties by higher-level governments.

The transfer system, in particular the many transfers earmarked for specific spending purposes, also severely limits the fiscal authority of local governments. The weaknesses of the transfer system are discussed in detail in Chapter 4 above. As noted, most county governments depend on fiscal transfers for the majority of their expenditures. Fiscally poor counties generally spend almost all funds that are not earmarked for specific purposes (such as capital investments) on staff-related expenses. The other special-purpose transfers are designed at and financed by higher levels, almost always the center. Consequently, local governments have little flexibility to allocate between and within sectors in accordance with a true budget project.

The usefulness and efficiency of this large number of often small projects designed at the central level is questionable. For example, in Ninglang county a significant portion of expenditures are not budgeted by the county. In Huaxian we spoke with township leaders who basically had no information about a road project in their township, since it was implemented by the county. Zhao et al. (2005b) reports that “no one at the grassroots levels has a comprehensive account of earmarked subsidies that pass through their territorial unit.” The need to raise matching funds and the specific administrative and other requirements of these transfers result in substantial costs at the local level. Clearly, requiring local governments to contribute and thereby show their commitment is a good practice. However, it is often not enforced, nor enforceable due to local fiscal constraints vis-à-vis the large number of earmarked transfers. Moreover, funds often do not reach the county in line with the annual budget process or even the next planning period. Uncertainties in the availability of specific projects and the availability of transfer funds further undermine local budget projects. In addition, the number of projects is often large (see Box 16), and implementation as well as monitoring and evaluation are weak.

Box 16. Projects Financed through Transfers by the Agriculture Bureau of Huaxian

Huaxian in Henan, a county of 1.23 million people, is one of the fiscally poorest counties in China – measured in terms of fiscal expenditure per capita. The county’s Agriculture Bureau received and implemented 13 different types of project transfers in 2002 and 2003, up from 10 in 2001. The average size of these transfers, if one excludes a large “good seeds” project worth RMB 4 million in 2003, is only around RMB 150,000. One should note that in addition to the Agricultural Bureau the county has many agriculture-related line bureaus, including an Animal Husbandry Bureau, an Agricultural Mechanization Bureau, a Forestry Bureau, a Water Resources Bureau, a Grain Bureau, a Land and Natural Resources Bureau, a Comprehensive Agriculture Development Bureau, etc. All of these have their own earmarked transfers.

Operating expenses and funds for the operation and maintenance of investments are often extremely limited. This is a result of the overarching priority of salary payments and the requirements imposed by specific mandates and special-purpose transfers. Table 41 provides an example from the agriculture-related bureaus in Ninglang county. Budgetary appropriations for operating expenses are basically zero. Because budgets are insufficient to cover all salary-related expenses, off-budget income is used primarily to make up for this shortfall, and only secondarily

to raise operating funds for the units. The consequences are substantial inefficiencies. Staff are employed, but they do not have sufficient funds to work efficiently. For example, agro-technical extension officers lack transportation, teachers lack teaching material, etc. Government agencies and, in particular, PSUs have a strong motivation to raise off-budget income and therefore are distracted from their core tasks (see Table 41).

Table 42. Budget Appropriations for Agricultural Units, Ninglang County

2003	Total	Salary	Operating	Salary	Operating	Off-budget Salary Expenses	
	<i>10,000 RMB</i>			<i>percent of total</i>		<i>10,000 RMB</i>	<i>% of budget salary expenses</i>
Agriculture Bureau*	251.0	249.5	1.5	99.4%	0.6%	20.2	8.1%
Animal Husbandry Bureau	106.8	105.5	1.2	98.8%	1.2%	8.7	8.2%
Forestry Bureau	367.6	365.6	2.0	99.5%	0.5%	15.7	4.3%

Note: The Agriculture Bureau excludes the Animal Husbandry Bureau, but includes the Farm Machinery Bureau, Seed Bureau, etc.

Source: Annex 2.

As policy mandates and the key expenditure items are determined externally, the ability of county governments to act in accordance with their own priorities is limited. These systems have elements of “upward” accountability of county governments as they require county governments to comply with higher-level mandates, follow the policies of the post establishment committee, and implement the projects and programs financed by earmarked transfers.

However, in practice, accountability is limited. The number of mandates and earmarked transfers is too large, and the information flow and coordination across line agencies too weak, as is the capacity of higher-level governments to effectively monitor and evaluate their policies and interventions. Transparency of local budgets to the general public, which would be another direction of accountability, is basically non-existent. Moreover, enforcement mechanisms are weakened by the fact that personnel decisions are made by the county leadership. The incentives of the county leaders themselves have been, at least until recently, measured against overall growth rather than by more balanced performance that includes the provision of public services to all citizens.

Consequently, counties still have substantial leverage in determining the use of funds, but often do so in a less systematic way than through an open and transparent budget process. County governments have the ability to determine the use of funds in many ways. In particular, they continue to raise funds outside the budget, from extra-budgetary or off-budget sources such as from land, or through borrowing. Given the limited capacity of higher-level governments to monitor and follow up, there are also diversions of budgeting funds from one intended purpose to another.

There are stark differences between public spending on “rural” areas versus “urban” areas within counties. A bias to invest in and spend on initiatives located in the county seat or larger towns rather than in villages is quite obvious at the local level. For example, Ninglang county’s 5-10 year investment plan showed that investments directly benefiting the county’s more than 80 percent rural population accounted for only about 23 percent of the plan (Annex 2). Urban-rural inequalities in terms of access to and quality of services such as education and health even within counties reveal a similar picture.

Chapter 6. Summary and Conclusions

6.1 Summary of Key Issues

In recent years, the Central Government has introduced many reforms aimed at improving the public finance system, especially at the county and township levels. Reforms such as the RFR and the abolition of agricultural taxes, and the *yixian weizhu* reform that moves responsibility for rural teachers' salaries up to the county level, have achieved specific results – reducing farmers' burdens, ensuring that teachers' salaries are paid, etc. Other reforms, such as extending the TSS to sub-provincial levels, pilot reforms in provinces directly managing county finances, counties managing township finances, treasury reform, the “three rewards and one subsidy” program, and the consolidation of jurisdictions (in particular townships and villages) have made substantial progress in the intended direction. However, many of the reforms will take time to produce an effect. For example, completing the TSS reform applies only to incremental revenues. The institutional changes to jurisdictions will also require time to implement and to yield their intended results.

Although each of the reforms achieved some specific successes, their overall outcomes have been rather mixed. This is partly due to the contradictions existing among the reforms – for example, while several of the reform measures are intended to enhance the fiscal resources of county and township governments, the RTFR has eliminated a good part of their revenue bases. Moreover, the reforms also have had negative “side-effects.” Overall, the avalanche of reforms is overwhelming at the grassroots levels, but not everything is implemented as intended. The reforms have also brought dramatic shifts in authorities and resources among the three levels of rural government: the county, township, and village. The net effects of these changes on the efficiency and responsiveness of rural services are as yet unclear, and some of the effects could well be negative.

More importantly, these reforms are not tackling the problems of building a healthier intergovernmental fiscal system. Despite the emphasis on rural development, the reforms in combination with differing levels of economic development and, therefore, different tax bases have led to a decrease in own revenues for local rural governments (county plus township) – in relative terms, i.e., compared to other levels of governments. At the same time, the expenditure assignments of local rural governments have increased, meaning that the differences between revenues and expenditures have also grown. Consequently, local rural governments now spend a much smaller share of their “own” resources. This is a disturbing trend as experience shows that management of “own” resources is better than management of funds from other sources. However, it also reflects the government's policy to “give more, take less,”⁸⁵ and potential negative effects can be managed through a strong accountability system and, in particular, an effective transfer system. However, such a system is not yet in place.

The intergovernmental transfer system is inefficient and recent equalization efforts have been insufficient to offset the growth in income disparities across provinces. Since the late 1990s the government has introduced many new transfer programs. This includes transfers targeted at poor and rural regions, and the overall amount of “fiscal capacity” transfers has

⁸⁵ Wen Jiabao said in March 2005: “We should give more, take less and further liberalize rural productivity.” *People's Daily*, March 14, 2005

grown rapidly. However, the system still puts far too little into ameliorating the large disparities in fiscal capacity across localities. For example, disparities in per capita budgetary expenditure are still very large. In addition, the efficiency of the system is limited due to a large number of earmarked transfers, whose design and implementation requirements as well as monitoring and evaluation needs are not matched by the existing capacity in the highly complex administrative system.

The imbalances and inefficiencies of the intergovernmental fiscal system and the mixed results of the reforms in the arena of rural public finance are felt most strongly at the local levels. Although increased transfers have allowed more public spending, the increased dependency on transfers has worsened budget efficiency, the ability to allocate budgets according to local needs, and possibly budget discipline at the local levels. The proliferation of transfers has increased the complexity and created inefficiencies of spending. It has exacerbated the lack of budget autonomy, with negative consequences for budget allocation. Budget discipline has not improved. Evidence such as the emergence of new fees via the creation of “project entities,” land sales, local-level indebtedness, and persistent overstaffing raise serious questions about the sustainability of the reforms and about the Central Government’s approach that relies heavily on an increase in (mostly earmarked) transfers to address issues in agriculture and rural development. As a result, progress in some areas has served to expose and highlight the need for further reforms and to call for increased attention to the delivery of public services for the NSC.

The autonomy of the grassroots level has been weakened and at the township and village levels, in particular, is extremely limited. Rather than strengthening these grassroots levels in terms of their ability to provide public goods and services to citizens, their positions were greatly weakened as they lost revenue sources and new funding sources for rural development came from the central level and were largely implemented by the county, with very limited authority left to the township or village. In the case of the township, this seems to be driven by an, at least implicit, intention of higher-level governments, which also promote or endorse downsizing of township staff and of merging townships or other administrative reforms intended to address the inefficiencies at that level. It stands, however, in contrast to the national policy of strengthening village institutions. Participation such as the *yishi yiyi* or other democratic institutions not only require political support, but – in order to be meaningful – also require authority over financial resources.

The true extent to which rural services have lagged behind the growing needs of the rural populace is difficult to ascertain. The current statistical reporting system provides very limited information on service delivery at subnational levels. When such information is available, it is not disaggregated between the rural and urban sectors. Estimates are increasingly difficult to make from regional totals because of the commingling of urban units in what used to be more purely rural categories of counties and townships. The extent of the inadequacy of rural services in the poor regions can only be glimpsed through anecdotal reports and field visits, which are necessarily limited in scope and coverage.⁸⁶ In the course of this study, for example, we visited unheated, un-lit schools in Henan and Yunnan provinces, in localities where winter temperatures often dip below freezing. We also saw many health clinics and hospitals in deplorable condition,

⁸⁶ Some recent reporting on rural deprivations have become best-sellers, including Cao (2000); Chen and Chuntao (2004).

with little capacity for providing health care. Most remarkably, because of the pervasive reliance on user charges, even in the most poverty stricken localities none of the most basic public services were provided free of charge.

Looking ahead, one has to recognize that neither the implementation nor the assessment of past reforms efforts have been straightforward.

First, the complex organizational structure impedes resource flows and policy change. As the Central Government continues to change policies and resources devoted to rural areas, these changes will have to be mediated not only by all agencies, but also by each successive level of government, before they reach the intended recipients. With so many layers, the process is hardly straightforward.

Second, and partly related to the complex administrative structure, is the challenge that the availability, reliability, and timeliness of information poses for the design and assessment of any reform effort. For example, it is impossible to calibrate exactly what public resources are spent on rural development by each government level. Since the statistical reporting system – on fiscal resources or the public services that they finance - does usually not delineate “rural” as a category, it is not possible to fully identify what government spends in rural areas or on rural citizens. The new category of *sannong* spending represents an effort by the Central Government to track what it devotes to the rural sector (see Annex 10), but it is very much a work in progress.

Third, it is increasingly clear that the inefficiencies of many local governments are a formidable obstacle to improving rural public finance. Many of these inefficiencies cannot be addressed solely through increased funding, but instead require reforms in administrative structures, personnel management, and incentive systems for the governments more broadly. In fact, the low quality of services observed during the field visits to Henan and Yunnan can in part be attributed to allocative decisions by local governments that were consistently unfavorable to rural citizens/users/residents. For example, the rural schools that had no money for heating or electric lighting had so many teachers that on average each teacher taught only twelve hours per week. In the same vein, agricultural extension services, police stations, and even emergency medical services were often spending nearly all of their budgetary appropriations on staff expenditures, leaving little or no funding for the vehicles or fuel needed to take them to the field. These allocative decisions can be traced to the distorted incentives created by the current system of budgeting, which uses staff numbers as the basis for calculating expenditure needs for local governments (and hence for the determination of transfers). The incentive to expand staff size in poorer regions is reinforced by the system of a nationally unified civil service wage-setting, which makes remuneration for public employment extremely attractive compared to local incomes.

Given this context, the government faces a substantial challenge to implement its current program to build a NSC and a harmonious society that brings benefits to all. We believe that a comprehensive reform strategy – implemented gradually through consistent reform steps – needs to be adopted (Chapter 6.2). Such a strategy needs to address the fundamental vertical and horizontal imbalances as well as inefficiencies of the intergovernmental fiscal system. This includes clear and appropriate expenditure assignments (Chapter 6.3) as well as more local revenues and an improved transfer system (Chapter 6.4). However, reforms have to go beyond public finance in a narrow sense, and they require improved accountability mechanism through strengthened coordination, monitoring, and enforcement all the way from the central level as

well as changing the incentive mechanisms at the county, township, and village levels (Chapter 6.5), to achieve the intended result. Finally, we stress the need to strengthen the participation of communities, villages and rural citizens, in local public finance and public service delivery (Chapter 6.6).

6.2 The Need for a Comprehensive Reform

There is a strong need for a comprehensive reform of China's intergovernmental fiscal system. This is the main lesson to be drawn from the recent reform efforts, where piecemeal adjustments in intergovernmental assignments or the provision of massive central transfers do not seem to resolve the main problems (see also World Bank 2000, 2002). The reform strategy should focus on improving the IFS and related measures in administrative reforms and capacity building, thereby strengthening the fiscal and administrative capacities of local governments.

The Central Government should lead the design of a reform strategy, with full participation and wide-reaching implementation responsibility for local governments. It is clear that given the size of the country and the diversity of the rural areas, including the capacity of local rural governments, China should not pursue a uniform strategy for all. Central and provincial governments should continue and possibly strengthen the diversity of arrangements with which they manage relationships with lower levels.⁸⁷ However, the Central Government needs to ensure the completeness of the reform at all levels, all the way down to the townships and villages. Obviously, local conditions need to be fully taken into account, but the same principles should apply throughout the country. How national policies are transmitted through the intermediate levels has a direct impact on outcomes. The current system of decentralized management of reforms – whereby provinces choose the design of reform measures for the prefectures, prefectures choose the design of reform measures for the counties, etc. – poses great risks to effective implementation. For example, as the RTFR has drastically changed revenue shares across tiers of rural government, a policy that permits the county to define the terms of the new revenue sharing with the townships under the “completing the TSS reform” program opens the door to replicating past problems of higher levels grabbing revenues and pushing down fiscal deficits.

A comprehensive reform strategy should be implemented through a step-by-step approach. The comprehensive reform strategy should provide a vision or a blueprint to guide the reforms. However, such a comprehensive strategy cannot be implemented in one step. Rather, careful analysis of individual steps has to be worked out and implemented in a sequential or even incremental manner. The various reform steps then need to be evaluated against the objective of the overall strategy so that a comprehensive reform can be implemented “gradually with purpose.” The key value of the strategy would be its clear and transparent objectives and principles. Step-by-step reforms should be implemented based on the objective of building an intergovernmental fiscal system that is coherent, transparent, and rule-based, with mechanisms for monitoring and evaluating subnational government behavior. Given China's vastness and diversity, and especially given the relatively small size of the Central Government, this comprehensive strategy should emphasize creating the right incentives for local governments. While being rule-based and coherent, this strategy must also build in enough flexibility to accommodate specific local needs in the rapidly changing Chinese economic and social

⁸⁷ What is important, however, is to base this diversity on a more rational, i.e., “scientific,” basis.

environments, where many rural communities are undergoing urbanization or rapid out-migration.

Each reform will require substantial political backing as well as awareness campaigns, training, and capacity building. The large numbers of recent reforms in rural public finance have not always been implemented with such support, resulting in unevenness in implementation. Moreover, the reforms have increased the complexity of the system. Any new reform should strive to improve the understanding and transparency of the overall public finance system.

The government might want to begin implementing an overall reform strategy through a faster-track pilot in one province and a selected number of its counties before rolling it out nationwide. Key elements of such a pilot would be a realignment of expenditure and revenue assignments at county, village, and community levels. Decision-making power for the provision of local public goods and services should be increased at the grassroots level, and the role of each level must be clearly defined. The performance on the ground, i.e., the provision of public goods and services and their impact on the well-being of rural citizens, must be the ultimate objective of such a reform. Consequently, the monitoring and evaluation of performance and its packaging into an incentive system for local governments and service providers should be key parts of any comprehensive reform pilot. By testing various accountability mechanisms, the pilot can provide valuable lessons for the implementation of an overall nationwide reform strategy.

6.3 Defining and Rebalancing Expenditure Assignments

A comprehensive reform requires a defining and rebalancing of expenditure assignments to match responsibilities with financial and management capacities, in consideration of economies of scale and local accountability. This calls for the government to clearly define who should provide what. The current system is not only undefined, its transparency is also limited due to its complexity. There are currently responsibilities for too many areas at each level and too many agencies of government. Concrete decisions must be based on careful and detailed analysis, and should be specific to local conditions. However, the following statements might stimulate thinking that could lead to a more comprehensive reform:

- a. It does not seem efficient for the Central Government to engage in the funding of specific, often village-level, public goods and services, such as village roads or dilapidated school buildings. This might be justifiable on an individual basis in order to transfer best practices in technology or project management, but it should then be carefully designed, supervised, and monitored and evaluated, and remain an exception. The Central Government should focus on (i) ensuring that the local governments have sufficient revenues to implement nationally-set service standards; (ii) setting the right policies for agriculture and rural development; and (iii) financing for “national goods” such as agricultural science and technology.
- b. Provincial Governments should take more charge in ensuring that counties and below have sufficient funding to implement national service standards. Provinces should do their part in strengthening the fiscal capacity of all grassroots-level governments. In addition, public services such as social safety nets or social security should be implemented by the provinces or even by the center.

In particular, specific attention should focus on rebalancing and reassigning expenditures

at the local levels. It is also important to think about the appropriate structure of government – i.e., how many tiers of government? Pilots such as those putting counties directly under the administration of provinces are commendable and their impact should be carefully analyzed. Such simplification – and its accompanying increased transparency – might apply to a whole government level or only to specific functions. Many key responsibilities can be assigned to basically only one level of government. Considerations of equity (financing) and efficiency (economies of scale and scope) should balance responsiveness to local conditions and preferences. It is advisable to cut some intermediate levels of government to ensure a more efficient delivery of public services, but decisions need to be based on specific local conditions. These might include the following:

- a. The counties clearly dominate the provision of many public goods and services. A social safety net and social security are beyond the capacity of this government level. A central role in agricultural support services and some local infrastructure services as well as some well-defined role in basic education and certain aspects of public health, are probably justified given county capacity. However, given the large fiscal imbalances it seems that the financing of some of the costly public services such as health and education are better financed at a higher level. On the other hand, some local infrastructural services could be more efficiently implemented by providing more authority to lower levels as the county might be too remote from the end-user.
- b. The relative strengthening of the county level vis-à-vis the townships that has taken place over the last few years might be positive given the limited capacity at the township level. However, this development seems to be more of a “default” reform implemented for specific purposes rather than a strategic realignment of responsibility that attempts to match government capacity with expenditure responsibilities, and expenditure responsibilities with revenues. It should be recognized that, in most localities, the township level is crucial for the implementation of policies and public service delivery in rural areas. Currently, townships act more like a dispatched unit of the county rather than an independent level of government with real authority over budget decisions. In any case, new developments should be reflected in the organizational structure and staffing of township-level units. Maintaining the current situation whereby townships have the structure and staffing of an independent government level and formal authority under this significantly changed situation leads to substantial inefficiencies. Pilots to reform townships, including merging or even abolishing them, should continue and need to be thoroughly assessed in order to provide clear guidance on the future role of townships.
- c. The villages, i.e., the communities, should be recognized as key for delivery of many local public goods and services. The village development plans under the poverty projects are a positive example of how community-level involvement can be increased. But there are also other ways of strengthening the involvement of citizens in public service delivery, e.g., through other “communities” such as water user associations or through stronger private engagement in service delivery (see Chapter 6.6 below).

The delineation of responsibilities between the government and the service provider must

be clarified. As an important part of streamlining efforts, the government should make greater efforts to differentiate aspects of public service provision, in particular between the financing and delivery of public services. Reform of the PSUs lies at the heart of this issue, but it obviously has substantial effects on the role of government as well as on other stakeholders, including communities, user associations, private enterprises, civil service organizations, etc. In order for the government to increase the “outsourcing” of service delivery it needs to improve its capacity in areas such as monitoring and supervision.

The defining of responsibilities as recommended above needs to take into account changing demands. In the future the demand for existing and new public services in rural areas is likely to grow. New areas will include a social security system with wide rural coverage, an effective land administration, waste collection and management, and other services. Therefore, all government levels need to systematically re-examine current needs and allocate responsibilities in an effective manner to address the dynamic changes.

Given China’s “dual” administrative structure it is particularly important that responsibilities across levels of government are reflected in the specific mandates and functions of individual line agencies. The current system is highly complex, in particular in the areas for agricultural and rural infrastructural services. Moreover, the current planning and budgeting of recurrent and capital expenditures without full integration by the 2 key line agencies, i.e., the MOF and the NDRC and their corresponding agencies at the local levels, lead to inefficiencies. Sarraf (2005) argues that a meaningful integration requires not only integrated budget preparation, unified budget documentation and presentation, and unified accounting and reporting systems, but also organizational and staffing integration.

6.4 Rebalancing of Revenue Assignments and Improving Intergovernmental Transfers

Revenue Assignments

The comprehensive reform also requires a rebalancing of revenue assignments to improve incentives for a more effective use of funds. Increasing frugal spending will require the rebuilding of revenue-raising capacities at the grassroots levels. Transfers alone are a very inefficient way to rebalance revenue assignments at the local levels with expenditure responsibilities. Local revenue autonomy has substantial benefits. Conventional wisdom calls for giving local governments some revenue autonomy because they are more likely to use revenue efficiently when they are responsible for raising it. As the increase in local revenue might be perceived to run counter to the objective of reducing the “farmers’ burden,” it is of utmost importance to clearly differentiate between an illegal or “unjust” fee and a taxation that is closely linked to a more efficient system with better service delivery and, hence, is welcomed by the citizens. Moreover, rural citizens still pay substantial fees for public services, such as contributions for infrastructure investments, education, or public health, but the impacts of these investments on efficiency are questionable.

A careful transition from the still existing fees toward reasonable taxation and user fees, which are linked in a transparent manner to service delivery, will ensure that a net increase in local revenues can be phased in and designed in a socially just way. In the short to medium term, user charges might be the best way to increase local revenues and efficiency – if the necessary accountability mechanisms are implemented first. For the longer term, a key objective should be to increase local tax revenues, also for the rural sector.

Revenues from land transactions should be included with local revenues and the creation of a land market administrative infrastructure should be a priority of the next reforms. Land is one of the main assets in rural areas and land-related revenue already accounts for a very large part of local government financing. However, most of this revenue is off-budget and non-transparent. The lack of a well-functioning land market also poses an obstacle for developing a possible property tax for rural land. Substantial inefficiencies exist in the raising and use of the current, largely off-budget revenues. There are numerous reasons to put the strengthening of the land administration system very high on the political agenda, many of them social, economic, or even environmental in nature. However, even from only a public finance perspective, an improvement in land administration seems to be an investment with high returns.⁸⁸

A further element to increase local revenue is to create a responsible system for local borrowing, so that local governments can pay for lumpier capital investments. Allowing local borrowing will – together with strong accountability mechanisms – also improve transparency and reduce the risks of the excessive “illegal” borrowing that some local governments seem to practice today. There is currently a wide disconnect between, on the one hand, the law that forbids borrowing by local governments, and, on the other, the realities of substantial local indebtedness, including that of townships and counties, and even of villages. This disconnect leads to substantial inefficiencies and risks. Some debt management measures have been introduced, but a more comprehensive strategy is missing. There seems to be a consensus that at least some local governments should be allowed to borrow legally and that a new legal and regulatory framework should be established to ensure prudent and responsible borrowing by local governments. The challenges of implementation of such a strategy include the establishment of a reliable local debt reporting information system; a coherent conceptual definition of local debt; the incorporation of local debt revenue and expenditure into the budget; improving and consolidating the current institutional arrangements for local debt management; design and implementation of a plan to help heavily indebted local governments; and ex ante and ex post controls on local borrowing (see World Bank 2006a). “Legalizing” borrowing should be implemented carefully, and the weak capacities of many rural local governments need to be fully taken into account.

Intergovernmental Transfers

Obviously, even after revenue assignments for local rural governments are strengthened, the transfer system will play a very important role and, thus, improving its efficiency is imperative. Analysis of the transfer system and recent reform efforts in this report leads to the strong conclusion that more of the same will not work. Extending public finance to the rural villages will require not only more resources, but more resources devoted to equalization, and much more effective use of the resources. Currently, transfers cannot address the tremendous differences in public service delivery and outcome.

Equalization will have to be much improved to meet the requirements of the government’s new scientific development paradigm and the goal of building a harmonious well-off society that benefits everyone. Hence, a crucial consideration is the balancing between equalizing block-grants and earmarked transfers for specific purposes. The increased importance of

⁸⁸ The government has been working, with support from the World Bank, on reform options and is supporting a pilot in Anhui province. Further testing and roll-out of successful models should be a strong priority for the government at all levels, including the Ministry of Finance and the Finance Bureaus.

General Transfers along with a reduction of earmarked and ad-hoc transfers is a clear way to go. In order to produce the right outcomes from increased General Transfers, however, the Central Government should offer the proper incentives for local governments and provide technical assistance to put in place effective monitoring and evaluation systems.

Moreover, earmarked transfers need to be consolidated and their design, implementation, and monitoring and evaluation strengthened. The current management of central transfers is too fragmented. There are too many different earmarked transfers with specific rules, targeting, and other implementation arrangements. This creates a significant administrative burden. Earmarked transfers for rural development projects or programs are particularly numerous, and they should to be consolidated. Much of the efficiency gain is achieved through better coordination, monitoring and evaluation, etc. discussed in the next section. For example, the MOF should have comprehensive oversight over all public funds to ensure their effective use. The incremental, piecemeal introduction of new transfers in recent years has exacerbated problems of fragmentation in the management of central transfers, risking duplication, and making the system even more nontransparent.

Overcoming the inefficiencies of the transfer system should be a short-term priority. While clarification of expenditure assignments and the alignment of revenue with these expenditure assignments need to be solved in a fundamental reform effort, China could gain significant improvements in the short run by consolidating many transfer programs, reducing earmarking, and implementing simpler transfer mechanisms more appropriate for the administrative capacities of all levels of government. To further enhance both transparency and simplicity, it would be helpful to systematically identify the total pool of equalization funds – to be decided based on potential tradeoffs between equalization, growth, and overall incentives for local revenue mobilization and expenditures.

6.5 Improving Government Coordination and Capacity

The reforms must go beyond the fiscal system and include wider administrative and other institutional reforms. Although these issues are not the main focus of this report, the analysis makes it clear that the organizational structure of the government is too complex and cumbersome, and thus needs to be streamlined to better serve the new paradigm that fundamentally reverses the former “agriculture feeding industry” model. The design of the RFR fully realizes the complementarity of fiscal and administrative reforms. However, while the fiscal elements of the reform were implemented rapidly, the institutional elements will require more time and effort. It is crucial that these associated reforms be carried out in order to sustain the “burden reduction” gains of the RFR. Obviously, a thorough review and reform of the IFS as recommended above already implies substantial changes to the administrative and political system. However, other things can be done in the short term, to improve the existing system.

There is a need for better horizontal coordination mechanisms across central and other levels of government. Currently, ministries and other agencies responsible for various aspects of rural development are highly fragmented and overall coordination among them is weak and largely limited to the top (ministerial) level through the Party, or so-called “leading groups” for specific policies or programs.⁸⁹ Working-level cooperation at the design stage of programs is

⁸⁹ As mentioned above, a number of local jurisdictions have rural affairs offices or departments that fulfill coordination functions. Management of World Bank-financed projects often includes, besides the standard “Project

largely lacking. Difficulties of working across agencies exist in all large organizations. However, in the area of China's rural development the difficulties seem to be aggravated by the very large number of agencies involved, the limited capacity of central agencies, and the fact that the implementation of agriculture and rural development policies and programs is dependent on all five levels of government. As discussed above, in China's model of a "nested hierarchy" each level of government provides direct guidance and funding only to the next-lower level, leading to considerable heterogeneity in the implementation of many policies and programs. At the same time, the pace with which new policies and programs have been created in recent years has led to an intensified need for coordination. The shift from policies focusing on agriculture or other sectors to a more comprehensive policy of a NSC strongly increases the need for improved coordination. This paradigm shift from sectoral to more comprehensive rural development policies has taken place in many developed countries and while other countries also struggle with problems of horizontal coordination, China might look for ideas – rather than for examples for adoption – in the coordinating institutions of these countries. The OECD (2006a, Chapter 3) describes the following options for horizontal coordination mechanisms:

- (i) "a special unit reporting directly to a head of Government": in the Chinese system this function is partly fulfilled by the Leading Group for Economics and Finance, but its staffing capacity allows it to deal only with relatively broad strategic policies; other coordination, such as that by the MOF or NDRC, is also focused on certain aspects of rural programs;
- (ii) "an integrated ministry to address several issues of importance to rural regions": such a ministry is absent in China and the MOF and NDRC "superministries" do not have the staffing or technical capacities to assume such a task; the unusually large number of agencies working on rural development issues suggests that some integration of functions would lead to efficiency gains;
- (iii) "policy proofing": while China certainly has a strong leadership for defining strategies and policy frameworks, we are not aware of any systematic "proofing" of specific policies and programs issued by line agencies; the creation of a body responsible for "policy proofing" against the set strategy and within the existing framework of other agencies' policies might be relatively easy politically and could lead to substantial efficiency gains; in the long run, such an institution could improve vertical coordination, including participation by stakeholders outside of government;⁹⁰
- (iv) "inter-ministerial co-ordination via working groups and formal contracts": World Bank experience in working with line agencies suggests that such working-level coordination is particularly difficult in China; the institutionalization of such working groups or even formal contacts, while highly desirable, would first require a change in the incentive system for the working units.

Strengthening the capacity of the Central Government. The diversity of China's rural areas is extraordinary, no surprise for the size of the country. Consequently, it is even more difficult to make general statements and recommendations. In fact, a key recommendation is that higher-

Leading Groups" and "Project Management Offices," so-called "Technical Advisory Groups" that provide technical advice to project management from the perspective of various sectors.

⁹⁰ See, for example, the "Rural Lens" in Canada (http://www.rural.gc.ca/lens_e.phtml).

level authorities must continue to provide substantial leverage to lower levels to make decisions in line with local conditions. At the same time, the call for extending public finance to villages strengthens the emphasis that decisions made at the local level should be conducive to the implementation of national policy. This requires that the Central Government promotes the institutional strengthening of grassroots organizations across the country, ensures greater equalization of fiscal spending across the country, including in villages, and holds lower-level governments accountable for achieving these results.

A key area of focus for the Central Government levels should be the strengthening of the monitoring and evaluation (M&E) capabilities at all relevant levels and in all aspects of public finance and service delivery. Without an improved transparency of fiscal resources and better information on the impact of policy reforms, public expenditures, or other forms of interventions, substantial inefficiencies will remain. An effective M&E system can provide government officials and the public in general with a better means for learning from past experiences, improving service delivery, planning and allocating resources, and demonstrating results. China has been making substantial progress in this area, but still has a long way to go. Effective M&E includes all areas of information, -- financial flows and auditing; procurement, input and output of programs; and the results of policy interventions. Instruments and approaches are numerous, and for impact M&E include client satisfaction surveys, citizen scorecards, rapid appraisal methods, participatory tools, public expenditure tracking surveys, cost-benefit and cost-effectiveness analysis, etc. There is very substantial and growing international experience on effective monitoring and evaluation of government activities (see, for example, World Bank 2005).

An effective M&E system has many stakeholders. The focus must be on strengthening government capacity and in this the Central Government needs to take the lead. At the same time, communities, citizens, and civil society organizations (CSO) also have a role to play. Moreover, a considerable degree of independence in the system is required to ensure its reliability. For example, the independence of agencies responsible for impact M&E should be increased. The current system whereby these agencies and their staff depend on their main funding and on personnel decisions from the same governments and government agencies whose performance they are monitoring is inappropriate.⁹¹ Finally, the role of the local people's congresses can be further strengthened in the M&E – as well as in the budgeting and planning processes – as this would increase accountability within the same level of government, where information asymmetries are less pronounced than when it comes to vertical accountability.

Substantial improvements can be made through improved capacity at the local level. The central level can support the strengthening of the capacity of local governments through training and fostering an exchange of knowledge across counties. In fact, past experiences have shown that many of the reforms rolled out by the Central Government have not been supported by adequate capacity-building activities, thus exacerbating the inadequate implementation in “weaker” localities. For example, the need for increasing the capacity in planning and budgeting processes at the local level is particularly strong.⁹² Information and communication technology

⁹¹ The fact that monitoring by the local Statistical Bureau or Environmental Protection Bureau, or auditing by the local Audit Bureau, is dependent on financing from that same local level is one example of insufficient independence; the fact that the Agricultural Bureau is responsible for both improving agricultural productivity and monitoring of pesticides is another.

⁹² Clearly, given the constraints many local rural governments face today, little can be expected. Local governments

(ICT) is developing rapidly and there are now many technical tools that can improve the capacity of local governments. For example, one way of improving the coordination of line agencies and various activities in rural development is through a GIS-supported analysis and presentation of spatial data (see Box 17). With the scope of service delivery expanding and the rural development strategy shifting from a focus on the agricultural to a broader comprehensive policy of a NSC, local governments will also have to increase their coordination mechanisms -- within local government, especially at the province and county levels; between local governments in order to enhance capacity-building across jurisdictions and to overcome spill-over effects; and between local governments and other stakeholders, in particular the private sector, CSOs, and citizens.

Box 17. GIS-based Planning Tools for Rural Development

Since the beginning of the market reforms in the late 1970s, China's planning process has undergone tremendous change. The call to build a NSC poses significant new challenges. The efficient delivery of public investments and services to China's villages requires an effective and comprehensive planning process, especially at the community and local government levels. Decisions need to be based on careful analysis of information from various sectors and sources, including the availability of land, water, and natural resources, the socio-economic conditions of villages, and the preferences and demands of rural citizens. Similarly, various types of fiscal resources, often coming down through different channels and with distinct administrative requirements, need to be coordinated by local governments to fully comply with the conditions set by any earmarked funds and, at the same time, to implement them in a well-targeted and integrated way that realizes the many potential synergies between investments and service delivery.

To address these problems in planning, Geographic Information Systems (GIS) have been developing rapidly and now present excellent tools for local governments (and communities) to analyze, process, and present spatially-related data in order to aid decision making. GIS is widely used around the world for purposes ranging from poverty mapping for regional planning to disaster response. While GIS is also used widely in China in the academic and research communities and, increasingly, in urban planning, rural areas and county governments are far behind in its application. However, long-term experience of such an integrated GIS-supported planning process for rural development exists within the country, for example in Jiangxi where it was introduced in the 1990s through its Mountain-River-Lake Program (supported by Gesellschaft für Technische Zusammenarbeit [GTZ] and other donors). The China Watershed Management Project, funded by DFID and implemented by the MWR and the World Bank, is developing similar systems of a county-wide GIS-based resources mapping and planning system for use by county governments in Gansu and other parts of western China. Given the demands placed on the capacity of local rural governments and villages to plan and integrate fiscal resources when implementing the NSC, the government might want to consider how to promote the widespread dissemination of such technology.

lack discretion on spending choices, wage payments have first claim on budgetary resources, and bailouts are available on wage arrears but not on defaults on provision of services. An increase in local government discretion on spending through a reduction in earmarking, in national mandates, in a loosening of the national payroll and post establishment system, etc. all are necessary preconditions for increasing accountability. Only in such an environment will local planning and budget processes be truly effective.

There is a need to further review the incentive system, in particular the performance evaluation of the local government leadership. Currently, the incentives guiding local officials still depend excessively on generating growth, holding down population growth, and preserving social stability, etc. Too little emphasis is placed on sound financial management and public service delivery. At the same time, the incentives of local government leaders play a crucial role in achieving the national aim of building a NSC. Hence, social impact, including in rural areas, and environmental performance should be included in the performance evaluations of local officials. The efforts made in this respect should be strengthened. Moreover, the planned reshuffling of county and township leaders in 2006 and 2007 and the enforcement of a five-year tenure should improve the incentive mechanisms.⁹³

A comprehensive reform will also require other changes to the personnel system. Again, this aspect of the government is not the focus of this report. However, personnel and public finance issues are closely interlinked, in particular at county and township levels where personnel costs constitute the majority of government spending. A better personnel system that gives local governments more control over recruitment and remuneration is a precondition to making local governments accountable for performance.

- The post establishment system as currently in operation should be reformed. A system that centralizes approvals for the creation and deletion of posts in an administrative body independent from the financial system has led to the creation and continued existence of posts that are unneeded and to overstaffing. The authority of the MOF and Finance Bureaus in determining the size and costs of the civil service should be strengthened.
- Greater use should be made of flexible, non-civil service terms of service, especially for employees of PSUs.
- The national unified civil service compensation system should be replaced by a decentralized system that is sensitive to local conditions. The Central Government should lay down pay principles and guidelines, but allow local jurisdictions to set their own pay levels. These pay levels should be transparent and agreed upon by village assemblies and township and county people's congresses.⁹⁴
- Steps should be taken to ensure that only those who go through the open, competitive system should be hired as civil servants.
- A rural pension system for government officials should be established as soon as possible. Officials should contribute to the system during their working life, and should be able to draw a reasonable pension from the system for their retirement. Retiree benefits should no longer be part of a particular agency's budget.

Building horizontal networks of local government can further improve local capacity and the ability of the Central Government to influence the local levels. As discussed above, the government structure is largely hierarchical, with very limited exchange of information across

⁹³ For further details on changes of local-level Party and government leaders see Li (2006).

⁹⁴ With the implementation of the new Civil Servants Law and the emphasis on a uniform nationwide salary system at a recent symposium presided by President Hu Jintao ("China to Reform Income Distribution System for Social Equality," Xinhua, July 6, 2006), recent policy in China has been in the opposite direction.

levels of government. For most of the recommendations discussed above, practical solutions exist within China, however, only in few and limited locations. The Central Government should disseminate information from within China – as well as international experience – and strengthen the evaluation and communication of experience from local institutional pilots. Moreover, there is a strong potential for improved learning across local Governments. A possibility to foster such “horizontal” learning is presented in Box 18.

Box 18. Local Government Associations – A Missing Link?

In most countries, local governments (or their heads) are organized in an association to provide mutual support. The regional scope, institutional structure, and objectives of such local government associations vary; they can be a loose group for the exchange of useful experience of neighboring localities or they can be nationwide associations with many organs and specialist committees and objectives that might include coordination, the provision of services such as legislative, research, technical, and public affairs assistance, and the representation of the common interests of all local government bodies to higher authorities and other institutions.

Although a China Association of Mayors exists (www.citieschina.org), direct cooperation among various local jurisdictions in China is limited and higher-level governments are generally involved in the information exchange or coordination among various localities. China’s counties and townships might benefit from the establishment of such local government associations. A simple institutional structure designed mainly for the exchange of information might be the easiest to realize. The Central Government, donors, or others could make use of such associations to strengthen the implementation of national policies and the capacity of local governments.

6.6 Strengthening of the Community Level

The current development of village finance is not sustainable. Village revenues remain very limited during a period of increased needs as the contributions of villages to capital investments put a strain on current expenditures, including maintenance. Regular village revenues are restricted to transfers from above and the majority of village revenues come from unsustainable income from transactions of land and other assets. Village financing is in a deficit situation and debts are at high levels. These developments are unlikely to improve when the policy to extend public services to rural areas is being implemented mainly through specific earmarked transfers, mostly from the Central Government. Clearly, a differentiated approach for the tremendously varying situations across China is necessary, but the following changes may improve the situation:

The roles of villages and other forms of communities in public service delivery need to be clearly defined. The current involvement of villages in the provision of public services is largely defined by the ability of the specific township and county government to provide public services and to involve villages in their provision. The increasing focus of the Central Government on extending public finance to rural areas has led to a strengthening of the top-down implementation approach. Insufficient strategic thought has been given to the involvement of villages and other types of communities. For example, while villages formerly had major responsibilities for the provision of public health and education, their roles are now marginal. The financing of these services clearly should be at higher levels of government. At the same time, involving

communities in the delivery – or even monitoring – of these services might be beneficial. Similarly, there needs to be a clear “ownership” of village-level infrastructure that is matched with the responsibility to operate and maintain the infrastructure at that level. Today, too much village-level infrastructure is still “owned” by the township, without the township level assuming operational responsibility. The formation of water user associations is not widespread but the promotion of such institutions should continue.

Village revenues need to be maintained on a sustainable basis. Villages need a secure and sustainable source of revenue, even in the current situation where the role of villages is largely limited to implementation and enforcement of government policies and contributions to the operation and maintenance of village infrastructure. Obviously, there is a fine balance between improving the villages’ ability to raise reasonable revenues, e.g., through user fees, and the reappearance of unjustified fees and charges, the reduction of which has been one of the great achievements of the RFR. Consequently, an accountability mechanism from both villagers (“upwards”) and higher-level governments (“downwards”) needs to be strengthened before this strategy is pursued.

Village debt needs to be controlled. While village debt is of little concern from a macro-economic point of view, and has helped to finance part of the village infrastructure over recent years, it nevertheless has a potential negative impact on the village itself. Lenders, including the financial sector and private individuals, suffer economic losses if funds are not repaid. Given the dire state of finance in many villages, in particular the poorer villages and those in the central provinces, such a scenario of default is not unlikely. Village accountants responded that on average they expect only a little more than half of the debt will be repaid. An important step in the control of village debt is its monitoring and public disclosure to villagers, the public, and the government. Moreover, the political ties of village authorities, including to financial institutions, should be reduced. However, the problems of village debt are unlikely to be solved as long as the key underlying problems continue to exist, i.e., the great need for capital investments, the insufficient funding from other sources, the matching funds requirements, etc.

New approaches for the provision of infrastructure services need to be sought. The way infrastructural investments are made is the key reason why village finance is not sustainable. A change in the approach to these investments is probably the single most important factor toward achieving sustainability. Currently, most of the rapidly increasing village-level capital investments are planned, implemented, and monitored from above, often by the county government. The task of the village administration is mainly restricted to providing necessary counterpart funds, and organizing farmers (formally, through voting – *yishi yiyi*) to provide contributions in cash (*jizi*). In practice villages usually need to assume responsibility for operation and maintenance of the infrastructure. Village (and often township) involvement in the decision-making process for the design and implementation, as well as the monitoring, is very limited. A better involvement of villages – or user groups / associations – in the provision of infrastructural services would clearly increase the efficiency of service delivery. Box 19 provides an example of community-driven development in infrastructural service provision drawn from international experience. One important element in increasing efficiency in infrastructural service delivery is the better linking of capital and recurrent expenses in the planning process. This can be improved by better institutions at the local level, but should be addressed at the center where the MOF and NDRC are often not well coordinated.

Box 19. Direct Government Financing of Communities

An answer to the question of which level of government can provide public goods and services most efficiently depends on a range of factors. The need for strong technical expertise in service delivery or economies of scales shifts the balance to higher-level governments; the importance of local knowledge, including local preferences, and the ability to use “social capital,” i.e., the beneficiaries’ contributions and involvement in the financing, implementation, operation, and maintenance and monitoring of public goods and services, shifts the balance to lower levels. Over the last decade or so, increasing evidence has shown that strong involvement by communities in the provision of public goods and services is beneficial from an economic and social point of view and may increase the sustainability of interventions. Consequently, many governments and donors, including the World Bank, are increasingly promoting what is called “community-driven development,” in particular for local infrastructure projects.

China already has substantial experience with participatory approaches. For example, poverty-reduction programs today give villages a major say in the design and planning of interventions. However, providing government financing directly into a community-run account exists only at an early experimental stage. Under such an approach, a local government agency or another institution provides funds directly to the communities responsible for managing the implementation of subprojects. Usually a subproject financing agreement is signed between the funding agency and the community, whereby all procurement and financial management responsibilities are devolved to the community. Funds are disbursed from an account opened by the community.

The benefits of such an approach have been found to be substantial. They arise in the form of better targeting of the priorities of the communities in the selection and design of subprojects; increased contributions by the communities, in cash and kind; reduced costs of investments through cheaper procurement; and increased sustainability through greater “ownership.” Nevertheless, there are also considerable costs to this approach. Communities and funding agencies both need to adapt to such an approach. Resistance from local authorities is often a key obstacle. Moreover, investments have to be made to build the capacity of the communities to manage funds and to conduct procurement, etc., and to build the capacity of the funding agencies to manage the “community-driven” process, to improve monitoring, and to provide services in the form of technical expertise, etc. to the communities. However, experiences and lessons from such a new approach are accumulating rapidly, from other countries and increasingly from within China as well. Consequently, with strong political guidance the adoption of direct financing of communities in a participatory approach should be relatively easy.

Source: Authors with reference to Silva (2002).

More generally, the participation of villages, other forms of communities, and citizens in financial aspects of local governments and villages, as well as in public service delivery, should be further enhanced. This includes all aspects of planning and design, implementation, and M&E of public resources and public service delivery. Most importantly, increased transparency can greatly improve accountability, and the existing rules need to be enforced more rigorously. Moreover, requiring local governments to publish budget and monitoring reports would improve performance by focusing attention on issues about which citizens are most concerned, and would also indirectly increase accountability as reporting would improve, including on the information available to higher levels of government.

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Accounting Yearbook of China
Census Data
China Agriculture Yearbook
China Finance Yearbook (CFY)
China Statistical Abstract
China Statistical Yearbook (CSY)
China Township and Village Statistics
Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties
Compendium of Local Fiscal Statistics
Compendium of Township Financial Statistics
Henan Statistical Yearbook
NBS Household Survey
New China 50 Years of Statistics
Rural Yearbook

Appendix 1: Monitoring Progress toward a *Xiaokang* Society

Appendix 1, Table 1: *Xiaokang* Indicator System proposed by the NDRC and UNDP

Category	Indicator	Unit	2002 value
Economic development	1. GDP per capita	USD	990.28
		Yuan	8184
	2. Ratio of poverty population	%	16.1
	3. Rural Engle coefficient	%	46.2
	4. Per capita annual disposable income of urban households	Yuan	7702.8
	5. Per capita annual net income of rural households	Yuan	2475.6
	6. Gini coefficient		0.403
Subsistence	7. Proportion of primary education in poverty areas *	%	98.6
	8. Ratio of under-five mortality in poverty areas *	‰	36
	9. Ratio of maternal mortality in poverty areas *	1/100000	50
	10. Halt and reverse of the spread of HIV/AIDS *	%	0.05
	11. Halt of the prevalence of TB *	%	0.44
	12. Proportion of people receiving safe drinking water in rural area *	%	55.1
	13. Proportion of sanitation toilets in rural areas *	%	40
	14. Ratio of roads to administrative villages in poverty areas	%	NA
Society	15. Ratio of medium income group	%	18
	16. Urban population as percentage of national population	%	39.09
	17. Ratio of employed persons in tertiary industry	%	28.6
	18. Ratio of non-farm employees	%	50
	19. Ratio of <i>dibao</i> in urban areas	%	20.6
	20. Ratio of <i>dibao</i> in rural areas	%	4.08
	21. Budgetary expenditure for public education as percentage of GDP	%	2.3
	22. Gender ratio of infants	%	NA
	23. Gender ratio in achieving universal primary education *	%	85
	24. Ratio of female employees in urban areas *	%	41.56
Environmental sustainability	25. Ratio of female employees in government	%	NA
	26. Environmental governance expenditure as percentage of GDP		NA
	27. Ratio of forest cover	%	16.55
	28. Greenbelt acreage per capita in urban areas	m ²	5.4
	29. Ratio of utilization of water resources	%	NA
	30. Ratio of industry <i>sanfei</i>	%	76.1
Quality of life	31. Life expectancy per capita	year	71.4
	32. Protein per capita per day in rural areas	kilo	71.09
	33. Per capita floor space of urban citizens	m ²	22.8
	34. Enrollment of university and college students per 100,000 persons	person	3611
	35. Number of doctors per 10,000 persons	person	14.7
	36. Number of hospital beds per 10,000 persons	Bed	23.2

Category	Indicator	Unit	2002 value
	37. Number of attorneys per 10,000 persons	person	0.96
	38. Ratio of criminal cases	%	34.53
	39. Unemployment rate	%	4.0
	40. International NGOs as percentage of NGOs	%	NA
	41. Per capita annual expenditure for buying books	Yuan	NA
Other	42. Number of computers owned per 100 urban households		20.63
	43. Ratio of domestic travel per capita	%	5.4

* referred from UN Millennium Development Goals (MDGs)

Source: Zhou (2005).

Appendix 1, Table 2: Evaluating a Rural Xiaokang Society

Indicators	Unit of measurement	General xiaokang value	Comprehensive xiaokang value	Weight
A. Economic Development				29
1. Available income per capita	Yuan	2200	36000	20
2. Proportion of work force in primary sector	%	50	<35	5
3. Proportion of population in small towns	%	16	35	4
B. Social Development				20
4. Rural NCMS coverage rate	%	10	90	8
5. Rural retirement pension coverage rate	%	1.8	60	4
6. Agricultural technicians per 10,000 people	#	1	4	4
7. Gini coefficient for rural residents		0.35	0.3-0.4	4
C. Population Quality				15
8. Mean year of schooling	Year	7.4	9	12
9. Life expectancy	Year	69.5	75	3
D. Living Quality				23
10. Engel ratio	%	49	<40	4
11. Index of housing quality	%	18	75	11
12. Proportion of expenditure on culture and entertainment of farmers	%	2.5	7	3
13. Peasant information level	%	28	60	5
E. Democracy and Legal System				6
14. Satisfaction rate on the opening of official village affairs	%	55	85	3
15. Satisfaction rate on social safety	%	60	85	3
E. Resources and Environment				7
16. Conversion of arable land area	%	-0.3	0	2
17. Forestry coverage rate	%	16.5	23	2
18. Water consumption per agricultural GDP (RMB 10,000)	M3	2600	<1500	2

Source: Rural Investigation Branch of the NBS.

Appendix 2: Documents No. 1 and their *Sannong* Policies

Reforms in the agricultural sector have been a central part of the China's reform process since the beginning of its opening and transition process in 1978. Fundamental changes at the outset included the household responsibility system (*jiating lianchan chengbao zerenzhi*) that provides farmers with user rights for their land and greater ability to decide on their own business. This and related institutional reforms as defined in five subsequent Documents No. 1 from 1982 to 1986 (see Table below) led to tremendous success in terms of agricultural and rural growth. This growth also extended to the secondary and tertiary sectors, thereby promoting China's comprehensive opening process.

Documents No. 1 Related to Agricultural/Rural Policies after 1978

Year	Content
1982	Make production contracts with households; consider them part of socialist economy.
1983	Further ensure production contracts with households as the formal mechanism of the agricultural economy.
1984	Continue to ensure production contracts with households and extend the land contracts to 15 years; encourage investment in long-term and productive projects.
1985	Adjust the structure of the rural economy and abolish unified procurement and sale; collect agricultural tax in cash rather than in kind.
1986	Continue the rural reforms and pay more attention to rural areas and agriculture.
2004	Increase rural net income and decrease urban-rural disparities.
2005	Improve comprehensive agricultural productivity by further intensifying rural work.
2006	Construct a NSC.

Source: Xinhua News Agency, at http://news.xinhuanet.com/ziliao/2006-02/09/content_4156863.htm

During the 1990s problems related to agriculture and rural development were increasingly prominent. There were conflicting objectives, but the discussion centered on the difficulties of increasing rural income. Rural net income, in particular in key grain-producing areas, had grown slowly and for some farm households had even declined. Consequently, the urban-rural disparities grew rapidly. By the beginning of the current decade, the problems related to agriculture and rural development (*sannong wenti*) were at the top of the political agenda and the Rural Fee Reform, one of the most fundamental reforms since the 1980s, was initiated. The importance of rural development was further underscored by the re-issuing of No. 1 documents starting from 2004. The documents increasingly stressed the comprehensiveness of agriculture and rural issues.

It is fully recognized that solving the problems of agriculture and rural development are key to achieving a *xiaokang* society. If a *xiaokang* society is considered a long-term goal, then improving the situation in agriculture and rural development through adequate policies is a necessary medium-term objective. Hence, the specific objectives emphasized in the No. 1 documents reflect the vision of a *xiaokang* society. This is most obvious in the latest document No. 1 which outlines the NSC. A number of attempts have been made to define these goals in terms of measurable indicators. For example, a system proposed by the NBS (see Appendix 1, Table 2) – as Document No. 1 of 2004 – includes six areas for comprehensive rural development, including economic development, social development, population quality, quality of life, democracy and legal system, and resources and environment.

Appendix 3: Linkages between Public Finance and the Financial Sector

Loans for agriculture and rural development increased from RMB 406 billion in 1995 to RMB 1,607 billion in 2003, with an annual growth rate of 18.8 percent. Agricultural and other rural insurances constitute another small part of the financial sector. While these funds should not be seen as public funds, there are strong linkages between the financial and fiscal sectors.

Rural financial institutions are largely limited to the Rural Credit Cooperatives, in many townships and villages the only formal lender, and the postal savings system. In addition, county seats and some township seats have branch offices of the Agricultural bank of China (ABC) and other state-owned – or private – commercial banks. Finally, the Agricultural Development Bank of China (ADBC) continues to be an important player in financing the state's involvement in grain and other commodity sectors.

For example, in Ninglang, a very poor county in Yunnan, the formal financial sector consists of an ABC branch with 3 sub-branches, all of which are in the county seat; 13 RCCs in 13 of the 16 townships and a county-level RCC with 2 sub-branches in the county seat; a postal savings system; and the ADBC which only lends to the Grain Bureau for the procurement of grain. In addition, the county has a PBC office and, since 2003, an office of the China Banking Regulatory Commission (CBRC). Only RCCs and the postal savings system have an office outside the county seat. Even in Shuangliu, a very rich county in Sichuan with a considerable number of commercial banks, ABC branches remain only at the township level; the only other formal institutions available in the rural areas are the RCCs and the postal savings offices.

Contingent liabilities. As the government is – at least de facto – the owner of the rural financial institutions, and the financial health of these institutions is generally poor, there is a considerable contingent liability. For example, during our field visit to Shuangliu county in December 2003, we were informed that out of the total outstanding loan portfolio of RMB 2.28 billion of the county's RCCs, about RMB 1 billion was classified as non-performing loans (NPLs) – about twice the county's own fiscal revenues in 2003. The RCC of Y Town – reportedly one of the better RCCs in the county – had a NPL portfolio of more than RMB 32 million, corresponding to more than three times the size of the town budget. The quality of the loan portfolio in Ninglang is extremely poor: 57 percent of the ABC loans, and a similar share of the RCC loans, are considered non-performing. This is despite the application of a weak standard for NPLs. For example, principal loans to PSUs, which have increased over the last years, are not considered NPLs since the funds are expected to be guaranteed by the government.

Although it is not entirely clear who bears the contingent liabilities of the RCCs, it can be expected that a high share, if not all, of the burden rests with county and township governments. The bailout when the RCFs were closed in Sichuan at the end of the 1990s provides an example of the risks involved. While deposits and performing loans of the RCFs were transferred to the RCCs, the NPLs had to be assumed by the township government. Since these did not have any financial capacity, higher-level governments helped out with the loans. But many towns are still repaying these loans today.

Borrowing with inadequate accountability. Rural financial institutions such as RCCs are important providers of credit to public entities. This is despite the fact that it is illegal for local governments to borrow. Obviously, this also represents a conflict of interest as local governments have substantial control over the RCCs. This situation leads to lending without adequate application of fiduciary restrictions. Many financial institutions will lend to public units

irrespective of the indebtedness of these units or the government. Loans to government entities are rarely categorized as non-performing based on the assumption that the government will always repay in the end. The consequences are high risks for both the government and the financial institutions.

The importance of this lending relationship between government and the financial sector is illustrated in our two case studies. In Ninglang, a large part of the financial sector's loan portfolio (RMB 280 million) is with the public sector. The ADBC's RMB 40 million loan portfolio exclusively finances public grain procurement. Of the portfolios of the ABC and the RCC, more than RMB 31 million is with PSUs, and a large part of the enterprise portfolio is with government-owned enterprises. In fact, only an estimated one-quarter of the loan portfolio is made up of performing loans with private enterprises or individuals.

Ninglang Rural Loan Portfolio, 2003

	RMB million	est. # of debtors	Average loan size
ABC*	190	8,000	23,750
To PSUs	30	30	3 million
To enterprises**	100	100	1.43 million
To individuals	60	7,900	8,000
RCC	50	20,000	2,500
ADBC	40	1	40 million
total	280	28,001	8,571***

Notes: * In addition to the sub-categories listed, the ABC has a small portfolio (about RMB 1.30 million) of micro-loans (RMB 1,000-2,000 each) disbursed through the RCCs and Grameen-type women's groups, more than 90 percent of which are NPLs.

** Including all 29 government-owned enterprises.

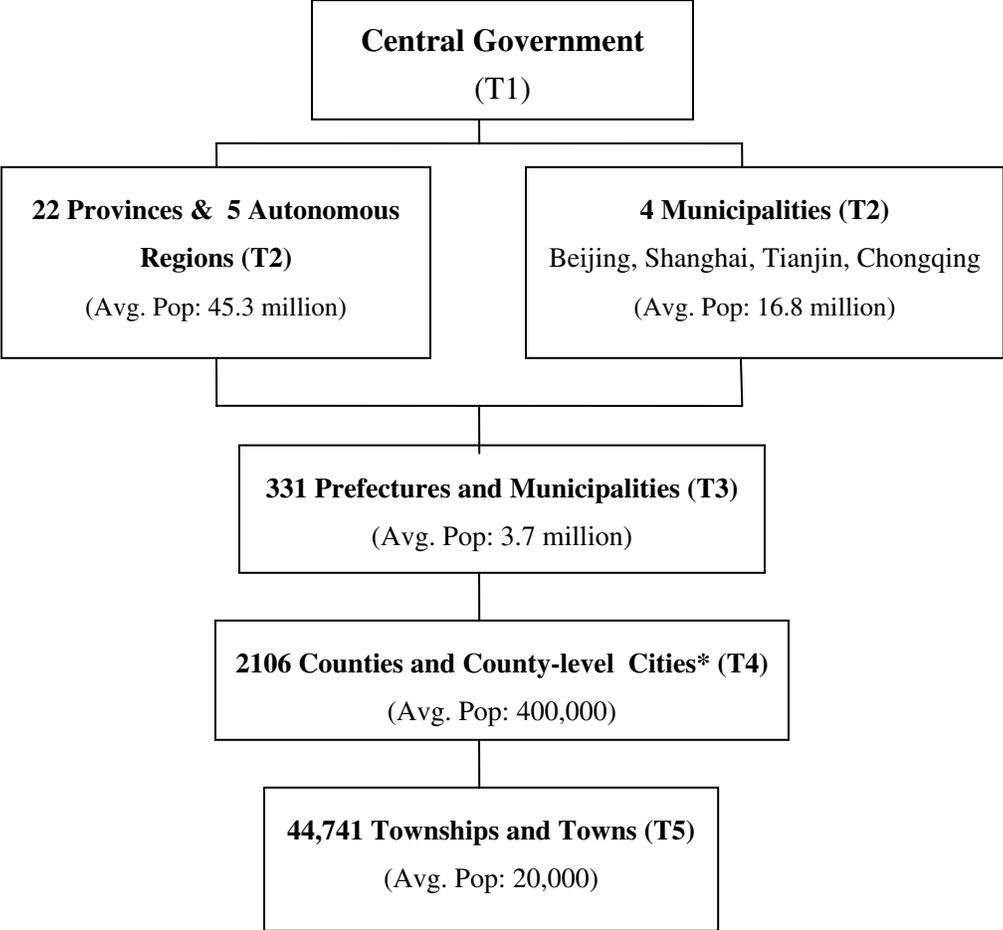
*** Average for the ABC and RCC only.

Policy lending without adequate compensation. The problems described above are compounded by the fact that the government uses RCCs or commercial banks such as the ABC to achieve policy objectives that conflict with profitable and sustainable management of the financial institutions – without adequately compensating them for these services. For example, the government might support local “dragonhead” enterprises in their search for credit by putting political pressure on institutions such as the RCCs or ABC branches.

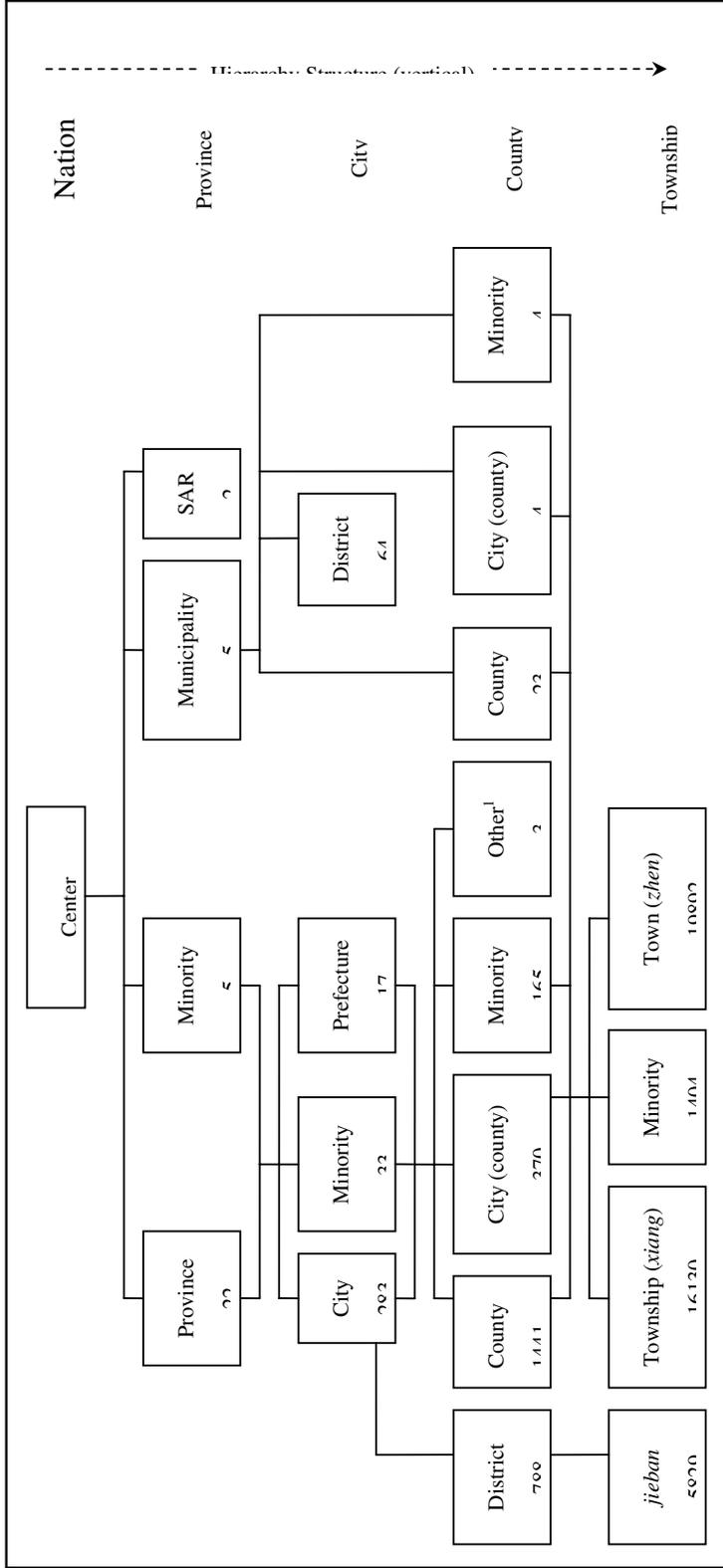
Source: Annexes 1 and 2.

Appendix 4: Government Organizational Structure

Appendix 4, Chart 1: China’s Government Structure by Jurisdiction

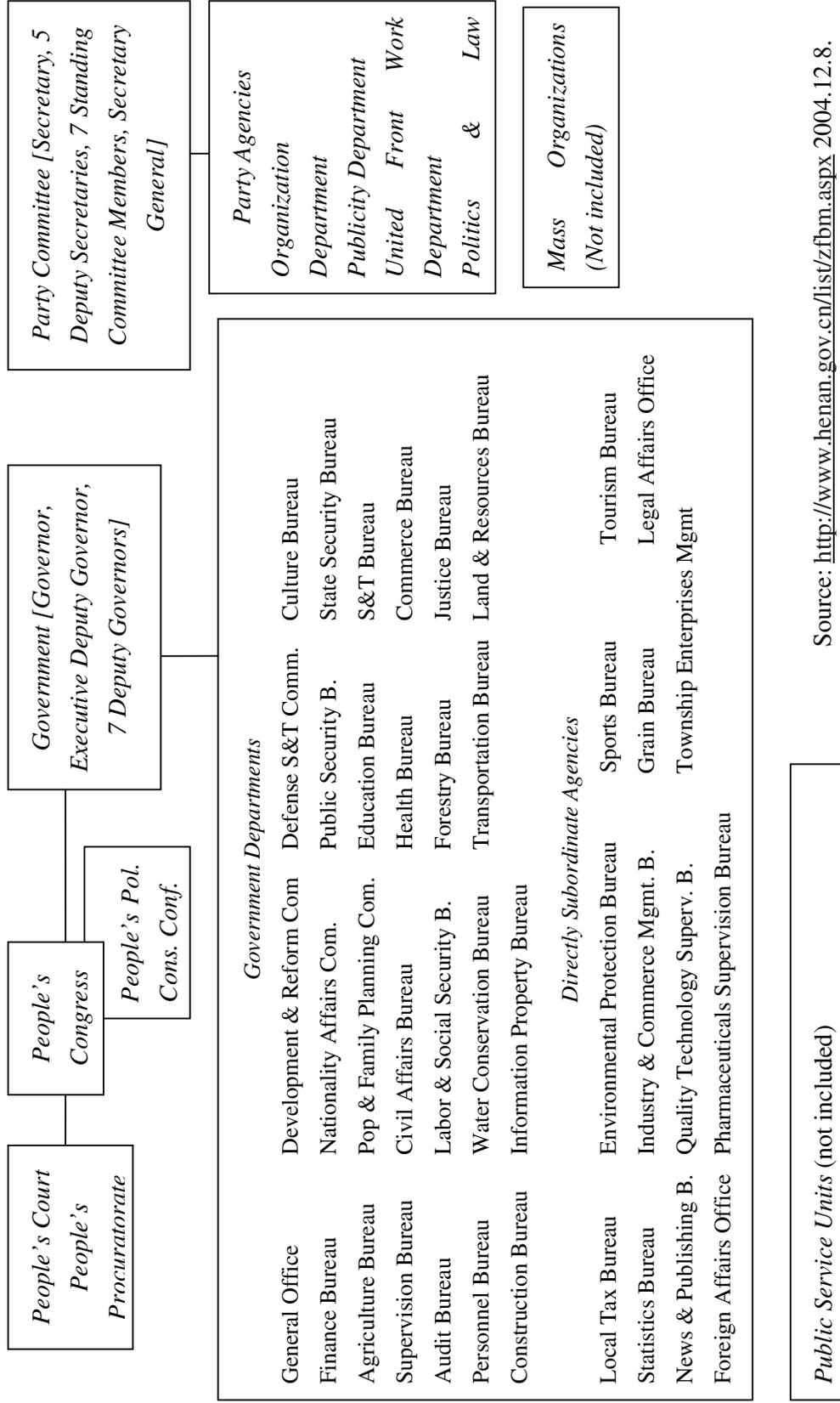


Appendix 4, Chart 2: China's Government Structure by Jurisdiction

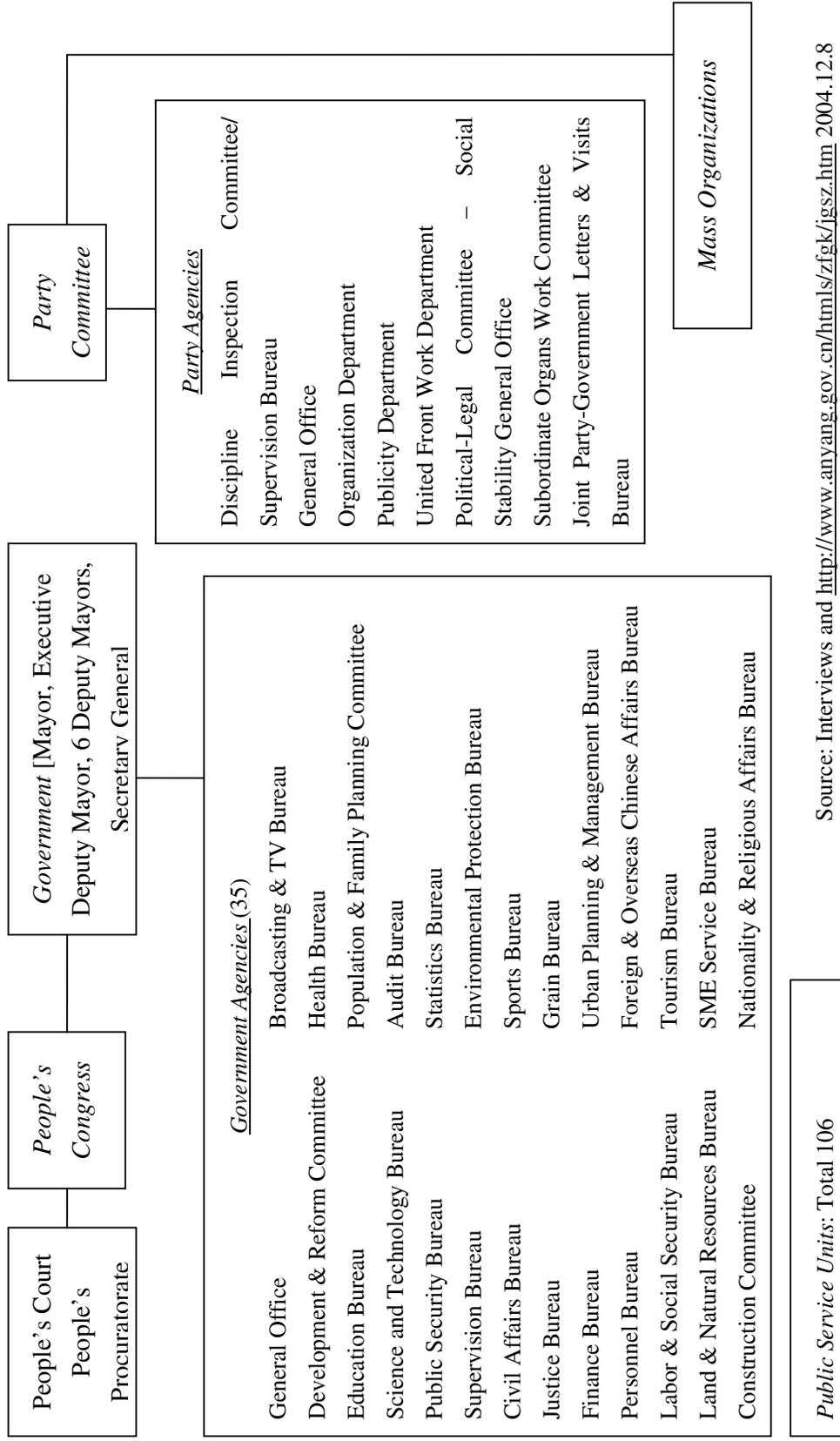


Note: "Other" includes one forestry district and two special districts.
 Data source: Brief Book on Jurisdictions of the PRC (2005 version).

Appendix 4, Chart 3: Structure of a Provincial Government: The Example of Henan

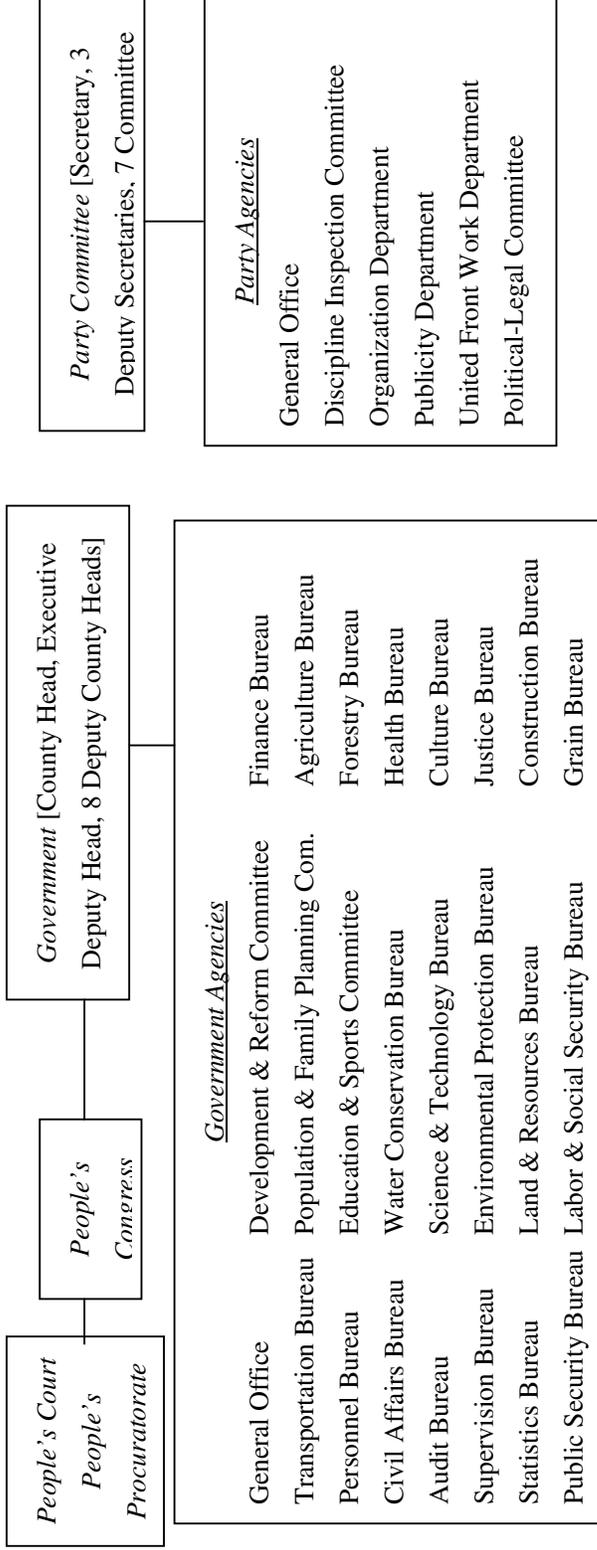


Appendix 4, Chart 4: Structure of a Municipal/Prefecture Government: The Example of Anyang City in Henan



Source: Interviews and <http://www.anyang.gov.cn/htmls/zfgk/jgsz.htm> 2004.12.8

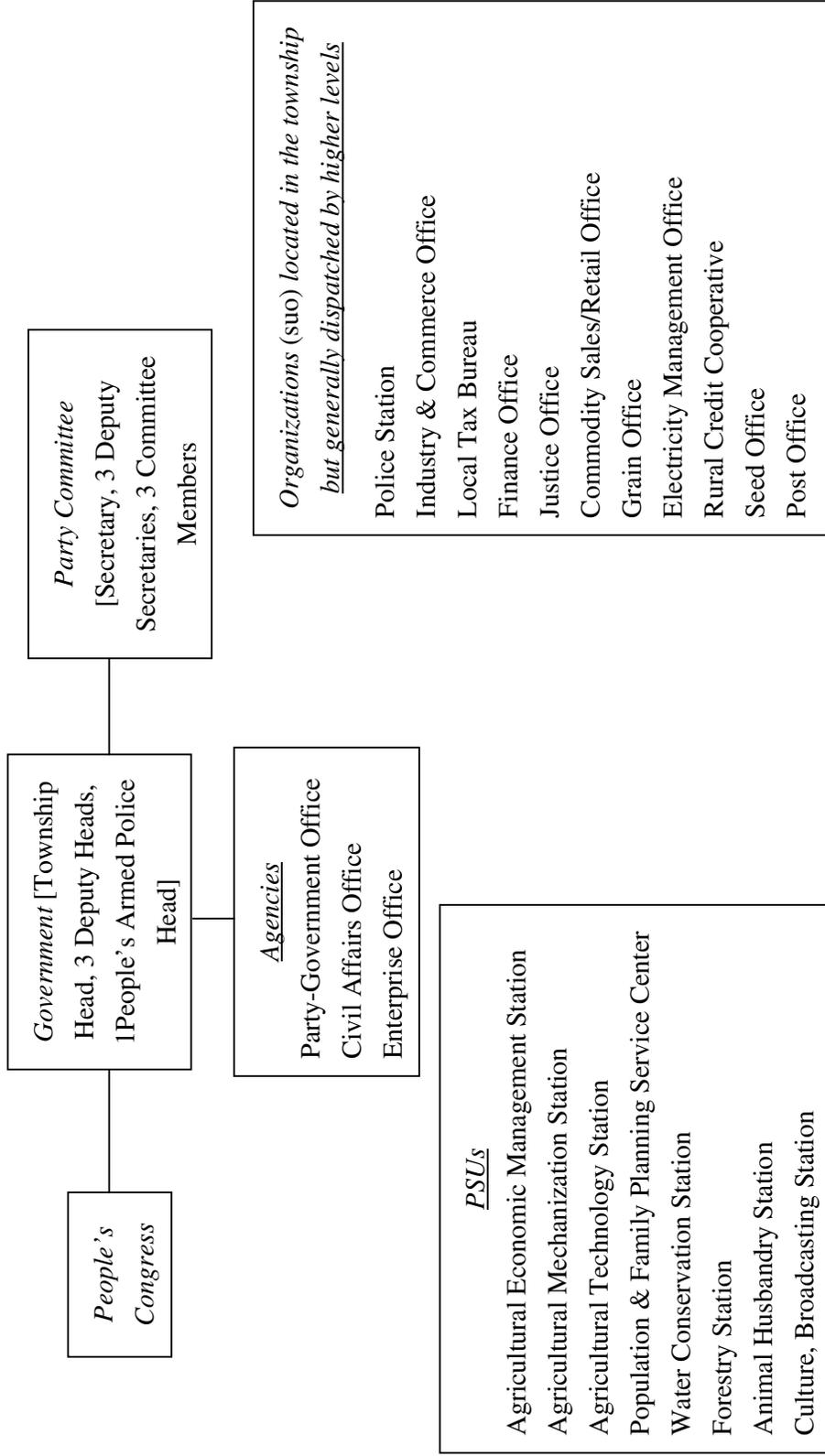
Appendix 4, Chart 5: Structure of a County Government: The Example of Huaxian in Anyang City in Henan



Public Service Units (PSUs): Party School, Party History Office, Archives Office, Committee for Concern on 'Next Generation' Work, Township & Town Enterprise Bureau, Broadcasting & TV Bureau, Agricultural Mechanization Bureau, Animal Husbandry Bureau, Organization Affairs Management Bureau, Culture, Tourism and Publishing Bureau, Administrative Public Service Center, Foreign Economic & Trade Cooperation Bureau, Air Defense Office, County Gazette Office, County Organization for the Disabled, Elderly Office, Teachers' Remedial Education School, County No. 1 Middle School, Commercial General Company, Supply & Marketing Co-op, Salt Bureau, Highways

Sources: Interviews and <http://www.hnhx.gov.cn/zfjg/zfjg.htm> 2004.12.8

Appendix 4, Chart 6: Structure of a Typical Township Government, Schematic Example



Appendix 5: The National Post Establishment System

China has a network of organizations to manage the creation and deletion of posts, to determine the organization of each government agency and PSU, and to determine their functions (the so-called “three fixes” [*sanding*]). During organizational restructuring each agency prepares a “three fixes plan” (*sanding fang’an*) that is approved by a joint Party-government agency set up at each administrative level and by higher-level committees, ultimately reporting to the State Commission on Public Sector Reform (*zhongyang jigou bianzhi weiyuanhui*) in Beijing. The SCPSR is chaired by the Premier and its members include senior Party and government officials in charge of organization and personnel work, finance, reform, and so forth.

Each province, city/prefecture, and county has established a post establishment committee. Generally, the head of the government at each level chairs the post establishment committee (*jigou bianzhi weiyuanhui*). The two deputy heads of the committee might be the deputy Party secretary in charge of organization and personnel work and the head of the Party’s Organization Department. Ordinary members of the committee may include the heads of the Finance Bureau, Development and Reform Commission, Labor and Social Security, and the Personnel Bureau, and the secretary general of the City Government General Office and a deputy head of the Party’s Organization Department.

A post establishment general office (*jigou bianzhi bangongshi*), often managed by the head of the Personnel Bureau, carries out the day-to-day work of the post establishment committee. This includes drafting rules and regulations based on the policies received from higher administrative levels, reviewing “three fixes” plans to ensure that they comply with official policy, making recommendations on increasing or decreasing the establishment of posts and organizations, and collecting data on the extent to which organizations are under- or overstaffed.

Generally, once higher levels have fixed a post establishment quota for a particular jurisdiction, the quota may not be changed until the next round of administrative reform. On a national level such reforms have occurred since the 1980s -- in 1982, 1988, 1993, 1998, and 2002. In between such reforms any increase in the number of posts within a government agency or PSU must be within its overall post establishment quota. Applications to increase the quota, usually only entertained during periods of administrative reform (when the “three fixes” plans are discussed) must be approved by higher levels, usually all levels including the SCPSR in Beijing. This makes changes to the post establishment quota outside of the reform periods virtually impossible.

The composition of these committees indicates that financial considerations are only one issue considered by the committees. Generally, they strive to balance the needs of local communities for employment and social stability, on the one hand, and the needs for efficiency, on the other. In poorer areas pressures on the authorities to act as employers of last resort are probably considerable.

There are various criteria for determining the post establishment. For administrative posts (civil service posts), official policy has identified criteria such as GDP, total land area, total population, urban and rural population, total value of agricultural output, total value

of industrial output, and so on. However, small numbers of demobilized soldiers might be hired outside the civil service system but in accordance with Party and government policy.

The central authorities have laid down other criteria for the PSUs. For example, the number of hospital beds, the number of students, and the length of roads by category of road determine staffing levels in hospitals, schools, and highways bureaus respectively. The SCPSR in Beijing has established these criteria, which are applied nationally. The criteria change from time to time. For example, in previous years the school establishment was determined by the number of classes taught, and not by the number of students. This led to practices such as schools having many small classes so that they could increase the quota of teachers.

During periods of reform, posts may be transferred from the control of one jurisdiction to another. Thus, management of rural primary school and junior middle school teachers, many of whom were on the township quota, was moved to the county during the 2001-02 reforms. Other changes have included the transfer of government agencies from local government control to “system” (*xitong*) control. Thus, posts in industry and commerce, previously managed by counties, are now controlled by higher-level industry and commerce departments. Such changes have also occurred in the management of regulatory agencies (for example, quality assurance agencies) to strengthen the regulatory state. When the regulatory agencies were under local management they were often too influenced by the concerns of local governments to the detriment of building a level regulatory playing field. When agencies are moved to system management, salaries are paid by the system, not by local government.

Source: Annex 4.

Appendix 6: The Rural Fee Reform Implementation Process

Year	Policies	Related policies	Scope
2000	<ol style="list-style-type: none"> 1. Abolish township overall fees (<i>xiang tongchou</i>), rural educational surcharges, and other administrative fees or government funds. 2. Abolish slaughter tax. 3. Abolish corvée labor. 4. Adjust agricultural tax (in terms of output and legal tax rate); the limit is 7 percent. 5. Adjust agriculture special products tax (avoid overlap with agricultural tax). 6. Change village reserve methods (as the added part of the agricultural tax, use only in village and <i>yishi yiyi</i>). 	<ol style="list-style-type: none"> 1. Standardization of rural charge management. 2. Reduce township-level government institutions and cut the fiscal fed population. 3. Reform and modify county and township fiscal management system. 4. Set up rural burden supervision system. 5. Set up other related institutions. 	Anhui, others voluntarily.
2001	<ol style="list-style-type: none"> 1. Confirm the taxed land area, products, and price. 2. Equalize the burdens of different kinds of employees in the rural areas. 3. Adjust the agriculture special products tax; reduce the tax on currency processes. 4. Solve village expenditures (staff salaries, administrative expenses, and expenditures for 5 guarantees) without increasing farmers' burden. 5. Solve problems of fees (for corvée labor, etc.); after abolishing corvée labor, implement <i>yishi yiyi</i> and establish upper limit. 6. Confirm the expenditure for compulsory education (expenditure at the county level). 	<ol style="list-style-type: none"> 1. Reduce township-level government institutions and cut the fiscal fed population. 2. Increase transfers at central and provincial levels. 3. Standardization of rural charge management. 4. Set up <i>yishi yiyi</i> institutions for financing and labor. 5. Put the policies into effect, set up supervision system. 6. Solve township and village debt problems. 	Anhui, others voluntarily.

Year	Policies	Related policies	Scope
2002	<ol style="list-style-type: none"> 1. Increase the scope of experimental units. 2. 3 guarantees (sustain reduction in farmers' burden, smooth operation of township and village government, and meeting the demands of educational expenses). 3. Training of government staff. 4. Keep policies in non-experimental districts. 5. Strengthen supervision. 	<ol style="list-style-type: none"> 1. Township institutional reform. 2. Rural education reform. 3. Public expenditure reform. 4. Reduce township-level government institutions and cut the fiscal fed population. 	<p>Anhui, Hebei, Inner Mongolia, Heilongjiang, Jilin, Jiangxi, Shandong, Henan, Hubei, Chongqing, Sichuan, Guizhou, Shaanxi, Gansu, Qinghai, Ningxia, others voluntarily.</p>
2003	<ol style="list-style-type: none"> 1. Ensure 3 guarantees (sustain reduction in farmers' burden, smooth operation of township and village government, and meeting the demands of educational expenses). 2. Adjust agricultural tax (ensure land contracting system, taxed products, and taxed price). 3. Strengthen the agricultural tax collection system, especially added tax to agriculture tax. 4. Strengthen RFR system. 5. Solve equity problems of the burden. 6. Strengthen <i>yishi yiyi</i>. 7. Strengthen agriculture charge management. 8. Solve rural debt problems. 9. Strengthen supervision. 		<p>Anhui, Hebei, Inner Mongolia, Heilongjiang, Jilin, Jiangxi, Shandong, Henan, Hubei, Chongqing, Sichuan, Guizhou, Shaanxi, Gansu, Qinghai, Ningxia, others voluntarily.</p>

Year	Policies	Related policies	Scope
2003	1. Ensure 3 guarantees. 2. Ensure <i>yishi yi</i> . 3. Publish tax and related information; one-fee for education in poverty areas; limitations of journals and newspapers; accountability for burden reduction. 4. Ensure the purposes in the use of transfers for the RFR.	1. Resources decrease and deficits increase. 2. <i>Yixian weizhu</i> .	Anhui, Hebei, Inner Mongolia, Heilongjiang, Jilin, Jiangxi, Shandong, Henan, Hubei, Chongqing, Sichuan, Guizhou, Shaanxi, Gansu, Qinghai, Ningxia, others voluntarily.

Sources:

“Notice on the RFR Experiment,” *Zhongfa* [2000], No. 7, Central Committee of the CCP and the State Council.

“Notice on Further Implementation of the RFR Experiment,” *Guofa* [2001], No. 5, State Council.

“Notice on Further Implementation of the RFR Experiment in 2002,” *Guobanfa* [2002], No. 25, Comprehensive Department, State Council.

“Notice on Comprehensive Implementation of the RFR Experiment,” *Guofa* [2003], No. 12, State Council.

“Notice on Further Implementation of the RFR Experiment,” *Guobanfa* [2003], No. 85, Comprehensive Department, State Council.

Appendix 7: Tax Assignments of the Central and “Local” Government Levels

I. Taxes exclusively assigned to the Central Government

1. Excise tax
2. Taxes collected from the Ministry of Railroads, and from the headquarters of banks and insurance companies
3. Income taxes, sales taxes, royalties from offshore oil activities of foreign companies and joint ventures
4. Energy and transportation fund contributions
5. Seventy percent of the three sales taxes collected from enterprises owned by the Ministry of Industry, Ministry of Power, SINOPEC (petrochemicals), and the China nonferrous metals companies
6. All customs duties, VAT, and excise taxes on imports
7. Enterprise income tax collected from banks and other financial institutions
8. Vehicle purchase tax
9. Vessel tonnage tax

II. Taxes shared between the central and local governments

1. Value-added tax (75:25 central: local)
2. Income tax of enterprises (except for special items): 100% local until 2002, 50:50 in 2002, and 60:40 from 2003
3. Personal income taxes: 100% local until 2002, 50:50 in 2002, and 60:40 from 2003
4. Natural resources taxes (coal, gas, oil, and other minerals if the enterprises are fully Chinese-owned): 100% central for offshore, and 100% local for land
5. Stamp tax on securities exchange: 50:50 from 1994, 88:12 from 1997, 91:9 from 2000, 97:3 from 2002
6. City maintenance and construction tax (Ministry of Railways, headquarters of major banks and insurance companies, 100% central, others 100% local)
7. Salt tax

III. Taxes exclusively assigned to local governments

1. Industrial and commercial tax and income tax levied on foreign and joint venture enterprises
2. Business (gross receipts) tax falling on sectors not covered by VAT (transportation and communications, construction, finance and insurance, posts and telecommunications, culture and sports, entertainment, hotels and restaurants, and other), except special items
3. Rural market (stall rental) trading tax
4. Urban maintenance and construction tax (a surcharge on the tax liability of enterprises for the business tax, consumption tax, and VAT) other than from the bank headquarters, insurance companies, and the Ministry of Railroads
5. Agricultural taxes (agricultural tax, animal slaughter tax, animal husbandry tax, agricultural special products tax, and title tax) – abolished in 2006
6. Urban land-use tax
7. Farmland occupation tax
8. Vehicle and vessel utilization tax
9. Vehicle and vessel usage license plate tax
10. Value-added tax on land transactions

11. Education surtax
12. Entertainment taxes
13. Property tax
14. Surtax on collective enterprises
15. Resources tax (on land)
16. Fixed-asset investment orientation tax (discontinued in 1999)
17. Fines for delinquent taxes

Source: Ministry of Finance.

Appendix 8: Budget Definitions

Based on the current budget classification system, which has 31 categories:

1. Expenditure for Capital Construction
2. Enterprise Innovation Funds
3. Geological Prospecting Expenses
4. Science and Technology Promotion Funds
5. Additional Appropriation for Enterprises' Circulating Capital
6. Agriculture Operating Expenses
7. Forestry Operating Expenses
8. Water Conservancy and Meteorology
9. Operating Expenses of Department of Industry & Transportation
10. Operating Expenses for Commerce
11. Operating Expenses for Culture, Sports, and Broadcasting
12. Operating Expenses for Education
13. Operating Expenses for Science
14. Operating Expenses for Health
15. Operating Expenses for Other Departments
16. Pensions and Relief Funds for Social Welfare
17. Expenditure for Retired Persons in Administrative Departments
18. Social Security Subsidy Expenses
19. Expenditure for National Defense
20. Expenditure for Government Administration
21. Expenditure for Diplomacy
22. Expenditure for Armed Police Troops
23. Expenditure for Public Security Agencies, Procuratorial Agencies, and Courts of Justice
24. Urban Maintenance Expenditure
25. Expenditure for Price Subsidies
26. Expenditure for Supporting Undeveloped Areas
27. Sea Area Development and Site Usage Fee Expenses
28. Debt Servicing Expenses
29. Earmarked Expenditures
30. Other Expenditures
31. Enterprise Loss Subsidies

The categories in this table are defined as follows:

Capital investments and development = 1, 2, 3, 4, 5, 24, 27, and 50% of 29

Economic services = 6, 7, 8, 9, 10, 13, and 15

Social services = 11, 12, 14, 16, 18, and 50% of 29

Administration = 17, 19, 20, 21, 22, 23

Subsidies = 25, 26, 31

This leaves only items 28 and 30 that are unassigned.

Appendix 9: Additional Statistical Information

Appendix 9 Table 1. Income Inequalities in Rural and Urban Areas (1978-2005)

	Net income of rural households (RMB/person)		Disposable income of urban households (RMB/person)		Urban / rural	
	nominal	1978 prices	nominal	1978 prices	nominal	1978 prices
1978	134	134	343	343	2.57	2.57
1980	191	186	478	436	2.50	2.35
1985	398	359	739	551	1.86	1.53
1990	686	416	1510	680	2.20	1.64
1995	1578	513	4283	997	2.71	1.94
2000	2253	646	6280	1318	2.79	2.04
2005	3255	835	10493	2086	3.22	2.50

Source: China Statistical Abstract, 2006.

Appendix 9 Table 2. Wealth Inequalities in Rural and Urban Areas

		Average wealth in 2002 (RMB per capita)	Growth rate from 1995 to 2002 (%)	Annual growth rate from 1995 to 2002 (%)
Nation	Total asset net value	25,897	114.0	11.5
	Land value	2,421	-36.8	-6.3
	Financial assets	5,643	195.8	16.8
	Net house property	14,989	249.5	19.6
Urban	Total asset net value	46,134	236.8	18.9
	Financial assets	11,958	211.3	17.6
	Net house property	29,703	396.3	25.7
Rural	Total asset net value	12,938	13.2	1.8
	Land value	3,974	-25.7	-4.2
	Financial assets	1,539	40.8	5.0
	Net house property	5,565	54.6	6.4

Source: NBS Household Survey, 1995, 2002; Shi et al. (2005).

Appendix 9 Table 3. Differences in Education among Urban, Town, and Rural Areas

	No formal education	Primary school	Primary middle school	Secondary school	Junior college and above	Education years
Urban	2.49	14.34	39.98	29.22	13.97	10.20
Town	4.20	21.37	44.31	23.79	6.33	9.14
Rural	8.74	38.88	43.92	7.75	0.71	7.33

Source: Research Team of China Education and Human Resource Report (2003).

Appendix 9 Table 4. Selected Departments related to Central Sannong Expenditure

Ministry	Key Departments	Responsibility
MOF	Dept. of Agriculture	
	SOCAD	Organize and implement agriculture integrated development and manage expenditures for integrated development
NDRC	Dept. of Regional Economy	Balance regional development; establish development planning for old revolutionary, less developed, border, and poverty areas; work for food planning
	Dept. of Rural Economy	Important problems with agriculture and rural development; balance agriculture, forestry, irrigation, and meteorology planning and development
MOA		Agriculture and rural development
MWR	Dept. of Rural Irrigation	Organize and implement policies related to rural irrigation; construct a rural irrigation infrastructure and service network; water supply and conservation in rural areas
	Dept. of Water and Soil Conservation	Organize and supervise policies related to environmental protection of nature; implement integrated development of the natural environment
MOST	Dept. of Rural and Social Development	Organize and implement technology planning and policies related to agriculture and rural development
MOE	Dept. of Basic Education	Organize and implement 9-years of compulsory education; reduce illiteracy and semi-illiteracy
MOH	Dept. of Grassroots Health and Maternal and Infant Health	Organize and implement policies related to rural health
MCA	Dept. of Social Welfare	Organize and implement policies related to the elderly, handicapped, orphans, 5 guarantees, and other low income groups
	Dept. of Relief	Manage and distribute materials and capital for natural disasters; implement <i>dibao</i> and <i>tekun</i> institutions
MOLSS	Dept. of Rural Social Security	Rural social security
MOC	Leading Group of Between County and Rural Roads	Standardize and rebuild roads between counties and rural areas
	Dept. of Rural and Urban Planning	Organize and establish policies related to rural construction

Source: Authors.

Appendix 9 Table 5. Ranking of Estimated Revenue Impact by Provinces, 2003

Province and national ranking	Taxes to be eliminated*	Five agric. Taxes	As percent of total provincial revenues	Taxes to be eliminated*	Five agric. taxes
1. Anhui	12.09	17.12	18. Chongqing	4.72	8.34
2. Henan	11.96	14.25	19. Xinjiang	3.69	5.77
3. Yunnan	10.86	13.57	20. Jiangsu	3.33	10.17
4. Hubei	9.96	12.79	21. Qingdao	2.54	8.18
5. Hunan	9.76	13.29	22. Ningxia	2.49	5.45
6. Jiangxi	9.52	13.82	23. Liaoning	2.31	6.18
7. Guangxi	8.82	11.72	24. Shanxi	2.17	3.32
8. Guizhou	8.13	10.38	25. Dalian	1.63	5.63
9. Jilin	7.94	12.43	26. Fujian	1.61	6.08
10. Hainan	7.76	10.68	27. Zhejiang	0.77	10.36
11. Hebei	7.69	10.03	28. Guangdong	0.71	4.90
12. Gansu	7.65	9.13	29. Ningbo	0.36	9.18
13. Shandong	7.62	10.99	30. Tianjin	0.18	4.83
14. Heilongjiang	7.21	9.93	31. Beijing	0.11	3.85
15. Sichuan	6.83	10.92	32. Xiamen	0.06	5.32
16. Shaanxi	6.12	8.32	33. Shenzhen	0.03	3.66
17. Inner Mongolia	5.92	9.83	34. Shanghai	0.01	7.54
18. Qinghai	5.82	7.37	35. Tibet	0.00	0.03
			<i>average</i>	4.75	8.52
			<i>standard deviation</i>	3.76	3.46
			<i>coefficient of variation</i>	0.79	0.41

Note: Taxes to be eliminated include the agricultural tax, animal husbandry tax, and agricultural special products tax. Shares are as percent of total provincial revenues. 'Provinces' include some major cities such as Dalian and Xiamen.

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

Appendix 9 Table 6. The Growing Importance of Transfers

	Total Transfers from the Central Government (RMB billion)	As percentage of	
		GDP *	Central Government Revenues
1986	46.4	4.5%	59.6%
1987	48.1	4.0%	65.3%
1988	53.8	3.6%	69.4%
1989	56.2	3.3%	68.3%
1990	58.5	3.2%	58.9%
1991	55.5	2.6%	59.2%
1992	59.7	2.2%	60.8%
1993	54.5	1.5%	56.9%
1994	238.9	5.0%	82.2%
1995	253.4	4.2%	77.8%
1996	272.5	3.8%	73.0%
1997	285.7	3.6%	66.3%
1998	332.2	3.9%	67.2%
1999	399.2	4.5%	68.3%
2000	474.8	4.8%	67.9%
2001	601.5	5.5%	70.1%
2002	736.2	6.1%	70.9%
2003	826.1	6.1%	69.6%
2004	1037.9	6.5%	71.7%
2005		6.3%	66.5%

* GDP from 1993 onward uses the revised series from December 2005.

Source: Budget speeches to the NPC; CSY various years; Lou (2000), Wong (1997).

Appendix 9 Table 7. Transfer Distribution in 2003

		Amount (billion)	Ratio of East, Center, and West (%)			Ratio to total transfer (%)
			East	Central	West	
Fiscal capacity transfer	General Transfer	745.3	4	46	50	7.2
	Transfer for minority areas	76.9	0	5	95	0.7
	Transfer for adjusting salary	993.5	4	49	47	9.5
	RFR transfer	523.3	14	47	39	5
	Final account subsidy	265.9	22	31	47	2.6
	Total	2604.9	8	44	48	25
Tax rebate and fixed subsidy under old institutions		4379.1	57	23	20	42.1
Earmarked transfer		3423.2	14	52	34	32.9
TOTAL		10402.7	31	38	32	100.0

Note: East includes Beijing, Tianjin, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, and Guangdong; Central includes Hebei, Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, and Hainan; West includes Inner Mongolia, Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang.

Source: Ni (2006), cited in Zhao et al. (2005a).

Appendix 9 Table 8. Transfer Distribution by Region in 2003

		Fiscal Transfer per capita				Share of Total (percent)			
		Av.	East	Central	West	Av.	East	Central	West
Fiscal capacity transfer	General Transfer	57.6	7.2	67.6	100.3	7.2	0.9	8.0	7.2
	Transfer for minority areas	5.9	0.0	0.8	19.7	0.7	0.0	0.1	1.4
	Transfer for adjusting salary	76.8	9.6	96.1	125.8	9.5	1.2	11.3	9.0
	RFR transfer	40.4	17.6	48.5	54.9	5	2.2	5.7	3.9
	Final account subsidy	20.6	14.1	16.3	33.7	2.6	1.7	1.9	2.4
	Total	201.3	50.1	216.0	308.7	25.0	6.2	25.5	22.1
Tax rebate and fixed subsidy under old institution		338.4	599.7	172.9	271.3	42.1	73.7	20.4	19.5
Earmarked transfer		264.5	115.1	229.7	479.4	32.9	14.2	27.1	34.4
TOTAL		1005.4	813.2	847.9	1393.9	100.0	100.0	100.0	100.0

Source: Calculations based on Ni (2006), cited in Zhao et al (2005a).

Appendix 9 Table 9. Shares by Administrative Level and by Province (2003)

Shares (%)	Revenues			Expenditures		
	Province	Prefecture	County	Province	Prefecture	County
Total Subnational	25.2%	36.3%	38.5%	26.4%	30.8%	42.7%
Beijing	52.4%	45.8%	1.9%	48.4%	47.7%	3.9%
Tianjin	49.0%	48.6%	2.4%	48.0%	48.5%	3.5%
Hebei	26.0%	29.2%	44.8%	23.6%	21.9%	54.5%
Shanxi	29.0%	31.9%	39.1%	32.7%	19.8%	47.5%
Inner Mongolia	14.0%	20.8%	65.2%	21.9%	25.7%	52.4%
Liaoning	21.7%	41.0%	37.3%	20.4%	41.7%	37.9%
Jilin	29.2%	36.4%	34.3%	33.2%	26.5%	40.3%
Heilongjiang	32.7%	33.4%	33.9%	25.7%	36.7%	37.6%
Shanghai	49.7%	49.4%	1.0%	36.9%	61.5%	1.5%
Jiangsu	11.4%	28.8%	59.8%	16.4%	27.4%	56.2%
Zhejiang	12.0%	24.6%	63.4%	12.8%	23.9%	63.2%
Anhui	14.1%	38.3%	47.6%	31.0%	24.2%	44.9%
Fujian	13.1%	35.9%	51.0%	23.8%	27.9%	48.3%
Jiangxi	17.4%	25.4%	57.2%	25.3%	17.4%	57.2%
Shandong	13.6%	30.2%	56.2%	17.7%	24.8%	57.5%
Henan	16.5%	32.2%	51.3%	21.0%	24.9%	54.2%
Hubei	22.1%	30.8%	47.1%	27.5%	22.4%	50.1%
Hunan	18.3%	29.8%	52.0%	25.8%	22.8%	51.4%
Guangdong	24.8%	50.9%	24.4%	13.8%	48.9%	37.3%
Guangxi	13.8%	33.2%	53.0%	26.5%	24.2%	49.3%
Hainan	34.4%	26.8%	38.8%	36.7%	17.5%	45.8%
Chongqing	42.4%	35.4%	22.1%	36.5%	33.3%	30.3%
Sichuan	30.8%	25.3%	43.9%	19.4%	23.7%	56.9%
Guizhou	22.9%	20.4%	56.8%	28.3%	16.3%	55.4%
Yunnan	21.0%	29.3%	49.7%	31.7%	17.5%	50.8%
Tibet	14.1%	44.2%	41.7%	67.0%	13.6%	19.4%
Shaanxi	18.6%	30.8%	50.6%	41.6%	18.4%	40.0%
Gansu	31.6%	29.7%	38.8%	30.7%	20.7%	48.6%
Qinghai	29.4%	19.0%	51.6%	49.4%	15.9%	34.6%
Ningxia	22.3%	37.2%	40.5%	43.9%	15.0%	41.1%
Xinjiang	13.6%	35.2%	51.2%	37.6%	18.7%	43.7%

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties.

Appendix 9 Table 10. Quota Subsidies before and after the Tax Sharing System Reform

(unit: RMB million)	1990	2000
Inner Mongolia	1842	1842
Jilin	107	107
Fujian	50	542
Jiangxi	45	45
Shandong	0	159
Guangxi	608	608
Hainan	588	171
Sichuan	0	343
Guizhou	742	742
Yunnan	673	673
Tibet	991	2787
Shaanxi	120	120
Gansu	126	126
Qinghai	656	656
Ningxia	533	533
Xinjiang	1529	1937
Total	8610	11,391

Source: Wong (1997, Table 1.3); Zhang and Martinez-Vasquez (2003, Table 8).

Appendix 9 Table 11. Local Fiscal Own Revenue by Government Level in 2004, Tax-sharing

	Total <i>bn RMB</i>	percent of total (%)					
		Total	Pro- vince	Prefec- -ture	Count y	Town level	of which: Towns
VAT	165.7	100	23.8	37.5	23.9	14.9	13.2
of which: export VAT rebate	-54.8	100	20.7	37.4	30.7	11.3	10.6
Sales tax	347.1	100	26.8	37.7	24.6	10.9	8.9
Enterprise income tax	137.3	100	38.1	35.4	18.3	8.2	7.5
Personal income tax	69.5	100	39.4	31.1	19.4	10.1	8.8
Nature resource tax	9.9	100	24.4	19.1	29.8	26.7	20.6
UMCT	67.0	100	8.4	52.5	28.0	11.2	9.9
Housing property tax	36.6	100	6.7	47.8	32.9	12.6	11.5
Land-related taxes*	30.5	100	8.7	39.8	36.2	15.2	13.8
Agricultural taxes*	24.2	100		1.2	15.3	83.5	56.5
Contract tax	54.0	100	11.8	54.4	26.1	7.7	7.0
State asset profit	22.3	100	4.8	38.3	55.1	1.9	1.5
Enterprise loss subsidies	-18.2	100	58.2	25.2	16.6	0.0	0.0
Administrative fee	90.5	100	44.2	27.1	26.4	2.2	1.7
Penalties	52.3	100	18.7	32.2	47.3	1.8	1.5
Earmarked revenue	49.1	100	28.7	39.3	28.5	3.5	3.1
Other	31.8	100					
Total revenue	1,169.3	100	24.9	36.9	26.7	11.4	9.5

Note: * Land-related taxes include the stamp tax, land-use tax, land value-added tax; agricultural taxes include the agriculture tax and (very small amounts of) the agricultural special products tax and animal husbandry tax.

Source: Compendium of Local Fiscal Statistics, 2004.

Appendix 9 Table 12. Local Fiscal Own Revenue by Government Level in 2004, Share of Total

	Total	Province	Prefecture	County	Town level	of which:
VAT	14.2	13.5	14.4	12.7	18.4	19.6
of which: export VAT rebate	-4.7	-3.9	-4.7	-5.4	-4.6	-5.2
Sales tax	29.7	32.0	30.3	27.4	28.2	27.7
Enterprise income tax	11.7	18.0	11.2	8.1	8.4	9.2
Personal income tax	5.9	9.4	5.0	4.3	5.3	5.5
Nature resource tax	0.8	0.8	0.4	0.9	2.0	1.8
UMCT	5.7	1.9	8.1	6.0	5.6	6.0
Housing property tax	3.1	0.8	4.1	3.9	3.5	3.8
Land-related taxes*	2.6	0.9	2.8	3.5	3.5	3.8
Agricultural taxes*	2.1		0.1	1.2	15.1	12.2
Contract tax	4.6	2.2	6.8	4.5	3.1	3.4
State asset profit	1.9	0.4	2.0	3.9	0.3	0.3
Enterprise loss subsidies	-1.6	-3.6	-1.1	-1.0	0.0	0.0
Administrative fee	7.7	13.7	5.7	7.7	1.5	1.4
Penalties	4.5	3.3	3.9	7.9	0.7	0.7
Earmarked revenue	4.2	4.8	4.5	4.5	1.3	1.4
Other	2.7					
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0

Note: * Land-related taxes include the stamp tax, land-use tax, land value-added tax; agricultural taxes include the agriculture tax and (very small amounts of) the agricultural special products tax and animal husbandry tax.

Source: Compendium of Local Fiscal Statistics, 2004.

Appendix 9 Table 13. Local Fiscal Expenditures by Government Level in 2004

	Total <i>bn</i> <i>RMB</i>	share of total (%)					
		Total	Pro- vince	Pre- fec- ture	Coun- ty	Town level	of which : Town s
Expenditure for Capital Construction	209.4	100.0	36.7	42.8	19.0	1.5	1.3
Enterprise Innovation Funds	74.2	100.0	24.8	47.8	23.5	3.8	3.1
Science and Technology Promotion Funds	22.8	100.0	23.3	39.7	34.7	2.4	2.1
Agriculture Operating Expenses	71.0	100.0	18.0	21.2	43.5	17.4	12.7
Forestry Operating Expenses	59.4	100.0	53.1	8.9	33.2	4.8	2.7
Water Conservancy and Meteorology	24.8	100.0	20.1	24.1	45.1	10.8	8.4
Operating Expenses of Department of Industry & Transportation	24.5	100.0	42.9	25.4	28.9	2.8	2.0
Operating Expenses for Commerce	3.3	100.0	18.1	39.7	42.0	0.3	0.2
Operating Expenses for Culture, Sports, and Broadcasting	52.1	100.0	22.9	26.5	36.6	14.0	9.8
Operating Expenses for Education	314.6	100.0	15.9	19.1	49.4	15.6	12.4
Operating Expenses for Science	12.4	100.0	62.3	25.4	11.5	0.8	0.7
Operating Expenses for Health	83.2	100.0	22.8	32.3	40.0	4.9	3.9
Operating Expenses for Other Departments	101.0	100.0	35.2	27.9	31.4	5.6	4.1
Pensions and Relief Funds for Social Welfare	55.6	100.0	9.5	26.6	51.1	12.7	9.8
Expenditure for Retired Persons in Administrative Departments	93.2	100.0	20.0	22.5	45.8	11.6	8.7
Social Security Subsidy Expenses	132.9	100.0	41.3	37.0	21.0	0.7	0.6
Expenditure for Government Administration	199.5	100.0	13.1	27.8	39.9	19.2	13.1
Expenditure for Public Security Agencies, Procuratorial Agencies, and Courts of Justice	146.6	100.0	25.5	36.9	36.7	0.9	0.8
Urban Maintenance Expenditure	96.8	100.0	7.0	47.9	39.0	6.2	5.7
Expenditure for Price Subsidies	37.8	100.0	77.0	16.6	6.2	0.2	0.2
Expenditure for Supporting Undeveloped Areas	17.3	100.0	40.4	10.0	44.8	4.8	3.2
Earmarked Expenditure	41.2	100.0	19.1	41.2	35.9	3.8	3.4
Other Expenditures							
Total Expenditure	2059.3	100.0	25.9	30.7	34.9	8.5	6.4

Source: Compendium of Local Fiscal Statistics, 2004.

Appendix 9 Table 14. Local Fiscal Expenditures by Government Level in 2004, Share of Total

	Total	Province	Prefecture	County	Town level	of which: Towns
Expenditure for Capital Construction	10.2	14.4	14.2	5.6	1.8	2.0
Enterprise Innovation Funds	3.6	3.4	5.6	2.4	1.6	1.8
Science and Technology Promotion Funds	1.1	1.0	1.4	1.1	0.3	0.4
Agriculture Operating Expenses	3.4	2.4	2.4	4.3	7.0	6.9
Forestry Operating Expenses	2.9	5.9	0.8	2.7	1.6	1.2
Water Conservancy and Meteorology	1.2	0.9	0.9	1.6	1.5	1.6
Operating Expenses of Department of Industry & Transportation	1.2	2.0	1.0	1.0	0.4	0.4
Operating Expenses for Commerce	0.2	0.1	0.2	0.2	0.0	0.0
Operating Expenses for Culture, Sports, and Broadcasting	2.5	2.2	2.2	2.7	4.2	3.9
Operating Expenses for Education	15.3	9.4	9.5	21.6	28.1	29.7
Operating Expenses for Science	0.6	1.4	0.5	0.2	0.1	0.1
Operating Expenses for Health	4.0	3.6	4.3	4.6	2.3	2.5
Operating Expenses for Other Departments	4.9	6.6	4.5	4.4	3.2	3.1
Pensions and Relief Funds for Social Welfare	2.7	1.0	2.3	4.0	4.0	4.1
Expenditure for Retired Persons in Administrative Departments	4.5	3.5	3.3	5.9	6.2	6.2
Social Security Subsidy Expenses	6.5	10.3	7.8	3.9	0.5	0.6
Expenditure for Government Administration	9.7	4.9	8.8	11.1	21.9	19.8
Expenditure for Public Security Agencies, Procuratorial Agencies, and Courts of Justice	7.1	7.0	8.6	7.5	0.8	0.9
Urban Maintenance Expenditure	4.7	1.3	7.3	5.3	3.4	4.2
Expenditure for Price Subsidies	1.8	5.5	1.0	0.3	0.0	0.0
Expenditure for Supporting Undeveloped Areas	0.8	1.3	0.3	1.1	0.5	0.4
Earmarked Expenditure	2.0	1.5	2.7	2.1	0.9	1.1
Other Expenditures	8.1	8.1	10.0	6.2	9.5	9.0
Total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0

Source: Compendium of Local Fiscal Statistics, 2004.

Appendix 9 Table 15. Breakdown of Earmarked Expenditures, MOF Department of Agriculture, 2003

1. Agriculture expenditures	Farmers' training
	Agricultural technology extension
	Subsidy for high-quality seeds extension
	Expenditure for disasters in rural areas
	Subsidy for rural cooperative organizations
	Subsidy for fishery and disaster relief for fishermen
	Animal and plant husbandry expenses
	Subsidy for agricultural machinery
	Subsidy for agricultural industrialization and agricultural products machinery
2. Forestry expenditures	Forest environmental improvement
	Subsidy for natural forest protection
	Cash subsidy for preventing wind and sandstorm in Beijing and Tianjin
	Cash subsidy for returning forestry and grassland from plantation land
	Forest plant diseases and insects and pests expense
	Subsidy for seeding grazing by air
	Subsidy for grassland and forest fireproofing
	Subsidy for interest on lending to forestry and combating desertification
3. Irrigation expenditures	Expenditure for super flood prevention and for fighting drought
	Expenditure for safety before flood season
	Subsidy for small construction of agricultural irrigation infrastructure
	Subsidy for natural environment protection in 8 areas
	Subsidy for providing flood information to foreign counties for free
4. Expenditures for supporting less developed areas	Expenditure for supporting less developed districts
	Three western regions (<i>sanxi</i>) construction expense
	Expenditure for supporting state-owned poverty forestry center
5. Other	Earmarked expenditure for medium and micro enterprise development

Source: Agriculture Department of MOF, 2004

Appendix 9 Table 16. Budgetary Expenditure per capita Growth in Poorest and Richest Counties

	A	B	C	(C/B)
	All counties	Poorest quintile of counties	Richest quintile of counties	Ratio of average per capita data
1994	35.3	25.7	23.9	4.03
1995	18.5	21.6	17.3	3.89
1996	21.0	20.3	24.6	4.02
1997	9.3	8.2	7.3	3.99
1998	5.0	6.9	5.8	3.95
1999	12.2	8.3	12.3	4.09
2000	7.7	7.6	18.6	4.51
2001	25.5	27.1	30.0	4.61
2002	20.6	29.0	15.3	4.12
2003	13.9	12.6	15.6	4.24

Note: Growth Rate (A) is calculated by all counties; Growth Rate (B) is calculated by poorest 20 percent of counties in budgetary expenditure per capita, defined by 2000 data; Growth Rate (C) is calculated by richest 20 percent of counties in budgetary expenditure p.c., defined by 2000 data. Data source: Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, various years.

Appendix 9 Table 17. General Budgetary Revenue and Expenditure after Reallocation between Central and Local Governments

Year	National revenue	Central total revenue	Incl.: Central level revenue	Incl.: Local submitting	National expenditure	Central total expenditure	Incl.: Central Level Expenditure	Incl.: Transfer to local
1990	293.71	147.46	99.24	48.22	308.36	158.98	100.45	58.53
1991	314.95	142.86	93.83	49.03	338.66	164.56	109.08	55.48
1992	348.34	153.82	97.95	55.86	374.22	176.69	117.04	59.65
1993	434.90	155.78	95.75	60.03	464.23	185.67	131.21	54.46
1994	521.81	347.66	290.65	57.01	579.26	414.35	175.44	238.91
1995	624.22	386.66	325.66	61.00	682.37	452.95	199.54	253.41
1996	740.80	426.50	366.11	60.39	793.76	487.38	215.13	272.25
1997	865.11	483.07	422.69	60.38	923.36	538.92	253.25	285.67
1998	987.60	548.91	489.20	59.71	1079.82	644.71	312.56	332.15
1999	1144.41	644.73	584.92	59.81	1318.77	823.89	415.23	408.66
2000	1339.52	758.83	698.92	59.91	1588.65	1018.52	551.99	466.53
2001	1638.60	917.37	858.27	59.10	1890.26	1177.00	576.80	600.20
2002	1890.36	1102.66	1038.86	63.80	2205.32	1412.35	677.17	735.18
2003	2171.53	1248.38	1186.53	61.86	2465.00	1568.15	742.01	826.14
2004	2639.65	1511.03	1450.31	60.72	2848.69	1830.20	789.41	1040.80
Growth form '94-04 (%)	17.60	15.83	17.44	0.63	17.27	16.01	16.23	15.85

Unit: RMB billion

Source: Finance Yearbook, 2005.

Appendix 9 Table 18. Township Government Revenue

	Self-raised funds by township government		Budgetary revenue
	Finance Yearbook	Accounting Yearbook	Local Fiscal Statistical Material
1996	27.29		
1997	29.58		
1998	33.73		
1999	35.89		
2000	40.33	35.48	107.16
2001	41.00		
2002	27.20		
2003	29.31	28.08	129.30

Unit: billion RMB

Source: Finance Yearbook, 2005; Accounting Yearbook, 2001, 2004; Compendium of Local Fiscal Statistics, 2003; and World Bank (2002).

Appendix 10. Central Government Expenditures for Rural Development

This Appendix discusses earmarked transfers in the context of (central-level) “*sannong*” spending, the most widely used and discussed in China, i.e. In addition, we look at government spending on “greater agriculture,” probably the best defined category of overall public expenditure for rural development. Obviously, these categories do not cover all public expenditures for rural development. The largest part is what is spent at the county and township level.

The Central Government reports on its public spending for the “*sannong wenti*”. As in most other countries, there is no reporting of overall “rural” (*sannong*) expenditure in China. However, the Central Government reports on its *sannong* spending. It includes both what the Central Government finances at its level, e.g., for national-level agricultural research or the administrative costs of key line agencies, and – mostly – central transfers earmarked for specific rural purposes. This is widely publicized and discussed, and provides information about the Central Government’s commitment to rural development.

However, the concept of *sannong* has to be interpreted with care. Of course, when interpreting this public expenditure concept one should also be aware that there are other, non-fiscal measures through which the (Central) Government supports agriculture, including border measures and price controls. In addition, this does not provide a comprehensive picture of the government’s expenditure on *sannong* as a whole. The following should be kept in mind:

- *The sannong concept does not include non-fiscal support to agriculture.* Non-fiscal support to farmers, however, is even greater than budget support, as reported in the recent OECD report (OECD 2005b). During the 2000-2003 period, price supports to farmers through the use of import tariffs, tariff-rate quotas, and price controls accounted for 56 percent of the Producer Support Estimate (PSE), which is the indicator of the annual monetary value of gross transfers from consumers and taxpayers to support agricultural producers arising from policy measures which support agriculture.
- *The sannong concept does not include all local government “sannong” expenses.* While the “earmarked transfers” included in the concept are reflected in the local government’s budget, spending from own revenues of local governments is not included. The concept does not include the “matching” funds of local governments for implementing the interventions, nor any additional resources that local governments allocate to rural development. Overall, the larger part of government spending for rural development is from local governments.
- *The sannong concept also does not include all Central Government spending related to agriculture, rural areas, and farmers.* First, many if not all transfers, including those for minority areas, salary increases, etc., benefit rural areas, but also urban areas and are not included in the concept. Second, it does not include extra-budgetary or off-budget expenses. This generally includes rural development projects by international donors. Third, it is not clear if the concept includes all agricultural price subsidies. For example the 2005 Statistical

Yearbook puts the 2004 budget expenditure for “Subsidies for Price Increases in Grain, Cotton, and Edible Oil” alone at RMB 66 billion (for all levels). Similarly, it is unclear if expenses to support the ADBC or other rural financial institutions are accounted for. Finally, not all central-level spending which is clearly directed toward “rural” areas is included in the concept, for example the appropriations to ensure the normal operation of town and township governments.⁹⁵

- *Only a limited breakdown of “sannong” spending is made public, limiting the transparency of the measure.* The categorization chosen seems to partly reflect the separate responsibilities of different departments within the MOF and the NDRC for various funds. The expenditure items for 2003 and 2004 that we obtained from the MOF are not easily comparable with other sources of information, such as the China Finance Yearbook. Even where the same terms have been used, the figures might not be consistent with other sources of information.

Overall central fiscal expenditure for rural development has steadily increased. The substantial involvement of the Central Government in rural expenditure reflects Central Government priorities, but also the imbalances in the intergovernmental fiscal system. The categorization of the central *sannong* spending clearly shows the government’s focus on a few key areas of rural development, including capital investment, partial compensation for national policies, and, to a much lesser extent, agricultural research and rural education and health. These are areas of high priority for the Central Government. At the same time, the use of earmarked transfers as an instrument of choice might not be the most efficient. As discussed in Chapter 4, the transfer system does not solve the fundamental imbalances in the intergovernmental system. Much of the “rural” expenditure of the Central Government, especially the local (village) infrastructure expenses, are for “local” goods, i.e., confined to a specific location with limited “spill-over” effects, and therefore should be financed by local governments and communities. And while earmarked transfers can increase innovations, too many earmarked transfers for local public goods can lead to substantial administrative costs.

By far the largest expenditure item is that for capital investment, in particular rural infrastructure and forestry programs. Capital investments can be found not only in those items categorized as “capital expenditure.” For instance, most of the investments under the comprehensive agricultural development and poverty alleviation programs also go to long-term investments in rural infrastructure, land improvements, etc.⁹⁶ Moreover, the “expenditure for supporting rural production” under the “expenditure for agriculture, forestry, and irrigation” includes a large share of rural infrastructure investments. Similarly, subsidies paid to farmers under the “grain for green” program, which are part of the “expenditure for policy subsidies,” are for long-term investments in trees. Overall,

⁹⁵ Wen Jiabao (2006, p. 15): “Starting from this year, the government will appropriate RMB103 billion annually to ensure the normal operation of town and township governments and to meet the needs of rural compulsory education.”

⁹⁶ “Comprehensive agricultural development funds” includes mainly capital investments for the improvement of arable land (land leveling, irrigation, and drainage, etc.). Similarly, “poverty alleviation” funds to a considerable extent go into infrastructure such as roads, water supply, irrigation and drainage, public buildings, etc.

well over half of the Central Government's expenditure for rural development is for rural infrastructure and other rural capital investments.

A strong government emphasis on capital investments is the appropriate strategy as it has high returns for overall economic and agricultural development as well as for poverty reduction. Infrastructure investments represent some of the most efficient uses of public resources. Research on China and elsewhere has shown the substantial returns of rural infrastructure on the overall development process (see Pinstup-Andersen and Shimokawa 2006). "Lumpy" investments for capital investments are also those for which local governments have the least capacity, in particular given their inability to borrow legally. Nevertheless, there are also disadvantages to funding what are essentially local goods from the central level. Many of the problems are associated with the fact that high-level decision makers are too far removed from the localities, their specific characteristics, and information on how interventions are implemented, etc. Good program designs including thorough monitoring and evaluation can mitigate these problems.

The next-largest expenditure item is the transfers for the implementation of the RFR. These central expenditures have increased rapidly and make up about 23 percent of the total central-level rural development expenditure in 2005 and 2006. The funds allocated for 2006 amount to RMB 78.2 billion. As discussed in Chapter 2, the funds compensate only partially for own revenues lost by local governments due to the RFR.

The central *sannong* spending also includes substantial "expenditure for policy subsidies" as well as direct subsidies. In principle, such subsidies represent less efficient use of public resources than those for infrastructure, research, or education. But, of course, the specific type of subsidy and how it is implemented is also an important determinant of efficiency. In the past, much of this category was used for the so-called "grain risk fund" which supported an inefficient grain procurement system. Recently, with the continued liberalization of the grain market, substantial parts of these funds have been redirected and the government has introduced a direct subsidy for grain producers.

Direct subsidies for grain producers have increased substantially. According to the 2006 budget speech, the Central Government spent RMB 13.2 billion in 2005 on subsidies to farmers to grow grain.⁹⁷ In April 2006 the government unveiled plans to offer an extra RMB 12 billion (US\$ 1.5 billion) in direct subsidies to nearly 600 million grain growers to offset rising production costs in 2006.⁹⁸ The subsidies will amount to total direct subsidies to grain growers of RMB 26.2 billion.⁹⁹ The direct grain subsidies are part of what is sometimes referred to as the "triple subsidy" to farmers, which also includes direct subsidies for improved varieties (RMB 3.87 billion in 2005) and to purchase agricultural machinery and tools (RMB 300 million). The direct subsidies represent a much more efficient use of public resources than the outdated procurement system. Nevertheless, their impact and effectiveness should be thoroughly investigated.

⁹⁷ The program was initiated in 2004.

⁹⁸ See "Gov't Increases Subsidies to Grain Growers," *China Daily*, April 12, 2006.

⁹⁹ According to its WTO commitments, China must limit its commodity-specific support for any given commodity to no more than 8.5 percent of that commodity's total value of production. For reference, the total output value of cereals and other farm crops was RMB 820 million in 2003.

While subsidies to grain producers are an instrument to achieve the national goal of food security, the programs are creating market distortions. For example, by providing additional incentives for farmers to produce grain and cultivate marginal land, the overall welfare effect for the nation as a whole is negative and in conflict with the (also national-level) goal of protecting the environment from overuse of water and soil erosion. Moreover, these incentives divert the scarce public resources from better uses and impose a substantial administrative burden, especially on local governments.

Relatively little emphasis is placed on agricultural research, rural education, and rural health. While the Central Government has assumed some major responsibility for the financing of local rural infrastructure, its involvement in the financing of agricultural research, rural education, and rural health has been very limited. In particular, the low involvement in rural health and education reflects the time-lag in the Central Government focus over the last few years. All these areas are central to rural development. Agricultural research, much of which can be done at the national level, has some of the highest returns of all public investments for rural development. Education and health have traditionally been assigned to the local government and only recently has the Central Government assumed some financial responsibility for them. However, compared to overall government expenditures, central contributions are still very small. And while more funding is needed for the provision of these services, it is not clear if the strategy of increasing central spending will lead to the desired results. More systematic reforms of the public finance system and of the incentives for local governments and service providers are needed.

Expenditures for some public services are small or even non-existent. There are a number of areas without much or any central spending, even though they would substantially contribute to rural development. For instance, areas such as improved land administration or animal health would benefit greatly from central programs to reform the existing systems, but they still seem to be underfunded today.

There are substantial issues facing the system of intergovernmental transfers. The overall focus of central-level expenditures on rural development is in line with national policies and, in particular, the focus on capital expenditures is commendable. At the same time, there are a number of issues related to these transfers that raise some concern about the government's strategy to further increase the number of transfers and, especially, earmarked transfers, to address rural development issues.¹⁰⁰

Most fundamentally, it is not clear whether addressing the *sannong wenti* and building the “new socialist countryside” through a strong focus on earmarked transfers is an effective strategy. It seems that it is necessary to rebalance the intergovernmental fiscal system in a way that assigns responsibility to the “right” level of government and to provide it with sufficient revenues.¹⁰¹

The transfers for rural development are all relatively tightly earmarked, each with

¹⁰⁰ According to the MOF, “earmarked” transfers are planned to increase from RMB 1.4 trillion during the last five-year period, to RMB 2.5 trillion by 2010. Given current developments, these seem to be conservative estimates.

¹⁰¹ Both strategies will require a strengthened accountability system, i.e., one in which the government and responsible service providers are well monitored and evaluated and where performance can be enforced.

specific objectives and requirements. Although Appendix 10, Table 1 shows only a limited number categories of “central spending,” many of these include a considerable number of individual earmarked transfers. In practice, line ministries, for example the State Forest Administration and the Ministry of Agriculture, often administer a considerable number of projects/earmarked transfers. Earmarked transfers can be an effective means to address specific issues and increase the adoption rate of new technologies or management approaches. However, too many earmarked transfers lead to administrative burdens at all levels. The Central Government’s capacity to monitor and evaluate these projects is very constrained. At the local level, it reduces the ability for effective budget planning according to local needs. Disbursement delays exacerbate this problem. Moreover, the projects require matching funds and, at a minimum, an administrative capacity to administer these funds.

Investment Programs of Selected Central Government Agencies

The China Agriculture Yearbook reports total central-level investment in the **forestry sector** of **RMB 38 billion** for 2003. This is roughly consistent with the 2004 China Forestry Development Report that reports RMB 34 billion in state budget and treasury bond support and an additional RMB 4.15 billion for “discounted loans for forestry and desertification combating projects.” The majority of these funds is for two main programs, the “Returning of Cropland to Forests” and the “Natural Forest Protection Program” (*tianbao*). Information provided by the Agriculture Department of the MOF for 2004 (see Appendix 9, Table 12) shows that it administers budgetary resources for a total of 8 different forest-related programs.

The 2004 China Agriculture Development Report states that the MOA has invested a total of **RMB 5.96 billion** of central-level funds (RMB 4.8 of state-bond funds) to “basic construction in rural areas.” This includes RMB 5.33 billion in the following 8 areas: (i) RMB 1.96 billion for agricultural resources and an ecological protection system, mainly grasslands; (ii) RMB 1.03 billion for animal and plant protection; (iii) RMB 0.87 billion for improved seeds and breeding varieties; (iv) RMB 0.8 billion for a “rural socialized services and management system,” including the building of key fishing ports, facilities for the fishery administration, public security organs, and land reclamation, etc.; (v) RMB 0.32 billion for quality and safety systems; (vi) RMB 0.25 billion for agro-science innovation and application; (vii) RMB 0.06 billion for poverty alleviation in Wuling, the Three-Gorges Resettlement, support for Tibetan development, and demonstrations for agricultural industrialization; and (viii) RMB 0.04 billion for an agricultural information and market system. The information provided by the Department of Agriculture of the MOF, as well as the China Agriculture Yearbook, 2004, shows that there are additional resources spent on smaller programs.

Source: China Agriculture Development, 2004; China Forestry Development Report, 2004; China Agriculture Yearbook, 2004. China Agriculture Yearbook, 2004 (p. 53) reports RMB 25.3 billion spent on “Returning Cropland to Forests” and RMB 8.1 billion on the “Natural Forest Protection Program”; the figures in the China Forestry Development Report, 2004 are RMB 17.7 billion and RMB 7.0 billion, respectively.

Appendix 10, Table. Total Government Expenditure for Agriculture (in 100 m RMB)

	Total	Expenditure for Supporting Rural Production	Expenditure for Capital Construction	Science & Technology Promotion Funds	Rural Relief Funds	Percentage to Total Government Expenditure
2000	1231.54	766.89	414.46	9.78	40.41	7.75
2001	1456.73	917.96	480.81	10.28	47.68	7.71
2002	1580.76	1102.70	423.80	9.88	44.38	7.17
2003	1754.45	1134.86	527.36	12.43	79.80	7.12
2004	2337.63	1693.79	542.36	15.61	85.87	9.67
2005	2450.31	1792.40	512.63	19.90	125.38	7.22

Source: CSY 2006