

## Fiscal Decentralization and Peasants' Financial Burden in China

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Using a political economy framework, this paper explores the tax-farming nature of China's fiscally decentralized system and examines why the system incurs a particularly heavy financial burden on peasants. It points out that a political hierarchy, financed by a tax-farming system in China, fails to contain the exploitative behavior of local officials. Such a system results in expenditure devolution and revenue centralization, and peasants at the bottom of the hierarchy bear the brunt of tax burden. As the financial pressure of excessive levies and fees reaches a perilous point, peasants resort to violent protests. Unless a fiscally decentralized system with horizontal accountability mechanisms evolves, the country's ability to sustain a centralized polity may become increasingly undermined. A case study of township finance is used to exemplify the exploitative nature of China's fiscal decentralization system.

*Key Words:* Fiscal decentralization; Public finance; Budget; Corruption; Financial burden; China.

*JEL Classification Numbers:* D7, H1, H2, H4, H5, H6, H7.

## 1. INTRODUCTION

Ding Zuoming, a young peasant from Luying village in Anhui's Lixin County, learned that the fees imposed by local officials were far too high by following Central Committee debates over reducing rural taxation on the radio. Ding led a delegation of peasants to the village Party committee, and drafted a series of letters appealing to higher authorities. However, he was charged with assaulting village cadres, and when he refused to pay the fine, Ding was arrested by the village police, tortured, and beaten to death. The "Ding Zuoming affair" was finally resolved by the arrival of a Central Committee team and a stipulated compensation to Ding's family. However, after eight years his family had still not been paid and his children had to leave school early to support the impoverished family (as reported in Chen and Wu's (2004) enlightening book *Survey on Chinese Peasants*).

The massive financial burden (*nongmin fudan*) on peasants was not unique to Luying village, but affected 900 million farmers nationwide. The issue of *nongmin fudan*, which began to surface in the late 1980s, landed at the center of China politics as the increase of the charges paid by peasants to local authorities was threatening the social stability in the countryside. The soaring skyscrapers, spreading highways, lavish five-star hotels, and luxurious nightclubs and Karaoke bars, were forged on a foundation of sacrifice, sweat and toil of hundreds and thousands of peasants. A growing literature in recent years documented the deteriorating situation in the countryside.<sup>1</sup>

The peasants were paying, as they put it, "more taxes than there are hairs on a cow." In addition to the agricultural tax that China had collected for 2,600 years, each township and village government added "three deductions and five charges" (*xiangtongchou he cun tiliu*). The "three deductions" collected by village were for collective investment, public welfare funds, and cadre compensation; and the "five charges" levied by townships, included charges for rural education, family planning, militia training, rural road construction and maintenance, and subsidies to entitled groups (Bernstein and Lü 2000, p. 744). Township governments operated in a policy vacuum without any mechanism of accountability and transparency or system of controls.

The severe financial burden on farmers had resulted in numerous peasant riots in the past fifteen years. The peasant riots of 1992 rivaled those in 1949, and have not yet subsided (Bernstein 1999, Bernstein and L 2000, Bernstein 2002, and Bianco 2001). In 2004 the government recorded 74,000 cases of rural unrest (Ang 2006). The rural revolts were mainly triggered by resistance "not just to the increase of the overall tax burden, but also

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<sup>1</sup>For example, Li Changping's *Telling the Prime Minister the Truth* and He Qinglian's *Modernization's Pitfall*, and Chen Guidi and Wu Chuntao's *Survey of Chinese Peasants*.

to the number of taxes and various supplementary charges and levies that are imposed haphazardly and even illegally, in order to fund, or under the pretext of funding, some particular project or other” (Bianco 2001, 248-249).<sup>2</sup>

Aware of the conventional wisdom that “the water can make the boat float, but it can sink it too,” China’s central leadership has paid close attention to the issue of peasants’ burden, and since the early 1990s a series of measures have been taken to tackle the problem. As early as in 1990, the State Council issued an “announcement” (tongzhi) and made a “decision” (jueding) regarding the “peasants’ burden” problem. “Regulations on Peasants’ Burden and Labor” in 1991 limited the “three deductions” and “five charges” paid to the village and township to no more than 5 percent of a household’s net income (Aubert and Li 2002). In 1996 the State Council sent top officials to Henan, Hunan, Hubei, Anhui and Shanxi provinces to ensure that the tax reduction was being properly implemented. And in May 1997, four more documents on the peasants’ burden problem were issued. In 2003, the rural Tax-for-Fee reform made its national debut, aimed at abolishing agricultural taxes and innumerable charges.

The current leadership is increasingly attentive to the grievances from the countryside, and has been talking about building a harmonious society, steering away from a blind pursuit of growth and paying close attention to the well-being of the people. It represents a shift in the party’s thinking. As China is keen on developing “a new socialist countryside”, a major goal of the new five-year economic program, a series of favorable policies will be implemented to completely rescind the agricultural tax, provide free rural compulsory education, strengthen new rural insurance schemes, promote modern agriculture, shift the government’s priority in infrastructure investment to the countryside, and improve county and township fiscal management systems (Wen 2006).

However, the reality is that decisions announced in Beijing are frequently not fully implemented in counties, towns and villages. Up to now, the peasants’ burden seems far from resolved in spite of Chinese leaders’ escalating rhetoric of alleviating peasants’ financial burdens and the dutiful propaganda slogans adorning walls in the countryside: “For the People” or “The People Work for Themselves”. Before the tax-for-fee reform, the official restrictions that limited rural fees no more than 5 percent of local per-capita household net income were commonly ignored (China Development Brief 2000 and Keidel 2005). In 2005, a quarter of government revenues paid the salaries and expenses of the 6 million officials at all levels, including banquets, chauffeured cars and trips abroad as well as salaries (Cody 2006).

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<sup>2</sup>This conclusion of the causes of peasant revolts is also shared by Bernstein and Lü (2000, p. 742-63).

It remains to be seen whether the comprehensive rural reform promoted in the new five-year plan will significantly improve the situation for peasants.

This paper sheds light on the impact of fiscal decentralization on the excessive peasants' financial burden in China. Fiscal decentralization has been a central component of China's economic policy since the opening-up and economic reform was initiated in 1978. Under the fiscal contract system (1980-93), tax collection was localized. Each level of subnational government contracted with the immediately subordinate level for revenue sharing either by proportion or a fixed quota with a percentage rate. The terms of contract were determined by negotiations between various levels of governments.

The tax-sharing reform in 1994 replaced the fiscal contract system with a tax assignment system, which for the first time explicitly defined central, shared, and local taxes between the Center and provinces. The tax collection was also split into central and provincial administrations, with the former collecting central and shared taxes and the latter collecting provincial taxes.

Under the fiscal contract system, China experienced unprecedented economic growth. Those who attributed the remarkable economic performance to fiscal decentralization argued that the material gains (fiscal retention) derived from the fiscal contracts with the Center (or an upper echelon) motivated local officials to spearhead the reform (Oi 1992). Others credit fiscal decentralization with restraining the Center's predatory behavior, enhancing the accountability of subnational governments, and tightening budget constraints (Qian and Weingast 1997; Qian 1998; Qian 1999). Theoretical arguments that fiscal decentralization improved allocative efficiency and enhanced the accountability of subnational governments were overshadowed by the protectionist behavior of subnational governments, which often led to "backward specialization", reduced allocative efficiency and softened budget constraints. This actually hindered macroeconomic stability and regional economic growth (Yang 1997; Steinfeld 1999; Young 2000).

These conflicting observations suggest a series of questions: why local officials' entrepreneurship and their enhanced accountability did not result in allocative efficiency and an optimized economic structure? Where and how had local officials' entrepreneurship been diverted? To whom were local officials held accountable? And to what extent do the answers to these questions shed light on the phenomenon — "local officials drive the people to rebel" (*guan bi min fan*) — in China's countryside?

This paper reconciles the contradictory observations of the effects of fiscal decentralization by arguing that fiscal decentralization in China is by nature tax farming, an incentive structure that dictates the behavior pattern of local agents. The behavioral patterns of local officials show that they pursue their parochial interests and self enrichment over enforcing

central policies, which leads to economic and social consequences including the unbearable financial burden on peasants.

The paper proceeds as follows. Section 2 examines the tax-farming nature of China's fiscally decentralized system and analyzes why such a fiscal system results in heavy financial burden on peasants. It also compares the contemporary fiscally decentralized system in China with its historical counterparts to show how they differ and why they stay much the same. Section 3 lays out the economic and social consequences of the tax-farming fiscal system in a case study of government finance at township level, the lowest bureaucratic echelon dealing directly with peasants. Section 4 discusses the political consequences of such a fiscal system and analyzes possible policy alternatives. Section 5 concludes.

## 2. TAX FARMING: THEORY AND PRACTICE

### 2.1. Tax Farming in Theory

This section examines how fiscal decentralization started in 1980 in China and how this practice fits into the configuration of tax farming. By definition, tax farming is “a system wherein the right to collect certain taxes [from a given region] owned by the state is auctioned off to the highest bidder” (Stella 1993, p. 217). The tax farmer (the tax-collecting agent) pays the bidding price (usually a lump sum) to the national treasury and “the difference between that sum and the sum actually collected represented his profit or loss.”<sup>3</sup> A truly competitive auction signals the profitability of sectors to which the auctioned tax applies (Çizakça 1989). In other words, if the auction on tax farming rights was perfectly competitive, the price of tax collection rights would exactly measure the true cost of efficient tax collection. While, in theory, tax farming could be an efficient mechanism of public finance, in practice it has rarely if ever operated in a transparent and competitive fashion as the state desired. For example, during the Roman Empire, the Censor at Rome auctioned the tax-collecting contracts every five years and fixed the remittance at the initial auction price, but “not much [else] was known about these auctions, which may not have been open auctions at all” (Balsdon 1962). The competitiveness of the auction is also undermined when the retention permitted to the regional agents (after remittance to the Center) is earmarked for specific central mandates. For example, in the Ottoman Empire for the period from 1520 to 1697 A.D., the prices of tax farming, which were earmarked for paying the salaries of the military, were either stagnant or frozen.<sup>4</sup> Under these circumstances,

<sup>3</sup>Columbia Encyclopedia, 6th ed., s.v. “tax farming.”

<sup>4</sup>Generally in a competitive bidding process, the “prices” should have been bid up over a long period of time regardless of short-term shocks that could have temporarily prevented the bidding prices from going up.

the bidding process was replaced by negotiations between the Center and its local military agents. The amount turned over to the Center fluctuated widely over time; the military agreed to pay a higher share to the Center (or the Center succeeded in increasing the share) in some years and bargained to reduce such dues in others (Çizakça 1993). Negotiations and renegotiations of the contracted amount pervaded the entire system of the Ottoman Empire (Darling 1996). In other cases, such as in the Roman Empire, tax-collecting companies were “strong enough to force the Senate to reduce the sum bid by a third” (Balsdon 1962).

A practical definition of tax farming should incorporate the fact that the bidding process is the second nature of this revenue generation mode. Hence, tax farming is a revenue generation system mediated through a middleman (tax farmer) who “stands between the landlord or state and the serf-tenants” (Fadl 1992). The tax farmer pledges to pay a fixed amount to the state (or the land owner) and then remunerates himself through extra levies placed on the serf-tenants (Fadl 1992).

Tax farming was used in republics like the Roman Empire, and authoritarian regimes such as Pharoic Egypt, ancient China, and the Ottoman Empire. Tax farming was also extensively practiced in early modern Europe and colonized Southeast Asia before the 20th century (Copland and Godley 1993, and Reid 1993). It tended to be a relatively effective method of revenue generation when agriculture was the dominant production mode in a vast geographic area and the bureaucratic institutional setting was modest.

First, tax farming carried low risk for the Center (Çizakça 1989). In the pre-modern history taxes were mostly levied on land and people in the form of physical goods because it was more important for a ruler to ensure the states proportion against a volatile agricultural output than to maximize its revenue proportionately against total output, as in the modern times. In recognition of the state’s fiscal prioritization, a regional tax farmer committed to remit a fixed amount of revenue to the Center, often in the forms of crops. Given that crop production depended on the weather, tax farmers carried the risk of revenue loss during poor harvests (lower tax collection than the contracted amount to the Center). Although tax farming ensured central revenue and devolved risks associated with revenue loss to the local agents or tax farmers, such assurance was (and is) achieved at a high transaction cost—the tax farmer retained all revenue that exceeded his obligation to the Center when the harvest was successful. By fixing the “price” paid to the Center on nominal terms and sometimes for several years, tax farming attributed the residual revenue, generated from the expansion of the economy, to the party that controlled tax collection in the long run, although it also bore the burden of a shrinking residual in waning years. In other words, while permitting a level of fiscal predictability—in

that the Center was more equipped to establish nationwide annual budgets when tax remittances were minimally set—the tax-farming system carried low tax buoyancy; tax generation in such a system tended to be inelastic with respect to income growth. To the Center, “the purpose of farming the taxes was evidently no more than to obtain a secure cash basis for the state budget by ensuring a minimum income in currency” (Weber 1976, p. 62).

Second, rulers chose tax-farming policy when there was an “inability to construct an elaborated state bureaucracy” to undertake the task of revenue collection in an extensive geographic area or when there was a “calculation that tax farming could be more efficient than a state bureaucracy in securing revenues” (Levi 1988, p. 72). The benefit of tax farming for the central government lay in acquiring revenue in a cost-saving manner while sparing the Center from footing the costs of revenue collection (Stella 1993).

## 2.2. Tax Farming during China’s Dynastic Era

The tax-farming structure in imperial China was characterized by bargaining between the Center and its bureaucratic agents. Tax collectors were not independent agents but government bureaucracies located at subnational levels. The central and provincial governments shared fiscal revenue in a fixed sum. The Center granted the residual amount above the agreed remittance level to compensate subnational government officials. Such an arrangement gave local bureaucratic agents complete control over tax collection and revenue information, and enabled these agents to better utilize tax collection as (1) a lever to falsify the budgets against the Center and (2) an instrument to exploit taxpayers.

For several centuries before the Qin Dynasty (221 B.C.-206 B.C.), the Imperial Court relied on the tributes from the provinces governed by feudal princes, whose aristocratic origins ensured that their local officials were independent from the Court (Webber and Wildavsky 1986, p. 61). Throughout feudalism, the recruitment of government officials became increasingly institutionalized. During the Han Dynasty (207 B.C.), recommendations and examinations still favored candidates from upper-class families. This situation was gradually replaced by a more egalitarian system ensured by nationwide gentry examinations at various academic levels beginning in the Tang Dynasty, 618 A.D.). Literate, bureaucratic careerists had administered China’s tax system ever since (Hucker 1987). In due course, the political structure of China also evolved from feudalism to centralized monism run by a bureaucratic hierarchy (Hucker 1987).

The bureaucratizing process during the Qin and Han Dynasties (221 B.C.-220 A.D.) was realized via a relatively successful transformation of feudal princes and aristocrats from being landlords of their own fiefs to

being landowners that held offices with the authority to collect taxes under their jurisdiction (Wang 1980; Weber 1976; and Huang 1999). This transformation ensured the success of bureaucratization and nominal centralization, incorporated tax farming into the remuneration system of the entire officialdom, and ensured payment at each hierarchical level. The Center succeeded in constructing an elaborate bureaucracy without having to pay local agents. Rather, local agents subsidized themselves by reserving a proportion of the payments-in-kind collected on behalf of the emperor or by simply remunerating themselves for their services (e.g., rice, silk, etc.). For example, from the time of the Three Kingdoms (220 A.D.-265 A.D.) to the early Jin Dynasty (265 A.D.-420 A.D.), the salaries of officials were extremely low with periodical breaks due to financial difficulties at the Center. Civil officials relied on random grants, and military officials depended on robbery (Huang 1999, pp. 149-151). This situation was often repeated at the turn of dynasties.<sup>5</sup> As the fiscal system became increasingly decentralized to appease the regional powers during the Sui (581 A.D.-618 A.D.) and Tang Dynasty (618 A.D.-906 A.D.), the cadre of bureaucrats expanded at an alarming rate, which tremendously exacerbated financial burdens at various government levels (Huang 1999, pp. 157-202). When the Center faced increasing financial constraints, Yang Yan, the Chancellor of the Emperor Dezong, introduced a tax reform in 780 A.D. to balance the government's budget.

One of the most important principles of this reform period was to set local tax levels based on the total government financial needs.<sup>6</sup> Should the government be incapable of controlling the growth of its spending, which was a typical problem of an authoritarian regime (Wildavsky 1985), indeed ordinary people had to bear the brunt of the tax burden. As a result, various levies and corvée impoverished the society, forced people to leave their hometowns, and even spurred rampant collective tax resistance (Huang 1999). This phenomenon often repeated itself as each dynasty came to an end.<sup>7</sup> The Song Dynasty (960 A.D.-1279 A.D.) witnessed rapid development of commerce and market economy, and the collection of taxes on markets was sold to tax farmers who were usually wealthy enough to pay the franchise and colluded with local officials to exploit merchants and farmers (Huang 1999). The armed forces in the Song Dynasty, like the Ottoman Empire, were also financed by local taxes and surcharges franchised to the military (Huang 1999). The Song Dynasty maintained a highly centralized fiscal system in nominal terms, but by the end of the Southern Song, local governments were not only incapable of remitting revenue to the Center,

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<sup>5</sup>For details, see Huang (1999).

<sup>6</sup>See *Jiu Tang Shu: Yang Yan Zhuan* (Old Tang Book: Biography of Yang Yan), quoted in *ibid.*, pp. 176.

<sup>7</sup>For details, see *ibid.*



but also relied on subsidies from the Center. The same fundamental disadvantage of a centralized fiscal system with its dampened incentives for local tax collection was evident during the first 30 years of the People's Republic since 1949.

By the time of the Ming Dynasty (1368 A.D.-1644 A.D.), the excessive surcharges on land for funding military resistance to invasions from northern minority groups resulted in unbearable tax burden. During the protests against excessive tax burden, Li Zicheng led large-scale peasant revolts, and then joined forces with external invaders to overthrow the rulers of the Ming Dynasty.

China's multi-layered hierarchical bureaucracy was maintained at a high transaction cost to the Center: state officials at each echelon staked their claim on the revenue, leaving little for the Center (Webber and Wildavsky 1983, p.83). On one hand, the increasing devolution of central expenses was inevitable and officials were forced to further squeeze taxpayers through surcharges and fees to bear all central mandates and administrative costs. On the other hand, the motivation of local official tax farmers in revenue collection depended on the freedom they possessed to extract revenues (Weber 1978, p. 965). Therefore, "At each step of the tax collection—local, provincial, and national—each official extracted irregular, extralegal payments from taxpayers. This combination of fee-for-service and institutionalized bribery became a regular feature of Chinese financial administration" (Weber 1978, p. 83). This situation remained until the last day of Imperial China—the Qing Dynasty (1644 A.D.-1911 A.D) (Hsü 1969).

During the Republic of China (1911-49), a process of centralization aimed at increasing state revenues (for both military and civilian purposes), relied on an enlarging number of tax farmers and mercenary soldiers (Duara 1987). From 1911 to 1927, surcharges were used as exclusive local revenues. For instance, Jiangsu Province had 105 categories of land surcharges and Zhejiang Province maintained 74. Revenue from surcharges was 31 times the land tax in Guanyu county, Jiangsu Province, and 26 times the land tax in Haimen (Chen 1936, p. 239). "The inexorable process of the state's intrusion into and extraction from local society led to violent local protests, which contributed to growing anarchy in local society as the Chinese state power expanded to the rural China" (Duara 1987, p. 132).

In effort to revamp the fiscal system, the Nationalist Party (Guomindang) clarified the central and provincial revenue sources, but left the provincial governments to decide on revenue distribution to their subordinate levels of government. As a result, counties receiving unfunded mandates from provinces (*jiao chai bu jiao fei*) managed to meet their hierarchical obligations by charging fees (Huang 1999, p. 442). Between July 1934 and August 1935, over 5,000 levies were abolished, but equivalent number of

new levies appeared, as reported by Finance Minister Kong Xiangxi at the Sixth Plenum of the National Party (Huang 1999, p. 448).

Tax farming, on the one hand, enabled the central government to operate the empire in a cost-saving manner by delegating revenue collection as well as its associated costs to the regions. The Center financed state operations by devolving administrative costs down to local taxpayers through cascading expenditure mandates to lower echelons. In addition, when the official's personal reward was proportional to the amounts collected, tax farming might also increase national revenue (Webber and Wildavsky 1986). Given the nature of imperial officials' remuneration based partly on their personal initiatives and the retention of any surplus beyond the amount collected for the Center, the system had a built-in inducement for rent-seeking behavior. This is "because when the state abrogates control over minor officials, it must condone excessive zeal in collection of fees, and close its eyes when officials take bribes or commit other irregularities" (Webber and Wildavsky 1986, p. 133). In other words, "although tax farming facilitates monitoring the outcome, it compounds the problem of monitoring the process. The greater the decentralization, the more difficult it is to monitor the process and achieve accountability" (Stella 1993, p. 219).

The implementation bias of subnational agents became a systematic byproduct of the incentives created by the tax-farming system that "rewarded" the bureaucrats/tax farmers who abused the system for parochial or personal gains. This undesirable outcome of the tax-farming system lies at the heart of the principal-agent relationship that dictates the financial flows of tax revenue. Tax farming could be a private solution to revenue generation only when tax farmers operated "at the point where private marginal revenue equals private marginal cost," (Stella 1993, p. 217). This optimal solution was only possible when tax farmers bore the full cost of revenue collection. In practice, however, the cost of revenue collection could be and actually was passed on to the taxpayers and the Center. The problem lay in the split of the property rights over taxation: the Center had the ownership over all tax bases, while the agents had effective control over profit-making on the same tax bases through the revenue production processes. Bureaucratic tax farmers, therefore, had no interest in preserving the tax bases, to which they had no claim whatsoever. They tended to maximize their income by reducing the remitted amount to the Center and maximizing the revenue they actually collected through exploitative practices. Consequently, the expansion of a bureaucratic system for tax collection was almost inevitable. This was by all means not exclusive to China's Dynastic cases. For example, the syndicate of tax collectors in Ancient Rome and seventeenth century France employed so many tax collectors that it more than replicated inefficient government bureaucracy

and directly contributed to the worsening of already restrained government finance (Webber and Wildavsky 1986, and Collins 1988).

As manifested by the vicissitudes of Chinese dynastic history, the decline of a regime financed by tax farming is inescapable because the state's own capacity of controlling and exploiting the revenue resources was abused by the unfettered discretion granted to the local officials or the official tax farmers (Webber 1978). The vital financial resources that the center politically and economically relied on were progressively pocketed by regional tax farmers, which in turn enhanced the bargaining power of localities.<sup>8</sup> Max Weber summarizes the economic consequence of tax farming as follows (Weber 1978, p. 199):

A state which collects money taxes by tax farming is a favorable environment for the development of politically oriented capitalism,<sup>9</sup> but it does not encourage the orientation of profit-making activities to the market. The granting of rights to contributions and their distribution as benefices normally tends to check the development of [market] capitalism by creating vested interests in the maintenance of existing sources of fees and contributions. It thus tends to stereotyping and traditionalizing of the economic system.

Consequently, “the long-run historical tendency set in motion by political capitalism is in the direction of feudal — or patriarchal-type economic structures” (Love 1986).

A financially restrained central government coupled with exploitative local agents may lead to insidious consequences. The empire may either be restrained or ultimately dismantled because “its agents continually ‘disappear’ into civil society, bearing the state's resources with them” (Mann 1984). The exploitative practices of tax farmers might also propel those being over-taxed to political opposition, which eventually leads to political and social instability—as Max Weber observed (Weber 1978, p. 965):

The control and full exploitation of the fiscal resources for the lord's own use is surrendered and perhaps, depending upon the measure of freedom left to the official or the office- or tax-farmer, the long-run yield capacity even endangered by ruthless exploitation, since a capitalist [tax farmer] will not have the same long-run interest in preservation of the subjects' ability to pay as the political lord.

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<sup>8</sup>For a discussion on the trade-off between transaction costs and relative bargaining power, see Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988), p. 17-29.

<sup>9</sup>“Political capitalism” is used by Weber (1978) to describe “non-market types of profit making” (Love, 1986). Love (1986) interprets the term as a system within which profits are directly derived from the political domain rather than from the expansion of markets that are driven by the commercial activities intends to satisfy the demand for consumption.

In contrast to other ancient empires, where tax farming was practiced in the form of central government licensing the right of certain taxes collection to private bidders, Imperial China merged the business of farming taxes into the Imperial bureaucracy. This was a significant institutional invention resulting, in part, from the increasingly institutionalized bureaucratic system since the Han Dynasty (206 B.C.).

The most distinctive feature was the hierarchy of cascading authority within the bureaucracy each level of bureaucracy exercised discretion and authority to farm the taxes of the adjacent subordinate level. In such a structure the burden of taxation was inevitably pushed downward to individual taxpayers. This bureaucratic tax-farming system, whereby one level of government was empowered to farm the tax revenue of the adjacent lower level, gives rise to two potential consequences. One is that the bureaucratic tax-farming system could make tax farmers more interested in preserving the political regime upon which their careers depend. Hence their benefits in preserving the tax base in the long run could be consistent with that of their political lord the central government. The other outcome is a tendency of bureaucratic tax farmers to perform additional administrative functions that amplified the need for extra revenue and tax power. This outcome implies enhanced motive and capacity to exploit taxpayers, which in turn increases the risk of revolts by taxpayers against the central government. An examination of China's dynastic past supports the proposition. Thus China's long-standing history of peasant revolutions provoked by extortionate levies which often resulted in the overhaul of the existing dynasty demonstrates that the modus operandi of bureaucratic tax farmers in China was not fundamentally different from those in other regimes in history. While a typical tax-farming system designed to "franchise unprincipled individuals to exploit the peasantry unchecked," may have contributed to the decline of, for example, the Ottoman Empire (Darling 1996, p. 119), Chinese bureaucratic tax farmers, with their careers dependent on the regime, were supposed to have enhanced behavioral compliance with institutional and ethical constraints that individual tax farmers in other regimes might be free of. However, as long as the ownership of economic resources was separate from the control over profit-making on the same resources—where the former belonged to the Center and the latter to the agents—bureaucratic tax farmers would not be encouraged to encompass the interest of the Center as their own. In this respect, tax farmers, be they bureaucrats or individuals, are identical in their pursuit for personal gains at the expense of the Center. The bureaucratic element of the Chinese tax-farming system by itself failed to restrain officials behavior of maximizing self-interests.

Historically, rulers usually believed that "promoting ideology may reduce the costs of enforcement" (Levi 1988, p. 52), provided that there

was no free-rider problem.<sup>10</sup> But the free-rider problem could be and was prevalent in the tax-farming system. It was believed by bureaucratic tax farmers that their individual compliance with the moral code in the face of utility-maximizing behavior on the part of others could not save the regime. Rather, following the herd was the only way to survive. In China's political culture, the moral code fashioned on the model of uncorrupted officials only reflected the fact that such examples were rare in reality (Solomon 1971). The pan-moralization of Confucian ethics on gentry values was therefore ineffective in ideologically enhancing the compliance of bureaucratic tax farmers.

Under a unitary hierarchical system, the choice of local officials was also limited—to obey hierarchical mandates and prevail or defy and become marginalized. The choice by most officials to remain in the officialdom fundamentally explains an unchecked central government and its unrestrained spending expansion. Given each echelon with a lowerarchy had the propensity to devolve expenditures, the echelon at the bottom had no choice but to pass the financial pressure directly onto taxpayers, or peasants. These taxpayers, in the absence of any institutionalized form of political participation, could only resort to violent expression when they were no longer able to stand the financial burdens.

### **2.3. Fiscal Reforms of the First Phase (1980-93)**

A highly centralized tax system dominated the first 30 years of the People's Republic (1949-79). During this period, the central government had exclusive say on revenue<sup>11</sup> and most of the expenditures. Subnational tax administrations, as the Center's agents, collected and remitted all taxes to the Center. Expenditures at subnational level were mainly financed by central transfers, complemented by a few self-retained local tax receipts.

The highly centralized pre-reform fiscal system (before 1980) was rigid, with little incentives installed to spur local tax collection and promote efficient use of revenues. It became a major concern of the central authorities as the opening up and economic reform made its national debut in the late 70s. In the first phase of fiscal reforms (1980-93), revenue was decentralized, with the provincial authorities still collecting all taxes, in the form of negotiated contracts with the Center. The contracts defined provincial revenue-remittance targets, which ensured financial flow to the Center. The Center allowed provinces to reserve any residual amount that exceeded the contracted remittance to the Center to remunerate themselves for (1) superior regional economic performance, and (2) assiduous tax collections.

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<sup>10</sup>Douglass C. North (1985, p. 394) measures ideological compliance by "the premium people are willing to incur not to free ride."

<sup>11</sup>The Center had sole discretion over what revenues were to be collected and at what rates.

Provincial governments thus acted as the de facto broker between the Center and subprovincial administrative units (e.g., municipalities, provincial state-owned enterprises (SOEs), etc.) to ensure that revenue-remittance targets were met on the one hand and on the other hand they made profits by extra levies on the same tax bases. During this period, the Center ended up making contracts that varied from one province to another. Expenditure was also decentralized under the circumstance that the subnational governments also had the discretion of spending the retained revenue. In the meantime, provincial governments were required to supplement the shared revenues by their self-generated income to balance their own expenditures (Wong 1991).

Apart from negotiating with the Center over sharing terms in order to reserve as much as possible, the provinces enjoyed exclusive control over tax collection, which enabled them to act strategically to escape sharing their revenues with the Center through the following ways: (1) transferring budgetary to extra-budgetary revenues, which were under the sole control of local governments; (2) granting generous tax concessions to local enterprises so that benefits could be accrued within the enterprises in the jurisdiction of subnational governments; (3) duplicating small and medium-sized SOEs (under the jurisdictions of subnational governments, where the income taxes go); and (4) establishing Special Economic Zones (SEZs) to expand subnational tax bases to the detriment of the Center (Wong 1991, World Bank 1989, World Bank 1993, World Bank 1995, Bahl and Wallich 1992, and Bahl 1999). In the bargaining process throughout the 1980s, the provincial governments progressively derived fiscal autonomy from the Center. For example, the share of financial resource at the discretion of the central government declined from 54.3 percent in 1980 to 28.3 percent in 1993.<sup>12</sup>

At the same time, the Center granted provinces the discretion to structure their fiscal relations with the adjacent level in a similar fashion, which indeed opened the door for provinces to exploit their subordinate levels of government. Hence, an underlying agreement between the Center and provinces was that the Center would often turn a blind eye to the behavior of excessive collections and irregularities (Webber and Wildavsky 1986, p. 133). The Center therefore faced the same dilemma as the rulers in the dynastic era of “whether the central government was keener to punish corrupt local authorities or to extend its own control over them” (Bianco 2001, p. 89).

The fiscal contract system did not define expenditure responsibilities for different levels of governments. In response to revenue constraints, governments at a higher level could devolve expenditures to lower levels along

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<sup>12</sup>See China Statistical Yearbook (Beijing: China Statistics Press, 2000), p. 268.

the hierarchy. As a result, government expenditures were passed downward, with a disproportionate share of spending needs, including economic development, infrastructure investment, and social services, fell on local governments.

#### **2.4. Fiscal Reforms of the Second Phase (1994-present)—Retaining Nature of Tax Farming**

The 1994 fiscal reform replaced fiscal contracts with a tax assignment system, under which taxes were reassigned (by tax category) into central and provincial exclusive taxes and shared taxes. In addition, tax collection was split into central and subnational administration, with the former collecting central and shared taxes and the latter subnational exclusive taxes.<sup>13</sup>

This reform focused only on (1) the revenue side, as manifested by the emphasis on raising the share of total government revenue in GDP, and (2) centralizing government revenues toward the Center, as manifested by the emphasis on raising the share of central revenue in total government revenue.

Revenue assignment. The tax assignment was by and large congruent to the principles advocated by fiscal federalism scholars.<sup>14</sup> The Center succeeded in assigning itself the most stable and the largest tax categories, albeit only in nominal terms in the transition period (immediately after 1993).

However, the 1994 reform reassigned revenue only between the Center and provinces. Each level of subnational government was, again, authorized to structure its intergovernmental fiscal relations with the adjacent tier of government in the same fashion.<sup>15</sup> If we assume that government is a monolithic entity that systematically seeks maximum fiscal revenues (Brennan and Buchanan 1980), then this administrative latitude allowed each level of subnational governments the potential to exploit the next level down in the same fashion it was exploited by its superior by assigning itself the most stable and largest portion of revenue. As such, this reform legitimated the tax exploitation on lowerarchies, which was not fundamentally different from tax farming in a multilevel government hierarchy.

Expenditure assignment. Conventional wisdom of fiscal federalism also provides that the assignment of expenditure responsibilities at different

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<sup>13</sup>For a detailed assessment of the 1994 tax assignment reform at its initial stage, see Wang (1997).

<sup>14</sup>For the details of the principle of revenue assignments, see Musgrave (1983).

<sup>15</sup>This situation is analogous to the reform in 1930s and the fiscal contract regime (1980-93), under which each level of government in the system had discretionary power over the next lower level in structuring their intergovernmental fiscal relations—defining revenue sharing arrangements, specifying expenditure responsibilities, and directing transfers.

levels of government must precede the assignment of revenue which should be guided by their respective spending requirements and cannot be determined in advance.

Again, the 1994 reform did not clarify expenditure assignments between different levels of government. Although the central authority specified the framework that provincial budgets should follow, such guidance was given only in “principle” and was vague.<sup>16</sup> In addition, with progressive economic reform, the budgetary expenditures substantially shifted toward the public goods provisions (e.g., social services), which further drained local financial resources. The budgets of provincial governments became increasingly constrained in part due to the centralization efforts in revenue and in part due to the increasing spending mandates from the central authority. For example, the laws in agriculture, education, and science and technology all required subnational governments to spend in these areas at an increase rate higher than that of governments’ current revenue (Wang and Zhang 1998).

The problem of vague expenditure assignment has further implications in a multilevel government. “Hierarchies need something—a controlled lowerarchy—to set on top of” (Wildavsky 1985). Analogous to the tax farming practice in the dynastic era, the hierarchical government structure in contemporary China still allows the cascading of expenditures top-down. Like the central government, provinces tend to devolve expenditure responsibilities to lower levels. Local fiscal stress is exacerbated and deficits are further devolved along the executive hierarchy. Under a reasonable assumption that each subnational government attempts to devolve some expenditure responsibilities to the adjacent level, the township level of government, at the bottom of this hierarchy, inevitably shoulders inappropriate portion of responsibilities and faces increasing pressures to spend. Thus, given revenues centralization and expenditure devolution, the financial difficulties of the lowest level of government, the townships, become extremely severe. It is the lowest level of government where one can observe the essential exploitative nature of the system. This is why we address township finance in the next section.

### 3. TOWNSHIP FINANCE<sup>17</sup>

Below the 27 provinces and autonomous regions and four municipalities (Beijing, Tianjin, Shanghai, and Chongqing (since 1996)), China has 333 prefectures and 282 prefecture level cities, 2,861 county level units (counties

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<sup>16</sup>Refer to the Budget Law of China, 1995.

<sup>17</sup>All numbers are in the unit by thousand (unless otherwise specified) to be consistent with the numbers in tables used in this section.



and county level cities, and county level city districts). Below the county level, there are 44,067 township and town governments.<sup>18</sup> Township is the basic administrative division in the vast countryside. From 1980 to 1984, township level governments gradually replaced people's communes (Jacob 1985). The responsibilities for finance and tax administration were also extended to this level in 1984 as part of the "nationwide effort to push the state's revenue-capturing apparatus closer to rural people". Also, it served as a material incentive to township government officials to prompt local revenue collections (Blecher and Shue 1996).

Townships are financially starved throughout the country. Bai (2002) documented the fragile financial position of township governments in Yun'nan and Qinghai. The 1,590 townships in Yun'nan in 2000 had an openly accepted financial deficit of 0.48 billion yuan and a hidden deficit of 0.93 billion yuan. In 2000 townships in Qinghai province had a financial deficit of 160 million yuan, with an average deficit of 588 thousand yuan for each township government.

The data on township used in the following analysis represents a typical situation of township finance in Jiangsu province. The analysis is based on township budgets, 1990-99. Data for 2000 and 2001 are budgeted figures, which can be a reference for the effects of central policy change, i.e., tax-for-fee reform (*fei gai shui* in 2001). It should be noted that Jiangsu was one of the two possible case studies to examine the effects of the first round of *fei gai shui*. The other case was Anhui province. *Fei gai shui* was promulgated in April 2001,<sup>19</sup> but the implementation was halted shortly in June nationwide, due, in part, to the concern that the rural tax-for-fee policy would terminate the provision of some vital public goods traditionally sponsored by township governments via surcharges (e.g., nine-year obligatory education was financed by educational surcharges), and partly due to the strong resistance from township governments. Jiangsu at that time had already implemented *fei gai shui* before the Center called for the cessation of the policy.<sup>20</sup> By 2006, agricultural tax, a tax that China has been collecting for 2,600 years, will be completely rescinded. Although the rural Tax-for-Fee reforms are remarkably reducing the tax burden on farmers by eliminating 33.6 billion yuan of agricultural tax and over 70 billion yuan in the form of "three village deductions and five township charges" (*xiangtongchou he cun tiliu*)<sup>21</sup> (Wen 2006), a majority of township governments, especially

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<sup>18</sup>China Statistical Yearbook (Beijing: China Statistics Press, 2004), p. 3.

<sup>19</sup>Source: "Shuifei Gaige Dashi Ji," (Major Events in *fei gai shui* Reform), *Jingji Cankao Bao* (Economic Reference Daily), 27 April 2003.

<sup>20</sup>After a termination of two years, *Fei gai shui* was reintroduced in the spring of 2003, right after the completion of the 10th National People's Congress.

<sup>21</sup>The "three deductions" are collected by village: collective investment, public welfare funds, and cadre compensation. The "five charges" are levied by townships including

those highly dependent on agricultural taxes in poor areas, have to grapple with further weakened fiscal capacity.

### 3.1. Township Expenditures

A significant feature of township expenditure is the high percentage of administrative expense, in particular expenditures on personnel including payroll to teachers, cadres, and government employees. Another feature is the relatively high spending on entertainment (Zhaodai Fei), in particular for guest expenditures, in both rich and poor townships.

The following two tables show the total expenditures 1990-99 of the township we investigate.<sup>22</sup> The total payrolls to primary and middle school teachers<sup>23</sup>, to cadres and government employees are actually budgetary spending. The table reveals its disproportionately increased share in budgetary spending (the lower part of Table 1). The total payroll consumed only 21.9 percent in 1990, but jumped to 71.7 percent in 1991. From 1994 to 1995, its share in budgetary expenditure increased from 55.7 percent to 86 percent, due to the large increase in the number of people paid by the budget. From the mid 1990s, total payrolls took more than three quarters of budgetary expenditure, and beginning in 1999, it consumed the full budgetary resources (100.6 percent) and reached as high as 144.6 percent in 2000 and 120.3 percent in 2001. The payroll had to be supplemented by non-budgetary resources. The payroll to primary and middle school teachers accounted for about half of the total payroll expenditures in the decade.

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charges for rural education, family planning, militia training, rural road construction and maintenance, and subsidies to entitled groups (Bernstein and Lü 2000, p. 744).

<sup>22</sup>This township also reported the budgetary figures for 2000 and 2001, which will help to examine the effect of fei gai shui reform in 2001 on township budget.

<sup>23</sup>The policy of compensating rural teachers by township budget changed in 2001. All the remuneration of rural teachers is now covered by county budget.

TABLE 1.

Township Expenditures (1990-2001) (Thousand Yuan) a/

Year	Expenditure by funding sources			Expenditure on payroll							
	A.1. A. Budgetary expen- diture	A.2. Extra-Township fund-raising village retention	A.3. Township general fund and retention	B.1 number of teachers	B.1 Payroll to government employees (incl. admini- strative units)	B.2. Payroll to government employees (incl. admini- strative units)					
1990	3284.3	1758.3	455.0	1071.0	16000	2410	385.6	1720	275.2	270	43.2
1991	1812.4	537.4	1275.0	1275.0	15600	2470	385.3	1870	291.7	340	53.0
1992	2857.8	1043.4	521.4	1293.0	21140	3060	646.9	1990	420.7	370	78.2
1993	3135.5	1264.0	558.0	1313.5	30510	2620	799.4	1840	561.4	320	97.6
1994	3817.0	1571.0	852.0	1394.0	31010	2820	874.5	1980	614.0	390	120.9
1995	4382.6	1659.2	1291.7	1431.7	31850	4480	1426.9	2250	716.6	650	207.0
1996	5673.7	1763.3	2356.9	1553.5	32120	4260	1368.3	2250	722.7	580	186.3
1997	7700.7	2043.1	2983.4	2674.2	35570	4450	1582.9	2240	796.8	790	281.0
1998	7557.6	2096.7	2786.7	2674.2	46230	4350	2011.0	2170	1003.2	760	351.3
1999	8998.7	3059.4	3265.1	2674.2	68540	4490	3077.4	2540	1740.9	680	466.1
2000	17242.6	5540.9	6877.5	4824.2	84790	9450	8012.7	3950	3349.2	1190	1009.0
2001	13562.7	8530.2	2431.5	2601.0	108000	9500	10260.0	3950	4266.0	1240	1339.2

Year	Percentage share of expenditure under corresponding funding sources in total expenditure			Growth rate of salary	Total payroll share in budgetary expenditure		Percentage share of corresponding payroll category in total payroll expenditure	
	A.1.	A.2.	A.3.		B.1	B.2.	B.1	B.2.
1990	53.5	13.9	32.6	-2.5	21.9	15.7	81.8	2.5
1991	29.7	70.3 b/	70.3	35.5	71.7	54.3	35.8	9.9
1992	36.5	18.2	45.2	44.3	62.0	40.3	52.2	7.5
1993	40.3	17.8	41.9	1.6	63.2	44.4	47.9	7.7
1994	41.2	22.3	36.5	2.7	55.7	39.1	53.2	7.7
1995	37.9	29.5	32.7	0.8	86.0	43.2	44.3	12.5
1996	31.1	41.5	27.4	10.7	77.6	41.0	48.4	10.6
1997	26.5	38.7	34.7	30.0	77.5	39.0	47.2	13.8
1998	27.7	36.9	35.4	48.3	95.9	47.8	35.4	16.8
1999	34.0	36.3	29.7	23.7	100.6	56.9	27.9	15.2
2000	32.1	39.9	28.0	27.4	144.6	60.4	21.4	18.2
2001	62.9	17.9	19.2	27.4	120.3	50.0	34.3	15.7

Note: a/ Number of 2000 and 2001 and budgeted instead of actual figures.

b/ This number indicates the combined share financed by extra-budgetary and Township general fund and village retention.

The lower part of Table 1 also shows the spending shares financed by different revenue source. For most of years in 1990s, the budgetary resources contributed to roughly one third of the total expenditures, with only 26.5 percent in 1997. The share of extra-budgetary expenditure increased from 13.9 percent in 1990 to 41.5 percent in 1996 and stabilized at a level close to 40 percent until 2000. Township general fund-raising and village retention dropped gradually from 45.2 percent in 1992 to 28 percent in 2000. The structure of financing changed dramatically in 2001 when the rural tax-for-fee reform was launched in Jiangsu.

As the township government expanded and the number of teachers increased,<sup>24</sup> the payroll entitlements pushed all other expenditures off the budget. The non-payroll township expenditures were financed by either extra-budgetary sources or various levies collectively named as “township general fund and village retention” (xiangtongchou he cun tiliu). Table 2 summaries the expenditures other than payroll.

The upper part of Table 2 shows the breakdown of township expenditures (other than payroll) by category and the lower part of the table shows the corresponding percentage share. The most notable expenditure category is the spending on entertainment (Zhaodai fei), which is used for treating associated people and working units at a higher level of the hierarchy or of the same level, or sometimes just “entertaining” themselves. It is controlled by the exclusive discretion of township cadres, and its lack of transparency is regarded by the villagers as a symbol of corruption. It increased rapidly and consumed an equivalent of around 50 percent of expenditure (other than payroll) throughout the 1990s.

Newspaper and magazine subscription is also a notable expenditure item in township budget. Annual newspaper and magazine subscription took 10 percent in total expenditure (other than payroll) in most of the 1990s. There have been grievances by township leaders and villagers about subscription mandates, e.g., imposed by the party hierarchy (e.g., Renmin Ribao by Central Propaganda Ministry) or by the central or the provincial government. A township government had to subscribe to several newspapers and periodicals from each upper hierarchical level — county, prefecture/city, province, and the Center — all of which believed that having their designated messages delivered to the grassroots was instrumental to ensure their grip on power. Or the mandate of subscription is an exertion of authority itself. Entertainment expenditure, and newspaper and magazine subscription, accounting for a combined share of around 60 percent, are the two most disliked spending categories by the people.

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<sup>24</sup>As shown in Table 1, number of people paid by budget increased from 2820 in 1994 to 4480 in 1995, and from 4490 in 1999 to 9450 in 2000. Number of teachers also jumped in these two time periods.

TABLE 2.

## Township Expenditures by Category (Thousand Yuan)

Year	Current expenditure (other than payroll) by category								Capital Expenditure	
	Total current expenditure other than payroll	A. School maintenance	B. Expenditure on voluntary soldiers	C. Expenditure on people's militia	D. Five guarantee family subsidies	E. Welfare of needy families	F. Catastrophe relief	G. Social Safety net	H. Entertainment expenditure	I. Newspaper and Magazine Subscription
1990	150.3		19.8	2.5	45	5			65	13
1991	258.0		23.7	3.2	52.3	8.7	79.50		71.7	18.9
1992	282.8		31	5	59	9.8			149	29
1993	349.6		47	7.1	63	11		190.5		31
1994	473.5		53	8.5	77	13			279	43
1995	606.3		62	8.5	81		86.80		311	57
1996	644.0		71.7	10.3	94	16			383	69
1997	920.9		126.1	36	228.8				451	79
1998	1001.3		126.1	36	228.8		48.40		473	89
1999	1075.4		126.1	36	228.8		48.40		537	99.1
2000	1498.8			59.9	400.8	62.6	48.40		783	144.1
2001	460						100.00		288	72
										300

## Percentage share of corresponding expenditure category in total current expenditure (other than payroll)

Year	Total	A.	B.	C.	D.	E.	F.	G.	H.	I.	J.
1990	100.0		13.2	1.7	29.9	3.3			43.2	8.6	
1991	100.0		9.2	1.2	20.3	3.4	30.8		27.8	7.3	
1992	100.0		11.0	1.8	20.9	3.5			52.7	10.3	
1993	100.0		13.4	2.0	18.0	3.1			54.5	8.9	
1994	100.0		11.2	1.8	16.3	2.7			58.9	9.1	
1995	100.0		10.2	1.4	13.4		14.3		51.3	9.4	
1996	100.0		11.1	1.6	14.6	2.5			59.5	10.7	
1997	100.0		13.7	3.9	24.8				49.0	8.6	
1998	100.0		12.6	3.6	22.9		4.8		47.2	8.9	
1999	100.0		11.7	3.3	21.3		4.5		49.9	9.2	
2000	100.0			4.0	26.7	4.2	3.2		52.2	9.6	
2001	100.0						21.7		62.6	15.7	

The tax-for-fee reform (Fei gai shui) initiated in 2001 forbids township governments from fund-raising activities and village retentions. As such, the budgeted extra-budgetary expenditure for 2001 reduced 4.446 million yuan and expenditures from township general fund-raising and village retention reduced 2.223 million yuan (Table 1, item A.2 and A.3). Although

budgetary resources increased around 3 million yuan (Table 1, item A.1), it still could not make up all the reductions from fund-raising and village retentions. The payroll continued to increase by about 2 million (from 8 million in 2000 to 10.26 million in 2001). As a result, township government had to cut non-payroll expenditures in order to balance the budget for 2001. Table 2 shows that the budgeted expenditure (net of payroll) was cut by more than 10 million yuan,<sup>25</sup> and some recurrent expenditures that traditionally assigned to township government (e.g., voluntary soldiers, people's militia, five guaranteed family subsidies, and welfare of needy families) were totally cut to zero for 2001. Although entertainment spending suffered the largest cut of half a million yuan (from 783 thousand to 288 thousand) and newspaper/magazine subscription was also cut by half (from 144.1 thousand to 72 thousand), their shares in total expenditure (net of payroll) increased respectively from 52.2 percent in 2000 to 62.6 percent in 2001 and from 9.6 to 15.7 percent. The analysis suggests that the tax-for-fee reform in Jiangsu further weakened fiscal capacity of townships to the detriment of expenditures on vital social welfare.

### 3.2. Township Revenues

The revenue of townships can be broadly categorized into industrial/commercial taxes and agricultural taxes, the former are shared with county and the latter are usually assigned exclusive to townships designated to compensate township employees and finance public services. Townships considerably rely on agricultural taxes, extra-budget resources, and a variety of township and village charges on farmers. These funds, of course, lack transparency; there is no formal definition or statistics about rural fee charges. It is common for townships in poorer areas to impose heavier charges and fees on farmers in order to get ends meet, which seriously damaged the fairness of the distribution of tax burdens (Zhao 2004). Township revenues by category from 1990 to 2001 are illustrated in Table 3.

The tax-for-fee reform significantly reduced township non-budget discretionary revenues. The estimated extra-budgetary revenue, township general fund, and village retention declined respectively from 6,898.7 thousand, 1,837.5 thousand, and 2,986.7 thousand in 2000 to 3,300 thousand, 1,441 thousand, and 1,160 thousand in 2001 respectively, which resulted in a total reduction of 5,823 thousand<sup>26</sup> in 2001. Consequently, the making-up of revenue resources fell almost completely on the agricultural taxes, which were at the sole discretion of township governments. The agricultural taxes

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<sup>25</sup>The budgeted sum of all expenditure categories other than payroll reduced from 1,499 thousand in 2000 to 460 thousand in 2001 (Table 2).

<sup>26</sup> $(6,898.7 \text{ thousand} - 3,300 \text{ thousand}) + (1,837.5 \text{ thousand} - 1,441 \text{ thousand}) + (2,986.7 - 1,160 \text{ thousand}) = 5,822.1 \text{ thousand}$  (Table 3)

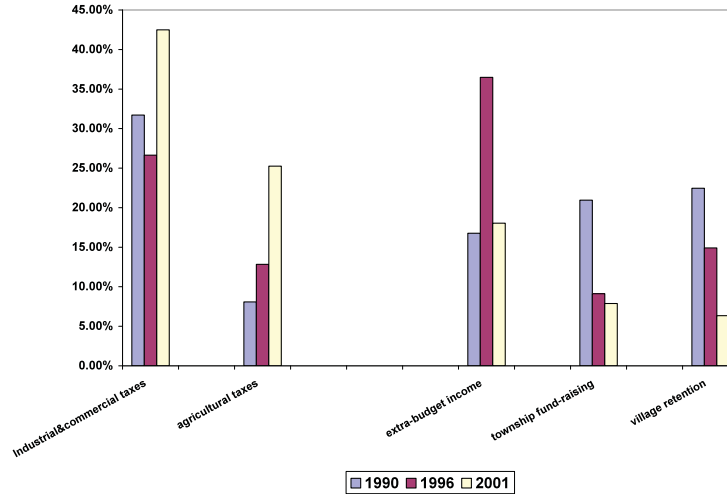
**TABLE 3.**  
Annual Growth Rate of Each Revenue Categories (Thousand Yuan)

Year	Industrial and commercial taxes		Agricultural Growth rate (A+B)	A. Agricultural Growth rate		B. Agricultural extra-special tax income		E. budget	fund-Growth rate	G. Township general Village raising income		H. Growth retention income	
	income	taxes		rate	rate	tax	tax income			rate	rate	rate	rate
1990	981.9	782.4		199.5		199.5	413.8			517.0		554.0	
1991	915.6	739.9	-5.4	175.7	-11.9	155.7	20.0	543.6	31.4	607.7	17.5	667.3	20.5
1992	1047.5	809.0	9.3	238.5	35.7	232.9	5.6	521.4	-4.1	615.0	1.2	678.0	1.6
1993	1156.0	909.0	12.4	247.0	3.6	247.0		582.0	11.6	481.0	-21.8	832.5	22.8
1994	1615.0	1039.0	14.3	567.0	129.6	550.0	17.0	852.0	46.4	598.0	24.3	796.0	-4.4
1995	1818.5	1228.2	18.2	583.3	2.9	549.3	34.0	1290.2	51.4	637.0	6.5	794.7	-0.2
1996	2575.0	1721.0	40.1	829.0	42.1	781.0	48.0	2356.9	82.7	589.7	-7.4	963.8	21.3
1997	2897.8	2043.8	18.8	829.0	0.0	781.0	48.0	2983.4	26.6	1066.1	80.8	1608.1	66.8
1998	3168.6	2314.6	13.2	833.0	0.5	781.0	52.0	2786.7	-6.6	1066.1	0.0	1608.1	0.0
1999	3536.8	2617.8	13.1	888.0	6.6	781.0	107.0	3265.1	17.2	1066.1	0.0	1608.1	0.0
2000	7037.5	5423.7	107.2	1545.8	74.1	1405.7	140.1	6898.7	111.3	1837.5	72.4	2986.7	85.7
2001	12388.6	7770.0	43.3	4618.6	198.8	4618.6		3300.0	-52.2	1441.0	-21.6	1160.0	-61.2

were, therefore, expected to be tripled from 1,545.8 thousand in 2000 to 4,618.6 thousand in the estimated budget of 2001.

Figure 1 compares the township revenue make-up in 1990, 1996, and 2001. Clearly, township finance in Jiangsu, an affluent area, also mainly relies on taxes and charges on peasants in the form of agricultural taxes, extra-budget income, and township and village charges. The ban on charging fees and other irregular levies, stipulated by the central policy, drove township governments to fill the financial gap by squeezing collection of agricultural tax, which was also completely borne by farmers.

The above analysis leads us to question the effectiveness of the tax-for-fee reform which was aimed at alleviating peasants' financial burden. As the central government faces persistent peasant revolts that are threatening social and political instability, "alleviating peasant financial burdens" has landed at the top of the political agenda. The central government reintroduced the tax-for-fee reform in a full scale in early 2003. Although our data is not updated to reflect the recent rural tax and fee policies, it is reasonable to estimate that the reform reduces the tax burdens on farmers at great expenses of further weakening township fiscal capacities which in turn undermines farmers' welfare. As we found out in 2001, townships in Jiangsu literally stopped financing expenditures on voluntary soldiers, people's militia, and subsidies to five guaranteed families and needy families.

**FIG. 1.** Township Revenue Structure 1990, 1996, and 2001

There are good reasons to be skeptical, as long as there is no mechanism to prevent upper levels in the bureaucracy from imposing unfunded spending responsibilities on the townships.<sup>27</sup>

### 3.3. Intergovernmental Fiscal Relations between the County and Townships

Generally, townships are heavily dependent on transfers from the county governments. In poor areas of the country, township finance is quite common to be directly managed by the county government, and township government is literally degraded as a department of the county government. From 1994 to 1999, intergovernmental transfers between the county and this township were still defined by an incremental contract, i.e., based on a baseline (according to the revenue of 1993) that was mutually agreed between the county and township, the township government remitted an amount with an annual increase of six percent to the county. Township governments could retain all the excess revenue collected.

Since the budget law strictly forbade local fiscal deficit in China (Budget Law, 1995), the transfer or remittance between county and township could be roughly estimated by the difference between the township budgetary expenditure and the budgetary revenue (column E in Table 4).

Table 4 shows that the budgetary expenditure (budgetary revenue net of remittance to the county) at the discretion of township government was barely enough to cover the payroll entitlements (column A in Table 4).

<sup>27</sup>See Bernstein and Lü (2000) for a remuneration of cases.



Expenditure assignments other than payroll were to be financed by sources other than budgetary income. As a result, all the expenditures except payroll had to be financed by either extra-budgetary revenue or various levies at the township level.

TABLE 4.

Streamline of Expenditure and Revenue Categories (Thousand Yuan)

A	B	C	D	E	G	H	I	J	
Total	Total	Budgetary	Budgetary	Transfers	Extra-	Extra-	Township	Income from	
Year	other than	Expenditure	revenue	from or	budgetary	budgetary	General	Township	
payroll	payroll			remittance	Expenditure	Income	Village	General Fund	
				to the		Retention	Retention	and Village	
				county				Retention	
1990	385.6	150.3	1758.3	981.9	-776.4	455.0	413.8	1071.0	1071.0
1991	385.3	258.0	537.4	915.6	378.2	1275.0	543.6	1275.0	1275.0
1992	646.9	282.8	1043.4	1047.5	4.1	521.4	521.4	1293.0	1293.0
1993	799.4	349.6	1264.0	1156.0	-108.0	558.0	582.0	1313.5	1313.5
1994	874.5	473.5	1571.0	1615.0	44.0	852.0	852.0	1394.0	1394.0
1995	1426.9	606.3	1659.2	1818.5	159.3	1291.7	1290.2	1431.7	1431.7
1996	1368.3	644.0	1763.3	2575.0	811.7	2356.9	2356.9	1553.5	1553.5
1997	1582.9	920.9	2043.1	2897.8	854.7	2983.4	2983.4	2674.2	2674.2
1998	2011.0	1001.3	2096.7	3168.6	1071.9	2786.7	2786.7	2674.2	2674.2
1999	3077.4	1075.4	3059.4	3536.8	477.4	3265.1	3265.1	2674.2	2674.2
2000	8012.7	1498.8	5540.9	7037.5	1496.6	6877.5	6898.7	4824.2	4824.2
2001	10260	460.0	8530.2	12388.6	3858.4	2431.5	3300.0	2601.0	2601.0

The tax assignment system was not introduced at the township level in Jiangsu until 2000 due to the lag of implementation as the reform went down along the hierarchy. The county had the sole discretion to structure the revenue sharing scheme with townships in the absence of any clear expenditure assignments in place between the two levels of governments. The sharing method since 2000 is more analogous to a contract scheme rather than a tax assignment formula. While the old sharing regime is effective, township governments must remit 20 percent of the increment of total industrial and commercial taxes to the county, with the year of 2000 as the base year. The budgeted remittances to the county were substantially increased for 2000 and 2001, creating a larger gap between budgetary expenditure and total payroll. And the county could and did devolve more expenditures down to the townships in response to its own budget constraints as a result of revenue centralization of the upper echelons of government.

### 3.4. Township Debt

In the absence of effective township elections (more or less in some areas than in others)<sup>28</sup> that theoretically could restrain governments' excessive taxing power, township governments are actively engaged in various fund-raising activities for projects to boost local economies. Also, township governments, faced with financial stress and the central mandate to balance budget, have innovated a variety of approaches to hide their deficit. One of the major approaches is "empty circulated revenues" (Caizheng Kongzhuang) which is partly financed by bank loans (Zhao 2004). In the 1990s, townships have accumulated large amount of debts that to various extent have incurred to individuals.

In 2000, the 1,590 townships in Yuan'nan incurred a total debt of 3.82 billion yuan which meant that the average township had a debt level of 3.3 million yuan. The structure of this debt consisted of three parts: circulating funds borrowed from the upper-level governments, loans from banks, and loans from various departments and the private sector. Townships in Qinghai in 1999 were also heavily indebted, with 3.394 million yuan of bank loans, 0.85 million yuan of fund loans, 0.25 million yuan of planned loan and 7.15 million yuan in loans from other sources. Besides the explicit debt, the townships also had a large number of implicit debts including arrears in water and electrical bills and staff wages. In Jilin Province, the combined township governments had a total debt of 1.31 billion yuan in 2000. By end of March of 2001, the unpaid salary of township government was 46.6 million yuan (Bai 2002).

Table 5 summarizes the debt situation of a township in our case. The debts are categorized into bank debt, fund-raising debt including Rural Cooperative Fund (nongcun xinyong hezuoshe) debt, debt to individuals, political investment debt (debt incurred due to failed investment in boosting political performance) (zhengji touzi zhaiwu), and other debts (mostly resulting from the generation of arenas or IOUs). All figures are the total balance of each debt category for the current year. Accumulated government debt for this township increased from 1,563.4 thousand in 1990 to 14,900 thousand in 2001. Among total government debt, the share of bank debt gradually decreased from around 60 percent to around 30 percent. Debts incurred from fund-raising<sup>29</sup> increased very rapidly, from 430.9 thousand in 1995 to 4,000 thousand in 2001. Its share in total debt increased from 9.8 percent in 1995 to 42.6 percent in 1999 and decreased to 26.8 percent in 2001. The declining share of fund-raising debt was largely ex-

<sup>28</sup>For case studies, see Zhong (1996) and Li (2002).

<sup>29</sup>Development projects, regulatory and administrative undertakings can all be financed by fund-raising, which "supposed to be voluntary but often took the form of compulsory assessment or apportionment (tanpai) on households (Bernstein and Lü 2000).

plained by the sharp increase of bank and other debts in the same period. Since 2000, township A also incurred 2,035.3 thousand debts directly to individuals in 2000, and by 2001, 1,700 thousand still on balance.<sup>30</sup>

TABLE 5.

Township Debts (Thousand Yuan)

Township A	Popula- tion capita (Yuan)	GDP per government (Yuan)	Total township		B.1 Rural		C. Political		D. Other debts
			government debt (1,000 Yuan)	A. Bank debt raising	cooperative	B.2 Debt performance incurred to individuals	investment failure debt		
1990	40379		1563.4	930					633.4
1991	40768		1612.4	1060					552.4
1992	40690		1798.5	1100					698.5
1993	40975		2953.0	1820					1133
1994	40926	1435.8	3067.7	1760					1307.7
1995	40884	2161.2	4408.4	2000	430.9	430.9			1977.5
1996	41127	4468.6	5951.3	2200	1059.9	1059.9			2691.4
1997	41029	4821.5	7268.6	2910	1219	1219			3139.6
1998	41051	4995.5	10684.9	2760	4406.2	4406.2			3518.7
1999	41060	5506.6	9468.1	2344	4032.8	4032.8			3091.3
2000	68655	5262.8	15114.3	5109.2	4456	1718	2035.3		5549.1
2001	68700	5895.2	14900.0	5200	4000	1500	1700		5700

Percentage share of debt category in total debt								
			Percentage share of sub-debt category in fund-raising debt					
1990			100	59.5				40.5
1991			100	65.7				34.3
1992			100	61.2				38.8
1993			100	61.6				38.4
1994			100	57.4				42.6
1995			100	45.4	9.8	100		44.9
1996			100	37.0	17.8	100		45.2
1997			100	40.0	16.8	100		43.2
1998			100	25.8	41.2	100		32.9
1999			100	24.8	42.6	100		32.6
2000			100	33.8	29.5	38.6	45.7	36.7
2001			100	34.9	26.8	37.5	42.5	38.3

<sup>30</sup>Based on the original numbers reported by the township governments, the calculated shares of debt to RCF and individuals for some townships don't add up to 100 percent of total fund-raising debt. We will keep them the way as they reported.

#### 4. TAX FARMING AND PEASANT REVOLTS

The tax farming system has deprived peasants from sharing in the fruits of reform and development, with urban-dwellers gaining higher income but paying less taxes; the tax farming system has also spoiled local cadres in their power abuse and corruption in the absence of any accountability schemes from below. When residents in Beijing are complaining about the impact of high percentage of private car ownership on city transportation, and when the village cadres are enjoying mobile phones, good meals and houses, peasants live hopelessly in the vast rural lands where the toilers may depend on giving blood to make a living (Chen and Wu 2004).

Several features of China's fiscal system elevate the potential for peasant revolts. First, tax farming, in its exploitative nature, allows each level of government to devolve expenses downward and centralize revenues upward, ultimately leaving the bottom level of the hierarchy, townships, financially starved. Second, the central government's attempt to restrain the excess local taxing powers by requiring them to keep a balanced budget only results in the proliferation of informal charges and fees on peasants in the absence of horizontal accountability mechanisms. "The notion of balance formalized implicit social understandings about the acceptable levels of taxing and spending," and the growth of spending is restrained by "social expectations about limits and by the level of taxation considered tolerable" (Webber and Wildavsky 1986, p. 331). While in a democratic institution, the level of tolerance can be expressed by local political participation or "voting with feet," two important channels of restraining local taxing power, such expression is simply a luxury in a hierarchical unitary state and "the balanced budget norm could be construed (and was, by hierarchical regimes) as an invitation to raise taxes" (Webber and Wildavsky 1986, p. 331). It is the case in China. The norms of balanced budgets justify the raising of taxes or instituting new ones when large increase of local government spending incurs. Moreover, the balance requirement induced a vigorous pursuit of extra-budgetary funds, fees, and irregular levies which provide financing for a major proportion of local expenditures. These non-budgetary resources are not reported and monitored by the budget, further exacerbating the problem of information asymmetry between the Center and subnational governments. Third, in the lack of horizontal accountability of local governments to their residents, local governments face few, if any, checks against their abuse of power. Instead, the current cadre system of direct appointment tends to make local officials mostly accountable to the upper/central government authorities, which has induced the indulgence of government entertaining activities, prevalence of white elephant projects, high rate of corruption, and inefficient public services provision. As local officials are not restrained by any form of citizen oversight in the current

system, they enthusiastically pursue visible economic performance as effort to get rated and promoted at the expenses of bankrupt local government and poor basic service delivery. Furthermore, the central government lacks the infrastructure and financial resources to enforce policy mandates, and also faces a dilemma of separating its agents' efforts to collect taxes from their ability to exploit taxpayers and peasants. The result is a fiscal system that exploits farmers through numerous illegal charges and fees but delivers inadequate levels of public goods and services.

Peasants resent "the number of taxes and various supplementary charges and levies that are imposed haphazardly and even illegally, in order to fund, or under the pretext of funding, some particular project or other" (Bianco 2001, p. 249). Even when Vice Premier, now Premier, Wen Jiabao pronounced the Center's ban on the local governments' excessive levies, the dictum did not prevent subnational government units from enthusiastically engaging in arbitrary levies, fines, compulsory contributions, various apportionments (*tanpai*), and fund-raising activities, all of which remained the major reason for excessive financial burdens of peasants.<sup>31</sup>

The increasing mobility of China's rural population, a phenomenon that was considered relatively inconsequential a decade ago, failed to restrain local government's excess taxing power in China. Theoretically, higher mobility should have an effect equivalent to "voting with their feet" that would restrain the excess tax power of local officials, who fear to lose tax bases than otherwise would be (Brennan and Buchanan 1980, Stein 2000). But in China, the problem resides in the general tendency of farmers to maintain strong roots in rural areas while seeking wealth in the urban cities<sup>32</sup>. Aware of the uncertain economic prospects in the city, the "floating" population keep strong connections to families left behind, and their ties to ancestral land sustain these rural-urban ties. However, the repatriation of their urban income makes their rural relatives more vulnerable to exploitation by local officials.

When the financial burden reaches a perilous limit, peasants seek various ways to resist through protests, litigation, or violent incidents. For instance, the villagers of Duzhuhu in Huangyu district have devised a set of signals to escape from tax collection — they bang a copper cymbal when a tax collection team is spotted coming from the west of the village; and a whistle is blown if the team is approaching from the east. At the sign, all the peasants grab any weapons they can and run out to attack the tax collectors (Chen and Wu 2004). Spontaneous protests, often flaring

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<sup>31</sup>Xinhua News Agency, 28 September 2000

<sup>32</sup>Premier Wen Jiabao pointed out that although an increasing number of peasants are now pursuing their personal developments in urban cities, the piece of land in their rural hometown remained to be their ultimate "social safety net" (Renmin Ribao, February 8, 2003).

into violence, appear to have taken place in many provinces. In Zizhou, Shaanxi, tax protester broke into a government building and took 40,000 yuan (USD 5,000). Mr. Ma Yenlin, leader of the protest, was sentenced to jail for five years. Farmers subsequently submitted a petition to Shaanxi Province High Court, with 30,116 signatures protesting against the ‘unjust treatment’ of Mr. Ma. (China News Digest 2000). In Daolin, Hunan, after a man allegedly killed himself due to increased taxes, thousands of peasants marched to the local government office, which ended using tear gas to disperse crowds (Los Angeles Times 1999).

Just as peasants’ revolts are getting harsh, suppressions by local officials are no less mercy. Chen and Wu (2004) document that if the peasants have no money to hand, the “tax collection team”, under the leadership of the village Party Secretary, will confiscate their pigs, furniture, grain and machinery; and in case of resistance, the team may call in the security forces and have the peasants beaten up, arrested or imprisoned. Some Chinese officials have suggested strong repression as the best response. Wu Shuangzhan and Sui Mingtai, commander and commissar of the paramilitary People’s Armed Police wrote a joint article in January 2006 urging training and preparation to put down the rural unrest. The senior leadership, while not discarding use of force, has been focusing more on tackling farmers’ underlying problems as the long-term solution (Cody 2006).

#### **4.1. Fiscal Policies Create Dilemmas for both Townships Officials and the Center**

The quandary faced by township officials is to finance an astounding range of unfunded mandates with scarce revenue sources. In addition to their locally initiated projects, township governments are responsible for the development and administration of TVEs, local agricultural projects, public works such as irrigation systems, forestry and flood control, township education, population control, public security, and people’s militia (Zhong 1996). It is not surprising that township officials resort to fees, surcharges, and other irregularities in order to get their ends meet. Unauthorized local taxes may not necessarily imply intentional corruption but reflect that “local governments in poorer areas, given their lack of profitable enterprises, expertise, and market outlets, are more susceptible to parasitic and extracting practices” (Bianco 2001).

The combination of a decentralized fiscal system and a hierarchical political structure creates a dilemma for government officials at higher levels to distinguish proper conduct of local agents from corrupted practices. The administrative lever of subnational echelons allows them to extract revenues and devolve expenditures not only to ease own budget constraints, but also use unfunded mandates to counter the tendency of each lower layer to conceal revenues from upper levels. As the tier of bureaucrats (or agents)

continues to press the peasants for the agents' organizational or personal gains, their misconduct fuels rampant social dissatisfaction. Should tax protests catalyze rural revolts,<sup>33</sup> they would nullify the central government's efforts to control local society. If the central government attempted to exercise control over the townships through its fiscal policies, it simply did not succeed.

#### 4.2. Paradoxical Approaches of the Center

The Center's increasingly dependence on its local/grassroots governments to control local society has produced paradoxical approaches in addressing the concerns raised in peasant revolts. On one hand, the Center tends to sympathize with the peasants when they appeal to the Center for reducing financial burdens (Bernstein 2002). Its gesture of appeasement has fostered the perception among rural Chinese that their protests have a better chance of extracting policy reforms when they circumvent lower levels and proceed upward through the state (Li and O'Brien 1996). A popular saying in rural China summarizes how the peasants view their relationships with the state and its bureaucratic agents at various hierarchical levels: "The center is our benefactor (enren), the province is our relative, the county is a good person, the township is an evil person, and the village is our enemy" (Zhang and Meng 1993). This saying vividly captures the hierarchically exploitative nature of China's fiscal system. Peasants perceive that the farther the government level is away from them, the less evil its officials are. On the other hand, in spite of its inability to control the behavior of subnational agents, the central government seems extremely reserved about promoting political reforms that would permit greater local political participation. In the 2001 National People's Congress (NPC) session, the then President Jiang Zemin made it clear that the present system of self-government at the village level would not extend to other jurisdictions (Li 2002).

The Center's paradoxical approach is merely a reflection of the state's shifting coalitions between the peasants and its local agents, depending on whether the Center is keener to collect popular support to limit the financial extraction of its agents at one time or more compelled to rely

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<sup>33</sup>The increasing threat of peasant revolts to political and social stability in the countryside can be reflected in the Chinese leaders' escalating rhetoric of alleviating the financial burdens of peasants. For example, the former premier Zhu Rongji, on his fact-finding tour to Jiangsu Provinces in April 2000, stressed that alleviating the financial burdens of peasants was "not only an important economic issue, but also a serious political issue" (Sina Financial News, 21 April 2000). Xinhua News Agency (28 September 2000) reported the urgent call from Vice Premier Wen Jiabao for alleviating peasants' financial burden.

on local agents to control local society when peasant revolts stir up social unrest (Tilly 1975, p. 24).<sup>34</sup>

The current leadership has followed the rhetoric of the previous government in making policies, which now seek to balance economic development and ease income inequality by investing in the hinterland and revitalizing the old industrial bases in Northeast. Premier Wen Jiabao's surprise visits to various peasant families in the rural areas resulted in the payment of long overdue wages.<sup>35</sup> These visits were widely reported in the press and seemed to usher a renewed sense of concern for peasants specifically and China's rural areas in general. However, the rampant levies of local governments that drive the peasants to economic and sometimes physical tragedy cannot be curbed without a systematic cure for an institutionalized political participation at the grassroots level. In doing so, this political reform would serve to check and restrain local governments' excessive taxing power from bottom up.

Apart from installing horizontal accountability mechanisms, the alternatives for the Center are few and fiscal reforms have demonstrated their limits. On the expenditure side, for example, the Center can define clearly the expenditure assignments for itself, provinces, prefectures, counties and townships. This policy may be effective in curbing the devolution of expenditures. But clarifying expenditure assignments between levels of governments may ultimately restrain the Center itself; hence, it is unlikely to be a central policy choice for the time being. The central authorities may also have the option of centralizing control of expenditures to the Center. But the feasibility of this policy is questionable. First, with the tax assignment reform in 1994 aimed at revenue centralization, the consolidation of expenditure may raise the suspicion that the central government seeks to return to a centralized fiscal system similar to the pre-reform one. Such a system is inefficient, not only as suggested by the theoretical literature, but also as demonstrated by China's pre-reform experience. Second, China, as "a state with modest resources and limited administrative capacity" is not able to survive financially without certain levels of local charge fees for services (Webber and Wildavsky 1986, p. 133).

On the revenue side, since the Center has the exclusive say on tax rates and tax bases since the 1994 tax assignment reform, some economists suggest assigning the subnational governments more discretion over local tax bases and rates, hoping that this may allow localities to finance the unfund-

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<sup>34</sup>For a discussion of "a game of shifting coalitions" in the context of Europe in transition from feudalism to modern society, see Charles Tilly ed., *The Formation of Nation States in Western Europe* (Princeton: Princeton University Press, 1975).

<sup>35</sup>A widely publicized report is that Premier Wen Jiabao helped a farmer named Xiong Deming get back her overdue one-year salary from the county officials, reported by Zhang Tianwei, *Beijing Qingnian Bao* (Beijing Youth Daily), 28 October 2003.



ed mandates with less dependence on illegal fees, borrowings, and central transfers (Ahmad 2003). However, in the absence of an institutionalized bottom-up mechanism (e.g., local political participation) to hold local governments accountable, this policy runs the risk of “legalizing” illegal fees in the form of taxes, as long as the subnational mandates require funding that considerably exceeds their currently available resources.

While democratic institutions may ultimately help to restrict local taxing power, the internal transformation of the bureaucratic culture is also necessary. China maintains an egalitarian bureaucracy which is open to students regardless of their social background through civil service examinations. However, once becoming part of the bureaucracy, they are more seduced to exploit the tax system for personal interests than develop public service ethos. In other words, this egalitarian gentry examination system allows the previously “ruled” to become the bureaucratic “ruler,” and thus effectively undermines the demand for the creation of pluralistic institutions in China.

## 5. CONCLUSION

In conclusion, a political hierarchy financed by a tax-farming fiscal system in China has the advantage of ensuring revenue flows to the Center in the early years, but it ultimately restrains the Center financially and fails to contain the exploitative behavior of local officials. The central government is plagued with undulating reactions of decentralization, when spurring local tax collection resides as the top priority, and recentralization, when strengthening central control over fiscal resources is needed. The real peril of the system lies in (1) an unrestrained central government that devolves an inappropriate share of expenditure mandates to sub-national levels; and (2) the principle-agent problem as a result of the splitting property rights over taxation: the Center has ownership over all tax bases, while the agents take charge of tax collection and have effective control over the extra revenues generated from the same tax bases. The agents, with no interest in preserving the tax bases for the Center, take on un-funded mandates, and their personal pecuniary interests tempt them to further extract revenues from the lower tiers. “Ultimately, the people paid” (Webber and Wildavsky 1986, p. 133). Poor peasants bear the brunt of the tax burden. As the financial pressure of excessive levies and fees reaches a perilous point, peasants resort to violent protests.

China’s current leadership has taken a series of actions, culminating in the initiative of building a new socialist countryside, in effort to pacify the mounting grievances in the countryside and to strengthen its grip on power. In particular, the Tax-for-Fee reform aimed at alleviating farmers’ financial burden will abolish the agricultural taxes universally by 2006. However,

the impact of the reform may be not as promising as expected, at least manifested by the township finance examined in this paper. International experience suggests that greater local revenue autonomy should be considered as an important reform in putting decentralization to work at the local level. In future a great challenge is to establish land and property taxes as the main tax base for county and township governments in China.

Also, it is keen to think about the definition of national minimal standards and means to ensure sufficient local finance for implementation in such areas as nine years compulsory education, basic medical treatment, and essential unemployment compensation and survivor and dependent insurance. The wide and growing divergence in basic public services between rural and urban areas has not only dented social fairness but also endangered country's cohesiveness. Although the equalization transfer system can be taken as an important approach to address the issue of regional disparity, China indeed relies on the Center to guarantee all citizens have access to basic public services through setting national minimal standards and centralizing basic public services to some extent. Most of governments at and under county levels lack the capacity to adequately provide basic public services; and assigning sub-national governments the primary role in basic public services provision also cause the equity problem due to the wide-ranging fiscal capacity among regions.

Furthermore, the country's ability to sustain a centralized polity with a fiscally decentralized system may become increasingly undermined in the absence of any horizontal accountability mechanisms. The lack of accountability of sub-national government officials to local residents jeopardizes the potential efficiency gains from decentralization reforms. The current cadre system of direct appointment makes local officials mostly accountable to the upper/central government authorities, which has induced the indulgence of government entertaining activities, prevalence of white elephant projects, a high rate of corruption, and inefficient public services provision. Therefore, it is necessary to start considering how to demand transparency and performance of local governments to their residents by empowering the community and even institutions, and by encouraging voices from citizens.

China's future is not dependent on whether we add more to those who have a plenty but whether we complement those who have nothing. Peasants, our under-privileged brothers and sisters, are the marginalized we shall look after.

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