

# **Fiscal Decentralization and Public Services Provision in China**

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## **Abstract**

The last decade has witnessed a world trend of fiscal decentralization in the developing countries as an escape from inadequate growth and inefficient governance. With respect to China, fiscal decentralization has been a fundamental aspect of its transition to a market economy; and the country has made substantial efforts to break down its highly centralized fiscal management system. China's fiscal system currently has five levels – central, provincial, prefecture, county, and township. Sub-national governments have been assigned primary responsibility for public services provision and financing. China's highly decentralized system could be a boon to managing service delivery, but the country's crave for rapid economic growth in the last two decades has kept the reform of the public services on the fringes of political agenda. Under the current arrangements, public services are extensively decentralized with sub-national governments taking a much larger portion of expenditure responsibilities that are out of line with international practice. The over-devolution of spending responsibilities has resulted in insufficient financing and provision for core public services, and particularly a default in the delivery of vital services in many rural and poor localities. Further, in the absence of mechanisms to ensure national minimum service standards, the decentralized public services delivery system is faced with growing inequality across the country due to the widening regional disparity in economic development over the past decade. This paper reviews fiscal decentralization policies in China, identifies prominent issues in the current public service delivery system, and examines the deficiencies in the existing intergovernmental fiscal system that have contributed to insufficiency and inequality in public services provision. It advises plausible reform options to further national objectives.

## **Introduction**

The last decade has witnessed a world trend of fiscal decentralization in the developing countries as an escape from inadequate growth and inefficient governance. With respect to China, fiscal decentralization has been a fundamental aspect of its transition to a market economy; and the country has made substantial efforts to break down its highly centralized fiscal management system.

China's vast population and territory, as well as its regional diversity, require decentralized management. Moreover, the former system of central planning and control was fundamentally incompatible with the decentralized decision-making of the market economy, and it has been gradually dismantled over the twenty-five years of fiscal decentralization. While some scholars (e.g. Lin and Liu 2000) treat these changes as a more or less carefully thought-out response to China's changing needs, many scholars believe that the evolution of China's fiscal decentralization has been an ad hoc and uncoordinated process; and it has been mainly driven by the breakdown of the old fiscal system as the central government tried to tackle one or another type of dysfunctional behavior (Wong 2000).

China has dispersed its highly centralized fiscal management system (1949-1978) with various forms of fiscal contracting systems (1979-1993) and later a tax sharing system (1994-present). The 1980s' and early 1990s' reforms were aimed at promoting local economic development through increasing local governments' responsibilities and through enhancing their autonomy in carrying out fiscal functions. The strategy did boost local growth in many regions, but it also brought many unintended problems including declining general government revenues, waning fiscal position of the overall government, weakening macroeconomic management, and rising regional disparities. At the culmination of the struggle, the 1994 Tax Sharing Reform was initiated as the first attempt to fix the intergovernmental fiscal system through the introduction of the Tax Assignment System (fenshuizhi), which explicitly defined central taxes, shared taxes, and local taxes. The tax structure was also simplified, and tax administration was split into National Tax Services and Local Tax Services. However, the grand undertaking was undermined by preserving many features of the pre-reform arrangements: a lump-sum

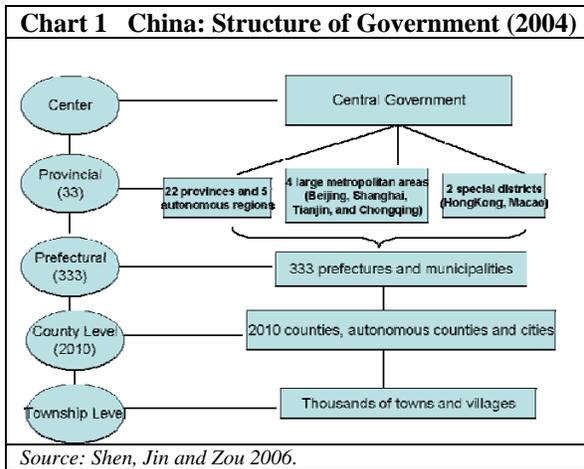
transfer, or tax rebate, was established to guarantee the coastal provinces' pre-1994 income level, and it remains the lion share of the total central transfers until today; the vague responsibility assignment between levels of governments was left untouched, which is indeed a principal cause of starved local finance and the enduring quandary of extra- and off-budget revenues; and furthermore, the equalization transfer has remained small after a decade of implementation, which further weakens the fiscal capacity of local governments. Particularly, the resulting deficient and unequal public services delivery have attracted massive attention.

This paper attempts to explore key issues and challenges in China's decentralized public service delivery and financing system. The paper is divided into four sections: section 1 provides an overview of administrative and fiscal decentralization in China; section 2 highlights prominent issues in China's public services delivery system; and section 3 examine the intergovernmental fiscal arrangements that have induced those challenges as discussed in the previous section. The paper concludes with some potential policy options.

## **1. China's Decentralized Government**

China is a unitary country with the world's biggest population (1.3 billion in 2006) and the third largest territory (9.6 million square kilometers). China's government is highly decentralized in terms of its five-level administrative structure and fiscal arrangement. There is strict vertical hierarchical relationship among different orders of government. Sub-national governments are organized in a four-level hierarchical way with each level of government reporting to the next highest level (see Chart 1). There are 33 provincial-level units including 22 provinces, 5 autonomous regions, 4 large metropolitan areas (Beijing, Shanghai, Tianjing, and Chongqing), and 2 special districts (Hong Kong and Macao). The sub-provincial level consists of 333 prefectures and municipalities at the prefectural level; 2010 counties, autonomous counties, and cities at the county level; and thousands of towns and villages at the bottom level. Township-level governments serve as the basic administrative division in the vast countryside. Village governments also

provide public services but are retreated as community units rather than government organ.



Corresponding to the government structure, China’s fiscal system also has five levels. Sub-national governments have been given considerable latitude in shaping local policies and managing fiscal resources. Most of the service delivery responsibilities are assigned to the sub-national governments yet for reasons of efficiency in tax collection and administration. Sub-provincial governments (prefecture, county and township) spent 77.2 percent of government expenditure on education, 74.9 percent for health care, and 49.3 percent for social security (see Table 1).

However, China is much less decentralized than what appears on the surface. The center exerts substantial control over localities through the intergovernmental fiscal system, several binding expenditure laws, and numerous expenditure mandates as well as its authoritarian political arrangement. Sub-national governments are largely dependent on shares of central taxes and grants after the 1994 reform. In 2003, they financed 67 percent of provincial, 57 percent of prefecture and 66 percent of county and lower level expenditures (Qiao and Shah 2006). The local fiscal dependence, combined with a hierarchical party structure and the absence of national elections, emboldens predatory behavior of the upper-level governments and hence confines the full benefits of fiscal decentralization.

<b>Function</b>	<b>Central</b>	<b>Provincial</b>	<b>Sub-provincial</b>
Education	8.2	14.6	77.2
Health Care	2.8	22.3	74.9
Social Security	11.4	39.3	49.3
Agriculture	11.9	46.5	41.6
Scientific Research	63.5	22.8	13.7
Public Administration	19.5	10.5	70
Public Security, Procurator, and Justice	5.4	25.4	69.1
Foreign Affairs	87.3	12.7	0
Foreign Aid	100		
National Defense	98.8	1.2	0
Capital Expenditure	44.4	23.1	32.5
<b>Consolidated Expenditure</b>	<b>30.1</b>	<b>18.5</b>	<b>51.4</b>

*Source: Data from Ministry of Finance of China.*

## **2. Decentralization and Public Services Delivery: Prominent Issues**

Over 75 countries have attempted to decentralize responsibilities to lower tiers of government in the last quarter century (Ahmad, et al. 2005). Decentralization is widely regarded as an instrument to improve service delivery. The rationale that supports this reform is that local governments, being closer to their constituencies, can be more responsive to local needs, and consequently, provide public services more efficiently. To achieve efficient services delivery, countries and national states must institute an effective division of labor among multi-levels of government and assign appropriate financing instruments (fiscal revenues) to match fiscal responsibilities.

China's highly decentralized system could be a boon to managing service delivery, but under the current arrangements, public services are over-decentralized with sub-national governments taking a much larger portion of expenditure responsibilities that are out of line with international practice. The over-devolution of spending responsibilities has resulted in insufficient financing and provision for core public services, and a default in the delivery of vital services in many poor localities. Further, in the absence of mechanisms to ensure national minimum service standards, the decentralized public services delivery system is faced with growing inequality across the country due to the mounting regional disparity in economic development over the past decade.

The following subsections will examine the outstanding issues in the current public services delivery system.

### **1) Extensive Decentralized Provision and Financing for Core Public Services**

Sub-national governments play a primary role in providing social services such as education, health care, social security, housing and urban/local services. In 2004, sub-national governments together financed 90 percent of public spending on education, 95 percent on health care, and 85 percent on social security (Shen, et al. Forthcoming). Core public services like education and public health, which are usually seen as responsibilities shared by central and provincial governments due to their important spillover effects for the society as a whole, are assigned to sub-provincial governments in China. As of 2003 (see table 1), about three fourths of overall government education and health care expenditure respectively was made by the sub-provincial governments (prefecture, county, and township). Some other redistributive activities as social security, unemployment insurance, and basic social welfare, which are normally assigned to the national or provincial levels in order to reap the benefits of risk pooling and equalization, also reside in local governments in China. Ma and Norregaard (1998) suggest that the expenditure assignment is largely a result of the division of budgetary agencies' affiliations. The central budget is responsible for state-owned enterprises, universities, hospitals, and research institutions, whereas the expenditures of budgetary agencies "owned" by local governments, including primary and secondary schools, local hospitals, and local infrastructure facilities are the responsibilities of local budgets.

It is critical to mention that rural governments (at the county and township levels) -- treated the same as urban governments in the Chinese fiscal system -- are responsible for daily government administration, providing core social services, and investments in infrastructure. As a result of revenue recentralization and responsibility devolution in the past two decades, rural governments are relatively bankrupt leaving many basic public services unfunded.

The following will use education and health care as examples to illustrate the feature of over-devolution in China's public services system.

## **Extensive Decentralization in Education Services**

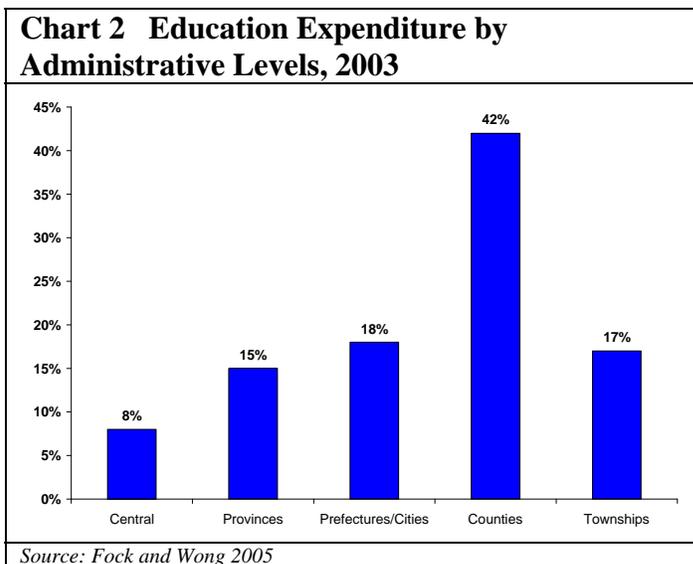
Although decentralized education provision suits diversified local cultures and increases resources to the education sector as a whole, the compulsory education is over-decentralized without taking into account local financial and managerial capacity. Since mid 1980s, two major reforms have been undertaken in the educational system: the first is the decentralization of authority and responsibility – local governments are responsible for the development of basic education in China; the second is the diversification of education financing -- budgetary allocations now constitute just over half of aggregate spending. The reforms have placed much greater demands on local resources and administrative capacity.

The division of responsibilities in education was first laid out in the Decision on the Reform of the Education Structure (1985) and later written into the Compulsory Education Law in 1986. According to the Implementation Suggestions of the State Council on the Guidelines for the Reform and Development of Education in China issued in July 1994, the central government retains the policy-making and overall planning role for education; the province has the overall responsibility for formulating the development plan, conducting inspections, determining operational standards, and providing assistance to counties to help them meet recurrent expenditures in education; cities or districts of large cities actually implement compulsory education in urban areas and counties serve as the main administration body in rural areas. The division of responsibilities between the county and the townships is not sufficiently clear in the guidelines. In real life, townships often bear major financing responsibilities, even in poor counties (World Bank. 2002, 97).

The decentralization policy and diversification of education financing were reassured through the promulgation of the ‘Mission Outline of the Reform and Development of China’s Education’ (*Zhongguo Jiaoyu Gai ge he Fazhan Ganyao*) in 1993. By 1995, the Education Law had further promoted the role of local communities and informal sectors in education (Mok 2002, 262).

The education expenditure by levels of government in year 2003 as demonstrated in Chart 2 provides a clear picture of dramatic financial burden at local levels. More than 90 percent of budgetary expenditures on education come from sub-national governments, over 50 percent are from the county and township levels, and particularly county

governments contribute more than 40 percent of the overall government education expenditure. For counties and townships, education becomes the single most important social service provided (World Bank. 2002, 94). To reduce the inequality in financing and service provision, the central as well as provincial governments provide support to poor areas by earmarked grants, but such allocations are usually too small compared to the needs.



Decentralized education service provision imposes a remarkable financial and management burden on county, township, and village levels of government. It may be theoretically workable to have higher level governments build schools and pay most of the salaries of teachers, leaving other running costs to local governments. The practical problem is that the system grants too much discretion at the intermediate levels, enabling them to push down expenditure burdens to the weakest links, which leaves little revenue at the lowest levels to support the funding requirements. Further, many lowest levels of government are incompetent to manage resources efficiently or effectively.

### **Extensive Decentralization in Health Care**

The salient feature of the decentralized healthcare system in terms of financing is self-sufficiency with very few resources transferred from higher levels of government to facilities at the lower levels to support recurrent costs. Basically each level of government

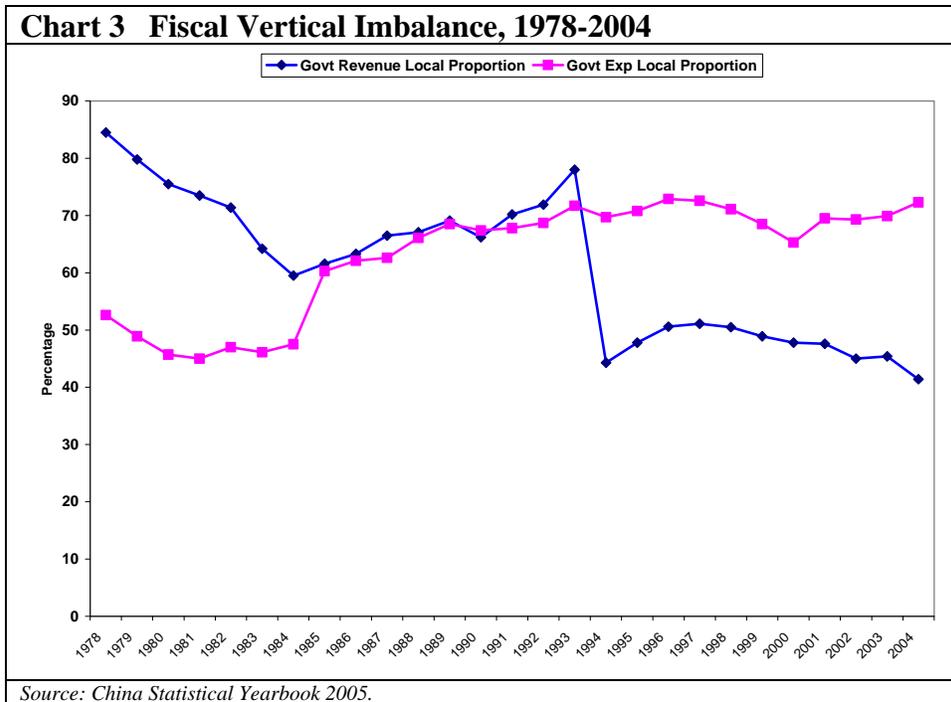
finances largely its own healthcare facilities with budgetary resources and user fees. Provincial governments support referral hospitals in the provincial capital, the Maternal and Child Health Bureau and the Epidemic Prevention Service at the provincial level. The same applies to prefecture, city, and county governments. At the bottom level, township health centers or township hospitals receive most of their financial support from township governments. The earmarked grants for specific objectives and activities are relatively small (World Bank. 2002, 118). As a result, close to 60 percent of total budgetary expenditure for health is the responsibility of counties and townships. Given that most budgetary resources go towards infrastructure costs and staff salaries, little money is left to cover services. Therefore, cost recovery is imposed on most local health services and ultimately on patients.

The over-devolution of health care services has posed critical challenges to financial affordability and administrative capacity on county and township governments. (Tang 2000) conducted a case study of a poor rural county in China that devolved finance and management of basic health services to townships. It confirms that townships literally cannot afford the assigned responsibilities and lack managerial capacity. It cautions against unrealistically rapid decentralization of health services in poor rural areas.

## **2) Insufficient Financing for Core Public Services**

Financial pressures on local governments have intensified since the introduction of the Tax-Sharing System in 1994. The 1994 Tax Sharing Reform re-centralized revenues without cutting local expenditures. The centralizing of revenues upward and devolving expenditures downward occurs at each level at the expense of the subordinate governments. The regressive outcome contributes to deteriorating fiscal vertical imbalances and leaves the lowest level of government—particularly those in the rural sector and poor regions—financially starved. The trend of vertical fiscal gap by administrative levels is shown in chart 3. The latest data in 2004 shows that local

governments collect 41.4 percent of overall government revenue, but spend 72.3 percent of the total budgetary resources<sup>1</sup>.



The insufficient financing for core public services is evident when we take a look at education services. The financial drain, particularly at the county and township levels, has resulted in government overall low education investment compared with international standards. For instance, if we compare the overall education financing in China, India, South & East Asia, Latin America, United Kingdom, and the United States, the education expenditure per 10 million population in the period 2000-2003 is 0.36 billion dollars in China, more than India but only about three percent of the UK and roughly two percent of the US. In this comparison, China ranks at the bottom when it comes to the education spending as percentage of GDP. China devotes about 2.8 percent of its GDP, much lower than the 5.3 percent in the UK and the 5.7 percent in the US and also below 4.1 percent in India (Chart 4).

<sup>1</sup> The local revenues take into account shared taxes. However, those shared taxes are more appropriately considered as central transfers according to international criteria as the central government decides the tax rate, defines the tax base, and also administers through National Tax Bureau. Therefore the fiscal vertical imbalance is more dramatic when the international criteria are applied.

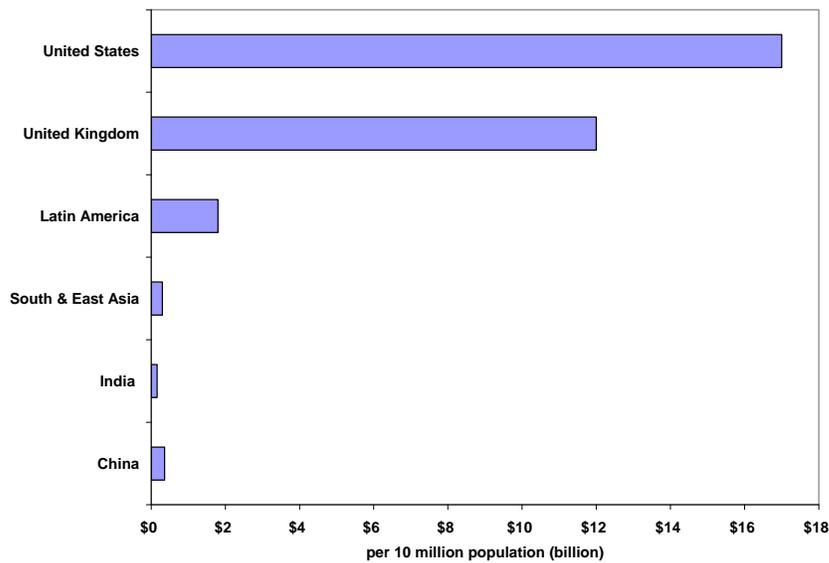
Aside from inadequate overall government investment in core public services, many local governments, especially those in poor western regions, spend much less than what is needed, providing fewer and lower quality public services and passing along a higher proportion of the costs to their constituents. For example, the program of the universal compulsory education is a valiant attempt to ensure minimum levels of education provision in China. However, it was introduced in the absence of an accompanying plan for providing resources. Governments at cities, districts of large cities, counties, and townships are paying for almost all of the recurrent expenditures in compulsory education. It imposes too much fiscal burden on the poor regions beyond their financial capacity, and the amount of earmarked grants from the central government is too small. Consequently, poor regions are not able to provide adequate schooling to children, which severely undermined the national goal of achieving nine-year compulsory education. Up to 2002, the 372 counties failing to achieve the “Two Basics”, namely, extending universal nine-year compulsory education among the school-aged population and literacy among those less than 20 years old, all concentrated in the disadvantaged rural western regions (Zhang, et al. 2004). In Hua County, Henan Province, 89.8 percent of budgetary education expenditure was allocated for salaries, 9.5 percent of recurrent costs, and only 0.7 percent for school maintenance in 2003. The primary schools in the county charge 150 yuan per year and junior secondary schools 100 yuan per year in order to supplement the county finance (Ministry of Finance 2005). The consequence is less education services are provided in terms of both quality and quantity, and more costs are passed along to the parents.

Similar to education, over-devolution of healthcare has led to a marked reduction of public financing of health care and services, and insufficient financing and provision in many local jurisdictions. Millions of people are dying because they cannot afford health care. A government survey in 2001 found that some 60 percent of rural residents avoid hospitals altogether because of the expense (Economist 2004). China’s rising living standards have resulted in a growing share of GDP spent on health. However, government spending on health, particularly at the central level, is falling, while the personal out-of-pocket portion is rising sharply (World Bank. 2002, 111). Overall, government finances a small proportion of total health expenditure, not including health

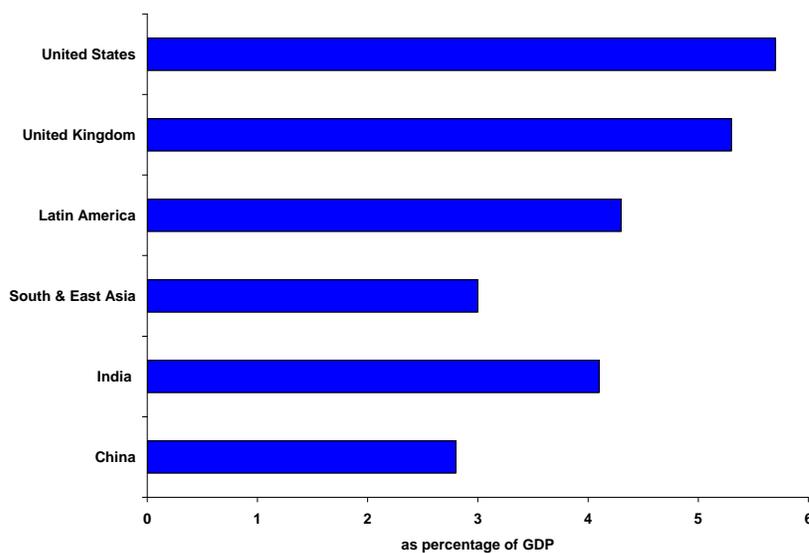
insurance schemes, accounting for 11 percent of total expenditure in 1999, compared with 28 percent in 1978 (World Bank. 1997). The share is very low compared to other countries -Argentina 57.5 percent, Australia 72 percent, Brazil 48.7 percent, France 76.9 percent, India 13 percent, Japan 80.2 percent, Pakistan 22.9 percent, Russia 76.8 percent, and USA 44.1 percent (World Health Organization 2000).

**Chart 4 Education expenditure comparison, 2000- 2003**

Education Expenditure per 10 Million Population (in billion)



Education Expenditure as Percentage of GDP



Source: Dahlman et al 2006

In 2003, the central government has taken care of only 2.8 percent of total budgetary spending on health and has handed the primary funding responsibility to the sub-national levels. Government subsidies diminish down the administrative hierarchy, and only about 20 percent goes to rural areas with more than 60 percent of population. In 1999, 53 percent of government subsidies for hospitals went to city hospitals, only 20 percent to county hospitals and 27 percent to township health centers (World Bank. 2002, 119). Township health centers have to depend on taxes and fees that they raise from farmers and businessmen, and even charge fees on preventive medicine. The WHO says that China is the only country in the western Pacific region which relies on patients to finance childhood immunizations. Now many peasants avoid such treatment (Economist 2004).

The insufficient healthcare investment from the central and local governments is not only reflected in the inadequate financing of core public health functions, but also in disoriented financial incentives for providers to raise revenues through chargeable services. The chronic under-funding of public health has created a culture of cynicism and corruption in China's hospitals. The focus on cost-recovery further hampers efforts to establish effective public health services. Both urban and rural hospitals have to generate their own revenues to cover most operational costs, mostly from selling medicine and medical tests. The skyrocketing medicine costs and willful over-prescription by doctors are biggest grievance of patients. And the common practices of paying up front before any treatment, as well as paying “red packets” (bribes) to doctors and nurses in order to get good treatment, demoralize the healthcare system as a whole.

### **3) Regional Inequalities of Public Service Provision**

China's regional disparities in fiscal spending and service provision are substantial by international standards, and have grown at a rapid rate. The levels of service provision are subject to local economic development due to the heavily decentralized public services system and inadequate intergovernmental transfers. The horizontal disparities occur across provinces and also within provinces. The unequal access to primary public

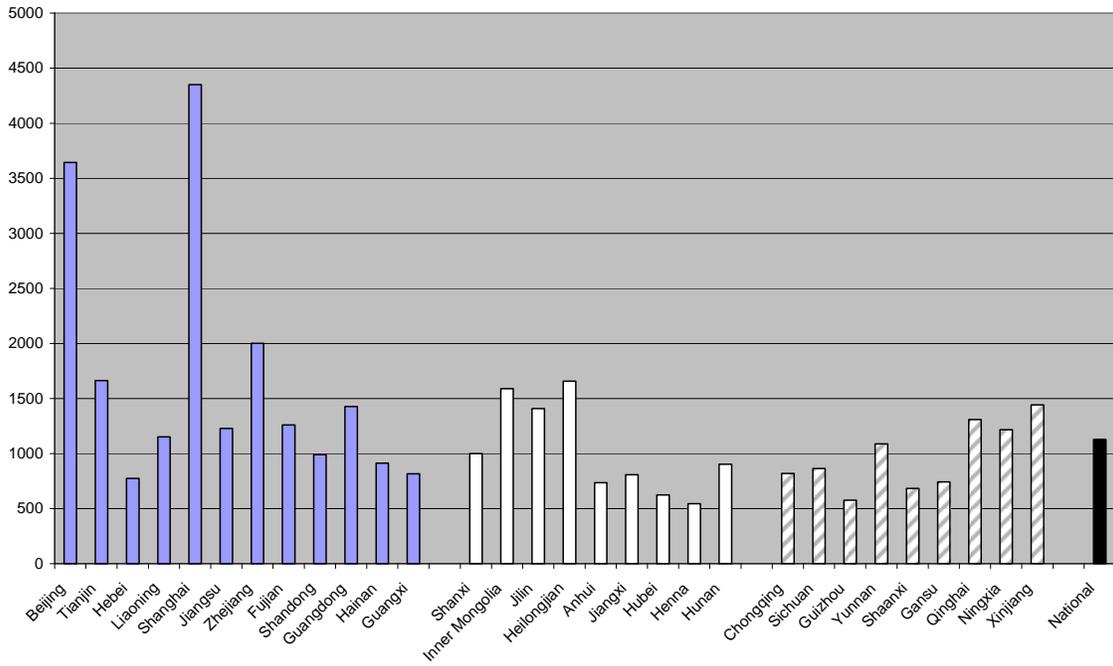
services is even more pronounced. While the high level of transfers may have corrected the vertical fiscal imbalances in the aggregate, on the whole they are not equalizing.

The following figures demonstrate vividly the education disparities among East, Middle and West regions. Chart 5 shows that education expenditure per student in primary and junior secondary education respectively among East, Middle, and West region. Disparities in education spending and quality of services across regions are rising. In poor and rural areas, local governments can hardly raise enough revenue to cover teachers' salaries, regardless of other non-teacher costs. In contrast, local governments in affluent areas can mobilize significantly more resources for education. This leads to substantial disparities in per-student educational spending across areas and regions. Tsang and Ding (2005) find substantial disparities in the level of per-student spending between urban and rural areas, and between coastal region and other regions: urban areas spend 84 percent more in primary education and 69 percent more in junior secondary education than their rural counterparts; and coastal provinces spend respectively 71 percent and 75 percent more than inland/western provinces.

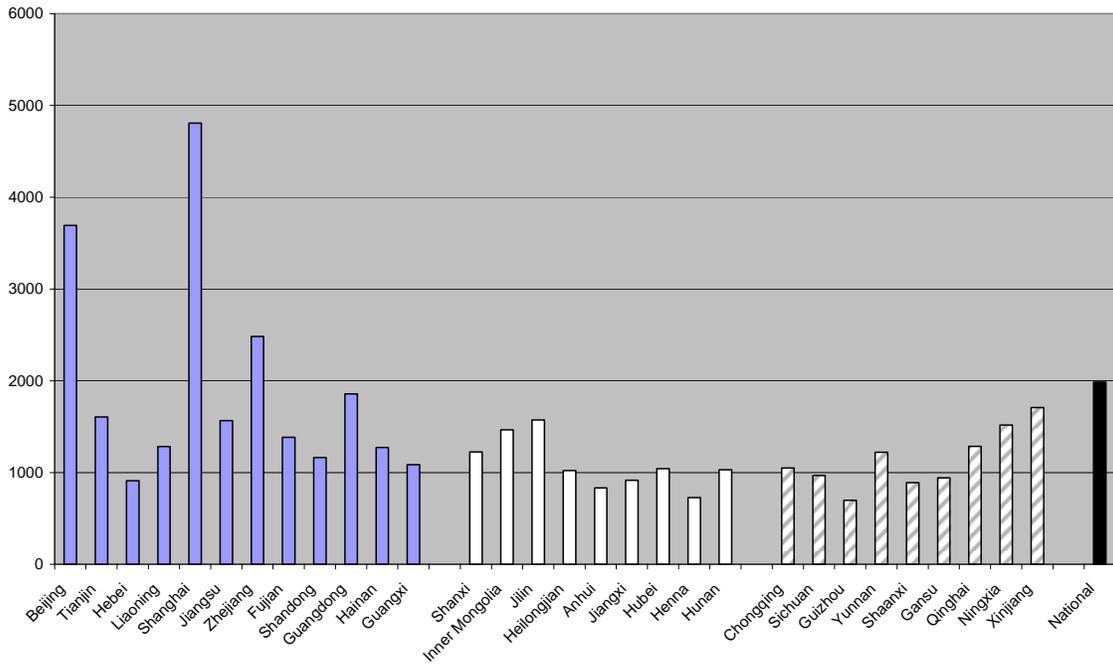
The most unfortunate segment lies in the inland poor rural regions. The high level of decentralization of health financing and provision in lack of sufficient funding at local levels has also severely undermined the equality concern across the country. The quality of healthcare is very much dependent on the financial health of the local budget, which gives wide variations to per capita expenditure across localities. In terms of fairness in financial contributions to health care, WHO Report 2000 ranked China 188 of 191 countries. There is a significant imbalance between health care in urban versus rural areas, and in economically advanced versus backward regions. The situation is compounded by the unequal subsidy of urban areas that receive 60 percent of total government health expenditure, while 40 percent goes to the rural areas where over 60 percent of the population lives. In poor regions the rural share appears to be even lower. Rural share was generally less than 30 percent, with a low of only 20 percent in Henan (World Bank. 2002, 116). More than 80 percent of the rural population pays out of pocket for health services. Some estimates put close to 50 percent of 60 million poor Chinese became indebted due to borrowing for health and medical reasons (Ooi 2005, 3).

**Chart 5 Regional Disparities in Education (2003)**

Primary education: education expenditure per student (Yuan)



Junior Secondary: education expenditure per student (Yuan)



Source: China Statistical Yearbook of Education 2003.

### **3. Fiscal Decentralization – explore causes for inadequate and unequal public services**

The central issues of insufficiency and inequality in the decentralization and public service delivery are the large gap between expenditure and revenue assignments at the local level and the lack of a strong fiscal transfer system. As local spending needs exceed fiscal capacity at a large margin, particularly in those poor regions, and the fiscal transfer system fails to support the financing of vital social services, local governments do not have options but to either provide fewer and/or lower quality services or to pass along the financial burden to their residents.

The extensive decentralization in public services provision and financing has also produced large and growing fiscal disparities that reinforce income disparities across the country. This is recognized by the central government. In 1995, a formula-based equalization transfer scheme was established, and the volume of the grant has been dramatically increasing over the past decade. However, the equalization grant (74.5 billion yuan in 2004), only accounting for about 5 percent of the total central transfers, makes almost no difference in its equalization effect.

The subsequent sections will discuss the prominent issues in the current intergovernmental fiscal system that result in insufficient and unequal public services provision in China.

#### **1) Vertical Fiscal Gap**

Since the 1994 tax sharing reform, the combination of pushing down expenditure responsibilities to lower levels of government without providing adequate financial support has generated an increasingly large fiscal gap (see chart 3), leaving local governments highly dependent on fiscal transfers from upper-level in fulfilling their spending needs. A close look at expenditure assignment and tax assignment is helpful to unveil the present quandary of local fiscal stress.

## Expenditure Assignment

As defined by the State Council Regulations on the Implementation of the tax sharing system in 1993, the central government is primarily responsible for nation-wide services including national defense, foreign affairs, the operation of the central government body, the macro-economic control and coordination of economic development, and providing funds for universities, hospitals, research institutions, newspapers, publishing houses, etc that directly under the control of the central government; while the sub-national governments are responsible for delivering most public goods and services, the development of the local economy, and operation of various institutions. See detailed responsibility assignment across the five-layer administration in table 2.

In the absence of specific central government guidelines, the actual division of expenditure responsibilities among sub-provincial governments is left to the discretion of each level of government. The higher-level government has discretion to determine the expenditure assignment of the level immediately below it. In other words, provinces determine the assignments of cities/prefectures, and the cities determine the assignments of counties and the latter determine the revenues and expenditures of townships. Literally, local governments at each level are responsible for delivering public services such as education, health care, social welfare, public safety, and other local and urban services; government administration; and local economic development. Exclusive local responsibilities include urban maintenance and construction, environmental protection, water supply, and community services (table 2).

<b>Public Services</b>	<b>Central</b>	<b>Provincial</b>	<b>Prefecture</b>	<b>County</b>	<b>Township</b>
National Defense	*				
Foreign Affairs	*				
Geological Prospecting Expenses	*				
Public Debt	*				
Education	*	*	*	*	*
Health Care	*	*	*	*	*
Social Welfare	*	*	*	*	*
Agriculture	*	*	*	*	*
Government Administration	*	*	*	*	*
Capital Construction	*	*	*	*	*
Research and Development	*	*	*	*	*
Culture Development	*	*	*	*	*
Policy Subsidies	*	*	*	*	*

Armed Police Troops	*	*	*	*	*
Urban Maintenance and Construction		*	*	*	*
Environmental Protection		*	*	*	*
Water Supply			*	*	*
Community Services				*	*

*Source: Ministry of Finance of China.*

Clearly, the hierarchical responsibility assignment has two prominent features. (a) Local governments, particularly at the county and township levels, are excessively loaded. In reality, education and health care are concentrated mostly at the county and lower levels although these public services are more appropriately assigned to central and provincial levels in respect to the spillover effects for the society as a whole. The redistributive government function for social security is mainly administered at the provincial and prefecture levels whereas it is commonly relying more on the central government in order to reap the benefits of risk pooling and equalization. (b) The responsibility assignment is ambiguous in the fact of wide concurrent expenditure assignments. The vague definition has created the loophole for each level of governments to push their responsibilities downward while retaining as much revenue as possible. Ultimately, the bottom level of governments is taking disproportionate large share of responsibilities with very limited revenue base.

### **Tax Assignment**

The 1994 tax sharing reform explicitly defined central tax, shared tax and the local tax. Taxes that can be used in the pursuit of maintaining national objectives were assigned as central taxes; the taxes that could be interpreted as more relevant to economic development were assigned as shared taxes; and the taxes more suitable to be collected and administered by the local governments were assigned as local taxes (table 3). The immediate impact of the tax-assignment system on the division of revenue sources between the central and local governments was very significant, and the ratio of the sub-national governments' revenue to the total plummeted from 78 percent in 1993 to about 44 percent in 1994. Although the ratio went up slightly after 1994, the average was below 50 percent (about 41 percent in 2004), compared to more than 60 percent for 15 years since 1978 (Chart 2).

As shown in table 3, the present tax assignment arrangement has two outstanding features. First, the central government gets grip on most fiscal resources (58.6 percent of the total tax revenues). Second, with relatively smaller revenue base, the local governments are still highly dependent on shared taxes which are more appropriately treated as central transfers according to international standards. In 2004, the local VAT accounts for 22.8 percent of the total local tax revenue, business tax 32.9 percent, Individual Income Tax 6.6 percent, and Enterprise Income Tax 15.1 percent. Further, the local own-source tax revenue is only about one fifth of the total local tax revenue, and appallingly no more 10 percent of the overall government tax revenue. The taxes assigned at the present time exclusively to the local level in general do not provide an adequate revenue base for local governments.

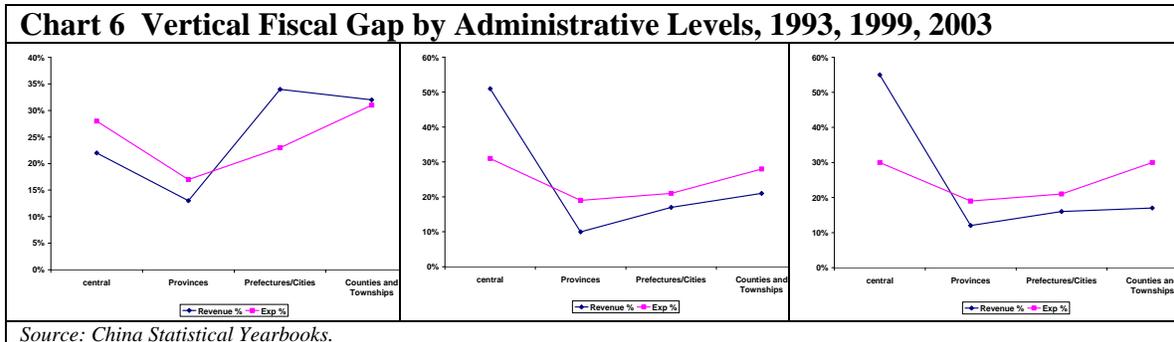
<b>Taxes</b>	<b>Central</b>	<b>Local</b>	<b>Share of Local Tax Revenue, 2004 (%)</b>
Tariffs	*	-	
Consumption Tax	*	-	
VAT	75%	25%	22.8
Business Tax	3%	97%	32.9
Stamp Tax on Security Transactions	97%	3%	0.0
Individual Income Tax	60%	40%	6.6
Enterprise Income Tax	60%	40%	15.1
Resource Tax	-	*	0.9
Urban Maintenance and Construction Tax	-	*	6.3
Urban and Township Land Use Tax	-	*	1.0
Agriculture Tax	-	*	2.3
Contract Tax	-	*	5.1
Farmland Occupation Tax	-	*	1.1
Vehicle Purchasing Tax	-	*	0.0
Other Local Taxes	-	*	5.7
<b>Share of Overall Government Revenue, 2004 (%)</b>	<b>58.6</b>	<b>41.4</b>	

*Source: China Statistical Yearbook 2005.*

### **Vertical Fiscal gap**

The present inter-governmental fiscal arrangement, with each level of government engaged in predatory behavior of pushing down expenditure to subordinate governments without providing adequate fiscal resources, has induced an increasingly widening vertical fiscal gap and intensified local fiscal stress, leaving core public services

unfunded in the rural sector and in the poor regions. The time series data in chart 3 clearly demonstrates the vertical fiscal gap is deteriorating over the past decade. An alternative perspective of investigating fiscal gap at each level of the government organ in different time, as shown in chart 6, delivers the evidence that the vertical fiscal gap at county and township governments is severe and worsening radically over the years.



In recent years, the critical financial problems at the local level have been recognized by the central government, and the policy-makers have come up with some corrective interventions (mainly by setting up a new fiscal transfer scheme). For instance, in 2001-2002, the central government established a new intergovernmental fiscal grant, “Grants for Increasing Wages for Public Servants”, to assist local governments in covering the cost of wage increases. Similar approach was applied for the rural fee reform in 2002 by creating a new central grant entitled “Grants for Rural Tax Reform”.

Although such corrective interventions deliver a positive signal of the central government’s willingness to gradually take back some responsibilities, the strategy itself is only a quick fix, not likely to sustain for meeting long-term needs. And these corrective interventions occur on an ad hoc basis, with the amounts often determined later in the fiscal year dependent on available budgetary resources. It raises unpredictability in local government budgeting (World Bank 2003).

## 2) Fiscal Transfer System and Public Service Delivery

Central-provincial and provincial-local fiscal transfers are the dominant source of revenues of provincial and local governments in China, accounting for 67 percent of provincial, 57 percent of prefecture and 66 percent country and lower level expenditures

in 2003 (Qiao and Shah 2006). Although the volume of fiscal transfers is large, the current system of intergovernmental transfers is poorly designed to support the financing of vital social services or to alleviate the widening regional disparities. Thus, the emphasis needs to be put on the effectiveness rather than the overall level of transfers.

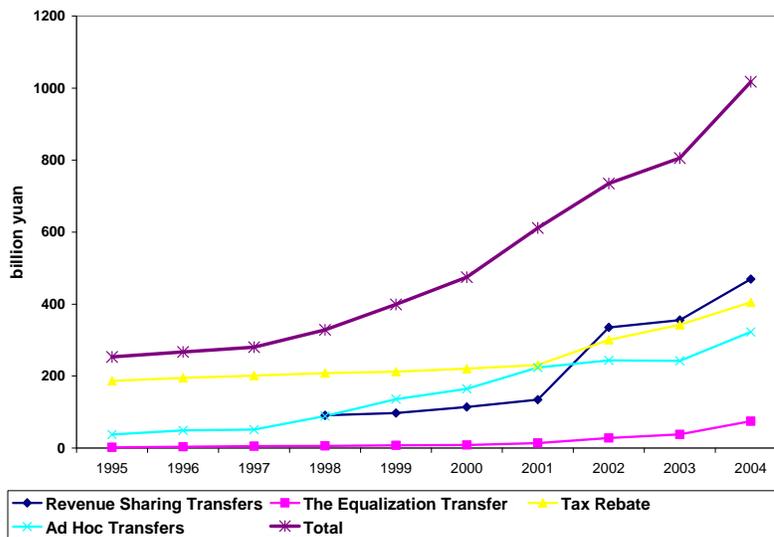
Central transfers<sup>2</sup> in China can be classified into two broad categories: general purpose and specific purpose transfers. The general purpose transfers consists of (a) revenue-sharing transfers (b) the tax rebate designed to return a fraction of revenues by origin (province of collection), and (c) the equalization transfer established in 1995 in an effort to ease the widening regional disparities. The equalization transfer was called “transitory period grant” until 2001 and then renamed “the general-purpose grant” since 2002. These three transfers constituted 63.8 percent of total central transfers in 2004. The equalization grant has grown rapidly in size from only 2.07 billion yuan in its initial year to 74.5 billion yuan in 2004. Specific purpose transfers include (a) grants for increasing wages (b) grants for rural tax reform (c) grants for minority regions (d) prio-1994 subsidies (e) other ad hoc transfers. About 200 plus ad hoc grants, termed the earmarked grants (*Zhuanxiang Zhuanyi Zhifu*) by the Ministry of Finance, China, are used to subsidize a wide variety of spending projects such as capital constructions and social relief for calamities. In 2004, the largest central-provincial fiscal transfer was the revenue sharing transfers (469.5 billion yuan), followed by the tax rebate (404.97 billion yuan) and earmarked grants (322.33 billion). These three transfers combined accounted for more than 80 percent of the total central-provincial transfers. The 2004 equalization transfer was 74.50 billion yuan, amounting to 5 percent of the total central-provincial transfers (Shah and Shen 2006).

Although the equalization grant has been growing rapidly (2.07 billion yuan in 1995 to 74.5 billion yuan in 2004), but growth in specific purpose transfers has outpaced the growth of equalization transfers. Chart 7 depicts the trend of funds allocation for the revenue sharing transfer, the equalization transfer, tax rebate, the ad hoc transfers, and the total transfers for the period of 1995 to 2004 (Shah and Shen 2006).

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<sup>2</sup> The sub-provincial transfer design is quite similar to that of central transfers to provincial governments, though the grant composition varies significantly across provinces due to the diversity of regional fiscal resources.

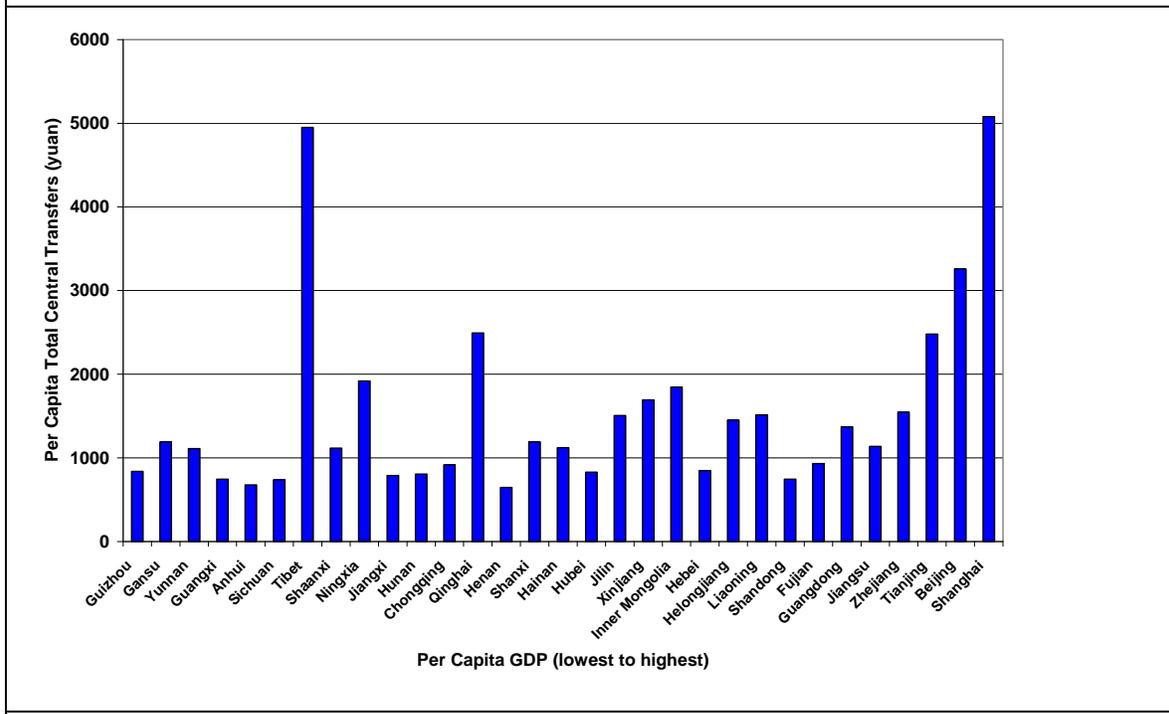
**Chart 7 Central-provincial Transfers, 1995-2004**



1. The revenue sharing transfers are only dated to 1998 due to data availability; 2. The ad hoc transfers, called the earmarked grants by the Ministry of Finance, account for major portion of the specific purpose transfers.  
Source: Shah and Shen 2006.

Chart 8 depicts the distribution of per capita central transfers by province in 2004. For the total central transfers, Shanghai, the richest province, was the highest per capita recipient province (5,079 yuan) and Henan the lowest (646 yuan) with the national average of 1117 yuan per capita. When it comes to revenue sharing transfers in 2004, Shanghai obtained the national highest per capita transfers of 2,830 yuan; Hainan received the lowest within the eastern region (179 yuan); Shanxi and Xinjiang were the highest recipients in the central and western regions respectively; and Tibet received the lowest in the western China and also in the nation. As for the tax rebate, Shanghai, Jilin, and Yunnan received the largest amount in the eastern, central, and western China respectively. For obvious reasons, the six coastal provinces – Beijing, Guangdong, Jiangsu, Shanghai, Tianjin, and Zhejiang did not receive any equalization transfers. Tibet received the highest per capita equalization transfer of 705 yuan (Shah and Shen 2006).

**Chart 8 Distribution of Total Central Transfers - Per Capita by Province - 2004**



The total central transfers also include revenue sharing transfers that are 25% of VAT and 40% of Personal and Enterprise Income Taxes in each province.  
 Source: Shah and Shen, 2006.

The Gini coefficients of inequality reported in table 4 confirmed that the various central transfers play some but insignificant equalization role. The equalization grant has a mildly equalizing impact on provincial revenues (the Gini is slightly reduced from 0.365 to 0.351). The weak equalization effect can be mainly attributed to the small pool of the grant – the grant only accounted for 7.3 percent of the total central transfers and the national per capita receipt of the grant was about 3 yuan. Thus, the grant’s redistributive impact is insignificant. The ad hoc grants have an equalizing impact on provincial revenues. The Gini index is reduced from 0.365 to 0.283 after adding the grants to per capita provincial revenues. Surprisingly, the equalizing effect of the earmarked grants is even stronger than the equalization transfer. It may be partly because the per capita equalizing transfer is very small, only about one percent of the per capita earmarked grants. While the program appears to promote provincial equity in a limited sense, the grant design does not score well on most criteria such as transparency, predictability, simplicity and objectivity. Taking the specific purpose grants into consideration, the Gini

coefficient for provincial revenues is reduced from 0.365 to 0.295. Thus, the grants also have an equalizing impact on provincial revenues.

<b>Table 4 The Equalization Impact of Central Transfers in China, 2004</b>		
<b>Provincial Governments (N=31)</b>	<b>Mean (per capita yuan)</b>	<b>Weighted Gini Index</b>
Provincial Revenues	904	0.365
+ The Equalization Grant	906	0.351
+ Ad Hoc Grants	1153	0.283
+ Specific Purpose Transfers	1070	0.295

Notes: The weighted Gini index, which weights each difference of per capita revenue by respective population is calculated as showed below:

$$G = \left( \frac{1}{2\bar{R}} \right) \sum_i^n \sum_j^n |R_i - R_j| \frac{P_i P_j}{P^2}$$

$\bar{R}$  is the national mean.  $P_i$  and  $P_j$  are the population of province i and j respectively. P is the national population, and n is the number of provinces. G varies from 0 for perfect equality to  $(1 - \frac{P_i}{P})$  for perfect inequality.

Source: Shah and Shen 2006.

#### 4. Pathways to Reform

China's crave for rapid economic growth in the last two decades has kept the reform of the public services on the fringes of political agenda. Now, with mounting regional disparities and burgeoning attention on social inequality, the reform to obtain an adequate and equitable public service delivery system has landed at the top of the government's timetable for the coming years. Given the objective of improving sufficient and equal public services provision in China, the present system of fiscal decentralization may not be sustainable in the long run. The way forward will almost certainly embrace a significant modification and reforms of the existing intergovernmental fiscal system. The central government needs to ensure sufficient financing for the minimum standards of core public service provision and set up a system of clear accountability with respect to the quantity, quality, timeliness and cost of the respective services. The level of horizontal and vertical disparities has to be curbed although it will continue to exist -

natural for a country the size of China with concentrations of population and vastly different levels of development in its various regions.

A few general policy options for China are listed as follows:

### **1) Build Sound and Transparent Responsibility Assignment**

It is essential to realign responsibilities with financial capacity at each government level. Local governments are supposed to gradually switch their focus from economic development to public services and social affairs. Some centralization of the responsibilities - moving the responsibility for the financing and provision of basic public services, such as education, health care and social security from the village, township or county level to a higher level of government - will enhance public service delivery in view of efficiency and administrative capacity as well as equity. Meanwhile, the provision of basic public services by the governments at and under county level also causes the equity problem.

### **2) Modify Tax Assignment to Improve Local Fiscal Capacity**

International experience suggests that local governments are more efficient and effective in delivering public services when they are also responsible for raising the revenues that they spend. Most federal systems provide local governments with their own sources of revenue, with autonomy to change at the margin, tax rates or other elements of the structure of the tax. A tentative list of the most widely used local taxes across countries would include property taxes, user charges, business license fees, permits and excise taxes, motor vehicle taxation, income taxes, and sales taxes.

In China, a limited discretion may be offered to local governments in setting local tax rates within a defined range. Second, an asymmetric approach can be explored as a means to allow major cities and other local governments with more developed capacity to introduce piggyback income taxes and other forms of local tax autonomy. Third, it is necessary to increase the share rates of local part in major taxes such as VAT and income taxes as the shared tax constitute major local revenues (about four fifth in 2004). An

alternative is to discontinue tax sharing for enterprise and individual income taxes, and allow supplementary variable flat rate charges by provincial-local governments.

It is also important to deepen tax system reform. The objective is to establish a stable tax base and main taxes at each level of government. When it comes to tax design, current VAT and enterprise income tax require massive attention. For example, the enterprise income tax is ownership-based. It is appropriate to make it a source based tax and have income attribution rules to attribute income to various locations based upon value added, employment and sales etc. This will help to significantly reduce fiscal gap in western provinces by clawing back additional enterprise income tax revenues.

### **3) Set National Minimum Standards for Core Public Services**

The dramatic regional inequalities in basic public services and the insufficient provision in certain regions are simply not acceptable in a country striving for a harmonious society. Minimum national standards should be set up for the following core public services: nine-year compulsory education, basic hygiene medical treatment, basic unemployment compensation and endowment insurance, and essential communal facilities services in rural public services. It is important to stress that it should be the role of the central government to guarantee all citizens have access to core public service.

### **4) Reform Intergovernmental Fiscal Transfer System to Support National Minimum Standards of Public Services and to Promote Equalization**

The current intergovernmental transfer system in China is required a series of reforms in order to support local governments with more equal opportunities in delivering an average level of local services. Central transfer needs to focus on national minimal standard of public services and provincial transfer should focus on equity of local service provision. Once the national minimum standards of public service delivery are clearly defined, they could be supported by special non-matching grants based upon standards and outreach of service. Second, it is critical to rationalize and simplify current fiscal equalization program, and the level of financing requires dramatic expansion. Third, current ad hoc transfers require thorough trimming as they are proliferating over the years

and in fact, these schemes blur the lines of central-local responsibility assignment, reduce local budgetary autonomy, and distort provincial decision-making and priorities.

**5) Promote Local Government Accountability for Better Public Services Delivery**

Enforcing local governments to provide sufficient and high-quality public services will also require greater local autonomy accompanied by tighter performance and accountability monitoring. With respect to spending autonomy, the centralized system of determining staffing and uniform national wage scales could be eliminated. Meanwhile, larger local autonomy should be accompanied by tighter performance and accountability monitoring in order to promote the alignment of incentives of local governments with their role. The central government may consider revising the targets and indicators used to evaluate local government performance; governments at each level may be required to make their decision making process more open and transparent and strengthen their monitoring and audit functions. Since timely availability of relevant and reliable information forms the basis for accountability, further efforts may be taken to establish proper government financial management system which will support the improvement and monitoring of results of fiscal policies, including public services delivery.

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